



## Press Release

Luxembourg, 26 January 2016

### European Commission's handling of financial crisis was "generally weak", say EU Auditors

The European Commission was not prepared for the first requests for financial assistance during the 2008 financial crisis because warning signs had passed unnoticed, according to a new report from the European Court of Auditors. The auditors found that the Commission did succeed in managing assistance programmes which brought about reform, despite its lack of experience, and they point to a number of positive outcomes. But they also identify several areas of concern relating to the Commission's "generally weak" handling of the crisis: countries treated differently, limited quality control, weak monitoring of implementation and shortcomings in documentation.

*"The effects of the crisis are still being felt today, and the resulting loan programmes have since run into billions of euros," said Mr Baudilio Tomé Muguruza, the Member of the European Court of Auditors responsible for the report. "So it is imperative that we learn from the mistakes which were made".*

The auditors analysed the Commission's management of the financial assistance provided to five Member States - Hungary, Latvia, Romania, Ireland and Portugal. They found that the Commission was successful in taking on its new management duties; given the time constraints, they say, this was an achievement. As the crisis unfolded, the Commission increasingly marshalled internal expertise and engaged with a wide range of stakeholders in the countries concerned. Later reforms also introduced better macroeconomic surveillance.

While pointing to a number of important positive outcomes, the detailed audit report identifies four main areas of concern about the Commission's handling of the crisis: the different approaches used, limited quality control, weak monitoring and shortcomings in documentation.

**Important positive outcomes:** the auditors noted that the programmes did meet their objectives. The revised deficit targets were mostly met. Structural deficits improved, although at a varying pace. Member States complied with most conditions set in their programmes, albeit with some delays. The programmes were successful in prompting reforms. Countries mostly continued with the reforms required by the programme conditions and in four of the five countries, the current account adjusted faster than expected.

**Different approaches:** the auditors found several examples of countries not being treated in the same way in a

*The purpose of this press release is to give the main messages of the special report adopted by the European Court of Auditors.*

*The full report is on [www.eca.europa.eu](http://www.eca.europa.eu)*

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comparable situation. In some programmes, the conditions for assistance were less stringent, which made compliance easier. The structural reforms required were not always in proportion to the problems faced, or they pursued widely different paths. Some countries' deficit targets were relaxed more than the economic situation would appear to justify.

**Limited quality control:** the review of key documents by the Commission's programme teams was insufficient in several respects. The underlying calculations were not reviewed outside the team, the work of the experts was not thoroughly scrutinised and the review process was not well documented.

**Weak monitoring:** the Commission used accrual-based deficit targets. Their achievement can only be observed after a certain time has elapsed. They ensure consistency with the excessive deficit procedure, but when a decision on programme continuation is to be taken, the Commission cannot report with certainty whether the Member State has actually met the target.

**Shortcomings in documentation:** the Commission used an existing and rather cumbersome spreadsheet-based forecasting tool. Documentation was not geared towards going back in time to evaluate the decisions taken. The availability of records improved, but even for the most recent programmes some key documents were missing. The conditions in memoranda of understanding were not always sufficiently focused on the general economic policy conditions set by the Council.

The European Court of Auditors recommends that the European Commission should:

- establish an institution-wide framework allowing rapid mobilisation of staff and expertise if a financial assistance programme emerges
- subject its forecasting process to more systematic quality control
- enhance record keeping and pay attention to it in the quality review
- ensure proper procedures for the quality review of programme management and content
- include variables in the memoranda of understanding which it can collect with short time-lags
- distinguish conditions by importance and target the truly important reforms
- formalise interinstitutional cooperation with other programme partners
- make the debt management process more transparent
- further analyse the key aspects of the countries' adjustment after programme closure.

Special Report No 18/2015: **Financial assistance provided to countries in difficulties** is available in 23 EU languages. See overleaf for Notes to editors.

## Notes to Editors

In 2008, Europe faced a financial crisis which turned into a sovereign debt crisis. The sovereign debt crisis was a consequence of various factors, including weak banking supervision, poor fiscal policies, and the difficulties experienced by large financial institutions (and the consequent bailout costs borne by the general public). The crisis swept across EU Member States in two waves, first affecting the non-euro area countries in 2008-2009 and later spreading to the euro area itself. In total, eight EU Member States were forced to seek macro-financial assistance - Hungary, Latvia, Romania, Ireland, Portugal, Greece, Spain and Cyprus.

## Scope of the audit

Special Report 18/2015 “Financial assistance provided to countries in difficulties” examined whether the Commission’s management of financial assistance programmes was appropriate. It asked the following questions: (i) Were the growing fiscal risks detected in time? (ii) Were processes sufficiently well-designed to offer comprehensive input into programme decisions? (iii) Did the Commission borrow at the best possible rates and in accordance with best debt issuance practices? (iv) Did the financial assistance programmes meet their main objectives?

It did not audit the decisions taken at the EU’s political level. It did not consider the counterfactual scenario of no financial assistance or the feasibility of resolving the crises by other means. Nor did it assess debt sustainability or the likelihood that the loans would be repaid. It did not evaluate whether the Council had chosen the most appropriate deficit targets or structural conditions to resolve the crisis. When auditing the Commission’s cooperation with other partners, it did not assess whether their involvement was justified.

## Hungary

The Lehman Brothers collapse generated a downward shift in investor sentiment in early October 2008. This led to a sell-off of government securities, a failed bond auction, and sharp currency depreciation. The stress in foreign exchange markets prompted liquidity pressures within banks, which faced difficulties in rolling over foreign exchange swaps. Hungary requested financial assistance because of the concern that the growing panic would upset market mechanisms enough to cause a sudden disruption to Hungary’s external financing capacity.

## Latvia

During the three months prior to the request for assistance, deposits had fallen by 10 %. This was led by a run on Parex Bank, which encountered severe liquidity problems after it lost more than a quarter of its deposits. In the same period, official reserves fell by almost 20 % as the central bank sold foreign currency to defend the currency peg. In November 2008 the government decided to step in and nationalise the Parex Bank. In December, the government imposed restrictions on deposit withdrawals from Parex. According to the Prime Minister, Latvia was in need of financial assistance for three reasons: to manage Parex Bank, to finance the budget deficit, and to stabilise the financial market. Increasing concerns regarding Latvia’s financial system and external debt resulted in the balance of payments and banking crises.

## Romania

With the onset of the 2008 global financial crisis, domestic financial markets and the banking system came under severe stress. Access to external funding was limited, leading to a spike in interest rates. The slowdown in capital flows led to large exchange rate depreciation of over 15 %, deteriorating asset quality and the further weakening of bank balance sheets. The central bank intervened to stabilise the Romanian leu. Romania’s credit rating was

downgraded to below investment grade, which increased both the risk premium and borrowing costs. Sovereign yields jumped to 9 %. Against a background of strongly increased risk aversion, increased pressures on the exchange rate, and of increasingly restricted access to the bond market for public borrowing, the Romanian authorities made a request for financial assistance in March 2009.

### **Ireland**

From late 2007, investor confidence in Ireland's property sector had evaporated amid concerns about oversupply and a price bubble. This left Ireland facing two problems: a sharp decline in cyclical construction related revenues, and the sudden emergence of large losses in the domestic banking system. In 2008–2010, Ireland had taken major measures to strengthen its banking sector. It provided government guarantees of domestic banks' liabilities. It injected capital amounting more to than 20 % of its GDP into the banking sector. The National Asset Management Agency took over banks' distressed land and property development assets. However, the government's obligations to the financial sector had pushed spreads on government bonds to historic highs and significantly reduced market access for the country.

### **Portugal**

The period before the request for financial assistance was marked by unfavourable developments in public finances and a worsening economic outlook. This led to a deterioration of confidence and rising market pressures on Portuguese debt, accentuated by the negative developments in euro area sovereign bond markets. As market access tightened, the government had increasingly resorted to shorter-term security issuances and other types of financing (such as private placement, syndicated issue and substantial short-term financing from domestic banks). In early May 2011, Portuguese 10-year spreads over Bunds increased to 650 basis points. Amidst consecutive downgrading of its sovereign bonds by credit rating agencies, Portugal became unable to refinance itself at rates compatible with long-term fiscal sustainability.

### **Greece**

EU assistance to Greece during the crisis will be considered in two separate special reports to be published by the European Court of Auditors: (i) an assessment of whether the Technical Assistance co-ordinated by the Commission contributed positively to the programmes' implementation and to the Greek reform process, to be published in the first quarter of 2016 and, later (ii) an assessment of the design, monitoring and results of the Economic Adjustment programme for Greece.