

Independent  
Evaluator  
appointed by the  
ESM Board  
of Governors

# EFSF/ESM Financial Assistance Evaluation Report



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# Foreword

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The EFSF and the ESM were established in the aftermath of the financial crisis, in the years 2010 and 2012. Their purpose is to provide access to financial assistance programmes for Member States of the euro area in financial difficulties. By doing so, these institutions create a firewall against instability and uncertainty.

In September 2016, the Board of Governors of the ESM under the chairmanship of Jeroen Dijsselbloem appointed me as Independent Evaluator to assess the relevance, effectiveness and efficiency of the EFSF and the ESM.

This report presents the results of reflections based on desk studies, surveys and interviews with authorities in member countries and international partner institutions, as well as input from other evaluations and published literature. I would like to thank the dedicated evaluation team under the leadership of Kari Korhonen, as well as Rolf Strauch as the project sponsor, and the external advisors for their valuable input. I would also like to thank all those who contributed with responses, comments and through frank discussions during the nine months of drafting this report.

It is the first time an evaluation of the two institutions has been undertaken. It covers the process of programme financing from request to exit between the years 2010 and mid-2016.

This report aims to enhance transparency and help the euro area prepare for future challenges. I hope the report will be useful for the Board of Governors and the ESM management as well as the authorities in member countries and international partner institutions in their endeavour to foster stability and prosperity in the euro area.

The recommendations are meant to serve as a guide for follow-up work, and to inspire the ESM further in its position as forward-looking guardian of systemic stability and as a cornerstone of the European financial architecture.



**Gertrude Tumpel-Gugerell**  
Independent Evaluator

This report was written under the leadership of the Independent Evaluator Mag. Dr. Gertrude Tumpel-Gugerell. The ESM drafting group was composed of John Goossen, Loukas Kaskarelis, Kari Korhonen, Alexander Molzahn, Dora Siklos, and Vilém Valenta, with the support of the wider evaluation team comprising Niyat Habtemariam, Dušan Kovačević, Oana Picincu, and Luís Rego. Vasco Campilho, Rudolf Alvise Lennkh, Dirk Mevis, Philip Kluge, and Gregory Knipping contributed to parts of the project.

The quotations scattered throughout the report are drawn from the evaluation interviews, and used with permission.

# Executive summary

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This report evaluates the relevance, effectiveness, and efficiency of EFSF and ESM financial assistance in safeguarding the financial stability of the euro area and its members. It primarily focuses on aspects that were not covered in detail by other evaluations, such as financing and the ESM programme governance framework. It is the first evaluation that covers all five euro area programme countries: Ireland, Portugal, Spain, Cyprus, and the second Greek programme up to its initial expiry in December 2014. These assistance programmes, totalling almost €300 billion, are among the largest in modern history. The evaluation does not assess the political aspects of the Eurogroup negotiations or individual programme policies that were the specific responsibility of other institutions.

## Main findings

### Establishing the firewall and country programmes

**The EFSF/ESM fulfilled their mandate of safeguarding financial stability in the euro area and its members, with support from other crisis measures.** The build-up of macroeconomic imbalances amid divergent economic policies, coupled with insufficient economic surveillance and banking supervision, resulted in severe financial distress when the global financial crisis hit. Under these circumstances, the creation of a euro area firewall proved necessary to complement international financial safety nets. The EFSF and ESM successfully filled the sovereign financing gap in the euro area and significantly supported government debt sustainability in programme countries by improving their borrowing conditions and smoothing repayment profiles.

Financial stability  
mandate

**Countries considerably improved their resilience, but macroeconomic outcomes of the programmes were mixed.** Programme strategies were at times a source of tension among key stakeholders. Programmes included measures that were not always crucial for addressing the causes of lost market access. Short- and long-term objectives were not always commonly understood and communicated, sometimes leading to optimistic expectations and subsequently to weakening ownership.

Programme  
outcomes

### Programme financing

**EFSF/ESM programme financing supported smooth programme implementation, but some modalities could be improved in the future.** For different reasons and to varying degrees, the authorities did not succeed in taking timely and comprehensive corrective actions. With the benefit of hindsight, programmes could have been requested earlier. Such delays are an inherent feature of financial assistance to sovereigns, but they increased the cost of rescue, weakened confidence and increased the risk of spillovers.

Timely  
intervention

## Financing instruments and disbursements

**The financing envelopes were sufficient to implement the programme strategies. The instruments chosen and disbursement processes were appropriate.** In some cases, however, unforeseen adjustments to financing and policy strategy were needed to comply with the programme envelope. While contingency buffers were discussed and included in all programmes, they were not sufficiently explicit to create confidence in some cases. The palette of instruments evolved during the crisis and although these were discussed actively, only some instruments were used. The design of the direct recapitalisation instrument made it very difficult to use in practice. The EFSF/ESM developed the disbursement process to adjust to changing circumstances and showed flexibility in response to the timing of programme reviews. Though disbursements were linked to compliance with conditionality, the criteria for compliance assessment were not always clear.

## Lending terms

**Established policies provided a basis for even-handed treatment of programme countries. However, lending and repayment terms were eased with a view to country-specific needs.** The size and timing of these measures differed across countries.

## Financial sector challenges

**The financial sector recovered more quickly when comprehensive strategies were designed and initiated upfront.** The extent of the financial sector challenges was not always recognised in time. Early recapitalisations contributed to improvements in depositor and investor confidence. However, upfront disbursements also weakened the institutions' influence on the timely implementation of subsequent measures. The multiple causes of high non-performing loan ratios highlighted the need for comprehensive strategies to address poor asset quality. These strategies included improving the efficiency of insolvency frameworks, but also targeted measures such as establishing "bad banks", or enhancing banks' internal work-out capacity.

### Programme exit and repayment capacity

## Programme duration and exit strategies

**The EFSF/ESM financial assistance programmes helped ensure market access at sustainable rates in all but one country, but more time would have been needed to finalise structural reforms.** The standard three-year programme period provided a window of opportunity for reforms, but public and political support for reforms faded as countries gradually regained market access and not all problems were solved. Follow-up arrangements were considered but a clean exit was preferred for political and market confidence reasons. Countries developed exit strategies mainly based on a build-up of cash buffers. Some programme countries exited without completing a final review, which can be considered a programme governance flaw.

## Repayment capacity

**The ESM's Early Warning System represents an appropriate tool to monitor countries' ability to repay, but its scope and enforcement power is limited.** It mainly relies on moral suasion and cooperation with partner institutions. However, concerns over repayment capacity can only be escalated on the basis of a liquidity assessment, not on long-term and structural considerations. Although the tool was developed over time, its scope is limited to programme countries, which does not allow it to capture systemic risks.



## Institutional framework

**The institutional framework governing the EFSF/ESM financial assistance worked reasonably well, but its complexity posed coordination challenges and raised efficiency concerns.** The joint nature of the programmes required a strong alignment of objectives among the partner institutions which posed challenges for all the institutions involved. Programme governance faced a multiplicity of stakeholder interests that were sometimes difficult to crystallise in a consistent strategy. Procedural arrangements and information sharing between partner institutions often relied on informal relationships. This was problematic in particular in relation to supervisory information.

Programme governance and information sharing

**This evaluation exercise was at times constrained by accessibility of data and documents.** The data on country programmes are not reported in a fully harmonised manner, partly due to the evolving programme governance framework. In several cases it was cumbersome to trace relevant background documents.

Data access and reporting

## Recommendations

### Recommendation 1.

**The ESM should focus on programme credibility and support ownership.**

The ESM should pre-empt delays in programme requests when problems cannot be effectively solved at national level. The Board should require the inclusion of clearly specified contingency buffers to reflect uncertainty. The ESM should seek ways to support programme ownership, among others through clear focus and realism, an appropriate communication strategy, and maintaining political legitimacy.

### Recommendation 2.

**Programme design should have clear objectives and priorities.**

The Board should give priority to macro-critical conditionality in programme design. The Board should clarify the short- and long-term objectives in order to develop more realistic expectations. Regaining market access is a key objective of the programmes. The Board should consider strategies to help maintain reform implementation in the post-programme period.

### Recommendation 3.

**The programmes should address financial sector issues upfront, but associated disbursements should be phased, based on progress.**

The Board should ensure that an explicit and comprehensive financial sector specific strategy, including the management of non-performing loans, is put in place from the start. The Board should require an upfront and continuous review of the banking recapitalisation and restructuring needs and related risks. The Board should link disbursements to progress on the comprehensive strategy.

**Recommendation 4.**

**The Board should further refine and develop the ESM governance framework.**

To align stakeholder objectives, the Board should set a policy framework for programme negotiations, design and review, as well as criteria for review of compliance – within the limits of the ESM Treaty. Furthermore, the Board should clarify the responsibilities of the programme partners ex ante to ensure effective collaboration and management of risks. The ESM should establish formal cooperation agreements including on information sharing. As a matter of good governance, the policy framework should require a closing report presented to the Board, even if some reviews were not concluded.

**Recommendation 5.**

**The ESM should enhance programme transparency and evaluability.**

The ESM should implement mandatory public reporting, including a database for the dissemination of harmonised data on country programmes. The ESM should evaluate the Early Warning System and the Greek programmes in due course. The ESM should ensure the evaluability of EFSF/ESM activities by developing its record and data keeping practices further and enhancing the traceability of relevant documents.

**Recommendation 6.**

**ESM Members may clarify the ESM's role in euro area institutional development.**

Going forward, ESM Members may discuss a broader preventive mandate for the financial stability of the euro area, including the ESM's role.

# 1. Introduction

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**This is the first evaluation of the financial assistance provided by the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF).** It was launched in the context of broader efforts to enhance transparency in euro area governance practices, and in recognition that evaluations are a standard practice of international organisations. Such evaluations improve the governance, transparency, and accountability of institutions, and enable the organisation to learn from its experience.

**This evaluation follows a number of audits, evaluations, and ex post assessments of different aspects of the country programmes by other institutions, none of which directly assessed EFSF and ESM activities.**

The European Commission has conducted ex post evaluations of the adjustment programmes for Ireland, Portugal, and Spain. In addition, the European Court of Auditors has audited European Commission practices in financial assistance programmes. The International Monetary Fund (IMF) crisis programme reviews in 2011 and 2015 collected lessons on its activities. Most recently, the IMF Independent Evaluation Office examined the IMF's engagement in three euro area programme countries, Greece, Ireland, and Portugal.

## 1.1. Purpose and scope of the evaluation

**In early 2016, the Chairperson of the ESM Board of Governors Jeroen Dijsselbloem requested a thorough evaluation of EFSF and ESM programmes to inform future decision-making.** The Board of Governors, which is the highest decision-making body of the ESM, comprising finance ministers of euro area countries, approved the scope of this evaluation in June 2016, and the precise Terms of Reference in October 2016.<sup>1</sup>

**Chairperson Dijsselbloem, in cooperation with the ESM Managing Director, Klaus Regling, appointed Gertrude Tumpel-Gugerell, the former vice-governor of the Austrian National Bank and a former member of the Executive Board of the European Central Bank (ECB), as the independent evaluator.**<sup>2</sup> She has produced this report in cooperation with the ESM project sponsor, evaluation manager, and evaluation team. In addition, external advisors, including a former deputy director of the IMF Independent Evaluation Office and the director of the evaluation service of the European Investment Bank, were appointed to support the ESM evaluation team. They advised the team, ensuring quality control and forestalling potential concerns about conflicts of interest. Two external consultants were also integrated into the evaluation team.

The report has been published following an ESM Board of Governors' discussion. A draft report was subject to a consultation with the members of the ESM Board of Directors and the partner institutions.

## Mandate

*“We're not used to formal evaluations. But it is useful to look back and learn lessons for the future.”*

*–Evaluation interviewee*

**The purpose of the evaluation is to assess the relevance, effectiveness, and efficiency of EFSF and ESM financial assistance in safeguarding the financial stability of the euro area and its members.** This report aims to add to the existing body of evaluations and distil and disseminate findings and lessons on different aspects of euro area programme operation. The mandate is primarily to look into past programme activities to draw lessons for future activities. The evaluation also aims to provide comfort to external stakeholders, including the general public, by providing transparency and validated information on the organisations’ activities. A critical and independent appraisal of the programmes is an important objective for euro area Member States.<sup>3</sup>

## Scope

**The evaluation addresses financial assistance provided through five programmes for five euro area member states, as well as the post-programme period up to the end of June 2016.** This includes the EFSF programmes for Ireland and Portugal, and the ESM programmes for Spain and Cyprus. The second Greek programme is also included up to its initial expiry in December 2014. Events in 2015 led to the adoption of a follow-up programme with the ESM. This ESM financial assistance for Greece (third Greek programme) is ongoing and therefore not subject to the evaluation. Box 1.1 sketches out the key elements of the country programmes.

The ESM Board of Governors posed a number of questions for each of the evaluation criteria, which concerned either the entire programme period or a specific phase (negotiation, execution, or post-programme monitoring). This evaluation addresses the following evaluation questions:

**Relevance** (consistency with country needs, institutional mandates, European policies, and global priorities):

- Did the EFSF/ESM comply with its mandate to safeguard the financial stability of the euro area and its Member States by deploying its programmes? How did their roles evolve over time?
- Were the EFSF/ESM financial assistance activities consistent with the prime objective?
- How were financing needs defined? Was the need for buffers considered appropriately in the financing envelope?
- What were the major factors affecting successful implementation?
- Was the granted assistance instrument appropriate and the programme period adequate?

**Effectiveness** (achievement of objectives):

- How can the ESM best support effective programme implementation, including in the post-programme period?

- Were members treated even-handedly in light of the size of assistance relative to each country's financing needs, lending terms, or disbursement practices?
- Did programmes target effectively the financing needs of a country and account for the specific requirements of bank recapitalisation?
- Was the financing planning and disbursement strategy conducive to effective programme implementation?
- Were the financing terms sufficiently flexible in view of uncertainty? Were programme contingencies assessed appropriately?
- Does the lending framework set out an appropriate creditor position, including on proportionality and the ability to monitor and assert rights?
- How has the need for possible follow-up arrangements been assessed?
- How did borrowing costs and maturity structure support programme achievement and programme sustainability?

**Efficiency** (how economically were funds, expertise, and time converted into results):

- Did the information provided ensure the efficient conduct of assistance?
- Were resources adequate?
- Have activities (e.g. fund raising and disbursements) taken place in a timely manner?

**Collaboration** (objectives and process of collaboration, methods of transparency for the membership base and the larger community, decision-making methods):

- What was the nature of the relationships with the relevant local, European, or international authorities and bodies, and what could be improved?
- How effective was the programme governance structure?

**The evaluation does not cover the political aspects of the Eurogroup negotiations or aspects of programme design that are the specific responsibility of other institutions.** As regards the programme conditionality, the evaluation does not assess individual past policies.<sup>4</sup> The report draws several lessons on general principles for programme design and mentions conditionality when it serves as an explanatory factor. Yet, the financial sector was dedicated a section in view of its large financing share. At the same time, the evaluation team was constrained by a number of evaluability issues. These include limits on data and document availability as well as access to some relevant interviewees.<sup>5</sup> Therefore the team sometimes had to resort to workarounds and the use of proxies. Moreover, the overall governance framework of the EFSF/ESM was taken as given. Investment activities and cost-efficiency of funding were left outside the scope of this exercise. The report does not evaluate the internal and resource efficiency of the two institutions, although some related aspects have been addressed (efficiency of disbursements and role of country team coordinators).

### **Several evaluation questions could not be addressed, or not fully.**

- Did ESM instruments and agreed policies work, and under what type of country-specific circumstances to ensure lasting effects? Did benefits prove sustainable?

It was considered too early to assess the lasting nature or sustainability of the programme outcomes (impact evaluation). The evaluated programmes were concluded relatively recently, with the last ending only in 2016. In addition, data availability constraints would have hampered modelling for such impact analysis.

- If the original implementation strategy was modified, were the compensating measures effective? Were there unintended effects?

Evaluation of compensating measures and unintended consequences would have required an in-depth analysis of conditionality, which was not feasible given the timeline of the exercise and the scope of EFSF/ESM responsibilities. Instead it was decided to prioritise the financing aspects of the financial assistance because that is the ESM's core mandate.

- Did requests for financial assistance programmes and the assessment by institutions comply with the requirements of the ESM Treaty and Guidelines?

This question turned out to be less relevant because all requests were made under the EFSF, where requests did not have to meet the same criteria.

To answer these questions, the evaluation team prepared a series of desk studies.<sup>6</sup> It conducted a survey of some internal staff and (former) members of the Board of Governors and Directors. The team also carried out 79 semi-structured expert interviews involving 130 respondents from programme countries, partner institutions, and ESM governing bodies.<sup>7</sup> Limitations included the lack of availability of some individuals involved in programme design/implementation but the large number of interviews and variety of expert backgrounds mitigates the consequences of such missing individual views.

This report is structured in seven chapters, which have a number of anonymous quotes from the evaluation interviews throughout. It begins by evaluating the relevance and effectiveness of the overall role of the ESM (Chapter 2). Chapter 3 addresses various aspects of programme financing, through six sections, closing on a sector-specific approach to financial sector repair. The report then moves on in Chapter 4 to members' programme exit strategies and the monitoring of repayment capacity. Chapter 5 evaluates collaboration in programme governance and the involvement of the EFSF/ESM in programmes. Chapter 6 draws conclusions and Chapter 7 presents recommendations.

The report is accompanied by technical appendices that include the Terms of Reference, and methodological notes including the evaluation's intervention logic and the vulnerability analysis. In addition, it presents the timeline of the crisis.

## 1.2. Euro area crisis resolution strategy

**Having built up macroeconomic and financial imbalances, the euro area was hit hard by the global financial crisis of 2008-2010.** The incomplete design of euro area economic governance at the time meant interactions between fiscal policy and wider macroeconomic imbalances had not been fully provided for. In a deeply integrated currency area, the negative confidence effects of the crisis in some countries risked spilling over the whole area, and members lacked some adjustment mechanisms owing to the fixed exchange rate and common monetary policy.

**The stability of the euro area was to a large extent premised on the effective functioning of the Stability and Growth Pact (SGP), which was intended to ensure the sound fiscal policies needed to sustain market financing for the sovereigns.** The rules of the SGP were intended to guide countries to correct their fiscal policies through peer pressure and the governance processes. Public finances, however, failed to accumulate sufficient room for manoeuvre prior to the crisis and ended up burdened with governments' crisis-triggered countercyclical measures and bank recapitalisations. This resulted in the financial situation deteriorating as the crisis unravelled, to the extent that a number of countries either risked losing or actually lost access to market financing at sustainable rates to cover budgetary shortfalls and refinance their maturing debt.

**European authorities devised a strategy to fight the crisis on the basis of five main pillars:**

1. At national level, member states made considerable progress on fiscal consolidation and structural reforms to reduce imbalances.
2. Monetary policy provided ample liquidity to financial institutions and eventually created a supportive interest rate environment, including via unconventional measures like long-term refinancing operations and asset purchase programmes.
3. The economic and fiscal surveillance framework was overhauled. Various policy initiatives were introduced aimed at ensuring fiscal discipline and restoring confidence, which strengthened the preventive and corrective fiscal governance. Transparency and coordination of budgetary processes were tightened, and the monitoring of macroeconomic imbalances was introduced. Euro area Member States further agreed to coordinate their debt issuance plans. Finally, Eurostat's powers vis-à-vis the national statistical authorities were strengthened.
4. The authorities introduced a common rule book for banks and took a number of institutional measures to enhance oversight and supervisory capacity, such as establishing the European Systemic Risk Board and European supervisory agencies. Supervisory decisions were placed at supranational level, superseding insufficient national supervisory practices. Later on, the Banking Union with a common supervisor and resolution mechanism was created to move the application of banking policies at the European level.

5. The euro area governments created crisis resolution mechanisms. After installing the Greek Loan Facility, which targeted only this country, the euro area established the EFSF, a temporary rescue fund, and ultimately the ESM as a permanent body. When setting up the support mechanisms, finance ministers emphasised that the firewalls alone did not substitute for sound national policies.<sup>8</sup>

### 1.3. Establishment of the EFSF and ESM

#### First steps under the EFSF

**Before the euro area firewall was set up in response to the global financial crisis, the European Union (EU) and its Member States made concerted efforts to support demand, investment, and liquidity across the continent, which increased debt-to-GDP (gross domestic product) levels considerably.** When Greece was shut out of financial markets, there was no institutional solution at hand despite general efforts to ensure stability. The Greek Loan Facility was based on bilateral loans from the euro area members.

**The next step was to streamline financial stability support procedures by creating the European Financial Stability Facility.**<sup>9</sup> The goal was to create a temporary structure to finance stability support that would be lean and cost-efficient. The EFSF, a public limited liability company under Luxembourg law, was incorporated less than one month after the European Council took the decision to set it up in May 2010. Its existence was meant to signal European commitment to the integrity of the euro area. The euro area Member States and the EFSF established a Framework Agreement to govern its €440 billion guarantee structure.<sup>10</sup>

**Then member countries moved to increase the EFSF's lending capacity.** The EFSF's effectiveness as a lender was dependent on maintaining the highest possible credit rating – which it achieved through a guarantee-backed lending capacity based on its highly rated guarantors. To achieve an effective €440 billion capacity, the euro area Heads of State and Government agreed in June 2011 to increase the maximum guarantee commitments to €780 billion, thus achieving 100% coverage of each issuance by highly rated guarantors.

**Members also increased the EFSF's operational flexibility.** The revised agreement expanded the list of available instruments. As well as offering loans to Member States, the EFSF was able to provide assistance tailored to more specific situations (see Section 3.2). In March 2012, the EFSF moved to a diversified funding strategy, based on short-term and long-term financing pools, from back-to-back funding. This structure severed the link between particular issuances and lending, and allowed the EFSF to take advantage of the corresponding maturity diversification (see Section 3.5). This model would later be replicated at the ESM.

**Soon after the EFSF's creation, it became clear that investors required a more permanent entity to reassure them that the euro area was indeed committed to the euro and would ensure financial stability.** Euro area leaders agreed on the principle of creating a permanent crisis resolution mechanism to safeguard the euro area's financial stability. Since the EFSF was already up and running, it was asked to prepare a new permanent institution.



## Creation of the ESM

**In October 2010, the European Council agreed on the need to establish a “permanent crisis mechanism to safeguard the financial stability of the euro area as a whole”.**<sup>11</sup> A first version of the ESM Treaty was signed in July 2011 but the evolution of its features and of the wider euro area governance rules required a revision of the ESM Treaty before its ratification process started. The final Treaty was signed on 2 February 2012 in Brussels, endowing the ESM with a capital structure to limit the burden on Members' public debt.<sup>12</sup>

**The ESM started operating with only a very small team.** The ESM was inaugurated as an international financial institution at a Board of Governors' meeting on 8 October 2012. It gradually built up key operations such as funding, lending, investment, risk, legal, policy, and other corporate functions. While growing rapidly to achieve the maturity required from an international financial institution, the ESM remained a lean organisation, relying on the outsourcing of non-core functions.

**Since its inception, the ESM has financed a financial sector programme for Spain, approved but not used under the EFSF, and a financial assistance programme for Cyprus, approved in April 2013.** In parallel, the ESM undertook a technical assistance mission to Cyprus to improve the country's capacity for debt issuance and management. The ESM also became an active part of programme and post-programme monitoring with its Early Warning System, which was enlarged to cover EFSF-funded programmes. More recently, the ESM started a financial assistance programme for Greece, which is still ongoing and therefore beyond the scope of this report.

### **The ESM is governed by euro area finance ministers who form the Board of Governors and each nominate a member for the Board of Directors.**

These bodies take formal decisions on financial assistance and institutional issues. The ESM Treaty assigns certain policy tasks to peer institutions, and formal decisions are often discussed in the Eurogroup, which is an informal euro area formation of the Ecofin council of the EU finance ministers.

#### **Box 1.1: Brief description of the country programmes covered by this evaluation**<sup>13</sup>

##### *Ireland*

**A 10-year long real estate-driven credit boom overheated and culminated in the collapse of Irish real estate prices in 2007.** To prevent banks from collapsing, the government provided them support and guaranteed their funding. Investors worried, however, that the losses at the banks were too big for the government to fund. They started requiring higher returns, eventually making it too expensive for Ireland to borrow money on financial markets.

**In November 2010, Ireland asked the EU and the IMF for financial support.** The following month, it became the second euro area country to enter an assistance programme. Creditors provided total support of €67.5 billion, which added to €17.5 billion in Irish own resources. The EFSF lent the Irish sovereign €17.7 billion, with the rest supplied by the EU, individual EU Member States, and the IMF.

**During its three-year assistance programme, Ireland fixed many of its structural problems.** Two major banks were closed down, while some of the remaining banks received a capital boost. A bad bank (NAMA or National Asset Management Agency) was set up to deal with problem loans and isolate them from the healthy banking business. The country reduced its fiscal deficit, and successfully exited its EFSF programme in December 2013.

#### *Portugal*

**Unlike some other programme countries, Portugal had suffered a long period of weak economic growth before the crisis.** Low interest rates in combination with loose credit conditions created an illusion of prosperity. This contributed to high debt levels for companies, households, and the government. Low productivity growth and significant wage increases weakened competitiveness.

**The country did not seize upon low financing costs to keep debt under control.** With large and persistent budget deficits, debt spiralled. When the global crisis hit Europe in 2010, investors lost confidence and demanded ever-higher returns on Portugal's bonds. Early in 2011, it became too expensive to borrow on financial markets, and banks became reliant on central bank liquidity. In April 2011, Portugal requested assistance from the EFSF, the EU, and the IMF. Its programme concentrated on fiscal stabilisation and structural reforms. The financial sector was not a primary element.

**The creditors made €78 billion available for Portugal over three years.** The EFSF, the EU, and the IMF each pledged a third of the total amount. As for Ireland, EFSF financing was provided under economic policy conditionality and Portugal committed to a large number of measures to reform its economy.

**Portugal regained market access but the macroeconomic outcomes were mixed.** The programme started to bear fruit with the budget and current account deficits shrinking but growth resumed slower than originally expected. The country exited the programme in May 2014.

#### *Greece – 2<sup>nd</sup> programme*

**Greece was on an unsustainable path before the crisis.** Once it joined the euro area, Greece, like many euro area countries, was able to borrow money at far lower rates than beforehand. It responded by boosting government spending, but revenues remained weak because of poor tax compliance and administration. Public debt soared quickly. The country lost competitiveness, in part due to wages rising too fast and lagging product market reforms. The result was a loss of market confidence in the sustainability of government debt. The IMF and euro area Member States agreed on a first aid package of about €110 billion in May 2010.

**In 2012, financial assistance from the first programme was judged to be insufficient.** The EFSF provided the bulk of a second programme, in which a total of €141.8 billion was disbursed, again with a contribution from the IMF. Banks and other investors contributed by writing down part of the value of their debt holdings, in the so-called Private Sector Involvement (PSI) programme. In 2014, the Greek economy returned to growth,

unemployment began to drop, and Greece temporarily regained its ability to raise money from the markets.

**As of late 2014, disagreement on the implementation of reforms arose, and Greece eventually fell back into recession.** The assistance programme was extended twice in the first half of 2015 but finally expired in June 2015. Nonetheless, fundamental problems remained and a third programme was agreed in August 2015.

### *Spain*

**Spain's problems first became visible in the housing market.** In the decade before the crisis, the economy grew much faster than the rest of Europe, fuelled by easy credit and a construction boom. When the credit crunch hit, real estate prices collapsed. Banks were left with huge losses, as clients struggled to repay mortgages.

**The country entered a recession with the budget deficit rising to 11% of GDP in 2009 and banks losing their ability to borrow money or raise capital.** Savings banks were the weakest; without support many would have collapsed. With the budget already stretched, the government had little room to manoeuvre. While Spain never lost access to market financing, raising money became increasingly expensive. In a bid to calm uncertainty and quickly address the banking issues, Spain requested assistance in June 2012.

**The ESM's financial assistance package was used for a sole purpose: recapitalising the country's banks.** The ESM committed up to €100 billion in assistance. Here, the IMF acted as an advisor. Only €41.3 billion was used. Funds were lent to the Spanish government who used them to support the banks.

**Spain modernised the banking sector, in particular the savings banks.**

Ownership structures were reformed, and risk management practices were improved. Spain exited its programme in December 2013 and gave a strong signal that it had returned to normal by voluntarily starting to repay ESM loans earlier than required. Programme conditionality focused on the banking sector. Spanish macroeconomic reform commitments were applied through the European Semester, annual cycle of economic and fiscal policy coordination within the EU.

### *Cyprus*

**In the 2000s, the Cypriot economy was booming, supported by a large off-shore banking sector and by the prospect of the country joining the euro.** Wage rises dampened exports but money kept flowing into the banking sector. Once Cyprus joined the euro in 2008, it was able to borrow more cheaply. The first signs of distress in the banking sector appeared in 2010. The banks had grown too rapidly and markets started to take a negative view. By mid-2011, Cyprus was no longer able to borrow money from investors.

**In June 2012, Cyprus requested assistance from the ESM and the IMF.** An ESM assistance programme of €9 billion was agreed in March 2013. In addition, the country agreed a programme of around €1 billion with the IMF.

The total loan package was roughly half the size of Cypriot GDP. The loan was provided directly to the sovereign. In return, Cyprus undertook to shrink its banks, recapitalise them in part through the bail-in of depositors, tighten its budget, and push through a wide range of measures to become more competitive.

**Cyprus modernised its economy during the programme.** Banks were restructured and recapitalised, and are now about half the size they were before the crisis. Cyprus has also improved financial regulation and supervision. It rationalised fiscal policies, implemented a long list of reforms in areas such as wage policies, the public administration, services, and updated its legal framework.

**The country gradually returned to the bond market.** The ESM eventually disbursed only €6.3 billion in loans out of a €9 billion envelope. Cyprus won back the confidence of investors and exited its programme in March 2016.

## 2. Role of the EFSF and ESM

**The euro area entered the economic crisis with an incomplete architecture to address the financing stress of its members.** Before the crisis, the idea of a euro area government losing market access at sustainable rates seemed remote, and financial markets failed to differentiate between euro area sovereigns. Euro area surveillance mechanisms and national banking supervision proved to be insufficient to prevent the build-up of macroeconomic imbalances and financial sector vulnerabilities. A financial backstop and centralised banking supervision were not set up.

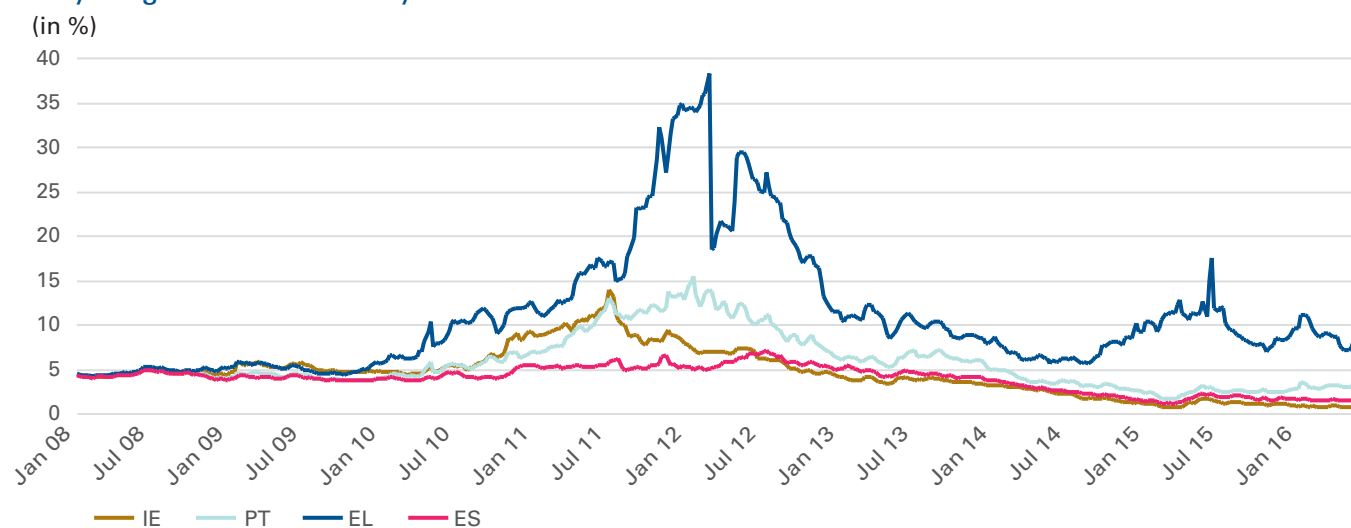
**This chapter assesses the EFSF/ESM's overall role in European crisis resolution and in country programmes.** It addresses whether there was a need for establishing the euro area firewall and implementing country programmes; the extent to which the EFSF/ESM's objectives and activities were in line with the euro area and country needs; and to what extent these objectives were achieved.

### 2.1. Euro area firewall and its systemic effects

**Given political and capacity constraints, international financial safety nets available at the onset of the crisis were not sufficient to deal with euro area crisis challenges.** Historically, countries unable to tap markets to service their external or government debt have recourse to a financial backstop. This role has traditionally been played by the IMF, but its lending capacity and internal rules made it very difficult to cover the financing needs of euro area countries – if not impossible. Roughly two thirds of the financial needs in the first Greek programme were covered by bilateral loans from other euro area countries. However, a systemic solution became urgently needed when more euro area countries started facing prohibitive borrowing costs and needed assistance (Figure 2.1). The legal and financial framework

Figure 2.1

#### 10-year government bond yields



Notes: 10-year yield not available for Cyprus. See list of acronyms for country codes.  
Source: Bloomberg

for bilateral loans was very complex and did not allow timely mobilisation of sufficient volumes of financial assistance. The bilateral loans also added to the debt levels of creditor countries.

**Establishing the EFSF and ESM were therefore key milestones in the euro area response to the economic crisis.** The need for a financial back-stop mechanism was particularly urgent in the currency union that was based on a no-bail-out premise, in the absence of a debt restructuring mechanism and with an imminent threat of contagion. The vast majority of interview respondents confirmed the critical need for a firewall to resolve the euro area sovereign debt crisis, and as a key part of the euro area financial infrastructure going forward.

**The EFSF and ESM successfully filled the sovereign financing gap in the euro area.** With its lending capacity of €700 billion, the EFSF and ESM represent the largest regional financial arrangement in the world, comparable to the global lending capacity of the IMF.<sup>14</sup> The combined EFSF/ESM lending capacity safely and timely covered the financing needs of the programme countries. At end-June 2016, the ESM's unused lending capacity amounted to €372 billion, which would be sufficient to provide financial assistance of a size similar to previous programmes.

**The EFSF and ESM made an important contribution to government debt sustainability in programme countries.** The EFSF's strong guarantee structure and the ESM's robust capital position allowed borrowing at very favourable interest rates – that were passed on to the programme countries, bringing them significant budgetary savings. EFSF/ESM financing was also provided at perceptibly lower rates than the IMF loans, which made the financial assistance cheaper for the euro area countries compared to standard IMF programmes (see Section 3.3). At the same time, EFSF/ESM financial assistance was provided at longer maturities than IMF loans and these maturities were subsequently extended further for some countries, thus substantially smoothing countries' repayment profiles (see Section 4.2).

**The existence of the firewall helped maintain financial stability in the euro area and its member countries, but its contribution is difficult to disentangle from other factors.** Establishing the EFSF and the ESM had a positive impact on confidence vis-à-vis countries benefiting from financial assistance – and the euro area as a whole – but the contribution is hard to quantify. The improvement in confidence was only gradual and compounded by other policy actions, such as the unconventional monetary policy measures or other amendments to the EU and euro area architecture, whose relative importance is difficult to assess. Nonetheless, a vast majority of respondents viewed the EFSF/ESM contribution as very important.

## 2.2. Country programmes

**Programme countries experienced a considerable build-up of imbalances and other vulnerabilities prior to the economic crisis, which were widely underestimated and insufficiently addressed.** Imprudent economic policies, weak economic surveillance and banking supervision, as well as lack of market pressure allowed large internal and external imbalances to accumulate in some euro area countries. The ESM's sovereign vulnerability assessment (see Lennkh 2017) confirms, with hindsight, that Ireland and

Spain faced a rapid increase in vulnerability in 2008-2010, whereas Portugal, Greece and Cyprus were subject to heightened vulnerability for an extended period of time (Figure 2.2). The adverse developments did not go unnoticed with warnings from international and some national institutions. However, the magnitude of the problem was not sufficiently recognised by national policy makers, nor was there appropriate pressure from the international institutions or markets to trigger decisive and timely corrective action. These findings are confirmed by economic data, as well as majority of interview respondents and previous studies.<sup>15</sup>

**Figure 2.2**  
**Evolution of sovereign vulnerability**



Note: The overall score is a weighted average of around 50 vulnerability indicators covering six vulnerability dimensions: (i) government borrowing needs, conditions, and debt structure; (ii) economic strength; (iii) fiscal position; (iv) financial sector health and other contingent liabilities; (v) institutional parameters and (vi) private leverage, credit, and real estate cycles. The weights are based on correlation and principal component analysis and expert judgement. Individual indicators are standardised using scores 1 (most vulnerable) to 4 (most resilient) with thresholds based on literature where available and quartiles of historical distribution of a pool of OECD and EU countries otherwise. No judgement is applied to final scores. See Lennkh (2017). Vertical lines indicate starts of the programme interventions. For Greece, the solid vertical line represents the second programme, while the two dashed lines represent the first and third programmes, which were not evaluated. Source: ESM calculations

**The progressive deterioration of the economy and waning market confidence made requesting financial assistance practically unavoidable.**

The weak starting position of the programme countries entering the crisis resulted in a rapid worsening of their economic and financial situations. The initial domestic policy response, albeit in some cases relatively strong by normal standards, proved insufficient given the unforeseen magnitude of the challenges. This put countries under severe fiscal stress that effectively prevented them from accessing financial markets and ultimately left the authorities with no other option than to request financial assistance. This conclusion was broadly supported by all respondents.

**Programme objectives broadly corresponded to country needs.**

The triggers for the crisis varied across programme countries but each country faced daunting challenges. In Ireland, Cyprus and Spain the main source of instability was a fragile and oversized banking sector. Greece and Portugal mainly suffered from the accumulation of macroeconomic imbalances and a loss of competitiveness. The heat map in Figure 2.3 illustrates, with hindsight, the main sources of vulnerability in each country before the start of the programme. While varying in magnitude, ranking and a primary source, all programme countries were confronted with a precarious fiscal situation, financial sector risks, and structural issues. All programmes address these three main challenges, albeit with different priorities. The interviews with key stakeholders show a broad consensus that the initial diagnosis was broadly adequate in identifying the main problem areas.

Figure 2.3  
Sources of sovereign vulnerabilities

|   | IE                         | PT   | EL   | ES   | CY   | IE                    | PT  | EL  | ES  | CY  | Rest of euro area |
|---|----------------------------|------|------|------|------|-----------------------|-----|-----|-----|-----|-------------------|
|   | Last pre-intervention year |      |      |      |      | Latest available data |     |     |     |     |                   |
|   | 2010                       | 2010 | 2011 | 2012 | 2012 | 2016                  |     |     |     |     | 2016              |
| <b>Overall vulnerability score</b>                          | 2.0                        | 1.9  | 1.6  | 1.9  | 1.8  | 2.7                   | 2.0 | 1.8 | 2.1 | 2.1 | 2.7               |
| 1 Government borrowing needs, conditions and debt structure | 1.6                        | 2.2  | 1.9  | 1.9  | 2.2  | 2.9                   | 1.7 | 1.5 | 2.1 | 2.0 | 2.7               |
| 2 Economic strength   | 2.7                        | 1.9  | 1.6  | 2.0  | 1.8  | 3.3                   | 2.3 | 2.0 | 2.5 | 2.0 | 2.6               |
| 3 Fiscal position   | 1.8                        | 1.1  | 1.2  | 1.7  | 1.3  | 3.1                   | 2.1 | 2.4 | 1.8 | 2.6 | 2.8               |
| 4 Financial sector and other contingent liabilities         | 1.3                        | 2.0  | 1.7  | 1.7  | 1.3  | 2.2                   | 2.0 | 1.8 | 2.3 | 2.3 | 2.9               |
| 5 Institutional parameters                                  | 3.1                        | 2.0  | 1.0  | 2.3  | 2.2  | 3.5                   | 2.4 | 1.3 | 2.2 | 2.2 | 2.7               |
| 6 Private leverage, credit & real estate                    | 1.5                        | 2.1  | 2.1  | 1.7  | 1.5  | 1.2                   | 2.1 | 2.1 | 1.9 | 2.1 | 2.3               |

|               |            |            |            |            |
|---------------|------------|------------|------------|------------|
| Score         | 1.0 to 2.0 | 2.0 to 2.5 | 2.5 to 3.0 | 3.0 to 4.0 |
| Vulnerability | High       | Elevated   | Moderate   | Low        |

Notes: Last pre-intervention year for Greece refers to the second programme. The overall score is a weighted average of around 50 vulnerability indicators covering six vulnerability dimensions: (i) government borrowing needs, conditions, and debt structure; (ii) economic strength; (iii) fiscal position; (iv) financial sector health and other contingent liabilities; (v) institutional parameters and (vi) private leverage, credit, and real estate cycles. The weights are based on correlation and principal component analysis and expert judgement. Individual scores are standardised using scores 1 (most vulnerable) to 4 (most resilient) with thresholds based on literature where available and quartiles of historical distribution of a pool of OECD and EU countries otherwise. No judgement is applied to final scores. In the case of Ireland, data anomalies related to multinational companies' activities may improve 2016 scores for indicators such as economic strength or fiscal ratios, but on the other hand they may have an adverse impact on the score for private leverage, credit, and real estate. See Lennkh (2017). Source: ESM calculations

**Views on prioritisation, sequencing, and the scope and detail of the underlying policies differed.** Most respondents agreed that macro-critical structural reforms should be given clear priority. Some said that programmes created a window of opportunity for reforms and that especially structural



reforms should have played a more prominent role. However, others said that the programme conditionality was too detailed, lacked focus, and required complex decision making. Ultimately, this undermined ownership and made the programmes more difficult to implement. There appears to be a broad consensus, however, that the breadth, depth, and level of detail of programme conditionality should be driven by country-specific circumstances. The strategy needs to be ambitious, but realistic and credible, while ensuring that the burden is spread across society in a fair way. Ownership of the programme by national authorities is a key element of success.

**Programme ambitions to achieve short- and long-term policy objectives were not always commonly understood or sufficiently communicated.**

There seems to be a prevailing perception among European stakeholders and the general public that by the end of the programmes, countries should have returned to sound economic and financial conditions. Some respondents viewed the programmes as short-term crisis management to regain market access, whereas restoring fully a sound underlying economic position is typically a long-lasting effort that stretches beyond the programme horizon. This sometimes represented a difference between the IMF and European approaches. In the view of some respondents, clarifying the ambition might have helped setting appropriate conditionality and avoiding unrealistic expectations on programme achievements. In their view, immediate crisis management should be driven by clearly defined targets designed to safeguard financial stability and regain market access. At the same time, they stressed that it is important that the reform momentum is maintained after the programme expires.

*“You cannot solve all the problems in five years that were created in three to four decades.”*

*—Evaluation interviewee*

**Designing programmes in a monetary union required attaching high importance to systemic considerations.**

Being part of the euro area meant programmes for these countries required considerations that were different from those of most standard IMF programmes. There was a very high risk, or perceived risk, of contagion, particularly during the first years of the crisis until 2012. Programme countries did not have an independent monetary authority that could fine-tune monetary policy to specific country needs. The exchange rate adjustment channel was not available and nominal adjustment had to be pursued through internal devaluation. Financing current account deficits did not represent a binding constraint. Certain policy options were not on the table as they were not in line with EU law, such as state aid rules or the no-bail-out clause. All this required an approach that was novel for all institutions involved in the programmes. At the same time, the need to safeguard financial stability of the currency union as a whole implied difficult trade-offs regarding optimal policies for individual programme countries.

### 2.3. Programme outcomes

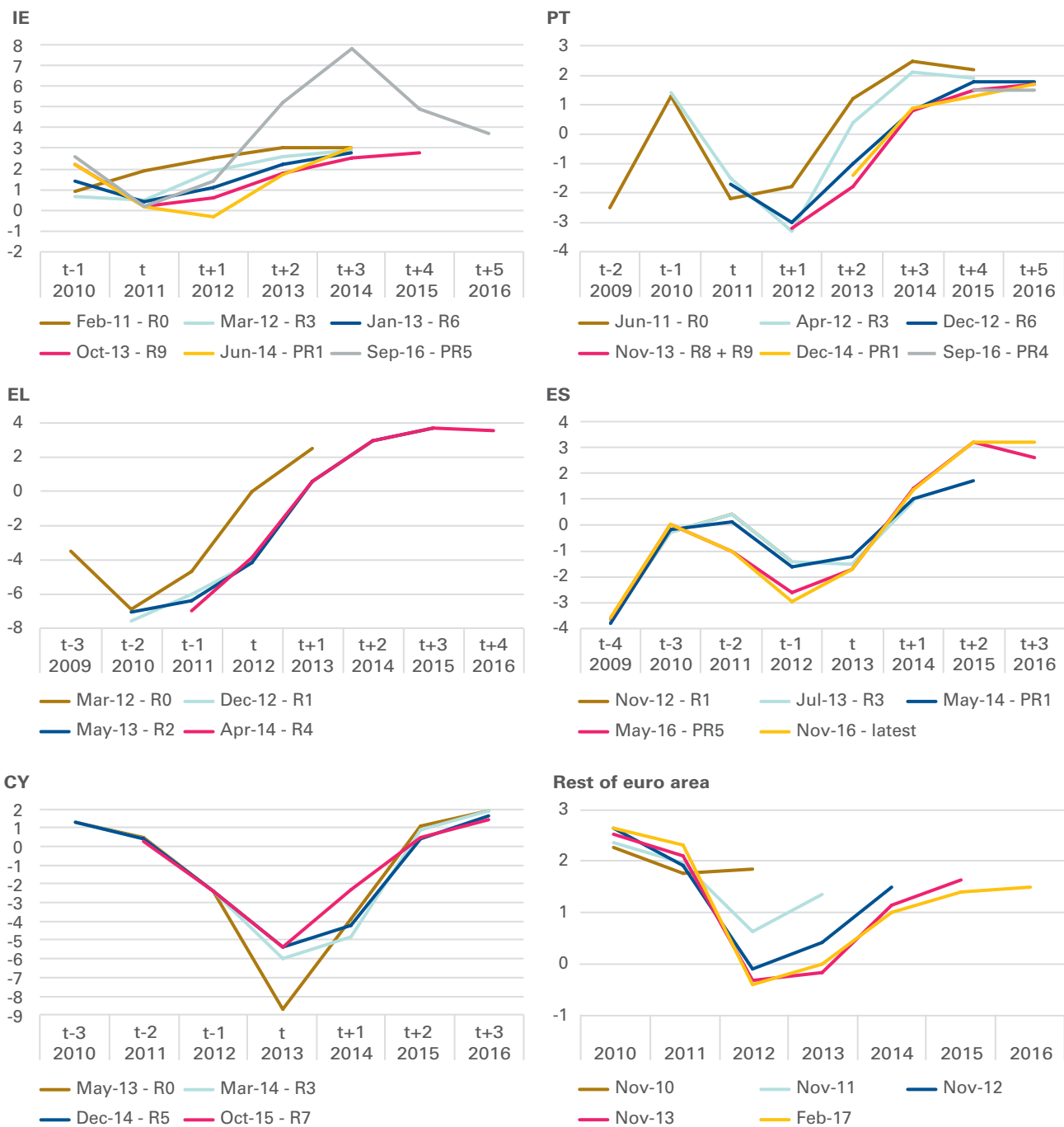
**The programme countries overall display considerable achievements, but reform efforts must continue to ensure their financial stability.**

Four out of five programmes were successful in restoring, or in the case of Spain stabilising, market access. The vulnerability indicators show perceptible improvements in most economic areas since the start of the programmes (Figure 2.3). Looking at the three main targeted areas, fiscal, financial and structural parameters improved considerably in all countries with the exception of the financial sectors in Portugal<sup>16</sup> and Greece and the fiscal position in Spain, which was not subject to specific programme conditionality. However, the vulnerability assessment shows that further reforms in some areas are still needed. Greece is the only country that required a follow-up arrangement, due to a mix of factors involving larger initial macroeconomic imbalances, deeper-seated structural problems, a less stable political situation, and lower implementation capacity

(described in more detail in the dedicated evaluation reports of other institutions). Nonetheless, Greece exhibits considerable improvements, in particular in the areas of the fiscal position and economic fundamentals.

**The macroeconomic effects of the programmes were mixed.** Although it is impossible to definitively assess programme performance without a reliable counterfactual scenario, comparing initial macroeconomic assumptions with the outcomes gives some indication. Portugal's economic outlook was

**Figure 2.4**  
**Evolution of real GDP growth assumptions**  
 (in %)

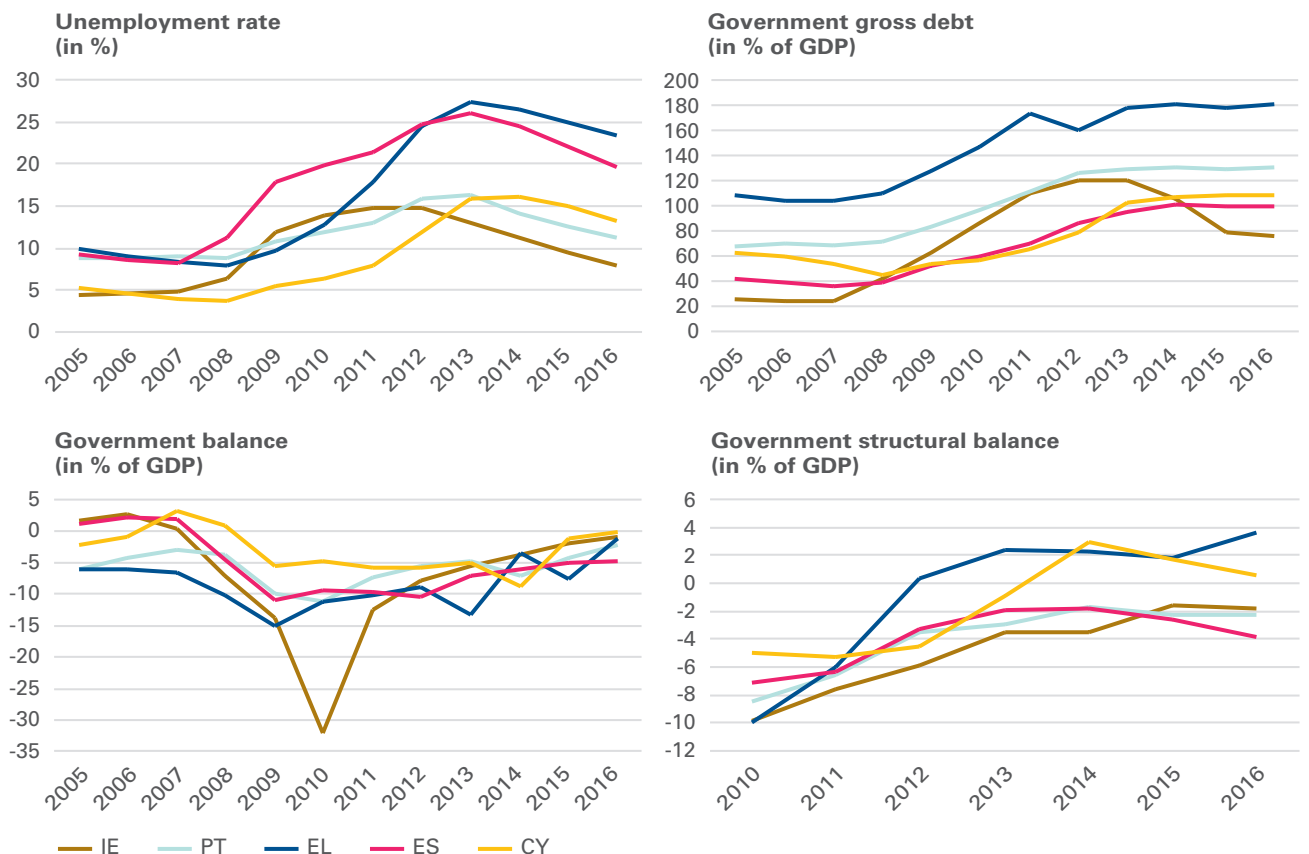


Notes: R0 refers to the initial programme. R1, R2 etc. refer to first, second etc. reviews. PR denotes post-programme reviews. Date refers to the publication date of the programme review.  
 Sources: For programme countries, programme documents and review reports (dates refer to publication); for the rest of the euro area, the European Commission economic forecast

revised downward several times, which had a negative impact on expectations and underlines the need for prudent and conservative estimates. Initial assumptions for Greece’s second programme were too optimistic, but since the first programme review the outlook has not changed substantially. The programmes for Ireland, Spain and Cyprus exhibit no major forecast bias. These programmes somewhat over-performed in relation to the initial assumptions.<sup>17</sup> Figure 2.4 illustrates these findings on an example of real GDP growth. During this period the economic outlook of the rest of the euro area was also subject to substantial downward revisions until 2013. Negative surprises in Portugal and Greece – which entered programmes in 2010-2012 – were therefore not solely due to domestic factors. In contrast, the programmes for Spain and Cyprus – which started in 2012-2013 – benefited from a more stable macro-economic scenario and a recovery in the euro area as a whole.

**Looking at the recent macroeconomic outcomes, programme countries are mostly maintaining solid growth but high unemployment remains an issue.** Economic growth in the programme countries has exceeded the rest of the euro area since 2014. In 2016 it was higher by an average of 1.4 percentage points. The growth performance is very good in Ireland, Spain and Cyprus. Economic growth in Portugal is broadly in line with the euro area average, whereas Greece’s recovery was interrupted in 2015 and only started gaining momentum in 2016. In contrast, labour market improvement has been only gradual, and unemployment rates remained above pre-crisis levels in June 2016 in all countries. In particular very high youth unemployment represents a serious problem (Figure 2.5). While programme countries significantly reduced fiscal deficits and put government debt ratios on a downward path, high debt levels still represent a source of vulnerability for most of them.

Figure 2.5  
Selected macroeconomic indicators



Source: Eurostat



## 3. Programme financing

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This chapter focuses in more detail on financing aspects of the EFSF/ESM programmes. It addresses whether the programmes were requested in a timely manner and whether the selected financing instrument was appropriate. It discusses the adequacy of the financing envelope and contingency buffers. It also evaluates the efficiency of the disbursement process, as well as the even-handedness of the lending terms. Finally, it assesses the effectiveness of the financial sector repair, as it represented an important share of the financial assistance.

### 3.1. Timing of request

**Official requests for assistance came with considerable delay. Since countries must initiate requests for a financial assistance programme, such delays had financial and political consequences for the government.** This section analyses the implications of the delayed timing of requests, and specifically the economic costs to the programme. We first look at the time that elapsed between when debates about the need for a programme began and when it was actually requested. Then we analyse the reasons for the delays, and the financial costs of waiting. More specifically, we examine the financing costs of public debt, capital outflows, losses of bank capital and increases in non-performing loans. Overall, the time that passed before the countries officially launched their requests was rather costly for them because financing needs were large, market pressures intensified, and the economic situation worsened.

#### Delays in requests for assistance

**Our findings indicate that debates on possible programmes started well before the countries – Ireland, Portugal, Spain, and Cyprus – submitted their official requests.** The timing question is less relevant for Greece as this evaluation covers its second programme, meaning it was already under European and IMF assistance. Table 3.1 shows that, according to respondents who were speaking with the benefit of hindsight, some countries could have asked for assistance over a year earlier.<sup>18</sup> Discussions with the IMF started earlier, in the context of its continuous surveillance, in some instances 18 months before contacting the European counterparts – although this is perhaps understandable given that Europe’s crisis resolution mechanism did not exist in 2009 and the features of the euro area’s safety net continued to evolve over 2010-2012.<sup>19</sup>

**In the aftermath of the global financial crisis, speculation on the potential eruption of sovereign troubles centred on countries with highly leveraged financial sectors and elevated levels of public debt and fiscal deficits.** From the start of 2010, Greece could no longer sell bonds and its domestic banks were buying bills for collateral to raise central bank liquidity and for risk management purposes. The risk of contagion was widely cited as one of the main reasons for approving a large support package to Greece.

Table 3.1: Timing of request

| Lender | Country  | Relevant early dates suggested by respondents | Formal request | Financial assistance facility agreement entered into |
|--------|----------|---|----------------|--|
| EFSF   | Ireland  | April-May 2009                                | 21 Nov 2010    | 22 Dec 2010  |
| EFSF   | Portugal | October 2010                                  | 7 Apr 2011     | 27 May 2011  |
| EFSF   | Greece   |   | 8 Feb 2012     | 15 Mar 2012  |
| ESM    | Spain    | Late 2010                                     | 25 Jun 2012    | 24 Jul 2012  |
| ESM    | Cyprus   | Second half 2011                              | 25 Jun 2012    | 8 May 2013   |

Source: Interviews conducted by the ESM evaluation team

**Five months after Greece was granted its first assistance package in May 2010, Portuguese and Spanish authorities had clear indications that they, too, might need to request assistance.**

- By November 2010 (according to press reports), the Portuguese Minister of Finance himself had raised concerns about the need of a programme. This suggests that Portugal could have acted at least seven months earlier. Portugal's bond market access dried up five months later, in April 2011, when it presented its official request for assistance, but it kept issuing bills throughout the crisis.<sup>20</sup>
- The Spanish situation is different as it never completely lost market access during the crisis, although it was severely challenged by banking problems. Spain maintained access to both bills and bond markets, although with shorter maturities and for smaller amounts, and – with rare exceptions – by tapping existing bond series. But Spain was frequently mentioned in the press in conjunction with the Portuguese situation, 18 months before the official request.
- As early as June 2011, there were media reports about a second support programme for Greece. The Greek EFSF programme should be seen in a different context given that it was already subject to an ongoing programme under the Greek Loan Facility, and had been offered IMF support since May 2010. The EFSF arrangement was triggered by political crises and the proposed (but cancelled) referendum in November 2011, as well as the need to complement sovereign debt restructuring involving the private sector (PSI).
- Most respondents interviewed in Cyprus thought that the government should have applied for assistance earlier. While the Cypriot situation developed more slowly, respondents said that efforts to obtain external assistance were mobilised early in the second half of 2011 – in the midst of a political crisis. At that time, Cyprus was threatened by a large exposure to the Greek economy (where PSI talks started in November 2011). This meant its access to markets was restricted to short-term financing, and in September 2011 it lost access to bond markets entirely.<sup>21</sup> Russia provided a €2.5 billion loan without macroeconomic conditionality, which temporarily mitigated financing pressures. In 2012, the government was only able to issue limited amount of bills twice and arrange occasional private placements.<sup>22</sup>
- For Ireland, market access troubles did not coincide with expert views. Ireland was shut out of the bond and bill markets from October 2010, as the banking crisis threatened public finances – just prior to the official

request for assistance in the following month.<sup>23</sup> After its request, only from early 2012 onwards Ireland was able to develop some market access by proceeding with bond exchanges and selling special amortising<sup>24</sup> securities. It also re-launched a T-bill programme in 2012.

**The vulnerability analysis in Chapter 2 supports the above observations.** The heat map (Figure 2.3) shows red flags were raised for three countries (Cyprus, Portugal and Spain) up to 18 months before the official request for assistance.

### Sources of delay

**Postponed decisions, lack of frank analysis and uncertain ownership of reform measures at national level were the main cause of delay.** The political systems dominated by opposing factions, in some countries, did not support consensus building. Leaders often considered the request for assistance as a political defeat. Governments may have had a tendency to delay the request because they thought they were capable of managing the crisis alone. IMF programmes suffer from such stigma,<sup>25</sup> and respondents said that the same applied to the euro area programmes. Some respondents said that there would have been no public support to go into a programme earlier. In some cases, ongoing approval processes of additional EFSF support instruments may also have played a role.

**There were distinctly different perceptions on timing between politicians and technocrats.** Those who were (former) politicians talked about phases of denial followed by attempts to contain the problems themselves, and attempts to delay the request because of the large political cost that was associated with it. Respondents at the technocratic level said they had often advised requesting a programme for months, and in some cases years, before the request was actually made. They regarded a programme as a window of opportunity to implement a number of reforms they had long been advocating but for which there had not been sufficient political support. Programmes, once agreed, strongly reinforced the finance ministry's position in the government.

In this context, a number of senior officials interviewed said that the institutions should consider how, and to what extent, they could support the national authorities in animating an early and constructive national dialogue. A postponed request may, however, in certain cases strengthen the resolution capacity and ownership of country authorities as well as the acceptance of programme measures by the population. The Irish authorities profited from a period of hesitation to draw up a diagnosis of the problem and to consider the corrective policies that led to their national recovery plan.<sup>26</sup> This formed the basis of the policy conditionality of their EFSF programme. Similarly, Spanish authorities imposed extra provisioning on the banking sector and implemented labour market reforms in the period before the request for a programme.

**In principle, early engagement would be beneficial.** This can be seen in the case of Cyprus where party interests and electoral cycles hindered discussions and delayed the application for too long, which made the problem bigger. On the other hand, only problems that cannot be solved at national level should be pushed for resolution at the European level.

**To facilitate early engagement without enticing moral hazard, we asked: what could the ESM do to improve incentives?** Respondents suggested investigating how institutions might facilitate early application in a more informal manner to alleviate any stigma from requesting financial assistance.

### Cost of delay

**Had applications for financial assistance been made 12 months earlier (meaning comprehensive measures or programme reforms were also taken earlier), it could have considerably reduced the costs for the economy.** While it is not possible to construct a full counterfactual, comparing financial market data at the time of the request with what respondents say would have been the earliest possible date for a request (Table 3.1) allows us to illustrate potential costs. While there is no ‘optimum’ time for asking for financial assistance, Figures 1-5 in Appendix E show costs arising from delay-related uncertainty leading up to the final agreement entering into force.<sup>27</sup>

**Overall, timings of the official agreements entering into force coincided with turning points for spreads, portfolio inflows, and the banking systems’ capitalisation levels.** But non-performing loans (NPL) continued to rise for several years. Given that the euro area crisis was largely defined by fiscal and financial stress as well as external pressures, these indicators provide guidance on potential costs, acting as a reasonable proxy.<sup>28</sup>

First, examining financial indicators of possible costs one year prior to the applications leads to the following conclusions:

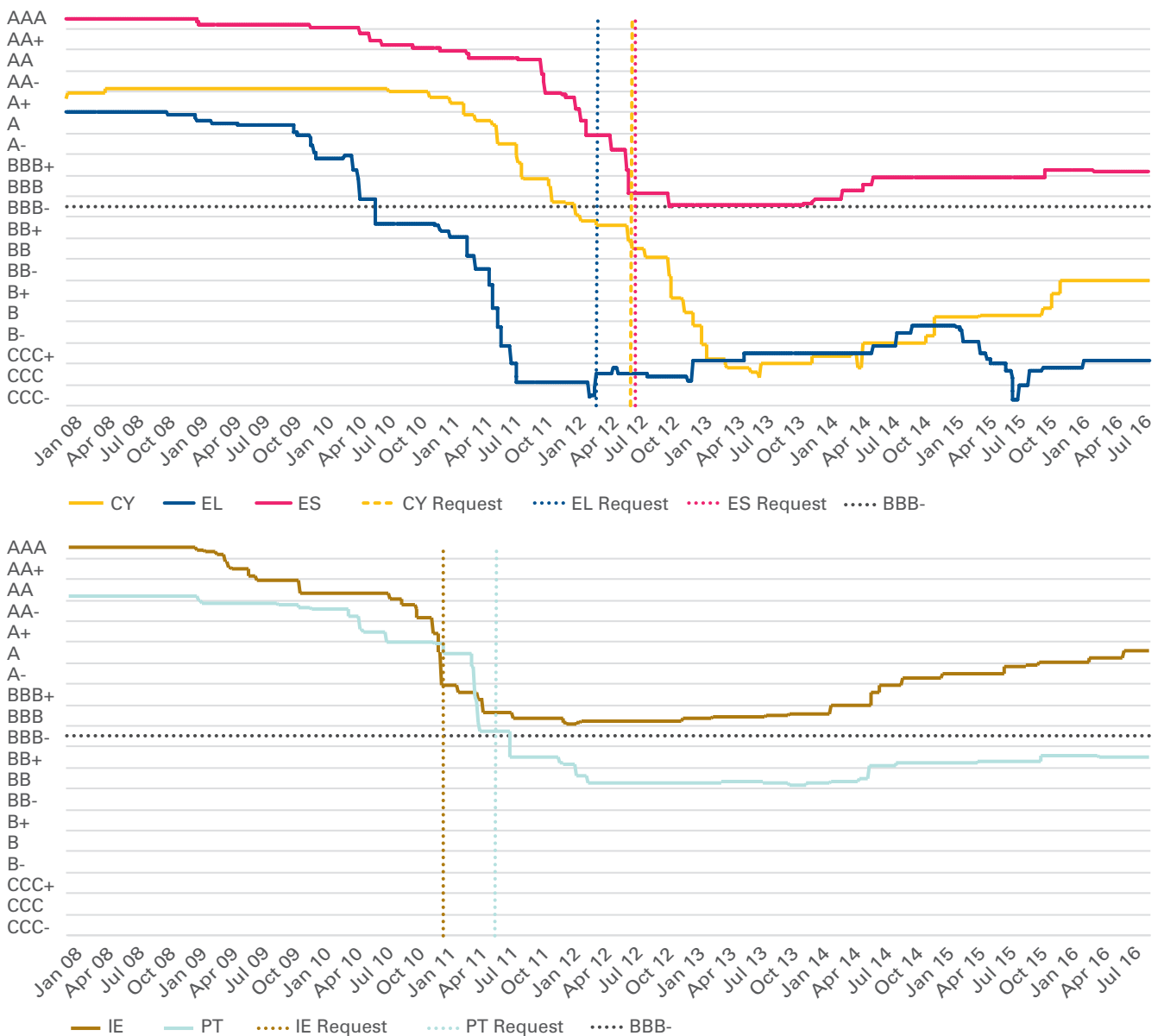
- **The rise in bond spreads and the fall in portfolio inflows were, in most cases, particularly pronounced in the year prior to the official agreement entering into force.** Bond spreads indicate an additional cost of financing for the sovereign in comparison to Germany. Portfolio flows provide capital and liquidity, and abrupt outflows may raise funding problems.
- **Bank asset quality in all the five countries would not have deteriorated by as much had assistance been sought earlier.** The stock of NPLs increased on average by five percentage points with Cyprus, Greece and Ireland strongly affected, while the increase was mitigated in Spain and Portugal. The Cypriot and Irish banking systems’ capitalisation levels also sagged.<sup>29</sup> Non-performing loans required provisioning and reduced profits. In crises, bank capital is often scarce and shortfalls in systemic institutions may put a burden on public finances. Several respondents from different ESM member countries said that an earlier identification of the problem in banking systems would have had a marked impact in capping costs. One respondent estimated that the cost of banking measures could have been reduced by half for his country if assistance had been requested earlier, as deposit outflows and the deterioration of bank balance sheets could have been reduced. Most country authorities who discussed the topic noted that it was not general practice in their countries to quantify these types of costs.



Second, examining a period longer than one year, leads to the following (see Appendix E): bond spreads rose particularly sharply for two countries (Cyprus by more than 200 basis points against July 2012, Spain by more than 300 basis points against July 2012), making financing at sustainable rates increasingly challenging; large negative portfolio flows hit Greece, Spain and Ireland in the quarters before the request; and the evolution of bank capitalisation varied. While it fell considerably in Cyprus, it was less relevant for the other four countries. Bank asset quality problems accelerated most sharply for Greece and Ireland. The depth of the secondary market for Greek and Spanish bonds deteriorated sharply as bid-ask spreads widened (Appendix E and Figure 4.4).

**The quality of sovereign market access for refinancing purposes deteriorated considerably in the six months before programme approval.** While Spain and Portugal relied on increasingly short-term issuance, Greece and Cyprus were practically closed out of bond market access. (Appendix E and Figure 4.3)

**Figure 3.1**  
Average ratings of programme countries



Notes: Dotted vertical lines refer to date of the respective official request entering into force. Dotted horizontal lines refer to investment-grade threshold. Sources: Moody's, Fitch, S&P

**In the period preceding requests, rating agencies also tended to downgrade the countries' creditworthiness.** For example, Ireland's rating was cut half a dozen times in the 12 months preceding the request. Figure 3.1 highlights the evolution of the average ratings of Moody's, Fitch and S&P of the five programme countries. The agencies' attitudes towards the likely success of a programme improved as the overall (European) policy response to the crisis evolved. In fact, following the respective official agreements entering into force, there were far fewer negative rating actions for Spain (1), Cyprus (2), and Greece (3) compared to the earlier programmes of Ireland (9) and Portugal (5). In addition, for the latter country programmes, rating agencies were faster to reverse their actions to positive, approximately within 12-18 months of the official agreements entering into force.

### 3.2. Choice of instrument

**The process governing the application for EFSF/ESM financing, and the choice of instrument used for that financing, were rather informal, to the extent that they took place outside EFSF/ESM Board proceedings.** In practice, key discussions take place prior to the official request during Eurogroup meetings and in the Eurogroup Working Group, which are the key policy-setting bodies for EFSF programme governance. For all five programmes under consideration in this report, the process was initiated under the auspices of the EFSF but in some cases (Spain, Cyprus) it was completed under the ESM. In each case, financial assistance was offered via the instrument indicated in the official request, with the exception of Cyprus which requested assistance targeting only the banking sector but was found to require broader support.

**The palette of instruments evolved during the crisis...** Originally, the EFSF could only provide financial assistance through loan facility agreements, but members started to discuss a more flexible application of the facility soon after the EFSF's creation. In July 2011, members decided to offer the following additional instruments of financial assistance: precautionary facilities, facilities to finance the recapitalisation of financial institutions through loans to governments and market support instruments (primary and secondary market purchases). The ESM adopted the EFSF's instrument set but the eligibility criteria evolved. Appendix F describes the instrument set, the related eligibility criteria and how they have been used in the recent crisis.<sup>30</sup>

**...but only the main instruments were used.** In practice, most members were granted a loan facility which was conditional on the implementation of a financial assistance programme. Only the loan facility was available at the time of Irish and Portuguese negotiations. The Greek second arrangement in 2012 required a financial assistance programme including a loan facility as well. Spain was granted a loan to support the recapitalisation of its banking system. Cyprus also requested banking sector support, but the challenges proved broader in the governing bodies' assessment, and Cyprus was also granted assistance through the standard loan facility.

**The board never activated the precautionary and market support instruments although members actively considered their use during the crisis.** A precautionary credit line could be activated in place of a loan facility or as a follow-up arrangement to a full programme. It could have played a role in keeping members from rolling back reforms after programme

exit thanks to the requirement of specific but lighter conditionality and active monitoring. Discussions on the potential use of the market support instruments took place in the case of Ireland and Spain, respondents said. They were not considered “very useful” or “needed,” so were not used.

**Board respondents and many respondents from programme countries said that the instruments used were appropriate, although there were some questions regarding Cyprus.**<sup>31</sup> Given the focus of reforms in this country, an indirect bank recapitalisation instrument similar to Spain might have been used if requested earlier. Ireland might have benefited from the indirect recapitalisation instrument, given its crisis was triggered by the banking system – but this would only have been possible if the July 2011 decision to broaden the instrument set had been taken earlier. With hindsight, respondents said the loan facility used was appropriate, and the Commission’s assessment underscores the role of front-loaded fiscal adjustment to regain confidence.<sup>32</sup>

**The requirement for unanimity may prevent the ESM from using the best-suited instrument, according to respondents.** The ESM direct bank recapitalisation became available with delay and many programme country authorities found it disappointing that the instrument’s availability was constrained following the introduction of the Bank Recovery and Resolution Directive (see Section 3.6). They said that this instrument could have reduced the debt burden on the sovereign. A minority said that it had become too theoretical an instrument as “there could hardly be a case where the problem concerns the financial sector only”. Similar views were expressed in relation to precautionary instruments as exit tools.

## Eligibility

**Requests for all five programmes were submitted under the EFSF framework, prior to the establishment of the ESM in October 2012.**

This was also the case for Cyprus and Spain, whose financial assistance was ultimately disbursed from the ESM. The EFSF Board of Directors made decisions on the financing facility agreement, while the Eurogroup and Eurogroup Working Group agreed on the substance of the programme.<sup>33</sup> The decision on which instrument to use involves a trade-off between programme requirements and the need to signal confidence. But the choice also matters for even-handed treatment of members and the gradual creation of a more rules-based approach in crisis resolution.

**The eligibility criteria for the EFSF emphasised preventing and fighting negative spillovers within the currency union.** Their purpose was to support euro-area members in difficulties caused by exceptional circumstances beyond their control. Such assistance aimed at safeguarding the financial stability of the euro area as a whole and its Member States. Detailed terms and conditions needed to take into account debt sustainability and the market situation for bond issuance.

**With the exception of Spain, members obtained a loan facility as part of a financial assistance programme, designed following an assessment of the existence of heightened financial stability risks through contagion and fiscal and structural challenges.**<sup>34</sup> The EFSF framework agreement required the European Commission and the ECB to assess such

risks in cooperation. This assessment had to be prepared under tight time constraints. Most board members surveyed considered this assessment adequate under the circumstances given that contagion was an overarching concern.

**The risk of contagion was perceived more strongly in the early period of the sovereign debt crisis than in later programmes.** For example, the literature confirms the existence of contagion in the euro area in 2012–2013. Elkhaldi (2014) found that countries exhibited the highest contagion characteristics before October 2012, while Tola (2015) found the proportion of contagious country-specific shocks fell markedly after the “whatever it takes” announcement by the President of the ECB in July 2012.<sup>35</sup> A minority of respondents to the board survey considered that the argument for contagion could have occasionally been made less forcefully. They said there was room to reduce the ad hoc nature of the assessment by better fleshing out the financial and economic interdependencies and recent shocks.

**Given the division of roles in the decision-making structure, it was not possible to conduct a full analysis of country eligibility for an assistance programme as called for by this evaluation’s Terms of Reference.** Programme decisions drew on the assessments of the European Commission and the ECB on financial stability risks. These were discussed in the Eurogroup and the Eurogroup Working Group. The conclusions of the assessments endorsed by them were not attached to the formal EFSF decision documents, nor explained transparently in the programme documentation that has subsequently been made public, nor in the Council implementing decisions. Moreover, public programme documents did not sufficiently demonstrate regional financial stability risks, which seem to have been used as the primary thrust to activate the EFSF facilities.<sup>36</sup>

Table 3.2: Assessment of triggers for assistance request

|                 | Primary trigger for request in Council decisions  | Triggers raised in policy discussions   |
|-----------------|---|---|
| <b>Ireland</b>  | Ireland’s loss of market access, reflecting rising concerns about the sustainability of the Irish public finances in view of comprehensive public support measures to the weakened financial sector.                  | Financial sector at the epicentre of the problem. Bank financing pressures due to high sovereign spreads. Significant spillovers. |
| <b>Portugal</b> | Portugal’s increasing pressure in financial markets, creating rising concerns about the sustainability of its public finances.  | Budgetary and structural measures to restore fiscal sustainability.   |
| <b>Greece</b>   | N/A   | Structural weaknesses and fiscal gaps as trigger, following PSI.  |
| <b>Spain</b>    | Burst of real estate and construction bubble and resulting economic recession raised concerns about viability of some banks that had accumulated large stocks of problematic assets.                                  | Bank asset quality and its impact on public finances.   |
| <b>Cyprus</b>   | Increasing pressure in financial markets, against the background of rising concerns about the sustainability of its public finances, including the required public support measures to the weakened financial sector. | In particular financial sector, but also on the fiscal and structural front.  |

Sources: European Council, European Commission

**Drawing on the eligibility criteria and the primary trigger for each programme, we nevertheless conclude that the requirements for each instrument were broadly met.** We reviewed relevant Council decisions and/or Commission proposals, and identified primary triggers in related policy discussions (Table 3.2). Keeping in mind the timing of requests, stability risks were evident as both Ireland and Portugal had lost access to bond markets, which supports their choice of a loan facility. Greek structural weaknesses and fiscal stress also fall into the criteria defined for this instrument.<sup>37</sup> At the same time, the banking sectors were not perceived as a major concern in Greece and Portugal.

**Respondents were widely of the opinion that the instrument choice for Spain was correct.** The request letter did not indicate a preferred instrument but specified the amount, which had already been published in a Eurogroup statement on 9 June 2012. As the Spanish facility for bank recapitalisation was initially negotiated under the EFSF, and transferred to the ESM when it started operations, it is not evident what eligibility criteria were used in decision-making. Given the uncertainties in defining recapitalisation needs, discussed further in Section 3.3, the decision could be justified by severed, though not completely lost, market access. Respondents pointed to imminent contagion risks, and this is supported in the academic literature, which argues that Spain was one of the key countries affecting financial stability of the core euro area.<sup>38</sup>

**Spanish authorities strongly favoured an indirect bank recapitalisation given the strong national stigma attached to a financial assistance programme.**<sup>39</sup> Chapter 2 nevertheless suggests that, with hindsight, the bank recapitalisation instrument might not have been the only possible choice for Spain.<sup>40</sup>

**In Cyprus, however, the scale of the challenges called for a full adjustment programme in spite of the political costs.** Cyprus submitted its request to the EFSF at the same time as Spain, in June 2012, without a specified amount. Due to political constraints, negotiations were long, lasting until 2013, with assistance finally granted as a macroeconomic loan from the ESM. Owing to the relatively large size of the troubled financial institutions and a loss of market access by the sovereign (see Section 3.1), the loan facility can be considered an appropriate choice. Fiscal and structural challenges were clear for the three remaining countries, as were the fears of contagion in the 2010-2012 period.

### 3.3. Sizing of financial assistance

We examine here how financing needs in the various programmes were derived and whether programme contingencies, and the need for buffers, were adequately taken into account, including the specific requirements for bank recapitalisation. In line with the scope of the evaluation, the specific targets for fiscal deficits under the programmes are not assessed.

**The size of financial assistance granted to the programme countries had to address three key factors.** First, it had to cover the financing gap that arose between the gross financing needs (GFN) – the budget deficit, amortisation of maturing debt, and capital injections to support the banking system – and the country's ability to provide for them on its own. Second, it

had to cover contingencies that might arise from unexpected external events, or if the underlying assumptions turned out worse than expected. Third, it had to create the basis for successful access to the financial markets by creating confidence for market participants that the country would be able to meet its financial obligations, including beyond the programme period. The fact that the request for financial assistance of the five EFSF/ESM programmes fell at a time when the aftershocks of the 2008-2009 global financial crisis were still being felt added to the usual uncertainty in making projections.

**The approach to define the size of financial assistance evolved over time and was linked to the country specific nature of the programme.**

Typically, a delegation from the European Commission, the ECB, and the IMF visited the country shortly after the official request. Initially, the EFSF/ESM were not part of these visits. A review of documents and interviews with key participants in the negotiations indicate that there was often considerable initial disagreement both among the various institutions and with country officials, reflecting divergent views on the size of the macroeconomic and banking problems, the scope for realistic fiscal adjustment, and the potential for burden sharing through PSI. For example, a major point of discussion at the time of initial negotiations on the Irish programme was whether or not senior bank bondholders should be subject to haircuts, which would have significantly reduced estimated financing needs but at the risk of potential regional contagion. By the time of the Cypriot programme, greater emphasis was placed on bailing in bank creditors to reduce the cost of bank rescue operations (see Section 3.6). Nevertheless, despite these differences of view, the size of estimated financing needs was agreed quickly in most cases – typically within a month before or after the official request. The exception was Cyprus where an agreement on the size was reached only nine months after the official request, following the presidential elections.

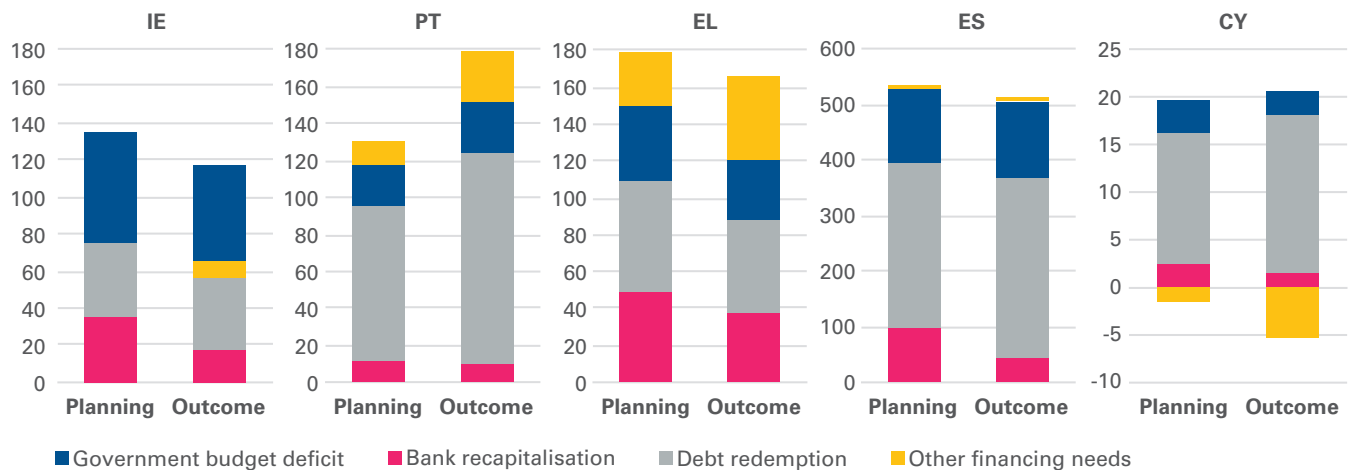
**The greatest variation in approach concerned the degree of rigour underlying initial estimates of bank recapitalisation needs,<sup>41</sup> and how contingency buffers were factored into the programmes.**

In countries where the banking sector was the core or at least a key part of the programme (Ireland, Spain, and Cyprus), stress tests or similar due diligence on the banking systems were conducted. In the case of Spain, the IMF's Financial Sector Assessment Program report (concluded one month before the official request) was considered the most reliable analysis.<sup>42</sup> In the case of Ireland, the programme built on the Prudential Capital Assessment Review conducted by the Central Bank of Ireland in 2010. The analysis included a stress test and identified the additional capital needs of the largest banks. In Cyprus, a consultancy firm prepared a due diligence report prior to the programme (March 2013) regarding the amount needed for the recapitalisation, which was further analysed by another consultant. In contrast, in Portugal, the recapitalisation amount identified by the supervisor at the beginning of the programme was based on systematic stress tests that only covered the largest banking groups. Banks that did not take recourse to public injections were not fully bound by programme conditionality. While part of the foreseen funds remained unused at the end of the programme, this prior assessment eventually proved too optimistic, with greater problems emerging in the post-programme period.<sup>43</sup>

**Financial assistance was predominantly used to serve existing liabilities towards creditors and, secondly, to finance the government's budget deficit.**

In relation to the economic size of the country, the initial estimates of GFN over the whole programme period were similar across most countries (between 75% and 90% of GDP). Cyprus required larger funding in relative terms (110% of GDP), while in Spain, the lower ratio of about 50% (measured

Figure 3.2  
Initially planned vs. actual gross financing needs  
(in € billion)



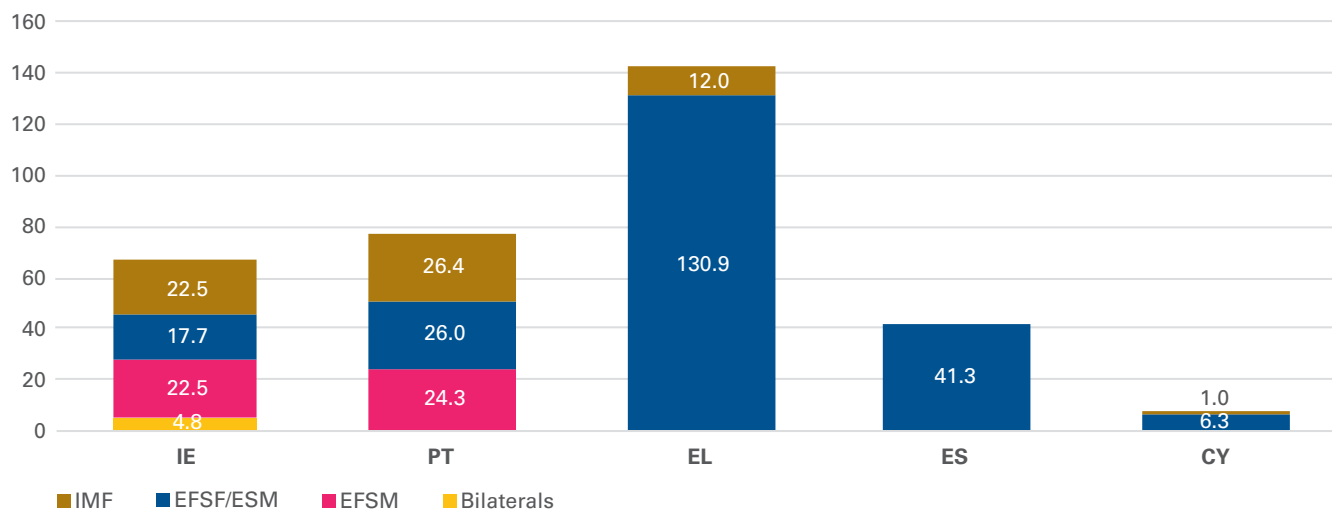
Notes: Planned gross financing needs for Spain at programme start are based on ESM estimates, because no published official estimates are available. For Cyprus, the data item "Other financing needs" includes privatisations, market financing, and other proceeds. For Greece, data on "Outcome" is based on the fourth review of the programme which partly contains estimations.

Sources: European Commission, Bank of Spain, Tesoro Público, IMF, ESM

over two years) can be explained by the shorter programme period. Debt redemption usually reflected the largest share of GFN (the second largest in the case of Ireland) (see Figure 3.2). Financing the budget deficit was in general the second largest need. Initial GFN estimates included a specific cash buffer target only in the case of Greece. While in some programmes a cash buffer floor was defined, an upper limit remained unspecified. Bank recapitalisation measures reflected about 15% of initially planned total GFN in Cyprus and around one quarter in Ireland, even though in both cases the banking sector was one of the major sources of the crises.<sup>44</sup> In Greece, where banking problems were a consequence of the broader crisis, one quarter of GFN was reserved for the banking sector. The Spanish programme, in which financial assistance was dedicated solely to the financial sector, had the largest banking envelope in absolute terms (€100 billion). However, it was comparatively small compared to other financing needs like debt redemption that a full programme would have potentially had to cover. In Portugal, initially estimated bank recapitalisation expenditure, at about 10% of total GFN, was relatively small. In the second Greek programme, the upfront cash payments to private investors as part of their agreement on the PSI represented another large category of financing (see other financing needs in Figure 3.2).

**The EFSF/ESM contribution to these financing envelopes varied significantly across countries but was generally large and increased over time.** External assistance was provided by different sources, in particular by the IMF, the EFSM and the EFSF/ESM. In the case of Ireland, bilateral loans represented an additional significant share.<sup>45</sup> In the Cypriot programme, a bail-in of senior bondholders and uninsured depositors contributed to the financing of bank recapitalisation measures, unlike in other programme countries where burden sharing was limited to junior bondholders. In the first two programmes, for Ireland and Portugal, the EFSF share of disbursements was one quarter and one third, respectively, alongside broadly equal contributions by the IMF and the EFSM. In subsequent programmes, European support was provided solely by the EFSF/ESM, which also represented the bulk of financial assistance. In the second Greek programme and the Cypriot programme, almost 90% of total external assistance was provided by the EFSF/ESM, while the Spanish financial sector assistance programme was fully financed by the ESM (Figure 3.3).

**Figure 3.3**  
**Financial assistance provided, by institution**  
 (in € billion)



Notes: For Cyprus, the IMF disbursed about €1 billion. For Greece, €10.9 billion disbursed and returned has been subtracted.  
 Sources: ESM, European Commission

**Actual gross financing needs were at or below initial programme estimates, with the exception of Portugal.** Total GFN recorded at the end of the programme matched expectations in the case of Greece and turned out significantly lower for Ireland, Cyprus,<sup>46</sup> and Spain. By contrast, actual GFN in Portugal exceeded initial estimates by 50%.<sup>47</sup> With the exception of Portugal and Spain, budget deficits developed more favourably than expected, but this can be related to higher economic growth only in the case of Cyprus. Bank recapitalisation measures turned out lower in all cases - if contingency buffers are taken into account (see Figure 3.2).

- In Greece, initial expectations for bank recapitalisation expenditure were broadly met at programme end, not taking into account the costs incurred from the PSI.<sup>48</sup> However, the cash upfront payments (for PSI and for bond buybacks) turned out much higher than expected and offset the more favourable outcomes in the government budget and debt redemption.
- In Spain, the outcome for GFN would have been higher if the regional governments had not been refinanced by a syndicated loan from local banks, channelled through a state financial institution.
- For Portugal, the reasons why actual GFN was so much higher than projected are threefold. First, higher than expected financing needs were not met by more frontloading of the financial assistance but by issuing treasury bills. The issuance of short-term debt, which needed to be rolled over, as well as the execution of bond exchanges and buybacks artificially blew up the total amount of GFN compared to a long-term funding solution. Second, while financial resources were too small in the beginning, they became ample towards the end of the programme. This excessive liquidity has been used to build up a sizeable cash buffer, also because no cash buffer ceiling was defined at programme start. Third, the budget deficit was higher than targeted in all programme years, partly reflecting weaker economic conditions and the incorporation of State Owned Enterprises (SOEs) in the public accounts.



**While being flexible in the technical execution of payments, financial assistance disbursements showed limited flexibility across programme years.** Usually, financing needs were high at programme start and gradually decreased thereafter along with increasing market access. Financial assistance disbursements were planned accordingly. The technical execution of payments was flexible in terms of precise date and size. Across programme years disbursements showed limited flexibility, however, and stuck to the original plan with a few exceptions. This rigidity might be partly explained by the close link to progress with conditionality. A common feature for Ireland, Greece and Portugal was that some of the disbursements scheduled for the first programme year were somewhat delayed. On the other hand, some interviewees mentioned that disbursements were too frontloaded and an even stronger shift of disbursements towards later quarters would have been preferred.

**In the early programmes, the magnitude of financial assistance also showed limited flexibility, which had both positive and negative effects on programme objectives.** The limited flexibility of disbursements in light of changing economic developments resulted in a replenishing of cash buffers at the end of the Irish and the Portuguese programmes. Higher cash buffers led to an improvement of market confidence which was conducive to regaining and maintaining market access, a key objective of the programmes. However, these developments were an unintended residual rather than an explicit feature of the original programme design.<sup>49</sup> A number of respondents and the Commission's own evaluation, however, concluded that high cash buffers have been supportive for exiting the programme with market access and without a precautionary arrangement. There were also adverse effects, however. The deceleration in reform momentum towards the end of the programme and the non-completion of the last Portuguese programme review can be partly explained by the higher cash buffer, which lowered incentives to act. This assessment is supported by interviews and shared by the Commission's own evaluation.<sup>50</sup> The initially determined size of the assistance envelope might have been justified given uncertainties and high volatility, especially with regard to the financial sector. The question remains, however, whether the disbursement of unused contingency buffers was needed or whether the main objective of the programme country was to take advantage of the favourable lending terms. The early repayments of IMF loans with comparatively less favourable lending terms (e.g. in Ireland and Portugal) also suggest such a conclusion. In its evaluation report, the Commission said that the Irish authorities and market participants voiced concerns that reducing or stopping the disbursements might have driven up sovereign funding costs. Overall, the large build-up of cash buffers seems to be more of an issue for the early programmes. In the cases of Spain and Cyprus, 60% and 30%, respectively, of the available envelope was not disbursed. In Spain, this was because no more funds were needed, and in Cyprus because the last review was not completed.

**Contingency buffers were considered in all programmes but not explicitly quantified in all cases.** Consequently, we were not able to determine how the total size of financial assistance was agreed by consulting the available programme documentation. Contingency buffers<sup>51</sup> were discussed in all programmes, but the available programme documentation reports the exact amount only for Ireland, Cyprus and Greece.<sup>52</sup> Explicit contingency buffers were solely related to the financial sector in the cases of Ireland, Cyprus, Greece, and Spain. In the Portuguese programme, a general buffer to provide for unexpected deviations from the baseline financing scenario was factored in, but with poorly documented quantification. The financing needs for financial sector support measures were subject to particular uncertainty.

Also in some countries, when bank support measures took place before the programmes started, they were insufficient. This may largely explain why the buffers considered relate only to the banking sector. No buffers for the financing of the budget deficit or the amortisation of public debt have been explicitly highlighted. This ambiguity in the analytical discussion suggests that the determination of the overall financing need was at least in part the result of political negotiation.

**Various limitations set by the lenders and borrowers influenced the envelope for financial assistance.** This was the case in the Irish and Spanish programmes.<sup>53</sup> For example, the size of early programmes (e.g. for Ireland and Portugal) were influenced by an informal understanding that the IMF would cover one third of financing requirements and EU institutions two thirds.<sup>54</sup> Other systemic considerations influenced whether senior bond holders were bailed in as part of the Irish programme and the choice of instrument for Spain. More generally, interviews with senior officials confirmed that the financing envelopes all faced such constraints. Programme design also faced constraints from the lenders' side.

**Contingency buffers included in the overall financing envelope, where earmarked, proved to be sufficient and only partly tapped.** The varying degrees of transparency with which these buffers were treated in the programmes complicates any ex-post accounting, but the situation in the countries can be described as follows:

- For Ireland, a contingency provision of €10 billion was factored into the total GFN, equivalent to about 30% of the total banking support scheme.<sup>55</sup> Baseline expectations for bank recapitalisation measures amounted to €25 billion, while actual expenditure was €18 billion, which implies that the buffer was not eventually tapped. This contingency buffer was not ring-fenced, which made it possible to deploy the unused amount to replenish the cash buffer. Eventually Ireland had a cash buffer of about €24 billion in the last programme year, representing a large share of three quarters of refinancing needs in that year.
- In the second Greek programme, a capital buffer of €5 billion was deemed appropriate to provide for higher funding needs (e.g. related to the sovereign debt buy-back or a potential further deterioration of macroeconomic conditions). The buffer accounted for about 10% of the total envelope of €49 billion that was planned for the recapitalisation of Greek banks. By contrast to Ireland, disbursements for bank recapitalisation were earmarked. Financial assistance for banks was paid through the Hellenic Financial Stability Fund (HFSF). After recapitalisation needs proved lower, the HFSF returned €10.9 billion to the EFSF in February 2015.
- In the Cyprus programme, a contingency buffer of around 50% was factored in, reflecting €1.3 billion out of the €2.5 billion envelope for financial sector recapitalisation. A small proportion (15%) of this buffer was used, leaving €1.0 billion untapped.

- In the Spanish programme, impairment losses of €55 billion were initially estimated. Under the assumption that financial sector stabilisation measures were planned to be solely financed by the EFSF/ESM assistance of €100 billion, this implies a buffer of €45 billion for unexpected events, which was also supposed to provide confidence to markets. In the end, actual expenditure totalled €41.3 billion, which left the buffer untapped. Also in Spain financial assistance was paid to a resolution fund, the Fund for the Orderly Restructuring of the Banking Sector.
- For Portugal, no explicitly quantified contingency buffers were communicated.

### 3.4. Disbursement processes

We assess here three related issues: whether disbursements have shown an appropriate degree of flexibility, both in terms of phasing and choice of funding instruments; the link between compliance with programme conditionality and disbursements of EFSF/ESM financing and whether administrative processes for actually disbursing funds have operated efficiently. Processes have evolved significantly over time and, where necessary, the main focus of the assessment is on current ESM procedures.

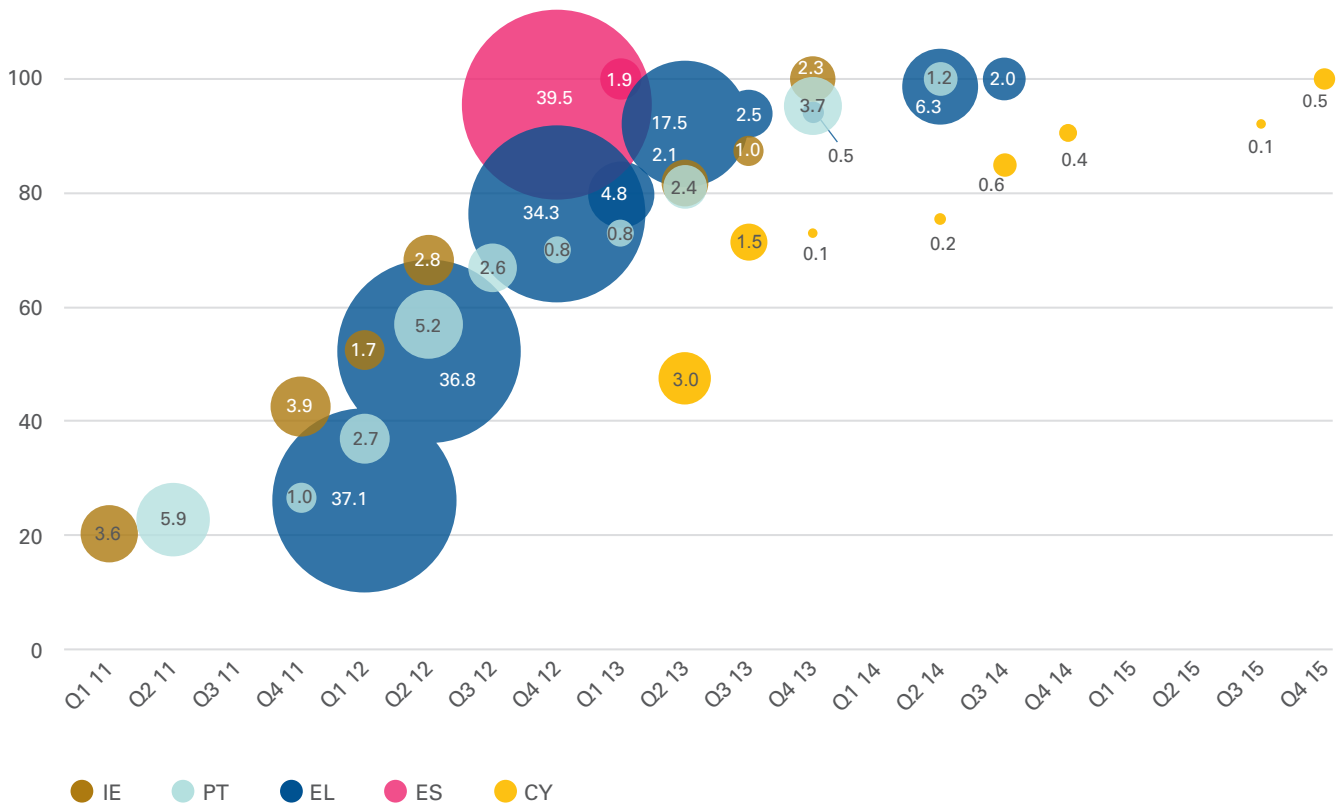
#### 3.4.1. Size and financial structure of disbursements

**The EFSF and the ESM were effective at making disbursements, especially considering the challenging circumstances.** Figure 3.4 shows the considerable variation in disbursement patterns responding to programme countries' needs.<sup>56</sup> The figure shows that the financial sector programme for Spain was disbursed almost in one shot, and that disbursements under the Greek and the Cypriot programmes were more front-loaded than under the Irish and Portuguese programmes. The institutions were able to respond to the front-loaded nature of financing needs, including for bank recapitalisation purposes, under turbulent market conditions, often raising amounts comparable to the largest European sovereigns in individual auctions. Special effort was required given that this was done without an established track record in the market. The disbursement schedule of each programme was customised to the financing needs of the programme country.

**Both the nature and the process of disbursements changed over time, with significant innovations introduced to meet changing circumstances.** The first EFSF disbursements ('pure back-to-back cash') had the same interest payment and maturity dates as the issuance. In addition, to maintain the highest credit rating for the EFSF, it kept part of the proceeds as a cash buffer. This meant additional costs because the full proceeds were not available to the programme country. The introduction of an over-guarantee in the case of the EFSF made cash buffers redundant for rating purposes, and they were excluded to improve cost efficiency. In the next phase, multiple disbursements (for Ireland and Portugal) were matched with money raised from a single issuance. Additional innovation was achieved by making several kinds of disbursement under the same envelope. The EFSF developed a liquidity pool by issuing long-term and short-term notes which allowed it to find payment and maturity dates that better fitted the programme country's preferred redemption profile. New disbursements would be financed by short-term issuances which would be rolled over into long term issuances over time.

Figure 3.4  
**Quarterly disbursement, by country**

(cumulative share of total disbursed amount in %, size of the bubbles represents the disbursed amount in € billion)



Source: ESM

**The EFSF also made significant innovations in providing financial assistance for use by financial institutions, most notably the use of disbursements in kind (see Box 3.1).** Respondents raised several issues regarding disbursements for bank recapitalisation. A few respondents expressed their preference for cash instead of in-kind disbursement, because the latter were traded by the recapitalised financial institutions in the international repo market, and it was not always possible to use the bonds as collateral. Although respondents recognised that in-kind disbursements ultimately fulfilled their recapitalisation purpose, the ESM could consider ways to provide cash disbursements in the future.

### Box 3.1: Disbursements and bank recapitalisation

Providing financial assistance for use by financial institutions required significant sums and alternatives to the cash disbursements that had been made until then.

For example, the ESM made a disbursement consisting of two portions of bills and three portions of floating rate notes to Spain.

In the Greek ECB Credit Enhancement Facility, the EFSF conducted a private placement transaction with the Bank for International Settlements (BIS) in Basel, delivered securities to the BIS and simultaneously booked a back-to-back loan against Greece. The securities were used to replace Greek collateral at the ECB that had become ineligible. The Greek PSI and Bond Interest Facilities worked in a similar way. Through an Issue and Repurchase Process, securities were legally created by issuing them against a bank and buying them back against the same price. After receiving them back to its custody account, the EFSF could deliver them 'free of payment' to a securities custody account of the Hellenic Republic, while a corresponding (back-to-back) loan was created with the same payment dates and amounts as the EFSF securities.

### 3.4.2. The link between conditionality and disbursements

#### **Disbursements are linked to the compliance with conditionality.**

The ESM Treaty entrusts monitoring compliance with conditionality to the European Commission in liaison with the ECB and, wherever possible, the IMF. The ESM Treaty, the instrument guidelines and the ESM's contracts call for the ESM Board of Directors to make a judgement on compliance with the terms of the Memorandum of Understanding (MoU) prior to taking a decision on disbursement, on the basis of an assessment by the European Commission of the programme country's performance.<sup>57</sup> As appropriate for a sovereign lending institution, the Board enjoys a large margin of discretion. However, the EFSF/ESM have adopted the IMF practice of prior actions (also called milestones) for certain key measures that need to be implemented before a review can be concluded or a disbursement can be made.

#### **Overall timing of the disbursement process is flexible, though delays in compliance reporting created problems in early programmes.**

Most programme country respondents said that the EFSF/ESM disbursement process was accurate and sufficiently flexible. The assessment of compliance with conditionality takes the form of a quarterly review, but the timing of reviews varied. Some respondents involved in early programmes said the timing of the compliance report was very tight. In one instance it was reported to be so tight that it caused the disbursement schedule to lag behind the financing needs. By contrast, a number of respondents praised the timing flexibility in the ESM's disbursement approval process compared to the quarterly disbursement framework of the IMF, which they deemed more rigid.

#### **The ESM has not established criteria for compliance monitoring and reporting, which has led to some ambiguity about the links between conditionality and disbursements.**

A few respondents deemed the framework for disbursement approval too open-ended and suggested the ESM develop a policy to clarify the link between the compliance with conditionality and disbursements.<sup>58</sup> There is no evidence from the surveys or the interviews that the partner institutions received guidance from EFSF or ESM as to how

compliance should be monitored and reported on. Such guidance could also provide better assurances for even-handed treatment of member countries in the future. The evaluation team has not assessed compliance with conditionality as the latter was outside the scope of the exercise. However, the European Court of Auditors audited financial assistance provided to five EU Member States including two which received assistance from the EFSF.<sup>59</sup> In its report, the Court found that reporting on compliance with conditions was unsystematic<sup>60</sup> and that instalments were released even though on-time compliance varied greatly between countries,<sup>61</sup> and despite compliance often occurring after a certain amount of time had elapsed.<sup>62</sup> On balance, this points to a degree of flexibility in the disbursement approval process.

### 3.4.3. Efficiency of administrative disbursement processes

Figure 3.5 shows a typical administrative disbursement process for ESM, from Board of Directors (BoD) approval to payment. The order of some of the steps may vary in individual cases. The process starts with BoD approval for the disbursement of a tranche. The Member then sends a Request for Funds to the ESM (the second step may also come first). The ESM sends the Member a signed notice for it to countersign. Then, the ESM makes the disbursement and sends a confirmation notice to the ESM Member, mostly on the same day.

Figure 3.5  
Typical ESM disbursement process



Note: T is the day of the Board of Directors' approval.  
Source: ESM

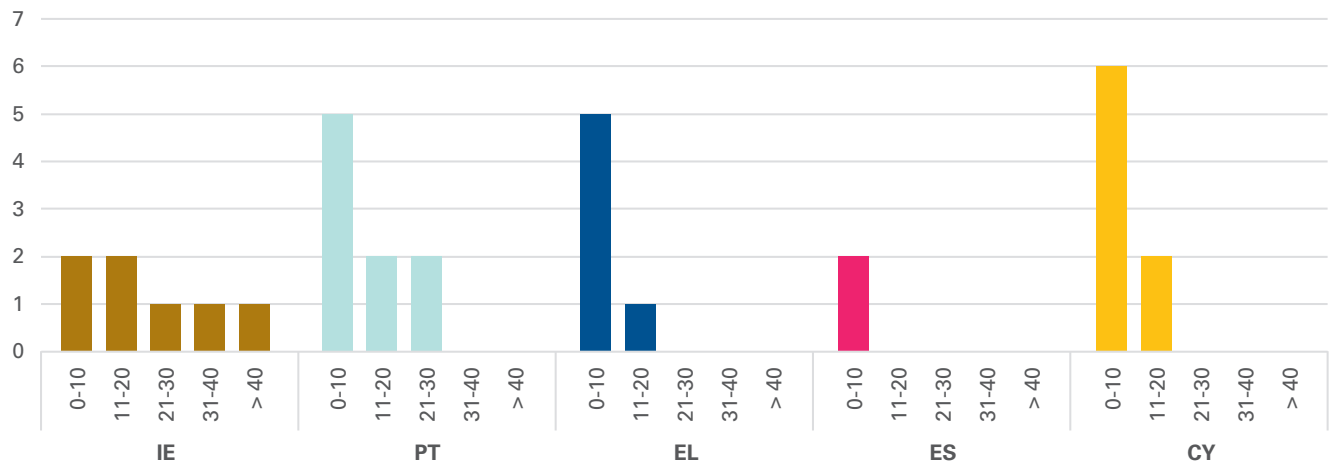
**The administrative disbursement process became more efficient over time.** An approximate<sup>63</sup> measure of the administrative efficiency of this process is the number of days between the date on which a programme country sends a Request for Funds and the date the disbursement is made. On average, it took the EFSF/ESM less than 12 days to disburse, with a minimum of one and a maximum of 67 days. The overall efficiency of disbursements improved over time (Figure 3.6). There is no correlation between the number of days it took to disburse and the size of the disbursed amount. In other words, the EFSF/ESM was equally efficient at disbursing smaller and larger amounts.

**Stakeholders are generally happy with the EFSF/ESM disbursement process.** Respondents from programme countries generally described the disbursement process as accurate and express being happy as 'customers'. The terms, especially the maturity of individual disbursements, took into account the maturity structure of existing public debt, avoiding a concentration of maturities in a specific year, and smoothing the debt profile as much as possible. On one occasion, a stakeholder highlighted the need to disburse a large amount very rapidly, when the EFSF confirmed that all the necessary preparations had been made and that disbursement was to be made shortly after. Various interviewees cited examples where the process had handled challenging cases flexibly.

Figure 3.6

**Frequency of disbursements, by days to disburse**

(vertical axis: number of disbursements. horizontal axis: days to disburse)



Source: ESM calculations

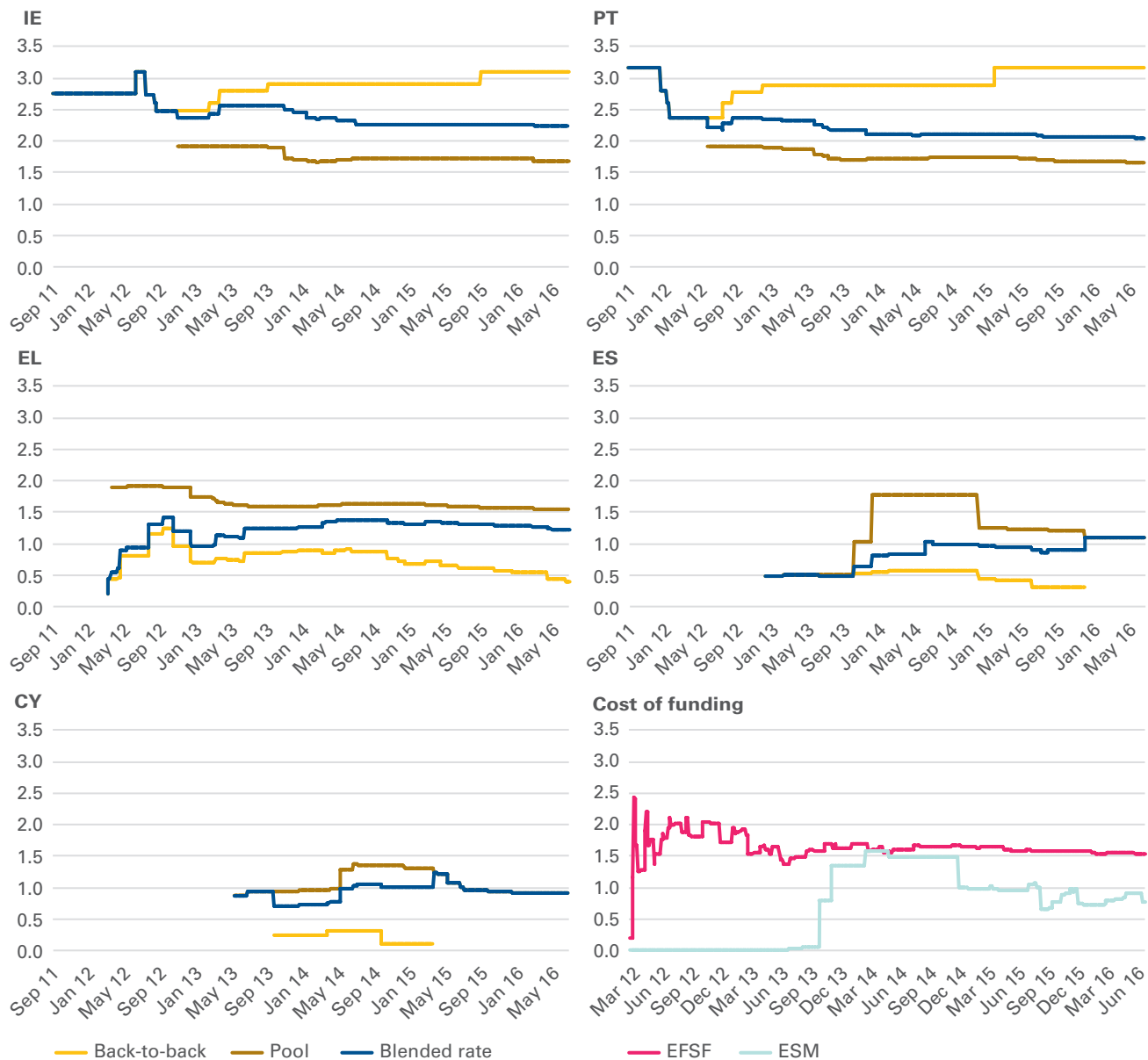
**3.5. Lending terms and contribution to budgetary savings**

**This section assesses the pricing policies of the EFSF/ESM, and their contribution to debt sustainability in programme countries.** Resources for EFSF/ESM financial assistance are raised in private capital markets. The price of the instruments offered to programme countries is calculated to cover funding and operational costs plus an instrument-specific margin. The pricing of the financial assistance therefore directly depends on the funding strategy (Box 3.2).

**The main objective of the EFSF/ESM's pricing strategy is to provide assistance at low cost to programme countries.** Initially this was a political decision that reflected a balancing of moral hazard and debt sustainability considerations. In the early stages, it was not clear whether countries should benefit from the lowest possible rates and the same lending conditions if they were subject to different sustainability risks. Over time, the objective of the euro area resolution strategy evolved towards underpinning debt sustainability. The EFSF/ESM were able to obtain funding at very low cost that was then passed on to the programme countries, while applying margins that were reduced over time to very small levels.

**Pricing was not as important as size and maturity considerations for countries receiving EFSF/ESM assistance.** Survey respondents indicated that the cost of the financial assistance was only a secondary issue for programme countries. Having access to a very large amount of funds at long maturities, thus smoothing repayment profiles, was the most important contribution, respondents said. For example, the Spanish request benefited from the positive confidence effect of a large financing buffer, for which the government incurred fees.

**Figure 3.7**  
**Average rates on EFSF/ESM loans, by type of funding**  
 (in %)



Notes: Average rates on back-to-back and pool-funded loans. The blended rate is an average rate weighted by an outstanding amount of back-to-back and pool-funded loans, including fees and margins, and as such depicts the overall price of lending.  
 Source: ESM calculations

**The ESM's pricing policy provided a basis for even-handed treatment of programme countries but lending rates varied and easing of lending conditions reflected country-specific needs.** The pricing strategy does not discriminate between individual countries but evolving funding and lending strategies combined with the evolution of market rates resulted in different lending rates (Figure 3.7). Replacing back-to-back loans with the diversified funding strategy increased flexibility and helped to reduce the interest rate and rollover risks. It also implied convergence of lending cost among the programme countries. This shift represented a decline in lending rates for Ireland, Portugal and Greece, as their original back-to-back loans were granted when market rates were higher, whereas the diversified funding strategy increased lending rates for Spain and Cyprus as they originally benefited from short-term back-to-back loans. Countries also benefited from reductions in margins, maturity extensions, and – in one case – a deferral of interest payments. These reflected sustainability and market access considerations and their size and timing differed across countries.



### Box 3.2: Evolution to a diversified, from a back-to-back, funding strategy

The EFSF/ESM raise funding for their respective programme loans by issuing debt instruments in the capital markets. They have used different funding and lending approaches over time, which enabled them to have low and stable costs of funding.

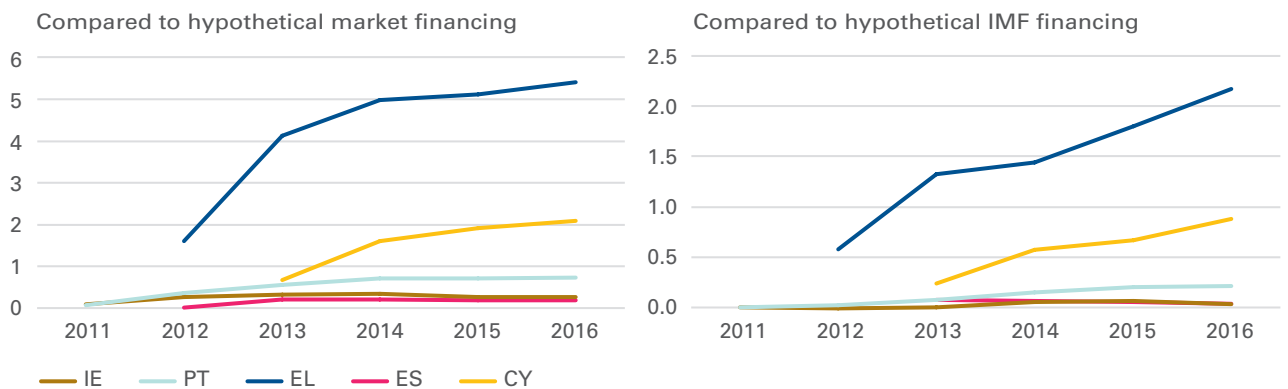
In 2011, the EFSF used a back-to-back strategy, matching funds raised from treasury bill and bond sales to programme countries' disbursement schedules.

In March 2012, the EFSF adopted a diversified funding strategy. Under this strategy, also adopted by the ESM, funds raised are allocated to a long-term pool comprising capital market instruments, and a short-term pool comprising its money market instruments and short-term notes. Disbursements, and a certain liquidity buffer, are funded from these pools.

Exceptionally, certain disbursements are sourced from individual funding operations that are not integrated into the short and long-term pools. In particular, to recapitalise banks, loans are made via the delivery of EFSF or ESM notes, termed 'in kind' disbursements, rather than with cash raised through the usual funding operations.

To express all costs of lending in a single rate, the ESM computes so-called blended lending rates. The blended rate reflects the overall lending rate, including the rate for back-to-back funded loans and pool-funded loans, and includes margins and fees. The evolution of the blended lending rates is a result of movements in the cost of funding, disbursements or repayments of loans, as well as decisions to adjust fees or margins.

Figure 3.8  
Budgetary savings from EFSF/ESM financing  
(in % of GDP)



Source: ESM calculations

**The EFSF/ESM financing brings sizeable budgetary savings for programme countries.** Figure 3.8 shows two illustrative exercises comparing budgetary savings from EFSF/ESM financing compared to hypothetical alternatives in which the additional gross financing needs would be met from market borrowing or from the IMF. In practice, neither option would have been feasible, but the calculations give an estimated lower bound of the potential overall impact of advantageous EFSF/ESM financing. Budgetary savings with respect to alternative market financing were highest for Greece (over 5% of GDP a year by 2015-2016), even though the calculation only includes the second programme, and sizeable for Cyprus. They were lower for Ireland and Portugal, given higher lending interest rates, and also for Spain, given lower

disbursed amounts as a percentage of GDP. Compared to a hypothetical scenario in which the full amount of assistance was provided by the IMF, or if the EFSF and the ESM had followed IMF’s pricing strategy, savings are significant for most programme countries.<sup>64</sup> It should be stressed that these calculations are approximate given uncertainty related to the counterfactual scenarios.

### 3.6. Financial sector repair

**Multiple causes led to the financial sector crisis experienced in European countries at the end of the last decade.** Programme documentation identifies the drivers relevant for the financial sectors in programme countries (Figure 3.9).<sup>65</sup> The causes can broadly be described as economic and institutional, domestic and foreign. On the economic side these were low growth, the bursting of a credit and housing price bubble, and government indebtedness. Also, in some cases, the high debt of households or firms was a contributing factor as it constrained their repayment capacity. In addition, oversized banking sectors led to stiff competition and the low profitability of banks. It therefore undermined their viability as the economic environment became more difficult. Institutionally, weaknesses in corporate governance structures and supervisory practices were the root cause of excessive lending in the years prior to the crisis. The economic and institutional problems were mostly home-grown. However, cross border spillovers from sovereign crises in other countries also had a direct impact on financial stability. More specifically, in the case of Cyprus, the Greek debt restructuring had a direct impact on its banking system. The crisis situation across Europe affected investor sentiment, banks’ ability to lend at affordable rates, and peoples’ willingness to borrow across borders.

**The causes of financial instability shaped the structure and timing of financial sector reforms.** As such, a specific financial sector repair strategy was designed for each programme, with objectives targeting three important aspects of the financial sector, namely, bank liquidity, capital adequacy and asset quality, and governance – in particular strategies for coping with increasing levels of NPLs.

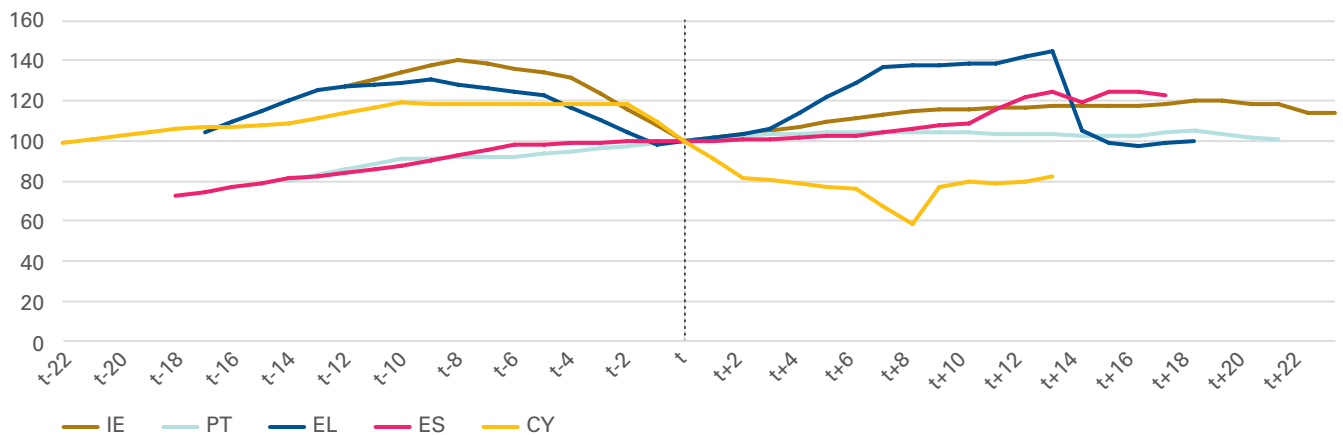
Figure 3.9  
Drivers that led to the need for financial sector repair

| Drivers  | IE | PT | EL | ES | CY |
|--|----|----|----|----|----|
| Weak corporate governance  |    |    |    |    |    |
| Weak financial supervisory practices                             |    |    |    |    |    |
| Slowing GDP growth   |    |    |    |    |    |
| Fast loan growth, real estate bubble, and poor lending practices |    |    |    |    |    |
| Overindebtedness of the private sector                           |    |    |    |    |    |
| Oversized banking sector   |    |    |    |    |    |
| Overindebtedness of the public sector                            |    |    |    |    |    |
| Contagion  |    |    |    |    |    |
| from the banking sector to the sovereign                         |    |    |    |    |    |
| from the sovereign to the banking sector                         |    |    |    |    |    |
| from other sovereign   |    |    |    |    |    |

Note: Timeframe used is one year prior to programme request.  
Source: ESM compilation, as identified in programme documentation

**As a first step, liquidity constraints were largely addressed via emergency measures taken by the Eurosystem.** Adequate buffers built into the financial sector envelopes contributed to improving confidence in the viability of banking sectors and thus the liquidity situation. The ESM played a vital role by authorising banks to use EFSF/ESM bonds as Eurosystem collateral. Private sector deposit runs ceased following the initiation of their respective programmes, with the exception of Cyprus, where private deposits suffered another negative shock. However, this can be attributed to the loss of confidence arising from the uncertainty surrounding the third Greek programme and its potential spillover effect to the Greek subsidiaries in Cyprus (Figure 3.10).

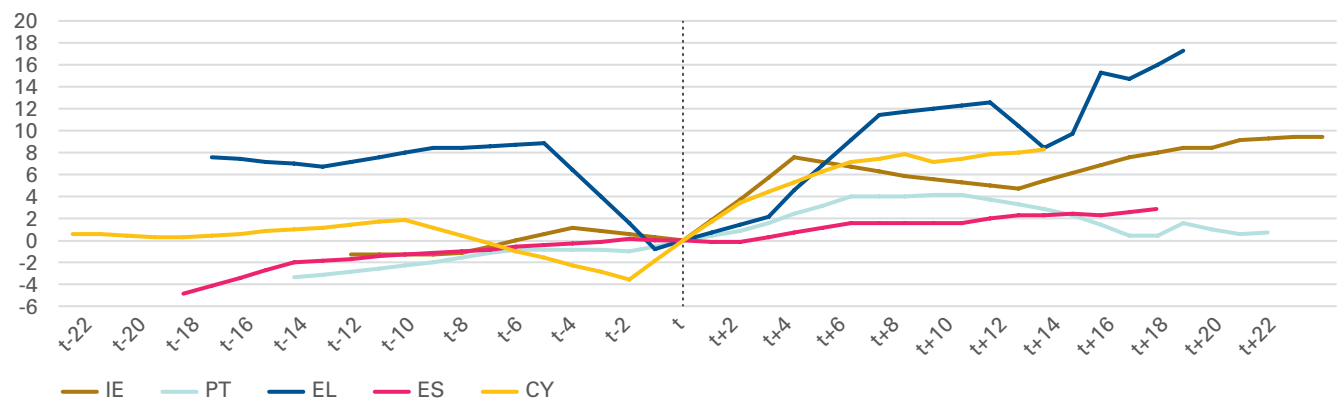
**Figure 3.10**  
**Private sector deposits before and after the initiation of the programme**  
 (t=100%, horizontal axis in quarters)



Sources: Bankscope, SNL, ESM calculations

**All financial assistance programmes contained measures to address problems related to banks' capital adequacy.** There were two reasons for this. In one case, there was a need to preserve existing levels of solvency against potential negative macro-developments identified as part of stress-test exercises as was the case in Portugal and Spain. In the other, capital had already eroded and first needed to be restored, as was the case for the Greek banks following the sovereign debt restructuring, which became known as the PSI. A high formation of NPLs also increased the need for additional recapitalisation actions, such as for Irish, Cypriot, and eventually, Greek banks (Figure 3.11).

**Figure 3.11**  
**CET1 ratio - change before and after the programme initiation**  
 (in percentage points, t=0, horizontal axis in quarters)



Sources: Bankscope, SNL, ESM calculations

**At the start of each country programme, the potential risks to the respective banking sector’s capital adequacy differed, which influenced the design and speed of the recapitalisation.** In some cases recapitalisations were front-loaded and thus executed at the early stages of the programme, which contributed to an up-front improvement in depositor and investor confidence. The ESM internal survey and respondent testimony show, however, that this approach also contributed to a loss of leverage by the creditor institutions to request necessary follow-up measures, given that the bulk of the financial envelope had already been disbursed for the purposes of the recapitalisation. In Spain, the financial sector conditionality was met diligently. This may reflect the different nature of the instrument and programme ownership. In other cases, recapitalisations were conducted at a later stage, but the capital-raising deadlines set by the national supervisors were tight due to the degree and urgency of the banks’ solvency risks. This may have contributed to investors requiring a lower price to attract a sufficient amount of private capital by the given deadline.

**Programme objectives regarding banks’ capital adequacy were also influenced by the evolution of EU-wide regulatory changes.** Those that most influenced the capital adequacy objective were the introduction of burden sharing, the increase of minimum capital requirements and associated stress tests adopted since the establishment of the Single Supervisory Mechanism. Respondents also said that the shift to bail-ins contributed to increased efficiency in the use of the financial sector envelope, given the lower potential need for the state to intervene in the funding of a troubled bank. The shift to a bail-in approach should reduce the need for state intervention and lead to a more efficient use of public resources.

**All financial sectors in programme countries suffered from poor asset quality but to varying degrees.** Many factors drove poor asset quality including, but not limited to, poor lending practices, prolonged supervisory forbearance, deteriorating economic conditions, overly debtor friendly legislation leading to moral hazard, lack of profitability and/or capital adequacy to enable sufficient provisioning.

*“In this kind of crisis situation, banks are always part of the problem.”*

*—Evaluation interviewee*

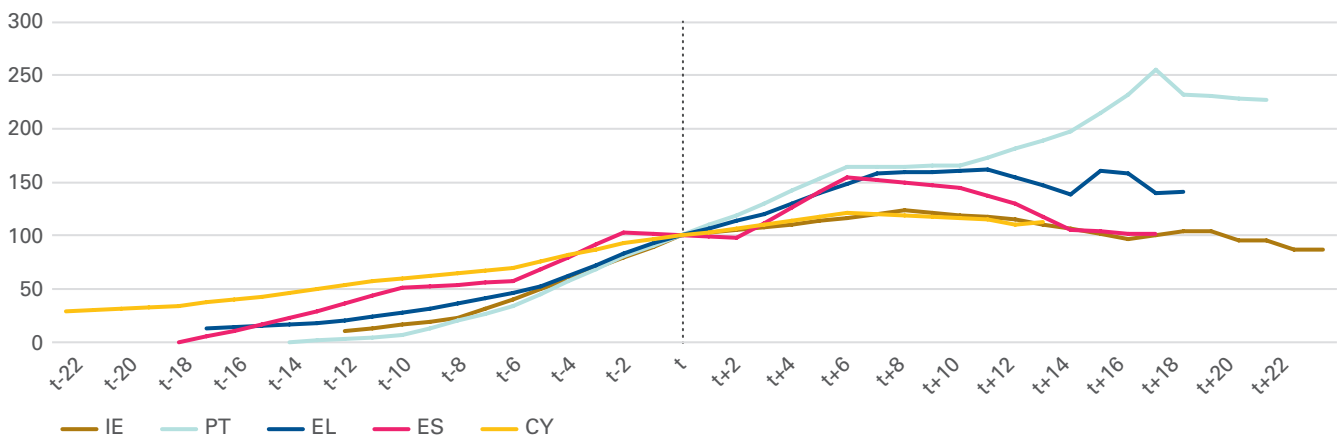
**The build-up of NPLs and lack of timely action to resolve them underlined weak bank governance in many programme countries’ banking systems.** In cases where NPLs stemmed from one specific loan segment, high NPLs can be attributed to risky bank lending activities, indicating inefficient internal controls and procedures on loan origination. In other cases such as Greece, NPLs stemmed from all loan segments due to the prolonged recession, reducing borrower capacity to repay, as well as ineffective judicial and legislative systems leading to moral hazard. Banks were also ineffective at working out their large NPL stocks. This stemmed from a lack of expertise and weak institutional set-up, such as, a lack of adequate NPL work-out divisions within a bank, inefficient internal reporting lines to banks’ credit committees, and a lack of a secondary market for NPL sales. It has been difficult to address governance with programme conditionality. Privately owned banking institutions are not direct signatories to the relevant MoUs; this was tackled indirectly via conditionality enhancing supervisory oversight and intervention powers.

**The multiple causes of high NPLs highlight the need for comprehensive NPL management strategies,<sup>66</sup> but in practice the implementation record is mixed.** Comprehensive NPL strategies were designed under all programmes, but the implementation of these measures has varied. In certain programme countries, such as Ireland and Spain, the implementation of the NPL strategy was more efficient, but in others, such as Greece and Portugal, NPL strategy implementation was considerably delayed or has only been partially implemented (Figure 3.12).

**Targeted NPL solutions proved effective in programme countries where high NPLs were concentrated in a single sector.** In Ireland and Spain, Asset Management Companies (AMC) were used to relieve banks' balance sheets of specific troubled assets, such as NPLs stemming from land and development loans or mortgages. However, in Greece and Cyprus where NPLs stemmed from all loan segments, AMCs were not part of the solution under the programmes. Rather, focus was placed on improving banks' internal work-out capacity and reforming the overall insolvency and judicial systems.<sup>67</sup> The benefits of the latter approach, however, take a longer time to materialise (Figure 3.12).

Figure 3.12

**Change in net NPLs before and after the initiation of the programme**  
( $t=100\%$ , horizontal axis in quarters)



Sources: Bankscope, SNL, ESM calculations

**The above factors created a vicious circle between banks and sovereigns across programme countries.<sup>68</sup>** Programme documents and economic studies provide significant evidence of this phenomenon. The vicious circle can be explained by the deterioration of asset quality. When real estate bubbles decelerate or burst, economic growth prospects become more subdued and households and firms face problems servicing their loans. The value of bank assets, collateral and profits decline. This often led governments to step in, offering state guarantees and public funding for recapitalising banks. Increasing sovereign liabilities, explicit and implicit through guarantees, in turn undermined the credit standing of the sovereign. As a consequence, this forced banks to reassess the quality of government debt which they were holding on their balance sheet. As described above, in many instances it was not actual strains on banks which caused this but people's doubts and lack of confidence. A key challenge of the programmes was therefore to pre-empt the emergence of a vicious circle, or to create at least sufficient confidence to stop it.

**Financial sector repair has been one of the main components of the financial assistance programmes.** Financial sector repair has consumed substantial portions of the overall EU financial assistance envelopes,<sup>69</sup> amounting to 49.6% for the five programmes. In Spain, the assistance package was fully dedicated to the financial sector. However, many respondents said that in full programmes encompassing fiscal, structural, and financial reforms, the focus on financial sector repair tended to be a secondary priority. Therefore, in full and even pure banking sector programmes, a frontloading of corrective actions regarding financial sector issues was warranted.

**Upfront recapitalisations created credibility for the programmes.** However, it created disincentives for the banks to address their legacy issues and left significantly less traction for the implementation of further conditionality. This is reflected in the different exit practices. At the end of the programme, Irish authorities conducted a Balance Sheet Assessment (BSA)/Asset Quality Review (AQR) to justify the stability of the financial sector, whereas in Spain, the programme ended without a comprehensive assessment.<sup>70</sup>

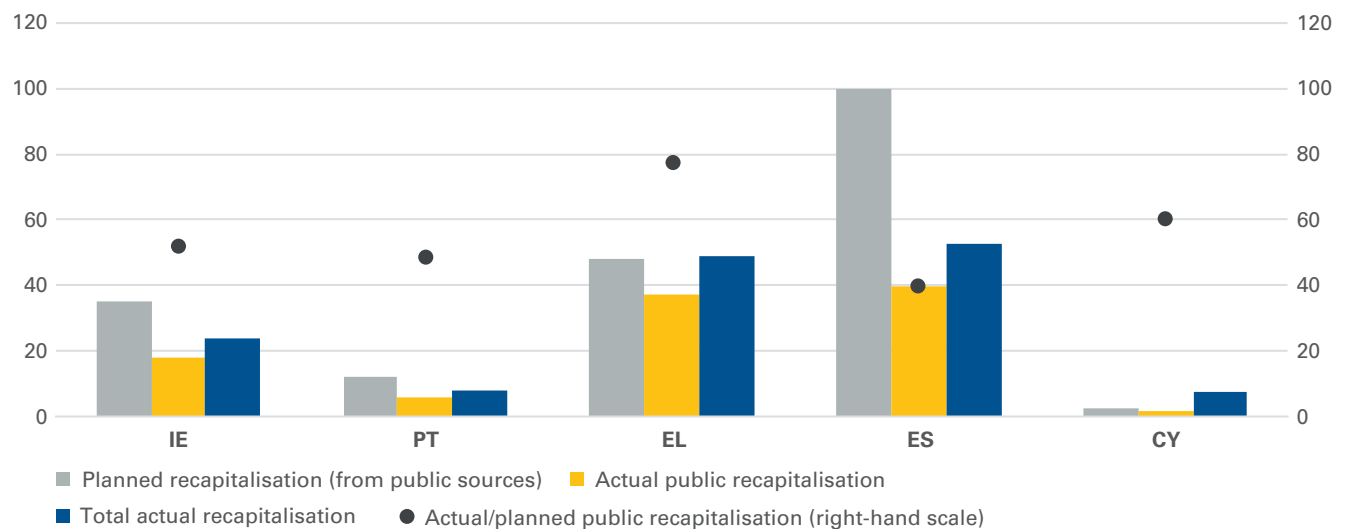
**The role of buffers for recapitalisation and resolution built into the financial sector envelopes were useful in restoring confidence, but their estimation, which reflected a high level of uncertainty, could not always ensure full transparency.** Buffers have ensured available financing is in place for unexpected needs and have helped create flexibility for banking sector stability. The flexibility was useful in particular for the financing of bank resolution, which is typically harder to foresee and has to be addressed in a rapid and discrete manner in order to stem a sudden loss of confidence in the system. Nonetheless, the estimation of buffers within financial sector envelopes was not transparent in all cases.

**The overall methodology for the estimation of financial sector envelopes varied over time.** The applied strategies were defined on a case by case basis. In certain cases, the authorities conducted a top-down assessment to identify capital shortfalls. There are examples where this top-down approach was complemented by a bottom-up exercise as well as the bottom-up method being the sole approach (for more details, see Section 3.3). The size of the associated financial envelope was on average twice the actual recapitalisation from public sources (Figure 3.13). The difference between the planned recapitalisation need and the actual capital injection was the largest in Spain, where the programme envelope envisaged a €100 billion capital shortfall, which was eventually reduced to €39.7 billion because of returned unused funds. On the one hand, the relatively large buffer added costs for the sovereign, but on the other hand it was necessary to restore the confidence in the financial sector. As the macroeconomic cost of a lack of confidence is difficult to quantify accurately, it is not possible to conclude on the overall costs and benefits. The buffer was the smallest in Greece, reflecting the trade-off between the prudent estimate for the recapitalisation needs and concerns over the long-term sustainability of public debt.

Figure 3.13

**Initially planned envelopes vs. actual funding needs in the financial sectors**

(in € billion, right-hand scale in %)



Source: ESM calculations, based on the relevant MoUs and ex post evaluation reports

**Unused bank recapitalisation facilities were treated differently across programme countries.**

Depending on the instrument provided and the programme design, the unused amounts intended for bank recapitalisation were either re-shuffled and used for other purposes, cancelled or returned. Portugal and Ireland received the full amount of the financial assistance package, although they did not fully use the bank recapitalisation envelope. The unused amount thus became part of the countries' liquidity buffers (Section 3.3).

**EU regulatory changes regarding bank recovery and resolution shifted crisis management strategy to burden sharing of liabilities from public rescue.**

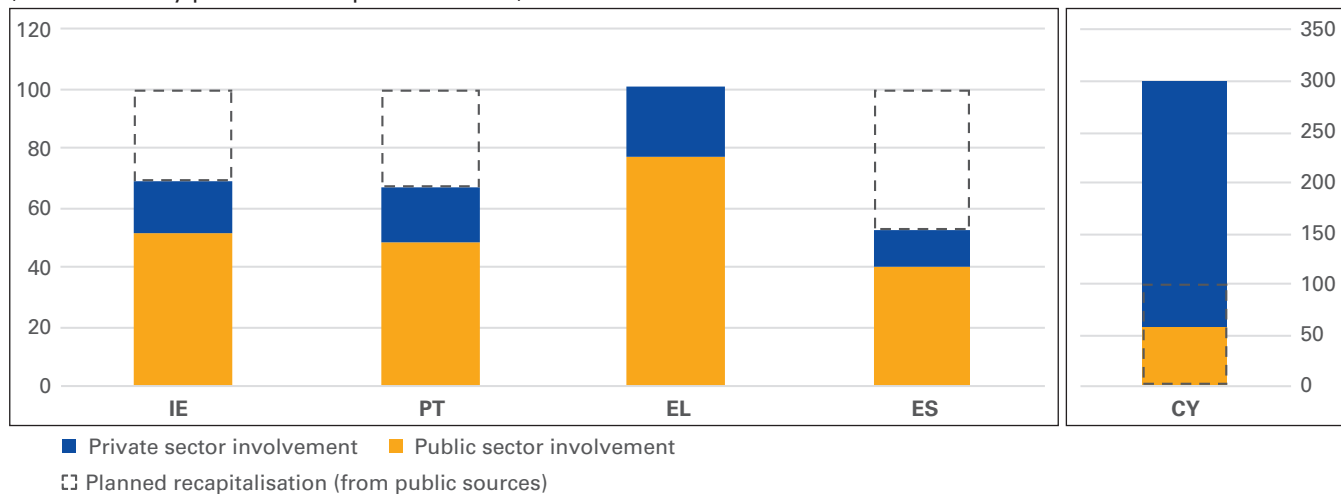
As the EU regulatory framework evolved, the financial sector strategy under the programmes was also adjusted. Prior to the introduction of the Bank Recovery and Resolution Directive (BRRD) in January 2016, the programme strategy included the role of the state as a backstop for financing potential recapitalisation needs when private investment fell short. In cases where privatisation proceeds were lower than expected due to the state's holdings in the banks subsequently deteriorating, this approach resulted in losses and thereby increased overall programme costs.

**Burden sharing helped reduce potential public losses.** The conversion of certain liabilities into equity as part of recapitalisations was applied prior to the full implementation of the BRRD due to a change in state aid rules in August 2013. Under the new rules, subordinated debt instruments had to be converted prior to the injection of state aid which reduced the amount of taxpayer money at risk.

**Although it reduced the potential amount of state aid, burden sharing was conducted in a non-systematic way.**

In Ireland and Spain, subordinated debt was converted. In Greece, both subordinated and senior debt were voluntarily converted into equity as part of the recapitalisation at more favourable terms than a mandatory conversion, yet reducing the execution risk of the process. On average for all programmes, 25% of the total recapitalisation amount was borne by private sector participants (Figure 3.14) through various means. In Cyprus, however, their involvement was significantly higher, at 80%, for

Figure 3.14  
**Public and private sector involvement in bank recapitalisations**  
 (in % of initially planned from public sources)



Sources: ESM calculations, based on the relevant MoUs and ex post evaluation reports

several reasons. First, bailing out the oversized banking sector was not feasible as it would have jeopardised the sustainability of the country’s public debt. Second, with the implementation of the BRRD, capital increases from public sources can only take place after a bail-in of private debt holders and uninsured depositors. Cyprus was the first programme country that underwent a full bail-in, which reflected BRRD arrangements that were going into effect.

**The timing of the approval of state aid and subsequent recapitalisation plans varied among programmes,<sup>71</sup> leading to uncertainty for the ESM.**

In a number of cases, EFSF/ESM financial assistance was used before the European Commission had approved banks’ restructuring plans. For the early programmes such as Ireland, delays lasted up to four years at one bank, but timing gradually improved over time. In the Spanish and Cypriot programmes, all the recapitalisations took place following the approval of the restructuring plans (Figure 3.15). Therefore, the risk of the EFSF/ESM injecting funds into financial institutions with potentially non-viable business models decreased over time.

**Where established, AMCs proved beneficial when they had a clear scope and objective.**

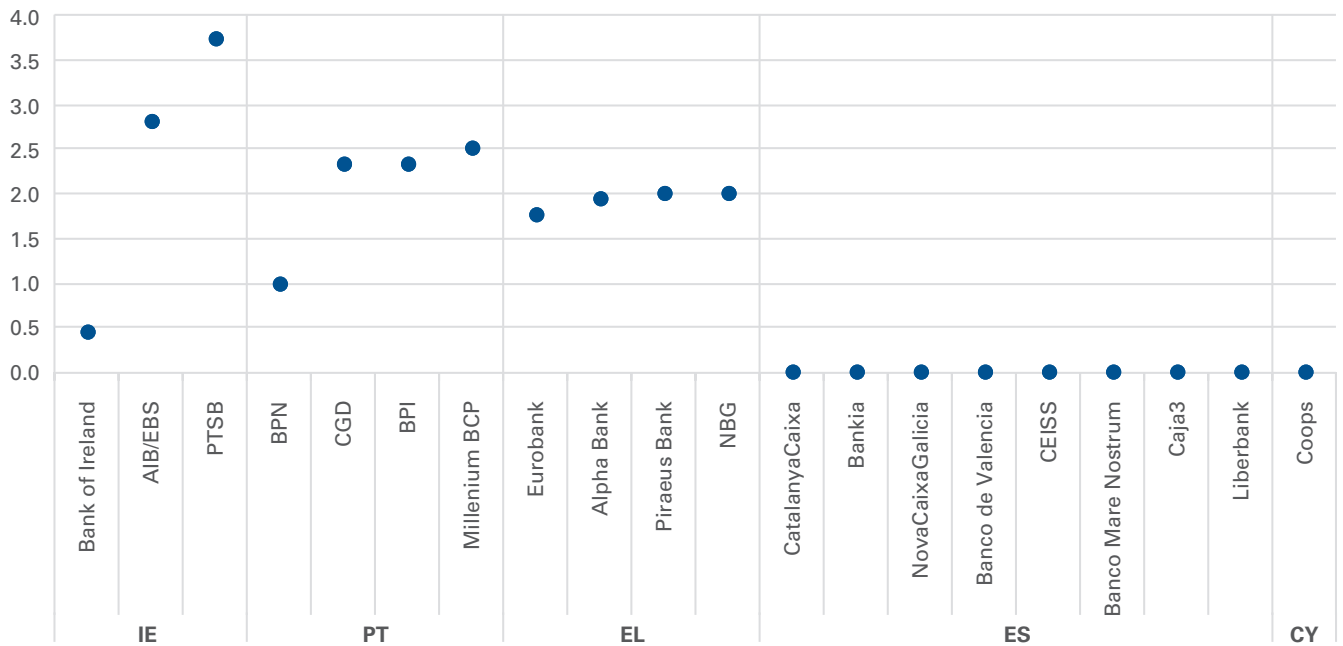
This was the case of the NAMA in Ireland and Sareb in Spain. In both countries, AMCs were deployed to help clean banks’ balance sheets of specific troubled assets. The AMCs’ success also hinged on the explicit prescription that Spanish and Irish banks needed to carve out toxic assets, which helped address disincentives banks may face when dealing with troubled loans.

**The banking sectors of programme countries eventually stabilised, however, profitability and asset quality remained an issue after programme exit. This highlights deficiencies in governance arrangements and, in some countries, NPL strategy implementation.**

Banking sectors under all programmes stabilised eventually, as measures to recapitalise banks, restore depositor confidence, enhance supervisory oversight, and improve banks’ corporate governance were mostly implemented. Despite these improvements, banking sectors have not yet been able to fully recover due to persistent legacy issues such as high levels of NPLs.



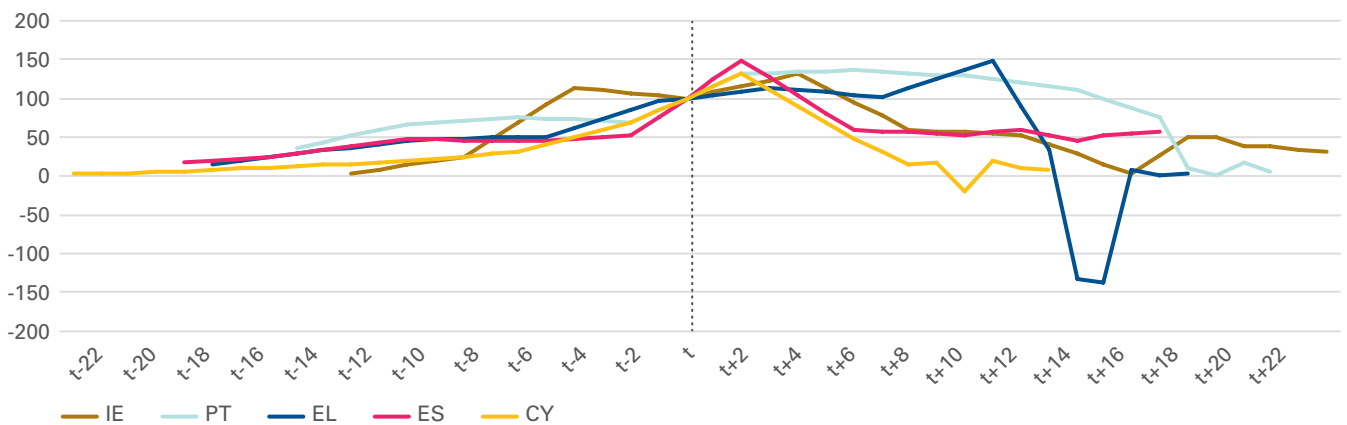
**Figure 3.15**  
**Time lag between the disbursement of financial assistance and the approval of state aid restructuring plans**  
 (in years)



Sources: European Commission State aid decisions, ESM calculations

**The recovery of the financial sector was faster when reform measures were implemented upfront.** In the Irish and Spanish banking sectors, where authorities reacted promptly, profitability reached its trough on average seven quarters after programme initiation and then stabilised (Figure 3.16). Both Ireland and Spain successfully implemented fiscal and structural reforms, which led to economic growth and supported the financial sector’s improving performance. In the other programme countries, banks are hardly breaking even and still suffer from high provisioning needs. A weak profitability outlook weighs on privatisation prospects and reduces the chances of recovering public investments in banks.

**Figure 3.16**  
**Change in banks’ operating profitability before and after the start of the financial assistance programmes**  
 (t=100%, horizontal axis in quarters)



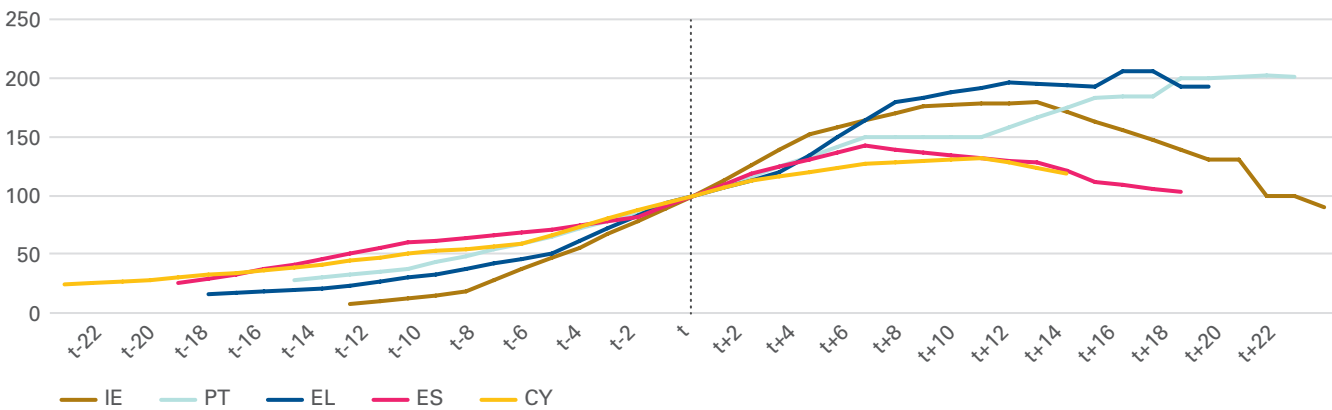
Sources: Bankscope, SNL, ESM calculations

**Comprehensive approaches for addressing crisis legacy issues proved more efficient.** The strategy to tackle financial sector problems covered every crucial step to facilitate the clean-up of banks' balance sheets both in Ireland and Spain. The upfront recapitalisation, the introduction or streamlining of insolvency and foreclosure frameworks, the creation of the legal background for loan sales as well as the set-up of bad banks were all part of the comprehensive strategy to reduce NPL formation and reduce the outstanding stock of NPLs. Some of these measures were implemented in other countries as well but in an isolated way. As a result, they could only deliver partial and less sustainable results. In Spain, NPLs started declining six quarters after the launch of the programme, while it took eight-to-10 quarters in Ireland and Cyprus (Figure 3.17). In June 2016, NPLs were still on the rise in Greece and Portugal, where – as mentioned earlier – the financial sector problems became apparent at a later stage and were treated in a less consistent way.

Figure 3.17

**Change in banks' gross non-performing loans before and after the start of the financial assistance programmes**

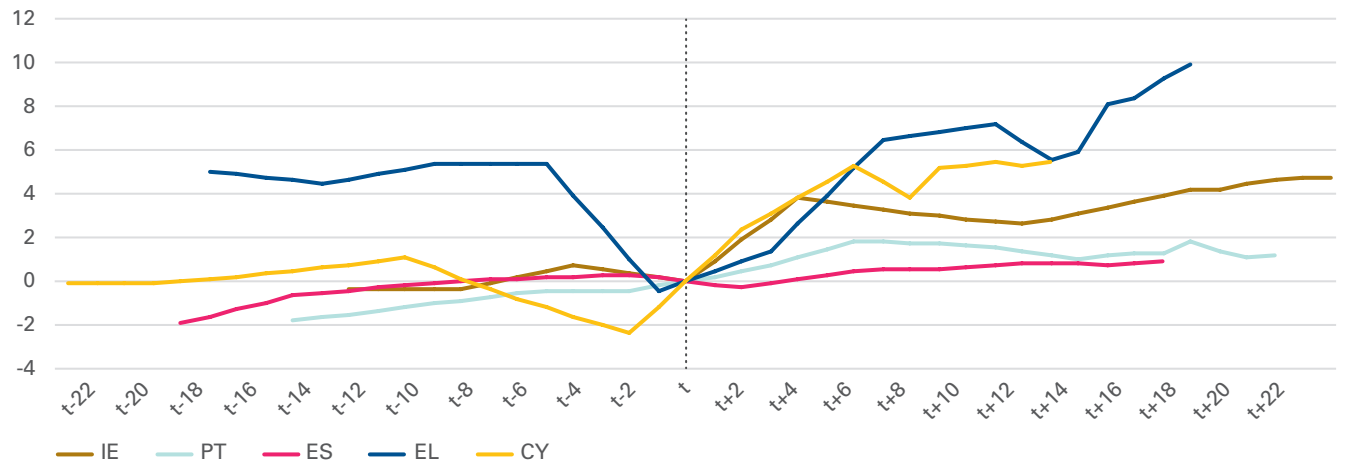
(t=100%, horizontal axis in quarters)



Sources: Bankscope, SNL, ESM calculations

**In countries where the financial assistance programme required substantial deleveraging, lending remained subdued.** Both supply and demand-side factors constrained new lending. As interest rates on lending increased to reflect the over-indebtedness of the private sector and an increase in overall risk in countries facing an economic crisis, it is also likely that demand for such loans also diminished. In the Portuguese banking sector deleveraging was less pronounced, while net lending declined considerably (Figure 3.18).

**Figure 3.18**  
**Leverage ratio – change before and after the programme initiation**  
 (in percentage points,  $t=0$ , horizontal axis in quarters)



Sources: Bankscope, SNL, ESM calculations



## 4. Programme exit and ensuring repayment capacity

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This chapter addresses whether the programmes had specific exit strategies, including how the need for any possible follow-up arrangement was assessed; how successful the programme exits were in restoring market access and how the repayment capacity is being ensured after the exit.

### 4.1. Planning the programme exit

**Exit strategies were not formulated in the initial programme plans and discussions on exit usually started as the expiry of the programme period loomed.** They typically began informally about three quarters prior to the expiry of each financial assistance arrangement, according to respondents.<sup>72</sup> At least initially, a majority of country officials and the EU institutions advocated for a follow-up arrangement. The European Commission and the ECB asserted that follow-up arrangements were justified as the countries in all the early programmes remained vulnerable to shocks post-exit. The ESM was also prepared to provide further support, had Members decided to grant further assistance, for example in the form of a precautionary credit line.

**While potential follow-up arrangements were discussed in each case, all countries, apart from Greece, made a “clean” exit.** Ireland was the first country to exit its programme. It set a model and precedent to follow, as it moved directly to market financing without requiring an additional safety net such as further official financing or a stand-by credit line (“clean exit”).

Figure 4.1  
Order of exit



Source: ESM

**Liquidity insurance and a continued focus on reform commitments drove considerations for a follow-up arrangement.** In two cases, the prospect of relatively cheap insurance against potential liquidity shocks after the prospective exit was the main driver of discussions. Both countries were wary of continued market uncertainties, although market conditions had started to improve. Some respondents said that in addition to backstopping financing needs, follow-up arrangements could have been an opportunity to maintain policy conditionality and ensure continued implementation of reforms. Some senior authorities stressed that when a country exits a programme, the quarterly review framework disappears and the government often starts facing demands to roll back reforms. Without a well-functioning national policy framework, such pressures are difficult to resist. One senior authority respondent advised planning this approach carefully, in advance.

**The possible, or perceived, political consequences of continued conditionality were the key factor motivating programme countries to reject follow-up arrangements, according to most respondents interviewed.**

Although some respondents regretted the easing up of pressure after programme exit, reform fatigue and change in electoral cycles meant further external scrutiny was not acceptable. Approaching elections also led some countries, such as Cyprus, to consider the exit option more favourably. Some countries under EFSF programmes were also concerned about market signals from the ESM's preferred creditor status should they have moved to a follow-up arrangement. A clean exit was also preferred by some non-programme countries.

**A precautionary credit line was the main option for a follow up arrangement considered in all discussions.**

It would have provided a safety net under less strict conditionality, and could have been politically more palatable. However, some respondents said that uncertainty on the type of conditionality they would face became a hurdle to making progress in domestic deliberations. Others thought that it might not be worth taking the risk of sending negative signals to the markets for a short facility.

**Some authorities said that the institutions did not show enough support in planning for the exit.**

For these authorities, the main target from the very beginning was to negotiate conditionality that would best support access to market financing. Other authorities said that they proactively approached the institutions regarding programme exit well before the end of the programme.

#### 4.2. Regaining market access

**One of the fundamental objectives of EFSF/ESM programmes is ensuring sustainable market access, which requires building sufficient credibility.**

Implemented successfully, it allows countries to finance their needs through the capital markets once again under conditions that do not jeopardise debt sustainability. Four programme countries regained or maintained market access during the programme period. Ireland managed to regain access to markets in the second year of the programme. Portugal started to issue larger amounts of medium- and long-term bonds after two years. Cyprus focused on medium-term bonds in the second year and issued longer maturities in the third year. In contrast, Spain was able to maintain its access over the whole programme period. Greece returned to the market in the third year, but only for shorter maturities and its access proved only temporary.

**The circumstances of programme exit varied significantly across countries.**

Some exited after successful programme reviews without delays or setbacks (Ireland, Spain) while others exited their programmes without concluding the final review (Portugal, Cyprus). As illustrated in Chapter 2, programme countries considerably improved those economic fundamentals relevant for regaining market access, such as underlying fiscal position and growth performance. Stabilising the economies of programme countries, including their financial sectors was a necessary, but not sufficient precondition for a clean exit.

**The accumulation of sizeable cash balances was a key part of exit strategies.** To support investors' confidence, programme countries followed an objective to cover six-to-12 months of financing needs by a cash buffer.<sup>73</sup> Respondents agreed that the cash buffer was an important confidence-boosting factor for bond sales. It also helped to build confidence with the programme partners in the euro area. Programme strategies to manage such buffers differed according to the type of programme. The Irish, Portuguese, Cypriot and Greek general government cash balances or primary cash balances were monitored via performance criteria. The Spanish programme was banking sector-focused so the government cash balance was not monitored under the programme.

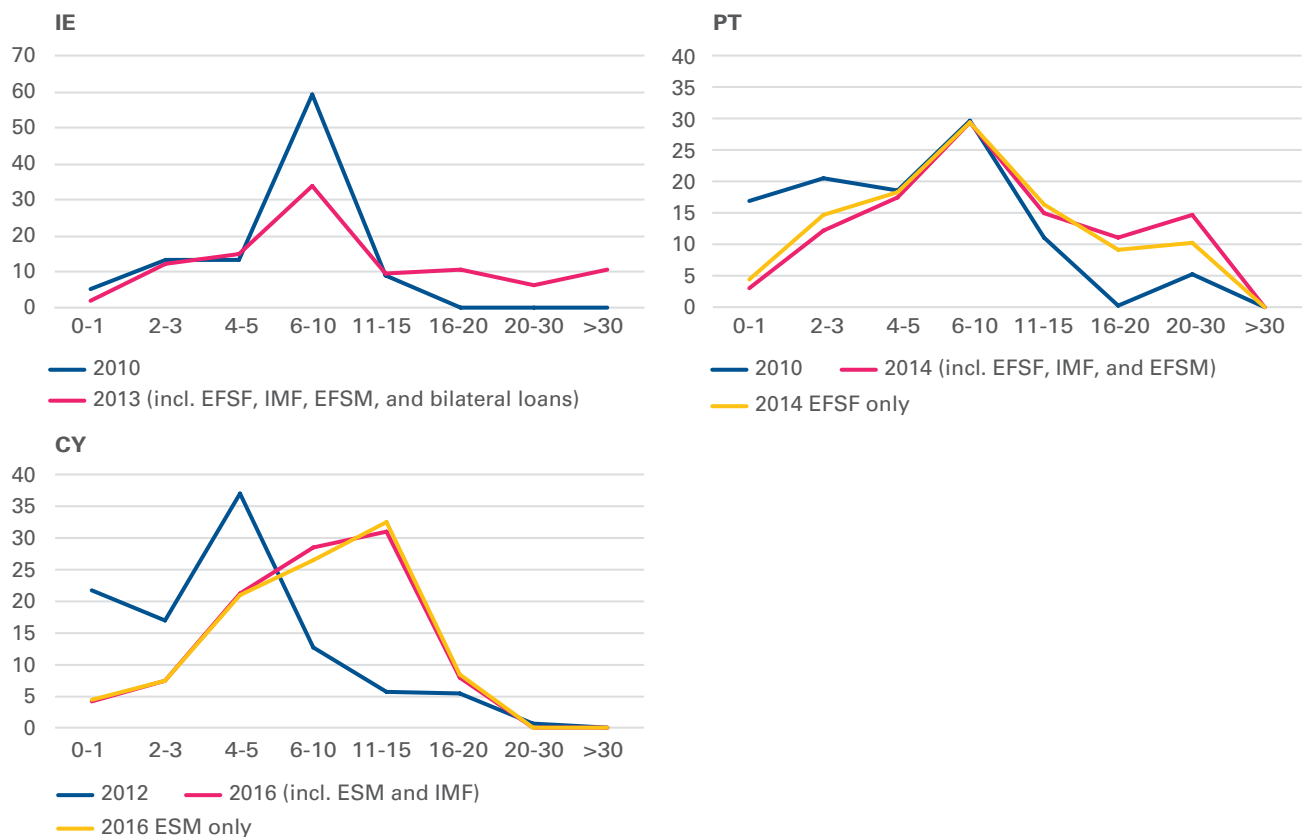
*"Building cash reserves was important in accessing markets and for prudence."*

—Evaluation interviewee

**Debt management offices also strove to diversify their investor base as they approached the expiry of the programmes.** They were strategically targeting investors whose strategies were to buy-and-hold the securities until maturity, while also tapping existing bond series to seek investors looking for liquid assets. Moreover, initially there was also a focus on domestic niche investors. Portugal focused on retail investors while Ireland launched amortising bonds, which enjoyed high demand from pension funds.

**Long maturities of EFSF/ESM loans and their extensions facilitated re-accessing the markets.** EFSF/ESM lending conditions had a major positive effect on the maturity structure of debt in all five programme countries. They smoothed repayment profiles, and thus reduced refinancing risks and positively influenced market perceptions.

Figure 4.2  
Maturity structure prior to and after extensions  
(in %)



Notes: For Spain, the maturity structure is little affected as the amounts disbursed are relatively small in relation to total debt. For Greece, the PSI distorted the change in maturity structure and data on post PSI extensions are not available. Sources: Debt management offices, ESM calculations

- **Ireland and Portugal** were granted maturity extensions for their EFSF liabilities, following those previously granted to Greece, supporting their ability to issue on the international capital markets towards the end of their programmes.<sup>74</sup> These extensions increased the average weighted maturity of EFSF loans to almost 21 years from 14 and brought down the high concentration of maturities in the six-to-10-year period (Figure 4.2). The extension also reduced the Portuguese short-term refinancing burden considerably around its EFSF programme exit. Interviews with debt management officials indicate that the 2013 maturity extensions changed market perceptions about economic prospects for Ireland<sup>75</sup> and, in particular, Portugal.
- The availability of long-term maturities of ESM financial assistance reduced **Cypriot** refinancing risks considerably. Cypriot market financing had been limited to relatively short-term market access. ESM financial assistance smoothed the redemption profile significantly moving the redemption peak by over five years into the future. New bond investors would therefore be financing a country with lower rollover needs in the first 10 years.
- In the cases of **Spain and Greece**, it is more difficult to disentangle the effects of various financing sources. Spain had continuous market access. Spanish interviewees nevertheless commented that the 12.5-year average maturity of the ESM support strengthened the maturity structure following concentration on short-term issuance in the run up to the programme. Greece had already benefited from longer maturities of the Greek Loan Facility and finally from the debt restructuring as a precondition for the EFSF programme. A more detailed analysis is constrained by the limited availability of fully comparable data.

**The risk of failure of the first bond sales was initially a concern in each country, given prevailing market uncertainties.** As they gradually regained market access, each programme country issued bills, syndicated bonds rather than auctioning them, gradually extended maturities and built cash buffers with the goal of regaining credibility. Some respondents said that Ireland and Spain had considered the option of using the ESM's primary market purchase instrument to reduce the risk of failed auctions. The potential benefits of using this instrument did not outweigh the political cost and negative signalling effects. The run-up to exit was challenging for the countries that exited first (Ireland, Spain, and Portugal). Respondents judged both the Banking Union announcement and Ireland's ability to sell non-performing bank assets as important factors supporting Ireland's return to full market access.<sup>76</sup>

**Accommodative monetary policy, and unconventional measures in particular, supported countries' market access.** The ECB's announcement of the Outright Monetary Transactions had a major positive impact on market confidence in the euro area sovereign bond market. Later on, its public sector purchase programme helped stabilise market access as it created strong demand for bonds of programme countries included in the purchases (Ireland, Portugal, and Spain). According to many respondents as well as the Commission, establishing the ESM also contributed to these favourable developments.<sup>77</sup>

#### Box 4.1: Indicators of market access

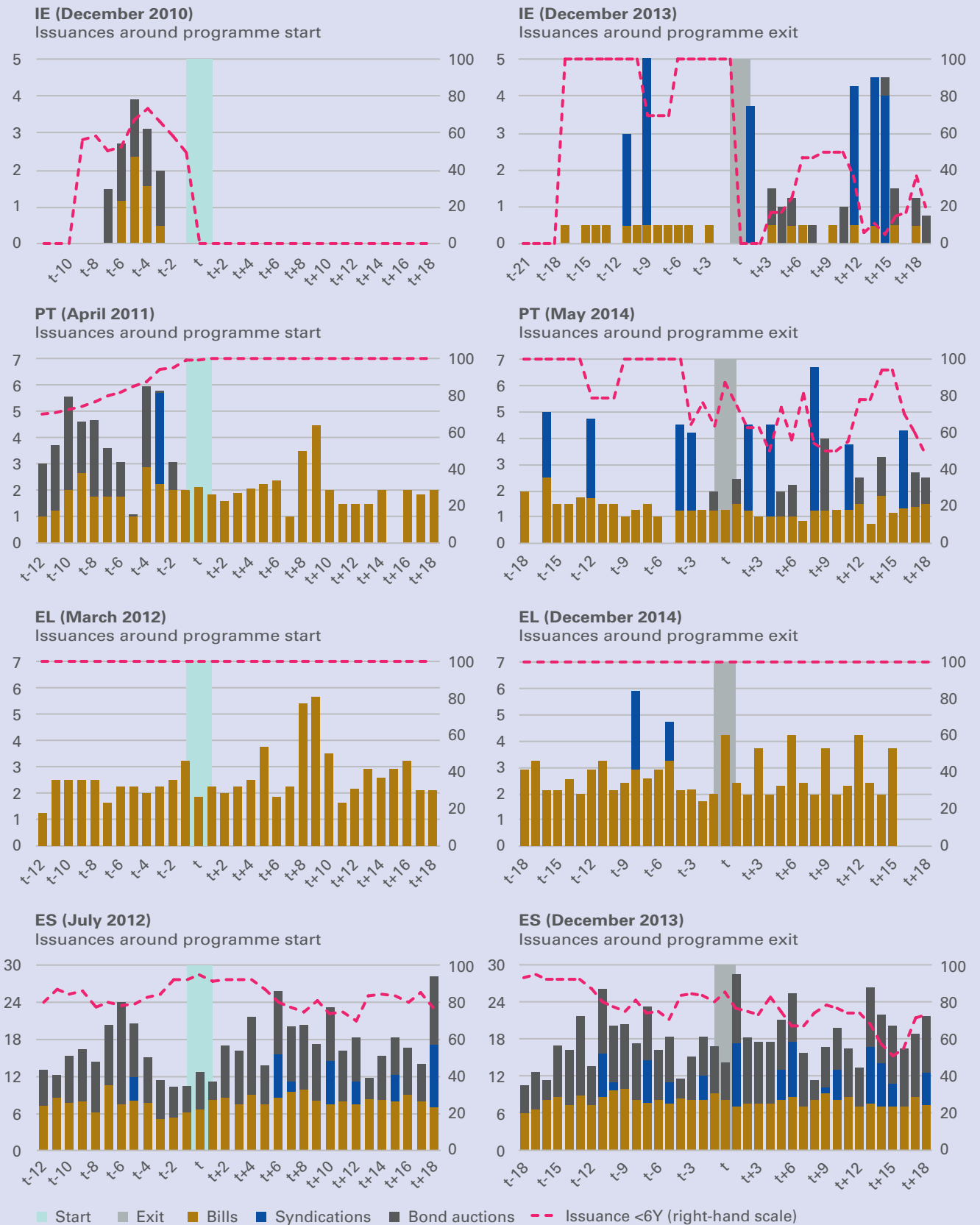
Quality of market access can be monitored using a broad set of indicators. We look here at the volume and maturity of new issuances and bid-ask spreads as indicators of the robustness of market access around the time of programme request and programme exit.

Figure 4.3 indicates that in the run-up to the programme, countries typically resorted to issuing at shorter maturities. By contrast, regaining stable market access is consistent with lower share of short-term issuances and increasing volumes.



Figure 4.3  
Market access around programme start and exit

(left axis in € billion, right axis in % of total, horizontal axis in months)

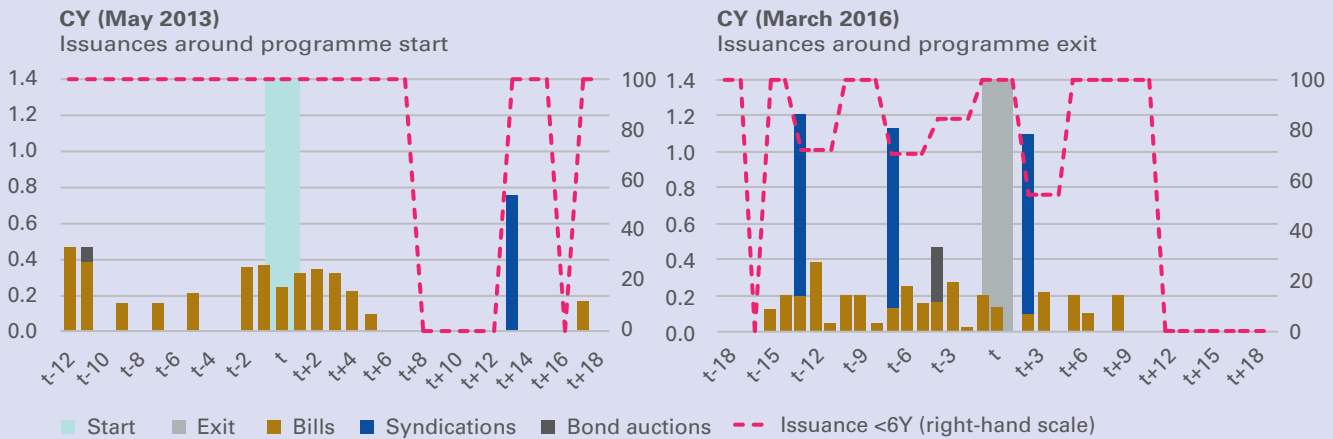


Sources: Bloomberg, Dealogic, ESM calculations

Figure 4.3 (continued)

Market access around programme start and exit

(left axis in € billion, right axis in % of total, horizontal axis in months)

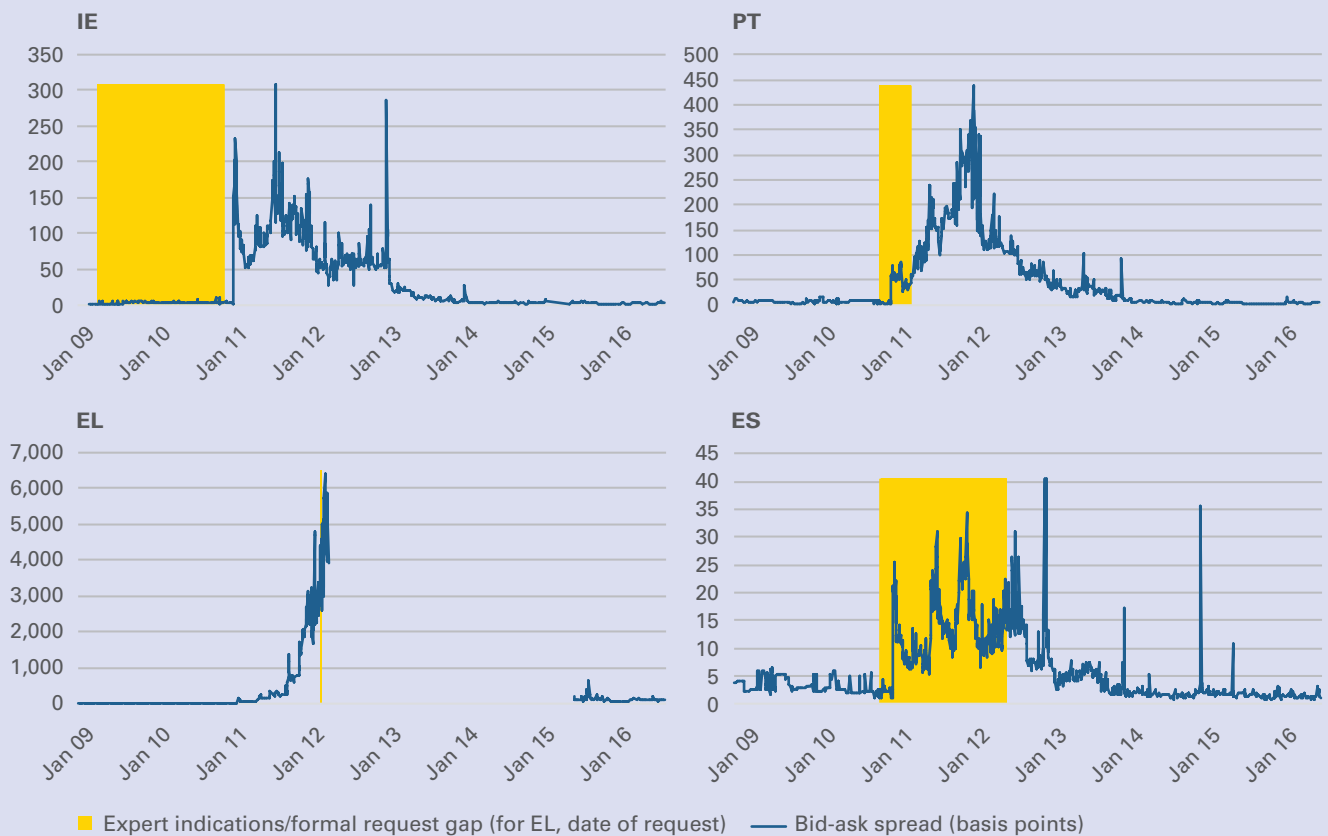


Sources: Bloomberg, Dealogic, ESM calculations

Bid-ask spreads in the secondary market, in short a difference between the highest price the buyer is willing to pay and the lowest price the seller is willing to accept, can provide an indication of liquidity in the market. Although the spreads can be affected by other factors, Figure 4.4 signals severe distortions in the sovereign debt markets in the period of losing market access. The yellow areas show a period from the first expert indications on the need to request the programme and the programme request. The normalisation of bid-ask spreads towards the end of the programme periods indicates improving prospects for regaining market access.

Figure 4.4

Functioning of the government bond market



Sources: Bloomberg, interviews conducted by the ESM

#### Box 4.2: ESM's technical cooperation in Cyprus

The ESM engaged in technical cooperation to support Cyprus regaining sustainable market access.

At the request of the Cypriot authorities, the ESM delivered technical assistance on debt management and NPL management. It advised the Public Debt Management Office (PDMO) of Cyprus on its core work and made recommendations to the Cypriot Treasury on how to assess and manage the risks of its government guarantees and also analysed those risks itself. Specifically, the ESM focused on optimising the PDMO's core work and strengthening its risk management. The ESM assisted the PDMO in defining its organisational structure, including on information technology infrastructure, internal controls, and staffing. It also looked at enhancing its market intelligence function, covering investor relations and the communication of market information. Part of the work was done jointly with the IMF.

The ESM's technical assistance is complementary to other institutions within its area of expertise. On the European level, the European Commission provides technical assistance to stakeholders to help implement Commission-funded programmes and projects. Under the European Union's cohesion policy such financial support can be used to pay for preparation, management, evaluation, monitoring, audit, and control. Capacity development through technical assistance and training is a core activity of the IMF, together with surveillance and lending.

Technical assistance is not linked to any policy conditionality but it requires development of an in-depth understanding of a particular member's institutional set-up and practices, as well as building strong working relationships. The Cypriot authorities expressed support for continued engagement at this level.

Unlike some of the other regional financing arrangements (Asean +3 Macroeconomic Research Office, Arab Monetary Fund, Eurasian Fund for Stabilisation and Development), the ESM does not have a specific mandate for technical cooperation. These activities were conducted on the basis of the ESM's institutional cooperation mandate and its financial assistance framework.

#### 4.3. Ensuring repayment capacity after exit

**The EFSF/ESM relied mainly on information exchange with the programme countries and partner institutions to ensure repayment capacity.** The programme relationship continues as long as financial assistance remains outstanding because the programme country is obliged to repay the financial assistance provided. Mindful of the sovereign context, the EFSF/ESM contractual lending framework expresses a measure of confidence. The contract terms, agreed by all member countries, are based on standard commercial lending contracts, leaving out some clauses. And though some event-of-default clauses apply, these are not used lightly in a sovereign context. To ensure repayment capacity, the EFSF and ESM therefore mainly rely on information provided by the programme countries through contractual information undertakings and the Early Warning System (EWS).

**Countries exiting the programmes are subject to post-programme surveillance.** The ESM Treaty<sup>78</sup> attributes post-programme surveillance tasks to the European Commission, and EU law<sup>79</sup> stipulates that the Commission conducts post-programme review missions in liaison with the ECB. In addition, the ESM Treaty provides for the establishment of an EWS to ensure that the ESM receives repayments in a timely manner. For reasons of efficiency, the institutions organise their post-programme and EWS missions jointly.

**The ESM can adequately monitor a country's ability to repay, but the role of the EWS is only that of a signalling device.** The EWS relies on moral suasion, peer pressure, and the powers of other institutions to achieve its purpose. Most Board respondents said the ESM adequately monitored programme countries' ability to repay. Respondents said that the EWS monitors but does not manage repayment capacity. They added that countries would be unlikely to support post-programme policy changes for the sole purpose of ensuring repayment capacity. A high-level official said the ESM Managing Director should notify the Eurogroup if he identifies risks to a country's ability to repay, and advise ministers of potential financial risks for the ESM's shareholders. A few respondents recommended that the ESM produce regular debt sustainability assessment updates, including information on cash buffers, market access conditions, and financing needs.

**The EWS did not pose an excessive administrative burden itself, but it added to other international surveillance frameworks.** There was broad consensus among respondents that the ESM needs to minimise the administrative burden of the EWS on member country authorities. The EWS is based on standardised data provision requirements, but in some cases it required additional enforcement efforts. Requests for confidential information should be carefully calibrated and duly justified. Some respondents pointed to the fact that certain types of information like cash projections are very volatile and therefore unreliable. Also, for reasons of efficiency, overlaps should be avoided between the activities of the European Commission and the ESM, while ensuring proper information sharing.

**The ESM needs to cooperate with other institutions as much as possible.** Some respondents stressed the importance of cooperation with the European Commission and the ECB, not only to enhance efficiency but highlighting the ESM's reliance on the information provided by these institutions. This further strengthens the case for establishing formal agreements on data provision between the ESM and the partner institutions as mentioned in Section 5.1. The IMF Independent Evaluation Office has also raised this issue.<sup>80</sup>

**Many authorities said that the euro area would benefit from a stronger preventive capacity.** Respondents raised this issue in the context of the EWS. The ESM's repayment capacity monitoring framework does not respond to this aspiration as it is not designed to prevent the rollback of reforms or address vulnerabilities in non-programme countries. In addition, the current monitoring and enforcement mechanisms did not prevent waning reform momentum towards the end of programmes and a standstill, if not reversal, of reforms after the programme exit in some countries.

**Box 4.3: ESM's Early Warning System**

According to Article 13(6) of the ESM Treaty, "The ESM shall establish an appropriate warning system to ensure that it receives any repayments due by the ESM Member under the stability support in a timely manner". The objective of the EWS is to determine the ability of the ESM Member to repay its obligations. This requires a regular assessment of the short-term liquidity position of the sovereign, its market access, the medium-term economic and financial outlook, and the long-term sustainability of public debt. It also requires an assessment of banking developments whenever relevant to assess repayment flows. Moreover, it takes into account and complements the fiscal and debt sustainability analysis that is provided by the European Commission and the ECB to the ESM during the programme and post-programme period.

ESM Members decided in December 2013 that the EWS system should not only apply to ESM programme countries (Spain, Cyprus), as foreseen in the Treaty, but also to EFSF programme countries (Greece, Ireland, Portugal).

In February 2015, the ESM Board of Auditors recommended improvements to the implementation of the EWS. The ESM subsequently prepared an updated EWS procedure following consultation with the ESM Members which the ESM Board of Directors approved on 4 February 2016. The updated EWS switched reporting to a quarterly pattern from the former irregular, payment-dependent reports. It required an expanded analysis of liquidity projections and medium-term outlook, the specification of information requirements related to cash flow data, and an assessment of the medium- and long-term economic and financial outlook.

The EWS is a process that feeds information into the ESM internal risk committee. When the committee identifies a repayment risk, it escalates it to the Board Risk Committee and subsequently, if needed, to the Board of Directors. So far, the EWS procedure has been escalated for two countries.



# 5. Institutional framework

This chapter assesses the following: whether the framework governing the cooperation was adequate; the EFSF/ESM role in programme activities, especially the effectiveness of coordination with other partners; and how well internal ESM processes functioned.

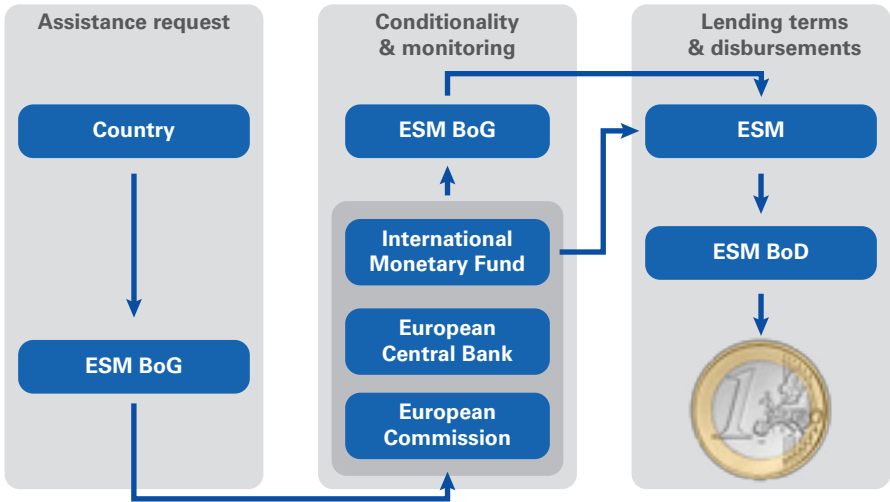
## 5.1. Governance of EFSF and ESM programmes

**The ESM provides stability support via financial assistance programmes that are conducted jointly with the partner institutions.** As illustrated in Figure 5.1, the ESM Treaty assigns tasks to the ESM Board of Governors (BoG, comprising all euro area ministers of finance), the BoD, the Managing Director, the European Commission, the ECB, and wherever possible, the IMF.<sup>91</sup> The BoG takes key decisions by unanimity. These include approving programmes, changing the authorised capital stock or the list of instruments, and admitting new ESM Members. It takes other decisions by qualified majority. The BoD takes decisions, mostly by qualified majority, on topics such as the disbursement of tranches or the adoption of instrument guidelines. The most important tasks assigned to the European Commission are to negotiate conditionality with programme countries, to assess risks to financial stability, debt sustainability and potential financing needs prior to programme approval by the BoG, and to monitor and report on compliance. The ECB is tasked with liaising with the Commission on some of these activities, and where possible the IMF is involved as well. The Managing Director conducts the current business of the ESM. In practice, several national parliaments also play a significant role in decision-making processes, based on different arrangements within the Member States.

*“The partition of who does what between programme partners could be more efficient.”*

—Evaluation interviewee

Figure 5.1  
Governance structure of ESM programmes



Source: ESM

**The institutional framework governing the cooperation between the EFSF/ESM and partner institutions worked reasonably well but its complexity had some adverse consequences with regard to coordination and information sharing.** The joint nature of the programmes required a strong alignment of objectives among the partner institutions. This posed challenges for all the institutions given that they have diverse mandates and are accountable to different stakeholders. These challenges have also been highlighted in reports by the European Parliament<sup>82</sup> and the IMF.<sup>83</sup>

**Programme governance faced a multiplicity of stakeholder interests that were difficult to crystallise in a consistent strategy.**

- **Despite extensive coordination efforts, the institutions did not always speak with one voice.** Many respondents from programme countries said that the institutions communicated different messages and pursued different priorities. Examples of this include attempts to impose the implementation of EU legislation, addressing competition concerns, protecting balance sheets, or insufficient consideration for the limitations posed by operating in a currency area. They underlined that other instruments are available for the pursuit of those objectives and suggested not burdening the EFSF/ESM programmes with them. The Independent Evaluation Office of the IMF identified the same phenomenon.<sup>84</sup>
- **ESM shareholders have specific preferences.** According to ESM Board respondents, they attach particular importance to shareholder interests when assessing proposed EFSF and ESM decisions. To varying degrees, they considered the preservation of the paid-in capital, the avoidance of future capital calls and nominal haircuts, timely repayment of disbursed loans, the avoidance of sovereign default, and the preservation of the ESM's credit rating to be key. However, it transpires from the interviews that these did not always translate clearly into operational guidance for the institutions.

**Different intensities in Board scrutiny reflected the developing nature of the EFSF/ESM.** Each organisation needs to operationalise its governance structure to ensure an effective implementation of its mandate. The IMF, as a mature organisation, provides a benchmark for crisis resolution organisations with its tradition of a rules-based decision-making framework. The EFSF/ESM were created in the middle of the crisis and established their rules and guidelines as it unfolded. As a consequence, EFSF/ESM Boards were naturally more involved in elaborating decision criteria and in setting up the programme governance framework. Simultaneously, individual ESM Board members took different approaches to assessing reports and proposed decisions. Responses to the Board survey show that they did not use common methods for their assessment of draft decisions. A number of Board members indicated that they conducted their own (risk) assessment of documents submitted to them<sup>85</sup> in particular prior to taking programme and disbursement decisions at Board level. Other respondents said they either did not conduct their own assessments, or only made a plausibility assessment, either because they trusted that the relevant author institution took their interests as a shareholder into account, or citing a lack of administrative capacity to do so. Some respondents from the institutions suggested that the ESM develops a policy for assessments by the Board, for example of compliance reports. Some Board respondents underlined the importance of independent staff assessments.



**Cooperation and procedural arrangements between partner institutions often relied on informal working relations.** There were no agreements governing exchange of information between the ESM and its partner institutions, either for ongoing programmes or for the post-programme phase. Experiences with data sharing varied based on the programme focus (fiscal vs. banking) and phase (ongoing programme vs. post-programme monitoring). Several interviewees cited personal relationships as important when it comes to the sharing of data and draft documents. Confirming similar findings from IMF and European Commission staff,<sup>86</sup> they said that the exchange of and access to prudential data for the financial sector was limited across the programmes, especially following the establishment of the Single Supervisory Mechanism (SSM). The ESM needs access to this data in cases where part of programme financing may be used for bank recapitalisation and when it is an important input for the assessment of repayment capacity.<sup>87</sup> In some cases, due to the reluctance of supervisors, the ESM was not allowed to participate in the supervisory meetings where individual banking issues were discussed. While this issue was swiftly addressed through a work-around during the programme phase, it re-emerged in the post-programme period.

**The data reporting on country programmes was not fully harmonised, which makes comparison of countries difficult and undermines programme transparency.** The published programme reports occasionally had information gaps and varying definitions. This made a direct comparison of country programmes as well as the comparison of programme review vintages of the same country difficult. The programme reviews are to some extent standardised but in several cases different approaches and definitions have been used. Though the presentation of information improved over time, fully standardised tables would enhance transparency. Furthermore, in those cases where the last review was not concluded, no final programme review is available (Cyprus and Portugal). In the case of Portugal, the Commission published a concluding programme report, which contained useful information. The Spanish programme documentation is not fully comparable with the other countries since detailed information on gross financing needs and national financing sources are not available. This might reflect the specific instrument for the Spanish programme, but a reporting approach that allows for direct comparison with other programmes would foster transparency.

## 5.2. ESM's involvement in programme activities

**The EFSF/ESM role in the programmes evolved over time and its contribution gained prominence in later programmes, in particular since the establishment of the ESM.** The early programmes were run under the EFSF which was a financing facility rather than an institution with a broader crisis resolution mandate. Many stakeholders said that the role of the EFSF was not clear to them and that it should have featured more prominently. This changed with the creation of the ESM, whose mandate and role in programme design was better defined and laid down in the ESM Treaty.<sup>88</sup> In the course of the programmes it became involved in the substantive discussion on policy conditionality. The EFSF/ESM participated through the Eurogroup Working Group and Eurogroup policy discussions, and through decisions of their respective Boards. This greater involvement enabled it to assess the implementation risks and prepare disbursements. Some respondents noted that the ESM's expertise was gradually recognised as complementary. Others said that in the future the ESM would be well placed to lead the coordination of programme activities on the European side, as it reports directly to its shareholders.

**The ESM’s engagement with national authorities improved over time.**

Many respondents from programme countries said they had a positive experience cooperating with the EFSF and ESM, commending their knowledgeable and expert staff. Respondents who were involved in early programmes point to some tough discussions on legal issues, noting that they were new to everyone. Various respondents expressed appreciation for the way the ESM assisted authorities in explaining and reviewing complex legal documents under tight deadlines. Figure 5.2 describes country authorities’ perception based on reporting from interviews. It shows the proportion of positive and negative sentiment among respondents from national authorities about the intensity and quality of involvement with EFSF/ESM. For this analysis, the evaluation team used an experimental tool.<sup>89</sup>

**As countries began to regain market access, some tensions tended to emerge.**

According to both ESM staff and other respondents, national authorities regarded the institutions’ interventions as more intrusive towards the end of programmes. Respondents from partner institutions said the commitment of the national authorities to pursue the reform agenda relaxed considerably. Fiscal and reform fatigue set in and the political costs of austerity created stronger resistance. The relationship with national authorities suffered as a result.

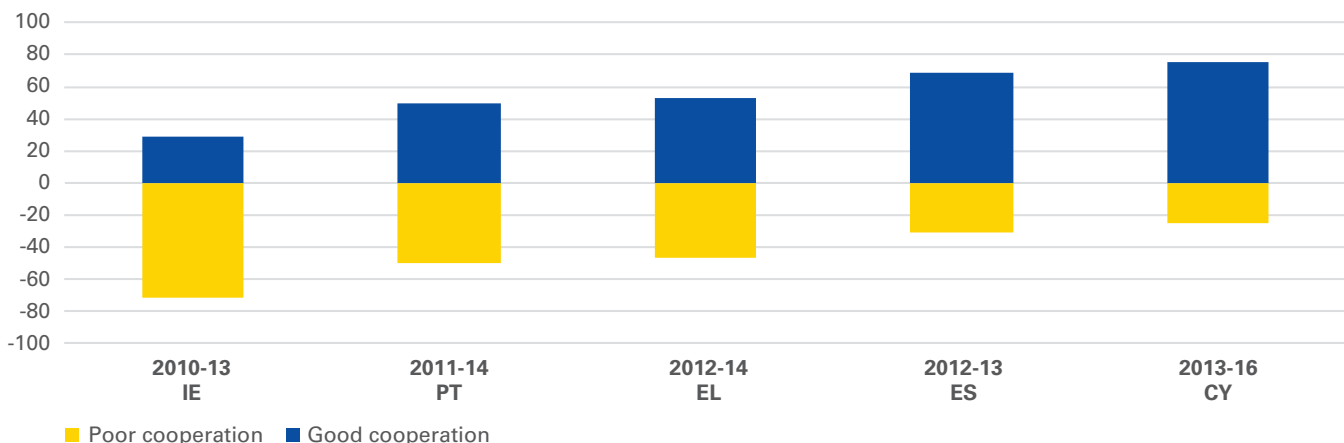
**Within the ESM, the Country Team Coordinators (CTCs) play a key role in managing country programmes.**

Their activities include the preparation of the Managing Director’s proposal for financial assistance facility agreements, preparation of disbursement decisions following the completion of programme reviews, input to the EWS, and country missions.<sup>90</sup> CTC duties are clearly spelled out in a document called CTC Terms of Reference.<sup>91</sup>

**Management guidance provides an appropriate operational framework for CTCs.**

The internal survey and respondent interviews show that CTCs receive enough guidance from management. At the same time, they also have a sufficient degree of flexibility to discuss and represent ESM policy views externally. The study also revealed that they frequently worked together to draw lessons on country work, and that management considered the arrangements suitable to the current scale of operations.

Figure 5.2  
**ESM’s involvement with national authorities**  
 (countries in chronological order, proportion of positive and negative answers)



Note: An analytical tool auto-coded for sentiment in NVivo.  
 Source: ESM interviews

**Efforts were made to minimise the risk of conflict of interest.** To reduce the risk of conflicts of interest or undue pressure in the country relationship, a CTC cannot be a national of the respective programme country as long as the programme is ongoing. This does not, however, apply to post-programme monitoring work. This could be reassessed. Country authorities said in a broader context of interviews that the institutions, without specifying the EFSF/ESM, should make an effort to better manage the turnover rate in mission teams to improve efficiency.



## 6. Conclusions

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**The creation of a euro area firewall proved necessary.** The build-up of macroeconomic imbalances amid divergent economic policies, coupled with insufficient economic surveillance and banking supervision, made the euro area vulnerable to economic shocks. When the global financial crisis hit, this resulted in severe financial stress and the eventual loss of market access for several euro area countries. Given various political and capacity constraints, international financial safety nets available at that time were not sufficient to deal with the euro area crisis. The firewall's mere existence provided a strong financial structure that lent the credibility of resilient members to the more vulnerable ones.

**The EFSF/ESM fulfilled their mandate of safeguarding financial stability in the euro area, with support from other crisis measures.** The EFSF and ESM successfully filled the sovereign financing gap in the euro area. They also significantly supported government debt sustainability in programme countries by improving lending conditions and smoothing repayment profiles. The EFSF/ESM's contribution to financial stability is, however, difficult to fully disentangle from other factors, such as accommodative monetary policy and national reform efforts.

**EFSF/ESM financial assistance helped restore or maintain market access in all but one programme country, but the programmes' macro-economic outcomes were mixed.** The programmes addressed three main challenges – fiscal sustainability, financial stability, and structural problems – albeit with different priorities and outcomes. Despite considerable achievements, some serious issues remain in most programme countries, such as high government debt, non-performing loans, and high unemployment.

**The scope and sequencing of the measures were at times a source of tension among key stakeholders.** The programme design included measures that were not always crucial for addressing the causes of lost market access and burdened the reform agenda. At the same time, short- and long-term objectives were not always commonly understood and communicated, leading to unrealistic expectations and subsequently to weakening ownership.

**Delays in requests for assistance increased the cost of rescue.** To varying degrees, the authorities waited too long with bold policy actions and, with the benefit of hindsight, programmes could have been requested earlier in most programme countries. Delay is an inherent feature of financial assistance to sovereigns. However, postponing comprehensive corrective measures weakened confidence and increased the risk of spillovers. Financing needs increased and government bond spreads widened. The overall cost increase is, however, difficult to quantify.

**The palette of instruments evolved during the crisis but only some instruments were used.** Even after the broadening of the toolkit, newly established instruments were actively considered but not activated. The design of the direct recapitalisation instrument made it very difficult to use in practice.

**The funds were sufficient to implement the programme strategy.** The financing envelopes varied according to country-specific needs. In some cases, however, unforeseen adjustments to financing and policy strategy were needed to comply with the programme envelope. The EFSF/ESM's share in official financing increased in later programmes. Contingency buffers were discussed during financing negotiations. They were included in all programmes but in many cases not sufficiently explicit to create confidence. Where explicitly quantified and documented, they helped to build confidence.

**The ESM developed the disbursement process to adjust to changing circumstances.** The back-to-back funding of disbursements was replaced by a diversified funding strategy. It made disbursements for bank recapitalisations in the form of securities. Though disbursements were linked to compliance with conditionality, there were no common criteria for compliance assessment. Delays in reviews required flexibility from the EFSF and ESM.

**Established policies provided a basis for even-handed treatment of programme countries but lending terms were eased with a view to country-specific needs.** Sustainability and market access considerations led to reductions in margins, extension of maturities, and a deferral of interest payments. The size and timing of these measures differed across countries. While flexibility in the disbursement approval process was a sign of efficiency, it also provided a poor basis for the even-handed treatment of member countries.

**The financial sector recovered more quickly when reform measures were implemented upfront.** The extent of financial sector challenges was not always recognised in time. Where recapitalisations were undertaken at the early stages of a programme, they contributed to early improvement in depositor and investor confidence. However, this approach also weakened the institutions' influence on timely implementation of agreed measures.

**Comprehensive approaches for addressing financial sector issues proved more efficient.** The multiple causes of high non-performing loans highlighted the need for comprehensive strategies to address poor asset quality. These strategies included upfront recapitalisations, enhancement of out-of-court insolvency and foreclosure frameworks, judicial reforms, as well as the establishment of companies managing impaired assets ("bad banks").

**Where established, "bad banks" had a clear role and, therefore, proved to be effective.** Targeted solutions proved successful where concerns about bank asset quality were concentrated in a single sector, such as troubled mortgages. In countries where non-performing assets stemmed from all loan segments, bad banks were not part of programme solutions. Instead, the focus was on improving banks' internal work-out capacity.

**To safeguard financial stability, in some early cases EFSF/ESM financial assistance was used prior to the approval of restructuring plans associated with state aid, which carried a risk.** For the early programmes, delays in approvals of plans reached up to four years, but timeliness later improved. This reduced the risk of financing potentially non-viable business models because recapitalisations in later programmes took place only after the approval of restructuring plans.

**Programme duration was mostly sufficient to regain market access but reform momentum waned over time.** Countries regained market access at sustainable rates supported by buffers and favourable circumstances, even if not all problems were solved. The standard three-year programme period provided a window of opportunity for reforms, but public and political support for reforms faded as countries gradually regained market access. Countries would have needed more time to finalise structural reforms.

**Follow-up arrangements were considered but a clean exit was preferred for political and market confidence reasons.** Countries developed exit strategies mainly based on a build-up of cash buffers to establish the credibility needed for market access. Some programme countries exited without completing a final review which can be considered a programme governance flaw.

**The effectiveness of the Early Warning System relies on moral suasion and cooperation with partner institutions.** Concern over a country's ability to repay can only be escalated on the basis of a liquidity assessment. Long-term and structural considerations are assessed under post programme surveillance by the Commission. Although the Early Warning System evolved over time and was seen to provide an adequate monitoring framework with a focus on risks, its scope is limited to programme countries.

**The institutional framework governing the cooperation between the EFSF/ESM and partner institutions worked despite its complexity.** The joint nature of the programmes required a strong alignment of objectives among the partner institutions which posed challenges for all the institutions involved. Programme governance faced a multiplicity of stakeholder interests that were difficult to crystallise in a consistent strategy.

**Cooperation and procedural arrangements between partner institutions often relied on informal relationships, in particular in relation to the sharing of data and draft documents.** The ESM depended on data from partner institutions for defining financing needs and assessing repayment capacity, yet there were no information exchange agreements in place. This was problematic in particular in relation to supervisory information.

**Partly due to the evolving programme governance framework, this evaluation exercise was at times constrained by accessibility of data and documents.** The data on country programmes is not reported in a fully harmonised manner, which complicates scrutiny by stakeholders, both across time or countries. Reports sometimes use different approaches and definitions. While the IMF provides data via a public database, the European institutions did not disseminate underlying data in a fully harmonised format. In several cases it was cumbersome to trace non-EFSF/ESM documents that were relevant for this evaluation.

**In synthesis:**

- The creation of the firewall was necessary for effective crisis resolution and confidence building. The EFSF/ESM effectively served their mandates and contributed considerably to financial stability in the euro area.
- Favourable financing conditions helped programme countries to regain debt sustainability, notwithstanding historically large country financing needs that were further increased by delayed requests for assistance.
- The financial assistance provided was sufficient to implement programmes. Implementation and monitoring of structural measures may require longer time horizons, and stronger administrative capacity in some cases.
- The recovery of the financial sector was more successful and conducive to growth when measures were taken upfront and comprehensively addressed non-performing assets.
- The ESM had limited access to information, especially to financial stability assessments with a potential impact on financing needs in various programme phases.
- The ESM has achieved credibility by acting in a professional and 'neutral' manner. Its assessment is appreciated both by creditor and borrower countries.



# 7. Recommendations

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In line with the Terms of Reference, the report draws up a number of recommendations, for which the ESM Management Board is requested to ensure appropriate follow-up. These recommendations are not meant as a criticism of past decisions that were taken in difficult circumstances, but are an invitation to further develop the policy framework and the ESM's role in the euro area institutional setup.

## Recommendation 1.

### **The ESM should focus on programme credibility and support ownership.**

- **The ESM should pre-empt delays in programme requests when problems cannot be effectively solved at national level.** Early determined policy action or programme requests can reduce financing needs, and contain the decline in confidence and the risk of spillovers in the euro area as a whole.
- **The Board should require the inclusion of clearly specified contingency buffers to reflect uncertainty.** Programme financing has to provide sufficient room for manoeuvre so that surprises do not require additional assistance. Markets and stakeholders are more confident when buffers are made explicit to correspond to perceived risk scenarios. The availability and early announcement of sufficient financing underscores the credibility of the ESM as the euro area firewall.
- **The ESM should seek ways to support programme ownership.** Ownership represents a key element of programme success. Realism of the programmes, an appropriate communication strategy, and maintaining political legitimacy can support programme ownership. The ESM could also consider how it could support consensus building.

## Recommendation 2.

### **Programme design should have clear objectives and priorities.**

- **The Board should give priority to macro-critical conditionality in programme design.** A clear focus on returning to the market and the adequacy of measures, as well as early implementation, would improve the chance of programme success.
- **The Board should clarify the short- and long-term objectives in order to develop more realistic expectations.** Short-term measures need to focus on closing financing gaps and maintaining financial stability. Disbursements should take place contingent on the implementation of agreed measures. Measures addressing long-term fiscal sustainability, competitiveness and other structural issues should be phased in from the outset of the programme, but may take beyond the programme period to bear fruit.

- **Regaining market access is a key objective of the programmes.** Exit strategies should form an integral part of programme design. They should be discussed and specified early enough to provide sufficient time for their implementation and to support their credibility.
- **The Board should consider strategies to help maintain reform momentum in the post-programme period.** To ensure reforms are continued, follow-up arrangements should be considered in the future. The Board could seek agreements with programme countries on their commitments toward the ESM after exit.

### Recommendation 3.

**Programmes should address financial sector issues upfront, but associated disbursements should be phased, based on progress.**

- **The Board should ensure that an explicit and comprehensive financial sector specific strategy, including the management of non-performing loans, is put in place from the start.** The extent of financial sector challenges was not always recognised in time. A comprehensive strategy would help break the vicious circle between the financial sector and the rest of the economy, and help speed up recovery.
- **The Board should require an upfront and continuous review of banking recapitalisation and restructuring needs and related risks.** This will allow the ESM to assess the potential impact from the financial sector developments on financing needs, and align supervisory action with programme processes.
- **The Board should link disbursements to progress on the comprehensive strategy.** This is particularly relevant when the financial sector share of the financing package is considerable. Phased disbursements would improve the Board's capacity to maintain an appropriate level of control.

### Recommendation 4.

**The Board should further refine and develop the ESM governance framework.**

- **To align stakeholder objectives, the Board should set a policy framework for programme negotiations, design and review, as well as criteria for review of compliance – within the limits of the ESM Treaty.** Furthermore, the Board should clarify the responsibilities of the programme partners ex ante to ensure effective collaboration and management of risks. This would ensure more consistent programme strategies but still allow for an adequate level of flexibility.
- **The ESM should establish formal cooperation agreements including on information sharing.** They would improve interinstitutional cooperation procedures and ensure that the ESM is provided with the information it needs for defining financing needs and assessing repayment capacity.
- **The policy framework should require a closing report.** As a matter of good governance, a closing report should be presented to the Board, even if some reviews were not concluded.

**Recommendation 5.****The ESM should enhance programme transparency and evaluability.**

- **The ESM should implement mandatory public reporting, including a database for the dissemination of harmonised data on country programmes.** A public database in line with IMF practice would allow appropriate scrutiny by stakeholders.
- **The ESM should evaluate the Early Warning System and the Greek programmes in due course.** The current evaluation was the first evaluation conducted on EFSF and ESM activities in the context of country programmes. The effectiveness of the Early Warning System should be evaluated separately. It merits its own appraisal because of its focus on risks to ESM shareholders and the fact that it was only recently reformed. The Greek programmes would require further evaluation – as foreseen in the Terms of Reference for this exercise – since they were largely outside the scope of this exercise given that it was too early to evaluate them.
- **The ESM should ensure the evaluability of EFSF/ESM activities.** The ESM should further develop its record keeping practices, improve databases, and enhance the traceability of documents that may be relevant for future evaluation exercises.

**Recommendation 6.****ESM Members may clarify the ESM's role in euro area institutional development.**

- **Going forward, ESM Members may discuss a broader preventive mandate for the financial stability of the euro area.** This evaluation found that the establishment of a firewall in the euro area was needed and that its mere existence helped to restore confidence. The ESM achieved credibility by acting in a professional and 'neutral' manner. Currently, the ESM's early warning mandate only focuses on programme countries and is limited in purpose. While discussion on the future of the euro area institutional setup is ongoing, the euro area would benefit from a stronger crisis prevention capacity. Euro area countries still face challenges that, however diverse, may require policy responses at the euro area level.

# Endnotes

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1. The Terms of Reference are published (as is) in the Appendix.
2. The role of the evaluator is to ensure the independence, credibility, and impartiality of the evaluation process. (Terms of Reference)
3. Jeroen Dijsselbloem, ESM press conference (2016).
4. Given the limitations to the scope, the evaluation did not analyse the degree of implementation. However, evaluations by the European Commission and, for example, Darvas (2017) offer some insight to this aspect.
5. A few key persons had left the public sector and were not easily reachable in the timeframe of the interviews. Programme countries and partner institutions have not always published information consistently over time and across reports, making comparisons difficult in some cases. The evaluation team relied mostly on public statements and programme documents, as well as summaries or summing-up letters of the Eurogroup or Eurogroup Working Group. The team did not analyse confidential Eurogroup or Eurogroup Working Group documents.
6. The desk studies include analyses of sovereign vulnerability, the cost of delay in requesting programmes, the financing needs and the sizing of assistance, the ESM-centred timeline of the crisis, the evolution of EFSF/ESM lending terms, the effectiveness of financial sector repair, and others.
7. Further profiling of the respondents is provided in Appendix B.
8. Euro area summit 29 June 2012.
9. European Council 9-10 May 2010.
10. The funds raised in the framework of the EFSF are recorded in the gross government debt of the euro area Member States participating in the support operation in proportion to their share of the guarantee given. Eurostat. Newsrelease, 27 January 2011.
11. See conclusions of the European Council, 28-29 October 2010.
12. “[...] borrowing of the ESM on financial markets will be recorded as ESM debt, and not re-routed to Euro Area Member States.” Decision of Eurostat on deficit and debt, Luxembourg, 31 January 2013.
13. More information on the EFSF/ESM programmes: <https://www.esm.europa.eu/financial-assistance>.
14. For comparison, the IMF’s global lending capacity, including all its quota-based resources and multilateral and bilateral borrowing arrangements, currently amounts to more than €1 trillion.
15. See, e.g., IEO 2011, Ioannou et al. 2011, and ECA 2015 and 2016.
16. The Portuguese programme concentrated on fiscal stabilisation and structural reforms. The financial sector was not a primary element.
17. Some of the programmes benefited from a more buoyant external environment than initially forecast.
18. The analysis draws primarily on expert interviews and a press search was conducted to validate the findings. In some instances, newspaper articles started debating the need for external assistance almost two years before any formal request was submitted. With the exception of Ireland, the perceptions of the interviewees and timing of press reports collected from FACTIVA corroborate each other. The references are to The Guardian, the Telegraph, Wall Street Journal, Der Spiegel, Dow Jones Global News Select, the EU Observer and Thisismoney.co.uk. There are further indications in The Irish Times on relevant public debates.
19. The view was also confirmed in a number of public depositions to the Irish parliamentary inquiry into the crisis.
20. Based on data by Bloomberg and Dealogic.

21. There were frequent press reports between June and November 2011 about money market funds' fragility and its links to the European debt crisis. References can be found for example in Wall Street Journal 27 June, Bloomberg.com, 3 June and Huffington Post, 20 November, 2011. The issues were initially raised in the IMF Global Financial Stability report October 2010.
22. Based on data by Bloomberg and Dealogic.
23. Interviews conducted by the ESM and Rojas (2016) explain how the Irish 10-year bond yield increased to almost 10% in September 2010, and how the Portuguese yield reached about 9% by April 2011.
24. Amortising bonds make equal annual payments over their lifetime (National Treasury Management Agency (NTMA) website).
25. IMF (2016), IMF (2010) and IMF (2008).
26. Ireland implemented significant consolidation measures (€15 billion, equivalent to 9% of GDP) in 2008-2010 prior to the agreement and implementation of the programme. These measures, however, did not prove sufficient at the time.
27. Use of the 12-month period allowed for a standard comparison between countries. Since the international surveillance cycles are annual, a 12-month period was considered reasonable.
28. The exceptions are Irish and Portuguese spreads, as well as portfolio inflows into Portugal, which continued to worsen for several months after the official agreement entered into force.
29. Portugal was an outlier with a rising CET1 ratio from 2010 to 2011, in advance of the NPL ratio.
30. Simplified from the EFSF and ESM guidelines.
31. IMF (2014a) suggested that the direct recapitalisation instrument could have served Cypriot purposes.
32. The economic adjustment programme for Ireland, European Commission (2011): "The activation of this financial assistance programme primarily aims at restoring confidence regarding Ireland, notably in the banks by providing assurances about their solvency and long-term viability as well as by enhancing the credibility of sovereign guarantees." Other Commission reports said that programmes primarily aimed at restoring confidence in banks and restoring external and sovereign debt sustainability to help the country recover access to international capital markets.
33. Indeed the board documents did not include request letters, Memoranda of Understanding or eligibility assessments.
34. This was corroborated in many programme country interviews, where respondents made clear that the euro area could fragment the financial system and that fiscal positions were fragile.
35. Elkhaldi, Chebbi, Naoui (2014) and Tola, A., Wälti, S., (2015).
36. Documentation of policy discussions revealed no particular discussion on the relevance of the regional risk criteria. The Board survey nevertheless shows that the partner institutions argued vehemently that there was a risk of contagion. A number of respondents argued that this was not fully convincing on occasion.
37. See also IMF (2013b).
38. For example Gonzalez-Hermosillo – Johnson (2014).
39. Kirkegaard (2012) and Garcia-Herrero – Wolff (2016).

40. European Commission evaluation (2016c), p. 26, nonetheless noted the following on the choice of instrument: "With the benefit of hindsight, the choice of a banking sector programme was appropriate given the overall state of the Spanish economy and the limited amount of assistance finally required. However, there was no certainty in mid-2012 that the relatively small programme envelope for the recapitalisation of Spain's banks would suffice to safeguard the sovereign's continued access to capital markets. Empirical evidence suggests that the latter was facilitated by the ECB's OMT scheme [...], rather than being the impact of the bank recapitalisation programme alone. [...] Still, in addition to measures directed at the financial sector, Spain needed a broader strategy to tackle macroeconomic sustainability issues given the country's large macroeconomic imbalances at the outset of the programme, which were being addressed by the European Semester/MIP recommendations." In addition, the paper underscored the positive role of the flexibility of the economy and its adjustment capacity in response to changing economic conditions, highlighting foreign trade, current account balance, and labour cost (ULC) developments.
41. In this section, the term "bank recapitalisation needs" includes bank resolutions and capital injections. By contrast, in Section 3.6, the term "financial sector envelope" is used. Both refer to the same amount.
42. Additionally, a bottom-up assessment of the capital needs of individual banks was undertaken by a consultancy firm.
43. An additional issue in Portugal was an underestimation of the financing needs of state-owned enterprises (SOEs).
44. The difference to the ratio used in Section 3.6 is due to the difference in the denominator, i.e. here the GFN versus EFSF/ESM disbursements in Section 3.6.
45. Ireland also contributed €17.5 billion of its own reserves (15% of GFN).
46. For Cyprus, the Commission's programme documentation reports financing needs excluding amortisations of short-term debt. It is noted in the initial programme description that Cyprus was supposed to continue rolling over T-Bills on the market at programme start and that programme funds would not be used for the redemption of T-Bills.
47. The GFN include the flows resulting from the rollover of T-bills and the execution of bond exchanges and buybacks.
48. In February 2015, €10.9 billion originally disbursed to the HFSF and earmarked for bank recapitalisation was returned to the EFSF, as recapitalisation needs proved lower.
49. Targets for cash buffers were defined explicitly only at later stages of the programme.
50. European Commission (2016a), p. 42.
51. The estimation of financing needs over a programme horizon can only be reliably quantified within a certain range. Buffers served to ensure sufficient financing under worse than expected outcomes and to generate investor confidence and support the economic recovery process.
52. For the quantification of the capital buffer in the second Greek programme see Bank of Greece (2012), Report on the Recapitalisation and Restructuring of the Greek Banking Sector.
53. European Commission (2015b, p. 37) and European Commission (2016c, p. 37).
54. Because of the large financing needs the euro area countries exceeded IMF access limits and were required to qualify for exceptional access under the IMF policies. This made the programmes highly political, which together with a high level of concentration of IMF commitments in (emerging and advanced) Europe, constrained the sizing of the Irish, Portuguese, and Cypriot programmes. As a consequence, the adjustment speed and the availability of financing had to be balanced. See also Truman, E. (2013).

55. See European Commission (2015b) and IMF (2015a), p. 12. It should be mentioned that the Commission's initial programme report mentions a contingency buffer of €25 billion by contrast.
56. The figure shows quarterly disbursements made by the EFSF and ESM to all programme countries. The Y-axis shows the cumulative amount of total disbursements made in percentage terms (adding up to 100%) and the size of each bubble shows the nominal size of quarterly disbursements. Due to rounding off, the figures do not necessarily add up with the total disbursed.
57. For ESM loans, Article 16(5) provides "The Board of Directors shall decide [...] after having received a [compliance] report from the European Commission [...], the disbursement of the tranches of financial assistance [...]." Article 3(3) of the Guideline on Loans specifies that "[...] after having received a report from the European Commission, on the monitoring of and compliance by the beneficiary ESM Member with the policy conditionality attached to the financial assistance facility [...], the Board of Directors shall decide to disburse [...]." Clause 5.3.4 of the General Terms for ESM Financial Assistance Facility Agreements requires that "the Board of Directors, after considering the most recent periodic assessment of the Beneficiary Member State by the Commission in liaison with the ECB, [is] satisfied with the compliance by the Beneficiary Member State with the terms of the MoU, including prior actions (if any)."
58. The IMF sets performance criteria for each review which condition disbursements. It nevertheless has a policy of waiving non-observance of individual criteria when the non-implementation is for justifiable reasons.
59. European Court of Auditors (2015).
60. European Court of Auditors (2015), paras 104-107; 191.
61. European Court of Auditors (2015), para 191. In its reply to the European Court of Auditors, the European Commission stated 'Instalments were released on the basis of an in-depth assessment of whether countries had complied with conditionality. Any delays in compliance were assessed on a case-by-case basis.'
62. European Court of Auditors (2015), para 201.
63. The aim is to assess efficiency of the ESM's internal processes; however, these are sometimes delayed by exogenous approvals, or events on which the EFSF and ESM processes depend, which reduces the reliability of the measure.
64. The IMF funds its assistance from central bank reserves and its charging is based on a short-term rate of the SDR, but the SDR is also a foreign currency for ESM Members and carries an exchange rate risk.
65. The heatmap (see Figure 2.3) identifies the key sources of sovereign vulnerability.
66. Aiyar, S. et al (2015).
67. Kilngiebel, D. (2000).
68. Acharya, Drechsler and Schnabl (2014).
69. Overall EU financial assistance envelopes relate to EFSM/EFSF/ESM disbursed amounts only. This excludes disbursements from the IMF. In comparison, Section 3.3 (endnote 41) the denominator is EFSF/ESM disbursements versus the GFN.
70. A Comprehensive Assessment was conducted in April 2014.
71. European Commission (December 2016b).
72. According to Eurogroup documents, the discussions on Ireland's exit started in March 2013 and on Portugal's in September 2013. IGCP annual report confirms 2013 as the year of planning the return to medium to long-term debt market.

73. Interviews and Commission programme review reports; National Treasury Management Agency (NTMA) annual report; NTMA focused on having twelve-fifteen months advance funding in place when the programme reached its end.
74. Eurogroup and Ecofin ministers meeting on 12 April 2013 agreed to lengthen the maturities of the EFSF and ESM loans for these countries by a weighted average of seven years, shifting short-term maturities beyond 2020. At the time of the decision, the same average maturity for the whole euro area stood at 7.3 years (European Commission 2013).
75. This is also mentioned as an important factor in the NTMA 2013 annual report.
76. The analysis draws on issuance data from Bloomberg and Dealogic.
77. European Commission (2016a).
78. Recital 17.
79. Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability.
80. "The IMF should establish a policy on cooperation with regional financing arrangements. [...] Areas where clarity could be provided include: (i) sharing of confidential information; [...] (iv) efforts to reduce the burdens placed on country authorities by large mission teams and duplication of information requests." Independent Evaluation Office (2016).
81. EFSF programmes, though slightly different, involved many stakeholders.
82. Report on the enquiry on the role and operations of the Troika (ECB, Commission and IMF) with regard to the euro area programme countries, 28 February 2014 (2013/2277(INI)).
83. "Among the areas identified for improvement are: (i) agreed procedures among the troika institutions that are transparently shared with their memberships and the public; (ii) enhancing the information flow to, and the role of, the IMF Executive Board in order to avoid information asymmetry with high-level euro area authorities; and (iii) efforts to reduce burdens placed on country authorities by large missions, staff turnover, duplication of documentation, and extensive conditionality.;" The IMF's Role in the Euro Area Crisis: What are the Lessons from the IMF's Participation in the Troika?, IEO background paper (2016).
84. "These and other conflicts arose in part because the IMF's objectives were not fully aligned with those of the euro area. The overriding concern of the European authorities was to preserve stability, and especially to preserve the single currency project. In contrast, the IMF's responsibility was also to the individual countries requesting financial assistance." (IMF IEO 2016).
85. For example assessments on the threat to the financial stability of the euro area, debt sustainability analyses, or compliance reports.
86. IMF (2016b): "The staffs of the three Troika partners were of the view that there is room for improving collaboration. The EC staff felt that the following issues need to be addressed in a more systematic manner: the reconciliation of technical analysis, the division of labor in terms of design and monitoring of conditionality, communication strategies, and information-sharing. The Fund staff raised the issues of sharing confidential information and modalities of assurances regarding euro area-wide policies affecting member countries with Fund-supported programs. These two issues have intensified since the establishment of the SSM in 2014. Staff were not guaranteed sufficient confidential supervisory information on Greece. In addition, in the future, it is not clear how to reconcile potential tensions between the staff's financial sector advice specific to Greece and relevant EU directives and the EC's and SSM's views or to secure EC's and SSM's assurances for implementation of agreed measures."



87. In written comments submitted on the ESM draft consultation report, the ECB does agree that a formal agreement between the ECB and the ESM on the sharing of confidential supervisory information or other data would be required.
88. In its Opinion attached to Eurostat's decision on the statistical classification of ESM debt (note 10), a few members of the Eurostat Committee on Monetary, Financial and Balance of Payment Statistics expressed concern that the proposed system of governance for the ESM would not provide enough autonomy in its decision-making process.
89. It extracted respondents' sentiment based on a standard linguistic examination of text (interview summaries and verbatim transcripts of the interviews) specifically coded for cooperation with national authorities. Then automatic filters were applied, looking at the sentiment of words in isolation regardless of context. The filters categorised text by "very negative", "moderately negative", "moderately positive" and "very positive". The percentages are calculated based on the number of words without assigning specific weights and aggregated by programme country. Negative sentiment on intensity/quality of cooperation is shown in yellow, positive sentiment in blue. The analysis does not differentiate between quality and intensity.
90. Country team coordinators broadly correspond to mission chiefs in the peer institutions.
91. Following an exploratory ESM staff survey at the beginning of the evaluation project, the evaluation team reviewed the existing guidance documents and interviewed the CTCs to understand their challenges. Having summarised the findings, management was interviewed to verify the consistency of views, and a background note was drafted for the record.

# List of acronyms

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|        |   |
|--------|---|
| AMC:   | Asset Management Company  |
| BIS:   | Bank for International Settlements  |
| BoD:   | Board of Directors  |
| BoG:   | Board of Governors  |
| BRRD:  | Bank Recovery and Resolution Directive  |
| CET1:  | Common equity Tier 1 capital  |
| CTC:   | Country Team Coordinator  |
| ECB:   | European Central Bank   |
| EFSF:  | European Financial Stability Facility   |
| ESM:   | European Stability Mechanism  |
| EWS:   | ESM's Early Warning System  |
| GDP:   | gross domestic product  |
| GFN:   | gross financing needs   |
| HFSF:  | Hellenic Financial Stability Fund   |
| IMF:   | International Monetary Fund   |
| MoU:   | Memorandum of Understanding   |
| NAMA:  | National Asset Management Agency  |
| NPL:   | non-performing loans  |
| NTMA:  | National Treasury Management Agency   |
| PDMO:  | Public Debt Management Office   |
| PSI:   | Private Sector Involvement  |
| SAREB: | The Company for the Management of Assets proceeding from Restructuring of the Banking System (Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria) |
| SGP:   | Stability and Growth Pact   |
| SOE:   | State-owned enterprise  |
| SSM:   | Single Supervisory Mechanism  |

## Country codes

|     |          |
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| IE: | Ireland  |
| EL: | Greece   |
| ES: | Spain    |
| CY: | Cyprus   |
| PT: | Portugal |

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