



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 16.11.2006
COM(2006) 695 final

**REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN
PARLIAMENT**

Comprehensive Report on the functioning of the Guarantee Fund

{SEC(2006) 1460}

TABLE OF CONTENTS

1.	Introduction	3
2.	Functioning of the Fund and main changes in the period 2003-2006.....	3
2.1.	Operations covered by the Fund	3
2.1.1.	Main characteristics of guarantees given to the EIB.....	4
2.1.2.	Macro-Financial Assistance and Euratom operations covered by the Fund	4
2.2.	Provisioning of the Fund	4
3.	Development and performance of the Fund over the period 2003-2006	5
3.1.	Shielding the Union budget from calls due to defaults	5
3.2.	Development of the Fund's assets	5
3.3.	Budgetary discipline.....	6
4.	The parameters of the Guarantee Fund	6
4.1.	Absorption capacity	7
4.2.	Main parameters.....	7
4.3.	Terms and conditions of Community guarantees to the EIB (new Financial Framework 2007-2013).....	7
5.	New provisioning mechanism.....	8
5.1.	Background	8
5.2.	Basic principles of the new provisioning mechanism.....	9
6.	Outlook.....	10
6.1.	Next enlargement	10
6.2.	New EIB external lending mandate	10
6.3.	Review of the institutional arrangements for the management of the assets of the Fund	10
7.	Conclusion.....	11

1. INTRODUCTION

Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 (“the Fund Regulation”) established a Guarantee Fund (“the Fund”) for external actions so that the Communities creditors could be reimbursed in the event of any default by the beneficiaries of loans granted or guaranteed by the Communities.

A first review of the functioning of the Fund took place in 1998 in accordance with Article 9 of the Fund Regulation¹. The Commission also made a proposal for amending the Fund Regulation. In accordance with Regulation No 1149/1999 dated 25 May 1999² which modified, among others, Article 9 of the Fund Regulation, two further comprehensive reports on the functioning of the Fund have to be prepared *both at the time of the conclusion of the first accession agreement..., and before 31 December 2006*, at the end of the present 2000-2006 Financial Perspectives, i.e. the present report.

Further to the signing of an accession agreement by ten States on 19 April 2003, the second comprehensive report on the functioning of the Fund was adopted in October 2003³.

The Commission Staff Working Paper (“the Annex”)⁴ completes this report by providing graphs, tables and attachments.

2. FUNCTIONING OF THE FUND AND MAIN CHANGES IN THE PERIOD 2003-2006

2.1. Operations covered by the Fund

In 1994, the Guarantee Fund was set up to limit the budgetary impact stemming from calls on guarantees given by the Communities budget for lending operations in third countries and to create an instrument of budgetary discipline.

The lending operations covered by the Fund relate to three different instruments which benefit from a guarantee from the Communities budget: guarantees of the European Investment Bank (EIB) external lending, Euratom external lending and EU Macro-Financial Assistance (MFA) loans to third countries.

The Fund covers the risk of loans and loan guarantees to **third countries**. Following its comprehensive report of 2003, the Commission made a proposal to amend the Fund Regulation in order to take into account future enlargements of the European Union. This second amendment of the Fund was adopted with Council Regulation (EC, Euratom) No 2273/2004 on 22 December 2004⁵. As stipulated in this amendment, if third countries become Member States, the Fund's coverage of the corresponding guaranteed lending is

¹ Parliament and Council are regularly informed in detail about all aspects related to the Fund. The management of the Fund is analysed in a yearly report (see last report COM(2006)366 and its annex SEC(2006)891).

A report to the budgetary authority on guarantees covered by the general budget is published semi-annually (see last report COM(2006)452 and its annex SEC(2006)1071).

² Article 1.4 of Regulation No 1149/1999.

³ COM(2003)604 of 13.10.2003.

⁴ SEC(2006)1460

⁵ OJ L 396, 31.12.2004, p. 28.

withdrawn and the Union budget directly covers these guarantees. In application of this Regulation early 2005, an enlargement-related amount of almost EUR 339 million has been reversed to the Community budget, thus reducing the size of the Fund.

At the end of 2005, the Fund has covered an amount of EUR 13.680 billion guaranteed lending of which EUR 13.554 billion for outstanding and EUR 126 million for accrued interest and the assets of the Fund stood at EUR 1.324 billion (see Graph 1 in Annex).

2.1.1. Main characteristics of guarantees given to the EIB

The lion's share of the Fund's coverage concerns loan guarantees issued with respect to loans granted in third countries by the EIB⁶. When the recipient of a guaranteed loan fails to make a payment on the due date, the EIB asks the Commission to pay the amounts owed by the defaulting debtor in accordance with the respective guarantee contract. If the EIB has a second public or private guarantor in addition to the Community guarantee, it is obliged to activate such third parties guarantees before a call under the EU guarantee is requested.

The Community Guarantee covers all credit risks of a guaranteed lending operation in third countries, unless the risk-sharing arrangements apply, in which case the Community Guarantee covers only specific political risks whereas non-political risks are borne and mitigated by the EIB.

2.1.2. Macro-Financial Assistance and Euratom operations covered by the Fund

In this type of operation covered by the Fund, the Communities borrow on the financial market and on-lend the proceeds (on a back-to-back basis) to non-member countries (MFA) or to companies (Euratom).

The loan repayments are scheduled to match the repayments of the borrowings due by the Communities. If the recipient of the loan is late in making a repayment, the Commission must draw on its resources to repay the borrowing on the due date. If the delay extends to three months after the due date, the Commission draws on the Fund to cover the default.

2.2. Provisioning of the Fund

The Fund is provisioned via the entry of a "Reserve for loans and loan guarantees to and in non-member countries" as a provision in the general budget of the European Union. The annual amount of the Reserve is defined in the Financial Perspectives for 2000-2006 and amounts to EUR 200 million at 1999 prices.

The base for the provisioning differs according to the guarantee rate applicable. All Euratom and MFA loans are guaranteed at a rate of 100%, i.e. the provisioning rate is applied to the total amount of the loan. The global ceilings on the loan guarantees granted to the EIB vary, depending on the loan portfolio concerned. Within each portfolio individual EIB loans are, de facto, guaranteed at 100% until the global ceiling is reached⁷. In order to determine the amount to be provisioned in the Fund, in a first step, the total loan amounts are multiplied by

⁶ 90% of total guaranteed amount outstanding on 31.12.2005.

⁷ At present the guarantee rate on the EIB external lending mandate is 65%. This rate is also proposed for the new EIB external lending mandate. In the past and for specific mandates, this rate has varied (100%, 75%, 70% respectively).

the respective guarantee percentages. The result of this calculation is then multiplied by the provisioning rate of currently 9%.

The agreement on the new Financial Framework 2007-2013 implies a change in the source of financing of the Fund from the present ring-fenced Reserve in the budget under the ad-hoc Heading 6 to a funding via a budget line (compulsory expenditure) under Heading 4 of the budget. This is an essential change in the way the necessary budgetary resources for the Fund are provided⁸. An annual amount of EUR 200 million in current prices, i.e. EUR 1.4 billion over the 2007-2013 period, has been foreseen to provision the Fund in the financial envelopes underpinning the agreement on the new Financial Framework.

3. DEVELOPMENT AND PERFORMANCE OF THE FUND OVER THE PERIOD 2003-2006⁹

3.1. Shielding the Union budget from calls due to defaults

Since its beginning in 1994, the Fund has efficiently fulfilled its main objective by preventing any disruption of budget implementation that would have occurred as a result of the defaults on lending operations guaranteed by the Union budget. Graph 2 in Annex shows how the Fund has succeeded in absorbing the impact of calls on the Community guarantee.

Had it not been for the Fund, the Communities would at several occasions have had to use budgetary resources to pay for activations of guarantees and this would have required redeployment of appropriations in the course of budget implementation. Since 2003, four calls for a total of EUR 9.2 million have been handled through the Fund, all concerning guarantees issued to the EIB for loans in the Republic of Argentina (see Table 1 in Annex which gives a detailed view on all flows in and out of the Fund).

The Fund has recovered all capital and interest due from the Republic of Argentina in the 2003-2005 period. Only penalty interest of USD 1.4 million (EUR equivalent 1.2 million) has still to be recovered by the Fund.

The recent low default related losses to the Fund should not be mistaken as a sign of a decreased risk for the Fund. Historically, annual losses had reached a maximum amount of EUR 303 million in the year 1995. At present the highest individual risk for a single country amounts to EUR 1.8 billion and in case of for instance a civil war situation the calls on the Fund could increase substantially as the experience with the former Federal Republic of Yugoslavia has shown.

3.2. Development of the Fund's assets

Graph 2 in Annex shows that the volume of the Fund decreased since 2001 when the Fund reached its peak of EUR 1.8 billion.

⁸ The Inter-Institutional agreement (IIA) of 17.05.2006 (OJ C 139, 14.6.2006, p. 1) has changed the budgetary source for the provisioning of the Fund. The impact of this change and the related Commission proposal for a new provisioning mechanism are discussed under Section 5.

⁹ The latest available final data relate to 31 December 2005. All figures for 2006 in the present report and its annex are estimates unless specified otherwise.

Apart from changes in the net amount of guaranteed lending due to new lending operations and amortisations of old loans, the decrease in the volume of the Fund is mainly caused by the accession of ten new Member States to the EU on 1 May 2004.

In addition to provisioning via the budgetary Reserve, the Fund's other main source of income is the interest earned on its assets which are managed by the EIB under the supervision of the Commission. The interest earned on the Fund's assets since 2003 fell in line with the volume of the Fund. This trend was further caused by a general decline in the market interest rates. At the end of 2005 the total assets of the Fund stood at EUR 1,299.4 million (market value excluding accrued interest). 75.8% of this amount were invested in bonds, 24.1% in deposits and 0.1% were held on current accounts. The interest earned during 2005 amounted to EUR 51.6 million. The net investment income of the Fund, i.e. interest earned minus the EIB's remuneration and other cost stood at EUR 50.7 million.

Another significant development is the decision by the Commission to present its financial statements according to the IPSAS inspired principles in 2005. The impact of this decision which will lead to an increase in the volatility of the valuation of the fund's portfolio is explained in Attachment 1 in Annex.

3.3. Budgetary discipline

The Reserve inscribed for the provisioning of the Fund together with the rules of the Fund have limited the new lending/guarantee capacity to about EUR 3 billion per year (depending on the guarantee rate) during the Financial Perspectives 2000-2006 (see Table 2 in Annex). In principle, whenever a new loan or loan guarantee is decided, a certain fraction of the capital amount of that loan or guarantee has to be provisioned out of the Reserve. The provisioning rate together with the amount of the Reserve therefore determines the overall amount of possible lending or guaranteeing.

With the abolishment of the Reserve beginning 2007, this mechanism will cease to exist in its present form. However, the budgetary discipline will be maintained through other mechanisms. Substantial elements of budgetary discipline remain in place which will ensure the guaranteed lending will evolve in full agreement with the Council and the European Parliament:

- the EIB's multi-annual external lending mandate will be limited over the 2007 to 2013 period (this Council Decision represents around 90% of the overall loan volume),
- Macro-Financial Assistance loans are subject to individual decisions by the Council, and
- the Euratom lending has a ceiling of EUR 4 billion of which around 85% have already been used. The remaining margin is about EUR 600 million.

4. THE PARAMETERS OF THE GUARANTEE FUND

One role of this report is to examine the adequacy of the functioning of the Fund and its parameters over time and to propose improvements where necessary. Concerning the functioning of the Fund, the provisioning mechanism has been identified to provide room for

improvement and a legislative proposal has been tabled by the Commission in April 2005 (see Section 5).

This section concludes that there are no reasons which would justify the change of the Fund's parameters. However, as the Commission proposals for new EIB external lending mandate and the new provisioning mechanism are still not adopted and prone to potential modifications, the Commission intends to address a new comprehensive report to the Council and the European Parliament. The report would be finalised in 2010 at the latest or at an earlier stage if a need for changing a parameter of the Fund would become apparent. It would review the Fund's parameters after a decision on the provisioning mechanism has taken place with regard to the experience gained under the new EIB mandate.

4.1. Absorption capacity

The capacity of the Fund to absorb the planned/estimated guaranteed operations by the Commission (MFA and Euratom) and the EIB is an important indicator for the evaluation of the appropriateness of the Fund's parameters. Between 2002 and 2006 (see Table 2 in Annex), the Fund's absorption capacity was sufficient to accommodate the planned and forecast lending operations. Therefore, no immediate reason to change the parameters of the Fund can be identified.

4.2. Main parameters

With a view to the stable medium term development of the Fund, the main parameter to be analysed is the target rate. The provisioning rate and the EIB guarantee rate will be of no importance once the Commission proposal for a new provisioning mechanism has been adopted, as only the application of the target rate to the outstanding amount determines the amount required for the Fund.

The Commission services consider that the current target rate, i.e. the ratio between the value of the Fund's assets and the total amount of guaranteed loans outstanding, of 9% is compatible with the present risk profile of the Fund. As the new EIB external mandate is not likely to change the risk profile of the Fund substantially in the foreseeable future due to the weight of existing loans, no reason to propose a change of this parameter has been identified.

4.3. Terms and conditions of Community guarantees to the EIB (new Financial Framework 2007-2013)

The guarantee coverage rate for the EIB's external lending mandate has an impact on the provisioning needs for the Fund only under the present provisioning rules. Once the new provisioning mechanism will be adopted, this parameter will not influence the level of the Fund's provisioning.

Furthermore, given the historically low default rate and the additional security of third parties guarantees, the guarantee coverage of 65 % of the EIB loan portfolio exposure appears to be sufficiently prudent. In addition, as shown in Table 3 in the Annex, the annual risk coverage ratio will slightly deteriorate over the period 2007-2013.

Against that background it does not appear opportune to propose any change in the rate of coverage at this stage.

It should also be mentioned that the Commission proposal for a new EIB external lending mandate extends the guarantee given to the EIB to include not only loans given by the EIB but also guarantees given by the EIB to other financial institutions. Furthermore, the Commission proposal clarifies the nature of the guarantee coverage which will be limited to risks of a sovereign or political nature. The impact of such changes on the overall risk profile of the Fund may be assessed in the framework of the next comprehensive report which will be presented in 2010 at the latest.

5. NEW PROVISIONING MECHANISM

5.1. Background

In April 2005, the Commission adopted a proposal¹⁰ (see Attachment 2 in Annex for a detailed presentation of the proposal) for a new provisioning mechanism for the Fund, i.e. the rules that determine how the Fund's assets are brought in line with the target amount of the Fund. The proposed amendment is in line with the needs identified in the second Comprehensive Report on the functioning of the Fund in 2003. At the close of writing this report, the proposal was still under discussion in the Council but had received a favourable opinion from the European Parliament¹¹ and the European Court of Auditors¹².

The motivation for this new provisioning mechanism was twofold.

First, experience had shown that the present rules have often led to an over-provisioning of the Fund and therefore a sub-optimal use of budgetary funds. This problem has mainly been due to uncertain forecast figures of EIB loan signatures in the provisioning process. Furthermore, the present rules result in several transfers in and out of the Fund during one year, a situation that creates unnecessary administrative procedures involving not only the Commission services but also the two arms of the budgetary authority.

Second, as mentioned before, the IIA implies as of 1 January 2007 a change of the budgetary source for the funding of the Fund from a dedicated Reserve to a financing via a budget line under Heading 4. The present provisioning mechanism is not compatible with this new budgetary setting. Maintaining the present provisioning mechanism would imply that budgetary planning and transparency would be compromised (see Attachment 3 in Annex).

In addition, it would be very difficult or even impossible to provision the Fund in accordance with the Fund Regulation should an unforeseen and therefore not budgeted decision on MFA loans be taken towards the end of a year. In this case a lack of credits on the budget line for the Fund would make it very difficult or impossible to find the means to provide the necessary appropriations to the Fund's budget line and therefore prevent the Community from providing the required assistance.

It should also be noted that with the present provisioning mechanism and taking into account that for the 2007-2013 period EUR 1.4 billion are foreseen to be used to provision the Fund, the maximum size of the EIB external lending mandate would only amount to EUR 17 billion

¹⁰ COM(2005)130 of 5.4.2005.

¹¹ SP (2006) 1094 OD of 17.3.2006.

¹² Opinion No 9/2005 (OJ C 313, 9.12.2005, p.6).

(assuming that no default related losses occur and that Euratom and MFA related lending will amount to EUR 4.5 billion, for details see Table 4 in Annex).

5.2. Basic principles of the new provisioning mechanism¹³

The proposed new mechanism is based on a provisioning linked to the outstanding amount of loans and guaranteed loans, i.e. on actual net disbursements (i.e. disbursements minus amortizations minus cancellations). This is the main difference to the present system in which the provisioning is based on loan signatures independent of the amounts actually disbursed as the disbursements of loans take place over several years.

Contrary to the present system of several annual transfers between the Fund and the Budget, only one single annual transfer is needed under the new provisioning system. The single annual transfer is determined as the difference between the target amount of the Fund at year-end and the value of the Fund's assets at year-end.

Early in the following year, the respective provisioning amount will be introduced in the budgetary planning process and inscribed in the budget for the following year when the amount will be effectively paid.

Losses to the Fund as a result of defaults would translate directly into increased provisioning needs. In order to maintain the Fund's main purpose, i.e. to act as a shock absorber for the Union budget, a smoothing mechanism has been introduced in the proposal for the new provisioning mechanism which will cap the annual amounts to a maximum of EUR 100 million per annum. This means that losses exceeding this cap will be paid back into the Fund over several years.

In order to avoid that the Fund, in the extremely unlikely case of a series of severe losses, would fall below a critical level of 50% of the target rate, it is foreseen that in such a case the legal provision is maintained according to which the Commission would submit a report to the budgetary authority on exceptional measures to replenish the Fund.

In conclusion it can be said that the main advantages of the proposal for a new provisioning mechanism are:

- The improvement of the efficiency of the use of budgetary means and reducing to one the number of annual transfers between the Union Budget and the Fund;
- A provisioning based on the variations of the observed net-disbursements, thus creating more transparency and improving the precision of the budgetary programming.

It should also be noted that this proposal is merely a technical improvement that does not change the principle of the Fund that the value of its assets should be equivalent of the target amount (9% times the total amount of outstanding guaranteed lending).

The new provisioning mechanism will be much stricter in maintaining the relation between the amount of guaranteed loans and the assets of the Fund in a transparent way. The overall budgetary needs during the next Financial Framework will, under the new mechanism, remain

¹³ For more details, see Attachment 3 in Annex.

substantially lower than would be the case under the present mechanism. However, any “shocks” such as important calls on the Fund or outflows due to accession of new Member States or IPSAS-accounting standards-induced fluctuations of the value of the Fund's assets will have a direct impact on the funding needs for the Fund. The resulting slightly higher volatility of the provisioning needs, which is the price for the improved mechanism, will have to be absorbed in budgetary terms.

6. OUTLOOK

6.1. Next enlargement

In 2007, two new Member states will become full Members of the Union and according to the Fund Regulation if third countries become Member States, the Fund's coverage of the corresponding guaranteed lending is withdrawn and the Union budget will directly cover these guarantees. Consequently, early 2007 an enlargement-related estimated amount of about EUR 260 million¹⁴ will be reversed from the Fund's assets to the Union budget, thus reducing the size of the Fund.

6.2. New EIB external lending mandate

Assuming that the Commission proposal¹⁵ for a new EIB lending mandate of EUR 33 billion for the period 2007-2013 would be adopted, the new provisioning mechanism would, according to simulations, under normal circumstances need less than the EUR 1.4 billion in nominal terms foreseen in the Financial Framework for this period. Even in the unlikely case of a prolonged series of major losses due to calls on the guarantee and/or adverse developments of the value of the Fund's assets, this amount would be sufficient (see Table 5 in Annex for details).

6.3. Review of the institutional arrangements for the management of the assets of the Fund

In application of the Fund Regulation, the EIB is managing the assets of the Fund on behalf and under the supervision of the Commission. Experience has shown that the Bank has always performed this task most satisfactorily.

However, from a cost point of view, the issue of whether the EIB or the Commission should manage the assets of the Fund has been raised. In 2003 a questionnaire of the European Parliament (CoCoBu) in relation to the 2002 discharge procedure has suggested that the Commission services could manage the portfolio at a lesser cost and therefore it should be considered to transfer the management of the Fund's assets to the Commission. Furthermore, the European Court of Auditors (ECA) has at several occasions raised a question on the adequateness of the management fees the EIB receives for the management of the Fund's assets. In addition to these fees non-negligible opportunist costs are borne by the Commission

¹⁴ Final figures will only be known at the end of this year.

¹⁵ COM(2006)323, SEC(2006)789 and 790 of 22.6.2006

services who invest a substantial amount of human resources to establish and monitor the investment strategy and an adequate liquidity management¹⁶.

In fact, the Commission services have themselves the adequate means and considerable experience in dealing with asset management. For instance the portfolio of the ECSC i.l. which is roughly of the same size and structure as the Fund assets is managed by the Commission services. The Commission services' fund management activities are fully audited, controlled by a risk management and conform to good banking practice.

The Commission is therefore evaluating whether it should take over the management of the Fund's assets itself. Once this evaluation is finalised, the Commission might present a proposal to amend Article 6 of the Fund Regulation.

7. CONCLUSION

Since 1994, the Fund has satisfactorily performed its main task as a shock absorber for the Union Budget. The new Commission proposal, if adopted, will improve the budget efficiency.

At this stage, no further legislative proposal is required. However, a new comprehensive report should be finalised in 2010 at the latest or at an earlier stage if a need to change parameter of the Fund becomes apparent.

¹⁶ For instance, the Commission services have the relevant information about the flows generated by Euratom, MFA loans and extraordinary flows caused by events such as enlargement, the supervision and relations with the ECA.