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COMMISSION DELEGATED DECISION (EU) …/…

of 6.6.2018

amending Annex III to Decision No 466/2014/EU of the European Parliament and of the Council granting an EU guarantee to the European Investment Bank against losses under financing operations supporting investment projects outside the Union, as regards Iran

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

The conclusion and implementation of the Joint Comprehensive Plan of Action (JCPOA) on Iran's nuclear programme has opened the way for a renewal of EU-Iran relations. This engagement between the EU and Iran takes place on the basis of the full and continued implementation of the JCPOA (which was concluded on 14 July 2015) by Iran and the other parties (the European Union, France, Germany, the United Kingdom, the United States, Russia and China). The International Atomic Energy Agency (IAEA) regularly verifies Iran's compliance with the JCPOA and has issued 10 reports (last report of 22 February 2018) confirming Iran's compliance with its nuclear-related commitments.

On November 14 2016, the Foreign Affairs Council had already welcomed 'the prospect of extending the third country lending mandate of the European Investment Bank (EIB) to Iran.'

The Commission's proposal of 14 September 2016 proposed amendments to the existing External Lending Mandate (ELM) Decision in a number of areas. The proposed changes included the addition of Iran to the list of potentially eligible countries. The amended ELM Decision was finally adopted by the European Parliament and the Council in March 2018 and entered into force in April 2018 (Decision (EU) 2018/412). The inclusion of Iran on the list of potentially eligible countries empowers the Commission to adopt a delegated act to render Iran eligible under the ELM, by adding it to the list of eligible countries.

Despite the US decision to withdraw from the JCPOA, the EU shall continue to pursue its political and economic interests in Iran, which are based on the full and effective implementation of the Nuclear Deal.

Following unanimous backing of EU Heads of State or Government at the leaders' meeting in Sofia on the evening of 16 May 2018 for the proposals of President Juncker and High Representative/Vice-President Federica Mogherini, the Commission on 18 May 2018 launched the process of consultation of experts designated by each Member State, paving the way for the adoption of this delegated act. Notwithstanding further assessment of operational prerequisites and decisions by the EIB's governing bodies and the progress made by Iran in complying with the applicable frameworks concerning anti-money laundering and combatting the financing of terrorism, the delegated act, once in force, will make the EU budget guarantee available for potential financing of activities in Iran under the External Lending Mandate, if and when the governing bodies of the EIB decide to take up such financing activities. All relevant rules and procedures will apply to the approval of individual financial operations and projects. The present decision does not constitute any commitment of the EIB to support projects in Iran, which remains in the competence of the governing bodies of the EIB.

2. ASSESSMENT OF THE ECONOMIC, SOCIAL, ENVIRONMENTAL AND POLITICAL SITUATION IN IRAN

Political context

EU-Iran relations are based on the following principles:

- Ensuring and supporting the full implementation of the JCPOA in order to further improve and deepen bilateral cooperation.

- Developing cooperative relations in areas of mutual interest to benefit the economic development, respect for human rights, prosperity and well-being of the people of Iran and the EU. These include cooperation on energy, environment, migration, drugs, humanitarian aid, transport, civil protection, science, education and culture.
- Promoting regional peace, security and stability as well as peaceful settlement of regional conflicts through dialogue and engagement.

EU High Representative/Vice-President of the Commission, Federica Mogherini, visited Iran on 16 April 2016 with seven other Commissioners and issued a joint statement with the Minister of Foreign Affairs of Iran, Mohammad Javad Zarif, launching gradual EU-Iran cooperation in a variety of areas and sectors. Cooperation currently ranges from economic, trade and investment talks, to education and science cooperation, environment and climate change expert exchanges and discussions on humanitarian and human rights issues. For the time being, the joint statement forms the basis for the bilateral cooperation agenda and it was endorsed by the Foreign Affairs Council on 14 November 2016.

Since his first election in 2013, President Rouhani has been able to launch economic reforms and introduce new fiscal policies. These reforms are now under pressure, partly due to the recent US decision to withdraw from the JCPOA. More generally, the Iranian government has fully fulfilled its nuclear-related commitments under the JCPOA but has expressed a clear wish for the remaining JCPOA parties to maintain the deal in a way that corresponds to its legitimate economic expectations. The EU will seek to find ways to protect legitimate economic interests and to enhance economic benefits for the Iranian people.

The human rights and democracy situation in Iran remains of concern to the EU, in particular the use of the death penalty, the rights of religious and ethnic minorities and of women and girls. Iran detains several European dual nationals and denies consular access as it does not recognise dual citizenship. The EU and Iran hold regular human rights discussion as part of the High Level Dialogue that is held twice per year. The EU also supports the annual UN General Assembly resolution on the human rights situation in Iran. Iran also participates in the Universal Periodic Review of the human rights situation.

In conclusion, while the JCPOA is under heavy pressure, the EU is determined to continue to stick to the agreement as long as Iran does. President Rouhani's moderate government and his economic policies deserve support and could lead to a more stable and predictable Iran, also in the regional context. EU-Iran cooperation in the economic field is of mutual interest. The EU was Iran's first trading partner before the sanctions.

Economic and social assessment

Background and economic performance pre-2016

Iran is the second largest economy in the Middle East after Saudi Arabia and the second most populous country in the region after Egypt, with an estimated Gross Domestic Product (GDP) of about USD 406 billion and a population of 80 million in 2017. It is an upper middle income country in the World Bank classification with gross national income (GNI) per capita reaching USD 5 470 (Atlas method) in 2016. Iran ranks second in the world in natural gas reserves and fourth in proven crude oil reserves and is a member of the Organization of the Petroleum Exporting Countries (OPEC).

From around 2000, Iran began opening its economy to the rest of the world through trade liberalisation, elimination of exchange restrictions and attraction of foreign direct investment (FDI). Iran gained observer status at the World Trade Organisation (WTO) and is still aiming to become a member. Increased export earnings improved its external position and culminated in a large build-up of international reserves and a low external debt-to GDP ratio. GDP growth accelerated to about 6% annually in the first decade of 2000, and GNI per capita reached USD 7 700 in 2011. According to the World Bank, poverty levels dropped from 15% to 9% between 2009 and 2013 partly due to a large cash transfer programme, but there is no official poverty line or data available. Iran's 69th on the UN's Human Development Index.

Expansionary policies including costly welfare and housing programmes between 2006 and 2014 caused a large budget deficit financed via the central bank and government lending to banks. These policies were one of the factors leading to lasting distortions in the financial sector and led to a high ratio of non-performing bank loans, low liquidity, high interest rates and little credit to private investment. With the tightening of the sanctions in 2012, oil exports halved, and the drop in public revenue from oil aggravated the already severe existing economic distortions.

Inflation rates fluctuated between 10% and 25% for most of the last 30 years and peaked at over 40% in 2013, with the rial depreciating strongly. As GDP contracted by 6% in 2012 (-1.7% in 2013), real GDP per capita dropped to USD 5 400 in purchasing power parity terms by 2014. The return to more stability-oriented economic policies under the new presidency in 2014 enabled the central bank to bring down the inflation rate and slow down the depreciation of the currency, but the unemployment rate rose from 10.6% in 2014 to 11.7% in 2015.

Negotiations for a Trade and Cooperation Agreement (TCA) between the EU and Iran have been on hold since August 2005, when Iran started to intensify its nuclear activities. The European Commission imposed trade restrictions in 2007. These sanctions were expanded in 2010 and further tightened in 2012 with far-reaching restrictions on all financial transactions and trading of petroleum products and related investments. The World Bank ended its lending to Iran in 2005 and currently has no Country Assistance Strategy (CAS) for Iran. The International Finance Corporation (IFC) closed previous investments by 2005, but the International Monetary Fund has been carrying out annual Article IV reviews.

Economic performance since 2016

The main short-term economic benefits from the Joint Comprehensive Plan of Action (JCPOA) and the lifting of EU sanctions since 16 January 2016 for Iran have been the re-connection to the financial system (in particular to SWIFT), access to frozen assets and to technology, an increase of trade volumes (oil exports and declining transport costs) and foreign investment. The remaining US dollar sanctions and concerns of international banks about possible negative repercussions on relations with US banks have hindered the conclusion of a number of business deals under the JCPOA even under the Obama administration.

Real GDP growth surged after the lifting of sanctions, but raising medium-term growth will require major reforms. The exceptional increase in oil production and exports pushed real GDP growth to 12.5% in 2016 but for 2017/18 (the Iranian year begins 20 March), growth is expected to have moderated to 4.3% as further increases in oil production are limited. In 2017/18, recovery broadened to the non-oil sector, aided by supportive fiscal and monetary policies and a recovery in construction and services activity. Real GDP growth is expected to ease further to 4% in 2018/19, as oil production stabilizes in line with Iran's OPEC cap.

The fiscal deficit remained moderate at 2.3% of GDP between 2016 and 2017 and is expected to narrow to 1.4% over 2018/19 (assuming no change in the oil price). Fiscal policy aims to achieve gradual consolidation and lower the oil dependency of public revenues from the current 33% of current expenditure to 20% by 2022, mainly through increasing VAT collection. Fiscal challenges include ineffective budget implementation and expenditure control as well as insufficient budgetary rules and procedures which do not allow for transparent and comprehensive budgeting and imply that fiscal risks are likely to be unreported.

Fiscal expenditure is set to increase over the medium-term to meet rising interest payments from higher public debt and the recapitalization of public banks as well as social security obligations. The risk of further accumulation of arrears remains high.

The unemployment rate is likely to remain close to 12% in the medium-term. Unemployment is much higher for youth and women, and the pace of job creation lags behind the fast growing number of new entrants joining the labour market.

Inflation averaged 9.9% during 2017/18 aided by moderation in food prices and stable administered prices. Inflation is expected to accelerate to 12% in 2018/19 following second-round effects of the depreciation in the exchange rate. The Iranian rial is partly pegged to the US dollar (official rate) and partly traded freely on the market (legally). Since the end of 2017, the Iranian currency lost over one third of its value against the US dollar and other foreign currencies. Most analysts agree with the Iranian central bank that the accelerated depreciation is not a consequence of weak economic fundamentals (stable inflation rate, current account surplus, sufficient foreign reserves). Limited access to foreign reserves outside the country in addition to substantial capital outflows - some related to the former sanctions, some for buying assets abroad out of security concerns - have added to external vulnerability.

Fears about the return of US sanctions and lack of trust in the country's banking system have become potent drivers of currency depreciation. In response to the free fall of the currency in April 2018, the government imposed restrictions on the ownership of US dollars, banned all currency trading outside of licensed exchange bureaus and allowed only trading at the new unified official rate set at 42 000 rial (from 37 000).

Progress on financial sector reforms

The reform of the banking sector remains one of the most pressing challenges. A legacy of the government's payment arrears, exposure to a stagnant real estate sector, uncontrolled fragmented financial institutions and poor risk management have resulted in capital shortages and high interest rates in the banking sector which has become a major impediment to private investment.

The central bank estimates the price tag of the necessary recapitalisation, dealing with non-performing loans and restructuring the sector (including non-bank credit institutions) at 30% of GDP. The central bank's Financial Sector Reform Plan is already bringing financial activities of a number of influential clerical organisations under central bank control, reportedly with the backing of the Security Council. The draft Banking Bill, in parliament since late 2017, lays out plans for stressed banks, updates the banking regulation, paves the way for Iran's banks to apply international financial reporting and risk management standards and eases conditions for foreign banks' establishment in Iran. These reforms go hand in hand with the reforms proposed in the Central Bank Bill, also still in parliament, which would strengthen the central bank's supervisory powers and independence and refocus its legal mandate to preserving low inflation. Both bills would improve the transparency of commercial banks' reporting and their supervision which are also necessary for improving the anti-money laundering/counter-terrorism financing (AML/CTF) regime.

More generally, as regards anti-money laundering and efforts to combat the financing of terrorism, the Financial Action Task Force (FATF) has agreed with Iran an Action Plan which

Iran is still in the process of implementing. Following Iran's agreement to implement the Action Plan, the FATF has suspended the call for counter-measures—previously in place—until June 2018. The Iranian Majlis is currently reviewing certain key pieces of AML/CTF legislation required by the Action Plan. Progress on this and on all aspects of the Action Plan will be considered at the next FATF meeting in June 2018. Iran is also included in the list of AML/CFT high-risk third countries adopted by the European Commission on 14 July 2016 which in general follows the FATF guidance.[1]

Progress on structural reforms

The current economic policy framework is determined in the 'Vision 2020,' adopted in 2012. It envisages Iran's transformation from a state-dominated (and partly state-controlled) economy to a more market-based economy by improving the business environment and competitiveness, modernizing the financial sector and attracting foreign direct investment.

The Iranian parliament approved the sixth five-year development plan (running from March 2016 until March 2021) which sets as economic goals 8% average economic growth, reducing the unemployment rate to 7%, keeping the inflation rate below 10%, reducing the share of oil revenue in the government budget from 31.5% to 22% and a pension reform. Overall, the plan sets out the path to fiscal consolidation and sustainability and confirms the will to economic reorientation towards a stronger private sector with limited state involvement.

Privatisation of state-owned enterprises has been high on political agenda since a 2006 constitutional amendment allowed the sale of most state-owned companies, except those in strategic sectors like upstream energy, aviation and shipping. A shortage of private-sector capital, the policy of granting shares to workers, co-operatives and to the poor ('justice shares') and the influence of vested interests linked to the state have hampered the privatization programme launched after 2005/06.

Given all these factors, privatisation has tended to transfer shares in state-bodies to quasi-state institutions, including pension funds, religious foundations and companies owned by the Iranian Revolutionary Guards Corps (IRGC)—a situation that undermines future partnerships with foreign firms, considering that IRGC-owned companies in effect remain blacklisted.

Despite a large and well-educated working-age population, labour market outcomes are weak. Labour force participation is low by international standards (40%), and unemployment has hovered around 11% over the past 30 years. Female labour force participation is very low (17%), whereas the unemployment rate for women might exceed 20%.

Given the rapidly increasing share of youth in the population, the high youth unemployment rate (30%) is a major challenge. Structural bottlenecks to private sector development cause low job creation rates and prevent the absorption of new entrants. Strict dismissal regulations, a weak relation between productivity and wages, and skills mismatches hamper the functioning of the labour market on the supply side.

Overall the Iranian economy has large potential, and economic institutions are formulating encouraging reform intentions, which at the same time face substantial obstacles linked to an opaque political economy. In order to fully exploit the opportunities presented by the JCPOA, the Iranian government would need to proceed with reforming and restructuring the finance and banking sector, transforming the public sector including state-owned and semi-public enterprises and adjusting the social welfare system in a fiscally sustainable way.

[1] Commission Delegated Regulation (EU) 2016/1675 supplementing Directive (EU) 2015/849 of the European Parliament and of the Council by identifying high-risk third countries with strategic deficiencies

The latest five-year- development plan not only sets out the path to fiscal sustainability, it also confirms the will to economic reorientation towards a stronger private sector with limited state involvement. At the same time, non-governmental political forces in Iran seem to be influential enough to keep parts of the economy outside of the government's control and are hindering the government's reforms as well as the development of a genuinely private sector and distort competition in the economy.

Reducing the influence of semi-public entities (the Revolutionary Guards, unlicensed clerical financial organisations) in the economy will be crucial for increasing efficiency, transparency and the participation of private investors. The government's commitment to reform the role of the state and to cut back the scale and influence of the quasi-public sector seems genuine, considering that it can only achieve its key policy goals of macroeconomic stability, economic growth and reducing unemployment with a stronger private sector.

For the EU economy, the opening and possible transformation of the Iranian economy offers significant opportunities for investment and exports but also for supporting socio-economic stability in the region. Considering the commitments taken in the JCPOA and the important potential of EU economic relations with Iran, the EIB could support the economic reorientation of the country towards strengthening the private sector to which the Iranian authorities have committed for instance by improving the access to finance for small and medium-sized enterprises. It could facilitate the attraction of modern technology and specific measures in services and agriculture which can play an important role in boosting productivity and income. Such support could contribute to fostering sustainable economic growth and reducing youth unemployment through modernising productive infrastructure and private sector development. The EIB could also consider supporting firms doing business with the Iranian market.

Environmental aspects

Iran's environmental challenges

Domestic policies pursued by Iran in past years have had grave environmental consequences. Sanctions have increased the demand for expanded water-resource infrastructure and secure food and energy. Today Iran's main environmental challenges are: water scarcity, land degradation (caused by desertification and deforestation), energy (CO_2 emissions are amongst the highest globally), air pollution, waste management and increasing biodiversity loss.

Iran’s fresh water supplies are under severe strain – 90% of the country is arid or semi-arid, and an estimated two-thirds of the rainfall evaporates before it can replenish rivers. The situation is aggravated by frequent droughts and climate change. The water crisis is such that more than 6,000 townships receive their drinking water from tankers.

In the post-1979 Revolution era, the Islamic Republic issued permits to allow thousands of wells to be dug across Iran to promote agriculture. Experts see this and the popular choice of dams during previous administrations as one of the main reasons for the decline in water resources. Over the past thirty years, Iran has built 600 dams – an average of 20 a year. There is no specific plan in place to remedy this water crisis.

Lake Urmia represents a major cross-border challenge. Lake Urmia is located near the Turkish border. The Lake was declared a Wetland of International Importance by the Ramsar Convention in 1971 and designated a UNESCO Biosphere Reserve in 1976. The lake’s watershed is important for agriculture in the region. The lake itself is home to a unique brine shrimp species called Artemia urmiana, a hardy species that can tolerate high salinity levels. The lake also supports many species of reptiles, amphibians and mammals and provides an important seasonal habitat for several species of migratory birds.

Lake Urmia, once the sixth-largest salt-water lake in the world (twice the size of Luxembourg) has been declining for 30 years. It has shrunk by about 90% over the last decade, exposing a salt desert that generates noxious dust. President Hassan Rouhani has pledged USD 5 billion over the next decade to revive Urmia. Iran is planning to pump water from Armenia and Georgia. The water will be brought from Armenia's Lake Sevan and Georgia's Kura River via three pumping stations in Iran.

While Article 50 of the Iranian Constitution stipulates that 'the preservation of the environment in which the present as well as future generations have a right to a flourishing social existence is regarded as a public duty in the Islamic Republic. Economic and other activities that involve pollution of the environment or cause irreparable damage to it are forbidden' and some environmental legislation exists, there is no overarching national plan or strategy for the environment. Implementation of said environmental legislation has been a challenge. Strengthening capacity and resources to oversee implementation, improving inter-departmental consultation and increasing fines could help improve implementation.

EU-Iran cooperation on environment and water

Iran has signalled environment as a priority area for cooperation with the EU. In April 2016, both sides issued a Joint Statement during a meeting between EU High Representative/Vice-President of the Commission Federica Mogherini together with the Commissioner for Environment, Maritime Affairs and Fisheries Karmenu Vella and Vice-President of Iran and Head of the Environmental Department Masoumeh Ebtekar in Teheran. In December 2016, Vice-President Ebtekar and Commissioner Vella signed administrative arrangements on a framework for cooperation on environmental matters.

Three thematic areas of work were agreed:

- Circular economy and waste management,
- Industrial emissions and air quality,
- Water management, including marine environment.

Since the signing, cooperation has continued at technical level. Technical meetings with the participation of EU and Iranian experts took place in November 2017 in Tehran. The meetings were organised with the Iranian Department of Environment and in close cooperation with related ministries.

Following the November 2017 meetings a scoping study for future cooperation has been written with a view to producing a roadmap for cooperation. It requires further discussion with the Iranian counterparts.

A Partnership Instrument (PI) proposal (Policy Support Facility, PSF) supports the implementation of the framework for cooperation on environment.

In April 2017, the Council authorised the Commission to negotiate a Memorandum of Understanding between the EU and Iran on cooperation on climate change.

The EIB could also consider playing a part in addressing Iran's environmental challenges through investments in areas such as renewable energy, energy efficiency and climate change mitigation and adaptation, providing needed finance as well as crucial technical support and knowledge required to tackle the challenges and ambitions described above.

3. CONSULTATION PRIOR TO THE ADOPTION OF THE ACT

The Commission consulted Member State experts at a meeting on 28 May 2018 called in accordance with the Interinstitutional Agreement of 13 April 2016 on Better Law-Making and the procedure it describes regarding the preparation of delegated acts.[2] The European Parliament and the Council also sent experts as foreseen in that agreement. The EIB also attended.

During the consultation of Member State experts, it was recalled that the European Investment Bank will continue to apply adequate policies and processes protecting its integrity as well as confidence in the Bank.

4. LEGAL ELEMENTS OF THE DELEGATED ACT

The present Commission delegated decision aims at amending Annex III of Decision 466/2014/EU by adding Iran to the list of eligible countries for EIB financing operations with EU guarantee coverage.

[2] OJ L 123, 12.5.2016, p. 1-14.

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amending Annex III to Decision No 466/2014/EU of the European Parliament and of the Council granting an EU guarantee to the European Investment Bank against losses under financing operations supporting investment projects outside the Union, as regards Iran

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Decision No 466/2014/EU of the European Parliament and of the Council of 16 April 2014 granting an EU guarantee to the European Investment Bank against losses under financing operations supporting investment projects outside the Union[3], and in particular Article 4(2) thereof,

Whereas:

(1) There has been notable progress in the economic, social, environmental and political situation in Iran since the adoption of Decision No 466/2014/EU.

(2) In November 2016, the Council welcomed the prospect of extending the European Investment Bank's External Lending Mandate to Iran.

(3) Decision (EU) 2018/412 of the European Parliament and of the Council of 14 March 2018 amending Decision No 466/2014/EU[4] added Iran to the list of potentially eligible regions and countries in Annex II of that Decision.

(4) Tangible steps taken by Iran to respect universal fundamental freedoms, rule of law and human rights would remain key for the shaping of the Union's future policy towards Iran.

(5) The European Investment Bank should continue to apply adequate policies and processes protecting its integrity as well as confidence in the Bank.

(6) Therefore, the Commission, with the involvement of the European External Action Service, has assessed that the overall economic, social environmental and political situation allows adding Iran to Annex III of Decision No 466/2014/EU, which includes the list of eligible regions and countries for European Investment Bank financing under Union guarantee.

(7) Decision No 466/2014/EU should therefore be amended accordingly,

HAS ADOPTED THIS DECISION:

Article 1

In point C(2) of Annex III to Decision No 466/2014/EU, the words:

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[3] OJ L 135, 8.5.2014, p. 1-20.

[4] OJ L 76, 19.3.2018, p. 30–43

'Bangladesh, Bhutan, Cambodia, China, India, Indonesia, Iraq, Laos, Malaysia, Maldives, Mongolia, Myanmar/Burma, Nepal, Pakistan, Philippines, Sri Lanka, Thailand, Vietnam, Yemen'

are replaced by the words:

'Bangladesh, Bhutan, Cambodia, China, India, Indonesia, Iran, Iraq, Laos, Malaysia, Maldives, Mongolia, Myanmar/Burma, Nepal, Pakistan, Philippines, Sri Lanka, Thailand, Vietnam, Yemen'.

Article 2

This Decision shall enter into force on the day of its publication in the *Official Journal of the European Union*.

Done at Brussels, 6.6.2018

For the Commission

The President
Jean-Claude JUNCKER