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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Comprehensive Report on the functioning of the Guarantee Fund

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1. THE FUND SHIELDING THE UNION BUDGET FROM CALLS DUE TO DEFAULTS SINCE 1994

The Guarantee Fund for external actions ("the Fund") was established in 1994 by Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994[1] in order to shield the Union budget in the event of any default by the beneficiaries of loans granted or guaranteed by the European Union. The Regulation has been amended three times[2] and the Fund is currently operated under Council Regulation (EU, Euratom) No 480/2009 of 25 May 2009[3] (codified version).

Four reviews of the functioning of the Fund have taken place (in 1998, 2003, 2006 and 2010). Further to the review in 2006, a new provisioning mechanism was implemented. It entered into force in 2007. This report presents the fifth review of the Fund and it was announced in the conclusion of the 2010 report.Additional information on the activity and the functioning of the Fund can be found in the annual reports on the management of the Fund and on the guarantees covered by the EU budget.

This report is structured as follows: the following two sections (2 and 3) recall the key features of the current provisioning mechanism and the functioning of the Fund. Then, section 4 highlights the main events which affected the Fund since the last comprehensive report in 2010 while section 5 covers the management of the Fund's assets. Section 6 gives the outlook of operations covered by the Fund and their impact on provisioning needs for the MFF 2014-2020. Section 7 reviews the target provisioning rate while section 8 concludes. A Commission Staff Working Document (SWD) complements this report by providing graphs and tables.

2. THE KEY FEATURES OF THE PROVISIONING MECHANISM

Three key features of the new mechanism introduced in 2007 are (a) the provisioning on the basis of net disbursements, (b) the smoothing mechanim and (c) the trigger values.

2.1. Provisioning based on net disbursements

The present provisioning mechanism introduced in 2007 changed the provisioning rules for the Fund by ending the former practice to provision the Fund on the basis of projections of loans signed, independently of the actual disbursements. The provisioning mechanism is since based on net disbursements. The objective of this change was the improvement of the functioning of the Fund by reducing to only one the number of annual transfers between the Union budget and the Fund and increasing the efficiency of the budgetary flows.

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1 Council Regulation (EC, Euratom) No 2728/94 (OJ L 293, 12.11.1994, p. 1).

2 Council Regulation (EC, Euratom) No 1149/1999 (OJ L 139, 2.6.1999, p. 1); Council Regulation (EC, Euratom) No 2273/2004 (OJ L 396, 31.12.2004, p. 28); Council Regulation (EC, Euratom) No 89/2007 (OJ L 22, 31.1.2007, p. 1).

3 OJ L 145, 10.6.2009, p. 10.

2.2. The smoothing mechanism

In order to protect the EU budget from shocks, the provisioning mechanism foresees a smoothing mechanism which aims at limiting the annual amount transferred to the Fund in case of major defaults.

The smoothing mechanism functions as follows: if, as a result of one or more defaults, the amount to be covered by the Fund exceeds EUR 100 million in a given year (impacting the budget at the beginning of the year n+2 after the pay-out), the excess over EUR 100 million is paid gradually into the Fund. In particular, the size of the annual tranche will be the lesser of EUR 100 million, or the remaining amount due (Article 6 of Regulation No 480/2009).

The smoothing mechanism has not yet been activated as the Fund has so far not been called for amounts exceeding EUR 100 million p.a. as a result of one or more defaults.

2.3. The trigger values

In addition, so-called trigger values have been introduced. Their function is to keep the budgetary authority informed about major losses in the Fund (triggered when the value of the Fund falls below 80 % of the target amount) or to induce a report by the Commission on exceptional measures that may be required to replenish the Fund (triggered when the Fund value falls below 70 % of the target amount). The trigger values have not been reached so far.

3. THE FUNCTIONING OF THE FUND

This section sets out the operations covered by the Fund and the evolution of the credit risk of the guaranteed loans.

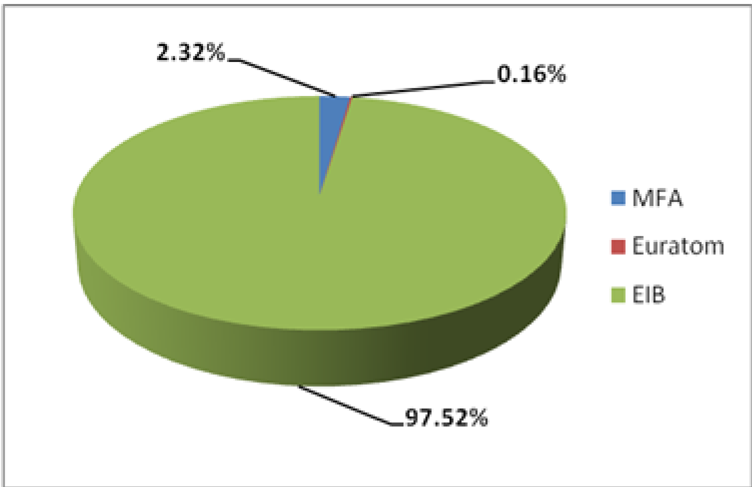
3.1. Operations covered by the Fund

The lending operations covered by the Fund relate to three different instruments which benefit from a guarantee from the European Union budget: guarantees to the European Investment Bank (EIB) for the loans or loan guarantees to operations in third countries, Euratom lending to third countries and EU Macro-Financial Assistance (MFA) loans to third countries. The chart in the SWD (section 1) describes the functioning of the Fund and all the financial flows impacting its value.

3.1.1. EIB external lending covered by the Fund – volumes and main risk characteristics of guarantees given to the EIB

About 97% of the total outstanding amount covered by the Fund are guarantees issued with respect to loans granted by the EIB for projects in third countries. Based on the forecasted execution of the mandate, this predominance of the EIB guarantees in the risk covered by the Fund will remain unchanged in the future. If the recipient of a guaranteed loan fails to make a payment on the due date and does not pay within three months thereafter either, the EIB asks the Commission to pay the amounts owed by the defaulting debtor in accordance with the EU-EIB guarantee agreement. If the EIB has another public or private guarantor in addition to the EU guarantee, it is activated before calling the EU guarantee.

Graph 1: Share of EIB operations covered by the Fund at the end of 2012 (capital and interest due)



EIB financing operations in third countries entered into with a State, entered into with a public sector or a private sector entity covered by a State guarantee, or entered into with regional or local authorities, or government-owned and/or government-controlled public enterprises or institutions with an appropriate credit risk, are covered by a comprehensive guarantee. For other types of operations, notably private sector operations, the guarantee is limited to well-defined political risk events.

3.1.2. Macro-Financial Assistance loans covered by the Fund

Macro-Financial Assistance (MFA) is being provided, in the form of loans and/or non-reimbursable grants, to support EU candidate, potential candidate and neighbourhood countries to resolve short-term balance-of-payments problems, to stabilise public finances and to encourage structural reform implementation. MFA is provided on an exceptional and temporary basis on strict economic policy conditionality, typically complementing IMF adjustment programmes. MFA operations have to be authorised individually by the Council and the Parliament.

Should a beneficiary country fail to honour its loan repayment obligations, the Commission may activate the Fund so as to repay the corresponding borrowing.

In 2012, the share of MFA operations was very limited (about 2%) in comparison with the total outstanding amount of capital and interests covered by the Fund (see Graph 1).

3.1.3. Euratom operations covered by the Fund

The Euratom loan facility may be used to finance projects within Member States (Council Decision 77/270/Euratom) or in certain third countries (Ukraine, Russia or Armenia) (Council Decision 94/179/Euratom). In 1990, the Council fixed a borrowing limit of EUR 4 billion, of which some EUR 3.7 billion have been signed and EUR 3.4 billion disbursed. The Commission shall inform the Council and propose a new borrowing limit when the total value of transactions reaches EUR 3.8 billion.

As in the case of MFA, the Fund could be called if a beneficiary fails to honour its loan repayment obligations.

In 2012, the share of Euratom operations was marginal (less than 1%) in comparison with the total outstanding amount of capital and interests covered by the Fund (see Graph 1).

3.2 Evolution of credit risk

The Fund covers the risk of loans and loan guarantees to third countries. Since the start of the implementation of the EIB's external mandate[4] for 2007-2013, the outstanding amount covered increased on average by 13.5% per year to about EUR 23.1 billion in 2013 (outstanding loans plus accrued interest). The growth of the outstanding amount covered by the Fund does not necessarily mean that the Fund bears a proportionally higher risk in proportion to the increase in the amount covered, as the overall credit risk must also be assessed on the basis of the quality of the borrowers. When assessing the evolution of credit risk over time it can be concluded that at the end of October 2013 there was a modest improvement in the credit risk profile of the covered loans compared to 2009. In particular, the proportion of the loans guaranteed by the Fund that relate to investment-grade borrowers has increased over time (see section 5 of the SWD). This observation is one of the elements which underpins the conclusion to maintain a level of 9% for the target rate.

4. EVENTS WHICH AFFECTED THE FUND OVER THE PERIOD 2010 – 2013

Two events which affected the Fund in the period were the defaults of guaranteed loans provided by the EIB to Syria and the EU membership of Croatia which are detailed below.

4.1. Defaults of guaranteed loans to Syria

In the wake of the deteriorating situation in Syria, the Foreign Affairs Council, the European Parliament and the European Council took certain decisions in 2011 towards the country. In particular, they prohibited disbursements by the EIB in connection with existing loan agreements. This decision was thereafter consolidated in Council Decision 2011/782/CFSP of 1st December, Council Regulation (EU) No 36/2012 of 18 January 2012 and Council Decision 2013/255/CFSP of 31 May 2013.

Whereas in previous years Syria had fully and timely serviced its loans to the EIB, since November 2011 the bank is facing arrears on loans to projects in Syria. As a consequence, and in line with the Guarantee Agreement between the EU and the EIB, the EIB has made 4 calls on the Fund in 2012 for a total amount of about EUR 42 million. During 2013, 8 supplementary calls were made on the Fund, for a total amount of 82.5 EUR million. An amount of EUR 2.1 million was recovered in 2012.

The total outstanding capital of guaranteed loans related to Syria amounts to approximately EUR 551 million with the last loan maturity in 2030. In conformity with the Guarantee Agreement, when the EU has made a payment under the EU Guarantee, it subrogates into the rights and remedies of the EIB. Recovery proceedings are to be undertaken by the EIB in respect of the subrogated sums, in accordance with the Recovery Agreement between the EU and the EIB.

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[4] Decision No 1080/2011/EU of the European Parliament and of the Council of 25 October 2011 granting an EU guarantee to the European Investment Bank against losses under loans and loan guarantees for projects outside the Union and repealing Decision No 633/2009/EC, OJ L 280, 27.10.2011, p. 1.

4.2. Croatia has become an EU member in 2013

Following Croatia's accession into the EU in June 2013, the risk associated with this country continues to be covered by the EU budget but will no longer be covered by the Fund. Consequently, an amount of about EUR 30.3 million corresponding to an exposure on Croatia of about EUR 337 million (outstanding amounts plus accrued interest) was transferred from the Fund to the EU budget in 2013.

5. MANAGEMENT OF THE FUND'S ASSETS IN A DIFFICULT MARKET ENVIRONMENT

This section assesses the performance and the evolution of the assets of the Fund over the period 2010-2013.

5.1. The performance of the Fund

During the whole period 2010- June 2013, the Fund had overall an absolute return on average of 2.42 % p.a.. Over the same period the benchmark of the Fund had an average return of 1.86 % p.a.. The benchmark of the Fund is a composite mainly built from iBoxx indices (in particular EUR Eurozone Sovereign and EUR Collateralized Covered indices) and Euribid for the short-term exposure. The Fund over-performed its benchmark index on average by 0.56 basis points p.a.. The performance of the Fund was obtained in the context of the most severe crisis in global financial markets in recent history. The assets of the Fund on 31 December 2012 amounted to about EUR 2 billion (of which about EUR 155.7 million represented the contribution due by the EU budget in early 2013). The sensitivity of the portfolio to interest rate risk, as measured by duration, was limited to about 1.45 at 30 June 2013.

5.2. Development of the Fund's size

Graph 2 in the SWD shows that the volume of the Fund decreased in 2007 and 2008 following the implementation of the new provisioning mechanism and increased since 2008 to reach about EUR 2 billion in 2012. The decrease in 2007 is explained by the slow pattern of loan disbursements at the beginning of the current EIB external mandate (but related to the previous mandates) resulting in a surplus of EUR 125.75 million transferred from the Fund to the EU budget. The acceleration in the rhythm of disbursements of the external lending mandate since 2010 and the growth of the MFA operations due to the financial crisis explain the increase in the size of the Fund's assets (see section 6 Table 1 in the SWD).

In addition to provisioning, the Fund's other main source of income is the return earned on its assets. The return earned on the Fund's assets fell since 2007 due to the general decline in the market interest rates to historically low levels. The return earned during the period 2007-2013 amounted to EUR 281 million (table 1, column-b, of the SWD, flows in and out since the creation of the Fund).

6. OUTLOOK FOR THE NEW MANDATE 2014 - 2020

This section reviews the outlook of the loan operations covered by the Fund (EIB, MFA, Euratom) and the potential provisioning impact during the MFF 2014-2020.

6.1. The EIB mandate

The EIB mandate represents more than 95% of the operations covered by the Fund. The provisioning mechanism of the Fund, which aims at maintaining the Fund at a level of 9% of outstanding loan disbursements, creates a de facto limit in the size of the EIB external mandate covered by the EU budget guarantee.

The Commission made a proposal for a decision of the European Parliament and the Council on granting an EU guarantee to the European Investment Bank against losses under financing operations supporting investment projects outside the Union [COM(2013) 293 of 23.05.2013]. This proposal puts forward a maximum ceiling of EUR 28 billion for the EIB financing operations under EU guarantee throughout the period 2014-2020 and breaks down the ceiling into two parts:

(i) a *fixed* ceiling of a maximum amount of EUR 25 billion; and
(ii) an *optional* additional amount of EUR 3 billion.

The budgetary impact of the potential activation of the optional additional ceiling would have to be calculated on the basis of updated forecasts on provisioning needs of the Fund at the time of the mid-term review.
Subsequent negotiations on the new mandate were concluded between the Council, the European Parliament and the Commission on 17 December 2013 with the agreement to increase the *fixed* ceiling by EUR 2 billion, bringing it to a maximum amount of EUR 27 billion. This agreement will need to be formally approved by the Council and European Parliament during 2014.

6.2. Macro-Financial Assistance

Since 2011 the Commission adopted four legislative proposals for macro-financial assistance (MFA): two in 2011, for Georgia in January 2011 and for the Kyrgyz Republic in December 2011, and two in 2013, for Jordan in April and for Tunisia in December.

From the second half of 2011, financing conditions in global capital markets experienced a significant deterioration. In addition, the Arab Spring and the resulting political and economic upheavals in the Arab Mediterranean partner countries put heightened pressure on the budgets and the external positions in these economies. These developments led to an increased demand for MFA in 2012 and 2013. The first case was the request by the Egyptian Government for a MFA of EUR 500 million, initially transmitted in June 2011 and renewed in February and November 2012. The second case was the request by Jordan in December 2012 for MFA support in the form of loans for up to EUR 200 million. Also, in August 2013, the authorities of Tunisia requested MFA of up to EUR 500 million. After estimating, in liaison with the IMF, Jordan's and Tunisia's residual external financing needs, the Commission adopted in April 2013 (Jordan) and December 2013 (Tunisia) legislative proposals for assistance of respectively EUR 180 and 250 million, in the form of loans. In December 2013, the legislative decision on assistance for Jordan was adopted by the European Parliament and the Council. The assistance is to be disbursed during 2014. The planned MFA to Tunisia is to be released in 2014 and 2015.

Following the critical developments in Ukraine, the Commission has proposed an additional emergency MFA operation of up to EUR 1 billion in loans, complementing the already

existing MFA programme of EUR 610 million in loans. Disbursements of the funds for both operations are foreseen over 2014-2015.

In addition, Armenian authorities also sent a request for a new MFA operation in February 2014.

The estimated projected disbursements of MFA loans during the period 2014-2015 (given the exceptional nature of MFA assistance, no forecast for the period beyond 2015 exists) represent about EUR 2.6 billion of which EUR 1.7 billion are estimated for 2014 and EUR 0.9 billion for 2015 (these figures include the latest MFA operation proposed for Ukraine). The disbursements under these loans will have an impact on the provisioning of the Fund in 2016 at the earliest depending on the rhythm of loan disbursements.

6.3. Euratom

In 2012, no loan disbursements were carried out under the Euratom loan facility.

A loan facility and a guarantee agreement were signed in August 2013 (EUR 300 million) with Ukraine to upgrade the safety of their nuclear power plants. A first tranche of this loan facility is expected to be disbursed in 2014.

In the 2014-2020 timeframe, one or two projects in Member States or in some specific Non-Member States might benefit from the remaining EUR 326 million which are still available under the facility.

The Commission will have to inform the Council and make a proposal for a new borrowing limit when aggregate loan amounts reach EUR 3.8 billion (currently EUR 3.7 billion).

6.4. Provisioning proposal for the 2014-2020 MFF

As can be seen in table 2 of the SWD, during the 2007-2013 financial framework, the available annual budgetary resources foreseen in the MFF 2007-2013 (EUR 200 million p.a. in current prices) were largely sufficient for the provisioning of the Fund in the majority of the years. The ratio between the total of transfers from the EU budget to the Fund and the total budget allocation is about 44% at the end of the period 2007-2013.

This utilisation level was affected by the adoption of the new provisioning mechanism in 2007 which ended the structural over-provisioning. In addition, the rhythm of disbursements of EIB loans signed under the current mandate observed in the period 2007-2009 was not as fast as expected. In 2011, the optional mandate in the field of climate change (EUR 2 billion in current prices) was activated; in addition, the ceiling for the Mediterranean countries was increased by EUR 1.6 billion in current prices (Decision No 1080/2011/EU). However, these changes will affect the provisioning in the 2014-2020 MFF.

According to the Commission proposal of 23.05.2013 for a new EIB external mandate, the total ceiling for the provisioning of the Fund for the 2014-2020 mandate would amount to EUR 1.193 billion, compared to EUR 1.4 billion under the 2007-2013 financial framework (both amounts in current prices).

The subsequent agreement of 17 December 2013 (in the course of negotiations between the Council, the Parliament and the Commission , still to be adopted by the co-legislator) to increase by EUR 2 billion the *fixed* ceiling of the EU Guarantee to the EIB also foresees an additional amount of EUR 110 million[5] in assigned revenue[6] to cover the additional provisioning needs of the Fund.

The total provisioning amount for the 2014-2020 MFF is expected to cover the needs of the Fund over the period 2014-2020, on the basis of the information available at the writing of this report and on the basis of expected patterns of disbursements and reimbursements of the guaranteed loans.

The effective annual needs for the provisioning of the Fund in 2014-2020 will nevertheless ultimately depend on the actual rhythm of signatures, disbursements and reimbursements of the loans on the three activities covered by the Fund (EIB's guaranteed loans, MFA and Euratom).

Another important factor which has an impact on the potential change in the needs of budgetary resources for this period is the impact of the calls on the Fund's assets following defaulted payments on guaranteed loans to Syria since 2011. The expected provisioning needs for 2014-2020 take account of the impact of existing calls related to Syrian defaulted loans having taken place in 2012 and 2013, as well as the hypothesis of continuing defaults on payments falling due until mid-2015. Considering the fact that this hypothesis is inevitably arbitrary, the calls related to Syria's defaults could end before or continue after this period.

Finally, the Fund's resources will be complemented by the return earned by investing the assets of the Fund. However, due to the historically low interest rates levels prevailing at the time of preparing this report, the returns may be lower than in the previous periods.

7. TARGET PROVISIONING RATE

An evaluation of the Fund was undertaken between September 2009 and February 2010. The purpose of the evaluation was to assess the relevance, effectiveness and efficiency of the Fund, with a particular focus on the appropriateness of the current levels of the main parameters of the Fund, notably the target rate. The study confirmed that the current level of 9% was appropriate in relation to the credit risk of the loans and guaranteed loan operations covered by the Fund.

[5] An amount of EUR 110 million, originating from operations concluded before 2007, paid back to the fiduciary account established for the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) and attributable to the support from the budget, shall constitute external assigned revenue (for the EIB external mandate 2014-2020) in accordance with Article 21(4) of the Financial Regulation and shall be used for the Fund.

[6] Since assigned revenue gives rise to additional expenditure appropriations without the need to raise additional own resources it does not count against the MFF-ceilings, see recital 8 of the Council Regulation laying down the multiannual financial framework for the years 2014-2020: ‘The MFF should not take account of budget items financed by assigned revenue within the meaning of Regulation (EU, Euratom) No 966/2012 of the European Parliament and of the Council (the "Financial Regulation").’

Even under an accelerated loss scenario[7], the quantitative assessment carried out as part of the abovementioned evaluation indicates that even unlikely big losses could potentially be covered by the Fund. In the past, the EIB has never accelerated calls on defaulting guaranteed loans in a context where the EU guarantee provides comfort that remaining payments due by the borrower will be covered even if the latter continues to default.

The Fund covers the credit risk of defaults in 42 countries. The 10 top countries to which the Fund has the highest exposure account for about 81% of the total exposure. The geographical distribution of the lending operations covered by the Fund is relatively stable over the period 2000-2013. The regional distribution of the EIB mandate explains this stability as the repartition of lending operations between the previous and the current mandate has many similarities. About 83% of the lending operations are focused on Mediterranean, potential and candidate countries (see graph 3 in the SWD).

The analysis of the evolution of the credit risk profile of the loans covered by the Fund as of the end of 2012 suggests that the major parameter of the Fund (the 9% "target" rate) is fixed at a sufficient level in relation to the risk borne by the Fund. In particular, the credit risk profile of the lending operations, as measured by the average weighted rating, improved slightly compared with the previous years (see 3.2 above and section 5 in the SWD). This lower risk profile is one of the reasons supporting the actual level of the target rate.

While the overall credit risk profile improved in recent years, in October 2013 about 49% of the loans in the guaranteed portfolio have a credit rating below investment grade. This implies that the probability of a default in one year is not negligible, according to the historical cumulative default rates for different credit ratings for sovereign risks over different time horizons published by the major credit rating agencies. However, this risk is deemed to be addessed by the 9% provisioning target rate.

During the period 1994-2011, the Fund was called upon for a cumulative amount of EUR 478 million and had a recovery rate of 100% (see table 1 of the SWD). The last calls were registered in 2012 and 2013 in relation to Syria. In 2012, an amount of EUR 42 million was called, of which EUR 2.1 million was recovered and 24 EUR million paid. The calls for 2013 are estimated to be about EUR 82.5 million.

Based on the analysis in this report, the major parameter of the Fund (the 9% "target" rate), is fixed at a sufficient level to take into account the risk borne by the Fund and the potential evolution of this credit risk due to the impact of the financial crisis.

8. CONCLUSION

The current provisioning mechanism continues to deliver the promised improvement in the budgetary process with a provisioning based on the observed net disbursements. This has resulted in an improved budgetary process for provisioning the Fund.

[7] Usually the Fund is only called to compensate for the amount of a missed payment (interest and/or capital) on a given due date. This means that the whole amount of future payments due affects the Fund only over time as these payments become due. Theoretically, after a missed payment, the creditor of a loan could demand all future payments. In order to simulate a maximum stress on the Fund, the quantitative analysis also simulated a scenario in which missed payments trigger an acceleration of all future due payments.

A quantitative analysis of the risk covered by the Fund and the Fund's 9% target rate has shown that this target rate, coupled with the other key features of the Fund, are appropriate. The Commission therefore does not see a need to change the target rate, or other Fund features.

Nevertheless, the target rate should be reviewed from time to time in order to assess if it continues to be commensurate with the risk profile borne by the Fund.
Such a review will be undertaken at the time of the mid-term review of the external mandate. If such review concludes that changes in the functioning of the Fund are required, a new comprehensive report on the functioning of the Fund would be issued.