COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.5.2007
COM(2007) 362 final

REPORT FROM THE COMMISSION

Annual Report from the Commission on the Guarantee Fund and its Management in 2006

{SEC(2007) 869}

TABLE OF CONTENTS

1. LEGAL BASE

Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 ("the Regulation") set up a Guarantee Fund for external actions ("the Fund") in order to repay the Community's creditors in the event of default by beneficiaries of loans granted or guaranteed by the Community (OJ L 293, 12.11.1994, p. 1). The Regulation was amended by the Council Regulation (EC, Euratom) No 1149/99 of 25 May 1999 (OJ L 139, 2.6.1999, p. 1), the Council Regulation (EC, Euratom) No 2273/2004 of 22 December 2004 (OJ L 396, 31.12.2004, p. 28) and last amended by Council Regulation (EC, Euratom) No 89/2007 of 30 January 2007 (OJ L 22, 31.1.2007, p. 1) ("the amended Regulation"). This last amendment will apply on 1 January 2007.

In accordance with Article 6 of the Regulation, the Commission entrusted the financial management of the Fund to the European Investment Bank (EIB) under an Agreement signed between the Community and the EIB on 23 November 1994 in Brussels and on 25 November 1994 in Luxembourg ("the Agreement").

Under Article 8.2 of the Agreement, by 1 March of each year the Bank must send the Commission an annual status report on the Fund and its management including the revenue and expenditure account, "statement of financial performance", and the financial statement for the Fund for the preceding year, "statement of financial position of the Fund". Further details of the report covering the year 2006 can be found in Section 2 of the Commission Staff Working Paper ("the Annex")[1].

In addition, Article 7 of the amended Regulation requires the Commission to send to the European Parliament, the Council and the Court of Auditors a report on the situation of the Fund and its management for each financial year by 31 May of the following year.

2. POSITION OF THE FUND AT 31 DECEMBER 2006

2.1 Financial analysis

The position of the Fund is presented in accordance with International Financial Reporting Standards (IFRS) at the close of the 2006 financial year. The Fund totalled EUR 1,379,697,691.89 (see Section 3 of the Annex: Statement of Financial position of the Fund at 31 December 2006, provided by EIB). This is the sum, since the Fund was established, of all

- budget payments to the Fund EUR 2,799,914,500.00;
- successive yearly net results EUR 575,869,592.23;
- recoveries of payments made by the Fund for the defaults EUR 575,673,913.77;

[1] SEC(2007)

– minus EIB management fees for an amount of EUR 714,719.38; corresponding to the payment to be made in 2007;

– commission received on late recovery in 2002 EUR 5,090,662.91;

– adjustment due to the application of IFRS for the valuation of the Fund's portfolio EUR 14,996,561.86 (See item "Reserves" in the Liabilities of the Guarantee Fund Balance Sheet in Section 3 of the Annex);

– less calls on the Fund's resources (EUR 477,860,856.19);

– successive repayments to the budget of the surplus in the Fund (EUR 1,775,870,000.00);

– and the exceptional repayment to the budget of EUR 338,831,402.07 in 2005, representing 9% of the outstanding operations as of 1 May 2004 granted to the ten new Member States (See in Section 1 the 2004 amendment of the Fund's Regulation).

After the deduction of accruals in account payables of EUR 743,249.38, thereof EUR 714,719.38 management fees (EIB's remuneration), the total of the net balance sheet of the Fund at 31 December 2006 amounts to EUR 1,378,954,442.51.

At 31 December 2006, outstanding lending and loan guarantee operations plus accrued interest on loans to Bulgaria and Romania amounted to EUR 2,899,334,719.06. As these countries became members of the European Union on 1st January 2007, as of the date, an amount of EUR 260,940,124.72 was repaid on the 14 February 2007 to the budget following the amended Regulation.

Article 3 of the amended Regulation requires that the amount of the Fund has to reach an appropriate level (target amount) set at 9% of the total outstanding capital liabilities arising from each operation, plus unpaid interest due.

Therefore, outstanding lending and loan guarantee operations for third countries[2] plus accrued interest totalled EUR 11,025,065,532.58 at 31 December 2006, of which EUR 109,809,066.54 were accounted for accrued interest . The ratio between the Fund's resources of EUR 1,118,014,317.79 (EUR 1,378,954,442.51 - EUR 260,940,124.72) and outstanding capital liabilities within the meaning of the amended Regulation was 10.1%. Since this is higher than the target amount of 9% of the total guaranteed outstanding amount (rounded amount of 992.26 EUR million), a repayment from the Fund to the general budget of the European Union has to be made, as provided for in the third paragraph of Article 3 of the amended Regulation in 2007. The amount to be inserted in 2007 as a surplus in the Preliminary Draft Budget of 2008 is EUR 125,750,000.00.

[2] The amended Regulation stipulates that operations towards accession countries covered by the Fund remain covered by the Community guarantee after the date of accession. However, from that date, they cease to be external actions of the Communities and are covered directly by the general budget of the European Union and no longer by the Fund.

2.2 Accounting presentation

Since the Commission decided to present its accounts according to new accounting rules inspired by IPSAS / IFRS principles, the pre-consolidated financial statements of the Fund have been prepared according to these principles as explained in the Annex.

2.3 Pre-consolidated financial Statement of the Guarantee Fund at 31 December 2006

The total amount of the pre-consolidated balance sheet is EUR 1,380,797,489.49. This includes the total amount of the Fund plus the arrears covered by the Fund, the accruals of interests on late payments and other accounting accruals in order to produce a full set of financial statements for the Fund at year-end to be consolidated in the EU consolidated balance sheet.

The major changes in the presentation of accounts are explained in the notes in order to reconcile the figures with the EIB financial statement presented in the Annex (paragraph 3.2).

2.3.1 Guarantee Fund Pre-consolidated balance sheet

Balance sheet: Assets (EUR)	2006	2005
Current assets		
Short-term receivables	**1,099,797.60**	**1,227,798.12**
Others	1,099,797.60	1,227,798.12
Short-term Investments	**939,964,332.03**	**1,008,639,934.02**
AFS Portfolio – cost	909,631,292.30	946,662,502.30
AFS Portfolio – actuarial difference	-7,298,412.75	-8,860,547.41
AFS Portfolio – adjustment to fair value	14,654,734.60	46,565,266.11
AFS Portfolio - accruals	22,976,717.60	24,272,713.02
AFS Portfolio - impairment		
Cash and cash equivalents	**439,733,359.86**	**316,024,023.23**
Current accounts	1,158,007.44	1,582,089.98
Short-term deposits - nominal	436,500,000.00	313,500,000.00
Accrued interests on short-term deposits	2,075,352.42	941,933.25
Other cash equivalent - cost		
Accrued interests on other cash equivalents		
Total Current Assets	**1,380,797,489.49**	**1,325,891,755.37**
TOTAL	**1,380,797,489.49**	**1,325,891,755.37**

Balance sheet: Liabilities (EUR)	2006	2005
A. EQUITY		
Capital (Guarantee Fund)	**685,213,097.93**	**650,303,097.93**
Payment from the budget	559,463,097.93	557,573,097.93
(surplus to be paid to the budget)	125,750,000.00	92,730,000.00
Reserves	**14,996,561.86**	**46,981,944.72**
First time application – Fair value reserve	341,827.26	416,678.61
Change in fair value of AFS assets	14,654,734.60	46,565,266.11
Accumulated surplus / deficit	**627,856,153.68**	**577,197,865.26**
Results brought forward	627,856,153.68	577,197,865.26
Economic result of the year	**51,965,637.41**	**50,658,288.42**
Total Equity	**1,380,031,450.88**	**1,325,141,196.33**
B. CURRENT LIABILITIES		
Accounts payables	**766,038.61**	**750,559.04**
Others	766,038.61	750,559.04
Total current liabilities	**766,038.61**	**750,559.04**
TOTAL	**1,380,797,489.49**	**1,325,891,755.37**

Note to the balance sheet:

- The "short-term receivable others" refers to the amounts of calls on the Fund. This amount includes the capital, the interests and the penalties due to the Community Budget following the intervention of the Fund further to the activation of a guarantee.

- The difference in "accumulated surplus" in equity compared to the financial position of the Fund presented in the paragraph 3.3 of the Annex is explained by the successive repayments of the calls and penalties to the Fund.

- The "account payables others" in 2006 include the EIB management commission, the audit fees, the accrual of closing accounts audit fees and the accrual of the recovery fees due to EIB following the payment of the penalty fees due to the Fund.

2.3.2 Guarantee Fund Pre-consolidated Economic Outturn Account

GF – Consolidated Economic Outturn Account (EUR)	2006	2005
Financial operations revenues	**52,981,320.04**	**51,555,876.17**
Interest income		
Interest income on cash and cash equivalents	11,443,127.48	6,280,520.69
Interest income on AFS assets	41,538,192.56	44,158,957.25
Other interest income		-88,004.16
Exchange gains		54,152.53
Realised gains on sale of AFS assets	0.00	1,150,249.86
Reversal of impairment losses on AFS assets		
Other financial income		
Financial operations expenses	**-1,015,682.63**	**-897,587.75**
Interest charges		
Interest charges on cash and cash equivalents		
Exchange losses	-128,000.52	
Realised losses on sale AFS assets		
Impairment losses on AFS assets		
Other financial charges	-887,682.11	-897,587.75
Thereof: Management fees	-714,719.38	-702,497.47
SURPLUS FROM NON OPERATING ACTIVITIES	**51,965,637.41**	**50,658,288.42**
SURPLUS FROM ORDINARY ACTIVITIES		
Extraordinary gains		
Extraordinary losses		
SURPLUS FROM EXTRAORDINARY ITEMS		
ECONOMIC RESULT OF THE YEAR	**51,965,637.41**	**50,658,288.42**

Note to the Pre-consolidated Economic Outturn Account:

- The adjustment in 2005 related to "other interest income" is due to the change in valuation of the penalties to receive.

- The "exchange gains" in 2005 refer to valuation of "other receivables".

"Other financial charges" include EIB management commission, the audit fees, the accrual of closing accounts audit fees and the accrual of the recovery fees due to EIB following the payment of the outstanding penalty fees due to the Fund.

3. PAYMENTS INTO THE FUND

3.1. Payments from the general budget in the course of the financial year

The legal base for the provisioning arrangements is described in Section 1 of the Annex.

The Council Regulation (EC) No 2040/2000 of 26 September 2000 (OJ L 244, 29.9.2000, p. 27) concerning budgetary discipline authorised the entry in the general budget of a reserve for loans and guaranteed operations. This item, to which appropriations of EUR 229 million in 2006 were allocated, is used for endowing the Fund by transferring amounts to the budget item for payments to the Fund.

In line with the legal base, one transfer totalling EUR 127,640,000.00 to endow the Fund was adopted by the budgetary authority in 2006.

– Transfer DEC20/2006[3]: EUR 127,640,000.00: this transfer was for payments into the Fund in respect of the Council Decisions of 22 December 1999, 6 November 2001 and 22 December 2004, in accordance with the arrangements set out in the Annex to the Regulation.

The decisions covered by this transfer are listed in Section 1 of the Annex.

The transfer of EUR 127,640,000.00 was paid under the mechanism for offsetting against the repayment of the Fund's surplus of EUR 92,730,000.00. Consequently, a net amount of EUR 34,910,000.00 was paid to the Fund on 31 July 2006.

On 30 January 2007, the Council adopted an amendment (See Section 1 on Legal Base) which will apply from 1 January 2007. The main objective of this amendment is to improve the efficiency of the use of budgetary means by provisioning the Fund on the basis of observed amounts of guaranteed loans outstanding.

According to the Interinstitutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management[4], the amount available for financing of the Fund will be carried out

3 SEC(2006) 646 final.
4 OJ C139, 14.06.2006, p. 1.

through a budget line under Heading 4 (External Relations) and not, as in the past, through a dedicated Reserve[5].

3.2. Interest from financial investment of the Fund's liquid assets

The Fund's liquid assets are invested in accordance with the management principles laid down in the Annex to the Community/EIB Agreement of 23/25 November 1994, amended by Supplementary Agreement No 1 of 17/23 September 1996 and Supplementary Agreement No 2 of 26 April/8 May 2002. By Supplementary Agreement No 2, the investment principles were changed in 2002 in order to correct the excess liquidity which had risen to over 50% of the Fund's assets and was restricting the yield of the Fund. While retaining the limit whereby at least one third of the Fund must be invested in short-term investments (up to one year), the instruments eligible for short-term liquidity were extended. They now include variable-rate securities, irrespective of their maturity dates, and fixed-rate securities with a maximum of one year remaining to maturity, irrespective of their initial maturity period. This is because fixed-rate securities are reimbursable at 100% of their nominal value at the end of their life, while variable-rate securities can be sold at any time at a price approaching 100%, whatever their remaining period to maturity. To maintain a balance between the various instruments for which liquidity is monitored, a minimum of 18% (corresponding to double the provisioning rate of the Fund) is kept in monetary investments, particularly bank deposits. This new structure helped to improve the Fund's yield while maintaining a prudent liquidity level.

At the end of 2006, the target structure of the portfolio as refined in 2005, i.e. an equal distribution of investments between the 2 and 10 year maturity was almost implemented. During 2007 the full implementation is programmed.

The performance of the portfolio was superior to its benchmark (see annex in paragraph 2.5.2 "Performance" for details). At the end of 2006, the out-performance amounted to 6.45 basis points.

The list of banks authorised to receive deposits is agreed by the Commission and the EIB. The original list has been regularly revised in the light of the latest changes in bank ratings. Most of the banks are members of the Euro clearing system. They all have a Moody's rating of at least A1 for long-term and P1 for short-term investments, or an equivalent Standard & Poor’s or Fitch rating. The investments made with them are governed by rules to ensure a higher return and to avoid the concentration of risk.

In 2006, interest income on cash and cash equivalents, on the Fund current accounts and on securities totalled EUR 52,981,320.04, broken down as follows:

– <u>Deposits and current accounts</u>: EUR 11,443,127.48; this represents the situation at 31 December 2006 including interest received on bank deposits EUR 10,272,574.00 and changes in accrued interest EUR 1,133,419.17 in

[5] Budgetary discipline will however be ensured as:
- for Macro-Financial Assistance loans, individual Council decisions are needed;
- for Euratom and EIB guaranteed loans, multiannual ceilings are approved by the Council.

2005. The current accounts amounted to EUR 37,134.31 comprising interest recorded on the current accounts.

– Securities portfolio: EUR 41,538,192.56; this amount includes EUR 44,781,061.69 of interest on securities, and changes in accrued interest (EUR 1,295,995.14) at 31 December 2006. The interest on securities is generated by investments placed in the form of securities in accordance with the investment principles laid down in the Agreement mandating the EIB to manage the Fund's liquid assets. From this figure must, however, be subtracted the EUR 1,946,873.99 entered in the course of the year as the difference between the entry price and the redemption value divided *pro rata temporis* over the remaining life of the securities held (corresponding to the spread of the premium or discount entered in the profit-and-loss account).

The interest received is entered in the results for the financial year.

3.3. Recovery from defaulting debtors

No recovery occurred in 2006. An amount of USD 1,448,433.44 relating to non paid penalty interest remains to be recovered by the Fund.

4. THE FUND'S LIABILITIES

4.1. Default payments

The Fund was not called for default payments in 2006.

4.2. EIB's remuneration

The second Supplementary Agreement to the Agreement signed on 26 April and 8 May 2002, lays down that the Bank's remuneration is to be determined by applying to each of the tranches of the Fund's assets the degressive annual rates of commission which relate to them respectively. This remuneration is calculated on the basis of the average assets of the Fund.

The Bank's remuneration for 2006 was fixed at EUR 714,719.38 and was entered in the profit-and-loss account and as accruals (liabilities) on the balance sheet. The remuneration was paid to the EIB in February 2007.