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REPORT FROM THE COMMISSION

**Annual report from the Commission
on the Guarantee Fund and its management in 2007**

{SEC(2008)1938}

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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”). 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 2007 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.

¹ SEC(2007)

2. POSITION OF THE FUND AT 31 DECEMBER 2007

2.1 Financial analysis

The position of the Fund is presented in accordance with International Financial Reporting Standards (IFRS) at the close of the 2007 financial year. The Fund totalled EUR 1,152,973,945.02 (see Section 3 of the Annex: Statement of Financial position of the Fund at 31 December 2007, 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 628,715,763.42
recoveries of payments made by the Fund for the defaults;	+ EUR 575,673,913.77
minus EIB management fees corresponding to the payment to be made in 2008;	- EUR 678,951.39
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 (See item "Reserves" in the Liabilities of the Guarantee Fund Balance Sheet in Section 3 of the Annex);	- EUR 3,627,413.49
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
less the repayment to the budget 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);	- EUR 338,831,402.07
less the repayment to the budget in 2007, representing 9% of the outstanding operations as of 1 January 2007 granted to Bulgaria and Romania after joining the EU at this date (See in Section 1 the 2004 amendment of the Fund's Regulation);	- EUR 260,940,124.72
Financial position of the Fund at 31 December 2007.	EUR 1,152,973,945.02

After the deduction of accruals in account payables of EUR 708,901.39, thereof EUR 678,951.39 management fees (EIB's remuneration), and the deduction of EUR 125.750.000,00 corresponding to the surplus established in 2007 for the budget 2008², the total of the net balance sheet of the Fund (Fund's resources) at 31 December 2007 amounts to EUR 1,026,515,043.63.

Article 3 of the amended Regulation³ 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 plus accrued interest totalled EUR 12,427,584,330.13 at 31 December 2007, of which EUR 125,845,866.67 were accounted for accrued interest. The ratio between the Fund's resources of EUR 1,026,515,043.63 and outstanding capital liabilities within the meaning of the amended Regulation was 8.26%. Since this is lower than the target amount of 9% of the total guaranteed outstanding amount (rounded amount of EUR 1,118.48 million), a payment from the general budget of the European Union to the Fund has to be made, as provided for in the second paragraph of Article 2 of the amended Regulation in 2007. The amount to be inserted in 2008 as a provisioning in the Preliminary Draft Budget of 2009 is EUR 91,960,000.00.

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, an amount of EUR 260,940,124.72 was repaid on 14 February 2007 to the budget following the amended Regulation.

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 2007

The total amount of the pre-consolidated balance sheet is EUR 1,153,957,868.29. 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.

² The amount of EUR 125,750,000.00 was repaid on the 31 January 2008 to the general budget of the European Union, as provided for in the third paragraph of Article 2 of the amended Regulation.

³ 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.

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*

<u>Balance sheet: Assets (EUR)</u>	2007	2006
Current assets		
Short-term receivables	983,923.27	1,099,797.60
Others	983,923.27	1,099,797.60
Short-term Investments	903,713,224.50	939,964,332.03
AFS Portfolio – cost	893,521,021.50	909,631,292.30
AFS Portfolio – actuarial difference	-5,928,251.48	-7,298,412.75
AFS Portfolio – adjustment to fair value	-3,895,732.16	14,654,734.60
AFS Portfolio - accruals	20,016,186.64	22,976,717.60
AFS Portfolio - impairment		
Cash and cash equivalents	249,260,720.52	439,733,359.86
Current accounts	1,232,834.25	1,158,007.44
Short-term deposits - nominal	246,600,000.00	436,500,000.00
Accrued interests on short-term deposits	1,427,886.27	2,075,352.42
Other cash equivalent - cost		
Accrued interests on other cash equivalents		
Total Current Assets	1,153,957,868.29	1,380,797,489.49
TOTAL	1,153,957,868.29	1,380,797,489.49

<u>Balance sheet: Liabilities (EUR)</u>	2007	2006
A. EQUITY		
Capital (Guarantee Fund)	424,272,973.21	685,213,097.93
<i>Payment from the budget</i>	390,982,973.21	559,463,097.93
<i>(surplus to be paid to the budget)</i>	33,290,000.00	125,750,000.00
Reserves	-3,627,413.49	14,996,561.86
First time application – Fair value reserve	268,318.67	341,827.26
Change in fair value of AFS assets	-3,895,732.16	14,654,734.60
Accumulated surplus / deficit	679,821,791.09	627,856,153.68
Results brought forward	679,821,791.09	627,856,153.68
Economic result of the year	52,761,227.92	51,965,637.41
Total Equity	1,153,228,578.73	1,380,031,450.88
B. CURRENT LIABILITIES		
Accounts payables	729,289.56	766,038.61
Others	729,289.56	766,038.61
Total current liabilities		766,038.61
TOTAL	1,153,957,868.29	1,380,797,489.49

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 2007 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)	2007	2006
Financial operations revenues	53,711,135.24	52,981,320.04
Interest income		
Interest income on cash and cash equivalents	10,018,308.25	11,443,127.48
Interest income on AFS assets	40,792,525.60	41,538,192.56
Other interest income		
Exchange gains		
Realised gains on sale of AFS assets	2,900,301.39	
Reversal of impairment losses on AFS assets		
Other financial income		
Financial operations expenses	-949,907.32	-1,015,682.63
Interest charges		
Interest charges on cash and cash equivalents		
Exchange losses	-115,874.33	-128,000.52
Realised losses on sale of AFS assets		
Impairment losses on AFS assets		
Other financial charges	-834,032.99	-887,682.11
Thereof: Management fees	-835,014.05	-714,719.38
SURPLUS FROM NON OPERATING ACTIVITIES	52,761,227.92	51,965,637.41
SURPLUS FROM ORDINARY ACTIVITIES		
Extraordinary gains		
Extraordinary losses		
SURPLUS FROM EXTRAORDINARY ITEMS		
ECONOMIC RESULT OF THE YEAR	52,761,227.92	51,965,637.41

Note to the Pre-consolidated Economic Outturn Account:

"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. PAYMENT FROM OR INTO THE FUND

3.1. Legal base for payment to the Guarantee Fund from the general budget

In line with the amended Regulation No 2728/94, the provisioning of the Guarantee Fund (the "Fund") follows a new provisioning rule. In this context, one of the main advantages of this system is its simplicity and its certainty about the budgetary requirements as all types of operations covered (EIB, MFA, Euratom loans) are known and follow the same rule of 9% of the amount of loans and guaranteed loans outstanding for the calculation of the target amount.

According to the Interinstitutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management⁴, the amount available for financing of the Fund is provided through a budget line under Heading 4 (External Relations).

3.2. Payment from or to the general budget in the course of the financial year

On 30 January 2007, the Council adopted an amendment to the Regulation No 2728/94. 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.

On the basis of 31.12.2006 outstanding guaranteed operations (EUR 11,025.07million), an amount of EUR 125.75 million corresponding to the 2006 surplus was inserted in 2007 to a special heading in the statement of revenue in the general budget of the European Union of the year 2008. This amount was paid in one transaction from the Fund to the budget on 31.01.2008. This surplus is exceptional as it is mainly explained by the first time application of the new provisioning mechanism which takes into account the effective loans disbursed during the previous year.

3.3. Interest from investments 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. One third of the Fund must be invested in short-term investments (up to one year). These investments 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

⁴ OJ C139, 14.06.2006, p. 1.

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 providing the required liquidity, a minimum of 18% (corresponding to twice the provisioning rate of the Fund) is kept in monetary investments, particularly bank deposits.

At the end of 2007, 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 reached.

During 2007, the portfolio achieved a total return of 3.099%.

The performance of the portfolio was slightly inferior to its benchmark (see annex in paragraph 1.5 "Performance" for details). At the end of 2007, the under-performance amounted to 16.5 basis points. This performance is explained by the impact of the so-called "sub-prime" crisis which caused a strong increase in market volatility and, more importantly, credit spreads to widen substantially which impacted negatively the performance of the Guarantee Fund portfolio vis-à-vis the benchmark. The under-performance of the Fund was particularly strong in July and November 2007 when investments in Eastern European bond markets and covered bonds not contained in the benchmark index suffered from the sub-prime crisis. In December 2007 an outperformance led to a partial correction of the under-performance.

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. 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 competitive return and to avoid the concentration of risk.

In 2007, interest income on cash and cash equivalents, on the Fund current accounts and on securities totalled EUR 53,711,135.24, broken down as follows:

- From deposits and current accounts: EUR 10,018,308.25; this represents the situation at 31 December 2007 including interest received on bank deposits EUR 10,614,035.07 and changes in accrued interest EUR 647,466.15 in 2006. The current accounts amounted to EUR 51,739.33 comprising interest recorded on the current accounts.
- From securities portfolio: EUR 40,792,525.60; this amount includes EUR 44,712,208.37 of interest on securities, and changes in accrued interest (EUR 2,960,531.24) at 31 December 2007. 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 959,151.53 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.

3.4. Recovery from defaulting debtors

No recovery occurred in 2007. 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 2007.

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 2007 was fixed at EUR 678,951.39 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 2008.