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COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

**Annual report from the Commission
on the Guarantee Fund and the management thereof in 2008**

{SEC(2009) 745}

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1. LEGAL BASIS

Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 (OJ L 293, 12.11.1994, p. 1; “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. The Regulation was amended by Council Regulation (EC, Euratom) No 1149/99 of 25 May 1999 (OJ L 139, 2.6.1999, p. 1), 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 the management thereof (“statement of financial performance”) and a financial statement for the Fund for the preceding year (“statement of financial position of the Fund”). Further details of the report covering the year 2008 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 a report to the European Parliament, the Council and the Court of Auditors on the situation of the Fund and the management thereof for each financial year by 31 May of the following year.

¹ SEC(2009)

2. POSITION OF THE FUND AT 31 DECEMBER 2008

2.1. Financial analysis

The position of the Fund is presented in accordance with International Financial Reporting Standards (IFRS) at the close of the 2008 financial year. The Fund totalled EUR 1 091 447 384.92 (see Section 3 of the Annex: Statement of Financial position of the Fund at 31 December 2008, as provided by the 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 676 733 999.20
recoveries of payments made by the Fund for defaults;	+ EUR 576 705 008.19
accrued ² EIB management and audit fees in 2008 corresponding to the payments to be made in 2009;	+ EUR 689 972.32
commission received on late recovery in 2002;	+ EUR 5 090 662.91
adjustment due to application of the 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 11 565 625.28
less calls on the Fund's resources;	- EUR 477 860 856.19
successive repayments of the surplus in the Fund to the general budget of the European Union;	- EUR 1 901 620 000.00
less the repayment to the budget in 2005, accounting for 9% of outstanding operations as at 1 May 2004 granted to the ten new Member States (See the 2004 amendment to the Fund Regulation in Section 1);	- EUR 338 831 402.07
less the repayment to the budget in 2007, accounting for 9% of outstanding operations as at 1 January 2007 granted to Bulgaria and Romania after joining the EU on that date (See the 2004 amendment to the Fund Regulation in Section 1);	- EUR 260 940 124.72
Financial position of the Fund at 31 December 2008.	EUR 1 091 447 384.92

The total net balance sheet of the Fund (i.e. the Fund's net cash resources) at 31 December 2008 amounts to EUR 1 182 717 412.60. This is the sum of the financial position of the Fund EUR 1 091 447 384.92, minus accrued EIB and audit fees of

² This amount of EUR 689 972.32 includes EUR 658 322.32 in EIB management fees and external audit fees of EUR 31 650.00 in 2008 (see paragraph 3.6, current liabilities, in the annex).

EUR 689 972.32, of which EUR 658 322.32 in management fees (2008 EIB remuneration), and the transfer from the budget of EUR 91 960 000.00, as established in 2008 for the 2009 budget.³

Article 3 of the amended Regulation⁴ requires the Fund to reach a target amount set at 9% of the total outstanding capital liabilities arising from each operation, plus any unpaid interest receivable.

Thus, outstanding lending and loan guarantee operations for third countries plus accrued interest totalled EUR 14 183 712 378.94 at 31 December 2008, of which EUR 136 800 205.24 was accrued interest. The ratio between the Fund's resources of EUR 1 182 717 412.60 and outstanding capital liabilities within the meaning of the amended Regulation was 8.34%. Since this is lower than the target amount of 9% of the total guaranteed outstanding amount (rounded amount of EUR 1 276 530 000.00), a transfer 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. The amount to be included in 2009 as provisioning in the Preliminary Draft Budget of 2010 is EUR 93 810 000.00.

2.2. Accounting presentation

Since the Commission decided to present its accounts in accordance with new accounting rules based on IPSAS/IFRS principles, the pre-consolidated financial statements of the Fund have also been drawn up in accordance with these principles, as explained in the Annex.

2.3. Pre-consolidated Financial Statement of the Guarantee Fund at 31 December 2008

The total amount of the pre-consolidated balance sheet is EUR 1 091 447 384.92. This includes the total amount of the Fund plus any arrears covered by the Fund, the accrual of interest on late payments and other accounting accruals and thus produces a full set of financial statements for the Fund at the year-end to be consolidated in the EU consolidated balance sheet.

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

³ The amount of EUR 91 960 000.00 was paid into the Fund on 23 January 2009 from the general budget of the European Union.

⁴ The amended Regulation stipulates that operations vis-à-vis 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.

2.3.1. *Guarantee Fund Pre-consolidated Balance Sheet*

<u>Balance sheet: Assets (EUR)</u>	2008	2007
Current assets		
Short-term receivables		983 923.27
Others		983 923.27
Short-term investments	886 949 667.40	903 713 224.50
AFS Portfolio – cost	857 292 051.50	893 521 021.50
AFS Portfolio – actuarial difference	-633 286.00	-5 928 251.48
AFS Portfolio – adjustment to fair value	11 509 579.98	-3 895 732.16
AFS Portfolio – accruals	18 781 321.92	20 016 186.64
AFS Portfolio – impairment		
Cash and cash equivalents	204 497 717.52	249 260 720.52
Current accounts	1 209 530.44	1 232 834.25
Short-term deposits – nominal	182 557 991.00	246 600 000.00
Accrued interests on short-term deposits	872 562.49	1 427 886.27
Other cash equivalents – cost	19 842 008.01	
Accrued interests on other cash equivalents	15 625.58	
Total Current Assets	1 091 447 384.92	1 153 957 868.29
TOTAL	1 091 447 384.92	1 153 957 868.29

<u>Balance sheet: Liabilities (EUR)</u>	2008	2007
A. EQUITY		
Capital (Guarantee Fund)	298 522 973.21	424 272 973.21
<i>Payment from the budget</i>	298 522 973.21	298 522 973.21
<i>(surplus to be paid to the budget)</i>		125 750 000.00
Reserves	11 565 625.28	-3 627 413.49
First time application –fair value reserve	56 045.30	268 318.67
Change in fair value of AFS assets	11 509 579.98	-3 895 732.16
Accumulated surplus/deficit	732 583 019.02	679 821 791.09
Results brought forward	732 583 019.02	679 821 791.09
Economic result of the year	48 085 795.09	52 761 227.92
Total Equity	1 090 757 412.60	1 153 228 578.73
B. CURRENT LIABILITIES		
Accounts payables	689 972.32	729 289.56
Others	689 972.32	729 289.56
Total current liabilities	689 972.32	729 289.56
TOTAL	1 091 447 384.92	1 153 957 868.29

Note on the balance sheet:

- "Short-term receivables/others" refer to the amount of calls on the Fund. This includes the capital, interest and penalties due to the budget of the European Union following release of the Fund guarantee.
- The difference in "accumulated surplus" in equity compared to the financial position of the Fund presented in paragraph 3.3 of the Annex is explained by the successive repayments of calls and penalties to the Fund.
- "Accounts payables/others" in 2008 include the EIB management commission, audit fees, the accrual of closing accounts audit fees and the accrual of the recovery fees due to the EIB following payment of the penalty fees due to the Fund.

2.3.2. *Guarantee Fund Pre-consolidated Economic Outturn Account*

Guarantee Fund – Consolidated Economic Outturn Account (EUR)	2008	2007
Financial operations revenues	48 907 685.22	53 711 135.24
Interest income		
Interest income on cash and cash equivalents	8 095 172.09	10 018 308.25
Interest income on AFS assets	39 622 151.89	40 792 525.60
Other interest income		
Exchange gains	105 124.43	
Realised gains on sale of AFS assets	1 085 236.81	2 900 301.39
Reversal of impairment losses on AFS assets		
Other financial income		
Financial operations expenses	-821 890.13	-949 907.32
Interest charges		
Interest charges on cash and cash equivalents		
Exchange losses		-115 874.33
Realised losses on sale of AFS assets		
Impairment losses on AFS assets		
Other financial charges	-821 890.13	-834 032.99
of which: Management fees	-658 322.32	-835 014.05
SURPLUS FROM NON-OPERATING ACTIVITIES	48 085 795.09	52 761 227.92
SURPLUS FROM ORDINARY ACTIVITIES		
Extraordinary gains		
Extraordinary losses		
SURPLUS FROM EXTRAORDINARY ITEMS		
ECONOMIC RESULT OF THE YEAR	48 085 795.09	52 761 227.92

Note on the Pre-consolidated Economic Outturn Account:

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

3. PAYMENT FROM OR INTO THE FUND

3.1. Legal basis for payment to the Fund from the general budget

In line with the amended Regulation, a new rule applies to the provisioning of the Fund. In this context, one of the main advantages of this system is its simplicity and the certainty regarding budgetary requirements, as all types of operations covered (EIB, MFA, Euratom loans) are known and apply the same rule of 9% of loans and guaranteed loans outstanding to calculate the target amount.

Under the Interinstitutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management,⁵ 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

The main objective of the 2007 amendment to the Regulation 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 outstanding guaranteed operations of EUR 12 427 580 000.00 as at 31.12.2007, an amount of EUR 91 960 000.00, corresponding to the 2007 provisioning, was inserted in budget line 01040114 "Provisioning of the Guarantee Fund" for 2008 in the statement of expenditure in the general budget of the European Union of the year 2009. This amount was paid in one transaction from the Budget to the Fund on 23.01.2009.

3.3. Interest from 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, as amended by Supplementary Agreement No 1 of 17/23 September 1996, Supplementary Agreement No 2 of 26 April/8 May 2002, and Supplementary Agreement No 3 of 25 February 2008. 20% 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 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

⁵ OJ C 139, 14.6.2006, p. 1.

balance between the various instruments providing the required liquidity, a minimum of EUR 100 000 000.00 is kept in monetary investments, particularly bank deposits.

In 2008, the portfolio achieved a total return of 6.42%.

Market conditions in 2008 were extremely difficult, as the financial crisis spread and affected all banks and started to impact on the real economy. The performance of the portfolio was inferior to the benchmark (see annex in paragraph 1.4.2. "Performance" for details). At the end of 2008, this underperformance amounted to 77.56 basis points. Underperformance of the Fund was particularly significant from the middle of September after the collapse of Lehman Brothers, and a substantial widening of yield spreads had a negative impact on securities not belonging to the basket of bonds underlying the Eurozone Sovereign Iboxx indexes. In particular, bonds issued by eastern European governments, in which the Fund portfolio has positions, suffered significant price drops in October and November. In December 2008 this underperformance was less severe due to the stabilisation of the market.

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 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 any concentration of risk.

In 2008, interest income on cash and cash equivalents, on the Fund current accounts and on securities totalled EUR 48 802 560.79, broken down as follows:

- From deposits and current accounts: EUR 8 043 015.28; this reflects the situation at 31 December 2008, including interest received on bank deposits of EUR 8 528 274.58 and changes in accrued interest (EUR 539,698.20) in 2008. Current accounts amounted to EUR 54 438.90, comprising interest recorded on current accounts.
- From securities portfolio: EUR 39 622 151.89; this includes EUR 40 834 028.61 in interest on securities and changes in accrued interest (EUR 1 234 864.72) at 31 December 2008. 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. Of this figure, an amount of EUR 22 988.00 must be adjusted from the securities 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

Penalty interest of USD 1 448 433.44 was recovered from the Republic of Argentina on 12 December 2008. At 31.12.2008, the Fund has no amount called to be recovered.

4. THE FUND'S LIABILITIES

4.1. Default payments

The Fund was not called for default payments in 2008.

4.2. EIB 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 calculated by applying degressive annual rates of commission to each of the tranches of the Fund's assets respectively. This remuneration is calculated on the basis of the average assets of the Fund.

The Bank's remuneration for 2008 was set at EUR 658 322.32 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 2009.