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**REPORT FROM THE COMMISSION TO THE COUNCIL
AND THE EUROPEAN PARLIAMENT**

comprehensive report on the functioning of the Guarantee Fund

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1. INTRODUCTION- 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 the Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994¹ 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 Fund regulation was amended three times² and is currently operating under Council Regulation (EC, Euratom) No 480/2009 of 25 May 2009³ (codified version).

Three reviews of the functioning of the Fund took place in 1998, 2003 and 2006. Further to the last review in 2006, a new provisioning mechanism was implemented which entered into force in 2007. An Inter-institutional agreement⁴ between the Council and the Commission concluded that in the context of the next Comprehensive report on the functioning of the Guarantee Fund a full analysis of the new provisioning mechanism be provided. In this framework, an evaluation of the Guarantee Fund was commissioned by the Commission in September 2009 with an external Consulting company in order to assess the functioning of the new provisioning mechanism and the different parameters of the Guarantee Fund particularly the 9% provisioning target rate.

The Commission Staff Working Document (SWD) completes this report by providing graphs and tables.

The present report demonstrates that the Guarantee Fund in its present setting functions well and that the new provisioning mechanism fulfilled the expectations. This analysis is underpinned by the findings of the evaluation of the Guarantee Fund by an external consultant which in particular confirms that the 9% target rate is appropriate in view of the risk covered by the Fund.

Consequently, the report concludes that there is at present no need to change the legal base of the Fund or any of the Fund's parameters.

2. FUNCTIONING OF THE FUND IN THE PERIOD 2007-2009

2.1. 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) external loans and loan guarantees, Euratom external lending and EU Macro-Financial Assistance (MFA) loans to third countries. The organization chart of the Fund in the SWD describes the functioning of the Fund and all the financial flows involved in the functioning of the Fund.

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 2009 145, 10.6.2009, p. 10.

⁴ 2005/0025 (CNS) of 16 January 2007.

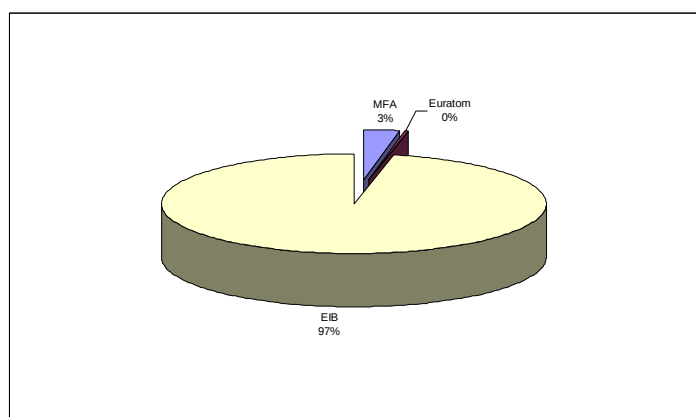
2.1.1. Monitoring of Risks

The Fund covers the risk of loans and loan guarantees to third countries. At the end of 2009, the Fund has covered an amount of EUR 16.361 billion guaranteed lending composed of EUR 16.239 billion for outstanding and EUR 122 million for accrued interest. Since the implementation of the EIB current external mandate⁵ started in 2007, the outstanding amount covered increased on average by 15% per year to EUR 16 361 million. The growth of the outstanding amount covered by the fund does not mean that the Fund bears a higher risk per euro covered. The monitoring of the risks borne by the Fund shows that risks remain stable regarding the credit exposure of the new operations as long as the new loans are signed for projects having the same risk profile as the current loans portfolio (see graphs in section 5 of the SWD). This has been the case since 2000. For this reason, the previous comprehensive report concluded in 2006 that the target rate was maintained at its 9% level.

2.1.2. EIB external lending – volumes and main risk characteristics of guarantees given to the EIB

About 97% of the total outstanding amount covered by the Fund concern loan guarantees issued with respect to loans granted for projects in third countries by the EIB. Based on the forecasted execution of the present 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, the EIB asks the Commission to pay the amounts owed by the defaulting debtor in accordance with the Commission-EIB guarantee agreement. If the EIB has a second public or private guarantor in addition to the EU guarantee, it is activated before a call under the EU guarantee is made.

Table1: Share of EIB operations covered by the Fund in 2009 (capital and interest due)



The EU Guarantee covers all credit risks of a guaranteed lending operation in third countries. All EIB Financing Operations entered into with a State, with a public sector or a private sector entity covered by a State guarantee, are '*ipso facto*' covered by a Comprehensive Guarantee. For other types of operations, notably private sector operations, the guarantee is limited to the well defined political risk events.

⁵ "Mandate" refers to the Guarantee envelope provided by the EU budget to the EIB. Mandates are usually granted for the length of a financial framework (present period 2007-2013) and are sub-divided according to regions and by activity sectors.

2.1.3. Macro-Financial Assistance covered by the Fund

In this type of operations covered by the Fund, the European Union borrows on the financial markets and on-lends the proceeds (on a "back-to-back" basis) to non-member countries (MFA loans). All MFA loans have to be authorised individually by the Council. The loan repayments are scheduled to match the repayments of the borrowings due by the EU.

2.1.4. 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 3.4 billion have been decided and disbursed. In 2002 the Commission proposed an increase in the borrowing limit from EUR 4 billion to EUR 6 billion, for which agreement has not yet been reached at the Council.

As for MFA loans, Euratom borrows on the financial markets and on-lends the proceeds (on a "back-to-back" basis) to companies active in the field of nuclear energy in certain third countries. The loan repayments are scheduled to match the repayments of the borrowings due by Euratom.

In 2009, the share of Euratom operations is marginal (less than 1%) in comparison with the total outstanding amount of capital and interests covered by the Fund (see table 1 above).

2.2. Provisioning of the Fund – satisfactory experience with the new provisioning mechanism

The new 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 independent of the actual disbursements. The new provisioning mechanism is now based on net disbursements. This change fulfilled its main objective namely to improve the functioning of the Fund by reducing to only one the number of annual transfers between the Union Budget and the Fund and by improving the precision of the budgetary flows between the Fund and the budget. In fact, as the provisioning takes place on the basis of the observed net disbursements of guaranteed loans, the necessary budgetary resources for the provisioning can be introduced in good time into the regular budgetary process. This change has ended the structural over-provisioning observed under the old provisioning mechanism which was appropriate during the set-up of the Fund.

As it can be seen in table 2 of the SWD, over the first half of the present financial framework period 2007-2011, the available budgetary resources for the provisioning of the Fund of EUR 200 million p.a. decided by the budgetary authority were more than sufficient for the provisioning of the Fund. However, depending on the rate of implementation of the EIB external lending mandate, estimations of the Fund's provisioning needs for the years 2012 and 2013 show that the Fund may require around EUR 598 million. The amount included in the indicative financial programming for 2012-2013 is EUR 400 million. This will be complemented by the interests earned on the assets of the Fund (see section 3.2). For the entire period 2007-2013 the total resources used and estimated are expected to be well below the total amount of EUR 1.4 billion originally foreseen for the financial framework 2007-2013. The ratio between the total of transfers from the budget to the Fund and the total budget allocation is expected to be about 60% at the end of the period 2007-2013.

2.3. Other parameters of the new provisioning 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. In addition, so-called trigger values have been introduced. Their function is to keep the budgetary authority informed about major losses in the Fund (trigger value of 80 %, i.e. 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 (trigger value 70 %).

The functioning of the smoothing mechanism can be explained 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 default), the amount exceeding EUR 100 million is paid back into the Fund in annual tranches of a maximum of EUR 100 million in the following years. 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 been activated since the implementation of the new provisioning mechanism as the Fund was not called during this period.

3. MANAGEMENT OF THE FUND'S ASSETS IN A DIFFICULT MARKET ENVIRONMENT - DEVELOPMENT AND PERFORMANCE OF THE FUND OVER THE PERIOD 2007-2009

3.1. Crisis context

During the period 2007 – 2009, the absolute return of the Fund's portfolio remained always positive and the portfolio did not suffer from any capital losses resulting from the financial crisis. Neither the external nor the internal auditors or the European Court of Auditors have raised any concern regarding the management of the Fund's assets by the EIB under the oversight of the Commission services. The EIB managed the fund's assets under the supervision of the Commission very successfully in a difficult financial environment.

During the whole period 2007-2009, the Fund had overall an absolute return on average of +4.6928% p.a.. However, against the background of the most severe crisis in global financial markets in recent history, the Fund underperformed its benchmark index on average by -15.27 basis points p.a.. The current size of total funds under management in the Guarantee Fund portfolio on 31 December 2009 amounted to a market value of EUR 1,240.5 million (cash included), with a modified duration of 3.01 years.

3.2. Development of the Fund's portfolio

Graph 2 in the SWD shows that the volume of the Fund decreased in 2007 following the implementation of the new provisioning mechanism and increased in 2008 to reach EUR 1,240.5 million in 2009. The decrease in 2007 is explained by the slow pattern of loan disbursements at the beginning of the current EIB external mandate resulting in a surplus of EUR 125.75 million transferred from the Fund to the Budget. On average the Fund's assets have increased by +2.5% p.a. on average since 2007. The value of the Fund's assets should continue to increase and reach about EUR 2.2 billion in 2013. The potential acceleration in the rhythm of disbursements of the external lending mandate in 2010 and the potential growth of MFA operations explain this expected acceleration in the value of the Fund's assets (see sections 6 and 7 of the SWD).

In addition to provisioning via its budget line, the Fund's other main source of income is the interest earned on its assets. The interest earned on the Fund's assets fell since 2007 due to the general decline in the market interest rates to historically low levels. The interest earned during the period 2007-2009 amounted to EUR 146 million (see table 1 of the SWD, flows in and out since the creation of the Fund). At the end of 2009 the total assets of the Fund stood at EUR 1,240.5 million (market value). 84.3% of this amount were invested in bonds, 15.6% in deposits and 0.1% were held on current accounts.

4. EVALUATION OF THE TARGET RATE

In 2006, the legal base of the Fund was changed with a view to implement the new provisioning mechanism in 2007⁶, the Commission agreed to provide in the present comprehensive report an analysis of the functioning of the new mechanism. In addition it was agreed to review the appropriateness of the Fund's main parameters, notably the 9 % target rate (relation of the size of the Fund to the overall amount of risks covered).

4.1. Credit risk profile analysis

The credit risk profile of the Fund has not changed since the last comprehensive report in 2006 (see paragraph 2.1.1 above and graphs in section 5 in SWD; the risk profile of the loans covered by the Fund in 2006 and 2009). During the same period the Fund has not been called to cover defaults. The analysis of the credit risk profile of the loans covered by the Fund suggests that the target rate should not be changed. The risk of default from a beneficiary of loan exists and is reflected in maintaining the target rate at 9%. It can be noticed that about 14% of the loan guaranteed portfolio in 2009 has a credit rating below B level (Moody's or equivalent) which means that 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, the probability of default in 1 year is not negligible.

The relative stability of the sovereign risk profile is due to the geographical distribution of the lending operations covered by the Fund which is relatively stable over the period 2000-2009. The distribution of EIB mandate explained this stability as the repartition of lending operations between the previous and the current mandate is similar. About 81% of the lending operations are focused on the Mediterranean countries and both potential and candidate countries (see the graph 3 in the SWD: the geographical distribution of lending operations covered by the Fund in 2009). The Fund covers the credit risk of defaults in 42 countries. The 10 highest countries account for about 81% of the total exposure. The maximum exposure in one country stands for 27% of the total risk in 2009.

Since 1994 the Fund was called for a cumulative amount of about EUR 478 million and had a recovery rate of 100% (see table 1 of the SWD). The last calls were in 2003 and 2004 in relation to the Republic of Argentina for a total amount of about USD 10 million. The amounts were fully recovered in 2004 and 2008 for the penalty interest.

4.2. Target rate

Based on our past observations and the credit risk profile analysis of the current lending operations covered by the Fund, the major parameter of the Fund (the 9% "target" rate), is

⁶ [see footnote 2].

fixed at a sufficient level to take into account the risk born by the Fund and the potential evolution of this credit risk due to the impact of the financial crisis.

5. EVALUATION OF THE FUND BY AN EXTERNAL CONSULTANT

An evaluation of the Fund was undertaken by GHK Consulting and Volterra Consulting 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.

To address the evaluation questions the study combined several qualitative and quantitative techniques, including desk research and analysis, interviews as well as quantitative risk modelling (Monte Carlo simulations).

5.1. Main Findings:

- the Fund is an effective and efficient mechanism for provisioning for the risks associated with EU's external lending actions;
- the costs of operating the Fund are modest in relation to the budgetary protection and stability offered by the Fund;
- the current management methods for the Fund are working effectively and are fit for purpose;
- the 9% provision target rate is at an appropriate level and provides a comfortable buffer against loss. Even under an accelerated scenario⁷ (a type of default as yet not observed with EU lending), the quantitative assessment indicates that a one in twenty year loss could potentially be provided for;
- the provisioning mechanism takes into account sufficiently well the risk profile of the Fund. Given the 'unlikeliness' of the Fund breaching either the 80 percent or 70 percent triggers, the current mechanism does allow satisfactorily for the associated missed loan payment risks.

As regards the adequacy of budgetary resources foreseen for the Fund, the conclusions of the evaluation are that:

- the payments to the Fund that are due to losses are capped by the smoothing mechanism at EUR 100 million. The modelling results suggest that the smoothing mechanism and the EUR 100 million limit are appropriate;

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 if it is not to be expected that these amounts will be paid. In order to simulate a maximum stress on the Fund, the quantitative analysis has also simulated a scenario in which missed payments trigger an acceleration of all future due payments.

- the payments to the Fund that arise from additional disbursements are projected to rise above the current annual budget allocation of EUR 200 million.

5.2. Recommendations:

- the Fund should continue to cover the external lending operations of the EU;
- the target rate of the Fund should be maintained at 9 per cent; although it should be reviewed from time to time;
- in the next financial framework, the budgetary resources foreseen for the Fund should better reflect the expected profile of provisioning needs. Accordingly, it would be prudent to increase the annual budget allocation to between EUR 250-300 million;
- further analysis should be carried out to determine whether the same quality of portfolio management services could be achieved by the Commission (as compared to EIB) at a lower cost (in relation to management fees paid to EIB).

5.3. Specific quantitative assessment of the target rate

The external evaluation of the Fund focusing among other points on a quantitative analysis of the Fund's risk profile and the corresponding level of the Fund's assets confirmed the conclusion of the Commission services that the target rate level of 9% enables the Fund to fulfil its main objective to provide a liquidity cushion in case of default by EU borrowers and ongoing budgetary stability. The study confirms that the current level of 9% is appropriate in relation to the current credit risk of the loans and guaranteed loan operations covered by the Fund. The sensitivity analysis performed by the external consultants, has shown that the approach to keep the target rate at this level (9%) is a prudent approach regarding the risk profile of the portfolio which takes already into account an unavoidable degree of uncertainty concerning the likelihood of defaults. The decrease of the target rate from its current level of 9%, which would allow to reduce the recourse to the budgetary resources allocated to the financing of the provisioning of the Fund, would not be a prudent approach. This is true in particular if one considers the risk profile of the existing portfolio of loans covered by the Fund and in the light of the deterioration of the economic situation in many countries subsequent to the financial crisis.

5.4. Impact of the financial crisis – increased volume of Macro-Financial assistance loans

The intensity of the international financial crisis has led several pre-accession and neighbouring countries to approach the Commission formally or informally with requests for MFA loans. The implementation of potential MFA loan operations to these countries would amount to about EUR 1.5 billion over the period 2010 and 2011 (no forecast for the period beyond 2011 exists) and will have a maximum impact of an additional amount of EUR 135 million on the provisioning of the Fund in 2012 at the earliest depending on the rhythm of loans disbursements.

5.5. Potential impact of the increase in the rhythm of EIB disbursements

The rhythm of EIB disbursements for loans signed under the current mandate observed in the period 2007-2009 was slow. Consequently, the annual transfers from the budget to the Fund have been substantially below the available budgetary means. The possible increase in the

rhythm of EIB disbursements together with the increase in MFA operations of about EUR 1.5 billion would imply that the available budget for the Fund will most likely not be sufficient without an increase of the budget line for the provisioning of the Fund during the period 2012-2013. It would increase the pressure on the budget line 01 04 01 14 for the provisioning of the Fund until the end of the financial framework in 2013.

5.6. Recommendations for the next financial framework post 2013

It is difficult to estimate the budgetary means of the Fund beyond 2014. It will depend mainly on the future reform regards the EU financial architecture (on the basis of the Camdessus Report⁸) and more precisely on the new EIB external Mandate under the new financial frameworks. In the situation of the assessment of the Fund, simulations were performed on the basis of a replicate mandate under the next financial framework. The results of simulations confirm that the profile of EIB disbursements would again strongly impact the provisioning needs of the Fund (see section 9 in the SWD). Based on the current situation, a flat annual budget for the provisioning of the Fund would not be recommended. This aspect will have to be considered when the next financial framework post 2013 will be drawn up.

5.7. Review of the institutional arrangements for the management of the assets of the Fund raised in the 2006's comprehensive report

In 2003 the EP budget committee has raised the issue of whether the Commission or the EIB should manage the Fund's portfolio. The only reason to propose such a change would be a potential cost advantage if the assets were directly managed by the Commission. No indication exists that the quality of the EIB asset management could be criticised and justify such a change. However, only a comparative analysis of the management costs of the EIB and the Commission could provide the necessary hard facts to propose such a change. At present, no reliable, detailed data exist on the (opportunity) costs of the Commission in case it would manage the assets of the Fund directly as compared to the EIB.

The Commission will decide in the future whether such analysis should be undertaken. Pending such a decision, no proposal is made to change the arrangement with the EIB.

⁸ The Camdessus Report was prepared by a group of "Wise persons" in the framework of the Mid-Term Review of the EIB external mandate in February 2010.

6. CONCLUSION

The new provisioning mechanism has delivered 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.

A thorough quantitative analysis of the risk covered by the Fund and the Fund's 9% target rate has shown that this target rate and the other main parameters of the Fund are appropriate. The Commission therefore does not see a need to change the target rate or other Fund parameters. Nevertheless these parameters should be reviewed from time to time in order to consider if they continue to take sufficiently into account the risk profile borne by the Fund. Such a review will be presented in the context of the next comprehensive report on the functioning of the Fund due in 2013.

Under the present financial framework, the total budgetary resources foreseen for the Fund are appropriate however improvements exist regarding the profile of the provisioning needs of the Fund. These should be implemented in the planning of the post 2013 financial framework.