EUROPEAN COMMISSION

Brussels, 20.10.2010
COM(2010) 580 final

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

**on guarantees covered by the general budget
Situation at 31 December 2009**

SEC(2010) 1218

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1. INTRODUCTION

The objectives of this report are to monitor the credit risks exposure borne by the budget of the European Union resulting from the guarantees given and the lending operations implemented directly by the European Union or indirectly through the EIB external mandates.

This report is submitted pursuant to Article 130 of the Financial Regulation which requires the Commission *to report to the European Parliament and to the Council twice a year on budgetary guarantees and the corresponding risks*[1]. It is completed by a Commission Staff Working Document with a set of detailed tables and explanatory notes (the "SWD").

2. TYPES OF OPERATIONS COVERED BY THE EU BUDGET

The risks covered by the budget of the European Union (the "Budget") derive from a variety of lending and guarantee operations which can be divided into two categories:

– loans granted by the European Union with macroeconomic objectives, i.e. macro-financial assistance[2] ("MFA") loans to third countries and in conjunction with the Bretton Woods institutions, balance-of-payments ("BoP") loans granting support to non-euro Member States experiencing balance-of-payments difficulties[3]; and

– loans with microeconomic objectives, i.e. Euratom loans and most importantly European Investment Bank ("EIB") financing of operations that are covered by EU guarantees[4] in non-Member States ("EIB external financing")[5] .

The EIB external financing, the Euratom loans and the MFA loans have since 1994 been covered by the Guarantee Fund for external actions ("the Fund"),[6] while BoP loans are directly covered by the budget. The Fund covers defaults on loans and loan guarantees granted to non-Member States or for projects in non-Member States. It was established:

– to provide a 'liquidity cushion' in order to avoid calling on the Budget every time a default or late payment on a guaranteed loan arises; and

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1 COM(2010)188 and SEC(2010)479 make up the previous report on the guarantees covered by the Budget at 30 June 2009.

2 MFA may also take the form of grants to third countries. For more information on MFA, see Commission report COM(2009)514 and SEC(2009)1279.

3 A similar mechanism that covers all euro area Member States has been set up on 11 May 2010, the European financial stabilisation mechanism (EFSM, not yet activated). Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (OJ L 118, 12.5.2010, p.1).

4 Most recently established for the period 1 February 2007—31 October 2011 by Decision No 633/2009/EC of the European Parliament and of the Council of 13 July 2009 (OJ L 190, 22.7.2009, p. 1) (the "External Mandate Decision"), replacing Council Decision 2006/1016/EC of 19 December 2006.

5 The figures concerning the EIB mandates are displayed in Table A1 and references to legal bases are listed in Table A4 of the SWD.

6 Council Regulation (EC, Euratom) No 480/2009 of 25 May 2009 establishing a Guarantee Fund for external actions (codified version), the "Guarantee Fund Regulation" (OJ L 145, 10.6.2009, p.10).

– to create an instrument of budgetary discipline by laying down a financial framework for the development of EU policy on guarantees for Commission and EIB loans to non-member countries[7].

Following an amendment[8] of the Guarantee Fund Regulation in 2004, the Fund's coverage is withdrawn if third countries become Member States and the risk is transferred from the Fund to be directly born by the Budget. The Fund is provisioned from the Budget and has to be maintained at a certain percentage of the outstanding amount of the loans and loan guarantees covered by the Fund. This percentage, known as the target rate, is currently 9%. If there are insufficient resources in the Fund, recourse will be made to the Budget.

In 2007, an amendment[9] of the Council Regulation set up a new provisioning mechanism. It functions through annual transfers from the Budget and involves a smoothing mechanism to limit the impact of calls on the Fund (see also Section 5.3 below).

In the context of the mid–term review of the EIB external mandate[10], an external evaluation was performed during the second semester 2009 in order to assess the functioning of the Fund and its parameters, including the target rate. The evaluation report[11] confirmed that the new provisioning mechanism fulfilled its objectives and the appropriateness of the current levels of the main parameters of the Fund, notably the target rate.

3. EVENTS SINCE THE LAST REPORT AT 30 JUNE 2009

3.1. Balance of payments support to non-euro Member States

During the second semester 2009, the BoP financial support was again active in terms of disbursements. Three additional operations took place in July for a total amount of EUR 4.2 billion. The third tranche of EUR 1.5 billion granted to Hungary was disbursed on 6 July 2009. In addition, the first tranche of EUR 1.5 billion granted to Romania and the second tranche of EUR 1.2 billion granted to Latvia were disbursed on 27 July 2009. All these loans have been financed "back-to-back" via the issuance of EU benchmark bonds.
In 2009, a total amount of EUR 7.2 billion was disbursed under the BoP financial programme enabling the EU to restore the confidence in the financial situation of the three non-euro Member States (Hungary, Latvia and Romania) which had been affected by the financial crisis. On average 63% of the loan operations decided[12] have already been implemented. The remaining balance is expected to be disbursed both in 2010[13] and 2011.

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7 Although external risks are covered in fine by the guarantee of the EU budget, the Guarantee Fund acts as an instrument to protect the EU budget against the risk of payment defaults. For a comprehensive report on the functioning of the Fund, see COM(2006)695 and the accompanying Staff Working Document (SEC(2006)1460).

8 Council Regulation (EC, Euratom) No 2273/2004 (OJ L 396, 31.12.2004, p. 28).

9 Council Regulation (EC, Euratom) No 89/2007 of 30 January 2007 (OJ L 22, 31.1.2007, p.1).

10 Report from the Commission to the European Parliament and the Council on the mid-term review of the external mandate of the EIB (COM(2010)173) and the accompanying Staff Working Document (SEC(2010)442).

11 http://ec.europa.eu/economy_finance/evaluation/completed/index_en.htm#external

12 See table A3a in the SWD.

13 During the first semester, a total amount of EUR 1.5 billion was disbursed of which EUR 500 million was granted to Latvia and EUR 1 billion to Romania.

3.2. Macro-financial assistance

During the second semester, the Council decided on 30 November 2009 new MFA operations for Armenia[14], Bosnia & Herzegovina[15], and Serbia[16] in the form of loans combined with a grant financial assistance to Armenia. Part of the loans and grant tranches are likely to be disbursed during the second semester 2010.

3.3. Euratom

The third tranche of USD 10.335 million for a Euratom loan in Ukraine[17] was disbursed on 15 October 2009. The loan has been financed "back-to-back" via a private placement borrowing operation.

3.4. EU budget guarantee for EIB external financing

Under the 2007-2013 external mandate the activity was strong during the second semester 2009 regarding both the volume of signatures and the amount of loans disbursed. Between the 30 June 2009 and 31 December 2009, EUR 3 317 million were signed (+39%). An acceleration of the rhythm of the loan disbursements could also be observed with an amount of EUR 1 855 million disbursed during the same period. At the end of 2009, the total amount of loans disbursed under the present mandate equals to EUR 3 044 million.

3.5. European Financial Stabilisation Mechanism

In the wake of the crisis in Greece, the Council and the Member States have decided in May 2010 a package of measures to preserve financial stability in Europe, including the adoption of a European Financial Stabilisation Mechanism (EFSM)[18].

This mechanism is based on Treaty Art. 122 (2)[19]. Its activation is subject to strong conditionality, in the context of a joint EU/IMF support, and will be on terms and conditions similar to the IMF (the risk of operations under the EFSM will be covered by the EU budget).

The other measures are provided directly by participating Member States and do not imply any risk to the EU budget:

- the financial support to Greece consisting of pooled bilateral loans provided by euro area Member States for a total amount of EUR 80 billion. EUR 30 billion are provided by the IMF in the context of a joint EU/IMF support amounting to EUR 110 billion in total.

- the European Financial Stabilisation Facility (EFSF) was set up with a capacity of EUR 440 billion. It is guaranteed on a pro rata basis by participating Member States.

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14 Council Decision 2009/890/EC of 30.11.2009 (OJ L320, 5.12.2009,p. 3-5)
15 Council Decision 2009/891/EC of 30.11.2009 (OJ L320, 5.12.2009,p. 6-8)
16 Council Decision 2009/892/EC of 30.11.2009 (OJ L320, 5.12.2009,p. 9-11)
17 Council Decision 94/179/Euratom of 21.3.1994 (OJ L84, 29.3.1994, p. 41–43)
18 Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (OJ L 118, 12.5.2010, p.1).
19 Art. 122(2) of the Treaty foresees financial support for Member States in difficulties caused by exceptional circumstances beyond Member States' control.

4. DATA ON RISKS COVERED BY THE BUDGET

4.1. Definition of risk

The risk borne by the Budget derives from the outstanding amount of capital and interest in respect of guaranteed operations.

Defaulting operations will be covered by the Fund when they are linked to third countries (55% of the total outstanding amount guaranteed as of 31 December 2009) and directly by the Budget where Member States are involved (BoP loans and loans to or for the benefit of projects in Member States account for the remaining 45% of the total outstanding amount guaranteed by the Budget). The large proportion of guaranteed loans linked to Member States is the result of the enlargement rounds[20] and the activation of the EU medium-term financial assistance facility for non-euro Member States (the BoP facility).

For the purpose of this report, two methods are used for evaluating the risks borne by the Budget (either directly or indirectly via the Fund):

– The method of calculating the total amount of capital outstanding for the operations concerned on a given date including accrued interest. This methodology allows determining the total amount of risk supported by the Budget on a given date for all future payment obligations independent of when in the future these payments are due and whether they are covered by the Fund or not (see table 1 below).

– The budgetary approach defined as "the annual risk borne by the Budget" is based on the calculation of the maximum amount of annual due payments which the EU would have to pay out in a financial year assuming that all payments of the guaranteed loans are in default[21]. The annual risk borne by the budget is joined in the table A2 of the Staff Working Document.

[20] According to Article 1, third paragraph, of the Guarantee Fund Regulation, once a country becomes a Member State, the risk on the loans is transferred from the Fund to the Budget.

[21] For the purpose of this calculation, it is assumed that defaulting loans are not accelerated, i.e. only due payments are taken into account (see also Section 1 of the SWD).

Table 1: Total outstanding amounts covered as of 31 December 2009 in EUR million

	Outstanding Capital	Accrued Interest	Total	%
Member States*				
MFA	90	0	90	<1%
Euratom	427	3	430	2%
BoP	9 200	104	9 304	31%
EIB	3 533	36	3 570	12%
Sub-total Member States	13 250	143	13 393	45%
Third Countries**				
MFA	495	2	497	2%
Euratom	54	0	54	<1%
EIB	15 691	119	15 810	53%
Sub-total third countries	16 239	122	16 361	55%
Total	**29 489**	**265**	**29 754**	**100%**

* This risk is directly covered by the Budget. This also includes MFA, Euratom and EIB loans granted prior to EU accession.

** This risk is covered by the Fund.

Tables A1, A2, A3 and A4 of the SWD provide more detailed information on these outstanding amounts, in particular in terms of ceiling, disbursed amounts or guarantee rates.

The total outstanding amount of capital and interest covered by the budget increased by EUR 6 077 million to EUR 29 754 million compared with the situation at 30 June 2009. This increase is mainly explained by the amount of EUR 4.2 billion disbursed under the BoP facility and also to the increase in the rhythm of EIB disbursements (EUR 1.8 billion during the second semester 2009).

4.2. Risk linked to Member States

Current risks on Member States result from loans granted prior to accession and the activation of the BoP facility.

At the beginning of 2010, the Budget will bear a maximum risk linked to Member States of EUR 890.1 million (representing the amounts due in 2010 and assuming that defaulting loans are not accelerated). Table 2 shows that Romania and Hungary are ranked first and second among Member States in terms of their outstanding amount.

Table 2: Ranking of the Member States according to the exposure with regard to the maximum risk borne by the budget at the beginning of 2010 (EUR million)

Ranking	Country	Maximum risk (M EUR, rounded)	% of the total maximum risk
1	Romania	279.6	31.4%
2	Hungary	196.3	22.1%
3	Bulgaria	88.0	9.9%
4	Czech Republic	82.0	9.2%
5	Poland	80.5	9.0%
6	Slovak Republic	65.6	7.4%
7	Latvia	60.2	6.8%
8	Slovenia	20.8	2.3%
9	Cyprus	9.7	1.1%
10	Lithuania	5.7	0.6%
11	Estonia	1.0	0.1%
12	Malta	0.7	0.1%
	Total	890.1	100.0%

The risk on Member States concerns EIB, MFA and Euratom loans granted before the accession to the EU and the loans granted under the BoP facility.

4.3. Risk linked to third countries

At the beginning of 2010, the Fund will bear a maximum annual risk related to third countries of EUR 1 234 million (representing the amounts due in 2010 and assuming that defaulting loans are not accelerated). The top ten countries according to their total outstanding are listed below. They account for 64% of the risk borne by the Fund. The economic situation of these countries is analysed and commented in the SWD.

Table 3: Ranking of the 10 most important third countries according to the exposure with regard to the maximum risk borne by the Fund at the beginning of 2010 (EUR million)			
Ranking	**Country**	**Maximum risk (M EUR, rounded)**	**% of the total maximum risk**
1	Turkey	343.9	21.8%
2	Egypt	202.8	12.9%
3	Morocco	152.2	9.7%
4	Tunisia	149.1	9.5%
5	South Africa	89.3	5.7%
6	Lebanon	70.6	4.5%
7	Brazil	63.1	4.0%
8	Serbia	61.5	3.9%
9	Syria	56.9	3.6%
10	Jordan	44.2	2.8%
Total of the 10		1 233.6	78.3%

The Fund covers the guaranteed loans of 44 countries with maturities extending up to 2039. Details by country are provided in Table A2 of the SWD.

4.4. Global risk covered by the Budget

In total, for 2010 the Budget will cover an amount of EUR 2 465 million representing the amounts due during this period, of which 36% are due by Member States (see Table A2 in the SWD).

4.5. Evolution of risk

- Balance of payments facility

During the second semester 2009, the global economy began to stabilise following a period of significant declines. Financial conditions in the financial markets have continued to improve. However the intensity of the international crisis continued to impact all the Member States and in particular Member States which have not yet adopted the euro. The activation of the EU medium-term financial assistance facility (BoP) facility) in December 2008 helped some of these countries to restore investor confidence. The overall ceiling of the facility was extended in December 2008[22] and in May 2009[23] to EUR 50 billion in order for the EU to continue to be able to react quickly to potential further demands for BoP assistance.

- European Financial Stabilisation Mechanism (EFSM)

- Financial assistance under the EFSM may take the form of a loan or of a credit line guaranteed by the EU budget. The Ecofin Council conclusions restrict the overall ceiling of the mechanism to EUR 60 billion[24], but the legal limit is provided in Article 2.2 of the Council Regulation, which limits the outstanding amount to the margin available under the own resources ceiling[25]. The mechanism has not yet been activated.

- Macro-financial assistance loans

MFA loans to third countries have been subject to individual decisions by the Council[26] and since the entry into force of the Lisbon Treaty by the European Parliament and the Council.

- Euratom loans

The Euratom lending to Member States or in certain eligible non-member countries (Russian Federation, Armenia, Ukraine) has a ceiling of EUR 4 billion of which around 85% have already been used. The remaining margin is about EUR 600 million.

The disbursement of the third (and last) tranche under the loan agreement for the K2R4 project (USD 10.3 million) in Ukraine took place on 12 October 2009.

- EIB loans

The previous EIB general mandate covering the period 2000-2007 expired on 31 July 2007. At this date, contracts corresponding to a total 98% of the overall ceiling under this mandate (EUR 20 060 million – see Table A5 of the SWD) had been signed. At 31 December 2009, a total amount of EUR 3 988 million remained to be disbursed under this mandate but may still be disbursed under EU guarantee within 10 years from the end of the mandate, at which time the EU guarantee lapses for any undisbursed amounts.

Following the Commission proposal to amend the legal basis of the EIB external mandate for the remainder of the current Financial Perspective 2007-2013[27], the Parliament and the Council must adopt the relevant decision before 31 October 2011. The EU guarantee is restricted to 65% of the aggregate amount of credits disbursed and guarantees provided under EIB Financing Operations, less amounts reimbursed and plus all related sums, with a

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22 Council Regulation (EC) No 1360/2008 of 2 December 2008 amending Regulation (EC) No 332/2002 establishing a facility providing medium-term financial assistance to Member States' balances of payments (OJ L352, 31.12.2008, p. 11-11).

23 Council Regulation (EC) No 431/2009 of 18 May 2009 amending Regulation (EC) No 332/2002 establishing a facility providing medium-term financial assistance to Member States' balances of payments (OJ L128, 27.5.2009, p.1-2).

24 Cf. Press release on extraordinary Ecofin Council meeting 9/10 May 2010 (http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf)

25 Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (OJ L 118, 12.5.2010, p.1).

26 After entry into force of the Lisbon Treaty, the co-decision procedure will be the ordinary legislative procedure.

27 COM(2010)174 of 21 April 2010.

maximum ceiling of EUR 27 800 million[28]. A total amount of EUR 11 928 million had been signed at 31 December 2009 under this mandate, of which EUR 8 884 million remained undisbursed at that date (see Table A6 of the SWD).

5. DEFAULTS, ACTIVATION OF BUDGET GUARANTEES AND ARREARS

5.1. Payments from cash resources

The Commission draws on its cash resources in order to avoid delays and resulting costs in servicing its borrowing operations when a debtor is late in paying the EU[29].

5.2. Payments from the Budget

No appropriation was requested under Budget Article 01 04 01 (p.m. line), "European Community guarantees for lending operations", as no default was recorded in the second half of 2009.

5.3. Activation of the Guarantee Fund for external actions

In the event of late payment by the beneficiary of a loan to third countries granted or guaranteed by the EU, the Fund is called on to cover the default within three months of the date on which payment is due[30].

During the second half of 2009, the Fund was not called.

6. GUARANTEE FUND FOR EXTERNAL ACTIONS

6.1. Recoveries

As of 31 December 2009, the Fund had no arrears to recover.

6.2. Assets

At 31 December 2009, the net assets[31] of the Fund amounted to EUR 1 333 590 221.

6.3. Target amount

The Fund has to reach an appropriate level (target amount) set at 9% of the total outstanding capital liabilities arising from each operation, plus accrued interest. The ratio between the Fund's resources EUR 1 333 590 221 and outstanding capital liabilities[32]

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28 Broken down into a basic ceiling of a fixed maximum amount of EUR 25 800 million and an optional mandate of EUR 2 000 million. The activation of the optional mandate may be decided by the European Parliament and the Council in the context of the mid-term review.

29 See Article 12 of Council Regulation (EC, Euratom) No 1150/2000 of 22 May 2000 implementing Decision 94/728/EC, Euratom, on the system of the European Communities own resources (OJ L 130, 31.5.2000, 1-12).

30 For more details, see Section 1.4.3 of the SWD.

31 Total assets of the Fund minus accrued payables (EIB fees and audit fees).

32 Including accrued interests.

EUR 16 360 727 665 within the meaning of the Fund Regulation has slightly decreased from 8.39% at 30 June 2009 to 8.15% at 31 December 2009.

At year-end 2009, the Fund resources were lower than the target amount. According to the provisioning rules of the Guarantee Fund Regulation, a provisioning of EUR 138 880 000 was inserted in the Preliminary Draft Budget of 2011. This amount will be paid from the Budget to the Fund in early January 2011.

7. EVALUATION OF RISKS: ECONOMIC AND FINANCIAL SITUATION OF THIRD COUNTRIES WITH THE LARGEST EXPOSURE

7.1. Objectives

The previous sections of this report provide information on quantitative aspects of the risk borne by the Budget, relating to third countries. However, the quality of the risks which depend on the type of operation and the standing of the borrowers (see Section 4.3 above) should also be assessed.

7.2. Risk assessment methods

The risk assessment presented in the SWD is based on the information on the economic and financial situation, ratings and other known facts of the countries having received guaranteed loans. This assessment does not include estimations of expected losses and recoveries which are inevitably highly uncertain.

Country risk indicators included in the tables in the SWD indicate the evolution of risk of defaults. This analysis is provided in the section 2 of the SWD for the countries having the highest credit risk and exposure to the Budget in 2009 and the countries having a direct exposure with the Budget (MFA and Euratom loans).