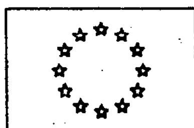

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 26.06.1996
SEC(96) 1131 final

REPORT FROM THE COMMISSION

COMMUNITY BUDGET
GUARANTEES IN RESPECT OF EIB LENDING OUTSIDE THE COMMUNITY

Community budget guarantees in respect of EIB lending outside the Community

1. When the Council adopted the decision concerning the guarantee for the EIB loan envelope of ECU 3 billion in favour of central and eastern European countries in December 1993, the Council invited the Commission to examine with the EIB the general question of whether to reduce the extent of the guarantee granted by the Community in respect of EIB external loans.

The Commission and the EIB presented a paper in which it was proposed to adopt a guarantee scheme based on a blanket guarantee of 75% for all EIB loans outside the Community.

Consensus on this proposal could not be reached and the Ecofin Council of 27.11.95 requested that a study be prepared by the EIB and the Commission on a new guarantee scheme which "devra envisager la possibilité qu'une partie des risques découlant de l'activité externe de la Banque soit assumée par celle-ci (par exemple le budget communautaire pourrait couvrir les risques politiques et non pas les risques commerciaux)."

2. The EIB and the Commission services discussed the matter extensively and a detailed study (appended to this report) was prepared by the EIB. It presents a thorough analysis of the guarantee issue and considers a series of alternative guarantee schemes.

The EIB concludes that a solid budgetary guarantee scheme remains a critical requirement for it to preserve its prime position in capital markets which is the necessary condition for the EIB to carry out its task within the Union and maintain a high quality and diversified loan portfolio. The EIB considers that a guarantee scheme based on a straight blanket coverage remains by far the best option for the EIB, Member States and the Commission. Such scheme would be simple and inexpensive to administer, would involve no risk of litigation and would be fully consistent with the EIB's Statute, mandates and current modus operandi. Moreover, the EIB considers that the level of blanket coverage could be lowered to 60%, which would reduce by some 35% the budgetary cost of guaranteeing Bank loans, thus helping to address the budgetary problem confronting the EC with respect to loans outside the Union.

However, the EIB shows in the Study that a scheme under which risks could be shared between the EC budget and the Bank along the lines suggested by the Ecofin Council, namely the separation of political and commercial risks, would also be feasible but would entail significant operational drawbacks. It would be more difficult and costly to administer, would involve risks of litigation, would imply more labour-intensive project structuring, and could result in considerable legal costs in case of default.

The Commission, on the other hand, is of the opinion that a blanket guarantee scheme only would not respect the Council's wish that a genuine risk sharing between the EC Budget and the Bank will be implemented. The guarantee scheme outlined below implies a separation of commercial and political risk along the lines suggested by the Council. This scheme, according to the Commission, would have no negative impact on the credit rating of the EIB, would be operational and would therefore represent an acceptable compromise solution.

3. The guarantee scheme that is proposed by the Commission and could be acceptable to the Bank would have the following main features:

- The Bank will assume commercial risks in a significant part of its lending outside the Community for the entire period covered by the new mandates. In the recent past, about one-fifth of Bank loans outside the Community would have been amenable to a sharing of risks between the Bank and the EC Budget. The share of such loans can be expected to vary in accordance with the content of new mandates to lend outside the Community and the availability of suitable projects and guarantees. But the Bank will seek to develop such opportunities wherever possible. In such cases, the EIB will not require guarantees from governments in recipient countries in order to avoid additional budgetary burdens on these countries.

- for those loans involving risk sharing, the EC Budget would assume only selected political risks, namely the risks of currency non-transfer, expropriation, war and civil disturbance. All other risks would be taken by the Bank and be covered by adequate guarantees;

- the remaining part of the lending as well as the above mentioned political risks would be jointly covered by a budgetary blanket guarantee of 50% of all loans signed with the deduction of repaid and cancelled loans, on a world-wide basis;

- the adequacy of guarantees would remain a matter of professional judgement by the Bank;

- the ceiling for the renewal of on-going EIB mandates would remain subject to:

    - the decision on the internal-external split of Bank operations as defined by the Bank's and the Union's decision-making bodies so as to maintain the essentially European focus of Bank lending;

    - the resources available in the Reserve associated with the Guarantee Fund for external operations, once adequate amounts have been set aside to make provisions for Euratom and possible balance of payments loans;

- the new guarantee scheme would be applicable to new mandates for Bank external lending.

Annex: 1 (Doc.BEI 96/189 - Annexes 1 à 11)

EUROPEAN INVESTMENT BANK

CA/297/96
7 May 1996

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Agenda
item n°

B O A R D O F D I R E C T O R S

GUARANTEE SCHEME FOR BANK LOANS OUTSIDE THE EUROPEAN UNION

ORIG. : E

Executive Summary

The attached report is a preliminary version of the study on the budgetary guarantee scheme for Bank loans outside the EU which was requested by the ECOFIN in November 1995 and that might be presented to the COREPER and, if possible, the ECOFIN by June. It has been prepared by the Bank after extensive discussions with the services of the Commission.

The background to the study is presented in Part 1. The budgetary guarantee issue is of **utmost importance to the Bank** and the Union both over the long run (decisions on this issue could have profound implications on the Bank's activities both within and outside the Union) and in the shorter term because this issue is an important element in the timely renewal of the three mandates ending in 1996.

The main analytical conclusions of the study are presented in Part 2. It shows that the current guarantee scheme has worked satisfactorily, has served the Union and the Bank well, and has been, for the Community, a least-cost solution to carry-out an important component of the EU's aid and co-operation policy. Strong budgetary guarantees have been necessary to ensure the compatibility between the Bank's highly leveraged financial structure (which is different from that of other international financial institutions which effectively have 100% equity/guarantee cover), lending to developing country borrowers (which involves significant risks) and access to capital markets on the finest terms, which is a necessary condition for the Bank to be able to fulfil its mandate within the Union.

Regarding future operations outside the EU, a solid budgetary guarantee scheme remains a critical requirement for the Bank because of:

- the **critical need to avoid any deterioration of the Bank's ranking within the AAA category**. Weaker guarantees could result in higher borrowing costs for the Bank in capital markets, which would make Bank lending rates less attractive and would make it very difficult for the Bank to maintain a high quality and diversified loan portfolio within the EU.
- the significant risks inherent to lending to developing country borrowers (as illustrated, *inter alia*, by the increase in arrears on Bank loans outside the EU);
- the decline in the average quality of Bank borrowers outside the EU that would result from the eventual enlargement of the Union.
- the possible erosion of the *de facto* preferred creditor status that has protected Bank loans to date.

The operational conclusions of the study are presented in Part 3. It concludes that of the four guarantee schemes that have been thoroughly analysed in the study, only two schemes would be consistent with the Bank's Statutes and lending policies as well as with the preservation of the Bank's role within the EU. These two schemes are based respectively on a 60% blanket coverage or on a combination of the separation between political and commercial risks (suggested by the ECOFIN) with a blanket coverage (§ 3.4). Both schemes would **reduce by 35% the budgetary cost of guaranteeing Bank loans**. In contrast, a loss-sharing arrangement project by project or a fixed budgetary coverage could have considerable adverse implications for the Bank. The minor immediate budgetary benefits to be gained from these schemes are dwarfed by the considerable risks they could imply for the Bank in its operations within the EU and the necessary upheaval in the delicate balance of responsibilities between the various European institutions and Member States for policy outside the EU.

1. Background

The ECOFIN asked the Bank and the Commission, in November 1995, to report before the end of 1996 on a new guarantee system. The study was requested because of:

- a growing awareness of the need to reconcile pressing budgetary constraints with the expansion of Bank operations outside the EU to support the Union's external policy.

- the feeling by a few Member States that the system under which all risks involved in Bank lending outside the EU are covered fully by a budgetary guarantee should evolve, and that the Bank could take part of project risks on its portfolio.

As mentionned at the January 29, 1996 Board meeting, the Management of the Bank considers that the budgetary guarantee issue is of **utmost importance to the Bank and the Union.** Over the long run, any decision in this regard could have profound implications on the Bank's activities both within and outside the Union. In the short run, this issue is an important element that conditions the global renewal of the three mandates ending in 1996 (Central and Eastern European Countries-CEEC-, Mediterranean countries-MED-, and Asia and Latin America--ALA). Indeed, the Commission stated repeatedly that programmed appropriations for the Guarantee Fund together with the current provisioning rules do not allow the renewal of the various Bank mandates to lend outside the Community at their current level. In any event, the overall level of Bank lending outside the EU, and therefore the country mix of its loan portfolio, will remain a matter for the Board and the Council to determine.

Two overriding concerns have led the efforts of the Bank in drafting the study and identifying solutions suitable to the EC and the Bank:

- Optimise the budgetary guarantee scheme to limit its cost to the EC budget while preserving an adequately strong protection of the Bank's assets.

- Avoid that the new guarantee scheme result in a fundamental change in the role of the Bank in the EU as a central financial institution and minimise its overall costs to the Bank.

The attached report is a preliminary version of the study the Bank and the Commission might present to the ECOFIN, possibly in June. [1] This draft study was discussed extensively with the services of the European Commission, but represents the Bank's conclusions.

2. Main Analytical Conclusions

Preserving the competitiveness of the Bank in capital markets is a critical requirement

The Bank was given the dual mandate (almost unique among supranational financial institutions--SFIs) to finance investment projects both inside and outside of the European Union, it

[1] The annexes mentionned in the Study are available upon request.

being understood that operations inside the Union are the Bank's clear priority and should not be affected by lending activities outside the Union. The Bank has a unique customer base that ranges from prime European borrowers (bank and corporate AAAs who are in a position to compare systematically the terms offered by the Bank to those of alternative sources of finance) to weaker borrowers both within and outside the Union. Therefore, more than other SFIs, the Bank has to be competitive in international capital markets, i.e., has to be able to raise resources on the finest terms possible, if it is to carry out successfully its task within the Union in full compliance with its Statutes and the subsidiarity principles, while maintaining a high quality and balanced portfolio.

The Bank's high asset quality has been one of the factors that have enabled the Bank to be seen as one of the best credits in the world within the AAA category, and make it possible to raise funds at terms often more attractive than other AAA credits. A necessary condition for the Bank to be able to continue to raise resources on such attractive terms is for its financial strength to remain unquestioned.

Any notable weakening of the budgetary guarantee scheme for Bank loans outside the Union could result in a deterioration of the Bank's ranking within the AAA category (negative implications on the perception of EIB bondholders and the assessment of credit rating agencies), which would result in higher borrowing cost. This would make it difficult for the Bank to maintain a high quality and balanced loan portfolio within the EU, and would jeopardise the fulfilment of its mandate.

The Bank's financial structure is cost-effective to shareholders but is not consistent with inherent risks of lending to developing countries

The Bank was given a gearing policy significantly less restrictive than that of most other SFIs,[2] reflecting the nature of risks to be taken by the institution (most of its lending is to be extended in Member States), thus limiting the budgetary cost of the institution for its shareholders. However, the resulting balance sheet structure is not consistent with the significant risks inherent to lending to developing country borrowers, in particular the catastrophic risks such as those that occur, for instance, on the occasion of debt crisis which affect developing countries on a more or less regular basis.

The necessary condition to ensure the compatibility between a highly leveraged balance sheet structure, operations in developing countries (which involve significant risks) and access to capital markets on the finest terms is therefore the availability of solid budgetary guarantees to cover loans outside the territory of member states.

The Bank's unique modus operandi outside the EU is predicated on the availability of strong budgetary guarantees

Unlike other SFIs, the Bank conducts its operations outside the Union under politically-motivated mandates and operates in countries that are not its shareholders. Indeed, Bank lending outside the Union is based primarily on decisions taken by the Council of Ministers. The choice of

[2] By statute, the Bank's loan and guarantee commitments cannot exceed 250% of subscribed capital, which is considerably higher than for most other SFIs which are limited to lending no more than 100% of their paid-in and callable capital and therefore in effect benefit from a 100% guarantee.

beneficiary countries is not only subject to the Bank's financial and economic criteria, but first and foremost, the result of political considerations that often expose the Bank to significant sovereign risks. Also, the Bank is almost the only SFI that operates in countries that are not its shareholders and are not directly interested in the financial well-being of the institution. The necessary corollary of these essentially political decisions has been the availability of strong budgetary guarantees to protect the Bank from the significant risks inherent to its activities outside the EU and to obviate the politically-sensitive need for the Bank or the Commission to discriminate among countries according to their creditworthiness.

Another specificity of the Bank is that its operations outside the EU are very diverse in nature and include IBRD-type operations (loans to middle-income developing countries, mostly to the public sector with sovereign guarantee), IDA-type operations (loans to low-income developing countries, mostly to the public sector) and IFC-type operations (loans and equity funding for private sector entities generally in middle-income countries). The availability of a full budgetary guarantee on loans outside the EU has made it possible to handle these diverse operations in a single institution with limited staff resources. (Of note, turnover per head in the Bank for operations outside the EU was, in 1995, about seven times as high as in the IFC and the EBRD). Using the Bank to support investments outside the EU with adequate budgetary guarantees has been the least cost solution to the EU. Any new guarantee scheme will have to reflect the unique diversity of Bank operations outside the Union and preserve the "least-cost" feature of the present arrangement.

The statutory requirement for adequate guarantees

The Bank's Statutes and lending policies, as well as previous decisions made regarding budgetary guarantees reflect the general awareness of the need to protect the integrity of the Bank's balance sheet to preserve the Bank's role within the Union.

By its Statutes, the Bank has to require adequate guarantees for each loan. Article 18(3) of the Statutes provides that when lending to a body other than a Member State, the Bank shall make the loan conditional either on "a guarantee from the Member State in whose territory the project will be carried out or ... on other adequate guarantees." When allowing by way of derogation the Bank to finance under Art. 18(1) of the Statutes projects outside the Union in developing countries, the Board of Governors has, in analogy to Art. 18(3), always made such derogation conditional upon the availability of a Member State or a Union guarantee as most lending outside of the Union was extended to public sectors borrowers with sovereign guarantees, none of which could be considered adequate as per Art 18(3).

The current guarantee scheme has served the EC and the Bank well

The study shows that the current guarantee scheme has been fully justified, has been used in a responsible manner by the Bank, and has served the Union, the Bank and its customers well. It has functioned satisfactorily both from an administrative standpoint (it has been simple and cost-

effective to operate in the Bank and the Commission) and from a budgetary point of view (Bank calls on the budgetary guarantees have been minor).[3]

* * *

A solid budgetary guarantee scheme remains a critical requirement for the Bank

In view of the above, and as the Bank's loan portfolio within the Union is characterised by greater exposure to the private sector, the Management of the Bank considers that any new guarantee scheme will have to continue to provide strong backing to Bank loans outside the EU because of:

- the critical need to avoid any deterioration of the Bank's ranking within the AAA category;
- the significant risks inherent to lending to developing country borrowers (as illustrated, *inter alia*, by the increase in arrears on Bank loans outside the EU;
- the decline in the average quality of Bank borrowers outside the EU that would result from the eventual enlargement of the Union;
- the possible erosion of the *de facto* preferred creditor status that has protected Bank loans to date.

3. Main Operational Conclusions on Alternative Guarantee Schemes

The main criteria to assess guarantee schemes should be their consistency with the Bank's Statutes and lending policies, their effectiveness in the sense that they do not jeopardise the Bank's role within the EU, and their operational efficiency. In view of these policy requirements, four different guarantee schemes have been analysed on the basis of the Bank's current operations and risk weighting outside the Union.

3.1 Scheme 1: Sharing losses on a project by project basis

During the 1995 discussions on the Guarantee Scheme, a few Member States suggested that the possibility that the Bank and the Budget share risks on a project by project basis should be considered. Under this scheme, the Bank would benefit for instance from a 75% budgetary guarantee, loan by loan regardless of the nature of the borrower/guarantor. In the event of default, the Bank would be entitled to call on the budgetary guarantor up to only 75% of the arrears, while it would have to bear the remaining amount of the loss. In fact, such a scheme would be a plain loss-sharing arrangement.

The study shows that a project-by-project loss sharing scheme would most likely be perceived as a weakening of the guarantee scheme--and of the Bank's balance sheet--and could result in higher borrowing costs in capital markets. This would jeopardise the Bank's activities

[3] Since the beginning of Bank activities outside the EU, loans for about ECU 12 billion were signed while the net cost of calls on guarantees has been limited to ECU 105 mn as of end-1995.

within the EU and make it very difficult to maintain a high quality and diversified loan portfolio. Such a scheme would not be consistent with normal banking practices because it would result in certain losses whenever a debt service default occurs, forcing the Bank to bear significant sovereign and other political risks that cannot be covered by adequate third party guarantees. Moreover, it would not be consistent with the Bank's Statutes and lending policies because a partial budgetary coverage project-by-project cannot be deemed adequate. This scheme would lead the Bank to concentrate its operations in the least vulnerable countries and discontinue operations in the more risky ones, which could have profound political implications (transfers of responsibilities from the Council to the Bank).

3.2 Scheme 2: A fixed ceiling of budget commitment

Under this scheme, the Budgetary Authority would fix the amount of the budgetary guarantee at a certain specified level. Within the given volume of budgetary guarantee, the Bank would decide the level of lending and guarantee it deems appropriate in view of the risks involved in various countries and projects.

The study concludes that this option has severe drawbacks that more than offset its possible benefits: it would be more costly to operate than the current scheme, could harm the Bank's effectiveness as an essential tool of the EU's economic policies, and would not be consistent with the Bank's Statutes (were it to be expected to yield significant budgetary savings) nor with the spirit of the various mandates which give all countries concerned access to Bank loans. At any rate, as in scheme 1, it would transfer to the Bank the responsibility of choosing between countries and regions, which would not be compatible with policies so far.

3.3. Scheme 3: The Bank's Preferred Guarantee Scheme

The study concludes that the most cost-effective guarantee scheme that optimises the EU financing instruments is based on a blanket coverage of Bank loans outside the EU by the EC Budget. Compared to the guarantee scheme discussed last year, it could feature a lower level of coverage provided the blanket coverage is globalised world-wide; as proposed last year, the blanket guarantee would cover only all loans signed minus loans cancelled and minus reimbursements.

The appropriate method to identify an adequate level of blanket coverage is to do a comparative analysis of the Bank's gearing policy with that of other SFIs. In that regard, one way to restore for Bank loans outside the EU an equity backing of 1:1 typical in multilateral development banks would be for the budget to cover at least 60% of risks, since under the Bank's gearing policies, the capital of the Bank can cover only 40% (1/2.5=40%) of the overall risks of lending outside the Union.

The 60% globalised scheme would present considerable advantages compared to alternative schemes:

- it would help to solve the budgetary dilemma by limiting the budgetary expenditure required to support Bank loans outside the EU. Indeed, reducing the blanket coverage to

60% from the current 100%/75%, would **reduce by 35% the budgetary cost of guaranteeing Bank loans**;

- it would safeguard the effectiveness of the Bank as an essential instrument to promote the balanced development within the Union while limiting at a minimum the equity contributions by Member States;
- it would be efficient from an operational standpoint: it would be as simple and inexpensive to operate as the current scheme;
- it would be fully consistent with the Bank's statutes, mandates and current modus operandi.

3.4 Scheme 4: Combining a separation of political and commercial risks with a blanket coverage

The Bank has also given thought to the possibility of a guarantee scheme under which, in appropriate cases, risks could be shared between the EC Budget and the Bank along the lines suggested by the ECOFIN (political versus commercial risks). The Commission sees attractions in such an approach.

However, experience in political risk insurers has shown that separating political and commercial risks is most difficult and contentious, and that basing a guarantee scheme on this distinction could result in significant operational difficulties. Moreover, the Bank is exposed to a broad and complex series of political risks because it lends to public and private sector borrowers. Given this background and to be consistent with the Bank's Statutes and lending policies, any scheme based on the separation of political and commercial risks should be structured as follows:

- Case 1: When adequate third party guarantees can be secured by the Bank (this would be the case in general for loans to private sector borrowers, which accounted for over 30% of total Bank loans outside the EU in 1995), the budgetary guarantor would cover only the risks of currency non-transfer, expropriation, war and civil disturbance; all other risks would be taken by the Bank, and be covered by adequate guarantees by first class banks or corporates.

- Case 2: When no adequate third party guarantees can be mobilised by the Bank (this would be the case essentially for loans to public sector entities), the loan would be covered fully by the budgetary guarantee. In this case, the budget would cover essentially the risk that the sovereign/public sector borrower/guarantor default on its obligations to the Bank. Such a risk is *in fine* exclusively political for the Bank (as explained in § 3.4 of the study).

- The overall coverage of the Bank's total loan portfolio outside the EU could be lowered to 60% (down from the current 100%/75%), as under the Bank's preferred solution, with the same favourable budgetary implications as under Scheme 3. However, it has to be kept in mind that such a reduction in the level of global coverage could be considered only on the basis of the average country creditworthiness resulting from the current mandates.

- Were such a scheme to be adopted, appropriate loan-loss provisions would have to be made by the Bank. The cost of these would have to be borne by the Bank, and ultimately by the

recipients of the loans. As a corollary, this type of risk sharing may allow a lower provisioning in the Guarantee Fund. (This would be a matter for the Budgetary Authority to decide).

- In any event, judgement on the adequacy of guarantees would have to be a matter of professional judgement by the Bank and its Board of Directors. However, one could envisage that the performance of the new guarantee scheme be monitored *ex post*.

It is obvious that such scheme would, compared with the Bank's preferred solution as described in § 3.3., involve several operational drawbacks. It would be more difficult and costly to administer, would involve risks of litigation, would imply more labour-intensive project structuring, and could result in considerable legal costs in case of default.

4. Proposals

Given the urgency and importance of the matter for the Bank's future activity outside the Union, in particular for the timely renewal of important mandates and for the Bank to be able to prepare these new activities, the Management Committee seeks the Board authority to negotiate, in consultation with the Commission, a new guarantee scheme as follows:

- the Bank gives preference to a guarantee scheme on a globalised basis along the lines of, and for the reasons given under, § 3.3. above;

- however, the Bank should not exclude the possibility of developing a variant under which the Bank could share risks with the EC Budget along the lines explained under § 3.4. above;

The Board would be kept informed on the development of these negotiations.

ANNEX 1

April 25, 1996

Study on the Guarantee Scheme for EIB Loans Outside the EU

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Introduction

The ECOFIN asked the Bank and the Commission, in November 1995, to report before the end of 1996 on a new guarantee system (see ECOFIN decision in Annex 1). The study was launched because of:

- a growing awareness of the need to reconcile pressing budgetary constraints with the expansion of Bank lending outside the EU to support the EU's external policy.

- the feeling by a few Member States that the system under which all risks involved in Bank lending outside the EU are covered fully by a budgetary guarantee should evolve, and that the Bank could take part of project risks on its portfolio.

The budgetary guarantee issue is of **utmost importance to the Bank and the Union**. Over the long run, any decision on this issue could have profound implications on the Bank's activities both within and outside the Union. In the short run, the guarantee issue is an important element that conditions the timely and global renewal of the three mandates ending in 1996 (Central and Eastern European Countries-CEEC-, Mediterranean countries-MED-, and Asia and Latin America--ALA). Indeed, the Commission stated repeatedly that programmed appropriations for the Fund together with the current provisioning rule are not consistent with the renewal of the various Bank mandates to lend outside the Community at their current level, and would allow no new macro-economic assistance loan from 1997 onwards.

The present report is a preliminary version of the study the Bank and the Commission might present to the ECOFIN. It aims at proposing solutions predicated on a rigorous and thorough analysis of:

- Bank lending outside the EU in the context of the Bank's global activity and the associated risks/constraints;

- current practices in other financial institutions (in particular Supranational Financial Institutions--SFIs-- and Export Credit Agencies--ECAs--) as well as in institutions specialised in risk coverage, to identify the relevant "state of the art" practices in a rapidly evolving business environment.

The report features three Parts. Part 1 presents the specificities of the Bank that explain the need for strong budgetary guarantees on Bank loans outside the EU. Part 2 presents the structure, operations and performance of the current budgetary guarantee scheme. Part 3 provides a critical assessment of various guarantee schemes alternative to the current scheme.

The Bank's preferred option is presented in §3.3. and consists in a guarantee scheme based on a blanket coverage of Bank loans outside the EU (with the blanket coverage being lowered possibly to 60%, from the present 100%/75%) and that would operate broadly along the lines of the present scheme, thus preserving its simplicity and cost-effectiveness. In contrast, the services of the Commission favour another guarantee scheme, combining a risk sharing between the Bank and the budget along the commercial versus political lines with a blanket coverage (see § 3.4). While the Bank considers that the latter guarantee scheme is feasible and consistent with its

Statutes and policies, it would nonetheless have operational drawbacks that make a guarantee scheme based on a straight blanket coverage preferable.

1. The Specificities of the Bank and the Need for Strong Guarantees on Loans outside the EU

1.1 The Bank's tiered dual mandate imposes a unique competitiveness imperative

The EIB is the "house bank" of the European Union providing long-term loans for capital investment to further EU policies with resources raised in the international capital markets. As such, the Bank has been given a **dual mandate** that is almost unique among supranational financial institutions (SFIs) to finance investment projects both inside and outside of the European Union. While the Bank was created to promote economic development and cohesion within the EC, it has also been agreed since the early 1960s that using the Bank as an instrument of the EC's aid and external policies was the **least-cost solution for the Community** (see §1.2).

However, there has always been a general agreement that the Bank's main remit is the promotion of economic development and cohesion within the Union, and that **financial co-operation with third countries should not interfere with the Bank's main task. This was stressed again in the November ECOFIN decision**. Because of this **tiered dual mandate, the Bank has a unique customer base** that ranges from prime European borrowers (bank and corporate AAAs who are in a position to compare systematically the terms offered by the Bank to those of alternative sources of finance) to weaker borrowers both within and outside the Union.

Therefore, **the Bank is, more than any other SFI, subjected to the imperative to be competitive in international capital markets,** i.e., has to be able to raise resources in international capital markets on the finest terms possible, if it is to carry out successfully its task within the Union in **full compliance with its Statutes and the subsidiarity principles**. Excellent asset quality, solid financial structure and strong membership support have enabled the Bank to secure a AAA rating from all rating agencies and to be universally seen as one of the best credit in the world within the AAA category. This has enabled the Bank to secure the best possible terms in international capital markets, and to **raise funds at terms often more attractive than other AAA credits**. This has been an essential asset to the Bank given its customer base and has enabled the Bank to maintain a **high quality and balanced loan portfolio**. The imperative to offer very attractive terms to its customers is reflected also in the Bank's on-lending margin, which is the finest of those practised by SFIs (See Annex 2).

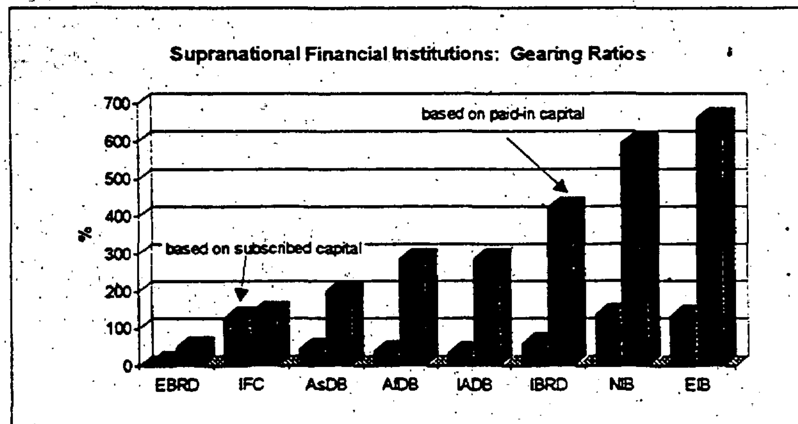
A necessary condition for the Bank to be able to continue to raise resources in capital markets at the best possible terms is for its financial strength to remain unquestioned. An important factor influencing the perception of the Bank's financial strength is the quality of its loan portfolio, which is essentially determined by the financial viability of its borrowers and guarantors. The perception of the strength of the Bank's loan portfolio outside the EU depends in part on the budgetary guarantee.

Therefore, the perception that the guarantee scheme for the Bank's operations outside the Union is weakened would most likely have negative implications on the perception of EIB bondholders and the assessment of credit rating agencies and could result in higher borrowing costs. This would **jeopardise the Bank's role in its core markets, make it very difficult for the Bank to maintain a high quality and balanced loan portfolio, and jeopardise the fulfilment of the Bank's mandate within the Community, which would be detrimental to the Bank, its shareholders and its customers.**

1.2 The Bank's financial structure is cost-effective to shareholders but is not consistent with inherent risks of lending to developing countries

The Bank was given a gearing policy significantly less restrictive than that of most other supranational financial institutions (SFIs), reflecting the nature of risks to be taken by the institution (most of its lending is to be extended in Member States), thus limiting the budgetary cost of the institution for its shareholders. By statute, the Bank's loan and guarantee commitments cannot exceed 250% of subscribed capital, which is considerably higher than for most other SFIs which are limited to lending no more than 100% of their paid-in and callable capital. (see Annex 3 for a comparison of SFI's financial structure). The only other notable exceptions to the 1:1 gearing ratio rule are the Nordic Investment Bank (2.5:1 as for the Bank) and the IFC (with an implicit gearing ratio of 3.3:1 resulting from the rule that the sum of paid-in capital, retained earning and general loss reserves must be at least 30% of risk assets).

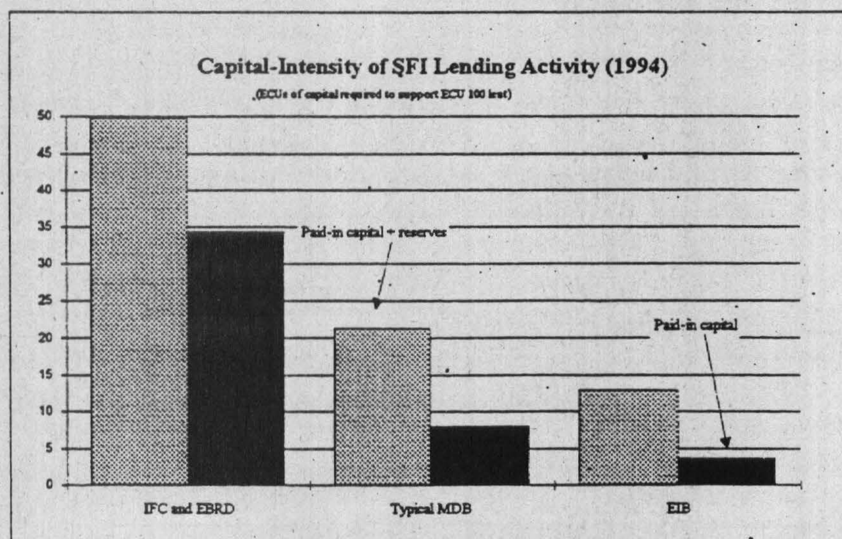
Being managed conservatively, all SFIs tend to maintain their actual gearing at a much lower level than allowed under their statutes. The Bank and the Nordic Investment Bank (NIB) have the highest actual gearing ratios, measured either with paid-in capital or subscribed capital, which reflects in large part the higher average quality of their loan portfolio. Despite higher gearing and leverage limits, IFC has been more equity-intensive than the Bank, with a gearing ratio measured on paid in capital at 147%, compared to 427% for the World Bank, some 600% for NIB and some 660% for the Bank (See Annex 3).[1] Other SFIs tend to have very conservative gearing ratios and their lending activities are therefore more equity-intensive (i.e., more costly in budgetary terms for their shareholders) than in the Bank, due to the inherent risks of lending to developing countries.



[1] This reflects IFC's statutory requirement that subscribed capital be largely paid in, which distinguishes the IFC from all other SFIs that have capital bases consisting largely of callable capital.

In sum, the Bank's financial structure requires considerably less budgetary support from, and represents a smaller contingent liability on, its shareholders than in other SFIs. At present, only ECU 4 of paid-in capital (ECU 13 of paid-in capital and reserves) are needed to support every ECU 100 lent by the Bank while ECU 8 (respectively ECU 21) are necessary in typical Multilateral Development Banks (MDB including AfDB, AsDB, IADB and IBRD) and some ECU 34 (respectively ECU 50) in IFC and EBRD, the very high equity-intensity of the latter institutions reflecting the high risk inherent to their lending and equity investment activities targeting the private sector.

Were the EU to set up a new European Development Bank taking over the Bank's activities outside the EU (or to create a special section within the EIB with its own balance sheet and capitalised separately) with a financial structure comparable to other SFIs, the necessary paid-in capital (and reserves) would be in the range of ECU 2 billion (based on the average actual gearing of MDBs) to ECU 5 bn (based on the IFC and EBRD actual gearing). Therefore, the use of the Bank to carry out lending mandates outside the EU with strong budgetary guarantees results in **substantial budgetary savings in terms of equity contributions by Member States** (between ECU 0.8 billion and ECU 3.6 billion), which more than offset the budgetary costs of the current guarantee scheme.



However, the Bank's balance sheet structure that results from its gearing policy is not consistent with the significant risks inherent to lending to developing country borrowers, in particular the catastrophic risks such as those that occur, for instance, on the occasion of debt crisis which affect developing countries on a more or less regular basis. **The necessary condition to ensure the compatibility between a highly leveraged balance sheet, operations in developing countries and access to capital markets on the finest terms has been the availability of very solid budgetary guarantees to cover loans outside the territory of member states.** Rating agencies have repeatedly stated that a high gearing ratio at the Bank is not a material weakness because of strong asset quality (and firm shareholder support). For its

operations in member states, asset quality is predicated on the strong creditworthiness of Bank borrowers/guarantors, while for its operations outside the EU asset quality is, from the standpoint of rating agencies, largely predicated on the strength of the budgetary guarantee. (See section 2 for a presentation of the Bank's current budgetary guarantee scheme. Of note, NIB has a similar financial structure and its operations outside the Nordic area are covered by very strong budgetary guarantees.[2])

1.3 A Unique Modus Operandi Predicated on the Availability of Strong Guarantees

1.3.1 Political nature of Bank mandates to lend outside the EU

Bank lending outside the Union is politically motivated and is based primarily on decisions taken by the Council of Ministers (see Annex 4 for a summary of the various mandates to lend outside the EU). **The choice of beneficiary countries is not only subject to the Bank's financial and economic criteria, but first and foremost, the result of political considerations that often expose the Bank to significant sovereign risks.** In MED and CEECs, the Bank is expected to lend to each and every country of the area with own resources, whatever the creditworthiness of the country. In the ACP region, some flexibility is provided by the availability of budgetary funds managed by the Bank on behalf of the EC (risk-capital), which enables the Bank to use own resources only in those countries with the highest relative creditworthiness. Regarding the ALA mandate, more freedom was given to the Bank which is not under formal obligation to lend to each and every eligible country.

Also, **the Bank is almost the only SFI that operates in countries that are not its shareholders.** These countries are not directly interested in the financial well-being of the Bank and cannot be subject to the same kind of pressure than countries in default to institutions in which they have a stake.

The necessary corollary of these essentially political decisions has been the availability of strong budgetary guarantees which have obviated the politically-sensitive need for the Bank or the Commission to discriminate among countries according to their creditworthiness. **Any significant weakening of such guarantees would necessitate a radical shift in the geographical allocation of loans outside the Union to protect the integrity of the Bank's balance sheet**, which would be necessary to enable the Bank to carry out its main task within the Union. It would imply a drastic limitation of Bank lending outside the EU to projects/countries where the Bank can secure guarantees deemed adequate as per Art. 18 (3) of the Statutes. (see §1.4)

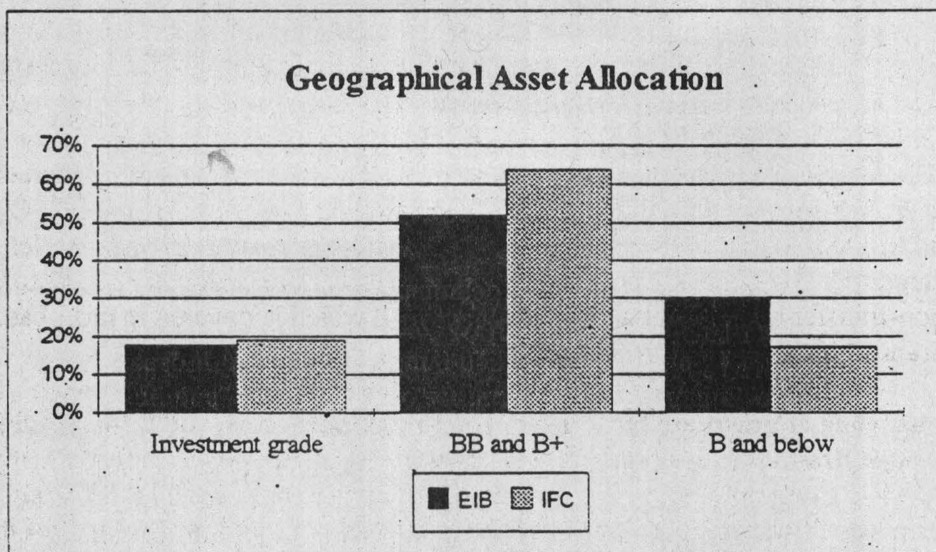
Such a limitation resulting from **sound and normal banking principles** would have two main implications:

- it would prevent the Bank from implementing its mandates as defined and interpreted to date;

[2] Loans under the Baltic Investment Facility and the Baltic Investment Programme are fully guaranteed by NIB members for principal and interest repayments. NIB lending in other developing countries benefit from a 90% guarantee from member states of both principal and interest payments.

- it would shift the essentially political decision to lend in certain countries from the Political Authority to the Bank.

It is important to note that **institutions with gearing ratios similar to that of the Bank have much less constraints on their geographical asset allocation**, which results in a heavier concentration of loans in a limited number of developing countries that rank high in terms of creditworthiness. About half of NIB loans outside the Nordic area is concentrated in Asia (NIB would not normally lend in countries rated below B+/B1) while IFC concentrates two-third of its lending in only 15 countries (out of some 120 countries in which IFC operates) and undertakes the bulk of its lending in countries rated B+ and above. Given that the Bank has had to allocate loans in developing countries as per its various mandates, the average quality of borrowers and of the first-line guarantors tends to be lower than for IFC and NIB. (see Chart below and Annex 8)



1.3.2. Plural Nature of the Bank's Operations outside the EU

One of the specificities of the Bank is that its operations outside the EU include IBRD-type operations (loans to middle-income developing countries, mostly to the public sector with sovereign guarantee), IDA-type operations (loans to low-income developing countries with risk-capital, mostly to the public sector) and IFC-type operations (loans and equity funding for private sector entities generally in middle-income countries). For all these operations, a flat and narrow margin of 25 bp over borrowing costs is charged, regardless of the nature of the borrower. **The availability of a full budgetary guarantee on loans outside the EU has made it possible to handle these diverse operations in a single institution with limited staff resources and to price loans to all borrowers uniformly.**

The Bank's interest margin on loans outside the Union is comparable to the IBRD's lending terms and principles. Other Multilateral Development Banks either adopt similar pricing schemes with higher spreads (50 bp + a 1% commitment fee at the AfDB, 40 bp at the AsDB, 50 bp at

NIB, ... see Annex 2) or, particularly in these institutions that lend essentially to the private sector, price their loans individually based on their risk analysis and in line with market prices. In the latter institutions that target private sector borrowers, interest margins are typically higher than in other SFIs to make the high loan-loss provisions that are required to match the riskiness of their portfolio. (The average lending spread at IFC is of some 300 bp).

Despite the Bank's uniform pricing policy, **Bank loans to the private sector can still be deemed to be priced in line with the market** because when a sovereign guarantee is not available (which is increasingly the case for private sector projects), the borrower is asked to set up an adequate guarantee for the Bank loan and to bear the corresponding costs. In this context, **the Bank has acted in good complementarity with its commercial guarantors (first class banks or corporates), sharing responsibilities to structure the financing package and assessing/pricing credit risks.** Thereby, the Bank has ensured that risks were priced explicitly in line with the market, thus avoiding undue subsidies. Also, this provides an appropriate protection to the budgetary guarantor (see §1.4).

The Bank's unique modus operandi is predicated on the availability of a strong budgetary guarantee scheme. The latter has enabled the Bank to operate flexibly in extremely diverse situations. It has provided the equity-type backing that has made it possible for the Bank to enter into IBRD-type operations with public sector borrowers in developing countries. Also, it has been sufficiently flexible to allow the Bank to finance private sector borrowers (IFC-type operations) and to put in place, in these cases, original guarantee structures under which commercial guarantors cover all credit risks (thereby protecting the budgetary guarantor) except the currency non-transfer risk--essentially a political risk--, which is covered in most cases by the budgetary guarantor. (see §1.4 and Annex 5).

In the absence of adequate guarantees for these operations, the Bank would most likely have to limit drastically its geographical presence and increase its interest margin on loans outside the EU to make loan-loss provisions. Of note, the Bank would most likely have to make higher loan loss provisions than other multilateral development banks because of its lower relative equity base. The increasingly competitive situation faced by the Bank within the EU and in a few countries outside the Union would rule out any uniform increase in the margin, which would confront the Bank (and the EC) with the **politically sensitive issues** of ranking countries, setting country exposure limits, and differentiating lending rates according to perceived creditworthiness.

Without appropriate budgetary guarantees, it would be virtually impossible to continue to conduct the Bank's broad range of operations outside the EU in the present structures and with the limited staff resources allocated currently in the Bank to lending outside the EU. Other SFIs are endowed generally with considerably more human resources than the Bank where turnover per head in 1995 (for operations outside the EU) was about seven times as high as in the IFC and the EBRD (see Chart below).[3] (Such comparisons should not be seen as judgements on the relative efficiency of the various SFIs but are aimed only at putting in perspective the staffing/operating

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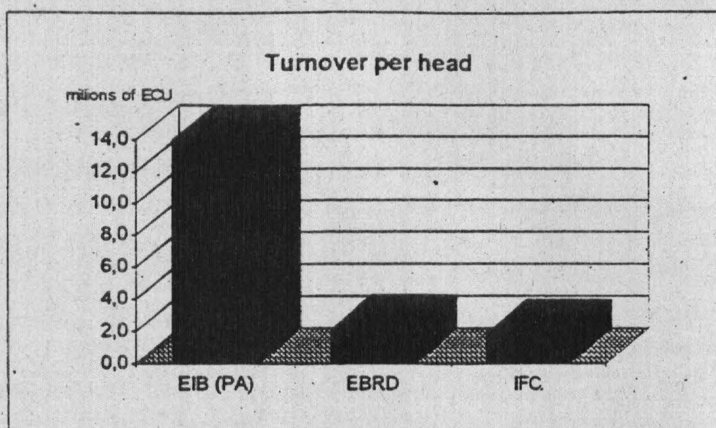
[3] Operations outside the EU amounted to ECU 2.8 billion and mobilised only some 200 staff members in the Bank (some 100 PA staff and about the same number of associated staff from the various other Directorates); while IFC employed 1,224 persons in FY 1995 for a total turnover of ECU 2.2 bn and the EBRD employed 964 persons for a total turnover of ECU 2.0 bn.

cost implications of the kinds of modus operandi of the various SFIs that result from their specific mandates, statutory constraints and market environment. In its lending activities outside the EU, the Bank works closely with the EBRD and IFC and values their contribution.)



1.4 The statutory requirement for strong guarantees

Given this background, as and when Member States have called on the Bank to assume responsibility for certain aspects of the Union's co-operation policy, they have always agreed to introduce, for its loans from own resources outside the Union, arrangements under which such loans are covered either by the joint and several guarantee of the Member States (ACP) or by a guarantee given in the name of the Union (MED, CEEC, ALA, and South Africa). This has been seen rightly as a necessary corollary to protect the Bank against the risks associated with lending operations in non-Union countries to which the Bank would not have exposed itself without a mandate from the Community instructing it to take part in the Union's external activities.

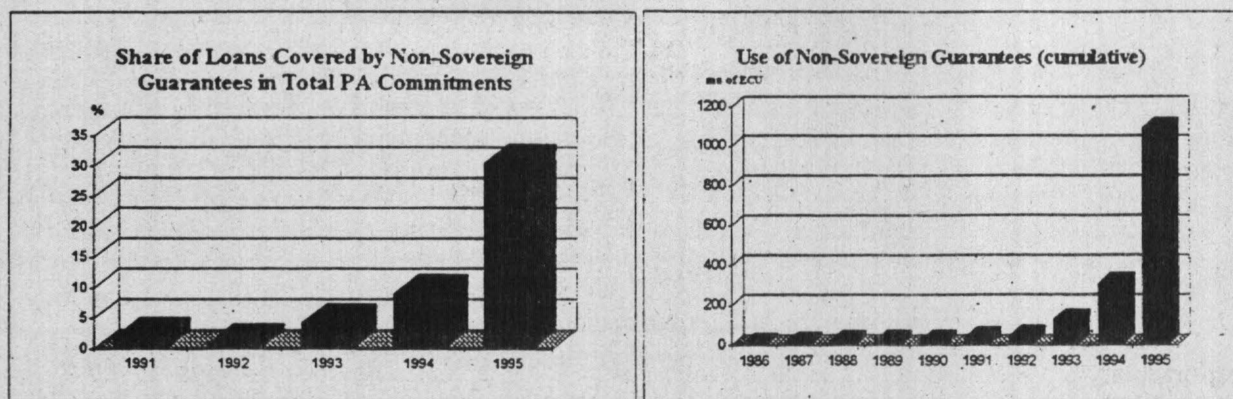
The Bank's statutes and the various decisions made regarding budgetary guarantees reflect the awareness of the need to protect the integrity of the Bank's balance sheet to ensure that the institution can continue to borrow on the finest terms in the international capital markets to preserve the attractiveness of Bank loans within the Union.

By its Statutes, the Bank has to require adequate guarantees for each of its lending operations. Article 18(3) of the Statutes provides that when lending to a body other than a Member State, the Bank shall make the loan conditional either on "a guarantee from the Member State in whose territory the project will be carried out or ... on other adequate guarantees." **When allowing by way of derogation the Bank to finance under Art. 18(1) of the Statutes projects outside the Union in developing countries, the Board of Governors has, in analogy to Art. 18(3), always made such derogation conditional upon the availability of a Member State or a Union guarantee as most lending outside of the Union was extended to public sectors borrowers with sovereign guarantees, none of which could be considered an adequate guarantee as per Art 18(3).**

This being said, **the Bank has always done its utmost to protect its budgetary guarantors** by selecting appropriately strong borrowers and setting up satisfactory first line

guarantees, requiring for each and every project additional security from developing country governments and/or project sponsors. **Until recently, the bulk of these first line guarantees were provided by sovereign guarantors, which reflected the fact that most of borrowers outside the EU were public sector entities.**

However, this situation is changing rapidly as several large operations in the various regions outside the EU have involved non-sovereign guarantees for project sponsored by private sector borrowers. **In 1995, 31% of the Bank's new loans outside the EU were guaranteed by a non-sovereign entity**; at end 1995, ECU 1.1 bn (over 10% of the total loan portfolio outside the EU) was covered by a non-sovereign guarantee. (see Annex 5 for the detail on the type of non-sovereign guarantees secured by EIB).



Such a shift in the structure of the Bank's first-line guarantees is in line with global market trends and basically reflects the world-wide privatisation drive and the increased reluctance on the part of governments to grant sovereign guarantees as they strive to implement sounder fiscal policy. (This is reflected in particular by the recent inclusion of long-term loans under the IMF external credit ceilings). The rapid increase in the use of non-sovereign guarantees results also from the Bank's ability to carve out non-transferability and currency non-convertibility risks from the coverage of third party guarantors.

2. Structure and Use of the Current Guarantee Scheme

2.1 The current guarantee scheme

To date, two kinds of budgetary guarantees have been granted in support of Bank loans outside the Union: a joint and several guarantee by Member States for ACP and OCT mandates, and Community budget guarantee for all other mandates (see Table below; Annex 4 provides a complete presentation of the guarantee schemes associated to the Bank's various mandates to lend outside the EU).

Current Guarantee Schemes

Region	Budgetary guarantor	Level of blanket coverage
ACP	Member States	75%
MED	EC	75%
CEEC	EC	100%
ALA	EC	100%
South Africa	EC	100%

For the MED and ACP mandates, budgetary guarantees have been provided as **blanket guarantees**, meaning that, up to the stated percentage of loans granted under each mandate, the guarantor (Member States or the Union) covers 100% of all repayment defaults on individual loans, until the 75% threshold is reached on a cumulative basis; the Bank would have to assume the losses above the threshold.

2.2 The Guarantee Fund: Structure and Implications for the Bank

To ensure a greater budgetary discipline and transparency, the Edinburgh Council decided in December 1992 to set up a Guarantee Fund to cover the risks resulting from the guarantees granted by the EC or loans extended directly by the EC. The Guarantee Fund is essentially a financial buffer aimed at helping the EC provide for risks and limit the fiscal implications of possible calls on the budgetary guarantee, but does not limit the contingent liability of the Budget. The Fund covers Community guarantees granted to the EIB and Euratom, loans for macro-economic assistance granted by the EC to third countries, and EC guarantees for commercial operations.

The operational rules of the Fund provide that these annual transfers should normally be equivalent to 14% of the principal of operations covered by the EC guarantee or extended by the EC. (See Annex 6) (Transfers to the Fund for loans extended under the MED mandate that benefit from a 75% globalised guarantee are equivalent to only 10.5% of the amount of the loans extended under this mandate). The percentage is to remain at 14% until the amount of the Guarantee Fund is equal to 10% of total loans extended by the EC or covered by an EC guarantee ("*montant objectif*").

The Fund exists legally since October 1994 and the first disbursements to the Fund were made in December 1994 (ECU 294 million). In 1995, the budgetary reserve available for the provisioning of the Guarantee Fund amounted to ECU 323 million. For the following years and until **1999, ECU 323 million at 1995 prices will be available by the Budget each year for provisioning the Fund.**

The Guarantee Fund acts effectively as a credit ceiling on EC lending operations and puts a quantitative restraint on the Community's capacity to grant and/or guarantee loans in

respect of third countries. Given the Fund's provisioning rules, the programmed appropriation provide for an annual ceiling of some ECU 2.2-2.5 billion during the 1996-99 period.

2.3 Bank Experience with Arrears and Calls on Budgetary Guarantees

Despite the very significant increase in Bank lending outside the EU, **Bank calls on the budgetary guarantee have been minor** (see Annex 7). The present system of guarantees has functioned very satisfactorily:

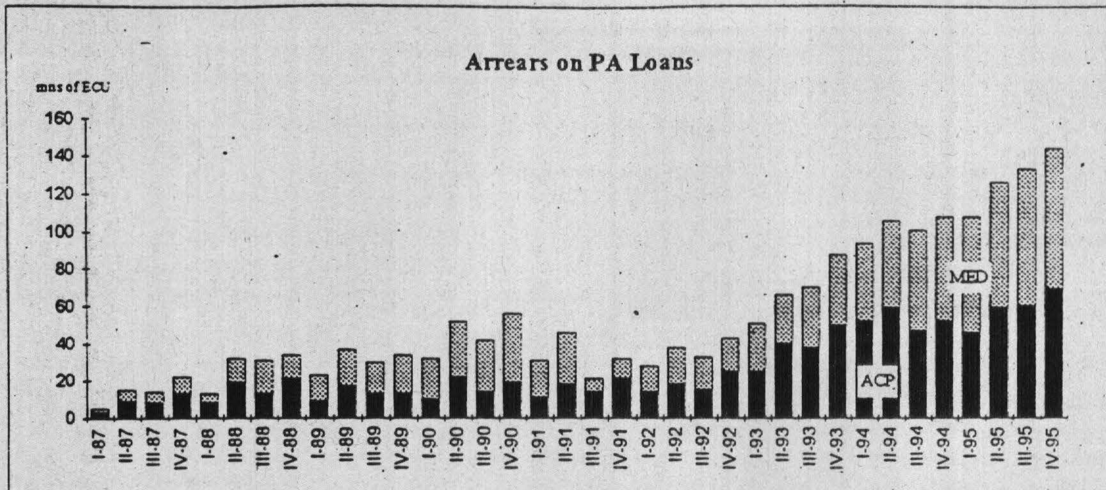
- From an administrative standpoint, it has been **very simple and cost-effective to operate in the Bank and the Commission**.
- From a budgetary point of view, **Bank calls on the budgetary guarantees have been minor**. Since the beginning of Bank activities outside the EU and up to the end of 1995, loans for about ECU 12 billion were signed while the net cost of calls on guarantees has been limited to ECU 105 mn as of end-1995, which represents 0.8% of total credit opened (and 1.5% of disbursed loans) since the beginning of Bank operations under the various Conventions, Protocols and Agreements.

The small amount of arrears and the resulting limited calls on guarantees are all the more remarkable that the Bank operates in countries with a relatively weak creditworthiness. (82% of loans outside the EU are in countries rated below investment grade and one third are in countries rated B and below, i.e., the lower tier of the sovereign risk spectrum).

The particularly low level of calls on guarantees results from:

- The **financial soundness of the Bank's borrowers** and the economic and technical soundness of the projects financed by the Bank; (Rating agencies and all institutions met during the preparation of this report insist on the paramount importance of these aspects).
- The **first-line guarantees** secured by the Bank that have effectively protected the EC/Member States budgets. As mentionned in § 1.4, the bulk of these first line guarantees have been sovereign guarantees granted by governments on the territory of which Bank financed projects were located. This is evolving rapidly, as the Bank is increasingly mobilising stronger non-sovereign guarantees to protect the budgetary guarantor.
- Although the average sovereign guarantor has a relatively low creditworthiness, the Bank has experienced few defaults because of the continued willingness of borrowers and guarantors to accord *de facto* **preferred creditor status** to the Bank.
- When arrears emerged and guarantees were called upon, the Bank has done its utmost to **recover these arrears** and refund the budgetary guarantor. To date, the recovery rate has been of some 52%, which is broadly in line with other SFIs. To date, the Bank has never had to write loans off its books.

Nonetheless, **arrears to the Bank have trended upwards and calls on guarantees have correspondingly increased steadily over the years** (see Chart below).



To date, defaults have been recorded only in the ACP and Mediterranean regions, and have resulted essentially from difficulties arising from political and macroeconomic problems, not from typical project risks falling more directly within the Bank's responsibility. As of 31/12/95, arrears to the Bank amounted to ECU 69 million in ACPs and ECU 74 million in the MED region, which is equivalent to respectively 3.9% and 1.8% of loans disbursed in each region (respectively 2.9% and 1.2% of credit opened) since the beginning of Bank operations under the respective Mandates.

Instalments settled by guarantee calls and still owed to guarantors by defaulting debtors were respectively ECU 41 million and ECU 63 million as of end 1995. These accounted for 2.3% and 1.6% respectively of disbursed loans in the ACP and MED regions. For operations in Central and Eastern Europe, Asia, Latin America and South Africa, there have been, up to now, no calls on the budget guarantee.

The following table shows the existing defaults as at 31/12/95.

Covered by Member States		Risks covered by EC budget	
ECU 68.9 million, of which:		ECU 74.0 million, of which:	
Nigeria	58%	ex-Yugoslavia	100%
Congo	12%		
Liberia	6%		
Zaïre	8%		
Togo	2%		

In ACP countries, arrears have increased steadily since 1987 owing to poor performance by several countries, reflecting poor macro-economic management and political instability. Countries mentionned in the Table above account for the bulk of defaults to date; some other

countries have come in and out of the list of defaulters to the Bank. It is unclear that the situation will improve under the ACP mandate. Regarding the arrears under the MED mandate, two cycles have been recorded with the Lebanon crisis in the late 1980s when arrears reached some ECU 37 million before being cleared in 1991; since then, the Yugoslavia crisis has led to the accumulation of arrears, which as of end-1995 had reached ECU 74 million.

In sum, **the current guarantee scheme has been fully justified, has been used in a responsible manner by the Bank which has never used it as a cover to accept unreasonable risks, and has served the Union, the Bank and its customers well.**

3. Analysis of alternative guarantee schemes

This chapter provides an analysis of the various guarantee schemes that were envisaged during the discussions that led to the ECOFIN decision to launch the study. In each case, the principle, structure, pros and cons of the scheme and its implications for the Bank (risks, balance sheet structure, pricing, etc.) are discussed, in view of the basic policy considerations that result from the analysis presented in Parts 1 and 2.

These various guarantee schemes were judged in light of three **basic policy requirements**:

- ***Consistency with the Bank's Statutes and lending policies***: The scheme must be fully consistent with the Bank's Statutes, in particular Art. 18(1) and Art. 18(3). Art. 18(3) provides that any loan has to carry "a guarantee from the Member State in whose territory the project will be carried out or ... other **adequate guarantees**." When allowing by way of derogation the Bank to finance under Art. 18(1) of the Statutes projects outside the Union, the Board of Governors has, in analogy to Art. 18(3), always made such derogation conditional upon the availability of a Member State (for the ACP mandates) or an EC guarantee.

- ***Effectiveness***: The scheme should safeguard the **effectiveness of the Bank** as an essential instrument to promote the balanced development within the Union and to finance investments in third countries. More than any other SFI, the Bank has to borrow in capital markets on the most favourable terms to be in a position to fulfil its mission within the Union and to meet the requirements of its customers which are very different from--and much more demanding than--the customers of other SFIs. Were rating agencies and investors to fear a weakening in the Bank's balance sheet, the Bank's ability to finance investments within the Union on attractive conditions could be severely jeopardised.

- ***Operational efficiency***: The scheme should be **efficient** from an operational standpoint. It should be **simple to operate** in the Bank and the Commission and imply no significant change to the way the Bank is structured and operates outside the Union.

3.1 Scheme 1: Sharing losses on a project by project basis

- **Structure of the scheme**

During the 1995 discussions on the Guarantee Scheme, a few Member States suggested that the possibility that the Bank and the budget share risks on a project-by-project basis should be considered. They argued that such a sharing of risks could provide a better framework for the Bank's management and the Board of Directors to make decisions on individual loans. (It should be noted in that regard that **up to now, debt service defaults have been entirely due to political risks**, which invalidates the argument that an indiscriminate risk sharing in all projects would improve incentives.)

Under this scheme, the Bank would benefit for instance from a 75% budgetary guarantee, loan by loan, regardless of the nature of the borrower/guarantor. In an event of default, the Bank would be entitled to call on the budgetary guarantor up to only 75% of the loss, while it would have to bear the remaining amount of the loss. In fact, such a scheme is better characterised as a loss-sharing arrangement.

- **Pros**

This scheme would be simple to operate and result in a small increase in the guarantee potential of budgetary resources (resulting from the move to 75% coverage of all projects) and in a somewhat slower use of the guarantee fund in case of defaults. Whereas under the current guarantee scheme ECU 12.8 in the Guarantee Fund are needed to support ECU 100 lent, the alternative scheme would necessitate only ECU 10.5, resulting in a 22% increase in the guarantee potential of budgetary resources. This gain is quite modest compared to the increased leverage of budgetary resources that would result from the schemes proposed in § 3.3 and 3.4. of the study.

- **Cons**

  - This guarantee scheme is **not consistent with normal banking principles** because it would result in certain losses whenever a debt service default occurs. It would force the Bank to bear some of the significant sovereign risks that result from the political nature of the various Mandates under which the Bank operates outside the Union, Mandates that give the Bank little latitude to select its countries of operation.

  - **This alternative is not consistent with the Bank's statutes** that call for adequate guarantees on each and every loan extended by the Bank. Indeed, it would imply certain losses on some projects for which the Bank could not mobilise appropriate guarantees, in particular, in operations with the public sector for which adequate commercial guarantees are generally not available.

  - Rating agencies would most likely stress that the new guarantee scheme is much weaker than the previous scheme, which could result in an **increase in the Bank's relative borrowing costs and impair the Bank's ability to lend in its core markets within the EU**.

- **It is doubtful that the scheme would result in any budgetary savings at all over the medium term.** Indeed, any loss incurred by the Bank on loans to developing country borrowers would deplete Bank reserves and accelerate the need for a Bank capital increase. **The scheme would merely shift the burden from the EC budget to the budget of Member states.**

- Were the Bank not to be given the latitude to allocate assets as it deems fit, **the quality of the Bank's assets would deteriorate**.

- Were Member States willing to give the Bank the latitude to adapt the geographical allocation of loans according to borrowers and guarantors' creditworthiness--a necessary condition for this option to be consistent with the protection of the Bank's asset quality--, this would result in a **radical departure in the way the Bank's mandates to lend outside the Union have been defined and interpreted to date.**

- In that case, the scheme would result in a major **transfer of power** from the Political Authority to the Bank, which would most likely be **unacceptable to Member States and could result in constant political tensions** between the Bank, other European institutions, Member States, and third countries.

- This would force the Bank to broach the delicate political and technical question of distinguishing/ranking countries outside the Union. To protect the quality of its assets, the Bank would likely have to **concentrate its lending activity outside the EU** in countries ranked in the upper creditworthiness tier (in line with IFC and NIB lending policy), which would be a major departure from the EU current policy.

- This scheme would require **major changes in the Bank's balance sheet structure and pricing policy.** Higher risks would require making provisions for developing country risks, which could be financed only on the basis of a higher interest margin on loans outside the EU. Activities outside the EU could not be cross-subsidised further by activities in EU countries, which rules out a uniform increase in the Bank's interest margin. Also, it would be very difficult to charge a uniformly higher interest margin on all loans outside the EU, because this could price the Bank out of some important markets (in particular, in countries with an investment grade rating).

- **Conclusion**

The project-by-project loss sharing option entails considerable risks for the Bank while it would yield only minor immediate benefits for the EC budget and, over the medium term, would merely shift the burden from the EC budget to Member States. Therefore, this option is inappropriate.

3.2 Scheme 2: A fixed ceiling of budget commitment

- **Structure of the scheme**

Under this scheme, the Budgetary Authority would fix the amount of the budgetary guarantee at a certain specified level, this amount remaining frozen for a certain period of time. As the Bank executes the new mandates for loans to third countries decided by the Council (and as the volume of outstanding loans grows), the effective cover provided by the budget guarantee would decrease accordingly.

The necessary corollary of this scheme is that the Bank should be free to decide how much it would lend globally to third countries and to choose the countries and borrowers it wants to lend to (within the limits imposed by the Council's decisions). Thus, the Bank could vary its effective rate of protection and take more or less risk by selecting countries, borrowers and amounts according to its own criteria and preferences.

This scheme would require a **major change in the way mandates and lending targets are given by the Council to the Bank.** One possibility would consist in fixing both a minimum amount carrying a full 75% budget guarantee and a maximum amount with the result that the effective cover for the Bank would vary in function of the volume of loans granted. Another possibility would be for the Bank to decide loan by loan the level of budgetary coverage it deems appropriate and modulate the imputation of its operations to the Guarantee Fund, based on the strength of the borrower.

The Bank's operational freedom combined with the acceptance of risks would lead to a situation where the limits imposed by the Council's decisions would be merely credit ceilings and there would be no "almost certainty" that Bank loans reach the authorised ceiling. Loans granted would remain well below targets (defined by external policy considerations) if the risks involved were considered unacceptable by the Bank.

- **Pros**

This scheme could present some benefits for the Budgetary Authority, but none for the Bank. It could help the Budgetary Authority to address the budget constraint issue while enabling the Political Authority to expand the Bank's mandates to lend outside the Union by reducing gradually the level of globalised guarantee, on the assumption that the Bank could accept a lower guarantee coverage. The gain in the guarantee potential of budgetary resources would result eventually from the willingness/capacity of the Bank to accept a lower guarantee coverage and cannot be computed in advance.

- **Cons**

  - A significant decline in the effective rate of coverage of loans outside the EU would **not be consistent with the Bank's statutes** (Art. 18(3)) that call for an adequate guarantee on each and every loan.

- This scheme could result eventually in a significant reduction in the level of effective protection of the Bank's loan portfolio and in a **significant increase in the Bank's exposure to credit risks outside the EU**. Rapidly, this could be perceived to weaken the Bank's financial strength and have **adverse implications on the Bank's borrowing costs**.

- For the scheme to be consistent with the protection of its financial strength, the Bank should be given the responsibility to select the countries to which it deems prudent to lend and to decide on how much to leverage the budgetary guarantee. **This option would leave the Bank with the political decisions on the overall level of its operations outside the EU and country/region allocation**, which are fundamentally political decisions that ought to be left to the Political Authority. It is **quite unlikely that the Political Authority would accept the transfer of power that ought to be associated to this scheme.**

- Under such a scheme, the Bank would be led to **concentrate its operations in the most creditworthy countries** and the gap between authorised ceilings and loans actually signed could widen.

- These trends would most likely be perceived negatively by the various Political Authorities within the Union and by the third countries concerned; this might result in **increased political pressures on the Bank**.

- Were the Bank to have to modulate the coverage of the various loans by the Guarantee Fund, and impute a specific percentage to the Fund loan by loan, the scheme might prove **quite costly to operate** and involve **potentially divisive discussions in the Board of Directors on the guarantee issue for each and every loan**.

- The loan loss provisions made necessary by explicit exposure to credit risks outside the EU would **reduce accordingly the reserves** the Bank would have accumulated (out of its operating surplus) to help postpone the next capital increase. This scheme could ultimately only shift the burden of supporting financially Bank operations outside the EU from the EC budget to the Member States.

- **Conclusion**

This option has severe drawbacks that more than offset its possible benefits and is not appropriate.

3.3. Scheme 3: A Guarantee Scheme Based on a 60% blanket coverage

The following section presents the possible structure and benefits of a budgetary guarantee scheme based on a blanket coverage, which is the Bank's preferred option. Under this proposal, **the essential benefits of the current guarantee scheme for the Bank, the Commission and Member States would be preserved while the budgetary constraint would be eased to a considerable extent.**

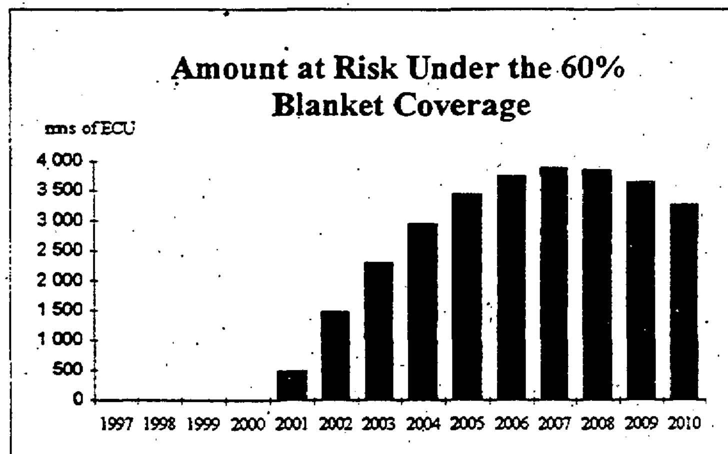
- **Structure of the scheme**

In essence, this option is an amended version of the scheme that was proposed by the Bank and the Commission during the 1995 discussions. It would feature:

  - a lower blanket coverage (60%),
  - a world-wide globalisation of the blanket coverage: the same blanket guarantee would cover all developing countries (at least ALA, CEEC, MED and South Africa; the ACP mandate would be considered in due course).
  - the blanket guarantee would cover only all loans signed minus loans cancelled and minus reimbursements.

The scheme would operate as the current guarantee scheme and thus enable the Bank/EC to continue to benefit from the cost-effectiveness of the current scheme. The main difference with the current scheme is that by moving to a 60% blanket coverage:

- the budgetary cost of guarantees would drop by 35%, which would ease to a considerable extent the budget constraint;
- a considerable amount of Bank assets would be "at risk" to the extent that they would no longer be covered by a budgetary guarantee (as shown in the graph below, which is based on the portfolio simulation presented in Annex 9).



- ***Reasons for considering a level of blanket coverage lower than 75%***

During last year's discussions, the Bank and the Commission had jointly defended the need to maintain a very strong guarantee scheme based on a high level of blanket coverage (75% of all loans signed minus loans cancelled and minus reimbursements). The lower level of blanket coverage proposed in this study is deemed possible because:

- whereas during last year's discussion a regional segmentation of the budgetary guarantee had been envisaged, the Bank now proposes, as a counterpart to the lower level of global coverage, to **globalise the blanket coverage on a world-wide basis to exploit genuinely the benefits of international portfolio diversification (a basic principle of banking and insurance).**
- During the last two years, the Bank has exploited new market opportunities to mobilise adequate third party guarantees instead of the traditional sovereign guarantees (see § 1.4). In so doing, the Bank has set up guarantee structures that provide **stronger protection to the budgetary guarantor** and that make it possible to reduce, in the future, the level of budgetary guarantee needed to support any given level of Bank lending outside the Union.

Reasons for not going below 60%

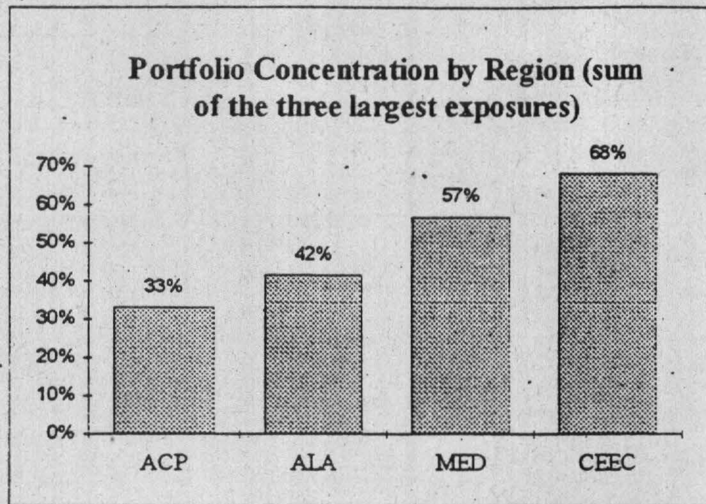
In the absence of reliable numbers on debt service defaults in developing countries and the inherently unpredictable nature of political risks as well as the typical contamination effect that characterises the occurrence of debt crisis, the appropriate level of blanket coverage has to be derived from a comparative analysis of the Bank's balance sheet structure with that of other SFIs. More specifically, **the principle for sharing risks between the Bank and its budgetary guarantors can be derived from the gearing policies of the various SFIs.**

Most SFIs benefit from a 100% equity backing of their lending operations because of the high risks inherent to lending in developing countries. Given the Bank's much higher gearing ratio (2.5:1), the Bank's capital can cover only 40% (1/2.5=40%) of the overall risks of lending outside the Union. For the Bank to have a balance sheet strength similar to that of typical Multilateral Development Banks (which are the relevant comparators given the nature of risks involved in lending to developing countries), the budgetary guarantee should fill the gap and cover 60% of the risks. Considering the budgetary guarantee as a quasi-equity backing, the *de facto* gearing of lending operations outside the EU would be reduced to a 1:1 level consistent with the typical risks of lending outside the Union.

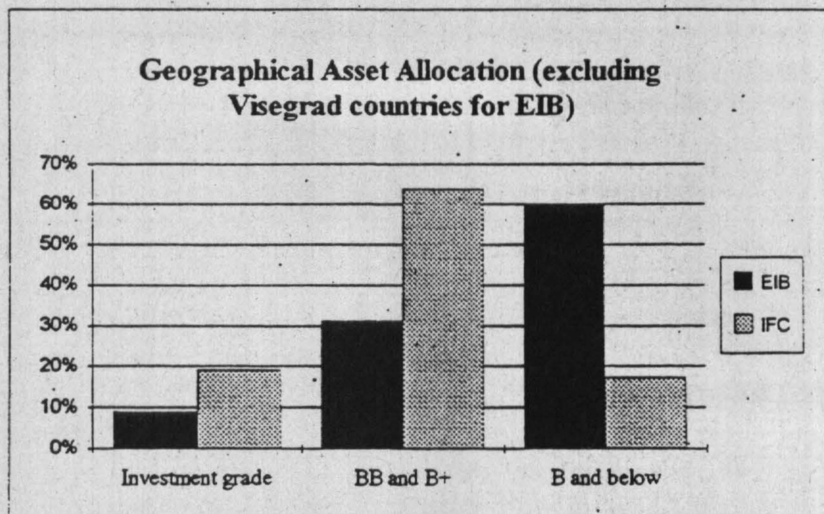
In addition, **the budgetary guarantee should be sufficient to cover not only usual risks but also catastrophic risks** such as those that occur, for instance, on the occasion of debt crisis which affect developing countries on a more or less regular basis. One of the main features of debt crisis is their contagious nature: defaults bunch together during debt crisis caused by global, systemic factors so that when a country defaults, other countries of the region tend to experience severe fiscal and balance of payments difficulties. If anything, the recent globalisation trend makes the contagion quicker and more broadly based, as illustrated by the recent Mexican crisis.

Given the geographical concentration of risks in the Bank's loan portfolio outside the EU, it would not be prudent to lower the level of world-wide blanket coverage below 60%. Given the concentration of the Bank's portfolio in a few countries in each region, a regionalisation of the blanket coverage with the proposed lower percentage would leave the Bank exposed to unacceptably high risks and should not be considered as a reasonable option. For instance,

existing loans to the three largest borrowers in Eastern Europe and the MED region account for respectively 68% and 57% of Bank exposure in each region.



Any new guarantee scheme should be consistent with the possible entry in the Union of several large borrowers outside the EU (CEECs and MED). In particular, a sufficiently high level of protection should be maintained to anticipate the **decline in the average quality of Bank borrowers outside the EU resulting from the eventual enlargement of the Union**. For instance, the adhesion of these countries to the EU would have a dramatic impact on the average credit rating of Bank borrowers/guarantors outside the EU, with a concentration of exposure in countries ranked in the lower creditworthiness tier (as suggested by the graph below, which can be compared with the current portfolio structure shown in § 1.3.1.). the four Visegrad countries are rated in the upper creditworthiness tier of countries in which the Bank operates--Czech Republic with a A rating, Hungary BB+, Poland BB and Slovakia BB+. These four countries account for 28% of total loans outside the EU signed as of end 1995--ECU 2.7 bn (see Annex 8)).



Last but not least, any new scheme should envisage the **possibility that the Bank's (and other SFIs') *de facto* preferred creditor status could be eroded in the future**. The share of debt to SFIs in developing country total external debt has tended to increase, in particular in Eastern Europe, so that there is an increasing possibility that severe fiscal and balance of payments problems in the future might affect more than in the past developing countries' ability/willingness to service their debt to SFIs in a timely manner. In a sense, this risk is illustrated by the recently-proposed Multilateral Debt Facility.

- **Advantages of the scheme**

  - The lower risk coverage under this option would ease considerably the budgetary constraint: lowering the level of blanket coverage to 60% would **reduce by 35% the budgetary resources needed to cover a given amount of Bank loans** under the current arrangements for the Guarantee Fund.

  - This scheme would be fully **consistent with the Bank's present Statutes, mandates, structures** (financial and staffing) **and practices** (appraisal techniques).

  - It would maintain an adequately **strong protection of the Bank's balance sheet**, provided the blanket coverage is world-wide. Under this option, the financial structure of the Bank's operations outside the EU would implicitly be similar to that in typical Multilateral Development Bank. **This would preserve the Bank's status in international capital markets at a minimum cost to the Community budget**.

  - The guarantee scheme would continue to operate as a **simple and low cost scheme**.

  - This scheme involves **no litigation risks**.

  - This scheme would be consistent with the trend towards increased reliance on non-sovereign third party guarantees: the Bank would continue to use the latter to protect the budgetary guarantors while **exploiting the additionality made possible, in part, by the budgetary guarantee** through carving out the risk of non-transfer and non-convertibility of currencies from the coverage of its third party guarantors (see Annex 5).

- **Conclusion**

The 60% globalised scheme is **the Bank's preferred option** because it would be fully consistent with the Bank's statutes, mandates and current modus operandi, would safeguard the effectiveness of the Bank as an essential instrument to promote the balanced development within the Union and would be efficient from an operational standpoint while it would help to solve the budgetary dilemma by limiting the budgetary expenditure required to support Bank loans outside the EU.

3.4 Scheme 4: Combining a separation between political and commercial risks with a blanket coverage

- **Structure of the scheme**

The ECOFIN requested in November that the Bank and the Commission envisage the possibility that risks be shared between the Bank and the budget along political versus commercial lines, with the budgetary guarantee covering only political risks for all projects while the Bank would assume commercial risks. In an event of default, the Bank could call on the budgetary guarantee only if the inability of the borrower to service its debt to the Bank results from non-commercial risks.

This option can be appealing from a conceptual standpoint. Indeed, the Bank, as a financial institution, is well equipped to assess and handle commercial risks. For its part, the Political Authority would cover political risks that result from the mandates given to the Bank to lend in countries where the Bank would not have been active otherwise. (This would be in line with general practice in most ECAs where selected political risks are borne *in fine* by the state. see Annex 10 for a presentation of the various instruments of political risk investment insurance).

This being said, defining political risks has always been a difficult and contentious exercise and basing a guarantee scheme on this distinction could result in significant operational difficulties. Moreover, the Bank is exposed to a broad and complex series of political risks given the nature of its operations that implies exposure to public and private sector borrowers. Given this background and to be consistent with the Bank's Statutes and lending policies, any scheme based on the separation between political and commercial risks should be structured as follows:

- **When adequate third party guarantees can be secured** (this would be the case in general for loans to private sector borrowers, which accounted for over 30% of total PA loans in 1995), the budgetary guarantor would cover only selected political risks (currency non-transfer, expropriation, war and civil disturbance as defined in the MIGA Convention); other project risks would be taken by the Bank, and be covered by adequate guarantees from first class banks or corporates. The third party guarantor would commit to guarantee the Bank's cash flow in all circumstances except if the inability of the borrower to service its debt to the Bank results from the occurrence of those selected political risks covered by the budgetary guarantor. The Bank would bear the risk that its third party guarantors be unable to comply with their obligations.

- **When no adequate third party guarantees can be mobilised** by the Bank (this would be the case essentially for loans to public sector entities), the loan would fall only under the coverage of the budgetary guarantee. Indeed, for those loans extended to public sector borrowers, risks are *in fine* exclusively political for the Bank because the Bank can incur losses on such loans only when the sovereign guarantor defaults, which is a typical case of political risk. [4] For loans falling into this category, the Bank would continue to mobilise

[4] To be sure, public sector borrowers can default for commercial reasons. However, in such cases, the Bank would call on its sovereign guarantors; therefore, arrears could be incurred by the Bank only were the latter not to comply with its guarantee obligations, which is a typical political risk. Moreover, it would be impossible for the Bank to

sovereign guarantees from developing countries with an ultimate backing by the budgetary guarantee.

For loans featuring an adequate third party guarantee, the Bank could carve out from the coverage of third party guarantors those risks covered by the budget (currency non-transfer, expropriation, war and civil disturbance as defined in the MIGA Convention--see Annex 11). All other risks would be covered by third party guarantors. This **carving-out strategy** is far better than the alternative approach that would consist in listing the risks that are covered by third party guarantors, which would be very difficult to achieve and would expose the Bank to endless litigation.

Breach of contract risks should be left to the third party guarantors, although this risk is often political in nature. This is essentially to minimise the risks of litigation (and the contingent liabilities on the Budget). Experience shows that it is extremely difficult to separate effectively the risk of breach of contract from the typical commercial risk. The issue has often been decided through litigation. [5] This issue could be revisited in a few years when experience has been gained in the possibility to effectively carve out breach of contract risks from the coverage of third party guarantors. Moreover, carving out breach of contract risks from the guarantee obligations of third party guarantors would create a considerable **moral hazard** since the Bank's guarantors would have no incentives to analyse properly the project and the documentation. [6]

Under this option, in addition to the sharing of risks mentionned above, **the overall coverage of the Bank's total loan portfolio outside the EU could be lowered to 60%** (down from the current 100%/75%), provided this is on a world-wide basis to enable the Bank/the Union to benefit from international portfolio diversification (see §3.3.2 and § 3.3.3). **This would reduce by 35% the budgetary resources needed to cover a given amount of loans under the current arrangements for the Guarantee Fund.** Moreover, because certain risks would not be covered by the budget, the pace of use of the Guarantee Fund could be slower than under the straight blanket coverage option.

Relations with the Guarantee Fund: All Bank loans outside the EU would be imputed to the Guarantee Fund (60% of the amount of loans signed, minus repayments and cancellations), whoever the guarantor is. Indeed, the budget would continue to cover selected political risks in all cases, which will have to be provided for, and it is impossible to quantify satisfactorily *a priori* the political and commercial risk components project by project. This being said, the Budgetary Authority could envisage a distinction of provisioning rates according to the quality of the guarantor, which would enable the Budgetary Authority to leverage further the resources invested in the Guarantee Fund.

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mobilise adequate commercial guarantees from acceptable banks or other first-class guarantors to cover risks involved in lending to public sector entities outside the Union.

[5] Moreover, one should be aware that market experience to date with limited or non-recourse finance--which raises the issue of breach of contracts more than other types of financing--has been very limited. Political risk insurers are generally reluctant to cover breach of contract risks. Insurer who provide beach of contract coverage generally guarantee only limited aspects of risks. Experience in MIGA and other political risk insurers will be discussed more fully in the final version of the paper and in an annex.

[6] The Bank's third party guarantors would bear the "documentation risks", as in the various PA operations involving a non-sovereign guarantee structured to date.

Calling on guarantees: Whenever a debt service default occurs, the Bank would call on its guarantors to ensure the continuity of its cash flow.

- When the loan is covered by an **adequate third party guarantee**, the Bank would call on the latter, who would have to ensure the debt service to the Bank unless the inability of the borrower to service its debt to the Bank results from one of the political risks that was explicitly excluded from its coverage. It would be for the third party guarantor to provide the evidence that the borrower's inability to service its debt to the Bank results from the occurrence of one of the political risks excluded from its coverage. If the debt service default results from one of the risks excluded from the coverage of the third party guarantor, the Bank would ask the budgetary guarantor to pay.

- In all other cases, the procedure would be identical to the current procedure: the Bank will call first on the sovereign/public sector guarantor and would call on the budgetary guarantee only if the sovereign guarantor does not honour its commitment.

Recovery mechanism: In all cases, the Bank would continue to ensure the recovery of arrears on behalf of the budgetary guarantor, as at present. The sums recovered would be transferred back to the Guarantee Fund.

- **Pros**

- This scheme features a genuine risk sharing that is consistent with the Bank's statutes, financial structure and practices.

- It would maintain an adequate degree of protection of the Bank's assets and preserve the strength of its balance sheet.

- It would require no fundamental change in the Bank's modus operandi.

- It would help to ease the budgetary constraint. The budgetary resources needed to cover a given amount of Bank loans outside would be reduced by about one third, and the use of the Guarantee Fund would be reduced by the externalisation of part of the risks from the budgetary coverage.

- It could enhance the additionality of the Bank's operations outside the Union and the complementarity between the Bank and potential guarantors (first class banks and corporates). The thrust of this additionality is that the Bank/EU budget would cover selected political risks while other risks (more commercial in nature) would be left to third party guarantors.

- **Cons**

  - Unlike the 60% globalised scheme, Scheme 4 could result in **litigation**. It could imply trilateral disputes between the Bank, the Commission and the third party guarantor. This could result in high legal fees and be detrimental to the image of the Bank/the Commission and sour the business relationships between the Bank and some of its working partners.

  - This scheme would be **more difficult and costly to administer** than the present guarantee scheme and than the 60% globalised scheme proposed by the Bank.

  - It would introduce **credit risks** linked to Bank lending outside the EU on the Bank's balance sheet. This would require the constitution of adequate loan-loss provisions on the Bank's books, which might require an increase in the Bank's interest margin on loans outside the EU, or be financed out of the Bank's operating surplus, which would reduce accordingly the reserves the Bank would have allocated to reserves to help to postpone the next capital increase.

  - it could result in additional difficulties to meet turnover targets: as governments are increasingly reluctant to grant sovereign guarantees, the Bank's ability to meet its turnover targets (set in the various mandates to lend outside the EU) would be conditional on obtaining adequate guarantees in the market. This should not be taken for granted since it would depend on commercial banks' appetite for developing country risks.

  - This scheme could result in endless discussions in the Board and with the Commission on a case by case basis on the adequacy of the guarantee scheme selected by the Bank and the resulting contingent liability on the Budget.

  - The mobilisation of third party guarantees for operations outside the EU would accelerate the use of exposure ceilings to individual banks/corporates defined in the Bank as experience shows that the guarantors used to guarantee loans outside the EU are in general institutions to which the Bank is already exposed as a result of its lending operations within the Union or its treasury operations.

- **Conclusion**

In sum, this scheme provides for **microeconomic risk-sharing** between the Bank and the budget as **it externalises from the budgetary guarantee certain categories of risk (mainly commercial risks)**. It would meet the request by some Member States that the Bank share risks with the budget and enable the budgetary authority to increase the guarantee potential of resources invested in the Guarantee Fund, while allowing the Bank to protect the integrity of its balance sheet. **However, this scheme would have significant operational drawbacks and is not the Bank's preferred scheme.**

EUROPEAN INVESTMENT BANK

CA/297/96
7 May 1996

Annexes 1 to 11
Document 96/189

Agenda
item n°

BOARD OF DIRECTORS

GUARANTEE SCHEME FOR BANK LOANS OUTSIDE THE EUROPEAN UNION

ORIG. : E

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Annex 3: Supranational Financial Institutions: Financial Structure

Annex 4: Present system of Community budget and EU Member State guarantees in respect of EIB loans in third countries

Annex 5: Analysis of the PA portfolio with Non-Sovereign Guarantees

Annex 6: Fonds de garantie

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Annex 1

COUNCIL CONCLUSIONS (ECOFIN)

OF 27 NOVEMBER 1995

Ref. : Community budget guarantees in respect of EIB lending outside the Community

1. The Council considered the nature and level of the guarantees provided from the Community budget for EIB lending in third countries.

2. The Council noted that discussions had thrown up a number of problems requiring closer examination before a final decision could be taken. With this in mind, the Council asked the EIB and the Commission to begin looking into a new guarantee system. In so doing, they should consider the possibility of part of the risk entailed by the Bank's external operations being borne by the Bank (e.g. the Community budget might cover political but not commercial risk).

Financial cooperation with third countries must not, of course, detract from the EIB's task of granting loans within the Union.

The new system must be consistent with the Bank's operating rules as laid down by the Treaty and must, in particular, respect the sole powers conferred on its Board of Directors by Article 11 of the Bank's Statute.

The Council asked the EIB and the Commission to submit a report to it as soon as possible. The Council undertook to consider the new system and to take a decision on it by the end of next year.

3. Pending a new system, the Council acknowledged the importance of enabling existing and fresh lending to go ahead in orderly fashion over a transitional period. The Council accordingly agreed that new decisions to grant Community budget guarantees for EIB lending in third countries would be based on the existing model.

The Council also agreed that the new system would be applicable to the new decisions to be taken during the transitional period in respect of loans not yet granted.

SUPRANATIONAL FINANCIAL INSTITUTIONS: LOAN PRICING POLICIES

Institution	Loan pricing policy
African Development Bank	Variable lending rate adjusted semi-annually to maintain a 50 basis point spread. Annual commitment fee of 1 % is charged on undisbursed loans. A 200 basis point fee is being considered.
Asian Development Bank	Variable lending rate adjusted semi-annually based on cost of borrowing plus a spread of 40 basis points. Commitment fee of 75 basis points levied on increasing percentage of undisbursed loan amount.
Corporacion Andina de Fomento	Variable lending rates set at LIBOR plus 85 - 400 basis points, depending on the tenor and risk of the transaction. Fixed lending rate set at cost of funds plus a profit margin of 100 - 225 basis points, plus a risk premium of 75 basis points and a surveillance fee of 100 basis points. On project loans, a loan origination fee of 1 % of the loan amount and a commitment fee of 0.75 % per year on undisbursed loan balances are charged.
European Bank for Reconstruction and Development	For private sector loans, variable and fixed rates to be based on prevailing market rates while considering cost of funds and loan risks. For public sector loans a new pricing scheme, maintaining a uniform 1 % margin over LIBOR was introduced in April 1994. Annual commitment fees on undisbursed loans of between 0.5 - 1 % for fixed and variable rate loans, respectively. Front end fee of 0.5 - 1 % will typically be charged at signing.
European Investment Bank	Fixed lending rate based on actual funding cost of the currency lent plus a spread of 15 basis points. Variable rate loans are repriced quarterly at a spread over the effective average cost of funds. Current policy is under revision in order to ensure greater flexibility.
Inter-American Development Bank	Loans are priced semi-annually at a rate based on effective funding costs over the previous six months, plus a spread covering administrative and other costs to meet income targets. Charges, which may be waived, include an annual fee of 0.75 % on the convertible currency portion of undisbursed loans, and a 1 % one-time charge on the principal amount. Included in the lending rate is a 1 % annual commission for a special reserve to meet obligations on borrowings and guarantees.
International Finance Corporation	Lending rates are based on prevailing market rates while considering cost of funds and loan risks. A front-end fee of 1 % at signing. Annual commitment fees on undisbursed loans of 1 % and 1.5 % for fixed and variable rate loans, respectively.
Nordic Investment Bank	Market based lending rates are set at disbursement. Loans are offered, on average, at 50 basis points over borrowing costs. Commitment fees are usually charged on undisbursed loans.
World Bank	Variable lending rate adjusted semi-annually to maintain a 50 basis point spread (reduced to 25 basis points for at least the current fiscal year reduced by way of waiver to eligible borrowers) over the weighted average cost of outstanding bank borrowings (excluding those to fund liquid investments) since June 30, 1982. Annual commitment fee on undisbursed loan balances has been reduced in the 1993 fiscal year for the fourth consecutive year to 25 basis points from 75 basis points.

SUPRANATIONAL FINANCIAL INSTITUTIONS: FINANCIAL STRUCTURE

INSTITUTION	Gearing ratio: BY STATUTE	Gearing ratio: Actual 1994 (in %): Disbursed loans/ paid-in capital + reserves	Gearing ratio: Actual 1994 (in %): Disbursed loans/ subscribed capital + reserves	Capital quality ratio: Actual 1994 (in %): Paid-in capital/ subscribed capital
African Development Bank	Loans outstanding plus undisbursed commitments and guarantees cannot exceed 100 % of subscribed capital, reserves, and surplus.	289	40	9
Asian Development Bank	Loans outstanding plus undisbursed commitments, equity investments, and guarantees cannot exceed 100 % of subscribed capital and reserves.	203	46	9
Corporacion Andina de Fomento	Loans outstanding limited to 450 % of paid-in capital, reserves, and retained earnings.	235	86	31
European Bank for Reconstruction and Development	Loans outstanding plus guarantees plus equity investment cannot exceed 100 % of subscribed capital, reserves and surplus.	52	11	20
European Investment Bank	Loans outstanding plus guarantees cannot exceed 250 % of subscribed capital.	664	135	7
Inter-American Development Bank	Loans outstanding plus guarantees cannot exceed paid-in capital plus the general reserve and the callable capital of non-borrowing members. Also, target reserves-to-loans ratio at 20-25 %.	289	36	5
International Finance Corporation	Paid-in capital, retained earnings, and general loss reserves must be at least 30 % of risk-weighted assets (on- and off-balance-sheet).	147	130	80
Nordic Investment Bank	Loans outstanding plus guarantees cannot exceed 250 % of subscribed capital.	598	139	10
World Bank	Loans outstanding plus guarantees cannot exceed 100 % of subscribed capital, reserves, and surplus. Also target reserves-to-loans ratio at 13 - 14 %.	427	61	5

Source: Standard and Poor's

PRESENT SYSTEM OF COMMUNITY BUDGET AND EU MEMBER STATE GUARANTEES IN RESPECT OF EIB LOANS IN THIRD COUNTRIES

Operations outside the European Union are conducted essentially on the basis of various decisions taken by the Council of Ministers and accepted by the Bank. These decisions differ from one region to another and are incorporated in the Conventions, Protocols and Authorisations governing the Bank's activities.

This annex contains:

1. a summary of the Bank's operations from own resources outside the EU under the relevant Conventions, Protocols and Agreements;

2. a description of the present system of guarantees for operations outside the EU;

1. EIB OPERATIONS FROM OWN RESOURCES OUTSIDE THE EU UNDER THE RELEVANT CONVENTIONS, PROTOCOLS AND AGREEMENTS

1.1 ACP States and OCT

The Fourth Lomé Convention, the origins of which date back to the First Yaoundé Convention concluded in 1963, currently encompasses 70 ACP States which have historical links with the EU. It runs for a period of ten years and has appended to it the First Financial Protocol covering the first five years (1990-1995) which provides, inter alia, for a maximum of ECU 1200 million in loans from the Bank's own resources.

Alongside the Convention, a Council Decision also provides for aid to the 20 Overseas Countries and Territories (OCT) which enjoy special ties with EU Member States. Under this decision, the EIB may grant loans from its own resources up to ECU 25 million.

Under the Second Financial Protocol (1996-2000) which was signed in November 1995 and is currently under ratification, the Bank can advance loans from its own resources for up to ECU 1693 million (including ECU 35 million for the OCT).

1.2 Mediterranean

The EIB's initial operations in the non-member Mediterranean countries date back to the 1960s. At the moment, the Bank advances its loans under the framework of:

- the fourth generation of Financial Protocols concluded between the Community and each of the Maghreb and Mashreq countries and Israel, covering the period from 1992 to 1996 and providing for a total of ECU 1300 million in loans from own resources; to this figure should be added ECU 80 million for Malta and Cyprus (1994-1998);
- financial cooperation, referred to as "horizontal" since it is deployed as an adjunct to the above-mentioned bilateral aid, for the region as a whole covering the same period and providing for a total of ECU 1800 million in loans from own resources;
- a mandate for ECU 250 million in favour of Gaza and the West Bank (1994-1998) to be set against the above horizontal financing component expiring in 1996 and subsequently against the next mandate for the Mediterranean. This mandate is based on the EU's initiative in support of the peace process and economic development in this region;
- financial assistance for Slovenia (financial protocol allowing for an amount of ECU 150 million for the period from 1993-1997);
- financial assistance provided under previous protocols.

1.3 Central and Eastern Europe

Since 1989, the Bank has been called on to operate in an increasing number of CEECs in the context of the EUs efforts to support the process of reform in these countries and to contribute towards establishing close links between them and the Community. Following decisions taken in 1989 and 1991, the Bank

advanced loans totalling some ECU 1700 million between 1990 and 1993 in Poland, Hungary, Bulgaria, the Czech Republic, Slovakia and Romania. A new ceiling of ECU 3 billion in loans from own resources has now been set for ten CEECs (the six mentioned above plus the three Baltic States and Albania) for a three-year period from 1994 to 1996. This mandate expires in December 1996 but will be automatically extended by six months if funds still remain to be deployed.

1.4 Asia and Latin America

A recent extension of EIB operations outside the EU concerns some thirty countries in Asia and Latin America which have concluded cooperation agreements with the Community and which are eligible for EIB finance. In 1993, the Bank was authorised to grant loans from its own resources up to a total of ECU 250 million per annum over a period of three years, which expired in February 1996, for projects of mutual interest and likely to strengthen links between the EU and the ALA countries. Discussions on the renewal of the Bank's mandate for Asia and Latin America are underway.

1.5 Republic of South Africa

The most recent extension of Bank operations outside the EU relates to South Africa where it was authorised, in 1995, to provide finance of up to ECU 300 million over a two-year period for investment forming part of the country's reconstruction and development programme. This new area of EIB activity falls within the context of the recent cooperation agreements between the EU and the Republic of South Africa.

1.6 Developments in operations outside the EU (own resources)

An overview of trends in contract signatures for EIB loans from own resources outside the EU under the various Protocols, Conventions and Decisions covering the past twenty years is set out in Table 1.

Table 1 :Finance contracts signed outside the European Union
(figures in ECU million)

Year	CEEC*	MED	ACP /OCT	ALA	RSA	Total external loans
1976	-	90.0	52.4	-	-	142.4
1977	-	85.0	67.0	-	-	152.0
1978	-	83.0	90.9	-	-	173.9
1979	-	347.7	73.2	-	-	420.9
1980	-	247.0	124.4	-	-	371.4
1981	-	238.0	158.4	-	-	396.4
1982	-	288.0	122.2	-	-	410.2
1983	-	337.2	90.0	-	-	427.2
1984	-	541.6	79.1	-	-	620.7
1985	-	416.5	167.8	-	-	584.3
1986	-	231.1	150.7	-	-	381.8
1987	-	27.7	161.1	-	-	188.8
1988	-	391.0	129.1	-	-	520.1
1989	-	330.8	155.1	-	-	485.9
1990	215.0	336.5	117.5	-	-	669.0
1991	285.0	227.0	269.5	-	-	781.5
1992	320.0	313.8	130.5	-	-	764.3
1993	682.0	679.0	147.4	99.0	-	1 807.4
1994	957.0	579.0	222.5	220.0	-	1 978.5
1995	1 005.0	1 014.5	204.7	288.0	45.0	2 557.2

* including operations in Slovenia

2. PRESENT SYSTEM OF EXTERNAL GUARANTEES

2.1 General aspects

As and when the Member States have decided to invite the Bank to take on certain aspects of Community cooperation policy, they have always agreed, along to the requirement of the Statutes (Art. 18), to establish, for EIB loans from own resources outside the Community, systems under which these loans are covered either by their joint and several guarantee or by a guarantee provided in the name of the Community.

2.2 ACP States and OCT

Lomé I : In view of the amount and geographic scope of Lomé I (1975) compared with the preceding Yaoundé Conventions, the Bank obtained a blanket guarantee for the ACP States and OCT. This is a guarantee from the EU Member States equal to 30% of the total amount of credit advanced under this Convention and covering any risk which could arise from these operations.

Lomé II to IV : As the perception of risks expanded, the blanket guarantee was increased to 75% of the total amount of credit advanced under each Convention and continues to cover any risk which could arise from these operations. The guarantees, newly established for each Convention or Financial Protocol and thus not cumulative as in the case of the Mediterranean (see below), are furnished directly by the Member States and not by the Community budget.

2.3 Mediterranean

2.3.1. From 1963 (first protocol with Greece) to 1977 (exceptional aid for Lebanon) the Bank obtained a 100% guarantee for its operations in the Mediterranean. In 1978 a blanket guarantee equal to 75% of total credit opened and covering any risk which might arise from these operations was introduced for all its loans from own resources in the Mediterranean countries (including operations in Spain, Greece and Portugal prior to their accession and in the former Yugoslavia). In contrast to the guarantees provided for operations under the Lomé Conventions, this is a guarantee given in the name of the Community which is cumulative in the sense that, when new protocols are signed, it is extended to loans advanced under these protocols. This system, introduced in 1978, has been consistently renewed.

2.4 Central and Eastern Europe; Asia and Latin America; South Africa

In view of the particular risks involved in financing operations in these regions, the Bank obtained a 100% guarantee from the Community.

Annex 5

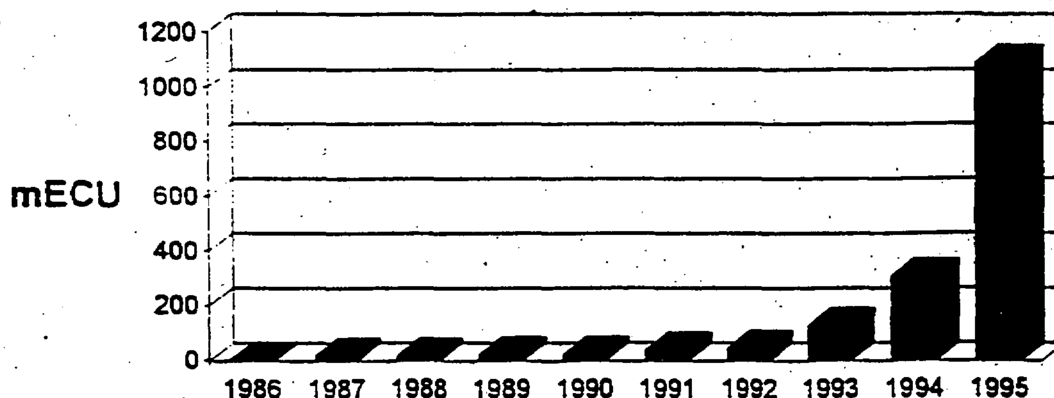
Analysis of the PA Portfolio with Non-Sovereign Guarantees

Introductory remark

For this analysis all PA loans on own resources signed and not completely reimbursed have been considered. The list of loans dates back until 1985. Loans with Non-Sovereign guarantee made before that date can be considered as marginal and would not influence the results of this analysis. The amounts taken into consideration are the amounts for which a loan agreement has been actually signed and a Non-Sovereign guarantee has been approved by the Bank's Board. Guarantees by CFD, KfW, Member Countries of the BDEAC and the Palestinian Authority were considered as Sovereign guarantee. For the purpose of this analysis only guarantees have been considered which cover at least part of the period after project completion[1]. If several guarantees exist in cascade, only the "guarantor of last resort" was considered[2].

Growth of lending with Non-Sovereign guarantees

The proportion of Non-Sovereign guarantees was only marginal and never exceeded 10% of the total signatures of PA loans on own resources up to 1994. However in 1995 this proportion increased suddenly to 31%. The increase is even more impressive in absolute terms where the signatures of loans with Non-Sovereign guarantees during the year 1995 represent more than twice the total amount signed in the ten previous years (782 mECU in 1995 against 312 mECU from 1985 to 1994; see the following chart and attachment 1 for a complete list).



Geographical distribution

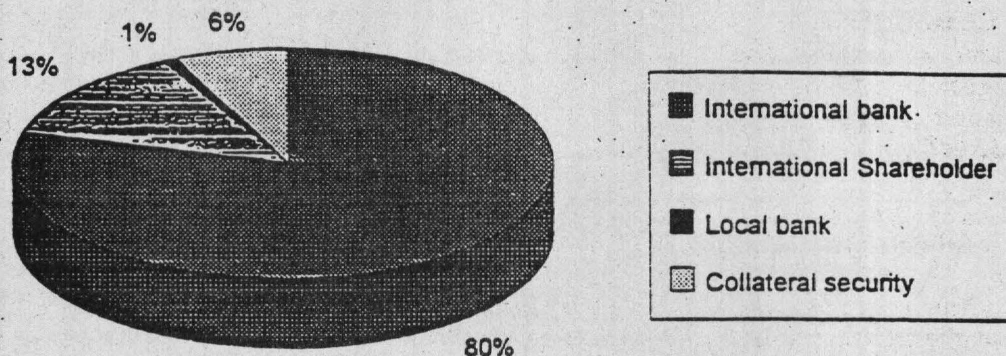
The analysed portfolio consists of 25 loans for a total amount of 1094 million ECU. 14 loans concern ACP countries (128 mECU or 12%), 2 loans Mediterranean countries (226 mECU or 21%), 4 loans Central and Eastern European Countries (520 mECU or 47%) and 5 loans Asian and Latin American countries (220 mECU or 20%).

[1] For instance if the European shareholder has given a completion guarantee and after project completion the loan is guaranteed by a local bank, only the latter has been taken into consideration

[2] For instance the project MIDOR in Egypt is guaranteed by a local bank, but a letter of credit is available from an international bank which can be used in case of default by the local bank. This was consequently considered as a project guaranteed by an international bank

Structure of the guarantee portfolio

The bulk of the loans analysed are guaranteed by international banks. International bank means for the purpose this analysis one or a group of banks from either the EU, Switzerland, Canada, the US or Japan which represent an acceptable risk for EIB. These loans represent 80% of the total :



(see attachment 2 for complete list).

Duration of the guarantee

Commercial banks often have difficulties to provide a guarantee for periods longer than 5 to 8 years. In a number of cases therefore the guarantee covers only part of the duration of the loan with the possibility to roll-over or to provide an alternative guarantee at the expiration of this period. Otherwise these loans would become due. 27% of the total amount concerned is covered by this type of roll-over guarantee.

Coverage of Convertibility and Transferability risk

Whenever an international bank covered in the past the complete political risk of a project it can be assumed, that arrangements have been made to counter-guarantee the risk by deposits of the shareholders or other kind of special relationship between the bank concerned and the project promoters. This kind of full guarantee has always been an exception. It was only in 1994, when commercial bank guarantees in emerging markets became more frequent that the issue of political risk coverage was raised. It does in fact increase the cost of the guarantee extraordinarily because Central Bank regulations in most of the member countries require the immediate provisioning of a political risk in the portfolio of a commercial bank unless it is insured or covered by the "umbrella" of a multilateral finance institution. The willingness of the Bank to renounce to the coverage of the risk of convertibility and transferability of foreign exchange by the commercial guarantors is considered as such an umbrella. The Framework Agreements concluded by the Bank with the governments of third countries which cover this risk put the Bank in a position to regard this specific risk as being covered by the host country government. This became practically the rule since 1994 and although only 6 loans have been signed with this particularity, their large amounts bring about that these loans represent 56% of the total (see attachment 3).

Attachment 1

Outstanding Loans with Non-Sovereign Guarantees - sorted by date of signature

Country	Project	Date signature	Amount in mECU	Duration in years	Guarantee category	Duration guarantee	With/Without Coverage Convertibility and Transferability risk
COTIV	SACO	851121	3.0	12	International Bank	Full	With
Sub-total 1985			3.0				
COTIV	SONACO II	861215	4.5	12	International Bank	Full	With
Sub-total 1986			4.5				
COTIV	UTEXI II	870730	10.0	12	International Bank	Full	With
AFRIE	EADB GL	871215	6.0	10	International Bank	Roll-over	With
Sub-total 1987			16.0				
SWAZI	SPINTEX SWAZILAND	891122	4.0	10	International Bank	Roll-over	With
Sub-total 1989			4.0				
CAMER	SBM Bananes A	911031	1.5	10	International Shareholder	Full	With
AFRI	AGECNA II A	911114	14.0	10	International Bank	Roll-over	With
Sub-total 1991			15.5				
MAURC	Maurilait Production	920727	2.0	12	Local Bank	Full	With
COTIV	SCODI A	921216	5.5	10	International Bank	Full	With
Sub-total 1992			7.5				
EGYPT	Jardins du Nil	930624	6.0	12	International Bank	Full	With
TCHEQ	SKODA	930726	70.0	15	International Shareholder	Full	Without
JAMAI	TDBJ GL II A	930922	5.0	10	International Bank	Full	With
Sub-total 1993			81.0				
ARGEN	Gas Natural BAN	941031	46.0	12	International Bank	Full	With
PHILI	Davao Cement	941214	23.0	8	International Bank	Full	Without
GUINE	SGHI A	941216	1.5	10	Local Bank	Full	With
CHILI	CTC	941220	75.0	8	International Shareholder	Full	With
MALI	SADIOLA	941222	35.0	8	Collateral security	Full	With
Sub-total 1994			180.5				
COTIV	PETROCI	950502	30.0	7	Collateral Security	Full	With
EGYPT	MIDOR	950629	220.0	18	International Bank	Full	With
HONG	Hungary Fin. Sec. GL	951122	150.0	15	International Bank	Full	Without
ARGEN	AGUAS ARGENTINAS	951201	70.0	15	International Bank	Roll-over	Without
POLOG	Polano Fin. Sec. GL	951207	100.0	15	International Bank	Full	Without
TCHEQ	CEZ	951214	200.0	15	International Bank	Roll-over	Without
ARGEN	AILINCO	951214	6.0	10	Local Bank	Full	With
COTIV	SACO II	951218	6.0	10	Collateral Security	Full	With
Sub-total 1995			782.0				
Total			1094.0				

Outstanding Loans with Non-Sovereign Guarantees - sorted by Guarantor category

Country	Project	Date signature	Amount in mECU	Duration in years	Guarantee category	Duration guarantee	With/Without Coverage Convertibility and Transferability risk	Sub-totals
MALI	SADIOLA	941222	35.0	8	**Collateral security**	Full	With	
COTIV	PETROCI	950502	30.0	7	**Collateral Security**	Full	With	
COTIV	SACO II	951218	6.0	10	**Collateral Security**	Full	With	71.0
COTIV	SACO	851121	3.0	12	**International Bank**	Full	With	
COTIV	SONACO II	861215	4.5	12	**International Bank**	Full	With	
COTIV	UTEXI II	870730	10.0	12	**International Bank**	Full	With	
COTIV	SCODI A	921216	5.5	10	**International Bank**	Full	With	
EGYPT	Jardins du Nil	930624	6.0	12	**International Bank**	Full	With	
JAMAI	TDBJ GL II A	930922	5.0	10	**International Bank**	Full	With	
ARGEN	Gas Natural BAN	941031	46.0	12	**International Bank**	Full	With	
EGYPT	MIDOR	950629	220.0	18	**International Bank**	Full	With	
PHILI	Davao Cement	941214	23.0	8	**International Bank**	Full	Without	
HONG	Hungary Fin. Sec. GL	951122	150.0	15	**International Bank**	Full	Without	
POLOG	Poland Fin. Sec. GL	951207	100.0	15	**International Bank**	Full	Without	
AFRIE	EADB GL	871215	6.0	10	**International Bank**	Roll-over	With	
SWAZI	SPINTEX SWAZILAND	891122	4.0	10	**International Bank**	Roll-over	With	
AFRI	ASECNA II A	911114	14.0	10	**International Bank**	Roll-over	With	
ARGEN	AGUAS ARGENTINAS	951201	70.0	15	**International Bank**	Roll-over	Without	
TCHEQ	CEZ	951214	200.0	15	**International Bank**	Roll-over	Without	867.0
CAMER	SBM Bananes A	911031	1.5	10	**International Shareholder**	Full	With	
CHILI	CTC	941220	75.0	8	**International Shareholder**	Full	With	
TCHEQ	SKODA	930726	70.0	15	**International Shareholder**	Full	Without	146.5
MAURC	Mauniait Production	920727	2.0	12	**Local Bank**	Full	With	
GUINE	SGHI A	941216	1.5	10	**Local Bank**	Full	With	
ARGEN	AILINCO	951214	6.0	10	**Local Bank**	Full	With	9.5
Total			**1094.0**					**1094.0**

Outstanding Loans with Non-Sovereign Guarantees - sorted by Coverage of Convertibility and Transferability Risk

Country	Project	Date signature	Amount in mECU	Duration in years	Guarantee category	Duration guarantee	Coverage Convertibility and Transferability risk	Sub-totals
COTIV	SACO	851121	3.0	12	International Bank	Full	With	
COTIV	SONACO II	861215	4.5	12	International Bank	Full	With	
COTIV	UTEXI II	870730	10.0	12	International Bank	Full	With	
AFRIE	EADB GL	871215	6.0	10	International Bank	Roll-over	With	
SWAZI	SPINTEX SWAZILAND	891122	4.0	10	International Bank	Roll-over	With	
CAMER	SBM Bananes A	911031	1.5	10	International Shareholder	Full	With	
AFRI	ASECNA II A	911114	14.0	10	International Bank	Roll-over	With	
MAURC	Maurilait Production	920727	2.0	12	Local Bank	Full	With	
COTIV	SCODI A	921216	5.5	10	International Bank	Full	With	
EGYPT	Jardins du Nil	930624	6.0	12	International Bank	Full	With	
JAMAI	TDBJ GL II A	930922	5.0	10	International Bank	Full	With	
ARGEN	Gas Natural BAN	941031	46.0	12	International Bank	Full	With	
GUINE	SGHI A	941216	1.5	10	Local Bank	Full	With	
CHILI	CTC	941220	75.0	8	International Shareholder	Full	With	
MALI	SADIOLA	941222	35.0	8	Collateral security	Full	With	
COTIV	PETROCI	950502	30.0	7	Collateral Security	Full	With	
EGYPT	MIDOR	950629	220.0	18	International Bank	Full	With	
ARGEN	AILINCO	951214	6.0	10	Local Bank	Full	With	
COTIV	SACO II	951218	6.0	10	Collateral Security	Full	With	481.0
TCHEQ	SKODA	930726	70.0	15	International Shareholder	Full	Without	
PHILI	Davao Cement	941214	23.0	8	International Bank	Full	Without	
HONG	Hungary Fin. Sec. GL	951122	150.0	15	International Bank	Full	Without	
ARGEN	AGUAS ARGENTINAS	951201	70.0	15	International Bank	Roll-over	Without	
POLOG	Poland Fin. Sec. GL	951207	100.0	15	International Bank	Full	Without	
TCHEQ	CEZ	951214	200.0	15	International Bank	Roll-over	Without	613.0
Total			1094.0					1094.0

Annex 6

GUARANTEE FUND

Purpose of the Fund

1. The European Council in Edinburgh on 11 and 12 December 1992 concluded that considerations of prudent budgetary management and financial discipline called for the establishment of a new financial mechanism, and that accordingly a Guarantee Fund should be set up in order to cover the risks related to loans and guarantees covering loans granted to third countries or for projects carried out in such countries. The Fund is mainly concerned with the following types of operation :

- Community loans for providing macro-financial assistance;
- Community guarantees on loans advanced by the EIB and EURATOM for micro-economic projects;
- Community guarantees for operations of a commercial nature, such as guarantees for loans made by financial institutions to fund purchases of foodstuffs or medicines.

2. The fund's resources are intended to reimburse the Community's creditors in the event of default on the part of the beneficiary of a loan granted or guaranteed by the Community.

Provisioning of the fund

3. The Council regulation establishing the Fund provides for a dual mechanism comprising a reserve entered in the general budget and a Guarantee Fund provisioned by the reserve. Payments equal to 14% of the principal amount of loan or guarantee operations shall be made into the fund until the target amount is reached of 10% of the Community's total outstanding capital liabilities, increased by unpaid interest due. The provisioning rate is to be reviewed when the Fund reaches its target amount and, in any case, no later than the end of 1999. The Fund is also to be endowed by interest on Fund resources invested and amounts recovered from defaulting debtors where the Fund has already honoured the guarantee.

4. Payments into the Fund are made in accordance with the following terms and conditions :

4.1. For Community borrowing/lending operations or guarantees to financial bodies[1], whether in one or more tranches, with the exception of those covered in section 4.2. below, the Commission initiates the procedure for payment into the Fund as soon as the Council has formally adopted the underlying decision. The amount to be paid into the Fund is calculated on the basis of the overall amount of the operation decided by the Council.

4.2. For Community borrowing/lending operations or guarantees to financial bodies under a framework facility, spread over several years, with a micro-economic or structural purpose[2], payments into the Fund are made in the form of annual instalments calculated on the basis of the annual amounts indicated in the financial statement attached to the Commission proposal.

4.3. As from the second year, the amounts to be paid into the Fund are corrected by the difference recorded as at 31 December of the previous year between the estimates taken as a basis for the preceding payment and the actual amount of loan contracts signed in the course of the same year.

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[1] Examples of this type of operation: loans for balance of payments support for third countries or the guarantee provided to a consortium of commercial banks to finance purchases of food products in third countries.

[2] Examples of this type of operation: EURATOM loans to third countries and guarantees provided to the EIB for loans in the Mediterranean and ALA countries, the CEEC and South Africa.

5. The rules concerning provisioning of the Fund only apply for operations decided and entered into as from 1 January 1993 (for more detailed information on the rules and operation of the Fund, see Council Regulation N° 2728/94 of 31 October 1994 establishing a Guarantee Fund for external actions, appended hereto).

Management of the Fund's resources

6. With regard to management of the Fund, the solution adopted divides responsibility between the Commission and the EIB: the Commission ensures administration of operations at budgetary level and the EIB is entrusted with financial management of the Fund's resources. The text of the mandate entrusting management by the Commission to the Bank was drawn up and approved by the Bank and the Commission.

Repercussions for EIB operations outside the Community

7. As the budgetary reserve for provisioning the Fund is limited to ECU 323 million per annum at 1995 prices, there is an implicit constraint on annual commitment capacity for new operations. In the Communication from the Commission to the Council of 26 July 1995 (COM (95) 404 final), the Commission points out that "this constraint is such that if the amount of the reserve and the guarantee mechanism remain unchanged, it would be impossible simply to renew the EIB's multi-annual loan allocations at their present level while maintaining a minimum macro-financial assistance capacity". In this same communication, the Commission also mentions that "the European Council meeting in Cannes confirmed the Union's intention of strengthening its financial cooperation with partner third countries, in particular the central and east European countries (CEECs) and the Mediterranean countries (MED)". There is consequently a risk that the constraints of the Fund could be exacerbated. The communication indicates that this situation would call for either a revision of the financial perspective, a decrease in the rate of guarantee cover on EIB operations outside the Community, an amendment to the regulation establishing the Fund to reduce the rate of provisioning of the Fund or a combination of these various possibilities to unblock the situation. The Commission summarised the current position and furnished additional details in its information note of 11 January 1996 by Mr de Silguy and Mr Liikanen (document SEC(96)49).

8. Against this background, it should be noted that when the Council held discussions last year on the problems of the Guarantee Fund, the Bank's representative issued a reservation, indicating that his institution could not commit itself to signing contracts for specific annual amounts but hoped to operate, as in the past, on the basis of multi-annual mandates and packages. An adjustment in the pattern of signatures to accommodate the accounting constraints of the Fund would not be manageable for the Bank (see introductory note N° 10872/95 of 19 October 1995 from the General Secretariat of the Council to the ECOFIN Council held on 23 October 1995). From the operational point of view, it is clearly impossible for the EIB to increase or reduce the volume of loans from one year to the next in line with a budgetary margin which is not known in advance, on the one hand, because of possible non-programmable macro-financial assistance and, on the other, because it is not certain in which year the target amount of the Fund will be reached and its provisioning rate can be reduced.

ANNEX: 1

12. 11. 94 Official Journal of the European Communities No L 293/1

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(Acts whose publication is obligatory)

COUNCIL REGULATION (EC, EURATOM) No 2728/94

of 31 October 1994

establishing a Guarantee Fund for external actions

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 235 thereof,

Having regard to the Treaty establishing the European Atomic Energy Community, and in particular Article 203 thereof,

Having regard to the proposal from the Commission (1),

Having regard to the opinion of the European Parliament (2),

Having regard to the opinion of the Court of Auditors (3),

Whereas the general budget of the European Communities is exposed to increased financial risk as a result of the guarantees covering loans to third countries;

Whereas the European Council on 11 and 12 December 1992 concluded that considerations of prudent budgetary management and financial discipline called for the establishment of a new financial mechanism, and that accordingly a Guarantee Fund should be set up in order to cover the risks related to loans and guarantees covering loans granted to third countries or for projects executed in third countries; whereas it is possible to meet this need by the establishment of a Guarantee Fund which may be drawn on to pay the Community's creditors direct;

Whereas the institutions have agreed, pursuant to the Interinstitutional Agreement of 29 October 1993, to enter into the budget a reserve relating to lending and guarantee operations for the benefit of and in third countries;

Whereas mechanisms currently exist for honouring guarantees when they are activated, in particular by drawing provisionally on cash resources, as provided for in Article 12 of Council Regulation (EEC, Euratom) No 1552/89 of 29 May 1989 implementing Decision 88/376/EEC, Euratom on the system of the Communities' own resources (4);

Whereas the Guarantee Fund should be constituted by the gradual payment of resources; whereas the Fund will subsequently also receive interest on its invested resources and amounts recovered from defaulting debtors where the Fund has already honoured the guarantee;

Whereas, by reference to the practice of international financial institutions, a ratio of 10 % between the Guarantee Fund's resources and guaranteed liabilities in principal, increased by unpaid interest due, would seem adequate;

Whereas payments to the Guarantee Fund equal to 14 % of the amount of each operation would seem appropriate to attain this target amount; whereas the arrangements for making such payments must be defined;

Whereas, once the target amount is attained, the provisioning rate will be reviewed, whereas if the Guarantee Fund exceeds the target amount the surplus will be paid back to the general budget of the European Communities;

Whereas the financial management of the Guarantee Fund should be entrusted to the European Investment Bank (EIB); whereas the financial management of the Fund should be subject to audit by the Court of Auditors in accordance with procedures to be agreed upon by the

(1) OJ No C 68, 11. 3. 1993, p. 10.
(2) OJ No C 315, 22. 11. 1993, p. 235.
(3) OJ No C 170, 21. 6. 1993, p. 25.

(4) OJ No L 155, 7. 6. 1989, p. 1. Regulation as last amended by Regulation (EC, Euratom) No 2729/94 (see page 5 of this Official Journal).

Court of Auditors, the Commission and the European Investment Bank;

Whereas the Treaties do not provide any powers other than those pursuant to Article 235 of the EC Treaty and Article 203 of the EAEC Treaty for the adoption of this Regulation,

HAS ADOPTED THIS REGULATION:

Article 1

A Guarantee Fund, hereinafter referred to as 'Fund', shall be established, whose resources shall be used to repay the Comunity's creditors in the event of default by the beneficiary of a loan granted or guaranteed by the Community.

The lending and guarantee operations referred to in the first paragraph, hereinafter refered to as 'operations', shall be those carried out for the benefit of a third country or for the purpose of financing projects in third countries.

Article 2

The Fund shall be endowed by:

— payments from the general budget of the European Communities pursuant to Article 4,

— interest on Fund resources invested,

— amounts recovered from defaulting debtors where the Fund has already honoured the guarantee.

Article 3

The Fund shall rise to an appropriate level, hereinafter referred to as 'the target amount'.

The target amount shall be 10 % of the Community's total outstanding capital liabilities arising from each operation, increased by unpaid interest due.

If, at the end of a year, the target amount is exceeded, the surplus shall be paid back to a special heading in the statement of revenue in the general budget of the European Communities.

Article 4

1. The payments provided for under the first indent of Article 2 shall be equivalent to 14 % of the capital value of the operations until the Fund reaches the target amount.

The provisioning rate shall be reviewed when the Fund reaches its target amount, and in any case no later than the end of 1999.

2. Payments into the Fund shall be made in accordance with the arrangements indicated in the Annex.

Article 5

If, as a result of the activation of guarantees following default, resources in the Fund stand below 75 % of the target amount, the rate of provisioning on new operations shall be raised to 15 % until the target amount has once more been reached or, if the default occurs before the target amount is reached, until the amount drawn under the activation of the guarantee has been fully restored.

If, as a result of the activation of guarantees on one or more major defaults, resources in the Fund fall below 50 % of the target amount, the Commission shall submit a report on exceptional measures that might be required to replenish the Fund.

Article 6

The Commission shall entrust the financial management of the Fund to the EIB under a brief on the Community's behalf.

Article 7

The Commission shall, by no later than 31 March of the following financial year, send to the European Parliament, the Council and the Court of Auditors an annual report on the situation of the Fund and the management thereof in the previous year.

Article 8

The revenue and expenditure account and the balance sheet relating to the Fund shall be attached to the Communities' revenue and expenditure account and balance sheet.

Article 9

The Commission shall, before 31 December 1998, submit a comprehensive report on the functioning of the Fund.

Article 10

This Regulation shall enter into force on the seventh day following its publication in the *Official Journal of the European Communities*.

Article 4 shall apply to operations decided on and committed as from 1 January 1993.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Luxembourg, 31 October 1994.

For the Council

The President

K. KINKEL

ANNEX

Arrangements for the payments stipulated in the first indent of Article 2

1. Payments into the Fund will be made in accordance with the arrangements set out in paragraphs 2 and 3, depending on whether the operations concerned are:

   (a) Community borrowing/lending operations or guarantees to financial bodies, whether made in one or more than one tranche, except those covered by (b) (1);

   (b) Community borrowing/lending operations or guarantees to financial bodies under a framework facility spread over a number of years and with a micro-economic and structural purpose (2).

2. For the operations referred to under point 1 (a) the Comission will start the procedure for making the payments into the Fund as soon as the Council has formally adopted the basic decision. The amount to be paid into the Fund will be calculated on the basis of the total amount for the operation decided on by the Council.

3. For the operations referred to under point 1 (b), payments into the Fund will be made in annual tranches calculated on the basis of the annual amounts indicated in the financial statement attached to the Commission proposal, adapted where appropriate in the light of the Council decision.

   The Commission will start the procedure for making payments into the Fund as soon as the Council has formally adopted the basic decision, or at the beginning of the following financial year if no operation is programmed for the current financial year. For subsequent financial years the Commission will start the payment procedure at the beginning of the financial year.

   As from the second year, the amounts to be paid into the Fund will be corrected by the difference recorded on 31 December of the previous year between the estimates that were taken as a basis for the previous payment and the actual figure for the loans signed during that year. Any difference relating to the previous year will give rise to a payment in the following year.

4. When it starts a payment procedure the Commission will check the situation with regard to the performance of the operations which were the subject of previous payments and, where the commitment deadlines originally laid down have not been met, will propose that this be taken into acount in calculating the first payment to be made at the start of the following financial year for operations already under way.

5. For operations decided on by the Council as from 1 January 1993 the Commission will start the procedure for making payments into the Fund as soon as possible after the entry into force of the Regulation, in accordance with the arrangements set out in the preceding paragraphs.

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(1) Examples of this type of operation: loans for the balance of payments of third countries or the guarantee granted to a consortium of commercial banks to finance the purchase of food products in third countries.

(2) Examples of this type of operation: Euratom loans to third countries and the guarantees granted to the EIB for its loans in the developing countries in Latin America and Asia (DCLAA) and the central and eastern European countries (CEEC).

Use of the Member States' or Community budget guarantee

As stressed in the report, the EIB has always arranged appropriate guarantees for its operations from own resources, so as to safeguard the guarantee also furnished by the Member States or the Community budget to comply with Article 18 of the Statute.

This security has consisted essentially of sovereign guarantees provided by the Associated States in which the Bank mounts operations. In fact, until 1993 the great majority of loans were made to these States themselves or their public institutions (see report and Annex 5). In the absence of such sovereign cover, guarantees have been furnished under arrangements offering adequate security (guarantees from banks, promoters or a combination of the two).

The tables below detail the use made of these guarantee arrangements in practice since their introduction, namely:

- **Table 1**: Summary of arrears on loans outside the European Union (appended hereto).
- **Table 2**: Historical summary of guarantee calls made in respect of arrears in the non-member Mediterranean countries (these tables are available on request from the Bank).
- **Table 3**: Historical summary of guarantee calls made in respect of arrears in the ACP States (these tables are available on request from the Bank).
- **Table 4**: Arrears covered by and still owed to the guarantors (appended hereto).
- **Table 5**: Geographical breakdown of lending by country in which projects are located (appended hereto).

While the conclusions emerging from the above tables are developed in the main body of the report, it is nevertheless worthwhile noting the following points:

- **Up until 1985 the Bank had recorded virtually no payment arrears** and consequently had not had to invoke the guarantee of either the Community or the Member States[1]. This reflected the general situation with respect to debt servicing vis-à-vis both multilateral and bilateral public development financing bodies.

- Developments in this situation were such that **as from 1987 the first payment arrears began to emerge** (ECU 2.8m for the ACP States and ECU 2.2m for the Mediterranean Countries in March 1987). No call needed to be made on the Community guarantee with respect to these initial late payments to the extent that the defaulting borrowers or the guarantors managed to settle these arrears within three months of the due date.

- **It is important to note that**, as can be seen from Table 1, **the time lapse between the occurrence of payment arrears and an actual call being made on the Community guarantee** represents a normal state of affairs, given that the various guarantee agreements concluded between the EIB and the Community provide for such guarantee to be invoked no later than three months after the due date in question. **The Bank makes use of this period of three months to take all possible measures to recover the sums concerned.** Indeed, these amounts are sometimes recovered even after a formal call has been made on the Member States' or Community budget guarantee, resulting in annulment of this call. Recovery of these amounts and administrative management of these procedures represents a considerable workload for the Bank's departments, the positive outcome of which depends largely, over and above contractual commitments as such, on thorough knowledge of projects and borrowers, enabling the Bank to benefit de facto, when the project and/or country situation so permits,

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[1] with one minor exception in 1984 relating to Liberia (three instalments of ECU 0.3m subsequently paid by the borrower and refunded to the Member States).

from preferential treatment. Payment arrears generally stem from forex transfer problems connected with the situation in the countries concerned rather than from difficulties with the projects themselves.

- **The first calls on the Community guarantee, in terms of actually requesting settlement from the Member States' or the Community budget guarantee, date from June 1988.** They related to Lebanon in the Mediterranean region and a number of ACP States (Zambia, Liberia and Nigeria). The graph in Table 4 provides an overview of developments (the graph in the main body of the report relates to aggregate arrears, i.e. amounts owed to the Bank plus amounts settled under the Community guarantee).

STATEMENT OF ARREARS ON LOAN INSTALMENTS - LOANS OUTSIDE THE COMMUNITY

OWN RESOURCES

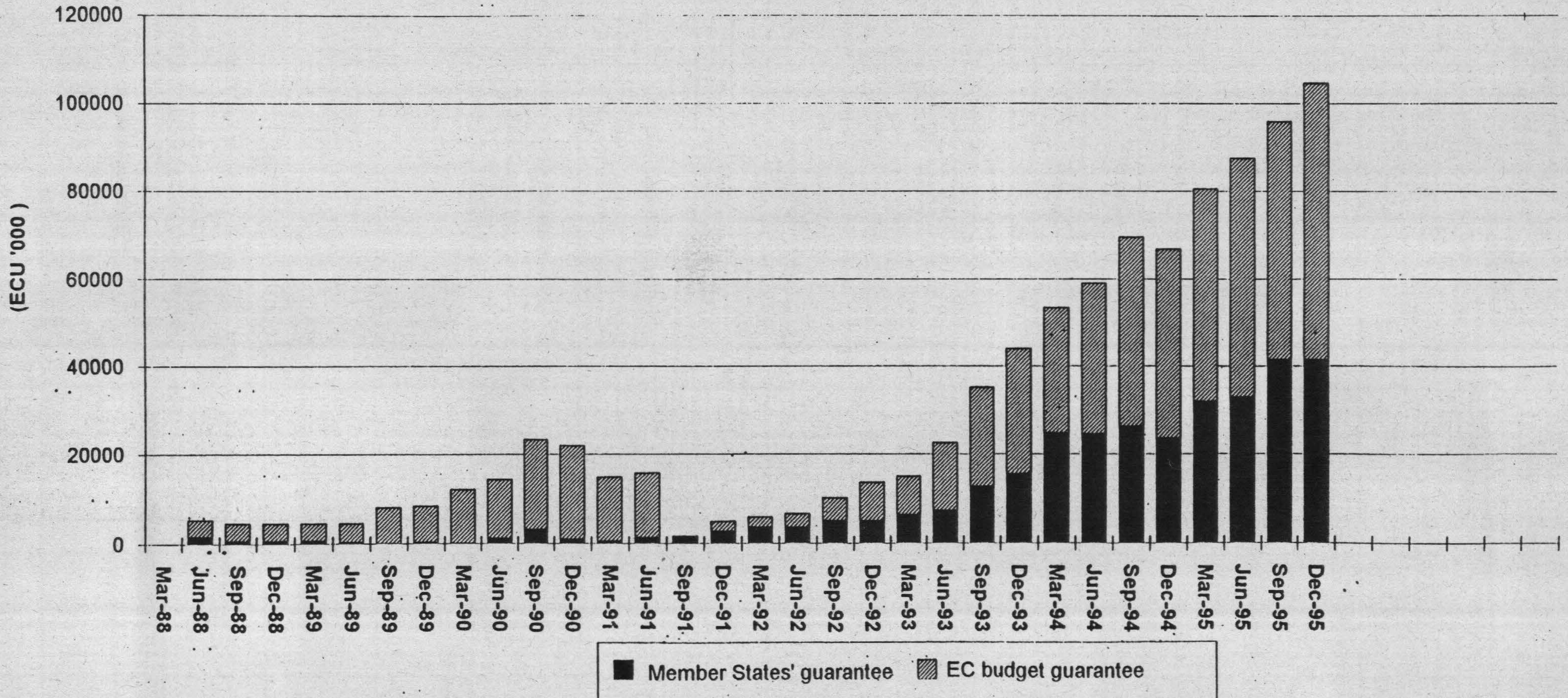
(ECU '000)

	ACP STATES			MEDITERRANEAN COUNTRIES			FORMER YUGOSLAVIA			TOTAL arrears	S/total still owed to guarantors
	Total owed to EIB	Instalments settled by the Member States(1)	TOTAL (a)	Total owed to EIB	Instalments settled by the EC budget(1)	TOTAL (b)	Total owed to EIB	Instalments settled by the EC budget(1)	TOTAL (c)	(a+b+c)	(g)
Mar-87	2 786		2 786	2 191		2 191				4 977	0
Jun-87	9 045		9 045	5 576		5 576				14 621	0
Sep-87	7 665		7 665	5 713		5 713				13 378	0
Dec-87	13 060		13 060	9 028		9 028				22 088	0
Mar-88	8 176		8 176	4 738		4 738				12 914	0
Jun-88	17 047	1 544	18 591	9 489	3 905	13 394				31 985	5 449
Sep-88	11 945	676	12 621	14 417	3 905	18 322				30 943	4 581
Dec-88	20 546	676	21 222	8 955	3 943	12 898				34 120	4 619
Mar-89	7 864	676	8 540	10 218	3 943	14 161				22 701	4 619
Jun-89	16 766	350	17 116	15 571	4 238	19 809				36 925	4 588
Sep-89	12 713		12 713	9 172	7 800	15 972				29 685	7 800
Dec-89	12 235	354	12 589	13 636	7 800	21 436				34 025	8 154
Mar-90	10 324		10 324	10 345	12 075	22 420				32 744	12 075
Jun-90	20 944	1 212	22 156	16 529	13 043	29 572				51 728	14 255
Sep-90	11 186	3 150	14 336	7 474	20 163	27 637				41 973	23 313
Dec-90	18 268	967	19 235	15 632	21 059	36 691				55 926	22 026
Mar-91	10 738	517	11 255	5 303	14 381	19 684				30 939	14 898
Jun-91	16 925	1 312	18 237	13 239	14 381	27 620				45 857	15 693
Sep-91	13 171	1 312	14 483	6 656	332	6 988				21 471	1 644
Dec-91	18 284	2 678	20 962	8 948	2 288	11 236				32 198	4 966
Mar-92	10 136	3 651	13 787	7 474	2 288	9 762	4 611		4 611	28 160	5 939
Jun-92	14 551	3 651	18 202	10 447	2 956	13 403	6 317		6 317	37 922	6 607
Sep-92	10 056	5 097	15 153	1 157	5 059	6 216	11 674		11 674	33 043	10 156
Dec-92	20 347	5 097	25 444	2 952		2 952	6 610	8 500	15 110	43 506	13 597
Mar-93	18 217	6 481	24 698	4 191		4 191	13 502	8 500	22 002	50 891	14 981
Jun-93	32 717	7 378	40 095	2 458		2 458	8 970	15 176	24 146	66 699	22 554
Sep-93	25 093	12 729	37 822	76		76	9 211	22 595	31 806	69 704	35 324
Dec-93	34 907	15 374	50 281	3 765		3 765	5 745	28 660	34 405	88 451	44 034
Mar-94	27 316	24 726	52 042	1		1	13 837	28 660	42 497	94 540	53 386
Jun-94	34 681	24 513	59 194	2 821		2 821	9 402	34 639	44 041	106 056	59 152
Sep-94	20 972	26 334	47 306	1 539		1 539	9 303	43 217	52 520	101 366	69 551
Dec-94	29 407	23 556	52 963	1 808		1 808	10 561	43 217	53 778	108 549	66 773
Mar-95	13 994	32 034	46 028	42		42	13 756	48 516	62 272	108 342	80 550
Jun-95	25 838	32 978	58 816	3 189		3 189	9 351	54 598	63 949	125 954	87 576
Sep-95	18 717	41 374	60 091	663		663	17 411	54 598	72 009	132 763	95 972
Dec-95	27 525	41 398	68 923	1 228		1 228	10 792	63 213	74 005	144 156	104 611

(1) Instalments settled by the guarantors and still owed to them

Source: weekly statement, arrears more than 10 days overdue; figures at end of quarter

ARRESU9.XLS



Source: weekly statements, arrears more than 10 days overdue; figures at end of quarter

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6. GEOGRAPHICAL BREAKDOWN OF LENDING BY COUNTRY IN WHICH PROJECTS ARE LOCATED

Countries and territories in which projects are located	No. of loans	Aggregate loans outstanding	Undisbursed portion	Disbursed portion	% of total
6.2. Loans for projects outside the Union					
6.2.1: ACP Countries/OCT					
NIGERIA	7	210 344 684	75 000 000	135 344 684	
ZIMBABWE	15	182 768 248	74 476 455	108 291 793	
COTE D'IVOIRE	13	116 591 727	10 491 869	106 099 858	
KENYA	9	105 949 734	13 000 000	92 949 734	
BOTSWANA	12	79 309 997	48 264 100	31 045 897	
GHANA	4	76 854 731	50 000 000	26 854 731	
JAMAICA	10	72 811 976	26 878 819	45 933 157	
MAURITIUS	9	70 202 386	52 000 000	18 202 386	
ACP GROUP	2	70 102 147	60 000 000	10 102 147	
PAPUA NEW GUINEA	7	69 698 190	41 000 000	28 698 190	
TRINIDAD & TOBAGO	5	64 896 406	26 055 593	38 840 813	
CAMEROON	9	52 379 561	8 000 000	44 379 561	
SOUTH AFRICA	2	45 000 000	45 000 000		
MALI	1	35 153 898	11 752 274	23 401 624	
FIJI	7	30 493 171	8 000 000	22 493 171	
BAHAMAS	3	26 861 730	14 000 000	12 861 730	
NAMIBIA	3	23 746 645	18 592 464	5 154 181	
MOZAMBIQUE	1	20 000 000	20 000 000		
GUINEA	3	17 492 118	7 500 000	9 992 118	
BARBADOS	4	16 946 383	10 000 000	6 946 383	
NETHERLANDS ANTILLES	6	14 804 827	5 000 000	9 804 827	
MAURITANIA	1	14 076 763		14 076 763	
REGIONAL - AFRICA	1	13 862 537	3 015 668	10 846 869	
FRENCH POLYNESIA	4	12 653 353	3 023 500	9 629 853	
SENEGAL	2	12 333 499		12 333 499	
MALAWI	5	9 279 531		9 279 531	
ZAIRE	1	7 756 649		7 756 649	
SAINT LUCIA	3	6 920 042	1 060 000	5 860 042	
NEW CALEDONIA	2	6 354 190	1 325 000	5 029 190	
GABON	3	6 036 778		6 036 778	
SWAZILAND	3	4 477 296		4 477 296	
CAYMAN ISLANDS	3	4 447 063		4 447 063	
LESOTHO	1	4 261 018		4 261 018	
CONGO	2	3 725 949		3 725 949	
BRITISH VIRGIN ISLANDS	2	3 480 651	1 300 000	2 180 651	
ARUBA	2	3 085 494	1 600 000	1 485 494	
SAINT VINCENT	1	2 705 764		2 705 764	
WEST AFRICA	1	2 648 381		2 648 381	
ZAMBIA	1	2 601 843		2 601 843	
EAST AFRICA	1	2 433 108		2 433 108	
FALKLAND ISLANDS	1	2 337 945		2 337 945	
TONGA	2	2 285 216	620 000	1 665 216	
TOGO	1	2 167 183		2 167 183	
CENTRAL AFRICA	1	1 598 418		1 598 418	
SEYCHELLES	1	1 378 438		1 378 438	
BELIZE	2	1 047 141		1 047 141	
NIGER	1	998 987		998 987	
MONTSERRAT	1	302 730		302 730	
LIBERIA	1	141 829		141 829	
Sub-total	182	1 537 806 355	636 955 742	900 850 613	1.34

6. GEOGRAPHICAL BREAKDOWN OF LENDING BY COUNTRY IN WHICH PROJECTS ARE LOCATED

Countries and territories in which projects are located	No. of loans	Aggregate loans outstanding	Undisbursed portion	Disbursed portion	% of total
6.2.2. Mediterranean Countries					
EGYPT	25	774 359 483	475 016 182	299 343 301	
MOROCCO	22	766 756 894	500 063 446	266 693 448	
ALGERIA	17	717 639 916	492 518 694	225 121 222	
TUNISIA	31	450 032 887	236 858 290	213 174 597	
FORMER FR OF YUGOSLAVIA (b)	18	420 311 940		420 311 940	
LEBANON	8	254 878 987	200 047 000	54 831 987	
JORDAN	26	198 109 515	111 217 184	86 892 331	
ISRAEL	4	97 000 214	68 000 00del0	29 000 214	
TURKEY	4	94 694 344	93 500 000	1 194 344	
CYPRUS	8	74 490 986	34 249 500	40 241 486	
SYRIA	5	54 783 349	11 855 200	42 928 149	
MALTA	5	46 349 671	26 720 500	19 629 171	
GAZA/WEST BANK	2	20 000 000	20 000 000		
Sub-total	175	3 969 408 186	2 270 045 996	1 699 362 190	3.46
6.2.3. Central and Eastern European Countries					
POLAND	15	1 005 655 609	707 530 284	298 125 325	
CZECH REPUBLIC	9	737 871 285	658 482 313	79 388 972	
HUNGARY	13	729 174 515	425 235 470	303 939 045	
ROMANIA	9	381 549 241	309 010 137	72 539 104	
BULGARIA	7	285 451 998	231 048 434	54 403 564	
SLOVAK REPUBLIC	8	252 378 561	145 128 013	107 250 548	
SLOVENIA	5	120 075 156	96 791 910	23 283 246	
ESTONIA	5	51 823 399	40 500 000	11 323 399	
ALBANIA	3	34 000 000	34 000 000		
LITHUANIA	3	28 952 585	23 003 261	5 949 324	
LATVIA	1	5 000 000	5 000 000		
Sub-total	78	3 631 932 349	2 675 729 822	956 202 527	3.17
6.2.4. Asian and Latin American Countries					
ARGENTINA	3	118 599 982	76 000 000	42 599 982	
CHILE	1	71 019 591	4 631 261	66 388 330	
PAKISTAN	2	60 000 000	60 000 000		
THAILAND	2	57 959 191	51 719 844	6 239 347	
INDIA	1	55 000 000	55 000 000		
CHINA	1	55 000 000	55 000 000		
PHILIPPINES	2	47 811 382	39 173 581	8 637 801	
INDONESIA	1	46 000 000	46 000 000		
COSTA RICA	1	44 000 000	44 000 000		
PERU	1	26 626 839	1 642 050	24 984 789	
PARAGUAY	1	17 000 000	17 000 000		
Sub-total	16	599 016 985	450 166 736	148 850 249	0.52
Total	451	9 738 163 875	6 032 898 296	3 705 265 579	8.49
GRAND TOTAL	5 193	114 636 808 650	18 545 044 986	96 091 763 664	100%

(b) Loans granted to public entities in the former Federal Republic of Yugoslavia are still considered as related to loans in the Mediterranean Countries.

ANNEX 8

Elements of Comparative Portfolio Analysis

(EIB and IFC)

Country	Rating	Total EIB Commitments	Total IFC Commitments
Singapore	AAA	0	14
Cyprus	AA-	74	
Total AAA and AA		74	14
Malaysia	A+	0	55
Total A+		0	55
Bahamas	A	27	
Czech Republic	A	738	107
Malta	A	46	
Thailand	A	58	644
Total A		869	751
Chile	A-	71	655
Israel	A-	97	11
Slovenia	A-	120	227
Total A-		288	892
China	BBB	55	180
Indonesia	BBB	46	642
Total BBB		101	821
Tunisia	BBB-	450	74
Colombia	BBB-	0	368
Total BBB-		450	442

Country	Rating	Total EIB Commitments	Total IFC Commitments
Botswana	BB+	79	2
Hungary	BB+	729	245
India	BB+	55	1 318
Namibia	BB+	24	7
Slovakia	BB+	252	
South Africa	BB+	45	14
Trinidad & Tobago	BB+	65	43
Uruguay	BB+	0	54
BB+		1 250	1 683
Barbados	BB	17	9
Egypt	BB	774	286
Mexico	BB	0	1 388
Morocco	BB	767	289
Philippines	BB	48	586
Poland	BB	1 006	277
Total BB		2 612	2 836
Argentina	BB-	119	1 413
Paraguay	BB-	17	15
Romania	BB-	382	7
Zimbabwe	BB-	183	222
Total BB-		700	1 657
Brazil	B+	0	1 609
Jordan	B+	198	93
Lesotho	B+	4	0
Mauritius	B+	70	37
Pakistan	B+	60	745
Sri Lanka	B+	0	28
Turkey	B+	95	886
Venezuela	B+	0	323
Total B+		427	3 721
Estonia	B	52	12
Fiji	B	30	23
Lebanon	B	255	92
Papua New Guinea	B	70	13
St. Christopher & Nevis	B	0	
St. Lucia	B	7	4
St. Vincent & the Grenadines	B	3	
Total B		417	143
Bangladesh	B-	0	15
Benin	B-	0	2
Bolivia	B-	0	116
Burkina Faso	B-	0	1
Costa Rica	B-	44	33
Ghana	B-	77	195
Jamaica	B-	73	44
Kenya	B-	106	138
Latvia	B-	5	16
Lithuania	B-	29	15
Mauritania	B-	14	289
Panama	B-	0	85
Peru	B-	27	155
Senegal	B-	12	56
Seychelles	B-	1	14
Tonga	B-	2	
Total B-		390	1 175

Country	Rating	Total EIB Commitments	Total IFC Commitments
Bulgaria	C+	285	5
Côte d'Ivoire	C+	117	106
Gabon	C+	6	105
Guatemala	C+	0	70
Mali	C+	35	69
Swaziland	C+	4	33
Tanzania	C+	0	48
Total C+		**448**	**436**
Algeria	C	718	10
Dominica	C	0	1
Dominican Republic	C	0	84
Ecuador	C	0	64
Ethiopia	C	0	22
Gaza-Cisgordania	C	20	
Syria	C	55	
Zambia	C	3	87
Total C		**795**	**267**
Albania	C-	34	0
Burundi	C-	0	6
Cape Verde	C-	0	2
Gambia	C-	0	6
Guinea	C-	17	30
Guinea-Bissau	C-	0	7
Honduras	C-	0	22
Malawi	C-	9	33
Nicaragua	C-	0	9
Niger	C-	1	2
Nigeria	C-	210	188
Togo	C-	2	12
Total C-		**274**	**317**
Belize	D	1	16
Cameroon	D	52	65
Congo	D	4	58
Grenada	D	0	6
Guyana	D	0	2
Haiti	D	0	2
Liberia	D	0	9
Madagascar	D	0	42
Mozambique	D	20	14
Rwanda	D	0	2
Sierra Leone	D	0	25
Somalia	D	0	1
Sudan	D	0	27
Ex-Yugoslavia	D	420	
Zaire	D	8	49
Total D		**505**	**317**
Totals		**9 600**	**15 524**

Simulation of Future Trends in Bank Loans Outside the EU

Commitments, Disbursements and Budgetary Allocations to the Guarantee Fund

The attached table and graphs illustrate the possible dynamics of Bank loans that would be covered by the new guarantee scheme and its budgetary implications under the current provisioning rules for the Guarantee Fund. It shows that a guarantee scheme based on a **60% blanket coverage** of Bank loans signed minus loans cancelled and reimbursed would result in a **35% reduction in the amount of budgetary resources needed to cover a given amount of Bank loans**. It shows also that reducing the level of blanket coverage to 60% would increase significantly the amount of Bank assets at risk: by 2007, some ECU 4 billion would be at risk in the sense that they would not be covered by a budgetary guarantee.

Assumptions are as follows:

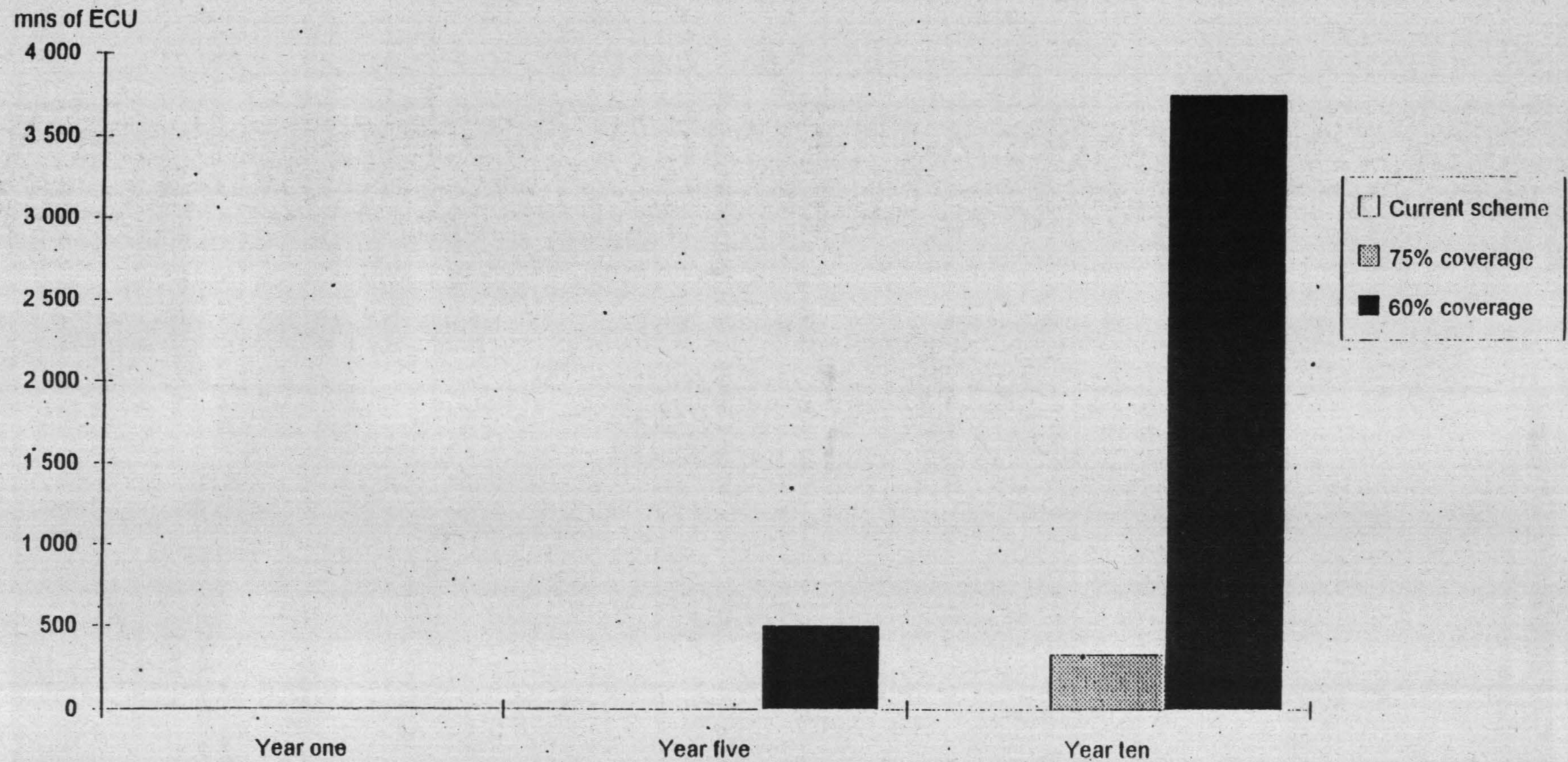
- Annual commitments: ECU 3 billion
- Disbursement profile: 10% of loans signed the first year, 30% during each of the next three years.
- Amortisation: over ten years, with a 3-year grace period.
- Guarantee Fund: current provisioning rules continue to apply (14% of the level covered by the blanket coverage)

Budgetary Implications of Alternative Coverage for EIB Loans

(in millions of ECU)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Portfolio dynamics (assuming that new PA commitments amount to ECU 3 bn per year)														
Flows (during the year)														
Signed	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000
Disbursed	300	1 200	2 100	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000	3 000
Repayments	0	0	0	43	214	514	943	1 371	1 800	2 229	2 657	3 086	3 514	3 943
Stocks (at year-end)														
Outstanding (disbursed)	300	1 500	3 600	6 557	9 343	11 829	13 886	15 514	16 714	17 486	17 829	17 743	17 229	16 286
Signed (cumulative minus repayments	3 000	6 000	9 000	11 957	14 743	17 229	19 286	20 914	22 114	22 886	23 229	23 143	22 629	21 686
To be disbursed	2 700	4 500	5 400	5 400	5 400	5 400	5 400	5 400	5 400	5 400	5 400	5 400	5 400	5 400
Budgetary funds to be allocated to the Guarantee Fund (cumulative)														
Under the current system	385	770	1 155	1 535	1 892	2 211	2 475	2 684	2 838	2 937	2 981	2 970	2 904	2 783
Amount at risk	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Under a scheme providing for a blanket coverage based on Bank commitments minus loans reimbursed and cancelled														
Blanket coverage at 75%														
Provisioning rate of 14%	315	630	945	1 256	1 548	1 809	2 025	2 196	2 322	2 403	2 439	2 430	2 376	2 277
Savings compared to current syste	18%	18%	18%	18%	18%	18%	18%	18%	18%	18%	18%	18%	18%	18%
Amount at risk	0	0	0	0	0	0	0	0	129	321	407	386	257	21
Blanket coverage at 60%														
Provisioning rate of 14%	252	504	756	1 004	1 238	1 447	1 620	1 757	1 858	1 922	1 951	1 944	1 901	1 822
Savings compared to current syste	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%
Amount at risk	0	0	0	0	497	1 491	2 314	2 966	3 446	3 754	3 891	3 857	3 651	3 274

Bank Assets at Risk under Alternative Blanket Coverage Schemes



ANNEX 10

POLITICAL RISK INSURANCE

A Survey of Multilateral, National and Private Market Insurance Instruments

Summary and conclusions

This annex is based on a thorough review of the operations of the various insurers of political risks made by Bank staff for the purpose of the Study requested by ECOFIN. It provides information on the various multilateral, national and private market insurance instruments to cover political risks.

Information of direct operational relevance to the study are as follows:

- Investment financing in developing countries involves considerable risks, in particular significant political risks.
- Private project sponsors and providers of finance are generally not prepared or able to bear political and sovereign risks and require political risk insurance. Demand for political risk insurance has remained very significant and has generally outstripped supply.
- **Demand for cover has concentrated on transfer risk and inconvertibility, expropriation, war and civil strife, and, to a lesser extent (at least to date), breach of contractual obligations by the host government.**
- Political risks do not lend themselves to statistical computation (and only little information on losses is available). By their nature, such risks are susceptible to aggregate into country, regional and even world-wide catastrophic events (the typical contagious or domino effect stressed in the study). Therefore, supply for this type of risks was and, essentially remains, a public sector "business".
- The three main sources of political risk insurance tend to be complementary and offer mainly cover for currency transfer risks, expropriation, war and civil strife. Breach of contract coverage, which raises considerable difficulties, is covered by only a few insurers. Exchange rate risks are in general not covered and coverage of catastrophic risks varies.
- Pricing is an essential component of political risk insurance. It is risk-related, and market-related in the Private Market. However, all actors acknowledge that risk-related pricing in this field is a very difficult exercise. Multilateral and national public schemes are, in general, cheaper than private insurers.
- Regarding portfolio management, insurers diversify their portfolio through country, sector and project exposure limits, and generally seek to avoid exposure in the most risky countries. They can re-insure a substantial part of their exposures.
- **Most insurers consider that the risks involved in lending to public sector borrowers are essentially political in nature (sovereign/country risk).**
- Insurers of political risks prefer that the risks they cover be identified and listed, and that all other risks be considered commercial risks and be left to the client. **The latter always bears the burden of proof in case of default.**
- **ECAs** are being increasingly involved in the field of **project finance.** In many cases, they have had to **renounce drawing a distinction between political and commercial risks** because in project finance breach of contract is one of the main risks and government are omnipresent. In this context, ECAs prefer to assume all categories of risks, charge adequately for this risk assumption, but cover only part of the contingent liabilities, with other insurers/partners assuming the rest of the contingent liabilities.

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Attachment I: MIGA: Guarantee Portfolio by Host Country
Attachment II: Information on Export Credit Agencies and National Investment Insurance Schemes

1. Demand for political risk insurance

Investment financing in developing countries involves considerable risks, in particular risks of macroeconomic instability (generally known as sovereign risk) and a myriad of significant political risks which private lenders or investors generally are not prepared to accept. The perception of political risks has continued to limit considerably the flow of finance, in particular foreign direct investment, to developing countries.

Therefore, most project sponsors and providers of finance require political risk insurance. Banks and companies still seek political risk insurance for projects in most former rescheduling countries in Latin America, Asia and Europe despite improved policies and renewed access to international capital markets. Many providers of finance also seek insurance in a number of countries that have not rescheduled.

The limited ability/willingness of private lenders and investors to handle political risks has led political risk insurers to expand the range of their products in the recent past. Demand for political risk insurance had traditionally focused on transfer problems and political disturbances as expropriation as well as elements of natural disasters (earthquakes, fire and floods, etc.). Transfer problems cover losses due to the inability to convert local currency to foreign exchange or restrictions on the transfer of amounts in foreign or local currency abroad. (see Annex 11 for the definition of selected political risks)

The current world-wide shift towards privatisation and private financing of infrastructure increases the complexity of financing deals and is altering the nature of political risks affecting investors or lenders. **In the new business environment, political risk is being extended well beyond traditional definitions**. The new forms of political risks that concern investors and lenders involve less outright interferences and more subtle threats to projects' viability stemming from government actions. These include cancellation of export or import licenses, changes in regulations and indirect or "creeping" expropriation. They also cover project losses due to unanticipated changes in exchange rates. These risks are by their nature more difficult to define, foresee and prove.

In sum, **demand for political risk insurance has remained strong and appears to have remained superior to global supply. In particular, most project sponsors and financiers consider that the availability of political risk insurance is very important in being able to structure project finance**. A recent market survey by the Institute of International Finance (IIF) shows that **for most project sponsors and financiers transfer risk and inconvertibility remain the most important risks, followed by expropriation, war and breach of contract.** A large majority consider that cancellation of permits or licenses, changes in laws and regulation, and unfair calling of bonds are also increasingly important.

Three main sources of political risk insurance help to meet the demand for cover: multilateral, national (by official Export Credit Agencies--ECAs--), and private sources. The availability of political risk insurance varies significantly among national, multilateral institutions and private insurers which tend to complement each other. The remainder of the paper is organised as follows: Chapter 2 presents the various instruments of multilateral political risk insurance. Chapter 3 examines the major aspects of insurance cover provided by national export credit agencies and investment guarantee schemes. Chapter 4 describes the private market for political risk insurance.

2. Multilateral political risk insurance

Multilateral institutions provide coverage for various types of political risks associated to investment projects in developing countries. Some specialised institutions such as MIGA cover the full range of traditional political risks. MIGA's activities and policies are discussed in § 2.1. [1]

In addition, the World Bank mainstreamed recently its guarantee programmes to cover selected political risks particularly in relation to contractual commitments of the host governments (and agencies) or changes in the legal environment. Regional development banks followed the World Bank's lead, developing guarantee programmes broadly similar to that of the World Bank. These guarantee programmes are presented in § 2.2.

Project sponsors or financiers consider in general that multilaterals usefully increase the protection available to cover government interference in projects and host government obligations.

2.1 MIGA

2.1.1 Background and financial structure

The Multilateral Investment Guarantee Agency (MIGA), established in 1988, is a member of the World Bank group and has 128 Member countries at present. The purpose of the Agency is to **help developing countries attract productive foreign investment**. It seeks to achieve its purpose through two essential means: the provision of guarantees (or insurance) against non-commercial risks and a programme of consultative and advisory services. MIGA has the capacity to tap the human and technical resources of the entire World Bank group.

To cover potential losses, MIGA was endowed with a **solid equity base** by its founders; it does not raise resources on financial markets. As of June 30, 1995, MIGA's authorised capital was USD 1,043 million, of which 20% (or USD 208 million) were paid in, including half in the form of promissory notes. The remaining USD 834 million is subject to call by the Agency when required to meet its obligations. Moreover, the Agency makes reserves for claims out of its operational surplus. As of June 30, 1995, MIGA's reserves for claims amounted to USD 17 million.

Until 1994, the Agency's risk-to-equity ratio was limited to 150%. In February 1994, as contemplated by the MIGA Convention, the Council of Governors decided to increase the maximum aggregate amount of contingent liabilities that may be assumed by the Agency to 350 % of the sum of the Agency's unimpaired subscribed capital and its reserves. Such increase was to be accomplished in two stages:

- an increase to 250 % in 1994 (providing for a USD 2.7 bn coverage capacity);

[1] Other specialised multilateral providers of political risk insurance include institutions in the Arab world, in particular MIGA's forerunner, the Inter-Arab Investment Guarantee Corporation, which now focuses mainly on export credit insurance.

- an increase to 350 % to be considered later.

2.1.2 Type of risks covered

MIGA covers selected political risks. It offers insurance against loss caused by non-commercial risks by issuing long-term (up to 20 years) guarantees on four different categories of risks:

- **currency transfer/inconvertibility**: protects against losses arising from the investor's inability to convert local currency returns into foreign exchange or to transfer local or foreign currency returns outside the host country. Currency devaluation is not covered. Any blocked local currency must be transferred to MIGA by the investor prior to payment of compensation.

- **expropriation**: protects against partial or total loss of the insured investment as a result of acts by the host government which may reduce or eliminate ownership of, control over, or essential rights over the insured investment. In addition to outright nationalisation and confiscation, indirect or "creeping" expropriation, for instance, a series of acts which, over time, have an expropriatory effect is also covered. Compensation will be paid upon subrogation of MIGA to the rights of the investor in the expropriated investment (e.g., equity shares or loan agreement) and assignment of those rights to the Agency.

- **war and civil disturbance**: protects against losses from damage to, or the destruction or disappearance of, tangible assets caused by politically motivated acts of war or civil disturbance in the host country including revolution, insurrection, *coup d'état,* as well as, under certain conditions, sabotage and terrorism.

- **breach of contract**: provides partial protection against losses arising from the host government's breach or repudiation of a contract with the investor. It is available only if the investor has obtained an award for damage in his favour, following an alleged breach of a contractual obligation by the host government and if, after a specified period of time, the award has not be paid. In effect, the coverage is similar to the risk of denial of justice: MIGA insures the investor against the impossibility to obtain or to enforce an arbitral or judicial decision recognising the breach of an obligation by the host government. In practice, this coverage has not been used frequently especially since some aspects of breach of contract risks can be covered under expropriation.

MIGA can cover new cross-border investments ("greenfield" investments)as well as new contributions to expand, privatise or financially restructure existing projects. It can cover various forms of investment, including equity, loans made or guaranteed by foreign equity holders, non-shareholder loans by commercial bank, provided that MIGA also insures equity in the project as well as non-equity forms of investment such as technical assistance and management contracts.

2.1.3 Pricing

MIGA has established a premium structure (outlined in the table below) that provides the basis for determining the premium rates for a specific investment. Accordingly, the following base rates may be adjusted up or down for a particular project depending on the project's risk profile, which depends in part on the sector and the country (for instance, the coverage of currency transfer risk can vary between 30 bp and 150 bp). The rates are defined in relation to the type of industry and coverage, and are applied to the amount of the investment at risk. The base rates shown in the table below are a good approximation of the average premium rates.

Base Premium Rates Charged by MIGA

(in basis points, per year)

Type of risk	Sectors		
	Oil and gas	Natural resources	Manufacturing and Services
Currency transfer	50	50	50
Expropriation	125	90	60
War and civil disturbance	70	55	55

2.1.4 General policy guidelines

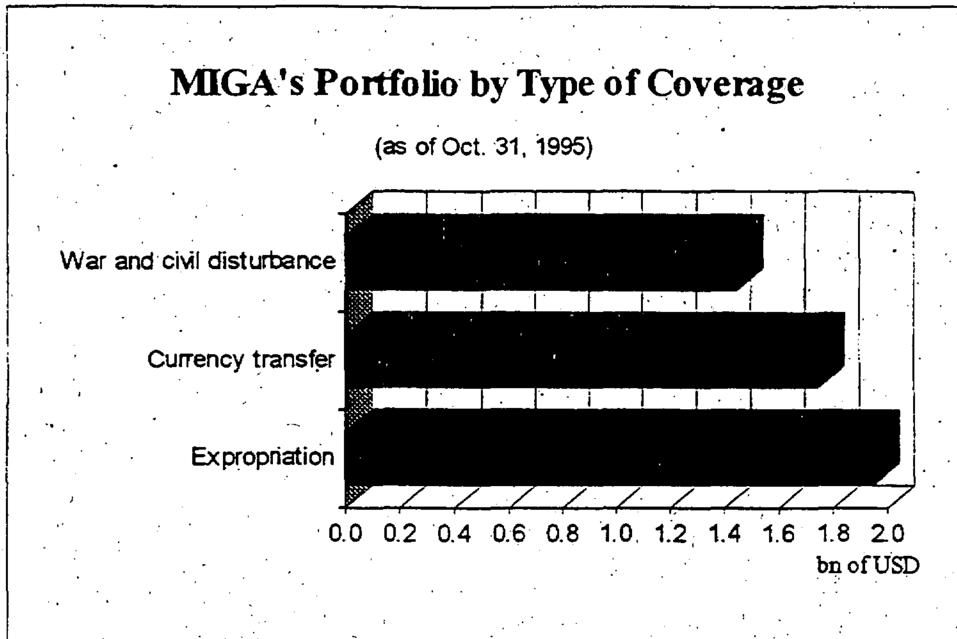
To manage its guarantee portfolio prudently, MIGA has consistently sought to **diversify its contingent liabilities by regions, country, and sector**. Exposure to individual country cannot exceed 15% of total guarantee portfolio, or USD 175 mn (recently raised to USD 225 mn). MIGA's guarantee portfolio is spread across 34 beneficiary developing countries (see Attachment I to Annex 10). Exposure limits to individual projects are, at present, quite restrictive (USD 50 mn per projects) and MIGA's maximum contingent liability normally cannot exceed 270% of investor's contribution to the project.

Reserves for claims are based on management's evaluation of potential claim payments. Given the lack of historical claims experience in MIGA, there is no actuarial or historical basis upon which to determine the Agency's expected claims experience. Accordingly, management relies on a premium-based methodology for establishing the reserve for claims, allocating about three-fourth of premium and commitment fee income to making reserves.

MIGA's guarantee capacity can be increased through recourse to re-insurance or co-insurance.

2.1.5 Experience to date

The maximum amount of contingent liability of MIGA under guarantees issued and outstanding at October 31, 1995 totalled some USD 2 billion.



As of that date, there have been no claims lodged with the Agency, which reflects in part the long-term nature of the projects covered and the fact that MIGA has been in operation for only a few years. MIGA's membership in the World Bank group has proven to be an asset both in terms of political leverage, dispute resolution ability, and analytical capacity.

2.2. Other Multilateral insurance instruments

In the recent past, the leading multilateral development banks have indicated their greater willingness to give guarantees to private lenders and investors against some political risks, mainly in infrastructure projects or natural resources, **to promote private sector investment**. The IBRD was the first MDB to re-organise its guarantee programme for this purpose. The Asian Development Bank (AsDB) and the Inter-American Development Bank (IADB) introduced announced new guarantee facilities modelled closely on the IBRD programme. Therefore, only the IBRD's guarantee programme is presented below. [2]

[2] Multilateral institutions also provide protection against political risks through devises as lender-of-record arrangements like the IFC B-loan programme. The EBRD also offers guarantees against some political risks.

2.2.1. Structure and purpose of the guarantee scheme

The IBRD mainstreamed its guarantee programme in 1994.[3] The purpose of the programme is to provide guarantees **covering commercial debt financing** for public and private entities in developing countries. Unlike MIGA, the World Bank does not guarantee equity capital.

The proposed guarantees are intended to mitigate those risks which are beyond the control of private lenders, including events of political *force majeure*. The IBRD considers that its guarantees are most likely to be used for financing infrastructure, where the demand for funding is large, political and sovereign risks are significant, and long maturity financing is often critical to a project's viability and which exceeds generally the capacity of specialised agencies like MIGA. The guarantee could be valuable in particular where activities traditionally undertaken and financed by the government are being shifted to the private sector but where the government and its agencies remain involved, for example, as regulator, provider of inputs or buyer of outputs.

There are limitations to expand the programme especially since the IBRD is required under its Articles to obtain a **counter-guarantee from the host government**. The counter-guarantee indemnifies the Bank for any payment it makes under its guarantee. (The World Bank argues that when the guarantee covers specific sovereign policy or contractual risks, the counter-guarantee demonstrates the commitment of the government to meet obligations entered into as part of the project.)

The potential use of guarantees is considered within the framework of the Bank's country assistance strategy and risk-management strategy; **guarantees are imputed to the Bank's usual country exposure ceilings**.

2.2.2. Risks covered

Since the World Bank's guarantees are intended to be catalytic, **only partial guarantees are offered, and risks are shared between the World Bank and private lenders**. The World Bank's objective is to cover those risks it feels uniquely positioned to bear given its experience with developing countries and special relationships with governments. Other project risks are taken by private sector lenders and other partner institutions.

The World Bank guarantees may be either for specified risks (the partial risk guarantee) or for all credit risks during a specified part of the financing term (the partial credit guarantee).

- **A partial risk guarantee** covers specified risks arising from non-performance of sovereign contractual obligations or certain political *force majeure* events. The new "partial risk" guarantee programme of the IBRD, IADB and AsDB are especially designed to protect private sector infrastructure projects from breaches of contract by

[3] The World Bank has had a guarantee programme since 1983, first under the World Bank's B-loan programme and then under the ECO, or Expanded Cofinancing Programme. Only a handful of guarantees were, however, provided under these programmes, which served as forerunners to the present programme.

public entities. It is most appropriate for "limited recourse financing" schemes such as build-own-operate-transfer or build-own-operate projects. Partial risk guarantees ensure payment in case of debt service default resulting from the non-performance of contractual obligations undertaken by governments or their agencies and similar projects. A partial risk guarantee can cover in particular:

- failure of governments to honour project obligations
- maintenance of agreed regulatory framework
- delivery of inputs by governments and government-owned entities
- payments for output by government/government-owned entities
- specific sovereign risks such as foreign exchange transfer risk and other political *force majeure* events.

- A **partial credit guarantee** typically extends maturities beyond what private creditors could otherwise provide--for example, by guaranteeing late-dated repayments or providing incentives for lenders to roll over short-term loans. **It covers all events of non-payment for a designated part of a financing**.

2.2.3. Pricing

The World Bank charges, at present, two fees for guarantee cover: a standby fee and a guarantee fee. These fees are charged either to the borrower or lender on the amount covered under the guarantee.

- The **standby fee** is applied during the period when the guarantee is in force but not callable. It is currently 25 bp per annum on the Bank's guarantee exposure, represented by the present value of the guaranteed amount at the first possible date of call.

- The **guarantee fee** is applied during the period when the guarantee is callable. It is currently in the range of 40-100 bp per annum on outstanding debt covered by the guarantee--this consists of a base fee of 25 bp plus an annual premium ranging from 15 to 75 bp. The premium is determined case by case to reflect the level of coverage and thus the value to the borrower.

Any guarantee fee above 25 bp is refunded to the host government, so that the net cost of the guarantee is the same as the spread on a World Bank loan. The World Bank is a co-operative institution and maintains a **policy of non-discriminatory pricing among its members**.

2.2.4. Use of the programme

Only limited experience has been accumulated to date, the new guarantee programme having been launched in 1994 only. Debt covered by outstanding Bank guarantees currently

totals some USD 1 ½ bn. World Bank officials consider that the guarantee programme is likely to remain a limited aspect of total IBRD activities, at least for the foreseeable future.

3. National vehicles for insuring political risks

3.1. Background: a considerable institutional heterogeneity

Export Credit Agencies (ECAs) have been the main source of supply of political risk insurance and guarantees, and their services are greatly valued by project sponsors and financiers, particularly in Europe and Asia. Their primary objective is the **promotion of national exports through insurance or direct extension of export credits**. Public sector guarantees are generally limited to operations deemed priority operations by the government.

ECAs traditionally give insurance and guarantees to either (or both) the exporters who are supplying or constructing projects or the banks who are providing the loans to finance the projects. This insuring activity would typically be that of COFACE of France, Hermes of Germany, SACE of Italy, ECGD of the UK, EID/MITI of Japan and CESCE of Spain. (See Attachment II to Annex 10). In addition to insurance activities, most agencies are involved in official financing support. Several agencies make export finance directly available to borrowers (US Eximbank), or will refinance credits extended by the private market.

A variety of solutions have evolved with regard to government involvement. The organisational form of the institutions providing insurance or financing ranges from a section of a ministry, or a government agency, through independent government agencies and semi-public joint-stock companies to private institutions operating partly under an agreement with the government. These solutions are reflected in the way these organisations are funded: from the budget, from special government funds, from loans and capital from the government, or from shares and bonds. Austria, Germany and the Netherlands conduct their export credit insurance programmes through private companies (OeKB, Hermes, and NCM respectively).

Another aspect that varies widely is the position of the export credit agency on the market for officially supported (insured or financed) export credit or, conversely, the role played by private organisations such as banks and insurance companies. This is complicated by the fact that some private organisations act partly in the public sphere on behalf of governments (Hermes and Treuarbeit in Germany, COFACE in France), and partly in the private sphere on their own account, while some public organisations act from time to time as if they were privately owned. An increasing number of official agencies are also experiencing the pressure of competition from private sector agencies.

Thus there is a wide range of approaches. At one extreme are those that combine a complete range of insurance and guarantee facilities, as well as additional options such as currency risk insurance, with a comprehensive financing support system (including participation in mixed credits). In the middle are systems that offer the usual insurance cover (pre- and post-shipment cover for political and commercial risks on individual or whole turnover policies), some development aid credits and additional insurance facilities, and credits that the domestic market cannot provide. At the other extreme would be an approach that provides only insurance, guarantees and credits that the international market cannot provide,

such as political risk insurance for higher risk countries or subsidised credits or guarantees for matching purposes and development aid credits.

Despite this institutional heterogeneity, it can be stated that **in their medium and long term and investment insurance activities, ECAs are acting as, or for, or on the account of their governments and are primarily engaged in supporting/providing tied finance**.

3.2. Risks covered

Traditionally ECAs cover embraces both political and commercial risks but they see political risk (defined as country risk) as the most important risk in medium- and long-term financing to developing country. All OECD countries and a number of other countries have set up specialised organisations to insure at least the political risk (risk of non-payment because of government-imposed restrictions) of providing export credit to foreign buyers, and many will also cover the "transfer" risk (risk of non-availability of foreign exchange to meet repayment obligations), although cover may be very restricted in markets with poor payment experience. Most of the institutions providing such insurance will also cover the commercial risks (risks of non-payments because of bankruptcy or default by the buyer) and some reinsure such risks taken by private institutions.

Although the relations between ECAs and their government are varied and often complex, **medium and long term political risks insured by ECAs are invariably taken--ultimately--by their governments.** This is not an area in which private sector insurers or reinsurers have been interested. **Many ECAs also provide Investment Insurance against selected political risks** (transfer of profits and dividends, expropriation/nationalisation and war/civil war).

There are two main approaches (see Attachment III to Annex 10 for details on risks covered by individual national schemes):

- the UK, US, Japan and Canada either lend directly or give 100% and unconditional guarantees to lending banks;
- France, Germany, Italy give conditional insurance and less than 100% cover.

Almost all bilateral official ECAs, lenders and insurers, provide coverage for traditional political risks--including transfer difficulties, war, revolution and nationalisation--. Agencies are for the most part ready to cover non-payment by government entities, but cover for changes in government regulations or cancellation of orders or export and import licenses is less readily available. Few will provide cover or protection against exchange rate changes. COFACE provides cover for embargo, cancellation of import licenses, war and civil strife.

Of note, political risk is defined as the risk associated with the country and the risk of non-payment by a public sector debtor (public sector entity which cannot be declared bankrupt and whose default would be the direct consequence of the state's responsibility). Hermes, COFACE and CESCE determine the basic premium for public sector buyers only on the basis of the country risk.

3.3 Pricing and Risk Mitigating Techniques

ECAs' financial results hinge crucially on two factors: realistic pricing and diversification of risks. After a decade of weak financial performance, all ECAs see realistic pricing of risks as an important objective. Premia were increased on several occasions since the early 1980s to limit the cash flow deficits incurred by most ECAs. They have refined and systematised their country risk assessment process and reinforced the link between the risk assessment process and cover policy. In particular, there is now a more direct link between the rate of premium and the perceived degree of country risk.

Premia vary with the borrowing country, the type of borrower, and the maturity of the export credit. Agencies see differentiated premium rates as a way to help dampen demand in riskier markets, thus rationing cover in an economically efficient manner, and to encourage a shift in the direction of trade towards stronger markets.

ECAs use highly structured premium systems. They classify countries into risk categories. Some ECAs attempt to quantify risks, and attach specific credit scores to countries. For instance, ECGD, COFACE and the US Eximbank employ quantitative systems of risk assessment and assign a probability of default and an expected loss coefficient to each new credit. ECAs consider payment performance the single most important factor in their assessment of country risk. They give significant weight to economic performance (which includes economic policies), indebtedness and adequacy of international reserves position. Some agencies monitor closely ratings of bond issues and secondary market prices of commercial bank debt of borrowing countries.

The average level and steepness of the premium curve varies substantially across agencies, as do the degree of differentiation among recipient countries and the methods of calculating premia. These differences reflect the variety of views on the relative importance of various risks and on the appropriate method of pricing each of them, as well as the fact that premium levels are used in conjunction with varying constellations of other cover policy instruments, and that the terms of the cover agreements vary widely.

For instance, the **premium system used by Hermes**, the German export credit insurance agency, utilises five country risk categories, namely:

Category 1: OECD countries

Category 2: Countries with well-established payments records and no expected payment difficulties;

Category 3: Developing countries with the typical level of developing country risk;

Category 4: Rescheduling countries and those with imminent payment problems;

Category 5: High-risk countries for which Hermes is off cover either entirely or for medium- and long-term loans.

A country where Hermes has a very high concentration of risk may be assigned to a higher country category. Premium charges are due at the time the risk begins, with very

limited exceptions. The new system differentiates between public and private buyers both for suppliers' and buyers' credits. **In the case of public buyers, the basic premium is determined only by the country risk.** For Category 3 countries - the category taken as the basis premium for determining premia - 1 percent of the covered amount is charged. Premium levels for other categories are adjusted by a factor reflecting the difference in country risk relative to Category 3. Thus for Category 1, the basic premium is 0.33 percent; for Category 2, 0.67 percent; and for Categories 4 and 5, 1.5 percent and 2 percent, respectively. In addition, a further, time-dependent premium component is charged. The annual level of this component is 0.72 percent of the outstanding covered amount for Category 3, and this level is adjusted by the same factors as the basic premium for each other category.

In the case of private buyers, an additional flat premium component is added, amounting to 35 basis points for the basic premium portion and an additional 25 basis points per annum. This surcharge is reduced if a commercial bank guarantee is available,[4] or an international financial institution is involved, and in the case of co-financing with bilateral aid.

Although useful, **premium differentiation has clear practical limits as a risk mitigating technique**. In certain cases, even the highest premia fail to compensate adequately for some of the risks taken, in particular in high-risk markets where demand for cover is highly inelastic with respect to premium levels. This is also a problem when premia are kept, for political reasons, at levels below those that would have been implied by risk assessment.

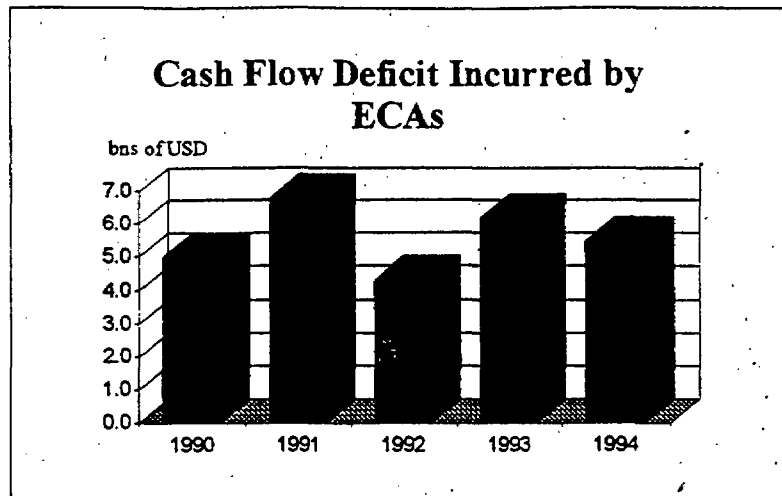
Risk diversification has proved to be difficult because of the strong links to particular markets for historical and geographical reasons and because of adverse selection: official support for export credit is sought only for exports for which private sector insurance is either not available or is more costly and for which self-insurance is seen as too risky by the exporter. All ECAs have therefore strengthened and refined risk-sharing and risk-reducing techniques to ensure portfolio diversification and improve the quality of their portfolios.

Almost all ECAs found it necessary to supplement high premia with other instruments, particularly **quantitative ceilings**, for countries seen as high risks. Limits on total exposure continue to be a feature of most agencies' cover policies toward at least some developing countries. This can be supplemented by **reducing the percentage of cover** on the assumption that forcing the exporter or financier to bear a part of the risk helps safeguard against badly designed or unviable transactions.

3.4 Performance in recent years

ECAs have incurred huge losses during the 1980s as a result of successive debt crises and creditor governments have had to fund substantial cash flow deficits. For several years, they have paid claims that were in excess of their premium income and most of them--at least in respect to their medium and long-term credit activities--have accumulated deficits. In addition, the recent trend toward debt forgiveness under the Toronto, Trinidad and Naples terms has worsened considerably the recoverability of some claims they have paid, with a negative impact on the finances and balance sheets of ECAs.

[4] From a bank acceptable to Hermes as the sole debtor for the amount involved.



Many agencies have responded with institutional and structural changes designed to improve their risk management techniques. However, agencies sometimes find it difficult to react appropriately to developments in borrowing countries, especially in major markets.. In particular, ECAs tend to stay on cover too long in countries that do not have apparent debt-servicing difficulties but are pursuing policies that could lead to future debt servicing problems.

One difficulty is that **early warning signals are usually not conclusive.** Moreover, ECAs are faced with strong pressure to help exporters gain an early foothold in countries seen as future growth markets, such as many of the countries in transition. In some of these cases, export credits have also been used as channel for significant financial support, even though country risk assessments indicated the need for a much more cautious stance. Conversely, most ECAs remain slow in reopening cover for countries that have had poor payments records in the past but that have more recently improved their policies and cleared their arrears.

3.5 ECAs and project financing

The traditional security for ECAs in projects in non-OECD countries has been government or sovereign guarantees. However, as other financiers/insurers, ECAs have been confronted by a major change in their market as a result of the ongoing world-wide privatisation wave. Moreover, there has been a **disenchantment and poor experience with sovereign guarantees** (see above). Finally, developing countries are increasingly reluctant to grant sovereign guarantees, in particular to private sector borrowers, in part under the pressure of the IMF (and the World Bank).

Together, these factors have resulted in much greater interest in limited recourse financing on the part of ECAs. However, project financing presents a whole new range of challenge and problems. Moreover, only limited experience has been accumulated by ECAs in this field and the lessons drawn below are very tentative. (These are drawn from a paper by Mr. Stephens--see references-- and discussions with representatives of various ECAs).

- In the emerging business environment, "privatised" needs to be in quotation marks because governments remain crucial elements in the financial viability of limited recourse projects;

- Many of the traditional mechanisms in ECAs and the OECD "regulatory framework"-- the so called Consensus-- are not ideally suited for project financing and privatised projects. Most of the present funding and insurance infrastructure is based on government buyers or government borrowers or government guarantees in respect to medium and long term credits for projects.

- ECAs are faced with considerable constraints: they do not have the necessary expertise in all sectors; their analytical capacity is limited (in terms of projects they can handle in the same time), designing and implementing risk-sharing arrangements has been very difficult;

- In designing **risk sharing mechanisms**, ECAs have preferred to **list the risks they cover** (and to define those risks as precisely as possible) and to leave all other risks to third parties. Moreover, they have had to **give up splitting risks between political and commercial risks**. In the field of project finance, ECAs have realised that insured parties (banks and project promoters) are very skilled in converting any event of default into the result of a political risk. Therefore, most ECAs now prefer to cover all types of risks involved in a transaction and to limit their exposure to any single project by sharing risks with other guarantors (including other ECAs).

- Breaches of contract is a most difficult issue but can be insured by certain ECAs, mainly as creeping expropriation.

4. Private political risk insurance market

The Private Political Risk Market emerged in the early 1970s when Lloyd's underwriters and brokers pioneered the insurance of overseas investments and exports contracts against political risks. Although the market has grown in importance to become an established market, it has remained a **relatively small niche of the global insurance industry and continues to complement rather than replace the function of state export credit insurance**. Moreover, heavy losses in the late 1980s and early 1990s have forced a number of players to leave the market, increasing the **oligopolistic nature of the private market**. This resulted in part from the shrinkage of the world reinsurance market. Finally, it is still a confidential market and very little information available.

4.1 Structure of the market

The main sources of private political risk insurance players include the Lloyd's of London, [5] and a handful of insurance companies (including monolines and multilines as well as

[5] **Lloyd's** is a market where member brokers place orders with the member underwriters, and can be compared to a stock exchange. Lloyd's underwriters are typically wealthy individuals ("the names") who

captives), most of which are based in the USA. In addition to Lloyd's, the main players include AIG (USA), CITI (a subsidiary of Citibank), Exporters Insurance Company Ltd., and UNISTRAT (Paris). Access to the clientele is mediated through a world-wide brokerage network and revenues and exposures are spread world-wide through an elaborate re-insurance system which serves as an essential portfolio management devise.

Brokers act as independent intermediaries between the purchaser and provider of insurance, doing the bulk of the paperwork without taking any risk on their own account. The usual brokerage commission varies between 15% and 20% of the premium. Only few brokers can handle political risk insurance contracts: indeed, it is difficult to identify and quantify political risks and to draft appropriate contracts.

Underwriters write insurance policies on their own account. Frequently, however, they roll over part of their exposure to **reinsurers**. There are two main forms of reinsurance: "treaty" reinsurance (providing a form of blanket coverage) and ad-hoc risk-by-risk "facultative" reinsurance. Reinsurance does not, with few exceptions, touch upon the legal relationship between the underwriter and the insured party. Rather it provides for reimbursement of the underwriter by the reinsurer of some of the cash out-flow resulting from claims to the insured. In exchange, the underwriter shares with the reinsurer in the premium under a key which reflects their respective exposures.

Total premiums for political risk insurance in 1995 is estimated to have been in the neighbourhood of USD 55-60 million, (CITI: USD 16-17 mn; AIG: USD 14-15 mn; Lloyds' USD 14-16 mn; UNISTRAT: USD 12 mn) for a **total volume of business of some USD 7-8 bn**.

Demand in the Private Market is mainly for two kinds of operations:

- operations that could be eligible to public insurance schemes but that do not fulfil all eligibility requirements (operations launched before the insurance request, significant foreign participation, lack of national interest, non-eligible country).

- specific operations or when insurance need is limited to specific parts of the operation or for restricted or a-typical risks.

Foreign exchange inconvertibility remains the main demand in the contract frustration field.

In all other cases, and because of the limitations of the Private Market (expensive and short-term orientation) public sector insurance provides the most economical source of coverage.

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group themselves into syndicates. Those syndicates are neither legal entities nor partnerships, and each member severally is liable only for his slice of the underwritten risk. They are managed by "underwriting agents" who underwrite risks on behalf of each individual member of the group. About 120 syndicates can write political risk policies. In practice, only a few syndicates are active in this market segment.

4.2 Risks covered

Private insurers operate only in markets and classes of business where premiums charged are deemed adequate for the risks assumed. The coverage sold by private companies is essentially geared to insure **short-term transactions of less than one year and supplements that offered by government agencies**. (For instance, CITI's average life of coverage is 13 months). Coverage period still does not exceed three years. Of note, AIG is considering the possibility to extend this coverage to up to seven years. The constraint is mitigated somewhat by so-called "revolving mechanisms": policies provide for automatic renewal at the end of each year for another three years. But the insured cannot claim any right to extension and premium tend to be increased in case of a deteriorating situation.

Private insurers have focused on the short-term segment of the market because this is the least risky. Indeed, short-term transactions are less vulnerable to contagious events which lead to catastrophic risks. Countries experiencing payment difficulties, which cannot turn to other sources of financing, generally settle their short-term debts in order to secure vital imports even when general debt servicing has been suspended. Short-term contractual obligations are generally not included in rescheduling procedures.

Because of the very limited time coverage, private market insurance are **generally inadequate to cover new investments**. In this case, investors are interested in being covered for the time they need to recoup their investment. Considering that frequently some "lead time" elapses before recovery begins, clients largely depend on underwriters' fair dealing in renewing the policy at stable terms. This is mainly for this reason that **private insurance is practically confined to existing investment.**

In geographical terms, private insurers focus primarily on **low- to medium-risk countries** in Asia and Latin America.

This being said, the private market is a **flexible source of political risk insurance**, particularly for obligors located in low-risk markets. The private market can tailor its policies to needs of individual clients and can write highly specialised "manuscript" coverages, which gives it a market edge vis-à-vis national schemes.

Under its political risk policies, the private market excludes commercial risks which are clearly within the control of the investor. Excluded risks also extend to losses caused by currency fluctuations or devaluations, as well as losses resulting from a general deterioration of the business environment even if such deterioration can be ascribed to political instabilities. Private insurers can provide three kinds of insurance against political risks:

- **export credit insurance**: protects exporters from losses due to the inability of foreign buyers to meet payments on contracts as a result of adverse political decisions or circumstances.

- **contract frustration insurance**: protects exporters should a foreign government's intervention somehow prevent an overseas customer from fulfilling a contractual commitment. Foreign governmental acts may range from trade embargoes and acts of war to currency inconvertibility. (AIG's coverage extends to contract or license cancellation caused by government interference; in contrast, Lloyds' does not cover

breach of contract because they consider that there is no way of knowing whether the commitment is fair and reasonable).

- **confiscation insurance**: protects an investor against the seizure of overseas assets by government nationalisation or expropriation.

In practice, private insurers have focused on transfer risks, expropriation and nationalisation. They may provide cover in limited instances against war, revolution and natural catastrophes. Virtually none provides cover against exchange rate changes.

Of note, when insuring a public obligor, private market insurers generally cover all reasons for non-performance by the obligor because risks are perceived to be too blended. For this eason, **insurers do not attempt to unbundle risks for public sector obligor and take full credit risk.**

4.3 Pricing Policies

The private market has remained an **expensive source of political risk insurance**, except in particular niches of the market (low-risk markets for existing investments). It provides **ad hoc, market driven/risk-related pricing**. As a result, unlike national schemes, **premiums vary considerably**. Annual rates range from as little as 0.1% to as much as 7% or even more of the insured value. Normally, rates appear to **cluster between 1% and 3%**; premiums below 1% apply almost exclusively to risks in industrialised countries or to global policies and quotations exceeding 5% are frequently intended to discourage companies from seeking insurance at all (cut-off rates). Examples quoted are of some 100 bp for currency convertibility risk; 100 bp for war risk; 50-100 bp for confiscation risk.

Premiums do not reflect the mathematical probability of loss (which is extremely difficult to evaluate), but rather the laws of supply and demand. More precisely, they are determined by underwriting capacity, risk perception, and general business variables. Underwriters usually fix premium rates dependent upon how much business they have already in the respective risk class, trying not to go beyond certain limits for aggregation of risks.

Regarding risk assessment, because of their total freedom in accepting risks and pricing policies, private underwriters can give more weight to project-related variables than to host country-related variables as determinants for foreign investors' or contractors' vulnerability.

Private underwriters' risk assessment includes the following aspects:

- vulnerability of the specific project: In that regard, it has been shown that large fixed equity investments are especially vulnerable.

- vulnerability of the sector

- fairness of contractual arrangements

- experience and reputation of the insured

- political stability of the host country
- home country-host country relationships
- umbrella factors (i.e., co-exposure with reputable persons or institutions in the project).
- contingency planning
- prospect for recovery, in case of loss (see below under indemnification).

4.4 Other Policies

Unlike national insurance agencies, private underwriters are **not subject to any political constraints**. Their underwriting, portfolio management, premium rating and risk management follow exclusively commercial rules. They have to show profits to get the capital reserves which determine their underwriting capacity and must meet client's expectations to sell insurance at profitable terms.

In striking this balance, underwriters do not seek to avoid paying claims as their first priority. The underlying consideration is to develop, on a long-term and overall basis, more premiums than claims. (Some consider that 40-50% of premium revenues should be paid out on claims.)

As a result, risk analysis is not of primary concern to underwriters. At the core of their management are attempts at balancing their portfolio which means the transformation of unmanageable contingencies into calculable costs by application of the law of large numbers. Yet, **political risks do not lend themselves to easy probability mathematics since they can aggregate to country, regional and even world-wide catastrophes.**

Portfolio balancing, risk analysis and premium rating are all closely intertwined. Risk variables determine the categories under which portfolios are balanced. In addition, perceived riskiness has a bearing on underwriters' decision to what line of business they allocate how much capacity. Premiums certainly reflect risk perceptions. But they are also function of available capacity, competition in a particular line of business, as well as general business considerations.

To build up a viable package of risks, different political risks are aggregated into one portfolio which frequently includes export credit risks. Diversification is sought by putting appropriate ceilings on risks which could materialise as a result of the same event or of interrelated events. The main ceilings relate to host countries, projects and clients. In addition, portfolios are balanced according to the three main types of political risks: confiscation and expropriation, various forms of contract frustration, riot and civil strife. Consideration is also given to a proper mix of sectors and home countries. Country ceilings quoted by AIG are of USD 425 mn; other major underwriters are believed to have lower country ceilings. Ceilings for individual projects are of USD 85 mn at AIG and lower in other major underwriters.

Risk assessment and underwriting capacity are interdependent. For instance, in the leading US underwriter, all exposures are graded between 1 and 10 according to the perceived risk level, level 1 reflecting the lowest and level 10 the highest grade. The insured amount is then multiplied by the risk coefficient so that the highest risks absorb 10 times the capacity of the lowest.

One of the important portfolio balancing techniques used in the private market is reinsurance through which all or part of liabilities assumed by a few underwriters is transferred to other insurance companies. In fact, the existence of re-insurance capabilities is a sine qua non condition for the existence of the Private Market for political risk insurance. As a result of reinsurance, a considerable number of companies (up to 1,000) can share in the insurance of a single large risk. The "atomisation" of large risks enables underwriters to increase their underwriting limits. For instance, CITI re-insures 87% of its risks. Other insurers are believed to retain a much larger share of the risk on their portfolio (some 40 % according to some interlocutors). AIG confirmed that they keep a "substantial share" of the risk on its balance sheet. However, they needed the assurance from their reinsurers that they would provide reinsurance for 7-year risks before considering the introduction of a new, longer term facility.

An essential element in the evaluation of risks is recovery. Regarding **indemnification**, any right which an insured party might acquire against a host country in connection with an expropriation/confiscation are, upon indemnification, being subrogated to the insurer. As a matter of business practice, underwriters require investors, under a due diligence clause, to attempt recovery from the host country before they pay out the claim. A waiting period of usually 12 months between the event causing the loss and indemnification aims at facilitating settlements between investors and host governments.

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GUARANTEE PORTFOLIO BY HOST COUNTRY (as of June 30, 1995)

(by percentage of maximum contingent liability)

Host Country	Portfolio Distribution	Host Country	Portfolio Distribution
Pakistan	9.7	Chile	3.0
Argentina	9.2	Costa Rica	2.0
Peru	8.5	Venezuela	1.9
Brazil	6.5	Honduras	1.9
Turkey	5.7	Ecuador	1.5
China	4.9	Hungary	1.4
Jamaica	4.3	Viet Nam	0.8
Czech Republic	4.1	Uganda	0.7
Tunisia	4.0	Morocco	0.6
Bangladesh	4.0	Russian Federation	0.6
Poland	3.4	Ghana	0.6
Philippines	3.4	South Africa	0.5
Indonesia	3.2	Tanzania	0.5
Slovak Republic	3.1	Kazakhstan	0.3
Trinidad & Tobago	3.1	Bulgaria	0.2
Uzbekistan	3.1	Madagascar	0.1
Guyana	3.1	Cameroon	0.1

Source: MIGA 1995 Annual Report

Information on Export Credit Agencies and National Investment Insurance Schemes

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FRANCE

ORGANISATION

The Compagnie Française d'Assurance pour le Commerce Extérieur (COFACE) was set up in 1946. A joint stock company with a capital of FRF 300 million, it is subject to the commercial code. Most of its shareholders are public sector companies (banks or insurance companies). Its activities fall into two spheres. Its main business is the provision of credit insurance and performance guarantees for commercial and financial transactions and other insurance services related to or designed to facilitate such transactions. It is also empowered to administer official credit insurance schemes on behalf of the government, and in this capacity it provides cover for a number of risks relating to international trade.

On its own account, COFACE covers commercial risks world-wide and political risks in OECD countries (excluding Turkey) provided that the credit risk does last not longer than three years. As the cover for these risks has not been backed by a State guarantee since 1 January 1990, COFACE reinsures them on the private market.

On behalf of the government COFACE provides cover for all other risks.

RESOURCES

COFACE derives its resources from premium income, investment income, and remuneration it receives from the government for administering the official credit insurance scheme.

RELATIONS WITH THE STATE

For guarantees issued on behalf of the government, credit policy is formulated at the beginning of the year by the Ministry of Economic Affairs and Finance. COFACE processes applications for guarantees and submits then to the CGCE. Decisions are made by the Director of External Economic Relations upon receipt of a concurring opinion from the CGCE. COFACE is also authorised to make decisions within the limits of the powers delegated to it by the Director of External Economic Relations. COFACE issues offers of cover and policies, settles claims and recovers moneys on behalf of the Government.

RELATIONS WITH THE PRIVATE SECTOR

COFACE has concluded a reinsurance treaty with the private sector for the business it conducts on its own account. In special cases, it sometimes concludes co-insurance agreements with other insurance companies.

COFACE does not have a statutory monopoly. The private sector is free to compete with it for both political and commercial risk business, but there is little competition at present.

FOREIGN INVESTMENT GUARANTEE

This guarantee covers political risks for a minimum of five and a maximum of ten years. It covers the risks of interference with property and non-transfer of income or dividends as a result of events of a political nature.

GERMANY

ORGANISATION AND STRUCTURE

Under the official export credit insurance scheme, the Federal Government carries both the political and the commercial risks. A mandatary consortium is authorised to provide and manage the insurance business in the name and for the account of the government. This consortium consists of a private insurance corporation, Hermes Kreditversicherungs AG (Hermes), the leading partner in the consortium, and Treuarbeit AG, a corporation in which public bodies hold a minority stake.

RESOURCES

The Federal Government can grant cover only within an exposure limit on total commitments fixed annually by Parliament. The ceiling for export credit insurance in the 1991 budget year was set at DM 165 billion. Thus, the authority for new cover essentially depends on the commitments already existing at the beginning of the fiscal year (about DM 152 billion at the end of 1991). Claims are paid from the budget, which is credited with premium payments and any recoveries from earlier claims.

RELATIONS WITH THE STATE

The consortium acts only in the name and for the account of the State.

In the Budget Law provision on export cover, a distinction is made between cover for promotion of exports and cover for exports of national interest. However, there are no preferential conditions either for cover in the national interest or for exports destined for developing countries.

Least-developed countries qualify for genuine aid facilities. Transactions that are of particular interest to the government may involve greater risks, as compared with normal standards. They are classified separately but are not subject to special ceilings.

INVESTMENT RISK INSURANCE

Capital investment risks are not included in the export guarantee system. There is a special programme for capital investment risks that is also handled by the Hermes-Treuarbeit consortium. The second-named company is the leading partner in this field. This programme provides cover against political risks such as nationalisation, expropriation, war, rebellion, payment moratoria, inability to convert or transfer remittances, and comparable actions or situations. Cover can be provided for up to 20 years and for at most 95 per cent of the investment. Apart from a flat charge of 0.5 to 1 per cent of the amount covered, a premium of 0.5 per cent a year of the amount covered is presently charged.

ITALY

ORGANISATION AND STRUCTURE

FUNCTION

The Special Section for Export Credit Insurance (SACE) was set up in 1977 by an Act regulating export financing (Act No. 227 of 24 May 1977), which made it responsible for the administration of government insurance and export credit guarantee programmes. SACE is an autonomous section of the Istituto Nazionale delle Assicurazioni (National Insurance Institute - INA). SACE has its own management and assets. It is empowered to insure and reinsure political risks, natural disasters, economic and commercial risks as well as exchange rate risks.

RESOURCES

The resources available for the settlement of claims derive, in principle, from premiums paid, recoveries, reserves and other assets, and from an endowment fund (at present L 7 274 billion), which is financed by the State.

RELATIONS WITH THE STATE

Insurance liabilities of SACE are guaranteed by the State within the limits of a revolving fund of L 18 000 billion for guarantees not exceeding 24 months, and a ceiling fixed annually under the Act approving the State budget for guarantees with a longer period. For 1993 this ceiling has been fixed at L 12 000 billion.

RELATIONS WITH THE PRIVATE SECTOR

Private insurance companies may insure export credits independently of SACE. The only private company with which SACE has signed a reinsurance agreement is the Società Italiana Assicurazione Crediti S.p.A. (General Credit Insurance Company - SIAC). Under this agreement, SACE undertakes to reinsure 45 per cent of all short-term commercial risks and 95 per cent of short-term political risks covered by SIAC. SIAC resources are entirely private.

INSURANCE FOR DIRECT INVESTMENTS ABROAD

Insurance for direct investments abroad has been available since July 1979. The scheme is applicable for any direct investment abroad, whether in the form of transfer of funds, supply of capital goods, technology, licences or patents, or for research and development activities and mineral production. The risks covered are: nationalisation, expropriation with inadequate compensation, confiscation, sequestration or any other measure or decision made by foreign authorities, as well as political developments and natural disasters that may result in loss or make it impossible for an Italian firm to continue its activities or be paid the sums due to it. The maximum cover is 70 per cent of investment value plus an annual 8 per cent of income from investments; the premium is 0.8 per cent a year.

NETHERLANDS

ORGANISATION

The Nederlandsche Credietverzekering Maatschappij N. V. (NCM) is a subsidiary of NCM Holding N. V. Shareholders of NCM Holding comprise major Dutch banks and insurance companies, as well as four foreign reinsurance and credit insurance companies. NCM has provided export credit insurance since 1925. An agreement with the Dutch government in 1932, broadened in 1946 and renewed in 1961, 1983 and 1991, provides for reinsurance with the Dutch government of non-commercial risks and commercial risks that fall outside the scope of private insurance.

NCM insures commercial risks for its own account and reinsures with the Dutch government non-commercial risks as well as those medium- and long-term commercial risks that it can take neither for its own account nor for the account of its private reinsurers. As the agreement with the Dutch government is based on a reinsurance arrangement, NCM handles all matters relating to credit insurance, including the processing and payment of claims.

NCM Credietverzekering voor Oost-Europa N.V., another subsidiary of NCM Holding, covers lease transactions for capital goods with Eastern European countries within the framework of a special credit insurance facility. All risks are reinsured with a trust, Stichting Economische Samenwerking Nederland Oost-Europa (SENO), set up by the Ministry of Economic Affairs.

RESOURCES

NCM Holding's activities for its own account are supported by its equity of NGL 304 million (31 December 1992). Technical reserves amount to NGL 690.2 million.

RELATIONS WITH THE STATE

NCM is authorised by the Minister of Finance to issue policies and addenda to policies if the cover extended is in line with general policy and the maximum liability does not exceed NGL 10 million per policy for buyers in all countries. For amounts between NGL 10 million and NGL 25 million, approval of the Export and Import Credits Guarantee Department of the Central Bank is required. For amounts exceeding NGL 25 million the approval of the Minister of Finance is required.

Co-operation between the government and NCM is based upon the principle that commercial risks are usually covered for the account of NCM and private reinsurers. Non-commercial risks are covered for the account of the government by way of reinsurance. The following risks are covered for the account of the government:

- political risks (including transfer risk);
- payment risks attached to transactions with government buyers;

- protracted default risks on private buyers in developing countries and insolvency risks on private buyers in certain developing countries, who cannot be reinsured in the private market;
- protracted default risks and insolvency risks incurred with private buyers in industrialised countries where the credit term exceeds five years;
- unfair calling of bonds;
- foreign exchange risks;
- political risks in connection with investments in developing and Eastern European countries covering such risks as expropriation, transfer delays, war, etc.

INVESTMENT INSURANCE

Based on an Act of Parliament of 23 April 1969, cover may be given for political risks in respect of new investments or extension of existing investments in developing countries, provided that an investment protection agreement has been concluded with the country concerned and the investment contributes to the economic development of that country. The government of the country where the investment is made has to approve the investment in order for it to qualify for insurance. Investment insurance has a maximum term of 15 years after completion of the investment or 20 years after issuance of the policy. As a special facility, investment insurance is also possible for investments in Eastern European countries (including the republics of the former USSR).

SPAIN

ORGANISATION

FUNCTION

The Spanish Export Credit Insurance Company (CESCE) was incorporated as a joint stock company in 1970. It supports Spanish exporters by means of a system of insurance policies designed to cover both commercial risks and political and extraordinary risks, as well as what are known as special risks. CESCE covers commercial risks for its own account and political and extraordinary risks on behalf of the State. CESCE also arranges joint insurance and co-insurance. It has concluded bilateral agreements with other export credit agencies on joint insurance.

RESOURCES

CESCE's share capital totals ESP 400 million; including a State share of 50.25 per cent. The remaining 49.75 per cent are owned by the private sector. Accumulated reserves total ESP 6.9 billion. Capital funds therefore total ESP 7.3 billion. For commercial risks, resources are provided by premiums paid, recoveries, fees and investment income.

For political and extraordinary risks, which are managed on behalf of the State, the company relies on reserves constituted by premiums paid, claims recovered, and contributions by the State to cover these specific risks.

RELATIONS WITH THE STATE

CESCE relies on the reserves described above. Its relationship with the State is governed by Law 10/1970 of 4 July 1970, which sets the legal grounds for its incorporation.

RELATIONS WITH THE PRIVATE SECTOR

Until 1984, CESCE had exclusive responsibility for commercial risk insurance. Since then, private companies authorised by the government have been able to operate in this area. Under the Ley de Ordenación del Seguro Privado (Private Insurance Act) of 2 August 1984, CESCE may reinsure its risks with Spanish or foreign reinsurers.

Foreign investment policies cover the risks of expropriation or the impossibility of transferring profits of Spanish investors in foreign countries.

UNITED KINGDOM

ORGANISATION

FUNCTION

The Export Credits Guarantee Department's (ECGD) main objectives are to facilitate UK exports by providing insurance and guarantees to UK exporters against the risks of non-payment by overseas buyers and to banks against non-payment of the finance that they advance to UK exporters and to overseas borrowers for goods sold on credit terms overseas.

ECGD derives its statutory powers from the Export and Investment Guarantees Act (EIGA) of 1991. Guarantees are given to UK exporters for exports of major projects and capital goods, construction works projects and services contracts. Investment insurance is covered under Section 2 of the Act. Reinsurance is also given to private sector insurers for short-term export credits.

ECGD is expected to run its credit insurance operations so as to generate sufficient reserves to give the level of break-even required by UK ministers. ECGD publishes commercial-style trading accounts and carries out all the administrative work necessary to meet these objectives. This includes processing applications for cover from initial receipt to issuing guarantee documents and the supporting tasks of: obtaining relevant commercial and economic information about buyers, borrowers and countries; determining premium rates and methods of risk control; collecting premiums; handling and paying claims; keeping accounts of income, expenditure and reserves; and maintaining relations with similar institutions in other countries.

RESOURCES

ECGD derives its income primarily form premium charges for its policies. It invests its cash surpluses in, or as the case may be, funds its cash deficit from, the UK Consolidated Fund. ECGD earns or pays interest on the positive or negative balance it holds in the Consolidated Fund. Recoveries of claims payments, interest on Consolidated Fund balances when in credit, and interest receivable under international debt rescheduling agreements are the main sources of secondary income. There are currently statutory liability ceilings on commitments in respect of trading operations of £ 35 billion for sterling business and SDR 15 billion for foreign currency business. These ceilings may be raised to £ 50 billion and SDR million by Statutory Instrument.

Interest rate support is provided from public funds, but while it is not limited to an annual ceiling, it is subject to public expenditure control. For the financial year 1992/93, the total net cost to public funds of interest support for fixed-rate export finance amounted to £ 111 million.

RELATIONS WITH THE STATE

ECGD is a government department responsible to the Secretary of State for Trade and Industry. The Export and Investment Guarantees Act of 1991 requires ECGD to obtain the consent of Her Majesty's Treasury for every guarantee it gives. In practice, the Treasury has delegated authority to ECGD to transact routine business within the constraints of the Department's risk management system. ECGD consults the Treasury and other UK government departments that might have an interest in any business that seems likely to breach those constraints, or might in any way be considered novel or contentious.

RELATIONS WITH THE PRIVATE SECTOR

Insurance for non-project short-term export credit is the primary responsibility of the private sector. ECGD does not offer any facilities direct to exporters for this sector. However, ECGD does provide a reinsurance facility to private sector insurers for short-term business where there is insufficient private capacity or where the private sector will not accept particular risks or risk on particular markets.

For project business, ECGD has very occasionally concluded risk-sharing arrangements with commercial lenders when it has been necessary to reduce ECGD's exposure.

INVESTMENT INSURANCE

ECGD's investment insurance scheme insures UK companies that invest directly, by equity or loan, in overseas enterprises. Cover is provided against the risks of war, expropriation and restrictions on remittances. The normal initial maximum period of cover is 15 years, and a premium of between 0.7 and 1 per cent is charged annually on the current insured amount. In addition, a commitment premium is charged on any difference between this amount and the maximum insured amount determined at the outset of the cover.

UNITED STATES

ORGANISATION

The Export-Import Bank of the United States, chartered in 1934 as an independent government agency, facilitates US exports by providing short- and medium-term insurance and medium- and long-term loans and guarantees. The guarantee and insurance coverage offered by Eximbank is designed to protect exporters against political and commercial risks. Eximbank derives statutory authority for the operations of its programmes from the Export-Import Bank Act of 1945, as amended.

Through its programmes, Eximbank fills gaps left by private-sector sources of export credit financing. For example, Eximbank provides longer maturities than commercial banks which prefer short terms, assumes foreign credit risks that the private sector finds unacceptable within the limits of its information on creditworthiness grounds, and neutralises the export credit subsidies of foreign government.

RESOURCES

Eximbank finances its operations with a combination of appropriated and borrowed funds. Under the Credit Reform Act of 1990, a subsidy amount is calculated for each direct loan, loan guarantee or insurance policy, based on the terms of the credit (grace and repayment periods, fees and interest rates) and the estimated probability of default on the credit. The subsidy component of the credit is obligated out of a total subsidy appropriation, while the remainder of the credit is borrowed from the US Treasury at interest rates based on Treasury securities of comparable terms.

For fiscal year (FY) 1993 (which ended 30 September 1993), the total subsidy appropriation for Eximbank programmes was USD 757 million. The Congressional Appropriations Bill did not contain individual programme limitations; however, this subsidy appropriation could support loans, loan guarantees and insurance not to exceed USD 15.5 billion. In FY 1992, the total subsidy appropriation for Eximbank programmes was USD 603 million, which was used to support loans, loan guarantees and insurance with a total value of USD 12.2 billion. In FY 1991, the last year before the Credit Reform Act came into force, the total face value of Eximbank direct loans, loan guarantees and insurance was approximately USD 11.5 billion.

The subsidy rate for each authorised credit is re-estimated each year on the basis of changes in terms, interest rates or default estimates. If the subsidy increases, additional subsidy funds are provided through a permanent indefinite appropriation. Losses on a credit are also paid through the permanent indefinite appropriation. After each credit is repaid, any profit made on the credit reverts to the US Treasury. Credits obligated before credit reform took effect at the beginning of FY 1992 continue to be funded out of the Eximbank revolving fund, which is now called the liquidating account. Additional funding requirements for this account are obtained from the permanent indefinite appropriation. For FY 1994, there in no overall activity limit - Eximbank may support as many exports as its subsidy budget will allow.

Eximbank's administrative expenses are funded through a separate administrative expense appropriation. For FY 1993, this appropriation was USD 45.6 million.

RELATIONS WITH THE STATE

PEFCO is a private corporation whose management is responsible to its Board of Directors and stockholders. While Eximbank unconditionally guarantees all PEFCO loans (thereby maintaining a measure of control over its activities), PEFCO operates as any other financing entity whose export credits are guaranteed by Eximbank.

RELATIONS WITH PRIVATE SECTOR

Eximbank encourages PEFCO to participate with commercial banks in export loans. PEFCO traditionally lends in conjunction with one or more commercial banks and will cover up to 85 per cent of export value.

RELATED ORGANISATION

Overseas Private Investment Corporation (OPIC)

FUNCTION

The Overseas Private Investment Corporation (OPIC) is a US government agency that provides project financing, investment insurance and a variety of investor services in more than 135 developing nations and emerging economies throughout the world. OPIC encourages American overseas private investment in sound business projects that have a positive impact on the host country's economy and environment. OPIC was authorised by law in 1969 and began operations in 1971.

OPIC assists American investors through three principal programmes:

- *Financing of investments through direct loans and loan guarantees*

  Medium- to long-term financing for sound overseas investment projects is made available through these two programmes. Direct loans generally range from USD 2 million to USD 10 million. Loan guarantees generally range from USD 10 million to USD 75 million. OPIC's financing commitment may range from 50 per cent of total project costs for new ventures up to 75 per cent for expansion of existing successful operations, with final maturities of five to 12 years or more. Additionally, OPIC has created a family of privately managed direct investment funds in various regions and business sectors. Currently these "growth funds" cover Africa, Asia-Pacific, Russia, Poland, Israel and the environmental sector. Growth funds for Latin America, South Asia, and the Middle East are planned.

- *Insuring investment projects against a broad range of political risks*

OPIC offers a number of programmes to insure US investments in emerging markets and developing countries against the risks of:

- currency inconvertibility: the inability to convert profits, debt service and other investment remittances from local currency into dollars;

- expropriation: loss of an investment due to expropriation, nationalisation or confiscation by a foreign government;

- political violence: loss of assets or income due to war, revolution, insurrection or civil strife.

Coverage is available for new investments and for investments to expand or modernise existing operations. Equity, debt, loan guarantees, leases and most other forms of long-term investment can be insured. Special programmes are also available for contractor and exporters of oil and gas projects.

– *Providing a variety of investor services*

OPIC investor services include: investment missions that take groups of US executives to selected countries to meet host country government officials, local business leaders, and potential joint venture partners who can play key roles in bringing proposed business ventures to fruition; reverse missions, which bring groups of foreign government officials and local business leaders to the United States to meet with their American counterparts; and investor conferences that cover a variety of investment-related subjects.

RESOURCES

Since FY 1992, OPIC has also received congressional appropriations to cover the costs of its credit programmes in accordance with the Credit Reform Act of 1990. In FY 1993, OPIC received USD 8.1 million to cover the administrative expenses associated with its credit programmes, and USD 8.9 million in subsidy budget authority. The subsidy budget authority is available for two years to support some USD 400 million in direct and guaranteed loans. The Credit Reform Act also authorises OPIC to borrow from the US Treasury such amounts as may be necessary to fund direct loan and guaranteed loan requirements for loans approved pursuant to the Act.

OPIC's insurance and guaranteed loan programmes carry the full faith and credit of the US government. In addition to its USD 2 billion in reserves available for programme requirements, OPIC also has USD 100 million in borrowing authority for insurance claims and standing authority for additional appropriations.

RELATIONS WITH THE STATE

OPIC is a wholly owned US government corporation. All of OPIC's guarantee and insurance obligations are backed by the full faith and credit of the United States, as well as by OPIC's own substantial reserves.

RELATIONS WITH THE PRIVATE SECTOR

One of OPIC's legislative mandates is to encourage development of the private sector political risk insurance industry. For that purpose, OPIC works closely with an advisory group of representatives of the private sector's political risk insurance industry to develop co-operative programmes to enhance the ability of the private political risk insurance industry to meet the political risk insurance needs of US investors.

A majority of members of the Board of Directors are from the private sector; all users of OPIC's programmes are from the private sector.

INVESTMENT AND BOND INSURANCE

Eximbank does not provide any type of bond insurance. Exporters are referred to private companies extending bond insurance or to OPIC for investment insurance.

OPIC provides political risk insurance to eligible US business investing in projects located in a developing country in which OPIC operates. The projects must be developmentally beneficial to the host country, consistent with the economic interests of the Unites States, and not have significant adverse effects on the US economy or levels of employment in the United States. A project should also be privately controlled and managed, but minority foreign government participation will not render a project ineligible. In addition to these criteria, OPIC does not insure loans of less than three years' average maturity.

Within these constraints, OPIC insurance is available to investors in almost any type of projects, a major exception being projects that produce armaments. In addition to insurance for equity or loan investments, special OPIC insurance coverage is available to protect US exporters, lessors and construction contractors. OPIC insurance is available only for new investment in new or expansion projects. To be eligible, an investor must be: a US citizen, a business organised in the US and more than 50 per cent beneficiary - owned by US citizens, or a foreign corporation, partnership or association wholly owned by one or more US citizens, corporations, partnerships or other associations.

OPIC insurance is offered against three types of political risk: inability to convert local currency earnings or returns of capital into dollars; expropriation or confiscation of an investment; and damage due to war, revolution, or insurrection. OPIC political risk insurance does not offer any protection against commercial risks or devaluations of local currencies.

DEFINITION OF ELIGIBLE POLITICAL RISKS

CURRENCY TRANSFER:

The risk of Currency Transfer is constituted when a Borrower of the BANK is unable, directly or indirectly, to convert local currency into a freely convertible currency or another currency acceptable to the Borrower, or to transfer outside the host country the local currency or the currency in which the local currency was converted, in order to make the payment of any sum due under a loan made by the BANK, as the direct and immediate result of any introduction attributable to the host Government of direct or indirect restrictions on conversion or transfer or any failure by the host Government (or by entities authorized to operate in the foreign exchange markets) to act on conversion or transfer on behalf of the Borrower.

EXPROPRIATION AND SIMILAR MEASURES:

The risk of Expropriation is constituted when a Borrower of the BANK is unable to make the payment of any sum due under a loan granted by the BANK or is deprived of its ability to control or dispose of its property or operate the (investment) project or material parts thereof, as the direct and immediate result of any measure by or attributable to the host Government and not limited to expropriation but including confiscation, nationalisation, requisition or any other measure equivalent to expropriation, which constitutes an administrative action or omission or a legislative action which requires no further legislation, regulation or administrative action for its implementation.

A series of measures which are integral parts of the same plan or program of the host Government and which are designed together to be expropriatory shall be regarded as one measure for the purpose of this definition.

No measure shall be deemed to be expropriatory if it constitutes a bona-fide non-discriminatory measure of general application of a kind that governments normally take in the public interest for the purpose of regulating economic activities in their territories.

Breach by the host Government of a contractual obligation to a Borrower of the BANK shall not, in and or itself, constitute an expropriatory measure.

WAR AND CIVIL DISTURBANCE:

The risk of War and Civil Disturbance is constituted when a Borrower of the BANK is unable, directly or indirectly, to make the payment of any sum due under a loan made by the BANK as the direct and immediate result of any military action or civil disturbance in the territory of the host country, including acts of war (whether declared or undeclared), revolution, insurrections and coups d' etats, riots and civil commotions ,terrorism and sabotage.

In all cases, acts of civil disturbance must have been undertaken with the primary intent of achieving a political objective. Acts undertaken primarily to achieve non-political objectives (such as labor or student interests) do not constitute civil disturbance for the purpose of this definition.

NB: These definitions, which are based in general terms on the risk definitions of the MIGA Convention, provide basic elements of definition of the political risks under consideration .They are subject to any revisions, amendments or extensions which may result from further examination of the issues at point, notably with the Commission and with potential users, corporations and banks, on the basis of their needs. For the purpose of these definitions the term Borrower includes the recipient of a Bank loan, a Guarantor, another debtor of the BANK or even if relevant the BANK itself.