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**COMPREHENSIVE REPORT ON THE FUNCTIONING OF  
THE GUARANTEE FUND**

Proposal for a

COUNCIL REGULATION (EC, EURATOM)

**Amending Council Regulation (EC, Euratom) No 2728/94**

**Establishing a Guarantee Fund for external actions**

(presented by the Commission)

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**PROPOSAL FOR A COUNCIL REGULATION (EC, EURATOM) No ..... of.....**

**Amending Council Regulation (EC, Euratom) No 2728/94**

**Establishing a Guarantee Fund for external actions**

## COMMISSION REPORT ON THE GUARANTEE FUND EXECUTIVE SUMMARY

This report is presented pursuant to the Regulation which set up the Guarantee Fund for external actions so that the Community's creditors could be reimbursed in the event of any default by the beneficiaries of loans granted or guaranteed by the Community.

This report takes stock of the Fund's operation since it was set up in 1994. On the basis of the conclusions drawn from this stock-taking the Commission is putting forward proposals for adjustments to certain of the Fund's parameters over the period covered by the next financial perspective.

1. The results of the first few years of the Fund's operation indicate that the objectives pursued have been attained within the parameters laid down by the rules governing the Fund.
  - As regards the protection of budget appropriations, the Fund's resources have been sufficient to prevent any budgetary impact. Had it not been for the Guarantee Fund, the budget would have had to intervene directly to cover defaults totalling ECU 410 million, which would have disrupted the implementation of the budget.
  - As regards budgetary discipline, the mechanism whereby the Fund is endowed from the reserve (for which a ceiling is set over the period of the financial perspective) has provided an effective framework for controlling new decisions by the Council on loans to non-member countries.

At the end of 1997 the Fund had reached its target amount, namely 10% of the Community's outstanding liabilities arising from guaranteed loans, i.e. ECU 862 million.

2. In the light of the above considerations, the Commission is proposing that the Regulation setting up the Guarantee Fund be amended and that the amount of the guarantee reserve for the period of the next financial perspective be reviewed accordingly.

- Amendments to the Regulation

The Fund's target amount should be reduced from 10% to 8%. The quality of the various loans guaranteed by the Community would justify a reduction in the target amount. Since 1994 the actual level of Guarantee Fund disbursements has been less than 5% of outstanding loan liabilities. Experience shows that a target amount of 5% would have been sufficient to cover the defaults. Given the uncertainty surrounding future risks the Commission proposes setting the Fund's target amount at 8%, taking

the view that this would give the Fund a reasonable safety margin for protecting the budget. It should be stressed that this safety margin is widened by the back-up possibility offered by the budgetary reserve if the guarantees called in exceed the amount available in the Fund.

The provisioning rate should be set at 6%. Now that the Fund is well established, it should be stabilised at its target amount, which would mean that any changes in the Fund should closely reflect the trend in the loans guaranteed. If the provisioning rate were held at its present level of 14%, the Fund would build up substantial surpluses and the contributions required from the Member States would be excessive. A sharp reduction in the provisioning rate would slow down the Fund's expansion. The simulations for the period 2000-2006 (attached to this report) show that a 6% provisioning rate would be sufficient to maintain the Fund at its target amount.

- Reduction in the reserve for guarantees entered in the budget for the period of the next financial perspective

To continue to provide appropriate financial cover for loans to non-member countries guaranteed by the general budget at their present level of around ECU 2,500 million per year, a cut in the provisioning rate to 6% should be accompanied by a proportional decrease in the reserve to ECU 150 million.

Before the end of the period covered by the next financial perspective, the Commission proposes a review of the Fund's parameters in the light of possible changes in the risks covered by the Fund following enlargement.

- Review of the provisioning rate

Article 4 of the Regulation stipulates that 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*". Now that the Fund has reached its target amount, the Commission proposes that the measures advocated above should be adopted in advance of that date and apply from 1999 onwards, given the financial advantages to the Member States. If the Council should decide on this course, certain provisions of the Regulation setting up the Fund will have to be amended as soon as possible; given the impact of these measures on financial discipline, the Commission proposes that in 1999 the level of the guarantee reserve should be reduced to ECU 150 million by interinstitutional agreement.

## 1. INTRODUCTION

Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 established a Guarantee Fund for external actions so that the Community's creditors could be reimbursed in the event of any default by the beneficiaries of loans granted or guaranteed by the Community. Article 9 of the Regulation stipulates that "*the Commission is to submit, before 31 December 1998, a comprehensive report on the functioning of the Fund*".

This report addresses three topics:

- The functioning of the Fund

The Commission presents a brief analysis, in the light of the experience gained over the period 1994-97, of the results achieved by the Fund as compared with the objectives set.

- The proposals for reforming the functioning of the Fund

On the basis of its findings, the Commission puts forward proposals for the reform of the Fund over the period covered by the next financial perspective.

- The review of the provisioning rate

Article 4 of the Regulation stipulates that "*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 Guarantee Fund having reached its target amount on 31 December 1997, the Commission recommends that the proposals for the reform of the Fund should be applied ahead of their formal adoption.

The annexes to this report set out financial data relating to the Fund's results over the period 1994-97 and present simulations on the development of the Fund over the period 1998-2006.

The Commission attaches a proposal for the amendment of Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 establishing the Guarantee Fund.

## 2. THE FUNCTIONING OF THE GUARANTEE FUND

### 2.1. The aims of the Guarantee Fund mechanism

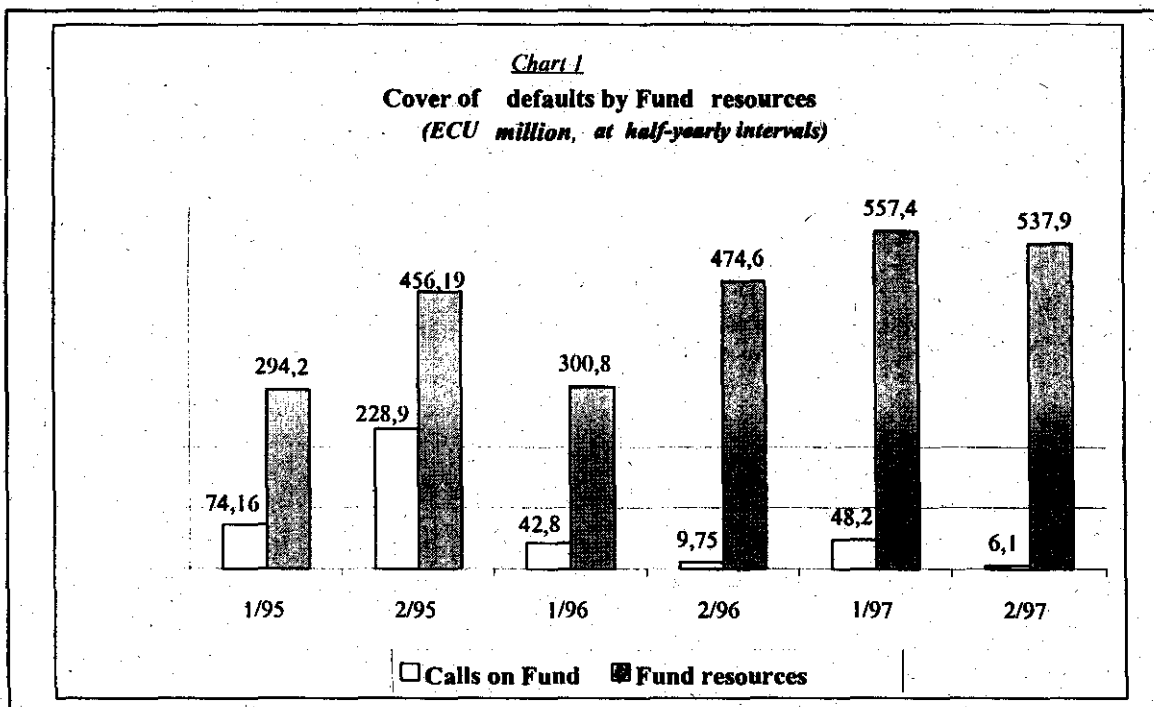
Set up at a time when the guarantees on loans granted to non-member countries were growing rapidly, the Guarantee Fund and the Reserve for Guarantees were intended:

- to provide the Community with an instrument to protect against the budgetary impact of Community guarantees being called in;
- to create an instrument of budgetary discipline by laying down a financial framework for the development of the Community policy on lending/borrowing and guarantees for EIB loans to non-member countries.

### 2.2. Performance of the Guarantee Fund over the period 1994-97

#### 2.2.1. Protection given by the Fund against unforeseen demands on budget appropriations in the event of default

The Guarantee Fund has prevented any substantial disruption of budget implementation which would have inevitably occurred as a result of the defaults on payments to the Community since 1994 (such defaults totalled ECU 410 million). Chart 1 shows how the Fund has succeeded in absorbing the impact of guarantee costs despite its fragile position during the start-up phase.



Source: Commission services

Had it not been for the Guarantee Fund (on which forty calls have been made since its establishment), the Community would repeatedly have had to use budgetary resources to provide the necessary guarantees and this would have required redeployment of appropriations in the course of budget implementation.

The tables in Annex 2 provide details of the financial movements which have affected the Fund and resulted in it reaching its target amount (10% of guaranteed liabilities) by the end of 1997. Several factors have contributed to the Fund's rapid growth:

- **Substantial payments from the reserve:** between 1994 and 1997, aggregate payments into the Fund from the reserve totalled ECU 1,066 million, as compared with ECU 7,405 million in new loans guaranteed, i.e. an average provisioning rate of 14.4% (see Annex 2). The resources generated by the investment of Fund resources also made a significant contribution to the growth of the Fund. By the end of 1997 these new resources totalled ECU 78.35 million, or 1% of liabilities;
- **Defaults covered by the Fund since 1995:** as is shown by Table 1 below, the level of disbursements from the Fund (aggregate disbursements, net of reimbursements) has never exceeded 5% of liabilities for guarantees. The highest percentage (4.8% in June 1996) was the result of defaults on the food aid loan to the CIS Republics. That loan could be classified as an extreme risk, however, given its short-term nature and the relative insolvency of certain beneficiaries.

<b>Table 1</b>												
<b>Disbursements from the Fund as a percentage of total loan liabilities</b>												
<i>ECU million</i>	Mar 1995	Jun 1995	Sep 1995	Dec 1995	Mar 1996	Jun 1996	Sep 1996	Dec 1996	Mar 1997	Jun 1997	Sep 1997	Dec 1997
<b>1. Disbursements</b>	33	39	43	267	273	293	281	264	290	295	295	291
<b>2. Liabilities (*)</b>	6,019	5,724	5,811	6,231	5,934	6,116	6,351	6,696	7,103	7,581	7,918	7,961
<b>3 = 1 as % of 2</b>	0.55	0.69	0.75	4.29	4.59	4.42	3.95	4.08	3.89	3.73	3.65	3.65
(*) Total outstanding capital liabilities, increased by unpaid interest due, as defined in Article 3 of the Regulation establishing the Fund. The rate of increase over the period 1995-97 was 2.7% of liabilities for loans (disbursements minus reimbursements), as calculated at 31 December 1997.												

Source: Commission services

- **The stability of guarantee disbursements from the Fund:** disbursements from the Fund have remained stable since December 1995, ranging from ECU 264 million to ECU 291 million. These figures do not reveal the financial flows in the opposite direction: of the ECU 410 million disbursed in guarantee cover, ECU 136 million was recovered by way of late reimbursements (see Annex 2);
- **The total risks covered by the Fund have increased only slightly since 1994:** guarantee liabilities rose from ECU 7,600 million in 1994 to ECU 7,960 million at the end of 1997, i.e. an increase of 4.5%. Over the same period the Fund itself grew at an average annual rate of 47%. These different rates of increase explain why the Fund exceeded its target amount (10% of liabilities on loans) within three years. Yet

there has been no decrease in lending activities since 1994; indeed, the volume of new guaranteed operations approved by the Council has increased by ECU 7,405 million (disbursements for these operations are spread over several years). Over the same period, however, the amounts reimbursed on earlier guarantees have amounted to ECU 3,100 million.

### 2.2.2. *Budgetary discipline*

The mechanism whereby resources are transferred to the Fund at a specific provisioning rate, from a reserve set at ECU 300 million (1992 prices) for the duration of the financial perspective, necessarily places limits on the annual capacity for guaranteeing new operations. Given the level of the reserve entered in the 1997 budget, this annual limit was ECU 2,350 million in 1997.<sup>1</sup>

The discipline imposed by the Fund mechanism showed its effectiveness when the Council came to discuss the medium-term programming of the new EIB lending envelopes. In its conclusions of 2 December 1996 the Council emphasised that the volume of external lending would have to be in line with the financial perspective and with Community budgetary discipline. The new EIB mandates and the overall limits for Euratom loans and financial assistance were fixed for a three-year period subject to the annual ceilings resulting from the mechanism.<sup>2</sup> This constraint has nevertheless been compatible with the Union's political ambitions as defined at the Essen, Cannes and Madrid European Councils, namely to increase Community support for non-member countries in the form of EIB loans (the new EIB mandate represents a 30% rate of increase).

The level of the reserve is fixed for the duration of the current financial perspective, so that any reduction in the provisioning rate would have the effect of easing the original constraint. Since the Regulation establishing the Fund required the provisioning rate to be reviewed once the Fund had reached its target amount, the Council expressed the hope that the provisioning rates could be kept at their present level until 1999 in order to maintain budgetary discipline.<sup>3</sup>

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<sup>1</sup> Calculated on the basis of a reserve of ECU 329 million and a provisioning rate of 14%.

<sup>2</sup> Conclusions of the Council of 27 January 1997: "The EIB lending envelopes covered by a Community guarantee are consistent with a provision of ECU 1,050 million for macro-financial assistance (MFA) assuming that ECU 750 million is needed for Euratom lending. The maximum for MFA will be increased to ECU 1,200 million if Euratom lending in the period of consideration does not exceed ECU 600 million."

<sup>3</sup> According to the Council's conclusions of 2 December 1996, the provisioning rates for the Guarantee Fund were to remain at their present levels until 1999. According to the Council's conclusions of 27 January 1997, "each payment to the loan guarantee fund will be based on the percentage required at the time of payment, that is 15% currently and 14% as soon as feasible".



### **2.3. Conclusions on the functioning of the Guarantee Fund**

Now that the Fund mechanism has been in operation for a few years, it is clear that the objectives pursued have been attained with the parameters defined in the Regulation setting up the Fund. During the start-up phase it was essential to ensure that the Fund grew as rapidly as possible to a size commensurate with the risks to be covered. Such expansion was also necessary because the Fund had to cover the risks attaching to loans granted before the date of its entry into force. After only three years the Fund has reached its target amount. The quality of the various loans guaranteed (on which the default rate is low) and the Fund's sound financial position (availabilities totalling ECU 862 million) would justify the adjustment of certain parameters to prevent the Fund growing to an excessive size.

### 3. THE GUARANTEE FUND IN THE FINANCIAL PERSPECTIVE 2000-2006. THE COMMISSION'S PROPOSALS FOR REFORM

Over the next Financial Perspective the Guarantee Fund ought to,

- first, have adequate but not excessive resources at its disposal in order to be financially viable in the event of unforeseen large calls to support defaults on guaranteed loans; and
- secondly, it ought not make excessive calls on the Member States in the financing of the Reserve for Guarantees. These considerations must also be consistent with the ability of the Fund to support the desired level of external financing by the EU in the future.

	Financial Perspective 1993-1999			Financial Perspective 2000-2006
	1992	1997	Forecast 1999	
	1992 prices	1997 prices	1999 prices	1999 prices
<b>(1) Reserve for guarantees</b>	<b>300 (a)</b>	<b>329 (b)</b>	<b>346 (b)</b>	<b>150</b>
<b>(2) Provisioning rate</b>	<b>14% (c)</b>	<b>14%</b>	<b>14%</b>	<b>6%</b>
<b>(3) Annual effective capacity at 100% guarantee [(3) = (1)/(2)]</b>	<b>2,140</b>	<b>2,350</b>	<b>2,471</b>	<b>2,500</b>

a) Edinburgh European Council - Reserve for guarantees fixed in 1992 prices;  
 b) amount of the Reserve for guarantees after technical adjustment;  
 c) provisioning rate fixed by Regulation No 2728/94 of October 31, 1994 establishing the Guarantee Fund for external actions.

Source: Commission services

Table 2 presents data on the determination of the Fund's maximum guaranteeing capacity in view of the constraints set out in the Edinburgh decision and Regulation 2728/94. The annual capacity of the Fund to provide 100% guarantee over the period 2000-2006 is determined by the combination of a Reserve of Ecu 150 million and a provisioning rate of 6%, as proposed below.

#### 3.1. The target amount

The Fund's performance over the past four years suggests that a target amount of 10% would be too large relative to default risks. Moreover, experience so far suggests that while the Fund could ultimately suffer losses as a result of defaults in practice it has served a bridging function for the period between default and re-financing of defaulted loans. This would suggest that a target amount of 10% is inevitably too high both from the perspective of the risks themselves and from the transitional function the Fund has so far performed.

*The target amount over the next Financial Perspective is proposed to be 8% of guaranteed liabilities. This level, which is significantly higher than the 4.79% realized worst calls on the resources of the Fund of June 1996 (see Table 1), is both consistent with prudential considerations and with Fund resources that are not excessively large relative to default risks. The proposed target amount is expected to provide adequate resources to safeguard against risks associated with future macro-financial assistance, and those related to the considerable exposure to countries of notable political and financial risk (Algeria, Bulgaria, Ukraine). Such risks, and a deterioration of the EIB's portfolio, may also arise from an extension of guaranteed credit to Newly Independent States (NIS). Maintaining a target amount of 8% appears to be an appropriate prudential measure.*

*It is essential to provide for events where the Fund's resources exceed or fall short of the target amount. In parallel to the current practice<sup>4</sup>, it is proposed that resources in excess of 8% be transferred to the EU budget. Should the Fund's resources fall below 75% of the target amount (6% of outstanding liabilities), it is proposed that the provisioning rate on new lending increase automatically to 7% until the target amount is achieved. Finally, should resources fall below 50% of the target amount the Commission will prepare a report and suggest exceptional measures necessary to replenish the Guarantee Fund.*

### **3.2. The provisioning rate**

The provisioning rate of 14% was intended to be transitional, until the Fund reached the target amount of 10%, and then would also decline to that level. Consistent with the proposal to lower the target amount to 8%, the provisioning rate must also be revised downwards. This revision ought also to take into account the growth in the Fund's non-reserve resources.

Non-Reserve resources consist of interest income and late reimbursements of capital and interest. The availability of such resources imply that the provisioning rate can be lower than what would be otherwise required in order to sustain the target amount of the Fund; alternatively, it will be possible to maintain the strength of the Fund as in the current Financial Perspective while, at the same time, calling on less resources to finance the Reserve for guarantees.

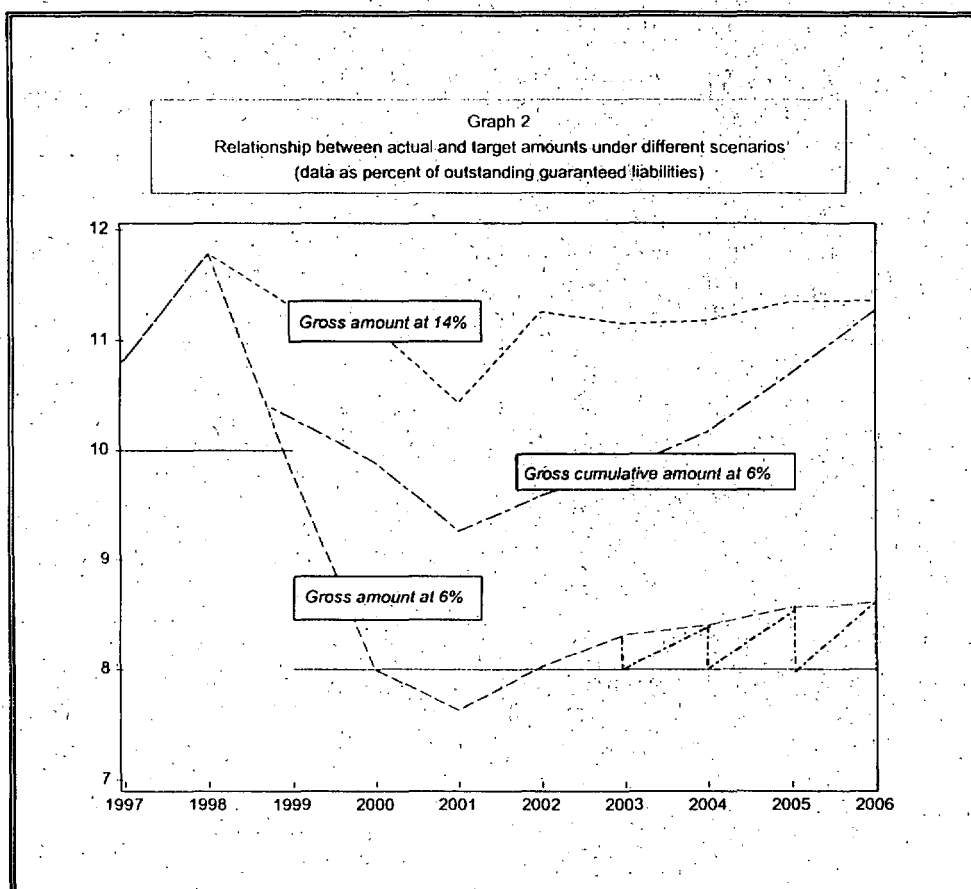
In 1997 alone, interest income amounted to Ecu 34.5 million or 0.4% of the stock of loans guaranteed while, over the period 1994-1997, cumulative interest income amounted to Ecu 78.4 million; also in 1997, late reimbursements amounted to Ecu 45 million or 0.6% of the stock of guaranteed loans, while the cumulative value of late reimbursements over the period 1994-1997 was equal to Ecu 136.4 million<sup>5</sup>. At the end

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<sup>4</sup> See Article 3 of Regulation 2728/94 of 31 October 1994.

<sup>5</sup> See Annex 2 for details.

of 1997, therefore, income from these sources was equivalent to marginally over 1% of the stock of guaranteed loans.



Gross amount at 14%:	Fund resources in year $t$ prior to reimbursement to the budget in year $t+1$ ; provisioning rate 14% ;
Gross cumulative amount at 6%:	Fund resources without reimbursement to the budget ; provisioning rate 6% ;
Gross amount at 6%:	Fund resources in year $t$ prior to reimbursement to the budget in year $t+1$ ; provisioning rate 6%.

Source: Commission services ; see Annex 1 for the details of the simulations.

Simulations show that, in view of non-Reserve resources, a provisioning rate of 6% is sufficient to endow the Fund with resources which are consistent with the target amount.

Key results of the simulations are presented in Graph 2 - the complete results are presented in Annex 1. The Fund's performance is depicted by three characteristics:

- First, gross resources, that is resources without transfers to the EU budget, under the assumption that the provisioning rate is set at 14% (denoted as "gross amount at 14%");

- secondly, under the assumption that no transfers to the budget take place, the Fund accumulates funds in excess of the target amount; under a provisioning rate of 6% this is denoted as "gross cumulative amount at 6%";
- finally, Fund resources net of transfers to the EU budget under a provisioning rate 6% are denoted as "gross amount at 6%"; the surplus in year  $t$  is transferred to the budget in year  $t+1$  and this is shown in the Graph by the marked area. The target amount is set at two levels, 10% for the period 1997-1998 and 8% over the period 1999-2006; a step decline is shown between 10% and 8% in 1999-2000 in the Graph.

The results show that with a provisioning rate of 14% the Fund would transfer large surpluses in excess of the mark of 10% to the EU budget over much of the whole period (the average amount is estimated to be Ecu 222 million). With the reduction in the provisioning rate to 6% the gross resources of the Fund remain generally above 9% of liabilities. Finally, the net resources of the Fund decline only temporarily below the 8% mark (to a trough of 7.63% in 2001) but they subsequently recover to the proposed target amount. Note that the surplus transferred to the budget after 2002 increases over time. The decline in the ratio of Fund resources to liabilities 2001 is principally a reflection the rapid increase in the stock of guaranteed loans at the beginning of the new financial envelopes on which the simulations have been based<sup>6</sup>. This increase reflects disbursements related to the renewal of the EIB mandates for three years 1997-1999.

The tendency of the Fund's resources to increase relative to guaranteed liabilities is partly a reflection of the provisioning mechanism itself. As long as provisioning for new loans takes place independently of repayments, the ratio of Fund resources to liabilities will tend to remain constant or increase unless the growth of new loans is greater than the growth in repayments. Over the horizon to 2006, simulations show that disbursement of new loans will peak in the beginning of next century and from 2003 onwards will decline; on the other hand, repayments are expected to follow an upward trend throughout the post-2002 period – see the results in Annex 1.

### **3.3. The level of the Reserve and the Fund's capacity for guaranteed lending**

It was noted previously that a rate of provisioning of 6% would be appropriate for the period covered by the new Financial Perspective. To determine the appropriate level of the Reserve, it is essential to consider the desired volume of new lending which will be subject to guarantee. While difficult to determine it ex ante with confidence, it is possible to take guidance from factors likely to play a role in determining developments in guaranteed loans in future years.

Between 1992 and 1999 the Reserve for guarantees<sup>7</sup> will have increased in nominal terms by Ecu 46 million to Ecu 346 million, or on average by 2.2% annually. The

<sup>6</sup> See the details in Annex 1.

<sup>7</sup> The Reserve for guarantees was defined in the Edinburgh European Council of December 1992 even though the Guarantee Fund itself was not established until October 1994.

corresponding maximum capacity for fully guaranteed loans during this period has advanced by a comparable growth rate. At the same time, over the period 1994-1997 the rate of utilization of the Reserve averaged 82.2%, clearly signalling that Reserve adequacy was not a binding constraint on guaranteed credit expansion.

	2000	2001	2002	2003	2004	2005	2006	Average 2000-2006
Annual value of the Reserve (a)	150	153	156	159	162	166	169	159
Annual capacity (a)	2,500	2,550	2,600	2,650	2,700	2,767	2,820	2,655
Projected increase in guaranteed loans (b)	2,293	2,293	2,293	2,293	2,293	2,293	2,293	2,293
Annual utilization of the Reserve (c)	0.92	0.90	0.88	0.87	0.85	0.83	0.81	0.87

(a) Determined by an annual increase of the GNP deflator of 2%, as proposed in *Agenda 2000*; (b) determined according to the calculations reported in Annex 1; account has been taken of the 70% guarantee for EIB loans; other loans enjoy a 100% guarantee; the projected increase refers only to new loans subject to a guarantee and it excludes loans which have been signed in earlier years and for which the Fund has already been provisioned; (c) ratio of the value of the Reserve necessary to support the projected growth in guaranteed loans (the product of the projected increase in guaranteed loans times the provisioning rate of 6%) relative to the total value of the Reserve; estimates are rounded.

Source: Commission services

For the new Financial Perspective, it is assumed that it will be necessary to support with guarantees an annual flow of lending comparable to that of the last years of the current Financial Perspective. Given the provisioning rate of 6%, a Reserve endowment of Ecu 150 million per year would make possible the extension of guaranteed loans of Ecu 2,500 million (1999 prices) annually over the period 2000-2006 at 100% guarantee. Assuming that the reserve is growing annually by 2.0% (the growth rate of the GNP deflator assumed in *Agenda 2000*), by the end of the next Financial Perspective the capacity for guaranteed loans is estimated to be Ecu 2,800 million. However, various factors, as discussed below, could give rise to an increase, but they could equally likely lead to a fall, in demands for guaranteed loans.

To judge the adequacy of the proposed level of the Reserve, Table 3 presents estimates of the value of the Reserve and of the Fund's annual capacity to guarantee loans, as well as estimates of the increase in the stock of guaranteed liabilities over the next Financial Perspective. The Reserve is assumed to grow by 2% per year. The increase in guaranteed loans is based on the projections reported in Annex 1. Note that in the latter estimates a distinction has been made between loans subject to 100% guarantee and EIB loans subject to 70% guarantee.

This comparison suggests that the Fund's capacity always exceeds the projected growth in lending. During the whole period, the average capacity of the Reserve equals Ecu 2,618 million while the average value of projected lending equals Ecu 2,293 million; the required Reserve to support the latter is Ecu 138 million.

It is uncertain whether the annual flow of guaranteed credit of Ecu 2,500 million, projected under the Commission proposal, will be adequate to meet all eventualities

over the period 2000-2006. *At this stage, the projected margin suggested in Table 3 appears to be adequate.* The present EIB envelopes will permit a significant amount of lending to CEECs which will complement the pre-accession strategy, and following enlargement EIB lending will not need to be guaranteed. Moreover, Euratom and macrofinancial assistance lending amounting to around Ecu 600 million per year would appear to be adequate. Changes may occur *following enlargement but until then there are no compelling reasons to permit the Fund's capacity to increase significantly above present levels.*

Over the next Financial Perspective there may be reasons favoring either a decrease or an increase in guaranteed lending. On the one hand, under the assumption that following enlargement third-country lending will not expand, the need for guaranteed credit, after peaking at the time of the next enlargement, will be reduced.

On the other hand, it is possible that credit in the form of either macro-financial assistance or Euratom loans will increase. Moreover, it is possible that EIB lending to Russia and other NIS will be initiated. In the area of macro-financial assistance it is possible that it will be necessary to provide increased support to Ukraine but also to other important EU neighbors such as Turkey, Albania, Bulgaria and the nations of the ex-Yugoslavia. Demands to increase Euratom loans, especially in favor of Ukraine but also in favor of Bulgaria, may also become substantial over coming years.

Moreover, demands for EIB lending may increase both in the context of reinforcing the EIB/CEEC envelopes and taking account of the possibilities of enlarging the MED programs, increasing loans in favor of Turkey and extending loans to support energy projects in the Mediterranean.

It is possible, finally, that the risk the Fund's portfolio is bearing may increase. With enlargement, some currently third countries will become Member States. An expansion of guaranteed lending towards a widening group of Eastern European countries, or towards countries of lesser creditworthiness, could raise the risks of default causing a deterioration in the Fund's portfolio<sup>8</sup>.

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<sup>8</sup> The stock of loans outstanding with to Hungary, Poland, the Czech Republic, Slovakia and Slovenia in 2002 is estimated at Ecu 6,020 million. This estimate is based on the assumption that 77% of the envelop decided buy the Council on April 14, 1997 in favor of the CEECs (Ecu 3,520 million) will be allocated to the five countries. The stock of guaranteed loans to the remaining countries, that is excluding the five candidates, is estimated at Ecu 13,137 million at the end of 2002, and the total stock at that time is estimated at Ecu 19,157 million.

Since accession to the EU reduces the resources the Guarantee Fund needs to hold to meet defaults on these loans by an amount equal to the Fund's target amount, it is clear that at some point following the first wave of accessions the Guarantee Fund would have to reimburse this amount to the EU budget. On the hypothesis that the new Member States constitute better risks than those still remaining within the framework of pre-accession or those not considered for membership at all, it is clear that the quality of the Fund's risk portfolio will worsen, perhaps significantly.

### 3.4. Review of the performance of the Fund

It is possible that, over the next Financial Perspective, the parameters of the Guarantee Fund may need to be modified. In particular, to respond to the possibility that the risks to which the Fund is exposed are changing in the years following enlargement it is necessary to provide for a review of its operation. Accordingly, the Commission is proposing that it would be appropriate to *review the performance of the Guarantee Fund at some point before the end of the next Financial Perspective*. This review should take the form of a Commission Report to the Council.

### 3.5. Transfer of the Fund's financial management to the Commission

As required by the Regulation establishing the Fund,<sup>9</sup> the Commission gave the EIB the task of managing the Fund's resources on behalf of the Community.<sup>10</sup>

Experience has shown that although the Bank has performed this task most satisfactorily over the past three years, in practice a good deal of assistance has to be provided by the services of the Commission. It would therefore be in the Commission's interest to take over the management of the Fund.

#### - With a view to administrative simplification

- \* The Commission makes a substantial contribution to defining the principles governing the management of the Fund: since the EIB's investment management must comply with the usual prudential rules for financial activities, the EIB frequently has to consult the Commission on investment strategy;
- \* Since the Commission alone has an overview of the guarantees concerned, it has to send the EIB monthly forecasts on how the Fund will develop over the next twelve months. The Bank needs this information to gauge the optimum duration for the Fund's financial investments;
- \* The Commission keeps track of the repayment dates for loans and borrowings, makes the arrangements for calls on the Fund, and monitors the recovery of sums due and the reimbursement to the Fund of the corresponding amounts. As things stand, all the relevant information has to be made available before the Bank can act, entailing a pointless duplication of the workload. Apart from the gains in productivity, direct management by the Commission would shorten the timespan needed for the transfer of resources and the dissemination of information.

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<sup>9</sup> Article 6 of Council Regulation No 2728/94 establishing a Guarantee Fund for external actions stipulates that "the Commission shall entrust the financial management of the Fund to the EIB under a brief on the Community's behalf".

<sup>10</sup> Agreement between the European Community and the European Investment Bank concerning the management of the Guarantee Fund, signed on 23 and 25 November 1994.



– **With a view to reducing costs**

- \* The Commission would save the charges currently paid to the EIB, which amounted to ECU 325,000 in 1997 and total ECU 710,000 since the Fund was set up in 1995.

This charge would be bound to increase with the level of capital managed by the Fund as a result of fresh EC or Euratom loans to the countries of Eastern and Central Europe.

The Commission, which has considerable experience in dealing with such matters on behalf of other Community institutions, proposes therefore that it itself should manage the investment of the Fund's resources and that Article 6 of the Regulation establishing the Fund should be amended accordingly.

**3.6. Implications of the proposals for the Fund's regulation**

Adoption of the Commission's proposals will require a corresponding revision of the Regulation governing the Guarantee Fund. This will take the form of a new Regulation based on a revision of the present Regulation. The text of the proposed amended Regulation is attached separately.

**4. IMPLICATIONS OF MAINTAINING THE PROVISIONING RATE TO THE END OF THE CURRENT FINANCIAL PERSPECTIVE AND SUGGESTIONS FOR REFORM**

The Ecofin Council has proposed that the provisioning rate ought to remain at the level of 14% to 15% until the end of the current financial perspective<sup>11</sup>. The implication of this is that, with the Fund having currently attained its target amount, and in view of the non-Reserve resources, which are expected to correspond to over 10% of the Reserve for guarantees and of total new Fund resources in each of the next two years, maintaining the provisioning rate at this level would tend to enrich the Fund considerably without a corresponding increase in risk. Furthermore, according to Article 3 of Regulation 2728/94, Fund resources at the end of the year in excess of the 10% mark are to be paid back to the EU budget. As a result, a situation would arise where the Reserve would be called upon to provision the Fund which would in turn reimburse the budget.

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<sup>11</sup> See Ecofin conclusions, SN 1247/1/97 of January 27, 1997.

Table 4			
The Guarantee Fund 1998-1999 with a provisioning rate of 14%			
(Ecu million)			
Operations	Situation December 31, 1997	Situation December 31, 1998	Situation December 31, 1999
Provisioning rate: 14%			
	Stocks	Flows	
<b>Credits</b>			
- Transfers from Reserve	1,065.96	312.05	312.83
- Interest income	78.36	43.09	57.04
- Late reimbursements	136.38	0.00	0.00
<b>Total resources</b>	<b>1,280.70</b>	<b>345.14</b>	<b>369.87</b>
<b>Debits</b>			
- Defaults	409.90	0.00	0.00
- EIB commissions	0.71	0.43	0.57
- Surplus transferred to EU budget		65.69	172.00

Source: Commission services

Simulation results presented in Table 4 highlight this point – see also Graph 2<sup>12</sup>. The results suggest that interest income will amount to 12.5% of the Fund's total new resources in 1998 and 15.4% in 1999. Furthermore, the simulation shows that the Fund would make transfers to the EU budget of Ecu 66 million in 1998 and Ecu 172 million in 1999. It is evident that a provisioning rate of 14% would require that an unnecessarily large amount of funds is called from the Member States. Consistent with the proposals outlined for the next Financial Perspective, *it is proposed that the Council consider adopting the provisioning rate of 6% already from 1999.*

To ensure that the reduction in the provisioning rate, if endorsed by the Council, does not endanger budgetary and financial discipline, it is essential that an effective ceiling be introduced to constrain the enlarged possibilities for extending guaranteed credit. *The ceiling can take the form of establishing a maximum level for the reserve, clearly lower than its total value, that can be used for the purpose of credit guarantees in 1999. The proposed maximum level of the reserve is ECU 150 million.*

This ceiling ensures continuity between the Fund's annual capacity under the old regime and that under the new regime governing the provisioning rate. In particular, with a provisioning rate of 14% and the reserve projected to be ECU 346 million in 1999, the capacity for fully guaranteed lending is ECU 2 471 in 1999; the same capacity is obtained with a provisioning rate of 6% and a reserve of ECU 150 million.

The Commission is proposing that:

<sup>12</sup> Detailed results and the assumptions used in these simulations are presented in Annex 1.

- the provisioning rate for the Fund be set at 6% as soon as possible. It therefore suggests that all the proposed amendments to the Regulation of 31 October 1994 establishing a Guarantee Fund should enter into force on 1 January 1999;
- that lending capacity be left unchanged with the guarantee reserve being cut from ECU 338 million in 1998 to ECU 150 million in 1999 and that the existing financial perspective be amended by interinstitutional agreement.

ANNEX 1

Simulations showing the evolution of the Guarantee Fund over the period 1998-2006, on the basis of three scenarios:

- 1) target amount at 10%, provisioning rate at 14% and repayment to the budget of the Fund's surplus over the target amount (scenario A)
- 2) provisioning rate at 14% in 1998 and at 6% over the period 1999-2006. No repayment to the budget (scenario B)
- 3) target amount at 8%, provisioning rate at 14% in 1998 and at 6% over the period 1999-2006. Repayment to the budget of the Fund's surplus over the target amount (scenario C)

	Situation at 31.12.97	Estimate for 31.12.98	Estimate for 31.12.99	Estimate for 31.12.2000	Estimate for 31.12.2001	Estimate for 31.12.2002	Estimate for 31.12.2003	Estimate for 31.12.2004	Estimate for 31.12.2005	Estimate for 31.12.2006
<i>ECU million</i>										
Guarantee liabilities on the basis of: (a)										
1. decisions already adopted by the Council (b)	7,961.00	9,483.00	11,207.00	13,404.00	15,671.00	15,901.00	15,641.00	14,648.00	12,991.00	11,445.00
2. new decisions planned (c)		205.00	637.00	1,119.00	2,089.00	3,543.00	5,650.00	8,315.00	11,191.00	13,853.00
3. Total liabilities (3.= 1.+ 2.)	7,961.00	9,688.00	11,844.00	14,523.00	17,760.00	19,444.00	21,291.00	22,963.00	24,182.00	25,298.00
Scenario A										
4. Gross amount of the Fund (d)	861.79	1,140.81	1,338.10	1,613.74	1,853.14	2,188.79	2,373.71	2,567.56	2,744.46	2,875.01
5. Gross amount of the Fund as % of 3.	10.83	11.78	11.30	11.11	10.43	11.26	11.15	11.18	11.35	11.36
6. Target amount at 10% (3.*10%)	796.10	968.80	1,184.40	1,452.30	1,776.00	1,944.40	2,129.10	2,296.30	2,418.20	2,529.80
7. Surpluses repaid to the budget in n+1 (4.-6.)	65.69	172.01	153.70	161.44	77.14	244.39	244.61	271.26	326.26	345.21
Scenario B										
8. Cumulative gross amount of the Fund (e)	861.79	1,206.50	1,400.29	1,625.22	1,843.23	2,072.06	2,312.19	2,564.20	2,828.72	3,106.30
9. Cumulative gross amount of the Fund as % of 3.	10.83	12.45	11.82	11.19	10.38	10.66	10.86	11.17	11.70	12.28
Scenario C										
10. Gross amount of the Fund. (d)	861.79	1,140.81	1,159.34	1,160.52	1,355.53	1,560.22	1,770.31	1,928.47	2,070.10	2,174.59
11. Gross amount of the Fund as % of 3.	10.83	11.78	9.79	7.99	7.63	8.02	8.31	8.40	8.56	8.60
12. Target amount at 10% for 1998 (3.*10%)										
13. Target amount at 8% over 1999-2006 (3.*8%)	796.1	968.8	947.52	1,161.84	1,420.8	1,555.52	1,703.28	1,837.04	1,934.56	2,023.84
14. Surpluses repaid to the budget in n+1 (10.-12.)	65.69	172.01	211.82	0.00	0.00	4.70	67.03	91.43	135.54	150.75

Source: Commission services

Assumptions made for the purposes of the table in Annex I

- (a) *Definition of guaranteed liabilities: liabilities are defined as the sum of disbursements, net of repayments obtained from the beneficiaries of loans. For the purposes of calculating the target amount within the meaning of Article 3 of the Regulation, the adjusted liabilities are obtained by increasing loan liabilities by the amount of unpaid interest due. Liabilities have been increased by the equivalent of three months' unpaid interest due.*  
*Calculation of liabilities:*
- \* *For borrowing/lending operations, disbursement in two instalments over two years and reimbursement of the capital as from the sixth year, in five equal annual instalments;*
  - \* *For EIB operations, disbursement on the basis of the assumptions made by the Bank: 0% in the year when the financing contracts are signed, then 10% in the second year, then 25% per year from the third to the fifth year, and 15% in the sixth year.*
- (b) *Decisions already adopted by the Council:*  
*Decision of 14 April 1997 granting a Community guarantee to the EIB (OJ L 102, p. 33, 19.4.1997) for an amount of ECU 7,105 million over three years beginning on 31 January 1997;*  
*Commission proposal for a decision guaranteeing a loan of ECU 150 million to FYROM (COM(98) 2 of 13 January 1998) pursuant to Decision 97/831/EC of 27 November 1997 concerning the conclusion of a cooperation agreement between the EC and the former Yugoslav Republic of Macedonia. Duration of loan: three years, 1998-2000.*
- (c) *Assumptions made for the new decisions planned:*
- \* *in the case of EIB loans over the period 2000-2006, renewal on the same three-year envelop of the overall allocations approved by the Council for 1997-99, i.e. ECU 7,255 million distributed in equal parts over three years;*
  - \* *in the case of Euratom loans and micro-financial assistance, ECU 200 million and ECU 400 million per year respectively over the period 1998-2006. These amounts were determined by reference to the overall limits approved in the Council conclusions of 27 January 1997.*
- (d) *The gross amount of the Fund is obtained as follows:  $Fund\ t = Fund\ t-1 + (resources\ t - costs\ t) - surplus\ t-1$  in relation to the target amount.*
- (e) *The cumulative gross amount of the Fund is obtained as follows:  $Fund\ t = Fund\ t-1 + (resources\ t - costs\ t)$ .*
- Other assumptions for the calculation of the Fund:*
- \* *Disbursements from the Fund are maintained at their level of 31 December 1997, i.e. ECU 315 million over the period 1998-2006;*
  - \* *Investment of Fund resources at an interest rate of 5% over the period.*

**Financial data on the performance of the Guarantee Fund  
over the period 1994-1997**

<b>Utilisation of the reserve from 1994 to 1997</b> (ECU million)					
	1994	1995	1996	1997	1994-1997
1. Reserve	318.00	323.00	326.00	329.00	1,296.00
2. Authorised withdrawals from the reserve	293.72	250.75	235.39	286.09	1,065.95
3. Rate of utilisation (2/1)	92.4%	77.6%	72.2%	86.9%	82.2%
4. Margin remaining in the reserve (1-2)	24.28	72.25	90.61	42.91	230.05
5. New operations guaranteed	2,098.00	1,762.50	1,651.00	1,893.50	7,405.00
6. Unused lending capacity (*)	161.87	481.67	604.07	2,86.07	1,533.67

(\*) Calculated on the basis of the margin remaining in the reserve at a provisioning rate of 15%.

Source: Commission services

<b>FUND LIABILITIES AND COVERAGE OF RISKS OVER THE PERIOD 1994-1997</b> (ECU million)							
Resources	Situation at 31.12.94	Change in resources in 1995	Situation at 31.12.95	Change in resources in 1996	Situation at 31.12.96	Change in resources in 1997	Situation at 31.12.97
1. Provisioning	293.72	+250.75	544.47	+235.39	779.86	+286.10	1,065.96
2. Interest	0.47	+ 23.53	24.00	+19.84	43.84	+34.51	78.35
3. Disbursements on guarantees	0.00	- 303.07	303.07	-52.54	355.61	-54.29	409.90
4. Other costs	0.00	- 0.19	0.19	-1.85	2.04	-6.96	9.00
5. Late reimbursements	0.00	+ 35.63	35.63	+55.72	91.35	+45.03	136.38
6. Amount of the Fund	294.19	+ 6.65	300.84	+256.56	557.40	+304.39	861.79
7. Liabilities	7,598.30		7,751.91		8,341.22		7,961.00
8. Target amount = 7*10%	759.83		775.19		834.12		796.10
9. Ratio = 6./7.	3.87 %		3.88 %		6.68 %		10.82 %

1. Provisioning = payments from the budget  
 2. Interest = interest on Fund availabilities invested  
 3. Disbursements on guarantees = amounts disbursed by the Fund  
 4. Other costs = EIB fees and other financial costs  
 5. Late reimbursements = arrears of payment accruing to the Fund, including penalty interest paid by debtors  
 9. Ratio = percentage to which risks are covered

Source: Commission services

**PROPOSAL FOR A COUNCIL REGULATION (EC, EURATOM) No ..... of .....**

**Amending Council Regulation (EC, Euratom) No 2728/94**

**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,

Having regard to the opinion of the European Parliament,

Having regard to the opinion of the Court of Auditors,

Whereas the Guarantee Fund is endowed by payments from the general budget of the European Communities, by the interest on its invested resources and by the amounts recovered from defaulting debtors where the Fund has already honoured the guarantee;

Whereas experience of the functioning of the Guarantee Fund indicates that a ratio of 8% between the Fund's resources and guaranteed liabilities in principal, increased by unpaid interest due, would be adequate;

Whereas payments to the Guarantee Fund equal to 6% of the amount of each operation would seem sufficient to attain the target amount;

Whereas the Guarantee Fund attained its target amount on 31 December 1997 and the provisioning rate should be reviewed;

Whereas if the Guarantee Fund exceeds the target amount the surplus is paid back to the general budget of the European Communities;

Whereas experience has shown that the various Commission departments are closely involved in the functioning of the Guarantee Fund;

Whereas, in these circumstances, the financial management of the Guarantee Fund should be entrusted to the Commission; whereas the financial management of the Fund is subject to audit by the Court of Auditors;

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

HAS ADOPTED THIS REGULATION:

Article 1

Regulation (EC, Euratom) No 2728/94 is hereby amended as follows:

1. In Article 3 the second paragraph is replaced by the following:  
“The target amount shall be 8% of the Community’s total outstanding capital liabilities arising from each operation, increased by unpaid interest due.”
2. Article 4(1) is replaced by the following:  
“The payments provided for under the first indent of Article 2 shall be equivalent to 6% of the capital value of the operations.”
3. In Article 5 the first paragraph is replaced by the following:  
“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 7% until the target amount has once more been reached.”
4. Article 6 is replaced by the following:  
“The financial management of the Fund shall be entrusted to the Commission.”
5. Article 9 is replaced by the following:  
“The Commission shall, before 31 December 2006, submit a comprehensive report on the functioning of the Fund.”

Article 2

This Regulation shall enter into force on 1 January 1999.

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

Done at ....., .....

For the Council  
The President



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