European Parliament

EU contingent financial liabilities

Abstract

Contingent liabilities for the EU budget have grown considerably in their magnitude and their complexity and will continue to increase under the MFF 2021-2027. This paper tracks their evolution, explains the risks they might impose on the EU budget, and analyses the risk management practices to address them. We forecast total contingent liabilities will more than double by 2027, reaching EUR 612 billion. This will be driven mainly by RRF loans and, to a lesser extent, by financial support to Ukraine.

A contingent liability can generally be defined as a financial obligation the size and occurrence of which depends on events in the future that are hard or impossible to predict. Given their dependence on specific events, the payments due to the financial obligation might not be made or called for at all. Because they constitute a risk of undesirable budgetary "surprises" with possible implications for the fiscal standing or even fiscal sustainability, contingent liabilities need to be accounted for and analysed. However, due to their highly uncertain nature, the fiscal risks of such liabilities are challenging to evaluate.

EU contingent liabilities have grown considerably in their magnitude and complexity and will continue to increase under the Multiannual Financial Framework (MFF) 2021-2027. This paper tracks their evolution, explains the risks they might impose on the EU budget, and analyses the risk management practices to address them.

Throughout this study, there is a distinction between three different types of EU contingent liabilities: budgetary guarantees, Macro-Financial Assistance (MFA) to third countries, and financial assistance to EU Member States. With budgetary guarantees, the EU covers implementing partners' losses that result from payment defaults by financing and investment operations. Macro Financial Assistance is the financial support provided by the Union to third countries (countries that are not members of the Union) in the forms of loans authorized by the relevant legal act. Financial assistance to EU Member States is provided predominantly in the form of SURE and RRF loans, although it has previously taken the form of Euratom, Balance of Payment or EFSM programmes.

At the end of 2021, the EU budget included a total of EUR 223 billion of contingent liabilities, with approximately EUR 163 billion related to loans granted to Member States and third countries and over EUR 60 billion related to guarantees provided in the context of programmes like EFSI, EFSD, EFSD+, and ELM. At the end of 2022, contingent liabilities increased to a total of EUR 312 billion, constituting an increase of 40% from the total contingent liabilities in 2021. The preliminary estimations produced by this study show that, in 2023, contingent liabilities further increased to a total of EUR 367 billion. Until the COVID-19 pandemic and by the end of 2020, budgetary guarantees and financial assistance to Member States were of similar magnitude and importance. However, with the implementation of SURE and the introduction of the RRF, financial assistance to Member States grew considerably in 2021 and continued growing at a significant rate in 2022. In 2022, the growth rate for financial assistance to third countries was also high, due to the expansion of Macro-Financial Assistance (MFA) to Ukraine, as well as for budgetary guarantees. Overall, financial assistance to Member States dominates contingent liabilities in the

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EU and constitutes between 55% and 70% of the total amount of contingent liabilities in 2020, 2021 and 2022. In the coming years, this share is expected to grow even further.

In order to consider future risks to the EU budget, it is important to group contingent liabilities into two main categories: provisioned contingent liabilities, e.g. those arising from budgetary guarantees and from financial assistance to third countries, and headroom-backed contingent liabilities, e.g. those stemming from financial assistance to Member States. These two categories of contingent liabilities have different implications for the types of risk they might imply for EU finances.

Provisioned contingent liabilities require that specific funding is set aside as an insurance buffer in the case of losses from the given liability, i.e. in case of a default. The Common Provisioning Fund (CPF), created in 2018 and operational since 2021, acts as a main line of defence against the materialisation of risks for provisioned contingent liabilities. The fund stores its resources in separate compartments corresponding to each of the contributing instruments. At the end of 2023, the market value of the CPF stood at EUR 18.8 billion and was evaluated by the European Commission to provide a sufficient buffer for outstanding risks due to provisioned contingent liabilities (European Commission 2024c).

Headroom-backed contingent liabilities, however, constitute a more direct risk to EU finances because they are not provisioned for. The headroom is the difference between the maximum amount of resources that the European Commission can ask Member States to contribute in a given year (own resources ceiling) and the funding that the EU requires to cover the expenses foreseen by the budget in the same given year. If the ceiling is high enough, this guarantees the EU will be able to cover all its financial obligations and risks from contingent liabilities that occur in a given year. Headroom-backed contingent liabilities dominate total contingent liabilities and, in 2022, constituted made up around 62% of the total. This type of contingent liability will continue to increase in the coming years, due mainly to RRF loans and financial assistance for Ukraine.

Budget guarantees are a source of risk exposure for the EU budget. Under all budgetary guarantee instruments, the EU (fully or partially) covers implementing partners' losses that result from payment defaults emanating from financing and investment operations (debt or equity). Currently, the most important guarantees involve the InvestEU Fund, the European Fund for Strategic Investments (EFSI), the European Fund for Sustainable Developments (EFSD), the External Lending Mandate (ELM), and EFSD+. Each of these guarantee schemes is now at a different stage in its planned cycle and, although EFSI has now concluded underwriting new operations, all five schemes will have outstanding budget guarantees for several years.

Financial assistance by the EU to third countries, excluding amounts provided to developing countries, is provided in the form of macro-financial assistance programmes (MFA). Such loans are financed via EU borrowing, in which case the EU remains liable vis à vis the final investors, including scenarios in which MFA beneficiaries would not pay or would not pay on time.

Furthermore, Euratom loans aim at providing funding to Member States and third countries for investments in the nuclear sector. However, these loans amounted to a mere EUR 0.3 billion in 2022.

The Russian invasion of Ukraine led to new macro-financial assistance programmes to Ukraine throughout 2022, and these programmes therefore contributed to the overall increase in MFA-related contingent liabilities. These programmes also resulted in the extension of the budget coverage currently applicable to loans to Member States to MFA+ loans to Ukraine for 2023 and 2024. In the event of a default, the required amounts would be drawn down above the MFF ceilings up to the own resources ceiling (from the headroom). This paved the way for MFA+ loans to Ukraine to be granted in a similar way to how financial assistance is granted to Member States, e.g. without provision. In 2022, since new MFA loans of approximately EUR 7.5 billion were disbursed, driven mainly by the additional support committed to Ukraine, outstanding MFA increased to EUR 15.0 billion.

Financial assistance to Member States is now predominantly driven by the creation of the temporary instruments for Support to mitigate Unemployment Risks in an Emergency (SURE) and the Recovery

and Resilience Facility. Before the pandemic, this financial assistance was produced predominantly by the European Financial Stabilisation Mechanism (EFSM) and, to a much smaller extent, by Euratom and Balance of Payment (BoP) programmes. Exposures for these types of contingent liability are not provisioned, and they are backed by the EU budget headroom. However, as seen above, it is important to highlight that the MFA+ programme for Ukraine in 2023 and financial assistance for Ukraine from the Ukraine Instrument are also headroom-backed, even though they consist of MFA to a third country.

Given different assumptions, this study forecasts that the baseline scenario is that by 2027, total EU contingent liabilities will reach EUR 612.0 billion. This total is almost double the current amount of EUR 311.9 billion reached by the end of 2022. This increase is predominantly driven by RRF loans and the assumption that RRF loans will be disbursed fully, as well as, to a more limited extent, by the Ukraine support programmes, and, to an even lesser extent, by budgetary guarantees.

Overall, given the increased volume of contingent liabilities and the increasing variety of exposures to contingent liabilities, the overall risk management framework looks fragmented and could be better organised. International debt transparency standards include timely publication of and clear communication on information regarding the evolution of contingent liabilities, which could be improved from the current reporting arrangement. A more active inclusion of the European Parliament can be beneficial in analysing and possibly legitimising the issuance of contingent liabilities. The functioning of the newly created Steering Committee on Contingent Liabilities (SCCL) lacks transparency and publicly available information. The stress testing exercise on the available headroom can be refined to include more extreme macroeconomic scenarios similar to the pandemic shock. Given the dominant concentration of exposure to Ukraine, the approach to provisioning of MFA to third countries might require changes. This provisioning is also becoming fragmented, as different programmes have adopted different provisioning rates despite belonging to the same sovereign authority. The ongoing suitability of a general provisioning rate of 9% to all other MFA to third countries should also be analysed.

Furthermore, the study discusses the distinction between provisioned and headroom-backed contingent liabilities. This distinction still appears warranted. Even though headroom-backed contingent liabilities are and will continue to be a dominating part of total contingent liabilities due to SURE and the RRF, it makes little sense to require provisions for them. Requiring Member States to provide ex-ante provisions on loans they themselves must pay back makes little economic sense and would also have political repercussions, since this requirement would make the joint liability of the RRF more salient. Nonetheless, due to the important role played by RRF loans, the European Commission should embed the new Debt Sustainability Analysis (which is part of the reformed Economic Governance Framework) within its analysis of headroom-backed contingent liabilities.

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