STUDY

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EU contingent financial liabilities

Policy Department for Budgetary Affairs

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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.

This document was requested by the European Parliament's Committee on Budgets.

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LIST OF ABBREVIATIONS

AECID	Agencia Española de Cooperación Internacional para el Desarrollo
AGRI	Agriculture and Rural Development Committee
BoP	Balance of Payment
BUFI Fund	Budgetary Fines Fund
CL	Contingent Liabilities
CPF	Common Provisioning Fund
DSA	Debt Sustainability Analysis
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EFSI	European fund for Strategic Investments
EFSD	European Fund for Sustainable Development
EFSD+	European Fund for Sustainable Development Plus
EFSM	European Financial Stabilisation Mechanism
EIB	European Investment Bank
EIF	European Investment Fund
ELM	External Lending Mandate
ECSC	European Coal and Steel Community
ETF	Exchange Traded Funds
EUR	Euro
FTC	Fiscal Transparency Code
GFEA	Guarantee Fund for External Actions
GFSM	Government Financial Statistics Manual
GNI	Gross National Income
IIW	Infrastructure and Innovation Window
IMF	International Monetary Fund
InvestEU	InvestEU guarantee programme

IPSAS	International Public Sector Accounting Standards
MFA	Macro-Financial Assistance
MFF	Multiannual Financial Framework
MIM	Mutual Insurance Mechanism
MPA	Multipronged Approach
NDICI	Neighbourhood, Development and International Cooperation Instrument
NGEU	NextGenerationEU
NRRPs	National Recovery and Resilience Plans
ORD	Own Resources Decision
PDM	Public Debt Management
PSDS	Public Sector Debt Statistics
RCAM	Régime commun d'Assurance Maladie des institutions de l'UE (Joint Sickness Insurance Scheme of the EU institutions)
RECIDE	Resilient City Development
RIDW	InvestEU Research, Innovation and Digitisation Window
RRF	Recovery and Resilience Facility
RRPs	Recovery and Resilience Plans
SCCL	Steering Committee on Contingent Liabilities
SDG	Sustainable Development Goals
SIW	InvestEU Sustainable Infrastructure Window
SISW	InvestEU Investments and Skills Window
SME	Small and medium-sized enterprises
SMEW	InvestEU small and medium-sized enterprises Window
SURE	Support to mitigate Unemployment Risks in an Emergency
TFEU	Treaty on the Functioning of the European Union
UN	United Nations
US	United States

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EXECUTIVE SUMMARY

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 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.

1. INTRODUCTION

The galaxy of EU financing instruments has increased significantly throughout recent years (Begg et al., 2022). This expansion necessarily leads to higher financial commitments on behalf of the EU, which results in increased EU contingent liabilities. These are liabilities which may arise in the future, but whose outcome is still very uncertain and therefore challenging to evaluate. However, these liabilities can constitute risks for EU finances.

Contingent liabilities expose the EU to fiscal risks which may or may not be covered by the MFF. Unspent funds in the EU budget and provisions in the Common Provisioning Fund (CPF) provide buffers if a beneficiary fails to honour its obligations towards the EU. If they are not sufficient, the Union can – as a last resort and only after having exhausted all other possibilities to find solutions within the existing budget – call on the Member States for revenues to temporarily -or permanently- cover the amount in question. The corresponding revenue could be over and above the MFF ceilings, while respecting the own resources ceiling.

The appropriate management of contingent liabilities is essential to ensure the sustainability of the EU's public finances. This study explores and presents the magnitude of such contingent liabilities, how they can affect the EU budget, and the existing approaches to mitigate any risks, as well as options for improvement.

The study aims to provide a granular assessment regarding the existing EU contingent liabilities, the risks associated with them, and the best ways to manage them. The study therefore has two main objectives:

- First, we explore the risks existing contingent liabilities cause for EU finances and the evolution of these liabilities and associated risks in the recent past. Our goal is to explain these complex structures in a way that is easy to grasp. We discuss each individual type of contingent liability in terms of its current magnitude and source. We also make projections for contingent liabilities in the EU until 2027.
- Second, we analyse the overall framework for identifying, monitoring and buffering any risks to the EU budget due to contingent liabilities. We explore what indicators and methodologies are currently used and discuss possible extensions, also drawing possible opportunities for improvements and best practices from other constituencies and large sovereign issuers to address contingent liabilities in national or supranational budgets. One of the central mechanisms for covering such risks is the Common Provisioning Fund (CPF), which has been in operation since 2021. We describe how the CPF functions and to what extent it addresses existing risks. Furthermore, other contingent liabilities are covered by the headroom embedded in the MFF through the Own Resources Decision (ORD). These are contingent liabilities that have increased and will continue to increase in the coming years.

2. CONTINGENT LIABILITIES IN THE EUROPEAN UNION

This chapter serves as an overview of how the current galaxy of the EU budget gives rise to contingent liabilities. The chapter begins with a discussion on what contingent liabilities are and continues with a presentation of all instruments leading to contingent liabilities and their magnitude and importance.

2.1. What are contingent liabilities?

A contingent liability can be defined very generally as a financial obligation the size and occurrence of which depends on uncertain events in the future that are difficult or impossible to predict. Given their dependence on specific events, the payments due to the financial obligation might not be made or called at all. For example, a contingent liability may arise from a guarantee which the EU covers to an implementing partner under a fund such as InvestEU. The implementing partner extends a loan or other investment operation (equity) and, if a payment default occurs, the EU budget covers these losses. Similarly, a contingent liability arises when macro financial assistance is granted to a third country or a Member State in the form of a loan. If the beneficiary defaults, the losses are covered again by the EU budget. In contrast to these examples, financial instruments are fully provisioned for, as they have a full 100% upfront provision. Since the default on such instruments will therefore not lead to any additional fiscal burden for the EU budget as these losses are already fully provisioned, they do not constitute contingent liabilities.

Due to their highly uncertain nature, the fiscal risks of such liabilities are difficult to evaluate.[1] One important question in their evaluation is therefore whether they become liabilities when they are created or only when the contingent event occurs. As noted by the Commission 'whether or not these contingent liabilities result in actual calls, and the size of any such calls, will depend on future events which cannot be predicted ex-ante'.[2] In accounting terms, contingent liabilities should be accounted for when they are incurred if the contingency has more than a 50% chance of occurring and if the payment risks can be reasonably evaluated. In statistical terms, however, the contingent liability is accounted for only if and when the contingency occurs.

Contingent liabilities need to be accounted for and analysed, because they constitute the risk of undesirable budgetary "surprises" with possible implications for the fiscal standing or even for fiscal sustainability. Such risks require increased awareness and understanding also because they could be an instrument to hide the incurrence of liabilities and could create stealth fiscal risks. Unlike direct support in the form of grants, subsidies or other expenditures, these risks can be concealed because they have no direct costs in a cash budgeting system and can be used to bypass public discussions embedded in budget processes. This situation might also lead to moral hazard problems, since risks can be transferred from the private to the public sector in the case of guarantees, thereby reducing incentives for prudent monitoring and selection, which in itself increases the likelihood the guarantee will be called. Due to such hidden risks and their possible implications for creditworthiness, the assessment of contingent liabilities has gained importance, especially in the aftermath of the Global Financial Crisis (Cebotari, 2008).

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1 There are numerous definitions for contingent liabilities. In accounting terms, contingent liabilities are those that remain off-balance sheet. In statistical terms, the IMF's 2001 Government Finance Statistics Manual defines contingent liabilities as guarantees and the net present value of accrued obligation of social security schemes. It is however unclear whether social security benefits can be defined as contingent liabilities, as their occurrence is certain.

2 European Commission (2023a). Report from the Commission to the European Parliament and the Council on financial instruments, budgetary guarantees, financial assistance and contingent liabilities Situation at 31 December 2022. COM(2023), 683 final, p.2.

Therefore, monitoring, safeguards and risk management are important to counteract such fiscal risks. The goal of such measures is to limit excessive reliance on such liabilities and to minimise the moral hazard spurring from them. This requires increased transparency through Parliaments and the general public and better risk management frameworks, which we discuss in Section 6. Transparency can be achieved by integrating decisions on contingent liabilities in the budget process (Cebotari, 2008) and further measures to strengthen scrutiny and accountability by providing clear information and full disclosure on the contingent liabilities incurred and possibly by implementing rules placing limits on the amount of such liabilities.

Contingent liabilities can be implicit or explicit. Explicit liabilities are purposefully taken by governments and are based on policies enacted or laws passed. They include guarantees (loan guarantees, export guarantees), government insurance programs, uncalled capital, natural disaster spending and others. Implicit guarantees are more subtle, as they are mostly ex-ante and not explicitly announced or accounted for. They are due instead to the political or moral need for the government to react ex-post to a specific event, such as in the situation of a crisis, natural disaster or insolvency of large entities. Examples include bailouts of public enterprises, financial institutions or subnational entities when the cost of not intervening is deemed too high or unacceptable, as well as natural disaster relief when there is no private insurance covering damages. Implicit liabilities are purposely not accounted for ex-ante, as this would worsen the moral hazard problem by creating expectations of interventions or bailout on behalf of the government in a situation of crisis. According to Cebotari (2008), contingent liabilities are most widespread in the form of loan guarantees, which are in place in most countries, while the fiscal costs are the most sizeable from implicit liabilities. Historically, these are especially sizeable in the area of bailouts of financial institutions. According to the dataset by Laeven and Valencia (2008), bailouts of the financial system averaged to about 13% of GDP in 442 crisis episodes from 37 countries between 1970 and 2007.

Contingent liabilities in most advanced economies are dominated by government guarantees. The main argument for taking on contingent liabilities, especially guarantees, which are backed by public budgets and can impose fiscal risks, is normally some form of market failure (Cebotari, 2008). Market failures are situations in which the market does not achieve an efficient, Pareto optimal outcome, e.g. insufficient provision of credit by private financial institutions, adverse selection of credit recipients, or inability to price a financial asset. Especially in the case of guarantees, governments take on contingent liabilities mostly to address market failures related to imperfect information, information asymmetries or externalities. However, a market failure on its own does not suffice as an argument for a government intervention and should be complemented by a cost benefit analysis showing that the intervention (e.g. a guarantee or other form of financial assistance) has a positive net present value.[3] In the next section we introduce the main types of contingent liabilities in the EU. In the EU, the contingent liabilities span beyond pure government guarantees, and the traditional economic analysis can be extended to also take into account other priorities (geopolitical, financial stability, normative goals such as addressing the green transition) when discussing the need for such interventions to correct a market failure.

Contingent liabilities are provisioned for or not provisioned for. Some types of contingent liabilities require a provision upfront when they are issued, e.g. in the case of guarantees, the expected cost of the guarantees should be budgeted upfront. Provisioning is mostly used for quantifiable contingent liabilities that are likely to materialise. For example, governments preparing budgets and

[3] Net present value (NPV) is used to calculate the current value of a future stream of payments by discounting these payments given a specific discount rate for each period.

financial statements on an accrual basis can recognize the net present value of the amount expected to be called as a liability on their balance sheet and expense in the income statement at the time when the liability is issued (Cebotari, 2008). This is the provision for a liability and an expense of uncertain amount and timing.[4] Other contingent liabilities, which are not provisioned for, might hide bigger fiscal risks for the budget. As we discuss below, non-provisioned contingent liabilities, the risks of which are harder to quantify, dominate the EU universe of contingent liabilities.

The next sub-section discusses the current universe of contingent liabilities in the EU. Debt transparency regarding these contingent liabilities is important to help timely decisions on necessary risk management actions and to improve the current set-up on risk management of contingent liabilities, where necessary. The importance of debt transparency and monitoring of contingent liabilities is detailed separately in Chapter 6.

2.2. Contingent liabilities in the EU

In the last decade, new financial instruments have expanded the galaxy of EU financial instruments (Begg et al., 2022). The current galaxy of EU financing instruments is therefore quite complex, given that it mixes old instruments with a decade-old history – such as guarantees provided by the European Investment Bank (EIB) to beneficiaries outside of the EU (under the External Lending Mandate since 1977) – and other, newer guarantees and financial assistance to third countries, as well as financial assistance to EU Member States. The accounting process for these old instruments in the EU budget has, however, been newly regulated with the 2018 revision of EU Financial Rules. Since the start of the pandemic and the current MFF 2021-2027 period, the EU's contingent liabilities have grown significantly, mainly due to increased financial assistance, primarily within the EU (through programmes like SURE[5] and NextGenerationEU), but also outside of the EU. Other important financial funds, such as EFSI and EFSD, found successors in InvestEU and EFSD+ under the MFF 2021-2027. Nonetheless, there is an important difference between budgetary guarantees, financial assistance, and financial instruments. Budgetary guarantees and financial assistance can lead to contingent liabilities, which are not budgeted for, while, for financial instruments, the contingent liabilities are fully provisioned at the time of their creation. This difference leads to an important trade-off: budgetary guarantees and financial assistance do not decrease the value of the EU budget at the time of their creation (or to a much lesser extent, as regards partly provisioned guarantees), but they do create uncertain risks of provision far into the future.

Throughout this study, there is a distinction between three different types of contingent liabilities in the EU – budgetary guarantees, Macro-Financial Assistance (MFA) to third countries and financial assistance to EU Member States. Under budgetary guarantees, the EU covers implementing partners' losses resulting from payment defaults emanating from 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 form of loans as authorized by the relevant legal act. Financial assistance to EU Member States is predominantly in the form of SURE and RRF loans, although it includes, to a smaller extent, Euratom and Balance of Payment (BoP) loans or EFSM programmes. These different types of contingent liabilities can then also be grouped into two distinct categories: provisioned contingent liabilities and headroom-backed (unprovisioned)

[4] Under the current International Public Sector Accounting Standards (IPSAS) standards for the public sector, these are contingent liabilities which fulfil two conditions: (a) the probability that the contingency will occur and hence a payment would have to be made is more than 50%; and (b) these payments can be reasonably measured, are defined as "provisions", while for those for which the probability is less than 50% are defined as "contingent liabilities" (Cebotari, 2008). In this definition therefore "recognised" contingent liabilities are "provisions".

[5] The European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE).

contingent liabilities. It is important to underscore that all MFA programmes up until the end of 2022 have been provisioned, while, since the beginning of 2023, the MFA+ programme for Ukraine and the Ukraine Facility are headroom-backed.

According to the official data, as of 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 EFSI, EFSD, EFSD+, and ELM (European Commission, 2022a). This amount corresponds to a 43% increase in total contingent liabilities compared to the total in 2020.

At the end of 2022, contingent liabilities further increased to a total of EUR 312 billion, an increase of an additional almost 40% in comparison to 2021. The contingent liabilities related to loans to Member States and third countries amounted to EUR 206 billion, an increase of 26%. A major part of this nominal increase is due to new loans to Member States as part of the Recovery and Resilience Facility (RRF)), which amounted to an increase of EUR 27.3 billion from EUR 17.9 billion in 2021 to EUR 45.3 billion in 2022. This constitutes an increase of 152% compared to 2021. At the same time, the percentage increase in financial assistance to third countries was also high (97.5%) because of the low starting level of Macro-Financial Assistance (MFA) (EUR 7.5 billion in 2021; EUR 15.0 billion in 2022). Contingent liabilities related to budgetary guarantees have also increased by 75.2% to EUR 106 billion, mainly due to the introduction of EFSD+ and InvestEU (European Commission, 2021a, 2022a, 2023a).

At the time of preparation of this study, official numbers on all contingent liabilities were only available up to 2022, as the annual report from the Commission to the European Parliament and the Council on financial instruments, budgetary guarantees, financial assistance and contingent liabilities for 2023 has not yet been published. This is the report that documents, in a consolidated form, the data regarding all three types of contingent liabilities by the end of the previous year. Working Document XI of the Draft General Budget of the EU also provides data in June on contingent liabilities, but only related to guarantees and MFA (provisioned contingent liabilities). We therefore make use of the annual data from the consolidated reports, as well as other European Commission Communications (2023a, 2024b), to report official data until end of 2022 and preliminary 2023 data. Since the different reporting arrangements and reporting frameworks with distinct official documents and formats are often challenging to compare, in Section 6, we discuss and recommend some improvements to streamline this process. A dataset documenting and tracking the evolution of contingent liabilities is one output from this study.

Table 1 presents a summary of the main sources of contingent liabilities in 2020, 2021 and 2022 and their annual growth rates.[6] The left part of Figure 1 presents the nominal level of the three main groups of contingent liabilities. Until the COVID-19 pandemic and by the end of 2020, budgetary guarantees and financial assistance to Member States were of a similar magnitude and importance. Financial assistance to Member States was lower than budgetary guarantees at the beginning of 2020 and increased by EUR 39.5 billion in 2020 solely due to the creation of the SURE instrument.

However, with the implementation of SURE and the start of the functioning of the Recovery and Resilience Facility (RRF), financial assistance to Member States grew considerably in 2021 from an already high base and continued growing markedly in 2022 (see right side of Figure 1). In

[6] Preliminary information on guarantees in 2023 is available from the Draft Budget for 2024, Title XI (European Commission, 2024a).

2022, the growth rate was also high for financial assistance to third countries, especially due to the expansion of MFA to Ukraine, as well as for budgetary guarantees.

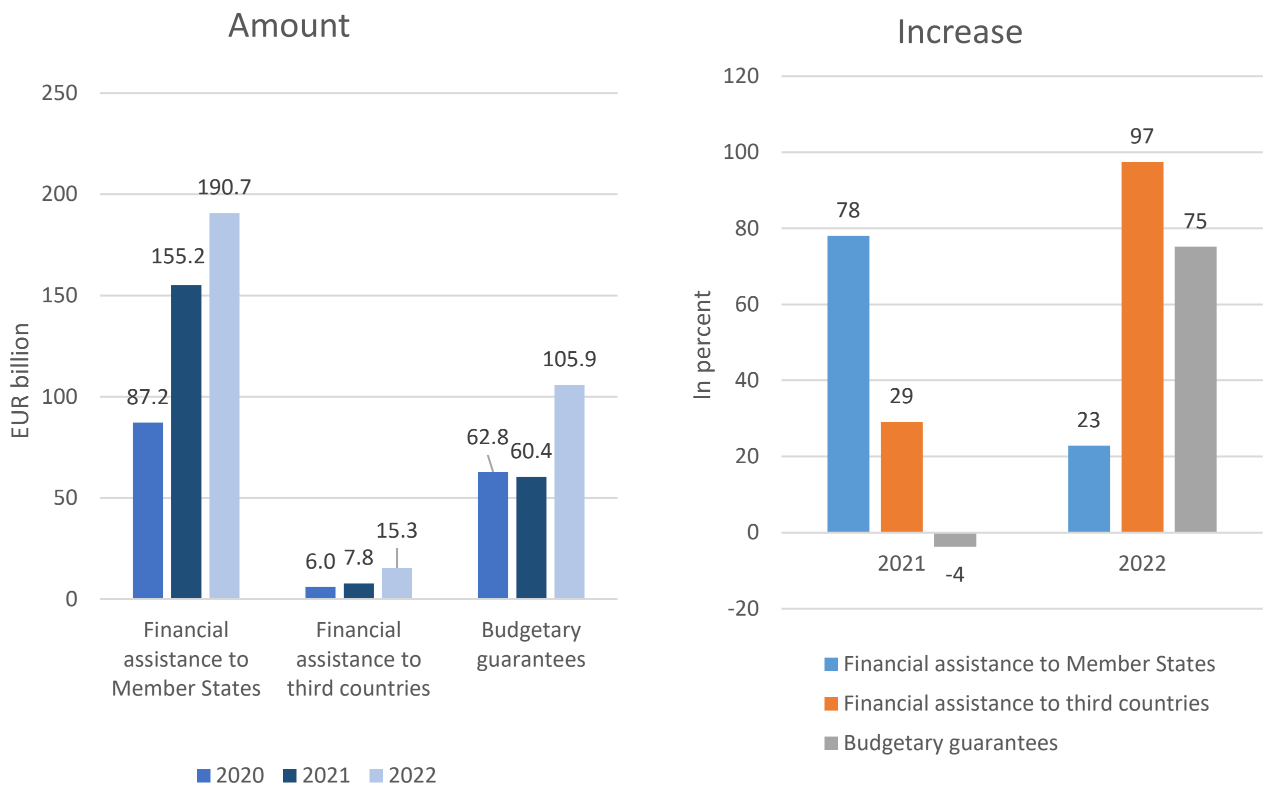
Since these growth rates hide very different starting magnitudes, the left part of Figure 2 shows the relative shares of each contingent liability type in total contingent liabilities in the EU. Financial assistance to Member States dominates contingent liabilities in the EU, ranging between 55% and 70% of the total in 2020, 2021, and 2022. This share is expected to continue to grow in coming years. Budgetary guarantees also play an important role within the total contingent liabilities (between 40% and 27%). Financial assistance to third countries has constituted a low share of contingent liabilities in the EU so far, yet this is expected to change as the MFA to Ukraine that has been agreed upon and will be implemented in the coming years is, in order of magnitude, bigger than the MFA accumulated so far. Therefore, the total growth of EU contingent liabilities in recent years has been driven by financial assistance to Member States and by budgetary guarantees (right side of Figure 2).

Table 1: EU Contingent Liabilities as of end 2020, 2021 and 2022 as reported by the European Commission

Contingent Liabilities	2020	2021		2022	
	In EUR billion		Change	In EUR billion	Change
Financial assistance to MS	**87.18**	**155.22**	**78.0%**	**190.74**	**22.9%**
BoP	0.20	0.20	-0.1%	0.20	0.0%
Euratom	0.08	0.05	-36.2%	0.03	-48.0%
EFSM	47.40	47.27	-0.3%	46.72	-1.2%
SURE	39.50	89.70	127.1%	98.46	9.8%
RRF		18.00	78.0%	45.34	152.0%
Financial assistance to third countries	**6.01**	**7.77**	**29.1%**	**15.33**	**97.5%**
MFA	5.81	7.47	28.4%	15.03	101.4%
Euratom	0.20	0.30	49.6%	0.30	0.0%
Budgetary guarantees	**62.78**	**60.44**	**-3.7%**	**105.87**	**75.2%**
EFSI	25.83	25.83	0.0%	25.79	-0.1%
EFSD	1.37	1.39	1.4%	1.18	-15.4%
ELM	35.58	33.03	-7.2%	30.60	-7.3%
EFSD+		0.20		27.02	13,410%
InvestEU				21.28	
Total	**155.97**	**223.42**	**43.2%**	**311.94**	**39.6%**

Source: European Commission (2021a, 2022a, 2023a).

Figure 1: Contingent liabilities per type



Source: European Commission (2021a, 2022a, 2023a).

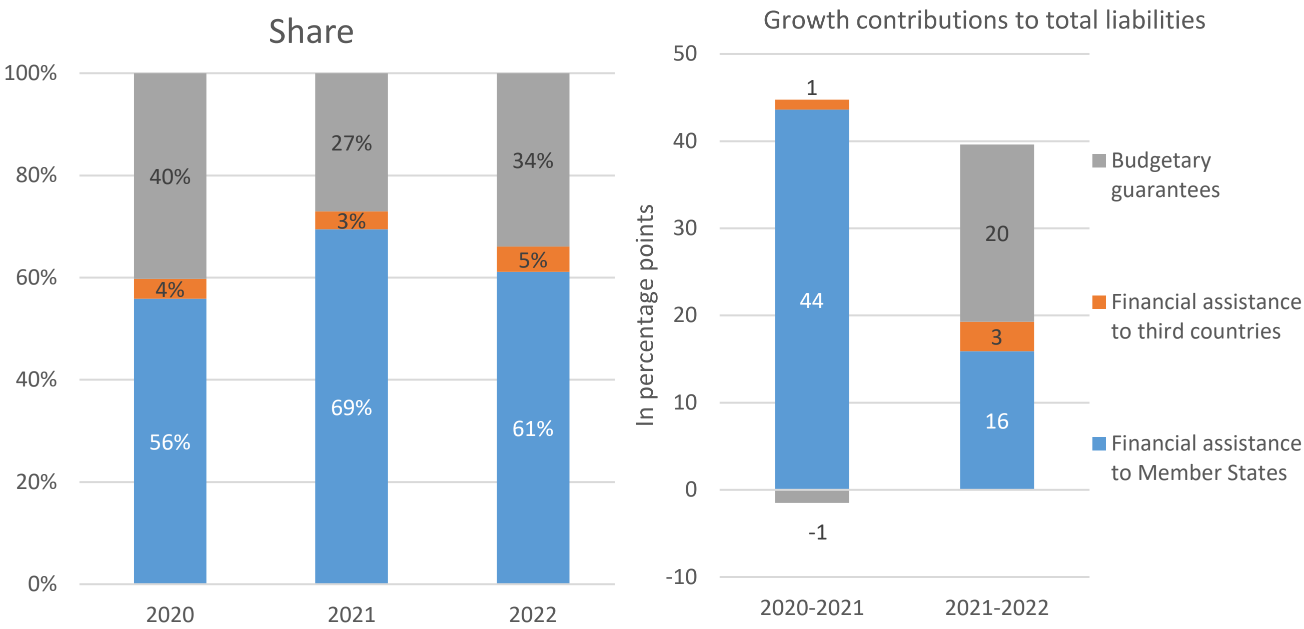
In order to identify future risks to the EU budget, it is important to group contingent liabilities into two main categories (see Figure 4):

- Provisioned contingent liabilities: provisioned contingent liabilities are those arising from budgetary guarantees and from financial assistance to third countries.
- Headroom-backed contingent liabilities: headroom-backed contingent liabilities are those stemming from financial assistance to Member States with the addition since 2023 of the financial assistance to Ukraine under MFA+ and the Ukraine Facility, as discussed further below.

These two categories of contingent liability 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, e.g. 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.[7] At the end of 2023, the market value of the CPF stood at EUR 18.8 billion and was evaluated as providing a sufficient buffer for outstanding risks due to provisioned contingent liabilities (European Commission, 2024c). According to the European Commission (2023b), the CPF is expected to receive an additional EUR 23.17 billion in inflows from its contributing instruments over the period 2023-2030, thereby signifying a considerable increase.

[7] For more details see European Commission (2023b).

Figure 2: Share and growth contributions of contingent liabilities by type



Source: European Commission (2021a, 2022a, 2023a).

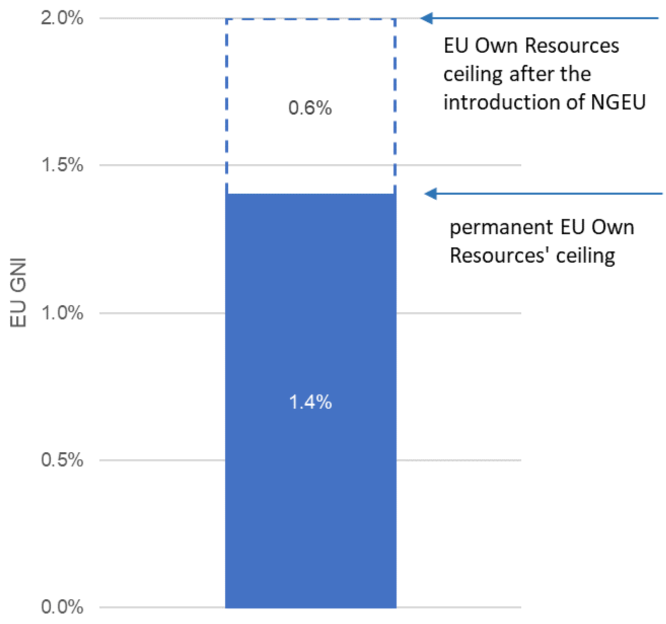
Headroom-backed contingent liabilities constitute a more direct risk to EU finances since they are not provisioned for. The headroom is the difference between the maximum amount of resources that the Commission can ask Member States to contribute in a given year (the own resources ceiling) and the funding that the EU requires to cover the expenses foreseen by the budget in the given year. If the ceiling is high enough, this guarantees the EU will be able to cover all of its financial obligations and risks from contingent liabilities occurring in a given year. It is important to note that the ceiling for revenues (the own resources ceiling) establishes the maximum amount of own resources the Union can request from Member States to cover its financial obligations. EU budget expenditure ceilings, on the other hand, are set through the long-term budget ceilings by the MFF Regulation subject to technical adjustments. They constitute ex ante the maximum amounts that the Union can either commit to pay or pay under the EU budget during the relevant period.

The headroom covers all contingent liabilities including those arising from financial assistance to Member States and from financial assistance to Ukraine under the MFA+ instrument and the Ukraine Facility. The Common Provisioning Fund (CPF) provides the buffer for provisioned contingent liabilities. If a beneficiary fails to honour its obligations towards the EU, the EU would first recourse to its budget to provide for the necessary resources, or to the Common Provisioning Fund for provisioned contingent liabilities. The Union can – as a last resort and only after having exhausted all other possibilities to find solutions within the existing budgetary framework – call on the Member States for revenues to temporarily -or permanently- cover the amount in question. The corresponding revenue could be over and above the MFF ceilings, while respecting the own resources ceiling[8] (European Commission, 2024c). **The introduction of NextGenerationEU increased the overall envelope of the EU budget 2021-2027 considerably.** The 2021 Own Resources Decision has also increased the standard, permanent Own Resources Ceiling from 1.4% by 0.6pp (Additional Own Resources Ceiling) to 2.0% of the Gross National Income (GNI) of the EU. This additional headroom is available only for

8 Availabilities under the relevant expenditure ceiling allow for the necessary replenishment of the CPF in case of need.

possible increases in expenses due to contingent liabilities under NGEU. This increase is exceptional and temporary and is due to the increased liabilities and expenses related to the COVID-19 rescue package. The own resource ceiling will be lowered back to 1.4% of GNI as soon as all liabilities of the EU budget related to NextGenerationEU have been repaid in full and therefore cease to exist (by 2058 latest).

Figure 3: Adjustment of the EU Own Resources' ceiling



Source: European Commission.

Headroom-backed contingent liabilities dominate total contingent liabilities. In 2022, they made up around 62% of total contingent liabilities (Figure 4). As forecast in Section 4, this type of contingent liability will continue to increase in the coming years, mainly due to RRF loans and financial assistance for Ukraine. The risks of any of these contingent liabilities are very uncertain and difficult to predict, as discussed further below, and would therefore require close monitoring.

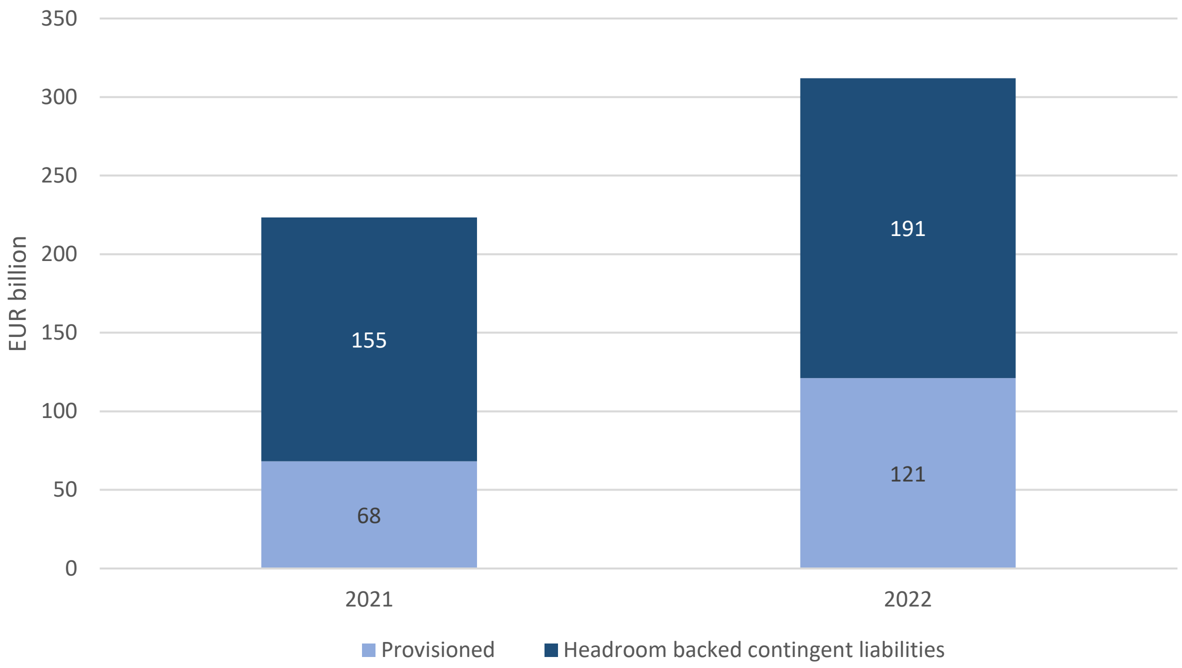
The 2023 Commission Report on the state of contingent liabilities in the EU (European Commission, 2023a) concludes that the risks of both categories of contingent liabilities are well accounted for. The provisioning available at the end of 2022 and included in the different compartments of the CPF is adequate to cover any contingent liabilities arising from budgetary guarantees and financial assistance to third countries, in line with the requirements of the legal framework. The headroom available under the current Own Resources Decision above the EU budget actual spending is also adequate to cover the obligations for all contingent liabilities of the EU under the current spending programmes and instruments (the temporary additional 0,6% for NGEU contingent liabilities only). This assessment is based on a detailed stress testing exercise that takes into account different possible scenarios and a combination of the worst-case scenario in terms of shocks hitting economic growth, expenditures and loans repayment together (European Commission, 2023a). The assumptions underlying this evaluation are discussed in Section 5 and Section 6.2 respectively, and some proposals for improvements are made.

Figure 5 summarises the main developments related to contingent liabilities from 2020 – 2023, including their absolute amounts, growth rates, relative share of different type of contingent

liabilities, and the distinction between the categories of provisioned and headroom backed contingent liabilities.

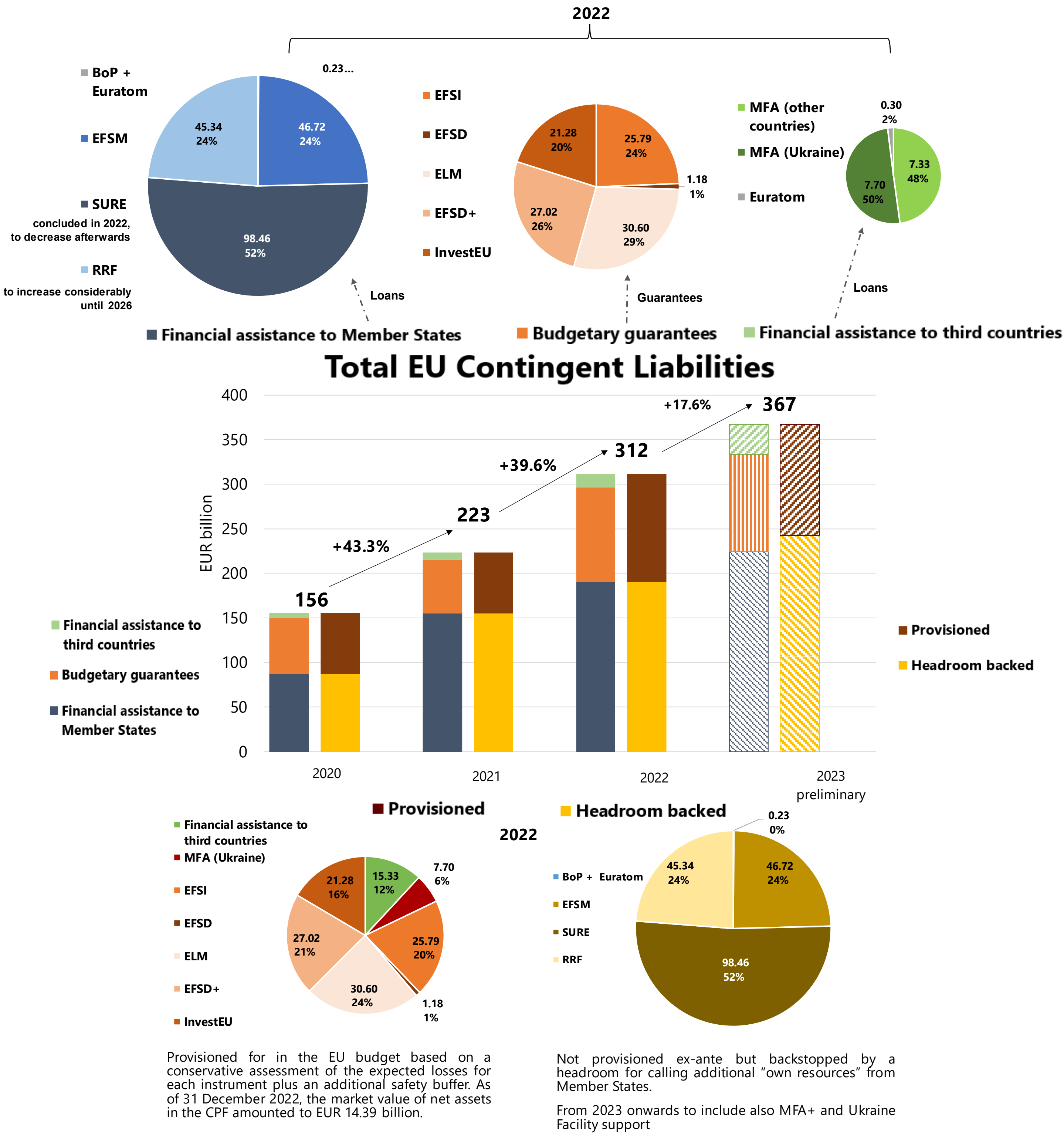
In the next chapter, we describe each type of contingent liability in the EU and its evolution during the MFF 2021-2027 and then analyse the implications of these developments. The developments of the two categories of liabilities – provisioned and headroom-backed contingent liabilities – are also discussed.

Figure 4: Contingent liability by category



Source: European Commission (2022a, 2023a).

Figure 5: Overview of EU Contingent Liabilities, in EUR billion



Source: European Commission (2021, 2022a, 2023a), own illustration, in EUR billion and current prices.

3. EVOLUTION OF CONTINGENT LIABILITIES IN THE EUROPEAN UNION

This section analyses the outstanding EU contingent liabilities in detail. Their evolution over recent years is tracked, and the source of the recent increases in individual components is analysed. The section highlights the dominant contribution of two sources to the recent rapid increase in contingent liabilities: RRF loans and MFA assistance to Ukraine.

3.1. Provisioned contingent liabilities

3.1.1. Budgetary guarantees

Budget guarantees are a source of risk exposure for the EU budget. Under all budgetary guarantee instruments and as stipulated by the respective guarantee agreements, the EU covers (fully or partially) implementing partners' losses resulting from payment defaults emanating from financing and investment operations (debt or equity). The available guarantee signed with counterparts represents the total guarantee that is covered by the EU budget and therefore the EU's maximum potential exposure, including operations authorised for signature but not yet signed. Currently, the budgetary guarantees involve the InvestEU Fund, combining 13 centrally managed EU financial instruments and the European Fund for Strategic Investments (EFSI) into one instrument, the European Fund for Sustainable Developments (EFSD), the External Lending Mandate (ELM), and EFSD+.

By the end of 2021, budget guarantees amounted to EUR 60.4 billion, as presented in Section 2 in Table 1. Budget guarantees have been stable throughout 2020 and 2021, and their share in overall contingent liabilities was significant, consisting of between 27 and 40% of overall contingent liabilities. By the end of 2022, budget guarantees had increased markedly to EUR 105.9 billion (34% of total contingent liabilities), an increase of 75.2%. This increase was driven by InvestEU and EFSD+ becoming operational.

Importantly, the guarantees reported throughout the report take into account the total available guarantee signed with counterparts. This is the total guarantee enabled by different EU instruments to be implemented by the implementing partners until the end of the respective instrument timeline. For example, in 2022, the total available EU guarantees increased due to the introduction of two new instruments – InvestEU and EFSD+ (with total available amounts respectively of EUR 21.2 billion and EUR 27.0 billion). The European Commission reports on contingent liabilities consider this total available guarantee signed with counterparts as the total contingent liability for the EU, and the same approach is followed in this study. Importantly, the risk exposure at the end of the reporting period, cf. 31.12.2022, can be lower than the value of the total available guarantee, as implementing partners, cf. the EIB, need time to sign the relevant operations with final recipients, after which available guarantees become callable. As reported by the European Commission (2022, 2023a, 2024c) the values of guarantees related to operations signed by counterparts and (therefore the current actual total contingent liability stemming from them) are lower: EUR 58.5 billion, 62.3 billion, and 66.2 billion, respectively in 2022, 2023, and 2024. This is, however, due to the fact that both new instruments, InvestEU and EFSD+, are in their ramp-up phase. As with the older instruments (EFSI, EFSD, ELM), we expect most of the available guarantee to be signed throughout the lifetime of the instrument. Since it is impossible to forecast when in the future these operations will be signed with beneficiaries, we already account for the total amount of these guarantees at the time of their creation, therefore in 2022.

The guarantee programmes introduced by the European Union stretch over several multiannual financial frameworks and focus on different types of investments. The main purpose of the EU budget guarantees is to act as a collateral covering default or late payments for projects managed by implementing partners. EU budget guarantees strengthen the balance sheet of the latter – such as the European Investment Bank (EIB), the European Investment Fund (EIF) and the European Bank for Reconstruction and Development (EBRD) – by lowering their refinancing costs in the bond market and securing liquidity for ongoing operations, which might otherwise not be available in the absence of the guarantee.

Well-managed public budget guarantees result in low levels of current and future expenditures and provide considerable leverage with respect to the size of mobilised funds. This makes them particularly attractive for policymakers, but, at the same time, this signifies that careful monitoring is required. In its annual reports,[9] the European Court of Auditors (2023) regularly reviews the exposure of the EU budget with respect to potential losses from budgetary guarantees.

This chapter distinguishes five guarantee schemes covering a total EU risk for signed operations by counterparts of EUR 62.4 billion as of 31.12.2022 and a total EU risk of available guarantees signed with counterparts of EUR 105.8 billion as of 31.12.2022, as explained above. The total risk for operations signed by counterparts at end of 2022 therefore represented 36% of an average annual budget under the current seven-year financial framework, i.e. EUR 173 billion annually. Table 2 collects key figures for the five guarantee schemes based on the European Commission (2023c).

Each of these guarantee schemes is currently 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. The schemes support different financial products used to finance investment projects (ranging from sovereign lending to private equity), and they support projects either directly or indirectly through financial intermediaries. The regional focus of the five guarantee schemes is either concentrated on investment activities within the European Union or in support of investment activities located in non-EU countries. Of the five schemes, the ELM has the longest track record, ranging back to 1977.

Different bodies within the EU architecture, such as the European Investment Bank and the European Investment Fund, and multiple bodies outside the EU architecture, within the open architecture approach, act as operational partners for the European Commission. These partners provide funds for investment projects submitted by local entrepreneurs or public entities. The structure of triple layers helps spread the risk of default of a project across local entities, partner institutions, and the EU general budget. While the early guarantee schemes preferred a single implementing partner, the more recently-introduced guarantee schemes tend to use an open architecture with multiple implementing partners.

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[9] European Court of Auditors (2023). Annual reports on the implementation of the EU budget for the 2022 financial year and on the activities funded by the 9th, 10th and 11th European Development Funds (EDFs) for the 2022 financial year. https://www.eca.europa.eu/ECAPublications/AR-2022/AR-2022_EN.pdf

Table 2: EU contingent and financial liability due to budgetary guarantees at 31.12.2022

	EFSI	InvestEU	EFSD	ELM	EFSD+	Total
	Year					
Introduction in	2015	2022	2017	1977	2021	
Extended in	2017	-	-	2021	-	
End of approval of operations by	2020	2027	2020	2021	-	
End of signature of contracts by	2022	2028	2020	-	2027	
	Number					
Signed projects	1531	28	17	668	-	
	EUR billion					
Available guarantee signed with counterparts[1]	25.793	21.280	1.176	30.599	27.020	105.869
EU risk for operations signed by counterparts[2]	24.615	2.108	0.534	30.599	4.515	62.371
EU risk for operations signed by counterparts and disbursed	21.084	0.324	0.446	20.909	0.156	42.919
Investment mobilised by guarantee[3]	502.953	2.939	-	132.052	-	-
Cumulative guarantee revenues[4]	1.428	0.003	0.002	0.028	0.001	1.461
Cumulated net guarantee calls[5]	0.182	0.000	0.001	0.853	0.000	1.036
Common Provisioning Fund [6]	8.464	1.700	0.698	2.467	1.067	14.395

Source: European Commission (2023c) – The EFSD+ open architecture window is comprised of available guarantees up to EUR 13.1 billion of which EUR 0.3 billion cover EU risk signed by counterparts at the end of 2022. – 1) Available guarantees under each program, after deducting guarantee calls and other expenses covered by the guarantee. 2) EU risk in the program. 3) Investments made by final recipients of signed and disbursed projects. 4) Under the agreements, the European Union is entitled to a remuneration for its guarantee. 5) Losses from guarantees net of recoveries and guarantee revenues. 6) The Common Provisioning Fund holds the assets that protect the EU budget against losses that may arise from financial instruments, budget guarantees or financial assistance to third countries. At market value as of 31.12.2022. Values for the Common Provisioning Fund in the ELM column correspond to the Guarantee Fund for external actions (GFEA), which holds the provisions for the external lending mandate (ELM), legacy (macro-financial assistance (MFA), and Euratom programmes.

EU guarantees cover a share of the losses if EU partners experience losses from their financial investment operations (debt or equity). All schemes implement a strategy of risk-sharing with the operating partner, where the EU typically covers the first or second loss piece, and the respective partners retain part of the risk on their own books. The risk-sharing strategy helps mitigate adverse selection and moral hazard-related issues and provides incentives for the correct identification and pricing of risk. In most schemes, the EU receives revenues from the underwriting of a guarantee. The lower part of Table 2 shows, that, excluding the ELM, losses from so-called net guarantees (cumulative guarantee calls minus cumulative recoveries) as of the end of 2022 are smaller than cumulative revenues.

a. European Fund for Strategic Investments

The European Fund for Strategic Investments (EFSI) was introduced in 2015 as an EU-wide response to the fall-out from the government debt crisis. Their introduction was part of the Juncker Plan and aimed at increasing the long-term growth path of the EU economy after the slow-down of the 2008/2009 financial market crisis.

EFSI was designed as a guarantee scheme to ease financial conditions for strategically important investment projects with a higher risk profile. Guarantees for loans provided by the European Investment Bank (EIB) and the European Investment Fund (EIF) started in 2015, were extended in 2017, and stopped underwriting at the end of 2022. EFSI guarantees act as a lever for the EIB group's own funds and form one pillar of the Investment Plan for Europe (Juncker Plan). Through the EIB and EIF activities, EFSI guarantees leverage private and public investments in the EU throughout strategic sectors relevant for the Europe 2020 strategy:

- Strategic infrastructure including digital, transport and energy;
- Education, research, development and innovation;
- Renewable energy and resource efficiency;
- Support for small and mid-sized enterprises.

Most of the EUR 503 billion investments mobilised by EFSI guarantees (cf. Table 2) are financed from private sector resources amounting to EUR 363 billion. Public sector investments cover the remainder. The sectoral distribution shows research development and innovation (34%), energy (17%), and small and mid-sized enterprises as the main beneficiaries of guarantee-backed finance.

EFSI is managed under two windows that each feature several portfolios and products:

- the Infrastructure and Innovation Window (IIW) managed by the EIB and comprising four portfolios;
- the SME Window (SMEW), managed by the EIF and comprising 11 products.

The distribution of investments covered by both windows is slightly tilted towards IIW with a total of EUR 288 billion of infrastructure and innovation investments executed in 699 signed projects. The SMEW generated EUR 215 billion within 832 signed projects. The underwriting policy by the EIB and the EIF had neither country-specific nor sectoral requirements, i.e. the allocation of guarantees across projects was driven by the structure of applications and therefore allowed for the alignment of risk management strategies along sectoral rather than geographical risk diversification.

Given the long-term nature of the investment projects covered by budget guarantees under EFSI, the EU will be exposed to risks of non-payment for a considerable period. Table 2 shows that EFSI disbursed EUR 21.1 billion up to the end of 2022. The leverage from EFSI can be seen by comparing the EU risk covered by operations signed (EUR 24.6 billion) with the total investment mobilised by all projects signed before the end of 2022 (EUR 503 billion). EFSI has been followed by InvestEU in 2022 after the start of the new MFF.

The agreement between the European Commission and the EIB group provides for a guarantee premium and participation of the EU in recovery proceedings after a guarantee call. The cumulated premium received by the EU up to the end of 2022 is bigger than accumulated losses from guarantees (Table 2). Because the warranty period is in its early stages and further projects may fail before all financial instruments mature, this optimistic picture may be reversed. Revenues from guarantee premiums cover realised losses, fees incurred, the further build-up of the EFSI compartment in the CPF, or they are transferred to the general EU budget.

b. **InvestEU**

The InvestEU guarantee programme is the successor to EFSI and thirteen other centrally managed financial instruments. The launch of InvestEU took place in 2022 after the start of the new MFF. The approval of new operations will end in 2027, while contracts associated with new guarantees can be signed until the end of 2028. InvestEU is implemented by the EIB, the EIF, and other partners and covers losses incurred by the implementing partners. It has been equipped with a maximum coverage of EUR 26.2 billion (European Commission, 2022a) over the period of 2022 to 2027. InvestEU intends to support investment spending by private enterprises and public entities by mobilising long-term funding. The four strategic sectors promoted under the EFSI have been expanded by targets covering finance for social enterprises and investments in social competences and skills (European Commission, 2023c). Through the EIF and its partners' activities, guarantees under InvestEU leverage private and public capital formation in the EU within the following strategic sectors:

- supporting financing and investment operations related to sustainable infrastructure (Sustainable Infrastructure Window – SIW);
- supporting financing and investment operations related to research, innovation, and digitisation (Research, Innovation and Digitisation Window – RIDW);
- increasing access to, and the availability of finance for, small and medium-sized enterprises (SMEs) and small mid-cap companies, and enhancing their global competitiveness (SME Window – SMEW);
- increasing access to, and the availability of, microfinance and finance for social enterprises to support financing and investment operations related to social investment, competences and skills, and to develop and consolidate social investment markets (Social Investments and Skills Window – SISW).

The underwriting policy for the InvestEU scheme will have no country-specific nor sectoral requirements, i.e. the allocation of guarantees across projects will be driven by the structure of individual applications and will therefore allow the alignment of risk management strategies towards project-specific risks, e.g. diversifying the underwriting of guarantees across projects applying different clean energy technologies within an economic sector or spreading risk across economic sectors using the same technology. The European Commission intends to support financing and investment operations with a higher risk profile, which are assumed to be better when shared at the EU-level rather than the level of individual Member States. InvestEU is also open to voluntary contributions by Member States.

InvestEU was designed to mobilise public and private financing sources to provide long-term funding and support for investment projects to the extent of a total of EUR 372 billion. This implies that an investment multiplier, i.e. the ratio between mobilised investment and available guarantees under the InvestEU-programme, of more than 14 for the guarantees is available. At the end of 2022, projects amounting to EUR 2.1 billion have been approved, and contracts covering EUR 324 million have been signed (cf. Table 2). The estimated mobilised investment was EUR 2.9 billion.

The European Union receives remuneration for its guarantees under InvestEU. The premium payment in 2022 amounted to EUR 2.8 million. These revenues have been partially used to cover a guarantee already called in and other expenses incurred. The remainder has been used to build up the InvestEU element of the CPF.

c. European Fund for Sustainable Development

The European Fund for Sustainable Development (EFSD) supports investments in third countries by offering a guarantee scheme oriented primarily towards Africa and neighbouring countries of the EU. The aim of the guarantee scheme is to reduce the gap between funds already available for investment and the amount of funds needed to meet the UN Sustainable Goals. Indirectly, the EFSD addresses the pressure arising from irregular migration by improving conditions in host and transition communities.

The EFSD guarantee scheme was established in 2017 with an investment period lasting until the end of 2020. At the end of 2020, the EFSD capacity was fully exhausted. The implementation is indirectly managed by the European Commission in cooperation with selected partner financial institutions who propose investment programmes to be covered by the EFSD Guarantee (cf. Table 3 for a list of partners). The European Commission initiated negotiations about the financial structures of the proposals involving the Guarantee Technical Assessment Group, which supports the European Commission in the financial design of contracts (Art. 4 Regulation (EU) 2017/1601) (European Parliament, 2023). The Assessment Group is specialised in financial risk assessment and has been specifically established for the EFSD guarantee scheme. The financial institutions involved in the guarantee agreements have four years to use the guarantee for the underlying operations. The duration of the guarantees should, as a rule, not exceed fifteen years.

The EFSD guarantee intends to leverage public and private sector financing of development projects and uses a risk-sharing structure for lending to local entrepreneurs. The default risk is shared with development banks and private sector investors, thereby reducing adverse selection bias in underwritten projects and moral hazard-induced defaults. All eligible partners require a pillar assessment that 'confirms compliance with EU accountability standards',[10] i.e., they must be recognised as pursuing a public service mission (EY, 2024). Partner institutions are mostly Member States' national development finance institutions and multilateral development finance institutions. These institutions are pillar-assessed. On the other hand, no private entity was pillar-assessed up to the end of 2022, and, consequently, no private entity is deemed an eligible counterpart to co-sign an EFSD guarantee agreement.

The area of activities supported is similar to the EFSI and InvestEU schemes and covers five key sectors:

- small business financing;
- sustainable energy and connectivity;
- local currency financing;
- digitalisation;
- sustainable cities.

[10] Lundsgaarde et al. (2022). p. 20.

The guarantees cover agreements with a selected group of partner financial institutions, and they are tailored to mirror the proposed investment programme by the partner involved. By the end of 2022, 18 agreements for guarantees had been signed. One of these was cancelled due to complicated negotiations in combination with the binding time constraints imposed by the EFSD timeline (Resilient City Development, RECIDE, together with partner institution AECID from Spain). Table 3 presents the maximum guarantee volume signed with each partner institution by individual agreements. Each partner institution can set up more than one agreement covering different proposed investment programmes. The number of agreements per partner can be seen from the number of columns in Table 3. The numbers in each cell represent the maximum guarantee signed with the partner institution. The EIB signed the largest volume of guarantees among partner institutions. Most of these guarantees did not support investment projects in partner countries. Instead, they were part of the EU initiative to increase access to COVID-19 vaccines in third countries (EUR 458 million). Among the other partnering institutions, Germany's KfW and France's AFD stand out with significantly higher volumes of guarantees.

Due to the early phase in the implementation cycle of EFSD, the amount of EU risk at the level of operations signed and disbursed is still low (Table 2). Consequently, the revenues from fees and the payments for guarantees called in at the end of 2022 were small.

Table 3: EFSD Financial information at the level of guarantee agreement at 31.12.2022

	Maximum guarantee signed in different programmes by partner in EUR million, by agreement			
Partner	Individual agreements			Total
FMO	100.0	40.0		140.0
CDP (EGRE NS)	30.0	12.0		42.0
EBRD	50.0	100.0		150.0
KfW	46.0	145.0	20.0	211.0
EIB	100.0	458.0		558.0
CDP (InclusiFi)	60.0			60.0
AFD	50.0	91.5		141.5
PROPARCO	68.2			68.2
COFIDES	20.0			20.0
IFC	58.0			58.0

Source: European Commission (2023c). Agence Française de Développement (AFD), Cassa Depositi e Prestiti (CDP), Compañía Española de Financiación del Desarrollo (COFIDES), European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), International Finance Corporation (IFC), Kreditanstalt für Wiederaufbau (KfW), Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (FMO), Private sector financing arm of Agence Française de Développement Group (PROPARCO).

d. External Lending Mandate

Under this mandate, the EU provides guarantees for third country financing operations of the EIB and therefore extends the EIB's risk-bearing capacity. The European Commission must form an opinion on each financing operation of the EIB and ensure compliance of EIB activities under the Mandate with EU assistance policies, programmes, and instruments deployed in different regions (Article 19 procedure under the EIB Statute).[11] The Article 19 procedure takes place early in the set-up process of a project. Similar to the InvestEU scheme, the ELM pursues the UN Sustainable Development Goals (SDG) and is aimed at inclusive growth and sustainable economic, environmental and social development. The guarantee scheme under ELM has been used by the EIB since 1977. The latest ELM covered the period 2014-2020 and was extended until 2021. The ELM guarantees were followed by EFSD+ starting from 2022 (Lundsgaarde et al., 2022).

The risk exposure of the EU is limited through a risk-sharing rule with the EIB and the final recipients of EIB funds. The EU budget guarantee covers 65% of EIB lending under ELM (for mandates 2007-2013 and 2014-2020), and the EIB itself covers on average 50% of the costs of a project. This limits the exposure of the EU general budget to risks emanating from financing operations carried out outside of the European Union. Table 2 shows that at the end of 2022, the EU risk for disbursed guarantees amounted to EUR 20.9 billion.[12] The guarantee premiums earned by the EU amounted to EUR 28 million and thereby did not cover the total amount of called-in guarantees. Guarantee payouts by the EU were concentrated on Syria, Lebanon, Ukraine, Belarus and Russia. A potential guarantee claim on an Enfidha airport loan in Tunisia was the subject of restructuring negotiations and relied on the recovery of tourism travel after the decline in arrivals caused by COVID-19. With respect to loans related to investments by non-sovereign borrowers in Ukraine, the EIB first adopted a standstill approach and did not engage in enforcement actions in the event of non-payment. Because of the ongoing war the EIB entered into proactive restructuring negotiations. Amounts owed to the EIB by Belarusian banks and covered by the ELM were settled in late 2022 and early 2023, [13] while recovery efforts with Russian clients are still ongoing (European Commission, 2023c).

e. European Fund for Sustainable Development Plus

The new EFSD+ guarantee scheme is set up under NDICI and has a wider scope in comparison to the former EFSD scheme. Budgetary guarantees have been extended from Sub-Saharan Africa and the Neighbourhood and Enlargement countries towards Asia and the Pacific and the Americas and the Caribbean. The EFSD+ guarantee capacity amounts to a maximum of EUR 39.8 billion, of which EUR 26.7 billion is allocated to Investment Window 1, where the EIB works as direct partner in operations with sovereign counterparts and non-commercial sub-sovereign counterparts. Additionally, EUR 13 billion will be directed towards investment projects involving private entities or commercial sub-sovereign entities that are financially and legally able to borrow without backing by a sovereign entity. This part will be carried out under an open architecture window. The period of activity starts in 2022 and lasts until 2028. EFSD+ projects are also subject to approval by the European Commission within an Article 19 consultation process. The role of the Commission in this process is to provide an opinion on the conformity of the proposed investments with relevant EU legislation and policies. Aspects such as project profitability and financial risk are outside the scope of the Article 19 procedure and remain the EIB's responsibility.

[11] The EIB Statute is annexed as a Protocol (No5) to the TEU and the TFEU, as an integral part of both Treaties.

[12] Differences with Table 1 are due to different reporting arrangements and definitions used – mainly due to the difference between signed and disbursed total amounts.

[13] Neither EC (2023c), nor EIB financial reports 2022 and 2023 specify how.

The EFSD+ Investment Window 1 contributes to the achievement of the three overarching priorities through operations that have the nature of public goods:

- Green Deal: Climate investments in both adaptation and mitigations;
- Global Gateway: Investments in infrastructure, exchanging goods and services, and connecting people around the world;
- Jobs and Sustainable and Inclusive Growth: Investments in education, health, and social protection and inclusion.

Projects within the open architecture part of the EFSD+ can be operated by the EIB and a range of implementing partners, i.e. international financial institutions including the European development finance institutions. These projects aim at mobilising private capital for investment rather than public infrastructure investment. Subsequently, institutional partners in projects signed under the EFSD+ Open Architecture have three years from the effective date of the guarantee agreement to conclude agreements for underlying operations with co-financing partners, financial intermediaries, or final beneficiaries. The duration of guarantees varies according to the window. Guarantees for SMEs are expected to have a shorter duration, while infrastructure guarantees may have guarantee durations of up to 15-20 years. Projects in the open architecture window pursue six investment areas:

- Micro, Small and Medium Enterprises (MSMEs);
- Connectivity: Energy, Transport and Digital;
- Sustainable Agriculture, Biodiversity, Forests and Water;
- Sustainable Cities;
- Sustainable Finance and Impact Investing;
- Human Development.

Apart from these priorities, part of the EFSD+ was used to extend the COVAX program under the EFSD and provide additional COVID-19 vaccines to partner countries. Details of the revenues from guarantees, called-in guarantees, and funds accumulated in the CPF are presented in Table 2. The portfolio risk cover for EFSD+ Investment Window 1 is provided by the EC on the basis of a 65% first loss piece, therefore providing substantial risk cover. The EFSD+ Investment Window 1, which is operated by the EIB as a direct partner, is not remunerated. The Open Architecture Window is also open for operations with commercial sub-sovereign counterparts and the private sector. Guarantee agreements under the Open Architecture Window cover each proposed investment program individually, and they are based on negotiations among the partner financial institution, the EC, and the Guarantee Risk Experts Group. The remuneration of a guarantee under the open architecture window should reflect the risk level, but Article 38(3d) of Regulation (EU) 2021/947 provides the opportunity to subsidise the premium in duly justified cases[14]. The provisioning rate shall range between 9% and 50%, depending on the type of operations. The legal basis for the External Action Guarantee lies in the NDICI-Global Europe Regulation.

[14] European Union (2021b): Regulation (EU) 2021/947 of the European Parliament and of the Council of 9 June 2021establishing the Neighbourhood, Development and International Cooperation Instrument – Global Europe, Amending and Repealing Decision No 466/2014/EU and Repealing Regulation (EU) 2017/1601 and Council Regulation (EC, Euratom) No 480/2009. https://eur-lex.europa.eu/eli/reg/2021/947/oj

3.1.2. MFA funding to third countries

Financial assistance by the EU to third countries, other than 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 versus end investors, including in scenarios where MFA beneficiaries would not pay or would not pay on time. These are the risks of this type of contingent liability. The legal basis for these programmes is Article 212 of the Treaty on the Functioning of the EU (TFEU).[15] The outstanding amounts of these at the end of 2021 were EUR 7.47 billion, of which EUR 1.65 billion consisted of new loans disbursed in 2021. **Lately, however, MFA programmes have grown considerably. MFA-related contingent liabilities increased by around 28% from 2020 to 2021.** In addition to MFA programmes, contingent liabilities also stem from Euratom loans.[16] Euratom loans aim at providing funding to Member States and third countries for investments in the nuclear sector. The total contingent liabilities of this type amounted to EUR 0.3 billion, both in 2021 and 2022.

On 24 February 2022, Russia invaded Ukraine. In terms of its effect on the EU budget, Russia's invasion of Ukraine risked slowing down economic growth and endangered energy supplies in Europe. Council Regulation (EU, Euratom) 2022/2496 amended the MFF as part of a package adopted by Parliament under the urgency procedure on 24 November 2022. This led to new additional macro-financial assistance programmes to Ukraine throughout 2022.

In 2022, outstanding MFA increased to EUR 15.0 billion since new MFA loans of approximately EUR 7.5 billion were disbursed. This increase was driven mainly by the additional support committed and disbursed to Ukraine as a result of the war. Amid the already escalating tensions preceding Russia's invasion of Ukraine, the European Commission proposed emergency Macro-Financial Assistance (MFA) of up to EUR 1.2 billion in loans on 1 February 2022. The European Parliament and Council approved this decision on 24 February 2022, and this thereby became the sixth MFA operation for Ukraine since 2014. The Commission and Ukraine signed a Memorandum of Understanding on 3 March which allowed for the disbursement of the first EUR 600 million instalment on 11 and 18 March 2022. Despite the outbreak of war disrupting Ukraine's ability to implement the agreed structural policy measures for the second instalment, the Commission disbursed this instalment on 20 May. This decision was made in the light of *force majeure* circumstances hindering conditionality fulfilment.

After the eruption of the war, as part of the EU's exceptional support programme to Ukraine, the Commission proposed a EUR 1 billion MFA operation on 1 July 2022. The MFA was directed at the provision of urgent financial assistance to address immediate funding needs and ensure that critical functions of the Ukrainian state could continue. Following adoption by the European Parliament and Council on 12 July 2022,[17] a Memorandum of Understanding was signed on 19 July and enabled the disbursement of the full amount in two tranches in early August 2022.

On 7 September 2022, the Commission proposed another exceptional MFA operation of EUR 5 billion. This decision was ratified by the European Parliament and Council on 20 September

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[15] Article 213 TFEU in urgent cases.

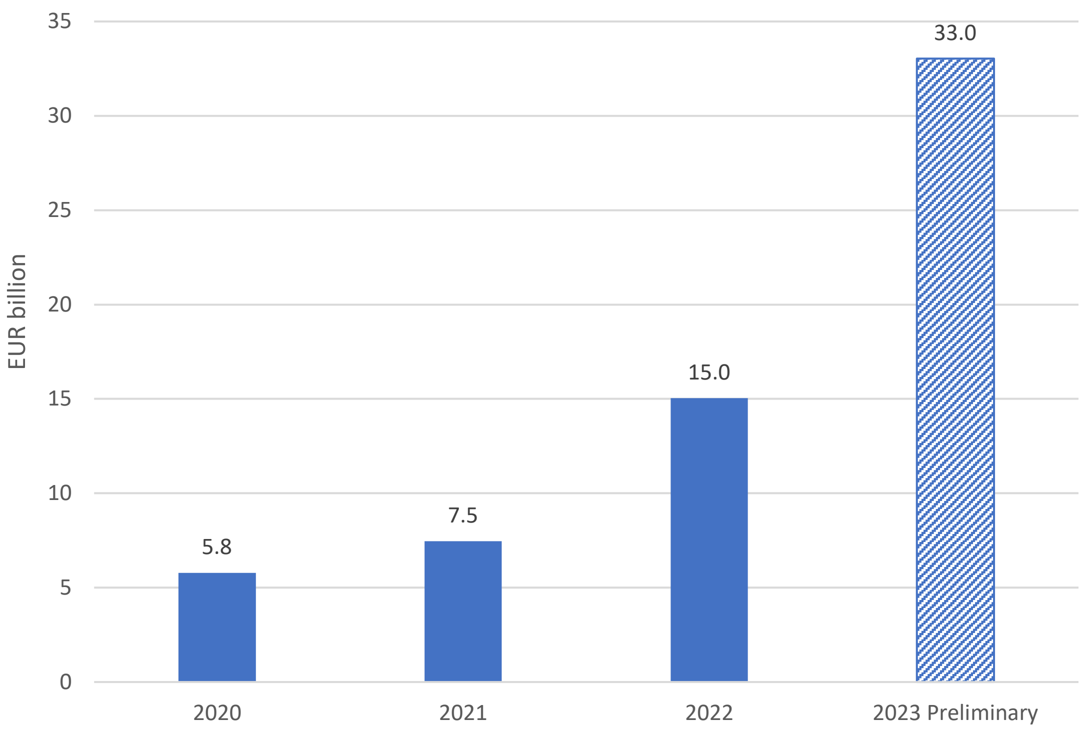
[16] Council Decision 94/179/Euratom of 21 March 1994 amending Decision 77/270/Euratom to authorise the Commission to contract Euratom borrowing in order to contribute to the financing required for improving the degree of safety and efficiency of nuclear power stations in certain non-member countries (OJ L 84, 29.3.1994, p. 41).

[17] Decision (EU) 2022/1201 of the European Parliament and of the Council of 12 July 2022 providing exceptional macro-financial assistance to Ukraine.

2022.[18] After the Memorandum of Understanding came into effect on 4 October, Ukraine received the first instalment of EUR 2 billion on 18 October, followed by EUR 2.5 billion on 22 November 2022. The final payment of EUR 500 million was made on 14 December 2022.

Since the start of 2023, financial assistance to Ukraine has been arranged through the new MFA+ programme[19] and, from 2024 onwards, through the new Ukraine Facility, regulated by the Regulation (EU) 2024/792.[20] The Regulation establishes the new Ukraine Facility as a dedicated instrument which will allow the EU to provide financial support to Ukraine for the delivery of reforms and investments in the country. Both instruments are not provisioned for, but rather are backed by the EU budget. The budget coverage currently applicable to loans to Member States was extended to MFA+ and the Ukraine Facility, creating an exemption since all previous MFA loans were provisioned for upfront.[21] In the event of a default, the required amounts would be drawn down above the EU budget actual spending (regulated by MFF ceilings) up to the own resources ceiling (from the headroom). This is why these financial assistance arrangements are discussed in detail in sub-section 3.2.2, which covers headroom-backed contingent liabilities.

Figure 6: Contingent Liabilities due to MFA, including MFA+ (Ukraine Support in 2023)



Source: European Commission (2021a, 2022a, 2023a, 2024b).

[18] Decision (EU) 2022/1628 of the European Parliament and of the Council of 20 September 2022 providing exceptional macro-financial assistance to Ukraine, reinforcing the common provisioning fund by guarantees by Member States and by specific provisioning for some financial liabilities related to Ukraine guaranteed under Decision No 466/2014/EU, and amending Decision (EU) 2022/1201.

[19] European Union (2022b): Regulation (EU) 2022/2463 of the European Parliament and of the Council of 14 December 2022 establishing an instrument for providing support to Ukraine for 2023 (macro-financial assistance +). https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32022R2463

[20] European Union (2024): Regulation (EU) 2024/792 of the European Parliament and of the Council of 29 February 2024 establishing the Ukraine Facility.

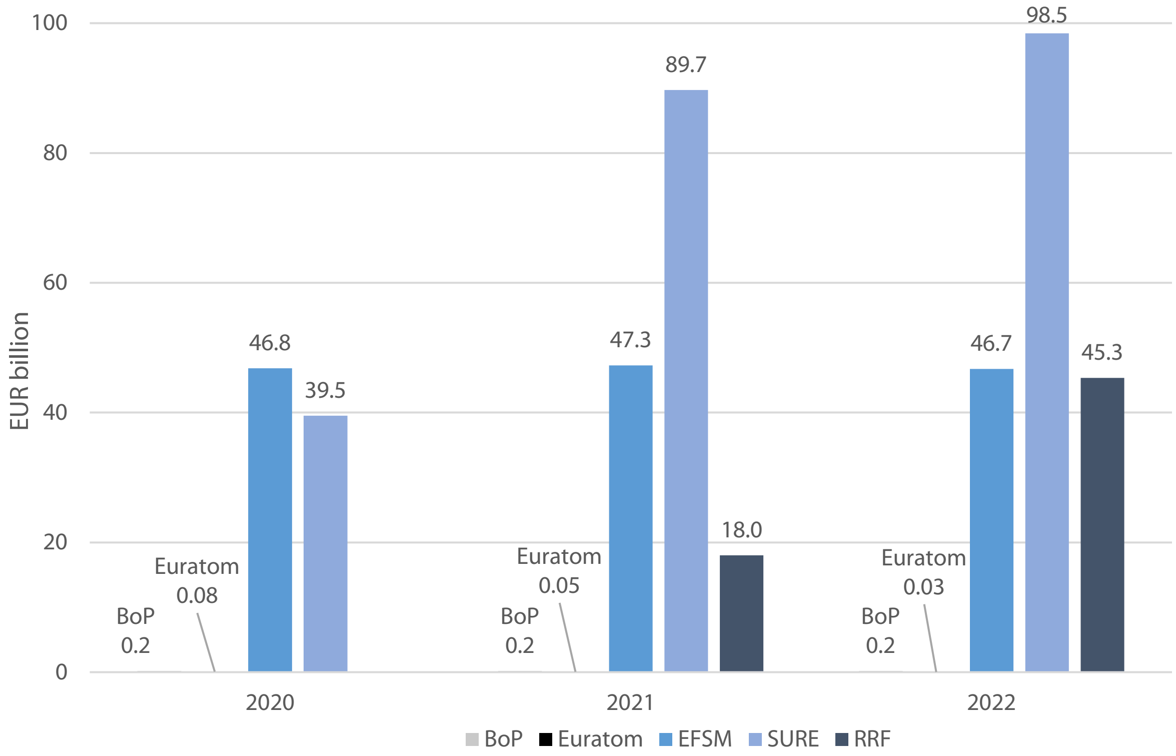
[21] This can be partially justified by the very uncertain rate of provisioning that will be required for this new MFA programmes.

3.2. Headroom-backed contingent liabilities

3.2.1. Financial assistance to Member States

Finally, the EU provides financial assistance to its Member States. Before 2020 and the start of the COVID-19 pandemic, this assistance was predominantly provided through European Financial Stabilisation Mechanism (EFSM) programmes and, to a much smaller extent, through Euratom and Balance of Payment (BoP) programmes. With the outbreak of the COVID-19 pandemic, the EU introduced the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE). Furthermore, and even more importantly, NextGenerationEU was created, and with it the Recovery and Resilience Facility, under which Member States can request and obtain loans as part of the funding for their National Recovery and Resilience Plans. Exposures for these types of contingent liability are not provisioned, and their sustainability is presented and evaluated in the Report under Article 250 of the Financial Regulation. They are therefore backed by the EU budget headroom. Importantly, in addition to these programmes, even though it constitutes MFA to a third country, the MFA+ programme for Ukraine in 2023 and financial assistance for Ukraine from the Ukraine Facility are also headroom-backed.

Figure 7: Development of Financial Assistance to Member States



Source: European Commission (2021a, 2022a, 2023a).

As discussed in Section 2, the dominant source of the increase in contingent liabilities in recent years has been loans to Member States under the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) and the Recovery and Resilience Facility (RRF). We put a special focus on these sources in this section, especially on RRF loans, which will continue to provide an increasing contribution to contingent liabilities until the end of the RRF in 2026. Earlier reports on the state of EU contingent liabilities up until 2022 have not fully embedded and analysed this question, as only a small part of the loans had already been requested or disbursed in 2021.

a. SURE

In the first weeks of the COVID-19 pandemic, the EU created its first instrument to fight the COVID-19-related slowdown in economic activity: the temporary Support to mitigate Unemployment Risks in an Emergency (SURE). The goal of this instrument was to ensure financing for Member States to combat the negative social and economic effects of the pandemic and to limit the effect of reduced or limited economic activity or unemployment. The instrument consists of up to EUR 100 billion in funding which Member States can receive in loans from the EU with favourable terms and which is granted to cover part of the increases in public expenditure directed at preserving employment in Member States. It therefore constituted a common response of the EU to ensure that the large macroeconomic shock related to the pandemic would not result in deep labour market disruptions and heightened unemployment in the EU. It was therefore meant to enhance and contribute to national short-term working schemes and other measures implemented to protect jobs and mitigate the risks of losing income (Pekanov, 2022). Part of the funding was also eligible to be used for healthcare and protection measures, with the goal of enabling workers to return more quickly to their workplace and operate in a less precarious environment.

The loans allocated to Member States through the SURE instrument were backed up by voluntary guarantees from Member States. Each Member State's contribution to the overall guarantee amount was determined by the relative share of the country to the European Union's total gross national income (GNI) as of the 2020 EU budget.

As per the initial time plan, SURE was under implementation until the end of 2022. During that time, the European Commission disbursed a total of EUR 98.4 billion in financial support in the form of back-to-back loans to 19 Member States, after approval by the European Council. All 19 EU Member States that requested a loan received their requested amounts in full. Table A1 in the Appendix reports all the borrowings requested and disbursed to Member States as part of SURE.

SURE payments were funded by a new type of bond: a social bond issued by the European Commission. The Social Bond Framework aims to assure investors that the funds raised will be used for social purposes. By 7 December 2022, the European Commission issued EUR 98.5 billion in social bonds across nine rounds and with a maturity ranging from 5 to 30 years. The instrument was highly rated, and there was significant investor interest, which was evidenced by the oversubscription and the favourable pricing terms.[22] The proceeds from the bonds were disbursed to the recipient Member States in the form of loans, aiding them in covering the expenses associated with funding national short-term work schemes and similar initiatives in response to the pandemic.

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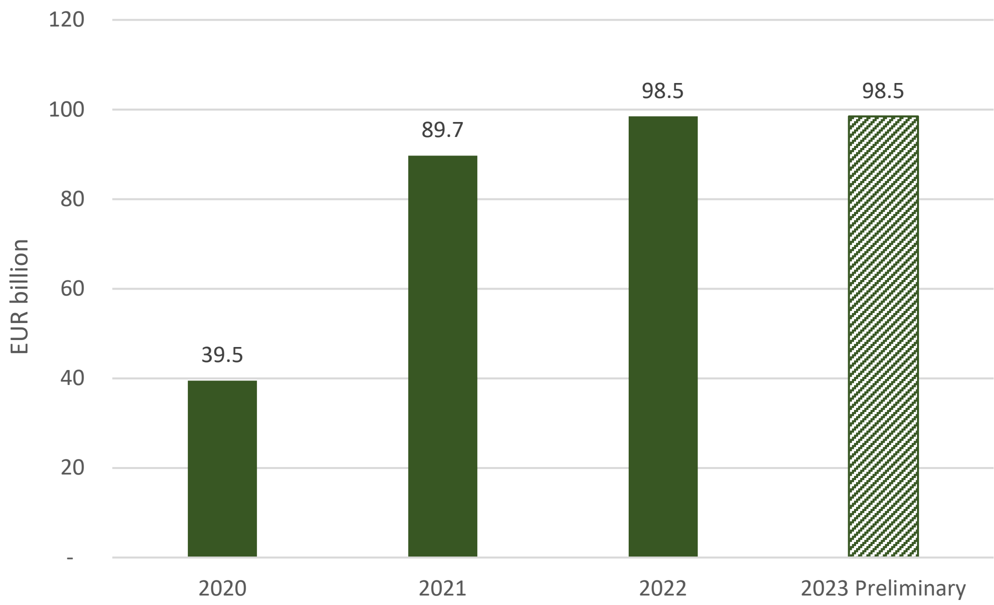
[22] For information on EU bond issuances, see European Commission Transaction Data, https://commission.europa.eu/strategy-and-policy/eu-budget/eu-borrower-investor-relations/eu-debt-securities-data_en

Figure 8: Contingent Liabilities due to SURE

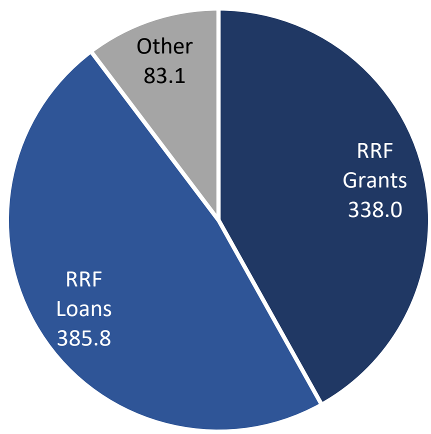


Source: European Commission (2021a, 2022a, 2023a, 2024b).

b. Loans from the Recovery and Resilience Facility

The creation of NextGenerationEU was a historic milestone for the European Union, with the construction of a common EU instrument serving as a temporary emergency measure to combat the economic repercussions of the COVID-19 pandemic and bolster economic recovery and resilience across the EU. Member States are set to receive significant financial resources from NextGenerationEU, particularly from the Recovery and Resilience Facility (RRF), to fund specific investments and reforms. The Recovery and Resilience Facility is the largest component of NextGenerationEU and constitutes 90% of its non-repayable allocations (Figure 9). However, the disbursement of these funds is dependent on the achievement of planned milestones and targets associated with these investments and reforms. In the section below, the overall impact of RRF loans on EU contingent liabilities is analysed.

Figure 9: Components of NextGenerationEU in EUR billion



Source: European Commission – In current prices.

Only RRF loans create EU contingent liabilities, since they need to be repaid by Member States. The disbursement of EU funding, including both loans and grants, from the Recovery and Resilience Facility is driven by the pace of the implementation of National Recovery and Resilience Plans (NRRPs) by Member States. The Recovery and Resilience Facility has a strict performance-based conditionality mechanism for the disbursement of payments. Payments are made to Member States when a given set of milestones and targets is sufficiently fulfilled. Member States that have fulfilled their given set of milestones and targets submit a payment request to the European Commission. The European Commission evaluates if the given set of conditions has been fulfilled and then disburses the funding. The same approach functions for both the grant and the loans components of the RRF.

By the first half of 2023, a total of EUR 153.4 billion was disbursed,[23] consisting of EUR 106.3 billion in non-repayable support and EUR 47.1 billion in repayable support through loans, out of approximately EUR 500 billion committed in RRF grants and loans. Most Member States have prioritised using the support from the RRF to finance investments and reforms. Considering the level and pace of loan commitments, approximately EUR 225 billion of loan support was available for Member States to commit in 2023. Member States had until 31 August 2023 to request their loan support components from the European Commission. As of 1 September 2023, 13 Member States requested loan support or additional one as per the revised RRF Regulation's Article 14(6). **The amount of loan support requested overall was EUR 292.6 billion (in current prices), corresponding to 76% of the total loan support available.**

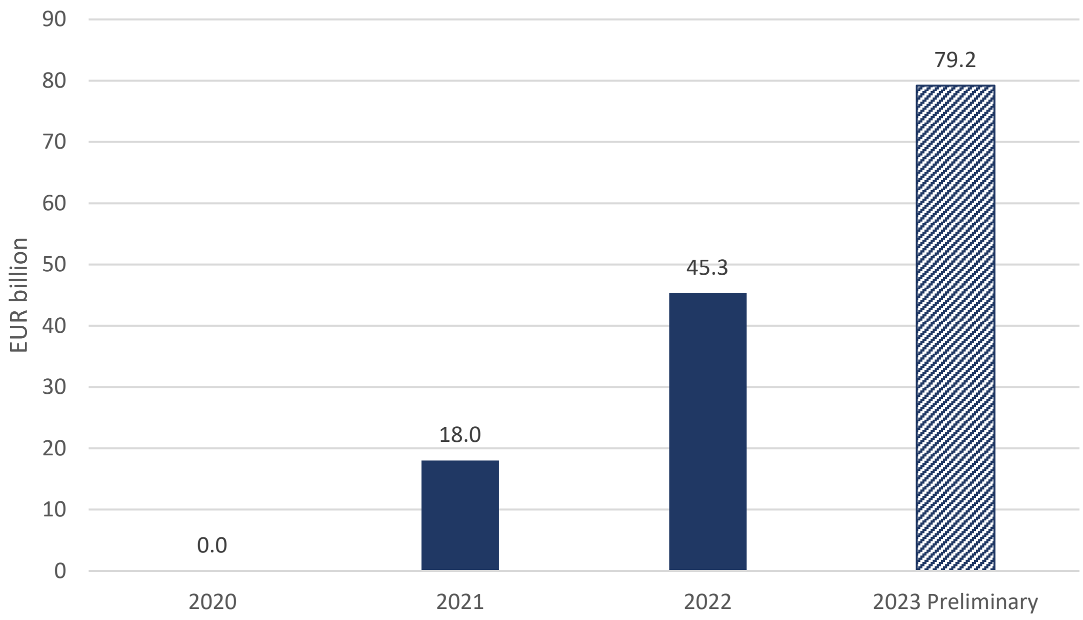
The RRF loans that Member States are expected to receive along the timeline of the RRF are considerable in size. By the end of 2022, Member States had received EUR 45.2 billion in loans from the RRF. By the beginning of 2024, Member States had received EUR 80.2 billion in loans from the RRF (European Commission, 2024b)**.** Table A2 in the Appendix presents all the loans support received for each Member state.

Evaluating RRF loans in terms of the contingent liabilities they create is more complicated due to the uncertainty about how much of the RRF loans will be actually disbursed. Their exact amount in the future is unknown because it depends on the delivery of investments and reforms by Member States. The Commission has also introduced its new unified funding strategy and applies this strategy to NGEU and all future EU borrowing and lending operations. Because of the performance-based approach to RRF payments from the Commission to Member States, the disbursement of funding from RRF loans to Member States is now de-linked from their funding through the new unified funding strategy. The disbursement comes at different points in time and only after the achievement of the negotiated milestones and targets.

The borrowing for NextGenerationEU bonds is backed by the EU through the EU budget and its headroom. Repayment of NextGenerationEU borrowing will start as of 2028 and will take place over a long-term horizon until 2058. Only the loans component of the RRF creates contingent liabilities. They will only grow up until 2026 and will start decreasing only after 2028.

[23] This includes EUR 56.5 billion in pre-financing. Annual grant disbursements under the RRF are projected to reach EUR 96 billion in 2024, with a subsequent decrease to EUR 39 billion in 2025, before rising again to around EUR 47 billion in 2026 (European Commission, 2023d).

Figure 10: Contingent liabilities due to RRF loans



Source: European Commission (2021a, 2022a, 2023a, 2024b).

3.2.2. MFA+ and Ukraine Facility (financial assistance to Ukraine since 2023)

In 2023, a total of EUR 18 billion in macro-financial assistance was made available to Ukraine under MFA+. On 9 November 2022, the European Commission proposed EUR 18 billion in loans to Ukraine for 2023 via this new MFA+ instrument. The European Parliament and Council approved the MFA+ Regulation on 14 December 2022. Following successful negotiations between the Commission and Ukraine concerning disbursement conditions, the Memorandum of Understanding and Loan Facility Agreement was signed on 16 January 2023. Both agreements took effect immediately. The initial EUR 3 billion instalment was disbursed on 17 January 2023, and the rest was disbursed throughout the year.

On June 20, 2023, as part of the 2021-2027 MFF review, the Commission also proposed the EUR 50 billion Ukraine Facility. This facility follows the model of the EFSD+ programme and combines loans, grants, and guarantees from the EU budget to provide ongoing financial support to Ukraine beyond 2023. The funds for grants and loans (EUR 38.27 billion in total) are to be allocated each year through a newly proposed Special Instrument called the Ukraine Reserve, which is above the MFF ceiling.[24] Similarly to the RRF, only the loans component (EUR 33 billion) of the Ukraine Facility creates contingent liabilities for the EU. The loans would be directly guaranteed through the available headroom, much like the MFA+ implemented in 2023. As the EU provides sizeable assistance to Ukraine in the form of loans, this further increases the need for real-time assessment of the calculations regarding the EU's associated financial risk exposure and their underlying basis (European Court of Auditors, 2022a).

The Ukraine Facility was adopted on the political level on February 1, 2024[25]. Its final form consists of a dedicated instrument of EUR 50 billion maximum (out of which EUR 33 billion in loans) to be disbursed between 2024 and 2027 to ensure stable and predictable support for Ukraine. Operationally,

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[24] The rest of the Ukraine Facility consists of Pillar II related to guarantees and Pillar III related to technical assistance.

[25] See further: https://eu-solidarity-ukraine.ec.europa.eu/eu-assistance-ukraine/ukraine-facility_en (last access 5 September 2024).

it will function similarly to the support in the form of financial assistance to Member States through the Recovery and Resilience Fund, described above, as funding is disbursed conditional on the completion of investments and reforms. The Ukrainian government prepares a comprehensive plan, called the Ukraine Plan, outlining proposed investments and reforms for the country's recovery, reconstruction and modernisation in line with the EU accession criteria. After the evaluation and adoption of this Plan, the European Commission will provide financial support to Ukraine of up to EUR 38.27billion from 2024 to 2027. This financial support will comprise of loans totalling up to EUR 33 billion, along with grant assistance (EUR 5.27 billion). This EUR 33 billion is therefore the overall maximum sum of the loans and funding relevant for evaluating EU contingent liabilities resulting from the Ukraine Facility.

On 20 March 2024, the European Commission disbursed the first instalment of EUR 4.5 billion of this support.[26] Based on these developments, we also forecast the overall amount of contingent liabilities due to MFA, including all forms of financial support to Ukraine. The results are presented in Figure 6 and are based on the total contingent liabilities accrued by 2023.

Finally, the MFA provided after the beginning of 2023 (EUR 18 billion) is not provisioned. Instead, it is backed by the headroom of the EU budget. It is important to note that there is no common framework to apply best practices in managing this risk, and some part of the previous MFA support is provisioned for (up until end of 2022), while another is unprovisioned. The overall risk assessment framework for the Ukraine exposure is fragmented, which increases the complexity of assessing it completely. Table 4 summarises the different risk provisioning rate for distinct Ukraine financial assistance programmes and demonstrates considerable variability in those. In Section 7, which concerns policy recommendations, the implications of this are discussed.

Table 4: Risk coverage of loans disbursed to Ukraine (as of end January 2024)

	Amounts disbursed	Coverage			
		Provisions	MS Guarantee	Headroom	Total coverage
Legacy exposures[1]	5,9 bn	9%	-	-	9%
MFA	6,0 bn	9%	61%	-	70%
MFA +	18 bn	-	-	100%	100%
Ukraine Facility	0 bn	-	-	100%	100%
Total	**29,6 bn**	**1,1 bn**	**3,7 bn**	**18,0 bn**	**77%**

Source: Own calculations. 1 – Old MFA programmes to Ukraine including EUR 0.3 billion from EURATOM portfolio.

[26] https://ec.europa.eu/commission/presscorner/detail/en/ip_24_1579

4. FORECAST FOR CONTINGENT LIABILITIES UNTIL 2027

This section provides a forecast on the future developments of contingent liabilities in the EU up until the end of the MFF 2021 – 2027 by analysing the expected developments for the current biggest components of total contingent liabilities in the EU.

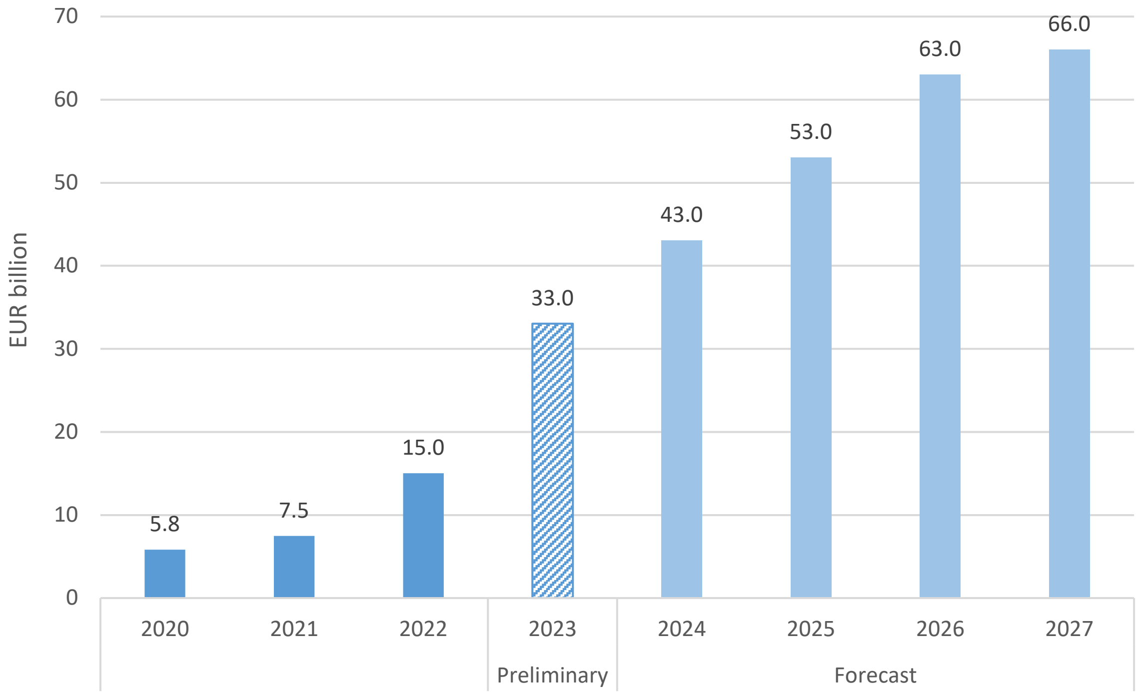
4.1. MFA to third countries

The forecast for the future contingent liabilities from MFA programmes to third countries is uncertain. New MFA programmes to third countries besides Ukraine are challenging to predict. Support to Ukraine, however, will dominate this type of contingent liabilities, given that the Ukraine Facility creates up to a maximum of EUR 33 billion in contingent liabilities in the form of loans and is therefore of an order of magnitude bigger than the MFA to third countries at the end of 2022 (EUR 15 billion). The disbursement from the Ukraine Facility will depend on numerous factors, both in terms of the geopolitical situation and the performance of Ukraine in delivering on the reforms and investments, which will become part of the Ukraine Plan. We assume that in 2024, 2025 and 2026, EUR 10 billion will be disbursed annually to Ukraine, and the rest – EUR 3 billion – will be disbursed in 2027.

This would result in contingent liabilities due to MFA and Ukraine Facility of EUR 66.3 billion by 2027. Of this amount, EUR 58.2 billion would consist of the total financial support for Ukraine. This constitutes 87.8% of the total contingent liabilities related to MFA and shows the extreme concentration that MFA might have on a single constituency in the future. However, due to the lack of further respective information, these calculations are made based on the assumption that no other MFA programmes will be implemented until 2027. On one hand, this is an extreme assumption, yet, on the other hand, previous MFA programmes to other third countries have been of a magnitude that does not constitute a significant difference to the total result, given the very large size of the Ukraine programmes.

The exposure of the EU to risks coming from different types of MFA to Ukraine has expanded considerably and is, in terms of magnitude, higher than any other MFA exposure to a single country. With the additional consideration of the loans granted through the RRF, Ukraine is the fourth biggest exposure to the EU budget, but the default risk related to Ukraine is much higher than for the other big sovereign exposures such as Italy and Spain. Since the start of the war in Ukraine, the character of the MFA exposure has changed, and it is now highly concentrated in the exposure to Ukraine. This MFA+ support requires an overall 70% collateral, of which 9% is already provisioned and another 61% consists of callable guarantees by Member States. This distinctive treatment of provisioning for different programmes towards the same sovereign is problematic, as it complicates the evaluation of total provisions and fragments the provisioning framework. Consequently, this is a problem we discuss further below. In 2023 the European Commission began a process of reviewing the provisioning rate for MFA to Ukraine. In this process, the 70% provisioning/collateral rate is to be reviewed every six months, starting on 30 June 2023, and on an ad-hoc basis, should developments so require (European Commission, 2023f). Subsequent reviews have not yet led to a change in the provisioning/collateral rate.

Figure 11: Contingent Liabilities due to MFA and Ukraine Support, current and forecast



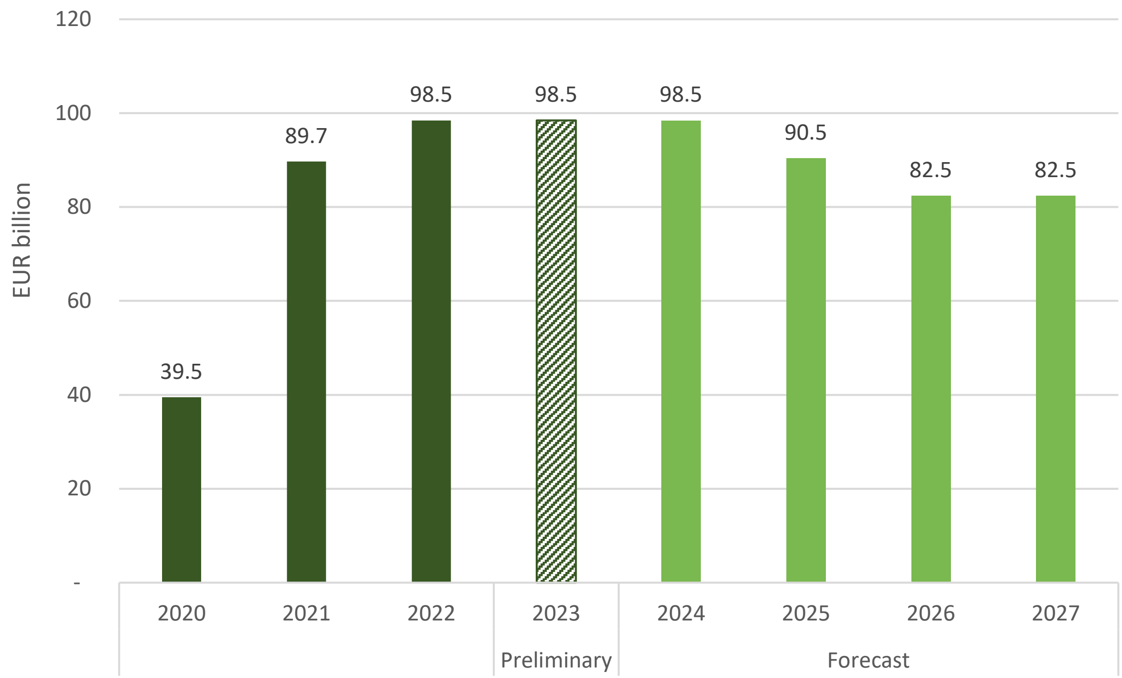
Source: European Commission (2021a, 2022a, 2023a, 2024b), own calculations.

4.2. SURE

Regarding SURE, the last disbursement in December 2022 marked the conclusion of the Commission's call for Member States to express interest in SURE loans. The availability of the SURE instrument ceased on 31 December 2022. SURE has reached its maximum amount at EUR 98.4 billion and cannot lead to any further contingent liabilities in the future.

The repayment of SURE loans will begin in 2025. According to the European Court of Auditors, in 2025 and 2026, EUR 8 billion will be repaid (see European Court of Auditors, 2022b, Figure 5). The sum of contingent liabilities due to SURE will therefore decrease from the current maximum size of EUR 98.4 billion to EUR 82.4 billion by 2027.

Figure 12: Contingent Liabilities due to SURE, current and forecast[27]



Source: European Commission (2021a, 2022a, 2023a, 2024b), own calculations.

4.3. RRF Loans

RRF loans have contributed significantly to the total increase in EU contingent liabilities and, as shown by the forecast below, will continue to contribute further for the duration of the RRF up until 2026. However, two specific aspects of the functioning of the RRF may limit the risks of steeply increasing contingent liabilities resulting from this instrument. While the RRF regulation (European Union, 2021a) enables the maximum RRF loans to be distributed to Member States to amount to EUR 385 billion, not all Member States requested their loans part of the RRF, and many of the Member States that requested loans did not request the full amount available. Indeed, at the end of the period for requesting their loans, EUR 92 billion has been left unrequested.

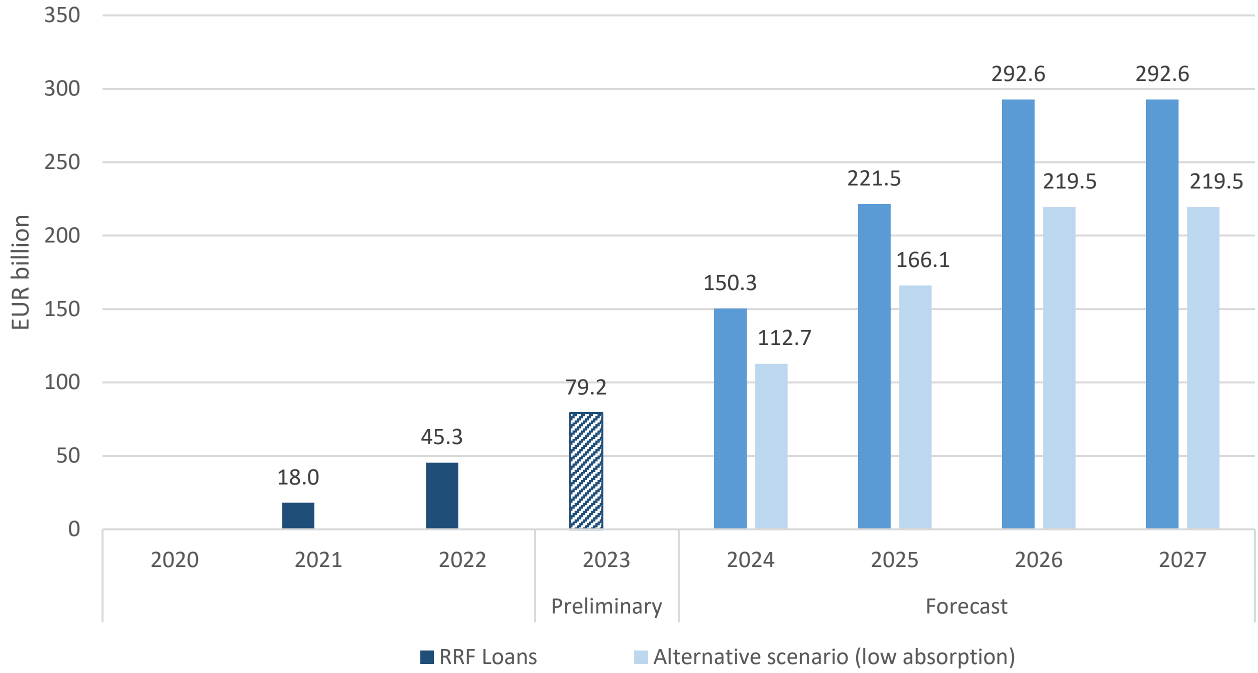
Even if they requested loans funding, Member States may not receive the full allocation of RRF loans funding allocated to them if they do not deliver on their milestones and targets. As Member States encounter varying delays and challenges in implementation, the disbursement profile is expected to shift and become less front-loaded and more backloaded. This could potentially lead to the disbursement of a smaller sum than initially planned in the form of loans, thereby leading to a lower than foreseen increase of contingent liabilities associated with financial assistance to Member States.

Therefore, we assume two scenarios of the final uptake of RRF loans up until 2026 and how this affects EU contingent liabilities. The calculation of the contribution of RRF loans to the overall increase in contingent liabilities in the coming years is based on these two scenarios. The first scenario assumes a full uptake of all RRF loans that Member States have requested. This will result in a total of EUR 292.6 billion of disbursed RRF loans by 2026, which is the total amount that Member States have embedded in their NRRPs by the deadline of 1 September 2023. This scenario assumes continued linear absorption of the funds from the EUR 80.2 billion currently disbursed to a total of EUR 292.6 billion by

[27] At the time of preparation of this study, no information was available concerning the repayment schedule of SURE after 2026.

2026, even though Member States have already been affected by significant delays. The second scenario takes such delays into account. Since it is impossible to know in advance how many of the milestones and targets will be sufficiently achieved by Member States and how the European Commission will evaluate them, we assume a relatively conservative scenario[28] in which only 75% of the total RRF loans will be disbursed to Member States, and we adjust the annual disbursements from the EUR 80.2 billion currently disbursed to EUR 219.5 billion by 2026.

Figure 13: Contingent liabilities due to RRF loans, current and forecast



Source: European Commission (2021a, 2022a, 2023a, 2024b), own calculation.

4.4. Total contingent liabilities forecast

Based on the current evolution of the different types of contingent liabilities and the decisions already taken on their further implementation, we forecast the total amounts of contingent liabilities through the MFF 2021-2027 up until 2027 in the following section. First, it is important to note that these projections assume:

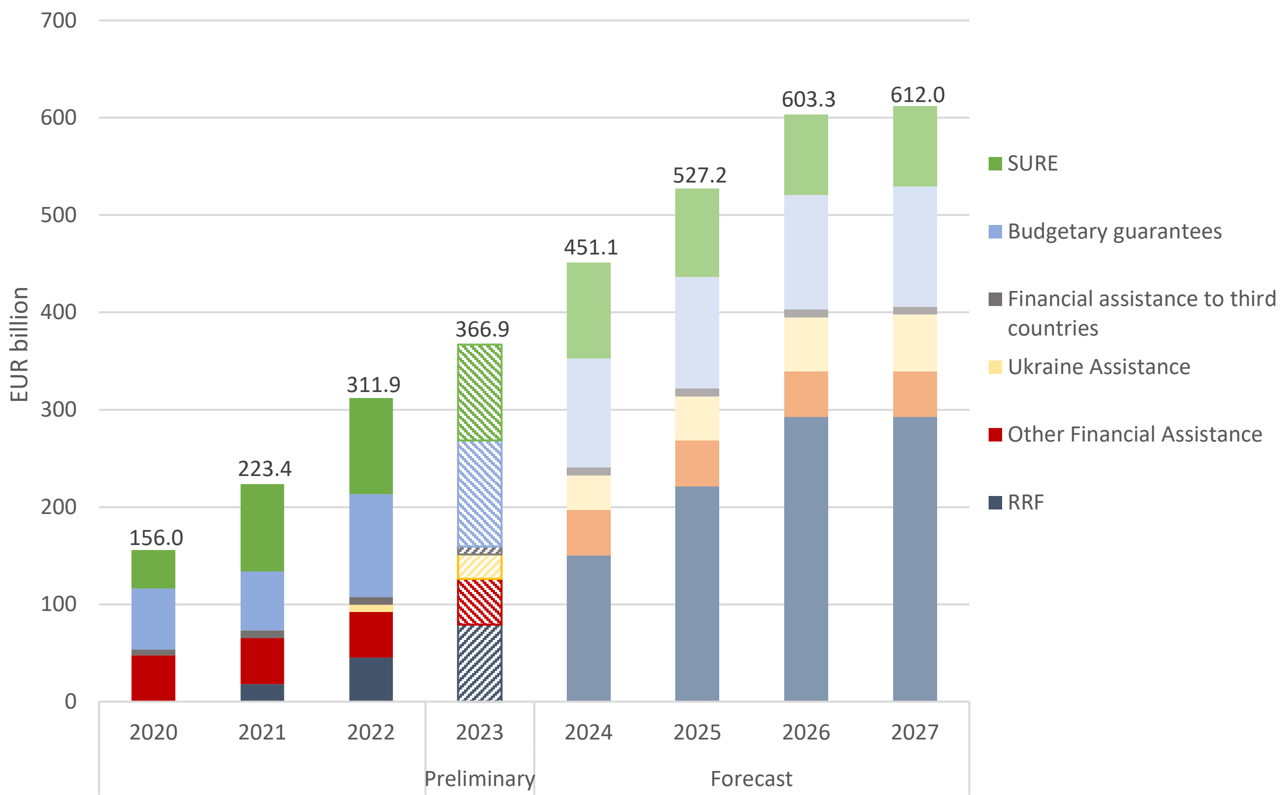
- Future disbursements from the MFA support to Ukraine, given the decisions taken in January 2024 on a EUR 50 billion MFA fund, including the EUR 33 billion in loans, for Ukraine, with annual payments of EUR 10 billion;
- the end of the availability of the SURE programme and the start of its repayment from 2025 onwards;
- future disbursements from RRF loans in line with a baseline scenario of full absorption by 2026, as described in Section 4.3;

[28] This scenario is conservative from a contingent liabilities point of view since more disbursement results in more financial risk due to these RRF loans being disbursed. If less loans are disbursed to Member States, then the financial risk from them will be lower.

- For the guarantees under EFSI, as EFSI concluded at the end of 2022 and has a long implementation period, we assume a constant amount of contingent liabilities as per the final value for 2022 of EUR 25.8 billion up until 2027, as described in Section 3.1;
- For the guarantees under InvestEU, the guarantees signed by the end of 2022 were EUR 21.2 billion, and we assume they increase in a linear manner until the total amount of EUR 26.2 billion is reached in 2027, as described in Section 3.1;
- For the guarantees under EFSD+, the guarantees signed by end of 2022 were EUR 27.0 billion, and we assume they increase in a linear manner until the total amount of EUR 39.8 billion is reached in 2027, as described in Section 3.1;
- For all the other types of contingent liability not specifically described above (ELM, Euratom, EFSM, BoP, new financial assistance programmes to third countries) we assume constant amounts of contingent liabilities as per the 2022 values or the 2023 preliminary values.

Given these assumptions, in the baseline scenario, total contingent liabilities in the EU will reach EUR 612.0 billion by 2027 (Figure 14). This is almost double the current amount of EUR 311.9 billion by the end of 2022. As becomes clear from Figure 14, this increase is predominantly driven by RRF loans, and, to a limited, but still significant, extent by contribution for the Ukraine support programmes and the increased budgetary guarantees.

Figure 14: Contingent Liabilities Forecast



Note: Other financial assistance includes BoP, Euratom and EFSM.

Source: European Commission (2021a, 2022a, 2023a, 2024b), own calculation.

5. COMMON PROVISIONING FUND

In this chapter, we describe the functioning of the Common Provisioning Fund and how it addresses risks from provisioned contingent liabilities. Under EU law, the variety of investment projects, financial instruments, counterparts, and regional partners covered by budgetary guarantees requires a provision for future potential pay-outs that is backed by funds invested in liquid assets. The Common Provisioning Fund (CPF), which 'will constitute a central pillar of the Union budgetary architecture over the course of the 2021-2027 Multi-Annual Financial Framework' (Commission, 2021b:1), provides the protection for the EU budget against unforeseen pay-outs. The operationalisation and rationale behind the CFP are presented in detail in a Communication adopted by the Commission in 2021.[29]

The Financial Regulation 2018[30] stipulates that a buffer for a part of EU contingent liabilities should be embedded in the EU budget after 2020 in the form of a Common Provisioning Fund. By providing appropriate provisioning in the form of financial assets, the Common Provisioning Fund acts as a first line of defence for the EU budget by covering the guarantee calls in relation to budgetary guarantees and repayment defaults of non-EU countries before the EU budget needs to step in. According to the Financial Regulation: *'The rules applicable to provisioning and to the common provisioning fund should provide a solid internal control framework. The authorising officers of the financial instruments, budgetary guarantees or financial assistance should actively monitor the financial liabilities under their responsibility and the financial manager of the resources of the common provisioning fund should manage the cash and the assets in the fund following the rules and procedures set out by the accounting officer of the Commission.'*

The CPF has been operational since 2021 and integrates formerly independent scheme-specific provisioning funds under a **single administrative umbrella.** The CPF was structured into 16 compartments in 2023. Of these 16 compartments, 13 held assets and were operational at the end of 2023 (European Commission, 2024c). Every guarantee scheme has a separate compartment. Additionally, the Guarantee Fund for External Actions (GFEA) covers legacy guarantees from the EIB external mandate.

The inception of the Common Provisioning Fund (CPF) coincided with the initiation of the new Multiannual Financial Framework (MFF) spanning from 2021 to 2027. Under Title X of the Financial Regulation, the Commission assumes the role of financial manager for the CPF, thereby encompassing responsibilities such as its establishment, the crafting of its investment strategy, and the guarantee of its prudent management. According to Article 214 of the Financial Regulation, the Commission is mandated to provide annual reports on the CPF to both the European Parliament and the Council. Provisions for EU contingent liabilities should, as a general principle, cover expected losses, plus a safety margin. One challenge is that this safety margin is not formally defined, and its size is therefore open to interpretation.

Created in 2018, the CPF acts as a capital reserve from which funds can promptly be accessed to cover all required outflows and guarantee calls resulting from financial instruments, budgetary guarantees, and provisioned loan programmes. To ensure its efficacy as a buffer, the CPF is

[29] Communication from the Commission to the European Parliament and the Council on the entry into operation of the Common Provisioning Fund. COM(2021) 88 final. https://eur-lex.europa.eu/resource.html?uri=cellar:dadce54e-7818-11eb-9ac9-01aa75ed71a1.0015.02/DOC_1&format=PDF

[30] Articles 211-214 and 258 of Regulation (EU, Euratom) 2018/1046.

managed with the primary objective of preserving capital. In order to ensure capital preservation, the European Commission implements asset liability management.[31]

The CPF is compartmentalised to correspond with the financial liabilities associated with different instruments and programmes and operates as a single internal pooled portfolio with a unified investment strategy distinct from other portfolios managed by the Commission. Any gains generated are reinvested back into the fund. The resources of the CPF are accounted for in compartments to track the amounts related to various contributing instruments. The annual reporting considers the current value of the assets in the portfolio because some of them might be used for necessary payments after defaults. If no default materialises, assets are held to maturity.

As of 31 December 2022, the market value of the outstanding shares for meeting necessary EU Contingent liabilities stood at EUR 14.39 billion, which was equal to the total value of net assets in the compartments. As of 31 December 2023, the market value of the outstanding shares for meeting necessary EU Contingent liabilities stood at EUR 18.80 billion. This marked an increase of EUR 4.4 billion (30% increase) from the 2022 value. In 2023, the CPF received EUR 3.53 billion of net contributions from the EU budget or from participating Member States and EFTA countries. The remainder of the increase in portfolio value (EUR 880 million) resulted from valuation gains of existing assets. This increase made it the largest portfolio directly overseen by the Commission.[32] The Commission also currently manages the following smaller portfolios:

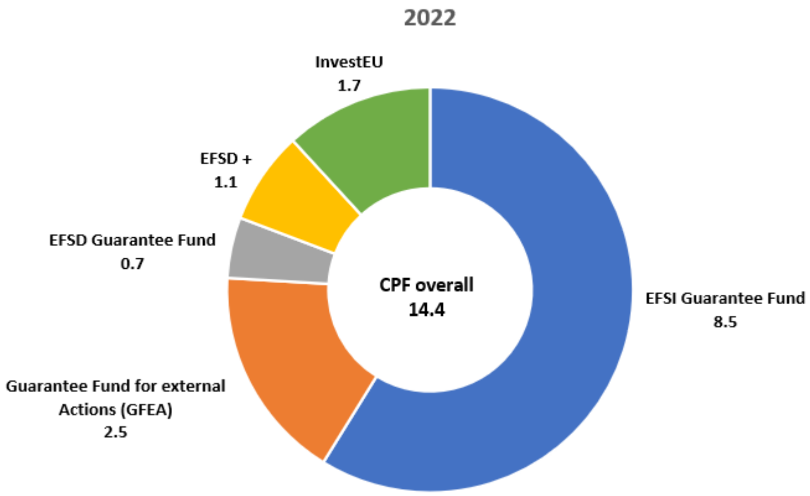
- BUFI Fund: gathers the proceeds of competition fines provisionally paid by companies that appealed the fine. The fund was created in order to manage such provisionally cashed fines and yield positive returns. The fines are directly or indirectly invested in very secure government bonds to preserve their value in case the amounts should be returned to the concerned party on foot of the cancellation or reduction of the fine by the Union courts;
- ECSC Fund: includes the Assets of the European Coal & Steel Community in Liquidation, which will become the assets of the Research Fund for Coal and Steel upon liquidation to co-finance through grants research and innovation projects in the areas of coal and steel;
- MIM: the Mutual Insurance Mechanism holds the funds that support the framework research programmes. It is similar to an insurance scheme for all beneficiaries by providing security against certain defaults in payment and replaced the Guarantee Fund in Horizon 2020;
- POPL: holds the reserves of the pension and sickness insurance schemes covering local agents in UN delegations (schemes managed by the European External Action Service);
- RCAM: holds the reserves of the Joint Sickness Insurance Scheme which is managed by the PMO and covers EU Officials.

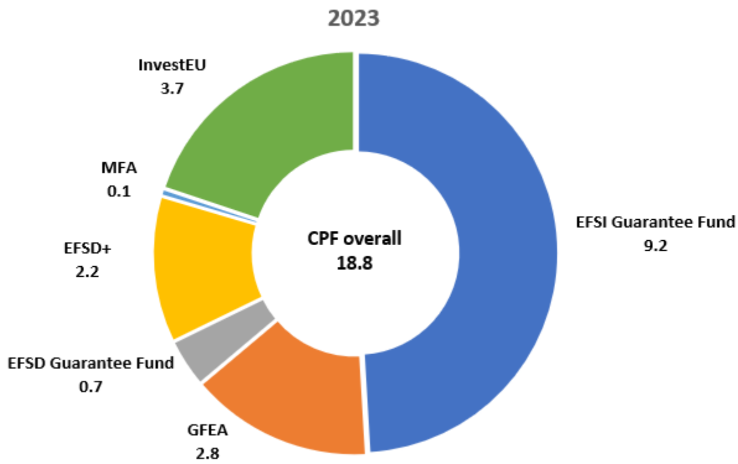
At the end of 2027 the maximum amount expected for the CPF is EUR 25 billion (European Court of Auditors, 2021). Figure 15 presents how the overall capital of the CPF was divided into the different compartments of the CPF in 2022 and 2023.

[31] A technique used to minimise exposure to market and liquidity risk through holding the optimum combination of assets and liabilities. More specifically it can relate to the practice of managing financial risks that arise due to mismatches – "duration gaps" – between the assets and liabilities as part of an investment strategy.

[32] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52023DC0288

Figure 15: Common Provisioning Fund and its compartments, 2022 and 2023 in EUR billion





Source: European Commission (2023b, 2024a), values in current prices.

The CPF is invested in money market funds and EUR- and USD- denominated fixed income securities. The EC defines the investment strategy of the CPF and reports annually to the European Parliament and the Council (European Commission, 2022b). Since 2024 the EC also publishes its High Level Risk and Compliance Policy on an annual basis, which serves to set up its risk management and risk appetite policy (European Commission 2024c). Interest receipts from assets held by the CPF are used to further build up funds. The CPF experienced a negative return of 8.8% in 2022 due to valuation losses (European Commission, 2023c). It is important to note that losses to the current amount of the CPF reported are unrealised losses. These losses result from the fact that the CPF is marked to market.[33] Therefore, bond and other asset losses are reported at their current value at the end of each year. Such losses may not be realised as long as there is no default which requires a necessary payment out of the CPF. Any value gains or losses would only be realised when the assets in questions are liquidated. For example, if the asset is held to maturity and no default occurs in the meantime, part of the accounted losses due to bond revaluation throughout 2022 will not ultimately be losses incurred by the EU.

[33] Mark-to-market valuation is an accounting method that values assets and liabilities at their current market values rather than historical costs.

In 2023, the valuation losses were partly compensated for, as the CPF posted an absolute return of 5.21% (European Commission, 2023c). The current high interest rate environment furthermore provides an opportunity for further positive returns in the coming years. In 2023, the European Commission started to invest part of the CPF funds into equity exchange traded funds (ETF). This enables the CPF to have a diversified exposure to broad equity indexes through a basket of stocks and thus can include better returns for the portfolio. The target level for the exposure of CPF to equity risk has been set at 7-8% of the fund's assets. These funds have higher expected returns, but they also carry investment risk.

However, in an example of comparison with other constituencies, it is important to highlight that the view of the UK Treasury is critical of provisioning public guarantees with asset purchases (HM Treasury, 2023). Their objection is that the use of provisioned funds exposes the budget to market risk and locks up public resources. HM Treasury requires departments to request permission from the HM Treasury and the UK Parliament if any new fund is created to meet contingent liabilities. The strict position of HM Treasury is understandable from the perspective of a sovereign entity with taxation power, since it can always tap the bond market or increase taxes to find the necessary funding, and it is therefore not necessary to keep provisions. However, under normal circumstances, the EU is financially bound by the MFF. As a result, under a balanced budget rule, the crystallisation of underwriting risks imposes a threat to the general budget outlays as outlined in the MFF when there is no buffer in the form of provisions. Proper provisioning consequently limits the risks from underwriting to other parts of the budget.

Since the comparison with a sovereign state with taxing power will not be correct in the case of the EU, we have instead utilised private companies as a benchmark. A comparison with two commercial credit insurance companies (Atradius and Coface) reveals that they hold financial assets in excess of their liabilities from insurance contracts. The comparison is limited to two credit insurers because the financial statements for most commercial credit insurers are not published separately. Instead, they are merged into the balance sheet of their holding companies with a broader range of risks covered. In addition to the small sample size, there is another caveat that weakens comparability: a high ratio in private insurance companies may be a consequence of the business model, with advances payments of the premium by the insured and conditional *ex-post* payments of the claim by the insurer. Given the point-in-time perspective of a balance sheet, this automatically creates a financial buffer. Furthermore, the income from financial assets can be used to cover part of the insurer's transaction costs and provide an opportunity to charge lower premiums. This creates an additional incentive to hold assets.

The computation of provisioning rates for the CPF is based on stress tests developed by the European Commission. Due to varying levels of risk covered under the five schemes, the CPF requires different provisioning rates for each.

At the end of 2022, the EFSI compartment of the CPF held EUR 8.5 billion, which corresponded to 40% of the EU risk from signed and disbursed projects. The provisioning rate of the total EFSI contingent liabilities is set at 35%. According to the EU (2022a), this is enough to cover the lifetime net losses at a 95% confidence level. This assessment is based on the EC's credit risk model with respect to the IIW debt and equity window and the SMEW, as of December 2021. The different windows are listed and explained in Section 3.1.1.

The target provisioning rate of InvestEU in the respective CPF compartment was chosen at 40%, i.e. slightly higher than the target rate of EFSI but close to the coverage realised within the EFSI scheme. Contributions to the InvestEU CPF compartment come from the general budget, Next Generation EU, and CPF internal revenues from the EFSI scheme. Member states participating in the InvestEU scheme have already signed agreements for provisioning the CPF under separate compartments.

As a result of risk sharing with national development agencies and multilateral development finance institutions, the EFSD's risk structure is unique. This structure may create a bias towards conservative investment projects with lower probability of default if national agencies also have a conservative investment approach. In the long term, the EC plans to implement a provisioning rate of 50% for EFSD guarantees, which is claimed to be consistent with estimated lifetime losses at the 90% confidence level. Because the endowment of the corresponding CPF compartment depends on the initial provisions and the revenues collected from guarantee fees, and also because the guarantees for disbursed investment finance still create little risk at the EU level, the respective CPF compartment was small at the end of 2022.

6. REPORTING AND RISK MANAGEMENT

Transparency regarding the accumulation of contingent liabilities is necessary, since debt intransparency might amplify public debt vulnerabilities and may impose additional costs on the economy and citizens. The lack of debt transparency can reduce investor confidence and therefore increase borrowing costs and thereby produce negative fiscal and macroeconomic effects. For borrowers, an accurate picture of the outstanding debt and contingent liabilities and their concrete terms and conditions is necessary in order to make informed decisions about future debt developments. For creditors, a full and well-informed picture on current outstanding debt is necessary for their risk assessments. The lack of such debt transparency can erode the credibility of the debt management body, and ex-post can increase borrowing costs and erode the accountability of the use of public resources. This section summarises a few best practices on debt transparency regarding contingent liabilities and their risk management by presenting some general foundations and international examples and then discusses the current reporting and risk management standards in the EU before concluding with some policy recommendations.

6.1. Reporting and risk management standards

There has been growing recognition of the potential fiscal costs and sustainability risks associated with contingent liabilities (Cebotari, 2008). This heightened awareness has prompted numerous countries to develop strategies for safeguarding their fiscal positions against such risks. These efforts have been further catalysed by calls for increased transparency from international institutions and the increasing emphasis placed by rating agencies on contingent liabilities when assessing sovereign creditworthiness. An analysis of various country experiences published by the IMF (Cebotari, 2008) reveals the emergence of a set of good practices in mitigating, managing, and disclosing risks associated with contingent liabilities, as well as the institutional arrangements for addressing them.

The mitigation of contingent liability risk necessitates a comprehensive understanding of the nature of these risks by policymakers, coupled with proactive measures to address them before entering into such liabilities. An explicit goal should be that decision-makers are fully informed and understand the nature of the risks spurring from contingent liabilities and that there is a proper record on when these liabilities have accumulated for accountability purposes. According to Cebotari (2008), this objective is best achieved through the implementation of a comprehensive framework that guides policymakers in:

1. Assessing the necessity of entering into contingent liabilities
2. Evaluating the net social or financial benefits of such actions
3. Identifying the entities best positioned to bear the associated risks
4. Ensuring accountability for decisions to assume these liabilities

This framework should also address the incentives and costs involved in issuing contingent liabilities, such as guarantees, by:

- Requiring risk-sharing with the private sector to mitigate moral hazard
- Charging beneficiaries for the fiscal cost of the liability (unless issued as a subsidy)
- Treating the subsidy cost of the contingent liability as budgetary expenditure, where feasible

Contingent liabilities are not typically recognised as debt per se, as any payments they might induce are very uncertain. Even so, their disclosure is crucial for debt transparency. Their disclosure is needed to provide information and account properly for any possible fiscal risks before they materialise. For borrowers, the disclosure of contingent liabilities supports debt management and helps determine any necessary budget allowances for possible losses. For creditors, this disclosure helps inform on any possible liabilities of the issuer of debt and how these liabilities could impact the ability to repay.

Debt transparency features prominently in initiatives of recent years, such as the IMF and World Bank Multipronged Approach (MPA). However, gaps in debt transparency persist and need to be addressed. A more recent analysis published by the IMF (Vasquez et al., 2024) concludes that debt transparency is an all-encompassing concept entailing a comprehensive, accurate and timely availability of data on public debt (both granular and on an aggregate basis), debt management operations and debt-related risks. After examining the legal frameworks for debt transparency in 60 jurisdictions, the study concludes that there are still significant gaps in the treatment of contingent liabilities which require improvements in the legal framework.

International standards and guidelines support the detailed and precise recording and disclosure of contingent liabilities. The most important international standards and guidelines include:

- *The IMF/WB Revised Public Debt Management Guidelines of 2014 (Revised PDM Guidelines)*[34] provide institutional and operational foundations to support sound policies and practices for managing public debt and reducing a country's vulnerability to domestic and external shocks.
- *The Fiscal Transparency Code (FTC)*[35] presents broad standards for fiscal reporting, including for debt-related information, fiscal forecasting and budgeting, fiscal risk analysis and management, and resource revenue management.
- *The 2014 Government Financial Statistics Manual (2014 GFSM)*[36] sets the economic and statistical reporting principles to be implemented when compiling and presenting fiscal statistics and outlines the principles for institutional coverage and sectorization of the public sector, definition and classification of liabilities, debt related operations, government guarantees and other contingent liabilities, valuation and accounting rules.
- *The Public Sector Debt Statistics: Guide for Compilers and Users of 2011 (PSDS Guide)*[37] includes recommendations on the measurement, compilation, use, and presentation of public sector debt statistics through timely and high-quality debt information.

Table 5 summarises the recommended disclosure and treatment of contingent liabilities following these different standards.

[34] Available at https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Revised-Guidelines-for-Public-Debt-Management-PP4855

[35] Available at https://www.imf.org/external/np/fad/trans/Code2019.pdf

[36] Available at https://www.imf.org/external/pubs/ft/gfs/manual/2014/gfsfinal.pdf

[37] Available at https://www.elibrary.imf.org/display/book/9781616351564/9781616351564.xml

Table 5: Contingent liabilities disclosure best practices according to international standards

Revised PDM Guidelines	Fiscal Transparency Code	PSDS Guide/ GFSM
Information of contingent liabilities should be disclosed in public accounts, including their cost and risk; valuation—face value or appraisal; and budget allowance for expected losses and/or notes to budget tables and financial accounts.	Stock of contingent liabilities should be annually disclosed, including all government guarantees, their beneficiaries, and the gross exposure.	A register of significant CLs is encouraged. CLs should be disclosed as memorandum items including guaranteed debt, other one-off guarantees and explicit CL such as legal claims, indemnities, uncalled share capital, etc.

Source: Vasquez et al. (2024), Table 1.

Vasquez et al. (2024) point out that domestic legal frameworks governing CL disclosure often present multiple weaknesses hampering transparency. Most of the jurisdictions have legal provisions for authorisation and issue of loan guarantees, but not on the proper disclosure of annual flows and existing stocks, the beneficiaries and the possible fiscal risks. The international standards and guidelines, however, prescribe that regular disclosure requirements should be included in the law. For loan guarantees, which are normally a large part of the government guarantee portfolio and of contingent liabilities (unlike in the EU), the disclosure should include at least the following information for each guarantee: i) type, intended purpose, beneficiaries, and expected duration; ii) total gross financial exposure (i.e., the maximum amount guaranteed); iii) fees charged, iv) crystallized guarantees,[38] iv) any reimbursement, recovery, or counterclaim by the government of crystallized guarantees; and v) where feasible, estimate of the likely fiscal cost (expected payments).

The problem is more acute for the broader universe of CLs beyond guarantees. Best practices in the legal framework in this area, as assessed by Vasquez et al. (2024) require disclosure of fiscal risk by the relevant fiscal oversight agency through, for example, a fiscal risk statement. The best practice here is that the information is well integrated within the budget process and that the analysis of fiscal risks also undergoes an independent assessment and scrutiny by other stakeholders such as the Parliament or the public. Embedding the reporting on contingent liabilities into debt management publications and fiscal reports ensures more efficient evaluation and mitigation of fiscal risks. This practice supports a more explicit role for different types of contingent liabilities and ensures that provisions will be available if, for example, the guarantee is called. A good practice is to report both on the stock and flow of CLs in debt statistics, the annual debt management report, or in another way through the debt sustainability analysis. In some cases, e.g. in the case of guarantees or implicit contingent liabilities, aggregate disclosure of the budgetary provisions should suffice if reporting transaction level information would be counterproductive, as it might increase moral hazard risks. Below, we discuss the extent to which these steps are embedded in the current annual budget process of the EU.

A too-narrow coverage of CLs by focusing only on loan guarantees is a problem in some jurisdictions. A requirement to budget the expected losses in the budget process normally contributes to better disclosure. Quantitative ceilings on government guarantee issuance also seem to have led to improved reporting and monitoring frameworks (Vasquez et al., 2024). Transparency can

[38] The position was closed and then opened immediately, which enables the previous losses or profits accumulated to crystallize (to be realized).

further be expanded by the legal designation of a central authority for information management and the creation of a registry of contingent liabilities with detailed information on different exposures.

In summary, international standards require a clear legal framework that governs the issuance of CLs, their monitoring, their disclosures, and budget allowances for expected losses according to the Revised PDM Guidelines and FTC. Guarantees should follow even stricter disclosure principles by transaction, including identification of beneficiaries and the gross exposure, according to the FTC. Finally, annual budget documents should include a comprehensive assessment of all fiscal risks from CLs, and there needs to be a register of significant CLs according to the FTC and PSDS guide.

Furthermore, external scrutiny of decisions on contingent liabilities is desirable and can be facilitated through early parliamentary involvement and submission for audit by national or international audit institutions. Several countries have established frameworks to proactively address risks related to contingent liabilities. Australia, for instance, has developed guidelines to determine when the government should issue guarantees and other contingent liabilities.[39] These guidelines stipulate that the government should only enter into such arrangements if there is a clearly identified risk, the benefits significantly outweigh the costs, there is a clear need for government involvement, and all alternative risk management options have been explored, including commercial insurance. The guidelines also require a thorough assessment of the specific risks, potential losses, and adequate protection for the state. Additionally, they mandate that the cost of government-borne risk is included in the value-for-money evaluation and that appropriate risk management measures are in place. Similarly, Canada has implemented principles to regulate the risks associated with government-issued loans and loan guarantees. These principles demand that the sponsoring department proves that the project cannot be financed on reasonable terms without government support and that the project's cash flow is sufficient to cover debt repayment, interest, operating costs, and provides a satisfactory return. Moreover, if the government is asked to assume significant risks, it should also consider the potential benefits if the project succeeds.

Ad hoc mechanisms can also be introduced to scrutinize decisions on contingent liabilities. The U.S. Congress has established independent boards to review loan guarantee applications for industries like steel, oil and gas, airlines, and rural television in the early 2000s. These boards, typically comprised by representatives from the Federal Reserve, Treasury, and relevant departments, help ensure an unbiased and analytical approval process. Their independence should, in theory, minimise lobbying influence and focus on assessing applications based on positive net social benefits by balancing nonmarket advantages of maintaining firms with the costs to taxpayers.

The management of retained risks requires systematic monitoring and the establishment of funding mechanisms to address potential realizations of these risks. Low-impact risks can be managed through budgetary flexibility, including measures such as contingency provisions, supplementary budgets, or allowing, under strict conditions, spending in excess of budget. Alternatively, contingency funds can be utilized for self-insurance purposes.

The disclosure of contingent liabilities should adhere to internationally accepted standards in accounting and fiscal transparency (Cebotari, 2008). Disclosure venues should include budget documentation and financial statements to enable an integrated assessment of the fiscal position. When providing information on contingent liabilities, it is crucial to achieve an appropriate balance between ensuring meaningful disclosure and avoiding overwhelming information. While there may be

[39] Financial Management Guidance No. 6, “Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort,” September 2003.

circumstances in which disclosing the magnitude of certain contingent liabilities is not desirable (as their explicit disclosure might increase moral hazard), this should not be used as a pretext for avoiding disclosure altogether. To ensure accountability, clear and strict responsibility for accurate reporting on contingent liabilities should be established. Regarding institutional arrangements for managing contingent liability risks, key considerations include determining where to house responsibility for monitoring and managing these risks and the degree of centralization required. The monitoring of all risks from contingent liabilities should be centralized within the fiscal policy-making institution. While centralizing risk management may be desirable, including through the integration of contingent liabilities management with conventional debt management, the appropriate setup is critically dependent on the public finance management system and capacity of the country in question.

In conclusion, the effective management of contingent liabilities requires a multifaceted approach encompassing comprehensive risk assessment, proactive mitigation strategies, systematic monitoring, transparent disclosure, and appropriate institutional arrangements. To effectively address challenges posed by contingent liabilities, the adoption and refinement of good practices are crucial in safeguarding fiscal sustainability and enhancing overall economic stability.

6.2. Reporting and risk management in the EU

The contingent liabilities already accrued and the expectations of further accrual of contingent liabilities in the years to come require a detailed, timely, efficient and transparent risk assessment and risk management process for the EU. In this section, we evaluate the current set-up and make policy recommendations for its further improvement and streamlining. In general, an Interinstitutional Agreement was concluded in December 2020 between the European Parliament, the Council and the Commission with the aim to provide the frame between the institutions for budgetary discipline, cooperation in budgetary matters and sound financial management, and new own resources. Its primary goal is to enable better coordination and transparency of information on budgetary matters. In more specific regard to contingent liabilities the Financial Regulation states the following: *'The contingent liabilities arising from budgetary guarantees can cover a wide range of financing and investment operations. The possibility of a budgetary guarantee being called cannot be scheduled with full certainty on a yearly basis as in the case of loans that have a defined schedule for repayment. It is, therefore, indispensable to set up a framework for the authorisation and monitoring of contingent liabilities ensuring full respect, at any moment, for the ceiling for annual payment appropriations set out in Council Decision 2014/335/EU, Euratom.*

'That framework should also provide for management and control, including regular reporting on the financial exposure of the Union. The rate of provisioning of financial liabilities should be set on the basis of a proper risk assessment of the financial risks arising from the related instrument. The sustainability of the contingent liabilities should be assessed annually in the context of the budgetary procedure. An early warning mechanism should be established to avoid a shortage of provisions to cover financial liabilities.' One fundamental challenge for the proper accounting and transparent assessment of contingent liabilities in the EU is the need to align information and data on contingent liabilities from different official documents and reporting time periods.

Currently, the major source of official information specifically on total contingent liabilities for the EU budget is the annual "Report from the Commission to the European Parliament and the Council on financial instruments, budgetary guarantees, financial assistance and contingent liabilities." This report is published yearly in October by the European Commission in accordance with the requirements of Article 250 of the Financial Regulation.[40] It is also based on a few additional documents:

- The Draft EU budget for the next year,[41] in particular working documents X and XI,[42] as input information on EU budgetary guarantees
- The long-term forecast report on future inflows and outflows for the EU budget, reporting on the EU's available financial capacity for the next 5 years, taking into account the planned budget expenditures[43]

The report documents, in a consolidated form, the data regarding all three types of contingent liabilities by the end of the previous year. Working Document XI of the Draft General Budget of the EU also provides this data previously available in June on contingent liabilities, but only the data related to guarantees and MFA (provisioned contingent liabilities). Data on contingent liabilities is therefore reported in different reports by the European Commission before consolidation at the end of October. In consideration of the international standards discussed in the previous sub-section, this means that not all the necessary information on contingent liabilities is available to the European Parliament when the Draft General Budget of the EU is published, since it does not include the information on the state of headroom-backed contingent liabilities. This information is included only in the Commission Reports published in the fall and not in Working Document XI. This reporting arrangement thus does not comply fully with the best practices discussed. Some summarized information can also be found in the Budgetary Transparency Report, published at the end of each year in accordance with Point 16 and Point 17 of the Interinstitutional Agreement between the European Parliament, the Council, and the Commission (European Commission, 2023g). This is an important source of information for the European Parliament, as information on the EU budget from the previous year is concisely consolidated. However, contingent liabilities are very sparsely covered.

The European Court of Auditors also publishes, independently, data evaluating contingent liabilities in the EU. This data is often published at different frequencies and in different separate forms. The different reporting arrangements and reporting frameworks with distinct official documents and formats are oftentimes not easily comparable. For example, the European Court of Auditors (2021) reported an increase in the exposure of the EU to contingent liabilities from EUR 131.9 billion in 2020 to EUR 277.9 billion in 2021. This is an increase of EUR 146.0 billion, or 111%. These results differed from those of the European Commission (2022a) because the European Court of Auditors initially treated RRF grants as contingent liabilities. While the RRF grants are liabilities for the EU, they are not contingent. The European Court of Auditors changed this treatment and did not include RRF grants in later reports.

An open access database with a time series of comparative data on contingent liabilities by components is not available. This complicates comparison and analysis. Therefore, one important recommendation is that data published so far in the annual Reports by the European Commission is also published in a separate dataset in a time series format, as this would enable

[40] Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union, amending Regulations (EU) No 1296/2013, (EU) No 1301/2013, (EU) No 1303/2013, (EU) No 1304/2013, (EU) No 1309/2013, (EU) No 1316/2013, (EU) No 223/2014, (EU) No 283/2014, and Decision No 541/2014/EU and repealing Regulation (EU, Euratom) No 966/2012 (OJ L 193, 30.7.2018, p. 1).

[41] European Commission (2023d), COM(2023) 300 of 5.7.2023.

[42] Working document X reports on the financial instruments used, pursuant to Article 41(4) of Financial Regulation. Working document XI reports on the implementation of budgetary guarantees, the Common Provisioning Fund and the assessment of the sustainability of the contingent liabilities arising from budgetary guarantees and financial assistance pursuant to Article 41(5) of the Financial Regulation.

[43] European Commission (2023e), COM(2023) 390 final of 20.6.2023.

the analysis of the evolution of different types of contingent liabilities. Additionally, the involvement of the European Parliament could be facilitated by the publication of ongoing analyses on contingent liabilities, similar to analyses done for the RRF. This will give the European Parliament another source of timely information, which so far has been insufficient, and help its active participation in the annual budgetary process.

The annual Commission Report on contingent liabilities (European Commission, 2023a), issued in accordance with the requirements of Article 250 of the Financial Regulation, also serves the goal of an encompassing assessment of the long-term evolution of the sustainability and possible risks from contingent liabilities, evaluated both with qualitative and quantitative factors. The report analyses the risks from provisioned liabilities and implements a stress testing exercise for headroom-backed contingent liabilities. To evaluate the possible risk for the EU Budget from provisioned liabilities, the report includes an analysis of the market value of the provisions held in the Common Provisioning Fund (CPF). To analyse the limits of the own resources ceiling and the available headroom for headroom-backed contingent liabilities, the report also includes a stress testing exercise for the headroom. This assessment results from a detailed stress testing exercise which takes into account different possible scenarios and a combination of a worst possible situation in terms of shocks hitting economic growth, expenditures, and loans repayment. This situation is discussed in the next section.

The Commission Report on contingent liabilities in 2022 (European Commission, 2023a) concluded that the risks of both types of contingent liability are well accounted for. The provisioning available at the end of 2022 included in the different compartments of the CPF was adequate to cover any contingent liabilities arising from budgetary guarantees and financial assistance to third countries and was therefore in line with the requirements of the legal framework. The available headroom under the current Own Resources Decision and under the additional 0.6% for NGEU was also adequate to cover the obligations for headroom-backed contingent liabilities of the EU under the current spending programmes, but we discuss the underlying assumptions of this exercise below.

In 2021, the European Commission created the role of Chief Risk Officer, which was a substantial improvement in risk management. The current risk management and compliance practices – the *High Level Risk and Compliance Policy*, have since been published in 2024 (European Commission, 2024c). These were important developments to strengthen and streamline the risk management approach.

The Commission monitors risks associated with contingent liabilities and is required to discuss them on a bi-monthly basis with the Steering Committee for Contingent Liabilities. The creation of the Steering Committee on Contingent Liabilities (SCCL)[44] aimed to improve the reporting and evaluation framework for contingent liabilities. Its goal is to discuss and decide on efficient methodologies for the implementation of budgetary guarantees and financial assistance. The Steering Committee includes the Financial Manager of CPF and the representatives of the Secretariat-General and of the relevant Directorates-General responsible for the budgetary guarantees, with the Accounting Officer and a member of the Cabinet of the Budget Commissioner participating as observers. In 2022, the Chief Risk Officer was introduced as an additional member. The Steering Committee coordinates the risk management for budgetary guarantees to ensure they are implemented in a way consistent with the need to protect the Union budget against the materialisation of undue risks. The Steering Committee reviews the functioning of the CPF to ensure that the provisions

[44] Commission decision of 24.7.2020 on establishing the Steering Committee on Contingent Liabilities arising from Budgetary Guarantees (COM(2020) 5154 final).

held by the CPF are managed in a way that serves the needs of the underlying budgetary guarantees. In 2022, the Steering Committee met four times and focused its attention on the specific risks coming from the increased financial assistance to Ukraine, given the very specific risk profile and considerable volume of this assistance, and the discussion of the proper safeguards for the realisation of any of these risks. **However, there is less transparency on the outcomes of the meetings of the Steering Committee and on any concrete decisions taken. Improvements can be pursued to address this.**

6.3. Stress testing the available headroom for headroom backed contingent liabilities

In this section, we analyse the assessment of the sustainability of the contingent liabilities in respect of the limits set by the own resources ceiling, as implemented in the European Commission annual reports on contingent liabilities. For example, in its Report for 2021, the Commission (2022) reported that *'[t]he EU's financial capacity under the existing legal framework (i.e. the Own Resources Decision and the 2021-2027 multiannual financial framework) is sufficient to cover the EU's existing obligations in relation to both spending programmes and financial markets (for debt issued under financial assistance programmes to Member States) - even under extreme adverse circumstances.'* To test this, the annual reports include a stress test analysis assuming different scenarios for economic growth and for revenues and expenditures of the EU budget.

The extreme adverse stress test scenario by the Commission considers the case of a revision of GDP growth of 1% below the latest macroeconomic expectations in each year throughout the forecast horizon (e.g. until 2027). However, it can be questioned if this scenario can be truly considered as 'extremely adverse.' During the pandemic, for example, the shock to economic activity was much greater than 1%. In comparison to pre-pandemic GDP forecasts of +1.4% by the European Commission (2019), real GDP growth according to Eurostat in the EU in 2020 was instead – 5.6%. This is a difference of 7 percentage points. Even after the milder slowdown of economic activity following the geopolitical turbulences in 2022, actual economic activity diverged by more than 1% from the expected growth rate before the shock of the Ukraine war and the ensuing energy crisis. The real GDP growth forecast by the European Commission (2021c) for 2022 was +4.3% at the end of 2021, and the forecast for 2023 was 2.3%. The actual realised real GDP growth rate was +3.4% in 2022 and +0.4% in 2023. The difference between expected growth rates and the realised growth rates after the energy shock have therefore been 0.9% and 1.9%, respectively. New unexpected shocks such as a pandemic-induced economic slowdown, supply side shocks, or geopolitical turbulences might result in similar growth volatility in the future. This constitutes a realistic risk to the stress testing framework currently applied by the European Commission. The stress test to economic activity assumed by the European Commission currently assumes a long-term revision and slowdown of economic growth by 1% below the latest macroeconomic forecast. Economic crises, on the other hand, often happen fast and rapturously and constitute a rapid economic downswing followed by a recovery.

To test the relevance of these macroeconomic assumptions, the latest headroom backed sustainability assessment published by the European Commission (2023a) is used. Instead of the assumption by the Commission of a 1% lower economic growth in comparison to the latest GDP forecast, we assume two scenarios of more significant economic downturn. In the first scenario, which is comparable to the shock to economic growth in the EU in 2023 in the aftermath of the energy crisis, we determine the headroom in a situation where real GDP is instead 2 percentage points lower than what was expected by the forecast. In a second scenario, we test an even more serious economic contraction, comparable to the one during the pandemic, where real GDP is lowered by 7 percentage points in comparison to the forecast.

Table 6 reports the results on how such deeper economic shocks affect the headroom available under two of the measures reported by the European Commission. Headroom 1 reports the available headroom under this reduced economic growth scenario, while Headroom 2 reports the available headroom under the assumed macroeconomic stress development, plus an additional stress on the revenue side (in the extremely unlikely scenario in which all unprovisioned contingent liabilities were to materialise at the same time) and on the expenditure side (annual EU expenditure projected at its theoretical maximum).

In both situations, the headroom is significantly lower in the year of the shock than in the European Commission projections. It is also consistently lower throughout the whole projection horizon in the case of the deeper shock, which resembles the pandemic induced recession. The European Commission (2023a) reports the remaining headroom under the own resources ceiling of 1.40% of EU GNI would amount to EUR 70.6 billion on average per year over the 2024-2027 period under its worst-case scenario: the combination of both macroeconomic shock and revenue and expenditure shock (a-b-c-d). This is reduced to EUR 58.7 billion on average in the case of a pandemic-like scenario with significant shock to economic growth of 7%. In the energy crisis-like scenario, it is relatively stable at around EUR 70.4 billion on average, due to the assumed economic recovery. In our projections for a pandemic-like scenario, the headroom is decreased by EUR 14.9 billion in the first year of the shock – from EUR 79.1 billion to EUR 64.2 billion, consisting of a decrease of 18.8%. In a more "normal" crisis of 2% GDP decrease to projections, the decrease is more moderate at EUR 2.5 billion.

These exercises show that the available headroom is especially sensitive to very extreme macroeconomic shocks, such as the ones observed during the pandemic. Embedding such a shock in the stress testing can therefore improve the framework for the analysis of the sustainability of headroom backed contingent liabilities. It is, however, also important to note that the reported safety buffer is still considerable and that some of the embedded shocks are extremely unlikely; our stress test exercise on the revenue side of the budget, for example, supposed that all Member States benefitting from financial assistance programmes simultaneously fail to honour their repayment when they are due.

Table 6: Stress Testing Exercise under (more) extreme economic shocks

	2024	2025	2026	2027
	in EUR billion			
Own resource ceiling (a1)	247.8	258.4	268.7	279.0
Own resource ceiling under macro stress of 1% (a2)	245.3	253.3	260.9	268.2
Own resource ceiling under macro stress of 2% (Energy crisis) (a3)	242.9	252.0	261.9	272.2
Own resource ceiling under macro stress of 7% (Pandemic) (a4)	230.6	240.3	249.9	259.5
Own resources to finance the budget (b)	133.2	159.3	186.6	185.0
Own resource to finance NGEU (c)	3.3	3.3	6.9	3.6
Additional own resources (d)	29.7	21.2	2.3	11.1
Headroom 1 (a2-b)	**112.2**	**94.0**	**74.3**	**83.3**
Headroom 1 Energy Crisis (a3 - b)	**109.7**	**92.6**	**75.3**	**87.3**
Headroom 1 Pandemic (a4 – b)	**97.4**	**81.0**	**63.3**	**74.5**
Headroom 2 (a2 – b- c- d)	**79.1**	**69.5**	**65.1**	**68.6**
Headrom 2 Energy Crisis (a3 – b- c- d)	**76.6**	**68.1**	**66.1**	**72.6**
Headroom 2 Pandemic (a4 – b- c- d)	**64.3**	**56.4**	**54.1**	**59.8**

Source: Own calculations.

Note: The risk assessment linked to the SURE instrument takes into account the specific counter-guarantee provided by all the Member States for 25% of the maximum amount of financial assistance. In practice, all annual payments in relation to the SURE loans can be excluded from the annual risk for the years covered in the period under examination, because the amounts falling due are fully covered by the Member States'guarantees. The additional own resources (d) expenditure maximum is projected at the theoretical maximum for: 1) the MFF payment ceiling in 2024-year, 2) future adjustments up to their potential maximum in any single year and 3) the annual ceilings of the thematic special instruments (the European Globalisation Adjustment Fund, Solidarity and Emergency Aid Reserve, and Brexit Adjustment Reserve) and the Flexibility Instrument.

6.4. Evaluation and reporting methodology – Financial Assistance Methodology

As reported in Working Document XI accompanying the Draft General Budget of the European Union in 2023, in the summer of 2023, the European Commission was still in the process of developing further its credit risk modelling tools for sovereign exposures. Most of the analysis reported in the Working Document XI in 2023 was based on quantitative and qualitative elements (related to previous defaults and reduction of risks through diversification) and combined with expert judgement. In relation to their much higher volumes, the dominant part of the provisions was for the Macro-Financial Assistance (MFA) programmes, which consisted of EUR 14.96 billion at the end of 2022, while Euratom loans to non-Member States only amounted to EUR 300 million at the end of the same year.

The different loans are provisioned under different compartments in the Common Provisioning Fund:

- A GFEA compartment consists of the old exposures (EUR 7.7 billion MFAs; EUR 300 million Euratom loans);
- An EFSD+ Post-2020 MFA includes the new commitments for MFA loans in 2022 (EUR 1.2 billion);
- A new compartment was created for the exceptional MFA loans to Ukraine of EUR 6 billion (Exceptional MFA I and MFA II). These exceptional packages to Ukraine have a coverage rate of 70% and consist of 9% paid-in provisioning from the EU budget and 61% of callable guarantees from Member States. This coverage rate is high in comparison to all the other programmes, which have a provision of maximum 50% (which is however already paid-in, whereas for MFA loans to Ukraine only the 9% are in fact paid-in).

DG ECFIN of the European Commission serves as an Authorising Officer on MFA loans. In this capacity, it conducts a comprehensive analysis of the economic and fiscal situation of each MFA beneficiary. This assessment by DG ECFIN is differentiated between countries in the Eastern Neighbourhood, the Southern Neighbourhood, and the Western Balkans. The evaluation for 2022 concluded that most countries exhibited a robust post-COVID recovery. However, the war of aggression initiated by Russia against Ukraine in 2022 significantly heightened economic uncertainty, exacerbated the energy crisis, and contributed to notable inflation in food and energy prices across the region. The overall analysis concluded that there are no factors that require the overall 9% target provisioning rate to be altered. The major factors underpinning this analysis were:

- The absence of any payment defaults in the reporting year of 2022, nor in previous years.
- The geographical exposure associated with MFA loans.
- The direct link of MFA programmes (excluding the three Ukrainian operations in 2022) with an existing IMF programme which is currently disbursing funds, along with a satisfactory track record in implementation, which ensures the financial sustainability of the third country and, consequently, the eventual repayment of Union funds. The direct link to the IMF programme has traditionally been a source of external analysis and further proof of debt sustainability. It is, however, important to note that such IMF debt sustainability analysis is not done or implemented for financial assistance related to EU Member States.
- The reasonably well-distributed maturities of loans related to countries benefiting from MFA across the current MFF and subsequent ones.

7. POLICY RECOMMENDATIONS

This section discusses policy recommendations and observations on challenges for the proper monitoring and evaluation of contingent liabilities. Given the growing role of contingent liabilities in the EU and the risk management practices currently in place, several policy conclusions and recommendations can be derived.

- **EU debt transparency requires transparency about contingent liabilities, which constitute fiscal risks that are not yet counted as debt but can become such. This transparency therefore includes the timely publication and clear communication of information regarding the evolution of contingent liabilities.** The current arrangement, in which a report on contingent liabilities is published at the end of October of the following year by the European Commission, does not seem timely enough for informed discussions and decision-making by the relevant stakeholders. Beyond that, the evolution of provisioned-backed and headroom-backed contingent liabilities is provided by two separate documents (Working Document XI of the Draft Budget for the following year and the Commission Report on contingent liabilities), published at different points in time in a given year. This makes the comparison and tracking of the evolution of total contingent liabilities to get at a comprehensive picture more difficult. On macro financial assistance (MFA) programmes, information on loan restructuring may also be difficult to obtain and should be streamlined.

- **A more active involvement of Parliament in decision-making and discussions regarding the accumulation of contingent liabilities is necessary.** Best practices in other countries include hearings in Parliament. Currently, this approach is not well institutionalised in the EU, as the European Parliament can raise questions. and the relevant Committees can discuss the topic by inviting representatives of the European Commission, but a discussion on a regular basis is not foreseen. The strongest possible involvement of the Parliament in sovereign countries, as analysed by the IMF, is the approval of any new guarantees by the Parliament and the setting of legislative maximum limits for the issuance of guarantees. This is currently embedded partly in the EU as the European Parliament is a co-legislator for the Multiannual Financial Framework.

- **The decisions and meeting agendas of the Steering Committee on Contingent Liabilities are not transparent and well-documented.** Greater transparency on the Steering Committee on Contingent Liabilities, its members and decision-making agenda should be provided.

- **The stress testing on the available headroom for headroom-backed contingent liabilities can be refined further to include more extreme macroeconomic scenarios similar to the deep economic shock incurred during the pandemic.** This is discussed in Section 6.3, and the implications for the headroom under more extreme economic scenarios are tested.

- **For MFA to third countries, the approach to provisioning might require changes given the dominant concentration of exposure to Ukraine. Furthermore, the provisioning of this exposure is becoming more complex and fragmented, as different programmes have adopted different provisioning rates (Table 4 and Section 3.2.2).** The split between different amounts of provisioning and coverage rates (9% for older legacy exposures, 9% provisioning and 61% callable guarantees by Member States for newer programmes, no provisioning for MFA+) is not consistent, as different rates are applied to the same sovereign state. Despite the fact that there is a number of different programmes provided to Ukraine, the risk is the same, since the borrower stays the same. Therefore, this different treatment is not in line with best practices in risk management, which should require the same coverage for the same risk.

- **Furthermore, for MFA to third countries in terms of all provisions in the CPF, while sovereign risk is provisioned on 9% and other windows are provisioned at 50%, the reasoning behind these rates is not clear.** The provisioning rate of 9% has been stable throughout the past decades; however, it is questionable if this provisioning rate should be kept the same. To monitor fiscal sustainability risks, the IMF conducts debt sustainability analyses (DSA) for its members. Since EU MFA programmes have been previously combined with an IMF programme, IMF DSA analysis was provided for them. The European Commission has therefore taken a passive debt risk management approach and previously used this IMF DSA analysis. Yet, the introduction of stand-alone programmes without the involvement of the IMF concerning third countries such as those in the Western Balkans and Ukraine requires that the European Commission has its own in-house ability to monitor, in real time, the delivery of milestones and targets (in case the programmes are attached to conditionalities) and a more dynamic risk management. Currently, it is also difficult to obtain information on the evaluation of risk by the Commission for financial assistance to third countries.

Furthermore, new and more complicated exposures bring sizeable risk due to high-risk concentration on single issuers of big size. such as Ukraine. In this context, more financial assistance without an IMF programme would require the Commission to have the necessary processes and skills to structure and monitor these projects in line with sound financial management principles. In addition, the Commission should ensure that risk management is adequate for the risk complexity and size inherent in these transactions, which has changed dramatically over the past three years. These developments merit the review of the principle of applying a general provisioning rate of 9% to all MFA to third countries and a change to an active and dynamic risk management approach for each transaction.

- **To ensure the correct provisioning for guarantees, implementing partners provide information on expected losses on different exposures.** It is important that the Commission also monitors whether such expected losses are realistic and consistent throughout different models used to estimate expected losses. If different models are used by the implementing partners, this can lead to inconsistencies due to the imported data. **In 2021, the European Commission created the role of Chief Risk Officer, which was a substantial improvement in risk management. Furthermore, the official High Level Risk and Compliance Policy was later published and is publicly available.** Even so, the information on lending activities and the exposures to separate countries as part of the different MFA programmes is not easily available, nor is it comparable throughout the years. Each year, this information is published as part of the Draft Budget Working Document XI, but only for a rolling window of the most recent three years and the next year and does not include explicit information on the accumulated exposure of MFA per country.[45] The growing risks to the EU budget from contingent liabilities imply the need for a better-integrated overall framework for risk management. The current framework does not fully explain or make clear the risk profile of the EU, nor its risk appetite and risk tolerance, as suggested by the best practices of the World Bank, the IMF and the EIB. In the future, the EU needs to better analyse and integrate these risks and make them clear to policymakers and decision-makers. The Steering Committee has not made much progress in

[45] Only annual flows for each year in the two years, the current year and next year are reported.

delivering a general framework for all risks. This general framework is necessary for an effective risk management framework.

- **The funds in the CPF are locked in, and there is a trade-off between making sure there are sufficient available resources and that EU taxpayers' money is optimally invested. More flexibility can result in better returns for the CPF and therefore also for EU taxpayers.** First steps were introduced in 2022 with the diversification of the CPF investment universe and by including equity investments via Exchange Traded Funds (ETFs). This enables the CPF to have a diversified exposure to broad equity indexes through a basket of stocks and therefore include better returns for the portfolio.
- **Finally, the traditional distinction between provisioned and headroom-backed contingent liabilities is currently still suitable, despite the changing landscape of EU contingent liabilities, and should be kept.** This issue deserves attention given the changing structure of contingent liabilities (provisioned versus headroom-backed), so it is discussed in more detail below.

Until the Ukraine crisis provisioned contingent liabilities consisted of traditional instruments such as budgetary guarantees and small, but numerous MFA programmes to third countries. The idea behind providing provisions is to ensure diversification of risks. Hypothetical loss rates for these programmes can be calculated, and, therefore, the risk they are exposed to can be diversified via provisioning. However, the risk from the new programmes related to Ukraine (MFA+ and the Ukraine Facility) is very uncertain and difficult to quantify. With this case, the high concentration of risk to a single sovereign will therefore contribute little to further diversification of the broader portfolio, especially given its size (EUR 7.7 billion in 2022 versus EUR 18 billion in 2023 and EUR 33 billion. for 2024 to 2027). These new programmes are therefore not provisioned, but headroom-backed. Presently, the concentration of MFA to third countries is very much dominated by this Ukraine exposure, which will be the fourth biggest EU loan exposure for the foreseeable future (the first three being RRF loans to Member States). The Annual Report of the European Court of Auditors (2023) points out that '*the approval of a further €18 billion at the end of last year will significantly increase this risk for future EU budgets*.'

Besides the Ukraine financial assistance, headroom backed contingent liabilities currently arise predominantly from new instruments such as SURE and RRF. These instruments serve as financial assistance to Member States. It makes little sense for Member States to provide themselves with ex-ante provisions for loans that they themselves have to pay. Doing so would also be politically difficult, since it would enforce the narrative about joint liability. Furthermore, the present risks of any country defaulting on their RRF loans seem rather small if evaluated via credit default swaps[46] on governments bonds or through standard government bond yields spreads to the safest asset (the German Bund). Additionally, the newly adapted Economic Governance Framework has embedded a Debt Sustainability Analysis as part of the European Semester. This analysis should serve as an early warning mechanism for debt sustainability issues any Member States may be facing. It therefore will be important to embed the DSA results in the considerations regarding contingent liabilities and in their reporting. Given all of this, it seems to make little sense to change the current arrangement and seek any changes to the distinction between provisioned and headroom backed contingent liabilities.

[46] Financial contracts, which are often used as a proxy for evaluating the risk of a default.

8. CONCLUSIONS

With this study, we aim to shed light on the current state and future evolution of EU contingent liabilities and the framework for their management. We discuss how contingent liabilities are accounted for and reported on, the functioning of the Common Provisioning Fund, and the buffers that are currently available to address risks from contingent liabilities in the case of future losses.

Given different assumptions, by 2027, total contingent liabilities in the EU will reach EUR 612.0 billion in the baseline scenario. This is almost double the current amount of EUR 311.9 billion by the end of 2022. This increase will predominantly be driven by RRF loans, and a more limited, but still significant, by contribution from the Ukraine support programmes and, to even lesser extent, by the increased budgetary guarantees.

Overall, given the increased volume of contingent liabilities and the increasing variety of exposures to contingent liabilities, the overall risk management framework appears fragmented and could be better organised. International debt transparency standards include the timely publication and clear communication of consolidated information regarding the evolution of contingent liabilities, and the current reporting arrangement in the EU could be improved. A more active inclusion of the European Parliament could be beneficial in monitoring the developments of contingent liabilities. The functioning of the newly created Steering Committee on Contingent Liabilities (SCCL) requires more transparency and publicly available information. The stress testing exercise on the available headroom could be refined to include more extreme macroeconomic scenarios similar to the pandemic shock. For MFA to third countries, the approach to provisioning might require changes given the dominant concentration of exposure to Ukraine. This provisioning is also becoming fragmented, as different programmes have adopted different provisioning rates even when they are granted to the same sovereign. It should also be analysed if a general provisioning rate of 9% to all other MFA to third countries is still suitable.

The distinction between provisioned and headroom-backed contingent liabilities still seems 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 the loans they themselves have to repay makes little economic sense and would also have political repercussions, as doing so would make the joint liability of the RRF more salient.

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ANNEX

Table A1: Proposed and disbursed SURE loans per Member State

Country	Proposed and disbursed loans in EUR billion
Belgium	8.2
Bulgaria	1.0
Cyprus	0.6
Estonia	0.2
Greece	6.2
Spain	21.3
Croatia	1.6
Hungary	0.7
Ireland	2.5
Italy	27.4
Lithuania	1.1
Latvia	0.5
Malta	0.4
Poland	11.2
Portugal	6.2
Romania	3.0
Slovenia	1.1
Slovakia	0.6
Czechia	4.5
Total	**98.4**

Source: European Commission.

Table A2: Disbursed RRF loans per Member State

Country	Date	Payment Request Description	Amount in EUR billion
Portugal	03.08.2021	Pre-Financing	0.4
Greece	09.08.2021	Pre-Financing	1.7
Italy	13.08.2021	Pre-Financing	15.9
Cyprus	09.09.2021	Pre-Financing	0.0
Romania	13.01.2022	Pre-Financing	1.9
Greece	08.04.2022	1st Payment	1.8
Italy	13.04.2022	1st Payment	11.0
Portugal	09.05.2022	1st Payment	0.6
Romania	27.10.2022	1st Payment	0.8
Italy	08.11.2022	2nd Payment	11.0
Greece	19.01.2023	2nd Payment	1.8
Portugal	08.02.2023	2nd Payment	0.1
Romania	29.09.2023	2nd Payment	0.9
Italy	09.10.2023	3rd Payment	8.5
Greece	28.12.2023	3rd Payment	1.9
Hungary	28.12.2023	Pre-Financing	0.8
Italy	28.12.2023	4th Payment	14.5
Lithuania	28.12.2023	Pre-Financing	0.1
Poland	28.12.2023	Pre-Financing	4.5
Portugal	28.12.2023	3rd Payment	0.4
Portugal	28.12.2023	4th Payment	0.2
Slovenia	28.12.2023	2nd Payment	0.3
Belgium	25.01.2024	Pre-Financing	0.0
Croatia	25.01.2024	Pre-Financing	0.5
Spain	25.01.2024	Pre-Financing	0.3
Total			**80.2**

Source: European Commission (2024).

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.

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