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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

ON THE GUARANTEE FUND FOR EXTERNAL ACTION AND ITS MANAGEMENT IN 2016

{SWD(2017) 296 final}

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1. INTRODUCTION

Council Regulation (EC, Euratom) No 480/2009 of 25 May 2009 (codified version) (‘the Regulation‘)[1] established a Guarantee Fund for external actions (‘the Fund’) in order to repay the Union’s creditors in the event of default by beneficiaries of loans granted or guaranteed by the European Union. In accordance with Article 7 of the Regulation, the Commission entrusted the financial management of the Fund to the European Investment Bank (EIB) under an agreement between the Community and the EIB dated 25 November 1994, and subsequently amended on 23 September 1996, 8 May 2002, 25 February 2008 and 9 November 2010 (‘the Agreement’).

Article 8 of the Regulation requires the Commission to send a report to the European Parliament, the Council and the Court of Auditors on the situation of the Fund and the management thereof for each financial year by 31 May of the following year.

This report together with the Commission Staff Working Document (SWD) provides this information. It is based on data received from the EIB, in line with the agreement.

[1] OJ L 145, 10.6.2009, p. 10; the Regulation codified and repealed Regulation (EC, Euratom) No 2728/94 of 31 October 1994 establishing a Guarantee Fund for external actions.

2. FINANCIAL POSITION AND SIGNIFICANT TRANSACTIONS OF THE GUARANTEE FUND

2.1. Financial Position of the Guarantee Fund at 31 December 2016

The Guarantee Fund totalled EUR 2,506,053,053.14 as of 31 December 2016 (EUR 2,343,091,110.14 as of 31 December 2015) (see Annex of the SWD: Guarantee Fund financial statements, as provided by the EIB).

The total balance sheet value of the Fund increased by about EUR 162.9 million in 2016. This is mainly explained by the following:

Increases:

- The contribution from the EU budget (provisioning amount) of EUR 240.5 million to adjust the Fund to the 9% target amount;
- The economic result on financial operations amounted to EUR 29.8 million;
- The portfolio valuation increased by EUR 3.4 million due to the mark-to-market adjustment of its value.

Decreases:

- Interventions of the Fund to cover defaulted payments for a total amount of EUR 110.8 million.

2.2. Significant Transactions of the Fund in 2016

- Since November 2011, the EIB is facing arrears on Syrian sovereign loans. As a consequence, and in line with the Guarantee Agreement between the EU and the EIB, the EIB has made 38 calls on the EU Guarantee Fund up to 31 December 2016 for a total amount of EUR 309.07 million (see point 5).
- On 29 September 2016, the Commission paid EUR 4.7 million to the EIB for a call on a defaulted loan to Enfidha Airport (Tunisia).
- In February 2016 an amount of EUR 257.1 million was transferred from the budget to the Fund corresponding to the provisioning amount for 2016.
- In February 2016, the contribution from the EU budget to the Fund was calculated following Article 3 and Article 5 of the Regulation:

  Article 3 of the Regulation sets the target amount for the Fund at 9 % of the total outstanding capital liabilities arising from each operation, plus any unpaid interest due.

Article 5 of the Regulation states that the amount to be transferred from the budget to the Fund in year n + 1 is calculated on the basis of the difference between the target amount and the value of the Fund’s net assets at the end of year n - 1, calculated at the beginning of year n.

To adjust the Fund to 9% of the total outstanding capital liabilities, an amount of EUR 240.5 million was calculated based on guaranteed operations outstanding at 31 December 2015 and entered in the EU budget of 2017 for the provisioning of the Fund. The amount was approved by the Council and the European Parliament and recognised as an asset (receivable) of the Fund in the balance sheet of 31 December 2016.

2.3. Significant transaction after the reporting date

In February 2017 the abovementioned provisioning amount of EUR 240.5 million was transferred from the EU budget to the Fund.

3. PRE-CONSOLIDATED FINANCIAL STATEMENTS OF THE FUND

The pre-consolidated financial statements of the Fund are prepared in order to include accounting operations which are not included in the Fund's financial statements prepared by the EIB (see SWD). They are part of the EU's consolidated financial statements.

3.1. Pre-consolidated Financial Position at 31 December 2016

Balance Sheet – Assets

	31 December 2016	31 December 2015
NON-CURRENT ASSETS	1,945,964,058	1,614,233,483
Financial assets	1,945,964,058	1,614,233,483
CURRENT ASSETS	324,202,070	493,752,100
Financial assets	122,687,046	387,792,573
Receivables	4,653,326	22,016,264
Cash and cash equivalents	196,861,698	83,943,262
TOTAL ASSETS	2,270,166,128	2,107,985,583

Balance Sheet - Liabilities

	31 December 2016	31 December 2015
CONTRIBUTOR'S RESOURCES	1,958,000,325	2,082,760,780
European Commission contribution	1,468,631,390	1,211,509,598
Fair value reserve	35,493,647	32,123,388
Retained earnings	453,875,288	839,127,794
NON-CURRENT LIABILITIES	259,381,269	-
Financial provisions	259,381,269	-
CURRENT LIABILITIES	52,784,534	25,224,803
Financial provisions	49,674,541	
Payables	3,109,993	25,224 803
TOTAL CONTRIBUTOR'S RESOURCES + LIABILITIES	2,270,166,128	2,107,985,583

The difference of EUR 235.8 million between the total pre-consolidated balance sheet value of the Fund (EUR 2,270,166,128) and the value of the Fund in the financial statements prepared by the EIB (EUR 2,506,053,053) can be mainly explained by the following items:

- The pre-consolidated financial statements include all amounts subrogated to the EU as a result of the guarantee payments for EIB calls on defaulted loan instalments (arrears due plus the interest accrued on late payments). However, in view of the political situation of Syria and based on a decision of the Accounting Officer of the EC, these amounts have been fully impaired in the 2016 financial statements.

- The current assets (Receivables) in the pre-consolidated financial statements include a claim from the EIB of EUR 4.7 million for a guarantee call on a defaulted loan to Enfidha Airport (Tunisia), which is currently being discussed with the EIB.

- Financial provisions of EUR 309.1 million relating to future instalments of the remaining outstanding Syrian loans have been recognised in the pre-consolidated financial statements in 2016.

- The current liabilitites (Payables) in the pre-consolidated financial statements include an accrued payable of EUR 2.1 million for the EIB recovery fees.

- The payments of calls from the Guarantee Fund to the EIB (and where applicable successive recoveries of the calls and late interests) are recognised as decreases (increases) of the Net Assets (EU Contribution) in the financial statements prepared by the EIB. In the pre-consolidated financial statements, the amounts paid for EIB calls are not deducted from the Net Assets as they become subrogated amounts. Related amounts are either accounted for as revenues (accruing late interest and penalties, foreign exchange gains) or as expenses (accruing EIB recovery fees, impairments, foreign exchange losses). This leads into a permanent difference between the Net Assets items (EU Contribution and Retained earnings) recognised in the financial statements prepared by the EIB and the pre-consolidated financial statements prepared by the EC.

3.2. Pre-consolidated Statement of Financial Performance

In the same way as the balance sheet, the pre-consolidated Statement of Financial Performance is prepared for inclusion in the consolidated Financial Statements of the EU.

	2016	2015
Revenue from operating activities	-	477,789
Expenses from operating activities	(310,636,400)	(1,591,683)
RESULT FROM OPERATING ACTIVITIES	(310,636,400)	(1,113,894)
Financial income	39,947,802	40,109,123
Financial costs	(114,563,908)	(68,365,473)
FINANCIAL RESULT	(74,616,106)	(28,256,350)
ECONOMIC RESULT OF THE YEAR	(385,252,506)	(29,370,244)

- The Expenses from operating activities mainly include an unrealised loss from the newly recognised financial provisions for future Syrian instalments (EUR 309.1 million), EIB management fees (EUR 0.9 million), accrued EIB recovery fees (EUR 0.5 million) and custody and audit fees (EUR 0.2 million)

- The Financial income mainly includes the interest income from the investment portfolio (EUR 14.4 million), realised gains on sale of financial assets (EUR 16.8 million) and accrued late payment interest on subrogated amounts (EUR 8.7 million)

- The Financial costs mainly include impairment losses on Syrian loans, subrogated to the EU in 2016 (see point 5).

4. GUARANTEE FUND TREASURY MANAGEMENT

4.1. Investment policy

The Fund's liquid assets are invested in accordance with the management principles laid down in the Annex to the Agreement, as amended[2]. Accordingly, 20 % of the Fund must be invested in short-term investments (up to one year). These investments include variable-rate securities, irrespective of their maturity dates, and fixed-rate securities with a maximum of one year remaining to maturity, irrespective of their initial maturity period. To maintain a balance between the various instruments providing the required liquidity, a minimum of EUR 100 million is kept in money market instruments, particularly bank deposits.

Up to 80% of the Fund can be placed in a portfolio of bonds with a remaining maturity of no more than 10 years and 6 months from the date of payment. The average duration of the placements of all Fund assets may not exceed 5 years. The investments in bonds should respect specific criteria such as liquidity, credit quality, eligibility of the counterparties and concentration limits. In order to ensure risk diversification, the total amount invested in the bonds per single issuer must not exceed 10% of the total nominal amount of the portfolio.

4.2. Performance and market developments

During the year 2016, the macro economic conditions and the very accommodative monetary policy environment has resulted in decreasing, and often negative, interest rates.

During the first half of 2016, the European fixed income market was characterised by elevated market volatility, the market sentiment being driven by the economic slowdown in China, some weak spots in the US recovery and declining commodities' prices, fuelling recessionary concerns, as well by the changes in the modalities of the ECB Extended Asset Purchase Programme (EAPP).

Sovereign bond yields continued to decline until September, as a result of the low nominal growth and the accommodative monetary policy. The market reactions to the UK referendum, held on 23 June 2016, on EU membership and to the U.S. presidential elections in November 2016 were also significant market-relevant events in 2016.

Bond markets were calmer during the third quarter, the highlight during the period being the Bank of Japan's monetary policy shift in September (signalling caps on Japanese Government bond yields), which accelerated expectations for fiscal policy support for global economies.

In the last quarter of 2016, the bond market has turned due to heightened political risks. There was a spike in volatility and an overall increase of medium to longer term benchmark interest rates. Medium to long-dated bonds and in particular the benchmark German 10-year yield turned positive again. In contrast, short-term rates

[2] Amended by Supplementary Agreement No 1 of 23 September 1996, Supplementary Agreement No 2 of 8 May 2002, Supplementary Agreement No 3 of 25 February 2008 and Supplementary Agreement No 4 of 9 November 2010.

remained anchored at deeply negative rates. Besides uncertainty among market participants concerning the monetary policy stance of major central banks, the main driver was the policy to be followed by the newly elected US president.

The result of the US presidential election sparked a significant re-pricing of many asset classes as particular attention was given to Trump's economic policy plans for fiscal stimulus, tax reform and deregulation. From his election to year-end, the market priced higher growth and inflation expectations, downplaying potential risks associated with certain themes of his election campaign concerning his trade and foreign policy approach. As a result, there was a big shift into equities and out of bonds in developed markets.

The performance of the Fund portfolio was monitored on a marked-to-market basis (MTM). During 2016, the portfolio delivered a 1.5563% MTM yearly return, outperforming its benchmark by +36.35 bps. The benchmark of the Fund is a composite index mainly built from iBoxx[3] indices (in particular EUR Eurozone Sovereign and EUR Collateralized Covered indices) and Euribid[4] for the short-term exposure.

The positive performance of the Fund in 2016 was mainly explained by the decline of the short end of the yield curves (see section 1.4.2 ‘Performance’ of the staff working document (SWD) for more details that occurred during the year).

5. CALLS ON THE GUARANTEE FUND

In the wake of the deteriorating situation in Syria, the Foreign Affairs Council, the European Parliament and the Council took decisions in 2011 prohibiting disbursements by the EIB in connection with existing loan agreements as well as supending EIB technical assistance contracts for sovereign projects in Syria. The restrictive measures were thereafter enshrined in Council Regulation (EU) N° 36/2012 of 18 January 2012, as amended.

As a consequence, no new financing operation has been pursued by the EIB since May 2011 and all on-going disbursements and technical assistance services to Syria have been suspended since November 2011 until further notice.

Since November 2011, the EIB is facing arrears on Syrian sovereign loans. As a consequence, and in line with the guarantee agreement between the EU and the EIB, the EIB has made 38 calls on the EU Guarantee Fund up to 31 December 2016 for a total amount of EUR 309.07 million (including penalties applied by EIB and amounts recovered).

[3] The iBoxx bond market indices are benchmarks for professional use and comprise liquid investment grade bond issues. They enable investors to analyse and select benchmarks that reflect their investment profile. They are used for fixed income research, asset allocation and performance evaluation.

[4] Euribid is the Euro interbank "bid" rate that the bank is willing to borrow money at ("bid"), while the more widely known Euribor is the Euro interbank offered rate at which the bank is willing to lend money.

On 29 September 2016, the Commission paid EUR 4.7 million to the EIB for a call on a defaulted loan to Enfidha Airport (Tunisia).

- Events after the reporting date (as of end of July 2017).

Until the end of July 2017, seven additional calls for defaulting payments in Syria have been made for a total amount of EUR 31.57 million (including penalties applied by EIB).

On 20 January 2017, the Commission received a second call from the EIB on a defaulted loan to Enfidha Airport (Tunisia) for a total amount of EUR 2.21 million (including penalties).

6. EIB REMUNERATION

The EIB remuneration is composed of the management fees and the recovery fees. The management fees cover the management of the Fund. The recovery fees cover the EIB's recovery efforts regarding claims following defaults covered by the EU guarantee for EIB financing operations outside the Union.

The second Supplementary Agreement to the Agreement dated 8 May 2002 establishes that the Bank’s remuneration is to be calculated by applying degressive annual rates of fees to each tranche of the Fund’s assets. This remuneration is calculated on the basis of the annual average assets of the Fund.

The Bank’s remuneration for 2016 was set at EUR 891,975 and was entered as expense in the Statement of Financial Performance and as accruals (liabilities) on the Balance Sheet.

The recovery fees payable to EIB are calculated on the basis of the Recovery Agreement signed between the Commission and the Bank in July 2014. At the end of 2016 the cumulated accrued amount of recovery fees was EUR 2,060,285.