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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 2017

{SWD(2018) 369 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.

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1 OJ L 145, 10.6.2009, p. 10; the Regulation codified and repealed Regulation (EC, Euratom) No 2728/94 of 31 October 1994 establishing a Guarantee Fund for external actions. It has been amended on 14.3.2018 by Regulation (EU) 2018/409 of the EP and of the Council

2. FINANCIAL POSITION AND SIGNIFICANT TRANSACTIONS OF THE GUARANTEE FUND

2.1. Financial Position of the Guarantee Fund at 31 December 2017

The Guarantee Fund totalled EUR 2,560,761,844.63 as of 31 December 2017 (EUR 2,506,053,053.14 as of 31 December 2016) (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 54.7 million in 2017. This is mainly explained by the following:

<u>Increases:</u>

- The contribution from the EU budget (provisioning amount) of EUR 137.8 million to adjust the Fund to its target amount of 9% of the total outstanding liabilities;
- The economic result on financial operations amounted to EUR 16.0 million;

<u>Decreases:</u>

- Interventions of the Fund to cover defaulted payments for a total amount of EUR 86.4 million.
- The portfolio valuation decreased by EUR 12.8 million due to the mark-to-market adjustment of its value.

2.2. Significant Transactions of the Fund in 2017

2.2.1 Calls on the Guarantee Fund 2017

Syria

In 2017, the EIB has continued 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 13 additional calls on the EU Guarantee Fund up to 31 December 2017 for a total amount of EUR 56.3 million (see point 5).

Enfidha Airport (Tunisia)

In 2017, the Commission paid EUR 28.7 million to the EIB for 3 calls on a defaulted loan to Enfidha Airport (Tunisia) (see point 5).

2.2.2 Provisioning of the Guarantee Fund 2017

In February 2017 an amount of EUR 240.5 million was transferred from the budget to the Fund corresponding to the provisioning amount for 2017.

The contribution from the EU budget to the Fund transferred in 2018 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 137.8 million was calculated based on guaranteed operations outstanding at 31 December 2016 and entered in the EU budget of 2018 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 2017.

2.3. Significant transactions after the reporting date (as of end February 2018)

In February 2018 the abovementioned provisioning amount of EUR 137.8 million was transferred from the EU budget to the Fund.

On 15 January 2018, EUR 0.14 million recovered from Enfidha Airport were credited to the Guarantee Fund. This amount was recognised as an asset (receivable) in the balance sheet of 31 December 2017.

In February and March 2018, EUR 10.6 million in total were paid in two calls for defaulted payments of Syria (EUR 3.2 million and EUR 7.4 million including penalties applied by EIB).

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 2017

Balance Sheet – Assets

	31 December 2017	31 December 2016
NON-CURRENT ASSETS	2,077,970,486	1,945,964,058
Financial assets	2,077,970,486	1,945,964,058
CURRENT ASSETS	344,990,638	324,202,070
Financial assets	120,771,792	122,687,046
Receivables	136,093	4,653,326
Cash and cash equivalents	224,082,753	196,861,698
TOTAL ASSETS	2,422,961,124	2,270,166,128

Balance Sheet - Liabilities

	31 December 2017	31 December 2016
CONTRIBUTOR'S RESOURCES	2,160,971,521	1,958,000,325
European Commission contribution	1,709,171,640	1,468,631,390
Fair value reserve	22,700,055	35,493,647
Retained earnings	429,099,826	453,875,288
NON-CURRENT LIABILITIES	208,033,976	259,381,269
Financial provisions	208,033,976	259,381,269
CURRENT LIABILITIES	53,955,627	52,784,534
Financial provisions	50,408,230	49,674,541
Payables	3,547,397	3,109,993
TOTAL CONTRIBUTOR'S RESOURCES + LIABILITIES	2,422,961,124	2,270,166,128

The difference of EUR 137.8 million between the total pre-consolidated balance sheet value of the Fund (EUR 2,422,961,124) and the value of the Fund in the financial statements prepared by the EIB (EUR 2,560,761,845) 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 2017 financial statements.
- The pre-consolidated financial statements do not include EUR 137.8 million of contribution from the EU budget to the Fund transferred in 2018 as this receivable is offset by the corresponding payable in the consolidated accounts of the EU.
- Financial provisions of EUR 258.4 million relating to future instalments of the remaining outstanding Syrian loans have been recognised in the pre-consolidated balance sheet in 2017.
- The current liabilitites (Payables) in the pre-consolidated balance sheet include an accrued payable of EUR 2.6 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.

	2017	2016
Revenue from operating activities	939,062	-
Expenses from operating activities	(3,834,219)	(310,636,400)
RESULT FROM OPERATING ACTIVITIES	(2,895,157)	(310,636,400)
Financial income	29,913,694	39,947,802
Financial costs	(51,793,999)	(114,563,908)
FINANCIAL RESULT	(21,880,305)	(74,616,106)
ECONOMIC RESULT OF THE YEAR	(24,775,462)	(385,252,506)

- Revenues from operating activities include reversed financial provisions resulting from a decrease in the present value of the outstanding future Syrian instalments.
- Expenses from operating activities mainly include paid EIB management fees (EUR 0.9 million) and the one-off EIB recovery fee (EUR 1.5 million; see point 2.2), 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 8.8 million), realised gains on sale of financial assets (EUR 9.2 million) and accrued late payment interest on subrogated amounts (EUR 11.7 million)
- The Financial costs mainly include impairment losses on amounts subrogated to the EU in 2017 (see point 5) and interest expenses on cash and cash equivalents (EUR 1.0 million).

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

[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.

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

The year 2017 was reflected by rising yields on the European fixed income markets, but this move was compensated by narrowing credit spreads to historically low levels.

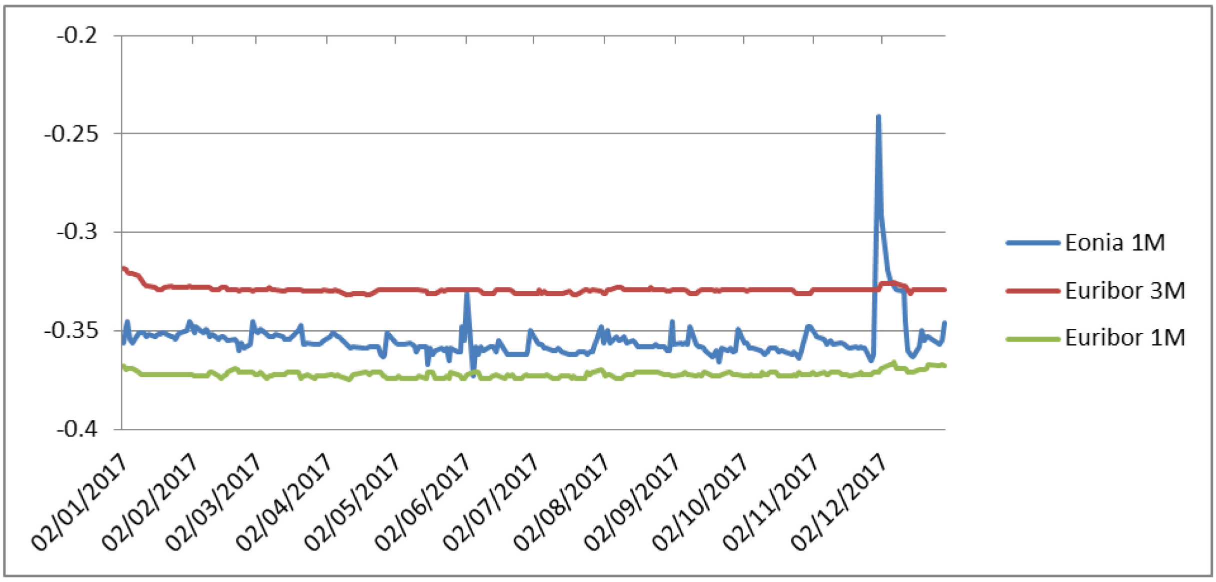
Rates volatility was affected by political events, including Dutch, French and German elections, expectations for lower central bank asset purchases and the improving global economic environment. The German sovereign curve rose by 14, 33 and 22 basis points in 2, 5 and 10 years tenors, respectively (the curve "bear steepened"). The year 2017 was characterized by the lowest market volatility in history, but it is underpinned by low macro volatility.

Although political uncertainty is expected to remain high in 2018 with a.o. the Italian elections, the global economy should continue to expand at an above average pace. According to the market consensus, the Eurozone is expected to grow by 2.2% in 2018 after 2.4% in 2017. In the same time, inflation should remain subdued around 1.5%, below the 2% ECB target. Despite the declining unemployment, as Phillips curves became flatter, price pressure is building up very slowly. The oil price rising to a 4 year high could counterbalance that effect.

Major global central banks are still conducting accommodative monetary policies with ongoing asset purchases, but normalization has already started. The FED is expected to hike rates 3 times in 2018, and ECB will continue with asset purchases of EUR 30bn a month until September 2018. ECB cut its monthly purchases from EUR 60bn to 30bn from January 2018, but reinvestments of redemptions add EUR 15bn monthly, making the drop less significant. Hawkish December ECB minutes and subsequent comments raise the likelihood of QE ending in September 2018 or at the end of the year the latest.

In 2018, European sovereign yields can rise further if strong economic fundamentals and rising inflation expectations due to higher oil prices are confirmed. Curves can bear steepen as short end is more anchored by forward guidance. The continuation of central bank asset purchases are still supporting credit spreads in the first half of 2018, but the current historical low levels can start to normalize and drift wider approaching September, when most probably ECB will end QE.

Evolution of Money Market rates during 2017 (source Bloomberg)



The performance of the Fund portfolio was monitored on a marked-to-market basis. During 2017, the portfolio delivered a 0.1624% MTM yearly return, outperforming its benchmark by +6.58 bps (see section 2.4.2 'Performance' of the staff working document (SWD) for more details that occurred during the year).The benchmark of the Fund is a composite index mainly built from iBoxxindices (in particular EUR Eurozone Sovereign and EUR Collateralized Covered indices) and Euribid for the short-term exposure.

5. CALLS ON THE GUARANTEE FUND

Syria

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 51 calls on the EU Guarantee Fund up to 31 December 2017 for a total amount of EUR 365.3 million (including penalties applied by EIB and amounts recovered).

Enfidha Airport (Tunisia).

From September 2016 until December 2017, the Commission paid EUR 33.4 million to the EIB for 4 calls on a defaulted loan to Enfidha Airport (Tunisia). The last payment took place on 15 December 2017.

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 management fees shall 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 management fees for 2017 were set at EUR 915,279 and were 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 2017 the accumulated accrued amount of recovery fees for Syria was of EUR 2,560,285. On 15 December 2017, one-off recovery fee of EUR 1,467,504 was paid as part of the final call of the defaulted loan to Enfidha Airport (Tunisia).