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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND
THE COUNCIL**

ON THE GUARANTEE FUND AND ITS MANAGEMENT IN 2011

{SWD(2012) 217 final}

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1. INTRODUCTION

Council Regulation (EC, Euratom) No 480/2009 of 25 May 2009¹ (codified version) the Regulation 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 signed between the Community and the EIB on 23 November 1994 in Brussels and on 25 November 1994 in Luxembourg ('the Agreement').

Under Article 8(2) of the Agreement, by 1 March of each year the EIB must send the Commission an annual status report on the Fund and the management thereof ('Statement of financial performance') and a financial statement for the Fund for the preceding year ('Statement of financial position of the Fund'). Further details of the report covering the year 2011 can be found in the Commission Staff Working Document (SWD).

In addition, 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.

2. FINANCIAL POSITION OF THE FUND AT 31 DECEMBER 2011

The financial position of the Fund is the sum of all the financial flows since the setting up of the Fund in 1994.

2.1. Financial flows of the Fund

The financial position of the Fund is presented in accordance with International Financial Reporting Standards (IFRS) at the close of the 2011 financial year.

The Fund totalled EUR 1,756,205,156.06 (see Section 3 of the Staff Working Document: Statement of financial position of the Fund at 31 December 2011, as provided by the EIB). This is the sum of the flows since the Fund was established:

¹ OJ L 145, 10.6.2009, p. 10 ('the Regulation').

Guarantee Fund	Amount at 31.12.2011	Amount at 31.12.2010	Change
budget payments to the Fund	3,384,734,500.00	3,124,564,500.00	260,170,000.00
successive yearly net results	802,354,046.04	760,201,245.08	42,152,800.96
recoveries of payments made by the Fund for defaults	576,705,008.19	576,705,008.19	0.00
other accounts payable (including EIB management fees)	770,809.98	747,058.18	23,751.80
fees received on late recovery (in 2002)	5,090,662.91	5,090,662.91	0.00
calls on the Fund's resources	(477,860,856.19)	(477,860,856.19)	0.00
successive repayments to the budget (including exceptional repayment to the budget due to the accession of new Member States)	(2,501,391,526.79)	(2,501,391,526.79)	0.00
adjustment of portfolio valuation according to IFRS valuation	(34,197,488.08)	(1,845,165.61)	(32,352,322.47)
Accounting value of the Fund	1,756,205,156.06	1,486,210,925.77	269,994,230.29

The accounting value of the Fund increased by about EUR 270 million in 2011. This is explained by :

Increasing

- The contribution from the budget (provisioning amount) of EUR 260.17 million to adjust the Fund to the 9% target amount
- The net revenues on financial operations amounted to EUR 42.15 million

Decreasing

- The portfolio valuation decreased by (EUR 32.3 million) due to price volatility in the context of the financial crisis.
- The Fund value also decreased by (EUR 0.024 million) due to a corresponding increase in the management fees paid to the EIB.

2.2. Significant transactions:

- (1) In January 2011, the contribution from the budget to the Fund was calculated following the article 3 and the article 5 of the Regulation :

Article 3 of the Regulation² sets a target amount for the Fund of 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 the 9% of the total outstanding capital liabilities, an amount of EUR 260.17 million was inserted to the budget 2012 for the contribution into the Fund. At 31.12.2010, the target amount was EUR 1,745.63 million corresponding to the 9% of the total outstanding guaranteed operations (EUR 19,395.86 million). The difference between the target amount and the net assets of the Fund EUR 1,485.46 million at 31.12.2010 was equal to EUR 260.17 million.

This amount was requested for the provisioning of the Fund in 2012 and was approved by the Council and the European Parliament in November 2011. It was subsequently recognised as receivable of the Fund from the budget.

- (2) On 28.02.2011 an amount of EUR 138.88 million was transferred from the budget to the Fund corresponding to the provisioning amount 2011 (see details in paragraph 3.2.1 provisioning of the Fund).

² The Regulation stipulates that operations concerning accession countries covered by the Fund remain covered by the EU guarantee after the date of accession. However, from that date they cease to be external actions of the EU and are covered directly by the general budget of the European Union and no longer by the Fund.

2.3. Significant transaction after the reporting date

On 20 February 2012 an amount of EUR 260.17 million was transferred from the budget to the Fund corresponding to the provisioning for 2012.

2.4. Presentation of the accounts

Since the Commission decided to present its accounts in accordance with new accounting rules based on IPSAS³/IFRS principles, the pre-consolidated financial statements for the Fund have also been drawn up in accordance with these principles, as explained in the SWD.

2.4.1. Basis of preparation

The Fund's financial statements have been prepared in accordance with the accounting rules adopted by the Accounting Officer of the European Commission, in particular "Accounting rule 11 - Financial assets and liabilities"⁴.

2.4.2. Changes in accounting policy

In the financial statements 2011 the Fund has changed its accounting policy for contributions. According to the previous accounting policy applied up to 31 December 2010, contributions were recognised or derecognised in the Fund's balance sheet at the date payments from or to the European Commissions were received or made. Under the new accounting policy applied since 1 January 2011, contributions are recognised or derecognised in the Fund's balance sheet at the date when they become due or owed according to articles 3, 4, 5 and 6 of the Regulation.

This change in accounting policy for contributions provides more relevant information about the balance sheet of the Fund, as Guarantee Fund funding decisions made and published are obligatory expenditures from the general budget of the European Union⁵.

The accounting policy change has been retrospectively applied and comparative information has been adjusted accordingly. The accounting policy change results in the following adjustments to the balance sheet:

Increase in current assets - contributions receivable by EUR 260,170,000 (Comparative figures 2010: increase in current assets – contributions receivable by EUR 138,880,000)
Increase in contributions allocated but not yet paid in by EUR 260,170,000 (comparative figures 2010: increase by EUR 138,880,000).

2.4.3. Impact of changes in accounting policy

The changes have no impact on the economic outturn account or on the provisioning calculation.

³ IPSAS, International Public Sector Accounting Standards.

⁴ This is based on the revised standards IAS 32 and 39 as issued by the IASB on 18 December 2003 and consequently, does not integrate the carved out provisions as set out in the version of IAS 39 endorsed by the European Commission on 19 November 2004.

⁵ Interinstitutional agreement (2006/C 139/01) between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management, OJ L C139, 14.06.2006, p.1.

2.4.4. Pre-consolidated financial statement for the Fund at 31 December 2011

A pre-consolidated financial statement of the Fund is prepared in order to include accounting operations which are not included in the Fund's financial statement prepared by the EIB (see Staff Working Document). The need to include such operations is due to the successive defaults which occurred since the existence of the Fund. If the beneficiary of a loan operation guaranteed by the Fund defaults, the pre-consolidated balance sheet should include any arrears due plus the interest accrued on late payments and other accounting accruals⁶ until the full repayments of amounts due to the Fund. Thus, there will be a full set of financial statements for the Fund at the end of the year to be consolidated in the EU consolidated balance sheet. At 31.12.2011, there is no default. So, the total amount indicated in the pre-consolidated balance sheet is EUR 1,756,205,156.06.

The major changes in the presentation of accounts are explained in the notes and reconcile the figures with the EIB financial statement presented in the SWD.

2.4.5. Guarantee Fund: Pre-consolidated balance sheet

The pre-consolidated balance sheet is the preparation of the balance sheet for its consolidation in the EU's consolidated financial statements. The main changes are explained in the notes to the balance sheet.

Balance sheet: Assets in EUR	2011	2010
CURRENT ASSETS		
Short-term Investments	1,194,552,654.14	1,153,319,651.66
AFS Portfolio - cost	1,206,885,759.50	1,134,968,726.10
AFS Portfolio – actuarial difference	913,066.98	(1,355,359.96)
AFS Portfolio – adjustment to fair value	(34,189,857.13)	(1,888,129.14)
AFS Portfolio - accruals	20,943,684.79	21,594,414.66
Short-term receivables	260,170,000.00	138,880,000.00
Others	260,170,000.00	138,880,000.00
Cash and Cash Equivalents	301,482,501.92	194,011,274.11
Current accounts	1,340,446.23	1,426,322.04
Short-term deposits –	299,600,000.00	123,637,000.00

⁶ Other accounting accruals include exchange rate differences if any, payable in other liabilities (mainly the recovery fees due to the EIB).

nominal		
Accrued interests on short-term deposits	542,055.69	155,055.48
Other cash equivalents – cost		68,708,475.06
Accrued interests on other cash equivalents		84,421.53
Total Current Assets	1,756,205,156.06	1,486,210,925.77
TOTAL	1,756,205,156.06	1,486,210,925.77

Balance Sheet: Liabilities in EUR	2011	2010
A. EQUITY		
Capital (Guarantee Fund)	987,277,788.12	623,172,973.21
Contributions paid in	727,107,788.12	484,292,973.21
Contributions allocated in	260,170,000.00	138,880,000.00
Reserves	(34,197,488.08)	(1,845,165.61)
First Time application – Fair value reserve	(7,630.95)	42,963.53
Change in fair value of AFS assets	(34,189,857.13)	(1,888,129.14)
Accumulated surplus / deficit	760,201,245.08	821,618,687.47
Results brought forward	760,201,245.08	821,618,687.47
Economic result of the year	42,152,800.96	42,517,372.53
Total Equity	1,755,434,096.22	1,485,463,867.60

CURRENT LIABILITIES		
Accounts Payables	770,809.98	747,058.17
Others	770,809.98	747,058.17
Total Current Liabilities	770,809.98	747,058.17
TOTAL	1,756,205,156.06	1,486,210,925.77

Notes to the balance sheet:

- ‘Short-term receivables/others’ contains the provisioning amount for 2012 due to be paid by the EU budget to the Fund in early 2012. It may also include the amount of calls on the Fund that may be receivable from time to time including the capital, interest and penalties due to the budget of the European Union following release of the Fund guarantee.
- The difference in ‘accumulated surplus’ in equity compared with the financial position of the Fund presented in the SWD is explained by the successive repayments of calls and penalties to the Fund.
- ‘Accounts payables/others’ in 2011 include the EIB management commission, audit fees, and the accrual of the recovery fees due to the EIB following payment of the penalty fees due to the Fund.
- In 2011 and 2010, the Commission did not record any impairments in respect of EU sovereign and sovereign guaranteed bond holdings in the Fund portfolio. No impairments were recorded of its holdings of Greek sovereign and sovereign guaranteed bonds.
- The Fund exposure against EU sovereign risk per country can be found in the SWD.

2.4.6. *Guarantee Fund: Pre-consolidated economic outturn account*

In the same way as the balance sheet, the pre-consolidated economic outturn account is prepared for inclusion in the consolidated financial statements of the EU. Main adjustments are explained in the note to the pre-consolidated economic outturn account.

Consolidated Economic Outturn Account in EUR	2011	2010
Financial operations revenues	44,976,268.71	43,367,717.93
Interest income		
Interest income on cash and cash equivalents	4,118,369.38	1,359,361.52
Interest income on AFS assets	40,771,673.71	40,351,233.09
Other Interest income	86,225.62	80,574.54
Realised gains on sale of AFS assets		1,576,548.78
Financial operations expenses	(2,823,717.61)	(850,345.40)
Realised losses on sale of AFS assets	(1,940,019.61)	
Other financial charges	(883,448.14)	(850,345.40)
Thereof: Management fees	(739,809.98)	(715,037.50)
Surplus from non operating activities	42,152,800.96	42,517,372.53
Economic result of the year	42,152,800.96	42,517,372.53

Note to the pre-consolidated economic outturn account:

‘Other financial charges’ include the EIB management commission, audit fees, and accrual of the recovery fees due to the EIB following payment of the outstanding penalty fees due to the Fund.

3. PAYMENTS TO OR FROM THE FUND

This section explains the financial flows going to or out of the Fund.

3.1. Legal basis for payments to the Fund from the general budget

The Regulation was amended in 2007⁷ to ensure a more efficient use of budgetary resources by provisioning the Fund on the basis of the observed amounts of guaranteed loans outstanding.

The target amount is 9% of the loans and guaranteed loans outstanding, including all types of operations covered (EIB, MFA and Euratom loans) outside the EU. The difference between the target amount and the value of the Fund's net assets will result in provisioning from budget line 01040114 'Provisioning of the Guarantee Fund' to the Fund or in payment from the Fund to the budget in the event of a surplus.

The amount available for financing the Fund is provided from budget line 01040114 'Provisioning of the Guarantee Fund' under Heading 4 (External Relations).

3.2. Payments to or from the general budget in the course of the financial year

3.2.1. Provisioning of the Fund

On the basis of the outstanding guaranteed operations of EUR 16,360.73 million as of 31.12.2009, an amount of EUR 138.88 million, was inserted in budget line 01040114 'Provisioning of the Guarantee Fund' in the statement of expenditure in the general budget of the European Union for 2011. This amount was paid in one transaction from the budget to the Fund on 28 February 2011.

3.2.2. Interest from the investment of the Fund's liquid assets

3.2.2.1. 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 by Supplementary Agreement No 1 of 17/23 September 1996, Supplementary Agreement No 2 of 26 April/8 May 2002, Supplementary Agreement No 3 of 25 February 2008 and Supplementary Agreement No 4 of 9 November 2010. 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. This is because fixed-rate securities are reimbursable at 100% of their nominal value at the end of their life, while variable-rate securities can usually be sold at any time at a price close to 100%, whatever their remaining period to maturity. To maintain a balance between the various instruments providing the required liquidity, a minimum of EUR 100 million is kept in money market instrument, particularly bank deposits.

⁷ Council Regulation (EC, Euratom) No 89/2007 of 30 January 2007 amending Council Regulation (EC, Euratom) No 2728/94 establishing a Guarantee Fund for external actions, OJ L 22, 31.1.2007, p. 1.

The list of banks authorised to receive deposits is agreed by the Commission and the EIB. The list has been regularly revised in the light of the changes in bank ratings. All banks have a Moody's rating of at least P1 for short-term investments or an equivalent Standard & Poor's or Fitch rating. The investments made with them are governed by rules to ensure a competitive return and to avoid any concentration of risk.

3.2.2.2. Performance

In an unfavorable economic environment the Fund delivered an absolute return of +0.7157%.

Financial markets in 2011 were mainly influenced by the continuing sovereign debt crisis in Europe. Financial market conditions deteriorated sharply over the summer on the back of sovereign debt concerns in the euro area despite the discussions about the extension of the EU rescue facility, the establishment of a permanent crisis mechanism starting mid-2013 (subsequently brought forward to mid-2012) and intensive efforts to resolve Greece's financing problems.

Risk premiums and interest rates on government bonds in 2011 increased in particular for countries on the periphery of the euro area.

As a consequence the performance of the Fund was very volatile during the year and was strongly impacted by uncertainty and volatility affecting the financial markets. The portfolio underperformed its benchmark⁸ by (138.85) basis points (see section 2.4. 'Performance' of the SWD for details) mainly due to the decrease in the market value of the greek bonds in the portfolio⁹.

3.2.2.3. Financial operations revenues

In 2011, interest income on cash and cash equivalents, on the Fund's current accounts and on securities totalled EUR 44,976,268.71, broken down as follows:

Description:	2011	2010
Interest income on cash and cash equivalent	4,118,369.38	1,359,361.52
interests received on short-term deposits	3,797,877.59	1,253,213.48
change in accrued interest on short-term deposits	302,578.68	91,363.69
Interest on current bank accounts	17,913.11	14,784.35
Interest income on AFS assets	40,771,673.71	40,351,233.09
interest received - Available For Sale portfolio	41,853,323.85	39,633,686.93
change in accrued interest – Available For Sale portfolio	(650,729.87)	1,396,474.35

⁸ Due to the insufficient ratings, Greek and Portuguese bonds are not represented in the benchmark.

⁹ Due to the insufficient ratings, Greek and Portuguese bonds are not represented in the benchmark.

premium discount	(430,920.27)	(678,928.19)
Income from securities lending activities	86,225.62	80,574.54
Realized gain on sale of financial assets	-	1,576,548.78
Interest from financial investment of the Fund's liquid assets	<u>44,976,268.71</u>	<u>43,367,717.93</u>

The interest received is entered in the results for the financial year.

3.2.2.4. Financial operations expenses

The financial operations expenses amounted to (EUR 2,823,717.61) of which (EUR 1,940,019.61) relate to realised losses on sales of available for sale assets. The rest includes the EIB management fees for (EUR 739,809.98), other financial charges for EUR (111,527.16) and the external audit fees for (EUR 32,111.00).

4. THE FUND'S LIABILITIES

The Fund's liabilities correspond to all the financial commitments due by the Fund.

4.1. Default payments

In 2011, no calls related to defaults were made to the Fund.

- Potential calls on the Guarantee Fund following defaulted payments

In the wake of a deteriorating situation in Syria resulting from serious violations of human rights and fundamental freedoms, the Foreign Affairs Council of 23 May 2011 decided to suspend all preparations in relation to new bilateral cooperation programmes and to suspend the ongoing bilateral programmes with the Syrian authorities under the European Neighbourhood and Partnership Instrument (ENPI) and MEDA instruments. Moreover, the Council invited the EIB to not approve new financing operations in Syria. The European Parliament in its Resolution of 7 July 2011 welcomed the Council conclusions to impose restrictive measures on Syria as well as the suspension of new EIB operations in the country.

In addition, the Council decided on 14 November 2011 to prohibit disbursements by the EIB in connection with existing loan agreements between Syria and the EIB as well as suspend EIB technical assistance contracts for sovereign projects in Syria. This Decision has been thereafter consolidated in Council Decision 2011/782/CFSP of 1st December 2011 and Council Regulation (EU) N° 36/2012 of 18 January 2012.

- Event after the reporting date

On 29 February 2012, the Commission was informed that a total of about EUR 15.4 million of repayments of loans granted to the Arab Republic of Syria due in November and December 2011 was still unpaid. The Fund could therefore expect to receive calls to cover the repayments of these loans during the first semester 2012 if the Bank would not receive the amounts due by the Arab Republic of Syria.

4.2. EIB remuneration

The second Supplementary Agreement to the Agreement signed on 26 April and 8 May 2002 lays down 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 2011 was set at EUR 739,809.98 and was entered in the economic outturn account and as accruals (liabilities) on the balance sheet.