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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on guarantees covered by the general budget
Situation at 31 December 2010

{SEC(2011) 1011 final}

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1. INTRODUCTION

The objective of this report is to monitor the credit risks borne by the budget of the European Union resulting from the guarantees given and the lending operations implemented directly by the European Union or indirectly through the EIB external mandates.

This report is submitted pursuant to Article 130 of the Financial Regulation which requires the Commission *to report to the European Parliament and to the Council twice a year on budgetary guarantees and the corresponding risks*[1]. It is completed by a Commission Staff Working Document with a set of detailed tables and explanatory notes (the "SWD").

2. TYPES OF OPERATIONS COVERED BY THE EU BUDGET

The risks covered by the budget of the European Union (the "Budget") derive from a variety of lending and guarantee operations which can be divided into two categories:

– loans granted by the European Union with macroeconomic objectives, i.e. macro-financial assistance[2] ("MFA") loans to third countries in conjunction with the Bretton Woods institutions, balance-of-payments[3] ("BoP") loans granting support to non-euro Member States experiencing balance-of-payments difficulties, loans under the European financial stabilisation mechanism (EFSM)[4] granting support to Member States experiencing difficulties beyond their control; and

– loans with microeconomic objectives, i.e. Euratom loans and most importantly European Investment Bank ("EIB") financing of operations in non-Member States ("EIB external financing")[5] that are covered by EU guarantees[6].

The guaranteed EIB external financing, the Euratom loans and the MFA loans have since 1994 been covered by the Guarantee Fund for external actions ("the Fund"),[7] while BoP and EFSM loans are directly covered by the budget.

The Fund covers defaults on loans and loan guarantees granted to non-Member States or for projects in non-Member States. It was established:

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1 COM(2011)150 and SEC(2011)371 make up the previous report on the guarantees covered by the Budget at 30 June 2010.

2 MFA may also take the form of grants to third countries. For more information on MFA, see Commission report COM(2010)513 and SEC(2010)1117.

3 Council Regulation (EC) N° 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments (OJ L 53, 23.2.2002, p.1).

4 The EFSM was set up on 11 May 2010 on the basis of Council Regulation (EU) No 407/2010 of 11 May 2010 (OJ L 118, 12.5.2010, p.1). It functions in a similar way as the Balance of Payments facility but is available to all Member States, i.e. including Euro area Member States.

5 The figures concerning the EIB mandates are displayed in Table A1 and references to legal bases are listed in Table A4 of the SWD.

6 Most recently established for the period 1 February 2007—31 October 2011 by Decision No 633/2009/EC of the European Parliament and of the Council of 13 July 2009 (OJ L 190, 22.7.2009, p. 1) (the "External Mandate Decision"), replacing Council Decision 2006/1016/EC of 19 December 2006.

7 Council Regulation (EC, Euratom) No 480/2009 of 25 May 2009 establishing a Guarantee Fund for external actions (codified version), the "Guarantee Fund Regulation" (OJ L 145, 10.6.2009, p.10).

– to provide a 'liquidity cushion' in order to avoid calling on the Budget every time a default or late payment on a guaranteed loan arises; and

– to create an instrument of budgetary discipline by laying down a financial framework for the development of EU policy on guarantees for Commission and EIB loans to non-member countries[8].

The Fund's coverage is withdrawn if third countries become Member States and the risk is transferred from the Fund to be directly borne by the Budget. The Fund is provisioned from the Budget and has to be maintained at a certain percentage of the outstanding amount of the loans and loan guarantees covered by the Fund. This percentage, known as the target rate, is currently 9%. If there are insufficient resources in the Fund, the Budget will have to provide the necessary Funds.

3. EVENTS SINCE THE LAST REPORT AT 30 JUNE 2010

3.1. Balance of payments support to non-euro Member States

During the second semester 2010, two operations took place for a total amount of EUR 1.35 billion. The fourth tranche of EUR 0.2 billion of the loan granted to Latvia was disbursed on 20 October 2010. This loan has been financed "back to back" via a private placement with a bank. On 22 September 2010 the third tranche of EUR 1.15 billion of the loan granted to Romania was disbursed. This loan has also been financed “back-to-back” via the issue of EU benchmark bonds. On average 83% of the BOP loan operations decided have already been implemented.[9]

3.2. Macro-financial assistance

During the second semester 2010, no loan disbursement took place.

The Council and the European Parliament adopted in July 2010 a decision to provide EUR 500 million to Ukraine[10] in the form of a loan. Together with a EUR 110 million loan from a decision taken by the Council in 2002, a total of up EUR 610 million is available for Ukraine.

3.3. Euratom

No loan disbursement took place during the reported period.

3.4. EU budget guarantee for EIB external financing

Under the 2007-2013 external mandate, the loan signature and disbursement rhythm accelerated during the second half of 2010 and amounted to respectively EUR 3,476 million signed and EUR 1,642 million disbursed. Thus, the *cumulative* amount of loans disbursed under the mandate reached the amount of EUR 6,129 million at 31 December 2010, up by 37% compared to 30 June 2010.

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8 Although external risks are covered *in fine* by the guarantee of the EU budget, the Guarantee Fund acts as an instrument to protect the EU budget against the risk of payment defaults. For a comprehensive report on the functioning of the Fund, see COM(2010)418 and the accompanying Staff Working Document (SEC(2010)968).

9 See table A3a in the SWD.

10 Decision n°388/2010/EU of the European Parliament and of the Council of 7 July 2010 providing macrofinancial assistance to Ukraine (OJ L 179 of 14.07.2010, p.1).

3.5. European Financial Stabilisation Mechanism

- Background

In response to the financial crisis, the Council and the Member States decided in May 2010 on a package of measures to preserve financial stability in the euro area and Europe at large.

The *European Financial Stabilisation Mechanism (EFSM)*[11] was set up on 11 May 2010based on Art. 122 (2) of the Treaty on the Functioning of the European Union (TFEU)[12].

Union financial assistance under EFSM takes the form of a loan, or of a credit line, granted to the Member State concerned. To this end, the Commission is empowered, on behalf of the European Union, to contract borrowings on the capital markets. The risk of operations under the EFSM is fully backed by the EU budget which guarantees the repayment of the borrowings in case of default of the Member State concerned.

The activation of financial assistance under EFSM is subject to strong conditionality, in the context of a joint EU/International Monetary Fund (IMF) support programme.

As part of the response to the crisis, two other mechanisms have been established which,unlike the EFSM, do not imply any risk to the EU budget. Instead, these mechanisms are guaranteed by the Member States participating in them, on a pro-rata basis.

The *European Financial Stability Facility (EFSF)* was created by the euro area member states as a Luxembourg-registered company owned by them, following the decisions taken on 9 May 2010 within the framework of the Ecofin Council. EFSF is able to issue bonds guaranteed by euro-area Member States for up to EUR 440 billion for on-lending to euro-area Member States in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and IMF and to be approved by the Eurogroup.

Following a request by the Greek authorities, euro area Ministers unanimously agreed on 2 May 2010 to activate *stability support to Greece* via bilateral loans from the other euro area member states, centrally pooled by the Commission. The support was provided in the context of a three year joint programme with the IMF involving a financial package of EUR 110 billion to help Greece meet its financing needs. The programme was accompanied with strong policy conditionality[13] negotiated with the Greek authorities by the Commission and the IMF, in liaison with the ECB. Euro area Member States contribute for their part EUR 80 billion[14] while the IMF supports this programme with a stand-by arrangement of about EUR 30 billion[15]. The representatives of the Member States of the European Union have decided on 5

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[11] Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (OJ L 118, 12.5.2010, p.1).

[12] Art. 122(2) of the TFEU foresees financial support for Member States in difficulties caused by exceptional circumstances beyond Member States' control.

[13] The main elements of policy conditionality were enshrined in Council Decision 2010/320/EU of 10 May 2010 addressed to Greece with a view to reinforcing and deepening fiscal surveillance and giving notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation of excessive deficit (OJ L 145, 11.6.2010, p.6). The conditionality was further detailed in a Memorandum of Understanding concluded between the Greek authorities and the Commission on behalf of euro area Member States.

[14] Of which, EUR 38 billion had been made available until March 2011.

[15] Of which, EUR 14.6 billion had been made available until March 2011.

May 2010 to entrust the Commission with the tasks in relation to the coordination and management of the pooled bilateral loans. This role does not imply an increase in the expenditure of the Commission or of any other item of expenditure under the EU budget.

- Operations in the second half of 2010

On 7 December 2010, the Council decided to grant Union financial assistance to Ireland in the context of a three year joint EU/IMF programme amounting to EUR 85 billion. Of this, a maximum of EUR 22.5 billion will be granted under the EFSM (for addititional details on this operation see paragraph 4.4 Evolution of risk).

4. DATA ON RISKS COVERED BY THE BUDGET

4.1. Definition of risk

The risk borne by the Budget derives from the outstanding amount of capital and interest in respect of guaranteed operations.

Defaulting operations will be covered by the Fund when they are linked to third countries (55% of the total outstanding amount guaranteed as of 31 December 2010) and directly by the Budget where Member States are involved (BoP loans and loans to or for the benefit of projects in Member States account for the remaining 45% of the total outstanding amount guaranteed as of 31 December 2010). The large proportion of guaranteed loans linked to Member States is the result of the enlargement rounds[16] and the activation of the EU medium-term financial assistance facility for non-euro Member States (the BoP facility).

For the purpose of this report, two methods are used for evaluating the risks borne by the Budget (either directly or indirectly via the Fund):

– Calculating the total amount of capital outstanding for the operations concerned on a given date including accrued interest. This methodology makes it possible to determine the total amount of risk supported by the Budget on a given date for all future payment obligations independently of when in the future these payments are due and whether they are covered by the Fund or not.

– The budgetary approach defined as "the annual risk borne by the Budget" is based on the calculation of the maximum amount of annual due payments which the EU would have to pay out in a financial year assuming that all payments of the guaranteed loans are in default[17].

– The results of these two methods are presented in the following two sections. Finally, there is a section on the evolution of risks.

[16] According to Article 1, third paragraph, of the Guarantee Fund Regulation, once a country becomes a Member State, the risk on the loans is transferred from the Fund to the Budget.

[17] For the purpose of this calculation, it is assumed that defaulting loans are not accelerated, i.e. only due payments are taken into account (see also Section 2 of the SWD).

4.2. The total outstanding amount of capital and interest covered by the budget

The total risk supported by the Budget at 31 December 2010 is presented in the following table 1.

Table 1: Total outstanding amounts covered by the Budget as of 31 December 2010 in EUR million

	Outstanding Capital	Accrued Interest	Total	%
Member States*				
MFA	38	0	38	<1%
Euratom	417	3	420	1%
BoP	12,050	197	12,247	35%
EIB***	3,240	30	3,269	9%
Sub-total Member States	15,744	230	15,974	45%
Third Countries**				
MFA	463	2	465	1%
Euratom	49	0	49	<1%
EIB***	18,747	135	18,882	53%
Sub-total third countries	19,256	137	19,396	55%
Total	**35,002**	**367**	**35,370**	**100%**

* This risk is directly covered by the Budget. This also includes MFA, Euratom and EIB loans granted prior to EU accession.

** This risk is covered by the Fund.

***About 83% of EIB lending operations (sovereign and sub-sovereign lending operations) are covered by a comprehensive guarantee while on the remaining operations the EIB benefits from a political risk coverage only.

Tables A1, A2, A3 and A4 of the SWD provide more detailed information on these outstanding amounts, in particular in terms of ceiling, disbursed amounts or guarantee rates.

The total outstanding amount of capital and interest covered by the budget increased to EUR 35.4 billion (increase of EUR 2.6 billion compared with the situation at 30 June 2010). The average growth amounted to 8%. The increase is mainly explained by the amount of EUR 1.4 billion disbursed under the BoP facility and by the increase of EIB disbursements in third countries (EUR 1.2 billion during the second semester 2010).

4.3. Annual risk covered by the Budget

In 2011, the Budget will cover (directly and via the Fund) EUR 4.8 billion representing the amount due during this period out of the total amount outstanding at 31 December 2010..

Of this, 3 billion approximately (63%) is due from Member States while the balance is due from third countries.

4.3.1. Risk linked to Member States

The risk linked to Member States concerns (a) EIB lending as well as MFA and Euratom loans granted before the accession to the EU and (b) the loans granted under the BoP facility following accession.

In 2011, the Budget will bear a maximum direct risk linked to Member States of EUR 3 billion[18] (63% of total annual risk).

Table 2 shows that Hungary and Romania are ranked first and second among Member States in terms of their outstanding amount.

Table 2: Ranking of the Member States according to the maximum risk borne by the budget in 2011 (EUR million)

Ranking	**Country**	**Maximum risk**	**% of the total maximum risk**
1	Hungary	2,209.6	73.3%
2	Romania	383.9	12.7%
3	Latvia	98.3	3.3%
4	Poland	81.9	2.7%
5	Bulgaria	76.9	2.6%
6	Czech Republic	73.6	2.4%
7	Slovak Republic	58.1	1.9%
8	Slovenia	14.3	0.5%
9	Cyprus	9.8	0.3%
10	Lithuania	5.5	0.2%
11	Estonia	1.0	0%

[18] Representing the amounts due in 2011 (out of the total outstanings at 31 December 2010) and assuming that defaulting loans are not accelerated. For details see Table A2 in SWD

12	Malta	0.7	0%
	Total	3,013.7	100.0%

4.3.2. Risk linked to third countries

The Fund covers guaranteed loans concerning third countries with maturities extending up to 2040. In 2011, in particular, the Fund will bear a maximum annual risk related to third countries of EUR 1. 8 billion[19] (37% of the total annual risk).

The top ten (out of fourty-four) countries are ranked below according to their total outstanding. They account for EUR 1,387.2 million or 79% of the annual risk borne by the Fund. The economic situation of these countries is analysed and commented in the SWD.

Table 3: Ranking of the 10 most important third countries according to the maximum risk borne by the Fund in 2011 (EUR million).

Ranking	**Country**	**Maximum risk**	**% of the total maximum risk**	**Euromoney credit risk ranking[20]**	
				03/2010	**09/2010**
1	Turkey	395.9	28.5	59/185	50/185
2	Egypt	211.4	15.2%	69/185	64/185
3	Morocco	171.3	12.3%	57/185	62/185
4	Tunisia	166.3	12%	71/185	69/185
5	South Africa	99.5	7.2%	53/185	44/185
6	Serbia	88.0	6.3%	76/185	70/185
7	Syria	76.8	5.5%	140/185	128/185
8	Lebanon	76.0	5.5%	82/185	76/185
9	Brazil	55.0	4.0%	51/185	42/185
10	Jordan	47.1	3.4%	72/185	67/185
Total of the 10		1,387.2	100.0%		

19 Representing the amounts due in 2011 (out of the total outstanings at 31 December 2010) and assuming that defaulting loans are not accelerated. For details see Table A2 in SWD

20 The higher the ranking number, the lower the creditworthiness of the country. Countries are rated on a scale of zero to 185; 185 represents the highest risk of default. A given country may improve its rating and still fall in the ranking if the average global rating for all rated countries improves.

4.4. Evolution of risk

Tensions observed in some sovereign-bond markets in the EU remained high despite the encouraging progress in economic sentiment during the second semester 2010.

- *Balance of payments facility*

The activation of the EU medium-term financial assistance facility (BoP) facility) in December 2008 helped Hungary, Latvia and Romania to restore market confidence. The first loan repayment will take place in December 2011.

The BoP facility with its overall ceiling of EUR 50 billion has a remaining capacity of EUR 36.4 billion EUR to provide further BoP assistance if required[21].

- *European Financial Stabilisation Mechanism (EFSM)*

The Ecofin Council conclusions restrict the overall ceiling of the mechanism to EUR 60 billion[22], but the legal limit is provided in Article 2.2 of the Council Regulation, which limits the outstanding amount to the margin available under the own resources ceiling[23].

In response to the Irish authorities' request on 21 November 2010, a three year joint EU/IMF financial support was provided. The total programme for Ireland will amount to EUR 85 billion. EUR 17.5 billion will be financed by an Irish contribution through the Treasury cash buffer and investments of the National Pension Reserve Fund. The remainder of the overall package will be funded by:

– The European Financial Stabilisation Mechanism (EFSM) up to EUR 22.5 billion[24] which is coveredby the EU budget;

– The European Financial Stability Facility (EFSF) for an amount of EUR 17.7 billion (not covered by the EU budget guarantee);

– The International Monetary Fund (IMF) for an amount of EUR 22.5 billion;

– Bilateral loans from United Kingdom (EUR 3.8 billion), Sweden (EUR 0.6 billion) and Denmark (EUR 0.4 billion).

- *Macro-financial assistance loans*

MFA loans to third countries have been subject to individual decisions by the Council[25] and since the entry into force of the Lisbon Treaty by the European Parliament and the Council.

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21 Please note that during the first semester 2011 the remaining ceiling has been reduced to EUR 35 billion due to the new precautionary assistance programme for Romania of EUR 1.4 billion decided on 27 May 2011.

22 Cf. Press release on extraordinary Ecofin Council meeting 9/10 May 2010 (http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf)

23 Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (OJ L 118, 12.5.2010, p.1).

24 A first tranche of EUR 5 billion was disbursed on 12 January 2011. Until June 2011 EUR 11.4 billion was disbursed.

The Council Decisions providing macrofinancial assistance to Armenia[26], Serbia[27] and Bosnia and Herzegovina[28] has not yet been implemented at 31.12.2010.

No MFA loans operations were implemented during the second semester 2010.

Euratom loans

The Euratom lending to Member States or in certain eligible non-member countries (Russian Federation, Armenia, Ukraine) has a ceiling of EUR 4 billion of which around 85% has already been used. The remaining margin is about EUR 600 million and could be disbursed to new projects in the Member States and Ukraine.

- *EIB loans*

The EIB general mandate covering the period 2000-2007 expired on 31 July 2007. At this date, contracts corresponding to a total 98% of the overall ceiling under this mandate (EUR 20,060 million – see Table A5 of the SWD) had been signed. At 31 December 2010, a total amount of EUR 3,022 million remained to be disbursed under this mandate but may still be disbursed under EU guarantee within 10 years from the end of the mandate, at which time the EU guarantee lapses for any undisbursed amounts.

Following the Commission proposal to amend the legal basis of the EIB external mandate for the remainder of the current Financial Perspective 2007-2013[29], the Parliament and the Council are expected to adopt the relevant decision before 31 October 2011. The EU guarantee is restricted to 65% of the aggregate amount of credits disbursed and guarantees provided under EIB Financing Operations, less amounts reimbursed plus all related sums, with a maximum ceiling of EUR 27,800 million[30]. A total amount of EUR 16,600 million had been signed at 31 December 2010 under this mandate, of which EUR 10,603 million remained undisbursed at that date (see Table A6 of the SWD).

5. DEFAULTS, ACTIVATION OF BUDGET GUARANTEES AND ARREARS

5.1. Payments from cash resources

The Commission draws on its cash resources in order to avoid delays and resulting costs in servicing its borrowing operations when a debtor is late in paying the EU[31].

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25 After entry into force of the Lisbon Treaty, the co-decision procedure will be the ordinary legislative procedure.

26 Council Decision 2009/890/EC of 30 November 2009 providing macro-financial assistance for Armenia (maximum of EUR 65 million in loan and EUR 35 million in grant).

27 Council Decision 2009/892/EC of 30 November 2009 providing macro-financial assistance to Serbia (loan facility with a maximum amount of EUR 200 million).

28 Council Decision 2009/891/EC of 30 November 2009 providing macro-financial assistance to Bosnia and Herzegovina (loan facility with a maximum amount of EUR 100 million).

29 COM(2010)174 of 21 April 2010.

30 Broken down into a basic ceiling of a fixed maximum amount of EUR 25 800 million and an optional mandate of EUR 2 000 million.

31 See Article 12 of Council Regulation (EC, Euratom) No 1150/2000 of 22 May 2000 implementing Decision 2007/436/EC, Euratom, on the system of the European Communities own resources (OJ L 130, 31.5.2000, 1-12).

5.2. Payments from the Budget

As no default was recorded during the second half of 2010, no appropriation was requested under Budget Article 01 04 01 (p.m. line) "*European Union guarantees for Union and Euratom borrowing operations and for EIB lending operations*".

5.3. Activation of the Guarantee Fund for external actions[32]

In the event of late payment by the beneficiary of a loan to third countries granted or guaranteed by the EU, the Fund is called on to cover the default within three months of the date on which payment is due[33].

The Fund was not called on during the second half of 2010.

6. GUARANTEE FUND FOR EXTERNAL ACTIONS

6.1. Recoveries[34]

As of 31 December 2010, the Fund had no arrears to recover.

6.2. Assets

At 31 December 2010, the net assets[35] of the Fund amounted to EUR 1,485,464,411.

6.3. Target amount

The Fund has to reach an appropriate level (target amount) set at 9% of the total outstanding capital liabilities arising from each operation, plus accrued interest. The ratio between the Fund's resources (EUR 1,485,464,411) and outstanding capital liabilities[36] (EUR 19,395,882,340) within the meaning of the Fund Regulation has decreased from 8.21% at 30 June 2010 to 7.7% at 31 December 2010.

At year-end 2010, the Fund resources were lower than the target amount. According to the provisioning rules of the Guarantee Fund Regulation, a provisioning of EUR 260,170,000 was inserted in the preliminary Budget of 2012. This amount will be paid from the Budget to the Fund in February 2012.

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32 Since its inception in 1994, the Fund has been called for a cumulative amount of EUR 478 million.

33 For more details, see Section 1.4.3 of the SWD.

34 Since its inception in 1994, the total recoveries by the Fund have amounted to EUR 576 million (it includes the amount of capital and interest repaid, plus penalties interests for late payments, plus exchange rate gains and losses realized).

35 Total assets of the Fund minus accrued payables (EIB fees and audit fees).

36 Including accrued interests.

7. EVALUATION OF RISKS: ECONOMIC AND FINANCIAL SITUATION OF THIRD COUNTRIES WITH THE LARGEST EXPOSURE

7.1. Objectives

The previous sections of this report provide information on quantitative aspects of the risk borne by the Budget, relating to third countries. However, the quality of the risks which depend on the type of operation and the standing of the borrowers (see Section 4.3 above) should also be assessed.

7.2. Risk assessment methods

The risk assessment presented in the SWD is based on the information on the economic and financial situation, ratings and other known facts of the countries having received guaranteed loans. This assessment does not include estimations of expected losses and recoveries which are inevitably highly uncertain.

Country risk indicators included in the tables in the SWD indicate the evolution of risk of defaults. This analysis is provided in the section 3 of the SWD for the countries having the highest credit risk and exposure to the Budget (MFA and Euratom loans included) in 2011.