The UK's risks and exposure to the European Investment Bank and other European financial mechanisms:

amounts, safeguards and breaches in the dyke

Bob Lyddon

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ISBN: 978-0-9564614-3-8

Published in May 2012 by
The Bruges Group, 214 Linen Hall, 162-168 Regent Street, London W1B 5TB

www.brugesgroup.com

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Executive Summary

The UK has Maximum Possible Loss of €149.2 billion on current capital and commitments to the institutions involved in the financing of the EU and the euro. That does not include any exposure through the International Monetary Fund.

As one of two remaining large EU Member States with a AAA-rating the UK plays an important role in back-stopping the EU and the euro.

The largest exposure is €110 billion to the European Union, including a €60 billion exposure to the European Financial Stabilisation Mechanism. A Member State's guarantee of the European Union's debts is joint and several, so if 26 Member States fail, the 27th pays everything.

The second largest exposure is to the European Investment Bank in Luxembourg, €1.9 billion of paid-in capital and €35.7 billion of immediately callable, subscribed capital. The EIB views the UK's contribution of €37.6 billion as representing 39.6% of its "Broad risk-bearing capacity", even though the UK is only a 16% shareholder.

The EIB has loans of €332 billion into EU Member States, and key figures have declined sharply from 2009-2011: broad risk-bearing capacity down 11%, percentage of loans into countries rated BBB+ and worse up from 14.5% to 27.9%.

Loans are concentrated onto the public sector but do not necessarily appear in returns on sovereign debt. There is also a major exposure to commercial banks. Lending volumes have risen since the start of the financial crisis, notably into Euro-In countries where the sovereign borrower has come under pressure but not actually sought a refinancing package.

It is critical to the EIB that it retains its own AAA-rating, which depends on the quality of its loans and of its shareholders. The quality of its loans has declined by its own lead measure (credit rating of the borrower's country); the average reliability of the shareholder group has declined. So, to maintain its AAA-rating, a call on the remaining large AAA-rated shareholders is likely.

The third area of exposure is to the European Central Bank. The UK – through the Bank of England – has a risk on paper of only €1.6 billion, but the ECB counts the bullion and currency reserves of the National Central Banks into its own reserves and it spins a very large wheel in its operations. Those operations, it appears, are executed by National Central Banks as the ECB's agent, whereby any losses are

taken by the ECB. Losses of over €10 billion would eliminate the ECB's capital: the ECB reportedly owns €40 billion of Greek government bonds, so a haircut of any size would eliminate its capital and cause it to call upon its shareholders.

The ECB itself, by contrast is seeking to claim a profit on these bonds at the completion of the bailout. The bailout permits these bonds to be exchanged for new bonds at full face value, whereas the ECB purchased them at a discount. The ECB regards that as a profit, whereas the new bonds are on an issuer that is in "selective default" (according to S&P) and a conservative accounting treatment would recognise any such profit only when the new bonds had been repaid in full.

The UK's position as a Euro-Out country but a 14% shareholder is opaque. The bankruptcy of the ECB would be a disaster for the euro, but also for the EU and for the financial reputation of its Member States. As such the UK, as an EU Member State, could not stand by and see the ECB fail. Letting the ECB go under would imperil the UK's AAA rating, as could the cost of bailing it out.

The UK, then, is linked far more directly into the mechanisms for the funding of the EU and for carrying out the operations to deal with the Eurozone debt crisis than the debate about further IMF contributions would infer. The exposure through the European Union should reduce in 2013, if the EFSM can be transitioned into a longer-term Eurozone-only arrangement, be that the EFSF or the European Stability Mechanism (ESM).

But the extra €35.7 billion of uncalled capital to the European Investment Bank is an ongoing, unconditional and irrevocable commitment and a call upon all or part of it can be considered likely, in order to enable the EIB to maintain its own AAA rating.

As well as this, the exposure to the European Central Bank is a wild card.

Introduction

The Eurozone debt crisis, coming at the same time as the UK's own austerity programme, has triggered calls from certain quarters for a re-examination of the UK's relationship with the EU. It has also triggered calls to reject any request from the International Monetary Fund for a new contribution from the UK, on the grounds that the IMF is involved in the support efforts for Greece, Portugal and Ireland, and that a new IMF contribution is a back-door bail-out for the euro.

This paper does not tackle any of those issues. Instead it seeks to quantify what the current exposure to the UK is through the direct mechanisms in which the UK participates in the funding of the EU.

The paper focuses first on the European Investment Bank, the EIB, based in Luxembourg, because it represents the most likely source of a large pay-in by the UK, and because it is an archetype, both in terms of its legal structure and its governance.

The paper then examines the other EU mechanisms - the European Union itself, the European Financial Stabilisation Mechanism, the European Central Bank/ Eurosystem, and the European Financial Stability Facility - for their similarities to the EIB, and for how they:

- Borrow money based on their recourse to backing from Member States
- Collectivise the risk across the Member States either on a joint and several basis (each Member State could be landed with the whole bill) or on a several but not joint basis (each Member State's bill is a fixed percentage of the whole)

The paper goes on to examine how debts, risks and liabilities can be passed along from the weaker EU mechanisms to the stronger ones: "stronger" means either that the mechanism has the right to collectivise claims to its owners on a joint and several basis, or to collectivise it to more countries, or both.

Lastly there is a short section on parliamentary safeguards, namely on the controls that are in place to avoid individual ministers making agreements that create large liabilities for their Member States.

In total the UK is currently on the hook for €149.2 billion in capital-at-risk and in unconditional and immediately payable capital calls or guarantees, separate from any IMF contributions:

Entity	Capital-at-risk	Capital calls/guarantees	Total
European Union	N/A	€110 billion	€110 billion
European Investment Bank	€1.9 billion	€35.7 billion	€37.6 billion
European Central Bank	€0.1 billion	€1.5 billion	€1.6 billion
Total	€2.0 billion	€147.2 billion	€149.2 billion

The risk appending to the UK's shareholding in the European Central Bank – quantified at just €1.5 billion – is nebulous: the ECB only exists because the euro exists, and the UK is a Euro-Out countries. Nevertheless the UK is a 14% shareholder, the ECB counts the UK's currency and bullion reserves as part of its own reserves, and the ECB is spinning a very large wheel on a very small capital base of just €10 billion. The spinning wheel's gyrations are on a par with the ECB's quoted reserves of €2.13 trillion, rather than with its capital, inferring the ECB contemplates the reserves as the collateral for its operations, and that it can access those reserves to cover any loss. The UK's Maximum Possible Loss in connection with the ECB needs to be considered as a wild card.

Note on IMF Funding

IMF funding, as in the case of the 2010 support for Ireland, is not granted in isolation or without stringent conditions. In that case the IMF provided 1/3 of the €67.5 billion non-Irish element of the package of €85 billion. A UK contribution to the IMF is not a back-to-back loan into a borrower country; the UK participates with many other nations as contributors, and towards many other nations as borrowers. IMF funding is contingent upon the other funding being made available in a co-funding model, and upon compliance with the IMF's conditions on austerity and supervision. As such the writer regards the UK's risks on Eurozone nations as tertiary through the IMF, and that the IMF issue is something of a distraction and relatively insignificant compared to the UK's primary exposure to EU financial mechanisms as shareholder and guarantor, and to the UK secondary's exposure to the 'wild card' of the European Central Bank and to the governance models through which exposure ceilings can be raised and safeguards removed.

Part 1: Introduction to the European Investment Bank

The EIB is a "supranational" bank or MLI (Multilateral Lending Institution) based in Luxembourg of which all EU Member States become shareholders upon accession. The shareholding percentage approximates to a share of EU GDP and population.

The EIB is a conduit for long-term loans to improve the infrastructure of EU countries. The EIB is very large; its total assets of around €420 billion are approximately double those of its nearest counterpart, the World Bank. The World Bank's loans of €50 billion and those of the European Bank for Reconstruction and Development of €10 billion compare to the EIB's €351 billion.

The EIB's loans-to-capital ratio was the weakest of any MLI as per 2009 figures:

- EIB – 828%
- World Bank – 357%
- EBRD – 173%

86% of EIB's assets are loans so, although EIB's liquidity policy calls for liquid assets to be held of at least 25% of projected annual net cash flow, EIB's liquidity ratios are lower than those of its counterparts. An institution can only extend itself like this when it has immediate access to powerful backers.

EIB is funded principally by the world's capital markets in terms of volume of funds:

- Its bonds carry the top S&P and Moody's ratings
- Its bonds are highly liquid in secondary markets
- They are accepted as collateral by the European System of Central Banks
- They are regarded as being "central bank money"

In terms of bearing the risk, it is the shareholders.

Part 1.1: EIB capital structure and rating rationale

The EIB utilises the favoured EU mechanism of being established as a legal person with very low paid-in capital of €11 billion, but with a high subscribed capital at €232 billion.

The difference is the committed but uncalled capital of €221 billion and that acts as a guarantee fund. The shareholders can immediately and unconditionally be called upon to pay that amount in, on a several but not joint basis.

The contributions are a fixed percentage of the whole, but payment by one shareholder is not contingent upon payment by all. Capital contributions are still outstanding. The UK has met all its capital calls.

Table 1a: Capital commitments to EIB (€)

The UK's slice of the subscribed-but-uncalled capital is 16.2% or €35.7 billion. This can be called in at any time.

Country	S&P Rating	Subscribed	Uncalled	Called	% of total
Germany	AAA	37,578,019,000	35,699,118,050	1,878,900,950	16.17%
France	AA+	37,578,019,000	35,699,118,050	1,878,900,950	16.17%
Italy	BBB+	37,578,019,000	35,699,118,050	1,878,900,950	16.17%
UK	AAA	37,578,019,000	35,699,118,050	1,878,900,950	16.17%
Spain	A	22,546,811,500	21,419,470,925	1,127,340,575	9.70%
Netherlands	AAA	10,416,365,500	9,895,547,225	520,818,275	4.48%
Belgium	AA	10,416,365,500	9,895,547,225	520,818,275	4.48%
Sweden	AAA	6,910,226,000	6,564,714,700	345,511,300	2.97%
Denmark	AAA	5,274,105,000	5,010,399,750	263,705,250	2.27%
Austria	AA+	5,170,732,500	4,912,195,875	258,536,625	2.22%
Poland	A	4,810,160,500	4,569,652,475	240,508,025	2.07%
Finland	AAA	2,970,783,000	2,822,243,850	148,539,150	1.28%
Greece	CC	2,825,416,500	2,684,145,675	141,270,825	1.22%
Portugal	BBB+	1,820,820,000	1,729,779,000	91,041,000	0.78%
Czech Rep	AA	1,774,990,500	1,686,240,975	88,749,525	0.76%
Hungary	BB+	1,679,222,000	1,595,260,900	83,961,100	0.72%
Ireland	BBB+	1,318,525,000	1,252,598,750	65,926,250	0.57%
Romania	BB+	1,217,626,000	1,156,744,700	60,881,300	0.52%
Slovenia	A+	604,206,500	573,996,175	30,210,325	0.26%
Slovakia	A	560,951,500	532,903,925	28,047,575	0.24%
Bulgaria	BBB+	410,217,500	389,706,625	20,510,875	0.18%
Lithuania	BBB+	351,981,000	334,381,950	17,599,050	0.15%
Luxembourg	AAA	263,707,000	250,521,650	13,185,350	0.11%
Cyprus	BB+	258,583,500	245,654,325	12,929,175	0.11%
Latvia	BB+	214,805,000	204,064,750	10,740,250	0.09%
Estonia	AA-	165,882,000	157,587,900	8,294,100	0.07%
Malta	A-	98,429,500	93,508,025	4,921,475	0.04%
Totals		232,392,989,000	220,773,339,550	11,619,649,450	100.00%

The EIB is highly rated firstly because of the supposed high quality of the bank's loan portfolio. Secondly, there is the ability to make a substantial capital call.

Then there is the imputed (but not tested) mechanism to further raise the subscribed capital and exercise even greater calls upon the shareholders.

Lastly the ratings of the shareholders play a major role. As at the end of 2009 all of the four largest shareholders (each owning 16.2% of the capital) were holders of AAA-ratings: Germany, France, Italy and the UK.

Since the 2010 Annual Report was published, France and Italy have lost their AAA-ratings.

Table 1b: Capital commitments by S&P long-term credit rating of shareholder's country as of February 2012

S&P Rating	Subscribed	Uncalled	Called	% of total
AAA	100,991,224,500	95,941,663,275	5,049,561,225	43.46%
AA+	42,748,751,500	40,611,313,925	2,137,437,575	18.40%
AA	12,191,356,000	11,581,788,200	609,567,800	5.25%
AA-	165,882,000	157,587,900	8,294,100	0.07%
A+	604,206,500	573,996,175	30,210,325	0.26%
A	27,917,923,500	26,522,027,325	1,395,896,175	12.01%
A-	98,429,500	93,508,025	4,921,475	0.04%
BBB+	41,479,562,500	39,405,584,375	2,073,978,125	17.85%
BBB	-	-	-	0.00%
BBB-	-	-	-	0.00%
BB+	3,370,236,500	3,201,724,675	168,511,825	1.45%
BB	-	-	-	0.00%
BB-	-	-	-	0.00%
B+	-	-	-	0.00%
B	-	-	-	0.00%
B-	-	-	-	0.00%
CC	2,825,416,500	2,684,145,675	141,270,825	1.22%
Totals	232,392,989,000	220,773,339,550	11,619,649,450	100.00%

As of now the amount of callable capital due from AAA-rated countries has fallen to €96 billion, compared to the €137 billion stated in the 2010 Annual Report. €72 billion of the €96 billion would be callable from the two biggest countries: Germany and the UK.

33% of the callable capital would now be due from countries that are rated A+ or lower.

21% of the callable capital would now be due from countries that are rated BBB+ or lower.

Given the reason a call might occur – repayment difficulties by the public sector entities in weaker EU Member States – it is reasonable to question whether the sovereign in the same EU Member State might be in a position to meet a capital call.

There has been an obvious deterioration in the reliability of this pillar upon which the EIB stands, during 2010 and 2011. Since the obligation to pay in is not contingent upon other shareholders meeting their call, it is reasonable to posit that the stronger shareholders may carry a disproportionate burden.

The UK's Maximum Possible Loss is €37.7 billion current commitment:

- €1.9 billion – 16.2% of the current paid-in capital
- €35.8 billion – 16.2% of the subscribed-but-uncalled capital

This would escalate by any increases in the subscribed capital which the agreement mechanisms do not allow the UK to block, and can be expected to be discussed when and if:

- Other primary shareholders lose their AAA rating and this imperils EIB's own AAA rating
- Other shareholders do not pay in their capital calls (€58 million of historical calls had not been paid in as of end of 2010)

The chance of a capital call is synonymous with the quality of the EIB's loan book, which can be expressed as the likelihood that EIB experiences loan write-offs exceeding €11 billion on a loan portfolio of €350 billion (i.e. of 3%). S&P and Moody's count the uncalled capital into the EIB's Risk-Bearing Capital, explicitly because the €11 billion paid-in capital is far too low to support the extent of the lending.

The reports all state that the loan portfolio is of very high quality, and that this is the other pillar of EIB's AAA-rating.

Part 1.2: EIB loan book quality and credit process

Note - EIB's disbursed loan book as per the 2010 Annual Report "Key statutory figures" on page 2 is €361 billion, with a further €91 billion committed but not yet disbursed.

Part of the lending is outside the EU. The main table "D.3.1 Loans for projects within the Union", which is the basis for Tables 2a and 2b in this analysis, states the outstanding loans as being 89.91% of the total at €332.8 billion. 89.91% of €361 billion is €324 billion, however, not €332.8 billion. €332.8 billion is 89.91% of €370 billion. There is a €9 billion discrepancy.

Likewise, when capital adequacy is calculated, the capital figures – which do reconcile – are expressed as percentages of (i) total assets + contingent payments and (ii) purpose-related loans. Under those calculations "purpose-related loans" should be €364 billion, and one wonders whether the definition is different from "Loans for projects". Likewise "total assets + contingent payments" should be €422 billion, whereas the Balance Sheet total is €420 billion.

These differences are not material to the overall picture but they do introduce difficulty in squaring all the figures up.

Part 1.2.1: EIB loan book quality due to concentration

This part of the analysis concentrates on the 89.91% of outstanding "loans for projects" that are made to borrowers in the EU. EIB state these as totaling €332.8 billion in their listings of loan outstandings (see Tables 2a and 2b).

The quality of the loan book is claimed to be high, because it is concentrated on highly-rated governments, banks, corporate and public-sector institutions:

- Loans are concentrated on public sector entities
- 62% of loans are covered by guarantees
- Loans to non-public entities are guaranteed by major banks

This concentration of loans into countries that have high credit ratings was stressed in the 2009 Annual Report as an advantage. The column in the following table headed "EIB S&P 2009" reproduces the breakdown of all EIB's loans supplied through S&P's 2009 analysis of EIB on pages 14-15.

There is no equivalent table in their 2010 report. Instead there is a lengthy table on page 15 showing where the largest exposures are, and this is summarized as follows:

- Three of the largest exposures are to AAA-countries (UK, Germany, France, the latter now being AA+)
- Spain (then AA; now A) and Italy (then A+; now BBB+) account for 29.6% of the loan book
- Portugal (then BBB-; now BBB+) and Ireland (then BBB+; now BBB+) account for 6.9% of the loan book

The column "2010" below is drawn from Table 2b and in turn from the EIB's Table D.3.1, and places the EIB 2010 loan outstandings inside the EU against today's country ratings. It would not appear from other evidence that the make-up of the EIB loan portfolio has altered during the same period to concentrate more loans into AAA and AA countries, rather the opposite. Instead, 3.81% of these loans (€17 billion of disbursed and undisbursed loans) is to borrowers in Greece. Its accounting treatment infers that the borrowers are not in default, nor have they experienced a material adverse change in their status so as either to make undisbursed loan amounts not available nor to put in doubt the full repayment of the loans.

So, although the figures are not strictly comparable, the table shows a distinct slide from top to bottom in quality, undermining this supposed pillar of the EIB's strength:

Country Rating	EIB S&P 2009	2010
AAA	39.5%	25.1%
AA	21%	15.6%
A	25.1%	21.4%
BBB+ and below	14.5%	27.9%
Total	100%	89.91%

Table 2a: Basis of "2010" column above - disbursed and undisbursed loans by country of borrower (€ 000) using 2010 outstandings but using February 2012 ratings

Country	S&P Rating	Number	Loan Amount	Disbursed	Undisbursed	% of total loans
Spain	A	696	67,388,000	63,517,730	3,870,270	14.94
Germany	AAA	688	57,312,575	48,133,100	9,179,475	12.7
Italy	BBB+	548	55,563,064	43,221,824	12,341,240	12.32
France	AA+	403	41,006,821	34,224,356	6,782,465	9.09
UK	AAA	233	30,523,750	24,813,567	5,710,183	6.77
Portugal	BBB+	320	24,032,904	21,411,740	2,621,164	5.33
Poland	A	189	23,104,374	16,507,833	6,596,541	5.12
Greece	CC	150	17,197,611	13,872,929	3,324,682	3.81
Hungary	BB+	125	10,710,227	8,437,892	2,272,335	2.37
Austria	AA+	196	9,815,879	9,239,879	576,000	2.18
Czech Rep	AA	113	9,705,203	7,729,744	1,975,459	2.15
Belgium	AA	94	8,737,168	7,149,325	1,587,843	1.94
Netherlands	AAA	66	7,807,107	5,423,587	2,383,520	1.73
Sweden	AAA	73	7,520,745	5,171,663	2,349,082	1.67
Finland	AAA	114	6,900,878	6,116,078	784,800	1.53
Romania	BB+	74	6,553,558	3,277,402	3,276,156	1.45
Ireland	BBB+	50	4,265,456	3,356,818	908,638	0.95
Slovenia	A+	54	3,089,494	2,185,805	903,689	0.68
Slovakia	A	44	2,617,823	1,116,366	1,501,457	0.58
Bulgaria	BBB+	42	2,429,605	1,090,550	1,339,055	0.54
Denmark	AAA	44	2,370,991	2,069,158	301,833	0.53
Cyprus	BB+	33	1,835,111	1,362,472	472,639	0.41
Latvia	BB+	27	1,602,681	817,681	785,000	0.35
Lithuania	BBB+	17	1,328,129	1,176,629	151,500	0.29
Estonia	AA-	14	1,068,217	489,908	578,309	0.24
Luxembourg	AAA	27	790,713	693,263	97,450	0.17
Malta	A-	5	301,055	145,555	155,500	0.07
Totals			405,579,139	332,752,854	72,826,285	89.91

Table 2b: Basis of "2010" column above - concentration of loans by S&P long-term credit rating of borrower's country using 2010 outstandings but February 2012 ratings

S&P Rating	Loan Amount	Disbursed	Undisbursed	% of total loans
AAA	113,226,759	92,420,416	20,806,343	25.1
AA+	50,822,700	43,464,235	7,358,465	11.27
AA	18,442,371	14,879,069	3,563,302	4.09
AA-	1,068,217	489,908	578,309	0.24
A+	3,089,494	2,185,805	903,689	0.68
A	93,110,197	81,141,929	11,968,268	20.64
A-	301,055	145,555	155,500	0.07
BBB+	87,619,158	70,257,561	17,361,597	19.43
BBB	-	-	-	0
BBB-	-	-	-	0
BB+	20,701,577	13,895,447	6,806,130	4.58
BB	-	-	-	0
BB-	-	-	-	0
B+	-	-	-	0
B	-	-	-	0
B-	-	-	-	0
CC	17,197,611	13,872,929	3,324,682	3.81
	405,579,139	332,752,854	72,826,285	89.91

Political risk/transfer risk has therefore increased dramatically in 2010, but this deterioration is only part of the story, because the EIB runs a considerable commercial risk.

Despite the stress on lending into the public sector, only a small proportion of its loans are either to the sovereign directly or carry the unconditional and irrevocable guarantee of the sovereign.

Part 1.2.2: Non-sovereign loans of EIB

The supposed strength of the EIB of concentration on highly-rated countries is misleading without the contractual commitment of the sovereign.

Some of the borrowing entities may enjoy a structural guarantee – e.g. the Deutsche Bundesbahn is constitutionally part of the Federal Republic. But other entities will simply be regional or municipal governments, or limited liability companies whose shares are owned by other public sector entities.

Ownership means "backing" but does not necessarily constitute:

- A guarantee
- A commitment to inject extra funds

To quantify this matter let us look at Table 2c. €317 billion of disbursed and undisbursed loans out of €405 billion in total are to entities which are neither the sovereign itself nor guaranteed by it.

A proportion of the amount will be under EIB's SME Loan Portfolio where the loan is counter-guaranteed by a commercial bank in the country concerned, but the majority will be to non-sovereign public entities. That is not to say that loans counter-guaranteed by commercial banks are a safe haven: the point here is to distinguish between "public sector" risk as sovereign risk, and "public sector" risk as exposure to entities that are in some way owned and controlled by the public.

Table 2c-i is based on the table in the EIB's Annual Report 2010 page 63 which lists, by country, the direct sovereign loans and the loans guaranteed by the sovereign.

Table 2c-i sets Total disbursed/undisbursed loans against disbursed/undisbursed loans to the sovereign by country.

Table 2c-i: Sovereign loan exposure compared to Total loan exposure (€ 000)

Country	TOTAL Loan Amount	TOTAL Disbursed	TOTAL Undisbursed	SOVEREIGN Disbursed	SOVEREIGN Undisbursed
Spain	67,388,000	63,517,730	3,870,270	1,243,000	-
Germany	57,312,575	48,133,100	9,179,475	-	-
Italy	55,563,064	43,221,824	12,341,240	1,136,000	-
France	41,006,821	34,224,356	6,782,465	-	-
UK	30,523,750	24,813,567	5,710,183	-	-
Portugal	24,032,904	21,411,740	2,621,164	513,000	-
Poland	23,104,374	16,507,833	6,596,541	5,428,000	1,502,000
Greece	17,197,611	13,872,929	3,324,682	6,128,000	1,740,000
Hungary	10,710,227	8,437,892	2,272,335	3,714,000	1,168,000
Austria	9,815,879	9,239,879	576,000	-	-
Czech Rep	9,705,203	7,729,744	1,975,459	2,681,000	816,000
Belgium	8,737,168	7,149,325	1,587,843	-	-
Netherlands	7,807,107	5,423,587	2,383,520	-	-
Sweden	7,520,745	5,171,663	2,349,082	-	-
Finland	6,900,878	6,116,078	784,800	452,000	-
Romania	6,553,558	3,277,402	3,276,156	780,000	2,077,000
Ireland	4,265,456	3,356,818	908,638	-	-
Slovenia	3,089,494	2,185,805	903,689	41,000	-
Slovakia	2,617,823	1,116,366	1,501,457	152,000	1,300,000
Bulgaria	2,429,605	1,090,550	1,339,055	107,000	985,000
Denmark	2,370,991	2,069,158	301,833	-	-
Cyprus	1,835,111	1,362,472	472,639	471,000	280,000
Latvia	1,602,681	817,681	785,000	375,000	525,000
Lithuania	1,328,129	1,176,629	151,500	1,020,000	112,000
Estonia	1,068,217	489,908	578,309	165,000	385,000
Luxembourg	790,713	693,263	97,450	-	-
Malta	301,055	145,555	155,500	-	-
	405,579,139	332,752,854	72,826,285	24,406,000	10,890,000

Table 2c-ii builds on Table 2c-i to calculate the Non-sovereign disbursed/undisbursed loans by deducting Sovereign disbursed/undisbursed loans from Total disbursed/undisbursed loans.

"Non-sovereign Sub-total" is all disbursed/undisbursed loans to entities other than the sovereign, but then an amount needs to be deducted from that, which is where the sovereign has guaranteed a loan to a Non-sovereign. That then delivers the final figures on exposures to Non-sovereigns: €317 billion.

Table 2c-ii: Extrapolation of Non-sovereign loan exposure from Total exposure and Sovereign exposure (€ 000)

Country	NON-SOVEREIGN Disbursed	NON-SOVEREIGN Undisbursed	NON-SOVEREIGN Sub-total	SOVEREIGN Guaranteed	NON-SOVEREIGN Total
Spain	62,274,730	3,870,270	66,145,000	14,675,000	51,470,000
Germany	48,133,100	9,179,475	57,312,575	1,873,000	55,439,575
Italy	42,085,824	12,341,240	54,427,064	3,769,000	50,658,064
France	34,224,356	6,782,465	41,006,821	932,000	40,074,821
UK	24,813,567	5,710,183	30,523,750	1,522,000	29,001,750
Portugal	20,898,740	2,621,164	23,519,904	7,161,000	16,358,904
Poland	11,079,833	5,094,541	16,174,374	7,710,000	8,464,374
Greece	7,744,929	1,584,682	9,329,611	5,583,000	3,746,611
Hungary	4,723,892	1,104,335	5,828,227	1,565,000	4,263,227
Austria	9,239,879	576,000	9,815,879	35,000	9,780,879
Czech Rep	5,048,744	1,159,459	6,208,203	462,000	5,746,203
Belgium	7,149,325	1,587,843	8,737,168	867,000	7,870,168
Netherlands	5,423,587	2,383,520	7,807,107	29,000	7,778,107
Sweden	5,171,663	2,349,082	7,520,745	838,000	6,682,745
Finland	5,664,078	784,800	6,448,878	1,146,000	5,302,878
Romania	2,497,402	1,199,156	3,696,558	320,000	3,376,558
Ireland	3,356,818	908,638	4,265,456	655,000	3,610,456
Slovenia	2,144,805	903,689	3,048,494	2,030,000	1,018,494
Slovakia	964,366	201,457	1,165,823	-	1,165,823
Bulgaria	983,550	354,055	1,337,605	-	1,337,605
Denmark	2,069,158	301,833	2,370,991	560,000	1,810,991
Cyprus	891,472	192,639	1,084,111	722,000	362,111
Latvia	442,681	260,000	702,681	221,000	481,681
Lithuania	156,629	39,500	196,129	-	196,129
Estonia	324,908	193,309	518,217	75,000	443,217
Luxembourg	693,263	97,450	790,713	167,000	623,713
Malta	145,555	155,500	301,055	290,000	11,055
Total	308,346,854	61,936,285	370,283,139	53,207,000	317,076,139

Part 1.2.3: EIB credit process and underwriting criteria

Let us stay with the lending to public sector entities, and test a leading bundle of hypotheses regarding this large portfolio, at the risk of repeating what has already been stated above:

- The status of borrowers as being publicly owned has been allowed to lessen the stringency of analysis of the borrower and its ability to pay back from its own resources
- Analysis concentrates on establishing that the loan purpose complies with EIB and EU policy objectives and that the project itself is technically viable, and that the quoted project costs are feasible
- Over-reliance on the identity of the borrower's owners – direct and indirect – without credit analysis on them
- Imputation of unconditional and irrevocable support from the owners up to and including the government, without that being explicitly stated or contracted
- Over-reliance on third-party guarantees - without credit analysis on guarantors

We have taken 8 examples of new loans recently approved, to show the type of lending that the EIB undertakes.

Source: http://www.eib.org/projects/pipeline/index.htm on 5th February 2012; EIB's up-to-date list of project loans in the pipeline

Three further points need to be made:

- These loans were approved by the EIB at the same time as severe doubts were being expressed as to the financial viability of the sovereign in the respective borrower's country;
- These loans are not to the sovereign, nor do they carry the sovereign's guarantee, but they certainly count as public sector debt, for which the source of repayment is the same as it is for sovereign debt: the capacity of the citizen and business to come up with taxes, levies and charges. In turn that derives from economic prosperity. Why should it be considered that, at a time when lack of economic prosperity was weighing down on the Kingdom of Spain, for example, that it should not weigh down also on its sub-divisions, like Castilla-La-Mancha, Aragon, or Castilla y León?

- Where do these loans appear in the public accounts? Are they consolidated into the debts of the Kingdom of Spain, or do they fall below the radar and only appear on the books of the respective region, or do they fall below the horizon on the books of a project company (such as Ibersol Electricidad Solar Iberica, S.L.U.), and do not get shown in the public accounts at all, as per the UK's PFI model?

Project example 1: Instalaciones AVE Albacete-Alicante

Promoter – Financial Intermediary	Administrador de Infraestructuras Ferroviarias (ADIF)
Location	Spain Albacete-La Encina-Alicante
Description	Financing of signaling & telecommunication schemes under a public-private partnership (PPP) contract for the high speed infrastructure between Albacete and Alicante
Objectives	Development of the detailed design of the project components – traffic control, fixed and mobile communications, and safety equipment. Execution of the construction works, including equipment testing
Sector(s)	Transport
Proposed EIB finance	€ 110 million
Total cost	€ 265 million
Environmental aspects	According to EU Directive 85/337/EEC amended by 97/11/EC and 2003/35/EC, the overall high-speed rail link project falls into the Annex I category and therefore an EIA is mandatory. Compliance with national and EU environmental legislation as well as potential impacts on Natura 2000 network will be verified during appraisal. The project planning predates the SEA Directive 2001/142/EC. The works included in this particular contract do not fall into Annex I nor II of the above mentioned Directive and consequently no EIA is required
Procurement	The PPP project will be procured under a competitive dialogue process. The contracting authority is a public promoter obliged to comply with the relevant applicable EU project legislation (EU directive 2004/18) and National Public Procurement legislation. The Bank will require the Promoter to ensure that contracts for the implementation of the project have been tendered and awarded in accordance with this legal framework and will review the awarded tender in this regard
Status	Approved - 12/04/2011.

Project example 2: Aguas de Castilla-La-Mancha II 2

Promoter – Financial Intermediary	Comunidad Autónoma de Castilla-La-Mancha
Location	Spain Region of Castilla-La-Mancha
Description	Financing of water infrastructure schemes in the region of Castilla-La-Mancha.
Objectives	The Bank has been requested to make the largest possible contribution to the financing of this investment program. The Bank has already approved a first loan of € 200 million under Aguas de Castilla-La-Mancha II.
Sector(s)	Water, sewerage, solid waste
Proposed EIB finance	Up to € 200 million
Total cost	Up to € 1 153 million
Environmental aspects	The project consists of a number of investments in water and wastewater works. It is expected to deliver multiple environmental benefits. Compliance with relevant European legislation - EIA Directive (97/11/EC), SEA Directive (2001/42/EC) and Birds as well as Habitats Directive (92/43/EEC), amongst others - will be assessed during appraisal
Procurement	Procurement for this project falls under Directives 2004/17/EC and 2004/18/EC. Compliance of the promoter with theses directives will be assessed during appraisal
Status	Approved - 20/05/2011

Project example 3: Acquedotto Pugliese

Promoter – Financial Intermediary	Acquedotto Pugliese S.p.A.
Location	Italy Puglia Region
Description	The project concerns the investment programme under the Master Plan, for the 2010-2012 period. The investments will mainly concern small to medium sized water and wastewater facilities and will be aimed at (i) reducing water losses, (ii) increasing the availability of water resources and (iii) expanding the water and wastewater networks and plants
Objectives	The project will contribute to meeting the requirements of the Urban Waste Water Treatment Directive and the Water Framework Directive. The resulting improved service standards and higher resilience to the effects of climate change qualify the operation as relevant for climate action
Sector(s)	Water, sewerage, solid waste
Proposed EIB finance	Up to € 150 million
Total cost	Up to € 370 million
Environmental aspects	Where and if applicable, the requirements of the Environmental Impact Assessment (EIA) Directive 97/11/EC, as amended by Directive 2003/35/EC, will be respected. The promoter will in such case, prior to utilising any EIB funds, be responsible for transmitting to the Bank the non-technical summary of the EIA. In addition, for any part of the scheme that may impact on a nature conservation site, the promoter will be required to provide to the Bank information on the mitigating measures needed to comply with the Habitats Directive
Procurement	The Bank will require from the promoter that contracts for the implementation of the project have been or shall be tendered in accordance with relevant EU procurement laws (2004/17/EC), with publication of tender notices in the EU Official Journal, as and where appropriate
Status	Approved - 19/07/2011

Project example 4: Ibersol CSP Project

Promoter – Financial Intermediary	Ibersol Electricidad Solar Iberica, S.L.U.
Location	Spain
Description	Construction, operation and maintenance of a concentrated thermosolar power ("CSP") plant with a capacity of 49.9MW and using molten salt storage technology, located in Villanueva de la Serena (Badajoz / Extremadura / Spain).
Objectives	The project supports national and EU renewable energy objectives. Additionally, the project will be installed in a Convergence region (Stricto sensu)
Sector(s)	Energy
Proposed EIB finance	€ 185 million
Total cost	Not applicable
Environmental aspects	The plant's site is currently used as arable land. Environmental impacts from the project are expected to be minor, mainly visual. By virtue of its technical characteristics the project falls under Annex II of Directive 85/337/EC, as amended by 97/11/EC and 2003/35/EC, which leaves the requirement for an Environmental Impact Assessment (EIA) to be determined by the competent national authorities. In this case the Spanish authorities have required an EIA to be carried out
Procurement	Neither the promoter nor the special purpose companies are subject to EU Procurement Directives. Suitable procurement procedures, including an appropriate selection of works, goods and services offered at competitive prices should be applied in the project's best interests. Details will be verified during appraisal
Status	Approved - 19/07/2011

Project example 5: Aragón Sustainable Development B

Promoter – Financial Intermediary	Comunidad Autónoma de Aragón
Location	• Spain • Región de Aragón
Description	Second framework loan for the financing of small and medium-sized investments in the areas of IT, RDI, education, health, social inclusion, urban transport, culture, administration, and environment in the region of Aragon
Objectives	The Quadrennial Strategic Investment Plan 2009-2012 seeks to contribute significantly to mitigating the current phase of economic slowdown, to support job creation and create the conditions for sustainable development
Sector(s)	Urban infra. Transport Telecom Health, Education Services
Proposed EIB finance	Up to € 150 million
Total cost	Up to € 744 million
Environmental aspects	The project is a multi-sector multi-scheme operation classified as Framework Loan. Some of the schemes may eventually fall under Annex I or Annex II of the EIA Directive 85/337/EEC, amended by Directives 97/11/EC and 2003/35/EC, or may have an impact on an area forming part of Natura 2000 network. It will be required that all the schemes will be implemented in compliance with the EU environmental legislation
Procurement	The promoter as a public administration entity is required to follow the EU public procurement rules (2004/17/EC and 2007/18/EC) including publication of contract notices in the EU Official Journal as implemented by national law, if and where appropriate. Projects with values below the EU thresholds will be procured according to the provisions laid down in national legislation
Status	Signed - 15/09/2011.

Project example 6: Sviluppo Metropolitana di Roma

Promoter – Financial Intermediary	Comune di Roma
Location	Italy
Description	The proposed project would consist of : a 1.1 km extension of underground line B, the acquisition of 15 new trains to operate on this line and some other interventions to modernise the infrastructure of underground lines A and B, including the extension of a depot
Objectives	The project will increase the extension, level of service, effectiveness and reliability of the public transport service in the Rome metropolitan area, contributing to the limitation of private car usage through an expected shift to the metro network
Sector(s)	Transport
Proposed EIB finance	Up to € 250 million
Total cost	Up to € 500 million
Environmental aspects	A full EIA has been carried out for line B extension. Rolling stock provision falls outside the scope of Directive 85/337/EEC (as amended); details on scrapping procedures will be assessed during appraisal. The other interventions on the lines are also outside the scope of the EIA Directive. The depot extension should fall under Annex II, according to which the need for a full EIA is decided on a case-by-case analysis by the Competent Authority. Full details will be checked at appraisal stage. The project is expected to have some positive impacts on environment thanks to the increase in public transport service quality
Procurement	The Promoter is a public entity subject to EU public procurement directives (2004/17/EC and 2004/18/EC). The Bank will require the promoter to ensure that contracts for the implementation of the project have been/shall be tendered in accordance with the relevant applicable EU procurement legislation with parallel publication of tender notices in the EU Official Journal, as and where appropriate. Details will be checked at appraisal stage
Status	Signed - 10/08/2011

Project example 7: ATM Rinnovo Materiale Rotabile

Promoter – Financial Intermediary	Azienda Trasporti Milanesi S.p.A.
Location	Italy Milan, Lombardy Region
Description	The project consists in the renewal of the metro fleet of ATM. In particular, the project includes the acquisition of up to 60 new metro trains that will replace part of the existing rolling stock currently operated on lines 1 and 2 of Milan's metro network. The new trains will be fully compatible with the most advanced systems for automatic operation; coupled with other investments on the signalling and power supply systems currently ongoing on line 1 and planned on line 2, the project will allow an increase in the passenger service capacity that would not otherwise be possible with the existing rolling stock
Objectives	The project will improve the quality of public transport services in terms of speed, comfort, availability and reliability. The project will increase the attractiveness of public transport in the congested urban area of Milan, contribute to reduced reliance on private cars and improve the quality of the urban environment. The use of regenerating braking systems will allow for an increase in energy efficiency, thus contributing to tackling climate change
Sector(s)	Transport
Proposed EIB finance	Up to € 200 million
Total cost	Up to € 600 million
Environmental aspects	The construction of the new rolling stock will take place in the manufacturer's plants and does not fall within the scope of Directive 85/337/EEC (as subsequently amended), therefore no EIA is required for the project
Procurement	The Promoter is subject to and follows EU Directives (2004/18/EC and 2004/17/EC) on procurement, including publication in the Official Journal of the European Union. All contracts will have to go through public tendering in compliance with European legislation. Under these conditions, the procedures chosen by the Promoter are suitable for the project and in line with the Bank's requirements. Application of EU legislation will be reviewed by the Bank's services during appraisal
Status	Approved - 01/07/2011

Project example 8: Castilla y León Education

Promoter – Financial Intermediary	Comunidad Autónoma de Castilla y León
Location	Spain Castilla y León
Description	The investment programme ("the project") comprises a range of small to medium-sized investments in the Spanish Autonomous Community of Castilla y Leon
Objectives	The investments are designed to enhance learning and research capability, cohesion and social welfare in the Spanish Autonomous Community of Castilla y Leon
Sector(s)	Services Health, Education
Proposed EIB finance	Up to € 200 million
Total cost	Up to € 600 million
Environmental aspects	Educational and social care facilities are not specifically mentioned in the EIA Directive on Environmental Impact Assessment, though elements of the project may be covered by Annex II of the Directive in relation to urban development. The Bank's services will verify the EIA screening decision of the Competent Authority during appraisal, as well as other environmental effects of the projects
Procurement	The Bank requires the promoter to ensure that all relevant contracts for the implementation of the project have been or shall be tendered in accordance with the relevant EU procurement legislation. The procurement procedures will be examined during appraisal
Status	Approved - 25/11/2011

Part 1.2.4: Summary of these example projects

The working hypotheses regarding new and existing loans is in every case the same:

- Large amounts are lent per borrower;
- Loans are made to the public sector, but only the minority carry an explicit guarantee from the sovereign;
- The loan is customarily, in the example of Spain, to a region, or to a municipality, or to a project company. In the case of loans to project companies, it is not always explicitly the case that a guarantee is taken from the sponsoring public authority;

- Such debts are not necessarily recorded as part of the Kingdom of Spain's public debt;
- Large loans were being approved despite the financial difficulties of the sovereign borrower in the respective country;
- Loans were approved and for their compliance with EU policies and directives, for their environmental impact, for the involvements of the public sector, for their proportion of total project cost, and for their feasibility from an engineering point of view – but not for the ability of the respective borrower to repay capital and interest on this loan and all their other indebtedness.

If this latter point were not the case, how would Project 2: Aguas de Castilla-La-Mancha II 2 be approved at the same time as the Spanish financial authorities were calling for substantial recapitalisation of banks because of their exposure to empty properties? A water supply project is paid for by usage tariffs met by householders and businesses. In a recession and in an area with high unemployment and many empty properties, such a project should be difficult to finance. If the debts are the responsibility of the Comunidad Autónoma de Castilla y León, then how do the figures of that entity look when all of its income derives from local taxes on businesses and private citizens, against the background of the current recession with national unemployment running at 22.9%?

Part 1.2.5: Borrower's accounting for EIB loans

EIB's reports do not make clear at which level they have been lending, compared to public data about public sector debt in, for example, Spain:

Government debt – €488 billion

Debts of the 17 autonomous regions – €115 billion

Debts of provinces & municipalities – €35 billion

Debts of public companies owned by regional and local governments – €26 billion

Source of data: http://www.etoro.net/forex-news/european-focus/eur/spain%E2%80%99s-hidden-debt-likely-to-be-revealed-after-elections-26366.html

There is a risk of asymmetric accounting, where EIB records the loans as ‘public sector in a highly rated country’ but they do not appear in that country’s own statements of government debt. This risk will be the more acute when the loan is to a limited liability company owned by a public entity.

The aggregation of all debts weighing on the public purse has been a problem in Greece, as it is in the UK: what is the total risk to the public purse of commitments made through PFI?

This is not to say that EIB’s loans are either unrecorded or unenforceable; it is rather that consolidated information on the full level of public sector debt is not reliably available from the borrower side, and it naturally is a much higher figure than the direct debt of the sovereign.

Part 1.2.6: Non-public sector loans

Turning lastly to that segment of the loan portfolio which is not granted to the public sector, this is the scheme where major commercial banks guarantee loans that the EIB makes directly to their SME clients. The commercial bank takes security from the SME, upon whom EIB does no credit analysis.

In the UK that bank could be Lloyds TSB; in Bulgaria it would be CIBank.

In the Republic of Ireland it will be Bank of Ireland and Allied Irish Banks.

In Greece it will be National Bank of Greece, and EfG Eurobank.

The EIB claims to have been guided by the bank’s public ratings when the programme was set up. Such ratings will have declined since then. It can be assumed that there are significant outstandings to unknown borrowers with, as security, guarantees from banks whose ratings are certainly no better than those of the sovereign in their country of operation, and possibly worse. There is no listing in the EIB Annual Report of the programmes, the guarantor ratings or the outstandings.

Part 1.2.7: Summary of EIB loan portfolio

The EIB's website does not contain a listing of outstanding loans, only of their loan production pipeline. The EIB has continued to supply large loans since the start of the financial crisis, and, in the case of Italy and Spain, to public borrowers who are separate from the sovereign borrower, but at a time when the sovereign was under severe pressure.

This fact raises the question of whether the correlation was considered between the sovereign's difficulties and possible payment problems for other public entities in the same country who draw their revenue from the same well.

Little comfort should be drawn from the contention that 62% of loans are covered by guarantees. The identities of these guarantors are not disclosed, and one fears the common banking lacuna: credit analysis on the borrower is allowed to remain sketchy because of the reliance on third-party guarantees, and the credit analysis on guarantors is sketchy as well. Where guarantors are public sector entities, there would be over-reliance on that factor alone, as there is when the borrower is a public sector entity.

The EIB's loan portfolio has anyway been constructed along the lines of what banking regulators regard as low risk: OECD sovereign and bank exposure. The regulatory frameworks (Basel I, Basel II and Basel III) grant substantial incentives to banks, in the form of reduced capital requirements, for lending to OECD public entities and banks.

The financial crisis has turned this view on its head: OECD banks and public entities have been shown to be a poor risk compared to corporates and even to private citizens, as well as compared to non-OECD banks. It has then to be assumed that EIB's book contains large exposures to sectors that have suffered the worst during the crisis.

Part 1.3: EIB capital adequacy

In this area the reference amount for "purpose-related loans" works out to €364 billion, which embraces loans outside the EU, but which does not reconcile with the "Loans disbursed" figure of €361 billion in the "Key statutory figures" of the 2010 Annual Report.

A range of figures for the EIB's capital adequacy is to be found.

S&P defines the EIB's ratio of equity to risk-bearing assets (loans, equity investments) as 10.9%. This is a figure more or less in line with Basel III targets as widely publicised.

At the same time the EIB states its Basel II ratio to be 27.2%.

There are further figures in S&P's report that distinguish between capital defined as "Narrow risk-bearing capacity" and "Broad risk-bearing capacity", with each definition subject to adjustments to include or exclude this and that asset and liability:

Measure with figures from 2010 Annual Report	Capital coverage
Narrow risk-bearing capacity/total adjusted assets + contingent payments	9.4%
Narrow risk-bearing capacity/purpose-related loans	10.9%
Broad risk-bearing capacity/ total adjusted assets + contingent payments	41.8%
Broad risk-bearing capacity/ purpose-related loans	48.3%

The "risk-bearing capacity" of the EIB can be calculated as follows from figures in the 2010 Annual Report:

Capital element	Amount	Aggregation A+B+C+D	Definition
Paid-in capital – A	€11.6 billion	€11.6 billion	Paid-in capital
Reserves (28.6) less adjustments (0.5) – B	€28.1 billion	€39.7 billion	Narrow risk-bearing capacity
Callable capital from AAA countries – C	€136.7 billion	€164.8 billion	Broad risk-bearing capacity
Callable capital from non-AAA countries – D	€84.2 billion	€260.4 billion	Total capital
Paid-in and callable capital (Total capital less reserves)	€232.3 billion	N/A	Paid-in and callable capital

Purpose-related loans, according to these figures, should then total:

1. 39.7 / 10.9% = €364 billion
2. 176.28 / 48.3% = €364 billion

The EIB's Capital Adequacy is not computed with reference to the total of paid-in and callable capital: then the ratio of that to loans would be 232/364 = 64%.

Instead the "Broad risk-bearing capacity" backs out the callable capital commitments from countries not rated AAA, and that ratio will now have fallen due to further downgrades.

Nor can it be the case that the Basel I methodology is used. Broadly this methodology would make EIB, with €39.7 billion of capital + reserves, significantly overcapitalised according to Basel I, with 20.4% coverage.

The EIB itself, as stated, claims 27.2% Basel II coverage but it is extremely difficult to know if this is realistic, in the absence of a sight of the methodologies for adjusting the face value of the loans by the Credit Conversion Factor or CCF, to define the risk-adjusted value of the loan. The Basel II "Internal Risk-Based Methodologies" permit a bank to apply a CCF to the face value, such that, when the bank allocates the 8-10% capital to account for the risk of loss, it is 8-10% of the "loan face value x CCF" and not "loan face value". CCF should deliver a smaller figure for a good risk; the CCF combines, or should combine, an assessment of the figures of the direct borrower, consideration of guarantees and tangible security, and then the maturity of the loan and its profile.

It is only worthwhile for a bank to adopt a Basel II Internal Risk-Based Methodology, rather than Standard Methodology (which is identical to Basel I) if it believes its lending risks are low and that it can support the loan book with less capital.

A Basel II coverage of 27.2% seems very generous and to infer quite low CCFs that understate the risks in a situation where several principles of banking come into play, that should call for higher – not lower – CCFs:

- Individual loans are large: a complete write-off on Comunidad Autónoma de Castilla-La-Mancha would knock out 2% of capital
- There is a concentration on a narrow borrower group, as well as on countries
- All loans are of the same type, are long-term and none are self-liquidating
- There is no retail business at all

The low amount of paid-in capital and reserves, compared to loans, is therefore only justifiable if the loan portfolio contains very little risk.

The wide range of values available for EIB's capital adequacy is itself an indicator of the uncertainty about the risk within the EIB's loan portfolio.

Lastly the "Broad risk-bearing capacity" has fallen significantly in 2011 due to shareholder downgrades.

The "risk-bearing capacity" capacity of the EIB based on the figures in the 2010 Annual Report but adjusted for shareholder rating changes in the meantime shows a much less healthy picture:

Capital element	Amount/ 2010	Aggregation/ 2010	Amount/ 2011	Aggregation/ 2011	Definition
Paid-in capital	€11.6 bil	€11.6 bil	€11.6 bil	€11.6 bil	Paid-in capital
Reserves (28.6) less adjustments (0.5)	€28.1 bil	€39.7 bil	€28.1 bil	€39.7 bil	Narrow risk-bearing capacity
Callable capital from AAA countries	€136.7 bil	€164.8 bil	€95.9bil	€135.6 bil	Broad risk-bearing capacity
Callable capital from non-AAA countries	€84.2 bil	€260.4 bil	€124.8 bil	€260.4 bil	Total capital
Paid-in and callable capital	€232.3 bil	N/A	€232.3 bil	N/A	Paid-in and callable capital

The amount callable from AAA-rated countries has fallen by €40.8 billion in one year, or by 30%.

The "Broad risk-bearing capacity" has fallen by this same principal amount, or by 23%.

Total capital remains the same.

Working on a loan figure of €364 billion and total assets of €421 billion, one can show the depletion of the "Broad" ratios in 2011 as follows, whereas the "Narrow" ones were static:

Measure with figures from 2010 Annual Report adjusted for ratings changes	Capital coverage/2010	Capital coverage/2011	Change
Narrow risk-bearing capacity/total adjusted assets + contingent payments	9.4%	9.4%	0%
Narrow risk-bearing capacity/purpose-related loans	10.9%	10.9%	0%
Broad risk-bearing capacity/ total adjusted assets + contingent payments	41.8%	32.2%	-9.6%
Broad risk-bearing capacity/ purpose-related loans	48.3%	37.2%	-11.0%

This shows the flip-side of placing such reliance on the quality of the shareholders.

Part 1.3: Correlation between borrowers and guarantors

There is a simple point here. The guarantors of the EIB are the sovereign EU governments. A major portion of the loans is to the public sectors of the same EU Member States.

Whichever level the loan is made to, the source of repayment is the economic prosperity of the geographic area to which the public authority pertains, represented either by taxes and levies, or by usage fees for water supply, motorway tolls, public transport or whatever.

If the EIB's borrower is unable to bring up the funds to repay the loan, what will be the situation of the sovereign in the same country? The reliance, accepted by the rating agencies, on the EU Member State sovereigns as guarantors to pay up extra capital takes little account of this correlation. How likely is it that, if the EIB's borrowers in Spain and Italy cannot repay their direct loans to EIB, that the Spanish and Italian sovereigns will be able to pay up on substantial capital calls from the EIB to fill any shortfall?

The borrower's capacity to pay declines just as the owner is short of money.

The failure to adequately recognize this problem is why the EIB could sign off and fund the eight example projects whilst the sovereigns in the same countries were experiencing multiple downgrades.

Part 1.4: Summary of EIB issues

The EIB has been a primary conduit for money "invested" into the Eurozone periphery countries for development of infrastructure. Given the problems of the sovereign borrowers in the Eurozone periphery countries – and remembering that EIB's loans are rarely to the sovereign but to public sector entities lower down the pecking order – the EIB's loan portfolio cannot be "of the highest quality" (2009 S&P report).

Likewise there is significant exposure to commercial banks in the same countries.

Eligibility criteria for EIB funding appear to place several factors on a par with the borrower's financial status, namely the borrower's identity and ownership, and the compliance of the project with EU policy guidelines, as well as the project's technical feasibility and cost.

Capital and reserves of €39 billion – the "Narrow risk-bearing capacity" - cannot be relied upon to cushion these losses, so a further recourse to shareholders is likely in the form of a call upon subscribed capital.

That recourse is the difference between "Narrow" and "Broad risk-bearing capacity", being the money callable from AAA-rated shareholders. Calls on lesser rated shareholders are discounted because of the doubts over whether they will pay up.

The UK is responsible for €36 billion of the €95.9billion that is callable from AAA-rated shareholders, so it is clear that EIB's well-being and its own AAA-rating depend increasingly upon the well-being and ratings of a very small number of strong countries, principally Germany and the UK.

Added to the €1.9 billion already paid in, the UK's risk on the EIB is €37.6 billion.

Part 2: Structure of and backing for the liabilities of other borrowers than the EIB

The second pillar of this paper is about the several other borrowing and lending actors within the European Union structure, aside from the EIB. The point here is that they replicate to a greater or lesser extent the structure of the EIB in collectivising risk and allocating it to the EU taxpayer.

European Union (http://ec.europa.eu/economy_finance/eu_borrower/)

The top one is the European Union itself. The EU is a legal person which can contract liabilities. The EU enjoys a AAA credit rating from the three major rating agencies, which reflects very strong Member State support.

The EU's AAA/Aaa/AAA ratings are based on the following:

- Borrowings are direct and unconditional obligations of the EU and guaranteed by the 27 Member States.
- Should a beneficiary country default, the debt service will be drawn from the budget of the European Union. EU Member States are legally obliged, according to the EU Treaty, to ensure that the budget always has sufficient funds to meet the EU's obligations. For this purpose the Commission may draw on all Member States. Thus investors are only exposed to the credit risk of the EU, not to that of the beneficiary of loans funded.
- The EU may not borrow to finance a budget deficit.
- "Back-to-back" lending ensures that the EU budget does not assume any interest rate or foreign exchange risk

The **European Commission**, acting on behalf of the European Union (EU), currently operates three programmes under which it may grant loans and fund these by issuing debt instruments in the capital markets:

- **European Financial Stabilisation Mechanism (EFSM):** support to Euro Area Member states, up to €60 billion, activated for Ireland for up to €22.5 billion and for Portugal for up to €26 billion
- **Balance-of-Payments (BoP) assistance:** to Member States that have not yet adopted the euro; up to € 50 billion (€11.4 billion outstanding)
- **Macro-Financial Assistance (MFA):** financial aid programme to assist non-Member States (€592 million outstanding)

- EU borrowing is raised on the capital markets and not from the budget, as the EU is not permitted to borrow to finance its ordinary budgetary expenses;
- The funds raised are in principle lent back-to-back to the beneficiary country, i.e. with the same coupon, maturity and amount. Notwithstanding the back-to-back methodology, the debt service of the bond is the obligation of the European Union, which will ensure that all bond payments are made in a timely manner.
- Total debt outstanding: €43 billion.
- Annual interest and principal obligations range from €1.3 billion in 2012 to a maximum €10 billion in 2021.
- Total borrowing in 2011: €29.2 billion (raised under EFSM: €13.9 billion for Ireland, €14.1 billion for Portugal; raised under BoP: €1.2 billion).
- Borrowing in 2012 so far: €3 billion, raised under EFSM: €1.5 billion for Ireland, €1.5 billion for Portugal.

The really important point, disguised in the wording that the EU's borrowings are "guaranteed by the 27 Member States", is that the guarantee is joint and several. There is no limitation by a percentage. The guarantee is unconditional. If 26 Member States fail, the 27th has to pay everything.

As such, and assuming that:

- the EFSM is fully drawn down to its maximum of €60 billion
- the BoP to its maximum of €50 billion

the Maximum Possible Loss for the UK under the EU's borrowings is €110 billion plus whatever is outstanding at the time under the MFA to non-EU countries (no ceiling is given but current outstandings of €592 million infer this programme is far smaller than EFSM and BoP).

The addition of the EFSM under the risk of the EU was agreed shortly after the 2010 UK General Election, by the Chancellor of the Exchequer, Alistair Darling, that is over the weekend while the Labour Party, despite losing the election, remained the national government and the coalition had not been formed.

European Financial Stabilisation Mechanism (EFSM):

The EFSM has no autonomous borrowings; all its funds are supplied by the EU on a back-to-back basis.

All its borrowings are thus effectively guaranteed by the UK.

European Central Bank/Eurosystem

The Bank of England is a shareholder in the European Central Bank, as are the central banks of all EU Member States: collectively the ECB and the National Central Banks (NCBs) are known as the Eurosystem (aka European System of Central Banks and ESCB).

The European Central Bank was established by a protocol annexed to the Maastricht Treaty in 1992 by agreement of the EU members, with the key objective of maintaining price stability. Owned by the NCBs within the EU, its other tasks involve implementing eurozone-wide monetary policy, taking care of the foreign exchange reserves of the ESCB and maintaining effective operation of payment systems.

Since the increase in capital in December 2010, the ECB has had €10.76 billion of capital, and aggregated reserves (i.e. including the common reserves of the NCBs) of €2.19 trillion. Profits of the ECB are shared amongst the eurozone NCBs according to their Capital Key (based on each EU countries' share in total population and gross domestic product of the EU).

It has proved convenient for the ECB to report its capital and reserves as including currency and bullion reserves that are owned by the National Central Banks and over which it has a questionable claim: €2.19 trillion. Indeed it is curious that a small entity should be allowed to consolidate into its figures certain assets owned by its shareholders, who each own a minority: a form of reverse consolidation not in accordance with Generally Accepted Accounting Principles.

Council Regulation 1010/2000 of 8th May 2000 sets out the rights of the ECB to be provided with "foreign reserve assets" from the member states, with an apparent ceiling of €50 billion. However, this refers only to assets that are not in euro or member states currencies or SDRs. The inference is that there is no limitation on the ECB's right to be provided with assets denominated in euros or the currencies of member states.

This leads on to a question of which entity in the Eurosystem actually carries out the "operations of the ECB". When, for example, the ECB intervenes in secondary

bond markets to support the price of a Member State's bonds, in whose securities custody account do the bonds so purchased reside? Is it the ECB, with its limited resources, or the Bundesbank or the Banque de France?

The ECB itself is small. It does not itself have anywhere near the resources to deal with the current crisis. It has to call upon the NCBs – its owners – to act in its name and, presumably, at its risk.

Liability for losses is shared between the eurozone NCBs:

> "In the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB and, if necessary, following a decision by the Governing Council, against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the national central banks in accordance with Article 32.5."

Furthermore, it is implied that an NCB can be held liable for specific losses as well as ECB-wide losses:

> "The Governing Council may decide that national central banks shall be indemnified against costs incurred in connection with the issue of banknotes or in exceptional circumstances for specific losses arising from monetary policy operations undertaken for the ESCB (Eurosystem) ."

Finally, those NCBs with subscribed but not paid-up capital are liable to have it called in, as happened in December 2010 when the ECB called in €5bn.

The hypothesis regarding bond support operations is that:

- The Governing Council of the ECB has authorized bond market operations to support Member State issuance of bonds under the heading of "monetary policy operations";
- The ECB thereby indemnifies any NCB against the losses it makes on the execution of the policy as the ECB's agent, so the "agent" NCB can transfer its losses to the ECB;
- Those losses are
  - "offset against the general reserve fund of the ECB";
  - if that is not sufficient the shortfall is set "against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the national central banks";

- In other words the “shareholder” NCBs have to pick up the losses originally incurred at any “agent” NCB in accordance with the capital key of the “shareholder” NCB;
- That is achieved by calling up further capital.

It has been widely reported that the ECB owns €40 billion of Greek government bonds. It is unclear whether it owns them directly or as backstop to an NCB holding them as the ECB’s agent. What is clear, however, is that a 70% haircut on the open-market price is €28 billion and that the ECB only has €10.76 billion of subscribed capital, and only half that in paid-in capital.

Nevertheless, the ECB’s current stance on these holdings is that it will be able to book a profit upon completion of the bailout, given that:

- The bailout contains no haircut for public sector creditors
- The ECB bought the bonds at a price below par, and they can be exchanged for new bonds at face value
- The old bonds can then be regarded as having been redeemed in full, crystallising the discount-to-par at the time of purchase as a realised profit.

It is not regarded as an obstacle that the bond issuer has paid no cash towards the redemption, and that, according to S&P, the issuer is in ‘selective default’.

This is a bizarre stance to take when private holders of the old bonds will be taking a 53% haircut. The ECB’s profits can be viewed as having been extracted from the private bond holders and not from the issuer. The new bonds are of dubious value, issued by a country in ‘selective default’, CC-rated, junk status and long-term. A conservative accounting treatment would hold the discount-to-par as a loss provision and only recognise that as a profit when the new bonds had been repaid in full.

This brings us on to the capital structure of the ECB, as shown in the tables on page 44.

The ECB uses the same mechanism as the EIB and the EFSF, to establish a limited liability entity with a difference between subscribed capital and paid-in capital. The difference operates as a guarantee fund that can instantly and unconditionally be called upon (as long as the guarantor is able to pay in).

For the guarantor this supposedly establishes a limitation of the Maximum Possible Loss, but is at odds with the inclusion of the currency and bullion reserves owned by the guarantors into the ECB's own reserves: that fact implies that these reserves can be tapped.

Indeed the inference goes beyond that, and overturns the supposed limitation of liability:

- That the Member States' currency and bullion reserves can be mobilized to support the ECB: assets can be moved down from an NCB to the ECB;
- That the reverse operation is also possible to achieve a similar effect: liabilities of the ECB can be moved up and made the liabilities of the ECB's owners – the Member State central banks;
- In turn the liabilities of the Member State central banks are the unconditional liabilities of the Member States themselves.

Appendix 1 lists the characteristics of the Eurozone NCBs, and shows that, on the face of it, the NCBs' liabilities are not the direct liabilities of the Member State that owns them. On the other hand do we not believe in the UK that deposits in the Bank of England and GBP note&coin issued by the Bank of England carry the same risk as UK gilts, which are the UK government's debts?

The whole concept of sovereign risk – i.e. credit risk-free money – rests on this assumption, that "central bank money" exists in these three forms of government debt, credit balances on accounts at the central bank, and note&coin, and that the three types are fully fungible (instantly interchangeable in every direction at face value).

Nevertheless, on paper the UK's Maximum Possible Loss through its shareholding in the ECB is €1.5 billion of which only €58 million is paid in.

Were the ECB to take a €28 billion "haircut" on Greece, the balance would almost certainly be called in, but there would then be a major discussion about recapitalizing the ECB and who should pay for that. Such a discussion would test the inferences that nationally-owned currency and bullion reserves could be tapped, that Member State NCBs should directly take responsibility for ECB debts, and thereby recourse is created to national exchequers.

Then the only difference between the UK's position through the ECB and the EU would be that the liability would be several but not joint: UK could only be called upon to shoulder 14.5172% of the burden, our capital key.

Shares in the ECB.

Shares: euro area NCBs:

NCB	Capital key %	Paid-up capital (€)
Nationale Bank van België / BanqueNationale de Belgique	2.4256	180,157,051.35
Deutsche Bundesbank	18.9373	1,406,533,694.10
EestiPank	0.1790	13,294,901.14
Central Bank of Ireland	1.1107	82,495,232.91
Bank of Greece	1.9649	145,939,392.39
Banco de España	8.3040	616,764,575.51
Banque de France	14.2212	1,056,253,899.48
Bancad’Italia	12.4966	928,162,354.81
Central Bank of Cyprus	0.1369	10,167,999.81
Banquecentrale du Luxembourg	0.1747	12,975,526.42
Central Bank of Malta	0.0632	4,694,065.65
De Nederlandsche Bank	3.9882	296,216,339.12
OesterreichischeNationalbank	1.9417	144,216,254.37
Banco de Portugal	1.7504	130,007,792.98
Banka Slovenije	0.3288	24,421,025.10
NárodnábankaSlovenska	0.6934	51,501,030.43
SuomenPankki - Finlands Bank	1.2539	93,131,153.81
Total2	69.9705	5,196,932,289.36

Shares: non-euro area NCBs:

NCB	Capital key %	Paid-up capital (€)
Българсканароднабанка (Bulgarian National Bank)	0.8686	3,505,013.50
□eskánárodníbanka	1.4472	5,839,806.06
DanmarksNationalbank	1.4835	5,986,285.44
Latvijas Banka	0.2837	1,144,798.91
Lietuvosbankas	0.4256	1,717,400.12
Magyar Nemzeti Bank	1.3856	5,591,234.99
Narodowy Bank Polski	4.8954	19,754,136.66
BancaNa□ional□ a României	2.4645	9,944,860.44
SverigesRiksbank	2.2582	9,112,389.47
Bank of England	14.5172	58,580,453.65
Total3	30.0295	121,176,379.25

Subscribed vs. Paid up capital in the ECB.

Subscribed vs. paid up capital:

	Subscribed capital 29 December 2010	Paid-up capital 29 December 2010
Nationale Bank van België/ BanqueNationale de Belgique	261,010,384.68	180,157,051.35
Deutsche Bundesbank	2,037,777,027.43	1,406,533,694.10
Central Bank of Ireland	119,518,566.24	82,495,232.91
Bank of Greece	211,436,059.06	145,939,392.39
Banco de España	893,564,575.51	616,764,575.51
Banque de France	1,530,293,899.48	1,056,253,899.48
Bancad'Italia	1,344,715,688.14	928,162,354.81
Central Bank of Cyprus	14,731,333.14	10,167,999.81
Banquecentrale du Luxembourg	18,798,859.75	12,975,526.42
Central Bank of Malta	6,800,732.32	4,694,065.65
De Nederlandsche Bank	429,156,339.12	296,216,339.12
OesterreichischeNationalbank	208,939,587.70	144,216,254.37
Banco de Portugal	188,354,459.65	130,007,792.98
Banka Slovenije	35,381,025.10	24,421,025.10
NárodnábankaSlovenska	74,614,363.76	51,501,030.43
SuomenPankki – Finlands Bank	134,927,820.48	93,131,153.81
Subtotal for euro area NCBs1	7,510,020,721.55	5,183,637,388.22
Българсканароднабанка (Bulgarian National Bank)	93,467,026.77	3,505,013.50
□eskánárodníbanka	155,728,161.57	5,839,806.06
DanmarksNationalbank	159,634,278.39	5,986,285.44
EestiPank	19,261,567.80	722,308.79
Latvijas Banka	30,527,970.87	1,144,798.91
Lietuvosbankas	45,797,336.63	1,717,400.12
Magyar Nemzeti Bank	149,099,599.69	5,591,234.99
Narodowy Bank Polski	526,776,977.72	19,754,136.66
BancaNa□ional□ a României	265,196,278.46	9,944,860.44
SverigesRiksbank	242,997,052.56	9,112,389.47
Bank of England	1,562,145,430.59	58,580,453.65
Subtotal for non-euro area NCBs1	3,250,631,681.03	121,898,688.04
Total1	10,760,652,402.58	5,305,536,076.26

European Financial Stability Facility (EFSF)

The EFSF is a separately-constituted legal person – a societe anonyme under Luxembourg law. The UK is not involved. EFSF has been established by the Eurozone governments to undertake operations on a much larger scale than the EFSM, and using money directly borrowed from capital markets.

The shareholder structure follows the same model as the EIB and the ECB: a large subscribed capital but a low paid-in one. The difference is a guarantee fund, callable instantly and unconditionally, as long as the guarantor can pay:

- €726 billion maximum guarantee commitments as of February 2012
- Maximum lending capacity €440 billion
- 65% "over-guarantee" facility in case some guarantors cannot pay up

In the case of EFSF the guarantors do not include Ireland, Greece and Portugal, who are classified on the "taker" side. But it is interesting to back out from the maximum guarantee commitments the amounts allocated to Member States that are not rated at least AA-.

Analysis of current EFSF shareholders and their commitments in accordance with their contribution keys, and then with shareholders rated BBB+ and below backed out (Source – EFSF investor presentation):

Member State	Rating	Commitment in € billions	Contribution Key in %	AA- and above only
Austria	AA+	22	2.99	22
Belgium	AA	27	3.72	27
Cyprus	BB+	2	0.21	
Estonia	AA-	2	0.27	2
Finland	AAA	14	1.92	14
France	AA+	158	21.83	158
Germany	AAA	211	29.07	211
Italy	BBB+	139	19.18	
Luxembourg	AAA	2	0.27	2
Malta	A-	1	0.10	
Netherlands	AAA	44	6.12	44
Slovakia	A	8	1.06	
Slovenia	A+	4	0.51	
Spain	A	92	12.75	
Total		726	100.00	480

The fact that the exclusion of countries rated below AA- delivers a figure fairly near to the €440 billion maximum lending capacity is a reasonably clear signal that they – Cyprus, Italy, Malta, Slovakia, Slovenia and Spain – are prequalified as "takers" not "givers", and can be expected to "step out" as Ireland, Greece and Portugal have done, resulting in a further readjustment of the Contribution Keys.

The result, for the participating Member States, is a look-though for the EFSF bondholders to the exchequers of the Member States, limited by the Contribution Keys: several but not joint liability, just like the exposure to the ECB but unlike the exposure to the EU.

Summary of Part 2

The UK has a Maximum Possible Loss of €110 billion plus accrued interest and outstandings under the MFA in connection with the borrowings of the European Union. That includes the exposure under the the EFSM, which supposedly has a lifetime of only 3 years, until 2013. That reduction is contingent upon the establishment of a viable successor.

The UK has a Maximum Possible Loss of €1.5 billion because the Bank of England is a shareholder in the European Central Bank, although that limitation could be tested in the circumstances described above.

Aside from the UK's exposure, the two points that jump out that repeat the lessons of EIB are:

- Constant re-use of the technique to expose Member State taxpayers as guarantors to the bondholders, namely to establish a legal person with very low paid-in capital but a high subscribed capital, and have that do the borrowing and on-lending;
- Pig-on-pork: reliance on a contingent liability as guarantor from the same entity, or nexus of entities, that should be paying up on the loan in the first place, without explicit statements that there is one group of "takers" and one group of "givers"

In addition, with the ECB, you have the issue of the small size of the ECB's capital compared to the scale of monetary operations being undertaken by the Eurosystem. If the ECB itself is the principal, or if NCBs are the principal as agent for the ECB, and significant losses are made, they will exceed the ECB's subscribed capital and test the limitations on Member State liability built into the ECB governance model.

Part 3: Interconnection of entities and how they act together as a concert party

The third pillar of this paper is the interconnection of these supposedly independent entities. They appear to act as a concert party without it being clear where the controlling brain lies. Each supposedly has its own executive management and independent governance. However the following facts and actions imply a nexus:

- The European Community is the borrower out of the capital markets for all the funds available through the European Financial Stabilisation Mechanism (EFSM)
- The EIB recently bought up a tranche of a bond issue of €3 billion of the European Financial Stability Facility (EFSF) when it could not be placed with investors
- The EIB supports the European Financial Stability Facility as a service provider for Accounting, Documentation and Infrastructure (i.e. office space)
- The European Central Bank is the EFSF's "agent for primary & secondary bond market purchases"
- The 2010 stabilisation programme for Ireland – in a total amount of €85 billion – was supplied as follows:
  - €17.5 billion from Ireland's own Treasury and Pension Reserve Fund
  - €22.5 billion from the IMF
  - €22.5 billion from the European Financial Stabilisation Mechanism
  - €22.5 billion from the European Financial Stability Facility and from bilateral loans from Denmark, UK and Sweden
- The European Central Bank purchased Italian government bonds in the primary market to support their price and it owns €40 billion of Greek government bonds
- Since this would exceed its own cash resources as the ECB entity, the bonds were actually bought by National Central Banks under the ECB's risk, and any losses can be recouped from the ECB and from its shareholders under their capital key

In this concert party it is opaque which entity is buying and owning bonds of which other entity, and at what risk to itself.

In such a concert party one is looking at a cascade effect where the prima facie risk-bearing entities – meaning those that do the lending and buy the bonds – can actually pass the loans or bonds, the risks on the loans or bonds, or any losses on loans and bonds along the line to the back-stopping entities.

Those back-stopping entities are the ones whose constitutions allow the greatest collectivization of risk. In other words they are the ones through which the access to the EU Member State taxpayers is the most direct, the most unconditional and the widest.

Naturally these are the ones that are the most highly rated by S&P, Moody's and Fitch, and which can borrow at the best rates and in the largest quantity.

These are the European Union, the European Central Bank and the EIB.

The European Financial Stabilisation Mechanism is not a direct borrower from the markets.

The European Financial Stability Facility is a direct borrower from the markets, but since its backing excludes non-Euro countries it is rated lower than the European Community and the EIB.

National Central Banks have recourse only to their own government.

And the main deltas between European Financial Stability Facility and National Central Banks on the one hand, and the European Union, the European Central Bank and the EIB on the other, are:

- Virtually unlimited recourse to the Member States
- UK

Losses out of the European Financial Stability Facility can easily be tracked back into the European Central Bank and the EIB, by having the European Central Bank and the EIB buy bonds and then making them take the haircut in their own figures when they go bad. Losses by National Central Banks on Eurosystem operations can be tracked into the ECB.

That would trigger a transfer of liabilities onto Member States in line with their capital key (ECB) or shareholding (EIB), subject to current ceilings, but subject also to the opaque mechanisms through which these ceilings can be raised. For the

UK this would mean a transfer of indebtedness onto the Exchequer of around €40 billion with the ceilings as they are.

Tracking losses in the European Central Bank and the EIB into the European Union would be more difficult, and represents the nuclear scenario. If losses found their way into the European Union budget, it would create a deficit in that entity for which all Member States are jointly and severally liable.

Nevertheless, there is precedent for that to happen. The establishment of the European Financial Stabilisation Mechanism in May 2010 is an example of how the supposed safeguards can be bypassed by agreement of Member State representatives, not even Presidents or Prime Ministers but Finance Ministers, without a vote either in national parliaments or the European Parliament.

A meeting of the Council of the European Union is allowed to set overall EU policy and resolve outstanding issues. Such a meeting can take place in two ways. Firstly as a summit with the heads of state or government from all 27 Member States present, and that meeting is chaired by the President of the European Commission, currently Mr Barroso.

The Council of the European Union can also meet, legally and validly, by convening the appropriate “topic” ministers from all 27 Member States, and its scope is likewise “to set overall EU policy and resolve outstanding issues” but only within the “topic” scope. The meeting must then be chaired by the President of the European Council.

This is what happened when the finance ministers met in May 2010 and agreed to establish the European Financial Stabilisation Mechanism with risk on the European Union. Alistair Darling as Chancellor of the Exchequer (UK finance minister) was validly empowered to commit the UK to this decision as it was within his and the meeting’s “topic” scope.

In addition to this, not all decisions have to unanimous or, put another way, there is no member state veto. The decision to establish the EFSM was subject to Qualified Majority Voting (QMV).

In other words there is a perfectly valid, legal and binding forum for an individual minister to commit their Member State to a policy in their own topic area without any debate in the national parliaments or the European Parliament. And there is a perfectly valid, legal and binding way for a Qualified Majority of Member States to commit a minority to increased risk.

Summary of Part 3

The various institutions involved are not autonomous and do not have independent governance in any meaningful sense.

There is a clear motivation to track liability back from the frontline institutions that originate risk, to the back-stopping institutions, which are the most highly rated by S&P, Moody's and Fitch, and which can borrow at the best rates and in the largest quantity.

These are the European Union, the European Central Bank and the EIB, whose constitutions permit the greatest collectivization of risk to the EU Member State taxpayers, in the most direct and unconditional manner.

The opportunity to collectivise risk is built both into the institutions' governance and into the forums through which the EU works, where legal, valid and binding means exist to bypass parliamentary scrutiny and opposition.

Overall summary

The UK's Maximum Possible Loss of €149.2 billion out of current commitments is significant, and particularly at this time. As one of two remaining large EU Member States with a AAA-rating the UK plays an important role in back-stopping the EU and the euro.

The smaller figure of €1.6 billion as UK's exposure through the European Central Bank is also questionable because of the scale of the ECB's transactions compared to its own resources, and the opaque path between the risk-originating arm of the European System of Central Banks and the shareholders. It cannot be discounted that the UK might be asked to back the ECB with more than €1.6 billion, especially if the ECB had to take a haircut on bond holdings.

The UK's guarantee for the debt of the European Union is large at €110 billion, but €60 billion of that would be retired if the EFSM is successfully transitioned to a successor facility without the UK's involvement in 2013.

The major area of concern is the EIB. Its capital coverage has depleted over the last year due to the ratings downgrades of other nations, with investors then becoming more reliant on the remaining large AAA-rated shareholders. The UK would shoulder 1/3rd of capital calls from AAA-rated shareholders.

Such a call – up to €35.7 billion – should be considered likely given the EIB's apparent loan underwriting methodology, the destination of their loans, their size and concentration, their maturity, and their weighting towards the public sector.

Far from being a safe haven, loans to the public sector in the Eurozone periphery must be considered at least to be less solid than loans to the sovereign in the same country, and therefore qualifying for an individual rating at least one notch below the sovereign. The table shows the best quality of the loan portfolio if it is set two notches below of the sovereign in each country, with CC being the minimum (Republic of Greece's current rating).

Few EIB borrowers will be directly rated; one hopes that EIB has not simply used the public rating of the sovereign as their credit assessment of each public sector borrower in the respective country. Instead a conservative approach would be to rate the individual loans as having, at best, the following ratings:

Table 3: Maximum S&P long-term rating of loans if the borrower, under "Loans for projects within the Union", is rated at two notches below the sovereign, or in the worst case CC

S&P Rating	Loan Amount	Disbursed	Undisbursed	% of total loans
AAA	-	-	-	-
AA+	-	-	-	-
AA	113,226,759	92,420,416	20,806,343	25.10
AA-	50,822,700	43,464,235	7,358,465	11.27
A+	18,442,371	14,879,069	3,563,302	4.09
A	1,068,217	489,908	578,309	0.24
A-	3,089,494	2,185,805	903,689	0.68
BBB+	93,110,197	81,141,929	11,968,268	20.64
BBB	301,055	145,555	155,500	0.07
BBB-	87,619,158	70,257,561	17,361,597	19.43
BB+	-	-	-	-
BB	-	-	-	-
BB-	20,701,577	13,895,447	6,806,130	4.58
B+	-	-	-	-
B	-	-	-	-
B-	-	-	-	-
CC	17,197,611	13,872,929	3,324,682	3.81
Totals	405,579,139	332,752,854	72,826,285	89.91

On this basis 49% of EIB's loans are rated no higher than BBB+. That changes the balance of risk definitively onto the shareholders, and in turn onto the strongest ones.

Source documents:

Standards & Poors 2011 Analysis of EIB

Standards & Poors press release of 16.1.12 reaffirming its rating of EIB

EIB 2010 Financial Report (issued in Q4 2011)

Eurosystem National Central Banks' public websites

European Central Bank public website and statutes

European Central Bank Annual Report 2010

European Union Investor Presentation December 2010

European Financial Stability Facility Investor Presentation February 2012

Weblinks

http://www.efsf.europa.eu/about/index.htm - the EFSF

http://www.forexlive.com/blog/2012/01/24/imf-wants-ecb-to-take-a-greek-haircut-ft/ - the ECB's holdings of Greek bonds

http://ec.europa.eu/economy_finance/eu_borrower/ - the EU as a borrower

Appendix

The National Central Banks in the Eurozone.

Deutsche Bundesbank:

- Ownership: Federal Institution (established by the Bundesbank Act), owned by the Government, legally autonomous.
- National Finance ministry: Federal Ministry of Finance (Bundesministerium der Finanzen)
- Relationship with finance ministry: Government puts forward President, Vice-president and another board member. Bundesbank partly responsible for regulating corporate banks, holds the state accounts, and carries out securities transactions for the government. Not responsible for maintaining stability of the financial system, not permitted to grant credit to the state.
- Capital and reserve contribution to ECB's aggregated balance sheet : €391.4bn

Banque de France

- Ownership: Government owned, officially independent.
- National Finance ministry: Ministry of Finance
- Relationship with finance ministry: Governor chosen by Government, responsible for maintaining economic stability. This specifically applies to implement the interest rate policy of the ESCB. Not permitted to grant credit to the state, but must provide at least annual reports to the government on its activities.
- Capital and reserve contribution to ECB's aggregated balance sheet : €493.4bn

OesterreichischeNationalbank (Austrian National Bank)

- Ownership: Stock corporation, owned by government.
- National Finance ministry: Austrian Ministry of Finance
- Relationship with finance ministry: Governed by a set of provisions. Charged with safeguarding economy of Austria, and the stability of the Eurozone. Governor chosen by government.
- Capital and reserve contribution to ECB's aggregated balance sheet : €92.6bn

National Bank of Belgium

- Ownership: 50% freely traded stock, 50% Belgian government
- National Finance ministry: Belgian Ministry of Finance
- Relationship with finance ministry: Governor chosen from Governing council of the ECB. Charged with maintenance of Belgian financial sector and the providing of financial services to the government, as well as all the implementation of ECB plans.
- Capital and reserve contribution to ECB's aggregated balance sheet : €58.8bn

Central Bank of Cyprus

- Ownership: Government owned, autonomous.
- National Finance ministry: Cyprus Ministry of Finance
- Relationship with finance ministry: Governor appointed by President. Maintains stability of the economy of Cyprus, supervises corporate banks. Implements ECB policy decisions. Prepares monthly balance sheets for Government.
- Capital and reserve contribution to ECB's aggregated balance sheet : €14.0bn

Bank of Estonia

- Ownership: Government owned, legally autonomous.
- National Finance ministry: Estonian Ministry of Finance
- Relationship with finance ministry: Governor and Chairman chosen by government. Charged with maintenance of Estonian economy, manages government reserves. Implements ECB policy decisions.
- Capital and reserve contribution to ECB's aggregated balance sheet : €2.2bn

Bank of Finland

- Ownership: Owned by Republic of Finland
- National Finance ministry: Finland Ministry of Finance
- Relationship with finance ministry: Governing board chosen by Government. Responsible for maintaining price stability, both within the Eurozone and Finland. Implements ECB policy decisions.
- Capital and reserve contribution to ECB's aggregated balance sheet : €25.1bn

Bank of Greece

- Ownership: 35% State owned, 65% Athens stock exchange
- National Finance ministry: Greek Ministry of Finance
- Relationship with finance ministry: Governor chosen by government. Primarily responsible for economic stability, both within Greece and as part of the ESCB in the Eurozone as a whole. The bank is accountable to the Greek parliament, and supports the financial policies of the Greek government.
- Capital and reserve contribution to ECB's aggregated balance sheet : €45.6bn

Central Bank of Ireland

- Ownership: Government owned (central bank reform act 2010), semi-autonomous.
- National Finance ministry: Irish Department of Finance
- Relationship with finance ministry: Governor chosen by Irish President. Legally mandated to maintain financial stability in Ireland, and also to implement policies of the ECB. The bank also conducts the role of Financial Regulator within Ireland.
- Capital and reserve contribution to ECB's aggregated balance sheet : €130.9bn

Bank of Italy

- Ownership: Government owned, autonomous
- National Finance ministry: Italian Ministry of Economy and Finance
- Relationship with finance ministry: Governor chosen by Italian President. Operates within framework of Italian law and provisions. Responsible for maintenance of financial stability in Italy as well as policies of ECB.
- Capital and reserve contribution to ECB's aggregated balance sheet : €382.2bn

Central Bank of Luxembourg

- Ownership: State of Luxembourg, but guaranteed autonomy.
- National Finance ministry: Luxembourg Ministry of Finance.
- Relationship with finance ministry: Government chooses Governor. Responsible for contributing towards ESCB's missions.
- Capital and reserve contribution to ECB's aggregated balance sheet : €51.8bn

Central Bank of Malta

- Ownership: Government owned, autonomous.
- National Finance ministry: Ministry of Finance of the Government of Malta.
- Relationship with finance ministry: Governor appointed by President. Responsible for maintaining price stability, regulation of commercial banks and implementing ECB policies.

Capital and reserve contribution to ECB's aggregated balance sheet : €10.2bn

De Nederlandsche Bank

- Ownership: Public limited company
- National Finance ministry: Dutch Ministry of Finance
- Relationship with finance ministry: Governing board appointed by government. Responsible for maintaining price stability, regulation of commercial banks and implementing ECB policies.
- Capital and reserve contribution to ECB's aggregated balance sheet : €102.5bn

Banco de Portugal

- Ownership: Government owned, autonomous
- National Finance ministry: Ministry of Finance and Public Administration.
- Relationship with finance ministry: Governing board appointed by government. Responsible for maintaining price stability, regulation of commercial banks and implementing ECB policies.
- Capital and reserve contribution to ECB's aggregated balance sheet : €43.8bn

National Bank of Slovakia

- Ownership: Government owned, autonomous
- National Finance ministry: Ministry of Finance of the Slovak Republic
- Relationship with finance ministry: Governing board appointed by government. Responsible for maintaining price stability, regulation of commercial banks and implementing ECB policies.
- Capital and reserve contribution to ECB's aggregated balance sheet : €7.3bn

Bank of Slovenia

- Ownership: Government owned, autonomous
- National Finance ministry: Slovenian Ministry of Finance.
- Relationship with finance ministry: Governing board appointed by government. Responsible for maintaining price stability, regulation of commercial banks and implementing ECB policies. Obliged to present periodical reports to the government.
- Capital and reserve contribution to ECB's aggregated balance sheet : €4.6bn

Banco de Espana

- Ownership: Government owned, autonomous
- National Finance ministry: Ministry of Economy and Finance
- Relationship with finance ministry: Governing board appointed by government. Responsible for maintaining price stability, regulation of commercial banks and Financial institutions, and implementing ECB policies. Obliged to present periodical reports to the government. Also, the providing of treasury services and financial agent for government debt.
- Capital and reserve contribution to ECB's aggregated balance sheet : €334.0bn

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The Bruges Group is an independent all–party think tank. Set up in February 1989, its aim was to promote the idea of a less centralised European structure than that emerging in Brussels. Its inspiration was Margaret Thatcher's Bruges speech in September 1988, in which she remarked that "We have not successfully rolled back the frontiers of the state in Britain, only to see them re–imposed at a European level…". The Bruges Group has had a major effect on public opinion and forged links with Members of Parliament as well as with similarly minded groups in other countries. The Bruges Group spearheads the intellectual battle against the notion of "ever–closer Union" in Europe. Through its ground–breaking publications and wide–ranging discussions it will continue its fight against further integration and, above all, against British involvement in a single European state.

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