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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL AND THE COURT OF AUDITORS

ON THE MANAGEMENT OF THE GUARANTEE FUND OF THE EUROPEAN FUND FOR STRATEGIC INVESTMENTS IN 2016

{SWD(2017) 235 final}

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1. INTRODUCTION

The legal basis for this report is Regulation (EU) 2015/1017 of the European Parliament and of the Council of 25 June 2015 on the European Fund for Strategic Investments, the European Investment Advisory Hub and the European Investment Project Portal and amending Regulations (EU) No 1291/2013 and (EU) No 1316/2013 — the European Fund for Strategic Investments[1] (the "EFSI Regulation"). The agreement on the management of the EFSI and on the granting of the EU guarantee (the "EFSI Agreement") was signed by the European Commission and the European Investment Bank (the "EIB") on 22 July 2015. An amendment to this Agreement was signed on 21 July 2016.

Article 16(6) of the EFSI Regulation provides that the Commission shall, by 31 May of each year[2], submit to the European Parliament, to the Council and to the Court of Auditors an annual report on the management of the EFSI Guarantee Fund (the "EFSI GF") in the previous calendar year, including an assessment of the adequacy of the target amount and the level of the EFSI GF and of the need for its replenishment. This annual report shall contain the presentation of the financial position of the EFSI GF at the end of the previous calendar year, the financial flows during the previous calendar year as well as the significant transactions and any relevant information on the financial accounts. The report shall also include information about the financial management, the performance and the risk of the EFSI GF at the end of the previous calendar year.

In 2016, an internal evaluation of the EFSI was carried out by of the Commission, which accompanied the legislative proposal[3] adopted by the Commission on 14 September 2016 ("EFSI 2.0 proposal") to increase the size of the EFSI and adjust the target rate based on findings from the internal evaluation.

2. OPERATIONAL CONTEXT

The EU Guarantee covers (up to EUR 16 billion) financing and investment operations signed by the EIB under the Infrastructure and Innovation Window ("IIW") and by the EIF under the SME Window ("SMEW"). Part of the overall EFSI operations is covered by the EU Guarantee while a part is carried out at the own risk of the EIB Group (at least EUR 5 billion).

According to Article 12 of the EFSI Regulation, the EFSI GF shall constitute a liquidity cushion from which the EIB shall be paid in the event of a call on the EU guarantee. In accordance with the EFSI Agreement between the EU and the EIB, calls are paid by the EFSI GF if their amount is in excess of the funds at the disposal of the EIB on the EFSI Account. The EFSI Account, managed by the EIB, has been established for the purposes of collecting the EU revenues resulting from EFSI operations under the EU guarantee and recovered amounts and to the extent of the available balance, for the payment of calls under the EU guarantee.

1 OJ L 169, 1.7.2015, p. 1.

2 This report is the second report on the EFSI GF. For last year report, see COM (2016) 353 final of 31.5.2016.

3 COM(2016) 597 final and accompanying SWD(2016) 297 and 298 final.

The EFSI GF is provisioned progressively taking into account the increase in exposure borne by the EU Guarantee.

According to Article 12(4), the resources of the EFSI GF are directly managed by the Commission and invested in accordance with the principle of sound financial management following appropriate prudential rules.

The EIB and the EIF are responsible for assessing and monitoring the risk of the individual operations and reported back to the Commission and the European Court of Auditors in line with Article 16(3) of the EFSI Regulation in March 2017. On the basis of this reporting and of coherent and prudent assumptions on future activity, the Commission maintains the adequacy of the target amount and the level of the EFSI GF under review.

Pursuant to Article 16(2) of the EFSI Regulation, the annual report of the EIB to the European Parliament and Council shall contain specific information on the aggregate risk associated with the financing and investment operations carried out under the EFSI as well on guarantee calls.

3. FINANCIAL ACCOUNTS

Financial information concerning EFSI is presented, below broken down in three sections; (1) the financial situation of the EFSI GF as at 31 December 2016 (2) the EFSI operations under the EU guarantee carried out by the EIB Group as at 31 December 2016 and (3) the financial flows and significant budgetary transactions in 2016.

3.1. FINANCIAL STATEMENTS OF THE EFSI GF[4] AS AT 31 DECEMBER 2016

The net assets of the Guarantee Fund stood at EUR 1,020 million as at 31 December 2016. The assets were composed of the investment portfolio, classified as available-for-sale (EUR 948 million), short term bank deposits (EUR 45 million) and cash and cash equivalents (EUR 26 million).

In terms of the 2016 statement of financial performance, the EFSI GF ended the year with an economic result of EUR 0.9 million. EUR 1.2 million was generated from interest income and realised gains from sales of fixed income securities. This was offset by operating expenses of EUR 0.3 million including the underlying FX forward sale of USD used to hedge the currency risk of the USD-denominated portion of the portfolio.

3.2. EFSI OPERATIONS UNDER THE EU GUARANTEE

The guarantee exposure of the EU in relation to disbursed outstanding EFSI operations by the EIB Group amounted to EUR 4,392 million, as at 31 December 2016, out of the legal commitment of EUR 16 billion guaranteed by the EU (Article 11 of the EFSI Regulation). The amount of EUR 4,392 million is recorded as a contingent liability in the notes to the 2016 financial statements of the EU.

In 2016, EFSI operations managed by the EIB under the Infrastructure and Innovation

[4] The audited financial statements of the EFSI Guarantee Fund are disclosed in the 2016 SWD EFSIGF report.

Window generated revenue of EUR 16.1 million for the EU. Of this amount, a receivable of EUR 11 million was recorded in the 2016 EU financial statements and was credited to the EFSI account in January 2017. Such amounts are subsequently recovered as assigned revenue to the EFSI GF.

For the EFSI operations managed by the EIF under the SME Window, the EU incurred in 2016 an amount of EUR 0.945 million concerning EIF administrative fees. The amount is payable to the EIF on 30 June 2017. In addition, a SMEW start-up fee of EUR 5 million was paid to the EIF from a dedicated budget line in 2016.

3.3. Financial flows and significant budgetary transactions in 2016

A budgetary appropriation of EUR 2,100 million was committed in 2016 relating to the provisioning of the EFSI GF in compliance with Commission Decision C(2016)311[5] for the financing of the Fund.

A total amount of EUR ca. 1,018 million was effectively paid into the EFSI GF during the year. Of this, the bulk came from payment appropriations of the general budget of the EU, while an amount of EUR 6.3 million was recovered from the EFSI Account (as assigned revenue).

4. Management of the EFSI GF in 2016

4.1. Financial Management

The Fund's liquid assets are invested in accordance with the management principles laid down in Commission Decision C(2016)165 of 21 January 2016 approving the asset management guidelines of the guarantee fund of the European Fund for Strategic Investments.

These guidelines foresee that the managed assets shall provide sufficient liquidity in relation to the potential guarantee calls, while still aiming at optimising the return and risk level that is compatible with maintaining a high degree of security and stability.

Investment and risk management strategies were adopted reflecting the investment objectives and outlook of market conditions. The investment approach aimed at enhanced diversification across various fixed income asset classes.

4.2. Market developments in 2016

In 2016 the European fixed income market was characterised by elevated market volatility. Sovereign bond yields continued to decline till September, as a result of the low nominal growth and the accommodative monetary policy. The market reactions to the UK referendum, held on 23 June 2016, on the membership of the European Union and to the US presidential elections in November 2016 were also major milestones in 2016.

During the building phase of the EFSI GF portfolio, April – December 2016, there was a pronounced twist in the European benchmark yield curve around the 7 years maturity point. In

5 Commission Decision C(2016)311 of 27 January 2016 on the adoption of DG ECFIN's annual work programme 2016, including procurement and grants, in the field of economic and financial affairs, serving as a financing decision.

particular, the short and medium term rates decreased by a range of 15 to 35 basis points (1 basis point = 0.01%) , increasing the levels of the bond prices (prices are inversely related to the interest rates). On the other hand, long-term rates increased by 10 basis points, thus changing the slope of the yield curve, which rose to its steepest levels in more than a year. Importantly, interest rates at certain key maturity points fluctuated significantly during this period[6].

In particular, there was high market volatility in the first half of the year, as the market sentiment was driven by the economic slowdown in China, some weak spots in the US recovery and declining commodities' prices, fuelling recessionary concerns, as well by the changes in the modalities of the ECB Extended Asset Purchase Programme (EAPP). The so-called core and semi-core benchmark yields (DE, FR, NL, etc.) were negative across maturities up to ~7years (depending on the jurisdiction). At the end of the second quarter, the UK referendum led to a sudden but short-lived rise in volatility followed by an important decrease in yields. The yield for 10-year German government bonds, for the first time, edged down below zero.

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

In the last quarter of 2016, the bond market turned due to heightened political risks. There was a spike in volatility and an overall increase of medium to longer term benchmark interest rates; in particular the benchmark German 10-year yield turned positive again. In contrast, short-term rates remained anchored at deeply negative rates. Besides uncertainty among market participants concerning the monetary policy stance of major central banks, the main driver was the policy to be followed by the newly elected US president.

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

4.3. MAJOR EXTERNAL[7] CASH FLOWS

An amount of EUR 500 million in payment appropriations was initially made available to the Fund for 2016. This amount was paid in to the EFSI GF gradually between April and July 2016.

During December 2016, an additional EUR 518 million was paid into the Fund, the bulk of which represented payment appropriations reallocated from other budget lines as part of the global transfer procedure.

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6 Example: the 10-year Bund yielded about 10 bps at the beginning of April. This dropped to a low of about -19 bps in early July, to finish the year at about + 20 bps.

7 'External' is defined by reference to the Fund. External cash flows include flows from/to the EU budget or from/to the EIB for guarantee revenues or guarantee calls but exclude cash flows 'endogenous' to the asset management activity (e.g. payments/receipts to/from counterparties for acquiring/selling securities).

There were no guarantee calls or any other outflows from the Fund in 2016.

It is presently foreseen in the EU budget that around EUR 2.3 billion will be paid into the EFSI GF during the course of 2017 bringing its total assets to an expected level of EUR 3.3 billion.

4.4. Composition and key risk characteristics of the portfolio

At the end of December 2016, the portfolio was made predominantly of securities issued by Sovereigns (42% of EFSI GF Market Value) as well as by Sub-sovereigns, supranationals and agencies (SSA) (23%). The remainder was mainly allocated to covered bonds and unsecured bonds issued by corporates and financial institutions. About 15% of the portfolio (included in the 42% allocation to sovereigns) was invested in liquid and highly-rated (AAA) USD denominated investments. The currency risk exposure of these investments has been hedged.

The portfolio duration[8] at the end of 2016 was 3.5 years. Average credit rating is A.

The bulk of the portfolio is invested in liquid securities and an adequate part (23% of the total portfolio value) matures in less than 12 months.

The profile of the portfolio, in terms of duration, credit risk and liquidity, has been calibrated in line with the forecasted cash-flows arising from the EFSI operations under the EU guarantee (e.g. projected calls, revenues).

4.5. Performance

As the first inflows into the EFSI GF arrived on 11 April 2016, the year-to-date (YTD) performance refers to the period April-December 2016 and it is calculated on a time-weighted basis in order not to be affected by the size of the portfolio, which grew considerably during the year.

The Fund delivered a YTD absolute performance of 0.23% in 2016. This slightly positive return was achieved against a background of volatile markets and deeply negative rates, especially for what is perceived by the markets as "credit risk free" and liquid exposures.[9]

5. Assessment of the adequacy of the target amount and the level of the EFSI GF

As of end-2016, total cumulated signatures under EFSI amounted to EUR 21.3 billion covering 28 Member States, of which EUR 14.2 billion was signed[10] by the EIB (121 operations) and EUR 7.1 was signed by the EIF (225 operations). Overall, this represents a significant increase compared to 2015, at the end of which total signatures amounted to EUR 1.2 billion.

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[8] Duration figures refer to 'modified duration' which measures the price sensitivity of a bond to interest rate movements. This figure is based on the concept that a security price and interest rates are inversely related.

[9] For example, the average yield of German 5 year bonds was – 46 basis points (ranging from – 29 to – 63 bps).

[10] The difference between total signatures and signed exposure depends on several factors, such as the latter excluding EIB share in equity-type operations as well as differences due to repayments and applied foreign exchange rates.

As of end-2016, the overall outstanding disbursed exposure covered by the EU Guarantee amounted to nearly EUR 4.4 billion up from EUR 0.2 billion in 2015. The exposure of the EU budget to possible future payments under the EU Guarantee in terms of signed operations (disbursed and undisbursed) amounted to EUR 11.2 billion.

Under the IIW the outstanding disbursed exposure covered by the EU Guarantee was EUR 4.02 billion, of which EUR 3.98 billion for debt operations and EUR 0.04 billion for equity-type operations[11].

Should there be any losses due to these operations, these will be covered by the EU Guarantee in accordance with the terms set out in the EFSI Agreement. In particular, the EU Guarantee under the IIW is granted in the form of a Portfolio First Loss Piece coverage for EIB debt operations and in the form of a full guarantee for equity/equity-type operations where the EIB invests at its own risk on a pari passu basis the same amount of resources.

As of end 2016 under SMEW, the total outstanding exposure covered by the EU Guarantee was 369.7 million, of which EUR 364.8 million for guarantee operations and EUR 5.0 million for equity operations[12].

Should there be any losses due to these operations, those would be covered primarily by the contributions of the InnovFin SME Guarantee Facility, the COSME Loan Guarantee Facility, and the EaSI Guarantee Financial Instrument. In the case of the SMEW Equity Product, any losses would be covered by the EU guarantee under the EFSI and the InnovFin Equity First Loss Piece (in the case of Sub-window 2).

The target amount of the EFSI GF is set at 50% of the total EU guarantee obligations, which currently stand at EUR 16 billion. This target was calculated before the start of EFSI. The Commission's internal evaluation of EFSI[13] concluded that the provisioning of the Guarantee Fund could be safely lowered.

The risk assessment of the different products supported by the EU Guarantee shows that overall the Union budget would be adequately shielded from potential calls under the EU Guarantee with an adjusted target rate for provisioning the EFSI GF of 35% (as proposed by the Commission in the EFSI 2.0 proposal), taking into consideration recoveries, revenues and reflows from EIB operations. The Court of Auditors has confirmed this assessment[14].

11 As at end 2016, the total signed (disbursed and undisbursed) exposure of the IIW portfolio benefitting from the EU Guarantee was EUR 13.38 billion of which EUR 12.84 billion for debt operations and EUR 0.54 billion for equity-type operations. However, due to the first loss piece coverage of the EU Guarantee, potential losses for the EU budget under the IIW were capped at EUR 10.6 billion.

12 As evidenced in the financial statements of the EU for end-2016, not including guarantee contracts whose availability period starts in 2017, amounts committed and undisbursed for guarantee operations under COSME, and those committed and undisbursed for equity operations. Including all the latter categories would imply a total outstanding (disbursed and undisbursed) exposure to be potentially covered by the EU Guarantee of EUR 701.3 million.

13 SWD(2016) 297 final.

14 Opinion No 2/2016 concerning the proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) Nos 1316/2013 and 2015/1017 and the accompanying Commission evaluation in accordance with Article 18(2) of Regulation (EU) 2015/1017.