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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 2019

{SWD(2020) 162 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 EFSI Regulation was amended by Regulation (EU) 2017/2396 of the European Parliament and Council of 13 December 2017 as regards the extension of the duration of the European Fund for Strategic Investments as well as the introduction of technical enhancements for that Fund and the European Investment Advisory Hub[2] (the "EFSI 2.0 Amendment"). The EFSI 2.0 Amendment increased, *inter alia*, the size of the EU Guarantee and adjusted the target amount. 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 and was amended and restated on 21 July 2016, 21 November 2017, 9 March 2018, 20 December 2018, 27 March 2020 and 27 April 2020.

Article 16(6) of the EFSI Regulation provides that the Commission shall, by 31 May of each year, submit to the European Parliament, to the Council and to the Court of Auditors an annual report[3] 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.

2. OPERATIONAL CONTEXT

The EU Guarantee[4] covers financing and investment operations signed by the EIB under the main part of the Infrastructure and Innovation Window ("IIW"), and by the EIF under the SME Window ("SMEW") and the SME / MidCap fund investment sub-window of IIW. 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[5].

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 and recovered amounts resulting from EFSI operations under the EU Guarantee 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 OJ L 345, 27.12.2017, p. 34.
3 This report is the fifth report on the EFSI GF. For previous reports, see COM(2016)353 final, COM(2017)326 final, COM(2018)345 final and COM(2019)244 final.
4 The size of the EU Guarantee has been increased from EUR 16 billion to EUR 26 billion by the EFSI 2.0 Amendment.
5 The size of EIB Group Guarantee has been increased from EUR 5 billion to EUR 7.5 billion by the EFSI 2.0 Amendment.

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

According to Article 12(4) of the EFSI Regulation, 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 backed by the EU Guarantee. On the basis of this reporting and of coherent and prudent assumptions on future activity, the Commission ensures the adequacy of the target amount and the level of the EFSI GF under review. In line with Article 16(3) of the EFSI Regulation, the EIB and the EIF reported back to the Commission and the European Court of Auditors in March 2019.

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 as on the guarantee calls.

3. FINANCIAL ACCOUNTS AND SIGNIFICANT BUDGETARY TRANSACTIONS IN 2019

Financial information concerning EFSI is presented below, broken down in four sections: (1) the financial situation of the EFSI GF as at 31 December 2019, (2) the EFSI operations under the EU Guarantee carried out by the EIB Group as at 31 December 2019, (3) the provisioning of the EFSI GF and (4) the calls and use of the EU Guarantee.

3.1. FINANCIAL STATEMENTS OF THE EFSI GF AS AT 31 DECEMBER 2019

The total assets of the EFSI GF[6] stood at EUR 6 688 million as at 31 December 2019. The assets comprised the investment securities portfolio, classified as available-for-sale (EUR 6 654 million), an FX forward sale of USD with positive net present value, classified as financial assets at fair value through surplus and deficit (EUR 3 million), and cash and cash equivalents (EUR 31 million).

In terms of the 2019 statement of financial performance[7], the EFSI GF ended the year with an economic result of EUR 21.7 million. The main contribution came from a postive net interest revenue of EUR 18.3 million and net gains from sales of available-for-sale securities[8] (EUR 17.1 million). This was offset by a negative foreign exchange revaluation result of EUR -13.1 million[9]. The remaining net expense of EUR -0.6 mainly consisted of custodian fees.

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 17.7 billion, as at 31 December 2019, out of the net available

6 The audited financial statements of the EFSI Guarantee Fund are disclosed in the staff working document accompanying the EFSI GF report.
7 See page 6 of the staff working document accompanying the EFSI GF report.
8 The net figure is composed of gains of EUR 18.5 million and losses of EUR 1.4 million.
9 After hedging the currency risk of the USD-denominated portion of the portfolio.

legal commitment[10] of EUR 25.8 billion of EU guarantee. The amount of EUR 17.6 billion is recorded as a contingent liability in the notes to the 2019 financial statements of the EU, while a provision has been recognised for the remaining amount of 0.1 billion (74 million).

In 2019, EFSI operations managed by the EIB under the Infrastructure and Innovation Window generated a net revenue of EUR 299.5 million for the EU[11]. Of this amount, a net receivable of the Commission from the EIB as at 31 December 2019 of EUR 50.8 million was recorded in the 2019 EU financial statements.

For the EFSI operations under the SME Window, the EU incurred cost of EUR 109.9 million in 2019[12]. Out of this, EIF fees and costs of EUR 37.9 million recorded in the 2019 EU financial statements are payable to the EIF after 31 December 2019.

3.3. Provisioning of the EFSI GF

A total budgetary appropriation of EUR 357 million was committed in 2019 relating to the provisioning of the EFSI GF. Of this amount, a budgetary appropriation of EUR 167 million was committed through Commission Decision C(2019) 875[13]. Additional commitment appropriations for an amount of EUR 190 million were committed as assigned revenue.

A total amount of EUR 1 166 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 163 million was recovered as assigned revenue (EUR 136 million from EFSI revenues and EUR 27 million from Connecting Europe Facility revenues) and an amount of EUR 3 million was transferred as additional payment appropriations at the end of the budgetary year.

3.4. Calls and use of the EU Guarantee

In 2019, in accordance with Article 8.1(a) of the EFSI Agreement, the EU Guarantee was called for an amount of EUR 3.5 million related to one defaulted equity-type operation under the Infrastructure and Innovation Window. In addition, an amount of EUR 1.4 million was called for EIB funding costs[14], EUR 27.3 million for value adjustments[15] and EUR 0.14 for recovery costs[16]. Under the SME Window, there was one call for an amount of EUR 8.1 million for non-euro hedging.

All calls have been paid from funds available on the EFSI Account. There were no calls paid from the EFSI GF.

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10 According to Article 11 of the EFSI 2.0 Amendment, the EU Guarantee shall not, at any time, exceed EUR 26 billion and not exceed EUR 16 billion before 6 July 2018. Calls and uses of the EU Guarantee, and provisions for portfolio guarantee products under SME Window, are deducted from the maximum amount of the EU Guarantee.

11 This amount includes EUR 135.0 million of unrealized revenue derived from upward movement of the IIW equity portfolios' fair value at 31 December 2019 compared to 31 December 2018.

12 This amount includes EUR 69.5 million of financial provisions in respect of the SMEW debt portfolios, as well as EUR 4.3 million of unrealized expenses derived from downward movement of the SMEW equity portfolios' fair value at 31 December 2019 compared to 31 December 2018.

13 Commission Decision of 11.02.2019 on the adoption of the annual work programme for 2019 for the Directorate General for Economic and Financial Affairs, serving as a financing decision.

14 See Article 8.1(d) of the EFSI Agreement.

15 See Article 8.1(b) of the EFSI Agreement.

16 See Articles 8.1(d) and 11.7 of the EFSI Agreement.

4. MANAGEMENT OF THE EFSI GF IN 2019

4.1. FINANCIAL MANAGEMENT

The EFSI GF's investment portfolio is 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 EFSI GF.

These guidelines foresee that the assets in the investment portfolio 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 2019

Fixed income markets saw noticeable fluctuations in 2019, with the 10-year German bond (bund) moving between 0.27% (in January) and -0.72% (in August) for a range of about 1%.

The year began with markets expecting an improving economy and rising inflation. The European Central Bank (ECB) was projected to start hiking interest rates, while the Federal Reserve was expected to continue its hiking cycle. The protracted trade deal negotiations between the US and China, however, triggered a lot of uncertainty with episodes of rapid and unexpected tariffs increases from both sides and no viable solution on the horizon. Uncertainty in Europe remained elevated as well, due to threats of tariffs imposed by the US on major industries, most notably the car industry. Consequently, global supply chains suffered, hurting the manufacturing sector and capital expenditures started being postponed.

All of this pushed demand for safe assets higher and bonds across all asset classes performed well while yields moved steadily lower until they bottomed out in August. By that time global growth has slowed down and inflation in Europe was hovering just above 1%. To support the economy, the Federal Reserve had started cutting interest rates in July and the ECB followed suit in September, together with a revival of their asset purchase program.

Another positive development was the overall resilience of the services sector across major economies. Towards the end of the year, it appeared very likely there would be a partial trade deal between the US and China. Market sentiment improved and coupled with lower liquidity and some year-end rebalancing/profit taking, yields rebounded and the bund closed at around -0.20%.

Overall, spreads of other European Government Bonds (EGBs) to the bund tightened, in the cases of Italy and Spain, by up to 110 basis points at the 10-year maturity point. Other fixed income sectors such as supranational, sub-sovereign and agencies debt together with covered and corporates bonds also performed well during the year.

4.3. COMPOSITION AND KEY RISK CHARACTERISTICS OF THE PORTFOLIO

On 31 December 2019, the investment portfolio was made predominantly of securities issued by Sovereigns, Sub-sovereigns, supranationals and agencies (SSA) and foreign governments (47% of market value against 59% for the benchmark) and covered bonds (18% of market value against 20% for the benchmark). The remainder was mainly allocated to unsecured bonds issued by corporates and financial institutions. About 6% of the portfolio was invested in liquid and highly-rated (AA/AAA) USD denominated investments. The currency risk exposure of these investments has been hedged. At the end of 2019, the exposure of the portfolio to bonds complying with environmental, social and governance criteria was above 6%, 5 times higher when compared to its benchmark.

The portfolio duration[17] at the end of 2019 was 3.07 years. Average credit rating is BBB+.

The bulk of the portfolio is invested in liquid securities and an adequate part (21% 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).

4.4. PERFORMANCE

The annual performance is calculated on a time-weighted basis in order not to be affected by the size of the portfolio, which continued to grow significantly during the year.

In a very challenging market environnement characterised by overall negative or historically low yields coupled with significant market volatility and uncertainties, the Fund delivered a annual absolute performance of 1.239 % in 2019. This return is in line with the annual performance of the EFSI benchmark (2.302 %).

5. ASSESSMENT OF THE ADEQUACY OF THE TARGET AMOUNT AND THE LEVEL OF THE EFSI GF

As of 31 December 2019, total cumulated signatures under EFSI amounted to EUR 68.7 billion covering 28 Member States, of which EUR 49.2 billion was signed under the IIW (532 operations) and EUR 19.5 billion was signed under the SMEW (630 operations). Overall, this represents a significant increase compared to 2018, at the end of which total signatures amounted to EUR 53.6 billion.

As of 31 December 2019, the overall outstanding disbursed exposure covered by the EU Guarantee amounted to EUR 17.7 billion (16.1 billion for IIW and 1.6 billion for SMEW) up from EUR 15.8 billion in 2018.

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 21.9 billion (18.3 billion for IIW and for 3.6 billion for SMEW).

Under the IIW, the outstanding disbursed exposure covered by the EU Guarantee was EUR 16.1 billion, of which EUR 15.2 billion for debt-type operations and EUR 1 billion for equity-type operations[18].

Should there be any losses due to these IIW operations, those will be covered by the EU Guarantee in accordance with the terms set out in the EFSI Agreement. In particular, the EU

[17] The duration figure refers 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.

[18] Due to rounding of the two figures for debt-type and equity-type operations, they add up to 16.1 bn instead of 16.2 bn

Guarantee under the IIW is granted in the form of a Portfolio First Loss Piece coverage for operations under the IIW Debt Portfolios and IIW NPB Equity Portfolio. Under the IIW Standard Equity Portfolio, the EU Guarantee is in the form of a full guarantee provided that the EIB invests at its own risk on a pari passu basis the same amount of resources.

As of 31 December 2019, under SMEW, the total outstanding disbursed exposure covered by the EU Guarantee was EUR 1.6 billion, of which EUR 1.2 billion for guarantee operations and EUR 0.4 billion for equity operations[19].

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

The target amount of the EFSI GF has been set at 35% of the total EU Guarantee obligations[20]. 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 this target rate, taking into consideration recoveries, revenues and reflows from EIB operations. Therefore, the target rate of 35% is considered adequate.

The EFSI GF is in the building-up phase until 2022 thus the need for replenishment will be assessed in a later stage.

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[19] As evidenced in the financial statements of the EU as at 31 December 2019, not including guarantee contracts whose availability period starts in 2020.

[20] See Article 12(5) of the EFSI Regulation.