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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 2017

{SWD(2018) 268 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"). At the end of 2017, the EFSI Regulation was amended by Regulation (EU) 2017/2396 of the European Parliament and Council of 13 December 2017 amending Regulations (EU) No 1316/2013 and (EU) 2015/1017 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 has, *inter alia*, increased the size of the EU Guarantee and adjusted the target rate. 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. The first amendment and restatement of the EFSI Agreement was signed on 21 July 2016. The second amendment and restatement of the EFSI Agreement was signed on 21 November 2017. The third amendment and restatement of the EFSI Agreement was signed on 9 March 2018.

Article 16(6) of the EFSI Regulation provides that the Commission shall, by 31 May of each year[3], 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.

2. OPERATIONAL CONTEXT

The EU Guarantee[4] covers 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[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

1 OJ L 169, 1.7.2015, p. 1.
2 OJ L 345, 27.12.2017, p. 34.
3 This report is the third report on the EFSI GF. For last year report, see COM (2017) 326 final of 16.6.2017.
4 The size of the EU Guarantee has been increased from EUR 16,000 million to EUR 26,000 million by the EFSI 2.0 Amendment.
5 The size of EIB Group guarantee has been increased from EUR 5,000 million to EUR 7,500 million by the EFSI 2.0 Amendment.

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.

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 backed by the EFSI Guarantee. 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. 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 2018.

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 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 2017, (2) the EFSI operations under the EU guarantee carried out by the EIB Group as at 31 December 2017 and (3) the financial flows and significant budgetary transactions in 2017.

3.1. FINANCIAL STATEMENTS OF THE EFSI GF[6] AS AT 31 DECEMBER 2017

The net assets of the Guarantee Fund stood at EUR 3,504 million as at 31 December 2017. The assets were composed of the investment portfolio, classified as available-for-sale (EUR 3,414 million), an FX forward sale of USD with positive net present value, classified as financial assets at fair value through surplus and deficit (EUR 6 million), short term bank deposits (EUR 40 million) and cash and cash equivalents (EUR 44 million).

In terms of the 2017 statement of financial performance, the EFSI GF ended the year with an economic result of EUR 2.4 million. EUR 10.6 million was generated from interest income, realised gains from sales of fixed income securities, and bond lending income. This was offset by operating and financial expenses of EUR 8.2 million, including the net foreign exchange result of the FX operations used to hedge the currency risk of the USD-denominated portion of the portfolio and its FX revaluation.

[6] The non-audited financial statements of the EFSI Guarantee Fund are disclosed in the staff working document accompanying the EFSI GF report.

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 10,128 million, as at 31 December 2017, out of the legal commitment[7] of EUR 16,000 million guaranteed by the EU. The amount of EUR 10,128 million is recorded as a contingent liability in the notes to the 2017 financial statements of the EU.

In 2017, EFSI operations managed by the EIB under the Infrastructure and Innovation Window generated revenue of EUR 61.0 million for the EU. Of this amount, a receivable of the Commission from the EIB as at 31 December 2017 of EUR 31.9 million was recorded in the 2017 EU financial statements.

For the EFSI operations managed by the EIF under the SME Window, the EU incurred in 2017 an estimated amount of EUR 12.7 million in the form of EIF administrative fees. The amount is payable to the EIF on 30 June 2018.

3.3. FINANCIAL FLOWS AND SIGNIFICANT BUDGETARY TRANSACTIONS IN 2017

A budgetary appropriation of EUR 2,641 million was committed in 2017 relating to the provisioning of the EFSI GF in compliance with Commission Decision C(2017)706[8] for the financing of the Fund.

A total amount of EUR 2,490 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 39.2 million was recovered from the EFSI Account (as assigned revenue) and an amount of EUR 0.4 million was transferred as additional appropriation at the end of the budgetary year.

4. MANAGEMENT OF THE EFSI GF IN 2017

4.1. FINANCIAL MANAGEMENT

The Fund'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 guarantee fund of the European Fund for Strategic Investments.

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.

7 According to the article 11 of the EFSI 2.0 Amendment, the EU guarantee shall not, at any time, exceed EUR 26,000 million and not exceed EUR 16,000 million before 6 July 2018.

8 Commission Decision C(2017)706 of 12 February 2017 on the adoption of DG ECFIN's annual work programme 2017, including procurement and grants, in the field of economic and financial affairs, serving as a financing decision.

4.2. MARKET DEVELOPMENTS IN 2017

The main market themes during 2017 included the improving global growth outlook, some bouts of political risk and changing assessments regarding the expected timing and speed of the "normalisation" of monetary policy in advanced economies.

Prospects for higher and more synchronised growth across the globe were increasingly validated by data releases, in the euro-area in particular, surprising on the upside.

At the same time, global inflation pressures remained overall relatively subdued, allowing major central banks to maintain an overall accommodative stance. In the US, however, the improving growth outlook allowed the Federal Reserve Bank (Fed) to pursue its plan of gradually withdrawing the accommodation. In the euro area, the European Central Bank (ECB) has also been signalling a path of gradual normalisation.

The markets kept a close eye on monetary policy announcements and related data releases trying to second-guess the time and pace of normalisation.

The euro exchange rate appreciated strongly, reflecting the better domestic growth prospects, expectations of an eventual normalisation of the ECB's monetary policy stance and a shift in investor appetite in favour of euro-denominated assets.

The European fixed income market was characterised by market volatility with Sovereign bond yields fluctuating sharply, especially around the time of the French presidential elections. After that, political risk perceptions subsided overall and Sovereign bond spreads of European bonds (relative to German bonds) generally declined from their peaks. Longer-term inflation expectations embedded in bond yields were rangebound over the period. As a result, the yield of the benchmark 10-year German bund fluctuated in a range between 0.16% reached before the French presidential elections and 0.60% to end the year at 0.43 %.

Longer United States bond yields initially increased until March but then took a declining trend until September 2017. The downward movement reflected mixed data releases and reservations in the markets about the United States administration's ability to push through growth-friendly reforms. Market-based inflation expectations in the United States remained contained, partly as a response to low actual inflation data. The market sentiment reversed in September and United States bond yields rose, partly on account of better than expected macroeconomic news and progress of passing tax reforms supporting expectaions of higher government borrowing and a potential pick-up in inflation. Beyond the intra-year fluctuation, 10-year United States Treasury yields finished the year at the same level they started it (around 2.40%). However, shorter term yields moved upwards during the year as the Fed lifted interest rates by 25 basis points[9] (bp) three times during the year in March, June and December pushing up the targeted range for the Fed Funds rate to 1.25%-1.5%.

[9] One basis point is equal to 0.01%.

4.3. MAJOR EXTERNAL[10] CASH FLOWS

An amount of EUR 2,490 million in payment appropriations was made available to the Fund for 2017. This amount was paid in to the EFSI GF gradually from April to December 2017.

There were no guarantee calls from the Fund in 2017. A total amount of EUR 0.4 million was paid to EIB for funding costs[11].

It is presently foreseen in the EU budget that around EUR 1,800 million will be paid into the EFSI GF during the course of 2018 bringing its total assets to an expected level of EUR 5,308 million.

4.4. COMPOSITION AND KEY RISK CHARACTERISTICS OF THE PORTFOLIO

At the end of December 2017, the investment portfolio was made predominantly of securities issued by Sovereigns (42.5% of market value) as well as by Sub-sovereigns, supranationals and agencies (SSA) (21.5% of market value) and covered bonds (25.5% of market value). The remainder was mainly allocated to unsecured bonds issued by corporates and financial institutions. About 18% 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.

The portfolio duration[12] at the end of 2017 was 3.47 years. Average credit rating is A-.

The bulk of the portfolio is invested in liquid securities and an adequate part (16% 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

The year-to-date (YTD) performance 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 zero percent in 2017. This zero return was achieved against a background of negative rates (especially for what is perceived by the markets as "credit risk free" and liquid exposures in Europe[13]) and rising interest rates in the United States[14].

[10] '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).

[11] See Art 8.1(d) of second amendment and restatement of the EFSI Agreement.

[12] 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.

[13] For example, the average yield of German 5 year bonds was – 34 basis points during 2017.

[14] For example 2-year US treasury yields increased by 69 basis points during the year. While increasing yields offer better reinvestment opportunities over time, they lead to an intial negative revaluation effect.

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

At the end of 2017, total cumulated signatures under EFSI amounted to EUR 37.4 billion covering 28 Member States, of which EUR 27.4 billion was signed[15] by the EIB (278 operations) and EUR 10.0 billion was signed by the EIF (328 operations). Overall, this represents a significant increase compared to 2016, at the end of which total signatures amounted to EUR 21.3 billion.

At the end of 2017, the overall outstanding disbursed exposure covered by the EU Guarantee amounted to nearly EUR 10.1 billion up from EUR 4.4 billion in 2016.

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 13.5 billion.

Under the IIW the outstanding disbursed exposure covered by the EU Guarantee was EUR 9.57 billion, of which EUR 9.36 billion for debt operations and EUR 0.21 billion for equity-type operations[16].

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 2017 under SMEW, the total outstanding exposure covered by the EU Guarantee was EUR 0.539 billion, of which EUR 0.491 billion for guarantee operations and EUR 0,048 billion for equity operations[17].

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, Cultural and Creative Sectors 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 was originally set by the EFSI Regulation at 50% of the total EU guarantee obligations. As of the entry into force of the EFSI 2.0 Amendment this

[15] 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.

[16] As at end 2017, the total signed (disbursed and undisbursed) exposure of the IIW portfolio benefitting from the EU Guarantee was EUR 25.2 billion of which EUR 23.57 billion for debt operations and EUR 1.63 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 12.13 billion.

[17] As evidenced in the financial statements of the EU for end-2017, not including guarantee contracts whose availability period starts in 2018, 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 1.34 billion.

target is set at 35% of the total EU guarantee obligations[18].

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 the target rate for provisioning the EFSI GF of 35%, taking into consideration recoveries, revenues and reflows from EIB operations.

[18] See Article 12(5) of the EFSI Regulation, as amended by the EFSI 2.0 Amendment.