



Council of the  
European Union

015426/EU XXVI. GP  
Eingelangt am 19/03/18

Brussels, 19 March 2018  
(OR. en)

7283/18

ECOFIN 260  
RECH 110  
FIN 238  
COMPET 167  
ENER 103

#### COVER NOTE

---

From: Secretary-General of the European Commission,  
signed by Mr Jordi AYET PUIGARNAU, Director

date of receipt: 2 March 2018

To: Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of  
the European Union

---

No. Cion doc.: COM(2018) 84 final

---

Subject: REPORT FROM THE COMMISSION TO THE COUNCIL on the five yearly  
review of the multiannual financial guidelines for managing the assets of  
the ECSC in liquidation and, on completion of the liquidation, the Assets of  
the Research Fund for Coal and Steel

---

Delegations will find attached document COM(2018) 84 final.

---

Encl.: COM(2018) 84 final



Brussels, 2.3.2018  
COM(2018) 84 final

**REPORT FROM THE COMMISSION TO THE COUNCIL**

**on the five yearly review of the multiannual financial guidelines for managing the assets  
of the ECSC in liquidation and, on completion of the liquidation, the Assets of the  
Research Fund for Coal and Steel**

## Introduction

Following the expiry of the ECSC Treaty in 2002, the Member States decided to transfer the assets and liabilities to the European Community (now EU) but keep them apart from the General Budget (Protocol<sup>1</sup> on the financial consequences of the expiry of the ECSC Treaty annexed to the Nice Treaty). The Commission is responsible for the orderly liquidation of the liabilities and to invest the existing assets on the capital markets to generate revenues for the financing of research in the sectors of coal and steel through the Research Fund for Coal and Steel (RFCS). After the end of the liquidation process (to last until 2027), these assets will be known as the “Assets of the Research Fund for Coal and Steel”.

On 1 February 2003<sup>2</sup> the Council adopted three Decisions necessary for the implementation of the Protocol, i.e. a general decision (2003/76/EC)<sup>3</sup> and decisions laying down guidelines for the asset management (2003/77/EC)<sup>4</sup> and for the RFCS research programme (2003/78/EC, replaced by 2008/376/EC)<sup>5</sup>.

In accordance with Article 2 of Council Decision 2003/77/EC, the Commission shall reassess the operation and effectiveness of the financial guidelines for the asset management of the ECSC in liquidation (the "Financial Guidelines")<sup>6</sup>, every five years and shall propose amendments if appropriate. The last assessment was reported upon in 2012 and no amendments proposed. A subsequent five-year report is now due.

## Review of the Financial Guidelines for the five-year period 2012 – 2017

According to Council Decision 2003/77/EC, as amended by Council Decision 2008/750/EC<sup>7</sup>, the Commission shall manage the assets of the ECSC in liquidation in order to "ensure that funds are available as and when needed, while still generating the highest return available, consistent with maintaining a high degree of security and stability over the long-term" (*point 3 of the Annex to Council Decision 2003/77/EC*).

In view of these objectives, the financial guidelines have worked well initially during the 5-year period 2012-2017. However, due to the protracted low-interest rate environment, they now appear to be too restrictive to provide an efficient basis for a prudent asset management approach<sup>8</sup> which delivers satisfactory returns. Against this background, it appears appropriate

---

<sup>1</sup> Protocol n° 37 to the Treaty on the functioning of the European Union, on the financial consequences of the expiry of the ECSC Treaty and on the Research Fund for Coal and Steel.

<sup>2</sup> OJ L29, 05.02.2003, p. 22.

<sup>3</sup> Council Decision 2003/76/EC of 1.2.2003 establishing the measures necessary for the implementation of the Protocol, annexed to the Treaty establishing the European Community, on the financial consequences of the expiry of the ECSC Treaty and the Research Fund for Coal and Steel (OJ L 29 p. 22).

<sup>4</sup> Council Decision 2003/77/EC of 1.2.2003 laying down multiannual financial guidelines for managing the assets of the ECSC in liquidation and, on completion of the liquidation, the Assets of the Research Fund for Coal and Steel (OJ L 29, p. 25), amended by Council Decision 2008/750/EC of 15.9.2008 (OJ L 255, p. 28).

<sup>5</sup> Council Decision 2003/78/EC of 1.2.2003 laying down the multiannual technical guidelines for the research programme of the Research Fund for Coal and Steel (OJ L 29, p. 25), replaced by Council Decision 2008/376/EC of 29.4.2008 (OJ L 130, p.7).

<sup>6</sup> Also referred to as Asset Management Guidelines or "AMGs" in short.

<sup>7</sup> OJ L255, 23.9.2008, p. 28.

<sup>8</sup> Note that the asset management activity is supervised by a dedicated risk management function, which monitors the adherence to the internal risk management framework of the Commission. In addition, risk and

to enlarge the eligible investment universe in order to allow diversification of the portfolio. Based on historical data, this could increase expected returns over a long-term horizon, even though it cannot be guaranteed that this will improve observed returns in particular over short to medium-term periods.

Looking at market conditions, these have been very challenging since 2012 as a low-yield environment has prevailed in the euro bond markets, primarily due to low economic growth and low inflation. The ECB's accommodative monetary policy, and in particular its bond purchase programmes which started in 2015, has further supported this trend. Consequently, yields have now reached historically low and even negative levels. Political uncertainty also impacted financial markets and led to various episodes of turmoil and volatility. Recent examples are the Greek crisis and UK referendum on EU membership.

Against this background, the results since the last review in 2012 were positive: amounts were disbursed as and when requested by DG RTD and, furthermore, the return of the portfolio has been satisfactory given the market environment and conservative investment guidelines. More specifically, during the period from 01 July 2012 to 31 December 2016, the portfolio provided a cumulative return of +8.3%. More details can be found in annual ECSC reports as well as in Annex to the Report, where the portfolio's composition as of December 2016 is also presented (see also Annex I to this report).<sup>9</sup>

The size of the portfolio decreased slightly during this 5 year period as the total return and new contributions received did not compensate for the cumulative outflows of EUR 216.4 million<sup>10</sup> paid to DG RTD and used to fund research in sectors related to the coal and steel industry<sup>11</sup>. Overall, the total market value of the portfolio as at 31 December 2016 stood at EUR 1.69 billion compared to EUR 1.74 billion as of 30 June 2012, a decrease of about 2.8%.

Despite the relatively good performance of the ECSC portfolio compared to relevant benchmarks, the revenues assigned to the funding of research projects for Coal and Steel have been decreasing over recent years. This is due principally to the low-interest rate environment. This has significantly driven down yields and adversely affected the revenues from the portfolio which could be made available for the Research Fund for Coal and Steel.

## **Reasons to change and proposals regarding the Financial Guidelines**

### Background

As of the end of 2016, the performance of the portfolio since the adoption of Council Decision 2003/77/EC has been satisfactory given the conservative investment guidelines. However, over the last years, market conditions have changed substantially. Looking ahead,

---

asset management systems and procedures are subject to regular audits by both internal and external auditors, as well as by the European Court of Auditors. No material issues have been raised relating to the management of the funds.

<sup>9</sup> The latest report is the "FINANCIAL REPORT of the European Coal and Steel Community in Liquidation (ECSC i.L.) at 31 December 2016", (C(2017)5870).

<sup>10</sup> Amounts made available to DG RTD are based on accounting figures subject to a "smoothing" mechanism which implies that in periods of lower yields/lower coupons, outflows may exceed the portfolio's returns.

<sup>11</sup> As foreseen in Council Decision 2003/77/EC.

the financial markets in general and the euro bond markets in particular have become even more challenging, due to strongly negative yields (in particular for securities from issuers with the highest credit quality), high probability of materialization of interest rate risk<sup>12</sup> and markedly reduced liquidity (especially in terms of bonds available for purchase) – entailing increased probabilities of very low or even negative returns going forward.

As of now, the two key working assumptions are that (1) the ECSC portfolio has a long-term investment horizon and (2) it is relatively free of material liabilities and hence is not subject to major outflows. On this basis, it is proposed to enlarge the universe of potential investments permitted by the financial guidelines in order to mitigate the impact from low or negative yields as much as possible and enhance the diversification and resilience of the portfolio. Several proposals are set out below. These enlarged investment possibilities must be implemented in ways that are consistent with the capital preservation over a long term horizon and stability objectives of the mandate while enhancing the portfolio's expected returns.

The proposals for a modification of the Financial Guidelines would broaden the eligible investment universe of available assets/instruments and possible combinations of risk exposures (e.g. interest and credit risk or even some diversified forms of equity market risk). New investment opportunities would allow the portfolio to be managed more efficiently (in terms of diversification and the risk-return trade-off) and with higher expected returns over the long-term.

It should be understood that over the short- to medium-term, these proposals could, depending on market conditions, increase the portfolio's volatility and may also entail negative performances for limited periods faced with unusual or unexpected market conditions.

In general, asset management involves an investment risk which cannot be fully eliminated, and returns on the investments may be positive or negative. During periods of very low interest rates and probable rate rises over the coming years, the only way to improve expected returns is to accept higher risk/higher volatility. Due to the intrinsic nature of investments, changing market conditions and interest rate environment, even safe and liquid assets may entail negative returns<sup>13</sup>.

### Current Financial Guidelines

The current Financial Guidelines follow a relatively conservative approach. This is reflected for example in strict absolute limit amounts (e.g. maximum EUR 250 million per EU Member State), high credit ratings (e.g. minimum credit rating of AA, except for EU Member States and EU Institutions) and restrictions on maximum maturity (e.g. maximum 10.5 years remaining at purchase).

---

<sup>12</sup> Given the very low-yield environment, the risk of rising interest rates is expected to remain high in the foreseeable future. For example, if central banks start normalizing monetary policy aggressively in case of rising inflation, the market value of fixed income securities will decrease.

<sup>13</sup> As the time of writing this report, the interest rate on German 2-year bond for instance is almost **minus** 0.75% p.a. (while the 10-year German bond only offers about +0.4% interest rate p.a.).

Current restrictions exclude investment by the ECSC portfolio in a wide range of financial assets. For example:

- the rating restrictions exclude almost the entire corporate and financial bond markets. Exposure to the latter could offer diversification and higher returns, which could be helpful to mitigate the impact of negative short-term rates<sup>14</sup> in the current environment;
- similar arguments can be made in respect of limits on maturity. These prevent investment in longer-dated bonds which could deliver similar benefits<sup>15</sup>. Modifying these restrictions would allow diversified asset allocations with higher expected returns for the portfolio, while keeping overall portfolio risk at similar levels as currently thanks to negative correlation effects;
- a number of asset classes and risk-management techniques are also excluded by the current investment guidelines.

Therefore, we recommend changing the current guidelines in order to allow the expansion of the set of investment possibilities through broadening the investment limits including new asset classes that are expected to allow the ECSC portfolio to earn higher risk-adjusted returns over the long-term. Those amendments would be compatible with the requirements laid down in Art 2(1) of Council Decision [2003/76/EC](#).

### Proposed changes to the Financial Guidelines

#### *A. Adjust the absolute limits, ratings and maturity restrictions*

It is proposed to adopt a more dynamic approach as regards the technical aspects of implementation that need some flexibility (such as determining risk, maturity and concentration limits).

This would allow calibrating them more regularly and closely to evolving market conditions. It would build on the recent guidelines adopted for the guarantee fund of the European Fund for Strategic Investments<sup>16</sup>, one of the other major portfolios managed by the Commission.

Risk tolerance could also be defined in broader terms (e.g. by listing the eligible asset categories as such). Limits could be better expressed in terms of market rather than notional value and defined as maximum percentage exposures of the total portfolio market value. This defines exposures more precisely, as due to the low or negative yield environment many securities are priced significantly above par (100%) and the nominals might no longer reflect the true economic value of such exposures. Another reason why a market value, percentage based limit approach has become more relevant is in case the total portfolio market value changes, either due to market valuation or caused by in- or outflows.

---

<sup>14</sup> Please also refer to point D below for a more sophisticated way to manage interest rate risk/duration

<sup>15</sup> Another benefit of longer-term bonds is higher convexity; in simple terms, their market values gain more for a given reduction in rates compared to the induced losses for an equivalent increase in rates.

<sup>16</sup> Commission Decision [C\(2016\)165](#).

### *B. Allow investments in other currencies*

Currently, the Financial Guidelines are silent on the eligibility of foreign currency investments. In this context it should be noted that euro denominated investments represent only c. 25% of the world bond market.

It is therefore proposed to explicitly allow investments in currencies from other major economies and/or other EU Member States in order to enhance diversification.

In particular, investing (partially) in US dollar denominated securities would allow access to large and liquid markets, such as the US government debt market. This could be helpful given the above-mentioned liquidity constraints in the euro bond markets. In addition, the US markets are not characterised by negative rates, and would allow to obtain different yield curve exposures, with possibly higher carry/roll down opportunities<sup>17</sup>.

The risk of losses due to the fluctuation of the foreign exchange rate could be hedged. Instruments exist to hedge such currency risk, but the current Financial Guidelines are silent on this type of operation. Should foreign currencies become explicitly eligible, it is proposed to also explicitly allow derivatives to hedge the foreign-currency risk of non-euro denominated exposures. The actual use of such instruments would of course involve a careful consideration of the relevant costs and prevailing market conditions<sup>18</sup>.

### *C. Broaden the scope of collective investment vehicles*

In 2014, an evaluation of DG ECFIN's treasury and asset management activities was carried out by a team of specialists from the World Bank. The World Bank reviewed in detail the processes used by ECFIN-L, and concluded that DG ECFIN achieves its objectives in the management of the portfolios under its responsibility, in compliance with sound industry standards. The World Bank also proposed a few recommendations to further improve the investment process and returns.

In particular, for funds with long-term horizons, the World Bank advocated investing a certain percentage of such funds into equity holdings, possibly via collective investment funds. These instruments, if selected carefully, will allow the portfolio to gain well-diversified equity exposure. As equities have a relatively lower correlation to fixed income investments, they would enhance the risk-return profile of the portfolio over a long-term horizon. On the other hand, allocations to equities may increase the volatility of the portfolio returns in short- to medium-term. The use of diversified equity exposure through funds (or ETFs) will mitigate these risks.

Collective investment vehicles are already mentioned in the current guidelines, but are associated with a credit rating requirement of not less than AA which *de facto* implies mostly short-term fixed-income collective vehicles only, excluding the majority of the fixed-income and equity funds that have no credit rating.

---

<sup>17</sup> "Carry": in simple terms, the carry is the income an investor is entitled to as a result of simply holding a security/portfolio (i.e. accrued interests/coupons), regardless of market value changes and/or curve movements; "roll-down": typically yield curves are upward sloping, hence as the remaining maturity of a bond shortens, else equal, investors require a lower yield – which is beneficial to a bond's price, as prices move inversely to yields.

<sup>18</sup> Note that the Commission services have acquired experience with such operations which have been allowed in the guidelines of the asset management of the EFSI Guarantee Fund.

It is therefore proposed to clarify the scope of eligible asset classes and collective investment vehicles in order to allow equity as well as broaden fixed-income investments, including in such well-diversified vehicles.

In summary, it is proposed to make all types of collective investment vehicles eligible (e.g. Money Market Funds, Exchange Traded Funds or Mutual funds). These can to various degrees offer diversified exposure to broad market indices, certain geographic sectors and/or particular asset classes such as fixed income and/or equities.

#### *D. Allow other hedging instruments to manage interest rate risk*

In the context of a peer review carried out by the World Bank, one observation was that instruments such as interest rate swaps and/or bond futures are currently not allowed. However, those instruments represent tools to efficiently manage interest rate risk and are frequently used nowadays by public financial institutions. Typically these markets are also liquid. For example, during the financial crisis, the futures' market remained highly liquid in contrast to the cash government bonds' market. The use of such instruments would be framed with robust risk procedures and IT systems in order to monitor and cope with the related operational workflows and intrinsic risk of this market. Use of these instruments would also require the development of capacity and infrastructure to service margin calls and track/account for changes in the value of these instruments.

## **Conclusion**

Over the reviewed period 2012 – 2017, the portfolio met its objectives of providing funds as and when required, maintaining a high degree of security and stability and achieving a satisfactory cumulative positive return compared to relevant benchmarks.

However, since some time, the financial markets in general and the euro bond markets in particular have become more challenging, notably due to the negative interest rates and reduced liquidity.

In order to enhance diversification, resilience and long-term expected returns of the portfolio, the Commission believes that the investment guidelines should be expanded in line with the conclusions set out in this report. This would allow the portfolio to sustain its capacity to deliver higher risk-adjusted returns.

In this context, the Commission will submit a proposal for a Council Decision to amend Decision 2003/77/EC laying down multi-annual financial guidelines for managing the assets of the ECSC in liquidation.