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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Comprehensive Report to the European Parliament and the Council on the use of the European Fund for Strategic Investments (EFSI) EU guarantee and the functioning of the European Fund for Strategic Investments (EFSI) guarantee fund

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1. Introduction

In 2014 the Commission announced the Investment Plan for Europe, a new initiative that was established in 2015 to support investment in Europe after the financial and economic crisis.

The European Fund for Strategic Investments (EFSI) was set up, together with the European Investment Advisory Hub and the European Investment Project Portal, under Regulation (EU) No 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 Project Investment Portal and amending Regulations (EU) No 1291/2013 and (EU) No 1316/2013 – the European Fund for Strategic Investments[1] (the EFSI Regulation), with the aim of kick-starting investments in the Union through the mobilisation of private finance.

The agreement on the management of the EFSI and on the granting of the EU Guarantee (the EFSI Agreement) was signed by the 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.

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 Regulation). The EFSI 2.0 Regulation has, *inter alia*, increased the size of the EU Guarantee and adjusted the provisioning target rate. A third amendment and restatement of the EFSI Agreement was signed on 9 March 2018 to reflect the EFSI 2.0 Regulation.

Article 18(3)(b) of the EFSI Regulation provides that the Commission shall, by 30 June 2018 and every three years thereafter publish a comprehensive report on the use of the EU Guarantee and the functioning of the Guarantee Fund.

Additional detailed information on the implementation of the EFSI can be found in the Staff Working Document[3] accompanying the Commission proposal for a Regulation of the European Parliament and of the Council on establishing an InvestEU Fund for the period 2021-2027, presenting the results of an independent external evaluation of the application of the EFSI Regulation.

1. OJ L 169, 1.7.2015, p. 1–38
2. OJ L 345, 27.12.2017, p. 34.
3 Placeholder reference

The cut-off date for all figures in this report is 31 December 2017.

2. The EU Guarantee

The Union provides an irrevocable and unconditional guarantee to the EIB for financing and investment operations under the EFSI. The EU Guarantee is the cornerstone of the EFSI. By providing higher risk bearing to the EIB, the EU Guarantee allows for an increase in the volume of higher risk projects supported by EIB financing and investment operations under the Infrastructure and Innovation Window (IIW) and, as a result, helps addressing market failures and sub-optimal investment situations. The EU Guarantee also allows for a greater volume of lending and a larger number of companies to be covered under the SME Window by the European Investment Fund (EIF) and thereby facilitates access to finance[4] for SMEs and small mid-cap companies.

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. The initial endowment of the EU Guarantee was of EUR 16 billion from the Union budget, complemented by an allocation of EUR 5 billion of EIB's own resources. These amounts were increased to EUR 26 billion and EUR 7.5 billion, respectively, by the EFSI 2.0 Regulation.

The EU Guarantee 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). The initial repartition between the two windows was of up to a maximum of EUR 13.5 billion for the IIW and up to a maximum of EUR 2.5 billion for the SMEW. Given the particularly strong response to the SMEW, the EFSI Steering Board, composed of members representing the Commission and the EIB, decided to use the flexibility provided in the Regulation[5] to reinforce the latter through the reassignment of EUR 500 million from the IIW to the SMEW in July 2016. The EFSI 2.0 Regulation further increased the share of the SMEW, setting a limit of EUR 6.5 billion that can be adjusted by the Steering Board up to a maximum of EUR 9 billion[6].

The nature of the EU Guarantee is revolving within the lifespan of EFSI, in that the available cover under the EU Guarantee may be made available to new operations following the amortisation of existing ones, provided that the EU Guarantee never exceeds EUR 26 billion as of 6 July 2018 (or EUR 16 billion prior to that) and that aggregate net payments from the general budget of the Union under the EU Guarantee do not exceed EUR 26 billion as of 6 July 2018 (or EUR 16 billion prior to that).

[4] Article 3 of the Regulation
[5] Article 11(1) and (3) of the Regulation
[6] Article 11(3) of Regulation, as amended

Table 1 - The split of the EU Guarantee and its development over time

(in billion EUR)	**EFSI 1.0**	**EFSI 1.0 adjustment**	**EFSI 2.0**
IIW	13.5	13.0	19.5
SME	2.5	3.0	6.5
Total EU Guarantee	**16.0**	**16.0**	**26.0**
EIB risk bearing capacity	5.0	5.0	7.5
Total EFSI	**21.0**	**21.0**	**33.5**

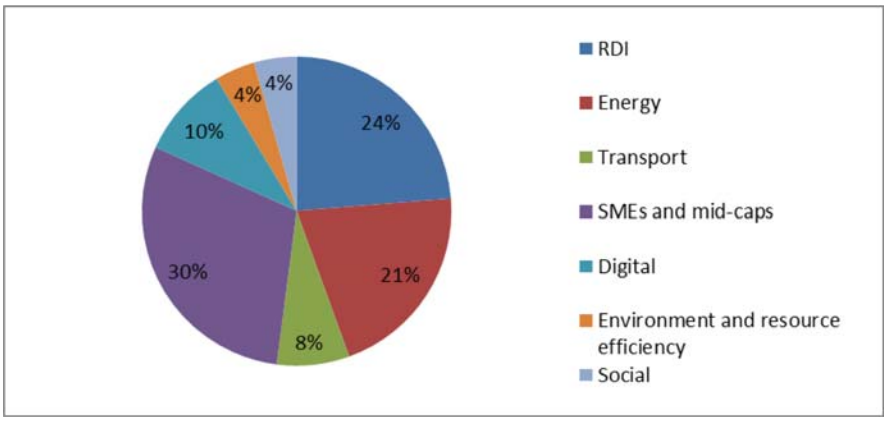
Source: Commission services

3. The use of the EU Guarantee

The present section reviews the use of the EU Guarantee under the different activities supported by the EFSI. The EU Guarantee covers different products under the two windows (IIW and SMEW).

As of end-2017, the EIB group (EIB and EIF) had signed 606 operations under EFSI for a total financing of EUR 37.4 billion. These operations are expected to mobilise invesments of EUR 207.3 billion in all 28 EU Member States and across all objectives set out in the EFSI Regulation (see Figure 1).

Figure 1: EFSI investment mobilised for signed operations under IIW and SMEW (by sector as of 31 December 2017)



Source: EIB

At the end of 2017, 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, whereas the overall outstanding disbursed exposure covered by the EU Guarantee amounted to nearly EUR 10.1 billion.

No guarantee calls on the Union budget due to defaulting operations were made during the period covered by this report. The EU Guarantee was only used to cover EIB funding costs, which were paid out of revenues from IIW operations.

3.1. Infrastructure and Innovation Window (IIW)

Under the IIW, the allocation of EIB operations to the debt or equity portfolio is based on the EIB's system of loan grading and the EIB's standard risk assessment. Under the IIW, the EU Guarantee amounting to EUR 13 billion is broken down as follows:

I. up to EUR 10.5 billion for debt-type operations.
II. up to EUR 2.5 billion for equity-type operations.

As of 31 December 2017, under the IIW, the EIB had signed 278 operations for a total financing of EUR 27.4 billion, which are expected to mobilise invesments of EUR 131.4 billion in 27 EU Member States.

3.1.1. IIW Debt Portfolio

The IIW Debt Portfolio includes all signed and not cancelled debt-type operations. For each debt-type operation, the EIB conducts its standard risk assessment, involving the computation of the probability of default and the recovery rate, without taking into account the EU Guarantee (in order to reflect the overall risk of the transaction[7]). The operations supported by the EU Guarantee typically have a higher risk profile than EIB normal operations and hence fall within the scope of *special activities*[8]. Less risky transactions may be incorporated into the EFSI portfolio, provided that a high added-value is clearly demonstrated and their inclusion is consistent with the criterion of providing additionality.

Under the IIW Debt Portfolio, the Union budget provides a 100 % first-loss piece guarantee for the debt portfolio implemented by the EIB under the EFSI. The first-loss piece is expected to be approximately 25 % for the IIW Debt Portfolio-Standard and 33% for the IIW Debt Portfolio-Hybrid[9] of the volume of the overall portfolio of operations financed by the EIB at the end of the investment period, whereas the residual risk is fully borne by the EIB.

The EU Guarantee may be called in case of defaults by EIB's obligors or, if a restructuring process is undertaken, to cover restructuring losses in relation to debt-type operations.

EIB debt operations generate revenues established in accordance with EIB pricing methodology. Risk-related revenues are shared between the Union and the EIB on the basis of the risk taken, in accordance with the risk- and revenue-sharing principles set out in the EFSI Agreement.

As of 31 December 2017, 207 debt-type operations (of which 14 hybrid operations) had been signed under the IIW for a total financing of EUR 24.1 billion.

3.1.2. IIW Equity Portfolio

The IIW Equity Portfolio includes all signed and not cancelled equity-type operations. Under this portfolio, the EU Guarantee may be used to support direct investments in individual companies or projects (equity-type direct investments) or financing for funds or analogous portfolio risks (equity-type portfolio).

The EIB performs its standard assessment and determines whether an operation bears equity-type risks or not, irrespective of its legal form and nomenclature. Equity-type investments are to be priced in line with the market, absent which market testing or benchmarking is to be used.

7 Annex II of the Regulation, point 6.
8 Special activities are defined in Article 16 of the EIB Statute.
9 A hybrid compartment within the IIW Debt Portfolio was created to accommodate specific operations such as risk-sharing operations, which EIB delegates fully to financial intermediaries, Asset Backed Securities, etc. As of 31 December 2017, the allocation of EU Guarantee to this portfolio was EUR 1 billion.

Under the IIW Equity Portfolio–Standard, for each operation the EU Guarantee covers 100 % of the amounts financed by the EIB provided that the EIB invests on a pari passu basis an equivalent amount on its own.

The EU Guarantee may be called to cover negative value adjustments[10] (unrealised losses), realised losses at divestment and the EIB funding costs, for the part of the equity investment guaranteed by the EU.

All the cash amounts considered as revenues, which are received in respect of the IIW Equity Portfolio–Standard, are used to remunerate the EU Guarantee.

The third amendment and restatement of the EFSI Agreement of 9 March 2018 foresees the creation of an IIW Equity Portfolio–NPBs. On a portfolio basis, the EU Guarantee shall provide 95 % of the first-loss piece, whereas the EIB shall retain the remaining 5% as well as the full residual risk.

As of 31 December 2017, 77 equity-type operations had been signed under the IIW for a total financing of EUR 3.3 billion.

3.2. SME Window (SMEW)

The SME Window (SMEW) of EFSI facilitates access to loan and equity financing for small and medium sized enterprises (SMEs) and, to a limited extent, also small mid-cap companies. It is implemented by the EIF.

In the area of support to loan financing, the part of the SMEW benefitting from the EU guarantee under EFSI boosts existing EU financial instruments for SMEs in such a way that their intervention is faster and that they can support a greater volume of lending and a larger number of companies. Specifically, the support is provided to the COSME Loan Guarantee Facility that enhances access to finance for riskier SMEs, to the InnovFin SME Guarantee Facility that focuses on innovative and research-intensive enterprises, to the EaSI Guarantee Facility which supports microfinance and social enterprises and to the CCS Guarantee Facility which provides dedicated support to SMEs in the cultural and creative sectors. Under these products, EFSI supports guarantees that the EIF issues to banks, ensuring that they extend lending to the target beneficiaries, with either greater overall portfolio volumes or at better terms than without the EU Guarantee.

[10] Value adjustment means change in the aggregate book value of the equity-type operations.

In the area of equity financing, the part of the SMEW benefitting from the EU Guarantee under EFSI supports a facility that the EIF uses to invest in equity funds, funds of funds or co-investment vehicles that channel equity financing to early stage companies (e.g. start-ups) and also growth and expansion stage companies (e.g. scale ups).

The EU Guarantee allocated to the SMEW under the EFSI Regulation amounts to EUR 3 billion (following the transfer from IIW described in section 2). With the EFSI 2.0 Regulation, the EU Guarantee extended to the SMEW was expanded by another EUR 3.5 billion available for deployment over the period 2018-2020. Apart from the instruments covered by the EU Guarantee under EFSI, the SMEW also benefits from a direct EIB contribution of EUR 2.5 billion which has served to extend the EIB's Risk Capital Resources mandate to the EIF in support of equity financing for SMEs and mid-caps. This direct EIB contribution to EFSI was extended by another EUR 1.5 billion in the context of EFSI 2.0.

As of the end of 2017, the EIF had signed SMEW operations with 305 financial intermediaries for a total EIF financing of almost EUR 10 billion. These operations are expected to mobilise investment of EUR 76 billion in all 28 Member States of the EU. By the end of 2017, a total of 135,785 companies had already received EFSI-supported financing under the SMEW and 1.5 million jobs were created or supported.

4. The functioning of the EU Guarantee Fund under EFSI

The Guarantee Fund under the EFSI (the Guarantee Fund) was established under Article 12 of the EFSI Regulation and it is funded mainly from payments from the Union general budget and revenues originating from operations under the EU Guarantee. The Guarantee Fund constitutes a liquidity cushion from which the EIB is to be paid in the event of a call on the EU Guarantee. The Guarantee Fund has to be maintained at a certain percentage[11] (the Target Rate) of the total amount of the obligations under the EU Guarantee, currently 35%. Thus, the liquidity cushion is intended to provide an appropriate safety margin avoiding exposing the Union budget to sudden guarantee calls, which could entail spending cuts or budget amendments. Therefore, it contributes to the predictability of the budgetary framework.

In accordance with the EFSI Agreement, calls are paid by the Guarantee Fund 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 Union revenues resulting from operations under the EU Guarantee and recovered amounts and, to the extent of

[11] The Target Rate was originally set by Article 12(5) of the EFSI Regulation at 50% of the total EU Guarantee obligations. As of the entry in force of the EFSI 2.0 Regulation, the Target Rate is set at 35% of the total EU Guarantee obligations.

the available balance, for the payment of calls under the EU Guarantee and for the payment of EIB recoverable administrative costs and recovery costs.

4.1. The provisioning mechanism of the Guarantee Fund

The Guarantee Fund is provisioned through:

- Contributions from the general budget of the Union; the budget allocated for the Guarantee Fund provisioning amounts to EUR 8 425 million;
- Revenues and any other payments received by the Union in accordance with the EFSI Agreement (i.e. projects benefitting from EFSI support); these assigned revenues to the Guarantee Fund amount to EUR 675 million;
- Returns (interests) on Guarantee Fund resources invested in the financial markets;
- Amounts recovered from projects for which the EU Guarantee was called (i.e. defaulting debtors).

The Guarantee Fund is provisioned progressively taking into account the increase in exposure borne by the EU Guarantee and it is directly managed by the Commission; its resources are invested in accordance with the principles of sound financial management and appropriate prudential rules.

4.2. Annual and cumulative flows

The payment schedule of the budget item provisioning the Guarantee Fund is presented in table 1. In 2016, an amount of EUR 1 018 million was made available to the Fund. Of this, the bulk came from payment appropriations of the Union budget (EUR 1 012 million) while an amount of EUR 6.33 million, resulting from operations under the EU Guarantee, was recovered from the EFSI Account (as assigned revenue). In 2017, an amount of EUR 2 490 million was made available to the Guarantee Fund. Of this, the amount of EUR 39.2 million, resulting from operations under the EU Guarantee, was recovered from the EFSI Account (as assigned revenue).

Table 1: Payment schedule to the Guarantee Fund from the Union budget

(EUR million)

	2015	2016	2017	2018	2019	2020	2021	2022	Total
Commitments	1 350	2 104	2 641	*2 010*	*167*	*153*			*8 425*
Payments		1 012	2 450	*1 800*	*1 150*	*1 088*	*525*	*400*	*8 425*

Note : The payment profile of year 2018 and onward is provisional.
The payment amounts presented for 2016 and 2017 do not include assigned revenues

As of 31 December 2017, the cumulative amount of EUR 3 508 million was paid and invested in bonds.

As of 31 December 2017, EFSI operations managed by the EIB under the IIW generated revenue of EUR 78.5 million for the EU[12], of which EUR 61.0 million during the year 2017.

As of 31 December 2017, an amount of EUR 0.4 million was paid to cover the EIB's funding costs. Moreover, an amount of EUR 1,0 million was paid to cover adminstrative fees and other costs for the EFSI operations managed by the EIF under the SMEW, in accordance with the EFSI Regulation and EFSI Agreement. These amounts were paid out of the EFSI Account.

4.3. Composition and key characteristics of the portfolio

The Guarantee 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 aims at enhanced diversification across various fixed income asset classes.

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[13] at the end of 2017 was 3.47 years. Average credit rating is A-.

12 See the Reports from the Commission to the European Parliament, the Council and the Court of Auditors on the management of the Guarantee Fund of the EFSI in 2016 and 2017.

13 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.

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).

4.4. Performance

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 two years.

Since inception in April 2016, the Guarantee Fund delivered an absolute performance of 0.2% percent at the cut-off date of this report, end of December 2017. This close to 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[14]) and rising interest rates in the United States[15].

4.5. Assessment of the adequacy of the Target Rate and the level of the Guarantee Fund

The Target Rate of the Guarantee Fund was originally set at 50% of the total EU guarantee obligations. This target was estimated before the start of EFSI.

In 2016, the Commission's internal evaluation of EFSI[16] concluded that the provisioning of the Guarantee Fund could be adjusted. The risk assessment of the different products supported by the EU Guarantee showed that overall the Union budget would be adequately shielded from potential calls under the EU Guarantee with an adjusted Target Rate for provisioning the Guarantee Fund of 35% taking into consideration recoveries, revenues and reflows from EFSI operations.

The Council and European Parliament approved the Commission proposal and the Target Rate has been set at the level of 35% of the total EU Guarantee obligations as of the entry into force of the EFSI 2.0 Regulation. The adequacy of the Target Rate was confirmed based on the EFSI portfolio end of 2017.

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

15 For example 2-year US treasury yields increased by 69 basis points during 2017. While increasing yields offer better reinvestment opportunities over time, they lead to an initial negative revaluation effect.

16. SWD(2016) 297

5. Conclusions

The independent evaluation of the application of the EFSI Regulation that underpins the Proposal for a Regulation of the European Parliament and of the Council establishing the InvestEU Programme[17] concluded to the overall relevance and effectiveness of the EU Guarantee.

Between 2014 and 2017, EIB Special Activities experienced an almost five-fold increase, with EFSI operations under the EU Guarantee accounting for 95% of EIB Special Activities in 2016 and 2017, thereby demonstrating the value-added of the EU Guarantee. Providing additional risk bearing capacity to the EIB and the EIF did lead to additional and higher risk financing by the EIB Group.

The evaluation further confirmed that the levels of the EU Guarantee and of the EIB contribution were appropriately sized for the period 2015-2018 as it allowed the EIB Group to mobilise a level of investment in line with expectations. The adjustment of the Target Rate for the Guarantee Fund under EFSI 2.0 resulted in a more efficient use of the EU budget. Moreover, as a large part of the additional funds required to provision the extension of the Guarantee Fund will originate from EFSI revenues and reflows from other financial instruments, the impact on other parts of the EU budget was limited, thereby leading to an increased efficiency of EU budget support.

Finally, the evaluation considered that overall, the approach to modelling the EFSI Target Rate appears to be adequate and in line with industry practice.

[17]. COM(2018) 439