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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT AND THE COUNCIL**

on the entry into operation of the Common Provisioning Fund

INTRODUCTION:

This Communication informs the European Parliament and the Council of the steps taken by the European Commission to prepare for the entry into operation of the Common Provisioning Fund¹ (CPF, the Fund) along with the new Multi-Annual Financial Framework (MFF). On the basis of the work carried out by the Commission, all legal, administrative and technical arrangements were in place to allow the CPF to commence operations in January 2021, and to receive and start managing the assets of the European Fund for Strategic Investments (EFSI) Guarantee Fund² on that date. The CPF is now ready to receive transfers of assets from the other contributing policy instruments (InvestEU Programme³, External Action Guarantee (EAG) under the Neighbourhood, Development and International Cooperation Instrument (NDICI⁴)) as soon as the legislative acts establishing them enter into force.

The common provisioning fund will constitute a central pillar of the Union budgetary architecture over the course of the 2021-2027 Multi-Annual Financial Framework. It will hold the provisions that secure the functioning of all the EU budgetary guarantees (EFSI, InvestEU, EFSD+ budgetary guarantees covered by the External Action Guarantee, External Lending Mandate (ELM)) and provisioned financial assistance programmes (macro-financial assistance⁵ (MFA) loans, Euratom loans) in a single portfolio. It is envisaged that the assets will grow from EUR 12 billion at inception to up to EUR 25 billion at peak size. The effective management of these Union assets is critical for anchoring the investment support that the Union provides through its budgetary guarantees inside and outside the EU.

This Communication:

1. recalls the rationale for the creation of the common provisioning fund, as set out in the Title X of the Financial Regulation;
2. explains how the common provisioning fund will be structured to serve the contributing policy instruments. It provides a tentative assessment of the dimensions of the CPF assets at the start of operations in 2021 and at its expected peak-time;

¹ As laid down in Article 212 of Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union, amending Regulations (EU) No 1296/2013, (EU) No 1301/2013, (EU) No 1303/2013, (EU) No 1304/2013, (EU) No 1309/2013, (EU) No 1316/2013, (EU) No 223/2014, (EU) No 283/2014, and Decision No 541/2014/EU and repealing Regulation (EU, Euratom) No 966/2012, OJ L 193, 30.7.2018, p. 1, (the Financial Regulation).

² 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, OJ L 169, 1.7.2015, p. 1.

³ Proposal for a Regulation of the European Parliament and of the Council establishing the InvestEU Programme, COM (2018) 439 final.

⁴ Proposal for a Regulation of the European Parliament and of the Council establishing the Neighbourhood, Development and International Cooperation Instrument, COM (2018) 460 final.

⁵ The framework for financial assistance to non-EU countries in the form of loans is established by Decisions of the European Parliament and/or of Council issued for that purpose.

3. presents the work undertaken by the Financial Manager of the common provisioning fund during 2020 to prepare the CPF management framework, including the adoption of asset management guidelines, framing of the investment policy, implementation of governance and risk management processes and preparation of the IT and accounting infrastructure;
4. emphasises the prudent approach that will be followed in managing the assets in the Fund in order to preserve the value of the portfolio to the extent possible faced with the challenges presented by prolonged negative rates on the assets in which the CPF invests;
5. explains the reporting that will be provided by the Commission to the European Parliament and to the Council.

1. RATIONALE FOR THE COMMON PROVISIONING FUND:

The common provisioning fund will hold the safety buffers (provisions⁶) to cover the financial liabilities arising from budgetary guarantees and financial assistance programmes, provided by the Union budget, in one common portfolio. The instruments that will contribute provisions include 3 already established guarantee funds (EFSI Guarantee Fund, the European Fund for Sustainable Development⁷ (EFSD) Guarantee Fund and the Guarantee Fund for external actions⁸ (GFEA)), as well as four new contributing policy instruments under the 2021-2027 MFF. Upon entry into force of the relevant legislative acts, the Fund shall be able to receive committed resources under the InvestEU and NDICI programmes in accordance with the scheduled flow of payments envisaged in the relevant legislative acts.

The provisions held in the CPF constitute the capital buffer for absorbing claims arising from project defaults or other losses experienced by implementing partners in respect of investment operations or from financial assistance loans supported by EU guarantees. There is a paramount need to protect the EU budget against the risk that losses incurred under the programmes exceed the assets available in the CPF to meet these calls. Given the importance of the CPF for the sound management of the EU budget, Title X of the Financial Regulation entrusts the Commission with particular responsibilities for setting up the CPF, defining its investment strategy and overseeing its sound management.

Joint management of the provisions for the different budgetary guarantees and financial assistance makes it possible to reap important economies of scale and scope. It allows the Commission to design and implement a single investment strategy, which caters for the underlying needs and constraints of the corresponding programmes through a single large portfolio. Combining the assets in a single portfolio allows them to be managed efficiently thanks to a rigorous investment policy and framework, so that the risk-return

⁶ In accordance with Article 212 of the Financial Regulation, the CPF shall hold the provisions made to cover financial liabilities arising from financial instruments, budgetary guarantees or financial assistance. The initial set of the contributing instruments reflects the requirements of the relevant legal acts. The envisaged structure of the Fund allows to add further contributing instruments at any time, subject to fulfilling requirements of the CPF asset management guidelines and of the relevant legal acts.

⁷ Regulation (EU) 2017/1601 of the European Parliament and of the Council of 26 September 2017 establishing the European Fund for Sustainable Development (EFSD), the EFSD Guarantee and the EFSD Guarantee Fund, OJ L 249, 27.9.2017, p. 1.

⁸ Council Regulation (EC, Euratom) No 480/2009 of 25 May 2009 establishing a Guarantee Fund for external actions (Codified version), OJ L 145, 10.6.2009, p. 10.

and liquidity of the portfolio are optimized and resources are available to meet guarantee calls from the underlying budgetary guarantees, or to reimburse EU borrowings under financial assistance when needed. This is especially important at the time when the increased recourse to budgetary guarantees and financial assistance creates bigger contingent liabilities for the EU budget. Furthermore, a joint management of the various guarantees allows the Commission to provide an aggregated and more effective overview of the management of CPF assets by adopting a centralized reporting approach.

The common provisioning fund holds out the possible added benefit of lower provisioning for participating instruments under specific circumstances, owing to the fact that pooling of the resources corresponding to the programmes with different risk characteristics will diversify some of the risks. Where there is a lower degree of synchronisation of calls on the different budgetary guarantees, the provisioning could be reduced commensurately without jeopardising sound financial management. This is the logic behind the concept of the Effective Provisioning Rate (EPR), as implemented through the Commission Delegated Decision⁹ supplementing Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council. This Decision defines the detailed conditions for the calculation of the effective provisioning rate of the CPF, which is presented in section 3.

The rules applicable to the provisioning and management of the CPF will provide the solid internal control framework needed to ensure the effective use of the EU budgetary resources and the efficient management and release of resources when needed by the respective budgetary guarantees and financial assistance.

2. COMMON PROVISIONING FUND ARCHITECTURE AND DIMENSIONS

The resources of the common provisioning fund will be contributed by three ‘legacy instruments’ and four new contributing instruments following the enactment of the corresponding legislative acts. The ‘legacy’ instruments contributing to the CPF represent existing instruments established under previous MFFs which need to be accounted for separately as they support a distinct set of guaranteed operations. Further contributing instruments may be added to the CPF subject to entry into force of relevant legal acts.

The provisions contributed by the different policy instruments are booked in different CPF compartments for the purpose of tracing the amounts relating to the individual contributing instruments, in line with the provisions of the Financial Regulation and the underlying legal acts. Each compartment corresponds to a contributing instrument. The share of compartments is determined on a pro rata basis, reflecting the contributions to and withdrawals from the assets of the CPF by each contributing instrument.

⁹ C(2020) 7684 final

	Budgetary guarantees	External budgetary guarantees	Provisioned financial assistance
Legacy	EU Guarantee under the EFSI (EUR 9.1bn)	EFSD Guarantee (EUR 750m)	
		GFEA ¹⁰ (EUR 2.8bn supporting ELM, MFA loans and Euratom loans ¹¹)	
		ELM	Pre-2020 MFA loans Pre-2020 Euratom loans
New	EU Guarantee under the InvestEU (EUR 10.4bn of which EUR 5.9bn from NGEU, EUR 3.5bn from MFF and EUR 1bn from expected reflows)	EAG under NDICI (EUR 10bn, supporting EFSD+ guarantee ¹² , MFA loans and Euratom loans)	
		EFSD+ Guarantee	Post-2020 MFA loans Post-2020 Euratom loans

In addition to the compartments which are financed from the Union budget, an additional omnibus compartment is foreseen for Member State compartments foreseen by Article 9 of the InvestEU Proposal. These Member State compartments will hold provisions, financed by Member State's resources coming from different sources, as the capital buffer for separately constituted national budgetary guarantees. This omnibus compartment will be segregated into separate Member States compartments as and when Member States establish budgetary guarantees under the InvestEU framework. The initial compartment structure is schematically represented below.

Effective provisioning rate calculated and applied by the Financial Manager											
Compartment structure - Financial Manager of the CPF	Legacy compartments							Member State compartments			
	EFSD	EFSD	GFEA	InvestEU	Post-2020 MFA	Post-2020 Euratom	EFSD+				
Underlying policy instruments - relevant Authorising Services			Euratom				9%	MS 1	MS 2	MS 3	MS ...
			MFA				50%				
			ELM				x %				
Level of individual provisioning for the underlying policy instruments controlled by the respective Authorising Services											

The architecture of the common provisioning fund ensures a clear segregation of duties between the Financial Manager and the Authorising Services responsible for the contributing instruments. The Financial Manager is responsible for the asset management operations of the CPF portfolio, reporting and calculation of effective provisioning at the compartment level. The Authorising Services are responsible for the management of the

¹⁰ Under its current legal basis, the GFEA resources are considered as one pool and are thus not segregated per underlying contributing instrument. Although Regulation No 480/2009 will be repealed following the transfer of the GFEA assets into the CPF, the provisioning of the 'legacy' GFEA portfolio will continue to be governed by that Regulation. The GFEA will therefore form a single compartment in the CPF, holding the provisions for both: external budgetary guarantees (ELM and its predecessor guarantees) and provisioned financial assistance (MFA loans authorised prior to the post-2020 MFF and Euratom loans authorised prior to the post-2020 MFF).

¹¹ Council Decision of 29 March 1977 empowering the Commission to issue Euratom loans for the purpose of contributing to the financing of nuclear power stations (77/270/Euratom), OJ L 088, 06.04.1977, p. 9.

¹² Under the External Action Guarantee based on the NDICI Proposal.

contributing policies, and consequently for overseeing the transfer of provisions to the CPF or instruction of guarantee or other calls for release of resources to meet the operational needs of the contributing programme.

The Fund is expected to reach EUR 25 billion over the course of the 2021-2027 MFF. The CPF immediately received EUR 8 billion in EFSI Guarantee Fund assets upon the entry into force of the MFF. This will be followed by the transfer of GFEA (EUR 3 billion) and EFSD (EUR 0.75 billion) provisions upon adoption of NDICI Regulation. This will result in a CPF with assets of around EUR 12 billion by mid-2021.

During subsequent years, the Fund will receive large inflows from the InvestEU Programme and the External Action Guarantee under the NDICI of between EUR 2 billion and EUR 3 billion per year. During the early years of the 2021-2027 MFF, the provisioning for InvestEU will consist primarily of resources mobilised through NextGeneration-EU (NGEU) borrowings. The amount of provisioning that is received from NGEU borrowing will depend on the volume of operations that can be committed by implementing partners before the end of 2023.

3. STEPS TAKEN IN 2020 TO PREPARE FOR CPF MANAGEMENT

Throughout 2020, the Commission has undertaken extensive preparations, dating back to the Communication of 25 March 2020 on the identity of the CPF asset manager and the related Commission Decision on the Asset Management Guidelines (AMGs). Sustained effort has been required on a range of topics, such as risk, back office, accounting, IT, legal and investment management, to permit the timely and efficient entry into force of CPF. This work has encompassed the following key milestones in the preparations (Annex provides a more complete description of the work undertaken):

1. The adoption of AMGs for the CPF in the form of a Commission Decision. The AMGs define the objectives, structure and operations of the CPF, and identify the source of the assets that shall be included in the CPF. The AMGs establish a prudent investment policy for the CPF, intended to ensure stability of the CPF's value and to preserve the capital in difficult market conditions (to the largest extent possible), so that the CPF would be able to honour the guarantee calls against the provisioning of the compartments on time and in full;
2. The adoption of the Commission Delegated Decision on the calculation of the EPR, including the methodology for that calculation. The objective of the EPR is to deliver efficiency gains in the use of budgetary guarantees and financial assistance, by pooling these individual provisions in the CPF and optimising the level of provisioning in view of the diversification of risks. It was expected that where the calls on the resources of the different guarantees were not closely correlated that the Union budget could afford to hold a slightly lower level of resources against the risks inherent in the guaranteed operations. The Delegated Decision was adopted by the Commission in November, 2020 and was subsequently transmitted to the European Parliament and the Council for scrutiny in accordance with Article 269(5) and (6) of the Financial Regulation. The Delegated Decision has entered into force on 25 February 2021;
3. The definition of an investment strategy and adoption of the benchmark agreed by the Accounting Officer of the Commission and the Financial Manager of the CPF;
4. The preparation of the new governance framework (see insert below);

5. The Accounting Officer has adopted the Manual of Procedures for the CPF operations. This manual provides a comprehensive, easy-to-use reference document providing an overview of the main business processes in the operation of the CPF. It covers the full lifecycle of the CPF, includes references to the governance and accountability arrangements, explains how the liquidity needs will be estimated, procedures for payment of guarantee calls and liquidity management, etc.

Focus on the governance:

The asset management governance for the CPF is based on the best practice in asset management and benchmarking with peer institutions¹³. The existing organisational framework for the management of assets by the Commission was reviewed and upgraded in early 2018. The independent asset management evaluation¹⁴, finalised in December 2019, endorsed the clear delegation of decision-making and lines of accountability, adequate segregation of duties, clearly defined roles and well-framed and documented procedures and processes, checks and balances at all levels of the decision making process, appropriate control and dedicated compliance function.

The governance arrangements define the roles and responsibilities of the main actors in this framework as follows:

- the Financial Manager of the CPF takes final responsibility for the decisions related to the financial management of the resources of the CPF as well as for the other portfolios managed by the Commission or outsourced to the European Investment Bank. This role has been delegated by the Commission to the Director-General of the Directorate-General for Budget (DG Budget);
- the Accounting Officer ensures that checks and balances are in place at all levels to support rigorous and independent oversight of processes and the sound financial management and accounting for the assets and liabilities of the EU budget;
- the Compliance Officer provides independent scrutiny of adherence to agreed procedures and advises on new or significant legal or procedural issues.

The decisions taken by the Financial Manager and agreed by the Accounting Officer are based on rigorous preparation, organised through an Asset Management Board, which proposes courses of action (e.g. approval or updates of investment strategy) for endorsement. The Asset Management Board and its sub-structures (risk and investment committees) together ensure that the asset management decisions are taken with due care, in a professional manner and both provide monitoring and oversight of the asset management processes. The governance considerations and risk management framework have been extended also to other Commission managed portfolios.

¹³ Following a peer review workshop with representatives of the World Bank and the European Stability Mechanism, a new governance structure was put in place for the asset management activities of Directorate General for Economic and Financial Affairs (DG ECFIN) as of 1 February 2018. Although DG ECFIN's governance structure was already assessed by peers (notably, the World Bank in 2014) as compliant with industry standards, the changes to the governance structure applied since early 2018 brought further improvements, in light of the anticipated increase in assets under management.

¹⁴ "Assessing the advantages and disadvantages of entrusting the financial management of the assets of the Common Provisioning Fund to the Commission, the EIB, or a combination of the two" by ICF and Keypoint Financial, December 2019.

The articulation between the management of CPF assets and that of the contingent liabilities arising from the budgetary guarantees supported by the CPF is ensured by the Steering Committee for Contingent Liabilities. This Steering Committee¹⁵ brings together the Financial Manager of CPF and the representatives of the Secretariat-General and of the relevant Directorates-General responsible for the budgetary guarantees, with the Accounting Officer, a member of the Cabinet of the Budget Commissioner participating as observers. The Steering Committee coordinates the risk management for the budgetary guarantees to ensure that the latter are implemented in a manner consistent with the need to protect the Union budget against the materialisation of undue risks. The Steering Committee reviews the functioning of the CPF to ensure that the provisions held by the CPF are managed in a way that serves the needs of the underlying budgetary guarantees.

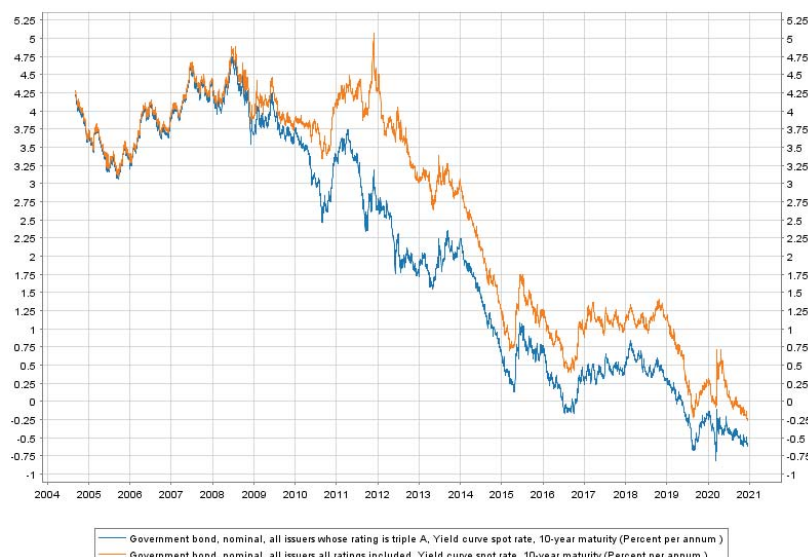
4. SAFE-GUARDING THE CPF VALUE IN CHALLENGING MARKETS

The AMGs require a prudent investment policy for the common provisioning fund, which aims, to the greatest extent possible, to preserve the value of its assets so that it can honour guarantee calls from the EU budgetary guarantees on demand and in full. This is also reflected in a conservative approach to the definition of eligible investments, which are principally confined to euro-denominated fixed income securities.

This focus on protecting the portfolio against undue volatility or fluctuations is in keeping with the need for CPF assets to provide a stable and predictable capital cushion for the budgetary guarantees, which rely on it. However, preserving capital – however modest it may seem as an investment objective – has become increasingly challenging in modern debt capital markets. Recently, the interest rates on the triple A euro-area government bonds (10 year maturity) fluctuated between -0.5% and -0.25% and occasionally reaching as low as -0.8% per annum. The graph below presents the trend decline in interest rates of triple A rated and all euro-area government bonds since 2004.

¹⁵ Commission decision of 24.7.2020 on establishing the Steering Committee on Contingent Liabilities arising from Budgetary Guarantees (C(2020) 5154)

Graph 1: Nominal interest rates of euro-area government bonds since 06/09/2004 [ECB SDW¹⁶]



The Fund's investment benchmark has been rigorously modelled in light of the prevailing market environment. Its objective is to deliver the best combination of low risk and stability while maximising return (minimising losses) in this context. It was approved by the Accounting Officer in September 2020 after rigorous validation through back-testing, sensitivity analysis and stress-testing.

The optimised CPF strategic benchmark has a duration of 3.4 years based on assumptions regarding the dynamics of the underlying policy instruments, notably the time-profile of inflows and calls on the provisions in the different compartments. The level of risk was capped so that the expected maximum amount of losses of the portfolio over the annual period cannot exceed 2% of the total portfolio with a high (95%) level of confidence. The absolute expected return that the benchmark can be expected to deliver annually ranges between -0.35% to +0.05%, with a central estimate of -0.15%.

The proposed investment strategy offers the optimised level of return for a conservative portfolio with limited risk-taking opportunities that is practically achievable in prevailing market circumstances without incurring undue investment risks.

Focus on Environmental, Social and Governance (ESG) factors in CPF investment policy

The asset management guidelines give a prominent place to the ESG policy in the selection and management of assets held by the Fund.¹⁷ First, the asset selection ESG criteria includes both a negative and a positive screening of assets to ensure consistency with Commission initiatives on the European Green Deal and related ESG objectives, such as strengthening sustainable finance and social fairness, etc. For example, the negative screening criteria excludes from the investments, activities related to the production or trade in ammunition and weaponry prohibited by the international conventions or gambling, where the income from this activity exceeds 25% of the revenues of the investee company. Second, the positive screening approach entails

¹⁶ Statistical Data Warehouse.

¹⁷ Art(9) and (10) of the AMGs.

choosing ESG-labelled bonds over non-ESG ones, whenever such selection is compatible with the overall considerations of our investment process. As a result, the current portfolios managed by the Commission already have a very strong ESG footprint, for instance about 9% of EFSI assets as of end of 2020 have been invested in ESG-labelled-securities. Maintaining and deepening this already strong ESG complexion requires constant monitoring and analysis of the markets, assessment of market depth and volume available for trading.

5. REPORTING AND ACCOUNTABILITY

In accordance with Article 214 of the Financial Regulation, the Commission shall provide annual reports on the common provisioning fund to the European Parliament and the Council. These reports will present the overall CPF performance as well as the additional information set out in the AMGs¹⁸. The Financial Manager will prepare the annual Financial Statements to accompany the annual report. Those financial statements shall be prepared in accordance with the EU accounting rules and will be consolidated into the Union provisional and final annual accounts.

Furthermore, Article 41 of the Financial Regulation envisages reporting on the individual budgetary guarantee programmes, which will also be accompanied by some information on the common provisioning fund. This includes information about the financial management, the performance and the risk at the end of the preceding year, the financial flows during the preceding year, the significant transactions and any relevant information on the financial risk exposure of the Union. The information will be attached to the draft budget in a working document.

The annual adjustment of the level of provisioning as a result of the application of the EPR also enters into the draft budget and therefore it is important to ensure the full transparency regarding the level of the EPR and the assumptions used in these calculations. However, given that the CPF will consist solely of EFSI Guarantee Fund assets for the first months of its existence, and that there will be no experience in the management of pooled liabilities at the time of calculation, the sensible approach would be to apply an EPR of 100% for 2021 and for the purposes of preparation of the draft budget 2022.

CONCLUSIONS:

With the introduction of the common provisioning fund, the asset management function of the Commission that has been in operation for over 30 years evolves to a new dimension, relying on robust governance and risk controls and proven technical expertise.

Throughout 2020, the Commission has invested heavily in preparing the legal, policy and technical framework for the management of the CPF. This work has equipped the Commission to manage effectively the transition to the CPF and the progressive activation of its constituent compartments during 2021.

¹⁸ Article 11 requires to include the key information on the portfolio composition, performance relative to benchmark, number of calls etc.; Article 10 requires to report on the ESG profile of the CPF