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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 Sustainable Development**

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1. INTRODUCTION

The legal basis for this report is Regulation (EU) 2017/1601 ('EFSD Regulation'). Article 16.3 of the EFSD Regulation, which states that the Commission shall provide to the European Parliament, the Council and the Court of Auditors a report on the management of the European Fund for Sustainable Development ('EFSD') Guarantee Fund in the previous calendar year, including an assessment of the adequacy of the provisioning and the level of the EFSD Guarantee Fund and of the need for its replenishment.

2. OPERATIONAL CONTEXT

The EFSD covers the financing of operations in Africa and EU Neighbourhood, including both blending operations and the EFSD guarantee.

The EFSD guarantee is a key innovative element used to reduce the risks for investment in sustainable development in partner countries, thus helping mobilise investments, foster sustainable and inclusive economic and social development, maximise additionality, as well as to crowd-in private sector funds. The guarantee is intended to serve as a risk mitigation mechanism to leverage private sector financing whilst avoiding market distortions.

The EFSD guarantee has been established for an overall amount of EUR 1.5 billion to be covered by the general budget of the Union. Additional contributions to support the EFSD Guarantee Fund include USD 50 million from the Bill and Melinda Gates Foundation, EUR 9.6 million from Denmark, EUR 300 000 from the Czech Republic, and EUR 100 000 from Estonia.

Article 14 of the EFSD Regulation sets up the EFSD Guarantee Fund, which constitutes a liquidity cushion from which the eligible counterparts shall be paid in the event of a call on the EFSD Guarantee. The Union has made available EUR 750 million to cover its financial liabilities, which corresponds to 50% of the EU guarantee obligations.

The EFSD Guarantee Fund has been effectively established in 2018. An amount of EUR 799 million has been paid to the Fund as of 31 December 2020.

Information on the results achieved by the EFSD Guarantee Fund in 2019 were provided by the Commission to the European Parliament, the Council and the Court of Auditors in the Report on the management of the EFSD Guarantee Fund¹.

¹ COM (2020) 346

3. MANAGEMENT OF THE EFSD GUARANTEE FUND IN 2020

3.1. Financial management

The investment portfolio of the EFSD Guarantee Fund is invested in accordance with the management principles laid down in Commission Decision C (2017) 7693 of 22 November 2017, applying also to the asset management guidelines of the EFSD Guarantee Fund.

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.

3.2. Market developments

Market developments in the year 2020 were dominated by the spread of the COVID-19 virus, its devastating impact on public health and the global economy, and the quick and strong policy response by governments and central banks.

Fixed income markets started the year with an optimistic tone, courtesy of progress in the US-China trade relationship and an overall positive sentiment regarding the economy. The 10-year German bond (Bund) yield reached a high of -0.16% mid-January, which would prove to be the peak level for the whole year.

Later that year, more than half the world's population was effectively put in total confinement as the threat of the virus became clear creating a global shock to both supply and demand, particularly for face-to-face services. The financial markets worldwide experienced a sudden shock, combined with a huge spike in risk aversion and volatility. The ensuing 'dash for cash' led many investors to the fire sale of assets, causing dislocations and threatening the stability of financial markets.

Equity markets plummeted and investors turned to safe assets, such as the Bund, whose yield quickly dropped to its year low of -0.86% by mid-March, and US Treasuries whose yields dropped even more, fuelled by two emergency rate cuts of the US Federal Reserve, totalling 150bps, at the beginning of March. Safe-haven yields then reversed and in tandem with the rest of the fixed income universe moved higher in the midst of market confusion and limited liquidity. The Bund moved back towards -0.20% ten days after reaching its year low. Spreads of other European government bonds to the Bund widened substantially, as did spreads of all other fixed income asset classes.

To restore confidence, governments implemented rescue packages and central banks provided monetary accommodation (e.g. policy rate cuts and/or asset purchases) at an unprecedented scale, helping markets to calm and overall asset valuations to rebound. Following a volatile March, spreads stabilised from April onwards, moving on a downward trajectory. The announcement of unprecedented fiscal packages worldwide and in Europe, notably the EUR 750 billion Next Generation EU, nudged the overall yield levels higher in June, but central banks proved their resolve and contained the move to ensure favourable financing conditions amidst lingering downside risks. For the rest of the year, euro-area yields and spreads were overall gradually decreasing, while investor confidence kept improving on the back of advances on the front of vaccination and the prospect of further stimulus following the US elections in November. The Bund finished the year at -0.57%.

Overall, the evolution of the fixed income markets, although characterised by a very high volatility, provided attractive investment opportunities, which in turn contributed to the positive return of the EFSD Guarantee Fund at year-end.

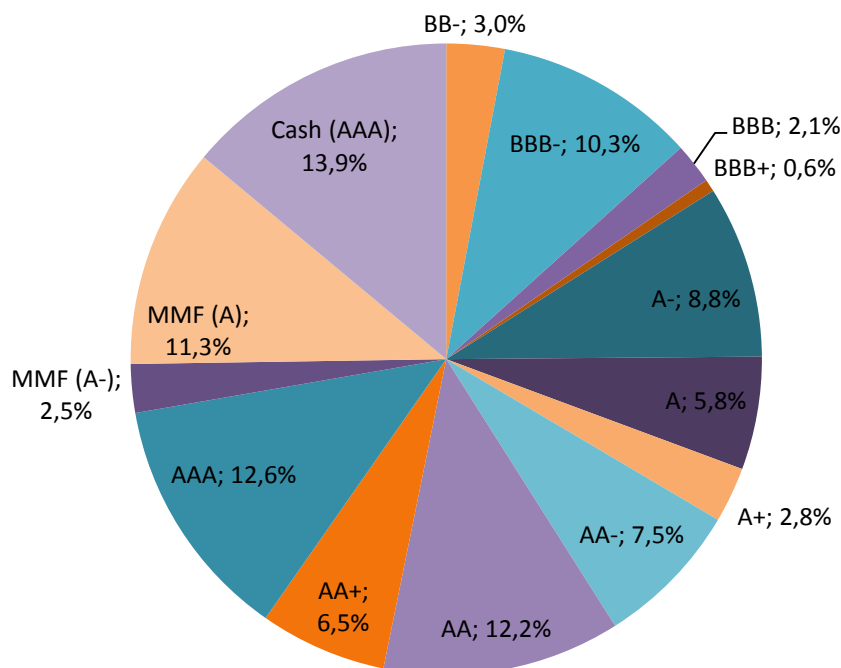
3.3. Composition and key characteristics of the portfolio

An investment strategy guides the management of the assets of the EFSD Guarantee Fund's investment portfolio in order to achieve the investment objectives. This investment strategy is expressed in the form of a benchmark, which sets the indicative target allocations to different categories of eligible financial assets in the portfolio.

As of December 2020, the investment portfolio was made predominantly of securities issued by Sovereigns, Sub-sovereigns, supranationals and agencies (SSA) and foreign governments (46% of market value against 52% for the benchmark), unsecured bonds issued by corporates and financial institutions (14% of market value against 18% for the benchmark) and covered bonds (14% of market value against 0% for the benchmark). The remainder was mainly allocated to Money Market Funds.

At the end of 2020, the proportion of bonds complying with environmental, social and governance criteria was 12%.

The portfolio duration at the end of 2020 was 2.41 years, and credit ratings of EFSD securities are split as follows:



The bulk of the portfolio is invested in liquid securities and money market instruments and an adequate part (32% 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 EFSD operations under the EU Guarantee (e.g. projected calls, revenues).

3.4. Performance

The annual performance is calculated on a time-weighted basis in order not to be affected by the size of the portfolio.

In a market environment characterised by health-related volatility and historically low yields, the Fund delivered an annual absolute performance of 0.734% (time-weighted performance, before any costs and fees) in 2020. This return is in line with the annual performance of the EFSD benchmark (0.507%). However, the 2020 performance of both the benchmark and the portfolio were largely driven by positive curve returns. Considering the historically low levels reached by the EU yields, the portfolio could be negatively impacted in the coming years by opposite curve movements (i.e. rising yields).

4. FINANCIAL ACCOUNTS

Financial information concerning EFSD Guarantee Fund is presented below. There were no calls on the EFSD Guarantee in 2020.

4.1 Financial statements of the EFSD Guarantee Fund as of 31 December 2020

The total assets of the EFSD Guarantee Fund stood at EUR 804.12 million on 31 December 2020. The assets comprised the investment securities portfolio classified as available-for sale (EUR 692.00 million) and cash (EUR 112.12 million).

In terms of the 2020 statement of financial performance, the EFSD Guarantee Fund ended the year with an economic result of EUR -0.62 million. The main reason for this was the negative interest charges on cash holdings and securities and fees (EUR -1.04 million) which could only be partially compensated by realised gains from security sales and security lending income (EUR 0.42 million). Unrealised capital gains / losses on positions still in the EFSD Guarantee Fund at the end of 2020 were only reflected in the valuation of the positions, but not in the economic result. Please refer to the point 3.4. for the performance of the EFSD Guarantee Fund including unrealised capital gains / losses.

Statement of financial performance for the year ended 31 December 2020

(amounts expressed in EUR, in brackets – expenses/losses, no brackets – revenue/gains)

	2020	2019
	EUR	EUR
Revenue from operating activities	-	-
Expenses from operating activities	-	-
Other expenses from operating activities	(15 000)	(15 000)
<i>Audit fees</i>	(15 000)	(15 000)
RESULT FROM OPERATING ACTIVITIES	(15 000)	(15 000)
Financial revenue	415 918	188 403
Interest revenue on:	152 600	(54 689)
<i>Cash and cash equivalents</i>	-	-
<i>Available for sale assets</i>	152 600	(54 689)
<i>Other interest revenue</i>	-	-
Realised gains on sale of AFS assets	250 985	240 839
Securities lending income	12 333	2 253
Financial expenses	(1 024 364)	(448 536)
Interest expenses on cash and cash equivalents	(197 065)	(404 272)
Realised losses on sale of AFS assets	(727 658)	(15)
Custody fees and other financial expenses	(99 641)	(44 249)
FINANCIAL RESULT	(608 446)	(260 133)
ECONOMIC RESULT OF THE YEAR	(623 446)	(275 133)

Balance sheet as at 31 December 2020

(amounts expressed in EUR, in brackets – expenses/losses, no brackets – revenue/gains)

ASSETS

	31 December 2020	31 December 2019
	EUR	EUR
NON-CURRENT ASSETS	435 238 107	348 061 980
Available for sale financial assets	435 238 107	348 061 980
CURRENT ASSETS	368 878 530	251 527 281
Available for sale financial assets	256 757 770	246 643 539
Receivables (i.e. securities lending fees)	2 197	1 595
Cash and cash equivalents	112 118 563	4 882 147
<i>Current accounts</i>	<i>112 166 318</i>	<i>4 885 215</i>
<i>Accrued interest on cash and cash equivalents</i>	<i>(47 755)</i>	<i>(3 068)</i>
TOTAL ASSETS	804 116 637	599 589 261

NET ASSETS AND LIABILITIES

	31 December 2020	31 December 2019
	EUR	EUR
NET ASSETS	804 091 888	599 567 587
Contribution from EU Budget	798 968 935	600 100 000
Fair value reserve	6 090 099	(188 713)
Retained earnings	(343 700)	(68 567)
Economic result of the year	(623 446)	(275 133)
CURRENT LIABILITIES	24 749	21 674
Other payables	24 749	21 674
TOTAL NET ASSETS AND LIABILITIES	804 116 637	599 589 261

4.2. Provisioning

The EFSD Guarantee Fund is provisioned from the general budget of the Union and the European Development Fund (EDF). For the 2014-2020 MFF, the detailed sources of funding of the EFSD Guarantee Fund include: EUR 400 000 000 from the EDF general reserve and EUR 350 000 000 from the general budget of the Union. The EFSD Guarantee Fund may also be endowed by voluntary contributions from Member States and other contributors, returns on invested resources, revenues and amounts recovered from defaulting debtors. Estonia, Czech Republic, Denmark and the Bill and Melinda Gates Foundation provided additional contributions totalling EUR 49 million.²

The Guarantee Fund was established in 2018. By 31 December 2020, the total payments received from Union funds (both general budget of the EU and EDF) into the Guarantee

² Estonia: EUR 100,000; Czech Republic: EUR 300,000; Denmark EUR 9.4 million; Bill and Melinda Gates Foundation: EUR 39.2 million (USD 50 million)

Fund, augmented by voluntary contributions, reached EUR 799 million. Until end-2020, there have been no calls on the EFSD guarantee.

5. ASSESSMENT OF THE ADEQUACY OF THE TARGET AMOUNT AND THE LEVEL OF EFSD GUARANTEE FUND

The EFSD Regulation sets the target amount of the EFSD Guarantee Fund at 50% of the total EFSD Guarantee obligations covered by the general budget of the Union. Additional voluntary contributions from Member States or other contributors are provisioned at 100%. The current level of the net assets in the EFSD Guarantee is EUR 804 million.

As of 31 December 2020, in total eighteen EFSD guarantee agreements worth EUR 1,549 million were concluded with ten financial institutions, exceeding the initial EFSD Guarantee capacity as a result of additional contributions from donors. The EFSD aims to address market failures and suboptimal investment situations and encourage private sector financing. In the course of 2020, as the COVID-19 virus spread around the globe, the Commission decided to use the EFSD Guarantee as a tool to help Partner Countries overcome the crisis. This meant that the EFSD Guarantee needed to adapt quickly to the economic needs created by the global pandemic by focusing on Micro, Small and Medium-Sized enterprises (MSMEs), local currency financing, and support to the health sector. Previously signed agreements covering MSME financing were topped up, new agreements were negotiated and signed. A particularly important shift was a new agreement to provide EUR 400 million in financing towards the distribution of COVID-19 vaccines to Partner Countries.

In acting as manager of the EFSD Guarantee and of the related Guarantee Fund, the Commission is responsible for ensuring that the required level of the liquidity cushion is maintained. The Commission is supported by the Guarantee Technical Assessment Group (G-TAG) comprised of credit-risk experts drawn from several European financial institutions. The role of G-TAG is to provide independent and impartial technical expertise on banking related matters, including for risk monitoring during the implementation of the projects benefitting from the guarantee.

As assessed by the G-TAG in their opinion of January 2021, based on the December 2020 data, the probability of depleting the EFSD Fund over its entire lifetime (estimated around 19 years), assuming a 75% average price subsidy, is comfortably below the EFSD risk tolerance limit of 10% under the average scenario. This is also the case for the average scenario, assuming a 100% subsidy and is in line with the limits set by the EFSD Guarantee Risk Policy Guidelines. Nonetheless, the EFSD's risk tolerance limit will be exceeded under the high-risk scenario assuming 75% or 100% fee subsidies. The probability of depleting the EFSD Fund over the 1-year horizon is less than 0.02% assuming 75% or 100% fee subsidies.