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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the common provisioning fund in 2023

{SWD(2024) 161 final}

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INTRODUCTION

This is the third annual report on the common provisioning fund (CPF) ([1]), covering the period from 1 January 2023 to 31 December 2023. It outlines key developments related to the functioning of the CPF in 2023, presents the main financial and risk parameters, as well as the fund's annual performance. It also presents the results of actions the Commission took to enhance the fund's longer-term performance through introducing a diversified investment universe.

The CPF, established under Article 212 of the Financial Regulation (FR), holds all provisions set aside by the EU budget or contributed by participating Member States and EFTA countries to cover risk of losses on operations guaranteed by the internal ([2]) and external ([3]) guarantees implemented by the European Union. In addition to budgetary guarantees, provisions are held in the CPF in respect of most of the macro-financial assistance (MFA) loans to third counties ([4]). The provisions held in the CPF constitute the capital reserve from which funds are drawn to meet guarantee calls on supported operations and other outflows.

The CPF became operational in January 2021. At the end of 2023 its market value stood at EUR 18.8 billion, making it the largest investment portfolio directly managed by the Commission.

Thanks to its prudent positioning, the CPF navigated well the market volatility seen in 2023 and was well placed to profit from strong market performance late in the year. In particular, the CPF posted an absolute return of +5.21%, helping it to claw back part of the 2022 losses (-8.9%) and to replenish provisioning of guarantees. Looking ahead, the present higher and positive interest rate environment offers a solid foundation for returns over the medium-term.

This report focusses on issues related to the management of CPF assets. The evolution of contingent liabilities arising from budgetary guarantees and EU lending, against which CPF assets are held as provisions, will be discussed in a separate report under Article 250 of the Financial Regulation.

([1]) Pursuant to Article 214 of the Financial Regulation (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 Commission shall report annually to the European Parliament and to the Council on the common provisioning fund. The Asset Management Guidelines of the CPF (Commission Decision of 25.3.2020 on the Asset Management Guidelines of the common provisioning fund (C(2020) 1896 final, OJ C 131, 22.4.2020, p. 3–11) provide further guidance on the contents of this report.

([2]) European Fund for Strategic Investments (EFSI) and InvestEU.

([3]) External lending mandate (ELM), European Fund for Sustainable Development (EFSD) and European Fund for Sustainable Development Plus (EFSD+).

([4]) Except MFA+ loans granted to Ukraine in 2023.

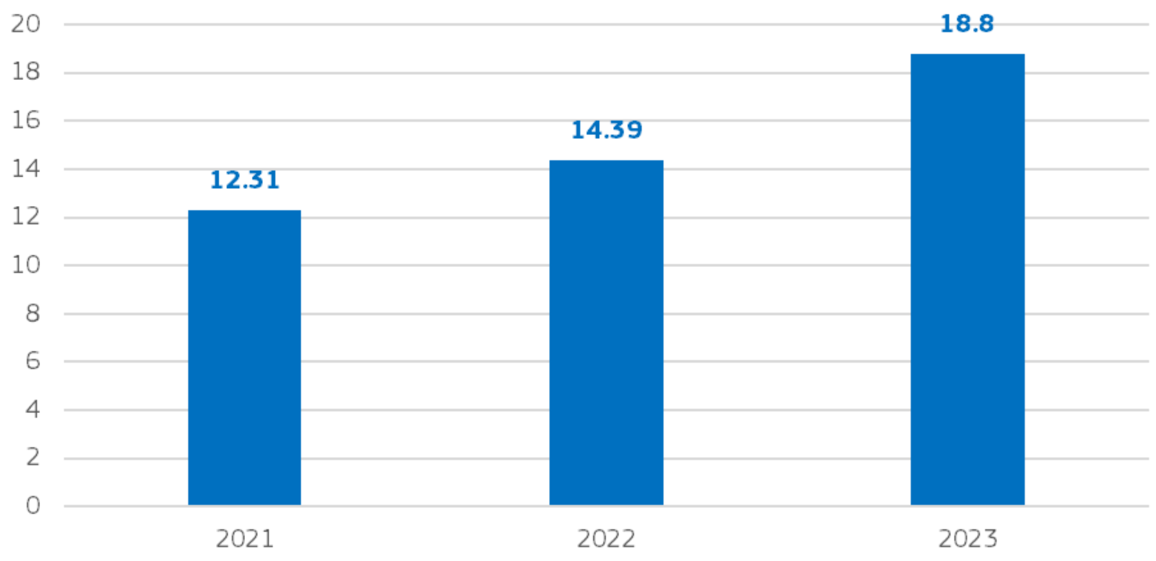
PART 1: KEY MILESTONES IN 2023

1.1. General overview

As in the previous years, the fund was managed in line with procedures under its established governance structure ([5]), and without operational incidents.

As at 31 December 2023, the value of net assets ([6]) was EUR 18.8 billion, representing an increase of EUR 4.4 billion on end-2022 (a 30% increase over the year). In 2023 the CPF received EUR 3.53 billion of net contributions from the EU budget or contributed by participating Member States and EFTA countries. The remainder of the increase in portfolio value (EUR 880 million) results from the increased market value of existing assets.

Figure 1: Evolution of CPF's net asset value (EUR billions)



More information on the financial statements is available in the staff working document accompanying this report.

1.2. Compartment structure

While the assets of the CPF are managed in accordance with a unique investment policy, they are held in different compartments linked to the individual budgetary guarantees and financial assistance programmes.

([5]) The governance structure was presented in the CPF annual report for 2021, [EUR-Lex - 52022DC0213 - EN - EUR-Lex (europa.eu)].

([6]) The net asset value (NAV) of the CPF is determined by the value of the total assets, less the liabilities, at the respective NAV calculation date.

The provisioning held by the CPF is earmarked per budgetary guarantee/financial assistance programme, in line with their respective legal frameworks ([7]). The amounts assigned to each budgetary guarantee are booked in distinct compartments to allow provisoning levels to be tracked relative to the levels set by the instrument establishing the guarantee. If provisions fall below certain levels, replenishments can be funded from the envelopes of the respective programmes.

In 2023, two new InvestEU Member State compartments were added ([8]) compared to 10 in 2022. The evolution of compartments over preceding years is described in more detail in the CPF reports for 2021 ([9]) and 2022 ([10]).

On 31 December 2023 the CPF was composed of 16 compartments, with 13 of them being fully operational and containing funds. The remaining compartments will be activated upon reception of the corresponding first inflows.

Table 1: CPF compartments as at 31.12.2023

Compartment	Market value in EUR as at 31.12.2023
Compartments opened in 2021	
EFSI	9,224,784,078.06
GFEA ([11])	2,776,909,740.77
EFSD ([12])	735,238,609.90
InvestEU ([13])	3,357,374,936.75
Compartments opened in 2022	
EFSD+	2,222,070,436.62
Post-2020 MFA	105,403,883.94
Exceptional MFA Ukraine ([14])	-
Post-2020 Euratom loans	-
Repurposed ELM loans Ukraine	-
InvestEU Guarantee Romania	80,817,782.06

([7]) In line with e.g. Articles 212.2, 212.4, 213.1 and 213.4 of the Financial Regulation.

([8]) For Malta and Bulgaria.

([9]) EUR-Lex - 52022DC0213 - EN - EUR-Lex (europa.eu)

([10]) EUR-Lex - 52023DC0288 - EN - EUR-Lex (europa.eu)

([11]) Guarantee Fund for external actions (GFEA), holding the provisions for the external lending mandate (ELM), legacy (macro-financial assistance - MFA) and Euratom programmes.

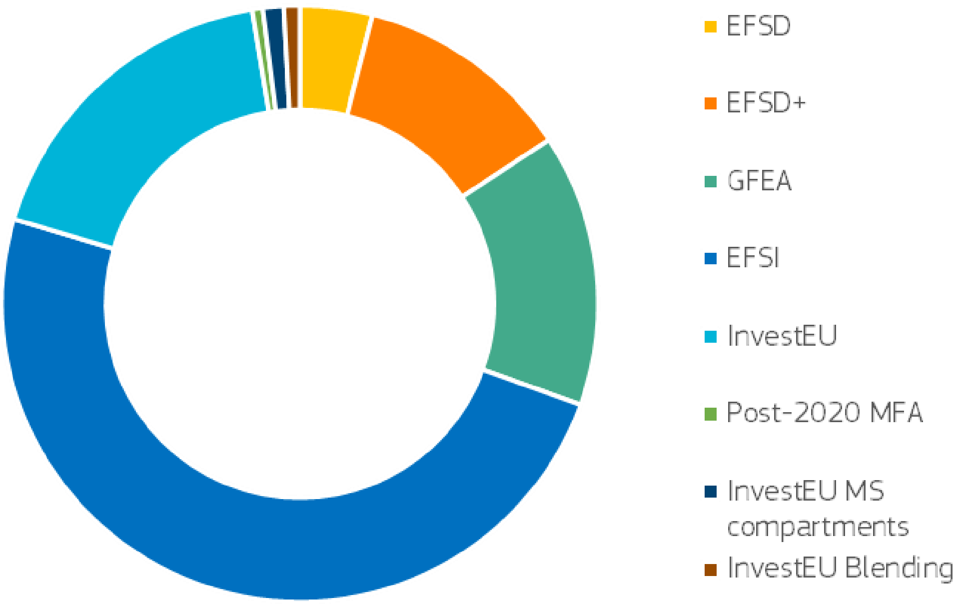
([12]) European Fund for Sustainable Development.

([13]) EU Compartment.

([14]) Under Decision (EU) 2022/12018 and Decision (EU) 2022/1628 providing exceptional macro-financial assistance to Ukraine.

Compartment	Market value in EUR as at 31.12.2023
InvestEU Guarantee Czech Republic	28,505,258.04
InvestEU Guarantee Finland	25,499.598.46
InvestEU Guarantee Greece	31,241,677.26
InvestEU Blending Operations	161,082,630.28
Compartments opened in 2023	
InvestEU Guarantee Bulgaria	41,334,023.23
InvestEU Guarantee Malta	6,352,640.21
TOTAL	**18,796,615,295.58**

Figure 2: CPF compartments size as at 31.12.2023



1.3. Guarantee calls and payment claims

The liquidity management of guarantee calls and payment claims is facilitated by a liquidity buffer, as provided for in the CPF Asset Management Guidelines (AMGs) ([15]). The liquidity buffer is constituted by limited reserves of cash held at the Commission's Central Treasury to cover the cash outflows expected to materialise over a 3-month period based on notifications from implementing partners.

([15]) Commission Decision of 25.3.2020 on the Asset Management Guidelines of the common provisioning fund (C(2020) 1896 final, OJ C 131, 22.4.2020, p. 3–11.

The buffer started 2023 with a balance of EUR 342 million. During the year it received inflows of EUR 114 million ([16]), while a net amount of nearly EUR 351 million was paid out in 2023 ([17]). At the end of 2023, the remaining balance of the liquidity buffer amounted to EUR 106 million.

The 2023 calls on the CPF provisions by the respective budgetary guarantees ([18]), as well as other demands on the resources held by the CPF compartments, are summarized below ([19]).

Table 2: CPF outflows in 2023, detailed overview

Compartment	in EUR mln	Nature of outflow
EFSD	**0.60**	guarantee calls
EFSD+	**0.04**	guarantee calls
GFEA	127.57	guarantee calls
	0.06	legal expenses
	127.63	**total**
EFSI	115.60	net calls and value adjustments of equity portfolios
	22.40	SMEW expenses and calls (net of replenishments) on guarantee products
	55.90	expenses (funding and recovery costs)
	193.90 ([20])	**total**
InvestEU	25.915	expenses (fees, negative interest, funding and administrative costs)
	1.585	guarantee calls
	27.50	**total**
InvestEU Romania	**1.20**	call under hedging cost reserve
Total outflows	**350.9**	

([16]) Out of EUR 114 million which are inflows coming from CPF redemptions, EUR 60.7 million are ELM recoveries.

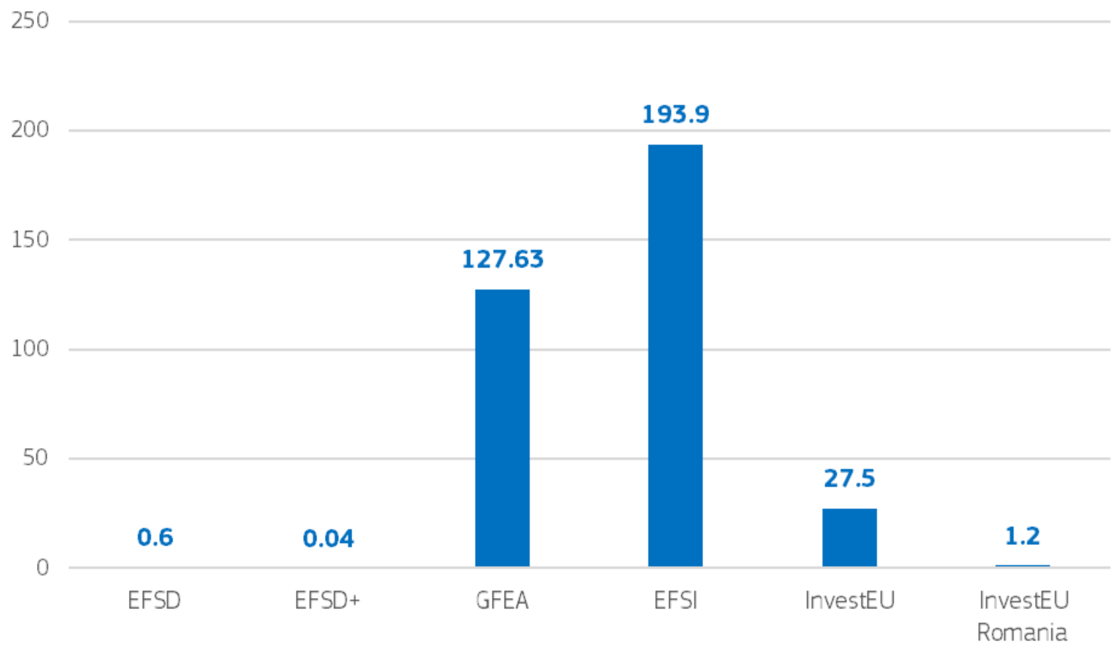
([17]) Compared to EUR 222 million in 2022.

([18]) Individual guarantee calls are mentioned in a separate report under Article 41(5) of the Financial Regulation (FR).

([19]) It is important to mention that payments may arise in 2024 or later, which may require ex post adjustment of the 2023 accounts.

([20]) Out of which EUR 14.7 million referring to 2022 calls, due to the fact that one of the payment transactions covered the period from 01/06/2022 to 30/11/2023.

Figure 3: 2023 CPF outflows per compartment (EUR millions)



1.4. Effective provisioning rate

Article 213 of the Financial Regulation provides that the provisioning of budgetary guarantees and financial assistance to third countries in the CPF will be based on the Effective Provisioning Rate (EPR) as defined in that Article. The EPR takes into account that the pooled management of the CPF – as opposed to the management of separate guarantee funds – could result in potential diversification if calls on the different compartments are not correlated in time or intensity.

The EPR is the ratio between

- the required amount of cash and cash equivalents in the joint-management set-up of the CPF, and

- the sum of the required amounts of cash and cash equivalents in case each compartment would be managed separately.

By law, the EPR should be set between 95% and 100%, with a figure below 100% pointing at a diversification effect. Following calculations based on the established methodology ([21]) and given the prevailing macro-economic and geopolitical uncertainties (some of the CPF compartments being highly dependent on the evolution of the situation in Ukraine), the Commission proposed that the EPR for 2023 remain at 100% due to the absence of any observed diversification between calls on the provisions of the different compartments. This approach was confirmed in the adopted Annual Budget 2024.

([21]) Commission Delegated Decision (EU, Euratom) C(2020)7684 supplementing Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council with detailed conditions for the calculation of the effective provisioning rate of the common provisioning fund (OJ L 42, 5.2.2021, p. 12).

PART 2: INVESTMENT STRATEGY, PORTFOLIO COMPOSITION AND PERFORMANCE

The general principles and considerations informing the CPF investment strategy are established by the CPF Asset Managment Guidelines and further described in the first CPF annual report for 2021 ([22]). Based on the conservative approach enshrined in its Asset Management Guidelines, and low risk-tolerance, the CPF is managed in a way that should, at least, deliver capital preservation over its investment horizon (9 years) ([23]). Reflecting this prudent investment policy, the assets in which CPF can invest are limited to highly liquid and highly rated fixed income securities. The bulk of the CPF has been to date restricted to investment in Euro- and US Dollar-denominated investment-grade fixed income securities (bonds). The Asset Management Guidelines were modified in 2022 to allow some limited investment in equity Exchange-Traded Funds to provide additional diversification opportunities for the CPF.

2.1. Composition and characteristics of the portfolio

As per its Asset Management Guidelines, the CPF maintains a liquid diversified portfolio, primarily investing in highly-rated debt instruments, such as bonds issued by governments, supra-nationals, state agencies and corporates.

The CPF portfolio at year-end was well diversified across the different asset classes in the eligible fixed income universe, including some limited exposure to non-euro denominated securities (USD), equity ETFs and cash or cash equivalents. Currency gains or losses on non-euro securities and transactions were largely offset by opposite changes in foreign exchange derivatives used as hedges.

The credit quality of the CPF portfolio was high, with an average rating of A, suggesting a negligible default probability ([24]).

Over 36% of the portfolio's market value was invested in AAA securities ([25]), with the rest distributed across the investment-grade scale.

USD-denominated investments represented 6.6% of the portfolio's market value ([26]), with currency risk hedged using forward contracts.

Equity represented 5.5% of the portfolio's market value at the end of 2023.

([22]) EUR-Lex - 52022DC0213 - EN - EUR-Lex (europa.eu)

([23]) Article 2(1) of the Asset Management Guidelines.

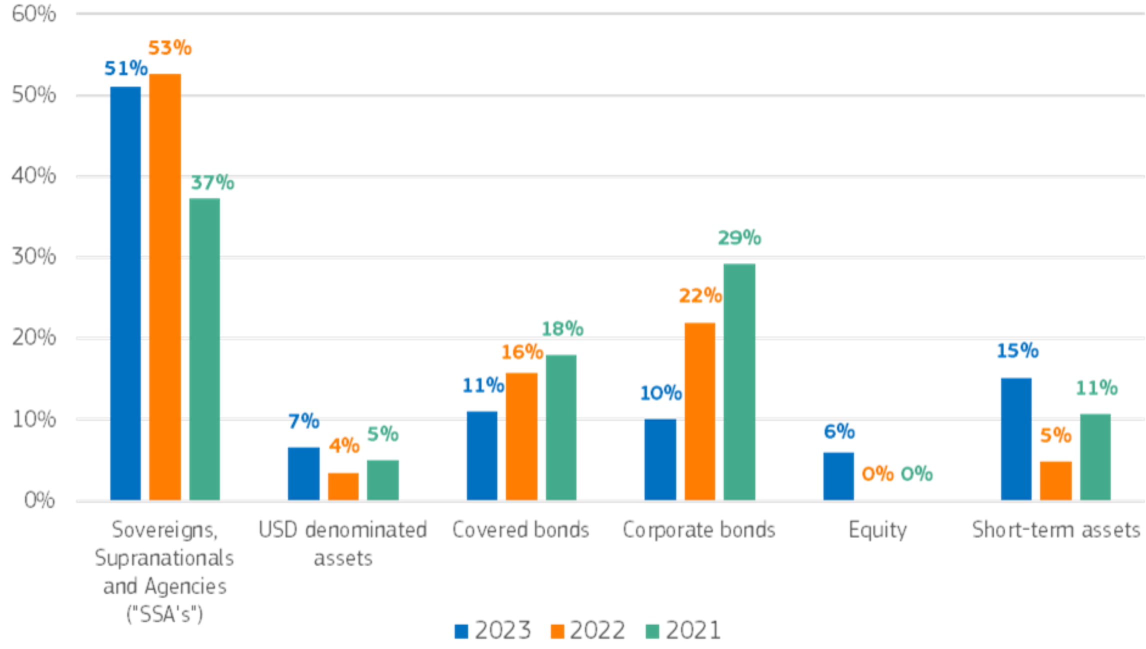
([24]) 0.04% default probability over a one year horizon.

([25]) Compared to over 35% in 2022.

([26]) Compared to 3.5% in 2022.

As of December 2023, about 15.2% of the portfolio consisted of short-term liquid assets ([27]), providing for a source of ready-to-hand liquidity in case of large outflows exceeding the size of the liquidty buffer described above ([28]).

Figure 4: CPF portfolio allocation at year-end (2023)



([27]) Compared to 18% in 2022.

([28]) On top of liquidity buffer described in Section 1.5.

2.2. Environmental, social and governance (ESG) footprint

In 2023 the ESG footprint of the portfolio remained strong, with 14.6% share of ESG-labelled bonds ([29]), compared to 14.0% in 2022. The proactive approach to ESG investing favours ESG-labelled bonds, provided they align with risk management criteria and overall investment strategy. In 2023 the Commission continued to reinforce the ESG footprint in the CPF's new investment strategy, as explained in the CPF annual report for 2022 ([30]).

2.3. CPF performance in 2023

In 2023, market volatility remained significant (see Box). In the last couple of months of 2023, however, inflationary pressure began to recede, leading to market expectations that cetral banks would start cutting interest rates in 2024. These expectations of pending rate cuts led to a partial reversal of the dynamic seen in 2022, and lent a positive impulse to the value of outstanding bonds owned by CPF. Further details on market developments are provided in the box below.

Against this background, the CPF achieved an annual return of +5.21% ([31]), in line with its portfolio benchmark (+5.40%). The newly introduced equity portion (on average about 3.1% during 2023) contributed +0.38 % to the total return of the portfolio. When looked at in isolation, the equity investment returned about +12.5%, which is more than twice the return of the fixed income portion in 2023.

([29]) In assessing whether bonds are classified as ESG-labelled for the purposes of CPF allocation, the Commission relies on the published assessment of the 'use of proceeds' of the asset in question by the analytics and data providers which the Commission uses for its asset management function.

([30]) EUR-Lex - 52023DC0288 - EN - EUR-Lex (europa.eu)

([31]) The cumulative return of CPF from inception to end-2023 is -5.22% reflecting the following sequence of annual returns: 2023 5.21%, 2022: -8.85%, 2021: -1.17%. Regarding the objective of capital preservation over the investment horizon (estimated at 9 years), this remains a fully achievable objective, especially considering that, post-2022, yield levels are firmly in positive territory, contrary to the negative or zero yield environment that prevailed when CPF was established.

Market developments in 2023

Inflation data and respective action from central banks were the main market drivers in 2023. Through early 2023, the European Central Bank (ECB) continued to raise its policy rates at every Governing Council meeting until September, when it paused, having reached a level of 4% for the deposit facility rate (from 2% to start the year). While some uncertainty regarding its sustainable return to the target level of 2% remained, inflation in Europe steadily decreased from its high starting point. In January, headline inflation stood at 8.6%. It had fallen to 2.4% in November, before slightly increasing, to close at 2.9% in December.

In the USA, headline inflation also receded, from 6.4% in January to 3% in June, before stabilizing and closing the year at 3.1%. The Federal Reserve Bank raised its key policy rate by a total of 1%, to a target range of 5.25% - 5.50%. The rate has remained at this level since July.

Besides hiking policy interest rates, major central banks kept signalling for most of the year that policy rates would not be reduced any time soon and would have to stay 'high for longer' to ensure inflation converges back to target. In this backdrop, bond yields were also gradually increasing during the first 9 months of the year and the 10 Year German government bond peaked at 2.96% in early October, from 2.44% at the start of the year.

In Q4, data releases showing lower than expected inflation allowed major central banks to pivot their communication in a less 'hawkish' direction and start to countenance the possible timing of the first policy rate cuts. This prompted markets to quickly price a substantial number of interest rate cuts in 2024, driving bond yields lower and, consequently, bond prices and returns higher. The 10 Year German government bond closed the year at 2.02%.

Moreover, economic growth defied negative forecasts that were prevalent at the start of the year, especially in the US, which posted a very strong growth rate, while Europe avoided a recession. The job market was also very strong, and the unemployment rates remained near record lows on both sides of the Atlantic.

The combination of resilient growth in the face of aggressive interest rate hikes and receding inflation extended the market rally to most asset classes. Besides government bonds, corporate bonds performed very well too. Likewise, equity markets posted a very strong rebound. STOXX Europe 600 index was up 12.7%, while USA's S&P 500 was up 24.2%.

CONCLUSIONS

The CPF posted a return of +5.21%, helping it to claw back part of the 2022 losses (-8.9%) and to replenish provisioning of guarantees. Looking ahead, the present higher and positive interest rate environment offers a solid foundation for returns over the medium-term. This is reflected in the portfolio's average yield-to-maturity, which remained at around 3% per annum at the end of 2023.

The challenging market situation encountered during 2022 underlined the risks of exclusive reliance on fixed income investments. To reduce dependency on bond markets, the CPF investment strategy was diversified in 2023 through investment in broad pan-European equity indices. The first year of experience with this new asset class was positive. The limited exposure to equity has shown its capacity to enhance returns consistent with the low level of risk. The CPF is well positioned to sustain its recovery trajectory and achieve longer-term stability and growth, in line with its investment objectives.