Workshop documentation
requested by the BUDG Committee

European Parliament

PROCEEDINGS
The EU borrowing strategy for Next Generation EU: design, challenges and opportunities

Budgetary Affairs

Policy Department D for Budgetary Affairs
Directorate General for Internal Policies of the Union
PE 733.141 - June 2022

EN

TABLE OF CONTENTS

WORKSHOP PROGRAMME 07

WORKSHOP PROCEEDINGS 09

IN-DEPTH ANALYSIS BY BRUEGEL 27
NEXT GENERATION EU BORROWING: A FIRST ASSESSMENT

POLICY PAPER BY SEBASTIAN MACK 63
DON'T CHANGE HORSES IN MIDSTREAM: HOW TO MAKE NGEU BONDS THE EURO AREA'S SAFE ASSET

BIOGRAPHIES OF SPEAKERS 83

PRESENTATIONS 91

Presentation by Grégory Claeys - Rebecca Christie - Pauline Weil,
Bruegel Senior Fellow - Non-resident fellow - Research assistant
Next Generation EU borrowing: a first assessment 91

WORKSHOP PROGRAMME

WORKSHOP ON

The EU borrowing strategy for Next Generation EU: design, challenges and opportunities

organized by the Policy Department on Budgetary Affairs
for
the Committee on Budgets

Wednesday, 27 October 2021
13:45 - 15:45
European Parliament, Brussels
Virtual meeting

DRAFT PROGRAMME

Opening remarks and Introduction

13:45-13:50	**Johan Van Overtveldt** Chair of the Committee on Budgets

13:50-13:55 **Valérie Hayer and Jose-Manuel Fernandes**
Co-Rapporteurs

Briefing by Bruegel on the EU borrowing strategy for NGEU

Authors

13:55-14:15 **Grégory Claeys - Rebecca Christie - Pauline Weil**
Bruegel Senior Fellow - Non-resident fellow - Research assistant

Discussants

14:15-14:25 **Sebastian Mack**
Jacques Delors Centre Policy fellow
Author of the policy paper *Don't change horses in midstream – How to make NGEU bonds the euro area's safe asset*

14:25-14:35 **Niall Bohan**
Commission DG BUDG
Director of asset, debt and financial risk management

Questions and answers

14:35-15:35 **Questions & answers**

Conclusions and closing remarks

15:35-15:40 **Valérie Hayer and Jose-Manuel Fernandes**
Co-Rapporteurs

15:40-15:45 **Johan Van Overtveldt**
Chair of the Committee on Budgets

***

***

PROCEEDINGS

Table of Contents

OPENING STATEMENTS 13

BRUEGEL (REBECCA CHRISTIE, GRÉGORY CLAEYS, PAULINE WEIL) 13

DELORS CENTRE (SEBASTIAN MACK) 18

COMMISSION DG BUDGET (NIALL BOHAN) 20

QUESTIONS AND ANSWERS 22

CONCLUDING REMARKS (CO-RAPPORTEURS) 26

Opening statements

The Committee Chair Johan van Overtveldt underlined that the EP as Budget Authority, has to monitor the bonds issuance very closely as our modest EU budget has to underwrite huge liabilities and will have to pay back several hundred billions of Euros in the coming decades. Even though Next Generation EU is in the strict legal sense not a breach of the equilibrium principle, we will have to deal with a budget de facto in deficit and a budget which will have to re-finance an unprecedented level of debts. This requires reflection, discussion, debate and we have invited experts to give input for our implementation report.

Co-rapporteurs for the implementation report introduced the workshop underlying:

José Manuel Fernandes

- NGEU is a means of **obtaining a geopolitical Europe and strengthening the Euro in a global context.**
- Very important that NGEU works well in terms of its outcomes but also as regards both the EU borrowing and the Member states' borrowing, and their coordination.
- this can be a "win-win" in spite of some views that Member states may have a harder time on the markets due to NGEU.
- NGEU must work properly without jeopardising future budgets, which means new own resources are needed.
- it is important in case we need future similar financing plans that a good precedent is set. This is historical as we have never been to the market before to change borrowed money into subsidies.

Valérie Hayer

- this workshop is timely and we hope it can provide some perspective on the Commission's strategy and some elements for comparing it with other major issuers' strategies.
- We need criteria to analyse the Commission's strategy and to assess its success.

Bruegel (Rebecca Christie, Pauline Weil)

These discussions represent a potentially important event for the future of EU borrowing because:

- It is the first discussion considering the EU as a **benchmark borrower**: EU borrowing on this scale is a major shift.
- It also is to change the perception of a large amount of debt from a risk to a strength. This can improve, strengthen, and make more robust the European bond and capital markets, whilst making the Euro stronger.

Our in-depth analysis[1] aims to show:

- The current development and potential evolution of the borrowing programme.
- How the programme interacts with the banks acting as intermediaries between the EU as an issuer and the financial markets.
- where the programme could head, going forward.

For context, the EU has been selling bonds on a smaller scale than the European Investment Bank (EIB) or the European Stability Mechanism (ESM) for a long time and they were considered a small but safe asset. This was for three programmes backed up by the EU budget in various ways. With the pandemic, a new will emerged to use the EU collective market access for the common good.

<u>The EU's borrowing needs</u>

The perception of the headroom between the payment and own resources ceilings changed during the euro crisis. There was an idea that this gap could be increased as much as needed during this when the EFSM was created. Back then, it was considered a legal overstep. Now, with the common need from the covid-19 pandemic and the previous experience from the euro crisis, the mechanism is found to be **legal and compatible** with the mechanisms of the EU and the political will of the people involved.

- NGEU was preceded by the SURE programme, which involved €100bn of borrowing during the course of 2020-21.
- NGEU involves up to €750bn of borrowing in 2018 prices.
- This includes €80bn to be issued in 2021 followed by €150bn annually from 2022 to 2026.

Following **2026** when new borrowing stops the EU's involvement in the capital market will continue with debt rollover, and through managing its place in the markets to prevent a sudden large balloon payment and allow the debt to be paid off gradually. This will help to ensure stability in not just the EU budget but also the financial markets where they are already getting used to EU debt existing on the market, playing a benchmark role in portfolios and bank balance sheets, and acting as a cornerstone on the capital markets. Repayment should be concluded, however, by **2058**.

NGEU can increase the prominence of the euro globally. The dollar is currently dominant because treasuries are the current undisputed risk-free global safe asset. Whilst NGEU is not on the same scale, its size means it can begin to play an infrastructure role, not just a financing role.

<u>Main features of the EU's borrowing strategy</u>

Going to the markets at scale requires strategy and a plan for working with both primary and secondary markets over time. This implies a diversified funding strategy which means thinking about cash management, the mix of short-term and long-term borrowing (working across the spectrum of

[1] Next Generation EU borrowing: a first assessment, Policy Department for Budgetary Affairs, Directorate-General for Internal Policies (PE 699.811) - October 2021.

maturities from 3 months to 30 years), the mix of syndicated bond sales (used hitherto) and auctions to achieve accurate pricing and low borrowing costs. .

Two main strategies

- **Diversified funding strategy**: for large issuers, regular and predictable issuances, long term perspective. What US, and major EU issuers have been doing for a long time, what the EU started doing in 2021.
    - Aim: low rates and a resilient source of funding. Investor diversity. Make EU bonds benchmark risk-free assets.

- Opportunistic strategy: more for small issuers, allows for punctual borrowing and adapting to market conditions.
    - Aim: to get the lowest interest rates.

A diversified funding strategy is recommended to the EU based on the above listed factors.

Main features of the diversified funding strategy for the EU

- Diverse type of securities: denominated in euros only. Across the spectrum of maturities (3-month bills- 30Y bon). Also included in this are Green bonds.
    - Diverse maturities: Spread out repayment, attract diverse investors, create a **yield curve**.
- Using a mix of syndicated bond sales and auctions is great to mix contact with both primary and secondary markets, get more accurate pricing and hopefully better borrowing costs for the issuer. Credit lines and private placements are also options.
    - Syndicated transactions: Less risky at start, allows for investor targeting.
    - Auctions: less costly, only method used for EU bills, and so far only for bond taps.

Before NGEU, the EU was only entering the markets right before it needed to make a payment, it did not have the chance to develop this benchmark yield curve or establish relationships with investors.

Developing relations with investors

The Borrowing strategy should generate confidence and ensure attractiveness of EU securities:

- Predictability and accountability: annual borrowing decision and funding plans twice a year. Markets should know when the EU plans to enter the market and what to expect.
- Attractiveness of EU securities: securing good ratings, high liquidity in secondary market. Should be attractive relative to peers.
- Confidence: Solid guarantees have been set up; Credible source of "income" for reimbursement: increase in callable "headroom" by 0.6% of MS GNI, and, if possible, increase in new EU own resources. So far, there is confidence that the EU will be a **"solid" borrower**.

The Importance of setting up a primary dealer network

The EU has set up a primary dealer network. Primary dealers are banks possessing a special responsibility to handle the syndicated sales and bid in the build auctions. Therefore, they help make primary and secondary markets. Bruegel highlights the importance of these secondary markets in the overall strategy.

Further, they mention another shift in EU borrowing and its role in the capital markets from the previous strategy of simple "buy and hold" selling of securities which are held for interest until their maturity. For a benchmark issuer playing a larger role**, liquidity is important**, in that its securities can sell quickly and trade on secondary markets. Auctions and primary dealer networks are important to acquire this. Only primary dealers can participate in auctions. This can also reinforce the strength of these securities as a risk-free benchmark asset and the role of the EU as a reliable issuer, through the selling on and circulation of these securities on the secondary market by primary dealers.

Primary dealers are important partners both for syndications and for auctions; relations must be managed well, especially in multi-country situations where national treasuries may lobby for national champions. Therefore, Bruegel recommends that **sufficient incentives are needed** to perform the job well.

Comparing the EU to other Issuers: Choice of a large PDN

The primary dealer network of the EU is vast relative to other major issuer's networks. This stems from the EU's strategy to have more dealers and thus less individual responsibility. This also comes from the decision to have a low auction participation duty (duty to bid at auctions for 0.05% of the total volume issued) in contrast with countries that have less dealers and a higher auction participation duty (e.g. for Spain the duty is at 3%).

Because dealers have an important role, the incentives for them need to be high enough that they undertake their role effectively. The incentives mentioned by Bruegel include:

- Reputational gain: that it looks good to be seen as a primary dealer that performs well for the European Union.
- Fees for syndication: Commission has opted for low fees, therefore Bruegel states **that it is important to monitor the situation in the longer term to see whether this incentive is sufficient**.

Money raised for 2021

€54 billion raised so far out of €80 billion.
In a syndication, primary dealers work as a syndicate placing bonds with investors. Since they act as intermediaries the bond sale is less risky but also more pricy.
Past syndicated transactions attracted a satisfactory and diverse pool of investors in terms of geography and types of buyers (traders/buy-and-hold investors), although international interest was not particularly high. Buy-and-hold investors provided price stability.
Past auctions were also successful being oversubscribed and having weighted average yields slightly above market prices. This shows secondary market interest.

<u>EU Credit Rating is also high and comparable to its Peers:</u>

- The EU is rated AAA by Fitch and Moody's, but AA by S&P, which takes the average of all MS ratings.
- The ESM is rated AAA by Fitch and S&P, but Aa1 by Moody's.

The EU has to watch the balance of dealers, to make clear there is no country bias. Primary dealer networks must be seen as apolitical.

<u>Impact on EU Countries Borrowing Strategy</u>

Currently, the EU has been doing a good job at coordinating with its debt management offices in a way that going into the market does not interfere with other debt sales.
Crowding out has been avoided thanks to careful management; interest in euro area debt has actually been creating crowding in from around the world. EU must keep an eye on crowding out but the current effects are positive.

The NGEU programme also grants the opportunity to certain member states to borrow **more cheaply on the market** than they would have otherwise done themselves. NGEU provides a cheap and reliable source of funding,.

<u>Risks and Opportunities for the EU in becoming a Large Issuer</u>

Usual risk for DMOs: manage cash flow, monitor liquidity (how well EU debt is trading), and market conditions to prevent spill overs.

Benefits to EU capital markets: temporary because of the temporary nature of the tool. The end date of NGEU will inhibit any lasting effects.

- Increase the pool of EU safe assets. A European benchmark for interest rates will emerge.
- Reduce market fragmentation and increase resilience.

<u>The EU as a Sustainable Business Hub</u>

The EU will become the largest green bond issuer and the largest sustainable finance source in the fixed income market, which is a great proof of concept opportunity.

<u>Opportunity to mitigate the Sovereign-Bank Doom Loop</u>

Potential opportunity: If the EU becomes comfortable with large-scale borrowing and recognises it as successful. It could consider making the borrowing aspect of NGEU a more permanent part of its budgeting.

Permanence would be beneficial from both a **market and budgetary perspective**.

Some of the more controversial aspects of the borrowing are the transfers from one country to another, a feature that can stay on a separate temporary track as linked to the crisis times, while the market would be much more sensitive to the permanence of the scheme.

Experts described how the Commission utilises the usual standards for assessing whether something is truly "green" however, standards are not strict enough to prevent all greenwashing. The Commission has been working on this with the European Green bond standards. It has been looking on getting

more stringent labelling with the taxonomy. This is an opportunity for the **Commission to have a global effect in setting higher standards in labelling green bonds.**

Main Recommendations

- Make sure borrowing goes smoothly
- Make sure yield curve is as **robust and reliable** as possible
- Make sure the primary dealer network is handled well in a way that minimises political tensions.
- Ensure green finance is properly implemented and effectively **avoiding greenwashing.**
    - Have the Commission lead in ambitious standard setting in sovereign green issuances.
    - Adopt as much as possible the EU taxonomy.
    - Make the climate tracking methodology of RRF more strict/scientific.
    - Align reporting obligations with European Green Bond standards as much as possible.
- Consider looking at current time limitations of NGEU, it made sense for Covid-19. Going forward and based on the track record of these experiences the EU will now have more opportunities to choose how it finances itself.

Delors Centre (Sebastian Mack)

Two main points to elaborate on, considering their relevance for the work of the EP committee on budgets, are:

- Green Bonds
- The importance of EU bonds for financial stability

Green Bonds

Some say the recent first issuing of green bonds by the Commission came too early. They argue this because the EU green taxonomy is not finalised yet and the EU green bond standard has not become law yet.

This decision to issue green bond presents benefits and risks:

- On its own, financing the recovery with green bonds does not make recovery spending any greener, i.e. no additional euro of NGEU is spent in a more sustainable manner because part of the funding comes from green bonds. Indeed the greenness is determined by the spending rules of the Recovery fund and by Member states recovery plans, yet the climate financing criteria of the Recovery fund are not as "dark green" as prescribed by the EU green taxonomy.
- However all recovery expenditure have to comply with the "do not significant harm" principle so rules exclude financing projects that would be environmentally harmful
- there are practical challenges associated with issuing part of NGEU debt as green bonds, the most pressing of which is preventing greenwashing and here the construction of the recovery fund is posing a particular challenge: normally the issuer of the bond is also the one who spends the money whereas in the case of NGEU the issuer of the bond is different from the entity which spends the money
- Commission is raising funds and is responsible towards investors in capital markets but it is the MS which actually spend the money, it will therefore be crucial that they stick to their promises made in the recovery plans and report honestly and thoroughly to the Commission on the use of the money; the Commission in turn is asked to carefully assess whether MS fulfil their commitments: projects which do not live up to their promises cannot be financed by green bonds

as allegations of greenwashing would be detrimental not only to investors who could feel betrayed that the money was used for other purposes than climate protection, but also to the credibility of the EU as an issuer, which could lead at worst to difficulty selling its debt on the markets, and the refinancing costs for NGEU debt could shoot up

- low funding costs is indeed one of the opportunities attached to green bonds; investors are willing to pay a higher price for green bonds than for conventional bonds; the first issue of green bonds confirmed this price add-on, which financial professionals call "greenium"; the latter will not disappear in the foreseeable future as the supply of green bonds is increasing but still limited; big institutional investors and recently also central banks are putting more and more emphasis on sustainability aspects; higher investor demand means higher prices for green bonds and lower yields: this reduces the funding costs of green bond issuers and the EU is now one of them, benefitting from this trend
- the second opportunity offered by the strategy to finance NGEU with green bonds lies outside the remit of NGEU and is directly linked to the EU green deal: selling up to EUR 225 billion in green bonds creates a massive boost for the greening of the financial system. With this step, the EU is giving a forceful signal to financial markets that it is eager to defend its leading role in sustainable finance. In concrete terms, the EU green bond issuance is expected to inspire other bond issuers and amplify sustainable investment generally. Therefore not only the spending side but also the funding side of NGEU is creating additional impetus for greening the European economy.

Importance of EU bonds for financial stability in Europe

- EU bonds are of particular importance for the Eurozone. So far, the monetary union did not have a common safe asset, only a national one, namely the Bund, German sovereign bonds.
- In the euro crisis we saw that relying on a national safe asset is extremely dangerous for the weaker members of the euro club .
- In the absence of a common safe asset, market participants fled towards German bonds, which raised borrowing costs sky high for crisis countries and nearly pushed the economic and monetary union off the cliff.
- EU bonds could become the common safe asset that the eurozone so urgently needs; already the announcement of NGEU, with its expected positive impact on growth, reduced risk premia for national EU sovereign bonds.
- The issuance of EU bonds could make sovereign interest rates converge even further. It is however too early to say that we have overcome the risk of a flight to safety: interest rates are compressed also due to the ECB heavily buying bonds in the secondary market.

Two thing are preventing EU bonds from becoming the new anchor of stability:

- Even if all NGEU loans were taken out the total amount of EU bonds would remain far below the current benchmark Eurozone issuer that is Germany. EU bonds are boxing in another "weight class" than the acting "champion" and as long as this is the case they will not be able to replace it
- Temporal limitations of NGEU debt is also hampering the safe asset status of EU bonds. With the start of the repayment phase the outstanding volume of EU bonds will constantly decrease, this will reduce the already limited liquidity and at some point, investors will face difficulties in replacing matured bonds with new ones.

Strong legal and political constraints stand in the way of making EU borrowing permanent (as opposed to exceptional and extraordinary as it currently is).
Nevertheless:

- From an economic point of view, it makes perfect sense to maintain the EU borrowing.

- The alternative to permanence is not tempting: when the EU starts to repay each year a certain amount of bonds that fall due, investors will probably start buying national EU sovereign bonds again, and we will be back to the situation we had before the Pandemic, without a common safe asset and with the threat of a new flight to safety at the next crisis.

Sebastian Mack, as an economist, strongly recommends:
- rolling over the debt so that bonds can stay in the market and
- increasing the outstanding volume, possibly.

Commission DG Budget (Niall Bohan)

Four main points and two concluding thoughts.

First remark:

- The NGEU issuance has the potential to, and is delivering important windfall benefits for the functioning of the EMU and international role of the Euro, which the Commission is keen to exploit. The paper by Sebastian Mack gives an excellent description of these benefits and the Bruegel paper showed how interest rates converged thanks to the perception of solidarity in the Recovery fund. Thanks to NGEU, there is signs of renewed confidence in the euro's stability and durability where previously doubts lingered among investors.
- however **NGEU is exclusively a funding machine for the Recovery fund**, its aim is not the creation of a safe asset in Europe.
- The NGEU lifetime, volume, and pace are dictated by the legal and budgetary architecture establishing the Recovery fund: the issuance of new debt will stop in 2026. There will be a lot of refinancing and large amounts of it in particular in the period 2026 to 2035 so the EU will remain present in the bond market as we manage the debt downwards until it is fully repaid by 2058. The bigger lesson is that NGEU, and SURE before it, show there is a very strong pent up demand by investors in Europe and across the world for this liquid, highly rated, euro denominated debt. Hopefully this will give food for thought when we think about the financing of future EU expenditure policies

Second remark:

- The biggest risk faced when funding the Recovery fund is that we would not be able to make available the money to the Member states and policies on good advantageous terms when they need it. The diversified funding strategy, well described in the Bruegel paper, is necessary to minimize this risk. The NGEU issuance programme is a huge risk mitigation machine. With the new EU bill programme in place now, we are confident that we can mobilise cash cheaply at short notice to avoid any liquidity shortfalls.
- We have thus been able to mobilize EUR 70 billion to date in bond issuances and a further EUR 14 billion via bills and that has allowed us to pay EUR 55 billion to 18/19 Member states pre-financing for the RRF and a further EUR 10 billion to top up EU policies; the money was made available to Member states within five days of the signature of financing or loan agreements: credit must be given here to the ECB which played a valuable role managing our NGEU payment flows.

The Bruegel paper identifies two sources of reputational policy risks that are the subject of the last two remarks.

Third remark:
Risk in managing the Primary Dealer Network (PDN):

- the successful implementation of NGEU depends on an effective EU PDN as it gives access to investors and distribution systems across the EU and beyond; the EU has a large network (42 banks from 12 Member states).
- Banks have been selected in a fair, objective manner: selection is driven by the behaviour of the banks (i.e. how they support the EU in auctions, in the secondary market trading)
- The process should not be driven by geographical balance considerations: we cannot compromise on deal execution quality; the geography of European banking is such that banks are domiciled predominantly in the economically largest EU countries.

Fourth remark:
Risk of greenwashing around Green Bonds:

- The NGEU green bond issuance programme is a historical opportunity to put the EU in the driving seat i.e. a global leadership role in sustainable finance markets: it's a chance to launch a EUR 250 billion programme of green bonds without waiting for the Green bond standard to enter into force in two or three years
- The framework built which was published on 7 September 2021 is robust: it goes beyond the standard ICMA principles and it uses the taxonomy as much as possible applying it to public expenditure in a suitably calibrated way.
- we have invested heavily in traveling around Europe to talk to investors, pension funds etc. We are vindicated by the turnout on the first transaction: a EUR 143 billion order book allowing us to issue the world's largest ever green bond issuance. That is a vote of confidence in the Green bond framework published
- we don't take it for granted and we invest now in monitoring information provided regularly by the Member states in order to ensure that the expenditures are made as planned; if we remove expenditure from the green bond programme for lack of "greenness" we will communicate about it in addition to the use of proceeds and impact reporting

Two thoughts to conclude:

- What is at stake is an unprecedented fiscal experiment and the Commission is determined to make it succeed to show that it deserves the trust of the EU legislators. To run it as objectively as it can there will be three levels of risk management, internal processes will be mapped and documented, reducing discretion and subjectivity; a Chief risk officer and a Compliance officer have been appointed; we are subject to internal and external audits which have already started. There will be extensive reporting to the EP and Member states on how this is rolled out.
- We have built a very lean, fit-for-purpose funding machine at high speed and at a very low cost for the EU budget and the tax payer, with no consultants, no private sector suppliers: it has been an EU pan European public sector effort with the support of the ECB, the EIB, the ESM, with staff secondments and project work, the Banque de France which is in particular running our auctions now and we have remained in very close contact with the national sovereign issuers as we need to work hand in hand with them.

The Commission is keen to continue working also with the EP to ensure NGEU continues to be a success story.

Questions and Answers

The Chair gave the floor first to Co-Rapporteurs Jose Manuel Fernandes and Valérie Hayer then to other BUDG Members.
Questions from MEPs and answers by experts and the Commission representative are grouped and summarised by subject below.

(Im)permanence and role of EU bonds

Many questions were raised by MEPs concerning the impermanence of NGEU bonds existing on the market and what consequences this entailed: could EU bonds be considered a safe asset? What is the effect of temporality on borrowing prices? How can this good start be maintained and what needs to be avoided? Could the demand for more joint outstanding debt create instability for the eurozone?

Bruegel:

- *Markets would love to see EU bonds being permanent, and seen as a benchmark asset. They would love the good yield curve that is currently being established to be a permanent feature in the markets. From a market infrastructure perspective, there is considerable interest to go forward.*
- *Politically, however, it is much less clear; such borrowing was previously considered unacceptable and only has occurred now due to the covid-19 pandemic. It remains to be seen whether it will be acceptable or in a new form going forward. It is up to the political leadership to decide on this.*
- *Permanence would strengthen the EU issued bonds role in the financial markets. The personal view of Rebecca Christie is that if the EU were to continue borrowing the money, divide it by a key and hand it out to MS without any transfer this would probably please the markets and lower borrowing costs. This would also help the euro be seen as more of an international currency and a player in the long-run.*
- *The permanence of the borrowing can be separate from the permanence of the spending*

For co Rapporteur Jose-Manuel Fernandes, NGEU is not only useful for the recovery but also to tackle digital and climate issues: is there sufficient money in the fund, should it be beefed up?

Delors:

- *This is a political decision. As Commission stated, the reason for EU borrowing is on the spending side, if the EU decides at a political level to spend more, then more borrowing will be needed.*

- *From the financial market side, the fund is not big enough. When adding the EU programmes, SURE and now NGEU we might be close to one trillion euros outstanding EU bonds. This is a lot lower than the current outstanding debt of Germany and only half that of Italy and France. To make a difference in the status quo and become a safe asset and benchmark, EU borrowing needs to be expanded.*

Role of the Parliament

One of the most prominent concerns/enquiries positioned to the Commission and the researchers was the role of the Parliament in the borrowing strategy and process. The co-Rapporteurs highlighted this in particular, and wondered what the role of parliamentary control is regarding the borrowing of other major issuers (the latter point was however not answered)

Bruegel:

- *Make sure people are doing their jobs; monitoring is naturally a role of the parliament. Ensuring fairness towards primary dealers and that objective criteria are upheld within the PDN network.*

- *Tone setting: if the Members in their capacity as representatives and lawmakers see the utility of having the euro as a stronger and mature currency, then supporting some form of permanence in the borrowing -which again can be completely separate from the permanence of the spending- could further its acceptance across the EU.*

Delors:

- *The EP did its best to obtain more political influence but Member states are now in the driving seat. Nevertheless, the EP should exert full political pressure on member states to ensure proper spending and should flag any incidents. It should give political support to the Commission's monitoring. Political pressure could be placed on the ECB, which is independent but accountable, to treat EU bonds like a European safe asset. Currently, the ECB discriminates against NGEU bonds. It applies higher haircuts than for national sovereign bonds, which means that banks get more money when handing in as collaterals national sovereign bonds, over EU bonds. The EP could tackle this in the monetary dialogue.*

Green bonds

Several questions were asked by MEPs on the topic of green bonds, including on greenwashing issues and uncertainties associated with secondary markets' reactions to green bonds. A question was also raised following Bruegel's recommendation that climate tracking methodology of RRF investments could be more strict, scientific, and adopt to a greater extent the EU taxonomy. Based on the news that the Commission plans to continue the 100-40-0% approach, a clarification of Commission's views was requested.

Bruegel:

- *Taxonomy is said to change and become more extensive in the future and it will be interesting for the Parliament to monitor the developments of this to see whether these extensions are reflected in EU borrowing as well.*

Commission:

- *Green bonds take as its core the climate taxonomy. Expenditures on policies and activities that are compliant with this will benefit from the 100% weighting. This will form the large part of the eligible Green Bond expenditure.*
- *There also many climate relevant expenditures that do not fit in the climate taxonomy. They are oriented towards productive investments by private sector actors, which can assess the impact of a project against climate taxonomy metrics (e.g. climate research or upscaling support for climate expenditure). These are admitted to the framework with a 40% weighting because we cannot do the measurements against the climate metrics in the same scientific way as required by the taxonomy. It's a common sense approach to cater for Member states actions that are clearly climate-relevant. The point made by Bruegel on transparency and the tracking of climate relevant expenditure is very valid, we are committed to it.*
- *Regarding the liquidity question on Green bonds, with the NGEU Green Bond issuance programme there is the chance to build an unprecedented liquid green bond curve.*

Perception of EU borrowing and effect on other issuers

Co Rapporteur Valérie Hayer found extremely interesting the virtuous effect NGEU has not only on EU borrowing but on national borrowing and asked whether this could be developed.
The attractiveness of EU borrowing to issuers / member states was a potential concern for some, including co Rapporteur Jose Manuel Fernandes.
The uncertainty surrounding the economy and how it will develop in/after the Covid crisis was also raised.

In addition, what could be the impact on EU bonds' trading of the agencies' different rating approaches, particularly of S&Ps lower rating "AA"?

Bruegel:

- *Borrowing through the EU is attractive to all member states due to its triple A rating and is cheaper for borrowing than through national means in nearly all member states.*
- *Joint EU borrowing plays to increase the activity of the euro area as a whole and in this sense all Member states stand to benefit from EU level borrowing.*
- *Further, financial markets are reacting in a positive way signifying that EU borrowing for grants is not perceived as something creating liabilities for countries outside their balance sheets.*

Commission:

- *The S&Ps different rating is still "stable with a positive outlook". There is a positive consensus across credit agencies.*
- *Support has in fact been strengthened by the recovery fund. They understand the budget is behind the debt and that the debt is being managed well within the own resources ceiling.*

<u>The effect on the EU budget of EU borrowing, and its audit</u>

NGEU repayments are already visible in the EU budget 2022 but what about the Members which do not receive NGEU grants like Hungary or Poland?

Commission:

- *There will be no repayment of NGEU debt principal before 2028. All that MSs will be asked to contribute to the budget will be the repayment of coupons and interest rates. A conservative approach has been taken, to allow for enough money in the budget being available to pay for the interest rate payments between now and 2027.*
- *The proposed amount of €380mn due for repayments for 2022 will be looked at in the annual budget discussions, however, according to Niall Bohan it is unlikely that these will be decisive matters, and a sensible outcome will be found.*

What is the external audit that Commission refers to?

Commission:

- *External audit refers to the ECA which is entitled to review the budget implementation.*

<u>International Interest in EU Bonds and Geographic Spread</u>

Questions were raised relating to the detailed geographical location of investors, the imbalance of investors between Europe and the rest of the world and the lack of interest in particular from the US and Asian investors.

Bruegel:

- *American investors are not as interested in euro bonds as they could be or they operate through intermediaries such as in the UK, which can explain the lack of direct American investors.*
- *The ESM is now issuing in dollars, which is encouraging some American investors to be more comfortable in euro area debt that could later translate into interest in European debt in euros.*

Delors:

- *EU debt is not regarded by all investors as a fully-fledged safe asset because of its limitations in time, in outstanding volume (decreasing already from 2028) and in liquidity.*

Commission:

- *Many Asian investors only invest in short round investments with maturities of less than ten years whereas European investors (such as pension funds, insurance companies,...) sometimes only become interested after ten years.*
- *The mix of European/non European investors varies from transaction to transaction. Interest was shown from China, Singapore, Japan, Indonesia so far, with others, as they become more aware of NGEU.*
- *The UK remains a global financial hub and hosts many asset managers and pension funds who access our issuances on behalf of investors across the world, explaining its large ownership of EU bonds.*

<u>The Primary Dealer Network</u>

Is the management of the PDN national-sensitive? What explains the lack of Central and Eastern European banks in the PDN? Are there improvements to be made?
Why are the duties of primary dealers so different when comparing issuers?

Commission:

- *There is an open membership process with objective criteria for prospective banks. No targeted selection occurs from within the Commission itself. There is no restriction on anyone applying, however no applications were received from Central and Eastern Europe.*

- *Rigorous and fair management shall exist with the PDN. A methodology exists which is strict and objective on which banks are able to engage in syndicated transactions. Syndicated fees are low because of the volumes at stake and because it is a good thing to do on behalf of the EU budget and taxpayers. Banks and member states where they are headquartered respect this and no attempt to influence the outcome or lobbying has been encountered.*

- *In the US the central bank, the federal reserve of New York, requires primary dealers to participate to a much higher level in auctions in order to be eligible to the PDN. In Europe the minimum amount to participate in an auction is much lower, at 0,05%. The reason is the US system is completely different where primary dealers are obliged to participate in a system run by the monitoring authority and there are no syndicated transactions organised by the US authorities. Our reference is European issuers rather.*

Bruegel:

- *There are two major differences between the US and EU. The 5% requirement in the US is to bid at multiple levels, not to buy. The US also has a single price auction system rather than a multiple price auction system. In the US when the authorities calculate the final price of the auctions they draw a line in the sand and everybody who gets securities buys them at the exact same price. So if you are required to bid 5% but4,9% of your bid is out of the money, you don't end up anywhere near the amount of the offering, that is just a back up to make sure the auctions don't fail. The EU system like most of the systems in the euro area is multiple price: they hand out all the bills or bonds at the best price for the EU and then they go down the list so that 0,05% is what you have to actually buy and take on to your balance sheet. It is really a major structural difference.*

Concluding Remarks (Co-Rapporteurs)

Jose Manuel Fernandes:
This workshop will help feed into the report. I hope NGEU will be a success and will provide stabilisation for the Eurozone and help make Europe a geopolitical actor. It is important to include all member states. NGEU can help the Eurozone in meeting its digital, climate, and recovery goals. I am happy with the good market reception and think it is heading in the right direction.
Parliament will do all it can to enhance its role, monitoring the process and ensuring accountability and democratic legitimacy.

Valérie Hayer:
You can count on Parliament's commitment to move forward in the interests of the European project. There is no lack of hands to make this work. There is also a collective responsibility to make it work. Repayment methods need to further be looked at and kept an eye on.

IN-DEPTH ANALYSIS

IN-DEPTH ANALYSIS
Requested by the BUDG committee

Next Generation EU borrowing: a first assessment

Policy Department for Budgetary Affairs
Directorate-General for Internal Policies
PE 699.811 - October 2021

EN

Next Generation EU borrowing: a first assessment

Abstract

The Next Generation EU programme is radically changing the way the EU finances itself and interacts with financial markets. This paper assesses the first design decisions made by the European Commission and the issuances that have taken place so far. It also outlines the potential risks and opportunities linked to this upgrading of the EU borrowing.

This document was requested by the European Parliament's Committee on Budgets.

AUTHORS
Rebecca CHRISTIE, Bruegel
Gregory CLAEYS, Bruegel
Pauline WEIL, Bruegel

ADMINISTRATOR RESPONSIBLE
Alix DELASNERIE

EDITORIAL ASSISTANT
Mirari URIARTE

LINGUISTIC VERSIONS
Original: EN

ABOUT THE EDITOR
Policy departments provide in-house and external expertise to support EP committees and other parliamentary bodies in shaping legislation and exercising democratic scrutiny over EU internal policies.

To contact the Policy Department or to subscribe for updates, please write to:
Policy Department for Budgetary Affairs
European Parliament
B-1047 Brussels
Email: Poldep-Budg@ep.europa.eu

Manuscript completed in October 2021
© European Union, 2021

This document is available on the internet at:
http://www.europarl.europa.eu/supporting-analyses

DISCLAIMER AND COPYRIGHT
The opinions expressed in this document are the sole responsibility of the authors and do not necessarily represent the official position of the European Parliament.
Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the European Parliament is given prior notice and sent a copy.
© Cover image used under licence from Adobe Stock

CONTENTS

LIST OF ABBREVIATIONS **34**

LIST OF FIGURES **35**

LIST OF TABLES **35**

EXECUTIVE SUMMARY **36**

1. INTRODUCTION **37**

2. WHAT ARE THE MAIN FEATURES OF A BORROWING STRATEGY? **39**

Market credibility 40

3. WHAT ARE THE MAIN ELEMENTS OF THE NGEU BORROWING STRATEGY PRESENTED SO FAR? **42**

The EU's primary dealer network 44

4. THE EU AS A 'QUASI-SOVEREIGN' ISSUER? **48**

EU debt issued so far 50

5. OPPORTUNITIES AND RISKS **54**

5.1. Impact on MS borrowing strategies 54

5.2. Impact on EU capital markets 55

5.3. International role of the euro 57

6. CONCLUDING REMARKS AND MAIN RECOMMENDATIONS **59**

REFERENCES **60**

LIST OF ABBREVIATIONS

BOP	Balance of Payments
ECB	European Central Bank
EEA	European Economic Area
ESDM	Economic and Financial Committee's Sub-Committee on EU Sovereign Debt Market
EFSM	European Financial Stability Mechanism
ESM	European Stability Mechanism
EU	European Union
GNI	Gross National Income
ICMA	International Capital Market Association
NGEU	NextGeneration EU
MFA	Macro-Financial Assistance
MFF	Multiannual Financing Framework
MS	Member States
PDN	Primary Dealer Network
RRF	Recovery and Resilience Plan
SURE	Support to Mitigate Unemployment Risks in an Emergency
US	United States

LIST OF FIGURES

Figure 1: Yield curves, France, Germany and the EU 48

Figure 2: Yield 10Y bonds 53

LIST OF TABLES

Table 1: Comparing the EU's borrowing strategy to that of major sovereign issuers 45

Table 2: Members of the PDN by country location of head offices 46

Table 3: Results of the first syndicated transactions 51

Table 4: Results of the first auctions 52

Table 5: Bid-ask spreads of major bonds in the last 3 months 53

Table 6: Holding of national debt by banks in the issuing country in the euro area 56

EXECUTIVE SUMMARY

The Next Generation EU (NGEU) programme is radically changing the way the EU interacts with financial markets because of its ambitious and ground breaking new public debt programme. The European Commission has thus adopted a totally new, diversified borrowing strategy, similar to that of other major issuers, to raise money safely, reliably and in a cost-effective manner. EU debt therefore has to be attractive to financial markets and must maintain a strong credit rating.

The EU plans to build a full benchmark yield curve by issuing a diverse range of debt securities, with maturities ranging from three months to thirty years. The EU also has set up a primary dealer network (PDN) of eligible banks to support the issuance programme, with issuance mainly through auctions and syndicated transactions. A well-functioning dealer network is crucial to help the EU sell debt smoothly, maintain liquidity and adjust borrowing plans to market conditions. So far, the EU's first issuances have shown strong investor interest, and the EU has achieved good ratings and strong relative pricing compared to its sovereign and supranational peers.

NGEU borrowing represents a unique opportunity to lay the groundwork for a European safe asset, which could help resolve some long-standing issues with the European macro and financial architecture. For it to succeed, EU debt will need to perform at least as strongly as other major euro-area issuers in terms of primary issuance and on secondary markets. The European Commission will need to monitor its dealer network to make sure it is well positioned to support market operations. It should also be careful that its selections of banks to work with in financial operations are considered fair, transparent and unbiased.

The EU will become the largest green-bond issuer as part of NGEU's mandate to issue up to a third of its debt in this market segment. If successful, this could further serve to bolster the euro’s international role. The EU will need to balance its commitment to new climate standards against current market conditions, to make sure that NGEU debt both supports new climate finance rules and attracts sufficient investor interest.

Overall, large volumes of EU-level debt will benefit the resilience of the euro area and of the EU capital markets. To fully reap the benefits of EU borrowing, however, the programme would have to be made permanent so that it provides a long-term safe asset and benchmark yield curve.

1. INTRODUCTION

The European Commission issues debt on financial markets on behalf of the European Union (EU) and historically has lent it to provide assistance to countries experiencing difficulties. This has allowed recipient countries to benefit from the low rates available to the EU as a highly-rated borrower, particularly at times when the countries themselves had lost market access. The EU budget is used as a guarantee for this debt in two of the three lending programmes: Balance of Payments (BoP) assistance for non-euro EU Member States (MS) and the European Financial Stability Mechanism (EFSM) for euro-area MS. The amounts are limited (at EUR 110 billion in total capacity)[2] as the Commission had to be able to cover debt servicing with the available margins under the own-resources ceiling, the so-called 'headroom' in the EU budget, which also acted as a guarantee against default by debtors. The Commission also raised funds for a third programme, Macro-Financial Assistance (MFA) for non-EU countries. But MFA debt is backed separately by the EU budget, primarily via a Guarantee Fund for External Actions.

In 2020, amid the COVID-19 crisis, the EU began to ramp up its public borrowing. **A first new instrument was created to provide loans of up to EUR 100 billion** to help countries finance short-term work schemes at lower cost: the temporary Support to mitigate Unemployment Risks in an Emergency (SURE). To accommodate the increased borrowing while protecting the EU's strong rating, the debt is guaranteed by not only the existing headroom[3] in the EU budget (like the BoP and EFSM instruments) but also by an additional EUR 25 billion in direct irrevocable and callable guarantees from Member States. But even with SURE, the EU's capacity to borrow remained limited. Volumes stayed small and these programmes also allowed only back-to-back financing – issuance of debt on a per-disbursement basis, and not bulk borrowing – thus preventing the EU from benefitting from market-access flexibility available to other major issuers.

The pandemic has required a stronger fiscal response. In July 2020, EU countries agreed to temporarily increase EU-level borrowing again, this time on a bigger scale and with an emphasis on investment in common priorities, such as boosting the green and digital transitions. **With NextGeneration EU (NGEU), Member States empowered the Commission to borrow up to EUR 750 billion in 2018 prices** (i.e. around EUR 806.9 billion at current prices) until 2026. This means that the EU will borrow up to around EUR 150 billion per year in the next few years. To make this possible, EU Member States agreed to increase the EU's debt guarantees via an added 0.6% of EU gross national income (GNI) in callable headroom, and countries also agreed to consider introducing new own resources in the future. Possible future own resources include digital, climate and financial-transaction levies, although all of these proposals would require substantial further technical work and political cooperation.
What is new about NGEU is not just the significant increase in the EU's borrowing power, but also the nature of the expenditures. NGEU borrowing will be used for loans but also, for the first time, grants. Indeed, NGEU will be used up to finance up to EUR 386 billion in loans, and EUR 421 billion in grants – these maximum amounts will only be disbursed if all countries request the full loans available to them and complete all the milestones.

In practice, this means that **the European Commission is now, and for the next five years, entrusted to issue debt in much higher volumes than it used to, putting the EU in the company of major European sovereign issuers** such as Germany, France and Italy. The EU quickly assembled a debt management team, adopted new practices and laid out its borrowing strategy. Issuance began in June

[2] Including EUR 50 billion for the BoP and EUR 60 billion for the EFSM (European Parliament, 2017)

[3] A similar mechanism was considered at the start of the euro crisis, but at the time was rejected as not being legally feasible. Under pandemic conditions, and with the lessons learned from the financial crisis, the method was now deemed in line with EU priorities (ESM, 2019).

2021. The EU will have to ensure sound borrowing and reimbursements, to be completed by 2058, in order to embrace the opportunities offered by this milestone financing programme. This in-depth analysis will assess the first decisions made by the European Commission in that regard, and will also outline the potential risks and opportunities linked to this upgrading of the EU borrowing.

2. WHAT ARE THE MAIN FEATURES OF A BORROWING STRATEGY?

A borrowing strategy is a comprehensive plan designed to help an issuer raise money to meet its funding needs. The plan thus governs how this entity interacts with investors. The features of the funding needs, such as the type of expenditure to be financed and the cash flow/budgetary resources that will ultimately be used to reimburse the debt, influence how the borrowing takes place and set out what kind of flexibility may be needed. To give some examples, sovereigns with strong automatic stabilisers – i.e. that have a budget balance that automatically fluctuates in a significant way with the economic cycle to tame it as much as possible – need flexibility to adjust their borrowing plans quickly in case of a crisis, while public development banks might follow a long-term strategy that prioritises consistent financing over the ability to make short-term changes.

There are various ways to tap markets, but they can broadly be split into two main strategies:

- Relatively low borrowing needs means issuers can tap financial markets only when they deem financing conditions to be most advantageous;
- Large issuers, such as major sovereigns, generally set up diversified funding strategies defined by regular and predictable issuances. The aim of such strategies is to make debt securities attractive to expand the investor base. The main objectives are to get the lowest interest rate at a given time and to ensure that funding needs will be easily met in the future. Avenues for diversification are twofold: first, offering different types of debt contracts, and second, using different issuance methods.

Sovereign and supranational debt contracts take mainly the form of fixed-income securities that have fixed periodic interest payments and full repayment of the money borrowed – the principal – at the end of the contract, when the debt matures. **When designing such securities, issuers must choose their key features**, such as which currency to borrow in. For example the European Stability Mechanism (ESM) issues in both euros and in dollars, while the EU will issue only in euros. Issuers can further choose whether to pay a fixed interest rate, which is the standard, or use some other measure, such as an inflation-linked or floating rate. A few issuers, including France and the United States (US), issue inflation-linked bonds, but these alternatives make up a relatively small part of the market.

The maturity – i.e. the duration of the contract that sets out when the principal will be repaid – is another important characteristic[4]. If the maturity of a fixed-income security is over one year, the security is called a bond, and if it is equal to or below one year, it is called a bill. Finally, some reporting criteria allow bonds to qualify as 'green' or 'social' bonds.
To sell debt securities to investors, issuers have different options[5]:

- In a **private placement** of bonds, the issuer sells bonds directly to investors without resorting to mandated banks. Another option is credit lines from banks[6]. The EU has also used this method in the past, particularly when it needed to raise specific sums in very short time periods (ESM, 2019).

[4] The maturity is different from the 'tenor', which is the remaining time until the security reaches maturity and not its original maturity.

[5] The initial exchange of a debt contract between an issuer and investors is called the primary market. Once a security is bought, the buyer is free to resell it to other investors. The trading of securities between investors is called secondary market.

[6] These two options are available to the Commission from a legal perspective but are not used by the Commission in its borrowing strategy.

- In **syndicated transactions**, the issuer announces the upcoming issuance of bonds to a group of banks, which receive fees to put together a so-called 'order book' of investor interest. The banks sometimes underwrite or guarantee the issuance, in case not enough investors want to take part, for example. The main advantage of syndication is that it gives the issuer some clarity about investors' interests and possible bond prices before the issuance. This is one of the main ways the EU historically sold debt.
- **Auctions** are used mainly by large sovereign issuers. The issuer advertises in advance the dates of auctions. Investors have a limited time to bid and when the auction closes, securities are delivered to buyers. Securities can be allocated using a single price method, such as in the US, where all buyers pay the same amount for securities at the designated yield, or a multiple-price method, preferred in Europe, which allocates securities first to investors willing to pay the highest prices, then the next-highest and so on until the entire offering has been handed out. Bond **dealers can then sell the securities quickly into the secondary market**, giving them a chance to make money and offering the EU a chance to quickly establish trading flows and assess liquidity.

  Auctions are typically cheaper for issuers than syndications because they do not involve fees paid to the coordinating banks and allow many investors to participate. However, auctions can be risky, particularly if they are not regularly used, because they do not involve price guarantees or pre-determined investor interest. Only extremely well-established issuers such as the US rely solely on auctions. Other large issuers, including Germany and France, use both auctions and syndication (see Table 1).
- **Re-openings** are opportunities for issuers to raise money and bolster market liquidity by offering additional amounts of securities already in circulation. This option is sometimes called 'tapping' an existing bond, meaning that a security with an original maturity of five years could be sold again six months later, with 4.5 years remaining to maturity and the same yield. For issuers that sell debt using multiple methods, a new security might typically be sold through syndication, while the re-opening would take place using an auction, since there would already be an established reference market price.

Market credibility

To ensure that securities attract the interest of investors and can be sold at low interest rates in the primary market, **issuers have to ensure that their debt is well-rated, will be repaid as promised and is liquid in secondary markets**, so investors are confident they can resell the securities quickly and easily if desired.

One way to facilitate smooth market operations is to set up a **primary dealer network**. This is a group of financial institutions under contract with the issuer to assist in public financing operations. Their obligations in primary markets are typically to **participate in auctions**, to be part of the **syndication selection pool** for choosing which banks coordinate syndicated issuances, and to serve as 'market-makers' in secondary markets, meaning they have to buy and sell securities on a regular basis. In practice this means that they have to bid (offer to buy) and ask (offer to sell) bonds on the secondary market, thus ensuring the liquidity of the bonds on a daily basis. Lastly, primary dealers typically have **obligations to report** to the issuer: they provide insights on market conditions to help the issuer conduct its borrowing operations.

Primary dealers are the main links between sovereign, and similar issuers, and the markets, and it is thus important to have enough participants interested in the role. The first incentive for financial

institutions to become a primary dealer is **reputational gain** (Preunkert, 2020): being part of a dealer network is perceived by financial institutions as a way to gain publicity and increase their own credibility. Dealers also generally receive **preferential or exclusive auction access**, giving them a leg up in secondary-market trading. However, managing the primary dealer networks and their incentives can be a political exercise for a supranational issuer such as the EU, which chooses banks from multiple countries and must consider geographical balance and national sensitivities.

Major issuers also gain market credibility if they are seen as a **benchmark**, which is to say a reference point against which other debt can be priced and weighed. This requires issuing securities in all common maturities to **establish a yield curve** of interest rates[7]. In normal conditions, securities with shorter maturities offer lower yields, while longer-term bonds offer higher returns. Different market segments attract different kinds of investors. Asset managers generally prefer to invest in the short-term part of the curve, while three- and five-year bonds tend to attract the interest of central banks, insurance companies tend to prefer fifteen-year bonds, and pension funds opt for the long-term bonds of between twenty and thirty years.

To sell all these bonds on a regular basis and avoid excessive price swings, large sovereign issuers usually do not follow opportunistic short-term strategies. Instead they aim to be **reliable, predictable and transparent**. This allows investors to anticipate that the issuer will provide a reliable source of benchmark and potentially risk-free assets for the years to come, and it helps the issuer minimise its overall borrowing costs.

[7] The yield curve is a representation of the relationship between market remuneration rates and the remaining time to maturity of debt securities. From a graphic perspective, the x-axis shows the different maturities and the y-axis shows the yield.

3. WHAT ARE THE MAIN ELEMENTS OF THE NGEU BORROWING STRATEGY PRESENTED SO FAR?

The European Commission aims to cover its funding needs by securing sustainable sources of funding at minimum costs. Funding needs are to cover the NGEU recovery plan. The plan is to borrow EUR 750 billion in 2018 prices from mid-2021 to 2026[8]. Amounts could change pending the submission and approval of all national recovery and resilience (RRF) plans (European Commission, 2019a), and will also depend on the appetite of countries for NGEU loans**. The Commission has said it will raise EUR 80 billion between June 2021 and the end of 2021 and, from then onwards, around EUR150 billion per year until 2026**. According to the current legislation, all net issuances are to cease after 2026.

When a security reaches maturity, investors need to be paid back in full. The issuer then has two financing options: it can **pay down** that amount fully using its cash flows (e.g. tax revenues for sovereigns), or it can refinance it by issuing new securities, a process known as **rolling over** the debt. Net issuance – gross debt issuance minus rolled-over debt – corresponds to 'new debt'. Under current legislation, there will be no new debt after 2026. Instead, the EU will start gradually paying down its total debt, a process of repayment that will have to start no later than 2028 and be completed by the end of 2058 (Council, 2020). To "*ensure the steady and predictable reduction of liabilities*" the own resources decision (Council Decision 2020/2053) outlines that "*the amounts due by the Union in a given year for the repayment of the principal should not exceed 7,5 %* [sic] *of the maximum amount of EUR 390 000 million for expenditure"* (Art 5.2).

Accountability, transparency and predictability are necessary for the borrowing strategy to be successful over time. The Commission publishes an **annual borrowing decision** that sets a ceiling on the volume of borrowing over that given year, and sets criteria for its profile (maturity and ceiling for the amounts per issuance). This broad scope for annual funding is complemented by **funding plans published twice a year,** which go into more detail in terms of the mapping of upcoming issuances and certify that funding needs over the given semester will be met. Funding plans offer predictability on target auction dates, target amounts to be financed by bonds, and expectations of the number and volume of syndicated transactions.

Several legal commitments have been put in place to ensure the EU's ability to service its payment obligations, and to convince investors that the EU will service its debt in a timely manner until 2058:

- On the guarantee of NGEU debt: of the total budget of NGEU, EUR390 billion is earmarked for grants and guarantees, and EUR360 billion is earmarked for loans (in 2018 prices). **Payment obligations for the grant elements of NGEU are to be covered by EU own resources, while loans will be repaid ultimately by their MS beneficiaries.** Although both the amount of borrowing that will ultimately take place and the value of EU countries' GNIs in the future remain uncertain, the increase in the 'headroom' by 0.6% of GNI is considered enough to convince markets that MS will provide enough to repay EU borrowing. The exact methodology for deciding this number has not been made public, but since it is acceptable to the EU and to the credit-rating companies, it appears to be sufficient.

- On the timely reimbursement of payment obligations: in answer to a European Parliament question (European Parliament, 2020), the Commission has estimated the interest rate costs for

[8] To forecast amounts in current prices during the programme, the EU applies a 2% annual inflation rate. The 2018 price amounts are thus hypothetical because in EU budgetary practice, a 2% annual rate of inflation is used to translate 2018 prices in euros to actual prices in euros, irrespective of actual inflation. The European Commission has communicated that NGEU amounts to €806.9 billion in current prices; see https://ec.europa.eu/info/strategy/recovery-plan-europe_en.

the period 2021-2027 at EUR12.9 billion over the seven years. Although this amount is shouldered by the EU budget and factored into the Multiannual Financing Framework (MFF) 2021-2027, in practice its exact value remains uncertain. The debt – repayment of interest and principal – will be serviced by the EU budget, ie with funds from existing and possible new own resources. **The Commission has also provided guidelines on safeguarding the sustainability of the borrowing position over time and the profile of outstanding debt**. A ceiling amount of debt per issuance was set at EUR20 billion, as a compromise between the imperative to issue in large volumes to ensure liquidity in secondary markets and to limit the potentially destabilising effect of an excessive number of bonds coming to maturity at the same time (either for future EU finances or because it would increase roll-over risk) (European Commission, 2021a). For 2021, upper limits of EUR125 billion in long-term funding, and EUR60 billion in short-term funding plans are in place (European Commission, 2021a). So far, the June 2021 funding plan has announced long-term borrowing equivalent to EUR80 billion for the rest of 2021, complemented with tens of billions in short-term borrowing to the extent needed to meet financing requirements (European Commission, 2021b).

Before NGEU, the EU had to time its borrowing operations alongside its disbursements. The Commission issued debt and loaned the proceeds directly to beneficiaries on the same terms they were borrowed at; debt and loans had the same duration and interest rates, thus, the Commission neither subsidised the loans nor risked having to meet payment commitments before loans were reimbursed. Given the simplicity and small volume of its operations, the EU's presence in financial markets was small and it didn't need to build a predictable and reliable strategy, nor could it adjust the timing of its borrowing operations even if market conditions would otherwise have warranted an adjustment.

For NGEU, the EU now uses a borrowing strategy that is diversified in terms of types of securities and ways to tap the markets. Borrowing is not directly connected to specific pay-outs. Indeed, given the large number of beneficiaries (27 countries plus the EU itself) and projects financed by NGEU, the mobilisation of funds on a per-disbursement basis would have been unnecessarily burdensome from an administrative point of view. Moreover, **the specific structure of NGEU, with a pre-agreed volume of funding and a more or less pre-agreed allocation to beneficiaries, provides visibility over funding needs**. No matter what happens in coming years, the Commission should issue NGEU debt between EUR100 and EUR150 billion annually in the five coming years, depending on how many countries request loans. These large amounts require large debt issuances on a regular basis.

How does the Commission diversify the types of securities issued to finance NGEU?

- The Commission has **no choice of borrowing currency**. It is legally specified that borrowing operations should be in euro (Council, 2020).
- The borrowing decision for 2021 forecasts issuances of **all common long-term maturities** up to 30 years: namely 3Y, 5Y, 7Y, 10Y, 15Y, 20Y, 25Y and 30Y bonds.
- The EU will be able to diversify its issuance because of its commitment to issue about 30% (roughly EUR250 billion) of its total NGEU issuance as '**green' bonds**, in line with sustainable finance market practices. All SURE bonds were issued as 'social' bonds. Those qualify respectively under the Green Bond Principles and Social Bond Principles established by the International Capital Market Association (ICMA) in terms of the transparency and disclosure criteria needed to meet those standards.
- The EU will use short-term **bills** to manage cash flow or handle temporary liquidity shocks. Markets like to provide financing in shorter installments while the EU uses the money over the long term, and also the EU needs a way to make sure it has enough cash on hand for payments or to

wait out temporary market conditions, such as a sudden and temporary spike in long-term bond yields. Short-term bills are generally considered to be risk-free and highly-liquid assets – the short maturity securities of well-rated sovereigns, such as the US, can be compared to cash holdings – so being a regular presence in the bill market also strengthens the euro.

As is common for European sovereign issuers, **the EU attracts buy-and-hold investors**. Buy-and-hold means that investors buy a security as a long-term investment to be kept until maturity, while others (sometimes called 'fast-money' investors, market makers or short-term investors) buy to trade and profit from the sales through price variations. The advantage of buy-and-hold investors is that they allow for a relative anchoring of bond prices, which is considered important for a new issuer selling bonds through syndication. There could be a trade-off between this stability and liquidity which is generally provided by short-term and market-making investors. However, given the large volume of EU securities, selling to buy-and-hold investors at first might not interfere with the liquidity imperative as long as there are enough securities trading regularly to show liquid markets and pricing that is not unduly volatile. Directing EU securities to a chosen class of investors can only be done through syndicated transactions, in which mandated banks are charged by the Commission to assign allocations to investors, and not through auctions, in which bonds and bills go to the highest bidders.

The Commission uses the TELSAT auction system, administrated by the Banque de France but separate from central-banking operations. This system uses a '**multi-price auction**', in which securities are supplied at the bid price with the highest bids served first and then going down until the volume is exhausted. The Commission began using auctions when it started selling bills, which, because they have shorter maturities, are perceived as very low risk and are likely to attract a lot of investors looking for cash-like assets. So far, the EU has only auctioned bonds as reopenings of maturities already issued through syndication, which already have relatively anchored pricing in secondary market trading. In the future, the EU may also sell new bonds at auction.

For EU bill auctions, **dates are communicated in the funding plan** – auctions typically take place every first and third Wednesday of the month. Three business days ahead of the auction, there is an announcement of the maturities and target volume of securities to be sold. Bond auctions will take place on the fourth Monday of the month. Five business days before the auction, the Commission requests opinions from primary dealers on what the terms and volumes of the sale should be. These are then announced three business days before the auction.

The EU's primary dealer network

The EU relies on its primary dealer network (PDN) to participate in auctions and manage its syndications. To become a primary dealer, a credit institution has to apply to the European Commission. The eligibility criteria include having a head office in the EU or in the European Economic Area (EEA) and being already a primary dealer for another European sovereign issuer. A further constraint is that any institutions that have been found in breach of EU antitrust laws are ineligible to take part in operations until and unless they are found to have taken sufficient remedial action[9].

Currently, the European PDN comprises 41 institutions, but applications remain open on an ongoing basis. The list includes institutions from 12 countries, including 12 with headquarters outside the EU (Table 2). In this selection process, the Commission chose to rely on a large network, which means obligations are less important than in countries with smaller PDNs. **Primary dealers, which are the only firms allowed to participate, are required to buy at least 0.05% of the bonds sold at auctions over a semester**[10]. **There is no set quantitative market-making obligation** at this stage (Table 1). Lastly, dealers have monthly reporting obligations to the Commission on their take of financial market

[9] See details: https://www.ft.com/content/130cf192-8fe0-4edb-a962-2625107eae2f

[10] For comparison, in the US primary dealers have the duty to bid (but not to *buy*) for the equivalent of 5% of the volumes auctioned.

conditions to help them take decisions on when and how it best to issue. In terms of incentives for dealers, fees paid to dealers that lead or co-lead syndicated transactions. These fees are lower than those paid by major EU issuers[11], but there is also prestige associated with participation in the European PDN (Preunkert, 2020).

Table 1: Comparing the EU's borrowing strategy to that of major sovereign issuers

Entity	France	Germany	Italy	Spain	United States	European Union
Auction type	Multi-price	Multi-price	Multi-price for short-term bills and single-price for bonds.	Mixture of single-price and multiple-price auctions.	Single price	Multi price
Syndication	For less liquid or new securities.	For less liquid or new securities.	For less liquid or new securities.	For less liquid or new securities.	No	So far for all new bond issuances.
Primary dealer networks	**Composition** 15	**Composition** 33	**Composition** 16	**Composition** 20 for bills; 19 for bonds	**Composition** 24	**Composition** 41
	Duties Participate in auctions (at least 2%); in all syndicated transactions; Market making on secondary markets (2% min). Advice on the issuance policy.	**Duties** Participate in auctions (at least 0.05%). Reporting obligations.	**Duties** Participate in auctions (at least 3%). Market making on secondary markets.	**Duties** Participate in auctions (at least 3%); Market making in secondary markets. Provide market insights.	**Duties** Participate in auctions (at least 5%). Secondary market activities (0.025%). Reporting obligations.	**Duties** Participate in auctions (at least 0.05%). Secondary market activities. Reporting obligations.
	Incentives Fees for syndications. Reputational gain. Access to a repo facility.	**Incentives** Fees for syndications. Reputational gain.	**Incentives** Fees for syndications Reputational gain. Exclusive participation in part of auctions.	**Incentives** Fees for syndications. Reputational gain. Exclusive participation in part of auctions.	**Incentives** Reputational gain	**Incentives** Fees for syndications. Reputational gain.
Green bond	First issuance on 24/01/2017.	First issuance on 02/09/2020.	First issuance on 3/3/2021.	First issuance on 7/9/2021	No	First issuance 12/10/2021

Source: Bruegel based on national sources.

[11] Fees for syndications are calculated as a share of the volume of securities sold. The share changes with the maturity of the bonds sold – the higher the maturity the higher the share, ranging from 0.05% for bonds with 1-4Y maturities to 0.170% for maturities above 28Y (European Commission, 2021), see https://ec.europa.eu/info/sites/default/files/about_the_european_commission/eu_budget/general_terms_and_conditions.pdf.

Dealer performance is assessed on an ongoing basis, and is used when choosing leading banks for syndicated transactions. A dealer that does not perform well in its support of EU bonds performance in primary and secondary market roles probably will not be chosen to lead syndicated transactions. Because of the importance of the role played by dealers in ensuring market performance and reporting, the Commission can also readjust their incentives. **Primary dealers are important partners for the Commission, hence relationships with them have to be managed**. For instance, the Commission has to ensure that it is transparent and fair in its choices of leading banks for syndications. Further, given the multi-country nature of the EU, there is also a challenge associated with maintaining a good balance in country representation in the PDN. Table 2 shows the list of dealers and leading banks in syndicated transactions by country and the share it represents and confronts it with a proxy in terms of size of each economy (for that we use the share of each country in the European Central Bank (ECB)'s capital). It confirms that up to now there has been a bias towards banks from bigger economies such as Germany and France, both in the choice of primary dealers and in the choice of leading banks for syndicated transactions. **We recommend that the EU monitor the mix of its dealer network and take care not to create bias or the appearance of bias.**

Table 2: Members of the PDN by country location of head offices

Country	Count of banks in the PDN	Share of banks in the PDN (%)	Count of total mandated banks in the four first syndications	Share of total mandated banks in the four first syndications (%)	Country share of ECB capital (%)
Austria	2	4.9	1	4.2	2.38
Belgium	1	2.4			2.96
Bulgaria					0.98
Croatia					0.66
Cyprus					0.18
Czech Republic					1.88
Denmark	1	2.4	1	4.2	1.76
Estonia					0.23
Finland	1	2.4			1.49
France	7	17.1	6	25.0	16.61
Germany	14	34.1	10	41.7	21.44
Greece	2	4.9			2.01
Hungary					1.55
Ireland	3	7.3	2	8.3	1.38
Italy	2	4.9	1	4.2	13.82
Latvia					0.32
Lithuania					0.47
Luxembourg					0.27
Malta					0.09
Netherlands	3	7.3	1	4.2	4.77
Poland					6.03

Country	Count of banks in the PDN	Share of banks in the PDN (%)	Count of total mandated banks in the four first syndications	Share of total mandated banks in the four first syndications (%)	Country share of ECB capital (%)
Portugal					1.90
Romania					2.83
Slovakia					0.93
Slovenia					0.39
Spain	3	7.3	2	8.3	9.70
Sweden	2	4.9			2.98

Source: Bruegel based on European Commission, European Central Bank. Note: If the share of banks from a given country in the primary dealer network (PDN) is above the country's capital key at the European Central Bank, the case is coloured in green. If the share is below, the case is orange and if the country is not represented in the PDN, the case is red.

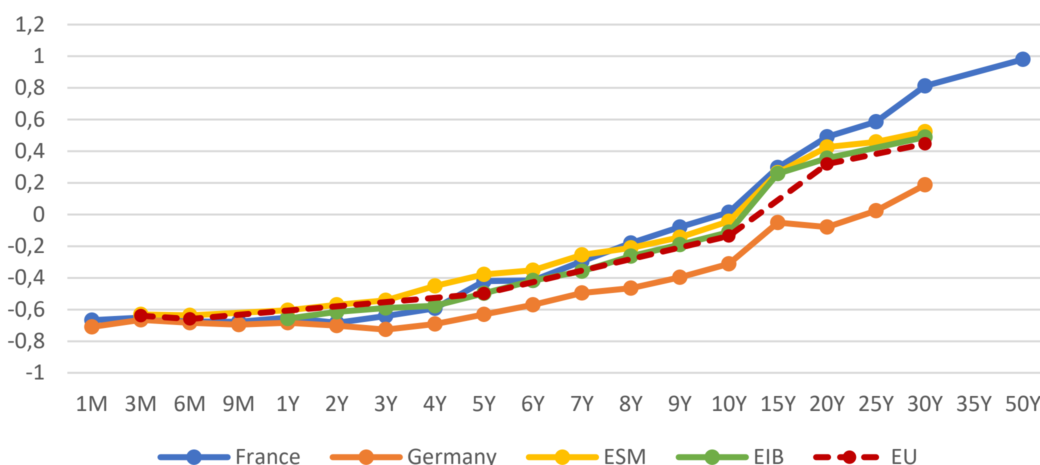
4. THE EU AS A 'QUASI-SOVEREIGN' ISSUER?

This section reviews and assesses the main features on the EU borrowing strategy for NGEU. Considering the importance of market performance and investor perceptions in assessing a borrowing strategy, **we conducted a number of interviews with market participants to perform this assessment**.

The EU is not a sovereign issuer *per se*, but since its debt is guaranteed by sovereign countries, it is considered a 'quasi-sovereign issuer'. The legal architecture set up to guarantee EU debt appears to be strong enough to compensate for the historical lack of substantial own fiscal resources. Most rating agencies consider that the guarantee for **EU debt is equivalent to 'joint and several liability'**, meaning that each country is liable to repay the debt both individually and jointly, which underpins their high rankings. Currently, both Fitch and Moody's rank EU debt as AAA. Standard and Poor's currently follows a different methodology and grades EU debt as the average of EU countries' rankings, which yields a AA rating[12]. In practice, EU securities trade on secondary markets between France (AA) and Germany (AAA), but closer to the former.

EU bonds are priced very closely to those issued by other EU supranationals, such as the European Stability Mechanism and the European Investment Bank (Figure 1). This is a success as it confirms the **usefulness of EU-level borrowing as a way for most EU MS to have access to cheaper borrowing**. In practice, the main differences compared to sovereign borrowing are the legal constraints on EU own resources and disbursements which strictly limit borrowing amounts and timing, while government funding needs can be adjusted from one year to the next (or even quicker, as the COVID-19 crisis has demonstrated) at the discretion of policymakers. However, given the novelty of EU borrowing on such a scale, its strong predictability could represent an advantage in terms of establishing confidence in EU debt at this stage.

Figure 1: Yield curves, France, Germany and the EU



Source: Bruegel based on Bloomberg. Data retrieved on 15/09/2021.

Most of the stakeholders we have interviewed appreciated that the Commission had managed in very little time to build infrastructure and practices that sovereign issuers built over decades. Short deadlines are a regular constraint in new steps for EU financial integration. The previous breakthrough creations of instruments for increased financial solidarity, which led to the creation of the ESM, were

[12] Standard and Poor's are currently in the process of re-evaluating their methodology, which could lead to changes in the EU's grade.

answers to critical moments of risk to the monetary union in the context of the sovereign debt crisis (ESM, 2019). However, NGEU represents a steep upgrade in the borrowing capacity entrusted to the Commission, using methods that were considered not feasible during the euro crisis.

Overall, **the Commission drew largely on common practices** of EU issuers and has indeed benefitted from the help of seconded experts from debt management offices (DMOs) and ESM personnel[13]. Setting up a PDN is a common practice for EU issuers. Out of 27 EU countries, 23 use a PDN. The countries that don't are generally small issuers (Preunkert, 2020). Further, choosing as an eligibility criterion that a bank has to be a member state or EU supranational primary dealer is a way to both benefit from their selection processes and anchor NGEU on European practices.

What is notable is the **choice to rely on a relatively large PDN** (41 institutions currently), whereas, except for Germany (33 institutions currently), most EU countries rely on fewer than 25 institutions. This choice is significant for relationships with primary dealers. As the group is bigger, their duties may be reduced: for example, they may not have formal market-making obligations, and auction-participation requirements may be limited. The EU's required auction-participation rate is similar to that of Germany, but much lower than France and Italy, which have, respectively, 15 and 16 primary dealers, and for which the participation minimum is 2% and 3% (see details in Table 1). The EU does not offer special access to auctions, like there is in other countries except Germany.

The Commission pays significantly lower fees for handling syndicated bond sales compared to typical market practices[14]. This could be problematic because being a primary dealer already appears to be a function that may not be not very profitable for banks, even if they benefit from good publicity and market presence. In practice, the volume of EU issuances should generate enough revenue to compensate for lower fees. **We recommend that the Commission monitor performance carefully and adjust its fees if need arises**.
More generally, **managing the dealer network should remain a major concern for the Commission** to make sure securities trade well on primary and secondary markets and to keep track of market conditions. **Depending on market conditions, the Commission may reconsider the incentives it offers primary dealers, or it could add market-making obligations in secondary markets.**

All primary dealers are private institutions that compete on financial markets, so the Commission needs to **be transparent and fair in how it manages the network**. Some challenges stem from issuing as a supranational entity, with a dealer network that includes overrepresentation of specific countries and no participants from others. When looking at the current PDN and at past syndications, it is for instance clear that German institutions are overrepresented compared to those from other countries, even when taking into account the sizes of the countries (e.g. this can be proxied with the capital key of each EU country in the ECB's capital, which is based on GDP and population size; Table 2). By comparison, the US gave up long ago on syndicated auctions in part because choosing banks could be too political and could spark competition among US states. Instead, the US has a PDN, coordinated by the New York Federal Reserve Bank, made up of financial institutions that are required to participate in US Treasury auctions and that have benefited from various kinds of central-bank support in exchange for being transaction counterparties[15].

Commission Decision 2021/625 (European Commission, 2021c) states that there should be competition in selecting banks for syndications and lists the activities against which there will be performance assessments, but **there is a lack of binding quantitative metrics**. The Decision also

[13] See for instance: https://www.esm.europa.eu/press-releases/esm-seconds-siegfried-ruhl-european-commission-inter-institutional-cooperation-combat

[14] See for instance: https://www.globalcapital.com/article/28wqcpy1y5daspdzf5qf4/ssa/supras-and-agencies/eu-cuts-fees-for-jumbo-next-gen-programme)

[15] See details here: https://www.newyorkfed.org/markets/primarydealers.

mentions that primary dealers should receive on a *"regular basis, at least yearly"* feedback on their performance. **These elements should be further specified.**

As we have seen, the Commission uses a **multi-price bidding system**. It further chose to retain some flexibility in terms of the volumes and types of securities to be sold up until a few days ahead of auctions, in order to take account of market conditions. The conclusions from auction theory and practice on the best auction method for sovereign issuers are not clear, but in practice auction rules have been fine-tuned to reduce financing costs and limit bidders' capacity for overly strategic bidding (Monostori, 2014). In the OECD, there is a balance between countries using single-price and multi-price auction systems while a third of OECD countries use both, depending on the type and maturity of the security sold (OECD, 2016). For instance, the US chose to use single-price auctions considering that it yields lower financing costs, but the supporting empirical evidence is ambiguous on how generally this conclusion can be applied (Garbade, 2005).

EU debt issued so far

A notable novelty of the EU strategy is the willingness to issue green and social bonds at large scale. European sovereign issuers have taken up this practice only recently – as recently as 2017 for France, and only in 2020 for Germany and 2021 for Italy and Spain. **Green and social bonds are new products** in general, with first issuances in 2007 and 2017 respectively**. Europe has an opportunity to become a major player in these fast-growing markets** – the European Investment Bank (EIB) was the first-ever green bond issuer. The Commission's overarching Green Bond Framework, adopted in September 2021, demonstrates that the EU aims to go beyond International Capital Market Association principles, although how it will do so remains unclear (European Commission, 2021d). We further discuss green bonds financing stakes below.

As far as the choice of currency is concerned, issuing in euro is common practice among European sovereigns, although some issue in other currencies, mostly the dollar, to take advantage of market conditions. For NGEU, the EU can **only borrow in euro**, which does have **some advantages**: the Commission's political agenda for the euro as a global currency supports euro-only issuance, and euro-only issuance also avoids the extra workload of setting up foreign exchange operations when borrowing in currencies other than that used for disbursements.

How has the EU performed in its first issuances? **At time of writing, there had been four syndicated transactions for NGEU**, between mid-June and mid-September 2021. These proved there is **strong market appetite for EU securities** (Table 3). Although undersubscription would have been worrying, it is worth underlining that a high cover ratio is not a definitive metric of success as some investors follow a bidding strategy with under-priced bids without expecting to be successful at auctions, or request more bonds than they intend to buy through syndicated transactions. Instead, **investor breakdown and bond prices may be of more use in assessing performance in primary markets**:

- **Buy-and-hold investors were well represented**, as out of the total volume of bonds issued, more than 35% went to fund managers and nearly 25% to central banks and official institutions, while less than 10% went to banks and hedge funds combined (Table 3).
- The diversification of the investor base from a geographical point of view was also well-balanced, with a large majority of investors from the EU, but with also a good representation of investors from outside the EU. As might have been expected, the United Kingdom, as a major financial centre, was the biggest investor in all issuances (Table 3).
- Table 4 shows that all auctions were oversubscribed, which means that the total bids made exceeded the value of securities sold, by a share expressed in the cover ratio. As mentioned

previously, oversubscription alone is not a mark of success, but it is encouraging that the Commission easily met its funding target. Indeed, the **volume allotted was very close to the ceiling volume announced** – as the Commission only provides a ceiling amount of the volume of securities to be sold ahead of the auction, it could moderate the actual volume sold depending on the bids received.

- The small difference between the highest accepted yield and the weighted average yield shows that there was no winner's curse, meaning that **no participant paid a substantially higher price than others**.
- Lastly, another encouraging result is that the weighted average yield at issuance is slightly above the one in secondary markets. This means that **investors who bought EU securities at auctions were able to resell them on secondary markets with a small price increase**, providing them with another incentive to buy EU bonds (even if this means that the EU could have issued bonds at a slightly lower cost).

Table 3: Results of the first syndicated transactions

	First 15/06/2021	Second 29/06/2021		Third 13/07/2021	Fourth 14/09/2021
	10Y	5Y	30Y	20Y	7Y
Amounts	EUR 20 billion	EUR 9 billion	EUR 6 billion	EUR 10 billion	EUR 9 billion
By type					
Fund managers	37%	33%	41%	37%	36%
Central banks / Official institutions	23%	30%	15%	17%	32%
Insurance and pension funds	12%	10%	18%	18%	7%
Bank treasuries	25%	21%	19%	24%	21%
Banks	2%	4%	5%	2%	2%
Hedge funds	1%	2%	2%	2%	2%
By geography					
Germany	13%	8%	27%	19%	7%
France	10%	8%	10%	9%	8%
UK	24%	30%	21%	24%	39%
Benelux	15%	6%	13%	11%	11%
Nordics	10%	12%	7%	12%	10%
Italy	5%	6%	7%	7%	6%
Other Europe	10%	11%	13%	15%	10%
Asia	10%	18%	1%		7%
Other	3%	1%	1%	3%	2%

Source : Bruegel based on European Commission.

Table 4: Results of the first auctions - Part 1

	EU-Bills	EU-Bills	EU-Bills	EU-Bills	EU-Bills	EU-Bills
Maturity	3M	6M	3M	6M	3M	6M
Type	New	New	Tap	Tap	New	New
Date of auction	15/09/2021	15/09/2021	22/09/2021	22/09/2021	06/10/2021	06/10/2021
Volume bids in million euros	10 181	11 507	5 238	5 437	4 983	3 656
Volume allotment in million euros	2 999	1 997	1 997	1 996	2 996	1 996
Weighted average yield	-0,726%	-0,733%	-0.74%	-0.74%	-0.79%	-0.75%
Highest accepted yield	-0,700%	-0,715%	-0.71%	-0.72%	-0.75%	-0.72%
Percentage awarded at highest accepted yield	51%	76%	92.61%	43.63%	44.71%	82.44%
Cover ratio	3.39	5.76	2.62	2.72	1.66	1.83
Volume announced	up to 3000	up to 2000	up to 2000	up to 2000	up to 3000	up to 2000

Table 4: Results of the first auctions - Part 2

	EU-Bonds
Maturity	5Y
Type	Tap
Date of auction	27/09/2021
Volume bids in million euros	5 812
Volume allotment in million euros	2 495
Weighted average yield	-0.49%
Weighted average price	102.35
Lowest accepted price	102.2
Percentage awarded at lowest accepted price	22.11%
Cover ratio	2.33
Volume announced	2000-2500

Source: Bruegel based on European Commission.

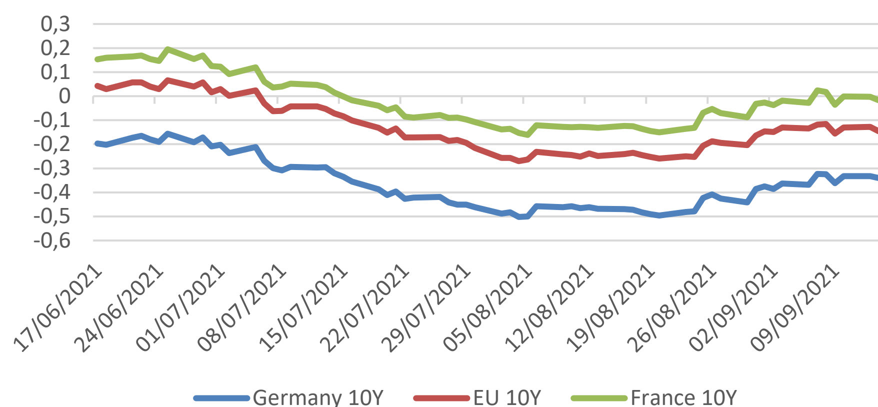
In terms of pricing, **NGEU securities have so far been trading between France and Germany, although closer to France, and close to other EU supranational securities** (Figure 1). We also note that so far, the price of EU debt securities is somewhat more volatile than the prices of French and German securities, which implies that liquidity is still lower than for major European sovereigns. This is confirmed by higher bid-ask spreads – i.e. the difference in the price investors offer for bonds and the price investors want in order to sell bonds, Figure 2 shows the mid price, which is the average of bid and ask prices (Table 5 and Figure 2). **The Commission should monitor whether EU securities trade in a stable manner, which is signalled by low volatility and stable spreads to benchmark bonds, such as Germany's and the liquidity in secondary market is good, as signalled by low bid-ask spreads**.

Table 5: Bid-ask spreads of major bonds in the last 3 months

	Germany 10Y	France 10Y	SURE 10Y	NGEU 10y
Average bid-ask spreads	0.002	0.003	0.108	0.088

Source: Bruegel based on Bloomberg. Note: Data retrieved on 15/09/2021.

Figure 2: Yields 10Y bonds



Source: Bruegel based on Bloomberg. Notes: Data retrieved on 15/09/2021. Mid-yields to maturity are displayed. The yield to maturity is the anticipated return of the bond if it is held until maturity. The mid yield to maturity is the average of prices asked by sellers and offered by buyers on the market.

5. OPPORTUNITIES AND RISKS

The EU will have to monitor for risks common to all debt-management operations. For example, the **cash flow mismatches between loan reimbursements or EU revenues and bond maturities should remain under scrutiny** and be tackled by smoothing-out debt repayments by continuing to roll over shorter-term debt after net issuance stops in 2026. Interest-rate risks arising from evolving market conditions also require careful management.

Moreover, because the EU offers lower syndication fees to its primary dealers than other EU issuers, the Commission should take extra care to monitor liquidity and whether its primary dealers have the right incentives to support liquidity. It also appears that some countries' banks are currently overrepresented in the PDN and in past syndications (Table 2), so in choosing banks for syndications, **the Commission may want to make a point of ensuring greater diversity or at least more transparency of the decision-making process.**

5.1. Impact on MS borrowing strategies

In terms of the **impact of NGEU bonds on Member States' borrowing activities**, there were initial fears that a large volume of EU debt issuances could have a crowding-out effect on demand for euro-area sovereign debt. So far, however, **the risk appears low**, because of market conditions, high investor demand and technical coordination among euro-area issuers. For the moment, anecdotal evidence points to an opposite effect: the new NGEU bonds seems to have caused a crowding-in effect, notably because of demand from non-EU investors[16]. This could be because the creation of NGEU has acted as a commitment device and a strong positive signal that EU countries want to stick together in the long run. During the euro crisis, the EU rejected the possibility of borrowing large amounts at the EU level when planning its market-access rescue programmes. For the EU now to turn to this mechanism to finance grants or to provide long-term borrowing to finance common priorities, **even if it is for the moment temporary, shows that such joint borrowing is legally and politically possible, which enhances the macroeconomic architecture of the euro area.**

However, even if crowding-out conditions have not emerged so far, there should be careful monitoring because market conditions could change significantly in the coming years. This could happen if, for example, the ECB were to reduce significantly its role in euro-area bond markets. Thus, **it is crucial that sovereign and EU issuance remains well coordinated within the Economic and Financial Committee's Sub-Committee on EU Sovereign Debt Markets (ESDM) which includes member state debt management offices, the ESM, the EIB, the Commission and the ECB**[17]**.** The ESDM meets at least twice a year and is in charge of technical analysis and monitoring of sovereign debt markets for the **Economic and Financial Committee**. The ESDM also currently has the mandate to promote further integration and better functioning of European sovereign debt markets.

NGEU debt represents a reliable and cheap AAA-rated source of financing countries can draw from in case of market stress. This is a welcome addition to the EU macroeconomic toolkit. Compared to the ESM, there is less stigma involved for countries requesting loans through NGEU. At time of writing, seven countries have requested loans[18]. The deadline is August 2023, so more countries may come forward. An appealing feature is that loan interest payments are calculated according to the average effective costs over a semester, as opposed to total average costs for the ESM. This can make

[16] See for instance the discussion involving major stakeholders (member state debt management office representatives, European Commission, ESM, EIB, etc.) in the following events: https://www.bruegel.org/events/eu-debt-vs-national-debts-friends-or-foes/ and https://www.omfif.org/events/team-europe-borrowers-forum.

[17] See details here: https://europa.eu/efc/efc-sub-committee-eu-sovereign-debt-markets_fr..

[18] Greece, Italy and Romania have requested the full amount of loans available to them, while Cyprus, Poland, Portugal and Slovenia requested between 16% and 37% of the loans available to them (Darvas *et al*, 2021).

NGEU loans more in tune with market conditions and enable simpler comparison with interest rates offered to countries (European Commission, 2019e). However, in our view, NGEU's current characteristics, and in particular its temporary nature and relative inflexibility (given that the ceiling amount to be borrowed was pre-agreed in July 2020), do not allow it to fully play the role of *"safe liability"*, as put by Coeuré (2016), meaning that Member States will not be able to use the facility to access markets as much as necessary in times of market stress.

NGEU debt issued for grants will be serviced using EU own resources, i.e. either through new own resources at EU level, or through increased 'headroom' backed by Member States. In this context, some institutions, such as the Bundesbank, have pointed out that NGEU ultimately creates off-balance sheet liabilities for EU Member States (Bundesbank, 2021), meaning NGEU debt is ultimately guaranteed by EU MS, but does not appear in their public accounts. However, even if Moody's did value this liability at 3% of EU countries' GNI, the rating agency decided not to include it in its assessment models, which shows it is **not concerned about the balance-sheet impact on EU members**.

So far, Eurostat has said in a 'Draft Guidance Note on the statistical recording of the recovery and resilience facility' that loans taken out under NGEU will be considered as debt to the EU (2020). No provisions have been made for grants, but we consider that these should not be treated as national debt (as Darvas and Wolff, 2021). Based on the reaction of markets and rating agencies, it appears that **NGEU has rather improved the attractiveness of EU countries' debt** for the reasons described above and also possibly because the euro is perceived as a stronger global currency because of the presence of increased joint borrowing. That said, this perception could turn around if political support for borrowing wanes, or if doubts arise regarding how NGEU funds are used and governed.

5.2. Impact on EU capital markets

Several benefits for EU capital markets are associated with the fact that NGEU bonds represent a large increase of the pool of risk-free assets in the EU.

- First, the euro area has a longstanding shortage of safe assets (Claeys and Wolff, 2020). A safe asset is a liquid asset that credibly stores value at all times, much like currency, and in particular during systemic crises. There is a high demand for this type of asset, from savers in need of a wealth-storage vehicle, domestic financial institutions seeking to satisfy coverage regulations and for use as collateral in financial operations, and from emerging market economies looking for ways to invest foreign-exchange reserves. **Sovereign safe assets – ie. assets rated AAA or AA – represent only 37% of GDP in the EU, compared to 89% in the US** (Banque de France, 2021). NGEU could represent about 5% of euro-area GDP. As EU debt is rated better than most Member States' debt, issuing at the supranational level mechanically increases the volume of euro-denominated safe assets. This offers more options for portfolio risk management, thus increasing the attractiveness of euro-denominated assets, which in turn benefits all issuers and bolsters a bigger international role for the euro.
- Second, if the EU were to become a permanent large-scale issuer, the yield curve of EU-bonds could become a European benchmark for interest rates. **Such a cross-border reference could reduce differences in financing conditions for companies across the EU and favour economic convergence.**
- Finally, large-scale EU-level debt could further bolster the resilience of European capital markets, by reducing the potential magnitude of capital flight from countries with weaker financials in times of market distress. During the financial crisis, weaker confidence in the euro overall led to more capital flight, so a globally stronger euro should maintain investor confidence better. NGEU debt could also help to reduce the sovereign-bank doom loop in which national

banks are over-exposed to their sovereign's debt, as EU bonds would provide banks with a true common safe asset to fill their regulatory coverage requirements.

However, on this last point, we believe that for now, **risk mitigation of the sovereign-bank doom loop will remain limited**, for two main reasons:

- First, the volume of EU debt needs to be much larger. In the euro area, all national debt held by banks in the issuing country represents 19% of GDP (Table 6), while NGEU debt represents only around 5% of euro-area GDP. The temporary and limited nature of NGEU makes it unsuitable to solve the sovereign-bank nexus issue, which would require permanent issuance at higher volumes.
- Second, EU bonds remain less attractive than sovereign bonds for banks to hold because, in the current ECB collateral framework for refinancing operations, the ECB applies a higher haircut to institutional and agency debt than to central government debt for a same given credit quality rating and residual maturity (European Central Bank, 2014). As discussed by Claeys and Goncalves Raposo (2018), haircuts applied in these monetary operations are very relevant in shaping markets' perceptions of the safety of a debt security. These haircut levels determine whether financial institutions will be able to exchange these assets easily and almost at par against the ultimate safe asset: central bank reserves. In our case, banks will get less reserves with EU debt than with similarly-rated sovereign bonds, which has no justification in terms of risk management for the ECB and should be addressed by the ECB. **We recommend that MEPs highlight this issue in the quarterly monetary dialogue with ECB President Christine Lagarde.**

Table 6: Holding of national debt by banks in the issuing country in the euro area

	Gross government debt		Government debt securities	Share of securities in gross debt
	Total	Held by domestic banks	Total	End 2019
2020	%GDP	%GDP	%GDP	% of gross debt
Austria	83.9	9.7	71.0	84.6
Belgium	114.1	14.2	96.8	84.6
Cyprus	118.2	18.2	78.6	66.5
Estonia	18.2	4.0	7.6	41.5
Finland	69.2	9.8	53.6	77.4
France	115.7	17.5	101.5	87.7
Germany	69.7	15.3	52.7	75.6
Greece	205.6		40.5	19.7
Ireland	59.5		40.2	67.6
Italy	155.8	39.5	130.4	83.7
Latvia	43.5	3.5	35.4	81.5
Lithuania	47.1	3.5	38.8	82.3
Luxembourg	24.9		18.3	73.7
Malta	54.8	19.4	46.8	85.4

	Gross government debt		Government debt securities	Share of securities in gross debt
	Total	Held by domestic banks	Total	End 2019
2020	%GDP	%GDP	%GDP	% of gross debt
Netherlands	54.5	8.4	44.7	82.1
Portugal	133.6	18.7	83.6	62.6
Slovakia	60.3	10.9	51.0	
Slovenia	80.8	9.4	71.7	88.7
Spain	120.0	26.9	104.1	86.7
Total EA	98.0	19.0	80.5	82.1

Source: Bruegel based on European Central Bank.

5.3. International role of the euro

To promote the international role of the euro, the Commission (2018) flagged as an opportunity the idea of **positioning the EU as the global sustainable-finance hub**. In the broader markets, the euro is unlikely to dislodge the primacy of the dollar but the euro already holds a strong place relative to the dollar in green finance: in 2019, almost half of global sustainable assets were denominated in euros. With NGEU, the Commission will be the biggest green-bond issuer, while SURE made it a major social-bond issuer. But more work remains to be done. The EU's Sustainable Finance Disclosure Regulation (Regulation (EU) 2019/2088), which came into force in March 2021, and its taxonomy of sustainable activities are ambitious steps to prevent greenwashing. These new reporting obligations and criteria for an asset to be tagged as green are much stricter than current market practices but do not yet target sovereign bonds. The NGEU Green Bond Framework confirms that so far, EU green bonds will only comply with ICMA regulations (European Commission, 2021).

The European Parliament should assess whether EU-issued green bonds comply as much as possible with the taxonomy and with standards for European Green Bonds that have been proposed by the Commission (European Commission, 2021f; European Parliament and European Council, 2021a). Indeed, the current methodology for climate tracking of RRF investments through a coefficient of contribution to climate and environment objectives of either 0%, 40% or 100%, explained in Annex VI of the RRF regulation (Regulation (EU) 2021/241), lacks scientific analysis and precision (European Parliament and European Council, 2021b). These markers could also be coupled with monitoring processes for effective impact. The EU is setting ambitious standards, and should aim to lead the way in showing their adoption for sovereign bonds.

On another note, the **fragmentation risk associated with the issuance of differentiated types of bonds** is low, according to market participants and rating agencies. On the contrary, differentiated issuance could be beneficial to the diversification of the investor base, with investors looking for green bonds in particular, and for lower borrowing costs thanks to a 'greenium' due to the high demand for green bonds. The results of the first green bond issuance by the EU on 12th October 2021 confirm these results. It was the biggest green bond issuance ever, with EUR 12 billion issued, and it attracted the biggest order book for green bonds ever, at EUR 135 billion, it was oversubscribed eleven times.

Overall, NGEU bonds could offer significant benefits to the development of EU capital markets, the enhancement of the international role of the euro and an increase in the European pool of safe assets, which could solve some of the main problems that have plagued the euro-area

architecture since its creation. However, the **major limitation to all the potential benefits listed so far is clearly the temporary nature of NGEU**: these are long-term issues that need a permanent solution. They will not be solved by a temporary issuance of EU bonds. Although market participants currently appear to consider the 2058 time horizon long enough to consider EU bonds as somehow permanent in their investment strategies, there is evident appetite for large EU debt issuances to become permanent. If the benefits envisioned manifest themselves, EU members will naturally have reasons to prolong, reuse or even make NGEU debt permanent.

6. CONCLUDING REMARKS AND MAIN RECOMMENDATIONS

The European Commission successfully organised large-scale borrowing in a short time under the auspices of the NGEU programme, as confirmed by the creation of an institutional architecture similar to that of major established sovereign issuers, and by the issuances that have already taken place. Over time the borrowing strategy may undergo some modifications to adapt to market conditions and to learn from experience. Implementing common EU borrowing was a very important signal sent to financial markets during the COVID-19 crisis. It showed EU solidarity and has generated confidence in the resilience of the euro area. NGEU is also a useful tool to give an additional option to Member States to borrow more cheaply (at least for most countries, in particular those most affected by the crisis), and to invest together in common priorities (such as the green and digital transitions) in order to support the recovery and sustainable growth.

Three main recommendations emerge from this report. First, market performance of EU bonds needs to be monitored carefully, and the EU may need to change the way it manages its primary dealer network depending on how primary and secondary market liquidity evolves. In particular, the Commission should be careful in how it selects banks for syndications and should ensure fairness and transparency, otherwise it could damage its credibility with MS and relationships with banks. Second, NGEU makes the EU the world's biggest green-bond issuer. Capitalising on this position may help strengthen the international role of the euro and set ambitious standards for sovereign issuances in sustainable finance, which means the EU also should step up efforts to align the green bonds it issues with Commission regulations on sustainable finance for private bonds.

Last, the benefits of large issuances of EU-level debt are significant. However, the temporary nature of NGEU prevents it from effectively solving any of the major challenges facing the euro area. If the programme is a success, it might bolster the political will to turn it into a permanent programme. This would, in turn, allow EU debt to become a true benchmark in international financial markets, and strengthen the role of the euro at home and worldwide.

REFERENCES

- Banque de France (2021) 'A European safe asset: new perspectives', available at: https://publications.banque-france.fr/en/european-safe-asset-new-perspectives
- Bundesbank (2021) 'Monthly Report May 2021', available at: https://www.bundesbank.de/resource/blob/866764/408fd36e79e250a95019d02781442755/mL/2021-05-monatsbericht-data.pdf
- Claeys, G. and G. B. Wolff (2020) 'Is the COVID-19 crisis an opportunity to boost the euro as a global currency?', Bruegel policy contribution, available at: https://www.bruegel.org/2020/06/is-the-covid-19-crisis-an-opportunity-to-boost-the-euro-as-a-global-currency/
- Claeys, G. (2020) 'The European Union's SURE plan to safeguard employment: a small step forward', Bruegel blog post, available at: https://www.bruegel.org/2020/05/the-european-unions-sure-plan-to-safeguard-employment-a-small-step-forward/
- Claeys G. and I. Goncalves Raposo (2018) 'Is the ECB collateral framework compromising the safe-asset status of euro-area sovereign bonds?', available at: https://www.bruegel.org/2018/06/is-the-ecb-collateral-framework-compromising-the-safe-asset-status-of-euro-area-sovereign-bonds
- Coeuré B. (2016) 'Sovereign debt in the euro area: too safe or too risky?', Keynote address by Benoît Cœuré, Member of the Executive Board of the ECB, at Harvard University's Minda de Gunzburg Center for European Studies in Cambridge, MA, 3 November 2016, available at https://www.ecb.europa.eu/press/key/date/2016/html/sp161103.en.html
- Council of the European Union (2020) 'Council Decision (EU, Euratom) 2020/2053 of 14 December 2020 on the system of own resources of the European Union and repealing Decision 2014/335/EU, Euratom', available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020D2053
- Darvas, Z. and G. B. Wolff (2021) 'The EU's fiscal stance, its recovery fund, and how they related to the fiscal rules', Bruegel blog post, available at: https://www.bruegel.org/2021/03/the-eus-fiscal-stance-its-recovery-fund-and-how-they-relate-to-the-fiscal-rules/
- Darvas, Z., et. al. (2021) 'European Union countries' recovery and resilience plans', Bruegel databases, available at: https://www.bruegel.org/publications/datasets/european-union-countries-recovery-and-resilience-plans/
- European Central Bank (2014) 'Collateral eligibility and availability', available at: https://www.ecb.europa.eu/pub/pdf/other/cea201407en.pdf
- European Commission (2018) 'Towards a stronger international role of the euro, Communication from the European Commission', available at: https://ec.europa.eu/info/sites/default/files/communication_-_towards_a_stronger_international_role_of_the_euro.pdf
- European Commission (2021a) 'Commission Implementing Decision of 1.6.2021 establishing the framework for borrowing and debt management operations under NextGeneration EU for 2021 C(2021) 3991', available at : https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2021.236.01.0075.01.ENG
- European Commission (2021b) 'Next Generation EU – Funding Plan June-December 2021', available at: https://ec.europa.eu/info/sites/default/files/about_the_european_commission/eu_budget/factsheet_funding_plan_v5.pdf
- European Commission (2021c) 'Commission Decision (EU, Euratom) 2021/625', of 14 April 2021 on the establishment of the primary dealer network and the definition of eligibility criteria for lead and co-lead mandates for syndicated transactions for the purposes of the borrowing activities by the Commission on behalf of the Union and of the European Atomic Energy Community', available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2021.131.01.0170.01.ENG&toc=OJ%3AL%3A2021%3A131%3ATOC
- European Commission (2021d) 'Next Generation EU – Green Bond Framework', Commission Staff Working Document, available at: https://ec.europa.eu/commission/presscorner/detail/en/ip_21_4565
- European Commission (2021e) '(EU) 2021/1095 of 2 July 2021 establishing the methodology for allocating costs related to borrowing and debt management operations under Next Generation EU', available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2021.236.01.0075.01.ENG
- European Commission (2021f) 'Proposal for a Regulation of the European Parliament and the Council on European green bonds' 2021/0191, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0391

- European Parliament (2020) Answer to a Parliamentary question, Question reference: P-005232/2020, dated of 06/11/2020, available at: https://www.europarl.europa.eu/doceo/document/P-9-2020-005232-ASW_EN.html
- European Parliament (2017) 'The instruments providing financial support to EU Member States, in-depth analysis for the BUDG committee', available at: https://www.europarl.europa.eu/RegData/etudes/IDAN/2017/572709/IPOL_IDA%282017%29572709_EN.pdf
- European Parliament and European Council (2021a) 'Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088', available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852
- European Parliament and European Council (2021b) 'Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility', available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R0241
- European Stability Mechanism (2019) 'Safeguarding the Euro in times of crisis', available at: https://www.esm.europa.eu/publications/safeguarding-euro-times-crisis
- Eurostat (2020) 'Draft guidance note on the statistical recording of the recovery and resilience facility', Methodological note, available at: https://ec.europa.eu/eurostat/documents/1015035/11337978/Draft_guidance_note_on_the_statistical_recording_of_the_recovery_and_resilience_facility.pdf
- Garbade, K. D. and J. I. Ingber (2005) 'The Treasury auction process: objectives, structure, and recent adaptations', available at: https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci11-2.pdf
- Leandro A. and J. Zettelmeyer (2019) 'The Search for a Euro Area Safe Asset', PIIE Working paper, available at: https://www.piie.com/publications/working-papers/search-euro-area-safe-asset
- Monostori Z. (2014) 'Discriminatory versus uniform-price auctions', Working Paper, available at: https://www.econstor.eu/bitstream/10419/141995/1/796715769.pdf
- OECD (2016) 'Sovereign borrowing outlook 2016', available at: https://www.oecd-ilibrary.org/sites/sov_b_outlk-2016-6-en/index.html?itemId=/content/component/sov_b_outlk-2016-6-en#back-note-e-000022
- OMFIF (2021) 'Team Europe borrowers forum bringing together the NGEU, EIB and ESM', Virtual panel organised on 21.09.2021, available at: https://www.omfif.org/events/team-europe-borrowers-forum/#request-to-attend
- Preunkert J. (2020) Primary dealer systems in the European Union, Maxpo Discussion Paper, available 20/1. Max Planck Sciences Po Center on Coping with Instability in Market Societies, Paris, available at: http://www.maxpo.eu/pub/maxpo_dp/maxpodp20-1.pdf

The Next Generation EU programme is radically changing the way the EU finances itself and interacts with financial markets. This paper assesses the first design decisions made by the European Commission and the issuances that have taken place so far. It also outlines the potential risks and opportunities linked to this upgrading of the EU borrowing.

PE 699.811
Print ISBN 978-92-846-8678-0 | doi: 10.2861/528735 | QA- 07-21-039-EN-C
PDF ISBN 978-92-846-8677-3 | doi: 10.2861/560551 | QA- 07-21-039-EN-N

Hertie School
Jacques Delors Centre

Policy Paper

Don’t change horses in midstream

How to make NGEU bonds the euro area’s safe asset

23 August 2021

#SafeAsset
#NGEU
#Eurozone

Sebastian Mack, Policy Fellow

The bonds financing the European Union’s recovery remain short of being the much-hoped-for safe asset of EU monetary union (EMU). However, with the right reforms they could well turn out to be just that. To earn safe asset status, the volume of EU debt should increase, EU borrowing made permanent, and the ECB treat supranational EU bonds in a more favourable manner. The flaws associated with failing to be a eurozone-only instrument are offset by remarkable fiscal and democratic benefits. If NextGenerationEU (NGEU) proves successful, then member states should seize the opportunity to create the long-awaited safe asset and put EU borrowing on a permanent footing before debt is repaid as of 2028.

Executive Summary

The eurozone needs a common safe asset to foster EMU stability and to address the shortage of safe euro-denominated assets. The European sovereign debt crisis highlighted the vulnerability of euro countries lacking a common safe asset and nearly pushed EMU off the cliff. To remedy this problem, several proposals have been put forward, but it took the coronavirus pandemic to make debt issuance possible at EU level. Under NGEU, the EU will issue debt up to EUR 807 billion and pay it back by 2058.

Against the multitude of objectives that academics and political decision-makers have linked to a euro area safe asset, there are four functions that it can realistically fulfil. First, it should provide a high-quality, liquid collateral for financial transactions. Second, it should prevent adverse shocks from triggering a 'flight-to-safety' as observed in the European sovereign debt crisis. Third, it should support the decoupling of private sector borrowing costs from those of domestic sovereigns. And fourth, it should facilitate the diversification of banks' sovereign portfolios.

The EU bonds financing Europe's recovery already fulfil important functions. They address the scarcity of safe euro-denominated assets and mitigate the home bias in banks' sovereign exposures. The launch of NGEU has increased investor confidence in European financial architecture and EU bonds could now reduce the fragmentation visible in euro area sovereign bond markets. However, the EU bonds' safe asset status is hampered by insufficient liquidity, the temporal limitation of NGEU, and an unfavourable treatment in ECB's monetary policy framework.

Making NGEU bonds the euro area's safe asset therefore requires three things: First, the EU needs to substantially increase its borrowing up to a level comparable to the largest eurozone sovereign issuers. Second, the temporary NGEU programme must be turned into a permanent common fiscal facility to ensure long-term market presence. And third, the ECB needs to apply to EU bonds haircuts that are no higher than those applied to national government bonds and abandon its caps on supranational EU bond purchases.

NGEU bonds backed by the EU-27 are not the ideal solution for the euro area. However, operating outside an intergovernmental eurozone setting also offers advantages: the Union method adds greater democratic control and NGEU does nothing to raise national debt levels. If NGEU proves successful, political decision-makers should seize the opportunity to create the long-awaited safe asset and put EU borrowing on a permanent footing before debt repayment begins in 2028.

The author would like to thank Kris Best for feedback and discussions. All remaining errors are mine • The document may be reproduced in part or in full on the dual condition that its meaning is not distorted and that the source is mentioned • The views expressed are those of the author(s) and do not necessarily reflect those of the publisher • The Hertie School cannot be held responsible for the use which any third party may make of the document • Original version

Hertie School
Jacques Delors Centre

Table of Contents

Introduction . . . 1

1 Old debates and new reality . . . 1
1.1 The need for a common safe asset and ideas for creating it . . . 1
1.2 NextGenerationEU is creating a new reality in financial markets . . . 2

2 Functions that a euro area safe asset can realistically fulfil . . . 4
2.1 Serve the proper functioning of financial markets . . . 4
2.2 Mitigate the flight-to-safety . . . 5
2.3 Support the implementation of monetary policy . . . 5
2.4 Help break the sovereign-bank doom loop . . . 6

3 Does NGEU debt deliver the safe asset for the euro area? . . . 6
3.1 Serve the proper functioning of financial markets . . . 7
3.2 Mitigate the flight-to-safety . . . 10
3.3 Support the implementation of monetary policy . . . 12
3.4 Help break the sovereign-bank doom loop . . . 13

Conclusion . . . 15

On the same topic . . . 16

Introduction

The lack of a common safe financial asset is a key deficiency in European monetary union. In recent years, academics have come up with a whole host of proposals to remedy this problem. However, so far none has ever gained political traction. Now, reality has overtaken the theoretical debate. Under NextGenerationEU (NGEU), the EU is raising common debt in significant volumes on capital markets – and the eurozone could finally get its safe asset: a common high-quality, low-risk and liquid debt instrument issued at the European level.

The new EU bonds are clearly not the safe asset that you would have drafted as the ideal solution for the eurozone. The NGEU programme is first and foremost designed to fight the pan-EU economic fallout from the coronavirus pandemic. Delivering a safe asset for the eurozone is not the primary objective of the recovery fund. Still, the bonds financing NGEU are creating a new reality in financial markets. So, the question is can these bonds nevertheless fulfil the functions of the much-hoped-for safe asset of the euro area?

This policy paper argues that the bonds issued under NGEU have yet to fulfil all functions of a safe asset for the eurozone. However, they do provide the EU's best shot at getting such an instrument off the ground in the foreseeable future. Therefore, it is politically sensible to aim at turning these bonds into that safe asset. This requires three things: First, the EU needs to substantially increase its borrowing. Second, the temporary NGEU programme must be turned into a permanent common fiscal facility. And third, the ECB needs to make its policy framework more favourable towards supranational EU bonds.

> "The bonds issued under NGEU provide the EU's best shot at getting a safe asset in the foreseeable future."

1 Old debates and new reality

The eurozone has a particular interest in a common euro-denominated safe asset. Safe assets are a cornerstone of daily operations on international financial markets. Banks and other financial institutions provide safe assets as high-quality collaterals in transactions. Central banks use safe assets for both conventional and unconventional monetary policies. Investment funds refer to safe assets as a benchmark to price riskier assets and rely on them as a store of value. The eurozone needs a common euro-denominated safe asset for two reasons: to address the general scarcity of safe assets and to foster EMU stability.

1.1 The need for a common safe asset and ideas for creating it

The lack of a common safe asset seriously threatens EMU stability. This danger became painfully obvious during the European sovereign debt crisis in the wake of the great recession around late 2009. In the absence of a common safe asset, market participants fled into German Bunds – the only asset perceived as safe – which, in turn, rendered borrowing costs for crisis countries soar sky-high. This flight-to-safety also damaged the balance sheets of banks that were highly exposed to their respective governments through domestic sovereign bond holdings. The vulnerability of individual euro countries to speculative attacks nearly pushed EMU off the cliff.

The scarcity of euro-denominated safe assets is problematic for financial markets. When the European sovereign debt crisis struck, several euro area economies saw their debt downgraded.[1] So, the supply of euro-denominated safe assets decreased. On the other hand, regulatory changes following the global financial crisis pushed banks, insurance firms and pension funds to hold more and higher-quality assets to prepare for the next crisis. Hence, the demand for safe assets increased. All in all, safe assets denominated in euro have become scarce and this is an impediment to the proper functioning of European capital markets.

Several proposals for a common euro area safe asset have been put forward since 2010.[2] Early suggestions aimed at ensuring funding for countries in distress whereas subsequent ideas concentrated on reducing the vicious circle ("doom loop") between banks and national governments. More recently, the goals of promoting the euro's international role and supporting the development of a capital markets union have won favour. However, until the coronavirus pandemic struck, none of these proposals obtained sufficient political support to see the light of day. With NGEU the terrain of this debate has now fundamentally changed.

1.2 NextGenerationEU is creating a new reality in financial markets

The EU is not a newbie at capital markets. Even before NGEU, the European Commission began borrowing from capital markets to lend money to neighbouring countries through the Macro-Financial Assistance (MFA) programme, to EU member states through its Balance of Payments (BoP) and the European Financial Stabilisation Mechanism (EFSM) programmes, and since 2020 under the Support to mitigate Unemployment Risks in an Emergency (SURE) programme. To finance the MFA, BoP and EFSM programmes, the outstanding volume of EU bonds amounted to EUR 52 billion in 2020. The SURE programme with issuances mainly in 2020–2021 is adding another EUR 100 billion. For these programmes, the Commission has used a back-to-back funding approach, meaning it issued bonds and transferred the proceeds directly to the beneficiary country on the same terms (interest rate, maturity) that it received. All lending activities to date have been funded through dedicated borrowings and not via the EU budget.

NGEU marks a new era for EU debt issuance. During the NGEU spending phase between 2021 and 2026, the EU will borrow up to EUR 150–200 billion annually and EUR 807 billion (in current prices) in total. The EU will, thus, raise capital amounting to 5% of EU GDP to support member states with loans and grants. Moreover, 30% of the entire NGEU debt will be issued as green bonds providing investors with additional transparency on the sustainable use of proceeds. Putting NGEU borrowing on top of existing EU programmes (EFSM, MFA, BoP and SURE), the total outstanding volume of EU bonds could peak close to EUR 1 trillion in 2026 (Figure 1). This will make the EU per se one of the largest bond issuers in Europe. From 2028 onwards, NGEU debt will be repaid by member states either directly (for loans) or through the EU budget (for grants) and by 2058 at the latest. To partly repay NGEU grants, the Commission is set to propose additional own resources for the EU.[3]

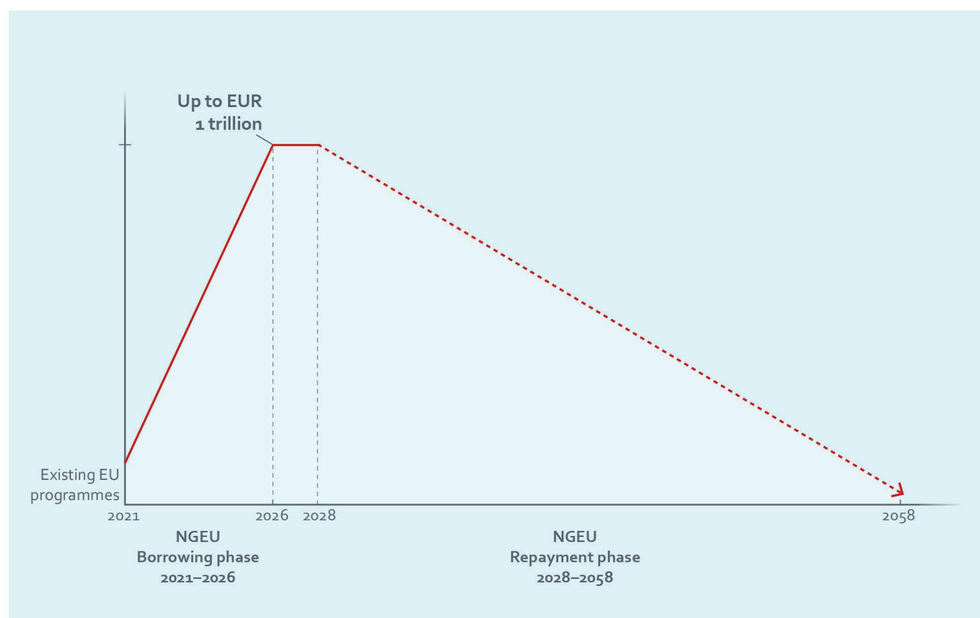
"The total outstanding volume of EU bonds could peak close to EUR 1 trillion in 2026."

[1] ECB, *The international role of the euro*, June 2021.

[2] Eurobonds, red/blue bonds, purple bonds, Sovereign Bond-Backed Securities (SBBS) and E-bonds, just to name the most prominent examples.

[3] European Commission, *Potential new sources of revenue*.

Figure 1: Schematic representation of the projected outstanding volume of EU debt: NGEU issuances on top of already existing EU programmes (EFSM, MFA, BoP and SURE).



Source: Own illustration. Design: Burak Korkmaz.

The Commission will behave more like other large and frequent issuers. The Commission will no longer rely on rigid back-to-back lending but move to pool funding. It will issue long-term EU-Bonds and short-term EU-Bills backed by the EU budget. Building on a newly minted Primary Dealer Network of 39 EU banks, the Commission will make use of auctions and syndications.[4] The Commission will annually publish a borrowing decision defining the maximum amount that it is authorised to borrow during a specific year. To communicate with the markets, the Commission will outline the borrowing calendar in six-monthly funding plans. All of this means that NGEU is fundamentally changing the role of EU debt in financial markets. Will it also bring about the long-awaited common safe asset?

[4] European Commission, *Primary Dealer Network.*

2 Functions that a euro area safe asset can realistically fulfil

Past debates have evolved over a multitude of economic and political objectives that a safe asset for the eurozone should achieve. Before assessing whether the bonds issued by the EU to finance the recovery deliver a safe asset, this section outlines the functions that such a safe asset can realistically fulfil and derive from there its required characteristics. This paper argues that four functions are especially important:

1. A European safe asset should **serve the proper functioning of financial markets** by providing a high-quality euro-denominated collateral for financial transactions.
2. It should **prevent adverse shocks from triggering a capital 'flight-to-safety'** that threatens individual member states with losing access to financial markets.
3. It should **support the ECB in implementing its monetary policy** by providing a common benchmark for a euro area term structure of risk-free interest rates.
4. It should **sever the financial link between national governments and banks** by facilitating the diversification and de-risking of banks' sovereign portfolios.

2.1 Serve the proper functioning of financial markets

To be attractive as collateral in various financial transactions for a broad range of investors from across the globe, a safe asset first needs to fulfil certain technical characteristics. Safe assets are marketable financial claims, commonly in the form of debt securities and preferably on public sector entities, that offer special conveniences in terms of safety to investors.[5] Since they can easily be turned into cash, investors are willing to pay a "money premium" for them. Safe assets need to be issued with a wide range of maturities to build a yield curve that financial market participants can refer to as a benchmark for the term structure of risk-free interest rates.

Safe assets require deep markets and ample liquidity. To be easily and always exchangeable, safe assets must circulate in a high-volume market generating large transaction volumes. The issuer must ensure that there is always sufficient supply of new bonds so that investors are not subject to roll-over risk, i.e. they can easily replace old bonds reaching maturity.

"Safe assets must circulate in a high-volume market generating large transaction volumes."

Credit quality in all situations is key. To count as risk-free, secure store of value, a safe asset must be of the highest credit quality. It must show low price volatility and information sensitivity under normal circumstances and even in a sudden and extreme crisis. Only if the asset has no or very low default risk, do investors consider it as safe harbour. This is what Markus Brunnermeier calls the "good friend analogy": it is around when you need it.[6]

---

[5] For a good overview, see for example ESRB, *Addressing the safety trilemma: a safe sovereign asset for the eurozone*, Working Paper Series No 35 / February 2017, pp. 6–12.

[6] Brunnermeier, Markus et al., *A Safe-Asset Perspective for an Integrated Policy Framework*, 29 May 2020.

2.2 Mitigate the flight-to-safety

A safe asset for the euro area must reduce fragmentation in the eurozone sovereign bond market. Since the outbreak of the global financial crisis, euro-denominated safe assets have become scarce. As a result, prices for triple A rated sovereign bonds such as the German Bund have skyrocketed pushing interest rates to historically low levels. The establishment of a eurozone safe asset would boost supply and could raise interest rates of high-rated sovereign bonds, thereby reducing fragmentation of the zone's sovereign bond market. This in turn would mitigate the flight to safety in times of crisis and prevent intra-euro imbalances from exacerbating. To have an appreciable impact on financial markets, the euro area safe asset would probably need to reach a volume comparable to that of the (so far) largest eurozone sovereign issuers.

The introduction of a common safe asset must, however, not crowd out demand for national euro area sovereign debt. As long as the euro area lacks a single treasury with common taxes and expenditures, each euro country needs to find buyers for its own debt. If investors started to disregard sovereign bonds offering less favourable risk-return-ratios, this would pose severe difficulties to the funding of some national governments. To avoid the crowding-out of national sovereign bonds, close coordination among national debt management offices and the EU in its role as new, large-scale issuer as well as communicating planned issuances to investors well in advance will be key.

2.3 Support the implementation of monetary policy

A euro area safe asset must build the risk-free benchmark yield curve for the eurozone. Although the 19 euro countries share the same currency and the ECB sets the reference interest rate for the entire eurozone, financial markets still use national sovereign bonds as a reference when calculating funding costs of private borrowers located in different member states. As a result, the cost of borrowing for the private sector is very different for each euro country and reflects fragmentation in the eurozone's sovereign bond market.[7] This amplifies the private sector's vulnerability to changes in national sovereign ratings and hampers the smooth and symmetric transmission of euro area monetary policy, particularly during periods of market stress.

To decouple the private sector's borrowing costs from the sovereign's funding costs, the safe asset would need to be the benchmark for pricing other assets in the eurozone. This would reduce national differences in lending and borrowing conditions and facilitate the ECB's conduct of monetary policy. To serve as the new anchor point for the eurozone, the safe asset would ideally be issued by members of the euro area. Such eurozone-only bonds would provide a truly euro area benchmark yield curve. To exploit the full stabilising potential of the euro area safe asset, the ECB would need to include it in the list of assets eligible for both regular open market operations and extraordinary asset purchases.

"The safe asset would need to be the benchmark for pricing other assets in the eurozone."

[7] ECB, Euro area statistics, *Composite cost of borrowing.*

2.4 Help break the sovereign-bank doom loop

A safe asset can help mitigate risks spilling over from sovereigns to their domestic banking sector and vice-versa. The eurozone crisis revealed the vulnerability of the bank-sovereign nexus, with euro area banks holding disproportionately high volumes of debt instruments issued by their home sovereign. Banking union promised to sever this doom loop but has so far failed to do so. By contrast, the coronavirus pandemic has inflated banks' holdings of domestic sovereign debt.[8] A common safe asset may facilitate potential risk-mitigating measures aimed at reducing the nexus between sovereigns and banks in the banking union. Banks could use the EU safe asset as collateral for interbank loans and ECB funding instead of national sovereign bonds. This would help break the vicious circle between banks and their domestic government where the downgrade of a sovereign triggers haircuts on sovereign bonds on banks' balance sheets. This in turn raises their funding cost and interest rates on loans, perhaps driving the economy into a recession and ultimately aggravating the problems of the downgraded sovereign. While a common safe asset alone cannot force banks to diversify and de-risk their sovereign portfolios, it does offer the means to break the infamous doom loop.

"A common safe asset offers the means to break the infamous doom loop."

For European banks to buy EU debt and hold fewer of their domestic sovereign bonds, the EU safe asset must match three conditions. First, the EU safe asset must offer a risk-return-ratio that is at least as attractive as the bonds issued by the bank's home sovereign. Only if a bank sees economic value in buying the common safe asset, will it reduce its domestic sovereign exposure. Second, prudential regulation must not treat the common safe asset less favourably than existing national sovereign debt. Today, EU banks can invest at unlimited volumes in EU national sovereign bonds denominated in the currency of the respective member state and without the need to back the exposure with capital. Hence, banks will buy the EU safe asset only if it benefits from the same preferential treatment as national sovereign bonds. Third, the EU safe asset must be eligible as collateral for open market operations conducted by the ECB. To be able to borrow central bank money, banks need to deposit securities at the ECB. So, banks will purchase the EU safe asset only if they can use it as collateral to receive fresh money from the ECB. And again, the ECB's collateral framework should not treat EU bonds less favourably than national EU sovereign bonds.

3 Does NGEU debt deliver the safe asset for the euro area?

With NGEU, the EU will for the first time borrow money to finance budgetary expenditures. This is a different way of creating a safe asset than under previous theoretical proposals. The core question therefore is whether EU bonds can fulfil the functions of a safe asset for the eurozone.

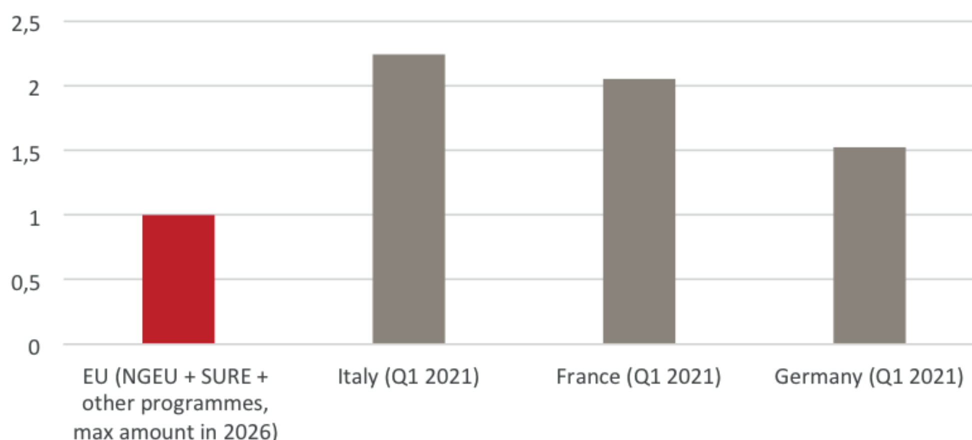
[8] European Commission, *European Financial Stability and Integration Review 2021*, May 2021

3.1 Serve the proper functioning of financial markets

To contribute to the proper functioning of financial markets, the common safe asset needs to be highly liquid, have no roll-over risk, and be of highest creditworthiness.

NGEU bonds will not provide the liquidity necessary to create a safe asset. Taking NGEU and existing EU programmes together, outstanding volume of EU debt will be close to EUR 1 trillion when all NGEU bonds are issued in 2026. Compared to national EU government bonds (see Figure 2), this is slightly below the current Eurozone benchmark bond, i.e. German Bunds adding up to EUR 1.5 trillion, and remarkably lower than French OATs (EUR 2.1 trillion) or Italian BTPs (EUR 2.2 trillion). Moreover, the fact that the EUR 100 billion SURE bonds are issued as social bonds and 30% of NGEU debt, i.e. up to EUR 225 billion, will be issued in green bonds significantly fragments the already small market in EU debt. For the time being, this reduces the liquidity and market depth of conventional EU bonds. However, it might pay-off in the long-term because investors increasingly prefer sustainable investment and thus liquidity in conventional bonds is expected to shrink. So, if EU bonds are to stay, it will be a trump card if they are already present in the market for sustainable bonds with a proven track record.

Figure 2: Outstanding volume of bonds issued by EU (projected) and selected national government bonds (actual).



Source: AFME[9] and European Commission.

The liquidity of the EU safe asset also suffers from the current distribution of investors in EU bonds. While the Commission's plan is to ensure a regular presence on all parts of the curve with as liquid as possible EU-Bonds,[10] the reality looks rather different. The NGEU bond issuances seen so far have been oversubscribed, but more than 90% of EU bonds ended up in the pockets of central banks, fund managers, insurers and pension funds as well as bank treasuries (Table 1). In practice, this means that less than 10% of the bonds issued are actively traded and available for use as underlying security in financial transactions. The bulk of them is just put into the safe. While it is premature to draw definitive conclusions given that the issuances have just started and investor trust has yet to be built, the distribution by investor types indicates that EU bonds are attractive to certain investors as their high rating offers a positive yield, but they are not (yet) perceived as

[9] AFME, *Government Bond Data Report Q1 2021*, 29 Jun 2021.
[10] European Commission, *The EU as a borrower.*

a safe asset. In any case, it is fair to say that if the proportion of hedge funds and banks in EU bond purchases remains flat, the transaction volume of EU bonds will fall short of what is required to create a safe asset that can always be bought and sold in the secondary market.

"The transaction volume of EU bonds falls short of what is required to create a safe asset."

Table 1: Distribution of investors by type.

	NGEU 10-year 15 June 2021	NGEU 5-year 29 June 2021	NGEU 30-year 29 June 2021	NGEU 20-year 13 July 2021
Central Banks / Official Institutions	23%	30%	15%	17%
Fund Managers	37%	33%	41%	37%
Insurance and Pension Funds	12%	10%	18%	18%
Bank Treasuries	25%	21%	19%	24%
Banks	2%	4%	5%	2%
Hedge Funds	1%	2%	2%	2%

Source: European Commission.

The temporal limitation of NGEU is hampering the safe asset status of EU bonds. As of now, NGEU is due to end by 2058 at the latest. So, if EU member states leave NGEU as a one-off exercise and decide against turning it into a permanent fund, then investors will at some point have difficulties in replacing old bonds reaching maturity. Again, the limited interest of banks and hedge funds in the first NGEU issuances (see Table 1 above) tends to suggest that some investor groups do not consider the EU bonds to be a safe asset and this could partly be because of their temporary nature.[11] With no change in the EU own resources decision, NGEU debt will be paid back from 2028 onwards and thus the outstanding volume of EU bonds will constantly decrease which ultimately will make it impossible for investors to roll over EU debt instruments reaching maturity.

"Some investor groups do not consider the EU bonds to be a safe asset because of their temporary nature."

The EU has been awarded the highest creditworthiness by credit rating agencies. The EU is rated AAA/Aaa/AAA/AAA (outlook stable) by Fitch, Moody's, DBRS and Scope and AA (outlook positive) by Standard & Poor's.[12] The EU debt is backed by the EU budget revenues and the member states' commitment to meet their EU repayment obligations before all other liabilities and to provide extra funding to the EU in the unlikely event that a member state does not repay. The extra funding exceeding member states' initial budget contributions is capped at 0.6% of each member state's Gross National Income (GNI) during the NGEU's lifetime. So, the liability for each member state is limited.[13] However, in the worst case, the EU can count on the economic strength of the five triple A rated member states (Germany, the Netherlands, Sweden, Denmark and Luxembourg) providing additional support of up to 0.6% of their GNI. Although this is not as safe as a joint and several

[11] Global Capital, *No such thing as a temporary safe asset*, 15 April 2021.
[12] European Commission, *EU's credit rating*.
[13] Council of the European Union, *Opinion of the legal service, Proposals on Next Generation EU*, 24 June 2020.

liability applying to all member states, the safety net seems strong enough to earn the EU the highest creditworthiness.

To contribute to the proper functioning of financial markets, NGEU borrowing should be extended. First, the volume of outstanding EU debt should substantially increase to create a deep and liquid market for EU bonds. Second, joint borrowing should be expanded under a more permanent mandate to guarantee the EU's long-term presence in capital markets. If the next two to three years prove that the pilot project of common debt and investment achieves its objectives – raising funds at very low cost without running undue risks and delivering on green and digital investment, generating higher growth, and ultimately avoiding any increase in divergences among member states – this would be a convincing argument to replicate this exceptional derogation from the normal ways of funding and use NGEU as a template also for future crises.

Box 1: Do EU bonds contribute to the proper functioning of financial markets?

Function: To contribute to the proper functioning of financial markets, a safe asset needs to be highly liquid, have no roll-over risk, and enjoy the highest creditworthiness.

Diagnosis: The EU bonds fall short of fulfilling this function. Regarding **liquidity,** the volume is insufficient to make a real difference for financial markets. While outstanding EU debt will peak close to EUR 1 trillion towards the middle of this decade, it would need to reach at least EUR 1.5 trillion to be at par with the German Bund and increase to more than EUR 2 trillion to play in the same league as the current biggest issuers, Italy and France.
In terms of **roll-over risk,** without extending the one-off programmes SURE and NGEU launched during the coronavirus pandemic, EU debt is set to constantly decline over time and so will its status as potential safe asset. As far as **creditworthiness** is concerned, the EU has been awarded top ratings by credit rating agencies. NGEU does not create a joint and several liability for the member states. However, in the worst case, the EU can count on the economic strength of the five triple A rated member states providing additional support of up to 0.6% of their GNI.

Recommendation: To contribute to the proper functioning of financial markets, two things need to change. First, **the volume of outstanding EU debt should substantially increase** to create a deep and liquid market for EU bonds. Second, **time-limited joint borrowing should grow into a more permanent mandate** to guarantee the EU's long-term presence in capital markets.

3.2 Mitigate the flight-to-safety

To mitigate a capital flight-to-safety, the safe asset would need to help address the scarcity of highly rated euro-denominated assets and reduce fragmentation in the eurozone sovereign bond market while at the same time avoid crowding out demand for national euro area sovereign bonds.

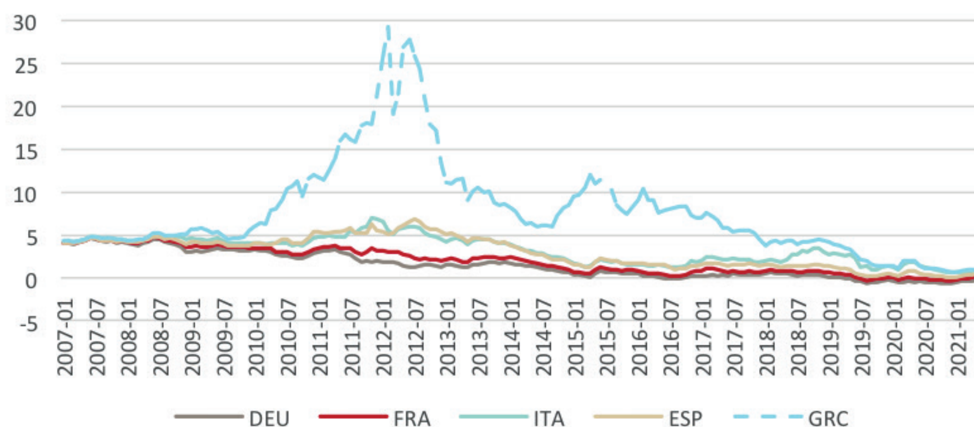
It is not likely that EU bonds will crowd out national debt issuances. Indeed, NGEU will put up to EUR 807 billion in additional debt instruments on the market. But given the current shortage in euro-denominated safe assets, the market seems ready to absorb an additional supply of annually EUR 150–200 billion in EU bonds. To avoid major collisions, the European Commission is coordinating its issuances close-

ly with member states. Furthermore, investors enjoy planning security through the Commission's six-monthly funding plans outlining the borrowing calendar for the next half-year. Latest evidence underlines that the NGEU issuances are well co-ordinated and managed: Italy (EUR 10 billion)[14] and Spain (EUR 2.2 billion)[15] issued new bonds just before and after the first NGEU issuance (EUR 20 billion) on 15 June 2021 and financial markets showed absolutely no problem at all in digesting this combined volume.

EU bonds have the potential to make the eurozone sovereign bond market less fragmented. The announcement of NGEU in 2020 alone brought down risk premia for EU sovereign bonds (Figure 3). This suggests that investors perceive the EU's financial architecture to have improved thanks to European solidarity in the coronavirus pandemic and, consequently, they rate national sovereign bonds safer and feel encouraged to buy more of them. Going forward, EU bonds could make sovereign bond yields converge even further because they make foreign investors pay more attention to EU capital markets; this, in turn, boosts interest in other European issuers. So, instead of crowding-out demand for national sovereign bonds, the so-called portfolio effect could crowd them *in*. By increasing the universe of highly rated bonds denominated in euro, EU bonds allow investors to accumulate more national sovereign bonds and build bigger portfolios.

"Going forward, EU bonds could boosts interest in other European issuers."

Figure 3: Long-term interest rates of selected euro countries.



Source: OECD.[16]

Foreign investors' appetite for EU bonds has yet to grow. While market experts expect the EU swiftly to become a must-have name for international investors,[17] the geographical distribution of investors in the first NGEU bond issuances reveals that the share of foreign investors has been relatively small so far (Table 2). Purchases by investors located in Asia and the rest of the world, including the US, were rather limited, although this picture is somewhat blurred because the UK (home to the City of London) serves as an important investment hub for international investors and soaked up close to a quarter of all EU bonds. Still, if the aim is to make EU bonds the common safe asset and promote the international role of the euro, then non-EU demand will clearly have to increase. While it is too early to draw definitive conclusions, EU bonds will attract more foreign investors if they

[14] Ministero dell'Economia e delle Finanze, *Syndicate placement results: BTP 10 Years*, 8 June 2021
[15] Tesoro Público, Resultado de últimas subastas, *Bonos del Estado*, Settlement date 06/22/2021
[16] OECD, *Main Economic Indicators, Long-term interest rates.*
[17] Tradeweb, *EU Issuance and the Evolution of European Bond Markets*, 28 April 2021.

match the technical characteristics of a safe asset, i.e. ample liquidity and permanent market presence. As highlighted in the section before, this would require the EU to increase borrowing volume and abandon time limits on EU debt.

"EU bonds will attract more foreign investors if they provide ample liquidity and permanent market presence."

Table 2: Distribution of investors by geography.

	NGEU 10-year 15 June 2021	NGEU 5-year 29 June 2021	NGEU 30-year 29 June 2021	NGEU 20-year 13 July 2021
UK	24%	30%	21%	24%
Benelux	15%	6%	13%	11%
Germany	13%	8%	27%	19%
Nordics	10%	12%	7%	12%
France	10%	8%	10%	9%
Italy	5%	6%	7%	7%
Other Europe	10%	11%	13%	15%
Asia	10%	18%	1%	3%
Rest of World	3%	1%	1%	0%
Total	100%	100%	100%	100%

Source: European Commission

Box 2: Do EU bonds mitigate a capital flight-to-safety?

Function: To mitigate a capital flight-to-safety, the EU safe asset would need to help address the scarcity of safe euro-denominated assets and reduce fragmentation of the eurozone sovereign bond market while at the same time not risk crowding-out demand for national EU sovereign bonds.

Diagnosis: The issuance of up to EUR 806 billion in NGEU bonds does not seem to crowd out national sovereign bonds. On the contrary, the additional supply of safe euro-denominated assets might even crowd in sovereign bonds. EU bonds thus have the potential to make sovereign bond yields converge and reduce the current fragmentation in euro area sovereign bond markets. However, the demand for EU bonds from outside the EU remains scant.

Recommendation: To increase its attractiveness for international investors, EU bonds' safe asset status would benefit from ample liquidity and permanent market presence. As highlighted in the section before, this would require the EU to **increase borrowing volume** and **abandon the temporal limitation of EU debt.**

3.3 Support the implementation of monetary policy

To support the implementation of monetary policy, the safe asset would need to be the benchmark for pricing other assets in the euro area and be eligible for ECB monetary transactions.

NGEU is not a eurozone instrument. The EU debt issued under NGEU is denominated in euro, but it also embraces eight EU member states with their own national currency. In addition, two out of five countries contributing to the triple A rating of the EU are not part of the euro area: Denmark and Sweden. Therefore, the EU bonds issued on the back of the EU-27 budget will hardly be able to create the fully constituted eurozone yield curve that the ECB could use for monetary policy purposes.[18] Albeit an imperfect proxy for the eurozone, the EU bonds' yield curve might still serve as a complementary reference yield curve and support the euro area in decoupling private sector borrowing costs from sovereign funding costs. The economic weight of the eurozone is already dominant in the EU-27 and is set to further grow with the imminent accession of Bulgaria and Croatia to the club of currently 19 euro countries.[19] So, the importance of the new "European yield curve"[20] as a benchmark for the pricing of other euro area assets will rise over time.

"The importance of the new 'European yield curve' for the pricing of other euro area assets will rise over time."

EU-27 bonds are an imperfect solution for the eurozone but applying the Union method to NGEU is fiscally and democratically beneficial. An important benefit of debt owed by the EU-27 budget is that it does not translate into national debt which could impair member states' debt sustainability and access to financial markets. Eurostat does not allocate the EU debt to the different member states as the exact repayment modalities will only be determined at a later stage. Beyond this financial aspect, the decision to anchor NGEU borrowing in the EU budget is highly advantageous in terms of parliamentary control, democratic accountability and checks and balances, all of which would not be available within an intergovernmental eurozone setting.

The ECB has integrated EU bonds in the conduct of its monetary policy, but regulatory barriers remain. The ECB is accepting EU bonds as collateral in open market operations and buying them in the course of its extraordinary asset purchases. However, the ECB does not treat EU bonds as the European safe asset. Under the ECB's collateral framework,[21] the supranational EU bonds face a higher haircut than national sovereign bonds, making them less attractive for banks who want to use them as collateral for receiving fresh money from the ECB. With regard to asset purchases, the ECB has limited itself to holding no more than 10% of all assets purchased in supranational bonds and to buy no more than 50% of the bonds of one supranational issuer.[22] However, to exploit the entire stabilising potential of the EU bonds and have full flexibility in conducting its monetary policy, the ECB would need to apply to EU bonds haircuts similar to national sovereign bonds and abandon its current purchase limits.

"The ECB does not treat EU bonds as the European safe asset."

[18] ECB, *Euro area yield curves.*

[19] European Commission, *Commission welcomes Bulgaria and Croatia's entry into the Exchange Rate Mechanism II*, Press release, 10 July 2020.

[20] IPE, *Commission to use rescue plan to create 'European yield curve'*, 7 October 2020.

[21] Guideline (EU) *2016/65* of the European Central Bank.

[22] Decision (EU) *2020/188* of the European Central Bank.

Box 3: Do EU bonds support the implementation of monetary policy?

Function: To support the implementation of monetary policy, the safe asset would need to be the benchmark for pricing other assets in the euro area and be eligible for ECB monetary transactions.

Diagnosis: The bonds issued on the back of the EU-27 budget will hardly be able to create the fully constituted eurozone yield curve. Although an imperfect proxy, they might still support companies in getting their financing costs priced more in line with the European safe asset than with the borrowing costs of the domestic sovereign. In addition, tying the bonds to the EU budget comes with economic and political advantages which would be unavailable in an intergovernmental eurozone setting. The ECB has integrated the EU bonds in the conduct of its monetary policy but does not treat EU bonds as the European safe asset.

Recommendation: To exploit the whole stabilising potential of the EU bonds and have full flexibility in conducting its monetary policy, the ECB would need to treat them like the European safe asset. Therefore, the ECB should apply to EU bonds haircuts similar to national sovereign bonds and abandon its current purchase limits in their regard.

3.4 Help break the sovereign-bank doom loop

To help break the sovereign-bank doom loop, the EU safe asset needs to have a risk-return ratio attractive to banks and benefit from the same treatment as national EU sovereign bonds with regard to prudential regulation and the ECB collateral framework.

NGEU bonds have the potential to reduce the doom loop between banks and their national sovereign. Looking at the first NGEU issuances, bank treasuries have been actively buying EU bonds to the tune of 20–25% in volume (see Table 1 above). Given that demand for EU bonds is concentrated in Europe (see Table 2 above), it is likely that banks located in the eurozone have been purchasing EU bonds to diversify their sovereign portfolio away from their home government. EU bonds rated with AAA are attractive to banks as they carry only marginal risk but offer a slightly higher return than the German Bund. However, banks headquartered in countries with lower credit ratings might be less interested in replacing the bonds of their home government by EU bonds since the latter's yield is lower.

Prudential regulation could encourage banks across the eurozone to buy EU bonds. For the time being, EU bonds benefit from the same preferential treatment in prudential regulation as national sovereign bonds: banks are not required to hold capital for them. However, EU bonds on their own will not ensure that banks throughout the euro area purchase them in significant amounts rather than national sovereign bonds. In the light of the risk-return-profile of EU bonds compared to central government bonds issued by non-triple A countries, it might thus be necessary to provide banks with additional incentives to make them replace substantial parts of their home sovereign debt holdings with EU bonds. One way to achieve this would be to introduce positive risk-weights for national sovereign bonds and to attach the zero risk-weight only to EU bonds. However, given long-standing political opposition and short-term economic constraints, amending the prudential treatment of sovereign exposures has proven difficult in the past.

The ECB should help make EU debt more attractive for Eurozone banks. Another way to incentivise eurozone banks to buy EU debt is to amend the ECB's collateral framework. Currently, the ECB accepts EU bonds as collateral for open market operations but applies a higher haircut to EU bonds (L1B = Category II) than to debt instruments issued by central governments (L1A = Category I). This means that banks get less money from the ECB when depositing EU bonds as collateral. However, to encourage banks outside triple A rated eurozone countries to buy EU bonds, the ECB should amend its collateral framework and apply similar or even more favourable haircuts to EU bonds than to debt instruments issued by central governments. The ECB strategy review[23] concluded on 8 July 2021 touched on the collateral framework but only with regard to climate-related risks. So, if EU bonds are to become the common safe asset, the ECB should amend its collateral framework accordingly.

"To encourage banks to buy EU bonds, the ECB should amend its collateral framework."

Box 4: Do EU bonds help break the sovereign-bank doom loop?

Function: To help break the sovereign-bank doom loop, NGEU bonds need to have a risk-return ratio that is attractive to banks and benefit from the same treatment as national EU sovereign bonds as regards prudential regulation and the ECB collateral framework.

Diagnosis: NGEU bonds benefit from the same zero risk-weight as national sovereign bonds. Eurozone banks have thus heavily bought NGEU bonds which is promising when it comes to diversification and de-risking of banks' balance sheets. However, due to their risk-return ratio, NGEU bonds are less attractive to banks located in high-yield countries. In open market operations, the ECB applies higher haircuts to EU bonds than to national EU sovereign bonds which is making EU bonds less attractive as collateral for banks.

Recommendation: The ECB should make its collateral framework more favourable towards supranational EU bonds and apply the same haircuts as to national sovereign bonds to encourage banks from all euro countries to reduce their exposure towards their domestic sovereign.

[23] ECB, *Strategy review.*

Conclusion

The EU bonds financing Europe's recovery already fulfil important functions of a euro area safe asset. An additional supply of up to EUR 807 billion in high quality bonds addresses the current shortage in euro-denominated safe assets. Their high credit rating makes EU bonds attractive for many investors and might well lead to increased demand for national EU sovereign bonds at the same time. European banks are buying EU bonds and thereby diversify and de-risk balance sheets currently biased towards domestic sovereigns. The launch of NGEU has already increased investor confidence in European financial architecture. EU bonds could now make sovereign bond yields converge further and thus reduce the fragmentation visible in euro area sovereign bond markets.

NGEU bonds are the best shot at getting a safe asset in the foreseeable future. The flaws associated with failing to be a eurozone-only instrument decline with each new country that joins the euro. So, over time, EU bonds may well help to decouple private sector borrowing costs from those of domestic sovereigns. Crucially, operating outside an intergovernmental eurozone framework offers remarkable fiscal and democratic benefits. Common borrowing channelled through the EU budget does nothing to raise the debt levels of individual member states and applying the Union method has the benefit of adding greater democratic control. It is, therefore, politically sensible to take advantage of NGEU bonds and make them the euro area's safe asset.

With the right reforms, NGEU bonds can be made the much-hoped-for safe asset. This would first and foremost require the political will to increase the volume of EU borrowing and to introduce a permanent common fiscal facility. It would also require the ECB to amend its provisions for the treatment of supranational EU bonds to fully exploit their potential for enhancing the implementation of monetary policy in the eurozone and for mitigating the home bias in banks' sovereign exposures.

EU member states have until 2027 to decide whether to extend the pilot project of common EU debt with regard to volume and time. If the negotiations for the next multi-annual financial framework do not amend the current plan, NGEU bonds will gradually be withdrawn from the market. So, if the coming years prove that common borrowing and investing are beneficial to the whole Union, political decision-makers should seize the opportunity to create the long-awaited safe asset for the eurozone and put EU borrowing on a permanent footing before NGEU debt starts being paid back from 2028 onwards.

"Decision-makers should seize the opportunity to create the safe asset before NGEU debt starts being paid back."

Hertie School
Jacques Delors Centre

On the same topic

- Nils Redeker
  Go big or go home – How to make European industrial policy work
  Jacques Delors Centre, Policy Paper, May 2021

- Sebastian Mack
  Beyond Wirecard – All of Europe needs independent financial supervisors
  Jacques Delors Centre, Policy Brief, April 2021

- Lucas Guttenberg, Johannes Hemker, Sander Tordoir
  Everything will be different: How the pandemic is changing
  EU economic governance
  Jacques Delors Centre, Policy Brief, February 2021

- Sebastian Mack
  Beyond transparency: Getting serious about greening Europe's financial system
  Jacques Delors Centre, Policy Brief, February 2021

- Lucas Guttenberg, Sebastian Mack
  Building EU green bonds that deserve their name
  Jacques Delors Centre, Policy Brief, October 2020

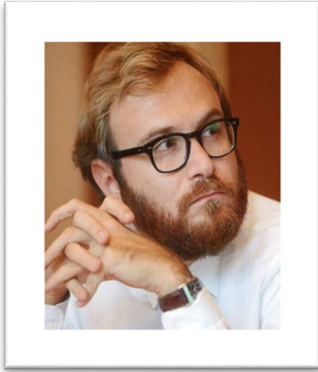
This policy paper is part of the Resilient Recovery Project funded by the European Climate Foundation (ECF).

Hertie School gGmbH • Chairman of the Supervisory Board: Bernd Knobloch • Chairman of the Board of Trustees: Frank Mattern • Managing Director: Prof. Mark Hallerberg, PhD, Dr. Axel Baisch • Registered Office: Berlin • Trade Register: Local Court, Berlin-Charlottenburg HRB 97018 B • Hertie School – founded and supported by the non-profit Hertie Foundation
Image © Markus Spiske, Source: Unsplash

Friedrichstraße 194
D – 10117 Berlin
Tel.: +49 (0)30/259 219 107

Online: delorscentre.eu
E-Mail: info@delorscentre.eu
Twitter: @delorsberlin

BIOGRAPHIES OF SPEAKERS



Grégory Claeys,
Senior Fellow, BRUEGEL

Grégory Claeys is a senior fellow at Bruegel and an associate professor at the Conservatoire National des Arts et Métiers. His research interests include European economic governance, macroeconomic policies and central banking. Prior to joining Bruegel, he has been a visiting researcher at the Central Bank of Chile and an economist in the French bank Crédit Agricole. He holds a PhD in Economics from the European University Institute.

Rebecca Christie ,

Non-resident fellow, BRUEGEL

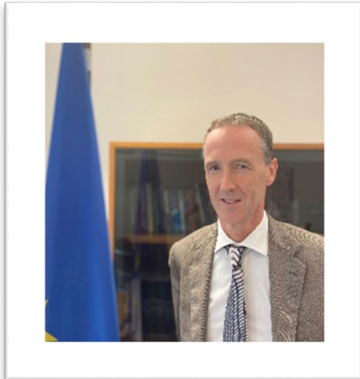
Non-resident fellow Rebecca Christie has been affiliated with Bruegel since 2019, writing about Brexit, EU financial regulation, and tax policy. She was the lead author on "Safeguarding the Euro," the official history of the European Stability Mechanism, and previously spent five years as a senior EU correspondent for Bloomberg News. During more than a decade in Washington, she wrote extensively about the U.S. Treasury, the Federal Reserve and financial regulation for Bloomberg, Dow Jones/The Wall Street Journal and the Financial Times. She is a dual US and Belgian national.

Pauline Weil,
Research assistant, BRUEGEL

A Research analyst at Bruegel, Pauline holds a master's degree from Sciences Po Lille. She also studied an MSc in Political Economy of Europe at the London School of Economics.
Prior to Bruegel, Pauline was an economist for the credit insurer Coface where she provided analysis on Europe, working from Paris, and then on Asia, from Hong Kong. She also pursued the Blue Book Traineeship at the European Commission, working for DG INTPA in the Directorate for Asia.

Sebastian Mack,
Jacques Delors Centre Policy fellow
Author of the policy paper Don't change horses in midstream – How to make NGEU bonds the euro area's safe asset

Sebastian Mack is a Policy Fellow for European Financial Markets at the Jacques Delors Centre in Berlin. His research focuses on European banking supervision and resolution, Capital Markets Union and financial crime. Previously, he worked as academic assistant and policy advisor to a German Member of the European Parliament's Economic and Monetary Affairs Committee and as audit senior for prudential regulation at an internationally leading accounting firm. Sebastian studied business administration, economics and European law at the University of Würzburg/Germany and the INSEEC Grande École Paris/France. He wrote his diploma thesis under the supervision of Prof. Dr. Peter Bofinger on the reform of the European Economic and Monetary Union and finished his studies as one of the top three graduates of his year. https://www.delorscentre.eu/en/team/profile/person/mack



Niall Bohan
Commission DG BUDG
Director of asset, debt and financial risk management

An Irish national, and economics graduate from Trinity College Dublin and the College of Europe, Bruges, Niall Bohan has held a number of policy and management roles since joining the European Commission in 1994. Between 2004-2017, he served as Head of Unit for the Asset Management, Banking, and Capital Markets Union units in the Commission department responsible for financial regulation and policy. Between 2011 and 2013, Niall Bohan served in the Task Force for Greece where he coordinated the provision of technical assistance to the Greek government to support reform of customs, public procurement, competition and investment licensing. Between 2017 and mid-2019, he led the unit responsible for legal and institutional affairs and risk management in the Commission department responsible for economic and financial affairs. Since mid-2019, Niall Bohan has served as head of the Commission Treasury and from July 2020 as Director for the department responsible for Financial Operations undertaken on behalf of the EU budget. This Directorate oversees the management of the budgetary guarantees provided by the Union budget to support investment (EFSI/EFSD), manages the financial assets owned by the Union budget, and undertakes the borrowing and lending operations to implement the SURE programme and NextGeneration EU Recovery Plan.

PRESENTATIONS

Presentation by Grégory Claeys - Rebecca Christie - Pauline Weil
Bruegel Senior Fellow - Non-resident fellow - Research assistant

Next Generation EU borrowing: a first assessment

Rebecca Christie, Grégory Claeys, Pauline Weil (Bruegel)
European Parliament BUDG Committee Workshop
27 October 2021

IMPROVING ECONOMIC POLICY   WWW.BRUEGEL.ORG   @BRUEGEL_ORG

The Commission's borrowing needs

- Before NGEU, **the EU was a small issuer**
- **SURE: substantial increase in capacity**: € 100 bn over 2020-21. The EU's transition to becoming a significant issuer.
- **NGEU:**
  - **Up to €750 bn in 2018 prices**.
  - €80 to be issued in 2021. Around **€150 bn annually** from 2022 to 2026.
  - Net issuance to stop at end of 2026 but roll-over possible to smooth repayments, as long as repayment to be concluded by 2058.

2

Main features of the EU's borrowing strategy

- **Definition**: Plan of an entity to meet its funding needs. Governs the entity's relations with its investors.
- Two main types of strategies
  - **Opportunistic strategic**: for small issuers, punctual borrowing, adapting to market conditions.
    Aim: to get the lowest interest rates
  - **Diversified funding strategy**: for large issuers, **regular and predictable** issuances, long term perspective. What US, and major EU issuer have been doing for a long time, what the EU started doing in 2021.
    Aim: low rates and resilient source of funding. Investor diversity. Make EU bonds **benchmark risk-free assets.**
- Main features
  - **Diverse type of securities**: € only. But all spectrum of maturities (3-month bills – 30Y bon). Green bonds.
    - **Diverse maturities**: to spread out repayment, attract diverse investors, create a yield curve.
  - **Diverse ways to tap** market: mostly syndicated transactions and auctions. Credit lines, private placements also options.
    - **Syndicated transactions**: less risky at start, allows to target investors.
    - **Auctions**: less costly, only method used for EU bills, and so far only for bond taps.

3

Developing relations with investors

- Generate investor confidence and ensure attractivity of EU securities by providing
  - **Predictability and accountability**: annual borrowing decision and funding plans twice a year.
  - **Attractivity** of EU securities: secure good ratings, high liquidity in secondary market.
  - **Confidence**: credible source of 'income' for reimbursement: increase in callable 'headroom' by 0.6% of MS GNI, and, if possible, increase in new EU own resources ('EU taxes').
- The importance of setting up a **primary dealer network**
  - **Supports issuances**: organization of syndicated transactions, supports running of auctions.
  - **Supports liqudity in secondary markets**
  - **Provides market insights to issuer** important to adjust borrowing plans.

  ➔ They are important partners, relations have to be managed: politically sensitive (especially in multi-country setup in which national treasuries will have tendency to lobby for 'their' champions), enough incentives needed to perform the job well.

4

Comparing the EU to other issuers: choice of a large PDN

Entity	France	Germany	Italy	Spain	United States	European Union
Auction type	Multi-price	Multi-price	Multi-price for short term bills and single price for bonds.	Mixture of single-price and multiple-price auctions.	Single price	Multi price
Syndication	For less liquid or new securities.	For less liquid or new securities.	For less liquid or new securities.	For less liquid or new securities.	No	So far for all new bond issuances.
Primary dealer networks	**Composition**: 15 **Duties** Participate in auctions (at least 2%); in all syndicated transactions; Market making on secondary markets (2% min). Advice for the issuance policy. **Incentive** Fees for syndications. Access to a repo facility. Reputational gain.	**Composition**: 33 **Duties** Participate at auctions (at least 0.05%). Reporting obligations. **Incentives** Fees for syndications. Reputational gain.	**Composition**: 16 **Duties** Participate at auctions (at least 3%). Market making on secondary markets. **Incentives** Exclusive participation in part of auctions. Fees for syndications Reputational gain.	**Composition**: 20 for bills; 19 for bonds. **Duties** Participate at auctions (at least 3%); Market making in secondary markets. Provide market insights. **Incentives** Exclusive participation in part of auctions. Fees for syndications. Representation at the Public Debt Market Advisory Commission. Reputational gain.	**Composition**: 24 **Duties** Participate at auctions (at least 5%). Secondary market activities (0.025%). Reporting obligations. **Incentives** Reputational gain.	**Composition**: 41 **Duties** Participate at auctions (at least 0.05%). Secondary market activities. Reporting obligations. **Incentives** Fees for syndications. Reputational gain.
Green bond	First issuance on 24/01/2017.	First issuance on 02/09/2020.	First issuance on 3/3/2021.	First issuance on 7/9/2021	No	Planned for October 2021.

So far, € 54 billion raised out of € 80 billion planned for 2021

Past syndicated transactions attracted a satisfactory and diverse pool of investors, in terms of geography and type – ie. buy-and-hold investors.

Source: European Commission

	First 15/06/2021	Second 29/06/2021		Third 13/07/2021	Fourth 14/09/2021
	10Y	5Y	30Y	20Y	7Y
Amounts	€ 20 billion	€ 9 billion	€ 6 billion	€ 10 billion	€ 9 billion
By type					
Fund managers	37%	35%	41%	37%	36%
Central banks / Official Institutions	23%	30%	15%	17%	32%
Insurance and Pension Funds	12%	10%	18%	18%	7%
Bank Treasuries	25%	21%	19%	24%	21%
Banks	2%	4%	5%	2%	2%
Hedge Funds	1%	2%	2%	2%	2%
By geography					
Germany	13%	8%	27%	19%	7%
France	10%	8%	10%	9%	8%
UK	24%	30%	21%	24%	39%
Benelux	15%	6%	13%	11%	11%
Nordics	10%	12%	7%	12%	10%
Italy	5%	6%	7%	7%	6%
Other Europe	10%	11%	13%	15%	10%
Asia	10%	18%	1%		7%
Other	3%	1%	1%	3%	2%

Past auctions have been considered a success as they were **all oversubscribed.** Also, **weighted average yields are slightly above market prices** (+7-15bp): a small increase (ie. lower yield) in prices **show interest in secondary markets**

	EU-Bills	EU-Bills
Maturity	3M	6M
Type	New	New
Date of auction	15/09/2021	15/09/2021
Volume bids	10 181	11 507
Volume allotment	2 999	1 997
Weighted average yield	-0,726%	-0,733%
Highest accepted yield	-0,700%	-0,715%
Percentage awarded at highest accepted yield	51%	76%
Cover ratio	3.39	5.76
Volume announced	up to 3000	up to 2000

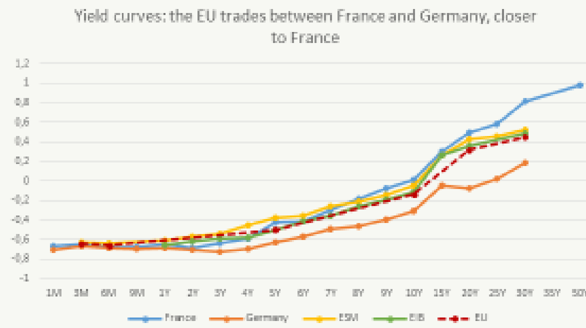
6

Source: Bloomberg

So far, NGEU debt trades between France and Germany, closer to France

EU bonds are perceived as safe assets issued by a **'quasi sovereign'** (as shown by informal poll of investors)

- Considered equivalent to "joint and several guarantee" by most rating agencies
- The EU is rated AAA by Fitch and Moody's, but AA by S&P, which takes the average of all MS ratings.
- ESM is rated AAA by Fitch and S&P, but Aa1 by Moody's – following French downgrade



Source: Bloomberg

7

Managing the primary dealer network: EU countries' banks are not equally represented in the PDN

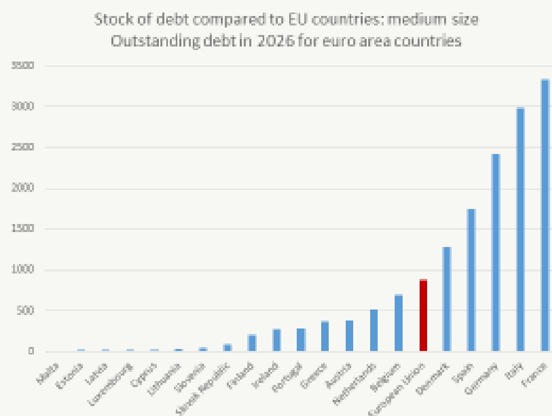
Country	Count of Bank in the PDN	Share of banks in the PDN	Share of total mandated banks in the past 4 syndications	Country capital key at the ECB
Austria	2	4.9	4.2	2.4
Belgium	1	2.4		3.0
Bulgaria				1.0
Croatia				0.7
Cyprus				0.2
Czech Republic				1.9
Denmark	1	2.4	4.2	1.8
Estonia				0.2
Finland	1	2.4		1.5
France	7	17.1	25.0	16.6
Germany	14	34.1	41.7	21.4
Greece	2	4.9		2.0
Hungary				1.5
Ireland	3	7.3	8.3	1.4
Italy	2	4.9	4.2	13.8
Latvia				0.3
Lithuania				0.5
Luxembourg				0.3
Malta				0.1
Netherlands	3	7.3	4.2	4.8
Poland				6.0
Portugal				1.9
Romania				2.8
Slovakia				0.9
Slovenia				0.4
Spain	3	7.3	8.3	9.7
Sweden	2	4.9		3.0
Total of represented banks	41	100	71.8	81.3

Source: European Commission, ECB, Bruegel own calculations

Legend:
Above ECB capital key: green
Below: orange
None: red

8

Impact on EU countries borrowing strategy



Source: IMF WEO

- **Risk of crowding out is low** for now, but lookout for potential impact of changes in ECB policy.
- Continued **issuance coordination** in the European Sovereign Debt Markets (ESDM) subcommittee gathering national DMOs, the Commission, the EIB, the ESM and the ECB.
- For most, **NGEU is a cheap reliable** source of funding, with less stigma than ESM. But cannot be considered 'safe liability' (like US bonds for the US) because not permanent and not supported by the ECB
- Opportunity to be **financed 'off-balance sheet'**: so far, only NGEU loans included in national accounts. Bundesbank flagged a risk of debt brake undermining. Rating agencies are not concerned.
- This **opportunity relies on confidence in NGEU governance** and positive impact on growth potential

9

Risks & opportunities for the EU in becoming a large issuer

- **Usual risks for DMOs**: manage cash flow, monitor liquidity and market conditions.

- Benefits to EU capital markets: but temporary because of the temporary nature of the tool
  - **Increasing the pool of EU safe assets**: attractivity of euro assets, international role of the euro A **European benchmark** for interest rates: increases convergence in corporate financing costs across EU
  - **Reduce market fragmentation** and **increase resilience**, less capital flight from fragile countries in times of distress if EU borrowing considered as commitment device that EU will stick together in the future

- Position the **EU as a sustainable finance hub** could benefit international role of the euro
- Brussels's effect: **ambitious green standard setting** but for now limited to the private sector.

- **Opportunity to mitigate the sovereign-bank doom loop.**
  - But this is limited by the size of NGEU (need almost 20% of GDP to replace national bonds), its temporary status and because still less attractive than sovereigns for refinancing operations at the ECB.

10

Main Recommendations

- Ultimately, the EC's interest is to generate confidence from markets and be useful to MS as a DMO.
  - Monitor market performance: **the goal is to get the yield curve with stable spreads to current benchmark (Germany) and to create liquid secondary market (with low bid-ask spread)**.
  - Relations to the Primary Dealer Network should be managed carefully and could be improved
  - EU bills can continue to be used to manage liquidity
- Green finance: to have the Commission **lead in ambitious standard setting for sovereign green issuances**
  - **Climate tracking methodology of RRF investments** can be more strict/ scientific. Adopt as much as possible the EU taxonomy.
  - **Reporting obligations**: get as close as possible to European Green Bond standards
- **All benefits of EU bonds are limited in time and magnitude by the temporary nature** of NGEU
  - 2058 seems so far like a horizon long enough to convince investors
  - NGEU as a test drive: **if substantial benefits** for international role of the euro, capital markets integration and resilience, and benefits to MS, manifest as planned: **NGEU is a successful occurrence of fiscal integration** – creating a precedent for future integration?

11

Thank you for your attention!

IMPROVING ECONOMIC POLICY

WWW.BRUEGEL.ORG @BRUEGEL_ORG

NOTES

A workshop was organised for the Budgets committee (BUDG) on "*The EU borrowing strategy for NGEU: design, challenges and opportunities*" on 27 October 2021. This document consists of an In-depth analysis by Bruegel entitled "*Next Generation EU borrowing: a first assessment*", a policy paper by Sebastian Mack entitled "*Don't change horses in midstream: how to make NGEU bonds the euro area's safe asset*", biographies of the speakers and the Power Point slides of the Bruegel presentation.

DISCLAIMER
This document is addressed to the Members and staff of the European Parliament to assist them in their parliamentary work. The content of the document is the sole responsibility of its authors and should not be taken to represent an official position of the European Parliament.