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Dear colleagues,

Lines of credit protection for investors in bonds issued by the European Union and the negative impact on these protections of the arrangements for the 2021-7 Multiannual Financial Framework and the Next Generation EU programme

Background

We are writing to you about the European Union (EU), its 2021-7 Multiannual Financial Framework (MFF) and the Next Generation EU programme (NGEU or the Coronavirus Recovery Fund).

We have written several papers about the financial constructions of the EU, including the EIB, EIF, ECB, TARGET2, and the EFSM. In particular we have enclosed with this communication our latest research published through Global Britain.

Our sources have been primarily the various types of document issued by the EU. Where we have referred to rating agency reports, it was to confirm that a reputable source had drawn the same conclusions we had.

Now we feel that we have been misled by EU-issued documents about how the EU budgetary arrangements fit together. This casts a shadow over some of our past work. This situation has come to light thanks to the creation of NGEU and its relationship to the MFF, and the relationship of the MFF to the EU budget: the documents and website pages issued by the EU after the recent ECOFIN summit appear, in our view, to overturn past assumptions and to dissolve several lines of credit protection for investors, and we wish to exchange views on that with yourselves.

It is possible that we, on our side, never understood what was plainly obvious and that we only have our own amateurishness to blame. Alternatively, perhaps it was never possible to understand the arrangements from EU-issued documents, without in-person briefings from EU officials, which was not an avenue open to us.

Our understanding of the context

Credit rating agencies, such as yourselves, issue ratings reports that attest to the existence of lines of credit protection for investors when they buy EU bonds or short-dated paper. The existence of these lines of protection must be contained either in public documents, or in private documents shared by the EU with credit rating agencies, or in representations made by the EU to credit rating agencies during in-person briefings.

We have access only to public documents (and it is possible that we have overlooked one or more) and to some of the credit rating agencies' reports. In consequence we take it that your access is superior to ours, but that it is similar between yourselves i.e. one credit rating agency is given the same access and information as another. Furthermore, it would be unrealistic to imagine that one agency is not familiar with another's work on the same issuer, which is not to say that the reports are identical and do not contain differences of opinion and emphasis.

The EU includes salient quotations from credit rating agency reports in its own investor presentations, such as the one from 2015, and there is common ground across those quotations. Where the EU includes such statements in its presentations, these become its own representations: they are presented by the EU as the EU's "credit strengths".

In other words there is a broad degree of common ground on the major issues between the different agencies, and that common grounds also appears to be shared by the EU about itself. This is why we have chosen to send one communication to all of you, rather than one each; had we done the latter, we would have based each one on your own agency's reports, and our view was that such an approach might not have been as productive as this one, since the basis is the common ground. However, please do not feel bound to this approach if you would like to correspond bilaterally after this (if indeed you choose to correspond at all).

What is the point of this letter?
The contention is that the 2021-7 MFF and NGEU appear to have dissolved several lines of credit protection for investors. This is of major concern. Below we have listed out all the lines of credit protection that appear to be challenged in bold type first, and following with the way in which that statement is challenged.

This is done in two sections:

1. Where a specific statement has been made in the Investor Presentation of July 2015 authored by the DG Economic and Financial Affairs of the European Commission;
2. Where a line of credit protection has been assumed or extrapolated from other lines or from documents.

<u>Section 1 – specific statements</u>

Funds raised [are] lent back-to-back: €390bn of the €750bn total of NGEU is being given out as grants. There is no loan behind that portion.

Funds raised [are] lent back-to-back to beneficiary country: the implication is that the back-to-back loans are always to sovereigns. However, there are no loans for the €390bn portion, to a sovereign or anyone else. It is uncertain whether the €360bn loans portion will be to EU Member States and on-lent by them, or whether the EU will directly take non-sovereign risk. For the purposes of comparison, the EU does take non-sovereign risk already, through its guarantees to the EIB. EIB's loans under EU guarantee can only be expected to track through to a sovereign where EIB's borrower is outside the EU. In the case of EU guarantees to the EIB for the InvestEU programme, though, the account party responsible to the EIB is not a sovereign borrower, and is unlikely to be a public sector entity: it will be a privately-owned project company, albeit one that ought to have a supply contract with a public sector entity for the project offtake.

A specific Council Decision determines the amount of a country programme, instalments and maximum (average) maturity of loan package: this is not the mechanism for the grants portion of NGEU; the repayment of the grants portion has to come out of future Payment Appropriations. It does appear to be the plan that a legal instrument will be created for each programme within the loans portion of NGEU, but whether the result will accord with the above statement remains to be seen, especially as regards who borrows the money from the EU.

Borrowings are direct and unconditional obligations of the EU. Its budget is treaty based and determined for 7 year periods: Multiannual Financial Framework (MFF): TFEU Article 122 has been used to cover NGEU. This is problematical because Article 122 does not contain several of the conditions that are incorporated in the NGEU, and it was clearly not drafted for the eventuality that it is being utilized for. Article 122 represents a flimsy basis in Treaty for the NGEU. The EU has obtained an opinion of its Legal Service 9062/20 dated 24th June 2020 and it is 68 pages long, a sure sign of the tenuous connection between NGEU and the Treaty. Were the connection to be clear and explicit, the opinion would have been 5 pages long. Moreover, the connection between the NGEU borrowings and the MFF is at best tenuous and is in fact non-existent if the EU's own website reflects the truth: it presents the NGEU and MFF as separate. If the NGEU-related borrowings are not part of the MFF, they are not part of the EU budget since the EU budget sits within and is subject to the MFF, and not vice versa (TFEU Article 312 – see below).

EU is legally obliged by the Treaty on the Functioning of the EU (Articles 310, 323) to provide through the EU budget the necessary funds to service the EU's debt obligations should loan beneficiaries default: Neither TFEU Article 310 nor Article 323 state this explicitly and exactly. Anyway, the fact that there is no loan behind €390bn of NGEU means this assertion cannot apply to the grants portion. Article 323 simply states that "The European Parliament, the Council and the Commission shall ensure that the financial means are made available to allow the Union to fulfil its legal obligations in respect of third parties." This is not quite the same as saying that the Member States will furnish the funds. Article 310 only has one sub-clause (4) of relevance to this topic and it is quoted against the next-following point below.

The EU may not borrow to finance a budget deficit: whilst sub-clause of 310.4 of the TFEU states: "With a view to maintaining budgetary discipline, the Union shall not adopt any act which is likely to have appreciable implications for the budget without providing an assurance that the expenditure arising from such an act is capable of being financed within the limit of the Union's own resources and in compliance with the multiannual financial framework referred to in Article 312," the NGEU does exactly this and threatens to create budget deficits. It is unlikely to create one in the 2021-7 MFF as long as funds are not disbursed in advance of their being borrowed, and as long as the minimum closest maturity date for the NGEU bonds falls later than 2027.

Looking further out than 2027, NGEU could create a budget deficit in future MFFs because no asset is retained regarding the grants portion that will deliver cashflow against the debts taken on to enable it, and because the related debt repayments are to be afforded out of new lines of Own Resources whose materialisation must be regarded as questionable.

The €750bn of debt will be repayable up to 2058, with maximum 7.5% falling due each year. Almost no debt should fall due during the 2021-7 MFF. An equal repayment profile from 2028 until 2058 would work out to €25bn per annum, whilst the NGEU states that no more than €56.25bn can mature each year. 52% of those amounts would have no borrower repayments against them i.e. €13bn per annum on average and €29.25bn as a peak. The EU's annual cash budget now is around €135bn so such debt payments would shrink the remaining cash budget by 10% on average and 22% at a peak if they were due now. These figures will be higher if there are defaults by borrowers on the loans portion.

The EU claim that the extra debt payments will be covered from its Own Resources, and particularly from the new taxes – like the Financial Transaction Tax – that it is introducing. This is speculative. It is possible that the EU will have a budget deficit in a future MFF caused by NGEU and that it will have to borrow again to cover it.

The EU has an additional contingent claim on Member States of about €30 billion annually over the 2014-2020 MFF period. This pledge is made for the express purpose of backing EU's financial obligations: if this contingent claim comes about through the mechanism of the MFF but the NGEU is separate from the MFF – and the EU presents it as such - how does this pledge serve to back the NGEU borrowings? Where is the pledge documented in respect of borrowings that are within the MFF?

The EU budgetary margin (difference between the annual MFF ceiling and the EU budget) serves as protection to investors by providing coverage against unexpected payment obligations": TFEU Article 312 states that "The annual budget of the Union shall comply with the multiannual financial framework.". This confirms that the MFF is superior to and dominates the EU budget and not vice versa. The EU budget must sit within the MFF and be smaller if there is to be any margin between the two. However, given that the MFF for 2021-7 is €1.07trn and that amount is entirely spoken for as per the final pages in the ECOFIN document, how does this "budgetary margin" come about?

<u>Section 2 – assumptions and extrapolations</u>

The EU budget is synonymous with the MFF: the terms "EU budget" and "MFF" will have been taken as synonyms by many, but this is clearly not the case as TFEU Article 312 makes clear. The "EU budget" is an annual budget. However, the relevant page on the European Commission's website on NGEU and MFF shows an "Overall budget 2021-2027" comprising the MFF and the NGEU separately, implying that the EU budget sits above the MFF and can be larger than the MFF. This directly contradicts TFEU Article 312 which construes the relationship as the other way round: "The annual budget of the Union shall comply with the multiannual financial framework".

"Union financial assistance", of which NGEU is a manifestation, is based on Treaty: the basis of NGEU in Article 122 is flimsy (see above). If the Treaty basis is successfully challenged after NGEU bonds have been issued, those bonds would not enjoy lines of credit protection.

"Union financial assistance" falls within the structure imposed by the MFF: in the case of NGEU, this "Union financial assistance" is separate and in addition to the MFF, as the EU's presentation of it makes clear.

Other instances of "Union financial assistance" fall within the MFF structure: if NGEU – by far the largest instance of "Union financial assistance" – falls outside the MFF, what is the proof that other instances (EFSM, BoP and MFA) fall within it?

"Union financial assistance" is controlled by the Council Decision on the system of the European Communities' own resources (2007/436/EC, Euratom): the Council Decision is the framework for the MFF but since the NGEU sits outside the MFF, this instance of "Union financial assistance" is not controlled by it and the others may not be either.

According to the Council Decision, an MFF is subject to maximum - a budget ceiling - of 1.24% of EU GNI (Payments Appropriation) and 1.31% of EU GNI (Commitments Appropriation): this MFF sets a Payments Appropriation of 1.40% of EU GNI and a Commitments Appropriation of 1.46% of EU GNI. Any protection afforded by the Council Decision has thus been dissolved.

The MFF is what the EU will spend: the EU will spend €1.07trn, which is around 1% of EU GNI if EU GNI is around €14trn per annum from 2021-7. A Payments Appropriation of 1.40% of that amount should approximate to €1.38trn, a difference of €0.37trn. What is this difference? Is this difference the grants portion of NGEU? Or is it the loans portion? Is it the "budgetary margin" or "fiscal headroom"? Or is it neither of these three? It cannot be the NGEU bond repayments because they are spread out until 2058 with no more than 7.5% of the total falling due in any one year.

The MFF is what the EU will spend: the EU will spend a Payments Appropriation of €1.07trn and the NGEU of €750bn during 2021-7, which adds up to 1.8% of assumed EU GNI rather than 1.40%, so its spending during 2021-7 greatly exceeds the ceiling in the Council Decision as a percentage of EU GNI.

The MFF when set is linked to a projection of EU GNI so as to define the amount: we struggle to find the projected EU GNI on which the MFF is based. We have had to calculate it ourselves.

The MFF contains sufficient "fiscal headroom" to call upon EU Member States for money with which to make the payments to investors: as the MFF does not apply to NGEU, this line of protection must be absent. We take the term "fiscal headroom" to be the same as "budgetary margin".

The "fiscal headroom" is the difference between the Payments Appropriation and the Commitments Appropriation: we had assumed this to be the case and read one or two credit agency reports that we understood as supporting this assumption. Under this reading the "fiscal headroom" for 2014-20 was around 0.26% of EU GNI, the difference in the 2014-20 MFF between a Payments Appropriation of 0.97% of EU GNI and an MFF ceiling of 1.23% of EU GNI set in line with the Council Decision. If average EU GNI over the period was €12.5trn per annum, the "fiscal headroom" would be €32.5bn per annum, and indeed two rating agencies have stated figures within this range. For the next MFF, though, the difference is only 0.06% of EU GNI: with EU GNI of around €14trn, this would yield a claim of only €8.4trn per annum. Where does the "fiscal headroom" come from within the EU budget structure if not from this difference, and from where then does the obligation of Member States derive to pay in additional resources of €30-40bn per annum to cover the EU's debts?

The "fiscal headroom", if in the range €30-40bn per annum, is sufficient to cover any shortfall between the EU's debt maturities and any defaults by borrowers on back-to-back loans: there are no back-to-back loans for the grants portion, and NGEU debts of €56.25bn can mature in any one year. There could also be claims on the EU budget in the same year deriving from its other loan and guarantee programmes. Either the "fiscal headroom" has been greatly increased for the 2021-7 MFF – and we are unclear how that has been done, if it has been – or the "fiscal headroom" could prove inadequate.

The accumulation of the mobilisations of "fiscal headroom" from prior MFFs which have not yet been discharged, and mobilisations during the current MFF, go into the "Reste à liquider": the ECOFIN document says this "Reste" will rise to only €308bn during the 2021-7 MFF, even though the EU will borrow €750bn during it, and there are €159bn in loans and guarantees outstanding already, with another €26bn in the pipeline during the current MFF, making €185bn in all at the end of the 2014-20 MFF. We have attached an Appendix to this letter that contains a calculation made in July this year of the EU's loans and guarantees.

Eurostat figures of "General government gross debt" give an accurate representation of the debts of each EU Member State: the reporting of EU public sector debts is at best partial. Several material and expanding types of debt are not being captured by Eurostat in the figures that are the anchor ones for compliance with the Stability & Growth Pact, and the Fiscal Stability Treaty.

Pages 9-11 of our recent research set out this problem and it is not just that the debts (on bonds and loans) of sub-sovereign public sector entities such as water, energy and transport utilities are not included. The problems extend to the Member State exposure through supra-sovereigns – like the EU, EIB and EIF – and to further sub-sovereigns, such as the project borrowers under the InvestEU programme.

The portion of NGEU which is to be relayed as loans will appear in the statistics if there is a "country programme" and the EU's borrowings are in the first instance relayed to an EU Member State, which then makes the loans. If, however, the EU makes the loans itself and direct, these loans will only appear in the statistics if the borrower is an entity whose debts falls within the scope of "General government gross debt".

Regarding the €390bn of debt taken up by the EU to finance grants, there will be no "country programme" as the source of debt repayment is the EU's Own Resources. However, the Member States are still responsible for the debt and it should be added to their own direct debts in the statistics. With some effort the respective figures for (i) the direct debts of supra-sovereigns, (ii) the direct debts of sub-sovereign public sector entities, and (iii) the indirect debts (via InvestEU) of sub-sovereign public sector entities, can be captured and brought into the public domain.

More difficult are the TARGET2 debts, firstly because only the netted amount is reported by the ECB (valid for about an hour on the last business day of each month) and secondly because the original debts contracted between central banks may or may not represent incremental public sector debt, depending upon whether the debt is a deposit or an overdraft and, if an overdraft, whether the collateral behind it has already been captured under the name of the issuing entity of that collateral. This is also explained in the research.

Eurostat figures do not give an accurate representation of the total debts weighing on the exchequers of each EU Member State: they could be 40% higher than Eurostat report, because of the debts held at one step removed from counting into “General government gross debt” which the Member State is nevertheless responsible for. NGEU’s €750bn falls into this category.

Open Issues
Given all of the above, there are a number of open questions:

If NGEU is not soundly based on Treaty, what is the quality of the basis of the EU’s other borrowing programmes:
1. EFSM
2. BoP
3. MFA?

If NGEU is not soundly based on Treaty, what is the quality of the basis of the EU’s guarantee programmes, under which the EIB is the guaranteed party:
1. EIB’s loans outside the EU
2. InvestEU
3. The EIB’s own Coronavirus response?

How does the “Reste à liquider” link to the EU’s supposed “fiscal headroom”?

What is the legal basis for the existence of the “fiscal headroom”?

How does that trigger an obligation on each Member State, and on a joint-and-several-liability basis, to come up with up to €30-40bn per annum to cover the EU’s debts:
1. If a back-to-back borrower defaults
2. When there is no back-to-back borrower at all?

Yours sincerely,

Bob Lyddon

Encl.
Appendix – the EU’s outstanding loans and guarantees
Brexit Paper #9: The Great EU Budget Deception

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BOB LYDDON CHART EXPLAINING THE €185 BILLION AT RISK

MOBILISATION OF EU LOANS AND GUARANTEES IN PREVIOUS AND CURRENT MULTIANNUAL FINANCIAL FRAMEWORKS				
COMPONENT	FACILITY SIZE	OUTSTANDING	REDRAWABLE	AT RISK
Previous Multiannual Financial Frameworks				
European Financial Stability Mechanism	€60.0bn	€45.7bn	€14.3bn	**€60.0bn**
EIB Guarantee for Loans Outside the EU	€29.5bn	€21.5bn	€0.0bn	**€21.5bn**
Balance of Payments Facility	€12.0bn	€2.5bn	€9.5bn	**€12.0bn**
Macro-Financial Assistance (MFA) to Non-EU Partner Countries (Evergreen facility; all repaid amounts are redrawable)	€5.6bn	€5.6bn[1]	All	**€5.6bn**
Euratom	€4.0bn	€4.0bn	€0.0bn	**€4.0bn**
Subtotal for Previous MFFs	€111.1bn	€79.3bn	€23.8bn	**€103.1bn**
Current, 2014-2020 Multiannual Financial Framework				
				FACILITY SIZE
EIB Guarantee for Loans Outside the EU				**€30.0bn**
First EIB Guarantee for InvestEU				**€16.0bn**
Second EIB Guarantee for InvestEU				**€10.0bn**
Macro-Financial Assistance (MFA) to non-EU Partner Countries COVID-19				**€0.3bn**
Guarantee to the EIB for the First-Loss on the €200bn EIB Response to COVID-19				**€16.0bn**
Further Guarantee to the EIB for the Continued Expansion of the non-COVID-19 Activities of InvestEU				**€10.0bn**
Subtotal for Current MFF				**€82.3bn**
TOTAL AMOUNT AT RISK				**€185.4bn**

These two operations, totaling €26.0bn, were advertised as being in the process of mobilization during the remainder of 2020, at the time the chart was drafted in June 2020.

[1] 2018 MFA Report CELEX_52019DC0324_EN_TXT page 15 shows budget allocations for 2017, 2018 and 2019 expected, but there is no statement of the total of loans outstanding and their maturities, or the total of future commitments. The amounts stated are about EUR0.8 bn per annum of new loans. Assuming an average maturity of 7 years, the total of loans outstanding at any one time would be EUR5.6 bn