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Follow-up note to Bruges Group paper "The ECB's Pandemic Emergency Purchase Programme"

Why is it claimed that the public credit ratings of EU and Eurozone bond issuers are inflated by 4 rating notches e.g. they carry a rating of AAA when it should be A+?

26th April 2021

This is the second of two notes deriving from discussion and questions after the launch of the Bruges Group paper. The other sets out the reasons why the UK's situation is structurally and materially better than that of the EU/Eurozone, even if the UK is heading in the wrong direction.

This note justifies the contention that the public credit ratings of EU and Eurozone issuers are four notches too high, with one reason for one notch.

Lack of a genuine sovereign behind the Euro

The relationship of each Eurozone member state to the euro currency is not the same as that between the UK and the pound, or the USA and the dollar. Eurozone member states have surrendered monetary sovereignty to the Eurozone authorities. They therefore lack important tools when it comes to managing their own economies (control of interest rates, money supply, exchange rate). This reduces their ability to take certain measures available to the UK and USA, and which reduce the risk of a debt default. This point is discussed in detail in the book "Managing Euro Risk" of 2020, co-authored by Barnabas Reynolds, David Blake and the writer.

Extra level of debt and contingent liabilities above each member state

The UK does not have a set of supranationals (EU/EIB/EIF/ESM) above the member state, which take on their own debts and create their own contingent liabilities for which the member state bears the risk of repayment. Member state liability is joint-and-several in the case of the EU, and several-but-not-joint in the case of the EIB, EIF and ESM. However, the EU has issued a series of first-loss guarantees to the EIB which convert what would have been a several-but-not-joint risk into a joint-and-several one. The writer estimated in late 2020 that each EU member state was exposed through the EU for €185bn. This will escalate during the 2021-27 Multiannual Financial Framework by the size of the Coronavirus Recovery Fund of €750bn, as well, no doubt, due to new guarantees to the EIB for its lending outside the EU and for its indemnities to the EIF for InvestEU projects. These operations are described in Appendices 2 and 3 of "Managing Euro Risk".

By the end of 2027 each EU member state could be on-risk for nearly €1 trillion through the EU, and for capital calls by the EIB and ESM in line with their share of EU and Eurozone GDP respectively, up to around €100bn for the largest countries, all of whom are in the Eurozone.

Extra level of debt in public sector entities below each member state

This layer of debt resides at public sector entities whose debts do not count within Eurostat's definition of "general government gross debt". The debts of provincial, regional

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and municipal government bodies are counted by Eurostat. The missing debtors are development bodies, power, water and transport utilities, and the sponsors of projects under the InvestEU programme.

The EIB's direct loan book of around €500bn is concentrated into EU public sector, non-governmental entities. It is reasonable to assume that this loan book is currently €400bn, excluding its SME loans, its loans outside the EU and its InvestEU loans. However, this figure does not include bonds issued by these debtors, or loans made to them by other lenders. There is no comprehensive database of these entities or their debts.

InvestEU is the EU's counterpart to the UK's PFI model. Whereas PFI is not in expansion mode, the InvestEU programme mounted through the EIB and EIF has doubled the size of the EIB/EIF activity since its launch and creates public sector obligations without creating public sector debts as recorded by Eurostat. The EIB was planning to have InvestEU reach a size of €500bn by the end of 2020, meaning all the money raised for InvestEU projects. Only about 13% of this money, or €65bn is sourced from the EIB, and as subordinated loans taking the second loss; the remainder is raised from external markets, with 4% benefitting from a first-loss commitment from the EIF as either a guarantee or an equity put option (which the EIF calls an "equity commitment"). The source of repayment of all this money is the purchase by an EU public sector entity of the offtake of the project but, as with PFI, the debts are not counted as liabilities of that public sector entity. The debt remains off the public sector balance sheet.

Capture of the rating agencies themselves by EU/Eurozone authorities
Finally there is the point that the rating agencies have been captured by the EU/Eurozone authorities. All four recognized agencies (Standard&Poor, Moodys, Fitch and DBRS) are registered and regulated, and coincidentally see all matters in the same way as the EU/Eurozone authorities wish them to be seen.

For example, Brexit – the loss of the EU's second largest net financial contributor – was viewed solely as a credit-negative event for the UK.

The unveiling of the Coronavirus Recovery Fund of €750bn drew no comment either (i) about the increased contingent liabilities of member states; or (ii) about the shaky legal foundation. Instead the comment was positive in terms of the creation of debt that was on a joint-and-several liability basis and which served the aims of federalization.

Summary
It might seem unfair on Germany to moot that it should have an A+ rating instead of AAA, until one registers that the main comfort being drawn by potential investors in the Coronavirus Recovery Fund is that they all track back onto Germany. The above analysis does not even touch the TARGET2 issue, where Germany has a claim of over €1 trillion on the ECB, which largely tracks onto ECB claims on Italy and Spain. Rating reports on these countries exclude any mention of TARGET2.

One could argue at length as to whether each issue is worth one full notch; some may be worth less, and some more. Ratings are meant to be conservative and the investors who rely on them risk-averse. This understanding has failed when it comes to the ratings of EU/Eurozone issuers.

BL/26.4.21

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