Banking on Europe Policy Brief

3/ 2023

The Commission's borrowing operations: A closer look at the new diversified funding strategy

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Key Points

- In response to the increased volume and number of borrowing operations under the Next Generation EU framework, the European Commission has developed a new funding strategy.
- The Commission now aims to establish a 'regular capital market presence' by issuing bonds under a single EU label, pursuing a more activist debt management strategy, and raising funds through regular auctions.
- Although these changes are significant in the context of EU borrowing, they largely continue long-term trends in EU borrowing reforms.
- The new funding strategy implies greater financial risks for the EU, but it also makes it easier to hold the Commission accountable by bringing its operations closer to that of national treasuries.

Introduction

When the European Commission was put in charge of conducting large-scale borrowing operations on behalf of the European Union (EU) to implement the Next Generation EU package, some observers argued that these changes represented a 'paradigm shift' in the EU's economic governance (Fabbrini, 2022). Although the Commission has borrowed funds on capital markets since the 1970s, both the amounts of money to be raised under the EU's pandemic response, and the task of disbursing them to the member states represent unprecedented challenges for the Union's treasury operations.

This policy brief explains how the Commission has reformed its borrowing since 2021. The technical and legal changes during this period represent a departure from some longstanding principles of EU borrowing. The EU's new debt management practices involve greater financial risks, but they are now more closely aligned with those of national treasuries, which may make it easier to hold the Commission accountable for its debt management.

EU borrowing before the pandemic

The European Commission was already responsible for several borrowing instruments before the COVID-19 pandemic. In the 1970s, it took charge of the Community Loan Mechanism and Euratom loans facility, with the former later transformed into the Balance of Payments Assistance Facility. Since the 1990s, the Commission has borrowed to provide Macro-Financial Assistance to third countries. In 2010, it was put in charge of the European Financial Stabilisation Mechanism (EFSM), which provided financial assistance to euro area members facing sovereign debt crises.

Over a period of 40 years, the EU developed a set of principles for how the Commission should raise and disburse funds for these instruments. These principles were included in a new article in the EU's Financial Regulation in 2018.[1] This regulation stipulated that the Commission could only raise funds in response to funding needs,[2] that it could not engage in maturity transformation, and that it could not expose the EU to any interest rate or commercial risk.[3]

The application of these principles meant that each time an instrument was used, the Commission first borrowed funds by issuing a bond that bore the label of that instrument and then lent the funds back-to-back (that is, with the same interest and maturity) to the recipient member state. To illustrate this point, consider what happened when the Commission participated in the Irish bailout under the EFSM. For each loan tranche, the Commission issued an EFSM bond and then passed the lending conditions on to the Irish government. As Ireland paid back its loan, the Commission used the funds to redeem the bond. The timing of when the Commission issue bonds and how much it raised, in other words, was 'entirely determined by the needs of the beneficiary' (European Commission, 2022, p. 7).

As a result of these rules, prior to 2020 the Commission tapped capital markets rather sporadically. The only sort of debt management operations that it could engage in was the refinancing of outstanding bonds at lower interest rates, that would then be passed on to the loan recipient. Curiously, even though all bonds issued by the Commission were secured against the EU budget, bonds with different labels had slightly divergent yield curves.

Reforming the Commission's funding architecture

Whilst these principles worked well for the Commission's borrowing instruments prior to the pandemic, they proved ill-suited to the requirements of Next Generation EU. The Commission needed to adjust its funding strategy to be able to raise up to €150 billion per year and to disburse these funds to all EU member states through either grants or loans.

To cope with these new demands, the Commission announced a new 'diversified funding strategy' for Next Generation EU in April 2021.[4] In December 2022, the Commission announced that this 'diversified funding strategy' would become the general borrowing method for all debt instruments from 2023 onwards. This new strategy overturned three longstanding borrowing principles applicable to the EU budget.[5]

First, the Commission will now issue bonds for all its instruments under the single label of 'EU bonds'.[6] As a result, funds will no longer be earmarked for specific instruments, but will go into a general funding pool. Concretely, this means that money raised through new EU bonds will no longer be linked to specific payments under Next Generation EU, or under the ongoing Macro-Financial Assistance for countries such as Moldova and Ukraine.

Second, the Commission has revamped the way it raises funds on capital markets. Instead of issuing funds on an ad hoc basis and aligning the maturities of its own bonds with its loans, the Commission will now raise funds through regular auctions and according to a pre-announced funding calendar. It will issue debt over a range of maturities between 3 and 30

[1] Article 220(2) and 220(6) Regulation (EU, Euratom) 2018/1046
[2] Article 220(7)
[3] Article 220(2)
[4] Communication from the Commission on a new funding strategy to finance NextGenerationEU COM(2021) 250
[5] Commission Implementing Decision C(2022) 9700
[6] There is one exception: Next Generation EU Green Bonds will keep their label (Spielberger, 2023)

years, and, for the first time, through a short-term bills programme.[7]

Third, the Commission has put in place a new framework for managing the financial risks associated with its borrowing activities. It will now conduct more active debt management operations by conducting repo operations and operations on secondary markets. To manage the resulting financial risks, it may now also trade derivatives, such as interest rate swaps.

As a result, the Commission's debt management operations now resemble those of national debt management offices. In fact, the Commission has explicitly announced that it wants to become a 'sovereign-style/super-national issuer' (European Commission, 2023, p. 9).

In the context of EU borrowing, however the new framework represents a departure from some well-established principles of EU borrowing. To enable an active debt management strategy, the EU repealed the Financial Regulation's prohibition on the European Commission from engaging in maturity transformation.[8] Since funds will no longer to be earmarked and lent back-to-back, the Commission will be exposed to new financial risks. It is fair to say that Next Generation EU not only had far-reaching economic effects, but also upended the rules of the EU budget.

One step closer to a European fiscal capacity?

The Commission is pursuing ambitious objectives in building up these state-of-the-art treasury operations. By issuing bonds under a single label, the Commission says that it wants to make it easier for investors to trade these bonds on the secondary market, and make EU bonds a safe asset (European Commission, 2022, p. 13). Yet, it remains to be seen whether this plan will come to fruition. Despite the EU's AAA-credit rating, the Commission borrows at considerably higher interest rates than the German government (Bonfanti & Garicano, 2022). And once the Next Generation EU expires in 2026, it is unclear whether the Commission will still need to borrow on a large scale. Momentous as the shift has been, it may yet prove short-lived.

The EU's new borrowing regime also brings additional financial risks. In late 2022, the Commission had to admit that rising interest rates on its bonds would imply additional borrowing costs of €450 million for the year (Pop, 2022).

Nevertheless, there are reasons to welcome the reforms. Under the new framework, the Commission has become more transparent about its borrowing plans and debt servicing costs. It has created the office of an independent Chief Risk Officer (CRO) at the European Commission's Directorate General for Budget (DG BUDG) to ensure that borrowing is consistent with a High Level Risk and Compliance Policy. In January 2023, the European Parliament's Budget Committee held its first hearing with the CRO about the Commission's borrowing plans for the following six months.[9] Under the new funding strategy, the Commission's debt management operations are becoming more like those of national treasuries, which will make it easier for the European Court of Auditors to evaluate the EU's debt management against that benchmark.

Whether the EU's borrowing operations represent a step forward in European integration is too early to tell. But it is already clear that the Commission's debt management now involves greater risks, and it will therefore require closer scrutiny.

[7] Commission Implementing Decision C(2022) 9700

[8] Article 220(2) of Regulation (EU, Euratom) 2018/1046 states that 'borrowing and lending shall not involve the Union in the transformation of maturities.

[9] Item 11, European Parliament, Budget Committee Agenda, 31 January 2023.

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Further Information

This policy brief is produced by Bilateral ESRC/FNR: Banking on Europe, a research project on the evolution and accountability of pan-European public financial institutions funded by the UK Economic and Social Research Council and the Luxembourg National Research Fund (Reference: ES/W000733/1). The views expressed are those of the authors' alone. For further details, please visit our website at www.bankingoneurope.com

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