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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on a new funding strategy to finance NextGenerationEU

INTRODUCTION:

The recovery instrument NextGenerationEU (NGEU) aims to repair the immediate economic and social damage brought about by the coronavirus pandemic, and make Europe greener, more digital, more resilient and better fit for the current and forthcoming challenges. It represents a powerful and innovative response to mitigate the economic damage caused by the pandemic while helping the EU economy to pivot to a new green and digital growth model. The NextGenerationEU will inject up to EUR 806 billion – 5% of EU GDP – into the EU economy in the form of expenditures and loans. The Commission will, on behalf of the EU, borrow the initial amounts through funding operations on international capital markets in the years 2021-2026. The financing raised by the EU will be repaid by Member States either directly (for loans) or through the EU budget (for the non-repayable support) by December 2058 at the latest.[1]

The Commission will need to execute financing operations up to EUR 150-200 billion per year over the period to end 2026. This amount is comparable with the funding needs of the largest Member States. This communication presents a sophisticated and well-organised funding strategy to ensure that these large amounts are available precisely when needed. It calls for an overhaul of how the Commission raises funds through bond issuance.

The legal and institutional preparations for NextGenerationEU are underway. Member States are completing the approval of the Own Resources Decision (ORD)[2], which is necessary to allow the EU to borrow on the markets. Work is advancing well on implementation of the Union policies and national recovery plans to be financed by NGEU.

By June 2021, the Commission will be ready to begin mobilising the funds so that they are available to finance NextGenerationEU expenditures as soon as the ORD has entered into force.

This Communication is adopted under Article 5(3) of Council Decision 2020/2053 that requires the Commission to establish the necessary arrangements for the administration of the borrowing operations and to regularly and comprehensively inform the European Parliament and the Council about all aspects of its debt management strategy.

Alongside this Communication, the Commission has today adopted a Decision on the governance arrangements and risk management systems for NGEU and a Commission Decision on the Primary Dealer network.

1. WHY IS A NEW FUNDING APPROACH NEEDED?

A new approach is needed because the financing methods traditionally employed by the Commission were designed for smaller financing needs. This funding strategy ensures that much larger volumes needed in the future will be available for Member States or Union policies when they are scheduled to be released. To comply with the principle of sound financial management (TFEU, art. 317), the implementation of NextGenerationEU must guarantee that the Union can meet payment pledges in a timely manner and is not forced to raise capital in adverse market conditions, generating unnecessary costs.

[1] Should new own resources be available before 1 January 2028, these will be used to start the repayments on the expenditures component earlier on.

[2] Council Decision (EU, Euratom) 2020/2053 of 14 December 2020 on the system of own resources of the European Union.

The EU is a longstanding and highly rated actor on international capital markets.[3] EU bonds enjoy the trust of international investors because they benefit from several layers of credit protection. Since last October, the EU has stepped up its bond issuance activities raising EUR 75 billion to finance SURE loans to 19 Member States on advantageous terms. These operations were executed as back-to-back financing. In this model, the EU borrows on behalf of the beneficiary Member States at favourable prices (by virtue of its high credit standing). The EU then passes the loans on to the Member States on the same terms and conditions. This approach was appropriate for past financing needs and helped establish the EU as a highly respected issuer in the capital markets. All this borrowing was done exclusively through syndicated transactions relying on a specially constituted group of banks to place the bonds with investors on the best available terms.

NGEU requires a more demanding approach to finance its operations on the capital markets because:

1. The amounts to be raised will be much greater: a maximum of EUR 806 billion[4] may need to be raised between now and end 2026.
2. All 27 Member States are entitled to receive a cumulative EUR 407.5 billion in grants[5] and up to EUR 386 billion in loans. A further EUR 12.5 billion will be allocated to EU programmes on a competitive basis.[6]

   With a "back-to-back" approach, the number of issuances would be significant, resulting in high transaction costs.
3. The disbursement schedule is complex and has a degree of uncertainty. In particular as regards the Recovery and Resilience Facility (RRF), which represents 90% of the total NextGenerationEU funds, payments are structured bi-annually to each Member State upon the achievement of agreed milestones and targets tied to the implementation of reforms and investment.
4. The maximum possible repayment of borrowed amounts to pay for EU policies in any given year is fixed by the ORD and these repayments depend on future payment appropriations in the EU Budget. The precise annual budgetary envelopes are unknown to date, necessitating some flexibility in the borrowing policy.

This calls for a highly efficient and agile funding apparatus that can raise significant amounts on a sustained basis, and that is capable of reacting swiftly in case of unexpected changes in a congested disbursement schedule or to changing market conditions. The maturity profile of the bonds issued must be aligned with the ability of the Union budget to repay investors when the bonds mature.

[3] The EU has been issuing bonds to finance financial assistance since the 1970s. The current financial assistance programmes financed by the Commission include Macro-Financial Assistance programmes for neighbourhood and developing countries, European Financial Stability Mechanism (EFSM), and the Balance of Payments mechanism. The EU has a total of 54bn € in outstanding loans under these 3 programmes. Issuance activity in recent years has ranged from 500m € in 2019 to 30bn € in 2011.

[4] All amounts in this Communication are expressed in current prices since this reflects the actual volumes that the Commission will be borrowing over a six year period. These amounts are equivalent to the volumes laid down in the Own Resources Decision which are expressed in 2018 prices.

[5] This amount covers national envelopes under the Recovery and Resilience Facility - RRF, Recovery Assistance for Cohesion and the Territories of Europe (React-EU), European Agricultural Fund for Rural Development and the Just Transition Fund.

[6] Horizon Europe, InvestEU Fund, Union Civil Protection Mechanism – rescEU.

To meet these challenges, the Commission will implement a "diversified funding strategy"[7], which combines a wide range of funding instruments and funding techniques, and relies on open and transparent communication to the market participants. This funding strategy will be modelled on the practices of large Member State issuers to adapt the volume, timing and maturity of funding transactions to the market environment. It will also provide the Commission with more flexibility in aligning the needs to repay borrowings with the means available under future budgets after 2028. Therefore, a diversified funding strategy will allow the Commission to fund the NextGenerationEU, with lower execution risk and at lower cost for the Member States and European taxpayers. Finally, this strategy will also offer benefits in terms of the stability and depth of European bond markets by providing them with a euro-denominated safe asset covering a broad range of maturities.

2. EIGHT SUCCESS FACTORS FOR THE NGEU ISSUANCE PROGRAMME:

In order to raise up to EUR 150-200 billion per year, the Commission will organize funding transactions in a way similar to that employed by large sovereigns. Bonds will be issued and regularly tapped across a range of maturities from 3 to around 30 years. In addition, an EU-Bill Programme for short-term paper will be established.[8] Auctions will be added as a new issuance format to issue the EU-Bills and EU-bonds.

The success of the issuance activities will be achieved by relying on a deep pool of the best qualified EU supervised banks. The Commission will make a sustained effort to develop an institutionally and geographically broad investor base.

Green bonds issued under NGEU will further expand the investor base and strengthen the EU's world leadership in green finance of the euro-denominated market. The diversified funding strategy will also take into account risk management constraints to ensure a sound financial management with a predictable redemption profile as per the obligations set by the legal ground (Own Resources Decision). Refinancing will be used to manage risk and preserve at all times the Union's credit rating.

The diversified funding strategy will be built around the following eight pillars:

2.1. Publication of regular funding plans:

The NGEU debt issuance will be undertaken on the basis of an annual borrowing decision, adopted by the Commission. This decision will fix the upper bound for the issuance that will fund the payments to the EU budget and loans to Member States, as well as the maximum amounts of short-term issuance. This borrowing will be organised on the basis of six-monthly funding plans. These funding plans will communicate how the EU will organise the issuance during the reference period. The NGEU funding plans will be based on regular and timely communication of information on upcoming payments to be made. It will also fix other key financial parameters of the borrowing to be undertaken such as the mix of short and long-term funding for the period, the maximum average maturity of long-term funding to be undertaken, and an upper bound on the expected average liquidity to be held as reserves.

[7] A funding strategy or a debt management strategy is "a rolling, medium-term plan outlining how [a public body] will meet the debt management objectives", which are generally "to ensure that [the public body] financing needs and its payment obligations are met at the lowest possible cost" – see "Government Debt Management: Designing Debt Management Strategies", World Bank (2017). A funding strategy is therefore an element of the debt management process and its purpose is linked to the debt management objectives.

[8] Via a new EU-Bill programme for securities with original maturities below 1 year.

By providing a clear signal of the indicative maximum amount of borrowing for the forthcoming six months, the annual borrowing Decision and the NGEU funding plan will ensure the predictability of issuances for investors, while maintaining flexibility and providing transparency to markets. Investors need information about the issuance pipeline in order to prepare investment planning on their side and ensure the successful absorption of NGEU issuance at lower cost. The NGEU funding plan should also serve as a basis for information by the Commission to the European Parliament and the Council[9] as well as for communication to the markets and to the public.

2.2. Effective coordination with national and peer issuers:

Publication of NextGenerationEU funding plans will also facilitate concertation with peer supranational and national debt management offices who also run large issuance programmes to meet their funding needs. Good coordination between NGEU issuance, Member States and pan-European institutions will be essential to avoid market congestion in particular periods. Through the SURE programme, the Commission has established effective communication channels with other EU issuers. Predictability of NGEU funding operations, including regular dates for NGEU auctions will further enhance the established coordination between the Commission, Member States and EU supranational issuers.[10]

2.3. Strong liquidity management to match inflows and outflows:

The key yardstick for measuring the success of the NGEU diversified funding strategy will be the avoidance of liquidity shortfalls – situations where the Commission does not have the funds immediately at hand to make NextGenerationEU payments. This would lead to considerable disruption for policy implementation. Avoiding such situations calls for a capacity to manage cash inflows and outflows through secure and purpose-specific dedicated prudential cash holdings for payments. Ongoing and rigorous liquidity planning will ensure that the prudential cash holdings are sufficient to avoid liquidity shortfalls while avoiding unnecessary and expensive cash balances. In order to ensure that these critical cash holdings are not subject to any counterparty risk, these prudential cash holdings will be held with the European Central Bank. NGEU prudential cash holdings will be kept to the lowest level needed given the amounts of upcoming payments over the short-term.

2.4. Strong execution capability to carry out individual funding operations:

The high frequency of transactions and significant funding volumes call for the use of a wider range of transaction formats (syndicated deals, auctions, private placements and additional issuance on the basis of an existing bond (“taps”)) and reinforced capacities to run the number and mix of transactions. The Commission will strengthen its execution capacities in two important directions:

a) A pan-European Primary Dealer network:

The significant volumes that the European Union will raise using the diversified funding strategy, will be executed and supported by the establishment of a Primary Dealer Network for the European Union (PD network). This network will be modelled on best practices put in place by sovereign issuers. Primary dealers, via a codified system of obligations and privileges, will support the smooth execution of EU issuances and support the liquidity of the EU bonds in the secondary market.

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[9] As foreseen in Article 5(3) of Council Decision (EU, Euratom) 2020/2053.
[10] As foreseen in Article 5(3) of Council Decision (EU, Euratom) 2020/2053.

Setting-up a PD network with clear criteria for membership will provide transparency on the selection of counterparties for the EU's primary market business. The rules to become a Primary Dealer for the EU and the relationship between the Commission and its Primary Dealer network are framed in the Commission Decision establishing a Primary Dealer Network adopted alongside this Communication.[11]

The Commission Decision on the Primary Dealer network establishes the key eligibility criteria for admission to the network and the subsequent rights and obligations of participants. The eligibility criteria allow a wide group of European supervised banks to become part of the PD network while ensuring at the same time that primary and secondary markets in EU securities receive support from a strong EU Primary Dealer network in the European Union. The Commission Decision launches the call for expressions of interest for membership of the EU Primary Dealer Network from banks regulated which are already active members of an EU sovereign or supranational Primary Dealer network. The Decision also establishes a fair and objective method for determining which Primary Dealers will be considered for participation in syndicated transactions.

These Primary Dealers will form the group from which the Commission will constitute the syndicates for the first NextGenerationEU syndicated transactions. This group will also be swiftly connected to the selected auction platform so that they can participate in NGEU bond auctions from September onwards.

b) A state-of-the-art auction platform:

Auctioning bonds and EU-Bills will be an important part of the NGEU funding strategy and a new element of the EU funding activities. Auctions are a cost-effective way of issuing debt and the only format for issuing EU-Bills. While syndicated transactions will remain the mainstay of the NGEU issuance programme, at least in the initial phases, the capacity to raise money quickly and cheaply via auctions will significantly enhance the Commission's ability to service its NGEU payment needs.

Work is underway to initiate the NGEU auction programme and EU-bill issuance in September relying on the services of an auction platform provided by a national central bank and already used by one of the large European sovereign issuers. The selected primary dealers will be connected to the selected auction platform over the course of the summer so that they can participate in auctions from September onwards. The Commission will then establish a regular programme of auctions, alongside its syndicated transactions.

2.5. Robust governance and risk management systems:

In view of the unprecedented volumes of the operations and the sophistication of the funding strategy that is needed, it is of paramount importance that NGEU operations are subject to a robust and independent risk management and compliance framework. This will ensure the proper oversight of the main business processes and their inherent risks, in ways that uphold sound financial management and that protect the Union's financial interests.

Alongside this Communication, the Commission has today adopted a Decision on the governance arrangements and risk management systems for NGEU.[12] This Decision establishes a clear and robust governance and risk management framework to structure the core decision-making processes (e.g. annual borrowing decision) and implementation modalities (funding plan) and capacities (e.g. auctions). It also establishes the principles and

[11] C(2021) 2500.
[12] C(2021) 2502.

structures needed to ensure the robust and independent oversight of all NGEU financial operations, based on separation of roles and responsibilities. In addition, this Decision provides that the temporary NGEU prudential cash holdings shall be held in a dedicated account with the ECB as an important safeguard against NGEU liquidity risks.

A central pillar of this risk management system will be the role of the Chief Risk Officer (CRO). The CRO should be responsible for developing a High Level Risk and Compliance Policy, which defines the risk management guidelines for the NGEU diversified funding strategy, and puts in place the systems for monitoring and reporting on these risks. Information and reporting flows in this framework will be organised to ensure independence, transparency and accountability. The system will ensure the probity and auditability of all transactions.

2.6. Fit-for-purpose back-office, payment and accounting solutions:

The expanded funding operations require the reinforcement of the Commission's back-office and accounting functions to ensure the efficient execution and the auditability and accountability of all transactions. This encompasses the systems for accounting for all transactions and related accounting entries, fail-safe handling of payments and timely settlement and reconciliation of transactions. The back-office function is already being upgraded to cover the settlement and administration of all activities in the NGEU programme, including extension to new transaction formats. Accounts and financial statements will be produced in accordance with rules and procedures established by the Commission's Accounting Officer. The financial statements will be audited and consolidated in the Union's annual budget accounts. The Commission is using tried and tested accounting software to set up all the needed capabilities so that the details of every transaction are fully and duly accounted for.

2.7. Well-priced and well-managed loans:

Up to EUR 386 billion in loans can be granted to Member States under the RRF. These loans are provided in a way that ensures they represent a powerful resource for Member States as they finance their recovery. The NGEU diversified funding strategy will allow the Commission to offer long-term loans on attractive terms to beneficiary Member States. The interest rate on these loans will be comparatively low as they will be financed by the NGEU funding pool, which enjoys both a very strong credit rating and a much lower average maturity than the loans. Repayment of the principal on these loans can also be spread evenly over time to avoid lumpy repayment obligations for the beneficiary Member States. The commencement of principal repayment can be deferred until Member States have emerged fully from the economic crisis and are reaping the returns on NGEU investments and reforms (e.g. by 10 years).

This approach to managing maturities and repayments will also help the Commission to manage any underlying risks that these loans may represent for the budget and guarantee in such a way that these are kept within strict limits, in full respect of sound financial management principles. It will also ensure equal treatment among Member States that request a loan as they will receive loans with identical maturities and repayment conditions.

This approach to determining the price, maturity and repayment schedules for loans will be reflected in the Loan Agreements that the Commission will sign with each Member State requesting loans.

2.8. Effective communication and investor outreach:

Clear and open communication to investors is critical for the success of the EU borrowing operations. To that end, the Commission is developing a comprehensive investor relations strategy and a series of tools to connect with its investor base. The strategy will enhance the direct outreach to investors and will cover strategic media relations and social media presence.

Through its issuance of "social bonds" under the SURE programme, the Commission is currently establishing itself as an important issuer of Environmental, Social, and Corporate Governance (ESG) labelled bond issuances. To play this role more effectively, the Commission is overhauling its communication strategy and is well advanced in the implementation of an Investor Relations database. Use of an Investor Relations database will help the Commission to manage its relationships with important investors in a more structured way. An EU funding newsletter will also be issued, allowing the Commission to communicate to the investor community in a regular and transparent manner. The Commission will also reach out actively to important investors across the globe through a systematic programme of structured visits ("road shows").

3. Where do we stand today?

The Commission is aiming to be ready to commence NGEU issuance once the ORD ratification process is completed. Preparations are well advanced. Four notable milestones have been achieved:

1. The underlying account structure has been configured, centred on the NGEU account at the European Central Bank with whom the Commission is at an advanced state of discussion. The payment circuits for routing NGEU proceeds through this account to the beneficiaries are being finalised.

2. The Commission is establishing the Primary Dealers Network following the adoption of the parallel Commission Decision on Primary Dealer Network. The period for expressions of interest from members of EU sovereign and supranational primary dealer groups is now open. The Commission will examine all applications and publish a first list of NGEU primary dealers towards the end of May.

3. The Commission Decision establishing the governance arrangements and risk management structures to ensure the accountability, transparency and sound financial management of these important activities has been adopted.

4. All the technical and operational preparations are being implemented to ensure smooth execution of transactions through established arrangements with public institutions for handling of funds and settlement of transactions.

4. Further steps before launch of first NGEU transactions:

Prior to the first NGEU issuance by June, the Commission will complete the following important milestones on the road towards full implementation of the NGEU issuance programme:

1. Unveil the auction platform that the Commission will rely on for both medium- and long-term bonds and EU-bills (mid May 2021).

2. Finalise the pricing and maturity policy for RRF loans. This policy will ensure parity of treatment and attractive and easy-to-manage repayment conditions for all Member States applying for loans.

3. Adopt the first framework borrowing decision and publish the first semi-annual funding plan for NGEU issuances and investor newsletter, providing a clear indication of our issuance intentions for the remainder of 2021 (early June 2021).

Upon ratification of the ORD in line with relevant constitutional requirements, which is expected before the summer, at the latest, the Commission will then be able to launch the first NGEU syndicated transaction based on our first Funding Plan.

5. FURTHER WORK STREAMS TO COMPLETE AND ENHANCE THE NGEU DIVERSIFIED FUNDING STRATEGY:

Work will continue on implementation of the NGEU Diversified Funding Strategy after the first issuance. Over the summer, the Commission will work closely with the auction system manager so that the auction programme can be launched in September 2021. The inaugural auction for the EU Bill programme will be another major landmark event in the life of the NGEU issuance programme.

On the lending side, the Commission will also continue to invest in its capabilities. Initially, in the interest of rapid disbursement of funds, the interest rate on loans to Member States may change periodically, and to a limited extent, as some of the bonds in the pool that fund the loans mature. To offer Member States the option of replacing these initial loans by fixed rate loans, the Commission will work quickly to build the capacity to offset maturity mismatches between the loan and the underlying funding instruments. This requires building the operational capacity to hedge interest rate risk (using interest rate swaps) stemming from the maturity transformation in such an operation. The capacity to offer fixed interest rates will be in place in 2022.

During this deepening phase, additional instruments could be implemented to improve the toolbox for managing the liquidity risk and the outstanding debt.[13]

6. NGEU GREEN BOND ISSUANCE:

In line with its efforts to reorient capital flows to more sustainable uses, as outlined in the 2018 Action Plan on Financing Sustainable Growth,[14] the Commission will fund 30% of the NGEU programme through green bond issuance. This could amount to up EUR 250 billion of green bond issuance, establishing the EU as one of the biggest green bond issuers globally and reinforcing the EU's policy and market leadership in sustainable finance.

The Commission is currently designing the issuance framework for green bonds under NGEU (the "NGEU Green Bond framework"). The NGEU Green Bond framework will build on the obligation for Member States to ensure that 37% of expenditures financed by the national Recovery and Resilience Plans is dedicated to investments and reforms addressing climate

[13] This could include possibility to use (1). repurchase agreements to raise money for a limited period in exchange for securities which are temporarily lent out; (2). commercial paper, which is an even more flexible instrument than T-bills and can be a useful complementary tool for small amounts. (3). the ability to run a buyback programme to manage the bond redemption profile.

[14] https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy_en.

change. That expenditure on climate-related investments, by Member States or regional/urban authorities, will be clearly identified, based on a methodology established in the Recovery and Resilience Facility Regulation. That methodology has already been aligned as much as possible with the taxonomy. The identified expenditure will constitute the eligible expenditure for the purposes of NGEU Green Bond framework.

The NGEU Green Bond framework will be based on twice-yearly information from the Member States about the expenditures on those investments and reforms. This information will allow the Commission to provide the necessary assurances to investors that the proceeds from issuing green bonds have been used for green investments.

The NGEU Green Bond framework will be based on well-known and established market standards while aligning to the upcoming EU Green Bond Standard wherever possible.

The NGEU Green Bond framework will be published in early summer. On that basis, the first NGEU Green Bond issuance could take place already in autumn 2021.

7. REPORTING TO EUROPEAN PARLIAMENT AND COUNCIL:

The NGEU funding strategy will be implemented on the basis of processes that ensure full accountability, a high level of transparency and deliver sound financial management of all NGEU financing flows. The Commission has put in place a strong governance and risk management framework, centred on the role of an independent Chief Risk Officer responsible for overseeing a strong Risk and Compliance policy to ensure the sound financial management of NGEU operations.

The implementation of NGEU will be of interest to the European Parliament and Council given the dimensions of the activities and their importance for the realisation of the economic and social objectives of the NextGenerationEU. Therefore, and as outlined in the Own Resources Decision and the Inter-Institutional Agreement[15], the Commission shall regularly and comprehensively inform the European Parliament and the Council about all aspects of its debt management strategy. Annual updates on borrowing and lending activities will be provided to the European Parliament and Council, in accordance with the requirements set out in Article 5(3) of the ORD from the third quarter of 2021.

8. CONCLUSION:

NextGenerationEU is the key to the Union's speedy and full recovery from this crisis. The NGEU diversified funding strategy is a critical component in its successful delivery. It will allow the Commission to operate efficiently, and mobilise on the financial markets the resources needed to power the Union's economic recovery. Ultimately, a diversified funding strategy will allow the Commission to fund NextGenerationEU, with lower execution risk and at lower cost for the Member States and European taxpayers.

Looking beyond the immediate economic and social crisis, a successful NGEU issuance programme will also strengthen the fabric of the Economic and Monetary Union, enhance the role of the euro in international capital markets and confirm EU leadership in sustainable

[15] Interinstitutional Agreement of 16 December 2020 between the European Parliament, the Council of the European Union and the European Commission on budgetary discipline, on cooperation in budgetary matters and on sound financial management, as well as on new own resources, including a roadmap towards the introduction of new own resources, OJ L 433I , 22.12.2020.

finance. It can strengthen the international role of the euro by deepening EU capital markets, offering global investors a new highly-rated and liquid euro-denominated asset, including a ground-breaking EU-bill programme. A high-profile and successful NGEU Green Bond issuance will assert EU leadership in building deep EU markets for sustainable finance.

For all of these reasons, a diversified funding strategy represents the right approach for financing NGEU. The Commission will be ready to commence NGEU funding operations once the legal conditions to start borrowing are finalised with the aim of issuing the first NGEU bonds by June.