

The evolution of the EU as a major borrower – impact of the new ‘safe’ asset on the euro area government bond market structure

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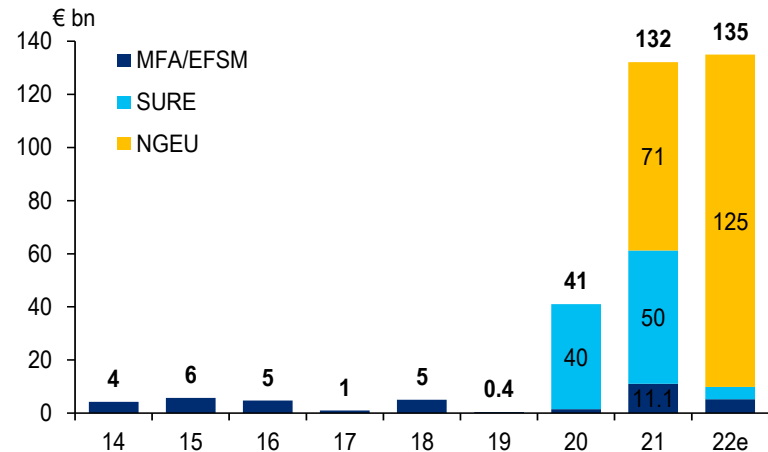
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The evolution of the EU as a major borrower

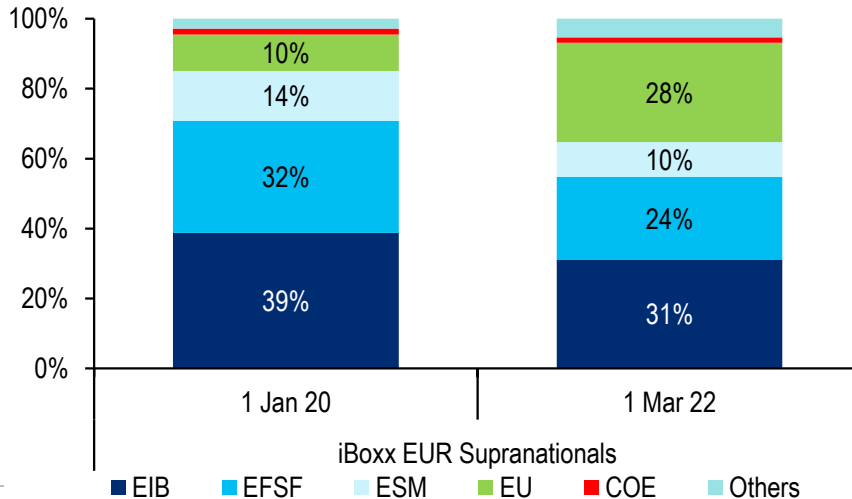
Before SURE started in October 2020, the EU was a relatively small and illiquid SSA issuer

- Prior to the start of SURE issuance in Q4 20, the EU was a small SSA issuer with average annual issuance of €2-5bn in the years following the EA sovereign crisis.
- After introduction of SURE followed by NGEU, it has become one of the largest issuers in the euro area.
- EU's weight in iBoxx EUR supranational index has increased almost three-fold. If NGEU is fully utilised, EU will double the size of the index and make up 65% of it.

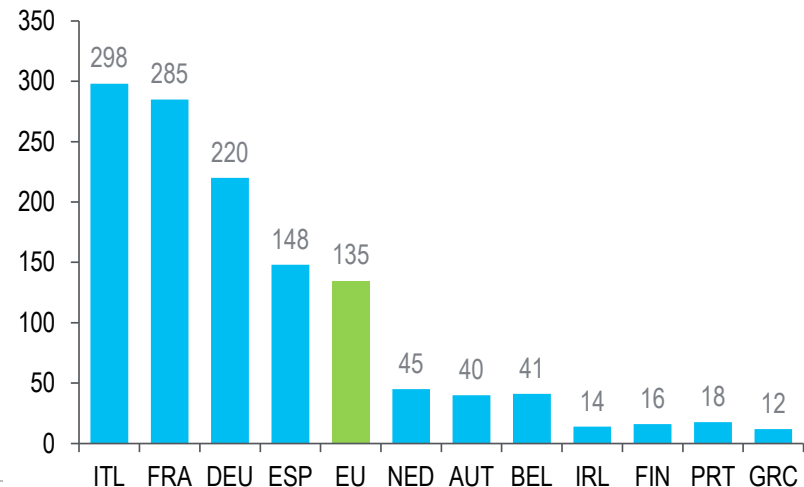
Introduction of SURE and NGEU has increased EU's funding needs exponentially (annual gross supply)...



EU's weight in iBoxx EUR supranational index has almost tripled in the last 1.5 years



...making it potentially the fifth largest issuer in the Eurozone this year (expected gross supply in 2022, € bn)

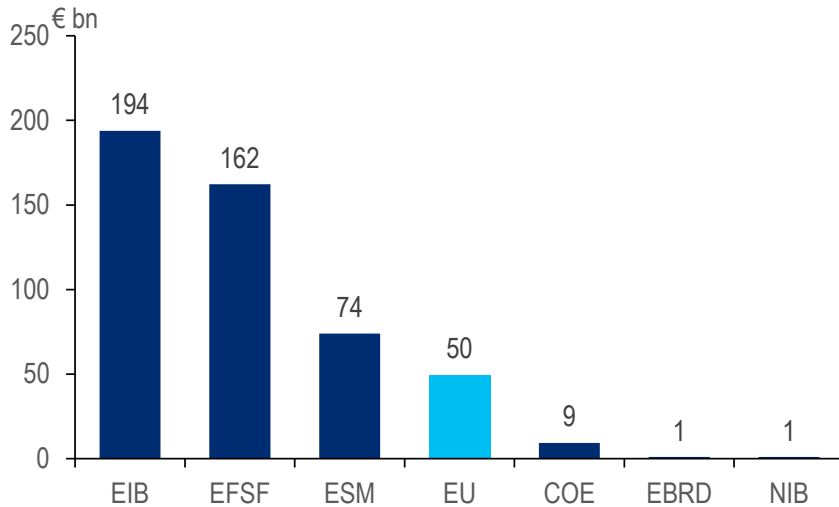


Source for all charts: Citi Research, Bloomberg, Markit.

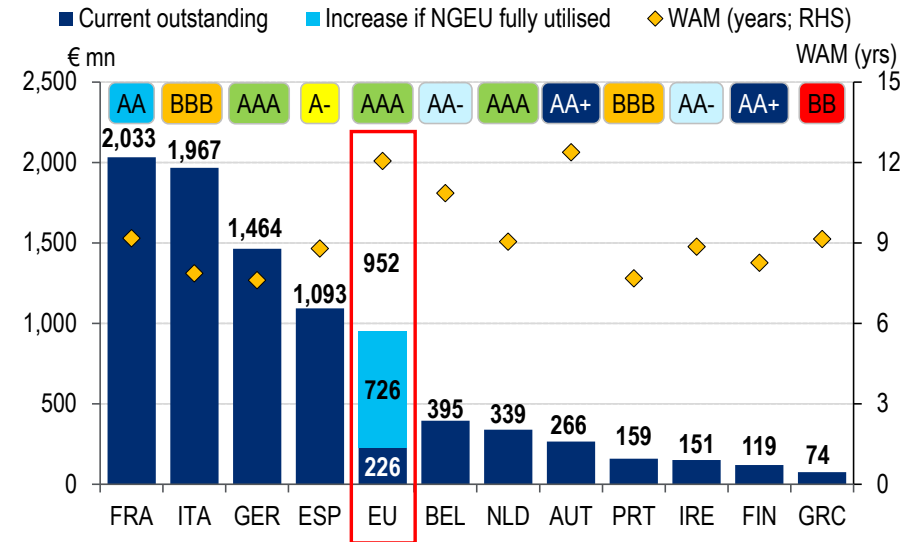
The evolution of the EU as a major borrower

Impact of the new 'safe' asset on the euro area government bond market structure

From being a medium-sized European supranational issuer (outstanding benchmark € bonds as at 1 January 2020)...

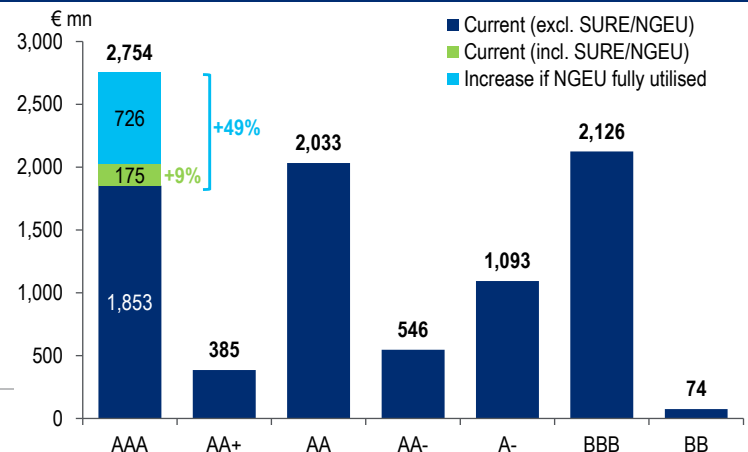


...to potentially the fifth largest issuer in the euro area (outstanding € bonds* / WAM of outstanding in years / median rating)



- In less than 1.5 years the EU has grown into one of the largest euro area issuers. Citi Research expects it to surpass the Netherlands by outstanding bonds by end of 2022 making it the sixth largest issuer within euro area.
- Following the introduction of SURE and NGEU, EU issuance has increased the volume of AAA-rated, 'safe' assets to investors by €175bn. If NGEU is fully utilised, the volume of AAA-rated assets will increase by nearly 50% from current levels.

EU issuance will increase AAA-rated 'safe' assets by nearly 50% if NGEU is fully utilized (outstanding per rating category; EGBs & EU)



Source for all charts: Citi Research, Bloomberg, European Commission. Note: * Fixed rate bonds and linkers.

The evolution of the EU as a major borrower

EU – Still more correlated with SSAs than sovereigns

The EU still trades more like a traditional SSA than a sovereign (correlation of total returns over past two years, iBoxx indices)

	EU	Supras	FRTR	DBR	NETHER	SSA France	SSA Germany
EU		99.6%	98.4%	93.2%	97.0%	99.0%	97.8%
Supras	99.6%		95.0%	93.1%	97.4%	93.9%	98.6%
FRTR	98.4%	95.0%		89.5%	96.4%	97.6%	94.5%
DBR	93.2%	93.1%	89.5%		97.7%	86.6%	91.8%
NETHER	97.0%	97.4%	96.4%	97.7%		94.4%	96.6%
SSA France	99.0%	93.9%	97.6%	86.6%	94.4%		95.6%
SSA Germany	97.8%	98.6%	94.5%	91.8%	96.6%	95.6%	

Source: Citi Research, Markit.

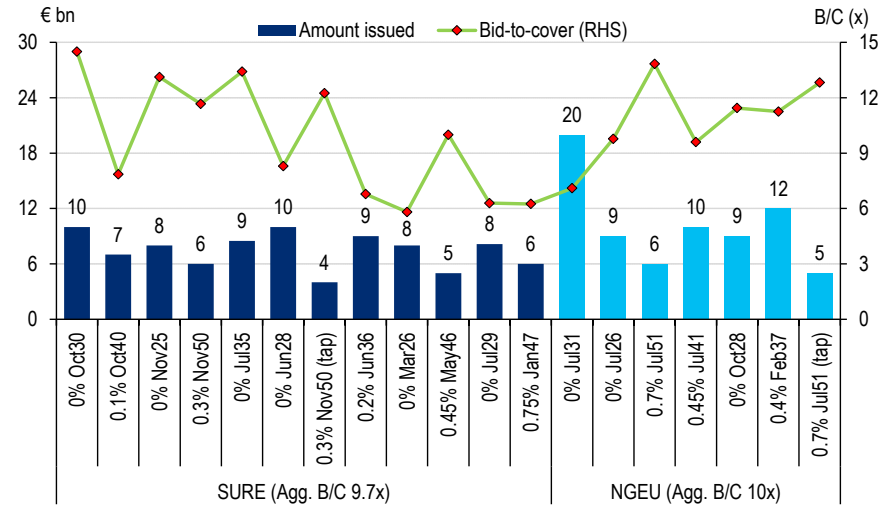
- Despite EU's issuance and outstanding volumes starting to reach similar levels as for select euro area sovereigns, it is still trading more like an SSA rather than a sovereign.
- EU's total returns in the past two years are more correlated with supras and French SSAs than with French or German government bonds.

The evolution of the EU as a major borrower

Potentially on the way to becoming a benchmark issuer but challenges remain

Despite high volumes the market has easily absorbed SURE and NGEU supply (volume and bid-to-cover ratios for EU syndications)

- The EU has successfully raised €90bn for SURE and €81bn for NGEU in less than 1.5 years. Demand has been very strong with all syndications at least six times oversubscribed (average 9.8x for SURE/NGEU).
- The EU has the potential to become a pan-EU 'safe' asset but certain challenges remain.



Supporting factors

- **Diversification:** Alternative for investors to take (indirectly) sovereign exposure with diversification from EGBs.
- **High ratings:** The EU is AAA-rated giving it an advantage over many EA sovereigns. Among EA countries only Germany, Netherlands and Luxembourg are AAA-rated.
- **Beneficial regulatory treatment:** 0% RW, HQLA level 1 treatment and low haircuts if used as ECB repo collateral / 0% capital charge for spread risk under Solvency 2.
- **Blueprint for EU crisis response:** Use of SURE or NGEU structure as a blueprint for EU's response to Ukraine-Russia conflict increases market's perception of its permanent nature.

Challenges

- **Index eligibility:** EU bonds are not included in EGB indices and this is unlikely to change.
- **Lack of futures contracts** limits investors' ability to trade in and out easily.
- **Temporary nature:** Although NGEU is considered by many investors a blueprint for the EU's future crisis response, it is still officially temporary.
- **Issuance activity still 'SSA-like':** NGEU bonds are issued primarily via syndication with auctions playing only a minor part (12% of NGEU supply). Moreover, EU deals are priced versus swaps rather than EGBs.

Discussion Points

- Do members think having Futures contracts on EU bonds is beneficial and/or feasible? What are the necessary steps for implementation?
- Do members think EGB index ineligibility for the EU will change?
- Do buy-side investors believe the EU is a Sovereign or a Supra issuer? What are the reasons for your choice?
- Do members think the EU will be used as a blueprint for a response to the Ukraine-Russia crisis or to future crises?
- How will the end of PEPP and APP impact the pricing of EU debt?

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