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Sine die

The European Recovery Fund and the timeless charm of perpetual bonds

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When Timothy Young went to Amsterdam in September 2015, the aim of his business trip had a somewhat historical significance: collecting the coupons accrued in the previous 12 years on a bond issued about four centuries earlier.

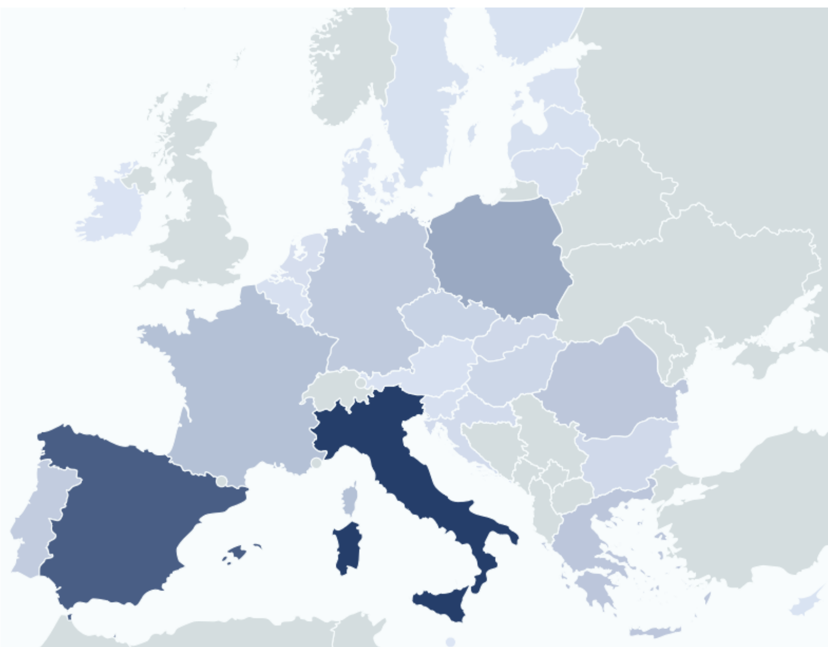
Mr. Young is among the curators of the Beinecke Rare Book & Manuscript Library, one of Yale University's most iconic places, and the security housed at the New Haven, Connecticut-based library is a perpetual bond carrying a 2.5% coupon that was issued in 1648 by a still-active Dutch water board.

Until not many weeks ago, consols -- named after the bonds with no maturity date issued by the British government since 1751 and definitively redeemed only in 2015 -- **were almost exclusive competence of scholars of economic history**. But as the coronavirus-induced crisis unfolded, several European economists, politicians and financiers have started assessing them as a possible building block of the post-Covid-19 economic recovery plan.

It is rather **unlikely that European Union** (or euro area) member **states will decide to carry out a joint issue of irredeemable bonds**, especially because, since the very beginning of the debate, the Recovery Fund has been conceived as a purely temporary tool.

Nevertheless, **the trend that**, already before the pandemic, **has led** states, companies and universities **to sell bonds with maturities as long as a century**, taking advantage of historically low interest rates, **may be destined to continue**.

Next Generation EU: grants and loans allocation (€bn)



Source: Bloomberg, European Commission

Next Generation EU (€bn)

Countries	Grants	Loans
Italy	81.807	90.938
Spain	77.324	63.122
Poland	37.693	26.146
France	38.772	--
Greece	22.562	9.436
Romania	19.626	11.58
Germany	28.806	--
Portugal	15.526	10.835
Czech Rep.	8.586	10.626
Hungary	8.101	6.968
Slovakia	7.939	4.874
Bulgaria	9.218	3.151
Croatia	7.365	2.648
Netherlands	6.751	--
Lithuania	3.908	2.419
Belgium	5.48	--
Slovenia	2.579	2.492
Sweden	4.691	--
Latvia	2.894	1.595
Austria	4.043	--
Finland	3.46	--
Estonia	1.851	1.441
Cyprus	1.433	1.088
Denmark	2.156	--
Ireland	1.91	--
Malta	0.35	0.642
Luxembourg	0.17	--

Source: Bloomberg, European Commission

The proposal

There is no personality in the world of finance who has expressed more support to the idea of the European Union as an issuer of perpetual bonds than the billionaire and philanthropist George Soros.

In a series of articles published on Project Syndicate (and subsequently relaunched by many other international news outlets), the Hungarian-born American financier has said that **the EU could raise up to €1tn through the issuance of irredeemable bonds, against the payment of a coupon rate of 0.5%**. With a yearly outlay of just €5bn and without any refinancing risk (the principal should never be repaid), European countries would have the opportunity to mobilize huge resources.

Life insurance companies would be among the natural buyers of the notes, thus holding the securities against their long-term liabilities, but subsequently **the asset could be included in the European Central Bank's purchase program**. Since the market may not be able to absorb a placement of this magnitude in only one solution, the bond could easily be sold in several following tranches.

On the eve of the April 23 European Council, **Spain presented a proposal that adopted the suggestion to feed the European Recovery Fund through the sale of consols**. The non-paper drawn up by Pedro Sanchez's government hypothesized an issuance of up to €1.5tn, which, according to Soros, would have allowed the financing of both the battle against the virus and the fight against climate change.

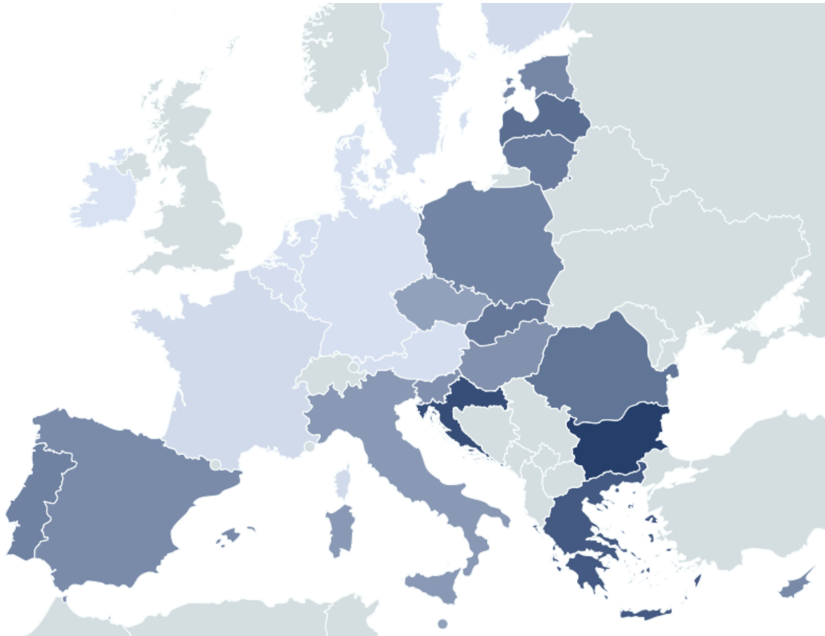
However, the Spanish plan was quickly dismissed by fellow EU leaders, seemingly because it was interpreted as a project to mutualise the public debt of European countries. In fact, **the only burden that would be shared between the bloc's governments** due to the joint issuance of perpetual bonds **would be the negligible annual interest expense** arising from the securities, Soros said.

George Soros
Chairman of Soros Fund Management and the Open Society Foundations

Financing [the EU Recovery Fund] with perpetual bonds is the easiest, fastest, and least costly way to establish it.

April 20, 2020

Next Generation EU: grants and loans allocation (% GDP, 2019)



Source: Bloomberg, European Commission, Eurostat

Note: Italy and Spain could be, in absolute terms, the main beneficiaries of the loans and grants that will be disbursed by the European Recovery Fund (see chart on page 1). The two Mediterranean countries are also at the top of the EU ranking that tracks the number of coronavirus infections. However, if the scale of European funds is compared to the size of each country's economy, Bulgaria and Croatia would prove to be the main recipients of the resources -- at around 20% of their GDP, compared to 10% for Italy and 11% for Spain. The final allocation of Next Generation EU's €750bn funds may be subject to even significant changes during the complex negotiations of the next weeks/months.

Risks

Well before George Soros gave his imprimatur to the proposal, the idea of financing the recovery of the European economy through the issuance of perpetual bonds had been put forward by Francesco Giavazzi and Guido Tabellini on Vox and then reformulated by Luis Garicano and Guy Verhofstadt on Project Syndicate. More recently, also the weekly magazine The Economist has spoken enthusiastically about it, defining prepetual bonds as "an ideal form of debt."

The advantages of a potential issuance of irredeemable debt securities by European states are clear, primarily the possibility of distributing over several generations the burden borne by governments to counter the economic fallout caused by the epidemic. **If it is true** -- as Giavazzi and Tabellini claim -- **that there are no institutional or legal obstacles to its use, for what reason** -- ask Giancarlo Corsetti, Aitor Erce and Antonio Garcia Pascual (again on Vox) -- **states have not been using irredeemable debt for some time now?**

According to the three economists, **institutions such as the European Commission** -- characterized by pristine ratings and low roll-over risk -- **would have no advantage in issuing consols, whose coupon rate would be between 2% and 3%** (well above the 0.5% estimated by Soros and substantially in line with the more conservative 2.5% calculated by Garicano and Verhofstadt). The EU's executive arm, on the contrary, should imitate the traditional banking business of maturity transformation, borrowing on the short segment of the curve (at negative rates) and lending longer-term to ailing member states.

Moreover, **from the point of view of the potential investors in the notes**, **perpetual bonds expose to many different risks**. Giampaolo Galli and Federica Paudice of Osservatorio CPI have identified some of them. The first risk is linked to the high duration of consols, which makes their market price highly sensitive to changes in interest rates. These are currently at extremely low levels and no one expects them to rise in the short term, but if and when this will happen, losses suffered by pension funds and insurance companies holding the bonds could generate serious problems of financial instability.

The same reasoning can apply to inflation which, after years of underperformance with respect to the 2% goal targeted by the ECB, could receive an upward boost by the unprecedented fiscal and monetary interventions deployed in recent months, with the consequence of eroding the real value of the fixed coupons paid by the bond (unless an indexing mechanism is devised).

Last but not least, the issuer's credit risk should be taken into account too: **will the European Union still exist in 50, 100 or 200 years?**

FOCUS: CoCo bonds

The debate on perpetual bonds that has developed in recent months has often described this type of securities as unusual or anachronistic, apparently forgetting **a category of issuers** that **regularly resorts to bonds with no maturity date: banks.**

Additional Tier 1 securities are at the same time the riskiest bank debt an investor can buy and **the highest-quality liability a lender can issue (in terms of loss absorbency)**. Indeed, AT1s are subject to write-down or conversion into shares if the bank's Common Equity Tier 1 falls below a minimum threshold (typically equal to 5.125% of Risk Weighted Assets). For this reason, they are often called CoCos, or contingent convertibles.

In fact, **although these bonds are in all respects perpetual securities, it is customary** (especially in the European market) **for banks to redeem these notes on their first call date**, usually 5 or 6 years after their issuance, and replace them with similar newly-issued securities. This practice could explain why, when talking about irredeemable bonds, thinking rarely goes to this type of subordinated debt.

The EU as a borrower (as is)

Lending capacity
- European Financial Stabilisation Mechanism (EFSM): €60bn, utilised €46.8bn, outstanding €46.8bn
- Balance of Payments (BoP) assistance: €50bn, utilised €13.4bn, outstanding €0.2bn
- Macro-Financial Assistance (MFA) to non-EU partner countries: no ceiling, outstanding €4.73bn

Mandate
Provide financial assistance to countries in financial and economic difficulty in order to promote economic and social integration of the member states

Shareholders
All European Union member states

Support to bondholders
EU budget and member states' obligation to provide the funds necessary to meet the EU's legal obligations

Credit ranking
De facto preferred creditor status

Ratings
AAA / Aaa / AA / AAA / AAA
(Fitch / Moody's / S&P / DBRS / Scope)

Source: European Commission (May 2020)

Yet, as Marcus Ashworth has pointed out on Bloomberg, **the coronavirus has been able to upset also this corner of the global financial system**. Under current market conditions, a bank that decides for the early repayment of a CoCo would be forced to refinance itself at far less favorable terms. **Deutsche Bank, Lloyds and Aareal Bank have** already **decided** in recent weeks **to violate the gentlemen's agreement sealed with their own bondholders**, by not exercising the call options embedded in their securities. ABN Amro, Royal Bank of Scotland and Barclays may soon follow in their footsteps.

Hamiltonian moment

On May 18, **Angela Merkel and Emmanuel Macron have announced that they had reached an agreement for the creation of a €500bn Recovery Fund** aimed at providing assistance to the European countries worst-hit by the coronavirus pandemic through grants instead of loans. Many commentators have wondered whether this was the Hamiltonian moment the European Union had been waiting for.

The reference is to the agreement that **Alexander Hamilton**, the first Secretary of the Treasury of the United States, managed to reach with Thomas Jefferson and James Madison in 1790, thanks to which it was **decided to transfer to the newborn federal government all the debts issued by the 13 American colonies during the** revolutionary **war of independence** fought against Britain.

As Stephen Mihm has recalled on Bloomberg, **the debts of all the states were consolidated into a new perpetual federal debt**, that could have been converted at the discretion of the government into securities with a closed maturity (a conversion that actually happened in the 1830s).

Stephen Mihm
Associate professor of history
at the University of Georgia

With a growing number of public and private debtors issuing debt of ever-lengthening maturity, why not go all the way, and stretch the yield curve to asymptotic infinity?

November 11, 2019

However significant (and pending the outcome of European negotiations), both the Franco-German plan and the subsequent proposal by the President of the European Commission Ursula von der Leyen are far from achieving an authentic fiscal union like the one Hamilton was able to forge in the United States of America exactly 230 years ago.

Moreover, **the Commission's** "Next Generation EU" **plan provides for Brussels to raise the €750bn needed** for the creation of the Recovery Fund **through the issuance of bonds with a maturity not exceeding 30 years**: all the notes will be repaid, at the latest, in 2058.

The coronavirus crisis has led the global financial community to confront -- with a pragmatic rather than merely academic approach -- on policy tools until recently considered taboo. **With bond yields near historic lows** and the need to attract investors interest in a market flooded with huge amounts of new (mainly public) debt, **the sale of non-redeemable bonds** by issuers with a strong credit rating is something that **cannot be excluded a priori**.