GlobalCapital

Sovereign Borrowers Roundtable

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Europe's sovereign borrowers stand tall amid fragile markets

The primary bond market for sovereign borrowers remained impressively resilient in the first half of 2023.

Europe's leading sovereigns made light of inflationary pressures, rising rates, a fragile economic outlook and turmoil in the US banking sector, meeting their funding objectives with apparent ease.

At the same time, investors shrugged off geopolitical uncertainty and an unfavourable supply-demand outlook as quantitative easing gives way to quantitative tightening. In spite of these dynamics, book sizes have remained healthy and average new issue premiums have stayed consistently low.

Against this backdrop, a group of Europe's best-respected sovereign borrowers gathered to share their views on conditions in the primary market in the first half of 2023, and on the outlook for the rest of the year.

Roundtable participants

Participants in the roundtable, which took place in London in June, were:

Phil Moore, editorial consultant, *GlobalCapital* (moderator)

Rui Amaral, board member, Portuguese Treasury and Debt Management Agency (IGCP)

Siegfried Ruhl, *hors* classe adviser, Directorate-General for Budget, European Commission

Maric Post, director, Treasury & Capital Markets, Belgian Debt Agency

Ben Adubi, head of SSA Syndicate & DCM, Morgan Stanley

Davide Iacovoni, director general, Treasury Department, Italian Ministry of Economy and Finance

***GlobalCapital*: As we're now approaching the middle of the year, how have sovereign borrowers' funding programmes evolved in the first half of 2023? Were you able to frontload efficiently in the early months of the year despite the headwinds we saw in March? And has your mix of auctions and syndications been in line with expectations?**

Rui Amaral, IGCP: 2023 has been an extraordinary year for Portugal and quite different from previous years. We began the year with a €24bn funding programme which we were planning to execute as normal through a couple of syndications and monthly auctions of Portuguese Government Bonds (PGBs) as well as some treasury bills issuance. So our planned gross issuance of PGBs was somewhere close to €20bn.

But with the rapid rise of rates and Euribor turning positive, demand from retail investors for savings certificates has exploded. Our original funding programme forecast a total of €3.5bn of retail-targeted net issuance, which was the figure we were counting on to fulfil our €24bn funding programme. This would have been a much higher figure than in previous years, where net retail subscriptions generally hovered around zero.

By the end of the first quarter, we had to revise this forecast to €12bn in the second quarter. So we suddenly saw retail accounting for 50% of our funding programme. This led us to skip a few auctions and reassess our programme because we found ourselves sitting on an unexpectedly huge pile of cash.

We have now made the necessary readjustments and we're in the process of resuming our programme for the second half of 2023.

Maric Post, Belgian Debt Agency: Our funding programme has been very much as expected. We have a funding plan this year of €47.5bn which is the largest in recent years, with the exception of 2020.

At the start of 2023 we announced that we would be doing three syndicated transactions this year. All of these were completed early in the year, which is not uncommon for us.

As to the rhythm of our funding, although the amounts we have issued are larger than usual, this has been exactly in line with previous years. This means we completed two-thirds of our funding in the first half of the year, and the remainder will mainly be auction-based as we now have our syndications out of the way.

We also have an offer of retail-targeted bonds in Belgium, which we issue four times a year and which can be traded in the secondary market. But we have not seen volumes comparable to those Rui was describing in Portugal.

Amaral, IGCP: I think our retail products are different because they are exclusively certificates where investors are guaranteed that they can always be reimbursed immediately at par, irrespective of what rates are doing.

***GlobalCapital*: Is this explosion of retail demand purely a function of the failure of banks to increase deposit rates in line with the rise in Euribor?**

Amaral, IGCP: Yes. We've seen a very rapid rise in Euribor. Certificates in Portugal paid Euribor plus a spread, but capped at 3.5%. We lowered the coupon on those certificates a couple of weeks ago, but up until then they were attractive relative to Portuguese Government Bonds and much more attractive than the remuneration offered on deposits. So yes, there was a direct inflow from deposits to floating rate certificates, although there is a limit on investment of €250,000 per person.

GlobalCapital: Retail has traditionally been an important source of demand in Italy. How has this fitted in to Italy's funding this year, and what has been your overall funding experience so far in 2023?

Davide Iacovoni, Italian Treasury: Our programme has developed smoothly, even though our financing needs have increased quite substantially compared to last year.

Although there is some uncertainty on the final numbers, for the time being we are estimating total bond issuance of around €320bn. So far, we have completed slightly below 60% of this total, which is quite satisfactory compared to previous years.

With respect to our initial plan, we are slightly ahead of target, and in terms of the mix between auctions and syndications we are more or less in line with expectations. In our guidelines we said we would be active at the long end, as well as in the inflation-linked and green bond markets. We have met all these commitments, issuing new 30-and 20-year benchmarks, a new green bond and a new linker in the first half of this year.

Of course, this has been supported by our retail programme. We have already issued two bonds dedicated to retail investors. One is the BTP Italia linked to domestic inflation which has always been tailored for both retail and institutional investors through two separate windows. This successfully raised just under €10bn in March.

In June, we launched a new family of products called the BTP Valore. The first issue was a four-year bond with a coupon step-up mechanism, where the coupon is pre-set but increases over time. This was an extraordinary success not so much for its size, although this was very significant because it exceeded €18bn. It was also notable for the orders we received and the number of people who participated. We're talking about more than 650,000 investors, which was far above all our previous retail offerings.

These are bonds that are traded in the secondary market via the Borsa Italiana's fixed income platform (MOT). This provides ample liquidity for retail investors with a minimum trading lot of €1000, although of course the liquidity isn't comparable to the institutional market.

"What we've seen in recent months is a much more direct dialogue between issuers, investors and banks aimed at pinpointing exactly where a deal's terms should come"

Ben Adubi, Morgan Stanley

These bonds were very appealing to retail where the pool of liquidity on current accounts is still quite large, at about €1.2tr to €1.3tr, most of which is earning very low returns. This means that not just government bonds but several other products designed for retail investors are increasingly attractive.

We've tried to support this participation as much as possible by creating momentum around our issuance windows. I expect we'll continue to pursue this policy within the BTP Valore family with some other products over the summer.

GlobalCapital: Siegfried, I assume the EU has a slightly different story to tell as you don't have the same natural retail investor base that a sovereign like Italy has.

Siegfried Ruhl, European Commission: You're right in the sense that we don't have a dedicated retail investor programme. But of course, our bonds can be bought by retail investors.

For us, the first half of the year was significant. It was the first six-month funding period when we used what we call our unified funding approach, and it was well-received by markets. This approach extends the sovereign-style funding strategy, which we introduced two years ago for our NextGenerationEU (NGEU) funding programme, to other EU policies financed via capital markets funding. Via this approach, we issue EU-Bonds across the curve in different maturities. This year we have applied this funding approach to other EU programmes, more concretely the Macro-Financial Assistance (MFA Plus) programme to support Ukraine.

In the first half of 2023 we announced €80bn of funding needs, €70bn of which are for NGEU, and some €10bn for the MFA Plus for Ukraine.

Our funding requirement in the first half of this year was significantly higher compared to the same period of the previous year when we raised €50bn. We successfully delivered on the €80bn, taking into account the changing market environment by increasing the number of transactions while slightly reducing the average amount per transaction.

In total, we completed eight auctions and seven syndications, which was an increase in the share of auctions compared to past periods. At the start of our sovereign-style funding operations, in the second half of 2021, we used auctions to raise 6% to 7% of our funding volume. Last year the share of auctions reached 25%, and in the first half of 2023 it increased to almost 40%.

This shows that we are using auctions as an efficient instrument to raise funding. It also demonstrates our commitment to supporting secondary market liquidity by tapping outstanding bonds mainly via auctions.

***GlobalCapital*: And it presumably underscores your objective of positioning the EU as a sovereign issuer?**

Ruhl, European Commission: Yes. This unified funding approach is definitely part of our effort to transition the EU, which has traditionally been seen as an SSA issuer, into the market of sovereign debt. What we are issuing is ultimately replacing sovereign debt; and in terms of volume, €80bn in six months is above the size of a typical SSA borrower. It is also more than most sovereigns are issuing.

We are now the fifth largest issuer in the euro market after the big four sovereigns. And we act in the market like a sovereign by offering large, liquid benchmarks and a bills programme at the short end of the curve, developing our auction programme, and building a homogenous curve through our unified funding approach. Over time we are gradually issuing all of our securities under the label of EU-Bonds, which is another step to ensure our transitioning into the sovereign bond asset class.

***GlobalCapital*: Has the experience of the four borrowers we've heard from been broadly representative of the European sovereign bond market in the first half of 2023?**

Ben Adubi, Morgan Stanley: Yes. I think that coming into this year there were plenty of discussions and concerns around the significant net issuance expected to come to market, given that QE was no longer going to be the main driver of secondary market purchases.

Looking at gross funding needs for the year across the EGB market, between 50% and 60% has already been completed. The EU's gross and net issuance are obviously similar, given that the unified funding approach is still at a relatively early stage. But when we look at total net issuance, I think we'd all be surprised that for the eurozone as a whole we're not 50% or 60% complete for the year. In fact, we're between 60% and 130% complete on a net basis. For example, Spain has completed about 60% in terms of net issuance for the year, while Belgium is already 112% funded in net terms. From a supply-demand perspective, this should be positive for funding dynamics heading into the back end of the year.

***GlobalCapital*: To what extent has the resilience of markets, both at a primary and secondary level, taken people by surprise this year? Has it been a pleasant surprise given the headwinds created by tighter monetary policy, the end of QE, war in Europe and the turmoil in the banking sector we saw in March?**

Iacovoni, Italian Treasury: Yes. In all honesty we have been positively surprised. But looking a little more deeply into the market I think there have been some stabilising factors that should not be overshadowed by all the headwinds you mentioned.

First, I'd say that the ECB approach has been highly transparent and gradual, which has been appreciated by market participants. People were expecting that sooner or later the huge amounts of liquidity being injected into the system would be withdrawn, especially in the context of the ECB's engagement in the fight against inflation. People also appreciate the ECB's preparedness to announce all their policy actions well in advance.

Second, and still on the subject of the ECB, its policy regarding the PEPP [Pandemic Emergency Purchase Programme] has maintained a decent amount of flexibility when it comes to reinvesting in bonds up until at least the end of 2024. The Programme hasn't used this flexibility much, but the ECB has sent a strong signal to the market about its possible use.

In addition, there is the TPI [Transmission Protection Instrument]. Even if we still have very little information about the operational aspects of the TPI, its existence has been a supportive factor.

All this is on the ECB side. But I should add that when it comes to Italy specifically, the change of government has been positive. So far, the government has been pragmatic and prudent. These two

"2023 has been an extraordinary year for Portugal and quite different from previous years"

Rui Amaral, Portuguese Treasury and Debt Management Agency (IGCP)

aspects have been welcomed by the market, which has recognised that the government is absolutely committed to reducing the deficit and bringing down debt. This has already been happening, with the Italian debt to GDP ratio falling quite significantly over the last couple of years. The government has no intention of reversing this trajectory and has been co-operating very closely with the European authorities in areas such as the recovery plan and the new EU rules on governance. These are factors that have surprised the market in a positive way.

***GlobalCapital*: In other words, Italy is benefiting from a combination of a supportive ECB and sound domestic policies which are more than compensating for the headwinds I listed.**

Iacovoni, Italian Treasury: Absolutely. Of course, we have been experiencing periods of heightened volatility, including structural volatility in the market due to uncertainty about the ECB. March was especially tense, and we saw some deterioration in liquidity but there has been no stress or panic comparable to what we saw during the sovereign debt crisis or in 2008. The market continued to be resilient despite the banking crisis in March and despite QT which is still to take place.

Post, Belgian Debt Agency: I agree that the signalling by the ECB has been very helpful for the market.

I also believe that the market has done an excellent job in preparing for the high issuance volumes that everybody was expecting and for the impact of QT following the increased supply. The corrections we saw in spread levels in the second half of last year proved that the market was positioning itself to absorb this expected supply. Part of the reason spreads moved the other way early in 2023 may have been that markets recognised they had taken this positioning too far. The volatility we saw in March perhaps justified the spread levels we saw late last year.

But all in all, I've been impressed with the way the market has set itself up to absorb the higher funding needs of European governments.

***GlobalCapital*: So elements like continued high book sizes have not necessarily been a surprise?**

Post, Belgian Debt Agency: No – because the other element alongside the signalling of the central banks that has been supporting the market has been the rate levels which have of course attracted investors to the fixed income market.

We spoke about retail demand, but another important element which is difficult to quantify has been the repositioning by some investors of parts of their portfolio into fixed income and away from some other asset classes. That's going to support the market going forward as well.

Amaral, IGCP: I'd agree with what has already been said about the pleasant surprises we've had this year.

I would add that with the economic outlook deteriorating in the second half of last year, inflation expectations rising and central banks starting to increase rates, we saw a lot of volatility. By December the mood had become very gloomy with bond yields rising steeply. This may have been an over-reaction, although we were also very affected by the geopolitical situation due to the war in Ukraine.

Some of the negative influences on the market have dissipated a little this year, and economically we've enjoyed some positive surprises. We've seen institutions ranging from the European Commission to the IMF revising their forecasts for the eurozone and elsewhere. And we've seen inflation starting to come down aggressively from its peak in October which created the momentum to reduce the gloom we had towards the end of last year.

At the beginning of January, we still didn't know how the market would unfold in 2023. It was in the first week of January that we issued our only syndicated transaction so far this year. This was a 15-year benchmark which went very well. The oversubscription level was in line with previous years. But after that yields compressed significantly, which allowed for several successful new issues. Some volatility came back in March, but we are now once again seeing very benign market conditions which have been reflected in the success of the deals we've seen coming to the market.

Ruhl, European Commission: What we saw in the first half of the year was an encouraging reflection of how developed and resilient the European capital market has become. This is thanks to what has been implemented over the last 10 to 15 years, starting with the response to the banking crisis of 2008 and the sovereign debt crisis. All these crises were ultimately resolved jointly, even if we initially had some disagreements within Europe. This is a normal process in a democracy.

Europe responded to the different crises of 2008 by creating EFSF/ESM and the Single Resolution Board, as well as strengthening the banking system and introducing other reforms. During the pandemic, EU countries agreed on several instruments to secure a joint European response. These lifted us out of the economic crisis caused by the pandemic more quickly than originally foreseen. It also supported the transformation of Europe into a greener, more digital, and more resilient continent.

The result has been that trust in the euro and the EU is at a record high. At the same time, investors outside Europe remain interested in investments in the EU. They are taking advantage of the higher yield environment in a liquid and safe market and coming back to the European market despite all the challenges we've faced. This is conclusive proof that what Europe has achieved over the last decade is now really paying off.

***GlobalCapital*: Is what you're saying about international demand based directly on the feedback you're getting from your dialogue with investors in the US and Asia?**

Ruhl, European Commission: What I'm saying is based on what we observe directly in the market. The turbulence in the banking sector in the US in March caused some increase in volatility in Europe. But there was no contagion in the European banking sector, which remained stable.

What I'm saying is also based on the feedback we've had from investors inside and outside Europe. For example, I was recently in Asia, which is a very important investor base for us, and the feedback we had from there was very positive.

Adubi, Morgan Stanley: I think the point Maric mentioned about the reallocation investors are making towards fixed income is important. We only have well-telegraphed information on the supply side of the coin because borrowers provide half-yearly or annual funding forecasts to the market. But on the demand side we have much less visibility. For example, who would have forecast that the retail investors we were discussing earlier would have come to the demand side of the equation as much as they have?

We've also seen a reallocation from credit to rates and from private and listed equities to fixed income. This has been an important factor supporting markets this year, but it is difficult to quantify because these numbers aren't made public.

One reason this has been so positive from our perspective is that the higher-quality component of order books has probably been materially larger than at any time over the last five to 10 years. This is important, given that although order books are still big, they are unlikely to hit the heights that they reached in recent years.

Looking at the discussion around liquidity in the banking sector and its impact on net supply, banks have not necessarily been passing on the benefits of rate hikes by the ECB to consumers on a one for one basis. This has meant that profitability-wise the banks are in a much better place than they have been over the last few years, which in turn means they're not supplying the market with additional TLTRO bonds.

What has been impressive is that where we have seen volatility over the last six to 12 months in – Europe in particular – is that there hasn't been the same kind of widespread response that there was in previous years. The response has been much more localised, targeted, and temporary. This has helped reassure market participants that tail risks are either being nullified or prevented outright.

***GlobalCapital*: The point you make about the quality of order books is interesting. What changes are borrowers seeing in the composition of their order books, especially at the longer end of the curve?**

Amaral, IGCP: In our case we've only done one syndicated benchmark this year in the first week of January, so I don't know how representative the order book was of the broader market this year. When we announced our deal, Ireland was in the market with a 20-year green bond. The difference in the tenors meant that the deals did not necessarily compete with each other.

In the case of our deal the level of over-subscription may have been slightly higher than it was in our previous syndication in April 2022 just after the Russian invasion of Ukraine. But in terms of the composition of the order book, the diversification of investors in this year's syndication was more or less the same. If there was one notable difference it was that maybe participation by bank treasuries came down a little.

***GlobalCapital*: What about Italy? What were the main features of the order books in the new benchmark trades that you mentioned earlier, Davide?**

Iacovoni, Italian Treasury: We have done several syndications this year and I completely agree with what Ben said about the quality of order books. This may not have been very evident at the start of the year when we launched a couple of transactions in 30 and 20 years, both of which went quite well.

The rising quality of order books only really started to become visible after the US bank crisis in March. Since then, in our transactions both in the linker space and on the green bond side, we've seen a notable increase in the quality of the books. In our case we have seen a slight reduction in the participation of bank treasuries, especially among domestic banks. Instead, we have seen more demand from central banks and official institutions, as well as from insurance companies and pension funds. In spite of Italy's credit rating, there was also a decent amount of long-term oriented investors' participation in our green bond and our 15-year linkers.

This means that far from being a negative trend, the disappearance of some of the balloon-style order books we saw in the past is probably restoring some normality to the market. We know perfectly well that part of the reduction of over-inflated order books is a function of declining activity from hedge funds which were left managing some losses when the rate cycle changed. But ultimately, I think this was a healthy development.

"The ECB approach has been highly transparent and gradual, which has been appreciated by market participants"

Davide Iacovoni, Italian Ministry of Economy and Finance

We're still waiting to see how the demand situation will evolve at the long end because for most of us, Italy included, the curve is inverted which is an important consideration for many investors. But for the time being, the trends we're seeing in book quality are encouraging.

Post, Belgian Debt Agency: I'd echo Davide's comments on the quality of books. The only difference we have seen compared with other issuers around the table is that participation among bank treasuries has still been very significant – in all maturities, surprisingly enough. Even in our 30-year transaction, banks had a very strong presence in the book.

In our most recent syndication, we probably had the highest quality book we've seen in many years, with very little flow visible in the market afterwards. So I'd agree that rising quality has been a clear trend throughout the year.

***GlobalCapital*: To what extent, if at all, has the resilience of the primary market this year reflected the way issuers themselves have been approaching bookbuilding, incorporating no-grow language and managing their relationships with investors and primary dealers more intensively? Or has it been business as usual?**

Adubi, Morgan Stanley: That's an interesting question because all the borrowers around this table approach their syndications in different ways. There is no definitive right or wrong approach. But I think one area which sovereign borrowers have been very pragmatic about has been their discourse with investors, which has increased over the last six to 12 months.

Davide mentioned curve inversion, and there are other considerations like high and low cash prices, and Z-spreads all over the place, all of which is generating an unprecedented divergence of views among banks, investors and issuers. This has meant that issuers have had to be much more attentive to their investor base than in recent years.

I would not say this means we always need to go into deals with anchor investors. But we do need an extremely good understanding of appetite and relative demand among institutions such as pension funds and central banks. Issuers have always been open to discussions with investors. But what we've seen in recent months is a much more direct dialogue between issuers, investors and banks aimed at pinpointing exactly where a deal's terms should come. Typically, we're never moving more than two or three basis points on any given deal, which means there isn't very much wiggle room to move pricing tighter. But a wider pricing range often means you need to be much closer to the investor base than in the past.

***GlobalCapital*: Is this symptomatic of a more general change in the way issuers approach investor relations?**

Adubi, Morgan Stanley: It's not so much that it has changed. It's more that its importance has increased. Everybody around the table is actively involved in investor marketing. But when it comes to specific deals, given how irregular various parts of the fixed income curve have become, you have to have a much lengthier and more detailed discussion with some of the core parts of the investor base.

***GlobalCapital*: Siegfried, as the EU with its current funding programme is a relatively recent arrival in this asset class, how do you approach the challenge of investor relations?**

Ruhl, European Commission: As you say, we are a relatively new issuer as a quasi-sovereign issuer in the sovereign space. From the beginning, open and transparent communications with investors has been an important priority for us. We started this initiative early, announcing our funding plans in detail, launching a website which provides detailed information about our work, and distributing a regular newsletter with updates about our work. We're also committed to regular global investor calls to explain the background to our funding plan.

Because 30% of our funding will be raised via NextGenerationEU green bonds, just over a year ago we added our green bond dashboard to our website. This is an extremely transparent account of the expenditures financed by our green bonds.

What we want to develop further is the individual or bilateral coverage of investors. This is dependent on available resources, but we are making good progress in this area.

We also recently launched an investor survey which is an ongoing initiative and is designed to gather feedback from our investors about where we could improve our approach to the market now that we've been in the market for two years.

***GlobalCapital*: Have any of the longer-established issuers around the table made any notable changes to their investor relations strategy this year?**

Iacovoni, Italian Treasury: We haven't made any specific changes. But I agree with Ben that when you launch some transactions in the market you need to have identified some key accounts in advance. We've been doing this via our primary dealers more than we did in the past.

The issuance process has been shortened in terms of time, and the number of revisions to price guidance is smaller, because in an increasingly volatile environment people want to move directly to a landing point and close the books as soon as possible. This makes it all the more important to have a clearer and deeper understanding of investors' intentions in advance and a more flexible approach during the transaction itself.

Investors have indicated to us that they appreciate the fact that everything is priced and closed early.

***GlobalCapital*: I'd like to move on to the impact that NGEU has had on the market. It's interesting that people have spoken about investors' reallocation of funds to this asset class. I read a research piece the other day which said that in 2019, the supply of safe assets in Europe — defined as sovereign bonds rated AAA/AA — amounted to just 37% of GDP, compared with 89% of GDP in the US. So far from crowding out other borrowers, has NGEU increased the pool of liquidity**

and helped to fill a gap and create a new benchmark that the European capital market needed?

Post, Belgian Debt Agency: It's always difficult to isolate an individual element influencing supply-demand dynamics.

The only conclusion we can really draw is that at times of heightened volatility we have seen clear differences between the very liquid issuers such as Germany, France and Italy and the smaller sovereigns. This was certainly a driver of some of the spread widening we saw last year.

But I don't think there has been a negative impact of another borrower being very close to our bandwidth in terms of issuance.

***GlobalCapital*: Presumably it makes the timing of new issues more important? From a simple numerical perspective, the arrival of another large borrower reduces the availability of issuance windows.**

Post, Belgian Debt Agency: Yes. That's something we all need to be conscious of. But the EU is a very transparent issuer, which is helpful, because it telegraphs which windows are likely to be closed at any given time.

Ruhl, European Commission: Besides, we have seen certain situations in the first half of this year where sovereigns and the EU were in the market on the same day, and this had no negative impact on demand or pricing.

I believe that the presence of the EU as a larger issuer ultimately makes the European capital market more attractive because it introduces an additional safe, liquid asset. It may not be *the* European safe and liquid asset which has been under discussion for many years. But it provides investors with a new and attractive investment alternative.

Adubi, Morgan Stanley: Sometimes I think we forget just how big and deep the European capital markets are. So I totally agree with Siegfried that this is another way for investors to express their views on duration.

We talk about liquidity and we see increasing amounts of trading by investors between European sovereigns and the EU and vice versa. But this isn't a zero-sum game. It is attracting a huge amount of capital from various parts of the investor universe, whether it's moving from credit to rates, for example, or from the US to Europe.

***GlobalCapital*: Siegfried, would you like to give us an update on how far you've come in terms of establishing the EU as a sovereign issuer? Where have you reached in terms of your liquidity journey? How important in this respect is the imminent classification of the EU as a category one issuer with respect to haircuts?**

Ruhl, European Commission: It all sounds a bit technical but you're right to say it is important in terms of the liquidity of EU-Bonds. The ECB announced that as from June 29 they would be treating us in their collateral framework as a category one borrower. This brings us to the same level as sovereign issuers and recognises that the EU should no longer be regarded as a typical SSA issuer in terms of how it's traded in the market.

But there is a bigger purpose behind all these technicalities. We have seen over the last 12 months that the EU performed in line with other names such as EIB and ESM and even with larger triple-A rated agencies like KfW. But at the same time, the yield performance decoupled a little from government bond markets. So we underperformed most of the sovereigns over this period.

This relative performance contradicts the purpose and idea of this joint financing mechanism. This is a political initiative which ought to generate an economic benefit.

One reason is that the EU has traditionally been treated as an SSA issuer and was not included in bilateral collateral frameworks when these were agreed 10 or 15 years ago. In those days, the EU issued maybe €1bn of bonds per year, which meant that it was not sufficiently liquid for collateral agreements.

Risk frameworks are another reason, as they allow investors to take bigger positions in government bonds than in SSAs. Consequently, sovereign bonds benefit from very strong structural support from investors with mandates linked to government bond indices. All of this means that a triple-A borrower which is the fifth largest issuer in Europe yields higher in some parts of the curve than lower rated and less liquid sovereigns. This is fundamentally unjustifiable.

***GlobalCapital*: It's great news if you're a hedge fund, isn't it?**

Ruhl, European Commission: Maybe. But even hedge funds' risk frameworks treat sovereign and SSA bonds differently.

But the arbitrage you'd expect to see in a perfect market is not happening. This is because of the structural hurdles I mentioned, which prevent capital from flowing as freely as it should between different types of public debt.

We have to overcome these hurdles, not just because it is in the interest of EU yields. In the long run, this would also help to strengthen and harmonise the European capital market, to the benefit of all issuers, including sovereign borrowers.

Eliminating this artificial split between SSA and government issuers would increase the pool of eligible safe and liquid assets available on the SSA market. There we have EIB, ESM and EFSF, all of which are also safe and liquid assets but are inaccessible at the moment for some parts of the investor base.

Removing this distinction would be a notable step forward in the development of the capital market.

Adubi, Morgan Stanley: I agree. We're all constantly striving to enhance the efficiency of the market. This applies to the pure trading side where algorithms and so on are becoming more common. It is also true on the ESG side where issuers are pushing the boundaries and setting new standards all the time. In the context of the rates universe, for the EU to try to break down these traditional barriers is just a natural step forward, given the size and significance of the issuer's funding programme.

So I think it's right that we're having these discussions at a time when the pipeline in the euro market is so significant. As I said earlier, I don't see this as a zero-sum game.

***GlobalCapital*: Sticking with the EU's funding objectives, how satisfied have you been with the progress you've made on diversifying your investor base outside Europe? According to your latest presentation, 6.5% of total investor subscriptions have come from Apac and 2.4% from the Americas, with take-up of green bonds from these regions slightly lower. This looks slightly underwhelming, given the extensive marketing you've done in Asia and North America.**

Ruhl, European Commission: It is easy to explain when you look at our history. Until 2019, the EU was a relatively small borrower, and an issuer with no more than €50bn outstanding was not very attractive for big central banks and sovereign wealth funds outside Europe.

We became a large issuer with the SURE programme in 2020 and NGEU in 2021. But at that time, we were still in a negative yield environment, which again was not very appealing for central banks outside Europe.

This has changed, and since the beginning of last year we have been in a positive yield environment. Now we are seeing a strong increase in interest from these accounts. This is reflected in continuous requests for information, bilateral calls and so on. These large institutions are also required to complete a number of internal processes in order to set up or increase risk limits for the EU. They weren't interested in doing this before because it didn't meet their size or yield requirements, but they are in the process of doing it now.

But interest and demand are increasing, especially from Asia and the Middle East and even from North Africa.

Indeed, 6.5% has been the historical average of our placement into Asia. This continues to be the share – with small variations depending on maturity – and this is mainly demand from central banks and sovereign wealth funds.

What is not reflected in the primary market statistics is the change we're seeing in investor behaviour. As our securities are becoming more and more liquid, an increasing number of large investors are buying the EU in the secondary market. Here they can buy the volume of bonds at the time they want, rather than at the time of our issuance.

So the primary market statistics aren't fully reflective of our investor demand.

***GlobalCapital*: I wanted to link this question into the topic of QT, which we haven't discussed very much today, possibly because there is still so little**

clarity about how it will evolve. But as and when it gathers momentum, will QT make it all the more important that borrowers reach into every pocket of demand they can? We've spoken about retail demand and linkers. What other options are borrowers looking at to maximise the diversification of their investor base? Are you still exploring ways of reaching into accounts like second-tier Japanese trust banks, for example?

Iacovoni, Italian Treasury: The answer is definitely yes. If you look at the composition of our stock of debt in terms of its holders you'll see that the ECB and the Eurosystem is still dominant with more than 30%.

As you said, we haven't discussed QT much, but it is the big elephant in the room, so this share is expected to fall. At the same time, especially since volatility in the market began to increase due to rising rates and so on, the participation of foreign investors has been coming down, albeit slowly and without the sort of abrupt changes we saw during the sovereign debt crisis. At the same time, we have seen stable demand both from domestic fund managers and domestic banks.

It's clear that because of QT and because of the new environment our investor base is likely to change quite significantly. So our challenge is to avoid as much as possible any kind of sharp or abrupt changes in the composition of our investor base arising from tensions that could itself create further stress in the market and so on.

This is why when you ask about whether we're aiming to engage with more foreign investors my answer is yes. We always maintain close contacts with foreign investors, but now we're aiming to increase the number of contacts, especially with funds in Asia, the Middle East, and the US, because our relationships with investors in the UK and Continental Europe are already well-developed.

In the US and Japan there are still a lot of investors who withdrew from our debt in 2011. They lost a lot of money then, so re-engaging with those investors is not necessarily straightforward, at least with some of them. So that is an area we are now prioritising.

We already talked about the retail component, which is still quite limited. The share of retail investors in Italian government debt used to be much larger than it is today. I don't think we'll be going back to the old days in terms of retail participation. But given the rates environment we're now in, this is definitely a good time to make some effort to generate more interest from retail.

Is this going to be enough to substitute for the ECB? I don't know. But the sooner we prepare for QT the better.

***GlobalCapital*: Rui, coming back to what you were saying about retail investors, I guess you don't want to be lulled into a false sense of security by the explosion you've seen in retail demand. Retail demand is good, but it's volatile and tends to be concentrated at the shorter end of the curve.**

Amaral, IGCP: Absolutely. That is something we're very conscious of. We certainly don't want to rely too heavily on retail. We want to have a more diversified investor base because we're conscious of tail risk. Retail demand is all well and good in normal circumstances. But in an extreme scenario we don't want to be dependent on an investor base that can be more volatile and always has the optionality to move away from public debt savings certificates and back to bank deposits or investment funds.

Our strategy this year is based on the belief that QT will have a very limited impact on Portugal. We estimate that we will see a reduction in net purchases from the ECB of Portuguese government debt of about €2bn. Combined with limited net issuance a little bit north of €3bn this means we're in a very comfortable position this year.

But we are committed to meeting more investors outside Europe, particularly official institutions from the Americas, Asia and even Africa. The initial feedback we've had from them suggests they are very positive on Portugal's credit story. Our fiscal consolidation story is strong, and investors understand that the debt dynamics going into the next five-year horizon are favourable. They will continue to reduce debt very aggressively and support the general deleveraging of the economy.

The only restriction we're still facing is that we're one ratings notch away from the minimum needed by many institutions to invest in a sovereign. A lot of the feedback we get from some official institutions and such international investors is that they need an A-rating. We have had some upgrades in the recent past and we are counting on further rating agencies upgrades and building on our positive macro and fiscal story.

***GlobalCapital*: In terms of credit metrics, what is the outlook for debt to GDP ratios in countries like Belgium and Portugal?**

Post, Belgian Debt Agency: If one takes the IMF forecasts into account, we'd see a turnaround and higher debt numbers after the strong reduction in debt-to-GDP over the past two years. If you take the numbers the government has submitted to the EU, the debt to GDP ratio for Belgium looks more or less flat in the coming years.

Amaral, IGCP: The IMF is notoriously conservative with its forecasts, but the data submitted by Portugal to the European Commission suggests you'll see an even more pronounced downward trajectory.

***GlobalCapital*: The other source of demand I wanted to ask you about is ESG funds. Does the whole Green, Sustainable and Social (GSS) bond market open up a new pocket of investor demand even for developed sovereigns that would not otherwise have been there? And if so, does it mean you have to tell a very different story, because we hear anecdotal suggestions that some dedicated ESG accounts may be less price sensitive?**

Iacovoni, Italian Treasury: We've seen increased interest in our green bonds from investors that have not participated in our conventional bonds. We're not necessarily talking about new accounts. In some cases, these are large global accounts that have set up specific sustainability funds or mandates.

We'd never get these accounts on board without issuing this sort of paper. So from a DMO perspective, green bonds are very useful for diversifying the investor base. In our last green transaction in April, more than 50% of investors were from the ESG community whereas in our previous transaction they accounted for about one-third.

But even dedicated ESG investors remain sensitive to rates. They are naturally hungry for sustainable paper, and maybe they'd be more reluctant to withdraw their orders after any reduction in guidance, but this does not mean they are insensitive to pricing.

Issuing bonds and achieving these results in terms of investor diversification does not come without a cost. I'm not referring to the cost with respect to pricing, but the costs associated with approaching investors and the pre- and post-issuance work, which is quite burdensome. Preparing the impact reporting is not easy because you need to collect information from several central administrations which tend to operate in very different ways to us. Collecting, selecting, and processing this information and then making it available and understandable to investors is costly and time consuming.

We've just finalised our last report on our BTP green issuance last year which ran to more than 150 pages. This was hard work. But investors have made it clear that they expect the information we give them to be extremely detailed. They want to know what sort of impact assessment you're doing and which KPIs you're using. And then they want to know all about the validation from second opinion providers and so on.

On top of all that, you have to interact with the ratings agencies, providing them with information about use of proceeds together with more general updates about the sustainability policy of the country.

I think it's worth incurring all these costs, especially for a large issuer like us. But you need to make a very substantial commitment of time and resources if you want to maintain a permanent presence in this market, as we do.

***GlobalCapital*: I guess you make all these arguments when people say there should be a greenium for your green bond issues.**

Iacovoni, Italian Treasury: The greenium is a bonus at the end. The main thing for us is investor diversification.

***GlobalCapital*: Siegfried, I'm sure you could talk about your green bond programme for hours, given that the EU will be the largest issuer of these bonds in Europe. But to what extent does your NGEU green bond programme reach into a separate investor base, and what role do you see these bonds playing in the future?**

Ruhl, European Commission: Even investors without a dedicated sustainable portfolio are taking green aspects into consideration more and more often. So for us, green bonds are an important instrument which is helping us to diversify our investor base and to offer an attractive product to those accounts that want to invest in green.

But I also see it as an instrument that will further support the development of the market for sustainable finance in Europe, which has traditionally been the global leader in this area. This trend started when EIB issued the first green bond 15 years ago, and since then more than 50% of green bond issuance worldwide has been done in euros.

We also think green bonds help to create a better awareness of the topic of sustainability. One of the core political objectives of the EU is to fight climate change, and this needs financing.

***GlobalCapital*: Just to sum up, how can we expect the primary market for sovereign issuers to evolve over the next six to 12 months?**

Adubi, Morgan Stanley: To summarise how we've seen things over the last six to 12 months and then extrapolate forward: we came into the last 12 months with central banks all at different stages of their journey towards terminal rates and at different points in their hiking cycle. I think this divergence will continue. Each of the major regions is at a different point in its economic cycle and we've had data releases from central banks demonstrating that inflation is reaccelerating in certain parts of Europe and on a downward path in others. We're still in the early phase of central banks globally adopting a more hawkish approach to monetary policy and I still don't think we've seen the full effects of this. So the question will remain: how do you balance taming inflation and ensuring that certain parts of the economy and markets avoid becoming stressed due to illiquidity. That's the challenge we'll be focusing on over the next six months or so.

***GlobalCapital*: I'll end with a very off-the-wall question which is not very fair because none of you are expecting it. Everyone talks about blockchain, which is already being experimented with in the primary SSA market. Rather than ask about blockchain, I'd like to ask if, in 20 years from now, AI will be doing your job? I'm sure it will be doing mine. But in the capital market, will AI determine the timing, currency, maturity, and pricing of your new issuance, with blockchain settling it in T+ nanoseconds?**

Ruhl, European Commission: It's difficult to imagine where we'll be in 20 years' time. But if we look back at the development of the capital market over the last 20 to 25 years, the impact of technology on primary markets – but also on other areas of our operations – has been massive. So I'm sure technology will continue to be changing our business significantly over the next five to 10 years.

Iacovoni, Italian Treasury: Your question gives rise to an obvious conflict of interest!

I don't know about AI but when it comes to blockchain if you give us such a long-term horizon of 20 years it is almost inevitable that many things will change across the entire value chain of the bond market. The problem is how are we going to get there and who will act as the first mover.

I remember when we were first talking about green finance and green bonds some years ago, I was not absolutely convinced about the prospects for this market but as we've all seen, things have changed quite substantially in a very short period.

But if we're trying to save money and generate the maximum efficiencies, it's obvious that technology is the future, even if it means a lot of organisational changes. But maybe this is the sort of Schumpeterian constructive destruction we should all be thinking about. GC


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