S U E R F
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Temporary Eurobill Fund (TEF): 30 FAQs

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The Temporary Eurobill Fund offers a modest, technical but concrete step that can be expanded progressively into a financial, economic and political structure if circumstances develop propitiously. This author has developed the TEF plan over several years – now comprehensively updated.[1]

1. What is the TEF Plan?

⇒ The Objectives:

- Re-enforce financial stability.
- Provide: a "safe asset" for banks to reduce the `doom loop' with their government; a "Risk Free Rate" yield curve to support CMU; a simple savings vehicle for citizens.
- Build trust amongst states, institutions and citizens to assist a European demos.

⇒ The Principles: for progress in deepening EMU are clear and include:

- No mutualisation of debts.
- Strengthen the post-crisis economic governance system.
- A proper role for market discipline.
- Financial solidarity with states that respect the rules yet lose market access.

⇒ The Mechanics: TEF is a simple "plainest of plain vanilla" plan:

- For a common institution created by participating Eurozone states to purchase the under-two year debt issuance of those states.
- The institution would finance such purchases by issuing its own bills - matching its assets in overall volume and maturity. "Back to Back" market finance for absolute simplicity and transparency.
- The TEF is a replacement of existing debt, rather than a mechanism to increase debt.
- Why two years? Nothing magical… (i) Seems long enough to give a state in difficulties time to realise and begin to change before markets cut off access (ii) enough issuance to become a major market sector with undoubted liquidity.
- The TEF will charge all borrowers an identical interest rate for a given maturity.
- The TEF's legal structure would replicate the tried and tested ESM Treaty. It would not require a change to EU Treaties so could be set up very quickly.
- Governance is inter-governmental – not Communautaire at this stage.
- If it did not prove effective, then it would cease to issue new bills and most of its bills would have run off within a year, and completely within two years.

[1] Follow on Twitter: #TemporaryEurobillFund

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Politics and vision

2. Political implications: creating a European *demos*?

The structure and governance of the TEF – in reality – provides a comprehensive political, economic and financial plan to deepen the Economic and Monetary Union, quite apart from meeting the urgent technical need for a `safe asset' for the financial system generally but especially banks (see FAQ 18).

The TEF plan is not designed to reach a specific, bold objective immediately. Instead, it just starts a process to build confidence and trust – amongst the nations, institutions and peoples - so that the ultimate results could be increasingly notable over, say, the next decade. It is just the first stepping stone along this pathway. The TEF would be an early `concrete achievement' in an institutional infrastructure to encourage consistency in national economic policies.

However, the political implications go far beyond a simple financial institution because the TEF - to paraphrase Monnet's words – "fuses the interests of the Eurozone peoples" into a vital component of the Eurozone financial system, rather than seeking to balance national interests.

ECB President Draghi spoke at his award of the Monnet Gold Medal and applied the Monnet method to analysing the current policy situation in terms of: effectiveness; insistence on subsidiarity; sense of direction; and concern for democratic backing. The TEF plan carefully reflects the framework of the EU's traditional Monnet method.

For the Eurozone, the time now feels sufficiently ripe to warrant further - perhaps both small and reversible - steps by launching the TEF because the plan demonstrably runs with both the grain of the markets and of the EU's political structure. As Schuman put it on 9th May 1950 (in his famous Declaration), *"Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."*

The sixth round of the European Semester is drawing to its conclusion and progress is evident on many fronts – growth, unemployment and (especially relevant) public finances. The EU27's sense of direction may now be returning. The wave of populism seems to be receding as the painful economic reforms undertaken since the Crash are bearing fruit – though the pain is by no means gone.

The politics of the TEF plan are all about deepening trust between the euro area states and thus building a sense of solidarity. So the TEF does not include indicators of distrust – such as collateral or surcharges on more indebted states. Instead, the focus is on sanctioning any breaches of trust – by providing a menu of increasingly painful penalties: political embarrassment, economic sanctions that impact at least some citizens directly and financial penalties that will – ultimately - have a major impact on them even if indirectly.

The alternative to a penalty regime is to build a genuine European political identity – a *demos* - amongst the moneyed savers of Europe who should be capable of being properly informed of the financial position of their government. Thus they should understand the consequences for their life savings of their own government pursuing unsound policies – despite the advice of their fellow users of the single currency. Europe can provide them with a safety net.

3. Citizens: a safe, simple, cheap savings vehicle?

For all EZ citizens, the TEF could provide a simple, understandable, easily accessible, flexible, low-cost, safe savings product. So "Europe" would provide a direct service to savers - often the most influential citizens.

In due course, the minimum denomination of the bills should be set low enough so that most individual citizens could invest their retirement savings – creating a "European" vehicle for savers. This should create a vested interest in the success of `Europe' – a step towards a European *demos* by fusing the interests of European citizens together in this very specific field. So the necessary systems should be set up as soon as practicable to sell these bills directly to citizens and business investors – as a potential alternative to holding bank deposits/money market funds. As a minor practical benefit - but perhaps looming larger – the TEF would help to restore citizen's trust in financial markets and this is a necessary requirement for a successful Capital Markets Union (see FAQ 19).

For citizens holding less than say €100,000 of TEF bills, the manager should be empowered to buy back the bills on demand at the then-current market price – with only a cost-recouping administrative fee. The TEF would create a gold standard for savers in terms of simplicity and flexibility so it should be a first step for citizens building a portfolio of higher-return capital market instruments.

4. Transfer union – avoiding it?

The legal structure is closely modelled on the ESM Treaty (see FAQ 13) and that was approved by all Courts that reviewed it. The ESM's conditionality is strong and the TEF would use the ESM as its backstop if a Member State finally became unable to repay its TEF bills as they came due (see FAQ 25).

The volume of the bills that a Member State could issue to the TEF would have been approved in advance as part of the Conclusions of the European Semester process (see FAQ 14). A significant deterioration in the State's finances should have been noticed within the Process – and thus countered by a gradual reduction in the TEF's exposure to that State. So – at worst – a modest ESM programme to pay off any bills still outstanding to the TEF should leave other TEF participants no worse off than their existing obligations under the ESM programme – with all its conditionality. This procedure would keep any `transfers' at the level of current commitments to the ESM - so a level that is already seen as no more than reasonable solidarity and clearly not a `transfer union'.

5. Moral hazard: matching liability to accountability?

It is clear that some outcomes must be avoided, as they will be unacceptable in major states such as Germany and France. In particular, anything that results in the €3 trillion annual output of the German economy taking on a `joint and several liability' – "mutualisation" - for €8 trillion of Eurozone public debt is manifestly impossible. That would be equally unacceptable to France with its €2 trillion economy. Markets would regard any such guarantees from smaller economies as utterly implausible.

Avoiding the `moral hazard' that would flow from any "mutualisation" is probably the top priority for any plan that involves Eurozone states in forms of collective issuance. The term sounds complex but US economist Paul Krugman defined it rather simply and pithily as **'any situation in which one person makes the decision about how much risk to take while someone else bears the cost if things go badly'**. The Maastricht Treaty "no bail out rule" (TFEU Article 125) epitomises the EU's prohibition of the risk "The Union (or a Member State) shall not be liable for or assume the commitments of central governments…" so the TEF plan must ensure that the "no bail out rule" is capable of being enforced.

The Expert Group[2] examined this concept exhaustively and concluded that the TEF would avoid any such hazard as it would replicate the ESM's structure. *"The Pringle judgment, where the Court of Justice has confirmed the conformity of the ESM Treaty with Article 125, only confirms this conclusion. The ESM is not based on joint and several liability of Member States, but only on pro rata commitments to pay in callable capital."* **Correspondingly, the TEF would NOT breach "the no bail out rule" as its legal structure would replicate the ESM.**

The proposed governance structure would also anchor ultimate decision-making with the Finance Ministers of participating states - they would be the Governors. Using the same voting structure as the

[2] Expert Group on Debt Redemption Funds and Eurobills; Graham Bishop was appointed by European Commission President Barroso in 2013 to an Expert Group on Debt Redemption Funds and Eurobills - details here. The Expert Group published its final report in March 2014 (link).

ESM, they would decide on the Fund's exposure to any given state – recalling that the short maturity of the bills means that exposure could be reduced to zero within two years if necessary.

So the TEF would function as an `early warning radar' for the ESM. If a period of difficulty turned into a major crisis, those same decision-makers could decide collectively to offer an ESM programme (with the normal strict conditionality) to pay off any exposure of a state to the TEF, leaving the liability under the control of exactly the same ministers – but now wearing an ESM hat - who are democratically-accountable to their own taxpayers. **Result: Control of the situation will be entirely in the hands of the political authorities whose citizens will be liable *pro rata* for their share of any loans – but only up to the limit of their callable ESM capital.**
At this stage, the accountability and liability would flow to an inter-governmental mechanism (see FAQ 12).

6. Benefits: if insufficient, easy winding down?

In designing any European financial project, there was always a tension between the ideal project of the `bond market vigilantes' seeking to protect their capital as much as possible via formal mutualisation *versus* what is thought to be politically possible given the state of public opinion in the various parts of the Eurozone.

The TEF plan has been designed to balance these tensions by means of an evolution of small - but concrete – steps. Crucially, if these steps do not develop as hoped, then TEF issuance can be halted and all outstanding bills will have matured within two years. So the TEF can be easily reversed (even to extinction) within two years. Moreover, the [five yearly] review of the TEF Treaty by national Parliaments would provide another opportunity for reflection (see FAQ 9).

7. Success: enlarging the size?

If the experiment works, then the Eurozone will have created quickly a global-scale financial instrument with many internal benefits. The TEF would build up in two stages:

- The first stage would consist of the TEF purchasing all under two-year new issuance – producing a fund of more than €500 billion in two years.
- If it all works well in terms of states following through their economic policy commitments, then the Governors (the Finance Ministers of participating states) would authorise the progressive buying-in of under two year `remaining life' old bonds (see FAQ 14). Naturally, this would begin experimentally by buying in bonds with a remaining life of say six months, then one-year, etc. The ultimate size of the fund might be perhaps €2,000 billion or more (more detail - see FAQ 20). This would create a single yield curve denominated in euro for maturities up to two years – the much sought after Risk Free Rate (more in FAQ 19).

8. Success: extending maturity/participants?

If successful, the maturity range could be extended beyond two years.

- **Maturity** – could be lengthened by a perhaps a year … but limited by
- The need to maintain the opportunity for market discipline to be applied to the largest part (say 70%) of a Member State's own yield curve.
- The need to have the remaining lending capacity of the ESM (OR EMF) big enough to offer a programme to any Member State in difficulty. This limit means that any given state's obligations TEF would not be significantly bigger than its existing commitment to the ESM's callable capital.
- Of course, the ESM/EMF could be enlarged in the future to enable this requirement to be fulfilled for a bigger TEF. But that would need a major new capital injection – subject to agreement by all national Parliaments – so a heavy procedure.

- **Participants** have to be members of the Eurozone, NOT be in an ESM programme and be in "good standing". At present – early 2018 - that would only exclude Greece. However, any state subject to the corrective arm of the EDP would be liable to especially careful scrutiny. Even states labelled as having an "excessive imbalance" under the European Semester process would be particularly scrutinised.

In the future, perhaps all "EU institutions" – defined as those under guarantees by the Member States - could be offered the chance of funding via the TEF if they could benefit --- ESM, EFSF, EIB, ECSC etc.

Should the requirement for all short term issuance to be via the TEF be extended to include the general government sector? It would clearly be advantageous for such guaranteed bodies to achieve the lowest funding costs and would increase the size pf the TEF by around €500 billion at full size. But the precise constitutional arrangements would need to be carefully scrutinised.

9. Temporary – why?

Democratic control by national parliaments in renewing the TEF's mandate is essential. Thus the "temporary" aspect is appropriate to allow national Parliaments to review the functioning of the Fund - through good times and bad, and its impact on their nation's public expenditure. If things go well, the Fund could be made permanent and both functions and scale enhanced. Eventually, it could be incorporated into the Treaty structure of the European Union – becoming Communautaire (see FAQ 12).

There are two aspects to the temporary nature:

1. **Probationary:** The euro area Member States have agreed far-reaching commitments about closer economic integration (banking union) and financing (ESM). The TEF plan builds on these solemn commitments. If the experiment in policy reform supported by the TEF's limited financial integration proves successful, then the political leaders of the day could choose to renew the Fund for another period following its successful probation.
2. **Temporary:** There is a second reason for the TEF being `Temporary'. Several states (perhaps 5-6) have national budgetary procedures that require prior approval of spending via a vote in their national Parliament. So the required budgetary control - a key part of democratic accountability - would be retained by national Parliaments via a regular renewal of the Fund's mandate.

The mechanics of "Temporary": The Fund would wind up after say [five] years with an entrenched termination date that can only be renewed by a positive and unanimous act of the national Parliaments. Depending on the issuance profile and any decision to continue issuing right up to the moment of closure, it could be a further two years before the last obligations of the Fund are redeemed. So the effective life would be seven years - before even considering a continuation.

If the economic reform process were judged to be failing, then issuance could be halted by the Governors at any time and exposure run off completely in a maximum of 2 years. If the Fund were terminated, each Member would revert to borrowing in the markets in its own name, and on terms determined by its own credibility in the light of the success of its own reform programme.

10. European Treasury: a basis?

The key step in the construction of the TEF is that participants would bind themselves to borrow all new funds in this maturity range only from the TEF.

However, Government debt management offices (DMOs) face particular challenges from short-term fluctuations in cash flows as large tax payments do not necessarily coincide with major, lumpy expenditure items. So they may need to swing from large deposits to day-by-day borrowings. The most basic function of a "treasury" is to cope with these swings. At a European level, some of these national swings may be able to be offset by a DMO purchasing very short-term bills from the TEF to absorb temporary liquidity, or issuing bills to the TEF to raise temporary liquidity. If the system overall is still not in balance, then the TEF could supply that most basic of Treasury `smoothing' functions by its own transactions with banks and capital markets. But once the TEF builds up in size it should be able to offer such centralised cash management – thereby providing an obvious, basic "European Treasury" function.

(The commitment to borrow all new short term funds from the TEF is the most rigorous form as it enhances the solidarity of the members against the `splitting of their credit' at any moment of intense crisis and market pressure. The political decision to be rigorous has already been taken: All EZ states have bound themselves quite tightly since the crisis (via the 6 Pack/2 Pack/TSCG) to pursue agreed sound economic polices – as set out annually in the Country Specific Recommendations. If they really intend to keep these promises, why would they refrain from binding themselves a little further in a way that gives distinct advantages – especially as an insurance policy against financial instability? Many observers do not seem to realise the degree of binding that has already been entrenched e.g. agreeing to reduce public debt annually by 1/20th of any excess over 60% of GDP.)

If the TEF grew to its full potential size and was continued after its probation, then it would surely be the foundation of a European Treasury.

11. European Finance Minister: a practical role?

- The President of the TEF's Board of Governors would have a key role as gate-keeper of actual short-term finance to the Member States. In addition, the President's influence on decisions to reduce buying-in of under two year remaining life securities and – even more dramatically - about restricting a state's access to the TEF would make the positon very influential. If this function were combined with that of Eurogroup President and, say, Economics Commissioner, then the role would have some of the functions normally attached to the term "finance minister".
- Put the other way round, as and when a "European Finance Minister" is appointed, that person would naturally chair the TEF's decision-making body.

12. Inter-governmental *versus* Communautaire?

The ESM model is entirely inter-governmental and current discussion about the governance of the proposed EMF looks to be going in the same direction. So the TEF initially would be set up by an Inter-Governmental Agreement (IGA) between euro area member states.

When the euro area broadens to include virtually all EU members, then it is easy to imagine pressure to expand parts of TEF governance to include the whole Community – perhaps making formal accountability to the European Parliament as a whole. For instance, a revamped European Semester process could readily provide a mechanism to manage some of the `European' liabilities created by the TEF. Accountability to the European peoples, and corresponding liability for `moral hazard', would then both be at the European level.

But such a Communautaire move would probably only be part of a broader decision to extend the Community method, rather than just a single item such as the TEF.

13. TEF Treaty: based on ESM Treaty?

The Expert Group's legal analysis concluded that the "economic" requirement of all participating states to bind themselves to issue **all** new under-two-year debt via the TEF would require an Inter-Governmental Agreement between the relevant states to set up an "International financial institution".

It would follow a similar **legal structure** to that of the ESM – though with only modest *pro rata* callable capital. There would be the crucial difference from the ESM: only euro states in `good standing' could borrow from the TEF - so each state remains fully responsible for its own debts. Their sound economic performance would make that responsibility entirely credible – as evidenced within the European Semester process.

The straightforward ESM Treaty has already been approved fully by all political, legal and judicial bodies as an appropriate inter-governmental structure for a specifically defined sub-set of EU Member States that share the euro as their currency. Editing the ESM text as a template for a suitable legal form is a simple matter. This author has reduced it to around 30 pages so using such an established template should mean the only delay would be in ratification rather than complex legal negotiations. **No change to the TFEU would be required.**

Some mechanics: The Fund itself would be set up by an Inter-governmental Treaty (between all members of the euro area.) The Council would agree unanimously that a Regulation under TFEU Article 352 would enable `enhanced co-operation' between the relevant members so that EU institutions could be used to an extent to assist the process.

- The Fund would help `develop ever-closer co-ordination of economic policies within the euro area' (Preamble to Protocol 14 of Lisbon Treaty on the Euro Group) so preparations for meetings of the Board of Governors would be prepared by the representatives of the relevant Finance Minsters – per Protocol 14, Article 1.
- The extent to which Union assets can be used will be determined by the EU-28's willingness to maximise the application of the `Community method' – **but all formal decisions must remain those of the Fund.**
- The European Commission would be required to provide information and services to the TEF but not take any part in the key decisions as these would be strictly reserved to the Governors (the Finance Minsters). However, the Commission would need to be empowered to provide these services and the Expert Group concluded that *"The other legal base to be examined is Article 352 TFEU (the flexibility clause). In short, recourse to that clause requires there to be a need for Union action to attain one of the Union's objectives as set out in the Treaties, within the framework of Union policies, and an absence of an express competence in the Treaties for such action. Also, the Court of Justice has made it clear that any measure adopted on this base must stay within the general framework set by the Treaties and not amount, in substance, to a modification of the Treaties."* NOTE: Article 352 can be operated under the "enhanced co-operation" rules.

Economics

14. Economic governance: Strengthening?

Now the sixth round of the European Semester is close to its concusion and progress is evident on many fronts – growth, unemployment and (especially relevant) public finances. The spring 2018 forecast of the Commission puts deficits well under 1% in 2018 and 2019. Importantly, public debt levels look set to fall to 84% of GDP – down by 10 percentage points since the 2014 peak.

But few would doubt that we need better instruments to foster the implementation of structural reforms. So this seems an appropriate moment to think about schemes of joint issuance of securities as the joint economic governance system has borne some good fruits. The broadening of the `common interest' of each EU member in the economic policies pursued by fellow members would be accelerated. The post-2008 economic governance reforms reflected in the European Semester process have already given a collective oversight of budgetary polices. The political decisions of the TEF about permission to borrow from it would deepen that oversight substantially – via both the signalling effect and cash implications as participating governments must commit to issue **all** new under-two-year debt through the TEF.

Economic policy co-ordination: The TEF would be an institution that binds the participating euro area states into closer financial solidarity – thus encouraging greater observance of the economic governance commitments and stabilising public finances. So the existing fiscal rules are the starting point for co-ordination, but a key advantage is the predictable and progressive involvement of "market discipline" (see FAQ 15). **Of course, if a state insists on pursing unsound policies then no "mechanism" can save it from the eventual, natural consequences of its own policy choices.**

The TEF would give ultimate powers to the finance ministers of participating states – making them the Fund's Governors – a key issue for controlling moral hazard (see FAQ 5). The Governors would authorise the purchase of a maximum amount of a state's bills during the year ahead to fund the budgetary needs reflected in the agreed cash-flow forecasts provided under the 2012 Treaty on Stability, Co-ordination and Governance (TSCG) - more popularly called the Fiscal Stability Treaty. When operating fully, these flows alone would build the TEF up to more than €500 billion outstanding.

As a separate decision, the Governors could decide to buy-in older bonds as the remaining life fell below the two year threshold (see FAQ 20) – increasing the Fund's size to around €2,000 billion.

The key for economic governance is that successful reforms will manifest themselves in improved public finances. However, given the stock of existing debt that must be rolled over, let alone any new debt, states will always want to issue shorter term bills. So the TEF's governance structure is specifically designed to reward compliance with EU economic policy rules by providing a modest cost-saving for most states.

The TEF would provide - state-by-state - a concrete mechanism to: (i) reward good economic `homework' according to the fiscal rules (ii) progressively – but slowly - penalise lack of effort (iii) operate with the grain of market discipline to graduate the carrot and stick incentives for each state and (iv) minimise the eventual costs if a state insists on pursuing economic policies that are likely to end `badly'.

15. Market discipline: progressive yet flexible?

For many states, the pooling will provide an interest-saving `carrot' but one that should be *de minimis*. However, the `stick' might be substantial as any over-run of cash requirements would then have to be funded by that state in the longer-term bond markets. As these issues would be junior to the TEF (see FAQ 24), holders might become increasingly concerned as fiscal over-runs built up and the junior status became a significant worry.

If the Governors themselves became concerned – perhaps as a result of the European Semester process - about a state deviating from the agreed rules, they might fail to agree on buying-in further securities as their remaining life fell into the purchase parameters. (See FAQ 14). The natural flow of redemptions would steadily reduce the Fund's exposure to a state – **unless the Governors made a positive decision to replace these redemptions with new purchases**. The absence of such a decision would send a clear message to the markets holding the other [70%] of the state's debts. Market participants have now learnt that the junior debts of a government consistently pursuing unsound policies are very risky.

This governance procedure creates a two-stage discipline mechanism by blending fiscal rules progressively with market discipline. The initial decisions not to buy-in bonds below a chosen maturity would send a message of concern that would be reflected in a widening yield spread for short term bonds versus the TEF curve **– an increasingly powerful signal rather than an actual cost to the offending state.** If the Governors' concerns reflected budgetary overshoots, then the TEF would provide an effective, market-driven (so virtually automatic when the yield curve is positive) penalty for breach of fiscal agreements within the European Semester process. The penalty would be gently progressive as only `excess' borrowing would take place at the longer end of a positive yield curve. This would represent an increasingly strong sanction but not be suddenly, and catastrophically, de-stabilising. The state would face a lengthy period of an increasingly steep slope rather than suddenly falling off a cliff.

In a normal world of a positive yield curve, the state will then automatically pay a penalty

interest rate. That penalty will rise sharply if a state deviates seriously from sound economic polices – as judged by the `bond market vigilantes', rather than weak ministers. If an EMF were given powers eventually to enforce debt re-structuring, then the vigilantes – as holders of junior bonds subject to Private Sector Involvement - would become increasingly concerned as they perceived policy veering off course. **The TEF creates a (small) carrot and (automatic) stick approach to encouraging better budgetary results.**

16. Solidarity: shock absorption?

The TEF was originally conceived to deal with the problem of a state losing market access to roll over a maturing bond issue. Providing the TEF decision-makers were convinced that a "domestically-shocked" state was making a sound policy response, they would permit the issue to the TEF of sufficient of the state's bills to pay off an imminent bond redemption on schedule (see FAQ 21).

However, the TEF would have no "fiscal capacity" function so there would need to be separate stabilization functions to deal with global or domestic shocks.

17. Risk sharing: assisting the private sector via BU and CMU?

Commission and academic papers suggest that by far the biggest component of risk-sharing of economic shocks comes via the private sector providing finance… so completing Banking Union and Capital Markets Union will be a major step to avoiding public sector involvement with all the risks of it slipping into a significant, and therefore undesirable, "transfer union".

A second aspect is the ability of citizens who become concerned about the stability of their bank – or even government – to shift assets into the TEF – though limited by the strong probability that the TEF will never be more than 10% of the size of the banking system. But the threat of such a rolling referendum by the citizens should encourage banks and states to remain conspicuously prudent so reducing the chance of shocks.

Financial

18. Banking union: a `safe asset' to cut the `doom loop'?

The TEF would make a significant contribution to banking union by providing a "safe asset" to banks, thereby sharply cutting the `doom loop' between banks and their sovereigns, thus directly reducing the riskiness of banks. The indirect contribution from enhancing the economic governance process would be a more fundamental, longer term benefit.

There seems to be substantial agreement at the highest levels of European politics that completing the Banking Union is an essential "next step". Without that, there will be no Capital Market Union either.

At the most technical level: Banking Union would be reinforced because TEF bills would be the most natural High Quality Liquid Asset (HQLA) for banks to hold to meet Capital Requirement Regulation liquidity rules, as they would be the safest, most liquid asset in the euro area. TEF bills should easily meet the EBA test of "Transferable assets of extremely high liquidity and credit quality". Based on the ESM template, supervisors should allow the same 0% risk weight for claims on the TEF. *(For the moment, we can set aside the debate on whether government debt in the Euro area should be defined as risk free, and therefore be 0% risk weighted for banks. This author has argued against this definition from the moment the euro was proposed – see my most recent submission to the BCBS).* Therefore banks would be safer: directly by reducing the doom loop with their national government; and indirectly by encouraging sound economic policies. The `doom loop' between banks and their sovereign would be cut by perhaps a quarter - at a stroke – by substituting "European" TEF bills for domestic government paper.

The Commission's Reflection Report last summer dwelt at length on the minimum need for the creation of a `safe asset' that would help reduce the doom loop between banks and their sovereign. In addition, such a reduction might reduce the need for banks to feel they must re-focus their balance sheet on their home country to avoid any risk of a disastrous split in the currency composition of assets and liabilities if the euro area broke up. So the creation of a safe asset is seen as a requirement for the successful completion of banking union – at the very least.

However, the TEF would offer benefits beyond the basic, technical need for HQLA as it would enhance the integration of the euro area's money and short term bond markets, whilst providing an anchor for medium term bonds. For equities, the removal of a significant risk of dis-integration of a part of the assets held by financial institutions (themselves a significant proportion of the main equity indices) should be a useful integrative impulse.

The need for "safe assets" is clear and was analysed by the Expert Group on DRF and Eurobills in 2014. This author was a member of that group and presented his plan for a Temporary Eurobill Fund that would be a `safe asset' as well as providing several other policy benefits. However, the Commission Report has focussed its `nuts and bolts' attention mainly on considering a plan for Sovereign Bond Backed Securities (SBBS) and will soon propose appropriate legislation (see FAQ 26).

19. Capital markets union: providing the ultimate euro "Risk Free Rate" yield curve?

The biggest contribution by the TEF to the success of CMU is likely to come from the provision of a yield curve of the highest credibility and liquidity - to act as the Risk Free Rate (RFR) and be a reference point for all other short term securities. (In reality, it might be more accurate to call it the "Least Risk Rate" but market parlance is now settled) These might be securitisations of SME loans or floating rate mortgages – any situation where it is essential that the interest rate reference is completely trusted to be beyond manipulation. The TEF curve will also be the reference rate for bank deposits and vast quantities of derivatives. As IOSCO recently put it *"Benchmarks play a key role in the financial system's core functions of pricing and allocating capital and risk. They impact enormous volumes of credit products (including loans, mortgages, structured products, short-term money market instruments and fixed income products) and derivatives and have other uses."*

All the wold's major trade associations are grappling with the immensity of the task of transitioning literally trillions of €, $ etc. away from IBORS to new reference rates. The TEF could provide that rate for euros, especially now that the European Money Markets Institute has given up trying to create a suitable EONIA within the constraints of the Benchmarks Regulation.

The ECB, ESMA and European Commission "have recently announced the launch of a new working group tasked with the identification and adoption of a *risk-free overnight rate* which can serve as a basis for an alternative to current benchmarks used in a variety of financial instruments and contracts in the euro area." The TEF yield curve can surely provide such a curve out to two years and once it can provide a facility that can centralise even very short term Treasury operations of participating debt managers (see FAQ 7 and FAQ 28), then it would be a "public authority" providing a risk-free overnight rate – within the meaning of the Benchmark Regulation.

In its report on "safe assets" volume I, the ESRB highlighted the benefits of financial market integration and capital markets union:

- Reserve currencies with deep and liquid markets for government debt are attractive to global investors.
- Further steps towards a capital markets union could be facilitated by an area-wide low-risk asset in sufficiently abundant supply that serves as a benchmark for asset pricing.
- Financial market participants need low-risk assets to collateralise transactions.

The TEF would provide these benefits for the Eurozone and enhances its financial integration.

20. Size: will its issues be a global scale?

The Governors would authorise the purchase of a maximum amount of a state's bills during the year ahead to fund the budgetary needs reflected in the cash-flow forecasts provided under the 2012 Treaty on Stability, Co-ordination and Governance (TSCG) - more popularly called the Fiscal Stability Treaty. The action of purchasing a state's bills would send a very clear signal of approval to market participants. When operating fully, these flows would build the TEF up to more than say €500 billion outstanding.

As a separate decision, the Governors would be empowered to buy-in a state's longer-term bonds as their remaining life fell below two years – or probably even shorter for initial experiments (see FAQ 7). Such actions would be intended explicitly to create a `risk free rate' euro yield curve (see FAQ 19) and improve financial stability (see FAQ 21). The action of including a state's securities in this purchase programme would send a particularly strong signal of approval of its economic policies so the TEF could expand to around €2 trillion in the fullness of time – becoming a *de facto* European Treasury (see FAQ 10). It would then be about the same size as the ECB's current QE programme but would own all under two-year government securities, rather than the QE programme's ownership of up to a third of over two-year bonds. NOTE: if all general government entities could borrow short term funds via the TEF, its size could reach €2.5 trillion.

This scale would support the euro's global role by providing a global financial asset that would be comparable with US T-bills. According to Bloomberg data, the US has a much shorter maturity public debt than the Euro area. So the US is inevitably going to be more liquid in the shorter maturities as its marketable debt is about half as big again as that of the Euro area.

However, if the TEF were at its full size, then say a monthly bill in year 2 could be around €60 billion – not dissimilar to the typical €65 billion of US Treasury bills up to one year. Combining all new issues and bond issues with a remaining life of under one-year, the TEF's issues for less than one year maturity could reach €100 billion – again if all were split into monthly issues. **These issues would be a global benchmark.**

Splitting TEF issuance into a standard monthly issue would give rise to a minor maturity mismatch. However, in a positive yield curve world, issuing say an 11-month bill to fund the purchase of an "11 month and 29 days" remaining life bond would give a useful carry-trade profit.

Who buys all these securities? Remember that these bills are just a replacement of existing debt that is already held by someone – bank, insurer, fund manager, company, or citizen. They would be offered the very highest credit in Europe – and, as an added bonus, by far the most liquid. That liquidity should command a yield premium that may leave Germany as the only state that would be able to issue in its own name at a yield below the TEF. Investors whose investment objectives require highly-rated assets may have to modify their criteria as the TEF would not need to be rated (see FAQ 22).

21. Financial stability: an improvement?

A key task of the TEF is to support the financial stability of governments by removing roll-over risk for maturing bonds where a state is at risk of losing market access as that vital moment of redemption.

If the Fund's Governors were sufficiently confident of a state's policies and had authorised the `buying-in' of a state's bonds with a remaining life of less than two years (see FAQ 7 and FAQ 14), then virtually all of a bond issue would be held by the Fund as the issue came up for repayment. Permitting a state to meet that roll-over within the Fund by the TEF purchasing new bills from the under-pressure government would entirely remove roll-over risk at times of economic uncertainty - enhancing the financial stability of governments.

Such a roll-over would have to be within the limits pf prudent public debt management (see FAQ 27). The operation of Collective Action Clauses (CACs) (see FAQ 23) would also buttress the power of the TEF by enabling it to postpone the maturity of a particular bond. However, such a draconian step would highlight the difficulties of a state and could precipitate even greater instability.

The TEF would contribute to improving financial stability in several other ways, including (i) helping complete banking union by the provision of a safe and High Quality Liquid Asset (see FAQ 18); providing a "risk free rate" (RFR) as a reference rate for financial products (see FAQ 19); and (iii) creating an asset that could be used by the ECB for non-standard monetary measures if they should be needed again in the future. The ECB's QE programme specifically excludes securities with a remaining life of less than two years so the TEF would be outside the current QE programme. If necessary in the future, TEF bills would be a natural public asset for the ECB to purchase as they would not represent monetary finance of governments and the state-by-state exposure would already have been agreed by the politically-accountable Governors.

22. Credit rating: is there a need?

Ratings agencies certainly have a valuable role to play in assisting the market's knowledge of smaller/under-researched issuers of securities. But no-one can say that the public finances of EU Member States are not well known as they are thoroughly scrutinised by professional investors as well as public bodies around the world such as IMF/OECD. Moreover, the European Commission makes detailed studies and each state's finances are subject to careful scrutiny by fellow Member States as part of the European Semester process.

If there is only one issuer of short-term "government" debt in the market, then there is no need to be concerned about the risk signals from credit ratings as the market price will reflect the views of the most well-informed investors in the world – rather than those of a rating agency. In any case, the top-rated ESM would act as the backstop and TEF bill-holders would benefit from seniority (see FAQ 24).

EU financial institutions should not face any regulatory impediments in holding un-rated assets as EBA, ESMA and EIOPA published final Reports on "mechanistic references" to credit ratings in the ESAs' guidelines and recommendations in early 2014. Accordingly, mechanistic references to credit rating requirements should have been removed by now from CRD/CRR/Solvency II etc. Doubtless, some rating agencies will publish unsolicited, low ratings despite the risk to their reputation by the market ignoring their rating and pricing the bills amongst the best credits, as well as the ECB according that accolade for collateral purposes.

If any investors (especially foreign) happen to have investment objectives that require a credit rating, then they are at liberty to change their objectives – or forego the safety and liquidity offered by TEF bills.

23. CACs: simplifying their operation?

The TEF strategy has a second strand beyond pooling under-two-year new issuance: potentially buying in older bonds as they fall into the category of under-two year remaining life. If the decision-makers have made such purchases (see FAQ 14), then the TEF will probably own the vast majority of an older issue as it comes to maturity – the moment of peak risk to financial stability. Collective Action Clauses have been embedded in all EU government issues since 2013. If – as would be very likely – the TEF owned more than the necessary 2/3 of an issue, then it would be simple to extend the maturity of that particular bond to any desired date. **So the TEF can provide a credible stabilisation function in two ways – at least initially**.

(If the situation were such that the state had to enter an ESM programme, then converting the ESM into an EMF might well incorporate the power to lengthen maturities of a state's entire debt with a single bond-holder vote. However, policy-makers should be aware of the risk of de-stabilising the financial institutions – such as banks, life insurance companies and pension funds – which hold this debt. They would suffer a sudden and major loss in the value of a significant portion of their assets.)

24. Seniority: *de facto* and *de jure*?

This is a very different issue from compulsory re-structuring of public debts that are deemed by "someone" to be unsustainable.

Markets now know that Private Sector Involvement (PSI) can happen and will cost them a great deal e.g. Greek PSI was a "haircut" of around 75% in the end. In practical terms "seniority" for a state is likely to be a different issue: what happens at redemption – who actually gets paid?

De jure seniority would follow on from modelling the TEF on the ESM Treaty's political statement giving seniority, as well as using the ESM as the backstop for any bills that fell into default.

De Facto seniority would reflect the simple fact is that the TEF would hold all the short-term paper that came up for frequent roll-over so it would be **the most likely to be the first to face a failure to redeem.** If the TEF had bought-in most of the older issues as they moved towards maturity, then the chances are it would be in a position to operate a CAC and possibly postpone the redemption of that particular security and forcibly apply it to any remaining holders.

As TEF bills – at full size – may amount to [30] % of a state's debts, it follows that the remaining [70] % are junior. In normal times, that should make little difference but will enhance the impact of the market's discipline if a state has to finance a significantly higher proportion of its issuance in the longer term/junior segment of the yield curve (see FAQ 15).

25. Default by a participant: what happens?

The European Stability Mechanism (ESM) is a key element in the design of the TEF as it will be the backstop.

If a state became unable to repay its obligations to the TEF – despite the existing panoply of economic governance coordination measures - then that state would be offered an ESM programme with the TEF's claims met first (see FAQ 24) as – by definition – they will be the first claims falling due. The ESM already has – politically - Preferred Creditor Status so the TEF's security would be doubly re-enforced. Correspondingly, no state would be allowed to have obligations to the TEF that exceeded the ESM's remaining lending capacity thus capping each state's commitment to such collective financial operations at its existing maximum contribution to the ESM's callable capital. Therefore the strength of the ESM is a vital back-stop to the TEF and any move to enhance its capability by converting it to a European Monetary Fund is welcome.

If market yields are signalling that more than one state is at risk, then the total exposure of all these states should be limited to the remaining ESM's capacity. (What trigger for a signal from market yields? Perhaps the Treaty of Maastricht admission rule (Article 4 Protocol) that 10-year yields should not be more than 2 percentage points above the average of the three lowest inflation states.)

If a major TEF participant does eventually **choose** to default on its public debt held at the risk of fellow members – **as opposed to be unable to pay and therefore take an ESM programme** - then the very existence of the European Union will be at stake. No set of technical rules can guard against the consequences of such a dramatic political choice.

26. SBBS *versus* TEF?

The ESRB has just published its long-awaited reports (Part I and Part II) on SBBS. They are exhaustive and thorough reports on an intellectually attractive idea that was generated in 2011 by the consequences of the Great Financial Crash. The plan is designed to create a new class of "safe assets" via an elegant securitisation of euro area government bonds. The SBBS would be held principally by banks as an alternative to direct holdings – especially of the banks' domestic government bonds.

The reports analyse in great detail the motivation to create such securities and highlight the necessary condition of often-contentious regulatory change that would be required to make them economically viable. The changes include (i) amendment of the regulatory treatment of sovereign exposures (RTSE) so that SBBS would benefit from the same risk weighting for the underlying government bonds. But that would require change in the `Basel' rules and countries like Japan can be expected to oppose strongly any move away from government bonds attracting a 0% risk weighting (ii) The EU's regulatory framework for securitisation would need to be amended, but would such strong public support imply corresponding support for the SBBS if a default occurred? Will other global regulators follow EU rules? If not, the investor base might be limited to the EU. (iii) The operation of Collective Action Clauses (CACs) in all EU government bonds since 2013 might pose legal difficulties in a default. Moreover, assembling the cover pool could be difficult unless DMOs agreed to co-operate closely in their issuance programme.

The reports also highlight the usual problem for the tranches of securitisations: who buys the risky, junior tranches? That risk appetite will govern the pace of creation of the senior tranches but the report offers no certainty that there will even be sufficient demand for the senior tranches.

My paper of 23 March 2018 analyses the unanimous objections of the EU28's debt managers. On such a sensitive matter, it seems unlikely that Finance Ministers will overrule the powerful and unanimous advice of their own debt managers about the risks of damaging the financial `blood supply' of all governments.

However, the ESRB's very thorough report does highlight the genuine need for `safe assets' and the TEF is designed to supply the `least risk asset' in the Eurozone as no asset is truly "risk free" even in nominal terms in a system where the government has given up the freedom to create the money with which it repays its debts (See my paper "The regulatory treatment of sovereign exposures" Comments by Graham Bishop on BCBS Discussion Paper).

Perhaps the real problem for SBBS in 2018 is that the concept was originally designed to mitigate a narrow – though important – problem. **The arguments today for the much wider solutions offered by a Temporary Eurobill Fund (TEF) remain intact: a safe asset; direct contribution to financial stability; global scale issues of great liquidity; flexible and progressive market discipline to enhance economic governance; and last – but certainly not least politically – a genuine fusion of euro area citizens' economic interests into a `European asset' that can be a core savings instrument for all.**

Operational

27. Public debt management rules: are they needed anyway?

Eurozone members have already committed themselves – under the TSCG Treaty - to report debt issuance plans **ex-ante** so it should only be a small step to formalise some basic common prudential rules for public debt maturity to minimise the risk of a state losing market access just as heavy redemptions are imminent.

- TSCG of 2012 Preamble: BEARING IN MIND that the need for governments to maintain sound and sustainable public finances .....further legislative proposals for the euro area concerning, in particular, ex ante reporting of debt issuance plans
- **Article 6:** further legislative proposals for the euro area concerning, in particular, ex ante reporting of debt issuance plans

At the time of the Expert Group in 2014, we looked at the numerical situation of public debt but hopefully governments will have taken the opportunity of low interest rates since then to lengthen their debt. The obvious rules should cover:

⇒ A **minimum average life** of a government's debt. Average life of Euro area governments listed debt was: 7 years (Since 2001: Range 6.2-7.7; average 6.7). The ECB reports that it has now risen to 7.2 years.

⇒ A **maximum percentage of the debt that is less than two years remaining life**. Euro area governments listed debt under 2 years: 23% (Since 2001: Range 22%- 30%; average 26%). Perhaps the proportion should normally be under [30] %; with an absolute and temporary cap up to [40] % to allow a state up to say two years to rectify an unexpected fiscal crisis.

⇒ An **absolute cap** on a state's borrowing from the TEF so that it never exceeds the remaining lending capacity of the ESM to offer a programme to pay off the state's obligations to the TEF.

28. Public debt management: Any constraints?

Subject to basic prudential rules on average life and maximum short term component (see FAQ 27), there need not be any constraints on public debt managers beyond the requirement that they must sell **all** their under-two year new debt to the one buyer: the TEF. In reality, that will not even be a constraint as it is probably only Germany that could issue below the TEF yield curve – given the likely pricing benefits flowing from the sheer liquidity of its issues, especially if the Governors decide to go to the second phase and buy-in under two year remaining life bonds.

The requirement of selling all new short debt via the TEF should not be a practical constraint. The counter-factual alternative would be for DMOs to sell at the market price indicated by the yield curve of their bonds with a remaining life under two years. That would almost certainly be above the yield of the best credit/most liquid security – the TEF. **So the freedom to issue outside the TEF structure might be a rather expensive freedom** (see FAQ 14).

As participating states would be free to maintain their current debt management policies, the TEF's maturity structure would simply reflect the pattern of demand by borrowing states – rather than any specific `risk management' activity thus re-enforcing the `plain vanilla' concept. In a second phase, the structure would simply become a by-product of past issuance by the members.

NOTE: It may be necessary initially to allow **very** short term borrowing (say up to one week) to be done outside the TEF as government finance can swing wildly day by day. In the fullness of time, it would be quite likely that the TEF itself can provide that buffer facility – becoming ever-more a European Treasury (see FAQ 7).

29. Costs and speed: can it be done cheaply and quickly?

The costs of setting up the TEF are likely to be minimal – and it can be done quite quickly:

- Some EU legislation will be necessary and, ideally, an Inter-Governmental Agreement to bind participating states to issue all new under-two year debt through the TEF. This is the normal activity of legislatures so the incremental cost will be trivial.
- Operational costs will simply be those of issuing perhaps 30 new securities - say 24 monthly issues + some weekly very short term issues. Any of the major existing Debt Agencies could do this with minimal incremental cost, as their servicing of their existing issues would fall away correspondingly. Alternatively, the ESM's facilities could be used as their activity is currently lower because the number of `active clients' is now reduced.
- The speed of implementation will be determined by the time scale for ratifying the necessary "Intergovernmental agreement" as it should be neither time-consuming nor expensive to make the Agreement as the ESM model (see FAQ 13) has already solved the most difficult legal and administrative issues.

Other

30. Origins and history of the TEF: How did it start?

This concept of eurobills originated with a working group convened by Wim Boonstra of Rabobank for the European League for Economic Co-operation (ELEC). The original 2011 proposal for ELEC Bills is here. A revised version was published shortly afterwards (link). The members of the group (link) covered a wide spectrum of private bankers, central bankers, academics and politicians from around the EU, and a timeline of the early work is here.

Subsequently, Graham Bishop developed a variant of this proposal into a detailed financial, economic and political plan for a Temporary Eurobill Fund (TEF).

About the author

Graham Bishop is renowned for his vision and the courage to propose radical ideas, yet ground them in a mastery of the technical details of the financial system... to the extent that he has even been referred to as a one-man think tank. He was elected as Vice-Chairman of the UK branch of the European Movement in 2017 and has been a Board Member of the Kangaroo Group for many years.

Due to his influence at the meeting point of politics, economics and finance, President Barroso appointed him in 2013 to be a member of the European Commission's Expert Group looking into initiatives for the joint issuance of debt in the form of a redemption fund and eurobills. The Group examined his proposal for a Temporary Eurobill Fund (TEF).

This "30 FAQs" draws together all the thinking and comments from around the EU since the idea began with a working group of the European League for Economic Co-operation (ELEC) in late 2011. It was first published on Europe Day, 2018 to provide a modest – at least initially - concrete achievement to match Schuman's famous call *"Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."*

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