 

The role of the Eurobond markets in pan-European capital markets

By Ruari Ewing and Andy Hill

There has been a certain amount of official sector commentary that Europe faces a problem of there being no developed pan-European capital markets. Such commentary might seem odd to some, depending (as so often is the case) on what is meant.

- Is "pan-European" meant in a geographic/continental sense, in a political sense (eg EU, EEA) or in a currency zone sense (euro)? Is the concept meant in a maximalist sense – ie that wider, international, cross-border markets encompassing both "Europe" and other geographies do not count? And if not, why not?
- Does "capital markets" refer to all types of capital instruments or are only certain segments in mind? For example, shares, sovereign bonds, or corporate bonds (and issued by larger or smaller companies, higher or lower rated)? Furthermore, does one risk conflating lack of access to certain markets with doubts as to their existence or level of development?

These questions are important, as appropriately addressing any "problem" (and avoiding unintended consequences[1]) effectively requires, as a preliminary, its clear enunciation.

There is at least one set of developed capital markets encompassing the whole of Europe in the geographic sense (so also including Europe's smaller political and currency areas). Those are the institutional cross-border markets for investment grade corporate bonds ("Eurobonds"), but which also involve significant official sector participation (mainly supranational and agency borrowers, but occasionally sovereigns also). Though emanating from Europe, they have become pretty much worldwide (albeit with various layers of practice specificities, some of which can be driven by localised considerations), clearing mainly through two international central securities depositories (ICSDs).

From a "primary" bond market (syndicated new issuance) perspective, borrowers and investors from any European (or non-European) country can participate in the "big pool" of the Eurobond markets[2] – though "bigger fish" tend to get more noticed, and so tend to get more commercial traction (with more attractive borrower pricing).

This should be unsurprising from a borrower perspective, as smaller "names", with less to borrow (below several hundred million euros at a time), present less investment volume, compared to larger names, over which investors' can spread their (fixed) investment costs (notably logistics and due diligence). Smaller names are also likelier to be more illiquid, so potentially facing pricing that is less attractive compared to their other funding options. Furthermore, smaller size often correlates with higher credit risk (larger branches are less likely to break in the wind) and so again with pricing attractiveness. (A further, similar, effect may come in terms of borrowers' credit ratings being subject to the "ceiling" of their country's sovereign credit risk rating.)

1. Including adversely impacting market segments that operate effectively across Europe with new rules and other changes aimed at different segments (especially when ease of doing business is at a premium due to the pandemic).

2. The Eurobond markets operate on a withholding tax-free basis. Also, investment grade risk analysis is focused on "probability of default" rather than "loss given default" that is more characteristic of high yield risk, with national insolvency idiosyncrasies being less material.

There is at least one set of developed capital markets encompassing the whole of Europe in a geographic sense: the Eurobond markets.

Since the vagaries of economic history have resulted in larger, investment grade, borrowers being unevenly distributed between countries (as well as countries having differing sovereign credit risks), it is understandable, from the perspective of countries with fewer large, higher-rated, corporates and lower sovereign credit ratings, that one might not perceive the existence of developed bond markets stretching across Europe (let alone beyond). However, this does not mean that they do not exist or that they are undeveloped.

From a "secondary" bond market (trading) perspective, market makers (usually large international banks) play a central role in liquidity provision. Since the probability of a seller being able to find a buyer at exactly the same time (the concept of "immediacy") is likely to be low, for bond markets to function efficiently requires the service of market makers. While market makers do not necessarily run large inventories (less so in recent years), and are unlikely to hold positions in every bond for which they are a liquidity provider, they nonetheless stand by ready to show clients prices (bids or offers) on request. This requires the market maker being able to take the other side of the client trade, taking the position, long or short, onto their own trading books, and running this position until a time when it can be offlaid, either with another client or in the wider market. The ability to provide this service, apart from a willingness to assume and mange market risk, requires balance sheet capacity, as well as access to funding and hedging markets, including repo, interest rate swaps, bond futures, and credit default swaps.

Thus, bond markets could be defined along the lines of secondary trading. In the case of sovereign bonds (rates), they are usually structured along the lines of issuers. That is a bank will likely have different trading desks dedicated to trading Germany, Italy, France, etc, with smaller markets possibly being grouped together in the same book (eg Belgium and Netherlands, or "Nordics"). For investment grade corporate bonds (IG credit), this is generally structured along the lines of currency and sector. For example, euro telecoms, autos, financials, etc. So at least in the case of IG credit, one could argue that there is a secondary pan-European market. It could also be noted from a credit market perspective that both repo and credit default swaps (CDS) can be considered pan-European.

Where European bond markets appear more fragmented is in the post-trade space, particularly with respect to sovereign bonds issued in the domestic CSDs. Here the ecosystem is characterised by multiple settlement systems, payment systems and CCPs, though initiatives such as TARGET2 Securities are going a long way to addressing this.

Europe may indeed be facing an important challenge in developing some pan-European capital markets (such as domestically auctioned and cleared sovereign bonds, unrated SME shares and bonds) – just not in the Eurobond markets that in EMEA in 2019 raised circa USD2.2 trillion in new capital (Source: Dealogic 2019 full-year EMEA DCM volume).

Incidentally, the largely institutional nature of contemporary Eurobond markets has been largely driven by retail consumer protection laws that have accentuated the relative inefficiency of retail capital raising – see further ICMA's CMU responses of April 2015 (at #91-103) and of March 2017 (at #64).

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