Empirical paper

Bond spreads issued by sub-sovereign European governments

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This paper identifies the factors that affect the spread of fixed and variable type bonds in the primary and secondary markets issued by sub-sovereign European governments. The analyses of both markets will be done separately to compare whether the determinants in the primary market coincide with those in the secondary market. The analyses will examine the period between February 2008 and December 2013 using data panel estimations. The conclusions are that both markets are approximately identical behavior and the signs of the variables matched what was expected in nearly every case. Also, we concluded that the most important in determining the spread sub-sovereign variable is the spread of the sovereign state.

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\textbf{R E S U M E N}

El artículo identifica los factores que afectan al spread de los bonos de tipo fijo y variable en los Mercados primarios y secundarios, emitidos por los gobiernos subsoberanos europeos. El análisis de ambos mercados será realizado por separado para comparar si los determinantes en el Mercado primario coincide con los del secundario. El análisis examinará el periodo comprendido entre febrero de 2008 y diciembre de 2013 utilizando una estimación por datos panel. Se concluye que ambos mercados tienen aproximadamente comportamientos idénticos y los signos de las variables coinciden con los esperados en la mayoría de los casos.

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Introduction

In times of low interest rates and major macroeconomic uncertainty it is natural that the types of investment which become more appealing are those regarded as relatively safe and which at the same time offer higher yields than investment grade sovereign bonds. Issuing sub-sovereign bonds has a number of potential advantages because bonds are usually issued with a term of 3–10 years and can thus help to improve medium to long-term financial planning. Also the costs may be lower than for bank loans, and they have a positive impact on fiscal policy solidarity. There are nevertheless also potential risks, they assume bigger risks than the central government and excessive indebtedness of sub-sovereign entities can jeopardize the solvency of the central government (Vetter, Zipfel, & Fritsche, 2014).

The sovereign debt crisis in the euro area has had major consequences for European bond markets. As a consequence of the crisis in Europe, the low yield spreads among government bonds issued by the Member States of the European Monetary Union (EMU) – which mainly were a result of the introduction of the common currency – now seem to be a phenomenon of happier times. In fact, creditors now have started to distinguish clearly between the different Members States of the euro area (Sibbertsen, Wegener, & Basse, 2013). A question at the heart of the policy debate is to which extent market prices of sovereign bonds reflect economic fundamentals in an appropriate fashion, or whether swings in risk appetite have led to an under-pricing of risk prior to the global financial crisis, and possibly an over-pricing of risk during the European sovereign debt crisis (Aizenman, Jinjarak, & Park, 2013).

Access to capital markets for financing is not homogeneous from one country to another.1 In Europe, the market for sub-sovereign bonds is dominated by Germany’s subordinate levels of government. Germany’s regions and local authorities appeal most to the market. Specifically, 40.97% of the outstanding debt of German local authorities is implemented as bonds with domestic placement even though some large states issue bonds through Euro Medium Term Notes (EMTN) that provide them with a more diverse investor pool and allow them to place bonds in other countries. Additionally, city-states such as Berlin, Hamburg, and Bremen, as well as Sarre and some states in East Germany and Rhineland-Palatinate, usually issue joint bonds – unique issuances for those who benefit from the guarantee of the bonds. This formula allows the bonds to increase in number and to be more diversely distributed, which allows them to benefit from a sufficient minimum liquidity.

Spanish institutions are the second-largest institutions using capital markets to obtain financing, and 35.99% of Spanish debt is financed by securities. If the municipal and provincial debt, which is bank debt, minus a few exceptions, were discounted, the weight of assets would be significantly higher. Spain’s Autonomous Communities (AC) governments have recently used mostly bonds to diversify their investor base after experiencing a significant increase in financing needs. Some more sophisticated communities have attempted to diversify their investor base by using EMTN programs, such as Generalitat Valenciana (since 1998) and Generalitat of Catalonia and Junta of Andalusia (since 2009) or Euro-Commercial Papers (ECP), which are short-term notes and are generally issued at a discount up to 360 days. (Generalitat Valenciana since 1993 and Generalitat of Catalonia since 2010).

Various Italian regional institutions recently began using capital markets, regardless of the size of the issuances and typically at very long terms (30 years) due to legal issues and the necessity to issue bonds with annual amortization. The use of the capital markets increased due to greater institutional needs, as well as financial conditions on loans granted by Italian banks well above the cost of financing in the marketplace. Italian institutions have begun almost exclusively using loans from the Cassa dei Depositi y Prestiti, a public bank controlled by the Italian treasury that has the capacity to make loans under market conditions because it offsets postal savings.

In the case of French institutions, except for Île-de-France, some other regions and the city of Paris, virtually all financing is done through bank loans or private placements. In fact, there are fifteen local and regional institutions using bonds, but only nine of these institutions are active. Furthermore, the French central bank has voluntarily included interest rate derivatives in these loans in a way that offers local institutions a financing package and derivatives that allow them to easily manage the risk of their debt portfolios. However, this apparent added value provided by the bank, which the regions support, has, at times, hidden the excess costs of financing. French institutions have begun struggling to finance the deficit due to the central bank’s liquidity issues. Thus, local French institutions created an investee for every entity that issues bonds in the capital market. The investee’s funds will be loaned to members in conjunction with their participation in social capital initiatives, following the Scandinavian model. The advantage of the Scandinavian model is that difficulties in accessing capital market financing due to small institutional size will be eradicated.

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1 Otero, Rodriguez, Martorell, and Merigó (2016) examines the effect of securitization and credit derivatives on stability in the banking sector.
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