

Janse, Kalin Anev

Article

Developing European Safe Assets

Intereconomics

Suggested Citation: Janse, Kalin Anev (2023) : Developing European Safe Assets, Intereconomics, ISSN 1613-964X, Sciendo, Warsaw, Vol. 58, Iss. 6, pp. 315-319, <https://doi.org/10.2478/ie-2023-0065>

This Version is available at:

<https://hdl.handle.net/10419/281397>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



<https://creativecommons.org/licenses/by/4.0/>

Kalin Anev Janse

Developing European Safe Assets

Safe assets rank as the most assured and reliable securities, commanding the highest credit ratings, and are a key component in a well-functioning capital market. Safe assets are critical for economies and their existence is especially welcomed in capital markets in times of market stress or uncertainty.

They are typically associated with three fundamental characteristics (Gorton 2017, Brunnermeier et al., 2016, 2017, Brunnermeier and Huang, 2018, Gorton and Odonez, 2022): a high credit worthiness (asset “quality”), an ability to retain value in the event of adverse market price movements (“robustness”) and a strong liquidity profile (“liquidity”).

Thanks to these characteristics, market participants can use safe assets as a refuge in the event of market turmoil, as collateral in financial transactions, as a risk management instrument or as a reference for pricing other financial securities.

The European safe asset base includes government bonds from the highest rated euro area countries, as well as bonds issued by European supranational institutions that are backed by the European Union or euro area countries. German Bunds naturally form the first level of safe assets in the euro area. They are complemented by government bonds from euro area countries with ratings similar to those of Germany.

Bonds issued by European supranational issuers – the European Investment Bank (EIB), the EU, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) – are part of this European pool of safe assets. They were created to respond to the various challenges Europe experienced. They are part of what markets define as the European safe assets.

The creation of the European safe assets stems from the important role that a deep safe asset base contributes to

© The Author(s) 2023. Open Access: This article is distributed under the terms of the Creative Commons Attribution 4.0 International License (<https://creativecommons.org/licenses/by/4.0/>).

Open Access funding provided by ZBW – Leibniz Information Centre for Economics.

Kalin Anev Janse, European Stability Mechanism, Luxembourg, Luxembourg.

financial stability in times of crisis, such as the global financial crisis and the European sovereign debt crisis. We witnessed the positive market impact that the creation and usage of safe assets had (Figure 1). The creation of the EFSF in 2010 as well as the ESM in 2012 and the financial assistance programmes of these two institutions, combined with the European Central Bank (ECB) response, helped to reassure the market. This was manifest with reduced bond yield spreads relative to Germany in several euro area countries. The EFSF, the ESM, and the coordinated policy response with the EU, ECB and International Monetary Fund contributed to this success. During the COVID-19 pandemic, the initial €540 billion policy response of the ESM, the EIB and the EU, followed by the €800 billion NextGenerationEU (NGEU) post-pandemic recovery vehicle further eased upward pressure on euro area countries’ bond yield curves.

As Figure 1 shows, the financial markets punished the absence of shock absorbers in Europe. But by 2015, when Greece needed more financial assistance, which the ESM provided, it was evident that even ten-year Greek government bond spreads versus German Bunds were less than half of those experienced five years earlier. By 2020, when the pandemic became a common shock for Europe, Greek government bond spreads widened even less. Over time, Europe’s financial architecture reassured markets, and we see less volatility and narrower spreads. Europe was able to calm markets.

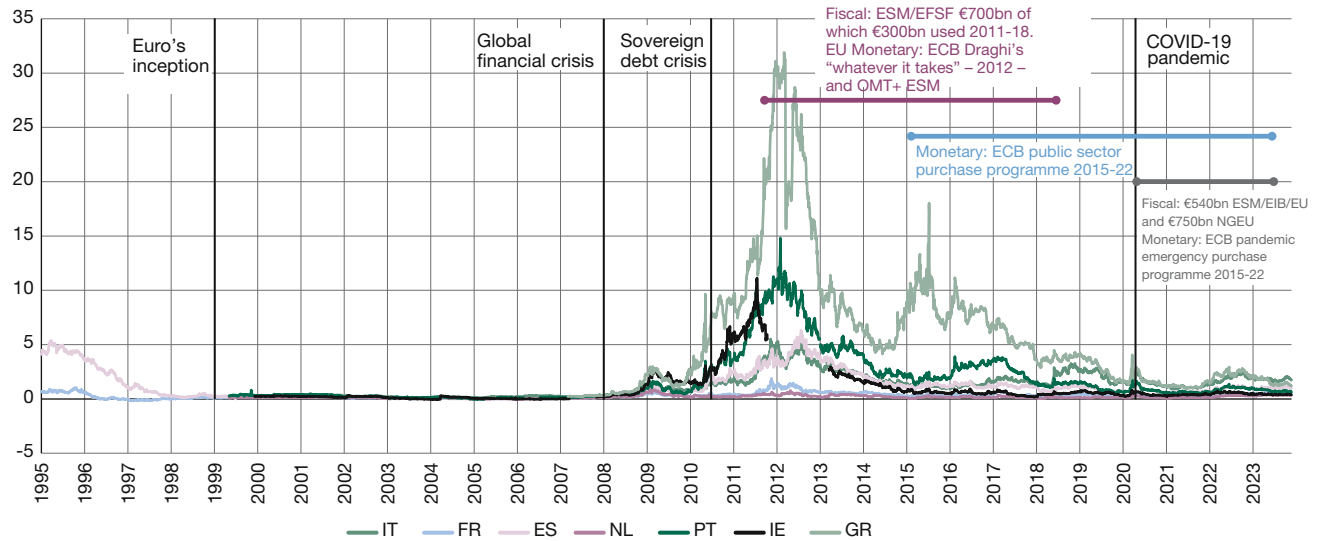
History of European safe assets

The EIB created the first European safe asset. It was founded in 1958 by the Treaty of Rome and was granted permission to issue bonds. From 1961 – when its initial loan of 20 million guilders was floated on the capital market of the Netherlands – to 1972 (just before the first enlargement of the European Economic Community), the EIB issued 99 loans for an equivalent amount of almost €2 billion (Bussiere et al., 2008). Initially, the EIB was backed by the six founding members: Luxembourg, Belgium, the Netherlands, Italy, France and Germany. Today, the EIB has 27 shareholders – the 27 member states of the EU.

The second European safe asset came from the EU. It issued several community bonds on private markets since the 1970s, which were guaranteed by the member states and distributed to countries where required (Meyer et al. 2020). The first European Community bond was issued in 1976 and used for Italy and Ireland.

Figure 1
Yield spread evolution of euro area sovereigns against Germany

Percentage points, 1 January 1995 - 22 November 2023



Source: Bloomberg, ESM.

The third European safe asset issuer was the EFSF, which was created in 2010 as a response to the global financial crisis and the European sovereign debt crisis. The EFSF issued its first bond in 2011 for the Irish adjustment programme.

The fourth European safe asset issuer was the ESM. Founded in 2012, the ESM issued its first bond in 2013 for the Spanish bank recapitalisation programme.

Comparison of European safe assets

The four European supranational issuers have different institutional bases (see Table 1). The EFSF is a private company under Luxembourgish law owned by the 17 countries of the euro area upon its creation. It excludes Latvia, Lithuania and Croatia, who joined the currency bloc later. The EFSF has very limited capital, and its bonds are backed by explicit guarantees of the 17 countries. The six best credit-rated euro area countries (Luxembourg, Finland, the Netherlands, Germany, France and Austria) over-guarantee up to 165% in order to ensure a safe asset status and high credit rating.

The ESM is an inter-governmental institution under international law. It has a paid-in capital of €80.5 billion and callable capital of €624 billion. It is owned by the 20 countries of the euro area.

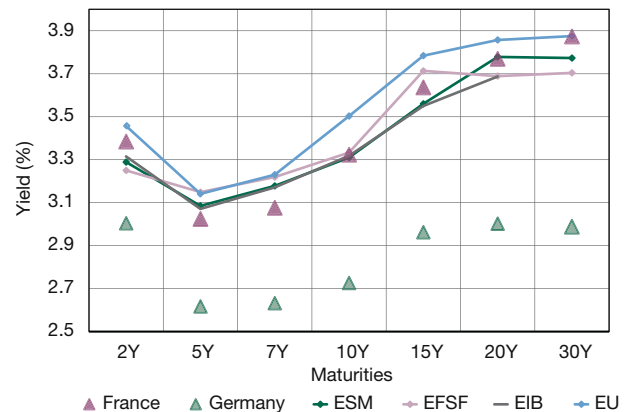
The EIB is owned by the 27 EU member states. Its paid-in capital is €22 billion, and it has €227 billion of unpaid subscribed capital. The EU is backed by its 27 member

states, and it has no paid-in capital. The EU borrowing is guaranteed by the EU budget.

The four European supranational issuers accounted for almost €1 trillion in euro-denominated bonds and notes as of 6 November 2023. The EU, with €431.3 billion was the largest, followed by the EFSF/ESM with €276.7 billion and the EIB with €250.7 billion. The four European safe asset issuers price close to the strongest European sovereigns. They include a market premium compared to Germany and are close to France (Figure 2).

Figure 2
Yield curve of the four European supranational issuers versus Germany and France

As of 6 November 2023



Source: Bloomberg, ESM.

Table 1
Comparison of the four European supranational issuers

	European Financial Stability Facility	European Stability Mechanism	European Investment Bank	European Union
Ratings	Aaa/AA/AA-	Aaa/AAA/AAA	Aaa/AAA/AAA	Aaa/AA+/AAA
Ownership	Private company under Luxembourgish law owned by the 17 euro area member states at the time of EFSF creation	Inter-governmental under international law owned by the 20 euro area member states	Owned by 27 EU member states	Owned by 27 EU member states
Guarantee	Explicit	Implicit	Implicit	Implicit
Subscribed capital paid-in	€745mn	€81bn	€22bn	Non applicable
Subscribed capital unpaid	Non applicable	€624bn	€227bn	Non applicable
Risk weighting	0%	0%	0%	0%
Liquidity coverage ratio	Level 1	Level 1	Level 1	Level 1
Purpose	Limited to rolling over maturing debt (outstanding loans €172.6bn: 76% GR, 14% PT, 10%IE)	Permanent institution, to enable countries of euro area to avoid/overcome financial crises	To support investment in infrastructure projects, and SME development, and to mitigate the effects of global warming	To support recovery from the COVID-19 crisis and investments into a sustainable economy
Eligible for the public sector purchase programme	Yes	Yes	Yes	Yes
2023 funding (estimates)	€20bn (liquid benchmark bonds, up to 2056, private placements)	€8bn (liquid benchmark bonds EUR, USD, maturities 1 to 45y, private placements)	Up to €50bn (mainly EUR, USD, 3-5bn size, benchmarks 2-30y, green bonds)	€170bn borrowing authorisation for the year (liquid bonds from 3y, 30% green format)

Sources: EU, EIB, ESM.

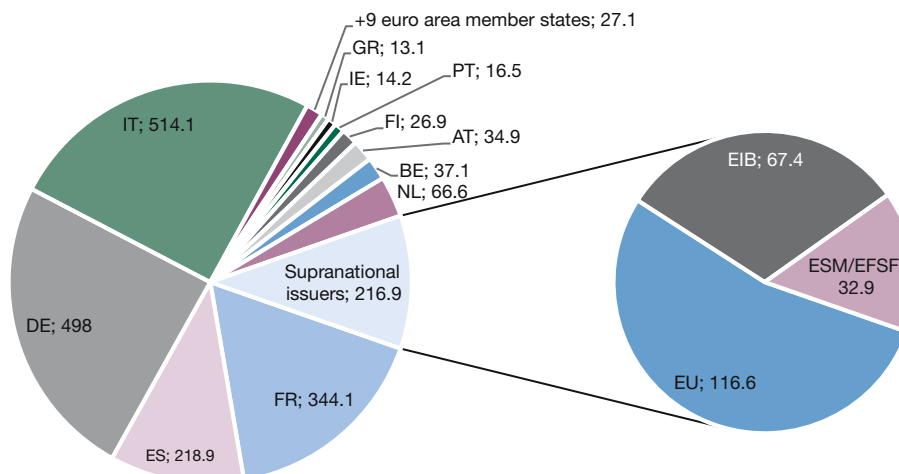
The longest established issuer, the EIB, has the tightest market pricing. It is followed by the European Stability Mechanism – with a strong capital base – and the EFSF. The EU trades the widest among the four issuers since the introduction of the NGEU vehicle.

In terms of market liquidity, the government bonds issued by Italy, Germany, France and Spain are the most liquid

ones. The European safe assets are fifth in terms of liquidity. Figure 3 displays daily average traded volumes for the main government and European safe assets.

It is worth noting the difference between highly rated government bonds and the ones from the four European supranational issuers. The latter have an insurance component to break the link between sovereign and banking

Figure 3
Market liquidity: Daily average traded volumes for European safe assets versus the main euro area government bonds
in billion euros

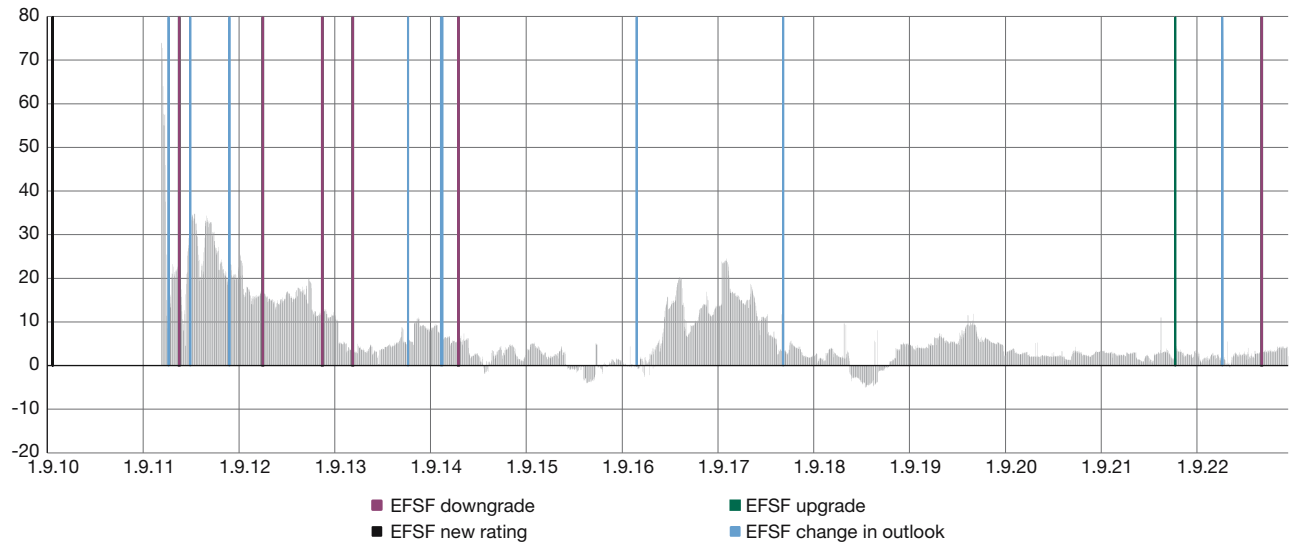


Sources: AFME, Finbourn, October 2022.

Figure 4

EFSF yield spread versus EIB through rating agencies decisions on EFSF

EFSF-EIB yield spread (basis points)



Sources: Bloomberg, ESM.

risks and allow a safe harbour for flight (Brunnermeier et al., 2011, 2017). This led to the proposal of the creation of European Safe Bonds (ESBies). Papadia and Temprano Arroy (2022) take it a step further and state that safe assets labelled in euro are critical for creating deep banking and capital markets unions. They also illustrate how far we have progressed already in European supranational bonds.

The size of European safe assets has been increasing over time, and this accelerated during the pandemic with the introduction of the NGEU vehicle. We have come some way in establishing European bonds as benchmarks and large investment assets with blended risk.

Markets' appreciation

Developing a safe asset status takes time. When the EFSF was created, it traded 75 basis points above EIB in its early years, as shown in Figure 4. The EFSF follows closely the rating of France and has gone through similar upgrades and downgrades over the last decade. Over time, the market started recognising the EFSF as a European safe asset. Despite the upgrades and downgrades, the EFSF converged to the price of the EIB. Over the years, the spread came down to 25 basis points and now the price is similar with moments where the EFSF goes through the curve of the EIB.

This shows that the market – despite the volatility and different ratings, mandates and capital structures – sees these European issuers as safe assets.

We have seen a counter-intuitive phenomenon in the European safe assets since the beginning of 2022. Despite the high ratings and good liquidity profiles of the European safe assets, their yield spreads relative to Germany widened significantly. However, this trend reversed somewhat in 2023.

These developments are the result of a number of factors, the effects of which need to be curbed to ensure that they do not lead to increased fragmentation and price distortion within the European safe asset base.

From a conjunctural perspective, the reduction of ECB bond holdings in the context of Quantitative Tightening has disadvantaged European supranational issuers more than sovereigns in terms of yield trends. Indeed, during the quantitative easing phase of ECB monetary policy, the ECB was able to purchase up to 50% of each outstanding bond line from supranational issuers, whereas this ceiling was limited to 33% in the case of sovereign bonds. The ECB Pandemic Emergency Purchase Programme (PEPP) came on top of these numbers. Quantitative tightening is now leading to a faster increase in free float for supranational bonds than for sovereigns, pushing their yields higher.

Additionally, the heavy bond supply from the EU to finance the €100 billion SURE and €800 billion NGEU programmes has pushed yields of the four supranational issuers higher. Given its relative weight in the supranational market segment, the EU has indeed become the main driving force for yield spreads of the European safe assets. The EU has repeatedly secured a substantial order book with a high issuance premium. This has added to upward pressure on yields in the supranational market segment as a whole.

A number of structural factors also explain the yield trends that have been at work since the beginning of 2022 within the European safe assets pool.

Firstly, the ECB's new anti-fragmentation tool, the Transmission Protection Instrument (TPI), which aims to mitigate speculative market fluctuations for sovereign bonds, does not cover supranational issuers.

Secondly, in the absence of specific hedging instruments, such as bond futures for German Bunds, bonds of supranational issuers are priced using the euro-denominated interest rate swap curve as a benchmark. Against a backdrop of rising interest rates over the past two years and heavy use of interest rate swaps by financial investors to hedge their bond positions, the spread of interest rate swaps against German Bunds has sometimes widened sharply, mechanically pushing up yields on the four European supranational issuers.

Thirdly, the non-inclusion of European supranational issuers in global sovereign bond indices has also limited the interest of some index funds in their bonds.

Finally, the four supranational issuers lack security lending facilities similar to those used by sovereigns to manage the liquidity of their bonds.

Future considerations

Over and above these conjunctural and structural factors that are holding back the consolidation of the European safe asset base, Europe needs a strong political commitment to ensure the continued success of the four European safe assets.

In particular, the concerns in the market regarding the EU as a bond issuer are twofold. Firstly, the market is wondering what will happen once the temporary NGEU mandate expires and new loans cease after 2026. Secondly, questions relating to indirect and direct taxation, which would provide the EU with its own financial resources, similar to the competence of sovereigns to collect taxes, remain unresolved.

In the longer term, there are political issues beyond the scope of this article that will need to be addressed. But the prevalence of more safe assets supporting borderless investing across Europe from completion of a capital markets union and further internationalisation of the euro offer investors, businesses and citizens enormous advantages. These changes also place the European capital markets on a more level footing with their counterparts in other major economies such as the United States.

References

- Brunnermeier, M. K., L. Garicano, P. R. Lane, M. Pagano, R. Reis, T. Santos, S. Van Nieuwerburgh and D. Vayanos (2011, 25 October), ESBies: A Realistic Reform of Europe's Financial Architecture, *VoxEU*.
- Brunnermeier, M. K., S. Langfield, M. Pagano, R. Reis, S. van Nieuwerburgh and D. Vayanos (2017), ESBies: Safety in Tranches, *Economic Policy*, 32(9), 175-219.
- Brunnermeier, M. K., L. Huang (2018), A global safe asset for and from emerging market economies, *Working Paper*, 25373, National Bureau of Economic Research.
- Bussière, É., M. Dumoulin and E. Willaert (eds.) (2008), The Bank of the European Union: The EIB, 1985-2008, Imprimerie Centrale.
- Gorton, G. (2017), The History and Economics of Safe Assets, *Annual Review of Economics*, 9, 547-586.
- Gorton, G. B. and G. Ordóñez (2022), The supply and demand for safe assets, *Journal of Monetary Economics*, 125, 132-147.
- Meyer, J., C. Trebesch and S. Horn (2020), Coronabonds: The forgotten history of European Community debt, *VoxEU Column*.
- Papadia, F. and H. Temprano Arroyo (2022), Don't look only to Brussels to increase the supply of safe assets in the European Union, *Bruegel Policy Brief*.