Box 7

Bond funding of euro area banks: progress in the issuance of loss-absorbing instruments

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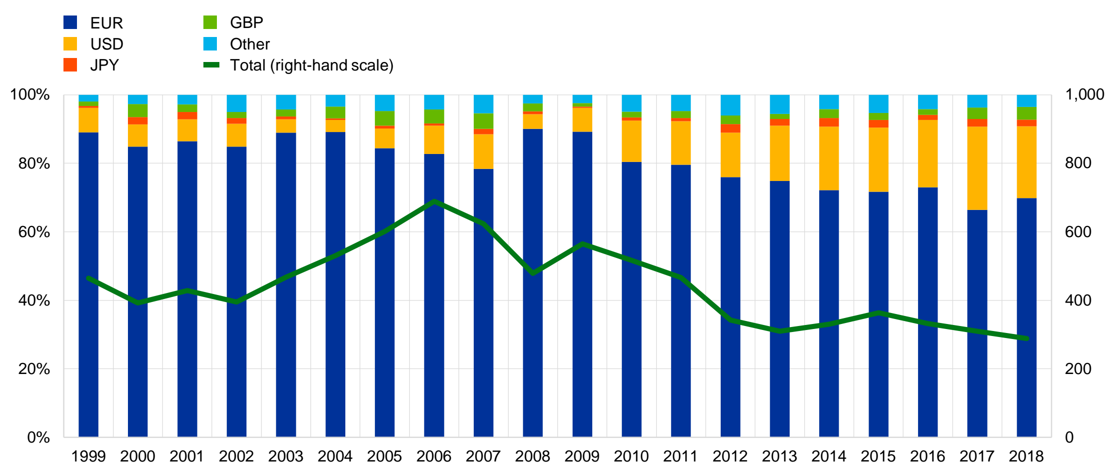
Global and European regulation is progressively introducing the requirement for banks to have sufficient loss-absorption and recapitalisation capacity, extending beyond equity capital. From 2019 onwards, G-SIBs need to have a minimum volume of total loss-absorbing capacity (TLAC), while all banks in the EU are being progressively informed about their bank-specific minimum requirements for own funds and eligible liabilities (MREL), subject to individual transitional periods. Against this background, this box presents developments in euro area bank bond issuance and spreads over the past years and discusses possible financial stability implications.

Chart A

Bond issuance of euro area banks has declined significantly since the financial crisis

Aggregate gross bond issuance by euro area banking groups

(1999-2018, percentages, € billions)



Sources: Dealogic, Bloomberg and ECB calculations.
Notes: Figures for 2018 are up to end-October 2018. Retained bond issuances are excluded.

Euro area gross bank bond issuance has been on a declining trend since 2006. While the global financial crisis led to an initial reduction in gross bank bond supply, this trend accelerated from end-2011 onwards following, among other factors, the Eurosystem longer-term credit operations and the sovereign debt crisis **(see Chart A)**. The aggregate gross issuance volume of bank bonds is expected to increase in 2019 and 2020, as shown by the recent funding plans of EU banks.[33] From a financial stability perspective, the more diversified currency composition of bond issuance over the past five years could be seen as pointing to increased resilience of issuance to idiosyncratic shocks through a broader investor base.

Despite the overall decline in recourse to the bond market by the sector as a whole, euro area G-SIBs have kept their issuance broadly stable since 2010. Their funding mix, however, has changed in favour of bail-inable debt at the expense of covered and senior unsecured bonds ahead of the January 2019 TLAC deadline (see **Chart B**, left panel). More recently, and as most have reached their minimum interim TLAC requirements,[34] the focus of G-SIBs has shifted towards optimising their capital structure to reduce funding costs. Accordingly, their supply of senior non-preferred (SNP) debt and/or debt issued by a holding company has increased considerably, and some G-SIBs have even announced their intention to substitute some of their hybrid capital (Additional Tier 1 and Tier 2) with SNP debt. This trend has been reinforced by the progressive harmonisation of MREL with the TLAC rules, including the amendments to the Bank Recovery and Resolution Directive (BRRD) in November 2017 introducing SNP debt in all EU Member States.[35]

[33] See "EBA Report on Funding Plans", European Banking Authority, September 2018.

[34] G-SIBs are expected to meet a minimum TLAC of 16% of the resolution group's risk-weighted assets as from 1 January 2019 and at least 18% as from 1 January 2022.

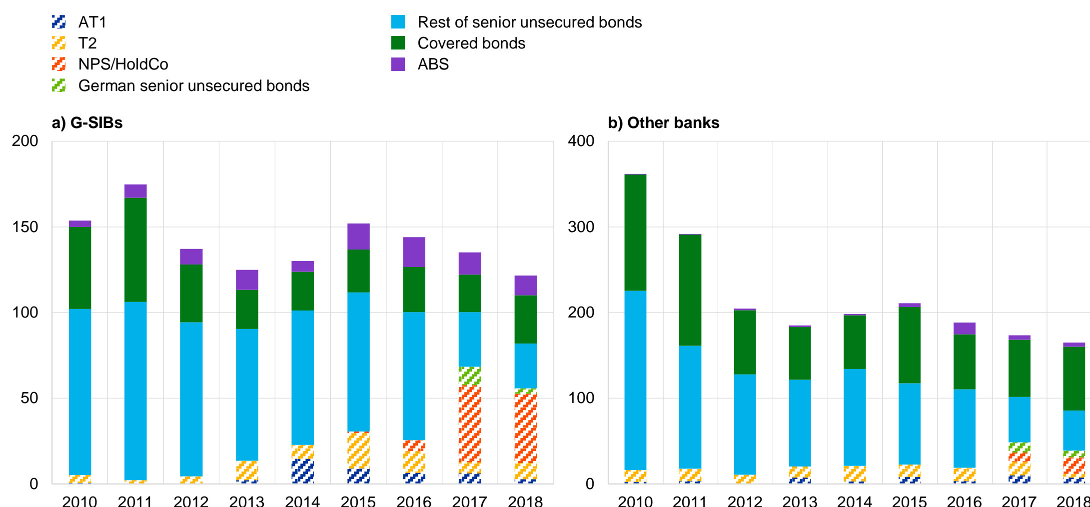
[35] One exception to this general trend is the case of German banks, given the recent amendment to the BRRD allowing German banks' senior unsecured debt to rank pari passu with the new SNP debt issuance, and that the German legislation enabling the introduction of senior preferred bonds only came into force on 21 July 2018.

Chart B

While bond supply from euro area G-SIBs has remained broadly stable, the issuance volume of other banks declined substantially following Eurosystem longer-term credit operations

Aggregate gross bond issuance by euro area banks

(2010-18; left panel: G-SIBs; right panel: non-G-SIBs; € billions; bail-inable debt shown in striped format)



Sources: Dealogic, Bloomberg and ECB calculations.
Notes: The classification of G-SIBs follows the Financial Stability Board's November 2017 G-SIB list, including Nordea. Figures for 2018 are up to end-October 2018. AT1 refers to Additional Tier 1 capital, T2 to Tier 2 capital, NPS to non-preferred senior bonds, HoldCo to structurally subordinated bonds issued by the holding company of the bank, and ABS to asset-backed securities.

In contrast to G-SIBs, the overall gross issuance volume from other euro area banks has roughly halved since 2010. Two observations underpin this development. First, other banks are on aggregate significantly less advanced in building up their (more costly) bail-inable debt, which accounts for less than 20% of their annual bond issuance on average (see **Chart B**, right panel). The volume of bail-inable debt issued by other euro area banks in 2018 amounted to €30 billion, which compares with an aggregated MREL shortfall of €117 billion, as estimated by the SRB at the end of 2017.[36] However, the MREL shortfall could be significantly higher as a result of the review of MREL rules envisaged in the upcoming BRRD2 and in relation to the adoption of a stricter methodology when computing the MREL eligible liabilities. The slow progress in issuing bail-inable debt might be partly explained by the more limited access to and higher cost of capital market financing for smaller banks, and by the uncertainty about the MREL requirements and timelines up until recently. Second, other banks have also reduced their issuance of covered bonds and senior unsecured debt by around 50% since 2010. Many of these banks are expected to slowly return to the bond market, e.g. to replace maturing TLTRO-II[37] funding, which will require rebuilding an investor base, initially in secured markets before moving into bail-inable debt. This notwithstanding, the aggregate volume of bond issuance by the other banks is expected to remain below pre-crisis levels, given the steady growth in their capital and deposit base, their deleveraging and the lengthening of the average maturity of their issuance over the past three years to roughly 7.5 years (i.e. 2.5 years longer than the average maturity in 2008-14).

[36] See "6th Industry Dialogue: 2017 MREL Policy". The sample used by the SRB to estimate the aggregated MREL shortfall covers 76 European banks comprising small and large institutions.

[37] TLTRO-II refers to the second series of targeted longer-term refinancing operations, introduced by the ECB in March 2016.

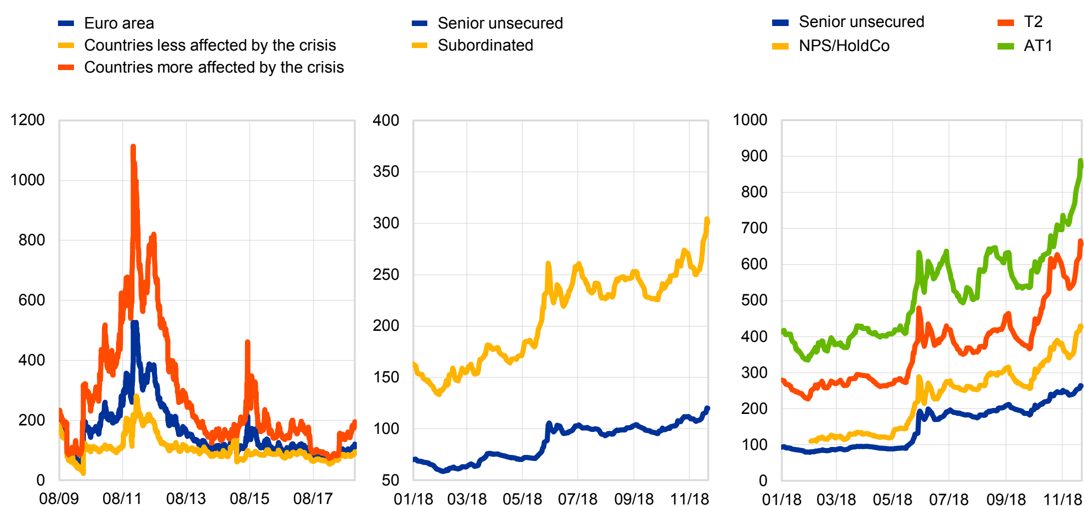
The slow progress in building up bail-inable buffers by other euro area banks exposes them to the risk of having to meet the requirements in a more challenging market environment. The spreads of senior unsecured bank bonds remain low across the euro area from a long-term perspective (see **Chart C**, left panel). While the spread required by investors to buy bail-inable debt issued by lower-rated or smaller banks is higher, until recently it was also low by historical standards. Political uncertainty and debt sustainability concerns in Italy, however, have contributed to an increase in bond spreads since end-May (see **Chart C**, middle panel), in particular for Italian banks alongside a temporary halt in Italian bank bond issuance in June. Market participants have differentiated between seniorities, with the largest spread widening having taken place for the most credit-sensitive asset classes (see **Chart C**, right panel). This episode serves as an illustration that changes in market conditions can be abrupt and can result in banks having to issue bail-inable debt to meet MREL requirements at significantly higher costs, which in some cases may even prove to be prohibitive.

Chart C

Spreads of bank bonds have increased since mid-May 2018, particularly for Italian banks

Spreads of senior unsecured bank bonds across the euro area (left panel), spreads of senior unsecured vs. subordinated bonds of euro area banks (middle panel), as well as spreads of Italian bank bonds for different seniorities (right panel)

(left panel: Aug. 2009-Nov. 2018; middle panel: Jan. 2018-Nov. 2018; right panel: Jan. 2018-Nov. 2018; basis points)



Sources: Dealogic, iBoxx and ECB calculations.
Notes: Z-spreads are used, defined as the basis point difference between the yield of a bank's bond and the yield of a maturity-matched euro swap. The aggregated spreads are computed as a weighted average of individual EUR-denominated bank bonds included in iBoxx indices. AT1 refers to Additional Tier 1 capital, T2 to Tier 2 capital, NPS to non-preferred senior bonds, and HoldCo to bonds issued by the holding company of the bank. Countries more affected by the crisis include Cyprus, Greece, Ireland, Italy, Portugal, Spain and Slovenia.

All in all, while most G-SIBs have fulfilled their minimum TLAC requirements, other banks are less advanced in building up their bail-inable debt. This might pose financial stability challenges going forward as some of the other banks may face limited market access and would have to progressively (re)build an investor base. At the same time, the combination of replacing maturing TLTRO-II funding and the need to issue MREL-eligible debt will lead to a sizeable volume of debt that will need to be absorbed by the market. In addition, as shown by the recent episode, funding costs are susceptible to sharp increases should risks be repriced, which would further complicate efforts to build up the necessary loss-absorption capacity.