Box 1

THE FUNDING OF EURO AREA MFIS THROUGH THE ISSUANCE OF DEBT SECURITIES

The recent tensions in the sovereign debt markets affected euro area MFIs' financing conditions and their access to wholesale funding in the second quarter of 2010. The impact was visible on bank bond spreads and bank credit default swap premia, which increased sharply in May and June 2010, but is also likely to have affected the debt issuance of euro area banks in recent months. Indeed, the MFI balance sheet data showed a net decline of debt securities issued by MFIs in both May and June 2010. This picture is confirmed by the latest results of the Eurosystem's bank lending survey (see Box 2), which point to a deterioration of wholesale funding access in the second quarter. Against this background, this box describes the most recent developments in euro area MFIs' issuance of debt securities.

Net debt security issuance

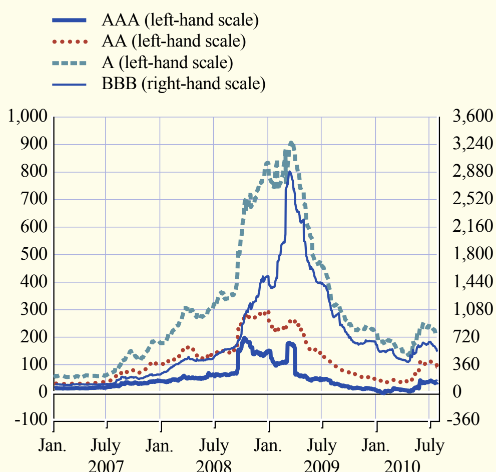
Tensions in markets for euro area sovereign debt implied direct spillover effects from higher sovereign yields to bank bond yields. Banks' exposures to sovereign debt, as well as the uncertainties surrounding those exposures, also seemed to increase counterparty risk and to affect banks' probability of default more generally. This was reflected, for example, in spreads on AA and A-rated bank bonds that rose by around 70-100 basis points between mid-April and mid-June 2010 relative to a composite euro area government bond index (see Chart A).[1] More recently, bank bond spreads have narrowed somewhat, reflecting, among other things, the publication of the EU-wide bank stress tests on 23 July 2010, but remained at elevated levels in comparison with the first quarter of 2010.

The sharp increase in MFIs' costs of issuing debt in the financial market in May and June 2010 may have deterred many euro area banks from renewing maturing debt, as reflected in negative net flows of debt securities issued by MFIs in these two months.[2] This development was also confirmed by debt securities issues statistics (for which data are available up to May 2010), which showed negative net issuance in the order of around €25 billion by euro area MFIs in May 2010 (see Chart B). This compares with a long-term average of around €22 billion in monthly net issuance by euro area MFIs. One reason for the generally subdued net issuance of debt securities by MFIs in recent months could be that the euro area banking sector is currently undergoing a

1 According to Iboxx; similarly, the Itraxx Senior Financials index of credit default swap spreads rose by around 100 basis points over the same period.
2 According to MFI balance sheet items statistics.

Chart A Euro area corporate bond spreads for financial institutions

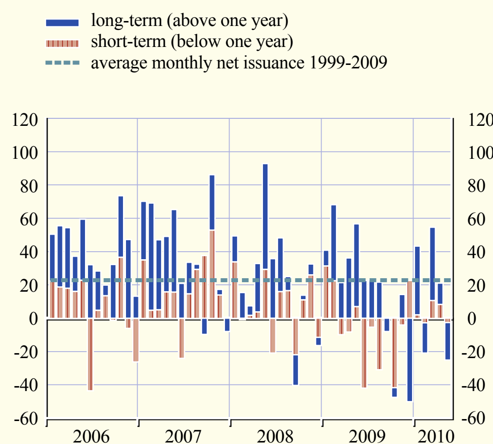
(basis points)



Source: Thompson Financial Datastream.
Note: The benchmark is the EMU AAA government bond index calculated by Merrill Lynch.

Chart B Net issuance of debt securities by euro area MFIs broken down by maturity

(monthly flows in EUR billions; not adjusted for seasonal and calendar effects)



Source: ECB.
Note: Last observation: May 2010.

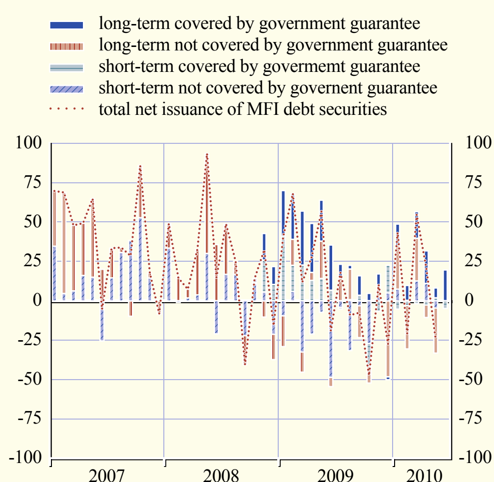
process of balance sheet adjustment and is, at the same time, facing rather weak demand for loans, which may have reduced the need for a financing of new activities. For some banks, the subdued net issuance activity in May and June may simply reflect a postponement of new debt issuance in the expectation of improved market conditions in the period ahead. At the same time, other (allegedly weaker) banks might have found the costs of entering the debt securities market prohibitively high throughout 2010.

Government guarantees in net debt security issuance

The existence of heterogeneity within the euro area banking sector as regards the capacity to tap market-based funding throughout 2010 is supported by the developments in the issuance of MFI debt securities backed by government guarantees. The use of government guarantees should facilitate issuance in the markets. In late 2008 and in the first half of 2009, the introduction of government support programmes, whereby banks issued debt securities covered by government guarantees, allowed banks to maintain their issuance despite the adverse market conditions for bank debt. In the first three months of 2010 the recourse of euro area banks to government support was low, as at least some banks were increasingly able to access market-based funding without government support (see Chart C). The deterioration in market conditions in April and May did not result in a marked increase in recourse to such government support, despite the fact that, in the first half of 2010, these programmes were still in place in most of the countries where they had been introduced. This suggests that the majority of euro area banks did not face such a large increase in funding pressure that they would be prepared to incur the cost entailed in issuing government-guaranteed debt securities. At the same time, issuance of such securities, while low, has not disappeared altogether in recent months. Recourse to this type of funding has been concentrated on MFIs resident in a few euro area countries that have been at the epicentre of the sovereign debt market tensions and on a few other specific issuers. This points to the existence of a subset of euro area MFIs that are being confronted with very tight borrowing conditions when attempting to tap market-based debt funding without government backing. However, government guarantees also allow MFIs to pledge the debt securities as collateral in Eurosystem refinancing operations and thereby obtain funding.

Chart C Net issuance of debt securities by euro area MFIs covered by government guarantee programmes

(monthly flows in EUR billions; not adjusted for seasonal and calendar effects)



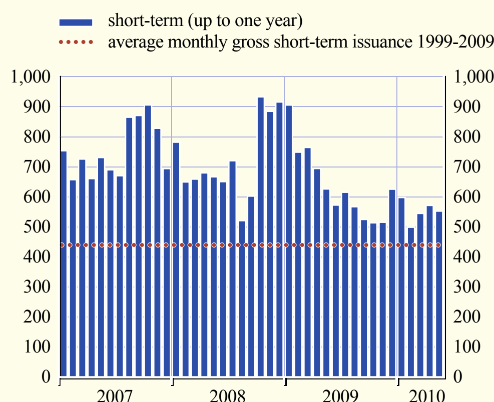
Source: ECB, ECB estimates.
Note: Last observation: May 2010 for total net issuance and issuance not covered by guarantees; June 2010 for net issuance covered by guarantees.

Gross debt security issuance

Notwithstanding the subdued net issuance of government-guaranteed and non-government-guaranteed MFI debt securities, on a gross basis, the euro

Chart D Gross issuance of short-term debt securities by euro area MFIs

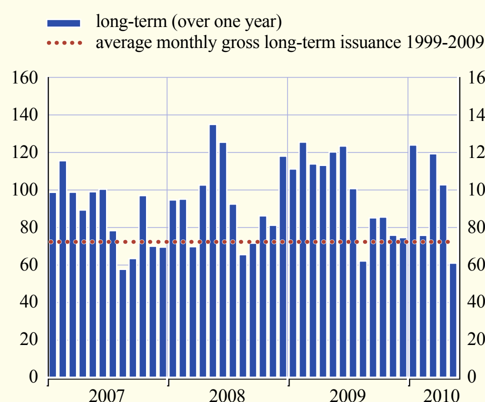
(monthly flows in EUR billions; not adjusted for seasonal and calendar effects)



Source: ECB.
Note: Last observation: May 2010.

Chart E Gross issuance of long-term debt securities by euro area MFIs

(monthly flows in EUR billions; not adjusted for seasonal and calendar effects)



Source: ECB.
Note: Last observation: May 2010.

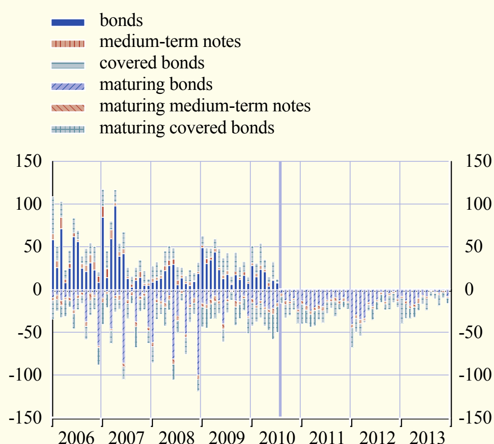
area banking sector as a whole remained capable of issuing substantial amounts of debt securities, also in recent months. Notably, the level of gross issuance of short-term debt securities (i.e. securities with an original maturity of up to one year) remained not only solid in May 2010, but also above the historical monthly average flow of gross issuance since 1999 (see Chart D). This suggests that, at the aggregate level, euro area banks remained capable of covering their short-term funding needs in the debt securities market, as is also reflected in the only modestly negative net issuance of short-term paper (see Chart B). Hence, the financial market tensions in May 2010 seem mainly to have dented banks' previous reliance on funding through longer-term debt securities (which possibly reflected the aim of taking advantage of low long-term interest rates). The gross issuance of longer-term debt securities contracted from a monthly level of around €100-120 billion in the two preceding months to about €60 billion in May (see Chart E).

Gross issuance and maturing issues of longer-term debt securities

Given the considerable volume of longer-term debt securities issued by euro area MFIs that will be maturing in the next few years, banks may be expected to increase their issuance at some time in the coming months in order to ensure their long-term financing. According to estimates based on data from Dealogic, a private data provider, euro area banks may face redemptions of outstanding longer-term debt issues in the order of approximately €1.3 trillion in the next 14 quarters up to the fourth quarter of 2013 (see Chart F). This, however, is less than the approximately €1.9 trillion which matured in the preceding 14 quarters (between the first quarter of 2007 and the second quarter of 2010). Over that period, euro area banks managed to issue around €1.7 trillion. Hence, while the amount of maturing debt that banks need to refinance in the next 2½ years is substantial, it appears manageable on the basis of experience in the recent past and subject to a normalisation of funding conditions in the debt securities market.

Chart F Longer-term debt securities issued by euro area MFIs – gross issuance and maturing issues

(monthly flows in EUR billions; not adjusted for seasonal and calendar effects)



Sources: Dealogic and ECB calculations.
Notes: "Maturing issues" on inverted scale. Dealogic debt securities data are less encompassing than the ECB's securities issuance statistics on which Charts B to E are based. The statistical methodology applied is also not directly comparable between the two datasets. Based on issues in the euro area by banks.

The need for a renewal of maturing debt securities issued could moreover be lower than in the past, to the extent that euro area banks may amend their business models – in the light of the financial crisis – by reducing their reliance on market-based funding and increasingly taking recourse to deposit-based funding. Indeed, a reassessment of funding strategies may be particularly called for in the context of the persistently subdued level of (non-retained) securitisation activity, which (according to Dealogic data) is still hovering at a low level of less than one-third of the average monthly issuance since 2000. Meanwhile, despite the recent move towards consolidation of public finances in euro area countries, debt-issuing banks are likely to face more intense competition for funds from both sovereign issuers and non-financial private issuers, as the latter may increasingly want to access market funding in the wake of the crisis.