Box 1

RECENT DEVELOPMENTS IN MFI LONGER-TERM FINANCIAL LIABILITIES

MFI longer-term financial liabilities are liabilities of MFIs which are not included in M3. They comprise deposits with an agreed maturity of over two years, deposits redeemable at notice of over three months and debt securities issued with a maturity of over two years, as well as capital and reserves. The annual growth rate of longer-term financial liabilities excluding capital and reserves (LTFLs) has been at high levels for much of the past two years, standing at 9.1% in May 2006.

In an accounting sense, robust growth in this counterpart to money exerts a dampening effect on the expansion of M3. Such a relationship is clear in cases where, for instance, the money-holding sector shifts funds from short-term deposits included in M3 into longer-term deposits included in LTFLs. However, changes in the growth of LTFLs may also simply be a reflection of developments in other counterparts of M3, in which case the link with M3 growth is less straightforward. For example, in the context of securitisation operations, MFIs may transfer loans (or the risk associated with them) to another institution, but this might be associated with a corresponding change in LTFLs. Against this background, this box looks into the structure of and recent developments in LTFLs in the euro area.

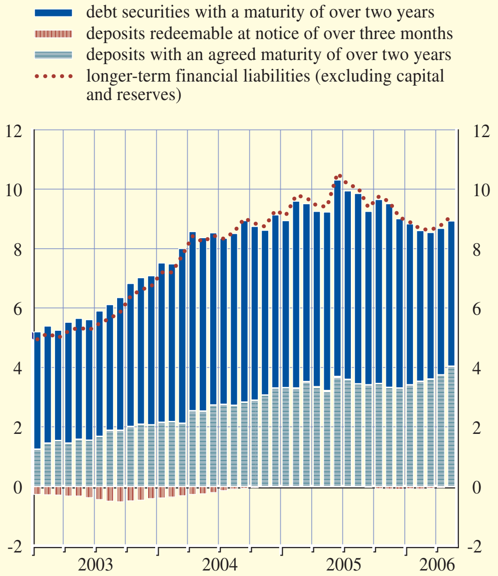
The recent strong growth of LTFLs comes from both longer-term debt securities and longer-term time deposits

In May 2006 debt securities issued with a maturity of over two years represented around 57% of the stock of LTFLs, while (time) deposits with an agreed maturity of over two years accounted for 40% and (savings) deposits redeemable at notice of over three months accounted for the remainder. Reflecting in large part the respective shares, longer-term time deposits contributed 4.0 percentage points to the annual growth rate of LTFLs in May 2006, while longer-term debt securities contributed 4.9 percentage points (see Chart A).

In recent months deposits with an agreed maturity of over two years and debt securities with a maturity of over two years have been growing at a broadly similar pace (see Chart B). However, looking at the respective developments over a longer horizon suggests that the dynamics of these instruments can be quite different. For instance, the annual growth rate of deposits with an agreed maturity of over two years registered a sharp decline at the height of the stock market boom in the early 2000s, which may have been related to substitution into equities in the wealth

Chart A Longer-term financial liabilities (excluding capital and reserves)

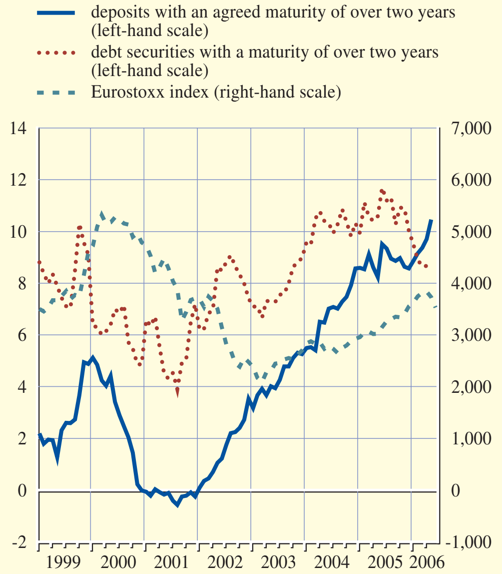
(annual percentage changes; contributions in percentage points; adjusted for seasonal and calendar effects)



Source: ECB.

Chart B Deposits and debt securities included in LTFLs

(annual percentage changes; adjusted for seasonal and calendar effects)



Source: ECB.

portfolio of the money-holding sector at a time of strong stock market performance. The growth rate recovered in 2002, when – in the context of heightened economic, financial and geopolitical uncertainty – investors (more than 50% of longer-term time deposits are held by households) sought safer, capital-certain assets such as deposits as a shelter from the prevailing market volatility.

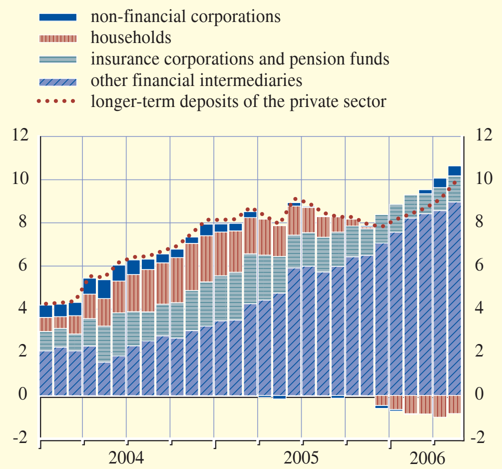
Developments in longer-term debt securities showed a somewhat different pattern. During the stock market boom the annual growth rate remained relatively robust at above 4%, which suggests that these securities were less profoundly affected by substitution into equities than the longer-term time deposits. Longer-term debt securities are held to a large extent by institutional investors who have regulatory constraints, financing needs and investment horizons which may prevent, or at least slow, their ability to switch quickly between debt securities and equities.

Developments in synthetic securitisation may partly account for the recent strong growth in LTFLs

The strong growth of longer-term deposits observed since mid-2004 is explained mainly by the accumulation of such deposits by other (non-monetary) financial intermediaries (OFIs). The latter's contribution to the annual growth rate of longer-term deposits has risen over recent quarters to stand at 9.0 percentage points in May 2006 (see Chart C). Moreover, it appears that the extent of OFI accumulation of longer-term deposits varies widely across euro area countries. This suggests that the marked growth in longer-term deposits reflects factors related to changes in the nature of financial intermediation associated with OFIs and to country-specific developments, rather than a general euro area-wide trend.

Chart C Longer-term deposits of the private sector

(annual percentage changes; contributions in percentage points; neither seasonally nor calendar effect-adjusted)



Source: ECB.

The strong growth in LTFLs and the large contribution from OFIs may reflect a shift from true-sale securitisation to synthetic securitisation.[1] Under the former type, the loan is transferred from the MFI balance sheet to the balance sheet of the OFI (specifically a financial vehicle corporation (FVC)), and this transfer may be directly financed by a corresponding reduction in OFIs' holdings of longer-term deposits. Both the growth in loans and the growth in LTFLs would then decline, but there would be no impact on M3 dynamics. In the case of synthetic securitisation, only the risk associated with the MFI loan is transferred to the FVC, with no direct impact on loans and LTFLs. Hence, increased use of synthetic securitisation rather than true-sale securitisation could imply somewhat higher growth in LTFLs (and MFI loans). In some countries of the euro area, recent regulatory changes have reduced

1 See Box 1, entitled "The impact of MFI loan securitisation on monetary analysis in the euro area", in the September 2005 issue of the Monthly Bulletin for details of these two types of securitisation.

the scope for removing asset-backed securities from the originator's balance sheet, in order to preserve the possibility of the holder having recourse against the issuer. This has led to more synthetic securitisation than in the past (and hence higher LTFLs).

The high degree of heterogeneity across countries in terms of contributions to the growth of longer-term debt securities probably reflects the fact that considerable differences remain in terms of legal and tax frameworks within the euro area, especially concerning the issuance of covered bonds. Such bonds, which are securitised by a dynamic pool of assets according to a mechanism set out in law, remain on the balance sheet of the MFI issuer. In 2005 an extremely pronounced rise in the issuance of covered bonds took place in most euro area countries. Thus, covered bonds appear to have progressively replaced asset-backed and mortgage-backed securities. As these bonds are typically issued in the form of securities with a maturity of over two years, they contribute to the rise in the growth rate of LTFLs.

For the issuer, the main attraction of covered bonds is that they provide access to more attractively priced financing in greater volumes and at longer maturities than in unsecured markets. Moreover, covered bonds enable their issuers to transfer the risk to other entities, which can help them to comply with regulatory requirements without reducing the size of their balance sheets. For the investor, such bonds offer portfolio diversification and the protection of a strong legal framework. Moreover, in the context of the new bank capital adequacy regulations embodied in Basel II, banks buying these bonds can decrease the risk-weighting if they opt for the "internal rating-based" approach. Moreover, this class of assets offers a good spread performance against government bonds.

As shown by recent developments in LTFLs, monetary analysis has become more complex

In terms of monetary analysis, recent developments in securitisation have several implications. First, shifts from true-sale securitisation to synthetic securitisation imply changes in the dynamics of the counterparts of M3, especially loans and LTFLs. Second, the increasing importance of OFIs may lead to greater volatility in the money series and, insofar as their holders are not known, can make it more difficult to gain insight into monetary and financial behaviour. Thus, it is crucial to monitor all counterparts to money (including LTFLs) as well as their sectoral composition to uncover the underlying monetary dynamics.