

Box 2

LONG-TERM DEBT SECURITIES ISSUANCE BY MFIs SINCE THE EARLY 1990s

Since 1992 debt securities issuance by MFIs has grown robustly at an average annual rate of nearly 8%. MFIs are the second largest group of issuers of debt securities in the euro area, accounting for more than 40% of the €11.2 trillion debt securities outstanding at the end of January 2007, just behind the corresponding share of the general government (42%). Short-term debt securities – in many cases closely linked to bank deposits – are part of the ECB's broad monetary aggregate M3.¹ The bulk of the debt securities issued by MFIs – accounting for nearly 90% of the total amount outstanding – are, however, notes and bonds with a long-term original maturity.²

This box focuses on long-term debt securities issued by MFIs and provides some insights into why banks – whose core activity is to lend out the funds that they receive in the form of deposits from the general public – issue these types of instrument. Debt securities issuance activity by banks may affect the monetary policy transmission mechanism. For example, access to funding by banks may have implications for the supply of loans, and thus for the conditions at which households and non-financial corporations are able to obtain bank financing.

Long-term debt securities as a source of funding

The growth in long-term debt securities appears to be related to three main aspects of banks' funding requirements. First, banks' balance sheets have generally expanded rapidly over the past few years, in large part on account of strong growth in lending to the private sector. In this context, MFIs have had recourse to the issuance of long-term debt securities in order to finance lending that was not financed through deposits and short-term debt securities.

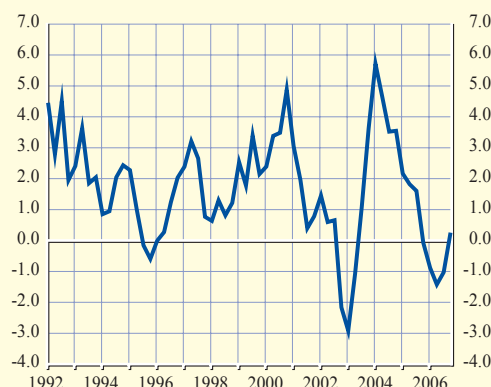
Second, while deposits from non-MFI residents plus short-term debt securities issued by MFIs remain MFIs' main source of funding, long-term debt securities issued by MFIs have been the

1 More specifically, debt securities issued by MFIs with an original maturity of up to two years are included in M3 when held by the money-holding sector. This is the definition of "short-term" used in the Eurosystem's balance sheet item statistics. However, this box uses the Eurosystem's securities issues statistics, for which "short-term means securities with an original maturity of one year or less (in exceptional cases two years or less). Securities with a longer original maturity, or with optional maturity dates, the latest of which is more than one year away, or with indefinite maturity dates, are classified as long-term".

2 Long-term debt securities are part of the broader analysis of longer-term financial liabilities of MFIs (see Box 1 entitled "Recent developments in MFI longer-term financial liabilities" in the July 2006 issue of the Monthly Bulletin). It should also be mentioned that the growth in short-term debt securities issued by MFIs is subject to substantial fluctuations. In particular, the growth in debt securities issued by MFIs with an original maturity of up to two years and held by the money-holding sector – as included in M3 – has increased sharply over recent months (see Box 1 entitled "Developments in short-term debt securities within M3" in the January 2007 issue of the Monthly Bulletin).

Chart A Growth in long-term debt securities issued by MFIs relative to other types of funding

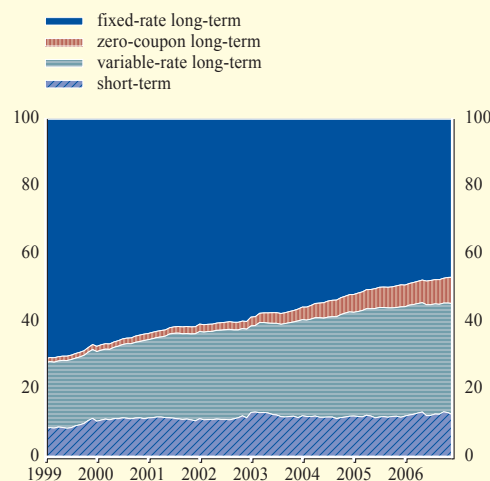
(percentage points)



Sources: ECB and ECB calculations.
 Note: The chart illustrates the differential between the growth in long-term debt securities issued by MFIs and the growth in the sum of deposits from non-MFI residents and short-term debt securities issued by MFIs. Data for Q1 2007 refer to January 2007.

Chart B Outstanding debt securities issued by MFIs

(percentage of total)



Source: ECB.

fastest growing funding source in most periods since 1992 (see Chart A). The relative decline in the role of deposits for bank funding may in part stem from households' increasing recourse to institutional investors to manage their savings in an environment of generally decreasing and low interest rates and increased private pension savings by an ageing population. Data from the financial accounts indicate that, of the financial assets held with financial intermediaries, the proportion held with MFIs (currency and deposits) has decreased by 4 percentage points since end-1997, while the shares held with mutual funds and with insurance corporations/pension funds (insurance technical reserves) have both increased (by 5 percentage points taken together). A larger share of financial investments in non-bank products – coupled with an expansion of banks' balance sheets within a context of profitable lending opportunities – may have led banks to diversify their funding sources by issuing long-term notes and bonds.

Third, banks – like any corporation – raise funds to finance mergers and acquisitions (M&A). While the introduction of the euro has had an important impact on the development of corporate bond markets in general³, it does not appear that the single currency has had a direct and permanent impact on the issuance of debt securities by MFIs.⁴

What types of debt securities do banks issue?

The overall growth rates of debt securities issued by MFIs may conceal differences in the types of debt securities that banks issue, using different combinations of maturity and rate fixation. Looking at the different types of debt securities – in particular fixed-rate long-term debt securities, variable-rate long-term debt securities and short-term debt securities – provides

3 European Commission (2002), "Bond market integration in the EU", The EU economy: 2002 review, European Economy No 6; de Bondt, G. J. (2007), "The role of the euro on the corporate bond markets in the euro area", Journal of Financial Transformation, Vol. 19, 14-19.
 4 De Bondt, G. J. and Lichtenberger, J. (2004), "Empirical estimates of the impact of the euro on the corporate bond market in the euro area", Applied Economics Letters, 11, 675-678.

additional insights into the factors underlying overall debt securities issuance. This breakdown is available as from January 1999 (and December 1998 for amounts outstanding).

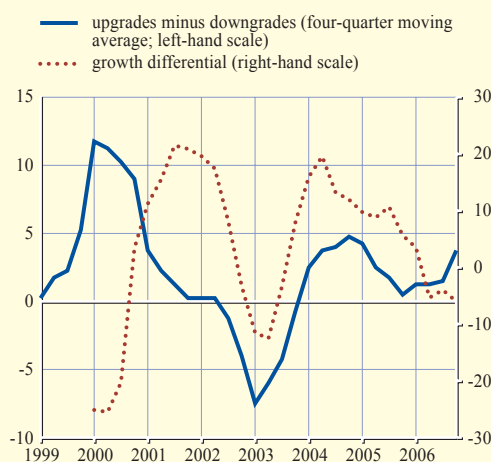
Banks issue long-term debt securities predominantly at long-term (i.e. fixed or zero-coupon) rates, which reflects the importance of covered bonds in several euro area countries. At the same time, the importance of long-term debt securities at short-term rates (i.e. at a variable rate) has increased considerably over the past few years. It also appears that banks may have sought to increase the matching of assets and liabilities on their balance sheets, possibly in preparation for the implementation of Basel II. Chart B shows that (i) there is a clear trend towards an increase in the importance of short-term rates, and (ii) that this increase is taking place at the expense of fixed-rate long-term debt securities, given that the share of short-term debt securities has remained broadly unchanged.

The progression of this two-pronged trend in bank funding may, in part, be related to swings in the creditworthiness of banks. Creditworthiness may affect the maturity at which banks raise funds at short-term rates. One notable feature is that variable-rate issuance tends to fall when issuance of short-term debt securities increases and vice versa. This negative relation may suggest that banks issue variable-rate long-term debt securities as substitutes for short-term debt securities. This practice allows banks to save on the transaction costs incurred when constantly rolling over short-term debt. The ability of banks to realise these savings may, however, depend on their creditworthiness, as longer maturities entail a higher duration of risk exposure for bond investors. In Chart C the increase in the importance of variable-rate long-term debt securities relative to short-term debt securities is reflected in a positive growth differential between the two throughout most of the period since 2000. The chart suggests that credit risk may indeed play a role, in the sense that variable-rate issuance by banks decelerates (in relation to short-term debt securities) when their creditworthiness deteriorates and vice versa.

All in all, it appears that capital markets are an important funding source for MFIs, complementing deposits. This is particularly the case in times of strong credit growth and increasing recourse to institutional investors to manage household savings. The issuance of variable-rate long-term debt securities by MFIs is likely to have been driven by increased matching of assets and liabilities – possibly in preparation for the implementation of Basel II – and by substitution for short-term debt securities, enabling banks to save on transaction costs when their creditworthiness is favourable.

Chart C Ratings upgrades minus downgrades for financial corporations in the euro area

(percentage points; number)



Sources: ECB and Moody's Credit Trends.

Note: The growth differential is calculated as the difference between the growth in variable-rate long-term debt securities issued by MFIs minus the growth in short-term debt securities issued by MFIs.