

## Senior unsecured bonds, covered bonds and asset backed securities in a portfolio approach to bank funding

This short paper addresses the medium term prospects of the capital market funding of European, in particular euro area, banks. It does so from a high level perspective, not going into any detail, thus neither fully taking into account the different situations, in terms of sovereign debt stress, prevailing in different jurisdictions of the euro area, nor distinguishing between euro and dollar funding.

The paper starts by recalling that a portfolio approach is as necessary in liability management as in asset management. Then it briefly reviews the environment, including the regulatory one, within which banks have to plan and achieve their funding. The paper then concludes that a necessary, but by no means sufficient, condition for banks to successfully rise to the challenge confronting them is to walk on three, fully functional legs: unsecured bonds, covered bonds and asset backed securities. The paper finally recalls some of the maintenance work which is needed to indeed make the three legs fully functional.

### A reference scheme: a portfolio approach to funding

For decades the portfolio approach has been the conceptual framework within which to set investment decisions. According to this approach, there are no "good" securities to purchase and "bad" securities to sell: investment decisions have to be taken with reference to a portfolio, calibrating its composition to achieve efficient risk-return combinations. This approach is, of course, as valid for liabilities as for assets. Indeed, both academic work and financial practice have progressed significantly towards an integrated Asset-Liability Management, as shown for instance in the paper by Elton and Gruber (1992). This notwithstanding, one often still finds ref-

erences to "better" or "worse" liabilities, as if their qualities could be gauged in isolation from the other liabilities and indeed from all the other components of the balance sheet.

The basic idea of a portfolio approach to funding is straightforward yet powerful: since the costs of different types of liabilities are not perfectly correlated, diversification can reduce the variability of overall funding cost for a given level of its average. The reasoning can be extended to availability, since some sources of funding are more robust to some shocks than others. The need of a portfolio approach to liabilities has been brought in sharper relief by the crisis that has engulfed advanced economies since 2007. As will be illustrated in the next section, some sources of funding, especially inter-bank, have just dried up, some others have only been available at higher prices, for lower

amounts and shorter maturities. Still others have weathered the storm with less damage. Overall, the banks which did not have a diversified liability structure suffered, in some cases acutely.

### The environment: past and prospects

In the current phase of the crisis, which finds its epicentre in the sovereign debt market of some European jurisdictions, insufficient diversification is taking a novel, and acute, form. A paper prepared under the aegis of the Committee on the Global Financial System<sup>2)</sup> lists four important channels through which sovereign risk affects banks funding: first, losses on holdings of government debt; second, reduced value of collateral consisting of domestic government securities; third, rating contagion, whereby the downgrade of a sovereign leads to a downgrade for banks located in that jurisdiction; fourth, weakening of the implicit or explicit government guarantee on bank liabilities. The effects of these channels are so important in the most stressed jurisdictions that banks which are there located end up with a totally lopsided liability structure, basically reduced to retail deposit and Eurosystem funding. The situation is, of course, very different in the other jurisdictions, representing by far the largest share of the euro area, where banks maintain a much more balanced liability structure.

The financial crisis heavily affected euro area markets for banks' debt financing: issuance of debt securities more than halved across all longer-term instruments, to around 100 billion euros per quarter. In the unsecured bank bond market, the issuance of (non-guaranteed) unsecured bank bonds reached a maximum in the first quarter of 2006 (around 180 billion euros) and then declined strongly, to around 40

*Francesco Papadia, Director General for Market Operations, European Central Bank<sup>1)</sup>, Frankfurt am Main*

*Auch wenn die Europäische Zentralbank für ihr breites Eingreifen als Intermediär während der Finanz- und nun auch während der Eurokrise nicht immer Beifall geerntet hat, so verteidigt der Autor dennoch das Vorgehen der Währungshüter. Gleichwohl müsse das Notenbank-Engagement so rasch wie möglich wieder zurückgeführt werden, damit sich die Märkte wieder selbst regeln können. Um in einem weiterhin turbulenten Finanzierungsumfeld bestehen zu können, müssen sich Banken seiner Ansicht nach auf drei handlungsfähige und funktionierende Bereiche stützen: Unsecured Bonds, Covered Bonds und Asset Backed Securities. Damit dies möglich ist, sieht er noch einigen Anpassungsbedarf – auch regulatorischen. (Red.)*

billion euros, in the last quarter of 2008. In parallel, guaranteed bank bonds became a significant part of new issued debt, peaking in the first quarter of 2009 at around 80 billion euros.

The effect of the crisis on asset backed securities (ABS) was dramatic: a vibrant market, amounting to approximately half a trillion euros per year, declined to close to nothing. Only more recently there are signs of renewed life in this market segment, when this is measured by private investors' interest.<sup>3)</sup> Indeed Barclays Capital (2011) even ventures that the time may soon come when the European ABS investor may be classified as merely a vulnerable instead of an endangered species.

The covered bond market suffered less during the crisis. In a way this is not surprising, as this is the only instrument offering two lines of defence to investors, the underlying assets and the signature of the banks, and protection against risk is particularly important when this is so prominent. However, also this instrument had its moments of weakness: in 2008 and early 2009, activity in both primary and secondary markets for covered bonds in the euro area was very subdued. Amid market uncertainty, there was a clear trend towards smaller deal sizes and shorter maturities. To re-vitalize the covered bond market, the ECB in 2009 launched the Covered Bond Purchase Programme, with positive effects on prices as well as quantities.

### Liquidity regulation as an answer

Also in terms of spreads, the crisis extracted its toll: from the, with hindsight, excessively low levels before the crisis, uncovered bond spreads reached 660 basis points in the first quarter of 2009 and covered bank bonds exceeded 100 basis points in some jurisdictions. Information on ABS spreads is less clear, in view of the lack of liquidity in the market. Still, a worsening can be detected there as well: just before the Lehman default, European RMBS traded at spreads near 100 basis points above Euribor, while in the second quarter of 2009 the spreads widened to a huge range of 350 to 800 basis points.

Much has been written about the crisis but we do not have as yet a comprehensive account of it. There is, however, one obvious component, which is a specific

manifestation of the insufficient diversification of liabilities mentioned above: the excessive reliance on short term funding. Perotti and Suarez<sup>4)</sup> have assimilated excessive short term funding to pollution accompanying industrial production: by borrowing excessively on a short term basis to fund long term assets, banks produce negative externalities, which should be corrected by regulation or by, so called, Pigovian taxes, those nice taxes which raise government revenue while addressing market imperfections instead of distorting incentives, as most taxes do.

The awareness that the crisis was aggravated by poor liquidity management gave the necessary impulse to introduce liquidity regulation in the Basel framework, thus providing a glaring missing component of overall bank regulation, which was until then concentrated on capital requirements.

Having achieved global liquidity regulation is by all means a positive development, however, further reflections are needed to optimize it. Two aspects in particular deserve special attention. First, the impact of regulation on the functioning of markets, to avoid unwarranted cliff effects between the markets for liquid assets and the other market segments. Second, how regulation will interact with the implementation of monetary policy. For instance, one may doubt that much progress would be achieved if the only consequence of regulation, and in particular of the so called liquidity coverage ratio, would be that banks would comply with it just exploiting the much broader variety of assets eligible for central bank refinancing than that of the assets which are liquid according to the regulation.

The fundamental fact remains that banks need to better control their maturity mismatch and, to avoid imposing on the real economy the risk of too short term horizon, this must be obtained more by increasing the maturity of liabilities than by reducing the maturity of assets.

### The actions of the European Central bank during the crisis

During the crisis, the European Central Bank like other central banks had to compensate, at least to some extent, the impaired functioning of the markets to avoid the even larger macroeconomic damages that would have derived from the reduced

availability and the increased cost of financial intermediation.

In a recent book (Papadia and Mercier 2011), the point was made that part of the intermediation that, before the crisis, was carried out on the books of the private sector moved, during the crisis, to the balance sheet of central banks. This applied initially to the interbank market but then extended, in the euro area, to two other market segments: the covered bond market and the sovereign bond of some jurisdictions.

To some extent, the paradigm of a smooth and integrated market, on which the implementation of monetary policy relies in advanced countries, was invalidated. With only slight exaggeration, one could say that financial markets in the more advanced countries took some of the characteristics of those in emerging economies. This has forced central banks, as mentioned above, to complement market intermediation with their own action. This action is still needed and European banks can count on the liquidity support of the European Central Bank, also leveraging on the abundant buffers of eligible paper that, with the exception of those in the most stressed jurisdictions, they hold. There is no doubt, however, that as justified as it still is, this supporting activity should be discontinued as soon as possible and the central bank should again leave to the market the intermediation function and the task of establishing appropriate interest rate premia between the different assets.

### Banks need to walk on three, fully functional legs

Banks are confronted with substantial funding needs both in the short and in the long run. Banks in a number of euro area countries have to roll over by end-2012 one third or more of their debt outstanding. In a McKinsey Report (2010) two, both daunting, estimates are reported for long term funding needs of banks in the whole of Europe until 2019: 2.3 trillion according to a static approach and 3.4 trillion according to a dynamic one.

All the arguments developed so far converge in supporting the conclusion that banks need to walk on three, fully functional legs: senior unsecured debt, covered

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**Verlagsleitung:** Uwe Cappel

**Anzeigenleitung:** Ralf Werner, Tel. (0 69) 97 08 33 - 43

**Anzeigendisposition:**

Anne Guckes, Tel. (0 69) 97 08 33 - 26,  
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bonds and ABS. Indeed, to summarize, liability diversification is a permanent necessity, made more acute by the crisis; developments in the sovereign bond market risk continue bearing negatively on the long term funding of European banks; liquidity regulation requires a deep change in liability management; central banks need to return as soon as possible to their limited task of controlling short term rates of interest; finally, banks funding needs are large.

From this point of view, the structural situation in the euro area is favourable as all three sources of funds are well represented. There are, however, challenges ahead and lessons to be learnt from the different resilience during the crisis<sup>5</sup>. Overall, despite some improvements, the most recent Financial Stability Review of the ECB (June 2011) says that "banks' funding risks have remained among the key vulnerabilities confronting the euro area banking sector".

Specifically in the covered bond segment, while the recent surge in issuance is a positive development, the primary and secondary market prices indicate a remarkable differentiation among issuers and countries. In addition, the increase in issuance raises the question of the optimal share of covered bonds in banks' total liabilities. The increase in covered bond funding leads to higher asset encumbrance. This reduces the protection of unsecured debt and depositors and, beyond a certain point, this becomes suboptimal. There is no evidence that this point has been reached. Still, both banks and regulators should devote the required attention to this issue.

### Positive signals

As mentioned above, the European ABS market starts showing positive signals, including the euro area. Indeed the European ABS market may reach 100 to 150 billion euros in distributed assets this year, up from 80 to 90 billion last year. This is not enough, however, given the needed level of funding. The improvements that are taking place reinforce, in any case, the lessons to be drawn from the crisis: demand is focussing on collateral exhibiting low risks and good performance and coming mainly from countries with low sovereign credit risk. Simplicity and transparency seem already to have entered the market, albeit in insufficient size.

Another area which is relevant is the clarity of the regulatory environment. Market participants suggest that there is a degree of uncertainty about this. This would make both issuers and investors unsure about the future market environment. The re-regulation of the industry has often been referred to by market participants as a piecemeal approach. Some commentators even say that without a holistic view, the recent regulatory incentives may in fact create an obstacle to the market's recovery.

It is very important here to keep a balanced approach. Even though some proposed regulations, such as the EC proposals on bail-in clauses and the net stable funding ratio, may increase costs, they may also increase the attractiveness of securitisation. An example in this direction is the central banks' requirement on loan level data on ABS. While increasing costs, this will have positive influences on the demand, thus contributing to a better resilience and addressing a quasi fatal flaw that appeared during the crisis.

### Maintenance work is needed

Even if the damage from the crisis was larger on some market segments than on others, all require maintenance, in some cases of the extraordinary kind. Indeed without a determined action to improve the structural functioning of all three market segments, there will be tensions in satisfying the demand for long term borrowing by banks, with inevitable negative repercussions on the real economy.

For unsecured bonds, the development of an appropriate post trade price transparency, along the line of the Trace procedure of the US, is a priority. The Financial Stability Forum report, entitled "Enhancing Market and Institutional Resilience" published in April 2008, recommended that securities market regulators work with market participants "to study the scope to set up a comprehensive system for post trade transparency of the prices and volumes traded in secondary markets for credit instruments". The Report also stated that "post trade information about prices and volumes in the secondary market is critical to the reinforcement of valuation practices for credit instruments and as supplementary information on the scale of risk transfers". In other words, post trade

price transparency would strongly support a return of market confidence. Overall, progress in this area has been insufficient and bolder measures than those agreed so far by the industry are needed.

As written above, the covered bond market suffered less during the crisis, still it is facing significant challenges. A double objective should be pursued here: a further enhancement of its quality standards and a deeper integration at European level. The labelling initiative developed by the European Covered Bond Council is a good basis for pursuing both objectives. A first achievement was the agreement on a covered bond definition that securities should fulfil to be labelled as covered bonds.

Moreover, the label should be enhanced by providing to the relevant parties statistics on volumes and prices on the primary and the secondary market and transparent access to other relevant information. Also the public consultation launched by the Covered Bond Investors Council of the International Capital Markets Association on a template fulfilling the information needs of covered bond investors is warmly welcomed. It would be ideal if the European Covered Bond Council and the Covered Bond Investors Council would join forces in order to achieve a meaningful transparency pillar of the prospective covered bond label.

### A strong "role model" for the ABS market

Maintenance work on asset backed securities will have to be more extended. The ABS market needs a strong "role model", helping to distinguish assets characterized by high standards of simplicity and transparency, which would eventually bring liquidity, from more bespoke kinds of securitization. Such a role model should bring back investor confidence in securitisation. To achieve these demanding goals, the role model may need to confine the pool to specific asset types, provide access to loan-by-loan data, require more comprehensive documentation and have precise rules and criteria on all parties involved in the transaction. It may also require specific features on the underlying assets such as the LTV, first lien, et cetera.

Overall, the role model should constitute a prime segment of the securitization mar-

ket. It would need "ins" and "outs" when looking at the whole spectra of securitization deals. In addition, the labelling as role model needs to be based on transparent, well documented and credible procedures. At the same time, any bureaucracy should be avoided.

The ABS industry should forcefully pursue initiatives to identify and designate simple, transparent and potentially liquid structures that would address the informational problem negatively affecting ABS, while alleviating the asymmetric information between issuers and investors. This will also contribute to improve internal evaluation processes within investor firms, including credit risk assessments and valuation methodologies, helping overcome the reputation problem that surrounds the ABS markets.

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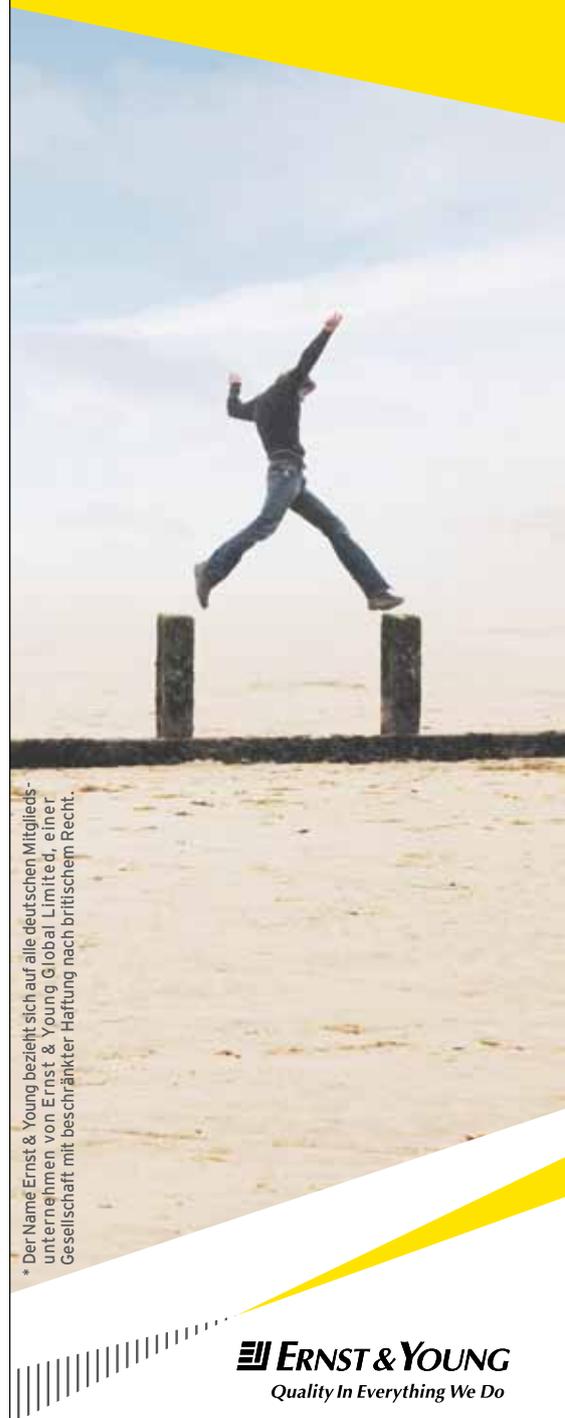
### Footnotes

- <sup>1)</sup> The views expressed are personal and do not necessarily represent those of the European Central Bank.
- <sup>2)</sup> See CGFS Papers, No 43.
- <sup>3)</sup> See European Central Bank (2011a); J.P. Morgan (2011a and 2011b), and Barclays Capital (2011).
- <sup>4)</sup> See Perotti and Suarez (2011).
- <sup>5)</sup> For an overview of the situation of bank funding in the euro area see Aberg et al (2011).

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