

## Box 8

Assessing the financial stability risks of a possible repricing in the market for subordinated bank bonds

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Prepared by Magnus Andersson, Benjamin Klaus and Cristian Perales

**The cost of subordinated bank debt in the euro area is low and may be susceptible to repricing.** Euro area bank bond yields and spreads have narrowed significantly since mid-2016, reaching levels last observed prior to the global financial crisis. The reductions have been particularly noticeable in the markets for subordinated bonds.<sup>57</sup> Against this background, this box first evaluates whether there are indications that the prices of these bonds may be vulnerable to a correction. It then assesses the potential financial implications stemming from a spread reversal in euro area subordinated bank bonds. The box focuses in particular on the holders of these

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<sup>57</sup> It should be noted that this trend is not specific for the banking sector. Euro area non-financial firms' financing costs have also developed favourably over the same period.

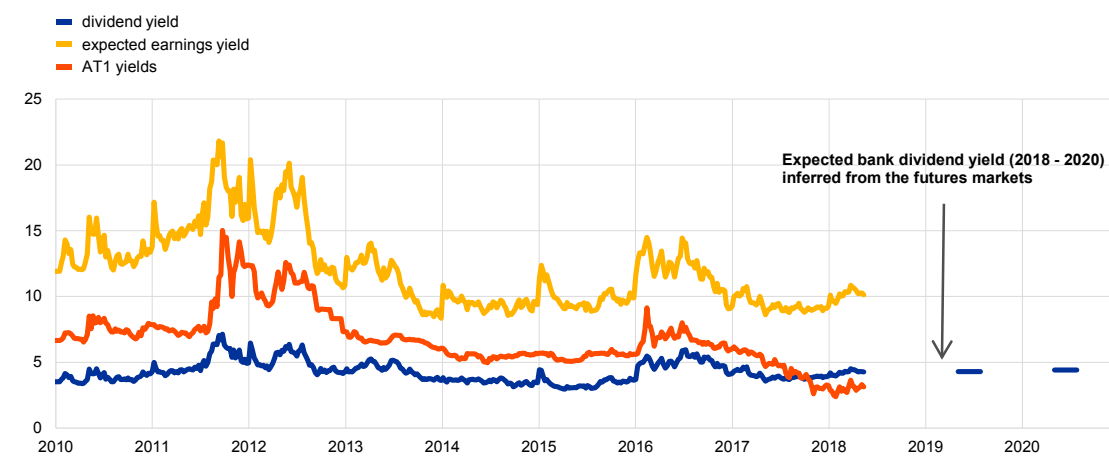
instruments and examines the sectors that may be particularly vulnerable to a turnaround in this market.

## Chart A

### Yields on subordinated bank debt decoupling from expected returns on bank equities

#### One-year-ahead dividend and earnings yield expectations and AT1 yields for euro area banks

(Jan. 2010 – May 2018; percentages per annum, median AT1 yield, index-average of earnings yield)



Sources: Bloomberg and ECB calculations.

Notes: The dividend and earnings yield series are based on the EURO STOXX bank index. The AT1 sample of banks consists of 21 large euro area banks.

**The price behaviour of euro area subordinated bank debt has decoupled from historical patterns.** Additional Tier 1 (AT1) bonds bear some similarities to bank equity owing to their hybrid features, and it would not be unreasonable to expect these similarities to be mirrored in the expected returns on AT1 debt and bank equity. Indeed, until mid-2016, yields on these instruments fluctuated broadly in tandem. Since then, however, yields on AT1 bonds have dropped sharply, thereby decoupling from the stable expected returns observed for bank equities (see **Chart A**).<sup>58</sup> This suggests that there is scope for a widening of spreads in AT1 bonds should the historical relationship be reinstated.<sup>59</sup> Furthermore, the sensitivity of AT1 spreads to changes in bank credit default swap (CDS) spreads (the latter being an indicator of bank default risk) has increased markedly in the past few years (see **Chart B**). This suggests that the introduction of the Bank Recovery and Resolution Directive (BRRD) may have clarified the level of risk attached to bank bonds and the relative riskiness of different instruments. At the same time, it points to sizeable upward risks to spreads on subordinated bank debt instruments should markets reassess the outlook for bank solvency.

<sup>58</sup> Some caution should be taken when interpreting dividend yields from a valuation perspective as banks (and non-financial corporations) tend to smooth their dividends out by varying the payout ratio.

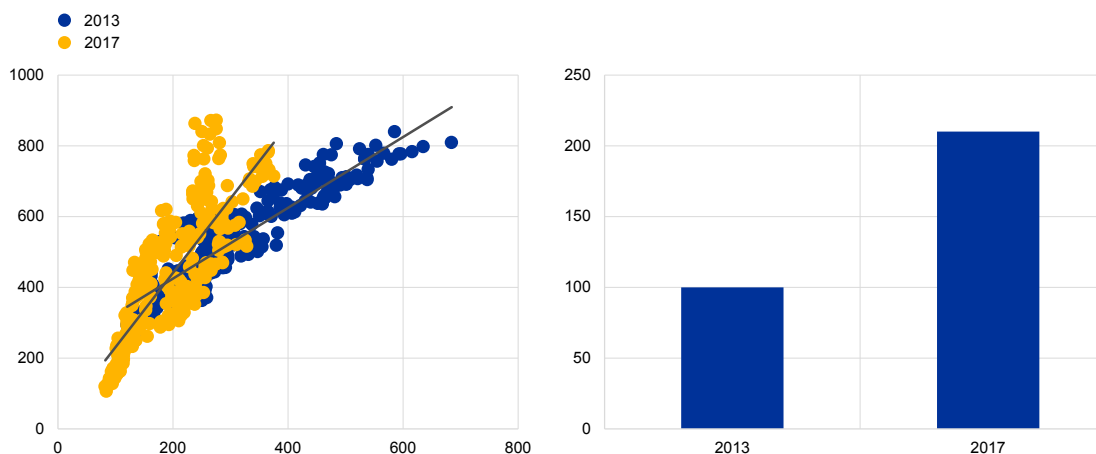
<sup>59</sup> When drawing inferences from this historical relationship, the significant differences in liquidity in the respective markets need to be borne in mind.

## Chart B

The pricing of subordinated bank debt is increasingly sensitive to default risk

AT1 bond spreads (y-axis) against CDS spreads (x-axis) (left panel) and impact of a 100 bp CDS spread shock on AT1 spreads (right panel)

(2013 and 2017; weekly data; basis points)



Sources: Bloomberg and ECB calculations.

Notes: The AT1 sample of banks consists of 21 large euro area banks. CDS spreads are for five-year subordinated instruments. The impact of a CDS spread shock on AT1 spreads as shown in the right panel reflects the relationship of both variables in each year as shown in the left panel.

### Euro area investors have increased their holdings of subordinated bonds issued by euro

**area banks, but with marked differences across sectors.** The market for subordinated debt has grown sharply since 2013<sup>60</sup> (see **Chart C** – left panel). Both supply and demand factors can explain this increase. From a bank perspective, these instruments have gained in importance owing to regulatory changes aimed at enhancing the resilience of the banking system, such as the minimum requirement for own funds and eligible liabilities (MREL). From an investor viewpoint, these instruments can provide an attractive vehicle to earn somewhat higher returns compared to other fixed-income assets in a low interest rate environment. Two significant dynamics across sectoral holdings can be observed over the same period (see **Chart C** – right panel). First, investment funds have increased their holdings of AT1 debt considerably and have become the main investors in these instruments, representing 62% of total euro area holdings in the second quarter of 2017, up from 15% in the fourth quarter of 2013. Second, the reliance of banks on household funding for subordinated debt has been reduced quite significantly since 2013. Nonetheless, the household sector still accounted for 22% of euro area holdings of Tier 2 (T2) instruments in the second quarter of 2017, down from 38% in the fourth quarter of 2013.

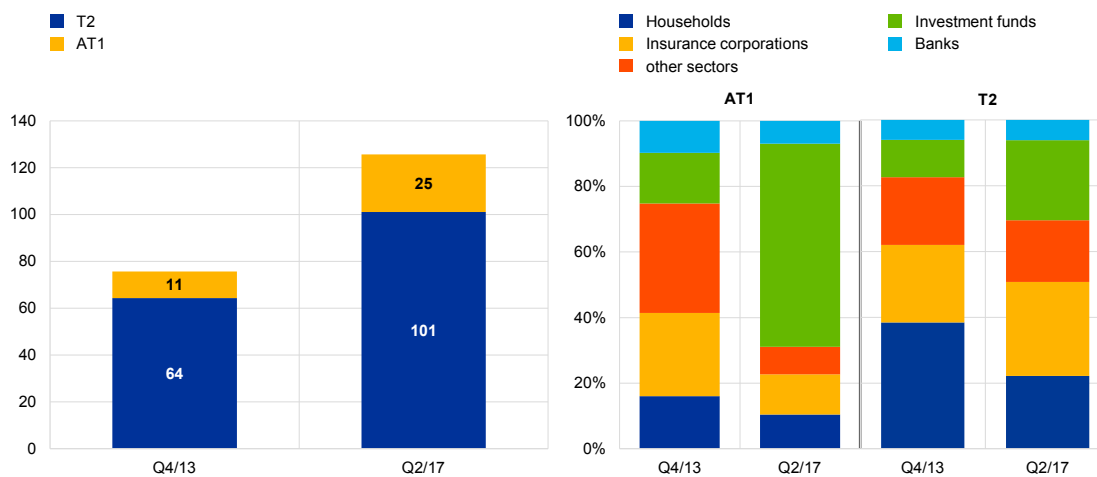
<sup>60</sup> The first reference period is the fourth quarter of 2013 as this is the first period for which the securities holdings statistics data are available. In addition, this period reflects the portfolio holdings of the different sectors ahead of the implementation of the BRRD.

## Chart C

Euro area investors have increased their holdings of subordinated bank debt and the investor base has shifted substantially towards investment funds

Euro area holdings of debt securities of significant banks by type of debt (left panel) and euro area holdings of debt securities of significant banks by holding sector and type of debt (right panel)

(Q4 2013 and Q2 2017; EUR billions and percentages)



Sources: Bloomberg, ECB and ECB calculations.

Notes: The sample consists of around 100 euro area significant banks. The large share of AT1 bonds held by “other sectors” in the fourth quarter of 2013 (right panel) was due to a government intervention in an ailing bank.

### The financial stability implications of a potential increase in spreads on euro area bank bonds partly depend on who the holders of these bonds are.

Although investment funds are professionally managed and should therefore have a sufficient understanding of the risks of investing in such assets, they are often “open-ended” funds which promise investors daily liquidity. Consequently, they could amplify price movements as a result of outflows if the bonds trigger losses. Furthermore, if the widening of bank bond spreads is associated with profound concerns about a bank’s solvency, large household exposures to T2 instruments might reduce the resolvability and loss-absorption capacity of the issuing bank owing to, for example, concerns about mis-selling and associated legal liabilities.<sup>61</sup> This may render a market solution and resolution more difficult. Finally, banks themselves have very low exposures to T2 instruments, and this limits the scope for direct contagion effects in such a scenario.

<sup>61</sup> See Opinion of the European Central Bank of 8 November 2017 on revisions to the Union crisis management framework (CON/2017/47).