ECB Amends Collateral Eligibility Rules: Implications for European Banks to Differ

On 8 February 2018, the ECB implemented previously announced changes to eligibility rules for its collateral framework. With senior subordinated bank debt soon to become ineligible, the market doesn't seem to have factored in the consequences yet. Scope believes, however, that the decision might affect issuers in Germany, the only jurisdiction with statutory subordination, more the others and could ultimately reduce liquidity in the senior bond market.

In December 2017, the European Central Bank (ECB) announced that unsecured debt issued by credit institutions or investment firms (or their closely linked entities) which are statutorily, structurally or contractually subordinated will soon be ineligible as collateral for the Eurosystem credit operations.[1]

The new guidelines were published on 8 February 2018[2], when the ECB updated the General Documentation. From 16 April, no new instruments in these categories will be added to the ECB list. Existing instruments which cease to fulfil the criteria will retain eligibility until the end of 2018. However, senior preferred unsecured debt issued by banks will continue to remain eligible.

The decision does not come as a surprise; statutorily subordinated bonds were meant to become ineligible on 1 January 2017, but the ECB granted a temporary waiver in October 2016. As a result, the status of both statutorily and structurally subordinated senior unsecured bonds did not change, though their usage limit was reduced to 2.5% from 5%.

Establishing a temporary framework, the ECB de facto aligned the treatment of senior bonds issued by German banks and those issued by holding companies (structurally subordinated), such as UK banks and some Belgian and Dutch banks. Contractually subordinated senior bonds (senior non-preferred) as in the case of banks in France and Spain, will remain ineligible, as these instruments are subordinated to other senior debt from the same issuer and therefore do not adhere in principle to the eligibility requirements.[3]

This has undeniably created a clear, albeit temporary, disparity in how bail-in-able senior bonds issued in different jurisdictions are treated: Banks with a holding company structure and banks in jurisdictions allowing contractual subordination could continue to issue OpCo senior or senior preferred debt and have them included in the list of eligible assets.

However, as all statutorily subordinated senior debt would have become ineligible, German issuers would have been affected disproportionately. In fact, the changes to Section 46f of the German Banking Act (KWG) and the German Resolution Mechanism Law (AbwMechG) modified the insolvency ranking in the Country and subordinated all outstanding plain vanilla senior unsecured bonds.

[1] Moreover, unsecured bank bonds issued by credit institutions established outside the European Union will also become ineligible.
[2] https://www.ecb.europa.eu/ecb/legal/pdf/ecb_2018_3_f_sign.pdf
[3] In order to be eligible as collateral for such operations, marketable assets must be debt instruments fulfilling the eligibility criteria laid down in Guideline (EU) 2015/510 (ECB/2014/60). In accordance with Article 64, eligible debt instruments will not give rise to rights to the principal and/or the interest that are subordinated to the rights of holders of other debt instruments of the same issuer.

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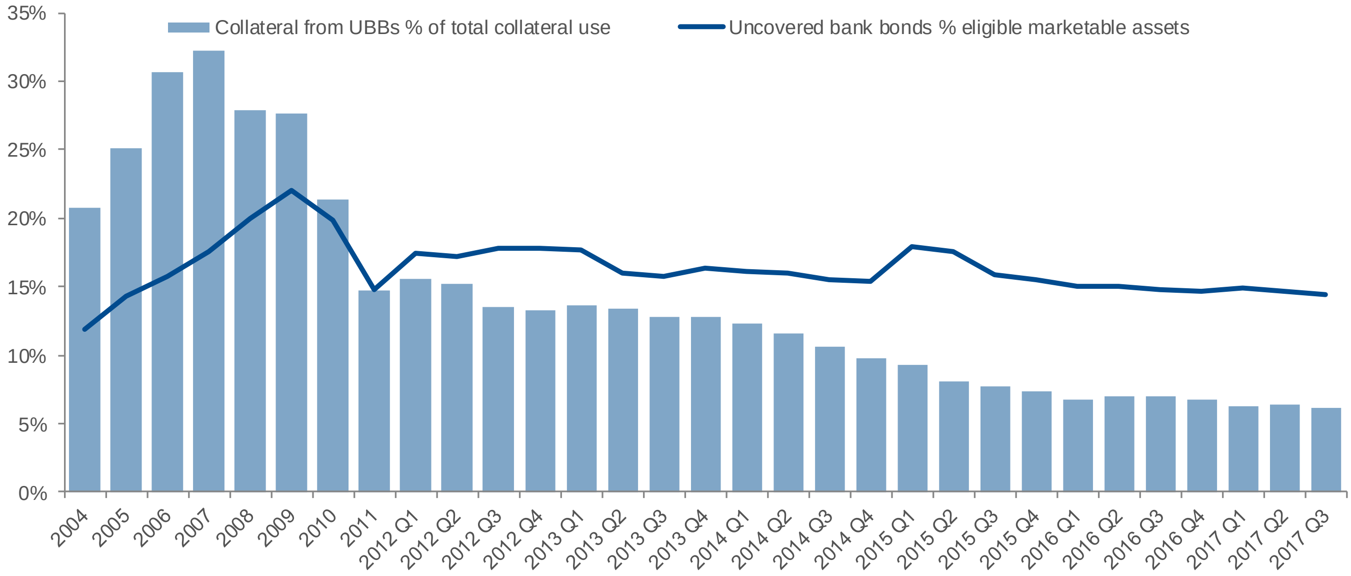
With transitional provisions soon to expire, and Germany not having opted for contractual subordination, all senior debt (except for a few preferred instruments) will soon become ineligible.

Albeit the share of unsecured (uncovered) bank bonds to total eligible marketable assets has declined only slightly in recent quarters, to 14% as of Q3 2017, these instruments are finding less use as collateral, only 5% as at Q3 2017. The trend can be, at least partially, explained by increasing haircuts and usage limits. However, asset classes as government bonds, ABS and covered bonds still make up for the great majority of the collateral posted.

Figure 1: Eligible assets and use of collateral, unsecured bank bonds



Collateral use after valuation and haircuts Source: ECB

We believe the ECB's decision to exclude all subordinated debt, regardless of seniority, is intended to avoid excessive concentration: any exposure to bail-inable securities, even temporarily, might weaken the ECB's role as a resolution authority in a default situation and impede its financial stability mandate.

As Bindseil, Corsi, Sahel and Visser point out[4] , credit-rating migration risk can be hedged through the use of haircuts but default risk cannot.

The decision could also be intended to decrease cross-exposures: credit institutions might be less prone to buy other lenders' bail-in-able debt as this will soon become ineligible as collateral. This would, in cases of stress, reduce the probability of a domino effect in the financial sector.

The effect of this disincentive is difficult to quantify, as there is no granular data on these bonds' use as collateral. However, a deep dive into the list of eligible securities sheds some light:

Holding companies

For the six banking groups with a holding company structure, HSBC Holdings, Barclays plc, Royal Bank of Scotland Group, Lloyds Banking Group, KBC Group and ING Group, the list of eligible HoldCo senior unsecured bonds is limited with EUR 33bn outstanding. We believe the use of this debt for repo operations is limited: investors in these securities are mostly insurance companies and investment management companies.

[4] http://www.ecb.europa.eu/pub/pdf/scpops/ecb.op189.en.pdf

Such groups also issue senior unsecured debt - which is and will remain eligible - from their operating subsidiaries: EUR 55bn of securities is currently eligible.

German banks

The ECB's securities holdings statistics[5] show that ca. 56% of the long-term debt issued by German monetary financial institutions (MFIs) is held by euro area MFIs.

As of 13 February 2018, the eligible unguaranteed unsecured bank bonds issued by German credit institutions include debt issued by 29 banking groups, for a total outstanding EUR 695bn.

While unclear how much is used as collateral, Bloomberg data shows that Dekabank and Deutsche Bank have the largest holdings of debt issued by the major German-bank issuers, which include the Landesbanken, DZ Bank, as well as Deutsche Bank and DekaBank themselves.

Indeed, domestic demand for German banks' debt has been historically strong, as shown by the Bundesbank's security holdings statistics series. Spreads on these securities have only marginally widened following the December announcement, to partially tighten again up to last week's decision. We believe the ECB decision could decrease liquidity in the German senior unsecured debt market and eventually reflect on prices, penalizing mostly smaller issuers.

[5] https://www.ecb.europa.eu/press/pr/date/2017/html/pr170202_1.en.html

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