

Box 8 Structural trends in euro bond markets

A broadening of alternative sources of bond finance can contribute to financial stability by enhancing the diversity of financing options available to agents in need of funds. For instance, the coexistence of corporate debt securities markets and bank financing is beneficial to the stability of corporate financing. Likewise, the development of markets for bonds that are tied in some way or another to mortgages – such as covered bonds and mortgage-backed securities – can help banks to match their assets and liabilities more successfully; they can also facilitate a wider dispersion of the interest rate risks that are associated with mortgage lending (see also Box 14 on the distribution and management of prepayment risk in European mortgage markets). Moreover, as liquidity in bond markets improves, issuers benefit from enhanced flexibility. This means that funding needs can be quickly and easily satisfied. This Box highlights some key structural developments that took place in the euro-denominated bond market between 1999 and 2003 and which are relevant for financial stability.

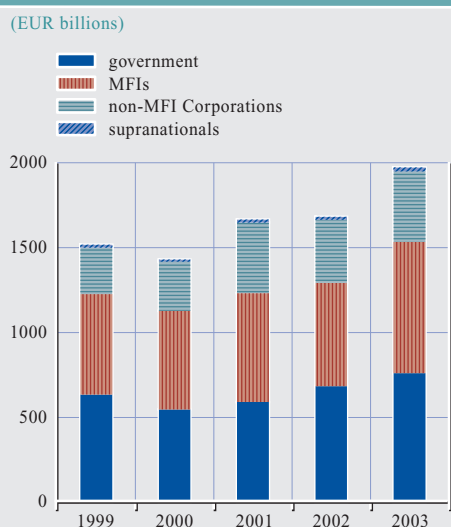
Chart B8.1 displays the structure of euro area bond markets in terms of issuers. The government bond market, which was the dominant segment in terms of issuance in 1999, has since then been broadly similar in size as issuance by financial institutions (other monetary financial institutions). After four years of broad stagnation, the issuance by financial institutions grew strongly in 2003. Within this segment, unsecured bonds still represent the highest issuance. However, a rather dynamic market segment is the euro covered bond market – a market for bonds issued by banks to fund mortgage loans and, in some countries, loans to the public sector. Furthermore, issuance of asset-backed securities, including mortgage-backed securities, is increasing. The euro corporate bond market (non-financial and non-monetary financial corporations), which constitutes the third largest issuer segment, grew significantly after the launching of the euro. The remaining issuer segment is issuance by supranationals.

Apart from growth in the extent to which private sector issuers have been tapping bond markets for funds, there has been a significant improvement in the liquidity of bond markets. Since 1999, the trend has been towards larger issue sizes. Whereas in 1999 the share of issues over EUR 2 billion was around 30%, it grew to slightly more than 40% in 2003 (see Chart B8.2).

From a financial stability perspective, there have been some notable developments in the euro covered bond and corporate bond markets. Chart B8.3 shows the geographic composition of issuers in the euro covered bond market.¹ Overall, the euro covered bond market amounted to around EUR 1.3 trillion at the end of 2003. Around EUR 0.9 trillion of these bonds were covered by loans to the public sector, with more than 90% issued by German banks. Around EUR 0.4

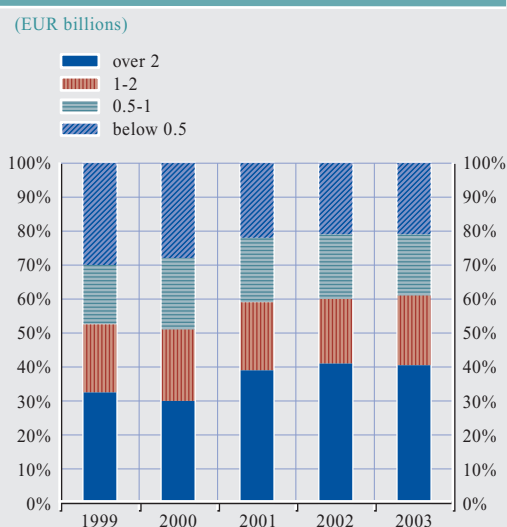
1 It should be noted that while the chart provides an approximate indication of the relative market sizes, exactly comparable figures are not available. Moreover, the new issuance of a large covered bond by a single bank, as demonstrated in 2003, can influence the percentages.

Chart B8.1 Gross issuance by issuers in the euro-denominated bond market



Source: ECB.

Chart B8.2 Gross issuance by issue size in the euro-denominated bond market



Source: European Commission.

trillion bonds were covered by mortgage loans.² The issuance of covered bonds declined between 1999 and 2001, mainly due to a sharp reduction in the issuance of German Pfandbriefe. A recovery subsequently got underway as issuance of covered bonds in other European countries began to increase. Much of this was due to product innovation, such as the development of structured covered bonds, and to enhancements to national covered bond legislation. Moreover, even in the absence of covered bond legislation, the issuance of euro-denominated covered bonds was stepped up in the UK – under UK common law and private contract law – in 2003 and 2004. From a financial stability perspective, covered bonds provide a means for mortgage banks to fund, via the capital market, long-term fixed-rate mortgage loans, and, in general, allow a better matching of banks' assets and liabilities when compared to funding via retail deposits.

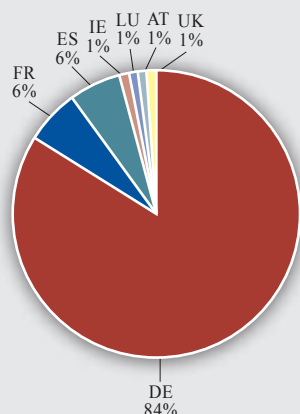
The euro corporate bond market witnessed exceptional growth after 1999 (see Chart B8.4).³ While in 1999 this market had been predominantly open to the highest quality credits, the market broadened to facilitate the funding needs of riskier issuers. In general, a maturing euro corporate bond market adds to the diversification of corporate financing. At times, bank lending does however prove to be the stabilising factor in corporate financing. As such, it is beneficial to the stability of corporate financing if both corporate debt securities markets and bank financing are available.⁴ Likewise, the more comparable in size the different sources of financing are, the greater the benefits from having multiple avenues of corporate finance and the larger the number of companies that have access to both bank financing and debt securities markets. In this respect, the euro corporate bond market may still have to expand further.

2 By comparison, Danish mortgage bonds are outstanding for an amount equivalent to around EUR 0.2 trillion.

3 See Baele et al. (2004), "Measuring Financial Integration in the Euro Area", ECB Occasional Paper Series, No 14. It should be noted that the chart displays amounts outstanding only of investment-grade corporate bonds with a minimum issue size of EUR 100 million, and which are included in the Merrill Lynch EMU Corporate Bond Index.

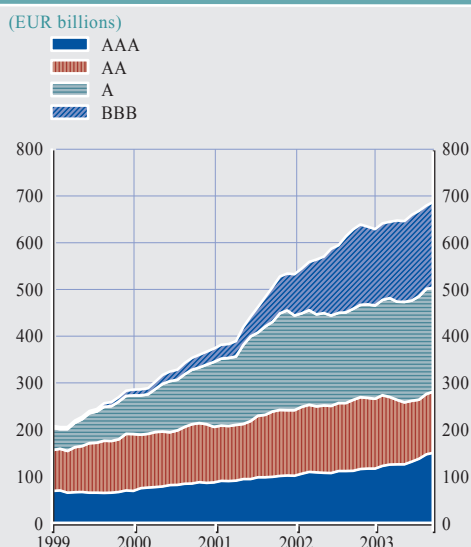
4 See Davis, E. P. (2001), "Multiple Avenues of Intermediation, Corporate Finance and Financial Stability", IMF Working Paper, No 01/115.

Chart B8.3 The euro covered bond market



Sources: European Mortgage Federation and ECB calculations.

Chart B8.4 The euro corporate bond market



Source: ECB.