THE EURO AREA BANKING SECTOR AND MREL: A CHALLENGE FOR MEDIUM-SIZED BANKS?

Lucía Ibáñez, Miguel Kruse, María Pollos, José María Serena and Miquel Tarí

BANCO DE ESPAÑA

https://doi.org/10.53479/37655

The authors belong to the Directorate General Financial Stability, Regulation and Resolution and are grateful for the comments received from Irene Gómez, Sara Larraga, Elisa Llorente, Francisco González, Sergio Mayordomo and an anonymous referee. E-mail address for comments: maria[dot]pollos[at]bde[dot]es.

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Abstract

The introduction of the Minimum Requirement for Own Funds and Eligible Liabilities has meant that euro area banks – including some smaller banks that had no previous experience on the debt markets – have had to issue more debt. At end-October 2023, large issuers still accounted for the bulk of issuance, but the number of issuances made by medium-sized banks had increased. These banks can achieve a lower issuance cost than their larger peers, by placing bonds that have a lower level of subordination and a shorter maturity, and thanks to their good financial ratios. However, certain challenges remain, such as their poorer credit ratings and the uncertainty regarding market capacity to absorb a larger volume of issuance by medium-sized banks.

Keywords: Minimum Requirement for Own Funds and Eligible Liabilities (MREL), Bank Recovery and Resolution Directive, unsecured debt, banking sector, subordination, subordinated debt.

1 Introduction

The funding structure of a large proportion of European – and Spanish – banks has historically been characterised by a high share of deposits and a lower share of wholesale funding. This is still true for Spanish banks, despite the increase in wholesale funding observed in the run-up to the global financial crisis, when unsecured debt issuances amounted to around 10% of the banking sector's balance sheet (Martín-Oliver, 2013). In addition, unsecured debt was used mostly by larger banks, which were better known to investors and more familiar with the debt issuance process. For example, at end-2015, of the Spanish significant institutions, all those with a balance sheet over €100 billion had issued debt instruments, whereas banks with smaller balance sheets were less active. In consequence, the ratio of unsecured marketable debt to total liabilities was much higher at the larger banks.

It was at that juncture, when access to debt markets was uneven, that the loss absorption requirement – the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) – was established across the European Union (EU). MREL is applicable to all EU banks, unlike Total Loss-Absorbing Capacity (TLAC) which is applicable only to global systemically important institutions (G-SIIs). The MREL requirements were introduced in response to banking crises which, in the absence of an adequate and uniform crisis management framework, tended to be managed through taxpayer-funded bail-outs. Under the MREL regulations, banks were allowed to meet these requirements with their own funds and liabilities with maturity of more than one year, including marketable debt instruments and other eligible liabilities, provided that they complied with a number of conditions deemed necessary for loss absorption and bank recapitalisation in the event of a crisis.

Overall, this crisis management strategy was expected to generate a series of benefits, although it was recognised that it could also pose some challenges (Avgouleas and Goodhart, 2014). Notable among the expected benefits would be the build-up of funds for loss absorption and recapitalisation, and enhancement of market discipline on banks. Various authors have documented increases in the price of loss-absorbing instruments relative to those of other comparable instruments (Lewrick, Serena and Turner, 2019; Cutura, 2021; Schäfer, Schnabel and Di Mauro, 2016; Koetter, Krause, Sfrappini and Tonzer, 2022). This suggests that the loss-absorption framework is credible.

The main difficulties arising from the introduction of the MREL framework included the potential costs for the banking sector of generating loss-absorbing capacity (Koetter and Nguyen, 2023). This was especially significant for banks that had no previous experience in the issuance of debt instruments (Restoy, 2016). Indeed, the banking sector overall recorded high issuance needs, estimated at around €117 billion, including €47 billion in subordinated debt (Laboureix, 2017). These difficulties were probably less severe for large banks, as they had greater experience in debt markets and it was easier for them to meet the fixed costs associated with debt issuance. By contrast, the challenges were more acute for smaller banks, which might face constraints on market access or, if they were able to access the market, investor demands for higher returns.

This article examines euro area banks' issuance of potentially MREL eligible debt instruments in the period from October 2018 to October 2023. This is a highly topical issue given that, since January 2024, compliance with MREL requirements has been fully binding following the end of the initial transitional period.[1] The analysis draws on a granular and comprehensive database, constructed by combining the Centralised Securities Database (CSDB) of the European Central Bank (ECB) and data from private providers.[2] This database makes it possible to examine both the volume and the cost of issues, and also, when combined with banks' financial reporting, differences by bank size. It thus complements the information on compliance with MREL requirements provided by the Single Resolution Board (SRB) (Single Resolution Board, 2024) or the European Banking Authority (EBA) (European Banking Authority, 2023) and other analyses of banks' issuance and cost of funding (SRB, 2023a; European Commission, 2023; Klaus and Sotomayor, 2018). Our analysis is limited to significant institutions (SIs) according to the size criterion, that is, those with a balance sheet over €30 billion. A distinction is drawn between the largest institutions, comprising G-SIIs, top-tier banks (those with assets over €100 billion), other Pillar 1 banks (also called fished-out banks)[3] which, selected by the resolution authorities, have subordination requirements for the purposes of compliance with MREL equivalent to top-tier banks, and all other banks with balance sheets of between €30 billion and €100 billion, hereafter referred to as "medium-sized banks".

1 With only a few exceptions based on Article12k(1) and 12k(7) of Regulation (EU) No 806/2014 of the European Parliament and of the Council (the Single Resolution Mechanism Regulation (SRMR)).

2 Eligibility ultimately depends on verification that the instrument in question meets all the eligibility criteria.

3 Banks designated by the relevant resolution authority that are not subject to Article 92a of Regulation (EU) No 575/2013 and that are part of a resolution group whose total assets are lower than €100 billion, and which the relevant resolution authority has assessed as reasonably likely to pose a systemic risk in the event of failure, in accordance with Article 45c(6) of Directive 2014/59/EU.

The results show that, for the period analysed (October 2018 to October 2023), most of the MREL eligible debt issuances were made by large banks, with no increase in the share of issuances by medium-sized banks. However, the number of medium-sized banks issuing debt instruments did increase. Analysis of the cost of issuance shows that, in the euro area overall, medium-sized banks pay a lower coupon on their fixed-rate issuances than large banks, even controlling for financial conditions at the time of issuance. The lower issuance cost for medium-sized banks is partly because their debt instruments have shorter maturities and a lower level of subordination. It is also because medium-sized banks that are able to issue such instruments on the market have better capital, liquidity and cost-to-income ratios and this, according to econometric estimates, helps to moderate their cost of funding. These results differ somewhat across jurisdictions. In Spain, for instance, the cost of funding for medium-sized banks is higher than for large banks. This can only be partially explained by their poorer cost-to-income ratio and their similar capital level compared with large banks. It may be associated with the relatively lower level of development of the Spanish market, which may restrict the investor base for medium-sized banks, as access to international markets is typically limited to large entities.

Nevertheless, the conclusions drawn in this article should be considered with a certain degree of caution, for several reasons. First, no account is taken of the fixed costs incurred by banks throughout the issuance process, which may be expected to be more difficult to absorb for medium-sized banks than for larger ones. Second, the analysis only covers the cost of issuance of fixed-rate instruments, leaving out a significant portion of MREL-eligible bonds.[4] Third, there are significant caveats that prevent an analysis of how the cost of issuance has evolved over time, given that during most of the period under review interest rates were low, and in such a setting the differences in this cost are smaller than in a high interest rate scenario. Lastly, the results could differ if banks with a balance sheet of less than €30 billion (the balance sheet size threshold used) were analysed, as they are more likely to face greater difficulties in accessing unsecured debt markets.

The remainder of the article is structured as follows. Section 2 presents the MREL framework in simplified terms. Section 3 describes the data used in the analysis. Section 4 presents a comparative analysis of market access for large and medium-sized banks. Lastly, Section 5 sets out the conclusions.

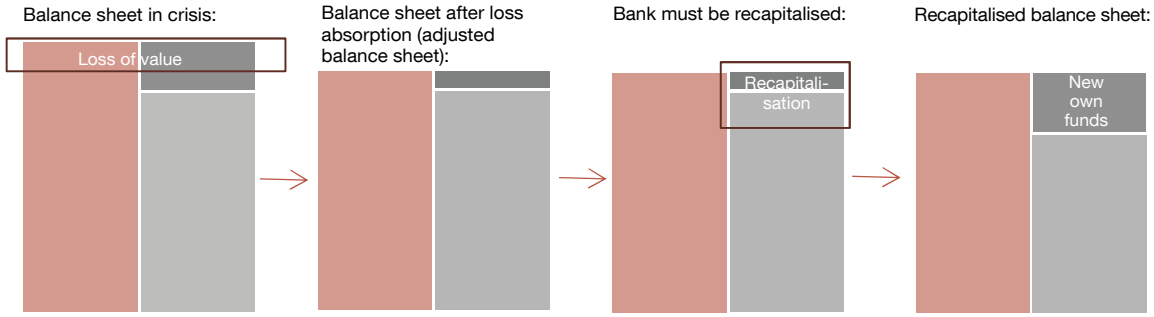
2 The MREL framework[5]

The EU resolution framework, laid down in Directive 2014/59/EU (the Bank Recovery and Resolution Directive, (BRRD)), requires that banks maintain a sufficient amount of own funds

4 Owing to data availability and given that fixed-rate instruments account for 63% of the debt instruments issued for which information on coupon value is available (5,659 bonds). The remainder are flexible-rate bonds (floating-coupon and interest rate-linked instruments) (27%), zero-coupon bonds (6%) and others (stepped-coupon and inflation-linked instruments) (3%). Fixed-rate instruments make up 62% of those issued by large banks, and 70% of those issued by medium-sized banks.

5 The framework described here refers to the external MREL to be met by the resolution entity. The specificities of the internal MREL to be met by subsidiaries, if any, are not included (Article12g of the SRMR). Neither is the methodology for the calibration of MREL for banks with a multiple point-of-entry approach, nor the requirement for banks for which the resolution authority envisages winding up under normal insolvency proceedings as a preferred tool over resolution proceedings.

Figure 1
Simplified process of loss absorption and recapitalisation



SOURCE: Devised by authors.

and debt that can absorb losses and can be converted into equity in order to recapitalise the bank should it fail.[6] The aim being that, in the event of a banking crisis that endangers financial stability, rather than public funds being injected, the bank's shareholders and creditors should be the first to bear losses during a bank resolution, so that the bank may return to business as usual (either by itself or after having been acquired by a third party). This requirement, MREL, is set by the resolution authority and is independent of the capital requirements[7] to which banks are also subject and which are determined by the supervisory authority under the solvency framework (for more details on the regulatory framework, see Annex 1).

MREL, regulated in Article 12 of the SRMR, is calibrated on a consolidated basis for the resolution group, in terms of: the resolution group's weighted assets (MREL-TREA, where TREA (Total Risk Exposure Amount) is the risk exposure obtained by applying the capital requirement methodology, i.e. synonymous with risk-weighted assets (RWAs)); and the denominator of the leverage ratio (MREL-LRE (Leverage Ratio Exposure), defined in the solvency framework). Banks must comply with both requirements – MREL-TREA and MREL-LRE – simultaneously.

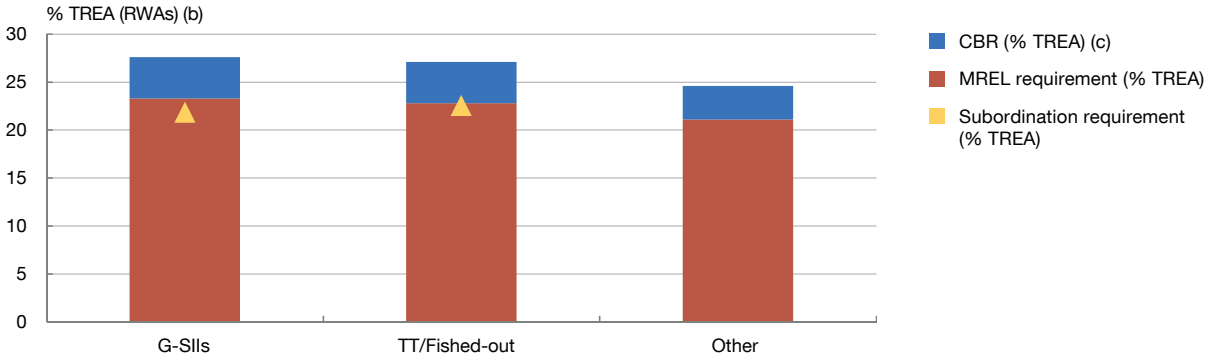
MREL is based on internal loss absorption and subsequent recapitalisation (see Figure 1), so its calibration comprises two components. The first is the loss absorption amount (LAA), which coincides with the capital decision set by the supervisor; thus it is assumed that the losses that a bank would absorb in a crisis are those defined in the solvency framework. The second component is the recapitalisation amount (RCA), which is calculated to determine the capital that a bank would need following the absorption of losses. The calculation of the RCA also stems from the bank's capital decision, which is applied to the bank's balance sheet total, less a series of downward adjustments that can be expected to have a greater impact on medium-sized banks, given that their preferred resolution tool is usually the sale of business (see Annex 1).

6 Pursuant to Article 32 of the BRRD, a bank must be considered as failing or likely to fail when it infringes or is likely in the near future to infringe the requirements for continuing authorisation, when its assets are or are likely in the near future to be less than its liabilities, when it is or is likely in the near future to be unable to pay its debts as they fall due, or when it requires extraordinary public financial support.

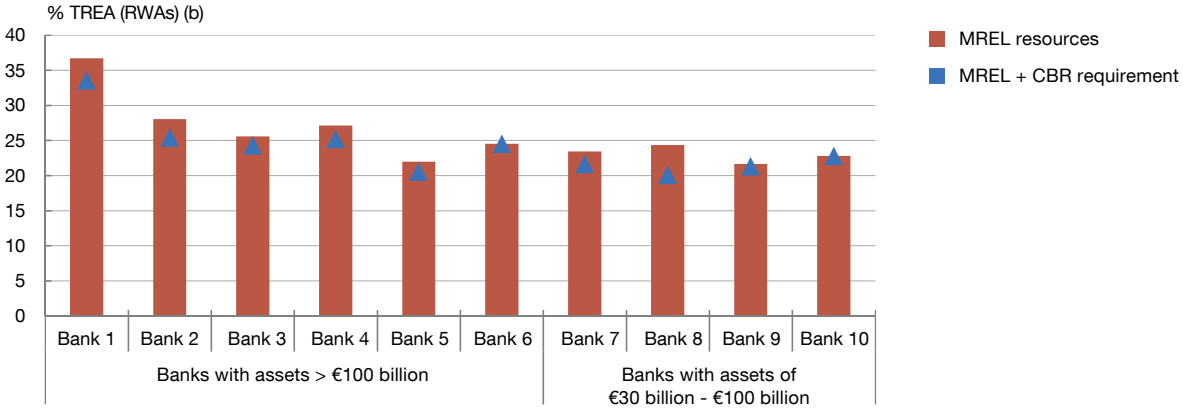
7 European Commission Regulation (EU) No 575/2013 (Capital Requirements Regulation (CRR)).

Chart 1
MREL in the EU and in Spain

1.a MREL requirement for G-SIIs, top-tier/fished-out and other banks (a)



1.b MREL requirement and resources in Spain (ten largest banks)



SOURCES: EBA MREL Dashboard Q2 2023 (Chart 1.a). Banco de España calculations and data reported by banks (Templates M_02.00) for 2023 Q2 (Chart 1.b).

a The chart shows the RWA-weighted averages for each class: G-SIIs; top-tier banks (those with total assets measured for the resolution group over €100 billion); and "Other", which are all banks other than those in the two previous classes, including those with assets under €30 billion for which the resolution authority has set resolution as the preferred strategy rather than winding up under normal insolvency proceedings. These "Other" banks are not subject to the subordination requirement, save for exceptions.
b TREA: Total Risk Exposure Amount.
c CBR: Combined Buffer Requirement. The CBR must be met with CET1 additional to that used to comply with MREL-TREA.

In consequence, in the EU overall the MREL requirements amount to around 23% of RWAs,[8] with medium-sized banks being subject to slightly lower MREL requirements than large banks (see Chart 1.a). The pattern for Spain is similar (see Chart 1.b).

To meet their external MREL banks may use their resolution group's own funds, calculated using the solvency framework methodology. They may also use liabilities, whether or not marketable instruments, provided that they are eligible liabilities[9] and that they meet the criteria laid down in the regulations.[10] In order to be eligible, the liabilities must be issued

8 Calculated as the average weighted by the TREA of each bank. Where a bank's MREL-LRE requirement is higher than its MREL-TREA requirement, MREL-LRE converted to the percentage of TREA is used to calculate the overall requirement.
9 Article 72a(2) of the CRR.
10 Article 12c of the SRMR.

directly by the bank[11] to counterparties outside the resolution group, they must not be directly or indirectly funded by the bank and they must have a residual maturity of more than one year. Moreover, they must include a contractual clause that recognises the power of the resolution authority to make a write-down or conversion, they must not be subject to netting agreements and they must not have contractual clauses allowing early redemption or repayment by the holder or the issuer that make the residual maturity less than one year, or accelerated future payments of interest or principal, or changes in the interest or principal payments according to the bank's credit quality. Nor may they be derivatives or collateralised (secured) liabilities. Accordingly, the following are MREL eligible instruments (provided they comply with the above-mentioned characteristics): CET1, AT1, Tier 2, subordinated liabilities,[12] senior non-preferred debt,[13] senior (unsecured) debt, non-covered non-preferred deposits[14] and structured notes.[15]

In Spain, the type of funds used to comply with MREL differs between large and medium-sized banks. Compared with large banks, medium-sized banks tend to rely more on own funds (see Chart 2.a); indeed, own funds account for around 82% of the funds used by medium-sized banks to meet their MREL requirements, compared with 65% for large banks. It should be noted that in order to comply with the solvency requirements, which, as a general rule, will coincide with the LAA component of MREL, banks must use the funds required by the solvency regulations, i.e. CET1, AT1 and Tier 2. The breakdown of eligible liabilities (see Chart 2.b) shows that medium-sized banks use more senior liabilities than large banks.

These features of the composition of MREL for medium-sized banks may be explained by two factors. First, the difficulties medium-sized banks face accessing debt markets may explain why they use own funds more than debt to meet their MREL. This issue is explored in Section 4 below. Second, the greater weight of senior debt at medium-sized banks may reflect the fact that they are not subject to the subordination requirement applicable to the largest banks (G-SIIs, top-tier and other Pillar 1 banks), which must meet a portion of their MREL with subordinated liabilities, that is, liabilities ranking below those that could be excluded from loss

11 Or exceptionally by subsidiaries of the resolution group, in accordance with Article12c(3) of the SRMR.

12 These are subordinated liabilities that are not recognised as own funds, for instance, subordinated instruments that are not AT1 or Tier 2 eligible but that are MREL eligible, or instruments that are Tier 2 eligible but have a maturity of less than five years (and more than one year to be MREL eligible).

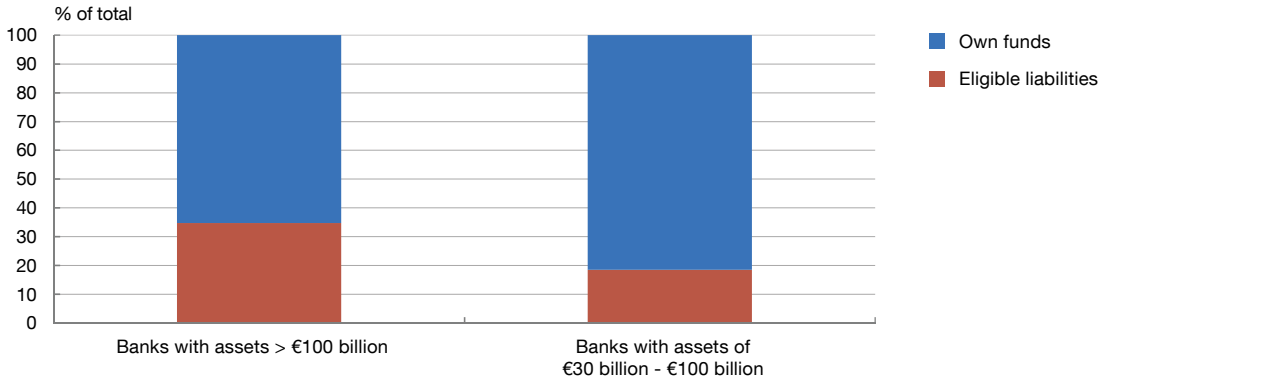
13 A credit category introduced in Spain by the 14th Additional Provision of Law 11/2015 of 18 June 2015 on the recovery and resolution of credit institutions and investment firms, in compliance with Directive (EU) 2017/2399 of the European Parliament and of the Council. These are debt instruments that meet a number of conditions, ranking above subordinated claims but below all other ordinary claims.

14 These are deposits other than deposits of micro, small and medium-sized enterprises and natural persons, provided they meet the eligibility criteria established in the regulation (for instance, they must have residual maturity of more than one year and must not allow early repayments).

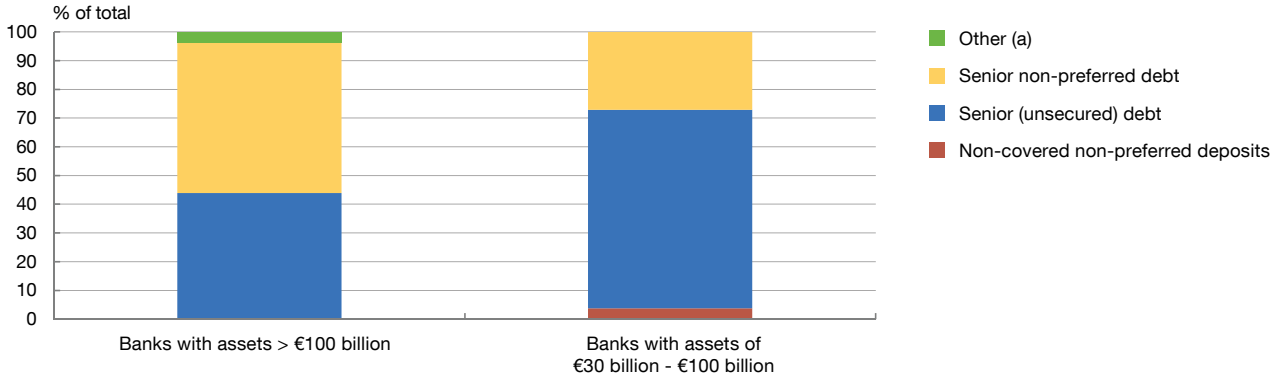
15 Structured notes are MREL eligible if the conditions set out in the SRB's MREL policy are met: if the principal amount of the liability relating to the debt instrument is known at the time of issuance, is fixed or increasing and is not affected by an embedded derivative and can be valued on a daily basis by reference to a liquid and active market for an equivalent instrument without credit risk, in accordance with Articles 104 and 105 of the CRR; or the debt instrument includes a contractual term specifying that the value of the claim in the event of insolvency and resolution of the issuer is fixed or increasing and is not higher than the amount of the liability initially paid. The amount of the eligible liability, if any, shall be equal to the principal or to the fixed or increasing amount referred to in the first of the above conditions.

Chart 2
MREL composition, by balance sheet size: Spain

2.a Composition of MREL resources of large and medium-sized banks



2.b Composition of MREL eligible liabilities (not own funds) of large and medium-sized banks



SOURCE: Banco de España calculations drawing on Templates M_02.00, M_03.00 and M_04.00 for 2022 Q4.

a "Other" are subordinated liabilities (not recognised as own funds).

absorption as they are protected by regulation.[16] Medium-sized banks are not subject to subordination requirements, although there are exceptions to this rule, for example, if there is deemed to be a high risk of creditors being worse off.[17]

3 Data

To analyse banks' market access we use a database constructed by combining CSDB data and additional information from private data providers, such as LSEG Eikon and S&P Capital IQ Pro.

16 By default, the subordination requirement for large banks is set at 8% of their total liabilities and own funds. This threshold may be raised (if the resolution authority determines that impediments to resolvability exist) or reduced (depending on the analysis of no creditor worse off (NCWO) risk, i.e. the risk that creditors may face greater losses as the result of a bank resolution procedure than had the bank entered into normal insolvency proceedings).

17 The EU resolution framework provides appropriate safeguards to ensure that the affected shareholders and creditors will not be worse off in resolution than in the event that the bank had entered into normal insolvency proceedings (the no creditor worse off (NCWO) principle).

The CSDB is compiled by the ECB as part of the European System of Central Banks, which also includes the national central banks of all EU Member States regardless of whether or not they have adopted the euro as their currency. The CSDB provides data on all capital, hybrid and debt instruments issued by EU residents. It has been reported monthly since October 2018, and we accessed data up to October 2023. It includes a broad range of attributes on the type of instruments issued, in addition to some information on the issuers. The CSDB covers all issuances across the Eurosystem.[18] To perform the analysis, the CSDB data are enriched with the issuance cost and other variables for the instruments drawn from LSEG Eikon.

Next we applied a series of filters to the instruments accessible in the CSDB to identify MREL eligible debt instruments issued by significant institutions. First, we identified instruments issued by banks and deposit institutions.[19] Second, we excluded issues of ordinary shares and certain instruments that are not eligible for MREL as they are secured funding instruments. Third, we disregarded instruments with an original maturity of less than one year. To ensure data quality, we performed manual checks on the sample of instruments resulting from applying these filters to Spanish banks, concluding that there were no omissions or incorrect classifications. Fourth, we disregarded bonds issued by less significant institutions (those with total assets under €30 billion).

Lastly, we disregarded instruments with an original maturity of less than two years, given that the issuances intended to cover MREL requirements usually have longer maturities to avoid refinancing risk (we take into account that, in order to be eligible, they must have a residual maturity of at least one year), as well as instruments with a volume of less than €25 million, owing to their lower economic relevance.

Overall, the sample examined is composed of 6,635 unsecured instruments, comprising 5,730 bonds issued by 44 large banks and 905 bonds issued by 50 medium-sized banks (see Charts 3.a and 3.b). The bonds are mostly euro-denominated (69%), but also include bonds denominated in other currencies, notably the US dollar (17%). To analyse the cost, this article focuses on the 3,580 unsecured fixed-rate instruments issued by large banks (2,992 instruments) and medium-sized banks (588 instruments), of which 67% are denominated in euro and 14% in US dollars.

In performing the analyses, we constructed a synthetic bond by aggregating the volume of all issuances from the same issuer, provided that they have the same maturity, level of subordination and year of issuance, irrespective of whether they were issued domestically or internationally.

The database was supplemented with financial information on issuers obtained from S&P Capital IQ Pro. Specifically, we examined the following financial ratios:

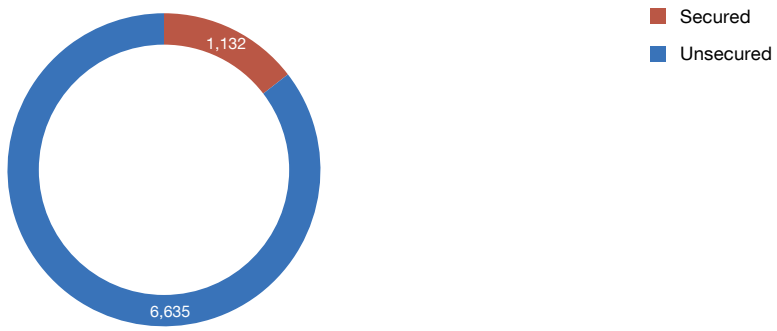
18 The CSDB also provides incomplete information on issuances outside the euro area, including those made by foreign subsidiaries of euro area banks. Given the focus on euro area resident issuers, these are excluded from this analysis.

19 We disregarded those where the issuer's sub-sector was not codes 122, 12202 or 12203.

Chart 3

Breakdown of debt instruments issued by the euro area banking sector (a)

3.a Number of debt instruments: secured vs. unsecured



3.b Number of unsecured debt instruments, by level of subordination

SOURCES: CSDB, LSEG Eikon, Datastream and S&P Capital IQ.

a The sample contains issuances by euro area medium-sized (total assets of €30-100 billion) and large (total assets of more than €100 billion) deposit institutions (privately owned domestic institutions and those controlled by foreign capital and excluding the central bank), with a maturity of two years or more and a volume equal to or greater than €25 million. Data for the period October 2018-October 2023.

b "Residual" includes unsecured structured notes (203); certificates of deposit/commercial paper (528) and uncategorised issuances (923).

— Return on Equity (ROE): this ratio is calculated as net profit divided by equity (average for the last two year-end figures).

— Common Equity Tier 1 (CET1) ratio: CET1 is the highest quality of regulatory capital. It typically includes shares, retained earnings and other reserves. The CET1 ratio shows the ratio between a bank's CET1 capital and its risk-weighted assets.

— Non-performing loan (NPL) ratio: a loan is considered non-performing when more than 90 days have passed without the borrower paying the principal or the interest, or when it is considered non-performing for other reasons. The NPL ratio is calculated as the ratio of NPLs to total loans of the bank in question.

— Cost-to-income ratio: this indicator calculates the ratio of income earned to the expenditure necessary to earn such income in a specific period.

— Liquidity coverage ratio (LCR): the LCR is the percentage resulting from dividing a bank's stock of high-quality liquid assets by the estimated total net cash outflows in a period of liquidity stress lasting 30 calendar days.

Lastly, we obtain information from LSEG Eikon on the issuer's Moody's credit rating.

4 Issuance of MREL eligible debt instruments

Degree of debt market activity

Large banks are significantly more active in issuing MREL eligible debt instruments, and account for 81% of the amount issued and for 77% of the number of issues in the period under review. Large issuers' greater share of the market total – in terms of both the number of issues and the volume issued – remains within the same ranges throughout the time series (see Chart 4.a). Despite their lower share of the total, European medium-sized banks have gradually gained market access. Specifically, there were 17 medium-sized issuers in 2018 and, with the exception of 2020, there have been over 30 in the following years (see Chart 4.b). This trend has been similar in the case of Spanish banks. In October 2023 six medium-sized banks had outstanding instruments, compared with only two in October 2018.

These patterns suggest that medium-sized banks may suffer some debt market access constraints, although they could also be related to a different funding profile. The upward trend in the number of medium-sized issuers is likely related to the need to comply with the MREL requirements, given the context of ample liquidity in the period 2018-2023.

Issuance cost

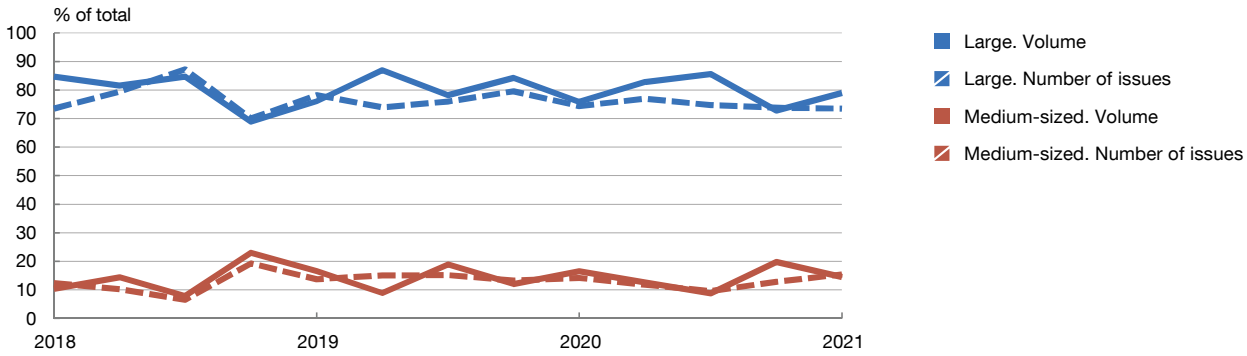
Next we examined the cost of debt issued by large and medium-sized euro area banks, looking at fixed-rate instruments.[20] Debt issued by medium-sized banks has a lower cost than that issued by large banks (see Chart 5.a). The cost is lower when considering both the median value and the weighted average.

This is partly because medium-sized banks have opted to issue instruments with a lower level of subordination; senior debt accounts for around 50% of the volume issued by large banks, a percentage that rises to 85% for medium-sized banks which, as mentioned above, do not have a subordinated MREL requirement (see Chart 5.b). In addition, large banks issue a non-negligible share of AT1 and T2 instruments which, due to their higher level of subordination and, therefore, probability of absorbing losses in the event of a potential resolution, are particularly costly.

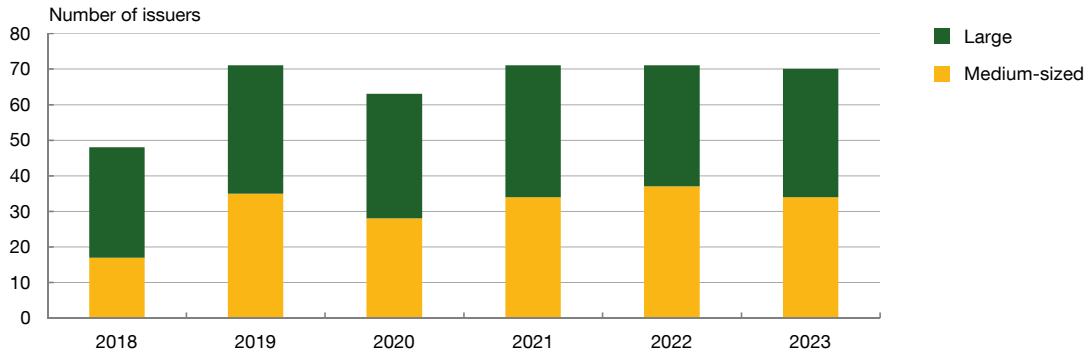
20 See footnote 3.

Chart 4
Overview of the debt issuance market (a)

4.a Volume issued and number of issues, by issuer size (b): euro area



4.b Issuers, by issuer size (b): euro area



SOURCES: CSDB, LSEG Eikon, Datastream and S&P Capital IQ.

a The sample contains unsecured issuances by euro area deposit institutions (privately-owned domestic institutions and those controlled by foreign capital and excluding the central bank), with a maturity of two years or more and a volume equal to or greater than €25 million. The sample includes the residual specified in Chart 3.b. Data for the period October 2018-October 2023.
b Large issuers have total assets of more than €100 billion and medium-sized issuers have total assets of €30-100 billion.

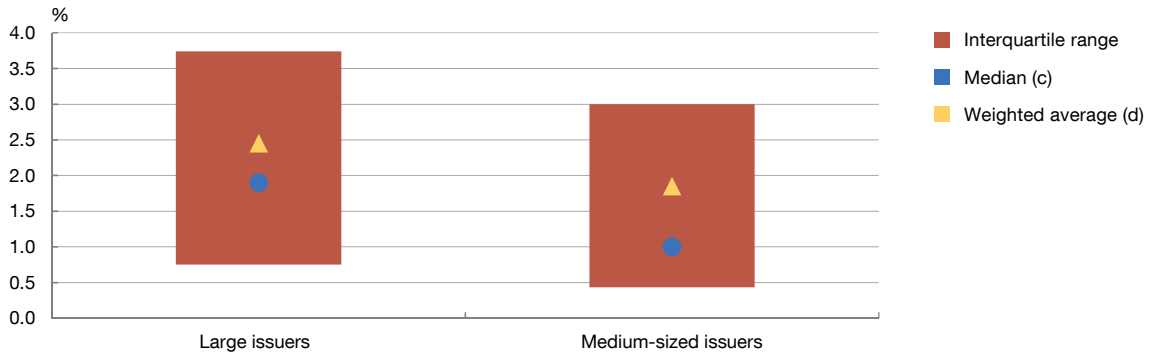
This lower issuance cost for medium-sized issuers is also related to the shorter maturity of their bonds, as the coupon required by investors usually increases with maturity,[21] because investors typically require a term premium. Indeed, in the euro area as a whole large banks' bonds have a median maturity of seven years, compared with just five years for those of medium-sized banks. This difference can also be observed when comparing the weighted average (see Chart 6.a). This pattern is broadly similar across all the jurisdictions analysed. Throughout the period under review, differences in maturity have not had a major impact on issuance cost, but they have become more important following the increase in interest rates: in 2023 the spread between the coupon required on a ten-year and a five-year bond was

21 As mentioned in Section 3, instruments with an original maturity of less than two years have been excluded from the analysis, to focus the study on MREL eligible bonds of economic importance (instruments cease to be eligible for MREL when their residual maturity is less than one year).

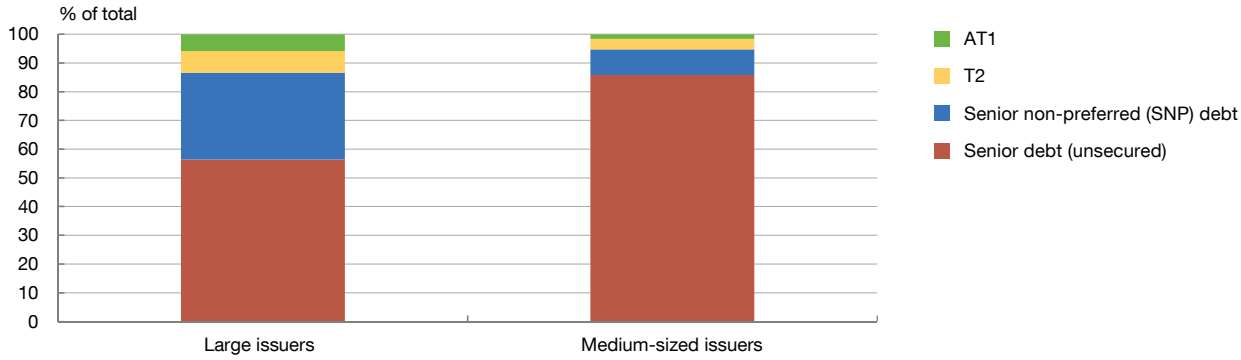
Chart 5

Issuances by large and medium-sized banks: coupon and volume issued, by level of subordination (a)

5.a Coupon, by issuer size (b): euro area



5.b Volume issued, by level of subordination and issuer size (b): euro area



SOURCES: CSDB, LSEG Eikon, Datastream and S&P Capital IQ.

a The sample contains unsecured fixed coupon issuances by euro area deposit institutions (privately owned domestic institutions and those controlled by foreign capital and excluding the central bank), with a maturity of two years or more and a volume equal to or greater than €25 million. The sample includes the residual specified in Chart 3.b. Data for the period October 2018-October 2023.
b Large issuers have total assets of more than €100 billion and medium-sized issuers have total assets of €30-100 billion.
c The median values are highlighted in yellow where there is no statistically significant difference between the medians of the two groups (medium-sized and large) at a significance level of 0.05.
d The average is weighted by volume issued.

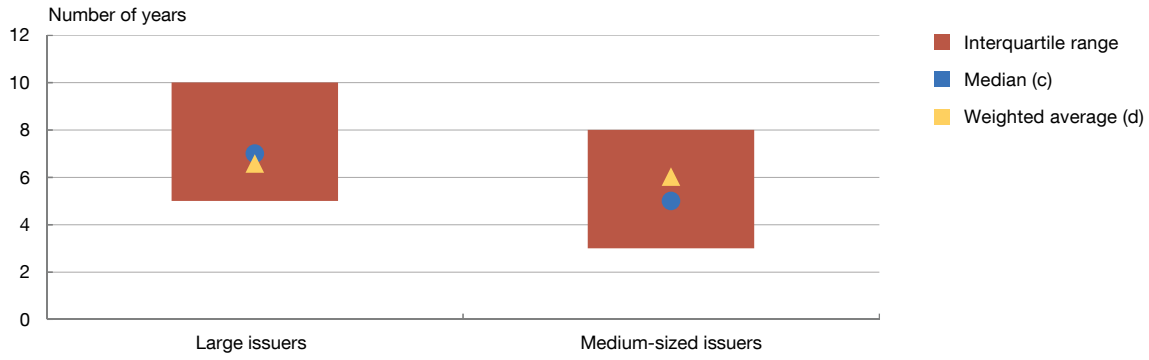
around 90 basis points for senior bonds, which is the deepest category. Nor are the differences in issuance cost associated with the fact that large banks issue proportionally more non-euro-denominated debt than medium-sized ones.

To examine whether the positive spread between the cost of bonds issued by large banks and those issued by medium-sized banks is due exclusively to differences in the level of subordination, maturity and year of issuance, we performed a linear regression which uses the instrument's coupon (cost) as the dependent variable and its issue date, level of subordination and bond maturity (years) as explanatory variables. The analysis of the unexplained fraction of the coupon (hereafter, "residualised coupon") shows that, even controlling for the aforementioned explanatory variables, the positive spread between the issuance costs of large and medium-sized issuers remains.

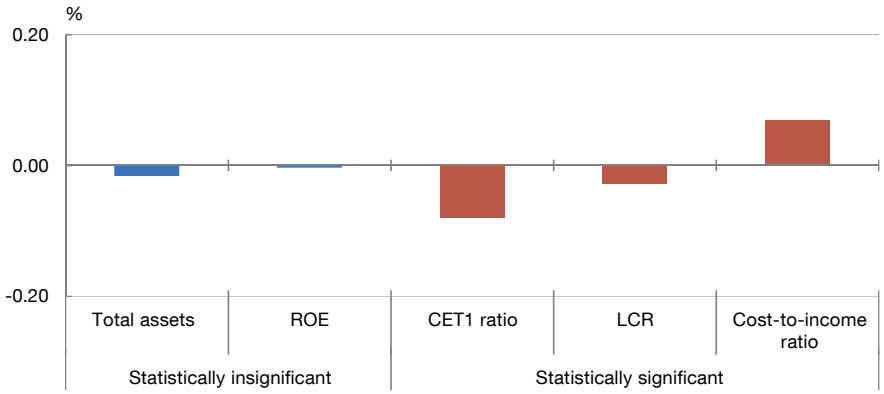
Chart 6

Issuances by euro area large and medium-sized banks: maturity (a) and coupon determinants

6.a Maturity, by issuer size (b)



6.b Impact of bank variables on issuance coupon (e)



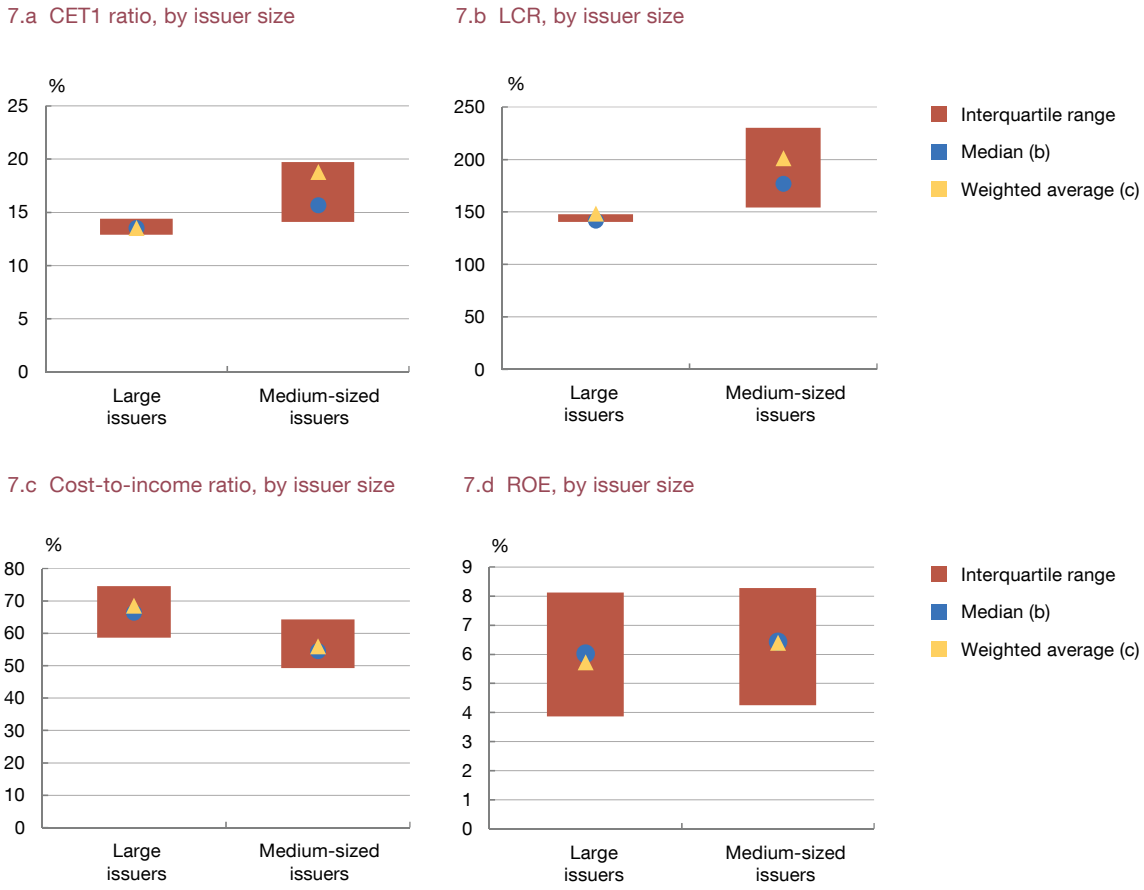
SOURCES: CSDB, LSEG Eikon, Datastream and S&P Capital IQ (Chart 6.a); Banco de España calculations (Chart 6.b).

a The sample contains unsecured issuances by euro area deposit institutions (privately owned domestic institutions and those controlled by foreign capital and excluding the central bank), with a maturity of two years or more and a volume equal to or greater than €25 million. The sample includes the residual specified in Chart 3.b. Data for the period October 2018-October 2023.
b Large issuers have total assets of more than €100 billion and medium-sized issuers have total assets of €30-100 billion.
c The median values are highlighted in yellow where there is no statistically significant difference between the medians of the two groups (medium-sized and large) at a significance level of 0.05.
d The average is weighted by volume issued.
e The impact is defined as a one standard deviation increase in the standardised variables analysed. We perform a linear regression that uses the coupon as the dependent variable and as explanatory variables the logarithm of total assets, the bond's original maturity, a dummy variable indicating whether or not the bond is a senior bond, the lagged annual real GDP growth rate, lagged inflation, the overnight index swap (OIS), the sovereign spread and the Tier 1 capital ratio, the LCR, ROE and cost-to-income ratio. The sample used contains (unsecured) senior debt instruments and senior non-preferred (SNP) debt instruments issued in euro at a fixed rate by deposit institutions resident in Germany, Austria, Belgium, Spain, Finland, France, Greece, Italy, Ireland, Portugal and the Netherlands (without excluding any issuer due to its balance sheet size), with a maturity of two years or more and a volume equal to or greater than €25 million for the period October 2018-October 2023. The logarithm of total assets, ROE and lagged inflation are not statistically significant, whereas the other variables are.

To drill down into the analysis, next we studied the impact of the issuer's financial characteristics on the issuance cost. The linear regression analyses show that this issuance cost is lower for banks with stronger financial ratios: the higher the CET1 ratio or the LCR the lower the coupon, and the higher the cost-to-income ratio (i.e. the lower the efficiency of the bank in question) the higher the coupon. By contrast, the size of the bank, measured by volume of assets, and its profitability have no significant effect on the issuance cost (see Chart 6.b).

Chart 7

Euro area large and medium-sized issuers: financial ratios (a)



SOURCES: CSDB, LSEG Eikon, Datastream and S&P Capital IQ.

a The sample contains euro area deposit institutions (privately owned domestic institutions and those controlled by foreign capital and excluding the central bank) that have issued uncovered bonds with a maturity of two years or more and a volume equal to or greater than €25 million in the period October 2018-October 2023. Large issuers have total assets of more than €100 billion and medium-sized issuers have total assets of €30-100 billion.
b The median values are highlighted in yellow where there is no statistically significant difference between the medians of the two groups (medium-sized and large) at a significance level of 0.05.
c The average is weighted by volume issued.

Differences in the financial characteristics of medium-sized and large issuers may contribute to banks' different financial costs. Medium-sized issuers have a higher CET1 ratio than large banks (see Chart 7.a). The LCR of medium-sized banks is also higher than that of large issuers, which is reflected both in a higher average weighted by volume issued and in the median value (see Chart 7.b). Medium-sized issuers are also more efficient, according to their cost-to-income ratio (see Chart 7.c) and they have higher ROE ratios (see Chart 7.d), although this variable has no significant effect on the issuance cost. The conclusions are robust, both by average weighted by volume issued and by the median value; the median tests indicate that this difference is statistically significant.

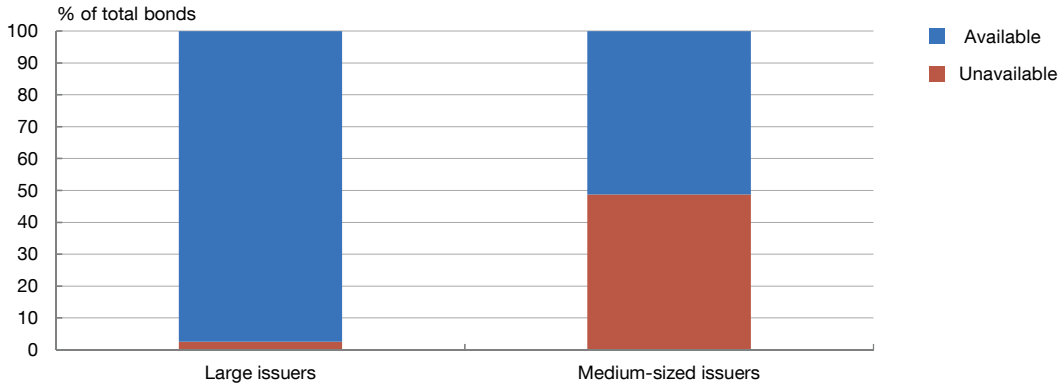
Market access challenges: credit rating

Medium-sized banks still face certain challenges when accessing debt markets, including three credit rating-related constraints. First, according to data from Moody's for the euro

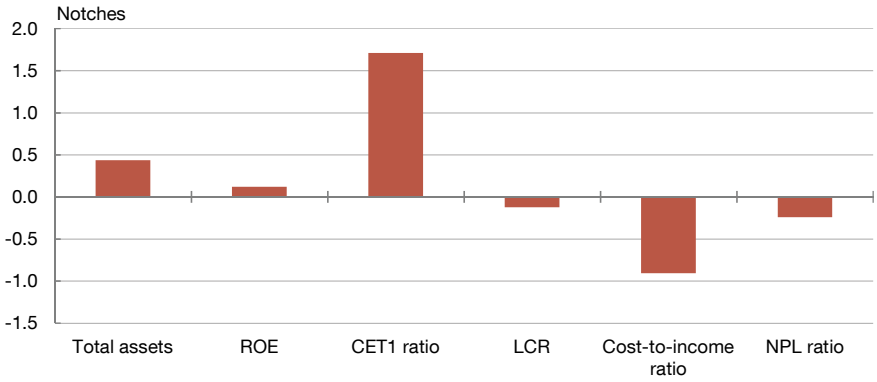
Chart 8

Euro area large and medium-sized issuers: credit rating (a)

8.a Availability of the issuer's credit rating, by balance sheet size (b)



8.b Impact of bank variables on the issuer's credit rating (c)



SOURCES: CSDB, LSEG Eikon, Datastream, S&P Capital IQ and Moody's.

a The sample contains unsecured issuances by euro area deposit institutions (privately owned domestic institutions and those controlled by foreign capital and excluding the central bank), with a maturity of two years or more and a volume equal to or greater than €25 million. The sample includes the residual referred to in Chart 3.b. Data for the period October 2018-October 2023.

b Large issuers have total assets of more than €100 billion and medium-sized issuers have total assets of €30-100 billion.

c The impact is defined as a one standard deviation increase in the standardised variables analysed. We perform a linear regression that uses the issuer's credit rating as the dependent variable and the issuer's total assets, ROE, CET1 ratio, LCR, cost-to-income ratio and NPL ratio as explanatory variables. All the variables are statistically significant at a significance level of 0.01. We use the Moody's credit rating with a numerical equivalence, where "AAA" equals 20 and "CA" equals 1, and the notch is a unit between rating levels.

area, bonds issued by medium-sized banks without a credit rating account for a large percentage of the total, with some cross-jurisdiction differences. By contrast, there are virtually no bonds issued by large banks without a credit rating (see Chart 8.a), a feature common to all the jurisdictions analysed. This reflects the high percentage of medium-sized issuers without a credit rating (58%). Second, for the sub-set of issuers with credit ratings, medium-sized banks have worse ratings than large banks (a median value one notch lower). Indeed, 25% of medium-sized issuers have credit ratings below investment grade. Lastly, the linear regression analysis shows that credit ratings improve with issuer size, even when taking into account the impact of issuers' financial characteristics on the rating (see Chart 8.b).

The fact that the larger the bank the better the credit ratings may be explained, first, by large banks being better known by investors, as they have a longer track record on debt markets and a higher issuance frequency, and there being, therefore, more information available on their capacity and willingness to repay. There is less information available on medium-sized banks and this poses problems of information asymmetry, in terms of both adverse selection (i.e. the actual risk profile of the bank) and moral hazard (in other words, how the bank will behave once the funding has been obtained).[22]

Cross-jurisdiction differences

The results of the analysis of the funding costs show some cross-jurisdiction differences. It is noteworthy that in Spain medium-sized banks' funding costs are higher than those of large banks. This is unrelated to potential differences in the level of subordination, maturity and year of issuance (see Chart 9.a). It may be partly explained by Spanish medium-sized banks having worse cost-to-income ratios than large banks, and not having better solvency ratios (see Chart 9.b). This is, however, only a partial explanation, as the linear regression analyses confirm that Spanish medium-sized banks pay a higher coupon than other large and medium-sized euro area banks, even when taking into account macroeconomic variables and issuers' financial ratios.[23] One aspect that could explain this would be the shallower depth of the Spanish domestic market, as smaller banks typically find it difficult to issue on international markets. This is an avenue for future research.

5 Conclusions

European banks must hold a sufficient amount of capital and debt instruments that can absorb losses and, where necessary, be converted into equity in order to allow for the proper implementation of the resolution plan by the resolution authorities.

The MREL framework quantitatively sets the percentage (both in terms of risk-weighted assets and of leverage ratio exposure) required of EU credit institutions. This has raised doubts about medium-sized issuers' ability to access debt markets, considering that they do so less frequently, with smaller issuances that have a lower level of subordination.

Using highly granular data on unsecured debt issuances by euro area credit institutions, we find that:

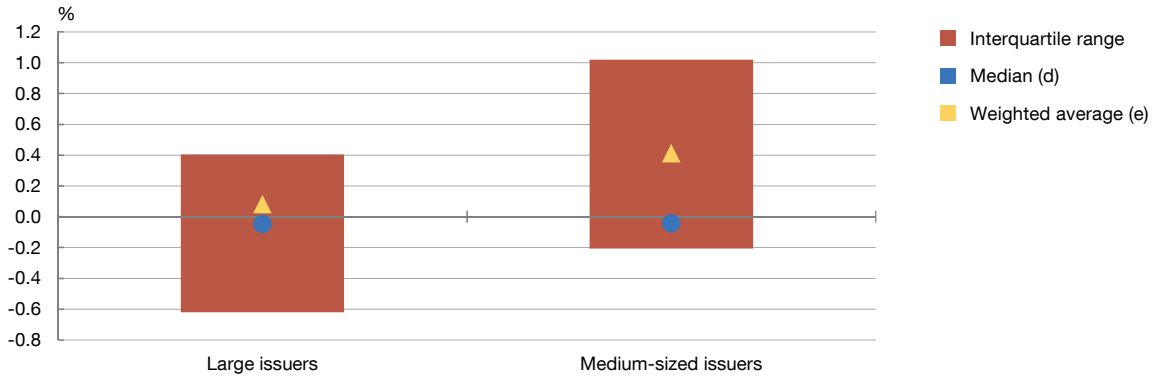
22 This may be linked to other circumstances, such as medium-sized banks having higher NPL ratios than large banks, although these ratios have been declining in recent years for all European banks (Laviola, 2023). Data limitations prevent a formal analysis of this hypothesis.

23 The linear regression model specified in Chart 6.b is used, adding as an explanatory variable a dummy that takes a value of 1 for the medium-sized banks in each country.

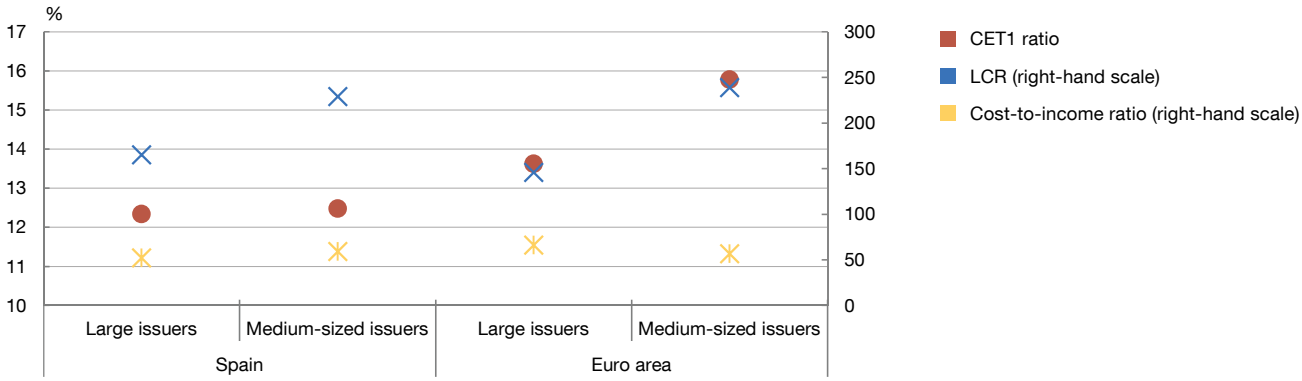
Chart 9

Spanish banks' issuance cost and issuer fundamentals (a)

9.a Residualised coupon (b), by issuer size (c): Spain



9.b Median value of financial ratios, by issuer size (c): Spain vs. euro area



SOURCES: SDB, LSEG Eikon, Datastream and S&P Capital IQ.

a The sample contains unsecured fixed coupon issuances by euro area deposit institutions (privately owned domestic institutions and those controlled by foreign capital and excluding the central bank), with a maturity of two years or more and a volume equal to or greater than €25 million. The sample includes the residual specified in Chart 3.b. Data for the period October 2018-October 2023.
b The "residualised coupon" or unexplained fraction of the coupon is the residual resulting from the linear regression of the coupon on maturity (years), level of subordination and issuance date.
c Large issuers have total assets of more than €100 billion and medium-sized issuers have total assets of €30-100 billion.
d The median values are highlighted in yellow where there is no statistically significant difference between the medians of the two groups (medium-sized and large) at a significance level of 0.05.
e The average is weighted by volume issued.

— The issuance market is dominated by large issuers, which have a better credit rating in the sample analysed.

— Potentially as a result of the needs established by the MREL requirements, since 2018 there has been a rise in the number of medium-sized issuers, which have taken advantage of the low interest rate environment.

— Euro area medium-sized issuers bear lower issuance costs than large banks; this is partly associated with the shorter maturity and lower level of subordination of their bonds.

— The issuance cost differences are also explained by the fact that medium-sized issuers have better solvency, liquidity and cost-to-income ratios than large banks.

— Some cross-jurisdiction differences exist: in Spain, medium-sized banks bear higher issuance costs than large banks, amid worse cost-to-income ratios and similar solvency ratios.

— Medium-sized banks still face some challenges in accessing debt markets, most notably their poorer credit ratings.

The findings suggest that, when building up their MREL capacity, medium-sized banks are consistently gaining market access, although certain challenges persist.

One question, looking ahead, would be whether markets would be able to absorb larger scale debt issuance by medium-sized issuers or by smaller issuers that were also subject to a resolution framework in the face of a potential crisis event.

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Annex 1 MREL regulatory framework

Key features of the MREL regulatory framework

Because it is a directive, each Member State transposes the Bank Recovery and Resolution Directive (BRRD) into its national legislation. The BRRD was transposed into Spanish legislation by Law 11/2015, Royal Decree 1012/2015 and Royal Decree-Law 7/2021 which regulate the early intervention and resolution processes for credit institutions and investment firms in Spain.

Law 11/2015 establishes the legal regime of the Spanish executive resolution authority (FROB) and has the ultimate objective of protecting financial stability while minimising the use of public funds. In addition, it confers on the Banco de España the role of preventive resolution authority tasked with drawing up resolution plans for the institutions under its competence for bank resolution (less significant institutions). In addition, the Banco de España collaborates with the Single Resolution Board (SRB) in those tasks with which it is entrusted in relation to significant institutions and institutions with cross-border activity, which are the SRB's direct responsibility. This distinction between the field of competence of the SRB and that of the national resolution authorities (NRAs) – the Banco de España, the National Securities Market Commission and the FROB are Spain's NRAs – stems from the Single Resolution Mechanism Regulation (SRMR),[1] which is directly applicable in the euro area. The Single Resolution Mechanism is the second pillar of the banking union, alongside the Single Supervisory Mechanism, the prudential supervision pillar. Therefore, the SRB is the authority that sets the MREL target of significant institutions, which are the focus of the analysis in this article.

Recapitalisation amount

The recapitalisation amount (RCA) is calibrated based on the capital decision set by the supervisor. A series of upward adjustments are applied to this decision,[2] including a market confidence charge, for the MREL calibrated in terms of total risk exposure amount (MREL-TREA), together with downward adjustments intended to factor in balance sheet depletion during resolution (Single Resolution Board, 2023b).

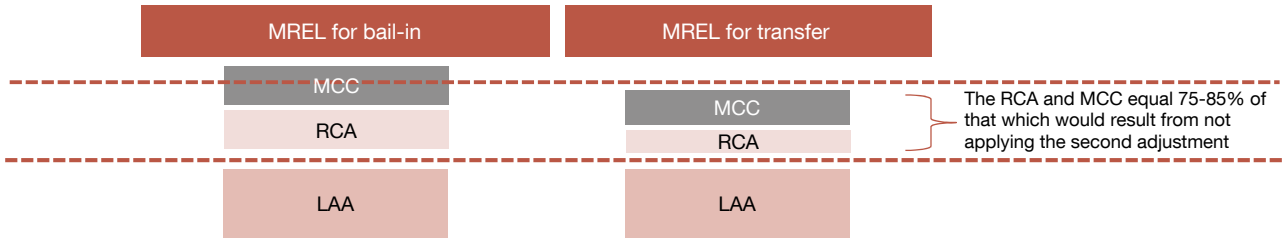
The first adjustment reflects the balance sheet depletion arising from the absorption of losses incurred in the crisis and is applicable to all institutions, irrespective of the resolution tool that the authority establishes as the preferred resolution tool in the institution's resolution plan.[3] The second adjustment only affects institutions whose preferred resolution strategy is the

1 Regulation (EU) No 806/2014 of the European Parliament and of the Council.

2 On the basis of Article 12d(3) of the SRMR.

3 Specifically, total assets are generally adjusted by an amount equal to the LAA (plus the combined buffer requirement for the MREL-TREA), with a limit of 10% of total assets.

Figure A1.1
MREL requirement: bail-in vs. transfer



SOURCE: Devised by authors.

transfer tool (sale of business to a third party via the acquisition of shares or assets and liabilities, the creation of a bridge institution and/or the application of the asset separation tool) and reduces the balance sheet (once the first adjustment has been applied) by a factor of 15%-25% (see Figure A1.1). The specific adjustment factor is determined on the basis of the institution's expected marketability in the event of a crisis, by interpolating the marketability of the institution compared with the sample of all the institutions under the SRB remit. It is greater the smaller the bank's size (measured by total assets), the lower its level of impairment (measured by the ratio of non-performing exposures net of allowances over total assets), the larger its depositor base (measured by the ratio of covered deposits to total assets) and the lower the level of uncertainty on the valuation of its activities (measured by the ratio of Level 3 assets to total assets).

This second downward adjustment to the RCA (which results in a lower MREL calibration) should affect medium-sized banks, whose preferred resolution strategy is typically the sale of business, more than large banks, whose preferred resolution tool tends to be bail-in (European Banking Authority, 2022).[4]

How to cite this document

Ibáñez, Lucía, Miguel Kruse, María Pollos, José María Serena and Miquel Tarí. (2024). "The euro area banking sector and MREL: a challenge for medium-sized banks?". *Financial Stability Review - Banco de España,* 46, Spring. https://doi.org/10.53479/37655

4 This adjustment is applied to the RCA after the adjustment for loss absorption.