

Box 9

BANK CAPITAL RATIOS AND THE COST OF MARKET FUNDING

An important policy issue is whether higher bank capital facilitates access to private funding markets. If the risk profile of banks' assets is similar, higher risk-weighted capital ratios should imply that banks are able to fund themselves at lower credit spreads.

In this box, market data on secondary market yields on senior unsecured debt and on covered bonds are used to analyse the relationship between the bank-specific cost of market funding and the Tier 1 capital ratio. Country-specific bank yield curves are analysed to control for the cross-country variation in sovereign bond yields, which are a reference point for pricing bank debt. The sample covers over 300 instruments for which yields are actively quoted, issued by more

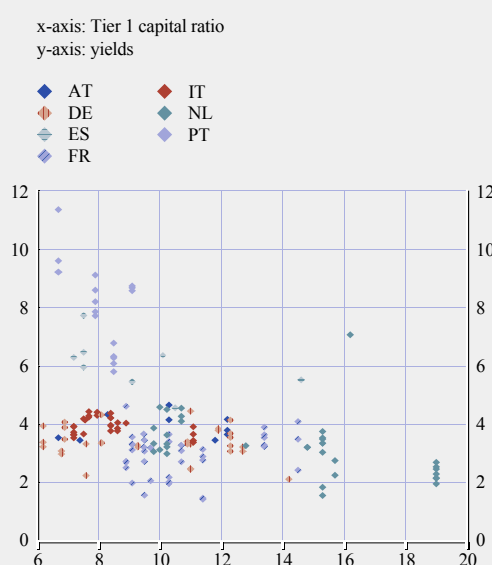
than 80 banking groups in 7 euro area countries. Some euro area countries are not represented in the sample if the total number of going-concern issuers in a country is below three.

While the level of yields may be affected by many factors, including perceived sovereign risk, the results suggest that in some countries higher-capitalised banks face lower yields than their lower-capitalised peers. The relationship between yields and Tier 1 capital ratios is found to be strong when the credit risk on sovereign and bank debt – as measured by credit spreads – is perceived to be high by market participants (see Chart A). On the other hand, this relationship is weak in countries where concerns about sovereign and bank default risk are not significant, although this may also be related to the existence of implicit government guarantees and the use of public support schemes. While formal statistical testing is not meaningful in this context due to the low number of banks in each of the jurisdictions, these results seem to hold true not only for senior unsecured bank bonds, but also for covered bonds, in spite of the latter being collateralised and therefore less exposed to the risk of the issuer's default (see Chart B).

The relationship between banks' capital ratios and their funding conditions in the markets can only be illustrated with yields on bank debt in secondary markets. Conditions in the primary markets are observed only at times when debt is issued, and funding quantities are not directly observable for some instruments. Therefore, the potential benefits from increasing banks' capital may not be as large as suggested by the secondary market yields if the banks are not able to access funding markets for large quantities. On the other hand, adequate capitalisation may help in regaining market access.

Chart A Yields on senior unsecured debt and the Tier 1 capital ratio of the issuer bank

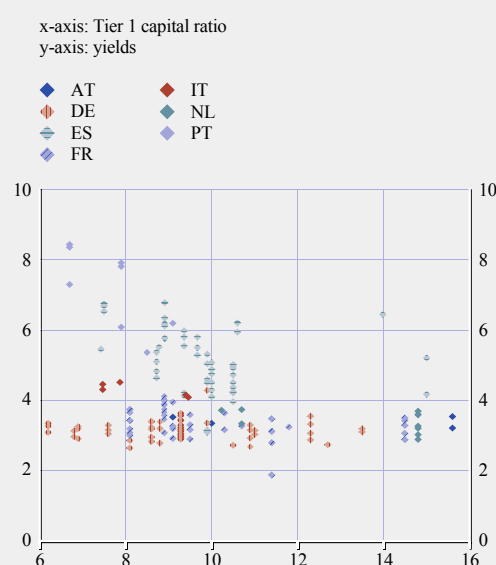
(March 2011; three-to-five-year maturities; percentages)



Sources: ECB, Bloomberg and individual institutions' financial reports.
Notes: Yields refer to fixed rate, euro-denominated instruments. If more than one instrument of the given maturity is available for one institution, the largest issues and the instruments of maturity closest to the middle of the bucket are displayed.

Chart B Covered bond yields and the Tier 1 capital ratio of the issuer bank

(March 2011; three-to-seven-year maturities; percentages)



Sources: ECB, Bloomberg and individual institutions' financial reports.
Notes: Yields refer to fixed rate, euro-denominated instruments. If more than one instrument of the given maturity is available for one institution, the largest issues and the instruments of maturity closest to the middle of the bucket are displayed.