EBF Comments on the EBA Consultation Paper on Asset Encumbrance

PART I: GENERAL COMMENTS

1. The EBF welcomes the EBA's efforts to establish a common harmonised European framework for reporting and determining the level of asset encumbrance. This will contribute to ensuring consistency when assessing the asset encumbrance of financial institutions and, moreover, to creating a level playing field.

2. We fully recognise the usefulness of reporting on asset encumbrance to assess banks' reliance on secured funding and the degree of structural subordination of unsecured creditors and depositors across institutions.

The second objective which the Consultation Paper pursues – i.e. to allow supervisors to assess the ability of institutions to handle funding stress, by providing an assessment of the ability to switch to secured funding - is, however, less obvious considering that it overlaps with what the CRR liquidity reporting framework (consisting of the LCR, the NSFR an Additional Monitoring tools) aims, amongst others, to achieve.

We would, therefore, strongly urge the final version of the ITS to focus exclusively on the first objective.

3. As the proposed reporting templates are highly complex and granular, they will generate significant costs both in terms of implementation of the required IT systems and of ongoing production.

Indeed, producing the required reporting streams represents a significant challenge:

- The main challenge of the proposed reporting framework consists in the requirement to link information that is currently lodged in different information systems within banks (i.e. accounting data and management data) or that is currently not linked within banks' IT-systems.

  It will already be a challenge to cross account and manage data on macro-aggregates and ensure consistency at that level. Requiring more granular levels of details to carry through both systems is clearly not feasible and will drive to implement counterproductive shortcuts which will not make sense. Hence we urge the EBA to limit the level of detail requested in the different tables.

- It will not be an easy task, moreover, to consolidate asset encumbrance data on a group-wide basis.

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As the Consultation Paper recognises, the cost of implementing the proposed requirements needs to be commensurate to the added value which the collected information may be expected to bring. We do not consider the proposed framework to achieve a right balance and strongly believe that ways should and can be found to simplify the reporting streams without significantly influencing the ability of banking supervisors to duly monitor and assess asset encumbrance.

Detailed proposals for simplification are made in Part II of this submission.

4. As it will inevitably take time to implement the proposed reporting streams and a minimum of one year should be given starting from the final version of the templates for banks' IT-systems to generate the information, it would not be feasible for banks to implement the proposed them during the first half of 2014.

The final version of the standard, therefore, needs to set a specific date in respect of the first remittance. We would like to suggest that the requirements would come into effect no earlier than January 1, 2015.

5. The proposed reporting streams will need to be supplied both on an individual and on a consolidated basis. It would seem to be more useful, however, bringing the consolidation circle in line with the one that that applies in the area of liquidity risk reporting.

Furthermore, it does not seems appropriate to produce the reporting specific to covered bonds on a consolidated basis (Part D) considering that the risk taken on covered bonds is a risk that should be appreciated for each vehicle separately.

It would also be useful to clarify which accounting values need to be used whenever local GAAP needs to be applied to on an individual entity basis whilst IFRS are being applied to produce the consolidated figures. Our understanding is that institutions would be required to use IFRS figures only if they are available – meaning that institutions would not be required to produce IFRS figures if they use local GAAP for accounting purposes (on an individual entity basis or on a consolidated level).

Finally, it is not clear how encumbrance through insurance entities needs to be treated at consolidated level. The reporting template should at least allow isolating the encumbrance from insurance entities in accordance with prudential consolidation as imposed by CRR/CRDIV.

6. As the European Banking Federation had observed in a letter which was sent to the EBA and the ESRB on 6 December 2012, the consultation provides a typical example of data requirements which would benefit from being discussed in common by all stakeholders involved first. The EBF had, therefore, suggested that an expert meeting be organised to brainstorm on possible ways to satisfy the supervisory information needs in the area of asset encumbrance in a most efficient way.

We are disappointed to note that the EBA has declined the invitation to engage into a dialogue with experts from the industry on a mere technical issue.

PART II: PROPOSALS TO SIMPLIFY THE PROPOSED SETS OF TEMPLATES

A: Encumbrance overview

This part is mostly useful as it would allow determining an asset encumbrance ratio in a rather consistent manner.

However, as it is currently designed, it is overly complex. It needs to be simplified.

- AE (Assets Template)

Even though this type of information will be needed for consolidation purposes, we do not see the need in this specific reporting to report the column "*of which: issued by other entities of the group*".

We question, moreover, the relevance of the column "*of which central bank's eligible*" on the ground that other information produced on the basis of the CRR liquidity reporting framework provides sufficient knowledge on the institution's capability to pledge assets and to obtain further liquidity. We would like to refer in particular in this regard to the Additional Monitoring Tools - Reporting on Counterbalancing Capacity. The detailed requirements which the Consultation Paper suggests introducing in this respect do not serve the objective concerning structural subordination.

Similarly, we also question the relevance of the lines "*of which xxx*" on the ground that they do not provide information on balance sheet subordination and, moreover, that the information is already obtained by means of other liquidity metrics.

Furthermore, and in line with a comment made above, it would make sense to report only accounting values, without the loss of any precision, considering that most encumbered securities are likely to be accounted for at fair value.

- AE-Collateral

Even though this type of information will be needed for consolidation purposes, we do not see the need to report the column "*of which: issued by other entities of the group*" here.

We question the relevance of adding the column "of which central bank eligible" and the lines "*of which xxx*", that are redundant with other liquidity reporting (for the reasons explained above).

For the sake of simplification, only one type of value should be reported in each row: either fair value or nominal.

- AE-Not pledged.

The last column "*Nominal of own debt securities issued not available for encumbrance*" does not bring any additional information on the capacity of encumbrance and, therefore, does not seem useful.

The column "*Carrying amount of the underlying pool of assets*" is of no interest considering that those items are already reported in the template AE-Assets.

Regarding ABS, the required split between "Senior", "Mezzanine" and "First Loss" categories of the underlying pool of assets is not useful since there is no clear split within the pledged pool of assets.

We also believe that there is no need to distinguish specifically self detained covered bonds and ABS. Accordingly, the section AE-Not pledged should be folded back in the AE-Collateral section (should it be estimated necessary, the corresponding information could be isolated in a row of this last section).

- AE-Sources of encumbrance

There is presently only very limited information carried in the institutions' accounting systems that connect a pledged asset to the liability requiring the pledging. As a consequence, the information that needs to be reported here will prove extremely difficult and very costly to implement.

Moreover, we see very limited added-value in formalising such connection. Hence we propose to limit the level of requested detail and remove the following axis:

- All the lines "of which xxx" that are already provided in other liquidity reporting and not useful for the pursued objective.
- The column "*of which from other entities of the Group*" for the reason explained above
- The columns "*of which collateral received reused*" and "*of which own debt securities encumbered*" that are already produced by existing liquidity reporting streams.

We neither see a need in this specific reporting to report the column "*of which: issued by other entities of the group*". It would not be appropriate to report information on the "% in market" of debt securities issued. Indeed, these debts should be reported at the individual level; at a consolidated level, they are eliminated so that the reporting supplied based on accounting values provides already all the necessary information.

B: Maturity data

The objective and added-value of this reporting is not obvious and appears redundant with the information already supplied in the NSFR framework.

C: Contingent encumbrance

The liquidity stress scenarios to assess contingent encumbrance have been defined in the CRR after a long period of discussion. We are concerned that EBA would go beyond its mandate by introducing new, additional scenarios which may prove inconsistent with the CRR. As a consequence we urge the EBA to stick to the already defined scenarios and remove this template from the Asset Encumbrance reporting framework.

In addition the proposed reporting is complex. It will be highly difficult to automatise these data streams and make them reliable without long and costly developments that may not even be exhaustive or achieve full reliability.

The first Scenario perfectly illustrates the danger of introducing inconsistency. We wonder what the basis is for the proposed 30% decrease in the fair value of encumbered assets and what sense does it makes for loans.

D: Covered Bonds

In general, and in line with our previous comments, a reporting on covered bonds should be done per vehicle, and not per individual entity.

Additionally, it is essential to us that a distinction is made between (i) covered bonds issuing entities that are exclusively funded by issuances of covered bonds (and are, therefore, by definition, fully encumbered) and (ii) other entities issuing covered bonds.

- AE-CB Issuance

The present value of the cover pool and of the covered bond liabilities may not be calculated. Anyway, this information is not useful to assess the risk generated by the vehicle. Thus, we recommend deleting these values from the framework.

The same comment needs to be made concerning the asset-specific value of the cover pool.

- AE-CB Eligible Assets

There is a specific perimeter problem with this particular template considering that unencumbered assets eligible for cover pool may not be directly held by the covered bond issuing vehicle. Thus, considering this reporting in isolation of the previous one does not seem useful.

In this part, we think only the nominal amount needs to be reported. Present value and Asset-specific value are not useful.

E: Advanced data

The difficulty outlined in our comment regarding the AE-Sources of encumbrance table equally applies in full to this section: the complexity of establishing connections between the pledged assets and the corresponding liabilities will make it extremely difficult and very costly to implement. This is all the more true because this template requires even more details about the source of encumbrance and the collateral type compared to the template in Part A.

Moreover, the added connections made by this reporting between the encumbered assets and the corresponding liabilities do not meaningfully enhance the information already reported in part A. Accordingly, we think it should be removed from the reporting framework.

PART III: ANSWERS TO THE SPECIFIC QUESTIONS

Q1: Is the definition of asset encumbrance sufficiently clear?

The consultation paper proposes to define asset encumbrance as follows:

> "*For the purpose of this Regulation an asset is considered encumbered if it has been pledged or if it is subject to any form of arrangement to secure, collateralise or credit enhance any transaction from which it cannot be freely withdrawn*".

It would have been helpful if the Consultation Paper would have explained why it has not been considered appropriate aligning asset encumbrance reporting to the reporting requirements that apply in the area of liquidity risk management (LCR & NSFR).

Although the definition is reasonably clear, providing some clarifications would be useful.

- The concept of "freely withdrawn" may be open to interpretation. It would in any event merit clarification by means of examples to be provided in the Explanatory Memorandum. It would need to be clarified in particular how excess collateral would need to be treated in terms of encumbrance. This is particularly important where covered bonds are concerned: should the collateral in a covered bond to cover pool in excess of the amount required to maintain a given rating be considered unencumbered? Should the excess amount above the required amount given the covered bond statutory regime be considered unencumbered?

  Hence, mention should be made of the precise conditions under which the cover pool amount in excess of the minimum coverage requirement can be considered encumbered or unencumbered, and how the minimum requirement should be calculated.

  Against this backdrop, we propose amending the definition as follows:

  > "*For the purpose of this Regulation an asset is considered encumbered if it has been pledged or if it is subject to any form of arrangement to secure, collateralise or credit enhance any transaction from which it cannot be freely withdrawn without requiring replacement or agreement by one or more of the transaction counterparties*".

- Any encumbrance information should also allow for securities received under a reserve repo trade. This approach is based on the idea that, if it is necessary to treat securities given out under a repo trade as encumbered, any asset received from another counterparty under a reverse repo trade should be treated as unencumbered with the encumbrance level being the net value of these securities. At this stage the main arguments for this approach are that:

  a) under the liquidity coverage ratio definitions also introduced in CRDIV (CRR) it is explicitly stated that any assets received under a reverse repo trade can be considered unencumbered and treated as part of an institutions liquidity buffer.
  b) given that both repos and reverse repos are traded under the same legal framework it would appear to make logical sense to ensure a consistent treatment of the underlying securities

- Our understanding is that, in contrast to what is required for High Quality Liquid Assets under the LCR, there is no need to consider whether the asset is part of a hedge relationship or that the unencumbered asset is under the control of a specific function. To avoid misinterpretation, it may be useful clarifying this explicitly in the ITS.
- Encumbrance from derivative transactions allows for netting according to the relevant accounting standards. But it is also important to see netting from a solvency, leverage ratio and LCR perspective. The template should, therefore, also show how asset encumbrance would be affected based on CRD IV netting methodologies (specified for credit counterparty risk when calculating RWA).
- The treatment of assets that are collateralised in pools that are not fully used should equally be clarified and reviewed.

  As a general rule, and consistently with LCR framework, a waterfall should be defined to determine the assets that are encumbered. For example, in pools combining both private claims and securities (such as those used to obtain central bank refinancing), private claims should be assumed to be encumbered first.

  Adopting a waterfall model that would take into account asset classes and potential haircuts would be preferable to applying the proposed pro-rata approach. It needs to be borne in mind, however, that the use of the pro-rata criteria to determine the availability of the unused part of the guarantee goes does not seem to be in line with the view adopted by the Basel Committee, i.e. that the criterion to be used to determine the availability of unused guarantees is liquidity: liquid assets will be available before less liquid assets. As a result, the approach which the EBA is proposing might result in further misalignments and contradictory regulatory reports dependent on the Supervisory authority requiring the information.

- Should a pro-rata approach nevertheless be maintained, more clarity would need to be provided on the way it would need to be calculated whenever the collateral provided consists of several asset classes (e.g. securities and loans) for which no common measurement method exists.
  - (i) Should the collateral then be measured on the basis of the accounting carrying amount of the collateral?
  - (ii) If varying haircuts apply depending on the nature of the collateral, should those haircuts be considered in the pro-rata allocation of un-encumbrance? An example would help institutions and ensure a common understanding of the framework.

- Finally, the amount pledged but unused should not be considered as encumbered and therefore not included in the ratio.

Q2: Do you agree with the decision to follow the level of application as set out for prudential requirements? If not, what other level of application would be appropriate?

The consultation paper takes the view that reporting needs to be done on an individual and on a consolidated basis.

However,

- asset encumbrance reporting that is performed on a consolidated basis is in general more relevant than reporting performed on an individual basis;
- it does not makes much sense to produce the reporting specific to covered bonds on a consolidated basis (Part D) considering that the risk taken on covered bonds is a risk that should be appreciated for each vehicle separately.

The following examples may illustrate why would be more appropriate to organise the reported on a consolidated or sub-consolidated level - depending on how the groups are constituted - considering the complexity and the diversity of funding business models amongst European banking groups.

- Assets pledged to the cover pool of a covered bond can be pledged from one entity to another inside the same banking group before finally guaranteeing the covered bonds issued by a specialised subsidiary.
- Securities from securitisation structures may be issued by one entity but detained by another entity within the same group.

What needs to be avoided is that entities within a banking group would end up reporting a distorted level of asset encumbrance which would reflect neither the entity's health, nor its ability to shift to secured funding in situations of stress.

Q3: Do you believe the chosen definition of asset encumbrance ratio is appropriate? If not, would you prefer a measure that is based solely on on-balance sheet activities (collateral received and re-used, for instance from derivatives transactions would not be included) or a liability?

- We agree that off-balance sheet items need to be included in the data gathering exercise considering that initial margin requirements to central and bilateral counterparties to cover derivatives exposures and other aspects of regulatory reform are the main reason explaining the recent increase in asset encumbrance levels.
- We also agree that the assets encumbrance ratio should not focus on liabilities.
- We concur with the view that an asset encumbrance ratio should be used only to define a reporting threshold considering the unfeasibility of establishing anoptimal level of asset encumbrance if national, market and business model specificities are taken into account.
- Our understanding is that the ratio formula which is reproduced at page 4 of annex II to the consultation –Reporting on Asset Encumbrance- is not well specified:

  {AE-Collateral;130;010}+{AE-Collateral;130;040} should replace

  {AE Collateral;010;010}+{AE-Collateral;010;040}

  in the Total assets formula to be consistent with the definition reported on page 11 of the Consultation Paper.

Q4: Do you agree with the thresholds of respectively 30 bn. € in total assets or material asset encumbrance as defined as 5% of on- and off-balance sheet assets encumbered? If not, why are the levels not appropriate and what would be an appropriate level? Should additional proportionality criteria be introduced for the smallest institutions?

Considering the Principle of Proportionality, the proposal to introduce a threshold based on totals assets and % of on and off balance sheet seems appropriate.

However,

- the conditions should not apply in a cumulative way: institutions fulfilling one of the criteria should be exempted;

- the threshold is too high. A threshold of EUR 50 bn would seem more appropriate;

- the proposed thresholds would result in exempting only small and medium sized banks which do not have more than a reasonable volume of assets encumbered. Credit institutions of a medium size (balance sheet volume of up to say to 50 bn EUR, to be calibrated if need be) but with a very low level of assets encumbered (below e.g. 1%) should be exempted as well.

On these grounds, the proposed thresholds (30 bn EUR balance sheet volume or 5% of assets encumbered) should be adjusted as follows:

> *Institutions are ~~not~~* ***only*** *required to report the information referred in point b of paragraph 1 or the information referred in paragraph 2 and 3 if they meet ~~each~~* ***any*** *of the following conditions:*
>
> *a)* ***T****hey have total assets, calculated in accordance with Section 1.6 of Annex II, of ~~less~~* ***more*** *than EUR [~~30~~* ***50*** *billion.] ~~;~~*. ***and*** *~~b)~~ they have asset encumbrance levels, as defined in Part Section 1.6 of Annex II, ~~below~~* ***above****[5]% ~~;~~*.
> *~~c~~b) ~~they have not exceeded either of the thresholds in point (a) and point (b) in the preceding two years. Institutions reporting for the first time may choose not to report the information requested in Paragraph 2 and 3, if the institution expects to meet both of the conditions in point (a) and point (b)~~ They have total assets, calculated in accordance with Section 1.6 of Annex II, of more than EUR [30 billion.] and at the same time they have asset encumbrance levels, as defined in Part Section 1.6 of Annex II, above [1]%."*

The following needs to be observed moreover:

- it would be appropriate to undertake further analysis to calibrate those thresholds;
- the waiver should not merely concern Part B, C and E but also Part A and Part D as it does not seem appropriate for very small institutions or institutions that do not encumber their assets, to report on asset encumbrance. If not, a very substantial number of insignificant reportings are likely to be produced, making it likely that they are never exploited and lowering the visibility of the important reportings;
- the forthcoming standard should include a review clause to make sure that they are adjusted to inflation or other developments on a regular basis.

Q5: Under what circumstances might unencumbered assets of the types of loans on demand, equity instruments, debt securities and loans and advances other than loans on demand not be available for encumbrance?

Given the diversity of European regulations and private contractual terms resulting in encumbrance according to the definition specified in this Consultation Paper, the answer would be highly specific not only to a given jurisdiction but also to the business model of each institution.

More importantly, the information would not contribute to improving the assessment of a given institution's capability to shift to secured funding under stress.

Q6: What additional sources of material asset encumbrance beyond the one listed in rows 20 to 110 and 130 to 150 in template AE-Source do you see?

No additional sources have been detected.

Q7: Do you believe the central bank repo eligibility criteria is an appropriate marketability criteria or should other criteria, such as risk weights, be used? If other criteria should be used, what could be the alternative?

As stated above, if the objective of the requirement is to assess accessibility to secured funding under stress, the existing liquidity reporting framework (LCR, NSFR and Additional monitoring tools) provides more accurate information. Anyway, the proposed criterion is not appropriate to capture structural balance sheet subordination and is likely to create a bias.

Nevertheless, the central bank repo eligibility criterion would be an appropriate marketability criterion on the ground of its objectivity and the relative ease with which it can be appreciated. However,

- central bank eligibility criteria will result in data that is not comparable due to differing definitions of eligibility for repo financing in the central banks;
- eligibility criteria, if imposed, should be brought in line with the LCR framework;
- considering that the central bank repo eligibility criteria represent a monetary policy mechanism with a remarkable European character, it is not possible to apply this criterion directly to financial institutions with presence in other geographical areas where these mechanisms are non-existent. As a result, making use of proxy variables seems warranted to adapt European regulatory requirements to other units. EBA Guidelines on this would be welcomed.
- the central bank repo eligibility criterion is not comprehensive as it does not include other assets that are taken into account in other regulatory inquiries on liquidity, notably, equity assets. Therefore, the first option presented in the proposal ("Identifying marketability with the criteria defining liquid assets within the liquidity reporting requirements") should not be discarded altogether.
- the criterion should in any event be extended beyond the local central bank and, more particularly, include all central banks considering that the aim would be to identify those securities that are marketable and not those which are pledgeable at the local central bank.

Q8: Do you believe the chosen scenarios are appropriately defined? What alternative definitions would you apply?

The liquidity stress scenarios to assess contingent encumbrance have been defined by the CRR after a long period of discussion and have been voted. The EBA would go beyond its mandate if it would introduce new scenarios, particularly if thise would be appear to ve inconsistent with the CRR. As a consequence we urge the EBA to stick to the already defined scenario and remove this template from the Asset Encumbrance reporting framework.

Moreover, the percentage chosen (30% decrease in value) is extreme and would not be appropriate where loans are concerned

It would, moreover, be highly appropriate reconsidering the linearity in the haircuts applied to assets: some sort of differentiation in terms of asset class should be taken into account.

Considering national stress test requirements, there is a potential for double stress-testing and overlap with recovery plans.

Q9: Does the instructions provide a clear description of the reporting framework? If not, which parts should be clarified?

In general, the instructions are clear.

Our main objection to what is being proposed is that the objectives presented in the Consultation Paper rely on an extensive interpretation of Article 95 of the CRR and overlap with the objectives pursued by other liquidity reporting. Thus some of the required tables are redundant with liquidity reporting and sometimes in contradiction with the CRR provisions.

Nevertheless, the following comments need to be made:

- In Part A, where self-issued ABS are concerned, the detailed rows “Senior”, “Mezzanine” and “First Loss” do not seem appropriate for the underlying pool of assets (since there is no clear split within the pool of assets that is pledged).

- The way in which depreciation of significant currencies should be tested in part C is not clear. Is it required to test the depreciation compared to the reporting currency? This should be clarified.

- The amounts to be reported should be net of the hedge, should a hedging relationship need to be documented. This should be clarified in the instructions. This will bring a lot of complexity to this reporting whilst it would be redundant with LCR and Additional monitoring tools which sufficiently highlight FX issues.

Q10: Do you identify any overlaps with the existing reporting framework, which could be mitigated?

- There exists obvious overlap with the data which need to be reported within the Liquidity Reporting Framework (LCR, NSFR and the ongoing consultation paper on additional monitoring tools), albeit with an added level of complexity imposing heavy implementation costs and an increased reporting burden on the institutions. This should be remedied.
- The templates seem to capture subordination of the balance sheet from one side and liquidity capabilities from the other. FINREP could be put at use to cover subordination whereas liquidity capabilities could be covered by the liquidity ratios. Mixing both issues would not only introduce an extraordinary burden for banks but would also be extremely complex.
- We also expect the EBA to reconsider asset encumbrance table (LR6) from leverage ratio reporting
- The templates assume a single allocation of encumbered assets to be matched against specific liabilities. Such an approach may not correspond to what happens in practice. As a result of this, we suggest a reporting based on cover pool level and not on an individual asset level.