

PIMCO

March 20, 2014

Response to EBA Consultation Paper: Draft guidelines on disclosure of encumbered and unencumbered assets

Dear Sirs,

PIMCO welcomes the opportunity to comment on the EBA's consultation paper on encumbered and unencumbered assets. PIMCO is a global investment solutions provider with more than 2,400 dedicated professionals in 12 countries that manages over \$1.9 trillion in investments for a wide range of clients, including public and private pension and retirement plans on behalf of millions of people around the world.¹ We are also advisors and asset managers to companies, central banks, educational institutions, financial advisors, foundations and endowments.

As an unsecured lender to financial institutions in both short-term and long-term securities and across the capital structure, we welcome initiatives that attempt to increase the transparency of disclosures by financial institutions. We strongly believe that transparency must go hand in hand with the increasing burden being placed on unsecured creditors who will be asked to shoulder the cost of the failure of an institution in the future. Detailed, timely information not only on earnings performance but also on balance sheet composition and regulatory metrics will be critical tools for investors in identifying the appropriate cost of financing and capital for institutions that may be deemed non-viable in the future. More symmetry of information between regulators on one side and private, unsecured creditors on the other is a necessary prerequisite for the new resolution system to function as intended.

Given this backdrop, we find several aspects of the consultation paper raise significant concerns – specifically the recommendation to classify as unencumbered assets legally pledged to central banks for emergency funding and the introduction of smoothing mechanisms and timing delays that will prevent market participants from reviewing accurate asset encumbrance information on a timely basis. We find the former to be particularly concerning as it effectively proposes that investors continue to lend blindly on an unsecured basis to stressed financial institutions while regulators with greater access to current information would remain fully secured. This information asymmetry might spur investors to pre-empt regulatory action by withdrawing credit earlier in times of stress, lest they get caught in a resolution of an organization and all of its associated economic consequences. The lack of disclosure could prove even more destabilizing than full disclosure of bank ELA usage as investors would likely “assume the worst” absent complete information.

¹ As of December 31st 2013

Please find below a full list of our comments which relate to the questions for consultation:

- 1. Emergency Liquidity Assistance:** The proposal states that “in public disclosures assets and matching liabilities encumbered to central banks via ELA shall be reported as unencumbered.”² While we support the ESRB recommendation that the amount of (emergency) liquidity assistance given by central banks should not be reported, the proposed misrepresentation is factually incorrect and could be subject to legal and accounting challenges, particularly from international investors and/or regulators (e.g., SEC for banks issuing in the US), and it would represent a reduction in the level of transparency currently available to investors. In the extreme, such an approach could result in public disclosures that show available collateral levels increasing at stressed banks as they lose market access because the assets pledged for ELA would be shown as unencumbered, while those pledged to market counterparties remain encumbered (i.e., the more a bank relies on ELA, the more “liquid” its balance sheet will appear in public disclosures). Rather than requiring banks to misrepresent encumbered assets as unencumbered, we would recommend that banks provide no information at all about the encumbrance levels of certain assets, namely those assets that private investors would not normally accept as collateral (e.g., whole loans / fixed assets). At a minimum, it is critical for investors to have an accurate understanding of the amount of available collateral in banks’ securities portfolios. Debt and equity securities pledged for ELA funding in Template B should be reported as encumbered and unavailable in public disclosures, even if the source of that encumbrance is not disclosed in Template C.
(This response relates to consultation questions 3, 4, 5, 6 and 8)
- 2. Granularity of disclosure:** Investors almost universally prefer more granular disclosure. The Enhanced Disclosure Task Force, of which PIMCO is a member, has recommended a more granular breakout of encumbered and unencumbered assets by balance sheet category, including breakouts for cash and equivalents, sovereigns, other investment securities, derivatives, loans and other assets. In terms of disclosure about the quality of encumbered and unencumbered assets, investors would find it useful to distinguish between “investment grade” and “below investment grade” debt securities. This information is crucial for investors considering unsecured investments in a bank because the encumbrance of the balance sheet directly impacts recovery rates in the event of a default and there are marked differences in the liquidity and secondary marketability of each of the balance sheet categories requested.
(This response relates to consultation questions 1 and 2)
- 3. Timing of disclosure:** The Enhanced Disclosure Task Force recommends disclosure of all relevant financial information at the same time. Disclosures on asset encumbrance should be

² The consultation paper states on page 12 that “Institutions should not disclose [...] the amount of emergency liquidity assistance (ELA) provided by central banks, which means that in public disclosures assets and matching liabilities encumbered to central banks via ELA shall be reported as unencumbered, such that the sum of encumbered assets corresponds to the institutions’ total assets on balance sheets;” In addition to the considerations outlined above, the italicized statement should be clarified, perhaps by expanding to include “encumbered and unencumbered assets”

no exception. Toward that end, we would encourage banks to provide information on asset encumbrance in conjunction with regular financial reporting, ideally on a quarterly basis, and there should be clear criteria that define when a time delay of up to six months is appropriate. In periods without significant systemic distress, complete disclosure of asset encumbrance information should be provided immediately, even if that provides a means for the market to identify institutions that are experiencing specific idiosyncratic challenges. For example, the EBA, ESRB or national regulators could designate whether there are systemic risks in a particular country on a quarterly basis and banks operating in that country would be allowed to delay asset encumbrance reporting that quarter for up to six months; however, if no such systemic risks are present then all banks should be required to provide their asset encumbrance disclosures in conjunction with regular financial reporting. *(This response relates to consultation question 9)*

4. **Sources of encumbrance:** Template C presents valuable information on sources of encumbrance that is critical to analysts' understanding of the institution's business model and the funding choices that affect its balance sheet. An open narrative as proposed in Template D would not only reduce comparability over time and across institutions, but could be less comprehensive if institutions were to emphasize certain forms of encumbrance at the expense of others. *(This response relates to consultation question 6)*
5. **Balance sheet reconciliation:** Reconciliation to balance sheet statements is important for debt and equity investors and reporting of median values is unlikely to tie to quarter-end financial statements. As a result, we would suggest that banks report both median and end-of-period balances for asset encumbrance disclosures. *(This response relates to consultation question 7)*
6. **Implementation date:** Asset encumbrance is a critical area of interest for investors at present and we would encourage the EBA to accelerate the finalization and implementation dates for the proposed technical standards with effective dates no later than 2016.

We would greatly appreciate your considering our comments.

Christian Stracke

Managing Director, Global Head of Credit Research Group, PIMCO
Co-Chair, Enhanced Disclosure Task Force

Philippe Bodereau

Managing Director, Head of Pan-European Credit Research, PIMCO