

POSITION PAPER



ESBG Response to EBAs consultation on Asset Encumbrance

WSBI-ESBG (World Institute of Savings Banks - European
Savings Banks Group)
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Dear Sir/Madam

Thank you for the opportunity to comment on the EBA consultation on *draft implementing technical standards on asset encumbrance reporting*.

1. General comments

Pledging assets or providing collateral are activities commonly undertaken by the banking industry and this is widely recognised by EBA. The provision of collateral is hence not specific to covered bonds and we do not consider covered bond programmes to be one of the main drivers of asset encumbrance.

It is worthwhile noting that the covered bond market is already the most transparent market segment compared to other asset encumbrance drivers, such as ECB money market transactions, derivatives, repo or securitisation transactions. Supervisors and investors have continuous access to detailed information regarding the volume and composition of covered assets set aside for covered bond holders. In addition, covered bond funding does not constitute the only form of long-term encumbrance. The ECB's two longer-term refinancing operations with a maturity of three years and collateral for longer-term derivatives, especially as part of the initial margin, are just another two examples of long-term asset encumbrance. This should be taken into consideration when introducing reporting templates that require information on covered bonds which is not required for other asset encumbrance drivers.

National covered bond legislation restricts the number or type of eligible assets. The German Pfandbrief Act, for instance, is particularly strict when it comes to the eligibility criteria for cover assets and thus considerably restricts the volume of outstanding covered bonds. Ultimately, the interests of secured and unsecured creditors must be fairly balanced by recognizing the added value covered bonds generate for the stability of financial markets.

We therefore challenge the negative connotation of 'asset encumbrance'. During the financial crisis, covered bond funding was the only point of access to private capital funding for a significant number of credit institutions. There is also evidence that covered bond funding prevented liquidity shortfalls and consequently insolvencies in the banking industry and that asset encumbrance was a strong contributor to financial stability during stressed periods. This benefitted both depositors and unsecured creditors.

We would like to emphasise that reporting requirements should not lead to limits on asset encumbrance. The main risks related to asset encumbrance identified by the EBA and the ESRB will be significantly diluted with the forthcoming proposals on bail-in.



Level of application:

Under Article XX, para. 5, section XX, page 10, materiality thresholds are defined beyond which institutes or groups (consolidated) are required to report only certain parts of information (templates Part A and Part D) on asset encumbrance. The first threshold of EUR 30 billion appears to be appropriate.

Reporting date/starting date:

The coming into force of the reporting requirements for asset encumbrance on 1st January, 2014 and the first reporting date of 31st March, 2014 are neither realistic nor possible due to the high data and reporting requirements. For this reason, we recommend that the requirements come into effect no earlier than 1st January, 2015.

Reporting frequency:

Generally speaking, we consider the quarterly frequency for the templates Asset Encumbrance (AE) Part A: Encumbrance Overview, AE Part B: Maturity Data and AE Part D: Covered bonds to be too high and half-yearly reports to be sufficient because changes, for instance, in the cover pool of covered bonds are relatively minor. Moreover, the detailed reporting requirements for asset encumbrance require considerable effort in order to prepare, analyse and report the data.

We consider the reporting frequencies for the templates Asset Encumbrance Part E: Advanced Data (every six months) and Asset Encumbrance Part C: Contingent Encumbrance (every twelve months) to be reasonable.

2. Comments on the templates

More specifically, we recommend improving consistency between the AE reporting templates and the existing requirements for LCR and/or NSFR reporting purposes where similar albeit not identical information is gathered. The complexity of collecting the requested AE figures must be weighed up against the added value for supervisors of receiving the targeted information rather than only slightly less calibrated figures. The complexity of the data collection exercise for banks is further exacerbated by the cover pool reporting requirements stipulated by national covered bond legislation which - again - are not completely identical to the AE templates.

Many templates require the allocation of encumbered assets to 'matching liabilities'. Template AE-Adv, for example, specifies that encumbered assets/encumbered collateral received should be listed against matching liabilities. Template AE-Maturity requires the allocation of encumbered assets to the corresponding residual maturity of liabilities as well as the AE-Assets and AE-Collateral templates where debt securities and loans on demand must be divided into 'encumbered' and 'unencumbered' and valued at FV and CA.

However, under most European covered bond regimes the allocation of an individual encumbered asset to a specific matching liability is not possible, as the cover pool on the whole serves as



collateral for all outstanding covered bonds. Since assets and liabilities are generally matched at cover pool level, the requested figures can only be collected at cover pool rather than at single asset and liability level. If, indeed, the templates are to be completed with figures collected at cover pool level, we would very much appreciate confirmation from EBA to this effect.

We also refer to the footnote below Template AE-CB Issuance (Part 'D') where additional sets of rows 010 to 040 are to be added for each additional covered bond. We advise replacing 'covered bond' with 'Cover Pool'.

We recognise the aim to use accounting values in order to reconcile the reported figures with the balance sheet items (FINREP). However, the instructions (Annex II) lack any further guidance. The validation rules appear incomplete in this context (referring to AE-Assets and AE-Sources only); this produces particular challenges for smaller institutions that apply local GAAP only and which do not report under FINREP.

In our view, the proportionality principle must be respected throughout all the templates. We regret that this principle is not observed, primarily, by Template D on 'covered bonds'. Explanation is provided below.

Proportionality must also apply to the reporting frequency. We question a quarterly frequency for templates A, B and D. Cover pool changes over a three-month period are not sufficiently material to justify quarterly reporting. Instead, semi-annual reporting seems to be a much more suitable interval.

Finally, the high level of complexity in the templates means that new IT systems are needed and this means that the entire reporting framework foreseen for January 1, 2014 should be postponed, for instance, until January 1, 2015.

Template AE - Covered Bonds Part D:

We understand that the addition in line 15 [additional sets of rows 010 to 040 to be added for each additional covered bond] means that Part D must be completed for each cover pool for X covered bonds. We request clarification of this matter.

Template AE- Advanced Part E of the template from line 37:

We are not certain how the template is to be completed. In our opinion, the term "matching liabilities" in column E is especially confusing. If the securities contained are to be presented here, then we would expect to see "matching assets" reported here. We would hence welcome a detailed explanation for the template, Part E.

3. Comments on the questions from the ITS

Q1: Is the definition of asset encumbrance sufficiently clear?"



We would advise an alteration to the definition in a way that it requires both pledging and absence of free withdrawal of assets rather than one of both. This should, for example, allow categorising of assets which are part of a bond lending program with the institution's clearing agent (e.g. a central bank) where the contract stipulates that those assets are at the institution's disposal at any time as unencumbered assets. These contract types usually stipulate that a certain percentage of the institution's deposited asset pool can be borrowed by the clearing agent without prior notice to the institution but requires the clearing agent to immediately provide the borrowing institution with the same or equivalent assets (e.g. cash) upon the institutions request. Therefore, this type of bond lending pledges assets does retain free withdrawal which does not make the assets operationally encumbered. Moreover, the institution does not necessarily know which assets of its pool have been borrowed by the clearing agent, creating a reporting issue. Consequently, we deem an update of the definition, as described above, advisable.

Regarding the assets included in Central Bank Facilities, we would modify the paragraph inside the box on page 9 as follows:

“Central bank facilities: Pre-positioned assets should not be considered encumbered, unless the central bank does not allow withdrawal of any assets placed without prior approval. Encumbrance of specific securities assigned as collateral should be allocated in order of increasing liquidity value.”

The liquidity criterion is more reasonable than a pro-rata rule since, if needed, banks would choose to mobilise the most liquid assets and leave the least liquid at the central banks. Currently, this is the criterion used by the Basel Committee for the LCR ratio.

The definition of encumbrance regarding Covered Bonds in the box on page 9 should clarify that it refers to “eligible assets in cover pools”.

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?

Yes, it seems to be appropriate to incorporate the ITS into the full reporting framework, especially into the COREP reporting framework.

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?

In order to be in line with the wide definition, it would be consistent to include off-balance sheet items in the calculation of the encumbrance ratio threshold. We therefore favour the second alternative that focuses on liabilities. In our view, it is important to also fully capture institutions with important off-balance sheet activities, because collateralised derivative transactions represent an increasing market segment and constitute an important driver of asset encumbrance.



The context of the ratio is somewhat confusing: Is this encumbrance-ratio to be seen as a general measure or only a measure in the context of the proportionality-threshold?

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?

We consider the proportionality criteria in general to be sensibly selected, but in every case institutions should not be required to report the information referred in point b of paragraph 1 or the information referred in paragraph 2 and 3 if they meet any of the mentioned conditions (30 bn € or 5%). We would prefer that both conditions were required to be fulfilled.

Regarding covered bonds the reporting requirements should be better calibrated on the basis of the proportionality principle. We see the need to provide reporting relief to institutions with small covered bond issuance activity.

We therefore advise the introduction of a 5% threshold for the specific reporting template for covered bond programs (Part D). Indeed, institutions should only be requested to report on covered bonds if their asset encumbrance level triggered by covered bonds is equal to or greater than 5%.

Below such a threshold, the encumbrance risk to institutions and to the financial system cannot be considered to be substantial and does not justify the reporting burden. In these cases, asset encumbrance triggered by covered bonds is sufficiently covered through template Part A which should be submitted on a semi-annual basis.

In the case of banking groups where funding is only processed through the parent company and group members are funded internally, asset encumbrance reporting should be restricted to single bank level while exempting group level.

In as far as funding is processed through the parent company "only" in the case of banks or financial holding groups and the group members are only funded within the group with the parent company, asset encumbrance reporting should be restricted to single bank level (via the parent bank).

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?"

Unencumbered assets might not be available for encumbrance in the following cases:

Assets that are not central bank eligible and are not recognized as security by private markets

Debt securities which are blocked for minimum reserve purposes and/or intraday-liquidity management



Syndicated loans where the borrower did not consent to the right to assign or transfer the loan or parts of the loan

We consider this to apply in the following cases:

If assets are not central bank eligible and are not recognized as security by private markets

Debt securities which are blocked for minimum reserve purposes and/or intraday-liquidity management

In as far as the borrower, e.g. in the case of pool liabilities, is not required by the contract to assign or transfer or sell the loan, such liabilities can only be conditionally transferred as security.

Assets where the credit quality and the usability are insufficient and if the valuation of the asset is not reliable.

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?

The template seems to correctly reflect all material asset encumbrance sources and we do not see any additional sources of material asset encumbrance.

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?

There are good arguments in favour of the central bank eligibility criteria because the crisis has demonstrated that repo-eligible assets were still marketable during stress scenarios.

With a view to asset encumbrance, the focus is primarily on potential options for encumbering assets in order to enable funding (refinancing). Generally speaking, with a view to the marketability of assets, the central bank eligibility of marketable and non-marketable assets or marketability as security on repo markets should serve as a basis for asset encumbrance (within the meaning of "marketability"). Refer also to the information provided under the following link:

http://www.bundesbank.de/Navigation/DE/Kerngeschaeftsfelder/Geldpolitik/Notenbankfaehige_Sicherheiten/notenbankfaehige_sicherheiten.html

or

<http://www.ecb.int/mopo/assets/assets/html/index.en.html>

However, we very much advocate a common approach across different reporting lines in order to streamline the reporting burden and achieve synergies. We therefore refer to Art. 404 par. 3 CRR in order to identify the marketability of assets in line with the criteria applied in the area of liquidity reporting.



In the same line of thinking, risk weights of assets are also appropriate as they are already available in the 'data-warehouse' of credit institutions. For practical reasons, however, we propose using the risk weight as a criterion because this is already available for analysis in the data warehouses.

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

The application of a 30% decrease of the fair value of encumbered assets is not realistic, so we doubt the value of the stress scenario. Stress scenarios are already embedded in national legislation. Under German law, for instance, a mortgage lending value must be applied to eligible real estate, and mortgages are only eligible for the cover pool up to 60% of the mortgage lending value.

The mortgage lending value is the prudently calculated value of a property. It represents the value which, throughout the entire life of the loan, is likely to be achieved for a property sold on the free market - irrespective of temporary (for example, economically-induced) fluctuations in value on the respective property market. The purpose of this requirement is to eliminate speculative influences.

Given the 60% limit for cover pool eligibility, a further stress scenario of a 30% decrease in market value would result in a market value level of around 20% or even lower which we do not consider to be a reasonable scenario. We therefore challenge the need for any additional stress scenarios for property and public sector assets.

Similarly, the depreciation of 10% in significant currencies overlaps national legislation where currency stress scenarios have to be reported in accordance with national covered bond rules. Since this also overlaps the requirement to report LCR ratios on the basis of a number of significant currencies, this reporting position appears redundant to us.

As a matter of principle, the cover value calculation on national level (net present value approach) already takes stress scenarios into consideration. The German Pfandbrief Act, for instance, stipulates depreciation in currencies of between 10 and 25%. Should these national simulations be factored into the scenarios of Template 'C', the resultant figures would be based on scenarios which would be stressed twice. For these reasons, we would welcome the exclusion of national stress simulations from the calculation of the stress scenarios of Template 'C' if this calculation is to remain.

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

Templates D and C are the root of most of our concerns:

Part 'D', Covered Bonds:

Template AE-CB Issuance:

It is not clear whether the template also applies to 'Registered Covered Bonds' as it does to 'Bearer Covered Bonds'. We recommend merging row 020 with 030. As the asset-specific value translates



into full fair value, we do not see how this value deviates from the market value of row 020. In such a case, we assume that the same figure will be entered in both rows. Alternatively, we would welcome guidance on the delimitation of market value and fair value.

Regarding rows 220 to 250, we would like to once again emphasize that figures cannot be supplied on single covered bond level, but only on cover pool level. Clarification of this matter would be much appreciated.

Template AE-CB Eligible Assets:

The reporting of unencumbered assets eligible for cover pool would mean a significant administrative burden. Covered bond issuers would have to apply the entire set of national eligibility criteria to all balance sheet items outside the cover pool. This exercise would require the classification of all 'remaining' balance sheet assets in terms of their potential eligibility features, the application of specific valuation rules to real estate assets and other covered bond specific criteria.

This administrative burden appears to be even more disproportionate in cases where the share of the cover pool in the balance sheet of the bank is insubstantial. In our view, the costs generated by the template do not justify the added value.

The term 'unencumbered assets eligible for cover pool' would also cover debt securities. However, debt securities are not listed in any of the subsequent boxes.

We challenge the availability of an 'asset-specific value' (IAS 39) of unencumbered assets. The reporting of the 'carrying amount' varies in accordance to the accounting rules applied (national accounting rules vs. IFRS) and is not intrinsic to cover pool management.

Finally, row 060 is unlikely to deliver any meaningful result. Cover pool derivatives and derivatives outside the cover pool are concluded on the basis of different master agreements. It is not legally possible to transform an unencumbered derivative into an encumbered cover pool derivative since such a transaction must be qualified as a 'novation' that would require termination of the existing unencumbered derivative contract. This means that it is not legally possible to encumber a derivative which has been concluded outside the cover pool.

Part 'C', Template AE-Contingent:

We refer to our response to Q 8.

In addition, some confusion arises from the wording: 'decrease by 30% of the fair value of encumbered assets' in comparison with Instruction N° 28 where 'it shall be assumed that all encumbered assets decrease 30% in value'. This leaves open to interpretation that a 30% decrease in value will only be applied to assets which have been valued on the basis of fair value and not to assets valued at book value (e.g. loans).



We would also welcome guidance on the treatment of hedge transactions within the stress scenarios (derivatives inside and outside cover pools). Ignoring these transactions would distort the overall picture significantly.

Part 'A', Encumbrance Overview:

Template AE-Collateral:

It is not clear whether row 230 'other collateral received' also covers mortgage collaterals. We believe that this is not the case. Otherwise, this reporting requirement would be extremely burdensome.

Template AE-Sources:

We would welcome guidance on the meaning of '% in market' of the requested carrying amounts (rows 090 to 110).

Part 'E', Template AE-Adv1:

We would welcome more detailed guidance on the figures required under the boxes: 'matching liabilities'. If the securities received are to be reported here, we would expect a 'matching assets' position.

Another difficulty arises due to the determination and reporting of the carrying amount of total unencumbered and/of which central bank eligible assets: we are unable to see how this assessment (valuation of potentially central bank eligible assets) can be carried out in practice. It is almost impossible to determine central bank eligibility merely on a theoretical basis, especially for non-marketable assets. The central bank eligibility of these assets can ultimately only be determined by submitting the assets to the central bank.

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

No further comments.



About WSBI-ESBG (European Savings Banks Group)

WSBI-ESBG – The European Voice of Savings and Retail Banking

WSBI-ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,631 billion, non-bank deposits of €3,500 billion and non-bank loans of €4,200 billion (31 December 2011). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI-ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI-ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.



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