



**VERBAND DEUTSCHER  
PFANDBRIEFBANKEN**  
Association of German Pfandbrief Banks

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## **vdp response to the EBA consultation on Asset Encumbrance**

### **Introduction:**

- General comments

Pledging assets or providing collateral are instruments commonly used by the banking industry, as this is well recognized by EBA. Hence, the provision of collateral is not specific to Covered Bonds and we don't think that Covered Bond programs constitute one of the main drivers of asset encumbrance.

It is worthwhile to note that the Covered Bond market is already the most transparent market segment in comparison with the other asset encumbrance drivers, such as ECB money market transactions, derivatives, Repo or securitization transactions. Supervisors and investors have access at any time to detailed information about the volume and composition of cover assets set aside for Covered Bond holders. In addition, Covered Bond funding does not constitute the only long-term encumbrance. The ECB's two longer-term refinancing operations with a maturity of 3 years and collateral for longer-term derivatives, especially as part of the initial margin, are just two other examples of long-term asset encumbrance. This should be taken into consideration when introducing reporting templates requiring information on Covered Bonds which are not required for the other asset encumbrance drivers.

National Covered Bond legislations restrict the number or types of eligible assets. For example, the German Pfandbrief Act is particularly strict regarding the eligibility criteria for cover assets, thus considerably restricting the volume of outstanding Pfandbriefe. At the end, the interests of secured and unsecured creditors have to be fairly balanced by recognizing the added value produced by Covered Bonds 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 access to private capital funding for a significant number of credit institutions. There is 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 is to the benefit of depositors and unsecured creditors.

- Specific comments on the Templates

More specifically, we advise to improve the consistency between the AE reporting templates and already existing requirements for LCR and/or NSFR reporting purposes where similar although not identical information is gathered. The complexity of collecting the requested AE figures must be balanced against the added value for supervisors of receiving the targeted information vs. only slightly less calibrated figures. The complexity of the data collection exercise for banks is further increased through cover pool reporting requirements stipulated by national Covered Bond legislation which – again – don't fully match with 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 shall be listed against matching liabilities. Template AE-Maturity requires the allocation of encumbered assets to the corresponding residual maturity of liabilities as well as Templates AE-Assets and AE-Collateral where debt securities and loans on demand must be divided into 'encumbered' and 'unencumbered' and valued at FV and CA.

However, in most European Covered Bond regimes the allocation of an individual encumbered asset to a specific matching liability is not possible, as the cover pool in whole serves as collateral for all outstanding Covered Bonds. As matching of assets and liabilities generally takes place at cover pool level, the requested figures can only be collected at cover pool rather than at single asset and liability level. Should the Templates indeed be completed with figures collected at cover pool level, we would very much appreciate confirmation from EBA at that respect.

We also refer to the footnote below Template AE-CB Issuance (Part 'D') where additional sets of rows 010 to 040 shall be added for each additional Covered Bond. We advise to replace 'Covered Bond' by 'Cover Pool'.

We recognize the aim to use accounting values in order to reconcile the reported figures with the balance sheet items (FINREP). However, we are missing further guidance in the instructions (Annex II). The validation rules appear incomplete in this context (refer to AE-Assets and AE-Sources only);

this produces particular challenges for smaller institutions applying local GAAP only and not reporting under FINREP.

In our view, the proportionality principle must be respected throughout all templates. We regret that this principle is first and foremost not respected by Template D on 'Covered Bonds'. Explanation is provided below.

Proportionality has also to apply to the reporting frequency. We question a quarterly frequency for the Templates A, B and D. Changes of or within cover pools are not material enough over 3 months justifying a quarterly reporting requirement. Instead, a semi-annual reporting seems to be a much more adequate time interval.

Finally, the high level of complexity of the Templates makes the implementation of new IT-systems necessary, requiring the postponement of the whole reporting framework beyond 1 January 2014, i.e. until 1 January 2015.

#### **Responses to the Questionnaire:**

Q1: Is the definition of asset encumbrance sufficiently clear?

Yes, we welcome that a wide definition has been proposed, based on economic principles and covering all assets that are subject to any restrictions in withdrawal.

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 into the calculation of the encumbrance ratio threshold. We therefore favor the second alternative focusing on the liabilities. In our view, it is important to also fully capture institutions with important off-balance sheet activities, because collateralized derivative

transactions represent an increasing market segment and materialize as an important driver of asset encumbrance.

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?

The reporting requirements must be better calibrated on the basis of the proportionality principle. We see the need to provide reporting relief to institutions with a small Covered Bond issuance activity.

We therefore advise to introduce 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 larger than 5%.

Below such a threshold, the encumbrance risk to institutions and to the financial system cannot be considered 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 delivered on a semi-annual basis.

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

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 a security by private markets
- Debt securities which are blocked for minimum reserve purposes and/or intraday-liquidity management
- Syndicated loan where the borrower didn't consent the right to assign or transfer the loan or parts of the loan

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.

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 favor of the central bank eligibility criteria as the crisis evidenced that repo-eligible assets were still marketable during stress scenarios. However, we very much advocate a common approach across different reporting lines in order to streamline the reporting burden and realize synergy effects.

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.

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

The application of a decrease by 30% of the fair value of encumbered assets is not realistic, we question the value of the stress-scenario. Stress-scenarios are already embedded in nation legislation. For example, under German law, a mortgage lending value has to be applied to eligible real estate and mortgages are only eligible to the cover pool up to 60% of this 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 can probably be achieved for a property that is sold on the free market – irrespective of temporary (for example, economically-induced) value fluctuations in the respective property market. This requirement serves to eliminate speculative influences.

Given the 60% limit for cover pool eligibility a further stress scenario of a 30% decrease of the market value would end up at a market value level of around 20% or even lower which we don't consider being a reasonable

scenario. We therefore challenge the need for any additional stress-scenarios for property and public sector assets.

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

As matter of principle, the cover value calculation on the national level (net present value approach) takes stress-scenarios already into consideration. For instance, the German Pfandbrief Act stipulates a depreciation of currencies between 10 and 25%. Should these national simulations be factored into the scenarios of Template 'C', the resulting figures would be based on scenarios which would be stressed twice. We would therefore welcome a dispensation from the inclusion of national stress simulations into the calculation of the stress-scenarios of Template 'C', should it be maintained.

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

Templates D and C raise most of our concerns:

➤ Part 'D', Covered Bonds:

- Template AE-CB Issuance:

As mentioned above, it is not possible under the German legal system (Pfandbrief Act) to allocate a single cover asset to a specific Pfandbrief. We therefore understand that all reporting statements should be delivered as aggregated statements on the level of the four existing types of cover pools, i.e. Hypothekendarpfandbriefe (Mortgage Pfandbriefe), öffentliche Pfandbriefe (Public Sector Pfandbriefe), Schiffspfandbriefe (Ship Pfandbriefe) and Flugzeugpfandbriefe (Aircraft Pfandbriefe). This should be clarified within the instructions of Annex II.

It appears uncertain if the Template also applies to 'Registered Covered Bonds', as it does to 'Bearer Covered Bonds'.

We recommend a merger of row 020 with 030. As the asset-specific value translates into a full fair value, we don't see how this value deviates from the market value of row 020. In such a case, we suppose

that the same figure will be introduced 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 emphasize again that figures cannot be delivered on a single Covered Bond level, but only on a cover pool level. Clarification at that respect would be much appreciated.

- Template AE-CB Eligible Assets:

The reporting of unencumbered assets eligible for cover pool represents a significant administrative burden. Covered Bond Issuers would have to apply the whole set of national eligibility criteria to all balance sheet items outside of 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 not substantial. In our view, the costs generated by the Template don't justify the added value.

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

Finally, row 060 will probably not lead to a meaningful result. Cover pool derivatives and derivatives outside of the cover pool are concluded on the basis of different master agreements. It is legally not possible to transform an unencumbered derivative into an encumbered cover pool derivative as such a transaction has to be qualified as a 'novation' requiring the termination of the existing unencumbered derivative contract. Hence, it is legally not possible to encumber a derivative which has been concluded outside of 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 the Instructions N° 28 where 'it shall be assumed that all encumbered assets decrease 30% in value'. There is room for interpretation that a 30% decrease in value shall 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 of cover pools). Ignoring these transactions would considerably distort the overall picture.

➤ Part 'A', Encumbrance Overview

- Template AE-Collateral:

Regarding row 140 (loans on demand), the instructions refer to the legal references and instructions in position row 020 Loans on Demand of template AE-Assets. There is a reference concerning IAS 1.54 (i), cash and cash equivalents. The instruction according Annex II defines „It includes the balances receivable on demand at central banks and other institutions“.

We would welcome clarification and/or more detailed instructions about the positions which have to be considered here beside the receivables and liabilities on central bank accounts and nostro accounts from other institutes, e.g. loans, money market etc. payable on demand? This concerns the account balances from encumbered loro accounts of other institutes from our understanding.

Concerning column 070 "Nominal of collateral received or own debt securities issued not available for encumbrance", we are missing instruction on the interpretation of "not available for encumbrance", assuming that this could be defined by the individual institute. If this should not be the case, it should be made clear and instructed.

It is unclear whether row 230 'other collateral received' also covers mortgage collaterals. We believe that this is not the case. Otherwise, this reporting requirement would turn out as particularly burdensome.

- Template AE-Not Pledged



Regarding column 040 "Nominal of own debt securities issued non available for encumbrance", we assume that this could be defined by the individual institute. If this should not be the case, it should be made clear and instructed.

- Template AE-Sources:

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

➤ Part 'B', Template AE-Maturity

It is not instructed which positions shall be reported under row 020 "Collateral received re-used (receiving leg)". Should the reporting cover collateral positions which are re-encumbered or should it cover all encumbered collateral positions?

Concerning row 030 "Collateral received re-used (re-using leg)", our understanding is the re-encumbered collateral positions. Obviously the position in row 020 "Collateral received re-used (receiving leg)" should include the collateral positions in total. If the positions under row 020 would be the re-encumbered ones, rows 020 and 030 would contain the same ratios. We would welcome clarification and/or instructions at that respect.

➤ Part 'E', Advanced Data

- Template AE-Adv1:

We would welcome more detailed instructions on the figures required under the boxes 'matching liabilities'. Should the received securities be reported here, we would expect a position 'matching assets'.

Another difficulty consists in the determination and reporting of the carrying amount of total unencumbered and/of which central bank eligible assets: we don't see how this assessment (valuation of potentially central bank eligible assets) can be carried out in practice. Especially for non-marketable assets it is almost impossible to determine the central bank eligibility just on a theoretical basis. Eventually, the central bank eligibility of these assets can only be determined by submitting the assets to the central bank.

- Template AE-Adv2

Concerning rows 020, 040, 060, 080, 100, 120, 140, 160, 180, the „Sources of encumbrance“ are divided by „Encumbered collateral received“ und „Matching liabilities“. We would welcome clarification/instructions about the liabilities that are meant. Received collateral is usually encumbered with respect to the assets. Which positions are included?

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

No further comments.

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