

Consultation Paper

Draft Implementing Technical Standards

On Asset Encumbrance Reporting under article 95a of the draft Capital Requirements Regulation (CRR)



Consultation Paper on Draft Implementing Technical Standards on Asset Encumbrance Reporting under article 95a of the draft Capital Requirements Regulation (CRR)

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1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Please send your comments to the EBA by email to EBA-CP-2013-05@eba.europa.eu by 24.06.2013, indicating the reference 'EBA/CP/2013/05' on the subject field. Please note that comments submitted after the deadline, or sent to another e-mail address will not be processed.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an e-mail message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.eba.europa.eu under the heading 'Legal Notice'.

2. Executive Summary

The Trialogue negotiations between the European Commission, Parliament and Council have introduced a mandate in Article 95a of CRR for the EBA to develop reporting templates for asset encumbrance. In order to allow institutions time to prepare for reporting of asset encumbrance beyond the templates already consulted upon by the EBA, the EBA has felt it necessary to advance its work on asset encumbrance templates and this consultation consequently seeks input on the reporting format for asset encumbrance.

This ITS consists of three parts. The first part consists of the legal text to be incorporated into the full reporting framework, which already consists of COREP, FINREP, Large Exposures, Liquidity and Leverage Ratio reporting. The legal text introduces a definition of asset encumbrance in addition to outlining the frequency of reporting and proportionality criteria in the reporting.

The second part consists of reporting templates and instructions for the templates. This constitutes the part that will be used for regulatory reporting on asset encumbrance going forward. The templates draw on existing concepts from the COREP and FINREP reporting framework, which should help institutions in the implementation of the asset encumbrance reporting.

The third part consists of a Data Point Model and validation rules. This is expected to achieve harmonisation by describing the business concepts and their relations in the necessary detail, and by defining all the relevant technical specifications necessary for developing IT reporting formats and common dictionaries of terms that can be used in the institutions' databases. The EBA will after the publication of this consultation paper incorporate the data point model (DPM) for the asset encumbrance templates into the DPM already available in the full reporting framework.

The European Systemic Risk Board (ESRB) published in February 2013 a Report on Bank Funding, which was accompanied by a set of recommendations. Recommendation C recommends the EBA to “[...] to issue guidelines on harmonised templates and definitions in order to facilitate the monitoring of asset encumbrance, in accordance with its established consultation practices”. The draft ITS presented in this Consultation Paper also serves the purposes of complying with the ESRB Recommendation.

In addition to this, the asset encumbrance reporting will provide supervisory authorities with the necessary information on the level of asset encumbrance in institutions. This will provide a valuable input for a number of reasons. Firstly, it will allow a harmonised measure of asset encumbrance across institutions, which will allow supervisory authorities to compare the reliance on secured funding and the degree of structural subordination of unsecured creditors and depositors across institutions. Secondly, it will allow supervisors to assess the ability of institutions to handle funding stress, by providing an assessment of the ability of switching to secured funding. Thirdly, it can be incorporated into crisis management, as it will allow for an assessment of the assets available in a resolution situation.

The finalisation of this ITS will be subject to the finalisation of the CRR/CRD IV proposal and the EBA will, after considering the input received in this consultation paper, finalise the ITS.

3. Background and rationale

Draft ITS on supervisory reporting and the CRR proposals

On July 20th 2011, the European Commission (EC) issued its legislative proposals on a revision of the Capital Requirements Directive ('CRD') which seeks to apply the Basel III framework in the EU. These proposals have recast the contents of the CRD into a revised CRD and a new Capital Requirements Regulation ('CRR') - which are together colloquially referred to as the CRD IV/CRR proposals.

In the Trialogue negotiations between the European Commission, the European Council and the European Parliament on the CRR proposals, an indication is given that the EBA is likely to be requested to incorporate reporting on asset encumbrance in its mandate in Article 95a CRR. The mandate in Article 95, which relates to COREP and FINREP reporting, will therefore also have to cover asset encumbrance reporting. Given that the EBA understands that institutions will require some time to implement additional templates, beyond the templates already consulted upon by the EBA, the EBA has felt it necessary to advance its work on asset encumbrance templates.

In anticipation of the finalisation of the legislative texts for the CRR, the EBA has therefore developed the draft ITS in accordance with the mandate contained in Article 95a of the EC's draft CRR. To the extent that the text changes as a result of ongoing negotiations among the EU institutions, the EBA will adapt its draft ITS accordingly to reflect any developments.

Furthermore, the ESRB Recommendations on funding of credit institutions, published in February 2013, also cover the topic of supervisory reporting of asset encumbrance. More specifically, Recommendation C recommends the EBA to "[...] to issue guidelines on harmonised templates and definitions in order to facilitate the monitoring of asset encumbrance, in accordance with its established consultation practices". The draft ITS presented in this Consultation Paper also serves the purposes of complying with the ESRB Recommendation.

The reporting on asset encumbrance will be incorporated into the reporting ITS that currently covers COREP, FINREP, Large Exposures, Leverage Ratio and Liquidity reporting. The reporting on asset encumbrance will consequently be included in the ITS consulted upon in 2011/CP50 and this ITS should be read together with this document.

To facilitate uniform and problem-free application of the Regulation, the draft ITS will include detailed instructions to the templates set out in Annex I, in particular:

- a. references to the relevant Articles of the CRR as included in the instructions of Annex II
- b. additional data definitions as included in the instructions set out in Annex II;
- c. validation rules (quantitative relations between rows and columns of each template, and among templates) set out in Annex IV;
- d. data point model containing all the relevant technical specifications necessary for developing an IT reporting format set out in Annex III; and
- e. XBRL taxonomies to ensure unambiguous IT interpretation of the data included in the ITS.

The XBRL taxonomies will be published separately at a later stage.

The nature of ITS under EU law

Any draft ITS is produced in accordance with Article 15 of EBA regulation. According to Article 15(4) of EBA regulation, an ITS shall be adopted by means of regulations or decisions.

According to EU law, EU regulations are binding in their entirety and directly applicable in all Member States. This means that, on the date of their entry into force, they become part of the national law of the Member States and that their implementation into national law is not only unnecessary but also prohibited by EU law, except in so far as this is expressly required by them.

Shaping these rules in the form of a Regulation will ensure a level-playing field by preventing diverging national requirements and will ease the cross-border provision of services. Currently, each time an institution wishes to take up operations in other Member States it has to comply with different set of requirements regarding supervisory reporting in each of them.

Background and regulatory approach followed in the draft ITS

This ITS provides uniform templates, which contain data fields that will provide competent authorities with the necessary information on the asset encumbrance in institutions in the form of quarterly reporting. This will ensure a harmonised approach to the definition of asset encumbrance and the reporting framework across all European institutions.

The development of the ITS was based on a number of principles. Firstly, the regulatory approach adopted in this ITS is to collect data arranged in a data structure, that refers as far as possible to data reported according to Article 95 CRR related to the minimum own funds requirements (COREP). This will minimise the implementation burden for institutions.

Secondly, the asset encumbrance templates are based on accounting values (carrying amounts) in order to ensure the possibility of reconciliation of the reported figures with the balance sheet items (FINREP). This is supplemented by a number of fields that collect market values/fair values. Again this should minimise the implementation burden and ensure a consistent harmonised approach.

Thirdly, it was agreed that proportionality principles were needed in order to lower the reporting burden for smaller institutions which have no material levels of asset encumbrance, due to their business models, lower complexity or other circumstances. As a consequence, these institutions will not be required to report all the templates and some templates at lower reporting frequencies. This allows for the implementation of the ITS in a proportionate manner.

Finally, not only the levels of actual encumbrance were considered of importance, but also the risk of additional encumbrance was deemed important. As a consequence, a template on contingent encumbrance was added, in a proportionate manner and at an annual reporting frequency. This will require institutions to calculate the level of asset encumbrance in a number of stressed scenarios related to significant asset value declines and currency shocks.

Contingent encumbrance denotes the additional assets which may need to be encumbered when the reporting institutions faces adverse developments (decrease of the fair value of the encumbered

assets, currency shock among others). In these cases, the reporting institution will need to encumber additional assets as a consequence of already existing transactions. Contingent encumbrance will hence be triggered by an external event over which the reporting institution has no control. Two scenarios have been added, but this may be expanded at a later stage.

Level of application and frequency of the asset encumbrance reporting

The level of application of the ITS will follow that of prudential reporting requirements (COREP). The frequency of reporting will for most institutions be quarterly, but a lower reporting frequency has been proposed for some templates.

In order to apply the ITS in a proportionate manner, not all institutions will be subject to reporting according to all templates in Annex I. Some templates will consequently not be required from smaller institutions without material levels of asset encumbrance.

The frequency, scope of application and envisaged application date of the ITS will be revised in order to be aligned to the final text of the CRR, as appropriate.

4. Draft Implementing TS on Reporting of Repurchase Agreements, Securities Lending and All Forms of Encumbrance of Assets

In between the text of the draft ITS that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

Contents

**Draft
Commission Implementing Regulation (EU) No XX/2013
of XX Month 2013**

laying down implementing technical standards with regard to supervisory reporting of institutions according to the [proposal for a] European Parliament and Council Regulation (EU) No [xx] of [date] on prudential requirements for credit institutions and investment firms

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,
Having regard to [Regulation (..) No xx/xxxx] of the European Parliament and of the Council of dd mmmm yyyy on prudential requirements for credit institutions and investment firms¹ ('CRR'), and in particular Articles 95 and 95a, thereof [ADDENDUM TO THE LEGAL BASES AS PRESENTED IN CP50]

Whereas: [ADDENDUM TO THE RECITALS AS PRESENTED IN CP 50]

....

(xx) The reporting on asset encumbrance is based on existing reporting concepts from prudential and accounting reporting and based on balance sheet items to the extent possible in order to minimise the implementation and reporting burden for institutions

(xx) The reporting on asset encumbrance is furthermore implemented in a proportionate manner as smaller institutions without material levels of asset encumbrance will not be subject to full reporting

(xx) The reporting on asset encumbrance incorporates the measurement of contingent encumbrance, which is considered to be of vital importance for especially institutions with material levels of asset encumbrance, as this is assessed to be a material risk to the liquidity and solvency profiles of institutions

....

¹ To be inserted once a final CRR text is adopted.

Chapter 1

Subject matter, Scope and Definitions

Article 1 [Addendum to Article 1 as presented in CP50]

- ... f) asset encumbrance in accordance with Article 95a of Regulation (EU) No x/2013 [CRR].

Explanatory text for consultation purposes

All ITS related to reporting requirements (Articles 95, 95a, 96, 383, 404 and 416 of CRR) are proposed to be included in one integrated draft Regulation text. Given that they complete the EU single rulebook for institutions in the area of supervisory reporting, it is therefore useful that they are grouped together in one legal text to facilitate a comprehensive view, improved understanding and compact access to them by legal or natural persons subject to the obligations laid down herein. The text is therefore an addendum to the draft ITS text on reporting proposed in the December 20, 2011 Consultation Paper on ITS on supervisory reporting and needs to be read in conjunction with it.

Article 2 [Addendum to Article 2 as presented in CP50]

5. 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

Explanatory text for consultation purposes

The definition of asset encumbrance is crucial for the reporting. It is therefore important that the definition is clear and can be implemented. The above definition appears to capture the aspects of encumbrance as clearly as it seems possible. It is important to note, that assets pledged that are subject to any restrictions in withdrawal, such as for instance assets that require prior approval before withdrawal or replacement by other assets, should be considered encumbered.

The definition is not based on an explicit legal definition, such as title transfer, but rather on economic principles, as the legal frameworks may differ in this respect across countries. The definition is however closely linked to contractual conditions.

The EBA sees the following types of contracts being well covered by the definition:

- Secured financing transactions, including repurchase and reverse repurchase contracts and agreements, securities lending and other forms of secured lending
- Various collateral agreements, for instance collateral placed for the market value of derivatives transactions
- Financial guarantees that are collateralised. It should be noted, that if there is no impediment to withdrawal of collateral, such as prior approval, for the unused part of guarantee, then only the used amount should be allocated (on a pro-rata allocation).
- Collateral placed at clearing systems, CCPs and other infrastructure institutions as a condition for access to service. This includes default funds and initial margins.
- 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. As for unused financial guarantees, the unused part, i.e. above the minimum amount required by the central bank, should be allocated on a pro-rata basis among the assets placed at the central bank.
- Underlying assets from securitisation structures, where the financial assets have not been de-recognised from the institution's financial assets. The assets that are underlying retained securities do not count as encumbered, unless these securities are pledged or collateralised in any way to secure a transaction.
- Assets in cover pools used for covered bond issuance. The assets that are underlying covered bonds count as encumbered, except in certain situations where the institution holds the corresponding covered bonds ('own-issued bonds').

As a general principle, assets which are being placed at facilities that are not used and can be freely withdrawn should not be considered encumbered.

Q1: Is the definition of asset encumbrance sufficiently clear?

CHAPTER XX

Format and frequency of reporting on asset encumbrance

Article XX

1. Reporting of the following information shall be submitted with a quarterly frequency on an individual and consolidated basis:
 - a) information on overall asset encumbrance according to Part A of Annex I
 - b) information on maturity of asset encumbrance data according to Part B of Annex I
 - c) information on covered bond asset encumbrance according to Part D of Annex I
2. Reporting of the following information shall be done with a semi-annual frequency on an individual and consolidated basis:
 - a) information on detailed asset encumbrance according to Part E of Annex I
3. Reporting of the following information shall be done with a annual frequency on an individual and consolidated basis:
 - a) information on contingent asset encumbrance according to Part C of Annex I
4. Reporting of information in accordance with paragraphs (1) to (3) shall be carried out in accordance with the instructions set out in Annex II.
5. Institutions are not 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 of the following conditions:
 - a) they have total assets, calculated in accordance with Section 1.6 of Annex II, of less than EUR [30 billion.];
 - b) they have asset encumbrance levels, as defined in Part Section 1.6 of Annex II, below [5]%;
 - c) 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)
6. Institutions that do not issue the bonds referred to in the first subparagraph of Article 52(4) of Directive 2009/65/EC are not required to report the information referred to in point (c) of paragraph 1.

Explanatory text for consultation purposes

The remittance dates as set out in Chapter 2 of the text provided in the December 20, 2011 Consultation Paper on ITS on supervisory reporting apply. The asset encumbrance reporting will consequently follow the same reporting dates as for prudential reporting.

Furthermore the level of application will follow that of Article 2 (2), such that reporting shall be done on an individual basis and on a consolidated basis for institutions subject to prudential requirements. Consequently, institutions that are not subject to prudential requirements in accordance with Article 6 CRR will also not be required to report data on asset encumbrance on an individual basis.

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 reporting will be subject to proportionality principles, as outlined above. Institutions that fall below both the threshold in terms of size (defined as total assets above 30 bn. €) as well as the threshold in terms of materiality of asset encumbrance (above or equal to 5% of total on- and off-balance sheet assets encumbered) will be subject to lower reporting requirements.

Two alternative definitions can be considered for the asset encumbrance ratio threshold. The first alternative measure is amending the ratio to exclude off-balance sheet assets. Such a measure would be simpler, but may not properly capture institutions with significant off-balance sheet activities, for instance a large derivatives collateralised book. A second alternative measure is focusing on the liabilities; that is defining a secured funding ratio calculated as secured liabilities divided by total liabilities. This measure would focus on the source of the encumbrance rather than the actual encumbrance. For all three measures it should be noted, that it is only intended as a reporting threshold.

In order to ensure that smaller institutions do not become subject to detailed reporting requirements, a supplementary proportionality measure could also be included. Smaller institutions may still be subject to detailed reporting, if they obtain a significant portion of funding from secured funding sources. In order to ensure that the smallest institutions does not become subject to detailed reporting requirements, additional proportionality criteria can be considered. Therefore it could be considered to only require institutions with total assets below a certain threshold, say 1 billion €, only to report the main template (Part A).

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?

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?

5. Content and methodology of the DPM

Content of the DPM

The DPM covers all data items included in the draft ITS. It is a structured representation of the data included in the above documents, identifying all the business concepts and their relations, as well as validation rules. It contains all the relevant technical specifications necessary for developing an IT reporting format.

Potential changes in the CRR text as a result of ongoing negotiations among EU institutions will be reflected in the final draft ITS.

DPM methodology

Data Points are the unique concepts associated to the cells of the templates of the reporting frameworks, and they must unequivocally specify the data to be reported. They provide the fixed context for the actual reported values, the Data Facts, which are then further identified by the variable context of the report instance (e.g. Entity, Period, etc.).

The approach chosen by the EBA was to define the DPM as a fully dimensional model. Thus the DPM describes each Data Point of the reporting frameworks, by means of a specific and unique combination of Members of different Dimensions. Each dimension is a category of information considered necessary to classify the data facts, and the members are the possible instances of the dimensions: {[Main Category].[Cash]; [Amount type].[Nominal amount]} are examples of [Dimension] [Members] pairs used in the model.

The model can be seen as an n-dimensional space where dimensions are the axes, and members are the axes coordinates; each data point has a precise position in this space, defined by specific coordinates (a unique combination of [*dimension*].[*member*] pairs). A data point can be described by additional dimensions, for instance a data point can have two dimensions, i.e. {[Main category]. [All assets] and [Counterparty sector].[Central governments]}.

Other properties of data, like the data type (e.g. monetary, percentage...), the period type (stock/flow), the category of item (assets, exposures, off-balance sheet, memo items, etc.) are also explicitly assigned to the data points.

Each Dimension takes its members from one specific Domain. Domains can be derived from categories of concepts identified in the reporting framework (e.g. Type of assets, Risk weight, Impairment status, etc.).

Domain members can also be organised into Hierarchies, which are useful for understanding the breakdowns of data, and to define validations of summary data, across the parent-child structure of members.

The DPM also includes metadata describing the reporting templates, and the relation between template cells and data points, making it possible to know for each table cell its dimensional categorisation and to know for each data point its respective coordinates of the templates.

Validation rules

To facilitate uniform implementation and avoid implementation problems, it is necessary to include validation rules (quantitative relations between rows and columns of each template, and among templates) in the final draft ITS.

In order to get feedback on technical details, a first set of validation rules are included for consultation purposes in Annex IV.

5.1 Annexes

The following documents show the link between the individual data points and the relevant cells in the templates regarding supervisory reporting requirements for the asset encumbrance templates

- Annex III of EBA/CP/2013/05 - Templates and Data Point Codes (MS Excel file)
- Annex IV of EBA/CP/2013/05 - Validation rules

6. Accompanying documents

6.1 Draft Cost- Benefit Analysis / Impact Assessment

The mandate to the EBA of drafting Implementing Technical Standards on reporting requirements covering asset encumbrance is a result of the Trialogue negotiations between the European Commission, the European Council and the European Parliament. For this reason no specific reference is made to the concept of asset encumbrance in the impact assessment document accompanying the July 2011 proposal of the CRDIV/CRR, nor to any of the elements justifying regulatory intervention.

The process of asset encumbrance is the pledging of assets, by an institution, against specific claims in order to secure or collateralise those claims, i.e. in order to make sure that creditors holding those claims can possess the assets should the institution fail to meet its obligations. Asset Encumbrance is the result of an institution creating a legally binding preferential claim on its assets or financial items it had received as collateral under other transactions in favour of a selected group of its creditors (including holders of claims on the reporting bank's general estate not recognized on balance-sheet); asset encumbrance is thus characterized by the loss of a previously enjoyed level of control over assets or collateral received.

The European Systemic Risk Board (ESRB) published in February 2013 a Report on Bank Funding that, among other topics, collects evidence on the materiality of asset encumbrance in Europe and describes some of the risks associated to it. The report backs a series of ESRB recommendations on the matter of bank funding: Recommendation C ('Monitoring of asset encumbrance by supervisors'), in particular, recommends National Supervisory Authorities to monitor the level, evolution and types of institutions' asset encumbrance. The ESRB explicitly asks NSAs to focus supervision on: i) framework, policies, and contingent plans for asset encumbrance management; ii) level, evolution and types of asset encumbrance and related sources of encumbrance; iii) level, evolution and credit quality of both encumbered assets and assets available for encumbrance; iv) evolution and types of contingent asset encumbrance.

The ESRB collected data on asset encumbrance for a sample of large European institutions and compared asset encumbrance levels in 2007 and 2011. The comparison highlights a substantial increase in the levels of assets encumbrance, with the median ratio of encumbered assets over total assets increasing from 7% in 2007 to 27% in 2011. The average asset encumbrance ratio, weighted by total assets, increased from 11% in 2007 to 31% in 2011.²

Increasing levels of asset encumbrance may pose the following risks to individual institutions and to the whole financial system:

² The ESRB could only collect data covering both 2007 and 2011 for 28 large European institutions. Depending on the uncertainty on the composition of collected data variables, the ESRB computed the encumbrance ratio under different assumptions. A 'conservative' version of the asset encumbrance ratio, for certain institutions, is computed by deducting from encumbered assets the amount of retained securities given that the latter could be reported as well under covered bonds and other collateralised securities. A less conservative version of the ratio includes matched repos in the encumbered assets value (numerator) as well as in the total assets value (denominator). The median and mean figures described here refer to the encumbrance ratio that includes matched repos.

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- 1) increasing structural subordination of unsecured creditors and depositors; the shift towards secured funding underlying asset encumbrance may imply decreased recovery rates for unsecured creditors and hence increased costs of unsecured wholesale funding, potentially leading to crowding-out of unsecured wholesale funding. The impact of asset encumbrance on unsecured investors' expectation of further encumbrance can potentially give rise to a phenomenon of self-fulfilling expectations. Bank funding excessively skewed towards secured funding and increasing encumbrance of high quality assets can negatively impact the rating received by institutions and hence generate further increases in encumbrance. Banking theory suggests that decreasing proportions of unsecured funding imply decreasing intensity of market discipline, since unsecured investors are notably the ones that have the right incentives to carry on monitoring and to correctly price in risks.
 - 2) Increasing funding and liquidity risks; institutions with encumbered balance sheets have fewer assets eligible for encumbrance, i.e. assets that act as an unused liquidity buffer and that can be used for unexpected future liquidity needs, such as committed credit lines and margin calls on derivatives positions.
 - 3) Increasing sensitivity of the liquidity profile of the institution to market values of collateral; whenever the value of collateral decreases, the institution usually has to provide additional collateral (additional encumbrance occurs) to offset the initial fall in value.
 - 4) risk that asset encumbrance worsens during phases of financial stress, amplifying the latter, and giving rise to non-linearities in the evolution of risks mentioned at points (a), (b) and (c) above; the perverse effects of debt subordination, funding and liquidity risks, are higher for higher levels of encumbrance of an institution's balance sheet.

Ultimately, the potentially negative implications of asset encumbrance can constitute a threat to the regulatory objectives of financial stability, depositor protection and reduction of systemic risk.

Furthermore the asset encumbrance reporting can be integrated into crisis management proposals, as the reporting will provide competent authorities and institutions with a harmonised and comparable set of information on the broad types of assets that will be potentially unavailable in a resolution situation.

Monitoring by supervisory authorities of asset encumbrance dynamics, introduced by Article 95a of the CRR through reporting requirements on asset encumbrance, is hence expected to contribute to the general policy objectives of the CRD IV/CRR policy initiative.

6.1.1 Problems addressed by the ITS and objectives

Within the mandate received by Article 95a of the CRR, the proposed draft ITS establish the type of information and data variables, formats and frequencies of the latter, which are appropriate in order to ensure that supervision of assets encumbrance, and the monitoring of the risks related to it, are effective and harmonised.

Effective and harmonised monitoring and supervision of assets encumbrance contribute to the realisation of the general regulatory objectives mentioned in the previous section. In particular,

harmonisation of supervisory practices related to asset encumbrance, which is the main objective of this ITS, contributes to those objectives by realising the following specific objectives:

- 1) increased effectiveness and efficiency of supervision of asset encumbrance in institutions operating cross-border in the Single Market.
- 2) Increased effectiveness and efficiency of supervision of asset encumbrance, and the associated risks, from a macro-prudential perspective in the Single Market.

As with any other reporting requirement, the technical standards on reporting asset encumbrance have to strike the right balance between the proportionality of the reporting compliance burden (costs) on the one hand, imposed on institutions when requiring to collect and report new data and new information, and the level of detail and data break-down which is appropriate in order to ensure that supervision of asset encumbrance, and the monitoring of risks related to assets encumbrance, are sufficiently effective and harmonised.

6.1.2 Proposed approaches and impacts on markets, institutions and regulators

The reporting requirements introduced by the draft ITS are expected to generate, at least in part, both on-going (employed staff hours) and one-off (investment in IT equipment) new compliance costs, born by institutions in order to carry out the processing and transmission to the supervisory authorities of data variables according to new and/or more detailed levels of balance sheet breakdown. New costs are more likely to arise for medium and small institutions, as within large institutions the necessary infrastructure and analytical tasks for monitoring and reporting asset encumbrance might already be in place.

National Supervisory Authorities will have to increase the resources, both on-going staff hours and infrastructure resources, devoted to processing the data on asset encumbrance received from the institutions under the scope of Art 95a of the CRR.

The benefits of the proposed ITS materialise to the extent that the general and regulatory objectives associated to effective and harmonised supervision of assets encumbrance are going to be achieved. Enhanced financial stability, depositor protection and reduced risk of systemic events are expected to result in reduced losses for institutions as well as for the Member States' economies.

Proportionality of the reporting requirements

The draft ITS proposes to address proportionality of compliance burden by introducing two levels of reporting requirements characterised by increasing levels of data breakdown and hence increasing levels of compliance burden. The information required is deemed to be necessary to ensure that supervision of asset encumbrance is sufficiently effective and harmonised over the institutions under the scope of the CRR.

One 'Main Template' includes all the information and data variables breakdown that all institutions addressed by Article 95a of the CRR are required to report.

The 'Advanced Templates' including information on the characteristics of encumbered and unencumbered assets in a detailed break-down of balance sheet items and the asset encumbrance information under hypothetical stressed scenarios (i.e. contingent asset encumbrance) are proposed as a reporting requirement for following set of institutions:

- 1) The institutions with an individual or consolidated balance sheet value of Total Assets equal to or larger than EUR 30 billion. These are the institutions whose profile of asset encumbrance is particularly relevant for the monitoring of the risks of systemic nature associated to trends of increasing asset encumbrance.
- 2) All the other institutions whose level of asset encumbrance, measured as the ratio between encumbered assets and total assets is equal to or larger than 5 %. This threshold may be calibrated following a data collection exercise carried out in cooperation with National Supervisory Authorities, in order to make sure that the right balance is found between the level of coverage, in terms of total assets in the Single Market, of the 'Advanced Templates' and the size and encumbrance levels of covered institutions.

Furthermore an additional template relates to the detailed information on covered bonds. This template will naturally only have to be filled in by institutions issuing covered bonds.

Encumbered Vs. Unencumbered assets

The split between encumbered and unencumbered assets, following from the proposed definition of assets encumbrance, constitutes the general level of breakdown proposed in all the templates accompanying the draft ITS.

As an alternative, a more detailed approach could require reporting of encumbered assets and, on the one hand, assets that are unencumbered but not available for encumbrance and, on the other hand, assets that are unencumbered and are available for encumbrance.

Given the type of funding and liquidity risks that might stem from asset encumbrance such a more detailed reporting breakdown would allow supervisory authorities to gauge a better a picture of the actual residual capacity of the institution to raise liquidity and/or funding by means of pledging available assets.

The harmonisation of such an additional split, though, would entail providing National Supervisory Authorities with a definition of unencumbered assets not available for encumbrance (an example being, for instance, goodwill) which would most likely be weak and subject to controversy and uncertain interpretation. Due to this disadvantage, and to the possibility for the supervisor of inferring information on the residual capacity of raising liquidity/funding via other sections of the templates, the alternative split is not proposed in the draft ITS, except for collateral received under collateral agreements that due to contractual restrictions cannot be re-used.

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?

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?

Marketability

As mentioned, one of the crucial concerns behind asset encumbrance has to do with its implications on the capacity of the institution with an encumbered balance sheet to raise liquidity and funding, should the necessity arise and/or should conditions of market stress materialise. With respect to this concern, monitoring only whether assets are currently encumbered or can be used to raise liquidity/funding, can provide an incomplete picture in that this does not consider the level of marketability of encumbered/unencumbered assets, i.e. how easy it is to trade those assets for funding and/or use for deleveraging purposes.

The draft ITS proposes eligibility for repo financing with the Central Bank as the criterion to identify more marketable assets from less marketable ones. The approach presents the following disadvantages:

- 1) It is an imperfect measure of marketability.
- 2) It is likely to result in non-fully comparable data in the Single Market given the different definitions of eligibility for repo financing with the Central Bank that currently exist in Europe.

As alternative approaches, the following were considered:

Option 1:	Identifying marketability with the criteria defining liquid assets within the liquidity reporting requirements.
	Part of the information on marketability of assets from a liquidity perspective will be collected from National Supervisory Authorities via the liquidity reporting requirements to be proposed as a component of the whole reporting requirement package. In addition, at the present stage, liquidity reporting requirements and liquid assets definition are still being defined and hence not ready to be used for asset encumbrance purposes. For these reasons this approach is not the proposed one in the draft ITS.
Option 3:	Identifying marketability via the risk weight assigned to assets within the credit risk framework.
	The link between risk weights assigned under either the Standardised or the IRB approach to credit risk and the marketability of assets does not appear to be stronger than the one between eligibility for Central Bank repo financing and marketability. In addition, information on risk weights on collateral received is not expected to be readily available within institutions' existing reporting practices.

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?

Carrying Amounts and Fair Values

To ensure investors' confidence in a transaction, the encumbrance of assets is particularly sensitive to changes in the value of assets (collateral) pledged. Changes in the market value of the pledged assets can materially affect their quality as encumbered assets and, related to this, the need for further asset encumbrance by institutions willing to sustain current levels of secured funding and/or additional sources of funding.

Given the risks associated to asset encumbrance (see previous section of this annex), an effective supervision of asset encumbrance levels and composition would not be realised if asset encumbrance reporting only required carrying amounts, if these are different from market/fair values.

The draft ITS proposes templates where reporting of encumbered and unencumbered assets' value is required, for some asset classes, both in terms of carrying amount and fair value. However in order to limit the burdens related to the calculation of market/fair value, this calculation is mainly required for equity instrument and various debt instruments.

Contingent Asset Encumbrance

To ensure investors' confidence, the encumbrance associated with a transaction typically increases if i) the value of assets (collateral) pledged decreases, ii) the rating assigned either to the entity pledging the assets or to the assets themselves decreases, iii) depreciation of significant currencies. In addition, as documented in data collected by the ESRB, institutions domiciled in jurisdictions where banking and sovereign stresses were more pronounced tend to report the largest increases in asset encumbrance, and asset encumbrance levels appear to be correlated with the rating assigned to the institution pledging the assets. In other words, asset encumbrance appears to be a response that varies, in magnitude, according to the severity of idiosyncratic and aggregate stress conditions and is characterised by nonlinearities, such that higher absolute levels of encumbrance tend to generate higher increases of encumbrance during/after stress events.

For the reasons just described, effective and harmonised supervision and monitoring of asset encumbrance cannot be carried out without the collection of data on the potential evolution of asset encumbrance levels and compositions during pre-established hypothetical scenarios of extreme but plausible stress (i.e. contingent asset encumbrance).

The reporting template on Contingent Asset Encumbrance proposes two different scenarios that attempt to incorporate three different types of extreme but plausible stress the reporting institution might experience:

- 1) A 30% decrease in the fair value of encumbered assets is meant to capture the implications, for asset encumbrance, of a more aggregate stress event, such a negative asset price spirals that can trigger during market phases of assets fire-sales and liquidity/funding crises.
- 2) A 10% depreciation in significant currencies aims at capturing the implications, for asset encumbrance, of disruptions in foreign currency markets which could, for instance, accompany episodes of sovereign stress.

The scenarios above represent choices which are consistent with the scenarios used by the ESRB to assess the distribution of asset encumbrance levels in adverse scenarios. A similar requirement is already included in the liquidity reporting, where the liquidity impact of a 3-notch downgrade is assessed – this may supplement the two above scenarios. More scenarios may however be added at a later stage.

In a regulatory framework where establishing a socially optimal level of asset encumbrance does not seem feasible, if national, market and business model specificities have to be taken into account, it appears to be extremely important for supervisors to draw a picture on the evolution of asset encumbrance under harmonised high stress scenarios.

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

Additional information on Covered Bonds issuance

The draft ITS proposes a reporting template for covered bonds programmes that gives additional information on cover pools and on eligible assets. Specific monitoring related to covered bonds is deemed necessary in order to ensure an effective and harmonised supervision of asset encumbrance and cover bond issuance, the main reasons being:

- 1) Covered Bonds programmes constitute one of the main drivers of assets encumbrance.
- 2) Asset encumbrance in covered bonds programs is mainly a long-term encumbrance, as opposed to encumbrance generated by repo financing and securities lending, and mainly involves loans assets.
- 3) Asset encumbrance profiles, due to covered bonds programs, are particularly heterogeneous, and hence difficult to compare, across institutions and Member States, due to the fact that the extent of overcollateralization varies not only as a function of varying national regulatory minimum requirements but also as a function of rating agencies requirements and the issuer's strategies in terms of voluntary collateralisation buffers.

6.2 Overview of questions for Consultation

Q1: Is the definition of asset encumbrance sufficiently clear?

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?

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?

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? 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?

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?

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?

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?

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

Additional questions in Annex II

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

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