European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

European Banking Authority
Tower 42 (level 18)
25 Old Broad Street
London EC2N 1HQ, United Kingdom
EBA-CP-2013-05@eba.europa.eu

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EBA consultation on draft implementing technical standards on asset encumbrance reporting

Ladies, Gentlemen,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on EBA draft implementing technical standards on asset encumbrance reporting.

Please find our general remarks and responses to specific questions in the following pages.

We will remain at your disposal,

Yours sincerely,

Volker Heegemann
Head of Legal Department

Lucia Duguleana
Advisor for Banking Regulation

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EACB position paper on EBA draft implementing technical standards on asset encumbrance reporting

The voice of 3.800 local and retail banks, 55 million members, 216 million customers

EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149 • lobbying register 4172526951-19
www.eacb.eu • e-mail : secretariat@eurocoopbanks.coop

A. GENERAL REMARKS

EACB appreciates the EBA's efforts to harmonize the reporting on asset encumbrance and ensure consistency in assessing the asset encumbrance of financial institutions. This would indeed create a framework useful for a better understanding the risks existing in the financial sector. We agree with the approach that encumbered an unencumbered assets are addressed together. However, we note certain issues relating to the asset encumbrance framework.

Burdensome reporting

As also mentioned in the consultation paper there will be an increase in the on-going (employed staff hours) and one-off (investment in IT equipment) types of costs. This increase is expected to be significant due to the complexity and granularity of the reporting templates.

We fully understand the usefulness of reporting on asset encumbrance in order to assess reliance of banks on secured funding. This is mostly covered by data in tables part A.

However, the assessment of the ability to handle funding stress, is already covered by the liquidity reporting LCR, NSFR or Additional Monitoring tools. Therefore, we recommend the EBA to remove these tables (B, C and D) from the Asset Encumbrance reporting.

We believe that the EBA requirements go far beyond what is required in article 100 of the final version of the CRR, which states that:

> "Institutions shall report to the competent authorities the level, at least in aggregate terms, of their repurchase agreements, securities lending and all forms of encumbrance of assets".

Additionally, the requirements also go beyond the recommendation of the European Systemic Risk Board of 20 December 2012 on funding of credit institutions (Recommendation D — Market transparency on asset encumbrance). The ESRB provides for a gradual approach in of the reporting requirements for the first year and a reporting semi-annual reporting frequency:

> "In view of the limited experience in disclosing reliable and meaningful information on asset quality, the EBA should follow a gradual approach, with a view to moving to a more extensive disclosure regime after one year. The guidelines should request credit institutions to provide:
>
> (a) The level and evolution of encumbered and unencumbered assets:
>
> > (i) for the first year following the adoption of the guidelines, this information should include a breakdown by asset type, provided on an annual basis;
> >
> > (ii) based on the experience gained until 31 December 2014, including in implementing Recommendation C, the guidelines should be amended to require information to be provided on a semi-annual basis and supplemented by a requirement to disclose a breakdown by asset quality,

provided that the EBA deems that such additional disclosure offers reliable and meaningful information."

Similarly to the ESRB recommendation with regard to gradual implementation refers to asset quality, we think that the detailed provisions for asset encumbrance should be also implemented gradually. For this purpose, we propose that for the year 2014 reporting should be requested initially on an annual basis for Part A (encumbrance overview). Any increase in the reporting obligations should only take place if it can be proven to result in reliable and meaningful information. In order to provide banks with sufficient time to take the necessary technical steps to implement the new requirements, reporting should not begin before Q3/2014. Switching to the semi-annual reporting with additional data requirements could be implemented as of 2015, following an evaluation of the results by the EBA.

In general, it would be a burdensome task to collect information that is either not available at the moment, currently found in different information systems in banks (accounting on the one hand, management data on the other hand), or that is currently not linked within the information systems of the banks. For example, the necessity to link encumbered assets and the corresponding liabilities in the "advanced data" template. This would be a very complex and burdensome activity that does not significantly enhance the information about encumbered assets provided in the main template. The "Advanced data" template should be deleted from the reporting framework.

In addition, the need to consolidate the data on asset encumbrance, which can be rather complicated, depending on the structure and the relationship between the different entities of a group.

Therefore, some of our experts believe that the threshold for a proportional application should be significantly higher - €100 billion.

First reporting date

The consultation paper contains no reference to the 1st reporting date for asset encumbrance. The implementation date for the CRD-CRR which will most probably be the 1st January 2014 is not feasible for the purpose of reporting on asset encumbrance. A minimum of one year is needed after the availability of the final version of the standard for developing and testing the required IT systems. In addition, a gradual approach as suggested by ESRB should be employed.

Reporting frequency

Generally speaking, we consider the quarterly frequency (for templates A, B, D) to be too demanding. Half-yearly reports should be sufficient because changes, e.g.in the cover pool of covered bonds, are relatively minor and do not lead to relevant modifications over a quarter. Moreover, the detailed reporting requirements for asset encumbrance require considerable effort in order to prepare, analyse and report the data.

Accounting information: IFRS and local GAAP

We believe that the accounting values should be used for the reporting on asset encumbrance. Furthermore, the standards that should be used are not clear when the local GAAP are used to produce individual accounts, and IFRS are used to produce the consolidated accounts.

Moreover, not all consolidated group are obliged to prepare IFRS reports and even if they do, it is prepared with yearly frequency. Therefore, some guidance is needed, if national accounting framework is used on the consolidated level and/or on the individual level.

The scope of application of the definition of asset encumbrance

At a first glance, the draft RTS deals only with the reporting standards for asset encumbrance to which European credit institutions must comply, cf. article 95a of the CRR. However, as one critical feature of the consultation paper is the definition of asset encumbrance, the consultation paper is likely to have effects on other reporting and regulatory standards. In particular, EBA's proposed definition of asset encumbrance will inevitably spill over to the LCR liquidity definition according to article 416(3)(a). The final version of CRR's article 416(3) requires institutions to report as liquid assets only assets that fulfill some conditions:

"(a) they are unencumbered or stand available within collateral pools to be used for the obtaining of additional funding under committed but not yet funded credit lines available to the institution.;

In practice, liquidity can be created also by repo transactions. If it is permitted by the bilateral contract, the securities are collaterals received from counterparties/customers. It is not clear whether the definition of asset encumbrance will have an impact on the interpretation of above mentioned provision and to what extent.

According to the consultation paper, institution must comply with the reporting requirement on an individual and on a consolidated level. We have some concerns about compliance with the reporting requirement on a consolidated level, as significant systems developments will be required.

Specific mortgage business model

In Denmark mortgage lending is conducted by specialized mortgage banks that fund the mortgage loans solely by issuing covered bonds (as they are not allowed to take deposits). Assets in cover pools make up the entire loan book of Danish mortgage banks, and the covered bonds have a priority claim on all other assets.

If the asset encumbrance definition as proposed in the CP is to be interpreted in the most strict sense, Danish mortgage banks will by their very design have an asset encumbrance ratio of virtually 100%, and consequently an LCR of 0% if the definition of asset encumbrance will also be used for the purpose of LCR. The asset encumbrance definition would thus pose an extreme unintended consequence for this specific business model. However, the liquid assets in the cover pools are not encumbered in the favour of any third party that would create structural subordination of simple depositors. Further, it would in no way reflect actual liquidity. The 'encumbered' assets are not tied up in any

absolute sense, nor are they unavailable for their intended purposes. In fact, they are fully available to cover the relevant liquidity outflows, e.g. payments to the covered bond holders.

In other words, there is no encumbrance "in the wrong direction".

The CRR explicitly requires that the business model diversity should be carefully respected. Therefore, the asset encumbrance definition should take due account of the different European business models as well.

B. ANSWERS TO SPECIFIC QUESTIONS

Question 1:
Is the definition of asset encumbrance sufficiently clear?

In our view there are a few issues that need to be clarified in the definition:

1. As noted in the general comments, we do not find the definition sufficiently clear as it does not take into account that asset encumbrance does not have a uniform material consequence and that the systemic risk of asset encumbrance depends on the specific business model, i.e. terms and conditions for any senior unsecured (or other secured) creditors.
2. The notion of freely withdrawn is not completely clear. In particular, it is not clear if excess collateral, in particular in the case of covered bonds, will be treated as unencumbered. This should be the case if the resulting situation does not require replacement or agreement by one or more of the transaction counterparties.
3. We agree with the treatment of underlying assets collateralized in pools that are encumbered to the level of the corresponding issued and sold securities. However, according to us, the treatment of assets that are collateralized in pools but not fully used should be reviewed – a waterfall approach that would take into account asset classes and potential haircuts would be preferable than a prorata approach as proposed by EBA. A waterfall approach would be consistent with Basel rules and also with the ECB practice. When a pro-rata approach is used, we recommend that the prorata share should be the same as the one used in CRR for LCR, i.e. priority is given to the less liquid assets. Furthermore, the underlying assets of the securities owned by the issuer should be considered unemcumbered (except if it is used in another pool, pool 3G for example).
4. The calculation of a pro-rata allocation is not completely clear. The following items have to be clarified before employing a pro-rata approach:
    a. the reference measure is not clear if the collateral provided contains several asset classes (for instance securities and loans) where there is no common measure of the value of the collateral - should it always be the accounting carrying amount of the collateral?

b. the treatment of haircuts that apply depending on the nature of the collateral is unclear - should those haircuts be considered in the pro-rata allocation of encumbrance?

5. It is assumed that all institutions use fair valuation for securities and derivatives. However, this is not always the case. We think more guidance is needed on how to approach the reporting requirement when fair valuation is not used.
6. A clarification is needed in the case of derivative transactions that are collateralised, but where the relevant national accounting framework does not allow fair valuation or the fair valuation option is not used by the institution.
7. It is not clear, how own debt securities have to be treated if the national accounting framework, unlike IAS, shows them both on the asset and the liability side and how these securities fit into the definition.

Question 2:
Do you agree with the decision to follow the level of application as set out for prudential requirements? If not, what other level of application would be appropriate?

The consultation paper requires that the reporting on asset encumbrance should be done on both individual and consolidated basis. Due to the links with the LCR as mentioned in the section above, it seems more appropriate to consider the liquidity prudential perimeter than the solvability prudential perimeter for a reporting on asset encumbrance. An opposite approach would result in inconsistencies of the data reported for the different purposes and would lead to additional implementation efforts.

Depending on how the groups are structured, it might be more relevant to report only a consolidated or sub-consolidated level. This might be relevant for some cooperative banks due to the specific relationships between the central institution and the local banks.

Moreover, the suggested reporting templates on an individual level will not show to what extent the encumbrance is an intra-group or, in case of co-operative banks, an intra-network phenomenon. Therefore, we suggest that the information requirements should be extended, on an optional basis, to intra-group / intra-network encumbrance reporting.

Question 3:
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 reused, for instance from derivatives transactions would not be included) or a liability?

EACB members agree that the definition of the ratio should not be based on liabilities but rather on the assets because encumbrance must relate to the asset side. With regard to including the off-balance sheet items the views are split. While some of EACB members agree with taking into consideration the off-balance sheet items, others fear that including the off balance sheet items would, in addition to making the technical

implementation more complex, provide a distorted image on the available and charged collateral. This would be due to the inclusion in the encumbrance calculation of the reused collateral and lead to inaccurate data being gathered and further used by ESRB in its reports on macro-prudential supervision. The Total assets formula page 4 of annex II – Reporting on Asset Encumbrance should be modified in order to be consistent with the definition reported on page 11 of the Consultation Paper. {AE-Collateral;130;010} + {AE-Collateral;130;040} should replace {AE-Collateral;010;010} + {AE-Collateral;010;040}.

Question 4:
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?

EACB generally supports the use of thresholds. However, the conditions should not be cumulative: institutions fulfilling one of the conditions should be granted the waiver.

Some of our members see an advantage in having some encumbrance reporting requirements which could better help the co-operation on ensuring liquidity and solvency of the institutions and network. However, other members are concerned with the increased costs that would result from the very detailed reporting. According to some of our experts, the threshold for a proportional application should be significantly higher - €100 billion.

The 5% threshold is too low as well. We suggest to test it on a sample of small and medium sized institutions. For the small institutions, benefitting from the exemption is dependent on the calibration of the ratio.

As the reporting is complex, we think there is a need for another threshold for the small institutions that are members of a network and where the encumbrance is related primarily to intra-network transactions.

Moreover, due to intragroup links, reporting on asset encumbrance is sometimes likely to be more relevant on a consolidated or sub-consolidated basis depending on the organization of the groups.

Question 5:
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) might not be available for encumbrance?

This situation might be rather country and bank specific. Assets or collaterals received might not be available for encumbrance when:

- the legislation applicable for the specific contract excludes that the claims could be transferred or pledged or encumbered or reused in any way

- or the transfer or pledge or encumbrance or re-use is legally permitted only with the prior consent of the debtor or issuer.

This kind of restriction occurs mostly in case of loans and equities, les frequently in case of debt instruments. In principle central bank eligibility criteria is too restrictive as it can lead, in some cases, to exclude some high quality assets (HQLA).

Question 6: 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?

In the future another possible source of asset encumbrance, at least partly, could be the use of assets for default fund of a central counterparty in the clearing of derivatives transactions.

It is not clear whether the payment commitments to protection funds or other kinds of mutual solidarity funds, that are secured by highly liquid assets, should be reported as source of asset encumbrance.

Depending on the national accounting framework leasing and factoring activities might raise encumbrance.

Question 7: 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?

The repo eligibility criterion is a good marketability criterion in general. Even when the marketability of the securities is uncertain, the central bank has to provide funding by accepting the central bank repo eligible assets, as collaterals. Therefore, the criteria should be extended to all central banks, not only the local Central Bank. Moreover, it should also be extended to the ability of using the assets as collateral in the repo market and to the HQLA assets.

Question 8: Do you believe the chosen scenarios are appropriately defined? What alternative definitions would you apply?

The scenarios should be defined more realistic. A 30% drop in value is very extreme. Assets that can be used for secured lending are usually high quality assets. Such a sharp drop in value is not plausible even in the case of aggregate stress scenario. At least a differentiation could be made regarding the different types of asset encumbrance: cover pool with legal requirements, ECB pooling, collateral for derivatives.

As an alternative, EBA could make use of the already existing stress scenarios used for internal liquidity risk models.

Furthermore, using the percentage of the decrease in the fair value of encumbered assets makes sense only for securities but not for loans.

In addition, it should be clarified what small institution will do if, in accordance with the national accounting framework, they do not use fair valuation for securities.

- Additional questions in Annex II

Question 9: Does the instructions provide a clear description of the reporting framework? If not, which parts should be clarified?

There are a few areas that are not clear. In particular:

1. The reference currency for testing of the depreciation of significant currencies in part C is not clear - should this be the reporting currency?
2. The treatment of hedges - should the amounts to be reported be net of the hedge

EBA should clarify the different parts of the templates. For instance, it should explain better that the source of encumbrance shows those product or transaction groups which give rise to encumbrance. It should also clarify the collateral received and the re-use of the collaterals received.

Reporting should be simplified. In particular there should be only one value reported. For example:

1. In the case of AE-assets for example, there should be the possibility that only the accounting values should be reported, and not fair values, as in some cases encumbered securities are likely to be accounted for at their fair value.
2. For AE-Collateral either fair value or nominal value should be reported. Fair value makes sense for securities, nominal for the other types of instruments (loans)

Certain elements do not seem relevant or do not bring any additional information benefit with regard to asset encumbrance:

1. In Part A of the description of the reporting framework, concerning the self-issued ABS, the rows "Senior", "Mezzanine" and "First Loss" are not relevant for the underlying pool of assets because there is no clear split within the pool of assets that is pledged.
2. AE-Not Pledged column "Nominal of own debt securities issued not available for encumbrance" doesn't bring any complementary information for the capacity of encumbrance and should be deleted.
3. "Carrying amount of the underlying pool of assets" "Carrying amount of the underlying pool of assets" is not relevant in this table as the assets are already reported in the template AE-assets

After publication of the final templates, we would appreciate a FAQ process to clarify any additional issues relating reporting on asset encumbrance.

Question 10:
Do you identify any overlaps with the existing reporting framework, which could be mitigated?

We believe that there are some overlaps with data reported in the liquidity framework (LCR and NSFR) but more complexity is imposed by requiring a different level of application (see also answer to question 2).

EBA should avoid requiring several different sets of reporting on the same elements. This could lead to significant implementation costs and increased reporting burden on the institutions.