UK FINANCE

A response to the PRA's consultation paper CP24/19 on

Asset Encumbrance

January 2020

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers and facilitate innovation.

We are pleased to respond to the PRA's consultation paper 24/19 on Asset Encumbrance. Asset encumbrance is an important mechanism that ensures that firms have access to appropriate levels of cost-effective liquidity, both in business as usual and under stressed conditions. So, we support the PRA's clarification of how firms should address asset encumbrance in ILAAP documentation as well as in recovery planning and resolution assessment.

Definition of Encumbered Assets

We agree with the PRA's definition of encumbered assets, but suggest it be completely aligned with the CRR 2 Article 411 (5) definition of unencumbered assets and the same definition, for the sake of continuity and completeness imported into Appendix 3, para 4.90, using the following wording:

> *Encumbered Assets means assets which are subject to any legal, contractual, regulatory or other restriction preventing the institution from liquidating, selling, transferring, assigning or, generally, disposing of those assets via an outright sale or a repurchase agreement;*

We note that the BCBS is currently consulting on the voluntary disclosure of sovereign exposures and consider it should be a firm's own decision, in its ILAAP document, to choose whether or not to provide a more detailed analysis of its unencumbered assets by exposure type.

We support a Pillar 2 approach

Our members confirm that they support a Pillar 2 approach, which is not based on LCR parameters and uses different timeframes, in their ILAAP creation, which includes an internally set asset encumbrance risk appetite and associated buffer. Their approach would be documented in the ILAAP and should not be anchored to the Pillar 1 LCR regulatory requirement.

Our members consider the quality of unencumbered assets and the likely behaviours of the firm's counterparties and required haircuts in the event of an idiosyncratic or market wide stress resulting in the downgrading of the firm itself by an ECAI or as a result of a reduction in collateral quality. We suggest that this should be reflected by amending para 2.18A as follows:

> *…consider the impact that the stress may have on their ability to encumber further assets, taking into account the likely reaction of their counterparties to a credit rating downgrade or market perception of the creditworthiness of either the firm itself or unencumbered assets, and associated increases in funding costs.*

NSFR Finalisation

We note that CRR2 entered into force at the end of June 2019 but most of the provision, including those relating to the Net Stable Funding Ratio (NSFR) will apply only from 20th June 2021. A number of delegated acts and implementing acts will need to be made prior to this in order for firms to be able to fully implement the NSFR. As the UK prepares to leave the EU our members would appreciate dialogue with the PRA to understand its approach to producing its own standards to support the introduction of the NSFR.

Investor confidence in stress

The consultation paper emphasises the importance of the firm having sufficient unencumbered asset headroom in a stress, with the objective of reassuring unsecured creditors that the firm can continue to access secured funding if need be. We note that the current Pillar 3 encumbrance requirement is that a firm should disclose the median level of encumbrance over a rolling four quarter period which smooths seasonal and other variations yet still enables an investor to identify relevant encumbrance trends. However different approaches to possible haircuts in the event of stress adopted by different banks are likely to lead to variability in the consistency of disclosures between banks. We believe minimum market standard haircut by type of collateral would be helpful in improving comparability and consistency of disclosure. Rating agency benchmarks provide a useful indicator of acceptable minimum haircuts, and so we suggest the supervisory statement should be enhanced by the addition of the following final, sentence at the end of para 2.18A:

> *Firms may wish to consider using ECAI market standard benchmarks to assess the likely levels of haircut applied to different types of collateral.*

PRA assessment of ILAAPs

The specific Pillar 1 LCR regulatory reporting requirements are clearly understood and have commonly accepted meaning. While recognising that Pillar 2 is a matter for both firm and supervisory judgement our members would appreciate a greater understanding of the key parameters on which the PRA focuses in assessing the likely future path of asset encumbrance in the event of either a firm specific or system wide stress. We would be delighted to facilitate such a discussion and promulgate its conclusions among our membership.

Resolution

We agree with the PRA that in resolution it is important that the firm should have continued access to sufficient liquidity so it can continue to meet its obligations as they fall due during the resolution process. This headroom capacity will be dependent on the quantity and quality of its unencumbered assets on entry into resolution. The consultation paper references the Bank of England's lending against its "usual risk tolerance". Members would appreciate clarity on whether this refers to the haircuts and asset classes in the Sterling Monetary Framework, any other public statements or assessments shared privately with individual firms.

We note that that Resolution Assessment Framework (RAF) requires valuation of four different types of exposure; assets, liabilities, instruments and business unit(s) for which a firm should have valuation methodologies. The chosen methodology is likely to vary by purpose of the valuation for which exposures are being assessed, particularly in the case of an entire business unit, where for instance, netting arrangements by legal entity or encumbered assets (including the ability to pay creditors) may impact its valuation.

We welcome the Resolution Authority's confirmation in its Statement of Policy that it will not prescribe a particular methodology for the valuation of assets encumbered. This will enable firms to continue to adopt their own approach to modelling encumbrance, allowing them to flex proportions depending on the nature of assets remaining to support ongoing access to liquidity.

With regular communication and feedback, we expect, together with the Resolution Authority, to develop a greater understanding of the proportion of a firm's balance sheet that should remain unencumbered to provide headroom for the bail-in administrator to be able to continue to access liquidity. We appreciate that this unencumbered proportion will depend on the nature and quality of a firm's assets.

Conservative levels of over-collateralisation

Member firms that issue regulated covered bonds (RCBs) are constrained by the FCA's Regulated Covered Bond sourcebook. Their RCB programmes are regularly stress-tested and the results used to set and monitor over-collateralisation (OC) requirements. The way in which the FCA sets OC requirements is not clear to members who are of the view that its approach is much more conservative (and unnecessarily so) than the OC levels required by Rating Agencies. As currently set by the FCA, the OC requirements favour wholesale market investors at the potential expense of

unsecured depositors/the Financial services Compensation Scheme as well as the resolution administrator.

In our view the FCA's approach on mortgage asset stresses should be closely aligned to the Bank of England's Sterling Monetary Framework requirements.

Responsible Executive

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