FEELING THE BURDEN

ASSET ENCUMBRANCE IS PUTTING MANY BANKS AT RISK OF RISING FUNDING COSTS, REDUCED ACCESS TO BORROWING AND HIGHER CAPITAL DEMANDS, SAY GILLY LORD AND CLAIRE RIEGER

The pledging of assets has always been a routine part of banking business. Banks post collateral to secure more favourable funding rates. They also provide assets in support of derivative trading and payment and settlement systems.

What has changed in the wake of the financial crisis is the amount of assets being used to secure funding. This includes a surge in covered bond issues (these made up around half of funding issuance among major UK banks in 2011 according to the Bank of England), repurchase agreements and calls on central bank funding programmes.

When assets are pledged and are no longer available to meet claims from unsecured lenders, they are said to be encumbered (see box 2). Market unease over rising encumbrance levels was highlighted in a recent fixed income investor survey carried out by Fitch, in which more than 80% of participants expressed concerns over the repayment of unsecured debt as a result of the increase in secured funding.

Vicious cycle

Lenders are charging banks with high encumbrance levels more for unsecured credit or even cutting off the funding tap altogether. The result is what the Bank for International Settlements has described as a 'vicious cycle' in which ever more collateral has to be pledged to secure sufficient funding, leaving even fewer assets available to repay senior debt holders (which now include depositors in the UK) and hence further diminishing access to unsecured credit.

Asset encumbrance is also now in the sights of regulators and rating agencies. Regulatory approaches around Europe vary (see box 1). Some have set ceilings on covered bond issuance geared to either the level of capital or assets. While supervisors in the UK have so far tended to look at encumbrance on a case-by-case basis, the Bank of England is now considering set limits on covered bond issuance or asset encumbrance.

Banks also face the possibility of higher capital charges if there is deemed to be a risk to depositors and other senior debt holders. Regulatory concerns are heightened by the possibility of a spike in margin calls that could follow a market stress such as sovereign default or plunge in house prices.

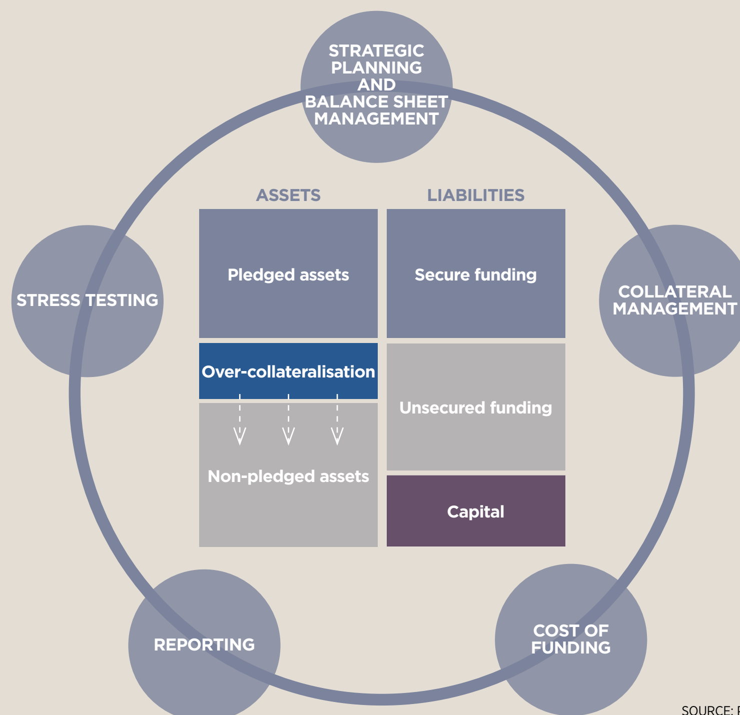
While rating agencies don't, as yet, specifically factor asset encumbrance into their ratings for unsecured bank debt, there is a general consensus among market participants that this is just around the corner.

Competitive differentiator

The spotlight on asset encumbrance also opens up opportunities as smart banks move to manage their collateral commitments more efficiently and operate with lower funding costs than their peers.

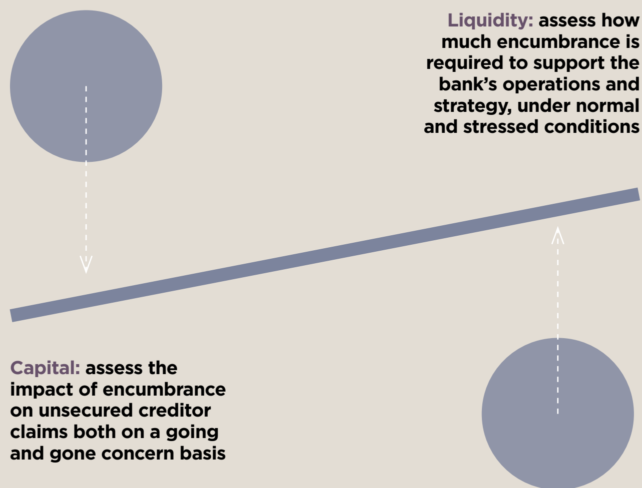
The essence of effective encumbrance management

FIGURE 1: A FRAMEWORK FOR MANAGING ENCUMBRANCE



SOURCE: PwC

FIGURE 2: HOW MUCH IS TOO MUCH?



SOURCE: PwC

is determining the right balance between secured and unsecured funding, both now and in the future, and in both stable and stressed conditions. (Figure 1 outlines a framework for assessing all the different dimensions of asset encumbrance.)

The underlying requirement is the development of a measurement methodology that brings together the key perspectives of capital and liquidity (see Figure 2). The critical consideration is gauging the tipping point at which excessive pledging of assets could actually raise unsecured credit costs and capital charges.

Once effective monitoring and management mechanisms are in place, the bank can then judge the level of encumbrance it can support over time, looking at its business model, risk appetite, funding capacity and available collateral quality.

The level of tolerance should balance the interests of unsecured lenders with the bank's ability to fund itself and carry out the activities that require asset pledging. One approach could be to calculate the expected loss associated with the portion of assets available to unsecured creditors and link this to a target debt issuance rating. Another could be to define a minimum level of unencumbered assets that should be available at all times to cover future funding requirements.

The tolerances should also take account of the hidden costs of secured funding, including acquiring further assets for over-collateralisation. In many cases, such analysis could reveal that secured funding is actually more expensive than unsecured alternatives.

The other key priority is how to communicate encumbrance to stakeholders. Being able to demonstrate that it is being managed within sustainable tolerances and cost of funding levels will not only provide greater assurance for regulators, rating agencies and senior debt holders, but also provide a favourable signal for shareholders. Indeed, the efficiency of encumbrance management could become an important benchmark in a market in which funding is constrained.

Winning formula

While the pledging of assets will always be an important tool in reducing funding costs, all banks need to be aware of the encumbrance tipping point beyond which credit costs could actually rise. Effective control of asset encumbrance through striking the right balance between collateral commitment and affordable funding is thus emerging as a key management consideration and competitive differentiator.

> The efficiency of encumbrance management could become an important benchmark in a market in which funding is constrained

BOX 1: DIFFERENT REGULATORY APPROACHES TO MONITORING ASSET ENCUMBRANCE

1. **Limits on covered bond issuance thresholds, depending on the level of capital (for example, Italy).**
2. **Limits on covered bond collateral/ issuance as a percentage of total assets (for example, Greece, Australia and Canada).**
3. **Encumbrance reviewed on a case-by-case basis (for example, UK and the Netherlands).**

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BOX 2: WHY IS ASSET ENCUMBRANCE UNDER THE SPOTLIGHT?

A certain amount of asset encumbrance is normal. But rising levels are beginning to cause concern among investors, regulators and rating agencies.

Encumbrance has now reached around 20% of European banking assets according to the Bank for International Settlements.

The pressure to post collateral to secure credit is especially acute in countries facing sovereign debt concerns.

In Greece, for example, the ratio of encumbered to total assets rose tenfold between 2005 and 2011, to one third. For Irish, Italian and Portuguese banks, the encumbrance ratio more than doubled during this period.

Particular investor concerns are focused on banks that are being forced to pledge more collateral than the value of the funds they are seeking to secure ('over-collateralisation'). This reduces the assets available to repay unsecured lenders. The remaining assets are also likely to be of lower quality than the pledged assets.