

Is asset encumbrance still a relevant metric for investors?



At the tail-end of the financial crisis, unsecured credit investors were concerned that banks with elevated levels of asset encumbrance (AE) presented heightened risk of non-payment. Fingers were pointed at voluminous levels of covered bonds, issuance of which never stopped during the dark crisis years (unlike unsecured debt). They were equally pointed at the post-crisis interbank market, which re-emerged in a collateralised form as opposed to the pre-crisis unsecured interbank market.

That was then. More than a decade after the crisis, AE is no longer such a feared metric for investors, and rightly so. Why is that?

EBA reports stable AE levels across the EU

A recent EBA report¹ shows a stable level of AE across the EU, with the ratio of encumbered assets to total assets (including collateral received) at 27.9% for a sample of 181 larger banks across the EU. Comparatively higher encumbrance levels are displayed by (i) banks with large mortgage balances funded by covered bonds (e.g. the Nordics, Germany, etc.), (ii) banks with a higher share of central bank funding provided during the sovereign-crisis years (Greece, Italy), and (iii) banks in areas where repos have played a significant role in the financial markets (UK, France).

The EBA's conclusion is that AE stability is a positive sign for the funding structure of EU banks. Fair enough.

The post-crisis unease about AE

In the years immediately after the crisis, the European Systemic Risk Board (ESRB) reported that across the EU banks' AE levels had dramatically risen from 11% in 2007 to 32% in 2011. With the memory of so many banks having been on the brink in 2008-09 still fresh, market participants were understandably fearful that were a bank to fail and be closed down by supervisors, a high level of AE would leave insufficient asset coverage for unsecured exposures in the scenario of an asset carve-out in liquidation.

That was when regulators started to require EU banks to disclose AE data, and when the EBA started publishing its annual updates on AE (from 2015). While investors were concerned about their unsecured bank holdings ending up in the bin in a post-liquidation asset carve-out, supervisors were rightly frowning on potentially insufficient non-encumbered safe assets supporting depositors outside deposit guarantee schemes (and also putting pressure on them). Mandatory AE reporting by banks went a long way to addressing market concerns, in addition to its value in supervision.

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¹ <https://eba.europa.eu/documents/10180/2908911/EBA+2019+Report+on+Asset+Encumbrance>

Why AE should be less of a concern today...

The resolution and recovery framework introduced in Europe in 2014 has led to a shift in market perception about the process of handling banks on the brink, and understandably so. Once in resolution, a failing bank undergoes loss sequencing through the capital-structure hierarchy, from equity upwards. For banks subject to resolution (a large category including most banks investors usually are exposed to) the extreme scenario of an asset carve-out in regulatory liquidation is implausible.

It was not that plausible in the post-crisis years either, at least not for the larger and more complex institutions. But the fog-of-war at the time understandably fuelled market apprehension about rising AE. Besides, investors feared that rating agencies were going to start incorporating AE metrics into their bank rating criteria, and this did in fact happen in some cases.

The (supposedly orderly) loss-sequencing process in resolution negates the crude asset carve-out scenario, even though secured debt and the collateral attached to it remain protected from bail-in. Investors in capital securities or in non-preferred senior may be more exposed to the risk of non-payment than preferred senior investors, not to mention secured investors, but mostly because of the resolution process rules rather than related to encumbrance levels.

In fact, some of the safest bank business models in Europe are those of firms focusing on activities like residential mortgage or public-sector lending – which both relate to relatively higher AE levels. Large Nordic banks, which rely heavily on covered-bond funding, are a good example of this. And, in general, those of a universal bank's activities being funded on a secured basis are far from being the riskiest in the quiver.

... and why it should still matter

That said, in the post-crisis world banks have to hold enough un-encumbered collateral to obtain central-bank funding should they need it. This is especially the case for banks in EU countries still affected by shakier sovereign risk, like Greece, Italy, or Cyprus. Central-bank funding would not be able to support such banks if sufficient eligible collateral were not available.

Equally, sovereign risk notwithstanding, providing liquidity to a bank in resolution would also need to be collateralised. This is why an insufficient level of un-encumbered assets is far from being a trivial matter.

AE remains relevant for small, unaffiliated entities

The majority of smaller banks in the EU, such as co-operative or savings institutions in Germany, Austria and Norway are part of larger groupings. But there is a number of smaller banks which are not part of such national groups, and which would also not be subject to resolution. Often, these small firms rely on unsecured brokered deposits for their funding, rather than on local retail deposits or debt. Should any of these small, unaffiliated banks be on the brink of failure, they would be likely placed in liquidation by their supervisors. Under such a scenario, AE becomes highly relevant.

Appendix:

Asset encumbrance ratios in selected EU countries

(September 2018)

| | |
|-------------|-------|
| UK | 32.2% |
| Germany | 31.3% |
| Italy | 30.7% |
| Sweden | 26.9% |
| France | 26.2% |
| Spain | 25.2% |
| Greece | 23.3% |
| Norway | 20.8% |
| Netherlands | 17.4% |
| Austria | 16.7% |

Source: Statista, 2019

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