BaFin

Federal Financial Supervisory Authority

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Asset-Encumbrance: What will happen to unsecured bank bonds?

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24 July 2012

The financial crisis led to a loss of confidence in banks. Investors became less willing to invest in unsecured bank bonds, or were only prepared to do so for higher rates of interest. This led to banks using increasingly secured funding—mainly covered bonds (in Germany Pfandbriefe), repurchase agreements (repos) and, due to the special circumstances, long-term refinancing operations (LTROs) of the European Central Bank (ECB). However, since the start of the crisis the proportion of asset-backed securities (ABS) has been falling. This article will throw more detailed light on how this development will affect the position of creditors holding unsecured claims.

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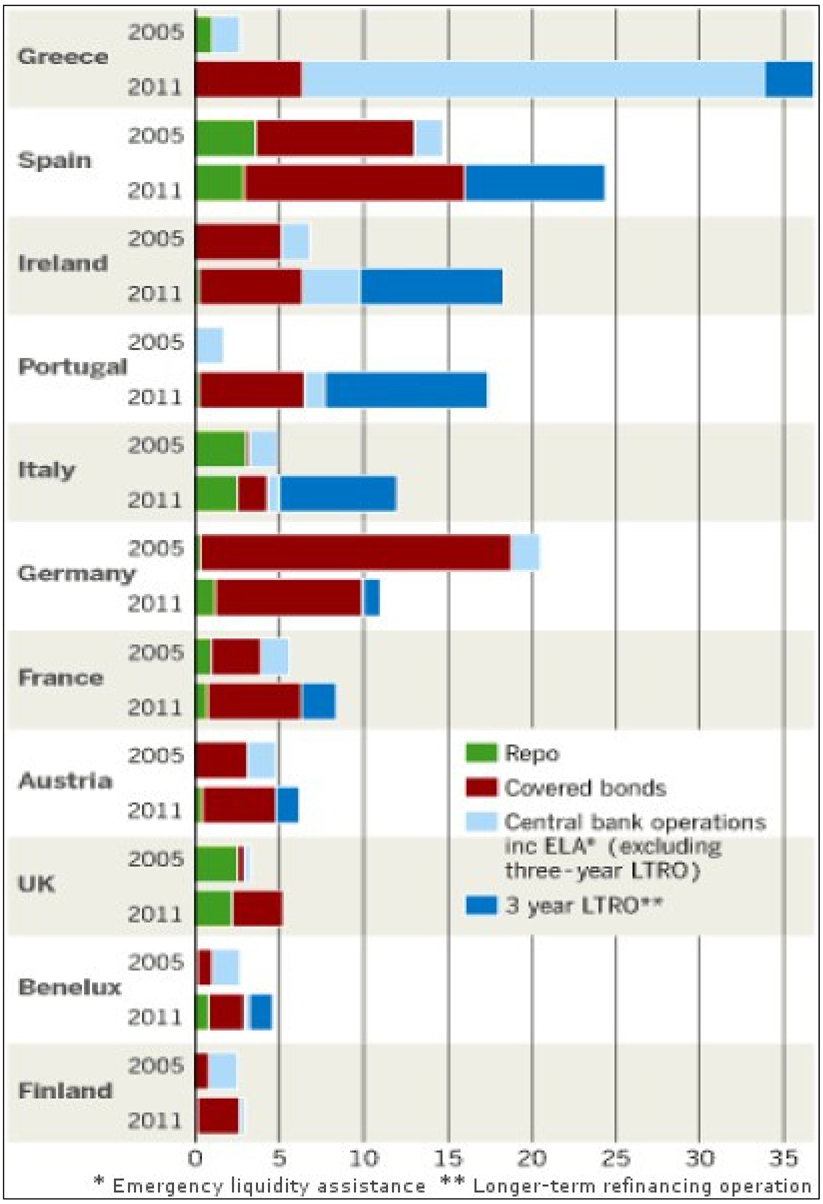
Current figures confirm the trend towards more strongly secured forms of funding: In 2012 loans totalling €1,100 billion mature at eurozone banks, 80 per cent of which are unsecured – but of current 2012 refinancing only 20 per cent is unsecured. The increasing proportion of secured refinancing will mean that, in case of insolvency, an ever larger part of the assets of a bank will be pledged with priority to specified investors (asset encumbrance). In consequence, where there is insolvency of an issuer, creditors holding unsecured bonds will seek recovery from a relatively small and mostly less valuable insolvency estate. This does not affect the claims of depositors against deposit guarantee schemes: Each depositor will receive compensation up to a specified upper limit regardless of the amount of the insolvency estate, although the right of recourse of the deposit guarantee scheme would also suffer under asset encumbrance.

The insolvency estate available to creditors will also be diminished by the increasing importance to provide collateral in derivatives transactions. This development expressly follows the recommendations of the G20 and the new European regulatory initiatives, such as the proposed European Market Infrastructure Regulation (EMIR). According to the International Swaps and Derivatives Association (ISDA), coverage of OTC derivatives has increased from 65 per cent in 2007 to around 70 per cent in 2012.

Europe-wide increase

Although only limited data is available, most European countries have seen a significant increase in asset encumbrance compared to 2005. Along with Greece, the Spanish banking sector has by far the highest (and increasing) level of asset encumbrance in Europe. The aggregate value of the German banking sector is also over 10 per cent (see Fig. 1).

Fig. 1: Asset encumbrance as percentage of aggregated total assets
(Double counting is possible, as covered bonds may also be used as collateral for LTROs)



Asset encumbrance as percentage of aggregated total assets Source: Carmel Asset Management, April 2012

For the 'unsecured creditor', the change in the figures is more important than the absolute value of asset encumbrance. Due to over-collateralisation, an expansion of covered payment obligations of an issuer typically results in a disproportionate reduction of assets from the insolvency estate available to unsecured creditors. For creditors, if there is insolvency this entails a falling insolvency ratio or increasing loss-given default (LGD).

Asset encumbrance for some European banks increased strongly in 2011. An important cause of this increase in asset encumbrance is the increased use or legal introduction of covered bonds as a form of refinancing. Only Germany, Ireland and Luxembourg — the three countries where public covered bonds (*Pfandbriefe*) dominate — registered a decrease (see Fig. 2).

Fig. 2: Outstanding covered bond volume

	Public	Mortgages	Total 2010	Increase over 2009	Share of total assets
Austria	21,126	9,647	**30,773**	23%	3.1%
Denmark	0	332,505	**339,227**[a)]	4%	**40.9%**
France	75,548	156,239	**320,480**[b)]	11%	4.1%
Germany	412,090	219,947	**639,842**[a)]	-11%	7.7%
Greece	0	19,750	**19,750**	**204%**	3.8%
Ireland	36,550	29,037	**65,587**	-19%	4.3%
Italy	10,092	26,925	**37,017**	**61%**	1.0%
Luxembourg	28,889	0	**28,889**	-9%	2.7%
Netherlands	0	40,764	**40,764**	**44%**	1.8%
Norway	1,837	69,871	**71,708**	32%	**14.5%**
Portugal	1,400	27,730	**29,130**	36%	5.2%
Spain	18,350	343,401	**361,751**	3%	**10.4%**
Sweden	0	188,750	**188,750**	**41%**	**16.4%**
UK	3,548	205,370	**208,918**	2%	4.2%
Total	609,430	1,669,936	**2,382,585**	4%	6.5%

Source: European Covered Bond Council ECBC, calculations by BaFin

a) including ship mortgages

b) including mixed assets

According to the Association of German Pfandbrief Banks (*Verband deutscher Pfandbriefbanken - vdp*), the volume (nominal value) of mortgage Pfandbriefe in Germany in the first quarter 2012 fell slightly to €209 billion and public Pfandbriefe decreased significantly to €330 billion. Compared with the aggregated total assets of the German banking sector of €8,523 billion *(Source: Statistics of the Monetary Financial Institutions, Bundesbank)*, this appears to be relatively low. With respect to individual Pfandbrief banks, the share is naturally much higher.

According to the vdp, for German Pfandbriefe the over-collateralisation ratio from 2008 to the first quarter 2012 for mortgage Pfandbriefe also increased from 20 to 29 per cent and for public Pfandbriefe from 11 to 21 per cent, which also further strengthens the encumbrance effect. For German banks the cover pool including over-collateralisation on the total assets is at least transparent due to section 28 of the Pfandbrief Act (*Pfandbriefgesetz – PfandBG*).

Internationally, the proportion of over-collateralisation is in some parts rising even more strongly. The reason for this is the increasing requirements of rating agencies on the cover pool, in order to maintain high bank ratings (AAA ratings where possible) for the covered bonds.

LTROs of the European Central Bank

A second important reason for the increase in asset encumbrance is derived from two asset-backed three-year tenders of the ECB (LTROs). The volume of the three-year tenders given amounted to €489 billion in December 2011 with an additional €530 billion in February 2012; in total this means a volume of €1,019 billion plus shorter maturity LTROs.

LTROs also anticipate a relatively high over-collateralisation, particularly in the peripheral Euro countries, as their ECB Eligible Assets have been expanded with more risky assets with corresponding higher haircuts.

According to the ECB, many German banks have also participated in the three-year ECB tenders. The Bundesbank and BaFin are monitoring whether risks might arise from the use of the LTROs by German banks.

Effect on unsecured creditors

Finally, if there were to be insolvency, higher levels of asset encumbrance would also have a detrimental effect on the (few remaining) investors in unsecured forms of funding. The reason for this is that there are only a few remaining freely disposable assets and these are typically of lower quality than collateral for covered bonds or for repos. Thus rising encumbrance levels mean that there is a disproportionately large increase in the loss for unsecured creditors during insolvency.

Since the credit crunch the proportion of banks' cheap secured refinancing has increased significantly to the detriment of expensive unsecured funding. This results in a negative cycle of more secured funding and even more expensive unsecured funding that could become even more pronounced due to bail-in plans within the framework of restructuring laws.

For this reason, efforts are taking place at national and international levels to limit asset encumbrance as a whole or, for example, to limit the emission of covered bonds or the size of the cover pool.

Similar proposals have been made at a European level as part of the negotiations regarding the regulatory package CRD IV. However, they are unlikely to be implemented or may only be implemented to some extent. An absolute limitation seems particularly critical, as they would endanger existing stable business models, particularly for issuers of mortgage Pfandbriefe. The banks would also lose operational options, particularly for refinancing shortfalls and rating downgrades.

EU Commission proposes flexible limit

Countries with new covered bond laws are limiting the volume of covered bonds in order to protect creditors of unsecured funding (for example, in Canada to 4 per cent of total assets, in Australia to 8 per cent, in New Zealand to 10 per cent). This appears to make sense, so as to improve acceptance of the new laws by creditors of unsecured claims and so that an overly sharp increase in encumbrance is limited from the outset.

A more flexible limit on asset encumbrance results from the proposal of the EU Commission for a Directive to establishing a framework for the recovery and resolution of credit institutions and investment firms dated 6 June 2012. Article 37 ff of the Proposal sets out the basis for a bail-in. Amongst other matters, the stipulation by national authorities that 'sufficient' amounts of liabilities be made available for restructuring should be ensured. This expressly excludes secured liabilities to the extent of the value of the collateral; a national option is currently planned for covered bonds within the meaning of Article 22 (4) of the UCITS Directive [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1985L0611:20080320:EN:PDF] (also includes Pfandbriefe under the Pfandbrief Act).

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Additional information

Other languages

- Asset-Encumbrance: Was wird aus unbesicherten Bankanleihen?

External links

- UCITS Directive [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1985L0611:20080320:EN:PDF]