

Policy Statement | PS18/20

Asset encumbrance

July 2020



BANK OF ENGLAND
PRUDENTIAL REGULATION
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1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 24/19 'Asset encumbrance'.¹ It also contains updated versions of Supervisory Statement (SS) 24/15 'The PRA's approach to supervising liquidity and funding risks' (Appendix 1), SS9/17 'Recovery planning' (Appendix 2), and SS20/15 'Supervising building societies' treasury and lending activities' (Appendix 3).

1.2 This PS is relevant to all PRA-regulated firms, except credit unions and insurance firms.

Background

1.3 In CP24/19, the PRA proposed to make clear that:

- firms should consider appropriately and thoroughly the potential impacts that asset encumbrance can have on their funding profiles, and put in place adequate risk management processes which include monitoring key metrics at appropriate committees, with clearly defined accountability for risk management, setting limits where appropriate;
- firms should document the above adequately in their internal liquidity adequacy assessment process (ILAAP) documents;
- building societies should manage their asset encumbrance in line with the PRA's existing expectations and proposed expectations set out in SS20/15, as well as with the PRA's proposed expectations for all firms in SS24/15 and SS9/17;
- firms should consider appropriately the effects that increased asset encumbrance might have on their abilities to maintain and restore their financial viability during a variety of stress scenarios; and
- firms should ensure that their levels of asset encumbrance do not unduly impair the amount and cash value of the assets which could be lent against in resolution, including by the Bank of England (the Bank) within its usual risk tolerance.

1.4 The PRA received two responses to the CP. Respondents generally welcomed the PRA's proposals, and requested that the PRA clarifies its proposed expectations and concepts in the CP.

Changes to draft policy

1.5 Having considered these responses, the PRA has made the following changes to the draft policy in SS20/15:

- paragraph 4.163 to reflect that 'market counterparties' does not refer to central banks; and
- paragraph 4.91 to reflect that the PRA will expect that building societies have an 'appropriate' forward view of collateral availability; not a 'comprehensive' one.

1.6 The PRA considers that these changes are not significant, and remove the potential for ambiguity.

¹ September 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/asset-encumbrance>.

Implementation

1.7 The policy presented in this PS will become effective from the date of publication on Monday 27 July 2020.

1.8 The policy set out in this PS has been designed in the context of the UK's withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1.9 The PRA has assessed that the policy would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'² for further details.

² April 2019: <https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018>.

2 Feedback to responses

2.1 The PRA has considered the responses received to the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions.

Definition of encumbrance

2.2 One respondent suggested that the PRA's definition of encumbrance for the purposes of the CP should be aligned with the definition in Capital Requirements Regulation (CRR) Article 411(5), as it is due to be amended by CRR II Article 1(106). That article defines an unencumbered asset as one which is 'not 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'.³

2.3 While the PRA offered the definition of encumbrance only for the purposes of understanding the proposals in the CP, it notes that firms should apply the definition set out in CRR II (as well as in the LCR Delegated Act) when measuring their asset encumbrance.

Likely behaviour of counterparties in stress

2.4 One respondent commented that a necessary part of a firm's stress testing of the stability of its funding is the likely behaviour of counterparties in a stress, especially if the stress includes a downgrade of the firm's credit rating.

2.5 The PRA agrees with this principle and considers that it is adequately captured in its proposal to insert paragraph 2.18A to SS24/15.

Minimum haircuts on collateral

2.6 One respondent suggested that in SS24/15 the PRA encourages firms to consider using External Credit Assessment Institutions (ECAI) market standard benchmarks to assess the likely levels of haircut applied to different types of collateral, for the purposes of their internal scenario analysis.

2.7 The PRA does not intend to encourage firms to use any particular benchmarks or haircuts when conducting analysis of risks associated with asset encumbrance. Firms should consider for themselves how best to conduct this analysis.

Likely future path of asset encumbrance in stress

2.8 One respondent requested that the PRA provides more detail on what it focuses on when assessing the likely future path of asset encumbrance in stress.

2.9 The PRA considers that the likely future path of asset encumbrance in a stress will depend significantly on the amount and types of encumbrance that the firm has, and on other factors such as the firm's business model. The depth of analysis that the PRA expects may also depend on the size and sophistication of the firm, and on factors such as whether it has established securitisation or covered bond programmes.

2.10 The PRA does not intend at this stage to prescribe what it expects to see from firms in making this assessment. As the PRA receives information from firms, it will consider whether it would be helpful to clarify any of its expectations in the future.

³ Regulation (EU) 2019/876, Article 106.

Resolution

2.11 One respondent asked for more detail on the PRA's comment that one risk of asset encumbrance is that it unduly impairs the amount and cash value of the assets which the firm could encumber with market counterparties, or with the Bank within its usual risk tolerance, to allow for the effective implementation of the firm's resolution strategy. In particular, respondents asked for clarification of the Bank's 'usual risk tolerance'.

2.12 The PRA refers to page 22 of 'The Bank of England's approach to resolution', which sets out the Bank's approach to providing liquidity in resolution.⁴ There, the Bank notes that it expects that liquidity first comes from firms' own resources. Where those resources are temporarily insufficient, and access to private sector funding is disrupted, the Bank has a flexible approach to providing liquidity to support a firm's resolution strategy. First, a firm in resolution would have access to the Bank's published liquidity facilities, as set out in the Bank of England Market Operations Guide.⁵ The Bank also has a flexible Resolution Liquidity Framework⁶ within which it may provide liquidity to firms against a broad range of collateral. The terms and conditions of any lending, including the cost of drawing, would be set in a way designed to support the effectiveness of the resolution regime, incentivise the transition of the firm back to market-based funding, and protect public money.

2.13 The PRA clarifies that a risk of asset encumbrance is that it unduly impairs the amount of assets that it could encumber with the Bank in a resolution situation.

Clarifying 'market counterparties' (regarding building societies)

2.14 One respondent suggested that there is some ambiguity with the PRA's proposed amendment to SS20/15 paragraph 4.163. In particular, the respondent asked whether the PRA intends to include central banks as a market counterparty.

2.15 The PRA did not intend for central banks to be included in 'market counterparties'. To resolve this ambiguity, the PRA will change its draft policy as follows: 'Under the extended approach, societies would set internal limits on the level of encumbrance (including to central banks) that they are prepared to accept in normal market conditions. Normally, extended approach societies would not be expected to encumber more than 20% of balance sheet assets with market counterparties (that is, excluding assets encumbered under facilities provided by the central bank).' (Underlining shows additional text to the wording proposed in CP24/19).

Reiterating that suggested encumbrance limits are not binding (regarding building societies)

2.16 One respondent referred to the PRA's proposal to reiterate that the encumbrance limits set out in SS20/15 paragraph 4.163, and Appendix 5 of the CP, are not binding. They suggested that this insertion might imply that other non-binding quantitative guidance in SS20/15 is not non-binding as the SS does not say so explicitly each time.

2.17 The PRA considers that it is important for all societies to assess for themselves the appropriateness of their management of risks associated with asset encumbrance. This is in line with its expectations of all firms. The PRA agrees and reiterates that other non-binding parts of SS20/15 continue to be non-binding, and that firms should consider the appropriateness of those suggested risk management practices for themselves also.

⁴ October 2017: <https://www.bankofengland.co.uk/paper/2017/the-bank-of-england-approach-to-resolution>.

⁵ <https://www.bankofengland.co.uk/markets/bank-of-england-market-operations-guide>.

⁶ October 2017: <https://www.bankofengland.co.uk/paper/2017/the-bank-of-england-approach-to-resolution>.

3 Appendices

- 1 SS24/15, 'The PRA's approach to supervising liquidity and funding risks', available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-approach-to-supervising-liquidity-and-funding-risks-ss>

- 2 SS9/17, 'Recovery planning', available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/recovery-planning-ss>

- 3 SS20/15, 'Supervising building societies' treasury and lending activities', available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/supervising-building-societies-treasury-and-lending-activities-ss>