Box 7

ASSET ENCUMBRANCE AT EURO AREA LARGE AND COMPLEX BANKING GROUPS

Asset encumbrance, or a declining pool of unpledged assets for unsecured creditors, has become quite topical in the context of a shift towards secured borrowing in bank funding patterns. While asset encumbrance as a result of an increased use of secured funding is frequently cited as a concern by analysts, its measurement at an aggregate level is not straightforward and must be inferred. This box attempts to shed more light on the magnitude of balance sheet encumbrance at euro area LCBGs, using data that are publicly available in the form of banks' annual reports.

In recent years, there has been a shift in banks' funding structures towards secured funding, including covered bond and repo funding, as well as, in some cases, collateral (liquidity) swaps. The share of covered bonds in total liabilities had increased in most euro area countries since 2006, with the notable exception of Germany (see Chart A). The increase in covered bond funding is compounded by the rising levels of over-collateralisation, i.e. the size of the cover pool assets relative to the bonds they collateralise, as required by rating agencies to maintain the high(er) ratings for covered bonds. Furthermore, the recent large take-up of Eurosystem liquidity on a secured basis has contributed further to the widespread perception of rising asset encumbrance.

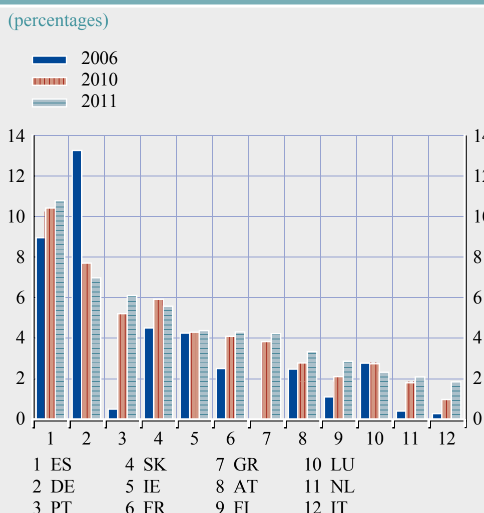
Looking at euro area LCBGs, the share of secured funding in total liabilities (approximated by the combined share of covered bonds and repo funding) varied within a wide range of between 2% and 32% at the end of 2011 (see Chart B), suggesting a significant heterogeneity in asset encumbrance levels among banks, which in turn reflected differences in their business models or specificities of their local funding markets.

Rising asset encumbrance levels have also led to concerns about the structural subordination of investors in senior unsecured debt. These concerns have been reinforced by uncertainty about the details of the forthcoming legislation on "bail-in" debt, which will probably involve unsecured senior bondholders sharing in the burden in the case of bank failures as part of plans to end taxpayer bailouts of financial firms. In addition, more countries may introduce depositor preference laws, thereby further reducing the volume of assets that would be left for unsecured creditors in the event of default.

Taken together, all these factors would imply lower recovery rates on senior unsecured bank debt, and unsecured debt investors may thus start to demand higher compensation for assumed risks. However, a cross-sectional regression analysis of five-year bank credit

Chart A Share of covered bonds in bank liabilities in selected euro area countries

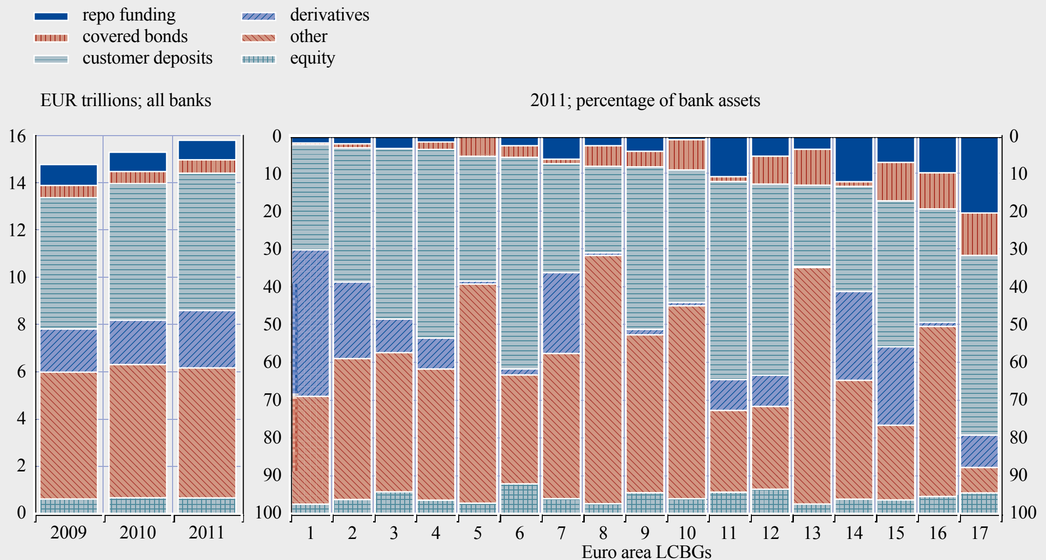
(percentages)



Sources: Association of German Pfandbrief Banks (vdp), Dealogic, ECB, European Covered Bond Council and ECB calculations.
Note: 2011 figures are estimates, except those for Germany.

Chart B Liabilities of selected euro area LCBGs from 2009 to 2011

(2009 – 2011)



Sources: Bank reports and ECB calculations.
Notes: Data cover 17 euro area LCBGs. Repo funding includes both central bank and private sector repos.

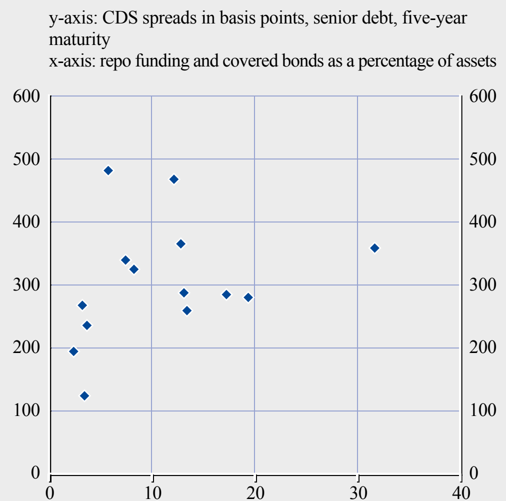
default swap (CDS) spreads on the share of secured funding in overall funding (calculated as the sum of repo and covered bond funding in total assets or in total assets excluding derivatives) and the corresponding sovereign credit default swap (CDS) spreads revealed that only the sovereign factor was a statistically significant driver of bank CDS spreads in 2011, and also in 2010 (see also Chart C).

If unsecured bank funding costs remain uneconomically high, banks will have to look for other sources of funding in the medium term. Options appear to be rather limited, however, as aggressive competition for deposits might reduce interest rate margins, while higher covered bond issuance or other secured funding would increase asset encumbrance further. Therefore, it is crucial that banks regain investor confidence by strengthening their balance sheets, first and foremost by increasing their capitalisation levels.

All in all, data publicly available in the form of banks' annual reports suggest that asset encumbrance at banks has been increasing, thereby warranting close monitoring. In addition, recent regulatory initiatives, in particular the "bail-in" debt provisions included

Chart C Asset encumbrance and bank CDS spreads

(2011; percentage of assets and basis points)



Sources: Bank reports, Bloomberg, Dealogic and ECB calculations.
Notes: Data cover 14 euro area LCBGs for which CDS spread data was available. Repo funding includes both central bank and private repos.

in forthcoming legislation on bank resolution, have contributed to investor perceptions that recovery rates for unsecured creditors are likely to be lower in the future. As a consequence, unsecured funding appears to have the potential to remain expensive, thereby depriving banks of this historically important source of funding, unless they regain investor confidence through stronger balance sheets and higher capitalisation levels. It must be acknowledged, however, that heterogeneity in asset encumbrance remains significant among banks, possibly also as a function of their business models. More generally, a dearth of hard data on asset encumbrance also highlights the need for a better disclosure, also of details on the level of haircuts/over-collateralisation for assets pledged under different forms of secured funding. In fact, the lack of clarity about the degree of banks' balance sheet encumbrance creates uncertainty among senior debt investors and could thus also contribute to higher unsecured funding costs, with concomitant strains on key financial institutions.