Supervisory Statement | LSS2/13

# Collateral upgrade transactions and asset encumbrance: expectations in relation to firms' risk management practices

April 2013

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PRUDENTIAL REGULATION
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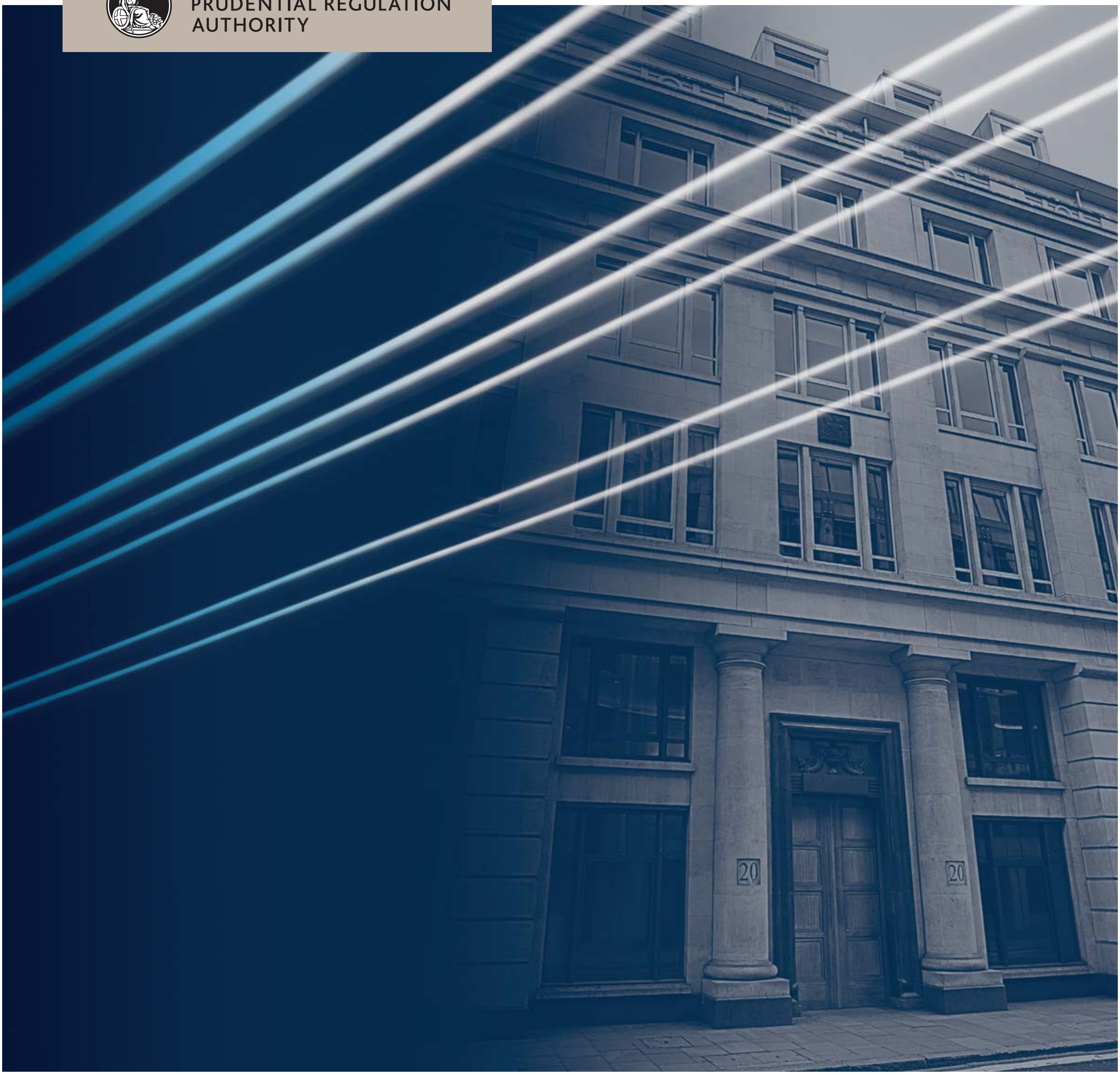

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# Collateral upgrade transactions and asset encumbrance: expectations in relation to firms' risk management practices

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From its commencement on 1 April 2013, the Prudential Regulation Authority (PRA) has adopted a number of legacy FSA policy publications relevant to the advancement of its objectives. This document, initially issued by the FSA, has been adopted by the PRA as a Supervisory Statement as part of this process. The PRA may choose to review this legacy publication at a later stage.

## Executive summary

An FSA consultation document was issued in January 2011 in response to an increasing trend of banks looking to improve liquidity by entering into new types of collateral upgrade transactions: in particular those transactions where banks look to access the liquidity embedded within asset portfolios held by insurers, although there have also been a number of transactions between two bank counterparties. The final guidance is included in Annex 1 of this document.

The PRA recognise that these transactions enable the temporary transfer of liquid assets to firms that need them, whilst at the same time providing the lending firm with secured exposures (which can benefit its creditors including depositors and policy-holders) and potentially an enhanced yield. We see a role for these transactions on a sensible scale, provided the risks are properly identified and managed by both parties.

Collateral upgrade transactions allow the borrower to exchange poorer quality assets (eg illiquid or less liquid and/or low credit quality) for better quality assets (eg liquid and/or high credit quality). Our potential concerns with collateral upgrade transactions include: the continuing trend to encumber balance sheets to the potential detriment of consumers; using borrowed assets to meet liquidity requirements and/or help funding, ie whether this provides resilient liquidity or funding benefits in a time of stress; whether risk management frameworks are adequate to deal with the increased risk from extended maturities, significant size, and the use of potentially illiquid or less-liquid, poorer quality and difficult to value assets as collateral; and whether such transactions hinder the resolvability of firms.

The objective of the guidance is to alert firms to our concerns about collateral upgrade transactions and our expectations for managing the associated risks.

For the purpose of the guidance, collateralised borrowing transactions are limited to those in which there is a material difference in the quality of assets exchanged, and are now referred to as collateral upgrade transactions. This difference in quality may be a function of differences in liquidity, credit quality or another risk parameter. In order to clarify the scope, we also refer to specific collateralised transactions not caught within the scope of the guidance (eg generally, short-term and routine transactions). See Annex 1, section A2 for the detailed guidance. Although this guidance focuses on particular transactions, we are aware that many of the risks identified here apply to other forms of collateralised borrowing, such as shorter dated repo transactions.

We have provided some further guidance of the transactions that we would wish to be notified of in advance of execution: broadly those that materially exhibit the risks of concern and are described in section A3.

For insurers we expect to be informed, in advance, of transactions for which it is proposed to hold a lesser amount of capital than for a comparable transaction, investment or structured investment.

## General

Firms should also be aware that we cannot restrict our discretion to take appropriate supervisory action to deal with matters as they develop. This may include providing individual guidance to firms on the adequate treatment of collateralised borrowing transactions within the parameters set in the guidance. It may also include preventing specific transactions that, due to their features or circumstances, pose unacceptable risks to our statutory objectives.

# Annex 1
# Guidance for collateral upgrade transactions

## A1. Application

The guidance applies to all firms undertaking collateral upgrade transactions that fall within scope.

The guidance covers the notification and general risk management expectations, applicable to both parties to the transaction, and guidance specific to insurers.

For the purpose of this guidance, references to:

- 'borrower' are to the firm that receives the higher quality assets and, in return for which, posts collateral; and
- 'lender' are to the other firm which provides the higher quality assets and, in return for which, receives collateral.

## A2. Scope

For the purpose of this guidance, a collateral upgrade transaction is where there is a material difference in the quality of assets exchanged, for a period of greater than a year (whether in a single transaction or by a series of transactions). This difference in quality may be a function of differences in liquidity, credit quality or another risk parameter. There are a number of means by which this outcome can be achieved and may take different legal forms.

The guidance applies to the forms of collateral upgrade transactions as described above, such as the following:

- long-term repo and reverse repo transactions, and long-term stock lending and borrowing (where long term is defined as greater than one year(1) or rolling or perpetual maturity); and

- any form of collateralised borrowing that is in substance economically similar, including synthetic transactions (eg a sale plus a collateralised and margined Total Return Swap).

In order to help prevent excessive pre-notification volumes of lower risk transactions there are certain transactions that are not in scope. Specifically the following are excluded:

- short-term repo and reverse-repo transactions, and short-term stock lending and borrowing transactions (where short term is defined as one year or less);
- the issuance of covered bonds;
- the creation of asset-backed securities;
- mortgage lending;
- leasing;
- collateralisation of amounts owed under contracts such as derivatives; and
- transactions with a central bank that would receive a 0% risk weight under the standardised approach to credit risk in BIPRU 3.

## A3. Risks

The transactions of concern to us have a number of features which can increase risk. We expect firms to have adequate risk management process and controls to consider these risks and ensure appropriate mitigants are put in place.

The risks are as follows, though this list is not exhaustive:

- asset encumbrance;
- liquidity;
- collateral;
- operational (including legal);
- intra-group; and
- scale and concentration.

### Asset encumbrance — borrower

If the transactions involve large haircuts, the borrower may be encumbering a significant proportion of its assets. This will structurally subordinate its unsecured creditors' (including depositors') claims over its assets given as collateral. This risks reducing the amount available to meet claims in the event of the borrower's default. Given the potential scale of these transactions, the risk of loss due to asset encumbrance could be significant, particularly during a period of market stress. The dynamic nature of the margining in these transactions, where a fall in the value of the collateral results in the borrower having to encumber more assets, and where triggers within transaction agreements may lead to additional margin calls, is likely to be exacerbated during such a period.

In the event that the borrower uses the borrowed assets to raise liquidity in the repo market, there will be further asset encumbrance and structural subordination of unsecured creditors, further increasing the risk of loss to those creditors.

The position on asset encumbrance articulated in an earlier FSA letter to the British Bankers' Association remains valid. This recognised that whilst covered bonds could present significant risks to the claims of unsecured creditors when they were a material source of funding, other secured funding methods such as securitisations, securities financing transactions and repo financing could also pose risks to unsecured creditors. Specifically there is an expectation that firms discuss with the regulator, in advance, all plans for covered bonds issuances and any other significant new asset encumbrance. The supervisory case-by-case assessment may

(1) We do not expect transactions to be structured at marginally less than a year merely to circumvent the guidance, without other justifiable reason.

result, among other outcomes, in an additional Pillar II capital charge, a cap on issuance and/or limit on the term of issuance.

## Liquidity — both borrower and lender

The liquidity provided to the borrower under the transaction may reduce in stressed times due to margin calls or other embedded triggers. This would particularly be the case where the borrower has pledged assets where falls in their market value are likely to be closely correlated with the borrower entering into a liquidity stress. As a result of these transactions, there is likely to be a significant reduction in the volume of liquid assets, both those eligible for the regulatory liquidity buffers and other buffers, that are available to the lender to cover its potential liquidity needs, such as cash outflows or margining requirements (on other transactions).

If a material part of a firm's liquid assets are borrowed or lent under such transactions, then a thorough analysis of its ongoing liquidity requirements should be undertaken before entering into such transactions, including an assessment of liquidity risk under stressed scenarios.

The analysis of the liquidity risk arising from these transactions should be based on cash-flow forecasts for a period of not less than the term of the transaction.

A firm should be satisfied that the cash flows under the following scenarios are sufficient to meet its liabilities as they fall due:

- Stressed expected cash flows with the transaction(s): with no event of default (eg inability to liquidate securities lent, adverse selection due to substitution rights, additional margin calls).
- Stressed expected cash flows with the transaction(s): with the counterparty default and retention of all collateral (eg maturity of collateral versus maturity of liabilities and reinvestment risk).
- Collateral liquidity: firms should include stresses under which the collateral becomes increasingly illiquid.

Banks (whether borrower or lender) are reminded that, as an extension of BIPRU 12.3, they are required under BIPRU 12.4 to consider multiple stress scenarios in addition to the regulatory stresses outlined in BIPRU 12.5 and above. Firms should document these stresses and associated risks in the Individual Liquidity Adequacy Assessment (ILAA).

## Collateral — lender

The value of the illiquid or less liquid and/or lower credit quality collateral being taken by the lender may be difficult to assess and obtain independent valuations for (in particular where asset-backed securities are being used). This may be the case both before and after default of the borrower.

Own-issued and own-originated securities being used as collateral are potentially exposed to wrong-way risk, exposing the lender to increased risk that the collateral is an insufficient credit risk mitigant.

If firms do not have adequate systems and controls in place to appropriately value and manage collateral, they should not enter into these transactions. In this regard:

- Collateral should be individually identifiable, and suitably diversified, with adequate information available about the underlying assets held through any securitisation vehicle.
- Firms should have an independent and robust challenge process in agreeing valuations with the borrower. Evidence of reliance on the counterparty's valuation instead of a firm's own assessment or undue reliance on outsourcing could be grounds for finding a serious failure of that firm's risk management systems and controls (see, for example, SYSC 3, 7, 8, 14–17, as applicable).
- Asset valuation at the point of default is likely to be difficult to estimate (eg due to an absence of a sufficiently rich data set). In such circumstances, we expect firms to use highly prudent valuation methodologies as part of both the initial and ongoing risk assessment of these transactions, particularly if there are concerns about wrong-way risk.
- Firms should assume that the greater the price volatility of the collateral, the more amplified the effect of correlation is likely to be, particularly during periods of market stress (eg the failure of a bank).

Where the likely exit strategy in the event of default is collateral retention, we expect firms to have conducted appropriate due diligence before entering into the transaction to ensure that collateral retention is a viable strategy (section A5 also covers this point for insurers).

## Operational risks (including legal) — both borrower and lender

Operational risk and legal risk (eg legal efficacy and operational consequences of material new clauses and new legal structures and arrangements) are untested and so may not work in the manner envisaged.

A firm should conduct legal reviews as necessary (as evidenced by a written and reasoned legal opinion) to ensure the enforceability and legal effectiveness of the collateral arrangements in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of the counterparty. The legal review should include, but not be limited to, analysis of:

- the legal effectiveness and enforceability of the contractual rights to liquidate and/or retain the collateral; and

- the ability of contractual and security rights to withstand challenge by liquidators and other creditors, including the extent of the lender's claim on excess collateral surviving post an event of default of the borrower (eg for how long).

Particular attention needs to be given to the circumstances in which standard documents (eg GMRA(1), GMSLA(2)) are varied, or where different legal structures or arrangements are used or created, or where asset types that were not previously provided as collateral are used.

Firms should consider the potential effect of regulatory changes (eg Solvency II) and other changes on the economic rationale for transactions, including any adverse capital implications arising from these. Firms should consider whether they have appropriate contingency arrangements in the event of a significant adverse change.

### Intra-group — both borrower and lender

Intragroup transactions potentially require a higher level of risk management and governance to ensure that any conflicts of interest (eg the interests of the relevant group company being set aside in the interest of another group company or the group as whole) are appropriately managed, and that transactions are carried out at arm's length.

### Scale and concentration — both borrower and lender

The scale and concentration risk of any collateral upgrade transaction (eg due to use of own-originated securities, single or few counterparties) may potentially exacerbate the above risks.

Firms should therefore have appropriate limit structures in place to manage these risks. This should include (but is not limited to): scale of transactions (eg size and maturity); the type of assets lent and collateral received; model sensitivities (eg duration or interest rate risk capped by some form of risk measure; minimum levels of over-collateralisation/haircut by asset class).

## A4. Notification to the PRA

Under Principle 11 Relations with regulators — A firm must deal with its regulators in an open and cooperative way, and must disclose appropriately to the appropriate regulator anything relating to the firm of which the regulator would reasonably expect prompt notice.

Any proposed significant transactions that are within scope should be notified to us well in advance of the execution date so the risks inherent in the proposed transactions can be assessed.

We consider a transaction to be significant if it materially poses one or more of the risks in section A3. For example, we expect to be notified of:

- any intra-group transaction;

- any transaction that relies on material amounts of own-issued and/or own-originated securities as collateral; and

- any transaction for which a firm proposes holding an amount of capital that is below that required to be held on a comparable asset (for example, some structured covered bonds that fall outside of the regulated covered bond regime).

It is possible that a transaction between two firms might pose material risks to one but not the other (eg due to differences in the size of the respective balance sheets). In this case only the firm that is exposed to the material risk is expected to notify us.

## A5. Guidance specific to insurers as lenders (in addition to Sections A1–A4 and A6)

The following guidance is specific to insurers in relation to these transactions.

### Pillar 1

We consider these transactions to fall within the definition of a 'stock lending' transaction (as defined in the PRA Handbook Glossary) and the provisions on stock lending in INSPRU 3.2.36R to 3.2.36AR must be met in relation to such a transaction for the purposes of GENPRU 2 Annex 7R (Admissible assets in insurance).

### Liquidity

If a material part of the insurer's liquid assets will be loaned or transferred under such transactions, then a thorough analysis of the insurer's ongoing liquidity requirements should be undertaken before entering into such transactions. This includes assessing the impact on liquidity risk under stressed scenarios, or as a result of higher than expected levels of policy surrenders, or of possible margin calls resulting from other unrelated transactions entered into by the insurer (see INSPRU 1.1.34R to 1.1.40G, GENPRU 1.2.26R to 1.2.31R, GENPRU 1.2.42R, SYSC 11 and INSPRU 4.1).

### Collateral re-hypothecation

If collateral is relatively illiquid and re-hypothecated, there may be difficulties in realising the collateral within a

(1) Global Master Repurchase Agreement.
(2) Global Master Securities Lending Agreement.

reasonable timescale, in the event of the borrower wishing to substitute the collateral, or in matching the insurer's liabilities in the event of counterparty default. There may also be additional risks for the insurer resulting from any leveraging of collateral received. The insurer should take account in its Pillar 2 ICA of any mismatch between the type, quality and liquidity of the collateral held by the insurer following any rehypothecation, and the collateral that would need to be returned to the borrower.

### Individual capital assessment

In addition to the risks associated with the current assets and liabilities on the balance sheet, the Pillar 2 ICA should also take account of all the additional risks associated with the transaction, including credit, liquidity, legal and operational risks, along with considering the reliability of asset valuations in both normal and stressed conditions.

For the purpose of this assessment, the loss given default should, depending on the likely exit strategy, either assume that the collateral would be sold at a distressed market price, or that the collateral will be retained at a suitably prudent 'market value' haircut allowing for the return of any excess collateral, and for any mismatch risk by duration, interest type (eg fixed/floating) and/or currency, between the remaining collateral and the liabilities.

The assumed probability of default should be based on an adequate assessment of credit risk in stressed conditions that should reflect the potential concentration risk if there are very few counterparties, the way in which concentration risk is being hedged (other than with collateral), the extent of encumbrance of the counterparty's assets, and the assumed absence of any external government or supra-national support for the counterparty.

An insurer should also be able to demonstrate the way in which it will cover its margin of solvency and maintain the capital level under its ICA/ICG (or Solvency II SCR and ORSA/supervisory review process) following a default event (ICA/ICG and SCR would then include a component in respect of credit risk on the collateral). We anticipate allowing an insurer a reasonable amount of time to restore this cover in appropriate circumstances, provided doing so is not incompatible with any directive applicable to insurance activities.