ESRB
European Systemic Risk Board
European System of Financial Supervision

RECOMMENDATION OF THE EUROPEAN SYSTEMIC RISK BOARD

of 20 December 2012

on funding of credit institutions

(ESRB/2012/2)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board[1], and in particular Article 3(2)(b), (d) and (f) and Articles 16 to 18 thereof,

Having regard to Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board[2], and in particular Article 15(3)(e) and Articles 18 to 20 thereof,

Whereas:

(1) Funding conditions for credit institutions have been significantly affected by the current crisis. Credit and interbank markets have remained impaired as a result of the strong links between credit institutions and sovereigns as well as the uncertainties over asset quality and the sustainability of some credit institutions' business models. Credit institutions have responded to this situation by making changes to their funding structures and asset portfolios.

(2) On 29 June 2012 the Euro area summit took an important step towards breaking the negative link between sovereigns and credit institutions. It envisaged a single supervisory mechanism and the direct use of European funds from the EFSF and ESM for bank recapitalisation/bailout and resolution. However, certain credit institutions still weigh negatively on sovereigns, and vice versa. This vicious circle needs to be broken in order to bring about the better functioning of the funding markets.

(3) In order to improve funding conditions it is necessary to re-establish the resilience of credit institutions and confidence in them. The recommendation of the European Banking Authority (EBA) for a minimum 9% Core Tier 1 capital ratio for credit institutions[3] has partly contributed to this aim. However, the current macroeconomic outlook imposes further strains on credit

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[1] OJ L 331, 15.12.2010, p. 1.

[2] OJ C 58, 24.2.2011, p. 4.

[3] EBA Recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence (EBA/REC/2011/1).

institutions' balance sheets.

(4) The on-going reform of the European Union regulatory regimes governing credit institutions (CRD IV package[4], in particular its provisions regarding the liquidity regime and the framework for recovery and resolution[5]), remain at the negotiation stage. The date on which the proposed packages will receive final approval and enter into force remains uncertain, as does the nature of the interrelations among the different instruments. Achieving clarity as to the regulatory framework would be beneficial not only for the credit institutions subject to it but also for investors.

(5) While public authorities, in particular central banks, have used extraordinary measures to reduce funding strains and create the conditions for credit institutions to strengthen funding structures in the future, credit institutions also need to actively strive to achieve sustainable funding structures.

(6) The monitoring and assessment of credit institutions' funding risks and funding risk management by national supervisory authorities is fundamental to the evaluation of the institutions' capacity to execute their own funding plans and reduce reliance on public sector funding sources. Likewise, the monitoring by national supervisory authorities of the recourse to innovative instruments and to the provision of uninsured deposit-like financial instruments may contribute to the timely detection of risks, allowing for further supervisory actions to be taken whenever necessary.

(7) The introduction of risk management policies on asset encumbrance is vital to ensure that credit institutions follow their own encumbrance levels and are therefore better able to cope with possible stress situations.

(8) The monitoring of asset encumbrance by the national supervisory authorities should cover encumbered assets and unencumbered but encumberable assets, as well as the sources of encumbrance, and the policies and contingency plans developed by credit institutions.

(9) Market transparency contributes to addressing asymmetric information. Information which is clear, simple and easy to compare is required in order to allow market participants to better differentiate risk profiles in terms of encumbrance.

(10) Market participants are subject – when applicable – to disclosure requirements based on International Financial Reporting Standard (IFRS) 7[6]. It would be appropriate at the same time

4 Proposal for a directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (COM(2011) 453 final), and proposal for a regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (COM(2011) 452 final).

5 Proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (COM(2012) 280/3).

6 In Europe these standards are adopted by means of Commission Regulation (EC) No 1126/2008 of 3 November 2008

to broaden the range of credit institutions disclosing information, to widen the disclosure to all means of encumbrance, to enhance the terms of disclosure and to create more uniform practices.

(11) The proposed terms for disclosure aim at preventing credit institutions from being subject to stigma effects and for this reason, central bank operations should not be disclosed in any way.

(12) The identification of best practices by the European and national supervisory authorities facilitates comparison of different issuances of covered bonds and contributes to better-informed risk analysis. The identification of best practices in respect of other financial instruments that generate encumbrance can contribute to similar improvements in these other markets. The acquisition of both types of instrument will be more appealing for investors as the costs involved in understanding the regulatory framework governing them would be lowered. Accordingly, it is desirable to incentivise the use of best practices at the highest quality standards.

(13) The Commission proposal for the establishment of a single supervisory mechanism[7] (as agreed by the Council on 12 December 2012) envisages conferring specific supervisory tasks necessary for supervision of credit institutions on the European Central Bank (ECB). For the purposes of carrying out these tasks, the ECB will be considered the competent authority under the relevant acts of Union law and have the powers and obligations which competent authorities have under those acts.

(14) The Annex to this Recommendation analyses the significant systemic risks to financial stability within the Union arising from the funding of credit institutions.

(15) In accordance with recital 29 of Regulation (EU) No 1092/2010, the observations of the relevant private sector stakeholders have been taken into account in preparing this Recommendation.

(16) This Recommendation is without prejudice to the monetary policy mandates of the central banks within the Union.

(17) Recommendations of the European Systemic Risk Board are published after informing the Council of the General Board's intention to do so and providing the Council with an opportunity to react.

HAS ADOPTED THIS RECOMMENDATION:

SECTION 1

RECOMMENDATIONS

Recommendation A – Monitoring and assessment of funding risks and funding risk

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adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (OJ L 320, 29.11.2008, p. 1).

[7] Proposal for a Council regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (COM(2012) 511 final).

management by supervisors

1. National supervisory authorities with responsibility for banking supervision are recommended to intensify their assessments of the funding and liquidity risks incurred by credit institutions, as well as their funding risk management, within the broader balance sheet structure, and should in particular:

   (a) assess the funding plans provided by credit institutions and their feasibility for each national banking system, on an aggregated basis, taking into account the business model and risk appetite of each institution;

   (b) monitor the development of funding structures in order to identify innovative instruments, request information on such instruments and analyse the information obtained to understand how risks may shift within the financial system;

   (c) monitor the level, evolution and behaviour of uninsured deposit-like financial instruments, which are sold to retail customers, and their potentially negative effects on traditional deposits.

2. National supervisory authorities with responsibility for banking supervision are recommended to monitor credit institutions' plans to reduce reliance on public sector funding sources and to assess the viability of such plans for each national banking system, on an aggregated basis.

3. National supervisory authorities and other authorities with a macro-prudential mandate are recommended to assess the impact of credit institutions' funding plans on the flow of credit to the real economy.

4. The EBA is recommended to develop guidelines on harmonised templates and definitions, in accordance with its established consultation practices, in order to facilitate the reporting of funding plans for the purposes of the recommendations contained in paragraphs 1 to 3 above.

5. The EBA is recommended to coordinate the assessment of funding plans at Union level, including credit institutions' plans to reduce reliance on public sector funding sources, and to assess the viability of such plans for the Union banking system, on an aggregated basis.

Recommendation B – Risk management of asset encumbrance by institutions

National supervisory authorities with responsibility for banking supervision are recommended to require credit institutions to:

1. Put in place risk management policies to define their approach to asset encumbrance, as well as procedures and controls that ensure that the risks associated with collateral management and asset encumbrance are adequately identified, monitored and managed. These policies should take into account each institution's business model, the Member States in which they operate, the specificities of the funding markets and the macroeconomic situation. The policies should be approved by each institution's appropriate management bodies.

2. Include in their contingency plans strategies to address the contingent encumbrance resulting from relevant stress events, which means plausible albeit unlikely shocks, including downgrades in the credit institution's credit rating, devaluation of pledged assets and increases in margin requirements.
3. Have in place a general monitoring framework that provides timely information to the management and the relevant management bodies on:
   (a) the level, evolution and types of asset encumbrance and related sources of encumbrance, such as secured funding or other transactions;
   (b) the amount, evolution and credit quality of unencumbered but encumberable assets, specifying the volume of assets available for encumbrance;
   (c) the amount, evolution and types of additional encumbrance resulting from stress scenarios (contingent encumbrance).

Recommendation C – Monitoring of asset encumbrance by supervisors

1. National supervisory authorities with responsibility for banking supervision are recommended to closely monitor the level, evolution and types of asset encumbrance as part of their supervisory process, and should in particular:
   (a) review the monitoring frameworks, policies and contingency plans put in place by credit institutions in terms of encumbrance and collateral management;
   (b) monitor the level, evolution and types of asset encumbrance and related sources of encumbrance, such as secured funding or other transactions;
   (c) monitor the amount, evolution and credit quality of unencumbered but encumberable assets available for unsecured creditors;
   (d) monitor the amount, evolution and types of additional encumbrance resulting from stress scenarios (contingent encumbrance).
2. National supervisory authorities with responsibility for banking supervision are recommended to monitor and assess risks associated with collateral management and asset encumbrance, as part of the supervisory review process. This assessment should take into account other risks, such as credit and funding risks, and mitigating factors, such as capital and liquidity buffers.
3. The EBA is recommended to issue guidelines on harmonised templates and definitions in order to facilitate the monitoring of asset encumbrance, in accordance with its established consultation practices.
4. The EBA is recommended to closely monitor the level, evolution and types of asset encumbrance, as well as unencumbered but encumberable assets at Union level.

Recommendation D – Market transparency on asset encumbrance

1. The EBA is recommended to develop guidelines on transparency requirements for credit institutions on asset encumbrance. These guidelines should help ensure that the information disclosed to the market is clear, easy to compare and appropriate. In view of the limited experience in disclosing reliable and meaningful information on asset quality, the EBA should follow a gradual approach, with a view to moving to a more extensive disclosure regime after one year. The guidelines should request credit institutions to provide:
   (a) The level and evolution of encumbered and unencumbered assets:
      (i) for the first year following the adoption of the guidelines, this information should include a breakdown by asset type, provided on an annual basis;
      (ii) based on the experience gained until 31 December 2014, including in implementing Recommendation C, the guidelines should be amended to require information to be provided on a semi-annual basis and supplemented by a requirement to disclose a breakdown by asset quality, provided that the EBA deems that such additional disclosure offers reliable and meaningful information.
   (b) A voluntary narrative, by which credit institutions provide the users with information that may be useful to understand the importance of encumbrance in the credit institutions' funding model;
2. For the purposes of paragraph 1(a), the EBA is recommended to specify in the guidelines the features of the disclosed data, in terms of units and lag of disclosure.
3. In developing these guidelines, the EBA is recommended to:
   (a) cooperate with ESMA, in order to build on the existing requirements included in IFRS with regard to asset encumbrance;
   (b) take into account relevant developments in related topics, in particular, those relating to the liquidity regulatory framework; and
   (c) ensure that the level and evolution of assets encumbered to central banks, as well as the amount of liquidity assistance given by central banks, cannot be detected.

Recommendation E – Covered bonds and other instruments that generate encumbrance

1. National supervisory authorities are recommended to identify best practices regarding covered bonds and encourage harmonisation of their national frameworks.
2. The EBA is recommended to coordinate actions taken by national supervisory authorities, particularly in relation to the quality and segregation of cover pools, insolvency remoteness of covered bonds, the asset and liability risks affecting cover pools and disclosure of the composition of cover pools.
3. The EBA is recommended to consider whether it is appropriate to issue guidelines or

recommendations endorsing best practices, after monitoring the functioning of the market for covered bonds by reference to these best practices for a period of two years. If the EBA identifies the need for a legislative proposal in this regard, it should report to the European Commission and inform the ESRB.

4. The EBA is recommended to assess whether there are other financial instruments that generate encumbrance which would also benefit from the identification of best practices in national frameworks. If the EBA concludes that such instruments exist, it should (i) coordinate the identification and encourage the harmonisation of the resulting best practices by the national supervisory authorities; (ii) act as defined in paragraph 3 regarding covered bonds, in a subsequent stage.

SECTION 2

IMPLEMENTATION

Interpretation

1. For the purposes of this Recommendation, the following definitions apply:

   (a) ‘credit institution’ means credit institution as defined in Article 4(1) of Directive 2006/48/EC [8];

   (b) ‘financial system’ means financial system as defined in Regulation (EU) No 1092/2010;

   (c) ‘national supervisory authority’ means a competent or supervisory authority as defined in Article 1(3)(f) of Regulation (EU) No 1092/2010. Whenever a national supervisory authority is not the competent supervisory authority, the ECB acting within the single supervisory mechanism is deemed the addressee of the relevant recommendation;

   (d) ‘encumbered asset’ means an asset which is, either explicitly or implicitly, pledged or subject to an arrangement to secure, collateralise or credit-enhance any transaction;

   (e) ‘innovative instrument’ means an instrument in respect of which, due to its novelty, little information is available about its behaviour, particularly in a stress event, thus exposing credit institutions to hidden risks, such as liquidity and funding crunch and legal or reputational risks;

   (f) ‘uninsured deposit-like financial instrument’ means a financial instrument that may resemble a deposit, but which entails risks different to those of a deposit, as this financial instrument is not covered by a deposit guarantee scheme;

   (g) ‘deposit’ means deposit as defined in Article 1(1) of Directive 94/19/EC[9];

   (h) ‘sustainable funding structure’ means a funding structure that can be perpetuated without public intervention and in respect of which the cost of funding does not affect the

8 OJ L 177, 30.6.2006, p. 1.
9 OJ L 135, 31.5.1994, p. 5.

viability of the institution.

2. The Annex forms an integral part of this Recommendation. In the case of conflict between the main text and the Annex, the main text prevails.

2. Criteria for implementation

1. The following criteria apply to the implementation of this Recommendation:
   (a) this Recommendation covers only the funding of credit institutions;
   (b) regulatory arbitrage should be avoided;
   (c) due regard should be paid to the principle of proportionality in the implementation, with reference to the particular systemic significance of the funding and encumbrance risks within each banking system and taking into account the objective and content of each recommendation;
   (d) specific criteria for compliance with recommendations A to E are set out in the Annex.
2. Addressees are requested to report to the ESRB and to the Council on the actions undertaken in response to this Recommendation, or adequately justify any inaction. The reports should at minimum contain:
   (a) information on the substance and timeline of the actions undertaken;
   (b) an assessment of the functioning of the actions undertaken in terms of the objectives of this Recommendation;
   (c) detailed justification of any inaction or departure from this Recommendation, including any delays.

3. Timeline for the follow-up

Addressees are requested to report to the ESRB and the Council on the actions taken in response to this Recommendation, or adequately justify any inaction, in compliance with the timelines set out below.

1. Recommendation A – National supervisory authorities with responsibility for banking supervision, national supervisory authorities and other authorities with a macro-prudential mandate, and the EBA are requested to report according to the following timeline:
   (a) by 30 June 2014, national supervisory authorities with responsibility for banking supervision are requested to deliver to the ESRB an interim report containing a first assessment of the result of the implementation of recommendations A(1) and (2);
   (b) by 31 January 2015, national supervisory authorities with responsibility for banking supervision are requested to deliver a final report on recommendations A(1) and (2) to the ESRB and to the Council;
   (c) by 30 June 2014, national supervisory authorities and other authorities with a macro-

prudential mandate are requested to deliver to the ESRB an interim report containing a first assessment of the result of the implementation of recommendation A(3);

(d) by 31 March 2015 national supervisory authorities and other authorities with a macro-prudential mandate are requested to deliver a final report on the implementation of recommendation A(3) to the ESRB and to the Council;

(e) by 31 December 2013, the EBA is requested to deliver the guidelines referred to in recommendation A(4) to the ESRB and to the Council;

(f) by 30 September 2014, the EBA is requested to deliver to the ESRB an interim report containing a first assessment of the result of the implementation of recommendation A(5);

(g) by 31 March 2015: the EBA is requested to deliver a final report on the implementation of recommendation A(5) to the ESRB and to the Council.

2. Recommendation B – by 30 June 2014, national supervisory authorities with responsibility for banking supervision are requested to report to the ESRB and the Council the actions taken in response to this Recommendation.

3. Recommendation C – the EBA and national supervisory authorities with responsibility for banking supervision are requested to report according to the following timeline:

(a) by 31 December 2013, the EBA is requested to deliver to the ESRB and the Council the guidelines referred to in recommendation C(3) and an interim report containing a proposal on how it intends to fulfil recommendation C(4);

(b) by 30 September 2014, the EBA is requested to deliver to the ESRB a first monitoring report on asset encumbrance for the purposes of recommendation C(4);

(c) by 31 December 2015, the EBA is requested to deliver to the ESRB and the Council a final monitoring report on asset encumbrance for the purposes of recommendation C(4);

(d) by 30 June 2014, national supervisory authorities with responsibility for banking supervision are requested to deliver to the ESRB a first monitoring report on the actions taken in response to recommendations C(1) and (2);

(e) by 30 September 2015, national supervisory authorities with responsibility for banking supervision are requested to deliver to the ESRB and the Council a final monitoring report on the actions taken in response to recommendations C(1) and (2).

4. Recommendation D – the EBA is requested to report according to the following timeline:

(a) by 31 December 2013, the EBA is requested to deliver to the ESRB and the Council the guidelines;

(b) by 30 June 2015, the EBA is requested to deliver to the ESRB and the Council an additional report on the implementation of recommendation D(1)(a)(ii).

5. Recommendation E – the EBA and national supervisory authorities are requested to report

according to the following timeline:

(a) by 31 December 2013, national supervisory authorities are requested to report to the ESRB and to the Council on the actions taken in response to Recommendation E (1);

(b) by 31 December 2013, the EBA is requested to deliver to the ESRB an interim report setting out the principles of best practice in relation to covered bonds which it has identified together with national supervisory authorities, and an assessment of the existence of other financial instruments which generate encumbrance in respect of which best practices need to be identified;

(c) by 31 December 2014, the EBA is requested to deliver to the ESRB an interim report setting out the principles of best practices for other financial instruments that generate encumbrance, if they were identified in the interim report mentioned in paragraph (b) of this timeline;

(d) by 31 December 2015, the EBA is requested to deliver a final report to the ESRB and to the Council containing an assessment of the functioning of the framework for covered bonds under the best practice principles and its view on recommended further action if deemed desirable;

(e) by 31 December 2016, the EBA is requested to deliver a final report to the ESRB and to the Council containing an assessment of the functioning of the framework for the other financial instruments that generate encumbrance under the best practice principles, if they were identified in the interim report to be delivered under paragraph (b) of this timeline, and its view on recommended further action if deemed desirable.

4. Monitoring and assessment

1. The ESRB Secretariat:

   (a) assists the addressees, including by facilitating coordinated reporting, providing relevant templates and detailing where necessary the modalities and timeline for the follow-up;

   (b) verifies the follow-up by the addressees, including by assisting them on request, and reports on the follow-up to the General Board via the Steering Committee.

2. The General Board assesses the actions and the justifications reported by the addressees and, where appropriate, decides whether this Recommendation has not been followed and if the addressees have failed to adequately justify their inaction.

Done at Frankfurt am Main, 20 December 2012

The Chair of the ESRB

Mario DRAGHI