The systemic risks of inhibiting collateral fluidity: Asset Encumbrance

What do we mean by asset encumbrance?

From a legal perspective, asset encumbrance is a claim against a property by another party. From a financial perspective, such claims have traditionally taken the form of security interests, such as pledges, given on assets by a borrower to a lender.

In other words, giving collateral encumbers assets. If the borrower defaults, the secured lender has the right to liquidate the asset or collateral to recover her cash. She is therefore given preference over unsecured creditors, who are said to be 'structurally subordinated' in terms of their priority in the event of bankruptcy.

Why is asset encumbrance important?

The main focus of regulatory concern about asset encumbrance is on: the impact on the credit risk of unsecured depositors; the problems created for deposit insurance or guarantee schemes and bail-in; and increased liquidity risk on secured lenders.

Encumbrance reduces the assets available to the liquidator in the event of a default by a bank and therefore the recovery rate of its depositors and other unsecured bank creditors.

Regulators would also like to see sufficient unencumbered assets remaining on banks' balance sheets to strengthen their resilience by providing a liquidity buffer against roll-over risk in stressed conditions. This buffer could then be used to generate liquidity.

Does repo encumber assets?

It is important to recognize that not all transactions encumber assets in the same way or to the same extent. For example, in the case of collateral pledged by an institution to cover exposure related to a derivatives contract, the entire amount of collateral pledged is encumbered. Unsecured creditors of the pledgor will not have a claim on those assets in the event of bankruptcy. Repo, however, is more nuanced.

In the case of repos, at least in Europe (which are usually transacted under the Global Master Repurchase Agreement), legal title to the repoed assets is passed from the repoer to the reverser. It is essentially an outright asset sale with an agreement to repurchase the asset at a future date. In the event of bankruptcy of the repoer, unsecured creditors do not have a claim on the repoed assets, since legal title has passed to the reverser. Instead they will have a claim on the cash received by the repoer, or whatever assets this cash has been used to purchase. In this respect, repo does not encumber assets.

Any encumbrance arising out of repos tends to be marginal, and relates to: (i) haircuts applied to repos – the over-collateralized portion of the transaction can be considered as encumbered; and (ii) contingent encumbrance – related to the potential credit and liquidity risk of selling the underlying asset at a price below the value of the repo including any haircuts and variation margining.

In other words, the asset encumbrance caused by a repo is, at worst, a marginal, partly contingent amount that, on one hand, depends on whether haircuts are given and, on other hand, reflects the quality of the underlying assets.

Careless terminology

Unfortunately, there is a tendency for commentators, practitioners, and even regulators to use terms such as 'repo', 're-hypothecation', 'pledge', and 're-use' interchangeably. This can cause unnecessary confusion, particularly when thinking about asset encumbrance.

Repo: as discussed above, repurchase agreements (in Europe) facilitate the legal transfer of title of an asset by means of an outright sale and the agreement to repurchase the asset at a future date. In this respect, assets that are repoed are not strictly being 're-used'; they can only ever be *used*.

Re-hypothecation: this relates to the right of a pledge to re-use or dispose of a pledgor's assets, either by means of sale or repo. When the right to re-hypothecation is exercised, the pledgor's property rights are replaced by a contractual right to the return of the same or similar (equivalent) assets. In practice, rights of re-hypothecation are typically given by hedge funds to prime brokers on assets in the fund's segregated custody account, where they will be subject to a pledge in favour of the prime broker. Outside of the US[1], re-hypothecation has nothing to do with repo.

Why do we need to get asset encumbrance right?

Measuring asset encumbrance is critically important, particularly in assessing risks to unsecured lenders. However, not all transactions encumber assets in the same way, or to the same degree. In the case of repos, for instance, any encumbrance is at best marginal. These nuances are often overlooked, and there is a tendency to view all secured funding transactions in the same way. The EBA, for example, defines asset encumbrance as:

'…an asset is considered encumbered if it has been pledged or if it is subject to any form of arrangement to secure, collateralise or credit enhance any transaction from which it cannot be freely withdrawn.'

At a time when the market is facing potential collateral supply-demand imbalances, and where there is an increasing need for improved collateral fluidity, it is essential that regulators do not misidentify asset encumbrance or restrict the usability of unencumbered assets.

[1] Under the law of New York, which is the predominant jurisdiction in the US, the transfer of title to assets via repo is not legally robust. In the event of a repo seller becoming insolvent, there is a material risk that the rights of the buyer to liquidate collateral could be successfully challenged in court. Consequently, repo takes a form that is more similar to a pledge with a right to re-hypothecation.