EUROPEAN CENTRAL BANK

15 January 2004

MEASURES TO IMPROVE THE COLLATERAL FRAMEWORK OF THE EUROSYSTEM: SUMMARY OF THE ANSWERS TO THE PUBLIC CONSULTATION

On 11 June 2003 the Eurosystem launched a public consultation on the measures to improve the collateral framework of the Eurosystem, and the public was invited to react by 15 September 2003. Market participants actively participated in the consultation procedure, submitting 59 responses in total. Some of the responses were prepared by individual banks and others were prepared by associations of market participants, including European credit sector associations, the European Payments Council, the ACI (and national affiliates) and some national market participant associations. All respondents welcomed the Eurosystem initiative to consult the market at this early stage of the discussions on the possible reform of the collateral policy.

This note presents a summary of the main elements of the responses received by the Eurosystem, starting with a section on the general statements made on the proposal to reform the collateral policy by establishing a single list, followed by a category-by-category review of assets proposed for inclusion in the single list. It goes without saying that the views expressed in this summary reflect the opinion of the financial sector industry, as presented in the consultation, and cannot in any way be imputed to the Eurosystem. However, the Eurosystem will, of course, consider market views when taking its decisions on improving the collateral framework.

1. General comments on the proposed reform

General support for the proposed reform:

Almost all the responses received support the proposal to replace the two-tier system by a single list of eligible collateral. Support for the reform is largely based on the desire to establish a level playing-field between counterparties, which is not entirely the case at present, since only some national central banks (NCBs) have chosen a tier 2 list composed of national assets. While these tier 2 assets are also accessible on a cross-border basis, this is not sufficient to ensure a truly level playing-field, as all participants should be in a position to use similar assets wherever they are located. A second argument in favour of reform is the need to increase the transparency of the collateral framework. Indeed, in the view of the respondents, a single list could reduce the current heterogeneity of the tier 2 lists, thus facilitating transparent use of the collateral framework at the pan-European level.

Nevertheless, it should be pointed out that in the case of a few responses from market participants and national associations in EU Member States not participating in EMU there was a call for a halt to the reform of the collateral framework, mainly because they are satisfied with the current arrangement. Some respondents also call for the re-introduction of the use of “out-collateral” by Eurosystem participants in the framework, as was the case before 1 July 2003. They argue, without elaborating, that phasing out this type of collateral affects their competitiveness.

An increasing need for collateral:

Nearly all respondents request that the new single list of collateral encompass more collateral than the current tier 1 list. Indeed, most respondents are of the view that the volume of the single list should be at least equal to the tier 1 and tier 2 volumes combined. Furthermore, most market participants request more collateral than is currently eligible and suggest, in particular, that new categories of collateral be included. They argue that the new collateral policy should cater for the increasing use of collateral in “a changing global payments environment” and of payment and securities clearing and settlement systems.

More collateral for the euro financial market:

Indeed, all respondents fear that the tier 2 assets currently eligible might be excluded from the single list (particularly where they have such assets in their country, and even when they are seldom or never used). They anticipate that the current developments in the market, such as the Basel II Capital Accord and the development of the secured segment of the money market (i.e. euro repo market), will de facto increase the demand for euro-denominated collateral. In this respect, banks’ balance sheets will be streamlined, and (reasonably priced) collateral will therefore become scarcer.

More collateral for the global markets:

Most respondents request the inclusion in the Eurosystem collateral framework of debt instruments denominated in G10 currencies. They argue that such assets are necessary to cope with the increase in global transactions (in particular in the context of the development of the Continuous Linked Settlement (CLS) system).

However, several respondents argue that an expansion of the collateral list should not come at the expense of the harmonisation, transparency and handling cost of the collateral framework.

A need for a harmonised collateral framework in a wider sense:

Most respondents indicate their support for further harmonisation of practices in the field of collateral. They call for “easy, cost-efficient and user-friendly procedures for posting collateral” and request the following:

- streamlining and harmonisation of procedures;
- access to the same collateral at an equivalent cost for all Eurosystem counterparties;
- low costs for counterparties, given a “public good” factor when using collateral for Eurosystem credit operations; reasonable haircuts should be applied;

- recognition that the availability of collateral at the place and time where it is needed is the critical factor for intraday credit in TARGET, rather than simply the overall level of collateral.

High expectations of the Eurosystem collateral framework:

Most respondents would like the implementation of the collateral framework to be based on the principles of harmonisation, expansion/diversification of eligible assets, neutrality in terms of competition, simplification of procedures (less administrative work), cost-efficiency and transparency of asset eligibility.

2. Main categories of current tier 2 assets to be considered for inclusion in the single list

In general, the answers support the principle of a single list that encompasses – alongside the tier 1 assets – at least the current tier 2 assets. However, this support is expressed in general terms, and no clear priority between the various categories of tier 2 assets has been expressed. The respondents promote the idea of creating a uniform collateral framework which is as broad and diversified as possible in terms of asset type in order to satisfy all, and not just a few, counterparties (in order to avoid affecting competition).

All respondents express little desire to see a phasing-out of any of the assets currently in the tier 2 list (particularly in the case of market participants in countries where these assets are eligible). In cases where phasing-out is mentioned as a possibility, participants recommend that it should be gradual, i.e. spread over a number of years.

2.1 Non-marketable assets (bank loans)

Strong support for bank loans:

Within the context of counterparties' call for a general extension of the list of eligible collateral, non-marketable assets and, in particular, bank loans are seen as important categories of asset for inclusion in the single list. Only a few responses do not favour their inclusion in the list.

From the perspective of the Eurosystem, the definition of a "bank loan" currently envisaged for the single list is restricted to corporate and government loans in euro; however, some counterparties' definition of the term appears to be wider. For instance, some respondents ask for foreign currency-denominated bank loans, "pools of loans" (or the portfolio approach), government-guaranteed loans and *Schuldscheindarlehen* also to be considered. Other categories of currently eligible non-marketable assets are also proposed for inclusion in the single list (Irish mortgage-backed promissory notes and Dutch loans).

Portfolio approach:

A large number of counterparties propose the acceptance of bank loans for collateral on a portfolio basis. They argue that a portfolio approach (i.e. the collective assignment of diversified loan portfolios, in line with ABS collateralisation practices) would eliminate the need to determine specific eligibility criteria for individual bank loans in terms of minimum size or minimum/maximum maturity. In their view, this approach would obviate the need to send notification to individual debtors.

Maximum flexibility for bank loans:

With reference to the characteristics of bank loans, the European banking industry calls for automated and efficient handling procedures. If these procedures are in place, defining a minimum amount for individual bank loans will lose relevance. On similar grounds, participants seem to suggest that neither a minimum nor a maximum maturity should be fixed, thereby allowing maximum flexibility.

However, in a number of responses, defining the minimum size and minimum/maximum maturity of bank loans was seen as relevant. For instance, some respondents suggested that the latter should be linked with the most common maturity spectrum for marketable tier 1 debt instruments, which appears to be between five and ten years. Some respondents suggest that the minimum residual maturity should be linked with the duration of the main refinancing operation, or an even longer period, such as one month. By contrast, other respondents favour a minimum maturity limit of no more than 48 hours. Finally, in the case of the minimum size, those respondents asking for such a threshold argue about what its optimal level should be in terms of a cost/benefit ratio (i.e. a high threshold implying that fewer bank loans will be eligible). Two groups have emerged: one requesting a smaller amount of no more than €100,000, and another requesting a higher minimum threshold, ranging from €500,000 to a few million euro.

No fee for bank loans:

Counterparties are generally opposed to applying particular cost recovery principles for this category of asset. In their view, imposing a fee would result in unfair treatment (vis-à-vis other categories of asset) and, on the basis of existing systems, would not appear to be justified. In addition, it was noted that the four central banks that have such assets in their tier 2 list do not charge fees to their users (either for credit assessment or for handling the collateral).

Efficient and automated procedures for handling bank loans:

Many respondents are of the view that bank loans have proven to be efficient and widely used in those countries where they are already eligible and appropriate procedures for their use exist. The opportunity cost of this category of collateral is lower than for other categories. This is particularly important for intraday credit operations. Moreover, these respondents argue that bank loans support the banks' fundamental task of financing the private sector.

Respondents suggest that the Eurosystem, with the support of the European banking industry, should take appropriate action to promote the legal harmonisation necessary to extend the eligibility of bank loans – and thus foster their use – across the euro area.

In order to minimise the administrative costs connected with their use, efficient and simple procedures should be put in place with a view to attracting more participants and managing a higher volume of collateral. In this respect, a large number of respondents call for a "centralised loan evaluation system". In some national and individual answers, the French set-up, based on an electronic system for mobilisation (i.e. TRICP) and involving almost no fee, is mentioned as a potential model.

IRBs at the disposal of the Eurosystem, but with strict confidentiality:

As regards credit assessment, most banks announce the development of an IRB (Internal Ratings Based) model – even before the outcome of the discussion on the review of the Basel II Accord. Most of them do not see any problem in disclosing information on their model to their central bank, but call for strict confidentiality as to the outcome, or at least strict anonymity as to the institution which has provided a credit assessment.

Syndicated loans:

Syndicated loans are also mentioned. Standardised documentation exists for such loans, as does a market where they are exchanged, thus allowing for easier transferability; in addition 60% of the loans are already rated by international rating agencies.

2.2 Equities

Positive attitude to including equities:

In principle, respondents have a positive attitude to including these securities, but some do not see a substantial business case. Respondents also expressed the view that their inclusion should not be detrimental to the inclusion of other types of asset in the single list – such as bank loans. In addition to their use in Eurosystem operations, the eligibility of equities would support the smooth functioning of securities clearing and settlement systems.

The costs in connection with including equities in the single list could be compensated by making eligible a large pool of equities (e.g. by including the basket of equities attached to the main indexes), implying that their eligibility should not be too restricted.

Finally, some respondents point to a number of legal issues, in particular in relation to corporate actions, that might be difficult to solve.

2.3 Other tier 2 marketable assets

In general, respondents support the inclusion of these assets in the single list. This favourable opinion is even stronger in countries where these assets are already eligible and represent a significant part of the collateral used. For these respondents, including only bank loans in the single list would not compensate for the loss of these assets.

3. New assets for the single list:

Strong support for euro-denominated debt instruments of non-EEA (European Economic Area) G10 issuers:

The respondents welcome the inclusion of euro-denominated debt instruments issued by issuers established in non-EEA G10 countries. Their inclusion can easily be achieved, as no additional costs would be incurred (same procedures as current tier 1).

Strong call for debt instruments denominated in other G10 currencies and even issued outside the EEA:

Most of the respondents call for an extension of the notion of foreign debt instruments to debt instruments denominated in other G10 currencies. These respondents advocate that the list of eligible collateral for intraday liquidity should be extended to G10 sovereign debt instruments (regardless of the G10 currencies in which they are denominated). It is noted, in particular, that both the US and the UK markets already allow the use of assets denominated in currencies other than their national currency. However, the market participants point out that any extension of the current list to include other currencies should be carefully considered before a decision is taken, in particular to avoid unfair competition issues vis-à-vis other markets (i.e. reciprocity issues).

According to many respondents, such an extension is necessary in order to address the need for global liquidity management, which is ever-increasing. In their view, banks throughout the world wish to diversify their funding basis. The promotion of foreign currency-denominated debt instruments in the Eurosystem collateral framework would be an incentive for other financial areas to accept euro-denominated collateral. In this respect, respondents take the view that mutual acceptance of foreign debt instruments should become the rule due to the globalisation of financial markets (as demonstrated, for example, by CLS).

Some other new categories of asset mentioned:

In addition, some respondents mention additional categories of asset that could be considered for inclusion in the single list. Among others, the following assets are mentioned: investment fund shares, credit derivatives (non-rated ABSs, MBSs, etc.), instruments indexed to equities or stock exchange indices, non-listed commercial papers, loans in other currencies than the euro and customer loans.

4. Issues relating to the implementation of the single list

No particularly strong views are presented on issues relating to the implementation of the single list. Most respondents feel comfortable with the current internet-based system used to access information on the list of eligible assets. Generally speaking, they take the view that one central database with an optimal functionality is required to check the eligibility of assets, particularly when the list of eligible collateral widens. However, the respondents call for more transparency with regard to the procedures used to determine the eligibility of assets. The current procedures for assessing potentially eligible assets are not regarded as transparent and are not easily understood by third parties.