THE SINGLE LIST IN THE COLLATERAL FRAMEWORK OF THE EUROSYSTEM

This article clarifies the process of replacing the current two-tier collateral system with a single list of collateral. Broadly speaking, two steps in the implementation of the single list can be distinguished. The first step, which was completed in May 2005, saw some amendments to marketable assets. The second step, the introduction of non-marketable assets – in particular bank loans[1] – into the single list, will enter into force in January 2007 and will be finalised in January 2012. The single list is a response to the drawbacks of the two-tier collateral framework against the background of an increasing degree of financial market integration in the euro area. It is aimed at enhancing the level playing field in the euro area, further promoting equal treatment for counterparties and issuers, and increasing the overall transparency of the collateral framework. The single list also takes into account the rising demand for collateralisation in private wholesale markets and the rising consumption of collateral by the Eurosystem. More generally, by increasing the liquidity of an entire asset class, such as bank loans, the single list of collateral promotes the smooth functioning of the euro area financial system. However, the acceptance of very diverse asset categories poses a number of challenges in terms of the design and maintenance of the collateral framework. Therefore, the Eurosystem will also continue to review and refine its collateral framework in the coming years.

1 INTRODUCTION

The present two-tier collateral framework was adopted in 1998 to ensure a smooth transition to the euro. In June 2003, the Eurosystem launched a public consultation on measures to improve the framework. Following the positive response to this initiative, the Governing Council approved in principle the move to a single list in the collateral framework and decided that it should be introduced gradually. The first step, focusing on marketable assets, was implemented in May 2005. The second step, the introduction of bank loans, will commence in January 2007 and will be finalised in January 2012.

This article clarifies the process of replacing the current two-tier system with a single list of collateral. Section 2 first describes the rationale for the single list. Section 3 presents developments and trends in the availability and use of collateral. Section 4 provides more detailed information about the gradual implementation of the single list and Section 5 concludes by identifying some future challenges for the collateral framework of the Eurosystem.

2 RATIONALE FOR THE SINGLE LIST OF COLLATERAL

In line with central bank practice worldwide, the Eurosystem provides liquidity to the banking system only on a collateralised basis. According to Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank, all credit operations by the Eurosystem need to be based on adequate collateral.

On the one hand, the concept of adequacy of collateral relates to the protection of the Eurosystem from possible losses in its credit operations. The Eurosystem has a low appetite for credit risk, as it wants to ensure the proper protection of the resources entrusted to it as well as its own financial independence. Furthermore, access to central bank credit should be based on the principles of transparency and equal treatment. Unsecured lending would not be compatible with these principles or with the accountability of the central bank, since it would require some discretion in the management of counterparty risk. On the other hand, collateralisation of central bank credit must ensure that the Eurosystem can carry out its

1 Although the term "bank loan" has been used throughout this article, the legal term is "credit claim".

tasks effectively. Among these tasks, as defined in Article 105(2) of the Treaty establishing the European Community, are the implementation of monetary policy and the promotion of the smooth operation of payment systems. Hence, there must be sufficient collateral available to counterparties, so that the Eurosystem can provide the amount of liquidity it deems necessary through its monetary policy and payment systems operations. Should the collateral policy result in a shortage of collateral in the banking sector as a whole or in a significant part of it, then the efficiency of the Eurosystem collateral framework would be called into question. This is because one of the principles underlying the monetary policy framework of the Eurosystem is the need to ensure participation of a broad range of counterparties. Moreover, the use of a real-time gross settlement system (RTGS) like TARGET for processing large-value payments in euro requires the provision of intraday credit by the central bank. Thus, the smooth functioning of TARGET relies crucially on the availability of sufficient collateral, not only at the aggregate, but also at the individual bank level.

The two-tier collateral framework was adopted by the Eurosystem to ensure a smooth transition to the euro. Counterparties have been in a position to use the assets they actually held on their balance sheets to participate in Eurosystem credit operations, and this helped to minimise the costs of adaptation to the new framework. Eligible assets were divided into two tiers in order to accommodate differences in financial structures between Member States at the beginning of EMU. Tier one assets consist of marketable debt instruments fulfilling euro area-wide eligibility criteria, while tier two assets, comprising assets deemed of particular importance for certain national financial markets and banking systems, only fulfil national eligibility criteria. Different categories of tier two assets are eligible in the different euro area countries, although in principle they can all be used on a cross-border basis throughout the euro area.

The current two-tier system has performed well in terms of ensuring sufficient availability of collateral to counterparties to meet the needs of both monetary policy and payment systems transactions. For example, even during the millennium date change the collateral framework proved resilient enough to cope with the substantial temporary increase in the demand for collateral. However, the two-tier system also has some significant drawbacks. The fact that some asset classes are eligible in some countries but not in others risks undermining the level playing field in the euro area. Particular concerns have been expressed by market participants about the eligibility of non-marketable assets, such as bank loans, in only a few countries. Since bank loans are primarily held by domestic counterparties and are therefore not readily accessible on a cross-border basis, it is mainly counterparties in countries where such loans are put on the tier two list which can benefit from the low opportunity costs connected to their use as collateral. Hence there is the risk that the current framework allows for "niches", giving a particular category of counterparties privileged access to the Eurosystem's credit operations through the use of collateral not available to other counterparties. Furthermore, the two-tier system, which necessarily results in heterogeneous eligibility criteria across countries, does not enhance transparency.

To overcome the drawbacks of the two-tier system, and against the background of an increasing degree of financial market integration in the euro area, the Eurosystem is working towards the introduction of a single list of collateral. The aims of the single list are to enhance the level playing field in the euro area, further promoting equal treatment for counterparties and issuers, and to increase the overall transparency of the collateral framework. Moreover, the single list takes into account the fact that, with increasing collateralisation in private wholesale markets and relatively high consumption of collateral by the Eurosystem, there are now competing demands on the collateral holdings of banks. More generally, by increasing the liquidity of an entire asset class, such as bank loans, the single list of collateral fosters the smooth functioning of the euro area financial system.

3 DEVELOPMENTS IN THE AVAILABILITY AND USE OF COLLATERAL

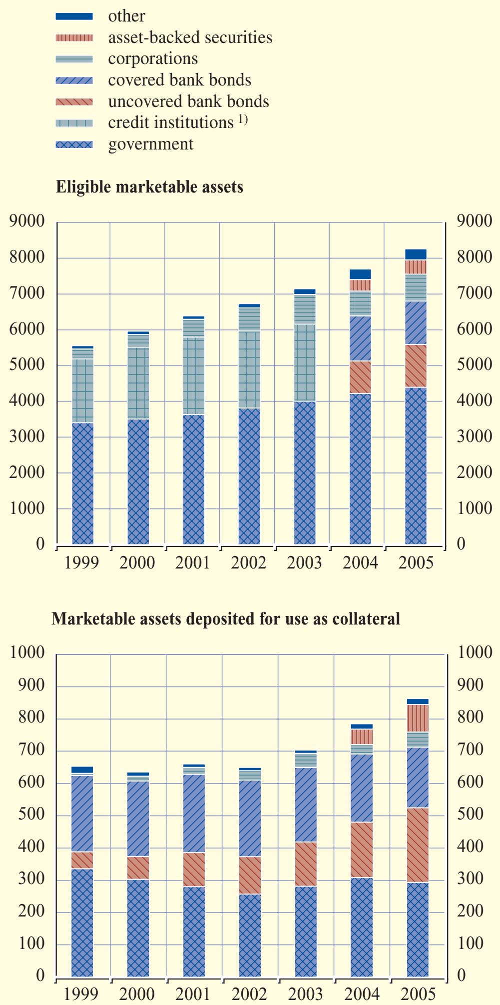
Both the amount of collateral available and the amount effectively used in monetary policy and intraday credit operations have steadily increased since the launch of the euro. The nominal amount outstanding of all eligible marketable assets increased from around €5.5 trillion in 1999 to around €8.5 trillion by the end of 2005, although a large proportion of this is not actually held by counterparties. Approximately 11% of these eligible assets, i.e. €902 billion, was deposited for collateralisation purposes with the Eurosystem.[2] The list of eligible marketable assets, currently numbering around 24,000, is published every day on the ECB's website (www.ecb.int).

Since the eligibility criteria have been kept general, the collateral framework of the Eurosystem is responsive to market innovations and follows market developments. The nominal amount outstanding and the composition of the eligible collateral pool have therefore grown in line with the general trends in the euro area financial markets. Markets for debt securities have grown substantially and diversified rapidly in the aftermath of the introduction of the euro. Private capital markets (corporate bond markets, debt securities issued by financial institutions and the rapidly increasing issuance of asset-backed securities) in particular have been the driving force behind these trends, supported by the strong growth in liquid and integrated derivatives markets.[3]

On the demand side, the consumption of collateral by the Eurosystem remained relatively stable between 1999 and 2002, but has steadily increased since then, by around 33%, from €650 billion in 2002 to €866 billion in 2005 (yearly averages). This growth in the use of collateral by

Chart 1 Marketable assets eligible and deposited for use as collateral in Eurosystem credit operations

(EUR billions)



Source: ECB.
1) A breakdown of credit institution data into covered and uncovered bank bonds was not available before 2004.

the Eurosystem can be attributed mainly to the increasing size of monetary policy operations needed to balance the growing liquidity deficit in the banking system. This, in turn, was caused

2 However, not all of the deposited collateral is used effectively. Counterparties tend to keep more collateral in the Eurosystem than what they actually use.

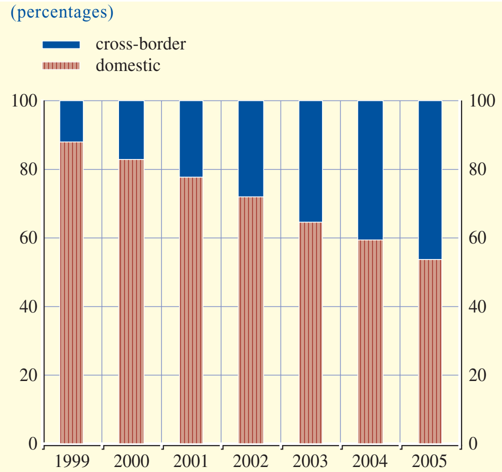
3 For example, the outstanding amount of corporate bonds grew by 97%, to €534 billion, between 1999 and 2005, which compares with a growth rate for euro-denominated euro area government bonds of 38%, to €4,195 billion, in the same period.

mainly by the rising trend in the volume of banknotes in circulation since the introduction of the euro banknotes and coins in 2002. By contrast, the use of collateral in intraday credits has stabilised, due to efficiency gains in payment system transactions. Thus, the liquidity needs of system participants have been reduced by the introduction of liquidity-saving features in modern large-value payment systems. These include, notably, offsetting algorithms in RTGS systems.

The composition of the asset pool used as collateral in transactions with the Eurosystem does not closely mirror the overall composition of debt markets, as can be seen from the different asset compositions shown in the two panels in Chart 1. This comparison between eligible collateral and collateral brought forward in credit operations with the Eurosystem shows that counterparties tend to bring to the Eurosystem proportionally more collateral with lower secondary market liquidity, such as covered and uncovered bank bonds and asset-backed securities, while government bonds are used proportionally less as collateral in credit operations with the Eurosystem. This tendency has become stronger over time: the share of government bonds decreased from 50% of deposited collateral in 1999 to 33% in 2005, while the shares of asset-backed securities and uncovered bank bonds reached 10% and 27%, respectively, in 2005. In 2005 these assets had shares of 52%, 5% and 15%, respectively, in the overall debt market.[4]

Chart 2 Domestic versus cross-border use of collateral

(percentages)



Source: ECB.

The growth in cross-border use of collateral, whereby a counterparty in a given country of the euro area uses collateral originating from another country of the euro area, is a good indication of the progress of financial market integration in Europe. At the end of 2005 almost 50% of collateral was used on a cross-border basis, compared with only about 12% in 1999. In several euro area countries cross-border collateral has in fact become the main collateral source. This points to the continuing geographical diversification of the holdings of banks. Moreover, it reflects the greater issuance of Eurobonds in international central securities depositories.

The increased cross-border use of collateral can also be linked to the growing efficiency of handling procedures. Procedures for the correspondent central banking model (CCBM) – the main channel for transferring cross-border collateral in Eurosystem monetary policy and intraday credit operations – have been enhanced, enabling a reduced processing time. Moreover, in addition to the 59 eligible links between EU securities settlement systems, "relayed links" (i.e. a combination of links) complying with the Eurosystem user standards will also become eligible, presumably in the first half of 2006, for the transfer of collateral in Eurosystem credit operations. However, despite recent increases recorded in the use of links, their overall use continues to remain relatively limited in comparison with the use of the CCBM. In 2005 the use of links represented around 8% of the total collateral held by the Eurosystem, compared with 36.8% for the CCBM. It is also interesting to note that the BIS Committee on Payment and

4 See the article in the February 2006 issue of the Monthly Bulletin entitled "Fiscal policies and financial markets" on the use of government debt collateral with different ratings in Eurosystem credit operations.

Settlement Systems (CPSS) has increasingly focused on the use of collateral in financial transactions, including the cross-border use of collateral. The CPSS recently published a report on cross-border collateral arrangements, the findings of which are summarised in Box 1.

In recent years, the demand for collateral for central bank credit operations has increasingly been competing with the expanding use of collateral in private wholesale markets. There has been a general expansion in trading activities, which has increased the need for risk mitigating techniques, in both cash and derivatives markets. In addition, the range of market participants has increased, reinforcing the need to manage counterparty risk more actively. Moreover, central counterparty clearing houses (CCPs), which typically rely on collateral to manage counterparty credit risk and liquidity risk between the trading and settlement phases, are broadening their scope. CCPs are increasingly expanding their activities from derivatives and repurchase transactions into outright securities markets.

The increasing use of collateral has coincided with the rapid growth in the European repo market in recent years. According to surveys conducted by the Eurosystem, the secured lending segment has become the largest component of the euro money market, representing around 35% of aggregate euro money market turnover.[5] The semi-annual surveys conducted by the International Capital Market Association's European repo council show that year-on-year growth in this market segment has recently ranged between 16% and 19% in terms of the value of outstanding contracts.[6] The share of cross-border transactions was around 53%. In terms of the asset types used as collateral, the composition of the private European repo market is different from the composition of the asset pool brought to the Eurosystem in its credit operations. Government bonds continue to be the main collateral source (86%) in this market, indicating that liquid assets which are easily transferable on a cross-border basis and with a credit risk that is easy to assess are still the preferred collateral in the European repo markets.

In view of the general increase in demand for collateral, the financial industry expressed, in the 2003 public consultation on measures to improve the collateral framework, a strong desire to expand further the range of eligible assets. The Eurosystem took these views into account when the measures on the single list were decided.

5 See Euro Money Market Survey, ECB, May 2005.
6 The outstanding value of contracts captured by the survey amounted to €5,883 billion in December 2005. This is only a very rough estimation of the total size of the market, as issues of double-counting have not been resolved and market coverage is not yet complete.

Box 1

SUMMARY OF FINDINGS OF THE G10 COLLATERAL REPORT

Over recent decades, the process of globalisation has led banks and other market participants to expand operations outside their countries of incorporation and to manage their liquidity and collateral in multiple currencies and jurisdictions. The Committee on Payment and Settlement Systems (CPSS) analysed institutional arrangements through which NCBs could accept "foreign collateral" on a routine and/or emergency basis to support intraday and/or overnight credit and published the main findings of its analysis in a report[1] released in January 2006.

1 Cross-border collateral arrangements, CPSS, January 2006, www.bis.org/publ/cpss71.pdf

The main findings of the report can be summarised as follows:

- The process of globalisation has led to an increased integration of financial markets, increased cross-border activity of banks and the use of collateralisation as a risk mitigation technique. The demand for collateral has also been influenced by technical innovations, including, in particular, the introduction of real-time gross settlement (RTGS) in payment systems and delivery versus payment (DvP) techniques in securities settlement. This has resulted in more complex liquidity and collateral management for banks. The interviews conducted by the working group appear to indicate that there is actually no shortage of collateral in normal market conditions; a shortage may appear, though, in emergency situations.

- The use of foreign collateral varies substantially among the central banks of G10 countries. Thus, while in Switzerland and the United Kingdom the amount of foreign collateral used for routine central bank operations is significant, in other countries it is much more limited.

- The same picture of heterogeneity prevails for internationally active banks, whose business has grown and become more complex over the years. These institutions have developed a variety of strategies and business models to accommodate local market practices and regulatory requirements. Some institutions have established subsidiaries, while other institutions rely on correspondent relationships with local banks. Thus, some institutions self-clear in only a small number of major currencies, so foreign participation in the payment system is relatively limited in many countries. For other currencies banks tend to rely on correspondent bank networks. Only a few banks participate directly in multiple payment and securities settlement systems around the world.

- Market infrastructure remains largely domestic in the G10 countries, which makes the movement of collateral from one country to another difficult. Despite considerable overlap between the operating hours of G10 settlement systems and those of G10 large-value payment systems, there remains scope for further synchronisation, particularly where time-zone frictions are greatest.

Given these findings and the heterogeneous situation that currently prevails, the report calls for a flexible solution. The variation in practices tends to exclude the adoption of a common policy for G10 central banks and to favour instead an “à la carte” approach. This would give central banks the latitude to decide whether and under what conditions foreign collateral could be accepted. However, it would not preclude coordination and cooperation between central banks at the bilateral or multilateral level so as to enhance the effectiveness of national central bank actions. This encompasses procedures such as the exchange of information between central banks and the further development of interoperability between national infrastructures.

Apart from this report, which focuses on central bank actions, market initiatives have been developed in parallel in the private sector, where activity was promoted by the Payments Risk Committee in 2005.[2]

2 Global payment liquidity: private sector solutions, Payments Risk Committee, Report by the Global Payment Liquidity Task Force, October 2005.

4 GRADUAL IMPLEMENTATION OF THE SINGLE LIST OF COLLATERAL

The current two-tier system is gradually being replaced by the single list. A gradual approach is necessary principally because the single list will comprise not only marketable assets, but will also be extended to non-marketable assets.[7] Accepting new marketable asset types as collateral is a relatively straightforward exercise. For marketable instruments the necessary infrastructures are in place to verify their existence and to transfer and mobilise them as collateral. Moreover, marketability helps to price and evaluate them. The information needed to assess their creditworthiness is also normally available in the public sphere. These preconditions are hardly ever fulfilled by non-marketable instruments such as bank loans. Therefore there is a need to develop operational systems and procedures at the central bank level that facilitate the use of these instruments as collateral, and this implies long lead times.

Broadly speaking, two steps in the implementation of the single list can be distinguished. In the first step the Eurosystem defined the marketable asset categories that should be included in the single list. This involved a careful review of the currently eligible marketable tier two assets in order to decide which ones could migrate to the single list. Also in the first step the Eurosystem assessed new categories of previously ineligible marketable collateral. The first step towards implementing the single list was achieved on 30 May 2005. It included: (i) the elimination of equities from the eligible assets; (ii) the specification of the non-regulated markets that are acceptable to the Eurosystem from a collateral management point of view; (iii) a refinement of the criterion regarding debt instruments issued by credit institutions; and (iv) the introduction of euro-denominated debt instruments issued by entities established in the G10 countries that are not part of the European Economic Area (EEA).

In the second step a specific framework for assessing, evaluating and mobilising non-marketable assets, in particular bank loans, as collateral will be implemented. This second step will enter into force in January 2007, when bank loans will become eligible as collateral for Eurosystem credit operations in all euro area countries. However, a fully unified regime for bank loans will not be in place until 1 January 2012.

4.1 FIRST STEP TOWARDS THE SINGLE LIST: FOCUS ON MARKETABLE ASSETS

As mentioned above, four issues were dealt with in the first step towards the single list.

First, in August 2004 the Governing Council took the decision to limit the collateral framework to debt instruments and not to accept equities, which were potentially usable in some countries as tier two collateral.[8] The first consideration for making equities ineligible was that the volume of eligible equities was very small. The second consideration was that equities are intrinsically more risky than debt instruments, so eligibility criteria have therefore to be restrictive, and this limits the volume of potentially eligible additional collateral. The third consideration was that, owing to their legal nature as an ownership right in a company, equities possess legal and operational features that make their use as collateral by the Eurosystem more complex than is the case for debt instruments. The fourth and final consideration was that, if equities were made eligible in the single list, it would have been difficult for reasons of consistency to exclude other financial instruments whose status lies between debt and equity (i.e. convertible bonds and subordinated debt). Such a broad acceptance of financial instruments

7 See the press release of 5 August 2004 – Review of the Eurosystem's collateral framework: second step towards a single list.

8 See the press release of 5 August 2004 – Review of the Eurosystem's collateral framework: second step towards a single list. The changes therein had been explained and pre-announced in the press release of 10 May 2004 – Review of the Eurosystem's collateral framework: first step towards a single list.

Timeframe for the gradual implementation of the single list

Launch of public consultation	Governing Council approved introduction of single list	First step: focus on marketable assets	Second step: introduction of bank loans	Uniform regime for bank loans
11 June 2003	10 May 2004	30 May 2005	1 January 2007	1 January 2012

with different ranks of seniority would have unduly increased the complexity of the collateral and of the risk control framework. Against this background the Governing Council decided that there was no clear-cut business case for including equities in the single list. Equities were withdrawn from the tier two lists on 30 April 2005. A nominal amount of collateral of €124.3 billion was thus no longer available. However, equities were, in practice, hardly used as collateral in those countries where they were eligible on the tier two list.

Second, with a view to integrating tier two marketable debt instruments into the single list, the Eurosystem specified in more detail the criteria that markets must fulfil in order for assets traded on them to be used as collateral in Eurosystem operations.[9] The rationale for such eligibility criteria is not to assess the intrinsic quality of the various markets, but to select those markets that are easily accessible to the Eurosystem, to ensure that transactions are enforceable and that the price formation is transparent. For this the Eurosystem defined three "high-level" principles: safety, transparency and accessibility. While regulated markets[10] are deemed automatically eligible, the functioning of non-regulated markets is assessed against these principles (this assessment will be repeated at least annually). On 30 May 2005, the Eurosystem published the list of non-regulated markets which are acceptable for Eurosystem credit operations. Some OTC markets that are currently acceptable for tier two marketable assets are not included in this list.[11] Assets listed, quoted or traded on these markets will remain eligible until May 2007. In December 2005 the nominal amount of assets to be potentially phased out stood at €57.6 billion.

Third, the specific restrictions imposed on debt instruments issued by credit institutions – which, unlike covered bonds, are not backed by collateral[12] – were simplified. Only the criterion requiring that these instruments are admitted to trading on a regulated market as defined in the Directive on markets in financial instruments was retained.

Fourth, in order to meet the increasing demand for collateral, the Eurosystem considered the possibility of accepting foreign marketable debt instruments. In particular, the extension of the place of establishment of the issuer to entities established in G10 countries which are not part of the EEA (i.e. the United States, Canada, Japan and Switzerland) allowed a significant amount of euro-denominated assets issued by non-EEA G10 issuers to be added. This extension, while implying minimal changes to the collateral framework, required some legal risks and operational complexities relating to the legal validity and enforceability of the collateral and to withholding tax reporting and other reporting obligations to be dealt with. In this context, an additional requirement was the

9 See the press release of 30 May 2005 – First step towards the introduction of the single list of collateral provided for in the revised version of the "General Documentation".
10 Regulated markets comply with the minimum common standards and supervisory regime laid down in the MiFID Directive (Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments).
11 See the press release of 10 May 2004 – Review of the Eurosystem's collateral framework: first step towards a single list.
12 Article 22(4) of the UCITS Directive (Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities) sets out the criteria for covered bank bonds. Debt instruments issued by credit institutions which comply strictly with these criteria are eligible in credit operations with the Eurosystem without further restrictions.

submission of a satisfactory legal assessment to the Eurosystem.

The first non-EEA G10 debt instruments were included in the ECB's list of eligible assets on 1 July 2005. So far approximately 460 new assets have been included with a total nominal amount outstanding of €142 billion. The Eurosystem is currently carrying out further legal analysis regarding a number of other issuers, including quasi-governmental issuers, and debt instruments. Once this analysis has been completed, other debt instruments may also be added to the list.

4.2 SECOND STEP TOWARDS A SINGLE LIST: INTRODUCING NON-MARKETABLE ASSETS

In August 2004 the Governing Council decided to include bank loans as an asset category in the single list. In the euro area, bank-based financing is still bigger than market-based financing. Bank loans therefore often remain the most important asset class on the balance sheets of banks. By accepting bank loans as collateral, the Eurosystem reinforces the principle of granting access to monetary policy and intraday credit operations to a broad range of counterparties. Bank loans have relatively low opportunity costs as collateral because they are rarely traded and counterparties have limited alternative uses for them. The availability of sufficient low opportunity cost collateral not only at the Eurosystem aggregate level but also at an individual bank level is relevant in particular for the smooth functioning of TARGET, the large-value payment system of the Eurosystem. Moreover, by increasing the liquidity of an entire asset class, such as bank loans, on the balance sheets of banks, the single list of collateral fosters the smooth functioning of the euro area financial system. This may also indirectly foster analogous developments in private transactions.

However, bank loans differ from marketable instruments in several important respects that create legal and operational challenges for the Eurosystem when accepting them as collateral. In particular:

- Bank loans encompass a range of diverse instruments tailored to the individual needs of borrowers. As a consequence, they lack standardisation and uniform documentation.

- Bank loans and often debtors are not usually rated by market agencies. Other credit risk sources may have to be used to assess the creditworthiness of debtors.

- The conditions of bank loans may prohibit sale to other parties, so it must be ensured that the loan documents permit assignment or participation.

- Secondary loan markets in Europe have been of limited significance thus far. As such, external price sources rarely exist for these assets.

- While systems of registration, deposit or book entry ensure the existence of marketable assets, there are no established safeguards to ensure the continued existence of a particular bank loan.

This has two-fold implications for the Eurosystem. First, there is a need to define specific eligibility criteria for bank loans to ensure that they comply with similar collateral standards to those for marketable debt instruments. Second, there is a need to develop operational procedures allowing the consistent assessment of credit risk and the safe transfer and mobilisation of bank loans.

In July 2005 the ECB published the specific eligibility criteria that will apply to bank loans from 1 January 2007 onwards.[13] The establishment of the debtor (or alternatively the guarantor) is restricted to a euro area member

13 See the press release of 22 July 2005 – Eurosystem collateral framework: inclusion of non-marketable assets in the single list.

country. The loan agreement must also be governed by the laws of a euro area member country. Moreover, the range of eligible debtors is restricted to non-financial corporations and public sector entities. In particular, interbank loans are excluded from eligibility so as to avoid potentially artificial increases in the collateral pool for counterparties. As regards the eligible loan types, undrawn credit lines, current account overdrafts and letters of credit are not eligible. As is the case for marketable debt instruments, bank loans where rights to the principal and/or the interest are subordinated to the rights of holders of other bank loans or debt instruments from the same issuer are also ineligible. Moreover, the Eurosystem decided to apply a minimum threshold to the outstanding amount of an individual bank loan. Due to the fact that the costs of assessing, evaluating and handling bank loans are higher than those for marketable debt instruments, there is a need to strike a balance between maximising the value of available bank loans and containing the costs. From 2007 to 2012 each NCB will apply a minimum size of its choice. However, as from 2012 a common minimum threshold of €500,000 will be introduced. Furthermore, the Eurosystem will consider applying harmonised fees for bank loans by 2012. In the meantime, each NCB may decide whether or not to apply fees to cover the costs of handling bank loans.

In addition to the eligibility requirements mentioned above, some further legal requirements are needed in order to ensure that the Eurosystem is able to establish a security interest in the collateral in the event of a counterparty default. Such requirements relate to the timing of the notification of the debtor about the mobilisation of the bank loans, to the banking secrecy issues concerning information about the debtors, and to the elimination of potential restrictions regarding the mobilisation and realisation of the loans. As there is no uniform EU-wide legal framework regarding bank loans and their use as collateral, these issues are not treated uniformly in the different national jurisdictions. As a result, the legal requirements and the way these requirements are met vary from country to country. The precise eligibility requirements will be set out in the ECB publication entitled "The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures" (henceforth referred to as the "General Documentation") to be updated in the autumn of 2006 and further specified in the respective national documentations. Exceptionally, specific clauses might be required in loan agreements between the counterparty and the debtor for the loans to be eligible as collateral. In addition to verifying the different eligibility requirements, specific procedures will be required to check the existence of such assets. The measures to carry out these checks are self-certification by counterparties and ad-hoc checks by NCBs and supervisors.[14]

Like any other eligible asset, bank loans must meet the Eurosystem's criterion of high credit standards. Since debtors of bank loans are often not rated by market agencies, there has been a need for the Eurosystem to base the credit risk assessment on a broader range of credit quality sources and to add evaluation procedures for non-marketable debt instruments to the existing procedures for marketable debt instruments. This has been one of the biggest challenges when accepting bank loans throughout the euro area. Box 2 describes the core principles and the set of techniques and rules establishing the Eurosystem credit assessment framework (ECAF), with a particular focus on the new component relating to bank loans. The amended ECAF will be implemented on 1 January 2007 when bank loans will become eligible throughout the euro area.

14 The Eurosystem, together with the European Commission, is currently exploring, as a long-term project, whether the legal framework regarding the mobilisation of bank loans as collateral, in particular for operations with the Eurosystem, could be harmonised at the EU level.

Box 2

PRINCIPLES AND KEY ASPECTS OF THE EUROSYSTEM CREDIT ASSESSMENT FRAMEWORK

The ECAF constitutes the procedures and rules which establish and control the Eurosystem's requirement of "high credit standards" for all eligible collateral. The acronym "ECAF" has been introduced recently in relation to the enlargement of the credit assessment framework to non-marketable debt instruments, but is understood to encompass the standards applicable to both marketable and non-marketable debt instruments. In the assessment of the credit standards of eligible collateral, the Eurosystem will take into account credit assessment information belonging to one of four sources: external credit assessment institutions (ECAIs), counterparties' internal ratings-based (IRB) systems, third-party providers' rating tools (RTs) and NCBs' in-house credit assessment systems (ICASs).

The Eurosystem's appetite for credit risk is defined in terms of a "single A" long-term credit rating.[1] This has been translated into an annual probability of default (PD) value of 0.10%. This is the central measure for the ECAF to establish the Eurosystem's high credit standards.

Credit assessment sources and performance monitoring

In order to ensure the consistency, accuracy and comparability of the four sets of credit assessment sources used in the ECAF, the Eurosystem has devised eligibility criteria for each of the four sources and will regularly monitor their credit assessment performance against the credit quality threshold.

As regards the eligibility criteria, in the case of ECAIs and IRB systems, the ECAF builds upon the Basel II Framework and the Capital Requirements Directive. According to this Framework, the ECAIs and the IRB systems are subject to a formal recognition and validation process by the national supervisors. A sufficient condition for eligibility in the ECAF is the recognition of the ECAI or IRB system by the relevant supervisor. An RT is a third-party application that assesses the credit quality of debtors by using, among other things, audited accounts. RTs will have to be individually accepted by the Eurosystem in order to form part of the ECAF. The acceptance process will comprise components of the recognition process for ECAIs and IRB systems according to the Capital Requirements Directive. The tools themselves will be operated by the RT providers. Eligible ICASs are currently operated by the Deutsche Bundesbank, the Banco de España, the Banque de France and the Oesterreichische Nationalbank. NCBs deciding to set up a new ICAS would be subject to a Eurosystem validation procedure.

The performance of the different credit assessment systems will be measured annually against the benchmark PD of the credit quality threshold. In the case of a significant deviation between the observed default rate of the set of all eligible companies of a system and the benchmark PD, the Eurosystem may ultimately apply a correction to the eligibility threshold for the credit assessments provided by the non-compliant system.

1 A long-term A- rating according to S&P and Fitch and an A3 rating according to Moody's.

Procedures for establishing high credit standards

In the assessment of the credit standard of marketable debt instruments, the Eurosystem takes into account, inter alia, available ratings by ECAIs, guarantees provided by financially sound guarantors and certain institutional criteria.

As regards the establishment of the high credit standards of its loans debtors, a counterparty can freely select one source from those that are eligible (ECAI, IRB, RT or ICAS). It will use that source as the principal tool for assessing debtors/guarantors of the non-marketable debt instruments to be submitted as collateral. It will then have to remain with this source for a period of at least one year. However, upon submission of a reasoned request, counterparties will be allowed to use more than one credit assessment source, namely in cases of insufficient coverage or other special circumstances requiring flexibility.

In the case of non-rated marketable debt instruments for which the Eurosystem's requirement for high credit standards cannot be assessed by ratings by ECAIs, a valid guarantee of a financially sound guarantor or certain institutional criteria, counterparties may select a credit assessment source in the same way as described above for non-marketable debt instruments.

Public sector entities

For public sector entities (PSEs) that are not rated by the credit assessment sources above, the Eurosystem has developed generic rules consistent with the treatment of PSEs under the new Basel II Framework to determine the conditions under which these would meet the Eurosystem's high credit standards.

Disclosure framework

In the case of marketable debt instruments, the current practice will be continued and a list of eligible assets published on the ECB's website. Debt instruments issued or guaranteed by PSEs will also be included in this list. However, in the case of non-marketable debt instruments, the list of debtors/guarantors eligible for an individual counterparty will remain strictly confidential. Non-rated marketable debt instruments from private issuers will also not be published on the ECB's website, as their creditworthiness assessment will rely on the ICAS, IRB or RT sources, as in the case of non-marketable debt instruments.

Further information on the rules and procedures of the ECAF will be made available in due course through communications and a revised version of the "General Documentation".

Since bank loans cannot be settled via the established market infrastructure used for marketable debt instruments, the Eurosystem also needs to set up procedures for using them, on both a domestic and cross-border basis. During the intermediate period, the handling of bank loans will make use of national procedures for domestic use of collateral, and resort to the CCBM for cross-border settlement. During this transitional phase, the procedures for the handling of bank loans will be re-examined in the light of the experience gained until then and more advanced solutions will be studied and possibly implemented.

Another category of non-marketable assets that the Governing Council decided to accept in principle in the single list are retail mortgage-backed debt instruments that stop short of fully-fledged securitisation. This asset category will initially include only Irish mortgage-backed promissory notes. This is due to the specific legal regime for such assets in Ireland, which cannot easily be replicated in other euro area countries. However, a large part of the euro area residential mortgage loans are already indirectly eligible as collateral in a securitised form, either as mortgage-backed securities or as covered bonds.

5 CHALLENGES AHEAD FOR THE COLLATERAL FRAMEWORK OF THE EUROSYSTEM

The acceptance of diverse asset categories also poses a number of challenges in terms of the design and maintenance of the collateral framework.

With respect to the design of the framework, it is no longer possible to apply a uniform set of eligibility criteria. Eligibility criteria are tailored to individual asset categories to ensure that distinct asset classes comply with the same collateral standards. This also applies to risk control measures. To level out differences in the risk profile, there is a need to differentiate risk control measures across asset classes. If this is done successfully, a uniform level of risk across asset classes is going to be achieved after the application of risk control measures. In the case of the Eurosystem, two sets of eligibility criteria and risk control measures broadly apply, one relating to marketable assets and the other to non-marketable assets. Operational and, specifically, handling procedures also differ. Given this, it will be a challenge to keep the collateral framework transparent for counterparties.

On the maintenance side, two issues broadly arise. First, the eligibility criteria for marketable debt instruments have been kept rather general. As a result, the collateral framework is responsive to financial market innovations. Thus, there is a constant need for the Eurosystem to refine its collateral policy to ensure that new collateral also continues to meet the Eurosystem's risk tolerance level. Keeping track of market developments in European fixed-income markets is clearly a challenge for the Eurosystem, since markets are undergoing rapid structural changes and products are tending to become ever more complex. A recent example has been the rapid developments in markets for structured finance and asset-backed securities. As a consequence the Eurosystem had to refine its collateral policy and in May 2006 new criteria will come into effect to assess the eligibility of asset-backed securities in addition to the criteria applicable to debt instruments in general. Asset-backed securities which were previously eligible but do not fulfil the new criteria will remain eligible for a transitional period until 15 October 2006.[15]

Second, as indicated above, the acceptance of heterogeneous asset classes poses challenges for the risk control framework. There is a trade-off between simplicity and accuracy. Hence, there is a need to monitor the actual use of collateral in order to determine whether an adjustment of the risk control framework may be necessary. For example, the disproportionate use of certain asset categories may indicate inconsistencies that need to be rectified in order to avoid an undue build-up of risks.

Against this background, the introduction of the single list is an important milestone, but the Eurosystem will continue to review and refine its collateral framework in the coming years.

15 See the press release of 13 January 2006 – Amendments to "The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures" relating to asset-backed securities.