REPORT ON ESTABLISHMENT OF A SECONDARY MARKET FOR BANK LOANS
(annotated outline)

INTRODUCTION

Rationale: Potential to increase the collateral pools (use in bilateral trades, triparty, for CCP collateralisation, etc.)

I. Relevant definitions

- What is the overall definition of a **credit claim**?

According to the new Financial Collateral Directive (FCD) definition in Art. 1(o), "credit claims' means pecuniary claims arising out of an agreement whereby a credit institution, as defined in Article 4(1) of Directive 2006/48/EC, including the institutions listed in Article 2 of that Directive, grants credit in the form of a loan". Chapter 6.2.2 of the General documentation on Eurosystem monetary policy instruments and procedures" defines credit claims for Eurosystem collateralisation purpose as "debt obligation of a debtor vis-à-vis a Eurosystem counterparty".

- What is the exact definition of an **eligible credit claim**? What are the minimum requirements for eligible credit claims for cross-border collateral with CCBM2?

The "General documentation on Eurosystem monetary policy instruments and procedures" intentionally does not provide an abstract definition of credit claims in order not to restrict the possibility of using new type of claims that could emerge over time in the banking business. This document rather states the eligibility criteria that a claim of a debtor vis-à-vis a Eurosystem counterparty should comply with in order to be used as collateral in Eurosystem credit operations. The first of these eligibility criteria simply makes reference to "debt obligations" and excluding un-drawn credit lines (e.g. un-drawn facilities of revolving credit claims), current overdraft and letters of credit from the category of credit claims - while, clarifies that credit claims that have a "reducing balance" are eligible, as well as certain syndicated loans. The other criteria rule the eligibility of debtor/guarantor (type, establishment, credit standards) and the minimum size, currency denomination and governing laws of the claim and the handling procedures. Furthermore, additional legal requirement are to be complied with, e.g. relating to verification, notification, credit secrecy and confidentiality, realisation. These depend on the respective legal framework of Member States.

As for any other asset, any eligible credit claims must be usable in a cross-border context through the euro area. No other eligibility criteria apply except for a limitation of the number of applicable laws and the minimum size that is 500,000 € for cross-border use, a threshold that will apply for domestic use as from 1 January 2012 (currently different threshold are applied). The Eurosystem has implemented a variant to the CCBM in order to cope with the cross-border use of credit claims. These criteria will not be affected by the introduction of CCBM2.

The definition of eligible credit claims for the secondary market should be broader than that adopted for Eurosystem collateral purposes. In particular, it should be considered to what extent UK (syndicated) loans can be included. How broader the eligibility will be depends on the risk appetite from the cash lender (i.e. counterparties willing to take on additional risk.)

- Will only **tradable** credit claims be eligible? If so, what does "tradable" mean? What will happen with the contractual agreement between the debtor and the credit institute?

Tradable means the legal documentation needs to cover/permit the transfer or pledge of the loan.

- Are the requirements in the future identical for **local and cross-border use of credit claims** as collateral?

CCBM2, via its credit claim module, will provide a common technical procedure for mobilising credit claims with the Eurosystem, although national legal requirements may still apply. Nevertheless, NCBs may decide not to opt for this module and maintain national procedures.

- What is the **definition of secondary market?** And who will be the **eligible market players and investors**?

The **definition of the secondary market** is provided in the Financial Collateral Directive (wholesale markets only). Initially only supervised credit institutions will be eligible, but it is not excluded that after a while other wholesale market participants would be interested in accepting this type of collateral as the need for collateralisation will increase in the future.

- What will be the **regulatory and compliance framework**?

The revised FCD provides the regulatory and compliance framework for central banks and banks. It could be expected that dealing with credit claims will be subject to the same (or similar) regulatory requirements as other products i.e. CEBS for the banks, and for infrastructure central banks and CESR. This may require some additional qualification of the existing requirements (e.g. checks on the existence of claims that are in the books of a bank)

II. REQUIREMENTS FOR ESTABLISHING THE SECONDARY MARKET

Identification of the loans

Credit claims need to be standardised so that each credit claim will be unique and recognised with a unique identification. An **identifier** (with no undue charge) at European level will allow each credit claim to be unique and recognisable. A common identifier may be preferable, but without the current pricing escalation.

The"**Issuer" CSD function** i.e. minimum activities that will make the asset "transferable" (record-keeping function) needs to be ensured. This implies the need for a full harmonised notation systems update as much as possible on a daily basis as already done through Eurosystem credit assessment framework (ICAS for instance but also IRB or RT to avoid notation costs).The work on the data base between both ICSDs (still no other CDS came forward) will largely harmonise the way loans will be presented. The evaluation of the loans will most likely be a little all over the place but as soon as we can streamline this process which will come through the legal documentation the better for the project. This function can be decentralised provided that there will be only one CSD per loan and that a single settlement platform (e.g. T2-S) is used and

and/or

Database (or easily accessible list or "basket" of eligible assets) in case of more centralised solutions - if more than one reference source, need to ensure that no double entry of claims is possible. The common database should be comparable with the ISIN database for securities. ICSDs are working on that.

2. **Standardised SWIFT messages** (under review as discussed between CCBM2 team and SWIFT).

3. **Legal framework and legal documentation**

- What legislation will govern a cross-border pledge/assignment of credit claims?

The new Rome Regulation (EC) No 593 of 17 June 2008 on the law applicable to contractual obligations (Rome I) addresses this matter in its Art. 14: "**Voluntary assignment and contractual subrogation. In brief:**

1. The relationship between assignor and assignee under a voluntary assignment or contractual subrogation of a claim against another person (the debtor) shall be governed by the law that applies to the contract between the assignor and assignee under this Regulation.
2. The law governing the assigned or subrogated claim shall determine its assignability, the relationship between the assignee and the debtor, the conditions under which the assignment or subrogation can be invoked against the debtor and whether the debtor's obligations have been discharged.
3. The concept of assignment in this Article includes outright transfers of claims, transfers of claims by way of security and pledges or other security rights over claims."

It does however <u>not</u> address the issues of third party effectiveness.

a. Is there a need for **harmonisation of the legal documentation**?

Yes. Harmonisation of legal documentation - for repo and securities lending (Eurosystem for pledge) is crucial.

Protection under revised Collateral Directive ensures some harmonisation. It abolishes any formality for the creation, validity, perfection, priority, enforceability or admissibility in evidence of collateral over credit claims. However, Member States may require the performance of a formal act, such as registration or notification, for purposes of perfection, priority, enforceability or admissibility in evidence against the debtor and/or third parties.

The legal framework is under discussions by the industry (ICMA/LMA/ possible EBF). Issues to be addressed: waiver of objections, confidentiality and banking secrecy, permission of use of claim as collateral, etc.

Moreover the following issues will need to be addressed:

a. What is the difference between a pledge and an assignment? What is the impact on the initial contract between debtor and credit institute? What is the difference if collateral has to be replaced?

b. How should the reuse of collateralised credit claims function? What is the difference in the reuse of collateral between fungible securities and not fungible credit claims? How long can a chain be without any possible disturbance?

Clearly this is a second step. If transfer of collateral is possible between 2 parties, re-use is just a variation on this.

c. What are the problems regarding the provision of equivalent collateral? What does it mean equivalent collateral?

d. Is there a risk that trading and reuse of credit claims could result in similar problems like the securitization and repackaging of mortgage backed securities (subprime crisis)? What is the difference?

No, that is not the same. With re-use the same basic product remains i.e. if you have a particular security, that security will remain as a single recognisable item. In other words, re-use is different from re-packaging.

4. Evaluation criteria (who will evaluate loans)

Under the assumptions that the secondary market will handle a larger number of credit claims than those accepted by the Eurosystem as collateral for its own operations, it will important to clarify:

- Which valuation/Pricing: methods, mechanisms? What are the haircuts? Euro and non-Euro currencies? How many currencies? Will there be a pooling solution including credit claims? Allowable baskets and "packaging" definitions? Credit ratings, credit rating Agencies, etc. – methods?

Many of the questions above will be settle between two parties, that can be central bank or other commercial entity. It depends on each participant risk appetite what will be eligible, haircuts, currency nomination, potentially pooling like baskets.

5. The infrastructure(s) for credit claim

Although credit claims are not considered securities the technical (not legal) infrastructure built around it will look much alike.

- Use of electronic trading platforms: When credit claims become “ISIN CODE” like, and in particular as volume is high enough to allow, electronic trading will be possible (provided the legal framework is permissible).
- Use of automated matching and confirmation facilities: With Swifts involvement this seems possible and even necessary if we have electronic trading in mind at a later stage.
- Interface with CCBM2: It would make life easier if the interface with CCBM2 would be standard to what will be developed in the market. It would also provide more robust resilence as market participants would easily transfer credit claims from the bilateral area to the central bank area and the reverse.
- Settlement platform(s): In case of more than one platform they should be fully interoperable

III. WORK IN PROGRESS AND FACILITIES AVAILABLE

Work in progress

- Correspondent with ANNA
- SWIFT messages (incl. CCBM2 messages)
- Work of EBF and ICMA legal groups
- ICSD work on common database

Facilities available

- Euroclear facility
- T2-S settlement platform
- Automated trading platforms?
- Others?

Further longer term releases

- Accounting structure for credit claims?
- Others?