



EUROPEAN CENTRAL BANK

11 June 2003

## PUBLIC CONSULTATION

### MEASURES TO IMPROVE THE COLLATERAL FRAMEWORK OF THE EUROSYSYTEM

#### 1 INTRODUCTION

The “Treaty”<sup>1</sup> and the “Statute”<sup>2</sup> require that the Eurosystem acts in accordance with the principle of an open market economy with free competition. In addition, Article 18.1 of the Statute establishes that Eurosystem credit operations have to be based on adequate collateral. In the current collateral framework, eligible assets are divided into two tiers. Tier one (the bulk of eligible assets) consists of marketable debt instruments fulfilling euro area-wide eligibility criteria. Tier two consists of a wider variety of asset types, ranging from marketable debt instruments to equities and bank loans, fulfilling the national eligibility criteria established by the national central banks (NCBs), subject to the minimum eligibility criteria established by the ECB. Tier two assets were included in the list of eligible collateral because of their importance for national financial systems at the start of Stage Three of Economic and Monetary Union (EMU). To ensure an equal treatment of Eurosystem counterparties and to avoid segmentation of collateral across countries, the Eurosystem ensures the possibility for counterparties to use collateral cross-border for all eligible assets and across the entire euro area.

It appears that, during the more than four years of Monetary Union, a large amount of collateral has been available to counterparties, encompassing a wide range of assets for collateralising Eurosystem credit operations, both for monetary policy and payment purposes.

However, the Eurosystem recognises that the heterogeneity of the assets included in the tier two lists of different euro area countries may not ensure a level playing field for counterparties and may somewhat decrease the transparency of the collateral framework. The Eurosystem is investigating whether and how this heterogeneity could be reduced, and under what conditions the two tiers of assets could be merged in order to obtain a single list. The Governing Council of the ECB, before taking

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<sup>1</sup> The “Treaty” to which reference is made is the “Treaty establishing the European Community” (Official Journal of the European Communities (2002/C 325/01)).

<sup>2</sup> The reference is to the “Statute of the European System of Central Banks and of the European Central Bank”, being Protocol No. 18 to the Treaty.

the decision which it deems most appropriate, is interested in collecting market participants' views on possible changes to the Eurosystem's collateral framework.

The basic idea put forward for the comments of market participants is to gradually move from a two tier collateral framework to a single list. The assets already accepted as collateral by the Eurosystem under tier one would be part of the single list.<sup>3</sup> The sections below review the main categories of currently eligible tier two assets with a view to their potential inclusion into the single list. In addition, a new category of assets being investigated for inclusion is mentioned, namely debt instruments issued in euro by issuers established in the non-EEA G10 countries. The text includes a number of questions, the answers to which would be of interest to the Eurosystem in revising its collateral framework policy.

The implementation of a revision of the collateral policy of the Eurosystem is expected to require the adaptation of operational systems and procedures, both for Eurosystem central banks and for counterparties. In addition, the potential introduction of some categories of assets will require legislative adaptation in some countries. For these reasons, the revision of the collateral framework, if and when decided, will require a gradual implementation over a number of years.

1. Do counterparties feel that it would be useful to move from the present two tier situation to a single list of collateral?
2. Should the single list encompass more collateral than the current tier one? Is the availability of collateral expected to increase or decrease in the future? What is the counterparties' view on the possibility of additional categories of eligible assets being available?

## 2 MAIN CATEGORIES OF ASSETS PRESENTLY IN TIER TWO TO BE CONSIDERED FOR INCLUSION INTO THE SINGLE LIST

### 2.1 Non-marketable assets (bank loans)

Currently, non-marketable assets (including bank loans) are eligible in six countries.<sup>4</sup> The Eurosystem is considering whether to make such non-marketable assets eligible throughout the euro area.

The main advantages of making non-marketable assets more widely eligible are that bank loans potentially provide the greatest increase in the amount of eligible assets for Eurosystem counterparties, are widely distributed across the banking sector, and counterparties can mobilise them at a comparatively low opportunity cost for Eurosystem credit operations.

However, making non-marketable assets generally eligible requires that specific solutions be investigated as regards the credit risk assessment of bank loan debtors, when a rating is not available; in particular,

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<sup>3</sup> Annex I (taken from the ECB publication entitled "The single monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures" – April 2002) describes these eligibility criteria in detail.

<sup>4</sup> These include pure bank loans in Spain, France, Germany and Austria, as well as private claims in the Netherlands and mortgage backed promissory notes in Ireland.

different alternatives need to be examined, such as accepting the credit score (or rating) coming from an Internal Ratings Based (IRB) Approach<sup>5</sup> or, as regards central banks, an in-house assessment or outsourcing the task of credit assessment. In addition, the use of non-marketable assets may entail substantial additional costs, on account of the need to develop and run the infrastructure to handle them – in many countries such an infrastructure does not at present exist. Such costs could only be justified if counterparties showed a significant interest in this particular type of collateral. Finally, from a legal point of view making non-marketable assets eligible requires the adaptation of national legislation in some countries.

In order to possibly extend the eligibility of bank loans to the entire euro area, some elements of harmonisation would need to be decided upon, including the minimum size for assets to be considered eligible, the range of their maturities and the eligible categories of debtors. In addition, the possible imposition of a fee, which would offset (at least in part) the costs for the Eurosystem of assessing eligible debtors, will have to be examined.

3. **Would counterparties have a general interest in using bank loans as collateral, in particular in those countries where they are not currently eligible?**
4. **Would counterparties located in those countries in which these assets are currently eligible expect any substantial disadvantage, either now or in the future, if these assets were removed from the list of eligible assets? What, in your view, would constitute an appropriate length of time for phasing out these assets?**
5. **Would counterparties be ready to offset, at least in part, the costs to the Eurosystem by paying a fee for the bank loans to be eligible within the Eurosystem as a whole? What would you consider a reasonable basis to be for such a fee?**
6. **Do counterparties have in place or are they planning to have, in the near future, IRB credit assessment systems with which they could also rate bank loans? Would they be ready to share information on their internal score or rating with the central banks of the Eurosystem? Would they want to see restrictions applied to the use of this information?**
7. **What would constitute an appropriate minimum size for individual bank loans to be accepted as collateral? From the counterparties' perspective, what maximum/minimum maturities should be chosen? What would the reasons for such preferences be?**

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<sup>5</sup> The IRB Approach is defined in the "Basel II: The New Basel Capital Accord" – the relevant documents are available at [www.bis.org](http://www.bis.org).

## 2.2 Equities

Equities are eligible as tier two assets in three euro area countries.<sup>6</sup> Extending the acceptance of equities throughout the euro area could support the smooth functioning of central counterparties' clearing houses and, in some euro area countries, a safer settlement of equities transactions. Equities have to comply with very stringent eligibility requirements such as being listed/traded on liquid, regulated markets with easily accessible prices. For this reason, only the most liquid and most secure equities are currently eligible. In the light of their legal nature as an ownership right in a company, equities possess legal and operational peculiarities that make their use by the Eurosystem more complex than debt instruments. The acceptance of equities would add a relatively small volume of collateral to the present tier one list. Depending on the collateralisation technique used, some operational aspects (ownership reporting rules, voting rights, etc) may be potentially more complex to handle than in the case of other assets. In addition, if the eligibility of equities were maintained and generalised, it can be assumed that some types of subordinated debt instruments would also be made eligible.

8. **Would counterparties have a general interest in the use of equities as collateral, in particular in those countries where they are not currently eligible?**
9. **Would counterparties located in those countries in which these assets are currently eligible expect any substantial disadvantage either now or in the future if these assets were removed from the list of eligible assets? What would be the length of time required for phasing out these assets?**

## 2.3 Other tier two marketable assets

Some additional categories of marketable assets currently in tier two and not mentioned in the previous sections are also being reviewed for eligibility in a single list. Such marketable tier two assets include:

- a) assets that do not fulfil the criterion currently applied to tier one assets of being listed or quoted on a regulated market according to the Investment Services Directive, or of being listed, quoted or traded on certain unregulated markets as specified by the ECB;<sup>7</sup>
- b) uncovered debt instruments issued by credit institutions and which do not fulfil more stringent eligibility criteria applied to similar instruments in tier one;<sup>8</sup>
- c) marketable tier two assets that do not fulfil the criterion currently applied to tier one assets of being rated by international rating agencies.<sup>9</sup>

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<sup>6</sup> They are eligible in Spain, the Netherlands and Portugal.

<sup>7</sup> Such assets can be found in virtually all the euro area countries: a list of all the national categories of assets is beyond the scope of this Consultation.

<sup>8</sup> For example, certificates of deposit (CDs) issued in Finland; CDs and bonds issued in the Netherlands; bonds issued in Italy.

<sup>9</sup> For example, some commercial paper and bonds issued by the public and private sector in Germany, Spain, France and Austria.

Specific eligibility criteria will have to be fulfilled by some of those assets.

- 10 Would counterparties have a general interest in the use of other tier two marketable assets as collateral?

### **3 NEW ASSETS FOR THE SINGLE LIST: FOREIGN DEBT INSTRUMENTS**

So far, the Eurosystem accepts in its tier one list of assets debt instruments: 1) denominated in euro; 2) issued in the EEA by borrowers established in the EEA; and 3) settled in the euro area. The Eurosystem is investigating the possibility of extending its collateral framework to debt instruments whose issuers are based in non-EEA G10 countries (i.e. Canada, Japan, the United States and Switzerland). However, the currency criterion and the location criteria would not change.

- 11 Would counterparties have a general interest in the use, as collateral, of debt instruments issued in euro by issuers established in the non-EEA G10 countries and located in the euro area?

### **4 SOME ADDITIONAL QUESTIONS OF A GENERAL NATURE**

12. Which order of priority do counterparties attach to the different categories of assets described in the previous sections?
13. Do counterparties wish to mention any other type of asset, the eligibility of which might be of relevance for them?
14. Are the existing procedures for disseminating information on the eligible assets considered satisfactory?

### **5 PROCEDURAL MATTERS**

All potentially affected market participants, especially Eurosystem counterparties, are invited to express their views on the ideas and questions presented in this public consultation. Credit institutions may coordinate their replies through their respective national and/or European banking associations, if they deem this more appropriate than commenting individually. As a general rule, the individual comments received will not be published. Instead, a summary of the replies received will be made public. This summary will not mention the sources of the replies.

Replies can be sent in English or in the relevant official EU language either to the ECB at the following address:

*European Central Bank*

*Secretariat Division*

*Kaiserstrasse 29*

*D-60311 Frankfurt am Main*

*Germany*

*Fax: +49-69-1344 6170*

*Email: ecb.secretariat@ecb.int*

- or to the respective NCB of the Eurosystem.

The deadline for contributions is: 15 September 2003

## **Bibliography**

Further information on the collateral framework of the Eurosystem may be found in the following publications which are available on the ECB's website:

*European Central Bank (2002): "The single monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures", April 2002*

*European Central Bank (2001): Monthly Bulletin article entitled "The collateral framework of the Eurosystem", April 2001*

*European Central Bank (2000): "Conference on the operational framework of the Eurosystem", May 2000*

ANNEX I. EXTRACT FROM THE ECB PUBLICATION “THE SINGLE MONETARY POLICY IN THE EURO AREA: GENERAL DOCUMENTATION ON EUROSISTEM MONETARY POLICY INSTRUMENTS AND PROCEDURES” DATED APRIL 2002

## 6.2 Tier one assets

The ECB establishes and maintains a list of tier one assets. This list is available to the public.<sup>10</sup>

Debt certificates issued by the ECB are listed as tier one assets. Debt certificates issued by the national central banks prior to the adoption of the euro in their respective Member State are also included in the tier one list.

The following eligibility criteria are applied to other tier one assets (see also Table 4):

- They must be debt instruments having: (a) a predefined principal amount; and (b) a coupon that cannot result in a negative cash flow. In addition, the coupon should be one of the following: (i) a zero coupon; (ii) a fixed rate coupon; or (iii) a floating rate coupon linked to an interest rate reference. The coupon may be linked to a change in the rating of the issuer itself. Furthermore, inflation-indexed bonds are eligible. These features must be maintained until the redemption of the obligation.<sup>11</sup>
- They must meet high credit standards. In the assessment of the credit standard of debt instruments, the ECB takes into account, inter alia, available ratings by market agencies, guarantees<sup>12</sup> provided by financially sound guarantors<sup>13</sup>, as well as certain institutional criteria which would ensure particularly high protection of the instrument holders.<sup>14</sup>
- They must be transferable in book-entry form.

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<sup>10</sup> This list is published and updated daily on the ECB's website ([www.ecb.int](http://www.ecb.int)).

<sup>11</sup> Debt instruments affording rights to the principal and/or the interest that are subordinated to the rights of holders of other debt instruments of the same issuer (or, within a structured issue, subordinated to other tranches of the same issue) are excluded from tier one.

<sup>12</sup> Eligible guarantees must be unconditional and callable upon first demand. They must be effective under the law governing the guarantee and enforceable under the law of a euro area country.

<sup>13</sup> Guarantors must be established in the EEA.

<sup>14</sup> Debt instruments issued by credit institutions which do not comply strictly with the criteria set out in Article 22 (4) of the UCITS Directive (Directive 88/220/EEC amending Directive 85/611/EEC) are accepted in tier one only if each issue as such is awarded a rating (by a rating agency) which indicates, in the view of the Eurosystem, that the debt instrument meets high credit standards. The eligibility of debt instruments issued under an issuance programme is assessed on the basis of an individual rating for each particular issue within that programme.

- They must be deposited/registered (issued) in the EEA with a central bank or with a central securities depository (CSD) which fulfils the minimum standards established by the ECB. They must be held (settled) in the euro area through an account with the Eurosystem or with an SSS which fulfils the standards established by the ECB (so that perfection and realisation are subject to the law of a euro area country). If the CSD where the asset is issued and the SSS where it is held are not identical, then the two institutions have to be connected by a link approved by the ECB.<sup>15</sup>
- They must be denominated in euro.<sup>16</sup>
- They must be issued (or, alternatively, guaranteed) by entities established in the EEA.<sup>17</sup>
- They must be listed or quoted on a regulated market as defined in the Investment Services Directive,<sup>18</sup> or listed, quoted or traded on certain non-regulated markets as specified by the ECB.<sup>19</sup> Furthermore, market liquidity may be taken into account by the ECB when determining the eligibility of individual debt instruments.

In spite of their inclusion in the tier one list, a counterparty shall not submit as underlying assets debt instruments issued or guaranteed by the counterparty, or by any other entity with which the counterparty has close links,<sup>20</sup> as defined in Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions.<sup>21, 22</sup>

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<sup>15</sup> The description of the standards for the use of eligible SSSs in the euro area and an updated list of the eligible links between these systems can be found on the ECB's website ([www.ecb.int](http://www.ecb.int)).

<sup>16</sup> Expressed as such or in the national denominations of the euro.

<sup>17</sup> The requirement that the issuing entity be established in the EEA does not apply to international and supranational institutions.

<sup>18</sup> Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ L 141 of 11 June 1993, pages 27 ff.

<sup>19</sup> Debt instruments issued by credit institutions which do not comply strictly with the criteria set out in Article 22 (4) of the UCITS Directive (Directive 88/220/EEC amending Directive 85/611/EEC) are accepted in tier one only if they are listed or quoted on a regulated market as defined in the Investment Services Directive (Directive 93/22/EEC) and comply with the requirements of the Prospectus Directive (Directive 89/298/EEC).

<sup>20</sup> In the event that a counterparty is using assets that, owing to an identity with the issuer/guarantor or the existence of close links, it may not or no longer use to secure an outstanding credit, it is obliged to immediately notify the relevant national central bank thereof. The assets are valued at zero at the next valuation date and a margin call may be triggered (see Annex 6).

<sup>21</sup> Article 1 (26) of Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L 126 of 26 May 2000, pages 1 ff., reads as follows:

“Close links shall mean a situation in which two or more natural or legal persons are linked by:

- (a) participation, which shall mean the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking, or
- (b) control, which shall mean the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 1 (1) and (2) of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking; any subsidiary undertaking of a subsidiary undertaking shall also be considered a subsidiary of the parent undertaking which is at the head of those undertakings.

A situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship shall also be regarded as constituting a close link between such persons.”



In spite of their inclusion in the tier one list, national central banks may decide not to accept the following instruments as underlying assets:

- debt instruments falling due for repayment before the maturity date of the monetary policy operation for which they are being used as underlying assets;<sup>23</sup> and
- debt instruments with an income flow (e.g. a coupon payment) occurring in the period until the maturity date of the monetary policy operation for which they are being used as underlying assets.

All tier one assets may be used in a cross-border context, implying that a counterparty can receive credit from the national central bank of the Member State in which the counterparty is established by making use of tier one instruments located in another Member State (see Section 6.6).

Tier one assets are eligible for all monetary policy operations which are based on underlying assets, i.e. reverse and outright open market transactions and the marginal lending facility.

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<sup>22</sup> This provision does not apply to: (i) close links between the counterparty and the public authorities of EEA countries; (ii) trade bills, for which at least one entity (other than a credit institution) is liable in addition to the counterparty; (iii) debt instruments which comply strictly with the criteria set out in Article 22 (4) of the UCITS Directive (Directive 88/220/EEC amending Directive 85/611/EEC); or (iv) cases in which debt instruments are protected by specific legal safeguards comparable with (iii).

<sup>23</sup> If the national central banks were to allow the use of instruments with a maturity shorter than the monetary policy operations for which they serve as underlying assets, counterparties would be required to replace such assets at, or prior to, maturity.

Table 4. Eligible assets for Eurosystem monetary policy operations

Criteria	Tier one	Tier two
<b>Type of asset</b>	<ul style="list-style-type: none"> <li>• ECB debt certificates;</li> <li>• Other marketable debt instruments.<sup>1), 2)</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Marketable debt instruments;<sup>1)</sup></li> <li>• Non-marketable debt instruments;<sup>1)</sup></li> <li>• Equities traded on a regulated market.</li> </ul>
<b>Settlement procedures</b>	<ul style="list-style-type: none"> <li>• Instruments must be centrally deposited in book-entry form with national central banks or an SSS fulfilling the ECB's minimum standards.</li> </ul>	<ul style="list-style-type: none"> <li>• Assets must be easily accessible to the national central bank which has included them in its tier two list.</li> </ul>
<b>Type of issuer</b>	<ul style="list-style-type: none"> <li>• Central banks;</li> <li>• Public sector;</li> <li>• Private sector;<sup>3)</sup></li> <li>• International and supranational institutions.</li> </ul>	<ul style="list-style-type: none"> <li>• Public sector;</li> <li>• Private sector.<sup>4)</sup></li> </ul>
<b>Credit standard</b>	<ul style="list-style-type: none"> <li>• The asset must be deemed of high credit quality by the ECB (which could include a guarantee of an EEA guarantor which is deemed financially sound by the ECB).</li> </ul>	<ul style="list-style-type: none"> <li>• The asset must be deemed of high credit quality by the national central bank which has included it in its tier two list (which could include a guarantee of a euro area guarantor which is deemed financially sound by the national central bank which has included the asset in its tier two list).</li> </ul>
<b>Place of establishment of the issuer (or alternatively the guarantor)</b>	<ul style="list-style-type: none"> <li>• EEA.<sup>5)</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Euro area.</li> </ul>
<b>Location of asset</b>	<ul style="list-style-type: none"> <li>• Place of issue: EEA;</li> <li>• Place of settlement: euro area.<sup>6)</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Euro area.<sup>6)</sup></li> </ul>
<b>Currency</b>	<ul style="list-style-type: none"> <li>• Euro.<sup>7)</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Euro.<sup>7)</sup></li> </ul>
<i>Memorandum item:</i> <b>Cross-border use</b>	<ul style="list-style-type: none"> <li>• Yes.</li> </ul>	<ul style="list-style-type: none"> <li>• Yes.</li> </ul>

1) They must have both: (a) a predefined principal amount; and (b) a coupon that cannot result in a negative cash flow. In addition, the coupon should be one of the following: (i) a zero coupon; (ii) a fixed rate coupon; or (iii) a floating rate coupon linked to an interest rate reference. The coupon may be linked to a change in the rating of the issuer itself. Furthermore, inflation-indexed bonds are eligible. These features must be maintained until the redemption of the obligation.

2) Debt instruments affording rights to the principal and/or the interest that are subordinated to the rights of holders of other debt instruments of the same issuer (or, within a structured issue, subordinated to other tranches of the same issue) are excluded from tier one.

3) Debt instruments issued by credit institutions which do not comply strictly with the criteria set out in Article 22 (4) of the UCITS Directive (Directive 88/220/EEC amending Directive 85/611/EEC) are accepted in tier one only under the following three conditions. First, each issue needs to be awarded a rating (by a rating agency) which indicates, in the view of the Eurosystem, that the debt instrument meets high credit standards. The eligibility of debt instruments issued under an issuance programme is assessed on the basis of an individual rating for each particular issue within that programme. Second, the debt instruments need to be listed or quoted on a regulated market as defined in the Investment Services Directive (Directive 93/22/EEC). Third, the debt instruments need to comply with the requirements of the Prospectus Directive (Directive 89/298/EEC).

4) Equities issued by credit institutions and debt instruments issued by credit institutions which do not comply strictly with the criteria set out in Article 22 (4) of the UCITS Directive are normally not eligible for inclusion in tier two lists. However, the ECB may authorise national central banks to include such assets in their tier two lists subject to certain conditions and restrictions.

5) The requirement that the issuing entity be established in the EEA does not apply to international and supranational institutions.

6) So that perfection and realisation are subject to the law of a Member State of the euro area.

7) Expressed as such or in the national denominations of the euro.