CROSS-BORDER USE OF COLLATERAL:

A USER’S SURVEY

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1 Introduction

The central banks of the European Union decided to conduct a survey to collect the users’ views on the cross-border use of collateral for Eurosystem credit operations. Input was obtained by means of a questionnaire addressed to banks that have made cross-border use of collateral (via links or via the Correspondent Central Banking Model – CCBM) and through individual interviews carried out by some central banks. The response was encouraging. Over 100 answers were received, representing approximately 75% of the users. The questionnaire was mostly addressed to the heads of the back offices. In addition, meetings with market participants in June and November 2000 provided additional feedback.

The main findings of this survey are presented in this report, which identifies views common to a wide range of counterparties across the euro area. It starts with a general evaluation of the use of collateral. Second, the cross-border use of collateral is compared with the use of domestic collateral. Third, the different channels – the CCBM and links – are assessed by the banks.

2 Use of collateral in general

Banks tend to divide their portfolios into two parts. The most liquid part is actively used for trading. The remaining securities are intended, in principle, to remain in the portfolio until maturity. This second block is the kind of collateral that is typically provided for credit operations of national central banks (NCBs). Collateral provided to NCBs normally consists of securities that are less liquid or more difficult for the credit institution to transfer.1 Furthermore, by providing high-yield debt instruments as collateral and keeping these instruments until maturity, banks seek to obtain a return from the difference between the long-term yield and the short-term yield.2 When deciding upon the cross-border use of assets as collateral, other factors mentioned are previous experiences (i.e. service and reliability of the correspondent central bank) or the cut-off time when using a securities settlement system (SSS) abroad.

There is a fairly high percentage of collateral deposited with central banks, which is not used to obtain credit.

Collateral is used mainly for intraday credit purposes, rather than for monetary policy operations. This conclusion is in line with the statistics that have been collected by the ECB. Two additional observations can be made. First, there are significant differences between banks, probably related to the different kinds of activities or organisational structures. Some banks obtain credit solely via monetary policy operations, while others do not participate in tenders, but make intensive use of payment systems instead (and consequently request intraday credit from their NCBs). Second, collateral obtained via the CCBM is, on the contrary, used more for monetary policy operations than for intraday credit.

1 An Italian security, for instance, may be very liquid in the Italian market, because it is frequently traded, but it may not be as liquid for a French institution that holds it, because the latter institution may own it through a long custody chain.
2 This is possible when there is a normal yield curve and stable or decreasing refinancing interest rates.
3 Domestic collateral versus collateral used on a cross-border basis

In general, the management of securities held on a cross-border basis is less flexible (compared with that of domestic securities), because their settlement requires a longer time as banks are less familiar with the settlement process in a foreign location. These difficulties make cross-border trading more complex. Instead, banks find it practical to make cross-border use of assets as collateral. Given that cross-border transfers are more cumbersome than domestic transfers, banks opt to minimise back office work by reducing the number of transfers and increasing the average time these assets are deposited at the NCB. Furthermore, it is a common practice for the assets to be pre-deposited at the NCB before the day on which the credit is obtained.

A higher cross-border use of collateral is expected to be triggered by the emergence of a sufficiently large and liquid repurchase agreement market, rather than by the availability of the different channels (CCBM/links) used by the Eurosystem for its credit operations.

It also seems that banks choosing to manage their treasury positions centrally will mobilise securities on a cross-border basis more frequently than those banks preferring to participate in the different European securities markets via their local subsidiary.

The capacity of eligible domestic assets to cover liquidity needs varies between countries. This may be explained by the fact that the size of the banking industry (demand for collateral) does not always correspond to the amount of securities issued in the local SSS (supply of domestic collateral). Therefore, when demand exceeds supply, an efficient cross-border use of collateral is more important.

The overall volume of eligible assets (domestic and cross-border) seems to be sufficient for the banking community. There has been no request from any bank to include new categories of assets as eligible. All the answers must be seen in the context of the current tender system, in which the volumes bid need not be backed by sufficient collateral. Collateral provided must only cover the final volume allotted.

4 Channels for the cross-border use of collateral

Banks were asked to evaluate the existing channels for the cross-border use of collateral (i.e. the CCBM and links). Several banks explicitly requested that their central bank open an account with Euroclear or Clearstream Luxembourg (ex-Cedel), even though no questions concerning remote access of NCBs to foreign SSSs were included in the questionnaire.

4.1 The CCBM

The CCBM is generally appreciated because it provides banks with the opportunity to provide assets as collateral on a cross-border basis (which, in most cases, did not exist before the start of European Economic and Monetary Union).³

A general evaluation of the CCBM is that it is “slow but reliable”. The service provided by the central bank is, in most cases, very much

³ Even within the same country, counterparties evaluate the sufficiency of eligible domestic assets differently. Some counterparties with a more international portfolio tend to regard eligible domestic assets as insufficient.

⁴ In this respect, counterparties tend to link their policy decision to use a euro area-wide range of collateral with the channels through which this collateral can be used (only the CCBM at the start of Stage Three).
appreciated. However, because it depends on factors that are external to the NCBs (i.e. the efficiency of the custodian or settlement finality at a foreign SSS), the CCBM is not always able to provide collateral on a cross-border basis to cover a liquidity need that arises late in the day. It is not unusual for operations to take more than two hours because of these external factors. Approximately 40% of the deliveries through the CCBM take place the day before the credit is requested in order to ensure the smoothness of the operation. **Banks prefer to deliver the collateral one day in advance to be on the safe side, rather than risk obtaining the funds too late in the day.**

The majority of the banks surveyed are satisfied with the service, although they **consider the procedures cumbersome due to the manual component.** For this reason, banks that start to use the service sometimes consider the process too complicated, although this criticism wanes as they become more familiar with it. Banks would like the CCBM to be enhanced by further automation. A possible extension of its operating hours was also mentioned.

The main problem encountered in using the CCBM is the lack of timely information on asset valuation. Moreover, the provision of securities incorporating a coupon payment during the period they are used as collateral has proven to be problematic in some cases, because of different legislation across the euro area and different collateralisation methods of NCBs.

4.2 Links

Once used, some banks have the impression that links are easier to use than the CCBM, but they remain much less flexible than the use of domestic securities. A majority of the users of links delivers the collateral one day in advance, given that transfers through links require a number of steps.

**Some banks criticised the design of the SSS links model because, when used for market operations, foreign assets are kept outside their logical settlement environment (i.e. where the assets are normally settled).** This results in a reduced service offering and a need to realign the positions with the local market to enable local settlement of normal trading. These movements are cumbersome to manage, expensive and time-constrained (i.e. there is no real-time link between most SSSs). Any delay in realignment might have an impact on the settlement of the trading activity, resulting in significant losses.

The vast majority of the securities held on a cross-border basis in an investor SSS (via a link) were used exclusively for central bank collateralisation purposes. Would the provision of delivery-versus-payment (DVP) facilities by links facilitate the use of securities for other purposes? Some banks consider it would be helpful, although it is not felt to be a crucial issue in general.

The low use of the links was explained by the fact that implementing new functionalities, such as the use of a new link, would be costly in terms of both IT development and staff training. In a changing environment characterised by frequent announcements of mergers and alliances, banks are reluctant to make additional investments unless they see a final solution. Until then, banks will make greater use of the CCBM because they have already adapted their procedures to it. **It seems that one of the main factors explaining the higher use of the CCBM is that it already existed.**

**Fees are not considered a relevant factor when choosing between channels.** Sometimes the CCBM is the only possible channel providing access to a certain kind of collateral (i.e. a link does not exist). When there is a choice between the two different channels, the service level and familiarity with the channel are more decisive factors.

**Banks feel that they have not been well-informed about how to use the links with their SSSs.** By comparison, the level of information received on the CCBM is considered just about adequate. Regarding sources of information, the ECB website is that used most.
Annex: Statistics on the cross-border use of collateral

Chart

Use of CCBM/links as a percentage of the total collateral provided to the Eurosystem