Outcome of the biennial review of the risk control measures in Eurosystem credit operations

U. Bindseil, Risk Management Division, European Central Bank

Money Market Contact Group
Frankfurt, 11 September 2008

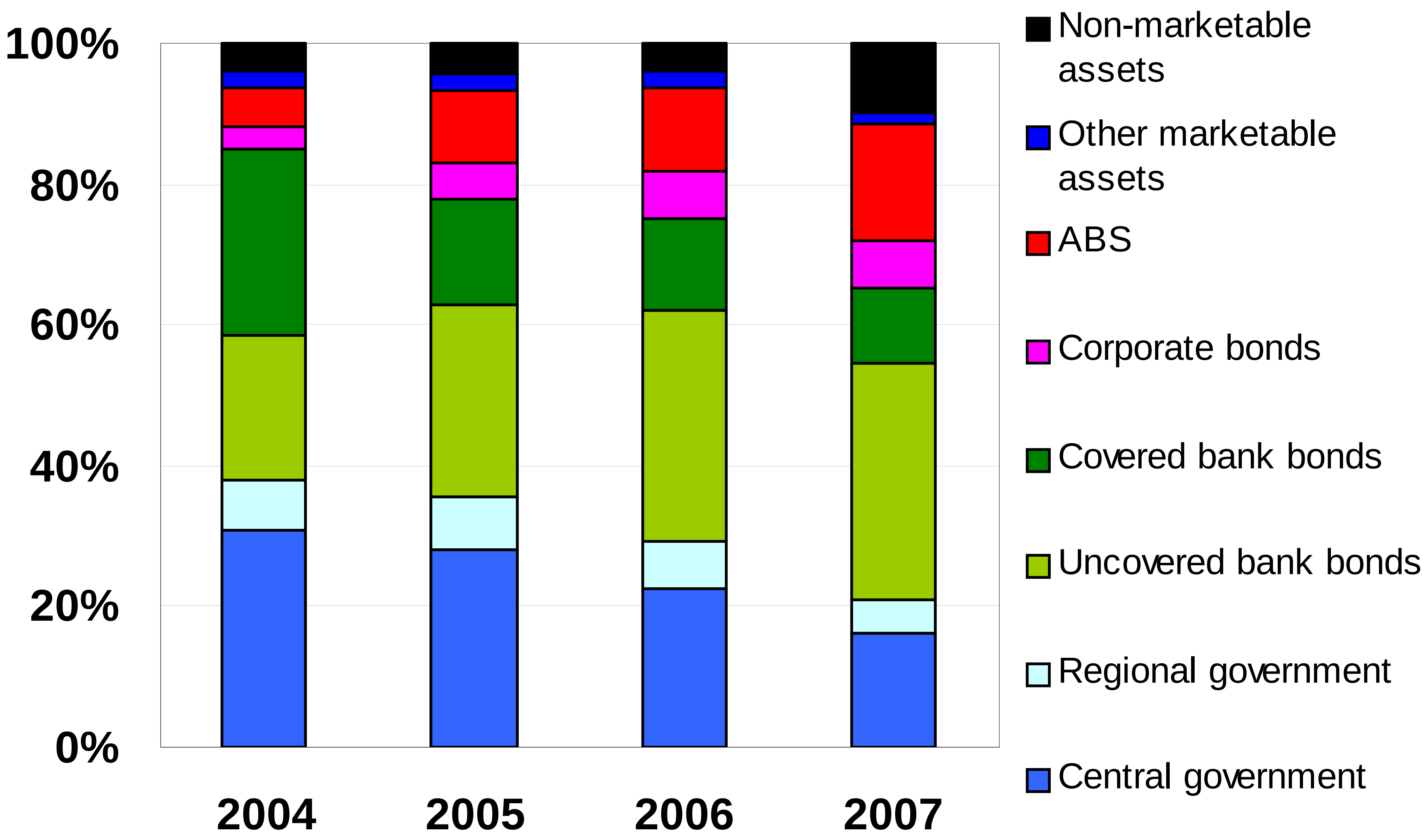
Outline

1. Collateral in Eurosystem credit operations
2. The new risk control measures
   a) Change in haircuts for marketable assets
   b) Extension of close link definition
   c) Higher rating disclosure standards
   d) Eurosystem discretion
3. Concluding remarks

1. Collateral in Eurosystem credit operations

- Article 18.1 of the Statute of the ESCB requires that credit shall be based on adequate collateral.
- Risk mitigation methods:
  - Collateral must fulfil high credit standards. Within the Eurosystem credit assessment framework (ECAF) these standards are defined in terms of a rating of A- or better or, equivalently, an annual probability of default of 10bps or less.
  - Valuation haircuts.
  - Daily valuation of collateral and daily variation margins.
  - Rule for the use of collateral: collateral submitted should not be issued or guaranteed by the counterparty or any other entity closely linked, in terms of ownership, to the counterparty.

1. Evolution of collateral held with the Eurosystem



2. New risk control measures

- Biennial review of the risk control framework: a regular exercise
- Some fine-tuning of the framework deemed necessary because of:
  - Improvements in methodology
  - Updated assessment of market and liquidity risk characteristic of assets
  - Trends in the use of eligible assets by counterparties
  - New developments in financial instruments
- Implementation: 1 February 2009

2.a. Change in haircuts for marketable assets

Old haircut schedule:

Levels of valuation haircuts applied to eligible marketable assets in relation to fixed and zero coupon instruments (%-ages)								
	Liquidity categories							
	Category I (govt bonds)		Category II (local and reg. govt, agencies, supras, Jumbo cov. Bonds)		Category III (trad. Cov. bonds, unsec. bank bonds, corporate bonds)		Category IV (ABS)	
Res. mat. (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon
0-1	0.5	0.5	1	1	1.5	1.5	2	2
1-3	1.5	1.5	2.5	2.5	3	3	3.5	3.5
3-5	2.5	3	3.5	4	4.5	5	5.5	6
5-7	3	3.5	4.5	5	5.5	6	6.5	7
7-10	4	4.5	5.5	6.5	6.5	8	8	10
>10	5.5	8.5	7.5	12	9	15	12	18

New haircut schedule:

Levels of valuation haircuts applied to eligible marketable assets in relation to fixed and zero coupon instruments (%-ages)									
	Liquidity categories								
	Category I (govt bonds)		Category II (local and reg. govt, agencies, supras, Jumbo cov. Bonds)		Category III (trad. Cov. bonds, corporate bonds)		Category IV (unsec. bank bonds)		Category V (ABS)
Res. mat. (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	all coupons
0-1	0.5	0.5	1	1	1.5	1.5	6.5	6.5	12*
1-3	1.5	1.5	2.5	2.5	3	3	8	8	
3-5	2.5	3	3.5	4	4.5	5	9.5	10	
5-7	3	3.5	4.5	5	5.5	6	10.5	11	
7-10	4	4.5	5.5	6.5	6.5	8	11.5	13	
>10	5.5	8.5	7.5	12	9	15	14	20	

***Assets in this liquidity category that are given a theoretical value will be subject to an additional valuation markdown of 5%.**

2.a Change in haircuts for marketable assets

- **Application of a uniform haircut of 12% to all ABS**
  - **Analysis showed that an upwards adjustment of haircuts for a significant part of eligible ABS was warranted. So far, haircuts for ABS ranged from 2% to 18%.**
  - **The maturity profile of the underlying assets in an ABS transaction normally differs from the maturity profile of the ABS itself. Therefore a distinction based on the maturity and the coupon structure of the ABS is not as relevant for determining the haircut as for other debt instruments.**
- **Application of a haircut add-on of 5% to unsecured bank bonds**
  - **The significant use of unsecured bank bonds by counterparties leads to concentration risk in the banking system that should be reflected in the valuation haircuts.**

2.a Change in haircuts for marketable assets

- **Application of a 5% valuation markdown for ABS valued theoretically**
  - **Recent experience demonstrates that the valuation of ABS can be subject to significant uncertainties especially when there are no market prices that could provide a reference for intrinsic value.**
  - **To mitigate the risk inherent in ABS without a valid market price the Eurosystem has opted to introduce a valuation mark-down of 5% for these instruments.**
  - **This results in a total haircut of 16.4% for ABS that are theoretically valued (95% x 88% = 83.6% = 100%-16.4%).**

2.b Extension of the definition of "close links"

- **Not an eligibility criteria, but a requirement for the <u>use</u> of collateral**
- **Close links create correlation between counterparties and collateral, which, if going beyond some level, undermines the adequacy of risk protection**
- **In addition to the cross-ownership of capital, there are ways in which a "financial close link" between a counterparty and an asset can be established.**
- **Such financial close links have been observed increasingly for ABS.**
- **In particular in the case of ABS, the new measure prohibits:**
  - **Providing liquidity support of more than 20% of the asset-backed security's nominal value.**
  - **Entering into a currency hedge with the ABS issuer.**

2.c Higher rating disclosure standards

- **All ECAI (rating agency) assessments must be based on public ratings. Advantages of public ratings in terms of supporting quality of ratings; recent trend of lowered transparency reflecting private placements.**
- **In particular for ABS:**
  - **credit ratings reports (pre-sale or new issue report) must be published that include:**
    - **comprehensive analysis of structural and legal aspects**
    - **detailed collateral pool assessment**
  - **rating reviews to be published at least quarterly**

2.d Eurosystem discretion

- It is recalled that the Eurosystem has discretion in excluding or limiting the use of certain assets, also at the level of individual counterparties, to ensure adequate risk protection.
  - In line with Article 18.1 of the ESCB Statute.
  - Common market practise, also enshrined in the Basle II rules, to regard as adequate collateral only collateral that is not (or is only limitedly) correlated with the counterparty that provides the collateral.

3. Concluding remarks

- **No change in collateral policy, still acceptance of a wide range of collateral. No change in the eligibility status of any asset type currently accepted in Eurosystem credit operations.**
- **Only refinement of particular elements of the risk control framework to ensure continued adequate risk protection for the Eurosystem, in view of trends in collateral practices and liquidity.**
- **Overall impact on the availability of collateral for counterparties is expected to be limited.**
- **Adequate timeframe for preparation since implementation is only as of 1 February 2009.**