L E A R N I N G C U R V E ®

Navigating Changes To The ECB's ABS Eligibility Criteria

Current economic conditions have meant that unprecedented government interventions in the market have become widespread. As the credit freeze has deepened, governments have been introducing new programs and adjusting existing ones to maintain stability and restore proper functioning of the markets. While the policies, by their nature, must be fluid and responsive to market conditions, the changes can be challenging to market participants from the perspective of predictability.

During the financial crisis, the **European Central Bank** has been a significant supplier of market liquidity through the ECB's open market operations. Through so-called "reverse transactions", market participants are able to enter into repurchase agreements with the Eurosystem, whereby financing is provided against collateral. In order for the collateral to be eligible, it needs to meet certain criteria.

Over the last nine months, the ECB has made numerous alterations to the criteria that must be satisfied for asset-backed securities to be used as collateral. The January 20, 2009 press release, which introduced the most significant round of recent changes, stated that the adjustments "aim at contributing to the restoration of a proper functioning of the ABS market". However, some might say that the timing of the amendments, in light of market conditions, has been unfortunate. Certain of the changes themselves contain uncertainties and the unpredictability of change, itself, can be challenging for market participants. This article provides an overview analysis of some of the recent modifications to the collateral framework that must be satisfied to secure ECB funding using ABS as collateral.

Background To The Collateral Framework

In terms of understanding the policy basis for the changes, it is important to keep in mind that the ECB's collateral framework, which forms part of the ECB's general open market operations, was originally established in 1998. This is in contrast to government intervention programs that have been specifically designed to deal with current market challenges. Thus, while an element of the policies are proactive in aiming to steer the restoration of a proper functioning of the market, in many ways the policies are reactive in that the ECB is attempting to refine a pre-existing regulatory framework, in order to deal with current conditions and an unprecedented level of use of the ECB's open market operations by market participants.

Ultimately, the primary objective of the Eurosystem is to maintain price stability and support the general economic policies of the European Community. The open market operations are used to steer interest rates, manage market liquidity and signal the stance of monetary policy. The eligibility criteria set out in the collateral framework aims to protect the Eurosystem from incurring losses in its monetary policy operations while ensuring equal treatment of counterparties, as well as enhancing operational efficiency and transparency.

Increased Valuation Haircuts For ABS

On February 1, 2009, the ECB increased the valuation haircut on ABS collateral. Valuation haircuts used to range from 2-12% depending on the characteristics of the relevant ABS. The valuation haircut was raised to 12% on all ABS. Further, where the value of ABS is determined on a theoretical basis rather than by reference to a market price, an additional valuation markdown of 5% is applied to the value of the ABS prior to the application of the 12% haircut. Since most ABS are theoretically valued, the total effective haircut applied to typical ABS by the ECB therefore increased from 2% to 16.4%.

Other haircuts may also apply, for instance, if the debt instrument is denominated in a currency other than the euro (see below). The haircuts applied by the ECB are cumulative and, therefore, in some circumstances, become substantial.

Restrictions On "Close Links" For ABS

As of February 1, 2009, a bank may not submit ABS as collateral if that bank, or any third party with which it has "close links" is the provider of currency hedging to the issuer of such ABS, or provides liquidity support for 20% or more of the outstanding amount of the ABS. A bank and an issuer, debtor or guarantor are considered to have close links when 1) either the bank owns directly, or indirectly through one or more other undertakings, 20% or more of the capital of the issuer, debtor or guarantor; 2) the issuer, debtor or guarantor owns directly, or indirectly through one or more other undertakings, 20% or more of the capital of the bank; or 3) a third party owns more than 20% of the capital of the bank and more than 20% of the capital of the issuer, debtor or guarantor, either directly or indirectly through one or more undertakings.

The ECB's rationale for this change would seem to be aimed at managing its counterparty risk. The ECB takes ABS as collateral to isolate itself from the counterparty's credit risk, but

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if that counterparty is itself providing support to the ABS structure, then the ABS is exposed and likely to lose value at the time when the ECB most needs to be able to rely upon it as collateral. However, depending on the circumstances, there is not always complete clarity as to how the close links restrictions apply to certain ABS structures and on what basis the 20% threshold should be applied.

Minimum Credit Ratings For ABS

On December 1, 2008, the minimum credit rating for eligible collateral was temporarily reduced to BBB- from A-, except for ABS that were still required to have at least an A- rating to constitute eligible collateral. This temporary measure applies until December 31, 2009. Debt instruments rated lower than A- attract an additional haircut of 5%. Furthermore, on January 20, 2009, the ECB announced two new eligibility criteria: that ABS issued on or after March 1, 2009 must have been awarded an AAA/Aaa credit rating at issuance, and that the previously existing A minimum rating threshold would have to be retained over the lifetime of the ABS. If the credit rating of the ABS falls below this threshold, there is a risk that the collateral has to be substituted.

Additional Rating Agency Requirements

Starting from February 1, 2009, the ECB announced that, in order for ABS to constitute eligible collateral, financial institutions must obtain a detailed presale or new issue report from an external rating agency containing a comprehensive analysis of the structure, collateral and transaction participants, which is made publicly available. Moreover, the external rating agency must publish a quarterly review on the collateral, transaction participants, capital structure and performance of the ABS.

Eligible Currencies For Marketable Debt Instruments

From November 2008, the currency of marketable debt instruments constituting eligible collateral was expanded to include U.S. dollars, U.K. sterling and Japanese yen, provided that they are issued and held/settled in the Euro area, and the issuer is established in the European Economic Area. Debt instruments in currencies other than the euro attract an add-on haircut of 8%.

Underlying ABS Assets May Not Be ABS

For ABS to be eligible collateral after March 1, 2009, the ECB announced that the underlying pool of ABS may not consist, in whole or in part, of tranches of other ABS. However, the ECB stated that this restriction would not apply where the issuance structure includes two special purpose vehicles and the true-sale requirements are met in respect of those SPVs so that the debt instruments issued by the second SPV are directly or indirectly backed by the original pool of assets without tranching. Although there was some ambiguity in its press releases, the ECB has since clarified that the true-sale requirement is in respect of both the notes issued by the first SPV to the second SPV and subsequently from the second SPV to the ECB.

Credit Operations Available Terms

On May 7, 2009, the ECB announced the availability of longer-term refinancing operations, which form part of the ECB's tender operations, with a maturity date of one year. Prior to this, the maximum term for the ECB's standard tender operations was six months.

Conclusion

The ECB's refinement of what constitutes eligible collateral has shifted numerous times in the past nine months. One might speculate that some of the changes appear to be reactive steps by the ECB in carrying out its policy objective of mitigating losses in the monetary system – i.e., certain adjustments appear to be addressing specific issues that have come to light in relation to some of the ABS that have been used as collateral in transactions with the Eurosystem over the last couple of years. The ECB may simultaneously be attempting to proactively steer market participants through policy tweaks – i.e., the amendments may be an indirect way of addressing the fact that over the past year a significant portion of European ABS issuances have been driven by originators' desires to enter into repos with the ECB rather than issuing ABS to third-party investors.

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At the same time, many of the ECB's overall policy changes — such as expanding the eligible currencies for marketable debt instruments, reducing the general minimum credit rating for eligible collateral, introducing LTROs with a maturity of one year, and (beyond the scope of this article) the recent decision that the Eurosystem will purchase euro covered bonds – seem to be expansive in nature. Thus, the ECB continues to play an active role in supplying liquidity into the market and supporting stability. Due to the natural fluidity of the eligibility criteria, the conditions and procedures for the execution of Eurosystem monetary policy operations and the continuing market turmoil, we expect that the ABS eligibility criteria will continue to evolve.

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