

No credit without collateral

11 Sep 2020 - Analysis - Monetary policy



Marjaana Hohti Head of Division



Katri Järvinen Adviser

In order for banks to obtain credit from the central bank and payments to be transmitted smoothly, adequate collateral is required. Collateral protects the central bank against the credit risk associated with the counterparty. Central bank collateral policy is aimed at supporting the objectives of monetary policy, financial stability and the functioning of markets.



By easing its collateral requirements during the coronavirus pandemic, the Eurosystem has proactively ensured that banks can maintain lending to the real economy. Guaranteeing the sufficiency of collateral has enabled banks to make full use of the Eurosystem's longer-term and low-interest rate refinancing operations.

The Bank of Finland has decided to establish a national framework for additional credit claims (ACCs) as from 1 September 2020. This will support continued bank lending especially to firms that have been buffeted by the pandemic. Under the ACC framework, corporate credit claims secured by the coronavirus pandemic-related public sector guarantees will be temporarily accepted as collateral.

The Eurosystem accepts a wide range of collateral

In accordance with its Statute, the Eurosystem may provide credit to banks only against adequate collateral. Collateral must comply with harmonised Eurosystem-wide eligibility criteria. The pricing and risk control measures for collateral have also been harmonised in the Eurosystem. This protects the Eurosystem against losses and ensures operational efficiency and a level playing field for counterparties.

Monetary policy collateral consists of marketable securities, such as bonds, and non-marketable assets, such as loans granted by banks to corporates and public sector entities. Eligible marketable collateral includes bonds issued by central governments, municipalities and local governments, covered and uncovered bank bonds, bonds issued by corporates and asset-backed securities.

To be accepted as collateral, marketable assets must be in book-entry form, admitted to trading on a market approved by the Eurosystem and of sufficient credit quality. [1] Assets accepted as collateral by the Eurosystem are referred to as 'eligible assets'. The eligibility criteria are laid down in full in the ECB's General Documentation Guideline. [2]

The Eurosystem publishes a list of eligible marketable assets which is updated on a daily basis. The national central banks (NCBs) assess the eligibility of securities issued and admitted to trading on their respective markets, monitor changes and report them on a regular basis to the ECB's list of eligible assets. Eligibility is also a prerequisite for bonds purchased under the ECB's monetary policy purchase programmes.

No common list is maintained of non-marketable assets. Instead, counterparties propose non-marketable assets for use as collateral with their home NCB and asset eligibility is always assessed on a loan-by-loan basis. The use of bank loans as collateral is influenced by, for example, national legislation and other specific national features. The processes for the use of credit claims as collateral therefore vary from one central bank to another.

The Bank of Finland has accepted credit claims, i.e. bank loans, as collateral since 2007. In recent years, bank loans have become one of the most significant asset types submitted as collateral to the Bank of Finland (in 2019 about 24% of all collateral was bank loans). The Bank of Finland has supplemented the ECB's General Documentation Guideline with its own 'Rules for counterparties'. [3] The Rules describe in more detail the legal, technical and operational requirements for the use of credit claims as collateral with the Bank of Finland.

Counterparty banks must have the operational capability to produce from their own information systems detailed, up-to-date information on credit claims pledged as collateral and any changes affecting their eligibility. Before the use of credit claims as collateral, counterparties must describe how they intend to submit the above information

^{1.} In addition, marketable assets must meet the criteria relating to e.g. non-subordination, currency and coupon structure.

^{2.} Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60) (recast).

^{3.} Implementation of monetary policy operations and collateral management at the Bank of Finland.

to the Bank of Finland. The Bank of Finland will check that the processes function according to the descriptions. Before pledging credit claims to the Bank of Finland, the counterparty bank itself will assess their eligibility. ^[4]

Bank loans are non-transparent instruments compared with marketable securities, and Finland does not have a national credit register. The Bank of Finland therefore conducts inspections of counterparty banks in accordance with the Eurosystem's requirements to verify that the information provided to it on credit claims is always up-to-date and accurate.

The coronavirus pandemic also affects collateral policy

By easing collateral requirements and procedures, the Eurosystem has sought to ensure banks' access to central bank funding even in difficult times. On <u>7 April 2020</u>, the ECB Governing Council adopted a broad package of temporary collateral easing measures which entered into force immediately and will remain in place at least until September 2021. The most significant change affecting the Bank of Finland's counterparties was the reduction of collateral valuation haircuts by 20% for all assets. The haircuts applied to non-marketable assets also decreased simultaneously on account of the regular review of the risk control framework. As a result, banks will receive a larger amount of central bank credit against existing collateral.

The use of unsecured bonds issued by banks was also relaxed by raising the issuer-specific concentration limit from 2.5% to 10%, allowing counterparties to use as collateral a larger share of uncovered bank bonds issued by other banks. In addition, in countries where the NCB has adopted an additional credit claim (ACC) framework, the criteria and procedures for ACC collateral were eased. To ensure the availability of collateral, the Governing Council decided on 22 April 2020 that marketable assets that met the eligibility criteria on 7 April will continue to be eligible despite potential rating downgrades.

In addition to the joint decisions, the Bank of Finland had already, on 1 April 2020, lowered the minimum threshold for credit claims for domestic use as collateral from EUR 500,000 previously to EUR 25,000 in order to support the availability of collateral for its counterparty banks and the flow of funding to firms and households.

^{4.} The counterparty bank is required to check the following information on the loan agreements: legal form of the loan agreement (negotiable/ordinary), type of principal, non-subordination, interest rate linkage, currency and the debtor's credit quality. In order to ensure that a valid security is created over credit claims in the event of a counterparty's insolvency, bank loans pledged to the Bank of Finland may not contain any restrictions on endorsement or realisation. A loan agreement between a bank and the customer may not contain any restrictions on the disclosure of information to the Bank of Finland and the Eurosystem.

Chart 1.

| Category | Collateral easing measures |
|-----------------------------------|---|
| Credit claims / ACC frameworks | Acceptance of ACC collateral covered by COVID-19 government guarantees |
| | Acceptance of new debtor types in ACCs covered by COVID-19 government guarantees |
| | Acceptance of expanded set of credit assessment systems |
| | Reduction of loan-level reporting requirements for credit institutions |
| | Removal of minimum size threshold for credit claims |
| Rating measures | Collateral eligibility 'freeze', rating floor imposed at credit quality step 5 (CQS5) |
| | ABSs: eligibility 'freeze', rating floor imposed at credit quality step 4 (CQS4) |
| Risk tolerance | Proportionate reduction of haircuts by 20% |
| | Reduction of haircuts for non-marketable assets |
| UBBs | Increase of concentration limit for unsecured bank bonds (UBBs) from 2.5% to 10% |
| Greek waiver | Acceptance of Greek sovereign debt as collateral |
| Source: ECB. | |

Additional credit claims broaden use of bank loans as collateral

In addition to the credit claims eligible under the Eurosystem's general collateral framework, the Eurosystem has, since December 2011, also temporarily enabled the use of credit claims which do not fully meet the Eurosystem's general eligibility criteria. The acceptance of such credit claims takes place on a central bank-by-central bank basis through the additional credit claim (ACC) framework. Every NCB can establish a country-specific ACC framework within the limits of the Eurosystem's common minimum risk control framework. However, an ACC framework is always subject to the Governing Council's approval.

The debtors or guarantors accepted under the ACC framework may differ from those under the general collateral framework. In addition, an ACC framework may include pools of credit claims and loans denominated in currencies other than the euro and the credit claims can be of lower credit quality than the generally accepted credit claims. Deviating from the general framework means a higher risk to the Eurosystem, and this

risk is mitigated by risk management measures. The collateral value of ACCs is calculated by applying higher valuation haircuts so that the collateral value of the loan takes into account any unforeseen changes in the actual value of the loan.

The decisions taken by the Governing Council in response to the coronavirus pandemic have meant that, since April, NCBs have been permitted to temporarily include in their ACC frameworks e.g. COVID-19-related public sector guarantees which would not necessarily be eligible under the general framework. By accepting as collateral credit claims covered by COVID-19 guarantees, central banks have supported the implementation of government guarantee schemes, the participation of banks in the Eurosystem's refinancing operations and the intermediation of finance in the economy, especially to small and medium-sized enterprises. Since the end of April 2020, the number of approved ACC frameworks has increased from 9 to 14.

The Bank of Finland has decided to adopt an ACC framework as from 1 September 2020. Under its ACC framework, the Bank of Finland will accept corporate loans fulfilling the criteria of the Eurosystem's general collateral framework except for the criteria for credit quality. The minimum credit quality requirement will be set at credit quality step 4 (CQS4), i.e. PD 1.0%, in the Eurosystem's harmonised rating scale, meaning a probability of default over a one-year horizon of 1.0%. Under the general framework, the threshold is CQS3/PD 0.4%.

In addition, the Bank of Finland's ACC framework will temporarily cover COVID-19 guarantees granted by the Finnish government. In Finland, such guarantees are granted by the state-owned export credit agency Finnvera Plc, primarily to SMEs. The Bank of Finland has limited the guarantees accepted under the ACC framework according to their purpose and the date of issue. This ensures that the eligible guarantees will concentrate on loans applied due to the effects of the coronavirus pandemic.

The Bank of Finland's role in the identification and monitoring of eligible assets

The Bank of Finland is responsible for assessing the eligibility of securities issued and listed in Finland. Assessments are conducted as new securities are issued onto the market. The assessment follows in detail the requirements specified in the ECB's Guidelines, to ensure the eligibility of assets and non-discriminatory treatment of issuers. When all the data necessary for eligibility assessment are available and the Bank of Finland has conducted the assessment, the securities that fulfil the eligibility criteria are reported to the ECB, which maintains a centralised list of assets eligible as collateral on behalf of the Eurosystem.

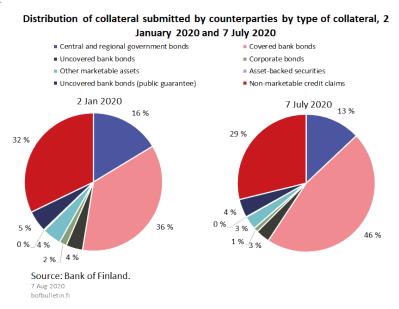
The Bank of Finland cooperates with the other Eurosystem central banks in the assessment and reporting of securities that are issued and/or listed outside Finland. In addition, complex or new structures in debt securities are reviewed more extensively on the Eurosystem level, to ensure harmonised implementation of the eligibility assessment of assets in the euro area.

Collateral submitted to the Bank of Finland

As a result of the corona pandemic, banks have participated more than ever in the Bank of Finland's refinancing operations. The value of banks' eligible assets has a direct impact on their possibilities of borrowing in central bank refinancing operations.

The amount of collateral pledged to the Bank of Finland has in 2020 increased significantly. The amount of collateral currently pledged to the Bank of Finland is higher than ever, over EUR 30 billion. The most popular collateral types have remained the same in 2020. The majority of the collateral is banks' covered bonds, public sector bonds and credit claims. Spring 2020 saw a change in the shares of the various types of collateral. Particularly the share of bank's covered bonds submitted as collateral has increased considerably in recent months (Chart 1).

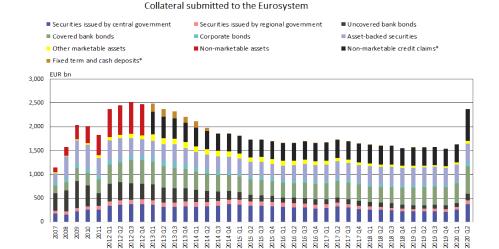
Chart 1



In the Eurosystem as a whole, the volume of collateral submitted to central banks also increased significantly in the second quarter of the year (Chart 2).

Chart 2

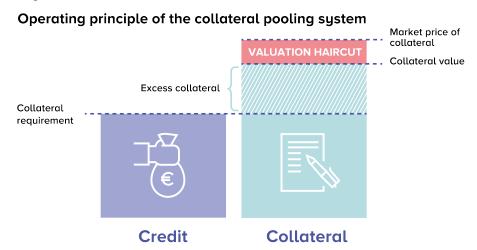
Source: European Central Bank



The Bank of Finland collects all eligible assets provided by one counterparty into a pool. The counterparty's total collateral requirement must be covered from this collateral pool. The total collateral requirement comprises outstanding monetary policy credit and interest, as well the intraday overdraft limit on the TARGET2 PM account, granted to ensure the smooth flow of payments. Securities submitted by the counterparty bank to the collateral pool are, however, not accepted as collateral at full nominal value; they are subject to valuation mark downs and/or haircuts. Collateral is valued on a daily basis. If the value of collateral falls below the collateral requirement, due to valuation changes, haircuts or redemptions, the counterparty must immediately submit new collateral. A counterparty cannot demobilise collateral from the pool or apply for new credit if it does not have a sufficient amount of eligible underlying assets.

As a rule, the Bank of Finland's counterparties have a significant amount of excess collateral. The value of collateral pledged to the central bank is thus considerably higher than the value of outstanding credit. In 2019, the amount of excess collateral of counterparties was on average some 40%.

Chart 3



Risks related to collateral controlled by various means

The objective of collateral is to protect the Eurosystem against a possible default of a counterparty bank. It is therefore important that the underlying assets are of good credit quality, their volume is sufficient and that the Eurosystem has taken into account appropriately the risks related to collateral, e.g. credit risk and the market risk related to value fluctuations. The uncertainty related to the realisation time and value of underlying assets is taken into account by risk control measures. The central bank must be able to realise the collateral sufficiently quickly, if necessary.

The Eurosystem has a variety of tools to control the risks related to collateral. Firstly, the collateral eligible for refinancing operations by the Eurosystem must have a sufficient credit rating. The eligibility of collateral is assessed based on the Eurosystem's credit assessment framework (ECAF). This common framework ensures equal treatment of both banks and credit assessment systems. As a rule, the minimum requirement for creditworthiness is considered the investment grade rating (BBB-), which corresponds to a 0.40% probability of default. Risk is also controlled by various limits that, for example, prevent large exposures to individual issuers. For example, uncovered bank bonds are subject to issuer (group)-specific concentration limits.

For securities to fulfil the eligibility criteria, the credit quality assessment must be provided by credit assessment systems belonging to one of the three sources approved by the Eurosystem. The sources currently approved are: 1) external credit assessment institutions (Standard & Poor's, Moody's, Fitch and DBRS; 2) national central banks' inhouse credit assessment systems (ICASs); and 3) counterparties' internal ratings-based (IRB) systems.

The Bank of Finland does not currently have an in-house credit assessment system. The banks must therefore use credit ratings granted by external credit rating institutions or can, under certain conditions, use their own IRB models. The counterparty must apply

via the Bank of Finland for acceptance of the use of its IRB system in the Eurosystem collateral framework. The credit assessment systems are also subject to ongoing monitoring. The performance of the systems and the quality of the credit rating assessments are evaluated annually. If the system's performance does not meet the quality criteria, the Bank of Finland can require corrective measures or, in more serious cases, use of the system for credit quality assessments can be restricted.

The Bank of Finland is responsible for quality control of the IRB systems it has accepted for use by its counterparties. This is done by requiring from counterparties an annual report and by conducting regular on-site inspections of banks. The Bank of Finland cooperates with supervisory authorities in monitoring the quality of banks' IRB systems.

The Eurosystem values on a daily basis all the eligible assets at market price; in the absence of a representative market price, a theoretical price is calculated. To determine the collateral value of an asset, the market value of the asset is subject to a valuation haircut. The haircuts are the larger, the higher the risk category of the underlying asset. For central government bonds, the haircut percentages may be as low as 0.5%, whereas for credit claims with a lower credit quality and longer maturities, the haircut may be as much as 60%. The total collateral value of a bank's asset pool after haircuts determines the amount of credit granted to the bank in Eurosystem credit operations. As the collateral is valued daily, the Eurosystem is kept up-to-date of the quality and adequacy of collateral.

Tags

COVID-19, COVID-19 virus, monetary policy, collateral