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ABS as collateral for ECB loans to banks and the importance of a functioning securitisation market

The size and structure of monetary policy operations of all major central banks have changed substantially in the last five years as a result of the efforts to implement appropriate responses to the on-going financial crisis. The changes varied in type and included, among others, the introduction of programmes of asset purchases and asset swaps, non-recourse forms of collateralised lending, lending in foreign currencies as well as an extension of the eligibility criteria of acceptable collateral in domestic credit operations. Indicatively, the Eurosystem has increased the size of credit operations from around EUR 300bn in 2004 to EUR 1200bn in 2012.

A "broad" collateral framework

The Eurosystem has always implemented a "broad" collateral framework, i.e. it has chosen to accept a broad range of asset types as collateral in its credit operations reflecting the large number of eligible counterparties, the heterogeneity of financial markets in Europe and the differences in business models of European banks. Despite this broad pool of collateral accepted even in normal times, the Eurosystem has implemented a considerable extension of collateral eligibility in the aftermath of the Lehman default and has again extended acceptability of credit in either its original form (credit claims) or securitised (ABS) in December 2011 and June 2012.

ABS have been accepted as collateral in Eurosystem credit operations from the beginning of the monetary union. The ABS market has been developing rapidly in Europe in the last ten years but its function has been severely impeded by the financial crisis. First the subprime mortgage crisis in the US caused a general mistrust in securitisation by investors which brought the ABS market to a standstill after the Lehman default. Signs of recovery were seen in late 2009 and 2010 but the sovereign crisis in Europe resulted in rating downgrades of banks and the funding instruments they originate (covered bonds and ABS), thus making it difficult for many European originators to bring to the market top-rated structures.

Section 2 recalls the importance of the ABS market as part of the funding options of banks, in particular during the current crisis. Section 3 outlines the principles of the Eurosystem's collateral framework and in particular the rules governing the use of ABS. Section 4 documents the need for transparency and the development of adequate market standards in the ABS market and section 5 concludes.

The issuance of European ABS increased markedly up to 2008 but during in particular 2008, the public placement of deals came to a complete stop. The total issuance has since then steadily decreased including the first half of this year. Although the share of publicly placed deals is increasing, it is doing so from a low level and only for very few jurisdictions. Looking for example into the RMBS market during the first months of 2012, only originating banks in the Netherlands and the UK have been able to place deals publicly.

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In einem funktionierenden ABS-Markt sehen die Autoren ein durchaus maßgebliches Element für die Umsetzung der Geldpolitik der Europäischen Zentralbank. Zwar räumen sie ein, dass ABS im Zuge der Finanzkrise am Leben gehalten wurde oder zumindest wesentlich davon profitiert, dass die EZB die Papiere als Sicherheiten für die Refinanzierung der Banken akzeptiert. Doch mit Blick auf die Zukunft bescheinigen sie dieser Assetklasse eine wichtige Funktion bei der Finanzierung der Wirtschaft. Sie bauen dabei auf eine Wiederbelebung der ABS-Aktivitäten unter Rückbesinnung auf die Kriterien Einfachkeit, Qualität und Transparenz. (Red.)

The importance of the ABS market in wholesale funding of banks

The absence of a full scale recovery of the securitization activity is unfortunate. In many ways, securitisation has an important role to play in financial markets. First, subject to a market based on a sound footing, it is a welfare improving activity since it is able to distribute risks in the financial system but also to transform illiquid products such as single mortgage loans or single SME loans into a liquid product. In this way, both originators of securitization transactions and investors in them could diversify their respective portfolios in terms of risk and return, and the market and funding liquidity of the financial system improves.

The funding needs of banks in the euro area going forward are substantial. To meet this demand in the medium to long term, several funding instruments need to be working properly, which would also equip banks with the means to use a portfolio approach to funding. Indeed, the importance of the three segments for banks' longer-term debt financing (unsecured debt, covered bonds and ABSs) can hardly be overstated. Their smooth functioning is a key element for a stable financial system and strong economic performance. First, they contribute to an efficient risk allocation and diversification, leading to lower costs of capital, higher economic growth and a healthy risk taking. Second, they tend to make lending decisions by financial institutions less dependent on business cycle conditions. Third, deep and stable funding markets make debtors less exposed to refinancing or liquidity risk, which increases banks' resilience and helps contain systemic risk. Fourth, liquid secondary markets and repo market also support the liquidity and thereby the efficiency and resilience of the financial system.

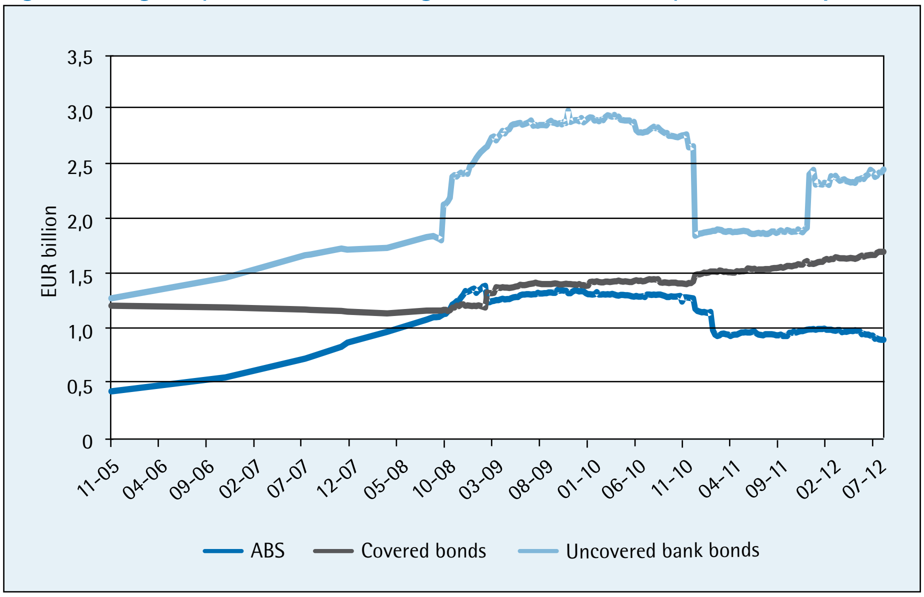
The force of diversification

The force of diversification, since long recognized in asset management, works fully also on the liability side: strengths and weaknesses of different funding tools are different and not perfectly correlated, which means that a good diversified liability structure achieves superior characteristics to what any single liability instrument can achieve, however good it is.

This was forcefully reconfirmed during the financial crisis that affected all the main segments of bank funding, in particular the wholesale funding channels. The observed impairment and market fragmentation included restrictions in access to funding for banks in several euro area countries. The funding markets have been affected in several ways, such as higher costs for funding, a drop in interbank liabilities, a decline in the unsecured money market, a sharp fall in securitization activity but a stable and increasing trend in issuances of covered bonds. Counterparty credit risk has also become acute and this, together with an increased uncertainty in money and capital markets, led to precautionary liquidity hoarding and to a decline in credit provision to the real economy.

However, the developments over the turn of this year look somewhat different. The ending of 2011 was characterized by low issuance and large spreads across asset classes while 2012 started somewhat more optimistically, with issuance picking up in both covered bonds and unsecured senior debts although this "trend" was broken during the second quarter of 2012. ABSs are still showing the same pattern as last year, with only a minority of deals – albeit increasing – from securitization activity being bought by real end-investors

Figure 1: Eligibility of different funding instruments for Eurosystem credit operations



Overall during the crisis, the importance of being able to have recourse to all three sources of funds (secured, unsecured and securitization) was confirmed, even if the secured segment was the one suffering the least. This is due to the fact that each type of security slices risk in a different way and can thus attract different investors. This factor makes these three markets for long-term instruments complements rather than substitutes.

Important for monetary policy

Needless to say, well-functioning wholesale markets are also important for imple-

Table 1: Eligible funding instruments (ABS, covered bonds and unsecured bank bonds) in Eurosystem credit operations

Group	Type	Nominal Eligible (Euro million)
ABS	CDO	2,040
	CMBS	8,909
	CONSUMER	29,992
	CONSUMER_AUTO_LOANS	20,022
	CONSUMER_CREDIT_CARDS	3,073
	CONSUMER_LEASE_RECEIVABLES	23,684
	GOVERNMENT	1,098
	OTHER	21,347
	RMBS_NON_PRIME	16,099
	RMBS_PRIME	701,852
	SMECLO	65,925
Total ABS		**894,040**
Covered bonds	Jumbos	502,727
	Pfandbriefe	1 192,234
Total Covered bonds		**1 694,961**
Uncovered bank bonds	Uncovered bank bonds	2 418,955
Total Uncovered bank bonds		**2 418,955**
Grand Total		**5 007,956**

menting monetary policy and to transmit the monetary policy stance, mainly through the bank lending channel, as bank funding markets play a key role in the transmission process, given the strong reliance on bank-based funding of the euro area non-financial private sector. Overall, well-functioning wholesale funding markets contribute to complete the economic and financial system. The development of these three markets is also reflected in the list of eligible assets that can be used as collateral in Eurosystem credit operations, as shown in figure 1.

Securitization, as a funding tool, has unique features. This is based on its extreme versatility regarding the underlying asset basis and, therefore, the underlying economic sector that it is funding. In that sense ABSs are uniquely shaped to provide targeted funding to a variety of economic activities and to provide the corresponding choice to the investor on his distribution of risk exposure. So, for example, while European ABS issuance since 2010 has been focused on the residential real estate sector (around 65 per cent), there is still a wide range of other types of securitisations in the market (auto loans, consumer credit and credit card receivables, leasing and commercial real estate) that have been issued. Table 1 shows the different types of ABS that are currently (August 2012) eligible for Eurosystem credit operations comparing them with covered bonds and unsecured bank bonds.

The use of ABS as collateral in the Eurosystem monetary policy operations

General features of the framework: Even before the crisis, the Eurosystem's counterparty and collateral frameworks were characterized by flexibility. First, since the beginning of the monetary union and the implementation of a single monetary policy, the Eurosystem has accepted a very broad range of assets as collateral; second, a broad range of counterparties can participate in refinancing operations; third, the same type of collateral is accepted in all credit operations; fourth, the counterparty and collateral eligibility criteria and the associated risk control measures are common across the euro area.

Two concerns drive the developments of our collateral framework at all times. First, in accordance with the Statute of the ESCB and the ECB, the collateral accepted by the Eurosystem in all credit operations must be "adequate".

In determining this "adequacy" the Eurosystem has to achieve two goals. The one goal is the provision of the necessary funding to the banking sector which, in turn, requires that sufficient quantities of eligible collateral are available on the balance sheet of counterparties. The other goal to be achieved is the integrity of the Eurosystem's balance sheet which requires that risks in lending to banks are kept under control.

To achieve this goal the Eurosystem applies a set of eligibility criteria for collateral and implements appropriate risk mitigating measures. The principle underlying these measures is the effort to equalize the "post mitigation risk" of any eligible asset, i.e. the remaining risk after the implementation of risk control measures, while being aware that we can never perfectly achieve the result. This would mean, for example, that by applying a haircut of 0.5 per cent to a Treasury bill, we achieve the same protection as when we apply a haircut of 60 per cent or more to a ten year bank loan, when both these assets are accepted as collateral in central bank operations.

The second concern is to stay abreast of market developments and financial innovation. To do so, the Eurosystem must remain ready to adapt its framework to such developments at any time. This may require changes in the eligibility criteria, including the acceptance of additional asset classes or adjustments in the risk control and valuation framework

The response to the crisis: An extreme case of "market development" that has required adjustments of the monetary policy implementation framework has been the crisis that the financial system has been facing essentially without interruption since 2007. A broad collateral framework, like the one adopted by the Eurosystem, can serve by itself as an automatic crisis mitigation tool.

This role has been further enhanced with targeted adjustments during the crisis years. In order to address the impairment in important market segments such as the money, covered bond and sovereign bond markets, the Eurosystem has launched a number of specific responses during the crisis. This also led to an increased intermediation via the central bank as the interbank market came to a halt.

Together with the two programmes of outright purchases focusing on covered and government bonds and the provision of liquidity with longer maturities and in different currencies, the built-in elasticity and a number of changes in the collateral framework were the most important responses to the crisis.

The built-in elasticity of the Euroystem collateral framework

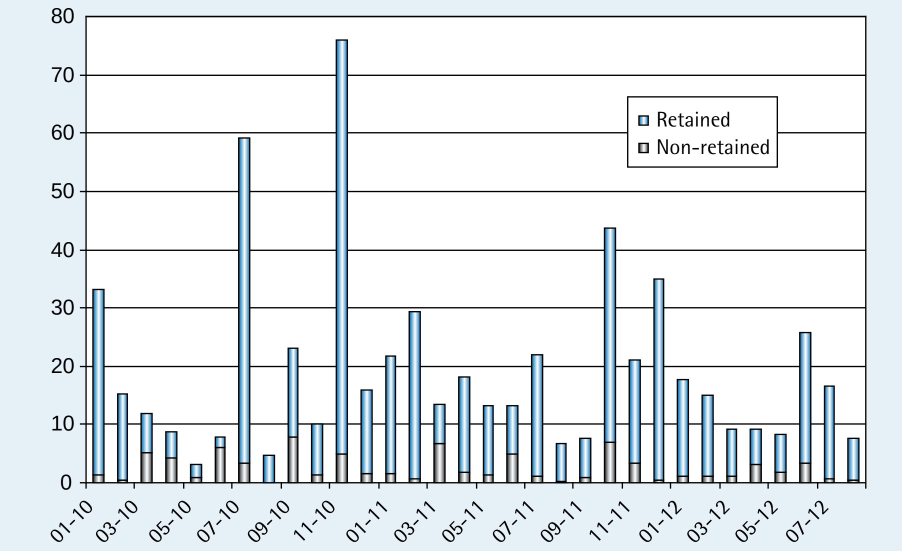
Before moving to the changes made, first, consider again the importance of the built-in elasticity of the Eurosystem collateral framework. In a serious financial crisis, bank funding markets freeze, and a part of the banking system has for some time to replace its lost access to interbank and capital markets through more recourse to central bank credit. Recourse to normal central bank credit is constrained by the value of central bank eligible collateral, which makes central bank collateral availability of banks the crucial parameter in the "passive" response of a central bank to a liquidity crisis, influencing fundamentally systemic financial stability. The central bank must tolerate in a liquidity crisis the elasticity of its credit supply to individual financial institutions for a number of reasons[1]:

First, if it does not, the confidence and liquidity crisis will deepen, because the stressed banks will be considered by investors and other banks as being in an even more precarious situation, and the loss of capital market and interbank funding and of deposits will accelerate, regardless of the stressed banks willingness to pay high interest rates. If the confidence crisis deepens and subsists for a long time, a credit crunch and economic contraction may result.

Second, the central bank is the only economic actor who is never liquidity constrained in domestic currency. Therefore, in case of counterparty default, the central bank can take its time to liquidate collateral, and maximize recovery. Finally, the central bank is considered a credit risk free counterpart, and therefore its borrowers accept that it imposes (even high) haircuts on collateral (as haircuts create risk exposure to the collateral provider if the cash provider is credit risky).

The last two points also explain why the central bank can accept illiquid assets which are not used as underlying assets in interbank repo markets, and why it should do so particularly in a financial crisis. This is not a sign of imprudence, but a reflection of the unique economic position and role of a central bank in a financial crisis. Adequate haircuts should protect the central bank against undue risk taking. While too low haircuts are therefore obviously problematic, too high haircuts can in the extreme also be self-defeating as they create an asset encumbrance problem for the stressed banks which makes it even more difficult for them to return to unsecured market funding, and hence may perpetuate central bank dependence.

Figure 2: Euro area ABS issuance: retained versus non-retained issuance (in EUR billion)



Source: JP Morgan

A number of changes regarding the acceptance of ABS

A number of changes regarding the acceptance of ABS were introduced in the aftermath of the Lehman default. On one hand, risk mitigation measures for accepting ABS as collateral were strengthened, recognizing the heightened risks characterizing some of these structures. Thus haircuts for ABS were increased and the requirement of two AAA ratings at issuance for ABS was introduced.

In addition, the Eurosystem tightened controls for the existence of close links between originators and counterparty transactions in the case of ABS brought to the Eurosystem by the originators themselves, and discontinued the acceptance of multiple layer structures.

At the same time however the Eurosystem continued accepting a broad range of securitization structures, despite the prevailing lack of confidence in the product in the market. In fact, the enlargement of eligible collateral introduced in October 2008 allowed banks to use ABS denominated in foreign currencies and also submit subordinated tranches if they were covered by a government guarantee.

More recently, the ECB decided to launch two longer-term refinancing operations of each with three years maturity. In order for banks to support the real economy after having used these two longer-term operations, the ECB decided at the same time to broaden the collateral framework.

The widening of the eligibility criteria

The widening of the eligibility criteria meant to foster bank lending. And it is again proof of the close connection of the Eurosystem's framework with the developments in the ABS market that, to achieve this, the collateral base was

Table 2: Use of collateral in Eurosystem credit operations by asset type (in EUR billion, collateral value after haircut)

	2004	2005	2006	2007	2008	2009	2010	2011	2012 Q1	2012 Q2
Central government securities	252,4	233,5	205,5	176,9	158,2	224,9	261,5	255,0	336,4	358,2
Regional government securities	57,7	64,8	61,3	53,4	62,2	70,5	71,0	82,1	99,8	98,5
Uncovered bank bonds	169,3	226,5	294,1	370,6	439,6	562,1	430,2	269,2	369,3	374,2
Covered bank bonds	213,3	190,1	172,5	162,8	173,9	272,8	264,5	287,8	404,1	423,1
Corporate bonds	26,9	44,2	60,0	76,5	95,8	115,2	101,7	95,7	95,6	95,4
Asset backed securities	45,0	83,5	109,3	182,1	443,6	473,6	490,0	358,0	407,5	407,3
Other marketable assets	18,9	22,0	19,9	16,2	15,8	21,0	32,7	57,8	73,8	77,9
Non-marketable assets	33,5	35,4	36,3	109,3	190,1	294,8	358,5	418,7	587,6	621,0
Total	**817.0**	**900.0**	**959.0**	**1 148,0**	**1 579,0**	**2 035,0**	**2 010,0**	**1 824,0**	**2 374,0**	**2 456,0**

broaden temporarily by accepting, out of other possible asset classes, additional ABSs fulfilling specific characteristics on top of the current rules. These characteristics point also to the direction of simpler, more transparent structures offering additional protection for the investor. Under these conditions, a lower rating at issuance is sufficient for eligibility.

Use of ABS as collateral in Eurosystem's credit operations: Since the crisis started, ABS has become one of the largest asset classes put forward as collateral in Eurosystem credit operations. In 2007, the share of ABS as collateral was around 16 per cent, before it increased substantially to 28 per cent in 2008, reflecting the poor situation in the ABS market as well as counterparties' use of retained ABSs as collateral. During 2011, the latest public figure, ABS constitute about 20 per cent of total collateral put forward to the Eurosystem, or around EUR 360 billion as shown in the table 2.

It has been said many times before that, during the crisis, the initial originate–to-distribute model turned into originate-to-retain and originate-to-repo model. Based on current figures from the market and our own collateral figures, this has not yet substantially changed (see figure 2).

Transparency and market standards

The fact that in times of financial stress and funding constraints, such transactions continued to be accepted by the Eurosystem can be seen as another indication of the close interaction between the Eurosystem collateral framework and the ABS market. During the current environment this practice was justified in order to provide liquidity to counterparties when they face market stress. It also kept the securitisation industry on-going, awaiting a real recovery. There are of course downsides with this practice. First, in situations when counterparties default, the liquidation process on these, often idiosyncratic, assets would most likely take longer compared with an asset that fulfills high market standards. Second, keeping this leeway for counterparties would not in the longer run foster the recovery of the market. In this respect, market participants are ultimately responsible to restart the securitisation market on a sounder basis.

As alluded to earlier, the access for banks to functioning wholesale markets is of utmost importance going forward, given the substantial re-financing needs and re-financing wall banks are facing. For this to happen, all major funding markets need to achieve an adequate level of functionality, and to reach this level, some maintenance work is needed.

In particular in the securitization market, in order to change the current situation, the ECB has been supporting the creation of a strong "role model", helping to tier assets characterized by high standards of simplicity and transparency, which would eventually bring liquidity, from more bespoke kinds of securitization. Such a role model should achieve what it takes to bring back investor confidence in securitization, reinforcing the fact that the performances on underlying assets in an ABS have been surprisingly good during the latest part of the crisis. In this way, investors would get the information they need to assess the structures and fit them into their intended risk profile.

To achieve these demanding goals, the role model may need to confine the pool to specific asset types, require documentation that is more comprehensive and have precise rules and criteria on all parties involved in the transaction. It may also require specific features on the underlying assets. Consequently, the role model should constitute a prime segment of the securitization market. The Prime Collateralised Securities initiative recently launched by the market is a promising tool in this direction.

It would also be important that this new model provides access to loan level data. To contribute in this direction, the ECB decided in December 2010 to establish loan-by-loan level information requirements for ABS in the Eurosystem collateral framework. The ECB has published six different loan level data templates regarding ABS classes, covering RMBS, CMBS, SME loan securitisation, consumer finance ABS, leasing ABS and auto loan ABS. These will be gradually phased-in, with the RMBS first.

In addition to the obvious benefits for the market, the Eurosystem has also a self interest in this initiative since the availability of the loan-level information is also intended to facilitate the risk assessment of ABS as collateral used by Eurosystem counterparties in monetary policy operations, as well as collateral management.

Parallel paths

Developments in the ABS market (both in the past and, to the extent foreseeable, also in the future) and the monetary policy implementation framework (in particular the collateral framework) of the Eurosystem have followed parallel paths. ABSs have been an integral part of the eligible assets spectrum of the Eurosystem and therefore their use as collateral has been contributing in significant degrees to the implementation of monetary policy. Under normal times, the versatility of the ABS as a funding instrument is enriching the monetary policy transmission mechanism.

In the crisis, the ABS market has been kept alive by the fact that the Eurosystem has continued to accept ABS that could not be placed in the market. Conversely, the implementation of monetary policy during the crisis required a large increase in central bank funding which was collateralised to a large extent via asset backed securities. Not surprisingly, when the need arose to support bank lending through the collateral framework, the Eurosystem extended eligibility of exactly this asset class.

Looking into the future, initiatives launched to enhance simplicity, quality and transparency in the ABS market should help fostering further this mutually beneficial relationship. A healthier, more liquid market would support funding of a wide range of underlying economic activities. Securities issued in such a market would also constitute high quality collateral for banks in central bank operations.

The views expressed are those of the authors and do not necessarily represent those of the European Central Bank

Footnote

See for instance U. Bindseil and F. Papadia (2006), "Credit risk mitigation in central bank operations and its effects on financial markets: the case of the Eurosystem", ECB Occasional Paper Series, No. 49; S. Cheun, I. von Köppen-Mertes and B. Weller (2009), "The collateral frameworks of the Eurosystem, the Federal Reserve System and the Bank of England and the financial market turmoil", ECB Occasional Paper Series, No. 107.