The creation of a single list of eligible collateral throughout the euro area

In May 2004, following a consultation with market participants, the Governing Council of the ECB announced plans to introduce a single list of eligible collateral to replace the Eurosystem's current two-tier collateral framework. In a first step, the collateral framework was extended in 2005 to include euro-denominated debt securities from the USA, Japan, Canada and Switzerland. From 2007, bank loans will also be eligible as collateral throughout the euro area. For the German banking industry this signifies the continuation of an established tradition in central bank refinancing, which the Bundesbank will supplement with a range of efficiency-enhancing measures.

The Governing Council's decisions are aimed at ensuring a level playing field for banks, debtors and different types of debt and increasing the transparency of the collateral framework. The Eurosystem's extended collateral framework with a single list of eligible assets still takes account of the different financial and banking structures in the individual countries. A particularly important aspect for the credit institutions is that they have a much larger volume of eligible assets to choose from. This enables them to make more flexible use of their assets both in operations with the central bank and in interbank business.

Collateralisation of credit operations

Categorisation of eligible assets

Pursuant to Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute), the credit operations of the Bundesbank and the other national central banks in the Eurosystem must be based on adequate collateral. At present, the eligible assets[1] are still divided into two tiers. However, no distinction is made between the two tiers with regard to the quality of the assets and their eligibility for the various types of credit operations.

– Tier one consists of marketable debt instruments which fulfil uniform euro area-wide eligibility criteria specified by the Governing Council of the ECB.

– Tier two consists of marketable and non-marketable assets which are of particular importance for national financial markets and banking systems. The eligibility criteria for these assets are established by the national central banks, subject to the minimum eligibility criteria established by the ECB.

German business loans

The tier two assets accepted by the Bundesbank mostly comprise business loans – following on from the Bundesbank's tradition of rediscount business. In addition to trade bills, bank loans to enterprises and commercial paper were included in the list of German tier two assets. The original spectrum of nationally diversified tier two securities within the Eurosystem ranged from debt securities issued by public and private sector borrowers which do not fulfil the tier one eligibility criteria through to equities.

Further development of the collateral framework

In the light of increasing financial market integration ...

The increasing integration of the European financial markets, the banks' intensified cross-border activities and the aim of fostering transparency and a level playing field between the Eurosystem's counterparties make it a logical step to replace the two-tier collateral framework with a single list.

... a single list of eligible assets is a logical step

In 2002, the Eurosystem had already begun to consider gradually switching from the two-tier collateral framework to a single list, the main foundation of which would be the established (already uniform) tier one list. Discussion focused on two main issues: first, which tier two assets are suitable for inclusion in a single list and, second, whether the collateral framework should be extended and, if so, how.

Public consultation in 2003

Before a decision was taken, a public consultation was carried out in the summer of 2003 to gather the views of market participants. The move to consult the market at such an early stage in discussions about reforming the collateral policy was very well received. The Eurosystem received 59 responses, 16 of which were from German banks and associations. The majority of comments from German and European associations and credit in-

1 The list of marketable eligible assets is updated daily and published on the ECB's website (www.ecb.int).

stitutions expressed, by and large, the same view.

An increasing need for collateral in the market ...

Most respondents were in favour of expanding the list of eligible securities. The reason cited was the growing need for collateral both in the money and capital markets and in securities settlement and payment transactions, a point which was also emphasised by the German respondents.

... led to the request that bank loans be included in the single list

Against this backdrop, German respondents, in particular, were keen for bank loans to be included in the single list. It was also suggested that the current definition of bank loans be replaced by a broader definition.

Gradual transition to a broader single list ...

In May 2004, following the positive response from the consultation procedure and after extensive studies, the Governing Council of the ECB announced its decision to change over gradually to a single list of collateral.[2] It was decided that all tier one assets and a substantial share of tier two assets (with a broader definition) would be combined in a single list of collateral. All in all, this significantly extends the range of securities available for use by the Eurosystem's counterparties.

... at the same time excluding certain tier two assets

However, some of the current tier two assets will not be included in the single list. These include equities[3] and, in particular, trade bills. It is true that, in Germany, the trade bill has a long-standing tradition as a refinancing instrument of the credit institutions. After monetary union was launched and rediscount business, which relied heavily on trade bills, was discontinued, trade bills initially "survived" as tier two assets. When the Oesterreichische Nationalbank removed trade bills from its tier two list a number of years ago, the Bundesbank was the only remaining national central bank in the Eurosystem which still accepted them. In the final step in preparation for the single list, trade bills will lose their status as eligible assets on 31 December 2006.

First step in the creation of a single list of eligible collateral

Extending the collateral framework by broadening the permissible geographical spread of issuers, ...

At the end of May 2005, the first measures towards a single list of collateral were initiated.[4] These included, in particular, the extension of the list of eligible assets to include euro-denominated debt instruments issued by entities domiciled in G10 countries outside the European Economic Area (EEA), ie the USA, Japan, Canada and Switzerland. In order to qualify as eligible assets, these securities must fulfil the eligibility criteria laid down in the "General documentation on Eurosystem monetary policy instruments and procedures."[5] In addition, this group of assets must have undergone a legal assessment. This is intended to ensure that, in the event of insolvency on the part of the issuer, the Eurosystem's rights are adequately protected under

2 See the European Central Bank press release from 10 May 2004, Review of the Eurosystem's Collateral Framework: First step towards a Single List.
3 Equities have already been removed from the tier two lists of Spain, the Netherlands and Portugal (as of 30 April 2005).
4 See European Central Bank press release of 30 May 2005, First step towards the introduction of the single list of collateral provided for in the revised version of the "General Documentation".
5 European Central Bank: "The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures", February 2005.

the applicable legal regime by the laws of the non-EEA G10 country concerned. After this legal assessment had been completed for the majority of G10 issues, on 1 July 2005 debt instruments with a nominal value of €137 billion were added to the list of eligible assets, 88% of which were accounted for by US issuers, 7% by Canadian and 5% by Japanese issuers.[6]

... by admitting non-regulated markets ...

The first step also entailed a refinement of some eligibility criteria for marketable debt instruments. A key criterion for the single list is that the assets are traded or quoted on a sufficiently liquid market constituting a benchmark market for the central bank. The aim of this is to provide a specific price source for valuing assets. These securities may also be traded in other markets; however, this has no bearing on their use in operations with the Eurosystem. Regulated markets as defined in the EU Directive on markets in financial instruments[7] are – as before – automatically accepted without the need for further assessment and are always given priority as the benchmark market. The decision about whether to accept non-regulated markets is based on a standard assessment of the markets' functional viability against the criteria of security, transparency and accessibility (this replaces the former exemptions which were granted on a case-by-case basis). The list of non-regulated markets accepted by the Eurosystem is published on the ECB's website[8] and is reviewed and updated at least once a year. As far as Germany is concerned, this list contains the unofficial market of a German stock exchange and the MTS Deutschland market in the case of Federal Treasury discount paper (Bubills). The admission of the unofficial markets to the list of accepted non-regulated markets has meant that roughly another 100 debt instruments – with a (nominal) volume of €7 billion – issued by German debtors have become eligible assets. These are mostly Pfandbriefe that are traded in the unofficial markets of the German stock exchanges. Some current tier two debt instruments are quoted exclusively on non-regulated markets which are not on the list of accepted markets. These debt instruments shall remain eligible until May 2007.

... and by relaxing the rating criterion for uncovered debt instruments issued by credit institutions

Furthermore, in the first step towards a single list of collateral, the rating criterion for debt instruments issued by credit institutions was relaxed. Whereas, previously, uncovered bank debt instruments had to have an issue or programme rating, it is now sufficient if the issuer is classified as eligible. As a result of this measure, approximately 450 uncovered debt instruments issued by German credit institutions with a (nominal) value of €22 billion have been added to the list of eligible securities. In the Eurosystem as whole, the list of securities has increased by €114 billion as a result of this measure.

6 As yet, no legal assessment has been carried out for Switzerland.
7 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments (MiFID). For further information on the regulation of markets see Deutsche Bundesbank, Securities market regulation: international approaches, Monthly Report, January 2006, pp 35-49.
8 A list of the individual regulated markets which are currently accepted is posted under http://www.ecb.int/mopol/implement/assets/assets/html/eligible_nonregmarkets.en.html.

Second step towards a single list of collateral

Inclusion of bank loans in the light of ...

In summer 2004,[9] in the second step towards a harmonised collateral framework, the Governing Council of the ECB decided to include bank loans in the single list from 1 January 2007.[10] This decision was motivated by a range of factors.

... increasing collateral requirements in banking business ...

– Financial operations in the markets are increasingly being collateralised. Marketable securities play a central role in this. Against this backdrop, bank loans – as they are comparatively illiquid assets and therefore have correspondingly low opportunity costs – are particularly suited for use in refinancing and payment operations with the central bank (intraday credit). By accepting bank loans as eligible assets, the Eurosystem is allowing credit institutions to reserve their marketable securities for use in private payment and securities settlement systems (such as the European Banking Association's Euro1 system and CLS/Continuous Linked Settlement) and interbank business.

... as additional liquidity cushion, ...

– The acceptance of bank loans provides the credit institutions with a greater collateral and liquidity cushion, allowing them increased operational flexibility.

... anchoring in the real economy ...

– From a monetary policy perspective, the inclusion of bank loans in the single list of eligible collateral will anchor central bank refinancing more firmly in the real economy. In keeping with the provisions of article 102 of the EC Treaty, this move will help to offset any privileged status of government debt instruments

... and a competitively neutral stance of the central bank's collateral policy

– Finally, the Eurosystem's collateral policy has to be (competitively) neutral. In particular, this involves being sufficiently open to the demands of both banks and the obligors of securitised and unsecuritised debt instruments and to evolving trends in the financial markets (eg towards securitisation).

Eligibility criteria for bank loans

Item	Current Bundesbank tier two loans	Future loans
Minimum amount	€10,000	Intermediate period: €10,000 from 2012: €500,000
Handling fee	None	Intermediate period: none from 2012: undecided
Minimum residual maturity	One month	No limit
Maximum residual maturity	Two years	No limit
Type of debtor	Non-financial enterprises	Non-financial enterprises and public sector
Location of the debtor	Germany	Euro area
Governing law of the loan agreement	German law	Law of a euro-area member state
Source for credit quality assessment	Bundesbank assessment	Four credit quality assessment sources

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9 See the European Central Bank press release from 5 August 2004, Review of the Eurosystem's Collateral Framework: Second step towards a Single List.
10 Furthermore, in this step, non-marketable retail mortgage-backed debt instruments, which currently include only Irish mortgage-backed promissory notes, shall be included in the single list. In Germany, securitised retail mortgage-backed debt instruments – in the form of Pfandbriefe or asset-backed securities – have always been eligible collateral.

Definition of eligible bank loans extended ...

In July 2005, the Governing Council of the ECB specified the criteria for the eligibility of bank loans[11] based on a broad definition of bank loans (see table on page 33). Bank loans are euro-denominated claims of a Eurosystem counterparty on an eligible debtor. They include syndicated loans and loans against borrowers' notes but not undrawn lines of credit, current account overdrafts or letters of credit. As in the case of subordinated securities, subordinated bank loans are not eligible. The loan agreement must be governed by the law of a euro-area member state.

... by abolishing the restrictions on maturity and introducing new class of debtor

For German credit institutions a particularly important aspect of the changeover to the single list is the abolition of the current maturity limits for bank loans, ie a minimum of one month and a maximum of two years. Furthermore, in future the definition of eligible debtors will be extended to include the public sector and the place of establishment of debtors will include all euro-area member states. Currently, only non-financial enterprises located in Germany are admitted to the German tier two list.

Transitional phase with national leeway

Alongside these common eligibility criteria, an intermediate regime will apply between 2007 and 2011. This will allow the national central banks some discretion with regard to the minimum loan amount and handling fees. The Bundesbank will maintain its current terms and conditions during the transitional phase. This means that, until further notice, the minimum loan amount will remain at €10,000 and no fees will be charged for the submission of bank loans. The Governing Council of the ECB has already decided on a universally applicable minimum threshold of €500,000 from 2012; the issue of fees is still undecided. A review of the transitional arrangement is, however, planned for 2010. This will focus on the transition to the unified regime from 2012. In the context of this review, the Eurosystem will need to consider the acceptance of loan portfolios – as requested by market participants in the consultation procedure – in order to enable the continued use of small bank loans, among other things.

High credit quality of debtors ...

Before the Bundesbank (and the other national central banks of the Eurosystem) accepts bank loans as collateral, it must be established that the debtor fulfils the Eurosystem's high credit standards. As well as the debtor's own credit rating, guarantees provided by financially sound guarantors may also be considered as an alternative.

... defined as minimum rating of A- corresponding to a 0.10% one-year default rate ...

The Eurosystem requires that eligible assets – both marketable and non-marketable – have a long-term external credit rating of at least A-.[12] To ensure comparability between ratings by rating agencies (external credit assessment institutions) and other sources, a threshold value of 0.10% for the (expected) annual probability of default was set. This value – based on the definition of default under the new Basel Capital Accord (Basel II) – is deemed a fair equivalent for the classification of eligible debtors.

11 See the European Central Bank press release from 22 July 2005, Review of the Eurosystem's Collateral Framework: Inclusion of non-marketable assets in the Single List.
12 This means a long-term rating of at least A- from Fitch or S&P, or A3 from Moody's.

... assessed by means of NCBs' credit assessment systems ...

Until now, the assessment of debtors' eligibility was carried out exclusively by the Bundesbank (or a few other national central banks which also have banks loans in their tier two lists) using its own credit assessment system. The Bundesbank, the Banco de España, the Banque de France and the Oesterreichische Nationalbank currently operate such systems and will continue to do so. The Bundesbank's system is used to assess the eligibility of German non-financial enterprises. The system uses model-based processing of quantitative and qualitative data or features and draws on the enterprises' annual accounts as the key source of financial information.[13]

... and in future three other credit quality assessment sources

With the inclusion of bank loans in the single list as from 2007, three other credit quality assessment sources will be accepted, with no differentiation of rank between the sources. The underlying Eurosystem Credit Assessment Framework (ECAF)[14] contains techniques and rules designed to ensure that the principles of accuracy, consistency and comparability are guaranteed between the sources and within the individual sources. The following alternative credit quality assessment sources are available.

External rating agencies

Rating agencies (external credit assessment institutions – ECAIs) may be used for the credit assessment.[15] In order for an ECAI to be accepted for refinancing purposes it must have obtained formal recognition under the Basel II framework by the competent national supervisory authority within the EU. It must also fulfil the Eurosystem's operational criteria, for example, with regard to the accessibility of the information.

Credit institutions' internal ratings-based (IRB) approaches

Under Basel II, credit institutions may use internal ratings-based approaches (IRB approaches) to calculate their regulatory capital provided that the IRB approach has been approved by the relevant supervisory authority. From 2007,[16] the credit institutions may apply to use these approaches in addition to assess debtors' credit quality for refinancing purposes.

Third-party rating tools (RTs)

As not every Eurosystem national central bank has an in-house credit assessment system (ICAS), credit institutions without an IRB approach may use rating tools. These are standardised assessment processes operated by the well-known international rating agencies. They assess the debtors' credit quality on the basis of quantative balance sheet data and can be purchased on the market as software packages. A rating tool must be accepted by the Eurosystem in order to qualify as a credit quality assessment source.[17] However, based on the information currently available, the Bundesbank predicts that the German credit institutions will not make much use of this option as their requirements for refinan-

13 For further details see the Deutsche Bundesbank, How the Bundesbank analyses enterprises' creditworthiness, Monthly Report, September 2004, pp 59-72.
14 See the European Central Bank press release from 22 July 2005, Review of the Eurosystem's Collateral Framework: Inclusion of non-marketable assets in the Single List.
15 The Bundesbank will notify the credit institutions concerned of the accepted external credit assessment institutions.
16 This applies to the Foundation IRB Approach; the Advanced IRB Approach is not likely to receive supervisory approval until after 2008. For further information on Basel II and the IRB approaches see, for example, the Deutsche Bundesbank, New capital requirements for credit institutions (Basel II), Monthly Report, September 2004, pp 73-98.
17 The Bundesbank will notify the credit institutions concerned of the eligible rating tools.

Classes of public sector debtors in Germany and their credit rating

Class of debtor	Treatment with regard to credit rating
1 State and local government/municipalities which, pursuant to the competent banking supervisory authority, are treated in the same way as the Federal Republic of Germany with regard to their capital adequacy requirements	Generic rating corresponds to the rating of the Federal Republic of Germany
2 Other public sector entities which, pursuant to the competent banking supervisory authority, are treated as banks with regard to their capital adequacy requirements	Generic rating one level below that of the Federal Republic of Germany
3 Any other public sector entities which do not come under class 2 (eg publicly owned commercial entities)	Treated as private non-financial corporations

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cing are already largely covered by IRB ratings and Bundesbank ratings (where appropriate, supplemented by ratings from external credit assessment institutions).

Choice of principal credit assessment system

Credit institutions must select a principal system for assessing debtors for a period of at least one year. This system should capture the majority of the credit institution's debtors. Each credit quality assessment source – rating agencies, national central banks, IRB approaches, rating tools – comprises several credit assessment systems (for example, the NCB in-house credit assessment system source currently consists of the systems operated by the Bundesbank and the central banks of Spain, France and Austria). In certain cases and upon request, more than one credit assessment system may be used, in particular, in order to achieve better coverage of the credit assessment of the debtors. Thus, if, for example, a German credit institution selects the Bundesbank's in-house credit assessment system as its principal system, it may apply to use another eligible system for its foreign debtors, ie another NCB system, an external credit assessment institution or a rating tool.

Regular performance monitoring via the "traffic light approach"

The Eurosystem will monitor the performance of the credit assessment systems chosen by the credit institutions using a so called traffic light approach.[18] This ensures the comparability of all credit assessment systems and compatibility with the Eurosystem's risk rules. Monitoring will take the form of an *ex post* comparison of the respective system's actual default rate against the benchmark value of 0.10%. The traffic light approach provides for graduated correction measures. Depending on the extent to which a system has failed to meet the requirements, an individually-tailored, stricter benchmark value will be set. The temporary or permanent exclusion of an assessment system is an option only in extreme cases. The exact structure of the traffic light approach and the quantification of the individual areas have not yet been completed and will be announced in the course of the year with a revised version of the "General Documentation".[19]

18 The credit assessment systems of the (four) national central banks have been subject to such a review since the start of monetary union.
19 The revised version will replace the current version of the European Central Bank document "The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures", February 2005.

Non-rated public sector entities

There will be a separate solution based on the Basel II rules[20] for public sector debtors for which neither an external rating nor an assessment by the credit institution's chosen system exists. This solution distinguishes between three classes of public sector debtor (see table on page 36). Class 1 includes state government and local government (municipalities). These are given the same credit quality rating as their central government provided that the banking supervisory authority treats them in the same way as the central government with regard to their capital adequacy requirements. Class 2 includes other public sector entities (PSEs) provided the loans granted to them are treated as loans to banks in terms of risk weighting – ie comparatively low risk rating. Otherwise, other public sector entities come under debtor class 3. The rating of debtors in class 2 is derived from the central government rating, but is one rating notch lower. This means that the central government must be rated at least AA in order for the class 2 public sector entities to be eligible, too. By contrast the assessment of class 3 is performed on a case-by-case basis in the same way as that of private sector debtors as the debtors in this class are for the most part commercial entities owned by central, state or local government.

Efficiency-enhancing measures by the Bundesbank as regards the acceptance of bank loans

In the light of the inclusion of bank loans in the single list, the Bundesbank's credit assessment procedure[21] has been made more customer-friendly to ensure that the high standards of quality for collateral continue to be met. One particular measure is the production of graded credit quality ratings to replace the former two categories of "eligible" and "ineligible". In order to secure the statistical robustness and the informative value of the analysis, there will be a greater sectoral breakdown so that the default probability of individual enterprises can be appropriately classified within the context of the respective branch. Furthermore, the Bundesbank will prepare its balance sheet assessment in the form of a standardised "fact sheet". Together with the Bundesbank's in-house rating (credit quality assessment), this provides the enterprises with a transparent view of their assessment results compared with those of other enterprises in the same sector.

Quality assurance adjustments to the credit assessment procedure ...

... with customer-friendly transparency, ...

As far as the submission of bank loans is concerned, the Bundesbank is planning to switch from the current practice of pledging to undisclosed assignment from 2007 at the latest. This move has been welcomed by market participants. It will do away with the cumbersome and – from the credit institutions' point of view – bothersome debtor notification as this is not a requirement for the validity of assignment under German law.

... transition from pledge to undisclosed assignment and ...

20 The approach will also take into account the additional work towards the implementation of the New Basel Capital Accord (Basel II) in the EU Capital Requirement Directive. When allocating the debtor to a particular class, the banking supervisors will consider any special features of the public sector entity which reduce the risk of default, such as the right to collect taxes and institutional arrangements.

21 For further details see the Deutsche Bundesbank, How the Bundesbank analyses enterprises' creditworthiness, Monthly Report, September 2004, pp 59-72.

... convenient submission procedure

Finally the Bundesbank – with the involvement of market participants – is developing a new electronic procedure for the submission and administration of bank loans. The procedure will be known under the acronym of KEV (*Kreditforderungen – Einreichung und Verwaltung*) and uses a web-based platform with interactive online interfaces to the credit institutions, which does not require any special software or hardware on the part of the customers.[22] In addition, a file-transfer mechanism will be available for transmitting several bank loans to the Bundesbank in a single file. This will replace the conventional, paper-based submission from 1 January 2007. Moreover, the new procedure will enable the Bundesbank to process the bank loans swiftly, making them promptly available to the credit institutions as collateral for monetary policy operations and payment-related operations.

A single list of collateral from 2007

As a result of these decisions, the Eurosystem's existing two-tier collateral framework will be replaced by a single list of collateral on 1 January 2007. This reflects the changes in the structures of the financial and banking markets and complies with the criteria of transparency and competitive neutrality. The comments received from the market participants in the public consultation were also given due consideration. The Eurosystem has considerably extended the spectrum of eligible assets, in particular, with the inclusion of euro-denominated debt instruments from the USA, Japan, Canada and Switzerland and the acceptance of bank loans as collateral throughout the euro area. A significant aspect for the German credit institutions is the fact that the new single list of collateral provides them with a larger volume of eligible bank loans. To ensure that they can be used flexibly both for the collateralisation of central bank loans and in payment systems, the Bundesbank, in consultation with the German market participants, is accompanying this step with various measures designed at enhancing efficiency.

22 In order to ensure a secure data transfer, access is via the ExtraNet, the Bundesbank's e-business platform, which is also used for the credit institutions' prudential and statistical returns.