Yves Mersch: Towards a new collateral landscape

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the 2nd Joint Central Bank Seminar on Collateral and Liquidity, hosted by the ECB and the Deutsche Bundesbank, Hamburg, 17 September 2014.

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Introduction

Ladies and gentlemen,

It is a pleasure to open the second day of the Second Joint Central Bank Seminar on Collateral and Liquidity, hosted by the European Central Bank (ECB) and the Deutsche Bundesbank. I will reflect on the developments we are seeing in what is often referred to as the "new collateral landscape" and, in particular, consider the role central banks have played and can continue to play in order to help shape this new landscape. In this regard I will concentrate on the 1) eligibility, 2) availability and 3) mobility of collateral assets, as these elements represent some of the key subjects in the unfolding collateral landscape.

Looking back at developments in recent years, it is clear that the financial crisis and the accompanying regulatory reforms have assigned a more prominent role to collateral and placed greater emphasis on high-quality assets in general. We have seen a clear shift away from the use of unsecured funding in favour of secured funding in the money markets. This structural change alone has created new issues and challenges and it is having a significant impact on demand for collateral assets and the way monetary policy is implemented and transmitted.

One of the key topics of discussion two years ago at the First Joint Central Bank Seminar on Collateral and Liquidity, was the growing demand for collateral. At that time, concerns were emerging that collateral was becoming scarcer, with expectations that demand would substantially outpace supply. These concerns were mainly fuelled by upcoming regulatory changes, the details of which were not fully elaborated at that time. Another prominent topic was the importance of collateral for central banks. In response to the crisis, many central banks had broadened their collateral frameworks to support their counterparties in accessing central bank funding given the problems with the availability of market funding. Taking the various elements together, there was general agreement that demand for collateral assets would indeed increase in the forthcoming years and hence collateral would become relatively scarcer, although an absolute collateral scarcity was unlikely. A subsequent study carried out by the Basel Committee on the Global Financial System (the CGFS) and published in 2013 reconfirmed this view, noting that while this increase in demand could lead to "temporary shortages in some countries", concerns about an absolute shortage of high-quality collateral assets appeared unjustified, given that the supply of collateral assets had risen significantly since the end of 2007.

Today, almost two years after the First Joint Central Bank Seminar, a new set of issues related to this relative scarcity of collateral is coming to the forefront. The regulatory framework is becoming clearer, but concerns are being raised about the impact of the new post-crisis regulatory regime on the financial system.

Eligible collateral

First, I would like to focus on the aspects related to the eligibility of assets for use as collateral in central bank credit operations.

As you well know, collateral eligibility criteria are defined by central banks first and foremost to protect central banks, and ultimately taxpayers, from the credit risk inherent in their credit operations with commercial banks. The Eurosystem is very clear on this aspect and the "adequacy" of assets for use as collateral is stipulated as a condition for lending in Article 18.1 of the Statute of the European System of Central Banks. The legal interpretation in this respect is clear and consistent. This concept of adequacy focuses on the "qualitative" aspect of assets that may be used as collateral with the Eurosystem. The adequacy of collateral in this respect is ensured via the following pillars: (i) market valuation should be the rule whenever possible, (ii) proper legal due diligence both as regards the asset to be accepted as collateral and also as regards the collateralisation technique used (iii) there should be minimum credit quality requirements and stringent rules and performance monitoring for all systems used to assess the credit quality of eligible assets and (iv) risk control measures, normally in the form of haircuts.

Another point I would like to emphasise is that the Eurosystem has been working to mitigate inherent pro-cyclicality in its collateral framework by extending it, by aiming at calibrating risk parameters over a medium-term horizon, avoiding strong reactions to temporary market movements, and eliminating cliff effects and broadening its acceptance of credit risk assessment systems.

I would also highlight that the Eurosystem's collateral framework which should cater for a level playing field in the euro area through a Single List of eligible assets, is an important factor in promoting the standardisation and harmonisation of relevant laws in Europe. The Eurosystem often has to face the fact that different aspects of securities laws in Europe are not yet properly harmonised. The Eurosystem eligibility criteria often de facto shape national and European rules. In the discussion on high-quality securitisation, the eligibility criteria of the Eurosystem could be a good starting point for future regulation.

Availability of collateral

Moving on, I would like to speak about the proportion of high quality assets that is effectively available to market participants.

With the greater reliance on collateralised funding and regulatory reforms undertaken in response to the financial crisis, it is clear that the share of banks' assets that are encumbered is rising. This intensifies the need for greater visibility regarding the amount of high-quality assets actually available for use as collateral or for regulatory purposes.

In a recently-published study, the ECB compared data for the overall global supply of high-quality assets with the share of such assets effectively available to the market. On the basis of existing data, the study concluded that the overall global supply stands at the equivalent of around €41 trillion. However, a significant proportion of this overall supply, representing at least 25%, was identified as being blocked on safe-keeping accounts of investors or central banks for policy-related purposes – so-called "idle securities". The availability of assets was also found to be constrained by shortcomings related to settlement arrangements, bringing the total for available high quality assets to an amount closer to the equivalent of €29 trillion – some €11 trillion less than the figure I referred to at the outset.

Overall this still leaves a sufficient buffer of high-quality assets available for market participants. Currently, collateral usage is the equivalent of around €10 trillion and it is expected that the increased demand due to mandatory CCP clearing and other regulatory reforms would be at most in equivalent of between €2-4 trillion. Nonetheless, we need to take into account that the available assets may not be equally available to all market participants in all regions. It is therefore important to monitor trends and developments in this area. In this respect, securitisation could be the appropriate relief. The recent joint paper by the ECB and the Bank of England (BoE) on the need for regulatory changes in the treatment of asset-backed securities (ABS) is also to be considered here.

The ECB is currently exploring aspects related to collateral velocity – in other words the rate of use and reuse of collateral. Some studies[1] have estimated that collateral is reused around three times on average, however, there are indications that this rate has declined since the onset of the financial crisis. As such, further work could provide a clearer picture across a wider range of assets and markets, with triparty collateral management systems serving as a good starting point to better grasp the rate of reuse in secured financing markets.

Another important element that affects the availability of collateral assets is settlement arrangements and, here again, the Eurosystem is working with the market to see how enhancements to settlement arrangements could overcome existing inefficiencies. Given that settlement arrangements influence both the availability and mobility of collateral, I will move on to the topic of mobility and address settlement arrangements in parallel.

Mobility of collateral

An important function of collateral in financial markets is that it should have the capacity to "change hands" when needed. Thus, collateral should be mobile. Inefficiencies in settlement arrangements, however, including at the level of financial market infrastructures, reduce the amount of assets that can be quickly mobilised and, therefore, the overall availability of collateral assets. The Eurosystem, like other central banks, therefore supports and fosters initiatives that contribute to improving the availability and mobility of collateral, without overlooking the need to preserve transparency and legal certainty.

Let me mention first the initiatives within the Eurosystem itself – TARGET2-Securities (T2S) being the most notable. The launch of T2S will make securities settlement – including collateral mobilisation – safer and more efficient for market participants and central banks alike. With the migration to T2S, a number of operational barriers which currently exist for cross-border settlement will be removed and operational friction will be reduced, allowing collateral to move more easily from where it is, to where it is needed. T2S will be an important piece in the "mosaic" of post-trade settlement. T2S will overcome the technical difficulties encountered today in quickly transferring collateral assets. The common and extended settlement timetables across T2S markets will also support more efficient mobilisation and management of collateral assets and, in this way, T2S is a crucial step to a better functioning financial market, at least from an operational point of view.

The Eurosystem has also taken initiatives in relation to the services for mobilisation of collateral for its own credit operations. One of the most significant developments in this respect is the introduction of support for cross-border triparty collateral management services which will go-live towards the end of this month. Triparty collateral management services, as many of you well know, allow institutions to manage their assets via a triparty agent and are ultimately targeted towards optimising the use of clients' assets. With the incorporation of these services into the Eurosystem framework on a cross-border basis, they will become operationally accessible to all Eurosystem counterparties, regardless of the location of the counterparty or the respective triparty service. This has raised a set of issues, primarily related to legal implementation, which also needed to be addressed. Once live, this enhancement will offer Eurosystem counterparties the ability to manage their overall collateral holdings in a more flexible and efficient manner and to flexibly switch their collateral between central bank refinancing and interbank market financing.

Central banks of course have not been alone in taking initiatives over the last few years. On the market, we have seen huge progress in the range and sophistication of services on offer to clients. A new report from Basel covers developments in collateral management services

[1] See, for example, "Velocity of pledged collateral: analysis and implications", Working Paper No 11/256, IMF, November 2011.

across G20 countries and takes stock of the existing and upcoming services in this field.[2] The many benefits gained from the innovation of service providers and the collaboration among them can be welcomed by central banks, as they allow for better information on collateral, better access to collateral and better mobility of available securities. Indeed, it is doubtful whether market participants would cope with temporary shortages of collateral arising from the regulatory reforms without the innovation that helps in the distribution of collateral. On the other hand, the increased sophistication of such services also implies increased complexity, increased operational and legal risks and, most notably, increased interdependencies stemming from new linkages between service-providing firms. A shortage of collateral or an inability to transfer collateral promptly can in some cases be an early indicator of liquidity problems or an even deeper set of issues. Close cooperation with competent supervisory and oversight authorities is therefore warranted, as the legal heterogeneity still impedes a fully functioning internal market.

Conclusion

Let me conclude.

As I mentioned at the outset, we have already observed a significant change in the collateral landscape over the last few years and it is a landscape that is continuing to evolve. In particular, key regulatory reforms have yet to make a real impact in the market and innovation in post-trade arrangements will be further pursued by the public and private sectors alike. Although the overall global supply of high-quality assets appears substantial, existing regional imbalances mean that we cannot become complacent. We must also continue to be vigilant regarding issues affecting availability and mobility, and take actions that address the factors that hamper the fluid transfer of assets, without mistaking liquidity and solvency issues for market inefficiencies.

In Europe, the T2S project has made significant progress and, when implemented, it will be a significant step forward. T2S allows for more efficient cross-border collateral flows so that collateral in one country will be easily accessible in other countries. This also offers possibilities for establishing linkages between T2S Central Securities Depositories (CSDs) and those from other geographical areas, which could ultimately lead to the creation of a more global network for the mobilisation of collateral assets. This type of global reach will make it more attractive to connect to Europe. In view of the planned discussion on bringing the right collateral to the right place at the right time, I will leave you with these suggestions for further reflection and I look forward to receiving feedback on your deliberations in due course.

I would like to end by wishing you an enjoyable second day of the seminar, with lively and fruitful discussions and I look forward to further cooperation among central bankers on the topic of collateral in all its forms in the months and years ahead.

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[2] See the CPMI report on collateral management services published on 8 September 2014.