

Second collateral pool

Introduction and associated framework

September 2013

DeNederlandscheBank

EUROSYSTEEM



Agenda

1. Second collateral framework *(Pieterjan van der Zwan)*
2. Legal implications *(Jeanine Palstra)*
3. Operational consequences *(Jacco Schreuder)*
4. Q&A

Second collateral framework

Overview

1. Why a second collateral framework?
2. Comparable collateral frameworks in the market
3. The current collateral framework
4. Amendments to the monetary framework and impact

Why a second collateral framework?

There are several reasons for setting up a second collateral framework:

1. The objective of the other services is different from the monetary tasks.
2. The broad eligibility of the current monetary framework combined with, in some cases, insufficient risk control measures.
3. The potential losses incurred for other collateral services are borne solely by DNB.
Own risk → own decision.

Comparison with other collateral frameworks

Rough classification of accepted type of collateral by framework (may differ by jurisdiction)

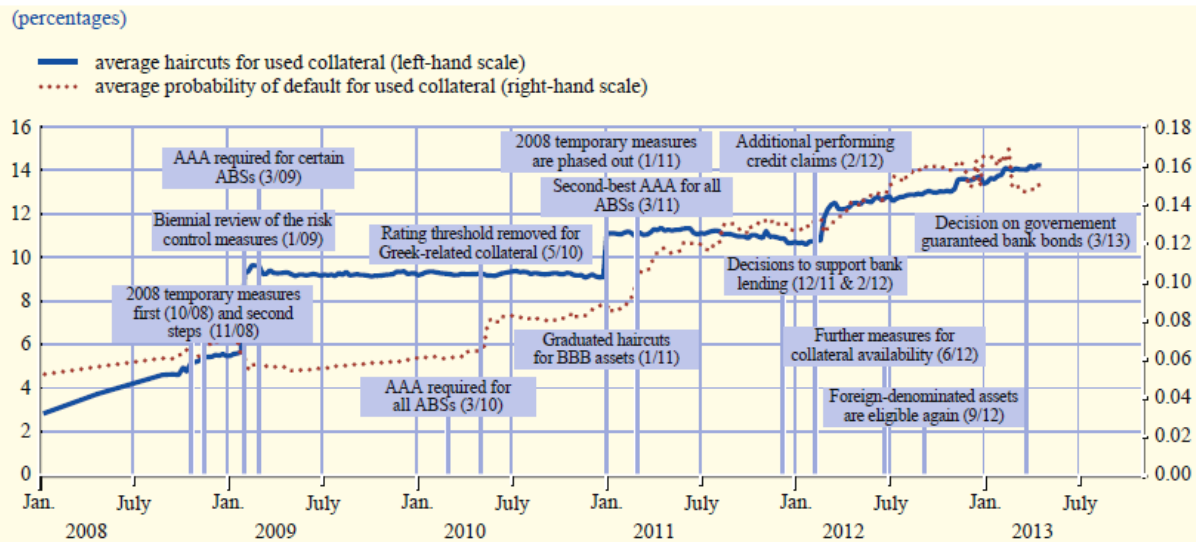
Collateral	Central Bank		Regulatory	CCP-repo	CCP-margin
	Broad	Narrow			
Marketable					
<i>Government (guaranteed)</i>	•	•	•	•	•
<i>Covered bond</i>	•	•	•	•	
<i>Corporate bond (incl fin.)</i>	•	•	•	•	
<i>Asset backed security</i>	•				
<i>Equity / Gold / MMF</i>			•	•	•
Non-marketable					
<i>Credit claims</i>	•		•		
<i>Cash / FTD</i>	•		•		•

Four pillars of the collateral framework

Dimension	Description
Eligible counterparties	Counterparties eligible for Eurosystem monetary operations must fulfill certain operational and prudential requirements defined by the ECB. Eligible counterparties must be financially sound.
Eligible assets	Marketable and non-marketable assets that fulfill uniform euro area-wide eligibility criteria specified by the ECB are eligible as collateral for monetary policy transactions.
Asset Valuation	To calculate collateral value, valuation haircuts are applied by deducting a certain percentage from the market value of the assets. This percentage depends on the asset, the credit quality category as well as the residual maturity.
Risk controls	-Variation margins -No close links

Broader eligibility of the monetary framework

Chart A Average haircuts applied to the collateral used by counterparties in Eurosystem monetary policy operations (weighted by the amount of collateral used, after valuation and before the application of haircuts)¹



Source: ECB.

1) Average haircuts for used assets are calculated as follows:

$$\frac{\sum (\text{Amount used after valuation and before haircuts} * \text{valuation haircuts})}{\sum (\text{Amount used after valuation and before haircuts})}$$

Objective for refining the framework

Objective: establish a floor for credit and liquidity risk

1. Prevent credit risk deterioration
2. Improve the liquidity profile
3. Decrease correlation between equity of the counterparty and quality of collateral

Temporary measures Eurosystem

The temporary measures of the Eurosystem:

1. Lowering credit risk tolerance from A- to BBB- *;
2. Lowering rating threshold for OMT /EU-IMF countries;
3. Other currencies marketables (USD, JPY and GBP);
4. Fixed-term deposits (SMP liquidity sterilisation)*;

Two of which have not been implemented by DNB:

5. BBB-rated ABS (asset-backed securities) and
6. Additional Credit Claims (ACC).

* Introduced as a temporary measure and later included in the permanent framework

Weaknesses of the current framework

The weaknesses of the current framework are:

1. Correlation between the quality of the counterparties and of the collateral:
 - a) *Uncovered bank bonds (UBB) including government-guaranteed bank bonds (GGBBs);*
 - b) *Own-use transactions (also called retained collateral)*

2. Liquidity and valuation risks of non-marketable

Amendments second collateral framework

Amendments for the second collateral framework to address risks from the temporary measures and weaknesses of the monetary framework.

Table showing step-up measures for second framework and their impact:

Step-up measures referring to the monetary framework	Impact collateral (bln)
a) increase lowest credit rating threshold from BBB- to A-	-0,5
b) exclude assets from countries with a rating waiver	0
c) exclude other currencies	0
d) exclude uncovered bank bonds including government guaranteed bank bonds	-0,8
e) exclude credit claims without a government guarantee	-0,03

The second collateral framework will be annexed to new contracts. Implementation of the second pool per 4-11-2013 and monitoring based on the second framework as of 2-1-2014.

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Legal implications

Overview

1. Legal documentation that has been amended
2. Amendments General Conditions
3. Legal set-up two collateral pools
4. New declaration of agreement
5. Sending documentation to counterparties

Legal documentation that has been amended

Mainly:

- General Conditions of DNB

In addition:

- Monetary Policy Transactions Conditions (MPTC)
- TARGET2-NL Conditions
- HAM Conditions
- CB-NL Conditions

Amendments to general conditions

1. Legal set-up two collateral pools:

Add provisions to the General Conditions of DNB to ensure that proceeds of a certain share of the collateral that counterparties have mobilised with DNB, can be attributed to monetary and intraday claims and another dedicated share can be attributed to other claims of DNB on its counterparties.

2. Other amendments General Conditions:

Modernisation, no material content amendments.

Legal design of two collateral pools

Claims of DNB on its counterparties are divided into two categories:

1. Claims on account of monetary policy transactions and intraday credit (monetary/intraday claims)
2. Claims on account of other purposes (other claims)
 - **Collateral for monetary/intraday claims:** assets which fulfil the eligibility criteria of the Eurosystem as defined in the General Documentation (monetary pool assets) and the MPTM, and which are administered by DNB on an account on behalf of the counterparty with label “monetary pool”.
 - **Collateral for other claims:** assets which fulfil the requirements of the new collateral framework (second pool assets) and which are administered by DNB on an account on behalf of the counterparty with label “second pool”.

Legal set-up of two collateral pools

- Assets in the monetary pool are primarily attributed to monetary/intraday claims.
- Assets in the second pool are primarily attributed to other claims.
- Any surplus after settlement of claims in one category can be used to settle claims in the other category

Legal set-up of two collateral pools

New articles in the General Conditions:

- Articles 9 to 12 General Conditions DNB
- Other than in the current General Conditions, the arrangement is described in several provisions to make a clear distinction between the two categories of claims and assets and to provide a more logical grouping.
- Article 9: Collateral for Monetary Pool Assets
- Article 10: Collateral for Second Pool Assets
- Article 11: Establishment of Pledges
- Article 12: Exercise of powers relating to collateral

Legal set-up of two collateral pools

Article 11 – Establishment of Pledges

Article 12 - Exercise of powers related to collateral

- No material change from the regulation of the same topics in the current Article 8 of the General Conditions of DNB
- Changes mainly in terms of terminology

Legal set-up of two collateral pools

Article 9 - Collateral Monetary Pool Assets

- Controls the allocation of the proceeds of the monetary pool assets to monetary/intraday claims.
- According to the new second paragraph of Article 9, the proceeds of Monetary Pool Assets shall first be applied to settle Monetary/Intraday Claims.
- Insofar as a surplus remains from these proceeds after these claims have been settled, this surplus shall be used to settle the other claims.

Article 10 - Collateral Second Pool Assets

- Describes allocation of proceeds of the Second Pool Assets to other claims
- According to the new second paragraph of Article 10, the proceeds of Second Pool Assets will firstly be applied to settle Other Claims.
- Insofar as a surplus would result after settling these claims, this surplus will be used to settle monetary/intraday claims.

Legal design of two collateral pools

- System whereby the desired distinction between the two categories of claims is achieved by a division in the way the proceeds of the pledge rights are distributed.
- In both cases, any surplus shall be used to settle claims from the other category

New declaration of agreement

- Establishment of new pledge rights on assets in the Monetary Pool and in the Second Pool
- New declaration of agreement and pledge agreement required
- No change compared to previous agreement
- New declaration of agreement (unchanged text) will be sent to counterparties in September
- Request to return signed agreement as soon as possible to ensure valid pledge rights have been established

Individual agreements with counterparties

- Second collateral pool serves primarily to secure other claims arising from non-monetary services provided by DNB
- For these other services, agreements have been entered into between DNB and the counterparties concerned.
- These agreements will be amended by DNB to the new situation that will apply from 4 November.
- These agreements will be sent to the relevant counterparties for signing in the course of September.
- Counterparties are requested to sign and return the agreements at their earliest convenience.

In the course of September, the relevant counterparties will receive the following (amended) documentation:

- General Conditions of DNB
- Declaration of consent and deed of pledge for signature
- Monetary Policy Transactions Conditions (MPTC)
- TARGET2-NL Conditions
- Conditions HAM
- Conditions CB-NL
- Adjusted agreements on non-monetary services DNB for signing

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Overview

1. Reason
2. Monetary activities
3. Non-monetary activities
4. What is required for the second collateral account?
5. What are the changes for Dutch banks?
6. Testing
7. Introduction

Operational consequences of a second collateral account

Reason:

- The DNB Executive Board has decided to separate monetary activities from non-monetary activities.

Result:

- Division of these activities into two collateral accounts.

Monetary activities

1. Open market operations:
 - a) *Liquidity providing tenders*
 - b) *Fixed-term deposits*
2. Credit facility in TARGET2
3. Reservation for TARGET2 Contingency Module

Non-monetary activities

- Guarantee to CCPs (e.g. LCH Clearnet)
- Banknote consignment
- Provision for EBA STEP2 (SEPA Direct Debit Credit Banks)
- ERMS services (deposits)

What is required for a second collateral account?

Actions DNB:

1. DNB opens new collateral account (6000 series)
2. DNB sends all confirmations and current account to BIC of second collateral account
3. DNB requests data from the counterparties on second collateral account:
 - a) *Unique BIC (preferably a BIC11)*
 - b) *Approval of corporate actions to Target2 account from first collateral account*
 - c) *Which BIC is used for sending the instructions?*

Changes for a counterparty regarding the second collateral account

- The instructions remain almost the same. Only in field 97A::SAFE// the correct collateral account number must be used (example: 97A::SAFE//6500)
- DNB sends the confirmations and the current account (MT535) to the BIC of the second collateral account.
- If the counterparty opens a second collateral account, the counterparty will receive 2 daily Statement of Account's.
- If the counterparty receives periodic emails with collateral value, the counterparty will as of now receive two emails.

Testing second collateral account

- The testing of the second collateral account is voluntary and at the initiative of the bank.
- Testing is possible in the first half of October 2013 (from 30 September to 11 October)
- The deadline is Friday 20 September 2013 (mail to collateral_management@dnb.nl)

Introduction of a second collateral account

- On 4 November 2013, the second collateral account should be operational.
- Mobilisation of collateral is possible as of 28 October 2013.
- From 28 October - if collateral is sufficient - DNB will transfer the blocked amounts from the first to the second collateral account.
- Sufficient collateral must be deposited by Friday, 1 November 2013 at 12 noon.
- On 4 November, the guarantees of LCH Clearnet will be charged to the second collateral account.

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