Using securities for mobilizing credit claims

Credit claims represent a significant and resilient source of collateral with central banks. However, their use as collateral is unequally distributed among the different jurisdictions, is close to *nil* in a cross-border context as well as on the interbank market. At the same time, financial institutions are facing increasing needs of collateral. Furthermore, the overall banking community as well as public institutions are seeking for innovative solutions stimulating the credit provision to non-financial counterparties ("NFCs") and in particular to small and medium-sized companies (SMEs).

Considering the above, analyses have been carried out by the French market place to identify the conditions under which the use of credit claims as collateral could be increased especially between credit institutions. In that respect, the market initiative promoted by the French market place, including the French banking Federation (FBF) and several major international banks active in France in the course of 2013 can contribute to this objective, by defining a new way to mobilize credit claims in the form of securities.

More specifically, the scheme described in this paper aims at allowing for the mobilization of eligible credit claims in the form of securities. The targeted population of credit claims encompasses the Eurosystem Single List credit claims only, i.e. loans with a high creditworthiness profile.

This scheme has directly benefited from the input of several working groups involving market participants (i.e. French credit institutions but also other European banks active in France and authorities), which have jointly designed the scheme. In this process, representatives from the securities regulatory authority and from the supervisory authority have also been associated to ensure that the envisaged scheme is compliant with the existing regulation. Besides, banks are expecting the Eurosystem analysis in or to determine the conditions under which this instrument could be considered as eligible collateral.

The project led by the French banking community has entered into its implementation phase. The vehicle will perform the first securities issuance by beginning 2014[1].

The following paper provides an overview of the expected benefits of the scheme (section 1) and details the main features of the securitisation vehicle (section 2).

[1] The French banking community has already selected the service providers, incl. the asset manager, the depository and the law firm in charge of setting up and running the SPV.

1. Business case and benefits of the scheme

The business case of this scheme lies in the observation that **credit claims are an underused source of collateral** (even if credit claims have proven to be particularly resilient since the start of the crisis) **and that an optimized use of credit claims would contribute to meet several general public policy objectives, including a positive contribution to SMEs' access to credit**.

Expected optimizations of the use of credit claims

Banks are currently facing increasing needs for collateral. In the short run, this phenomenon is related to an increasing demand of investors for secured transactions. In the medium term, banks will face increasing needs for good quality collateral in order to cope with regulatory requirements such as Basel 3 liquidity ratios and revised solvency ratio, EMIR regulation and tighter risk policies of CCPs. In that respect, increasing the overall amount of collateral that can be mobilized on the interbank market through the securitisation of credit claims will offer banks with more flexibility to manage their collateral baskets and hence address these additional needs.

At the same time, due to operational and legal constraints, credit claims are nearly unused as collateral in private transactions between credit institutions. Furthermore, their use is unequally distributed among jurisdictions and is nearly *nil* in cross-border situations.

The main reasons for this situation lie in the fact that in some jurisdictions, the **operational processes and legal framework** for mobilizing credit claims do not allow a massive usage of this collateral type. In particular, the **absence of efficient processes for collateralizing credit claims on a cross-border basis could be seen as a source of fragmentation.**

Considering that the current situation described above does not answer adequately banks' increasing needs for collateral, **new ways for mobilizing of credit claims need to be sought in order to facilitate the use of this collateral.**

In order to answer these needs, the scheme described in this paper aims at creating a **simple (no tranching) and transparent instrument that aims at being replicated in several jurisdictions:**

- The scheme could be particularly instrumental in countries where the use of credit claims is not widespread, either due to legal constraints for the direct mobilization of credit claims to the Eurosystem[2] or due to operational impediments faced by the central bank;
- The use of securities will also significantly ease the cross-border mobilization of credit claims.

[2] In particular, it seems that the legal constraint applicable in some jurisdictions, a prior notification to the debtor ahead of the credit claims' mobilization (which can be a barrier to a wider use of credit claims), would not apply in this kind of scheme thanks to legal exemptions. This element will have to be investigated further at a local level.

Expected contributions to general policy objectives

This scheme is fully in line **with several public policy objectives** as:

- It takes place in a context where solutions are sought by different private and public actors to foster credit provision to SMEs. **In this perspective, supporting a more efficient mobilization of credit claims as collateral contribute to increase the liquidity of this collateral and hence to ease credit provision to NFCs.**
- This scheme should contribute to **decrease the intermediation role of central banks and increase the available amount of collateral in private markets by making credit claims usable as collateral on the interbank market.** Indeed, the benefits for mobilizing credit claims via securities are also obvious for OTC transactions and can be included in baskets of collateral used for triparty collateral management services. A clear interest has already been expressed and repeated by significant market participants for this type of scheme, particularly by the major credit institutions currently working on the project but also by other market representatives such as the **European Repo Council** or the **European Covered Bond Council**.
- It is in line with the G20 objectives to **reduce dependency on rating agencies**, since the assessment of the collateral will be based on NCB's In-house Credit Assessment Systems (ICAS) or counterparties' Internal-Rating Based (IRB) systems (or rating tools), both being credit assessment sources already accepted by the Eurosystem. Relying on ICAS and IRB will hence ensure full independency vis-à-vis the rating agencies.

2. Detailed characteristics of the scheme

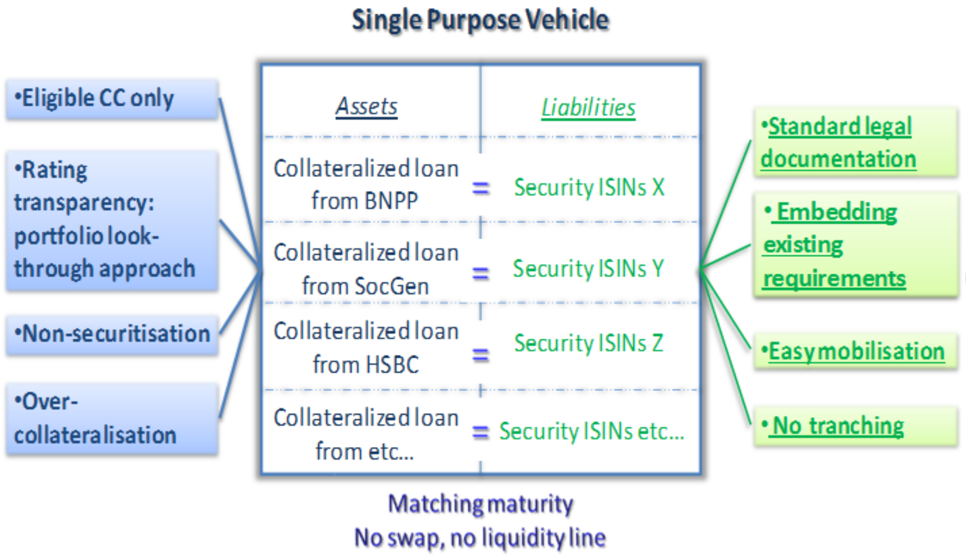
The following section provides a detailed description of the scheme being set up in France. Based on these features, similar schemes for the mobilization of credit claims in the form of securities could be replicated in the euro area.

The design of the scheme aims at keeping it simple, transparent and robust. The simplicity and transparency objectives aim at avoiding the introduction of biases in the transformation of eligible credit claims into securities. The robustness of the scheme lies in the fact that adequate measures are already embedded in its design, in order to address default situations and protect securities' holders in case such default ever materializes.

2.1 Features of the issuance

Basically, a single and standardized Special Purpose Vehicle (SPV) **is set up and shared by several banks.** Each participating credit institution has its own independent compartment(s)[3] in the single SPV . **Each compartment is bankruptcy remote from the other compartments of the SPV and is not submitted to any tranching.** The issuance process consists in the **issuance of securities by the credit institution dedicated compartment, these securities being secured by the credit claims** collateralized in favor of the considered compartment. These principles are detailed below and can be illustrated as follows in diagram 1.

DIAGRAM 1 - ILLUSTRATIVE VIEW OF THE VEHICLE'S STRUCTURE



In particular, regarding the **composition of the underlying portfolio securing the issuance**, the instrument is featured as follows:

- **Underlying credit claims are accepted under the conditions that they are fully compliant with the current permanent Eurosystem collateral eligibility criteria** (i.e. Single List – excluding Additional Credit Claims), which are defined in the General Documentation;
- Underlying credit claims are assigned to an intermediary bank as security interest by the originator as a guarantee to an intermediary loan (hereafter "the main loan"), provided by this intermediary bank to the originator[4]. As it is already the case for the direct mobilisation of credit claims with Eurosystem NCBs, all underlying credit claims have to be free from any right from a third party to be accepted as collateral of the main loan[5] and allow the realisation of the claims (with the attached rights and collateral)**.** The main loan is then be sold by the intermediary bank to the SPV's relevant compartment and the

[3] Each credit institution can have one or several compartments in the SPV as described below. The compartments of a bank are fully segregated from the compartment(s) held by other banks participating in the SPV, hence ensuring bankruptcy remoteness.

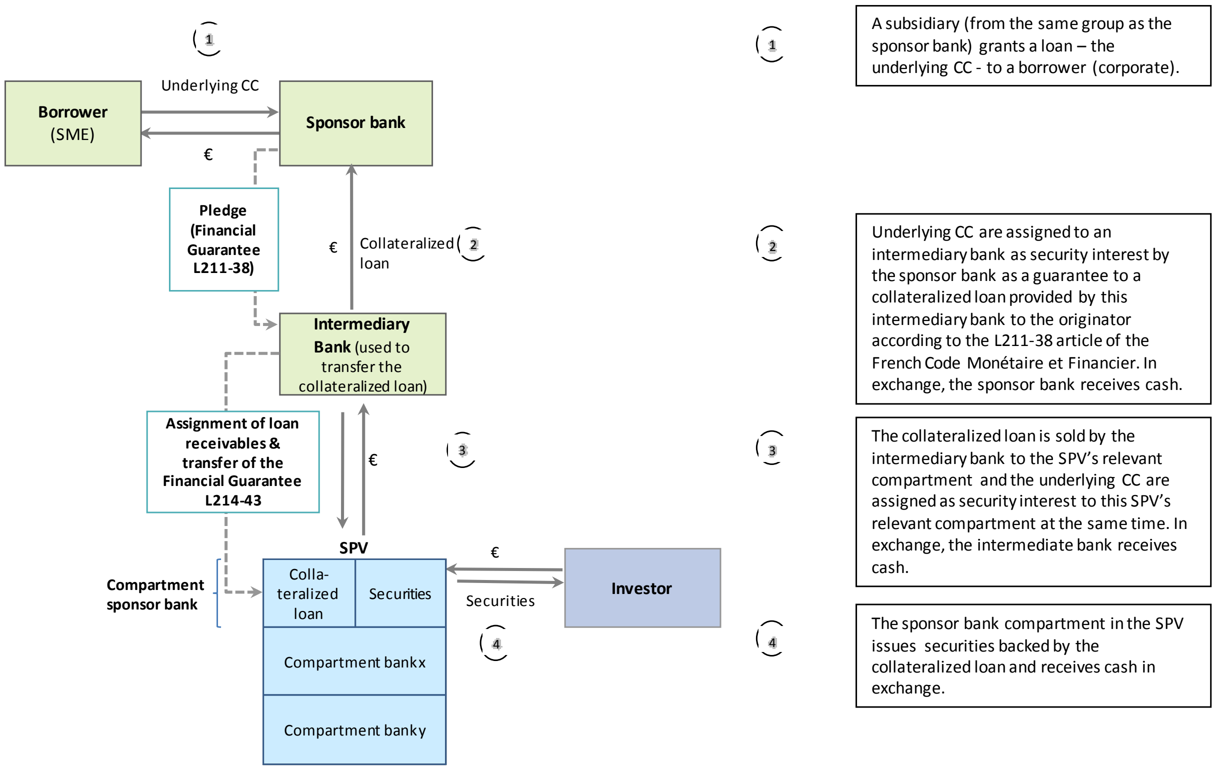
[4] French banks decided to structure the transaction by using an intermediary loan but this scheme can of course be adapted in other jurisdictions.

[5] Please note that when this condition (which will be a condition of eligibility in order, for a credit claim, to be accepted as collateral of the main loan) is met, the very protective regime set by the financial collateral directive will apply (e.g. article 4 of the directive requires the absence of any formal requirement for the enforceability of the collateral).

underlying credit claims are assigned as security interest to this SPV's relevant compartment at the same time. Once the loan is sold by the intermediary bank to the SPV, the intermediary bank is no longer involved in the transaction, which becomes a bilateral transaction between the SPV and the originator. The process can be illustrated as in Diagram 2 below (additional information on the roles of the different stakeholders can also be found in Annex A – Glossary).

DIAGRAM 2

CREDIT CLAIMS MOBILISATION TECHNIQUE USING THE COLLATERAL DIRECTIVE (TRANSPOSED IN FRANCE VIA THE FINANCIAL GUARANTEE - ARTICLE L211-38 OF THE FRENCH MONETARY AND FINANCIAL CODE)



- **This assignment to the SPV compartment is irrevocable and means that (i) the SPV owns once and for all the main loan granted from the intermediary bank to the originator and (ii) as a consequence, that it is granted a security interest in (temporarily, i.e. until the loan is reimbursed) the underlying credit claims (with the collateral attached to those claims, as the case may be). In case of a triggering event such as a default in the reimbursement of the main loan, from a legal point of view, the temporary ownership of the credit claims (with the collateral attached to those claims, as the case may be) becomes definitive (as foreseen by the financial collateral directive 2002/47/EC as amended by 2009/44/EC).** As owner of a loan secured by the credit claims, the SPV benefits from the protection provided by the financial collateral directive, and in particular from its article 8, which provides protection for the financial collateral, in case of insolvency. In principle - depending on national implementations of the financial collateral directive - the structure is expected to be legally sound in all EU jurisdictions, as is the case in France.

- The portfolio of underlying credit claims are transferred twice a week to the dedicated compartment of the SPV (by a cancel and replace mechanism) in order to allow the transfer of credit claims which have very short term maturity and protect the securities holders against risks of anticipated reimbursement of the credit claims (identical to the current framework currently in place for the direct mobilization of credit claims).
- A **minimum compulsory overcollateralization** of the portfolio is being defined. The overcollateralization of the underlying portfolio depends on the credit claims composing the portfolio and on the haircut applied on the issued securities (see also annex B). The compliance with portfolio minimum overcollateralization will be detailed in the legal documentation along the lines described below:
    - In case the portfolio is exceeding the minimum overcollateralization requirement, the issuance of additional securities is allowed;
    - In case the portfolio does not meet the minimum portfolio overcollateralization requirement, the financial institution either has to (i) anticipate the reimbursement of some securities, or (ii) add cash collateral to compensate the lack of credit claims in order to keep the securities eligible.

As far as the **securities issued by the dedicated compartment** are concerned, they are featured as follows:

- **The securities are fully backed by the main loan acquired by the compartment of the SPV.** The main loan is itself secured by the whole portfolio of credit claims transferred to the intermediary bank.
- **The securities are *pari passu* bonds (i.e. no tranching)**, with possible refinement of the bonds features per compartment, in order to allow the issuance of securities with different expected maturities[6].
- **The features of the securities matches (including in terms of expected maturity) with the features of the main loans acquired to the dedicated compartment of the SPV**, i.e. each security issued :
    - Has exactly the same features (e.g. interest rate, expected maturity) as the corresponding main loan secured by the credit claims;
    - Does not include any interest rate swaps nor FX swaps (or any kind of derivatives

[6] In that respect, the legal maturity of the securities will be probably longer and will in any case depend on the maturity of the underlying credit claims.

instrument).

- In order to allow compartment holders to issue securities with specific profile (e.g. for investment purposes), the compartment can issue securities that have an **homogeneous credit claims portfolio** (hence allowing differentiation between securities secured by SME credit claims and securities secured by PSE credit claims) via the opening of different compartments dedicated to one type of underlying assets (each of the compartments relying on a specific profile of underlying credit claims, including in terms of maturity). Each compartment is fully independent from the other.

  The securities issued by one dedicated compartment are all accelerated (monthly frequency and variable interest rate) in case of (i) default of the institution having provided the credit claims or (ii) of default/acceleration of one of the securities issued by the compartment (cross acceleration clause[7]). As the underlying assets (i.e. the main loans, secured with the portfolio of credit claims and backing the securities) belong to the SPV and are managed by a management company (the "société de gestion" in France), should a triggering event occur, the management company will have to realize the collateral in compliance with the contractual documentation of the SPV. In order to keep the transaction performing, this will require the designation of a back-up servicer in case of default, which will be in charge of ensuring the collection of payments.

2.2 Credit assessment of the collateral value and legal risk mitigation measures

Credit assessment and eligibility check of the underlying credit claims

As already mentioned, the vehicle is featured by the fact that the assessment of the underlying portfolio of credit claims is performed independently from the credit rating agencies' intervention. To that purpose, the detailed assessment of each credit claim will rely either on the Internal Credit Assessment System (ICAS) of a central bank (when available), on the sponsor bank IRB assessment or on other sources already accepted by the Eurosystem, such as rating tools or PSE ratings.

As regards the processing of this credit assessment information for the securitisation purposes, different options can be envisaged, i.e. either relying on the asset manager of the SPV that is fully entrusted of managing the credit assessment information provided by the sponsor banks[8], or relying on the central bank's intervention (in particular when the central bank's ICAS is used).

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[7] The cross acceleration clause will be applicable to the securities from a dedicated compartment of the defaulting counterparty (no cross-compartment/cross-counterparty acceleration). If the defaulting counterparty owned more than one compartment, each compartment will be accelerated separately.

[8] Of course, should an outsourcing be envisaged, this option should be subject to appropriate controls/contractual arrangements to govern such arrangement.

As far as the set up of the vehicle in France is concerned, the eligibility criteria and credit assessment of the credit claims are going through the standard infrastructure for the assessment of credit claims (already existing infrastructure provided by the NCB for the direct collateralisation of credit claims, i.e. "TRICP" facility –see annex C) **and the asset manager is entrusted with the task of ensuring the integrity of the securitization process on the basis of the information provided by the central bank (i.e. ensuring that the securities issued by the SPV are secured by the eligible credit claims only according to the information provided by the central bank).** This solution has the advantage of capitalizing on the existing IT facilities and processes for the direct mobilization of credit claims, hence allowing to reuse tools, communication channels and procedures already in place.

Credit assessment methodology

The following credit assessment methodology is followed. **The credit quality of the instrument is assessed by transparency**, that is to say directly by assessing the credit quality of the underlying portfolio just as if the underlying credit claims were directly posted as collateral.

This credit assessment methodology for the underlying portfolio of credit claims relies on the credit assessment sources currently accepted by the Eurosystem, i.e. the vehicle will rely on ICAS and/or approved IRB and/or PSE ratings or rating tools.

As far as the French vehicle is concerned, i.e. considering the fact that the central bank has a role in checking the eligibility of the credit claims (as mentioned above), after the SPV has received the composition of the portfolio from the sponsor bank, the asset manager transfers the detailed data on each credit claim of the considered portfolio to the TRICP facility. On the basis of the credit assessment retrieved from the central bank's ICAS (or from the IRB of the relevant banks), the Credit Quality Steps[9] (CQS 1 / CQS 2 / CQS 3) of the credit claims, the maturity bucket (0-1 year / 1-3 years / 3-5 years / 5-7 years / 7-10 years / >10 years) and the interest rate types (fixed/floating) are provided back to the SPV. The complied information is sent back to the asset manager and allows the latter calculating that the minimum overcollateralization is met.

Calculation of the collateral value (value after haircuts) and minimum level of underlying collateral oversize

The value after haircuts of the issued security is intended to be equal to the value after haircuts of the underlying credit claims. The scheme will rely on the following hypotheses:

- The haircut applied to the security is fixed at x% (x being strictly positive);

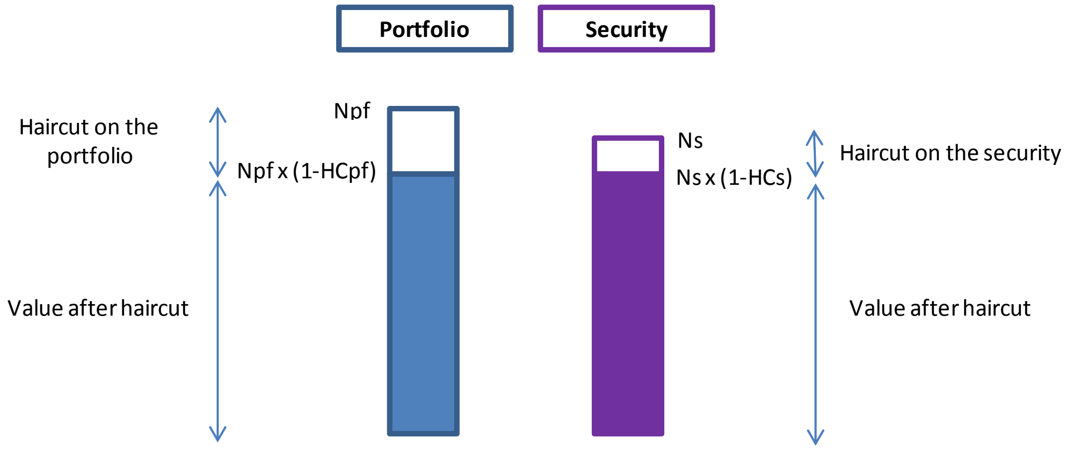
[9] http://www.ecb.int/paym/coll/risk/ecaf/html/index.en.html

- The underlying credit claims are applied haircuts according to the existing haircut schedule;

- The value after haircuts of the security should be equal to the value after haircuts of the portfolio.

Therefore, as the haircut on the security is strictly positive, the legal documentation of the vehicle will stipulate which minimum level of overcollateralization is required (see diagram 3 below).

DIAGRAM 3 - EQUIVALENCE BETWEEN THE VALUES AFTER HAIRCUTS OF THE PORTFOLIO AND THE SECURITY



Legend: Npf : notional of the underlying portfolio;

Ns : notional of the security;

HCpf : haircut of the portfolio (weighted average of the haircuts applied to each and every underlying credit claim);

HCs : haircut of the security (a pre-specified haircut according to the category of the security).

As the value after haircuts of the portfolio has to be at least equal to the collateral value of the security, the minimum over-sizing of collateral has to be the maximum of (i) 100%[10] and (ii):

$$(ii) = \frac{\mathrm{Npf}}{\mathrm{Ns}} = \frac{(1 - \mathrm{HCs})}{(1 - \mathrm{HCpf})}$$

The asset manager will calculate the minimum overcollateralization – on the basis of the credit quality distribution of the portfolio and of the haircut schedule for credit claims - and check that the minimum overcollateralization level is complied with at all times.

Legal risk mitigation measures

The legal documentation will ensure that all the risks linked to the mobilization of credit claims via a security are adequately addressed and that the securities holder will not incur specific risks from a legal point of view.

In particular, the legal documentation will ensure that t**he holder of securities, which are issued by a dedicated compartment, will have a dual recourse**, i.e. both on the underlying portfolio and on the financial institution holding the compartment.

In case of default of the credit claims servicer (i.e. the sponsor credit institution as this is almost always the case in a structured transaction), a **back-up servicer** will have to be appointed. Furthermore, all necessary actions will have to be taken to ensure that the cash-flow stemming from the underlying can keep on being collected in an orderly manner, even in case of the default of the originator bank. The obligation and the procedure to appoint a back-up servicer and deal with default situations will be specified within the contractual documentation.

In that respect, it should be highlighted that the legal documentation will be standardized and will apply to all compartments of the vehicle. This contractual standardization will ensure the robustness of the scheme and the protection of the securities holders.

Furthermore, in order to limit legal risks, the corporate structure of the SPV is kept as simple as possible, in order to promote transparency, safety and neutrality. In case of an insolvency of counterparty, other shareholders will continue with the insolvency administrator of the insolvent counterparty. Besides, in such a scenario, there would be no solvent liquidation of the SPV. Under French law (at least), compartments of an SPV are independent one from another: the possible liquidation of a given compartment has no impact on the others[11]. In addition to that, the SPV goes on operating with the counterparties *in bonis*. When a counterparty becomes a defaulting entity,

[10] A minimum of 100% has been introduced to ensure that no apparent under-collateralization is allowed. Without this requirement, this case could happen if the underlying credit claims are of very high quality and therefore have a very low average haircut (HCpf) which could be lower than that of the security (HCs) and therefore could imply an overcollateralization of less than 100%.

11 Please refer to article L. 214-43 of the French Monetary and Financial Code.

although it is a shareholder of the SPV which is a public limited company, the SPV continues to provides its services to the other credit institutions (that are *in bonis*) while winding-up proceedings have been engaged against the defaulting counterparty, managed in compliance with the winding-up rules. At this end, the share ought to be sold as usual. This mechanism discards the risk of "piercing the corporate veil" and hence ensures that the scheme is robust and risk-adverse.

Conclusion

Although this project is basically sponsored by banks, the benefits of the securitisation of credit claims will go beyond the sole banking community.

Of course, there is an obvious interest for banks, as it will enlarge the scope of collateral that can be used on interbank markets and facilitate the operational management of this collateral type through standard collateral settlement and management facilities. The inclusion of this additional debt instrument in the pools of collateral of banks will provide banks with further flexibility to manage their baskets of collateral ; as a result, it will help them to cope with the additional collateral needs expected in the near future with the enforcement of several regulatory requirements.

In addition, as it is currently designed, the securitisation of credit claims will contribute to meet several general public objectives, such as lowering the dependency on rating agencies (in line with the G20 conclusions), contributing to a more efficient use of collateral, reducing central banks' intermediation role and facilitating distribution of credit to the real economic sphere.

As regards the investors' side, although the debt instrument may not be accessible to individual final investors, it will nevertheless answer needs of institutional investors that are looking for new profiles of instruments, typically SME oriented instruments that are barely proposed on European financial markets. In that respect, the feedback received from several investors illustrates that the absence of rating is not seen as a blocking point, as they intend to rely on their internal expertise anyway to assess the credit worthiness of the instrument based on the information provided on the underlying composition of the portfolio of credit claims.

Last but not least, the securitisation of credit claims will contribute to ease SMEs access to credit, as banks will have further flexibility to refinance their loans to SMEs and hence additional room for providing new credits. Of course, with regards to the magnitude of the SME needs in Europe and the different profiles of SMEs, a large range of solutions has to be envisaged in order to address SMEs' needs comprehensively. In particular, it is worth highlighting that other very instrumental solutions are also being implemented in Europe, such as improving the conditions under which SMEs can have a direct access to financial markets. Considering the diversity of SMEs profiles and in particular the fact that many SMEs are still dependent on the banking system to get access to funding, both types of initiatives – i.e. an increased disintermediation and optimized distribution of credit by banks – are complementing each other and need to be fostered in parallel. In this perspective, the replication of these solutions in the different euro area jurisdictions would maximize their impact on the real economic sphere.

ANNEXES

Annex A – Glossary of the different stakeholders in the securitisation process

Asset manager	Management company of the SPV. In the scheme described above, it manages the securitization structure and the day-to-day business of the SPV (accounting, securities settlement instructions, etc.)
Depository :	Third party providing custody and control services. According to the French financial regulation, the depository controls that the asset manager/management company ensures its diligence and respects all its obligations.
Intermediary bank	Bank that is generally belonging to the same banking group as the sponsor bank. Used in the French scheme to transfer the underlying credit claims to the SPV's relevant compartment by means of the granting of a collateralized loan
Originator bank	Counterparty of the collateralized loan that has granted a credit to a borrower. Can be the sponsor bank or another bank of the same banking group, depending on the banking group structure
Sponsor bank	Every bank participating in the project and owning at least one compartment of the SPV.
SPV - special purpose vehicle	Issuance structure common to the whole banking community
TRICP	Banque de France facility used for the eligibility check and credit assessment of the underlying credit claims. Detailed information on each credit claims provided by the originator bank to the SPV are transferred by the latter to TRICP. In turn, TRICP provides the allocation of the notional amount of credit claims per CQS/maturity/rate type back to the SPV.

Annex B –Minimum Overcollateralisation computation

According to the approach currently envisaged, the asset manager will use the following information to assess the credit claims:

- The credit quality of a loan: such credit quality will be based either on ICAS or on IRB Probability of Default (PD) using the categories (CQS1, CQS2, CQS3, etc….) according to the table below.

	PD
CQS 1	0,01%
CQS 2	0,10%
CQS 3	0,40%
CQS 4	1,00%
Ineligible	

- The final maturity of the loan: such maturity will fall within one of the defined bucket of maturities (0 to 1 year / 1 to 3 years / 3 to 5 years / 5 to 7 years / 7 to 10 years / above 10 years).
- The type of interest rate: if the interest rate is floating according to an index then we will assume the floating haircut, for any other interest rate type (whether fixed rate or a more complex pattern) we will assume the fixed rate haircut.

For each of those categories, the table below identifies the possible applicable haircut.

	Variable Rate	Fixed Rate					
		0-1 y	1-3 y	3-5 y	5-7 y	7-10 y	>10 y
CQS 1	12,0%	12,0%	16,0%	21,0%	27,0%	35,0%	45,0%
CQS 2	12,0%	12,0%	16,0%	21,0%	27,0%	35,0%	45,0%
CQS 3	19,0%	19,0%	34,0%	46,0%	52,0%	58,0%	65,0%
CQS 4	100%	100%	100%	100%	100%	100%	100%
Ineligible	100%	100%	100%	100%	100%	100%	100%

Those haircuts are equal to the haircut defined for Credit Claims, but excluding any Additional Credit Claims.

Annex C – Information flow for the assessment of the underlying credit claims

For the direct mobilization of credit claims as collateral of Eurosystem credit operations, Banque de France is already involved in the operational process for the eligibility check and credit assessment of the credit claims received as guarantee, through the TRICP and FIBEN facilities.

The set up of the SPV capitalizes on the existing facilities .

For the credit claims securitisation, each bank provides a file with the detailed list of all credit claims assigned as collateral for the relevant compartment of the SPV (including as well information stemming from the IRB of the bank when available). This takes place twice a week.

After receiving this file, the SPV provides it to the TRICP facility which provides a feedback to the SPV with (i) the distribution of the credit claims notional amount per Credit Quality Step/Maturity/Rate Type (information refreshed on a daily basis) and (ii) a processing report. This information allows the SPV (through its asset manager) determining the value of the collateral and identifying if the minimum level of overcollateralization is still met. A feedback is then provided by the SPV to the bank. This can be illustrated as follows in diagram 4.

DIAGRAM 4 - INFORMATION FLOW BETWEEN BANKS, THE SPV AND TRICP