

ECB further tightens Eurosystem rules

On 20 January 2009, the European Central Bank ("ECB") announced further amendments to the European System of Central Banks' ("ESCB") legal framework of the Eurosystem, as set forth in chapter 6 of the ECB General Documentation on Eurosystem Monetary Policy Instruments and Procedures ("**General Documentation**"). These new changes relate in particular to the amendments to the General Documentation as announced in the autumn of 2008 which came into force on 1 February 2009 (see our Newsletter "ECB tightens Eurosystem rules" of September 2008). They have now been published officially on 5 February 2009¹.

The changes further tighten the ECB's eligible assets requirements and consist of (i) a higher rating requirement for asset-backed securities ("**ABS**") used as Eurosystem collateral, (ii) a prohibition of certain two tier ABS structures and (iii) the introduction of a counterparty exposure limit regarding uncovered bank bonds.

Moreover, the ECB had announced a number of measures on 15 October 2008 designed to temporarily expand the Eurosystem collateral framework until the end of 2009 (see our Newsletter "ECB expands Eurosystem collateral framework" of October 2008). According to an ECB press release dated 20 January 2009, these measures are not affected by the above adjustments.

1. AAA rating

With regard to ABS used as collateral, the Eurosystem now requires an AAA/Aaa rating from an accepted external rating agency. This is required "at issuance" for all ABS issued as of 1 March 2009, and for the remainder of their term, they must maintain a "single A" rating (A/A2). ABS issued before 1 March 2009 are not subject to this new rule (for such ABS, the A/A2 rating requirement remains in place).

2. No ABS of other ABS

ABS issued as of 1 March 2009 may only be used as Eurosystem collateral if their underlying asset pool does not include other ABS. The relevant restriction provides that: "*they [i.e. the assets underlying the ABS] must not consist, in whole or in part, actually or potentially, of credit-linked notes or similar claims resulting from the transfer of credit risk by means of credit derivatives or tranches of other asset-backed securities*". According to an explanatory annotation in the official text², this "*requirement does not exclude asset-backed securities where the issuance structure includes two special purpose vehicles and the 'true sale' requirement is met in respect of those special-purpose vehicles so that the debt instruments issued by the second special-purpose vehicle are directly or indirectly backed by the original pool of assets without tranching.*"

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¹ Guideline of the European Central Bank of 20 January 2009 amending Guideline ECB/2000/7 on monetary policy instruments and procedures of the Eurosystem (ECB/2009/1) (2009/101/EC), OJ L 36 of 5 February 2009, pages 59 to 61.

² OJ L 36 of 5 February 2009, page 60.

This clarifies that, on the one hand, ABS structures with two special purpose vehicles ("SPV") (two-tier structures) are still possible if the first SPV purchases the underlying assets and sells them on to the second SPV which then issues the relevant ABS. Furthermore, structures where the first SPV merely repackages the assets bought by it and sells the – untranched – repackaging notes to the second SPV also appear to be eligible. On the other hand, two-tier structures are not possible if already the first SPV either transfers the assets' credit risk by way of credit derivatives to, or itself issues tranching securities (ABS) which are then bought by, the second SPV.

However, it is still uncertain what impact this new rule will have on many of the typical asset-backed commercial paper ("ABCP") transactions. In this respect, further guidance from the ECB would be highly desirable.

In contrast, it is now clear that this new rule does not relate to statutory covered bonds. According to the above-mentioned explanatory annotation in the official text, the concept of tranches of other ABS does not include covered bonds which comply with article 22 para 4 of the European UCITS Directive (85/611/EEC of 20 December 1985), i.e. statutory covered bonds.

Finally, the new rule also contains a grandfathering provision whereby ABS issued before 1 March 2009 are exempted from this new restriction until 1 March 2010.

3. Uncovered bank bonds counterparty exposure limit

A Eurosystem counterparty (i.e. the party acting as repo counterparty vis-à-vis the relevant National Central Bank ("NCB") or otherwise obtaining credit from such NCB under the Eurosystem) must provide collateral to the relevant NCB. Such counterparty may use uncovered bank bonds issued by the same issuer or by an entity with which such issuer has "close links" (see definition in chapter 6.2.3 of the General Documentation, as amended) as part of this collateral, however, the proportion of the value of such collateral in relation to the total value of all collateral provided is

limited to 10 per cent (i.e. 10 per cent after the relevant haircuts have been applied under the ECB rules).

However, this 10 per cent limitation will not apply (i) to uncovered bank bonds which are guaranteed by a public sector entity which has the right to levy taxes and (ii) if (after all the relevant haircuts have been applied) the total amount of such uncovered bank bonds issued by the same or a closely linked issuer does not exceed Euro 50m.

Finally, there are some grandfathering rules: To uncovered bank bonds that were submitted as collateral to the NCB before 20 January 2009, the new 10 per cent counterparty exposure limit does not apply before 1 March 2010. And if two or more issuers of uncovered bank bonds merge or otherwise establish a "close link", the new limit only applies one year thereafter.

4. Conclusion

Of course, it is for the ECB to determine in its own discretion which kind and quality of assets it accepts as collateral in its Eurosystem. However, its timing for these latest restrictions of the eligible assets criteria could, in the light of the current market developments, not have been much worse. It is also particularly unfortunate that the scope of the new prohibition of two-tier ABS creates quite some uncertainties with regard to ABCP.

With the above-described changes, the ECB intends to ensure that it receives "adequate collateral" (see article 18.1 of the ESCB Statute). Ignoring the bad timing of the changes, the introduction of a counterparty exposure limit and the increase in the required rating are certainly appropriate steps to achieve higher quality collateral. However, why the quality of ABS should be increased by a prohibition of certain two-tier structures, i.e. by looking at the technical structures rather than the content/underlying assets of an ABS transaction remains a mystery. In summary, with these new changes at this time, the ECB might have done a disservice to itself as well as to the economy.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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