Box 2

REVIEW OF THE RISK CONTROL FRAMEWORK

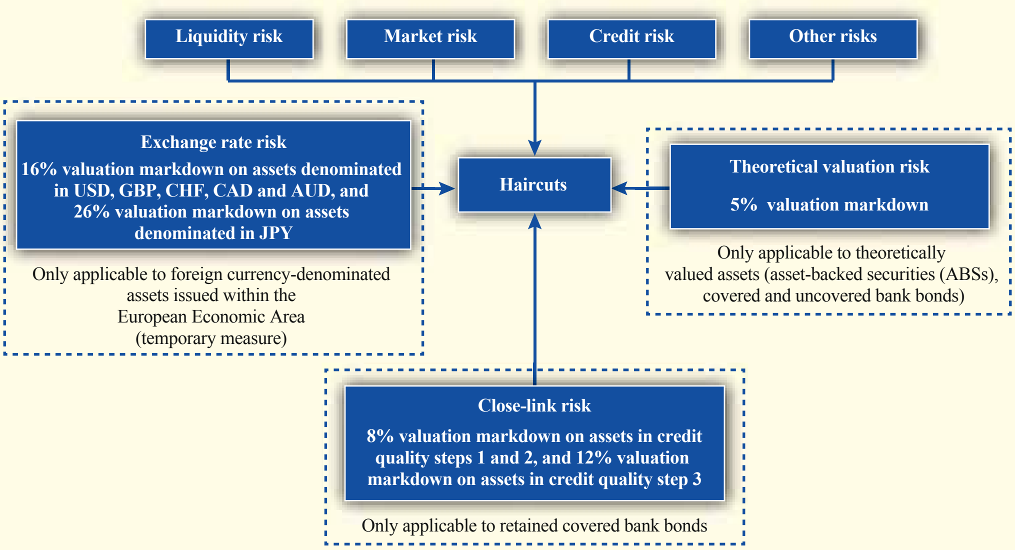
To maintain an adequate risk protection of the Eurosystem, the ECB regularly adjusts the eligibility rules and haircuts applied when accepting collateral in the Eurosystem's monetary policy operations. While eligibility rules guarantee that the Eurosystem requirement of high credit standards for all eligible assets is met, an adequate valuation and the application of a haircut protect the Eurosystem from other sources of risk that could materialise during the liquidation of the pool of collateral after the default of a counterparty. The haircut provides the central bank with a buffer to protect it against losses if the counterparty fails to pay back the loan.

In general, the calibration of haircuts is based on the principles of protection, consistency, simplicity and transparency. In particular, it aims to ensure the equivalence of risk across different types of assets, i.e. that the loss in the value of collateral that the Eurosystem might expect to incur – albeit with low probability – in an adverse scenario is the same for the different asset types. For example, the risk connected with the liquidation of a triple-B-rated covered bond is very different from that associated with the sale of a triple-A-rated government bond – all other factors being equal, the relative secondary market liquidity of the two asset classes differs, as do the risk of a default of the issuer and the volatility of market prices, etc. Accordingly, the haircuts applicable to such covered bonds are higher than those applicable to government bonds in order to align the residual risks inherent in the collateral upon liquidation.

Risk components for determining haircuts

Haircuts need to cover various sources of risk to collateral that could materialise between the default of a counterparty and the sale of the collateral: such risks emanate from market liquidity conditions, price volatility and even from the possibility of a default on the part of the issuer of the asset. The Eurosystem also takes into account further risks such as exchange rate risk, valuation uncertainty and retention risk, as shown in stylised form in the chart. Following a thorough analysis of these risks on the basis of a broad set of data covering a long time span, which prevents changes to the framework from being pro-cyclical, the Eurosystem regularly revises the schedule of haircuts applicable to collateral accepted in its monetary policy operations. The latest review led to, in particular, changes in the haircut schedule that were announced

Risk components that contribute to haircuts



Source: ECB.

on 18 July 2013 and to changes in the treatment of the retained covered bonds and asset-backed securities (ABSs).[1]

Changes for retained covered bonds

Covered bonds that are pledged as collateral by the issuer, also referred to as "retained" covered bonds, entail additional risk in the case of the default of the counterparty. In fact, the implicit guarantee of the issuer is lost and only the underlying cover pool guarantees for the value of the asset. Accordingly, following the latest review of the risk control framework, the Eurosystem announced the introduction of a valuation markdown of 8% for retained covered bonds in credit quality steps 1 and 2, and one of 12% for retained covered bonds in credit quality step 3.

Changes for asset-backed securities

In order to increase the transparency of the ABSs accepted as collateral for monetary policy operations, the Eurosystem recently introduced the reporting of information at a loan-by-loan level as an eligibility requirement for ABSs involving any one of six types of underlying assets (loans to small and medium-sized enterprises (SMEs), residential mortgage-backed securities (RMBSs), car loans, leasing receivables, consumer finance and commercial mortgage-backed securities (CMBSs)). Moreover, a number of further requirements were introduced, such as the mandatory notification of planned modifications to an ABS, as well as additional close-link and servicing provisions for ABSs accepted within the scope of the temporary measures. Given that these adjustments have diminished the risks stemming from these securities, the Eurosystem relaxed the eligibility criteria for ABSs, also with a view to bringing them into line with the eligibility criteria of other types of assets. In particular, it replaced the requirement of two triple-A ratings for ABSs subject to loan-level reporting requirements with a requirement of at least two single-A ratings, reflecting their improved transparency and standardisation. Furthermore, the haircuts applicable to these ABSs were reduced.

Overall, the changes announced on 18 July serve to strengthen the risk control framework and enhance the protection of the Eurosystem, while also improving the framework's overall consistency and expanding the list of collateral accepted within the scope of the Eurosystem's permanent collateral framework.

1 See the press release of 18 July 2013 (available on the ECB's website at: www.ecb.europa.eu).