Paul Hastings
StayCurrent
A Client Alert from Paul Hastings
October 2010

Further Developments in the Operation of the ECB Repo Facility

BY CONOR DOWNEY & DIEGO SHIN

On 9 October 2010, the European Central Bank (ECB) published its latest set of amendments[1] to the *General Documentation on Eurosystem Monetary Policy Instruments and Procedures* which, among other things, provides the framework governing access to the ECB's emergency liquidity facility, commonly known as the "repo facility". In the context of the ECB's eligibility criteria for asset backed securities (ABS) access to the facility, many of the amendments codify in formal legal terms modifications to the ECB's criteria as adopted over the course of the past couple of years and on which we have previously commented[2]. However, in a number of areas the ECB has gone beyond this and introduced additional potentially significant changes.

The highlights of the amendments made to the ECB's ABS eligibility criteria consist of:

1. The inclusion of an express right in favour of the Eurosystem to reject assets, limit the use of assets or apply supplementary haircuts to assets submitted as collateral by specific counterparties.

   Given the extensive use of the ECB repo facility by financial institutions during the early stages of the credit crisis, commentators have already questioned the quality of the collateral being posted to secure such financing. Specifically, ABS has attracted attention particularly as significant volumes of ABS transactions have been issued exclusively for the purpose of accessing the ECB repo facility. Some of these transaction, particularly those issued early in the "credit crunch" were seen as not being of the standard that would be expected by third party investors in the public markets. As some financial institutions failed, the ECB was been left 'holding the bag' with some of these transactions but finding itself unable to dispose of this collateral into the market at reasonable pricing. On this basis, it is hardly surprising that the ECB would wish to have greater discretion in its ability to refuse to provide liquidity in particular circumstances such as in the case of troubled financial institutions. Whether this step comes somewhat late in the context of the credit crisis is another question.

2. The introduction of new requirements as to the applicable jurisdiction governing the laws of the underlying assets. This involves requiring that the cashflow generating assets backing the ABS must be sold to the ABS issuer by an originator or an intermediary incorporated in the EEA and the obligors and the security backing such assets together with the governing law of those obligations must be subject to the law of an EEA country.

Although the *General Documentation on Eurosystem Monetary Policy Instruments and Procedures* as initially drafted allowed ABS backed by non-EEA collateral to be eligible for the repo facility, it became apparent during the early stages of the "credit crunch" that the ECB was reluctant to offer financing in respect non-EEA exposures. A number of non-EEA transactions were concluded in 2007 and 2008 but in 2009 it became clear that the ECB was increasingly hostile to such transactions. These latest steps clearly signal the ECB's intention to close the door on providing liquidity to finance non-EEA operations. In addition to this step, already announced measures will exclude ABS backed by collateral denominated in US Dollars, Japanese Yen or Pounds Sterling collateral with effect from 31 December 2010 and, in January 2009, the ECB made re-securitisations ineligible as collateral for its repo facility. The new amendments announced last week will apply immediately for new ABS but existing eligible transactions will remain eligible until 9 October 2011. However, it seems rather unlikely that there will be any financings of non-EEA assets from October 2011 as a result of these measures.

3. A loosening of the restriction on collateral being guaranteed by, generally, a 20 per cent. affiliate of the financial institution seeking access to the ECB liquidity facility. Specifically, the amendment now exempts the following from this 'close links' restriction: (i) guarantees from any public sector entity which has the right to levy taxes; (ii) covered bonds issued in accordance with Article 22(4) of the UCITS Directive; (iii) certain debt instruments which enjoy comparable benefits to those covered bonds issued in accordance with the UCITS Directive; and (iv) residential loan structured covered bonds which do not comply with the UCITS Directive but which meet the other ECB eligible collateral criteria, including:

   a) the residential mortgage loans backing the structured covered bonds are denominated in Euro, the related obligors are incorporated, and the security backing such loans are located, in an EU Member State and the governing laws of the loans are that of an EU Member State;

   b) the residential mortgage loans are guaranteed by an eligible guarantee issued by a guarantor, who does not have 'close links' to the issuer, rated at least A+/A1/AH by an accepted external credit assessment institution (ECAI) and which guarantee is payable within 24 months of default;

   c) high quality substitute collateral is permitted up to 10% of the cover pool with any excess only being permitted upon an in-depth review by the relevant national central bank (NCB);

   d) an 80 per cent. loan to value on each loan based on a conservative market valuation;

   e) minimum mandatory over-collateralisation of 8 per cent.;

   f) maximum individual loan amount per residential mortgage loan of €1 million;

   g) stand-alone credit assessment of the cover pool to correspond to an annual probability of default (PD) level of 10 basis points;

   h) a minimum single A long-term rating of each of the issuer and related parties to the transaction; and

   i) a legal opinion confirming that:

I. the issuer is a credit institution incorporated in an EU Member State and which is not a special purpose vehicle;

II. the issuer and the place of issue of the bonds is subject to special public supervision designed to protect bondholders;

III. in the event of insolvency of the issuer, that bondholders have priority in the repayment of principal and interest from the underlying assets;

IV. the bond documentation set out that proceeds derived from the covered bond issue must be invested in conformity with relevant national covered bond legislation or other legislation applicable to the assets in question.

For the many European jurisdictions which have long-standing or recently enacted covered bond laws (including the UK, Spain and Germany), this measure has little effect. However, a number of jurisdictions, particularly France and The Netherlands have no such laws but significant issuance of covered bonds under principals of general law. This measure can be seen as a further sign of the desire of regulators and legislators to encourage and preserve the covered bond market as well as giving France a little additional time in which to enact its anticipated covered bond law.

4. The clarification that any new issuances of ABS under a fungible tap issuance requires that all ABS issued under the same ISIN have to comply with the eligibility criteria in place at the date of the latest fungible tap issuance (e.g. two AAA ratings at issuance will be required at the time of any tap issuances as well). To the extent that a tap issue is not compliant with the applicable eligibility criteria, this will mean that all ABS under the same ISIN code will be ineligible irrespective of the date of their issuance. However, non-fungible tap issuances will be considered issuances of separate ABS.

   This technical measure closes off a loop-hole that some issuers might have tried to exploit in relation to the already-announced requirement for ABS to have two AAA ratings which will clearly be expensive and time-consuming to arrange.

In conclusion, these measures can be seen as recognition by the ECB of the continued importance of the repo facility to the European ABS markets. Much as everyone involved (including the ECB) would like to see a re-emergence of this market, this has not happened as quickly as might be wished. Clearly the policy of the ECB is to slowly and carefully seek to reduce the extent to which the market relies on its repo facility. These measures are perhaps a recognition that the market still requires it more than had been hoped at this stage and introduces some short-term relaxations of forthcoming restrictions. This can only be seen as a positive sign of the commitment of the ECB to the ABS market and recognition by it of the importance of the repo facility and the continuing need to take a flexible approach to its operation.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

London

Conor Downey
44-20-3023-5165
conordowney@paulhastings.com

Diego Shin
44-20-3023-5177
diegoshin@paulhastings.com

---

[1] http://www.ecb.int/ecb/legal/pdf/l_26720101009en00210055.pdf

[2] See http://www.paulhastings.com/publicationdetail.aspx?publicationId=1570 and http://www.paulhastings.com/publicationdetail.aspx?publicationId=1471.