C A D W A L A D E R

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

265 Strand, London, WC2R 1BH
Tel +44 (0) 20 7170 8700
Fax +44 (0) 20 7170 8600
DX: 238 (Chancery Lane)
www.cadwalader.com

Clients&FriendsMemo

ECB Eligible Collateral: The ECB Raises the Bar

21 January 2009 The European Central Bank (ECB) specifies criteria which must be satisfied for asset backed securities to be included on the ECB's list of eligible marketable assets.[1] Banks, or bank branches, established in a Eurozone[2] member state can use asset backed securities (ABS) included on such list as collateral for monetary operations, including one month and three repo financing, with the central bank of such member state. Repo financing from central banks has become an increasingly important part of banks' funding strategies over the past year as the availability and cost of credit on the interbank market or from commercial counterparties has reduced significantly.

We have acted for originators, arrangers and collateral managers on the structuring of securitisations involving the issue of senior ranking ABS which is to be ECB eligible collateral. We have also acted for originators and collateral managers on the restructuring of securitisations so that the senior ranking ABS issued can become or remain ECB eligible collateral.

In our previous Clients & Friends Memo titled "*ECB Eligible Collateral: What Has Changed?*" (10 September 2008) we discussed changes to the eligibility criteria for ABS announced by the ECB by press release on 4 September 2008 and to take effect from 1 February 2009. Those changes related to, among other things: (i) the valuation haircut applied to ABS provided as collateral; (ii) the ability of the provider of currency hedging in respect of ABS to use such ABS as collateral; and (iii) the ability of the provider of liquidity support in respect of ABS to use such ABS as collateral.

On 20 January 2009 the ECB announced by press release two further changes to the eligibility criteria for ABS.[3] The ECB described the changes as complementing the technical refinements of risk control measures that it had announced in its 4 September 2008 press release.

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1 ECB, "*The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures*", 12 November 2008 (http://www.ecb.europa.eu/pub/pdf/other/gendoc2008en.pdf)

2 The Eurozone comprises the sixteen European Union member states that have adopted the euro as their sole official currency, being Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Spain.

3 http://www.ecb.int/press/pr/date/2009/html/pr090120.en.html

However the changes are not minor ones but are potentially significant for banks originating, structuring or investing in ABS.

The first change is that, in order to be ECB eligible collateral, ABS issued on or after 1 March 2009 must be rated “AAA/Aaa” from an accepted external credit assessment institution (ECAI),[4] at issuance.

The second change is that, in order to be ECB eligible collateral, ABS must be backed by a pool of underlying assets that does “not consist, in whole or in part, of tranches of other ABSs”.

Requirement that ABS have a minimum rating of “AAA/Aaa” on issuance

The existing ECB criteria already require that ABS have a minimum rating of “A-/A3” in order to be ECB eligible collateral. The minimum rating of “AAA/Aaa” on issuance will be an additional requirement.

The press release of 20 January 2009 states that “[o]ver the lifetime of the ABS, the previously existing single A[5] minimum rating threshold would have to be retained”. Although not entirely clear,[6] in our view, this statement, taken together with the absence of any statement that ABS issued prior to 1 March 2009 must be rated “AAA/Aaa” at issuance, should be read as providing that:

(1) ABS issued on or after 1 March 2009 and rated “AAA/Aaa” at issuance will remain ECB eligible collateral even if downgraded, provided that its rating is at least “A-/A3”; and

(2) ABS issued prior to 1 March 2009 does not need to have been rated “AAA/Aaa” at issuance in order to be ECB eligible collateral and is only subject to the already existing requirement that its rating be at least “A-/A3”.

Impact of the requirement on already issued ABS

Investors currently holding ECB eligible ABS which was issued with a rating less than “AAA/Aaa” will not be affected by the new requirement. Similarly, originators which have already undertaken securitisations of assets in which the senior class of notes intended to be

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[4] An ECAI is a credit rating agency the credit assessments of which an EU member state supervisor has determined may be used by credit institutions for the determination of risk weight exposures according to the EU Capital Requirements Directive (Directive 2006/48/EC). Standard and Poor's, Moody's Investors Service and Fitch Ratings are ECAIs in all Eurozone member states.

[5] The reference to “single A” in the press release should not be taken as indicating that the minimum required rating is “A/A2” and not “A-/A3”. The ECB criteria referred to at fn. 1 above provides (at page 41) that “single A” means a minimum long-term rating of “A-” by Fitch or Standard & Poor’s, or “A3” by Moody’s, or “AL” by DBRS.

[6] We are currently seeking confirmation from the ECB that our reading of the press release is correct.

ECB eligible collateral was issued with a rating less than “AAA/Aaa” will not be affected. However, originators will need to be conscious that if an existing securitisation is rolled over into a new securitisation the senior class of notes issued in the new securitisation issued on or after 1 March 2009 will need to be rated “AAA/Aaa” on issuance in order to be ECB eligible collateral. This requirement may encourage originators to prolong the maturity of existing securitisations the senior class of notes of which is rated less than “AAA/Aaa” by amending their terms to extend the revolving period or allow the pool of underlying assets to be replenished.

Impact of the requirement on future issuance of ABS

The ECB criteria have always provided that only the most senior class of ABS will be ECB eligible collateral. The capital structure of almost all ABS marketed to investors has included a senior class rated “AAA/Aaa”. The requirement that ABS have a “AAA/Aaa” rating on issuance will therefore affect those originators undertaking securitisations primarily for the purpose of creating ECB eligible collateral to use in repo transactions with Eurozone central banks rather than for marketing to investors.

In such securitisations the size of the most senior class of ABS, and thus the amount of ECB eligible collateral generated, is maximised by issuing the most senior class of ABS with a rating that is as near as possible to the minimum required rating of “A/A3”. If the most senior class of ABS is to have an initial rating of “AAA/Aaa” its size will have to be reduced so as to provide extra subordination. The amount of ECB eligible collateral generated from underlying pools of assets will therefore reduce. This may make such securitisations and central bank repo financing less attractive relative to other sources of funding.

The ratings criteria for swap counterparties providing swaps for such securitisations are less onerous where the most senior class of notes is rated less than “AAA/Aaa”. Consequently there are more potential counterparties for such swaps and the pricing offered by such potential counterparties may be more competitive. The requirement that the most senior class of notes be rated “AAA/Aaa” on issue may therefore make securitisations which include swaps hedging payments received in respect of the underlying assets more expensive.

Assessment of the merits of the requirement

The statement in the ECB press release of 20 January 2009 that the changes set out therein “aim at contributing to the restoration of a proper functioning of the ABS market” appears to be an oblique reference to the fact that over the past year European ABS issuance has become increasingly driven by the creation of ECB eligible collateral to be used by originators themselves for repo transactions with Eurozone central banks rather than by sales to third party investors. The ECB may hope that the requirement that ABS issued on or after 1 March 2009 have a “AAA/Aaa” rating on issuance will encourage originators and arrangers of new ABS to structure it in order to attract interest from third party investors rather than solely for the purpose of using the ABS as collateral for repo financing from Eurozone central banks.

The ECB's decision not to apply the requirement that ABS have a "AAA/Aaa" rating on issue to ABS issued prior to 1 March 2009 as to ABS issued on or after 1 March 2009 may have resulted from a concern about the effect on banks which have already provided as collateral to Eurozone central banks ABS issued with a rating of less than "AAA/Aaa". If such ABS ceased to be ECB eligible collateral such banks would have to redeem the ABS and use the underlying assets to issue new ABS that would have a "AAA/Aaa" rating on issue. The temporary unavailability of such ABS as collateral would prevent such banks from rolling over their repo funding and could impair their position in an already stretched credit market.

The approach taken by the ECB in relation to the introduction of the requirement that ABS be rated "AAA/Aaa" on issue in order to be ECB eligible collateral appears to have been motivated more by pragmatism than by principle. The ECB is trying to encourage new ABS issuance to be directed at third party investors without withdrawing the liquidity that it has already provided in return for existing ABS.

The ECB has at least, sensibly in our view, provided that ABS issued with a "AAA/Aaa" rating on issuance remains ECB eligible collateral even if downgraded provided it is rated at least "A-/A3" allowing Eurozone credit institution investors to be comfortable that a downgrade of such ABS below "AAA/Aaa" will not prevent them from using it as ECB eligible collateral provided the rating remains at least "A-/A3".

Requirement that the underlying assets backing the asset backed securities not themselves be asset backed securities

The existing ECB criteria do not require that the underlying assets backing ABS be of any particular type or meet any particular requirements, other than that they not consist of credit-linked notes or similar claims resulting from the transfer of credit risk by means of credit derivatives. From 1 March 2009, the ECB criteria will now require that the underlying assets backing ABS must not themselves be tranches of other ABS. However, ABS issued prior to 1 March 2009 be exempt from this requirement until 1 March 2010.

Types of ABS affected by the requirement

The new requirement appears to us to affect, or at least potentially affect, principally three different types of ABS:

(1) collateralised debt obligations (CDOs) which are backed by other collateralised debt obligations, mortgage backed securities or other asset backed securities;

(2) ABS which are backed by mortgage loans, corporate loans or some other type of claim but where, for tax, regulatory or other reasons, the securitisation is structured so that some or all of such claims are not held directly by the special purpose vehicle (SPV) issuing the ABS but instead by an intermediate SPV which in turn issues securities to the SPV issuing the ABS; and

(3) repackaged ABS, i.e. where one or more asset backed securities are transferred to an SPV issues new ABS backed by the asset backed securities transferred and possibly also by currency and basis swaps entered into by the SPV.

Collateralised debt obligations

CDOs of ABS and CDO squareds,[7] having as their underlying assets diverse pools of collateralised debt obligations, mortgage backed securities or other asset backed securities issued by different issuers, clearly fail to meet the new requirement that ECB eligible ABS not be backed by underlying assets that are ABS.

In addition, CDOs which have as their principal underlying assets high yield bonds or corporate loans but the terms of which permit a limited portion of their underlying assets may be asset backed securities will fail to meet the new requirement if any of their underlying assets are ABS.

The position is less clear in relation to CDOs which may according to their terms include some ABS as part of their underlying asset, but do not in fact, hold any ABS. The wording of the ECB criteria excluding ABS backed by credit-linked notes or other credit derivative derived claims refers to claims consisting "in whole or in part, actually or potentially" of such claims. By contrast, the wording in the press release excluding ABS backed by other ABS refers only to the underlying pool consisting "in whole or in part" of other ABS. The absence of the words "actually or potentially" from the wording in the press release might be taken to indicate that a CDO will satisfy the requirement so long as it does not in fact have ABS as part of its underlying assets even though its terms permit such ABS to be held by it. Against that, it is difficult to imagine that the ECB would wish to involve itself in monitoring whether or not a particular CDO from time to time includes ABS in its pool of underlying assets. We are currently seeking clarification from the ECB on this point.

Asset backed securities structured with a securities-issuing intermediate vehicle

The simplest structure for ABS involves a single SPV that acquires and holds the underlying assets and issues the ABS. However, also common are structures in which the SPV acquires and holds some or all the underlying assets is different from the SPV that issues the ABS. In such two SPV structures funding is provided from one SPV to the other by way of a loan or securities issuance.

The more complex two SPV structure is usually used because of tax, regulatory or marketability reasons. For example, if Italian loans were transferred to a non-Italian SPV Italian withholding tax would apply to interest payments on such loans. Securitisations where some of the underlying assets are Italian loans may be structured so that the Italian loans are transferred to an Italian securitisation vehicle established under Italian Law 130 of 30 April 1999 which then

7 A CDO squared is a CDO the underlying assets of which are tranches of other CDOs.

issues notes (the interest on which is exempt from Italian withholding tax) to the non-Italian SPV which directly holds the non-Italian loans which is issuing the ABS. Another example is that in Portuguese securitisations involving Portuguese securitisation funds (*fundos de titularização de créditos*) the practice has been for the Portuguese securitisation fund to issue units not directly to investors but instead to an Irish SPV which in turn issues notes to investors. This structure was developed partly because of a view that the Portuguese securitisation law did not permit Portuguese securitisation funds to issue different classes of units with different payment priorities and partly because, particularly at the time of the first Portuguese securitisations, English law governed notes issued by an Irish SPV were considered more marketable than units issued by a Portuguese securitisation fund.

There are many other structures which use an intermediate SPV and where for tax or regulatory reasons the link between the intermediate SPV and the issuer SPV must be securities rather than a loan. The requirement that the underlying assets of ABS not themselves be tranches of other ABS might go so far as to prevent the ABS issued by such structures from being ECB eligible collateral. We are not sure that this was the intention of the ECB and note that the wording of the press release states that "the underlying pool should not consist, in whole or in part, of tranches of other ABSs". The reference to "tranches of other ABSs" appears to indicate that the ECB's intention is only to exclude from ECB eligible collateral ABS backed by notes issued in another ABS transaction in which two or more classes of notes were issued and not to exclude ABS backed by notes issued by an intermediate SPV where such notes comprise all of the notes issued by that intermediate SPV. We are currently seeking clarification from the ECB on this point.

Repackaged ABS

ABS is repackaged in order to combine two or more different ABSs into a single ABS with different characteristics than each of its components and/or to embed currency and/or basis swaps to change the denomination, interest rate or payment dates of the ABS. In the context of the ECB collateral criteria, repackaging of ABS can facilitate the creation of ECB eligible collateral by allowing:

(1) ABS denominated in currencies other than euro to be converted into ABS denominated in euro;[8] and

(2) ABS which is not the most senior class of ABS issued by the issuer thereof to be converted into ABS which is the most senior class of ABS issued by the repackaging vehicle.[9]

[8] ABS denominated in currencies other than euro can be used as ECB eligible collateral only on a temporary basis until 31 December 2009 and if denominated in Sterling, U.S. dollars or Japanese yen and are subject to an additional 8% haircut that does not apply to euro-denominated ABS. For more details see our previous Clients & Friends Memo titled "*The Continuing Evolution of ECB Eligible Collateral*" (23 October 2008).

The new requirement that ECB eligible ABS not be backed by underlying assets that are ABS will prevent repackaging being used for these two purposes. If a credit institution is holding non-euro-denominated loans then it will remain possible for it to structure ABS with a currency swap so that the ABS issued is denominated in euro and potentially ECB eligible. However, if a credit institution is holding non-euro-denominated ABS then it will not be possible for it to convert such non-euro-denominated ABS into euro-denominated ABS and use it as ECB eligible collateral.

Impact of the requirement on already issued ABS

The requirement that the underlying assets backing ABS not themselves be tranches of other ABS is not met by CDOs of ABS and CDO-squareds and any of these that are currently ECB eligible collateral will therefore cease to be ECB eligible collateral from 1 March 2010. We do not see any method of restructuring such assets to enable them to meet the requirement.

As regards other CDOs which have ABS as only a portion of their underlying assets, such ABS could be sold and the terms of the CDOs changed to prohibit future acquisition of ABS. However, as ECB eligibility is relevant only to the investors holding the most senior class of notes issued by such CDOs, such sale of ABS and changes of terms might be resisted by investors holding other classes of notes. If the price that would be obtained for such ABS on a sale is less than the value at which it is currently being taken into account for the purposes of the CDO, then investors and the CDO manager may prefer not to sell such ABS. Investors and CDO managers will need to be mindful of the different considerations in negotiating any changes.

In the case of asset backed securities structured with a securities-issuing intermediate SPV the consequences of the requirement that the underlying assets backing ABS not themselves be tranches of other ABS depend on the ECB's position as regards underlying assets that are ABS but represent all of the ABS issued by a particular issue and not just a tranche of such ABS. If the ECB's position is that such underlying assets do not satisfy the requirement then then there is a significant amount of ABS which will cease to be ECB eligible collateral from 1 March 2010. In that case we expect that restructuring such ABS to preserve ECB eligbility will be problematic because:

(i) in most cases the securities-issuing intermediate SPV will have been included in the structure in order to overcome a tax or regulatory issue and would not have been used if any alternative were available; and

(ii) the affected ABS is generally widely distributed, ECB eligibility is relevant only to the senior investors and junior ranking investors gain nothing by the restructuring.

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[9] As noted above, the ECB criteria have always provided that only the most senior class of ABS will be ECB eligible collateral.

Impact of the requirement on future issuance of ABS

The statement that simpler ABS structures are needed to attract investors back to the market has become almost a mantra of commentators over the past year or so. The ECB, by introducing the requirement that the underlying assets of ECB eligible ABS not include any ABS, is doing its bit to try to encourage simpler structures. The requirement makes it unattractive to include in CDOs of predominantly corporate loans or high yield bonds a bucket for ABS and we do not expect to see such buckets on new CDOs.

The requirement will impact on new CDOs of commercial real estate (CRE CDOs). The handful of European CRE CDOs undertaken to date have included as underlying assets junior ranking commercial mortgage loans or junior ranking commercial mortgage backed securities or a mix of the two. CRE CDOs which have junior ranking commercial mortgage backed securities as part of their underlying assets do not satisfy the requirement that the underlying assets of ECB eligible ABS not include any ABS. On the other hand CRE CDOs which have only junior ranking commercial mortgage loans as their underlying assets satisfy the requirement as such junior ranking commercial mortgage loans are not ABS. Over time this is likely to encourage those structuring commercial mortgage backed securities (CMBS) and CRE CDOs to create subordination outside of the CMBS transactions themselves by tranching the underlying commercial mortgage loans into senior and junior pieces.

Finally, the requirement will deter repackagings of ECB eligible senior ABS as the repackaged ABS will not be ECB eligible collateral.

Assessment of the merits of the requirement

A number of possible motivations lie behind the introduction of the requirement that the underlying assets of ABS not themselves be tranches of other ABS. The ECB may have been concerned to prevent institutions acquiring portfolios of junior or mezzanine ABS at the discounted prices currently seen in the market and using those portfolios as underlying assets for CDOs of ABS and CDO squareds which would have senior notes that would be ECB eligible and could be used to obtain senior funding from the ECB. The ECB may have been concerned about the complexity of the models used to rate CDOs of ABS and CDO squareds and the value of the resulting rating. The ECB may equally have wished to limit the use of non-euro-denominated ABS to create ECB eligible collateral by repackaging such non-euro-denominated ABS with a currency swap.

As noted above, the requirement that the underlying assets of ABS not include tranches of other ABS may mean that ABS structured with a securities-issuing intermediate vehicle cannot be ECB eligible collateral. The requirement may also have the effect of increasing, rather than decreasing, the complexity of securitisations, first because it makes repackagings of ECB eligible senior ABS less attractive and thereby makes it more attractive to undertake within the ABS itself the structuring which would previously have been effected by the repackaging.

Conclusions

The ECB's announcement of 20 January 2009 was not anticipated. By contrast, the ECB's previous announcement of 4 September 2008 followed the regular review of risk control measures for Eurosystem credit operations which the ECB conducts every two years and had been anticipated for some time. However, there had for some time been a considerable amount of speculation that the ECB would increase the minimum rating requirement for ABS from "A-/A3" and there was some surprise when such an increase was not announced in the 4 September 2008 announcement.

It seems that the ECB has now taken the opportunity to increase the minimum rating requirement but in a relatively sensitive manner so that ABS issued prior to 1 March 2009 is not affected by the increase and ABS that is downgraded can remain ECB eligible collateral provided it retains a rating of at least "A-/A3".

The ECB has also provided that ABS will not be ECB eligible collateral if its underlying assets include tranches of other ABSs. This provision is understandable as an attempt by the ECB to exclude from the scope of ECB eligible collateral both complex ABS such as CDOs of ABS and CDO-squared and certain ABS constructed primarily with a view to being used for repo transactions with Eurozone central banks. However, as noted above, there is a risk that the scope of the provision may go further than intended by the ECB.

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If you have any questions regarding the foregoing, please contact:

Angus Duncan	+44 (0) 20 7170 8640	angus.duncan@cwt-uk.com
Nick Shiren	+44 (0) 20 7170 8778	nick.shiren@cwt-uk.com
Robert Cannon	+44 (0) 20 7170 8735	robert.cannon @cwt-uk.com