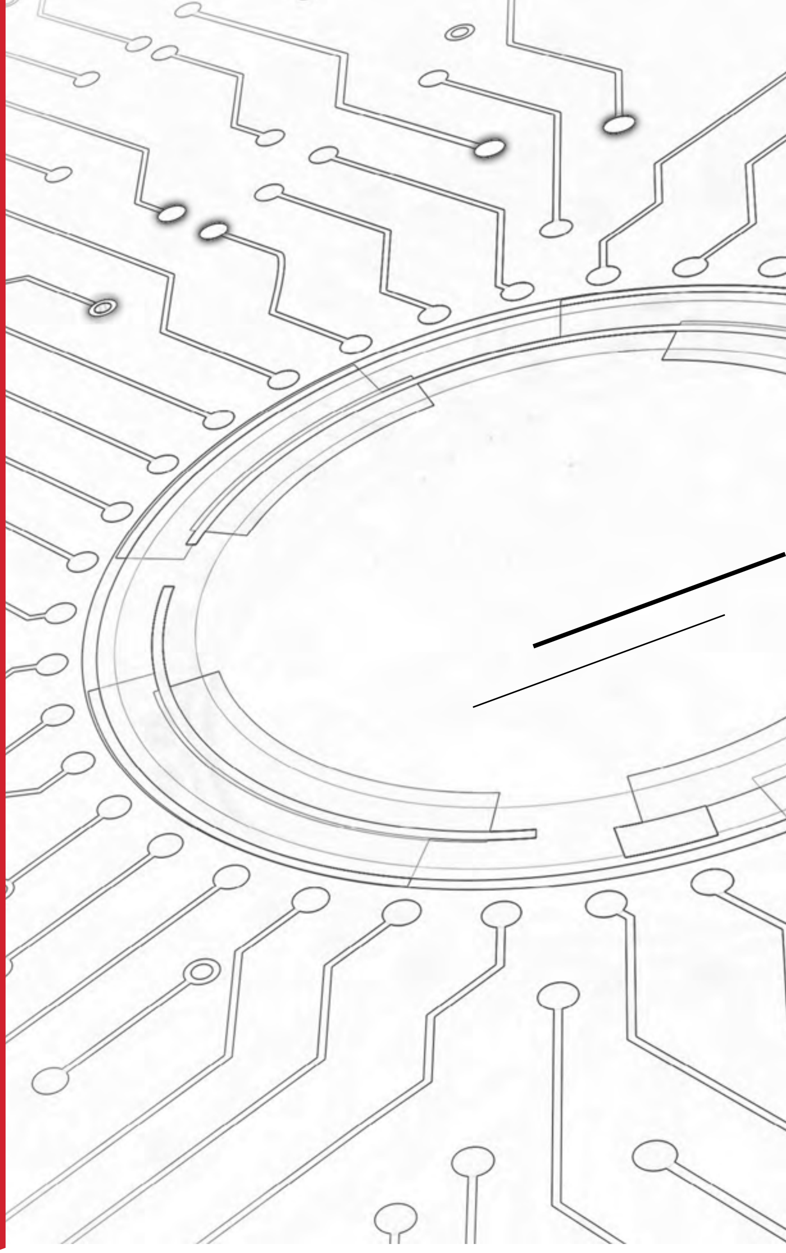
ECMS

a game changer to access your central bank

Whitepaper - June 2022



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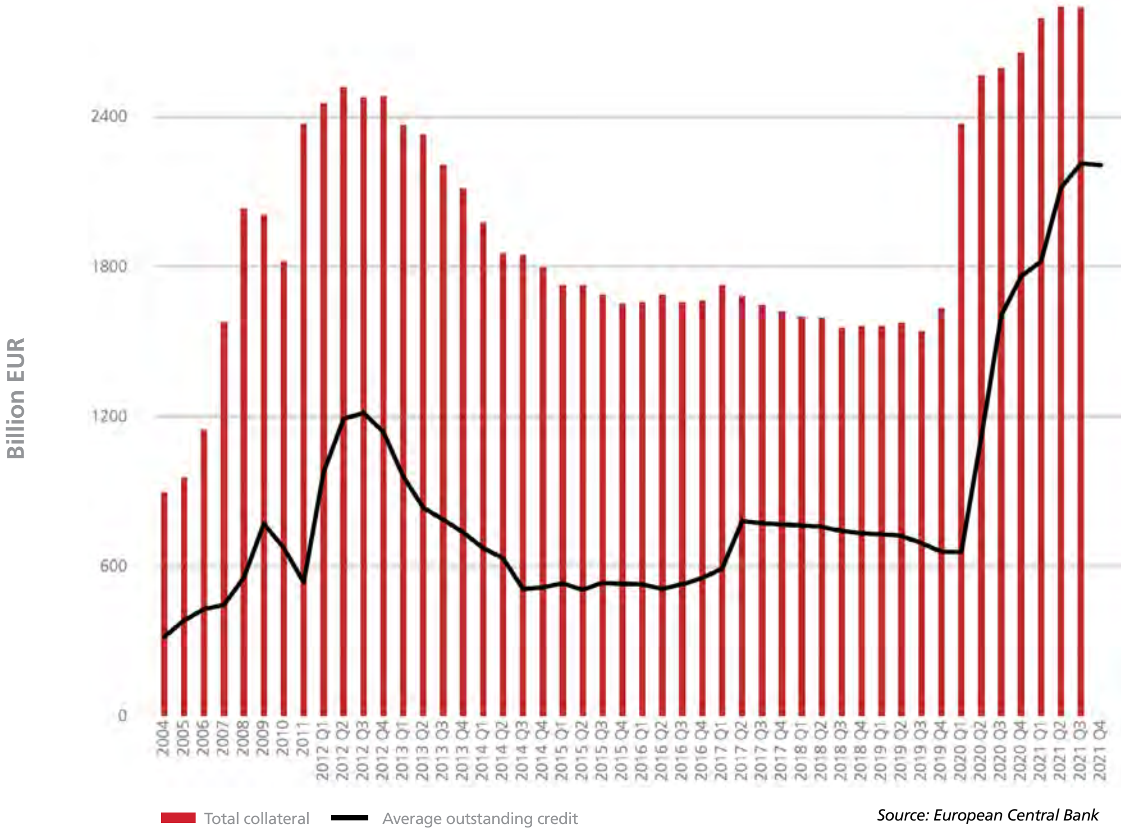
How important is central bank liquidity?

Central banks play an important role in ensuring sufficient liquidity is available to financial markets. Historically, they have always acted as lenders of last resort by providing distressed institutions with liquidity, in addition to processing more routine operations, for example by providing credit to support settlement in central bank money. Perceptions around accessing central bank liquidity have been progressively changing and today using central bank credit has become a commonly used liquidity management tool for many financial institutions. This shift started as a result of the financial crisis of 2008.

Until 2008, interbank liquidity was not an issue, the cost of cash was low and market spreads were stable. Most trades were conducted in the inter-bank market but since 2008, the market faced a widening of the Overnight Index Swap (OIS) and Bank Offered Rates (BOR) spreads, reflecting the risk aversion of banks and lower interbank lending. Central banks then took over by lending massively to banks.

In Europe, figures from the European Central Bank (ECB) (Fig 1.) show a steady increase in the amount of collateral deposited by banks and in the credit granted by the Eurosystem central banks. Unsurprisingly, more pronounced spikes occur during times of volatility, for example during the European sovereign debt crisis and more recently at the onset of the COVID pandemic. Overall, the amount of collateral provided to Eurosystem central banks has now doubled compared to before the 2008 financial crisis.

Fig. 1: Total use of collateral within the Eurosystem



Source: European Central Bank

Central bank collateral frameworks and credit – how it works

In the Eurozone, these shifts were reflected in policy shifts by the Eurosystem of central banks and the ECB. Eurosystem liquidity has played a pivotal role for credit institutions since the financial crisis in 2008 and European crisis in 2011.

Historically, ECB liquidity management comprises assessing the liquidity needs of the banking system and supplying or absorbing the appropriate amount of liquidity through open market operations. In the case of the Euro area, credit institutions' liquidity needs mainly arise from two factors. First, the ECB imposes minimum reserve requirements on Euro area credit institutions. Second, liquidity needs are created by what are known as autonomous factors.

These changing liquidity needs mean Credit Institutions need to regularly adapt the collateral they have posted to their central bank. It is standard practice for the ECB to take collateral when injecting liquidity, whether intraday for payment system purposes, in short-term or long-term Open Market Operations (OMO), or overnight in Standing Facilities (SF).

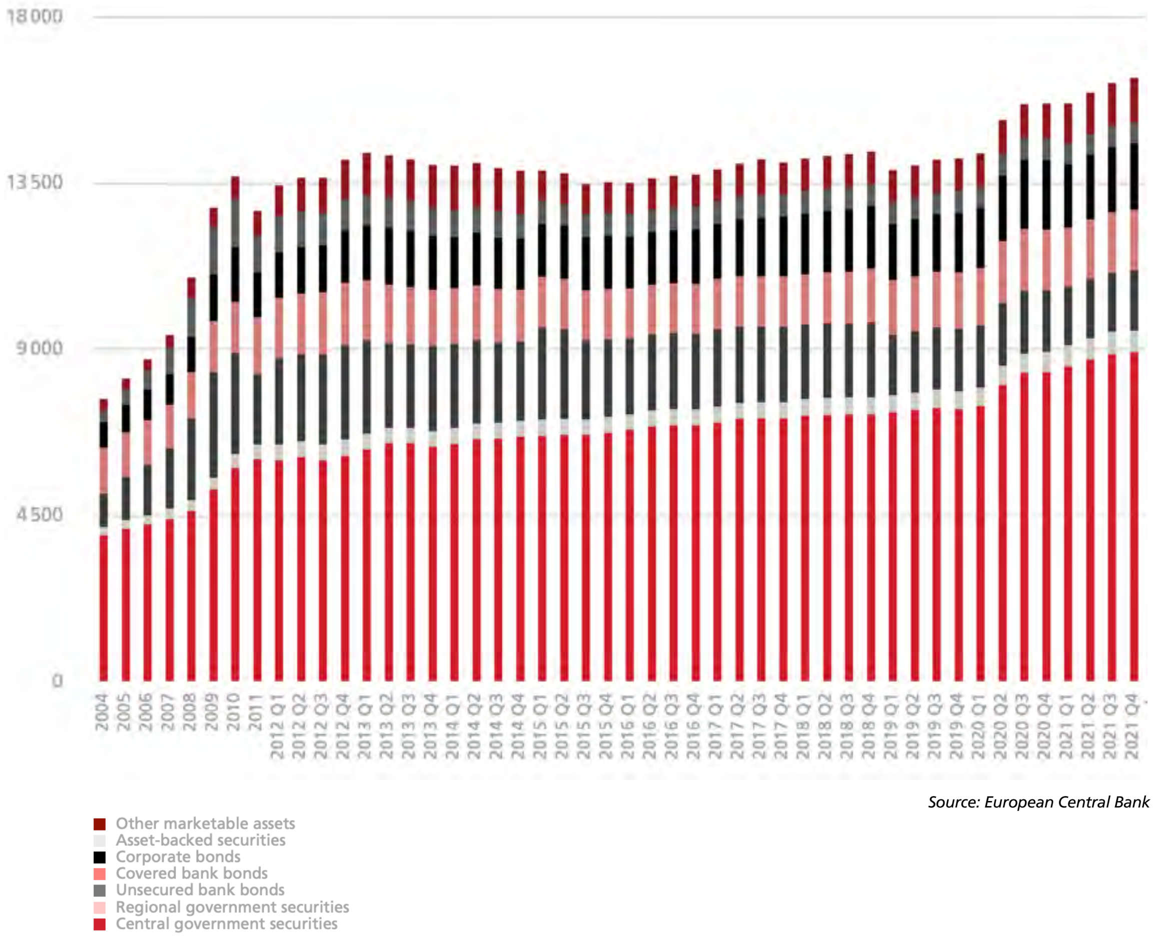
In 2015, when action on key Interest rates (deposit facility rate, main refinancing rate and marginal lending facility rate) became insufficient to control the level of interbank market rates and government bonds, the ECB switched to unlimited tenders and started buying back assets through quantitative easing.

Why is collateral management with the ECB the first step?

The ECB provides credit only against eligible collateral. Collateral can be in the form of marketable assets such as financial securities and non-marketable assets such as credit claims. The eligibility of assets is assessed by each National Central Bank (NCB) according to the criteria specified in the Eurosystem Collateral Framework.

During the past 10 years, the ECB collateral framework has been broadened to increase collateral availability for credit institutions and thereby facilitate the provision of increased credit by the Eurosystem. These modifications included, among others, the acceptance of additional credit claims in some Euro area countries. Figures from the ECB below illustrate the increasing total value of eligible marketable assets during the past 15 years (Fig. 2).

Fig. 2: Total eligible marketable assets (bn€)

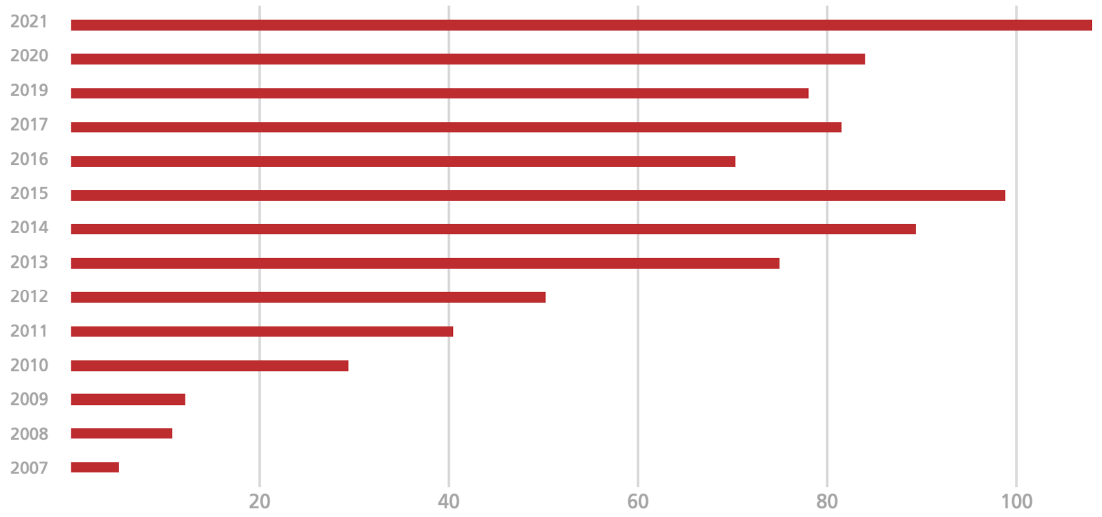


Source: European Central Bank

Liquidity is provided by the central bank on a desynchronised basis, with the delivery of collateral taking place first. As a result, the mobilisation of collateral plays a key role for all credit institutions to ensure they have all the tools in place to mobilise and demobilise assets and credit claims.

Market infrastructures have played a significant role in providing tools and technologies to pool assets globally by developing new links to Euro markets and offering services such as Triparty (Fig. 3), which was also adopted by the ECB. The usage of triparty services is one example of innovation which has allowed banks to quickly mobilise bonds during a crisis or under stressed market conditions.

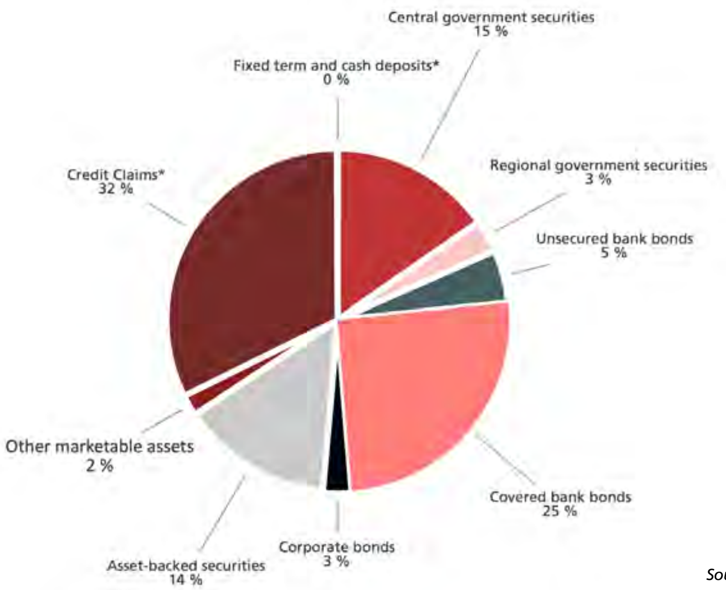
Fig. 3: Collateral provided to NCBs through Euroclear's collateral management services, globally



Source: Euroclear

It is worth noting that the increase in collateral deposited with the Eurosystem specifically has been accompanied by changes in the type of assets used. Credit claims and covered bank bonds are increasingly used as collateral (Fig. 4), an evolution with significant operational implications given the complexity of mobilizing credit claims, a non-marketable asset class.

Fig. 4: Use of collateral by collateral type



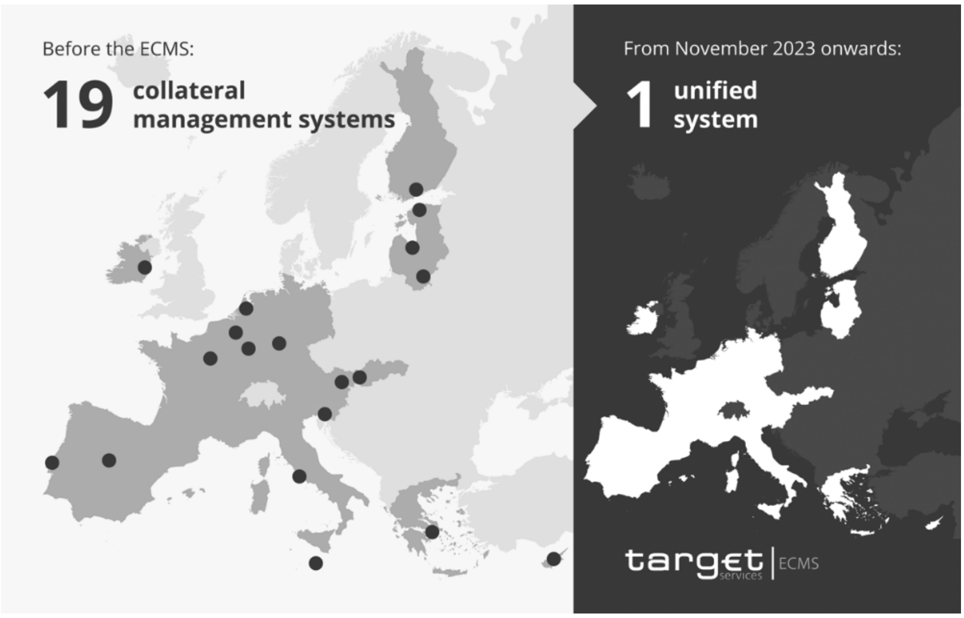
Source: European Central Bank

What is ECMS?

Each central bank maintains software systems to manage the collateral they receive and the credit lines they grant. Each of these collateral management systems is unique and imposes its own processes on users that need to deliver collateral and obtain liquidity.

The Eurosystem Collateral Management System (ECMS) is a new system which will replace the existing collateral management systems of the 19 Eurosystem central banks. ECMS will become the sole system used to manage both collateral and credit in Eurosystem credit operations (Fig 5).

Fig. 5: The transition to ECMS



Source: European Central Bank

ECMS will launch in November 2023 following extensive testing with counterparts and CSDs throughout 2022. Upon launch, all existing collateral positions and outstanding credit will be migrated to ECMS, highlighting the need for banks to be ready in time to interact with ECMS.

Together with the other TARGET services that the Eurosystem offers, ECMS aims to improve the flow of cash, credit and securities throughout Europe. ECMS is expected to provide operational and cost efficiencies for both central banks and their counterparts by replacing the current different systems with a single centralised system. In addition, it is a significant step in the continuing development of the Capital Markets Union (CMU).

It is crucial to all credit institutions to have the processes and systems in place to pledge all types of collateral (marketable assets and credit claims) with the ECB allowing them to obtain credit for intraday liquidity needs within T2S and to participate to liquidity operations.

Multi-pooling supported by the future platform ECMS!

ECMS is part of the Vision 2020 initiative which includes major upgrades to the Eurosystem's market infrastructure landscape. Whilst all credit institutions will maintain the relationship with their NCB, the new connection with ECMS must also be implemented.
The benefits for banks include:

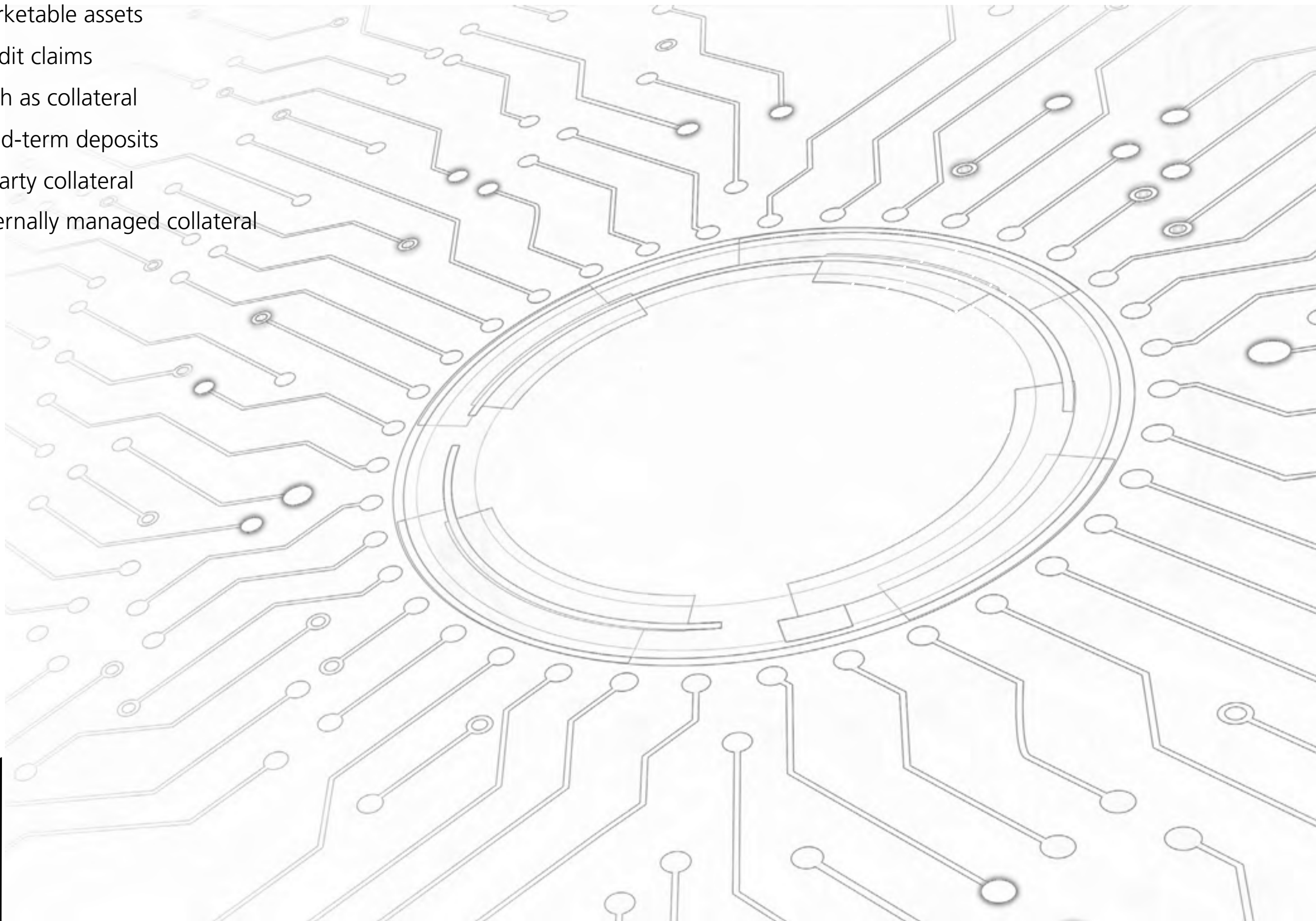
- a harmonized process for credit claims (registration & mobilisation)
- ECMS support for multi-pooling, i.e. a consolidated view on all pools of collateral even if held in different locations
- easier use of Correspondent Central Banking Model (CCBM) and triparty mechanisms

Firms have different ways of mobilising collateral and correspondingly, the collateral position of a firm can be spread across several pools, for example:

- Marketable assets
- Credit claims
- Cash as collateral
- Fixed-term deposits
- Triparty collateral
- Externally managed collateral

ECMS will interact with T2, T2S, and all Euro area CSDs and triparty agents to manage marketable assets and credit claims used as collateral in Eurosystem Credit operations. This enables ECMS to have a view on all assets provided by a counterpart and to support a multi-pooling functionality: It is the difference between the total collateral available in all locations and the amount of outstanding Eurosystem monetary policy operations which determines the credit line in the ECMS.

Some assets will be managed outside of ECMS, like certain pools of additional credit claims. Each NCB will keep the total value of this externally managed collateral updated within ECMS to ensure ECMS can correctly assess the collateral received by the NCB.



How will this impact you?

ECMS will primarily impact counterparties of central banks by changing the procedures to mobilise and demobilise collateral and to request changes in credit lines. It will also result in changes to the required content and format of instructions, impose new operational deadlines and a introduce a new User Interface. All of which will require adaptations to IT systems and operational procedures.

This is especially true for the mobilisation of credit claims. Market practice to mobilise credit claims currently varies greatly across different European markets. Whilst having a single process under ECMS will be a big step forward for counterparties and generate substantial operational efficiencies, it will require a significant adaptation in the short term. In addition, ECMS will process collateral exclusively according to the Single Collateral Rulebook for Europe (SCoRE). SCoRE documents a series of standards for post-trade processing and affects the areas of billing, triparty collateral management and, in particular, corporate actions.

SCoRE aims to draw a line under previously fragmented corporate action processes across Europe. Significant changes have been made to align processes around payment dates and timing, entitlement calculation and messaging. The result is a single harmonised process for many events. Not only will the processes for several types of corporate action change, in addition these changes will apply to all holders of the security, whether it is used for collateral management within the Eurosystem or not.

Finally, ECMS has chosen ISO 20022 for STP communication and will reuse the Eurosystem Single Market Infrastructure Gateway (ESMIG). Counterparts wishing to communicate through SWIFT with ECMS will need to adopt ISO 20022 messaging and develop a connection with ESMIG if they don't already have one.

How should you prepare?

ECMS launches in November 2023. Whilst this is more than a year away, the critical nature of access to the central bank and the forced migration in November 2023 mean that preparations should already be underway. Central banks are organising market working groups which provide a valuable forum to clarify aspects of how ECMS will work and to exchange information with others. They also serve to monitor progress in individual markets and ensure no one is lagging behind.

Crucially, users of ECMS will need to implement and master the workflows required to deliver collateral and request a credit line before launch. At a time where roadmaps are under pressure from a variety of regulatory initiatives, the prospect of adjusting to ECMS can feel especially challenging.

Which is why there are a variety of options that can be used to lighten the burden. For example, foregoing STP communication and resorting to using the ECMS User Interface can be a temporary solution to remove the need to immediately migrate to ISO 20022 and develop a connection with ESMIG.

A number of service providers also provide solutions tailored to specific problems. For example, SWIFT translation services have become a common solution for firms struggling with ISO 20022.

VERMEG and Euroclear – here to help

Both VERMEG and Euroclear are also developing services to ease access to ECMS.

Euroclear's Central Bank Access is available in both Euroclear Bank and the ESES CSDs (Euroclear France & Euroclear Nederland). It provides clients with a triparty-like service to access their central bank. A single instruction to Euroclear is sufficient to trigger the selection of assets and their delivery to ECMS, with Euroclear managing the full settlement lifecycle.

Under Central Bank Access, Euroclear will maintain a continuous collateral value at the central bank to ensure constant purchasing power.

Euroclear will also automatically substitute securities if they are required to meet other settlement obligations and will ensure all collateral securities delivered meet Eurosystem eligibility requirements.

EASY Collateral from VERMEG addresses a common need by maintaining a real-time view on both available inventory and collateral deposited in ECMS. It also provides a comprehensive dashboard in which all interactions with ECMS can be monitored. Mobilising & Demobilising Credit Claims and Marketable Assets can easily be managed through its direct connection to ECMS and its Optimization tool.

EASY COLLATERAL by VERMEG

Increasing collateral needs, optimisation and the case for centrally managing collateral

All financial institutions are facing increasing collateral needs following the implementation of new regulatory frameworks such as mandatory clearing and the Uncleared Margin Rules (UMR). Accordingly, financial institutions are looking for solutions allowing them to:

- have a real-time, holistic and accurate view of their inventory and collateral requirements
- assess the optimum collateral allocation based on internal and external constraints
- manage their asset inventory (i.e. hedging shortfalls, investing excess or performing arbitrage on positions)

And, as collateral, like capital and liquidity, becomes a scarce resource, having the ability to move assets and optimise collateral allocation globally across agreements, counterparts and custodians is key for firms' success in the future.

Building or maintaining such a holistic collateral management function requires substantial and continuous effort. It all starts with having the tools to effectively settle and monitor each collateral pool. Implementing the changes needed to access ECMS are key to ensuring the central bank pool can be managed seamlessly. In light of the criticality of this pool, stepping up preparations is key.

About Euroclear

Euroclear group is the financial industry's trusted provider of post trade services. Euroclear provides settlement and custody of domestic and cross-border securities for bonds, equities and derivatives to investment funds. Euroclear is a proven, resilient capital market infrastructure committed to delivering risk-mitigation, automation and efficiency at scale for its global client franchise.
The Euroclear group comprises Euroclear Bank, the International CSD, as well as Euroclear Belgium, Euroclear Finland, Euroclear France, Euroclear Nederland, Euroclear Sweden and Euroclear UK & International. The Euroclear group settled the equivalent of €992 trillion in securities transactions in 2021, representing 295 million domestic and cross-border transactions, and held €37.6 trillion in assets for clients by end 2021.

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About VERMEG

VERMEG is a specialized software house covering three main market segments in financial services: Collateral management & Asset Servicing, Regulatory reporting and Digital transformation.
VERMEG is the number one provider worldwide of collateral management solutions for Central Banks.
Its business solutions have been designed to address the challenges linked to the transformation of the financial services industry, but also to support these players in the overhaul of their information system; through cost reductions and time-to-market control. In addition to offering standard software solutions that meet evolving digitized needs, VERMEG provides tailor-made solutions based on our own tools, project and business expertise.

VERMEG has over 1500 employees and supports more than 550 clients in 40 countries.

For more information, please visit **vermeg.com**

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