Whitepaper

Activating your federal pledging strategy with electronic collateral

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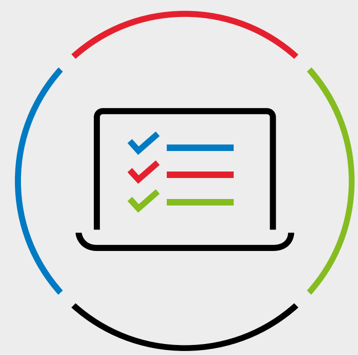
Learn how to prepare to pledge electronic collateral to the Federal Reserve Banks and the critical risk factors in protecting those assets throughout their lifecycle

As banks and credit unions increasingly generate loans as electronic assets (eAssets) through the use of electronic signatures and digitization of ink-signed paper, depository institutions must ensure they remain in a position to leverage their eAssets for liquidity support — whether pledging as collateral to the Federal Reserve Banks (FRB) or recycling that capital through securitization, sale, or acquisition of eAssets.

Although the FRB has opened the door to electronic collateral, the path to certification can be complex and not well-defined. As a result, institutions must make important decisions in determining the legal, operational, and technology investments necessary to satisfy the FRB requirements.

Equally important to consider when pursuing FRB certification to pledge electronic collateral is how to maintain and enable the transfer of the legal and enforceable rights of those electronic assets. Just like their paper predecessors, digital loans are subject to strict regulations that aim to mitigate risk and ensure legal compliance. Like any loan, a digital loan can last for up to 30 years and be in the possession of multiple parties during its lifetime.

When preparing to pledge electronic collateral to Federal Reserve Banks, important best practices should be considered to protect the value of the collateral and minimize risk throughout its lifecycle.



Electronic collateral: eAssets that are pledged by a borrower to a finance source as collateral to secure funding.

eAsset: Authenticated digital documentation that embodies financial value and which can be held, managed, sold, transferred, or leveraged in compliance with the control requirements of the Uniform Commercial Code (UCC), the Electronic Signatures in the Global and National Commerce Act (ESIGN Act), and the Uniform Electronic Transactions Act (UETA), including for authoritative copies, transferable records, and controllable electronic records.

Federal Reserve Banks are embracing electronic collateral

The Federal Reserve Banks are rapidly adapting to the shift to electronic asset creation, often called eAsset. Over the past year alone, most districts have updated their electronic collateral certifications and are finding ways to accept electronic collateral from their members. The timing is crucial, as depository institutions seek to ensure they have robust liquidity strategies. The FRB is also encouraging depository institutions to prepare for leveraging the FRB discount window. With the establishment of the FRB Borrower-in-Custody (BIC) program, supported by Operating Circular 10, a trust is created between member institutions and the FRB. Trusting depository institutions to self-assess and manage pledged assets fosters efficiency and flexibility. It also defines the expectations for asset quality and management to meet FRB criteria for a security interest.

Electronic assets can deliver even greater efficiency and flexibility, but managing and pledging them under the BIC program involves unique complexities and requirements. Decisions related to processes, technology, and execution will lay a solid foundation for FRB acceptance. If done correctly, those investments can also create leverage across asset categories, protect asset value, and optimize marketability should you need additional secondary market options in the future.

Interpreting the certification requirements of the Federal Reserve Bank

The FRB certification documents and attestation are complex and can be difficult to interpret. Most institutions find it challenging to understand the controls and requirements expected for FRB-pledged electronic assets. Some key areas of concern include:

- **FRB requirements:**
  The Federal Reserve Banks do not specifically guide depository institutions in how to meet requirements. Rather, it is up to each organization to understand and implement the important aspects of an electronic asset management process and effectively communicate that through the certification documentation to the Federal Reserve Bank.

- **Processes:**
  Processes and process documentation updates are required for origination, loan processing, pledge decision-making, asset protection, and auditing. Paper and electronic workflows may diverge in some areas while having common dependencies in others. Asset certainty protection and control are important factors in process design.

- **Operational effectiveness:**
  Evaluating all aspects of operational impact is critical since perceived operational convenience in certain areas can create complexity and risk in compliance, auditing, and future asset utilization.

- **Technology:**
  Selecting proper technology is imperative to ensure you can demonstrate that electronic assets are originated under legally acceptable standards and that control can be demonstrated throughout the asset lifecycle. Assets originated or acquired with recognized signature tools but held in a file management server can potentially be acceptable to the Federal Reserve but might not withstand legal scrutiny or qualify as transferable.

- **Asset labeling:**
  Each Federal Reserve Bank defines the requirements for identifying and labeling of wet-signed collateral. For electronic assets, labeling each pledged asset with a tamper-evident watermark and segregating pledged assets from others are the minimum steps you should take to protect the value of an asset thoughout its lifecycle.

- **Attestation:**
  The Federal Reserve Bank will ask each member to attest to the controls and protections it has in place to protect FRB security interests. A legal review of your processes and technology utilization can provide assurances and confidence in compliance while maintaining asset integrity throughout its lifecycle.

Fundamentally, the Federal Reserve Banks should ensure the enforceability of FRB interests in pledged collateral and that the collateral is unencumbered if the FRB needs to take control.

Protecting the certainty and enforceability of your electronic assets should be the highest priority, with considerations extending beyond the Federal Reserve Bank

Frequently, depository institutions migrate to digital lending with certification to pledge to the FRB as a key requirement.

A positive aspect of the FRB is that it frequently works to find ways to accept a bank's collateral.

Although the depository institution may be approved to implement procedures that seem optimal, these decisions can ultimately compromise the marketability of those eAssets in other markets. For example, using a splash screen or pop-up screen presented at log-in to a pool of assets where only a portion may be pledged, or changing the file name to reflect a pledge status, would not be considered sound practices. Managing pledged assets in these ways might meet an FRB risk profile and seem efficient, yet will fail to meet the rigorous requirements of proving authenticity and control should a sale or other monetization opportunity be desired.

Why is control so important? Control is to the Digital Original® what possession is to paper securities

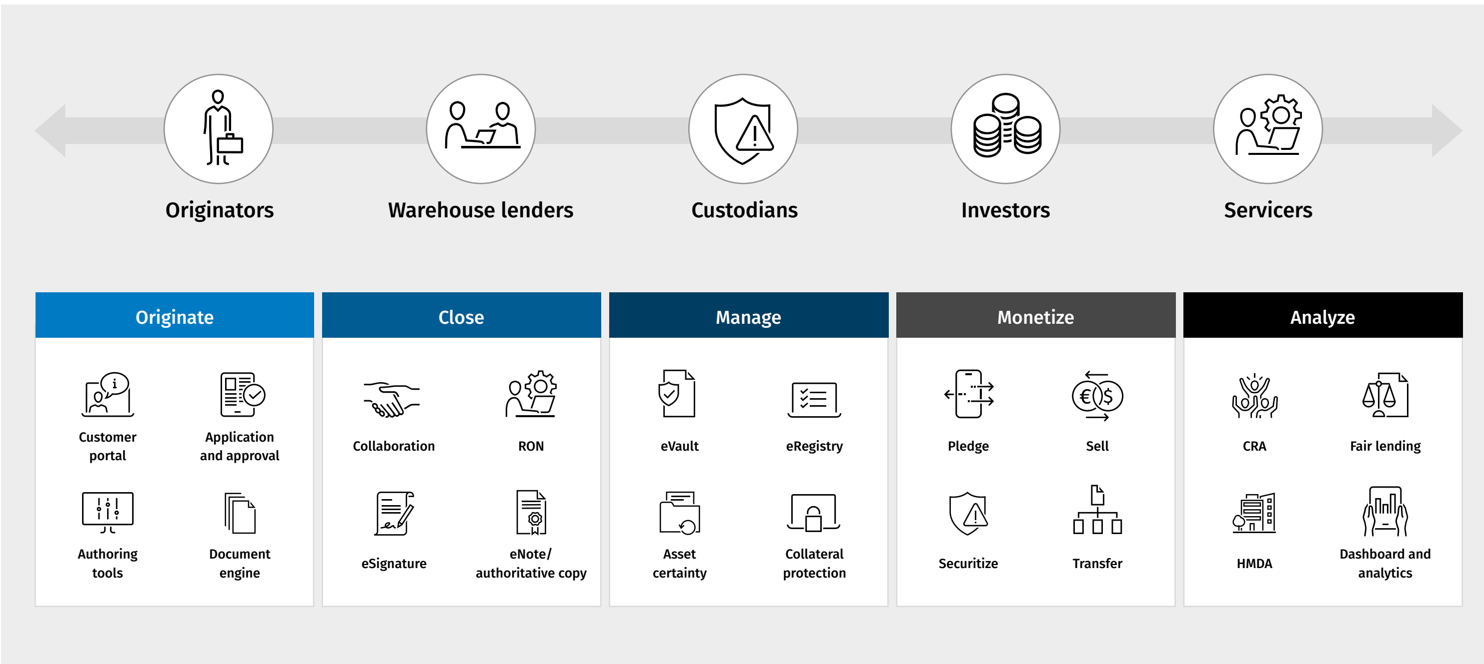
Proving authenticity and control is governed by state and federal laws, which require a system that reliably establishes the person assigned, issued, or transferred the Digital Original®. There are six criteria for creation, storage, and assignment that comprise the safe harbor for control:

- A single Digital Original copy of the record or records exists, which is unique, identifiable, and unalterable
- The Digital Original copy identifies the secured party as the assignee of the record or the person to whom the authoritative copy was last transferred
- The Digital Original copy is communicated to and maintained by the person asserting control or its designated custodian
- Copies or revisions that add or change an identified assignee of the Digital Original can only be made with the participation of the person asserting control
- Each copy of the Digital Original, and any other copy, is readily identifiable as a copy that is not the Digital Original
- Any amendment to the Digital Original is readily identifiable as the authorized or unauthorized amendment

Meeting these six criteria establishes the burden of proof that a financial organization holds the Digital Original. Supported by an evidentiary trail of ownership captured with each participant's involvement, a control record of the loan's history and an immutable chain of custody is established. Embedded in the eAsset, this audit trail, along with proper eAsset management and secured party eAsset-level identification, provides the lender the ability to demonstrate authenticity. With the establishment of control, maintaining of control, and effective transfer of control throughout the lending ecosystem, a demonstration of control is achieved that is fundamental to the receiving (secured) party's ability to enforce the rights of the loan.

Choosing a path of perceived simplicity or operational ease can be more costly than expected, as it introduces risk to enforcement rights or rating valuation downgrades in the secondary market.

Establishing an end-to-end controlled and compliant digital lending lifecycle for any electronic asset is essential.



Final thoughts:

Build your liquidity strategy to include the Federal Reserve Banks but also certainty in the legal enforceability of your eAssets throughout their lifetime.

Remember that trust is the greatest currency in the lending ecosystem.
Trust and asset certainty ensure that all participants minimize risk and maximize compliant-first market liquidity.

Best practice models for creating digital asset certainty (eOriginal eCertainty®) are well established for millions of electronic loans and their utilization as collateral with the FRB and through other monetization channels.

Utilizing an eOriginal eAsset® Management solution and active ecosystem provides the levers to liquidity options and asset protection.

The Federal Reserve certification process can be daunting. Advisory resources and solutions are available from Wolters Kluwer to help you expedite the process and provide a foundation to build, protect, and leverage your digital electronic assets.

Explore how Wolters Kluwer can help you **optimize your collateral management and liquidity →**

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Wolters Kluwer reported 2024 annual revenues of €5.9 billion. The group serves customers in over 180 countries, maintains operations in over 40 countries, and employs approximately 21,600 people worldwide. The company is headquartered in Alphen aan den Rijn, the Netherlands.

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