Three strategies financial institutions should adopt before pledging electronic assets

When pledging electronic collateral to the Federal Reserve System, financial organizations cannot just replicate the same processes they use for traditional “wet-signed” paper transactions. Instead, they must consider various factors, from ensuring the authenticity and immutability of loan documents to the technology used to create, secure, and send electronic assets (eAsset®).

Adopting a right practice for electronic collateral brings numerous benefits to institutions including greater flexibility in their liquidity strategy and the ability to monetize assets with ease and at a maximum value in the secondary market. The question is how to prepare eAssets in a way that establishes clear ownership and control, builds trust among parties, allows for easy transfer, and minimizes the potential for their Federal Reserve Bank (FRB) to challenge their validity as pledge-eligible assets.

Here are three key strategies financial institutions should implement before pursuing certification to pledge eAssets to their FRB.

Focus on Digital Asset Certainty™

Achieving Digital Asset Certainty is the first crucial step organizations must take when pledging collateral to the FRB. Digital Asset Certainty involves creating and maintaining unique, immutable, verifiable, and authenticated, distinguishable assets from all other copies. This practice helps ensure the integrity, enforceability, and authenticity of assets when pledging to the FRB or monetizing through other channels.

eAsset management solutions and processes for achieving and maintaining Digital Asset Certainty are well-established in the market, fully vetted across all asset classes, and critical to favorable ratings and market valuations. As expected, evaluating workflows, systems, and processes is essential. Originating to legal and statutory standards for each asset class, demonstrating lifecycle chain of custody and control of the asset, and clearly identifying the secured party at the individual financial instrument level are things you need to pay attention to. The market provides multiple options for origination, and a compliant eAsset management solution provides the necessary control, eAsset protections, and secured party identification. The right solution to support Digital Asset Certainty allows you to focus on sound processes and seamless integration with existing dependent processes and functions, such as treasury or core systems.

Digital Asset Certainty supports the establishment, maintenance, and transferability of control, enabling a receiving party, such as an FRB, to enforce their rights in the underlying instrument.

Achieving eAsset certainty involves:

- Ensuring eAssets meet regulatory, statutory, and legal requirements such as Electronic Signatures in Global and National Commerce Act (ESIGN), Uniform Electronic Transactions Act (UETA), and applicable Universal Commercial Code (UCC) Articles, to minimize risk and maximize the liquidity potential of digital portfolios beyond FRB pledging.
- Creating a Digital Original® or authoritative copy to ensure the authenticity of the eAsset. Supported by the eDeposit® of Digital Originals and authoritative copies into a compliant eAsset management solution will provide assurance they remain immutable, trusted, negotiable, and transferrable.
- Implementing systems, procedures, and risk decisions that align with the strict establishment of clear chains of custody and control, along with supporting evidence, throughout the eAsset lifecycle.
- Applying a tamper-sealed watermark to identify the controlling and secured parties at the financial instrument level. For example, when pledging to the FRB, the eOriginal eAsset Management Solution provides a compliant transfer of control to a dedicated FRB pledge eVault instance, with a tamper-sealed watermark applied reflecting the FRB's security interest in eAssets pledged to the FRB.

Following these steps will help define the establishment, maintenance, and transferability of eAssets. They allow the receiving party, investor, or lender to enforce their rights against the underlying collateral as necessary.

Leverage an eAsset Management solution and eVault instances to secure eAssets

Pledging eAssets requires a thoughtful consideration of process adaptations and system infrastructure from origination through the pledge process and eAsset management. The goal is to originate eAssets that are unique, identifiable, and unalterable, with the Digital Original clearly distinguished from a copy and the secured party clearly identified at the financial instrument level. A robust underlying infrastructure of this nature will include a compliant eAsset management solution. When pledging an eAsset, the solution deploys a separate and secure eVault designated to the secured party (e.g., FRB) to reliably hold, watermark, and manage the single, authoritative copy of a pledged eAsset. This separate eVault satisfies FRB expectations under the Borrower in Custody (BIC) program, with the pledging institution continuing to act as the controller and designated custodian for its FRB.

Management of eAssets with this disciplined approach, creates trust to support FRB certification as well as options in the secondary market.

The disciplined approach to eAsset management and strategic utilization of eVault instances can effectively activate operational efficiencies and create trust for opening new avenues for monetizing eAssets in the secondary market. In addition to FRB pledge opportunities, financial institutions can use eVault instances to enable counterparty relationships across asset classes, support interbank lending, securitize, or buy and sell eAssets. For example, Wolters Kluwer's eOriginal® eAsset® Management Solution and extensive ecosystem provides lenders with direct access to the secondary market and ensure third parties have confidence to enforce rights and recycle that capital as needed.

Adapt to accommodate eAsset pledging

Facilitating the successful pledging of eAssets will require institutions to adapt current processes. The extent of change is dependent on the current state.

If currently originating electronically signed financial instruments: Considerations include originating and managing them as Digital Originals or authoritative copies and managed in a compliant eVault and eAsset management system, demonstrating control over the eAssets, implementing decision processes for pledge eligibility, and utilizing a separate pledge eVault instance with tamper-seal watermarking, among other necessary adjustments.

If transitioning to a digital lending strategy: Adapting will be more challenging, but very rewarding if you pay careful attention to every aspect of the workflow and engage stakeholders and functional departments early in the planning. Understanding the requirements for the end state (e.g., ensuring you have the data and compliance needed for pledging eAssets) and working backward to origination can help you identify areas for adaptation. These areas may include data requirements, document language changes, technology architecture, legal requirements, divergent processes, and supporting system needs. One example would be financial institutions must consider the content of their various lending documents to ensure they comply with electronic asset legal requirements. In this case, getting legal involved early would be valuable. There will be a need to differentiate electronic collateral from wet-signed documents in core systems and as part of your data plan. An architecture that includes a separate eVault instance for pledged collateral is a must.

Additionally, financial organizations should carefully evaluate their existing processes and resource transition. With a move to digital, are they deliberate in ensuring an exceptional client experience and creating efficiencies? Do they have the capacity to fully manage digital assets? Are their current operations and infrastructure agile and future-proof to adapt to evolving secondary market and capital requirements? Does their eAsset strategy provide the liquidity necessary to address institution needs quickly? These essential considerations will help organizations lay a solid foundation for effective, efficient, and compliant eAsset pledging.

To learn more about best practices for pledging eAssets, check out our webinar: *Building strategies for liquidity success in a digital lending ecosystem*

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

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Wolters Kluwer reported 2023 annual revenues of €5.6 billion. The group serves customers in over 180 countries, maintains operations in over 40 countries, and employs approximately 21,400 people worldwide. The company is headquartered in Alphen aan den Rijn, the Netherlands.

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