



eBook

Capitalizing on electronic collateral: How lenders can pledge electronic assets to the Federal Reserve

“The Federal Reserve Bank now permits financial institutions to pledge digital assets as collateral in the discount window program.”

New asset class, new opportunity

Lending institutions such as consumer and commercial financial institutions rely on their Federal Reserve Bank (FRB) for short-term funding. The FRB’s lending program, known as the discount window, plays a key role in sustaining the liquidity and stability of the banking system and capital markets.

In a significant development, the FRB now permits financial institutions to pledge digital assets (or eAssets®) as collateral in the discount window program, essentially creating a new asset class. This represents a major opportunity for loan originators as it provides a new option for financial institutions to monetize their loan value.

Today’s financial institutions are increasingly creating digital assets — including mortgages, auto loans, and equipment leases — as a way to accelerate processes and deliver better customer experiences. But what ultimately makes these electronic assets viable is when the investor community accepts them — by securitizing them, serving as a custodian bank, or, in the case of the FRB discount window, accepting them as pledged collateral.

But pledging digital assets presents new challenges for financial institutions. Although financial institutions are accustomed to working with paper loans under the Borrower-in-Custody (BIC), the FRB program for pledging electronic collateral requires adaptations and nuances needed when seeking certification to pledge eAssets. Pledging eAssets introduces new bank processes and requirements.



Pledging is the process by which FIs provide collateral to the FRB in exchange for borrowing funds through the discount window. Pledged assets can include government securities, mortgage-backed securities (MBS), and digital assets such as eAssets. Pledging is conducted under the FRB’s BIC program, which permits FIs in sound financial condition to pledge loan collateral while retaining possession of the collateral.

The promise of eAssets

In order to pledge eAssets, the FRB requires financial institutions to be certified specifically for electronic collateral under the BIC program, a process that requires answering questions about origination, control, management, labeling, and protection of FRBs security interest. However, most financial institutions established wet-signed asset management processes years ago. The team members who put them in place are likely in other roles or no longer available to help current staff adapt processes to a new electronic asset workflow and certification with the FRB.

The solution is to deploy a proven, end-to-end platform for eAsset management with best-in-class eVault capability. Such a platform will not only provide financial institutions with eAsset Certainty for pledging electronic collateral to the FRB, but also enable the digital assurances for additional monetization scenarios, both current and future. Ultimately, effective eAsset management promotes digital process efficiencies, monetization flexibility of loans in the secondary market, and new competitive advantages.



“The FRB requires financial institutions to be re-certified under the BIC program to pledge eAssets.”

Advantages of eAssets and digital lending investments



Digital process efficiencies and savings



Highly secure asset protection and loss prevention



Better borrower experiences



Competitive advantage over less-agile rivals



Increased velocity for monetization of loans in the secondary market



Financial market access via an extensive eAsset ecosystem

Overnight lending and liquidity

Financial institutions have three primary channels for overnight loans and liquidity. One of these is borrowing from other financial institutions under the Federal funds rate, which are reserves that FIs deposit at Federal Reserve Financial Institutions. The FRB funds rate is the interest rate at which depository institutions, such as financial institutions and credit unions, lend reserve balances to other FIs on an uncollateralized and typically overnight basis.

Another channel is Federal Home Loan Financial Institutions (FHLBs). Along with the FHLB, government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, who play an important role in the housing finance system, provide liquidity support to member FIs such as commercial financial institutions, credit unions, savings institutions, and insurance companies.

The third avenue for overnight loans is the Federal Reserve System, which comprises 12 Federal Reserve Financial Institutions located in Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, San Francisco, and St. Louis.

The FRB's discount window is the central banking system's lending component to its member financial institutions. Financial institutions rely on the FRB discount window — which is typically overnight but can be up to 90 days — for liquidity support and to supplement their current cash position. (See Figure 1)

“Financial institutions rely on the FRB discount window for liquidity support to supplement their current cash position.”

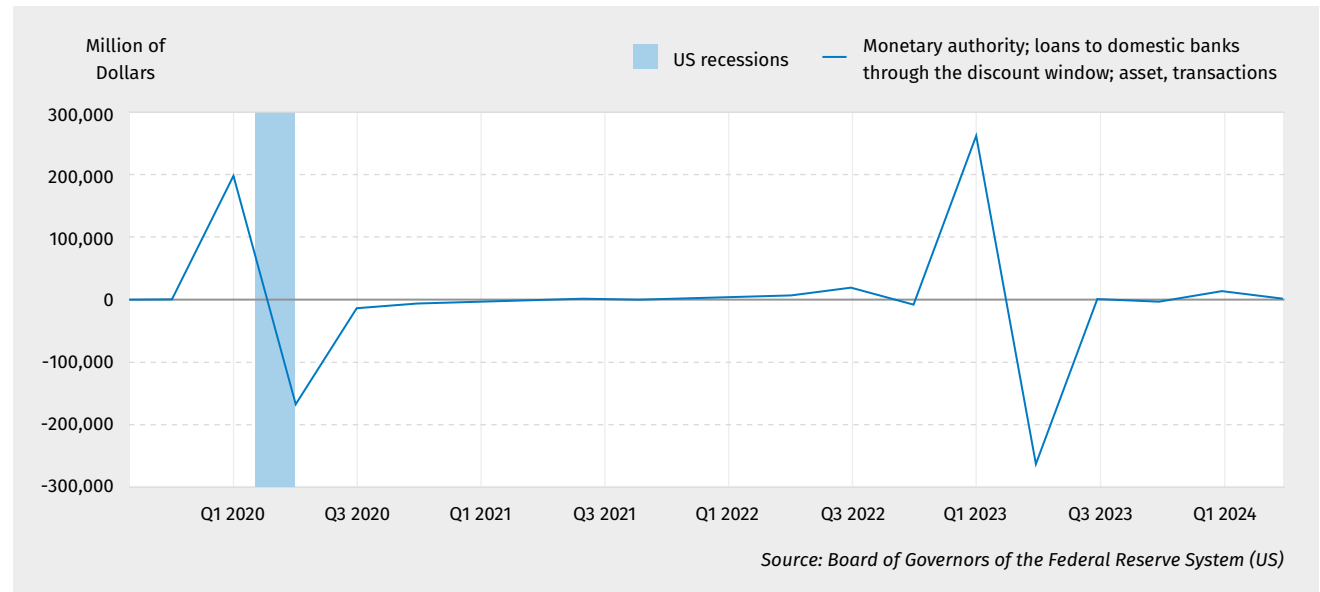


Figure 1: Loans to US financial institutions through the discount window, Q1 2020 - Q1 2024

Pursuing a digitized process

Reliance on the FRB discount window tends to increase during periods of economic instability. The FRB is encouraging FIs to be positioned to take advantage of the discount window as a foundational component of their liquidity strategy. An FI's readiness would include establishing a BIC relationship and to tap the window at least once per year. This represents an opportunity for lenders to take advantage of eAssets for pledging.






Yet most of the trillions of dollars worth of collateral pledged in active periods is still based on wet-signed paper documents. Financial institutions have put in place systems, processes, and protections to manage the paper-based assets under their control. Each, and sometimes daily, borrowing financial institutions refresh the loans they have positioned to pledge. Then each month, they provide their FRB with a report that identifies the actual pledged loans. For pledging eAssets, many of the established processes will follow similar flows but with greater efficiency and lower direct resource involvement.

A digitized workflow begins with an exceptional user experience at origination and follows an integrated end-to-end process that can expedite loan verification, funding, and asset monetization including pledge availability. eAssets begin with a compliant eSignature process immediately followed by a direct eDeposit of the loan into an eAsset Management System and eVault. This all-digital approach ensures a clear electronic line of sight to demonstrate control and to defend the authenticity of the eAsset. The digitized process relies on some of the same core systems as its traditional wet-signed counterpart, but the way information flows into loan decisioning is unique.

To pledge eAssets, financial institutions must have their digital workflow certified with the FRB's BIC program. The 12 Federal Reserve Financial Institutions operate independently, with their own requirements and documentation for BIC electronic collateral certification. Guidelines and information on requirements is limited and questionnaires are detailed and complex. Expert resources are available to assist FIs in the completion of the questionnaire and process design.

Confronting the challenges of a new asset class

To benefit from pledging eAssets, FIs will need to address key issues, including:

-  Existing BIC processes based on wet-signed paper assets
-  Current manual reporting of pledged loans to the FRB
-  Manual or partially digitized loan origination workflows
-  Outdated information flows for loan decisioning
-  Re-certification for the FRB's BIC program with digital workflows

“With eAssets, financial institutions have a chance to digitize pledging, along with their end-to-end lending processes.”

“A more strategic approach is the adoption of a proven, purpose-built solution for end-to-end eAsset management that can deliver a positive return on investment (ROI).”

Digitizing lending and secondary market monetization

To digitize lending and monetization of eAssets in the secondary market — and to achieve BIC certification — FIs should follow the right practices for compliant eAsset origination and lifecycle management. Carrying over practices from Covid years, such as retaining esigned documents in a file server or relying on an imaging system, will result in a rating downgrade, value loss, and limiting options.

A more strategic approach is the adoption of a proven solution for end-to-end eAsset management that can deliver a positive return on investment (ROI). A comprehensive solution delivers numerous operational, business decision, and competitive advantages, including:



A purpose-built eAsset Management solution to manage and secure all categories of eAssets



Digitized processes for operational efficiencies and better customer experiences



Lifecycle monetization of eAssets in the secondary market at maximum value



A preferable position on operations and cash flows



Flexibility to manage diverse digital assets today and in the future



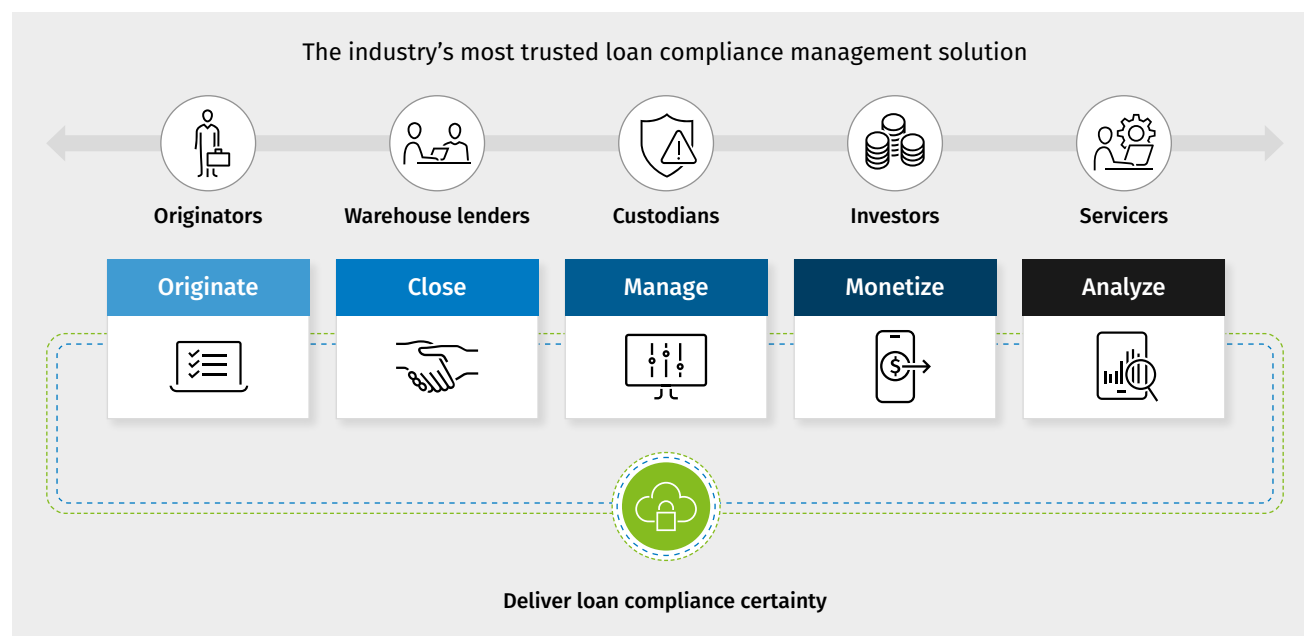
Advantage over competitors that lack digital lending capabilities

An eVault solution to maximize compliant liquidity

The optimal solution to harness these advantages is the eOriginal® eAsset Management solution. eAsset® Management is a trusted, purpose-built solution for multiple asset classes that meets all legal requirements.

With eAsset Management, financial institutions can achieve Digital Asset Certainty — the assurance that eAssets are created, stored, and assigned in full accordance with all industry compliance standards. They can likewise maintain the highest level of legal enforceability throughout the eAsset lifecycle. (See Figure 2)

The eOriginal eAsset Management solution with flexible eVault utilization is the trusted solution for thousands of industry-leading organizations, including the largest buyers and insurers of asset-backed securities (ABS) in the United States. eOriginal eVault reliably establishes the entity to which the single, authoritative copy of an eAsset is assigned, issued, or transferred. In other words, it provides a secure environment that ensures eAssets can remain negotiable and transferable.



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Figure 2: eOriginal eAsset Management for compliant liquidity

With this immutable digital record, FIs can pledge, sell, and securitize eAssets with full compliance and maximum value. They can leverage an extensive ecosystem to enable counterparty relationships across asset classes, in support of digital lending from origination to sale in the secondary market. (See Figure 3)

The eOriginal solution provides eAsset Certainty with encryption, end-to-end audit trails, and tamper sealing. Tamper sealing applies a digital watermark and integrity check so FIs can digitally track every action taken on an eAsset as a digital chain of custody and evidence. Financial institutions can use the eOriginal eAsset Management solution with a dedicated FRB pledge eVault instance to pledge electronic collateral to the FRB without the need for any special modifications. A foundation of trust is established allowing for efficient and secure eAsset monetization across an extensive eOriginal ecosystem.

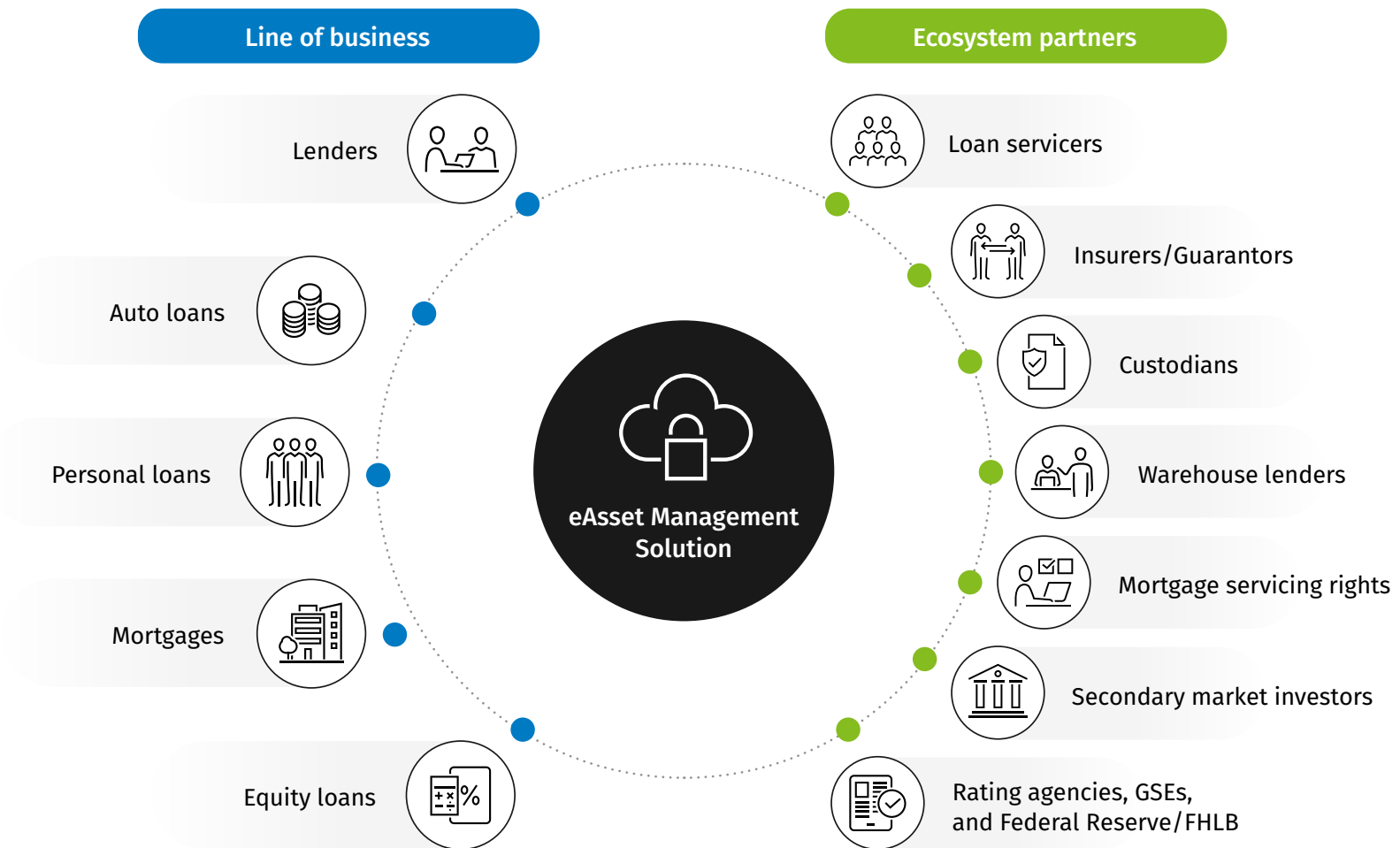


Figure 3: Managing loan type across partners

Services to support eAsset pledging

As FIs continue to pursue eAsset pledging, they can benefit from the guidance of an experienced, trusted advisor. Wolters Kluwer offers comprehensive services to help financial institutions navigate their end-to-end eAsset journey.

We assist financial institutions in achieving BIC electronic collateral certification through our established, comprehensive eBIC program that includes a set of key criteria that financial institutions must address to present a compelling case to secure certification. We also maintain documented BIC requirements, along with the expectations of all 12 Federal Reserve Financial Institutions.

Our experts can help financial institutions complete BIC electronic collateral certification documents, with question-by-question guidance, and response content. We will also co-present the certification request to the FRB and present the system for approval.

In addition to BIC certification documentation assistance, we help with strategy, system, and process design to develop an efficient digital process for pledging that integrates with existing core systems. We can also provide training for bank staff involved with pledging.





The right practice for pledging electronic collateral

Wolters Kluwer has established best practices for using an eVault for pledging electronic collateral. A key practice is to designate a separate Pledge eVault used only for that purpose, with all included eAssets marked as being pledged to the FRB. As defined in the FRB BIC program, the eAsset remains under the control of the pledging institution, but the security interest of the FRB is clearly identified and protected through the control protocols of eAsset Management solution and pledge eVault instance.

Finally, Wolters Kluwer offers financial institutions ongoing support through a best-practice structure for complying with the FRB's yearly audits and revalidations. This multi-week program takes a deep dive into bank processes and procedure for eAsset management, helping financial institutions provide the FRB with answers to specific questions and insights into the operational context. As a result, financial institutions can demonstrate to the FRB that they have implemented robust processes and are maintaining strict controls.

“A key best practice is to designate a separate Pledge eVault used only for that purpose.”

eAsset pledging services and support

- ✓ Guidance in achieving BIC electronic collateral certification
- ✓ Training of bank staff involved with pledging
- ✓ Co-presentation of the BIC certification request for approval
- ✓ Best practices for a pledge compliance and eAsset value certainty
- ✓ eAsset strategy, system, and process design
- ✓ Best practices for FRB audit compliance

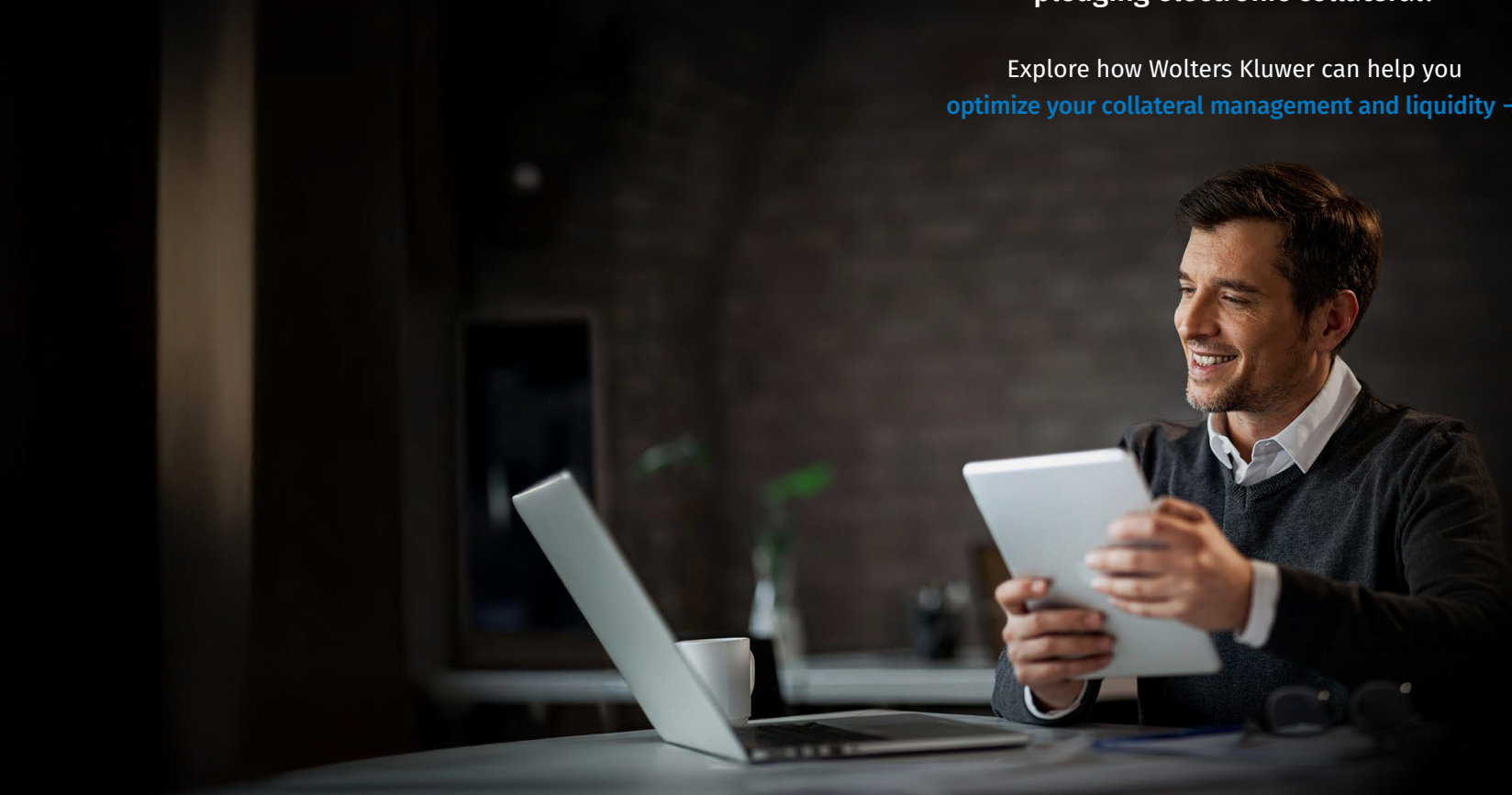
Next steps for financial institutions now

Loan originators have a strategic opportunity with the FRB's acceptance of electronic collateral for discount window pledging. They can benefit from an efficient and secure monetization of loans in the secondary market, tap liquidity options for greater agility, and out-compete flat-footed rivals. An end-to-end platform for eAsset management, including a best-in-class, purpose-built eVault, gives financial institutions the technology and process foundation they need to gain full advantage of pledging electronic collateral.



**Ready to benefit from
pledging electronic collateral?**

Explore how Wolters Kluwer can help you
[optimize your collateral management and liquidity →](#)



About Wolters Kluwer Financial & Corporate Compliance

Wolters Kluwer (EURONEXT: WKL) is a global leader in information, software solutions and services for professionals in healthcare; tax and accounting; financial and corporate compliance; legal and regulatory; corporate performance and ESG. We help our customers make critical decisions every day by providing expert solutions that combine deep domain knowledge with technology and services.

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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