

**FINANCIAL SERVICES ACTION PLAN  
FORUM GROUP ON THE CROSS-BORDER USE OF COLLATERAL**

**ISSUES PAPER  
FOR THE  
FIRST MEETING OF THE GROUP**

## 1. Introduction

The Commission's Communication on *Implementing the Framework for Financial Markets: Action Plan*<sup>1</sup> has recognised that progress is needed to facilitate the effective cross-border use of collateral in the context of financial transactions. A range of problems currently exist concerning the acceptance and enforceability of cross-border collateral in securities settlement systems and consequently the potential to further develop collateral use is to some extent constrained.

The use of collateral to back cross-border payment and securities transactions has increased substantially in the EU. The 1998 Directive on Settlement Finality<sup>2</sup> constitutes a milestone in establishing a sound legal framework for payment and securities settlement systems. However, the increased use of collateral has systemic implications in the event of failures by market operators, and the potential to further develop the use of collateral is also constrained. Therefore, future research should be devoted to e.g.:

- the applicable law governing collateral arrangements in general;
- whether or not a pledge or title transfer is enforceable in the event of the insolvency of the collateral provider.

The Commission's Financial Markets Action Plan has recognised the problem and accorded top priority to proposing a directive on the cross-border use of collateral, with the ultimate goal to provide legal certainty as regards validity and enforceability of collateral provided to back cross-border securities transactions.

The purpose of the Forum Group will be to advise the Commission as to the best way of achieving legal certainty as regards validity and enforceability of collateral provided for cross-border use.

## 2. The cross-border use of collateral

### ➤ ***Growth in the use of cross-border collateral***

Collateral is used to back cross-border payment and securities transactions. Collateral gives are able to lower borrowing costs if they can convince lenders to accept their securities as collateral. Its use has increased substantially in the EU in recent years. Each day, hundreds of billions of euro are now provided to collateralize transactions, and the market is growing. The introduction of the single currency has been one new important factor in this trend. The growth of European debt and derivatives markets, and the fact that the new European System of Central Banks has been set up in such a way that is able to accept a wide range of assets for the collateralisation of payments, have been other driving factors.

### ➤ ***How collateral is used***

Collateral is used to provide a guarantee against all kinds of liabilities. Two types of collateral can be distinguished:

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<sup>1</sup> COM(1999)232, 11.05.99

<sup>2</sup> Directive 98/26/EC of 19<sup>th</sup> May 1998 - OJ L166

- **Pledge collateral** does not transfer ownership, the ownership of the pledged collateral remaining with the pledgor. Pledge collateral is thus subject to restrictions which limit the collateral taker's ability to use securities. Moreover certain formalities must be observed in order to perfect a pledge collateral, formalities which may vary depending on the law governing a collateral arrangement.
- As a result of such difficulties, **title transfer collateral** has been developed. In this case, the legal ownership is transferred and the collateral taker is under such an arrangement entitled to freely dispose of the assets, subject only to a contractual obligation to redeliver securities to the collateral provider at maturity date. Repurchase agreements (repo's) are the most prominent example of title transfer collateral. By enabling the collateral taker to sell, lend or to further repo securities under such an arrangement, financial institutions holding the collateral are able to use it efficiently, lowering their own costs and therefore the cost of the financial services provided to the collateral provider.

### 3. The current regulatory framework for the cross-border use of collateral

#### ➤ ***The Settlement Finality Directive and the implementation of Article 9(2)***

The Settlement Finality Directive is to date, the only piece of European legislation regulating collateral. The Directive needs to be implemented by 11<sup>th</sup> December 1999. Its aim is to reduce the risk associated with payment and securities settlement systems and thus to contribute to the efficient and cost effective operation of cross-border payment and securities settlement arrangements in the Community. In particular, the Directive aims to reduce systemic risk in the finality of settlement and the enforceability of a collateral security.

Article 9(2) applies the "*place of intermediary approach*" (based on the principle of *lex rei situs*). This article determines which law the collateral taker has to apply in order to secure a valid legal entitlement to the collateral, and in particular whether this entitlement is good against third parties.

However, different approaches have been adopted by Member States currently in the process of implementing this article of the Directive. For some experts, Article 9(2) determines the applicable law only for collateral arrangements between system participants<sup>3</sup>. For others, Article 9(2) can be applied more widely<sup>4</sup> to address the question of applicable law for transactions even beyond and outside systems.

Outside the scope of this directive, the legal framework for collateral is characterised by a host of conflicting national laws.

### 4. Work to be Carried out by the Forum Group

The Settlement Finality Directive has clarified the legal situation for collateral used within systems. However further clarity is needed in order to achieve legal certainty, for instance with

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<sup>3</sup> In particular the Spanish, French and Austrian authorities have indicated their intention to implement along these lines.

<sup>4</sup> This is the prevailing view in a number of Member States, in particular in Germany, Netherlands and Belgium

regard to the way of setting up collateral or with regard to its cross-border use. Current laws and rules throughout the European Union relating to collateral are complex and in parts inconsistent; they are in fact in important respects out-of-date. They therefore create uncertainty and unpredictability regarding the effectiveness of the intended protection, leading to increased risk for the financial markets.

The Forum group will thus need to assist the Commission in:

- Identifying the problems and most important factors leading to uncertainty;
- Recommending the appropriate course of action(s) taken in order to improve legal certainty for cross-border collateral.

➤ ***Identifying problems and uncertainties***

The forum group will need to give consideration to the following issues:

- The Settlement Finality Directive already gives explicit protection to collateral security provided in the context of payments and securities and settlement systems, which cannot be affected by insolvency proceedings. It needs to be considered whether this “privilege” should be extended to collateral security in general.
- While national collateral rules cannot be fully harmonised, any future Community measure will have to resolve the issue as to which jurisdiction will govern the collateral security. This issue, which basically is a matter of the location of the security, has been solved in the context of payment and securities settlement systems (albeit subject to interpretation), but not in a more general context.
- Some collateralisation techniques (i.e. pledges or repo’s), are not valid in all jurisdictions. It needs to be considered whether Community measures are necessary to alleviate any inconveniences which market operators may encounter as a result of differences in national laws.
- Top-up collateral security provided on the basis of daily mark-to-market may not be respected in all jurisdictions in the event of defaults.
- Current discussions at the Basel Committee and in Brussels have highlighted concerns by banks that the current framework is not sufficiently flexible with regard to the acceptance of eligible collateral for prudential purposes. Although consideration is being given to widening the range of instruments eligible as collateral, the supervisory authorities will need to be satisfied that any collateralised transaction that attracts a reduced capital charge has legal certainty in the event of the insolvency of the borrower.
- Other questions, not covered under the above points may also need to be addressed.

***What action can be taken to improve legal certainty for cross-border collateral?***

- As the methods and standards governing the constitution and use of collateral are largely determined by national legal provisions, their coherence at European level will also require legal measures, for instance in the form of a harmonising directive.

- As to the question of whether or not the “privileges” of the Finality Directive can be extended to situations outside systems, a significant part of the answer will depend on whether or not systemic risk is demonstrably involved in these situations.
- Many Member States appear to have interpreted Article 9(2) of the Settlement Finality Directive in a broader way. Consequently the extension of the Directive’s scope may need to be legally confirmed.
- The question as to whether or not collateralisation techniques can be harmonised among Member States needs to be studied in taking into account the degree to which underlying general civil law principles would be affected by such harmonisation.
- Thus as a basis for a starting point The Commission Would like to ask the members of the Forum Group to consider the following questions concerning a possible outline of a Directive:
  - (1) *Scope of the new Directive on Cross-border Use of Collateral*
    - (a) Could the scope of the Finality Directive just be extended from participation in systems covered by the Directive to bi-lateral agreements between the participants themselves as mentioned in article 2 of the Directive. It means that the new Directive should mainly cover agreements concerning collateral between credit institutions, as defined in the banking directives, as well as investment firms, as defined in the ISD, and similar institutions located outside the Community?
    - (b) Collateral securities could also be defined in line with the Finality Directive and thereby cover securities provided under a pledge as well as a repo. (The characteristics of these two types of collateral should not be hampered. However other kinds of title of transfer could be considered)?
  - (2) *Protection of collateral securities*  
 With the purpose of protecting collateral from the effects of the insolvency law applicable to the insolvent participant, would it be a way to proceed to determine that the law covering the insolvency regarding the pledge should be the same as the law covering the collateral taker?  
 In this case, the pledgee should only, when establishing the collateral, collect information on the rules on establishment according to the *lex rei sitae* principles. (It is assumed that the pledgee is aware of the local bankruptcy legislation). This approach seems more realistic than to completely insulate the pledge from the effect of insolvency as in the Finality Directive, because the new Directive should cover bi-lateral agreements and thereby not systems with standardised rules and the possibility of supervision.
  - (3) *Location of collateral*  
 Will it create the necessary certainty, if article 9(2) in the Finality Directive should be incorporated into a Cross-border Collateral Directive with the same scope as mentioned under question 1.a. (This could be considered together with the proposal in the last pullet point on page 12)?  
 (Cross-border collateral outside the scope of the new Directive i.e. outside the use of collateral in the context of financial transactions will still not be covered).
  - (4) *Exemption from bankruptcy legislation concerning Top-up collateral*  
 Assuming that it is possible to protect cross-border use of collateral from the pledgor’s

bankruptcy legislation as mentioned under question 2, would an exemption from the existing bankruptcy legislation, which prohibits use of top-up collateral provided on the basis on daily mark-to-market calculations, offer sufficient protection to the banking industry?

(5) *Realisation of securities*

As mentioned above, it should be considered whether or not collateralisation techniques can be harmonised to some extent. For liquidity reasons and thereby systemic risk, the question is whether or not the new Directive should explore the area of when the pledgee is able to realise the securities e.g. immediately or few days after the default of the pledgor?

(6) *Netting and retroactivity*

The Finality Directive also includes other rules in the area of bankruptcy legislation; recognition of netting and abolition of retroactivity - the so called zero hour rules. The question is whether it is necessary that a Directive on Cross-border Use of Collateral contains such rules? (Such rules would go further than regulating the validity of collateral securities e.g. to the extent that bi-lateral netting is set off. Furthermore if the proposal under question 2 is deemed useful, there would be no cross-border problem concerning collateral in bankruptcy cases, because the applicable insolvency law would be the law governing the pledgee).

Further questions have been raised in a paper by ISDA "*Collateral Arrangements In the European Financial Markets: The Need For Law Reform*" which was presented to the Giovannini group in March 1999. This paper is enclosed in annex and could also form the basis of discussion.

Another possible approach with a view to defining what is required in the area of collateral law reform would be to request forum group participants to gather examples of best practice, in terms of documentation/contracts, which might eventually form the basis of harmonisation at Community level.

## 5. Timeframe

In order to meet the deadlines set by the Commission's action plan, the following timeframe will need to be followed:

September 1999	Constitution of the Forum group
October 1999	First of a series of 3-4 meetings
March 2000	Conclusions of the Forum group
Spring 2000	Launch consultation
End 2000	Proposal for a directive
2003	Adoption of directive



## ANNEX

**GIOVANNINI GROUP 1 MARCH 1999  
CONTRIBUTION TO  
AGENDA ITEM 2**

International Swaps and Derivatives Association – February 1999

### **Collateral Arrangements In The European Financial Markets: The Need for Law Reform**

#### **1. Introduction**

Taking collateral is one of the principal ways in which financial market participants reduce credit risk. Lack of legal certainty seriously impedes the efficient use of collateral and needlessly limits the amount of business that could otherwise be done on a collateralised basis. This in turn restricts access to financial services and raises costs, particularly for small- and medium-sized businesses. Some legislative improvements have been made in recent years, for example, in Belgium, France, Luxembourg and the United Kingdom and in the Settlement Finality Directive but it is still fair to say that current laws and rules throughout the European Union relating to the use of collateral are complex, inconsistent, impractical and in important respects, out-of-date. They therefore create uncertainty and unpredictability regarding the effectiveness of the intended protection, leading to inefficiency, cost and increased risk for the financial markets.

#### **2. Collateral: pledge versus title transfer**

Collateral arrangements in the financial markets typically involve the delivery of securities or cash by one party to another participant in the market. The counterparty may be a counterparty to a privately negotiated transaction, a clearing house for an organised market, a settlement agent for a settlement system or some other market participant with a potential credit exposure to that party. The delivery of securities or cash is either

- subject to a pledge or other security interest (referred to as pledge collateral in this paper), or
- by outright sale, as, for example, in the case of a repo transaction (referred to as title transfer collateral in this paper).

Some difficulties creating legal uncertainty apply to both kinds of collateral, some to just one type. The most common problems are listed below. (While arrangements involving cash collateral raise problems, greater difficulties are associated with

collateral arrangements involving securities, and the remainder of this paper focuses therefore on these arrangements)

### 3. Main legal impediments to the efficient use of collateral

- *cumbersome and impractical rules for creating, “perfecting”, maintaining and enforcing pledge collateral.*

Pledge collateral is the traditional approach to collateral. Under this approach the pledgor remains the owner of the assets transferred to the pledgee, the pledgee having a partial interest only. Typically, the pledgor delivers the pledge collateral to the pledgee (or its nominee), although the necessity for this varies under different national laws.

Many jurisdictions have “false wealth” rules, designed to protect the pledgee by allowing him to verify whether the goods proffered by the pledgor as security are free and clear of the claims of third parties. These rules, often referred to by lawyers from common law jurisdictions as “perfection” requirements, take various forms. They may include requirements as to the form or manner of entering into (executing) the relevant pledge documentation, the making of a filing or other registration of the pledge, the use of a “pledged account” to hold the securities and/or the delivery of notice to a third party. Uncertainty as to which rules apply and in which cases and the impracticality of complying with such requirements in fast-moving securities markets and in relation to dematerialised or immobilised securities held through a chain of custodians mean that these rules impede or discourage the effective creation and/or perfection of valid pledge collateral arrangements. The consequence of failure to comply with these rules, where they apply, is often the invalidity or unenforceability of the pledge collateral, a potentially disastrous result.

- *legal restrictions on the use of pledge collateral*

Most financial institutions holding collateral in the form of securities in fungible form consider it a commercial imperative that they be able to deal freely with the securities until they are required to re-deliver securities under the collateral arrangement. Freedom to deal would include the freedom to sell, lend or repo the securities or to re-pledge (rehypothecate) them to a third party, subject always to an obligation to return equivalent fungible securities to the collateral provider assuming that it performs its obligations in full. By dealing freely with the securities, the financial institution holding the collateral is able to use it most efficiently, lowering its own costs and therefore the cost of financial services provided to the collateral provider.

Under pledge collateral arrangements, however, the pledgee has only a partial interest in the pledge collateral it holds, and therefore any use of the collateral (except possibly repledging of the collateral) risks destroying the original security interest by disposing of the ownership interest of the pledgor out of which the limited interest of the pledgee arose. In addition, a pledgee generally has fiduciary obligations in relation to the custody of collateral that are unnecessary in the context of tradeable dematerialised or immobilised securities.

- *Uncertainty regarding enforceability of title transfer collateral*

Title transfer collateral was developed in order to overcome the two areas of difficulty mentioned above. Because the transferee of the collateral is in this case the legal owner, it is entitled to do what it likes with the assets, subject only to a contractual obligation to return equivalent fungible securities. And because it is the owner, it is also free of fiduciary obligations to the transferor in relation to the custody of the collateral. (The main disadvantage of title transfer collateral is of course that it incurs an exposure to the transferee, since the transferor would be an unsecured creditor for the value of the collateral in the event of the transferee's insolvency).

While title transfer collateral (of which securities lending and repo arrangements are special cases) works well in relation to modern methods of trading, holding and transferring securities, in some jurisdictions there is thought to be a significant risk that it could be recharacterised as pledge collateral on the grounds that its purpose is similar to the purpose of pledge collateral. Recharacterisation would, of course, defeat the purpose of using a title transfer collateral arrangement to avoid cumbersome formalities and restrictions on use.

In many jurisdictions, including England, recharacterisation risk is avoided on the basis that, notwithstanding the purpose of arrangement being essentially the same as a pledge, the credit risk taken by the transferor on the transferee means that there is a substantive difference between pledge collateral and title transfer collateral. On that basis, therefore, the choice of the title transfer approach is not a sham, but a genuine and legitimate choice, with its own set of advantages and, of course, risks. Other jurisdictions lay more emphasis on the intended purpose and would therefore recharacterise. In addition, since title transfer collateral arrangements are based ultimately on set-off or netting, they are vulnerable if there are restrictions on insolvency set-off in the collateral provider's home jurisdiction or if the relevant netting legislation in that jurisdiction is not broad enough to encompass title transfer collateral.

- *Uncertainty as to conflict of laws rules*

One of the most difficult areas for global financial institutions operating on a cross border basis is determining which jurisdiction's laws apply to which aspect of a collateral arrangement, including creation/perfection, priority relative to adverse claimants and enforceability of the arrangement. Not only are the choice of law rules potentially difficult to apply within a single jurisdiction, but another jurisdiction relative to the arrangement might choose differently, meaning that the same question (for example, whose law governs perfection in a particular case?) will be answered differently by courts in different jurisdictions.

These rules, to the extent they apply to securities, are generally based on the assumption that the security exists in certificated form. They deal inadequately and with paradoxical results in relation to securities held in dematerialised or immobilised form in modern clearing systems and/or through a chain of custodians. Not surprisingly, Belgium and Luxembourg have dealt with these issues by statute, but the position is generally unclear and/or unsatisfactory as a practical matter in most, if not all, other European jurisdictions.

- *Vulnerability of mark-to-market collateral arrangements*

Collateral arrangements intended to secure or support net credit exposure under a master agreement are generally adjusted on a daily basis by comparing the net exposure under the master agreement with the value of collateral on hand. If there is a shortfall of collateral, additional or “top-up” collateral must be provided. If there is a surplus of collateral, then some or all of the surplus may be returned to the collateral provider. Margining arrangements in relation to futures and options on organised markets generally operate on a similar basis.

Under the preference rules of some jurisdictions, deliveries of top-up collateral made by a party during a specified period (the “suspect” or “preference” period) prior to its insolvency may be invalidated by the liquidator or other relevant insolvency official, who may require the collateral holder to return the “top-up” collateral without deduction, off-set or other application against the exposure of the collateral holder to the insolvent.

In addition, under “zero hour” rules of some jurisdictions, formal insolvency proceedings are deemed to commence at the midnight immediately preceding the time that the formal insolvency proceedings were actually initiated (for example, by petition of a creditor or by court order). This can mean that transfers of collateral occurring prior to the time proceedings were actually initiated could also be subject to avoidance by the liquidator or other relevant insolvency official.

When daily collateral movements have occurred over the course of, say, a six-month suspect period, a substantial portion of the collateral held by the collateral holder could be subject to avoidance in this way, with potentially grave consequences for the collateral holder (and possibly, by consequence, for its creditors).

#### **4. The way forward: the principles that should underpin collateral law reform**

Any proposal to rationalise and harmonise national laws in each of the Member States with regard to collateral arrangements is necessarily ambitious. Ideally, fundamental issues of property law and insolvency law, as well as a number of other relevant areas of law, need to be addressed from both a civil law and a common law perspective.

While the Settlement Finality Directive was a valuable step in that direction, its aims were limited since it was intended to assure the integrity of payments and securities settlement systems. Nonetheless, it may provide a model for a more ambitious Directive dealing with these issues, perhaps expanded to cover modernisation generally of the rules relating to securities ownership, transfer and pledging laws. An alternative approach might be for each national jurisdiction to address its own problems on the basis of commonly agreed goals.

There are certainly some basic principles that should underlie any proposed reform of EU or national law relating to collateral arrangements involving cash and securities. The ideal regime would combine the best elements of the pledge collateral and title transfer collateral approaches, obviating the need for these alternatives. It is suggested that this can be achieved, while safeguarding the interests of the collateral taker, the collateral provider and third party creditors of each of these parties, by establishment of a regime embodying the following principles:

- There should be no special procedures for establishing the collateral arrangement and there should be no (or very minimal) requirements regarding the form, content and/or manner of entering into the collateral documentation.
- There should be no requirement that any registration or filing be made with any authority or any notice given to any third party.
- The collateral provider should be required to deliver possession of the collateral to the collateral taker (or its nominee); the collateral taker should be free to deal with the collateral as though it were the outright owner of the assets; and third parties purchasing from the collateral taker should be able to obtain a clean title to the assets.
- In the event of the insolvency of the collateral taker, the collateral provider should be able to redeem its securities from the estate of the collateral provider.
- The substantive law governing the establishment and priority of the collateral arrangement should be the law chosen by the parties. Where no law has been chosen by the parties, the law governing the rights of parties to securities held by a global custodian in a clearing system should be governed by the law of the jurisdiction where a party would most naturally go to enforce a claim against that global custodian.
- For any purpose for which it is relevant, the law should make clear that the interest of a party in dematerialised or immobilised securities held by a financial intermediary in a clearing system consists of a personal and co-proprietary interest in a pro rata portion of the pool of securities held by that financial intermediary in that clearing system, and not as a traceable property right in individual securities held by a sub-custodian or as a mere contractual claim against that financial intermediary.
- Mark-to-market collateral arrangements should be protected from the effect of preference and zero-hour rules (and similar insolvency rules) provided that they were entered into, in the case of preference rules, prior to commencement of the relevant suspect period.