

Financial Collateral Arrangements



European Commission

DG Internal Market & Services

FINANCIAL MARKETS INFRASTRUCTURE

UNIT G/1

EC Collateral Directive



Council Directive
of 6 June 2002 on Financial
Collateral Arrangements
2002/47/EC

Collateral

Collateral:

- the provision of assets to secure the performance of an obligation,
- whereby the assets can be provided:
 - either by transfer of full ownership from a collateral provider to a collateral taker
 - or by the transfer of possession from a collateral provider to a collateral taker under a security right (e.g. pledge, charge or lien), where the full ownership of the assets remains with the collateral provider

Aims of the Collateral Directive:

- Removal of the major obstacles for the (cross-border) use of collateral
- Creation of clear, effective and simple regimes for financial collateral arrangements
- Limitation of administrative burdens, formal acts and cumbersome procedures to create and enforce financial collateral
- Recognition of specific risk mitigation techniques used in the financial markets
- Recognition of the right to re-use pledged collateral
- Creation of legal certainty on the applicable law

The Collateral Directive contributes to:

- Integration and cost efficiency of the financial markets
- Stability of the financial system
- Reduction of risks (legal risks and credit risks) and losses
- Enhancing cross-border transactions and competitiveness

The Directive is hence an important part of the Lisbon Strategy

The Collateral Directive complements:

- EC Directive of 19 May 1998 on settlement finality in payment and securities settlement systems (98/26/EC)
- EC Regulation of 29 May 2000 on insolvency proceedings (1346/2000/EC)
- EC Directives on the reorganisation and winding-up of credit institutions of 4 April 2001 (2001/24/EC) and of insurance undertakings of 19 March 2001 (2001/17/EC)

Drafting process

- Initiation in the Action Plan of 11 May 1999
- Preparatory work of the Forum Group on Collateral (October 1999 - May 2000)
- Preparation of the Commission proposal (June 2000 - March 2001)
- Publication of the Proposal for a Directive on 30 March 2001
- Establishment of a Council Working Group and start of the Parliamentary debates in May 2001
- Finalisation of the work on a Common Position in March 2002
- Adoption of the Directive on 6 June 2002

Structure of content

- Scope and definitions (Articles 1 and 2)
- Substantive collateral law (Articles 3 - 6)
- Substantive insolvency rules (Articles 7 and 8)
- Conflict of law rule (Article 9)
- Procedural matters (Articles 10 - 13)

Personal scope of application

- The Directive applies if the **parties** (collateral taker and collateral provider) belong to one of the following categories:
 - *Public sector bodies* (excluding publicly guaranteed undertakings)
 - *Central banks, ECB, BIS, multilateral development banks, IMF, EIB*
 - *Supervised financial institutions* (credit institutions, investment firms, insurance undertakings, etc.)
 - *Central counterparties, settlement agents, clearing houses*
 - *Persons other than natural persons, unincorporated firms and partnerships, provided that the other party is one of the aforementioned entities*

Personal scope of application

- **Opt-out** possibility regarding the personal scope of application (Article 1(3)):

Member States may exclude from the scope of this Directive financial collateral arrangements where one of the parties is a *person other than natural persons, unincorporated firms and partnerships*

Material scope of application

- The Directive applies to **financial collateral** in the form of:
 - **Cash**; or
 - **Financial instruments**

Material scope of application

- **Cash** consists of:
 - money credited to an *account* in any currency
 - similar claims for the repayment of money, such as *money market deposits*

Material scope of application

- **Financial instruments** are defined as:
 - *shares* in companies and equivalent securities
 - *bonds*
 - other forms of *debt instruments* if these are *negotiable* on the capital market
 - any other *securities* which are normally dealt in and *which give the right to acquire* any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including *units in collective investment undertakings, money market instruments* and *claims* relating to or rights in or in respect of any of the foregoing

Material scope of application

- **Opt-out possibility regarding the material scope of application (Article 1(4)):**

Member States may exclude

- **the collateral provider's own shares,**
- **shares in affiliated undertakings, and**
- **shares in undertakings whose exclusive purpose is to own means of production that are essential for the collateral provider's business or to own real property**

Material scope of application

- **Financial collateral arrangements** can be established under one of the following collateralisation techniques (“two track approach”):
 - **Security financial collateral arrangements, and**
 - **Title transfer financial collateral arrangements**

Material scope of application

- **Title transfer financial collateral arrangements:**

Arrangements, including repurchase agreements, under which a collateral provider transfers full ownership of financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations (e.g. repos, reverse repos, credit support arrangements, etc.)

Material scope of application

- **Security financial collateral arrangements:**

Arrangements under which a collateral provider provides financial collateral by way of security in favour of, or to, a collateral taker, and where the full ownership of the financial collateral remains with the collateral provider when the security right is established (e.g. a pledge, charge, lien, etc.)

Material scope of application

The Directive applies only

- to financial collateral once it has been *provided* and
- if the *provision* of the financial collateral can be *evidenced in writing* and
- if the financial collateral *arrangement* can be *evidenced in writing or in a legally equivalent manner*

Material scope of application

- Relevant **financial obligations** have to be:
 - secured by a financial collateral arrangement and giving right to cash settlement and/or delivery of financial instruments
 - including future, contingent, or prospective obligations or obligations against third parties or of a specified class or kind arising from time to time

Abolition of formal acts

- The Directive **disapplies** administrative burdens, formal acts and cumbersome procedures to create, validate, perfect, enforce or admit in evidence financial collateral arrangements or the provision of financial collateral under such arrangement, e.g.:
 - notarial deeds
 - registration requirements
 - notification requirements
 - public announcements
 - other formal certifications (data certa)

Enforcement

- In case of an **enforcement** event (in or outside insolvency), realisation of *security financial collateral arrangements* shall be possible:
 - by *sale* or *appropriation* (if agreed) of the financial instruments, and *set-off* or *application in discharge* of the relevant financial obligation,
 - without
 - *prior notice*
 - *court authorisation*
 - *public auction*
 - *waiting period*

Appropriation

- Appropriation is possible only if:
 - this has been *agreed* by the parties in the security financial collateral arrangement; and
 - the parties have agreed on the *valuation* of the financial instruments
- Member States, which did not allow appropriation on 27 June 2002, were not obliged to recognise it, provided they informed the Commission on the use of this *opt-out possibility* (Article 4(3))

Ex post control

- Member States may allow in their national legislation an ex post revision to be made by the Courts
- Such control is limited to evaluating whether the realisation and valuation of financial collateral and the calculation of the relevant financial obligation has been conducted in a *commercially reasonable manner*

Right of use

- Contractually agreed right of the collateral taker, *to use financial collateral* provided under a security financial collateral arrangement as if he were full owner (i.e. sell, pledge on, lend, etc.)
- If exercised, the collateral taker incurs an obligation to transfer back *equivalent collateral*
- Equivalent collateral transferred back will be treated as if it were original financial collateral (also in case of insolvency)
- The obligation may be subject to a *close-out netting* provision

Title transfer arrangements

Recognition of title transfer arrangements (cf. the ISDA credit support annex or the margin maintenance annex of the European Master Agreement):

- No '*re-characterisation*' by courts, causing an eventual avoidance)
- Enforcement by *close-out netting* shall be possible

Close-out netting

- Close-out netting (*contractual* or *statutory* arrangements which upon occurrence of an *enforcement event* result in the *acceleration* of the mutual obligations, the *conversion* into monetary amounts and/or *set-off* of the mutual claims) shall be protected:
 - in case of insolvency (opening of reorganisation or winding-up proceedings)
 - against judicial or other attachments

Disapplication of insolvency provisions

- No *retroactive effect* of winding-up or reorganisation proceedings on financial collateral
- No invalidation, avoidance or reversal of:
 - obligations to provide additional financial collateral ("*top-up collateral*"), in order to take account of changes in market value
 - the right to exchange financial collateral against financial collateral of the same value ("*substitution*")

Conflicts of law rule

Application of the principle contained in Article 9(2) of the Settlement Finality Directive (the *PRIMA* or “place of the relevant intermediary approach”) to determine the law applicable to certain matters relating to *book entry securities*, i.e.:

- *legal nature and proprietary effects*
- *priorities*
- *perfection requirements*
- *realisation*

will be governed by the law of the country where the *relevant account is maintained*

(excluding conflict of law rules of that country)

Conflicts of law rule

- Potential need for modification, if the Community decides to sign and ratify the *Hague Convention* on the law applicable to certain rights in respect of securities held with an intermediary of 13 December 2002
- The Convention is based on the main principle that the parties to an account agreement can choose the governing law, provided that in the jurisdiction chosen, the intermediary has an office that is engaged in a business or other regular activity of maintaining securities accounts
- This principle is *not compatible* with Article 9(2) of the Settlement Finality Directive (objective location of securities account) and with the wording of Article 9 of the Collateral Directive (although the recitals give certain leeway)
- An amendment to the Directive, if the Convention were to be ratified, would provide clarity and transparency

Implementation

- All 15 "old" Member States were obliged to implement the Directive by 27 December 2003 at the latest
- All 10 "new" Member States were obliged to implement the Directive by 1 May 2004 at the latest
- Bulgaria and Romania should implement the Directive by 1 January 2007 at the latest

Commission Report

- Not later than 27 December 2006, the Commission shall present a *Report* to the European Parliament and the Council *on the application of this Directive*
- The report should deal in particular with the application of:
 - The opt out possibilities under Articles 1(3) and 1(4) (regarding the scope of application);
 - The use of the opt out possibility under Article 4(3) (regarding appropriation) and
 - Article 5 (right of use)
- The report should contain, if deemed appropriate, proposals for a revision of the Directive