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Financial collateral arrangements

Before the end of 2003, Member States of the European Union are required to implement new Community provisions on arrangements by financial institutions concerning financial collateral. The aim of the provisions is to increase the efficiency of financial markets and enhance financial stability. These provisions are likely to be incorporated into the Agreement on the European Economic Area. They would thereby, inter alia*, have a bearing upon the Central Bank of Iceland's transactions with credit institutions. The following article describes the main points of the new provisions.*

1. Objectives of the new provisions

Directive 2002/47/EC on financial collateral arrangements[2] constitutes part of the European Commission's framework for Financial Services Action Plan of 11 May 1999 for the development of financial services and financial markets within the Community. The Directive aims to contribute to the integration and cost-efficiency of the financial market as well as to the stability of the financial system in the Community, thereby supporting the freedom to provide services and the free movement of capital in the single market in financial services. It also aims to facilitate the implementation of the common monetary policy within the framework of the economic and monetary union, by promoting the efficiency of the cross-border operations of the European Central Bank and allowing participants in the money market to balance the overall amount of liquidity in the market among themselves.

The Directive provides for a Community regime applicable to financial collateral arrangements. These involve bilateral financial collateral arrangements on the provision of securities and cash as collateral under both security interest and title transfer structures including repurchase agreements (repos).

The objective of the Directive is to remove certain obstacles to the efficient use of financial collateral arrangements in the European financial market. Such obstacles mostly involve excessive administrative burdens made in national law regarding the form, substance and completion of such agreements, and inconsistencies between the national laws of individual Member States in this field. However, the Directive entails only a minimum harmonisation of rules under national law, and Member States may set more specific provisions in order to attain its objectives as appropriate.

Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with the Directive by 27 December 2003 at the latest.

2. Parties to agreements on financial collateral arrangements

Parties to agreements on financial collateral arrangements which are subject to the provisions of the Directive are specific financial market institutions, including, *inter alia*, public sector debt and account management bodies, central banks, multilateral development banks, financial institutions, central counterparties, settlement agents and clearing houses. In addition to these institutions, persons other than natural persons, including limited

1. The author is Deputy Director of the Central Bank of Iceland's Financial Stability Department.
2. Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L 168, 27.06.2002, p. 43).

liability companies, unincorporated firms and partnerships, may participate in such arrangements provided that the other party is an institution as defined above. In their national law, however, Member States may confine eligibility to the aforementioned institutions.[3]

3. Formal requirements

Different formal requirements by Member States regarding financial collateral arrangements have hindered their effective cross-border utilisation and thereby obstructed financial market integration within the EU. Instead of providing for harmonised formal requirements, the Directive opted to minimise them in order to secure mutual recognition by Member States of the validity of such arrangements. Article 3 of the Directive prohibits Member States from making formal requirements for the creation, validity, perfection or enforceability of a financial collateral arrangement. However, they may insist that the arrangement can be evidenced in writing or in a legally equivalent manner.

4. Enforcement procedures

The Directive grants parties to financial collateral arrangements extensive scope to agree among themselves on procedures for enforcement of obligations, cf. Article 4. Procedures may involve the sale of financial instruments,[4] their appropriation on the basis of an agreed valuation, and the setting-off of their value against the relevant financial obligations. Member States are obliged to recognise such enforcement procedures subject to the terms agreed in the arrangement. They may not set requirements for prior notice of the intention to realise, conducting it in a prescribed manner, or its approval by any court, public officer or other person. Furthermore, Member States shall ensure that a financial collateral arrangement can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider or collateral taker.

However, these provisions are without prejudice to any requirements under national law to the effect that the realisation or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted in a commercially reasonable manner.

5. Right of use of financial collateral

If and to the extent that the terms of a security financial collateral arrangement so provide, Member States shall ensure that the collateral taker is entitled to exercise a right of use in relation to financial collateral provided under the security financial collateral arrangement, cf. Article 5 of the Directive. In exercising a right of use, a collateral taker incurs an obligation to transfer equivalent collateral to replace the original financial collateral at the latest on the due date for the performance of the relevant financial obligations. Instead of providing new collateral, the collateral taker may set off the value of the equivalent collateral against the relevant financial obligations.

6. Title transfer

Financial collateral may be provided in the form of a security financial collateral arrangement or a title transfer financial collateral arrangement. The best known form of the latter arrangement is a repurchase agreement.

Under the Directive, legal provisions on financial collateral arrangements shall apply to both collateral and title transfer, cf. Article 6. Extending the same legal protection to repurchase agreements reduces uncertainty about their performance and enforcement on default, which facilitates their use. This is therefore an important provision for institutions that engage in such transactions, e.g. central banks.

7. Close-out netting

Enforcement of obligations by parties to a financial collateral arrangement can be simplified with a provision on close-out netting. Under such a provision, a specific event will cause the obligations between the parties to fall due. The obligations are

3. Article 1 of the Directive.

4. Financial instruments means shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and 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.

then converted into a monetary claim in a predefined manner and settled. A netting provision may be made in a financial collateral arrangement, a separate agreement or a statutory rule.

Under Article 7 of the Directive, Member States shall ensure that a close-out netting provision can take effect in accordance with its terms, notwithstanding winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker.

8. Insolvency proceedings

Divergences in Member States' insolvency law have in some respect hindered the development of new ways of using and enforcing financial collateral arrangements, especially cross-border. To facilitate the use of financial collateral arrangements, enhance legal certainty, increase liquidity in the financial system and reduce systemic risk, Member States are obliged under the Directive to adopt specific provisions on financial collateral arrangements relating to national insolvency law.

Under Article 8 of the Directive, Member States shall provide special legal protection for financial collateral arrangements with respect to insolvency law. This applies where a financial collateral arrangement or a relevant financial obligation has been provided on the day of the commencement of winding-up proceedings or reorganisation measures. If the arrangement was made *prior to* the commencement of such proceedings or measures, it may not be declared invalid or void or be reversed. If made *after* the commencement of such proceedings or measures, however, it shall be legally enforceable and binding on third parties, provided that the collateral taker can prove that he was not aware, nor should have been aware, of them.

If the parties to the arrangement have agreed on additional, substitute or replacement financial collateral, these provisions shall remain legally valid and enforceable if agreed upon on the same day as – *but prior to* – the order or decree on winding-up proceedings or reorganisation measures. Likewise, they remain legally enforceable in the case of an arrangement to secure a prior claim.

9. Conflict of laws

When parties in different Member States have made a financial collateral arrangement and the security has been transferred by the collateral provider to the collateral taker, the law of the country where the financial collateral is located has applied under what is known as the *lex rei sitae* rule. In the case of book entry securities (dematerialised or electronically registered) securities, however, some legal uncertainty has prevailed concerning which laws are applicable to the agreement.

Directive 98/26/EC[5] on settlement finality in payment and securities settlement systems provides that the law applicable to book entry securities provided as collateral is the law of the jurisdiction where the relevant register, account or centralised deposit system is located. Directive 2002/47/EC extends this principle to financial collateral arrangements involving book entry securities provided as collateral in a cross-border context. Article 9 of the Directive states that any question with respect to specified matters arising in relation to book entry securities collateral shall be governed by the law of the country in which the relevant account is maintained.[6]

10. Impact of the rules in Iceland

The Directive is likely to be incorporated into the EEA Agreement, thereby obliging Iceland to implement it into national law. It is not unlikely that this will occur around mid-2004.[7] Transposition into Icelandic law would require specific legal provisions on collateral and insolvency to be adopted regarding financial collateral arrangements. The main provisions would involve evidencing of financial collateral arrangements, enforcement procedures, right of use, title transfer financial collateral arrangements, close-out netting, conflict of laws and the impact of winding-up proceedings or reorganisation measures on the validity and enforcement of financial collateral arrangements.

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5. Article 9 of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L 166, 11.6.1998, p. 45).
6. It should be pointed out that Article 9 is likely to be amended to bring it into line with the Hague Securities Convention.
7. A draft bill for incorporation of this Directive is now being prepared at the Ministry of Justice.

If implemented into Icelandic law, these provisions would apply to credit facilities entered into by credit institutions with the Central Bank of Iceland. Beyond that, the importance of these provisions for Icelandic credit institutions is not entirely clear. Hitherto, they have only rarely made financial collateral arrangements with each other or with foreign counterparties. Such arrangements could be more likely, however, as a result of increased activity by Icelandic credit institutions within the European Economic Area, meaning that the provisions may become more important for them in the future.

The new provisions extend the rights of financial institutions, which are collateral takers under such arrangements, regarding the use and enforcement of contractual obligations over and above those of other collateral takers. In protecting the institutions against financial losses as a result of counterparty insolvency, they would serve to limit the contagion effect that disruptions to individual institutions could have on the financial system as a whole. Thus the provisions may be regarded as a means for reducing systemic risk and contributing to financial stability in Iceland.