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**EUROPEAN
FINANCIAL MARKET
LAWYERS GROUP**

**PROPOSAL
FOR AN EU DIRECTIVE
ON COLLATERALISATION**

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EUROPEAN FINANCIAL MARKET LAWYERS GROUP

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This document has been prepared by the European Financial Market Lawyers Group (EFMLG). The members of the EFMLG, whose names are set out in the Annex, are each expert in the field of financial markets law in the legal system of their Member State with a high degree of practical experience. However, the members of the EFMLG participate in the work of the Group on a strictly personal basis. The views expressed in this paper are those of the members and do not necessarily reflect those of their institutions or of the ECB.

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Annex – Members of the EFMLG

1. Summary

- 1.1 Collateralisation is a widespread technique which is increasingly used in the European Union, but the laws of the Member States relating to the methods of providing collateral and the enforceability of collateral present numerous difficulties, particularly for participants in the international financial markets.
- 1.2 The European Central Bank established in 1999 a European Financial Markets Lawyers Group (EFMLG) to discuss the possibility of promoting initiatives that would lead to a harmonisation in EU financial markets activity. One such area that clearly needed attention related to the use of collateral. It was therefore decided that the EFMLG would carry out a survey on the law relating to collateralisation in the Member States. The results of the survey by the EFMLG (which will be released at a later date) demonstrate the difficulties inherent in cross-border collateralisation in the European Union.
- 1.3 New legislation at a European level to simplify and harmonise the law relating to collateral is necessary and is justified by the benefits it would bring to participants in the international financial markets and to consumers in the form of enhanced stability in those markets and lower costs.
- 1.4 The aim of any new legislation should be to create a clear, simple and effective framework for collateralisation. It should reduce the formalities and administrative procedures associated with the creation and enforcement of pledges and transfers of title and should provide appropriate protection from the application of insolvency law to collateral provided under pledges and transfers of title. It should not adversely affect consumers.

2. Collateralisation

- 2.1 “Collateralisation” is the provision of assets (“collateral”) to a creditor by its debtor in order to secure the performance of the debtor’s obligations.

In the European Union (as elsewhere) national laws relating to collateral embody concepts of property and ownership reflecting the history of the Member States and their attitudes to debt and creditors’ rights. These date from times when debts were simple to calculate and collateral was generally provided in the form of tangible assets, whose value did not fluctuate greatly and which could be readily identified.

- 2.2 The legal methods by which collateral is provided vary from Member State to Member State. This paper uses the generic terms “pledge” to describe the provision of collateral by security interest, where the debtor remains owner of the assets, subject to rights in favour of the creditor to satisfy the debt and related costs from the assets, and “transfer of title” to describe the provision of collateral

by transfer to the creditor of ownership of the assets, where the creditor must return to the debtor equivalent assets once the debtor has satisfied the debt and related costs.

- 2.3 Collateral is used throughout the European Union in all types of transactions, including residential mortgages, secured consumer lending, corporate finance, the capital markets, bank treasury and funding, payment and clearing systems and general bank lending.
- 2.4 Collateral is of particular importance in the financial markets. The financial markets are characterised by the speed and volume of transactions and their operations are of both a domestic and cross-border nature. The collateral provided is most often cash or securities, namely government bonds or high quality corporate bonds or other securities, in certificated, immobilised or dematerialised form and frequently held in or through accounts with custodians and clearing systems.
- 2.5 Creditors who obtain collateral which is enforceable (i.e., that can be used to satisfy the debt of the debtor if it fails to pay its debt, including when it is insolvent) can reduce their credit risk and make available credit lines for further business.
- 2.6 The laws and practices relating to collateralisation differ considerably between Member States.

3. Need for Legislation at European Level

- 3.1 There are three main reasons why legislative change is necessary.

Firstly, the collateral laws in the European Union fail to provide an acceptable minimum standard of certainty, particularly for cross-border transactions. This results in costs and delays, as creditors are forced to obtain legal opinions on a case by case basis.

Secondly, new legislation in the European Union simplifying and strengthening the laws relating to collateralisation would reduce credit risk and the use of credit lines and balance sheets and therefore free capital for further business. It would also reduce systemic risk in many different areas.

Thirdly, simpler and more flexible laws relating to the provision and re-use of collateral would increase the liquidity in the securities markets and make them more efficient, resulting in lower costs for participants and ultimately for consumers.

- 3.2 The survey carried out by the EFMLG shows that the laws relating to collateral in the Member States of the European Union present a patchwork of rules that require simplification and harmonisation.
- 3.3 The findings of the EFMLG survey indicate that the inherent level of legal uncertainty poses problems in particular for financial institutions operating on a cross-border basis.

Contrary to purely domestic situations (where the legal background is usually known and the chosen law normally coincides with the applicable insolvency laws), in a cross-border transaction the laws of different Member States may apply to different parts of the transaction. For example, the assets provided by the debtor may be situated in one Member State (whose legal system will be applicable to determine ownership rights in respect of the assets and publicity requirements), the debt may be governed by the law of another Member State and the debtor may be incorporated in a third Member State (whose legal system will generally regulate issues relating to its insolvency, including the allocation of its assets between its creditors).

The international financial markets are changing quickly, driven by the effects of information technology, globalisation and a move towards greater reliance on the international, market-driven financial system. The cross-border use of securities (achieved primarily through the immobilisation and dematerialisation of securities and their transfer through ever more complex computerised depository and clearing systems), together with the international nature of institutions participating in the financial markets, make it increasingly difficult to identify which laws of Member States apply and to which parts of the transaction.

- 3.4 In the international financial markets, business tends to migrate towards those Member States whose legal systems provide flexibility and certainty in connection with the taking of collateral.

Development of the laws of Member States in this area has been sporadic and haphazard and often as a result of competitive pressure between Member States. The result is that there is a number of special national regimes (of differing effects and on differing aspects of collateral).

Continued reliance on competitive pressure between Member States as an engine for change is not the way forward.

- 3.5 The EMFLG is of the view that it is necessary to remove certain of the existing problems by appropriate legislation.

4. Areas of Difficulty Identified by EFMLG Survey

4.1 Pledge

Historically, the legal systems of the Member States favoured the pledge as the method of providing collateral.

4.1.1 Several difficulties relating to the pledge result from the formalities required for its creation. These are as follows:

- **Form**

There may be a requirement that the pledge, in order to be valid, must be in writing or in a particular form. It may be necessary to specify the amount of the debt outstanding (a potential problem if it is fluctuating) or to list with precision the assets provided as collateral.

- **Publicity and Registration**

In the majority of Member States there are requirements relating to publicity and/or registration of collateral arrangements. These derive from the legislator's desire to make third parties dealing with the debtor aware that certain of its assets have been provided to another person as collateral and are not generally available to its creditors in an insolvency.

Publicity or registration of the pledge may involve costs or delays which are prohibitive from the perspective of the creditor who has only an immediate and short term need for the securities in question. However, failure to satisfy such requirements may render the pledge void.

The traditional rule of private international law in most Member States is that ownership rights (and hence publicity and registration requirements) are dictated by the law of the place where the assets are situated. In the international financial markets it is often difficult, on the basis of the relevant private international law rules, to establish (from a legal point of view) where the assets are situated.

In respect of securities, however, the EFMLG acknowledges that a first major step to solve these uncertainties has been undertaken in the Directive on Settlement Finality in Payment and Securities Settlement Systems (the "Settlement Finality Directive"), which provides certainty relating to the determination of the applicable law and the insulation from insolvency proceedings of assets provided as collateral within a settlement system. The EFMLG also notes that there is a tendency amongst Member States to extend the application of the rules provided by that

Directive beyond the mere context of payment or security settlement systems, thus establishing a rule of general application, and that this is to be welcomed.

However, there are still areas of doubt in the private international law of certain of the Member States on this topic.

- Taxes and Fees

Stamp and other documentary taxes may apply to pledges. Different types of tax may apply to different types of pledge. Often, stamp duty must be paid if the documents relating to the collateral arrangement are to be used in court.

4.1.2 Insolvency laws in the Member States have an impact on pledges, since it is in an insolvency of the debtor that collateral faces its most difficult test. This is the point when different interests (creditors, shareholders, attaching parties) compete for the assets of the debtor, usually under the control of a court or other authority. The legal systems of Member States must balance these interests and all do it in different ways.

However, some general principles of insolvency law are common to the laws of all the Member States in one way or another. These are: that different debts may have different priorities but that creditors having the same priority must be treated equally; that prior to an insolvency there is a “suspect period” and any dealings with assets (e.g. pledges) during this period will be subject to particular scrutiny; that enforcement of collateral may only be carried out in accordance with certain prescribed procedures; and that enforcement may be delayed or prevented.

The EFMLG notes that the Settlement Finality Directive has improved the position with respect to the cross-border impact of insolvency laws. Nonetheless, the EFMLG survey has highlighted the following areas of difficulty:

- Substitution of Assets

It is often the case that the debtor wishes to retain the right to substitute the assets provided as collateral with other assets of the same economic value. This is particularly important in the financial markets, where substitution is necessary in order to accommodate both short and long term funding and trading strategies and is often carried out on an automated basis.

Under the legal systems of some Member States, substitution may have the effect of creating a new pledge (and so all the necessary formalities may need to be repeated and a new suspect period may commence) and/or of changing the nature of the existing pledge. Substitution of assets may also (if the creditor does not retain a right to prevent substitution) result in the pledge having a lower priority in the insolvency of the debtor.

- Top-Up of Assets

The value of the collateral and/or the debt may fluctuate as a result of market conditions and the credit rating of the debtor may deteriorate. In such cases, creditors often require the provision of ‘top-up’ collateral (the value of which is usually determined by a process of “marking to market”). This is supplementary collateral provided in order to ensure that the value of the aggregate amount of collateral provided is at least equal to the value of the debt or better reflects the increased credit exposure of the creditor to the debtor.

The provision of such top-up collateral may (particularly in the case of top-up collateral provided to protect against increased credit exposure) be interpreted as preferential treatment for the creditor and, if it occurs in the suspect period, may render the top-up (or indeed the pledge itself) void.

- Prescribed Procedures for Enforcement

The creditor wishes to use the collateral to cover its exposure to the debtor. This means that the creditor needs the right to realise, by sale or otherwise, the collateral (free of any interference and undue administrative burdens, but subject to the obligation to obtain a reasonable price for the collateral in the circumstances).

It is a rule in several Member States that the creditor may not enforce its rights to the collateral by appropriating to itself the collateral upon the default of the borrower without an appropriate court order (and this rule also underlies some of the resistance to the transfer of title – see Section 4.2 below). This is the rule against the so-called “pactum commissorium”.

Often, the sale of the collateral by the creditor is subject to specific procedures. In certain Member States, notice of sale must be given to the debtor. In others, the creditor must serve a demand for payment on the debtor by process-server and, if the debtor does not object within a stated period, may then, once it has received the necessary court authorisation, proceed to a sale of the assets.

In addition to the cost, such a procedure may reduce the protection of the creditor if the market value of the assets is falling.

- Delay or Prevention of Enforcement

Protection from enforcement may be granted to a debtor who is insolvent, usually by court order. The rights of the creditor to enforce the collateral may be delayed for substantial periods, for example if the insolvent debtor and its trustee in bankruptcy so request or if the debtor is the subject of a particular insolvency procedure.

4.1.3 Pledges in the Member States are subject to another limitation, which is particularly disadvantageous to participants in the financial markets:

- Re-use

In the international financial markets, creditors (who may themselves also be debtors) may wish to re-use collateral that has been provided to them by their debtors. This re-use (sometimes called “rehypothecation”) may involve them transferring title to the collateral to third parties. This appears to be problematic under the legal systems of most Member States.

The issue is that re-use is not consistent with the basic concept of pledge in most Member States (where the debtor providing the assets as collateral nonetheless remains the owner of the collateral, subject to the pledge in favour of the creditor). Thus the creditor cannot freely use the pledged securities because of the absence of full and unfettered ownership of the securities in question. This is not the case where the transfer of title is utilised (and explains why there is pressure to use the transfer of title). The inability to transfer or pledge the relevant securities severely limits the range and type of transactions on offer to participants in the market.

4.2 Transfer of Title

The transfer of title as a collateralisation method was frequently not recognised under the laws of many Member States (probably because it was felt to be inappropriate to use a transfer of title to achieve the economic effect of a pledge for a limited period of time). But today it is increasingly seen as an efficient alternative to the pledge and has been recognised by or introduced into the legal system of many Member States. It involves the debtor transferring full legal title in the collateral to the creditor, who becomes the legal owner. The creditor, as owner, can use the transferred assets as it wishes subject to the contractual obligation to return equivalent assets to the debtor.

4.2.1 In several respects the transfer of title is a simpler process for taking collateral than the pledge. There are minimal requirements of form and perfection compared to the pledge and the private international law aspects are greatly simplified. There are no restrictions relating to the re-use of the collateral in question.

4.2.2 The transfer of title is not, however, without its drawbacks. These can be summarised as follows:

- Recharacterisation

As mentioned above, many legal systems in the European Union did not traditionally permit the creditor to take ownership of the debtor’s assets as security

for the debt. Transfers of title therefore run the risk, in appropriate circumstances, of being “recharacterised” as disguised pledges. This could (if, for example, the relevant pledge formalities had not been carried out) result in the creditor losing its rights to the collateral altogether. In a minority of Member States the transfer of title is not recognised and there is consequently a high risk of recharacterisation.

- **Absence of Insolvency Set-Off**

The legal analysis of the enforcement of collateral under a transfer of title is that the creditor’s obligation to return equivalent assets is given a monetary value and this amount is set off against the amount of the debt owed to it by the debtor (the so called “close out”). Thus the existence of such a right of set-off (particularly in the insolvency of the debtor) is regarded as essential for the transfer of title to work. However, the legal systems of many Member States contain restrictions on such rights to set-off once insolvency proceedings have commenced and thus effectively prevent the use of the transfer of title. In some cases, specific legislation intended to introduce netting into the legal system of a Member State was not wide enough to cover transfers of title.

- **Increased Credit Exposure**

A debtor who has over-collateralised its exposure to the creditor with a transfer of title has a credit risk against the creditor that it would not have if the parties had used the pledge.

If the creditor becomes insolvent, the debtor will have only a right to claim an amount equivalent to the value of the excess collateral (whereas if the assets had been pledged, it would still be the owner of the assets, subject to the pledge).

- **Tax and Accounting Issues**

Transfers of title may give rise to complicated tax and accounting issues since, in the absence of special treatment, they are analysed in exactly the same way as disposals of assets. These issues are not discussed in this paper and warrant separate and detailed consideration.

5. Aims and Application of New Legislation

5.1 The new legislation must provide a clear, simple and effective collateralisation framework. It should strengthen (and validate where necessary) both the pledge and the transfer of title, since there may be circumstances in which one and not the other is the most suitable method of providing collateral.

The new legislation should ensure that wherever possible market participants may use either the pledge or the transfer of title as a way of providing collateral with a

minimum of formality, bearing in mind that the fundamental aim for the creditor in taking collateral is to ensure that, if the debtor does not pay the debt, the creditor will be able to use the collateral (or the proceeds of sale of the collateral) quickly and effectively to satisfy the debt.

- 5.2 There are certain important areas which the new legislation will not change, as they lie beyond its scope. Those include, in particular, the laws of the Member States relating to fraud, dishonesty, breach of trust and the like and the tracing of assets into the hands of third parties. It is intended that these laws will be left untouched.

- 5.3 There are a number of different ways to achieve greater certainty in respect of collateralisation and to protect collateral from the application of the insolvency laws of the Member States. The creation of a new type of security interest (as under the new Chapter 8 of the Uniform Commercial Code in the U.S.A.) would be one way of achieving this. Other approaches could be a model collateral law for adoption in the Member States or the creation of a new collateral instrument.

The EFMLG has considered, and rejected, proposing any legislation which would comprehensively change the legal characteristics of taking securities as collateral. The creation by legislation of a special area of commercial activity, protected from the application of national insolvency laws, may be the optimal solution for the international financial markets as they operate within the European Union. But it is considered by the EFMLG to be too far-reaching, and not something that is likely to find immediate favour with the Member States. For this reason, a more modest approach is advocated in this paper, aimed at resolving smaller administrative and technical matters that are likely to make the path towards taking collateral smoother, but not to improve the legal status of established collateral beyond what it is now under existing law.

- 5.4 Any new legislation will involve changes to the legal systems of the Member States and, depending on the complexity and depth of these changes, may result in difficult and time-consuming implementation. It is necessary to balance the advantages that the new legislation would bring against the impact on the existing legal systems of the Member States. The new legislation should aim to achieve those changes which can most easily and quickly be assimilated by the legal systems of the Member States while at the same time providing greatest benefit to market participants.

The guiding principle should be that technical, mechanical rules (especially e.g. as relate to suspect periods, preferences and the like) should not restrict the provision of collateral in good faith.

- 5.5 It will be a difficult task to modernise such technical, mechanical rules without in some circumstances coming into the domain of insolvency law. Whilst there is no

intention to alter the fundamental principles of each Member State's insolvency laws, certain rules of insolvency law may need to be modified in order to ensure that the aims of the new legislation are met. The effect of such modification might be to create elements of protection from the application of insolvency laws. No doubt, the greater this protection, the more inclined Member States will be to limit the categories of persons who fall within this scope.

However, the parties able to benefit from the legislation should be as widely defined as possible, since to do otherwise would severely limit the potential benefits of the legislation. The new legislation should state that it applies as a minimum to any transaction involving a Central Bank, investment exchange, clearing house, trustees for bondholders (or similar), credit institution or other financial institution. It would be possible for Member States to extend the application of the Directive to other categories of person.

- 5.6 The assets that may be provided as collateral under the Directive must include, as a minimum, securities (certificated, immobilised and dematerialised), wherever issued, and cash. It will be possible for Member States to specify that other types of asset may be brought within the scope of the legislation, although the complexity of Member States' laws relating to certain types of asset (for example real property and intellectual property rights) means that these should not be covered by the Directive.
- 5.7 There seems to be no need to limit the types of exposure that may be covered and so obligations arising under all sorts of transaction (whether on exchanges, OTC or otherwise) involving at least one of the persons mentioned above, could be collateralised under the new legislation.

6. Outline Provisions of New Legislation

- 6.1 The new legislation should provide a single, uniform framework, based on certain core elements, for the taking of collateral across the European Union. It may also comprise supplemental elements, which the Member States may use to complement that framework to the extent they feel this is necessary and desirable in their own legal systems.

The new legislation will simplify the Member States' laws relating to the provision of collateral by both the pledge and the transfer of title.

- 6.2 The core elements of the new legislation are as follows:
- A pledge or transfer of title may be created by simple contract. The contract need not be in writing as long as there is sufficient evidence as to its terms. There should be no requirements as to form, documentary taxes or registration.

- Publicity and/or registration requirements relating to pledges will be replaced, where appropriate, by a notice (which may be in electronic form) of the existence of the pledge. Such a notice need be given only once and, in the case of a pledge over a securities account (which it is envisaged will be the primary method of providing collateral), will cover all substitutions and top-ups of assets under the pledge. The notice will be given to the broker, custodian or depository maintaining the account in which the debtor's securities provided as collateral are registered and the pledge will be perfected once the existence of the pledge is noted against the account. Where securities are not held in an account the notice may be given to the debtor's custodian or replaced entirely by a transfer of the securities to a pledged account in the name of the creditor.
- Pledges with different priorities may be created in respect of the same collateral.
- The transfer of title will be expressly recognised as a valid method of providing collateral and will not be subject to the risk of recharacterisation.
- Where assets taken as collateral under an existing pledge are substituted in good faith, this should not be regarded as creating a new pledge and the substituted assets shall be subject to the existing pledge to the extent their value does not exceed the value of the assets for which they were substituted.
- Insolvency law rules relating to suspect periods, preferences, transfers at an under value, zero hour and the like will be modified so as to ensure that the aim of the new legislation (removal of administrative and technical barriers to the effective taking of collateral) is met.
- Enforcement of collateral under a pledge or transfer of title will be free of administrative and formal requirements. The legislation will permit the parties to establish the monetary value of the debtor's obligation and to provide that this may be set off against the monetary value of the creditor's obligation. (In the case of a pledge, the creditor's obligation is to return to the debtor the assets provided as collateral and in the case of a transfer of title it is to return equivalent assets). For both the pledge and transfer of title, the establishment of the monetary value of the creditor's obligation may be by any appropriate method in the relevant market (including sale).
- No notice of enforcement to the debtor will be necessary. The creditor will have an obligation to achieve the best valuation it can reasonably get in the relevant market.
- In order to facilitate enforcement, the pledge or transfer of title may validly provide for the automatic termination of obligations upon a default (to be defined by the parties) or an insolvency.

- Insolvency set-off will be valid and will apply to all the obligations between the debtor and creditor, with no possibility of “cherry-picking”.

6.3 The supplemental elements of the new legislation are as follows:

- The parties may by contract provide that the creditor will have the right to re-use the assets provided as collateral under a pledge.
- If there is over-collateralisation under a pledge, the debtor will (subject to rights of third parties acting in good faith) have automatic first priority rights over the assets pledged, or over their identifiable proceeds, to the extent of the over-collateralisation.
- The legislation will include provisions relating to the tax and accounting aspects of pledges and transfers of title whose purpose will be to ensure a level playing field throughout the European Union.
- Amendments will be made to other relevant laws as appropriate in each Member State to take account of the provisions of the new legislation.
- Amendments will also be made to other relevant laws in order to ensure that the principles of Article 9(2) of the Settlement Finality Directive are applied to all aspects of collateralisation in the Member States.

7. Type of Legislation

In view of the complexity of the current position relating to collateralisation in the European Union, the desire to introduce harmonising legislation and the need to preserve flexibility for the Member States, it is proposed that the most appropriate legal instrument to bring about the changes proposed above is a Directive.

The elements of the Directive set out above are intended to set a minimum standard and Member States will be able, in their national implementing legislation, to apply the Directive to a broader range of situations and persons if this is felt desirable.

8. Conclusion

The harmonisation of national laws relating to collateralisation in each of the Member States will have many benefits for the participants in the European financial markets and will strengthen the markets themselves. It will increase competition in the European financial markets and will lead to reduced costs for participants and consumers.

ANNEX

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