EUROPEAN FINANCIAL MARKETS LAWYERS GROUP

STATEMENT ON A PROPOSAL FOR A DIRECTIVE ON FINANCIAL COLLATERAL ARRANGEMENTS (COM(2001) 168)

The European Financial Markets Lawyers Group (EFMLG)\(^1\) is composed of legal experts of major European credit institutions participating in the daily elaboration of the EONIA\(^2\), and was organised by the ECB in 1999 in order to discuss possible initiatives that would lead to increased harmonisation in the legal aspects and contractual practices of European financial market activity following the introduction of the euro on 1 January 1999.

The EFMLG very much welcomes the Commission initiative of 27 March 2001 for a Directive on Financial Collateral Arrangements, which is currently debated in the European Council and Parliament. The introduction of the single currency further enhanced the possibility of cross-border securities transactions, using the existing and newly created links between securities settlement systems and between organised markets. However, the European financial markets are still hampered by the lack of a single or uniform set of legal rules. National legal systems divide the euro zone and the EU at large. Those entities participating in European financial markets on a pan-European level still have to cope with the existence of 15 different legal systems.

To contribute to the integration of cross-border financial market activity, the EFMLG elaborated and circulated to the relevant European institutions in June 2000 a report proposing an EU directive to harmonise some basic legal features regarding collateralisation and is grateful that most of the issues raised in the EFMLG proposal were considered by the Commission when preparing a draft Directive on Financial Collateral Arrangements. The EFMLG is pleased to see that the passage of the proposal through the EU legislative process has addressed most of the concerns contained in the EFMLG report and that on 13 December the ECOFIN has given its political approval to the draft directive and on the same day the European Parliament adopted a resolution endorsing Mr Pérez Royo's report on that draft. 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 market and will strengthen the markets themselves.

\(^1\) The members of the EFMLG (listed in the Annex to this note) participate in the work of the Group on a strictly personal basis. The views expressed in this statement do not necessarily reflect the views of any particular member of the Group, of their institutions, or of the ECB. No EFMLG publication may be taken as legal advice or in relation to a particular transaction.

\(^2\) EONIA is the acronym for the European Overnight Interest Average rate calculated on a daily basis by the ECB upon data transmitted by major credit institutions active in the euro money market.
The directive will increase competition in these markets and lead to reduced costs for participants and consumers.

The EFMLG fully supports the aims of the Directive and believes that the integration of banking and financial services within the European Union can only be truly successful if the customary forms of financial collateral arrangements are harmonised in a manner that facilitates cross-border access to capital markets, by reducing administrative and legal costs and by providing a sound and more efficient enforcement system.

The EFMLG, however, before the final text of the Directive is adopted, would like to highlight still several concerns about some of the provisions that remain, in our view, unsatisfactory.

The Financial Services Action Plan in general, and this directive in particular, represent a significant and welcome incursion by EU law into those areas of commercial activity normally governed by codes of law relating to private obligations. Throughout the EU, the hallmark of commercial laws of this kind is the very detailed level of legal certainty they provide, and the ease with which they evolve to meet the needs of an ever-changing commercial environment.

Indeed, it has been argued that the use of directives to engineer changes to commercial law carries with it the danger of compromising the 'to-the-minute, to-the-cent' level of legal certainty that commercial dealings (and especially those in the financial markets) require, by reason of the inherent unpredictability of the national implementation process. And it has been widely noted that the implementation of article 9(2) of the Settlement Finality Directive illustrated this problem, in that, although properly implemented as a matter of Community law, the results did not deliver to the financial markets the level of harmonisation it had hoped for.

The EFMLG therefore intends to follow closely the implementation of the collateral directive and might, if appropriate, be able to assist public authorities in steering the process. And in order to ensure that the right interpretation is given to some of the directive's key provisions, the EFMLG sets out in the rest of this letter some detailed comments intended to reveal the commercial background to those provisions.

1. **Personal scope of application:**

From the perspective of the members of the EFMLG, the question which entities may benefit from the draft directive is of crucial relevance. In its June 2000 paper, the EFMLG said that “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 draft of 27 March 2001 provides, in Article 2(4), that both the collateral taker and the collateral provider must each be a public authority or a central bank, a financial institution or a person other than a natural person whose capital base exceeds EUR 100 million or whose gross assets exceed EUR 1,000 million. This definition excludes not only natural persons but small and medium enterprises (SMEs) as well, leaving them vulnerable to the risks and uncertainties of the current situation. As in practice SMEs undertake a range of transactions requiring collateralisation, to exclude them is to create a competitive distinction which does not seem justified. Moreover, any application of a certain threshold on the basis of the capital base or gross assets is bound to lead to uncertainty with regard to the application of the proposed directive, particularly as such basis may actually change since the most recent accounting statement.

Therefore, the EFMLG welcomes the decision by ECOFIN and the Parliament to abolish the above-mentioned threshold and strongly believes that the directive should apply to all collateral providers and takers regardless of their dimension and activity. However, the option given in the current draft for member states to exclude non-financial businesses from the regime prescribed by the directive is broadly equivalent to an exclusion of such businesses from the scope of application of the directive. If the aim of the directive is to abolish existing administrative burdens and complexities and to create a clear framework in the field of collateral, then it is difficult to see why any businesses should continue to bear the inconveniences, risks and costs of the present system, be they SMEs, or non-financial entities in general.³

2. Formal requirements:

The EFMLG welcomes the intention of the proposed directive to remove outdated form requirements for financial collateral arrangements. However, the EFMLG is concerned that Article 2(2) in the version of the original draft requires collateral arrangements to be made in writing “or evidenced in writing and signed by or on behalf of the collateral provider”. In its June 2000 paper, the EFMLG recommended that “The contract need not be in writing as long as there is sufficient evidence as to its terms.”

The proposed form requirement would be impractical and would ignore the reality of many transactions evidenced either only by recorded telephone conversations or by inclusion in master agreements or by

³ A clarification would be appreciated to the effect that by virtue of the now envisaged inclusion of “unincorporated firms and partnerships” in a revised version of Article 2, the exclusion of “natural persons” is de facto limited to consumers.
reference to General Business Conditions which are not signed. In addition, many Member States abolished the requirement of signed arrangements some time ago and the draft directive would constitute a step back for them in this respect if Article 2(2) were to remain unchanged. We believe this requirement should be dropped and the determining factor should be that the collateral arrangement can be proven if it is contested. The EFMLG understands that the draft Article 2(2) is intended to be adjusted substantially in line with our past recommendation and appreciates this fact very much.

3. Realisation by appropriation:

Article 5 allows the collateral taker, upon default by the collateral provider, to liquidate quickly without any waiting periods which could impair the value of the security. The EFMLG strongly recommends implementation of the proposal to give the possibility of appropriation by collateral takers in case of an enforcement event, provided that the creditors are prevented from benefiting from any undue enrichment. Such appropriation may prove to be the more appropriate form of realisation. This may particularly be the case in times of market turbulence.

4. Right of re-use:

The EFMLG, whilst welcoming the intention to provide full recognition for a right of re-use, agrees with the new language proposed by ECOFIN and the Parliament clarifying the text of Article 6 such that the right of use for pledged collateral is only possible with the collateral provider's prior consent.

5. Rating related top-up collateral:

Although Article 9 of the directive permits and offers legal certainty to “top-up” and substitution mechanisms, it fails to deal with the common scenario in which top-up is required due to a deterioration of the credit rating of the collateral provider. We realise that this omission reflects reluctance to propose measures conflicting with insolvency laws of some Member States which discourage provisions under which a creditor’s position is improved as a result of an insolvency-related event or a context of deteriorating credit-worthiness. We believe, however, that it is preferable to address this situation and offer legal certainty to all situations where top up is linked to an objective trigger. If such trigger event is objective, it cannot lead to a discretionary misuse by the parties. Moreover, there is no immediate connection between a change of rating and an insolvency.

---

4 The Explanatory Memorandum could state, in its comments on either Article 6 or Article 7, that no such consent is required in the case of a title transfer arrangement.
The refusal to accept top-up in this situation could also lead to financial institutions demanding more collateral up-front, to protect themselves against a possible future downgrading of their client, leading in turn to higher costs for the collateral provider.

6. Conflict of law rule:

From the outset, the EFMLG maintained its position that a clear and simple conflict of law rule is of high relevance for the functioning of cross-border use of collateral. We therefore fully support the position expressed in Article 10 which reiterates the principle laid down in the Settlement Finality Directive and establishes that when dealing with book entry securities, it is the law of the country of the intermediary through which the collateral taker holds its interest which applies.

In this context, the EFMLG acknowledges both the initiative of the Commission and the related work conducted in the context of the Hague Conference on Private International Law. The EFMLG stresses the need to achieve consistency\(^5\) between the two initiatives, as only a single solution would solve the current situation of uncertainty. However, any solution envisaged should try to be consistent with both market practice and the degree of certainty already provided by the Settlement Finality Directive, i.e. that locating the accounts is made by the application of clear and objective criteria. The EFMLG will address the market perspective on the European implementation of the draft international convention that may result in the context of the Hague Conference on Private International Law at a later stage.

In view of this, the EFMLG is asking the European Parliament and the Council to take these views into account when finalising their positions on the proposed Directive.

\(^5\) A particularly important aspect is whether cash collateral should be subject to the same mandatory conflict-of-laws regime as book-entry securities; this is not envisaged, in principle, by the present informal draft for the Hague Convention envisaging such a regime. A drafting (but potentially also substantive) point to be harmonised is that Article 10 refers to the location of the relevant account, while the present draft of the proposed Hague Convention refers to the relevant office or branch of the intermediary involved.