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**EFMLG RESPONSE TO THE COMMISSION QUESTIONNAIRE  
REGARDING THE TRANSPOSITION OF  
DIRECTIVE 2002/47/EC ON FINANCIAL COLLATERAL ARRANGEMENTS**

The European Financial Markets Lawyers Group (EFMLG)<sup>1</sup> is a group of legal experts from the EU banking sector dedicated to analysing and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in Europe following the introduction of the euro.

The EFMLG very much welcomes the Commission initiative to publicly consult with the financial industry on the transposition of the EC Directive on Financial Collateral Arrangements, in anticipation of the preparation of its customary evaluation report.

The creation of legal certainty in respect of cross-border collateral transactions in the European Union has always been an issue dear to the heart of the EFMLG. We would like to recall that in order 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<sup>2</sup> and is grateful that most of the issues raised in the EFMLG proposal were considered by the Commission in the legislative process

The EFMLG is pleased to see that the process of implementation of the directive in the 25 EU Member States has finally come to a conclusion. Throughout the transposition phase, the EFMLG has continued to closely monitor the way in which the Member States have

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<sup>1</sup> The members of the EFMLG (see [www.efmlg.org](http://www.efmlg.org)) participate in the work of the Group on a strictly personal basis. The views expressed in this response do not necessarily reflect the views of any particular member of the Group or of their institutions. No EFMLG publication may be taken as legal advice or in relation to a particular transaction.

<sup>2</sup> See EFMLG website [www.efmlg.org](http://www.efmlg.org).

implemented core provisions of the Collateral Directive and a EFMLG report describing the main findings is scheduled for finalisation and publication in April 2006. We will be happy to share these findings with the Commission in due course. As a practical matter, however, given the quite recent state of transposition in a significant number of countries may not allow to draw conclusive findings on the way that the Collateral Directive is making an impact on market practice and jurisprudence.

The EFMLG is still highly supportive of the aims of the directive and continues to believe 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.

In the light of the aforementioned interests, the EFMLG would like to issue some views in respect of the questions brought forward by the Commission:

#### **1. Personal scope of application:**

From the perspective of the members of the EFMLG, the question which entities may benefit from the directive is of crucial relevance. Already in its June 2000 paper, the EFMLG stated 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.”

Implementation of the personal scope of the Collateral Directive in Article 1(2) varies widely between Member States regarding the potential parties to financial collateral arrangements benefiting from protection under the new regime. Whilst it is positive from an EFMLG perspective that only Austria has used a full opt-out under Article 1(3) of the Collateral Directive, it has to be noted that other Member States have chosen a personal scope which either provides for more nuanced limitations or for a wider application than foreseen by the Collateral Directive. This state of diversity results in a distortion of competition and a continuous need for further due diligence to determine if, or under which conditions, a collateral transaction would profit from the new regime.

In the view of the EFMLG, it should be contemplated to remove entirely the opt-out possibilities and to expand the personal scope of application to a wider range of entities.

#### **2. Material scope of application**

The EFMLG acknowledges that Member States benefit from some discretion in the implementation of the Collateral Directive, allowing them to extend its protection beyond the terms it defines. However, as a practical matter, it is noted that whilst most Member States use a concept of “financial instruments” identical or very close to the Collateral Directive’s definition, in some countries, the definition used is wider, to cover also credit claims and receivables,

swaps and futures, cash-settled derivatives and financial commodity derivatives. It is suggested that in the light of these experiences, the Commission should assess whether the beneficial effect of the Collateral Directive could be generally extended to other types of assets commonly used in the financial markets. In this connection, experience could be drawn from the scope of the term 'financial instruments' as used in recent Community legislation (see for instance the Capital Requirements Directive).

### **3. Re-use of collateral**

The EFMLG appreciates that by way of transposition of the Collateral Directive, the recognition of the right to re-use pledged collateral should be recognised in all 25 EU countries. To this end, almost all Member States introduced specific provisions in their national legislation allowing a right of re-use in accordance with the Collateral Directive, sometimes by using the exact wording contained in Article 5 of the Collateral Directive, sometimes by adapting the rule to the national context. So far, there seems to be no case law indicating how courts will apply and interpret the right of use. In the view of the EFMLG, continued close monitoring is necessary to ascertain that the resulting new legal regimes is indeed yielding the intended results in an equivalent manner in all EU Member States. If increased practice will reveal short-comings, a further review of the respective provisions should be envisaged.

### **4. Realisation by appropriation**

The EFMLG welcomes that no Member States has made use of the opt-out possibility provided for in Article 5 regarding the possibility of appropriation by collateral takers in case of an enforcement event.

### **5. Protection of top-up collateral**

Although the Collateral Directive permits and offers legal certainty to mark-to-market and substitution mechanisms, it fails to deal with the common scenario in which top-up is required due to a deterioration of the the financial standing, such as evidenced by its credit rating, of the collateral provider. We realise that this omission was based on the 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. The EFMLG continues to 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. 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. Protection of netting arrangements**

In the view of the EFMLG, the protection of netting arrangements is of paramount importance to financial market participants. It reduces credit risk, and hence allows an increase in the credit exposures that institutions are able to accept. In conjunction with this, the amount of capital legally required for credit institutions to cover their credit exposures could be reduced. Netting can also contribute to reducing settlement and liquidity risk and, as a consequence, systemic risk. The EFMLG appreciates that through implementation of the Collateral Directive, mutual and bilateral close-out netting arrangements should now be generally recognised.

However, the way that netting arrangements are protected still differs and there are shortcomings in a number of jurisdictions as is revealed by the non-existence of lack of positive legal opinions, which would merit the on-going attention of the Commission.

Furthermore, the EFMLG would like to use this opportunity to reiterate its proposals made to the Commission already with its 2004 Report on the Protection for bilateral insolvency set-off and netting agreements under EC law. In this report, the EFMLG identified various legal uncertainties on the enforceability of contractual set-off and netting agreements that result from certain provisions of the Insolvency Regulation, the Banks Winding-up Directive and the Collateral Directive. To resolve these uncertainties, we still believe there is a pressing need for legislative clarification on the scope of protection for insolvency close-out netting arrangements under Community law.

The main reason for such legislative clarification is that it is deeply uncertain whether the set-off protection in Article 6 of the Insolvency Regulation encompasses close-out netting. As a result, the enforceability of close-out netting arrangements in insolvency proceedings concerning non-financial counterparties is unclear in many EU Member States. Financial market participants and regulators consider it essential to have a high degree of certainty on the enforceability of contractual set-off and netting agreements in case a counterparty should default. The Community and the Basel Committee on Banking Supervision share this concern for certainty in view of the implications of the legal enforceability of set-off and netting agreements for the prudential supervision of credit institutions and the stability of the international financial system. Ensuring legal certainty would guarantee the necessary level of legal protection for key financial instruments, which play a vital role in modern financial markets. This would make transactions and the legitimate expectations of parties more certain in an area where any doubt creates severe risk of systemic damage and impaired market efficiency.

In the view of the EFMLG, the protection for close-out netting provisions in the Collateral Directive is not sufficient to overcome this uncertainty, since the Collateral Directive applies only to close-out netting provisions in a financial collateral arrangement or an arrangement of which a financial collateral arrangement forms part. In addition, Member States may opt to exclude from the scope of the Collateral Directive financial collateral arrangements in which the

collateral taker and the collateral provider do not both belong to one of the listed categories of financial institutions and public authorities. This potential exclusion could further reduce the protection for close-out netting provisions in financial collateral arrangements with non-financial counterparties.

Clarification is also warranted to the extent that the Community *acquis* on the enforceability of bilateral set-off and netting agreements is incoherent, due to the divergent approaches taken by the Community legislator to overcoming legal uncertainties on their enforceability. The EFMLG considers that the Collateral Directive's approach to the enforceability of insolvency set-off and netting agreements is conceptually preferable to the approach in the Insolvency Regulation and the Banks Winding-up Directive.

Ideally, the EFMLG would support an EU legal act on close-out netting. Such a legal act would deal with inconsistencies between the considerable body of netting legislation that exists at the level of the Member States by providing criteria by which a Member State can assess whether its own netting legislation is adequate against EU standards. However, we recognise that this proposal might not be feasible at present in view of the legislative agenda of the Commission following the Financial Services Action Plan (FSAP). We would urge the Commission to take advantage of the current review process of the Collateral Directive, to consider proposing amendments to the Collateral Directive's close-out netting provisions.

Without prejudice to other possible legislative solutions, including a possible EU legal act on close-out netting, we suggest to consider that the definition of 'close-out netting provision' in Article 2(1)(n) of the Collateral Directive be amended as follows:

'(n) "close-out netting provision" means a provision of an [ ] arrangement, **whether or not such** arrangement **forms part** of [ ] a financial collateral arrangement [,] or, in the absence of any such provision, any statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise: (i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; and/or (ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.'

Also, consistent with this amendment, recital 14 of the Collateral Directive could be amended as follows:

'The enforceability of bilateral close-out netting should be protected, not only as an enforcement mechanism for title transfer financial collateral arrangements including repurchase agreements but more widely. Sound risk management practices commonly used in the financial markets should be protected by enabling participants to manage and reduce their credit exposures

arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of **any collateral provided.**'

The central provision that imposes the obligation to recognise close-out netting is Article 7 of the Collateral Directive. However, Article 7 still requires a "collateral provider" or "collateral taker", i.e. a close-out netting agreement that is secured or accompanied by a collateral arrangement. We therefore propose to consider deleting the words "in respect of the collateral provider and/or collateral taker" in Article 7(1)(a) and replacing them with **"in respect of a party to the close-out netting provision"**, in line with what has been done in a number of Member States.

There is also a need to protect close-out netting provisions and transactions entered into thereunder from measures mentioned in Article 8. In some European jurisdictions, the bankruptcy courts have challenged or may challenge the master agreement or transactions concluded under the master agreement solely for the reason that they are entered into between the parties within a prescribed period of time. We hence suggest that Article 8(1) could be amended by inserting after the words "Member States shall ensure that" the words **"a close-out netting provision, transactions entered into under a close-out netting provision"**. Given our experience in certain jurisdictions, we also recommend the same for Article 3(1). We suggest the addition of the words **"a close-out netting provision, transactions entered into entered into under a close-out netting provision"** after "... or admissibility of".

## **7. 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. In the EFMLG's views, it is encouraging that all Member States have implemented Article 9, thus providing a clear and reliable basis for determining the law applicable to collateral transactions throughout the EU. The EFMLG would like to encourage that going beyond a limited conflict of laws rule for the purpose of collateral transactions, the Commission should propose a general rule based on the existing Community legal acts for all aspects of book-entry securities, whether in a collateral transaction or not, thus avoiding split regimes. In this context, the EFMLG acknowledges both the work currently undertaken by the Council and the Commission related to the proposed Hague Convention on the law applicable to indirectly held securities. The EFMLG stresses the need to achieve a adequate balance between the degree of certainty and reliability achieved in the EU under the current regime and the needs of European market participants as well as for the interest in global solutions.

In view of above, the EFMLG would again like to congratulate the Commission on the beneficial effects for the European financial markets achieved by the Collateral Directive and stands ready to further accompany and support the Commissions activities in this field in the future.

Best regards,

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Chairman