

## **M e m o r a n d u m**

### **Directive 2002/47/EC on Financial Collateral Arrangements (the "FCD") – the Commission's Evaluation Report of 20<sup>th</sup> December 2006 – Proposal for a Revision of the FCD or New Directive**

We welcome the Commission's Evaluation Report on the Directive 2002/47/EC on Financial Collateral Arrangements (the "FCD") and the conclusions reached therein. However, we encourage the Commission to reconsider at least its recommendation for continuing the opt-out provisions on the scope of the FCD.

#### **1. Personal Scope of Application:**

The question which entities may benefit from the FCD is of crucial relevance. From a financial institution's perspective, carrying out business cross border and vis-à-vis all types of counterparts including non-financial institutions and individuals, the personal scope of the FCD should be as widely defined as possible. Whilst it is positive that only two Member State have 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 FCD. This state of diversity results in a continuous need for further due diligence to determine if, or under which conditions, a collateral transaction would profit from the new regime. We strongly encourage the Commission to contemplate to remove any opt-out possibilities and to expand the personal scope of application to a wider range of entities (including, at least, entities other than consumers).

#### **2. Material Scope of Application**

We welcome the Commission's conclusion to consider the broadening of eligible collateral in order to cover "credit claims". However, the Commission should extend the scope beyond credit claims and include all receivables whether arisen under a loan agreement or under any other contract (e.g., a purchase or service agreement). This would be in line with Basel II and the revised Banking Directive which, if certain requirements are met, recognise the assignment of receivables as eligible credit risk mitigation. The Commission should also aim for enhancing the existing scope of eligible collateral described by the terms "financial instruments" and "cash". The Commission should especially address some of the legal issues that have been identified when implementing the FCD, e.g., the inclusion of debt obligations and shares "not tradable in the capital market" or whether the delivery of cash by money transfer is covered by the FCD. We suggest that in the light of these experiences, the Commission should assess whether the beneficial effect of the directive could be generally extended to other types of assets commonly used in the financial markets.

#### **3. Rating Related 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 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. 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 which cannot lead to a discretionary misuse by the parties.

#### **4. Protection of Close-out netting arrangements**

The protection of close-out 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. We therefore appreciate that the Commission is willing to further explore the possibility of improving the existing framework for netting. However, we would appreciate if the Commission would not hesitate to swiftly start this exercise and involve the financial industry at the earliest stage possible. We attach a first draft directive on close-out netting, which, however, is to be understood as feasibility study only.

Enclosure

**DIRECTIVE 2007/.../EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL**

of [ ] 2007

on close-out netting arrangements

THE EUROPEAN PARLIAMENT AND THE  
COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the  
European Community, and in particular Article 95  
thereof,

Having regard to the proposal from the  
Commission,

Having regard to the opinion of the European  
Central Bank,

Having regard to the opinion of the Economic and  
Social Committee,

Acting in accordance with the procedure laid down  
in Article 251 of the Treaty,

Whereas:

- (1) Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements constituted a milestone in establishing a sound legal framework for the legal certainty of financial collateral arrangements...
- (2) [ ]
- (3) This Directive complies with the fundamental rights and follows the principles laid down in particular in the Charter of Fundamental Rights of the European Union.
- (4) Since the objective of the proposed action, namely to create a minimum regime relating to the enforceability of close-out netting arrangements, cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale and effects of the action, be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective.

HAVE ADOPTED THIS DIRECTIVE:

Article 1

**Subject matter and scope**

1. This Directive lays down a Community regime applicable to close-out netting arrangements and transactions governed by them which satisfy the requirements set out in paragraphs 2 and 5.
2. The parties of the close-out netting arrangement must each belong to one of the following categories:
  - (a) a public authority including:
    - (i) public sector bodies of Member States charged with or intervening in the management of public debt, and
    - (ii) public sector bodies of Member States authorised to hold accounts for customers;
  - (b) a central bank, the European Central Bank, the Bank for International Settlements, a multilateral development bank as defined in Article 1(19) of Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, the International Monetary Fund and the European Investment Bank;
  - (c) a financial institution subject to prudential supervision including:
    - (i) a credit institution as defined in Article 1(1) of Directive 2000/12/EC, including the institutions listed in Article 2(3) of that Directive;
    - (ii) an investment firm as defined in Article 1(2) of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field;
    - (iii) a financial institution as defined in Article 1(5) of Directive 2000/12/EC;
    - (iv) an insurance undertaking as defined in Article 1(a) of Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and a life assurance undertaking as defined in Article 1(a) of Council Directive 92/96/EEC of 10 November

1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance;

- (v) an undertaking for collective investment in transferable securities (UCITS) as defined in Article 1(2) of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS);
- (vi) a management company as defined in Article 1a(2) of Directive 85/611/EEC;
- (d) a central counterparty, settlement agent or clearing house, as defined respectively in Article 2(c), (d) and (e) of Directive 98/26/EC, including similar institutions regulated under national law acting in the futures, options and derivatives markets to the extent not covered by that Directive, and a person, other than a natural person, who acts in a trust or representative capacity on behalf of any one or more persons that includes any bondholders or holders of other forms of securitised debt or any institution as defined in points (a) to (d);
- (e) a person other than a natural person, including unincorporated firms and partnerships;
- (f) a natural person.

3. Member States may exclude from the scope of this Directive close-out netting arrangements where one of the parties is a person mentioned in paragraph 2(f). If they make use of this option Member States shall inform the Commission which shall inform the other Member States thereof.

4. The transactions governed by close-out netting arrangement are transactions listed in Annex I.

5. This Directive applies to close-out netting arrangements and transactions governed by it if that arrangement and the transaction can be evidenced in writing or in a legally equivalent manner.

## Article 2

### Definitions

1. For the purpose of this Directive:

- (a) "winding-up proceedings" means collective proceedings involving realisation of the assets and distribution of the proceeds among the creditors, shareholders or members as appropriate, which involve any intervention by administrative or judicial authorities, including where the collective proceedings are terminated by a composition or other analogous measure, whether or not they are founded on insolvency or are voluntary or compulsory;
- (b) "reorganisation measures" means measures which involve any intervention by administrative or judicial authorities which are intended to preserve or restore the financial

situation and which affect pre-existing rights of third parties, including but not limited to measures involving a suspension of payments, suspension of enforcement measures or reduction of claims;

- (c) "close-out event" means an event of default, termination event or any similar event as agreed between the parties on the occurrence of which, under the terms of the close-out netting, the termination and close-out under the close-out netting arrangement comes into effect.
  - (d) "close-out netting arrangement" means an arrangement between two parties by which, on the occurrence of a close-out event, whether automatically or upon designation of a termination date, 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 the estimated replacement costs or losses allocated to them, 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.
  - (e) "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.
  - (f) "commodities" means any commodity or related service, including electricity, freight, capacity, emission rights, climate factors, inflation rates and price related spreads.
2. References in this Directive to a transaction "governed" by a close-out netting arrangement are to a transaction that
- (i) was entered into by the parties by reference to that close-out netting arrangement, irrespective of whether such reference was made explicitly or implicitly,
  - (ii) incorporated the terms of that close-out netting arrangement,
  - (iii) was included in that close-out netting agreement by a provision therein,

irrespective of whether that close-out netting arrangement was entered into prior or after the conclusion of such transaction.

3. References in this Directive to "writing" include recording by electronic means and any other durable medium.

### Article 3

#### **Formal requirements**

Member States shall not require that the creation, validity, perfection, enforceability or admissibility in evidence of a close-out netting arrangement or transactions governed by it be dependent on the performance of any formal act [, including registration, notarization or the provision of a "certain date"].

2. Paragraph 1 is without prejudice to the application of this Directive to close-out netting arrangements and transactions which can be evidenced in writing or in a legally equivalent manner.

### Article 4

#### **Enforceability of close-out netting arrangements**

1. Member States shall ensure that on the occurrence of a close-out event the close-out netting arrangement comes into effect and is enforceable as provided in the terms agreed in the close-out netting arrangement.

2. The operation and enforceability of the close-out netting arrangement shall, subject to the terms agreed in the close-out netting arrangement, be without any requirement to the effect that:

- (a) prior notice of the intention to terminate and close-out of the close-out netting arrangement or the transactions governed by it must have been given;
- (b) the operation of the termination and close-out arrangement or its terms be approved by any court, public officer or other person;
- (c) the current value or the terminated transactions or the estimated replacement costs or losses are determined as of a prescribed date or point in time or in a prescribed manner; or
- (d) in respect to partnerships, trustees, insurance companies and UCITS, mutuality is given in respect of all rights and obligations governed by that close-out netting arrangement.

5. Member States shall ensure that a close-out netting arrangement can take effect in accordance with its terms

- (a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the

party that is subject to such proceedings or measures; and/or

- (b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of any right governed by that close-out netting arrangement.

5. This Article shall be without prejudice to any requirements under national law to the effect that the operation of the close-out netting arrangement must be conducted in a commercially reasonable manner.

### Article 5

#### **Certain insolvency provisions disappplied**

1. Member States shall ensure that a close-out netting arrangement, as well as transactions governed by it, may not be declared invalid or void or be reversed on the sole basis that the close-out netting arrangement or the transaction has been entered into or come into existence:

- (a) on the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement; or
- (b) in a prescribed period prior to, and defined by reference to, the commencement of such proceedings or measures or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures.

2. Member States shall ensure that where a close-out netting arrangement or a transaction has been entered into or has come into existence on the day of, but after the moment of the commencement of, winding-up proceedings or reorganisation measures, it shall be legally enforceable and binding on third parties if the party not being subject to such proceeding or measures was not aware, nor should have been aware, of the commencement of such proceedings or measures.

### Article 6

#### **Conflict of laws**

1. Any question with respect to any of the matters specified in paragraph 2 arising in relation to the enforceability of a close-out netting arrangement shall be governed solely by the substantive civil law chosen by the parties of the close-out netting arrangement or otherwise governing the close-out netting arrangement.

2. The matters referred to in paragraph 1 are:

- (a) the legal nature of a close-out netting arrangement;
- (b) the requirements and legal steps necessary to render a close-out netting arrangement and the transactions governed by it effective and enforceable;

- (c) the effects of winding-up proceedings or reorganisation measures on the operation of close-out netting arrangement; or
- (b) the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all creditors.

Article 7

**Report by the Commission**

Not later than [ ], the Commission shall present a report to the European Parliament and the Council on the application of this Directive accompanied where appropriate by proposals for its revision.

Article 8

**Implementation**

Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by [ ] at the latest. They shall forthwith inform the Commission thereof.

When Member States adopt those provisions, they shall contain a reference to this Directive or be

accompanied by such reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

Article 9

**Entry into force**

This Directive shall enter into force on the day of its publication in the Official Journal of the European Communities.

Article 13

**Addressees**

This Directive is addressed to the Member States.

Done at Brussels, [ ] 2007.

For the European Parliament	For the Council
The President	The President
[ ]	[ ]

ANNEX I

LIST OF TRANSACTIONS

1. Options, forwards, futures, swaps, caps, floors in respect to financial instruments, commodities, currencies, interest rates, credit risks, event risks or other parameters or indices or basket that consists of such financial instruments, commodities, currencies, interest rates, credit risks, event risks or other parameters, irrespective of whether traded on a regulated market or over the counter, and irrespective of whether settled through a clearing or settlement system or by payment of cash settlement amounts or physical delivery of the underlying instruments, and any option on the above transactions or combination of them;
2. Repurchase transactions and buy/sell back transactions in respect to financial instruments or commodities;
3. Loans in respect to cash, financial instruments or commodities; or
4. Financial collateral provided under a title transfer financial collateral arrangement, as defined in Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements that forms part of the close-out netting arrangement.