EUROPEAN CENTRAL BANK

OPINION OF THE EUROPEAN CENTRAL BANK

of 26 June 2003

at the request of the Austrian Federal Ministry of Justice
on a draft Federal law
implementing Directive 2002/47/EC of the European Parliament and of the Council
of 6 June 2002 on financial collateral arrangements

(CON/2003/11)

1. On 6 May 2003 the European Central Bank (ECB) received a request from the Austrian Ministry of Justice for an opinion on a draft Federal law (the draft law) implementing Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements[1] (the Directive).

2. The purpose of the draft law is to implement the Directive in Austria. Consequently, the Austrian authorities were not legally obliged to consult the ECB under Article 1(2) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[2]. However, the ECB has an interest in the harmonised implementation of the Directive in respect of the draft of which the Council of the European Union consulted the ECB and the ECB delivered its opinion on 13 June 2001 (CON/2001/13)[3]. In the light of the latter opinion, the ECB strongly welcomes the opportunity to give its opinion on the draft law as it addresses matters directly relevant to the Eurosystem's core fields of competence and as it has an impact on the efficient and safe use of financial collateral arrangements in European Union financial markets as well as on the Eurosystem's collateralised operations.

3. The draft law introduces a new Federal law concerning financial collateral arrangements in financial markets (Bundesgesetz über Sicherheiten auf den Finanzmärkten) intended to implement the Directive. According to the explanatory notes, the draft law will (as provided in the Directive) only apply to professional financial market participants. The draft law implements the Directive's uniform rules for the provision of securities and cash deposits as collateral and facilitates the realisation of such collateral. Furthermore, the draft law is intended to contribute to (i) improved integration of the European financial markets and (ii) the stability of financial systems. The ECB

1 OJ L 168, 27.6.2002, p. 43.
2 OJ L 189, 3.7.1998, p. 42.
3 OJ C 196, 12.7.2001, p. 10.

notes that the draft law is particularly relevant to the Eurosystem as it also applies, in accordance with the Directive, to the Eurosystem national central banks and to the ECB.

4. In a general context, the ECB refers back to its view that the Directive represents a significant and important effort to advance the efficient and safe use of financial collateral, both at a domestic and cross-border level. The promotion of simple and reliable methods of collateralisation is of fundamental interest to the ECB, as well as to the national central banks, as it will help to ensure the smooth functioning of the Eurosystem's single monetary policy. This will go beyond what has already been achieved by the implementation 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[4] (the Settlement Finality Directive) to establish a sound legal framework for payment and security settlement systems as well as for the central banks' operations. The Eurosystem's involvement derives from the second indent of Article 18.1 of the Protocol on the Statute of the European System of Central Banks (ESCB) and of the ECB, which provides that in order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may conduct credit operations with credit institutions and other market participants, with lending being based only on adequate collateral. In this context, the ECB strongly welcomes the fact that the Austrian authorities have prepared the draft law far in advance of the time limit for implementation laid down in the Directive.

5. The ECB notes that according to Section I, § 2(1) of the draft law, it covers (i) public sector bodies, (ii) financial market authorities including, *inter alia*, the national central banks and the ECB, (iii) financial institutions subject to prudential supervision, (iv) central counterparties, settlement agents or clearing houses, and (v) legal entities acting in a trust or representative capacity. This is in line with the Directive. Furthermore, Section I, § 2(2) of the draft law states that it shall apply to the provision and realisation of financial collateral involving on the one hand, another incorporated company, a partnership with limited liability or an unincorporated company, where no firm with unlimited liability is a natural person, and on the other hand a financial market participant, as defined in Section I, § 2(1) of the draft law. Limiting the application of the draft law to the entities listed in Section I, § 2(2) of the draft law constitute a partial opt-out in the context of Article 1(3) of the Directive. The ECB would like to stress in this context that it should be ensured that an opt-out, and in particular a partial opt-out, does not create uncertainty regarding the application of the Directive and of the draft law. The ECB has always acknowledged the need to assess carefully the extent of any limitations to general insolvency regimes, whereby it is necessary to take into account various considerations ranging from legal certainty, the efficiency of cross-border collateral transactions and the ease of collateral management to, in certain cases, supervisory interests, especially potential reorganisation measures. The ECB suggests considering whether those provisions in the Directive that do not deal with protection against the effects of insolvency, but instead cover substantive law or conflict of law rules, could be made applicable without limitation

4 OJ L 166, 11.6.1998, p. 45.

to all entities. Establishing different regimes for the creation and use of the same kind of collateral, depending on the type of parties involved, implies evaluating the status of the parties to an arrangement and tends to disrupt collateralised transactions. In addition, from the ECB's point of view, all systems and their participants protected by the Settlement Finality Directive as well as central counterparties (which are of crucial importance for the efficient functioning of payment and settlement systems) and all entities with access to the Eurosystem's credit operations must be able to benefit from the Directive by its implementation in the Member States.

6. The ECB notes that the draft law adopts the definition of 'financial instruments' set out in Article 2(1)(e) of the Directive. However, the ECB suggests considering whether the draft law could be extended to cover all types of assets eligible for Eurosystem credit operations, including, *inter alia,* credit claims in the form of bank loans. This approach would safeguard and promote the efficient cross-border use of all assets eligible for Eurosystem credit operations and would advance implementation of the Eurosystem's single monetary policy. Moreover, the ECB would like to stress that using undefined legal concepts, such as "claims relating to or rights in or relating to", as set out in Section I, § 3 No. 5 of the draft law, should not create uncertainty regarding the application of the draft law to the various proprietary and contractual instruments used in modern financial markets, e.g. derivatives or sub-participation rights.

7. The ECB welcomes the abolition of formal requirements for financial collateral arrangements. The ECB notes that Section I, § 4(1) of the draft law, is fully consistent with Article 3(2) of the Directive. The latter allows financial collateral arrangements to be evidenced "in writing or in a legally equivalent manner". In the opinion of the ECB, it is important that national laws implementing the Directive should not exclude transactions under general terms and conditions, which are not normally signed by the parties, or other current market practices. The only reason requirements of form should continue to exist is to provide the necessary evidence in insolvency situations.

8. Moreover, the ECB notes that Section I, § 4(3) of the draft law provides for proprietary rights to be transferred by way of book-entry. Whilst going beyond what the Directive requires (according to Article 2(1)(g) of the Directive, a proprietary right only needs to be evidenced by book-entry), the ECB acknowledges that a provision of this kind provides a high degree of certainty as to the exact point in time when rights are transferred.

9. The ECB notes that Section I, § 5 of the draft law permits the realisation of collateral by way of sale or appropriation, provided that the financial collateral arrangement expressly allows such methods of realisation. This wording is more restrictive than the Directive. In the ECB's opinion, Article 4(1) of the Directive is drafted to establish the free realisation of collateral by sale as the rule, but allowing the parties to limit or exclude such rule.

10. The ECB notes that Section I, § 7 of the draft law grants the right to reuse collateral provided under a pledge arrangement ("*Verfügungsrecht*"), following closely the wording of Article 5 of the Directive. Combining elements of pledges and full transfers of ownership could therefore potentially improve the liquidity of pledges and make them more efficient. The ECB notes that the draft law does not seek to amend the Austrian law on pledges and, consequently, the right of reuse as set out in Section I, § 7 of the draft law appears to create a right *sui generis*, distinct from both a pledge and a full transfer of title. In order to avoid any uncertainty in this context, the ECB suggests considering whether the distinction between a pledge and a 'right of reuse' is sufficiently clear, in particular whether a pledge is transformed into a 'right of reuse' when a collateral taker exercises the option to reuse the assets, or whether the assets would be provided under a right *sui generis*, which would not constitute a pledge in the first place.

11. The ECB welcomes Section I, § 9 of the draft law, which recognises close-out netting provisions in accordance with Article 7 of the Directive.

12. Because sound and efficient risk management practices commonly used in the financial markets, including the Eurosystem's risk control framework, rely on the ability to manage and reduce credit exposures arising from all kinds of financial transactions on a net basis, limiting market agents to using particular risk mitigation techniques (e.g. only close-out netting) could impair financial stability. As a consequence, Article 8 of the Directive protects the validity of both substitution of assets and the provision of top-up collateral from any adverse impact arising after parties conclude an original agreement on top-up collateral arrangements and an initial security interest is created or transfer of title takes place. The ECB understands that no limitation on the availability of such risk mitigation techniques is effective in Austria.

13. Finally, the ECB notes that under Section II of the draft law, implementing Article 9 of the Directive, the law applying to cross-border use of collateral in book-entry securities shall be the law of the country in which the securities collateral account is maintained. The ECB would like to point out in this context that the draft law might be affected by the Hague Convention on the law applicable to certain rights in relation to securities held with an intermediary (the Convention), the ratification of which is currently being considered by the Community and the Member States. Article 9 of the Directive, and consequently Section II of the draft law are not compatible with the Convention in so far as the Convention adopts a choice of law approach. The ECB wishes to stress that all parties involved in the legislative process should investigate closely the Convention's potential impact on systemic stability and on the treatment of collateral transactions to avoid undermining the current level of protection. This might include, *inter alia*, limiting the choice of law applying to proprietary rights in respect of securities held on accounts with a systemically important system (in particular securities settlement systems evaluated and used by the Eurosystem) to the law governing that system, as well as other measures designed to safeguard systemic finality, certainty and transparency.

14. The ECB confirms that it has no objections to the competent national authorities making this opinion publicly available at their discretion. This opinion will be published on the ECB's website six months after the date of its adoption.

Done at Frankfurt am Main on 26 June 2003.

The President of the ECB

[signed]

Willem F. DUISENBERG