

EUROPEAN CENTRAL BANK

OPINION OF THE EUROPEAN CENTRAL BANK

of 13 June 2001

at the request of the Council of the European Union concerning a proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements

(CON/2001/13)

(2001/C 196/09)

1. On 3 May 2001, the European Central Bank (ECB) received a request from the Council of the European Union for an opinion on proposal COM(2001) 168 final of 27 March 2001 for a Directive of the European Parliament and of the Council on financial collateral arrangements (hereinafter referred to as the 'proposed Directive').
2. The ECB's competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the ECB, the Governing Council of the ECB has adopted this opinion.
3. The ECB appreciates that in order to meet the objectives of ensuring an integrated European financial market and supporting the smooth functioning of the single monetary policy in the economic and monetary union, the creation of a uniform minimum legal framework for arrangements set up to limit credit risk in financial transactions through the provision of securities and cash as collateral under both pledge and transfer of title arrangements (including repurchase agreements) is proposed. It is noted that recital 10 of the proposed Directive states another general intention to protect 'Sound risk management practices commonly used in the financial market'. The core provisions of the proposed Directive, however, only encompass close-out netting and top-up collateral as defined in Article 3(1)(s) and Article 9(2)(a), respectively. It should be clarified that this is not to be understood in a way that other kinds of risk management practices commonly used in the financial market would be regarded as being unenforceable.
4. The ECB highly welcomes this initiative as a significant and important effort to further promote the efficient and safe use, both at a domestic and cross-border level, of financial collateral, beyond that already achieved by the 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 ⁽¹⁾ (hereinafter referred to as the 'Settlement Finality Directive') for the establishment of a sound legal framework for payment and security settlement systems as well as for the operations of central banks. The ECB would like to recall on this occasion the importance of a full implementation of the Settlement Finality Directive by all Member States.
5. The ECB would like to emphasise that it shares the conclusion of the Commission that the existing rules applicable to collateral in the European Union (EU) could be considered to be too complex and impracticable, especially in cross-border transactions. The promotion of simple and reliable methods of collateralisation is of fundamental interest to the ECB, as well as to national central banks, as it will further increase the smooth functioning of the single monetary policy of the Eurosystem (the ECB and the national central banks of Member States participating in stage III of the economic and monetary union), beyond what was already achieved by the implementation of the Settlement Finality Directive as regards the insulation from the effects of insolvency of collateral provided to a national central bank or the ECB. The interest of the Eurosystem derives from the second indent of Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank, which provides that in order to achieve the objectives of the European System of Central Banks 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.
6. Although the Eurosystem already benefits from the application of the Settlement Finality Directive to its credit operations, this amounts mainly to protection from the effects of an insolvency of a counterparty. The ECB therefore welcomes the attempt by the proposed Directive to resolve the wider problems affecting the use of collateral, especially in a cross-border context. In the view of the ECB, this encompasses in particular a restriction on the imposition of onerous formalities on both the creation and the enforcement of collateral arrangements, an effective and simple Community regime for the creation of collateral and the protection of financial collateral arrangements from those rules of insolvency law that would inhibit the effective realisation of collateral or cast doubt on the validity of techniques currently used. Moreover, the ECB supports the creation of legal certainty with regard to cross-border use of book-entry assets, by the introduction of a clear and unique rule for determining where such assets are located, building on and further specifying the principles contained in the Settlement Finality Directive. This will not only support

⁽¹⁾ OJ L 166, 11.6.1998, p. 45.

- the efficiency of operations necessary for the conduct of the single monetary policy where the Eurosystem provides liquidity to its counterparties against collateral both in a domestic and in a cross-border context, but also enhance the legal certainty and efficiency of those operations where money market participants balance this liquidity across the market with transactions among themselves that match individual surpluses and shortages of liquidity.
7. It is noted that the scope of the proposed Directive (Article 2(4)) is limited to public authorities, central banks, financial institutions under prudential supervision and legal persons with a capital base exceeding EUR 100 million or gross assets exceeding EUR 1 billion. The ECB would like to stress that the application of a certain threshold on the basis of the capital base or the gross assets should not lead to uncertainties as regards the application of the proposed Directive, in particular as such basis might change since the most recent accounting report. In addition, from an ECB point of view, it has to be ensured that all systems and their participants, that are protected by the Settlement Finality Directive, central counterparties, which are of crucial importance for the efficient functioning of payment and settlement systems, as well as all entities that have access to the refinancing operations of the Eurosystem, will also benefit from the application of the proposed Directive.
 8. In general, the ECB acknowledges the need to carefully assess the extent of any limitations to the general insolvency regimes, whereby various considerations, which range from legal certainty, the efficiency of cross-border collateral transactions and the ease of collateral management to, in certain cases, supervisory interests, especially the possibility of reorganisation measures, have to be taken into account. However, it is suggested that it be considered whether those provisions in the proposed Directive that do not deal with protection against insolvency, but with substantive law or the conflict of law rule, could be made generally applicable, without the application of a threshold or other criteria. The creation of differing regimes for the establishment and use of the same kind of collateral, depending on the type of parties involved, implies ascertaining the status of the parties to an arrangement and is prone to create distortions in the smooth functioning of collateralised transactions. In any event, the introduction of a recital stating that Member States are allowed to go beyond the proposed Directive should be considered.
 9. The ECB is in favour of the definition of 'financial collateral arrangements' contained in Article 3(1)(a) of the proposed Directive encompassing both pledge structures and all transfer of title arrangements (e.g. repurchase transactions or credit support arrangements), in order to contribute to the stability of the financial markets in the EU and to protect the collateralisation techniques used by the Eurosystem.
 10. The ECB takes note that the proposed Directive covers both 'financial instruments' as defined in Article 3(1)(h) (including transferable securities) and cash. However, the ECB suggests that it be considered whether the scope of the proposed Directive could be extended to cover all types of assets that are eligible for Eurosystem credit operations, including *inter alia* credit claims in the form of bank loans. Such a solution would safeguard and promote the efficient cross-border use of all assets eligible for Eurosystem credit operations, which already benefit from a full insulation from the application of insolvency proceedings by virtue of Article 9(1) of the Settlement Finality Directive. This would further enhance the implementation of the single monetary policy of the Eurosystem.
 11. The ECB welcomes the removal of formal requirements for financial collateral arrangements, apart from the requirement for an agreement to be in writing or evidenced in writing and signed by or on behalf of the collateral provider. This remaining requirement should not exclude transactions under general terms and conditions, which normally are not signed by the parties, or other existing market practices. The sole justification for any remaining formality should be the necessary evidence in insolvency situations.
 12. The ECB also supports that, in order to limit the administrative burdens for participants using book-entry securities as collateral, the only perfection requirement should be, for transfers in ownership, the delivery of the collateral, and for other financial collateral security arrangements, either the delivery or the recording by the relevant entity maintaining the securities collateral account.
 13. The ECB takes note that the proposed Directive foresees the enforcement of collateral with minimum formalities and without any assistance from or interference by courts or public authorities (Article 5). In this context, any modification to existing national insolvency procedures should take into account the aims of the proposed Directive (legal certainty, the efficiency of cross-border collateral transactions and the ease of collateral management) as well as the interest of prudential supervisors in effective reorganisation measures and the stability of the financial system, the latter being of concern to the Eurosystem as evidenced by Article 3.3 of the Statute of the ESCB and of the ECB. Moreover, the ECB stresses the importance of the principle contained in Article 5(4), that any realisation needs to be conducted in a commercially reasonable manner. Finally, Article 5 of the proposed Directive deals with enforcement by sale or by close-out netting. It could be considered also to allow a collateral taker to appropriate the collateral in case of an enforcement event, provided that the creditor is prevented from benefiting from undue enrichment.

14. The ECB also notes that there may be a discrepancy between Article 2(6)(b) and Article 5(3) of the proposed Directive (enforcement events), which might have to be removed. Article 2(6)(b) refers to 'obligations owed to the collateral taker by a person other than the collateral provider', but at the same time, the enforcement events of Article 5(3) only relate to the collateral provider and the collateral taker and not to any such third party obligor (e.g. a parent company providing collateral in order to secure the obligations of its subsidiary vis-à-vis a credit institution).
15. The ECB welcomes the intention of the proposed Directive to render effective close-out netting provisions in case of opening of insolvency or reorganisation proceedings. The enforceability of close-out netting as an enforcement mechanism should be effective and protected in general in the event of default, whether due to insolvency or other events. Moreover, the ECB understands that the enforceability of close-out netting is not restricted to certain financial collateral arrangements, e.g. repurchase agreements, but will be applied more widely, for all kinds of arrangements aiming to reduce risk and credit exposure, including, but not limited to, cross-product netting provisions and netting arrangements involving more than one financial collateral arrangement. To this end, both the definition of close-out netting in Article 3(1)(s) and Article 8 could be specified and clarified further. The close-out procedure should apply to the entire collateral and liabilities against which the collateral has been provided. The collateral taker should not be exposed to the risk of 'cherry-picking' by the receiver or liquidator of the collateral provider affirming favourable executory contracts and rejecting unfavourable executory contracts. As sound and efficient risk management practices commonly used in the financial market, including the risk control framework of the Eurosystem, rely on the ability to manage and reduce the credit exposures arising from all kinds of financial transactions on a net basis, any limitation to the scope of application of the proposed Directive to certain risk mitigation techniques could impair financial stability.
16. The ECB notes that Article 6 of the proposed Directive entails the right of use of collateral provided under a pledge arrangement, according to which the collateral taker is in a position to 'use' (sell, lend, repo or pledge) collateral pledged to him. Thus assimilating pledge arrangements and arrangements involving full transfer of ownership might potentially enhance the liquidity and efficiency of pledge arrangements. However, it is acknowledged that this concept might entail substantial changes to the legal systems of some Member States.
17. The ECB is generally in favour of the insulation of top-up collateral from the effects of insolvency. Where the collateral arrangement provides that, after the initial security interest or title transfer has been effected, there will be further collateral movements, those further collateral movements should be protected from invalidation as a result of circumstances that arise after the original agreement between the parties on the top-up collateral arrangement was concluded and the initial security interest or title transfer took place. The protection of top-up collateral will foster the effectiveness of risk control management systems, including the risk control framework of the Eurosystem. In addition, the ECB would like to mention that the second sentence of recital 11 should not be read in a way that would invalidate top-up collateral arrangements other than those referred to in Article 9(2)(a), in so far as they are currently recognised and valid in certain Member States.
18. The ECB also supports recognition of the substitution of assets, where the collateral arrangement stipulates that the collateral provider may substitute collateral after the security interest or title transfer has been effected, provided the substituting collateral is of no greater value than the collateral it is replacing. This will allow an increased effectiveness of the collateral management of all entities active in collateralised transactions, as well as contribute to the smooth functioning of securities settlement systems, by reducing settlement fails and thus enhancing financial stability.
19. The ECB welcomes the principle enshrined in Article 10 of the proposed Directive, according to which the law applicable to cross-border collateral arrangements in book-entry securities shall be determined as being the law of the country in which the securities collateral account is maintained (in accordance with the principle already set forth in Article 9(2) of the Settlement Finality Directive). It has to be ensured, however, that the alternative criteria contained in Article 10(2)(a) of the proposed Directive in order to identify the place where an account is maintained ('... provided that the relevant intermediary allocates the relevant account to that office or branch for purposes of reporting to its account holders or for regulatory or accounting purposes'), do not lead to new uncertainties as to which law applies. In this context, the ECB urges the entities concerned, in particular the Member States, to try to achieve, in the context of the ongoing discussions on a draft convention on 'the law applicable to dispositions of securities held through indirect holding systems' at the level of the Hague Conference on private international law, a solution which is consistent with the principles contained both in Article 10 of the proposed Directive and in Article 9(2) of the Settlement Finality Directive.

20. The ECB would like to raise the question whether the proposed Directive (and particular Article 10(2) referring to a relevant intermediary) also sufficiently covers situations of direct holdings in case of certain depository structures which merely reflect the holdings on an underlying register or directly in the books or records of an issuer, or structures in which securities are considered to be located in the books of the member of the central depository system.
21. Finally, in view of the high importance of further enhancing the efficient and safe use, both at a domestic and cross-border level, of financial collateral arrangements, both for the EU financial markets in general and the conduct of Eurosystem collateralised operations in

particular, the ECB would like to encourage all parties involved in the process of drafting and, ultimately, implementing the proposed Directive, to use all efforts for a quick finalisation of this process.

22. This opinion shall be published in the *Official Journal of the European Communities*.

Done at Frankfurt am Main on 13 June 2001.

The President of the ECB

Willem F. DUISENBERG
