Financial collateral arrangements and the financial markets

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Overview

– The use of financial assets as security
– The nature of a financial collateral arrangement
– The legal framework for financial collateral arrangements
– The use of financial collateral arrangements in the financial markets
  – Derivatives
  – Repos and securities lending
  – Margin lending and prime brokerage
  – Structured finance
– Financial collateral arrangements and law reform
The use of financial assets as security

– Convenience and cost-effectiveness of using cash and investment securities as “collateral” or “margin” for financial obligations
– Historical challenges applying traditional personal property security law to intangible financial assets
– The development of the repo and securities lending markets and title transfer collateral for derivatives
– Continuing difficulties across the European Union
– Directive 2002/47/EC on financial collateral arrangements
– Implemented in the UK by the Financial Collateral Arrangements (No. 2) Regulations 2003
Financial Collateral Arrangements Directive

– Two types of financial collateral arrangement
  – Security financial collateral arrangement
  – Title transfer financial collateral arrangement

– Common features
  – Counterparty scope – private individuals excluded
  – Need for evidence in writing (including electronic form)
  – To secure or “cover” relevant financial obligations

– Financial collateral
  – Cash
  – Financial instruments
  – Credit claims (from 2009)

– To be provided so as to be in the possession or under the control of the collateral taker
Security financial collateral arrangements

– Creation of a security interest over financial collateral
– No formalities for creation, validity, perfection, enforcement or admission in evidence, other than the requirement of a writing.
– Therefore, for example:
  – No requirement for registration or official date-stamping for perfection
  – No formal notice or judicial supervision or public auction for enforcement
– Collateral taker has right of use of financial collateral, if agreed
– Collateral taker has a right to appropriate financial collateral on default, if agreed
– Protection from insolvency rules, including insolvency stays or freezes
Title transfer financial collateral arrangements

– No creation of security interest
– Title transferred to taker who only has contractual obligation to return “equivalent collateral”
– Because the taker is the legal owner, there is no need to grant a right of use or right of appropriation
– Because title transfer financial collateral arrangements rely on set-off or netting, Member States must
  – Recognise and give effect to the arrangement and not recharacterise it as security
  – Recognise and give effect to close-out netting provisions
– Protection from insolvency rules, including insolvency stays or freezes
Forms of financial collateral

– Financial instruments
  – Equity securities
  – Debt securities if negotiable (tradeable) on a capital market
  – Warrants and similar securities
  – Fund units and money market instruments
  – Other tradeable rights and interests relating to above
– Cash
  – Money credited to an account and similar claims
  – UK: sums due under a financial collateral arrangement or close-out netting arrangement
– (from 2009) credit claims, that is, loans made by a credit institution
Advantages of a financial collateral arrangement

– Ease of creation
– No need for perfection
– Ease of enforcement
– Protection from insolvency rules, including stays or freezes
Financial collateral arrangements - issues

- Questions regarding scope
  - Counterparties
  - Relevant financial obligations
  - Financial collateral
- Requirement that financial collateral be “provided” to the taker, meaning delivered (etc.) … so as to be in the possession or under the control of the taker
- Query re above in relation to certain floating charges
- Safe harbour protections from insolvency rules
  - Impact on behaviour of secured creditors
  - Impact on position of unsecured creditors
- Policy justifications based on:
  - Need for stability and efficiency of financial market operations
  - Value-volatility of financial collateral and avoiding value destruction
Use of financial collateral arrangements in the financial markets

– Derivatives
  – Cleared derivatives – clearing house margin
  – Non-cleared derivatives
  – ISDA Credit Support Annexes, DRV Besicherungsanhang, etc.
– Securities sale and repurchase ("repo") agreements
– Securities lending agreements
– Margin lending and prime brokerage
– Structured finance
Financial collateral arrangements and law reform

- Uncertainties regarding the legal nature of financial collateral, in particular, intermediated securities
- Leading to uncertainties regarding:
  - Creation, perfection, enforcement of security
  - Law applicable to various aspects of a cross-border financial collateral arrangement
  - Substantive law relating to intermediated securities
  - Chapter V – special provisions in relation to collateral transactions
- BCBS-IOSCO Final Report on Margin for Derivatives (September 2013)
Questions?

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