

ALLEN & OVERY

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SECURED LENDING IN COMMERCIAL TRANSACTIONS – TRENDS AND PERSPECTIVES

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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
- ISDA paper “Collateral Arrangements in the European Financial Markets – the Need for National Law Reform” (March 2000)
- EU Financial Collateral Arrangements Directive (2002)
- Hague Securities Convention (2002)
- Geneva Securities Convention (2009)
 - 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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