

# **The Financial Collateral Arrangements Regulations 2003: Regulatory Impact Assessment**

## **Introduction and summary**

1. This regulatory impact assessment estimates the costs and benefits associated with the Financial Collateral Arrangements Regulations 2003. The Regulations implement the Directive on Financial Collateral Arrangements<sup>1</sup> into UK law.

## **Purpose and intended effect**

2. The Directive is an element in the Community's Financial Services Action Plan. It aims to create an efficient and effective single market for financial collateral arrangements. It will also support improved financial stability, by providing a way to reduce the risk that one firm failing will cause another to fail.
3. The Directive will principally be relevant to financial institutions and large companies.
4. Financial collateral arrangements involve the use of cash and/or financial instruments to provide security in a transaction. For the creditor, certainty of payment is increased through the greater ability to retain or realise collateral. For the debtor, transaction costs (for example, in the form of pricing of collateral) should be reduced.
5. The arrangements the Directive is intended to cover involve situations where possession or control of the financial collateral passes to the collateral taker.
6. The Directive is deregulatory. It does not impose new regulation upon businesses. It aims to remove legal obstacles to the use of collateral, and so to enable businesses to access finance more easily. It is unlikely to have an impact on competition. This is because the financial markets it would affect are already

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<sup>1</sup> Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

characterised by a wide range and diversity of suppliers of capital and the Directive will enhance this character. It will also enable innovation among suppliers of finance to continue and reduce costs for both suppliers and their customers.

## **Benefits and costs**

7. The Directive increases the choices available to creditors and debtors in their choice and administration of collateral. This will assist them in optimising their financial arrangements. It should, therefore, bring economic benefits by improving the service capital markets provide.
8. It is not easy to quantify the benefits. Some relevant considerations include:
  - *the reduced cost of capital.* Savings will arise because creditors receiving collateral will be prepared to accept lower rates of return, reducing the cost of capital for business. This benefit will be divided between creditors (in terms of reduced risk) and debtors (in terms of reduced cost of capital).
  - *the opportunity cost in providing collateral.* Some of this saving will be offset because of the opportunity cost to the debtor of providing financial assets as collateral. This will depend on the alternative uses of the assets if they had not been provided as collateral.
  - *... as potentially mitigated by techniques known as “substitution” and “re-use”.* The opportunity cost identified can itself be reduced by allowing the collateral-provider to change the financial assets provided as collateral (“substitution”), or by allowing the collateral-taker to “re-use” the financial assets taken as collateral. Provisions in the Directive allow for re-use and provide protection for substituted collateral. In each collateral arrangement, the parties will decide what use (if any) they would like to make of these provisions. “Substitution” directly helps reduce the opportunity cost identified above. “Re-use” enables the creditor to reduce the rate of payment that the debtor is asked to make, by providing the creditor with the means of making a return in addition to the return generated from the debtor.

- *legal and administrative savings.* Legal and administrative savings will be realised, since the Directive removes formalities involved in the giving and taking of collateral, and because it will create a more uniform European framework for collateral arrangements (which often have cross-border elements that can go across a number of domestic jurisdictions).
- *implications for non-collateralised creditors.* There will be effects on the position of the debtor's non-collateralised creditors. In the event of insolvency, they would no longer have access to the assets which had been used as collateral (or only to the extent that the value of these assets exceeded the liability which had been secured by the collateral arrangement). The risks faced by non-collateralised creditors might therefore increase, depending on the wider effects the collateral transaction has on the debtor's business. It is possible, for example, that the superior access to capital the collateral arrangement facilitates might improve the prospects of the debtor's business and therefore in fact **reduce** the risks the non-collateralised creditors face. The debtor will have to weigh up the relative benefits of entering into a collateral arrangement against the possible costs if higher rates of return are demanded in future by non-collateralised creditors. Existing non-collateralised creditors - such as bondholders - will not always be able to adjust the rates of return they receive on their capital. However, in this respect, the debtor's decision to use collateralised arrangements is not different from any other business decision by the debtor. Potential new non-collateralised creditors will also need to consider the implications of the (potential) debtor's collateral arrangements, where these are material, as part of their assessment of the debtor's creditworthiness. As always, transparency is a key element in creditor protection. International accounting standards provide a framework that supports transparency of accounts in respect of financial collateral arrangements. The UK's accounting standards already reflect this and similar pan-EU standards for listed companies are due to be introduced in the near future.

- *changes in patterns of business following the implementation of the Directive.* There could be changes in patterns of business following the implementation of the Directive. The alterations in other Member States' domestic law might move some business from the UK to their law or jurisdictions. On the other hand, UK financial firms stand to benefit from increased opportunities to do business, and UK businesses will benefit from the wider capital market.
  - *the benefits of improved financial stability.*
9. The size of the benefits and costs will also depend on the degree to which domestic law already supports collateral arrangements. Laws in the UK are already among the most amenable to collateral arrangements in the EU. The domestic effect of the Directive will therefore be correspondingly less. The Directive should, however, clarify and improve some aspects of law in the UK.

### **Securing compliance**

10. The Directive does not raise compliance issues because of its deregulatory nature.

### **Impact on small business**

11. In general, financial collateral arrangements are more likely to be used by larger businesses and financial institutions. Some Member States may wish to limit the Directive's scope to bigger businesses, or even just financial institutions. However, the Directive's general rationale would seem to suggest that as many businesses as possible should benefit from its provisions.

### **Consultation**

12. Within Government HM Treasury has consulted the devolved administrations, the Department for Trade and Industry and the Department for Constitutional Affairs. Informal public consultation has been held with a variety of trade associations and other interested parties. In July 2003 HM Treasury published a formal consultation paper containing the draft Regulations and partial regulatory impact assessment. Respondents generally welcomed the draft Regulations. No

comments were received on the partial regulatory impact assessment. Some respondents were concerned that by not extending the Directive to cover collateral subject to floating charges the full benefits of the Directive might not be realised and that this might cause practical difficulties. While serious thought was given to extending the Directive to cover floating charges we rejected this idea in the interests of providing appropriate protection for third parties, particularly unsecured creditors who appear after the floating charge has been taken.

### **Monitoring and evaluation**

13. HM Treasury intends to ask trade associations (and other interested parties) for their assessment of the effects of the Directive three years after its implementation.

### **Declaration**

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

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November 2003

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