Implementation of the Directive on Financial Collateral Arrangements

July 2003

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Implementation of the Directive on Financial Collateral Arrangements

PREFACE

This consultation document seeks views on proposed legislative measures for implementing the Directive on financial collateral arrangements (2002/47/EC) into UK law.

Drafts of the proposed regulations are attached at Annex A. A partial Regulatory Impact Assessment is attached at Annex B. The Treasury would be grateful for any comments on the draft regulations or on the partial Regulatory Impact Assessment to be sent by **10 October 2003** to the following address:

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Please could respondents give details of any organisation whose views they represent.

Responses and a summary of responses, may be published. Any responses, or part of responses, which you do not wish published should be clearly marked as confidential.

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CONTENTS

Chapter One	Introduction
Chapter Two	Scope
Chapter Three	Formal Requirements
Chapter Four	Financial Collateral Arrangements
Chapter Five	Insolvency
Chapter Six	Conflict of Laws
Chapter Seven	Implementation Timetable
Chapter Eight	Summary of Questions
Annex A	Draft Regulations
Annex B	Partial Regulatory Impact Assessment

CHAPTER ONE

Introduction

THE DIRECTIVE

1.1 The European Parliament and the Council of the European Union adopted a Directive on financial collateral arrangements on 6 June 2002[1].

1.2 The purpose of the Directive is to promote the integration and cost efficiency of the financial markets and the stability of the financial system. It sets out rules for the provision of financial instruments (principally securities) and cash as collateral. It relates to financial collateral arrangements for both security interest and title transfer structures including repurchase agreements.

1.3 The Directive is intended to cover arrangements in which possession or control of the financial collateral passes to the collateral taker.

1.4 The UK identified[2] the Directive as one of its ten priority Financial Services Action Plan measures. In an Explanatory Memorandum to Parliament[3] the Economic Secretary to the Treasury noted that the Directive:

> *"will help complete the single capital market. The Government is therefore keen to see the Directive adopted as quickly as possible and that it meets the objective of reducing the cost of capital in the EU. Reducing the cost of capital will, in turn, improve the EU's competitiveness, including that of the UK".*

1.5 The adoption of the Directive was a welcome development: by providing additional and reliable means of financing across the EU it will help both investors and those seeking finance. This will reduce the cost of capital, contributing to

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[1] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

[2] *Completing a Dynamic Single European Financial Services Market: A catalyst for Economic Prosperity for Citizens and Business across the EU*, HM Treasury, July 2000.

[3] EM of 5 May 2001 on the Commission's proposal for the Directive.

greater prosperity in the EU. For the creditor, certainty of payment is increased through the ability to retain or realise collateral. For the debtor, transaction costs (for example, in the form of pricing of collateral) should be reduced. The Directive will principally be relevant to financial institutions and large companies.

SCOPE

1.6 The types of arrangements to which the Directive applies are set out in its Article 2. The collateral covered by the Directive is financial collateral - that is cash and financial instruments (principally, securities). It does not cover arrangements governing other types of collateral, for example commercial property, plant and machinery or book debts (receivables).

1.7 The financial collateral arrangements covered by the Directive are:

- Title transfers; and
- Security arrangements.

1.8 In the UK, and much of Europe, title transfer is currently the preferred financial collateral arrangement, since it is less subject to uncertainty and formalities. (In the USA, by contrast, security is the usual method.) The two methods have different characteristics - for example, with regard to the collateral provider's retention of ownership rights and the collateral taker's ability to deal with the collateral. They can have different implications with regard to tax and accounting treatment. However, they both have the same basic aim of providing the collateral taker with security against default by the collateral provider. By minimising the formalities which Member States can impose and standardising the enforceability of both types of financial collateral arrangement, the Directive allows the parties to choose whichever type of collateral method is most appropriate to their particular circumstances.

1.9 The Directive is limited to transactions where both parties are corporate bodies (i.e. non-natural persons) and one party involved is either:

a) a public body (the Debt Management Office and the Bank of England being the UK public bodies to whom the Directive is most likely to be relevant);

b) a financial institution under prudential supervision; or

c) a regulated central counterparty, settlement agent, clearing house or similar institution.

EFFECT

1.10 The objective of the Directive is to enable financial collateral to be used more effectively across the EU by providing legal support for a number of features important in collateral use:

- *Validity*. Collateral arrangements will be recognised and enforceable across the EU. Under the law governing creation of security interests and the insolvency regimes of some Member States at present, the validity of some types of collateral arrangements and of some common provisions in those arrangements, has been open to question.

- *Abolition of formalities for creation of collateral*. Collateral arrangements will not require formalities (such as execution in a particular form or publication, notification or registration in a particular manner) in order to be valid and enforceable against the parties to the arrangement and third parties. This is because such formalities are not practical in modern financial markets. (In some Member States notification or registration formalities are necessary even though the collateral consists of constantly-changing, electronically-held securities portfolios). Article 3 addresses this issue.

- *Protection for types of provisions commonly used in collateral arrangements.* These types of provisions, which parties may choose to include in their arrangements, are:

    - *Right of Substitution:* that is, where a financial collateral arrangement allows the collateral provider to substitute different collateral for that originally provided. The replacement collateral is to be treated in the same way as the original collateral was under the terms of the

arrangement. Article 2(2) specifically includes such a provision within the scope of financial collateral arrangements covered by the Directive. It does this by stating that financial collateral shall still be regarded as being "provided" to the collateral taker even if the collateral provider has the right to substitute the financial collateral provided. The Directive also prevents an arrangement from being declared invalid on the basis that either a substitution of collateral took place in a prescribed period prior to winding-up or reorganisation measures, or it took place after the relevant financial obligations were incurred (see Article 8(3));

    - *Right of use:* that is, where the arrangement permits the collateral taker to "re-use" the collateral provided, for example selling it to a third party. But the collateral must be replaced in due course by equivalent collateral. The Directive requires Member States to give effect to terms in financial collateral arrangements which give the collateral taker a right of use and to ensure that the collateral taker's rights under the arrangement are not invalidated by exercise of this right of use. The Directive also provides that the equivalent collateral is to be treated in the same way as the original collateral was, and as if it had been provided at the same time;

    - *Top-up collateral*. Additional collateral called for because of changes in the value of the original collateral and/or in the amount of money owed is protected from certain provisions of insolvency law on the same basis as the original collateral (see Article 8(3)). However, top-up of collateral in response to changes in the creditworthiness of the parties to the collateral arrangement is not protected by the Directive.

- *Realisation.* The Directive enables collateral subject to a security financial collateral arrangement to be realised quickly if the collateral provider defaults. It also requires Member States to ensure that the collateral taker can realise his security in the event that either the collateral provider or the collateral taker becomes insolvent (see Article 4).

- *Choice of law.* There will be a consistent approach to deciding which domestic law governs proprietary aspects of the collateral arrangement, for example what is required for the creation of an interest that is valid against third parties (see Article 9). This uses a similar approach to that adopted in Article 9(2) and Recitals 18 to 21 of the Settlement Finality Directive. It extends this approach to cover financial collateral arrangements within the scope of the Directive. **See Explanatory Memorandum 8257196 (COM(96)193) of 15 July 1996 and the subsequent House of Commons European Legislation Committee Report of 22 July 1996. See also Explanatory Memorandum 9785197 (COM(97)345) of 13 August 1997.**

1.11 By putting in place uniform arrangements and minimizing the level of formality required, the Directive aims to make collateral arrangements easier to enter into and enforce. This should in turn lower the cost of capital for EU businesses raising money across Europe.

IMPLEMENTATION

1.12 The overall approach in implementing the Directive is to extend the scope and usefulness of financial collateral arrangements as widely as possible having regard to general UK policy on insolvency. We have aimed to provide a clear, helpful and effective legal framework. We have avoided rewriting law needlessly, recognising that the law in the UK already reflects many of the Directive's provisions. We have sought to promote further flexibility in the use of financial collateral arrangements in order to assist the competitive position of London as an international financial market.[4]

1.13 The Directive will be implemented in UK law through regulations made under section 2(2) of the European Communities Act 1972. The regulations will apply to England, Wales, Scotland and Northern Ireland. Although some of the areas on which the Directive impacts are devolved to the Scottish Executive (e.g. areas of insolvency law) it has been agreed with the Scottish Executive that a single set of regulations implementing the Directive should

[4] For example, see Chapter Four on rights of use over collateral.

be made by the Treasury. Where the provisions of Scottish and Northern Irish law materially differ from those in English and Welsh law the draft regulations have specifically dealt with the differing legislation. But the majority of the areas which the regulations cover do not have significant differences between the jurisdictions and the regulations mostly refer to specific legislation for those jurisdictions which has the same or similar effect as the English legislation. The draft regulations are at Annex A. The proposed provisions of the draft regulations are discussed in the subsequent chapters of this consultation document.

CHAPTER TWO

Scope

2.1 Regulation 2 of the draft regulations defines many of the terms used in the draft regulations, and through these definitions determines which arrangements fall within the scope of the regulations.

PARTIES

2.2 The draft regulations do not exercise the opt-out under Article 1(3) of the Directive to exclude corporate bodies from the scope of the implementation. This would clearly be contrary to both the overall policy objective and to the current, broadly consistent position in UK law (i.e. where many of the Directive's provisions already apply *irrespective* of the identity/capacity of the parties).

2.3 Moreover, the same considerations mean that we have chosen to extend the scope of the implementation to cover all financial collateral arrangements as between two corporate bodies; i.e. non-natural persons, not limiting it to those arrangements which involve a financial institution. As well as being consistent with the overall policy objectives it considerably simplifies implementation by avoiding the need for reproducing in UK law the elaborate definitions of Article 1(2)(c) of the Directive in particular and makes the law clearer, simpler and more consistent.

2.4 It would be consistent with the overall approach to go further and apply the same principles to all financial collateral arrangements, including those involving *individual natural persons* (whether in a personal/non-business capacity or that of a sole trader). However, our view is that this is unlikely to be legally feasible using the implementing powers in the European Communities Act 1972.

Question 1: Do you support the extension of the scope of the implementation to cover all financial collateral arrangements as between two corporate bodies where one is not a financial institution? Would you support

further extension to include arrangements involving individual natural persons?

SCOPE

2.5 The draft regulations do not exercise the further opt-out in the Directive at Article 1(4)(b) for Member States to exclude “financial collateral consisting of the collateral provider's own shares, shares in affiliated undertakings within the meaning of the seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts, and shares in undertakings whose exclusive purpose is to own means of production that are essential for the collateral provider's business or to own real property.”

2.6 We do not see any need to exercise this opt-out. This provision was introduced solely to prevent the unintended application of the Directive to real property under certain Finnish mortgage practices by which, we understand, householders use companies or shares in companies as collateral in their domestic mortgage purchase transactions.

2.7 The Directive applies to arrangements in which the collateral used is either cash or financial instruments. Draft regulation 2 defines cash as “money credited to an account, in any currency, or similar claim for repayment of money” mirroring the definition in the Directive. A consideration is whether this definition of cash should include a sum due or payable in connection with the operation of a close-out netting provision. If such sums are not included as “cash” this might lead to financial collateral arrangements falling partly within and partly outside the scope of the regulations. We understand that it is frequently the case that security is created over the settlement amounts due under derivative contract close-out netting provisions. If the settlement amounts due under a close-out netting provision are not clearly defined as “cash” they would not be capable of protection a part of a financial collateral arrangement and thus some arrangements would only be partly covered by the regulations.

Question 2: Should the definition of "cash" include a sum due or payable in connection with the operation of a close-out netting provision?

2.8 Draft regulation 2 also defines a "title transfer financial collateral arrangement" and a "security financial collateral arrangement". These are the two different types of financial collateral arrangement to which the Directive and the draft regulations apply. In a title transfer arrangement, full ownership of the collateral is transferred to the collateral taker, who only transfers equivalent collateral back to the collateral provider when they have satisfied or performed the obligations that the collateral arrangement was intended to protect. If the collateral provider defaults, then the value of the equivalent collateral that the collateral taker was due to return is set off against that of the collateral provider's obligations, with an amount equal to any surplus being paid to the collateral provider.

2.9 In a security arrangement, although the collateral taker obtains, or is designated as obtaining, possession of or can exercise some control (even if only restrictive control) over the collateral, he does not become the owner of it. If the collateral provider defaults, then the collateral taker is entitled to sell or appropriate the collateral (depending on the provisions in the agreement), apply the proceeds against the amounts owed and return the excess proceeds (if any) to the collateral provider.

2.10 The definition of "security financial collateral arrangement" and of "security interest" means that the draft regulations do not apply to floating charges before the charge has crystallized and some control over the collateral has passed to the charge holder. Serious thought was given to extending the regulations to all floating charges. However, we have rejected this extension in the interests of providing appropriate protection for third parties, particularly unsecured creditors who appear after the floating charge has been taken. Such creditors may not know that any of the company's property is subject to a floating charge and would not be able to establish this via the register. Although not extending the regulations to all floating arrangements means that the implementation of the Directive will not apply to all

the contracts that it might, this is justified given the need to provide a balance between market efficiency, on the one hand, and the safety of the parties to the arrangements and of third parties, on the other, thereby helping to avoid - among other things - the risk of fraud (see Directive preamble, paragraph 10).

Question 3: Do you agree that, in the interests of protecting third parties, the regulations should only apply to floating charges where both:
(a) the charge has crystallized; and
(b) some element or designation of possession or control of the collateral assets has passed to the collateral taker?

CHAPTER THREE

Removal of Formal Requirements for Creation and Validity of Financial Collateral Arrangements

3.1 Article 3 of the Directive provides that Member States shall not impose any formal requirements on financial collateral arrangements, subject to the requirement that they be evidenced in writing. The preamble to the Directive sets out at paragraph 10 the type of formal requirements which the Directive prevents from being requirements for perfection of a financial collateral arrangement. These include execution of any document in a particular manner, registration in a public register and the provision of evidence in a particular form as to the date of execution of a document or instrument.

3.2 The draft regulations require that a financial collateral agreement is evidenced in writing through the inclusion of that requirement in the definitions of "security financial collateral arrangement" and "title transfer financial collateral arrangement". For the avoidance of any doubt the definitions in the regulations also state that "writing" includes recording by electronic means. Draft regulation 3 prevents certain sections of legislation from applying which would impose formalities on some financial collateral arrangements. Draft regulations 4 and 5 deal with equivalent Scottish and Northern Irish legislation where necessary.

3.3 Draft regulation 3(1) disapplies section 4 of the Statute of Frauds 1677 from financial collateral arrangements. This section requires signature by a party, or his authorized agent, of an agreement to be liable for the debt of a third party before such an agreement may be enforced. Draft regulation 3(1) therefore makes an agreement to secure a third party's debts without a signature enforceable if that agreement is part of a financial collateral arrangement.

3.4 Draft regulations 3(2) and 3(3) also disapply sections which require certain types of agreement or transfer to be signed by a particular party or his agent before the agreement or transfer is valid. Section 53(1)(c) of the Law of Property Act 1925 applies to a disposition of an equitable interest or trust

and is prevented from applying to financial collateral arrangements by draft regulation 3(2). Section 136 of the Law of Property Act 1925 requires signature by the assignor or his agent before legal title can pass to a debt or thing in action, this requirement is disapplied from financial collateral arrangements by draft regulation 3(3). The other requirement in section 136 to pass valid legal title is to notify the debtor in writing and this still applies to financial collateral arrangements. This is because such notice is not a formality within the description set out in the Directive and there are sound reasons for maintaining a requirement for a debtor to be notified of any assignment of his debt.

3.5 As a result of article 3, it is also necessary to disapply section 395 of the Companies Act 1985. This section renders certain charges created by a company void against the liquidator, administrator or any creditor of the company if those charges are not registered. While section 395 relates only to certain types of charge (set out in section 396) and charges over certain types of property, some of those charges could be part of a security financial collateral arrangement. It could apply, for example, where a floating charge is granted over assets of the company consisting of cash and/or securities. Therefore, draft regulation 3(4) provides that section 395 does not apply to security financial collateral arrangements (security financial collateral arrangements is a term which is defined in the draft regulations).

3.6 Draft regulations 4 and 5 disapply the legislation in Scotland and the legislation in Northern Ireland which has the same effect as section 395 of the Companies Act 1985 in England and Wales. That is, in respect of Scotland, section 410 of the Companies Act 1985 and, in respect of Northern Ireland, article 402 of the Companies (Northern Ireland) Order 1986.

Question 4: Do you agree that the draft regulations remove requirements for all the formalities which are realistically likely to impact upon the creation and perfection of financial collateral arrangements?

CHAPTER FOUR

Security Financial Collateral Arrangements to take Effect in Accordance with their Terms

RIGHT OF USE

4.1 Article 5(1) requires Member States to ensure that, where a security financial collateral arrangement includes a term which permits the collateral taker to exercise a right of use over the collateral, that term can take effect. A "right of use" is defined in the Directive as a right of the collateral taker to use and dispose of the financial collateral provided under the security financial collateral arrangement as the owner of it in accordance with the terms of the arrangement. The draft regulations make explicit at regulation 12 that where a security financial collateral arrangement provides for a right of use then that right must be enforceable by the collateral taker.

4.2 There is no UK legislation which conflicts with this requirement and therefore no specific legislation is referred to within the draft regulations. However, there has been some doubt previously about the effectiveness of right of use provisions under UK law due to the application of several equitable principles by the courts to protect the giver of a security interest. These equitable rules include the rule against clogs on the equity of redemption, the rule against collateral benefits and the equitable maxim "once a mortgage always a mortgage". The regulations will prevent any remaining doubt about the ability of security financial collateral arrangements to enable collateral takers to re-hypothecate the collateral they receive under such arrangements. This will give institutions which receive collateral for their exposures, and their clients, more freedom to tailor the type of collateral arrangement they use to their needs. At present there is a tendency to use title transfer financial collateral arrangements where the collateral taker wants to be able to re-use the collateral in safety under the UK legal system. However, this has real disadvantages where the arrangement is cross-border or the collateral consists of securities held by an intermediary. The increased freedom to re-use collateral under security financial collateral

arrangements is therefore a valuable additional flexibility for collateral takers.

REALISATION OF SECURITY AND CLOSE-OUT NETTING PROVISIONS TO TAKE EFFECT WITHOUT FORMAL REQUIREMENTS

4.3 Article 4 requires that Member States shall ensure that security provided under a financial collateral arrangement can be realised by the collateral taker in the following ways if the agreement so provides:

- Sale;
- Appropriation; and
- Setting off the cash or the value of financial instruments against the relevant financial obligations secured by the collateral, or applying the collateral to discharge those relevant financial obligations.

The Article further provides that if a Member State does not permit appropriation prior to the Directive being adopted then it is not required to alter its legal system to permit it. Appropriation is and has for some time been permitted under UK law for these types of arrangements, so this opt out does not apply to the UK. The Directive therefore obliges the UK to ensure that where a security financial collateral arrangement contains a provision allowing appropriation, that provision can take effect in accordance with the terms of the arrangement. As this is already the position in the UK, the regulations do not need to make any alterations to UK law in order to implement the Directive.

4.4 Article 4(4) further requires that such realisation must be able to take effect without any requirement to give notice or to apply for court approval or that the realisation be conducted in any prescribed manner such as a public auction. There is one type of security interest in the UK which at present requires a court order before the collateral subject to it can be appropriated. That is a mortgage which requires a court order before it is possible to foreclose on the mortgage. This procedure is aimed at protecting the mortgagor from having

their property appropriated by the mortagagee without due notice and an opportunity to settle their outstanding financial obligations. Such a procedure is more appropriate where the property mortgaged is land and buildings or movable property of a business. But where the collateral is cash or securities it is a cumbersome procedure which delays the realisation of the collateral assets. This can have a particularly damaging effect where the collateral's value is changing significantly over a short period of time, hence the need to be able to realise the collateral without such a formal procedure delaying the process.

4.5 In order to implement the Directive the draft regulations therefore provide at regulation 8 that, where an arrangement comes within the scope of the regulations, there is no need to apply to the court for a foreclosure order prior to appropriating the collateral which is subject to the mortgage. As permitted by the Directive, and with a view to ensuring that collateral providers are protected from unscrupulous undervaluing of the collateral, draft regulation 9 provides that the collateral taker must value the collateral appropriated at the market value at the time that it was appropriated.

4.6 Article 7(2) basically imposes the same requirements on Member States in relation to the operation of close-out netting provisions. So where a financial collateral arrangement provides for close-out netting it should be able to take place without any of the formal requirements set out in article 4(4). There are no such requirements in UK law which currently affect the operation of close-out netting provisions so it is not necessary for the draft regulations to contain any specific provision implementing that part of the Directive.

CHAPTER FIVE

Insolvency – financial collateral arrangements to take effect in accordance with their terms despite winding up or reorganisation of a party to the agreement

A: ARTICLE 4

5.1 Article 4(5) says that:

> *Member States shall ensure that a financial collateral arrangement can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures*[5] *in respect of the collateral provider or collateral taker.*

5.2 Therefore, draft regulations 6 and 7 disapply various provisions of insolvency legislation relating to the administration of companies. It is clear that the process of company administration falls within the definition of "reorganisation measures" in the Directive. Therefore where legislation provides that steps can be taken during administration, or in the period immediately prior to administration, which would prevent a financial collateral arrangement taking effect in accordance with its terms, the draft regulations disapply that provision. The draft regulations refer to paragraphs of Schedule B1 to the Insolvency Act 1986 which is not in force as yet (the new schedule is inserted by Schedule 16 of the Enterprise Act 2002). However, the new Schedule will come into force in September 2003 and will therefore be in force by the time these regulations are due to be made in December 2003. The provisions of the Insolvency (Northern Ireland) Order 1989 which are disapplied by draft regulation 7 are equivalent to the provisions of the Insolvency Act 1986 which are disapplied by draft regulation 6.

5.3 Paragraph 43(2) of Schedule B1 of the Insolvency Act 1986 prevents any person from enforcing security held over a

[5] The terms "winding-up proceedings" and "reorganisation measures" are defined in Article 2(1)(j) & (k) and cover various, but not all, types of insolvency-related procedures in the UK.

company's property when that property is in administration without the consent of the administrator or the permission of the court. By virtue of draft regulation 6, this will not apply to financial collateral arrangements. Hence, a person who holds security under such an arrangement will be able to enforce their security without such consent or permission. Nor will it apply under paragraph 44 of Schedule B1, which imposes an interim moratorium on the enforcement of security once an administration application in respect of a company has been made. Article 23(1)(b) and 24(3)(c) of the Order has the same effect in Northern Ireland and is disapplied from financial collateral arrangements by draft regulation 7.

5.4 Paragraphs 70 and 71 of Schedule B1 enable an administrator to take action or dispose of property which is subject to certain types of charge as if that property were not subject to the charge. Draft regulation 6(1)(b) prevents this applying to financial collateral arrangements and draft regulation 7(1)(c) disapplies the equivalent Northern Irish legislation.

5.5 Paragraph 41(2) of Schedule B1 of the Insolvency Act 1986 provides that where a company is in administration, any receiver shall vacate office if the administrator requires him to. Articles 28(1) and (2) of the Insolvency (Northern Ireland) Order 1989 have the same effect in Northern Ireland. The draft regulations prevent this from applying to financial collateral arrangements, thereby ensuring that they can take effect in accordance with their terms even where a party to the agreement is in administration.

5.6 Although Schedule B1 of the Insolvency Act 1986 will replace the existing administration provisions in Part 1 of the Act for the vast majority of companies, the existing provisions remain in force for those companies which have a special administration scheme. These special administration schemes are preserved by section 249 of the Enterprise Act 2002. Therefore the draft regulations also disapply the equivalent sections of the existing administration legislation (at draft regulation 6(3)) in order to ensure that the Directive is implemented in relation to those special administration schemes as well.

5.7 Section 178 of the Insolvency Act 1986 allows an administrator to disavow any onerous property or contract of the company but this provision does not apply to financial collateral arrangements by virtue of draft regulation 6(3). The equivalent provision for Northern Ireland is disapplied by regulation 7(3).

B: ARTICLE 7

5.8 Article 7(1) provides that:

> *Member States shall ensure that a close-out netting provision can take effect in accordance with its terms:*
> *(a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker; and/or*
> *(b) notwithstanding any purported assignment judicial or other attachment or other disposition of or in respect of such rights.*

5.9 Although there are no provisions of the Insolvency Act which we consider it necessary to disapply from financial collateral arrangements in order to give effect to Article 7(1), draft regulation 13 includes an express provision that close-out netting provisions are to take effect in accordance with their terms. This is to deal with any doubts there may be about the effectiveness of such terms when a company becomes insolvent due to common law or equitable principles which could be used to undermine close-out netting provisions. Modification of the Insolvency Rules at draft regulation 14 also ensures that a close-out netting provision can take effect in accordance with its terms during liquidation. Rule 4.91 is disapplied by the draft regulations because this rule sets down a standard currency and conversion procedure for all netting provisions. However, such standardised procedures may conflict with the specific provisions of a financial collateral arrangement and so prevent it taking effect in accordance with its terms. Rule 4.90 will continue to apply to financial collateral arrangements, and there is no need for the regulations to make specific mention of this.

5.10 There are currently proposals to amend the Insolvency Rules, which are out to consultation. These include proposed amendments to rule 4.91 and rule 4.90, and similar provisions in relation to companies in administration. It is therefore likely that the final collateral regulations will differ from the draft regulations to take these amendments into account. It is not possible to confirm at this stage what those amendments are likely to require due to the need to see the Insolvency Rules in their final form.

C: ARTICLE 8

5.11 Article 8(1) of the Directive provides that a financial collateral arrangement may not be declared invalid or reversed on the *sole* basis that the arrangement came into existence, or was provided, on the day of the start of winding-up proceedings or reorganisation measures, or in a prescribed period prior to the start of such proceedings or measures. There are no provisions in UK law which need to be disapplied in order to deal with Article 8(1)(a) – this provision is aimed at jurisdictions with a system which deems the winding-up or reorganisation of a company to have commenced at midnight on the day that the order is made.

5.12 Article 8(1)(b), however, does require a change in current UK legislation to be implemented. This is because section 129 of the Insolvency Act 1986 deems that the winding-up of a company commences when the petition seeking winding-up is presented. Section 127 of the Insolvency Act 1986 provides that any disposition of the company's property or transfer of shares which is made after the commencement of winding-up is void, unless the court orders otherwise. The Directive views the commencement of winding-up as the time at which the court issues an order for the winding-up of the company. Therefore, within the terms of the Directive, section 127 makes any disposal invalid on the sole basis that the disposal is made in a prescribed period prior to the court's order to wind-up the company. Draft regulation 10(1) therefore disapplies section 127 for financial collateral arrangements.

5.13 The Directive only requires the disapplication of legislative provisions which prevent financial collateral arrangements

being enforceable on the basis *solely* of the arrangement being entered into during a time period set with reference to the start of winding-up or reorganisation proceedings. Therefore, there is no need to change the application of sections 238, 239, 242, 243, 244 and 423 of the Insolvency Act because those sections all include other requirements in addition to those which are to do with the arrangement being entered into during a set time period. Similarly section 245 of the Insolvency Act 1986 does not need to be disapplied as being inconsistent with Article 8(1). Section 245 provides that if a company creates a floating charge at a relevant time the charge is invalid to the extent that consideration for the charge is paid before the charge is created. However, Section 245 contains another requirement aside from the prescribed period requirement before a floating charge may be invalid, that is, the requirement that there is no new consideration paid at the time or after the charge is created. So section 245 does not fall foul of Article 8(1) of the Directive.

Question 5: Do you agree with this analysis regarding the impact of Article 8(1) on section 245 of the Insolvency Act 1986?

5.14 However, section 245 does conflict with Article 8(3)(ii). This part of the Directive provides that where a financial collateral arrangement includes an obligation to provide financial collateral or top-up collateral or a right of substitution for the collateral provider, the provision of any of those types of collateral shall not be treated as invalid on the basis that the relevant financial obligations were incurred prior to the date of provision of the collateral.

5.15 Therefore, as there are situations where section 245 will prevent a financial collateral arrangement taking effect as Article 8 of the Directive requires it to, draft regulation 10(2) disapplies it from financial collateral arrangements in order to properly implement the Directive. The consequences of disapplying this section are that more floating charges will be able to be enforced when a company goes into administration or liquidation leading to there being less assets available to pay off the unsecured creditors of the company. This provides another reason not to apply the

regulations to all floating charges in the interests of the safety of the parties to the arrangement and third parties.

Question 6: Do you agree with this analysis regarding the impact of Article 8(3)(ii) on section 245 of the Insolvency Act 1986?

CHAPTER SIX

Conflict of Laws

6.1 Draft regulation 15 gives effect to Article 9 of the Directive on conflict of laws. It provides that various matters relating to book entry securities collateral which is provided as part of a financial collateral arrangement is governed by the law of the country in which the relevant account is maintained. Those matters are:

- The legal nature and proprietary effects of book entry securities collateral;
- The requirements for perfecting a financial collateral arrangement relating to book entry securities collateral;
- Whether a person's title to or interest in such book entry securities collateral is overridden by or subordinated to a competing title or interest; and
- The steps required for the realisation of book entry securities collateral following the occurrence of an enforcement event.

6.2 The draft regulations use the definitions of "book entry securities collateral" and "relevant account" provided in the Directive. The draft regulations also contain a further definition, that of "intermediary", which mirrors to a certain extent the definition used in the Hague Convention without the limitation that such an intermediary must be acting in the course of a business.

6.3 As acknowledged as a possibility on adoption of the Directive, this Article may need to be adapted to take into account the implementation of the Hague Convention[6]. We will consider this regulation further as more becomes apparent on the Commission's approach to implementing the Convention in respect of EC law.

[6] Hague Convention (36) on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary.

CHAPTER SEVEN

Implementation Timetable

7.1 The consultation period on the proposed legislative measures for implementing the Directive on financial collateral arrangements in UK law closes on 10 October 2003. We will then consider any amendments necessary to our proposals in time to allow for the implementing legislation to be laid before Parliament in December 2003.

CHAPTER EIGHT

Summary Of Questions

Question 1: Do you support the extension of the scope of the implementation to cover all financial collateral arrangements as between two corporate bodies where one is not a financial institution?

Question 2: Should the definition of cash include a sum due or payable in connection with the operation of a close-out netting provision?

Question 3: Do you agree that, in the interests of protecting third parties, the regulations should only apply to floating charges where both:
(a) the charge has crystallized; and
(b) some element or designation of possession or control of the collateral assets has passed to the collateral taker?

Question 4: Do you agree that the draft regulations remove requirements for all the formalities which are realistically likely to impact upon the creation and perfection of financial collateral arrangements?

Question 5: Do you agree with our analysis regarding the impact of Article 8(1) on section 245 of the Insolvency Act 1986?

Question 6: Do you agree with our analysis regarding the impact of Article 8(3)(ii) on section 245 of the Insolvency Act 1986?

Question 7: What is the typical cost of capital saving for the debtor if a transaction is collateralised? (This might be expressed as an interest rate saving. It would vary depending on a number of factors, including how much of the liability was collateralised). The saving in terms of reduced risk for the creditor might be harder to ascertain.

Question 8: Would the opportunity cost of providing assets as collateral depend only on business-specific factors? Or could some estimate be made from general principles?

Question 9: Is there any indication of the savings associated with re-use and substitution?

Question 10: What are the legal and administrative costs currently involved in collateral use? If these could be identified, then it might be possible to estimate the corresponding savings due to the Directive. However, the effects on non-collateralised creditors would be very difficult to assess. They would depend on the effect of collateralising on debtors' businesses. The improvement in financial stability would also be difficult to value.

Question 11: What is the value of assets in use as collateral at present? This might indicate the scale of the likely increase in collateral use following the Directive's implementation, particularly if the differing uses in more and less collateral-friendly jurisdictions could be identified.

STATUTORY INSTRUMENTS

2003 No.

FINANCIAL SERVICES AND MARKETS

The Financial Collateral Arrangements Regulations 2003

Made - - - -	*2003*
Laid before Parliament	*2003*
Coming into force - -	*2003*

The Treasury, being a government department designated (**a**) for the purposes of section 2(2) of the European Communities Act 1972 (**b**) in relation to collateral security, in exercise of the powers conferred by that section, hereby make the following Regulations:

Part 1

General

Citation and commencement

1. These Regulations may be cited as the Financial Collateral Arrangements Regulations 2003 and shall come into force on 26th December 2003.

Interpretation

2.—(1) In these Regulations —

"book entry securities collateral" means financial collateral provided under a financial collateral arrangement which consists of financial instruments, title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary;

"cash" means money credited to an account, in any currency, or a similar claim for repayment of money;

"close-out netting provision" means a term of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or any legislative provision under which on the occurrence of an enforcement event -

(a) the obligations of the parties are accelerated to become immediately due as an obligation to pay an amount representing the original obligation's estimated current value, or are terminated and replaced by an obligation to pay such an amount; or

(**a**) The European Communities (Designation) (No. 3)Order 2003 [***Drafting note: This order has been made but is not yet in force, it is due to come into force on 19th August 2003]***

(**b**) 1972 c. 68

(b) an account is taken of what is due from each party to the other in respect of such obligations and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party;

"corporate body" means any body with legal personality except a natural individual, including a body constituted under the law of a country or territory outside the United Kingdom or a body constituted under international law;

"enforcement event" means an event of default, or any similar event as agreed between the parties, on the occurrence of which, under the terms of a financial collateral arrangement or by operation of law, the collateral taker is entitled to realise or appropriate financial collateral or a close-out netting provision comes into effect;

"equivalent collateral" means -

(a) in relation to cash, a payment of the same amount and in the same currency;

(b) in relation to financial instruments, financial instruments of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description or, where the financial collateral arrangement provides for the transfer of other assets following the occurrence of any event relating to or affecting any financial instruments provided as financial collateral, those other assets;

"financial collateral arrangement" means a title transfer financial collateral arrangement or a security financial collateral arrangement, whether or not these are covered by a master agreement or general terms and conditions;

"financial collateral" means either cash or financial instruments;

"financial instruments" means -

(a) securities normally traded on financial markets;

(b) any rights to acquire such securities where those rights are normally traded on financial markets; and

(c) claims relating to, rights or interests in or in respect of any of the foregoing,

and includes shares, stock, debentures, debenture stock, loan stock, bonds, units of a collective investment scheme within the meaning of section 235 of the Financial Services and Markets Act 2000 (**a**) and money market instruments;

"intermediary" means a person that maintains accounts to which financial instruments may be credited or debited, for others or both for others and for its own account and is acting in that capacity;

"relevant account" means, in relation to book entry securities collateral which is subject to a financial collateral arrangement, the register or account in which entries are made, by which that book entry securities collateral is transferred or designated so as to be in the possession or under the control of the collateral taker or a person acting on his behalf. The relevant account may be maintained by the collateral taker;

"relevant financial obligations" means the obligations which are secured or otherwise covered by a financial collateral arrangement and such obligations may consist of or include

(a) present or future, actual or contingent or prospective obligations (including such obligations arising under a master agreement or similar arrangement);

(b) obligations owed to the collateral taker by a person other than the collateral provider;

(c) obligations of a specified class or kind arising from time to time;

"reorganisation measures" means measures which involve any intervention by administrative or judicial authorities which are intended to preserve or restore the financial situation and which

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(**a**) 2000 c. 8

affect pre-existing rights of third parties, including but not limited to measures involving a suspension of payments, suspension of enforcement measures or reduction of claims;

"security financial collateral arrangement" means an agreement, evidenced in writing, where –

(a) the purpose of the agreement is to secure the relevant financial obligations owed to the collateral taker;

(b) the collateral provider provides a security interest in the financial collateral to the collateral taker on terms that it may either

(i) appropriate the financial collateral;

(ii) sell the financial collateral;

(iii) set off the value of the financial collateral; or

(iv) exercise any combination of the rights set out at (i) to (iii)

in order to discharge the relevant financial obligations;

(c) the financial collateral is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or a person acting on his behalf. Any right of the collateral provider to substitute equivalent financial collateral or withdraw excess financial collateral shall not prevent the financial collateral being in the possession or under the control of the collateral taker; and

(d) the collateral provider and the collateral taker are each corporate bodies.

"security interest" means any legal or equitable interest provided by way of security including –

(a) a pledge;

(b) a mortgage;

(c) a fixed charge;

(d) a floating charge where the collateral charged is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or a person acting on his behalf. Any right of the collateral provider to substitute equivalent financial collateral or withdraw excess financial collateral shall not prevent the financial collateral being in the possession or under the control of the collateral taker; and

(e) a lien.

"title transfer financial collateral arrangement" means an agreement, evidenced in writing, where -

(a) the purpose of the agreement is to secure or otherwise cover the relevant financial obligations owed to the collateral taker;

(b) the collateral provider has transferred legal and beneficial ownership in financial collateral to a collateral taker on terms that when the relevant financial obligations are discharged the collateral taker must transfer legal and beneficial ownership of equivalent financial collateral to the collateral provider; and

(c) the collateral provider and the collateral taker are each corporate bodies.

"winding-up proceedings" means collective proceedings involving realisation of the assets and distribution of the proceeds among the creditors, shareholders or members of a body as appropriate, which involve any intervention by administrative or judicial authorities. They include such collective proceedings whether or not they are founded on insolvency and whether they are voluntary or compulsory. They further include such collective proceedings if they are terminated by a composition or other analogous measure;

"writing" includes recording by electronic means.

Part 2

Modification of legislation and court procedures for financial collateral arrangements

Certain legislation requiring formalities not to apply to financial collateral arrangements

3. (1) Section 4 of the Statue of Frauds 1677 (**a**) (no action on a third party's promise unless in writing and signed) shall not apply (if it would otherwise do so) in relation to a financial collateral arrangement.

(2) Section 53(1)(c) of the Law of Property Act 1925 (**b**) (Disposition of equitable interest to be in writing and signed) shall not apply (if it would otherwise do so) in relation to a financial collateral arrangement.

(3) Section 136 of the Law of Property Act 1925 (legal assignments of things in action) shall not apply (if it would otherwise do so) in relation to a financial collateral arrangement, to the extent that the section requires an assignment to be signed by the assignor or a person authorised on his behalf.

(4) Section 395 of the Companies Act 1985 (**c**) (certain charges void if not registered) shall not apply (if it would otherwise do so) in relation to a security financial collateral arrangement or any charge provided under a security financial collateral arrangement

(5) Section 4 of the Industrial and Provident Societies Act 1967 (**d**) (filing of information relating to charges) shall not apply (if it would otherwise do so) in relation to a security financial collateral arrangement or any charge provided under security financial collateral arrangement.

Certain legislation affecting Scottish companies and requiring formalities not to apply to financial collateral arrangements

4. Section 410 of the Companies Act 1985 (certain charges void if not registered (Scotland)) shall not apply (if it would otherwise do so) in relation to a security financial collateral arrangement or any charge provided under a security financial collateral arrangement.

Certain legislation affecting Northern Irish companies and requiring formalities not to apply to financial collateral arrangements

5. Article 402 of the Companies (Northern Ireland) Order 1986 **e** (certain charges void if not registered) shall not apply (if it would otherwise do so) in relation to a security financial collateral arrangement or any charge provided under a security financial collateral arrangement.

Certain legislation restricting enforcement of security not to apply to financial collateral arrangements

6. (1) The following provisions of Schedule B1 to the Insolvency Act 1986 (**f**) (administration) shall not apply to any security interest provided under a financial collateral arrangement –

(a) paragraph 43(2) (restriction on enforcement of security or repossession of goods) including that provision as applied by paragraph 44 (interim moratorium); and

(b) paragraphs 70 and 71 (power of administrator to deal with charged property).

(2) Paragraph 41(2) of Schedule B1 to the Insolvency Act 1986 (receiver to vacate office at request of administrator) shall not apply to a receiver appointed under a charge provided as part of a financial collateral arrangement.

(**a**) 1677 c. 3
(**b**) 1925 c. 20
(**c**) 1985 c. 6
(**d**) 1967 c . 48
(**e**) S.I. 1032/1986 (N.I. 6)
(**f**) 1986 c . 45 (Schedule B1 of the Insolvency Act 1986 is inserted by section 248 and Schedule 16 of the Enterprise Act 2002 c. 40)

(3) The following provisions of the Insolvency Act 1986 (**a**)(administration provisions retained in relation to special administration regimes) shall not apply in relation to any security interest provided under a a financial collateral arrangement –

(a) Sections 10(1)(b) and 11(3)(c) (restriction on enforcement of security while petition for administration order pending or order in force); and

(b) Section 15(1) and 15(2) (power of administrator to deal with charged property).

(4) Section 11(2) of the Insolvency Act 1986 (receiver to vacate office when so required by administrator) shall not apply to a receiver appointed under a charge provided as part of a financial collateral arrangement.

(5) Section 178 of the Insolvency Act 1986 (power to disclaim onerous property) shall not apply (if it would otherwise do so) to any financial collateral arrangement.

Certain Northern Irish legislation restricting enforcement of security not to apply to financial collateral arrangements

7. (1) The following provisions of the Insolvency (Northern Ireland) Order 1989 (**b**) (administration) shall not apply to any security interest provided under a financial collateral arrangement –

(a) article 23(1)(b) and article 24(3)(c) (restriction on enforcement of security while petition for administration order pending or order in force); and

(b) article 28(1) and (2)(power of administrator to deal with charged property).

(2) Article 24(2) of the Insolvency (Northern Ireland) Order 1989 (receiver to vacate office at request of administrator) shall not apply to a receiver appointed under a charge provided under a financial collateral arrangement.

(3) Article 152 of the Insolvency (Northern Ireland) Order 1989 (power to disclaim onerous property) shall not apply (if it would otherwise do so) to any financial collateral arrangement.

No requirement to apply to court to foreclose on a mortgage to enforce a security financial collateral arrangement

8. Where a legal or equitable mortgage is the security interest provided to the collateral taker under a security financial collateral arrangement on terms that include a power for the collateral taker to appropriate the collateral, the collateral taker may exercise that power in accordance with the terms of the security financial collateral arrangement, without any order for foreclosure from the courts.

Duty to value collateral in accordance with market price on appropriation

9. Where a collateral taker exercises a power contained in a security financial collateral arrangement to appropriate the financial collateral and it is necessary to value the collateral in order to discharge the relevant financial obligations outstanding under the security financial collateral arrangement, the collateral taker must value the financial collateral at the market price for the collateral at the time that he exercised the power.

Modification of the law on insolvency

10. (1) Section 127 of the Insolvency Act 1986 (avoidance of property dispositions effected after commencement of winding up) shall not apply (if it would otherwise do so) to any property or security interest transferred or provided under a financial collateral arrangement.

(**a**) These provisions of the Insolvency Act are preserved in relation to special administration regimes by section 249 of the Enterprise Act 2002.

(**b**) S.I. 1989/ 2405 (NI 19)

(2) Section 245 of the Insolvency Act 1986 (avoidance of certain floating charges) shall not apply (if it would otherwise do so) to any charge provided under a security financial collateral arrangement.

Modification of Northern Irish insolvency law

11. (1) Article 107 of the Insolvency (Northern Ireland) Order 1989 (avoidance of property dispositions effected after commencement of winding up) shall not apply (if it would otherwise do so) to any property or security interest transferred or provided under a financial collateral arrangement.

(2) Article 207 of the Insolvency (Northern Ireland) Order 1989 (avoidance of certain floating charges) shall not apply (if it would otherwise do so) to any charge provided under a security financial collateral arrangement.

Part 3

Financial collateral arrangements to take effect in accordance with their terms

Right of use under security financial collateral arrangements

12. If a security financial collateral arrangement provides for the collateral taker to use and dispose of any financial collateral provided under the arrangement, as the owner of it, the collateral taker may do so in accordance with the terms of the arrangement.

Close-out netting provisions to take effect in accordance with its terms

13. If a financial collateral arrangement contains a close-out netting provision it shall take effect in accordance with its terms notwithstanding that the collateral provider or collateral taker under the arrangement is subject to winding-up proceedings or reorganisation measures.

Modification of the Insolvency Rules

14. (1) Where the collateral provider or the collateral taker under a financial collateral arrangement goes into liquidation and the financial collateral arrangement permits or the mechanism provided under the arrangement permits either-

(a) for the debt owed by the party in liquidation under the arrangement, to be assessed or paid in a currency other than sterling; or

(b) for the debt to be converted into sterling at a rate other than the official exchange rate prevailing on the date when the company went into liquidation

rule 4.91 of the Insolvency Rules 1986 (debt in foreign currency) shall not apply unless the arrangement provides for an unreasonable exchange rate or either party uses the mechanism provided under the arrangement to impose an unreasonable exchange rate in which case the rule shall apply. (**A**)

(**A**) [Drafting note: The Insolvency Rules are going to be amended before these regulations are made and alterations will need to be made to the final regulations to take account of these amendments once they are settled]

Part 4

Conflict of laws

Standard test regarding which country's law is applicable to book entry securities financial collateral arrangements

15. (1) Any question relating to the matters specified in paragraph (2) of this Regulation which arises in relation to book entry securities collateral which is provided under a financial collateral arrangement shall be governed by the domestic law of the country in which the relevant account is maintained.

(2) The matters referred to in paragraph (1) are –

(a) the legal nature and proprietary effects of book entry securities collateral;

(b) the requirements for perfecting a financial collateral arrangement relating to book entry securities collateral and the provision of book entry securities collateral under such an arrangement;

(c) the requirements for rendering a financial collateral arrangement which relates to book entry securities collateral effective against third parties;

(d) whether a person's title to or interest in such book entry securities collateral is overridden by or subordinated to a competing title or interest;

(e) the steps required for the realisation of book entry securities collateral following the occurrence of an enforcement event.

Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Regulations)

These Regulations implement the European Parliament and Council Directive 2002/47/EC on financial collateral arrangements ("the Directive"). The Regulations apply to England, Wales, Scotland and Northern Ireland.

Regulations 3,4 and 5 prevent certain legislative provisions which require formalities before an agreement is perfected and enforceable, from applying to financial collateral arrangements. The Directive provides that the only formality which may be required for a financial collateral arrangement to be perfected and enforceable, is that the arrangement be evidenced in writing. Legislation which requires signature by a particular person or entry of the arrangement in a register is therefore disapplied from financial collateral arrangements by these Regulations.

Regulations 6 and 7 prevent certain provisions of the Insolvency Act 1986 and the Insolvency (Northern Ireland) Order 1989 from applying to financial collateral arrangements. The provisions which are disapplied are those which prevent enforcement of security interests when a company is in or is approaching administration proceedings. This is because the Directive requires Member States to ensure that financial collateral arrangements are effective and enforceable even where a party to the arrangement enters reorganisation procedures such as administration.

Regulation 8 provides that where a collateral taker under a security financial collateral arrangement has a mortgage over the collateral provided under the arrangement he may enforce any right of appropriation of the collateral, which the arrangement provides for, without applying to the court for an order for foreclosure. The Directive requires that any right of appropriation under a financial collateral arrangement should be enforceable without the need for a court order. Regulation 9 imposes a duty on the collateral taker, if he exercises such a right of appropriation, to

value the collateral in accordance with equitable principles at the best price reasonably obtainable for the collateral.

Regulations 10 and 11 prevent certain provisions of insolvency law from applying to financial collateral arrangements so that where such arrangements are entered into or collateral is provided under such arrangements in a prescribed period prior to the commencement of winding-up proceedings, the arrangement remains enforceable once winding-up commences unlike other agreements which the company may avoid.

Regulation 12 provides that a collateral taker under a security financial collateral arrangement may use the collateral as if he were the owner of it, if the arrangement provides for such a right of use and so prevents any equitable principle being applied by the courts to override such a term in a financial collateral arrangement.

Regulation 13 provides that a close-out netting provision in a financial collateral arrangement is to take effect in accordance with its terms even if a party to the arrangement is being wound-up or is subject to reorganisation proceedings. Regulation 14 further provides that the specific provisions in such a term in a financial collateral arrangement regarding the currency in which obligations are to be calculated and the rate of any currency conversions will displace the rule in the Insolvency Rules 1986 on the subject unless the rate set through the arrangement is unreasonable.

Regulation 15 imposes a standard test, as set out in the Directive, for deciding which domestic law will apply to book entry securities provided as collateral under a financial collateral arrangement, where there is a conflict of laws issue to be decided. The test is that the arrangement shall be governed by the domestic law of the country in which the "relevant account" (as defined in regulation 2) is maintained.

ANNEX B
PARTIAL REGULATORY IMPACT ASSESSMENT
Directive on Financial Collateral Arrangements

Purpose and intended effect

1. 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.

2. The Directive will principally be relevant to financial institutions and large companies.

3. 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.

4. The arrangements the Directive is intended to cover involve situations where possession or control of the financial collateral passes to the collateral taker.

5. 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.

Benefits and costs

6. 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.

7. 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).

Question 7: The secured rate of interest in the sterling money market is usually between 0.1-0.2% lower than the unsecured interbank rate. What is the typical cost of capital saving for the borrower if other transactions are collateralised? (This might be expressed as an interest rate saving. It would vary depending on a number of factors, including how much of the liability was collateralised and the creditworthiness of the borrower). The saving in terms of reduced risk for the creditor might be harder to ascertain.

- *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.

Question 8: Would the opportunity cost of providing assets as collateral depend only on business-specific factors?

- *... 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.

Question 9: Is there any indication of the savings associated with re-use and substitution?

- *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).

Question 10: What are the legal and administrative costs currently involved in collateral use? If these could be identified, then it might be possible to estimate the corresponding savings due to the Directive. However, the effects on non-collateralised creditors would be very difficult to assess. They would depend on the effect of collateralising on debtors' businesses. The improvement in financial stability would also be difficult to value.

- *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 Directive's adoption.* There could be changes in patterns of business following the Directive's adoption. 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.

Question 11: What is the value of assets in use as collateral at present? This might indicate the scale of the likely increase in collateral use following the Directive's implementation, particularly if the differing uses in more and less collateral-friendly jurisdictions could be identified.

- *the benefits of improved financial stability.*

8. 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

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

Impact on small business

10. In general, financial collateral arrangements are more appropriate for bigger businesses. 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

11. Informal consultation has already been held with a variety of trade associations and other interested parties. This consultation document constitutes wider, formal consultation.

Monitoring and evaluation

12. 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.