

Financial Collateral

Financial Markets Infrastructure
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***These slides accompany the explanation of the acquis to Albania and North Macedonia and can only be used for that purpose.
Their content is subject to further development of the acquis and interpretation by the Court of Justice of the European Union***

Financial Collateral Directive (FCD)

- Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements

Financial Collateral - 1

- The **provision of assets** (e.g. securities) by a **borrower** to a **lender** to **secure** the performance of an obligation by
 - transfer of full ownership from a collateral provider to a collateral taker

OR by

- transfer of possession from a collateral provider to a collateral taker under a security right where the full ownership of the assets remains with the collateral provider

Financial Collateral - 2

- Minimises **risk** of financial loss to lender if borrower fails to meet their obligations to lender
- Used throughout EU to support financial transactions (e.g. derivatives, general bank lending)
- Increasingly important since financial crisis because of market need for more **secured funding**
 - helps creditors manage their exposures
 - reduces their capital requirements
 - supports supply of **credit** in the economy
 - reinforces **liquidity** of securities market

FCD - Origin

- Legal framework before FCD: **National rules** were
 - non-transparent and impractical
 - resulting in **uncertainty** as to the effectiveness of collateral as protection in cross-border transactions

FCD - Objectives

- Create a clear, efficient and harmonised **EU legal framework** for receipt and enforcement of financial collateral
- Facilitate **cross-border** use of financial collateral
- Reduce **credit losses**
- Ensure the proper functioning of **EU post-trade systems**
- Contribute to **integration** and **cost efficiency** of European financial markets
- Encourage **cross-border business and competitiveness**
- **Stability** of the financial system

Comparison SFD - FCD

- **1998 Settlement Finality Directive (98/26/EC)**
 - Protects clearing and settlement in payment and securities settlement **systems** and central bank operations
 - Legal certainty for book-entry securities
- **2002 Collateral Directive (2002/47/EC)**
 - Protects collateralisation techniques developed by **wholesale market participants**
 - Much broader scope than SFD
 - Legal certainty for book-entry securities

FCD – Personal scope

- **Collateral taker and collateral provider must each be a**
 - public authority
 - central bank, multilateral development bank, the ECB, BIS, IMF, EIB
 - supervised financial institution (including credit institutions, investment firms, ...)
 - central counterparty, settlement agent or clearing house
 - person other than a natural person, including unincorporated firms and partnerships (*MS opt-out option*)

FCD – Material scope

- **Financial collateral to be provided must consist of**
 - cash
 - financial instruments (*MS opt-out option for collateral provider's own shares*)
 - credit claims (*MS opt-out option for consumer credits*)

FCD – Key provisions - 1

- Simplification of the use of financial collateral through the reduction of **formal requirements** (e.g. registration of collateral)
- Minimum formal requirements for collateral arrangements:
 - financial collateral must be evidenced in **writing**, or in a durable medium, ensuring traceability of collateral
 - Collateral must be in the **possession** of or under the **control** of the collateral taker or a person acting on the collateral taker's behalf

FCD – Key provisions - 2

- Improving **enforcement** of financial collateral arrangements (e.g. if borrower defaults on their obligation to the lender, lender can immediately realise the collateral, in or outside insolvency proceedings, e.g. by sale or appropriation of financial instruments, set-off)
- **Right of use** of financial collateral by the collateral taker under security financial collateral arrangements
- Recognition of **title transfer collateral arrangements**
- Recognition of **close-out netting provisions** (even if collateral taker of provider is subject to insolvency proceedings)
- Certain **insolvency provisions** disapplied – Member States blocked from applying national insolvency rules

FCD – Key provisions - 3

- Enhance legal certainty regarding law applicable to **book-entry securities collateral** in **cross-border** border situations:
 - *Lex rei sitae* rule: The applicable law is the law of the Member State where the financial collateral is located
 - Hence, it is necessary to settle where book-entry securities financial collateral is located

Additional information

https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/post-trade-services/financial-collateral-arrangements_en

https://ec.europa.eu/info/law/financial-collateral-directive-2002-47-ec_en