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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Evaluation report on the Financial Collateral Arrangements Directive (2002/47/EC)

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(Text with EEA relevance)

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1. INTRODUCTION

The Financial Collateral Arrangements Directive 2002/47/EC (hereafter only "FCD" or "the Directive") creates a uniform EU legal framework for the (cross-border) use of financial collateral and thus abolishes most of the formal requirements traditionally imposed on collateral arrangements. Financial collateral are assets provided by a borrower to a lender to minimise the risk of financial loss to the lender in the event of the borrower defaulting on its financial obligations to the lender. Collateral is increasingly used in all types of transactions, including capital markets, bank treasury and funding, payment and clearing systems and general bank lending. The collateral provided is most often in the form of cash or securities.

The objective of the Directive was to achieve a greater integration and cost-efficiency of European financial markets by simplifying the collateral process, improving legal certainty in the use of collateral and reducing risks for market participants. Prior to the Directive, only collateral provided to a central bank or in combination with participation in a designated system enjoyed protection under Article 9 (1) Settlement Finality Directive (SFD)[1]. A more comprehensive approach in the form of the FCD became necessary because divergent national rules applied to the use of collateral were frequently impractical and often not transparent, resulting in uncertainty as to the effectiveness of collateral as a means of protecting cross-border transactions.

Article 10 of the Directive provides that

"Not later than 27 December 2006, the Commission shall present a report to the European Parliament and the Council on the application of this Directive, in particular on the application of Article 1(3), Article 4(3) and Article 5, accompanied where appropriate by proposals for its revision."

This report assesses FCD's implementation, its impact, and whether the Directive needs amendment[2].

2. METHOD AND SCOPE OF THE EVALUATION

To prepare this report, the Commission asked the Member States, the ECB, and the EEA States at the beginning of 2006 to reply to a questionnaire regarding the implementation and application of the FCD. A less extensive questionnaire was also created for the private sector. All Member States, apart from Spain, have replied. Also one EEA State –Norway- has replied. The Commission has received 27 replies directly from a broad spectrum of key financial market players and organisations, including the ECB. Some Member States have also annexed replies from the private sector to their own replies. Consequently, this evaluation draws on that extensive material. Since that material has been made public, the report does not repeat its content unless required. The questionnaires and the replies are published on the DG

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1 Dir. 98/26/EC on Settlement finality in payment and securities settlement systems, OJ L 166, 11.06.1998, p.45-50

2 This report refrains from commenting on the negotiations for a UNIDROIT Convention on substantive rules regarding intermediated securities

MARKT Web-site[3]. Further information about the evaluation procedure is included in annex 1.

Given the short history of the FCD, it would be premature to draw any conclusions on the impact of the Directive. Consequently, this report focuses on implementation-related matters and short-term results.

3. IMPLEMENTATION AND IMPACT OF THE DIRECTIVE

The FCD was adopted on 6 June 2002 and implemented by most Member States in the course of 2004; only two Member States[4] have met the implementation deadline of 27 December 2003, while nine Member States did not implement the Directive until 2005. Among the EEA countries, Iceland and Norway have implementing legislation. The Commission considers that, overall, Member States have adequately implemented the FCD and this has also been testified by various contributions from the industry.

3.1. Relevance of the Directive

The EU repo market, one of the largest financial markets in the world, has been growing rapidly during the latest years with a total value of € 5.883 billion euro in December 2005, compared to € 3,788 billion euro in December 2003 and € 1,863 billion euro in June 2001[5]. Furthermore, according to Eurosystem[6] data, collateral in use in Eurosystem credit operations has increased by approximately 33%, from € 650 billion to € 866 billion euro between 2002 and 2005.

There is also a growing trend that a counterparty to the Eurosystem in a given Member State of the euro area uses collateral originating from another Member State of the euro area. At the end of 2005 almost 50% of Eurosystem collateral was used on a cross-border basis, compared with only 12% in 1999. This is illustrated in the following chart[7].

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3 http://europa.eu.int/comm/internal_market/financial-markets/collateral/index_en.htm

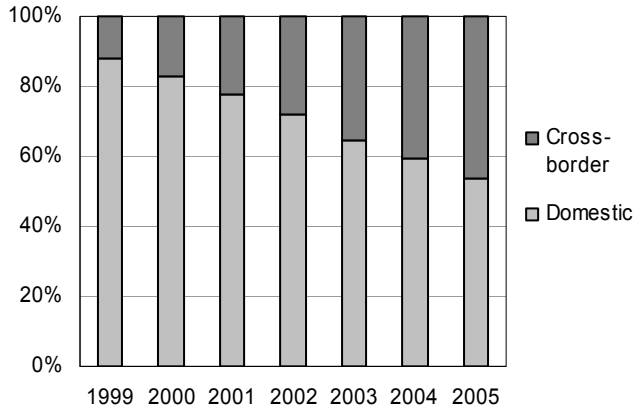
4 Austria and the UK

5 The International Capital Market Association (ICMA) European repo market survey, March 2006.

6 I.e. arrangement whereby the ECB and the National Central Banks that have adopted the euro carry out the tasks of the European System of Central Banks within the Euro area.

7 ECB Monthly Bulletin, May 2006: The Single list in the collateral framework of the Euro system, p. 78

Chart 1: Domestic versus cross-border use of collateral



These figures illustrate that the Directive has not been received in a vacuum, but is of significant relevance for today's financial sector.

3.2. Effectiveness

It is too early to fully assess whether the Directive has led to greater integration and cost-efficiency of European financial markets. However, in general, respondents[8] agree that the FCD has made it easier to use financial collateral in the European financial market and that it has simplified and made considerably more efficient the procedures for doing so.

The FCD has reduced the legal and administrative burdens of taking and enforcing collateral. It has simplified the procedures for the creation, perfection, validity and enforceability of financial collateral by providing that the only formal requirement for its provision is that it must be evidenced in writing or in a legally equivalent manner. It has also improved the legal certainty in respect of certain techniques used in collateral transactions. The FCD helps market participants, to better manage legal risk, thus contributing to reducing capital charges under Basel II.

European collateral programs have mushroomed over the last few years: for example, since December 2002, ABN AMRO reports a 240 % increase in the number of financial collateral arrangements with EU counterparties with a similar increase in the use of EU denominated assets as collateral[9]. ABN AMRO considers that (the expected arrival of) the FCD facilitated the conclusion of those agreements and this opinion is shared by others as well[10]. The Commission subscribes to this opinion.

3.3. Efficiency

Market participants have incurred minor costs in changing their information systems, but - more importantly - the FCD has reduced the legal and administrative costs of taking and

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8 See, for instance, the replies from ISDA (International Swaps and Derivatives Association), EFMLG (European Markets Lawyers Group) and ESBG (European Savings Banks Group)

9 ABN AMRO Response to Question 5.

10 Zentraler Kreditausschuss, Response to Question 3.

enforcing collateral by simplifying the aforementioned procedures relating to financial collateral and has resulted in collateral opinions being subject to fewer qualifications[11].

4. KEY ISSUES

This Chapter deals with the seven key issues identified in the evaluation exercise. Firstly, it considers the question whether additional types of assets used in the financial markets, such as credit claims, should enjoy the protection of the FCD. It then assesses the three opt-out provisions, the right of re-use, the call for an enhanced legal regime for close-out netting, and finally the conflict-of-laws rule.

4.1. Material Scope of the Directive – Credit claims

4.1.1. New types of collateral

Three Member States - the Czech Republic, France and Sweden - include specific kinds of receivables, such as credit or other claims, in the list of assets that may serve as collateral under the Directive. They have thus widened the Directive's material scope of application in their jurisdictions. The Czech Republic has included credit claims in the national transposition. France includes also claims and different forms of rights, provided they are assignable. Sweden has included money loans in the national transposition. Credit claims are also collateralisable in certain other Member States subject to legal conditions.

In the last few years new types of assets have also become important for collateral operations for financial market or central bank purposes. In particular, the ECB Governing Council decided in 2004 to introduce credit claims as an eligible type of collateral for Eurosystem credit operations as of 1 January 2007. Consequently, the question has been raised whether credit claims for central bank purposes, should enjoy protection under the FCD.

4.1.2. Eligibility criteria

In July 2005, the ECB published the specific eligibility criteria that will apply to those credit claims[12], which include, inter alia, the following: the place of establishment of the debtor (or alternatively the guarantor) is restricted to a euro area member country. The loan agreement must be governed by the laws of a euro area member country. The range of eligible debtors is restricted to non-financial corporations and public sector entities.

Thus, as of 1 January 2007, certain credit claims will be eligible as collateral across the euro area for the first time. The total actual use of credit claims in all participating Member States combined is currently difficult to estimate. Nonetheless, the ECB indicated that for instance claims of up to € 800 billion euro extended to the general government sector alone are expected to be eligible and could be used by counterparties in the Eurosystem credit operations.

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11 City of London Law Society Financial Law Committee, Response to Question 3.

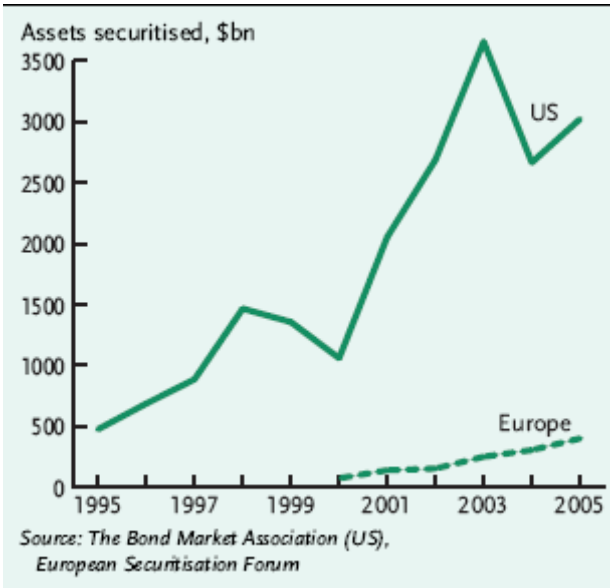
12 For further information please see the ECB publication entitled: "The implementation of monetary policy in the Euro area: General documentation on Eurosystem monetary policy instruments and procedures", publication date: 15 September 2006.

4.1.3. Economic rationale for extending eligible collateral to credit claims

The increased use of collateral is a positive development, since it enables investors to access funds and credit institutions to provide lending more efficiently. Extending the FCD's scope of eligible collateral to credit claims would further contribute to a level playing field among credit institutions in all Member States and would stimulate the cross-border use of this instrument as collateral. If the use of credit claims as collateral would be facilitated, consumers/debtors would also benefit as the use of credit claims as collateral could ultimately lead to more intensive competition and better availability of credits.

As a result of credit claims currently not being eligible collateral, a significant amount of capital in the form of credit claims lies immobilised in the balance sheets of credit institutions in Europe. According to the estimate of the ECB this amount exceeds 50 % of the balance sheet of credit institutions in the euro area. Extending eligible collateral to credit claims would make it possible to mobilise this sizeable capital, thereby putting it to more efficient use in the European economy. It would also place European credit institutions at a more equal footing with international competitors such as from the U.S., where credit claims traditionally represent a much smaller part of the balance sheet. The different level of securitization is illustrated in the chart below.

Chart 2: Securitization issuance



Having a uniform legal framework enhancing the usability of credit claims as collateral would also be beneficial for financial market transactions as it would increase the availability of new asset types, for instance in respect of secured credit operations. Furthermore, extending eligible collateral to credit claims could provide a useful complement to securitisation. Securitisation is an important and valuable instrument, providing investors with another type of lending instrument and enabling banks to raise funds more easily. Nevertheless, it also exposes participants to the volatility of the capital markets. Facilitating the usage of collateral by extending eligible collateral to credit claims would consequently make it a complement to securitisation for those credit institutions that are not prepared to raise funds in the capital markets.

Currently, there are differences in the EU Member States as regards the formalities and techniques available to collateralise credit claims as was the case in relation to securities and cash before the advent of the FCD. Extending the scope of the FCD to credit claims would provide a level playing field to all market participants across the EU.

Finally, making credit claims part of eligible collateral in all Member States may contribute to increasing the availability of highly liquid collateral for financial transactions. Credit claims used as eligible collateral for the ECB would permit credit institutions to use highly liquid assets such as government securities that are currently held with the Eurosystem for other uses in the European economy.

In view of the above, the Commission concludes that an amendment of the FCD to include credit claims would maximise the economic impact of the ECB Governing Council's decision and be beneficial for financial market participants.

4.1.4. Legal issues relating to use of credit claims as collateral

In addition to Eurosystem eligibility requirements, some further legal issues need to be addressed in order to ensure that the Eurosystem is able to establish a legally valid and enforceable security interest in credit claims. Such issues relate, for example, to whether the debtor must be notified of the collateralisation of his credit claims, to banking secrecy concerning debtor information, and to the elimination of potential restrictions regarding the mobilisation and realisation of the loans. As there is no uniform EU-wide legal framework regarding credit claims and their use as collateral, these issues are not treated uniformly in the different national jurisdictions.

The obvious way to deal with some of these concerns would be to extend the scope of the FCD. The Eurosystem is currently exploring the technical issues relating to the use of credit claims as collateral. Depending on the progress of this work, the Commission will consider proposing amendments in the course of 2007.

4.2. Opt-out provisions

4.2.1. Personal scope of the Directive - Article 1(3)

During the negotiation of the Directive (as well as in the implementation phase), much attention was paid to the question who should benefit from the protection of the Directive, as special treatment for collateral arrangements could be seen to be contrary to the general principle of equal treatment of creditors within insolvency proceedings. Article 1(3) FCD gives the Member States an option to exclude arrangements where one of the parties is a person mentioned in Article 1(2) (e).

Several Member States considered the possibility of applying the full opt out, but ultimately only Austria decided to do so. Only five Member States have applied a partial opt-out: the Czech Republic, Slovenia, Sweden, France and Germany. In the Czech Republic the implementing legislation applies the opt-out only to undertakings of a certain size in terms of any two of the following three criteria: assets, turnover and capital. In Slovenia, the implementing legislation excludes those legal entities that are not defined as 'large companies' under the law on commercial companies, such as small and medium-sized undertakings, associations and certain civil law legal entities. Swedish legislation limits the possibility to re-pledge assets to financial agents. France has exercised a partial opt-out for transactions under

the special regime that excludes essentially ordinary companies. The German transposition includes transactions between two corporate entities, which are defined as undertakings excluding natural persons, single merchants and partnerships. However, if the collateral giver is an undertaking, only financial collateral used to secure specifically defined financial obligations is covered, thus excluding mainly long-term cash loans involving undertakings.

Ten Member States (Belgium, Denmark, Estonia, Finland, France, Germany, Italy, Luxembourg, Spain and UK) have widened its personal scope of application to cover also entities not mentioned by the Directive.

Some energy industry representatives (e.g. the European Federation of Energy Traders (EFET) want to expand the FCD to cover also non-regulated entities, such as energy trading companies, in a way that arrangements between such entities (including close out netting provisions agreed within such arrangements) would also be protected. The Commission has considered this suggestion, but believes that such an extension would fall outside the intended scope of the Directive, which is anchored on the protection of arrangements at least one of the parties to which is a public sector body, central bank or financial institution.

4.2.2. Option to exclude certain shares – Article 1(4) (b)

Article 1(4) (b) FCD gives Member States an option to exclude from the scope of the Directive financial collateral consisting of collateral providers' 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.

Only one Member State - Denmark - has applied a full opt-out pursuant to Article 1(4) (b). A partial opt-out for specified types of assets is applied by Germany, Ireland and Sweden. Germany does not consider the collateral provider's 'own shares' as well as the shares of affiliated undertakings within the meaning of the Directive 83/349/EEC to be 'financial collateral' if such collateral provider or affiliated undertaking is a corporate or other person falling under Article 1(2)(e) of the Directive. Ireland excludes from the scope of 'financial collateral' under the Directive shares in companies whose exclusive purpose is either to own means of production that are essential for the collateral provider's business or to own real property. In Sweden, the opt-out extends only to non-listed shares in affiliated undertakings in case of bankruptcy.

Since there is no noticeable effect on the functioning of the internal market, the Commission does not want to re-open the debate at the European level and, consequently, will not present any proposals to delete either one of the opt-out provisions.

4.2.3. Appropriation - Article 4(3)

Article 4(3) FCD allows certain Member States to opt out of the right of appropriation for the collateral taker. Appropriation essentially means that the collateral taker in an enforcement event may - under certain conditions - keep the assets as its own property instead of selling them. However, no Member State has made use of this option. Consequently, all 25 Member States are now recognizing appropriation for the collateral taker in case of an enforcement event. Therefore, at the next revision of the FCD, Article 4(3) could be deleted.

4.3. Right of-use - Article 5

Article 5.1 FCD stipulates that the Member States should ensure that the collateral taker is entitled to exercise a right of use in relation to financial collateral provided under the security financial collateral arrangement, if and to the extent that the terms of the arrangement so provide. A 'right of use' means that the collateral taker has the right to dispose of the collateral in favour of a third party by transferring ownership or by vesting a security interest. By providing the possibility of granting a general right of disposal to collateral takers, the FCD enhances the liquidity of the cash and securities markets.

For many Member States the right of re-use was a novelty, but now all Member States provide in their legal systems that the collateral taker is entitled to exercise a right of re-use if (and to the extent) provided for under a collateral arrangement. The establishment of the right of use under the Directive does not seem to give rise to any problems, but it remains to be seen what experience the market will have with the use of this right. Thus, the Commission considers that no further action is needed at present.

4.4. Recognition of Close-out Netting Provisions – Article 7

Close-out netting is an arrangement commonly used in financial markets to settle all agreed but not yet due liabilities to, and claims on, a counterparty by one single claim/liability. Close-out netting is important for the efficiency of financial markets, as it reduces credit risk and enables financial institutions either to reduce their regulatory required capital and/or to increase their exposure. As a matter of general insolvency law in some Member States, if a party to a transaction becomes insolvent its claims against other parties can no longer be netted out.It is, however, crucial for market participants to be able to rely on a legally protected netting mechanism in the event of insolvency of their counterparty.

The FCD acknowledged this by introducing, in Article 7, the obligation that a close-out netting provision can take effect according to its terms, notwithstanding the onset of insolvency or other similar proceedings and events and without regard to certain other matters that might otherwise affect close-out netting. For many Member States this was yet another novelty, and a not lightly taken step away from the principle of equal treatment of insolvency creditors. Today, the principle of close-out netting is well established in all Member States, but it remains to be seen how these netting provisions are applied in practice.

There are also suggestions to improve the coherence of EU legislation on netting and to expand the material scope beyond the collateral arrangements. The Commission is open to considering such suggestions, but as this Directive deals primarily with financial collateral and only peripherally with netting as a method to enforce collateral arrangements, it considers an amendment of the Directive would not be appropriate to improve the general EU framework for netting. It would seem better to have a single 'over-arching' set of amendments to several existing directives aimed at improving the consistency of the *acquis*. Besides Article 7 FCD, other relevant EU financial instruments that contain provisions on netting (and set off) include the SFD (Articles 2(k) and 3), the Winding-up Directive[13] (Articles 23 and 25) and the Regulation on Insolvency proceedings 1346/2000 (EC) (Article 6). However, further reflection is needed to see whether such a solution would be feasible.

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[13] Dir. 2001/24/EC on the reorganisation and winding up of credit institutions, OJ L 125, 05.05.2001, p. 15 – 23.

4.5. Conflicts of law – Article 9

The conflict of laws rule in Article 9 FCD aims to determine which law shall govern certain proprietary aspects regarding indirectly held securities involving a foreign element, - a question that may otherwise give rise to legal uncertainty. Article 9 FCD reflects the prevailing Community rule on conflicts-of-law, which is also found in Article 9 (2) SFD and the Article 24 Winding-up Directive, and which is based on the principle of the location of the securities account. This rule differs from the rule contained in The Hague Securities Convention of 2002, which allows parties to an account agreement a certain degree of freedom to select the applicable law for determining proprietary rights in the securities. These rules are incompatible and, if the European Community would decide to adopt the Convention, the above three Directives would require being adapted accordingly.

The question whether or not the Community should sign the Convention is discussed in the Council on the basis of a Commission proposal of 2003[14]. In its legal assessment[15], the Commission services have reiterated their support for the Hague Securities Convention. This evaluation does not seek to compare the two legal regimes or to duplicate this discussion. What both regimes have in common is that they both seek to achieve legal certainty over the applicable law for indirectly held securities. The Commission is of the opinion that there is not a sufficient level of legal certainty at present, neither at the international level nor at Community level. Therefore, also in the event that the Council would decide not to go forward with the Convention, Article 9 FCD (as well as Article 9 SFD and Article 24 Winding-up Directive) would still have to be amended to improve the situation within the Community by specifying the exact criteria for determining the relevant location of account. The example of the two Member States (France and Portugal), that have developed such criteria, shows that different interpretations are indeed possible.

5. CONCLUSIONS

Most Member States transposed the FCD provisions into their laws after the deadline for implementation set by the Directive and nine only in the course of 2005. Market experience with the use of the Directive is thus relatively recent and it is thus premature to make a final assessment of the impact of the Directive. Yet, the overall impression is that the FCD is functioning well and has come at the right moment. By removing the administrative burdens and legal formalities that previously hampered collateral procedures the FCD has made the taking of financial collateral and the enforcement of collateral obligations simpler and more efficient.

Based on its findings, the Commission would propose the following next steps:

(1) Credit claims: The Commission will consider proposing amendments to extend the FCD depending on the progress made in respect to the technical issues relating to the use of credit claims as collateral.

(2) Opt-out provisions on the scope: Maintain the opt-out provisions.

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[14] Proposal for a Council Decision concerning the signing of the Hague Convention on the Law applicable to certain rights in respect of securities held with an intermediary, COM (2003) 783, dated 15.12.2003.

[15] Commission staff working document "Legal assessment of certain aspects of the Hague Securities Convention", SEC (2006) 910, dated 3.6.2006.

(3) Opt-out provision on appropriation: Deletion of Article 4(3) at the next revision of the FCD.

(4) Right of use: No further action is needed at present.

(5) Netting: The Commission will further explore the possibility to improve the general EU framework for netting.

(6) Conflicts-of-law regime: Amend Article 9 FCD (as well as Article 9 (2) SFD and Article 24 Winding-up Directive), either as a consequence of a Council Decision to sign the Hague Securities Convention or (in case the latter would not occur) in order to specify the exact criteria for determining the location of account.

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