THE EUROSYSTEM'S CREDIT OPERATIONS AND LEGAL PROTECTION OF COLLATERAL UNDER COMMUNITY LAW

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ABSTRACT

La garanzia è diventata di recente un requisito fondamentale per il corretto funzionamento dei mercati finanziari e monetari nell'Unione Europea al fine di ridurre il rischio di credito. A causa della mancanza di un quadro legale di riferimento armonizzato ed orientato al mercato, rischi legali di varia natura potrebbero pregiudicarne l'efficacia, specie nel contesto delle operazioni transfrontaliere. L'Eurosistema, come ogni operatore di mercato, deve tener conto di simili rischi nell'ambito delle proprie operazioni di rifinanziamento.

La prima parte del contributo si concentra sul quadro legale di riferimento dell'Eurosistema in materia di garanzie. Ai sensi dello Statuto del SEBC e della BCE, le operazioni di credito devono basarsi su garanzie adeguate, da un punto di vista sia finanziario che giuridico. Oggetto di attenzione sono i principali rischi legali, alla luce dei vincoli operativi derivanti dalla politica monetaria unica. Si procede quindi ad esaminare il modo in cui l'Eurosistema ha gestito il rischio legale attraverso la regolamentazione, tenendo conto delle legislazioni nazionali, di aspetti quali requisiti di forma, ubicazione, uso transfrontaliero ed escussione della garanzia, costruendo un quadro legale basato sui princìpi di armonizzazione e decentralizzazione.

La seconda parte mira a descrivere succintamente il quadro legale dell'UE, che è stato costituito in pochi anni, con il fine di accrescere l'efficienza e la solidità legale della prestazione di garanzie, a beneficio del mercato finanziario integrato e della politica monetaria unica. In particolare, vengono in considerazione le Direttive sulla definitività degli ordini di trasferimento, sulle procedure di risanamento e liquidazione degli enti creditizi e sulle garanzie finanziarie. Il quadro giuridico dell'UE non è ancora definitivo, tuttavia è stato conseguito un consistente miglioramento.

I THE PRINCIPLE OF ADEQUATE COLLATERAL UNDER THE STATUTE OF THE ESCB AND THE ECB

I.I REQUIREMENT OF COLLATERAL

Article 18.1 2nd indent of the Statute of the European Central Bank (ECB) and of the European System of Central Banks (ESCB) states that, in order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks (NCBs) may conduct credit operations with credit institutions and other market participants, with lending based on adequate collateral.[1] To be more precise, Article 18 applies only to the ECB and the NCBs of those Member States that have adopted the single currency[2] (the "Eurosystem"[3]). The Eurosystem enters into credit operations when carrying out its tasks, i.e. the implementation of monetary policy, the conduct of foreign exchange operations, the holding and management of the official foreign reserves of the Member States, and the promotion of the smooth operation of payment systems.[4]

In the course of preparatory work on the Statute, the Committee of Governors did not reach any consensus on the requirement of adequate collateral. The proposal to the Intergovernmental Conference which drafted the Maastricht Treaty[5] put the relevant text in square brackets. In fact, although most NCBs used to take collateral in order to limit credit risk in the context of their transactions, their statutes did not always expressly require it.[6] The absence of an express obligation allows more flexibility, for instance in the context of abnormal operational situations, or the adoption of alternative risk control measures, such as the levying of fees.[7] However, the legislator finally decided that a prudent approach would be justified due to the role of the Eurosystem as manager of the European currency and of the official foreign reserves, and with regard to the responsibilities which are given to the individual NCBs and to the ESCB as a whole concerning the prudential supervision of credit institutions and the overall stability of the financial system.

Although the final text of Article 18 has put a certain constraint on the operational capacity of the Eurosystem, the same provision has conferred on the ECB quite broad powers of definition with regard to the notion of adequate

[1] Article 18.1 lists open market and credit operations in two separate indents, and the requirement of adequate collateral is only mentioned in the latter. However, it goes without saying that collateral must also be taken when the Eurosystem conducts credit operations through open market interventions.

[2] See Article 43 of the Statute of the ESCB and the ECB (the "Statute").

[3] The Governing Council of the ECB has adopted the term "Eurosystem" to denote the composition in which the ESCB performs its basic tasks (see Article 3.1 of the Statute).

[4] The Eurosystem may also enter into credit operations when the market needs financial assistance due to the malfunctioning of market infrastructures or liquidity shocks affecting financial stability. Interventions in favour of a single illiquid bank should remain within the national competences of NCBs, with regard to their links with prudential supervision. See on this issue R. Smits, *The European Central Bank* (The Hague: Kluwer Law International, 1997), p. 269.

[5] See Smits, op. cit., p. 272. On Article 18, see also J. V. Louis, "L'Unione économique et monetáire", in *Commentaire Mégret: Le Droit de la CEE*, 2nd edition (Brussels: L'Université de Bruxelles, 1995), p. 81.

[6] For instance, the statutes of the Banco de España, the Central Bank and Financial Services Authority of Ireland, and Suomen Pankki did not contemplate collateral.

[7] The Federal Reserve charges fees in the context of its intraday credit operations. See H. W. Richards, "Daylight Overdraft Fees and Federal Reserve Payment System Risk Policy", *Federal Reserve Bulletin* (December 1995), pp. 1065-77, quoted by Smits, op. cit., p. 273.

collateral. In fact, according to Article 18.2, the ECB may establish general principles for open market and credit operations entered into by the Eurosystem, including principles governing the announcement of conditions under which it stands ready to enter into such transactions.

Therefore market-oriented instruments remain in the full domain of the Eurosystem, which can “regulate indirectly – and without recourse to administrative control and or restrictions – money and market conditions”.[8] On the other hand, mandatory instruments used to implement monetary policy (minimum reserve requirements under Article 19 and other instruments of monetary control under Article 20) are subject to the regulatory power of the Council.

In accordance with Article 108 of the Treaty, Member States have adapted the statutes of NCBs in order to make them compatible with the Treaty and the Statute.[9] In some cases, the principle of “adequate collateral” has been embodied expressly in the NCBs’ statutes.[10] In other cases, legislation has entrusted NCBs with a broad range of operational capacity within the limits set out by the Statute and by the ECB’s regulatory acts; those national provisions that restricted the categories of eligible collateral were repealed.[11]

1.2 THE ADEQUACY OF COLLATERAL FROM A LEGAL PERSPECTIVE

The Eurosystem has assessed the adequacy of collateral for its own operations on the basis of two different perspectives. Firstly, eligible assets must be financially sound and ensure operational efficiency.[12] Secondly, collateral must be legally enforceable, i.e. it must be valid and realisable to the benefit of the creditor under the relevant jurisdictions.

This legal analysis requires the assessment of two elements which are strictly linked to each other: the nature of the collateral arrangements, and the legal framework that regulates the collateral.

With regard to market-oriented instruments, the Eurosystem acts in accordance with applicable national law. The ECB has organised the Eurosystem’s credit operations on the basis of the principle of decentralisation (Article 9 of the Statute): each NCB may, acting in its own name, enter into contractual relationships with counterparties established in its own territory, on the basis of standard terms and conditions of a contractual or regulatory nature, which are harmonised by way of regulatory acts issued by the ECB. Therefore,

[8] See the introductory report to the Draft Statute, published in *Europe*, Document No 1669/1670, 8 December 1990, p. 25.

[9] For more information, see the reports of the European Monetary Institute (EMI) and the ECB’s Convergence Report of 1998, available on the ECB’s website (www.ecb.int).

[10] See Article 16 of the consolidated version of the Statutes of the Nationale Bank van België/Banque Nationale de Belgique, published in *Moniteur belge*, 12 January 1999, No 990112-84, and 12 March 1999, No 990312-421.

[11] Italy has followed this approach: see Article 6, paragraphs 2-3 of the Legislative Decree of 10 March 1998, No 43, published in *Gazzetta Ufficiale della Repubblica Italiana*, 14 March 1998, No 61, and Article 41 of the Statute of the Banca d’Italia, published in the Gazzetta, 30 April 1998, No 91.

[12] See Chapter 2.3 of this paper.

collateral is established in accordance with the relevant national law and in the legal form adopted by each NCB, on the basis of its common practice.[13]

Harmonisation of the regulatory and operational regime has had a material impact on existing NCB practices with regard to risk control measures.[14] Keeping the principle of an open market economy with free competition in mind (Article 2 of the Statute), the collateral framework takes market standards into account.[15] In line with the needs of a single money market, the Eurosystem accepts collateral located abroad.

In this context the Eurosystem has to deal, on the same footing as all market participants, with a variety of legal risks[16] in relation to its own refinancing operations. Risks arise from national jurisdictions which traditionally impose formal and procedural requirements on the perfection and realisation of collateral in order to make it valid and opposable to third parties, with the objective of limitation of derogation to the general principle of *pari passu*. In addition, the existence of a cross-border component in credit operations adds further complexity and uncertainty due to the application of foreign law.

With regard to collateral, legal risks may be grouped into four categories[17]: a) establishment risks, b) realisation risks, c) custodian risks, and d) conflict of law risks.

a) *Establishment risks* arise when the formalities for perfection of collateral are not respected. The outcome may be that collateral is invalid, either due to an operational failure (which is very likely if the formalities for perfection are very burdensome) or to an incorrect interpretation of the law. One peculiar case of establishment risk is the so-called recharacterisation risk. This risk arises in jurisdictions where repo arrangements are not legally recognised and may be recharacterised by courts as security interests: if the formalities for the perfection of pledges are not carried out, the collateral may not be valid.[18]

b) *Realisation risks* occur in the event of default of the collateral provider. In such cases, the civil law (or, in the event of insolvency, the bankruptcy law) may limit the rights of the creditor of enforcement on assets in different ways. Waiting periods, reduction of the claim, special procedures for sale and judicial authorisations may

[13] See Smits, op. cit., p. 263.

[14] According to Article 32.4 of the Statute, the Governing Council of the ECB may decide that NCBs should be indemnified for losses arising from monetary policy operations. The existence of a harmonised risk control framework may give grounds for the application of this provision.

[15] It is worth noting that upon the entry into force of Article 102 (the former 104 A) of the Treaty on 1 January 1994 (the start of the second stage of Economic and Monetary Union), Member States had to repeal any provisions which considered only public debt instruments eligible as collateral for NCBs' credit operations to the detriment of private issuers.

[16] Legal risk is broadly defined as "the risk of loss because of the unexpected application of law or regulation or because a contract cannot be enforced" (quoted from Bank for International Settlements (BIS), "Cross-border Securities Settlements" (1995), report prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries (CPSS), available at www.bis.org).

[17] See EMI, "Standards for the Use of EU Securities Settlement Systems in ESCB Credit Operations" (1998), p. 31, available on the ECB's website.

[18] On the subject of recharacterisation risk, see J. Benjamin, "Recharacterization Risk and Conflicts of Law", in *Butterworths Journal of International Banking and Financial Law* (1997), p. 513.

all delay or hinder the realisation of collateral. Any such delay, however, could cause market risks due to the loss of value of collateral on the market. Legal obstacles to the recognition of close-out netting techniques also fall within this category of risk.

c) *Custodian risks* arise because financial instruments eligible as collateral are issued with central securities depositories (CSDs) which are subject to operational and, at worst, insolvency risk. This risk requires the legal features of these depositories to be identified in order to assess the degree of protection of the rights of the collateral taker, acting as the pledgee or owner of securities.

d) *Conflict of law risks*[19] arise from the cross-border use of collateral and from the access of a foreign entity to credit operations. In a complex but not exceptional case, the validity of collateral may be subject to three different jurisdictions: the *lex contractus*, which regulates credit operations and collateral arrangement; the *lex rei sitae*, the law of the place where the collateral is located, which determines the conditions for perfection and realisation of collateral[20]; and the *lex concursus*, which in the event of insolvency of the collateral provider affects the realisation of collateral. The *lex contractus* may be agreed by the parties according to the Rome Convention, whereas the *lex rei sitae* and the *lex concursus* are determined by mandatory law.

The single monetary policy brought with it the cross-border use of collateral: banks may offer assets which are located in a foreign jurisdiction as collateral. According to general principles of private international law, the *lex rei sitae* regulates the exercise of a right *in rem*. However, this rule was intended for moveable things, in particular physical securities, but was not applicable to book-entry securities[21], which have however fully replaced physical securities on financial markets. Given that investors may maintain their interest on securities through a constellation of accounts located in different jurisdictions, a special international private law rule was needed to clearly determine the law applicable to collateral established on such instruments.[22]

The interference of the *lex concursus* on the realisation of collateral was already an element of concern before the introduction of the single currency: according

[19] See R. Potok (ed.), *Cross-border Collateral: Legal Risk and the Conflict of Laws* (London: Butterworths, 2002); and A. M. Corcoran, "Cross-border Financial Transactions: 25 Questions to Consider in Making Risk Management Decisions", in G. Ferrarini, K. Hopt and E. Wymeersch (eds), *Capital Markets in the Age of the Euro* (The Hague: Kluwer Law International, 2002), p. 332.

[20] In fact, the borderline between the *lex contractus* and the *lex rei sitae* is vague, and inconsistencies between the relevant jurisdictions may cause uncertainty on the validity of collateral. See M. Perassi, "I sistemi di pagamento internazionali", in *Banca, Borsa e Titoli di credito* (2000), I, p. 507; and Benjamin, op. cit., p. 516.

[21] Book-entry securities are issued in immobilised or dematerialised form through a CSD (see R. Goode, "The Nature and Transfer of Rights in Dematerialised and Immobilised Securities", in *Journal of International Banking and Financial Law* (1996), No 4, p. 167; and C. Bernasconi, "The Law Applicable to Disposition of Securities Held through Indirect Holding Systems", Hague Conference on Private International Law, Preliminary Document No 1 of November 2000, available at http:/hcch.e-vision.nl/upload/sec_pd01e.pdf). In both cases, interest on securities is identified and transferred by means of book entry onto an account. In some countries the investor may keep this account directly with the issuer or its agent *(direct holding system)*, but in most countries the investor's interest on securities is recorded on the books of an intermediary which, in turn, may have its interest recorded with another intermediary, and so on until the last intermediary of the chain which holds an account with the issuer *(indirect holding system)*.

[22] See on this aspect R. D. Guynn, "Modernising Securities Ownership, Transfer and Pledging Law", in *Capital Markets Forum (Section on Business Law of International Bar Association)* (1996), pp. 35-41.

to European Community (EC) law[23], branches of banks incorporated in another country are subject to the monetary policy of the host country and must enter into monetary policy operations with the host central bank. The *lex concursus* tends to override the *lex contractus* and the *lex rei sitae*. However, in the absence of a harmonised European regime for the conduct of bank insolvency proceedings, uncertainty as to the applicable *lex concursus* could arise. As this paper will show, in some countries the principle of universality was in force; while other countries followed the principle of territoriality, with several nuances. This implied that in the event of insolvency of a multi-branch bank, local proceedings could open in tandem with the main proceeding, each one subject to its own *lex concursus*.

2 THE EUROSYSTEM'S LEGAL FRAMEWORK ON CREDIT OPERATIONS

2.1 THE ECB'S GUIDELINES

In most cases the legal risks examined above could only be solved through legislative reforms, as explained below in Chapter 3. In the meantime, the Eurosystem has managed such risks by setting out its own legal framework for credit operations, within the limits allowed by national laws.

Article 18, as already noted, gives to the ECB the power to regulate the open market and credit operations of the Eurosystem. On this basis, the ECB has enacted several legal acts in the different field of competence of the Eurosystem[24]: the "Guideline on monetary policy instruments and procedure of the Eurosystem which regulates monetary policy credit operations"[25]; the "Guideline on a Trans-European Automated Real-time Gross Settlement Express Transfer System (TARGET)"[26], which regulates intraday credit operations; and the "Guideline on the foreign reserve management of the ECB by NCBs and the legal documentation for operations involving the foreign assets of the ECB".[27] Such Guidelines are binding for the Eurosystem (Articles 12.1 and 14.3 of the Statute), but do not have a direct effect on market participants. NCBs are obliged to implement them in their legal frameworks in accordance with the powers conferred on them by national statutes and to execute their operations accordingly.

The Guideline on monetary policy may be considered a sort of framework legal act.[28] It is basically composed of two annexes: the General Documentation on

[23] See Article 27 of 2000/12/EC Directive ("The Consolidated Banking Law Directive") published in OJ, L 126 26.5.2000.

[24] The following quotations refer to the legal acts currently in force.

[25] ECB/2000/7 published in OJ L 310, 11.12.2000, p. 1; ECB/2003/16 published in OJ L 69, 8.3.2004, p. 1.

[26] ECB/2001/3 published in OJ L 140, 24.5.2001, pp. 72-86; ECB/2002/1 published in OJ L 67, 9.3.2002, pp. 31-32; ECB/2003/6 published in OJ L 113, 7.5.2003, pp. 10-13.

[27] ECB/2001/1 published in OJ L 207, 17.8.2000, p. 24; ECB/2001/5 published in OJ L 190, 12.7.01, pp. 26-28; ECB/2001/12 published in OJ L 310, 28.11.2001, pp. 31-32.

[28] With regard to the eligibility criteria for assets accepted as collateral for intraday credit operations, the Guideline on TARGET makes reference to the same criteria that are valid for monetary policy operations (Article 3 (f)). Foreign reserve assets transferred by the NCBs to the ECB, which the above-mentioned Guidelines refer to, are managed by the NCBs acting as agents of the ECB on the basis of standard market documentation. Foreign reserve assets that remain with the NCBs are managed exclusively by the NCBs within the limits set by Article 31 of the Statute.

Eurosystem Monetary Policy Instruments and Procedures (the "General Documentation"), and the Additional Minimum Common Features (AMCF).

The General Documentation[29] describes the operational framework[30] chosen by the Eurosystem, providing accurate information on eligible counterparties[31], open market and bilateral operations, procedures, eligible assets and minimum reserves. The AMCF aims at harmonising the contractual or regulatory arrangements which NCBs adopt for monetary policy operations.

2.2 THE LEGAL FORM OF COLLATERAL

The General Documentation (Chapters 3.1 and 4.1) states that NCBs have the option to execute credit transactions either in the form of repurchase agreements[32] or as collateralised loans, where the collateral has the nature of a pledge or charge. The power of NCBs to select their preferred collateralisation technique is a result of the principle of decentralisation[33], and is also one of the ways through which the Eurosystem may limit legal risks relating to collateral: each NCB should adopt a safe legal technique in its own jurisdiction, on the basis of its consolidated practice. However, this approach may not be fully effective in a cross-border context: if assets are located in a foreign country, requirements for the perfection and realisation of collateral are subject to the rule of that foreign country. If the foreign country's legislation does not provide safe mechanisms for the collateral technique generally adopted by the financing NCB, or if the assets provided as collateral are subject to special legal features, then the collateral practice and contractual arrangements of the financing NCB are also affected and must be adapted, with the cooperation of the NCB in which the collateral is located.[34]

2.3 THE LOCATION OF COLLATERAL

Chapter 6 of the General Documentation sets out the criteria which assets must fulfil to be eligible for monetary policy operations. These criteria aim to protect

[29] The Governing Council of the ECB has just adopted the last version of the General Documentation, which shall enter into force on 30 May 2005 and is already available on the ECB's website.

[30] In this respect see G. Vento, "The Eurosystem Operational Framework – the Use of Collateral and Liquidity Distribution in the Euro Area: Towards a Single Interbank Market?", *BNL Quarterly Review* (2004), p. 72.

[31] Supervised credit institutions are the only eligible counterparties for monetary policy operations (General Documentation, Chapter 2.1). Banks and other entities that participate in TARGET (investment firms, clearing and settlement agents, and some public entities) may access the Eurosystem's intraday credit facility; it is worth noting that public entities may be exempted from collateral requirements, see Article 3 (f) of the Guideline on TARGET. In the absence of any restrictions in the Guidelines of the ECB (see footnote 27), operations on foreign assets may be conducted with banks and other market participant in accordance with Article 18 of the Statute.

[32] On the use of repo transactions for monetary policy purposes, see BIS, "Implications of Repo Markets for Central Banks" (1999), available on the BIS's website.

[33] Chapter 2 of the General Documentation implements such a principle, whereby it specifies that eligible counterparties may access the Eurosystem's standing facilities and open market operations based on standard tenders only through the NCB of the Member State in which they are established. The ECB may only conduct fine-tuning bilateral operations on its own under exceptional circumstances, subject to the decision of the Governing Council (Chapter 1.3.1).

[34] In this respect, see the legal documentation adopted by the Banca d'Italia for the acceptance of some foreign collateral in "Strumenti di politica monetaria dell'Eurosistema: Guida per gli operatori" (2004), pp. 101-30, available on the Banca d'Italia's website (www.bancaditalia.it).

the Eurosystem from incurring losses, ensuring the equal treatment of counterparties and enhancing operational efficiency.[35]

It is worth examining the eligibility criteria[36] concerning the location of eligible assets, since location determines the *lex rei sitae*, i.e. the law applicable to the perfection and realisation of collateral. Article 17 of the Statute allows the Eurosystem to accept book-entry securities as collateral. Since the drafting of the Treaty, book-entry securities have fully replaced physical securities on financial markets: accordingly, the General Documentation requires that eligible assets must be as a rule transferable in book-entry form. The legal uncertainties relating to the application of the *lex rei sitae* rule to book-entry securities have already been mentioned. The European legislation has agreed on the principle – as will be seen below – that the perfection and realisation of book-entry securities collateral are regulated by the law of the place of location of the relevant account where the rights of the collateral taker are legally recorded. On this basis, the General Documentation states (Chapter 6.2) that assets must be held in the euro area[37] through an account with the Eurosystem or with a securities settlement system (SSS) which fulfils the standards established by the ECB, "so that perfection and realisation are subject to the law of a euro area country". Therefore this criterion is based not only on operational efficiency (i.e. the need to ensure immediate access of the Eurosystem to the settlement accounts), but also on legal reasons, since it allows the Eurosystem to check that formalities relating to the perfection and, if needed, realisation of collateral are properly executed in a well-known jurisdiction.

The Eurosystem has adopted standards which SSSs must comply with to be eligible for the settlement of monetary policy operations.[38] As already mentioned, one of the risks that the collateral taker bears is custody risk, i.e. the risk that due to insolvency or operational failure of the custodian, the interest of the collateral taker may be affected. One of these standards (Standard 1) concerns the legal soundness of the SSSs. It prescribes that SSSs must have a sound legal basis under the jurisdiction of incorporation and must provide for adequate

[35] The General Documentation distinguishes between tier one assets and tier two assets. The former consist of marketable debt instruments fulfilling uniform euro area-wide eligibility criteria specified by the ECB; the latter consist of additional marketable and non-marketable assets which are of particular importance to national financial markets and banking systems and for which eligibility criteria are established by the NCBs, with the approval of the ECB and subject to minimum eligibility criteria established by the ECB. However, there is no distinction between the two tiers with regard to the quality of the assets and their eligibility for various types of operations. The Eurosystem intends to replace the current two-tier system with a single list of eligible collateral (see the last version of the General Documentation, footnote 29). In order to organise a smooth transition to a single list, the following measures are envisaged. Firstly (as from May 2005), euro-denominated debt instruments issued by entities established in G10 countries that are not part of the European Economic Area (EEA) will be introduced in tier one; equities will be withdrawn from the tier two lists of those countries that currently have them eligible. In a second stage, bank loans and non-marketable retail mortgage-backed debt instruments will be included in the single list.

[36] The other eligibility criteria for tier one assets are that they must be debt instruments, should meet high credit standards, must be denominated in euro and issued (or alternatively guaranteed) by entities established in the EEA, and must be listed or quoted on a regulated market or on certain non-regulated markets as specified by the ECB.

[37] However, assets may be deposited/registered (issued) in the EEA with a central bank or with a CSD that fulfils the minimum standards established by the ECB.

[38] See EMI, "Standards for the Use of EU Securities Settlement Systems in ESCB Credit Operations", op. cit.

protection for the rights of the NCBs and the ECB in respect of securities held in their accounts in such systems. The legal framework which regulates the SSS must ensure that the holder of securities is entitled with a proprietary right as distinct from a mere contractual claim, in order to be protected in the event of insolvency of the system operator or the depository.

2.4 CROSS-BORDER USE OF COLLATERAL

The cross-border use of collateral is an essential feature of the operational framework of the Eurosystem. It ensures equal treatment of counterparties in the euro area, and fosters integration of financial markets. Counterparties may obtain funds from their refinancing NCB (the "home NCB") by providing assets issued or held in another Member State of the euro area as collateral. The General Documentation (Chapter 6.6) states that cross-border transfer of securities may take place in accordance with two alternative options: the correspondent central banking model (CCBM), or the links between SSSs.[39]

The CCBM is based upon a correspondent agreement between the Eurosystem members under which they act as custodians for each other in respect of assets issued or held in their local depository or settlement system. A counterparty which intends to obtain credit from its home NCB instructs its correspondent in the country where its securities are held to transfer them to the central bank of that country (the "correspondent NCB") for the account of the home NCB. The collateral is managed by the correspondent NCB on behalf of the home NCB: formalities for its perfection and realisation are subject to the law of the state of the correspondent NCB, since the account where the collateral is registered is located there. The correspondent NCB ensures the legal soundness of collateral on the basis of its expertise in the local jurisdiction.[40]

Links between SSSs allow a participant in one SSS (the "investor SSS") to hold securities issued in a foreign SSS (the "issuer SSS") without being a participant in the latter. The investor SSS enters into a depository agreement and opens an account with the issuer SSS on which the global position of its participants is recorded (the "omnibus account"). When a counterparty intends to transfer to the home NCB foreign assets which have been issued in the country of the issuer SSS, the transfer takes place on the books of the investor SSS where both the NCB and the counterparty have their own accounts. The omnibus account held by the investor SSS in the issuer SSS is not affected by the transaction. The collateral is established according to the law of the state of the home NCB, since that is where the relevant account is located. The eligibility of links for their use in monetary policy operations is subject to assessment by the Eurosystem according to the same standards that apply to domestic SSSs.

[39] See Perassi, op. cit., p. 510.

[40] At the time of the launch of the single monetary policy, the CCBM model was envisaged as a transitional arrangement, since links between SSSs were very limited at that time. The situation has now changed, as the Eurosystem has assessed the eligibility of many links. However, the General Documentation (see footnote 25) no longer refers to the transitional nature of the model. Counterparties may freely decide between one of the two alternative models.

From the perspective of collateral management, the advantage of the correspondent model is that NCBs may benefit from the expertise of their correspondents. This could prove worthwhile, especially if the counterparty is subject to an insolvency proceeding in a foreign state. However, transfer through a link undeniably limits the cross-border dimension of the transactions, since the *lex rei sitae* and the *lex contractus* coincide.

2.5 HARMONISATION OF LEGAL DOCUMENTATION

The AMCF are designed to achieve a minimum level of harmonisation with regard to the terms and conditions adopted by the Eurosystem for monetary policy operations. In compliance with the principle of decentralisation, NCBs retain a certain discretion in tailoring legal documentation on the basis of their practice and legal environment. However, harmonisation is also needed to ensure equal treatment among all participants in the euro area as well as to manage credit risk properly. In actual fact, most of the individual AMCF deal with the treatment of counterparty default and the realisation of collateral. The AMCF list the individual instances of counterparty default (AMCF I.6) and the following remedies which should be at the disposal of NCBs. In particular, they should be "in a legal position to realise all assets provided as collateral without undue delay" (AMCF I.7), and "without there being prior claim over the assets concerned" (AMCF II.23). The basic features of repurchase transactions, including mark-to-market arrangements, substitution of assets and the mechanics of close-out netting (II. 17-22), are also part of this minimum harmonisation.

NCBs have implemented such principles in their legal documentation to the extent possible given the legal constraints imposed by national legislation. As already noted, Community legislation was needed to modernise national legislation on collateral as well as to regulate complex cross-border issues and to create legal certainty.

3 EUROPEAN UNION LEGISLATION ON COLLATERAL

3.1 THE BACKGROUND AND THE OVERALL LEGAL FRAMEWORK

Over the last fifteen years, collateralisation[41] has become an essential feature for the proper functioning of monetary and financial markets, payments and securities settlement systems. The increasing volume of financial activity generates credit risks which may have systemic implications, as recognised by the monetary authorities.[42] Measures like collateral, netting and exposure limits (caps) all limit such risks. The derivative markets are based upon the payment of margins to

[41] On the reasons behind the development of collateralisation, see J. Benjamin, *Interests in Securities: A Proprietary Law Analysis of the International Securities Markets* (Oxford: OUP, 2000), p. 80. Benjamin particularly draws attention to the "need to achieve new regulatory capital efficiencies in an increasingly competitive market".

[42] See BIS, *Cross-border Securities Settlement Systems*, op. cit., and *Core Principles for Systemically Important Payment Systems* (2001), report prepared by the CPSS, available on the BIS's website.

clearing houses; other markets and SSSs have put in place guarantee funds to ensure that transactions can be performed. In the secondary money market, transactions with terms longer than one month are mostly collateralised.[43] Central banks have developed gross settlement systems in order to reduce systemic risks in their national payment systems: intraday liquidity granted against collateral is an essential feature that ensures the proper functioning of these systems.

A common legal framework was needed to reduce legal risks and make collateralisation effective, in particular in a cross-border context. The legislative initiative was spurred by the introduction of the single currency, the establishment of the Eurosystem legal framework and the need to complete the single financial market.

In a short space of time the Community legislator has enacted a number of legal acts which deal with collateral and insolvency issues: Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems (the "Settlement Finality Directive"); the Regulation on insolvency proceedings of 29 May 2000 (EC/2000/1346, the "Insolvency Regulation")[44]; Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding-up of credit institutions (the "Winding-up Directive"); Directive 2001/17/EC of 3 March 2001 on the reorganisation and winding-up of insurance undertakings; and Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the "Collateral Directive").

The Eurosystem has contributed to this process through the opinions released by the EMI and the ECB and the participation of its representatives in the drafting working parties, with regard to its twofold function as both a market player and a guarantor of financial stability.

The Settlement Finality Directive (SFD), the Winding-up Directive (WUD) and the Collateral Directive have a special relevance for the collateral activities of the Eurosystem and more generally of monetary and financial markets, and are accordingly individually examined in detail below in sub-sections 3.2-3.4.

3.2 THE SETTLEMENT FINALITY DIRECTIVE

The SFD[45] aims at eliminating legal risks which affect payment and securities settlement systems in the event of insolvency of their participants. Legal protection of collateral provided to participants in the systems is one of the measures envisaged for this purpose. The SFD also applies to collateral provided in connection with operations of the ESCB, including monetary policy operations, and thereby contributes to the development of the Eurosystem legal framework (Recital No 10). Therefore, the ESCB may be subject to the rules of

[43] See the ECB report on "The Euro Money Market" (2001), available on the ECB's website.

[44] The Insolvency Regulation applies to the insolvency of institutions other than banks, insurance undertakings and investment firms; it has special relevance since its provisions have been partially transposed in the Winding-up Directive. See D. Devos, "The European Directive of 19 May 1998 on Settlement Finality in Payment and Securities Settlement Systems", in *Capital Markets in the Age of the Euro*, op. cit., p. 366.

[45] On the SFD, see Devos, op. cit., p. 361.

this Directive as collateral taker either in intraday credit operations in TARGET, or in other central banking operations.

The definition of collateral ("collateral security", Article 2 (m)) encompasses "all realisable assets" provided in whatever legal form, including the expressly mentioned pledge and repurchase agreements. The SFD derogates to insolvency law in order to ensure satisfaction of the rights of the collateral taker. Then it sets out the rule of private international law which determines the law applicable to book-entry securities provided as collateral.

The rights of holders of collateral security are "insulated" from the effects of the insolvency of the provider[46] (Article 9): insolvency law is not applicable to collateral takers in so far as it: a) imposes procedural constraints on the right of realisation of collateral (such as waiting periods, judicial authorisation, filing of creditors' claims, etc.); b) limits the right of the collateral taker to satisfy its claim on the secured assets, by admitting the concurrence or preference of other creditors. Therefore, the general rules applicable to collateral, i.e. the *lex rei sitae*, should regulate the procedures for realisation.[47] Article 9 applies irrespective of whether one (the main proceeding in the Member State of incorporation) or more proceedings (local proceedings in the Member States with regard to the establishment of branches) are being opened within the European Union (EU); it may also be relevant in the event of proceedings opened in third countries (Article 2 (j)).[48] The Collateral Directive has broadened, as shown below, the scope of application of the principle set out by Article 9.

As already noted, the rule of *lex rei sitae* required adaptation to the peculiar nature of book-entry securities. Article 10 of the Directive is based upon the so-called place of the relevant intermediary approach (PRIMA), according to which the rights of collateral holders on securities which are legally recorded on a register, account or centralised deposit system located in a Member State shall be governed by the law of that Member State. The PRIMA has been broadly considered as a qualification of the *lex rei sitae* rule, although one distinguished scholar has drawn attention to its peculiarity[49], since in the absence of a paper form, it is no longer possible to identify the physical location of the security.

3.3 THE WINDING-UP DIRECTIVE

The WUD[50] has further contributed to legal certainty with regard to the enforceability of collateral in the context of insolvency proceedings of banks.

[46] Devos, op. cit., p. 385, notes that this provision takes inspiration from Article 5 (1) of the Insolvency Regulation, but goes further than it since "insulation" also takes effect when the assets provided as collateral are located in the same Member State as the one where the insolvency proceedings have been opened, whereas Article 5 applies the same principle only in the event that assets are located in another Member State. See also Chapter 3.2, footnote 55.

[47] See Devos, op. cit., p. 386.

[48] In this case, the receiver may not challenge Article 9 on the grounds of its incompatibility with the local insolvency law, since the Directive should be considered part of the international public policy of Member States. See Devos, op. cit., pp. 377-78.

[49] See R. Goode, "Security Entitlement as Collateral and the Conflict of Law", in *Journal of International Banking and Financial Law* (September 1998), p. 22.

[50] See E. Galanti, "The New EC Law on Bank Crisis", in *International Insolvency Review* (2002), p. 49; and A. Campbell, "Issues in Cross-border Bank Insolvency: The European Community Directive on the Reorganization and Winding-up of Credit Institutions", available at *www.imf.org/external/np/leg/sem/2002/cdmfl/eng/campbpdf*

It has introduced a regime of mutual recognition of measures for bank crises. A clear legal framework is now in place with regard to the authorities entrusted with crisis management and the national law which comes into play. The WUD applies to the crisis (reorganisation measures or winding-up proceedings) of banks in the European Community with at least one branch in a Member State other than the one in which they have their headquarters, and only to the crisis of branches of non-EC banks when such banks have branches in at least two Member States. It is based upon the principles of unity and universality. The principle of unity provides for the exclusive jurisdiction of the home Member State's administrative or judicial authorities regarding the decision to implement a crisis management measure in a specific bank, including in branches established in another Member State (Articles 3.1 and 9.1). The Community legislator does not intend to depart from the "home country control" rule in case of difficulties, and will grant equal treatment to all creditors in case of liquidation. The principle of universality implies that a single insolvency proceeding, established and regulated by the home Member State's law, shall be effective with the consequent prohibition of any secondary proceeding being opened by the host authorities. The decisions taken within the proceeding shall be recognised and capable of producing effects in all Member States, without need of any formality or *exequatur* procedure.

The application of the principle of universality is mitigated by the introduction of some exceptions[51] which provide for the application of the *lex rei sitae* or the *lex contractus* instead of the *lex concursus*.[52] It is worth noting that a number of these exceptions relate to financial transactions and collateral arrangements. In such cases, the forum concursus shall apply foreign insolvency law to determine the treatment of these rights and contracts.[53]

The derogation in favour of the *lex rei sitae* is justified by the fact that the location of the assets to which the rights refer creates an objective connection with another jurisdiction. These exceptions relate, inter alia[54], to rights on dematerialised or immobilised financial instruments where the register, account or centralised deposit system is held or located in a Member State (Article 24). In this case, in line with the PRIMA, the law of the Member State where the relevant account is located, i.e. its insolvency law, shall regulate the enforcement of proprietary rights.

The location of assets is also relevant regarding rights in rem in respect of tangible or intangible, movable or immovable assets belonging to the credit

[51] This derogation is also contained in the Insolvency Regulation (Articles 5 to 15).

[52] Galanti, op. cit., p. 51, explains this outcome as a compromise adopted in the course of preparatory works between the supporters of a paramount application of the universality principles, and the advocates of a "softened" universality which would have allowed secondary proceedings. In particular, the latter were concerned about the treatment of local creditors, whereas the former considered the opening of secondary proceedings inconsistent with a system based on home country control. The compromise solution gives some protection to creditors in host Member States, while at the same time ensuring that there is no possibility of a further set of legal proceedings being initiated (see also Campbell, op. cit., p. 11).

[53] However, Recital No 17 states that the exceptions in favour of the lex loci or the lex contractus have to be literally interpreted, while other issues, "such as the lodging, verification, admission and ranking of claims concerning those contracts and rights and the rules governing the distribution of the proceeds of the realisation of the assets […] are governed by the law of the Member States".

[54] The other derogation concerns rights in respect of immovable property, a ship or an aircraft subject to registration (Article 20 (b) (c)).

institutions, or rights based on a reservation of title on assets which are situated within the territory of another Member State at the time of adoption of the insolvency proceeding (Articles 21 and 22). Such rights, according to the provision, are not "affected by the insolvency proceedings".[55]

Netting agreements, repurchase agreements and transactions carried out in the context of regulated markets (Articles 25 to 27) remain subject to the *lex contractus*[56], whose application is justified by Recitals 23 and 24. The conflict of the *lex concursus* with the rules normally applicable in the context of the economic and financial activity of the credit institution and its branches must be regulated, in particular to ensure the security of transactions and the protection of the integrity of regulated markets. This approach follows the same direction adopted by the SFD, whereby the law regulating the system (the *lex contractus*), rather than the *lex concursus*, determines the rights and obligations of a participant regarding the system. In this way, both Directives encompass not only the settlement of transactions, but also dealing on financial markets and bilateral netting agreements, on the basis of the same principle of the *lex contractus*.[57] It has been noted[58] that these rules allow not only free choice in terms of the law applicable to this legal relationship, but also the chance to choose an applicable law taken from outside the EU. This may lead to a tendency to select the most favourable legal jurisdiction ("choice of law shopping"), and may even cause disintermediation in the European markets.

This remark leads us to some concluding considerations on the objective and effects of the provisions set out by the WUD. This Directive dictates rules which permit the solution of conflicts of law. This approach is of great value in terms of legal certainty: in the banking sector, the opening of potentially conflicting insolvency proceedings is no longer admitted; a financial market or a central bank that has contractual relationships with a number of operators may establish ex ante that only one single law, i.e. either the *lex contractus* or the *lex rei sitae*, will apply to its transactions, irrespective of the place of incorporation of counterparties. However, in some cases the determination of the applicable law may indeed be unclear, especially taking into account the recalled principle of literal interpretation of derogations to the *lex concursus*.

[55] This rule repeats the content of Article 5 of the Insolvency Regulation and is also similar to Article 9 of the SFD. However, under the Insolvency Regulation "the insulation" does not take place when secondary insolvency proceedings are opened: in such an event, the rights of the collateral taker shall be subject to the insolvency law of those proceedings. With regard to banks, secondary proceedings are not contemplated by the Directive. According to Devos, op. cit., p. 373, Article 21 means that the holder of the right in rem "should be exempted from any restrictive rules intending to avoid abuses to the detriment of other creditors". Galanti, op. cit., p. 62, holds that a narrower interpretation of Article 21 may be that rights *in rem* "do not straightaway escape from the proceeding but that they are not voided as a simple effect of its opening". This latter position may be supported by the fact that rights *in rem* as defined by Article 21 cannot benefit from more favourable treatment than rights on book-entry securities, which would be subject to the *lex rei sitae* as defined by Article 24. In any case, Article 21 is without prejudice to the application of the special regime regulated by the SFD with regard to collateral given to central banks and participants, with the insulation of the rights of collateral holders from insolvency law (Recital No 26).

[56] However, even the provision on set-off (Article 23) contains a derogation to the *lex concursus* which is based upon the contract law applicable to the claim of the credit institution subject to set-off.

[57] See Galanti, op. cit., p. 61, who reports that the advocates of derogation put forward this argument in the course of preparatory work.

[58] Galanti, op. cit., p. 61.

The WUD did not aim at harmonising substantive rules on insolvency in the EU. In the context of this Directive, harmonisation was not a realistic objective (see Recital No 6). Further progress toward a reduction of legal risks called for greater harmonisation of the European insolvency law with regard to the treatment of collateral arrangements, taking the objective of ensuring the competitiveness of the European financial market into account.

3.4 THE COLLATERAL DIRECTIVE

The Collateral Directive is the last and the most ambitious piece of EU legislation on collateral issues. It complements the other legal acts considered above (Recital No 4), but in fact goes well beyond their limited scope in this field. The Commission announced its intention to proceed further with legislation on collateral in its Financial Services Action Plan (FSAP)[59] after the adoption of the SFD. The preamble of the Collateral Directive explains its objective: "A Community regime […] for the provision of securities and cash as collateral […] will contribute to the integration and cost-efficiency of the financial markets as well as to the stability of the financial system" (Recital No 3). This Directive also aims at improving the efficiency and legal soundness of the cross-border operations of the Eurosystem, which are necessary for the implementation of monetary policy, and at improving collateralised transactions entered into the secondary money market (Recital No 12).

The Collateral Directive concentrates on the profile of harmonisation: only one provision is devoted to conflict of law issues (Article 9, on the law applicable to book-entry securities collateral). It touches upon aspects regulated by the *lex contractus* (the recognition of title transfer arrangements and right of use), the *lex rei sitae* (perfection and enforcement) and the *lex concursus* (close-out netting and avoidance rules). Harmonisation has requested material amendments to the basic rules of civil law, which are all extremely ancient. However, the Council adopted the Collateral Directive in a very short time-frame, one year after the proposal of the Commission. This apparent contradiction may be explained by the fact that this Directive takes its inspiration from consolidated market practice, as embodied in the master agreements adopted by the financial market associations. Moreover, past case laws have often recognised legal arrangements such as repo contracts, close-out netting and marking to market, even though they were not expressly regulated by national civil law. Finally, the previous Directives paved the way for this comprehensive legislative intervention.

3.4.1 SCOPE OF APPLICATION AND PERFECTION REQUIREMENTS

The Collateral Directive[60] applies to public authorities, central banks, financial institutions subject to prudential supervision and central counterparties,

[59] COM (1999) 32.

[60] On the Collateral Directive, see J. Coiley, "New Protections for Cross-border Collateral Arrangements: Summary and Analysis of Draft EU Directive on Financial Collateral", in *Journal of International Banking Law* (2001), p. 119; G. Morton, "Modernization of EU Financial Law: The Directive on Financial Collateral Arrangements", *Euredia* (2003), pp. 11-40; and F. T'Kint and W. Derijcke, "La Directive 2002/47/CE concernant les contrats de garantie financière au regard des principes généraux du droit des sûrétes", *Euredia* (2003), pp. 41-57.

settlement agents and clearing houses; it also applies to non-financial entities other than natural persons, provided that the other party of the collateral arrangement is a public or financial institution as listed above (Article 1.2). The issue of its subjective scope proved very controversial in the course of preparatory work. The Commission had originally submitted that only large-sized legal persons other than financial institutions would be encompassed by the Directive[61], as the proposed legislation was addressed to the needs of the monetary and financial markets. Some delegations, by contrast, were in favour of extending the subjective scope to all undertakings, or even to natural persons, in order to avoid any disparity of treatment or segmentation of the credit market. Others supported instead a restrictive approach, since the Collateral Directive sets out a derogation to the insolvency law.[62] Final agreement was reached with the inclusion of an opt-out clause: Member States may decide to exclude non-financial entities from the scope of the Directive. To our knowledge, only a few countries have exercised this opt-out clause.[63]

Regarding its objective scope, the Directive applies to financial collateral, i.e. cash and financial instruments, taken for the purpose of securing financial obligations, namely obligations which give right to cash settlement and/or delivery of securities (Article 2.1 (d-f)). The ECB[64] suggested extending the notion of financial collateral in order to cover all types of assets that are eligible for Eurosystem credit operations, including credit claims in the form of bank loans. However, this proposal was not accepted, probably for procedural reasons.

The definition of collateral arrangements (Article 2.1 (a-c)) encompasses title transfer arrangements (i.e. arrangements, including repurchase agreements, under which a collateral provider transfers full ownership of the collateral to the collateral taker); and security arrangements (i.e. arrangements under which a collateral provider provides collateral by way of security to, or in favour of, a collateral taker, and under which the full ownership of the collateral remains with the collateral provider).

The Collateral Directive takes its inspiration from the "functional approach" typical of common law, which is based upon the underlying economic function of the collateral arrangements. Continental civil law, on the other hand, is based on the "formal approach", i.e. the provision of a specific form devoted to security (pledges).[65] The ECB has welcomed the functional approach, since it

[61] See the proposal of the Commission, in OJ C 180 E, 26.6.2001, p. 312.

[62] The ECB (in its Opinion of 13 June 2001, OJ C 48, 12.7.2001, p. 10, paragraphs 7-8) expressed concern that the application of thresholds would create uncertainty and as a compromise proposed that the provisions that do not deal with protection against insolvency, but with substantive law or the conflict of law rule, could be made generally applicable.

[63] Namely Austria, Malta, Slovakia, Sweden, France and Germany (in the latter three cases to a very limited extent). This implies that most states have solved the trade-off between a broader derogation to the civil and insolvency law regime and the risk of segmentation of the credit market and of choice of law shopping in favour of the first option.

[64] Opinion of the ECB, op. cit., paragraph 10.

[65] See G. Ferrarini, "Changes to Personal Property Security in Italy: A Comparative and Functional Approach", in R. Cranston (ed.), *Making Commercial Law – Essays in Honour of Roy Goode* (Oxford: Clarendon Press, 1997), p. 477. Ferrarini here recalls that the American Uniform Commercial Code was the first to adopt the functional approach. See also R. C. C. Cuming, "The Internationalization of Secured Financing Law: The Spreading Influence of the Concepts UCC, Article 9 and Its Progeny", in *Making Commercial Law,* op. cit., p. 499; and Coiley, op. cit., p. 119.

encompasses and protects all the collateral techniques adopted by the Eurosystem.[66] The functional approach implies the legal recognition of security based on title transfer arrangements (see Article 6) and, in particular, of repurchase agreements, which some jurisdictions did not consider valid yet or did not expressly regulate. In fact, the Collateral Directive goes even further than this by extending rights of use[67], of appropriation and close-out netting, which are normally linked to title transfer arrangements, to security collateral. It follows that the differences between the two legal forms of collateral are becoming increasingly indistinct.

For the purpose of its application, the Collateral Directive requires that financial collateral "has been provided" and that "provision can be evidenced in writing" (Article 1.5).[68] Provision is defined (Article 2.2) as collateral "being delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker". Evidencing the provision requires the identification of the financial collateral.[69] Recital No 9 explains that "provision" not only defines the scope of application of the Collateral Directive, but also sets out the "only perfection requirement that national law may impose in respect of collateral" (see also Article 3). The objective is to limit the "administrative burden for parties using financial collateral". The perfection or enforceability of collateral may not be subject to any other formal acts, such as those listed by Recital No 10. The Collateral Directive considers that this solution provides a balance between market efficiency and the safety of parties to the arrangement and third parties, thereby avoiding inter alia the risk of fraud. However, a distinguished scholar has criticised[70] the dismissal of any system of publication, since even the functional approach broadly recognises the need for publicity, which would also be easy to implement with modern technology, in order to protect the interests of third parties to obtain information on the assets of their debtors.

3.4.2 ENFORCEMENT

The Collateral Directive extends the privileged treatment on the enforcement of collateral recognised by the SFD for the benefit of central banks and systems to collateral arrangements entered into by the other parties covered by the Collateral Directive. Moreover, the derogation is not limited to disapplication of the *lex concursus*, as set out by the SFD, but also impinges on the *lex rei sitae*, since the special enforcement rules are also relevant upon the occurrence of events of default not related to insolvency.

The Collateral Directive is designed to introduce rapid and non-formalistic enforcement procedures with the aim of safeguarding financial stability and

[66] See the Opinion of the ECB, op. cit., paragraph 6.

[67] The recognition of the right of use is somewhat anomalous since it goes against the general principle *of nemo plus ius transferre potest quam ipse habet*, although the right is subject to the agreement of the collateral provider. On the right of use, see Morton, op. cit., p. 18. The Collateral Directive holds that the right of use will increase liquidity in financial markets (Recital No 19).

[68] The collateral arrangements under which collateral has been provided must be also evidenced in writing or in an equivalent manner (Article 1.5, 3rd sub-paragraph).

[69] For the purpose of book-entry securities collateral and cash, it is sufficient to prove that provision has been registered in the proper account (Article 1.5, 2nd sub-paragraph).

[70] G. Ferrarini, "Le garanzie su strumenti finanziari nel diritto comunitario: orientamenti e prospettive", in *Il Fallimento*, 9 (2002), p. 1003.

limiting contagion effects in case of a default of a party (Recital No 17). For this purpose, it leaves parties considerable freedom in the definition of enforcement mechanisms. However, discretion creates risks of abuse that may have a material impact on financial stability as well. The Collateral Directive only partially contrasts these side-effect risks, as this paper demonstrates below.

Collateral may take effect in accordance with the terms agreed in the financial arrangements, notwithstanding the commencement of winding-up or reorganisation measures (Article 4.4). The definition of reorganisation measures also includes cases in which authorities decide to suspend payments (Article 2.1 (k)). In such cases, rapid realisation may conflict with the interest of prudential supervisors in effective reorganisation measures and the stability of the financial system, as the ECB has also pointed out.[71] The same risk exists with regard to the definition of "enforcement events", i.e. events of default or similar events agreed between parties which may trigger the right of enforcement (Article 2.1 (l)). The provision seems to leave full discretion to the parties on the definition of what is "similar" to an event of default[72]: courts can hardly control the material relevance of such events on this basis.

Articles 4.1 and 4.2 define the enforcement procedures for security collateral arrangements. Financial instruments may be realised by sale or appropriation[73] (the latter only if parties have agreed and have determined the valuation of the financial instruments). Cash collateral may be realised by set-off. Article 4.4 specifies the principle of the rapid and non-formalistic enforcement procedure by clarifying that, subject to the terms agreed by the parties, realisation of collateral should not be subject to formal procedures as listed in the article (prior notice, approval of courts, public sale and waiting periods).

Article 7 provides for the full recognition of close-out netting clauses: these may take effect in accordance with their terms, and prevail on mandatory insolvency rules and on legal set-off mechanisms.[74] It is worth noting that the definition of close-out netting (Article 2.1 (n)) aims to include all the possible variants which the practice elaborates. Close-out netting provisions of derivative arrangements, such as the International Swaps and Derivatives Association (ISDA) master agreement or the European Master Agreement (EMA), should also be included in the scope of the definition to the extent that a financial collateral arrangement should form part of the derivative arrangement.[75]

The provisions briefly examined above (Articles 4 to 7) are subject, according to Article 4.6, to any requirement under national law to the effect that the

[71] See the Opinion of the ECB, op. cit., paragraph 13.

[72] The approach of the Directive reflects the current market practice embodied in the standard contractual documentation, which usually contains a detailed list of events of default or termination events.

[73] Member States that did not allow appropriation on 27 June 2002 are not obliged to recognise it. To our knowledge, no state has yet exercised its right to opt out.

[74] For more on netting, see P. R. Wood, *Title Finance, Derivatives, Securitisations, Set-off and Netting* (London: Sweet & Maxwell, 1995).

[75] According to Article 6.2 (on the recognition of title transfer collateral) and Article 5.5 (on the right of use), the obligation of the collateral taker to transfer equivalent collateral may also be subject to a close-out netting provision.

realisation or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted in a commercially reasonable manner. The Community legislator has therefore left it up to Member States to decide whether the collateral provider or third parties, including receivers or liquidators, should have any right to challenge the realisation procedure or the relevant clauses agreed by parties. This approach can be criticised[76], since a principle of harmonisation on this very sensitive issue would have been appropriate in order to avoid the risk of competing legal jurisdictions. However, it is acknowledged that the risk of abuse is substantially reduced when parties adhere to standard market documentation which sets out criteria for the realisation and valuation of financial collateral and the calculation of financial obligations.[77]

3.4.3 DISAPPLICATION OF INSOLVENCY LAW

Article 8 of the Collateral Directive provides for a minimum harmonisation of national insolvency rules which, in order to ensure compliance with the *pari passu* principle, regulates the validity of collateral arrangements entered into a prescribed period prior to the commencement of the insolvency proceeding or on the same day of commencement. These rules are peculiar in every jurisdiction: in some cases, automatic avoidance rules based only on the timing of transactions are in place, whereas in other cases the voidness of an act is subject to further or different circumstances, such as the detrimental nature of the act to the estate and the creditors or the bad faith of the counterparty. The Directive is intended to repeal just the national provisions that belong to the first category.[78]

Article 8.1 states that financial collateral arrangements and the provision of collateral under such arrangements cannot be declared void *on the sole basis* that they have come into existence or have been provided on the day of the commencement of the proceeding, but prior to the issuance of the decree (the “zero hour rule”), or in a prescribed period prior to the commencement of the proceeding (“the suspect period”). Article 8.2 ensures the validity of any collateral activity arising[79] on the same day of the proceeding but after its commencement, if the collateral taker proves its good faith.

The Collateral Directive further repeals the “zero-hour rule” with regard to collateral arrangements that lie outside the scope of the SFD. The protection of collateral provided after the commencement of proceedings is entirely new, as the SFD contains a similar provision to be used only “exceptionally” in the case of transfer orders (Article 3.1, 2nd paragraph).

[76] See also the Opinion of the ECB, op. cit., paragraph 13.

[77] In the wake of this, the Italian legislator (Article 8.1 of the Legislative Decree of 21 May 2004, No 170, in *Gazzetta Ufficiale della Repubblica Italiana*, No 164, 15 July 2004, p. 11), has stated that contractual clauses on realisation and valuation are presumed to be commercially reasonable if they are in line with contractual arrangements determined by the Banca d’Italia, in agreement with the *Commissione Nazionale per la Societa’ e per la Borsa* (the Italian supervisor for the stock exchange and financial markets), taking into account market practices on collateral arrangements.

[78] Subject to the contents of Article 8, the Directive leaves the general rules of national law unchanged in relation to the avoidance of transactions (Article 8.4).

[79] The provision applies where on such a day and after the commencement of the proceeding, a financial collateral arrangement or a relevant financial obligation has come into existence, or financial collateral has been provided.

Article 8.3 provides for special regulation of top-up collateral and substitution clauses.[80] These clauses regulate very common market practices in the financial markets, and are normally included in the standard market documentation. They are considered by regulators and supervisory authorities as a sound system for managing credit risk.[81] It is worth noting that the definition of top-up collateral does not cover collateral provided as a consequence of a deterioration in the financial soundness of the debtor: this is not accidental, as national insolvency law does not generally recognise protection to disposition of assets in favour of creditors that are aware of a deterioration in the financial position of their debtors.[82]

The Collateral Directive requires the repeal of national rules which provide for invalidity of provision of top-up or substitute collateral *on the sole basis* of the timing of the provision, as defined by Article 8.1, *and/or* on the basis that relevant financial obligations were incurred prior to the date of the provision of the top-up or substitute collateral.[83] As for Article 8.1, the wording "on the sole basis" implies that whenever national legislation makes the avoidance rule subject to requirements other than those set by Article 8.3, such as bad faith on the part of the collateral taker, there is no need for implementation in national legislation.[84]

3.4.4 THE EXTENSION OF THE PRIMA APPROACH

The Collateral Directive has extended the scope of application of the PRIMA to cases where the relevant account is located outside the EU. Article 9 of the Collateral Directive lists those matters that are regulated by the law of the location of the relevant account in relation to book-entry securities collateral (legal nature and proprietary effects, perfection and realisation, competing titles, etc.).

4 CONCLUDING REMARKS

The establishment of a EU legal framework on collateral has clearly substantially reduced the legal risks encountered by the Eurosystem and financial operators in financing operations. However, there are three main reasons why this process is far from complete.

[80] Article 8.3 (a) defines top-up collateral as an obligation to provide financial collateral or additional financial collateral in order to take account of changes in the value of the financial collateral or in the amount of the relevant financial obligations. A substitution clause (Article 8.3 (b)) entrusts the collateral provider with a right to withdraw financial collateral upon providing, by way of substitution or exchange, financial collateral with substantially the same value.

[81] In this respect, the Opinion of the ECB (op. cit., paragraphs 17 and 18) supports the protection of such clauses as a way of fostering the effectiveness of risk control management systems, including the risk control framework of the Eurosystem. In particular, the recognition of substitution of assets would allow financial operators to increase the effectiveness of collateral management, as well as to contribute to the smooth functioning of securities settlement systems by reducing settlement failures and thus enhancing financial stability.

[82] See Recital No 11 of the Commission's proposal.

[83] In fact, the existence of a time-lag between the existence of the financial obligation and the provision of collateral is often considered by insolvency law as evidence of an absence of consideration or of the existence of fraud.

[84] See Morton, op. cit., p. 35.

Firstly, the WUD and the Collateral Directive have not yet been implemented by all Member States, notwithstanding the expiry of the envisaged deadlines. The assessment of consistent implementation among Member States will be crucial in order to ensure a level playing-field in the markets and the proper functioning of the adopted rules in a cross-border context.

Secondly, the Eurosystem's legal framework on collateral is subject to adaptation prompted by the process of consolidation of the regulatory and operational framework. A notable example is the recent decision[85] to include credit claims in the form of bank loans in the prospective single list of eligible collateral. Credit claims have not been regulated by the examined EU Directives. Some harmonisation of national legislation concerning this kind of collateral might be warranted, as recalled by the ECB in its Opinion on the Collateral Directive.

Thirdly, regulation on book-entry securities remains at the top of the agenda of the Community legislator in the field of financial law. As far as international private law is concerned, the possible ratification of the recent Hague Convention would require amendments to the Directives at hand.[86] In the meantime, the Commission has announced that it intends to propose harmonising substantive law on interest in securities with an intermediary, as the absence of such a law is now considered to be the most important source of legal risk in cross-border transactions.[87]

[85] See the last version of the General Documentation, footnote 29.

[86] Reference is made to the Hague Convention "on the law applicable to certain rights related to securities held with an intermediary". The Convention has adopted a different approach based on the agreement between the intermediary and the account holder. See D. Devos, "The New Hague Convention on the Law Applicable to Securities Held with an Intermediary and Its Relevance for the ESCB's Cross-border Use of Collateral", collected in this book.

[87] On this project, see the Communication of the Commission of 28 April 2004 on "Clearing and Settlement in the European Union – The Way Forward" (COM (2004) 312). The International Institute for the Unification of Private Law (UNIDROIT) has been working on the same project and has already produced a preliminary draft convention (available at www.unidroit.org).