

# ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN · BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN  
BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E.V. BERLIN · DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN  
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

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## **Directive 2002/47/EC on Financial Collateral Arrangements Questionnaire to the Private sector for the drafting of the Evaluation Report - Re- sponse of the Zentraler Kreditausschuss**

Dear Mr. Thorsén,

we would like to cordially thank for the opportunity to respond to your questionnaire for the drafting of the Evaluation Report on Directive 2002/47/EC on Financial Collateral Arrangements. Please find attached our comments on this questionnaire.

Yours sincerely

For the Zentraler Kreditausschuss  
Federal Association of German Cooperative Banks/  
Bundesverband der Deutschen  
Volkbanken und Raiffeisenbanken

 by proxy 

Jochen Lehnhoff

Dr. Holger Mielk

**Enclosure**

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## **Response of the Zentraler Kreditausschuss<sup>1</sup>**

### **to the Questionnaire to the Private sector for the drafting of the Evaluation Report on**

### **Directive 2002/47/EC on Financial Collateral Arrangements**

31 March 2006

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<sup>1</sup>The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR) for the cooperative banks, the Bundesverband deutscher Banken (BdB) for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB) for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV) for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,300 banks.

## **A. General Remarks to the implementation of the Directive:**

There have been apparent divergences in the implementation by the various Member States of the personal scope of the Directive 2002/47/EC on Financial Collateral Arrangements (the “Directive”) in Article 1(2) regarding the potential parties to financial collateral arrangements benefiting from protection under the new regime. The right to opt-out under Article 1(3) of the Directive was exercised differently. Some Member States have chosen a personal scope which either provides for more graded limitations or for a wider application than was intended by the Directive. This diversity brings difficulties when trying to evaluate the new regime for collateral transactions. As a result of these variations, legal uncertainty is felt still.

As far as the implementation in Germany is concerned, Germany has included corporations and partnerships where the counterparty meets the criteria referred to in Article 1(2)(a) through (d) of the Directive and the collateral is provided for the purchase, sale, repurchase, lending or similar transaction in relation to a Financial Instrument<sup>2</sup>, or for a loan financing the purchase of a Financial Instrument. Cash loans are intentionally not included.

## **B. Most important required improvements:**

Due to the uncertainties mentioned under question number 9 and 10 concerning Article 7, there is a need for legislative clarification on the scope of protection for insolvency close-out netting arrangements under EC law. We would recommend extending the application range.

## **C. Remarks to single questions (Q1 - Q11)**

### **Q1: What are the positive impacts of the Directive?**

Legal certainty of financial collateral arrangements including e. g. the technique of bilateral close-out netting has been improved as it was ensured that certain provisions of insolvency law do not apply to financial collateral arrangements.

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<sup>2</sup> The term „Financial Instrument“ is based on Council Directive 93/22/EEC of 10 May 1993 on the investment services in the securities field. During the upcoming implementation of the revised Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions (Basel II) the German legislator will probably adopt the new definition of “Financial Instrument” used therein. Whether this will impact the scope of the personal application is not yet predictable.

The positive impacts can be seen beyond the Directive's periphery, as impulses resulted in a stronger usage of collateral by banks.

**Q2: Have those whom the directive was intended to benefit encountered a reduction of burdens as a result of the new regime?**

(Please see answer to Q1 above).

The intended reduction of formal requirements is one benefit – even if these requirements (e.g. necessity of registration of collateral or to provide a certain date) are in fact not completely abolished, due to the fact that law firms continue to advise complying with these requirements.

**Q3: Have those whom the directive was intended to benefit encountered favourable effects for their risk management as a result of the new regime?**

The actual effects for risk management are difficult to measure as the collateral instruments in question were established before the Directive and as collateral agreements were in practice at least since the beginning of the 90's. They became part of best banking practice prior to their legislative regulation. However, the willingness to rely on financial collateral has improved as the comfort level when applying such instruments was strengthened through the Directive's implementation. This correlates with the Basel II framework under which banks are encouraged to use risk mitigation techniques because the possibilities of obtaining regulatory recognition have been expanded. The Directive was therefore beneficial in so far as it enhanced the awareness and the range of options to meet the aforementioned requirements. Also, the incentives of Basel II were secured by the Directive.

**Q4: Has the use of collateral been increased in the EU?**

As described under the answer to question No. 3, the use of collateral has been increased continuously over the last years. This growth is mainly attributed to the anticipation of the new Basel II Framework. Overall, the Directive provided more

legal comfort and definitely supported the trend of collateralisation in a very positive manner.

**Q5: Do you have any materials that reveal the extent to which the achievement of the objectives of the Directive may be measured (for example, statistics about use of collateral)?**

Due to the lack of representative updated statistics, the extent of the Directive's achievement of objectives is difficult to evaluate at this time. The International Swaps and Derivatives Association Inc. (ISDA) conducts yearly surveys amongst its members assessing, amongst other issues, the use of collateral under the ISDA Credit Support Documentation. These ISDA Margin Surveys indicate that the estimated value of collateral has grown globally from 250 million USD in 2001 to 719 million USD in 2003 to 1.2 billion USD in 2005. The figures presented are global figures and there is no break-down in respect of the European Member States available. However, an estimate of 33% of the collateral is "European" collateral (consisting of EUR or GBP cash or European government bonds). The International Capital Market Association (ICMA) performs similar surveys for the European Repo Market, which shows comparable increases. In addition to that, the use of collateral agreements has increased within the last years. Especially, the European collateral programs grew which is certainly to an important extent triggered by the Directive.

**Q6: Are you aware of any developments or innovations in market practice that would justify reviewing the effectiveness of the Directive?**

There have been developments especially in the area of additional collateral (Article 8 (3)(a)) (also referred to as "top-up"-collateral – see recital 17).

The issue could be described with "rating – dependent requests for additional collateral". As a consequence of rating-sensitive assessments of regulatory capital we observe an increase of threshold and minimum transfer amounts linked to a party's credit rating (and to some extent linked to the Net Asset Values [NAV] of a counterparty) as new criteria that may lead to an obligation to provide additional collateral, e.g. if a downgrade occurs. We therefore recommend to extend the scope of the Directive as suggested under Q10.

**Q7: Are there any negative impacts of the Directive?**

We are not aware of negative impacts.

**Q8: Is there any implementation cost due to the Directive?**

As far as direct costs are concerned, we did not notice any.

**Q9: Specify any major problems of transposition or interpretation that occurred of which you are aware.**

Article 7:

The Directive contains the most appropriate provision to cope with close-out netting compared to previous directives and/or regulations so far.

Member states should be encouraged to implement Article 7 in the broadest sense possible (i.e. not restricted to the scope of financial collateral arrangements) in order to create more legal certainty in the context of financial market trading activities which is one of the paramount targets to be achieved by this Directive.

Article 8:

The possibility to challenge the provision of collateral within certain periods before the opening of insolvency proceedings (“suspect periods”) has been eliminated, but only if the collateral taker has a right to require the collateral at the time (e.g. in the context of a margin call). Collateralization agreements made within these periods in relation to existing, previously uncollateralized business may still be challenged.

**Q10: Do you have any suggestions for specific revisions to the Directive? If so, please explain what they are.**

Recital (14):

Banks engage in physically settled trades in commodities. Under the Basel II framework, as far as trading book treatment or the recognition of collateral for exposure in the trading book is concerned, financial instruments and commodities are governed by the same rules. In order to further support the regulatory recognition of collateral as an important risk mitigation technique and the positive incentives the Directive should also cover those commodities.

We would therefore like to suggest a revision of Recital (14) to read as follows:

*“The enforceability of bilateral close-out netting should be protected, not only as an enforcement mechanism for title transfer financial collateral arrangements including repurchase agreements but more widely, where close-out netting forms part of a financial collateral arrangement. Sound risk management practices commonly used in the financial market should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions and transactions in commodities on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of the collateral.”*

Article 2 (1)(b):

As far as cash and title transfer cash collateral is concerned, Article 2 (1)(b) does not properly reflect the market practice. Cash (other than physical money in the form of notes and coins) is no property, but a claim against the bank holding the account. Cash collateral is provided by credit transfer. It is uncertain whether the credit transfer of “book money” to the counterparty – which is carried out by instructing the bank to crediting the account to the other beneficiary – would be recognized as Financial Collateral.

A transfer of ownership in cash, as referred to in the definition of Title Transfer Financial Collateral Arrangements is inconceivable in German law. Thus it is uncertain whether Collateral which is constituted by way of credit transfer to an account held by the collateral taker may fall within the scope of the application of the rules of the Financial Collateral Arrangements.

Our proposal for Article 2(1) (b) is therefore to include the words “or transfers monies” so it would read:

*“ ‘title transfer financial collateral arrangement’ means an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of financial collateral or transfers monies to a collateral taker for the purpose of securing*

*or otherwise covering the performance of relevant financial obligations.”*

Articles 2, 3 and 7:

In some Member States the implementation of the collateral directive appears to have lead to the peculiar situation that master agreements with collateral support annexes are considered enforceable whereas netting agreements without credit support annexes are not enforceable. Moreover, in other jurisdictions the implementation of the Directive seems to show the obviously not intended result that netting agreements without collateral arrangements are deemed to be enforceable whereas the agreement of collateral arrangements in addition to a master netting agreement could harm the enforceability of the close out netting provision. These results do not make sense as both parts form a unity in the context of close-out netting. Further, the enforceability of stand-alone netting agreements is equally important. Therefore the following revisions are suggested:

Article 2(1)(n) -Definitions:

*“(n) ‘close-out netting provision’ means a provision of an arrangement whether or not such arrangement forms part of a financial collateral arrangement, or, in the absence of any such provision, any statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise:”*

Article 3 – Formal requirements and Article 7 - Recognition of close-out netting provisions:

We recommend for Article 3(1) to insert the words

*“a close-out netting provision, transactions entered into under a close-out netting provision,”*

after

*“... or admissibility in evidence of”.*

Article 7 still requires a “collateral provider” or ”collateral taker”, i.e. a close-out netting agreement that is secured or accompanied by a collateral arrangement. We

therefore propose to replace 1(a) of Article 7 by the following:

*“(a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of a party to the close-out netting provision; and or (b) ....”*

Article 8 – Certain insolvency provisions disapplied:

There is a need to protect close-out netting provisions and transactions entered into thereunder from measures mentioned in Article 8. In some European jurisdictions bankruptcy courts challenged the master agreement or transactions concluded under the master agreement just for the reason that they are entered into between the parties within a prescribed period of time. We hence propose that Article 8(1) should be amended as follows:

*“1. Member States shall ensure that a close-out netting provision, a transaction entered into under a close-out netting provision, a financial collateral arrangement, as well as the provision of financial collateral under such arrangement, may not be declared invalid or void or be reversed on the sole basis that the close-out netting provision, the transaction entered into under a close-out netting provision, or the financial collateral arrangement has come into existence, or the financial collateral has been provided:”*

Article 8(3)(a) - top-up collateral:

We would like to suggest the following:

*“(a) 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 obligation or a material adverse change in the creditworthiness of the collateral provider that is reflected in a deviation from agreed ratings, financial covenants or other objective criteria.”*

**Q11: Article 10 of Directive 2002/47/EC on Financial Collateral Arrangements stipulates that the Commission's report on the application of the Directive should deal in particular with the application of Article 1(3), Article 4(3) and 5. Please make any comments you think it would be helpful for the Commission to receive about these provisions.**

The collateral taker must be able to exercise the right of use set out in Article 5 regarding financial collateral taking the form of a restricted security right in rem (pledge). This right of use has to be ensured by the Member States. Although the right of use has not been taken up specifically in German legislation, the doctrine of the irregular pledge has been developed by case law and jurisprudence. Nevertheless, legal certainty would be enhanced (particularly from the point of view of non-German counterparties) by a statutory clarification with regard to the collateral taker's right to use the collateral assets. Non-German counterparties in particular have to some extent difficulties in comprehending the German concept of irregular pledge, which leads to questions regarding the German Law legal opinion on the ISDA Credit Support Documents from time to time.