# European financial markets: financial collateral arrangements and legal certainty, consequences on the SMEs

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PURPOSE : to protect the provision of financial collateral on a bi-lateral basis between two parties to a collateral agreement. CONTENT : since beginning of the 1990's a number of professional bodies have raised awareness about the legal uncertainty faced by payment and securities settlement systems, central banks and participants in the financial markets. This is reflected in the increasing flows in these systems and their signficance for a well functioning modern society. The increased volumes also caused a higher degree of credit exposure for market participants, giving them strong incentives to reduce risk through netting or collateralization. The 1998 Directive on Settlement Finality constitued a milestone in establishing a sound legal framework for payment and securities settlement systems. This Directive is to date the only piece of European legislation regulating cross-border collateral in the context of financial transactions. Further measures are needed to facilitate the efficient use of cross-border collateral. In order to study this issue, the Commisison constituted a Forum Group on Collateral in 1999. In light of this process it has reached the conclusion that the most appropriate way forward is the adoption of a EU Directive on the use of Collateral, by which the sound legal basis laid down by the Settlement Finality Directive for payment and securities settlement systems would be extended generally to transactions in financial markets. On the whole, this present proposal focuses on the provisions of collateral between two parties to a collateral arrangement. The principle objectives of the proposed Directive are: - ensuring that effective and reasonably simple regimes exist for the creation of collateral under either title transfer (including repo) or pledge structures, (i.e. providing that the only perfection requirement or procedure to follow to protect a collateral agreement should be that the interest be notified to, and recorded by, the relevant intermediary maintaining the securities account; - providing limited protection of collateral arrangement from some rules of insolvency law, in particular those that would inhibit the effective realization of collateral or cast doubt on the validity of techniques such as close-out netting, the provision of top-up collateral and substitution of collateral; - creating legal certainty regarding the conflict of laws treatment of book entry securities used as collateral in a cross-border context by extending the principle adopted in Article 9(2) of the Settlement Directive; - limiting the adminstrative burdens affecting the use of collateral in the financial markets by restricting the imposition of onerous formalities on either the creation or the enforcement of collateral arrangements; - ensuring that agreements permitting collateral taker to re-use the collateral for its own purposes under pledge structures are recognised as effective, as for repos. Lastly, a sound and efficient legal regime for limiting credit risk through the use of collateral will improve the functioning and stability of the European financial markets. ?