

*Proposal for a Directive on financial Collateral arrangements
COM(2001) 168 final*

ISDA Statement of position

ISDA welcomes the Commission's proposal of 27th March, 2001 for a Directive on financial collateral arrangements. ISDA continues strongly to support this initiative, and welcomes the proposal as an important stage in the completion of an integrated European capital market.

The International Swaps and Derivatives Association, Inc. ("ISDA") is an international organisation with more than 500 members [list attached]. These members include the world's leading dealers in privately-negotiated derivative transactions. In addition, ISDA's members include many of the businesses, financial institutions, governmental entities and other end-users that rely on privately-negotiated derivative transactions to manage their financial and other market risks with a degree of efficiency and effectiveness that would not otherwise be possible.

We are pleased to see that many of the issues raised by ISDA during the drafting stage have been addressed in the new proposal.

This initiative is very important, with significant benefits for the European financial markets in increased efficiency and legal certainty in relation to collateral markets, improving pricing efficiency in the market, deepening the market, reducing credit and systemic risk, strengthening the European financial system and improving its competitiveness relative to other markets in the global economy.

The key issues raised for our members by the current draft of the Directive are:

- 1) the scope of the Directive in terms of persons who may benefit
- 2) the treatment of ratings-related "top-up" deliveries of collateral
- 3) clarification of the provisions dealing with a collateral taker's right to use collateral

In addition, we have various more minor comments on various aspects of the Directive (to be submitted under separate cover), which we hope will be helpful in finalising the text.

1. Scope of the Directive: persons who may benefit

For our members, the most important point raised by the draft Directive concerns its scope in terms of the persons to whom it applies. The chief concern is that Article 2(4)(c), which deals with persons other than public authorities, central banks and financial institutions, excludes many important participants in the market.

We understand that the Commission believes that the current definition would cover roughly 95 per cent. of counterparties in the wholesale financial markets. This is at odds, however, with the experience of our members, whose own estimates of the percentage of such counterparties *excluded* from the Directive range from 15 to 75 per cent. of their market. Among a representative sample, the largest members of ISDA tended to have the highest proportion of their counterparties for collateralised trading excluded from the Directive.

Our members embrace a wide range of sizes, forms of organisation and business specialisations. It is clear, however, that many important classes of counterparty would be excluded from the Directive, with implications for financial system stability. For example, many corporate end-users of the wholesale financial markets in privately-negotiated derivative transactions, securities repurchase and stock lending transactions would be excluded. So would most hedge funds. (We assume, moreover, that the term "financial institution under prudential supervision" [used in Article 2(4)(b)] would be construed so as to include asset management entities and insurance undertakings, as well as credit institutions and investment firms. Certainly, all these classes of entity are major potential beneficiaries of the Directive and should, in ISDA's opinion, be included.)

The exclusions clearly raise questions of potential systemic risk, since the enhanced risks identified in the report of our Collateral Law Reform Group published in December 1999 and in a number of similar studies would continue to apply to significant portions of the business of leading financial market participants. Also, given the interdependence of the market (with structured financial transactions with a number of components, as well as hedging and back-to-back transactions), legal uncertainty in relation to collateral supporting one part of a structure or chain risks weakening the other parts.

Members have also raised a number of technical questions about the operation of Article 2(4)(c). How is "capital base" defined? How is "gross assets" defined? What happens under a mark-to-market collateral arrangement, where deliveries are made on a regular basis throughout the term of the arrangement, if for any reason the capital base or gross assets of a person fall(s) below the relevant threshold. Would the old rules then apply to the whole arrangement, with consequent problems, for example, if old and impractical perfection requirements then apply?

It is counter-intuitive to exclude from the scope of the Directive smaller corporate collateral providers, as this class of counterparty may well span a broader range of credit quality. It also belies the Commission's stated intention, both in the Explanatory Memorandum and in the Impact Assessment Form, that the Directive is intended to benefit small and medium-sized enterprises (SMEs).

Finally, it is not clear what the policy reason is for excluding any corporate entity from the effect of the Directive. The Directive benefits both the collateral provider and the collateral taker, by improving the former's ability to access the markets on a collateralised basis and enhancing the latter's confidence in its credit and legal risk management.

ISDA urges the European Parliament and the Council to widen the scope of the Directive to include all corporate counterparties.

2. The treatment of ratings-related "top-up" deliveries of collateral

Many members have pointed out the prevalence of ratings-related thresholds, transfer amounts and other "trigger levels" in current collateral documentation. They would like to see Article 9 extended to cover such provisions. The Explanatory Memorandum indicates that this type of provision was excluded from Article 9 because, "it conflicts more directly with insolvency law policy, which in general discourages provisions under which a creditor's position is improved as a result of, or at the time of, an insolvency related event or at least a context of degraded or deteriorating credit-worthiness".

In a certain sense, of course, all collateral arrangements are intended to improve a creditor's position in the eventual insolvency of the collateral provider relative to unsecured creditors. The question is where to draw the line from a policy point of view between protecting the

legitimate function of collateral as a credit risk mitigation tool and invalidating unlawful preferences and similar transactions.

The use of ratings-related trigger levels – as distinct from trigger levels tied explicitly to insolvency proceedings – results in a more efficient use of collateral and in a more cost-effective use of collateral from a collateral provider's point of view. Because the trigger is ratings-related, it is objective and not within the discretion of the collateral provider or the collateral taker, so there is no element of intentional preference, often an important element in such rules, at the time it is invoked.

It is important to recognise that ratings downgrades are not synonymous with or inevitably followed by insolvency. Downgrades (and upgrades too) are far more common than insolvency, and merely indicate a change – often a small change – in probability of default. It is entirely appropriate that this change in probability is recognised in the terms on which a party may gain access to financial markets – just as the initial probability is assessed at the outset of any arrangement.

In the absence of protection for ratings-related "top-up" deliveries of collateral, it is highly likely that market participants would have to demand higher levels of collateral at the outset than would otherwise be the case (which is not particularly cost effective for corporate collateral providers with good credit ratings). Also, financial institution collateral takers would possibly have to rely, in the absence of ratings-related collateral requirements, on ratings-related early termination events, "break" clauses and the like. Widespread use of such clauses would arguably be more disruptive and entail a higher degree of systemic risk, for example, in the event that a large hedge fund gets into financial difficulties, than reliance on ratings-related collateral provisions.

A consequence of upholding the current exclusion of ratings-related "top-up" deliveries of collateral would be considerable disruption and administrative burden to market participants, who would have to renegotiate agreements or else see these fall outside the scope of the Directive.

ISDA urges the European Parliament and the Council to revise Article 9 to include ratings-related "top-up" deliveries of collateral.

3. Clarification of the provisions dealing with a collateral taker's right to use collateral

A number of our members have commented that the treatment of a collateral taker's right to use collateral taken under a security financial collateral arrangement ("SFCA") is not as clear in the draft Directive as it was in the draft of June 2000. The June 2000 draft made it clear, in Article 6(1), that a collateral taker under a SFCA only has the right to use collateral if the terms of the SFCA so provide. The comparable provision in the new draft now appears in the definition of the term "right of use" in Article 3.

This appears to be essentially a drafting point, which may be addressed in a number of ways. One possibility would be to amend the words "in accordance with" in the definition of "right of use" to read as follows: "if such a right is provided in".

Uncertainty on the right to use also needs to be addressed in the drafting of Article 6(1) of the current draft Directive, which appears to apply regardless of what is provided in the relevant SFCA. What happens, in other words, if there is a conflict between this provision and the drafting of the SFCA. When does the obligation under Article 6(1) actually arise? If it arises immediately on the use of the collateral by the collateral taker, how soon does it need to be satisfied? In other words, is it a breach of this obligation if the collateral provider does not

transfer equivalent collateral into the relevant collateral account so as to become subject to the SFCA within a particular period? If so, how long is that period?

We raised a number of questions on the equivalent provision (Article 6(3)) of the June 2000 draft proposal at that stage. These questions do not appear to have been addressed in the final proposal.

ISDA urges the European Parliament and the Council to clarify the provisions of the draft Directive dealing with a collateral taker's right to use collateral.