CHANGES TO THE UK FINANCIAL COLLATERAL REGIME WILL INCLUDE CREDIT CLAIMS AND MAY CLARIFY TREATMENT OF FLOATING CHARGES

Source: Ashurst

The Financial Collateral Arrangements (No.2) Regulations 2003 (the **Financial Collateral Regulations**) implement the EU Financial Collateral Directive [1]. Collateral arrangements which fall within the Regulations have a number of advantages over those which do not. New regulations published by the UK Treasury [2], which themselves implement an amending Directive [3], will:

- include claims under credit agreements as eligible "financial collateral",
- clarify the scope of security interests which can constitute "financial collateral arrangements", in particular benefiting some structured repo trades, and
- resolve some (but not all) of the associated conflicts-of-law issues.

The new regulations will take effect on 6th April 2011.

CREDIT CLAIMS WILL CONSTITUTE FINANCIAL COLLATERAL

The main change is that credit claims may now be provided as financial collateral within the meaning of the regulations. "Credit claims" here are defined, broadly, as claims arising out of an agreement under which a credit institution grants credit in the form of a loan. This change, which has been well trailed, should help market participants to mobilise credit claims as collateral in financing operations and ultimately may open up, via the growing long term repo market, alternative funding options for such assets.

MEANING OF "POSSESSION"

The Financial Collateral Regulations require that, for a security interest to constitute a financial collateral arrangement, the relevant collateral be within the possession or control of the collateral taker. Recent case law [4] has indicated that "possession" was not relevant in the context of intangible assets and required a high level of "control", including the legal right to prevent a collateral provider from dealing with the relevant assets prior to enforcement - which would be generally inconsistent with an English floating charge. Under the new regulations, "possession" will now include the case where cash or financial instruments have been credited to an account held by or on behalf of the collateral taker, whether or not the collateral is then further credited in the books of such account holder to an account of the collateral provider, and provided that the collateral provider's rights in such collateral are limited to the substitution of collateral with new collateral of the same or greater value or withdrawal of excess collateral.

Where security interest arrangements can be drafted to benefit from this change, (that is, where the rights of the charger are appropriately restricted) a wider range of such arrangements should now fall within the scope of the Financial Collateral Regulations - even if those arrangements would be characterised as floating charges.

The amendment also clarifies the treatment of security structures where the collateral-taker is acting as custodian for the collateral provider (for example, in prime brokerage arrangements).

SUBSTITUTION OF COLLATERAL

Historically there has been a concern that repo transactions, which operate on the basis of an outright sale for legal purposes, could be re-characterised as the grant of a floating charge if the repo seller (that is, in this context, the collateral provider) retained unfettered rights of substitution over the repo securities. Whilst the degree of concern was not necessarily high, the potential downside was significant, in that the transaction (if re-characterised) would be void as against liquidator of the repo seller for lack of registration.

This downside is mitigated if the "floating charge" qualifies as a security financial collateral arrangement, as such arrangements are exempt from registration. The Financial Collateral Regulations state expressly that rights of substitution do not preclude a security interest from being an eligible financial collateral arrangement, and hence exempt from the registration requirement. However, in a quirk (or error) of UK implementation, substitution in this case was defined as the right to substitute identical assets, rendering that exemption more-or-less pointless. Accordingly, there was a related concern that substitution rights would make this exemption from the registration requirement unavailable. The new regulations amend the position to protect transactions which contain a right to substitute assets of the same or greater value.

CONFLICTS OF LAWS

The new regulations provide that the English courts will not recognise or enforce orders of a foreign court or foreign insolvency proceedings insofar as the same would not have been permitted under the relevant parts of the Financial Collateral Regulations. It is worth remarking however that the Treasury has left unresolved some other complicated conflicts of laws issues arising out of the Financial Collateral Regulations.

References

(1) Directive 2002/47/EC

(2) Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010, SI 2010/2993)

(3) Directive 2009/44/EC

(4) Gray & Ors v G-T-P Group Ltd Re F2G Realisations Limited (In Liquidation), [2010] EWHC 1772