ACLE Seminar 'Multifaceted Collateral in the Prism of Laws'

Abstract

In 2002, the European legislature considered that a legal framework to facilitate financial collateral transactions such as repurchase agreements (repos), securities lending and derivatives would 'contribute to the integration and cost-efficiency of the financial market as well as to the stability of the financial system' in the EU. Market practice and industry standards have consistently been facilitated by legislatures across the globe, even when having to derogate from longstanding rules of property and insolvency law. For instance, netting in the context of collateral transactions has been widely protected, also in insolvency, whilst the enforcement and recognition of security rights under these transactions has been liberalised.

However, since the 2007/2008 Global Financial Crisis, international legislators and policymakers acknowledge the major role that collateral transactions may play in connection with undermining (rather than promoting) financial stability. More specifically, repos were instrumental in the failure of Lehman Brothers, while securities lending and derivatives transactions had similar effects in connection with the demise of AIG. Both events were a catalyst in triggering the biggest worldwide recession in decades.

The rules supranational legislators have laid down to both facilitate and restrict collateral transactions relate to several fundamental issues of law: among other things, they concern the creation and priority of security rights, the formalities to transfer securities and cash credited to accounts, the reuse of collateral, recharacterization (of title finance) by the courts and safe harbours in bankruptcy. In other words, prompted by dramatic economic events, legislators have thought it appropriate to re-evaluate fundamental concepts of private law, but these responses have largely been of a public or administrative law nature. This is all the more significant since in only very rare instances private law concepts as fundamental as ownership, its transfer, creditor priority and the creation of security interest are revisited at the supranational level. This is important both as a theoretical and practical matter—not often do international regulators require changes in private law, which ordinarily remains exclusively a national affair.

It is these developments that have prompted the writing of our new book titled 'Financial Collateral: Law and Practice', exploring the concept and use of financial collateral from a legal and practical perspective. Yet there is an additional, more economic reason why collateral in international finance transactions should be the topic of current research: financial collateral now has money-like equivalence and has therefore become an increasingly important component in financial markets. For instance, regulators and supervisory authorities across the globe now require that important categories of derivatives are centrally cleared (in the EU under the Regulation on Market Infrastructures (EMIR) and in the US under Title VII of the Dodd-Frank Act), and financial collateral must invariably be posted in the context of such mandatory clearing.

Moreover, policy makers and central banks have sought to use the ('lending') rate used in repos to inject liquidity into the economy in an attempt to address the severe economic crisis caused by the COVID-19 pandemic. Thus, again, collateral plays a critical role in a major economic development, and it remains to be seen to what extent the current crisis will require fundamental changes as to collateral's legal framework.