BDK Newsletter

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MONTENEGRO: FINANCE

FINANCIAL COLLATERAL ACT

The Montenegrin Parliament adopted legislation regulating financial collaterals (*Zakon o finansijskom obezbeđenju, "Official Gazette of the Republic of Montenegro", no. 44/12*) ("**Financial Collateral Act**"). The law came into force on 16 August 2012. Even though Montenegro is not yet a Member State, the legislation implements the EU Financial Collateral Directive.

The Financial Collateral Act applies if the non-Montenegrin collateral taker or the collateral provider is one of the undertakings listed in Article 1(2) of the Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements or, in the words of the Financial Collateral Act:

(i) public sector body of an EU Member State charged with or intervening in the management of public debt or holding accounts for customers (excluding the entities whose debts are guaranteed by the state);

(ii) a central bank of an EU Member State;

(iii) the European Central Bank, the Bank for International Settlements, the European Investment Bank, and the International Monetary Fund and a number of listed multilateral development banks (the International Bank for Reconstruction and Development, the International Finance Corporation etc);

(iv) a financial institution from a EU Member State subject to prudential supervision including:

- (a) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits in another's name and for its own account [sic!] (this is probably a drafting error);
- (b) an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the principal financial activities;
- (c) an investment firm the regular occupation or business of which is the provision of investment services for third parties on a professional basis and other undertakings operating under the regulations governing investment firms;
- (d) an insurance undertaking, operating in accordance with the regulations applicable to the insurance business;
- (e) an undertaking for collective investment (presumably in transferable securities, although the law omits to spell this out);
- (f) a company managing an undertaking for collective investment in transferrable securities;

(v) a central counterparty, settlement agent or clearing house, including institutions acting in futures, options and the financial derivatives markets of EU Member States;

(vi) a legal person acting in a trust or representative capacity on behalf of any one or more persons that includes any bondholders or holders of other forms of securitised debt or any institution as defined in points (i) to (v) above.

With respect to the Montenegrin collateral takers or providers, the Financial Collateral Act applies to:

(j) public sector bodies in charge of managing public funds;.
(ii) the Central Bank;
(iii) banks, microcredit financial institutions, undertakings engaged in credit and guarantee services;
(iv) the Central Depository Agency;
(v) the state Fund for Health Insurance
(vi) the state Fund for Pension Insurance;
(vii) the Investment-Development Fund of Montenegro;
(viii) insurance companies;
(ix) investment funds and investment fund management companies;
(x) brokers

Financial collateral comprises financial instruments, monetary funds (money deposits and claims for account balance, but not cash) and credit claims.

The Financial Collateral Act allows both title transfer and the creation of a pledge on financial collateral, thus fitting into both types of the ISDA Credit Support Documentation (Transfer - English Law, as well as Security Interest- English Law and Security Interest – New York Law). The pledgee (other than the pledgee of a credit claim) has the right to use the collateral as if it were its owner, which includes the right to rehypothecate the collateral.

An agreement on financial collateral can be concluded orally, but has to be evidenced in writing.

In case of default, the collateral taker under a pledge arrangement is authorized to sell, retain or net the collateral. Retention of a financial instrument or set-off of collateral taker's claim against the value of the credit claim given as collateral is permitted only if the pledge agreement provides for such retention/set-off, as well as for the evaluation of the collateral.

The Financial Collateral Act shields the financial collateral arrangements, including close-out netting effected there under, from insolvency of the collateral taker. Netting shall not be affected by the taker's or the provider's insolvency. The financial collateral arrangements made or implemented prior to the opening of insolvency proceedings against the collateral provider shall not be vulnerable solely on the basis of the provider's insolvency. The arrangements entered into after the opening of insolvency proceedings against the provider shall survive if the taker was not aware and was not required to be aware of the opening of insolvency proceedings against the provider.

Although the adoption of the Financial Collateral Act is a welcome step on Montenegro's complicated journey of harmonization with the EU *acquis,* it seems to be ahead of the current level of the development of the Montenegrin financial market. Notably, no financial collateral regulation exists in neighbouring Serbia, which has a more mature financial market. In any event, the implementation of the EU Financial Collateral Directive is a positive development, although it is not sufficient to instigate sophisticated financial transactions.

It should be also noted that the Financial Collateral Act is divorced from the regulations applicable to the underlying financial derivatives transactions (primarily, the general Insolvency Act and a special insolvency regulation applicable to banks), which do not support close-out netting and do not shield the derivatives transactions from avoidance as is the preference in cases of insolvency of the Montenegrin counterparty.

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