Serbia: Draft Financial Collateral Act - A Welcome Initiative

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Introduction

The International Swaps and Derivatives Association (ISDA) published in March 2000 a document in which it briefly outlined the principles that an effective and efficient modern legal regime for collateral arrangements should embody[1]. Sixteen years later, Serbia still does not have legislation dedicated to creation and enforcement of eligible financial collateral. With respect to securing obligations between financial market participants, the application of general security and insolvency rules is universally recognized as inefficient, cumbersome and unpredictable.

The legal gap that exists in the Serbian legal system concerning financial collateral is soon to be filled-in. The National Bank of Serbia ("**NBS**") has circulated for public debate a draft Financial Collateral Act based on the EU Directive on financial collateral arrangements (2002/47/EC) ("**Financial Collateral Directive**"). In this paper we analyse, among other things, whether the draft adequately reflects the objectives of the Financial Collateral Directive, and whether it meets the ISDA long-established standards.

Scope of the application of the proposed Financial Collateral Act

According to draft Article 3, the Financial Collateral Act will be applicable to financial collateral arrangements where at least one of the parties belongs to one of the following categories: (i) domestic and foreign public authorities, including the Republic of Serbia, the EU, the EU Member States and other countries; (ii) central banks, including the NBS, the ECB and other central banks; (iii) domestic and foreign financial institutions subject to prudential supervision, including Serbian-licensed banks, investment firms, insurance undertakings, UCITS, management companies etc., and their foreign peers; (iv) domestic and foreign central counterparts, settlement agents, and clearing houses; and (v) legal entities acting in a representative capacity on behalf of any of the listed persons. Accordingly, the NBS did not use the opt-out possibility to exclude from the scope of the Financial Collateral Act financial collateral arrangements where only one of the parties is a qualified institution. Pursuant to certain restrictions and conditions, even individuals can act as collateral providers under the financial collateral arrangements.

The following assets qualify as financial collateral according to the draft: (i) cash, i.e. money credited to a payment account in local or foreign currency, explicitly excluding banknotes; (ii) negotiable financial instruments, within the meaning set forth in the capital markets regulations; and (iii) credit claims, i.e. transferable receivables arising from the loan agreements with banks.

The draft Financial Collateral Act applies to provision of financial collateral under both security interest and title transfer structures. Transfers of secured property to the lender and similar legal techniques for the establishment of collateral have not been recognized by Serbian law until this draft.

Implementation of financial collateral arrangements

The ISDA Principles recommend that the excessive formalities with respect to the implementation of financial collateral arrangement be avoided. The draft Financial Collateral Act follows the Financial Collateral Directive in that it does not require that the creation, validity, perfection, or enforceability of the financial collateral depend on the performance of any formal act. Based on Article 11 of the draft Act, financial collateral is perfected once it is *provided* to the collateral taker, if that can be evidenced in writing. The collateral will be deemed "provided" when transferred or otherwise designated so as to be in the possession or under the control of the collateral taker or a person acting on the collateral-taker's behalf. The draft further specifies what constitutes sufficient evidence that a particular type of financial collateral (cash, financial instrument or credit claim) is provided. Finally, the draft authorizes the Central Securities Registry to adopt bylaws regulating the conditions and manner in which the creation of financial collateral in the form of book-entry securities will be evidenced. The NBS has also reserved the right to elaborate on the manner in which financial

collateral in the form of cash and credit claims will be evidenced.

The use, substitution and redemption rights

The draft Financial Collateral Act follows the Financial Collateral Directive and the ISDA Principles insofar as it allows the collateral taker under the security financial collateral arrangement to use and/or dispose of the collateral as if it was the owner, provided this is stipulated in the collateral arrangement (Article 12). The right to use and/or dispose of the collateral may be granted to the collateral taker notwithstanding whether the collateral provider is in default. Draft Article 12, paragraph 4 protects the rights of third parties – acquirers of the collateral - by establishing that these persons gain ownership of collateral without encumbrances. The right to use and/or dispose of the collateral does not apply to financial collateral in the form of credit claims.

Contrasting the right of collateral taker to use financial collateral is the right of collateral provider to substitute or redeem the financial collateral, based on mark-to-market adjustments and provided that this is stipulated in the financial collateral arrangement (Article 13 of the draft Financial Collateral Act). Conversely, the collateral provider may be required to top up the collateral if its value falls below the amount of the secured claim.

Enforcement of financial collateral

The draft Financial Collateral Act provides that, upon an event of default, the collateral taker has the right to enforce its secured claim in one of the following manners, depending on the type of financial collateral and the terms of the financial collateral arrangement: (i) by offsetting the amount of *cash* against, or applying it in discharge of, the secured claim; or, as the case may be, (ii) by appropriating or selling the *financial instrument* or *credit claim* and offsetting its value against, or applying its value in discharge of, the secured claim (Article 14 – 16). The financial collateral arrangement may provide for enforcement without prior notice to the collateral provider, without the approval or decision by the court, public authority or any other party, without public auction or any other manner of sale, and without any grace period.

Treatment of financial collateral arrangements in case of insolvency

Article 18 of the draft Financial Collateral Act transposes the provisions of Article 8 of the Financial Collateral Directive concerning disapplication of certain provisions of insolvency legislation. Financial collateral arrangements will be exempted from the automatic stay provided in the Serbian Insolvency Act. The rule will permit collateral taker to exercise any contractual right under the security agreement, notwithstanding the insolvency proceedings, including the use and enforcement of financial collateral. The close-out netting provisions of the financial collateral arrangement would

also survive the opening of insolvency proceedings against one of the participants in the transaction. The entering into financial collateral agreement and provision or substitution of financial collateral may not be challenged or declared void on the sole basis that this happened during the vulnerable period before the decision on initiation of insolvency, liquidation or reorganization proceedings,. Where a collateral arrangement was concluded or a collateral was provided or substituted on the day of the commencement of insolvency, liquidation or reorganization proceedings, or after the decision commencing such proceedings, it will be legally enforceable against and binding on collateral provider and any third parties if the collateral taker can prove that it neither aware, nor it should have been aware of the commencement of such proceedings.

1 ISDA, Collateral Arrangements in the European Financial Markets: The Need for National Law Reform, 4.

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