

Cash collateral Structures, Options and Credit Risk Mitigation

The Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010 came into force on 6 April 2011. The Regulations are designed to facilitate the taking of collateral in the financial markets and to reinforce the validity of security arrangements of this kind. This Briefing examines the effect of the 2010 Amendment Regulations and the current status of English law in this area.

Introduction

Cash collateral for outstanding or contingent obligations may be taken in a variety of circumstances. For example, cash may be taken to cover the reimbursement obligation of the applicant for a bank guarantee or documentary credit. Or it may be taken by way of margin to cover price fluctuations in relation to derivatives, futures or other contracts.

The importance of cash collateral in financial transactions is therefore obvious. Like all forms of security, its importance has been further emphasised by the ongoing financial crisis.

The central role of such collateral and the need to ensure its legal validity engaged the attention of the European Union some years ago as payment and securities settlement systems ceased to be matters of purely domestic concern but operated increasingly in a cross-border environment. This gave rise to the Settlement Finality and Financial Collateral Directives. The first directive is principally concerned with systemic risks within designated securities and payment settlement systems such as CHAPS and CREST, but the Financial Collateral Directive is more widely available in transactions between banks and their clients. It is the latter measure, and the broader subject of cash and cash equivalent security, which form the subject matter of this Briefing.

But wider issues may also arise. For example, it remains the preferred option of many banks to require the execution of a standard form of charge over cash collateral and the registration of that security at Companies House. But this may not always be acceptable to the borrower or guarantor providing the security. Apart from possible sensitivity about the impact of negative pledge undertakings in other financing documents, the mere fact of registration of such an arrangement may have an adverse impact on the customer's credit standing and may, for example, in some cases result in a tightening in supplier terms of payment.

Matters are further complicated by a variety of factors. For example, cash or other financial collateral is most frequently taken as security for contingent or future obligations, and insolvency may supervene before such an obligation has crystallised into a debt which is due and payable. In addition, where collateral is taken at the outset of a transaction, the bank will wish to know that it can treat the cash collateral as credit risk mitigation and thus reduce its exposure for capital adequacy purposes. There is thus in some respects a tension between the modern financial collateral rules --which seek to simplify the taking of security-- and the credit risk mitigation rules --which require a degree of formality in order to qualify for enhanced capital treatment. In practice, of course, this tension is unlikely to be of great significance because banks will in any event tend to err on the side of caution in documenting their security arrangements.

Although a range of items, including government securities, are acceptable collateral for these purposes, this Briefing focuses specifically on the use of security consisting of cash placed on deposit with the lending bank itself.

Against this general background, the present Briefing considers the following matters:

- a. the essential features of a financial collateral arrangement taking into account the amendments which came into effect on 6 April 2011;
- b. the requirements which must be met in order for the cash collateral to be taken into account in calculating the bank's risk-weighted assets for capital adequacy purposes;
- c. the implications of these rules for particular transactions;
- d. the extent to which security over cash continues to require registration at Companies House; and
- e. finally, a few conclusions will be stated.

Financial Collateral Arrangements

The EU's Financial Collateral Directive was implemented in the United Kingdom by the Financial Collateral Arrangements (No 2) Regulations 2003.

Financial collateral arrangements fall into two categories:

- a. a "title transfer financial collateral arrangement" involves the outright transfer of legal and beneficial title to collateral to a creditor on the footing that equivalent security will be re-transferred once the underlying obligation has been paid; and
- b. a "security financial collateral arrangement" under which collateral is delivered into the possession or control of the creditor to secure an obligation of the debtor.

"Financial collateral" includes cash and certain securities and, with effect from 6 April 2011, has been extended to include receivables under bank loans. However, as noted above, the present briefing is principally concerned with cash security.

Where a security structure amounts to a financial collateral arrangement, then the following rules will apply:

- a. there will be no formal requirement for any guarantee or transfer of collateral to be in writing or signed by the collateral provider;
- b. the requirement for registration of the security at Companies House will not apply;
- c. the appointment of an administrator to the collateral provider does not affect the creditor's right to enforce its security (in other words, the administrator's moratorium does not apply to this type of security);
- d. equally, the administrator will have no right to deal with the collateral, to the detriment of the creditor;
- e. to the extent to which the collateral arrangement might otherwise amount to a floating charge, the collateral cannot be made available to preferential creditors, nor can the security be set aside on the basis of Insolvency Act rules providing for the avoidance of floating charges;
- f. a liquidator cannot disclaim a financial collateral arrangement; and
- g. enforcement of the security is complete when notice of appropriation is given to the debtor, and there is no requirement for any court order as a prelude to such appropriation.

It will thus be seen that a security which falls within the definition of a "financial collateral arrangement" benefits from a number of advantages. In particular, a minimum of formality is required in order to create a valid security, and registration of the collateral arrangement is not necessary (although, as noted below, old habits die hard, and registration is frequently effected in practice). In addition, the collateral is effectively "insulated" from the consequence of the debtor's insolvency. Furthermore, the fact that the security can be exchanged or substituted

and thus effectively constitutes a floating charge will not expose the bank to the claims of preferential creditors.

In terms of the formalities required to create a financial collateral arrangement, it therefore appears that it is merely necessary to demonstrate that the collateral provider intended to create the necessary security. This could be demonstrated by email correspondence or even by oral evidence although, for obvious reasons, banks will in practice continue to seek a document with a physical signature. Apart from natural caution, appropriate documentation will be required in order to obtain the benefit of credit risk mitigation techniques (see below). The core requirement will be that the collateral is transferred to the bank or is placed under its possession or control. Unfortunately, the details of this particular requirement have created various difficulties. In particular, the High Court in *Re F2G Realisations Ltd (in liquidation)* cast doubt over the nature and extent of the "possession or control" required in order to create a security financial collateral arrangement. In a case specifically relating to the financial markets, a more robust approach was adopted in *Mills and others (joint administrators of Kaupthing Singer & Friedlander Ltd) v Sportsdirect.com Retail Ltd*, but the situation remained unclear. Happily, however, the 2010 Amendment Regulations have clarified the situation and confirm that the creditor is in "possession" of collateral in the form of cash and financial instruments where the collateral has been credited to an account in the name of the creditor or a custodian acting on its behalf. It might be thought that—even without clarification—this was a fairly obvious meaning of the expression "possession or control", but it is not now necessary to pursue that particular issue. For present purposes, it is now clear that cash held within a blocked account at the lending bank itself will be in the "possession" of the bank, so that it may form the subject matter of a valid financial collateral arrangement.

As was the legislative intention, the Financial Collateral Regulations thus create a flexible framework for the creation of security with the minimum of fuss. How does this tally with the desire to complete a security structure which will be effective from a capital adequacy perspective?

Credit Risk Mitigation

The capital adequacy regime introduced by Basel II and the EU's Capital Requirements Directive - as implemented in the UK through the FSA's Handbook - contemplates that the bank's effective exposure can be reduced to reflect the value of collateral held by the bank. There are two core sets of conditions for that treatment.

First of all, the collateral must fall within the eligible categories. These include:

- a. arrangements for the on-balance sheet netting of mutual claims or reciprocal cash balances; and
- b. cash or cash equivalent instruments.

Various other items, including securities issued by governments, central banks, regional authorities and certain other organisations also qualify as eligible collateral for these purposes, but those items fall beyond the scope of this Briefing.

Under the terms of the FSA's Handbook (BIPRU), the principal legal or formal requirements for cash collateral held with the bank itself include the following:

- a. the arrangement must be contractually valid under the law which governs the arrangement;
- b. the security must be properly documented and must include clear and robust provisions for the realisation of the collateral;
- c. the security must be enforceable in all relevant jurisdictions notwithstanding the insolvency of the chargor. If the security consists of a cash deposit with a bank in England, then it may be argued that England would be the only "relevant jurisdiction" for these purposes, since the security would be effective and enforceable here regardless of any insolvency law or other challenges under the law of the chargor's home country. In practice, however, the bank will usually seek an opinion from the chargor's jurisdiction in any event (e.g. to confirm the due authorisation and execution of the charge), and this should also confirm that the security would remain valid under the local law in the event of the chargor's insolvency;
- d. the bank must have the legal right to take possession of the security and to liquidate it on default. This will not normally present any difficulty where the security is taken under a standard charge and, as noted above, appropriation of the security will occur when the bank gives notice to the chargor to the effect that the security is being enforced;
- e. if the security is to be held for a long period, then a periodic enforceability review may be required;
- f. the bank must have in place adequate risk management processes to control any risks arising from the use of mitigation techniques and for the periodic revaluation of the collateral where necessary. In practice, the first requirement will usually be satisfied by means of an adequate block on the account concerned. However, additional requirements may apply in particular cases. For example, where the currency of the collateral and the currency of the underlying obligation are different, the bank will need to apply appropriate haircuts and will have to monitor fluctuations in exchange rates in order to ensure that the exposure remains fully covered; and
- g. where a bank adopts the standardised approach to capital adequacy and the financial collateral simple method, it may apply a zero per cent risk weight to the covered exposure provided that the deposit is held within the bank itself and both the exposure and the deposit are determined in the same currency (BIPRU 5.4.2IR). A slightly different

approach applies where the bank adopts the internal ratings based approach to capital adequacy and uses the financial collateral comprehensive method - e.g., volatility adjustments may be required. Nevertheless, in the case of a straightforward transaction involving an exposure and a deposit in the same currency, the net effect will be substantially the same.

Implications for Specific Transactions

How, then, do these rules operate in practical terms? This question can perhaps best be analysed by reference to the structures and arrangements typically in use in the banking market for the purpose of taking security over cash deposits.

Charge over Deposit

In a typical case in which a bank issues a letter of credit or performance bond it will require a cash deposit equivalent to the face of the amount of the instrument by way of security. This may be provided by the applicant for the credit, or it may be provided by the applicant's parent company, which will also guarantee its subsidiary's reimbursement obligation.

In the ordinary course, it will be clear that this structure constitutes a "financial collateral arrangement" for the purposes of the Regulations described above. This will have the following consequences in terms of the rules discussed earlier:

- a. if created by an English company or a foreign entity having a registered establishment in Great Britain, the security will not require to be lodged at Companies House under section 860, Companies Act 2006, and hence remains valid even though not so registered;
- b. if created by a foreign company, the security will be treated as valid in England even though it may not have been registered under corresponding requirements under the laws of its home jurisdiction;
- c. the security cannot be diminished by preferential debts, nor can its enforcement be affected by the administrator's moratorium; and
- d. it will follow that the security will be effective in all relevant jurisdictions and the documentation will give the bank the right to apply the cash deposit in satisfaction of the applicant's reimbursement obligation. The cash will thus constitute eligible collateral for the purposes of the credit risk mitigation rules outlined above.

Contractual Set-Off

It will often be the case that the issuing bank will not require cash collateral at the time of issuing a documentary credit or bond, but will reserve the right to call for such security if an event of default occurs.

In such a case, the bank will not usually go to the trouble of requiring the execution of a charge over an empty collateral account. However, the facility agreement itself may contain provisions to the following effect:

- a. if an event of default occurs, then the bank may at that point demand the provision of cash collateral to cover its exposure;
- b. when any funds are credited to the collateral account, they will stand charged to the bank as security for the reimbursement obligation. At the point of time at which such cash is received, the security structure would constitute an effective financial collateral arrangement. Consequently, the bank would be in the same position as if it had taken a charge over deposit in the manner described above. The credit risk mitigation treatment for cash collateral would also apply with effect from the date on which the funds are credited to the collateral account, provided that the necessary conditions set out in the FSA Handbook have been met; and
- c. alternatively, the facility letter may simply allow a right of set-off against the cash collateral. The mutual set-off claims would be governed by English law, since they would arise as between a facility and a deposit account located with an English bank. This may amount to a valid arrangement for the netting of mutual claims and, thus, could qualify for the credit risk mitigation treatment as soon as the funds are received into the collateral account. In practice, however, a relatively loose arrangement of this kind would only qualify for credit risk mitigation treatment if it has been documented and effected in line with the legal and operational requirements outlined above.

Flawed Asset Structures

A bank will occasionally be asked to accept a so-called “flawed asset” structure, under which:

- a. a cash sum is deposited with the bank;
- b. that sum is expressed to be repayable only when corresponding obligations – either of the depositor itself or one of its affiliates – are discharged; but
- c. no formal security interest or right of set-off is created over the funds concerned.

In such a case, the deposit is effectively held in suspended animation until the corresponding obligations are discharged. The bank is not obliged to repay the deposit but, equally, has no right to apply it against the corresponding exposure in the event of a default. The bank thus has a matching asset and liability, but is unable to apply the asset in reduction of the liability.

Various points may be made about this type of hybrid structure:

- a. first of all, it is often requested by borrowers who wish to avoid the explicit creation of security, on the footing that this will contravene negative pledge undertakings in the customer’s other financing documents. It must be doubtful whether a flawed asset arrangement does in fact achieve this objective. It is true that no security is created in a purely legal sense, because, there is no charge over the deposit or any right to apply it in diminution of the underlying obligation. But negative pledges tend to be drawn in very wide terms. For example, the negative pledge in the standard Loan Market Association documents prohibits the creation of any “security interest”, and that expression is defined to include “...a mortgage, charge, pledge, lien or other security interest securing any obligations of any person or any other agreement or arrangement having a similar effect...”. It is thus likely that even a carefully drawn flawed asset arrangement will contravene such a negative pledge because the arrangement has a similar effect to security;
- b. nevertheless, and whilst a flawed asset arrangement will in practice often be acceptable to the bank, it seems that it will not amount to a financial collateral arrangement and would not qualify for credit risk mitigation treatment because it lacks one of the key criteria, namely, the ability to appropriate and apply the collateral against the corresponding exposure; and
- c. in practice, however, the situation will not remain permanently outstanding. If the customer becomes insolvent, then the Insolvency Rules 1986 will apply on a mandatory basis, regardless of the terms of any contract. Specifically, rule 4.90 of those Rules will require that the collateral and the corresponding obligation should be netted off against each other for the purpose of calculating claims in the administration or liquidation.

Registration Requirements

As noted above, one of the advantages of a qualifying financial collateral arrangement is the specific waiver of any requirement to register this form of security at Companies House. This may be of assistance to banks where customers are reluctant to allow the registration of such an arrangement. However, leaving aside the very limited cases in which the customer might raise such an objection, it will remain the practice of banks to take a cautious approach and lodge the security document for registration at Companies House within 21 days of its execution. The time and cost involved in completing this formality are limited, and registration may help to avoid any unnecessary disputes with an administrator or liquidator at a later date.

It may be added that registration of such security arrangements at Companies House is in any event only required where the collateral provider is a company incorporated in Great Britain, or is a foreign company which has registered an establishment in this country. Registration is not required merely on the basis that the security consists of cash held on an account with a bank in Great Britain.

Conclusions

It will thus be seen that legislation designed to support collateral arrangements is of considerable potential benefit to banks in facilitating the completion of security arrangements over cash deposits. The revisions introduced by the 2010 Amendment Regulations have clarified the main difficulties, thus enhancing the attraction of financial collateral arrangements as a security structure.

However, the scope of the options available to the bank is in some respects constrained by the need to optimise the use of capital. It will thus be important to ensure that the security is structured so as to benefit from the credit risk mitigation regime created by Basel II.

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