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Draft Practice Guide to the UNCITRAL Model Law on Secured Transactions

Note by the Secretariat

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III. The interaction between the Model Law and the prudential regulatory framework

A. Introduction

1. This Chapter is addressed primarily to financial institutions that are subject to prudential regulation and supervision ("regulated financial institutions"). Typically, banks and other financial institutions that receive repayable funds, or deposits, from the public to extend loans would fall under this category. The Chapter may also provide useful guidance to national authorities exercising prudential regulatory powers and supervisory functions ("regulatory authorities").

2. The purposes of this Chapter are to assist regulated financial institutions to fully benefit from the Model Law and to emphasize the need for closer coordination between the Model Law and the national prudential regulatory framework. This coordination should be understood in the broader context of interaction of the Model Law with other domestic laws (see Chapter I.D). Core policy choices underlying the prudential regulatory framework, whether national or international, are not addressed in this Chapter.

3. Capital adequacy standards, also referred to as capital requirements, for regulated financial institutions are a key component of a State's prudential regulatory framework. They typically require regulated financial institutions to control their exposure to various risks and to hold adequate capital to absorb losses, having in view both the soundness of the individual institutions as well as the stability of the financial system as a whole. Capital adequacy standards typically define specific requirements to curb operational risk, market risk, and liquidity risk associated with operation of regulated financial institutions. The focus is primarily on credit risk.

4. Capital requirements are primarily concerned with the absorption of unexpected losses.[1] To this purpose, they define the minimum amount of capital (referred to as "regulatory capital") that regulated financial institutions are required to maintain at any point in time in relation to their exposure to risks. Regulatory capital is calculated through a capital adequacy ratio between the risk-weighted assets of a regulated financial institution and its own funds, primarily composed of shareholders' equity and long term subordinated debt. Hence, the amount of capital is not fixed, but is relative to both the overall business volume of the regulated financial institution and the risks associated with its business. In practice, for every financing transaction, like an extension of a loan, regulated financial institutions calculate a capital charge, which represents a portion of regulatory capital and reflects the level of risk of that transaction (in particular, credit risk). Loans that present a higher level of risk are subject to higher capital charges than those considered less risky. For regulated financial institutions, this means that the riskier the exposure the higher the amount of regulatory capital required.

5. National statutory or regulatory laws defining capital requirements determine the risk weights of different classes of assets, provide for capital adequacy ratios and define the procedures to calculate capital charges. Capital requirements do not prevent regulated financial institutions from extending new loans. If a regulated financial institution extends a new loan, it must either increase the amount of its own funds or reduce its exposure to credit risk, for instance, through the adoption of a risk mitigation technique.

6. In addition to regulatory capital, national regulatory authorities prescribe requirements to manage expected losses. In particular, regulated financial institutions

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[1] Expected loss refers to a loss that is statistically expected to occur on an exposure within a given period, for example, one year from the extension of a loan. Unexpected loss refers to a loss that is greater than what is expected from a statistical standpoint within a given period. Expected and unexpected losses are typically determined through models based on historical observations to determine frequency and impact of relevant credit events.

are required to adopt procedures to monitor expected losses associated with a given credit facility and to set aside reserves, or allowances, which increase as the credit facility deteriorates. These rules are often referred to as provisioning requirements or loan loss provisioning. They typically prescribe categories for the classification of loans depending on whether they are performing, underperforming, or non-performing. Financial institutions typically are required to assess, in a forward-looking manner, the likelihood of incurring losses on each loan to determine the appropriate regulatory category and to set aside the corresponding provisions. In this process, regulated financial institutions may take into account the loss absorption capacity provided by collateral.

7. International efforts have been made to ensure that prudential regulation of financial institutions is coordinated and that it is applied through supervisory practices which are consistently applied across jurisdictions. The Basel Committee on Banking Supervision (BCBS) is one of the organizations entrusted with the task of establishing internationally recognized standards on capital requirements contained in the Basel Capital Accords. In addition, there are international accounting or financial reporting standards that may be applied in conjunction with prudential regulation.

8. Before the enactment of the Model Law, there may not have been sufficient legal certainty for regulated financial institutions to take into account security rights in movable assets when calculating loan loss provisioning and regulatory capital. The provisions of the Model Law (coupled with the Registry) provide the necessary legal certainty, predictability, and transparency for the sound management of credit risk with respect to expected and unexpected losses. Through further coordination between the Model Law and prudential regulation, it might be permissible for regulated financial institutions to take into account security rights in movable assets when determining provisions and capital charges.

B. Key terminology

9. Terminology used by regulated financial institutions and national regulatory authorities may differ from those used in the Model Law. The following are some examples:

Collateralized transactions	One of the techniques that regulated financial institutions may adopt to mitigate credit risk. They encompass any consensual arrangement whereby the exposure to credit risk is covered, fully or partially, by a right in an encumbered asset (including a security right under the Model Law).
Credit risk mitigation	Various techniques, such as collateralized transactions, rights of set-off, and guarantees, used by regulated financial institutions to reduce their exposure to credit risk. When specific requisites are met, credit risk mitigation techniques could be accounted for in the calculation of capital charges.
Eligible collateral	Assets that are encumbered by a security right and may be taken into account for the calculation of capital charges.

Eligible financial receivables	Claims of less than or equal to one year that arise from the sale of goods or provision of services in commercial transactions, including debts owed by buyers, suppliers, governmental authorities, or other unaffiliated parties and that may be taken into account for the calculation of capital charges. They do not encompass claims arising from securitizations or credit derivatives.
Physical collateral	Tangible movable assets such as machinery, raw materials and motor vehicles, with the exception of commodities and aircraft (which typically belong to the category of specialized lending exposures).
Specialized lending exposure	Specialized lending exposures may encompass various types of credit facilities, including commodities finance and object finance.

C. Enhancing coordination between the Model Law and national prudential regulation

10. The primary objective of the Model Law is to increase access to credit at a reasonable cost, through the establishment of a modern secured transaction regime facilitating, among others, the creation and enforcement of security rights in movable assets. Under the Model Law, financial institutions may acquire a security right to reduce their exposure to credit risk, which should incentivize them to extend more credit. The Model Law does so by covering a wide range of assets and permitting parties to tailor their arrangement to fit their needs and expectations (see Chapter I.B).

11. National prudential regulation generally takes into account collateral in mitigating the credit exposures of financial institutions. However, the lack of coordination between capital requirements and the Model Law may inadvertently discourage regulated financial institutions from extending credit secured with rights over certain movable assets. This is because capital requirements may take a conservative approach towards certain movable assets that would not necessarily qualify as eligible collateral, thereby treating such loans as unsecured when calculating capital charges.

General prerequisites

12. For a collateralized transaction to be recognized as an eligible credit risk mitigation for calculating capital requirements and potentially reducing capital charges, some essential requisites need to be met. In particular, following internationally recognized capital requirements, legal certainty over security rights and their efficient enforceability upon default of the debtor are essential prerequisites.

13. With respect to collateralized transactions, financial institutions are usually required to demonstrate that two pre-conditions are met. First, a security right must have first priority aside from statutory and preferential claims. Chapter V of the Model Law provides a comprehensive and coherent set of priority rules (see Chapter II.G). Similarly, recommendation 239 of the Legislative Guide on Secured Transactions provides that the priority of a security right continues unimpaired in insolvency, except as otherwise provided under insolvency law. Therefore, it is possible for regulated financial institutions to clearly identify the priority of their security right. Second, a security right must be enforceable in a timely manner. Chapter VII of the Model Law provides rules to facilitate efficient and expeditious enforcement of a security right (including expeditious relief as provided in article 74). In short, the Model Law provides mechanisms whereby regulated

financial institutions could meet the general prerequisites enumerated in capital requirements for the calculation of capital charges.

14. Financial institutions are also required to develop sound internal procedures to control, monitor, and report any risk associated with the collateral including those that could potentially compromise the effectiveness of credit risk mitigation. Moreover, they are usually required to establish internal procedures to ensure expeditious enforcement of security rights. To this end, it is important for financial institutions to become familiar with the relevant provisions of the Model Law, particularly on the steps necessary to enforce their security rights (see Chapter II.H). They should also adopt policies to ensure that the priority of their security rights is not undermined, for instance, by the inadvertent lapse of the effectiveness of a registration of a notice (see Chapter II.E).

15. If a collateralized transaction involves connections with more than one State and thus may be governed by foreign law, financial institutions would need to ensure that their security rights are adequately protected (mainly their priority and enforceability) under that law. Provisions in Chapter VIII of the Model Law provide clarity on the applicable law to achieve the necessary certainty (see Chapter II.J).

Capital requirements

16. There are various methodologies to assess credit risk and to calculate corresponding capital charges. Under the standardized approach, risk weights are set forth in national statutory or regulatory laws, which also set out eligible collateral. Typically, and as provided in international standards, the list of eligible collateral includes only highly liquid assets, such as funds held in deposit accounts with the lending financial institution, gold, and intermediated securities.[2] Independent undertakings in the form of commercial letters of credit might also reduce capital charges if certain conditions are met. However, commercial letters of credit have been increasingly replaced by supply chain and receivable financing, supported by the United Nations Convention on the Assignment of Receivables in International Trade. Accordingly, movable assets that usually compose the borrowing base of businesses (such as receivables, inventory, agricultural products, and equipment) are typically not eligible collateral under the standardized approach. Therefore, they are not normally taken into account when capital charges are calculated, while they might be taken into account for provisioning purposes.

17. Subject to certain minimum conditions and disclosure requirements, regulated financial institutions may be permitted by national regulators to use more sophisticated methodologies. These methodologies are based on internal models and are often referred to internal ratings-based (IRB) approaches. If authorized to adopt these approaches, regulated financial institutions would be able to rely on their own internal estimates of risk components in determining the capital requirement for a given exposure. The risk components include measures of the probability of default, loss given default, the exposure at default, and effective maturity. In some cases, regulated financial institutions may be required to use a value established by national regulatory authorities, rather than an internal estimate for one or more of the risk components. Regulated financial institutions using these approaches are allowed to recognize additional forms of collateral subject to conditions being met, such as financial receivables and other physical collateral. For regulated financial institutions with approval to use their own estimated values of loss given default, the estimate must be grounded in historical recovery rates and must not solely be based on the collateral's estimated market value. Internal ratings-based approaches tend to be applied by regulated financial institutions that are familiar with more sophisticated approaches for risk management.

18. The process to authorize the use of internal models is generally prescribed in national statutory or regulatory laws. In line with recognized international standards,

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[2] The Model Law does not apply to security rights in intermediated securities (article 1(3)(c)).

authorization requires a thorough supervisory examination of the risk-management practices of the regulated financial institution as well as scrutiny of the reliability of internal models. Furthermore, regulated financial institutions are required to implement sound internal procedures to assess and manage credit risk. Regulatory authorities may establish additional requisites to foster the soundness and the reliability of the models. Regulatory authorities may authorize or reject a request for authorization to use internal models and may also withdraw any previous authorization.

19. Upon authorization, regulated financial institutions may take into account receivables and physical collateral for credit risk mitigation purposes.

20. For financial receivables to be considered as eligible collateral, regulated financial institutions are typically required to have the right to collect or transfer the receivables without any consent of the debtor of the receivable (see articles 58, 59, 82 and 83 of the Model Law). Regulated financial institutions are required to ensure that their security rights are made effective against third parties and have priority over competing claims in line with the Model Law. Regulated financial institutions are typically required to have a right to proceeds (see articles 10, 19 and 32 of the Model Law). Furthermore, regulated financial institutions are required to establish lending policies determining receivables, which could be included in the borrowing base, and those, which will not be taken into account when setting the amount of available credit. Finally, a number of requisites exist to ensure that regulated financial institutions implement sound processes to manage the credit risk associated with receivables. Such requisites include due diligence requirements on the borrower and the industry, mechanisms to set advance rates, policies to ensure that the receivables are diversified and not unduly correlated with the borrower, and that the receivables are continuously monitored. In addition, regulated financial institutions are required to establish processes for collecting receivables in situations of distress.

21. For physical collateral to be considered as eligible collateral, regulated financial institutions need to comply with a number of requisites. Typically, they need to demonstrate the existence of liquid markets to dispose of encumbered assets in a timely manner. Transparent and publicly available prices should also be available to allow for an estimate of the value to be realized in case of default. Similar to the requisites concerning eligible financial receivables, the rules on eligible physical collateral require regulated financial institutions to enjoy first priority in the original collateral as well as its proceeds. In addition, capital requirements may require institutions to include in the loan agreement a detailed description of the physical collateral as well as the right for regulated financial institutions to inspect the collateral whenever deemed necessary. Moreover, national regulatory authorities ordinarily require financial institutions to indicate the types of physical collateral accepted and to establish internal credit policies for auditing and supervisory examination purposes, with respect to the advance rates applied for each type of collateral. Physical collateral must be regularly monitored and periodically revaluated to take into account its deterioration and obsolescence.

22. In addition to the regulatory regime for eligible collateral, national regulatory authorities may authorize regulated financial institutions to classify exposures as specialized lending, which are subject to a different regime for the calculation of capital charges. For this purpose, specialized lending exposures should generally satisfy specific regulatory criteria: (i) the lender should have a substantial degree of control over tangible assets and the income that they generate; (ii) the exposure should be to a borrower which has the sole purpose to finance and/or operate tangible assets; and (iii) the primary source of repayment should be the income generated by the assets being financed, rather than by the independent capacity of the borrower. Specialized lending exposures are typically divided into different sub-classes. Two of those sub-classes are particularly important in the context of secured transactions: commodities finance and object finance.

23. Commodities finance is generally understood as structured short-term lending secured with inventories or receivables of exchange-traded commodities (such as crude oil, metals, or crops) where the loan will be repaid solely from the proceeds of the sale of such commodities rather than from other business activities of the borrower. Depending on the nature of the inventory and receivables, under capital requirements, a transaction secured with such inventory or receivables may be considered either as a corporate exposure, for which credit risk is mitigated through eligible physical collateral, or as specialized lending exposure in the form commodities finance.

24. Object finance refers to the funding of acquisition of high-value assets (for example, ships, aircraft, satellites, and railcars) where the repayment of the loan depends on the cash flows generated by such assets. The Model Law might not apply to security rights over such assets (see article 1(3)(e)), which may be governed through an international legal framework established by the Convention on International Interests in Mobile Equipment (Cape Town Convention) and its Protocols or other domestic laws that govern secured transactions involving such high-value assets.

25. While coordination efforts between the Model Law and prudential regulation may result in reduced capital charges, that is not the sole purpose. Rather, the purpose of such coordination is to promote sound risk management that is based on a thorough assessment of risks related to collateralized transactions. The result of such coordination informs the design of a legal and regulatory framework that incentivize prudent and inclusive credit environment.

Annex

The Model Law and work by UNCITRAL in the area of secured transactions

UNCITRAL has prepared a number of instruments in the field of security interests. These instruments may help readers to better understand the policies and principles underlying the Model Law.

United Nations Convention on the Assignment of Receivables in International Trade (2001)	• Provides uniform rules on the assignment of international receivables with an aim to enhance availability of credit on the basis of such receivables • Includes autonomous conflict-of-laws rules
Legislative Guide on Secured Transactions (2007)	• Provides a broad policy framework for an effective secured transactions law governing security rights in movable assets with an aim to enhance the availability of affordable credit • Includes commentary and legislative recommendations to assist States in their secured transactions law reform
Legislative Guide on Secured Transactions: Supplement on Security Rights in Intellectual Property (2010)	• Provides guidance to facilitate extension of secured credit to intellectual property right holders using such rights as encumbered asset • Includes commentary and recommendations dealing specifically with security rights in intellectual property
Guide on the Implementation of a Security Rights Registry (2013)	• Provides commentary and recommendations on the establishment and operation of an efficient and accessible security rights registry, increasing transparency and certainty of security rights
UNCITRAL Model Law on Secured Transactions (2016)	• Provides a comprehensive set of legislative provisions for enactment by States to deal with security interests in all types of movable assets • Includes Model Registry Provisions dealing with the registration of notices in a publicly accessible security rights registry
Guide to the Enactment of the Model Law (2017)	• Provides guidance to States in their enactment of the Model Law • Explains briefly the thrust of each provision of the Model Law and their relationship with the corresponding recommendations of the Legislative Guide on Secured Transactions