Angelic Interiors Limited
Gross Example of IRHP Mis-selling

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Background

- The company had been classified as Private under COB
- Historically, had purchased out of money caps as insurance against an unexpected rise in interest rates
- Lloyds talked AIL into executing a £20m collar on the 27 June 2007 to 'save money'
- A collar is where a customer buys a cap to protect itself against a rise in interest rates but also writes a floor against a fall in interest rates
- Writing an option is a risky business as you are going short of interest rate volatility at a strike price, and you can quickly become exposed
- It is interesting to note that the first tremors from the oncoming systemic liquidity event were already being felt and that these first crystallised on 31 July 2007 when two Bear Stearns hedge funds filed for bankruptcy

When is a hedge not a hedge?

- The original credit sanction had called for a hedging transaction of £15m against the facility marked of £20m
- However, on the date the IRHP was executed the amount borrowed by AIL was just over £3m with an expiry date of 3.5 years
- Yet the bank sold the company a 5-year interest rate collar for £20m i.e. a hedge both much larger and much longer than the underlying borrowing. This is not a hedge and in fact AIL had inadvertently been encouraged into writing a largely uncovered option – this is a very risky undertaking indeed and given the timing pretty foolhardy for even the most sophisticated market participant
- The only rational explanation for the bank's action is that by making the collar longer and larger than appropriate and by selling a collar rather than say out of the money caps, the bank would be making many more times day 1 profit (at least £300k)
- Even if had been for the right amount and the right expiry date it is pretty clear that AIL would have been far better economically hedged by the use of out of the money caps rather than a collar. As the most risky scenario for AIL was a sustained economic recession, affecting property prices, and this would almost certainly be accompanied by a material fall in interest rates

Inadequate sales process

- As sale was pre MIFID then COB applied
- COB 7.9.3.R is absolutely explicit that a bank can’t grant credit for a Private customer for such designated investment business until the ‘customer has given their prior written consent to both the maximum amount of the loan or credit’
- COB 5.4.6E requires the bank to provide the company with a form of notice prescribed in COB 5 Annex 1 E (a warrants and derivative risk warning notice) and AIL would be required to have acknowledged receipt of the notice and confirm acceptance of its contents on writing
- Neither document was sent by the bank and thus neither was signed and returned
- Other failures include a very inadequate sales leaflet setting out 7 benefits and no disadvantages from executing a collar which hardly meets the requirement in COB 2.1.3 R of ‘clear, fair and not misleading’
- In pushing the interest rate collar that they executed, which was far more profitable to the bank it is quite clear that the bank was not acting in accordance with COB 2.2.2. that requires that ‘a firm does not conduct business under arrangements that might give rise to a conflict with its duty to customers’
- In summary a completely non-compliant sales process led entirely by the desire for day 1 profit on execution
- This ignores the very real legal issues that arise from the fact that there was never an ISDA Master Agreement signed and whilst a trade confirmation was sent 7 weeks later nobody was ever asked to sign it on behalf of the company

Hidden credit lines

- As the bank didn’t comply with COB 7.9.3R then AIL was completely ignorant of the additional credit line marked against the company for the interest rate collar
- With interest rates falling rapidly in late 2008 and early 2009 tis additional credit line probably peaked in circa May 2009 at circa £3.8m, which given the drawn facility it was actually hedging was less than £10m is a massive ‘hidden’ add-on
- We have in writing confirmation from the bank’s lawyers that these Treasury limits were treated as hard limits and are thus part of the very important LTV covenant ratio
- This additional derivative credit line was clearly an important part of the internal justification for moving AIL to the specialist Business Support Unit where the company, along with its sister company, could be more intensively managed for the bank’s benefit

What to do next?

- Having inflicted material harm on AIL by grossly mis-selling one derivative what was the bank’s next step?
- The answer was to roll the existing £20m collar into a new £40m interest rate swap. This was executed on the 1 October 2010
- If anything, this is actually an even worse economic hedge as the pay fixed rate swap was for 5 years whereas the two facilities only had 15 months and 4 months to expiry. This is gross overhedging and completely unjustifiable
- All it really does is illustrate the greed of the bank, as the sole driver is to take another large pay day from the new sale, as well as the complete power and knowledge asymmetry between the bank and its client
- I won’t detail all the sales process failures or the legal documentation failures/weaknesses but they do not paint the bank in a positive light
- Justice demands recompense for these two very damaging derivatives and to think that the FSA classified AIL as sophisticated, due solely to the size of the interest rate collar, whereas if AIL had been sophisticated it would never have agreed to execute the damaging collar and it would have remained unsophisticated!