IRHP Sales Rules & Margin Credit

Eight Million Reasons for an **'expert'** to

KNOW THE RULES!

2 Statements by John Swift KC

Swift Report

- **“The question of contingent liability [...] was not covered under FSMA, nor the Principles and Rules made under it.”**
- “I used the words ‘contingent liability’ to have the same meaning as the utilisation of credit limit.”

Treasury Select Committee

- “Customers who were eligible for their cases to be reviewed by the banks and the skilled persons did not lose out in terms of breach by reason of the lack of a specific obligation to disclose a hidden credit line.”
- “My understanding was that there was no obligation on the banks, either of common law or under the COBS, even under that one to which you referred, to disclose that quantification of their own risks.”

CONTINGENT LIABILITY = CREDIT LIMIT – NOT IN RULES – SO NO OBLIGATION TO DISCLOSE!

3 Statements by David Capps – Ashurst

- “The expression we have seen used is not margin requirements, but rather the expression “margin credit” has been raised by certain commentators.”
- “margin credit appears to us to just be another way of saying hidden credit line, contingent liability or CLU. **We do not actually think that this expression ‘margin requirements’ is really engaged.”**
- “If you want the detail, <u>there is reference to a requirement to disclose contingent liabilities</u>. We take the view that the contingent liability of the customer, under the IRHP, is the potential break cost from day one, right the way through until expiry of the swap.’”
- “My understanding of Swift’s findings is that the banks were not under an obligation to disclose their internal credit limits to IRHP customer’s and it would not have made any material difference in an assessment of mis-selling.

MARGIN CREDIT, CLU, CONTINGENT LIABILITY ALL = BREAK COSTS!

Did Swift KC & Capps MISLEAD the TSC about MARGIN LENDING?!

4 Is Contingent Liability in FSMA/the Rules?

- [*contingent liability* investment]

  As Published: 2001

- [approved collateral]

  As Published: 2001

- for any form of security for the discharge of any liability arising from a *contingent liability* investment for any form of security for the discharge of any liability arising from a *contingent liability* investment ...**COBS 14.3 Information about designated investments (non-MiFID provisions)**

As Published: 2007

- designated investments , financial commitments and other additional obligations, including *contingent liabilities*, additional to the cost of acquiring the...

- **COBS 16.3 Periodic reporting**

  As Published: 2009

- ....retail client ; or (b) operates a retail client account that includes an uncovered open position in a *contingent liability* transaction, ...

- **COBS 18.1 Trustee Firms**

  As Published: 2007

- ... Special rules for providing basic advice on a stakeholder product 16A.4.5 4 Guidance on *contingent liability* transactions ...

- **COBS 18.5 Residual CIS operators and small authorised UK AIFMs**

  As Published: 2007

- ... amount of payment due to the fund 6 in respect of the lending; 6 6 6 6 (19) Transactions involving *contingent liability* investments.

THERE ARE 56 ITEMS UP TO THE REVIEW PERIOD IN A SEARCH ON CONTINGENT LIABILITIES IN THE FCA HANDOOK!

5 FCA Glossary Definitions Margin

Margin - (1)135 (in *COLL*) **cash or other property paid**, transferred or deposited under the terms of a *derivative*;

margin lending transaction - has the meaning in point (10) of article 3 of the *SFTR*.149 (Securities Financing Transaction Regulations)

(10) 'margin lending transaction' means **a transaction in which a counterparty extends credit** in connection with the purchase, sale, carrying or trading of securities

margined contract (in *COLL*,44 *CASS 4* and *CASS 744*) **any contract in *derivatives***.

margined transaction requirement - **the total amount of *client money* a *firm* is required to segregate in *client bank accounts* for *margined transactions*** under the *client money rules*, in accordance with *CASS 7.16.32 R*.

6 Are Margin Requirements part of a Swap Sale?

SCHWAB: Margin lending is a flexible line of credit that allows you to borrow against the securities you already hold in your brokerage account.

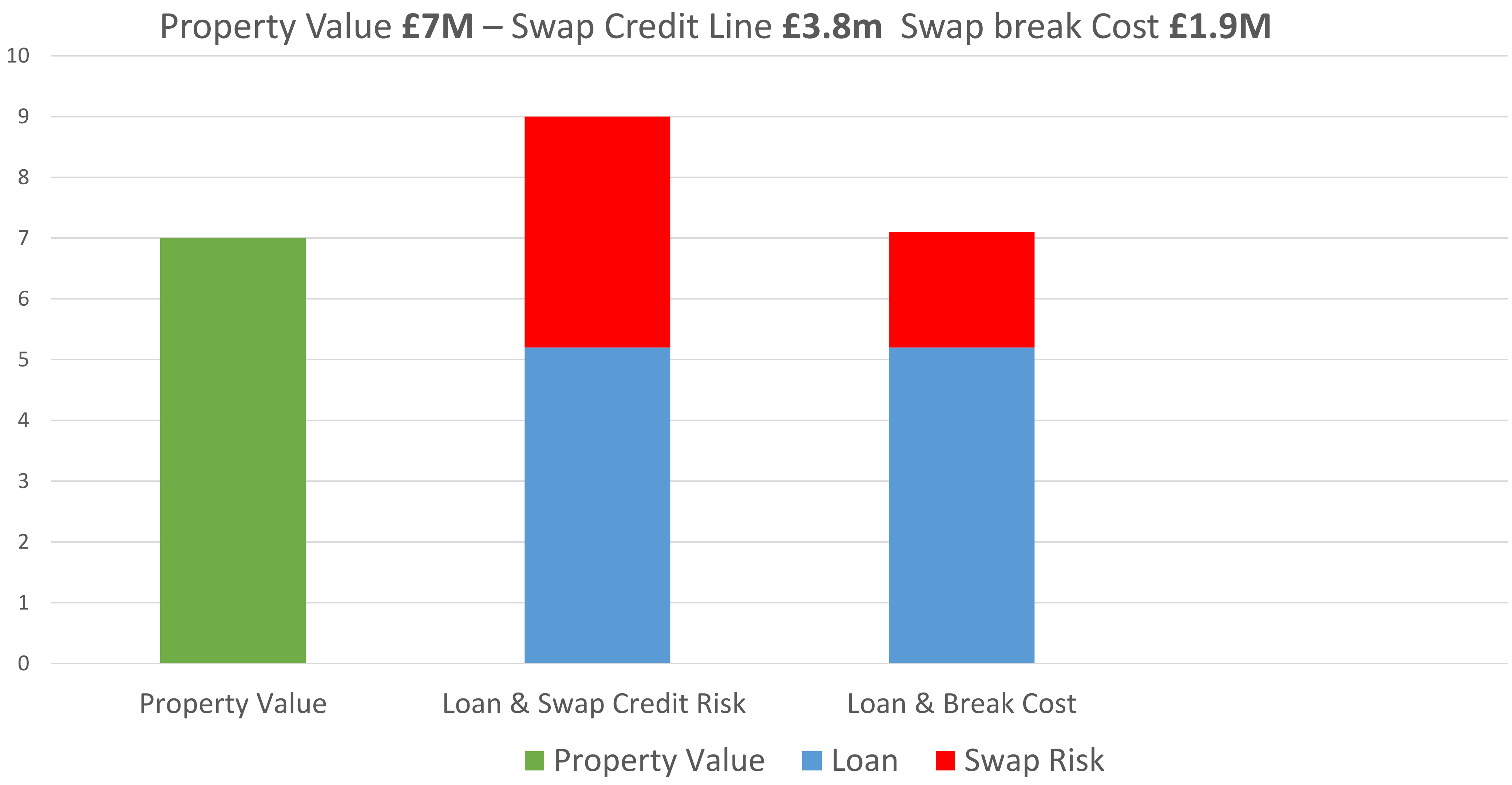
All Over The Counter (OTC) swaps and Fixed Rate Loans with credit lines contain direct derivative exposure with margin risk, where that risk is not covered by cash deposited with the bank, margin calls can only be met by the bank extending credit against your secured assets (for SME's = property).

David Capps:

"We do not actually think that this expression "margin requirements" is really engaged"

Mr Capps COULD NOT BE MORE WRONG!

7 Credit Line or Break Costs, which is the larger risk?



8

RBS CREDIT FILE EXAMPLE

Credit Limit of £188k is part of aggregate lending of £1.408m

Motor Proposal Confirmation.pd | App 1 RMP Print Connection Sun

File | C:/Users/steve/Desktop/BankConfidential/Bank%20Signature%20Forgery/App%201%20RMP%...

Draw | Read aloud | 1 of 1

Ref	Cust Name	CIN Number	CIS Code	Comp Reg Number	AggLM (GBP)(K)	AppPD / ProPD	RLGD / FLGD	Sec
A	[redacted]				1,408.947	19/-	2/2	Other self

Facilities

Ref	Account Type	Account Description	Account Identifier	Sort Code	Ccy	Nominal Limit(K)	Limit (GBP) (K)	Rec Cleared Bal (GBP) (K)	Revised Review Date	Expiry Date	So
A1	Loan	Re-Finance Loan	[redacted]		GBP	743.747	743.747	743.747 DR	01/02/2011	25/09/2031	Na
A7	Cards	One Card	[redacted]		GBP	2.000	2.000		01/02/2011		Na
A8	Overdraft	Overdraft	[redacted]	560034	GBP	17.000	17.000	18.453 DR	31/12/2010		Na
A9	Interest Rate Swap/Hedging	10 year SWAP until 2	[redacted]		GBP	188.000	188.000		01/02/2011	26/03/2020	Na
A13	Loan	Refinance Loan 2	[redacted]		GBP	458.200	458.200	458.200 DR	01/02/2011	26/09/2031	Na

SCR_CON_031 RBS

9 Risks of Margin Calls Increasing Credit Line?

In the Hurl case in the Times, a £50k credit line in January 2008 on a £775k loan increased to £304k by March 2009 as rates dropped, adding 40% to the loan indebtedness!

- Increases in a swap credit line will damage your firms credit rating.
- Because the credit line is a ‘hard’ liability it can breach your Loan to Value covenant forcing a transfer into GRG or similar distressed business unit.
- It can stop you re-banking because any new lender will have to lend you the full amount of the credit line risk on top of the loan.
- The increase in liabilities can lead to security breaches and push you into insolvency.

EVERY SWAP CLIENT SHOULD HAVE BEEN INFORMED OF THESE RISKS!

10 Should MARGIN be notified to a Retail Client?

COBS 16 Annex 1R 01/11/2007 - Trade Confirmations

Must Include –

12. The total consideration

13. a total sum of the commissions and expenses charged...

14. the rate of exchange obtained where the transaction involves a conversion of currency

COBS 16.3.6R 01/11/2007

(1) If a *firm*

...(b) **operates a *retail client* account that includes an uncovered open position in a contingent liability transaction,**

it must report to the *retail client* any losses exceeding any predetermined threshold, agreed between it and the *retail client*.

(2) The *firm* must report:

(a) no later than the end of the *business day* in which the threshold is exceeded;

CLIENT MUST BE NOTIFIED OF INITIAL MARGIN & MARGIN CALLS!

11 SME Swap Target Market – Pre MIFID

PRE MIFID COB Customer

Private – Individual, partnership, smaller firms less than £5m net assets.

Intermediate Customer – Listed Company, Public Authority, firms with £5m or more net assets.

Market Counterparty – Government, central bank, state investment body.

Expert Private – Investment expert in relevant area.

Over £5m net = deemed competent

12 SME Swap Target Market – Post MIFID

Post MiFID Retail Client

Retail – Individuals, partnerships smaller firms

Professional – Credit firm, investment firms etc. & large undertakings meeting 2 of 3 of:
– balance sheet total of €20m,
– net turnover of €40m,
– own funds of €2m.

Eligible Counterparty – Credit institutions, central banks, Governments etc.

Elective Professional – Investment expert in relevant area

13 Sales Rules - Margin Lending/Credit - COB

Restrictions on lending to private customers

COB 7.9.3R01/12/2001

A *firm*, subject to the exceptions in *COB 7.9.5 R*, **must not lend *money* or grant *credit*** to a *private customer* (or arrange for any other person to do so) in the course of, or in connection with, its *designated investment* business **unless**:

(1) **the *firm* has made and recorded an assessment of the *private customer's* financial standing**, based on information disclosed by the *private customer*;

(2) the *firm* has **taken reasonable steps to ensure that the arrangements for the loan or *credit* and the amount concerned are suitable**, based on the information disclosed by the *private customer*, for the type of *investment agreement* proposed or which the *private customer* is likely to enter into; and

(3) **the *private customer* has given his prior written consent to both the maximum amount** of the loan or *credit* and the amount or basis of any interest or *fees* to be levied in connection with the loan or *credit*.

YOU COULD NOT LEND MONEY OR GRANT CREDIT WITHOUT THE CUSTOMERS EXPRESS WRITTEN CONSENT TO THE MAXIMUM AMOUNT OF CREDIT RISK!

14 Sales Rules - Margin Lending/Credit in COBS

COBS 14.3.2 R 01/11/07 - Providing a description of the nature and risks of designated investments

A firm must provide a client with a general description of the nature and risks of designated investments, taking into account, in particular, the client's categorisation as a retail client or a professional client. That description must:

(1) explain the nature of the specific type of designated investment concerned, as well as **<u>the risks particular to that specific type of designated investment</u>, in sufficient detail to enable the client to take investment decisions on an informed basis;** and

(2) include, where relevant to the specific type of designated investment concerned and the status and level of knowledge of the client, the following elements:

(a) the risks associated with that type of designated investment including **an explanation of leverage** and its effects and the risk of losing the entire investment;

(b) the volatility of the price of designated investments and any limitations on the available market for such investments;

(c) the fact that <u>an investor might assume</u>, as a result of transactions in such designated investments, **financial commitments and other additional obligations, including contingent liabilities**, additional to the cost of acquiring the designated investments; and

(d) any **margin requirements or similar obligations**, applicable to designated in investments of that type.
(this point (d) was missing from the COBS 14.3.2 quote in the Swift report!)

'LEVERAGE' - is the use of debt in order to undertake an investment or project (Investopedia)

15 Was it Appropriate to Provide Margin Credit?

COBS 10.2 Assessing appropriateness: the obligations

COBS 10.2.1R01/11/2007*RP*

(1) When providing a service to which this chapter applies, **a *firm* must ask the *client* to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered** or demanded **so as to enable the *firm* to assess whether the service or product envisaged is appropriate for the *client*.**

(2) When assessing appropriateness, a *firm*:

(a) must determine **whether the *client* has the necessary experience and knowledge in order to understand the risks** involved in relation to the product or service offered or demanded;

(b) **may assume that a *professional client* has the necessary experience and knowledge** in order to understand the risks involved in relation to those particular *investment services* or transactions, or types of transaction or product, for which the *client* is classified as a *professional client*.

A FIRM COULD ONLY OFFER MARGINED PRODUCTS TO A PERSON WHO WAS CAPABLE OF BEING A PROFESSIONAL CLIENT IN THAT AREA, OTHERWISE…

16 Margin Credit – Was it Appropriate?

COBS 10.3 Warning the client

COBS 10.3.1 R 01/11/2007 *RP*

(1) If a *firm* considers, on the basis of the information received to enable it to assess appropriateness, that the product or service is not appropriate to the *client*, the *firm* must warn the *client*.

17 Elective Professional Status Swap Client

COBS 3.5.3R 01/11/2007 Elective professional clients

- A firm may treat a client as an elective professional client if it complies with

(1) and (3) and, where applicable, (2):

(1) the firm undertakes an adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that **the client is capable of making his own investment decisions and understanding the risks involved** (the "qualitative test");

(2) ...in the course of that assessment, at least two of the following criteria are satisfied:

(a) the client has carried out transactions, in significant size, on the relevant market at an average frequency of **10 per quarter over the previous four quarters**;

(b) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000;

(c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged;

(3) ... the client must state in writing to the firm that it wishes to be treated as a professional client ...the firm must give the client a clear written warning of the protections and investor compensation rights the client may lose; (the "quantitative test")

IF THE ABOVE CRITERIA WAS MET IT WAS APPROPRIATE TO OFFER MARGINED TRANSACTIONS

18 What about Sophisticated Clients?

SOPHISTICATED INVESTOR STATEMENT

Please confirm whether you qualify as a sophisticated investor on the basis that in the **last three years** you have received a certificate from an authorised firm confirming you understand the risks involved with [type of investment] [**Note 1**].

❑ No

❑ Yes

If yes, what is the name of the authorised firm? ____________

OR

This does not apply to me.

❑ Yes

I accept that being a sophisticated investor will expose me to promotions for investment where there is a significant risk of losing all the money I invest. I am aware that it is open to me to seek professional advice before making any investment in a high-risk investment.

Signature:

Date:

- You can certify an '**investor/ customer'** as sophisticated in order to market more complex & unregulated financial products to them.
  (Financial Promotions Order)

- **THERE IS NO SUCH STATUS AS 'SOPHISTICATED CLIENT' IN MIFID** AND THE TERM **SOPHISTICATED CLIENT** DOES NOT APPEAR IN THE FCA HANDBOOK GLOSSARY.

- HENCE THE WEASEL WORDS IN IRHP REVIEW OF '**RETAIL CLIENTS'** THEN BEING CALLED **'SOPHISTICATED CUSTOMERS'!**

19 Compliant Retail Client Swap Sales Process

1. Categorise Client as Retail Client.
2. Explain all of the risks of a swap including the break cost risk, additional requirement for initial margin credit & the maximum extent this may increase to.
3. Explain the maximum risk being based on rates reducing to zero (or negative with LIBOR).
4. If Client wishes to proceed undertake Appropriateness assessment, evidence of which must be kept on Appropriateness file.
5. **If Client does not have experience/understanding of derivative, leverage/margin credit then provide warning that the product is not appropriate, do not trade.**
6. If Client confirms expertise/experience in margined transactions undertake quantitative/qualitative tests to check status.
7. If Client is Professional level, go ahead with sale but consider allowing Client to retain Retail Client status for enhanced protections.
8. Client negotiates ISDA terms including margin requirements & collateral

20 SUMMARY

- CONTNGENT LIABILITY has been in the rules since the start of the Financial Services & Markets Act (FSMA) in 2001.
- ALL DERIVATIVES trades are MARGINED transactions with MARGIN REQUIREMENTS.
- MARGIN LENDING relates to ANY CREDIT advanced to a client to TRANSACT a product such as a SWAP – this is a MARGIN REQUIREMENT.
- UNDER COB any credit advanced for investment business HAD TO BE DISCLOSED AND AGREED TO, this was NOT an INTERNAL BANK RISK it was the CUSTOMERS DIRECT RISK.
- UNDER COBS, the banks were under an OBLIGATION TO DISCLOSE RISKS of '**ANY MARGIN REQUIREMENT**' OR '**SIMILAR OBLIGATION**' to allow a client to make AN INFORMED DECISION
- FROM 1ST NOVEMBER 2007 if a client had no experience in MARGINED TRANSACTIONS, it was NOT APPROPRIATE to sell them a SWAP product
- CREDIT LINES/MARGIN CREDIT are NOT the same as BREAK COSTS, they include the Break Costs, but are a higher level of risk
- The MARGIN CREDIT RISK is **THE LARGEST RISK** a client will face from a SWAP and could be TWICE AS MUCH as the BREAK COSTS – **OR MORE!!!**

ON THESE FACTS THE TSC WAS MISLED!