13 November 2013

A derivative contract is a regulated product by any other name.

Derivative based TBLs and FRLs should be included in the FSA's review of the mis-selling of interest rate hedging products.

"Tailored Business Loans" (TBLs) and ***certain types**** [1] of commercial "Fixed Rate Loans" (FRLs) are currently excluded from the FSA Statutory Review (SR) into the mis-selling of Interest Rate Hedging Products (IRHPs). This has been done despite the FSA, and many others in the banking industry, readily admitting that these products are Interest Rate Hedging Products. They also admit that these products exhibit the same potentially ruinous features that led to the findings of mis-selling in the case of "Standalone" SWAP IRHP products. Not only do we believe that the present exclusion of these products from the Statutory Redress Scheme is unjust but we also believe that it is erroneous for at least 2 reasons.

Firstly the exclusion is based on faulty nomenclature (Names chosen by the products' suppliers that have wrongly become used as Legal Definitions) and secondly on a demonstrably incorrect interpretation of the the FSA's published Regulatory Intent.

These are the 2 strands to our argument. Although these are separate, they do regularly intertwine.

1) Legal Definitions

Summary:

The FSA have effectively allowed the banks to evade their responsibilities in this matter by allowing the banks to decide what to call the products and then accepting that the names that they choose become legal definitions that allow the banks to then claim that these products are not what they substantively are. We propose that the legal definitions accepted by the FSA to exclude our product from Statutory Protection are wrong. The argument that our product is not covered by MIFID is not based on the facts but on erroneous nomenclature.

We produce a more detailed and supported argument on this statement below.

2 Regulatory Intent

Summary:

The Head of the FCA (Martin Wheatley) said (to the Treasury Select Committee) that our products are "economically similar but legally different". Evidence from the FSA's own material shows that the clear regulatory intent is to be inclusive of our products. Even without our comments relating to (1) above, the regulations are clear that it is the product's characteristics, ***not the product's name,*** which determines its regulatory status. To continue to allow the banks to evade their responsibilities simply by ignoring the over-riding importance (in Regulatory terms) of product characteristics is not consistent with the FSA's own interpretations of its own objectives and regulatory intent.

We produce a more detailed and supported argument on this statement below.

1) Legal Definitions

Regulated IRHP v non-regulated loan?

What are these products? Are they, as the banks claim, a simple and straightforward Fixed Rate Loan? Our contract (a FRL but TBLs are very similar) has 2 basic purposes: to establish credit and to hedge against future base rate changes. We already had base rate linked loans for the full amount covered by the new products and so the only use that the new product had for us was its hedging function. We bought it purely for short term interest rate protection. In order to provide this our bank chose to incorporate the IRHP characteristics within the same single contract as the credit facility. Other banks chose to create a second "Standalone" contract (and these banks are now paying the price for this through being held to account by the Statutory Review). Presumably this dual intent makes our product a "hybrid" or "composite" financial product, or instrument. We will look below at some other significant features.

Firstly, we must be clear again that we are not talking about ALL" "fixed rate loans". Most Fixed Rate Loans, including those "sold on the High St", typically have all of their costs and values defined at the outset: specifically, any early repayment fees are often a fixed fee or a predefined proportion of the amount repaid. This may make a "standard fixed rate loan" a "hybrid instrument" but it does not make it any more than that.

This is not the case with our contract. With our contract a very significant component of the value of the contract is derived at a future date by reference to the performance of an underlying index. This value is unknown at the outset (although it is possible to illustrate the potential ranges, none of the banks even tried to do this). In our case, these values are derived from the Sterling Swap Index; this is itself derived from market expectations of future borrowing costs. This makes it a very different contract from one based, say, on Bank of England Base Rates. It also makes it very different from the "standard High St" loans that the banks assert that our loans resemble. This assertion is false: economically serious differences clearly exist and these are substantive. One of the key differences is that the Early Repayment Fees that can arise on our FRLs can be very high in relation to the original size of the contract. As these differences are derived entirely from the unique reliance of these contracts on a derivative index in their calculation, then this, according to all common definitions of derivative contracts, makes these contracts derivative contracts.

To argue that the contract is not a derivative contract because there exists a non-derivative host contract (a loan) is not tenable. The non-derivative part of the contract does not "host" the derivative element. These single, hybrid contracts do not end when the principle loan is repaid: they only end when the derivative liabilities are calculated and paid for ***and*** the principle is repaid. They are dual use or hybrid contracts. Both elements of the contract must be satisfied. Overall, the contract derives a very significant part of its value from an underlying index. This makes it a derivative contract.

Is this important? Well, yes it is because the critical MIFID (The EU Markets in Financial Instruments Directive) definition, apparently relied on by the FSA to exclude these contracts from the Statutory Review, in turn relies on the use of the term "derivative contracts". However MIFID then leaves little room for doubt that ALL such "derivative contracts" are intended to be covered by the scope of MIFID. If this is true then the FSA's assertion that these contracts are outside the scope of MIFID, and therefore outside the scope of the SR, is, quite rightly, dead in the water (although it is moot that the FSA should be solely relying on MIFID definitions anyway). It is not moot that these contracts re derivative contracts in their own right.

We are not saying that these products are inherently of no use. They are and they do have a valid place in the range of potential products that can provide protection from interest rate rises for SMEs. But, legally, customers who are sold these products should be protected by the same rules that cover customers buying separate “Standalone” SWAP products. A derivative is a derivative, whatever it is called. And derivatives are covered by MIFID. The dangers are the same. The information requirements are the same. The banks could have chosen to follow the spirit of the FSA rules on disclosure of terms and product suitability, without this proving unduly onerous, but they chose not to. It is wrong that so many small businesses (and their employees and suppliers) are now being forced to pay such a high price for the banks’ shortcomings.

Ironically the banks currently most exposed to the costs of the Statutory Review are the ones that, maybe, tried to be more honest about the nature of the contracts that they were creating (although the FSA still found huge failings - 90% of these Standalone contracts were mis-sold). But at least the banks told the customers that these contracts were there. In the case of the FRIs and TBLs, there seems something inherently dishonest about a contract, represented as “simple and straightforward” by a well known Relationship Manager of long standing, that then turns out to have huge contingent liabilities that were not even hinted at during the sales process.

So where is the evidence used by the FSA to claim that these products are outside the scope of the review? The FSA/FCA have also, so far, refused to release the legal basis of their position. (This is apparently an ongoing and evolving situation as the definitive legal advice has been requested from the FSA by the Treasury Select Committee).

In the meantime, we can maybe get some idea of this basis if we look at the Q&A of an MEP and the EU Commission:

These first two points are the Q&A from an MEP to EU Commission about this matter. Probably something similar forms the basis of the FSA stance. We have used green text to highlight the important sentences.

Question for written answer E-004336/2013
to the Commission
Rule 117
Arlene McCarthy (S&D)
Subject:Implementation of MIFID I
The MIFID I legislation is designed, amongst other objectives, to introduce rules governing conflicts of interest relating to the sale of investment products. In June 2012 the UK regulator, the Financial Services Authority (FSA), found that 90 % of interest rate swap agreements (IRSA) sold to SMEs had been mis-sold. However, it has concluded that loans (such as tailored business loans) with interest rate hedging products (IRHPs) embedded, as opposed to sold separately, are not covered by MIFID I legislation.
Does the Commission consider the mis-selling of loans in which IRHPs have been embedded and not sold separately to be covered by the conflict-of-interest rules introduced in the MIFID I legislation? If so, does it consider the UK to have fully implemented MIFID I?

ANSWER
EN
E-004336/2013
Answer given by Mr Barnier
on behalf of the Commission
(21.6.2013)

Directive 2004/39/EC
(MiFID) applies to the provision of investment services and activities in relation to financial instruments. The list of financial instruments covered under MiFID is set up in Annex I, Section C of MiFID. Loans are not financial instruments under MiFID. A mechanism to calculate interests that uses an embedded hedging product does not change the nature of the loan and therefore does not turn the loan into a financial instrument.

As a financial instrument is "the written legal obligation of one party to transfer something of value, usually money, to another party at some future date, under certain conditions" he cannot be saying that the "loan" is not a financial instrument. However, Mr Barnier may well be correct to assert that "loans are not financial instruments ***under MIFID***" (at least in so far as MIFID seek to define "financial instruments"). But is also he correct to state that "mechanisms to calculate interest rates that uses an embedded hedging product does not change the nature of the loan and therefore does not turn the loan into a financial instrument" (again as covered by MIFID)?

If, by this, he means that these alterations to a basic loan contract do not change the characteristics of the contract in a way that substantively changes their legal definition then any examination of the evidence contradicts his position. If, by so changing the contracts they become derivative contracts, as we evidence above, then this process ***does*** make them financial instruments for the MIFID definition. The use of "embedded" is also distracting. "Hidden" may be more accurate but really it is the nature of the contract itself that is important not what we choose to call it. The element that makes these contracts derivative contracts is ***not necessarily*** in the way of an "embedded swap". The element that makes these contracts derivative contracts is simply a part of the contract itself. These contracts do not contain hidden or embedded derivative contracts. They are derivative contracts. And this element does make the contracts quite distinct from the Fixed Rate Loans encountered on the High St.

Even if we accept the term "embedded derivative" it is still clear that the FSA's position does not resonate with the International Accounting Standards (IAS) definition of "embedded derivatives". The IAS " extract" derivative components for accounting purposes so that these values (characteristics) do not remain "concealed" in their host contract. The IAS say: "IAS 39, §10 defines an embedded derivative as "a component of a hybrid (combined) instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative." It appears that, for the IAS at least, a derivative becomes a derivative for reasons of character not nomenclature. This is true also for other EU definitions.

Further issues arising from the above exchange of letters can also be cleared up. There is no general definition of a "Financial Instrument" under MIFID. We must look instead to Section C Annex 1 of MIFID (an enumeration of Financial Instruments covered by MIFID) where Para 4 states "Options, futures, swaps, forward rate agreements, and *any other derivative contracts* relating to securities, currencies, interest rate yields or other derivative instruments, *financial indices* or financial measures which may be settled physically or *in cash*." (our italics).

Section C Annex 1 MIFID Para 10 seems to be a "catch-all" para and states (inter alia) "any other derivative contract…....not otherwise mentioned in this Section, which have the *characteristics* of other derivative financial instruments……" (our italics). MIFID is clearly meant to be an inclusive Regulation as opposed to an exclusive one.

In the light of the above it is clear that the statements made by Mr Barnier is are not strictly true. Firstly the "mechanisms to calculate interests" that he refers to are not being used to calculate interest rates. The mechanisms are being used to calculate the extent of a single contingent fee at a future point in time. These mechanisms are "embedded" in the contract only to the same extent that the loan conditions are "embedded" in the derivative contract. Both intentions are expressions of the reasons for the contract and the claim that the character of one is subsumed by the character of the other cannot be substantiated.

Furthermore, this contingent fee derives its extent from an index that aims to measure the markets' interpretation of future interest rate movements; this is not the same thing at all. Instead, It would appear that our contract is a "bilateral contract where a significant part of the value of the contract is derived from the future (and unknown) value of an underlying (and unconnected) index". This may well not "change the nature of the loan" but it, indisputably, creates a contract with a completely different character and value from a straightforward loan contract. This element makes the contract a derivative contract. Our contract is an agreement to exchange certain cash flows at a point in the future that is contingent upon certain actions action by either party. Some of these were pre-defined (although, in our case, not documented) but a significant portion were not.

It would appear from the facts that, by opting not to specify the values of the contract at the outset, Triodos Bank (and some other banks) were creating derivative contracts - despite their insistence that, contrary to all common sense, that these are "simple and straightforward" fixed rate loans. The nature of these contracts is such that, even outside of the Statutory Review, it is unlikely that Triodos were allowed to provide such a contract without falling foul of the FSA rules. What is clear is that the current situation with respect to the legal status of our contracts is based on incorrect foundations

Some further sources covering these key definitions, especially of "derivative contract", can be found below[*2] " derivative contracts". There is also a brief discussion about financial complexity, again with references.

2 Regulatory Intent

As well as the erroneous legal definitions that we have discussed above, we also argue that the nature and intent of the FSA's Statutory Objectives, and the design of their Principles Based Regulatory Regime, means that it is the economic characteristics of the product that are important not the name that the banks have chosen to call the product.

The FSA have said that the products are "economically similar" but legally different. Whereas the economic similarities are clear the legal differences are less so (as discussed above). The FSA have so far refused to reveal the legal basis of this argument although they do appear to say that the MIFID rules, even if not as exacting as the FSA's own rules, still have supremacy. This also does not fit the facts.

The FSA have long been at pains to explain that producing ever-lengthening rulebooks detailing and naming products that are or are not covered by this or that paragraph or regulation would be both counterproductive and inefficient. They make it clear that this "Rules based Regulatory Regime", although necessary, cannot on its own deliver the outcomes that the FSA has set itself as the real objectives of its regulation. To achieve these outcomes it is necessary to move more towards a "Principles Based Regulatory Regime".

Further help in understanding the regime can also be found in the FSA document "Principles-based regulation. Focusing on the outcomes that matter" published in April 2007. In this paper, and in many other instances, the FSA state that a large proportion of the regulations are focused on ensuring that customers are given the information necessary for them to make informed and responsible decisions ("focusing on outcomes that matter"). The regulations seek to make more informed consumers of financial services.

One of the key methods to achieve these "outcomes that matter" is that firms must follow the "High Level Principles" that the FSA expects firms (and presumably also the FSA itself) to use for guidance.

These are covered in its 11 point "Principles for Business" Statement. In this, Principles 6-10 are the most relevant:

6. A firm must pay due regard to the interests of its customers and treat them fairly.

7. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

8. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

9. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.

10. A firm must arrange adequate protection for clients' assets when it is responsible for them

However, we are still told that our products are excluded despite containing the same characteristic dangers that were at the root of the FSA's recent findings into the sale of "standalone" derivative contracts. In this review the FCA cited 5 main reasons why the products had been mis-sold. The first 3 of these are directly and fully relevant to our product;
1) Poor disclosure of exit costs;
2) failure to ascertain the customers' understanding of risk;
3) non-advised sales straying into advice.

With respect to 1) they then go into much more detail (in a paragraph "Break Costs"). In this they say that "we found that in a high proportion of sales customers were not given sufficient information to enable them to understand the potential size of the break costs. We saw examples in the pilot where the break cost exceeded 40% of the value of the underlying loan". ***This is also a key feature of our products.***

The FSA do not then explain how a "standalone" derivative product, the existence of which is clear to both parties at the outset, is any more dangerous than the embedded/concealed/hybrid derivative whose existence is clear, at the point of sale, only to certain financial professionals. The very opposite seems to be the case: how could we have known of the dangers that the FSA are aware that our product contains if we were not party to the full structure of the contract? In the meantime we are told that fixed rate loans are not covered by MIFID and it is this that the FSA are referring to when they say that their view is correct. This is despite the same characteristics being present in both products. This is "Rules Based Regulation" at its worst. This is exactly what the FSA have sought to counter with their move to "Principles Based Regulation".

There is a very great deal of material, from the FSA and elsewhere, that could be drawn upon to back up our argument. A few examples of this from the FSA are:

"Over the next few years we will move to more principles-based regulation, supplementing our risk-based and evidence-based approach. This is a continuing process, which will require significant change of behaviour by both firms and the Financial Services Authority (the FSA)".
and
"The balance of the FSA Handbook and our approach to supervision will rely increasingly on principles and outcome-focused rules rather than detailed rules prescribing how outcomes must be achieved".
and
"We take a risk-based and proportionate approach to regulation, founded on the assessment of risks to our statutory objectives, taking into account the principles of good regulation".

It seems clear to us that, if the facts of the FSA's own Principles" and "Outcomes" are to be followed then the exclusion of our product from the statutory process is incorrect.

The current legal position does also not bare comparison with industry norms. There are very many examples of banks referring to these products as IRHPs and also examples where banks claim that these products are similar in intent and nature to the standalone products that are a part of the review. Indeed, many in the industry argue that these products are all the more dangerous for the presence of only the single document: two documents at least allow the customer to see that there are two parts to the contract.

We would look forward to any replies that we receive that seek to genuinely address these issues above. In the meantime many 100's of small businesses are left gasping for life under the weight of financial commitments that they had no experience to have been able to anticipate. This is especially so as the scale of these was concealed from them by their trusted Relationship Managers at the time the contracts were entered into. As well as the direct damage on these small businesses, their families, employees and suppliers are also having to cary the weight of the banks' continual denial of even the most basic duties of decency to their customers.

NOTES

CONTEXT.

All of the above has to be seen in context: we were a small farm trying to deal with a complicated scenario that involved a very substantial range of hazards and risks. Only a few of which were directly related to the financial product provided for us by Triodos. We had virtually no previous financial experience with the exception of 2 previous mortgages, some small, standard, variable rate business loans and an overdraft. The only financial knowledge that we possessed was that picked up from day to day newspapers. When we talk above about “complex financial products” and “derivative contracts” this is done with respect to our state of knowledge *at the time we became committed to the product*. But the knowledge itself has had to be discovered in response to the gut certainty that the exclusion of these products from Statutory Redress is inherently wrong. It should also be taken in the context of the quality and quantity of information banks gave to customers in respect of those products - especially prior but also following commitment to the products.

All Fixed Rate Loans are not the same

[*1]Please note that we are only referring to a certain type of derivative based “fixed rate loans” that have been sold in an unregulated transaction to small businesses. The great majority of fixed rate loans, despite lacking the dangerous features of our products by having fundamentally different structures and characteristics, are still regulated products. The implication seems to be that as soon as an individual borrows money for a business, however small or young that business may be, they immediately cease to require the statutory protection afforded “ordinary” borrowers against exploitative practice by huge financial organisations.

[*2] Derivative Contracts and complexity

(1) According to the Office of the Comptroller of the Currency, U.S. Department of Treasury. (February 2013). "A derivative is a financial contract whose value is derived from

the performance of some underlying market factors, such as interest rates, currency exchange rates, and commodity, credit, or equity prices. Derivative transactions include an assortment of financial contracts, including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof."

(2) Deloitte say: A derivative is a financial instrument:

- Whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price, or index;
- That requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors; and
- That is settled at a future date. [IAS 39.9] (This definition is also in use inside EU documents such as The document International Accounting Standard 39 Financial Instruments: Recognition and measurement" published 18 Feb 2011)

(3) Wikipedia: A **derivative** is a financial contract which *derives* its value from the performance of another entity such as an asset, index, or interest rate, called the "underlying"

As it was at the time this Early Repayment Fee, contingent or not, was a very significant part of the value of the contract to us. The potential extent of the fee must be considered prior to agreement if that agreement is to be said to be "fair". But it can only be considered if the banks explained that it existed. It would have been quiet possible for the banks to have given good indications of the potential extent of this fee, but they chose not to do so. The fee can become very significant, in relation to the size of the original contract, and this is exactly what has happened. It is this characteristic that has led regulators to impose restrictions and conditions on the sale of similar contracts to " unsophisticated" customers.

(4) The Technical Committee of the International Organization of Securities Commissions (IOSCO):

"complex financial product" – a financial product whose terms are not likely to be understood by an average retail investor,[2] where the product has a complex structure, is difficult to value without specific skills/systems and/or has a very limited or no secondary market and is therefore potentially illiquid.

(please note here that it is the presentation of key information that is the important fact as to whether or not someone can understand a product)

[2] it is worth noting that the recent FINLA Notice on Complex Products in the US, whilst it does not seek to propose a definition of a complex product, does include the likely lack of understanding of an average retail investor as a possible characteristic indicating complexity. This should also be taken in the light of the comments above about the extent of information provision by the banks with respect to the contracts under discussion..