



White Paper:
Uniform Herstellkader
Rentederivaten MKB



Cases brought by MKB clients against banks claiming mis-selling of derivatives have garnered much attention in the press as the Ministry of Finance has intervened due to the scale of the issue. In this paper we review the Uniform Herstelkader Rentederivaten MKB delivered by the Derivatives Committee, and draw attention to a number of anomalies and inconsistencies.

1. Intro

On 5th July the Derivatives Committee established by the Ministry of Finance delivered their proposal for a uniform resolution to the issues surrounding MKB derivatives. This committee of three people was appointed by the Minister of Finance at the request of the AFM to resolve the protracted process with multiple court cases/outcomes which had developed around derivatives in the sector.

The committee proceeded from the basic premise that debate on communication flows and who said what to whom would prove endless and therefore fruitless so should be avoided. Instead they assumed breach of the duty of care, aiming to categorise the problems and provide a limited set of remediation steps. As a result, the proposal is not a comprehensive top-down analysis from first principles, but rather a bottom-up reflection of the actual cases arising. Furthermore, it makes no statement about how transactions should be concluded in future but it is hard to imagine it not acting as a de facto guideline, with an inflationary effect on borrowing costs.

The proposal is enforceable under the authority of the Ministry of Finance, to be supervised by the AFM, with their normal range of measures against non-compliant banks. Some of our more pedantic points should be viewed in this light. There is however a three-month pilot phase to allow for fine-tuning.

2. Scope

The scope of cases which qualify for resolution is defined in terms of:

- Timeframe;
- Clients;
- Products.

a. Timeframe

Qualifying derivatives must either

- Have been open between 1st April 2011 and 1st April 2014;

Or

- Transacted after 1st Jan 2005 with an end date after 1st April 2011 but terminated early.

In the former case the obligation lies with the bank to notify the client, while for the latter the obligation lies with the client to inform their bank.

b. Clients

Clients are required to have been non-professional and non-knowledgeable at the time of transaction, defined as follows:

i. Non-professional

- At least two of the following must apply at group level:
 - ✓ balance sheet < 20mln;
 - ✓ turnover < 40mln;
 - ✓ equity < 2mln.

ii. Non-knowledgeable

Clients which did not have any of the following at the time of transaction:

- ✓ A balance sheet in excess of €10mln, with more than 80% consisting of real estate or financial assets;
- ✓ A written Treasury Policy for hedging;
- ✓ At least one employee with more than 5 years' treasury knowledge;
- ✓ An external derivatives advisor.

c. Products

All interest rate derivatives are considered in scope.

JnB Comment:

- It is unclear why a start date criterion is applied to derivatives terminated early but not to open positions potentially transacted on the same day.
- Some of the criteria for knowledgeability will be hard to establish as fact, opening the possibility for dispute.
- The definition of interest rate derivatives is circular, and inconsistently applied in the proposal.

3. Four Step Approach

The proposal is structured in four steps for consideration of each case:

- Does the bank need to change products now on open positions?
- Does the bank need to amend terms now or retrospectively?
- Standard settlement for remaining cases;
- Assessment of any extra charges imposed by the bank.

Priority is given to the lowest notional value transactions.

a. Changes to products

These changes apply to structured products which in the opinion of the committee should never have been sold, except swaptions, which are excluded from this step.

Structured products are defined as anything which is not a collar, a cap, or a simple swap.

Structured products must be either substituted or settled, and in both cases the outcome must be positive for the client. eg. any positive MtM is paid to the client but the client doesn't have to pay negative MtM.

Structured products are split into those with optionality sold by the client and those without. In the case of the former a suitable substitute product is decided by the committee, while for the latter substitution must always be with a simple swap.

JnB Comment:

- It is not clear why caps are excluded from the structured products, but not floors, especially since collars which contain floors are also excluded.
- The value of the old derivative must be determined in order for the substituted swap to be equivalent. This is non-trivial, and unless tightly defined can open up opportunities for the banks to profit.

b. Amendment of terms of open or terminated positions

These amendments apply to non-structured products (and swaptions) which were not necessarily mis-sold but where the terms are judged to be inappropriate for the client and include:

- Mismatches: overhedging on notional or maturity, conventions, non-appropriate loans;
- Margin calls;
- Early redemption.

In all cases compensation takes the same form whereby the mismatch is repaired retrospectively and matched for any remaining term, with all costs being carried by the bank.

i. Notional mismatch

These are only in scope if the bank could have known at inception that an overhedge might develop and didn't act.

Retrospective repair takes the form of all net cashflows on the excess being returned with interest.

JnB Comment:

- How the bank should have known there was a risk of over-hedging is not specified. This could include any form of pre-hedging.

ii. Tenor mismatch

Two scenarios are included:

- the start date of the derivative is more than 4 weeks after start date of the loan;
- the maturity date of the derivative is more than 4 weeks after maturity of loan.

In cases where the mismatch has been fixed then penalties still apply to the period prior to the fix being applied.

In the second scenario the bank is obliged to rollover financing till end of swap or unwind the swap.

JnB Comment:

- It is likely that coupon date is meant rather than start date.

iii. Convention mismatch types

These include differences in:

- Reference rate;
- Reset date;

- Floor in the loan but not in the derivative.

Retrospectively, cashflows must be repaid as if no floor was in place, and floor removed for remaining tenor.

Amendments are only applicable when there is a one-to-one relationship between a loan and a derivative, and there is more than one-week difference in date mismatches (thereby excluding possible short-term rate jumps).

JnB Comment:

- It is likely that fixing date is meant rather than reset date.
- In the case of a floor on the loan, the repair does not seem to be limited to the period when the floor was in effect due to negative rates, but applies to the entire term of the trade.

iv. Margin calls

Here an exception is made for cases where the loan has been ended on initiative of the client, but not the derivative.

Retrospective interest must be paid on all collateral posted.

JnB Comment:

- We assume collateral calls are meant rather than margin calls.
- It appears that banks are rewarded for not fulfilling their duty to close the derivative along with the loan.
- There is no consideration of any interest already paid to the client.
- The fact that a collateralised swap has a better fixed rate is not accounted for.

v. Early redemption

There are four forms of redemption considered:

- by planned instalments;
- occasional unplanned instalments;

- unplanned cash sweeps;
- repayment on winding up the company.

It is assumed that MKB clients understand there is no penalty for repaying a floating loan but there is for a fixed loan, but are unaware how this relates to a derivative, and consequently why falling rates mean penalties for swap termination.

Retrospectively they should be compensated to the level of a fixed loan early redemption allowance. (eg. 10%), and for any remaining term the same rights as a fixed loan should apply.

JnB Comment:

- If redemption was planned at inception this should be reflected in the derivative price, while unplanned redemption would create an over-hedge which is already catered for above. Therefore, it is unclear what scenario is being covered here.
- The effect of this will be to make hedging more expensive as banks will build in optionality for early redemption.

c. Standard settlement for remaining cases

A standard settlement schema (Coulance) applies to all cases not considered above. This schema is based on the notional value of the derivatives, and applies retrospectively to net cashflows, while for any remaining term the present value of the position is used.

| Notional | Cashflow/Present value |
|-----------------|------------------------|
| 0 - €2.5mln | 20% |
| €2.5mln – 10mln | 10% |
| > €10mln | 0% |

The payment due to any one client is capped at €100,000.

Two exceptions apply:

- Caps;

- If the bank can provide documentary proof that it stated at the time of the transaction that it wouldn't give a loan without a related swap.

JnB Comment:

- It is not clear whether the notional thresholds apply to aggregate positions or individual derivatives, and if the former whether it is net notional or absolute.
- The option of documentary proof of the original conditions contradicts the principle of not examining transactional discussions.

d. Assessment of extra charges

The committee assumes that MKB clients were under the impression that a derivative protected them from any change in rates. However, in some cases the loan contracts specified rate changes based on triggers such as overall debt or revenue changes.

These conditions are considered invalid and all extra charges must be returned to the client, with the original terms applying for the remainder of the term. However only notional which has not been considered for, and benefited from the coulance above is eligible.

JnB Comment:

- It is not clear why remediation of extra charges related to the loan should be dependent on the existence of a derivative.
- This leaves the possibility open that credit charges can be changed on notional which has benefited from the coulance above.