

Swap Credit Lines

The Truth about Margin Credit

BankConfidential C.I.C &
David Glynn Ex Bank CEO & Derivatives Expert - January 2022



2. Weasel Words obscure the Truth

- ▶ Contingency
- ▶ Contingent liability
- ▶ Internal Risk Measure
- ▶ Measure of the Banks Risk
- ▶ IRP Credit
- ▶ Mark to Market
- ▶ CLU
- ▶ Credit Line Utilisation
- ▶ CEE
- ▶ Credit Equivalent Exposure

ALL = MARGIN CREDIT

3.Swap - ISDA Master Agreement

1.Master Agreement

2. Schedule

3. Credit Support Annex

4. Confirmation

= Standard Contract Terms

= Bespoke Terms

= Agree margin & collateral arrangements

= Trade Terms



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Lawyers/Derivative Experts Negotiate

- Credit Support Annex

- Initial Margin
- Variation Margin thresholds (margin calls)
- Acceptable collateral
- Treatment of collateral
- Security Terms

4. Margin Credit Rules

Post MiFID COBS (post Nov 2007)

Pre MiFID - COB (pre Nov 2007)

7.9.3 A firm..., 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...

(2) the firm has taken reasonable steps to ensure that the arrangements for the loan or credit and the amount concerned are suitable...

(3) the private customer has given his prior written consent to both the maximum amount of the loan or credit

14.3.2 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...

(1) explain the nature of the specific type of designated investment concerned, as well as the risks particular to that specific type of designated investment, 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...

(c) the fact that an investor might assume, 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 investments of that type.

5. Margin Credit - Real or Contingent

The Flawed Legal Precedents

Titan Steel Wheels, Crestsign, Thornbridge, Fine Care, Morley, PAG, Bailey etc. - either Professional Clients or corporate, COB/COBS did not apply.

Parmar - COBS did apply - Judge Hochhauser QC:

- a) He accepted the bank's submissions that CEE was not a contingent liability as it represented the bank's near worst-case scenario in the event of a default by the claimants.
- b) The method of calculation of the CEE varied between banks and the break costs may not even comprise part of that figure.
- c) It was not the practice of Barclays or indeed other banks to disclose their CEE limits. As the claimants' own expert agreed, the CEE limit was entirely different from the break costs and would therefore not ever be payable by the customer.
- d) In this instance, the CEE limit had no impact whatsoever on the claimants' ability to borrow further funds from the bank and the bank's refusal to lend funds for a proposed property purchase was based on entirely unrelated reasons.

6. Credit Line = Hardcore Swap Obligation

Banks Credit Risk

Contingent liability

CEE

Credit Equivalent Exposure

CLU

Credit Line Utilisation

Internal Risk Measure

Mark to Market

IRP Credit

=

Customers Credit Risk

HARDCORE

CREDIT

OBLIGATION

7.Perks v NatWest Markets Plc 2022

NatWest Witness - Neil Graham, Regional Director Restructuring & Chartered Accountant is asked whether the Bank's CLU leads to a client obligation by Perks Counsel;

Q. it says the CLU as dynamic number “represents where the bank believed the MTM could potentially move over the life of the trade, based on the 95% confidence level a 1 in 20 chance that the MTM will move to in this extent based on historic volatility.” Now, this is as far as you are aware an accurate description of the CLU, you are aware of the CLUs?

A. Yes.

*Q. And then the CLU informs, does it not, of the **contingent obligation**?*

A. Yes.

*Q. And then that **contingent obligation** or the credit line can vary depending upon what happens to the CLU and that depends upon what happens to the mark-to-market?*

A. Yes.

Counsel then asked him if the credit line reported on the Banks RMP credit system was the clients **contingent obligation**, to which the answer was;

A. Yes

8.Perks v NatWest Markets Plc 2022

Q. That entry on the RMP system was used by the bank when, as one of the factors when considering whether to lend to a client or on what terms. For example, it was used by the bank for a loan to value ratio, wasn't it?

A. It would, yes, if you were looking at the connection ... you would certainly look at it when you are looking at effectively the risk of the overall connection because it is part of the exposure of that customer.

Q. So it forms part of the exposure of the connection and therefore is taken into account when you determine lending decisions?

A. Yes.

Q. So it could affect whether the bank decides to lend at all. Is that right?

A. It could, if you are right at the margin in terms of, you know --

Q. But it could for example it could push a connection over a loan to value ratio, couldn't it?

A. Subject to the movements in the market, yes.

Q. And that pushing it over a loan to value ratio could eventually result in connection being moved over to GRG?

A. - Ooops... Mr Graham realised the game was up and did not answer the question!

At the outset of a swap you've purchased a loss making investment. Paul Sinclair QC stated (emphasis added);

'the mark-to-market is negative on day one of a swap, because the AV, which is the profit that the bank takes on the swap, is immediately deducted or added on to the mark-to-market. So if you broke a swap on day one, you would still have to pay, in this case it was £32,000... So there is immediate loss on day one because of the liability to pay the fixed rate, which is above the floating rate, and because of the AV and therefore the mark-to-market.'

9.Perks v NatWest Markets Plc 2022

Mr Graham was further asked;

Q. the way that the contingent obligation works, because a contingent obligation recorded in the credit list is not, unlike any other obligation that is recorded in this, might not be used, mightn't it?

A. Only if they don't take out a hedging instrument

If you purchase a swap it comes with a credit obligation which is not contingent, it is an immediate hardcore debt!

10.Perks v NatWest Markets Plc 2022

The Contingent Obligation is a larger debt than the CLU

This email led to a **£320k credit obligation** on Bank credit file & breach of LTV:

Subject: REMINDER - SWAP Limit Increase Required Excess RE:PERKS CLAYTON JOHN AND LEANNE KAY - L

Dear Ross,

For PERKS CLAYTON JOHN AND LEANNE KAY, please note that GBM have a LIMIT excess as detailed below.

CIS Code: Z3GMYGB
Limit: 114,000
CLU: 254,581
Excess: 140,581

GBM have a Limit excess today which we believe is due to MTM (mark to market) movements.

No new trades have been undertaken.

The CLU is a dynamic number which represents where the Bank believes the MTM could potentially move over the life of the trade.

Based on:

95% percentile confidence level

one in 20 chance the MTM will move to this extent based on historical volatilities

We strongly recommend that you build in a 15-20% fluctuation when requesting your limit as this avoids the need to revert for to credit for increases. All Credit units should be aware of the need to occasionally increase limits to cover market movements.

Please arrange for a sufficient limit to be recorded.

11.Perks v Natwest Markets Plc 2022

Was the bank comfortable with the admissions made by Neil Graham?

P Sinclair QC in his closing arguments:

'Mr Neil Graham was cross-examined about all of this on the hoof, in a sense. It wasn't something that he had given evidence about and it is not something that he knows, it is not his area, and we would submit that in some respects his evidence was wrong, particularly on the LTV question.'

For Mr Sinclair to contradict evidence given under oath is itself a very unusual step, bearing in mind Mr Graham is a highly qualified banker & GRG Director and accountant and yet Mr Sinclair stated:

'He did suggest, I think, that it might -- the contingent obligation could push a connection over a loan to value ratio covenant. That is wrong, in our submission. He just got that wrong... So we don't accept that the CLU had the impact that my learned friend suggests on the LTV calculations, and we don't accept that there is a duty on the bank to volunteer information about the CLU.'

You will note that not only is Mr Sinclair attempting to undo Mr Graham's testimony, he is confusing Mr Graham's evidence on the **CONTINGENT OBLIGATION** with the CLU or CEE...

12.The IRHP Review & Contingent Obligations

MARGIN CREDIT disclosure Failure = Largest Rule Failure in the sale of IRHP's.

Providing Credit for Investment Losses = Foreseeability

Internal KPMG Project Rosetta Files on a NatWest case state:

'The setting and monitoring of the contingent liability, is not however covered in the IRHP review.'

And

'The setting of any contingent liability is a credit risk function carried out as part of the operational process. The process is not related to the sales standards agreed with the FCA in respect of the past Review of IRHP's.'

The FCA focussed on the 'contingent liability' on the banks credit files whilst ignoring the CONTINGENT OBLIGATION on the customers...

13.Perks v NatWest Markets Plc 2022

Banks evidence in previous cases that the Bank manager didn't earn a commission from swap sales...

From: McGuigan, Jane
Sent: 29 November 2007 16:23
To: Mcclurg, Scott (Glw Commercial)
Subject: Income !!!!!!!

Angela has confirmed that deal has been done and her income was £32k so that's £16k for ushurray!!

About the only good news I've had today

Jane

Swap Credit Lines

Accounting for the Contingent Obligation

Dave Glynn Ex Bank CEO, Derivative Expert - January 2022

15. Accounting the Swap Credit Obligation

Of course, it cannot be that one side of the entry, the *debit (charge)* or *credit (income)* can be *real* whilst the contra-entry is *contingent*. The balance sheet simply *wouldn't balance*.

There is nothing *contingent* about the book entries RBS are required to pass when taking the *MtM* value of the Swap into profit. It is a straightforward *credit* to the P & L Account. It necessarily follows that the contra-entry must be to a balance sheet asset account reflecting the amount *due from the swap counterparty*, therefore to a *debtor (or receivable) account* in the name of that *counterparty*.

In these instances, RBS' specific counterparty is the very borrower who gave *all monies guarantees* in respect of the associated loan (plus all and any other *monies*, at any time, owing to the bank).

16.Perks v NatWest Markets Plc 2022

- ▶ **FIXED RATE = LOAN BENCHMARK ON THE STRIKE DATE**
- ▶ **E.G. 5 YEAR SWAP RATES HAVE NO RELEVANCE**
- ▶ **2007 Base Rate Swap Fixe Rate: 5.60% (*Base = 5.75%*)**
- ▶ **Term: Minimum 5 years - Broken: July 2009 – **APS** – Break cost: £191k Spreads £62k**
- ▶ **Forced July 2009 Libor (1M) Swap Fixed Rate 5.40% (*Libor 1m = 0.61%*)**
- ▶ **Term: Minimum 5 years - Broken: March 2011 - Break cost: £225k Spreads £172k**
- ▶ **Total cash drawn - £459k – Group deemed insolvent in October 2008**

17.Perks v NatWest Markets Plc 2022

FIXED RATE 5.40%						SUMMARY ENTRIES		
1	2	3	4	5	6	IN RBS BOOKS		
WEEK	Date	LIBOR K	RES VAL	SPREAD	MtM		DR	CR
			2,194,000	£453,964	£447,426	TOTAL	£907,928	£907,928
1	09/08/2009	0.61%	£2,194,000	£8,755	£447,426	SWAP INCOME		£447,426
12	09/07/2010	0.61%	£2,131,147	£104,444	£353,780	SWAP DEBTORS	£447,426	
24	09/07/2011	0.61%	£1,978,204	£202,822	£256,679	SPREADS	£453,964	
36	09/07/2012	0.61%	£1,824,841	£293,868	£166,333	SWAP DEBTORS		£453,964
48	09/07/2013	0.61%	£1,671,898	£377,578	£82,792	SWAP DEBTORS	£6,538	
60	09/07/2014	0.61%	£1,518,955	£453,964		SWAP INCOME		£6,538

18.Perks v NatWest Markets Plc 2022

FIXED RATE 0.61%

1	2	3	4	5	6	7
WEEK	Date	LIBOR K	RESIDUAL VALUE	SPREAD	DISC RATE	MtM
12	09/08/2009	0.61%	£2,194,000		0.61%	
20	09/07/2010	0.61%	£2,131,504		0.61%	
24	09/07/2011	0.61%	£1,979,430		0.61%	
36	09/07/2012	0.61%	£1,826,940		0.61%	
48	09/07/2013	0.61%	£1,674,867		0.61%	
60	09/07/2014	0.61%	£1,522,793		0.61%	

19. Perks v NatWest Markets Plc 2022

FIXED RATE 2.95%

1	2	3	4	5	6	7
WEEK	Date	LIBOR K	RESIDUAL VALUE	SPREAD	DISC RATE	MtM
				£196,249		£193,689
12	09/07/2010	0.61%	£2,131,504	£25,354	0.61%	£172,973
20	09/03/2011	0.61%	£2,030,260	£57,790	0.61%	£140,986
24	09/07/2011	0.61%	£1,979,430	£73,419	0.61%	£125,535
36	09/07/2012	0.61%	£1,826,940	£117,923	0.61%	£81,375
48	09/07/2013	0.61%	£1,674,867	£158,864	0.61%	£40,519
60	09/07/2014	0.61%	£1,522,793	£2,980	0.61%	0

20.Perks v NatWest Markets Plc 2022

COMPARATIVE MtM					
WEEK	LIBOR	DATE	5.40%	0.61%	2.95%
			MtM	MtM	MtM
			FORECAST	0	£193,689
ACTUAL			ACTUAL	£3,698	£197,166
1	0.61%	09/08/2009	£451,271	£3,058	£196,156
12	0.57%	09/07/2010	£356,501	£2,433	£175,549
24	0.62%	09/07/2011	£258,594	£1,971	£127,481
36	0.67%	09/07/2012	£169,836	£3,607	£84,935
48	0.49%	09/07/2013	£84,981	£2,137	£42,683
60	0.49%	09/07/2014	£6,243	£159	£3,138

21.Perks v NatWest Markets Plc 2022

LOAN TO VALUE ANALYSIS									
1	2	3	4	5	6	7	8	9	10
WEEK	DATE	LOAN	SWAP	TOTAL	LOAN TO VALUE		SWAP CAPACITY		SECURITY
					LOAN	+SWAP	LTV 75%	LTV 80%	
1	09/08/2009	£2,194,000	£451,271	£2,645,271	73.13%	88.18%	£56,000	£206,000	£3,000,000
12	09/07/2010	£2,131,147	£356,501	£2,487,647	71.04%	82.92%	£118,853	£268,853	
24	09/07/2011	£1,978,204	£258,594	£2,236,798	65.94%	74.56%	£271,796	£421,796	
36	09/07/2012	£1,824,841	£169,836	£1,994,677	60.83%	66.49%	£425,159	£575,159	
48	09/07/2013	£1,671,898	£84,981	£1,756,879	55.73%	58.56%	£578,102	£728,102	
60	09/07/2014	£1,518,955	0	£1,518,955	50.63%	50.63%	£731,045	£881,045	

22.Perks v NatWest Markets Plc 2022



TRANSFER TO GRG 3 MONTHS AFTER THE IMPLEMENTATION OF THE 2009 SWAP



TIMED TO COINCIDE WITH RBS ENTRY INTO THE APS