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Margin Loans: capital complications?

Introduction

In mid-January 2019, the Prudential Regulation Authority (the ***PRA***) published a consultation paper on the eligibility of financial collateral as a credit risk mitigant (the ***Consultation Paper***).[1] The Consultation Paper proposes certain changes to the eligibility of financial collateral as credit protection under the Capital Requirements Regulation (the ***CRR***), as implemented in the UK. The Consultation Paper focusses on collateralised financing transactions where there is a material correlation between the value of the financial collateral and the credit quality of the obligor.

Background

Chapter 4 of the CRR sets out the circumstances in which certain credit risk mitigation techniques can be applied to reduce the capital impact of exposures held in the banking book, including with respect to secured lending transactions. These techniques include the provision of funded credit protection.[2] Equities included in a main index constitute eligible collateral.[3]

Article 207 of the CRR sets out the requirements for financial collateral to qualify as eligible collateral for credit risk mitigation purposes.[4] The requirements of Article 207 include a "wrong-way" correlation test. Article 207(2) provides that the "credit quality of the obligor and the value of the collateral shall not have a positive material correlation".

The Consultation Paper applies to firms which are supervised by the PRA. Therefore it is relevant to UK banks, building societies and PRA-designated UK investment firms that are subject to the CRR. Accordingly, the changes proposed in the Consultation Paper are not relevant to UK branches of firms established in other EEA countries or in non-EEA jurisdictions.

Purpose of the Consultation

The PRA states that it has been reviewing the practice of firms in applying capital to secured financing transactions. The PRA's review has been focussed in particular on secured financing transactions where the collateral is wholly or to a greater extent made up of shares in a listed company.[5] Indeed, the Consultation makes specific reference to margin loans, where a firm or firms provide financing against security over a block of listed shares (the ***Collateral Shares***), usually based on a loan-to-value ratio which the obligor must maintain at all times.[6] Commonly, this would be by providing extra collateral as the value of the Collateral Shares falls, either in the form of cash,

1 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2019/cp119.pdf?la=en&hash=D3F9D6E6305E1FB84A3956BABCF7B72C32F9F3B9

2 Funded credit protection being a technique where the reduction of the credit risk on the exposure that a firm has to an obligor derives from the right of the firm, in the event of the default of the counterparty or other specified credit events relating to the counterparty, to liquidate, or to obtain transfer or appropriation of, the relevant financial collateral. This would include a security interest taken over a custody account and the shares credited to it.

3 See BIPRU 4.2. For firms which use the "financial collateral comprehensive method", eligibility is expanded to include equities not just included in a main index but also those traded on a recognised investment exchange or a designated investment exchange.

4 The requirements of Article 207 apply regardless of whether a firm applies the "financial collateral simple method" (where that firm uses the standardised approach to credit risk) or the "financial collateral comprehensive method" (generally where a firm uses the IRB approach – see BIPRU 5.4).

5 Although that is not to say that the changes to Supervisory Statement 17/13 proposed in the Consultation couldn't apply to other sorts of transaction or types of collateral.

6 Where (i) shares issued by multiple issuers or (ii) multiple types of financial collateral make up the collateral for a loan, such transactions could equally be caught by the proposals, although it seems that transactions where the shares of a single issuer make up the collateral package are the most relevant.

further shares in the same issuer, or additional assets. For the purposes of this note, such transactions shall be referred to generically as ***Margin Loans***.

The PRA is concerned that practice in some firms may have resulted in collateral for Margin Loans being recognised as eligible for credit risk mitigation purposes when it should not have been. As such, it considers that an addition to its Supervisory Statement 17/13 on "Credit Risk Mitigation" (the ***Supervisory Statement***) should be made to clarify how the PRA understands Article 207(2) to apply. The Consultation attaches the PRA's proposed amendment to the Supervisory Statement and asks for responses from firms by 10th April 2019.

Whilst the Consultation specifically mentions "non-recourse" loans, which are referred to as transactions where the lender's recourse is limited to the Collateral Shares as a matter of contract, or where the only material asset of the obligor is the Collateral Shares, its relevance is not limited to such transactions.[7] Where there is a possibility of the existence of a material positive correlation between the Collateral Shares and the credit quality of the obligor, the proposals in the Consultation will be relevant.

The PRA's specific concern

Where the creditworthiness of the obligor is materially dependent on the value of the Collateral Shares, the PRA's view is that the risk mitigation provided by such collateral may be compromised. In those circumstances, Article 207(2) is relevant as a material positive correlation between the credit quality of the obligor and the value of the Collateral Shares may exist, as those Collateral Shares cannot be relied upon to mitigate losses at the point of default.

The PRA is concerned that, in some cases, firms are not correctly applying the material positive correlation test, and are failing to consider each relevant characteristic of the obligor, the relevant transaction and the Share Collateral. The legislation does not contain a set test for a material positive correlation to occur, and the PRA now wishes to provide extra guidance to firms to help them assess correctly the question as to whether a link between the credit quality of the obligor and the value of the Collateral Shares undermines the risk mitigation provided by those Collateral Shares.

[7] Note that the Consultation seems to use the terms "non-recourse" and "limited recourse" interchangeably. Whilst it is a point that entities responding to the Consultation may wish to request clarification on, for the purposes of this note we assume that both terms refer to transactions where the obligor grants a security interest in the Collateral Shares (plus cash margin/dividends) only, and either the lender agrees it will have no further recourse to any assets of the obligor or the obligor does not have any other assets.

The PRA's proposals

In its proposed addition to the Supervisory Statement, the PRA makes it clear that each transaction is different and no particular characteristic is a mark of a material positive correlation arising. However, the PRA does refer to a number of characteristics that could be relevant, including the legal connectedness of the issuer of the Collateral Shares and the obligor, similarities in the business models of the issuer and obligor and exposure to the same jurisdictions. The absence of a legal connection between the issuer and the obligor does not preclude the possibility of a material positive correlation arising.

By way of guidance to reinforce its proposals, the PRA also provides two examples of transactions where it considers that the Collateral Shares should not be recognised as eligible collateral:

(i) A non-recourse Margin Loan where the lender has recourse to the Collateral Shares only and no claim of any sort on the obligor's other assets.

(ii) A Margin Loan made to an SPV whose sole or primary asset consists of the Collateral Shares. Importantly, the PRA clarifies than an expectation of financial support for the SPV from a sponsor should not be considered an asset of the SPV.

It is important to note that the Consultation is not relevant to these types of transaction only. Even where a Margin Loan is structured as either (i) a full recourse transaction to the obligor (in the sense that whilst the security interest granted to the lender is over the Collateral Shares only, the lender will have a claim against the value of the obligor's assets generally in an obligor insolvency) or (ii) other forms of collateral are provided in addition to the Collateral Shares (e.g. a security interest over further assets or third-party guarantees), the additional guidance on correlation test in the proposals remains relevant.

Analysis

The PRA proposals could impact a variety of types of Margin Loan. Following the approach taken in the Consultation, we divide our analysis between non and full recourse transactions.

Non-Recourse Transactions

The PRA's proposals are most obviously relevant to transactions where a single strategic shareholder, who is or has been historically very close to the relevant issuer, wishes to monetise its stake in that issuer. These are often transactions entered into by PDMRs or PCAs of PDMRs with respect to the relevant issuer[8], where the obligor either has few other assets or would not wish the lender to have any access to them. In these cases, the matters the PRA wishes

[8] Persons Discharging Managerial Responsibilities and Persons Closely Associated with such persons, under the Market Abuse Regulation.

to clarify are relatively clear, and the proposals clearly reflect concerns about Margin Loans to entities with limited other assets where the value of Collateral Shares has fallen rapidly and there was a close connection between the issuer and obligor.

Of course where Collateral Shares are no longer eligible financial collateral for the purposes of Article 207, lenders may look to what other assets of the obligor are available for the purposes of taking security in the future in order to attempt to reduce the cost of Margin Loans for obligors. Whilst not only perhaps reducing the attractiveness of the transaction for obligors, such additional security over assets which may be illiquid or located in a variety of jurisdictions will increase the complexity and execution risk of such transactions significantly.[9]

Full Recourse Transactions

Not all Margin Loans are non-recourse transactions, either on a legal or practical basis (and as explained above, transactions which would historically have been executed as non-recourse deals may not be in the future). The Consultation is relevant to these transactions too, as the guidance around the application of Article 207(2) is not restricted to non-recourse financings.

For Margin Loans made to obligors on a full recourse basis where that obligor has access to other assets which are not necessarily correlated with the Collateral Shares, further clarity could be useful in a number of areas. These include:

(i) How should firms assess the value of non-correlated assets required relative to the value of (a) the Collateral Shares and (b) the size of the loan itself in order to conclude that no material positive correlation occurs?

(ii) Is it sufficient that the obligor simply holds non-correlated assets of a certain value for the life of the financing, or are there circumstances where the PRA expects a security interest over a portion of those assets to be granted to the lender in order to break the positive correlation?

(iii) The proposed addition to the Supervisory Statement makes clear that "mere expectations" of support from sponsors of an SPV should not be considered an asset of the SPV. This would imply that a legally enforceable guarantee or other commitment from an entity holding real non-correlated assets would be of value in altering the capital treatment for a Margin Loan which would otherwise fail the test in Article 207(2). Whilst presumably the material positive correlation test should be extended to the assets of the guarantor, assuming that test is passed, should the value of the guarantee be assessed relative to the usual rules for the assessment of third-party guarantees as a credit risk mitigant?[10]

Finally, whilst the PRA focuses on Margin Loans, they are of course not only the sort of transaction where financial collateral is used, and could have a material positive correlation with the credit quality of the counterparty. A variety of strategic equity derivatives transaction structures involve the taking of security over listed shares only and firms should consider the impact of the PRA's proposals on the capital treatment of those transactions too.

Conclusions

Margin Loans are structured, situation specific transactions, and each one has different features. Where a firm is subject to the CRR, as applied in the UK, the PRA's proposals may well have an impact on the capital treatment of a range of Margin Loan structures. In turn, that may well lead to structuring developments with lenders needing to look to other assets held by the obligor or the obligor group to support equity financing transactions.

Firms have until 10th April 2019 to respond to the consultation. We would be happy to discuss the form and content of those responses with our clients, including how the points of uncertainty raised in this note should be addressed.

[9] Margin Loans of course usually contain a right of the lender to call for cash margin to be provided as the value of the Collateral Shares fall. We assume that the PRA would expect firms to conduct their analysis of the eligibility of shares as financial collateral without taking into account when and how the terms of the loan might require the provision of cash collateral, on the basis that it should be assume the value of the Share Collateral could fall through any such triggers before such cash collateral could be provided, leading to an immediate demand for repayment of all amounts outstanding.

[10] Depending on the answer, it is possible to see Margin Loans which would otherwise fail the material positive correlation test containing detailed negotiated asset maintenance covenants with respect to the obligor's other assets.

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