

# **FINANCIAL INSTITUTIONS UPDATE**

**PI CONFERENCE OXFORD**

**19 - 20 JULY 2005**

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**ROBINOMIS**

# INTRODUCTION

1. HOT TOPICS – NOTIFICATIONS
2. LEGAL/LEGISLATIVE DEVELOPMENTS
3. POLICY WORDING

# **FREQUENCY OF CIVIL LIABILITY CLAIMS AGAINST FINANCIAL INSTITUTIONS – WHY?**

- ACTIVE REGULATOR
- ACTIVE LITIGANTS

# **SOURCE OF CLAIMS**

- UNSUITABLE FINANCIAL PRODUCT SALES
- UNSUITABLE FINANCIAL ADVICE
- TRANSACTIONAL ERRORS

# **HOT TOPICS**

- (i) MORTGAGE PRODUCTS
- (ii) COMPLEX FINANCIAL INSTRUMENTS
- (iii) REGULATORY EXPOSURES
- (iv) HEDGE FUNDS

# **MORTGAGE PRODUCTS**

- SAMS
- TLPs
- ENDOWMENTS

# SHARED APPRECIATION MORTGAGES

A mortgage which offers the consumer low monthly repayments in exchange for the lender taking a proportion of any increase in the value of a mortgaged property.

# SHARED APPRECIATION MORTGAGES (SAMs)

- Lender charges a lower-than-normal mortgage rate in exchange for a percentage of the appreciation in the house.
- Allows the borrower to lower the mortgage payments; however, the borrower will have to share any appreciation in property values with the lender.
- Allows the lender to take a position in the housing market and hedge against interest rate changes (if interest rate and housing price changes are correlated). Unfortunately, for the lender, a decline in housing prices results in the lender receiving a “below-market” rate on the loan coupled with no share of appreciation on the house.
- A typical SAM will have the lender and borrowing splitting the appreciation evenly. Any additions to the value of the dwelling (such as a swimming pool) can be credited to the borrower’s basis.



# TRADED LIFE POLICIES

- Also known as Viatical Policies – US.
- Life Insurance Contracts sold at a discount by policyholder to third party.
- Allows policyholder to unlock policy benefits prior to death.
- The purchaser (third party) continues to pay premiums.

- Third Party will receive the sum insured on the death of policyholder.
- Difference between the purchase pricing and the continuing premiums, and the sum insured represents the return on the investment.

## **ENDOWMENTS**

Abbey Life	-	£800,000
Allied Dunbar	-	£725,000
Friends Provident	-	£675,000

- Number of endowment related complaints up by 1/3 in 2004 year.
- 63% of complaints to FOS relate to Endowments for 12 month period ending March 2005.
- 80% of endowment mortgage holders face a shortfall.
- 7,000 new claims resulting in £10 million compensation – FSCS.

# **COMPLEX FINANCIAL INSTRUMENTS**

- **CONTRACTS FOR DIFFERENCES – CFD**
- **CREDIT DEFAULT SWAPS – CDS**
- **COLLATERIZED DEBT OBLIGATIONS – CDO**
- **CREDIT DERIVATIVES - CD**

- Speciality Insurance Exposure.
- Used by financial institutions to spread risk.
- Fastest growing products in the financial market.
- Also pose the greatest risk:-  
*B of A vs. Banca Popolare*  
*Barclays Capital/HSH Nordbanc.*

# ROBINOMIS

- Various warnings by Regulators.
- \$2.6 billion – notional value of these products in the system.
- Breakdown between lending and trading departments.
- Market manipulation/Insider Trading.

# **HEDGE FUNDS**

1. LONG TERM CAPITAL MANAGEMENT
2. FSA DISCUSSION PAPER -  
RISKS/REGULATION.
3. CLOSE EYE.



# WHAT ARE HEDGE FUNDS

1. Another form of investment vehicle.
2. Sell stock they do not own.
3. Borrow heavily.
4. Use dynamic trading strategies.
5. Aim to pay returns even when market is falling – (IRIS Hedge Fund)

# FSA DISCUSSION PAPER

1. Hedge Funds Not Regulated – Splits
2. Domino Effect due to close operating ties between Hedge Funds.
3. Investment Banks.
4. Sharing/leaking of information.
5. One third – One half of daily turnover on LSE/NYSE.

**NOTE:**

FSA recently requested details from large investment banks of pre-marketing calls made to Hedge Fund Investors.

Concerned about Insider Trading/Market Manipulation

# REGULATORY EXPOSURES

1. One third of the 500 UK largest companies believe they will be investigated by the Regulator.
2. Most companies ignorant of Regulator's powers and sanctions.
3. One in seven companies has no compliance officer or procedures in place to deal with a regulatory investigation.

## RISKS:

1. Investors do not understand the nature of the investment.
2. Confused by products on offer.
3. Myriad of Regulations.
4. Missed opportunities.

## **US v. UK**

- Different Corporate Culture.
- Different types of fraud.
- Share Options vs. Shareholder Control.
- US Style of Enforcement – Too Aggressive?

# **LEGAL/LEGISLATIVE DEVELOPMENTS**

- MARKET ABUSE DIRECTIVE
- SEYMOUR v. OCKWELL AND ZURICH IFA LTD. 2005 EWHC 1137 QB.
- IFG FINANCIAL SERVICES v. FOS AND JENKINS 2005 EWHC 1153 QB.

# MARKET ABUSE

1. July 1, 2005.
2. Common EU approach to detecting and preventing financial malpractice.
3. Contrast FSMA.
4. MAD sets minimum standards.
5. Sunset Clause – 2008.



# AIT CASE

1. First criminal prosecution in the UK under market abuse regime of FSMA.
2. Three directors charged with making misleading, false, deceptive statements.
3. Commenced May 2005 – ongoing.
4. Heavy fines and/or 7 years in jail (Worldcom – 25 years).

# **CITIGROUP**

1. £13.9 million (£4 million and £9.9 million)
2. Not market manipulation but lack of internal controls.
3. Cross-border transactions.
4. FSA no authority over one of the trading desks.
5. Long term consequences of this decision.

**SEYMOUR v. OCKWELL & CO.  
AND ZURICH IFA LTD.  
2005 EWHC 1137 QB**

1. Proceedings against IFA and product provider.
2. IFA sought contribution from product provider.
3. IFA's duties:-
  - (i) Document must be clear, fair and not misleading.
  - (ii) Explain nature of risk to client.

- (iii) IFA's duties are non-delegable.
  - (iv) Exercise independent judgement.
4. Zurich as product provider owed a duty to the IFA for any misleading statements, but that did not abrogate the IFA's responsibilities.

# **IFG FINANCIAL SERVICES LTD v. FOS AND JENKINS 2005 EWHC 1153 QB**

1. Sets a dangerous precedent.
2. IFG sued for investments in wrong investment fund.
3. Losses not due to nature of investment but fraud of the investment manager.

- IFG obtained a legal opinion that IFG not obliged to make good the losses as losses resulted from a separate act.
- FOS ordered IFG to make good the loss.
- IFG sought judicial review of the FOS decision.
- Court upheld FOS decision on grounds it was fair and reasonable.

- FOS did not have to follow the law.
- Remains Good Law as no appeal.
- Jurisdiction £100,000.
- Civil Liability Insuring Clause.
- Lumberman's Case.

# DEVELOPMENTS IN POLICY WORDING

1. Very little movement.
2. Market Abuse Exclusion.
3. Investment Banking Exclusion.
4. Reinstatements/Extended Reporting/Reduction in deductibles – SOFT MARKET.
5. Defence Costs for Regulatory Investigations.



5. Civil Liability Clause to include cover for “DIRECTIVE OR RECOMMENDATION OF A REGULATORY AUTHORITY.”
6. Technology Failure Exclusion – BI Cover.
7. Mis-selling Exclusion.
8. Improper Funds Practises Exclusion.
9. Reluctant to write PI cover for Investment Banks.