

**Cases brought by MKB clients against banks claiming misselling of derivatives accumulated to the point that the AFM requested the assistance of the Ministry of Finance. The resulting proposal achieves a pragmatic short-term solution but misses the opportunity to bring true long-term stability to the sector, and may even have the opposite effect.**

On 5<sup>th</sup> 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 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 with regards to derivatives in the sector.

The committee proceeded from the 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 the duty of care owed by the banks due to the asymmetric relationship had been breached, and aimed 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.

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. There is however a three month pilot phase to allow for fine-tuning.

In many ways the proposal is an admirable solution; it manages to hang together despite its internal inconsistencies, nobody is going to be particularly happy with it, but crucially nobody is going to be dissatisfied enough to risk doing something about it. Rumbblings in the press from banks and lawyers about not accepting the proposal are likely little more than jockeying for position in the pilot phase.

The proposal divides the cases in to four categories. The first two of these deal with the more complicated structures and terms which are deemed inappropriate for MKB clients. The general solution is for these to be converted to plain interest rate swaps at the expense of the banks, thus tacitly asserting that these simple swaps are acceptable products for MKB clients. How this conversion will be achieved, and more importantly priced is not clearly specified, leaving the risk that the banks can apply their significant knowledge advantage.

The third category, and in some ways the core of the proposal is the 'coulance', a payment to clients with in-scope derivatives of up to a maximum €100,000. Having agreed the appropriateness of simple swaps, the justification here shifts to knowledge; the assumption is made that all clients were at least partially unaware of the potential consequences of derivatives and would possibly have not entered into them had they fully understood them. However, they are not to be fully recompensed, estimation of the actual cost incurred by clients suggests that this compensation is woefully insufficient. Instead the €100,000 is presumably based on some assessment on the number of genuine cases, and the probability of success in courts which have proven unpredictable in cases pursued so far.

The final category assumes that clients were allowed to mistakenly believe that derivatives would also protect them from conditions attached to the loan itself, conditions giving rise to increased interest rates under certain circumstances which have indeed transpired. However compensation is therefore only due to clients who have a derivative accompanying

their loan. The implication being that those who did not enter into a derivative fully understood the consequences, which may be open to dispute.

The proposal contains ad hoc assertions which border on the inconsistent and reflect a bottom-up approach which responds to specific cases rather than applying general principles. There are a number of more technical anomalies and a lack of clear specification on important points which may make the proposal difficult to apply in practice without encouraging the disputes it seeks to avoid. But the Ministry of Finance has what it wanted, a blanket solution to put an end to the issue. The AFM gets something quick so it can go back to routine business, The banks get to limit reputational damage by swallowing the costs. The claim lawyers get their percentage (some take as much as 25%) without risking a day in court. And many MKB clients get a nice pay-out for doing what they may well have done anyway. So maybe not a bad outcome all round.

Which is all well and good, but an opportunity has been missed and future problems may have been created rather than averted. While the decision to simply assume failure in the duty of care rather than become bogged down in disputes is sensible, it says nothing about what obligations banks have in substituting existing derivatives and managing those positions to expiry, nor, more importantly, does it say anything about what duty of care is expected of banks in dealing derivatives with MKB clients in future. Although not part of the remit, it is hard to imagine the industry will not treat it as a de facto guideline, rather than risk further accusations of negligence. This will limit the options open to more sophisticated clients, and bring inflationary pressure to bear on borrowing costs as banks price in the kind of optionality encouraged by the proposal. And for anyone minded to reject the proposal it will still have a formative effect on the judgement in any court case.

Although the AFM acted responsibly in bringing the issue to the attention of the MoF and requesting assistance, its inability to manage the situation calls into question the sufficiency of its resources in terms of both knowledge and manpower. If it is to continue to perform its function then a review is presumably necessary, both of the rules it is required to apply, and its capability to do so. In which case one wonders why the Ministry didn't simply apply a moratorium on derivative transactions in the MKB sector similar to that applied to housing associations in the wake of the Vestia affair. The cases have been running for two years yet the committee has produced a proposal in two months. This seems unnecessarily hasty and misses the opportunity to bring genuine long-term clarity and stability to the sector.