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Margin lending: a brief introduction

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In these uncertain times with volatile markets we are refreshing this briefing paper on margin lending. This briefing sets out a brief summary of a typical margin loan structure, the risks to borrowers and lenders involved in margin lending, steps that can be taken to minimise such risks and some applicable legal considerations for lenders offering margin loans as part of their services.

What is margin lending?

Margin lending describes the provision of financing backed by a portfolio of cash, shares, units in managed funds, commodities, derivatives and any other form of market traded asset which is extended to individual or corporate borrowers for the purposes of financing investments.

A key feature of margin lending is that the ability to borrow funds is determined by the assets in the portfolio, their loanable value and a credit limit based on the borrower's financial position.

Margin loans can be made by lenders to individual borrowers, limited partnerships, private and public companies, limited liability partnerships and other incorporated associations.

What are "margin calls"?

During the life of a margin loan, the borrower must maintain an agreed security coverage ratio at all times – in other words, the mark-to-market value of the portfolio must be a multiple of the outstandings under the loan (depending on the market volatility of the portfolio assets). If the security coverage ratio falls below the required level, a "margin call" is triggered and the borrower will be under an obligation either to pay down the loan or "top-up" the portfolio with additional assets to restore the coverage ratio and ensure that it is maintained. A failure by the borrower to meet the margin call (by "topping up" the collateral or paying down the loan) will permit the lender to sell assets in the portfolio (as agent for the borrower, or, if the security arrangements qualify as financial collateral arrangements under the Financial Collateral Regulations (see below), by the remedy of appropriation) and apply the proceeds of sale towards repayment of the sums owing to it. The more volatile the portfolio assets that are falling in value, the shorter the timeframes for meeting margin calls, and the faster the lender will wish to liquidate those assets that are declining in value in the scenario where a borrower defaults on a margin call.

What are the risks to the borrower and how can they be reduced?

Although transactions may vary, the main risks to the borrower are:

↘ *Market volatility, margin calls and the risk of losing assets.* If the market declines, it is likely that the value of the portfolio will also decline. If the value of the portfolio falls below the required security coverage ratio threshold, a margin call will be made. Many margin loans are "full recourse" meaning that even if the value of the portfolio falls to zero, the borrower is still liable to repay the full amount outstanding, which may result in the borrower needing to sell assets outside the portfolio in order to make repayments should the value of the portfolio reduce to zero. This risk is increased if the margin loan is made on an "on demand" basis, meaning that the loan is repayable on demand at any time by the lender. If the margin loan is "limited recourse", then the only recourse the lender has is to the secured portfolio. A limited recourse transaction results in increased due diligence by the lender on the portfolio assets and increased focus at deal structuring stage on the exit and enforcement mechanisms.

In the case of a mixed portfolio (rather than a single stock) transaction, to minimise the risk of losing assets and margin calls being made, the borrower must ensure that it is conservatively geared, its investments are diversified and monitored (particularly in light of any loan balances it has) to ensure that it is in the position to meet margin calls and repay the sums outstanding under the margin loan. In addition, by gearing conservatively, the borrower could potentially reduce the possibility that a reduction in the security coverage ratio could result in a margin call (as the borrower would have borrowed less under the loan).

Borrowers should seek legal advice on the documentation relating to the margin loan (and, importantly, any related custody and security documentation) to ensure that they are familiar with their own obligations, the lender's rights and the timeframes within which margin calls must be met and how long the lender is required to wait before it exercises its rights. There is also a risk, in the case of illiquid securities, that the valuation obtained by the lender is too low and that under the Financial Collateral Regulations (see below), the security is effectively appropriated by the lender. During the life of the loan, it is important that borrowers check their loan account regularly as the value of the mark-to-market value of the portfolio could change very quickly and, if the value falls, the borrower must ensure that, if required, it will be able to sell the portfolio assets, or pay down the loan, or top up with other assets, bearing in mind that the timeframes within which margin calls must be met can be very short (e.g. 24 hours or less).

The terms of the margin call provisions and valuation mechanics in the margin loan agreement are the area of the most focus for negotiation in these transactions. Agreeing the frequency and method of valuation is critical. If the underlying portfolio is a range of interests in managed funds, then the lender will typically expect "haircut" mechanisms, i.e. an ability to reduce the value of a particular security and to exclude assets from the collateral pool in the event of liquidity constraints imposed by the fund manager under the terms of the fund documentation.

- *Increase in borrowing costs*. Variable interest rates are subject to change at any time. In a rising interest rate market, a borrower's borrowing costs are also likely to increase and the interest expense on the loan balance may exceed the distributions/ dividends a borrower earns on its investments unless it has an adequate alternate source of income to fund interest costs (failing which, a margin call may be made by the lender). To minimise the risk, borrowers should ensure that they have enough surplus cash flow to make interest payments, or consider entering into a swap arrangement to fix the interest rate on all (or some) of the loan. If possible, borrowers should make regular interest payments (rather than capitalising the interest) to keep the outstanding debt under control.
- *Reducing income and servicing the loan*. The timing of dividend or distribution payments may not coincide with the timing of interest payments, they may also reduce or not be paid at all. To minimise the risk, borrowers should ensure, in the case of a mixed portfolio transaction, that their investments are diversified or spread in different industries and/or markets, to reduce the risk of their entire portfolio of assets falling at the same time. In addition, gearing more conservatively and ensuring that surplus cash is available to meet payment obligations or margin calls would minimise the risk of being unable to make such payments and losing assets.

What are the main risks to the lender?

The main risks to the lender are:

- *Falling mark-to-market value of portfolio*. If the value of the portfolio of assets (or particular assets in the portfolio) securing a margin loan starts rapidly declining, the lender will be faced with a balancing act between maintaining its relationship with the borrower and managing its risk exposure by ensuring that the value of the collateral provided as security remains sufficient to repay the borrower's outstandings. In these circumstances, a lender will wish to act as quickly as possible and make a margin call, giving the borrower a limited timeframe within which to respond before the lender takes further action to appropriate (if such right is available to the lender), sell out the assets and enforce its security to recover the sums outstanding under the loan facility.

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- *Borrowers failing to meet margin calls*. If a margin call is made and the borrower fails to pay down the loan or top up the collateral, it is important to ensure that there is effective internal communication within its organisation between its legal, credit and relationship functions to ensure that any action is taken in accordance with the documentation entered into between it and the borrower and that any negotiations with the borrower are conducted on a "without prejudice" basis, so that no oral agreements are inadvertently made between the lender and the borrower which might compromise the lender's right of recourse. Before the lender takes an enforcement action or sells out any of the assets forming part of the portfolio, lenders must also ensure that they are fully aware of any applicable local law requirements (for example, to act reasonably (as required under US law) or in good faith (as lenders are required to act in most civil law jurisdictions) or to wait a certain specified period of days).
- *Delays to the timing of enforcement*. In a volatile, rapidly declining market, a lender will wish to act speedily in order to ensure maximum recovery and minimise its exposure. Where a lender is entitled to sell out or enforce its security (and has followed all the necessary steps prior to enforcing), the attitude of the English courts is more lender-friendly as to the timing of enforcement than many other jurisdictions. Under English law, whilst a lender must give a reasonable period of time for a borrower to pay before enforcing an "on demand" loan (or a loan that has been made repayable on demand upon the borrower's default), the reasonableness requirement may be satisfied by as little as two hours' notice on a banking day in the jurisdiction of the borrower. Conversely, in other jurisdictions, particularly those whose legal systems are based on civil codes (e.g. France, Belgium, the Netherlands), there is a wide concept of good faith, which requires lenders to take into account the effort that a borrower would need to expend, in practice, in order to comply and any unforeseen changes in circumstances, in deciding how much time should be given to a borrower to remedy a breach. Courts in such jurisdictions are given a large degree of discretion in interpreting this concept, and in some jurisdictions courts have held that lenders must give borrowers periods as long as 2 months to comply.
- *Fund Suspensions,* Lenders should also be aware of the risk of fund suspensions during the life of the loan. That is, periods when dealings may be suspended, particularly in funds with a relatively illiquid asset base, such as commercial property. However, equity funds may also be affected and one high-profile example of this was the lengthy suspension (and ultimate closure) of the Woodford Investment funds. Fund suspensions may result in significant portfolio revaluations and also lengthy periods where investors are prevented from selling securities.

  At a regulatory level, the FCA requires property fund managers to consider suspending funds during times of extreme market volatility, to avoid risking a “fire sale” of illiquid assets and where portfolio values cannot be assessed accurately.
- *Borrower's insolvency, default and other risks inherent in loan transactions.* Whilst margin loans can represent a greater risk to lenders, particularly in times of a market downturn such as now, the pricing of such loans tends to reflect the degree of risk and lenders can exercise their rights (particularly if the loan documentation is governed by English law and the assets are custodied with the lender) fairly rapidly. There are, of course, similar risks associated with margin loans as are inherent in other types of loan transactions – one

of the more substantial ones being the borrower becoming bankrupt or insolvent.

Structuring and security considerations to minimise risk for UK lenders?

When considering whether to make a margin loan to a borrower, lenders will consider how best to structure the loan facility and documentation to ensure that they can exercise their rights to make margin calls, appropriate and/or sell out assets and enforce their security.

↘ *Carry out Due diligence – borrower and portfolio*. When considering whether to make a margin loan to a particular borrower, lenders are advised to conduct due diligence on the borrower and its financial position considering, in particular, the borrower's ability to honour its obligations under the margin loan facility (including repayments of interest and principal). In addition, lenders will carry out due diligence on the portfolio of assets which are to be used to secure the loan facility, carrying out the necessary financial calculations as to the value of the underlying assets and their market performance, liaising with other lenders or market players with separate exposures in relation to the same assets where relevant and obtaining a valuation of the collateral that will most closely reflect its market value and, where possible, a projection as to how the relevant securities will perform in the future. Account will also be taken of the size of a holding of a particular asset (e.g. shares in a particular entity) to be sold and its impact on the market price of such assets (i.e. whether a sale might move the market).

↘ *Lending to individual borrowers.* When lending to individual borrowers (or small partnerships or trustees who are individuals), or seeking to obtain security from individual borrowers, lenders should consider whether the financing arrangements will be regulated by the Consumer Credit Act 1974 and The Financial Services and Markets Act 2000 (or whether any exemptions apply) and should consider all the relevant legal considerations applicable to transactions involving individuals. For a summary of the relevant considerations, please refer to our briefing paper entitled "Lending to individuals".

↘ *Legal advice – all applicable jurisdictions*. As well as carrying out the standard due diligence on the borrower's financial position, lenders should map an exit strategy that is specific to the proposed margin loan at the outset to ensure that, in both a downturn scenario where the value of the underlying collateral assets rapidly falls and the scenario where the borrower becomes insolvent or bankrupt, the lender is aware of the timeframes and process in the relevant jurisdictions (which should be clearly outlined in its documentation), as well as the legal rights it has to enforce its security and to appropriate or liquidate the borrower's assets.

Lenders are advised to take legal advice in all applicable jurisdictions – the jurisdiction of incorporation of the borrower, the laws of the jurisdiction by which the loan agreement is proposed to be governed (for our purposes, this is assumed to be English law) and the laws of the jurisdiction where the portfolio assets are listed or custodied. The latter is of particular importance, particularly where the relevant securities are listed on a foreign exchange, registered under local laws or custodied with a foreign (i.e. non-UK) entity as there may be limitations/ delays in the timing of enforcement against such shares under the laws of the relevant jurisdiction. For example, in France, there may be a lengthy delay in enforcement caused by the legal requirement that a lender take into account the borrower's circumstances in complying with a demand before it can enforce and sell the assets. There may also be specific procedural requirements on enforcement. In Turkey, for instance, enforcing security over shares governed by Turkish law could take up to 12 months if the lender has not provided for a contractual sell out right in the loan agreement, as the lender would need to apply to the Turkish "Execution Office" to sell the shares on the Turkish stock exchange.

Lenders will also need to ascertain whether the laws of the jurisdiction where the portfolio securities are listed or held will recognise English law security, or whether security governed by local laws should be taken over the assets.

It is also worth checking whether the actual loan arrangements have a bearing on the security structure. For instance, Spanish law does not recognise the concept of a security trustee and, in a syndicated transaction under Spanish law, security must be granted in favour of every lender (or one lender provided it holds it as agent for the other lenders).

↘ *The all important issue of custody*. Where the portfolio assets are held or custodied will determine the rights that the lender can exercise against those assets and the speed with which such rights may be exercised. Under English law, where securities are custodied with a UK lender, English law security can be taken over such assets (irrespective of the jurisdiction governing the securities, with limited exceptions). Where the securities are so custodied (i.e. the securities are transferred into the name of the lender or its nominee) and security in respect of the assets is granted in favour of the lender, legal title to the shares (as a matter of English law) passes to the lender or its nominee. In exercising its rights in respect of securities in a sell out scenario, the lender would act as agent for the borrower (and the transaction would not be for the bank's account). In a scenario where the securities are not custodied with the lender and, in particular, where there is a right to substitute the securities forming part of the portfolio, the lender may only have a floating charge over the portfolio, meaning that other creditors could have priority over the lender's security over the assets (if they hold a fixed charge or a mortgage over the assets) and, in a scenario where the borrower goes into liquidation proceedings, unsecured creditors would be entitled to a portion of the recoveries under the floating charge (up to a maximum of £800,000).

When structuring the transaction and deciding where the assets forming part of the portfolio are to be custodied, local advice should be sought in the jurisdiction governing the assets. For example, Russian law is not familiar with, and may not recognise for Russian legal and regulatory purposes a non-Russian nominee and collateral arrangement where an international custodian (not having a Russian depository licence) effectively acts as a nominee or custodian for an underlying client and holds securities in the Russian registration/ custody systems. However, if a local sub-custodian (having a Russian depository licence) is used, all legal rights to the securities will sit with the international custodian (i.e. the UK lender) and the UK lender should be able to rely on the English law security governing the margin loan collateral.

↘ *Margin calls, top up and sell out*. Where the value of the portfolio and the security coverage ratio falls and the lender wishes to make a margin call, it must do so in accordance with its contractual rights set out in the loan documentation. For example, if the documents provide that a margin call must be made in writing, it is not sufficient for

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a margin call to be made by telephone and a written notice must be given. Whilst it is important to lenders to maintain the relationship with the borrowers, having a telephone conversation with a borrower, followed by an e-mail in informal terms may have benefits in terms of customer relationship management, but if a formal margin call is to be made, a formal written notice (whether given by e-mail or otherwise) should state so in no uncertain terms.

Care must be taken when drafting notices provisions, particularly in standard form documents and when considering them prior to making a margin call. When examining whether notices formalities have been complied with, courts will take into account how notices were given (i.e. by what means), addressee and recipient of the notices, the timeframe in which the notices were given and the time when such notices are deemed to have been received.

After making the margin call, the lender must ensure that any timeframes afforded to the borrower for meeting the margin call (i.e. paying down the loan or topping up collateral to restore the security coverage (or loan to value) ratio) will have passed before the lender takes any steps to liquidate or appropriate the collateral and enforce its security. The time afforded to borrowers can, under English law, be very limited – i.e. 24 hours or less.

↘ *Enforcement*. If a borrower fails to comply with a margin call, as mentioned above, it is important for the lender to ensure that its internal communications between the credit risk, relationship manager and legal teams are aligned and effective to ensure a "united front" and the establishment of the most effective strategy on enforcement. If the lender negotiates with the borrower, care must be taken that such negotiations are conducted on a non-binding, non-prejudicial basis to the lender's rights under its loan and security documentation.

If the lender wishes to appropriate the collateral by exercising its rights under the Financial Collateral Regulations (see below), it can do so immediately upon the security becoming enforceable.

If the lender wishes to sell out, whilst it would need to give the borrower a "reasonable" amount of time to honour its payment obligations before it can do so, case law suggests that in margin loans, as the lender and the borrower both have a substantial exposure to negative market movements, it is legitimate for the lender to seek to protect itself against a fall in the value of securities As mentioned in the previous section, what constitutes a "reasonable" amount of time under English law has been interpreted in a lender -friendly way by the courts and (in the absence of agreement to the contrary) as little as 2 hours can be considered to be a "reasonable" amount of time for these purposes. When exercising its rights, it is of crucial importance that the lender acts in accordance with its rights under the documentation and any applicable laws. Failure to do so could result in the borrower challenging the action by the lender in court.

A lender should ensure when drafting documentation, particularly standard form documents, that the lender's rights are clearly set out. The importance of clear drafting cannot be overstated.

↘ *Financial Collateral Regulations.* Where the borrower and lender are both corporate entities, the assets forming part of the portfolio constitute "financial collateral" or "cash" for the purposes of the Financial Collateral Arrangements (No. 2) Regulations 2003 (as amended) (the "Financial Collateral Regulations"), the portfolio is custodied or in the control of the lender and the security documents expressly include a right, by reference to the Financial Collateral Regulations, of appropriation of the collateral, the lender may, on enforcement, appropriate the financial collateral and become the absolute owner of the collateral when the security has become enforceable. It will, however, have to value the securities and account to the borrower for any value in excess of the sums due to the Lender.

↘ *Documentation and operational procedures.* A lender's documents should clearly outline the lender's rights to make margin calls, when such rights arise, the borrower's obligations when a margin call is made, the timeframe for meeting margin calls and the rights of the lender in the event of a default by the borrower to meet a margin call.

The security documents should clearly set out when the security becomes enforceable and the rights of the lender following the security becoming enforceable (including (without limitation) appropriation (where applicable), sell out, assignment and novation). It is important that the lender can exercise such rights without the consent of the borrower, or even notice to the borrower in order to expedite the enforcement process.

It is equally important for lenders to ensure that their operational procedures are closely aligned to their documents, particularly where margin calls are not made by members of the lender's legal team who may be less familiar with the rights afforded to, and obligations imposed upon, the lender under its margin loan documentation.

Provided that the lender complies with the terms of the margin lending documents and any local law requirements on enforcement (see above), and does not act in a way which seeks to take improper advantage of a borrower, it will be difficult for margin borrowers to challenge forced sales of portfolio securities on the grounds that they were precipitate, that the market might have rallied or that they were somehow unfair.

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