Financial Crisis 2007-08 & FCA Rules to Protect Client Assets

Author: Varsharani Dattatray Pawar

Introduction:

This review article concludes the causes of 2007-08 financial crisis and steps taken by the United Kingdom government post crisis. It gives an overview of the FCA functionalities and CASS rules designed to protect the client assets and money.

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1. Financial Crisis 2007-08

The financial crisis started in 2007 in the United States subprime mortgage lending and spread across Europe and Asia damaging the entire banking system until the Federal and Europian governments came to the rescue. Let’s see how Northern Rock and Lehman Brothers went down.

1.1 Northern Rock

Northern Rock was one of the first victims of the financial crisis which started on 14th Sept 2007. The cause of the downfall of this bank was bad securitization of the client assets (US Home loans). Banks lend money to one another un interbank wholesale market securitizing assets from one another. Northern Rock was more dependent on the funds coming through securitization. Instead of offloading the risk they continue to get mortgages on client assets until other banks stopped lending money. It is a classic example how the financial instruments can shift the risk away from the bank. As the funds stopped flowing through Northern Rocks had to seek help from the Government and on 22nd Feb 2008 bank was taken in control by Govt. Downfall of the Northern Rock clearly shown the lack of regulation and failure of the regulatory system that could have detected the crisis in early stage.

1.2 Lehman Brothers

Lehman Brothers was one of the biggest banks to collapse in 2008 mortgage meltdown. They filed bankruptcy on 15th Sept 2008, it was the largest bankruptcy in US history. This is how it happened, in mid 2000 there was a boom in the US housing market. Banks were offering loans on cheaper rates. As the interest rates were less, investors were seeking for new investments to get more returns. To take advantage of this situation, banks bundled all the mortgages into security bonds and sold to investors. The mortgage paid by the lenders pooled and paid to the investors who purchased those bonds Soon, most of the mortgages from eligible borrowers were sold off. To continue gaining profit, banks and brokers started lending loans to borrowers with bad credit history, unstable income, having more probability to be default. These types of borrowers are called subprime borrowers. From 2001-2006 percentage of lending money to subprime borrowers doubled. The debt from the subprime borrowers was called as the risky debt. Risky debt was bundled with safer debts and sold off to investors and other banks. Soon subprime borrowers with risky debts started to default and housing property prices started to crumble down. Banks found themselves with the enormous bad debt mixed with good. Due to the uncertainty, interbank credit system was stopped. The enormous bad debt and no interbank credit caused the downfall of the

Lehman Brother. This again exposed the failure of the regulatory system to detect these risks.

Apart from Northern Rock and Lehman Brothers, BNP Paribas, Bear Stears, Washington Mutual and many other went bankrupt in this financial crisis caused by subprime market mortgages and misuse of client assets and money. The crisis shown the insolvency of the investment firms and collapse of the banks is not just a theoretical risk. To avoid these risks preventive measures have been taken by all the affected countries like UK and USA who had most damages. Risks in the financial market are inevitable but with proper rules and regulations these risks can be managed and acted upon proactively. Let's see what preventive measures taken by the United Kingdom government to mitigate the risks.

2. Effects of Financial Crisis:

Downfall of major financial institutions from UK or USA did not affect just those countries but it shaken the economy of the whole world. Soon after banks from the Asian market started to get in trouble until the European Government and Federal Government came to rescue and distributed funds worth trillions of dollars. Because of the crisis, stock prices went down drastically, people lost their jobs, many small businesses went down, there were no new jobs. The crisis caused great recession from 2008 to 2012. People have lost their lifetime savings, their livelihood and faith in the banking system.

3. Preventive Measures:

The downfall of the Lehman Brothers and other firms resulted in lengthy and complex litigation and regulators understood the need of effective controls to segregate the client's money and assets. Financial Conduct Authority has been founded in April 2013 in UK which will regulate the UK's financial market. FCA created and strengthened the rules to ensure the safety of client's money and assets. Client assets sourcebook (CASS) was created and it includes the rules that firm/bank should comply when they are holding and controlling the client money and assets. These rules are updated regularly to enhance the integrity of the UK financial system and to secure the appropriate consumer protection.

4. What are Client Assets?

Client assets include money, securities and other property that the firm look after, but belongs to the client. FCA insists "A firm must arrange adequate protection for client assets when it is responsible for them."

5. What is Client Money?

Client money is the money of any currency that a firm holds or receives on behalf of the clients as a part of its investment business. Let's see some examples:

- A client sells a security to an investment firm and passed the stock to the firm but has not provided any specific instruction regarding the payment. The firm then holds the stock but does not pay client for it. The firms required to include cash amount because of the client into client's money account and hold it in until it is being paid to the client.
- An investment firm receives dividend on behalf of the client from registrar, but the firm is unable to pay the client until the following day. So, it has to include and hold that much amount of money in the client's money account until it is paid to the client.

- If the investment firm receives some funds in their account but unable to identify who the funds belong to. The fund will be investigated and if not identified it will be put into daily amount of client money to be held in client money bank account.

6. What are safe Custody assets?

Firms has responsibility to ensure the safety of any non-cash assets they might hold on behalf of the client. Client assets rules are designed to ensure that the client assets are identified and segregated from the firm's assets.

Client assets should not be used in securities financing transactions without the client's consent.

There are few exceptions like:

- If the firm has right to rehypothecate the client assets, then they can use them in security financing transactions.
- Client assets can be used by the firm if they are held during the securities settlement.

7. What are Physical assets?

When a client keeps their physical certificates or loan notes with an investment bank, it is the duty of the bank/firm to maintain books and records of their possession. Access to the safe should be controlled to prevent the safe custody assets being misused or misplaced. Regular reconciliations should be performed to ensure that firm's record of the client assets held in the safe, agree with the actual physical holdings in the safe. Any discrepancies identified during the stock count reconciliation must be promptly investigated and corrected.

8. Assets held with third party

If the firm wants to use any third-party custodian to hold their assets, then they should assess the third party with the aspect of the skill and due diligence.

Safe custody assets must be identifiable from assets belonging to the firm or the third party with the use of differently titled accounts or equivalent measures. They contractual arrangements with the third-party custodian need to ensure that the client's ownership rights are recognized and protected. There will be non-lien or right of set-off over the client account in respect of obligations owed to the custodian, unless those obligations relate to one or more of the firm's clients or the lien is required by applicable law in the jurisdiction.

9. Asset Acquisition

If the client wants to give custody of their assets to any investment firm/bank, then they must approach Operations Regulatory control for the approval. They must provide a detailed proposal that will describe the new custody arrangement. Custody request template must be filled and get approved by Business MD and operations. Final approval is provided by IB CASS Certified individual then the firm will hold the client assets on behalf of the client.

10. Registration and recording legal entities

As per the FCA rule safe custody assets should be on the client's name or on the appropriate nominee company formed by a bank to act as a legal title holder of the client assets.
Client assets can be registered on third party's name in a few exceptional cases. Even if registering assets to a third party is considered, it has to be in the best interest of the client.

There are four categories of registering client assets in order of the strength of protection:

- The client itself
- A Nominee companies. After the introduction of PS 14/09, firm's and client's assets cannot be held in the name of the same nominee.
- Any other third party (agent) if outside the UK and it is market practice in the jurisdiction.
- Firm outside UK having market practice in their jurisdiction.

We have seen different types of assets and how they are acquired. Now we will see how the CASS rules are designed to protect these assets

11. Targets of CASS Rules

- Prevent the use of client assets by firm without agreement from client.
- Protect the ownership rights of the clients in case of insolvency of the firm
- Reduce the risk of loss of client assets due to administration error, negligence or inadequate records.

12. Firm Classification according to Client money and assets they hold (Source: CASS 1A.2.7)

- **CASS Large firm:**

A firm holding total client money more than 1 billion Euros or safe custody assets valued more than 100 billion Euros in the previous financial year or projecting to hold in current financial year.

- **CASS Medium Firm:**

A firm holding total client money equal to or more than 1 million Euros and less than 1 billion Euros or safe custody assets valued equal to greater than 10 million Euros and less than 100 billion Euros in the previous financial year of projecting to hold in current financial year.

- **CASS Small Firm:**

A firm holding Client money less than 1 million Euros or the client assets less than 10 million Euros in the previous financial year or projecting to hold in current financial year.

13. How the protection is achieved?

There are four core concepts on which the CASS rules are based:

13.1 Identification:

Client Assets must be identified and differentiate from the firm's own money and assets. In case of the downfall of the firm, the administrators will decide what the relevant legal entity is holding and who has the right to those assets. Regulations insists that the accounts, records and bank statement should be clear enough to decide whether the assets, money, or securities belongs to the client or the firm.

13.2 Segregation:

Just identifying and differentiating the client assets won't be helpful if the assets are not held separately. FCA states that the client assets and firm's assets must be held separately. To segregate the client assets and firm assets, firms operate with the separate bank account and custody accounts. This helps them to avoid mixing of the assets. The acknowledgement and Non-Lien letters are required to comply and to be legally effective with the FCA's requirements for all client accounts held with the bank, custodian and third parties like exchanges and clearing houses.

13.2.1 Non-Lien Letters

Non-Lien letter is written by the asset owner stating that the asset has no mortgages on it. There are significant controls within the firm surrounding the receipt and issuance of acknowledgment and non-lien letters. It is an important document to meet the FCA's requirements. The printing of such letters on the wrong legal entity's letterhead or the inclusion of brackets in the text of the document can render the document inadequate. To avoid this, four eye checks, play an important role.

13.2.2. Acknowledgment letters:

This letter signifies that the money or the assets are not owned by the firm but owned by the client/ It also recognizes that the firm cannot use the client assets to offset any debt the firm might have. Firms and banks with which the client money is held, exchanges the acknowledgment letter. This letter should be considered before entering into new agent bank agreement.

13.3 Due diligence and diversification:

All the investment firms, banks, insurance agencies required to exercise due diligence, skill and care to ensure they are eligible and fit for the purpose. Since the financial crisis of 2007-08, FCA mandate the firms to diversify the risk introducing 20% limit for the affiliated banks holding the client money. Protection for the client money and assets can be achieved by distributing the deposits across the number of banks.

13.4 Calculation and Reconciliation:

Firms must perform reconciliations of the client money and assets to ensure that their books and records are accurate. They must assess that they have sufficient funds available in order to meet the client's claim.

Reconciliation frequency is measured by the transaction volume, size and complexity. There are certain minimum standards to be met depending upon the type of the reconciliation. Internal and external client money reconciliation performed daily, whereas for the safe custody assets reconciliation is performed on daily, monthly or bi-annual basis depending upon the type of custody being reconciled. Reconciliation must be undertaken by a person who is not responsible for production and maintenance of the records.

14. Key Changes in CASS rules

We have seen the core principles on which the CASS rules are based. FCA continues to update the CASS rules and makes sure that the rules are strong enough without having any loopholes that can be exploited.

14.1 Introduction of CF 10a- CASS Operational oversight Function:

CF 10a function signifies the responsibility of operation effectiveness, reporting any oversight to the firm's governing body and submitting CMAR to FCA.

Previously all the medium and large firm had to allocate the function of CF 10a to senior manager or director. This has now replaced with the Senior manager regime (SMR). This change has been done because firms have divided the CASS operational oversight between number of staffs across different functions like finance, operations or compliance which resulted in the oversight and poor control over the rules. The CF 10a function has mitigated that risk.

14.2 CMAR: Client asset and money return:

FCA has introduced a portal called Gabriel (https://gabriel.fca.org.uk/) to collect, validate and store the regulatory data. All medium and large firms must complete a CMAR on the Gabriel portal on a monthly basis. This provides an overview of each firm client money and assets positions and their holding. CMAR includes cash and stock reconciliation breaks, the value safe assets where and how the assets are held and no on the clients for the regulated entity in question.

14.3 CASS Resolution Pack (RP)

CASS resolution pack was added to the CASS rulebook in October 2012 in the chapter 10. The resolution pack contains the documents and records that can be used by insolvency practitioner while returning client money or assets.

There are certain guidelines to maintain a CASS resolution pack like:

- The content of the RP must be updated and reviewed from time to time, any changes to the client holdings must be reflected in RP within 5 business days.
- The CF10a must attest in respect of compliance with the rules at least annually to be the board.
- All documents within RP must be made available within 48 hours upon the request of insolvency practitioner or FCA.

14.4 Diversification:

This rule ensures that the investment firms cannot hold more than 20% of client money or assets with a group entity or combination of such entities at any point of time. Firms must monitor this daily and move funds to external banks accounts if required.

14.5 FCA Policy Statements 14/09

FCA conducted a study in 2013 with investment management firms and in June 2014, they introduced new processes surrounding governance and management of stock shortfalls.

14.6 Financial reporting Council

The requirements which cover how client money and assets auditors must plan and conduct their work have been updated by FCA. This resulted in a new client assets assurance standard being published by the Financial reporting council.

Investment firms/banks must have a risk and control framework in place, and it should include a CASS rule matrix of applicable ruleset. They should have a CASS controls mapping for every application of CASS rule.

Auditors evaluate whether management responsible for governance seeks to maintain a culture of honesty and ethical behavior towards beneficial owners of client assets. Auditors make sure that firms are following the CASS culture and maintaining the documentations that adequately describes the firm's business model. They also assess that firms are conducting CASS specific risk and control assessments and has good control over third party administrators.

The financial reporting council promote high quality of corporate governance and reporting to foster investment. The FRC standards for corporate reporting audit and actuarial practice, It also monitors and enforces accounting and auditing standards.

15. Structural Reforms:

More recently, several domestic and international reforms to bank regulations have been introduced or are currently being implemented and seek to improve the resilience and resolvability of banks, through making changes to their structure.

Ring-fencing is the UK legislative requirement that states larger UK banks should separate UK and other European economic area retail banking activities from the rest of their business by 1 January 2019.

Structural reform transforms the way the UK financial services industry operates in order to make it more resilient in the event of financial crisis.

Apart from the client assets and money holding in custody firms hold client assets like collaterals or mandates. CASS has rules to protect them as well.

16. What are collaterals?

Firms receive cash or non-cash assets as collateral form the client as an obligation to the firm. IF any client keeps cash or non-cash assets as a security in order to secure the loan then these assets are called as collateral.

FCA identifies collateral assets separately and has separate rulebook (CASS 3) for collaterals. Client asset and money do not apply to the collateral if the client is default. Let's have a look on collateral assets rules.

17. Collateral Asset Rules:

- If a firm uses the collateral assets, they do not treat them a custody or client money. However, firms must maintain records and must be able to return the collateral assets to the client once the client's obligation towards the firm is over.
- Unlike client assets and money, firms can use the collateral assets.
- As per the FCA, for the retail and prime brokerage clients a statement must be sent out to them stating which of their assets are being held as custody and which of them are collaterals.
- If the firm is going bankrupt the clients has right to surrender, reaffirm or redeem the collateral assets. Surrender means the client hand over their assets to the firm and will have no ownership post-bankruptcy. Reaffirm means, the client continues to make the payments with new agreement and gets the collateral assets back once the obligation is over. Redeem states that the client purchases the assets with the price of current market value. Client has to inform the firm their intention within 30 days of the declaration of insolvency.

18. Conditions to Apply Collateral rules:

- Collateral rules are applied when the firms receive or hold money or assets from clients to secure the obligations the client owes to the firm.
- FCA collateral rules do not apply when the firm may only use the collateral received from a client when the client is default. This is also known as "having a bare security interest". In these cases, up until the time that the client is default, firm must provide protection the collaterals.

19. Mandates

The mandate rules applied when the firm control rather than hold, client assets or the firm can create liabilities using the assets in the name of the client. These rules are written in CASS 8.

19.1 What qualifies a Mandate?

- An asset obtained by the firm with client's consent.
- An asset retained by the firm
- If the firm can control the assets on behalf of the client held outside the firm including potentially another entity within the group.
- Mandates do not require client's involvement to be used.
- When the firm is in a position to be able to give instructions to another person in relation with the client assets.

20. Types of Mandate

20.1 Fee collection mandates

These mandates are used where a client instructs the firm to debit the client's bank account on a regular basis with an amount to cover any fees or commission rather than deducting money from their portfolio. This helps the client to maximize the profit on their portfolios. This is different than a standing order where the client sets up a recurring payment to the firm.

20.2 Discretionary Investment Mandate

These mandates allow the firm to control clients' investment portfolios in line with broader limit such as their attitude to take a risk, type of their assets or geographical limits

20.3 Regular investment Mandate

Firm can collect regular sums from the client bank account either by direct debit or recurring debit for investment into their portfolio.

21. CASS rules to protect the Mandates:

Firm must maintain adequate records of the use of mandates which includes:

- An up to date the list of mandates including details of condition of use.
- Records of all transactions made with the mandate
- Controls that limit the use of mandate
- Procedures and controls around the giving of the instructions under the mandate
- Controls around any passbooks or any similar documents held on behalf of the client preventing their misuse.

Conclusion:

Risk in the financial market is inevitable. The crisis had prolonged effects on the global economy. Trillions of dollars were lost and it took great effort and time to recover from the crisis. These risks can be managed with the due diligence and following the regulatory rules. FCA has ensured safety of the client assets and prevented its misuse. Many firms have come under scrutiny and fined by FCA because of the violation of CASS rules. These rules will play a vital role in future and mitigate risks before they lead to any crisis like 2007-08.

References:

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[2]. CASS-FCA Handbook
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