Budget Representation from the All-Party Parliamentary Group on Fair Business Banking

Autumn Budget 2018

26 September 2018

1. Confidence in the Commercial Lending Market

Small and Medium-sized Enterprises (SMEs) are vital for the prosperity of the UK economy. A recent report by the Centre for Policy Studies[1], quoting statistics from the Department for Business Energy and Industrial Strategy, showed that SMEs account for 99.9% of businesses, generate £1.8 trillion in turnover, employ more than 60% of people in the private sector and are responsible for almost 70% of movement from unemployment into the private sector.

However, over the past decade, the relationship between banks and their SME customers has been damaged by a series of high-profile scandals. Business banking scandals at RBS and Lloyds HBOS adversely affected thousands of small businesses, their owners and employees. Most business owners understandably assumed that adequate protections were in place to deal with such problems. They believed that they had access to an easily accessible form of dispute resolution if things were not dealt with satisfactorily by their bank; and that their bank would be held to account and made to rectify any poor behaviour.

However, this was shown to not be the case. Business customers have found out through bitter experience that they have less regulatory protection and fewer options for pursuing redress than individual consumers, even though they face similar problems and do not have the sophistication or resources enjoyed by larger companies. Most commercial lending is not regulated, and businesses do not have the same right of action that private individuals do to pursue damages for breaches of financial regulations under section 138D of the Financial Services and Markets Act (FSMA).

These high-profile scandals, and the lack of adequate redress mechanisms, have led to a loss of trust between companies and banks, undermining confidence in the financial services industry and contributing towards a fall in demand for borrowing by businesses.

A recent article in *The Times*[2] used data from the SME Finance Monitor to demonstrate the lack of trust in banks felt by SMEs. The article showed that in 2017, only one in six companies that were not using external finance said they would be willing to do so, down from a quarter in 2015. Furthermore, only one in three SMEs were willing to borrow to finance growth in 2017 compared to a half in 2015. The article also demonstrated that only 5% of companies reported making a new loan or overdraft application in the previous 12 months, a figure which has more than halved since 2012.

[1] Rishi Sunak MP 'A New Era for Retail Bonds', Centre for Policy Studies, November 2017

[2] Times Article 15th March 2018 'Small Firms Say No to Bank Loans'

The lack of confidence and trust is having a damaging effect on the UK economy and steps must be made to ensure that businesses have access to suitable, efficient and affordable redress mechanisms.

2. Current Dispute Resolution Landscape

Business customers have less regulatory protection and fewer options for pursuing redress than individual consumers. Most commercial lending is unregulated, and businesses do not have the same right of action that private individuals do to pursue damages for breaches of financial regulations under section 138D of the Financial Services and Markets Act (FSMA).

Businesses can seek independent redress through the Financial Ombudsman Service (FOS), which aims to provide a quick, free, impartial and informal process for relatively low-value financial services disputes. However, only microenterprises with a turnover of less than €2 million and no more than 10 employees are currently eligible to take a case to the FOS, while its compensation limit of £150,000 is often inadequate to cover the losses sustained by businesses.

The FOS is a form of Alternative Dispute Resolution (ADR), which performs a valuable role, but operates behind closed doors, so does not afford the opportunity for public scrutiny. Furthermore, it cannot act where a business has gone, or been forced, into administration and lacks the powers of a court, for example to require disclosure of information and to compel witnesses to give evidence. Therefore, it cannot provide the more formal dispute resolution mechanism that businesses require for complex and often life-changing disputes.

The courts are therefore often the only formal dispute resolution mechanism available to businesses. Although they are a tried and tested method of resolving disputes, SMEs face significant barriers in accessing them. There is an often-insurmountable imbalance of power and resources between financial firms and their business customers and many businesses cannot afford the cost of a court case, which can be lengthy, particularly with the risk of having to meet the other side's costs if a case is lost.

It has also been accepted that the common law is not sufficient in financial services disputes, which is why there has been the introduction of the regulations set out in the FCA Handbook and PRA Rulebook. However, businesses are barred from bringing actions for breach of the Financial Conduct Authority (FCA) or Prudential Regulation Authority (PRA) rules.

This means that there is currently a significant problem for businesses in accessing justice, which is partly due to a lack of legal rights. However, there is also a gap in provision between the disputes dealt with by the FOS, which has a claim limit of £150,000, and those claims which are large enough to attract litigation funding (claims usually of at least £5 million) and so make going to court feasible. It is estimated that businesses would need to incur at least £50,000 in legal fees and other disbursements prior to even making an application for litigation funding.

The FCA has stated that "Only a very small proportion of SMEs take their disputes with financial services firms to court" and the fact that the FCA is proposing to extend the eligibility criteria for the FOS is further acknowledgement that a gap in dispute resolution provision for businesses exists. Yet even if the changes to the FOS eligibility criteria go ahead, this gap will persist and the FCA still "sees a role for both the Ombudsman and a tribunal as they meet different needs".

3. Policy Recommendations for the Budget 2018

To create a level playing field between financial firms and businesses, and address the twin issues of SMEs' lack of legal rights and the gap in dispute resolution provision, the APPG on Fair Business Banking recommends the following:

3.1 Enhance the Legal Rights of SMEs

Businesses are restricted from bringing actions for breaches of the FCA Principles for Businesses and the FCA rules. Primarily, the FCA Principles for Businesses 'which are high level standards' require a firm, amongst others, to pay due regard to the interests of its customers and treat them fairly (Principle 6). They enable the FCA to bring public enforcement action against financial firms for breaches and are not actionable by 'private persons' under section 138D of the Financial Services and Markets Act (FSMA).

Although most of the FCA rules are actionable and provide the right to bring an action for damages for losses suffered as a result of breaches of the FCA rules, this is currently limited to 'private persons', which excludes almost all businesses.

This has led to illogical consequences. For example, while sole traders or partnerships can bring an action for breach of the FCA rules, a company or limited liability partnership of similar size and/or sophistication is not a 'private person' and is unable to bring an action. It is unreasonable that the ability to bring an action should depend entirely on the legal form, rather than the size or the sophistication, knowledge or experience of a business.

The best and simplest way to extend the legal rights of SMEs is, therefore, by extending the section 138D right of action. This would be done by amending the 'private person' definition contained in the FSMA's Rights of Action Regulations 2001 (FSMA (RAR) 2001), which is secondary legislation, and would have the effect of giving SMEs a right of action for breach of the FCA rules.

An alternative approach would be to extend SMEs' rights of action for breaches of the FCA Principles for Businesses. These principles are broader than the FCA rules and so would afford SMEs greater legal protection, which may be deemed necessary. It is, therefore, suggested that PRIN 3.4.4R is amended to remove this restriction. In addition, PRIN Schedule 5 Rights of action for damages, which sets out the FCA rules which are actionable under section 138D, should be amended to reflect the removal of this restriction and this could be implemented by secondary legislation.

3.2 Extend Regulatory Protection

Not all financial services provided by firms are regulated, an example being commercial lending, including fixed-rate loans. Here the regulatory regime under FSMA does not apply, so the FCA is unable to bring enforcement proceedings and private persons are unable to bring section 138D claims. This seems anomalous given the problems that have arisen in this area, so the definition of regulated activities as set out in FSMA and FSMA (RAO) 2001 should be amended to include certain unregulated activities such as commercial lending, which could be done by secondary legislation.

3.3 Establish a Financial Services Tribunal

With the extension of section 138D, SMEs would be able to enforce their new legal rights in the courts. However, a new Financial Services Tribunal would be an additional forum in which to resolve disputes and so fill the gap in dispute resolution provision. It would be modelled on existing tribunals, such as the Employment Tribunal, with two wing members from business and financial services backgrounds

to support the judge by providing knowledge and experience and the use of an inquisitorial as well as adversarial approach.

The tribunal would have full legal powers to enforce disclosure of information and the attendance of witnesses and clear procedural rules. However, it would use its procedural flexibility to deal with cases in an appropriate manner depending on their nature and complexity and ensuring simple, low-cost access to justice for claimants.

The default position would be that the losing side would not pay the other side's costs to remove this element of risk for claimants. However, claimants could apply to have this changed in cases deemed complex and, therefore, costlier. To recognise the imbalance in power and resources between banks and small and medium-sized businesses, such complex cases could be subject to 'qualified one-way cost shifting', so businesses would be able to recover their costs, subject to a cap, while financial firms would not.

It is proposed that the Financial Services Tribunal would be created under the Tribunals, Courts and Enforcement Act (2007), which gives the Lord Chancellor the power to amend the lists of tribunals in Schedule 6 of the 2007 Act. Although administrative tribunals can be established through secondary legislation, primary legislation is required for tribunals such as the Employment Tribunal.

Given that the proposed Financial Services Tribunal would hear private banking disputes, rather than hear appeals against administrative decisions, it would be more akin to the Employment Tribunal. As such, it is suggested that primary legislation would be required to establish a new Financial Services Tribunal.

3.4 Consultation on Insolvent Firms

Former owners or shareholders of insolvent businesses currently find it extremely difficult to resolve a dispute and recover losses since they cannot take their cases to the FOS. The current right of action under section 138D can be assigned by a private person. So, if this right is extended to businesses, as proposed, they will enjoy that right, too, and it should be possible for administrators or liquidators, as assignees, to bring section 138D claims.

However, insolvency practitioners are very reluctant to pursue claims on the basis that the costs are likely to outweigh the benefits. This seems particularly unfair given that many businesses have found themselves forced into insolvency by poor conduct on the part of a financial firm. The APPG therefore proposes that the Government launches a consultation to look at how this situation might be improved, a precedent being the existing consultation into restructuring the corporate insolvency framework. The APPG supports the principles in the consultation and encourages the Department for Business, Energy and Industrial Strategy to pursue this legislative agenda.

3.5 Address Time Limitations

Many business cases go back many years and so their claims have run out of time. Generally, the limitation period for bringing a claim is six years in England and Wales, and five in Scotland. Even if no agreement has been reached with a bank to extend the limitation period by entering into a 'standstill agreement', Section 32 of the Limitation Act 1980 does postpone the running of any applicable limitation period where:

- The action is based on the fraud of the defendant.

- Any fact relevant to the claimant's right of action has been deliberately concealed from him by the defendant (including the deliberate commission of a breach of duty in circumstances in which it is unlikely to be discovered for some time).
- The action is for relief from the consequences of a mistake.

In any of the above cases, time only runs when the claimant discovers the fraud, concealment or mistake; or could have done so with reasonable diligence. This could provide grounds for some claimants. However, the APPG calls on the UK Government to see what else could be done to ensure that those who have suffered from historic banking abuses, within the past 10-15 years in some instances, will be able to take their case to the Financial Services Tribunal.

4. Costs to the UK Economy

The APPG propose that the Financial Services Tribunal would be funded by the Treasury in the same way as other tribunals. However, the APPG suggests that the Treasury introduce a small levy on financial services companies to meet the cost which would require legislation.

The administrative costs of running the Financial Services Tribunal would depend on the number of cases. Richard Samuel, a barrister at 3 Hare Court, has stated that the Employment Tribunal costs around £80 million per annum to run and it is unlikely that the cost of a Financial Services Tribunal would exceed that.

The cost of running a Financial Services Tribunal represents good value for money when set against the IRHP redress scheme, which cost the banks £141.5 million in 2012-13 alone.

5. Benefits to the UK Economy

The APPG is of the firm belief that the implementation of the above policy recommendations will have a major impact on the SME lending market, impacting economic growth and the UK economy. Implementing these changes to the redress landscape for SME borrowers will increase their confidence that they have access to efficient redress in the event of a dispute. This will have consequential effects on borrowing and economic growth.

5.1 Business Confidence

In the wake of the financial crisis, the banking sector's reputation has suffered from a number of disturbing scandals, many of which have had a catastrophic effect on thousands of individual lives and livelihoods. Over the last few years, debates in the House of Commons have highlighted instances of the mistreatment of business customers by banks[3]. These and other scandals such as the fraud at HBOS in Reading, which resulted in bankers going to jail and left many businesses in severe financial difficulties, have caused enormous distress to many people and undermined public confidence in the financial services industry[4]. Crucially, these scandals, and the lack of redress mechanisms in the UK has damaged business confidence, and consequently caused a slowing of economic growth.

By increasing the opportunities for business owners to access redress mechanisms that are cheap, quick and effective, they will have the confidence they need to seek finance from banks which will be used to expand businesses, employ staff and contribute to the UK economy.

[3] Hansard 15th December 2016 https://goo.gl/4Da6Qr; Hansard 18th January 2018 https://goo.gl/JEZw57
[4] Telegraph, 30th November 2017, 'Lloyds settles with fraud victims who helped uncover HBOS Reading scandal

5.2 Encourage Lending

The provision of financial services to SMEs is essential to enable them to grow and fulfil their potential, and none more so than funding. Lack of access to the capital they need is a longstanding issue for SMEs and has knock-on effects for the UK economy. As Rishi Sunak MP explains:

"We have a world-beating record when it comes to creating entrepreneurial start-ups. Some 21 per cent of UK firms are less than two years old, a higher figure than even the US (19 per cent). Yet when it comes to growing those businesses – the stage at which access to capital is most crucial – Britain's record is dismal. In a ranking of 14 OECD countries, the UK comes a lowly 13th in terms of the proportion of start-up businesses that grow to having 10 or more employees within three years".[5]

This fact is impacting on the productivity of the UK economy as it means that UK firms are investing less than their rivals in other countries.

Within the UK banking sector, an investigation by the Competition and Markets Authority (CMA) showed that the 'Big Four' banks account for some 90 per cent of business loans'. 'Such limp competition is likely to result in less availability of credit, higher prices and poor service for SMEs. That makes it unsurprising that 40 per cent of SMEs report being unsatisfied with their bank, while only 13 per cent trust their bank to act in their best interests.

This lack of competition has led to an imbalance of power between key providers, the main clearing banks, and business customers of all sizes. This has adverse consequences for businesses, which may have little option but to accept unfavourable and onerous contractual terms in order to access funding needed to develop their business. Equally, once committed to facilities which involve borrowing, it can be difficult to change suppliers even if a better alternative could be found. Financial services tribunal is essential to correct this imbalance of power, to level the playing field and encourage more business lending.

For further information please visit our website www.appgbanking.org.uk or click here to read our full report: Fair Business Banking for All.

[5] Rishi Sunak MP 'A New Era for Retail Bonds', Centre for Policy Studies, November 2017