Part 1 - Submission to the Review of the FSA/FCA intervention on IRHP mis-selling

APPG on Fair Business Banking

APPG Background:

An All-Party Parliamentary Group (APPG) is a cross-party special interest group for Members of Parliament (MPs) and peers. The APPG on Fair Business Banking is one of the largest and most prominent APPGs within Parliament, with 115 members from both the House of Commons and the House of Lords representing the Conservatives, Labour, Liberal Democrats, Scottish National Party, Democratic Unionist Party, Plaid Cymru, Green Party and Independents.

The APPG is currently Co-Chaired by Kevin Hollinrake MP (Conservative) and William Wragg MP (Conservative). The Vice-Chairs are Tonia Antoniazzi MP (Labour), Harriet Baldwin MP (Conservative), Kirsty Blackman MP (SNP), Dr Lisa Cameron MP (SNP), James Cartlidge MP (Conservative), Peter Gibson MP (Conservative), Andrew Griffith MP (Conservative), Julian Knight MP (Conservative), Chris Law MP (SNP), Ben Lake MP (Plaid Cymru), Chris Matheson MP (Labour), Chris Stephens MP (SNP), Alison Thewlis MP (SNP), Tom Tugendhat MP (Conservative), Sammy Wilson MP (Democratic Unionist Party), Lord Cromwell (Crossbench) and the Earl of Lindsay (Conservative).

The APPG was originally formed in 2012 as the APPG on Interest Rate Swap Mis-selling to bring to the attention of Parliament, the regulator, the press and the public the plight of businesses that were mis-sold interest rate hedging products (IRHPs). The APPG applied intense pressure for urgent action to bring relief to those businesses impacted by the mis-selling, culminating in a powerful House of Commons debate on 21 June 2012[1], in which founding Chair, Guto Bebb, called for a dispute resolution system "that allows such cases to be settled in a constructive manner, in agreement between the FSA, the banks and their clients." His closing remarks in the debate were: "We need to move forward and to have transparency and openness. We need to identify the scale of the problem and the FSA needs to take a decision showing that as a regulator it has teeth and it will have an effect on the situation."

The Financial Services Authority (FSA) took action later that month, instigating an IRHP review and redress scheme to address the widespread mis-selling by banks of interest rate hedging products (IRHPs) to their small business customers from 2000 onwards.

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[1] https://hansard.parliament.uk/Commons/2012-06-21/debates/12062137000003/InterestRateSwapProducts?

The APPG continued to monitor the development and implementation of the scheme and the performance of the banks and the independent reviewers, raising many issues of concern with the regulator and the banks. It secured a further debate entitled "interest Rate Swap Derivatives"[2] on 24 October 2013 to draw attention to the poor progress that had so far been made by the banks and the FCA on the redress scheme. In addition to a debate of 17 December 2013 on the Tomlinson report[3] about Royal Bank of Scotland (RBS) Global Restructuring Group (GRG), which had relevance for some customers sold IRHPs, it also debated the motion "*that the House believes the FCA is not fit for purpose and that the house has no confidence in its existing structure and procedures*"[4] on 1 February 2016, during which many concerns about the IRHP review scheme were raised.

The remit of the APPG was expanded after the 2015 General Election to that of Fair Business Banking in recognition of the wide range of problems that persist between businesses and their finance providers, with IRHP mis-selling just one piece in a larger jigsaw of poor conduct. Members of Parliament have made frequent representations to the APPG bringing to its attention cases which share similar characteristics and which highlight:

(i) the imbalance of power that exists between businesses and the banks;

(ii) the lack of satisfactory redress mechanisms and rights of action available to businesses; and

(iii) the difficulties faced by owners of insolvent companies who seek restitution and redress for misconduct by financial firms.

The APPG welcomes this review:

We welcome the launch of this lessons-learned review into the supervisory intervention on Interest Rate Hedging Products (IRHPs) and look forward to learning John Swift's findings and recommendations in due course.

We acknowledge the positive achievement of the IRHP redress scheme(s); over £2billion in compensation was secured for almost 14,000 IRHPs mis-sold by banks to their business customers. If no action had been taken by the FSA then a large proportion of those customers would almost certainly not have had an opportunity to obtain any redress for the damage and losses they sustained as a result of the mis-selling.

The FSA/FCA intervention also brought rapid interim relief for many customers through the suspension of 'swap' payments, it put a halt on placing businesses into administration, stopped any further sales of the most complex and risky IRHPs - structured collars - and almost certainly improved compliance in respect of meeting the information needs of customers in future sales of financial products.

[2] Hansard, 2013, Interest Rate Swap Derivatives
[3] Hansard, 2013, Tomlinson Report
[4] Hansard, 2016, Financial Conduct Authority

However, we are disappointed that the start of this investigation should be so long overdue, considering that the products concerned were mis-sold over a decade ago and it is nearly 5 years since the IRHP customer redress scheme was closed to new entrants.

There might be a less pressing need for this review had the regulator had shown a greater willingness to listen to and attempt to positively address some of the serious concerns expressed by impacted businesses and their representatives, campaign groups, the APPG, the media and also the Treasury Select Committee. Prior to Andrew Bailey's tenure at the helm, there was no acknowledgement from anyone at the FSA or the FCA that any of the concerns about the IRHP redress scheme might be valid

Many of those who were judged by the scheme to have been mis-sold IRHPs were dissatisfied with the compensation it provided for their direct or consequential losses, and in some cases both.

In respect of **direct loss**, over 10% of the sales that were found to be non-compliant resulted in no redress at all through the review and 'alternative products' featured in around 40% of outcomes where redress for direct loss was offered

Payments for **consequential loss** amounted to just £46m over and above the £463m in interest at 8% which was added to all basic redress awards. According to FCA figures there were only 58 payouts of £100,000 or over for consequential loss. 48% of those whose consequential loss claims were assessed received no further redress, and over 66% of claims were awarded less than £10,000 in additional redress.

We also have serious ongoing concerns that the regulator's intervention in response to mass IRHP mis-selling failed thousands more businesses who have yet to be put back in the position that they would be in had there been no mis-sale and who may have lost billions of pounds more than the sums so far paid out by the IRHP redress scheme. There are three main groups of impacted business customers who have not been able to recover their damage or losses through this scheme.

Two groups of customers were excluded from the review:

- **a)** Customers **mis-sold fixed-rate loans** and other types of complex loan products which exposed them to many of the same downsides and risks as stand-alone IRHPs but which are considered by the FCA to be unregulated;
- **b)** Customers who meet the criteria to be considered "**sophisticated**" in the review but who were nevertheless entitled to regulatory protection at the time they were mis-sold IRHPs.

A third group of customers who were technically able to participate in the IRHP redress scheme, provided that they did not meet the sophistication criteria, but for whom the scheme appeared incapable of providing meaningful redress where mis-selling had occurred were:

- **c)** Former owners/directors of **insolvent businesses**

It is also a matter of great concern to the APPG, impacted customers, their representatives and many others that not one banks nor any individual involved in the mis-selling of hedging products has been held accountable for the widespread egregious conduct that took place.

If this review process identifies that there were failings in the regulator's response to the mass mis-selling of IRHPs then it is possible that some of the damage sustained by impacted customers could have been avoided or at least mitigated sooner.

It is also of significance that the design of the redress scheme that the regulator chose to implement as part of its response to this issue appears to have been used as a blueprint for other "voluntary" redress schemes that have followed it. One subsequent scheme which shared a number of characteristics with the IRHP redress scheme was that provided by Lloyds Banking Group (Lloyds) for customers impacted by the "HBOS Reading" fraud.

Just like the IRHP redress scheme the Lloyds scheme had the objective of providing fair and reasonable redress swiftly to those who were entitled to it and was described as 'non-legal' and 'straightforward' for customers. In each scheme the process was opaque; full details of the methodology and how rules were to be applied in practice were not made public at the outset. In both schemes, decisions on redress were made behind closed doors by the Bank using evidence collated by the bank, or on its behalf, which was not shared with customers and relatively little detail as to how decisions were reached was provided in outcome letters. Redress decisions and the way in which they were communicated to customers were subject to the oversight of an 'independent' third party, but the participation of customers and/or their representatives was limited to the opportunity to provide their own information for consideration by the Bank. The time that both schemes took to provide most customer outcomes was substantially longer than initially envisaged.

A review of the Lloyds scheme has already been conducted and in his report of that review[5], Sir Ross Cranston concluded that the Lloyds redress scheme was not entirely fit for purpose and recommended that the Bank re-assess a significant proportion of the decisions made within it. The replication in the Lloyds scheme of any flaws that were present in the original IRHP scheme could have been avoided if they had been exposed sooner through this lessons-learned review process.

Scope of this lessons-learned review and relevance of the Cranston Review:

The Cranston Report[6] into the assurance review of the Lloyds Customer Review for customers impacted by the 'HBOS Reading fraud' has set an authoritative benchmark for such assessments; it is even-handed, forensic and incisive.

The scope of this lessons-learned review is wider than that of the Cranston Review. Sir Ross Cranston was required to evaluate one bank's customer redress scheme to see whether it could and did satisfactorily compensate those impacted by the HBOS Reading fraud. The task of uncovering

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[5] The Cranston Review

[6] The Cranston Review

what had happened at HBOS Reading was taken out of the hands of the regulator and the Bank; the matter was the subject of criminal proceedings resulting in a number of prosecutions.

In the case of interest rate hedging, the regulator had to investigate, define the problem(s) and determine the banks involved before organising and overseeing a means of compensating affected customers as swiftly as possible. This lessons-learned review needs to examine and assess the wider performance of the regulator in response to the whole issue as well as carrying out an assessment of the customer redress scheme(s) it instigated.

In this submission we outline below some of the key issues in the mis-selling of IRHPs to SMEs. We then raise some points for consideration in an assessment of the regulator's role in the supervisory intervention on IRHP mis-selling before turning to focus on aspects of the IRHP redress scheme, including some observations on parallels that we have identified between the IRHP redress scheme and issues that concerned Sir Ross Cranston in his review of the Lloyds scheme.

Although John Swift has to consider multiple concurrently-run IRHP redress schemes, instead of just one bank's scheme, in essence he needs to make the same kinds of assessments in respect of each bank's IRHP scheme as Sir Ross Cranston did about the Lloyds scheme to determine whether it was capable of consistently providing fair and reasonable redress to impacted customers and whether it actually achieved that in practice. In view of the fundamental similarities between the IRHP redress scheme(s) and the Lloyds scheme for those impacted by 'HBOS Reading', we believe that Sir Ross Cranston's approach and many of his observations and findings are very pertinent to this part of this lesson-learned review.

It was important that the terms of reference of this review should be wide enough to include all of the investigatory work undertaken by the Authority and any judgements and decisions it made prior to announcing the IRHP redress scheme, as well as its involvement in the design, implementation and ongoing oversight of the scheme. We question the need to set a definite starting point of 1 March 2012; we are concerned that any matters of significance to this review from before that date should not be arbitrarily excluded from its consideration and trust that John Swift will take a pragmatic approach where a rigid application of what may be an indiscriminate choice of dates might risk compromising the review.

We note that the Terms of Reference include the following statement: "*The Review is not intended to be a route by which the redress scheme or individual cases can be re-opened*". We would tend to agree that it would not necessarily be a good idea to re-open or duplicate any scheme that was found to have significant flaws. However, it is important that, should John Swift reach the conclusion that the Authority's intervention in respect of interest rate hedging did not secure fair redress for significant numbers of business owners, it remains open to him to make recommendations for appropriate remedial action, such as providing urgent access to an effective alternative redress process for affected customers.

Bank mis-selling of IRHPs to business customers – key issues:

The House of Commons debate of 21 June 2012[7] on '*Interest Rate Swap Products*' provided a clear exposition of many of the key issues involved in the mis-selling of IRHPs by banks to their business customers. As successive MPs related details of their constituents' cases, often using powerful language, a pattern of unsavoury behaviour emerged, common to all of the large banks, of businesses targeted for sales which appeared to be driven by profit or commission rather than the customer's needs. One MP quoted a constituent as saying "I would have been better off going to Wonga," while Guto Bebb, the founding Chair of the APPG who led the debate, summed up the experience of many: "(b)usinesses did not go looking for these products; they were approached with a solution to a problem that often they did not have."

It is worth re-capping some of the points raised by MPs in this debate. These included:

- A widespread failure to take into account the information needs of financially unsophisticated customers, when banks should have taken extra care to ensure that they provided a satisfactory level of information to those customers in order for them to be able determine whether products were suitable for them.
- Customers without previous investment and/or derivatives trading experience incorrectly classified into a category designated for financially sophisticated clients, who are offered a lower level of regulatory protection.
- Complex products described as "protection" by bank salesmen who downplayed or even concealed the not inconsiderable risks. One MP suggested that there was "an intention…not to inform customers because they wanted the business for their own bank," while another stated he had evidence of banks "wilfully deciding not to explain the disadvantages of such products."
- Regulated Sales conducted by individuals who were not suitably qualified or knowledgeable about the products and lacked the required FSA authorisation.
- Customers given the impression that they were being advised by the Bank's employees, and being influenced by trusted Relationship Managers, while banks' disclaimers absolved them of responsibility for any advice provided during what could be a very lucrative sales process, As one MP succinctly put it: the bank "hides behind the small print that says… that any advice given was not, in fact, "advice". Guto Bebb, quoting from a survey conducted by campaign group Bully Banks, noted that "87% of businesses surveyed by Bully Banks were unaware that the adviser was not an adviser but a salesperson" and that "in 95% of cases, businesses stated categorically that they entered into these agreements on the basis of advice and guidance given by their bank relationship managers".
- Even if they were aware that they might need it, most SMEs may not have had access to reliable and affordable independent advice about these products. One MP stated, "We should not expect business people to be personally expert in these kinds of products, nor should they have to pay separately for a financial adviser. We should also remember that accountants—

[7] Hansard, 2012, Interest Rate Swap Products

and I am one—may not be allowed to give advice on these kinds of products unless they are also registered as financial advisers." Another MP noted that their constituent had discovered that there were only two firms with the necessary authorisation to provide independent advice on these products to SMEs but that both were outside the budget of his business.

- Businesses had little choice but to enter into products that they neither sought nor particularly saw a need for in order to secure funding for future investment or even just to renew or extend existing borrowing and to prevent loans from being called in.
- Legally binding contracts were conducted verbally over the phone with a delay of months in some cases before written confirmation was received by customers.
- Some Banks were unable or unwilling to supply customers with evidence of a verbal contract, eg the recording or transcript of the phone conversation in which the trade was conducted.
- In some cases IRHPs exceeded the term and/or value of the loan(s), with the business required to continue servicing the IRHP even if the underlying loan had been repaid or expired or else incur large costs to exit from the instrument.
- While IRHPs were sold on the basis that they would make future interest rates predictable – akin to a fixing the rate – MPs noted that banks could still vary the amount that the customer paid in interest simply by increasing the margin they charged on top of the swap rate and that some businesses were also charged additional fees, prompting one MP to note: "I fail to understand the logic of charging a struggling business an extra fee for struggling."

Some MPs also related their constituents' experiences or thoughts of dispute resolution:

- A number of MPs in the debate highlighted the failure of existing dispute resolution methods to provide a satisfactory resolution for sufficient numbers of impacted businesses. Some spoke of business owners who were fearful of causing further damage to a vital ongoing relationship by complaining or speaking out against their bank and of threats made by banks to remove or adversely alter customers' facilities should complaints be pursued. Several MPs stated that their constituents had asked not to be identified for this reason.
- Banks failing to deal constructively with complaints in a timely manner and according to FSA complaints-handling procedures was another common theme.
- MPs noted that there were few reports of successfully upheld complaints through the Financial Ombudsman Service (FOS) among those businesses small enough to be eligible and that, in any event, the maximum award limit of £150k was unlikely to be sufficient to cover the losses of many businesses which were mis-sold IRHPs.
- They also made it clear that legal action was not a realistic option for most businesses, due to the costs and resources required, or being timed out, or fear of further compromising their relationship with their bank and potentially putting their own personal finances and home at risk. One MP asked "how can you sue a bank you need to support you?" Another MP also noted that would-be claimants could have difficulty in finding suitably experienced and unconflicted legal representation as lawyers capable of litigating against banks were often retained by those banks and therefore unable to act for businesses.

- MPs pointed to businesses in administration, where mis-sold IRHPs were blamed for the demise of the business, and which were facing enormous challenges trying to seeking solutions and relief through the law.
- It was noted that where a business owner had pursued litigation there was unlikely to be any precedent set that could be of wider general application and relevance to others mis-sold IRHPs due to most cases eventually settling out of court with gagging orders placed on the individuals involved.

The MPs were uncertain of the scale of the problem in terms of the numbers of businesses affected but several gave examples of medium-sized and larger businesses impacted in their constituencies, indicating that issues with mis-sold IRHPs were not restricted just to the smallest businesses. They highlighted the potential loss of jobs and negative effects for local economies and on business owners and their families, with many facing uncertainty, and homes and health at risk, observing that the longer the FSA delayed before taking action, the greater the risk of further harm being caused to businesses. There was also a warning of the risk of other similar mis-selling scandals occurring in the future if there were no consequences for the banks.

A significant issue that did not feature in the June 2012 debate was the "contingent liability" attaching to many IRHPs. Entering into IRHPs other than simple Caps – so swaps and collars – could increase the customer's liabilities to the bank even without triggering break costs because it required its own dedicated security. This could be a substantial amount - equal to or in excess of the potential costs to break the IRHP before the end of the term - and which, just like the break costs, could fluctuate significantly with interest rates; going up as interest rates went down. This security arrangement would be achieved between the lending and investment arms of the bank, usually without seeking the prior agreement of the customer or even notifying them. This means that many customers who entered into IRHPs may have been unaware of the full extent of their liabilities to their bank or even that those liabilities could extend beyond the value of their borrowing. The contingent liability could also cause the customer's total liabilities to approach or even exceed the total value of the assets held as security by the bank, which in some cases included a business owner's own home.

The regulator's role in the supervisory intervention on interest rate hedging products:

An important part of this lessons-learned review is to assess whether it was reasonable for the regulator to make the judgements and decisions that it did if its aim was to remedy the loss suffered by those customers who stood in need of its protection. The review needs to determine whether the regulator provided a reasonable response to the problem as it existed in reality and not just as it was perceived or understood by the Authority.

To do this it will need to ascertain whether the FSA/FCA undertook sufficient exploration and consulted widely enough so as to cast sufficient light on all relevant issues and reach a good level of knowledge and understanding of those issues without being unduly influenced by the interests of

just one party, both at the outset of the intervention and at key decision points during the design and development of the IRHP redress scheme.

While certain later decisions had an impact on the final redress scheme rules, the tone and direction of the regulator's response to the mass mis-selling of IRHPs to businesses was set by certain judgements and decisions made in the initial stages of its intervention. It is particularly important that John Swift and his team examine the nature and extent of the FSA's initial investigatory work prior to reaching agreements with several banks as these almost certainly limited the regulator's ability to modify its approach in response to further or new details emerging in the future. They should also assess whether, when reaching those agreements with the major banks, the FSA retained a sufficient degree of control over the IRHP redress scheme process and any flexibility to adapt its views and actions in response to the emergence of any new or contradictory information or evidence at a later date in the intervention, or whether it ceded an unhealthy degree of power to the banks.

The FSA's initial investigation:

As a minimum, in addition to checking its own records for enquiries and complaints about IRHPs made directly to the FSA, we would have expected the FSA to have examined a representative selection from each of the following sources:

- customer files from each of the main banks;
- banks' complaints handling files and data;
- FOS complaints, both upheld and not upheld;
- Bank policies and procedures, such as training manuals and policies on staff incentivisation of all employees involved in sales of IRHPs to SMEs, including Relationship Managers and support staff;

We know that the FSA received testimony from some business customers with IRHPs in April 2012. In addition to hearing from a thoroughly representative range of affected businesses which were customers of each of the banks responsible for most of the sales of IRHPs, we would have expected the FSA to have sought information from at least the following range of stakeholders and experts:

- businesses' legal/expert advisers
- trade bodies for business and any other representative organisations
- banks
- banks' representatives, including trade bodies and legal and expert advisers
- Inhouse experts and other employees of FSA/FCA
- FOS
- independent experts including those with technical product knowledge which did not have links to or any commercial relationship with a bank
- civil servants/government representatives including from Treasury

- Members of Parliament
- whistleblowers from any or all relevant functions of banks, where available, including business relationship managers, IRHP salespeople and staff in credit departments

This review should assess in particular which sources of information and advice the regulator relied upon when it formed critical views at an early stage in the intervention about hedging products and whether they could be safely sold to SMEs by banks.

Views formed by the regulator at an early stage

It is clear that the following views of the regulator had a major influence on the shape of the redress scheme and the type of redress outcomes that it would provide where products were found to have been mis-sold:

- ***IRHPs are not inherently inappropriate for SMEs***
- ***It was not unreasonable to make lending conditional on the acceptance of an IRHP***

John Swift and his team need to determine whether, in the light of all the information that should or could have been available to the regulator, it was reasonable for it to take the views that it did on IRHPs and SMEs.

IRHPs not inherently inappropriate for SMEs:

In June 2012 the FSA instructed banks to immediately stop selling structured collars to SMES, but there was no prohibition placed on other types of IRHPs which may limit the customer's ability to benefit fully from downwards movements in interest rates, including swaps and collars. It is clear from the methodology of the review and other statements from the regulator that it categorised swaps and collars without callable features as "simple" products alongside caps (which allow the customer to benefit fully as interest rates drop) and that, in its opinion, none of these products were inherently unsafe for SMEs.

The FSA's view on the appropriateness swaps and collars for SMEs was pivotal for the design of the IRHP redress scheme; it opened up the possibility for "swap for a swap" and "non-compliant sale but no redress" outcomes.

It is important for this review to assess whether decision-makers at the FSA had sufficient knowledge and understanding of the benefits, downsides and risks of each type of product for SMEs. It needs to consider whether, in the light of everything that the FSA knew and/or should have known and understood about IRHPs and their potential impacts on SMEs, it was reasonable for it to take the view that only the most complex/risky variants - structured collars - should not be sold to SMEs and that other IRHPs which limit the ability to benefit from downwards movements in interest rates - swaps and collars - are not inherently inappropriate for these customers.

We would have expected the FSA to have undertaken a cost/benefit analysis to consider the positive and negative effects that different types of IRHPs - caps, swaps and collars - of various values and terms could have in low and high interest rate environments on different types and sizes of SMEs with loans of differing values and term, on both interest-only and repayment terms.

As a minimum we would have expected the FSA to have considered the following issues:

In a falling/low interest rate environment:

- The size of the potential break costs of IRHPs and how these could vary with the length of term and complexity of the instrument.
- The likely impact of businesses sustaining interest payments at above the prevailing interest rates without the benefit of a more buoyant economy that higher interest rates might have been expected to accompany.
- The potential extra cost burden for those on repayment terms as opposed to interest-only if capital instalment calculations referenced the lower variable interest rate payable on the loan rather than that of the higher rate IRHP.
- The extent to which the loss of flexibility to dispose of assets or otherwise pay down loans and restructure or refinance the business or simply move banks could disadvantage businesses by restricting their ability to respond to events or changes in circumstance, whether planned or unforeseen, such as the severe economic downturn in which they found themselves post 2008, changes in competition, regulation or law, or the relocation, serious illness, divorce/break up, retirement or even death of a person with significant control in the business.
- The wider risks to those employed in SME businesses with IRHPs.
- The potential impact on the customers and service users of sensitive and critical businesses, including the many care homes and doctors' and dentists' surgeries which were sold IRHPs.
- The types of dispute resolution accessible to customers and how effective they might be at achieving a timely resolution in the event of a dispute.
- The impact of any **contingent liability**.

The Contingent Liability:

To date there has been very little clarity of the extent to which the regulator took the issue of the contingent liability of IRHPs into account during its intervention.

It is imperative for this review to ascertain the extent of the FSA's knowledge and understanding of the contingent liability of certain IRHPs during the early stages of its intervention on interest rate hedging products.

It should determine whether any banks disclosed this issue to the regulator and whether it sought and received further independent technical and legal advice in respect of the contingent liability. It needs to establish if the FSA/FCA considered whether this liability could crystallise in the event that

the customer breached any of their conditions of lending and whether it may have actually been the cause of such a breach in some cases, in the form of an immediate or subsequent breach of Loan to Value (LTV) ratio. If so, this might have been enough to give the bank cause to take further action against the customer, such as the adverse alteration or withdrawal of facilities and/or transfer to the bank's special measures or 'turnaround' division and/or the imposition of punitive charges which might include an increase in the customer's margin on top of the rate of interest charged on the loan and IRHP. If there was no actual breach, the contingent liability may still have affected a customer's ability to borrow in future, even where this was planned and previously agreed in principal by the bank.

The impact of the contingent liability could have been even more significant for customers following the financial crash when many assets were also down-valued by a considerable amount.

Many business customers appear to have remained largely unaware of the contingent liability of their own IRHP and the potential consequences of it, even while they participated in the IRHP redress scheme. It is hard to escape the conclusion that customers should have been fully informed about any contingent liability attaching to an instrument and of all the potential implications for their business prior to the sale and that without full disclosure of this issue unsophisticated customers would not have been able to make an informed decision about which IRHP, if any, to enter into. It is also difficult to imagine that, in the event that full details had been disclosed and they had fully understood the implications and risks of the contingent liability many business owners would have opted to enter into any interest rate swap or collar.

In a rising/higher interest rate environment

- In any counterfactual situation where higher rates of interest would be paid by businesses but for the IRHP, not all other things would remain equal; in an economic upturn that might well accompany increased interest rates those businesses might also expect to see increased turnover and higher revenues.
- Businesses retained the flexibility to restructure, dispose of assets or otherwise repay borrowing.
- Banks could still raise the effective rate paid by businesses by increasing their margin.
- In certain circumstances, where IRHPs had callable features or on breach of any lending conditions, banks could take the unilateral decision to terminate IRHP agreements.

Not unreasonable to make lending conditional on the acceptance of an IRHP:

This position led to the concept of a 'Legitimate Condition of Lending' (LCOL), paving the way for perverse outcomes which found that, on the one hand, insufficient information was provided about a specific product at the point of sale for the customer to make an informed decision about it, but,

on the other hand, this was immaterial because the customer had already agreed to enter into that product or a similar one at the time they signed their loan agreement.

It is our understanding that many, and quite possibly the majority, of those found to have an LCOL in the redress scheme had little or no knowledge of hedging products or indeed of what type of IRHP would be acceptable to their bank at the time that they signed a loan agreement that required them to have hedging.

This review needs to examine:

- What investigations were undertaken by the FSA to determine whether customers were likely to be aware of the features and all potential downsides and risks of specific types of IRHPs including any contingent liability at the time they signed a new or revised loan agreement which required them to enter into a hedging product.
- If the Authority considered whether customers who did not understand all of the risks of an IRHP at the point of sale could, prior to this, have realistically been aware of the full implications of agreeing to lending where entering into an IRHP was condition.
- Whether it was reasonable for the regulator to expect customers to have known what they did not know, ie to make decisions about whether to accept terms of lending without full knowledge of the implications of any terms requiring them to enter into hedging.
- Whether it was reasonable for customers to be required to enter into a product which might cause them to be in breach of lending conditions, for instance if the amount of security required for the IRHP were to take them over their LTV limit.
- Whether it was reasonable for banks to impose a requirement to enter into hedging in a situation of such extreme information asymmetry and without a properly functioning market, ie no competitive pricing and little realistic freedom to purchase from a range of suppliers or a sufficient degree of knowledge among customers to be able compare different products across the market before purchase.
- Whether the profit to be realised by banks selling certain types of hedging products were out of proportion to any benefit to the customer and the extent to which the decisions by banks to impose a condition of hedging may have been motivated by considerations of profit rather than risk reduction.

Key decisions on eligibility and access to redress:

Decisions were made in the early stages of the regulatory intervention to limit access to potential redress through a redress scheme to a subgroup of those customers sold standalone IRHPs. We identified three main groups of customers for which the redress scheme failed to secure redress; those who met the 'sophistication' criteria, those sold loan products with similar downsides and risks to standalone IRHPs and insolvent businesses.

This review needs to consider whether, as a result of limitations on eligibility and access to redress in the IRHP redress scheme, financially unsophisticated customers were left without access to any

alternative effective dispute resolution process and also whether a lack of consequences for mistreatment of certain groups of customers could increase the risk of further poor conduct towards those customers in future.

Customers who met the 'Sophistication' Criteria:

FCA progress figures as at September 2016[8] indicate that over 10,000 sales were not eligible to have their IRHP sale(s) reviewed through the redress scheme as a result of meeting the sophisticated criteria, and that the amended tests introduced following the Pilot Scheme may have been responsible for excluding at least half of that number. Only 291 sales met the 'subjective' test, where the Bank was able to demonstrate that "*at the time of the sale, the Customer had the necessary experience and knowledge to understand the service to be provided and the type of product or transaction envisaged, including their complexity and the risks involved*."

In its report of its 2105 investigation into SME lending, the Treasury Select Committee stated:

"The arbitrary sophistication test may have been necessary to obtain agreement to a voluntary scheme from banks, but it is clear that not all non-sophisticated customers have been included in the review."[9]

This review needs to consider whether it was reasonable for the Authority to retrospectively strip regulatory safeguards from those customers who had been assessed as falling within the category of 'retail client' or 'private customers', at the time of their sale(s), indicative of a lack of financial sophistication and a requirement for a high level of regulatory protection.

To do this the review team should look at:

- Whether there is any precedent for effectively downgrading the regulatory classification of customers post-sale in this way, without their prior knowledge or consent.
- When the decision was taken to include the concept of sophistication in the methodology of the review, which organisation proposed it, and the rationale behind it, and whether reaching agreement with the major banks was dependent on some such measure to exclude a proportion of claims.
- Why the decision was taken to revise the tests for sophistication following the Pilot Scheme and whether the revisions actually delivered the stated aims.
- How many customers who would have been excluded previously were able to access the redress scheme as a result of the changes following the Pilot Scheme.
- The value of IRHPs excluded from the review by the initial 'objective' tests and the additional value of IRHPs excluded as a result of the changes to those tests after the Pilot Scheme.
- The extent of the risk/benefit analysis and consultation undertaken by the FSA before deciding to introduce a barrier to redress for so many customers. For example, we would

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[8] https://www.fca.org.uk/publication/data/aggregate-progress-final.pdf

[9] Conduct and competition in SME lending, Treasury Select Committee Report of Session 2014–15, pg 38

expect the FSA to have looked at a sample of customer cases to confirm whether this customer group genuinely had less need of regulatory protection and how many would realistically be able to litigate or have access to any alternative form of effective dispute resolution. We would have expected the FSA to consider, among other things, the wider risks to the employees of businesses mis-sold IRHPs which were unable to access redress and the message it was sending out to financial firms that there were likely to be few consequences for mistreating customers in this profile

Customers sold loan products with similar downsides and risks to standalone IRHPs:

Considerably more of these loan products were sold to businesses than stand-alone IRHPs; in excess of 60,000 between 2001 and 2013, according to the FCA[10]. However, customers with these products were excluded from the IRHP redress scheme, on the grounds that they are not regulated products. However, the FCA acknowledged that, "*a customer who has taken a loan with an 'embedded' IRHP may be faced with exactly the same repayment features and exactly the same (potentially large) break costs that the customer would have faced had the customer taken out a loan and a standalone IRHP*. [11] "

Customers with these products have faced similar issues and made similar complaints to those with stand-alone IRHPs, but the view of the regulator has been that they are not regulated products and it does not have the powers to act.

We note that in the matter of mis-sold IRHPs the regulator decided to instigate a 'voluntary' redress scheme as opposed to a statutory one. We also note that Clydesdale and Yorkshire banks, singled out for special attention in the Treasury Select Commission inquiry into SME lending[12], did agree to review sales of some complex variants of their Tailored Business Loans (TBLs), although not the more common fixed rate TBLs.

This review should examine:

- The extent and findings of any investigations conducted by the FSA/FCA into the impact of these loan products.
- Whether the regulator held discussions with banks at any time during the intervention about their sales of loan products that incorporated hedging.

[10] Letter from Martin Wheatley to Rt Hon Greg Clark MP, 9 May 2013, referred to in the Treasury Select Committee's report, Conduct and Competition in SME Lending, 10 March 2015, pg 48
[11] Letter from Martin Wheatley to Rt Hon Greg Clark MP, 9 May 2013, referred to in the Treasury Select Committee's report, Conduct and Competition in SME Lending, 10 March 2015, pg 49
[12] Conduct and competition in SME lending, 10 March 2015

- Whether it could have been possible for the regulator to reach agreement with those banks which sold loan products that incorporated hedging to provide a 'voluntary' redress mechanism for those customers.
- Whether there is a requirement for an investigation into possible regulatory failure in respect of the mis-selling of these loan products.[13]

Insolvent businesses:

It is our understanding that a considerable proportion of businesses sold IRHPs by their banks subsequently entered insolvency. Although these customers were not excluded from the scheme per se, the regulator appeared to take no action towards attempting a practical solution to the difficulties of providing meaningful redress for insolvent companies.

The separation of redress for consequential loss from that for direct loss and the decision taken by most of the banks to 'split' redress and pay basic redress to customers in advance of assessing claims for consequential loss was not helpful to insolvent customers. In the absence of a total settlement covering all losses, it was likely that any sums due to cover direct redress would be paid by the Bank back to the main secured creditor, which was the same Bank which had mis-sold the IRHP.

This review should assess

- What consideration, if any, was given to insolvent businesses from an early stage in the intervention process, including the extent to which the FSA/FCA took account of the lack of downsides and the potential upsides for a bank should it decide to tip an asset-rich business into insolvency compared to the permanent and potentially catastrophic consequences for that business.
- Whether arrangements for assessing and paying redress for direct loss and consequential loss through the IRHP review could have been organised in a different way that could have been of more help to insolvent companies.
- Whether, in light of the 'voluntary' nature of the IRHP redress scheme, it might have been possible to reach agreement with the banks to develop an alternative review and redress scheme which could produce meaningful redress for this group.

Important decisions on the structure and methodology of the review

John Swift and his team need to review key decisions that were made in respect of the redress process in the early stages of the intervention. They should assess the relative input of the banks and their representatives/advisors and any other stakeholders or consultants into the decision-making process and, where appropriate, examine the reasoning behind those decisions, the impact they may have had on customers and consider whether they were reasonable decisions to make.

[13] We refer to *How the Financial Conduct Authority will investigate and report on regulatory failure*, April 2013

As a minimum we believe this review should examine the decisions on the following aspects of the redress scheme:

- The role of the Independent Reviewer
- Assessment of 'advised' and 'non-advised' sales
- Separation of claims for basic loss and consequential loss
- Assessment of claims for basic loss
- Assessment of claims for consequential loss
- One-way disclosure of information and evidence
- Lack of transparency of the methodology and rules
- Customers told that they did not need advice or representation

We consider some of these aspects of the redress scheme in the next section.

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