The All-Party Parliamentary Group on Fair Business Banking

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

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.

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

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

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.

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

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

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 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

[5] The Cranston Review
[6] The Cranston Review

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.

[7] Hansard, 2012, Interest Rate Swap Products

- 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— 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.

[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

- 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 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

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[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

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.
- 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

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

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.

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

The IRHP redress scheme(s)

We turn now to the requirement for John Swift and his team to evaluate the actual mechanism that was instigated and overseen by the FSA/FCA to provide redress to customers mis-sold IRHPs.

How the review will evaluate the mechanism for redress and FSA/FCA oversight of it

Within the Terms of Reference, the review team has been asked to address:

Point 3 "*Whether overall, the scheme delivered fair and consistent outcomes for SMEs within the scope of the scheme in a proportionate and transparent way*," including 8 subsidiary points (a) to (h).

Point 4 "*Whether the redress exercise was delivered in an effective and timely way, including whether [sic] the effectiveness of the FSA's and later the FCA's oversight of the timeliness of redress, and communications about timescale*."

In such a complex enquiry as this, which involves vested interests and highly polarised views and where the findings could potentially be critical of and highly embarrassing for the commissioning body, the FCA, the Terms of Reference need to be clear and unambiguous and they should not try to pre-empt the investigation. We recognise that this is not easy to achieve.

Point 3 in the Terms of Reference clearly communicates the need to put considerations of fairness at the heart of the review team's evaluation of the scheme but with little qualification as to what that should actually mean in practice. Sir Ross Cranston notes that, ""fair" *is a*

word which is commonly used and which, instinctively, most customers understand. However, it is difficult to define it precisely."[14] He goes on to discuss various interpretations of 'fair', and also 'reasonable', which were of relevance to his review of the Lloyds scheme and which informed his principles for assessment, which we consider below as we believe that they are equally pertinent to this review. Just as Sir Ross did, John Swift will need to clearly set out his understanding of the term 'fair' and how he applies it in the context of this review.

Point 3 of the Terms of Reference also refers to consistency in respect of customer outcomes and that is undoubtedly a very important consideration for this review since it covers parallel processes run by several banks' covering thousands of customers. It is clear that John Swift and his team will need to determine whether the methodology of the scheme was configured and implemented in the same way by each bank so as to consistently provide the fair and reasonable redress that the IRHP scheme was committed by the FSA to deliver, on a large scale and in a timely manner.

However, fairness demands that banks do more than just providing a *consistent* level of redress for customers with similar circumstances; the review team needs to determine whether customers actually received the appropriate type and level of redress relevant to the particular circumstances of their case. This requires an independent, impartial assessment of what constitutes 'fair and reasonable redress' in this context rather than simply accepting without question the review scheme's own definition of it.

In our view, making judgements on what a "fair outcome" should look like will be one of the biggest challenges for this review team. It will need to take stock of the nature and severity of the damage caused by the sale of interest rate hedging products to banks' SME customers, and attempt to reconcile entrenched conflicting views.

Sir Ross Cranston's comment that "*(d)etermining what is fair often involves the balancing of competing interests*."[15] is particularly germane here. The review team needs to determine whether an appropriate balance was reached in a scheme in which the parties in whose interest it was to limit redress payouts, where possible, were responsible for making decisions on redress in their customers' cases and may also have had a major say in the design of the process itself and its definitions of appropriate redress.

It would be a formidable challenge to achieve that balance in a case such as this where the interests of the parties were diametrically opposed. The cost to banks to unwind large numbers of their lucrative sales of IRHPs to SMEs could run to £billions while survival for many SME customers, struggling with the cost of borrowing in a tough trading environment, could be dependent on whether they could be released from their IRHP(s) without having to pay fees to do so.

The following comment of Clive Adamson in his letter to the banks of 29 July 2013 suggests that not only did the FSA attempt to balance these conflicting interests, but that it believed that it had done so:

[14] The Cranston Report, pg 63

[15] Report of The Cranston Review, pg 63

"We are confident that our position will provide fair outcomes for consumers sold IRHPs by [firm name] and, where appropriate, fair and reasonable redress. We are also confident that our position is fair to the banks who sold these products."[16]

It is important for the review team to determine what the FSA intended when it wrote of being fair to the banks and whether this position was compatible with its stated commitment to delivering fair redress to customers mis-sold IRHPs, or if the FSA's confidence here was misplaced, and if so, did its redress solution ultimately entail unwarranted compromises.

Before we go on in the following section to consider in greater depth some of the issues involved in evaluating whether the scheme was able to secure fair and reasonable redress for customers mis-sold IRHPs, we want to outline some concerns that we have about points 3 and 4 in these Terms of Reference:

1. Under point 3, the subsidiary points (a) to (h) pinpoint specific issues for consideration. These are all important issues and we have no doubt that they each need to be considered as part of this review, but we are concerned that including them in the Terms of Reference in this way could have the perverse and undesirable effect of limiting the field of vision of the investigation.

   It is difficult to list every issue and to capture all of the essential elements of each of them in a few words in the Terms of Reference and there is a danger that attention will be directed to only the issues specifically mentioned, to the exclusion of others, and that the focus will be on the way in which they have been framed or defined in the Terms of Reference rather than on a more holistic view of the full substance and detail of each issue. We would hope that these subsidiary points will be treated by the review team as more in the nature of spring boards to their investigations than perimeter boundaries.

2. We're not clear on the meaning of "proportionate" in the context it is used in point 3 as there is more than one possible interpretation and we are concerned that, depending on that context, its use here may not be entirely appropriate. We look to clarification from John Swift as to his understanding of what is intended by its use here.

3. We also want to comment on the inclusion of the word "transparent" in the same sentence in point 3. Anyone with any knowledge or experience of the IRHP redress scheme will know that the review team will struggle to find signs of transparency within it. We would hope that when the review team confirms that transparency does not appear to have been a major consideration in the design of the scheme, it does not simply reach the conclusion that, notwithstanding initial claims by at least one

[16] Letter from Clive Adamson to the banks, 29 January 2013

bank that the scheme would be transparent[17], it was never aiming to be a transparent process and so it cannot be judged on that basis. It's important that instead this review goes on to question why transparency was not considered to be a necessary feature and examine the extent to which the almost total lack of transparency has impacted on the scheme's ability to secure fair redress for customers.

4. Not included in the published Terms of Reference are any clear instructions or requirements as to how the review team should conduct its review of the IRHP redress scheme and how far and wide the review team can cast its net to capture information and evidence.

   It is clear to us that the delivery of a robust, independent assessment is heavily dependent upon John Swift and his team having access to all relevant information and evidence held by those organisations involved and any other parties with significant knowledge of the issues. Relevant parties include the FSA/FCA; banks; independent reviewers/skilled persons; customers and their advisers and representatives; MPs; independent experts in law, regulation, finance and hedging/derivatives; and any whistleblowers, where they are prepared to make themselves available. In addition to customer data, it is important for the review to have full sight of communications between the organisations involved, and all hitherto confidential material, including contracts, agreements, undertakings and settlements between all and any parties.

   It is not evident from these Terms of Reference that the review team will be granted access to all of the data and also to the relevant staff from each of the banks and the firms that fulfilled the role of Skilled Person or Independent Reviewer. We will be seeking clarification from John Swift on whether requests for information, evidence and contact with personnel have been met in each of those organisations.

In respect of how the review is conducted, we have looked to the multi-level approach that was specified in the Terms of Reference for the Cranston Review. In his review of the Lloyds IAR redress scheme, Sir Ross Cranston had the clear expectation that fairness towards customers should be embedded into every part of the process and that if it did not achieve this, the bank could not be confident that the scheme would deliver consistently fair outcomes.

His team conducted a thorough evaluation of the methodology, rules and processes of the scheme to determine whether it was designed and constructed in a way that was likely to lead to consistently fair results *and* they also carefully examined a representative sample of customers' cases to see how the scheme actually worked in practice. We absolutely believe that a similar approach is appropriate here.

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[17] Barclays sent to its customers with IRHPs documents entitled 'Guide to the Review of Sales of Interest Rate Hedging Products' in November 2012 and February 2013. Both claim in two places that the IRHP review and redress scheme is a "transparent" process.

Methodology

To the extent that the methodology of the IRHP redress scheme has so far been put into the public domain, it is not all in a single document and it does not provide comprehensive detail on how all aspects of the review should have been conducted. John Swift and his team will need to confirm that the same methodology was used by each of the banks and whether this included additional and/or different material to the documents that were published at the behest of the Treasury Select Committee in 2015. They will need to determine whether the methodology was fit for purpose and whether it was consistently interpreted and applied by all banks in the same way across the review of all of their sales.

It is particularly important for the review team to explore why the methodology was not disclosed to customers at the outset of the review and determine the extent to which this could have disadvantaged review participants, as well as undertaking an evaluation of whether the methodology was entirely consistent with what customers were told about how the review would operate.

Customers

The customer files held by the bank are unlikely to tell the whole story, so it is very important that John Swift and his team should also hear directly from customers and, where applicable, advisors who experienced the scheme.

If few former review customers have taken the opportunity to provide written testimony to the review this should not necessarily be seen as indicative of a general lack of interest or willingness to contribute. It could be that awareness of this review among that cohort of customers is not great, and we have also found, for various reasons, that many business owners find it easier or more convenient to talk about their case than to write about it.

Sir Ross Cranston makes it clear in his report that he placed a great deal of importance on speaking to customers in his review of the Lloyds scheme; not just those related to the sample files he examined but any that wished to talk to him or provide information in any other way. He noted that "*an overview of what customers told me had great value. Although for some it meant they had to relive difficult memories, for many, including those who found the experience painful, it provided them an opportunity to express their views about the Customer Review, which in many cases they felt they had been denied previously. For me and my team, their views complemented the information we derived from our examination of the sample cases. Importantly, they also provided insights into and highlighted issues which needed to be more at the forefront of our inquiry*."[18]

Many people are relying on this review to evaluate all aspects of the redress scheme, including those that were hidden from view. It is quite clear to us that public confidence in the results of this review will be very much dependent on the extent to which it is able to successfully engage with those impacted by IRHP mis-selling. We would urge John Swift and his team to be proactive as Sir Ross Cranston clearly was in his review, and to reach out to former review

[18] Report of The Cranston Review, pg 55

customers as well as those who were excluded from it and those who are declared as having 'opted-out' and encourage them to give evidence through conversations, possibly in response to specific questions, in meetings or phone calls, or in whatever format they prefer, with or without the support or assistance of an adviser or representative, according to their preference.

Principles of Assessment

In Chapter 9 of the Cranston Report[19], Sir Ross Cranston explains how he drew on dictionary definitions, regulatory rules and guidelines, legislation and case law to inform his interpretation of "fair" and "reasonable" and identify types of conduct indicative of fair and reasonable treatment of customers. He determined that the Lloyds scheme needed to be judged/assessed on its own merits rather than simply compared to a legal process which it was not intended to replicate, but had a different objective which was to produce widescale redress swiftly and at little cost to participants. However, it still needed to be capable of providing fair redress consistently and its design and methodology needed to be fit for that purpose. The same is true here and the expectations that Sir Ross had for the fair treatment of customers in the Lloyds review are just as applicable to this one. Among those expectations were that:

- communication with customers, including the details of decisions, should be clear and comprehensive enough so that they should know what they would need to do at each stage to be able to put forward their best efforts to secure a favourable outcome;
- what the scheme required customers to do must not be too onerous and sufficient support and help should be provided, where necessary;
- the level of disclosure should be appropriate to the evidential requirements and vice versa;
- a sufficient degree of independence should be delivered by a properly functioning Independent Reviewer and;
- there should be a straightforward and effective appeals process

Broadly he took into account:

- whether communication with customers was clear, fair and not misleading and provided them with sufficient appropriate information
- whether the scheme functioned in the way it had been represented to customers
- whether the scheme placed any unreasonable or burdensome demands on customers
- whether customers had the opportunity to make effective representations to further their case
- whether the bank acted in good faith, and in particular whether it was open in its dealings with customers
- whether the decision-making process took into account irrelevant matters or failed to consider relevant matters.

[19] The Cranston Review, Chapter 9: Principles of assessment of Cranston Review

- Whether there was disparity in the relative bargaining positions of the parties

What constitutes fair redress – Assessing fair redress through the review

In the Pilot Report, the FSA made a clear public commitment to those mis-sold IRHPs: "*All 'non-compliant' sales will be considered for redress. Redress must be fair and reasonable in each case. Redress should aim to put customers back in the position they would have been in had the breach of regulatory requirements not occurred*."[20]

On its website, the FSA and then the FCA continued to confirm this commitment and also added a reference to consequential loss to the broad definition of redress:

"*Fair and reasonable redress means putting the customer back in the position they would have been in had the regulatory failings not occurred, including any consequential loss*."

In order to establish whether the FSA/FCA was able to deliver on the pledge it made to customers, this review team needs to determine whether the three kinds of possible outcome produced by the scheme were fair outcomes for customers who were mis-sold IRHPs and whether the scheme was set up to deliver the most appropriate outcome for each customer.

The three potential outcomes, as outlined in the Pilot Report, were:

- *Full redress – if it is reasonable to conclude that, had the sale complied with the regulatory requirements, the customer would not have purchased any IRHP, fair and reasonable redress will be the exit from the IRHP at no charge and a refund of all payments, including, where appropriate, any break costs previously paid.*

- *Alternative product including a different product and/or a different profile (e.g. amount, duration or structure of IRHP) – if it is reasonable to conclude that, had the sale complied with the regulatory requirements, the customer would have purchased a different IRHP, fair and reasonable redress will be the alternative product and the refund of any difference in payments between the alternative product and the product actually purchased, including, where appropriate, the difference in any break costs previously paid.*

- *No redress – if it is reasonable to conclude that, had the sale complied with the regulatory requirements, the customer would still have bought the same product, or the customer suffered no loss* [21]

In considering what fair redress for such customers should look like we turn again to Sir Ross Cranston, who noted that:

[20] Financial Services Authority, Interest Rate Hedging Products - Pilot Findings, March 2013, pg 14
[21] Pilot Findings, March 2013, pg 14

"*what amounts to a fair offer of compensation will depend on a range of factors. These will include the level of harm or loss suffered by the customer, the nature and gravity of the conduct causing the harm and the level of compensation which may be awarded by a court in the particular circumstances*."[22]

Compensation which may be awarded by a court

A redress scheme which was proposed as a more cost-effective and inclusive alternative to many individual claims being fought through the courts cannot be seen to deliver markedly inferior compensation to that which might otherwise have been achieved through litigation or any other effective dispute resolution process available to affected customers.

Obstacles to making comparisons on redress

However, there are limited opportunities to make comparisons between outcomes that customers have received through the IRHP redress scheme in cases of IRHP mis-selling and the level of compensation a court may have awarded in similar circumstances. The very fact-specific nature of many cases and the lack of detail in the redress scheme data released by the FCA are clearly factors which affect the extent to which effective comparisons can be made, but the main issue is that so few cases have made it to court and, among those that have, there has been limited success – visibly, at least - for SMEs.

Access to litigation in these kinds of disputes has been restricted, not just by claimants' lack of resources and the expiry of limitation in many cases, but also, in part, because there may be no legal cause of action for companies in respect of relevant regulatory breaches. Where well-presented cases with legal merit have been pursued by SMEs, banks have mostly sought to settle out of court on confidential terms.

Consequential Loss - comparisons with other commercial disputes

Claims for consequential loss made through the redress scheme were assessed separately to basic redress and "on the basis of established legal principles in relation to claims in tort and for breach of statutory duty", according to the FSA/FCA, so it may be possible, given access to more detailed outcome data for the scheme than has so far been published by the FCA, to compare the level of success and quantum of redress delivered on consequential loss claims through the redress scheme with awards for damages made to businesses litigating disputes involving claims for equivalent loss or damage.

Forensic accountants and other experts, commissioned by customers to help submit consequential loss claims through the IRHP scheme, who have made their own comparisons between this process and their experience of damages claims in other business disputes, have told us that it has been inexplicably very much harder to achieve a favourable consequential loss outcome in the IRHP review than in other comparable consequential loss claims on which they have worked.

[22] Report of The Cranston Review, pg 63

Members of the APPG share the concerns of experts and constituents alike that the total level of redress paid out specifically for consequential loss through the review, excluding payments of 8% interest on redress, is so low at only £46 million. We would encourage the review team to utilise its unique access to redress scheme outcome data to undertake its own comparative analysis on redress for consequential loss. We consider how consequential claims are dealt with through the review in more detail below.

Customers who 'opted-out' of the redress scheme

We would also ask John Swift's team to look more closely into the category of customers who are recorded as having 'opted-out' of the review. The FCA final update of 'Progress of sales through stages of the review' gives the figure of 2,038 customers who have 'opted-out'. At 10% of those assessed as 'non-sophisticated' for the purposes of the review, this suggests that a significant chunk of the review population elected not to benefit from any redress that might have been due to them through the scheme. If indicative of a lack of confidence among these customers that the scheme was capable of delivering satisfactory redress in their case then this is very pertinent to the question of how redress through the scheme might compare with other resolution mechanisms.

The review team needs to establish whether those who are recorded as having 'opted-out', or at least the majority of them, did so passively, by not responding to invitations to participate, or took a positive decision to exit from the scheme, and whether the level of opting-out here is common to other mass redress schemes.

If it is the case that these are mainly Category B customers who failed to engage with the redress scheme, then the review team needs to investigate whether more could and should have been done by the FSA/FCA and/or the banks to encourage or secure greater participation or else whether automatic entry should have been extended beyond those with category A products.

Alternatively, if 10% of the total 'non-sophisticated' redress scheme cohort actively decided to remove themselves from the scheme after some involvement in it, then there are further questions to be answered. Our understanding is that, subject to their claim being within the limitation period, customers retained the right to continue to pursue litigation in tandem with the redress scheme or to attempt it after the review, if dissatisfied with their outcome through the review. We question why so many customers would decide to completely withdraw from the process, rather than pursue it to completion and reject the outcome for basic redress and/or consequential loss if they were not satisfied with either.

The review team needs to discover at what stage customers were most likely to withdraw from the process and the main reasons for doing so. It is also important to determine if there were other factors in common, such as insolvency, business sector or size, the type, size and/or term of product, the complexity of the case, the value of the claim and whether it comprised a large element of consequential loss, whether there were particularly serious conduct issues involved, whether the customers were represented by particular law firms and/or other experts and/or whether legal action or alternative dispute resolution (ADR) was already in progress or likely to be pursued.

Ideally the review should try to establish whether many of those who opted out of the redress scheme were able to secure a more favourable level of redress outside of the scheme than if they had remained within it. We recognise that this may not be easy to accomplish if there has been widespread use of 'gagging orders' to ensure that settlements remain confidential, but we believe that it should be attempted nonetheless.

The level of harm or loss suffered by the customer and the nature and gravity of the conduct causing the harm

With irreconcilable differences between the perceptions and views of the involved parties on the amount of customer loss that should be attributed to an IRHP or the extent of the bank's culpability for that loss, it is very difficult to gain a definitive picture of either.

What is not in dispute is that, following rapid falls in reference interest rates in 2008-9, the borrowing costs of thousands of SMEs were far greater than they might otherwise have been had they not entered into certain types of IRHPs and a significant proportion of affected businesses became financially distressed. But losses alone, however substantial, were not necessarily indicative of mis-selling. All customers - and none more so than business customers - are expected to take responsibility for their own decisions about financial products and services and not simply blame the seller when things go wrong.

Banks determinedly refused to accept liability for losses suffered by businesses after entering into IRHPs, pointing out that businesses had freely entered into commercial contracts under which they would either make or receive payments, depending on where the reference rate of interest happened to be; that the customer should have sought independent advice before entering into the contract if there was any aspect of it about which they were unsure and that the Bank could not have foreseen that reference rates of interest would fall so low and remain there for such a period of time. The banks maintained that in most cases the borrowing costs of a business stayed relatively stable after entering into an IRHP, so any losses sustained by that business during the difficult trading conditions of the ensuing economic downturn were not due to the costs of servicing the IRHP.

The alternative view of business customers who entered into certain types of IRHPs was that it was these IRHPs which had hindered or, in some cases, prevented businesses from trading their way out of recession. This was because, in addition to the obvious ongoing servicing costs and the consequences if they became unaffordable, these instrument had severely curtailed the ability of those in charge of the business to take key decisions, for instance on restructuring debt, expanding, contracting or redirecting the business and buying or selling assets in a controlled way, when they chose to do so. Many of those affected claimed that their business suffered huge losses due to being locked into one or more of these instruments and the underlying lending after their bank had engaged in unfair sales techniques, which included failing to properly inform, or misinforming customers about the potentially huge early exit fees.

It was not easy for business customers to make headway against the narrative of the banks as they faced considerable challenges trying to both detail all of their losses and expose issues with banks' IRHP sales processes.

Problems determining losses

While it is relatively straightforward to calculate the so-called 'direct' costs of IRHPs, it has been very much harder for affected customers to identify and prove which other losses should be attributed to IRHPs. These products were not sold in a vacuum but were inextricably linked to other - mainly unregulated - facilities provided by a bank in the context of an ongoing relationship with the customer and against a wider background of connected and unconnected events and circumstances which included the financial crisis of 2008. It is not straightforward to isolate the effect of the IRHP from all other decisions and actions of the business and bank to determine whether, without the IRHP, additional losses would have been avoided or quicker and easier to mitigate, for example, where a business was subject to punitive action, including alteration and withdrawal of facilities; transfer to a special measures/turnaround division; changes to the margin rate of interest; the imposition of other fees and costs and, in extreme cases, the appointment of LPA receivers; forced sale of properties at fire sale prices or the onward sale of loans to unregulated equity funds.

Detailing and quantifying the losses, including any loss of profits, of the business is an exercise which involves the consideration of possible and likely scenarios, requiring skills and knowledge not within the repertoire of many business owners. Some customers may remain unaware of the full effects of the IRHP on their business, for instance as a result of the contingent liability. Most would want help from forensic accountants, lawyers or other experts to prepare an effective statement or claim for loss over and above the direct costs of the IRHP. Not all could afford to pay for third-party support and a 'DIY' account of losses was likely to have differed fundamentally from what an expert might have produced. Irrespective of whether customers engaged a third-party, they would almost certainly have struggled to gain access to critical evidence held by the bank in order to back up their claim.

Challenges exposing issues with banks' IRHP sales processes.

Opacity around the effects and consequences of some IRHPs, and the fact that it may have been months or years after the sales process before problems manifested, also made it harder for customers to identify specific failings of their bank in relation to the sale process.

IRHP sales processes were mainly conducted verbally and with the further passage of time, it has only become harder for those involved to recall all of the details accurately and produce confirmatory evidence, often in the face of contradictory accounts from the bank. There may be little contemporaneous documentary evidence available, aside from contractual agreements which often incorporate disclaimers, not necessarily written in plain English, designed to absolve a bank of responsibility for some things, notably for providing advice. The bank's own records are unlikely to knowingly document any instances of misconduct or accept any liability. These records will almost certainly have been written by, or feature

contributions from the staff involved in the contested sale and consequently cannot be considered to provide a complete and entirely reliable account of events.

Furthermore, without a certain level of legal and regulatory knowledge and vocabulary, customers may not have been aware of the duties owed to them by their bank during the IRHP sales process - some have stated that they did not even know that it was a sales process - and so not all would have been able to appreciate the distinction between terms such as "appropriateness" and "suitability" and identify all issues or failings, let alone to articulate these in terms of any relevant specific breaches.

An important example where we believe the gulf in regulatory knowledge between banks and their business customers led to a representation of bank conduct that was disproportionately favourable to the bank is in respect of the distinction between 'advised' and 'non-advised', or 'execution-only' sales. We drew attention earlier to evidence presented in parliament by Guto Bebb that large numbers of customers sold IRHPs by their banks believed that they were being advised by representatives of those banks.[23] The FSA/FCA noted in the report of Pilot Scheme and elsewhere that it had found examples of "non-advised sales straying into advice". We are concerned that this analysis does not adequately capture the seriousness of the issue if customers genuinely believed that they stood in need of advice and that their bank was providing advice, but banks had sole discretion to decide how sales of IRHPs should be categorised and could avoid the higher level of duties that would be owed to the customer should a sale be categorised as 'advised'. Where the bank failed to make it sufficiently clear to the customer in plain English and in good time before any discussions concerning the transaction that it was being made on a non-advisory basis and the overriding perception of the customer was that advice was given, the fact that this may have had an impact on the customer's decision should be just as relevant to the categorisation of the sale as the bank's view of the matter.

It is our understanding that the majority of IRHP sales by banks to SMEs were made ostensibly on a 'non-advised' basis, but we look to the review team for confirmation of this point and this is an area which we believe warrants particular attention in this review.

In June 2012, once the FSA confirmed that there had been wide-scale poor sales practices across a number of banks which had sold IRHPs to SMEs, several banks were finally brought to some form of acknowledgement – through their agreements with the FSA and the resulting redress scheme – that some IRHPs had been mis-sold and that there was a need to compensate those customers who had suffered damage and loss as a result.

Impact of the time it took to acknowledge the poor conduct and loss

Any audit of conduct and loss in relation to mis-sold IRHPs must take into account the effects of relevant post-sale behaviour of the banks and inaction by the regulator. Customer losses

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were likely to compounded, prolonged and, in some cases, amplified as a result of banks' refusal to acknowledge mis-selling

We know that a good number of customers, including some in severe financial distress, complained to their banks that they had been mis-sold IRHPs, but we are not aware of a single complaint about a mis-sold IRHP made by a business customer prior to the IRHP redress scheme that was upheld by the bank without it being referred to FOS.

Thousands of affected customers effectively had no voice through the regulatory system to highlight any concerns about their treatment, as up until 2019 any enterprises larger than microbusinesses were not covered by the complaints handling provisions in DISP and so there was no obligation for banks investigate and respond appropriately to complaints from these larger businesses. However, where financial firms become aware of problems, either directly through a DISP-eligible customer complaint or through FOS, they are supposed to try to put things right, not just for those customers who have complained, but also for other affected customers who have not complained.

If there had been less obfuscation and denial by banks, or the regulator had acted more quickly, the scale of the damage from IRHPs could have been far less, with some losses curtailed much sooner and others perhaps avoided altogether by some customers.

The ongoing failure by banks to acknowledge all of the issues with some IRHPs, notably the contingent liability of swaps and collars, has confounded customers' efforts to identify all of the detrimental effects of those products as well as all aspects of faulty conduct, and prevented some customers from arriving at an accurate assessment of all of their losses and liabilities.

Approach taken by the FSA/FCA IRHP redress scheme to determining conduct and loss

The IRHP redress scheme considered bank conduct and customer loss separately from each other. Poor conduct, as defined through the scheme, was a failure by the bank to meet all of the required regulatory standards during the sale of the IRHP. Banks were found to have breached those regulatory standards in over 90% of eligible IRHP sales, but since there was no assumption within the scheme that a deficient IRHP sale process automatically led to customer detriment, these breaches, on their own, were not enough to secure redress.

The pilot scheme stated that:

"*redress will not be owed to the customer in all cases where the sale did not comply with the regulatory requirements. This is because the breach of the regulatory requirements may not have affected the outcome of the sale, and so the breach did not actually result in a loss for the customer*."[24]

[24] Pilot Findings, March 2013, pg 14

Where it found there had been a non-compliant sale, the scheme determined whether the conduct of the bank caused the customer to suffer loss by considering what the customer would have done had the sale met the required regulatory standards. The customer was only found to have suffered loss where it was decided that they would have made a different decision on which, if any, product to have if there had been a compliant sale process. Monetary redress was due if it was determined that the customer would have taken no product at all or else one that cost less to service than the original IRHP.

It may seem not unreasonable to ask what, if anything, the customer would have done differently had the bank conducted a decent sales process, but there are clearly very many variables involved and the redress scheme appears to rely on at least three big assumptions to arrive at an answer:

- that all problems with the sale are captured within the relevant regulatory requirements,
- that given sufficient quantity and quality of information the customer would be able to make the right decision on which IRHP (if any) would suit their needs *and*
- that someone who was not the customer would be able to tell what the customer's decision would be.

Responsibility for the sale

The question posed by the redress scheme to determine whether the sale of the IRHP caused the customer to suffer loss, appears to reduce down to this: in the absence of regulatory breaches in the sales process, *but all else remaining equal*, would the customer would have made the same decision? What this does is to effectively shift the burden of responsibility for the IRHP decision and any resulting detriment away from the bank and on to the shoulders of the customer.

We noted earlier that it is usual to expect a customer to take responsibility for their decisions in respect of financial products and services. However, that expectation usually rests on the reasonable understanding that the customer is able to make a free and fully informed decision as to whether the item being sold suits their needs and the cost is acceptable to them. In our view, the same should be true here and it is therefore necessary to consider quite how much responsibility the customer could reasonably be expected to bear for their decision to enter into an IRHP.

We believe that it is necessary to consider whether the customer was or could have been in the position to make an independent and informed decision about which product (if any) was right for them. Given a satisfactory quantity and quality of information, could the customer have gained sufficient understanding and predictability of all the costs, risks and implications of the product over its lifetime?

This review will need to decide whether it was appropriate for the regulator to take the approach that it did in the IRHP redress scheme. It will also need to determine whether the scheme took account of sufficient relevant factors, including all pertinent issues of conduct,

and excluded from consideration irrelevant matters to arrive at its assessment of whether redress was owed in each case to the customer and, if so, what form that redress should take.

We look below at the scheme's methodology (to the extent that it has been released into the public domain) to see whether it was able, or even attempted, to expose the nature and gravity of all of the faulty conduct and to try to determine which factors it took into account when making its determinations. We go on to consider whether the redress scheme was able to uncover the full extent of each customer's loss and provide a satisfactory level of redress in each case.

First, we highlight some of the factors which could have a bearing on the customer's ability to make an independent and informed decision about which product (if any) was right for them.

Factors which may have affected the customer's ability to make an independent and informed decision

The following is by no means an exhaustive list:

- **Customer trust in their bank**
- **Customer needs and requirements**
- **Banks' motives for wanting customers to have IRHPs**
- **Imbalance of power**
- **Information asymmetry**
- **The customer's choice of product**

Customer trust in the bank

It is important to view the sales of IRHPs to SMEs within the context of their pre-financial crisis times and consider the role that customer trust played in the sales process. At that time, it was quite normal for a business owner/director to enjoy a good and possibly long-standing relationship with a dedicated Relationship Manager who would provide a more personal, bespoke service than that on offer to ordinary domestic customers. That Relationship Manager is likely to have initiated discussions about interest rate protection, informed the customer of any requirement or preference of the bank in respect of hedging and, in most cases, would have made the initial introduction to the authorised derivatives expert(s) from the Bank's investment arm who provided information and possibly also advice to the customer on a range of products, before carrying out the 'trade call' to close the deal.

If the customer trusted their primary contact at the bank and colleagues introduced by them to always act in good faith or, at the very least, do nothing to put their business in jeopardy, then they would have no reason to doubt the information they received from them about IRHPs, including assurances that an IRHP would reduce risk to both parties.

Customer needs and requirements

The FCA states on its website that "[*t]he purpose of an interest rate hedging product (IRHPs) [sic] is to enable the customer to manage fluctuations in interest rates*."

We would question how many business customers would actually need to be able to manage movements of interest rates in both directions, or whether it can even be assumed that all SMEs who entered into IRHPs had an overt need for interest rate management.

In order to appreciate the particular needs and requirements of the individual SME customer and whether they could be met by any available IRHP, or whether any limitations, costs and any other downsides and risks outweighed the benefits, it is necessary to consider the customer's motive(s) for engaging in the IRHP sales process and their likely reasons for entering into a particular product.

It is important, for instance, to consider whether the sales process was initiated by the customer or bank and whether the customer expressed any concerns or anxiety about possible rate rises and the affordability of loan payments before the subject was introduced by the bank.

It is apparent that in a significant proportion of cases the primary goal of the customer was to satisfy the requirements of their bank or to make their lending application more acceptable so that they could borrow money. It needs to be recognised that many customers effectively had no choice but to enter into some form of IRHP if they wanted to borrow money from that particular bank. Even if there was no formal or explicit condition of lending requiring the customer to enter into an IRHP, we know that in some cases it was made clear to the customer that unless they agreed to an IRHP their application for lending was unlikely to be approved.

Whether or not a customer could avoid the obligation to have an IRHP by switching to another lender was dependent upon a range of factors, including the degree to which they were already committed to existing borrowing with the first lender, whether there was any time pressure to secure the funds and whether any other lenders had the appetite to lend to the customer without a similar demand for hedging.

Cost is an important consideration for all customers; regardless of the primary reason for entering into an IRHP, a critical requirement for the customer was to be able to continue servicing their debt so a hedging solution needed to be achieved within an acceptable cost. Customers had usually already negotiated or agreed an acceptable variable rate with their bank consisting of base or libor plus a margin, prior to any discussions about hedging.

Where the main reason for the customer having an IRHP was to satisfy the demands or wishes of the bank, we believe that it is likely that they would focus on those products which might appear to offer the lowest cost solution to achieving that end, ie satisfying the bank. Any product with a premium might not fit this profile and, in any event, the customer may not have been able to commit to an upfront premium without requesting and receiving approval for additional borrowing. Any product which would enable the customer to continue at their existing borrowing rate or else would not require too much of an immediate uplift of that rate would be likely to appear the most attractive.

Equally, in our view, those customers who *were* looking to specifically manage their future rate of interest would be just as wary of locking themselves from the outset into a rate that was much higher than the prevailing rate and so might also prioritise those products which offered an initial rate that was as close to their existing rate as possible.

The business and personal lives of owners and directors of small and medium-sized businesses are likely to intertwine to the extent that significant personal events like a serious illness or divorce may have a huge impact on the business, potentially necessitating urgent action which might include the restructure of debt and/or buying or selling of assets. So, a key requirement for all of this customer group and one that was perhaps not always fully appreciated until it was gone, was to retain flexibility. Many business owners were nearing retirement age when they entered into long-term IRHPs, for instance, and they might have anticipated selling part or all of the business or otherwise restructuring the debt.

Another important consideration is the customer's attitude towards risk. Where customers were required or encouraged to have an IRHP by their bank, it is likely that they would see their needs as being aligned with those of the bank in respect of risk. It seems safe to assume that most, if not all, of this group of customers, including those positively seeking interest rate protection, and particularly those nearing retirement, were seeking to reduce risk, rather than take on additional or alternative risks, including high break costs and associated contingent liability.

Banks' motives for wanting customers to have IRHPs

The reason banks usually stated for wanting their business customers to have IRHPs was to reduce risk to the customers themselves and thus to the bank. Customers were likely to infer from this that their interests coincided with those of the bank, which may have helped to shape their own view of the products, including how appropriate they were and whether or not to accept a condition of lending that required them to have some form of hedging.

It also became apparent that sales of some of these products were very profitable for banks. This did not necessarily invalidate the bank's stated position in respect of seeking to minimise risk to customers and the bank. However, it seems impossible to reconcile this position with some of the hedging products that the banks actually sold.

The FCA's figures show that the vast majority of the potential population of the redress scheme was sold a swap or collar. These are products which exposed customers to not inconsiderable risks. Structured and callable products introduced further risks for customers and banks also actively sold these, in addition to allowing some customers to be 'overhedged' through entering into an IRHP with a term and/or value that was greater than that of the underlying loan.

If the recommendations and requirements of banks' credit functions for customers to enter into IRHPs were made with the genuine intention of reducing risk to the Bank then, at the very least, there appears to have been a critical failure on the part of each of the banks to align the interests and goals of their credit function with those of their sales division.

Alternatively, if banks' credit functions were found to have acted in collaboration with sales divisions and attached recommendations and requirements for hedging to their approval of customers' loan applications with the aim of increasing the volume of sales of IRHPs, then this would constitute a serious conflict of interest and particularly egregious conduct towards the affected customers.

In either case it is pertinent to question whether it was appropriate for banks to require some customers to enter into an IRHP as a condition of lending, particularly if those customers were unaware of the financial interest of the bank and, where applicable, individual employees.

We would have expected the regulator to attempt to determine the respective motives of these divisions in each of the banks to understand whether they were pulling in opposite directions or working in tandem. Relevant areas of inquiry would include:

- examination of banks' policies and internal communications between credit and sales divisions;
- looking into the respective gains for banks that came from sales of different product types and combinations of notional value and term to ascertain whether it was in the bank's financial interest to sell more of the complex, risky and/or longer-term products;
- examination of the incentivisation of both FSA authorised and non-authorised staff to determine whether it was likely to encourage sales of more profitable product combinations than those which could reduce the customer's risk level to the bank;
- examination of how and at what stage approval was sought and granted for credit lines in respect of those products that had a contingent liability and whether, once put in place, a credit line might prevent further borrowing, for instance for the payment of a cap premium.

Imbalance of power

Lack of negotiating power

Many SME customers effectively had no option but to enter into some form of IRHP if they wanted to borrow money from their bank. A condition of lending might even specify that the customer needed to have an IRHP of type, value and term satisfactory to the bank. Some customers may have remained unaware that there was a specific condition until it was too late to withdraw from the loan without serious consequences.

Even if there was no formal or explicit condition in the lending agreement requiring the customer to enter into an IRHP, it might have been made clear to the customer that, unless they agreed to an IRHP, their application for lending was unlikely to be approved, or that the bank was unhappy with the level of risk that the unhedged customer represented.

Significant barriers prevented many customers from switching to another lender to avoid having an IRHP.

Voluntary codes of conduct exist to offer some protection to the smallest businesses. We believe that it is possible that in some instances, when banks imposed a condition of lending requiring the customer to have some form of hedging and that customer could not understand the implications of that condition, this may have breached the relevant code of conduct at the time, the Business Banking Code. We would have anticipated that the FSA/FCA would have investigated each Bank's use of conditions of lending to assess whether they were created and applied fairly and reasonably.

In cases where the customer was not obliged to accept an IRHP, the bank might apply a more subtle pressure by initiating and developing customer concerns about possible interest rate rises.

<u>Monopolistic supply</u>

Although IRHPs were sold by several banks, each effectively each had a monopoly over its own customer group since there were considerable barriers to customers moving to an alternative supplier, including existing and prospective debt and associated security obligations and limited customer knowledge.

Ordinarily, in a well-functioning market, the customer has a choice, so if he or she is not happy with the price or deal offered by one supplier they can switch to another. Here, free from competition, banks could control which product features to offer at what value, term and cost and how much product information to make available to the customer. This potentially allowed unfavourable product configurations and pricing to go unmoderated.

There might be the appearance of choice, as customers were presented with various product combinations, but ultimately the bank remained in control of the sales process and could pre-select what the customer was able to choose from. This could be even more of a 'Hobson's choice' if the customer had a condition of lending and was therefore obliged to enter into one of the products.

The customer's sensitivity to price might mean that the least appropriate product combinations could appear more attractive than simpler, less risky ones. If a customer with 5 year loan, whose priority was to keep their initial cost of borrowing at the lowest rate possible were to be offered a choice between a 5 year swap with relatively high rate of interest, 10 and 15 year swaps with progressively lower rates, and a product which gave the bank the option to cancel it after 2 years, also at a lower rate of interest, then they might well be tempted by either one of the longer term swaps or the callable/cancellable product.

For the most part customers had no means of making price comparisons to see if the products they were offered represented good value for money. We would have anticipated that the FSA/FCA would have investigated the pricing of products to determine whether unmoderated pricing unduly influenced which products were sold in greater numbers and whether prices were often structured and possibly even manipulated to sell the more lucrative product combinations.

It is necessary to consider how likely it would be that, given a real choice, customers would have entered into riskier products, including swaps and collars, had they been made aware of all of the downsides and risks.

Timing

The stage in the lending application when the idea of hedging was first proposed could make a difference to how much flexibility the customer had to alter certain parameters, such as restructuring or pulling out of the loan, or else refinancing with another lender.

The timing of when information was provided to the customer about individual products available to them could also affect whether or not they were aware of the implications of agreeing to a condition of lending requiring them to enter into an IRHP. Where the loan was agreed and possibly also drawn down prior to the customer receiving information about specific IRHP products, there was also less chance that they would have access to funds to choose pay the premium on a cap if it was offered as an option at that point. Similarly, if the bank's credit function approved and implemented any credit prior to the trade call, in the expectation that the customer might opt for a swap or collar, this could affect whether or not customer could borrow to finance the upfront premium of a cap.

Information asymmetry

IRHPs were novel products for most SMEs and the limited availability of alternative sources of information and advice could lead to a sizeable gulf in knowledge between banks and their business customers, leaving most customers heavily reliant on their bank for information. In such a situation 'you don't know what you don't know'; if customers had no reason to suspect nor the means of discovering that information they received from the bank was unreliable or not sufficient for them to understand all of the consequences, costs and risks of each product, then they were almost certainly unaware that they might need external information or independent advice.

Customers' information needs included sufficient detail on a range of products, with full transparency of all costs, potential costs and contingent liability over the lifetime of each product and of the relationship between benefits, cost and risk so to allow the customer to make comparisons and determine which product represented the best solution and the best value.

Customers also needed to made aware that the product could effectively be entered into over the course of a phone call, with no cooling off period and prior to the provision of any terms and conditions.

They should also have been made aware of the banks commercial interest in the sales of those products and the extent to which individual bank personnel were incentivised and might benefit personally from any sales they made.

The need for all of this information began at the same time as discussions for any potential lending for which a connected IRHP might be required or offered. Those who were not made

aware of the implications of signing a loan agreement which included a condition requiring them to have an IRHP effectively had no opportunity to make an informed decision about whether or not they needed or wanted an IRHP.

Customers with existing IRHPs could not be considered to have significantly lower information needs than those with none, if each sale process was conducted prior to significant falls in interest rates and was equally deficient as the next.

Experience of a domestic or buy-to-let fixed-rate mortgage could not be considered relevant knowledge and potentially might lead to serious misconception on the customer's part, as we consider below.

The bank was in a position to control which information it supplied (and didn't supply) in respect of specific products, including the type of products and the juxtaposition of value, term, rate(s) and premium (where applicable). It could be very difficult for the customer to make meaningful comparisons between the cheeseboard of products presented to them. It was also possible for the customer to be 'steered' towards the particular product that was most advantageous for the bank and/or for the seller personally.

The customer's choice of product

The range of hedging products sold by banks to their SME customers as protection against the risks of interest rates rising comprised of caps, interest rate swaps, collars and structured collars, a more complex variant of the collar. Some products might also include 'callable' and/or extendable features.

All of the factors we have looked at above could affect customers' perceptions of which, if any, of these products could fulfil their needs and requirements at an acceptable cost.

We use the following product summaries on the FCA's own website to illustrate the hazard of providing an insufficient level of detail about IRHPs to the uninformed customer, even where there may be no intention to deceive:

The purpose of an interest rate hedging product (IRHP) is to enable the customer to manage fluctuations in interest rates. These products are typically separate to a loan.

We have identified four broad categories of IRHPs sold:

Swaps; which enable customers to 'fix' their interest rate.

Caps; which place a limit on any interest rate rises.

Collars; which enable customers to limit interest rate fluctuations to within a simple range.

Structured collars; which enable customers to limit interest rate fluctuations to within a specified range, but involves arrangements where, if the reference interest rate falls below the

bottom of the range, the interest rate payable by the customer may increase above the bottom of the range.

Interest rate swaps

An interest rate swap is a separate contract to the underlying loan agreement. It is an agreement between two parties whereby one type of interest payment is swapped for another; such as exchanging a fixed interest rate payment for a floating payment.

In practice, if the floating interest rate payment increases because base rates rise, the customer receives an amount that they can use to off-set the increase in loan repayments. Conversely, if the floating interest rate payment decreases as a result of falling base rates, the customer makes an additional payment to the bank under the terms of the swap, but benefits from lower loan repayments. The customer's costs therefore effectively remain stable.

Caps

A cap is a separate contract to the underlying loan agreement that can have the effect of limiting increases in a customer's loan repayments if interest rates rise.

A customer typically pays an upfront fee and/or an ongoing premium for a cap. The lower the agreed interest rate, the higher the fee.

As interest rates fluctuate, a customer's loan repayments will fluctuate. If base rates are above the agreed interest rate, the customer receives a payment from the bank that can be set against the increased loan repayments. If interest rates are below the cap, then no payment is made.

Simple collars

A simple collar involves a ceiling and a floor. As interest rates rise, loan repayments will increase, but increases are capped at the rate agreed as the ceiling. Similarly, as base rates fall, any reductions in loan repayments are limited to the rate agreed as the floor.

Structured collars

Structured collars are in some respects similar to simple collars. They enable customers to limit interest rate fluctuations to within a range. However, while the ceiling functions in a similar way, the floor is more complex and customers can end up paying increased interest rates if the base rate falls below the floor. They require a more difficult assessment of the benefits and risks

Inexplicably, having identified 'poor disclosure of exit costs' as one of the main failings of banks in respect of their sales of IRHPs to SMEs, the FSA/FCA's own descriptions of swaps and collars omit any mention of such a critical characteristic, which could potentially amount to between 20% and 40% of the value of the loan or IRHP. Neither is there any reference made to the contingent liability arising from the connected security requirements which were usually put in place by the bank without seeking the customer's permission or even informing

them, and which may, in some cases, have led to an immediate or subsequent breach of one or more covenants of the customer's loan agreement.

In the absence of the critical context of the downsides of some of these IRHPs, with the exception of the structured collar, there is little to indicate what may have gone wrong with these products and why they were considered to have been mis-sold in large numbers.

It could be inferred that business customers who were seeking a degree of certainty or predictability of their borrowing costs were simply caught on the wrong side of the collapse in interest rates and, despite apparently having had no issue with paying the prevailing rate of interest prior to late 2008, they were unhappy at having to continue paying those rates after the rapid falls in the base rate.

The only product which appears problematic is the structured collar; its description is the only one to mention risk, but the reference is vague, noting simply that these products "*require a more difficult assessment of the benefits and risks*," and specifying only that "*customers can end up paying increased interest rates if the base rate falls below the floor*."

Cap

The Cap is the only product description that makes reference to an explicit fee or cost, (although the FCA omits to mention that there was also a premium to pay on some collars offered to SME customers). This, and the absence of any reference to the possibility of very large break fees to exit any of the other products could make the cap appear poor value in comparison with them.

What is not obvious is that this is the only product able to reduce or eliminate the customer's exposure to the risk of interest rate rises against a known cost and without introducing any additional risk. It can be seen that the cap provides a trade-off between the payment amount, made upfront or in instalments, and the extent to which the risk is offset.

It is not made explicitly clear in the description of either the swap or collar that while these products may not require payment of a pre-defined fee, the level of protection they can provide from rising rates does come at a different kind of cost - added risk. The risk of rising interest rates is traded against the risk of the opposite event - interest rates falling. So, one risk is substituted for another; in order to have certainty against borrowing costs increasing significantly, the customer has to surrender the possibility of benefiting from substantially lower costs should rates drop below a certain level.

It can be seen from the description of the cap that the customer's choice was not just between the different types of instrument; there were further critical and fine judgements in which it was necessary to balance benefits, risks and costs and for which they would need to take a view on what they thought might happen to interest rates over the lifetime of the instrument.

Collar

A collar incorporates a cap as its ceiling, the cost of which is met with the use of a floor which limits how far the customer's interest rate may fall. This allows the customer to remain on the prevailing rate on entry into the cap and benefit from some degree of downwards movements in reference rates, but, in practice, the greater the protection required from rising rates, so the lower the cap, the higher the floor will need to be raised to offset the cost of the low cap, limiting the degree of flexibility to a slim band between cap and floor.

Swap

An interest rate swap has a cap and floor set at the same rate, which prevents exposure to any rate rises but offers no possibility for the customer to participate in any fall in interest rates below that rate, which would usually be set at higher than the prevailing variable interest rate.

The customer's decision

The immediate prospect of being locked in from the start into paying above the prevailing rate with a swap or the restriction on participating in any but the smallest of interest rate falls caused by a high collar floor may have tempted some customers to 'overhedge' - to take on an IRHP with a term that exceeded that of their loan(s). This is because longer term products could usually present the opportunity to keep immediate and future costs lower by setting the swap rate or collar floor at a lower rate than shorter term products of, say 5 years or less.

Instead, or in addition, customers might be drawn to take on greater complexity and additional risk. Callable or extendable elements could lower the customer's rate(s) but gave the bank the option to cancel the contract at one or more specific intervals of the term, or to extend the contract for a further period. A structured collar might also seem less of a crazy choice to the customer as it appears from the FCA descriptions. The advantage that the customer might see in a structured collar is that it could enable them to have a lower floor than on an ordinary collar and so participate to a greater degree in falling rates. Some structured collars offered by one bank were even labelled "value" collars. There was the risk that the customer's rate could track up above the ceiling level if the reference rate fell below its floor(s) but even if it did the customer might not actually pay a higher interest than if they had taken an alternative collar or swap.

The eventual degree of choice of the customer was subject to the range of product options that was presented by the bank. For instance, where the customer's priority was to keep the existing cost of borrowing to a minimum, the only choice provided that could offer an acceptable interest rate window might be between a structured collar, a callable product or one with a much longer term than they required or desired. A long-term collar or structured collar without a premium which enabled the customer to continue at existing base rate and participate in at least some downwards movement in rates could make a long-term cap with a low ceiling rate and a considerable upfront premium appear to disadvantage if little clarification was provided of potential break charges and the positive suggestion of a potential break gain was introduced.

A cap might not be a viable option if the customer didn't have available funds for the up-front premium and it was not made available with instalments. We know that in many cases the customer was not told that there even was such a thing as a cap.

So critical and sometimes very difficult choices and judgements involving considerable compromise on needs and requirements might need to be made by customers without the context of full knowledge of all possible products or of the potential risks of some, including the possible scale of potential break costs and contingent liability. A greater degree of misunderstanding may have also played a part in some decisions, whether by accident or design. For instance some customers maintain their understanding was that an option to extend or cancel applied to both parties, not just the bank, while others reportedly placed great reliance on statements by their bank's derivatives expert(s) that there was a strong possibility or even likelihood that the bank would pay them to exit early from the product.

In the absence of information about the potential cost to exit IRHPs, statements on the FCA website, such as *"Swaps; which enable customers to 'fix' their interest rate" and "The customer's costs… effectively remain stable"* could and almost certainly did lead some business customers to underestimate the risks of some products, in the mistaken belief that an interest rate swap is just like a domestic or buy-to-let fixed rate mortgage.

With a traditional fixed rate mortgage, any penalty for exiting from the product before the end of the term is typically both pre-defined and capped. If base rate falls there may come a point when it is financially advantageous for the customer with a fixed rate mortgage to pay the redemption fee to be released from the fix and refinance with an alternative loan product so as to have lower interest payments. The cost to 'break' a swap is not only largely unpredictable for the customer but will almost certainly increase substantially if the reference rate of interest declines, making it more expensive and so *less* cost effective to exit from the product as the reference rate goes down.

Since the corresponding security requirement is likely to also increase in line with the revised level of break charges, the value of the business customer's assets might also be insufficient to cover the security requirement of further borrowing to pay the break charge and exit the swap.

It is also far from certain that the customer's borrowing costs always 'remain stable' under an interest rate swap. The loan and swap are two separate products where the payments for each are debited (or credited where applicable) separately and so not necessarily in synch. there might be monthly payments to the loan but quarterly debits for the swap, for instance. For those on repayment terms, loan instalments typically remain static between periodic reviews and adjustment, but the charge for the swap directly tracks changes in the reference rate of interest and so can fluctuate significantly from one settlement date to the next.

Businesses which had seen a negligible effect on costs from swaps entered months or years earlier, experienced huge spikes in their swap payments from the end of 2008. Delays in reviewing loan repayment instalments following the successive rapid drops in the reference rate of interest put excessive strain on cashflow for some of these customers as it meant that while the swap costs were immediately adjusted up to reflect the falls in reference rates, they

continued to make larger loan payments based on the previous higher rate of interest. While this might be a temporary issue it could have a lasting impact if it led to a default as a result of any late, missed or returned payments.

The variable interest rate paid by business customers is typically made up of at least two elements, the reference rate, eg bank of England base rate or Libor, and a margin on top of this rate. Where banks were able to vary this margin, they could effectively override the protection provided by any interest rate management product. A single instance of default, such as might easily have occurred during an initial mismatch in loan and swap payments following significant interest rate falls, as outlined above, could give the bank the right to increase the customer's margin, as could a breach in of one of the covenants of the loan such as the loan to value ratio (LTV). A breach of LTV might be triggered by the contingent liability immediately on entry into an IRHP, or else when many properties were subsequently down-valued due to the financial crisis. Some businesses may have been transferred into banks' special measures or turnaround divisions as a result of that initial temporary pressure on cashflow and/or their higher risk status due to their high cost of borrowing and the contingent liability of their IRHP, in combination with any down valuation in their assets. This might lead to punitive action, including additional increases in the margin and further costs and alterations to facility terms.

Appropriateness of the Products

The nature of the actual products and, in particular, whether any were inappropriate to be sold to SME customers is critical to these considerations. It seems self-evident that banks should not attempt to sell products that are inherently inappropriate for their customers, but it's not clear that they always have an explicit duty not to do so, even where the transactions are regulated. If there is a gap in the regulations, however, it does not seem fair to expect the customer's responsibilities to stretch to fill it.

In this instance the regulator made a judgement that just one of the products sold – the structured collar – was not appropriate for these customers. At the outset of its intervention, the FSA took decisive action to halt any further sales of these products to 'retail clients' and committed to provide automatic redress to all of those that had been sold structured collars where they did not meet the redress scheme's tests for 'sophistication'.

The FSA labelled other swaps and collars that had no callable or extendable elements 'simple' products and enabled banks to assume, for the purposes of redress, that customers would have purchased these products, given a compliant sales process. By allowing banks to redress review participants with non-compliant sales into swaps and collars, the regulator sent out a clear signal that it considered these to be appropriate products for banks to have sold to their 'non-sophisticated' SME customers.

Neither in the pilot report, nor on its website does the FSA/FCA give a clear explanation for its decision to differentiate between structured collars and other collars and swaps in the way that it did. The Pilot Report simply records that "*the inappropriate sale of complex varieties of IRHPs to 'non-sophisticated' customers*" was among the serious failings found by the FSA, and the following statement on the website provides no greater clarification as to which are the particularly problematic features and risks of the more complex products:

"*We found that when properly sold, in the right circumstances to the right customers, these products can protect customers against the risk of interest rate changes. However, when sold to 'non-sophisticated' customers, likely to be smaller businesses which wouldn't necessarily have specific expertise and understanding in this area, some products may not have been appropriate for their needs.*

In these cases, we found that the bank did not follow our rules in a number of areas, including how a number of products were sold, in particular the sales of structured collars."

There can be little doubt that structured collars are a poor choice of instrument for SMEs looking to achieve interest rate management, but it's not clear to us that ordinary collars and swaps are able to offer much of an improvement. Key downsides and risks, including the limited ability to benefit from interest rate reductions, potentially huge break charges and the associated contingent liability, are common to all of these products.

The FSA/FCA did concede that customers would not have opted for products with the potential for very large break costs, an inherent risk with all swaps and collars. However, rather than confront this clear contradiction by reviewing its position on how appropriate products with very large break costs and a sizeable (frequently undeclared) contingent liability actually are for SMEs, and whether they should be included in redress outcomes, the regulator side-stepped the issue by facilitating the synthetic construction of sanitised alternative products with a maximum term and a less unacceptable level of break costs, but still lacking transparency on contingent liability, for use in redress outcomes.

Clive Adamson's letter to the banks of 29th January 2013 declared that a key principle underpinning the process for determining an alternative product was that "*in the absence of relevant evidence to the contrary… the Customer would not have taken an IRHP with a potential break costs greater than 7.5% of the notional value of the IRHP in a pessimistic but plausible scenario*."[25] This principle was made public well in advance of the release of the letter, but it was only when customers and their representatives began to complain that some alternative redress products had potential break charges in excess of 7.5% that any further clarification of the words "*in a pessimistic but plausible scenario*" was provided by the FCA. It conceded that the reference to 7.5% did not mean that break charges on replacement swaps and collars would actually be limited to 7.5% of the product's notional value.

Our assessment is that, even if those products generated by the application of the mind-dizzyingly clever "7.5% rule" had been available and were offered to customers during the original sale, the effect of making the product term short enough to lower the potential break

[25] Letter from Clive Adamson, FCA to the banks, 29 January 2013, pg 10

charges, albeit not necessarily to the equivalent of 7.5%, would be likely to make the initial interest rate(s) unattractive to customers and that, given a genuine choice, they would be unlikely to choose one of them.

The Redress Scheme – Assessment of conduct, loss and redress

Redress scheme methodology

Full details of how the redress scheme would assess conduct and loss were not available to most participants when they entered the review and to date there is still no clear public repository of the entire redress scheme methodology in one place. Instead it is necessary to piece together details from various documents that were published belatedly, but this is unlikely to constitute a final definitive version applicable to all banks since each bank was required to produce its own methodology and, as far as we are aware, these have not been made public.

The review team will obviously need to examine copies of each of the bank's own methodologies to confirm whether they provide any significant additional detail that is not in the documents so far released and that they are consistent which each other and also that there was consistency in their implementation across the banks.

From two key documents, the Banks' Agreement/undertaking and a letter from Clive Adamson of the FCA to the banks with attached annexes, we can tell the following:

The IRHPs that banks sold to SMEs were divided into three categories, A, B and C, based on the FSA's assessment of how complex and risky each product was, and a different route was provided into the redress scheme for each category, although the scheme's bespoke 'sophistication' tests did not discriminate according to product, excluding around 10,000 sales across all three categories. Where it was decided that the customer was due redress, it is also not clear to us how much difference, if any, the customer's original product made to the kind of redress they received.

Sales of category A products which did not meet any of the tests for 'sophistication' had direct entry into the scheme, where they were all considered to be non-compliant and they also qualified for automatic redress. Sales were still reviewed using a set of 8 'Sales Standards' and some other factors, to determine whether redress should include an alternative IRHP, which could be either a category C product - a cap - or a category B collar or a swap.

Customers with category B products had to accept an invitation to opt in to the redress scheme and have their sale reviewed, while category C products would only be included in the scheme where the customer made a complaint. Sales of opted-in Category B and C customers who were found to be 'non-sophisticated', according to the scheme's tests, needed to be reviewed against the Sales Standards to see if they complied with regulatory standards and, if not, there was a further assessment of certain factors to see whether they

qualified for redress, which could be a full tear up and refund of all 'direct' costs or an alternative product and refund of any excess payments.

There are critical gaps in the detail of the methodology and there is a great deal that is not clear from these documents. We have a number of very serious concerns about the methodology and how it was implemented by the banks.

Key concerns about the redress scheme methodology and its application

Lack of any effective disclosure process

Banks were not required to share or disclose information or evidence to customers participating in the review. This disadvantaged customers who needed to be able to make representations on their case; their ability to do so effectively might be impacted because:

- relevant events may have taken place several years earlier so there might be gaps in the customer's recollection;
- customers were unable to see critical pieces of internal bank evidence, such as credit reports and communication between between bank employees. We know that some customers were not even able to obtain a recording or transcript of their trade call;
- they might require specific pieces of evidence which they were missing, copies of which the bank still held;
- some customers lacked understanding of the products and their effects and/or what occurred during the sale process and access to the Bank's evidence could have helped to clarify key details.

In addition:

- customers were not able opportunity to verify whether the bank's records were entirely accurate and/or complete;
- important evidence held by banks might not be presented to the review if customers were not in a position to flag it up;
- not all customers were able to obtain disclosure through another means, such as a data subject access or through FOS and those who were able to attempt to access data through these methods may have had limited success.

The only really effective alternative was litigation and this was not available or accessible to many, which resulted in an inequality of arms among redress scheme participants.

The process was one-sided and lacked transparency

The methodology of the review was not shared with customers until 2015 when the Treasury Select Committee decided that it – or the parts that the committee had seen - needed to be put in the public domain. While extracts of the methodology had previously been revealed

by the FSA/FCA, other critical aspects were not disclosed and prior to its release customers were left at a huge disadvantage if they remained unaware of specific issues and pertinent points to address in their submissions to the redress scheme. Important evidence might not be presented to the redress scheme as a result.

Some customers could have had an advantage over others if they or their advisers were able to deduce certain aspects of the methodology prior to its release. Others may have also inadvertently increased the likelihood of an unfavourable outcome because they were unaware of how information they supplied might be interpreted. For instance, if a customer stated that they had just wanted a fixed rate loan, this might be taken as an indication that they were happy to enter into an interest rate swap, even though the two are very different in terms of the level of risk to the customer.

We are particularly concerned that it may not have been evident to all customers how the decision(s) on redress were to be made; that whether or not the product was found to have been mis-sold was only one part of the decision-making process on redress; that the term 'loss' might not actually mean financial loss, and that they might be redressed back into a product similar to their original one. If they had been fully alerted to this possibility, they may have provided alternative evidence or presented their evidence differently. In our view, without sight of the methodology, customers' chances of avoiding or overturning a decision that they would have had an IRHP were greatly reduced.

Relevant evidential standards, including the level of proof and the type of evidence that would satisfy the Bank, were also not made explicitly clear to customers so, for instance, they might not know how their verbal or written testimony would be treated by the redress scheme and whether they would need to supply additional confirmatory evidence.

The process was extremely one-sided, with the bank in control of the selection of which items of evidence to include and which to exclude from consideration. The customer was not able to see what evidence was submitted by the bank so could not verify its accuracy and relevance or provide any counter evidence, if necessary, nor confirm that their own evidence was given sufficient prominence.

Effectiveness of Independent Reviewer oversight

The Independent Reviewer was no substitute for the customer, in terms of the intimate knowledge they had of their case, so could not necessarily always verify the accuracy and relevance of specific pieces of evidence.

In addition, the Independent Reviewer's oversight could only be truly effective if they had the time, resources, remit and inclination to be able to conduct a thorough independent review of *all* of the evidence and not just those items which had been presented or highlighted by the bank, so as to be able to draw their own conclusions, independently of the bank's decision. If the Independent Reviewer was only able to approve or disapprove of what the Bank had selected then this could be seen as just marking the Bank's homework.

Sales Standards

There were 8 Sales Standards defined in the banks' Agreement or Undertaking of 2012 to be used in the review of each customer's sale process. In most cases, the burden of proof rested not on the customer, but on the bank; it had to provide evidence to demonstrate that the respective standard had been met. This undoubtedly contributed to the level of non-compliant sales processes that were found through the scheme. That said, the review team needs to be confident that the redress scheme was capable of exposing the full extent and gravity of the banks' poor conduct in respect of the sale of IRHPs and we're not convinced it was even attempting to do this.

We have the following concerns:

1. The questions that form the Sales Standards are asked in such a way that they invite the Bank to prioritise evidence favourable that is favourable to it or that comes closest to showing that the relevant standard was met. It appears that, when selecting evidence to put forward, banks need only to try to demonstrate that each Sales Standard has been met rather than provide negative evidence of where it has not, so the review of the sale is unlikely to expose evidence of the most egregious failings and poor conduct on the part of the bank. It is clearly better for the bank to present nothing of significance than to produce incriminating evidence. For instance, we believe that this process would not necessarily indicate if a bank had sought to deliberately mislead the customer on any point. If specific details of conduct revealed by the Sales Standards are relied on in the decision-making process, as they should be, this could clearly have an impact on the decision on the customer's redress.

   We question whether the process could have been designed in a better way to more fully expose the range and degree of the misconduct rather than just testing for whether a baseline minimum standard had been met? And if so, would the banks have agreed to it?

2. The requirement for banks to have "due regard" to customers' information needs in the fourth Sales Standard and to obtain information about the customer in other standards may have perversely led to the introduction of a secondary 'sophistication' test. We are concerned that banks may have differentiated between customers with essentially similar information needs and wrongly determined that some with a higher education qualification, a certain type of business, profession or former profession, such as a doctor, dentist, lawyer or accountant, had lower than average information needs, despite having no more knowledge or experience of derivatives trading than other customers found to have high information needs.

   It needs to be pointed out that the eligibility criteria for the review was revised ostensibly to "ensure that the review is focused on those small businesses that were unlikely to understand the risks associated with IRHPs."[26] Furthermore, if the

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customer was not made aware that they had been wrongly designated as having 'lower than average' information needs, then if they were not made aware of that assessment, they could not realistically challenge it.

The review team should look at the extent to which an additional test of 'sophistication' was applied, and whether it had an impact on the relevant customers' treatment in the review, ie if it affected consideration of what information it was reasonable to provide to a customer rather than simply how that information was presented. However well-educated or proficient a customer was, they still needed to receive the same level of information as any other 'non-sophisticated' customer, and it still needed communicated in a way that was clear, fair and not misleading.

3. The fourth Sales Standards requires that a bank "*has had due regard to the information needs of the Customer and provided comprehensible, and fair, clear and not misleading information about the features, benefits and risks of **relevant alternative** Interest Rate Hedging Products*"

   The use of the word "relevant" presents banks with a very low bar to meet. Relevant could mean any kind of product, with any length of term or level of break charges and it does not necessarily mean appropriate, which, in our view, would be a more fitting word to use here. If a customer, in particular one with a condition of lending, was only shown risky and complex products then they would not be able to make an effective comparison and an informed decision on which product would be most suited to their requirements.

4. We have concerns about the way in which the issue of advised and non-advised sales is treated in the relevant Sales Standards (5 – 8).

   There is no information given as to how the decision is taken on categorisation of the sale – advised or non-advised - and whether the bank needs to supply evidence to demonstrate that it has been correctly categorised. The issue of advice was not addressed in any detail in the Pilot Report, nor do relevant pages on the FSA/FCA website say much on the subject, so if the customer did not have access to the Sales Standards, they may not have covered it in any submission that they made to the redress scheme. They may also not have understood or appreciated the relevance of the issue from the point of view of the regulatory rules, but they may nonetheless have believed that they were being advised by the bank. We question whether a statement by a customer in their submission that they believed they both needed and received advice from their Bank in respect of the sale of an IRHP would have been treated as a relevant piece of evidence in respect of the Sales Standards? If so, would it be taken as evidence of an advised sale or a non-advised sale in which advice had been given?

If the scheme was able to unwrap customers' contractual obligations in respect of an IRHP it should also be able to look at whether any disclaimers in relation to advice that the customer had signed were fair and reasonable. It is important that any such disclaimers were written in plain English and to be found within documents that the customer would have read and understood to be applicable to their situation. For instance, if the only document provided to the customer that contained disclaimers about the giving of advice talked exclusively or extensively about investments and/or trading derivatives then it is unlikely that the customer would have appreciated its relevance to them.

In relation to an advised sale, there is no detail provided on the criteria that are used to determine whether the Bank met the condition on suitability of a personal recommendation. Realistically it seems unlikely that many customers would have been in a position to advance technical arguments to counter any assertions of the Bank in this regard.

In relation to the sixth Sales Standard, we suggest that the bank might not be inclined to search for evidence that it provided advice where it was not supposed to have done so. This standard might be easily met by the bank if there was a presumption that no advice was given unless evidence was revealed that showed otherwise.

We also note again that the customer may not have addressed advice-giving in their evidence to the scheme if they were unaware of its significance to the review of their sale and so important evidence whether or not advice was provided may not have been revealed. Customers who used advisers who could recognise the technical distinctions between advice and information might have been more likely to successfully argue that they received advice, so could have had an advantage here. It is also pertinent to question whether the customer would need to provide corroborating contemporaneous evidence if they stated in their submission that advice was given. It might not be possible for the customer to provide that evidence, for instance, if the advice was provided orally.

5. There is no mention of a number of additional issues that we believe should have been dealt by the Sales Standards. They include:

    - **conditions of lending**
    - **contingent liability,**
    - **incentivisation of staff**
    - **product pricing**

Conditions of lending

An obvious drawback to only defining conduct as poor if it breaches regulatory rules, is that activity in relation to products and services that sit outside of the regulatory perimeter may

not be subject to scrutiny and moderation, such as commercial fixed rate loans with similar risks and downsides to IRHPs.

IRHPs are regulated, but they were sold in conjunction with other commercial facilities which are not regulated. The inclusion in loan agreements of a condition requiring the customer to enter into a hedging product constitutes conduct by banks that is very pertinent to sales of IRHPs and may have a material effect on customer outcomes in the redress scheme. While this activity is unlikely to be captured by any regulatory rules, it is possible that, in respect of some customers at least, it could have breached the relevant code of conduct[27] to which most banks were subscribed, if the customer was not made aware of all the implications of the condition.

In our view it was important to assess at the sales review stage whether the customer with a condition of lending was able to make an informed decision about whether or not to agree to the lending on those terms. This means that they should have been provided with clear fair and not misleading information about the sorts of IRHPs that they might be expected to have, before committing to the loan.

Contingent Liability

We believe this to be a critical omission from the Sales Standards, as it should be considered in the decision on redress and specifically in the decision on whether or not the customer should receive an alternative product. The review team should confirm whether details and/or evidence pertaining to the disclosure and/or effects of a contingent liability needed to be presented by the banks to satisfy any of the Sales Standards (it is relevant to several)? The contingent liability was not routinely disclosed to customers prior to or during the sales process so they may have remained unaware of its existence and consequently made no mention of it in their evidence.

Incentivisation of Staff

There should be consideration given as to whether customers were informed about any incentivisation of derivatives salespersons, Relationship Managers and any other bank staff to sell or facilitate the sale of an IRHP. Had the customer been made aware of the extent to which any members of bank staff were incentivised, they may have made a different decision, assuming they were free to do so, about whether to have an IRHP, and if so, which one.

Product Pricing

There should be consideration given as to whether the high information asymmetry and monopolistic conditions allowed products to be offered to customers at prices that were

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excessively high in comparison to their value and/or to the prices they might attract in a properly functioning, competitive market.

How the scheme assesses whether an 'LCOL' – legitimate condition of lending - was legitimate

In our view the most appropriate stage at which to examine whether an LCOL was legitimate would be during the review of the sale, when it should have been considered whether, prior to accepting the terms of the loan, the customer had received clear fair and not misleading information about the sorts of IRHPs that they might be expected to enter into to satisfy the requirement for hedging. Relevant to that assessment is whether it was disclosed to the customer that some IRHPs require security against the possibility of the break charges crystallising. If the redress scheme found that were regulatory breaches during the sales process itself, then it is very unlikely that the customer was in a position to be able to make an informed decision about whether or not to agree to a loan which included a requirement for hedging.

As we noted above, however, LCOL is not mentioned in the Sales Standards. Instead it is addressed in 8 points under K. 'Definitions' in Annex 3 on Redress of Clive Adamson's letter to the banks of 29th January 2013.[28] We have reproduced the points from that document below:

Legitimate condition of a lending arrangement

40. In order to determine whether or not the sale of an IRHP is a legitimate condition of lending (LCOL), the firm should consider all the facts of the case. Although we set out below factors that may be considered when making this decision, we emphasise that these factors are not exhaustive and that satisfying one (or more) does not automatically mean there is a LCOL. We stress that it is important for the firm to reach rounded judgements having given proper consideration to all the facts and circumstances of each case.

41. The firm should consider whether there is evidence that the firm's credit policies required the Customer to have the IRHP. For example, subject to other factors, the sale of the IRHP may be a LCOL where the Customer's loan/facility met a specified criterion (e.g. credit rating, risk rating, LTV etc) for which the firm's credit policy required interest rate protection.

42. There should also be consideration of evidence that indicates that the sale of the IRHP complied with the firm's documented lending process. For example, the firm's documented lending process may have stipulated that interest rate protection must be agreed with the credit function. Where that decision to make the IRHP a condition of the loan has been agreed with the credit function, then, subject to other factors, this may be a LCOL.

[28] Letter from Clive Adamson, FSA to the banks, 29 January 2013, pg 13

43. Subject to other factors, the firm should consider whether there is evidence that the hedging complied with the requirements of the credit function, such as the notional value of the hedge and duration.

44. The firm should consider whether there is evidence that the Customer's circumstances made it reasonable for firm to impose the requirement to hedge. For example, subject to other factors, for there to be a LCOL the file must evidence that at the point of sale it was reasonable for the Customer to be hedged in light of the risk of interest payments.

45. Similarly, there should be consideration of any evidence that suggests that sales incentives/inducements inappropriately influenced the decision to make the IRHP a condition of the loan. For example, it is not a LCOL where there is evidence that sales staff put in place the IRHP solely for commercial (and/or personal) benefit without due regard for the needs of the Customer.

46. The firm should also consider whether there is evidence that the communication of the IRHP as a condition of lending was in good time, fair, clear and not misleading. For example, for there to be a LCOL, the Customer must have been informed in a timely manner of the condition in the loan/facility before accepting it.

47. The firm should also note that where they are satisfied that the condition of lending is legitimate, there must be a further assessment to ensure that the sale of the particular IRHP complied with the regulatory requirements.
Express wish for interest rate protection

The only one of these points to address the adequacy of any information given to the customer prior to signing the loan agreement is point 46, but that is only in relation to the communication of the condition itself.

We are very concerned that there appears to be no process within the redress scheme which questions whether the customer was aware of the implications of an LCOL, including the security arrangement necessary for some types of IRHP.

Most of the points above represent a very low bar for the bank to meet to demonstrate that a condition of lending was legitimate for the purposes of the redress scheme. Points 41, 42 and are concerned with whether the condition was consistent with stipulations in the bank's credit policies and lending process respectively and 43 relates to relevant requirements of the credit function. None of them questions the rationale or reasonableness of the requirements themselves.

Point 44 does consider whether a requirement might be reasonable, but is hardly a robust examination. All customers with a loan face the risk of interest payments, so in that sense it would not be hard for the bank to evidence that it was reasonable for the Customer to be hedged, if there was no mention of the possibility of any adverse risks. It does not follow, though, that it was reasonable for the Bank to impose a requirement on the customer to

hedge. Just as there is no inconsistency in believing that swimming is good for your health but that swimming with sharks might be harmful, it is possible to view hedging as reasonable in principal, while also accepting that it might not be appropriate in every situation.

The Bank might neglect to put forward evidence that is relevant to Points 45 and 46, but these two points do offer possible areas where the customer might be able to challenge the assessment of an LCOL, but only *after* receiving a redress outcome that stated that there was an LCOL and then only if the customer had sight of the methodology *and* access to relevant evidence. The use of the word 'solely' in point 45 might create a high hurdle for the customer and 'timely' in point 46 is open to interpretation.

There is a shift here in the burden of proof from the approach in the Sales Standards, making it relatively easy for the Bank to demonstrate that a condition of lending was legitimate while it is the customer who needs to provide evidence to demonstrate that the condition was not legitimate.

The banks and FSA/FCA knew that the redress scheme included some quite specific, detailed rules on LCOL. This review should consider whether customers should have been informed of these rules before providing submissions to their bank.

The review should also consider whether some customers may have been confused by the idea that banks were allowed to require customers to have a product in conjunction with lending, when this is expressly not permitted in other cases, such as PPI.

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An All Party Parliamentary Group (APPG) is an interest group that occupies a strategic and effective position within Parliament. It is cross-party, with a minimum number of parliamentarians from the Government and the official opposition, and cross-house, made up of both peers and MPs. The APPG on Fair Business Banking is a platform through which businesses, professionals and trade bodies can discuss issues regarding commercial banking and its role in the life cycle of a business, and through which parliamentarians can access information on banking, finance and related issues, including business rescue and insolvency, on behalf of constituents. As a cross-party group, the APPG is an effective vehicle to effect meaningful change via the Parliamentary system. The Group's status is that of an APPG is bound by the rules set out by The Office of the Parliamentary Commissioner for Standards. It does not have charitable status, or official status in the House, nor is it funded by Parliament. It relies wholly on the participation and contribution of parliamentarians, industry members and stakeholders committed to creating a strong platform for business in the UK to thrive. The APPG is coordinated and administered via the APPG on Fair Business Banking Secretariat.

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