KEVIN HOLLINRAKE MP

HOUSE OF COMMONS
LONDON SW1A 0AA

Charles Randell CBE
Chair
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

4th April 2019

Dear Mr. Randell,

RE: Lessons learned review of the Supervisory intervention on Interest Rate Hedging Products (IRHP)

Thank you for your letter dated 19th March regarding the scope of the 'lessons learned' review of the Supervisory intervention on Interest Rate Hedging Products. The APPG's view on what should be included as part of the review is specified below.

The Process of the Review

In order to gain a comprehensive picture of the strengths and weaknesses of the IRHP review it will be necessary to invite/encourage testimony and feedback from a range of parties, including but not necessarily limited to:

- Customers of each of the banks with different types and sizes of businesses who had a range of products and received a range of outcomes;
- Customers' expert/legal advisers, particularly those who advised/represented a number of customers;
- Customer representative groups, bodies and organisations;
- Members of Parliament;
- Banks and their representatives;
- Independent Reviewers;
- The FOS;
- Whistleblowers who may be present or former members of staff at relevant banks and Independent Reviewers and the FSA/FCA and FOS. There must be suitable procedures in place to ensure complete confidentiality.

The Stages of FSA/FCA Action

The Lessons learned review should undertake an examination of all stages of the FSA/FCA action, including:

1. Review undertaken in first half of 2012, prior to the announcement of 29 June 2012
2. Agreement with banks (and subsequent revisions of terms of that agreement) and initial development of scheme rules, including scope of independent reviewers
3. Pilot scheme
4. Development of the full scheme – including changes following the pilot
5. Implementation – including any ongoing changes

For each of these stages there should be an assessment of which organisations and individuals were consulted and/or invited to contribute and the input they made to the process. How many of each of the following contributed information and views and what was the respective weight placed on their contribution:

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- Inhouse experts and other employees of FSA/FCA;
- independent experts;
- affected businesses who were customers of each of the different banks and representative of a range of different business sectors and sizes;
- businesses' legal/expert advisers;
- trade bodies for business and any other representative organisations;
- banks;
- banks' representatives, including trade bodies and legal and expert advisers;
- civil servants/government representatives including from Treasury;
- whistleblowers.

1. The review undertaken in the first half of 2012, prior to the announcement of 29 June 2012

There must be an examination of the scope, investigations and findings/conclusions of the initial review into 4 banks' sales of IRHPs that took place in early 2012, prior to the announcement on 29th June 2012 that those 4 banks had agreed to review their sales of IRHPs to non-sophisticated customers. This should examine the extent to which the following issues were explored:

- Whether IRHP sales were usually initiated by the customer or the bank.
- Advised versus non-advised sales: how much feedback/information was gathered from customers on their perceptions/understanding of whether advice was given even where banks claimed the sales were 'non-advised'?
- The training and incentivisation of sales and other staff, including Relationship Managers and their support staff.
- Whether certain specific poor sales techniques were common across the banks.
- Whether there was functioning competition in the market for sales of IRHPs to SMEs, including whether there was competitive pricing and freedom to purchase from a range of suppliers and knowledge among customers to compare the market before purchase.
- Examination of whether customers were disadvantaged by the inflexibility of some products, as a result not just of the potential break charges but also the (usually) undisclosed contingent liability, causing a risk of being locked in for years as customers of the same bank, with no freedom to switch banks.
- Examination of conditions of lending: whether the FSA 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?
- Examination of whether unlawful sharing of data occurred between different entities: i.e. between the lending/clearing bank and the investment bank, for example between Barclays Corporate and Barclays Capital.
- Examination of the issue of consequential losses and whether this was adequately researched.
- How many customers were interviewed and how many legal/ expert advisers to businesses were consulted during this process?
- Were there any contributions from whistleblowers?

This section of the 'lessons learned' review should also consider the extent to which investigative work was carried out by the four banks including:

- How many bank staff were interviewed and in which functions?
- How many case files were reviewed for relevant compliance documentation/records of sales, correspondence etc and were the case files of interviewed customers selected for review?

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- Was the banks complaints handling examined to see if complaints about IRHPs were properly investigated and what proportion were upheld? Were any complaints about IRHPs upheld prior to the review?
- What information was sought from the various parties including technical knowledge?

2. The agreement with the banks (and subsequent revisions in terms of that agreement) and initial development of the scheme rules including the scope of independent reviewers

We would like to see the following points examined which related to the FSA's actions following the review in the first half of 2012 and prior to reaching an agreement with the four biggest banks:

- Did the FSA seek independent technical information and/or advice?
- To what extent was scoping information and research shared with the banks prior to reaching an agreement?
- How much input did each of the various contributors, and in particular the banks themselves and their representatives, have into the development (and any revisions) of the agreement(s) and the scheme rules? What independent expert input, if any, was sought when negotiating with the banks?
- The reasoning behind the lack of transparency around the scheme rules and principles and procedures and the impact this had on those using the scheme.
- Why it was decided not give customers direct access to the Independent Reviewer and whether customers may have been disadvantaged as a result. Were there specific requirements about how data should be presented by the banks to the Independent Reviewer? i.e. should it be organised/sorted in a specific order, such as date order and were banks permitted to highlight the pieces of information and evidence that they wanted the Independent Reviewer to focus on?
- How the Legitimate Condition of Lending was designed to be applied, including what investigations banks were obliged to undertake, i.e. was it simply necessary for a condition to be mentioned in records and/or a clause inserted into a loan agreement for it to qualify as legitimate or did it have to be justified by credit evidence and evidence that the customer was notified in sufficient time (how much time was sufficient?) and did the customer need to understand the implications of the condition? There should be investigation to see if the condition was properly applied.
- The definition and assessment of advised/non-advised sales. How does the meaning of the term "non-advised sale", as used in the review, relate to/differ from the category of "execution-only" sale?
- Was any agreement sought or were there discussions with banks at this stage about their sales of fixed rate loans with potentially large break fees.

3. The pilot Scheme

The following issues relating to the pilot scheme must also be examined as part of the Review:

- The extent to which customer groups and advisors were involved in the development of the pilot scheme.
- Examination of the sophistication criteria:
    - Which parties were involved in the decision to alter the sophistication test?
    - Examination of the effects of the changes.
    - How many extra businesses were included as a result of changes?
    - How many businesses were excluded as a result of the changes?
    - What was the value of IRHPs excluded from the review by the initial test?
    - What was the additional value of IRHPs excluded as a result of the £10m rule change to the test?
- What other changes were made between the pilot and the main review e.g. consequential losses?

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- Were any consequential loss assessments carried out in the pilot? If not, why not?
- Examination of why there wasn't a clear and full explanation of the meaning of the words "in a pessimistic but plausible scenario" at the time of the initial presentation of the condition that an alternative product "would not have had potential break costs in excess of 7.5%, in a pessimistic but plausible scenario, of the amount hedged at the point of sale maximum". This was initially taken at face value by most people, but later revealed to be a very complex hypothetical concept which could allow for banks to decide on alternative products with much higher break charges than 7.5%.

4. Development of the full scheme - including changes following the pilot

The following issues relating to the development of the full scheme must also be reviewed:

- Examination of any changes to the scheme rules, sales standards and any other processes or procedures following the pilot.
- Examination of any changes to the description and scope of the role of Independent Reviewer between the pilot and the full review.
- Examination of why there was no requirement for banks to share with the customer all of the data and evidence on which they were relying and the effect that the lack of transparency has had on trust and confidence in the integrity of the process.
- Examination of how the treatment of those with 'Category A' products in the pilot compares to how these customers were subsequently treated in the full review.
- Examination of the proportion of outcomes with "no redress" and alternative products in the pilot compared to the full review.

5. Implementation of the IRHP review – including any ongoing changes

The following areas relating to the implementation of the IRHP review must be investigated:

- Assessment of the fact-finding process put in place by each bank and the extent to which this varied between the banks, between customers and over the course of the review. How straightforward was this process for customers? Was it fair and reasonable to expect customers go through this process without any advocacy/representation?
- Assessment of how well the scheme rules and sales standards were applied by each bank in practice – including the extent to which different banks were permitted to have different interpretations of rules and/or standards. Was there any unintended undesirable interpretation / gaming of the process by any individual banks.
- Examination of whether different banks interpreted and applied a Legitimate Condition of Lending differently, producing inconsistent outcomes for customers.
- Examination of the role of the Independent Reviewer, including the extent to which this varied between reviewers and between banks, between the pilot and the full review and over the course of the full review.
- Examination of why the review took so much longer than originally anticipated by the FSA/FCA and the extent to which this may have disadvantaged participants.
- Look at whether there were levels of sophistication within the non-sophisticated category. Did some banks implement undisclosed additional sophistication tests affecting those educated to degree or postgraduate level and certain professions, such as those qualified as accountants, solicitors and doctors? If so, were these assessments approved by Independent Reviewers and the FSA/FCA?
- In what proportion of sales that the banks assessed as 'non-advised' did the customer indicate that they believed they were being advised?
- Examination of whether some customers with high notional value products may have been treated differently and/or received different outcomes to those with lower value products.

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- Examination of how the issue of consequential losses was handled in the review and why so little has been paid out in consequential loss payments and the extent to which this was affected by the narrowness of scope of the review.
- Did the Authority effectively monitor whether personnel involved in IRHP sales were subsequently involved in any capacity in the review process – whether as members of bank or Independent Reviewer teams – and whether any other bank staff were employed by/seconded to any Independent Reviewer? Did the FCA look into reports that there were some inappropriate staff movements.

A number of comparative studies should also be made as part of the 'lessons learnt' review:

- Comparing outcomes between different banks.
- Comparing outcomes in the IRHP review between customers with similar products/sales processes but different notional value of IRHP(s).
- Comparing the difference in the proportion and cost of alternative products awards for those with Category A original products and those with Category B original products.
- Comparing outcomes between those using legal/expert representation and those with no advice or representation.
- Comparing outcomes between limited companies and unincorporated sole traders/partnerships.
- Comparing outcomes between those who launched legal proceedings or were in a position to do so compared with those for whom this was not an option.
- Comparing outcomes of similar case through different dispute processes – so between the IRHP review and FOS, and between the IRHP review and litigation
- Calculation of the total cost excluding the costs of redress but including the costs of the independent reviewers of the IRHP review process and the individual cost to each bank to run their own review process.

Furthermore, in outcomes where there was a non-compliant sale but either no redress was provided or the redress included an alternative product - so-called "swap for a swap" outcomes, although they could involve a swap, collar or cap – were common and highly contentious. There were few, if any, customers who believed that they would still have entered into any kind of swap or collar if they had been made fully aware of the risks and potential costs, with many maintaining that they were not told about caps so could not know if they would have agreed to one. There should be a thorough investigation of:

- The use of these kinds of outcomes to determine whether they were employed by some banks as a way to limit their redress bill. The investigation should compare cases with different redress outcomes and look at banks' reasoning and evidence for these types of outcomes as well as considering their decisions on type of product, pricing and term of alternative products.
- This investigation should also look at whether the likelihood of receiving no redress and alternative product outcomes increased over the course of the IRHP review.

General Issues of Importance

Further to the structured points above, the review must also consider the following general issues:

- There were widespread breaches of regulatory rules and standards, cases where salesmen were not FSA authorised at the time they sold products, cases where relationship managers were closely involved in the sales process and allegations of misrepresentation and fraud. Why has no action been taken against individuals or organisations for clear cases of misconduct?

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- Has the FSA/FCA conducted any investigation into the banks' handling of complaints about IRHPs and fixed rate loans? If not, why not and if it has, why has it not published the findings of that investigation?
- Could the actions of the FOS have disadvantaged some customers? For instance, when a FOS outcome preceded a review outcome, including where a rigid deadline was implemented to accept or decline that offer prior to the customer receiving an outcome from the review.
- The issue of advice: Is it safe to permit 'non-advised' sales of complex products to customers who have no previous knowledge and understanding of those products? Should certain products be sold on an advised-only basis to certain categories of customers.
- Insolvent businesses: how they were failed by the review, including recommendations for legislative and/or regulatory changes that could improve the prospects of redress for these businesses.
- How did long delays in the process impact on customers' legal rights, including the expiry of the limitation period for some, particularly in view of FSA/FCA advice that legal advice was not necessary?
- There must be an examination of the time taken to initiate an investigation into banks' sales of IRHPs to business customers and to take action, including whether the FSA logged and responded to enquiries/complaints about IRHPs prior to 2012? Consideration of whether any routine supervision or other regulatory activities might have detected problems sooner?
- Was independent technical advice sought/received on appropriateness/suitability of IRHPs for SMEs? Examination of assumptions that were formed within the FSA/FCA about the inherent suitability/appropriateness of these products for SMEs and whether these were made after exposure to a full spectrum of views and experiences about the potential and actual impact of the products on this cohort of customers and whether they were reasonable assumptions to make.
- Examination of what consideration, if any, was given to insolvent businesses from an early stage in the 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. Consideration of whether it might have been possible (with the agreement of the banks, if necessary) to develop a review and redress scheme which could produce meaningful redress for this group?
- Examination of whether any consideration was given to the possible impact on customers' legal rights – particularly in relation to legal limitation periods and in light of the length of the process for many customers – prior to the FSA taking its position that it was not necessary for customers to have legal advice or representation. Examination of whether customer detriment occurred as a result of the FSA decision.
- Examination of whether customers had the knowledge and capability to obtain a satisfactory level of disclosure of the information and evidence necessary for them to participate effectively in any review. Look at whether customers were disadvantaged in the light of the FSA stating no legal advice was needed because they were not aware of their right to issue a Subject Access Request. Look at whether consideration was given to the barriers to limited companies in particular obtaining necessary data.
- At what stage did the FSA/FCA become aware of the similarity of the impact of fixed rate loans with potentially large break fees, or so-called 'hidden swaps'? At any point did the Authority carry out a scoping exercise of these products similar to the pre-review investigation into the sale of IRHPs? If so, what were the findings? At what stage did the Authority seek legal advice into the regulatory status of these products?
- Examination of when the decision was taken and the effect of the decision to prevent access to the review to thousands of customers who fell within the definition of "private customers" or "retail" customers and so arguably were entitled to the same regulatory protection as all of those who were not excluded?

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- Was there an attempt made at any stage to consider the bigger picture, including the inter-relationship of regulated and unregulated aspects of each customer journey? – ie unregulated lending linked to regulated IRHP sale, a combination of which could have led to financial distress, punitive changes to facilities (unregulated), extra charges (potentially unregulated) and in some cases transfer to banks' special measures, or 'turnaround' departments (unregulated), loan sales to (unregulated) private equity firms and, in the worst case scenario, insolvency and liquidation.
- At what stage was the FCA made aware of the mainly undisclosed contingent liability or separate line of credit required as security for many IRHPs and its potential impact on businesses? Did any of the banks disclose this issue to the FSA/FCA? Did the Authority seek independent technical and/or legal advice about this issue and, if so, when, and what was the result of that advice? Were the banks questioned about potential impacts on existing and future borrowing, LTV ratios, breaches of lending conditions etc and whether any of these could have led to punitive action and/or transfer to special measures departments? If such enquiries were undertaken, at what stage did this occur and what conclusions, if any, were reached. Was this issue intentionally excluded from the scope of the IRHP review scheme and if so why?

Please do not hesitate to get in touch if you require any further information about any of the above.

Yours sincerely,

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Co-Chair of the All-Party Parliamentary Group on Fair Business Banking

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