Financial Services Authority

Interest Rate Hedging Products

Pilot Findings

January 2013

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1

Executive Summary

In 2012, we carried out a review that found serious failings in the sale of interest rate hedging products (IRHPs) to small businesses. As a result, eleven banks[1] agreed to review the sale of around 40,000 IRHPs made on or after 1 December 2001 to certain 'non-sophisticated' customers. This report sets out our findings from the pilot reviews completed by Barclays Bank Plc ("Barclays"), HSBC Bank Plc ("HSBC"), Lloyds Banking Group ("Lloyds") and The Royal Bank of Scotland Plc and National Westminster Bank Plc (collectively "RBS"). We expect to announce our findings from the pilots of the other banks in the coming weeks.

The work on the pilot has confirmed the FSA's initial findings that there was significant mis-selling of IRHPs. We looked at 173 sales to 'non-sophisticated' customers from across the four banks and found that over **90% did not comply with one or more of our regulatory requirements**. We looked at a further 133 cases to check the application of the sophistication test.

The pilot confirmed our view that **the independent reviewers play a vital role in this exercise**. The independent reviewers assessed each case in the pilot (as they will do for the full review). We saw evidence of the independent reviewers challenging the banks' views on both whether the sales met our regulatory requirements and on redress, and the views of the independent reviewers prevailed.

The pilot identified some areas where changes or clarifications are necessary to the review approach **to ensure the review delivers fair and reasonable outcomes for customers.** In particular, we have:

- changed the 'sophistication test' to ensure the review is focused on those small businesses that were unlikely to have understood the risks associated with these products; and

1 Our initial review looked at sales by Barclays, HSBC, Lloyds and RBS. We announced that these banks had agreed to review their sales on 29 June 2012. On 23 July, we announced that Allied Irish Bank (UK), Bank of Ireland, Clydesdale and Yorkshire banks (part of the National Australia Group (Europe)), Co-operative Bank, Northern Bank and Santander UK had also agreed to review their sales, and Irish Bank Resolution Corporation (formerly Anglo Irish Bank and Irish Nationwide Building Society) had agreed to review sales of IRHPs from its UK branches. Northern Bank subsequently confirmed they had not sold any IRHPs that would fall within the scope of the review to relevant customers.

- created a set of redress principles to ensure there is a sufficient degree of consistency across the banks in determining fair and reasonable redress, including in relation to consequential loss.

Barclays, HSBC, Lloyds and RBS have agreed to conduct the review in line with the approach set out in this report. We expect the banks to aim to complete their review within six months, although we accept that for banks with larger review populations this may take up to 12 months. We have made sure that the banks will prioritise cases where customers are in financial difficulty.

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Background

In 2012, we found serious failings in the sale of IRHPs to small businesses by some banks. These failings included the inappropriate sale of complex varieties of IRHPs to 'non-sophisticated' customers and a range of poor sales practices, including:

- poor disclosure of exit costs;
- failure to ascertain the customers' understanding of risk;
- non-advised sales straying into advice;
- "over-hedging", i.e. where the amounts and/or duration did not match the underlying loans; and
- rewards and incentives being a driver of these practices.

On 29 June 2012 we announced that Barclays, HSBC, Lloyds and RBS had agreed to conduct a proactive redress exercise and past business review in relation to their sales of IRHPs to certain categories[2] of 'non-sophisticated' customers[3] on or after 1 December 2001.

The banks agreed to:

- automatically provide fair and reasonable redress to non-sophisticated customers who were sold structured collars;
- review the sales of other IRHPs (except caps or structured collars) to non-sophisticated customers to determine whether redress is due; and
- review the sale of caps to non-sophisticated customers to determine whether redress is due if a complaint is made by the customer during the review.

On 23 July, we announced that Allied Irish Bank (UK), Bank of Ireland, Clydesdale and Yorkshire banks (part of the National Australia Group (Europe)), Co-operative Bank, Northern Bank and Santander UK had also agreed to review their sales on the same basis,

2 Customers categorised under our rules as either "private customers" (in respect of sales made between 1 December 2001 and 31 October 2007) or "retail clients" (in respect of sales made since 1 November 2007).

3 A customer will be considered 'non-sophisticated' in cases where the customer does not meet the 'sophistication test'.

and Irish Bank Resolution Corporation (formerly Anglo Irish Bank and Irish Nationwide Building Society) also agreed to review sales of IRHPs from its UK branches.

We required each bank to appoint an 'independent reviewer', approved by us, to ensure the review is carried out objectively and consistently, and that fair and reasonable redress is paid to the customer where appropriate. Each independent reviewer has been approved by us to ensure that they have the appropriate skills, knowledge and expertise to scrutinise the bank's review and that there are no conflicts of interest. Where we have identified the potential for a conflict of interest between individual customers and the independent reviewer, we have required the banks to appoint a second independent reviewer to review those cases.

We asked each bank to carry out a pilot of a small sample of the typically more complex cases before beginning the full review. The pilot was vital to ensuring that each bank's approach to reviewing their sales would deliver fair and reasonable outcomes for customers.

Throughout the pilot we have engaged with a range of stakeholders including Bully Banks and the Federation of Small Businesses, who have provided helpful input into the process.

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Findings from the pilot

We have focused our attention on the pilots conducted by Barclays, HSBC, Lloyds and RBS. The remaining banks' pilots are not covered by this report. Further information on the timetable for the other banks is available in the 'next steps' section of this report.

Barclays, HSBC, Lloyds and RBS completed their pilots at the end of 2012. Since then, we have reviewed each bank's and independent reviewer's approach to the pilot, including by looking at individual cases, to assess whether the banks and independent reviewers are correctly determining whether:

- the customer was 'non-sophisticated' or 'sophisticated';
- the sale of the IRHP complied with our regulatory requirements; and
- it is appropriate for the customer to receive any redress and, if so, what redress would be fair and reasonable.

The work on the pilot has confirmed the FSA's initial findings that there was significant mis-selling of IRHPs. We looked at 173 sales to 'non-sophisticated' customers from across the four banks and found that over 90% of the sales did not comply with one or more of our regulatory requirements. A significant proportion of these sales are likely to result in redress being due to the customer. (Given the small number of typically more complex cases in the pilot, these results may not be fully representative of the results of the review.) We also looked at a further 133 cases to check the application of the sophistication test. This informed the changes that we have made to the test for assessing whether customers are included in the scope of the review (described in the next section).

Broader findings from the pilot

The pilot proved extremely valuable. It has allowed us to test the effectiveness of each bank's approach to the review and whether the outcomes for customers are fair and reasonable, as well as consistency between the banks. It also enabled us to identify examples of best practice from the approaches of the different banks and independent reviewers.

As a result, we have identified some changes and clarifications that are necessary to the review. In particular, we have made changes to ensure the review is focused on those small businesses that were unlikely to have understood IRHPs. We have also provided greater clarity on assessing whether sales complied with our regulatory requirements and how to determine fair and reasonable redress. These clarifications will ensure there is greater consistency of approach across the banks. These changes are described in more detail in the next section.

Independent reviewers

The pilot demonstrated the value of the independent reviewers in ensuring the outcomes for customers are fair and reasonable. The independent reviewers assessed each case in the pilot (as they will do for the full review) and we saw evidence of the independent reviewers challenging the banks' decisions both on whether sales complied with regulatory requirements and on redress. The independent reviewers have a particularly important role to play in making the often difficult judgements about what the customer would have done in the absence of a breach of the regulatory requirements to determine what constitutes fair and reasonable redress. In the event of a disagreement between the bank and the independent reviewer on the outcome of a case, the independent reviewer's conclusion will prevail.

Customer engagement

We asked each bank, as part of the process of reviewing a sale, to engage with their customers. The pilot confirmed just how important it is that each customer is given the opportunity to provide their recollection of the sales process and any written material that they consider relevant to the review of their sale. Customer engagement also provides the bank and the independent reviewer with an opportunity to ask the customer to clarify issues that may be unclear from evidence held on file, for example the chronology of certain events or the content of a meeting or call.

We would encourage all customers who are involved in the review to take advantage of the opportunity to engage in the review exercise. We have had positive feedback from consumer representatives on the customer engagement process. The independent reviewers have also found it helpful in their assessment of cases. We have seen a number of examples in the pilot where the customer's input has affected the outcome of the file review:

- In one case, the customer purchased a product giving the bank an option to exit the IRHP after five years. The customer's input, when taken with other evidence, showed they had been misled into believing that they could also exit the contract without costs after five years, when this was not the case.
- In another case, the customer was able to supply a document that was not already available in the file. This highlighted the poor disclosure of break costs in the literature that had been provided by the bank, which was not evident elsewhere in this case.

- In an advised sale, the customer asserted that they did not need or want the product and was incorrectly informed that it was a requirement of their loan that they purchase the product. This supported the evidence on file and resulted in a conclusion that there had been a breach of regulatory requirements.

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How the review will be conducted

This section outlines the changes and clarifications that are necessary to the review approach in light of the pilot findings. Each of the banks must agree to conduct the full review in line with this before they may begin the full review. This is essential to ensure the review delivers the right outcomes for customers.

Sophistication test

The review is focused on the sale of IRHPs to 'non-sophisticated' customers. 'Non-sophisticated' customers are generally small businesses that are unlikely to have possessed the specific expertise to understand the risks associated with these products. As this is not a readily identifiable group, we created a test that would enable the banks to differentiate between the 'sophisticated' and 'non-sophisticated' businesses that were sold these types of products (the 'sophistication test').

Original sophistication test

Under the original sophistication test, a customer was deemed to be sophisticated if, at the time of sale, the customer had **at least two** of the following:

- a turnover of more than £6.5m; or
- a balance sheet total of more than £3.26m; or
- more than 50 employees.

These criteria reflect the test used in the Companies Act 2006 to determine whether a company can take advantage of the lighter reporting requirements for small companies, which are less likely to have staff or advisers with appropriate knowledge and skills.

A customer could **also** be deemed sophisticated if the bank was able to demonstrate that, at the time of the sale, and irrespective of the size of the business, the customer had the necessary experience and knowledge to understand the service to be provided and the type of product or transaction envisaged, including its complexity and the risks involved.

Findings on the original sophistication test

During the pilot exercise, we observed that the original sophistication test, specifically the application of the three 'objective' criteria, did not always achieve the outcome we expected.

For example, a farmer or a bed and breakfast business with a large balance sheet (by virtue of owning property, land and/or machinery) and a large seasonal workforce could have been excluded from the review under the original test because the balance sheet and employee numbers exceeded the relevant thresholds. However, farmers and bed and breakfast businesses are examples of the types of non-sophisticated small businesses that should be included in the scope of the review. We have therefore amended the sophistication test to ensure that these types of 'non-sophisticated' customers **can be included** in the review.

Conversely, there were businesses who were classified as 'non-sophisticated' under the original test that we thought were likely to have understood the risks associated with IRHPs and should not be included in the review. Specifically, as the three criteria were applied to the individual legal entity that purchased the IRHP, the potential existed for small subsidiaries of large multi-national corporations to be included within the review, as they did not necessarily in their own right have a large turnover or substantial numbers of employees. Similarly, the test also allowed specially constituted entities (e.g. Special Purpose Vehicles (SPVs)) that were either part of a Companies Act 2006 group or nevertheless were connected entities to be included. These structures are common in large property development or property investment businesses. We have therefore amended the sophisticated customer criteria to ensure that these types of sophisticated customers **are not included** in the review.

Specifically, we have amended the way the three criteria can be applied to different to types of businesses to help ensure that:

- customers who meet (only) the balance sheet and employee number criteria are included in the review where the total value of their 'live' IRHPs is equal to or less than £10m;
- subsidiaries of large groups and SPVs forming part of a large group are likely to be excluded from the review;
- company groups that are not able to take advantage of the lighter reporting requirements under the Companies Act 2006 for small groups are likely to be excluded from the review[4]; and

4 This is consistent with the position under the review for individual companies that are unable to take advantage of the lighter reporting requirements for "small companies" in the Companies Act 2006 (see above).

- SPV customers that are constituted in a way that falls outside the Companies Act 2006 definition of a group but are nevertheless connected entities are likely to be excluded from the review where the total value of their 'live' IRHPs is more than £10m.

The second element of the original sophistication test, related to the experience and knowledge of the customer, has not changed as a result of the pilot. Further information on how the new sophistication test works in respect of groups or connected entities can be found on our website: www.fsa.gov.uk/static/pubs/other/irs-flowchart-2013.pdf.

Overall, the new sophistication test will provide a greater level of assurance that the review will be focused on those small businesses that were unlikely to have had the specific expertise and skills needed to understand the risks associated with these products.

Assessing compliance with regulatory requirements

The banks will need to assess whether each sale complied with the regulatory requirements (our Principles, rules and guidance) at the time of sale.

We have had rules in place governing the sale of IRHPs to 'non-sophisticated' customers[5] for the whole period covered by this review.[6] Based on these rules, we would, for example, expect that for sales within the review:

- The bank provided the customer with appropriate, comprehensible and fair, clear and not misleading information on the features, benefits and risks associated with the IRHP in good time before the sale.
- If the IRHP exceeds the term or value of any lending arrangements, the potential consequences were disclosed to the customer in a comprehensible and fair, clear and not misleading way.
- In relation to an advised sale: A) The bank has obtained sufficient personal and financial information about the customer, including the customer's investment objectives, level of education, profession or former profession and relevant past experience of IRHPs. B) The bank has taken reasonable steps to ensure that the personal recommendation is suitable for the customer.

The pilot has confirmed our view that, to determine whether a sale complied with our regulatory requirements and, if not, whether redress is due, a case-by-case assessment of all relevant evidence is necessary. In particular, the banks will need to consider whether, taking into account all the circumstances, it is reasonable to conclude that the customer could have understood the features and risks of the product. This means we are not able to

5 Customers categorised under our rules as either "private customers" (in respect of sales made between 1 December 2001 and 31 October 2007) or "retail clients" (in respect of sales made since 1 November 2007).

6 For example, COB 2.1.3 R, COB 5.2.5 R, COB 5.4.3 R to COB 5.4.6 E and COB 5 Annex 1 for sales up to 31 October 2007, and COBS 2.1.1 R, COBS 2.2.1 R, COBS 4.2.1 R, COBS 14.3.2 R for sales from 1 November 2007. In addition, Principles 6 and 7 applied throughout the period.

provide either the banks or customers with a precise test of what constitutes a compliant or a non-compliant sale that can be applied in the same way in every case.

If a customer is dissatisfied with the outcome of the review, they may have recourse to the Financial Ombudsman Service where they are eligible. Other customers may be able to take action through the courts.

Break costs

One of the most significant issues in assessing the compliance of a sale is break costs (or 'exit costs'). The nature of IRHPs means the scale of any break costs is inherently uncertain as, depending on market conditions, the customer may have to make a payment to the bank or the bank may have to make a payment to the customer. In the pilot we found that in a high proportion of sales customers were not given sufficient information to enable them to understand the potential size of the break cost. We saw examples in the pilot where the break cost exceeded 40% of the value of the underlying loan.

Our view is that, for the disclosure of break costs to comply with our regulatory requirements, the bank should be able to demonstrate that:

- In good time before the sale, the bank provided the customer with an appropriate, comprehensible and fair, clear and not misleading disclosure of any potential break costs.

To determine whether a sale complied with our regulatory requirements, the banks will need to take account of the individual circumstances of the customer and the circumstances of the sale to determine whether it is reasonable to conclude that the customer could have understood the features and risks of the product. This will be a case-by-case assessment which may involve a consideration of:

- the customer's knowledge and understanding of these types of products generally;
- the customer's interaction during the sales process;
- the complexity of the product; and
- the quality and nature of the information provided during the sales process and when and how it was provided.

Principles of redress

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.

To help achieve consistency of customer outcomes, we have agreed a set of principles to be applied in each case. In our view, there are three potential outcomes for customers:

- 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.

As noted above, 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.

In cases where fair and reasonable redress is an alternative product, the following principles will also apply:

- The alternative product will be simple – this is because we believe that, if the original sale had complied with our regulatory requirements, customers would only have purchased simple products (e.g. a cap, vanilla swap or vanilla collar).
- The 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 – this is because we believe that, if the original sale had complied with our regulatory requirements, customers would have not entered into a product with potentially sizeable break costs. This principle is for the purpose of this redress exercise only and does not represent a change of our rules in this area or the setting of new guidance.

Consequential loss

Some customers may have suffered additional losses over and above the 'normal' losses that may have been caused by the breach of regulatory requirements during the sale of the IRHP. We call this 'consequential loss', which could include costs such as overdraft charges and additional borrowing costs.

The banks will use an established legal approach to determine consequential losses, which will involve a consideration of whether the loss was caused by the breach and whether the loss was reasonably foreseeable at the time of the breach of the regulatory requirements.

This is the approach used when considering loss in claims in tort and for breach of statutory duty. Further information on how the banks will determine consequential losses can be found in our FAQs.

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Next steps

Barclays, HSBC, Lloyds and RBS have agreed to conduct the review in line with the approach set out in this report. Each of these four banks will be able to proceed with the review as soon as the independent reviewer has confirmed to us that the necessary changes have been made to the bank's review process. The review will include revisiting the pilot cases in accordance with the changed approach.

We expect the banks to aim to complete their review within six months, although the priority must be delivering fair and reasonable outcomes for customers. We accept that for banks with larger review populations this may take up to 12 months. We have made sure that the banks will prioritise cases where customers are in financial difficulty.

We expect to announce our findings from the pilots of the other banks who agreed to conduct reviews in the coming weeks. Once the reviews are underway, the independent reviewers will be responsible for ensuring, on an ongoing basis, that the reviews are carried out in line with the changed approach and that customers receive fair and reasonable redress where appropriate.

We will continue to monitor the banks' progress and results for the full duration of the review. We will also closely monitor the effectiveness of the independent reviewers in scrutinising the banks' reviews, and will not hesitate to take action if we have any concerns.

Customer communications

We will be writing to the customers of the four banks covered by this report in the coming weeks to inform them of our findings and what it means for them. We will write to the customers of the other banks once we have announced our findings from their pilots.

We expect all banks to have a robust process in place for engaging with customers during the review. This includes the process for seeking the customer's engagement in the sale review, but also to ensure that they communicate clearly, directly and fairly the proposed redress.

Moratorium on payments

In November, the British Bankers' Association (BBA) announced that the banks will review and consider each case carefully and, on a case by case basis, where the bank determines financial distress to be present in relation to meeting ongoing swap payments, the bank, will, at the customer's request, suspend the collection of swap payments pending the outcome of the review.

Given the importance of this issue, we will be requiring the independent reviewers to make sure, and to confirm to us, that the banks have the right processes to deal with circumstances of financial distress in line with the BBA's announcement.

Complaints to the Financial Ombudsman Service

As indicated in June 2012, we have considered whether it would be possible to establish a special scheme where the Financial Ombudsman Service would deal with complaints from businesses in this review that would otherwise not have recourse to the Financial Ombudsman Service.[7]

We have decided that it would not be appropriate to do so for this particular case. This is because of the important role of the independent reviewers in ensuring that the banks conduct their reviews appropriately, and provide fair and reasonable redress where appropriate. However, the existing eligibility threshold will allow the smallest and most vulnerable businesses to complain to the Financial Ombudsman Service if they are not satisfied with the outcome of the review in relation to their sale. Where larger businesses are unsatisfied with the outcome, they may be able to take action through the courts.

Claims Management Companies

There are claims management companies who may offer to submit a customer's complaint to the bank or the Financial Ombudsman Service. However, they will charge for using their services and this could involve the payment of a significant fee (relative to the amount of any redress received). Customers do not need to use a claims management company because the process is straightforward.

7 The Financial Ombudsman Service can currently consider complaints from any business that meets the microenterprise definition at the time at which it complaints. A micro-enterprise is an entity that has fewer than 10 employees and an annual turnover or balance sheet that does not exceed €2million.

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