LEXLAW
Solicitors & Advocates

4 Middle Temple Lane
Temple
London EC4Y 9AA

DX: 4 CHANCERY LN

Tel: 0207 1830 529
Fax: 0207 1830 539

admin@lexlaw.co.uk
www.lexlaw.co.uk

Our Ref: MAA/MTJ/SKS/RDJ/KXO
Your Ref:

The Chief Executive
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London, E14 5HS

DX:

FAX: 020 7066 0991
EMAIL: Martin.Wheatley@fca.org.uk
CC: Luke.Seaman@fca.org.uk

10 October 2013

Dear Mr Wheatley

NOTICE OF FAILINGS IN AND ABUSES OF THE IRHP REVIEW
Re: The Banks' Reviews of Interest Rate Hedging Products ("the Review")

1. We write on behalf of our SME clients, who have been mis-sold interest rate hedging products ("IRHPs") by a wide range of banks (including Barclays Bank, HSBC, Lloyds Bank, the Royal Bank of Scotland and Clydesdale and Yorkshire Banks). Our clients have expressed grave concerns to us about the Review, which concerns we also share.

2. There is a risk that the deep-seated problems we describe in this letter will prevent our clients and other SME customers from achieving appropriate redress from the banks under the Review, thereby rendering the Review otiose.

3. In the circumstances we write to put the Financial Conduct Authority ("the FCA") on notice of specific cases in the Review where the bank is behaving abusively and/or contrary to the letter or intent of the scheme. We also make representations about the Review scheme itself and the flaws inherent therein. We ask the FCA to take urgent action both to prevent continued abuse of the process of the Review and to correct the failings in the Review scheme.

Conflicts of Interest in the Review

4. On 29 June 2012, the FCA (formerly the Financial Services Authority) announced that it had found serious failings in the sale of IRHPs by a wide range

of banks (including Barclays Bank, HSBC, Lloyds Bank and RBS), including *"the inappropriate sale of complex varieties of IRHPs to 'non-sophisticated' customers and a range of poor sales practices"*.

5. According to the FCA, the types of poor sales practices committed by these banks included:

    A. Poor disclosure of exit costs;
    B. Failure to ascertain the customers' understanding of the risks;
    C. Giving advice in supposedly non-advisory sales;
    D. Selling IRHPs where the amount and/or duration of the hedge exceeded that of the underlying loans; and
    E. Allowing internal incentives and rewards to encourage these poor sales practices.

6. The FCA was clearly and correctly of the view that the banks' mis-selling of IRHPs needed to be investigated, with redress to be offered to wronged customers who had suffered losses as a result of the mis-selling that had taken place.

7. It is unfortunate that the FCA decided that the best party to investigate the banks' mis-selling of IRHPs would be the banks themselves. We find it surprising that the wrongdoer financial institutions have been entrusted by the regulator with a review to determine their own regulatory misconduct.

8. While the banks are obliged to present their findings under the Review to an "independent reviewer" in order supposedly to ensure that an impartial, independent and thorough review has been conducted of each customer's case, this only raises further issues about the Review.

9. We understand that the "independent reviewer" is, in fact, appointed by the respective banks; for example, HSBC Bank has appointed Deloitte LLP to *"review our assessments of (i) whether customers meet the sophistication customer criteria, (ii) whether redress is owed and (iii) if the redress that is proposed is fair and reasonable"*.

10. While we understand that the FCA is able to reject a bank's choice of "independent reviewer", we are not aware of any instances in which the FCA has actually done so. The fact that the banks are able to appoint their own "independent reviewers" at all casts obvious doubt on the independence of the reviewer and therefore also puts in doubt the proper scrutiny and oversight required for effective conduct of this Review. This is particularly the case where the appointed reviewer is a large financial institution who will inevitability have an ongoing relationship with the bank in question which they will be anxious to preserve.

11. The banks are now reviewing their own mis-selling practices, deciding whether each customer should be included in the Review, determining (if a customer is

included) whether to offer any redress and finally determining the amount and form of any redress.

12. After this process, the banks may then have their decisions scrutinised by "independent reviewers" whom they have themselves appointed. This is a fundamentally flawed basis for the conduct of the Review and will not achieve the impartial, independent and thorough investigation of the banks' mis-selling of interest rate hedging products for which purpose the Review presumably exists.

13. There are obvious questions as to why the wrongdoer banks have been allowed by the regulator to review their own wrongdoing. We understand that this is not the usual practice of the FCA. We invite you to explain why on this occasion you decided that the wrongdoer could review its own wrongdoing and why you chose not to appoint your own independent reviewers (as you have done in the past) in order to ensure that a truly independent review took place.

14. For the reasons set out above, we consider that it is misleading to describe the Review as an "independent review" or an "FCA review". We are concerned that the use of these and similar descriptions is likely to give an inaccurate impression to customers and members of the public as to the terms and conduct of the Review.

15. We quote one such recent example from DLA Piper UK LLP, acting for RBS and NatWest against our client whom we shall call Partnership G:

    "The Bank considers the FCA review to be analogous to the methods of ADR listed in paragraph 8.2 of the Practice Direction, and we note that it is an independent review conducted at no cost to your client." (emphasis added)

    We consider this may be a deceptive and abusive misdescription of the Review, as the Review is not being conducted by the FCA nor by an independent party appointed by the FCA. The Review cannot and should not be described as an "independent review" and we request that the FCA take steps to ensure banks desist from such inaccurate and misleading descriptions in future.

    We note that all recognised types of Alternative Dispute Resolution ("ADR") would involve an information parity and equality of arms between parties which the Review does not seek; therefore it is also incorrect to describe the Review as analogous to ADR.

16. Furthermore, the FCA's approach to this Review has enabled a large number of questionable practices by the banks in the conduct of the Review, including:

    A. Unreasonable exclusion of customers from the Review;
    B. Fettering of customers' appeal rights against the sophistication assessment;
    C. Lengthy and unreasonable delays in conduct of the Review; and
    D. Unfair and one-sided conduct of the Review.

A. Unreasonable Exclusion of Customers from the Review by the Banks

Unreasonable Exclusion of Customers sold Tailored Business Loans from the Review

17. On 23 July 2012, the FCA announced that the Clydesdale and Yorkshire Banks had agreed to review their sales of interest rate hedging products. However, because the FCA had previously specified that the Review would include the sales of structured collars, "simple" collars, swaps and caps, Clydesdale and Yorkshire Banks have seen fit to exclude from the Review their sales of "Tailored Business Loans" to many of their customers.

18. "Tailored Business Loan" is a term used by Clydesdale and Yorkshire Banks to describe a loan that contains an embedded IRHP. This allows these banks to incorporate interest rate risk management features that would not be possible for simple loans but are typical for IRHPs. "Tailored Business Loans" amount (in our view) to financial instruments regulated by the Markets in Financial Instruments Directive, which are contained within a loan "wrapper". It is unfortunate and unfair that these banks have unilaterally excluded the sale of these products from the Review on the basis that they are allegedly loans rather than hedging products.

19. We are disappointed that the FCA did not take the opportunity to clarify this issue in its written submissions to the Court of Appeal in the Green & Rowley mis-selling case, in which the FCA only provided general descriptions of swaps, caps, "simple" collars and structured collars.

20. It is incumbent on the FCA, as regulator, to ensure that the Review is addressed to the substance of the sales and not to their form.

Unreasonable Exclusion by Improper Application of the Sophistication Assessment

21. Customers can only have their cases considered under the Review if they are assessed by the banks as being "non-sophisticated" customers. We are concerned that allowing the banks to decide which customers are included in the Review may allow the banks to exclude unfairly some of their customers from participating in the Review. We note from the figures released by the FCA on 28 August 2013 that over 30% of sales of IRHPs have been excluded from the Review on the basis that those customers are allegedly "sophisticated". We know from our own experience that this includes a number of customers who are not sophisticated in any normal sense of the word.

22. We are also concerned that any customer who disagrees with their bank's assessment of their level of sophistication will have to appeal to their bank rather than to an independent body capable of making a fair and independent decision about a customer's inclusion in the Review.

23. By way of a first example, we have recently written to Lloyds Bank regarding their erroneous assessment of our client, Company C, as "sophisticated". However, despite the arguments advanced on behalf of Company C, as things

presently stand, Lloyds Bank have full discretion to continue improperly to exclude our client from the Review, and our client has no effective recourse to obtain regulatory redress. We shall refer to our client's experience under the Review again in relation to the unreasonable delays in the Review and the effect of such delays on potential limitation dates.

24. By way of a further example, we also refer to the experience under the Review of another of our SME clients, Family K, who agreed a suspension of payments with Lloyds Bank in February 2013 in relation to the balancing payments under their interest rate hedging product. However, Lloyds Bank stated that it could terminate that suspension in the event that Family K was notified that *"you are not within scope of the Review because you are a "sophisticated customer""*. Lloyds Bank subsequently stated in May 2013 that it had classified Family K as an intermediate/professional customer, as a result of which our client was required to resume making payments that it could not afford. Despite repeated requests by us, Lloyds Bank has declined to provide any explanation of this incorrect classification. We consider it a matter of abuse that an incorrect classification was used to exclude Family K from the Review.

25. As a result of our instruction and because the case fell just inside the limitation period, Family K instructed us to investigate and commence legal proceedings, following which Lloyds Bank were forced to pay Family K full compensation (in excess of £1 million) for the mis-sold product. It is of grave concern to us that had circumstances been slightly different, Family K might have been unjustly excluded from any effective redress by their apparently arbitrary exclusion from the scope of the Review.

26. While many SME customers have been excluded from the Review after being assessed by their banks as "sophisticated" customers, the banks (with the agreement of the FCA) are foregoing the sophistication assessment in some cases in order to reach the redress stage as soon as possible. NatWest, for example, have indicated that they do not believe that a sophistication assessment is necessary where *"we believe there is a strong likelihood that customers will be non-sophisticated and therefore eligible for this review"*.

27. However, there appears to be no objective basis for determining whether there is a *"strong likelihood"* that a particular customer is "non-sophisticated", and this unfair application of the sophistication assessment is symptomatic of a review process that allows the wrongdoer banks to determine their own regulatory misconduct.

28. Such bypassing of the sophistication assessment (particularly after lengthy delay) is an improper tactic deployed by RBS and NatWest for the purpose of protecting these banks from having to admit openly that a particular customer may have been a "non-sophisticated" customer at the time of being sold an interest rate hedging product. This conduct is not the hallmark of a transparent, fair and open review process.

Unreasonable Exclusion by Improper Sophistication Assessment Criteria

29. In addition to the significant issues concerning the application of the sophistication assessment by the banks (as explained above), there are also fundamental flaws in the criteria contained within the sophistication assessment itself.

30. We refer with great concern to the experience of our client, Company G, who was classified by Yorkshire Bank as a retail client before being sold an interest rate swap on that basis in May 2008. According to the FSA's guidance entitled *"Implementing MiFID's Client Categorisation requirements"* (at http://www.fsa.gov.uk/pubs/other/mifid_classification.pdf), retail clients should be *"afforded the most regulatory protection"*, whereas professional clients *"are considered to be more experienced, knowledgeable and sophisticated"*.

31. Company G was classified as a retail client rather than a professional client because Yorkshire Bank correctly recognised that our client did not have any experience or knowledge of interest rate hedging products and was therefore non-sophisticated. However, Yorkshire Bank is now attempting to exclude Company G from the Review by including the turnover and net assets of Company G's parent company and thereby mis-classifying Company G as a "sophisticated" customer (under the revised sophistication assessment criteria).

32. Retail clients such as Company G are entitled to the *"most regulatory protection"* and it is therefore unacceptable that the FCA has allowed wrongdoer banks to deny their SME customers any regulatory protection even when those customers were previously considered (at the time of sale) to be non-sophisticated.

33. In addition, according to the FCA's own flowchart about the Review (which can be found at: http://www.fca.org.uk/your-fca/documents/fsa-irs-flowchart), there is a stage in the sophistication assessment where a bank can decide that a customer had, at the time of sale, *"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"* and therefore define that customer as "sophisticated" and so exclude that customer from the Review.

34. However, there are no stated parameters governing how a bank should decide whether a customer actually had that level of experience and knowledge in relation to interest rate hedging products at the time of sale. Therefore, given the astonishing level of discretion allowed to the banks in making this decision, it appears that it would be possible for a bank arbitrarily to exclude a customer from the Review by deciding that the customer had the requisite level of knowledge and experience.

35. Furthermore, we also note that customers can be defined as sophisticated (and therefore excluded from the Review) if they have existing IRHPs with a total value of more than £10 million. However, this criterion is flawed and unjust, and a simple example will demonstrate why this is so: what would happen if a customer

who had a loan of £3 million with a bank was sold £11 million in IRHPs (which that customer could not afford to break) by that bank?

36. Under the present criterion, that customer would be assessed as "sophisticated" and excluded from the Review, even though that customer would have been the victim of a substantial amount of over-hedging by its bank. Please note that we have clients who have been excluded from the Review by their banks on such a basis, and we are in no doubt that there are other customers who have been similarly excluded from the Review.

37. Given that the FCA noted back in June 2012 that over-hedging had been a recurrent problem with the banks' mis-selling of IRHPs, this is a disturbing and illogical omission by the FCA and will only serve to deny redress to many customers who have suffered most from the banks' mis-selling of IRHPs precisely because of the high and excessive value of the IRHPs in question.

B. Fettering of Customers' Appeal Rights against the Sophistication Assessment by the Banks

38. According to the FCA's website, at http://www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products/questions?category=sophisticated--nonsophisticated-customers, if a customer believes that they have been incorrectly assessed as "sophisticated", then they can appeal to their bank under the Review, in which case the bank's decision will be re-examined by the independent reviewer.

39. However, some banks are attempting to exclude customers from the Review by failing to inform them appropriately or at all of their right to appeal, which is a fettering of SMEs' rights to seek proper regulatory redress.

40. We are dismayed that it appears that the FCA has not provided clear guidance to banks about the terms in which they should write to customers to inform them that they have been classified as "sophisticated". We recommend that the FCA provide mandatory wording that must be included which sets out the customer's right to challenge such classification by the bank.

C. Lengthy and Unreasonable Delays in the Conduct of the Review by the Banks

41. On 31 January 2013, the FCA announced that *"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."*

    As a result of the FCA's announcement, customers have been led to believe that the Review would be completed by 31 January 2014 at the latest. However, according to the FCA's own figures as at the end of August 2013, there have been only 10 cases where a final offer of redress has been accepted by the customer, which means that only 0.03% of customers have completed the

Review to that recent date. It therefore appears unlikely that the Review will be completed within the FCA's target timescale, especially given that RBS is still attempting to decide whether 43% of its customers (i.e. 4,602 out of a total of 10,528) should be assessed as "sophisticated" or "non-sophisticated".

42. These lengthy delays in the Review were inevitable once the FCA surrendered control of the Review to the banks, who have no incentive to complete the Review within a reasonable timescale. The banks are still collecting payments from the vast majority of their customers under the mis-sold IRHPs, despite the substantial delays in the Review. There is a serious risk that customers could suffer irreversible consequences from the adverse effect on their cash flows of having to continue making payments while the banks delay giving redress.

43. We note that, in response to complaints from customers about the mis-selling of payment protection insurance ("PPI"), the Financial Services Authority created a scheme in August 2010 whereby banks were obliged to deal with a PPI mis-selling complaint within eight weeks of receiving the complaint. By contrast, the FCA's approach to the timescale of the Review has been dithering and indecisive, and has led to distress and uncertainty among customers.

44. These delays must be considered against the backdrop of the prejudice suffered by customers, not least of which is the ongoing loss of the right to pursue legal remedies which for many customers have either become or are soon to be time barred. This is a matter of grave concern which we expand on below.

<u>The FCA's Irresponsible Attitude towards Limitation</u>

45. The FCA stated in its press release dated 4 September 2013 that the *"IRHP review can deliver fair and reasonable redress to customers without them needing to hire lawyers"*, which is merely the latest of a series of claims by the FCA that customers do not need to obtain legal advice in relation to the mis-selling of IRHPs. The FCA has always been aware that the majority of these products were sold to SMEs in the period between 2005 and 2008.

46. These claims are dangerous to customers because many of these cases will be coming up to their "limitation date", which is usually six years after the date when the IRHP was presented or sold. Once that limitation date has passed, it will be too late for many thousands of customers to bring legal proceedings against their banks, and customers will have needlessly lost an avenue of potential redress in reliance on the FCA's advice. We consider that this is a failure of the FCA's regulatory responsibility towards consumers.

47. By way of illustration of the dangers of expiring limitation periods, consider the experience of Company C, which was sold two Category A interest rate hedging products by Lloyds on 24 July 2007, and was sold another Category A product on 1 December 2008 (with Category A being the category designated by the FCA for the most complex interest rate hedging products). On 27 September 2012, Lloyds wrote to our client to confirm that they had been assessed as a

"non-sophisticated" customer and were included in the pilot Review for the sales of all three products.

48. Company C was asked to provide additional information to Lloyds in order to *"assist us with the Review of your cases"*, and provided this information in October 2012. Company C then met with Lloyds under the Review on 25 October 2012, and then heard nothing further from Lloyds about the Review, even though customers who had been sold Category A products should have proceeded straight into the redress phase.

49. Following the FCA's revision of the sophistication assessment criteria on 31 January 2013, Lloyds decided to re-assess Company C as instead being a "sophisticated" customer (which erroneous assessment our client is disputing). However, for reasons that Lloyds have not yet explained, Lloyds failed to communicate this decision to our client until 23 August 2013, even though our client's limitation date was potentially on or around 24 July 2013 (being six years after the first sale).

50. Fortunately, Company C sought legal advice in time and has protected its limitation period by issuing a protective claim form in July 2013. However, had our client followed the FCA's and Lloyds' advice to rely solely on the Review, then our client might have been denied access to both legal and regulatory redress.

51. In the circumstances, we are dismayed that the FCA is advising customers not to seek legal advice, especially given the potential expiration of limitation periods and the enormous delays that have plagued the Review. Any observer of this conduct would have to question whether the banks' legal advisers and Review team might be using delay precisely in order to exclude their customers' rights to seek redress through the courts.

52. This is a matter which the FCA should investigate and we ask you, in light of your mandate to protect and champion the cause of the customer, to issue urgent guidance to affected customers which warns them about the risk of losing their legal rights.

D. Unfair and One-Sided Conduct of the Review by the Banks

53. We are also surprised at the FCA's advice that customers should not seek legal advice in relation to the Review given that the banks (who are already more legally and financially sophisticated than their customers) are instructing City law firms to act on their behalf in the Review. For example, Barclays have instructed Eversheds LLP *"to gather all relevant information from customers and Barclays staff regarding the sale of IRHPs and to present that factual information to Barclays"*. We note it is part of the FCA's regulatory duties to seek to protect customers of financial services institutions.

54. The role of Eversheds LLP in Barclays' conduct of the Review also highlights another fundamental problem with the Review, which is that customers are

expected to provide information to the banks (whether via interview or written statement) about their experiences of the sales process and their contemporaneous understanding of the particular IRHP they were sold, and the banks are then able to use that information to decide what level of redress (if any) should be offered.

55. However, there is no reciprocal obligation for the banks to provide information to their customers about their incentives for selling IRHPs or their reasons for believing that IRHPs would be suitable and/or appropriate for customers. It is therefore difficult for customers to judge whether an offer of redress (once eventually received) is appropriate when they do not have the full information about the banks' mis-selling.

56. Furthermore, this unequal access to information makes it simple for the banks to provide low offers of redress in the safe knowledge that customers will not be able to make an impartial assessment of the redress offered, *especially* if customers have followed the FCA's advice and not sought independent legal advice. In order to ensure that the Review is conducted fairly, we cannot understand why the FCA has not insisted that information be fairly shared between the banks and their customers.

57. We are also concerned that the banks are gathering information from customers in an unfair manner that may be designed to limit any attribution of liability to the banks. For example, HSBC gathers information from its customers using a standard Interest Rate Hedging Review Customer Response Form, in which one of the questions customers have to answer is *"Please provide your recollection of what you were looking to achieve as a business and how you and the bank reached a conclusion that interest rate protection was required and/or desirable"* (our emphasis).

58. This is what, in the legal sphere, we call a "leading question", because the question *how* the customer and the bank reached a conclusion presupposes that they *did* in fact reach such a conclusion. The purpose of the Review is to analyse whether the banks mis-sold IRHPs to customers who did not require or desire those products, and yet the above question takes it for granted (a) that interest rate protection was required and/or desirable; and (b) that the customer and the bank had reached that conclusion together. These are clearly inappropriate assumptions for the banks to make, which prejudge the outcome of the Review process, and we are dismayed that the FCA has allowed banks to put such dangerously leading questions to customers under the Review.

The Role of the FCA

59. The FCA states on its customer-facing website (www.fca.org.uk/about/what) that it has three purposes:

    A. Regulating the financial services industry – *"We help them keep to the rules and maintain high conduct standards"*;

B. Protecting consumers – *"We regulate the financial services industry to ensure firms stick to the rules and consumers don't fall victim to scams or get tied in to unfair contracts"*; and
C. Championing consumers – *"We aim to ensure the financial services industry treats consumers fairly and keeps to our rules and standards"*.

60. However, in relation to the mis-selling of IRHPs, the FCA has allowed the wrongdoer banks to review their own mis-selling. Consequently, the banks have been able unfairly to exclude customers from the Review, delay the conduct of the Review, withhold information from their customers and decide the extent to which they should provide redress to customers.

61. The mis-selling of IRHPs occurred because the banks were incapable of adhering to the required legal and regulatory requirements without external oversight. We are therefore extremely disappointed that the FCA has refused to heed the lessons of the past and is allowing the banks to regulate themselves, thereby abdicating its responsibilities as a regulator.

We invite you to consider urgently the above representations made on behalf of our clients and other SME customers who have been similarly affected and to re-evaluate both the processes of the Review and your role within it.

Yours faithfully

LEXLAW