**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/SKS/KXO
Your Ref:

For the attention of: Mr John Swift QC
FCA Head Office
12 Endeavour Square
London, E20 1JN

DX:

FAX:
EMAIL: IndependentInvestigation.InterestRateHedgingProducts@fca.org.uk
CC:

26 September 2019

Dear Sirs

**REPEATED NOTICE OF FAILINGS IN THE FCA'S IMPLEMENTATION AND OVERSIGHT OF THE INTEREST RATE HEDGING PRODUCTS (IRHP) REVIEW AND REDRESS SCHEME**

We write further to the investigation into the FCA's implementation and oversight of the Interest Rate Hedging Products (IRHP) Review and Redress Scheme ("the Review") on behalf of our SME clients, who have been mis-sold interest rate hedging products by a wide range of banks (including Barclays Bank, HSBC, Lloyds Bank, the Royal Bank of Scotland and Clydesdale and Yorkshire Banks).

Our clients expressed grave concerns to us about the Review prior to its implementation; however, the FCA's chief executive (Martin Wheatley) disregarded those concerns. Given the prescience of those concerns, we ask the FCA to take urgent action in order to ensure that the failings in the FCA's implementation and oversight of the Review are not repeated.

**Conflict of Interests in the Review**

On 29 June 2012, the FCA (formerly the Financial Services Authority) announced that it had found serious failings in the sale of interest rate hedging products by a wide range of banks (including Barclays Bank, HSBC, Lloyds Bank and RBS), including *"the inappropriate sale of complex varieties of IRHPs [Interest Rate Hedging Products] to 'non-sophisticated' customers and a range of poor sales practices"*.

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 interest rate hedging products where the amount and/or duration exceeded that of the underlying loans; and
E. Allowing internal incentives and rewards to encourage these poor sales practices.

The FCA was clearly and correctly of the view that the banks' mis-selling of interest rate hedging products needed to be investigated, with redress to be offered to wronged customers who had suffered losses due to the mis-selling that had taken place.

It is unfortunate that the FCA decided that the best party to investigate the banks' mis-selling of interest rate hedging products and determine the extent of the banks' regulatory misconduct was the banks themselves.

The banks were obliged to present their findings under the Review to an "independent reviewer" to supposedly ensure that an impartial, independent and thorough review had been conducted of each customer's case.

However, the "independent reviewer" was, in fact, appointed by the respective banks; for example, HSBC Bank 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"*.

While we understand that the FCA was able to reject a bank's choice of "independent reviewer", we are not aware of any instances in which the FCA actually did so. Furthermore, the fact that the banks were able to appoint their own "independent reviewers" at all clearly demonstrated that these reviewers were not independent and therefore did not provide 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 inevitability has an ongoing relationship with the bank in question that they will be anxious to preserve.

The banks were reviewing their own mis-selling practices, deciding whether each customer should be included in the Review, determining whether to offer any redress and (if so) finally determining the amount and form of any redress.

After this process, the banks then had their decisions scrutinised by "independent reviewers" whom they themselves appointed. This was a fundamentally flawed basis for the conduct of the Review and failed to achieve the impartial, independent and thorough investigation of the banks' mis-selling of interest rate hedging products for which purpose the Review presumably existed.

The dangers inherent to the conflict of interests in the Review between the banks and their "independent reviewers" were highlighted dramatically by credible reports that KPMG (an "independent reviewer" for RBS) were pressured and *"browbeaten"* by RBS into minimising compensation paid for mis-sold IRHPs to RBS's customers.

There are obvious questions as to why the wrongdoer banks were allowed by the regulator to review their own wrongdoing. 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.

For the reasons set out above, 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 gave an inaccurate impression to customers and members of the public as to the terms and conduct of the Review.

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

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

However, the Review was not being conducted by the FCA or by an independent party appointed by the FCA. The Review could not and should not have been described as an "independent review" and the FCA must take steps to ensure banks desist from such inaccurate and misleading descriptions in future.

Furthermore, the FCA's approach to the Review enabled several questionable practices by the banks in the conduct of the Review, including:

A. Unreasonable exclusion of customers from the Review;
B. Lengthy and unreasonable delays in conduct of the Review; and
C. Scheme manipulation (i.e. unfair and one-sided conduct of the Review).

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

<u>Unreasonable Exclusion by Improper Application of the Sophistication Assessment</u>

Customers were only able to have their cases considered under the Review if they were assessed by the banks as being "non-sophisticated" customers. It is therefore concerning that allowing the banks to decide which customers were included in the Review allowed the banks to unfairly exclude some of their customers from the Review. We note from the FCA that over 34% of IRHP sales were excluded from the Review on the basis that those customers were allegedly "sophisticated". However, we know from our own experience that this included customers who were not sophisticated in any normal sense of the word.

It is also concerning that any customer who disagreed with their bank's decision to classify them as "sophisticated" had to appeal to their bank rather than to an independent body capable of making a fair and independent decision.

By way of a first example, we wrote to Lloyds regarding their erroneous assessment of our client, Company C, as "sophisticated". However, despite the arguments advanced on behalf of Company C, Lloyds were able to continue improperly excluding our client from the Review, and our client had no effective recourse to obtain regulatory redress.

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 under their interest rate hedging product with Lloyds in February 2013. However, Lloyds 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 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 declined to provide any explanation of this incorrect classification, which only served to wrongly exclude Family K from the Review.

As the case fell just inside the limitation period, Family K instructed us to investigate and commence legal proceedings, following which Lloyds were forced to pay Family K full compensation (in excess of £1 million) for the mis-sold product. It is of grave concern 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.

There does not appear to have been any objective basis for determining whether a particular customer is "sophisticated", and this unfair application of the sophistication assessment was symptomatic of a review process that allowed the wrongdoer banks to determine their own regulatory misconduct.

Unreasonable Exclusion by Improper Sophistication Assessment Criteria

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

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. 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 subsequently attempted 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).

Retail clients such as Company G are entitled to the "most regulatory protection" and it is therefore unacceptable that the FCA 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.

In addition, according to the FCA's own flowchart about the Review, there was a stage in the sophistication assessment where a bank could 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"*, thereby defining that customer as "sophisticated" and so excluding that customer from the Review.

However, there were no stated parameters as to 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 was possible for a bank to arbitrarily exclude a customer from the Review by claiming that the customer had the requisite level of knowledge and experience.

Furthermore, we also note that customers were defined as sophisticated (and therefore excluded from the Review) if they had existing IRHPs with a total value of more than £10 million. However, this criterion was flawed and unjust: 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?

Under the criterion in the Review, that customer would have been assessed as "sophisticated" and excluded from the Review, even though that customer would have been the victim of substantial over-hedging by its bank.

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 was a disturbing and illogical omission by the FCA and only served to deny redress to many customers who suffered most from the banks' mis-selling of IRHPs precisely because of the high and excessive value of the IRHPs in question.

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

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 were led to believe that the Review would be completed by 31 January 2014 at the latest. However, according to the FCA's own data, the Review was not completed until 30 September 2016 (i.e. over two and a half years after that announcement).

The lengthy nature of this delay in the Review was inevitable once the FCA surrendered control of the Review to the banks, who had no incentive to complete the Review within a reasonable timescale (particularly as the banks were still able to collect payments from the vast majority of their customers under the mis-sold IRHPs).

By contrast, 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 requiring banks to deal with PPI mis-selling complaints within eight weeks. By contrast, the FCA's approach to the timescale of the Review was dithering and indecisive, and led to distress and uncertainty among customers.

This delay must be considered against the backdrop of the prejudice suffered by customers, not least of which was the ongoing loss of the right to pursue legal remedies which for many customers became time-barred. This is a matter of grave concern which we expand on below.

The FCA's Irresponsible Attitude towards Limitation

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 was merely the latest of a series of claims by the FCA that customers did not need to obtain legal advice in relation to the mis-selling of IRHPs. The FCA had always been aware that the majority of these products were sold to SMEs in the period between 2005 and 2008.

These claims were dangerous because many of those cases were 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 was too late for many thousands of customers to bring legal proceedings against their banks, and customers needlessly lost an avenue of potential redress in reliance on the FCA's advice. This was a failure of the FCA's regulatory responsibility towards consumers.

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 Company C 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.

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.

Following the FCA's revision of the sophistication assessment criteria on 31 January 2013, Lloyds decided to erroneously re-assess Company C as instead being a "sophisticated" customer. However, for reasons that Lloyds failed to explain, Lloyds failed to communicate this decision to Company C until 23 August 2013, even though the applicable limitation date was on 24 July 2013 (being six years after the first sale).

Fortunately, Company C sought legal advice in time and protected its limitation period by issuing a protective claim form in July 2013, and subsequently obtained redress through litigation. However, had Company C followed the FCA's and Lloyds' advice to rely solely on the Review, it would have been denied legal and regulatory redress.

In the circumstances, it is dismaying that the FCA advised customers not to seek legal advice, especially given the potential expiration of limitation periods and the enormous delays that plagued the Review. Any observer of this conduct would have to question whether the banks' legal advisers and Review team were using delay precisely to exclude their customers' rights to seek redress through the courts.

**C. Scheme Manipulation – Unfair and One-Sided Conduct of the Review by the Banks**

It is also surprising that the FCA would advise customers not to seek legal advice in relation to the Review given that the banks (who are already more legally and financially sophisticated than their customers) were instructing City law firms to act on their behalf in the Review. For example, Barclays 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.

Unequal Access to Information in the Review

The role of Eversheds LLP in Barclays' conduct of the Review also highlights another fundamental problem with the Review, namely that customers were expected to provide information to the banks, and the banks were then able to use that information to decide what level of redress (if any) to offer.

However, there was 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 were suitable and/or appropriate for customers. It was therefore difficult for customers to judge whether an offer of redress (once eventually received) was appropriate when they did not have the full information about the banks' mis-selling.

Furthermore, this unequal access to information made it simple for the banks to provide low offers of redress in the safe knowledge that customers were unable to make an impartial assessment of the redress offered, especially if they had followed the FCA's advice and not sought independent legal advice. Given that the Review needed to be conducted fairly, it is impossible to understand why the FCA did not insist that information be fairly shared between the banks and their customers.

It is also concerning that the banks gathered information from customers in an unfair manner designed to limit any attribution of liability to the banks. For example, HSBC gathered information from its customers using a standard Interest Rate Hedging Review Customer Response Form, in which one of the questions customers had to answer was: *"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"* (added emphasis).

This was 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 was to analyse whether the banks mis-sold IRHPs to customers who did not require or desire those products. However, that question by HSBC took it for granted that (a) interest rate protection was required and/or desirable; and (b) the customer and the bank had reached that conclusion together. These were clearly inappropriate assumptions for the banks to make, which prejudged the outcome of the Review process, and it is dismaying that the FCA allowed banks to put such dangerously leading questions to customers under the Review.

**The Role of the FCA**

The FCA states on its customer-facing website that the FCA has three purposes:

A. Protecting consumers – *"we secure an appropriate degree of protection for consumers"*;
B. Protecting financial markets – *"we protect and enhance the integrity of the UK financial system"*; and
C. Promoting competition – *"we promote effective competition in the interests of consumers"*.

However, in relation to the mis-selling of IRHPs, the FCA allowed the wrongdoer banks to review their own mis-selling. Consequently, the banks were able to unfairly 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.

The mis-selling of IRHPs occurred because the banks were incapable of adhering to the required legal and regulatory requirements without external oversight. It is therefore extremely disappointing that the FCA refused to heed the lessons of the past and allowed the banks to regulate themselves, thereby acting as a banking trade union and 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 Review and your role within it.

We look forward to hearing from you.

Yours faithfully

LEXLAW