



The FCA Review and Redress Scheme

Replacement Caps Valuation Report

Selection of interest rate caps imposed as replacement products

Warwick Risk Management
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The FCA Review and Redress Scheme - Replacement Caps Valuation Report

Executive Summary

The FCA Review and Redress Scheme (the '**FCA Scheme**') was established with the stated purpose of providing fair and reasonable redress to the small and medium-sized enterprises ('**SMEs**') which were victims of bank mis-selling of complex and inappropriate interest rate hedging products ('**IRHPs**').

A controversial aspect of the FCA Scheme is that, in certain circumstances, the mis-selling banks are entitled to impose on the SME customer a replacement IRHP as an alternative to paying full redress. In practice, only half of the SMEs adjudged to have been the victims of mis-selling have received full redress. The remainder have either received no redress at all or have been faced with the imposition of a replacement IRHP. For the latter group, the most common outcome has been the imposition of interest rate caps ('**Replacement Caps**') as alternatives to the originally mis-sold IRHPs.

We have been requested by Ordinary People in Business Limited to review a sample of the Replacement Caps imposed under the FCA Scheme, including Replacement Caps imposed by each of the four major UK High Street banks, namely Barclays Bank, HSBC, Lloyds Bank and RBS (collectively, the '**Banks**'). We have been requested to analyse the pricing of the Replacement Caps and to evaluate whether such pricing is fair and reasonable.

An important preliminary point is that all of the Replacement Caps under the FCA Scheme have been constructed "after the event" and imposed retrospectively. The Replacement Caps have little or no economic value to the SMEs. Most of the Replacement Caps had already expired worthlessly before the dates of their retrospective imposition. The remainder, i.e. those yet to expire, have cap rates which are far above current interest rate levels, meaning those caps have a current value that is either zero or negligible. Therefore the only economic impact of the Replacement Caps has been to reduce, often substantially, the amounts of redress that would otherwise have been payable by the Banks to the victims of their mis-selling.

We have considered a selection of the Replacement Caps imposed by the Banks as alternative products under the FCA Scheme, one cap for each of the four banks named above. The additional losses imposed on the customers in the four examples range from £37,620 to £202,403. Those losses have been exacerbated because the Replacement Caps were priced by the Banks at high multiples of their fair value, ranging from 175% of fair value to more than 1,600% of fair value.

We consider that the overpricing of the Replacement Caps violates an important principle of the FCA Scheme, which is to put customers back into the position they would have been in had the mis-selling not occurred. But for the mis-selling, the customers would have had the option to "shop around" between competing cap providers and thereby achieve pricing that was at or close to the prevailing market prices. Customers would not have been obliged to pay the excessive prices now being retrospectively imposed by the Banks.

Author of the Report

This report has been prepared by Nick Stoop of Warwick Risk Management. Nick has fifteen years' derivatives experience in senior positions at major banks, including as Head of Swaps at Mitsubishi Finance in London and Head of Capital Markets at HSBC in Thailand. In both of those roles he was in charge of the pricing, sales, trading and risk-management of his bank's portfolios of long-term currency and interest rate hedging products. Prior to entering the swaps market, Nick taught mathematics, having trained as an economist gaining a BA and an MA from Cambridge University.

Data sources and benchmarks

The valuations in this report have been calculated at mid-market rates using data from a range of market sources including the Bank of England, the British Bankers Association (BBA), the International Swaps and Derivatives Association (ISDA), Thomson Reuters and ICAP plc. The author also uses Bloomberg, a major global provider of real-time and historic pricing data and analytic tools and widely recognised as a benchmark in the finance and banking community.

Independent verification

The valuations in this report have been calculated by Warwick Risk Management on the basis of historical pricing data which is believed to be reliable. In addition, the valuations have been independently checked and confirmed by two other firms, also widely regarded as experts in the field of interest rate hedging products, namely:

- **Pegasus Capital LLP** of Access House, Cray Avenue, Orpington, Kent, BR5 3QB, whose website address is www.pegasuscap.co.uk; and
- **Vedanta Hedging Limited** of Acre House, 11-15 William Road, London NW1 3ER, whose website address is www.vedantahedging.com.

The Replacement Caps

The RBS Replacement Cap

Table 1 below illustrates a Replacement Cap imposed by RBS. In 2004 RBS mis-sold an interest rate swap to its customer, a care home operator. The customer was categorised as “non-sophisticated” for the purposes of the FCA Scheme.

In 2014 the bank admitted the mis-sale but instead of paying full redress imposed the Replacement Cap illustrated in the table below.

The Replacement Cap, which was imposed retrospectively in 2014, had a notional start date in 2004 and a notional end date in 2009. The cap expired worthlessly so had no value to the customer.

The theoretical 2004 value of the RBS Replacement Cap was £3,700, illustrated in the table below. However, RBS priced the Replacement Cap at £20,829, representing 563% of its theoretical 2004 value.

The RBS Replacement Cap had the effect of depriving the customer of £37,620 of redress (including 8% interest) that would have been payable but for the imposition of the Replacement Cap.

Table 1 – The RBS Replacement Cap

Amount	£450,000 (declining monthly*)
Cap rate	6.47%
Floating index	Monthly average base rate
Term	5 years
Start date	1 March 2004
End date	1 March 2009
Notional cap purchase date	26 January 2004
Theoretical cap value on that date	£3,700
Actual redress offer date	27 March 2014
Actual value of cap at redress date	£0
Price charged by RBS for Replacement Cap	£20,829
RBS excess charge in £	£17,129
RBS excess charge as %	463%
Additional loss imposed on the customer	-£37,620

* The repayment schedule of the RBS Replacement Cap is shown in Appendix I below.

The Barclays Replacement Cap

Table 2 below illustrates a Replacement Cap imposed by Barclays. In 2004 Barclays mis-sold a Structured Swap to its customer, the owner of a holiday park. The customer was categorised as “non-sophisticated” for the purposes of the FCA Scheme. The Structured Swap was sold on the basis of materially false advice about the risks of the contract contained in the salesperson’s written presentation to the customer.

In 2013 the bank admitted the mis-sale but instead of paying full redress imposed the Replacement Cap illustrated in the table below.

The Replacement Cap, which was imposed retrospectively in 2013, had a notional start date in 2006 and a notional end date in 2009. The cap expired worthlessly so had no value to the customer.

The theoretical 2006 value of the Barclays Replacement Cap was £1,825, illustrated in the table below. However, Barclays priced the Replacement Cap at £29,693, representing 1627% of its theoretical 2006 value.

The Barclays Replacement Cap had the effect of depriving the customer of £46,217 of redress (including 8% interest) that would have been payable but for the imposition of the Replacement Cap.

Table 2 – The Barclays Replacement Cap

Amount	£5,000,000
Cap rate	7%
Floating index	Quarterly average base rate
Term	3 years
Start date	26 July 2006
End date	26 July 2009
Notional cap purchase date	26 July 2006
Theoretical cap value on that date	£1,825
Actual redress offer date	8 July 2013
Actual value of cap at redress date	£0
Price charged by Barclays for Replacement Cap	£29,693
Barclays excess charge in £	£27,868
Barclays excess charge as %	1527%
Additional loss imposed on the customer	-£46,217

The HSBC Replacement Cap

Table 3 below illustrates a Replacement Cap imposed by HSBC. In 2007 HSBC mis-sold a highly complex interest rate derivative, namely a base rate extendible swap, to its customer, an investor in commercial property. The customer was categorised as “non-sophisticated” for the purposes of the FCA Scheme.

In 2014 the bank admitted the mis-sale but instead of paying full redress imposed the Replacement Cap illustrated in the table below.

The Replacement Cap, which was imposed retrospectively in 2014, had a notional start date in 2007 and a notional end date in 2012. The cap expired worthlessly so had no value to the customer.

The theoretical 2006 value of the HSBC Replacement Cap was £13,700, illustrated in the table below. However, HSBC priced the Replacement Cap at £46,466, representing 339% of its theoretical 2007 value.

The HSBC Replacement Cap had the effect of depriving the customer of £70,001 of redress (including 8% interest) that would have been payable but for the imposition of the Replacement Cap.

Table 3 – The HSBC Replacement Cap

Amount	£2,500,000
Cap rate	6.5%
Floating index	Monthly average base rate
Term	5 years
Start date	10 October 2007
End date	10 October 2012
Notional cap purchase date	10 October 2007
Theoretical cap value on that date	£13,700
Actual redress offer date	6 February 2014
Actual value of cap at redress date	£0
Price charged by HSBC for Replacement Cap	£46,466
HSBC excess charge in £	£32,766
HSBC excess charge as %	239%
Additional loss imposed on the customer	-£70,001

The Lloyds Replacement Cap

Table 4 below illustrates a Replacement Cap imposed by Lloyds. In 2008 Lloyds mis-sold a complex interest rate collar to its customer, an individual with investments in commercial property. The customer was categorised as “non-sophisticated” for the purposes of the FCA Scheme.

In 2014 the bank admitted the mis-sale but instead of paying full redress imposed the Replacement Cap illustrated in the table below.

The Replacement Cap, which was imposed retrospectively in 2014, had a notional start date in 2008 and an end date in 2018. Although the Lloyds Replacement Cap has not yet expired, it is effectively worthless to the customer. The customer has received no payments to date under the cap and is not expected to receive any payments in the future, because the cap rate (5.62%) is so far above the current level of base rate (0.5%). The current Bloomberg valuation of the product is one penny.

The theoretical 2008 value of the Lloyds Replacement Cap was £78,800, illustrated in the table below. However, Lloyds priced the Replacement Cap at £137,656, representing 175% of its theoretical 2008 value.

The Lloyds Replacement Cap had the effect of depriving the customer of £202,403 of redress (including 8% interest) that would have been payable but for the imposition of the Replacement Cap.

Table 4 – The Lloyds Replacement Cap

Amount	£3,500,000
Cap rate	5.62%
Floating index	Monthly average base rate
Term	10 years
Start date	29 August 2008
End date	29 August 2018
Notional cap purchase date	29 August 2008
Theoretical cap value on that date	£78,800
Actual redress offer date	15 July 2014
Actual value of cap at redress date	£0.01
Price charged by Lloyds for Replacement Cap	£137,656
Lloyds excess charge in £	£58,856
Lloyds excess charge as %	69%
Additional loss imposed on the customer	-£202,403

Conclusions

As stated above, it is a controversial aspect of the FCA Scheme that, in certain circumstances, the mis-selling banks are entitled to impose on the SME a replacement IRHP as an alternative to paying full redress. The only economic effect of the replacement IRHPs has been to reduce the amounts of redress that would otherwise have been payable by the Banks to the victims of their mis-selling.

According to figures published by the FCA, as at 31 December 2014, just over half of the 15,646 redress outcomes communicated to customers offered full redress to customers adjudged to have been mis-sold. The remainder have either received no redress at all or have been faced with the imposition of a replacement IRHP, with 4,336 of those customers facing the imposition of a Replacement Cap.

The FCA declared that the “*core tenet*” of the FCA Scheme is “*to pay fair and reasonable redress to Customers where appropriate. In our view, fair and reasonable redress requires that the Customer be put back into the position they would have been in if there had not been any breach of the Regulatory Requirements.*”

We consider that the Banks’ overpricing of the Replacement Caps is in violation of that core tenet, because the pricing of the caps is neither fair nor reasonable and fails to put the customer in the position they would have been in had the mis-selling not occurred.

Nick Stoop
Warwick Risk Management
Warwick House, 8 Addison Crescent, London W14 8JP

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Appendix I – Repayment profile of the RBS Replacement Cap

period start	period end	notional	period start	period end	notional
01-Mar-2004	01-Apr-2004	450,000.00	01-Sep-2006	02-Oct-2006	405,155.98
01-Apr-2004	04-May-2004	448,632.92	02-Oct-2006	01-Nov-2006	403,516.11
04-May-2004	01-Jun-2004	447,257.53	01-Nov-2006	01-Dec-2006	401,866.25
01-Jun-2004	01-Jul-2004	445,873.77	01-Dec-2006	02-Jan-2007	400,206.37
01-Jul-2004	02-Aug-2004	444,481.59	02-Jan-2007	01-Feb-2007	398,536.38
02-Aug-2004	01-Sep-2004	443,080.95	01-Feb-2007	01-Mar-2007	396,856.23
01-Sep-2004	01-Oct-2004	441,671.78	01-Mar-2007	02-Apr-2007	395,165.86
01-Oct-2004	01-Nov-2004	440,254.04	02-Apr-2007	01-May-2007	393,465.21
01-Nov-2004	01-Dec-2004	438,827.68	01-May-2007	01-Jun-2007	391,754.22
01-Dec-2004	04-Jan-2005	437,392.64	01-Jun-2007	02-Jul-2007	390,032.81
04-Jan-2005	01-Feb-2005	435,948.87	02-Jul-2007	01-Aug-2007	388,300.94
01-Feb-2005	01-Mar-2005	434,496.31	01-Aug-2007	03-Sep-2007	386,558.52
01-Mar-2005	01-Apr-2005	433,034.92	03-Sep-2007	01-Oct-2007	384,805.51
01-Apr-2005	03-May-2005	431,564.64	01-Oct-2007	01-Nov-2007	383,041.84
03-May-2005	01-Jun-2005	430,085.42	01-Nov-2007	03-Dec-2007	381,267.43
01-Jun-2005	01-Jul-2005	428,597.19	03-Dec-2007	02-Jan-2008	379,482.23
01-Jul-2005	01-Aug-2005	427,099.92	02-Jan-2008	01-Feb-2008	377,686.17
01-Aug-2005	01-Sep-2005	425,593.53	01-Feb-2008	03-Mar-2008	375,879.19
01-Sep-2005	03-Oct-2005	424,077.98	03-Mar-2008	01-Apr-2008	374,061.21
03-Oct-2005	01-Nov-2005	422,553.22	01-Apr-2008	01-May-2008	372,232.17
01-Nov-2005	01-Dec-2005	421,019.17	01-May-2008	02-Jun-2008	370,392.01
01-Dec-2005	03-Jan-2006	419,475.80	02-Jun-2008	01-Jul-2008	368,540.65
03-Jan-2006	01-Feb-2006	417,923.03	01-Jul-2008	01-Aug-2008	366,678.03
01-Feb-2006	01-Mar-2006	416,360.82	01-Aug-2008	01-Sep-2008	364,804.08
01-Mar-2006	03-Apr-2006	414,789.11	01-Sep-2008	01-Oct-2008	362,918.73
03-Apr-2006	02-May-2006	413,207.83	01-Oct-2008	03-Nov-2008	361,021.91
02-May-2006	01-Jun-2006	411,616.94	03-Nov-2008	01-Dec-2008	359,113.55
01-Jun-2006	03-Jul-2006	410,016.36	01-Dec-2008	02-Jan-2009	357,193.58
03-Jul-2006	01-Aug-2006	408,406.05	02-Jan-2009	02-Feb-2009	355,261.93
01-Aug-2006	01-Sep-2006	406,785.95	02-Feb-2009	02-Mar-2009	353,318.53