Swap-for-a-swap

Swap mis-selling and illegitimate lending conditions

Inconsistent redress under the FCA Review scheme

Warwick Risk Management
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Swap-for-a-swap: swap mis-selling and illegitimate lending conditions

Executive summary

In 2012, the Financial Services Authority (the '**FSA**') carried out an investigation that found serious failings in the sale of interest rate hedging products ('**IRHPs**') to small businesses by some banks. The FSA found that over 90% of sales did not comply with regulatory requirements. The mis-selling caused significant harm to a large number of small businesses across the UK.

The FSA recognised that, in some cases, small businesses were required to purchase an IRHP as a condition of their lending arrangement. It also recognised that some of these conditions were not 'legitimate' credit conditions but had been imposed for the benefit of the banks' swaps salespeople, without due regard for the needs of the small business customers.

In May 2013 the FSA's successor, the Financial Conduct Authority (the '**FCA**') launched a full review (the '**FCA Review**') into the sales of IRHPs to non-sophisticated customers. The rules of the FCA Review (the '**Rules**'), published in February 2015, were designed to ensure fair and reasonable outcomes for customers and a consistent approach across the banks' review teams.

The Rules explicitly recognised the relationship between illegitimate lending conditions and swap mis-selling. Many businesses were prompted to purchase IRHPs because of the lending conditions in their loan agreements. If a lending condition was not based on a legitimate credit rationale but was imposed purely to generate a sale, then it was not a legitimate condition. According to the Rules, where an IRHP was mis-sold on the back of an illegitimate lending condition, the customer is entitled to full compensation.

It has been our experience that while most of the banks in the review have observed the Rules, RBS has not. A major issue is that RBS has repeatedly relied on illegitimate lending conditions to justify 'swap-for-a-swap' redress outcomes. Instead of paying full compensation to customers, the bank has instead imposed replacement IRHPs, which have the effect of significantly reducing the amount of compensation paid.

RBS's approach is out of step with that taken by the other banks in the review, meaning that RBS customers, who form more than 50% of the review population, have been denied the same fair and consistent treatment afforded to the customers of other banks in the review. Lloyds Bank and Santander, for example, have rigorously followed the Rules of the review, with the result that customers of Lloyds Bank and Santander are much more likely to receive fair redress than equivalent customers of RBS.

The FCA has a duty to ensure consistency across the banks in the review. The idea that RBS should be excused from following certain rules is not compatible with that requirement. Yet RBS has been allowed to deliver significantly reduced redress outcomes on the basis of lending conditions that would be automatically disqualified as illegitimate by the other banks.

In order to achieve fair and consistent outcomes for all customers in the FCA Review, we recommend that all RBS redress decisions based on lending conditions be re-reviewed. We further recommend that the re-review be performed by a different firm of independent reviewers, for example the firm that reviewed the Lloyds Bank and Santander cases.

This report addresses the following matters:

1. Background to the mis-selling of IRHPs;
2. Illegitimate lending conditions;
3. The rules of the FCA Review;
4. Inconsistent review treatment across banks; and
5. Recommendation.

Two appendices are attached to this report:

I. Research data;
II. The Sales Standards; and
III. Examples of non-compliant redress determinations.

1. Background to the mis-selling of IRHPs

From the late 1990s onwards the UK's high street banks expanded their trading divisions and invested in swaps trading staff and systems in an effort to catch up with their competitors, mainly the international investment banks. But generating a return on that investment was challenging because the swaps market was by then dominated by sophisticated market professionals and had become intensely competitive. Profit margins on interest rate swaps had become small, typically less than one hundredth of a percentage point.

It was comparatively difficult for banks to achieve significant profit margins through normal trading with other market counterparties. But retail customers including small and medium-sized enterprises ('**SMEs**') represented a profitable opportunity for the banks. SMEs typically:

- had little or no previous experience or understanding of interest rate derivatives;
- lacked access to price information;
- were dependent on their banks for funding; and
- trusted their banks for advice.

In the majority of cases, SME customers were introduced to interest rate hedging products ('**IRHPs**') via the imposition of lending conditions. Customers were denied new loans or refused the renewal of existing facilities unless they agreed to purchase an IRHP.

It has since been acknowledged by the financial regulators that the majority of sales of IRHPs to unsophisticated customers did not comply with the appropriate regulations. The extract below was published by the FSA in January 2013:

> *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.*

The FSA's pilot study revealed that more than 90% of the sales reviewed did not comply with regulatory requirements, a proportion subsequently confirmed by the FSA's successor, the Financial Conduct Authority and now corroborated by the banks' basic redress decisions under the FCA Review.

The FSA recognised that bank sales staff were incentivised to advise inexperienced customers to purchase complex and inappropriate products, often larger in amount and longer in duration than the customers' loans. The sales were unusually profitable to the selling banks because, unlike professional counterparties, small businesses lacked understanding of the products and had limited bargaining power. The risks of the IRHPs were not adequately disclosed by bank salespeople. Customers would have been less likely to agree to the contracts had they understood the risks.

The damage caused by mis-sold IRHPs was often severe. Customers were prompted to enter into IRHP contracts unaware that the contracts carried immediate break costs, equal to the upfront profits

booked by the banks on the transactions. The initial break cost of an IRHP contract could be more than £100,000. The cost to escape the contracts would grow over time as interest rates fell, in some cases to more than £1,000,000.

Customers trapped by high break costs found themselves deprived of the flexibility to conduct their business normally, to buy or sell assets, to repay their loans early or to refinance with another bank. As such they became vulnerable to transfer to the banks' recovery divisions where they faced increased costs and in some cases insolvency and the loss of their businesses.

In 2012, the FSA agreed with nine of the High Street banks that those banks would review their sales of IRHPs made to unsophisticated customers since 2001. The FCA launched the full FCA Review in May 2013.

The stated purpose of the FCA Review was to deliver fair and reasonable outcomes for customers. A set of redress principles was agreed in order to ensure consistency across the banks.

2. Illegitimate lending conditions

Lending conditions played an important role in prompting unsophisticated customers to purchase inappropriate varieties of IRHP. During the period covered by the FCA Review, it was not unusual for lending banks to require that borrowers purchase an IRHP as a mandatory condition of the associated lending arrangement.

In some cases, the lending condition may have reflected the calculation of the bank's credit function that the borrower needed to mitigate its exposure to interest rates. In such cases the appropriate hedging product for a small business customer is an interest rate cap, which provides protection against the possibility of increased interest rates in exchange for a modest premium, payable up-front or in instalments over the life of the contract.

In other cases, the imposition of the lending condition was driven by bank sales staff, to facilitate the profitable sale of a high-margin IRHP to a 'captive' customer. The condition was often imposed at the eleventh hour, for example after the customer had already committed to purchase a property and so had no realistic option other than to accept the condition.

Illegitimate lending conditions were deployed to prompt the sales of potentially deleterious products such as swaps, collars, bank-cancellable swaps, structured collars, geared collars, knock-in options, trigger swaps and other complex varieties of IRHP.

Such products offered no risk management benefit compared to simple caps. But unlike caps, the more complex varieties of IRHP exposed unsophisticated customers, unwittingly, to potentially devastating risks, which risks were rarely disclosed by commission-driven salespeople. The risks included high potential break costs to escape from the transactions, loss of business flexibility (including the flexibility to change banks), transfer to the banks' recovery divisions and the insolvency of the business.

The regulators have agreed that a mandatory hedging condition should be considered illegitimate if it was imposed by a salesperson for his or her personal or commercial benefit without having due regard for the interests of the customer.

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3. The rules of the FCA Review

The rules of the FCA Review (the '**Rules**') were agreed between the FSA and the banks in January 2013 but not published until February 2015. The Rules set out a number of principles designed to ensure fair redress for customers and consistency between the different banks. In our opinion, had the Rules been consistently applied, then the majority of the small businesses affected by IRHP mis-selling would have received fair and reasonable basic redress outcomes.

It is regrettable that the FCA resisted publishing the Rules until pressed to do so by the Treasury Select Committee in February 2015. By that date, many businesses and their advisors had already been penalised by being required to argue their cases on an uneven playing field, whereby the Rules were known to the banks but not to the victims of bank mis-selling.

It is even more regrettable that the FCA has still not published the methodology agreed with each bank and independent reviewer which sets out the methods by which the banks and the reviewers have agreed to apply the Rules, notably the Rules regarding illegitimate lending conditions.

Most regrettable is that the FCA has failed to ensure that the Rules were consistently applied by all of the banks in the FCA Review. That failure has led to a significant proportion of the review population being denied fair redress and feeling pressure to accept non-compliant redress outcomes. We consider that the FCA's failure to enforce its Rules or to ensure consistency across the banks represents a significant failure of the regulator.

The Rules explicitly recognised the relationship between illegitimate lending conditions and swap mis-selling. According to the Rules, businesses prompted into mis-sold IRHPs on the basis of illegitimate lending conditions are entitled to full redress.

In our experience, most of the banks in the FCA Review have observed the Rules and have applied them appropriately. But RBS, responsible for more than 50% of cases in the review, has been allowed to violate the Rules applying to illegitimate lending conditions, with the effect that swap-for-a-swap outcomes have been imposed on businesses which should have received full redress.

Legitimate condition of a lending arrangement (Rules 40 to 47)

The Rules address at length the legitimacy or otherwise of lending conditions, demonstrating the importance of the issue to the architects of the FCA Review. Rules 40 to 47, under the heading ***"Legitimate condition of a lending arrangement"***, set out the factors to be considered in order to determine whether or not the sale of an IRHP was a legitimate condition of lending ('**LCOL**').

Some of the relevant Rules are copied below (with our emphasis added):

> *Rule 43. Subject to other factors, the firm should consider whether there is evidence that the hedging complied with the **requirements of the credit function, such as the notional value of the hedge and duration**.*
>
> *Rule 45. Similarly, there should be consideration of any evidence that suggests that sales incentives/inducements inappropriately influenced the decision to make the IRHP a condition of the loan. For example, **it is not a LCOL where there is evidence that sales staff put in place the IRHP solely for commercial (and/or personal) benefit without due regard for***

> ***the needs of the Customer**.*
>
> *Rule 46. The firm should also consider whether there is **evidence that the communication of the IRHP as a condition of lending was in good time, fair, clear and not misleading**. For example, for there to be a LCOL, the Customer must have been informed in a timely manner of the condition in the loan/facility before accepting it.*

For a condition to qualify as a legitimate credit condition according to the Rules of the FCA Review, the condition must have been communicated to the customer in a clear manner and in good time before the transaction. A generic formulation referring for example to *"a notional amount, period and level of interest acceptable to the Bank"* does not constitute clear communication. The minimum requirements in terms of clear communication of the condition include:

1. The notional amount to be hedged must be specified; and
2. The duration of the required hedge must be specified.

According to the methodology agreed between the banks and the FCA, if these minimum requirements in terms of communication have not been met, then the condition must be disqualified as an illegitimate condition according to the Rules of the FCA Review.

Further examples of illegitimate conditions include:

- Cases where bank sales staff put in place the condition purely for commercial benefit without due regard for the needs of the customer. Such cases violate Rule 45; and

- Cases where the condition was imposed at the 'eleventh hour', for example where the customer had already committed to the purchase of a property. Such cases violate the *'in good time'* requirement in Rule 46.

In a number of cases, there was no credit rationale for the hedging condition. Sometimes the condition appears to have been imposed in order to facilitate the profitable sale of a complex IRHP to a non-sophisticated customer. According to the Rules of the FCA Review, such conditions should be disqualified as illegitimate conditions.

Full tear-up – Rules 16 and 17

The determination as to whether or not a hedging condition was legitimate is critical to the redress outcomes for the victims of IRHP mis-selling.

If the IRHP was mis-sold but the hedging condition was deemed legitimate, then the bank is entitled to redress the customer into an alternative IRHP (i.e. a swap-for-a-swap), thereby reducing or eliminating the amount of redress payable to the customer.

But if the hedging condition was not legitimate then the appropriate redress is deemed to be full redress, that is the full tear-up of the mis-sold IRHP with no replacement product. In such cases the customer is compensated in full for all past over-payments under the mis-sold product and is released from all future liabilities under the contract.

Rules 16 and 17 of the FCA Review, under the heading ***"Full tear-up"***, state as follows:

Rule 16. In the event of a non-compliant sale, where the IRHP was not a legitimate condition of the lending arrangement, and where the counter-factual is that the Customer would not have purchased an IRHP, fair and reasonable redress is presumed to be a full tear-up.

Rule 17. When considering the counter-factual, the firm can consider whether there was an express wish for interest rate protection (see para. 48 [i.e. Rule 48]*).*

Express wish for interest rate protection – Rules 48 to 51

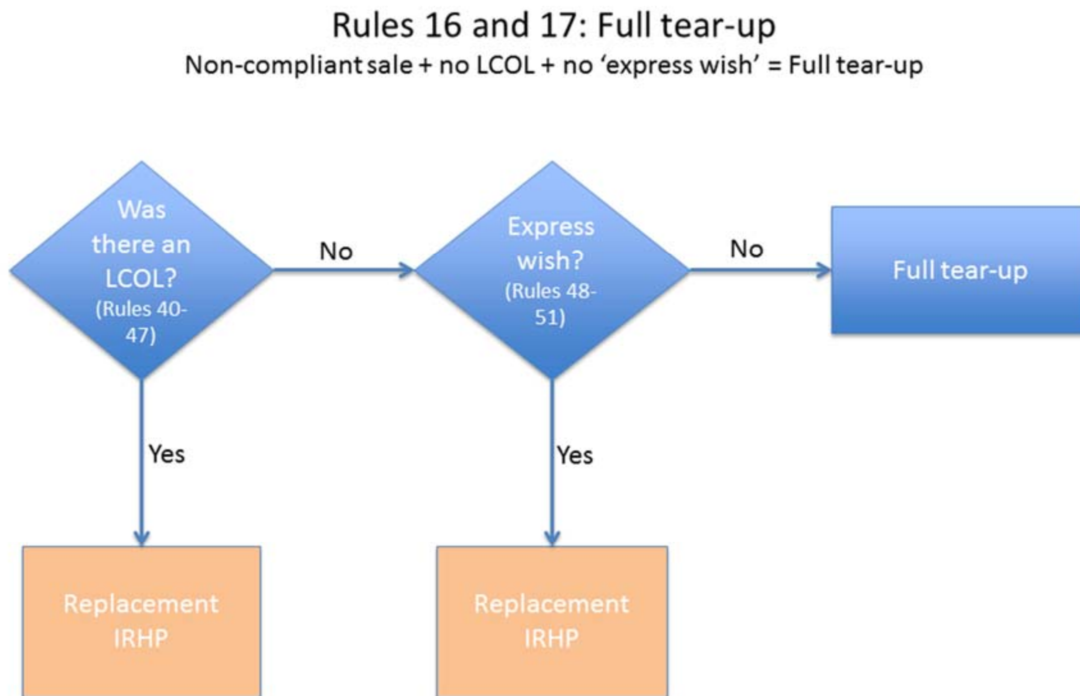
Rules 48 to 51 of the FCA Review, under the heading ***"Express wish for interest rate protection"***, set out the circumstances which must apply in order that the Bank may determine that the customer had an 'express wish' to purchase an IRHP.

According to the Rules, in order for an IRHP sale to qualify as a customer's 'express wish', there must have been an unsolicited request from the customer to purchase a specific IRHP; the discussion and the decision to have the IRHP must have been customer-led, not bank-led.

Logically, small business customers cannot be said to have had an 'express wish' to purchase an IRHP in cases where the bank introduced the subject of IRHPs via a lending condition, whether that condition was legitimate or illegitimate. In such cases the discussion and decision were led by the bank. Therefore, the IRHP was not the 'express wish' of the customer.

Fair and reasonable redress

According to Rules 16 and 17, where the sale was non-compliant, there was not an LCOL and there was no express wish, then fair and reasonable redress is presumed to be a full tear-up, as illustrated below.



Where an IRHP was mis-sold pursuant to an illegitimate lending condition, then the decision to purchase the IRHP cannot be said to have been the customer's 'express wish'. Therefore, according to the Rules of the FCA Review, fair and reasonable redress is presumed to be the full tear-up of the mis-sold product with no replacement IRHP.

If the lending condition was illegitimate, then swap-for-a-swap is not a legitimate redress outcome.

4. Inconsistent review treatment across banks

Unfortunately, there have been major inconsistencies between banks regarding the treatment of illegitimate lending conditions within the FCA Review. While in our experience the majority of the banks have observed the Rules of the FCA Review, RBS has not done so.

In many cases where full redress is due according to the Rules, notably the Rules about illegitimate lending conditions, RBS has instead imposed swap-for-a-swap outcomes on its customers. A material effect of this is a significant reduction in the compensation that would otherwise have been payable for the mis-sold IRHP. Sometimes no redress at all is paid, because the replacement swap is every bit as damaging as the originally mis-sold product.

As a result, RBS customers have been unfairly and inconsistently treated within the FCA Review compared to the customers of other banks.

Rule violations by RBS

RBS is the bank having the largest number of cases in the FCA Review, with more than 50% of all such cases.

Our analysis of 154 IRHP sales by RBS to non-sophisticated customers, attached below as Appendix I, indicates that in more than 80% of cases RBS relied upon a lending condition either to make the initial IRHP sale, or to justify its decision not to offer full redress, or both, even though the bank has admitted that it mis-sold the products.

The businesses most affected include property investors (50.7% of cases), care home operators (25%) and NHS GP practices (15.1%). The average losses suffered by these businesses were in the region of £650,000 per IRHP transaction.

Most of RBS's lending conditions that we have analysed have been illegitimate conditions according to the Rules of the FCA Review. Such conditions were imposed in order to generate IRHP sales rather than being based on a legitimate credit rationale.

The rules of the review require that, when considering the legitimacy of a credit condition, there should be evidence that the condition complied with the requirements of the credit function, such as the amount to be hedged and the duration. If the amount and duration have not been specified by the credit function, it cannot be a legitimate credit condition.

Most of RBS's conditions fail this test. Instead, RBS has tended to rely upon vague, generic wording in its loan documentation, typically requiring *"a hedging instrument acceptable to the Bank at a level, for a period and for a notional amount acceptable to the Bank"*. In the majority of cases the bank did not clearly communicate:

- which minimum amount to be hedged was acceptable; and
- which minimum period was acceptable.

Many of RBS's conditions were therefore not legitimate credit conditions but were imposed by sales staff to generate sales. In such cases, where the product was mis-sold, customers are entitled to full redress.

While other banks pay full redress in similar circumstances, RBS does not. It regularly relies on illegitimate lending conditions in order to justify swap-for-a-swap outcomes instead.

The rules about illegitimate lending conditions are important. If there was no credit rationale for the condition, then the customer was simply exposed to a swaps salesperson, incentivised to maximise the profit for the bank without due regard for the needs of the customer. The illegitimacy of such lending conditions was recognised by the regulators when the FCA Review was launched and its rules were drafted.

By relying on illegitimate lending conditions to justify swap-for-a-swap redress outcomes, RBS is treating its customers unfairly. Many RBS customers have felt pressured into accepting unsatisfactory redress outcomes, unaware that those outcomes were in breach of the Rules.

Role of the Independent Reviewer in the LCOL determination

KPMG accepted appointment as, and was approved by the FSA to act as, the 'Independent Reviewer' in respect of the redress scheme operated by RBS. Pursuant to this appointment, the Independent Reviewer undertook the responsibility for (inter alia) determining whether the redress offered to customers in individual cases was "appropriate, fair and reasonable".

The Independent Reviewer's duties therefore include the duty to check whether there was a legitimate condition of lending and, if so, to check whether that condition was communicated to the customer in a clear manner and in good time before the transaction. Specifically, the Independent Reviewer is required to ensure whether the notional amount to be hedged and the duration of the required hedge were clearly communicated to the customer.

The duty of Independent Reviewer extends to checking whether the bank imposed the condition based on a legitimate credit rationale or alternatively, whether the bank unfairly imposed the condition simply to generate a sale.

We consider it regrettable that KPMG appears to have neglected this important duty in a significant number of cases.

Contrasting treatment of LCOL by other banks

RBS's approach is out of step with the approach of other banks within the FCA Review, including Santander and Lloyds Bank.

In a recent case, the Santander review team advised that they couldn't pass the credit condition as legitimate because the tenor (minimum period) had not been specified:

> *"…**because they didn't specifically mention the tenor** … under the very, very strict definitions of whether the credit condition is legitimate in this Review, we can't pass it."*

Santander further clarified the methodology agreed with the FCA as follows:

> *"The Review states that you should tell the customer the amount that needs to be hedged and the tenor for which the hedge will run."*

The FCA has confirmed that the redress methodology is the same for all of the banks in the review. It therefore follows that RBS is in breach of the Rules when it relies upon illegitimate credit conditions, whereby the amount of hedging required and its duration were not specified by the bank's credit function.

Lloyds Bank is another bank which has in our experience conducted its review in accordance with the Rules. In a recent case, Lloyds Bank's initial redress decision was to offer the customer a replacement IRHP because it considered that there had been a legitimate condition of lending. At a post redress meeting it emerged that the condition had not been properly communicated to the customer, because the amount and duration had not been specified, and that as a consequence the condition had been illegitimate. An appeal was made to the bank's review team.

Lloyds Bank considered the information provided in the appeal and agreed that the lending condition had not been a legitimate condition. Accordingly, the bank changed the outcome of the review to offer full redress to the customer. The following is an extract from the bank's revised decision letter (with our emphasis):

> *"**Interest rate hedging was not a requirement** of the underlying borrowing being granted to you. However, you understood it to be a requirement … and took the products on this basis. In light of the above, **the outcome of the review … has changed and it has been determined that full redress is now due to you**."*

It has been our experience RBS's conduct of its review is significantly out of line with the conduct of other banks. RBS had repeatedly relied upon illegitimate lending conditions in order to justify swap-for-a-swap redress, in violation of the rules followed by the other banks.

Comment on the divergence of approach between RBS and the other banks

We understand that Lloyds Bank's methodology evolved through dialogue between the bank and its independent reviewer (Ernst & Young or 'EY'), with continuous reference to and meetings with the FCA to clear up any ambiguities.

We do not understand how or why the FCA has allowed the approach taken by RBS and its independent reviewer (KPMG) to diverge so much from the approach taken by the other banks.

When imposing hedging conditions, RBS rarely communicated to customers what amount was required to be hedged or for what duration, as was recently confirmed by an RBS case handler:

> *"I have got 700 cases that I manage, I've very rarely seen it drilled down to that specifics (sic)."*

Mark Spurin, Managing Director at RBS in charge of the bank's review team, accepted at a recent meeting that whether or not a condition of lending was legitimate is an important part of the review process and highly significant to the amount of redress payable. Mr Spurin acknowledged that RBS had often failed to specify to the customer the amount or the duration required by its hedging

conditions, but insisted that such specification was not required and that the bank's methodology had been approved by the FCA.

The role of the FCA

The FCA's duty is to protect consumers from the harm caused by bad conduct in the financial services industry. Swap mis-selling represents serious bank misconduct which has caused severe harm to small businesses customers. That harm is exacerbated for customers denied fair redress under the FCA Review.

Illegitimate lending conditions played an important role in the mis-selling, as was recognised at the outset of the review and when the Rules were drafted. If a condition was not based on a legitimate credit rationale but was imposed purely to generate a sale then it was not a legitimate condition, therefore redress is payable to the customer. The rules are the same for all of the banks.

We believe that the FCA should ensure consistency across the banks. The idea that RBS should be excused from following certain rules is incompatible with that requirement.

5. Recommendation

The approach adopted by RBS, whereby it relies on questionable lending conditions to impose swap-for-a-swap redress, compares unfavourably with the approach taken by the other banks in the FCA Review.

Lending conditions which would have been disqualified by other banks as illegitimate have been used by RBS to justify reductions to the redress payable to the victims of the bank's IRHP mis-selling.

Given that RBS is responsible for more than half of the cases in the FCA Review and has been relying on questionable lending conditions in an estimated 80% of those cases, we consider that this inconsistency of approach represents a serious failure of the FCA Review, affecting up to 40% of the small businesses involved.

The unfair treatment of RBS customers compared to the customers of other banks undermines the stated purpose of the FCA Review, which was to deliver fair and reasonable outcomes. It is also incompatible with the FCA's duty to ensure consistency across the banks.

Where standards diverge between banks, we consider that in order to ensure fair and consistent outcomes, the FCA should impose the standard that provides the best outcome to customers.

We therefore recommend that RBS's redress outcomes based upon lending conditions be re-reviewed. This is considered particularly important for those customers who have accepted unfair redress decisions, unaware that those redress decisions were determined in violation of the Rules of the FCA Review.

We further recommend that the re-review be performed not by KPMG but by a different firm of independent reviewers, for example by EY, the firm that reviewed the Lloyds Bank and Santander cases.

Author of the Report

This report has been prepared by Nick Stoop of Warwick Risk Management. Nick was an early pioneer of the swaps market and was the co-inventor of the asset swap, a technique which assisted the development of fixed income trading by removing the currency and interest rate risks from bonds and other fixed income securities, enabling those instruments to be valued and traded purely on a credit basis. Nick has advised central banks and supranational institutions including the World Bank on the structuring of derivative products and their application to the development of domestic bond markets.

Nick has fifteen years' derivatives experience in senior positions at major banks, including 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 swaps. Prior to entering the swaps market, Nick taught mathematics, having trained as an economist gaining a BA and an MA from Cambridge University.

Nick is currently acting as a consultant to individuals and small companies in the context of the FCA Review and to larger companies engaged in or considering litigation.

Acknowledgments

The author wishes to thank Nick Sandstrom of Warwick Risk Management for his assistance in the preparation of this report, as well as Adrian Maurice, CEO of Pragmaticum Limited and Jeremy Roe, Chairman of Bully-Banks, for their helpful comments and suggestions.

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Appendix I – Research data

The research data below is based on our analysis of 154 RBS transactions in the FCA Review. We have looked at the following:

1. The role of lending conditions in the IRHP sales process;
2. The average losses per transaction;
3. The types of business affected; and
4. RBS's share of the FCA Review population.

1. The role of lending conditions in the IRHP sales process

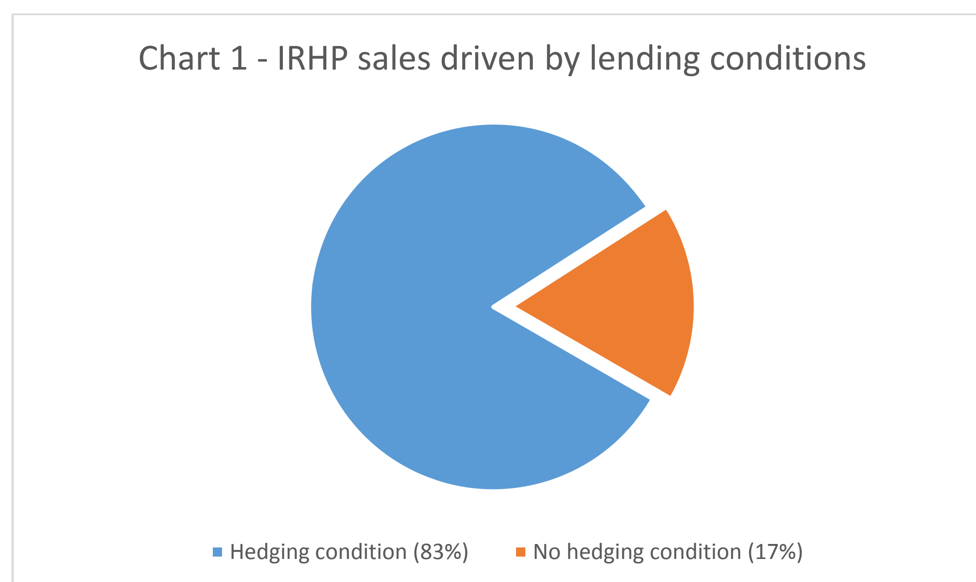

Chart 1 illustrates the fact that the majority (83%) of IRHP sales to small business customers were driven by lending conditions, i.e. the requirement that a borrower must purchase an IRHP as a condition of the related financing.

Most small businesses had no prior knowledge or experience of IRHPs before being obliged to purchase one as a condition of new financing or of the renewal of existing facilities.

The FSA and FCA have acknowledged that more than 90% of the IRHPs sold to unsophisticated customers were sold on the basis of inadequate disclosure by the selling bank of the risks involved.

2. Average losses per transaction

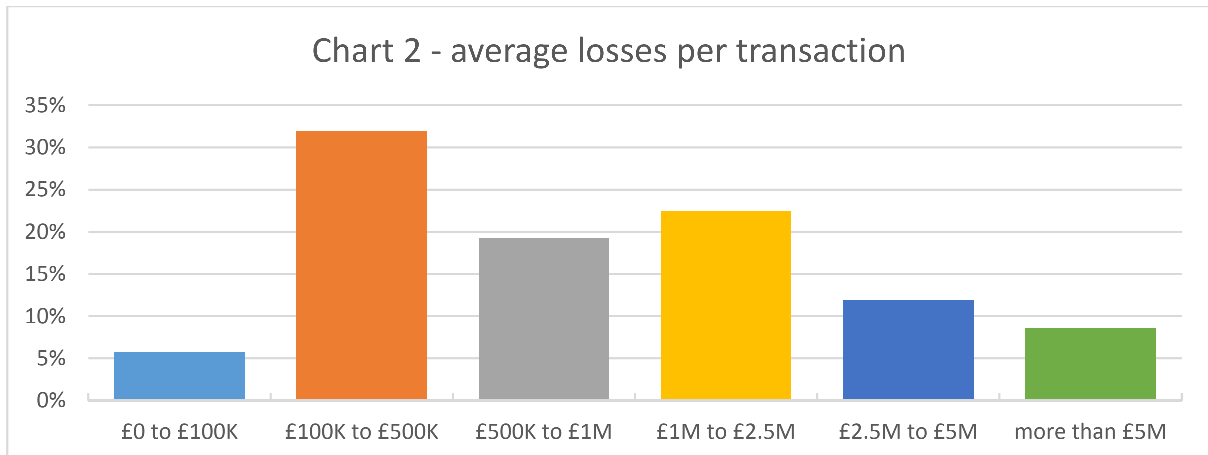

Chart 2 illustrates the serious adverse impact that mis-sold IRHPs have had on the small businesses affected.

The average loss per transaction was £648,000, although in more than 40% of cases the losses exceeded £1,000,000. Several NHS GP surgeries have suffered losses in excess of £2,500,000.

3. The types of business affected

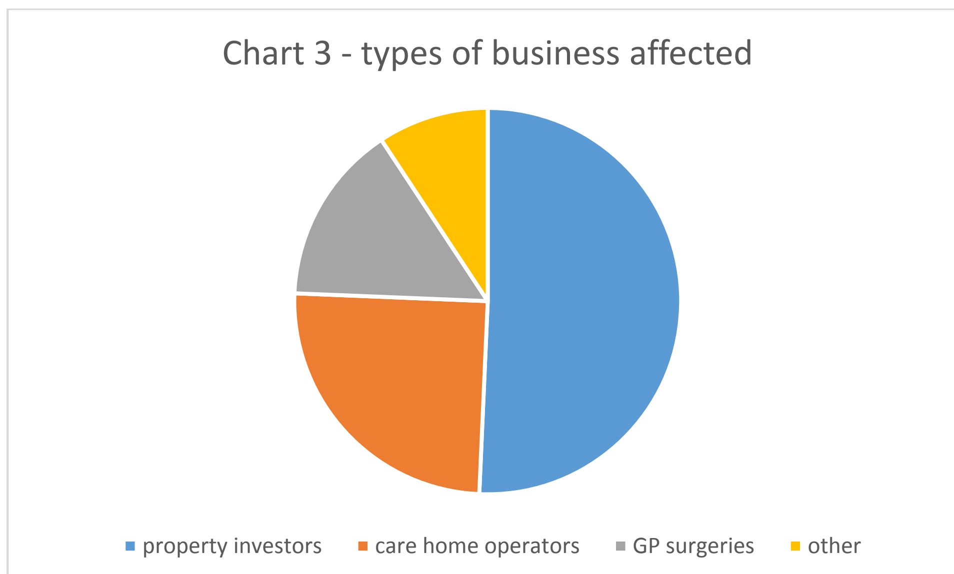

Chart 3 illustrates the types of businesses affected by IRHP mis-selling.

The largest cohort is property investors (51%) which includes private individuals and 'Mr and Mrs' companies as well as larger businesses such as hotels and public houses.

The healthcare sector has been particularly hard-hit, with care home operators accounting for 25% of IRHP sales and NHS GP surgeries a further 15%.

Other (10%) includes retailers, transport firms and industrial companies.

4. RBS share of the FCA Review population

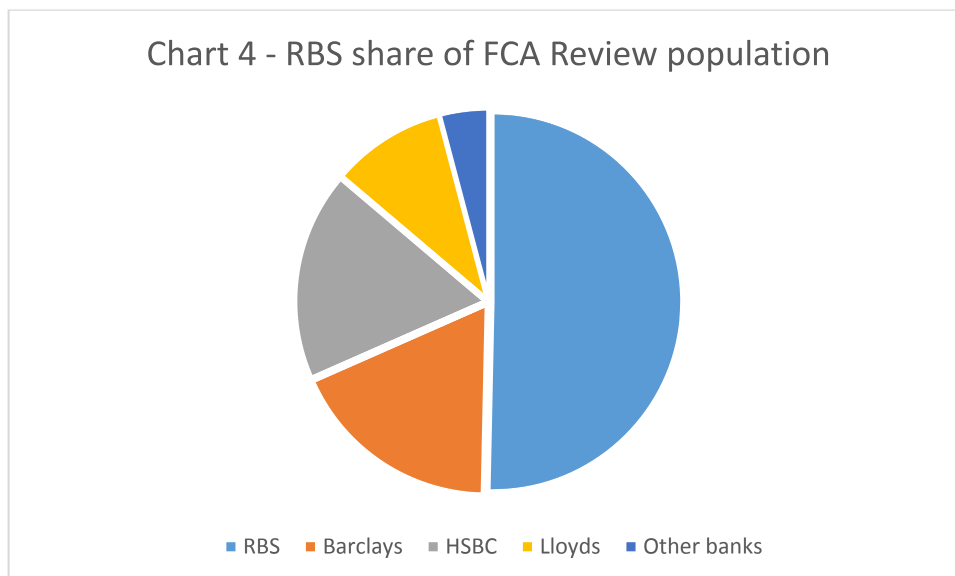

Chart 4 illustrates the relative numbers of customers of each bank within the FCA Review population.

RBS customers account for more than half (50.3%) of the FCA Review population.

Barclays and HSBC customers account for 18.1% and 17.8% respectively, with Lloyds customers a further 9.7%.

The remaining 4.1% are customers of the other banks in the FCA Review scheme, namely 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.

Appendix II – the Sales Standards

The sales standards (the '**Sales Standards**') listed below were agreed between the banks and the regulator for the purpose of the FCA Review. Failure by a bank to comply with one or more of the Sales Standards in the course of an IRHP sale means that the IRHP was mis-sold and that the customer is entitled to redress.

Sales Standard 1
In good time before conclusion of the contract, the Firm has provided the Customer with appropriate, comprehensible and fair, clear and not misleading information on the features, benefits and risks associated with the Interest Rate Hedging Product.

Sales Standard 2
In good time before conclusion of the contract, the Firm has provided the Customer with an appropriate, comprehensible and fair, clear and not misleading disclosure of any potential break costs.

Sales Standard 3
The Interest Rate Hedging Product does not exceed the term or value of any lending arrangements without a legitimate reason, and if it does, the potential consequences have been disclosed to the Customer in a comprehensible and fair, clear and not misleading way.

Sales Standard 4
The Firm has had due regard to the information needs of the Customer and provided comprehensible, and fair, clear and not misleading information about the features, benefits and risks of relevant alternative Interest Rate Hedging Products.

Sales Standard 5
In relation to an advised sale: The Firm has obtained sufficient personal and financial information about the Customer, including the Customer's investment, level of education, profession or former profession and relevant past experience of Interest Rate Hedging Products. The Firm has taken reasonable steps to ensure that the personal recommendation is suitable for the Customer.

Sales Standard 6
In relation to a non-advised sale, no advice has been given to the Customer during the sales process.

Sales Standard 7
In relation to a non-advised sale on or before 31 October 2007, the Firm has taken reasonable steps to ensure that the Customer understands the nature of the risks involved and provided the Customer with the relevant risk warning notice.

Sales Standard 8
In relation to a non-advised sale on or after 1 November 2007, the Firm has assessed whether entering into the Interest Rate Hedging Product is appropriate for the Customer by determining whether the Customer has the necessary knowledge and experience to understand the risks involved. The Firm has obtained information regarding the client's level of education, profession or former profession, and relevant past experience of Interest Rate Hedging Products.

Appendix III - Examples of non-compliant redress determinations

Example 1: NHS GP surgery in Wales

Background

In 2006, RBS sold the partners in the NHS GP practice a 20-year swap. The swap has caused and continues to cause significant damage to the practice and has imposed losses to date of more than £600,000, with potential future losses of £1,400,000 by the expiry of the contract. The contingent liability incurred as the result of the swap has deprived the surgery of vital business flexibility, including the ability to attract new doctors into the practice.

Non-compliant sale

None of the partners in the surgery had any prior knowledge or experience of interest rate hedging products before RBS inserted the condition that they must purchase an IRHP into their loan agreement. The swap was sold in violation of several of the Sales Standards and on the basis of inaccurate and misleading information provided by the swap salesman:

- The salesman violated Sales Standard 2 by telling the doctors that the swap would have no break cost if interest rates remained unchanged. In truth, the swap carried an immediate break cost of £130,000;
- The amount and duration of the swap exceeded the associated loan, in breach of Sales Standard 3; and
- No cap was offered, in breach of Sales Standard 4, even though a cap premium would have been easily affordable to the doctors.

Illegitimate hedging condition

The hedging condition was vaguely worded, whereby the required hedging must be *"for a period and for a notional amount acceptable to the Bank"*. At a post redress meeting, the RBS case handler was unable to explain what the requirements of the credit function were and admitted that neither the acceptable amount nor the required period had ever been communicated the customer. The hedging condition was therefore not a legitimate credit condition according to the Rules of the FCA Review.

Appropriate redress outcome

The swap was sold in violation of the Sales Standards and on the basis of an illegitimate lending condition. Therefore, according to the Rules of the FCA Review, appropriate redress is presumed to be the full tear-up of the mis-sold swap with no replacement IRHP.

RBS redress outcome

RBS imposed a replacement swap inflicting historic losses calculated by the bank at more than £560,000 at July 2014, which losses continue at the rate of approximately £27,000 per month until 2027. The case handler estimated that the doctors faced future losses under the replacement swap to be in the order of £1,400,000. RBS's principal justification for the imposition of the replacement swap read as follows:

> *"The purchase of an IRHP was a legitimate condition for entering into the associated lending arrangement … Therefore an appropriate IRHP is required as redress."*

Example 2: Group of care homes in the South of England

Background
The group cares for more than 300 people in six different locations. The owners of the group both have backgrounds as mental health nurses and had no prior knowledge or experience of interest rate hedging products before RBS inserted the condition that they must purchase an IRHP into a 2006 loan agreement. They had in fact expressed a strong preference for floating rate funding but RBS offered them only a selection of complex IRHPs and did not include a simple cap among the hedging options. The group was prompted to purchase a swap which inflicted losses of more than £1,000,000, severely damaging the business.

Non-compliant sales
RBS acknowledged that the sale of the swap was in breach of the Sales Standards:

- Inadequate and misleading advice was given about the potential break costs, in violation of Sales Standard 2. The salesman implied there would be no break cost unless the market moved, whereas in truth the swap contained an immediate and undisclosed built-in cost of £150,000 (RBS's up-front profit on the transaction); and
- RBS offered only complex and high-risk products to its inexperienced customer and did not include the risk-free cap in the menu of hedging options, in violation of Sales Standard 4.

Illegitimate hedging condition
The loan agreement contained a condition required the purchase of an IRHP *"for a period and for a notional amount acceptable to the Bank"*. At no stage did RBS communicate to the customer either the required period or the required amount, meaning that the condition was not a legitimate condition according to the rules of the FCA Review. Each of the products between which the customer was obliged to choose had the effect of impairing the customer's credit standing.

Appropriate redress outcome
The swap was sold in violation of the Sales Standards and on the basis of an illegitimate lending condition. Therefore, according to the Rules of the FCA Review, appropriate redress is presumed to be the full tear-up of the swap with no replacement IRHP.

RBS redress outcomes
RBS imposed a replacement swap which inflicted historic losses of more than £1,000,000, all but eliminating the redress that should have been paid. RBS's principal justification for the replacement swap read as follows:

> *"The purchase of an IRHP was a legitimate condition for entering into the associated lending arrangement … Therefore, an appropriate IRHP is required as redress."*

Example 3: Family-run business in East Anglia

Background
In 2008, RBS sold the business a 10-year bank-cancellable swap. The swap was cancellable after 5 years at the option of RBS at which stage it was a "lose/lose" bet for the customer. If interest rates remained low, the customer would either have to pay a break penalty or else suffer losses on the swap for the remainder of the 10 years. But if interest rates increased, the customer would not profit, because the bank could cancel the swap (at no penalty), leaving the customer exposed to high rates.

Non-compliant sale
The customer had no knowledge or experience of interest rate hedging products before being prompted to enter the swap pursuant to a hedging condition.

RBS acknowledged that the sale of the swap was in breach of several of the Sales Standards:

- RBS failed to provide adequate disclosure of the potential break costs of the swap, in breach of Sales Standard 2;
- RBS admitted over-hedging, whereby the term and value of the swap were greater than the term and value of the loan, in breach of Sales Standard 3; and
- RBS failed to provide adequate information about relevant alternative IRHPs, notably risk-free caps.

Illegitimate hedging condition
The hedging condition was in the loan agreement which was transmitted to the customer less than 24 hours before the swap was transacted. The condition was vaguely worded, whereby the required hedging must be *"for a period and for a notional amount acceptable to the Bank"*. At a post redress meeting, the RBS case handler admitted that neither the acceptable amount nor the required period had ever been communicated the customer, meaning that the condition was not a legitimate condition according to the rules of the FCA Review.

Appropriate redress outcome
The swap was sold in violation of the Sales Standards and on the basis of an illegitimate lending condition. Therefore, according to the Rules of the FCA Review, appropriate redress is presumed to be the full tear-up of the mis-sold swap with no replacement IRHP.

RBS redress outcome
RBS imposed a replacement swap inflicting historic losses on the customer calculated by the bank at more than £550,000. RBS's principal justification for the replacement swap read as follows:

> *"The purchase of an IRHP on terms acceptable to the bank was a legitimate condition for entering into the associated lending arrangement … Therefore, we have offered you redress to an alternative IRHP that satisfies this condition."*

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Example 4: Individual owning a food packaging business

Background

RBS sold the individual an interest rate collar in 2006 and in 2008 restructured the collar into a larger swap. The 2008 swap was £1.25 million larger in amount than the associated loans and had a 10-year term, compared to the 5-year term of the loans. The losses on the IRHPs contributed to the insolvency of the individual's company, which prior to the IRHPs had been one of the largest of its type in the UK.

Non-compliant sales

The individual had no prior knowledge or experience of interest rate hedging products before RBS inserted the condition that he must purchase an IRHP into the 2006 loan agreement. RBS acknowledged that the sales of the IRHPs were in breach of several sales standards:

- RBS admitted that it failed to provide adequate disclosure of the potential break costs, in breach of Sales Standard 2;
- RBS admitted over-hedging, whereby the term and value of the 2008 swap were greater than the term and value of the related loans, in breach of Sales Standard 3; and
- RBS admitted that it had failed to provide adequate information about relevant alternative IRHPs, in breach of Sales Standard 4.

In the course of the 2008 sale, RBS's salesperson provided inaccurate and misleading information to the individual, telling him that that the market consensus was for interest rates to rise over the long term when the opposite was true. The market consensus was reflected in the inverted yield curve for swaps, whereby future interest rates were trading at lower levels than current rates.

Illegitimate hedging conditions

The 2006 loan agreement contained a condition required the purchase of an IRHP *"for a period and for a notional amount acceptable to the Bank"*. At a post redress meeting, RBS acknowledged that at no stage had it communicated to the customer either the required period or the required amount, meaning that the condition was not a legitimate condition according to the rules of the FCA Review.

There was no hedging condition at all in the loans related to the 2008 swap, although RBS argued that the 2006 condition "carried over" into the 2008 transaction. Given that the 2006 condition was an illegitimate condition, the 2008 condition was also not a legitimate condition.

Appropriate redress outcome

The IRHPs were sold in violation of the Sales Standards and on the basis of illegitimate lending conditions. Therefore, according to the Rules of the FCA Review, appropriate redress is presumed to be the full tear-up of both products with no replacement IRHPs.

RBS redress outcomes

RBS imposed replacement IRHPs inflicting historic losses calculated by the bank at more than £550,000. RBS's principal justification for the replacement IRHP in each case read as follows:

> *"The purchase of an IRHP was a legitimate condition for entering into the associated lending arrangement…"*

Example 5: NHS GP surgery in the Midlands

Background
In 2006, RBS sold the surgery a long-dated swap. The swap has caused severe damage to the business and inflicted losses in the region of £2,000,000.

Non-compliant sale
The swap was sold pursuant to an illegitimate lending condition and on the basis of negligent and misleading information provided by RBS to the principals, who had no prior knowledge or experience of interest rate hedging products.

The swap was sold in violation of several of the Sales Standards:

- RBS admitted that it failed to provide adequate disclosure of the potential break costs, in breach of Sales Standard 2;
- RBS explained that over-hedging might occur, but did not explain the potential adverse consequences of the over-hedging, in violation of Sales Standard 3; and
- RBS failed to provide adequate information about relevant alternative IRHPs, in breach of Sales Standard 4.

Illegitimate hedging condition
The 2006 loan agreement contained a condition required the purchase of an IRHP *"for a period and for a notional amount acceptable to the Bank"*. RBS also provided a 'Pitch Book' presentation but that document made no reference to any hedging condition, let alone specify the period and notional amount that would be acceptable to the bank. The hedging condition was therefore not a legitimate condition according to the Rules of the FCA Review.

Appropriate redress outcome
The swap was sold in violation of the Sales Standards and on the basis of an illegitimate lending condition. Therefore, according to the Rules of the FCA Review, appropriate redress is presumed to be the full tear-up of the swap with no replacement IRHP.

RBS redress outcome
RBS determined that even if the sale had been compliant the customer would have purchased an identical IRHP. RBS's principal justification for the determination read as follows:

> *"The purchase of an IRHP was a legitimate condition of your borrowing…"*

Example 6: Small business in the Home Counties

Background
RBS sold the business an interest rate swap in 2007. The swap caused severe damage to the business and has inflicted losses of more than £800,000. The swap had a duration of 15 years even though the related loan was for only 5 years, meaning that the swap continued to damage the business even after the loan had expired.

Non-compliant sale
The business had no prior knowledge or experience of interest rate hedging products before RBS inserted the condition that it must purchase an IRHP into its loan documentation. The sale of the swap was in breach of several of the Sales Standards and was made on the basis of distinctly unsuitable advice provided by the swap salesman.

- RBS admitted that it failed to provide adequate disclosure of the potential break costs, in breach of Sales Standard 2;
- The swap represented considerable over-hedging, in breach of Sales Standard 3, because it was for 15 years compared to the loan which expired after 5 years; and
- RBS admitted that it had failed to provide adequate information about relevant alternative IRHPs, in breach of Sales Standard 4.

The salesman advised the business that over-hedging a 5-year loan with a much longer dated swap would be ***"prudent"*** even though one of the principals in the business was 68 years old and suffering from cancer.

Illegitimate hedging condition
The loan agreement contained a condition required the purchase of an IRHP *"for a period and for a notional amount acceptable to the Bank"*. At no stage had did the Bank communicate to the customer either the required period or the required amount, meaning that the condition was not a legitimate credit condition according to the Rules of the FCA Review.

Appropriate redress outcome
The swap was sold in violation of the Sales Standards and on the basis of an illegitimate lending condition. Therefore, according to the Rules of the FCA Review, appropriate redress is presumed to be the full tear-up of the swap with no replacement IRHP.

RBS redress outcome
RBS imposed a replacement IRHP inflicting historic losses calculated by the bank at more than £590,000. RBS's principal justification for the replacement IRHP read as follows:

> *"The purchase of an IRHP was a legitimate condition for entering into the associated lending arrangement, therefore we are required to redress you into an IRHP."*