

INTEREST RATE HEDGING PRODUCTS

Executive Summary

Interest rate hedges include a variety of different products sold to customers to help protect them against interest rate risk. In principle, interest rate hedging products can meet customers' needs, as they provide greater certainty over future loan repayments. However, these products can also be very complex and, therefore, susceptible to mis-selling.

Our review has found serious failings in the sale of interest rate hedging products to small and medium sized businesses (SMEs). We have evidence which raises concerns about the sales we have reviewed in certain banks. These concerns include (i) inappropriate sales of more complex varieties of interest rate hedging products (such as structured collars) and (ii) a number of poor sales practices used in selling other interest rate hedging products. We also found that sales rewards and incentive schemes could have exacerbated the risk of poor sales practices. Practices varied across banks, but we found sufficient evidence of poor practices to justify action by the FSA.

Interest rate hedging products can be an appropriate product when properly sold in the right circumstances. However, when sold to customers who are likely to lack expertise and understanding of the product (i.e. 'non-sophisticated customers'), some interest rate hedging products may be inappropriate.¹ In order to provide a swift solution for customers, we have reached agreement with Barclays Bank Plc ("Barclays"), HSBC Bank Plc ("HSBC"), Lloyds Banking Group ("Lloyds") and The Royal Bank of Scotland Plc and National Westminster Bank Plc (collectively "RBS") banks to provide appropriate redress where mis-selling has occurred. We have agreed with Barclays, HSBC, Lloyds and RBS that they will:

- (i) provide fair and reasonable redress to non-sophisticated customers who were sold structured collars,
- (ii) review sales of other interest rate hedging products (except caps or structured collars) to non-sophisticated customers; and
- (iii) review the sale of caps if a complaint is made by a non-sophisticated customer during the review.

The exercise for each bank will be scrutinised by an independent reviewer and overseen by the FSA.

Background

Interest rate hedging products are typically separate to a loan and, if so, are regulated by the FSA. These products were frequently marketed to customers who had a loan with the bank. There are broadly four types of products that have been sold to customers:

- swaps – enabling the customer to 'fix' their interest rate;
- caps – placing a limit on any interest rate rises;
- collars – enabling the customer to limit interest rate fluctuations to within a simple range; and
- structured collars – enabling a customer to limit interest rate fluctuations to within a specified range, but involves arrangements where, if the reference interest rate falls below the bottom of the range, the interest rate payable by the customer may increase above the bottom of the range.

¹ For these purposes we have defined 'sophisticated customer' as: in the financial year during which the sale was concluded, a customer who met at least two of the following: (i) a turnover of more than £6.5 million; or (ii) a balance sheet total of more than £3.26 million; or (iii) more than 50 employees. Alternatively, the firm is able to demonstrate that, at the time of the sale, the customer had the necessary experience and knowledge to understand the service to be provided and the type of product or transaction envisaged, including their complexity and the risks involved.

We have focused on the sales of interest rate hedging products since 2001, but the greatest volumes were sold in the period 2005-2008, before the base rate fell sharply to its current, sustained, historic low. During this period, some banks reduced the minimum loan value for which they were willing to offer interest rate hedging products, widening the target market of customers.

A number of customers have complained, directly to us, through their MPs and the media, that they were mis-sold interest rate hedging products by the major retail banks. Many complainants indicated that they believed they were purchasing hedges with a view to reducing their vulnerability to interest rate increases or fluctuations on loans they had taken out, but were given inadequate explanation of the risks involved. These risks included the scale of the any potential exit costs', the element of speculation that existed in regard to structured collar products and the risks the customer would face if the base rate fell significantly.

Over the past two months we have reviewed a significant amount of documentation from the banks (including sales files, customer complaints and telephone calls). We have also talked to over 100 customers who came forward so we could better understand their experience.

Summary findings

Product complexity

Interest rate hedging products can protect customers against the risk of interest rate movements and can be appropriate when properly sold in the right circumstances. However, there are some products that are particularly complex, and that also introduce a degree of interest rate speculation. This is particularly the case with 'structured collars' which can effectively result in customers paying more if base rates fall below an agreed level, requiring a very finely balanced judgement on the part of a customer.

Sales practices

We have found evidence of a number of poor sales practices across a number of products. These practices vary across banks and include:

- 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.

We also found evidence of poor record keeping.

We have communicated our findings to each bank directly.

Next steps

Barclays, HSBC, Lloyds and RBS

We have categorised the products into three broad groupings to reflect the complexity. The treatment of customers will vary depending on which category their product falls in.

We have agreed with Barclays, HSBC, Lloyds and RBS that they will:

- (i) provide redress on the sale of structured collars to 'non-sophisticated customers' made on or after 1 December 2001;

- (ii) review sales of other interest rate hedging products (except caps or structured collars) for ‘non-sophisticated customers’ on or after 1 December 2001; and
- (iii) review the sale of a cap if a complaint is made by a ‘non-sophisticated customer’ during the review. Complaints from sophisticated customers will not be subject to the past business review but will be dealt with in accordance with the banks’ usual complaints handling procedures.

The exercise will be scrutinised by an independent reviewer and be overseen by the FSA. Not all customers will be owed redress, but for those that are, the appropriate redress for each customer will be determined on the basis of what is fair and reasonable, and could include a mixture of cancelling or replacing existing products with alternative products, and partial or full refunds of the costs of those products.

CEOs have personally confirmed that they will have responsibility for oversight of this exercise within their bank and will ensure that complainants are treated fairly. They have also committed that, except in exceptional circumstances such as, for example, where this is necessary to preserve value in the customer’s business, they will not foreclose on or adversely vary existing lending facilities, without giving prior notice to the customer and obtaining their prior consent, until a final redress determination has been issued or redress provided to the customer.

Future sales

We have agreed with Barclays, HSBC, Lloyds and RBS that they will cease marketing structured collars to ‘retail clients’².

Other banks

Our review has focused on the four major retail banks. Our intention is to contact the other banks who have sold interest rate hedging products (which represent a small proportion of the sales) with a view to determining whether similar practices have occurred and, if so, agreeing a similar course of action.

FOS eligibility criteria

We have written to the Financial Ombudsman Service (FOS) today inviting the scheme operator to think about whether, working with the FSA and the industry, there could be a specific scheme for dealing with the outcome of the review and related matters.

What this means for customers

Customers of Barclays, HSBC, Lloyds and RBS

Structured collars

As a result of the agreement with Barclays, HSBC, Lloyds and RBS , for customers who bought structured collars:

- the bank(s) will contact customers to explain whether they fall within the scope of the review (i.e. whether they are considered sophisticated or not);
- if they fall within the scope of the review they may need to respond to requests for information from their bank;

² ‘Retail clients’ as defined under our rules.

- the bank(s) will propose fair and reasonable redress, which is reviewed and agreed by the independent reviewer; and
- once the customer agrees the redress proposal, they will be issued with a final redress proposal.

Other interest rate hedging products (except caps or structured collars)

Customers who bought other interest rate hedging products (except caps or structured collars) from Barclays, HSBC, Lloyds or RBS will be:

- contacted by their banks to explain whether or not they are considered non-sophisticated.;
- if they fall within the scope of the review (i.e. determined to be non-sophisticated) their bank will ask them whether they want their sale to be reviewed;
- if the customer wants their sale to be reviewed, they may need to respond to requests for information from their bank;
- where it is appropriate in the individual circumstances, the bank(s) will propose fair and reasonable redress on a case by case basis, which is reviewed and agreed by the independent reviewer; and
- once the customer agrees the redress proposal, they will be issued with a final redress proposal.

Caps

Customers who purchased caps are not included in the scope of the review unless they complain to their bank during the course of the independent review and are non-sophisticated customers. If the customer does complain, it will be considered in the same way as the other interest rate hedging products (except structured collars) category. However, if a customer complains after the independent review their complaint will be dealt with in accordance with the banks' usual complaints handling procedures.

Previous complaints

In most cases, those customers who have previously complained to their banks or the FOS will still be subject to this review.

FOS rights

If customers are not satisfied with the outcome of the review they will still have the opportunity to refer their complaint to the Financial Ombudsman Service subject to meeting the eligibility criteria.³ If the customer does not meet the ombudsman service's eligibility criteria, or they believe that they have suffered a loss that is more than £150,000, then they will need to consider whether to take action through the courts.

Sophisticated customers

Customers sold interest rate hedging products who fall outside the definition of non-sophisticated customers are not within the scope of this review. They may complain and their complaint will be dealt with in accordance with the banks' usual complaint handling procedures

Claims management companies

³ The FOS is able to consider complaints brought by micro-enterprises against FSA-regulated firms. A micro-enterprise is a business that has a turnover or an annual balance sheet not exceeding 2 million Euros and employs fewer than ten persons.

There are specialist claims management companies and law firms who may offer to submit a customer's complaint to the bank or the FOS. However, they will charge for using their services. They may ask for a fee up front, or offer to act on a 'no win, no fee' basis - meaning they will take a proportion of any redress customers may be given. This may be as much as a third of any money due back to the customer. Customers do not need to use a claims management company because the process is straightforward.