HOUSE OF COMMONS LIBRARY

DEBATE PACK

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Commercial Financial Dispute Resolution Platform

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Summary

This debate is a call for the establishment of a broader and more inclusive system of dispute resolution of commercial disputes in financial services than currently exists. The debate is scheduled for 15 December 2016 in the Chamber. It is sponsored by George Kerevan MP (SNP).

The background is that there have been two separate ongoing issues between banks and small firms – interest rate swaps and the RBS global restructuring group – which have both highlighted the limitations of the Financial Conduct Authority (FCA) in providing a remedy when the activity is at or beyond the edge of the regulatory perimeter.

Compromise settlement procedures – or bespoke schemes as the FCA called them - overseen by the FCA and accepted by the banks, have been lengthy and have produced unequal results. Significant compensation was provided to many but others felt left out of the process due to technicalities. The other issue took even longer to resolve, followed multiple Reports which have yet to be acted upon.

With the possibility of future, similar issues arising, the debate calls for regulators and industry groups to work together "to create a sustainable platform for commercial financial dispute resolution". The issue was first raised during an evidence session of the Treasury Committee by the head of the FCA Andrew Bailey.

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1. Background

1.1 Introduction

It is hard to have missed the fact that the financial services sector has been embroiled in 'scandals' with its customers over 20 years at least. From endowment mortgages to bank charges to PPI misselling, the list goes on. Resolving these consumer issues has cost the industry billions of £s; but at least there has been a resolution, thanks, in the main, to the offices of the Financial Ombudsman Service (FOS) which provides a relatively speedy and free compensation service to individuals and small firms. However, this protection only applies where the complaint is about a regulated activity by an authorised person. Where the activity is beyond this perimeter the FOS (nor the Financial Services Compensation Scheme which provides compensation when firms become unable to meet their commitments) cannot help.

Box 1: Regulatory perimeter

Where the perimeter lies is not always straightforward but broadly it is set out in the list of regulated activities under the Financial Services and Markets Act 2000. Since the Act was first passed its scope has widened hugely, as more areas were seen to be needing regulation. For example mortgages were broadly absent to begin with and, recently, the FCA has become responsible for consumer credit.

There have been two separate ongoing issues between banks and small firms – the sale of interest rate hedging products and the actions of the RBS Global Restructuring Group – which have illustrated the limitations of the Financial Conduct Authority (FCA) in providing a remedy when the activity is at or beyond the edge of the regulatory perimeter.

Compromise settlement procedures overseen by the FCA and accepted by the banks, have been lengthy and have produced unequal results. Significant compensation was provided to many but others felt left out of the process due to technicalities.

1.2 Initial discussion of future remedy.

The impetus for this debate came from an exchange in oral evidence sessions at the Treasury Select Committee shown below. Andrew Bailey is Chief Executive of the Financial Conduct Authority; the PRA is the Prudential Regulation Authority. Mr Bailey considered whether there was the need for another body to operate in these 'grey' areas.

> **Q144 George Kerevan**: Do you draw any general conclusions about these ad hoc redress schemes and how we can move forward on that?
>
> **Andrew Bailey:** I do. The problem goes back to what I said right at the beginning, which is that, when it is outside the regulatory perimeter, these are schemes that are created by the firm. We, as I said earlier, have levers that we can use on them, and we do. However, what I have learnt from my IRHP involvement, coming late into it, is that people feel that they have not had their day in

> court. Now, they do not want to have a literal day in court because that is obviously very expensive. However, what I conclude from this is that it is not satisfactory from the point of view of the FCA, because the FCA has been involved in creating a lot of bespoke processes. We discussed this on the board a number of times. Were there to be a mechanism that could substitute for these—let us loosely call it a tribunal, for the sake of argument—rather like the ombudsman but for more complex cases, because corporate cases often are more complex, this would be a big step forward. From the point of view of the things that come out, we are creating a lot of work for ourselves. However, I am very sympathetic to the people involved, so we have to do it. However, if there were to be a process that could substitute for this and to which people could go and know that they could go, I think this would be a big step forward.
>
> […]
>
> **Q149 George Kerevan**: You have said throughout the Committee hearing today, and you say again in this report, that one of the issues is that we are dealing with a set of redress cases that arose from unregulated products being sold by regulated bodies, and that leaves you in an anomalous position when it comes to dealing with them. What would you change? Where should the debate go in order to try to deal with that?
>
> **Andrew Bailey**: You can do that in a number of ways. You could extend the regulatory perimeter. I am not sure that the case is proven for that. Or, coming back to your previous point, you say that you now have the senior managers regime. Let me step back for a moment. One of the differences between the PRA and the FCA is that the PRA, naturally in prudential supervision, looks at the whole firm because firms obviously stand or fall together. FCA conduct supervision is done by activity. That is a big difference. However, the FCA has now got more whole-firm tools—it has always had some—from the senior managers regime as well as the fitness and properness requirements. Now, you could say that—and this is certainly worth looking at—we have got that and it gives you more of a hold over the firm. If we were to go back to our previous conversation and say that we could solve the complaint scheme/redress process—which frankly is the most difficult part of this—through some form of tribunal, I think we should answer the question before opting for extending the regulatory perimeter. Do you think that acceptably does it? That is a valid question to tackle.[1]

1.3 Perimeter Issues

Interest rate hedging products

The interest rate swap 'scandal' is complex.[2] Indeed it is the very complexity that is at the heart of the claims for compensation.

In short:

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[1] Treasury Select Committee hearing 8 November 2016

[2] One aspect of the complexity is that different methods or products were sold that went under different names. Sometimes this subject is referred to under the broader title of interest rate hedging products.

- A complex financial product was taken out by a large number of small businesses. The purpose of the product was to protect borrowers from rising interest rates.
- The banks claimed that their customers knew what they were buying and that they were under no pressure to take out the cover. Customers said that they had no idea what they had bought and that the cover had been a condition of being granted the loan (or overdraft) they had gone to their bank for in the first place.
- Most of the loans appear to have been sold by specialist sales persons rather than the normal relationship manager the customers dealt with.
- A consequence of the financial crisis was a dramatic fall in interest rates to unimaginable, historic low levels. The 'swap' protection was therefore wildly unnecessary.
- Customers were now on loans at very high (relative) interest rates which they could not escape from because the banks refused to break the contract unless they were compensated for the loss of interest on these expensive loans. The sums requested by the banks for breaking the contracts frequently ran into the £100,000s.
- But the contracts were often constructed such that the bank could terminate after a period of, say, five years. So, if interest rates had not fallen so dramatically, or had actually risen in the interim, the borrower would not have benefited from the 'cap' protection because the bank would have cancelled the contract. But as the bank was benefiting it obviously wouldn't cancel.

By about 2010/11 therefore, as the UK economy headed towards recession, a significant number of small firms were being told that they could not stop paying excessive market rates on their loans because they had signed up to years and years of 'protection', in a contract they could not understand. Their only way out was to pay their bank £100,000s to escape. Many were not happy.

By 2012 the issue had surfaced in a backbench members' debate[3] and the Financial Services Authority (FSA) was outlining its approach to the Treasury Committee, as set out in this letter from the then Chairman of the FSA, Adair Turner, to the Chair of the Committee.

The FSA began an investigation which focused heavily on the issue of complexity and whether small businessmen really had the competence to judge what they had signed up to. In its summary findings it found major faults with the products and the way they were sold and to whom.[4]

[3] HC Deb 21 June 2012, c1085
[4] FSA Update, June 2012

It then tried to establish a consistent redress scheme with the banks. Most of the work was left to the banks to review what they had done and judge, against the FSA's principles, whether they had mis-sold. An independent reviewer was supposed to observe proceedings however, their role is much debated by unhappy businessmen. Since the scheme itself has subsequently come in for significant criticism the details are shown below. All nine banks which sold these products were part of the Review. The FSA said:

> 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.[5]

In January 2013 the FSA reported the result of a 'pilot' in-depth review of a sample of cases. It found that over 90% of the sales did not comply with one or more regulatory requirement. A significant proportion of the 173 cases were likely to result in redress being due to the customer.

The table below is a summary of the outcomes from the review.

[5] Ibid, p4

Interest rate swap review

Outcomes to:	Jun-15	Dec-14
Joining the review		
Sophistication assessments completed	100%	100%
Customers invited to join review	20,200	19,100
Overall customer opt-in rate	90%	89%
Compliance		
Compliance assessments complete (% of customers opted in)	97%	100%
Overall rate of non-compliant sales	90%	100%
Redress		
Redress determinations complete (including compliant and non-compliant sales where no redress is due)	17,600	17,000
Redress determination letters sent (including compliant and non-compliant sales where no redress is due)	17,600	17,000
Outcomes		
Offers accepted ('full tear up' and alternative product offers)	12,540	11,270
Redress paid *(£ millions)*	£1,991	£1,785
Outcomes where no redress is due	3,428	2,855

Source: Financial Conduct Authority

The Financial Conduct Authority (which inherited the Review from the FSA) commented towards the end of summer 2016 that:

> The banks have sent 18,200 redress determinations to customers, 14,700 of which include a cash redress offer, and 3,500 confirm that the IRHP sale complied with our rules or that the customer suffered no loss.
>
> To date, around 13,900 customers have accepted a redress offer and £2.2 billion has been paid out, including £507 million to cover consequential losses. This means that, so far, around 95% of offers have been accepted.
>
> In addition to the £2.2 billion of redress paid to customers, the banks have set aside money to cover the costs of having to terminate customers' IRHPs early (the banks bear the cost of IRHP payments that customers would have made in the future), the costs of employing more than 3,000 people to carry out the review exercise, and the costs of engaging independent reviewers to look at every case.[6]

This issue is dealt with in greater depth in another Library Paper *Interest rate swaps on business loans* SN 6306

The FCA has a frequently updated webpage on this subject which includes the status of the Review and other matters: Interest rate hedging products. The FCA produced a briefing specifically for a Backbench Business debate in December 2014.[7] Internal Parliamentary users can find this briefing here.

[6] FCA; Interest Rate Hedging Products webpage
[7] HC Deb 4 December 2014 c477

RBS Global Restructuring Group

The fullest exposition of this affair is part of the Treasury Committee Report into small firm lending here. (TSC 11th Report: Competition and Conduct in SME Lending; March 2015).

In short:

> 54. In November 2013, Lawrence Tomlinson, then Entrepreneur in Residence at the Department for Business, Innovation and Skills, made a number of allegations against RBS in his report entitled *Banks' Lending Practices: Treatment of Businesses in Distress*. Principally, he alleged that RBS was "unnecessarily engineering" businesses into default in order to move the business from local relationship management to turnaround divisions—such as GRG. He alleged that the purpose of doing so was to generate revenue through "fees, increased margins and devalued assets".[
>
> […]
>
> 56. In response to Dr Tomlinson's report, RBS asked law firm Clifford Chance to review and report on the "principal allegation" of Dr Tomlinson's report. Clifford Chance was asked by RBS to investigate the allegation that RBS was "guilty of 'systematic and institutional' behaviour in artificially distressing otherwise viable businesses, putting its customers 'on a journey towards administration, receivership and liquidation'". The Clifford Chance report focused on a sample of customer files that was intentionally compiled in a way that was, according to Clifford Chance, "more likely to identify facts adverse to the bank", interviewing 138 customers and reviewing 130 files.

The major difficulty for the FCA in providing a resolution was that commercial lending was outside of the regulatory perimeter, hence in theory, it had no locus to act. The scale of the complaints, coming on top of the very similar interest rate swap problems, and a certain amount of political clamour ensured that something had to be done.

The 'official' compromise response from the FCA was to set up a requirement for complaints to be heard by an independent review. Cases would be overseen by a 'skilled person' familiar with the case. Small firms thought that the skilled person was acting on their behalf, but this was not how it worked in practice for many firms. There is considerable bitterness amongst a group of small business owners who saw their businesses dismembered, in their view, unfairly.

There is a page on the FCA website which includes updates on where the case is now and FAQs on the process. In short the FCA has received the 'skilled person's report and is considering its response. The statement on receiving the report can be found here.

As a result of the report, RBS has committed itself to reviewing cases and providing compensation if required. The FCA commented:

> RBS has today announced how it will address poor outcomes faced by certain SME customers who were referred to GRG between 2008 and 2013. The key elements of RBS's announcement are:
>
> a new complaints review process; and

an automatic refund for complex fees charged to SME customers in GRG.

RBS's proposals were developed with our involvement. We agree these are appropriate steps for RBS to take.

While the FCA still needs to see further detail about how the scheme will operate, we believe that it is an important step for RBS to put in place an appropriate complaints review process which should provide certain SME customers with a route to make a formal complaint, should they wish to do so. Additionally, RBS has agreed to provide automatic refunds for complex fees to some SME customers. In particular, the FCA notes and welcomes the involvement of an independent third party to provide oversight of the complaints review process. The independent third party will provide reports to the FCA on a regular basis.[8]

1.4 Financial Ombudsman Remedies

The Financial Ombudsman Service was set up by the Financial Services and Markets Act 2000. It provides a free dispute resolution process funded by the industry. It covers all individuals in dispute with 'authorised persons' and this protection is offered to small firms too. Figures are available in the Ombudsman's Annual Review: the numbers are substantial:[9]

Financial Ombudsman caseload

Year ended 31 March	Cases resolved
2016	438,802
2015	448,387
2014	518,778
2013	223,229
2012	222,333
2011	164,899

Source: Financial Ombudsman Annual Review 2015/16

The Review continues:

complaints from small businesses

This year 4,777 of the complaints referred to us came from small businesses – around 5% more than the previous year.

To use the ombudsman, small businesses must have an annual turnover of up to two million euros and should have *fewer than* ten employees (defined as a "micro-enterprise" under EU rules).

The proportion of complaints about different types of products remained broadly the same as the previous year. Within these categories, the problems we saw included:

1,299 complaints about current accounts

328 complaints about interest-rate hedging products

8 FCA website
9 Financial Ombudsman Service Annual Review 2015/16

> 219 complaints about commercial property insurance
>
> As in previous years, we think the actual number of small businesses who've used our service is likely to be higher – because some small business owners choose to bring complaints to us in a personal capacity. Around one in ten consumers who complained to us are self-employed, whereas only around one in a hundred complaints are recorded as business disputes.
>
> During the year we carried out research into the complaints we receive from small businesses – to better understand the issues causing disputes to be escalated to us. We highlighted the mismatch in expectations that can arise between small businesses and financial providers.
>
> Our research also suggested that, in many cases, small businesses don't have specialist support with financial and legal matters – and that their knowledge of financial services isn't any greater than that of individual consumers. In ombudsman news in September 2015, we gave more details about what we found through our research – as well as our case handlers' perspectives on resolving the problems small businesses bring to us.[10]

The *Ombudsman News* article referred to above can be found here.It is based on a larger piece of work published in August 2015: *micro-enterprises and financial services a review of complaints*. Its conclusions included:

> Our results show some important patterns. In particular, our analysis of the differences among the complaints and the micro-enterprises involved suggest three possible lessons to consider further.
>
> micro-enterprises aren't necessarily different to private individuals when dealing with money matters We looked at complaints from businesses in different sectors, of different sizes, and which were having difficulties with a range of financial products. From what we've seen, micro- enterprises have varying levels of understanding about how financial products work– just like private individuals.
>
> And when micro-enterprises have problems with money matters, they're not necessarily better-equipped to deal with them than private individuals. For example, few of the micro-enterprises that contacted us were supported by lawyers or accountants, either in their original problem with the provider or in their complaint to us. No one should routinely assume that micro-enterprise customers will understand financial products and services better than private customers.
>
> *problems caused by terms and conditions are common*
>
> Our review showed that many micro-enterprises – just like private individuals – don't know about important terms, conditions or features of the financial products they've bought, or necessarily understand their implications. This can often lead to problems after the product has been taken out.
>
> Financial providers might be able to reduce the likelihood of something going wrong for micro-enterprises by improving their understanding of what's being sold. If things are clear at the outset, there are likely to be fewer problems later.

[10] Financial Ombudsman Service Annual Review 2015/16

there's a mismatch of expectations about "relationships"

We found high expectations among some micro-enterprises about the support and care they should receive from financial providers – especially in complaints about bank lending. These impressions could be created and increased by financial providers' focus on a distinct offer for business customers.

In our review, we found a number of micro-enterprises had been disappointed with the service they'd received from their business or relationship manager. Coupled with the lack of other sources of support, micro-enterprises could be expecting financial providers to keep a closer watch on their financial affairs than they're able or obliged to do.

Clarity from providers about exactly what they're offering micro-enterprises – and about the need for micro-enterprises to pay close attention to all their risks themselves – may prevent disappointment and difficulties later on.[11]

[11] Financial Ombudsman Service: *micro-enterprises and financial services a review of complaints*

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