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Interest Rate Swaps on Business Loans

By Timothy Edmonds

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Summary

This note summarises the issue of 'mis-sold' business loans. The loans in question were attached to interest rate guarantees which, following the dramatic falls in interest rates since the financial crisis, have left borrowers paying much more for their loans than they would otherwise have done.

A lengthy redress process was established by the banks involved, encouraged by the Regulator who had no direct supervisory role with respect to these instruments. The process was much criticised as being too complex, too lengthy and small businesses felt they had less support than they were expecting. However, at its conclusion nearly 14,000 firms have received compensation totalling over £2million. More compensation was forthcoming for consequential business losses.

1. Introduction

A growing number of individual complaints and media interest in 'interest rate swaps' highlighted a new 'financial scandal' coming on top of the general financial crisis in 2007/8. A combination of possibly poorly understood and complicated financial contracts, combined with an extraordinary economic backdrop, left some small businesses in particular with what they see as crippling high interest rates on loans at a time when the rest of the economy enjoyed record low interest rates.

At the start, it is worth bearing in mind that the financial services industry is particularly susceptible to things working out exceptionally well or spectacularly badly for customers, because they often deal with products with a lifespan of many years and are dependent on a set of assumptions or forecasts that may prove to be completely wrong. Equitable Life is an example where for some people, unrealistic promises based on traditional high rates of inflation, had to be honoured and they did well from that. Some equity release mortgages have been criticised as being unfair, but only because house prices rose unexpectedly fast for a long period.

When the unexpected favours the consumer there are only contented individuals happy with their choice. When the reverse is true, there is a 'scandal'. This note tries to explain what happened and how individual businesses were treated as part of the redress programme.

2. Interest Rate Protection

2.1 What are interest rate swaps?

The British Bankers Association has produced a factsheet setting out the mechanics and advantages of swaps for business customers. Part of this is shown below:

What are interest rate swaps?

A common interest rate risk management product is an interest rate swap. Interest rate swaps are used to manage potential exposure to risk in interest rates. The variable rate of interest that a customer has on a loan is swapped to a fixed rate. Interest rate swaps account for the majority of transactions with small and medium-sized enterprises (SMEs) Swaps are negotiated individually between the customer and the bank and may include further options and clauses.

An interest rate cap offers unlimited protection for a borrower if rates rise above an agreed level, whilst allowing a borrower to participate fully in any falls in base rate. The customer pays a premium for such a contract.

How do interest rate swaps work?

Interest rate swaps are used to manage potential exposure to changes in interest rates. The swap allows the business to control the underlying variable rate of interest paid by crediting or debiting the business with the interest difference between the variable rate and the fixed interest rate. This means that if the variable rate is higher than the fixed rate the customer will be credited, but if the variable rate is lower than the fixed rate the customer will be debited.

and budget with a greater degree of certainty over their borrowing costs.

Why are swaps used instead of fixed rate loans?

An interest rate swap can offer additional flexibility: a swap can be entered into in respect of all or some of the loan amount and duration. This allows customers to tailor the protection to their particular circumstances: for example, where a customer wants the ability to repay part of their loan earlier than final maturity, they may choose to hedge part but not all of their loan; or where customers anticipate refinancing after the original loan term, there may be good reasons for a customer to select a swap which runs beyond the term of the original loan. In addition, given an interest rate hedge may be transferred to a new bank, a customer may not need to break its hedge upon a change of its relationship bank.

However, unlike a fixed rate loan, the interest rate swap agreement is a separate contract from the loan contract and must be terminated independently - repaying the underlying borrowing does not automatically terminate the interest rate structure.

Can customers terminate their interest rate swaps early?

It is possible for a customer to terminate their swap early; however, and as with fixed rate commercial mortgages, doing so incurs the cost of the difference between the interest rate on the contract and what interest rates are predicted to be for the remaining life of the transaction. This is known as the break cost. It is also important to note that it may also be possible to terminate a product in part or to restructure it to account for any change in a client's circumstances.

2.2 The complaint

An account of the way in which interest rate swaps worked, can be heard on a Radio 4 'Report' programme that used real-life examples of how they worked in specific cases. It can currently be heard here.[1]

One example mentioned in the programme was of a buy – to - let investor with a portfolio of 25 properties on modest borrowings (average 45% borrowing). In 2007, after negotiating a loan, the borrower claims that he was told that taking out a hedge product was a requirement of the loan. The bank – RBS – denies this. It is crucial in understanding the chain of events to remember that there are two components, the loan agreement and the swap agreement. In practice, it has been the charges due under the swap agreement which have caused the outcry.

The borrower was referred, as most borrowers appear to have been, to a specialist hedge sales team. His agreement fixed the maximum rate of interest at 6.95% - so if interest rates rose above that he was protected. On the other hand, if interest rates fell he would have to pay an increasing premium. In his case, if they fell below 3.75% he would have to pay 6.95%. Of course, in early 2007 the prospect of significant interest rate falls due to an impending worldwide financial crisis seemed, at the very least, remote.

The initial interest rate charged on the loan, and the date it was agreed, is not revealed by the programme so the degree of protection offered by the 'cap' cannot be calculated exactly. However, in January 2007, the Bank of England base rate was 5.25%; commercial bank loans would have been above this rate and must have been below the 6.95% cap in this agreement. So, although the exact amount of protection being offered is not clear at most it can only have been 1.75% and is likely to have been less. For example, if the loan was taken out in July 2007 when the Bank of England rate was 5.5% and the bank charged 1% over base rate for the loan, the margin of protection offered would have been only 0.45%.

The Bank of England rate continued to fall from December 2007 to March 2009 when it stood at 0.5%. Under a flexible rate loan agreement, the borrower would have had the benefit of this reduction, possibly paying 1 – 2% on the loan. From the perspective of a borrower

[1] This note has used this example simply to illustrate the chain of events which has led to the current interest. Use of this example is not intended to confer legitimacy, or otherwise on any explicit or implicit claims arising out of it. Nor does it have any way of verifying the facts mentioned in the case.

with a ‘swap’ arrangement they were suddenly paying perhaps five percentage points more on a loan (actually the swap charge equivalents) than they would have done without the ‘protection’ of the hedge. But for the borrower in this case matters were about to get worse.

The agreement in this case included swap protection for ten years and the loan was for five years –allowing for the possibility of the loan being renewed after five years. RBS refused to renew the loan which meant that the swap agreement was broken and the penalties for breaking that agreement were levied. As well having to repay the loan the borrower had to find ‘breakage’ fees of £260,000 or continue with monthly swap payments for five years, even though the loan had been repaid. This was described as “paying for car insurance on a car one has already sold”.

A further feature of typical agreements which critics have pointed out is that, as in this case, RBS had the option of cancelling the swap agreement after the five year term, and at every quarter after that. So, if interest rates had actually risen steeply after five years, the borrower would not have benefited from the ‘cap’ protection because the bank would have cancelled the contract. But as the bank was benefitting it, obviously, wouldn’t cancel. This feature might be thought to be a partial response to those who say that the problems of people caught by this are that they took a bet and it simply turned out wrong. In practice, they would argue, there was a fair bet on interest rates for five years and a swaps gamble for a further five in which the bank held all the right cards.

3. Redress

3.1 Redress procedures

As indicated by the then Economic Secretary, Chloe Smith, in a backbench members' debate, the old Financial Services Authority (FSA) has taken the lead in looking at the issue.[2]

In April 2012 it wrote to the Treasury Committee outlining its intended approach. This can be found here.

At the end of June 2012, the FSA published its summary findings.[3] It found:

> 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[4]

The FSA talked to the main banks concerned and agreed a way forward for possible claims. It is outlined below:

> **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;

2 HC Deb 21 June 2012, c1085
3 FSA Update, June 2012
4 Ibid p2

(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'

[...]

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 banks 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;

the banks 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 banks will propose f air 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[5]

The FSA also announced that it would carry out a 'pilot' in-depth review of a sample of cases. In January 2013 the FSA reported the result of this study. It found

> The work on the pilot has confirmed the FSA's initial findings of mis-selling of IRHPs. The FSA looked at 173 sales to non-sophisticated customers and found that over 90% of the sales did not comply with at least one or more regulatory requirement. A significant proportion of these 173 cases are likely to result in redress being due to the customer. However, the small number of typically more complex cases in the sample may not be representative of all IRHP sales.
>
> The pilot has also enabled the FSA to consider the principles that should govern the review. As a result, the FSA has revised the eligibility criteria to ensure that the review is focused on those small businesses that were unlikely to understand the risks associated with those products. This might include, for example, bed and breakfast businesses which would previously have been ineligible due to their large numbers of seasonal workers. At the same time, some businesses that fell under the criteria published last June will be excluded. These include, for example, small subsidiaries of multi-national corporations, or Special Purpose Vehicles that are sophisticated enough to have understood the terms of the product or have sufficient resources to obtain advice.
>
> Where redress is due, the FSA has reiterated the fundamental principle that it must be fair and reasonable for individual customers.
>
> […]
>
> The FSA has also been reviewing sales of IRHPs by Allied Irish Bank (UK), Bank of Ireland, Clydesdale and Yorkshire banks, Co-Operative Bank, and Santander UK. The FSA aims to be able to confirm that these banks can launch their reviews by 14th February.
>
> Customers of all these banks will be directly contacted by the banks and will not need to involve other advisers[6].

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5 Ibid p4
6 FSA Press Release 31 January 2013

3.2 Redress outcomes

The table below is a summary of the outcomes from the review. In brief, nearly 14,000 firms received compensation totalling over £2billion.

Interest Rate Swap Review Outcomes		
Customers Reviewed	30,784	
of which		
sophisticated		10,577
non-sophisticated	20,207	
of which		
Category A	1,599	
Category B	14,242	
Category C	2,328	
of which		
Compliant (with due process)		1,556
Non- compliant	15,014	
Category A contracts and non-compliant contracts	16,613	
Redress		
Full tear up	8,555	
Alternative cap	4,322	
Alternative other product	1,794	
no redress		1,942
Offers of redress accepted	13,936 £2.197 million	

There was a further exercise, now largely complete, to look at claims for consequential business loss. The results are shown below:

Progress of bespoke consequential loss claims	
Number of customers who have submitted a bespoke claim	3,814
Assessments complete	3,742
% Assessments complete	98%
Analysis of completed assessments of bespoke claims (amount payable above 8% a year)	
No additional redress	1,795
£1 to £9,999	1,296
£10,000 to £99,999	593
£100,000 to £999,999	52
£1,000,000 +	6
Consequential losses payable	
8% a year added to every offer	£463m
Additional losses payable over and above 8% a year	£46m
Total consequential losses payable inclusive of 8% a year	£509m

FCA Website

Further information about the review process can be found now on the Financial Conduct Authority website here.

During the course of his speech at the FCA's 2017 Annual Public Meeting, Andrew Bailey said about IHRP:

> So let me start with some of the longstanding issues and let me start with interest rate hedging products. The review work is nearly completed, a small number of cases are outstanding. As you may know, a case called Holmcroft has been granted leave to appeal to the Court of Appeal; that hearing, I believe, is scheduled for December. And once the redress scheme cases are finished and relevant legal proceedings are concluded, we will carry out a lessons-learned exercise, and we will be transparent in how that exercise is put together.[7]

Financial Ombudsman

The FOS is a free service to the user and hears complaints brought against authorised companies by either individuals or small firms. The loans complained of here were generally made to small businesses. The FOS definition of small business is based on the EU definition of "micro-enterprises" (an EU term covering smaller businesses) – as long as they have an annual turnover of less than two million euros and fewer than ten employees.

Decisions made by the FOS are binding on the lenders. This could include setting aside the terms of the agreement or compensation. According to the FOS, some cases have been referred to them for adjudication. If a small firm receives an offer of compensation from the banks as a result of the FSA review (see above) they can still reject it and make a claim with the Ombudsman instead.

The September 2013 edition of Ombudsman's News includes a summary of cases dealt with by the Ombudsman and their outcome.

The lenders

Another option open to businesses is simply to try and renegotiate their loans with the lender. This may be an increasingly viable option for firms, especially if a body of Ombudsman 'case law' emerges that is generally unfavourable to the banks.

Litigation

Several law firms and claims companies have started to tailor their services towards managing legal claims in this area. The exact nature of the legal claim would depend on the facts in each case. One of the issues regarding legal action is that the Ombudsman can only make awards up to £150,000. Hence, for some firms legal action might be necessary if they wanted to reclaim sums in excess of this.

7 FCA Annual Public Meeting transcript.

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