FCA ignored warnings banks would game interest-rate swap redress scheme; lawmaker urges Bailey to revisit bank-led schemes

Jun 19 2019 Rachel Wolcott, Regulatory Intelligence

The Financial Conduct Authority (FCA) ignored warnings from independent derivatives experts that banks would attempt to game the interest rate hedging product (IRHP) redress scheme.

Abhishek Sachdev, chief executive at London-based Vedanta Hedging, raised nine points of urgent concern with Charles Randell, the FCA chairman, in April this year regarding the set-up and running of the scheme. Sachdev asked, for example, why the FCA had repeatedly refused free advice offered by FCA-authorised companies such as Vedanta on the matter.

Sachdev responded to Randell's call for input for the forthcoming IRHP supervisory intervention lessons learned work on behalf of the SME Alliance and shared that contribution with Thomson Reuters Regulatory Intelligence (TRRI).

"[A]lthough the FCA had a terribly difficult challenge of balancing SME redress with the cost of such redress to the banks, I cannot forgive the FCA for failing to listen to points that were being made to it as per below," Sachdev wrote to Randell.

The FCA declined to comment on Sachdev's criticism, but said it received a large number of responses to its lessons learned review and plans to publish the terms of reference shortly.

Jim Shannon MP (Democratic Unionist Party (DUP)), concerned about the way bank-led redress schemes were set up and managed, has approached Andrew Bailey, FCA chief executive, to argue that customers found to have been treated unfairly by or excluded completely from the IRHP scheme should be allowed a second chance at compensation. That potentially would come through the Dispute Resolution Scheme (DRS), set to open in September/October this year.

Flaws exposed in the IRHP redress scheme and other bank-led redress schemes, such as the Lloyds/HBOS Griggs review and the Clydesdale and Yorkshire Banks' (CYBG) review of structured collars, IRHPs, caps and tailored business loans (TBL), means those reviews should all be reconsidered — not a complete reopening of the process — with a view that viable cases could go into the DRS, a DUP spokesman told TRRI.

Nine points of criticism

Vedanta Hedging was paid a nominal fee by the FCA in 2012 to give advice to Christina Sinclair and Julie Dunne, who at the time were the FCA's lead directors setting up the review, Sachdev told Randell in the email.

Sachdev sent Randell nine points he believes should be considered as part of the lessons-learned exercise. The full text can be found here.

- When free advice was being offered by FCA-authorised companies such as Vedanta Hedging on how banks would try to "game" the system, why was this repeatedly refused from 2013-2015?

- Why did neither the banks nor the FCA publish the voluntary agreements until forced by the Treasury Select Committee? This had a material impact on the SMEs yet to conduct their review, as it finally showed them what the "rules of the scheme were".

- The principles of common law and tort were supposed to be followed in assessing consequential loss claims (as specifically stated to Sachdev by Sinclair in a May 2013 meeting). Yet, as the process unfolded, hardly any SMEs were awarded anything material regarding consequential losses. Dozens of Vedanta's SME clients did, via litigation, achieve some material portions of their consequential loss claims, which had hitherto been outright rejected by the IRHP review.

- The threshold excluding IRHPs with a £10 million and above IRHP notional was illogical. Hundreds of corporates had £11 million of debt, but were still classified as retail, and thus should have still been part of the IRHP review. In some cases, the banks mis-sold larger and larger IRHPs to an SME (by restructuring them), and in doing so, the final IRHP may have been larger than the £10 million limit. This meant that the actual IRHP which caused them the harm was excluded from the review.

- If an SME was sold four IRHPs, the first three could be classified as mis-sold, but the fourth one was deemed compliant just because of the customer's "prior experience with derivatives".

- There was a wholly misplaced focus on the complexity of IRHP which led to poor outcomes in the redress scheme. The actual real harm caused to the SME was in the additional payments caused by the IRHP and its associated breakage costs, not its complexity.

- The above point also meant that in many instances during the redress process, an IRHP was replaced with what was deemed to be a "simpler" Category B IRHP. This meant, however, that the net redress due to the SME was often negligible, and again failed to grasp the point that if an SME did not did not understand the breakage cost of one IRHP, it would not understand the breakage cost of another, similar type of IRHP, unless this was a cap.

- No regard was given to the contingent liability (i.e., credit cost) of these derivatives. In simple terms, entering into collar, swap or structured collar would require the SME to enable part of its balance sheet to be used to underwrite the potential breakage cost of the IRHP. SMEs were almost never told about this hidden contingent liability charge and therefore could not make an informed decision about paying a premium for a cap, or giving up some of the equity/security for another IRHP about which they had not been told.

- Hidden swap loans, also known as tailored business loans (TBL) from CYBG, as well as fixed-rate loans, often from Lloyds/HBOS, were excluded from the scheme because they did not contain stand-alone IRHPs. The FCA argued these products were outside its regulatory perimeter, but it could have used its overall authorisation to require banks to address those loans as part of the voluntary process.

"This isn't an exhaustive list and these are the same points people have been giving the FCA for at least five years," Sachdev said.

DUP: Bank-led reviews require a second look

The DUP has told the Bailey that part of the scope of the IRHP lessons-learned exercise should include the potential to reopen cases and reconsider compensation levels, depending on its findings. If the lessons-learned exercise determines mistakes were made in scoping the original scheme — those customers totally ruled out of IRHP redress, because they were tagged as "sophisticated" or had a CYBG TBL, for example — then those customers should be eligible for the DRS if they meet the eligibility requirements.

"There needs to be a balance between the costs to banks, what the regulator can do and the needs of the customers. There is some low-hanging fruit here that could be addressed, but more data and more detail on the redress scheme outcomes needs to be provided by the FCA to assess what's possible," Sachdev said.

The FCA said the purpose of the DRS is to give those that haven't been through a review process an opportunity to do so. "Customers still have the right to litigate through the courts," it added.

CYBG's 2012 voluntary scheme that covered 1,500-1,600 structured collars and the caps that were left out of the IRHP scheme is another the DUP would like revisited. Here, the DUP has suggested a judge-led review of that voluntary review. Where compensation is found to be inappropriate, it should be corrected by the judge. Claims that were ruled out or not considered should be eligible for the DRS.

The FCA said CYBG tailored business loan customers should be considered by the DRS.

A DUP spokesman said: "We fully recognise that there will not be a wholesale reopening of the outcomes of all and every case which has been through the independent redress process. However, we completely agree with the Chancellor's letter of the 19 January which says: 'I do of course expect the backward-looking scheme to carefully consider the merits of taking forward work on each case presented to it by a business.' Therefore, we believe that each and every review needs to have a proper assessment that it's achieved the objectives set out, has been reasonable and fair redress made. Where that has not been the case, those cases should become eligible for the historical DRS scheme. The first example of this approach has now been undertaken by Sir Ross Cranston in relation to the Lloyds HBOS cases."

The DUP's position is the Cranston review should have the ability to change amounts awarded by the Griggs review. The DUP is working with Lloyds to agree that as part of the Cranston review terms. Those ruled out or deemed ineligible from the Lloyds scheme should have the right to go to the DRS.

- ***Rachel Wolcott*** *is risk management and financial regulation correspondent for Thomson Reuters Regulatory Intelligence.*