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FCA regulation of interest rate hedging products: one rule for some?

KEY POINTS

- Business loans with embedded interest rate swaps are not contracts to secure a profit or avoid a loss by reference to fluctuations in interest rates.
- The borrower under such an "embedded loan" is not a party to the contract for difference made between the bank and a third party.
- "Embedded loans" are therefore not regulated by the FCA.
- In the absence of any FCA action on embedded loans, there are two bases for redress.

INTRODUCTION

A significant lacuna in the regulation of financial services has been highlighted recently by the House of Commons Treasury Select Committee's review of conduct and competition of lending to small and medium sized businesses (SMEs).

Although the FCA has the power to regulate standalone interest rate hedging products, it has confirmed in evidence to the Committee that it has no power to act in relation to business loans in which such interest-rate swaps were "embedded".

Whilst it has been able to force some of the banks to set up and implement compensation to customers with standalone IRHPs in appropriate cases, it has therefore been unable to offer any similar redress to the thousands of small and medium sized businesses who complain that they have been mis-sold such loans.

This article explains:

- the different types of interest rate hedging products (IRHPs);
- the FCA's action on regulated standalone IRHPs;
- the FCA's inability to act on loans with "embedded" interest-rate swaps; and
- the other remedies available to SMEs.

TYPES OF INTEREST RATE HEDGING PRODUCTS

Variable interest rates on loans rise or fall in line with the benchmark on which they are based. Significant adverse movements in variable rates are a risk both to the business with a loan and to the bank through the business's diminished interest rate cover.

Businesses can protect themselves from this interest rate risk by purchasing a stand-alone interest rate hedging product; or by taking out a loan with the hedging features embedded within the contract itself. As to these:

- **Standalone Interest Rate Hedging Products** (IRHP) are a type of derivative contract sold by banks. They are a separate contract to that of the underlying loan agreement. Businesses with IRHPs typically pay for their loan separately from the IRHP. The IRHPs can then provide interest rate protection by creating a separate set of payments to and from the business that offset the variability of the interest rate paid on the underlying loan.
- **Loans with embedded interest rate hedging features** (Embedded Loans) are individual loan products that contain interest rate hedging features embedded within the contract of the loan itself. There is no separate contract. When paying off the loan, the business typically makes only a single payment that accounts for both loan interest and interest rate protection.

There is a variety of types of such hedging, each offering a different sort of interest rate protection. There are three key types of such protection available: caps, swaps and collars:

- **Caps** can set a maximum interest rate to be paid by the business for the underlying loan, but do not set a floor. This means that, over time, the interest paid on the underlying loan cannot exceed a certain amount, but is allowed to fall freely when interest rates fall.
- **Collars** can set both maximum and minimum interest rates to be paid by the business for the underlying loan. This means that, over time, the interest paid on the underlying loan can both rise and fall, but only to a pre-determined maximum or minimum level. Collars can vary in complexity, with **structured collars** offering more complex interest rate ceilings and floors.
- **Swaps** can be used to fix the interest rate to be paid by the business for the underlying loan – over time, the interest paid for the underlying loan can vary, but the total amount paid by the business remains unchanged. The term "swap" is also frequently used to describe an interest rate hedging product. Used in this context, the term does not exclusively refer to fixed rate products.

From about 2001 these types of products were sold to many small and medium-sized businesses (eg broadly those with 0-250 employees) (SMEs). At a time when interest rates hovered around 5%, and had historically been much higher, many SMEs saw advantages in fixing the rates of interest on their commercial loans. Those products that offered such a fix – which seemed similar to familiar, fixed-rate domestic mortgages – were therefore superficially attractive to SMEs. However, few SMEs appear to have taken financial advice (whether in-house or external) on the possible implications of these complicated products. They do not appear to have appreciated the termination provisions written into these contracts.

When interest rates fell, many SMEs sought to terminate their standalone IRHP agreements or repay their embedded loans. It was then that they realised the onerous terms of their contracts – and the significant termination or early repayment penalties that had been written into the terms and conditions.

These terms differed from provider to provider. Often, the termination clause obliged the borrower to pay a charge for the future interest due under the remaining period of the loan – the notional rate being the difference between: (i) the interest rate prevailing at the time of repayment; and (ii) the rate at the time that the loan was taken out. In addition, many included the cost to the bank of terminating the hedging arrangement which it had entered into with a third party to mitigate its own interest rate risk of entering into the loan. In some cases, these "break" costs amounted to hundreds of thousands, even millions, of pounds; and they threatened the very viability of the businesses.

FCA'S ACTION ON STANDALONE IRHPS

Concern over hedging products prompted the old Financial Services Authority (FSA) into action.

Standalone IRHPs are contracts for differences (CFDs) for the purposes of Art 85 of the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 (RAO). The definition of a CFD includes "rights under … any contract the purpose … of which is to secure a profit or avoid a loss by reference to fluctuations in … an index or other factor designated for that purpose in the contract". The purpose of a standalone IRHP is to secure a profit or avoid a loss by reference to fluctuations in interest rates – and thus is a CFD. It follows that they relate to "an investment of a specified kind" within the meaning of s 22 of the Financial Services and Markets Act 2000 and accordingly entering into or terminating such contracts constitutes a regulated activity that falls within the perimeter of regulation by the FCA.

In June 2012 the Financial Standards Authority (FSA) (as the FCA was then) announced that it had found "serious failings in the sale of IRHPs to some small and medium sized businesses". The FSA identified a range of poor sales practices including: failures to ascertain the customers' understanding of risk; non advised sales straying into advice; "over-hedging" (ie where the amounts and/or duration did not match the underlying loans); rewards and incentives being a driver of these practices; and, importantly, the poor disclosure of early repayment or "break" costs.

As a result, nine UK banks entered into voluntary agreements with the FSA to conduct a redress exercise in relation to their sales of IRHPs. Each redress process was guided by the principle that "redress must be fair and reasonable", and that "redress should aim to put customers back in the position they would have been in had the breach of regulatory requirements not occurred". The voluntary agreements establishing the IRHP scheme were supported by independent reviewers appointed under s 166 of the Financial Services and Markets Act 2000 – who oversee and verify every case.

To date, these banks have sent 17,000 redress determinations to customers – 14,000 of which include a cash redress offer. Around 12,000 customers have accepted a redress offer and £1.9bn is being paid out, including more than £400m to cover consequential losses. In addition to the £1.9bn of redress, the banks have set aside money to cover the costs of having to terminate customers' IRHPs early (as the banks have agreed to 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.

FCA'S INABILITY TO ACT ON EMBEDDED LOANS

In the course of its review of standalone IRHPs, the FCA identified similar problems with loans with the features of interest rate hedging facilities written into the contract.

The hedging element of such "loans with an embedded IRHP" shares many features of a standalone IHRP. A borrower who has a loan with an 'embedded' IRHP may be faced with exactly the same repayment features as a customer with a standalone IRHP. This can include, like standalone IHRPs, break costs when a customer repays the loan early.

Given the size of some of these commercial loans, such "break costs" can be substantial. In some cases, companies have reported the charges to be as much as 40% of the principal value of the original loan.

There is a large number of Embedded Loans. Data collected from Barclays, HSBC, Lloyds, National Australia Bank Group and RBS suggests that more than 60,000 of fixed rate loans with such mark to market break costs have been sold since 2001, significantly more than the 40,000 standalone IRHP's covered by the FSA's review.

Such Embedded Loans are *not*, however, within the FCA's regulatory perimeter. In its evidence to the Treasury Select Committee, the FCA was clear that, whilst standalone IHRPs are (for the reasons explained above) within its regulatory reach, loans with embedded IRHPs are not. This is because:

Embedded Loans are not CFDs. Such a loan is a contract for the customer to borrow and the bank to lend. It is not a contract to secure a profit or avoid a loss by reference to fluctuations in interest rates. The "break costs" arise only when a customer decides to terminate the contract early. As a contingent clause, it does not operate to change the purpose of the contract as a whole.

It follows that they are not specified investments under the RAO; and entering into or terminating such contracts does not constitute a regulated activity.

As a result, the conduct elements of the principles for business (and other FCA/FSA conduct rules) do not apply when a bank enters into, or terminates, such a loan.

Further, given that commercial loans are not listed as a regulated activity

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in the RAO, the FCA has extremely limited powers to investigate or bring enforcement action in respect of the sale of loans with embedded interest rate hedging features. The FCA is unable to establish a redress scheme in respect of any failings to disclose properly break costs in contracts for a relevant loan, or to regulate the banks' future conduct in that respect.

The FCA's analysis is entirely consistent with the general scheme of the RAO. The borrower under such an embedded loan is not a party to the CFD made between the bank and a third party, which is the relevant specified investment under Art 85. The borrower may be exposed, under the loan agreement, to liability to pay the break costs incurred by the bank and its hedging arrangements, but that does not change the nature of the loan agreement so as to render it a CFD itself. Nor does the customer thereby acquire a right or interest in the CFD that has been entered into by the bank under Art 89 of the RAO. The only specified investment that is made in such circumstances is that made between the bank and the third party. Whilst the specific features of such a loan may, as a matter of individual construction, bring it into the FCA's purview, such Embedded Loans generally fall outside the FCA's regulatory perimeter.

Given that a commercial loan is not listed as a regulated activity in the Regulated Activities Order 2001, the FCA has extremely limited powers to investigate or bring enforcement action in respect of the sale of loans with embedded interest rate hedging features. The FCA's existing IRHP review does not extend to such loans.

The Treasury Select Committee was not happy with this apparent inconsistency. It explored this issue at length with the FCA, and was only satisfied once it had received confirmation from both the FCA's external counsel (Charles Flint QC) and the Treasury Select Committee's own specialist advisor (Jonathan Fisher QC).

The Committee was particularly concerned that, whilst many SMEs were akin to consumers in their understanding of financial transactions, these business loans were not regulated. Although its members were keen to see an expansion of the FCA's powers to include commercial lending to SMEs, it was clear that the Government does not favour any such extension of the regulatory perimeter. It adheres to the fundamental principle that business lending should not be regulated. And it has no appetite for general business lending to come under regulation.

Nonetheless, the Committee recommended that the Treasury should publish an assessment of the feasibility, benefits and costs of adjusting the perimeter of regulation to cover loans with features of interest rate hedging products.

REMEDIES FOR SMES WITH EMBEDDED LOANS

In the absence of any FCA action on Embedded Loans, there are two bases for redress for those detrimentally affected by such Embedded Loans: some SMEs can turn to the Financial Ombudsman Service (FOS); all can sue in the courts.

Financial Ombudsman Service

FOS is an independent service for settling certain complaints fairly, reasonably, quickly and informally. It considers complaints from those who are dissatisfied with the outcome of a bank's internal complaints procedure. It can re-assess any relevant case on a "fair and reasonable basis". Its service is free to the complaining customer, as it is funded by the banks through individual case fees and an annual levy.

However, FOS is not available to all SMEs. It can only consider complaints from small businesses with an annual turnover of less than €2m and fewer than ten employees. Its awards cannot exceed £150,000 – and in any event the banks do not technically have to follow the ombudsman's decision. The FCA is, however, committed to consult on an expansion of the remit of the FOS.

The Courts

Any SMEs can, of course, litigate. It is, however, prohibitively expensive to sue a bank; and even a small risk of having to meet a significant adverse costs order is enough to deter most small businesses from taking on one of the industry's goliaths.

In any event, the ongoing relationship between an SME and its bank can make such legal action difficult. The practical reality is that, given the dependence of the SME on its bank, it is an incredibly difficult decision for an SME to decide to sue its bank.

CONCLUSION

Many SMEs are alarmed by the threat to their businesses that are posed by the interest rate hedging products.

Whilst the FCA has ensured that those with standalone contracts can seek redress from the banks, it has been unable to do the same for those with Embedded Loans. Given the limited jurisdiction of the FOS, and the prohibitive expense and risk of litigation, many SMEs may be left without effective redress.

This is serious for them. It is also potentially detrimental for the economy as a whole. SMEs are the backbone of the UK economy and key to the recovery and long term growth of the economy – employing 60% of all private sector employees and generating a combined annual turnover of £1.6trn (or 47% of the private sector total). No wonder the Treasury Select Committee is concerned about the threat to their viability. ■

Further Reading:

- Compensating customers who have been missold interest rate hedging products [2013] 8 JIBFL 507.
- Interest rate swaps and the sale of the unknown: blind alleys, an enfeebled equity and the triumph of certainty over fairness [2014] 1 JIBFL 9.
- LexisPSL: Financial Services: Guidance – Interest Rate Hedging Products – Role of the Independent Reviewer.