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Dear Andrew

Interest Rate Hedging Products

The Treasury Committee has asked a number of questions about the IRHP Review scheme, including some questions specifically regarding the voluntary agreements between the FCA and the banks, which set out the methodology for the review. I have set out in this letter what I hope will be helpful information in answering these questions.

I continue to believe that the scheme has delivered fair and reasonable redress for the vast majority of customers, and £1.8 billion has been paid out in redress to over 14,000 businesses. We continue to look at every case that is brought to us, and the feedback we receive from customers is an important part of the way we ensure the banks are following the correct processes within the IRHP Review.

We have responded to over 1,200 pieces of correspondence in the last year, including over 126 responses to Members of Parliament. In every instance where a case raises concerns which may indicate wider problems with the banks' approach to the IRHP Review, we have followed up with the banks and independent reviewers. Where necessary we have asked the banks to provide us with additional evidence in order for us to assure ourselves that the correct process has been followed. While some people may remain unhappy with their redress offer, it does not necessarily mean that the offer is unreasonable.

We have concerns that some customers may be spending a significant amount of money on claims management companies or advisers, on claims for consequential losses that do not appear to have a reasonable chance of success. The IRHP Review does not replace customers'

usual rights, and customers may still have recourse to the Financial Ombudsman Service or the courts, more information about which I include below.

Fairness of the IRHP process

The IRHP Review provides an enhanced mechanism for customers who are least likely to have understood the risks of the IRHPs to have their complaints considered by the bank and an independent skilled person. Generally, customers with a complaint against a regulated firm outside of the IRHP Review, can take the following steps.

1. Complain to the bank: the bank will review the complaint and respond, offering redress where appropriate.
2. Refer the complaint to the Financial Ombudsman Service: if the customer is an individual acting for purposes outside his trade, business or profession, or a 'micro enterprise' (an EU term covering certain smaller businesses) and if the customer is dissatisfied with the bank's response they may be able to refer their complaint to the Ombudsman.
3. Pursue the case through the courts.

The IRHP Review does not remove or replace customers' rights to go to the FOS or through the courts; it therefore should not be compared to those alternatives.

The relevant comparison with how the IRHP Review operates is with the banks' usual complaints handling procedures, and there are some differences in how the two operate, as set out below.

Usual complaints handling process	IRHP Review process
Complaints made outside the FOS limitation period can be rejected by firms without considering the merits.	Applies to all sales of IRHPs to eligible customers since 1 December 2001.
Requires a customer to make a complaint to the bank.	Banks have proactively identified all customers who were sold swaps, collars and structured collars and <i>invited</i> them into the review. Customers with cap products are able to complain and opt-in to the review.
The bank assesses the case.	The bank assesses the case, and every case is overseen by an independent reviewer.

The IRHP Review in effect enhances a number of processes, providing customers with a straightforward and potentially quicker way to obtain fair and reasonable redress.

Sophistication Test

The sophistication test was designed to identify those smaller businesses that were less likely to have understood the risks associated with IRHPs or to have had resources enough to access independent, expert advice.

The scheme has two main eligibility criteria:

1. Size of the business: this is based on the Companies Act 2006 small company or small group test. Businesses or groups of businesses that at the time of the sale had a turnover of more than £6.5m and either a balance sheet total of more than £3.26m, or more than 50 employees, are not eligible for the scheme. Around 4,900 sales were excluded on this basis.
2. Value of IRHPs sold: the scheme excludes businesses that at the time of the particular sale being assessed had purchased IRHPs with an aggregate notional value of more than £10m, either on an individual or group basis. Around 5,200 sales were excluded on this basis.

Businesses that are not eligible for the review have been informed that they can still complain to their bank if they have concerns about the sale of their IRHP. Around 360 customers, approximately 3% of the sophisticated customer population, have complained to their bank on this subject.

The Committee asked for our view of the value of swaps sold to sophisticated customers. We believe a basic estimate of the value of these swaps is unlikely to provide any meaningful insight of the kind the Committee is looking for, as any analysis of potential redress would have to make highly speculative assumptions about rates of mis-selling, when and what products were sold, and whether customers terminated these products early.

Role of independent reviewer

The oversight by independent reviewers is comprehensive, and covers all aspects of the banks' reviews. This includes assessing and ensuring:

- The accuracy and completeness of the banks' review populations;
- The appropriateness of the banks' approach to evidence gathering;
- The appropriateness of all of the banks' engagement with customers; and
- Assessing whether the methodology has been applied appropriately in every case.

The independent reviewers report regularly to the FCA both on the judgements they are making and how the banks are performing. In addition, whilst the banks were dealing with basic redress offers, we brought together the independent reviewers on a monthly basis to discuss the methodology and case studies to ensure a consistent approach. In relation to assessing consequential loss claims, the independent reviewers have obtained their own independent legal opinion which helps them to assess cases in a consistent way.

The Committee expressed concern about whether the independent reviewers were given the opportunity to see and hear the customer's evidence. The independent reviewer has access to all of the information provided by the customer. The banks are not free to choose what information the independent reviewer sees. The independent reviewers oversaw the design and implementation of the banks' review processes, including the systems and controls around information-gathering and sharing.

A specific allegation put to me by Mark Garnier MP was that from a 70-page document submitted by the customer; only one paragraph was included in the information passed to the independent reviewer. All the banks will have slightly different approaches, and one of the

banks produces an executive summary document of evidence relating to each case, which may include only one paragraph from a specific piece of evidence. However, all evidence, including every submission received from customers, is separately uploaded to a secure evidence database and shared in full with the independent reviewer. As I have explained above, the independent reviewer has access to all of the information provided by the customer and oversight of their systems and controls.

Fair, reasonable and consistent redress offers

In addressing the Committee's concerns about consistency of outcomes, it is helpful to confirm the figures.

	30 Apr 2014	31 Dec 2014
Redress offers communicated - full refunds or caps	9,519	12,199
Total redress offers where cash is payable	10,811	14,119
% Full refunds and caps	88%	86%
Total redress offers communicated (including where no redress is due)	11,871	15,646
% Full refunds and caps	80%	78%
Total outcomes communicated (including compliant sales)	12,782	16,974
% Full refunds and caps	74%	72%

As I set out in my previous letter to the Committee, we would not expect each bank to have identical proportions of full refunds, caps, other alternative products and compliant sales. There are differences between the sales and types of products of each bank, and therefore there are differences in the banks' underlying review populations which may reasonably result in variances in the profiles of the banks' redress offers. For example:

- Although all banks have a high rate of non-compliant sales, the nature and extent of these failings has varied from firm to firm. For example, some banks' explanations of break costs were clearer than others.
- The mix of business types that were sold IRHPs is not the same across all the banks. Some banks have a much higher proportion of customers that, due to the nature of their business, may have been more likely to take out some form of interest rate protection.
- The typical length of IRHP sold by some banks was much shorter than for other banks.
- Some banks have a greater number of high-value IRHP sales. Typically, although not always the case, customers who purchased higher-value IRHPs appear to have been more engaged in the sales process.

Alternative products

A considerable amount of work has been undertaken to ensure that if alternative products, including caps, are offered to customers, they are priced fairly.

Before banks began making offers within the IRHP Review, our own technical specialists, supported by an independent derivative expert, scrutinised the banks' pricing models to ensure they were consistent, both with one another and with market data. Where a redress offer is based on a replacement product, the pricing is also verified by an independent reviewer. Replacement IRHPs are priced with reference to the prices available to retail customers at the time, but moderated to remove the prices at the upper end of the scale.

The FCA is aware of reports commissioned by customers from other derivative experts, which suggest a lower price for the IRHP, and consequently more redress. The methodology used in these expert reports is generally based on products sold in the *wholesale* market, which differs from pricing in the retail market. The difference exists because, as in many areas of financial services, the incremental costs of selling products to small retail customers is higher than selling to large institutions.

15-year caps

The Chairman asked a specific question about 15-year caps. We share your view that 15-year caps were rarely sold. Equally, customers being offered caps with a term of 15 years or more are not a common redress outcome within the IRHP Review; we estimate they represent around 2% of redress offers.

We are aware of views expressed by some derivative experts that 15-year caps should not be included in customers' redress offers because, realistically, banks would have rarely offered this option in the original sales presentation. However, by opening up the possibility for caps to be offered as redress, these customers have received significantly more redress than they would have had we limited the choice of alternative products to swaps and collars.

IRHP Agreements

We do not recognise a number of the allegations raised by the Committee that the agreements were 'watered down'.

- **The role of the skilled person in assessing legitimacy of the banks' condition of lending**

The final drafting of the IRHP agreement actually clarified the fact that the parties to the agreement were the FCA and the banks, not the independent reviewers, who received separate instructions through their section 166 mandate. It did not change the requirement of the independent reviewers to look at every case and assess whether the revised methodology was applied appropriately, including on condition of lending. The independent reviewers report to us on this specific point.

- **Offsetting redress**

The agreements generally prevent the banks from offsetting redress payable to customers against money owed to the banks. The final methodology includes one exception to this rule that allows the banks to offset redress against loans provided for the purpose of paying break costs, but only if the loans are still outstanding. This is a logical approach, as it puts customers back into the position they would have been in had the breach of the regulatory requirement not taken place; but for the breach the customer would not have entered into the IRHP and would not have needed to take out a loan in order to pay the break cost.

- **Separating consequential loss**

The usual method for dealing with redress in a past business review is for the regulated firm to deal with all customer losses with a single redress offer. As such, there was no discussion of either tying or separating consequential losses in the context of our agreement with the banks.

After the Review started, we began receiving feedback from customers who felt that their businesses could effectively be "held to ransom" if they had to wait for their consequential loss claim to be assessed before being able to utilise their basic redress money. For this reason we encouraged the banks to put in place a process whereby customers who urgently needed the money could receive it before submitting a claim for consequential losses. All the banks have put in place such a process.

The change was made to address the customer feedback, and we believe this was the correct decision; however, the arguments for and against separating payments are finely balanced. We were concerned that customers could end up paying a significant portion of their basic redress to advisers in the pursuit of unrealistic consequential loss claims, and unfortunately this does appear to have happened in a number of cases.

I hope the information provided helps address the Committee's concerns. Due to the interest in this subject from a number of sources, I believe it will be useful to make this letter more widely available, and as such I will be placing this letter in the public domain.

Yours Sincerely,



Martin Wheatley
Chief Executive