Financial Conduct Authority

FINAL NOTICE

To:	**Clydesdale Bank PLC**
Firm Reference Number:	**121873**
Address:	**40 St Vincent Place** **Glasgow** **Strathclyde** **G1 2HL**
Date:	**24 September 2013**

1. ACTION

1.1. For the reasons given in this notice, the Authority hereby imposes on Clydesdale Bank PLC (Clydesdale) a financial penalty of £8,904,000 for breaching Principle 6 of the Authority's Principles for Businesses (the Principles).

1.2. Clydesdale agreed to settle at an early stage of the Authority's investigation. Clydesdale therefore qualified for a 30% (Stage 1) discount under the Authority's executive settlement procedure. Were it not for this discount, the Authority would have imposed a financial penalty of £12,720,000 on Clydesdale.

2. SUMMARY OF REASONS

2.1. The penalty relates to Clydesdale's conduct from April 2009 to April 2012 (the Relevant Period). Clydesdale failed to pay due regard to the interests of its customers and treat them fairly after it discovered an error in how it had calculated some of its customers' mortgage repayments.

2.2. In January 2005, Clydesdale implemented a new mortgage repayment calculation system for its customers with variable rate mortgages. There was an error in this system which caused monthly interest and capital payments to be calculated incorrectly whenever there was an interest rate change. Clydesdale did not discover the error until April 2009.

2.3. Clydesdale identified over 42,500 customer accounts that were affected by the calculation error. Approximately 25,000 of these accounts were capital repayment mortgage accounts and approximately 17,500 were interest only mortgage accounts.

2.4. The error had the greatest impact on customers with capital repayment mortgage accounts. The majority of these customers made repayments that were insufficient to repay their mortgages by the end of their agreed terms (i.e. underpayments). Clydesdale considered that it was generally entitled to recover the capital shortfalls that had accrued on these accounts. These customers therefore faced increases in their monthly mortgage repayments to correct their mortgage payment and make up for the shortfalls caused by Clydesdale's error.

2.5. Following discovery of the error, Clydesdale took steps to investigate the nature and cause of the error and to ensure that all future repayment calculations would be accurate. However, Clydesdale took too long to complete these steps. This delay prolonged the impact of the error, significantly increasing the amount of the capital shortfalls which Clydesdale generally sought to recover from customers. In the interim, Clydesdale continued to send its customers mortgage account statements which incorrectly suggested that if they continued making the minimum repayments on their accounts, their mortgages would be repaid by the end of their mortgage terms.

2.6. Clydesdale accepted that, in certain circumstances (in particular where customers had acted to their detriment in reliance on the accuracy of Clydesdale's repayment calculations), it was not entitled to recover the capital shortfalls from its customers. However, the communication exercise that Clydesdale implemented to notify its customers of the error was unclear and unfair and gave rise to a significant risk that customers who should not have been required to cover the capital shortfall were not identified. In particular:

(1) Clydesdale's letters to customers who had made underpayments failed to make clear that, depending upon their individual circumstances, they might not necessarily have to cover any capital shortfall arising from the calculation error. On the contrary, the letters gave customers the impression that they had no option but to cover the shortfall in full.

(2) Clydesdale's explanation in the letters did not make clear that the capital shortfall was solely caused by Clydesdale's calculation error.

(3) Although the letters gave customers a telephone number to call Clydesdale's customer services team to discuss their repayments, there was a significant risk that customers would not call as they were unaware that they might not necessarily have to cover their capital shortfalls.

(4) For the approximately 8,000 customers who did call, Clydesdale's customer services team was not instructed to enquire proactively into customers' individual circumstances and similarly failed to make it clear to all customers that they might not necessarily have to cover their capital shortfalls. Instead, they only assessed customers' individual circumstances if the customers themselves indicated that they may have suffered detriment.

(5) Where the customer services team internally escalated cases for assessment, the assessors rejected claims for redress on the basis that there was no evidence of customer detriment (in circumstances where enquiries of the customer had not properly been made) or applied a test which was too strict. It agreed in some cases not to collect the shortfall, but in other cases it rejected claims where redress ought to have been made (e.g. by Clydesdale writing-off all or part of the capital shortfall).

(6) As a result of the above, there was a significant risk that customers who should have received redress did not receive redress. The Authority considers that most customers who made underpayments would have spent the 'savings' they made each month as a result of the error (but did not know about). The Authority therefore considers that it would have been unfair to require those customers to make good their capital

shortfalls. Clydesdale paid or credited £3,638,448 in redress to affected customers. However, the final capital shortfall for underpaying customers was £21.2 million in total: had Clydesdale carried out a clear and fair communication exercise, it is likely that the sum paid or credited in redress would have been far greater.

2.7. Approximately 22,000 accounts had capital shortfalls as a result of Clydesdale's error, 84% of which were capital repayment mortgage accounts. In addition there were approximately 21,000 accounts that were affected by the error but which did not have capital shortfalls, 68% of which were interest only mortgage accounts. Whilst the impact of the error was greatest for customers who had capital shortfalls some of whom faced substantial increases to their monthly mortgage payments when the error was discovered, some customers who did not have capital shortfalls may also have suffered detriment. Clydesdale's communication exercise should have made clear to these customers the differing ways in which the error may have affected them and the possibility that they may have been entitled to redress, but it failed to do so.

2.8. Clydesdale also failed to appreciate that over 5,000 customers who had repaid or remortgaged their accounts by the time that the communication exercise was rolled out may have also been adversely affected by the error. It therefore did not contact these customers.

2.9. The Authority views these failings as particularly serious for the following reasons:

(1) Customers relied on Clydesdale to calculate the correct amount of their mortgage repayments, which are typically a household's largest monthly outgoing.

(2) Due to the time taken by Clydesdale in investigating the calculation error, notifying customers of the error and adjusting their repayments, the total capital shortfall on the approximately 22,000 accounts that underpaid increased substantially to £21.2 million at its peak.

2.10. Clydesdale's failures therefore merit the imposition of a substantial financial penalty.

2.11. Clydesdale accepts that it should have dealt with this issue differently. In order to demonstrate its commitment to treating customers fairly, Clydesdale has voluntarily decided to provide redress over and above that which the Authority would have compelled it to provide, by writing off the capital shortfalls accrued by all customers who underpaid as a result of the error. These customers will be automatically compensated without having to participate in a further communication exercise. This approach is welcomed by the Authority. Clydesdale has also agreed to contact all other customers affected by the error to give them an opportunity to seek compensation if they believe they have suffered detriment or, if they still have a mortgage with the Firm, to ask for a return of previous overpayments (meaning their mortgage balances will increase) (see further from paragraph 6.22 below). This will include some customers who were excluded from the original communication exercise because, for example, they had already repaid their mortgages.

3. DEFINITIONS

3.1. The definitions below are used in this Final Notice:

(1) the "Act" means the Financial Services and Markets Act 2000;

(2) the "Authority" means the body corporate previously known as the Financial Services Authority and renamed on 1 April 2013 as the Financial Conduct Authority of 25 The North Colonnade, Canary Wharf, London, E14 5HS;

(3) "Clydesdale" means Clydesdale Bank PLC, trading under both the Clydesdale and Yorkshire Bank brands;

(4) "DEPP" means the part of the Authority Handbook entitled "Decision Procedure and Penalties Manual";

(5) "DISP" means the part of the Authority Handbook entitled "Dispute Resolution: Complaints";

(6) "ENF" means the part of the Authority Handbook entitled 'Enforcement', in force during the Relevant Period up to 27 August 2007;

(7) "FOS" means the Financial Ombudsman Service;

(8) "Group" means National Australia Bank Group;

(9) "Principles" means the Authority's Principles for Businesses;

(10) "Relevant Period" means the period between April 2009 and April 2012; and

(11) "TCF" means treating customers fairly.

4. FACTS AND MATTERS

Background

4.1. Clydesdale is a subsidiary of National Australia Bank Ltd and part of the Group.

4.2. Clydesdale provides retail and commercial banking services, and offers a variety of mortgages to its retail customers. As at 30 September 2010, the value of its variable rate mortgage portfolio (total loans outstanding) was £9,824 million.

Mortgage repayment calculation system

4.3. Customers rely on Clydesdale to calculate accurately the minimum repayments that they need to make to ensure that the total capital and interest due is repaid by the end of the mortgage term. For variable rate mortgages, customers' monthly mortgage repayments increase or decrease depending on whether the referenced interest rate (for example, the Bank of England base rate) increases or decreases. For the majority of customers who have set up direct debits in relation to their mortgage repayments, Clydesdale recalculates the amount of their repayments and debits this sum directly from their chosen bank accounts.

4.4. Some customers chose to make additional payments to their mortgage accounts (overpayments) with the intention of reducing the terms of the mortgages. Customers could choose to make a one-off overpayment or a monthly overpayment. For customers making monthly overpayments, following any change in the mortgage interest rate, Clydesdale would calculate a new monthly payment amount which included the agreed overpayment.

Implementation of the new calculation system

4.5. On 17 January 2005, Clydesdale implemented a new repayment system to calculate its variable rate customers' mortgage repayments.

4.6. When interest rates changed, this repayment system immediately recalculated a customer's mortgage repayments. However, the formula used in the new system was flawed. It calculated a customer's new repayment solely by adjusting the previous month's interest in accordance with the interest rate change, without also adjusting any repayment of principal or taking into account the different number of days in the month preceding the month in which the change occurred. Consequently, Clydesdale's customers' mortgage repayments were calculated inaccurately.

Detection of the calculation error

4.7. The error went unnoticed until April 2009, when a group within Clydesdale's technology function discovered it while investigating a series of unrelated issues.

4.8. The impact of the calculation error differed for capital repayment and interest only mortgage accounts:

(1) For capital repayment accounts, interest rate rises tended to result in an overpayment and interest rate falls tended to result in an underpayment. Each miscalculation was compounded when successive interest rate increases or decreases took effect because the repayment system assumed that previous calculations were accurate. The Bank of England base rate dropped overall from 4.75% in January 2005 to 0.50% in April 2009. As a result of the cumulative effect of the interest rate changes in this period, particularly from April 2008 to March 2009 when the Bank of England base rate dropped from 5.25% to 0.50%, the majority of Clydesdale's capital repayment mortgage customers affected by the error did not make repayments at a level sufficient to repay their mortgages by the end of their terms.

(2) For interest only accounts affected by the error, when interest rates rose or fell the error sometimes had the effect of causing overpayments and sometimes resulted in underpayments. However, the over or under payments on these interest only accounts were relatively small in comparison to those on capital repayment accounts affected by the error.

4.9. Clydesdale identified that the calculation error affected 42,648 of its mortgage accounts, around one third of Clydesdale's mortgage book. Of these accounts, Clydesdale identified that 21,844 had capital shortfalls as a result of underpayments, 18,374 (or 84%) of which were capital repayment mortgage accounts and 3,470 (16%) of which were interest only mortgage accounts. The impact of the error varied significantly between different underpaying customers. For example, one customer had a capital shortfall of £18,501, whilst another had a shortfall of less than £20. The average capital shortfall was £970, with a median of £497.

4.10. As a result, underpaying customers were faced with varied increases to their monthly repayments:

(1) For 3,719 mortgage accounts, there was a monthly increase of under £2;

(2) For 1,907 mortgage accounts, there was a monthly increase of between £2 to £5;

(3) For 1,815 mortgage accounts, there was a monthly increase of between £5 to £10;

(4) For 7,040 mortgage accounts, there was a monthly increase of between £10 to £50;

(5) For 3,535 mortgage accounts, there a monthly increase of between £50 to £100;

(6) For 2,409 mortgage accounts, there was a monthly increase of between £100 to £200;

(7) For 1,247 mortgage accounts, there was a monthly increase of between £200 to £500; and

(8) For 172 mortgage accounts, there was a monthly increase of over £500.

4.11. Clydesdale identified that the remaining 20,804 accounts affected by the error did not have capital shortfalls, 14,181 (68%) of which were interest only mortgage accounts and 6,623 (32%) of which were capital repayment mortgage accounts. These accounts did not accrue capital shortfalls either because the error resulted in customers making overpayments (rather than underpayments), or because customers had deliberately made overpayments to reduce the terms of their mortgages which were instead used to cover capital shortfalls that otherwise could have accrued. The impact of the error was greatest for accounts that had capital shortfalls because the customers involved were being asked to increase their monthly mortgage payments to correct the error and so make up for their shortfall. By contrast the monthly payments being made by customers whose accounts did not accrue capital shortfalls were already at sufficient levels to ensure full repayment by the end of their contractual terms. Furthermore, the majority of the accounts which did not accrue capital shortfalls involved interest only customers for whom the impact of the error was relatively limited, with many paying only a few pounds more each month than they needed to pay. However, it is possible that some customers who did not have capital shortfalls nevertheless suffered detriment (see paragraph 4.46).

Clydesdale's response to discovering the calculation error

FOS guidance on mortgage underfunding

4.12. Following consultation with the banking industry, including Clydesdale, the FOS published guidance in June 2001 describing its approach to determining complaints involving '*mortgage underfunding*'. This covered situations where the borrower had made a regular repayment quoted by the lender, but the lender (in this case Clydesdale) had quoted too low a figure.

4.13. The FOS guidance stated the following '*where the lender was 100% to blame*':

'*Ordinarily, we will tell the lender to write off the capital shortfall that has built up to the date the mistake was sorted out – and we will not deduct notional past savings. Exceptionally, we will deduct notional past savings (without interest) from the capital shortfall:*

- *to the extent the lender can show that the past savings are still retained by the borrowers as identifiable and readily-realisable assets;*
- *unless the borrowers can show that it would be unreasonable to do so in the particular circumstances.*'

4.14. The FOS guidance was updated in August/September 2010 but the position where lenders were entirely to blame did not materially change.

4.15. While the FOS guidance was not strictly binding on Clydesdale, it was a significant factor to consider. Moreover, DISP provided that guidance published by the FOS and decisions by the FOS concerning similar complaints were two factors that may have been relevant in the assessment of any complaints that Clydesdale received from customers.

Clydesdale's decision to recover the capital shortfall

4.16. Clydesdale decided not to follow the approach set out in the FOS guidance. For customers who had been making underpayments on their mortgage accounts, Clydesdale considered that it was generally entitled to recover from them any capital shortfalls that had accrued.

4.17. Clydesdale decided to conduct a communication exercise with its affected customers to explain the calculation error and its impact; confirm the amount of customers' new mortgage repayments and the date from which this would take effect; and invite customers to call its customer services free of charge for further information and assistance.

4.18. For the accounts that Clydesdale identified as having capital shortfalls, Clydesdale notified customers it would increase their monthly mortgage repayments (i) to cover the capital shortfalls that had accrued; and (ii) to correct the levels of their future mortgage repayments.

4.19. Clydesdale acknowledged that it was not entitled to recover customers' capital shortfalls where:

(1) in reliance on Clydesdale accurately calculating customers' mortgage repayments, they acted to their detriment (for instance, by making a purchase that they otherwise would not have made) and it would be unfair for Clydesdale to require them to cover the capital shortfall that had accrued; or

(2) the new mortgage repayments would result in customers experiencing financial hardship.

4.20. However, as described in paragraphs 4.26 to 4.44 below, Clydesdale's communication exercise did not make it clear that customers might not have to cover the capital shortfall and was insufficient to identify customers who should not have to cover the capital shortfall.

4.21. In formulating its strategy in response to the error, Clydesdale wrongly sought to balance its own commercial interests in securing repayment of the capital shortfall against the requirement to treat customers fairly. For example, one email of 3 August 2009 stated: '*We all agreed that the issue is very complex and difficult to get right from all perspectives. We were all very aware of TCF, FOS position, but also the commercial view – if we basically said "sorry for the mistake and we have adjusted your account, but going foirward [sic] your payment will be £x" then the costs could be as much as £25m… I realise that there are TCF considerations but the amounts for the majority are relatively low, so we should* *be able to point out our error as part of the review and move the cases back to a correct payment strategy going forward*.'

Fixing the calculation error

4.22. Changes to the repayment system were implemented in late September 2009, thereby preventing a capital shortfall accruing on any of Clydesdale's new customers' mortgage accounts. However, the capital shortfalls on the existing affected mortgage accounts continued to grow until the respective customers' repayments were adjusted. Clydesdale did not put in place any interim measures after it discovered the error. This meant that customers who signed up for variable rate mortgages between April and September 2009 were potentially exposed to the error. However, as there were no changes to the Bank of England base rate in this period, these customers were not adversely affected in practice.

4.23. Following work to resolve the error, Clydesdale did not start the roll-out of its communication exercise, to inform customers of the issue and tell them the amount of their adjusted mortgage repayments, until 8 March 2010. The adjusted mortgage repayments took effect approximately three months after notification.

4.24. In the time between Clydesdale's discovery of the error and its adjustment of customers' mortgage repayments, the total capital shortfall for underpaying customers increased substantially to £21.2 million at its peak.

Mortgage account statements

4.25. Throughout the Relevant Period, Clydesdale issued annual mortgage account statements to all customers who had capital repayment mortgages which stated, '*Should you make the minimum repayments on this contract, the amount outstanding on this account will be repaid in full in [x] months and [y] years*. *This does not take into consideration any overpayments you may have been making*.' However, from April 2009 (when the calculation error was discovered by Clydesdale) to at least March 2010 (when the communication exercise started), the statements issued were inaccurate, at least for underpaying customers, because, as Clydesdale was aware, the minimum repayments had been calculated incorrectly and were not sufficient to pay off customers' loans by the expiry of their mortgage terms. Clydesdale did not wish to amend the statements until it had investigated the cause of the error, was fully confident that any new calculations would be accurate and had prepared its customer communication exercise. However, this meant that Clydesdale continued to send out incorrect statements after it discovered the error.

Clydesdale's communication exercise

4.26. From discovery of the calculation error in April 2009 through to February 2010, Clydesdale formulated detailed plans for dealing with the calculation error, including the design of a customer communications strategy as described in more detail below. This included the drafting of tailored template letters which would be sent to separate categories of customer, the setting up of a dedicated call centre to deal with customer queries, the drafting of detailed scripts for handling calls, the establishment of a panel of senior staff to assess claims for redress and the formulation of the principles that would be applied in dealing with claims.

Roll-out of letters to customers

4.27. Clydesdale's communication exercise started from 8 March 2010 with letters being sent to affected customers on a rolling basis. The last of the letters were sent in October 2010.

4.28. Between April 2009 and March 2010, at least 5,366 Clydesdale customers who had variable rate mortgages closed their accounts. However Clydesdale failed to appreciate that the customers involved may have been affected adversely by the calculation error and so did not contact these customers at all.

Contents of letters sent to customers

4.29. Clydesdale's customers could only assess properly how to respond to the calculation error if the nature of the error, its impact and the options available to them were explained clearly and fairly in Clydesdale's communication letters.

4.30. Clydesdale's letters adopted a similar structure for all of the different categories of customer involved.

Clydesdale's explanation of the calculation error

4.31. A typical letter for a customer with a capital shortfall explained:

'*We recently undertook a review of your mortgage that has revealed an inaccuracy in the way your repayments were calculated. The effect of this, when combined with last year's unprecedented rapid reduction in interest rates, is that your minimum payment has fallen below the level required to repay your* *mortgage within the agreed term. We would like to sincerely apologise that this situation has occurred.'*

As a responsible lender we always aim to treat our customers fairly, so please rest assured that we have done our utmost to ensure this inaccuracy is corrected on your account as quickly as possible.'

4.32. This explanation did not make clear that the capital shortfall was solely caused by Clydesdale's calculation error.

Clydesdale's options for its customers

4.33. In its letters to customers with capital shortfalls, Clydesdale stated that it intended to increase customers' monthly repayments to ensure the mortgage balance would be repaid within the original contractual terms. It explained that the '*new amount will also cover the shortfall on your account (on which you also pay interest)*'. Clydesdale informed customers that their direct debit payment would be automatically adjusted from a specified date (approximately 3 months from the date of the letter).

4.34. The letter further went on to state:

'*In the event our proposed solution is not suitable for your particular circumstances, please do not hesitate to contact our Customer Care Team on the Freephone number above. Our advisers will be able to discuss other ways that you can bring your mortgage repayments up to date with the minimum of fuss; for example, making a one off payment or extending the term of your mortgage to repay the underpayment.'*

4.35. Clydesdale's letter would have suggested to underpaying customers that there was no alternative to bringing their mortgage repayments up to date. Clydesdale's letters did not make clear that, depending on individual circumstances, customers might not have to repay their capital shortfalls.

4.36. Accordingly, there was a significant risk that customers would not contact Clydesdale's customer services team, even if they had suffered detriment as a result of the calculation error.

Customer calls

4.37. Clydesdale set up a dedicated unit to deal with telephone calls from customers who were affected by the calculation error. Clydesdale provided all of its call handlers with training and guidance when dealing with such telephone calls.

4.38. When explaining the calculation error to its customers who had been making underpayments, call handlers were instructed to explain:

'*What we are trying to do is resolve this matter quickly and amicably, to get you back on course to pay off your mortgage within the agreed term and to ensure you are put back in the position you would have been had the inaccuracy in your payment not occurred. To help achieve this we have a variety of options in order to find the right one for your situation, which we can work through with you, such as extending the term, making a lump sum payment option, or perhaps a different mortgage product. We will work with you to find the one that is best for you.*'

4.39. These instructions, in a similar way to Clydesdale's customer letters, implied that there was no option but for underpaying customers to cover their capital shortfalls. There was again no reference to customers not necessarily having to do so or being asked to provide details of their personal/financial circumstances for further assessment.

4.40. Customers who, unprompted, described personal/financial circumstances which suggested to the call handlers that they should not have to cover their capital shortfalls were referred to specialists for further assessment. However, call handlers only assessed customers' individual circumstances if the customers themselves indicated that they may have suffered detriment. The onus was on customers to provide details of circumstances that would lead to a referral.

Claims assessment

4.41. Since call handlers were not instructed pro-actively to elicit customers' personal/financial circumstances, specialists did not always have sufficient information to consider adequately whether customers were entitled to redress and claims were rejected on the basis that there was no evidence of customer detriment.

4.42. In assessing claims for redress, specialists also applied a test which was too strict and unfair to customers. Clydesdale would agree to write-off the capital shortfall where, for example, a customer could provide evidence of significant capital expenditure or the taking out of additional loans on the basis of lower monthly mortgage repayments. However, Clydesdale wrongly rejected claims where there was evidence that customers had changed their day-to-day expenditure on the basis of lower monthly repayments but had not made any major capital purchases.

4.43. A number of customers were dissatisfied with the rejection by Clydesdale of their respective claim to have their capital shortfalls written-off and referred their cases to the FOS. Generally, the FOS dealt with such complaints in accordance with its publications and determined that the capital shortfall should be written-off. Nevertheless, Clydesdale did not modify its approach following these FOS determinations.

4.44. Clydesdale closed its dedicated unit dealing with telephone calls from customers affected by the calculation error in April 2012.

Communications with overpayers

4.45. The letters that Clydesdale sent to customers referred to in paragraph 4.27 above included letters to customers who did not have capital shortfalls on their accounts because they had made overpayments. While the impact of the calculation error was greatest for customers who underpaid, some customers who made overpayments may have suffered detriment and been entitled to redress.

4.46. Those customers who made overpayments solely as a result of the error (i.e. inadvertently) may have suffered detriment if, for example, they incurred overdraft charges on another account that they would not have incurred if they had saved the overpayments involved in that account. Those customers who deliberately overpaid to shorten their mortgage terms but whose overpayments were utilised to cover the capital shortfall may have suffered detriment by, for example, increasing their day-to day expenditure or buying a one-off item in the belief that they had paid off more of their mortgages than they actually had.

4.47. Clydesdale's letter should have made clear the differing ways in which the error may have impacted on these customers and the possibility that they may have been entitled to redress. Instead, Clydesdale implied that there was no option but for any deliberate overpayments made by these customers to be utilised to cover any capital shortfall that would otherwise have accrued. It did not address at all the fact that customers may have made overpayments inadvertently as a result of the error.

4.48. Furthermore, whilst not referred to in the scripted training and guidance, Clydesdale's call handlers also incorrectly told a number of customers who had made deliberate overpayments to their mortgage accounts that they were not affected by the calculation error.

Redress paid by Clydesdale

4.49. The total number of mortgage accounts in respect of which a telephone call was made to the dedicated unit was 8,155, approximately one fifth of the total number of affected accounts. Of the 8,155 telephone calls, 1,227 cases were referred to specialists for further assessment. In total, Clydesdale paid or credited £3,638,448 in redress to its affected customers.

4.50. Had Clydesdale carried out a clear and fair communication exercise, it is likely that a greater number of customers would have made contact with the firm in order to have their personal/financial circumstances assessed, and a greater number of customers would have received redress.

5. FAILINGS

5.1. Principle 6 states:

'A firm must pay due regard to the interests of its customers and treat them fairly.'

5.2. Between April 2009 and April 2012, Clydesdale breached Principle 6 because, in its handling of the calculation error, it failed to pay due regard to the interests of its customers and treat them fairly. This included the following failings:

(1) Having decided in principle to recover the capital shortfall from its affected customers, Clydesdale did not notify its customers of the error and their adjusted repayments in a sufficiently timely manner. This resulted in an increase in the amounts customers were required to repay to make up their capital shortfalls, with the total capital shortfall for underpaying customers reaching £21.2 million at its peak.

(2) Despite having discovered the calculation error in April 2009, Clydesdale continued to send affected customers who had capital repayment mortgages account statements which, at least for underpaying

customers, were inaccurate. They incorrectly stated that, should customers meet their minimum repayments, their loans would be paid off in full by the end of their respective mortgage terms.

(3) Clydesdale’s customer communication exercise was inadequate:

(a) Clydesdale’s letters to customers were unclear and unfair: Clydesdale did not explain clearly to its customers the nature of the calculation error, its impact and the options available to them. Therefore, customers were not in a fair position to consider properly their response. Moreover, Clydesdale implied that there was no option but for its underpaying customers to cover their capital shortfalls. As such, there was a significant risk that customers who should not have had to cover their capital shortfalls did not have their personal/financial circumstances assessed to determine whether this was the case.

(b) Clydesdale failed to deal with its customer calls adequately. For any customers who did call, Clydesdale’s customer services team was not instructed to enquire proactively into a customer’s individual circumstances. These instructions again implied that there was no option for underpaying customers but to cover their capital shortfalls.

(c) Where claims were referred for specialist assessment, they were not always dealt with fairly. Clydesdale rejected claims for redress on the basis that there was no evidence of customer detriment. However, Clydesdale applied too strict a test in assessing customer claims and so did not provide redress in all appropriate cases.

(d) As a result of the above, there was a significant risk that customers who should have received redress did not receive redress. The Authority considers that most customers who accrued capital shortfalls would have spent the ‘savings’ they made each month as a result of the error and, accordingly, it would have been unfair to require those customers to make good the capital shortfall.

(4) In addition to the approximately 22,000 accounts that had capital shortfalls as a result of Clydesdale’s error, there were a further approximately 21,000 accounts that were affected by the error but which

did not have capital shortfalls. It is possible that some of the customers involved also suffered detriment. Clydesdale's communication exercise should have therefore made clear to these customers the differing ways in which the error may have affected them and the possibility that they may have been entitled to redress. It failed to do so.

(5) Clydesdale also failed to appreciate that over 5,000 customers who had repaid or remortgaged their accounts by the time that the communication exercise was rolled out may have also been adversely affected by the error. It therefore did not contact these customers.

6. SANCTION

Imposition of financial penalty

6.1. The Authority has considered the disciplinary and other options available to it and has concluded that a financial penalty is the appropriate sanction in the circumstances of this particular case.

6.2. On 6 March 2010, the Authority's current penalty policy for determining financial penalties came into force. Clydesdale's misconduct took place before and after 6 March 2010. However, as the Authority considers that Clydesdale's roll-out of an unclear and unfair customer communication exercise from 8 March 2010 was the most serious aspect of its misconduct, it has determined the appropriate financial penalty under its current penalty policy.

6.3. DEPP 6.5A sets out a five step framework to determine the appropriate level of financial penalty.

Step 1 - disgorgement

6.4. Pursuant to DEPP 6.5A.1G, at Step 1 the Authority seeks to deprive a firm of the financial benefit derived directly from the breach where it is practicable to quantify this.

6.5. Given that Clydesdale has agreed to a further customer contact and remedial redress exercise covering all customers affected by the calculation error, as described from paragraph 6.22, the Authority has not identified any financial benefit that Clydesdale derived directly from its breach. Therefore, Step 1 is £0.

Step 2 - the seriousness of the breach

6.6. Pursuant to DEPP 6.5A.2G, at Step 2 the Authority determines a figure that reflects the seriousness of the breach. Where the amount of revenue generated by a firm from a particular product line or business area is indicative of the harm or potential harm that its breach may cause, that figure will be based on a percentage of the firm's revenue from the relevant products or business area. However, the Authority recognises that there may be cases where revenue is not an appropriate indicator of the harm or potential harm that a firm's breach may cause, and in those cases the Authority will use an appropriate alternative.

6.7. The Authority considers that the revenue generated by Clydesdale from its mortgage book is not an appropriate indicator of the harm or potential harm caused by its breach of Principle 6 in this case.

6.8. In considering an alternative metric to use at Step 2, the Authority has focused on the most serious aspect of Clydesdale's breach, namely its implementation of a customer communication exercise that was unclear and unfair. The greatest impact of this was on those customers whose mortgage accounts had capital shortfalls (and who were unfairly required by Clydesdale to increase their monthly mortgage repayments to make up their capital shortfalls). The Authority therefore considers that the total capital shortfall that accrued on these accounts is the most appropriate indicator of the harm or potential harm caused by Clydesdale's breach of Principle 6. The total capital shortfall amounted to £21.2 million.

6.9. Having determined that the total capital shortfall is the most appropriate metric to use at Step 2, the Authority must decide on a percentage of this amount that will form the basis of the penalty. DEPP 6.5A.2G (13) provides that in those cases where revenue is not an appropriate indicator of harm, the Authority will adopt a similar approach, and so will determine the appropriate Step 2 amount for a particular breach by taking into account relevant factors, including those set out in DEPP 6.5A.2G. However, in such cases the Authority may decide not use the 0 to 20% percentage levels that are applied in cases in which revenue is an appropriate indicator of harm.

6.10. The Authority considers it likely that the majority of customers who had a capital shortfall will be entitled to redress, and that the 0 to 20% percentage levels referred to in DEPP 6.5A.2G (3) are therefore too low when using total capital shortfall instead of revenue. The percentage levels that the Authority considers it appropriate to use in this case are as follows:

(1) Level 1 – 0%;

(2) Level 2 – 25%;

(3) Level 3 – 50%;

(4) Level 4 – 75%; and

(5) Level 5 – 100%.

6.11. DEPP 6.5A.2G (11) lists factors likely to be considered level 4 or 5 factors. Of these, the Authority considers that the following factor is particularly relevant to this case:

(1) '*The breach caused a significant loss or risk of loss to individual consumers, investors or other market users.*' Clydesdale paid or credited £3,638,448 in redress. However, the final capital shortfall for underpaying customers was £21.2 million in total: had Clydesdale carried out a clear and fair communication exercise, it is likely that the sum paid or credited in redress would have been far greater.

6.12. The Authority also considers the following factors to be relevant:

(1) Clydesdale's inadequate customer communication exercise affected over 42,500 mortgages, which are typically a household's largest financial commitment.

(2) Clydesdale did not modify its customer communications strategy even after a number of dissatisfied customers referred their cases to the FOS and the FOS determined that their capital shortfalls should be written-off.

6.13. The Authority considers that the appropriate level to reflect the seriousness of Clydesdale's breach of Principle 6 is level 4.

6.14. Therefore, Step 2 is 75% of £21.2 million, i.e. £15.9 million.

Step 3 - mitigating and aggravating factors

6.15. Pursuant to DEPP 6.5A.3G, at Step 3 the Authority may increase or decrease the amount of the financial penalty arrived at after Step 2, but not including any amount to be disgorged as set out in Step 1, to take into account factors which aggravate or mitigate the breach.

6.16. Clydesdale has agreed to undertake a further redress exercise, the details of which are set out from paragraph 6.22. Had Clydesdale not agreed to undertake an appropriate redress exercise, the Authority would have taken steps to compel it to do so and would have regarded this as an aggravating factor. However, given that Clydesdale has voluntarily decided to provide redress beyond that which the Authority would have compelled it to provide, by writing off the capital shortfalls accrued by all customers who underpaid without subjecting them to the inconvenience of a further customer communication exercise, the Authority considers it appropriate to reduce the financial penalty at Step 2 by 20%.

6.17. Therefore, Step 3 is £12,720,000.

Step 4 - adjustment for deterrence

6.18. Pursuant to DEPP 6.5A.4G, if the Authority considers the figure arrived at after Step 3 is insufficient to deter the firm who committed the breach, or others, from committing further or similar breaches, then the Authority may increase the penalty.

6.19. The Authority considers that the Step 3 figure of £12,720,000 represents a sufficient deterrent to Clydesdale and others. Therefore, Step 4 is £12,720,000.

Step 5 – settlement discount

6.20. Pursuant to DEPP 6.5A.5G, if the Authority and the firm on whom a penalty is to imposed agree the amount of the financial penalty and other terms, DEPP 6.7 provides that the amount of the financial penalty which might otherwise have been payable will be reduced to reflect the stage at which the Authority and the firm reached agreement.

6.21. The Authority and Clydesdale reached agreement at Stage 1 and so a 30% discount applies to the financial penalty at Step 4. The total financial penalty after this Stage 1 discount is 70% of £12,720,000 i.e. £8,904,000.

Further communication and redress exercise

6.22. Following publication of this Notice, the Firm will conduct a further customer communication and redress exercise, as set out below.

Letters to customers

Underpayers

6.23. The Firm has voluntarily decided to write off the capital shortfalls accrued by all customers who underpaid as a result of the error. These customers will be given redress without having to participate in a communication exercise.

(1) Where such customers have open mortgage accounts with the Firm, their accounts will be automatically credited by the amounts to be paid to them. They will also receive a letter from the Firm to confirm this.

(2) Where such customers no longer have mortgage accounts with the Firm, they will be sent letters inviting them to contact the Firm to confirm how they would like to receive the payments the Firm has agreed to make to them.

Overpayers

6.24. The Firm will also send letters to customers affected by the error who did not accrue capital shortfalls on their accounts because of overpayments to give them the opportunity:

(1) to seek compensation if they believe that they may have suffered detriment; and/or

(2) if they still have a mortgage with the Firm, to ask for a return of previous overpayments (meaning their mortgage balances will increase).

Customers not contacted in 2010

6.25. The Firm will also send letters to customers who were affected by the error but who had repaid or remortgaged their accounts between January 2008 and March 2010 and so were not contacted by the Firm as part of its communication exercise in 2010. These customers may be underpayers or overpayers and will be invited to contact the Firm to find out whether they are entitled to compensation.

Customers who previously received redress

6.26. Customers who previously received full redress from the Firm will not be included in this further exercise.

Customer support team

6.27. Customers who are invited to contact the Firm will be asked to call the Firm's dedicated customer support team. Customers may be asked questions about their financial circumstances to enable the Firm to determine whether they are entitled to compensation.

6.28. Customers do not need to do anything until they receive a letter from the Firm. In the meantime, further information about the Firm's further customer communication and redress exercise can be found on its website at www.cbonline.co.uk.

7. PROCEDURAL MATTERS

Decision maker

7.1. The decision which gave rise to the obligation to give this Notice was made by the Settlement Decision Makers.

7.2. This Final Notice is given under, and in accordance with, section 390 of the Act.

Manner of and time for Payment

7.3. The financial penalty must be paid in full by Clydesdale Bank PLC to the Authority by no later than 8 October 2013, 14 days from the date of the Final Notice.

If the financial penalty is not paid

7.4. If all or any of the financial penalty is outstanding on 9 October 2013, the Authority may recover the outstanding amount as a debt owed by Clydesdale Bank PLC and due to the Authority.

Publicity

7.5. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the Authority must publish such information about the matter to which this notice relates as the Authority considers appropriate. The information may be published in such manner as the Authority considers appropriate. However, the Authority may not publish information if such publication would, in the opinion of the Authority, be unfair to you or prejudicial to the interests of consumers or detrimental to the stability of the UK financial system.

7.6. The Authority intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

Authority contacts

7.7. For more information concerning this matter generally, contact Guy Wilkes (direct line: 020 7066 7574) of the Enforcement and Financial Crime Division of the Authority.

Tom Spender

Head of Department

Financial Conduct Authority, Enforcement and Financial Crime Division