



Left high and dry

A growing number of small firms complain UK banks wrongly sold them complex insurance. Compensation could cost billions



SWINGS AND ROUNDABOUTS: Interest rate swaps were meant to give security, but costs soared unexpectedly. REUTERS/TOBY MELVILLE

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LONDON, AUGUST 22, 2012

When businessman Colin Jones approached his local bank for a loan in 2007, he had little idea what an “interest rate swap” was, let alone a “structured collar”.

Jones wanted 400,000 pounds (\$630,000) to buy a

small hotel in North Wales and Royal Bank of Scotland said he could have the money if he also took out a swap - a form of insurance designed to protect him from a rise in interest rates.

Like a growing number of small business owners in Britain, Jones now regrets signing up. His hotel was repossessed in July last year after a sharp drop in rates during the financial crisis pushed charges on the deal to an unaffordable 30,000 pounds a year, the

same as the repayments on his loan.

“I’ve lost my house, my wife and I have separated, I lost my self respect and I lost the respect of my local community because they don’t see what’s going on in the background. People just assume that you’ve done something wrong,” Jones said.

The 48-year-old is caught up in what could become the UK banking industry’s next big scandal. An increasing number of firms that bought the disputed insurance products are claiming compensation and their advisers say the bill could run into billions of pounds. UK banks already face paying 8.8 billion pounds in compensation for disputes over other insurance.

Leading lenders Barclays, HSBC, Lloyds and RBS agreed to review their interest rate swap sales in June after the Financial Services Authority (FSA), Britain’s banking regulator, said it had found “serious failings” in the way the instruments were sold to small firms. Seven smaller banks have also agreed to review their swap sales.

But so far the banks have made provisions for only modest sums: Barclays and RBS, the country’s biggest small business lenders, have set aside 450 million pounds and 50 million pounds respectively. Others are not so sanguine.

“The banks are underplaying the scale of the problem,” said Stuart Brothers, a solicitor at Newport-based law firm SRB Legal whose clients include firms seeking compensation. Small firms say the banks did not properly explain the complex products or warn of the risks involved.

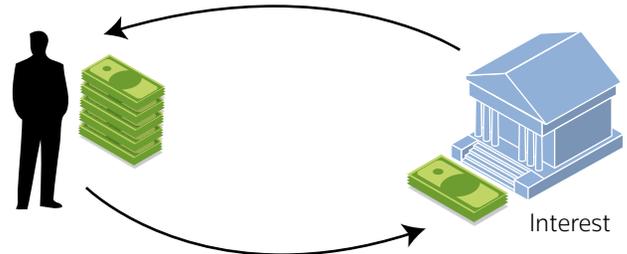
Reuters has spoken to banks, former bank employees and small business owners, and been shown bank emails and phone conversation details. They paint a picture of an aggressive sales culture where bank staff under pressure to hit targets fell short of their obligation under FSA rules to provide “clear, fair and not misleading” information about their products.

The disputes threaten to tarnish further the reputation of banks. While UK lend-

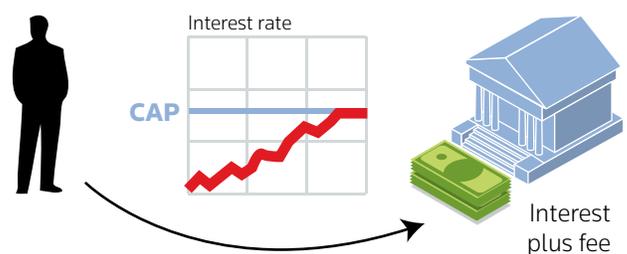
The swap problem

How British banks cashed in on insurance against interest rate rises.

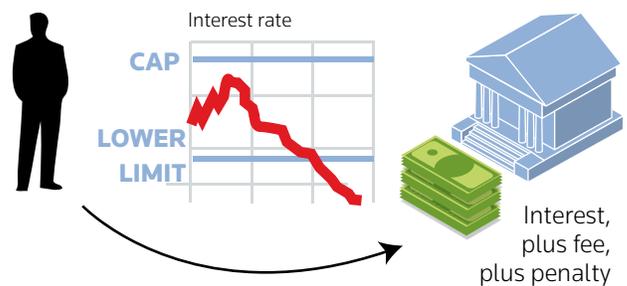
Bank lends money to small business owner, who pays interest on the loan



Bank also sells business owner interest rate swap that caps loan rate in exchange for a fee



But some swaps – especially those known as structured collars – impose penalties if rates fall beyond a set limit. Business owner can be landed with far higher costs than expected



ers are now being accused of starving small businesses of funding in the aftermath of the credit crunch, the swap claims show some banks were previously only too happy to make loans if they could sell profitable insurance at the same time.

Interest rate hedging products are supposed to protect bank customers against rates going up by making their future repayments more predictable. They come in many flavours, some called swaps and others “caps”, with the more exotic structured

collars allowing the repayment rate to fluctuate within a specified band.

The more complex products, especially structured collars, had an important catch: if the Bank of England (BoE) base rate fell significantly, borrowers could suddenly find themselves paying far more than they expected.

This was to prove costly for businesses that took out such hedges in the run-up to the credit crunch, which triggered a dramatic 1.5 percentage point cut in base rates in October 2008 as the BoE scrambled to

prop up the economy. Four further cuts brought the base rate down to 0.5 percent, where it has remained.

The accusation that banks did not make clear the consequences of a drop in rates lies at the heart of many cases of alleged mis-selling among the 28,000 swaps sold to small businesses between 2001 and 2008. Many aggrieved borrowers also allege that banks did not reveal the size of the break fees they would have to pay to terminate their hedge contracts early.

Jones says that in April 2007 he verbally agreed to his deal during a telephone call with an RBS salesman who told him “pretty much the quote has to be done over the phone” because it was a “live market”, according to a transcript of the conversation, made from a recording by the bank and seen by Reuters.

During the five-minute call the salesman told him a rise in interest rates was “looking like a dead cert” because of high inflation data published that morning. The salesman told Jones the swap would “essentially” fix the rate on his loan for five years, without spelling out what would happen if rates fell instead. He also failed to give Jones a proper indication of how much it would cost to break the swap early.

Jones is pursuing RBS for redress under the process launched by the FSA in June. RBS declined to comment on his claim.

Rate swap products were marketed most aggressively between 2005 and 2008, before the base rate fell sharply. In the final years of the long credit boom, banks were keen to sell more products to a debt-saturated corporate sector, and the logical next step was to extend lucrative hedging contracts, previously offered mainly to bigger firms, to small businesses.

“I think the loans were used as loss leaders,” said Abhishek Sachdev, a former Lloyds Banking Group salesman who left to provide independent advice to businesses through his firm Vedanta Hedging. “If the bank knows every loan it makes has some sort of hedging attached to it, profit-

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Former Lloyds salesman

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In the drive to grow the market for rate swaps, bank managers came under pressure to refer small business clients to their treasury departments, which would try to sell borrowers rate swaps to hedge their loans. They were pitched as providing security, and in some cases presented as a condition of getting a loan.

At the same time, sales staff were offered substantial bonuses to encourage them to hit rising targets.

“The carrot was bonuses. The relationship managers would be incentivised,” Sachdev said. “The stick was that if the relationship manager gave a client a loan for a million pounds, and didn’t introduce anyone to treasury, they would say you haven’t hit your target this month, you’ll lose your bonus.”

A spokesman for Lloyds disputed that view and said: “Interest rate derivative products were not products that we sold widely to our SME (small and medium size enterprise) customers.” He said over 90 percent of Lloyds’ SME customers chose simple fixed rate loans.

The spokesman added: “We are fully engaged and participating in the review of interest rate derivative products, which will provide redress to certain customers, as set out by the FSA.”

A sense of the pressures at work is evident in an email chain, seen by Reuters, which shows a regional sales director at one bank (not Lloyds or RBS) celebrating a deal struck in August 2008 by one of his relationship managers, earning the lender an immediate windfall of 180,000 pounds. The emails were shown to Reuters on the condi-



ROLE SWITCH: Abhishek Sachdev left Lloyds to advise small businesses on hedging and how to claim compensation. **REUTERS/HANDOUT**

tion that those involved remain anonymous.

“Could everyone please go and hug (name redacted) because this deal just got us to our full year income target!” the sales director says, expressing relief that a deal was done after a client unexpectedly proved to be a “particularly strong negotiator”.

Another executive writes: “This has been one of my more challenging deals to get executed - and also a very profitable one - all credit to (name redacted) as I know he must have had as many challenges in getting this client across to (name redacted) bank as I have in engineering the final combination of cashflows.”

The client is seeking compensation, alleging the product was not properly explained to them.

James Ducker, another former Lloyds salesman who now advises small businesses on hedging, said banks were mesmerised by the high profits they could make on rate swaps, and responded by ratcheting up sales targets.

“If in year one I made a 200,000 pound profit and in year two my target was 500,000, how do I make the extra money? And the answer was penetration, i.e. you need to sell more products to more people, and you

need to increase the margins," he said.

"I used to ask on a regular basis where would my individual targets stop. The targets just went up and up."

A spokesman for Lloyds noted that Ducker and Sachdev have an interest in advising claimants in swap disputes and said: "We would always suggest that customers with any concerns come to us direct, as we are keen to resolve them wherever possible."

It is not just former salesmen taking the banks to task. Conservative lawmaker Guto Bebb, who represents businessman Jones in the UK parliament, first became aware of interest rate swaps when Jones approached him during his weekly meeting for constituents in Aberconwy, north Wales. Bebb has since campaigned vigorously on behalf of small businesses who claim they were mis-sold the products.

"There was a drive to get these products sold, and sold to businesses where I would say the banks knew full well they were not sophisticated enough to understand what was being offered," Bebb told Reuters.

Another unhappy customer is Paul Reynolds, general manager of Birmingham-based property developer and estate agent City Estates Midland Limited, who says a hedge his firm bought from HSBC alongside a 4.3 million pound loan has turned into a financial straitjacket.

The cost of the swap soared after the unexpected drop in interest rates in 2008; the company has so far paid 1.2 million pounds, according to Reynolds. The financial burden has forced the firm to shed staff and sell property at "firesale prices", he says.

City Estates was not explicitly warned about the consequences of rates falling, and was not told clearly how much it would cost to exit the arrangement early, alleges Reynolds.

"We've had to make two people redundant and we had planned to hire another nine - that's 11 people claiming (welfare) benefit instead of working," he said.

HSBC declined to comment on the case, citing customer confidentiality, but



LOST BUSINESS: Colin Jones, pictured with his wife from whom he is separated, says his bank failed to warn him of the risks of swaps. **REUTERS/STEVE LEWIS/HANDOUT**

8.8 billion
The amount set aside by the UK's five biggest banks to pay claims for compensation over the mis-selling of payment protection insurance

Sources: HSBC, Lloyds, Barclays, RBS and Santander UK

said it hoped to find a satisfactory resolution through the FSA review process.

It added: "We believe that interest rate protection products are appropriate tools to help businesses to manage the impact of interest rate fluctuations, a view shared with the Financial Services Authority and the UK Government, in a recent white paper on banking reform."

Britain's battered banks already face paying 8.8 billion to compensate customers who were encouraged to buy insurance cov-

ering repayments on mortgages and other loans if borrowers lost income through unemployment or illness. The banks sold the insurance to many people who were ineligible for it - the policies often did not cover the self-employed, for example - or who did not realise they were getting insurance along with a loan.

The industry is also reeling from investigations into claims that it rigged Libor, the London interbank rate, a scandal that has cost Barclays 290 million pounds.

The final cost of compensation for interest rate swap mis-selling is hard to quantify. Although small firms bought just 28,000 of the contracts, while millions of consumers bought payment protection insurance (PPI), the average cost of settling swap mis-selling cases is likely to be far higher.

Compensation payouts for PPI policies typically run to hundreds or a few thousand pounds; but payouts on interest rate swaps can run to millions. Bebb said he is aware of one firm in his constituency that received an out-

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of-court settlement worth 16 million pounds after claiming it had been mis-sold a swap.

Chris Hale, a solicitor at Bracewell Law, another legal firm advising small businesses which bought the products, estimates the affair will cost the banks between three and six billion pounds, citing steady growth in his client list.

“The last month has been our busiest in terms of new clients and approaches to us,” he said.

If small businesses pursue lenders through the courts rather than the FSA process, the banks’ costs could rise substantially if courts make awards for “consequential losses” – business opportunities missed as a result of being locked into expensive swap contracts. The bill could also be pushed up by claims management companies, which carry out legal paperwork in return for a cut of any compensation payout. Such firms are widely seen as encouraging more claimants to come forward.

Against this, payouts on swaps could be mitigated by the process instituted by the FSA. Only “non-sophisticated” customers who bought structured collars qualify for

automatic compensation under the scheme. They are defined narrowly as businesses with less than 6.5 million pounds of sales, fewer than 50 employees, or assets worth less than 3.26 million pounds.

Companies deemed to be “sophisticated” and those sold products other than structured collars must have their cases assessed in a process monitored by an independent reviewer. If they don’t agree with the eventual decision, they can challenge it in court.

The FSA has also said banks will be allowed to compensate wronged customers by offering them replacement products, a cheaper option than reimbursing them.

Some experts say those measures explain why banks are making relatively modest provisions; they also warn that the FSA process could delay cases coming to court.

The hedging contracts were generally subject to a six-year statute of limitation, leaving a closing window of opportunity for companies to contest rate swap deals through legal channels. As most of the hedges were sold before the base rate began its steep fall in 2008, businesses which believe they were misled only have

until 2014 to lodge their claims.

In the meantime, thousands of small business people may be left to rue the day they allowed their banks to talk them into transactions they didn’t properly understand.

“I’m angry day and night,” said Reynolds of City Estates Midland about his experience with banks. “To put it in plain English, I hate them.”

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BRIGHT LIGHTS: The Canary

Wharf financial district of London. British banks are under fire on several fronts.

REUTERS/EDDIE KEOGH

