Using Experts in Interest Rate Swap Disputes

There has been extensive coverage of the mis-selling of Interest Rate Swaps – some containing embedded and sometimes complex options – to Small and Medium-sized Enterprises (SMEs) in the UK.

This briefing paper provides background on a number of issues which we believe lawyers and their clients will find helpful if they are making or defending claims in this field.

Background

On 29 June 2012, the then Financial Services Authority (now FCA) announced that it had reached agreement with four major banks – Barclays, Lloyds, HSBC and RBS – so that the banks would provide appropriate redress where mis-selling of interest rate derivatives had occurred. Independent reviewers were appointed and approved by the then FSA to ensure that the correct level of compensation – if any – would be paid by the banks. On 23 July 2012 a further seven banks agreed to do the same thing.

The independent reviewer process is obviously an attractive route for clients of the banks who feel that they were mis-sold interest rate hedging products, because it provides a low or no cost method of settling the dispute, and avoids expensive mediation or court costs. Furthermore, the banks are obliged to approach every client who was sold these products if there is a case for mis-selling.

What is covered?

However, not all interest rate hedging products are automatically included in the scheme; structured collars were specifically mentioned and the banks agreed that no further sales of these products would be made to retail customers. Structured collars were sold under a number of different brand names, but essentially they gave the client a maximum and minimum rate payable on the product, but also raised the rate (although never above the maximum) if interest rates fell below certain levels. With the massive fall in interest rates seen after the financial crisis, the vast majority of these minimum rates kicked in, and clients found themselves paying higher rates – even while market interest rates continued to fall.

Not all suspect products were structured collars; many interest rate swaps were also "structured" in different ways. They could be cancellable (by the bank), extendable (by the bank) or increased or decreased in amount (by the bank); all of these features involved the client – often unknowingly – selling one or a series of options to the bank. Selling options is a potentially risky activity for a small business and banks were frequently at fault in not making it transparent that the client was taking on these risks when it bought such products.

Not all clients will be eligible for this scheme:

- Firstly, "sophisticated" customers will be excluded; the FCA's position is that this is intended only to exclude clients who should have been very familiar with the complexity of these products. It is clear that some banks have excluded claims on the basis of the FCA parameters, even if it appears that the client was non-sophisticated. The only immediate way forward in these situations is to institute legal proceedings, but time limitations may already exclude some cases, and with others the time left will be very limited.

- Secondly, if the bank believes that the client fully understood the product when it was sold, then such clients will also be excluded. These situations will often be worth appealing – probably with expert support.

Redress offers

It is important to bear in mind that any redress offer from the bank is binding on the bank, but not on the client. This suggests that in many cases the first offer will not necessarily be the final offer and a period of negotiation may well ensue. If the final offer is not acceptable to the client, the client will still have available legal or non-legal methods of recourse.

But how does a small business assess what is a fair offer, and how can it tell whether the independent assessor has taken into account all the facts that might have established mis-selling? It is difficult to create a template that will answer either question definitively – specific circumstances will always have to be taken into account.

Essentially – and in very simple terms – there are three possible outcomes:

- The bank may decide that the hedge should be voided and all costs associated with it repaid; this is clearly the “best” solution, so it will probably come as no surprise if this is not what is offered.
- The second is the replacement of a structured collar (for example) with a more straightforward vanilla collar. It is also assumed that a client would not have bought a hedge if it might be expected that under “reasonably pessimistic” assumptions about interest rates the break cost would be more than 7.5% of the nominal value of the hedge. This generally means that the tenor of the new hedge is between 5 and 7 years, but so far it has been impossible to ascertain the exact methodology underpinning the calculation.
- The final outcome is that the bank decides that the original hedge should stand. This is most likely for 5 years or under and more straightforward hedging products like vanilla swaps.

Clearly nobody will appeal if the bank chooses to refund everything under the first option, although consequential losses may still be an issue (see below). In the case of both the second and third options, it may be worth appealing – the downside is after all limited, since the original offer is binding on the bank. Expert advice may be required at this stage, as some cases have been successfully appealed on the basis of quite technical arguments about the replacement hedge being offered.

The FCA scheme specifically mentions consequential losses; “certain” legal expenses are included but there is no exact definition of what “certain” means. It seems reasonable to assume that reasonable legal costs up to the date of the announcement of the scheme will be allowed, but in some cases it may well extend beyond that.

The scheme includes the payment of interest on amounts reimbursed calculated at 8% pa simple interest. If a borrower’s extra interest costs are higher than this, these can be claimed as a consequential loss, although of course the “normal” interest addition will then be void.

Finally, consequential losses based on loss of profits or business are possible although the FCA does warn that this may delay the process. Any claims under this heading will clearly require strong supporting evidence, especially where it is argued that a bank's actions led to the borrower experiencing solvency problems or breach financial covenants.

In summary, therefore, it is worth giving careful thought before accepting any redress offer that does not involve the voiding of the hedge product.

For further information

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