How do you solve a problem like mis-selling?

Mark Beaumont delves into the murky depths of IRHP mis-selling and advises how IPs can avoid the risks.

Some businesses would have survived the recession were it not for a mis-sold interest rate hedging products (IRHP), but now find themselves insolvent. A successful claim against a bank for mis-selling and the consequential losses is therefore a potential source of revenue for some insolvent businesses, and their creditors. There are though many challenges in bringing a claim of this type because of the:

- complex nature of derivatives contracts;
- banks aggressive approach to litigation;
- challenges in proving consequential losses;
- need for significant litigation funding and after the event (ATE) legal expenses insurance.

Thousands of insolvent businesses are passing through a review set up by the FCA in 2012 (the FSA at the time). This followed the finding that banks had mis-sold IRHPs to SMEs across the country.

Almost 3,500 reviews of consequential loss have been completed, but just four firms have been awarded over £1m by their bank. With so few insolvent businesses receiving significant funds, despite the catastrophic effect of mis-selling on some businesses, there is clearly a need for a comprehensive solution to support IPs and businesses in securing the appropriate redress, but first, let's look at the background.

What is an interest rate hedging product?

IRHPs are products sold to customers at the same time as taking out new loans or renewing existing lending facilities. IRHPs were marketed by banks and financial institutions as an alternative to fixed rate loans as a mechanism to reduce or negate the risk of rising interest rates.

The FCA has identified four principal types of IRHPs:

1. swaps – agreements in which a floating interest rate is 'swapped' with a fixed rate;
2. caps – where a ceiling is set for interest rates above which the customer would not have to pay;
3. simple collars – that give customers a range in which interest rate rises can be limited;
4. structured collars – where the customer bears the risk of interest rates falling below the lower limit of the collar.

Problem, what problem?

When properly sold, IRHPs can protect customers against the risk of interest rate fluctuations, but some UK banks didn't restrict sales just to those that needed the protection. Many customers did not understand the products or the potential costs ramifications for their business, and yet were put in a position where they felt that they had to purchase an IRHP.

In cases of mis-selling we can ask questions of the bank, such as: did the bank consider whether an IRHP was actually appropriate for the business? Were exit (breakage) costs explained to the customer? Was the IRHP matched to the borrowing, in terms of both value and duration? Did the client understand the impact of the hedge on the banks loan to value (LTV) calculations? Was the bank manipulating the underlying interest rates (LIBOR) while selling the hedge?

Where a business may have fallen victim to a mis-sold IRHP, there are several causes of action to bring a claim against the bank. These include a breach of an established duty of care or failure to comply with regulatory obligations, fraudulent manipulation of underlying interest rates, or negligent and/or fraudulent misrepresentation at the time of sale.

Solution, what solution?

The FSA (now the FCA) identified the problem of IRHP mis-selling and, in agreement with the banks, established a review of sales made since 2001 to 'unsophisticated' customers. Because of the narrow scope of this review, many businesses have been unable to achieve appropriate redress: their business falls outside the parameters of the review, or their most significant losses fall outside the parameters, or the banks are only offering basic redress and not consequential losses.

This means that litigation may be the only viable option to achieve genuine redress for businesses, especially those where the consequential losses are exacerbated by insolvency. Which brings us back to the complex nature of derivatives contracts, and therefore the deep understanding needed to successfully pursue a claim against a bank.

What IPs need is a professional partner capable of identifying viable claims and accessing the necessary expertise across several key areas:

- understanding the FCA review process, including issues relating to set-off, swap-for-swap offers and tax liabilities flowing out of accepted basis redress offers;
- legal expertise in both insolvency and banking litigation, including specialist lawyers and barristers willing to act on CFAs;
- forensic accounting skills to establish consequential losses;
- consequential liability expertise to assess the true (hidden) LTV ratios being used by banks to assess customers with derivatives contracts;
- innovative 'stepped' litigation funding and ATE insurance to maximise recoveries (funding agreements starting at just 5 per cent of damages recovered).

Pulling all of this together can be complex and expensive, and yet the risks of ignoring potential claims are high for an IP – consequential loss claims can be worth tens of millions, and depriving creditors of the right to pursue claims of this nature could be deemed negligent or worse.

IPs with concerns, or possible claims, should find a partner with genuine expertise in this area and a willingness to triage files for free, with a view towards funding and insuring them for litigation. Once a file has been reviewed there will either be a potential claim or the IP will have comfort to close the file without risking accusations of wilful ignorance. Any genuine claims can then be pursued under a fully funded and insured model that completely de-risks the IP and creates an opportunity to bring value back into the insolvent business to pay off outstanding fees and creditors.

MARK BEAUMONT is co-founder of Annecto Legal Ltd.