Mis-selling of Interest Rate Hedging Products ("IRHPs"): under the FCA redress scheme the "alternative product" is crucial in determining any consequential losses

Whilst attracting some publicity, the mis-selling of IRHP by banks in the UK has not attracted the headlines in the general media and press that the mis-selling of PPI protection cover has received. This possibly has something to do with the complexity of the mis-selling issue itself. After all, you have to be a sophisticated investor to understand any of this, so presumably the story would only play to a sophisticated audience.

As a consequence of this, despite a second parliamentary debate held in October 2013, there has until now not been much information available concerning consequential losses potentially recoverable under the redress scheme operated by the Financial Conduct Authority ("FCA"). In this article we briefly consider the consequential loss aspects based on our understanding of the FCA redress scheme, as well as our experience of a particular case under the scheme where the bank has issued its redress letter confirming that the IRHP was mis-sold, where it has confirmed the "alternative product", quantified the loss in respect of the differential in the interest paid and has then invited a claim in respect of the consequential loss.

From a cursory review of the FCA guidance literature on the redress scheme established in partnership with the various banks it appears, to this reader anyway, that the consequential loss aspects of any claim are being downplayed. The overriding impression I get is that the FCA assumes that the interest payable on any loss flowing from the differential interest rates (a *generous* simple interest rate of 8%) may well exceed the value of any consequential loss claim. Whether or not that will actually hold true will vary from case to case and will depend on the underlying evidence available.

Under the redress scheme the bank reviews the product that was sold, confirms whether or not it was mis-sold and then suggests the "alternative product" that should have been taken up by the customer. In our opinion, the "alternative product" will be crucial in establishing the extent of any consequential losses. We say this because ultimately the position a claimant would have been in but for the mis-selling of the IRHP will depend on its cashflows and any penalties incurred by refinancing elsewhere, both of which of course would be dependent on the "alternative product".

The key question to answer therefore when looking at prospective consequential losses is: what would the situation have been absent the mis-selling? This is where the "alternative product", or rather perhaps more accurately it should be called the alternative scenario but for the mis-selling, becomes paramount. I make the distinction between the "alternative product" and the alternative scenario because it seems to me that in referencing the "alternative product" the redress scheme seems to prejudge that a business would have taken a "product" from the same bank. This seems to me to be rather presumptuous; who is to say it wouldn't, and would have instead moved elsewhere or stuck with its "base rate plus x" deal.

Looking briefly then at the "alternative product", the redress letter we have seen suggested a capped interest rate product and included a cashflow statement (in an appendix) that compared the

position under the mis-sold IRHP with the projected position had the “alternative product” been adopted. However, the redress letter does not:

- explain why the “alternative product” would have been adopted;
- explain what the full terms and options were with the “alternative product”. In particular, it does not clarify whether the arrangement fee charged at the outset in the cashflow within the appendix could have been deferred and added to the loan so that it could be funded over the term rather than upfront (this potentially makes a big difference to the cashflow) and does not explain that there would be no redemption/penalty charge as there would be with an IRHP;
- clarify what other products were available;
- clarify whether the customer could have stayed on the “base rate plus x” deal that had previously applied over many years – this in itself is interesting, as presumably the bank ultimately will say you would have had to take some sort of product – albeit this would entail one of the bank’s salesman hitting targets and getting a bonus, again; and
- it completely ignores the notion that you might have gone to another lender and agreed a deal in line with what you had before – which would certainly have been a realistic option prior to the summer of 2008.

All of the above points are important because they all serve to inform the position as to what actually would have happened absent the mis-selling. You need to understand what this position would be (sometimes referred to as the counter factual position) to be able to run the comparative cashflows in order to then fully appreciate what would have been different and what this would then have meant for your business.

Many businesses found themselves in difficulty because the interest charge under the IRHP was high relative to available income, this may have caused problems in meeting interest payments, which in turn may well have led to the bank placing the business in its equivalent of the “special measures” department. These departments will have been aggressive and are likely to have compounded issues by taking the following steps:

- appointing expensive accountants to review the business and advise on further action (interestingly, the same accountants that are now acting as independent reviewers under the FCA’s redress scheme);
- instructing valuers (paid for by the business) to ultimately revalue (downwards) the assets on which bank loans were secured;
- requiring further personal guarantees and security;
- levying further fees and charges; and
- then ultimately demanding repayment of capital - which probably entailed the sale of assets at low points in the value cycle.

Any of the above measures, or a combination of the above, may have been catastrophic to many businesses, potentially resulting in:

- business failure;
- the sale of income-generating assets at below long term trends in value; and

- a curtailment of business activity, effectively halting investment in projects and further expansion of the business.

To the extent that any of these outcomes could have been avoided but for the mis-sold IRHP, we must again turn back to the comparison of cashflows on this; the actual losses incurred and the profits foregone will constitute consequential losses.   Next comes the hard bit...   evidencing it.