MONEY MATTERS.

Money Matters with Dr P Singh

# Swaps Misselling Scandal - PART 3

In the last edition of Money Matters we continued the sorry account of SMEs missold financial derivatives (swaps) by banks and – if misselling were not bad enough - the trouble SMEs have experienced seeking proper redress.

Members of the House of Commons Committee have raised a number of concerns about the swap review: a lack of consistency in the application of the scheme between banks, a lack of transparency about how the scheme was being run, a lack of appeals process, and the inappropriate nature of some alternative redress offered to businesses.

During the course of the banks' review of stand-alone swaps, an even bigger can of worms was unearthed. It was found that some SMEs had been granted loans where the swap is not stand-alone but is embedded in the loan, a so-called 'tailored business loan' (TBL). Just four banks alone (Barclays, HSBC, Lloyds, and National Australia Bank Group (NAB) were found to have sold 60,000 of these sold since 2001 to SMEs, considerably more than the 40,000 stand-alone swaps the bank review. Complaints by SMEs had been received in relation to TBLs sold by at least 10 banks, and especially in relation to those sold by the Clydesdale bank. In 10 years to 2012, the Clydesdale admitted it had sold over 11,000 TBLS to at least 6000 SMEs.

When a SME faces massive interest costs because it agreed to pay the bank a fixed rate on its TBL and market rates have fallen to almost zero, the SME will naturally try to end the TBL. The bank will usually agree to this but in return for a break cost paid by the SME.

This is fair and reasonable, however, the breakage costs charged by banks have been as high as 40 per cent of the original loan. For example, Michael Neeld, who purchased a TBL, said that he faced a break cost of "up to £200,000" on a loan of £1,000,000 of which £600,000 was fixed for 22 years. Lawrence Beere, who also purchased a TBL, said that he faced a "breakage cost in excess of £1.1 million" on a £3.9 million loan. NAB Customer Support Group told the House of Commons Committee "Most affected customers perceived that any break cost would be in the region of between 1% or 2% of the amount of the loan, consistent with those of domestic mortgages."

Patrick Walton, a former Managing Partner of Clydesdale's Financial Solutions Centre concedes that "with the benefit of hindsight it was clear we were selling [TBLs] to customers who did not always understand what they were getting into in a falling interest rate environment."

For a bank's sales literature to say to a SME that the TBL's features, risks and benefits would be 'marked to market' if terminated early is far too brief and casual, especially given

a) the general lack of financial sophistication of the bank's SME customers,

b) the size of the break cost that some SMEs now face, and

c) the mistaken perception among some SMEs that break costs would be in-line with those paid to redeem residential mortgages early.

The banks can justifiably be criticised for not quantifying to SMEs the break cost the SME would be liable to pay under possible interest rate environments, and for not even pointing out break costs in their loan contract. Not even banks however, thought market rates could fall so low and stay there for so long.

If these revelations are not enough to show some banks failed in their duty to their customers, instances of pressure-selling used by Clydesdale bank, for example, will confirm it. At Clydesdale, the pressure was not just applied to the SME, but to the bank salesperson also – he/she faced disciplinary action if targets were not met. Mr Walton (formerly at Clydesdale) described Clydesdale's culture "to be the most corrosive and threatening [he had] ever encountered". This is a clea illustration of the occurrence of distorted an damaging incentives in the retail banks, a is similar to the distorted incentives seen the investment banks.

In our final part, we look at some of the sible alternatives to obtain proper redre mistreated SMEs and whether there hope for them.

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