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CONDUCT RISK

Lessons learnt from Interest Rate Hedging Products

Anyone who watched the recent BBC Panorama programme - 'Britain's New Banking Scandal' - about Interest Rate Hedging Product ("IRHP") mis-selling, could probably not help but wonder "how could this have happened?" Could the "victims" have been as naïve and trusting as they appeared? Could the banks have been as malicious as they were portrayed? What lessons can financial services senior executives and those in product design, distribution, sales and those in second line oversight in banks do to avoid this type of scandal happening again?

Background

A review conducted by the Financial Services Authority ("FSA"; now the Financial Conduct Authority, "FCA") in 2012 found serious failings in the sale of IRHPs to small and medium sized businesses ("SMEs"). As a result, four banks, followed by a further seven, agreed to review their sales of around 40,000 IRHPs made to certain 'non-sophisticated' customers from 1 December 2001 onwards. The FSA first published an update in August 2012, followed by a report in January 2013 (based on pilots completed by Barclays, HSBC, Lloyds and RBS) explaining the banks' failings and customers' redress routes.

Between 2001 and 2008 the prevailing economic trends indicated continued global GDP growth, leading to a feeling of security, and scepticism regarding the possibility of a market crash. UK interest rates were very low and appeared stable; few predicted that they would fall to levels not seen since the 1930s. This stable interest rate environment and the desire amongst many to lock into the low rates fuelled the steady growth of IHRP sales. Traditionally offered to wholesale market participants, their distribution of IRHPs expanded to less experienced investors with varying risk profiles, including investors who subsequently were classified as 'non-sophisticated'.

Typically designed and sold as a tool to reduce exposure to changes in interest rates,[1] IRHPs were marketed as a way to eliminate uncertainty over future loan repayments. However, these products can be very complex and, therefore, susceptible to mis-selling. Paradoxically, instead of reducing costs through a reduction in exposure to interest rate volatility, many consumers ended up paying considerably more than expected. Structured interest rate collars are one example of a product designed to provide protection against increases in interest rates, but the product was often sold without making it clear that, in the event that interest rates should fall below a pre-defined level, the customer would be subject to paying higher fees - which is what later transpired. In this instance, far from hedging the risk, the risk is increased.

A situation where a "good" product turns "bad" due in part to the unanticipated events, is not unusual in mis-selling scandals; Payment Protection Insurance ("PPI") is not dissimilar in that sense. To complicate matters, the FCA, and before them the FSA highlighted in their behavioral economics work that people do not always make choices in a rational and calculated way, often basing decisions on intuitive, rather than fully rational input. Notwithstanding the possibility of irrational customer behavior, the regulator found widespread serious failings in the banks' sale of IRHPs.

What Went Wrong

In particular the report found:

- Widespread failure to ascertain the customers' understanding of risk;
- Non-advised sales straying into advised sales;
- 'Over-hedging' (i.e. when the hedge principal amount and/or duration did not match the underlying loans);
- Poor disclosure of exit costs and terms; and
- Rewards and incentives that acted as a driver of these practices.

Widespread failure to ascertain the customers' understanding of risk

According to the report, a disproportionately high number of customers complained that they didn't fully understand the monetary implications of the products they were sold; a finding made forcefully in the Panorama programme. The report states that "many complainants indicated that they believed they were purchasing hedges with a view to reducing their vulnerability to interest rate increases or fluctuations on loans they had taken out, but were given inadequate explanation of the risks involved.

[1] IHRPs can also be used to speculate on changes in interest rates.

These risks included the scale of any potential exit costs, the element of speculation that existed in regard to structured collar products and the risks the customer would face if the base rate fell significantly." Whether, in this case, customers' lack of understanding arose from an inability to understand the complexity of the product (level of customer sophistication) or because the product details were not accurately communicated (misrepresentation) is difficult to ascertain. The FCA's 'Lessons from behavioral economics'[2] sets out a number of reasons why customers make predictable mistakes when choosing financial products, the most relevant to IRHP's being:

- **Products are inherently too complex for most customers.** IRHPs are difficult products to understand and difficult to explain, with complex features and charging structures. This contrasts with many ordinary, routine banking products which customers would more easily understand and have experience of. This level of complexity leading to a lack of understanding was a strong message in the Panorama programme.
- **Decisions may require assessing risk and uncertainty.** People are generally poor intuitive statisticians and are prone to making systematic errors in decisions involving uncertainty. This was one of the prevalent features of the purchase of IRHPs, with customers misjudging the probability of changing rates. Customers did not have the sophistication to assess the risk they were facing and the FCA determined that firms didn't pay sufficient regard to regulatory requirements regarding suitability and appropriateness. They failed to understand customer's needs sufficiently including: investment objectives, level of education, attitude to risk, capacity for loss and relevant past experience of sophisticated products including IRHPs.

Non-advised sales straying into advised sales

The FCA makes an important distinction between 'advised' and 'non-advised' sales of financial products. Non-advised sales are typically used when the product is simple, straightforward and hence one which a reasonable lay-person with full disclosure of the features of the product could reasonably make an appropriate assessment of suitability. In the case of more complex products, non-advised sales can occur when a customer has the necessary experience and knowledge to understand the risk involved (FCA's Conduct of Business Rules 9 &10). The provision of advice is typically required for the selling of more complex products to less experienced customers, and is necessarily more onerous in terms of process in order to ensure product suitability. But despite the clear cut regulatory definition, all too often non-advised sales appeared to stray into advised sales due to the salesperson providing more information and clarification during the customers' decision-making process. This resulted in customers 'perceiving' that they had been advised to buy the product. The underlying issue is that an advised sale requires a higher level of suitability and appropriateness, which unfortunately wasn't performed in many of the sales of IRHPs.

'Over-hedging' of risks

The report found widespread evidence where the period covered by the IRHPs did not match that of the underlying loan. The reason for this discrepancy was not clear, but may have been the result of a salesperson not inquiring about the details of the loan, or an intentional mismatch, the cost of which was not fully explained. Whatever the reason, the result was that often customers were left paying for the IRHP long after the loan was repaid.

Poor disclosure of exit costs and terms

The FCA highlighted that contract exit costs were often not adequately explained during the sales process. A large number of customers attempting to exit these products early should have alerted banks to an underlying issue, as should the high levels of complaints regarding exit charges. Where complex products are offered, it is critical that management oversight is rigorous and in this case, management should have been aware of, and acted on, the IRHP related complaints.

Complaint levels are a useful barometer against which to identify potential mis-selling situations. The prevalence of mis-selling of these products over a ten year period indicates that insufficient or unsatisfactory root cause analysis was performed on customer complaints.

Rewards and incentives which drove inappropriate behaviours

A particular focus of the political and media community in relation to the causes of the recent financial crisis and, in particular, the sale of unsuitable products has been the role of remuneration - specifically its link to mis-selling. The Panorama programme quotes a former salesperson referring to the sale of IRHP's as "driven by big bonuses" saying.... "...you could get double your salary as a bonus, and your boss can get a bonus and your bosses get a bonus". Martin Wheatley (FCA CEO) stated in the programme that in "some cases the banks were selling more complicated products than they needed because they made more profit." The common practice of remunerating sales staff based on sales levels has been substantially altered, although not eliminated.

What Could Have Been Done To Prevent This From Happening? And What Can Be Done To Prevent Similar Situations Occurring?

There are five main areas firms should consider to avoid similar situations occurring:

- Product design;
- Appropriate training;
- Product documentation clarity;
- Record retention; and
- Management information.

Product design

Most IHRPs were structured as "collars", containing a cap (limit on the amount of interest expense the customer would incur) and a floor (limit to how low the customer's rate could fall). The cost to the customer of getting a cap was offset by the floor; if there was no floor, the cap would have involved a large upfront expense. One of the key criticisms, especially in the case of structured collars, was their configuration with respect to the interest rate floor which would result in customers owing the bank money if rates fell below an agreed level.

Many of these products dated back to 2001, meaning they were designed in a period where the base rate fluctuated between a high of 5.75% (February 2001 and July 2007) and a low of 3.5% (July 2003). Since March 2009 the base rate has been 0.5%, implying structured collars with an aggressively designed floor could have caused heavy losses for customers after this date. Given the superior expertise banks have in analysing interest rate movements, the pricing and distribution of such products suggests banks could have benefited from 'information asymmetries' between themselves and their customers. It is reasonable to assume, the banks considered all manner of potential interest rate movements and their monetary implications, whereas customer may not have done.

Lessons learned:

- Rigorous market research should be conducted using customer focus groups to properly refine and define the suitable target investor base for specific products;
- Consider how best to classify your firm's retail professional clients to incorporate the FCA's 'sophisticated' and 'non-sophisticated' customer types;
- Confirm customers' understanding of products and evaluate customers' experience using mystery shopping techniques and customer call-backs;
- Given that customer's decisions will often be made on the basis of stress, anxiety, fear of loss rather than the cost / benefit choices, ensure products are not designed to appeal to consumer biases and that salespersons are aware that biases may exist;
- Stress test what may be "extreme" scenarios to fully understand the product's performance;
- Define "key performance indicators" numerically, and determine when they become "key risk indicators";
- Ensure that any product that is directly or indirectly linked to another product (e.g. a loan and an IRHP) is reviewed to understand how the profits from one are used to compensate/top-up the losses of another; and
- Assess the possibility of customer default in the case of highly complex products.

Appropriate training (products and the sales process)

Some of the products being sold to small business owners classified as retail customers were complex derivatives designed in the investment banking divisions of the high street banks involved. It may be inappropriate therefore, to assume that retail salespeople understood the features typically built into such contracts. Firms must provide robust and documented internal training programmes that ensure salespersons have the right level of knowledge to explain complex products.

Lessons learned:

- Ensure the right people are involved in establishing template marketing materials for use by sales staff (i.e. not just the Sales and Marketing Teams) that enable salespersons and customers to understand what is being offered;
- Before sales staff are approved to sell particular products, test their understanding;
- Test sales staff to ensure they understand the difference between "advising" and providing information;
- Ensure that feedback on product performance and complaints (including root cause analysis) is used to inform product design and individual training plans; and
- Review client relationship management data regularly to understand what products are being sold to what clients and by whom; look for unusual sales patterns.

Clarity of documentation

Due to the complexity of certain IRHPs, documentation providing an explanation of the nature and specifics of these products to the customer were key to preventing mis-selling and defending accusations that it occurred. Sales of IRHPs frequently took place over the phone which made it difficult for the salesperson to convey salient details and confirm customers' understanding. Customer information packs explaining the best and worst case scenarios, including graphs showing the customer's liability in the case of the most extreme economic conditions, should accompany pre-sale, not post-sale disclosure material.

Lessons learned:

- Use simple, straightforward language in all communications and documentation;
- Include multiple impact scenarios and use visual tools (graphs and diagrams) to aid understanding;
- Ensure product documentation is written with the objective of supporting the customer, not defending the firm against future claims. For example, do not allow direct or indirect obfuscation of unattractive product attributes (such as penalties and early exit fees); and
- File reviews, mystery shopping and customer call backs can and should be used to verify that the approved sales documentation is actually being used by the sales staff.

Record retention

One consistent feature of mis-selling and past business reviews is the poor documentation maintained by firms. The most frequent being evidence of customer classification, product suitability and customer discussions. All firms will have policies, procedures and systems designed to record sales, transaction details, and customer communication, but all too often firms fail to collect proper evidence. As a result, even those firms that intended to, or did "the right thing", can't prove it, resulting in a 'guilty' verdict for the firm.

Lessons learned:

- Ensure your sales staff follow internal procedures and evidence their actions and decisions, remaining compliant with internal record keeping requirements.

Management Information informing conduct risk

Detailed analysis of sales figures by product type, commission levels vis-a-vis particular products, early exits and complaints could have been used individually and in tandem to identify the possibility that sales were being made inappropriately, outside the firm's conduct risk appetite. In the case of IRHPs, the mere fact that complex derivatives were being sold in large numbers to non-sophisticated customers should have been a mis-selling red flag. The fact that this situation continued for as long as it did indicates senior management reporting was inadequate, or not acted upon.

Lessons learned:

- Ensure management information includes detailed analysis of what products were being sold to each client classification type. For example, how many retail or non-sophisticated clients were sold collars;
- Ensure management information includes an analysis of the number of products sold where the term was inconsistent with the underlying products term;
- If your firm is making sales via a third party distribution network, ensure you are receiving relevant management information including commissions and client classifications; and
- Monitor complaint levels and the detailed root causes, and ensure findings are fed back to the product design team for action and front office line management for sales staff specific issues.

Final thoughts

If the banks and individual salespeople involved in IRHP mis-selling had put the needs of the customers at the heart of their business, this latest scandal would have been avoided. In other industries (think pharmaceuticals) when products are known to be mis-sold or don't do what "they say on the tin", they are recalled by the firm and the customer's position rectified. Perhaps when financial services firms begin to take action of their own, independent of public, regulators and government interference, trust will start to be regained.

[2] FCA Occasional Paper No.1 – Applying behavioural economics at the Financial Conduct Authority, 10 April 2013

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