FINAL DECISION	
complaint by:	Business H
complaint about:	Bank S
complaint reference:	
date of decision:	August 2013

This final decision is issued by me, Tony Boorman, an ombudsman with the Financial Ombudsman Service. It sets out my conclusions on the dispute between a small business (Business H) and Bank S about an interest rate hedging product – an interest rate collar.

Under the rules of the Financial Ombudsman Service, I am required to ask Business H to let me know whether they accept or reject my decision by 30 October 2013.

summary of complaint

This dispute is about the sale by Bank S to Business H of an interest rate hedging product – a "collar" – sold in connection with a loan agreed by Bank S. The sale took place in 2007.

my provisional decision

On 26 October 2012 I issued a provisional decision upholding this complaint. I provisionally concluded that in the circumstances of this case the "base rate collar" should not have been recommended to the business by the bank without more thought about flexibility and the potential impact of cancellation charges – and the Bank S should have provided better information about the product it sold.

I invited the parties to reach a mutually acceptable agreement about a settlement in light of my initial observations. To help guide discussions, I set out what I considered fair compensation might look like in the circumstances. This was a re-working of the loan and hedging arrangement on the basis that, if properly advised and informed, Business H would have taken out a cap for 20 years but not a floor.

Business H was broadly in agreement with my provisional findings, namely, that Bank S offered it advice about a collar product which was unsuitable and failed to provide it with sufficient and adequate information concerning the potential break costs of the product. However, Business H submitted that rather than a 20-year cap product, if it had been properly advised and informed, it would not have opted for any interest rate hedging product at all.

Bank S indicated that it would offer redress in line with my provisional decision. However, the parties were unable to reach an agreed settlement.

I wrote to both parties on 21 February 2013 to clarify my views on redress, which I will return to later.

Bank S said that although it does not agree with every aspect of my provisional decision it agrees to implement the recommendation made and clarified in my letter of 21 February 2013.

Business H remained certain that it would not have entered into a hedging agreement but said that in order to expedite matters it would accept the finding that it would have entered into a cap but reserve all its rights to change this position should this matter proceed further through litigation or the review into the selling of hedging products to small businesses which certain banks (Bank S included) have agreed with the Financial Conduct Authority (FCA)[1]. Business H also questioned the calculation and figures which Bank S put forward in response to my provisional decision.

I have carefully considered the points made by both parties. Having done so, I am not persuaded that I should depart substantially from the findings set out in my provisional decision and subsequent letter of clarification.

While both parties have indicated their willingness to reach a settlement on the basis of my recommendations, they have been unable to agree on how that settlement should be structured. They have also been unable to reach any alternative settlement. As such I have also set out below more detail in respect of how this matter ought to be settled.

background to complaint

a) events leading up to the complaint

Business H is an offshoot of a media company. It was established to act as landlord for the small office block where the media company (with related owners) is the main tenant. In 2007 it decided to consolidate all of its borrowing into a single loan and to seek funds to renovate and refurbish the building it owned.

Business H approached Bank S for assistance. In February 2007 Business H discussed with Bank S a business loan for £356,000 on a capital and interest basis, to refinance existing debt of approximately £275,000 and to provide additional funds.

In assessing the loan, Bank S's relationship manager noted in an internal memo that Business H was an "*existing good customer*" and that "*previous facilities have operated without issue and foresee no change on the new facilities*". The relationship manager recorded that a 20 year term for the borrowing had been agreed due to "*financial prudence*" and that the "*LTV* [loan to value ratio] *is conservative*".

The loan was in due course approved on the basis of a variable interest rate of Bank S's base rate + 2%. At around the same time there was a discussion of interest rate hedging – and a "base rate collar" was agreed. The precise nature of this arrangement I will set out in more detail later in this decision. But in essence it was a separate agreement with the bank, under which any variation in the loan interest rate payable above an agreed "cap" or below an agreed "floor" was netted off against payments to or from the bank – so that it effectively created an interest range with an upper and lower limit.

In 2009 there was further discussion between Business H and Bank S – the business indicated it was hoping to benefit from reduced interest rates and enquired about breaking the collar. It was told it was not possible to explain the potential costs involved in breaking the agreement and that "*you would have to have five degrees in maths*" to understand how the costs would be calculated. After further enquiries in

[1] The Financial Services Authority (FSA) at the time of this complaint.

September 2009, Business H was given an estimated cost to exit the arrangement of £35,500 – and £48,000 just to exit the floor.

Business H has become increasingly concerned by the burden that the collar now represents on the business which continues to trade, but like many other businesses it is under pressure given wider market difficulties.

b) The complaint and the bank's response

Relations between the bank and Business H declined and the business raised a formal complaint about the collar and associated arrangements. It said:

- Bank S sold it a product that was complex and inappropriate for its needs; *and*
- the potential scale of the penalty costs to exit the arrangement was not explained.

Bank S did not agree. It said the hedging was a condition of the loan and the lending would not have been granted unless a hedging arrangement had been agreed. It was satisfied that it had acted appropriately and that the decision to enter the collar arrangement was one that Business H had freely made after having the available products fully explained to it.

Business H was not satisfied by this response and it referred this complaint to the Financial Ombudsman Service.

The complaint was investigated by one of our adjudicators who obtained further information from the parties. The adjudicator's opinion was that the complaint should not be upheld. Business H objected to that initial assessment and reiterated its concerns about the arrangement. As the parties could not agree on an outcome and in view of the significance of the sums involved, and the wider interest in disputes of this nature, the dispute has been referred to me for determination under the rules of the ombudsman scheme.

Accordingly, in light of these developments and given the desirability of resolving matters as promptly as practicable – while recognising the significance of the issues for both parties – I issued my provisional decision on this case.

my findings

I have included only a brief summary of the complaint (above). But I have read and considered all the evidence and arguments available to me from the outset, in order to decide what is fair and reasonable in all the circumstances of this complaint.

a) jurisdiction

I do not have a free hand to investigate complaints from all of Bank S's business customers. I can only consider complaints from those businesses and other customers who meet the eligibility criteria set out in the dispute resolution rules (DISP) section of the FCA Handbook of rules and guidance.

I am satisfied that Business H falls within my jurisdiction as it is a micro-enterprise – and as such it is an eligible complainant for the purposes of DISP. Broadly this means that, at the time Business H referred its complaint to Bank S, it was an enterprise which both employed fewer than 10 persons and had either a turnover or annual balance sheet that did not exceed €2 million.

In this context, in accordance with European Law, the number of “employees” is calculated on a full time equivalent basis and includes: persons working for the enterprise being subordinated to it and considered to be employees under national law, owner-managers, and partners engaged in a regular activity in the enterprise and benefiting from financial advantages from the enterprise.

In this case, Business H’s annual turnover at the relevant time was less than £40,000 per year and it had at most three 'employees' – two directors and a financial administrator/book keeper. The media business of which Business H’s directors were also partners was also a small business with five employees (including the two partners) and a turnover of around £300,000.

So even taking the headcount and turnover of the connected business, I am satisfied that Business H is a micro enterprise for the purposes of our rules and consequently I can consider the complaint.

I am also satisfied that the Business H was, in the language of the FCA’s review of interest rate hedging products, a “non-sophisticated customer”.

b) relevant considerations

When considering what is fair and reasonable, I am required to take into account relevant: law and regulations; regulator’s rules, guidance and standards, and codes of practice; and, where appropriate, what I consider to have been good industry practice at the time.

I am mindful that this is a complaint between a relatively modest-sized business customer and a bank. My general approach when considering cases in relation to business customers is to analyse the circumstances of the customer and the nature of the transaction. In broad terms, the larger and more significant the transaction is, the more I would expect a business customer to pay particularly careful regard to its contents.

Similarly, the professional knowledge of the business and/or its ability to access professional support will be of relevance in assessing the case. A small corner shop, for example, is unlikely to have the facilities to analyse complex legal and financial transactions and may be unable to access independent advice on the issues – whereas a larger business is more likely to have these facilities, or the ability to access independent advice.

So, depending upon the nature of the business, I might consider it fair for the bank to exercise more care in its dealing with the corner shop than with a large business. This might include going to greater lengths to make sure the business understands all the implications of the transaction.

I am also mindful that the protections available for personal customers (in law and in self-regulatory codes) go beyond those made available to business customers in some respects. It is important, therefore, to avoid applying to this case (and similar cases) provisions and considerations that are only appropriate in the case of personal customers.

But this does not mean that business customers have no protection in law. Even if the complainant is not a *“private person”* under section 150 of the Financial Services and Markets Act 2000 (and therefore does not have a statutory right of action), that does not mean that the FCA Principles and Conduct of Business Sourcebook (“COBS”) rules do not apply to the respondent business.

Neither does it mean that the Principles and COBS are irrelevant for the purposes of determining this complaint by reference to what is, in my opinion, fair and reasonable in all the circumstances. Clearly the same points can be made in respect of the Conduct of Business (COB) rules which preceded the present COBS and were in place when this collar was sold.

The application of many of the regulatory rules at the time depended on the classification of the person with whom the financial business conducted investment business. In the Principles and COBS, the term “customer” usually refers to a private customer and intermediate customer, but not market counterparties. The term “client” covers customers and market counterparties.

I am satisfied that for the purposes of the rules at the time of the transaction, Business H was a “private customer” – that is, someone who is neither a “market counterparty” nor an “intermediate customer”.

In other words, Business H was a private customer because it was it was not: a listed company, a partnership with net assets of at least £5 million at any point in the previous two years, someone Bank S had classified as an expert private customer and taken the steps set out under COB 4.1.9R, or any of the other market counterparty or intermediate customer classes.

The Principles and conduct rules remain important standards that a financial business must still observe in the conduct of its business, irrespective of whether its customers are individuals or businesses, large or small. Many of those standards reflect the obligations that I would expect to exist at law anyway for a business in dealing with its customers.

In *R(BBA) v FSA and FOS* [2011] EWHC 999 (Admin) at 162, Ouseley J made it clear that the Principles are best understood as *'the ever present substrata'* which *'always have to be complied with'*. The Principles and more detailed conduct of business rules are therefore relevant considerations that I am obliged to take into account when considering what is fair and reasonable, in accordance with my obligations under DISP 3.6.4R and statute.

The Principles that are of particular relevance to this and other similar complaints are:

- Principle 1
  “A firm must conduct its business with integrity”

- Principle 6
  “*A firm must pay due regard to the interests of its customers and treat them fairly*”

- Principle 7
  “*A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading*”

- Principle 9
  "A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment".

In addition, in specified circumstances, the more detailed FCA Conduct of Business (COB) rules apply. These came into force on 1 December 2001. Of particular relevance to this complaint are:

- clear, fair and not misleading communication

  COB 2.1.3R (from 1 December 2001)
  "When a firm communicates information to a customer, the firm must take reasonable steps to communicate in a way which is clear, fair and not misleading".

  COB 2.1.4G (from 1 December 2001)
  "When considering the requirements of COB 2.1.3 R, a firm should have regard to the customer's knowledge of the designated investment business to which the information relates".

- requirement to know your customer

  COB 5.2.5R (from 1 December 2001)
  "Before a firm gives a personal recommendation concerning a designated investment to a private customer, or acts as an investment manager for a private customer, it must take reasonable steps to ensure that it is in possession of sufficient personal and financial information about that customer relevant to the services that the firm has agreed to provide".

  COB 5.2.7G (from 1 December 2001)
  "If a private customer declines to provide relevant personal and financial information, a firm should not proceed to provide the services described in COB 5.2.5R without promptly advising that customer that the lack of such information may affect adversely the quality of the services which it can provide. The firm should consider sending written confirmation of that advice".

- requirement for suitability generally

  COB 5.3.5R (from 6 April 2006)
  "(1) A firm must take reasonable steps to ensure that, if in the course of designated investment business:

  (a) it makes any personal recommendation to a private customer to:

  (i) buy, sell, subscribe for or underwrite a designated investment (or to exercise any right conferred by such an investment to do so); or
  (ii) elect to make income withdrawals,

  …the advice on investments or transaction is suitable for the client.

(3) In making the recommendation or effecting the transaction in (1), the firm must have regard to:

(a) the facts disclosed by the client; and

(b) other relevant facts about the client of which the firm is, or reasonably should be, aware".

- customers' understanding of risk

  COB 5.4.3R (from 15 November 2001)
  "A firm must not:
  (1) make a personal recommendation of a transaction;…
  with, to or for a private customer unless it has taken reasonable steps to ensure that the private customer understands the nature of the risks involved".

c) overview

Taking these considerations into account together with the points raised by the parties in this dispute, the key initial questions I need to ask are:

- whether Bank S gave Business H advice about the interest rate collar (and if so whether the bank took adequate steps to ensure that the advice was suitable); and

- if Bank S did not give advice, whether it gave Business H information that was clear, fair and not misleading in order to put it into a position where it could make an informed choice about the collar.

I also need to consider whether or not the way Bank S administered the requirement it placed on Business H to purchase a collar was fair - and whether, in all the circumstances, it represented a reasonable exercise of its commercial discretion.

d) developments since my provisional decision

i) legal issues

I am aware that since I issued my provisional decision, the Mercantile Court of the Manchester District Registry handed down its judgment in *Green and Rowley v Royal Bank of Scotland plc* [2012] EWHC 3661 (QB) – relating to an interest rate hedging instrument. The Court made some comments on the relevant legal and regulatory position. I have considered the judgment carefully. Having done so I am not persuaded there is a need to change the key questions outlined above or my approach to answering them.

The Court addressed issues concerning common law duties of care and *Hedley Byrne* negligent mis-statement (which establishes a duty of care owed in circumstances where a statement is made and there is reliance on it). The Court considered whether or not advice was given and if so, whether that advice was in breach.

Briefly, in that case, which concerned a meeting which took place in 2005, the Court concluded that:

- It was difficult to retrieve evidence of the meeting between the parties in 2005. Green and Rowley's testimonies needed to be assessed alongside the evidence produced by RBS. The Court found RBS's evidence of the meeting to be impressive and reliable, as opposed to Green and Rowley's which was considered to be inconsistent.

- There was not enough evidence to suggest that advice was given in this case.

- The Court was not convinced that even if RBS had given certain details of the swap (relating to *'breakage costs'* and whether the swap was separate to the loan), Green and Rowley would not have proceeded. The Court did not consider COB 2.1.3R and 5.4.3R to be relevant to the duty not to make a negligent mis-statement, and in the event they did apply, there was no breach.

- In 2005, the margin had consistently been fixed for as long as the RBS representative could recall and therefore any change could not be envisaged.

- As the swap was, in principle, *'portable'* there could have been no mis-statement: Green and Rowley understood that any transfer to another bank would require that bank's consent.

I accept that the Court's decision in *Green and Rowley* is relevant to my considerations here and I have taken it into account. I am, however, mindful of the Court's finding that it was a *'highly fact-sensitive case'*.

In my opinion, Business H's complaint has a materially different factual matrix. Amongst other things, the Court found Green and Rowley to be *'both intelligent and experienced businessmen albeit not previously versed in swaps but this particular swap was very straightforward and they would have had no difficulty in understanding it, or if they did they would have asked.'* In this case Business H had limited experience and access to professional advice and no readily available means of assessing the most complex aspects of the agreement Bank S encouraged it to enter.

I also note that the Court appeared to have found that COB 2.1.3R and COB 5.4.3R are not encompassed within the *Hedley Byrne* duty. This issue is not strictly relevant in the context of this decision (because I have found that advice was given). But even if this was a complaint solely about the provision of information, I would still consider the COB rules to be a relevant consideration that I would take into account, in accordance with my duties under DISP 3.6.4R and statute. That is because, as I have already mentioned, the Principles and the COB rules remain important standards that a financial business must still observe in the conduct of its business.

The Court's analysis in *Green and Rowley* was focussed upon the application of common law duties, rather than a direct analysis of the bank's adherence to the COB rules and other regulatory rules. Importantly, the judgment was not an assessment of what is fair and reasonable. I must determine this complaint by reference to what is, in my opinion, fair and reasonable in all the circumstances of the case.

ii) the regulator's statement

Since my provisional decision the FCA (at the time, the FSA) published its statement on the review of cases it had asked certain banks to carry out in January 2013. It reported on the pilot findings and – in the words of its press statement – confirmed the start of a full review of interest rate mis-selling.

I have carefully considered the FCA statement. It is important to note that the statement deals with the arrangement for a proactive review of interest rate sales by certain banks. It is not directly concerned with how individual disputes should be handled. But both are concerned with delivering fair and reasonable outcomes – so the FCA's conclusions are, it seems to me, of relevance here.

I note the FCA stresses that '*to determine whether a sale complied with regulatory requirements, and if not whether redress is due, a case by case assessment of all relevant evidence is necessary*'. The FCA's analysis of the merits of these issues is, in my view, entirely consistent with the analysis I set out above. I note in particular the significance of clear disclosures generally, with a special focus on break costs, is stressed by the FCA, as is the importance of suitable advice.

In summary, nothing in the FCA statement gives me reason to change my analysis of the merits of this dispute. In my view, the review process described by the FCA and my decision here would seem based on similar broad principles.

On the specifics of redress it also appears to me that the FCA principles for the review and my proposed approach in this case are aligned. My conclusion on redress here is specific to the particular circumstances of this case, but also seems consistent with the alternative product provision in the FCA approach.

e) summary

I have reconsidered these issues in the light of the representations of the parties and the other relevant developments I highlight above. I am satisfied that for the purposes of resolving this dispute the key initial questions I need to resolve, remain those set out in the overview above.

To explore these questions I need to consider the terms of the collar (and associated agreements) and the way it works in practice and how the various arrangements were agreed (the transaction process).

about the initial arrangement

Interest-rate hedging products take various forms and the issues associated with each are somewhat different. This "cap and floor" arrangement was an agreement separate from the loan agreement and entered into by Business H and Bank S (albeit a different trading division of the bank from that which agreed the loan itself).

As such it was an investment product that, while connected to the loan, was separate from it and could continue to operate (subject to the other conditions of the collar agreement) even if the loan was fully redeemed.

The hedging product in this case was described as a “base rate collar”. The collar was set to cover a sum of £356,000 and had a 20-year term. It was set to amortise (reduce in line with planned capital repayments). The collar provided a means by which payments would not exceed an agreed upper rate – 5.5% – but at the same time could not fall below an agreed lower rate – 4.75% – regardless of base rate movements.

So taking into account the margin of 2% above base rate, the overall maximum rate Business H could expect to pay was 7.5% and the minimum it could expect to pay was 6.75%

To set these rates in context, it is worth remembering that at the time of this transaction, base rate was 5.25% so the pay rate under the loan was expected to be 7.25%.

Clearly, a collar arrangement has in principle a number of attractions for the parties. The borrower knows the maximum amount of interest he will need to pay regardless of base rate fluctuations. And the lender has some additional assurance that the borrower will be able to service the debt in a range of interest rate environments.

But this was a very long term arrangement. And Business H could only terminate the collar on notice and with the consequence that, as described by the bank, *“there may be a cost depending on prevailing market rates at the time”*. This would not be calculated by some predetermined formula. In essence, as I understand the position, if the expected future path of interest rates at the point of termination was expected by the market to be *above* the hedge position, the bank would make a gain (as it could sell the outstanding position in the market). Conversely, if the market expectation was for rates *below* the hedge rate then the bank would make a loss (it would forego the expected margin or incur costs in the market to net out its position).

If market sentiment remains reasonably constant from the outset then the costs of termination will be (relatively) modest. But the sums involved can be substantial if the expectation of future rates is significantly below the position established in the collar. To give a very simplistic example: a reduction of 3% in rates below the floor rate for a £350,000 notional sum equates to about £10,000 a year in interest. Again, simplistically, if that differential was expected to exist over the next ten years of the loan, then the “economic cost” of termination could, it appears, amount to as much as £100,000 (note that is over a quarter of the value of the loan itself).

So, to summarise the collar, it provided the bank with a valuable safeguard that the customer was protected from adverse interest rate movements that might put in doubt the business’ ability to service the loan. For Business H, the overall arrangement provided certainty about the range of interest payments it would be required to meet.

However, if rates fell significantly and consistently below the floor rate set in the collar, it could, in certain circumstances, act as a major restriction – as Business H would pay rates above market rates and would not be able to terminate the agreement without a very substantial fee.

The net effect of all this is that Business H was taking the risk that it could not benefit from interest rate reductions beyond a small margin, but had the comfort that it would not be adversely affected by significant increases in interest rates.

But it should be noted that customers normally carry all interest rate risk if they have a variable-rate loan. The collar provided some benefit in terms of smoothing out year to year fluctuations. And there is nothing objectionable about loans with collars that (to borrow language from the retail sector) have reasonable extended “tie-ins” and/or “redemption charges”.

Just as with many loans today, consumers may be paying a rate that is above present prevailing market rates – if they “fixed” or purchased a collar at a time when rates were expected to remain high. That will be disappointing for the consumer – but the lender will have done nothing wrong, if the consumer freely chose that deal with good information about the terms that would apply.

about the transaction

Following some initial discussion between Business H and Bank S, a meeting was arranged to discuss the loan and collar which was held on 7 February 2007. The bank’s notes of that meeting say that it was attended by the bank’s relationship manager, a representative from its treasury department and Business H.

The bank’s note describes Business H’s borrowing needs and state that base rate caps, collars and swaps were discussed *“taking care to highlight potential costs to exit Collar or Swap early”.* It was noted that *“[the] Customer wanted to hedge for full term of borrowing”* and *“[was] Keen to minimise premium but requires some form of flexibility”*.

Fact sheets intended to describe the products were left with the business.

The fact sheet headed “Base Rate Collars” says:

> *“A Collar may suit a business that:*
>
> - *Wants to protect against the risk of higher rates*
> - *Wants the opportunity for some benefit if rates fall*
> - *Does not believe that rates will fall below a certain level for a sustained period*
> - *Wants to reduce or eliminate the need to pay a premium”*

The document also sets out some “disadvantages”:

- *You will not benefit from a fall in rates below your pre-agreed downside limit and you may end up paying more than the prevailing base rate*
- *If you wish to cancel the collar during its lifetime there may be a cost depending on prevailing market rates at the time”.*

I have also seen an undated “investment advice form” completed by Bank S around the time of the meeting, which records similar points and further expands on Business H’s stated understanding of the risks involved. It says Business H *“understands that there may be a cost to exit the floor before maturity”*. No discussion of the potential magnitude of that cost was recorded.

Also completed at the time of the meeting was the bank's "terms of business" document. It is a complex document of six pages that sets out the general terms of business. It included a "derivative risk warning notice" that says:

> *"This notice cannot disclose all the risks and other significant aspects of derivative products such as futures, options, and contracts for differences. You should not deal in these products unless you understand their nature and the extent of your exposure to risk. You should be satisfied that the product is suitable for you in the light of your circumstances and financial positions."*

The business signed this document on the last page under the words;

> *"I/We have read and acknowledge receipt of the Derivatives Risk Warning Notice set out above. I/We hereby signify my/our acceptance of the terms of the Private Customer Agreement and the Derivatives Risk Warning Notice".*

I note the risk warning, to which the bank has referred in subsequent correspondence, does not refer to "hedging", "swaps" or "collars" – and that the information made available to the business did not explain that the collar was a "derivative product". I find it doubtful that the business fully understood how (if at all) this risk warning referred to its circumstances.

The terms of business sets out that in some circumstances the bank will recommend investment transactions to the customer – and that where advice is offered, all reasonable steps will be taken to ensure the recommendation is suitable and that the customer understands the nature of the risks involved. The terms of business are silent on whether or not advice was to be provided in this instance.

It seems to me that both the loan and hedging transaction had essentially been arranged at the first and only meeting on 7 February 2007. It appears that at that time, the loan had been made conditional on having hedging arrangements in place – and that the type and term of hedge had been agreed. Only the details were left to be finalised. The documentation from the time suggests that the bank outlined various options at the meeting. The bank's internal notes say that:

> *"caps, collars, swaps discussed. Customer wanted to protect for full term of the loan with a degree of flexibility but wanted to minimise the premium, as such decided that a collar would meet these requirements"*.

Clearly, I cannot now be certain how the discussion in February 2007 progressed. But I have seen a note from the bank that suggests it set out a number of options in relation to cap and floors. The way these options are presented is to focus on the length of the arrangement (5, 10 or 15 years), different levels of the cap and floor % interest level (so for example a floor of 5.00% or 4.75%) and the level of upfront premium the customer would pay or receive from/to Bank S.

In essence the customer was invited to "buy" a cap level for a premium and "sell" a floor level for a premium resulting in a net premium payment to the bank – a one off initial charge usually added to the loan.

In this case, a 5-year cap at 5.75% would incur a premium of £8,277, whereas a 5-year cap at 5.25% would have a premium of £12,486. In contrast, the sums at 15 years would be £12,513 and £18,362 respectively. A "floor" could be sold by the customer, although a 4.75% floor for five years appears to have had nil value.

However, if Business H opted for a "floor" over 15 years, it would provide a benefit of £5,791 that could be set against the premium for the cap.

On 9 February Bank S sent an email to Business H setting out illustrative costs of a base rate swap compared to a base rate cap and floor. By this stage the focus was solely on a 20-year term (it would seem that the figures had not been available for the meeting on 7 February). The collar was eventually finalised at 5.5-4.75%. The cap at 5.5% was the middle option of the range of cap interest rates and similar to the swap fixed rate the bank was offering.

It was expected to attract a premium of £17,770. The floor rate of 4.75% was the lower of the floor rates (5.0% – 4.75%) illustrated in the bank's email, and would involve a benefit of £11,299. The email went on to illustrate permutations of monthly cost for Business H if the collar was chosen at different rates *("the most you would have to pay per month"; "the least you would have to pay per month")*.

In response to this information, a member of Business H's staff (not one of its directors) emailed Bank S with the question *"Our accountants have just asked me whether there would be any penalty charges for early repayment?"* The bank called the business to answer the question and said:

> *"I thought I would give you a call rather than just.. you know.. reply to your e-mail"*

The bank official then explains there would be never be any cost to exit the cap. He says that the customer might be able to sell the cap if they no longer wanted it. He explains that there may be a cost (or a benefit) and similar considerations would apply to the collar.

> *"It depends where the market is, it depends how long is left".*
>
> *"Potentially there could be a cost, it depends where the market is"*
>
> *"But the worst case scenario is that the rate is at 3% and you have got no borrowing to protect anywhere…*
>
> *[at 3%] then potentially…., well, there would be a cost to exit, again if rates are higher then that cost would be less. But it is difficult to put a figure on it, it is impossible to put a figure on it".*

By 23 February 2007 Bank S made an offer of lending that had been increased by agreement by the net premium for the collar arrangement. And on 26 February 2007 the collar was put in place in a phone conversation between the bank and Business H. The call recording is brief and focused on confirming the details of the transaction. The bank's representative says briefly that they have previously covered that there could potentially be a cost to "bail out" early. But he does not explain how this will be calculated or of what magnitude the cost may be.

On the following day the Bank S sent the business a letter confirming the transaction. This stated the factual details of the transaction – it did not describe the product – and Business H returned a signed copy confirming that the details of the transaction were stated correctly.

As can be seen, the transaction was carried out in something of a rush (as many of these transactions are). The first meeting took place on 7 February 2007 and the terms of the loan and hedging arrangement seem to have been essentially agreed at that point. Limited further discussion took place and new information that was relevant to the bank's requirement for Business H to arrange a hedging product seems to have been ignored.

The collar was put into place on 27 February 2007 and in the intervening period the bank's representative had been unavailable on holiday, as had one of Business H's directors. In fact, the necessary paperwork was emailed to him for signature and returned by fax.

the loan application

The bank's notes about the loan application include a form for completion by the relationship manager, which appears to set a number of criteria by which the loan application should be considered. Of particular interest is the indication that interest rate hedging is required where the loan to value (LTV) ratio is in excess of 70%. The loan application was processed on an assumed LTV of 71% based on a property value of £500,000.

It seems this value was a conservative assumption based loosely on a valuation some years before, perhaps identified as the minimum LTV upon which the bank would lend.

However, a professional valuation of the property was undertaken at Bank S's request that reported the market value of the property at the time was £800,000. That was set out by the valuer in a letter to the bank dated 19 February 2007. This valuation was sufficient to give a modest LTV of around 45%, well below the bank's stated criteria for requiring interest rate hedging.

It seems clear Bank S was aware of this higher professional valuation. The bank's internal notes refer to a *"verbal confirmation of £800k held"*. Nevertheless, the bank notes as an action point on the file *"introduce treasury to complete the deal"*. And when it set out the loan terms in its letter of 23 February, it included a requirement to purchase interest rate hedging.

Subsequently, during the handling of this complaint, Bank S has said that setting this condition to purchase a hedge was a prudent decision by the relationship manager – as the nature of the business meant that its income was likely to be fixed and that it was, therefore, vulnerable to interest rate increases. However, I am aware of no evidence of a rationale of this type being recorded at the time the loan was agreed – and certainly this does not seem to have been explained to Business H.

my conclusions on key issues

Before setting out my conclusions on the key questions I set out above, I need to deal with a preliminary issue. That is, whether it was fair and reasonable for Bank S to make the lending conditional on Business H's purchase of an interest rate hedging product.

As a general approach, I am reluctant to intervene in a decision about the security or other conditions a lender wishes to determine in exchange for provision of a loan – particularly some five years after the event. And I am particularly reluctant to do so in the case of business customers, unless it is clear that the lender has acted unlawfully, or in a manner that is self-evidently unfair and unreasonable. My normal approach will be to conclude that such matters fall within the reasonable commercial discretion of the lender.

In the present case, the question of whether or not the requirement to arrange a hedge was a reasonable exercise of the commercial discretion of Bank S is confused by lack of clear evidence about the rationale at the time for the requirement. At face value it seems clear that the new valuation placed the LTV for the loan at a low level, and one below the bank's then standard criteria for requiring an interest rate hedge.

The bank now says that the decision to require a hedge as a term of the lending was within its discretion – and was determined because of the expected fixed nature of the rental income upon which Business H would rely to repay the loan. But if that was the reason, it does not seem to have been explained to Business H at the time. Of course, an alternative explanation might be that the decision to proceed with the requirement was more about a simple desire to sell more of this hedging product to small and medium enterprise (SME) customers.

On balance, while the evidence is suggestive of a commercial sales imperative on the part of the bank, I cannot ignore its proper interest in securing the repayment of its lending. Business H relied on rental income from a few small offices in a single location. It was clearly exposed to the risk that a high interest rate environment would both place pressure on its tenants' ability to meet rental terms, while at the same time increasing, perhaps substantially, its own lending costs.

In that sense, Bank S's recent explanation of the hedge requirement does make reasonable commercial sense. So I conclude that the requirement was neither unlawful, nor an unreasonable exercise of commercial discretion on the part of Bank S in the particular circumstances of this transaction.

But I am concerned that Bank S did not explain the reasoning for the hedging requirement to Business H at the time. At a minimum, the position should have reminded Bank S that a collar was something of "an added extra" for its customer, where the risks inherent in the investment they were selling could also have an adverse impact on Business H (as well as potential benefits).

Accordingly, my conclusions on the key initial questions I need to answer are set out below:

- whether Bank S gave Business H advice about the interest rate collar (and if so whether that advice was suitable for the business);

The documentation is unclear about whether or not advice was given. But there is nothing in the documentation that states it was not advice. I note that the bank's representative completed an "investment advice form" around the time the collar was arranged (albeit this was an internal document in the bank) and it sent to Business H its terms of business which provide for the possibility that advice might be offered.

The notion that Business H should obtain its own financial advice before agreeing the collar was not recorded as being discussed with it – and the bank knew that the advice and support available to the business (other than that provided by Bank S itself) was limited. But Business H was not knowledgeable about financial transactions of this nature and had not previously been subject to requirements of this form. Accordingly, it was not credible that the business could represent that it was capable of understanding and accepting the terms and risks of the collar.

Instead, the bank introduced and explained the notion of the collar. It clearly took Business H through some options and provided some comparisons of the costs of the different options. It did not to my mind make clear that it was not giving advice – rather it encouraged Business H during this transaction to rely on its advice. Whilst it is clear that there was a discussion of options and that Business H had a role in deciding which option it preferred, it did this in the context of the information and advice it received from Bank S.

Certainly it will have appeared as advice from the business's perspective. The bank directed Business H to this product and actively encouraged (to the point of making it a requirement) the purchase of a hedging product. And it provided the advice and guidance around the options, from which it seems Business H made a selection.

Bank S says it did not give advice – but its own (albeit internal) documentation was headed investment advice. At best its position was confused. In my view Bank S's actions were such that they amounted to investment advice – and as such it should have followed the regulatory and other requirements that apply when professional investment advice is given.

But in my view the advice the bank *did* give, paid insufficient attention to the needs of Business H. While a collar arrangement may well have suited the business's immediate needs, it also had some inherent weaknesses. In particular, the floor could, in significantly low interest periods, effectively tie in the business to the arrangement because of very high cancellation charges. In my view that does not make all collars unsuitable – but it raises questions, especially where the term of the arrangement is lengthy.

Small businesses are often not well suited to make fixed long-term commitments. While it is true that the business had entered into a 20-year loan to refinance existing borrowing, the exit strategy from the decision was reasonably clear if the business did not prosper. The collar, in contrast, assumed a 20-year life and in present circumstances imposes an almost insurmountable burden on the business, effectively eradicating any room for financial manoeuvre that it might otherwise have had. And the longer the "floor" the more likely such risks were to occur and the more significant the costs of exit could become.

I am mindful that in this case, as I understand the position, Business H had received some grant from public funds in respect of its activities. That grant placed restrictions on the ability of the business to sell the property in certain circumstances for ten years (of which around five were still to run in 2007). So in practice, Business H had a need to assure its position for at least five years. The bank recorded that Business H was keen to hedge for the full term of the loan. But that does not, in my view, make the advice to do so suitable. The bank was obliged to offer suitable advice, not simply to provide a product to meet the business's uninformed preference.

So my final conclusion therefore is that, on balance, Bank S did, in fact, give advice in this case. The cap element of the collar clearly met some of the business' needs in that it provided some protection from interest rate increases. And the notion of a collar (that is, a floor as well as a cap) was not in my view *unsuitable* for Business H in its circumstances, given its desire to minimise the premium for this arrangement. But for the reasons set out above, a floor of 20 years – with the possibility of significant cancellation charges – was not suitable overall for the needs of Business H as a small business.

In this case, Bank S can argue that the decision on the length of the collar was one made by Business H not itself. There are somewhat different recollections of events here. But in any event, I think it is clear that in so far as it made a choice here, Business H was acting in reliance on the advice it received – and that advice did not draw sufficient attention to the downside risks arising from potential cancellation costs.

The other question I need to answer is:

- if the bank did *not* give advice, whether it gave Business H sufficient information upon which to make an informed choice about the collar arrangement.

In any event – or alternatively if I am not correct in concluding that the bank gave advice – it is relevant to consider whether or not Business H had sufficient information to make an informed choice. My final conclusion is that it did not.

The bank knew that the business had limited experience and access to professional advice. It was speaking to its accountant as might be expected but not to an adviser with significant experience of this type of hedge product.

Critically, in my view, Bank S failed to draw adequate attention to the potential impact of cancellation costs on the transaction. The term was at best opaque. The simple reality was that charges for cancellation could (and did) amount to a very significant sum – Business H was told in 2009 that the break cost of the floor would be £48,000 (approximately 13% of the notional sum). Even if such terms were not uncommon at this time, by any standards that is a significant provision – at least in its real world impact – and unusual at least from the perspective of Business H.

Crucially, nowhere in the documentation made available to the business (either before or immediately after the transaction) is there a clear statement of the possible scale of the fees involved in cancellation. The fact that there might be charges (or benefits) is clear, but not the scale of the possible quantum. The clearest statement the bank makes of the scale of the break cost to say that *'it is impossible to put a figure on it'*.

In this case the focus of the bank and the business in the upfront premium rates payable/receivable under the collar seem to me to have established a frame of reference within which any talk of cancellation charges would have been understood. Business H received around £11,000 for the 'sale' of the floor to Bank S. Surely if it wished to exit from the arrangement, any cancellation should have been framed by that charge? Of course, this is not in reality how the cancellation fee is calculated. But that was not explained. Instead, there was a vaguer reference to "*market rates at the time"*. And it puts in some context the significance of the £48,000 quoted as the charge for breaking the floor.

My overall conclusion is that Bank S acted unfairly in its dealings with Business H. It gave the business advice to purchase a collar that it knew (or should have known) was not a good fit for the business's needs. And whether or not it gave advice, it effectively hid the potential impact of cancellation charges on a transaction that has had the effect of tying Business H in to a 20-year arrangement. While a cap for an extended period may have been a prudent purchase for Business H, it was not adequately advised. Nor did it have any means of making an informed decision about the risks associated with a long-term floor.

I am also mindful in this case that Bank S introduced the condition of interest rate hedging to Business H on the basis of a provisional, and seemingly arbitrary, valuation of the business property. It did not remove that condition when the true value of the property became known. It is difficult to avoid the conclusion that the transaction – especially in respect of the "floor" – was driven by an imperative to sell more of this product to customers such as Business H, rather than a thoughtful assessment by Bank S of this client's interests.

uncertainty and hindsight

Before reaching my final conclusions on fair compensation in this case, it is appropriate to sound a note of caution about the risks of hindsight in the present case.

Expressed directly, businesses and consumers who freely entered into an arrangement to fix interest rates at what now appear high levels will understandably now regret the decision they made. And the fact that we all now know that base rates are at (UK) record lows – and have remained so for over three years – does not, of course, mean that this was predicted or expected. Indeed, given the history of (UK) interest rates, some customers may well have felt that increases in rates well above 6% were a very real risk.

And, whilst major banks such as Bank S might reasonably be assessed as having better knowledge of the risks inherent in the long-term fixing of interest rates and the potential for interest rate volatility, it clearly cannot be expected to have had a crystal ball. The current position on interest rates was not widely predicted in 2007, even in financial circles.

But the inherent variability of interest rates was understood. In the UK in the 20 years prior to 2007, base rates had varied from 14.875% in October 1989 to 3.5% in July 2003. Internationally, even amongst the present G20 economies the range of variation has been much wider. The US base rate fell to 1.13% in 2003, while Japan's base rate has not risen above 1% since 1995.

International comparisons are fraught with difficulties. But the possibility of retaining low or even 0% rates was clearly not out of the question. So while the present position may not have been a central prediction in 2007, it is not in my view such an exceptional position (in relation to interest rates) that it could be accurately discounted as 'it will never happen in your life time'. Certainly, Bank S's comment that 3% was a "worse case scenario" was misplaced.

fair compensation

I have found that Bank S gave inadequate information to the Business H to enable it to make an informed choice and that it gave unsuitable advice. Bank S knew, or should have known, about the way the collar could work in various market conditions. But it did not adequately alert Business H to those risks, nor did it give it Business H adequate and real opportunities to make its own enquiries. Specifically, it gave the business no means of understanding the potential size of the break payments it might face.

Clearly, I cannot now be sure what Business H would have done had the full potential impact of the various provisions of the collar agreement been brought to its attention – in a manner that would have enabled it to make an informed decision. Recollections now of perspectives in 2007 will inevitably be uncertain or affected by subsequent events.

The paperwork at the time gives the impression that Business H was keen to restructure its finances but was trying to be financially "prudent" and to retain "some flexibility". It clearly saw benefit in guarding against any possible increase in rates at least in the medium term.

But Business H emphasised at various points its needs for flexibility in its financial arrangements. It was a small business. Its fortunes rested not just on its business property market, but on the welfare of the two directors as owner-managers of the main tenant. The business clearly had potential but there were also risks and uncertainties.

Overall, while no doubt Business H envisaged a successful long-term future, it would – it seems to me – have been reluctant to make an unnecessary long term commitment that might tie it into particular financial arrangements. Certainly, the business might have been well advised to avoid such long term commitments.

Subsequently, Bank S has sought to rely on those terms that it knew it had not explained or highlighted adequately. It told Business H there would be costs of around £35,500 when it enquired about breaking the arrangement in 2009 (£48,000 to break the floor). The decision by Bank S to rely on the charges in 2009 had the effect of significantly narrowing Business H's room for manoeuvre when flexibility was particularly important to it.

Business H for its part says if it had been properly advised and had sufficient information then it would not have entered into any hedging arrangement at all.

I am aware of arguments that in cases such as this, given the failings by the bank, the logical conclusion of any redress should simply be to remove the 'unfair' collar and compensate the customer accordingly. However, it is well established both in the courts, and in the decisions of this service, that the appropriate approach to redress is to consider what would have happened had the 'unfair' transaction not taken place and to contrast the position of the customer following the poor advice with that which would (probably) have occurred but for that poor advice.

Clearly in some cases this may mean that no purchase would have been made at all. In other cases despite the poor information and/or advice, the consumer may have made the purchase in any event (sometimes this is referred to as the insistent consumer). But in many cases the customer is likely to have made alternative arrangements. Having considered the position carefully I think this is such a case. That is while I accept that Business H may not have actively sought to hedge and that it was not given sufficient information, I have concluded that hedging was a lawful and reasonable condition of lending. Therefore I conclude that Business H would have purchased a hedging product of some sort in order to access the lending it desired.

Taking account of the overall circumstances of the case I have concluded that in considering fair compensation it is right to conclude that had Business H been properly advised (and would have agreed if properly informed) it would *not* have taken the risk of facing such high break charges and so it would *not* have entered into any agreement that included a floor on these terms. I have concluded that, on balance, Business H would instead have entered into an agreement just to cap rates.

In cases such as these, mapping the path of what *might* then have occurred – and the implications of any differences – can be complex. What alternative arrangements would Business H have made in 2007? If it had not faced such a large break cost in 2009, what would it have done to rework its finances? What impact would all these differences have made to their current position? Considerable time and expense for all parties could be spent in debating each of these issues (and the numerous subsidiary issues that these would entail).

submissions made by the parties concerning the award

Bank S has made an offer based on the assumption that cap would have been at 4.75% – the floor rate of the collar actually sold. It offered no explanation for that choice and I find it unreasonable.

It is impossible to know with any certainty what cap rate the business would have chosen but the evidence available shows it was offered pricing for caps at 5.25%, 5.5% and 5.75%. I am satisfied it is fair and reasonable that a rate of 5.5% – the cap rate actually sold – should be used as the basis of calculating any redress.

I also note that Bank S's initial offer of redress was based on Business H entering into a new cap with an increased notional amount of £1 million – where the original notional amount was only £356,000. I can see no justification for this large increase other than to hedge the borrowing entered into by Business H since the Base Rate Collar in 2007. As that is not the subject of this complaint I see no justification to include this in my considerations. My award will be based on a cap with a notional sum not in excess of £356,000.

Business H has questioned the figure of £17,700 which Bank S provided as the price for the cap I propose as an alternative product. Business H says this is unreasonably high and includes an unfair profit. However I do not agree that a revised price for the cap is appropriate or necessary for the purposes of my award. £17,700 is the price which was quoted at the time of the arrangement, and therefore I consider it is the price which Business H would have paid.

Business H's solicitor has also included in its claim what appear to be all of the overdraft interest and charges the business has paid during the existence of the collar. I have seen no persuasive evidence that but for the existence of the collar, Business H would not have used an overdraft facility. The economic climate has been difficult since 2008 and many businesses have suffered a downturn in income as a result. In any case, I have concluded that this dispute would best be resolved by fully reworking the accounts to place Business H in the position it would have been in had it arranged a cap but not a floor, taking into account any direct or consequential charges incurred or credits received.

The principle of reconstruction seems to me the best means of addressing redress in these types of settlement. By re-working (that is, fully reconstructing) all those accounts through which Bank S and Business H conducted business (including current accounts and loan arrangements, together with the hedge itself) all those charges and interest that would otherwise have been avoided will be appropriately accounted for. Charges and interest that do not flow from the existence of the floor arrangement will not be affected.

Business H's solicitor has also included 'legal fees' in its claim – presumably a statement of the solicitor's fees. I do not propose to make an award in this regard. The Financial Ombudsman Service is an informal service and professional representation is not normally required. I am not of the view, in this instance, that Business H could not have brought this complaint without professional assistance.

Finally, I have carefully considered the submissions of Business H regarding the inconvenience caused to the business as a result of distress, and pressure caused to the directors by "the hedge experience". I realise that the bringing of this complaint was no small decision and that the amount of time taken will have been of concern. And I sympathise with the health issues suffered by the directors. But I have seen no persuasive evidence that the actions of the bank were directly responsible for these health issues. Therefore I believe it would be unreasonable to single out the impact of the hedge on the directors' as meriting a specific award without strong evidence to support this. None has been submitted and I therefore make no separate award for inconvenience caused to Business H as a result of distress and health issues on the part of the directors.

Bank S has put forward its calculations for redress. I do not agree that the redress calculated by Bank S is fair and reasonable in the circumstances. For the reasons set out above, I do not agree with Bank S's proposal in relation to the alternative product. I also do not agree with Bank S's proposal on how to calculate compensation due in relation to the difference between a revised product and the collar Business H actually took. I also do not consider that the calculations proposed are in line with the FCA's conclusions on redress.

It appears to me that in making its calculations Bank S has effectively taken the difference in payments between the product sold and the alternative and proposed a refund of any over-payments. Bank S has also proposed to add 8% simple interest to the overpayments, and also to add 8% simple interest to the cost of the cap. Bank S says adding interest in this manner is in line with usual practice.

I do not agree. In my view the calculations on redress should be a full reworking of the account, to place Business H in the position it would have been in had it been sold the alternative product. I do not consider that simple interest should be added to any overpayments as an approximation of any loss, and instead an exact calculation should be made, taking into account any charges incurred or credits earned. I also do not consider that 8% interest should be added to the cost of the cap, as a reworking of the account will (amongst other things) deduct this amount from the loan cost over the subsequent period.

I have considered in these circumstances whether my conclusion of this case should be further delayed by the review process. I have decided that no delay is necessary on my part.

The bank's review of its sale to Business H (as required by FCA) will no doubt proceed as is appropriate for Bank S's regulatory obligations. If it transpires that Business H later thinks any compensation proposed by Bank S under its review would be more beneficial than the redress I propose, then it would be open to Business H to accept the outcome of the review.

my final decision

For the reasons set out above, I uphold Business H's complaint. This base rate collar should not have been recommended to the business by Bank S without more thought about flexibility and the potential impact of cancellation charges, and Bank S should have provided better information about the product it sold.

Where I uphold a complaint, I have the discretion to make a money award requiring a financial business to pay fair compensation, plus any interest and/or costs that I consider appropriate. And/or I may make directions requiring a financial business to take certain actions. In the circumstances of this case, I have done both.

determination and award

I uphold the complaint.

I order Bank S to re-work the loan and hedging arrangement as if Business H had entered into a base rate cap at 5.5% starting on 26 February 2007 over a 20-year term and with a notional sum of £356,000.

This action should reflect the following practical considerations:

- If re-working the arrangements results in Business H having made overpayments, and it seems likely, Bank S should refund those overpayments.
- If the account was overdrawn, any overdraft interest, charges and fees that would not have been incurred had the lower payment been made should be refunded.
- If the account would have been in credit, interest at the rate applicable to the account should be added for the period it would have been in credit.
- The calculation will need to be carried out on a rolling basis for the whole period in order to show any compounding affect on the account.
- Bank S should also review in full the accounts of Business H and reconsider any discretionary actions such as margin renegotiations or placing the accounts into any form of special measures. I do not propose to interfere in the bank's legitimate commercial decisions in this regard but it is fair that the conduct of the re-worked account be the relevant factor in the application of that discretion.
- If Bank S believes it is legally obliged to deduct tax from the interest, it should send a tax deduction certificate with the payment. Business H may then be able to reclaim any tax overpaid from HM Revenue and Customs, depending on the circumstances.

I am mindful that if a final decision is accepted by Business H the maximum binding money award I can make in this case is £100,000. (I note that had the business referred the matter to me after 31 December 2011 that limit would be £150,000). Having regard to the sums paid to date in this matter, I am mindful that the money award I recommend may exceed this limit.

Given the circumstances of this complaint, I recommend that the Bank S should pay any and all sums I have concluded would be fair compensation and which are above the maximum money award. Although I note Bank S is not under an obligation to meet this recommendation, I note it has previously indicated it will pay the amount in full.

In any event I require Bank S to notify Business H whether it will accept my recommendation by 4 September 2013, and to copy me in to this correspondence.

Business H should note that if Bank S refuses to accept my recommendation, the law is unclear as to whether it would be able to accept my decision and go to court to ask for the difference.

Under the rules of the Financial Ombudsman Service, I am required to ask Business H to accept or reject my decision by 30 October 2013.

Tony Boorman
deputy chief executive & deputy chief ombudsman