

BANKS

Britain's financial watchdog says banks sold small firms a product they did not understand. Banks say some customers were sophisticated enough to know better.

Too smart to compensate?

BY MATT SCUFFHAM

BANKS TOO BIG TO COMPENSATE?

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Scott Wotherspoon runs a small tiling firm in Scotland. In 2008, when he bought a shopfitting company, he asked his accountants to check its books. There was no problem with the shopfitter. But Wotherspoon was about to run into trouble with his bank.

The 43-year-old borrowed about \$4 million from Royal Bank of Scotland. As part of the transaction, the bank insisted he buy a hedging product, a kind of insurance policy, so he could keep repaying the loan even if interest rates rose. If interest rates fell instead of rising, that would cost extra - which Wotherspoon alleges the bank did not explain. He thinks he is due compensation for mis-selling, like thousands of other businesses that Britain's financial watchdog has ruled are eligible.

But Wotherspoon now faces a second blow: The regulator won't look at his claim because his company is now too big. His story shows how businesses which may have suffered because of bank misbehaviour face a new wave of frustration. First, their banks sold them financial products few could understand. Now, the banks say some of their customers should have known better.

Scandals of all sorts have already cost Britain's four main banks more than 36.5 billion pounds (\$57 billion) in fines since 2009, according to CCP Research Foundation, which examines ethical issues in organisations. Earlier this month, the Financial Conduct Authority, the main UK financial regulator, levied the biggest fine ever on UK banks for manipulating the foreign exchange market.

The scandal that hit Wotherspoon's tiling firm involved financial products known as swaps. In 2012, the regulator, the Financial Conduct Authority (FCA), found "serious failings" in the way banks had sold the swaps to small firms. It set up a compensation scheme and ordered the banks to review nearly 30,000 potential victims. Like



SWAP DEAL: Scott Wotherspoon (cover), owner of British firm Tilecraft, wants compensation for a hedging product sold to him by his bank, Royal Bank of Scotland (above). The bank says his firm was sophisticated enough to know what it was buying. **REUTERS/RUSSELL CHEYNE; STEFAN WERMUTH**

“We’re not a sophisticated business. We’re a tiling company.”

Scott Wotherspoon
Tilecraft owner

thousands of other firms, Wotherspoon's was deemed ineligible for compensation - in his case, because his firm was ruled to be too big, or financially "sophisticated," and should have understood what it bought.

Swaps are a form of financial derivative - products Warren Buffet once called "financial weapons of mass destruction." Though they are regularly used by big firms, the FCA said in its ruling that banks should not have sold them to small companies. Such firms aren't sophisticated enough to understand them, the FCA said.

That question of sophistication is at the centre of Wotherspoon's case.

When Wotherspoon took out his loan,

and bought the swap as required by RBS, his firm, Tilecraft, was small.

But as a result of the deal, Tilecraft grew big enough that, according to the compensation rules, it was now sophisticated enough to understand swaps.

Wotherspoon says that's wrong.

"I didn't have a clue what I was doing," he said. "We're not a sophisticated business. We're a tiling company... We basically took the bank's advice."

In Britain, most small businesses depend for finance on their banks. Those looking for advice often rely on their local bank adviser or accountant, who may not know much about swaps. Iain Coke, head of financial services at ICAEW, an accounting body, said the type of swap sold to Tilecraft would be unfamiliar to many qualified chartered accountants.

RBS told Reuters it has been fair, and the Financial Conduct Authority (FCA)

defended the way the compensation scheme works.

CONFLICT OF INTEREST

So far, the compensation scheme’s administrators say firms who bought swaps are due redress in 13,913 cases. But the scheme has ruled that they are too financially sophisticated in 10,361 cases. If all those firms were in the scheme, they would add billions to the compensation bill, derivatives experts say.

In cases like Wotherspoon’s the compensation scheme equates size with sophistication. This, say critics such as the Federation of Small Businesses (FSB), is too crude a measure.

Abhishek Sachdev, a derivatives expert, says the scheme has serious shortcomings. These include a fundamental conflict of interest: The scheme was set up by the FCA, but relies on the banks themselves to decide who is eligible for compensation.

The banks work with assessors including big accountancy firms such as KPMG which, while independent, are appointed by the banks.

For mis-selling swaps, the banks set aside 4.4 billion pounds to compensate small businesses. So far, they have paid out 1.5 billion pounds. Barclays said last month it was reducing its total payout budget.

“There are very significant ‘get out’ clauses and banks are prepared to go to incredible lengths to manipulate it,” said Sachdev, who has given evidence to parliamentary committees on the scheme.

Wotherspoon’s bank, RBS, is state-owned after a 45-billion-pound bailout in the 2007-9 financial crisis. Chief Executive Ross McEwan said in February the bank was “the least trusted company in the least trusted sector of the economy.” He has vowed to make it “the most trusted bank.” It is Britain’s biggest lender to small firms and has nearly half the cases in the compensation scheme.

The FCA said around 200 customers have raised concerns about the review

FCA compensation scheme

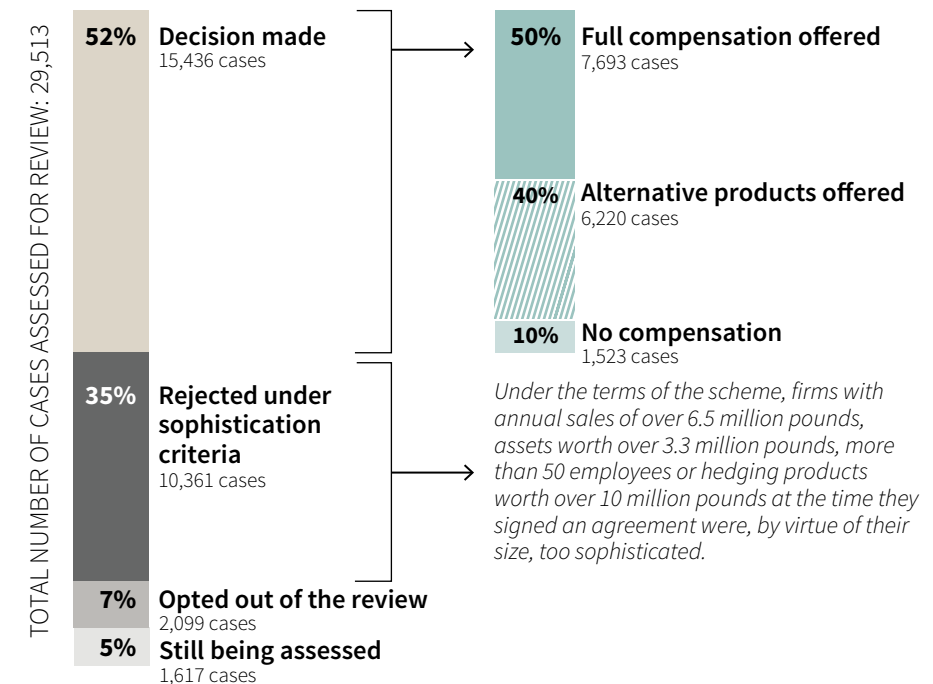
In 2012, Britain’s financial regulator ruled that banks had mis-sold interest rate swaps. It ordered the banks to pay compensation. But not everyone is happy with the scheme.

Cases in review

Royal Bank of Scotland (RBS), Britain’s biggest lender to small firms, has 48% of total cases in review.

Bank	Cases	Funds for compensation
RBS	7,353	£1.46 bln
HSBC	3,160	£616 mln
Barclays	2,902	£1.34 bln
Lloyds	1,638	£580 mln

Compensation



Percentages may not add up to 100 due to rounding.

Source: Financial Conduct Authority

M. Ulmanu/Reuters Graphics

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process over the past six months. Some small business owners have told Reuters their banks offered alternative products which they didn't want. Others, who were advised by the FCA they did not need to use lawyers, say the banks brought in their own attorneys who took evidence their customers had provided and used it against them.

British Bankers Association Chief Executive Anthony Browne said in July that a huge amount of work had been done to reform the banks. RBS told Reuters it had worked with the regulator to "ensure that all customers mis-sold these products get fair and reasonable redress." The BBA said banks have tried to be as professional and efficient as possible. "Thousands of customers have been happy with the compensation they've received," said a BBA spokesperson.

But conservative lawmaker Mark Garnier, who is part of a group which oversees the work of Britain's finance ministry and financial regulator, said he is not convinced firms are getting a fair deal.

"We will continue to push for businesses to get their money back," he said. "We are very angry and we are doing our level best to put pressure on the regulator. There are still very, very bad habits in banks."

"THIS IS THE SWAP FOR YOU"

For Wotherspoon, financial sophistication arrived in a Porsche driven by an RBS saleswoman.

It was April 2008, and his business had made a profit of 510,000 pounds the previous financial year on sales of 5.5 million. One of its clients had come up for sale and Wotherspoon saw an opportunity to expand. The acquisition would take Tilecraft's annual sales to around 21 million pounds.

Tilecraft agreed to pay 2.2 million pounds for the firm. Wotherspoon's accountants did due diligence, and RBS agreed to lend Wotherspoon 2.6 million pounds to fund the acquisition and expenses related to it.

He says RBS then said he would need



CITY: London's reputation as a financial centre has been hit by scandals that have cost Britain's four biggest banks more than 36 billion pounds in fines since 2009. REUTERS/ANDREW WINNING

£6.5million

Annual sales above which firms had compensation rejected.

Source: Financial Conduct Authority

to buy a swap, to ensure he could keep repaying if the interest payments on his loan rose. "It was definitely a condition. There were no maybes." RBS declined to comment on the sale process.

The loan agreement did not stipulate that the swap must come from RBS, but Wotherspoon says he believed that was what the bank meant. "They said, 'Before you sign the paper we'll get our swaps lady in, who will tell you what swap you should get.' She said, 'This is the best swap for you,' then jumped into the Porsche she had waiting outside to go and sell it to somebody else," he said.

Wotherspoon had agreed to buy something called an 'amortising base rate collar.'

What the saleswoman didn't tell him, Wotherspoon said, is that if interest rates

were to fall significantly, his company would be liable for extra charges.

Seven months later, in Nov. 2008, the Bank of England cut interest rates by 1.5 percentage points.

The move was meant to help small businesses by making loan repayments cheaper. For people holding swaps like Tilecraft's it did the reverse. The extra charges eventually amounted to 159,000 pounds including the cost of breaking the agreement, contributing to the company making a loss of 455,000 pounds in the year to March 2010.

TOO BIG TO COMPENSATE

Tilecraft applied to join the compensation scheme in May last year. It learned that it was considered too sophisticated to be eligible six months later. Under the terms of the scheme, firms were too sophisticated if at the time of an agreement their sales were more than 6.5 million pounds, their assets worth more than 3.3 million pounds, they had more than 50 employees or they already held hedging products worth over 10 million pounds.

When Tilecraft bought the shopfitting

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firm, it was smaller than all those cutoffs. But the acquisition took its annual sales over the limit. Because the swaps deal was finalised after the takeover, Wotherspoon failed the test.

“It’s all down to dates, really,” said Wotherspoon.

RBS declined to comment on the timeline of the sale, but said Tilecraft was ‘sophisticated’ under the guidelines, an outcome agreed with the independent reviewer, acting on behalf of the regulator but appointed by RBS.

FSB, the small business lobby, says the sophistication test bears little relation to reality. Of more than 10,000 other companies that failed the test, 4,803 were rejected on grounds of size alone. It’s not clear how many grew too big only as a result of buying a swap.

“The application of the sophistication criteria inevitably left many small firms that should have been compensated out in the cold,” said John Allan, national chairman of the FSB. “The criteria were by definition arbitrary and lacking in nuance.”

TOO BIG TO FAIL

If firms like Tilecraft were eligible for compensation, the banks’ compensation bill would increase. Derivatives expert Sachdev estimated the industry would need to pay out 25 billion pounds, more than five times the funds set aside, of which almost half would come from state-owned RBS. That calculation is based on banks paying out average compensation of 850,000 pounds for each claim.

That could make it more difficult for the government to sell off stakes in the banks it bailed out: RBS and Lloyds Banking Group.

The prospect of such a bill – on top of the costs of other past misconduct – encourage banks to ensure as few cases as possible get into the scheme, industry specialists say.

As the scheme stands now, the only chance



CLEAN UP: Britain’s Financial Conduct Authority began work in 2013 as part of an overhaul to the regulatory system following the financial crisis. **REUTERS/CHRIS HELGREN**

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John Allan

National chairman of small business lobby FSB.

for firms like Tilecraft to recover their losses is legal action. Few have the funds.

“I’d rather put my effort into getting business and just keeping going,” said Wotherspoon.

When Tilecraft fell into the red, RBS moved the account into its Global Restructuring Group (GRG), a turnaround specialist for ailing businesses. In May 2010, GRG lent Tilecraft 96,250 pounds to buy its way out of the swap the bank had sold Wotherspoon. As security, it took a 10 percent stake in Tilecraft and increased the interest on its loans to 3 percentage points above Britain’s benchmark interest rate, according to Wotherspoon. RBS declined to

comment on those actions.

Earlier this year, the FCA launched a separate inquiry into the way RBS had handled companies in difficulty. The regulator defended the sophistication test as necessary to make the scheme workable.

The FCA said the independent assessors who check the banks’ ruling on compensation claims are not being lenient with the banks, and it is satisfied the vast majority of businesses allowed into the scheme are happy with their compensation.

1 US dollar = 0.6393 British pound

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