SWAPS AND LIBOR MANIPULATION

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1. Introduction

1.1. Between December 2001 and June 2012 a number of leading high street banks sold a variety of Interest Rate Hedging Products ('**IRHPs**' or '**Swaps**') to (at least) 19,100 non-sophisticated SMEs[1]. In June 2012 certain of those banks[2] agreed under pressure from the Regulator – the (now) Financial Conduct Authority ('**FCA**') – to undertake a review of these transactions and to offer redress where the sale was found to be non-compliant with certain benchmark standards agreed between the banks and the FCA ('the **Review**'). In the result, the sales transactions were found to be non-compliant in at least 91% of cases.

1.2. By December 2014 the banks participating in the Review had paid out c£1.8b in compensation to customers who had opted into the Review. Of that sum, only £365m represents payment for consequential losses. In practice the Review has been operated by the banks in a manner that has not led to much in the way of consequential loss redress being paid to customers who were mis-sold IRHPs.

1.3. Whilst the above scandal was in progress a number of the same banks who were 'mis-selling' derivatives were also engaged in manipulation of the LIBOR rate. In particular:

1.3.1. On 27 June 2012, Barclays Bank was fined $200 million by the Commodity Futures Trading Commission, $160 million by the United States Department of Justice and £59.5 million by the Financial Conduct Authority for attempted manipulation of the Libor and Euribor rates. Barclays manipulated rates for at least two reasons. Routinely, from at least as early as 2005, traders sought particular rate submissions to benefit their financial positions. Later, during the 2007–2012 global financial crisis. They artificially lowered rate submissions to make the bank seem healthier.

1.3.2. On 19 December 2012, UBS agreed to pay regulators $1.5 billion ($1.2 billion to the US Department of Justice and the Commodity Futures Trading Commission, £160m to the UK Financial Services Authority and 60m CHF to the Swiss Financial Market Supervisory Authority) in relation to LIBOR manipulation. The investigations showed that UBS traders had colluded with other panel banks and had made over 2,000 written requests for movements in rates from at least January 2005 to at least June 2010 to benefit their trading positions.

1.3.3. On 6 February 2013 RBS submitted to fines of $325 million imposed by the U.S. Commodity Futures Trading Commission, $150 million agreed with the Department of Justice and £87.5 million imposed by the FCA £87.5m in relation to LIBOR rigging between January 2006 and March 2012.

1.3.4. On 28 July 2014 Lloyds Bank admitted that between September 2006 and June 2009 the bank had routinely manipulated its GBP LIBOR submissions to benefit its money market trading positions (in addition to making false submissions in relation to its US dollar and Japanese Yen LIBOR submissions). The Banks submitted to a reduced financial penalty imposed by the FCA in the sum of £105m. Lloyds was also fined $105 million by the U.S. Commodity Futures Trading Commission and $86 million fine by the U.S. Department of Justice for attempting to fix the Libor rate for yen, sterling and the U.S. dollar.

1.3.5. On 23 April 2015 Deutsche Bank AG was fined £226,800,000 by the FCA following findings that it had manipulated its LIBOR submissions to benefit trading positions

[1] Financial Conduct Authority Interest Rate Hedging Review Progress report at: http://www.fca.org.uk/static/documents/banks-progress-position.pdf

[2] In particular: Allied Irish Bank (UK), Bank of Ireland, Barclays Bank, Clydesdale & Yorkshire, Co-operative Bank, HSBC Bank, Royal Bank of Scotland, Santander UK, Lloyds Banking Group

and engaged in collusion with the intention of improperly influencing the submissions of other panel banks. The period of misconduct was from (at least) January 2005 to December 2010.

1.4. In many instances the IRHPs which were mis-sold to SMEs were referenced to LIBOR. The effect of the manipulation of the reference rate during the financial crisis was artificially to lower rates with the result the ‘mark to market’ (the ‘**MTM**’) cost of exiting trades was increased.

1.5. The result of the derivative mis-selling – coupled with LIBOR manipulation – has been to lead to a significant number of SMEs being subjected to a variety of insolvency processes. This paper will look at the mechanisms potentially available to ensure proper redress is provided through the Review. It will also seek to summarise the current state of the law in relation to LIBOR rigging based claims.

2. Sales of IRHPs

2.1. IRHPs are regulated financial products. Accordingly, they may only be transacted or recommended by entities (‘**Firms**’ in regulatory parlance) holding a relevant Part IV Permission issued by the FCA. Firms recommending or arranging transactions in IRHPs are required by the Regulator to comply with benchmark standards set by

2.1.1. The Conduct of Business Rules (‘**COB Rules**’) in transactions between 1 December 2001 and 31 October 2007; and,

2.1.2. The Conduct of Business Sourcebook Rules (‘**COBs Rules**’) in relation to transactions post-dating 1 November 2007.

2.2. The key COB Rules are

2.2.1. **COB 2.1 – Clear, fair and not misleading communication** Rule 2.1.3: ‘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’.

2.2.2. **COB 5.4.3 – Requirement for risk warnings** (1) A firm must not: (1) make a personal recommendation of a transaction; or … (3) arrange (bring about) or execute a deal in …a derivative 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.

2.2.3. These Rules apply whether or not the relationship giving rise to the trade is one in which the Bank assumed a responsibility to advise on the transaction.

2.3. The key COBs Rules are:

2.3.1. **COBS 2.1.1 R**: A Firm must act honestly, fairly and professionally in accordance with the best interests of the client.

2.3.2. **COBS 2.2.1 R:** A Firm must provide appropriate information in a comprehensible form to clients about investments and proposed investment strategies including appropriate guidance on and warnings of the risks associated with investments on such investments and strategy.

2.3.3. **COBS 14.3.2 R:** A Firm must explain the risks of the specific type of investment being recommended and / or in the case of derivatives arranged (whether pursuant to a recommendation or not) the risks particular to that type of investment and in sufficient detail to allow the client to make an informed decision.

2.3.4. Again, these Rules apply whether or not the relationship giving rise to the trade is one in which the Bank assumed a responsibility to advise on the transaction.

2.4. Whether the transaction was governed by COB or COBs the key disclosure issue affecting the sale of IRHPs relates to the 'mark to market' exit or 'break cost' in the event the trade is terminated early. There is an asymmetry of information as between the Bank and its customer in almost all cases. The Bank is well aware and able to model from the inception of the trade the potential break cost. Indeed, in practice it will monitor the break cost throughout the life of the IRHP.

2.5. For example, assuming a swap written with a 10 year tenor at a rate of say 5% in reference to a notional sum of £10m, the Bank will know that if the trade is broken in year 5 when interest rates may have fallen to 1% and are predicted to remain at that level, it may cost the swap counterparty £2m to exit the transaction. The risk of this liability arising is treated as a contingent liability of the swap counterparty which in the case of public limited companies should be accounted for in their annual accounts. This contingent liability is secured in the Bank's favour under the (usual) all-monies charging clause in the loan which is hedged by the swap. This has serious implications for the borrower's ability to maintain compliance with (for example) a loan to value covenant ('**LTV Covenant**').

2.6. During the financial crisis (2007 to 2012) the following scenario began routinely to unfold:

2.6.1. Banks required borrowers to provide revaluations of their property portfolios. These generally showed a decrease in the value of the Bank's security. Even although the loan facilities were being serviced, a fall in property value was relied on to trigger an event of default (i.e. breach of the LTV Covenant), entitling the Bank to both call in the loan and terminate any linked hedge.

2.6.2. In many cases, even if the LTV Covenant was not breached by a devaluation of the security, the inclusion of the MTM cost in assessing the borrower's liability to the Bank had the effect of triggering a breach of the LTV.

2.7. The above risks were not in practice explained to borrowers who – to the contrary – were sold IRHPs based on assurances that they offered a form of protection against interest rate rises and provided security to the business. In truth and fact, whilst executing a swap did enable a borrower to (potentially) fix the future cost of borrowing – and facilitate compliance (for example) with an interest cover ration covenant ('**ICR Covenant**') – the potential for the swap to go out of the money and to create an unaffordable MTM triggering a default in respect of the LTV Covenant worked to the borrower's disadvantage. The latter risk was one wholly outside the borrower's control.

2.8. The risks inherent in the vanilla swap scenario outlined above are exacerbated in the case of yet more toxic swaps – such as structured collars and digital swaps – where the swap rate increases adversely to the swap counterparty in a falling interest rate environment. The disadvantages and dangers of IRHPs are also exacerbated by other exotic IRHP variants – such as extendible collars where the Bank reserves an option to extend the tenor of the swap, increase the notional sum and swap rate depending on the economic environment obtaining at the initial swap term date.

2.9. In seeking to make good a claim that product risks were not warned to the borrower it is necessary to show a duty on the part of the Bank to provide an appropriate warning. Here a distinction falls to be made between (1) individual and (2) corporate claimants. The former are 'private persons' within the **Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001**[3] to whom a right to claim damages for breach of the COB/ COBs Rules is given. Claimants in this category can therefore rely on the Conduct of Business Rules adumbrated above.

2.10. Claimants in the corporate category are not entitled to rely on the COB/ COBs[4] Rules.

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[3] The term 'private person' is there defined as '*(a) any individual, unless [immaterial proviso] … [he suffers the loss in question in the course of carrying on — any regulated activity; or any activity which would be a regulated activity apart from any exclusion made by article 72 of the Regulated Activities Order (overseas persons)*'

[4] See Titan Steel Wheels Ltd v The Royal Bank of Scotland plc [2010] 2 Lloyd's Rep 92

2.11. Corporate Claimants are therefore only able to bring a claim if they can identify a cause of action other than the Conduct of Business Rules. This may be afforded by establishing a contract to advise (where there is evidence the Bank has agreed to advise on hedging) or where it can be shown the Bank assumed a duty to give accurate information about the transaction it was proposing (but not advising/ recommending) the customer to incept.

2.12. In practice is difficult to show the Bank agreed to advise a customer in that the relationship between customer and banker is typically non-advisory. In **Goldsworthy v Brickell**,[5] Nourse LJ stated: "*A Banker, being a person having a pre-existing and conflicting interest in any loan transaction with a customer, cannot ordinarily be trusted and confided in so as to come under a duty to take care of the customer and give him disinterested advice*".[6]

2.13. In **Lloyds Bank Plc v Cobb**,[7] the following test was suggested by Scott LJ: "*The ordinary relationship of customer and Banker does not place on the Bank any contractual or tortious duty to advise the customers on the wisdom of commercial projects for the purpose of which the Bank is asked to lend money. If the Bank is to be placed under such a duty, there must be a request from the customer, accepted by the Bank, or some arrangement between the customer and the Bank, under which the advice is to be given … in order to place the Bank under a duty of care to the borrower, the borrower must, in my opinion, make it clear to the Bank that its advice is being sought. The mere request for a loan, coupled with the supply to the Bank of the details of the commercial project for whose purposes the loan is sought, does not suffice to make it clear to the Bank that its advice is being sought*."

2.14. The difficulty in showing that even a request for advice which is acted on by the Bank ripened into an assumption of an advisory role lies in the fact that the Bank will routinely seek to preclude any advisory role raising by reference to 'basis of dealing clauses' contained in its Terms of Business or other documents brought into existence in connection with the trade (e.g. an ISDA Master Agreement, Trade Confirmation or literature promoting its swaps). These provisions have been treated as effective in a number of cases to prevent a customer alleging advice was given on which type of IRHP was suitable: see in particular to **Grant Estates Ltd v Royal Bank of Scotland**[8] and **Rowley & Green v RBS**[9] and most recently **Crestsign Limited v National Westminster Bank Plc and The Royal Bank of Scotland**[10].

2.15. Nonetheless, even where a non-advisory relationship is deemed to be in place, it is established that a Bank arranging a Swap will still owe a limited duty as described in paragraph 153 of Tim Kerr QC's judgment in Crestsign: 'In my judgment, [the Bank] came under a duty to explain fully and accurately the nature and effect of the products in respect of which [it] chose to volunteer an explanation, but I do not think [it] came under a duty to explain fully other products that Crestsign might have wanted to purchase but which [it] did not wish to sell, such as an interest rate cap product. An explanation of such other products, for the purpose of presenting a balanced picture, would be the territory of an advice-giving duty, which was excluded on the documents as I have already found'.

2.16. The difference between the 'advisory' and 'non-advisory' scenario lies in this: in the latter, the duty is confined to giving an accurate description of the product being offered when volunteered i.e. a duty not to make any positive mis-statement about the product; in the former, there is a wider duty to offer positive advice and ensure then transaction being arranged is in fact suitable.

2.17. Where the COB/ COBs Rules apply, these import a positive duty to warn and therefore go beyond a duty not mis-state. A non-advisory basis of dealing clause will not prevent a

[5] [1987] CH 378
[6] *Ibid* at 404
[7] Decided 18 December 1991, CA (unreported).
[8] [2012] CSOH 133
[9] [2012] EWHC 3661
[10] [2014] EWHC 3043

private person therefore complaining that he was not given information about risks. He can base a claim on the COB/ COBs Rules without having to show that anything misleading was said. In other words, such a claimant can complain about an omission to warn; a corporate claimant who is not in an advisory relationship can only complain about a misrepresentation not that the Bank failed to warn of risks.

2.18. Private persons are further protected by COB and COBs Rules prohibiting the Bank contracting out if its regulatory duties. See: **COBS 2.1.2R** which provides that '*a firm must not, in any communication relating to designated investment business seek to: (1) exclude or restrict; or (2) rely on any exclusion or restriction of; any duty or liability it may have to a client under the regulatory system*' and (2) **COBS 2.1.3G** which specified that '*(1) In order to comply with the client's best interests rule, a firm should not, in any communication to a retail client relating to designated investment business: (a) seek to exclude or restrict; or (b) rely on any exclusion or restriction of; any duty or liability it may have to a client other than under the regulatory system, unless it is honest, fair and professional for it to do so*'[11].

2.19. If an advisory relationship can be established a corporate Claimant, although not able to enforce the COB/ COBs Rules directly will be entitled to point to them as indicating a set of benchmark standards summarising what would be expected of a competent derivatives advisor: see **Gestmin SGPS SA v Credit Suisse (UK) Ltd and another**[12] at [122].

2.20. If a framework as described above can be constructed then a juridical platform is established from which to complain that inadequate information or advice was provided about – in particular – the break cost of the IRHP the customer has taken out. Here the issue is as to the amount of information a Bank seeking to comply with its 'advisory' or 'information providing duty' should provide. In particular, does a Bank discharge its duty by (1) warning that a break cost may arise if the trade is exited early or (2) by going on to provide an illustration of the potential magnitude?

2.21. The law is not yet settled. In a non-advisory relationship where the COB/ COBs Rules are not in play, there is authority that a Bank will 'just' satisfy its duty to provide information by warning of the existence of a break cost (see **Green and Rowley** and **Crestsign**) and will not be treated as in breach by failing to illustrate the potential exposure in figures; where the relationship is advisory and/ or where the COB/ COBs Rules apply there is as yet no decided case. However, it is clear that (1) the FCA inclines to the position that correct application of the COB/ COBs Rules requires the provision of an illustration: this was the position it adopted in intervening in **Green and Rowley** in the Court of Appeal; (2) the premise of the Review is that the requirement to meet the information needs of a customer for whom an IRHP is being arranged dictates that an illustration should have been provided.

2.22. In all cases the final building block of a claim is to show what the customer would – on the balance of probability done and been able to do – if correctly advised or correctly and adequately informed (or at least not misinformed) as to the risks of the product arranged by the Bank. This will require the customer to demonstrate that if the sale had been transacted compliantly then he would have borrowed and been able to borrow on a different (less expensive) basis i.e. unhedged with the Bank that mis-sold the Swap or with another lender or that the loan would have been hedged by way of a less onerous alternative derivative instrument – such as a cap (which could be exited at no cost and would have allowed full participation in any fall in interest rates below the cap strike rate). Aside from any comparative increase in servicing costs, the borrower/ swap counterparty will seek to recover the *ex hypothesi* avoidable break cost of the mis-sold derivative.

[11] Cf COB 2.5.3R and/ or COB 2.1.2R 'a firm must not, in any written or oral communication in connection with designated investment business, seek to exclude or restrict, or to rely on any exclusion or restriction of, any duty or liability it may have to a customer (which for these purposes includes a retail customer) under the regulatory system'

[12] [2013] EWHC 3560 (Comm)

3. Expert evidence

3.1. Proving a mis-selling claim is difficult without expert evidence. There are issues that arise which in any conventional professional negligence claim or financial product mis-selling case would be routinely addressed by expert evidence. For example, without expert evidence:

3.1.1. A Court cannot reach an informed and balanced view as to the practices adopted by Banks seeking to comply with their COBs duties. The implementation of COBs is as much a matter of market practice as it is legal pronouncement as to what is required.

3.1.2. A Court cannot price an alternative counterfactual product when assessing quantum without expert evidence as to market pricing of derivatives.

3.1.3. A Court cannot safely determine whether a representation as to future interest rate movements made to a borrower to induce acceptance of a particular IRHP with its embedded rate without expert evidence of historic perceptions of forward yield curves.

3.2. The above propositions might be expected to be uncontroversial. However, in practice, the Banks have universally objected to claimants deploying expert evidence. Decisions at first instance vary up and down the country as to whether expert evidence on the above issues is needed. In **Battrick v Royal Bank of Scotland Plc** the Court ordered expert evidence as to selling standards and practices, reasoning[13]: '*The risk in excluding expert evidence of the type I have described is that the court determines what is or is not good enough to meet the standard required by the relevant COBS rule in a vacuum which is filled only by the parties' partisan submissions. In my judgment, a court ought to be slow to hold that a bank acted in breach of its statutory duty and/or was negligent on that basis. For all of these reasons I made the order granting permission for expert evidence in this case*'

3.3. The above decision was inferentially approved in **Warner Retail v RBS**.[14] In **Crestsign Limited**[15] expert evidence on derivatives sales practices was described by the Judge as 'helpful'. Despite this Banks prefer to maintain a playing field that preserves the asymmetry of knowledge by resisting the use of expert evidence. The issue is due to be considered by the Court of appeal in **Spring Rental Limited v Barclays Bank Plc** (on 15 December 2014 Lord Justice Lewison granted permission to appeal against a case management decision refusing permission for expert evidence, commenting that '*the appeal had a real prospect of success*'; it is listed for hearing in the Court of Appeal on 29 – 30 June 2015).

4. The Review

4.1. In June 2012 the FCA announced that agreement had been reached with Barclays, HSBC, Lloyds and RBS that they would participate in a pilot review of IRHP sales transactions. The purpose of the Review was to gather information as to sales methods and establish a benchmark for judging if the sales had been conducted in a manner compliant with the COB/ COBs Rules. For the purposes of this exercise – and as between the Regulator and the Bank – no distinction was drawn between corporate and individual customers. In July 2012 Allied Irish Bank (UK), Bank of Ireland, Clydesdale and Yorkshire Banks, Co-operative Bank, Northern Bank, Santander UK and Irish Bank Resolution Corporation signed up to the Review.

4.2. By January 2013 agreement had been reached as to the standards to be applied in assessing the compliant nature of a transaction. Under pressure from the Treasury Select Committee the specification and standards emerging from this process have now been made public. They reflect a minimum standard of benchmark compliance with the requirements of COB and COBs.

[13] 18 October 2013, Bristol Mercantile Court

[14] [2014] EWHC 2818

[15] Judgment on costs: [2014] EWHC 3095, [31]

4.3. Key provisions in the review process include determining whether the Bank complied with the following at the point of sale:

June 2012 Specification

4.3.1. '1.9.1. In good time before conclusion of the contract, the Firm has provided the Customer with appropriate, comprehensible and fair, clear and not misleading information on the features, benefits and risks associated with the Interest Rate Hedging Product'.

4.3.2. '1.9.2. In good time before conclusion of the contract, the Firm has provided the Customer with an appropriate, comprehensible and fair, clear and not misleading disclosure of any potential break costs'.

4.3.3. '1.9.4 The Firm has had due regard to the information needs of the Customer and provided comprehensible, and fair, clear and not misleading information about the features, benefits and risks of relevant alternative Interest Rate Hedging Products.'

January 2013 Agreement

4.3.4. (By Annex 2 to the January 2013 Agreement ('the Sales Review Principles') '2. …The assessment of the sale requires an objective assessment of the facts to determine whether, in that Customer's circumstances, the Firm has complied with the Regulatory Requirements (taking into account the Sales Standards) and in particular, whether the Customer was provided with sufficient information to enable the Customer to understand the features and risks of the product'.

4.3.5. (By Annex 2 to the January 2013 Agreement ('the Sales Review Principles') '3. …the assessment of a sale requires an objective assessment of the facts to determine whether in that customer's circumstances the firm has complied with the Regulatory Requirements (taking into account the Sales Standards) and in particular whether the Customer was provided with sufficient information to enable the Customer to understand the features and risks of the product'.

4.3.6. (By Annex 2 to the January 2013 Agreement ('the Sales Review Principles') '4. …this case by case assessment should involve (but is not limited to) a holistic consideration of the following:

- The size and nature of the Customer
- The Customer's knowledge and understanding of these types of products generally and the specific product purchased
- The Customer's interaction during the sales process
- The complexity of the product; and

The information provided during the sales process, particularly the quality and nature of the information provided, when and how it was provided and how long the Customer had to digest and understand it.'

4.3.7. (By Annex 2 to the January 2013 Agreement ('the Sales Review Principles') '5. …the level and nature of disclosure required must meet our requirement for being clear, fair and not misleading…a consideration of all the circumstances of the case must be carried out to determine whether the sale complied with the Regulatory Requirements (taking into account the Sales Standards)…'

As to determining redress

4.3.8. (By Annex 3 to the January 2013 Agreement) '7. The core tenet of this proactive redress exercise and past business review is to pay fair and reasonable redress to Customers where appropriate. …Fair and reasonable redress requires that the

Customer be put back in the position they would have been in if there had not been any breach of the Regulatory Requirements'.

4.3.9. (By Annex 3 to the January 2013 Agreement) '11. When considering the counterfactual the firm should presume in the absence of evidence to the contrary that the Customer would have purchased a simple product (cap, vanilla swap or vanilla collar) without any callable or extendable elements'.

4.3.10. (By Annex 3 to the January 2013 Agreement) '12. When considering the counterfactual in cases where the firm has failed to comply with the Regulatory Requirements in relation to the disclosure of break costs the firm should presume in the absence of relevant evidence to the contrary …that the Customer would not have taken an IRHP with a potential break cost greater than 7.5% of the notional value of the IRHP in a pessimistic but plausible scenario'.

4.3.11. (By Annex 3 to the January 2013 Agreement) '13. Relevant evidence might include the Customer's demands, needs and intentions at the time of the sale, including any testimony by the Customer about the reasons at the time of the sale for purchasing the IRHP **but in this context the firm should also take into account the impact that the failure to comply with the relevant Regulatory Requirements may have had on those demands, needs, intentions and reasons**' (emphasis added).

4.3.12. (By annex 3 to the January 2013 Agreement) '19. In the event of a non-compliant sale, where the counter-factual is that the Customer would have purchased an alternative IRHP …fair and reasonable redress is presumed to be an alternative product that provides such protection'.

4.3.13. (By annex 3 to the January 2013 Agreement) '22. The appropriate alternative product will be the IRHP that the Customer would in the counterfactual scenario have taken'.

4.3.14. (By annex 3 to the January 2013 Agreement) '22. Two key principles underpin the process for determining an alternative product …(i) the firm should presume, in the absence of evidence to the contrary, that the Customer would have purchased as simple product (cap, vanilla swap or vanilla collar) without any callable or extendible elements …(ii) when considering the counter-factual in cases where the firm has failed to comply with the Regulatory Requirements in relation to the disclosure of break costs the firm should presume, in the absence of evidence to the contrary …that the Customer would not have taken an IRHP with a potential break cost greater than 7.5% of the notional value of the IRHP in a pessimistic but plausible scenario. This means the tenor of the product should not exceed the maximum term….'

4.3.15. (By annex 3 to the January 2013 Agreement) '23. **It is not reasonable to use a vanilla swap or a vanilla collar as a 'default' option as the alternative must be determined on the basis of the evidence available; and determined considering the financial sophistication, knowledge and understanding of the Customer**' (emphasis added).

4.3.16. (By annex 3 to the January 2013 Agreement) '24. The firm should take into account the Customer's circumstances at the time of the sale when considering what term the Customer would have opted for were it not for the breach of the Regulatory Requirements. …'

4.3.17. (By annex 3 to the January 2013 Agreement) '25. If during the original sale the customer said they did not want a cap on the basis that they did not wish to pay a premium, then the assessment of the sale should consider whether any breach of the Regulatory Requirements contributed to that decision; for example, a lack of disclosure in relation to the features and risks of non-cap products'.

4.3.18. (By annex 3 to the January 2013 Agreement) '27. The pricing of an alternative product must be fair and reasonable in the circumstances'.

4.3.19. (By annex 3 to the January 2013 Agreement) '28. **In the event that the alternative product is a cap or vanilla collar, the strike rate of the cap should be defined according to a holistic consideration of the circumstances of the Customer at the time of the original sale.** It is not sufficient for the strike rate of the alternative product to default to the actual strike rate or the most common strike rate at the time of the original sale if a collar was originally sold' (emphasis added).

5. Enforcing the Review

5.1. A question which frequently arises in relation to the Review is: what remedy is available to the customer who has been mis-sold an IRHP to compel the bank to pay proper redress – in particular for consequential losses?

5.2. Typically 3 scenarios are encountered:

5.2.1. The bank admits a mis-sale and offers compensation calculated by reference to a substitute trade into which it alleges the customer would have entered in any event. The effect of the offer is often (at least) to reduce the compensation which would be paid if the original, mis-sold IRHP was simply torn-up. At worst, the notional substitute trade generates a notional claim to interest which would have been payable to the bank exceeding the servicing cost of the substitute trade. The effect of this process of 'reverse engineering' is to reduce or eliminate the compensation which would otherwise be payable to the customer ('the **Reverse Engineering Problem**').

5.2.2. The bank admits a mis-sale and offers the customer an option **either** (1) to accept an offer of basic redress (either reimbursement of the servicing costs of the mis-sold IRHP or a partial reimbursement calculated by reference to a notional and less offensive substitute trade) plus 8% - where the 8% is intended to compensate for consequential losses **or** (2) to accept the offer of basic redress not augmented by the addition of 8% interest and to assess a claim for consequential losses. Payment of the basic redress sum is deferred until settlement of the claim for consequential losses ('the **Deferred Redress Problem**').

5.2.3. The scenario at 4.2.2(1) arises but the bank agrees to pay the basic redress whilst the claim for consequential loss is determined; in this scenario the customer is obliged to compromise all other claims against the bank relating to the mis-sold IRHP. In due course, whether the route to consequential loss redress follows the scenario in 4.2.2 or 4.2.3, the bank determines that the claim for consequential loss does not meet the 'factual and legal' tests for recovery (the '**Refusal of Consequential Loss Problem**').

5.3. In principle, a borrower dissatisfied with the form of a Redress Offer may refer the matter to the Financial Ombudsman Service ('**FOS**'). This is of limited help in that (1) the jurisdiction of the FOS is capped at £150,000 (plus interest) which is woefully inadequate in the majority of cases and (2) the avenue is not available to any corporate entity which does not satisfy the 'micro-enterprise' definition i.e. an entity that has fewer than 10 employees and an annual turnover or balance sheet that does not exceed €2million.

5.4. In the case of an individual claimant it is arguable that any failure to implement the Review in accordance with its terms may be entail a breach of two particular areas of the COBs and DISB Rules[16] – that is:

5.4.1. **COBS 2.1.1R**: (1) A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule): not implementing the Review in a manner that complies with this Rule may itself entail a breach of the Rule.

[16] Dispute Resolution Rules

5.4.2. **DISP1.4.1R**: which imposes a duty to 'investigate [a] complaint competently, diligently and impartially, obtaining additional information as necessary….assess fairly, consistently and promptly: (a) the subject matter of the complaint; (b) whether the complaint should be upheld; (c) what remedial action or redress (or both) may be appropriate… taking into account all relevant factors….[and] to offer redress or remedial action when it decides this is appropriate.'

5.5. This may open an avenue to overcome the Deferred Redress Problem. The authors have encountered numerous instances of Banks withholding payment of the basic redress sum due in respect of the servicing costs of an admittedly mis-sold IRHP, as a ransom against the customer's non-acceptance of an inadequate offer of redress in respect of consequential losses. Prima facie this infringes the above Rules.

5.6. Where an offer of basic redress has been accepted on the basis that a separate claim for consequential losses will be assessed, the Bank will require the customer to sign a form of compromise waiving all and any other claims connected with the mis-sale of the product – save as regards consequential losses. The parameters within which a claim to consequential loss will then fall to be determined are clearly defined by the Review. To be recoverable, any such loss must satisfy a 'factual' and 'legal' test i.e. the loss must have been caused in fact by the mis-sale of the derivative and be of a kind which is legally 'foreseeable'. It is accordingly arguable that the compromise agreement creates a contract whereby the Bank – in exchange for the benefit of the compromise – agrees to pay to the customer such compensation for consequential losses as meets the criteria set by the legal and factual tests. This could render the Review contractually enforceable.

5.7. The Review process is overseen by an independent reviewer approved by the FCA. In practice offers of redress are routinely expressed to have been approved as appropriate, fair and reasonable by the independent reviewer. In practice, this decision is announced without any explanation as to what factors the reviewer has taken into account to reach the decision taken and therefore without the customer being afforded any opportunity to challenge the stance taken by the independent reviewer. On 24 April 2015 in **ex parte Holmcroft Properties Limited** the Court gave permission for this process to be judicially reviewed. If ultimately successful the review decision challenged by Holmcroft will be quashed and the reviewer will be directed to re-consider the outcome of the consequential loss assessment[17].

5.8. Finally, as to the problem of reverse engineering. The FCA report dated March 2013 '**Interest Rate Hedging Products – Pilot Findings**' indicated that where a transaction requires redress in the form of a re-written trade: '*The alternative product [should] not [be one which would have had a] break cost in excess of 7.5%, in a pessimistic but plausible scenario, of the amount hedged at the point of sale – this is because we believe that, if the original sale had complied with our regulatory requirements, customers would have not entered into a product with potentially sizeable break costs*'. This approach has been re-stated in the Review specification. In practice it has led to many Banks substituting the most expensive alternative substitute product that is possible to select so long as it does not entail a break cost in excess of the indicated 7.5% level. This is clearly not in-line with the overall approach required to be taken in determining appropriate redress.

6. LIBOR Update

6.1. The 'London Interbank Offer Rate' was established in 1986 and until 2012 was administered by the British Bankers Association. The BBA defined the LIBOR Rate as: '*The rate at which an individual contributor panel bank could borrow funds were it to do so by asking for and then accepting interbank offers in reasonable market size just prior to 11.00 London time*'. It was originally quoted in 3 currencies: US Dollars, UK Sterling and Japanese Yen. It subsequently grew to include 16 currencies. There are presently 5 currencies: USD, GBP,

[17] The reviewer was held to be exercising a public function in the context of the process as overseen by the FCA; as such the customer was entitled to be properly heard: **Kanda v Government of the Federation of Malaya** [1962] AC 322 and **O'Reilly v Mackman** [1983] 2 AC 237

EUR, JPY and CHF LIBOR. There are 7 different maturities: overnight, 1 week, 1 month, 2 months, 3 months, 6 months and 12 months.

6.2. There were originally 16 Banks making up the BBA LIBOR submission panel. The rates submitted were analysed by eliminating the top and bottom 4 submissions (the outliers) and taking an arithmetical mean of the remaining 8 submissions.

6.3. Prior to the financial crisis there had been a prolonged period of credit expansion funded by the development of financial structures which took the form of repackaging long term debt to investors through securitization. In this way Banks were able to offer long term funding and overcome the threat to liquidity otherwise posed by relying on short term deposit taking as the source of funds from which to lend. With the onset of the financial crisis – in particular the risk of default in the sub-prime lending market – wholesale funding through securitization dried up almost overnight. Lending was greatly reduced as Banks became increasingly concerned over management of their liquidity risks.

6.4. During the crisis there was increased dependency on short-term borrowing to cover long term lending already in place. The reduction in lending meant that there was much less evidence of market rates as a basis for making LIBOR submissions; in the absence of evidence, Banks resorted to making up rates. Here, there was an incentive to under-report on the basis that it implied the submitting bank was of greater covenant strength than was in truth the case.

6.5. In **Graiseley Properties Limited and Others v Barclays Bank Plc**[18] the Court of Appeal upheld a decision of Flaux J that in offering LIBOR referenced IRHPs the bank was making a series of representations about the integrity of the rate. In particular that Barclays had impliedly represented (by words and conduct):

6.5.1. It was not Barclays' policy or practice to make false or misleading LIBOR submissions to the BBA or to engage in any practice which would or might improperly influence Sterling LIBOR such that it represented a different rate to that defined by the BBA.

6.5.2. It did not intend in the future (and in particular during the term of the interest rate hedging instruments recommended to and arranged for the customer) to make false or misleading LIBOR submissions to the BBA or to engage in any practice which would or might improperly influence Sterling LIBOR such that it represented a different rate to that defined by the BBA.

6.5.3. It had no reason to believe that the LIBOR rate was not calculated in accordance with the BBA definition; and,

6.5.4. It had no reason to believe that the LIBOR rate would be improperly influenced in the future by Barclays.

6.6. Given the over-whelming evidence of attempted manipulation of LIBOR by Barclays it was well arguable that the above misrepresentations had been made. The remedy of strength in this context is rescission (it will almost certainly be impossible to show any real loss as a result of accepting a hedged loan referenced to a fake LIBOR rate). As Longmore LJ said at para[30]: '*The banks' submissions boiled down to saying that they were prepared to accept that they would do nothing dishonest or manipulative during the term of the contract and that should be enough for any counterparty. I can only say that, in my view, it is arguably not enough. If the day after the contracts had been made, the banks had told their counterparties that they had been manipulating LIBOR in the past and intended to do so in the future, but would be happy to pay any loss that their borrowers could prove, the borrower would (arguably) be sufficiently horrified so as to think he would be entitled to rescind the deal. The law should strive to uphold the reasonable expectations of honest men and women. If in the end it cannot do so, that should only be after a proper trial*'.

[18] [2013] EWCA Civ 1372

6.7. As the above decision was made in the context of an application to strike out the merits of the overall claim have yet to be determined at a full trial. Further, there are unresolved issues over whether:

6.7.1. It is enough that at the time the hedged borrowing was taken there was evidence of LIBOR manipulation affecting currencies other than the currency of the loan or whether the loan and hedge must be in a currency the claimant can show was being manipulated.

6.7.2. It is enough that there had been manipulation of rates in the (recent?) past or if it is necessary to show that the actual hedged borrowing was affected by manipulation?

6.7.3. Manipulation of (say) dollar rates cross-contaminates the integrity of GBP LIBOR.

6.8. There are at least 3 reasons for believing that dollar manipulation can affect GBP LIBOR. In particular (and taking Barclays as the exemplar):

6.8.1. The Bank had as great an incentive artificially to lower its dollar submission rates as it did its sterling submissions. A show of strength in dollars would engender a market perception it was a strong covenant to lend to in sterling too.

6.8.2. Secondly, it would have looked dangerously odd to have quoted a rate for one currency that was out of line with the other in terms of its presentation of credit risk.

6.8.3. Also, currency markets are interdependent so that if a false rate in one currency appears to offer a better return to a funder there is an incentive to covert (say) dollars to sterling as the currency of the loan and forward buy an equivalent dollar sum so as to replace the converted money when required. Differences in rates would be expected to be arbitraged out. In practice there is therefore the potential for rates in one currency to be influenced by a falsely reported rate in another currency.

6.9. In **Graiseley** the claimant relied on the suite of misrepresentations summarised above to claim rescission of the hedging instruments taken in connection with 2 particular facilities. The Court has recently extended the **Graiseley** analysis to hold that it is arguable that a compromise agreement waiving claims for IRHP mis-selling may also be vulnerable to rescission if entered into in reliance on misrepresentations as to the integrity of LIBOR: see **Eagle Strategic Property Limited v Lloyds Bank Plc** (13 January 2015, Bristol Mercantile Court).

6.10. Further, the extent of the Royal Bank of Scotland's manipulation of LIBOR remains in issue. It has admitted manipulation of JPY and CHF but denied fiddling GBP LIBOR. In a recent decision of Birss J in **Property Alliance Group Limited v Royal Bank of Scotland**[19] the Court ordered disclosure of what was referred to as 'Attachment C' to the Deferred Prosecution Agreement entered into between the Bank and the US Department of Justice. Part of the basis for the decision was that '*the document is potentially of real significance in this action and its disclosure is likely to assist PAG and this court in dealing with the case'*. This implies that the DofJ may at least be investigating RBS over sterling LIBOR manipulation.

7. Concluding remarks

7.1. Given the dates at which most of the IRHP sales took place conventional mis-selling claims are now increasingly vulnerable to the Limitation Act 1980 – save where standstill agreements have been entered into.

[19] [2015] EWHC 321

7.2. The interest in proceedings to enforce the Review or causes of action based in fraudulent LIBOR rigging lies in the fact that they are not (yet) vulnerable to limitation defences.

7.3. The scope and reach of actions brought on the above bases remain to be worked out by the Courts.

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