Dear Mr. Tyrie,

I am writing in response to a request to provide documents to the Treasury Select Committee (TSC) inquiry on SMEs. The Committee has asked for the legal opinions used as the basis for our decision that loans with similar features to interest rate hedging products (IRHPS) fell outside our regulatory remit. We refer to these loans as “relevant loans” below. The Committee has also asked for copies of agreements between the FCA and banks in relation to their review of sales of IRHPS.

**Relevant loans**

We can confirm that we have received legal advice from Charles Flint QC of Blackstone Chambers on this issue. This advice is consistent with our internal position that:

1) Contracts for relevant loans are not specified investments under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("RAO") and accordingly entering into or terminating such contracts does not constitute a regulated activity;

2) The conduct elements of the Principles for Businesses (and other FCA/FSA conduct rules) do not apply when a bank enters into a contract for a relevant loan or terminates the contract; and

3) Under our current powers the FCA is unable to establish a redress scheme in respect of any failings to properly disclose break costs in contracts for a relevant loan, or to regulate the banks’ future conduct in that respect.

I understand the Committee is particularly concerned with the question of why standalone IRHPS are regulated products, while relevant loans are not. This is in light of the fact that the “break cost” of a relevant loan may be linked to the cost to the bank in terminating a hedging arrangement it has entered into with a third party to mitigate its own interest rate risk. It is this aspect of relevant loans which has led to the majority of complaints from customers.
Standalone IRHPs are contracts for differences ("CFDs") for the purpose of Article 85 of the RAO. The definition of a CFD includes "rights under ...any... contract the purpose...of which is to secure a profit or avoid a loss by reference to fluctuations in...an index or other factor designated for that purpose in the contract". This includes, for example, interest rates. A standalone IRHP is duly a CFD, as the purpose of the contract is to secure a profit or avoid a loss by reference to fluctuations in interest rates. Standalone IRHPs are therefore regulated products.

In determining whether a contract for a relevant loan is a CFD it is necessary to consider whether the purpose of the contract is to secure a profit or avoid a loss by reference to fluctuations in interest rates. Our view, which is consistent with advice from counsel and existing case law, is that contracts for relevant loans do not have that purpose; rather the purpose of the contract is for the customer to borrow and the bank to lend. There are a number of reasons for this; in particular the break cost clause only arises in the event that the customer decides to end the contract early. While we recognise the serious consequences this may have for customers, this subsidiary, contingent clause cannot change the purpose of the contract when taken as a whole.

Relevant loans have been referred to by a number of different terms, such as "embedded" or "hidden" swaps. This description is not entirely accurate. The customer is not a party to the hedging arrangement entered into by the bank with the third party. The clause under which the break cost arises is, in substance, a liquidated damages clause under which the parties have agreed the basis on which damages will be assessed in the event of a default or early termination. Such terms are in place in many commercial loan contracts. If it were the case that this clause resulted in the contract falling within article 85 of the RAO, this would bring within regulation many commercial loan contracts which could not properly be described as CFDs or other contracts having a speculative or hedging purpose.

This analysis is entirely consistent with the general scheme of the RAO. The customer is not a party to the CFD made between the bank and the third party, which is the relevant specified investment under Article 85. The customer may be exposed, under the loan agreement, to liability to pay the break costs incurred by the bank under its hedging arrangements, but that does not change the nature of the loan agreement so as to render it a CFD. Nor does the customer thereby acquire a right or interest in the CFD entered into by the bank under article 89 of the RAO. The only specified investment is that made between the bank and the third party.

There is nothing in the Markets in Financial Instruments Directive (2004/39/EC) which requires relevant loans to be regulated. Our position on this is consistent with the views expressed by the European Commission.

It is not possible to say with any degree of certainty that every product labelled an "embedded swap" by a customer is outside regulation. Whether or not a product is regulated will depend on the exact construction of the contract, which can only be determined on a case by case basis. In reaching our view we have reviewed a precedent of the contracts which are subject to the majority of complaints and instructed counsel to advise on the same. Ultimately it is the banks' responsibility to determine what regulatory requirements apply to the products they provide, however we have no evidence to suggest that they have categorised relevant loans incorrectly.

Having determined that relevant loans are not regulated products, we have considered whether any of the FCA's conduct rules nonetheless apply, or other FCA powers relating to redress are available, in relation to the aspect of the relevant loans which has led to the majority of complaints, namely the "break costs" clause. As stated above, we have concluded that those rules do not apply and our redress powers are not available.
The position set out above is consistent with the advice provided by Charles Flint QC. The Committee will appreciate that Mr Flint's Opinion itself is subject to legal professional privilege, and that there is a strong public interest in maintaining the confidentiality of legal advice.

Disclosure of the Agreement

We understand the Committee's reasons for wishing to see the agreement between the FCA and the banks on IRHPs, and recognise of course the role of the Committee as a key part of ensuring the regulators' accountability to Parliament. We consider however that we are unable to provide a copy of the agreement because of the statutory confidentiality restrictions governing the FCA.

As you are aware, UK and European Union law requires that supervisory information is confidential between firms and the regulator. The confidentiality restrictions in section 348 of the Financial Services and Markets Act 2000 ("FSMA") protect the commercial interests of regulated firms, encourage cooperation with regulators, and safeguard those who wish to disclose sensitive information to us. Section 348 also implements the confidentiality obligations contained in a number of European directives, such as Article 53 of the Capital Requirements Directive IV.

The Information Tribunal has confirmed that the content of the agreement with banks is indeed "confidential information" for the purposes of section 348. This was in a case dealing with a request for disclosure of the agreement under the Freedom of Information Act 2000. (The Tribunal noted construing section 348 in a manner which allowed disclosure "could lead to the unfortunate consequence of discouraging parties from proceeding where possible by informal negotiation, giving the FCA no alternative to a full investigation and sanction" and accepting that "an informal route may result in a faster, more efficient and favourable outcome to the public".)

We appreciate that select committees have broad powers to send for "persons, papers or records" and that written and oral evidence provided to select committees is protected by parliamentary privilege. However, the FCA has received external counsel's advice (from Richard Gordon QC) which suggests that a request from a select committee does not of itself allow the FCA to disclose confidential information.

The FSA has been able to provide materials protected by section 348 to the select committee and the Parliamentary Commission on Banking Standards when the relevant firms have consented to disclosure of the information. This is not the position in this case.

We have considered whether we could provide the Committee with an anonymised version of the agreement. However, given that the agreement reached with all the banks was almost identical, this would still result in disclosing information which is confidential under section 348.

I appreciate that these confidentiality restrictions do give rise to a tension between the regulators' need to act within the statutory framework and the Committee's desire to ensure proper accountability, and I would of course be happy to have further discussions with the Committee's clerks to explore any alternative solution.

Yours sincerely

Sean Martin
General Counsel