

Banks' Lending Practices: Treatment of Businesses in distress

A report by Lawrence Tomlinson, Entrepreneur in Residence at the Department for Business, Innovation and Skills

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*****The following report has been redacted for the purposes of publication in order to protect the identity of the businesses who submitted evidence. It should be read as a summary of findings and solutions*****

1. Forward

It is important to remember that post-crash and bail-out, the banks needed to remove bad debt from their books, to downsize parts of their portfolio and rid themselves of risky lends. This is not unreasonable and it is to be expected that certain businesses, especially those with property, may be affected by this process. The evidence gathered for this report, however, raised concerns about some banks' strategy for improving their financial performance where it appears to be impacting on good and viable businesses.

The experiences of many businesses across the country suggests that, at least within RBS, there are circumstances in which the banks are unnecessarily engineering a default to move the business out of local management and into their turnaround divisions, generating revenue through fees, increased margins and devalued assets.

Much evidence was received about the practices of RBS' turnaround division, Global Restructuring Group (GRG) which typifies this behaviour. Once in this part of the bank, the business is trapped with no ability to move or opportunity to trade out of the position – they are forced to stand by and watch an otherwise successful business be sunk by the decisions of the bank. The bank extracts maximum revenue from the business, beyond what can be considered reasonable and to such an extent that it is the key contributing factor to the business' financial deterioration. This is not an open and transparent process, nor is it a proportionate response from the bank. During the process businesses are completely in the dark as to what is happening around them until it is too late. Most worryingly, the businesses affected are often perfectly viable and but for the action of the bank, would have been able to positively contribute to UK growth.

If businesses had more options for moving their banking facilities, and there was more transparency prior to entering this process, businesses would be better protected from the banks opportunistic behaviour in which they manipulate the businesses' financial positions for their own gain. Business lending therefore desperately requires an injection of transparency, more accountability and increased competition to give businesses a real alternative before they are forced down this process towards unnecessary insolvency.

I would like to stress that this is not a reflection of every bank, and that there are banks who are treating customers well and actively aiding growth.

Lawrence Tomlinson

Entrepreneur in Residence, Department for Business, Innovation and Skills

1. Introduction

There are a number of questions that need to be looked at before considering the evidence received in the course of writing this report:

- Why would a bank want to 'create' a default and distress an otherwise viable business?
- Have the businesses acted irresponsibly?
- Why has the relationship between bank and business changed so dramatically?
- Is this sustainable for the banks' long term growth?

The desire to grow the bank and business together for the long term has been outstripped by a profit driven approach to boost the commercial performance of the bank, even when this comes at the detriment of clients. As such, the banking culture has led to an enormous deterioration in the bank/business relationship.

The amount of profit business lending generates for the bank is extremely low compared to the revenue targets bankers are incentivised to meet – lending to businesses alone will not create large revenue increases. Therefore, rather than supporting a business, there are times when it is more profitable for a bank to stress the business. As one banker put it, to “put in a little cash and take all the value”. This value may come from the fees generated in business support divisions of the bank, increasing margins or taking the assets from the business. These sections of the bank should be turnaround divisions, aimed at improving business performance but the evidence received indicates the opposite and that these are being used as profit centres for the bank.

The bank will argue that to enter the turnaround division, the business must be struggling. However, from the evidence received, this is not always true and the trigger point for the business' move into the business support division is sometimes so insignificant, given the otherwise positive performance of the business, that the reaction by the bank can only be considered as utterly disproportionate at best and manipulative and conspiring at worst. In the most shocking circumstances, the distress or breach of banking arrangements is directly caused by a change in loan terms by the bank, such as a sudden reduction in EBITDA multiples creating an equity gap, or the significant undervaluation of an asset.

It is true that there will be many occasions where the business is struggling and does need to go into business support and eventually insolvency. The concerns outlined in this paper, however, are around those businesses that do not deserve to enter these support units and the treatment they receive once in them.

2. Summary of solutions

We need to ensure that businesses are better protected and put on a fairer playing field with the bank to stop this abuse of power in the banking relationship. This means careful investigation of the types of behaviour outlined in this report and consideration of the conflicts of interest from which these perverse behaviours derive.

I would urge all the banks to look closely at the way they handle businesses in distress. The banks must ensure that there is effective oversight of this part of their business, and that robust processes are in place to ensure fair treatment and avoid conflicts of interest. In addition, the FCA and government need to consider whether the regulatory framework is adequate to protect businesses in distress who are, by definition, in a particularly vulnerable position.

Allegations of previous abuses require thorough independent investigation and, if there have been abuses, the instigators should face the full consequences.

With proper investigation and effective solutions I am confident that we can rebuild SME confidence in how banks treat customers who fall into financial difficulties. This in turn will encourage more businesses to approach their bank for finance to grow.

Ultimately, the best safeguard would be a more competitive banking market within which customers can vote with their feet. RBS and the Lloyds Group have around 60% of small and medium size business lending and similar control of retail banking which is not healthy for the UK. They are now bigger than 'too big to fail', are clearly too big to regulate and have become even more remote from their owners,

There are strong arguments for splitting the Government backed banks into six solely retail and commercial banks from RBS and Lloyds, each with about 10% market share. The other parts of the banks should be sold, such as the equity and investment businesses, using the proceeds to recapitalise the retail and commercial banks to the latest, and future, Basel requirements.

Returning RBS and Lloyds to full private sector ownership in their current form would be a return to the banking landscape of 2003, possibly with even less competition. Although there is now more regulation in place, we have seen before that regulation does not always prevent banks from acting inappropriately. Given the lack of any real change in the banking sector, there is nothing that will stop 2018 being the same as 2008 unless radical action is taken now.

Most businesses need utilities like gas, water and electricity to operate. Proper finance and financial services are required by businesses as much as any other utility. Banking stocks should therefore become utility stocks, not racy stocks to gamble on. The returns should be a steady and sustainable yield, in the region of 6%. This would reverse the perverse culture which incentivises the banks to harm the financial position of a good business if doing so will help their commercial position. Instead banks would once again adopt a more traditional approach to lending in which the banks growth is in line with that of the business and customer, not at their expense.

3. Findings

Much of the evidence received in the process of writing this report was in relation to the behaviour of RBS, but not exclusively so. Whilst this is to be expected to a degree, given their size and market share, the numbers received for RBS are still disproportionately high.

The cases and experiences of businesses we received can be categorised as part of an overall process as follows:

1. The bank artificially distresses an otherwise viable business and through their actions puts them on a journey towards administration, receivership and liquidation.
2. Once transferred into the business support division of the bank the business is not supported in a manner consistent with good turnaround practice and this has a catalytic effect on the business' journey to insolvency.
3. The insolvency process lacks fairness and accountability leading to financial implications and biased outcomes to the detriment of the business owner.

This report considers each part of this 'process' separately and the mechanisms adopted by the bank. From the evidence that we received, it was apparent that, whilst each case is different and has its own characteristics, when taken as a whole the pattern soon clearly emerges. Many of the businesses who submitted evidence have done so in confidence.

Not all of the cases that we heard about go through the full process from stage 1-3 and some relate to specific parts of the process outlined above. However, it became very clear, very quickly that this process is systematic and institutional. Conversations with whistle blowers, experts and lawyers have also confirmed that it is often, in fact, the better businesses that enter such a path as there is more to be gained by the bank from this than from a less asset rich business. This suggests an element of intent in the bank's decision to distress these businesses.

It is also important to stress that where businesses submitted evidence and it was deemed that the bank acted justifiably and the business was not viable and was distressed, they have not been included as part of the evidence base. There were, nevertheless, very few cases like this and even where the business could have been considered to have been struggling, the reaction of the bank was so heavy handed that they actively prevented the business from turning around.

4. Engineering a Default

There are numerous mechanisms by which a business may be put into default and transferred to business support by the bank. This often takes the form of one of the following:

- Reassessment of loan to value – revaluation which significantly undervalues the business' assets and puts them in to breach of their covenants
- Technical breach of covenants – such as a temporary dip in EBITDA or a late submission of information. These are often breaches that have no bearing on the performance or viability of the business
- Removal of or change to facilities and the move to asset based finance

Each of these have the same effect of enabling the bank to identify the business as being distressed in order to move them out of local management. The first stop for such businesses is usually the turnaround division of the banks, although some may go straight into the insolvency process. To emphasise, this does not happen to all businesses, so some may breach covenants, even on a regular

basis and never move out of local management. For those it does happen to, however, it seems possible to predict what the end of the process will be for them having seen the number of cases which pass from this initial, constructed default to insolvency or near insolvency.

When asked, a whistleblowing ex-RBS banker confirmed that they could not think of any occasion in which a business entered RBS' Global Restructuring Group and came back into local management. They explained the process as such:

“Each month relationship managers would submit the figures for their customers to the credit team in the bank. Should anything flag, it would be passed to the ‘watch’ committee. For example if a business is not in breach of its banking agreements but is say 10% down on budgeted performance, they will keep their eye on it. They may decide to offer it to GRG, or order a check of the business’ LTV. If GRG want to take it, and see some value from the business for the bank, it would then be passed directly to GRG and the relationship manager would be prevented from contacting the business at all going forward.”

The points made by the ex-banker suggest that there is a process by which businesses are assessed for their potential value to GRG not their level of distress. In fact, two businesses could be operating at similar levels of performance, but one may have assets whereas the other does not. The one without assets could be allowed to continue trading as normal as there is no additional value for the bank in putting it into GRG, whereas the business with assets will enter GRG as there is more value to be made from that than continuing to lend to the business as normal.

Furthermore, if the banks are engineering defaults as is suggested in the following sections of this report, it is important to remember that this closes all doors for the business. Once they are moved into GRG they are considered risky. With the increased margins and fees, their cash flow will also be impaired, again making their proposition look less attractive to a competitor bank – even if the business has been artificially distressed due to the actions of the bank.

If they have been missold a swap, the contingent liability of that swap on their assets may outdate the length of their facility agreement with the banks too. When it comes to moving banks they are unable to do so as their assets are all secured against the swap and there is therefore no security available for the new lender. The business will therefore not be able to meet the risk profile of the potential new bank and they are stuck with whatever terms their current bank offers, however onerous they may be.

a. Revaluations and Changes in Loan to Value

This has been one of the most common complaints in the evidence received for this report. Revaluation of assets appears to be used on frequent occasions to put businesses into default of their loan agreements.

It is standard in most banking documents that the bank retains the right to demand a revaluation of assets. A change in the valuation of the assets often means that the business is in breach of its loan agreement and its loan to value (LTV) ratio is affected. However, valuation is an art, not a science,

and it is therefore easy for these valuations to be manipulated, especially when additional circumstances such as quick sales are added to the mix. Many businesses have submitted evidence demonstrating what appear to be unquestionable under-valuations of properties. They are so stark compared to original and current values of the property that their accuracy has to be called into question as well as the reason behind such an inaccuracy.

Not only is the undervaluation itself a concern, so is the relationship between the bank and the valuers. Often, much of a valuer's work will come from the banks and there is therefore an inherent conflict of interest as there is a natural incentive for the valuer to act in the interest of the bank. When you couple this with the fact that there is no redress for undervaluation whilst there is for overvaluation, it is easy to see why valuers would naturally want to put a conservative estimate on the value of a property.

Banks are also able to order valuations as if in the instance of a fire sale, for example, posing the question, "how much would we get if the property was sold in the next 6 weeks?". Clearly, under such sales the value of a property, especially a commercial property, will be extremely low comparable to the actual potential sale price under normal circumstance. There is, however, no obligation for the bank to sell the property at speed, even if the valuation is done on that basis. Therefore, the artificially low value of the property still counts as a breach of LTV even if the property is not going to be sold at that price. The property may still be worth, or near to, the original valuation and in reality the business is well within its LTV but through this revaluation process, the business is effectively put into default – despite how well the rest of the business is performing.

The following are just a few examples of the many cases of reduction in valuation of assets that received:

- A two thirds reduction in valuation in 2 months, during which the business' RBS Relationship Manager informed them that, "*no one has ever been sued for undervaluing a property*".
- A revaluation, in the same month, by the same valuers, reduced the valuation of the asset by £1.3m (over 17%) due to the new instructions given to the valuer by the bank.
- A desktop valuation (having never visited the property) reduced the value of the asset from £5m to £1.6m in 2 years. This allowed the bank to renegotiate its terms and significantly increase their margins.

The evidence also brought to light many examples of revaluations being done on desk top calculations where the property is not even visited and there are mistakes in the documentation. In instances where businesses are potentially being put into administration based on the results of revaluations, it seems remiss of the bank not to even complete a full revaluation. The evidence also demonstrated a number of occasions where the asset has subsequently been sold at a far higher price than the banks valuation – a price at which the business would have been well within their LTV.

In regards to RBS, there is an additional incentive for these types of revaluations and fire sales - West Register. There are multiple accounts of West Register buying properties later down the line when the business has gone into insolvency at cut prices. When you look at the inaccuracy of the valuations of many of these assets, there is a potential for easy profit to be made from the cheap purchase of properties that later can be resold nearer the original valuation.

West Register's portfolio risks being a significant conflict of interest within the bank and from the cases I have heard, there is a clear risk of a perception arising that the intention is to purposefully distress a business to put them in GRG and subsequently take their assets for the West Register. at a discounted price. The practice needs to be stopped and the conflict of interest removed.

b. Technical Breaches of Covenants

Every business which secures banking facilities will be required to sign a contract with the bank. These are sizeable documents, with numerous covenants, terms and conditions. It is important to note that these are also standard documents and it is extremely rare for businesses to be able to renegotiate the contract terms. Not every covenant indicates that the business is in distress or that the businesses loan will be terminated as a result of a breach. They are merely intended to be flags in the system to give the bank the ability to monitor the business' performance and discuss potential issues. If you were to ask a local relationship manager about these covenants, they would simply say that they are nothing to worry about and "it is just a way to get us all back around the table".

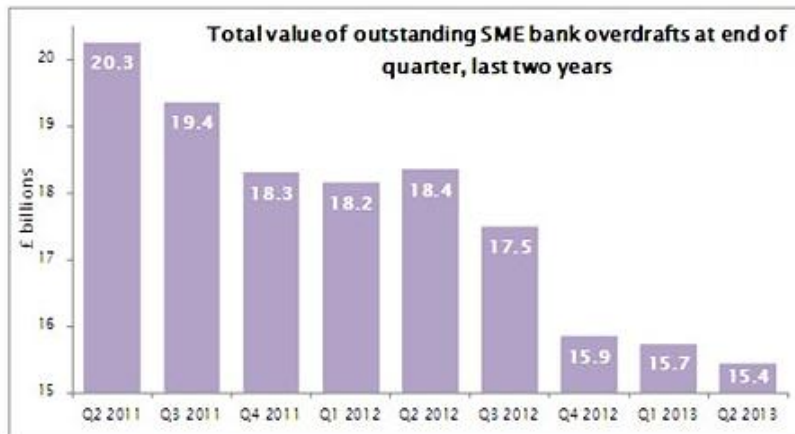
Evidence received as part of this reporting process suggests that in some instances, these covenants are being used to put the business into default and transfer them out of local management. In some cases, the breach could be as insignificant as being one day late in providing non-vital information on accounts. The business could be operating well, and there could be no change in profit or turnover, and the business up to date with all repayments, but the breach is used to trigger the move of the business out of local management.

The use of covenants in this manner goes beyond what is expected by the business as the reaction of the bank is so utterly disproportionate. Some breaches even occur with the permission of the bank, for example a temporary drop in EBITDA whilst the business integrates new machinery that will enable them to grow is notified to the local manager, who agrees with the business' plans – however, once the drop occurs, the business is still put into restructuring *despite* the prior notification and agreement of the bank.

c. Removal and Changes to Facilities

Overdrafts and unsecured loans are a concern for banks. In the case of overdrafts, for example, the banks are required to hold 100% capital backing and it is generally an unsecured loan. The value of outstanding bank overdrafts drawn by UK small businesses is clearly declining. Overdrafts have reduced by £3bn, 16%, over the past year alone and by £5bn since 2011. The following chart produced by Syscap from Bank of England data shows the significant decrease in overdraft figures¹:

¹ <http://www.syscap.com/news-and-views/2013/september/small-business-bank-overdrafts-plunge-by-16-in-a-year/#.Ulu9clCkorw>



*Source: Bank of England

Overdrafts are a very capital intensive form of lending for the banks, especially under the latest capital requirements. Similarly loans which were negotiated a few years ago may have less securities than the bank now require for their own risk assessments. Whilst it may be reasonable for the banks to want to change facilities, or renegotiate terms and personal guarantees, there are instances where the bank is not acting fairly when doing so and the resulting outcome has severe consequences for the business. Essentially the business is pushed into a corner given the speed and lack of ability to move to a different lender. The business is thus forced to accept terms they otherwise would not.

As a whistle blowing ex-banker previously told us, the internal process in the bank is to “...lend as little as you have to in order to remain ahead of your competitors in order to make sure you got as much out of the customer’s wallet as possible.” At the point of renegotiating a facility, the bank can think “where else will the business go?”. The impact of this is especially obvious when you take into account swaps, many of which out strip the length of the loan preventing the customer from moving to another lender due to the contingent liability to the bank. In this instance the bank has free rein on where to set the terms of the new loans, or whether to even renew at all.

The business’ performance and growth potential may not have changed, but the banks decision to change lending criteria has meant that the business is unable to meet the new terms and thus has to either make up the equity gap themselves, seek other finance, or downsize their business.

d. Transparency

It is vital to stress in regards to all that has proceeded so far, that this is not a transparent process. There is much confusion on the part of the businesses that are unaware of what is happening. Cases have even been submitted where the default that triggers the businesses descent into business support has not been adequately explained. Whilst looking at cases after the fact, there appears to be a clear movement towards the business’ final destination, the rationale and reason for their treatment is not clear to the business at the time it happens.

In one very clear example, the business frequently asks for the reason for their transferral into GRG, however, the reason changes throughout the conversation, flicking between LTV, inability to pay interest due to the swaps and no credible repayment options. The bank either appears to be confused as to why the business is going into GRG, or wants to mask the true reason why.

Transparency is vitally important, especially for the business once they are in or about to go into business support. If the bank is aiming to put the business into insolvency from the outset, this should be made clear to the business so they may try to find alternative sources of finance, pay down their debt if they have personal wealth or prevent them from taking decisions in the winding down of the business worsens their own position.

Furthermore, if there is an entire sector that the bank is no longer 'in' and wants to get rid of customers, why not tell them and give them the opportunity to move elsewhere? By not being totally straightforward with their customers the banks in these situations are damaging the reputation and financial stability of good businesses and business people.

5. Treatment of Businesses in Business Support/Turnaround Divisions

Once a breach or default has occurred the business is then often sent to the turnaround division of the bank. In RBS this is known as the Global Restructuring Group (GRG). The business' relationship with the bank is then moved entirely to this division of the bank and they are no longer able to maintain contact with their local relationship team. At RBS, we have heard evidence that relationship managers will be disciplined if they contact the client whilst in GRG. Some criticism of the other banks' turnaround divisions were received, however these appeared to be isolated cases in comparison to the more widespread practices within GRG in particular.

Businesses across the country have a real fear of entering these divisions of the bank given the experience of others in their network. There are very few examples received as part of this evidence gathering process where the business has gone into GRG, in particular, and gone back into local management.

We heard some shocking examples of business owners being confronted with last minute demands for information and money. In some instances this has even happened despite a tragic family bereavement. There are many examples of demands being made during or just before bank holidays, when it is extremely difficult for businesses to withdraw funds to pay the bank back.

It is also exceedingly difficult for the business to find an alternative source of finance as once they are in BSU or GRG, they are classed as being distressed. For many other finance providers are not able to absorb the risk that has now been associated with the business so are unable to offer an alternative source of finance.

Many of the businesses who submitted their experiences of these divisions did not need to turnaround prior to entering BSU or GRG but the impact of the process is such that once in these divisions they become increasingly distressed by the levels of fees, bureaucracy, and restrictions on trading capabilities. On the rare occasion that the business has been able to find alternative finance

and leave the turnaround division of the banks, they have subsequently demonstrated the viability of their business, posting increased profits. That said, their growth and ability to operate during their time in the BSU or GRG has had a negative impact on their capabilities as a business in the meantime.

a. Increase in Margins and Excessive Fees

The business is often fined on entry into GRG or BSU for breaching their covenants. More often than not, their interest on the loans will also be increased. Whilst the bank may argue that this increase in interest reflects the greater risk the bank faces as a result of the business' instable position, this is unhelpful for the business, making it increasingly hard for them to trade out of their difficult situation. It is also difficult to justify when empirically the business' commercial performance is unchanged and they have not missed any payments to the bank. The term of the loan may also be shortened dramatically so the business is having to regularly pay set up fees.

One business who submitted evidence demonstrated that in fees alone, their time in GRG had cost them £256,000. This is not to mention the detrimental impact it had on their operability or the costs of refinancing with another finance provider. Another informed that RBS made them pay an immediate sum of £40,000 to carry on with our current lending.

There is also often a requirement for an Independent Business Review (IBR) to be undertaken by an external accountancy firm. Again this comes at great cost to the business, who often do not even get to see the report though the money is taken directly from their accounts. Examples of fee levels included a range from £25,000 through to hundreds of thousands of pounds.

Given the relationship between the banks and these accountancy firms, there is a real potential for a conflict of interest. The business does not get a choice of who their IBR is as often they are appointed by or on the request of the bank. When you consider that the business is not afforded the opportunity to read the report, it is easy to see how these reports may be used to protect the banks interests at the expense of the business. Much of the high value work received by these firms comes from the banks so it is naturally in their interest to protect the bank's financial position.

At best, there is little accountability for the IBR and resulting actions, denying the business of the ability to respond to parts of the report or challenge its accuracy. There is also a clear potential conflict of interest, especially when you consider the number of cases reported in which the same company which acts as an IBR also later becomes the business' administrator.

b. Requests for Information

Evidence was also received of banks and IBRs frequently requesting information from the business. This process is often repetitive distracting the business from being able to concentrate on their day to day tasks, with the risk that their facilities may be pulled if they do not provide the information requested. The whole system is so laborious that the Directors of the business are not able to run the business effectively, putting increasing pressure on the businesses operations and making it even harder for them to 'turnaround'.

c. Shadow Directors

The decisions made by the bank and IBR whilst the business is in GRG can have detrimental impacts on the business' ability to operate effectively as a business. As these divisions of the bank are supposed to be turnaround divisions, their focus should be on helping the business to improve their performance and not become a zombie business. Concerns should arise when a part of the bank which is supposed to be helping the business to improve performance is in fact actively making business operations impossible.

It is vital the business is given the opportunity to trade out of their difficulties, where this does not detriment their ability to uphold their agreements with the bank. If the bank is not going to lose money - i.e. the business is able to keep up with their repayments, and there is no other justifiable reason to prevent the business from taking action to turnaround - it is hard not to suspect that the bank does not have the businesses best interest at heart when they refuse such actions.

Evidence provided by businesses suggests that the bank has actively prevented some businesses from taking action which would prevent the business from going into default or would pay off the debt.

A regular complaint received is the direction for businesses to delay or stop paying their suppliers. This has a knock on effect of damaging the business' credit rating and relationship with supplier-who may also be distressed by the delay in payment. If the business is unable to pay their suppliers, then they are unable to maintain normal business operation, their productivity drops and they have less products and services to sell. The outcome is likely to be that the business will end up in a distressed position. It also has a knock on effect on the viability of the whole supply chain that will have outstanding invoices, potentially losing clients and putting them at risk of breaching their own financial commitments. Considering that RBS and Lloyds have 60-65% of the market share in business lending, it is likely that they will be financing at least part of the very supply chain that they are distressing.

It is important to keep front of mind that GRG is meant to be a turnaround division, a part of the bank in which a business who is struggling, or has become a 'zombie business' is helped to reinvigorate the business. If, as the evidence suggests, GRG is actually designed to be a profit making centre for the bank, then it is not a turnaround division and the message to the customer is misleading.

It is also worth noting that evidence has been received that suggests businesses are being directed by the banks and IBRs not to pay HMRC when in GRG. When taken in the context of the Enterprise Act 2002 and the removal of Crown preference in insolvency, the impact of this on HMRC is significant. HMRC sits behind the bank in insolvency and is unlikely to collect this money owed to them from the insolvency pot, if that is where the business ends up.

d. Personal Guarantees

To provide themselves with more security over the loans, banks ask for personal guarantees (PG) and cash injections into the business. Whilst it is fair to ask for security over loans and to ask the

business owner to demonstrate their own confidence in the business, it is not fair to do so if the bank has no intention of supporting or helping the business. Many businesses that go into GRG/BSU are encouraged to invest more of their personal wealth into the business and increase their PGs, in return for which the bank will continue to support the business. Unfortunately, we have heard of many circumstances in which the bank has made these representations to the business but in quick succession the business has been put into administration and the business owner left bankrupt as a result.

There is a natural risk/reward balance in any business and it is fair to accept that the business owner should share part of the risk with the bank as well as taking the rewards. However, if the bank knows it is not going to support the business and will take actions as described above which distress the business, then their statements on which the business is relying could be considered a misrepresentation. This is simply another way of extracting more value from the business at their expense.

One business provided an account of their experience which shows how his personal injection of cash into the business was extracted with knowledge that the business was to go into administration in just 6 weeks' time.

6. The Insolvency Process

a. Conflicts of Interest

Insolvency is always going to be a difficult time for any business, risk and potential losses are an inherent part of business. When businesses that would have been solvent and viable but have ended up in insolvency due to the decisions of the bank, their treatment within insolvency becomes a key concern. Good practice in insolvency is extremely important for all the creditors, including the bank, HMRC and the business owners. At present, evidence presented to this report process suggested that this is not always the case. Not only did some of the businesses we heard from not deserve to be pushed into administration, but once in the insolvency process, the behaviour of the administrators, receivers and/or insolvency practitioners (IPs) was unfair and opaque.

The relationship between the different parties involved in business finance has been touched upon in the preceding sections. The potential for conflicts of interest in insolvency is also rife. Evidence received from businesses shows that there are many occasions in which the IBR who works with the business whilst in business support is also the business' administrator. Despite reassurances from the party involved that there are Chinese walls to prevent conflicts from occurring, this does not appear to necessarily be true.

The relationship between the bank, IPs, valuers and receivers should undergo careful analysis. The interdependency of these businesses on banks for generating custom establishes a natural loyalty and bend towards the interests of the banks. Often the bank recommends or instructs the IP directly, so their preferential treatment is critical to their clientele. Maintaining independence and a fair hand for all parties involved appears extremely difficult. As witnessed most clearly in the case of

asset based finance, often nothing is left for any creditors other than the banks as fees typically match the level of funds left in the pot.

The impact of insolvency on the business owner's right to legal redress is highly significant. Once an administrator has been appointed, the directors lose their right to legal redress. If any of the parties involved in the insolvency is acting in an unjust manner, it is thus for the administrator to take actions. Given the conflict of interest and inclination in favour of the other parties involved in the insolvency, it is unlikely that the administrator, unless acting truly independently, would take such action – especially when you consider that given the business in question is now insolvent, there is no real future for future dealings, however they are likely to work with the other parties involved in insolvency proceedings. It would not be in the best interest of the administrator to take action against their colleagues in this field.

b. Sale of Assets

As above mentioned, there is a real potential for conflict of interests in the sale of assets out of the insolvency pot. RBS has a particularly precarious position given its West Register commercial portfolio under which it can make huge profits from the cheap purchase of assets from 'distressed' businesses.

A number of businesses felt that the West Register has been interested in taking their property. Others have stated that they believe their property was purposefully undervalued in order for the business to be distressed, enabling West Register to buy assets at a discount price.

A number of businesses complained about West Register's interest in their property and felt they had been forced into a corner where they had to accept conditions they otherwise would not.

7. Lack of Redress

For many businesses that go through the process outlined above there is no recourse available to them. Every potential avenue of help is shut and they are often left bankrupt, or near enough, and feel betrayed by the financial organisation they have been customers of for many years.

Whilst this paper has not formally discussed the misselling of interest rate hedge products (IRHPs), it is important to note the impact that they have had on many who have been through the process outlined above. Often the costs involved with the IRHP has been the trigger for their difficulties and many have lost their businesses, properties and family inheritance as a result of the bank's action. For those within the FCA review process who have been considered 'unsophisticated borrowers', no compensation can bring back what they have lost, the banks are dragging their heels on

consequential damages but even if awarded, the business will never get back what they have lost. Once the family farm has been sold, it cannot be recovered and the business owner feels like a failure despite the fact that this is solely due to a product that had been inappropriately sold to them, as they have lost their children's inheritance.

Furthermore, those businesses who are deemed sophisticated by the regulator's review process are equally at a loss of means for redress. They too may have been received similarly bad sales practice but due to some arbitrary test they are considered sophisticated enough to have been aware of what they have been sold. The costs involved for them in the legal process will be exceedingly high and for many prohibitive. Given the timescales of the swaps misselling, many are also nearing their limitations and therefore they are having to rush to submit their case. This puts them at a natural disadvantage given the lack of time afforded to them for gathering a coherent and comprehensive case. For many time will lapse their money will dry up and they will not receive the compensation they deserve due to the bad behaviour of the banks.

Given the FCA have assumed responsibility for this misselling scandal this report has not looked at the intricacies of what happens to swaps victims in depth but it is vital that the inadequacies of this system of redress is borne in mind, especially when you consider the disadvantage they are already at within the legal system.

a. Banks Internal Complaints Procedures

The banks do have internal procedures for settling disputes. Some of the evidence received for this report does suggest these are not working effectively and the decisions made are not impartial within the bank. Businesses are passed from pillar to post, often with the specifics of their complaint not adequately responded to. They do not receive answers to the questions posed, with the bank specifically avoiding answering direct questions. There is no 'stoppage time' within the banks once a complaint has been made so the activity which the bank is complaining about continues throughout.

Evidence was even submitted of instances where the individual banker that the business has complained about has in fact run the internal complaints procedure against themselves.

Rarely do these processes lead to an adequate resolution for the business and it is apparent that they need an external, impartial body to take a fair decision. However, the delays of going through this process mean that the business is in an even weaker position once they seek external support. These internal processes are not fit for purpose of resolving disputes and complaints from businesses in regards to the bank's behaviour.

b. Taking Action Against the Banks

Most of the businesses that provided evidence as part of this report were frustrated by the lack of redress open to them. For many the door to recourse had been shut on a number of occasions.

The Financial Ombudsman Service, for example, has a ceiling on the size of a claim they are able to take a decision on as they are only able to direct a financial institution to compensate up to a maximum of £150,000. The Ombudsman is also only able to look at complaints from very small business with a turnover of up to two million euros and fewer than ten employees. It also excludes all those who have complaints against unregulated parts of financial services, such as Asset based finance. This closes the door for many who are seeking redress as their claim is either too big, does not fall into regulated activity or can be spun as a 'commercial decision by the bank'.

For those who fall outside the jurisdiction of the Ombudsman, the only real option for them is legal action. There are a number of issues with the unfairness of businesses' position within the legal system which are discussed in the following sections, however, prior to any of these issues is the question of whether or not the business is even eligible to take legal action. Once a business has been put into administration, the business owner is no longer a director of the business and therefore unable to pursue legal remedies – only the administrator can do this.

As discussed above, there is much concern that the administrators often have conflicts of interest and are in fact appointed by the bank, or at least on the advice of the bank, meaning there is little incentive for them to initiate legal proceedings. The business owner can then not take any action against what has happened to them unless the bank brings a case against them, for example calling in a personal guarantee, in which case the business can instigate a counter claim. At this point, it is worth bearing in mind that the business owner may be under serious financial strain as a result of the banks actions, possibly having invested personal money into the business prior to its collapse, meaning the cost of taking legal action is unaffordable for them.

c. Access to Legal Advice

Any law firm that does business with the banks will have a clause in their contract, preventing them from taking action against the banks. This means that for businesses the pool of solicitors available to give them advice and take their case is extremely limited. When you consider the size of the banks and the amount of work they undertake with a range of legal professionals, it is clear to see the problems businesses have in finding legal advice. Many of the top law firms will be conflicted so even if the business has the resource to pay them, they are not able to access the same class of legal advice that the banks can. For many businesses, finding a suitable solicitor is thus exceedingly difficult. Often their own solicitor, who has helped them and their business for many years, is even unable to help in this situation.

Not only is it difficult for businesses to find a suitable solicitor, but the costs involved in taking the case are so extortionate that the business is unable to follow their action through to court.

More cases could be settled earlier if the process was transparent and businesses were not taken through this unduly drawn out legal process as a result of the banks PR effort. It is right that cases in dispute should go through the courts, but they should do so on as equal a footing as possible. If the

bank is restricting the cases that go through the court, this is limiting the public knowledge of the banks behaviour, removing accountability and impeding businesses ability to take action against the bank.

8. Solutions

The purpose of this report has been to identify the issues in banking practice and how this damages good and viable UK businesses. It is however important to highlight the three key areas where Government reform could help prevent the behaviour above.

What follows provides a précis of the gaps in current legislation and problems in the banking market place that require rectification. Further work and consideration will be required to develop each area further.

a. Business Protection

Protecting businesses, especially SMEs, when issues and disputes with the banks arise is important to give proper redress and disincentivise poor treatment of business. As outlined above, there is nowhere for businesses to turn and many wish only to have a fair hearing. Their frustration is palpable and this reflects badly on the Government as many question why there is not more intervention when vulnerable smaller businesses are being treated so appallingly.

Given the importance of finance for businesses commercial operability, it seems astonishing that for many there is no independent avenue for them to question the way they have been treated by their finance provider. This is not a case of questioning the commercial decision of the bank, but the fairness of their behaviour. The lack of any recourse means that for many, they have no option but watch their business go unnecessarily into insolvency. There is a desperate need for this to be reversed and for some protection to be afforded to businesses. When you consider the David and Goliath like battle businesses face when trying to take action against the bank, it seems only fair that they are provided some assistance.

b. Removing Conflicts of Interest

It is also important that the wider potential conflicts of interest between the banks, IBRs, valuers, administrators, insolvency practitioners and receivers are given careful consideration. Where these conflicts occur, it does so at the expense of the business. If collusion did not happen between these parties and their relationships were more transparent, then better fairness between the parties could be ensured.

This requires further investigation and consideration by the Government to ensure that the law is being upheld and these conflicts do not impact on the businesses ability to operate.

c. Competition

Without competition in the banking sector, these scandals will continue to come to light and ever more business will be hurt in the process. There are too few disincentives for the banks not to treat their customers poorly. There is nowhere else for the business to turn as the two biggest banks, RBS and Lloyds, control the majority of SME lending, so they are able to squeeze profit out of the client, even if it detracts the business, in the knowledge that they will be unable to leave the bank and therefore obliged to accept these draconian conditions. Their book is also so large that in these instances when significant profit can be made from businesses in this manner, they know they have a steady stream of other customers to lend to.

Rather than treating the business fairly and looking at the long term growth of the bank, they are able to concentrate on short-term gain, safe in the knowledge that if the bank were to collapse once more, the Government would not be able to allow it to do so. It is a one-way bet as the bank can play a risky game, whilst knowing that any consequences of their actions will need to be supported by the Government.

In the smaller banks, where there is not such a safety net, their key concern is to secure and retain good customers, as these will be the main stay of the banks books. If they treat them badly, they know that there are other banks who could step in and take their customers. They therefore need to remain competitive and ensure they understand, and work in the interest of, their client base. The customer has to come first. It is interesting to note the distinction in the evidence received about the smaller banks compared the Government-backed banks. Santander UK and Handelsbanken, for example, were some of the only banks where evidence was received expounding the virtues of the banks work and how they had saved them from the mistreatment of the bigger banks. The negative experiences of businesses from other banks other than RBS and Lloyds also appeared to be more isolated, rather than institutional.

With RBS and Lloyds at the size they are at, these smaller and challenger banks will never be able to adequately compete to take their customers and drive true market forces. The size and domination of these two banks therefore means they are able to manipulate the market dynamics and could actively prevent the growth of other banks. Once the loan terms have been agreed, it also means the businesses have signed up to the bank, they are able to extract value from them in other ways.

It is vital that RBS and Lloyds are made significantly smaller, removing conflicts of interest within the bank, and creating a number of smaller, purely retail/commercial banks. They will then have to compete for businesses' custom in the same way as other banks and the incentive to maintain relationships with businesses and encourage them to growth will be reinstated. The lack of competition in the market place is largely what enables the banks to behave in the way they do. There is no real accountability for their actions and the incentives within the banks are completely misaligned with long term growth.

It is vital for the long term health of the UK economy that competition is injected directly into the heart of banking, with a clean slate to start again. Not only will this improve treatment of businesses, it will also have a positive impact on the perception of businesses towards the bank encouraging them to grow and invest in their businesses once more.

The Government has a unique opportunity to take action to instigate this change. Whilst the ideal scenario would be the creation of six banks out of RBS and Lloyds, by boosting the size of Project Rainbow and Project Verde to create fully functioning challenger retail and commercial banks, the Government would be taking significant steps towards a fairer more competitive banking landscape. Selling the investment and private equity parts of the bank will free them of any potential conflicts and the need to meet shareholders' desire for large revenue increases. Instead they would be able to focus on growing the bank by lending to businesses and creating a steady yield through investment in business. The sale proceeds can then be used to recapitalise the rest of the bank.

More competition in the banking market place is absolutely vital for the future of UK GDP. Most businesses rely on finance as much as another other utility. Therefore having these large institutions who act as racy stocks, aiming for 15% revenue increases, simply flies in the face of what businesses really need. They require a financial institution who is looking to achieve a steady yield in which growth of the client is the main driver of bank growth. The Government has a golden opportunity to create this, and ultimately something which will secure the economic growth of the country for many decades to come.

9. Conclusion

The findings of this report and the evidence that underpins it paints a worrying picture of the banking landscape and the interplay between businesses and banks. There is no longer a level playing field on which banking agreements can take place with each party making informed decisions on risk and reward. The balance of power has tipped too far in favour of the banks. Given their past reckless behaviour and the size and domination of the two biggest banks, this leaves businesses in an extremely vulnerable position. Without better protection in both the short and the long term, businesses will continue to fail at the hands of the institution that should be supporting them.

Even if the process outlined above is an incorrect interpretation, and this is simply a misconstrued perception of the banking landscape, it is a perception shared by many businesses. The lack of recourse and experience of their fellow business people creates a climate of distrust and fear amongst the business community. It certainly does not engender a desire to grow and invest in business. This stifles job creation and the growth of the real economy.

Contrary to the above assertion, the findings of the report do clearly show heavy handed, profiteering and abhorrent behaviour of some of the banks towards businesses. At the very least, the report demonstrates the ability for these types of behaviour to occur and the lack of redress open to businesses. The evidence received does however indicate a far darker situation than just the existence of conditions which could lead to the mistreatment of businesses – it is undeniable that some of the banks, RBS in particular, are harming their customers through their decisions and

causing their financial downfall. The cases and experiences businesses have shared follow such a consistent pattern, with detrimental consequences for otherwise good and viable businesses, that it should no longer be ignored.

The country requires a plan to rebalance the relationship between business and bank, providing more protection for businesses and giving them the real option of moving banks, securing the finance their business truly deserves and requires. Let's all do something today that makes a difference – let's make it so.