Break Charge on Replacement Products – Fact, or Fiction?

In cases where the Bank during the redress process replaces the mis-sold Interest Rate Hedging Product with a ‘Replacement Product’ and then charges the SME either a premium for a ‘Cap’ or comes up with a break cost for a ‘Swap’ or ‘Collar’, the figure that the bank comes up with, which has a material and massive impact on the amount of cash the recipient gets back has proven to be a fiction in most cases.

The problem is that the Interest Rate Hedging Products are indexed to Base Rate, and not LIBOR. Whilst the most common pricing mechanism for valuations of these sorts is Bloomberg, for Base Rates as an index there is no volatility data in Bloomberg, and only about 12 months view of the forward curve. Both are essential. There is therefore no way of looking at how forward looking Base Rates trade as a spread to LIBOR swaps.

The assumptions that one would have to make in order to come up with a ball park figure are pretty big, leaving the resultant calculation open to very large plus or minus error margins.

Sound complicated? It makes it impossible, so how does the bank provide figures as accurate as £184,567.89?

The answer is that they are a fiction. The result could just as easily be £100,000 or £280,000. We can bet that it’s not likely to be the higher figure though. SME claimants are being sold short in offers therefore, where a replacement product is part of the deal, to the tune of tens of thousands of pounds.

The impact? Rearrange the words ‘over, eyes, the, wool, pull, yours’ in order to come up with the thing that the banks can do, and are good at.