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Problems derived from derivatives

"I like not fair terms and a villain's mind", says Bassanio about Shylock in *The Merchant of Venice*. Shylock was of course a banker of his time, a profession as unpopular then as now. One, less well-publicised, source of shame emerging now for bankers is the mis-selling of derivatives to businesses, including retailers.

It is alleged that banks have sold complex derivatives that were inappropriate and poorly understood by the customer. For example, a bank may have sold a swap that supposedly hedges a business's floating rate debt.

Say you have a 25-year loan or mortgage at a floating interest rate. A sharp-suited banker comes along and points out that if interest rates rise, you might not be able to afford the interest payments. But he can sell you a product that 'fixes' that rate. If interest rates rise, the derivative will pay you the difference. If interest rates fall, however, you pay less on your mortgage but have to make payments to the derivative.

That sounds great, doesn't it? Well, perhaps, but what if you redeem the loan early? Perhaps the business is booming and you don't need that debt any more, or it is struggling and you want to shut up shop.

Your mortgage is no more, but the swap lives on. The bank will of course cancel the swap in return for you paying the remaining 15 years of difference between current interest rates and the fixed swap rate. In today's low interest environment, that could be very expensive indeed.

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Another trick was to sell a 'multi-callable' swap. This was often marketed as being cheaper than a 'vanilla' swap – for a very good reason. At certain times, the bank could just cancel the swap at no cost if it didn't like the way interest rates were going.

It was like an insurance policy that the underwriter could cancel just before he spotted that your house was about to catch fire. Needless to say multi-callable swaps are more profitable for banks than vanilla ones.

It is alleged that banks liked to sell ever more complex derivatives, as these have higher margins, are difficult to price-compare and less easy for a small business to understand. Anyway, as soon as the bank issued the derivative, it would sell the risk on, and so book all the profit – and bonus – straight away.

This is how, it is claimed, little old ladies running corner shops have ended up with long-term, complex, and sometimes ruinous, derivatives.

Finally the Financial Services Authority has woken up to the issue. It has agreed a compensation scheme for small business customers of the big four banks. These banks are writing to customers to see if there has been mis-selling. An additional investigation has also been started into others, including National Australia Group (Clydesdale and Yorkshire Banks) and Santander.

Shylock was eventually forced to give all his (legitimately-earned) money away. Don't expect a modern day repeat of that here.