# MAKING A FUSS ABOUT THE FOS

IFAs don't like the way it operates and consumers don't like the decisions it makes. Where has the Financial Ombudsman Service gone wrong, asks **Jeff Salway**?

MOST OMBUDSMAN CASES are decided in favour of firms, but among IFAs the service has still managed to achieve a level of unpopularity that Urs Meier could sympathise with. Meier was the Swiss referee that managed to incur the wrath of English football followers at the recent European Championships, but at least he only managed to upset one side.

In the case of the FOS however, most parties with which it deals, from consumers and consumer groups to life offices and IFAs, have some kind of axe to grind.

Some life offices have reached the point where they would rather make compensation payments – up to a certain amount – than allow the complaint to go to the FOS, even where the validity of the claim is questionable, simply because it is cheaper in the long run.

Meanwhile consumer groups are concerned that too few people are complaining and that, of those that do, only a minority are winning compensation.

For IFAs the crux of the matter is the modus operandi and the accountability of the ombudsman rather than the results of its deliberations.

Despite industry assertions of bias towards the consumer, over 60% of all complaints are settled in favour of the firm. Of all mortgage endowment complaints tackled by the FOS, less than 10% are against advisers and of those, four out of every five are rejected.

But despite the statistics, there can be little doubt that the ombudsman is losing the confidence of IFAs anxious about anything that can put more pressure on professional indemnity insurance levels. The FOS has worked tirelessly in its efforts to convince all parties that it is entirely impartial and operates in a truly independent fashion, but the challenge that it faces continues to stiffen.

If one specific aspect troubles IFAs more than any other it is that, unlike consumers, they do not have any right of appeal. Instead firms must accept the decision and if so inclined, take the matter to judicial enquiry, a step that most small and medium-sized IFAs can ill-afford to take.

Industry anxiety over the issue seems set to thrive, as the Treasury is unlikely to introduce an appeals mechanism when it completes its review of the service.

The frustration is exacerbated by the £360 case fee that IFAs have to pay regardless of whether the case is upheld or rejected, although the FOS recently announced that companies would not have to pay a fee for the first two cases in any year. The situation has led to one IFA labelling the lack of comeback against spurious claims a "disgrace."

> Over £10bn is paid in compensation claims, the equivalent of £500 per household, with the average payout figure rising about 15% each year

The other main concern is the setting of precedents without regard to the wider implications of cases. The complaint that IFAs have is that the FOS is not consulting internally or with the FSA on what it is doing and so creating inconsistency on cases that are similar.

## Compensation culture

Somewhat inevitably, debate concerning the FOS has a habit of re-igniting the compensation culture argument. The extent to which the UK may or may not have a budding compensation culture was the subject of a survey conducted earlier this year by Norwich Union, which revealed that 96% of respondents believe that people are more likely to seek compensation now than 10 years ago.

With 87% suggesting Britain was developing a compensation culture, the study reinforced the impression that people are now more willing to 'blame and gain' and that the UK's compensation bill is heading skywards.

A more recent study carried out by Aon Risk Management found that 70% of UK businesses think the "have-a-go" culture is placing a massive burden on industry. Of the companies surveyed, over 60% said they had experienced an increase in the cost of claims that they had dealt with in the last five years and 50% had seen the number of claims rise.

The study concluded that not only does a compensation culture exist, but that it poses a serious threat to the profitability of UK industry and to jobs.

Every year, according to the Institute of Actuaries, over £10bn is paid in compensation claims, the equivalent of £500 per household, with the average payout figure rising about 15% each year.

The financial services industry provides a graphic example of the growing demand for compensation. The 57% increase in the number of complaints received by the FOS in the 2003/2004 year was mirrored by the experience of the Financial Services Compensation Scheme. The FSCS saw claims rise from 841 in the 2002/2003 financial year to 3,342 in the last year, with a further 14,000 claims forecast for the current year.

If compensation culture is indeed on the rise, what has caused it? The reasons given for its advance are varied. On a socio economic level, some argue that the UK has changed from a collective and introverted society to a more individualistic one. Others focus on improved access to information, making people more aware of their rights and the means through which to seek compensation, while the influence of the US has also been cited as a factor.

Media coverage of high profile payouts and the 'no-win, no-fee' phenomenon are added supply side influences, but all the above have combined to create an environment in which people are evidently more comfortable with claiming than ever before.

Debate over the issue has been vigorous. Last year Sir Howard Davies, in his valedictory speech as chairman of the

FSA, said the task of compensating genuine victims of mis-selling was "not being assisted by those who appear to believe that every loss to investors, whatever the cause, should be compensated".

His comments were described as reckless and irresponsible by the Consumers' Association, which was widely believed to be the target of Davies's attack.

But a spokesperson for the FSA has recently been on record supporting the idea of a culture of compensation. He conceded that the uphold rate suggested that there were more spurious than valid complaints going in, reflecting an increase in the culture of complaining on the off chance.

With just 30% of endowment mis-selling claims upheld in the last five years by the FOS and its predecessor, the Personal Investment Ombudsman Scheme, IFAs believe more should be done to discourage inappropriate claims.

In response, Alison Hoyland, a spokeswoman for the FOS, said: "Most complaints are made because consumers believe they have valid grounds for complaint. Complaints that are trying it on are very few and far between. The first port of call is the customer contact division, which took half a million complaints last year, of which only a fifth went any further. At that point it is not a case and the firm is not charged".

According to AIFA, the situation would improve if the FOS published more clear guidelines outlining what does and does not represent a fraudulent or vexatious complaint.

Paul Smee, director general of AIFA, added that if a complaint were proved fraudulent according to those guidelines, he could see no reason why the case fee should not be waived.

However Garon Anthony, of law firm Pinsents, pointed out that the difficulty was in judging when a misguided claim becomes a fraudulent one.

"Where do you draw the line between a frivolous claim and a dishonest one? There are people out there who bring spurious claims. But provided the IFA explains the risk and correctly assesses the client's attitude to risk and so on, there probably is not a valid claim. But that is different to being fraudulent".

Either way, frustration at the lack of substance in some complaints is becoming more apparent among IFAs, many of whom blame a burgeoning compensation culture in the UK and what they perceive as the regulator's active facilitation of it.

## Accountability

In recent months, the industry challenge to the ombudsman has begun to centre more on its accountability.

Strictly speaking, the FOS is not even accountable to the FSA. However the FSA, under the powers invested by the FSMA, dictates the terms for the FOS, so in that sense the latter is not above or beyond the regulator.

Even the Tories have addressed this particular point. A policy memo issued by the shadow treasury alleged that the FOS had become a "major problem" by making decisions contradicting FSA regulations. The memo accused the FOS of having "taken on a supreme court law-regulating mode by establishing precedents".

It is this perceived blurring of the boundaries that has helped give oxygen to the belief that the FOS, accused of being court, judge, jury and executioner, is unaccountable and too powerful.

A treasury select committee questioned chief ombudsman Walter Merricks in June over the issue of appeals and made reference to the accountability of the service. The exchange featured Norman Lamb MP asking Merricks if the FOS had a concern about natural justice where new evidence comes to light.

Frustration at the lack of substance in some complaints is becoming more apparent among IFAs

When Merricks contended that the FOS was not a court, the MP replied that the FOS still made "quasi judicial decisions that can affect people's livelihoods".

However Merricks himself has likened the FOS disciplinary process to that of criminal and civil courts. In late 2003 he said, "Both can demand redress, but they operate entirely independently, judging the same behaviour from different standpoints. But the FOS looks at what is reasonable and fair, rather than being bound by legalities".

Comparing the FOS to a court of law has become a popular pastime for IFAs and financial services lawyers.

Robert Morfee, head of financial services litigation for Bristol-based solicitors Clarke Willmott, accuses the FOS of dressing itself up as a consumer champion but behaving as a court.

"The firm is required to defend itself against a body that can impose a sanction on it. At the same time it tries to mediate to promote settlements as a mediator. These are inconsistent positions as it cannot be a court and a mediator at the same time.

"All in all, the FOS's approach promotes real disquiet, in my experience, both with consumers and financial services firms."

Clarke Willmott, currently in discussions with several parties that share an interest in the way that the FOS works, have expressed the opinion that the service has wandered off the path of "genuine law" in two areas especially.

The first relates to risk. According to Clarke Willmott, the ombudsman's insistence that many complaints will turn on the consumer's attitude to risk when the policy was sold is based on the wisdom of hindsight.

Secondly, the ombudsman's recommended endowment compensation assessment process omits two significant factors. Not only is the underlying value of the house not taken into account, but also the savings on interest are omitted. This implies that the compensation process ignores one aspect of the investment (the house) and focuses only on the losses supposedly suffered in the endowment policy.

There are other areas of concern, believes Morfee, including the business of taking evidence in secret in that what one party says is not open to the other party. He also suggested that the FOS disregards in some cases the provisions of the Limitation Act – which sets out the maximum times which for which a claim for damages will be heard – because it removes the right to a limitation defence. Finally, according to Morfee, the notion that disputes as to fact can be resolved in the basis of written statement is mistaken and provides real grounds for anxiety.

## Europe

For those seeking to challenge the FOS from a legal perspective the European regulatory route may offer the most potential.

There is doubt over whether the lack of an appeals process is compatible with Article 6 of the European Convention on Human Rights.

The legislation stipulates that everyone is entitled to a fair and public trial by an independent tribunal established by law. Judicial decisions made since then have established that this relates to corporate bodies as well as individuals.

However there is no provision for a hearing after the final binding decision by the ombudsman, signifying that the FOS may be in breach of the ECHR.

According to one lawyer, there has been no challenge based on this but there is the opportunity to do that and it is suggested the FOS is not compatible with the

European Convention on Human Rights.

Brussels has already agreed to hear the complaints of an IFA unhappy about the power wielded by the FSA. The Worcester-based adviser submitted a petition to the European Parliament outlining his concern that in some cases the regulator operates in contravention of the rules of natural justice and also the European Court of Human Rights and the Human Rights Act. He described the FSA as being a self-appointed judge, jury and executioner of small firms.

The European Parliament has accepted the petition and is examining the issues that it raises, including the legal basis for regulators, the appeals process against decisions and how they are held to account.

There is also a question mark over whether the £360 case fee charged to IFAs by the FOS – regardless of whether the case is upheld – is strictly fair practice. The case fee itself is not a breach of ECHR but the fact that it is without recourse may be, one lawyer has advised. There is unrest among IFAs over the fact that where the FOS cannot readily dismiss a complaint, it charges a case fee, even if the complaint is later rejected.

"Under the Human Rights Act no one should be penalised in the absence of evidence that they have done wrong. The FOS case fee flies in the face of this," argues IFA Brian Lentz.

Some IFAs have suggested that in cases that are rejected or proved to be spurious it would be fair to charge the fee back to the complainant. Indeed the FOS has reported a marked rise in cases where complainants have been informed by IFAs that if the ombudsman rejects their complaint, they will be liable for the adviser's costs.

But in a recent national newspaper article accusing IFAs of using underhand tactics to discourage people from pursuing complaints, the FOS said that "under no circumstances" would consumers have to pay costs, even for rejected complaints.

However this is contradicted in the small businesses section of the FSA website, which suggests that in the event of frivolous or vexatious complaints it would be "legitimate for firms, through their terms of business, to seek to reclaim costs and expenses reasonably incurred by the firm as a result of defending these complaints through the FOS".

In response to *Money Management*'s query, Alison Hoyland insisted that the FOS had never said that in "no circumstances" would customers have to pay costs. But she stressed that only in very limited circumstances would a firm be justified in seeking costs from a customer.

## The Financial Ombudsman Service – background

WITH THE INTRODUCTION OF THE Financial Services and Markets Act 2000 in November 2001, the Financial Ombudsman Service (FOS) replaced the previous ombudsman and legally became the statutory ombudsman scheme covering most areas of personal finance.

Prior to the formation of the FOS there were eight separate ombudsman schemes in the financial services industry: The Banking Ombudsman, Building Societies Ombudsman, Personal Insurance Ombudsman, Investment Ombudsman, Insurance Ombudsman, Personal investment Ombudsman, Securities and Futures Complaints Bureau and Arbitration Service and the Financial Services Authority Direct Regulation Unit and Independent Investigator.

When mortgage and insurance intermediaries come under FSA authorisation in the next six months, the jurisdiction of the FOS, which is already the largest ombudsman scheme in the world, will widen from 10,000 firms to over 30,000, making it the only port of call for all personal finance complaints.

### HOW IT WORKS

Consumers can go to the FOS when they are not satisfied with the response of the firm and have waited at least eight weeks. A complaint to the FOS must be made within six months of the firm's final response letter, which must refer to this fact.

When cases are submitted the FOS first attempts to solve them by mediation, a method that resolved 40% of cases last year. If mediation is unsatisfactory the case moves to adjudication, at which point 49% of cases in 2003 were resolved, 69% of those in favour of the firm.

Both parties have the right to reject the decision of the FOS adjudicator assigned to the case and take the matter to the Ombudsman, whose decision is final.

Firms are obliged under FSA rules to co-operate fully with the FOS and failure to do so can open the way for disciplinary and enforcement measures.

Where the firm is judged as liable, the FOS, which has the power to make decisions up to a total award of £100,000, seeks to award compensation sufficient to put the complainant in the position in which they would have been had the actions complained about not occurred.

If the firm being complained about has ceased to operate, the complaint may be taken to the Financial Services Compensation Scheme, as long as the firm was authorised by the FSA. However the FSCS cannot handle complaints relating to advice given prior to 28 August 1988.

### CONTACTS:

- Financial Ombudsman Service: 0845 080 1800 *www.financial-ombudsman.org.uk*
- The Financial Services Authority: 0845 606 1234 *www.fsa.gov.uk*
- Financial Services Compensation Scheme: 020 7892 7300 *www.fscs.org.uk*

It is worth bearing in mind that the whole idea of the ombudsman service is that it must be free to consumers, meaning that charging case costs to consumers, even for vexatious claims, would be inappropriate. Even so, it is apparent that the funding of the service needs to be looked at in order to avoid such situations arising.

## Dissenting voices

It would be erroneous to imply that the FOS has inadvertently succeeded in uniting IFAs through its actions. However, recent months have witnessed the creation of a number of groups attempting to provide IFAs with a platform from which their grievances can be heard.

One of the most high profile is the IFA Defence Union, an internet based forum founded by Alasdair Sampson, of Glasgow law firm Drummond Miller. He became involved after taking on several cases of advisers seeking to protect themselves against complaints.

The group was formed after Sampson disagreed with FOS research declaring that most IFAs were happy with the ombudsman and felt comfortable with its procedures. Sampson claims that he has received dozens of calls from IFAs concerned about the structure of the FOS and that just one was happy with an FOS decision affecting them.

The group's actions have included the submission of a petition to the European Parliament and the publication of a standard letter for IFAs to send to their MPs.

The letter, which runs to over 1,500 words, presents a range of points to consider regarding the legal status of the FOS and its actions, suggesting that it is unaccountable and biased towards the consumer. It also addresses the right of appeal issue, non-chargeable cases and the fact that IFAs pay fees irrespective of whether the case is proven or not.

The FOS retort to groups critical of its procedures, such as the IFADU and Clarke Willmott, has been unswerving. It has pointed out that 66% of claims made against IFAs last year were found in their favour. At the final stage, in front of the ombudsman, the IFA success ratio falls to 50%.

The FOS also drew attention to the change made to its fees structure in April, which meant IFAs no longer incur case-handling charges unless more than two cases have been brought against them.

This was introduced to reflect the demographics of the companies drawing the most complaints. Of the complaints received in the financial year to April 2004, 68% came from just 40 companies described by the FOS as "bigger, high street life offices".

## Firms complained about 2003/2004

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|---|---|
| Life assurers | 38% |
| Advisers & brokers | 27% |
| Banks & building societies | 13% |
| General insurers | 13% |
| Fund managers | 9% |
| **Number of cases resolved by FOS:** | |
| 2000 | 22,100 |
| 2001 | 28,400 |
| 2002 | 39,194 |
| 2003 | 56,459 |
| 2004 | 76,704 |

**Source:** FOS Annual Review 2003/2004.

The attitude taken by some small IFAs towards the ombudsman has also come in for criticism from the service, which maintained that a growing number of advisers were adopting hostile and obstructive practices in order to delay compensation payments.

## Consumer counterpoint

However this is not to imply that the FOS naturally favours the consumer. On the contrary, a litany of complaints can be heard with increasing clarity from the complainant side of the fence. The attack on the FOS is coming from more than one irate source.

The fact that the service is funded by the industry, through annual subscriptions and case fees, is unhealthy in the eyes of consumer groups, who view it as undermining the impartiality of the FOS.

But this should be set against recognition that industry funding derives not from a voluntary contribution but a requirement for firms to pay it.

Others are unhappy with the proportion of complaints that are rejected, currently about two thirds, and the time that it takes for cases to be handled.

Attempts by the FOS to improve the latter have met with criticism, particularly when it was revealed that staff would receive bonuses for closing complaints quickly. Groups including the Consumers' Association, in a rare collusion with IFA opinion, were quick to ask whether this would threaten the quality of the assessments made.

The quality of the FOS's case handling was also questioned by an independent review commissioned by the service. The review by Professor Elaine Kempson, published in late July, said that the training of FOS staff had developed in an ad hoc manner and that there needed to be a more formal system of quality checking across the organisation.

Consumer gripes about the FOS have been taken up by a number of campaign groups. Several have been spawned by the endowment mis-selling scandal, of which 'Endowment Justice' is one of the most aggressive.

The FOS comes in for severe criticism from Endowment Justice, which on its website accuses the service of being slow, extremely difficult to deal with, protective of life companies and failing to be entirely impartial.

As far as complaints are concerned, Endowment Justice believes that these come not from a growing public inclination to claim but what it alleges is a "high probability" that both current and surrendered endowment policies were mis-sold.

A more cautious approach is taken by Endowment Action, the *Which?* website that focuses more on the advice given in alleged mis-selling cases than on shortfalls created by difficult market conditions. This is just as well given that the CA has itself actively promoted endowments on several occasions in the past, giving them *Which?* magazine best buy awards in both 1983 and 1990.

The Endowment Action website includes a 'letter generator' that one IFA has claimed leaves it vulnerable to legal consequences. The IFA insists that if a claim from the letter generator proves to be fraudulent, there may be grounds to report the Endowment Action portal under the assistance section of the Proceeds of Crime Act.

However Louise Sampson of the CA responded: "We have no comment to make on that but our lawyers have inspected the site and are satisfied with the content.

"IFAs should stop putting out negative messages that put genuine complainants off making claims".

## FSMA review and right of appeal

The role of the FOS is currently being revisited as part of a review of the Financial Services and Markets Act.

Among the issues will be how the FSA enforces action as a result of FOS decisions, if regulatory action should sometimes replace decisions made by the FOS and whether an external appeals system should be introduced.

Currently, judicial review is the only way to challenge an FOS decision, but apart from being a costly, drawn-out process, all reported cases of challenge through judicial review have failed.

An FOS update in July reviewed the pre-consultation points made by consumer bodies and life offices, including the arguments for and against an appeals process. In favour was the argument that the absence of an external appeal created an imbalance in favour of the com-

plainant. There was also reference to the possibility that the lack of appeal breached 'fair trial' provisions in Article 6 of the European Convention on Human Rights.

Reasons given in favour of maintaining the present system included the FSMA requirement that the FOS resolves disputes quickly and with minimum formality.

If the Treasury review were to result in the introduction of a process for companies to appeal against decisions, the move would require primary legislation to amend the FSMA, a factor that makes such an outcome improbable. The cost of setting up an appeals structure has also been highlighted as an objection by the treasury.

The notion of an appeals process has been explored cautiously by AIFA. Paul Smee, director general of AIFA, said earlier this year that due to the good record of IFAs that have received complaints, such a process would not need to be extensively used. But he conceded that the creation of an appeals process would increase the accountability of FOS.

IFA Gill Cardy, of London-based Professional Partnerships, observed that the facilitation of appeals would be recognition of the potential implications that decisions can have for firms.

"Given the potential effect on a business and the fact that people can go out of business if PI insurance goes up because of claims, even where they are rejected, there should be a right of appeal.

"I have seen an FOS judgement where they confused permanent health insurance and private medical insurance. I would like to think that when it is clear that the case handler lacks knowledge you could go back and appeal. But you can't".

Ian Harvey, a Liberal Democrat MP in North Devon, has added his voice to the appeal call. Harvey believes that the FOS is making case law beyond the remit of the regulator and wants action to help firms without recourse to appeal against FOS decisions.

As expected, the CA has come out firmly against the prospect of an appeals system, claiming that it would lower the chances of consumers getting a fair decision and slow down the claims process. Mick McAteer at the CA has described the FOS as the most effective cog in the regulatory wheel in terms of acting in consumer interest and one that would see its effectiveness undermined by an appeals system.

However Alasdair Sampson of the IFA Defence Union pointed out that facilitating appeals would not only benefit IFAs.

"One of the principle grievances of IFAs – which is not the fault of the FOS as such – is the lack of an appeals system. The CA says that it is not necessary and that it will slow things down. But what needs to be recognised is that an appeals system would be of benefit to both consumers and IFAs".

A more likely outcome of the review will be the adoption of the wider implications route, whereby there would be a process enabling firms to appeal when the FOS decision has wider implications. Insurance companies have been lobbying for this with greater vigour than they have for the introduction of an appeals process.

Similarly, the Treasury Select Committee report on restoring confidence in long-term savings, published in late July, recommended that while communication on wider implication cases could be improved, "calls for a general appeals process should be resisted".

## Conclusion

It is clear that the grievances of both IFAs and consumers are valid. Thousands of people are justified in claiming compensation for what they genuinely feel is a loss of money arising from a contract they did not sufficiently understand. Consequently, access to a free and fair claims process is vital to the process of restoring consumer confidence in the industry.

Similarly IFAs have genuine grounds for being perturbed at certain elements of the FOS formula, not least the case fee that they have to pay even where complaints against them are inaccurate or vexatious.

Therein lies the case for discarding the £360 fee charged to IFAs and finding another way to fund the system. Making the first two cases free is seen as a token gesture by IFAs unhappy with the principle, in that they are required to pay a fee even when they are cleared of wrongdoing.

IFAs are not helped by the practice that has been adopted by many insurers of paying out on claims to avoid onerous work and expense further down the line. There are numerous examples of this occurring where further investigation of the claim may well prove that it was invalid. This is dangerous for small IFAs in particular, as meeting a demand for compensation is effectively an admission of guilt on behalf of the IFA.

As Gill Cardy said, "People seem to be putting claims in because they can. It does not do someone any harm to put in a claim, regardless of its impact on a firm. It ought to be possible to have a mechanism to discourage spurious claims and it should be recognised as a business issue for IFAs, regarding professional indemnity insurers and so on".

The industry has until 1 October this year to respond to the FSA consultation on the FSMA review. But whatever the outcome, what is certain is that the FOS, by its nature as an organisation that seeks to settle unresolved disputes, will continue to be the focus of intense debate.

What is less clear is the extent to which its work is influenced by a culture of compensation and how it retains the confidence of the industry that funds it.

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## Main complaint causes

### ENDOWMENTS

The latest FOS annual review, which covered the period between 1 April 2003 and 31 March 2004, revealed that of its complaints over the period, 67% related to mortgage endowments.

In the space of 12 months, complaints regarding mortgage endowments rose from under 15,000 to over 50,000, a level that the industry and the ombudsman had not anticipated.

In the late summer of 2003, according to the FOS, the volume of complaints doubled from about 1,000 new cases a week to almost 2,000 a week, forcing the FOS to recruit a hundred more new staff to handle the workload.

So far more than 500,000 people have received compensation totalling £875m and the FSA has imposed fines worth £5.2m on companies deemed guilty of mis-selling endowment mortgages.

### SPLIT CAPS

The split caps investigation has become the biggest and one of the messiest in the history of the regulator. The FOS has received 5,000 complaints relating to the split-caps debacle in the last three years but just 1,500 have so far been resolved. The majority of these were rejected as it was judged that they fell outside the jurisdiction of the FOS, while of the remaining 375 cases, 50% were found in favour of the investor.

### PRECIPICE BONDS

Precipice bond mis-selling allegations are the latest scandal to rock the industry and a growing number of investors are to be affected by losses as more bonds mature. July's Treasury Select Committee report into restoring confidence in long-term savings estimated that savers with precipice bonds have suffered capital losses in the region of £2.2bn.

The FOS is receiving around 500 precipice bonds complaints each month and has collected in the region of 6,000 in the last year. Most have been resolved, according to the FOS, with 40% being ruled in favour of the consumer.