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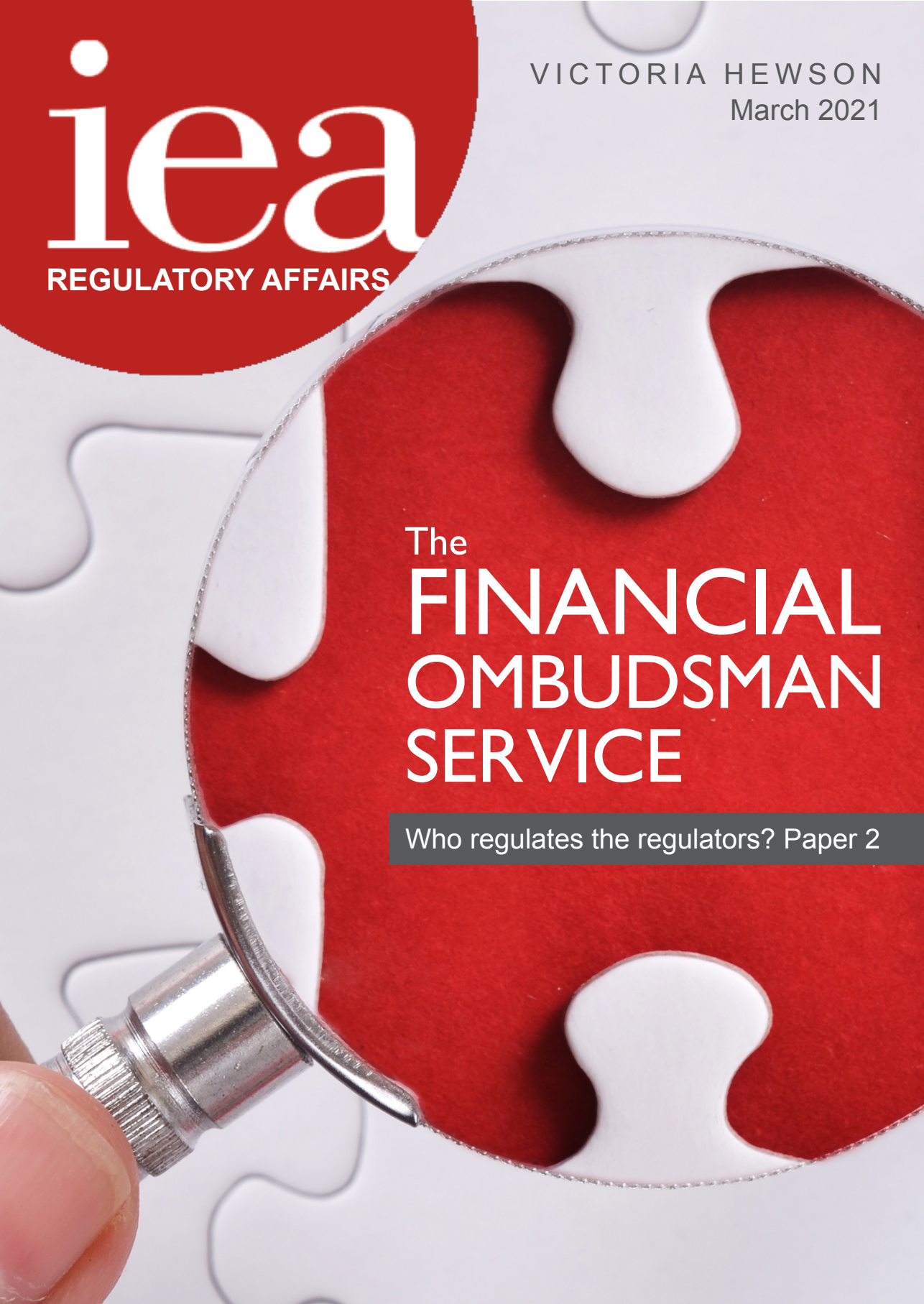

The FINANCIAL OMBUDSMAN SERVICE

Who regulates the regulators? Paper 2

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Summary

- While not formally a regulator in the strict sense, the Financial Ombudsman Service (FOS) exercises *de facto* regulatory powers in retail financial services, as its rules and determinations direct the behaviours of firms.
- While intended to be independent, the FOS has a close relationship with the Financial Conduct Authority. Ombudsmen, however, have considerable discretion to make determinations of complaints brought to them based on what they consider to be fair and reasonable in the circumstances. While required to take law, regulation and good industry practice into account, they are not bound to follow them. This has been described as a disapplication of the rule of law.
- The FOS has expanded its role from resolving complaints to 'preventing detriment', which seems to overstep its statutory function. The formal expansion of its jurisdiction into small and medium sized business complaints and the increase in the limit of the amount of compensation it can award seem likely to further increase the complexity of its cases, calling into question the fairness of decisions and further highlighting the need for greater transparency on internal decision-making policies. Increasing complexity and the higher amounts of financial compensation that may be awarded in some cases also suggest that there should be a review of the charging structure for FOS cases.
- While some form of alternative dispute resolution is necessary for consumers in dispute with financial service providers, there are signs that the way the FOS operates has introduced unfairness and uncertainty for firms (especially small and mid-market providers). There is evidence of anti-competitive effects in lending and advice markets, and limited evidence of improvements in consumer outcomes in financial services generally.

- The FCA (pursuant to its statutory objective of the promotion of competition) should undertake an investigation into the effect on competition of the FOS and its decisions.
- A more formal channel for dispute resolution in financial cases involving small and medium sized businesses (previously recommended by the Treasury Committee of the House of Commons) should be considered.

Regulator profile: the Financial Ombudsman Service

While not formally a regulator, the Financial Ombudsman Service (FOS) is included in this series because it operates in ways that constitute regulation by setting the rules and procedures for complaints and by informing the regulatory approaches of the Financial Conduct Authority (FCA).[1] In her remarks on the publication of the FOS's annual complaints figures for 2019/2020, FOS Chief Ombudsman Caroline Wayman noted that the FOS is increasingly 'not just resolving disputes that are brought to [it], but working with others to stop unfairness arising in the first place' (FOS 2020a). FOS rules are included in the FCA Handbook. Firms are expected to implement them in their internal procedures for customer complaints before the FOS is involved and reflect FOS decisions in their determination of complaints. It has been argued that the FOS has an 'undesired and commercially damaging "quasi-regulator" status' (Morris 2008). Accordingly, it should be expected to show adherence to principles for good governance of regulators such as clarity of role, prevention of undue influence, accountability and transparency, funding and performance evaluation (OECD 2014).

1 As set out in the Memorandum of Understanding between them dated 18 December 2015.

Who	The Financial Ombudsman Service Limited is a company limited by guarantee. The Chairman is Baroness Manzoor and the Chief Ombudsman and Chief Executive is Caroline Wayman, who is standing down from the position with effect from 16 April 2021. Her successor is not known at time of writing. There are two principal ombudsmen, 10 lead and managing ombudsmen and 480 ombudsmen, a total average of 675 staff over the year ending 31 March 2020.
Purpose/establishing legislation	The FOS was established under the Financial Services and Markets Act 2000 to 'provide a scheme under which certain disputes [relating to regulated financial services] may be resolved quickly and with a minimum formality by an independent person'. Rules concerning which complaints are covered by its jurisdiction and certain requirements for firms to communicate consumer rights in respect of the ombudsman are set by the Financial Conduct Authority, and are set out in the 'DISP' section of the FCA Handbook. The FOS sets its own procedures for handling complaints brought to it and these are published on its website. Initially only individuals and micro businesses (with fewer than 10 employees and less than £2 million annual turnover) were eligible to bring complaints to the FOS but in 2019 the FCA changed the eligibility rules so that small and medium sized businesses (that employ fewer than 50 people or have a balance sheet of less than £5 million and a turnover of less than £6.5 million) could also bring complaints to the FOS. Financial services covered have steadily expanded and the FOS jurisdiction now includes banking, insurance, advice, and consumer credit. In 2018 the jurisdiction was extended to include complaints about claims management companies (CMCs) that had previously been covered by the Legal Services Ombudsman.

Accountability	The FOS is independent from the FCA but the FCA has certain management responsibilities towards it and is required under the Financial Services and Markets Act 2000 (FSMA) to 'ensure that the FOS is at all times, capable of exercising its statutory functions'. The chairman of FOS is appointed by the FCA with the approval of HM Treasury. The Board is appointed by the FCA. The Board of FOS Limited produces an annual plan and budget for public consultation and an annual report and accounts, which are submitted to Parliament. The FOS and the FCA are required by the FSMA to co-operate and there is a memorandum of understanding between them. The FOS is required to report to the FCA annually on the discharge of its functions. Since 2013, the National Audit Office has had oversight of the FOS as its external auditor. Under FSMA, the panel of ombudsmen is to be appointed by FOS Limited, and is to consist of persons that 'appear to [FOS Limited] to have appropriate qualifications and experience'. If they are unhappy with an ombudsman decision, a consumer may decline to be bound by it and take their claim to the ordinary courts. Firms are bound by the decision with no right of appeal. Ombudsmen decisions can be judicially reviewed but the discretion allowed to the ombudsmen by statute, and the fact that they are not bound to decide in accordance with law and regulation, means that judicial review is unlikely to be (and has not been) viable in most cases. There is an independent assessor for complaints about the service provided by the FOS. The independent assessor is appointed by the board of FOS Limited.

Rule-making power	The FOS is required to make 'scheme rules' setting out its procedures for referral, investigation, consideration and determination of complaints. It has the power to 'publish such information, guidance or advice as it considers appropriate'. It is required to resolve complaints 'by reference to what is, in the opinion of the ombudsman, fair and reasonable in all the circumstances of the case'. Arguably the formulation of the FOS's internal rulebook for deciding cases therefore amounts to rule making. The FCA must approve the rules governing the scheme, and some of them are set out in the FCA Handbook. Other procedural rules are set out on the FOS website. FSMA gives the FCA the power to set certain rules for the FOS scheme, including the scope of the compulsory jurisdiction, the maximum financial awards it can make and time limits for bringing complaints.
Price-setting power	None.
Enforcement powers	Ombudsman determinations that are accepted by the complainant are binding and enforceable through the courts.
Funding	The FOS is funded through a combination of group payments made by large financial service groups, levies paid by smaller, independent businesses and a per case fee of £550 payable after the 25th complaint referred against each business. The FOS sets the case fee and the FCA sets and collects the levy, in consultation with the FOS. There is no charge to consumers for the handling of their complaints, whatever the outcome.
EU element	The FOS complies with the EU Alternative Dispute Resolution Directive, which requires member states to make ADR available to consumers. The ADR Directive, implemented in UK law through the Alternative Dispute Resolution for Consumer Disputes (Competent Authorities and Information) Regulations 2015, discourages charging consumers for using an ADR service, and states that any charge should be nominal.

Assessment against objectives

> Consumer confidence is crucial to a successful business, and effective ADR methods have become increasingly recognised as necessary to building and maintaining consumer trust.
>
> (Beqiraj, Garahan and Shuttleworth 2018)

There was no formal impact assessment or cost/benefit analysis on the establishment of the FOS but its objectives can be drawn from its statutory functions and those of the FCA. The statutory function of the FOS under FSMA is resolution of disputes between consumers and firms quickly and with a minimum formality by an independent person. FSMA provides that: 'A complaint is to be determined by reference to what is, in the opinion of the ombudsman, fair and reasonable in all the circumstances of the case'.[2]

Under FSMA, the FCA has a statutory objective of protecting consumers. But it also has an objective of 'promoting effective competition in the interests of consumers in the markets for … regulated financial services'. Its interfaces with the FOS should therefore have regard to maximising competition in the consumer and SME financial services markets.

In the first annual report of the FOS (after it had been established as an entity, bringing together several existing small, specialist ombudsmen, but before its statutory powers had come into force) the then Chief Ombudsman set out what he saw as its longer-term objectives, in addition to the statutory objective. These included promotion of the avoidance of disputes as well as their resolution, taking decisions that are consistent, fair and reasonable, and being cost effective and efficient, so as to be seen as good value. The Chief Ombudsman set out to ensure that the industry would be aware

2 Section 228 FSMA.

of ‘consistent policies’ and that the FOS would act predictably and consistently. In the long term, he reflected,‘harmonised ombudsman arrangements should prove beneficial both for consumers, in terms of accessibility and for the financial services industry, in terms of cost efficiency’. While understandably the exercise of setting up the new service had entailed extra costs, with investment in additional management and new technology, he acknowledged that the industry ‘will want to see this reflected in due course in lower unit costs’ (FOS 2000).

For the purposes of this profile, we will therefore examine the achievement of objectives under two headings: 1) providing fair and reasonable resolution of disputes at speed and with minimal formality; and 2) providing value for money and supporting competition and consumer welfare.

Fair and reasonable; quickly and with minimal formality

The FOS sets the rules for bringing complaints to it. These rules need the consent of the FCA and are published in the ‘DISP’ section of the FCA Handbook. The FOS also sets its internal procedures for dealing with cases, and the policies and parameters that adjudicators and ombudsmen apply in determining complaints. The current process involves an initial review and decision by an adjudicator. If accepted by the consumer, this becomes the final and binding determination. If not, the matter will be taken to a more senior ombudsman, who will look again at all of the circumstances and give a final determination. This is effectively an internal appeals process and the scheme as a whole has been found to meet ECHR standards for a fair trial.[3]

Ombudsmen must make a decision based on what seems ‘fair and reasonable in all the circumstances’. FCA Handbook rule DISP 3.6.4 requires that in considering what is fair and reasonable in all the circumstances of the case, FOS ombudsmen are to take into account: ‘relevant: (a) law and regulations; (b) regulators’ rules, guidance and standards; (c) codes of practice; and (where appropriate) what he considers to have been good industry practice at the relevant time’.They are not bound by them, though, and a former Chief Ombudsman described FOS

3 In the case of *Heather Moor & Edgecomb Limited v United Kingdom* [2011]. Application no. 1550/09 ECHR.

decision-making as making its own law.[4] Even when interpreting and applying law and regulation, the latitude afforded to the ombudsman is extremely wide, as confirmed by case law from firms seeking judicial review of decisions.[5] The regulations comprising the principles for business in the FCA Handbook (such as principles 2 and 6 - treating customers fairly and acting in their interests, and acting with skill, care and diligence) are deliberately wide and subjective. They operate as a general framework and cannot necessarily be satisfied by complying with specific individual regulations, and can even lead to outcomes that diverge from decisions of other relevant regulators such as the Pensions Ombudsman.

It is therefore not surprising that, when fairness is set at such a level, many consumers consider that they have been treated unfairly, and the FOS agrees with them. There is evidence that this makes it difficult to provide financial services profitably, especially at the lower end of the market to less well-off consumers. Bespoke services are costly, and when the risks associated with dealing with that section of the market are already inherently high, the viability of serving those consumers is threatened, as has been seen in the contraction of suppliers in the consumer lending market, and in the 'advice gap' identified in the FCA and HM Treasury Financial Advice Market Review, discussed below.

There is a tension inherent in the FOS primary objective to determine complaints quickly and with minimum formality and the way in which it is required to make decisions that are fair and reasonable. Being fair to all parties requires a certain level of due process and that takes time and involves some measure of formality.

As the number of complaints to the FOS increased sharply in the years after its establishment, in particular complaints about mis-sold payment

4 In a speech in 2001 then Chief Ombudsman Walter Merricks said 'We do not have to pretend to "find" what the law is. We unashamedly make "new law"' (quoted in Speaight and Hamilton 2011: 8).

5 Such as Berkeley Burke (R (Berkeley Burke SIPP Administration Limited) vs Financial Ombudsman Service Limited [2018] EWHC 2878 (Admin)), where a SIPP provider executed a transfer of a client's pension fund into an investment scheme that turned out to be fraudulent. Even though it was an 'execution only' service, and the client had been recommended to take advice and declined it, the ombudsman found that the firm should have carried out due diligence on the investment (which would have involved investigating title to properties in Cambodia) before accepting the instruction, in order to satisfy principles 2 and 6. The judge found that the ombudsman was entitled to make that determination: it was not making a new rule, simply applying the very broad principles within the margin of discretion allowed to him.

protection insurance (PPI), a backlog built up and complaints were taking months to resolve with tens of thousands of cases taking longer than a year. This was attributed to volatility of demand affecting workforce planning, and in some cases, the need for a novel legal point to be resolved in the courts. In March 2021, the Chief Ombudsman resigned, in the midst of media criticism of the backlog.[6]

Because of this, and because it is a form of ADR and not a court or tribunal, the FOS structures itself and provides training and guidance to case handlers on the basis that specific legal and financial expertise is not required. This has led to reliance on standard forms and case management systems, which may indicate that speed and absence of formalities have been prioritised over fairness. There have been significant improvements in the transparency of FOS decision making, in particular following the Hunt Report in 2008, but as discussed below, a great deal of the FOS internal rulebook remains unpublished.

The Lloyd Report, following an independent review in 2018, found that while individual ombudsmen and adjudicators are not highly trained and need not be qualified either in law or financial regulation, they are diligent and generally act with integrity. Moreover, the report did not identify institutional bias in favour of firms (Lloyd 2018). The FOS operates a quality assurance programme that involves a number of checks on the decisions and communications of adjudicators and ombudsmen in order to maintain quality and customer satisfaction (FOS 2018). But this itself does not guarantee fairness or reasonableness in substance, and there have been persistent concerns that the FOS prioritises efficiency and turnover of cases over quality (to address backlogs and stay on top of volumes), and that the knowledge management systems that guide decision-making still lack transparency.

It was envisaged when the FOS was established that many cases would require hearings to help determine disputed matters, but in practice the proportion of cases that have a hearing is small. If a respondent firm wishes to be heard to defend itself, this can be (and invariably is) denied and the case proceeds based on written submissions and correspondence. There is also an imbalance in the standard of evidence that the FOS takes into account. For example, in its guidance on investment advice complaints,

6 'Fos chief steps down amid case backlog', *Financial Times*, 11 March 2021 (https://www.ftadviser.com/fos/2021/03/11/fos-chief-steps-down-amid-case-backlog/).

the FOS website states that it will 'take into account the customer's own records and recollections' – that is, recollections of the complainant that are not supported by evidence. Expectations on firms are much stricter, and even documentary records of, for example, customers' stated risk appetite will not prevent the FOS from finding that financial advice given was unsuitable.[7] Moreover, the criteria that the FOS is required to apply to make determinations, as described above, are arguably inherently unbalanced in ways that cannot necessarily be addressed by process improvements and quality assurance.

In its 2019/2020 annual report, the FOS described its impact on 'preventing detriment'; the Chief Ombudsman wrote of the FOS 'playing its part in preventing detriment' and 'telling banks to step up to help victims of fraud'. It could be argued that both of these activities ('preventing detriment' and 'telling' banks what to do, beyond adhering to determinations of complaints) exceed the statutory remit of the FOS. Preventing detriment is not the same as fairly resolving complaints. A consumer could suffer detriment without any unfairness or breach of substantive rules. The fact that FOS places such emphasis on prevention of detriment, rather than fair and lawful treatment of consumers, risks unbalancing its outlook. It is also at odds with the principles of good regulation under FSMA, which include the general principle 'that consumers should take responsibility for their decisions' and refer to risk levels associated with certain financial products, clearly acknowledging that the objective is not to eliminate risk.[8] Consumers can only be protected from detriment if all risk of a product not meeting their needs or expectations rests on the firm, thus removing responsibility from the consumer, in contravention of FSMA. The recent emphasis on prevention of detriment is not only in danger of taking the FOS outside of its statutory remit; it threatens the fairness and reasonableness of the process as a whole.

The relationship between the FOS and CMCs (who bring complaints on behalf of consumers in return for a share of any compensation that is obtained) is concerning and also brings into question the fairness of the scheme as a whole. Because it is funded based on the number of complaints received, the FOS receives significant income as a result of complaints pursued through CMCs and the aggressive marketing strategies of CMCs

7 See FOS information for businesses on 'Assessing the suitability of investments' (https://www.financial-ombudsman.org.uk/businesses/complaints-deal/investments/assessing-suitability-investments).

8 Section 1C FSMA.

in attracting complainants. As it is also now responsible for deciding on complaints about CMCs, this is a potential conflict of interest.

As the statutory scheme for PPI compensation (that provided CMCs with most of their revenue in recent years) has now closed, they are diversifying into new markets. CMCs now intermediate 8/10 of complaints in consumer lending (compared with 3/10 across all complaints) (FOS 2020b), so have clearly benefited from the policy change at the FOS that caused the uphold rates in this sector to rise (as described below). This bears the hallmarks of regulatory capture - just as one set of complaints is extinguished another can take its place, so ever more rules and officials are needed.

With the economy in recession and unemployment rising due to the pandemic, in 2020 the FCA issued guidance on consumer lending, requiring forbearance measures and flexible approaches tailored to the circumstances of customers who are in financial difficulties and unable to repay loans. Many small businesses have received emergency loans under the Coronavirus Business Interruption Loan and Bounce Back Loan Schemes to which normal FCA rules on creditworthiness and affordability did not apply. Concerns were raised that banks would have subsequent complaints from borrowers about those loans being upheld by the FOS, because even if firms have followed the FCA guidance, the FOS must act independently and could find that customers were not treated fairly or were effectively mis-sold loans that they could not afford. To address this risk the FCA and FOS have exchanged correspondence and the Chief Ombudsman has acknowledged the contextual information that the Chief Executive of the FCA provided to assist in determination of possible future complaints by the FOS.[9] Policy makers should pay close attention to how complaints from SMEs about loans under these schemes are handled by the FOS.

Value for money, competition and consumer welfare

The cost per case has increased steadily over the lifetime of the FOS and in the year to 31 March 2020 it was £920, materially over the budgeted cost of £650. The Chief Ombudsman attributes this to the increase in the complexity of cases, as the proportion of routine PPI complaints that make

9 'FCA and FOS clarify approach to lending under coronavirus loan schemes', *Out-Law*, 12 May 2020 (https://www.pinsentmasons.com/out-law/news/fca-fos-clarify-coronavirus-lending).

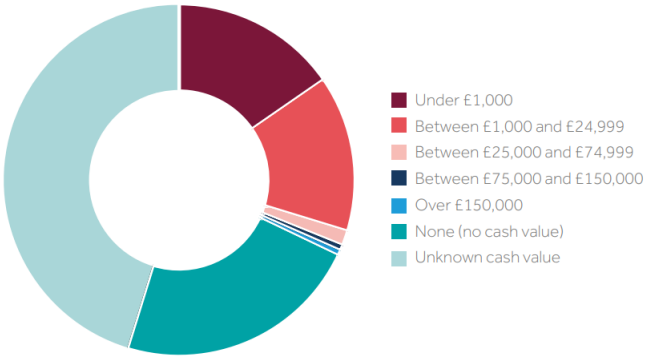
up the caseload has declined. The FOS has introduced some of this complexity itself, as it seeks to address issues of vulnerability and focuses on 'helping people who have experienced economic and domestic abuse, and problem gambling' (FOS 2020b). Some of it is driven by market trends such as take up of self-invested pensions, where there has been an increase in complaints. All this raises the question of whether such complex cases would be better dealt with in another forum, especially now that complaints from small and medium sized businesses are in scope and the maximum award that the FOS can make has been increased by the FCA from £150,000 to £350,000. The NAO reviewed the efficiency of the FOS operations in 2012. It made recommendations for achieving efficiency in scale and other process improvements to address the surges in demand the FOS had experienced since its establishment, some of which were already being implemented in a large-scale change programme (NAO 2012). As the FOS is still struggling with these challenges (and as can be seen above, has very high staff costs) it may be time for the NAO to carry out another in depth review.

It is difficult to assess the average value of cases, as many of them, especially the higher value and more complex investment and pensions cases, may not involve a financial payment, but rather a direction to take certain steps to restore the consumer to the position that they should have been in.[10] There is a strong incentive for firms to settle cases where redress can be made up to the case fee of £550[11] (payable by the firm whatever the outcome) so it can reasonably be assumed that complaints upheld by the FOS will generally involve higher amounts than this. It seems likely that a significant proportion of cases incur costs (including the internal costs of firms) that are disproportionate to their value, especially considering that only around a third of cases are upheld (FOS 2020b). Of those complaints that are upheld, a significant proportion have resulted in compensation of less than £1,000 (see Figure 1) and the case fee for such cases will be the same as for more complex ones. In the past, different charging for different types of complaints has been ruled out as itself causing greater complexity (Kempson et al. 2004), but recent changes to the scope of the FOS's jurisdiction suggest it may be time to revisit this question.

10 It was a recommendation of the Hunt Report in 2008 that this practice should end and all awards should be of defined sums, but this was not implemented.

11 The fact that in 2019 alone firms paid out redress of over £100 million in respect of complaints that they had not upheld suggests that this is widespread (FCA 2020).

Figure 1: Proportion of all complaints to FOS in financial compensation ranges



Based on averages for all upheld complaints from 2015/2016 to 2017/2018. Source: Financial Ombudsman Service.

In the FOS Annual Report for the year ended 31 March 2020, the Chairman of the FOS noted that 'there are too many complaints coming to the service'. Calling for greater focus on best practice in customer service in the industry, she reflected that 'it can't be in the interests of those businesses generating high volumes of complaints that so many of their customers need to turn to our service to get the fair resolutions they need'. This is surely right, but perhaps should provoke further reflection on why after 20 years of the FOS, firms have not come to this conclusion themselves, or if they have, why they have not been able to act upon it. It is worth considering whether the way the FOS works might itself be part of the reason for numbers of complaints being sustained – by the way its regulations require firms to actively remind consumers of the right to escalate their complaint even if they have resolved it with the firm,[12] the active solicitation of complaints through advertising and engagement with partners like Citizens Advice, or by encouraging firms to, in effect, incorporate an assumption of complaints to the FOS as part of their internal procedures and budgets.

As well as the specific objective of dealing with individual disputes, the FOS plays a part in the wider objective of the regulatory system to promote competition. Proponents of ombudsmen schemes claim that the availability of an independent complaints and redress mechanism gives consumers

12 FCA Rule DISP 1.5.4 (https://www.handbook.fca.org.uk/handbook/DISP/1/5.html).

confidence in buying financial products (Beqiraj et al. 2018). Commentators in the industry argue that this allows the FCA to take a less prescriptive approach in rule making, as individual unfairness from the operation of broad, principles-based rules can be remedied *ex post* by the ombudsman. If this had been achieved, it could be expected that there would have been improvements in customer satisfaction and competition in consumer financial service markets, and a light-touch rule book. In practice, consumer satisfaction and competition are difficult to measure. Complaints to the FOS have risen over its lifetime, although the number has declined from its peak in 2013/14 at the height of claims for PPI compensation and for the year 2019/20 it stood at 271,268 (FOS 2020a). The number of complaints to firms (most of which are resolved without being referred to the FOS) has increased over the lifetime of the FOS, but fell slightly year on year in the first half of 2020 (FCA 2020)(although the FCA's change in the way it records complaints data in 2016 makes it difficult to track numbers consistently). The NAO reported in 2016 that while fines and redress mechanisms have substantially reduced the incentives for firms to mis-sell financial products, and measures like the Senior Managers Regime are intended to further improve governance and internal controls, the FCA could not provide evidence on whether its actions were reducing the overall levels of mis-selling (NAO 2016). Complaints in other sectors, such as pensions, investments and payday lending, have trended upwards as the PPI redress scheme closed in August 2019, suggesting that mis-selling (as defined by the FCA and understood by the FOS) is still widespread[13] or that CMCs and opportunistic complainants have become adept at framing claims.[14] Neither could be counted as a successful regulatory outcome.

Simply looking at the number of complaints and the uphold rates over time does not necessarily show whether consumer confidence and satisfaction have improved or not. There are too many other factors and influences for this to be clear. For example, increased awareness of the FOS and of consumer rights generally due to rules that require firms to remind the consumer of their right to take a complaint to the FOS, and social media and consumer advocacy campaigns, could have led to more complaints even if firms' services were improving. Specific redress schemes

13 'After PPI, what could be the next banking mis-selling scandal?', *Financial Times*, 30 August 2019 (https://www.ft.com/content/2abb8482-c9b3-11e9-a1f4-3669401ba76f).

14 A former chairman of Barclays Bank suggested that the PPI redress scheme had turned 'portions of Britain into fraudsters', after his bank received so many spurious claims driven by CMCs. See: '£36bn - the cost of PPI atonement to the UK banking sector', *The Telegraph*, 4 August 2019 (https://www.telegraph.co.uk/business/2019/08/04/36bn-cost-ppi-atonement-uk-banking-sector/).

such as those concerning mis-sold mortgage endowments and PPI, and CMC marketing, have increased consumer awareness, and there have even been instances of the FOS obtaining contact details of possible complainants from the FCA in order to solicit complaints (Speaight and Hamilton 2011).

It is difficult to measure how effective competition is in retail financial services generally, and there is a lack of data on the FOS's effects on competition. This aspect has been neglected in the many reports on its performance and in the FCA consultations about changes to applicable rules. The NAO found in its 2016 report on mis-selling and redress in financial services that 'regulation aimed at preventing the sale of unsuitable products could have unintended consequences, such as discouraging innovations that could benefit consumers'. One firm told the NAO that 'it considered that firms had become more reluctant to introduce new products, because they could subsequently be regarded as mis-sold if they prove to be unsuitable for some consumers' (NAO 2016). The FCA has powers in respect of competition investigation and enforcement, but tends to focus on perceived market failures, rather the effects of its own regulations (a general failing of competition policy in the UK (Booth 2020)). In its mission statement on competition, the FCA envisages more interventions, not fewer, in the pursuit of competitive markets in the interests of consumers (FCA 2018a).

The impact of FOS decisions on the short-term, high-cost lending market is a high-profile example of how it has affected competition in the market.[15] A change made by the FOS in 2019 to its internal criteria for assessing the fairness and reasonableness of affordability criteria applied by firms making such loans became apparent in the uphold rate of complaints in respect of this market sector. The uphold rate for complaints about home collected loans (also known as home credit) went from 39 per cent in 2018/19 to 84 per cent in 2019/20. In guarantor lending it went from 32 per cent to 89 per cent over the same period (FOS 2020a). The effect on the availability of these products was marked. Data from the FCA shows a 40 per cent decline in loans made between Q4 2018 and Q4 2019.[16] The review into the unsecured credit market by former interim executive chairman of the FCA Christopher Woolard, commissioned by the FCA and

15 'Financial Ombudsman defends approach after lender criticism', *Financial Times,* 14 September 2020 (https://www.ft.com/content/69461a98-2c39-454e-ac34-09ffee93c720).

16 FCA Freedom of Information Response (https://www.fca.org.uk/disclosure-log/2020).

published early in 2021, acknowledged the 'potential cooling effect on investment and growth' from 'perceptions of regulatory uncertainty in the credit market' (Woolard 2021) (though without acknowledging that the perceptions are based on reasonable foundations).

The overall volume of complaints in banking and lending declined in 2018/19 and this trend continued in 2020, due in part, as noted by the Chief Ombudsman in the 2019 annual report, to a number of short-term lenders going into administration. This is one way of reducing the number of complaints but it questionable whether it is fair and reasonable for an unaccountable body to make a decision that causes legal businesses to become non-viable, without consultation or publicity. Not only is this damaging to the firms concerned, but the impact on consumers who need access to short-term credit and, in the absence of regulated providers (in what was already a concentrated market), turn to unregulated and informal lending, could be very detrimental (APPG on Alternative Lending 2020).

Another sector that has seen an impact from the operation of the FOS is financial advice. The FCA and HM Treasury found in their 2016 Financial Advice Market Review (FAMR) that there is an 'advice gap', with less affluent consumers being excluded from the provision of personal financial advice as it is not cost effective for advisers to provide it. Regulatory costs, including the costs of redress schemes such as the FOS and the Financial Services Compensation Scheme (FSCS) are highlighted as contributory factors causing a reduction in the number of advisers and an increase in fees: 'advice is expensive and is not always cost-effective for consumers, particularly those seeking help in relation to smaller amounts of money or with simpler needs' (HM Treasury and FCA 2016). The FAMR downplays this structural issue of regulation, and seems to accept the submission of consumer organisations that such regulatory costs are a necessary part of doing business well. The FAMR recommended better use of technology to serve less well-off consumers more efficiently and greater outreach and transparency by the FOS to assist independent financial advisers (IFAs). It proposed exploring further regulation of professional indemnity insurance (PII) provision to address the difficulty that many IFAs have in finding commercially viable PII in light of the unpredictable and non-time-limited exposure to customer claims that they face,[17] rather than questioning whether the underlying risks posed by this system are justified.

17 'Adviser PI premiums soar up to 900%', *Financial Times,* 24 April 2020 (https://www.ftadviser.com/regulation/2020/04/24/adviser-pi-premiums-soar-up-to-900/).

These data points are not conclusive, but it is notable that the many reports that have been carried out into the functioning of the FOS have not considered whether the operation of the FOS is conducive to the FCA's competition objective or is beneficial to consumers at large, as opposed to individual consumers who have their complaint dealt with. It has been suggested that the uncertainty and cost now built in to the FOS system is favoured by large firms who can afford it where mid-market operators cannot, a profoundly anti-competitive outcome (Samuel 2018).

The EU ADR Directive of 2013 was based on the premise that 'Ensuring access to simple, efficient, fast and low-cost ways of resolving domestic and cross-border disputes which arise from sales or service contracts should benefit consumers and therefore boost their confidence in the market' and that a harmonised approach was needed because 'The disparities in ADR coverage, quality and awareness in Member States constitute a barrier to the internal market and are among the reasons why many consumers abstain from shopping across borders and why they lack confidence that potential disputes with traders can be resolved in an easy, fast and inexpensive way. For the same reasons, traders might abstain from selling to consumers in other Member States where there is no sufficient access to high-quality ADR procedures. Furthermore, traders established in a Member State where high-quality ADR procedures are not sufficiently available are put at a competitive disadvantage with regard to traders that have access to such procedures and can thus resolve consumer disputes faster and more cheaply.' Since then, the Commission has continued to bemoan the persistent refusal of EU citizens to shop across borders, and has proposed ever more interventions to encourage them to do so.[18]

18 As summarised by the European Commission (https://ec.europa.eu/digital-single-market/en/new-eu-rules-e-commerce).

Rule of law

> As a matter of policy... politicians decided to disapply what we know as the rules of law to financial firms when they created FOS.
>
> Richard Samuel (*New Law Journal* 2019)

Although the FOS is not a court or judicial body and its decisions are not binding precedents in strict legal terms, they have the effect of precedent in practice, as ombudsmen strive for consistency and as firms change their processes and behaviours to reflect outcomes.

There is no question that a dispute settlement mechanism for consumers outside of the ordinary courts is necessary, to respect access to justice under the rule of law, both as a matter of principle and in the interests of the good functioning of the market. Imbalances of power and funding make it unfeasible for consumers to bring claims against financial service providers in the courts. The cost of pursuing a claim and risk of being liable for the firm's costs if unsuccessful, and the relatively small value of claims, would mean even the strongest of claims would go unfought. It is less obvious that a mandatory ombudsman like the FOS is the best way of providing this, and the current construct of the FOS contravenes the rule of law in several important and damaging respects.

Successive reports and consultations have called for greater transparency, and while the FOS now publishes its decisions, and has gradually given more information about its decision-making policies and practices, it still does not publish its 'own law'. This infringes the rule of law requirement for transparency and legal certainty and the principle that in a democratic society, changes to the law should not generally be made other than by Parliament or by way of rule-making powers granted by Parliament. In 2016 the FCA and HM Treasury Financial Advice Market Review called

on the FOS to establish, by summer 2016, 'a more visible central area for firms...bringing existing resources (e.g. summary of approach, technical guidance notes, case studies etc.) together in one place to help advisers'. This has not been done. Decisions and case studies are available, and, although they are expressly not to be taken as binding precedents, firms can draw principles from the general direction of the decisions. However, it is known that FOS case handlers and ombudsmen draw on internal knowledge management systems to help them maintain consistency (Hunt 2008). It would surely assist firms, especially smaller firms which do not have the legal and compliance resources to keep up to date with the flow of decisions and case studies, to have the 'knowledge' that the FOS relies on made publicly available (Speaight and Hamilton 2011).

That the FOS is not bound to apply the law, only to take it into account, also undermines the principle of freedom of contract. A typical case study[19] describes a consumer complaining that they were charged £2,000 for exceeding the maximum mileage under a car finance agreement. Even though the mileage limit was clearly stated in the contract, and there was no suggestion that the contract was obscurely worded or misleading, the complaint was upheld on the grounds that the credit broker had not actively brought it to the consumer's attention and her prior credit agreements had not included such a term. This seems likely to undermine the ability of a business to rely on its binding terms of business in matters where the FOS has jurisdiction. It also risks disincentivising consumers from reading and considering the terms they are entering into, when it is known that any undesirable terms that are subsequently discovered will be overturned. The imbalance against consumers that prevails in the legal system more generally is reversed here, and the objectives of the FCA to protect consumers are not balanced by an equivalent objective of fairness for firms. While this may favour those consumers who successfully complain to the FOS, it surely disadvantages consumers at large if firms charge more, innovate less and serve a narrower, lower-risk market as a result of the lack of legal certainty.

The FOS is not bound by its own precedents or by law, so it is possible for firms to be compliant with FCA regulation and acting in accordance with their terms and conditions and still have a complaint upheld against them if the ombudsman considers this to be fair. The early aspiration of

19 'A consumer says that she wasn't aware that the finance agreement had a mileage cap', FOS case study (https://www.financial-ombudsman.org.uk/decisions-case-studies/case-studies/consumer-says-wasn't-aware-finance-agreement-mileage-cap).

the Chief Ombudsman for a predictable and consistent approach has not been realised. The lack of prospectivity (another key component of the rule of law) that this has caused was illustrated by the change the FOS made to its internal parameters for fairness in affordability criteria applied by lenders, described above. This change was not published or notified to firms, which only realised that the criteria they were applying to determine whether a consumer could afford a loan were being deemed unfair as a matter of policy when it became obvious from the number and nature of complaints against them that were being upheld.

Many people are uncomfortable with short-term 'payday' lending and consider it to be exploitative and damaging to the borrowers. But an unelected and unaccountable body such as the FOS should not be in a position to make decisions that amount to additional regulation of that sector. Such rule-making should properly be a matter for Parliament. MPs would be able to consider the wider implications of restricting short-term, high-cost lending and produce rules that are transparent and prospective in effect.

Procedurally, while it was envisaged on the establishment of the FOS that oral hearings would often be necessary, in practice they are almost never held. There is no right of appeal for firms, although the two-tier process that the FOS now operates can be said to resemble an internal appeals process. It has also been argued that the relationship between the FOS and the FCA is too close, and that the FOS is therefore not independent and impartial.

There is no 'long stop' barring complaints being brought, as long as they are brought within three years after the consumer discovers the issue, or ought reasonably to have discovered it. While the procedures of the FOS have been found by the European Court of Human Rights not to violate the ECHR right to a fair trial, many firms, especially smaller and independent providers such as IFAs, consider that issues like the lack of a long stop (that would apply in other professional services contexts such as law and accountancy) penalise them unfairly, and make it difficult to obtain professional indemnity insurance, given the open-ended risks this entails. The FCA and HM Treasury have recognised this but consider that the burden on advisers is outweighed by the interests of consumers in having protection when buying long-term financial products such as pensions, where incorrect advice may only come to light decades later. In making this determination, however, the FCA and HM Treasury are not only

privileging the interests of consumers over advisers, they are privileging the interests of those consumers who are wealthy enough to benefit from receiving advice on their pensions and investments over those consumers who, as the report also found, are not receiving advice because it is not economically worthwhile for advisers to serve that market.

The acknowledged increase in complexity of the cases coming before the FOS will surely make these issues of legal certainty and procedural fairness more pronounced. It may be time to consider again proposals made by legal commentators for a tribunal for appeals from the FOS by firms, with support to fund the costs of the consumer (Speaight and Hamilton 2011), and for a general financial services tribunal as an alternative track to the ordinary courts for small businesses (Beale 2018; Samuel 2018), the latter as recommended by the Treasury Committee and endorsed by the FCA in 2018 alongside its policy on extending the jurisdiction of the FOS to SMEs (FCA 2018b).

Conclusion and recommendations

The FOS is not delivering on key objectives and its operation is deficient in respect of key principles for regulatory governance, such as transparency and accountability, role clarity and maintenance of trust.

The mandatory jurisdiction and emphasis on the role of the FOS in the complaints handling rules in the FCA Handbook, and the impact of large statutory compensation schemes together with increasing advocacy and awareness of consumer rights, have given the FOS significant influence in the regulatory system and consumer financial services markets. However, it is not clear that this has led to increased consumer confidence and competition, or to a lighter touch rule book for financial services.

In practice, the FCA Handbook is highly prescriptive and the FOS operates like a nationalised customer service department, making determinations against firms that have complied with all applicable laws and regulatory requirements, based on what ombudsmen and adjudicators consider to be fair. Firms, especially smaller firms and newer entrants which are not in a position to make provision for unpredictable consumer compensation awards, can be deterred from innovating or from serving higher risk or lower value consumers. As the FCA's competition objective specifically refers to innovation and the ease with which new entrants can enter the market, this should be of concern to it. Rules on complaints handling are so prescriptive that there is little incentive or opportunity for firms to distinguish themselves and compete on customer service. High volumes of complaints and generally low uphold rates suggest that the rules reminding consumers of their right to escalate a complaint to the FOS free of charge, even when they have accepted a firm's settlement, encourage opportunistic complaints.

The cost of cases has increased as the jurisdiction of the FOS has expanded – both by way of formal rule changes adding small and medium size businesses and increasing its award limit, and by way of the FOS extending its objectives to include prevention of detriment and protection of vulnerable consumers. This acts in the interests of large firms, who can absorb the costs involved, at the expense of smaller and mid-market firms. The FCA, under its competition objective, should undertake a review of the impact of FOS and FCA complaints rules on competition in retail financial services markets. It should also consider whether a single ombudsman service for the whole financial services industry, including consumers and small businesses, and covering complaints about CMCs, is still the right approach. A single body has been good for consumer awareness but suffers from a lack of specialism amongst case handlers and potential conflict of interest in its dealings with CMCs.

While satisfaction with the service offered by the FOS is reasonably high amongst consumers who make complaints and firms, it cannot provide good outcomes for consumers as a whole if it undermines free and competitive markets, which rely on clear and transparent legal structures so providers can reasonably foresee and plan for liabilities in accordance with rule of law principles. If there is to be a compulsory jurisdiction, it should operate with full transparency on internal decision-making policies and allow a route for appeals by firms to ensure that the process and decisions are consistent with the rule of law. A more structured approach to case fees for more complex or high-value complaints should also be considered by the FOS and FCA.

The new Chief Ombudsman will no doubt be under pressure to take operational steps to address high profile issues with case backlogs, but unless structural problems arising from the incentives created by the system are addressed, such issues seem likely to persist.

The wider implications of regulation based on the underlying principle of ‘treating customers fairly’ are beyond the scope of this paper. The FCA and HM Treasury should, however, consider whether imposing paternalistic duties on financial service providers is good for the market in financial services or whether it causes clustering to cautious standards by firms (stifling innovation and competition) and brings consumers to a state of learned helplessness, where reliance on known ex post remedies and redress disincentivises responsible, informed decision-making by individuals.

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