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"General Insurance, the Public Interest, and the Ombudsman"

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It is now nearly three years ago – December 1997 - since the Government announced that there would be a new ombudsman scheme for financial services. The rationale for a unified arrangement looks fairly obvious and pretty appealing. A one stop shop for consumers confused by stories of misselling and an industry where distinctions are becoming blurred; and a consistent service to the industry with the hope of lower unit costs. Disappoint all those personal finance journalists whose stock article for a slow news week was a "How to Complain" story showing six mug-shots of different ombudsmen above a tangled chart.

why financial services?
But why do financial services as opposed to other services need an ombudsman? Why not grocery, electrical goods, or motor vehicles? I would identify a number of features:

First, the fact that financial services are intangible. Buy a TV or a car or a washing machine and you can examine it, shake it, kick it, test it out; and if it doesn't work, that can be fairly obvious, or at least it can be checked by a repairman. Comparing the price demanded with the quality of the products on offer is something consumers are used to. But how can you tell whether a motor insurance policy is good value until you have a claim? Or whether you have overpaid for a fixed term investment policy until it matures in perhaps 10 years time?

Second, the fact that these services are governed by complex law trade practices or contractual conditions. For those in the industry these practices, laws, customs and conditions are the regular daily stuff of their work and they know exactly how they have all developed and why. The market is developing to produce new and more sophisticated financial products all the time. Some have real extra value to meet customers' needs. Some on the other hand look as if they have been invented by experts in "confusion marketing". Do we really need over 4,000 different mortgage products?

The third feature is that financial services are provided by large institutions to individuals. In effect this is virtually a legal requirement. To be a bank or an insurance company you must have a large amount of capital and meet stringent solvency margins checked by a regulator. But this has the consequence that when a customer is dissatisfied, he may feel overawed and at a disadvantage

when trying to do battle with the large organisation. It has its own lawyers, its own staff who are familiar with the services and products. But he feels isolated on his own.

Finally, financial services providers operate in a very competitive market. The old days when bank charges, and savings and loan rates were identical have gone. Innovation, customer care, market positioning, quality assurance and promotional spending are key watchwords. My own view is that the propensity to complain is fuelled by a competitive environment, a challenging media, and most importantly the advertising and promotional activity institutions undertake. This kind of promotion sets expectations. And it is a truism that complaints arise through a mismatch of expectations and delivery. So how people's expectations are set is absolutely vital. If advertisements constantly suggest that insurance can bring peace of mind, that banks will provide efficient service and good customer care, or that investment products will produce high returns, then that is what consumers will rightly expect, and if it is not delivered they will justifiably complain.

The history

It is worth remembering a little of the history of the ombudsman arrangements in the UK. The story begins 20 years ago in the field of insurance. Insurance companies began to realise that telling people whose complaints had been rejected that if they did not like the result they should take the company to a court was not a very consumer friendly way to deal with a dissatisfied customer. So they invented the idea of an independent adjudicator and took the name ombudsman. There were five key elements to the scheme:

- first it would only deal with complaints when they had been considered at the highest level internally by the company concerned;

- second the service would be free to consumers and be paid for by the industry;

- third, control over the appointment of the Ombudsman and the management of the scheme would rest with an independent body;

- fourth that the member institutions would be bound by the ombudsman's decision, but that a disappointed consumer's legal rights would remain unaffected; and

- fifth and finally, the ombudsman would have the right to make decisions, not only on the basis of the law and the terms of the contract, but on what would be fair and reasonable given all the circumstances of the case.

Funding of the scheme was split between a collective contribution to overheads and a case fee to incorporate a “user pays” element, thus providing appropriate incentives for improvement.

These features were rapidly copied by other sectors of the financial industry. Another, the voluntary scheme for banking customers emerged in 1986, a statutory one for customers of building societies a year later, and shortly thereafter schemes under the Financial Services Act for investment customers. And it is a model that embraces the main feature of the old schemes that the government has chosen for the new statutory scheme.

The original scheme was established by the industry itself in order to add to the confidence of its customers by increasing its collective reputation. It is in the interest of all consumers that they are able to buy financial services with the confidence that, in the unlikely event that something goes wrong, there is an independent person to whom they can turn. Likewise increased consumer confidence naturally benefits the industry.

benefits for the industry

For the industry it has obvious side benefits: the financial contributions to the scheme are probably less than the legal fees it would pay if cases went to court, and there is probably a saving in management time. And there is an excellent answer to any approach from the media about a customer complaint: “Has the person complained to the ombudsman? If not why not?” Human error will always happen in the best of companies, and it will often be easier that redress is determined by someone independent. And every business finds that among its customers are people who become obsessive, or as it is sometimes put, “the balance of their priorities becomes disturbed”. Such people will never take “no” for an answer, and it is a relief to pass them to the ombudsman. It is then our task to see whether, beneath the anger and emotion, there is a genuinely valid complaint.

benefits for consumers

For consumers the benefits are more obvious. The person who has a complaint can approach the ombudsman, without fear of having to pay more, or of forfeiting any legal rights – a real “no lose” situation. We are often described as consumer champions, which is not quite how I put it. I see it this way: in investigating a complaint we work on the customer’s behalf in investigating the case, and putting our expertise to work to check facts and files. In this way we produce a “level playing field” between the customer and the institution. But when it comes to a decision, we are impartial and neutral. If the facts show that the complaint is not valid, we must reject it. But even in doing that, we add value. Our explanation is often accepted by the consumer because it comes from an impartial source, and we are often thanked by customers whose complaints we have turned down. Finally we can give to those customers who are uncertain whether the treatment that they have received is fair or not, a reassurance that no company itself can

give. Because we see the whole of the market, we alone are well placed to say whether a particular transaction was fairly conducted or not.

But what standards is the ombudsman to apply when dealing with a complaint, and what should be the scope of his involvement?

how are the plans going?

So far we have at least got the construction well under way. All the staff are on our payroll, in our new home in South Quay near Canary Wharf where the fit out was completed in April on time and on budget. We have negotiated service level agreements with the existing schemes allowing us to employ their staff and process their complaints in return for an agreed level of payment. The IT infrastructure is working, and after some disruption the cases are flowing through the system. A major consultation exercise on complaint eligibility, the scope of the scheme and internal complaint handling has been completed and draft rules published. We now employ some 400 staff, we have a budget of around £22 million, and we expect around 300,000 new public contacts a year and to deal with around 25,000 disputes.

Of course we have a good deal still to do. A further consultation on funding rules, setting out how our funds should be raised from various sectors of the industry is due this autumn, we have to design and install a new casework system, to harmonise all our forms and standard letters, to train all staff in the new rules and systems, to prepare and consult on a budget for the new financial year and plan for actually raising the cash. There is plenty to do in the next year.

So until 'N2' – the date on which the Financial Services and Markets Act will be brought into force - is as yet unknown the Financial Ombudsman Service operates through the legal powers of the existing schemes. In mid July the Government said that it could be expected in "about a year's time" whatever that may mean. While the delay is welcome in some respects, giving us more time to plan, too long a period in which we have to operate through the existing complaints-handling and ombudsman schemes as a 'service provider' would not be desirable.

who are we?

Structurally and legally we are a small off-shoot of the FSA. As a corporate body, we have a board appointed by the FSA, and I am appointed by the board. Our budget is to be approved by the FSA, but we are to be operationally independent. The service is divided into three main casehandling divisions, banking, insurance and investment, each headed by a principal ombudsman, each of whom is aided by three or four other ombudsmen and a total of 200 case adjudicators. Most of the complaints will be settled by the adjudicators by conciliation, but of course this is achieved against a background where both parties know that an ombudsman decision could make a binding award. Of the adjudicating staff, most have a background in the industry, and some are lawyers. We have an

enquiries unit with 80 staff to receive phone calls and to process written complaints before they are investigated.

We will be following the practice of previous schemes in publishing details of our main precedent setting cases and rulings; indeed you can already access and search online a full digest of reports and cases decided by me and my predecessors as Insurance Ombudsman. Our unified scheme will follow suit with the aim of contributing to the virtuous circle of raising standards in the institutions and spreading knowledge of pitfalls and good practice for the benefit of institutions and applicants alike. The FSA will also be requiring institutions to report to it details of complaints received by them and how they have been handled. There is considerable interest in the industry about whether the FSA may eventually move to publishing these figures in "league tables".

Standard setting

The terms of reference of the Insurance Ombudsman, to be mirrored in the rules of the new Financial Ombudsman Service, require the ombudsman to consider the terms of the contract, the applicable law, the general principles of good insurance practice, the ABI's Statement and codes of insurance practice; and to assess what solution would be fair and reasonable in all the circumstances.

It is worth reflecting on the extent to which "good insurance practice" has been identified and set down and from what source these derive. The ABI's Statement of General Insurance it will be recalled was introduced largely to persuade the government not to legislate generally on the Law Commission's report on non disclosure in insurance law, and the IOB was created at the same time. The Statement ameliorates what was recognized as the somewhat harsh effect of the law on non disclosure in the consumer field, by requiring insurers to ask relevant questions at proposal; it also prevents them relying on an exclusion to decline claims where the exclusion was not connected with the insured event. These look like fairly simple consumer protections that any self-respecting trader would wish to adopt. In addition there are now statements on critical illness insurance and income protection insurance.

These days codes of practice issued by trade associations have come in for criticism, and even the Office of Fair Trading has been uncertain of their role. The ABI bolstered the credibility of its code by bringing into being a code monitoring committee with a group of independent members and an independent chairman. But this too was seen as less than satisfactory and now the ABI's code on general insurance sales has been overtaken by the advent of the General Insurance Standards Council. Yet it is odd that these principles have not been included in the GISC's private customer code. The Statements of insurance practice are to remain the property of the industry rather than the new self-regulatory body. And the ABI is shortly to launch a General Insurance Claims Code which again will omit reference to the principles in the Statement. Why is it

the ABI and not the GISC that is producing the Claims Code? To say the least there is a somewhat uneven picture emerging.

The ombudsman is not a regulator. Nor is it the ombudsman's role to be the primary standard setter, through we recognize that in many areas, particularly those where no regulatory regime applies, the decisions that an ombudsman makes in individual cases will have the effect of setting a standard. In the world of general insurance this has meant the handling of claims. To take a very common example from the field of household insurance three piece suites caused endless problems. One armchair is damaged, but the policyholder sees his whole suite as ruined. The insurer sees an undamaged sofa and second armchair and is reluctant to pay for a whole new suite. One of my predecessors settled much of the argument by offering a relatively easy to apply formula – pay for the damaged item and 50% of the value of the remainder. Our digest of cases and reports is full of rulings from which general messages about the standards to be applied can be derived. Of course they are only binding in the individual case, but insurers know what will happen if a similar case is referred.

The ombudsman has hitherto been kept well out of the territory of most day to day interest to you – rating and underwriting. Indeed there is a specific exclusion from the insurance ombudsman's terms of reference. The assumption is that premium levels are set against the background of a free market, and consumers can shop around if they want.

The new Financial Ombudsman Service will have a broader scope across a wider picture. We will in the future have the power to accept complaints about the way premiums or bank interest rates have been set, but we will also have the right to decline to investigate such complaints if they involve the exercise by the firm of legitimate commercial judgement – whatever that may mean. Presumably evidence of unfair discrimination on the grounds of sex, race or disability would not be legitimate. And I am interested in the suggestion contained in your report that there is evidence that customers who are thought to be less likely to shop around at renewal might complain that they are being unfairly treated. The current Banking Code has some provisions designed that customers who are less prone to test the market every week do not suffer worse treatment. Banks must not allow the rates on superceded accounts to be down-graded by comparison to other comparable accounts offered by the bank. Some banks are now starting to offer differential terms to customers according to their risk rating – familiar territory for insurers. It will be interesting to see if this produces complaints for us.

The whole subject of the ombudsman's role in standard setting is about to receive further scrutiny. The Cruickshank report on competition in banking recommended that the ombudsman should set the standards to be applied in consumer and small business transactions, rather than the banking industry writing the Banking Code which is what happens now. The Government did not

accept this recommendation, and neither did I. The Treasury decided to ask an independent group to review self-regulatory mechanisms in the banking sector. Its membership is in the process of being finalised and the Economic Secretary to the Treasury said last week that she hoped to be able to make an announcement about the membership of this group shortly. We stand ready to contribute to the work of this group. Of course we should feed back to the industry and to consumers the results of what we do, and sometimes we need to produce clear guidance on which the industry can act. The point is often made that the ombudsman can rule on a particular case, but even where we see that many other consumers may be affected by the same problem, we cannot ensure that the firm changes its practice or that other customers are compensated. In relation to both general insurance and banking (as opposed to investment business) there is no regulator empowered to require firms to act in relation to whole classes of business.

Your excellent and thoughtful report on the public interest raises a number of other issues the ombudsman has to consider. The role of agents and the law of agency is certainly confusing. To find that an intermediary is simultaneously both the agent of the policyholder and of the insurer and entitled to receive commission from the insurer is unusual and often makes it very difficult to sort out the obligations of such an agent when things have gone wrong. As your report mentions, insurance intermediaries now present themselves as simply direct product retailers rather than as advisory agents. Often they brand the insurance under their own name and it is sometimes only with difficulty that the customer discovers with whom the insurance has been placed.

conclusion

The new service we are establishing is in good heart, preparing for a challenging time ahead. We know that there are high expectations of us from politicians, regulators, the industry, the media and consumers. Yet the most worrying challenge is that our very popularity may overwhelm us with work. Our hope is that the preparations we are making and the cooperation of those who work with us will ensure that this fate does not befall us, and that we can provide for consumers and the industry a service of which all of us can be proud.