Financial Services Authority

Direct line: 020 7066 4600

Email: david.kenmir@fsa.gov.uk

Mr Evan Owen
Preswylfa Dyffryn
Ardudwy
Gwynett
L44 2EH

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Our Ref:

Your Ref:

Dear Mr Owen

THE FINANCIAL OMBUDSMAN SERVICE, THE ECHR AND OTHER ISSUES

1. Following our meeting in November, we identified certain questions which we wanted to consider further, before replying to you. It has taken longer than I hoped to prepare this reply, but as you will doubtless appreciate, we wanted to research the issues you raised thoroughly and to discuss the letter with the Ombudsman. As we said when we met, we are not entitled to speak for the Ombudsman. We would summarise your questions as follows:

   A. Does Article 6 of the European Convention on Human Rights ("ECHR") require the Ombudsman to allow the parties to a hearing to cross-examine each other?

   B. Should the Ombudsman regard the FSA's consumer publications as starting time to run, in the context of the time-barring of mortgage endowment complaints?

   C. Should an independent financial adviser ("IFA") be responsible where it has advised a consumer on the basis of product literature or other material provided by a regulated product provider; should the Ombudsman decline to determine complaints, where there is a dispute between an IFA and a regulated product provider as to their respective liabilities for a complaint?

   D. Why should IFAs which have resigned or retired from regulation before December 2001 ("N2") continue to be subject to the Ombudsman's jurisdiction?

2. When dealing with the various points you put to us in Birmingham, I have not distinguished between those made by you and those made by Andrew Kerr. This has been done for convenience and is not intended to be discourteous.

3. There are three preliminary points to make regarding your questions with respect to the Ombudsman, which expand on what I said towards the start of our meeting. These relate to the framework for the Ombudsman's accountability.

- First, the manner in which the Ombudsman determines individual cases is a matter for it alone to decide as an independent body. However, the FSA and the Ombudsman have procedures in place for handling complaints that may have wider implications for firms and consumers. "Wider implications" cases include those where there is a widespread issue which could give rise to significant consumer detriment and where regulatory action by the FSA may be appropriate. This process is not designed to respond to complaints by the parties about individual cases, or the procedures of the Ombudsman or the FSA.

- Second, while the Ombudsman's determination is likely to include many of the considerations which would be relevant in a court of law in determining liability, the Ombudsman is not limited to reaching the same outcome as a court. Parliament's objective, as reflected in the Financial Services and Markets Act 2000 ("FSMA"), is for the Ombudsman to achieve a "fair and reasonable" result in individual cases.

- Third, there are nevertheless checks and balances on the Ombudsman's powers. These are the high level requirements in FSMA, the more detailed requirements that are set out in the Disputes Resolution: Complaints ("DISP") part of our Handbook, and the need, as a public body, to comply with the principles of public law and the Human Rights Act. As you know, judicial review is available to firms (or complainants) who consider that the Ombudsman has not complied with any of these standards.

Subject to these points, our more detailed response to your questions is as follows.

A Cross-examination and ECHR

4. As you will appreciate, cross-examination is a right expressly given by the ECHR to a defendant charged with a criminal offence. In relation to civil cases, including Ombudsman decisions, individual countries have a greater latitude in ensuring that, looked at overall, there has been a "fair trial". The Ombudsman's usual practice is to resolve cases without the need for hearings. If a complaint cannot be resolved by adjudication, the Ombudsman will consider whether a hearing will help to resolve the issues in dispute and whether the complaint can be fairly determined without an oral hearing - whether or not one of the parties has requested one. Where the Ombudsman decides to hold a hearing I understand that he writes to the parties with an explanation of the procedure he will adopt. That procedure is less formal than court proceedings and there is no cross-examination, but each party can ask the ombudsman to put

questions to the other party, provided that these are relevant to the issues in the determination.

5. We do not consider that this process means that the determination will be in breach of Article 6. While cross-examination is a part of the trial process in conventional civil litigation in the UK courts, the Ombudsman process follows the inquisitorial model, in which the decision-maker directs the conduct of the hearing, including asking questions of the parties. These questions could be suggested by the parties, or come from the decision-maker himself. This model is used in a number of countries which have signed up to the ECHR and we do not think that the Ombudsman is in breach of Article 6 in following it.

B FSA material and time-bars

6. Our understanding of your proposition is that, because the FSA has published, since late 1999, fact sheets and other information aimed at consumers, to alert them to the possibility that their mortgage endowment policies might suffer a shortfall, the Ombudsman should treat that date as when time should start to run, for the purpose of time-barring consumer complaints.

7. We think that the Ombudsman is right in not accepting that as a general proposition. There are a number of reasons for this view. First, our fact sheets and other consumer publications can only ever be generic and are not aimed at individual consumers. They should not be interpreted as having indicated to any particular consumer that they had in fact been mis-sold an endowment policy. Rather, the publications were intended, at a high level, to alert consumers to various possibilities, of which mis-selling was one.

8. Second, it should be clear from the updates to DISP 2.3 from February 2003 onwards that we have not regarded our consumer publications on their own as being sufficiently specific to an individual consumer's circumstances to trigger the time-bar provisions. It would not be consistent with this approach to attribute awareness of a "cause for complaint" to all consumers, simply on the basis of our consumer publications. Our view is that time-barring (as with other areas of the Ombudsman's jurisdiction) is a fact-specific issue, so that the question of whether a consumer, in relation to any individual complaint, did in fact have the relevant awareness, before he or she received the first "red" letter, can only be decided by reviewing that consumer's circumstances. For convenience, I attach paragraphs 3.9 to 3.11 of our Policy Statement on Consultation Paper 158, published in January 2003, which covered this ground.

9. That the Ombudsman is approaching the time-barring issue by reference to the circumstances of individual complaints (including, therefore, the ability to find that time did start to run before the first "red" letter was received) can be seen from the case studies set out in the Ombudsman News (for example, in editions 40 and 50).

C Responsibility for complaints as between an IFA and the product provider and how they should be decided

10. You were critical, at our meeting, of the possibility that an IFA could be liable to a consumer, where the IFA had advised the consumer using material prepared by a product provider. Obviously it is necessary to consider the facts of each case, but it seems to us that where a consumer receives specific advice from an IFA, responsibility for the advice given would usually rest with the IFA.

11. This does not mean that the IFA is subject to a strict or absolute liability. The courts only require the IFA to meet the standards of the reasonably competent professional adviser. Nor does it mean that a product provider can avoid liability where, for example, the complaint relates to misleading financial promotions sent by the product provider to the consumer, or a failure by the product provider to fulfil its contractual obligations to the consumer, where such a contract exists, rather than the suitability of the product. In addition, an IFA may be able to rely on information received from a third party, if the requirements set out in Rule 2.3.3R in the Conduct of Business ("COB") part of our Handbook are met.

12. A development of the concern discussed above is this. In the course of making an advised sale, it will be usual for an IFA to take into account promotional and other material provided to the IFA by the product provider. You consider that, where the consumer makes a mis-selling complaint, it is not fair for the Ombudsman to determine the complaint between consumer and IFA in isolation. You think a fairer approach would be for the Ombudsman to exercise its discretion, and refer the question of the respective liabilities of the IFA to the consumer, and of the product provider to the IFA, to the courts to resolve.

13. We do not agree with this suggestion. The policy underpinning the Ombudsman scheme is to provide an alternative to the courts as a way of resolving disputes between a customer and financial services firms, for present purposes, the IFA. This in turn reflects the difficulties involved in litigating through the courts (expense, delay and complexity). These adverse factors would be magnified, if the litigation involved not only the determination of the consumer's claim against the IFA, but also the IFA's claim against the product provider.

14. While we accept that this is capable of imposing a material burden on a small firm/sole trader IFA, we think it is a reasonable policy outcome as between the interests of consumers and regulated firms. It is also possible that PI insurance may be available to the IFA in circumstances in which similar funding for a consumer would not be. The Seymour v Ockwell case shows that small IFAs are able to obtain a contribution from a large product provider through the courts.

D Complaints about pre-N2 business against retired IFAs

15. While some retired IFAs may consider it unfair that they remain subject to the Ombudsman's jurisdiction despite having resigned or retired prior to N2, we must also consider the interests of the customers of those firms who would otherwise have

no recourse to the Ombudsman in relation to complaints about pre-N2 business. Taking into account that a retired IFA could be liable to a claim in the courts for at least 15 years from the date of his advice to a consumer and also the long-term nature of many of the products sold through IFAs, we think that it is reasonable in policy terms for retired IFAs to remain liable, subject to the rules in DISP (including the time bar rules), for their advice after they have left regulation.

16. Against that policy background, the Treasury's transitional provisions, the DISP rules and the old PIA/Fimbra rules determine the Ombudsman's jurisdiction over complaints about pre-N2 business. The Ombudsman does not have a discretion (except where provided for in the transitional provisions and the rules) to treat a complaint as outside his jurisdiction when it is not. Before considering this material, I should note that the alternative to transitional provisions giving the present Ombudsman jurisdiction would have been to keep in force the former ombudsman schemes and powers. This would have been expensive and a greater burden on firms. Furthermore if firms could avoid their obligations to their customers simply by cancelling their authorisation it would seriously undermine our consumer protection and market confidence objectives.

17. It may be helpful to set out our understanding of how the Treasury's transitional provisions and the rules affect firms which ceased to be authorised before N2. In summary, key issues for IFAs will usually be whether or not a firm joined the PIA from July 1994 onwards and when a complaint was received. If e.g. a Fimbra firm became a PIA member on or after July 1994 then, if the firm could not resolve the complaint, the consumer could refer it to the PIA Ombudsman ("PIAOB") (provided the complaint arose out of business regulated by the PIA, or earlier business which was subject to the rules of either the SIB or (in this case) Fimbra). It follows that, in this type of situation, because the PIAOB is a scheme covered by the Treasury's transitional provisions, the firm could be subject to the present Ombudsman's jurisdiction.

18. In relation to those firms which were Fimbra members, did not join the PIA but had not effectively resigned from Fimbra by April 1996, the position is similar. Fimbra's rules and any changes to them, were binding on any firm which was still a member at that time, even if it was not actively trading. With the setting up of the PIA and the PIA Ombudsman, Fimbra's rules were changed with effect from April 1996, to require members to cooperate with the PIAOB. This was subject to the qualification that a complaint against a Fimbra member which had not been resolved and which had been referred by the consumer to Fimbra's arbitration scheme before April 1996 would be concluded under that scheme.

19. Ultimately, the test is whether the firm was at any time subject to a requirement of the PIA or Fimbra to co-operate with and be subject to awards of the PIAOB. A firm did not need to be a member of the PIA at N2 in order to be subject to the PIAOB's jurisdiction at N2. As outlined above, this will cover Fimbra firms that became members of the PIA or which were subject to the Fimbra rule change in April 1996 which made them subject to the PIAOB (e.g. because their application to join the PIA had yet to be determined). It will also cover firms that became Appointed

Representatives of PIA member firms, as the PIA rules (Rule 8.1.1(3)) applied PIA procedures to any complaints relating to business written when the firm was directly authorised by Fimbra. A Fimbra member which had effectively resigned from Fimbra before the various transitional rule changes took effect, and had not become an Appointed Representative, would not, on the other hand, be subject to the present Ombudsman's jurisdiction.

20. I am aware that, in some quarters, there is surprise that the Ombudsman is not subject to the 15 year long-stop limit that governs court claims in negligence. The Policy Statement referred to in paragraph 8 above also covered this ground, noting that there was no requirement for the rules to follow the time limits for court claims (although, as a matter of policy, they generally do). The Statement also explained that, having regard to the long-term nature of retail financial services products (such as pensions and endowments), "we do not consider it is in the interests of consumers to rule out the possibility of complaints being dealt with outside the 15 year period that would apply to court cases. Nor do we consider this necessary to prevent hardship to firms".

I hope that the above will help you understand the FSA's position in relation to the questions you raised at our meeting in Birmingham.

The matters raised in this letter are of importance and we expect them to be of interest to many of our stakeholders. Therefore in order to ensure that our position is fully understood we intend to publish this letter on the FSA's website and make it available to the media.

Yours sincerely

David Kenmir
Managing Director
Regulatory Services Business Unit

3.8 A few respondents commented on the short time (one month, which by necessity covered the 2002 Christmas and New Year period) given to respond to CP158 and requested an extension of the consultation period.

Our response: We were concerned that some consumers might start to be affected by time bars, resulting from the first reprojection letters, as early as February 2003. So we aimed to make rules at the FSA Board in January. We also wanted to ensure that our response to time bar issues was proportionate. As well as taking account of the phasing of the reprojection system, we also drew conclusions from:

- consumer research on the understanding of endowment problems and the ease of making a complaint; and
- quarterly data returns to us from endowment providers, which indicated the fairness of complaint handling.

We initiated pre-consultation with trade bodies (including ABI and AIFA) in July 2002 who then determined how best to engage with firms.

As a result we did not have fully relevant information on the need for changes to time limits, and their likely impact, until November 2002. To make rules at our January Board, and avoid our emergency powers under s155 (7) of FSMA, we had to adopt a one-month consultation process. We also received a high number of responses representative of all relevant sectors, trade bodies and specialist individuals covering the full range of views. So we did not consider an extension was necessary.

Q2: Comments are invited on the three proposed rule changes:

Q2(a): Time should only start to run as a result of sending a reprojection letter, if it is a red letter.

3.9 About a third of respondents disagreed with the proposal that a only red reprojection letter ("there is a high risk that your endowment policy will not pay out the target amount at the end of the term") should start the time running. They suggested that either red and amber ("a significant risk"), or all colours of letter, should start the timing.

Our response: Our view is that:

- a consumer receiving a red letter will have specific information that their policy is likely to fall short of its target sum at maturity. This, alongside the messages contained within our factsheet, alerts them to the grounds on which they might have been mis-sold, and the likelihood that they will have lost money as a result;
- consumers who received an amber or green ("the policy is on track") letter might also be alerted to the fact that they might have cause for complaint that the policy was mis-sold to them. They too may have suffered financial damage as a consequence, but in these cases the likelihood of this damage will be less clear from the reprojection

letter. We consider that the receipt of an amber or green reprojection letter would not provide such clear intimation of financial damage as would justify the start of the three-year limitation period. These consumers remain entitled not to complain until the point where they become aware that there is a potential problem relating to their own circumstances (potentially at the point where they receive a subsequent and red reprojection letter);

- a customer who receives an amber letter will have been told that there is a risk of the endowment not paying out enough to cover the target amount. Receipt of such a letter might give rise to a duty on consumers to take steps to mitigate the loss that they have suffered. This could require them to take action to reduce their exposure to the market risk to which they are subject. This might involve, for example, converting their interest-only mortgage into a repayment mortgage, or topping up the endowment policy with extra payments. A failure to take action of this type might result in the complainant receiving less compensation than would otherwise be the case. This is because the losses suffered after the duty to mitigate loss arose might not be compensatable in full or at all. Whether a duty to mitigate in fact arises will depend on the facts of each individual case.

3.10 Some respondents believed that the three-year time bar began in January 2000, with the first FSA factsheet, or earlier, when the mortgage endowment problem came to light. And so they believed that the three years had already expired, from the time the policyholder first became aware of the issue.

3.11 Some respondents believed that there might be individual circumstances by which consumers came into possession of requisite knowledge of grounds for complaint *before* the first FSA instigated mailings in January 2000.

Our response: We agree that for some consumers, the 'time clock' would have started ticking at some earlier point, and our proposed rule changes do not alter the normal time limits of such circumstances. However, any such knowledge would have to include some form of individualised calculation which indicated that a shortfall was expected, using the potential growth rates used for illustrations at the time, and providing encouragement to take action as appropriate. We believe that consumers receiving standard form annual statements, or surrender values of their policies, or other communication (e.g. from an IFA), would not in themselves be enough to alert consumers to both:

- potential mis-selling of their policies; and
- resulting financial damage so as to start the three year limitation period.

Similarly general media stories, and a mailing or FSA factsheet in the absence of any individualised statement would not be enough to start the 'clock ticking'.

Q2(b): The extension where necessary of the time limits, to allow complainants six months after the receipt of a reminder within which to complain.