ombudsman
news

Financial Ombudsman Service

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essential reading for financial firms and consumer advisers

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about this issue

On page 2 of this issue we look at cases involving mortgage underfunding. This is the situation where someone with a repayment mortgage has paid the full repayment amount quoted by the lender – but subsequently discovers that the lender quoted an incorrect amount. It can often be several years before anyone realises that something is wrong. And by then, the borrower may have paid off much less of their mortgage capital than they thought. Our article examines the four most common areas of difficulty in the mortgage underfunding disputes that are referred to us, and explains the approach we take when deciding fair compensation.

Following the expansion of our jurisdiction last month to include insurance intermediaries, we set out on page 5 the range of insurance intermediary activities that we now cover. We also explain the transitional arrangements for dealing with complaints when the event that is the subject of the complaint occurred before insurance intermediaries joined our jurisdiction.

Finally, on page 7 our article *is compensation taxable?* explains – in broad terms – our understanding of some general principles relating to the tax treatment of any compensation that we award.

edited and designed by the publications team at the Financial Ombudsman Service

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1 common problems in resolving mortgage underfunding cases

Mortgage underfunding cases continue to form a steady part of our work. They involve repayment mortgages, where borrowers have been paying the full repayment amount quoted by their lender – but subsequently find that the lender quoted an incorrect amount. It can often be several years before anyone realises that something is wrong. And by then the borrowers may have paid off much less of their mortgage capital than they thought.

Our briefing note *Redress for mortgage underfunding* (found on our website – www.financial-ombudsman.org.uk – in the publications section, under 'technical briefing notes') explains the approach we take when deciding fair compensation in underfunding cases. Mortgage lenders are able to use that information to arrive at a suitable offer of compensation, thereby settling the matter satisfactorily without the need for our direct involvement. Customers are able to use the briefing note to check that the offer made to them is in line with the sort of amount we would be likely to recommend or award, if their dispute remained unresolved and was referred to us.

But we still see cases where mortgage lenders do not seem to have taken proper account of the approach set out in our briefing note, or have perhaps not interpreted it in the way it was intended. To help clarify matters, this article examines the four most common areas of difficulty in the cases referred to us:

- using out of date compensation calculations
- accounting for periods of mortgage arrears
- accounting for capital repayments and overpayments; *and*
- changes in the customer's circumstances.

using out of date compensation calculations

Some mortgage lenders are still using the methods of calculation that were used by the former Building Societies Ombudsman and Banking Ombudsman schemes.
These methods were superseded some years ago when these schemes merged into the Financial Ombudsman Service.

... it can often be several years before anyone realises that something is wrong

phone **0845 080 1800**
switchboard **020 7964 1000**
website **www.financial-ombudsman.org.uk**
technical advice desk **020 7964 1400**

Financial Ombudsman Service
South Quay Plaza
183 Marsh Wall
London E14 9SR

We never use the outmoded calculation methods now, even if the underfunding began before the Financial Ombudsman Service existed, and we are likely to uphold complaints referred to us where the mortgage lenders have tried to offer settlements based on old methods (a common example is offering to pay half of the shortfall in the mortgage balance). If we are satisfied that the only reason the case has not been settled is because the mortgage lender used an out of date method of calculation, we may decide to make an additional award of compensation to reflect the fact that the lender has caused the customer unnecessary inconvenience.

accounting for periods of mortgage arrears

The idea of compensating mortgage borrowers in underfunding cases is to make up for the fact that they have lost the chance to make the higher repayment. Some mortgage lenders take the view that, if mortgage borrowers were in arrears for any amount of time, then they would not have been able to afford the higher payments anyway. These lenders argue that the borrowers have lost nothing during the period when they were in arrears, so any compensation for underfunding should be reduced accordingly.

... every case is individual, and the effect of arrears can be a difficult area to decide.

We consider such an approach to be over-simplified. We look far more closely at the customer's arrears history before making a decision about whether the arrears should affect the overall compensation figure. Lenders will find it helpful to look at the type of arrears on the account before arriving at a settlement offer. Every case is individual, and the effect of arrears can be a difficult area to decide.

We will, for example, look at whether the arrears were static or whether they were increasing over the whole period of underfunding. If the arrears were clearly increasing and the customers cannot identify any realistic means by which they could have made higher monthly payments, we may conclude that no actual loss was caused through their paying the wrong amount. However, we may still award some compensation for the inconvenience caused.

Arrears are often caused by a specific event, such as unemployment. In these cases, customers usually address the problem as soon as possible, generally by paying off the arrears by means of a set amount each month. If the arrears were decreasing over the period of the underfunding because the customer was budgeting sufficiently (and there was enough available income), then we are likely to conclude that the customer would also have been able to budget for the higher repayment amount. In that case, we would not reduce the compensation at all.

... the customer's financial circumstances may have changed for the worse by the time the underfunding is recognised.

accounting for capital repayments and overpayments

Mortgage lenders are sometimes unsure how to treat the effect of capital repayments and overpayments. Confusingly, a mortgage can still be underfunded even if – because the customer has made capital repayments or extra monthly payments – it is actually on course to be repaid before the end of the original term. The extra payments that the customer made mask the underfunding – they do not cancel it out.

Customers often make capital repayments if they receive a financial windfall. If the customer was still maintaining the monthly repayments, we normally assume that the customer could also have maintained the higher monthly repayment – had the lender requested it – and this would have put the customer even further ahead with their payments. The mortgage lender should take the customer's capital repayment into account when calculating the balance that the account should have reduced to, if the lender had quoted the correct monthly repayment.

Some customers decide to try to repay their mortgage more quickly, either by paying a set amount each month, over and above their basic mortgage repayment, or (when interest rates fall) by continuing to pay at the higher rate. There is no reason to suppose that such customers would not have adopted the same strategy if the lender had quoted the correct repayment amount. Extra repayments of this type should not usually interfere with a customer's entitlement to compensation for the underfunding caused by the lender quoting an incorrect monthly repayment.

changes in the customer's circumstances

The customer's financial circumstances may have changed for the worse by the time the underfunding is recognised. Retirement may be imminent or the customer may have been obliged to leave work early. This may mean that the ordinary approach to underfunding does not produce a fair outcome. So the lender might have to make an extra allowance for the effect on the borrower of having to maintain higher repayments from a fixed or reduced income.

Lenders should be open to the idea of tailoring settlement offers to take these types of special circumstances into account, by providing (for example) interest-only or interest-free concessions where appropriate.

2 transitional arrangements for insurance intermediaries

In issue 42 of *ombudsman news*, we noted that our jurisdiction has recently expanded to include insurance intermediaries. This article outlines the insurance intermediary activities that are now covered by the Financial Ombudsman Service. It also explains the arrangements for dealing with *relevant transitional complaints* – those that concern events that occurred before insurance intermediaries joined our jurisdiction.

firms within our jurisdiction

From 14 January 2005, the following activities became regulated by the Financial Services Authority (and therefore fell within our jurisdiction):

- dealing in insurance contracts as agent
- arranging deals in insurance contracts
- advising on insurance contracts
- assisting in the administration and performance of insurance contracts.

This means that many firms which carried out such activities and were previously outside our jurisdiction – such as insurance brokers – are now covered by the ombudsman scheme. We also have jurisdiction over firms that have been granted interim permission by the Financial Services Authority to carry out general insurance mediation activities.

There are a few specific exceptions to this extension of our jurisdiction:

- travel agencies – when the insurance is sold as part of a package holiday
- retailers – when selling extended warranties on some goods, such as refrigerators and televisions
- loss adjusters – but *not* loss *assessors* who act for customers in relation to insurance claims; *and*
- the handling of insurance claims on behalf of insurers under a delegated authority.

retrospective jurisdiction

As well as having jurisdiction over complaints about events occurring on or after 14 January 2005, the Financial Ombudsman Service also has a limited 'retrospective' jurisdiction. This covers some complaints about events that occurred before 14 January 2005. The retrospective jurisdiction comes about because of provisions set out in a statutory instrument informally known as *The Mortgage & General Insurance Transitional Order*.

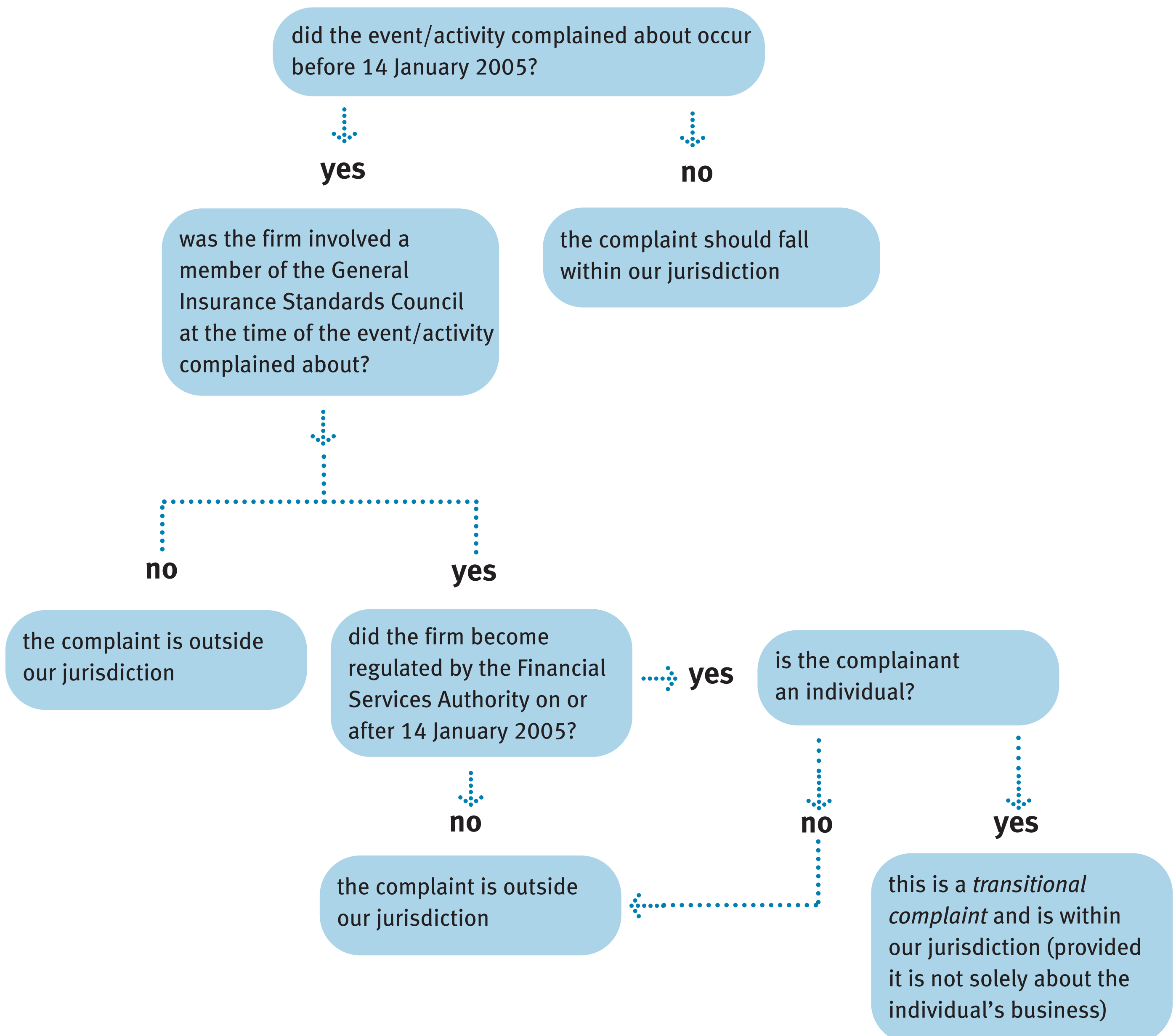
... our jurisdiction has recently expanded to include insurance intermediaries

The Order allows us to look at complaints about intermediary activities that occurred before 14 January 2005 if:

- the firm was a member of the General Insurance Standards Council at the time of the event complained about
- the complaint would previously have been covered by the General Insurance Standards Council Dispute Resolution Facility
- the complainant is an individual who is acting otherwise than solely for the purposes of his business; *and*
- the firm became regulated by the Financial Services Authority on or after 14 January 2005.

Such complaints are known as *relevant transitional complaints*. While we will determine them in line with our 'fair and reasonable' jurisdiction, we must also take into account what the General Insurance Standards Council might have decided. We will not have jurisdiction over any complaints that the Council was already handling before 14 January 2005. Our usual time limits will apply.

In a future issue of *ombudsman news* we will include case studies illustrating some of the jurisdiction issues surrounding transitional arrangements for intermediaries. In the meantime the following flow chart should help to clarify which retrospective complaints we are able to look at.



3 is compensation taxable?

This article is based on a technical briefing note, published on our website at www.financial-ombudsman.org.uk. It explains, in broad terms, our understanding of some general principles relating to the tax treatment of any compensation that we award. In particular it deals with:

- compensation in mortgage endowment cases
- compensation for being deprived of money
- compensation for investment loss
- compensation where an account is reconstructed.

The exact tax treatment of the compensation awarded to any individual consumer is likely to depend both on the circumstances of the case and on the consumer's own wider financial and tax position. This is not something the Financial Ombudsman Service can advise on. Ultimately it is a matter to be resolved between the individual consumer and the Inland Revenue.

1 compensation in mortgage endowment cases

Where we uphold mortgage endowment complaints, we usually require the firm to put consumers in the position they would be in now if they had originally taken out a repayment mortgage instead of the endowment mortgage. Our approach to redress in these cases follows the guidance in the Financial Services Authority's handbook (DISP Appendix 2 – often still referred to as 'RU89' by some in the industry).

Payment of compensation calculated in this way is unlikely to create any liability to income tax or capital gains tax. But surrendering or selling the endowment policy may trigger a gain that may be taxable. The firm will then usually be liable to refund any tax (under DISP Appendix 2, paragraph 2.5.9G).

2 compensation for being deprived of money

The following are examples of compensation in cases where we uphold a complaint that the consumer has been deprived of money.

- An insurance company wrongly refused to pay out on Mr A's insurance claim. We required the insurance company to pay Mr A's claim, plus interest on the claim to the date of payment.

- A bank did not pay Mrs B the proceeds of her investment until June, even though the investment had matured in January. We required the bank to pay Mrs B interest on the proceeds from January to June.

- Mr C was not in a position to invest, but an investment company wrongly persuaded him to pay into one of its investment policies. We required the investment company to cancel the policy from the beginning and to refund Mr C's contributions with interest.

In cases like these:

- The compensation we award is for being deprived of money. As in the examples on page 7, this is usually interest until the date the money is paid.

- This part of the compensation is potentially subject to income tax, even if it is not described as interest. Usually the law requires a firm to deduct income tax at the basic rate from such compensation – and to pay this to the Inland Revenue. This is to prevent tax evasion.

- If the consumer is not liable to income tax at the basic rate, they can reclaim the deducted income tax from the Inland Revenue. In order to help the consumer reclaiming the tax deducted, where relevant, the firm is required to provide the consumer with a certificate of tax-deduction.

3 compensation for investment loss

Where we award compensation for an investment loss – typically because the consumer was put in the wrong product or account – the tax position depends on whether the consumer still has the wrong product or account.

a) where the consumer *still* has the product/account

The following cases are examples of compensation where we uphold complaints that the consumer was put in the wrong investment or account, which the consumer still has.

- Miss D was planning to invest but had no particular investment in mind. An investment company wrongly advised her to take out an unsuitable investment – which then lost money. We required the investment company to pay Miss D what her investment would have been worth if the capital had grown at 1% a year above Bank of England base rate, less the current value of the unsuitable investment.

- Mr E was planning to take out investment X, but a financial adviser wrongly persuaded him to take out an unsuitable alternative investment – Y – which performed worse. We required the financial adviser to pay Mr E what investment X would have been worth, less the current value of the unsuitable investment – Y.

- Mrs F had money in her deposit account with a bank. The bank wrongly persuaded her to move the money into an unsuitable investment which then lost money. We required the bank to pay Mrs F what her money would have been worth if it had been left in the deposit account, less the current value of the unsuitable investment.

In cases like these:

- The compensation we award is for investment loss. As in the examples above, this is usually based on what would otherwise have happened to the consumer's money.
- This kind of compensation is not usually subject to income tax, even if it is calculated by reference to an interest rate. And the law does not require a firm to deduct income tax at the basic rate.
- The consumer may be liable to pay capital gains tax on it. Whether or not capital gains tax is payable will depend on the consumer's individual circumstances. The law does not require firms to deduct capital gains tax from such compensation.

b) where the consumer *no longer* has the product/account

The following cases are examples of compensation where we uphold complaints that the consumer was put in the wrong investment or account, which the consumer no longer has.

- Miss G was planning to invest but had no particular investment in mind. An investment company wrongly advised her to take out an unsuitable investment – which then lost money. To reduce her loss, Miss G cashed in the unsuitable investment a year ago. We required the investment company to pay Miss G:
  - her loss (calculated as what her investment would have been worth a year ago if the capital had grown at 1% a year above Bank of England base rate, less the sale price of the unsuitable investment); *plus*
  - interest on that loss from the date the unsuitable investment was cashed in until the date the compensation was paid.

- Mr H was planning to take out investment X, but stockbrokers wrongly persuaded him to take out an unsuitable alternative investment – Y – which performed worse. The unsuitable investment matured a year ago. We required the stockbrokers to pay Mr H:
  - his loss (calculated as what investment X would have been worth a year ago, less the maturity value of the unsuitable investment – Y); *plus*
  - interest on that loss from the date the unsuitable investment matured until the date the compensation was paid.

In cases like these:

- The tax treatment of the two parts of the compensation is likely to be different.

- The compensation for the investment loss to the date the unsuitable investment was sold (or matured) is not usually subject to income tax – in the same way as explained in section 3(a).

- The compensation for being deprived of the investment loss from the date the unsuitable investment was sold (or matured) is potentially subject to income tax – in the same way as explained in section 2.

4 compensation where an account is reconstructed

The following cases are examples of where we require firms to reconstruct an account.

- A building society temporarily mislaid two of the mortgage repayments that Mr and Mrs J had made. We required the building society to reconstruct Mr and Mrs J's mortgage account, so that the interest was adjusted to what it would have been if the repayments had been credited at the right time.

- A bank agreed an increased overdraft for Mr K, but forgot to update its computer system. The computer system treated the increased overdraft as unauthorised, and applied a higher rate of interest and charges. We required the bank to reconstruct Mr K's account, so that only the correct interest and charges were applied.

The tax position will be based on the account as reconstructed – and will be the same as if the firm had never made the error.

window stickers

The FSA's rules require firms to display a notice in their branches or sales offices, showing that they are covered by the Financial Ombudsman Service [rule reference DISP1.2.9(3)]. This rule does not prescribe the format, size or wording of the notice, so firms have the scope to produce the notice in their own house style, to match their marketing and information materials.

Many firms have chosen to show they are covered by the Financial Ombudsman Service by displaying our window sticker in their offices. For more details about the sticker please contact our technical advice desk on 020 7964 1400.

services for firms and consumer advisers

our **external liaison team** can

- provide training for complaints handlers
- organise and speak at seminars, workshops and conferences
- arrange visits

phone **020 7964 1400**
email **liaison.team@financial-ombudsman.org.uk**

contact our **technical advice desk** for

- information on how the ombudsman service works
- help with technical queries
- general guidance on how the ombudsman might view specific issues

phone **020 7964 1400**
email **technical.advice@financial-ombudsman.org.uk**)

treatment of section 75 claims

Q At the Citizens Advice Bureau where I work, we sometimes advise clients who have difficulties after purchasing goods and services from traders based outside the UK. We always check whether the clients used a UK credit card and, if so, whether section 75 of the Consumer Credit Act might assist them. As you will be aware, this legislation says that credit card providers are jointly liable with suppliers if a consumer has a valid claim for misrepresentation and/or breach of contract where the cash price of an item is between £100 and £30,000.

We understand that the Office of Fair Trading is going to appeal against the High Court ruling – made in November 2004 – that the consumer protection given by section 75 of the Consumer Credit Act 1974 did not generally apply to overseas transactions.

What approach is the Financial Ombudsman Service taking in cases involving section 75 claims for overseas transactions that you deal with in the period between the November court decision and the later appeal?

A Whether section 75 applies to transactions made while abroad has long been a matter of dispute.

Many people now use their credit cards – rather than travellers cheques or cash – to pay for goods and services while they are abroad. As you say, the recent High Court ruling decided that section 75 does not apply generally to transactions abroad. The Office of Fair Trading then announced that it would appeal against this decision.

Many card issuers voluntarily give their customers protection on overseas transactions that is equivalent to that provided by section 75, up to the amount of the credit provided to the customer. The Financial Ombudsman Service will take this good banking practice into account when deciding what is fair in any particular case.

suitably qualified?
a financial adviser writes ...

Q I've recently seen a letter in the trade press querying the qualifications and experience of your case-handling staff. Exactly what kind of background do these staff have?

A Our 500-plus team of adjudicators come from a wide range of backgrounds – from IFAs, trading standards officers and compliance officers to accountants, lawyers and stockbrokers. The qualifications of our staff reflect their diverse backgrounds and meet the needs of the particular type of work we have recruited them for. This breadth of experience and qualifications can also be found in our panel of ombudsmen, whose biographical details you can see on our website (www.financial-ombudsman.org.uk). Click on *about us* and then go to *our ombudsmen and senior staff*.

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