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essential reading for people interested in financial complaints – and how to prevent or settle them

Financial Ombudsman Service

ombudsman news: banking and loans

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chief ombudsman

We received plenty of feedback on the first one - not just in response to the mortgage underfunding consultation - and it's good that the industry, commentators, and other interested parties are keen to follow so closely what we're doing.

We start with our feedback statement about the consultation on mortgage underfunding that we included in our first issue. We circulated this feedback statement a few weeks ago to those who responded to the consultation and to lenders, but it now gets a wider airing. We continue the mortgage theme with some comments on the signature and retention of mortgage offers. We also look at early repayment charges on business loans, and highlight how lenders treat such charges differently from the charges on domestic mortgages.

Our "in brief" section includes: the treatment of insurance complaints after N2 (the date when the Financial Services and Markets Act takes effect and the Financial Ombudsman Service acquires its full powers); a case where the firm was held not to be liable for what its customer did; and some issues concerning accounts of minors.

In preparation for N2, we have introduced a new computer system and new procedures, while firms are preparing to meet the Financial Services Authority's requirements about internal complaints-handling procedures. We touch on some issues connected with these preparations.

in this issue

We also include a guest article written jointly by the British Bankers' Association, Building Societies Association and Council of Mortgage Lenders. They fulfil an important role as industry trade associations and we appreciate their contribution to ombudsman news.

As always, I'm grateful to our team of ombudsmen and staff for their continuing and unfailing commitment - and to those, both within the division and in the communications team, who have put together this banking and loans edition of ombudsman news.

mortgage underfunding compensation: feedback statement

background

In the March 2001 banking and loans issue of ombudsman news, the Financial Ombudsman Service consulted about the approach to compensation in cases of mortgage underfunding - where the borrower had made the regular payment quoted by the lender, but the lender had quoted too low a figure.

The Banking Ombudsman Scheme and the Building Societies Ombudsman Scheme had differing approaches to calculating compensation in such cases - both approaches prepared and published some time ago by former ombudsmen.

We consulted about a proposed new single approach for the Financial Ombudsman Service, for complaints received from the date we call "N2" (1 December 2001 - when the Financial Ombudsman Service acquires its full powers under the Financial Services and Markets Act 2000).

In view of the consultation, the Banking Ombudsman Scheme and the Building Societies Ombudsman Scheme both withdrew their previously published approaches. As this meant suspending work on current cases, the consultation period was necessarily short. We are grateful to all those who took the trouble to respond. Respondents understood the reason for the shortness of the consultation period.

Banks provide the majority of mortgages. Nine banks responded: Barclays; Bristol & West; Clydesdale; Halifax; HSBC; National Westminster; The Royal Bank of Scotland; Yorkshire; and one other bank, which did not wish to be named.

Building Societies provide most other mortgages. Eleven building societies responded: Britannia; Ecology; Furness; Nationwide; Penrith; Skipton; Stroud & Swindon; Yorkshire; and three societies who did not wish to be named. Five consumer bodies responded: Consumers' Association; Financial Services Consumer Panel; Limavady Community Development Initiative; National Association of Citizens Advice Bureaux; and Northern Ireland General Consumer Council.

Three other bodies responded: the Council of Mortgage Lenders; Forbes, Solicitors; and the Office of Fair Trading.

if the lender was less than 100% to blame

The consultation was about the approach to compensation where the lender was 100% to blame. Some lenders asked what our approach would be where we considered a lender less than 100% to blame.

We did not consult on this because we do not intend to change the approach to this currently adopted by the Banking Ombudsman Scheme and the Building Societies Ombudsman Scheme. This is summarised later in this feedback statement.

missing repayment vehicles

Some lenders also touched on the approach to compensation in cases of missing repayment vehicles - where the policy intended to repay an endowment or pension mortgage had not been taken out or had lapsed.

Different considerations may arise in missing repayment vehicle cases. They are outside the scope of this consultation. We will consider the approach to these cases in due course.

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compensation - common approach

No respondent questioned the desirability of adopting a harmonised approach for compensation in banking and building society mortgage underfunding cases.

notional past savings

The key issue respondents focused on was the suggestion that, where the lender was 100% to blame, notional past savings should not be deducted in most cases. The consumer bodies and most banks supported this approach. Most building societies opposed it.

Support for not deducting notional past savings came from:

- five banks
- two other banks, in cases where the mortgage offer gave the wrong repayment
- one building society
- five consumer bodies
- one firm of solicitors.

Opposition came from:

- two banks
- ten building societies

(including the four lenders which asked for their responses to remain anonymous).

Neither camp welcomed the prospect of making detailed enquiries into how borrowers had arranged their past and current finances in reliance on the incorrect information from the lender - in order to see whether the past savings were identifiably available still to set against the shortfall.

FSA mortgage endowment advice

The consultation document mentioned the prospect of Financial Services Authority guidance to firms on the approach they should take to notional past savings when dealing with complaints about mortgage endowments. That guidance has since been published.

The Council of Mortgage Lenders indicated to us differences of view among its members about whether it would be logical and consistent to harmonise the treatment of notional past savings in mortgage underfunding cases with that Financial Services Authority guidance.

The Financial Services Consumer Panel considered that mortgage underfunding cases and mortgage endowment cases were entirely different. We consider there are some comparisons to be made. But there are also some crucial differences.

The guidance from the Financial Services Authority deals with the consequences of a rule breach by an investment firm. It is guidance to firms about the approach they should take in all mortgage endowment cases, based on legal and regulatory requirements. It deals with notional past savings in the context of putting borrowers in the position they would have been in if they had taken out a different type of mortgage - and considers whether any amount payable by the firm should be affected by those savings.

This feedback statement deals with the consequences of an error by a lender. It is a briefing about the approach that the ombudsmen will take in those mortgage underfunding cases that come to us for resolution, based on fairness (which may go beyond legal and regulatory requirements). It deals with notional past savings in the context of correcting an error in the mortgage the borrowers actually took out - and considers whether the mortgage debt owed to the firm should be affected by those savings.

concerns

Concerns expressed by those lenders which opposed the proposed approach to notional past savings included:

Cost to the lender.

Some lenders commented that the proposed approach would substantially increase the cost to lenders. We accept that this is so in individual cases. But we consider this a less material consideration than providing borrowers with fair compensation for lenders' mistakes. Lenders can reduce the cost of their mistakes by improving their systems, to minimise the number of cases in which they quote the wrong repayment, and by themselves auditing repayments on a periodic basis.

Complainants would be making a profit.

Some lenders argued that borrowers would be making a profit if they did not account for the notional past savings - even if the money had been spent in good faith on things that could not now be turned back into cash. But we consider this fails to take account of the severe practical difficulties facing borrowers with unexpected holes in their mortgage accounts, which they cannot fill now with money spent in good faith, in previous years.

Unfairness to other borrowers.

Some lenders suggested that it would be unfair to other borrowers if notional past savings were disregarded. This would leave complainants better off than borrowers who had been quoted the right repayment. But we must also consider fairness between complainant and firm. And we find it difficult to believe other borrowers would envy the complainant who, even if the unexpected hole in the mortgage account were filled, is faced with a sudden and unexpected hike in future repayments because of the lender's mistake.

Borrowers who identified an error would have an incentive to say nothing.

Some lenders pointed out that compensation increased the longer it was before the mistake was detected. This would give borrowers who realised the mistake an incentive to say nothing. But even under the previous approaches, compensation increased the longer it was before the mistake was detected. And we do not hold lenders 100% to blame in cases where we consider the borrowers must have detected the error earlier. The notional past savings are likely to have accrued in comparatively small monthly amounts. In the light of our experience, we consider it is fair and reasonable to make some assumptions about how most borrowers are likely to have acted.

They are likely to have arranged their finances in reliance on the information from the firm. Most borrowers live up to their incomes. It is likely that they will have spent the savings on things that could not now be turned back into cash. So the notional past savings are unlikely to be available now to fill the sudden gap.

An unexpected mortgage shortfall is a real burden, added to by a sudden hike in future payments. After carefully considering the views expressed, we consider that it would be fair and reasonable not to deduct past savings in the majority of cases.

borrowers in arrears

The effect of this approach to notional past savings is that, in the majority of cases, borrowers will be given credit for the repayments they would have made if the lenders had provided correct information.

We do not consider it fair and reasonable to give borrowers such credit where it is apparent they would not have made the correct repayments, because they ran up arrears even against the incorrect lower repayments quoted by the lenders.

Two of the consumer bodies that responded commented on the treatment of borrowers in arrears. One agreed with our intended approach. The other argued that borrowers in arrears deserved additional consideration.

borrowers in advance

Sometimes, unknown to the borrowers, the underfunding lengthens the mortgage term.

Occasionally, this is counterbalanced by capital payments the borrowers made (perhaps from an inheritance or a redundancy payment) with the intention of shortening the original mortgage term.

We are likely to disregard such capital payments when calculating compensation.

past inconvenience

Two lenders argued that, if we do not deduct notional past savings from any capital shortfall, we should at least take them into account in assessing whether to award compensation for past inconvenience.

We find that point persuasive. The borrowers will have derived passing benefits from the notional past savings. Ordinarily, it would be fair to set that against any passing distress or inconvenience until the error is sorted out.

So, where we disregard notional past savings, we are unlikely to award compensation for past distress or inconvenience - except to the extent that such compensation would exceed the amount of the notional past savings.

future inconvenience

Two consumer bodies considered that compensation should be awarded for the inconvenience of having to make increased future payments.

But we consider that adding further compensation for the future repayments, at the rate which the borrowers should actually have been paying from the start anyway, would over-compensate borrowers.

Another consumer body considered that lenders should give a period of grace before implementing increased payments, and should waive any early repayment charge for borrowers wishing to remortgage.

We do not propose to make these points part of our general approach, but they are options that lenders may wish to consider and that we may decide are fair and reasonable in the circumstances of some specific cases.

future approach where the lender was 100% to blame

A typical case where the lender was 100% to blame would be where the mortgage offer itself quoted an incorrect monthly repayment, the borrowers paid that amount in good faith, believing it to be correct, and the borrowers raised the matter with the lender as soon as the discrepancy became obvious.

The Financial Ombudsman Service will be required to decide cases on the basis of what is fair and reasonable in the circumstances - which means that it is not limited to the strict legal and regulatory position. The Banking Ombudsman Scheme and Building Societies Ombudsman Scheme are in a similar position (unlike some other current ombudsman schemes).

The Financial Ombudsman Service intends to adopt the following approach in cases it receives from N2, where it considers the lender was 100% to blame. The approach will be kept under review in the light of experience.

The Banking Ombudsman Scheme and the Building Societies Ombudsman Scheme have decided to adopt the same approach in respect of cases received before N2.

Ordinarily, we will tell the lender to write off the capital shortfall that has built up to the date the mistake was sorted out - and we will not deduct notional past savings.

Exceptionally, we will deduct notional past savings (without interest) from the capital shortfall:

- to the extent the lender can show that the past savings are still retained by the borrowers as identifiable and readily-realisable assets;

- unless the borrowers can show that it would be unreasonable to do so in the particular circumstances.

Where appropriate, we will also award compensation for past distress or inconvenience - but only so far as it exceeds any notional past savings we have disregarded.

Ordinarily, we will not award compensation for the future inconvenience of having to make increased payments.

future approach where the lender was 100% to blame

Exceptionally, we will further modify the approach where we consider it reasonable in the circumstances of the particular case.

For example:

• Where the borrowers are near or beyond retirement and cannot afford the future payments, even if the whole shortfall to date is written off, we might award some compensation in respect of the future additional payments, or require part of the loan to be interest-free.

• Where the borrowers would not have taken out the mortgage at all if they had been told the correct repayment figure, we might compensate them on the basis of putting them in the position they would have been in if they had not been misled.

• If the borrowers could have afforded the correct repayment at the outset, but later ran up arrears by failing to pay all of the incorrect lower repayment, compensation is likely to be reduced accordingly.

examples

The consultation paper gave examples of the different approaches, based on a case where:

the loan was intended to be a £50,000 repayment mortgage over a 25 year term

the monthly payments were actually of interest only, because of a mistake by the lender

the mistake was discovered after 5 years, with 20 years of the term left

at that stage, the mortgage debt was £3,836 higher than it should have been

notional past savings were £3,363.

The effect of the new approach is shown below.

The examples assume we decided that £250-worth of inconvenience was caused to the borrowers.

Ordinarily:

• we would not deduct any of the notional past savings from the capital shortfall

• we would require the lender to write off the whole capital shortfall of £3,836

•we would not award anything for inconvenience, because the disregarded notional past savings of £3,363 exceed the £250 we would otherwise have awarded.

Exceptionally, if the lender showed that £1,000 of the past savings formed an identifiable and readily-realisable part of the borrowers' current assets:

• we would deduct £1,000 of the notional past savings from the capital shortfall

• we would require the lender to write off the remaining £2,836 of the capital shortfall

• we would not award anything for inconvenience, because the disregarded notional past savings of £2,363 exceed the £250 we would otherwise have awarded.

Exceptionally, if the lender showed that all the past savings formed an identifiable and readily-realisable part of the borrowers' current assets:

• we would deduct all of the notional past savings from the capital shortfall

• we would require the lender to write off the remaining £473 of the capital shortfall

• we would also award £250 for inconvenience.

where the lender was less 100% to blame

Typical cases where the borrowers would have to accept part of the blame, and where we would reduce the compensation proportionately, are where:

• the mortgage offer itself quoted an incorrect monthly repayment; the borrowers initially paid that amount in good faith, believing it to be correct; but the borrowers later discovered the discrepancy and kept quiet; or

• the mortgage offer itself quoted the monthly repayment; but the lender collected the wrong amount by direct debit; and the borrowers kept quiet about the discrepancy in circumstances where they must have realised something was amiss; or

• the lender provided, and discussed with the borrowers, an illustration that quoted the correct monthly repayment; the subsequent mortgage offer quoted an incorrect monthly repayment; and the discrepancy was such that the borrowers must have realised something was amiss.

Some lenders appear to over-estimate the ability of borrowers to spot such mistakes. By their very nature, these are mistakes that have not been spotted by the lender - despite its greater knowledge and resources. Borrowers must not shut their eyes to the obvious. But was the mistake obvious if the lender itself did not spot it.

Not unreasonably, borrowers expect lenders to be able to calculate repayment figures correctly. Most borrowers do not have the knowledge or resources to audit lenders' figures. Most borrowers know nothing about "repayment profiles".

Many borrowers believe that the capital balance on a repayment mortgage hardly decreases in the early years, and the true capital position is often confused by the debiting of other items (such as property insurance premiums) to the mortgage account. But once the borrowers do discover the problem and keep quiet, it would not be fair to disregard any notional past savings which accrue after that.

practical issues

past cases

We will not reopen past cases where a full and final settlement was agreed between lender and borrower.

Nor will we reopen past cases that were the subject of an initial decision (accepted by both parties) or of a final decision by the Banking Ombudsman Scheme or Building Societies Ombudsman Scheme.

current cases

We will adopt the new approach in cases we have on hand. In some cases, this may mean that we award compensation that exceeds earlier offers made by lenders in good faith - based on the previous approaches before they were withdrawn. We will endeavour to make it clear to the borrowers concerned that the lenders are not to be criticised for this.

future cases

We will adopt the new approach in all new cases we receive. No doubt lenders will bear this in mind in attempting to settle mortgage underfunding cases directly with borrowers.

Lenders may quote our approach, provided they do so fairly and not selectively.

distress and/or inconvenience

Some lenders queried the factors to be taken into account when assessing compensation for distress and/or inconvenience. We will be publishing more general guidance on this topic in due course.

Meanwhile, in view of specific queries raised, we wish to make it clear that such compensation is not proportionate to the size of the loan or to the borrower's income.

Compensation should reflect what an average person would have suffered in the circumstances of the case - taking into account such factors as the age, health, intellectual capacity and experience of the particular customer.

In most cases, it is likely to be at least £150. It might go up as far as £1,000 (or more in an exceptional case) if:

- the lender pursued the borrowers for alleged (but non-existent) arrears;
- the lender was slow to accept and correct its mistake; and
- hardship was caused to the borrowers.

help for lenders

Lenders wishing to settle cases with borrowers themselves along the lines we would adopt, but unsure of how our approach would apply in particular circumstances, can contact our technical advice desk:

phone: 0207 964 1400 or by email: technical.advice@financial-ombudsman.org.uk

signature and retention of mortgage offers

Many complaints from domestic mortgage borrowers involve a dispute about what was - or was not - said during the mortgage interview. Often, the borrowers allege that they chose a specific mortgage deal on the strength of some particular comment or assurance from the lender's employee.

Usually, the point at issue is one that should have been covered in the mortgage offer, so our first step is to ask for a copy of this. The lender's position is strengthened if it can produce a copy of the mortgage offer, endorsed with the borrowers' signed acceptance.

If the lender can produce a copy of the offer, signed by the borrowers, then the borrowers cannot dispute having seen it. And, with limited exceptions, customers who sign a document such as a mortgage offer letter are bound by what it says - whether or not they read it.

But some lenders don't ask borrowers to sign mortgage offers. House buyers have to deal with a multitude of papers and if mortgage offers are not given sufficient importance, it is more understandable that borrowers may fail to spot problems at the time. Requiring borrowers to sign and return a copy of the mortgage offer emphasizes the importance of the document. And, as we have said before, it's not good enough for the lender to try and shift the responsibility on to the conveyancer.

Things are made even worse if the lender doesn't keep copies of mortgage offers as a matter of routine. Such lenders expect us to rely on what they say would have been sent to the borrowers - and they then send us sample copies of what their documentation looked like at the time. That can backfire on the lender, as the following case study illustrates.

04/01

signature and retention of mortgage offers

When Mr and Mrs A applied for a mortgage, the lender gave them a detailed two-page mortgage illustration, produced by its computer system. Mr and Mrs A proceeded with the mortgage, but decided to repay it after a couple of years. The lender then claimed that since they were repaying the mortgage within five years, they would have to pay an early repayment charge. The lender said the early repayment charge was explained in the mortgage offer, and in its instructions to the conveyancer.

However, the lender did not have a copy of either document. It asked us to rely on the documents it said its computer would have produced in respect of the particular product code.

how we helped

Mr and Mrs A said they had not expected to receive any documents other than the illustration, and that they had not, in fact, received a mortgage offer.

The conveyancer still had a copy of the lender's instructions on file and provided us with a copy. This document explained the early repayment charge, but we were not satisfied that the conveyancer had explained the charge to Mr and Mrs A. That failure counted against the lender, rather than the borrowers. In completing the mortgage, the conveyancer was acting for the lender. Indeed, the lender's instructions to the conveyancer specifically said "please act for us in the transaction".

The lender asked us to assume that Mr and Mrs A must have received a mortgage offer, and that (like the instructions to the conveyancer) that offer must have referred to the early repayment charge. We were not prepared to make that assumption. The offer should have been produced by the same computer system that produced the detailed illustration. But the illustration did not mention the existence of an early repayment charge. So the system was not infallible. Or did the lender want us to assume its computer was designed to produce detailed illustrations that did not mention the early repayment charge that would suddenly appear in its mortgage offers.

early repayment charges on business loans

Single-figure base rates have become the norm in recent years, but many people can remember when (not that long ago) interest rates were three times what they are now.

So fixed rates provide an obvious benefit to borrowers - who know their repayments will remain affordable throughout the fixed rate period.

Fixed rate loans for businesses have generally been around for rather longer than they have for domestic mortgages.

And the trend towards lenders making early repayment charges linked to interest rate movements arrived in the business loan market before moving to the domestic mortgage. An increasing number of businesses are complaining to us about this type of early repayment charge.

why make a charge-

We have no quarrel with the principle of lenders imposing reasonable early repayment charges on fixed rate loans that are repaid early. Typically - to balance their books - lenders fund fixed rate loans by borrowing in the money market at fixed rates for fixed terms.

If borrowers redeem their loans early, lenders can be left to pay interest on their own borrowing. And if interest rates have fallen in the meantime, the lenders will face a shortfall between what they can earn on the repaid money and what they still have to pay on their original money market loans.

But why draw a distinction between the market for business loans and the market for domestic mortgages- Are there different considerations between those two markets- Well, the simple answer is - yes, there are. That's the reason for this article.

legal position - transparency

The law says that adults (including those who sign on behalf of a business) are usually bound by any contracts they sign - whether or not they read them or understand them.

But unusual or onerous contract provisions are not binding if they are buried in the small print. And, because of their potential impact, early repayment charge provisions will usually be onerous. They must therefore be fairly brought to the attention of the person signing the contract - either by being obvious and intelligible in the contract itself, or by being pointed out and explained.

To this extent, the position is broadly the same whoever the lender is dealing with. But how far should the average business be treated differently from the average domestic mortgage borrower-

We take the view that someone who runs a business should be more used to dealing with business contracts. So we generally expect a higher level of understanding from business owners, or a higher readiness to seek professional advice on anything they don't understand. Put another way, business owners will find it more difficult to satisfy us that they should not be bound by the clear terms of a document which they have signed.

legal position - transparency (continued

But there are different sorts of business borrower. At either extreme, a lender could be dealing with highly qualified and experienced people running a substantial business, or with an inexperienced sole-trader who's only just gone into business, perhaps using the trade he learned as an employee before being made redundant.

We are required to decide cases on the basis of what is fair in the circumstances. The contract documentation needs to be appropriately intelligible. But experienced business people who did understand cannot escape liability because a less experienced person might not have done.

Some lenders' business loan agreements and domestic mortgage agreements contain similar contract provisions, but are very differently worded. The business loan agreement is usually the one the lender has not reviewed as recently, so its language is generally much less plain. There seems no good reason for that.

fairness

Our adjudicators have already decided a number of domestic mortgage cases in favour of borrowers because the early repayment charge provision, though brought sufficiently to the borrower's attention, was unfair under the Unfair Terms in Consumer Contracts Regulations (see page 26 of the March 2001 edition of ombudsman news for just one example).

But - at least for the purposes of those Regulations - businesses are not consumers. So, the Regulations do not apply to business loans. That can produce unfortunate results for inexperienced sole-traders.

In effect, they alternate several times each day between being a consumer and being a business owner - but they are treated differently by the law, depending which "legal hat" they are wearing.

practical issues

how is the early repayment charge calculated-

Early repayment charges based on the movement in market interest rates usually start from the fixed rate at which the lender actually lent to the borrower. The movement is measured to some current rate - typically either the current fixed rate at which the lender says it will lend money to new borrowers or the current fixed rate it says it can get by reinvesting the money on the money market.

To calculate the charge, the interest rate differential is then multiplied by the amount being repaid early and the unexpired term of the original fixed rate period. Some lenders then go on to discount that figure to give a "net present value". This takes into account the fact that the lender is getting its money in one go, earlier than it would have done if the loan had continued for the full fixed rate period.

But the way in which some lenders calculate their charges does not always agree with the "explanations" that appear in their own loan agreements. Some of those "explanations" appear unnecessarily complex or ambiguous. And there are some common principles that lenders could adopt to achieve reasonableness and fairness.

The key points are perhaps best illustrated by some recent examples.

06/02

early repayment charges on business loans

Here is an extract from one lender's early repayment charge provision:

"... any loss will reflect the cost to the Bank of unwinding funding transactions undertaken in connection with the Loan. Costs will be incurred when there has been a reduction in the Market level of the appropriate interest rate underlying the Loan. The cost will be equivalent to the loss of interest income (including loss of margin) to the Bank as a result of re-deploying funds at a lower interest rate than that which prevailed when the Loan was booked."

Our adjudicator was satisfied that the contract provision had, in this case, been satisfactorily drawn to the attention of the borrowers, M & C. However, M & C did not think the lender was actually calculating the charge in accordance with its own explanation. The reference to "a reduction in the Market level of the appropriate interest rate underlying the Loan" should be taken as referring to a current lending rate.

The lender was using the rate at which it said it could reinvest the money on the money market for the remainder of the original fixed rate period; this produced a higher early repayment charge. Although the lender may have intended to operate the clause in this way, it did not actually say that "redeploying" meant reinvesting. The lender prepared the documents - and it is a well-established principle that any uncertainty in a document is to be construed against its author.

how we helped

During our adjudicator's investigation, we also suggested to the lender that to reflect the true loss to the lender, the charge should be discounted to its net present value - even though this was not specifically stated in the contract provision. The lender responded initially by saying it only did this when the early repayment charge exceeded £100,000 (in this case, it was a little over £90,000).

On appeal, the ombudsman upheld the adjudicator's decision. But before we issued a final decision, the lender told us it had changed its policy and now discounted all early repayment charges - at a higher rate than the adjudicator suggested in his adjudication.

So, in the event, the overall reduction in the early repayment charge increased between our adjudication and final decision. M & C have not yet repaid the loan but, when they do, the effect of our recommendation will be to reduce the early repayment charge by more than a third.

06/03

early repayment charges on business loans

In this case, involving a different lender, the borrowers, S&J, were given a choice when they took out their £380,000 loan.

They could pay either:

- a non-refundable prepayment option fee of 1.5% of the loan "up-front"; or

- a market-rate early repayment charge if they wanted to repay some or all of the loan before the end of the twenty-year fixed rate period.

S&J decided not to pay the 1.5% fee (£5,700) and took the risk of an early repayment charge.

The early repayment charge provision in the loan agreement said, among other things, that the borrowers indemnified the lender against any funding losses it incurred as a result of early repayment. The clause went on to say that the amount the lender claimed could not be challenged - unless the figure was obviously, and blatantly, wrong.

how we helped

When S&J wanted to repay their loan early, they were not happy with the size of the early repayment charge - it was over £30,000. And although our adjudicator decided that S&J were required to pay a charge, she considered that the lender was not calculating the charge fairly, in accordance with the contractual provision. She also decided that the lender's statement that the amount due was not open to challenge did not prevent her from delving into the formula it had used.

When she did so, she discovered that when the lender identified the current lending rate for the purpose of calculating the charge, it did not necessarily do so on the same day the borrowing was to be repaid. So there could be a mismatch either way - benefiting either the borrower or the lender. We considered the lender should not approximate the figure in this way, when the contractual provision did not provide for it. Borrowers are entitled to have their charges calculated accurately.

In this case also, the lender did not discount the early repayment charge to its net present value. But we said that it should do that too. So the overall effect of our recommendations was to say that the lender should make a substantial refund to the borrowers.

Although the lender is now challenging the exact calculation of the discount, it does accept that the way it applied its early repayment charge formula meant that it had charged the borrowers too much - and that discounting was appropriate.

early repayment charges on business loans - things for lenders to consider

- Take a fresh look at your business loan agreements. Are they as clear and intelligible as the agreements for your domestic mortgages-
- Think about the sort of borrower you're dealing with. Doesn't an inexperienced sole trader need to be treated differently from a large, long-established business-
- Do you actually calculate charges in the way that your contract provisions say- Are those provisions clear, or open to misinterpretation-
- Should you not, as a matter of course, be looking to re-lend the money- Using a current fixed lending rate will result in lower early repayment charges to borrowers.
- Are you discounting early repayment charges, to allow for the fact that you are now receiving all the money in one lump sum.

in brief ...

- insurance complaints after N2
- case study - firms not responsible for what their customers do 06/04
- case study - minors' account 06/05

insurance complaints after N2

Many banks and building societies sell general insurance (such as loan payment protection) as intermediaries. Complaints about such sales are covered by the Banking Ombudsman Scheme or Building Societies Ombudsman Scheme - whose cases are dealt with by the banking and loans division of the Financial Ombudsman Service.

But from N2, (1 December 2001 - the date when the new regime comes into effect), complaints will be allocated to the Financial Ombudsman Service's case-handling divisions according to the product involved, rather than the type of firm that sold it. So the insurance division will deal with complaints that are solely about insurance. And, when dealing with subsidiary insurance issues in banking complaints, the banking and loans division will follow the insurance division's lead, to ensure a consistent approach.

So (if they haven't already done so) banks and building societies may wish to look at the April 2001 insurance issue of ombudsman news, to familiarise themselves with the Insurance Ombudsman's general approach to such cases. This focuses principally on the responsibilities of the insurer, but there are also implications for intermediaries. See the back page of this edition for details of how to obtain our publications.

You can get further guidance on our general approach to insurance cases from our technical advice desk:

phone 020 7964 1400

email: technical.advice@financial-ombudsman.org.uk

firms not responsible for what their customers do

Banks and building societies check up on people who open accounts with them. But there is a balance to be struck between being overly cautious and overly free-and-easy. A firm can't necessarily be held responsible for what its customers use their accounts for, provided it acted reasonably and with an appropriate amount of care. Here's a recent case which shows what we mean.

06/04 - Mrs B replied to a national newspaper advertisement offering "business opportunities" linked to betting on horses.

Mrs B replied to a national newspaper advertisement offering "business opportunities" linked to betting on horses. The advertiser had a banking account and Mrs B paid money into that account. But the "opportunities" were a scam - the money was soon withdrawn and the advertiser disappeared. Mrs B said the firm where the advertiser had its banking account should pay her money back.

Her reason was that she had subsequently discovered that, at the time she paid her money into the account, the advertiser had been under investigation for fraud.

The firm knew of the investigation - but the account had been properly opened. At the time Mrs B paid the money over, no prosecutions had been started and there was no freezing or court order in place. The firm therefore had no authority to refuse to accept money paid into the account, and was under no obligation to do so. So we did not require the firm to make any payment to Mrs B.

minors' accounts

Complaints involving the accounts of minors don't come up very often. But, with more banks and building societies trying to encourage children to open accounts, such complaints may well grow.
More often than not, the law about what a minor can, and cannot, be held accountable for is not always fully understood - especially by parents or relatives, who invariably become involved in the complaints

06/05- Mr C was 16 years old and had two current accounts (with different firms) and a savings account. He managed these accounts well.

He recently paid in to one of his current accounts a £2,000 cheque from Mr D, and then withdrew most of the money and gave the cash to Mr D. Shortly afterwards, the cheque bounced, so Mr C owed the firm £2,000 and was unable to get the money back from Mr D.

Mr C's father argued that his son had been "led astray" by Mr D. Up until then, his son had been careful with his money. The father said the firm had failed to protect his son from the effects of having a cheque bounced.

He wanted the firm to write off what his son owed.

If this had happened in England or Wales, English law would have provided that repayment of an overdraft cannot be enforced against a minor. But Mr C lived in Scotland, where the position is different. Ordinarily in Scotland, 16 year olds are liable for what they do. But Scots law also allows a court to set aside a transaction if it considers it to be "prejudicial".

So, in effect, Mr C (through his father) was asking us to consider his withdrawal of the money as "prejudicial". However, we decided Mr C was well aware of the risk and effect of a cheque bouncing - because it had happened to him before. He paid the money to Mr D knowing what might happen, even though he may have considered it unlikely. We did not uphold the complaint.

procedures - towards N2

The March 2001 issue of ombudsman news outlined the modifications we are making to our complaint-handling process, in readiness for N2. We've made a start at making some of those changes already - so that, by 1 December, the transition should be reasonably seamless for everyone.which reach us. A recent case highlights some points.

our new computer system

Our new computerised case-handling system - "Croesus" - has now been rolled out and the banking and loans division transferred to this system towards the end of May.

It was no easy task to devise a common computer system which would fully support the handling of cases under the new Financial Ombudsman Service rules - while allowing all the existing schemes to operate under their old rules. We felt that where there were differences of practice and procedure which weren't rule-based, we'd try to bring them together as we launched Croesus. This would mean there'd be less for firms to have to get used to when N2 arrives.

In this, we were very much mirroring what the Banking Code Standards Board has been saying over the past few months - that well ahead of N2, firms should start changing their in-house complaints-handling procedures to meet the requirements of the Financial Services Authority.

A key change to our procedures occurs where a customer telephones us about a complaint that has not yet reached deadlock. If the customer agrees, we record the details and pass them to the firm for attention. There have been the inevitable minor teething problems but initial feedback about the impact Croesus has had on firms has been very helpful. We have made some immediate changes to improve how we do things, but we hope firms will keep their comments coming.

firms' final response letters

The changes we're making will be more than matched by the changes across the industry as a whole. So, at a time when firms are reviewing the way in which they deal with complaints, it's perhaps timely to mention a few points about firms' final response letters - what some are used to calling "deadlock" letters.

These letters usually comply with the basic requirements of saying that the complaint has reached the end of the in-house complaints procedure, and providing information about referring the complaint to the relevant ombudsman scheme. But more often than we would like, the letters do little more. It can be very unhelpful to a customer, and frustrating for us, if we have to seek out a sequence of correspondence to get the whole picture. There are times when we don't get the whole picture until much later on - and we then find that the complaint, or the firm's response, has been misunderstood and it could all have been sorted out much earlier. So, here's an extract from our recently published briefing for banks and building societies.

Whatever else the complainants show us, they must show us your final response (or "deadlock") letter. So it is in your interests for the final response letter to set out your position clearly. It is helpful to include:

- an apology or expression of regret - whether the complaint is justified or not, you have an unhappy customer
- a summary of the complaint
- a summary of the outcome of your investigation on whether you acknowledge that there has been some fault on your part n any offer you have made to settle the complaint n how long that offer will remain open
- if appropriate, why you consider the complaint is outside our rules - but explain that it is for us, not you, to decide this
- a clear statement that the letter is a final response and that, if the customer is dissatisfied with the final response, he or she may refer the complaint:

- before N2 [in the case of a bank], to the Banking Ombudsman Scheme within 6 months

- before N2 [in the case of a building society], to the Building Societies Ombudsman Scheme

- after N2, to the Financial Ombudsman Service within 6 months.

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Remember - the final response letter should be written in clear, plain language. If possible, it should stand alone. Avoid referring to previous correspondence which may not be readily available to the customer or to us. If you have to refer to previous correspondence, attach a copy.

If you haven't got a copy of our briefing and would like one, contact our technical advice desk:

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

proposals for the future of the banking and loans liaison group

a guest article written jointly by the British Bankers' Association (BBA), Building Societies Association (BSA) and Council of Mortgage Lenders (CML)

industry responses to the BBA/BSA/CML by Friday 31 August 2001

background

Following a suggestion from the Financial Ombudsman Service, the Banking and Loans Liaison Group was established in January 2000.

It comprises representatives from the BBA, BSA and CML plus a selection of practitioners from banks and building societies. Walter Merricks (chief ombudsman), David Thomas (principal ombudsman, banking and loans) and other Financial Ombudsman Service representatives also attend.

The Liaison Group's short-term aim has been to deal with the raft of consultation documents issued by the Financial Services Authority and the Financial Ombudsman Service - on, for example, the rules of the new scheme and appropriate funding mechanisms.

The Group has also looked at the "nuts and bolts" of the Financial Ombudsman Service itself and of the Financial Services Authority's rules on internal complaints procedures.

We believe it has fulfilled a useful purpose during this process. However, now that the bulk of this consultation is over, it is time to ask if there is a longer-term role for the Liaison Group - and, if so, what that role is. This article addresses that issue.

existing arrangements

Under existing arrangements, the Boards of the Banking Ombudsman Scheme and the Building Societies Ombudsman Scheme Boards have provided the corporate governance of the (voluntary) banking ombudsman and (statutory) building societies ombudsman, but have also acted as a high level forum to enable the ombudsmen to discuss issues, in confidence, with senior industry figures.

Recognising that the existing scheme boards will effectively disappear at N2, it was always the intention that, in the longer term, the Liaison Group would take over the function of providing the ombudsmen with a body with which to discuss what may broadly be described as strategic issues.

The Liaison Group evolved - and has developed - on a rather organic basis. In particular, there are no terms of reference, no specific criteria for membership, no channel to feed back to the respective trade association Councils, no real provision for secretariat, and no mechanism to elect an appropriate chair. All parties are eager to address these "democratic deficit" issues before N2.

challenge

On the assumption that some form of Liaison Group should continue (and the trade associations think it should) the challenge is to establish a body (or bodies) to pick up:

- the roles of the existing scheme boards (excluding corporate governance); and
- the more "nuts and bolts" focus of the current Liaison Group.

In addition, a re-born Liaison Group would be the obvious forum in which to discuss the Financial Ombudsman Service's annual budget consultation - before each trade association takes it to Council.

The ombudsmen feel it would be useful to have a forum in which to float topics that may be covered in ombudsman news as well as to have some input to the various briefings the Financial Ombudsman Service issues.

One possible future model is for a re-born Liaison Group to pick up both strategic and practitioner issues. Experience suggests, however, that it is not sensible to attempt to mix policy issues with operational issues of the "nuts and bolts" variety.

As an alternative, the current money-laundering model provides a useful benchmark, although that structure may be subject to change post-N2.

The Joint Money Laundering Steering Group, composed of the trade associations and chaired on a rotational basis by a Director General/Chief Executive Office of one of them, concentrates on strategy/policy issues. It also produces its own Guidance Notes. The Money Laundering Advisory Panel is pitched at the level of practitioners and concentrates on more "nuts and bolts" issues.

The money-laundering model would translate quite easily into the Financial Ombudsman Service arena, and is the preferred option of the three trade associations. In effect we would end up with the Liaison Group operating as a high level body to discuss strategic policy issues. Operational issues would be dealt with via a new "Practitioners Panel". Members of the two bodies would be drawn from the membership of the three trade associations on as fair a basis as possible.

suggested way forward

The trade associations intend to draft a common paper for all three Councils, setting out in detail the proposed "modus operandi" of the re-born Liaison Group and the Practitioners Panel. But, in order to do so, we require your input and views.

Once the paper has been to all three trade association councils, it would be the intention for the new groups to meet (for the first time post-N2) in December 2001.

The authors of this article would welcome your feedback. If you would like to have a say in what happens, please send any comments, by Friday 31 August 2001, to:

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