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INTRODUCTION

1. The Regulatory Climate

Up until the late 1970s the financial services industry in the United Kingdom was largely unregulated in the formal sense. The model was that of self-regulation without legal rules. Since 1979 there has been a shift towards more formal regulation. Deposit-taking institutions are regulated either by the Bank of England (the Bank), under the Banking Act 1987, or by the Building Societies Commission under the Building Societies Act 1986. Insurance companies are regulated by the Department of Trade and Industry under the Insurance Companies Regulation 1981 and the Insurance Companies Act 1982. The Financial Services Act 1986 covers all those 'carrying on investment business in the United Kingdom', including the Stock Exchange, investment advisors, investment managers (such as pension fund holders), the marketing of life assurance, and dealers in futures. Although the Securities and Investment Board is the head regulator, the day-to-day regulation is undertaken by regulators attached to the different sectors. Lloyds of London, the insurance market, is exempted from the Financial Services Act and still operates a self-regulatory system. Consumer credit is regulated by the Office of Fair Trading. Other more general forms of regulation which potentially have an impact on the financial services industry include: the Takeover Panel which operates under a voluntary arrangement to control company takeovers (Morse 1991); the Department of Trade and Industry, which has a range of statutory powers to control the running of companies; and the Office of Fair Trading and the Monopolies and Mergers Commission can inquire into anti-competitive practices (Fair Trading Act 1973). In addition to such formal regulation, new informal mechanisms have also grown up, which are typically concerned with the relationship between customers and the

suppliers of financial services: for instance, ombudsman schemes and codes of practice are now common place.

Although there is a range of regulatory structures, within the financial sector the Bank of England has a pivotal role. Aside from its work as the supervisor of the banking system, the Bank has a more general role because of both its links with government as a result of being the central bank and its part in appointing other regulators, such as the Securities and Investments Board (Financial Securities Act 1986).

These developments of formal and informal regulation have taken place since 1979. They, therefore, present the curious spectacle of a Conservative Government under Margaret Thatcher (which was first elected in 1979, then reelected in 1983 and 1987) being strongly committed to free market principles and yet introducing an unprecedented system of regulation into the financial services industry. An understanding of how this came about provides an insight into the forms of regulation that were adopted (Clarke 1986; Gower 1988; Hall 1987; Graham 1985; Moran 1984; Moran 1988).

The City of London has long been a leading world centre of financial services, particularly in insurance and banking, and this situation was maintained as financial services become increasingly internationalized during the 1970s and 1980s. For the most part London's continued dominance was due, not to changes in domestic institutions, but rather to an influx of foreign companies. For them one of the major attractions of London was its lack of formal regulation. This obviously had benefits for London, but it also brought serious problems. It attracted companies of dubious quality, such as the Bank of Credit and Commerce International which set up its effective headquarters in London and was closed in July 1991, and even good quality foreign institutions, released from the restrictions of home regulators, felt unconstrained by the UK tradition of informal regulation. There had also been a growing recognition amongst regulators worldwide since the 1970s, particularly since the collapse of Bankhaus Herstatt in 1974, that the international effects of the collapse of major

international finance companies meant that it was important to harmonize regulatory systems to ensure they operated according to certain minimum standards. This led to international initiatives, such as the setting up of the Committee of Banking Regulations and Supervisory Practices at Basle in 1974 and the European Community's first banking directive in 1977. It was, therefore, a curious paradox that the UK, whilst at the forefront of such initiatives did not itself have systems of formal regulation.

The Conservative Government was also committed to a lengthy programme of privatizing state-owned organizations through the sale of shares. The Government wished to spread the ownership of shares as widely as possible as part of their goal of creating 'a property-owning democracy'. They wanted to encourage people who had never invested in shares before to have the confidence to do so, indeed it was hoped that people would go from buying privatization issues to investing more widely. This required a market in shares that was accessible to small investors and a system of protecting the investments which would discourage investors from taking the view that shareholding was a high-risk enterprise. However, the most stagnant and anti-competitive part of the domestic financial industry was the Stock Exchange. Self regulation allowed the Stock Exchange to operate restrictions on entry, which reduced competition, and enabled higher fees to be charged, which deterred small investors. Moreover, the self-regulatory nature of the Stock Exchange placed the objective of investor protection in doubt.

At the same time, in other sectors of the financial services industry competition between suppliers was increasing. This was particularly evident in the banking sector where the retail banks faced strong competition from the building societies, particularly after the Building Societies Act 1986 removed many of the restrictions on the societies' business. With their core business under pressure, the major retail banks were forced into unfamiliar sectors, such as international banking, loans to third world nations, domestic banking in foreign countries, acting as agents in the sale of houses, providing insurance and share dealing facilities, and

giving investment advice. The ability of the retail banks to cope with such business has been questioned, and certainly some lost heavily, most notably in loans to the third world, the purchase of foreign banks and the attempts to enter into share dealing in the late 1980s. Competition for business has also resulted in cost cutting with banks reducing staffing levels or merging with other banks. Furthermore, the expensive branch system, which has been the foundation of retail banking, has come under scrutiny as the banks seek to move into cheaper systems, such as automated teller machines and telephone banking.

The early 1980s also saw events which powerfully undermined the City's traditional argument that self-regulation worked effectively without the need for legal rules. Two major securities dealers failed and the Government set up an inquiry under Professor Gower. His consultation document (Gower 1982) and subsequent report in 1984 (Gower 1984), followed by the Government's own proposals (HM Government 1985), laid the foundation for the Financial Services Act 1986. Gower could hardly have been more critical of self-regulation:

The perceived defects of the present system are complication, uncertainty, irrationality, failure to treat like alike, inflexibility, excessive control in some areas and too little (or none) in others, the creation of an elite and a fringe, lax enforcement, delays, over-concentration on honesty rather than competence, undue diversity of regulations and regulators, and failure overall to achieve a proper balance between governmental regulation and self-regulation. (Gower 1982, para 10.04, quoted in Moran 1988, p. 24. Also Gower 1987)

Gower was concerned with the investment sector, but the self-regulatory techniques of other parts of the financial industry had also been under attack for some time. In banking, the crisis over the collapse of some small banks in the early 1970s had led to tightening of regulation and eventually to the Banking Act 1979. This was replaced by the Banking Act 1987 when a major bank, Johnson Matthey, failed in 1984.

Over a longer period there had been the advance of the UK consumer movement. Consumer rights have been recognized by the courts since at least the eighteenth century and have been codified since the nineteenth, but a network of consumer institutions, both state and private, really only emerged as a major force from the 1950s. In the context of financial services, the consumer lobby has long taken the view that the City's self-regulation is likely to work in the interests of the firms providing the services rather than the protection of consumers. Consumer groups, therefore, pressed for independent regulation.

2. *Financial Regulation in the UK*

The basic approach of regulation in the financial industry in the UK is to seek to ensure the soundness of the suppliers of services and to regulate the relationship between the parties, rather than the services they supply. This is done through a mixture of legal rules and voluntary agreements. Having said that, there is no consistency of objectives or methods in the various regulatory systems (Gowland 1990). For instance, in banking and insurance, as will be seen, the primary objective seems to be to safeguard the system rather than individual firms or customers, and the regulator does not see its task as being to intervene in the relationship between the customers and the firms. On the other hand, in that part of the financial services industry which is regulated under the Financial Services Act 1986 the focus is less on the health of the system as a whole than on ensuring the prudential management of the suppliers of financial services and the protection of individual investors; indeed the Gower Report was titled, *A Review of Investor Protection* (Gower 1984) and the Government White Paper setting out its proposals was called, *Financial Services in the United Kingdom: A New Framework for Investor Protection* (HM Government 1985; Mayer 1993). This does not mean, however, that the relationships between banks or insurance companies and their customers are unregulated. They are, of course, covered by the normal rules of contract law as supplemented by statute law,

such as the Unfair Contract Terms Act 1977 (although, as will be seen, this does not apply to the insurance industry) and the Consumer Credit Act 1977, by Good Banking, the banking industry's Code of Banking Practice, by the Statement of Insurance Practice, and by the Banking and the Insurance Ombudsman schemes. Some of these rules and schemes do not affect the product directly, but merely seek to ensure transparency in the relationship so that customers are provided with information about the product and their rights and obligations: this is, on the whole, the case with Good Banking.

In part the lack of regulation of the product and of the relationship between the customer and the supplier results from the nature of contract law in the UK. Under common law rules are built up through a system in which the decisions of previous courts, particularly of the higher courts, become difficult to overturn. As a result reform of the rules by the courts can be virtually impossible to achieve, and any changes require the intervention of Parliament, which is usually hard to obtain because of pressure of time and the priority given to other, allegedly more urgent, government business. The introduction of codes of practice and ombudsman schemes often broadens the range of remedies available to the customer and in effect increases their entitlement to a remedy beyond that which the law allows: for instance, the Banking Ombudsman gives compensation for inconvenience, and the Insurance Ombudsman looks not only to issues of legal entitlement, but also at notions of fairness.

3. The Problems

There are other problems with these systems of financial regulation (Khoury 1990; Mayer 1993). One objective of deregulating the financial markets was to create free markets in which there would be unobstructed competition, but there was also the desire to avoid scandals which might damage the credibility of the markets. In seeking the latter objective systems of rules were created, which meant that the law and the regulators were

intervening in the market. They also brought costs of administering the system, which are typically met by the industry and taxpayers, and compliance costs, which are also met by the industry. Ultimately, the bulk of these costs is passed on to the consumer in higher fees. The consumer is, therefore, given no choice about the level of protection he or she wants. This may be justifiable in banking regulation which is supposedly concerned with protecting the banking system on behalf of the national interest, but seems less easy to justify - if the goal of competition is as important as the Government believes - in those sectors covered by the Financial Services Act 1986. The regulatory structures may also be seen as rather unsubtle instruments which do not distinguish between different parts of the industry and between different types of investor. Is it necessary to provide the same level of protection to a sophisticated investor, such as a pension fund which invests millions of pounds, as to the ordinary citizen who is investing a few hundred pounds?

Once government has imposed statutory regulation then it has, in effect, acknowledged a need to protect consumers through regulation of the industry. This makes it harder to resist demands for more regulation and protection whenever there is a major loss of consumers' funds. Moreover, once the precedent has been created then the next scandal is likely to be blamed on the government and a failure to react with legislation is likely to be heavily criticized: for instance, the post-Financial Service Act fraud committed by newspaper publisher Robert Maxwell on his company's pensioners and the post-Banking Act (1987) collapse of the Bank of Credit and Commerce International both led to pressure being brought on the government, to official inquiries (the Goode Inquiry into pensions and the Bingham Inquiry into BCCI) and to promises of legislation. Setting up such a framework of regulation and consumer protection makes it more difficult for the government to argue that investment is a risky business, that investors must be cautious in making investments, and that investors, not the government, must bear the losses. Without the acceptance that investment is a risky business, there is the danger

that both investors and suppliers of financial services will engage in reckless decisions. However, the desire to make a success of privatization issues meant that the risk element in share investment was not emphasized, and it is hard to convince people that putting money in a pension, or a bank account is a hazardous venture.

There is also the problem which a single European market in financial services poses to an industry where there is a high level of regulation. The level of regulation and the costs associated with it are issues for UK financial companies when competing in the UK against companies from other member states where regulations and costs may be less severe since, as a general rule, the UK cannot impose higher levels of regulation than are in force in the non-UK company's home country. So, for instance, if there is no ombudsman scheme in the home country then a supplier will not be required to join a UK scheme and will not, therefore, have to meet the associated compliance costs. UK companies might seek to advertise their own membership of such schemes as demonstrating a concern for consumer protection, and so, perhaps, make their products more attractive to consumers, but the evidence of a small survey of banks and building societies (see 'The Banking Ombudsman' below) does not indicate any move in this direction.

4. Conclusion

It is one of the key themes of the UK report that, whilst regulation of the financial service industry has been a response to international (worldwide rather than strictly European) changes in that industry, the most powerful factors have been domestic, most notably the various scandals which have surrounded branches of the industry and the political objectives of the Conservative Government since 1979. The domestic influences are reflected in level of intervention and the fractured nature of the regulation of the financial services industry, with its variety of rules, regulators and objectives. The impact of the European single market, both on trade between member states in financial services and on regulation, is less easy to detect.

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THE SUPERVISION OF BANKING IN THE UNITED KINGDOM

1. Introduction

After a brief outline of the structure of the banking system in the United Kingdom, this chapter discusses the development of its regulation. It is argued that this has been driven by a combination of domestic crises and the changing nature of the world financial markets rather than by the various European Community directives on banking.

2. The Structure of the British Banking System

With over 500 authorized banks, the UK is not only a European, but also a world centre for banking, and as such the industry is of great importance to the national economy. These banks can be divided into retail banks, merchant banks and foreign banks.

The retail banks are the largest of the UK banks. This sector is dominated by Lloyds Bank, Midland Bank, NatWest Bank and Barclays Bank. In total the retail banks have about 13,000 branches throughout the country. They offer day-to-day banking services to personal and corporate customers, such as cheque books, facilities for obtaining cash, credit cards, foreign exchange, money transfer facilities and loan arrangements. The merchant banks are not in the retail market and do not have chains of branches; instead they engage in raising large-scale corporate finance. Because of the importance of this part of the banking market most of the merchant banks are owned by retail banks or by foreign banks. The importance of London in international banking has resulted from, and has led to, an influx of foreign banks. Some of these have established subsidiaries in the UK and others have taken over UK banks, but most have merely set up a representative office in London.

There are other institutions which, although not banks and not subject to regulation under the Banking Act, offer specialized banking services. There are the building societies (see below) whose core business has been to provide mortgages, that is loans over a period of, usually, up to 25 years for the purchase of houses by private individuals. The money lent is raised by offering good interest rates to private individual savers. The building societies have traditionally had a virtual monopoly over mortgages, however, during the 1980s the banks and other lenders began to expand into this sector. Recently, particularly since the relaxation of the limitations on building societies under the Building Societies Act 1986, the distinctions between them and the banks have been reduced, and they now offer many of the services, such as cheque books and credit cards, which were previously the preserve of the banks.

There are also finance companies which specialize in providing loans for the purchase of cars and so forth. Many of these companies are owned by banks. Finally, a growing number of large retailing and manufacturing companies offer banking services: for instance, the major car manufacturers own finance houses, and Marks and Spencer plc, a large retail store, issues its own credit cards and runs various investment schemes.

The competition between the different financial institutions has cut into the traditional business of the major retail banks leading them to seek their profits in what have sometimes turned out to be hazardous loans or unfamiliar areas of business, such as international banking and domestic banking in foreign countries, mortgage lending, acting as agents in the sale of houses, providing insurance and share dealing facilities, and giving investment advice. The ability of the retail banks to cope with such business has been questioned. Certainly, many of the large banks have in the past lost heavily by entering unfamiliar sectors, most obviously in lending to the less developed countries in the 1970s. Competition for business has also resulted in cost cutting with banks reducing staffing levels or merging with other banks. Furthermore, the expensive branch system, which has been the

foundation of retail banking, has come under scrutiny as the banks have moved into cheaper systems, such as automated teller machines and telephone banking. Competition for business has tended to cut the links between corporate customers and the banks as the customers were able to find alternative and cheaper sources of finance during the boom of the 1980s. The consequence of this has been that when the recession came at the end of the 1980s, companies who got into financial trouble found themselves without a long-term relationship with the banks and the banks seemed, therefore, less willing to help these customers with inevitable consequences for British industry.

Coming in the wake of various scandals, such as the collapse of the Johnson Matthey bank in 1984 and of the Bank of Credit and Commerce International in 1991, criticisms that the banks were in some way failing British industry coupled with the allegations from consumer groups about the poor treatment given to individual customers meant that British banking has continued to be regarded as an issue of political importance. Banking, it is felt, is not an issue that can be left simply to the banks.

3. *The Shift in Bank Supervision in the 1970s*

In the wake of the closure of the Bank of Credit and Commerce International (BCCI) in July 1991, questions have been raised in the UK, as elsewhere, about the nature of bank supervision. What is the function of a supervisor? What powers should a supervisor have? When should they be used? How should bank supervisors in different countries cooperate to supervise international banks?

In the UK the supervisor is the Bank of England (the Bank), which was established in London in 1694. Created as a private bank, it has always had a close involvement with government, and so, although it did not become state owned until 1946 (Bank of England Act 1946), it was long been regarded as a public institution with a key role to play in bank supervision.

Before the Banking Act 1979, the Bank supervised British banking without formal legal powers - the limited power under the

Bank of England Act 1946, section 4(3), has, apparently, never been used. The Bank relied on its relationship with the tight-knit banking community centred around the headquarters of the major banks and the other financial institutions in the City of London. That relationship was rooted in mutual trust and the deterrent to dishonesty was exclusion from this City 'club'. Moreover, both the Bank and the banking community were keen to exclude lawyers and politicians from the supervisory system (Moran; Geary & Weale). Why, then, was it felt necessary to set up the more formal, statutory system of supervision?

The main problems with the informal system were the very things which were regarded as its main strengths: trust, cooperation and its elitism. As one writer has put it, 'Regulation was pictured as an exchange between partners, not as an exercise in authority.' (Moran, p. 18) But such a system only works if there is a good relationship between the supervisor and the supervised. This required the Bank not to go beyond what the banks regarded as reasonable, otherwise the relationship of mutual trust might have been put under strain. Moreover, the Bank had to rely on the banks themselves for information about the conduct of their businesses. All of this seemed to present no serious problem until the expansion of the financial markets and the heightening of competition between financial institutions developed in the 1960s and 1970s. It was then that the notion of the financial sector as a small club began to disappear.

The 1960s also saw the emergence of a strong consumer movement in the United Kingdom, which regarded government as having a positive duty to intervene in the market to ensure that consumers were well informed and protected. Each collapse of a financial institution increased pressure for tougher supervision. Of course, the likely consequence of giving in to pressure for protection through supervision is to create continued pressure for further supervision. Moreover, since government has, by setting up a supervisory structure, conceded that it has a role to play, then when things go wrong, the government and the supervisor are likely to get at least some of the blame. Of course, greater

consumer protection is also likely to lead investors to alter their assessment of the risk involved in investment. They may begin to assume that investment is risk-free and alter their decision-making process accordingly. This environment may also affect the behaviour of the banks and investment managers.

However, there was nothing new in these issues, and, whilst they provided a channel for the course of change in the system of supervision, they were not the immediate cause of that change. For this we need to look at what was happening in the financial markets in the 1970s. From the 1960s as the financial markets grew so institutions offering banking services developed outside the traditional banking sector. Under existing law (the Company Act 1967, section 123) these 'secondary banks' found little difficulty in becoming certified as moneylenders by the Board of Trade, a government department with no direct link to the Bank. This certification process was not particularly rigorous and did not, in practice, imply continuing supervision. Since these banks had been established outside the traditional banking community, they were also outside the supervision regime operated by the Bank (Geary & Weale). Problems with some of the secondary banks emerged in 1973-75. A number had built their businesses on lending to property developers, who, in turn, depended for their profit and for their ability to repay loans on the rising value of commercial property. When this market collapsed in the 1970s many of the banks came under pressure. There followed a general concern about the effect the crisis might have on confidence in sterling and in the larger banks which had themselves lent money to the secondary banks (Reid; Moran; Fay; Geary & Weale).

At roughly the same time the problem of supervising international banks was highlighted by the failure of Bankaus Herstatt in 1974. In separate discussions between bank supervisors from the leading industrial nations at Basle and supervisors from the European Community (which eventually led to the First Banking Directive) the United Kingdom was in a curious position: it had virtually no legal framework for supervision, and yet it was taking a leading part in the formulation of international rules.

4. *Regulation after the Banking Act 1979: 1979-87*

In many ways the Banking Act 1979 was an odd response to the problems of the 1970s (Moran). It went beyond the requirements of international agreements, such as the European Community's first banking directive of 1977. For instance, the Act, but not the directive, included a deposit protection scheme (see below). However, at the same time, the Act was not a complete response to some of the issues raised in the 1970s. One reason why the secondary banking crisis of 1973-75 had caused such a problem was the fear that, because the major banks had lent money to these marginal banks, panic might spread to them, yet this issue of inter-bank loans was not dealt with in the Act.

Although the Banking Act 1979 applied to all banks, the key objective was to impose control on the secondary banks since these were seen as the only source of real problems. The Act, therefore, divided the banks into two groups, with the smaller banks (termed 'licensed deposit takers') being subjected to much tighter supervision. As for the larger banks, they were put into the other group and subjected to a much lighter regime, indeed the Governor of the Bank declared at the time that he did not see the need for statutory supervision (Fay). Moreover, the Bank continued to believe that the best way to supervise all banks was through a modified version of the pre-Act model, that is, by relying on information provided by the banks and informal discussions with senior management.

It came, therefore, as something of a shock when a major bank, Johnson Matthey Bank (JMB), collapsed and had to be rescued in 1984-85 in an operation led by the Bank. JMB was one of the five gold bullion dealers who made London a leading gold market, so it was believed by the Bank - some have later argued, wrongly - that to allow JMB to collapse would be to threaten London's dominance of this important sector (Bank of England 1985; Committee on Banking Supervision 1985; Fay; Hall 1987; Moran; Treasury 1985).

The role of the Bank in the JMB collapse was viewed with concern by the major banks, who were brought in to assist in the rescue, and by government ministers, who were critical of the Bank's failure to keep them informed (Moran; Fay). It became clear that there had been a fairly lax attitude to even the soft requirements of the Act that applied to major banks. The Bank's internal systems had not been sufficiently sensitive to recognize the warning signs that preceded the collapse. The case also revealed a problem in the relationship between the Bank and JMB's auditors. Without an inspection team the auditor, who was employed by the supervised bank, was a vital source of independent information for the Bank. However, the auditors and the Bank of England were each bound by the confidential nature of their respective relationships with the supervised bank so that it was made extremely difficult for each to keep the other informed of any suspicions they might have had.

For the Bank of England JMB was only part of the problem. The banks faced increased competition during the 1980s as the financial markets were deregulated in the United Kingdom and elsewhere, and rapid improvements in information technology meant the internationalization of the markets. The rapidity of these developments made supervision difficult since it was not only the banks who were entering unfamiliar territory, but also the Bank of England (Leigh-Pemberton 1993). For the Bank the developments of the 1980s presented a tension between the goals of competition and of establishing sound financial markets.

In the wake of the JMB collapse, both the Bank of England and the Chancellor of the Exchequer, Nigel Lawson, claimed that there was no fundamental problem with the system of supervision. Lawson wrote that, 'the JMB debacle represented a wholly atypical lapse in a system of supervision that has a good record over the years' (Treasury 1985). But this was contradicted by the breadth of the suggestions for reform in the government's response (Treasury 1985), and by the relative speed with which a new Banking Act was passed. Indeed, the various failures of the system listed in the government's proposals for reform (Treasury 1985)

seemed to suggest, not a good system that had slipped up in this one case, but a bad one which had at last been found out. The core of the problem continued to be that the Bank placed too much reliance on, and hence trust in, the supervised bank.

5. *The Banking Act 1987*

The British Bankers Association (1987) feared that the Banking Act 1987 would introduce a more intrusive, rigid and bureaucratic system of supervision. The Association favoured flexibility which would enable the Bank to adjust its method of supervision to the individual institutions. However, the Bank had already declared itself keen to maintain, 'a difficult course between the dangers of inadequate supervision and the constraints of excessive regulation' (Bank of England 1985, p. 46). As a result, the tradition of informality survived after the enactment of the Banking Act 1987, although in an altered form:

The Act in general retains the traditionally unregulated system of supervision that existed under the 1979 Act, relying upon the flexibility and cooperation of the Bank and the regulated institutions. However, the Act does strengthen the Bank's supervisory role by giving a clearer definition of the Bank's function and extending its investigatory powers. (Penn 1989, p. 2)

The 1987 Act sets out frameworks for the authorization of new institutions and for the supervision of authorized institutions. It also creates a system by which the Bank is made accountable to outside bodies, and it continues the depositor protection scheme set up by the 1979 Act (Penn 1989).

The Act abolishes the two-tier system and subjects all 'deposit-taking' institutions (see sections 5 & 6; *SCF Finance Co Ltd v Masri* [1987] 2 WLR 58) to the same regime. All deposit-taking institutions must be authorized by the Bank and only those with a capital of more than five million pounds can call themselves 'banks'. Branches of overseas banks which wish to accept deposits in the UK must also obtain authorization. The procedure that must be followed in an application for authorization is not laid down in

the Act, but, in practice, the Bank requires a formal introduction from a reputable bank, or firm of lawyers, or accountants and also the completion of a questionnaire. The Act (schedule 3) does, however, list minimum criteria which must be satisfied before an institution can be authorized, although the Bank can, and does, add other criteria. The theme of the criteria is a concern to ensure, not that the institution will behave in particular ways towards its customers or that it will achieve specified performance targets, but that it will carry out its business in a prudent manner. This extends to consideration of the institution's capital reserves, liquidity, large loan exposures, provision for bad debts and for depreciation in assets, internal control mechanisms, accounting procedures, and the suitability of those in positions of importance, including managers and large shareholders. The Bank has issued a Statement of Principles (under section 16: Bank of England) in which it outlines its interpretation of the rather imprecisely defined criteria in the Act and the factors that it will take into account when making a decision about authorization and supervision. The Statement lays great emphasis on the protection of potential depositors (see below), and says that, 'The objective is to assess all the risks to which a particular institution is exposed in the light of its ability to manage those risks.' (para 2.11)

Although the powers given to the Bank to carry out its supervision of authorized deposit takers are increased by the Act they are still founded on the notion that this work is best done by obtaining information from the supervised bank, its officials, shareholders, auditors and other persons and companies connected with it. However, the supervised bank can be required to supply a report, prepared by an accountant, on a particular aspect of the business (section 39), and this is typically used to look at matters such as large exposures and bad debts. The Bank also has other powers, although these are not commonly used: the right of entry for its officers, although there is still no properly developed inspectorate or system of regular on-site inspection, and the right to appoint someone to conduct an inquiry into the conduct, ownership or control of the bank (sections 39-41).

Ultimately, the Bank has the power to revoke authorization. In addition to specific situations, in which the Bank can - or in some situations, must - revoke authorization (section 11), such as when a bank becomes insolvent, there is a general power to do so if the interests of existing or future depositors are threatened (section 11(1)(e)). The Bank does have the option to grant conditional authorization (section 12), that is, it can allow a bank to operate, but only in ways which the Bank of England prescribes: this can be used, for example, to restrict the ability to accept deposits from the general public, or to force the removal of a particular officer of the bank.

The Act makes the Bank accountable to certain outside authorities. The Bank provides an annual report to the Chancellor of the Exchequer, and this report is published (section 1(3)). The Chancellor is responsible to Parliament for the legal framework within which supervision takes place, and, although not strictly responsible for day-to-day supervision, is likely to be challenged in Parliament when things go wrong. In addition, there is a Board of Banking Supervision (section 2), which consists of three Bank officers and six other people. The Board's role is to advise the Bank on the way it should carry out its functions under the Act, both in general terms and in relation to specific banks. Where the Bank is unwilling to follow the advice given then the matter is referred to the Chancellor of the Exchequer.

Finally, there is the deposit protection fund (Part II of the Act), which was introduced in the 1979 Act. The aim was 'to prevent severe hardship among the most vulnerable depositors' (Banking Supervision, para. 3.5). If a bank collapses depositors are able to claim 75% of their deposits up to a maximum of 15,000 pounds from the Deposit Protection Board. The Board obtains its funds from the banks but is independent of them.

6. *Is the Banking Act 1987 a Success? The Case of BCCI*

In July 1991 most of the offices around the world of the Bank of Credit and Commerce International (BCCI) were closed.

Although different forms of BCCI were registered in Luxemburg and in the Cayman Islands, the principal centre of its operations was the United Kingdom - it has been alleged that the UK was chosen in the 1970s partly because supervision was fairly lenient at that time.

After the closure of BCCI the Governor of the Bank of England, Robin Leigh-Pemberton, explaining why the Bank had not stepped in sooner, said that, although there had been evidence of fraud by individual officers, there was no reason to believe that there had been 'systematic fraud' until July 1991 when the Bank received a report by the accountants Price Waterhouse, which it had ordered under the 1987 Act. He added, 'If we closed down a bank every time we had a fraud, we would have rather fewer banks than we have.' (Kochan & Whittington, p152)

What eventually led to the exposure of BCCI was not so much the various drugs money laundering cases that came to trial in the late 1980s, but an investigation into the illegal purchase of banks in the USA by BCCI. The US authorities have subsequently complained about the lack of assistance that the Bank of England gave them during this inquiry. Indeed, it has been alleged that the Bank decided to close BCCI, not because of the Price Waterhouse report, but because it was known that the New York District Attorney was about to issue an indictment against various BCCI officials following his investigations. To be fair to the Bank, similar allegations about failure to take action have also been made against the US authorities (see generally, Kochan & Whittington).

Whatever the truth of all this the BCCI affair raised a number of problems. The ability of BCCI to continue in business for so long seemed to show that the lessons of the secondary banking crisis and the JMB collapse had not been learnt, namely, that a system which places a large measure of reliance on the supervised bank for the information with which the work of supervision will be done is vulnerable if that bank is deceitful. But an indication of the difficulties facing a supervisor can be seen in the divided criticism from depositors who argued that the Bank had failed to protect them: some argued that the Bank should have either closed

the bank or warned prospective depositors of the risk involved; others, however, claimed that the Bank had acted too hastily in not waiting for a rescue package to be put together by the Sheikh of Abu Dhabi, who was a major investor in the bank.

The Bank and government ministers argued that depositors had to bear the risk that an investment might go wrong. But clearly this requires that depositors are supplied with sufficient information for them to be able to make a fully-informed decision about the risk involved. Ministers and Bank officials argued that because BCCI offered slightly higher interest rates than major banks then the depositors were on notice that the investment involved a higher degree of risk as if this were all the information that a depositor would need. Of course, the Bank faces a difficult choice: should it undertake a public form of supervision which might lead to depositors withdrawing funds, or should it attempt to restructure the bank in secret, or should it close the bank as soon as any evidence of fraud appears? The Bank favours the second option, but, of course, this means that the depositors cannot make a fully-informed decision about their investments.

As with JMB, there was also the problem of the Bank's sources of information. Once again the issue arose as to whether the Bank should regard auditors as a reliable, independent source, when they are paid by the supervised bank and also in view of the different approaches likely to be required when auditing a bank's accounts from those required when acting as a sort of surrogate supervisor.

But BCCI raised new issues, such as the potential problem of using a supervisory structure devised for western-style banks to supervise a bank part of whose business was structured around Islamic banking methods.

BCCI has also highlighted the protections that the Bank has against law suits. Under section 1(4) of the 1987 Act neither the Bank nor its employees are liable for any acts or omissions in carrying out bank supervision, unless it can be shown that the act or omission was in bad faith. Since bad faith is extremely difficult

to prove, this section gives the Bank virtual immunity from actions brought by depositors who lose money and who seek to argue that those losses can, in part, be traced back to the Bank's acts and omissions. Incidentally, similar difficulties face bank employees who allege that they have been wrongfully dismissed because the Bank has decided they are not 'fit and proper persons' to work in a bank. Before the Act there was no such immunity, and the argument advanced for its introduction was that it would enable the Bank to act swiftly to protect depositors without having to be too concerned about possible legal actions. However, it could be argued that the immunity might have the opposite effect in that it could allow the Bank to delay its decision to close a bank because it would know that even though depositors funds were in danger the Bank would not be liable. Whatever the truth of that allegation, section 1(4) does effectively eliminate any accountability of the Bank to the depositors.

Even more than was the case with the 1979 Act, the 1987 Act was passed to restore confidence in the British banking system, and, against the broader background of the deregulation of the UK financial markets after 1986, it was also part of the effort to promote confidence amongst prospective investors about the ability of the authorities to regulate the markets and to protect investors funds. The scandal surrounding the collapse of BCCI and the subsequent revelations of some of its employees suggests that the Act seems to have failed when measured against its ability to prevent collapses, detect corruption, or protect the depositors; whether it succeeded in maintaining confidence in the British banking system is a more difficult question to answer.

An inquiry was set up under the High Court judge, Mr. Justice Bingham, to look into the supervision problems raised by BCCI. Bingham concluded that no radical restructuring of the existing system of banking supervision in the UK or internationally was required, although he did suggest ways in which the system might be strengthened, and he commented that, 'ultimately supervisory arrangements can be no more effective than those who operate them: it is on the skill, alertness, experience and vigour of the

supervisors, in the UK and abroad, that all ultimately depends.' (Bingham)

7. *The Objectives of Bank Regulation*

Since, as has been argued, at the heart of UK banking supervision is a broad measure of discretion in the hands of the Bank, it is of importance to have some clear idea of the direction in which the Bank is heading when it considers how to use its powers. In general terms, there is a tension between the need to set standards through supervision and the increased competition which banks have faced in the last two decades. Competition has put pressure on profit margins and hence has made it more difficult for banks to meet certain prudential standards, such as rules on capital adequacy and liquidity. The regulator has to be aware of the dangers posed to depositors in relaxing the standards, whilst, at the same time, not imposing excessively restrictive rules on the banks which might make them uncompetitive, particularly in the wake of the establishment of the internal market. This balancing act is made more difficult by a lack of clarity about the objectives of supervision.

One of the issues to have emerged from the BCCI affair was an apparent shift in the objectives of supervision as expressed by Bank officials. In broad terms the choice is between: avoiding 'systemic disturbance', which means the setting of minimum prudential standards for all banks and, in the event of a bank's imminent collapse, assessing the likely effect of that event on the banking system as a whole as a guide to deciding whether a bank should be rescued; consumer protection, either by ensuring that individual banks do not fail or by providing compensation if they do; crime prevention; and, because bank regulation has been drawn into mainstream politics, it is impossible to ignore the impact of the political objectives of government (George). Any system is likely to seek all of these aims to some degree, the issue is which predominates when there is a conflict as there was in the supervision of BCCI.

In Fact Sheet: The Bank of England, which was a general description of the Bank's work produced for visitors just before the BCCI collapse, the aim of supervision is said to be, 'ensuring a sound and stable banking system' (Bank of England 1991). This also seems to have been what led to the decision to rescue JMB, indeed, the Chancellor of the Exchequer, Nigel Lawson, wrote after the JMB collapse:

An effective system of banking supervision is as important as the banking system itself. For without it there will not be the confidence on which sound banking depends - from the confidence of the individual depositor that his money is safe, to confidence in Britain as one of the foremost o,?) financial centres in the world. (Treasury 1985)

Yet an examination of the provisions of the Banking Act reveals a concern with the prudential management of individual banks, not systemic problems. In another publication, Fact Sheet: Banking Supervision, also produced before BCCI failed, the Bank states that, 'The main purpose of banking supervision is to protect depositors and potential depositors in banks... Given the overriding concern with the protection of depositors, the major question for the supervisor is whether a bank is financially sound.' (Bank of England 1990) The 1985 government reform proposals, which laid down the issues on which the Banking Act 1987 was constructed, seemed clear that the aim was to ensure that individual banks were prudently run so that depositors funds would be protected, concluding that protection of the system flowed from this:

The primary role of the banking supervision is to reduce the risk of capital loss to depositors as a result of the banks with which they place their funds being run imprudently. In this way, supervision also fulfils a wider role in safeguarding the stability of individual banks, and thus of the banking system as a whole. (Treasury 1985, para. 3.1)

Similarly, in the Statement of Principles, issued by the Bank in 1987 under the Banking Act 1987 (section 16) as a guide to the

way in which it intended to use its statutory powers, the Bank emphasised the protection of depositors directly. The Statement declared that the Act:

enables the Bank to exercise its powers before the threat to the interests of depositors or potential depositors becomes very great or immediate. The Bank can, therefore, where necessary intervene before the deterioration in the institution's condition is such that there is a serious likelihood that depositors will suffer a loss... [The Bank] would generally revoke [authorization of the a bank] where there was no reasonable prospect of a speedy and comprehensive remedial action, even though the threat to depositors was not immediate, for example because the institution currently had adequate capital and liquidity. (Bank of England, 1987)

However, in the wake of the BCCI collapse, in which thousands of depositors lost millions of pounds, spokespersons from the Bank of England queued up to claim that the objective was neither to protect individual depositors nor individual banks, but to ensure the safety of the system. They proclaimed the existence of a distinction between protecting the system and protecting the depositors and that the former did not necessarily flow from the latter. The Bank, it was claimed, was primarily concerned, not with the protection of depositors, but with preventing a systemic collapse. Obviously, enforcing prudential standards will provide some protection for depositors by, presumably (although for BCCI depositors there experience would suggest otherwise), preventing banks from becoming insolvent or acting fraudulently, but when the worst happens and a bank fails then, at that crucial time, the effect of the objective being protection of the system becomes clear since the Bank may decide - as it did with BCCI, but not with the 'secondary banks' and JMB - that the failure of this bank may not have an adverse effect on the banking system.

It has been said in 1993 by a key official in the Bank of England that since deposits were, unlike shares, pensions and insurance, an uncomplicated financial product, there was no need for the sort of regulation concerned with investor protection that is contained in

the Financial Services Act 1986 (George 1993). Those who invest in complex financial products need protection because, whilst it is thought to be a good idea that people should invest in these products, they might be unable to understand them fully. In such circumstances it was, in this view, proper for regulatory authorities to intervene in the relationship between the supplier and the investor. However, the uncomplicated nature of bank deposits meant that no such intervention was needed here, so the Bank was only concerned with prudential supervision, not the nature of the relationship between a bank and its depositors or in the direct protection of those depositors. As Robin Leigh-Pemberton, the Governor of the Bank, put it, 'the role of the banking supervisor is to seek to enforce prudent conduct by banks, not customer satisfaction' (Leigh-Pemberton 1993, also 1992b). For him the aim is to 'allow bank management to exercise their commercial judgment but within a framework which seeks to limit the risk to depositors.' (Leigh-Pemberton 1993) So, whilst a regulator under the Financial Services Act will look both at the structure of the business to ensure it is run prudently and at its conduct towards customers, the Bank is only concerned with the former. However, the fact that the Bank claimed that it did not recognize the danger signs until July 1991 and also that many apparently sophisticated, large-scale investors lost funds when BCCI collapsed might put into doubt the view that the depositing of money in a bank is an activity which is so uncomplicated as to require no regulation.

This links into another point. The assertion that there is no need for regulation of deposits because it is an uncomplicated financial service cannot be maintained at the same time as an assertion that depositors should accept that deposits are risk investments. As has been argued, depositors in BCCI were not given the information they needed to be able to make a rational decision about whether or not to deposit funds. The Bank of England maintains confidentiality in exercising supervision functions on the ground that if it announces that a bank is facing difficulties then there is likely to be a withdrawal of deposits which will cause the bank to collapse. But if the Bank was unable to detect the depth of the

problems at BCCI then it seems harsh to expect the depositors, with less access to information, to be able to do so. Moreover, although the regulated banks are given the opportunity to make representations to the bank, the secrecy of the regulatory process means that it is impossible for depositors to have a role in this process. Similarly, there is no opportunity for taxpayers or their representatives in Parliament to make representations about the process even though any rescue is likely to involve the expenditure of public funds by the Bank. The slim degree of accountability after decisions have been taken is of little value. It is important to consider whether some greater transparency in the regulatory process can be provided (for transparency in the USA, see Brown 1992).

Clearly, there are difficulties with an approach which concentrates on consumer protection. Most obvious is the risk of 'moral hazard', that is, offering a high level of protection may lead to recklessness amongst banks and depositors, and also the more prudent institutions would have to bear the cost of compensation, which would further reduce their competitiveness. To offset these problems the regulator would have to impose severe standards in order to prevent any failures, and these would increase costs and reduce international competitiveness.

There are, however, also problems with focusing on the protection of the banking system and largely ignoring depositor protection. What amounts to a systemic failure is difficult to define, as is, therefore, what threatens such a failure (Gowland). After the JMB rescue, there was a certain amount of anger expressed behind closed doors by the major banks who, having been persuaded to rush to JMB's assistance by the Bank, felt, on mature reflection, that allowing JMB to fail would probably have had no major effect on the banking sector as a whole. Moreover, a concern to prevent systemic collapse is likely to mean that the supervisor will only look to the protection and rescue of the larger banks, which is likely to give an unfair competitive advantage to them by undermining confidence in small banks and in banks, like BCCI, which are regarded as outside the mainstream.

8. *Europe and the Single Market*

The preceding discussion shows how the development of bank supervision has been guided primarily by domestic concerns, even the BCCI collapse has been seen in this light within the UK. It cannot be denied that the pressure from Basle and the EC on countries to harmonize regulatory standards has had its effect, indeed the UK has been one of those pressing hard for such harmonization. However, it is likely that the UK supervisory structure would have developed in much the same way as it has without those agreements.

Yet international agreements on supervision set only minimum standards since the aim is to eliminate weak supervisory regimes, and so reduce the opportunities for fraudulent banks to avoid regulation. Such agreements are, therefore, unsuited to sophisticated financial centres. Agreements on standards are not seeking to enforce exactly the same regimes, indeed, even if the rules are the same, there is no guarantee of uniform enforcement. Moreover, there is a danger that the home country rule as it operates within the single market, under which banks are regulated according to the rules, and by the supervisor, of their home state, will work to the disadvantage of banks working in the state in which they are authorized where that state has a high level of regulation and of enforcement.

The Single Market raises other issues for banks and their customers (Dixon). Although London is one of the world centres of banking, UK retail banks are not likely to find it easy to slip into Europe. There are several obvious difficulties. The first is the cost. Retail banking is all about providing customers with access to banking services on a day-to-day basis. The traditional way of achieving this in the UK has been through setting up a branch network, but this is a lengthy and expensive process. Moreover, the differences between banking services and customer expectation in different countries may make UK retail banking difficult to export: there is no guarantee that a good UK retail banker will be a good banker in Spain or Greece. There are, of course,

alternatives. A bank can takeover a bank in the targetted country and in this way acquire the skill of local staff: NatWest and Barclays have been active in making such acquisitions. A UK bank may also merge with a foreign bank, as in the case of the Royal Bank of Scotland and Banco Santander in Spain, or it may develop arrangements for customers travelling or doing business outside the UK. Neither of these last two options provides a real strategy for increasing the number of foreign customers which a UK bank has. A better possibility may be telephone banking, which, potentially, surmounts the problem of providing branches, although it does require some way of allowing customers to gain access to cash.

Of course, well before the Single Market UK retail banks were developing various forms of involvement in the banking sectors of European countries. However, many have stepped up their efforts during the last few years in anticipation of the Single Market increasing trade and, thereby, increasing demand from UK corporate customers for banking facilities abroad. It may be that providing services to corporate customers will still tend to be the dominant concern of UK banks.

The other side of this issue is the entry into the UK market of foreign banks. Until fairly recently the Bank of England, although welcoming foreign banks on a small scale, was keen to prevent them from taking over major British banks. The Bank also helped to protect UK retail banks against foreign competition. A combination of factors has undermined the Bank's ability to o,?) continue with this policy: the financial crises facing some banks in the 1980s, the Thatcher Government's free market ideology, the approach of the Single Market, and the creation of a formal, legal framework for the supervision of banks which made it difficult for a substantial foreign bank to be refused authorization.

In 1992 the Hong Kong and Shanghai Bank achieved what would have been unthinkable only a short time ago by acquiring Midland Bank, one of the largest of the UK retail banks. Other foreign banks are also keen to acquire stakes in the UK market: Deutsche Bank of Germany, Credit Lyonnais of France and the

Swiss Bank Corporation all seem to be looking to establish themselves in the UK as part of a broader strategy to become world banks. Credit Lyonnais have, it is said, shown interest in entering retail banking by taking over one of a small bank with a national branch network, such as the TSB or the Abbey National Bank. Many UK merchant banks have sought to make, or to strengthen, links with foreign banks. For instance, in February 1993 it was announced that Charterhouse had been bought by Credit Commercial de France and Berliner Handels-und-Frankfurter Bank in a deal which, it was claimed, would give the merchant bank instant access to European markets (Independent on Sunday, 7 Feb. 1993). This followed in the wake of the successful partnership between Morgan Grenfell merchant bank and Deutsche Bank, and the intention is that appropriate European business will be fed to Charterhouse by the French and German parent banks, as has happened with Morgan Grenfell. The UK market is highly competitive and the link is seen as a way of enabling such UK merchant banks to expand quickly into foreign markets.

The other major issue concerning the Single Market is whether UK customers will seek banking services from banks outside the UK. Research still needs to be done in this area, but it seems likely that such cross-border banking has had little impact at least on individuals. Whilst each of the member states operates its own currency and its own fiscal policy, customers, who have little time or experience to read the markets, are likely to want to do large transactions, such as getting mortgages, in their own countries and to view foreign loans as something of a gamble on notoriously unstable currency rates, especially in view of recent fluctuations in the markets. Where other, smaller value banking services are concerned then it seems likely that the inconvenience of banking abroad and a lack of familiarity with foreign banking practices will deter UK customers. It is more likely that the effect will be on corporate customers who sell to markets in other European countries or who set up factories abroad.

Finally, as is well known there has been considerable concern in the UK about various aspects of the Maastricht Treaty. One of

the least publicized issues involves the European Central Bank. It is intended that national central banks will be subordinate to the European Central Bank (ECB). The ECB will be independent of the other EC institutions, and the national central banks will become independent of their governments by the end of the century (generally, see, Hain 1993). This is a development which is welcomed by those in the UK who wish to detach fiscal policy from politics and hold up the Bundesbank's role in the German economy as a model. Others denounce it by arguing that fiscal policy should not be in the hands of unelected and largely unaccountable officials, whose decisions may be guided by narrow economic considerations rather than broader social issues.

9. *Bank Supervision: Some Conclusions*

There is no doubt that the Bank's reputation as a supervisor has fallen in the 1980s and 1990s. The JMB collapse appeared to show that the Bank had failed in the most important work of a supervisor, that is, to keep informed about the banking sector, and the BCCI affair seemed to demonstrate that the Bank had learnt little from JMB. But the Bank, like any other regulator, faces some virtually insuperable problems.

One of the problems lies in the lack of clarity about the objectives of bank supervision. The Bank seems to be trying to achieve several objectives at the same time. These objectives are ill-defined and sometimes in conflict. Yet the Bank is often under pressure from the government, the media and bank depositors to do different and often incompatible things. For instance, a government may ideologically favour a limited free market approach in which banks should not be prevented from failing as long as confidence in the banking system as a whole is maintained; at the same time, the collapse of a bank, which has no significant effect on that confidence, is still likely to lead to a public outcry and to pressure on the government and on the Bank.

The method of prudential supervision employed in the Banking Act does not seem suited to the expressed objective of ensuring

confidence in the banking system since it is concerned with the solvency of individual banks. The decisions about whether or not to rescue a failing bank, which are decisions about the impact on the confidence in the banking system, fall outside the Banking Act, and so are as unstructured as they were before the first Act in 1979. It may be difficult, even unwise, to seek to structure such decisions, however, it does provide some problems in seeing the objective of the Banking Act. Even the limited aim of prudential supervision, namely, maintaining the solvency of individual banks, is a hazardous exercise since it relies on assessments of risks, such as the likelihood of a loan being repaid, which are impossible to make with complete certainty. Prudential supervision seeks to restrict the free use of funds by banks, but this may have the effect of stifling investment in industry and limited innovation, which government is not likely to regard as desirable. On the other hand, the shift towards a more rule-based system of supervision raises the rather different concern that banks will treat rules as defining the maximum level of conduct rather than as the minimum, and that in making commercial decisions they will come to look to the rules rather than make judgements about the assessment of actual risks.

The concentration on prudential management leads to the justification of a high degree of secrecy to prevent depositors from panicking in a way in which the supervisor might regard as unwarranted. This is put above the need for depositors to have full knowledge and undermines the argument that there is no need for regulation of the relationship between banks and depositors. In any case, the history of bank supervision in the UK is based on building a close relationship between the Bank and the supervised banks in which confrontation and publicity is avoided. Instead, there is still a basic reliance on informality, trust and cooperation. This puts in doubt the ability to provide a totally detached system of supervision in which the interests of the depositors are given priority. The Bank of England has traditionally also played the role of the representative of the City in general and the banks in particular, and as such it has sought to ensure the continued

success of the banking sector, the representation of the interests of the banks in discussions with the government, and the maintenance of the relative autonomy of the banks from outside interference. This alignment with the interests of the banking community, from which its roles as supervisor emerged, can seem to sit uneasily with its work of supervision, particularly where disgruntled depositors are concerned. Moreover, supervision ignores important issues which concern depositors and other customers. For the past two or three years, as the recession has deepened customers with mortgages or business loans have found difficulties in repaying and criticism has grown about the way in which the banks have treated such customers. In particular it has been alleged that they fail to pass on interest rate cuts, that they are unsympathetic to those who are in debt, that they overcharge customers for services, and that they provide customers with little information about the terms on which accounts are operated. The argument that there is a free market in banking services which enables the customer to move an account does not, of course, work for those who are in debt to a bank. Such issues lie outside the supervisory role as the Bank sees it, and they are, therefore, left to the individual bank's own complaints mechanisms or the Banking Ombudsman or the courts.

It is possible to see various competing perspectives on banking supervision. First, there is the view of the larger banks that depositors and customers need protection, not from them, but from the fringe banks. Of course, JMB and the problems faced by Midland Bank in the 1980s shows how one of the well-established banks can get into difficulties. Moreover, a restrictive policy towards smaller banks, which reduces their competitive edge of their larger rivals, is likely to cause them to collapse, since if depositors are faced with the choice between two banks - one large, one small - both offering the same product, the likelihood is that they will opt for the large bank on the - doubtless correct - assumption that should the banks get into difficulties it is likely that the large bank would be rescued because the collapse of a large

bank would more probably be seen as having an effect on the confidence in the system as a whole.

The second perspective is the free market approach of the Conservative Government. Here the argument is that the customer should be allowed to have a free choice between competing suppliers of goods or services. However, the willingness of government to allow an entirely free market is constrained by the importance of banking to the national economy and to the achievement of a government's fiscal policies. Such concerns are likely to underpin the effort to strengthen the prudential management of banks so as to ensure their continuing good health.

The third perspective is that of the consumer lobby which argues for providing consumers with more information, but since this does not always give them the ability to protect themselves, government needs to intervene to provide protection. But absolute depositor protection might encourage reckless investment by the depositors and by the banks, which, in the event of a collapse, would have to be paid for by the customers of prudent banks. Prudential management is unlikely to ensure that no banks fail, and even striving to achieve this goal would be likely to reduce the rate of return on investments by hampering the ability of the banks to use the money deposited with them; moreover, depositors are citizens and often workers who have at least an indirect interest in the banks investing money in the British economy. It might also be asked whether it is either necessary or desirable to protect people from the consequences of their own poor investment decisions. However, it seems reasonable to argue that investors - including bank depositors - cannot be expected to possess the sort of information and ability to interpret that information that they would need to make informed investment decisions, and to leave them to their fates is likely to undermine confidence in banks.

In the development of bank supervision, both formal and informal, the competition between these different perspectives can be seen. For example, the Conservative Government wanted a free market, but its goal of encouraging broader public involvement in investment meant it was also committed to intervention to secure

protection for investors. It is this competition that leads to the sort of confusion over the objectives of bank supervision which emerged during the BCCI crisis. Of course, it is no longer sufficient to consider just the domestic issues in supervision, internationalization of markets has led to a recognition of the importance of harmonizing regulatory rules and of improving both the cooperation and flow of information between supervisors. The importance of international banking to the UK means that the UK Government and the Bank of England have been at the forefront of efforts at harmonization not just in the EC, but also on a more global scale through the Basle Committee. But, the creation of minimum standards provides no guarantee that those standards will be enforced or enforced consistently. The confusion within the UK about objectives and methods gives some indication of the problems that the supervision of international banks faces.

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THE REGULATION OF BUILDING SOCIETIES

1. *The Development of Building Societies in the UK*

The first building societies of the late eighteenth century were exactly as the name suggests, groups of people who formed together to build houses for themselves (Thornton and McBrien, 1988, p. 25). These societies ceased to function once the buildings had been completed (Lloyd, Waters and Ovey, para 2.01). However, by the early nineteenth century they had become permanent and were attracting money from outsiders. They began to borrow money from people who were seeking to invest rather than to build, and they lent this money to house buyers. This was the form which led to the modern building societies (Boleat et al 1992, p. 1).

According to statistics in the annual reports of the Chief Registrar of Friendly Societies and the Building Societies Commission (Boleat et al 1992), the number of societies has continually dropped, from 2,286 in 1900 to 110 in 1991. To a large extent this can be explained by mergers of societies. Certainly, the number of members (that is, depositors and borrowers) has increased dramatically, despite a slight fall in figures since 1989. At the end of 1991 the largest eight societies accounted for 74.6% of the industry's assets.

Building societies are the main savings institutions for individuals in the United Kingdom. Until the early 1980s they dominated the mortgage market to the extent of enjoying a near monopoly. Competition between societies was restricted by agreements: so, for instance, the Building Societies Association laid down the interest rates which societies should offer to both investors and borrowers (Callen and Lomax 1990, p. 503). However, as the banks faced increased competition in their traditional sectors, so they turned to new markets including mortgage business. Competition also came from new financial

institutions (Nellis and Litt, p. 2). As a result the building societies' domination was undermined, with a drop from 90% of the mortgage market in the late 1970s to 55% ten years later (Observer, 11 Oct. 1987), and they sought to extend their business.

The Building Societies Act 1986 allowed building societies to expand into sectors from which they had been excluded. The societies began to offer to personal customers most of the services that they might expect from a bank: cheque books, credit cards, loans for the purchase of cars and the like. However, section 5(1) of the Act reiterated the core function of the societies as being 'that of raising, primarily by the subscriptions of members, a stock or fund for making to them advances secured on land for their residential use.' The most significant consequence of this has been to exclude the societies from engaging, by and large, in the fields of international and corporate finance. As will be seen, the societies have complained about this restriction, however, it can be argued that it protected them from the losses incurred by the retail banks during the recession of the early 1990s.

2. Regulation before 1986

The Building Societies Act 1874 provided that the societies were to be incorporated and seen as a distinct legal entity. The Act also laid down specific but restricted objectives for the societies (Nellis and Litt 1990, pp. 6-7). The Acts of 1894, 1939, 1960 and the consolidation statute of 1962 did little to change the original restrictive legislation. The restrictions made it difficult for the societies to compete with other financial institutions for investors funds. 'It became increasingly clear that changes in building society behaviour and further deregulation would be required if they were to be able to compete effectively' (Callen and Lomax 1990, p. 504).

The Building Societies Association also argued that change was needed for two other reasons. First, 'prudential supervision of societies needed to be brought in line with that for other

institutions'. Second, 'the constitutional machinery under the 1962 Act was beginning to creak and the need for a more modern framework was recognised.' (Boleat 1992) Recommendations for change came from the Association's Working Group Report, *The Future Constitution and Powers of Building Societies* (January 1983). This argued for, amongst other things, a widening of the functions. The government produced a discussion paper, *Building Societies: A New Framework* (command 9516, July 1984), in which it was admitted that the restrictions placed on the societies were outdated.

3. *The Building Societies Act 1986*

These recommendations led eventually to the 1986 Act, which, for the most part, came into force on 1st January 1987. The preamble, or introduction, to the Act sees it as making 'fresh provision with respect to building societies'. (It is worth noting that the building societies, like the banks, are also subject to the relevant provisions of other legislation, such as the Financial Services Act 1986 and the Consumer Credit Act 1974.) The Act is concerned not only with the constitution and regulation of societies, it also provides some detail on the operating powers of building societies in Schedule 8. As well as setting out the criteria for prudential management (s. 45(3)), the Act (s. 1) establishes the Building Societies Commission to regulate and supervise the societies. Part IX of the Act also requires the societies to belong to the Building Society Ombudsman scheme.

4. *The Regulatory Framework: The Building Societies Commission*

(a) *The constitution of the Commission*

The duty of supervising the societies and ensuring they observe the legal requirements initially rested, under the Regulation of Benefit Building Societies Act 1836, with 'a certifying barrister',

and then later with the Chief Registrar of Friendly Societies. By the early 1980s the Registrar's statutory powers for regulating the societies had become 'wholly inadequate' (Lloyd, Waters and Ovey, para. 1.03). At the Bill stage of the 1986 Act it was agreed by the government and the Chief Registrar that the supervision of the post-Act building societies 'would be better vested in a body rather than in a single person' (Boleat et al 1992, p. 6). As a result, the Commission was established under section 1 of the Act.

The Commission is an independent body consisting of up to ten full or part-time members appointed by the Treasury (s. 1(2)). It is financed by a levy on the industry (s. 2), which in 1993 amounted to £3.9 million. The Commission currently employs a staff of around 50. The statutory functions of this body are given in section 1(4): namely,

- to promote the protection by each building society of the investments
- to promote the financial stability of societies generally
- to ensure that the principal purpose of building societies (s. 5(1), see above) is maintained - to administer a system of regulation of the societies
- to advise and make recommendations to the Treasury and to other government departments on matters affecting building societies.

At the 8th Annual Building Societies Conference in April 1993, one of the Commissioners, Terry Matthews, said that he saw the main areas of activity as lying in three areas. First, the Commission sought to ensure prudent business management. The duty not to endanger depositors funds lies with each society, but the Commission have to check that unnecessary or excessive risk is avoided. Second, the Commission seeks to ensure that members' legal rights and the legal restrictions on societies' powers are observed. Third, the Commission has a miscellaneous, but important role in such matters as overseeing mergers and takeovers and in drawing up secondary legislation affecting building societies.

(b) The statutory limits ('nature limits')

Certain restrictions are placed on the societies by the Act:

(i) under section 7 (also Building Societies (Limits on Non-Retail Funds and Deposits) Order 1987 (1987/2131)) non-retail funds must not exceed 40% of the society's total funds. Non-retail funds include investments by trustees for certain institutions, by charities and by occupational pension funds;

(ii) under section 8 50% of a society's funds must be in the form of shares;

(iii) class 1 assets (that is, first mortgages on residential property: section 20) must not exceed 75% of commercial assets held by the society. The total percentage of class 2 (other secured loans) and class 3 (investments and unsecured loans) assets must not exceed 25%, and class 3 may only be up to 15% (section 20);

(iv) under section 21(3), liquid assets (as defined by the Commission: section 21(7)) must not exceed one-third of a society's total assets.

If a society breaches any of these limits there are three courses of action open to the Commission: the society may be required to submit a restructuring plan to the Commission for its approval; the Commission may require the society to hold a meeting of its members to consider converting the society into a company (section 97); or the Commission may order a combination of these two approaches. If a society fails to comply with such directions, then the Commission can issue an order requiring compliance, or it can present a petition to the High Court to wind up the society (s. 37; Lloyd, Waters and Ovey, para. 18.03). It has been argued that the primary objective for the Commission is to ensure that the society does not turn into an ordinary commercial company.

(c) Prudential management

Sections 58 and 59 of the Act provide that each society must have at least two elected directors, of whom one shall be appointed

Liquidity, and 1991/5, Liquid Assets Regulations 1991 and Prudential Requirements: Liquidity). The fourth criterion concerns the method for assessing the adequacy of securities for advances secured on land (section 13). The fifth ensures that there are in place adequate accounting records and systems of control (s. 71; Prudential Note 1987/4, Systems). The recent Building Societies (Accounts and related Provisions) Regulations 1992 (1992/359) implements the EC Directive on the Annual Accounts and Consolidated Accounts of Banks and other Financial Institutions (86/635/EC) and brings the societies into line with recent changes in company law. The sixth criterion concerns the proper direction and management of the society. It includes a requirement that the management is 'fit and proper' and that they conduct themselves 'with prudence and integrity'. Lastly, the seventh criterion is that the business be conducted with 'adequate professional skills'.

The Commission uses a range of methods to carry out its prudential supervision. The most important of its formal methods is the issuing of prudential notes which set out what is required of societies for them to fulfil the above criteria. The Commission also regularly receives financial information from the societies; it issues policy statements on various issues; it receives annual reports from each society and also from the auditors of the societies (sections 71 and 82); it also holds supervisory and annual review meetings with each society (Boleat et al 1992, p. 8).

If a society does not comply with the requirement of prudential management, the Commission may make use of its powers under sections 41-43 (see below). Under section 55 it may investigate and report on the conduct and business of a society. In order to assist the Commission's investigations it has power to obtain information, documents and so forth under section 52.

(d) Powers under Schedule

One of the objectives of the 1986 Act was to allow the societies to offer a wider range of services to customers, along the lines of those offered by banks.

as the 'chairman'. There must also be a chief executive, who is responsible, alone or jointly, for the conduct of the society's business.

Norman Digance argued at a 1993 Building Societies Association seminar that, amongst other things, prudential supervision was meant to achieve the safety of investors' personal savings and to inspire both investor and market confidence. He said that in carrying out prudential supervision the Commission needed to be consistent, even handed and understanding, and that it needed to strike a balance between, on the one side, proper and adequate supervision, and, on the other, undue intervention (Digance 1993).

Section 45 sets out the criteria for prudential management. If a society fails to satisfy any of these the Commission may assume that the society is prejudicing the security of shareholders' investments and the Commission can exercise powers under sections 41 and 42 (see below).

The first criterion concerns capital adequacy, that is, the maintenance of adequate reserves: this was one reason for the closure of the New Cross Building Society in 1984. The framework for assessing the adequacy of reserves was set out in the Commission's Prudential Note 1987/1, Capital Adequacy: A Framework for Assessment, now superseded by Note 1992/1, Implementation of European Directives: Own Funds of Credit Institutions and Solvency Ratio for Credit Institutions, which implements the EC directives. This note sets the minimum solvency ratio at 8%, as calculated by the Basle formula, but from 1994 a threshold will be set annually for each society by the Commission which takes into account the nature and risks of each society's business. Any society which does not comply, or is likely to be unable to comply, will have to produce a rectifying plan.

The second criterion is a satisfactory commercial asset structure. The commercial assets are the total assets minus fixed and liquid assets (for class 1, 2 and 3 assets see above). The third criterion is liquidity (see above; also, Prudential Note 1987/3,

Section 34 allows societies to provide financial services or services related to land, this is further expanded on in Schedule 8 (see Schedule 8, Parts I, II, III). The original Schedule 8 in the Act was too restrictive (Lloyd, Waters and Ovey, para. 10.01) and was amended in four subsequent statutory instruments (1987/172, 1987/1848, 1987/1976, 1987/2019). Eventually a new Schedule 8 was introduced in 1988 (1988/1141). This allows the societies to offer services in six areas: banking, investment, insurance, trusteeship, executorship and land services. The definitions of these areas are very wide, although the Commission has provided some guidance. Excluded are unsecured loans to the corporate sector and financial market making, and there are restrictions on exposure to general insurance underwriting (Matthews 1993, para 12).

5. *The Building Societies Ombudsman*

Section 83 of the Act provides that an individual may bring a complaint about a building society. The Act does not set up an Ombudsman scheme it merely requires the societies to be members of a recognized scheme. However, the only recognized scheme under the Act is the Building Societies Ombudsman. This came into operation in 1987 and is independent of the government. After an investigation the Ombudsman may require a society to perform certain actions or to pay compensation.

6. *Building Societies Investor Protection Board*

Since 1982 there has been a voluntary scheme run by the Building Societies Association, but this has been put on a statutory footing under section 24 of the 1986 Act. Funds are only raised as and when a society becomes insolvent (s. 26). Compensation of 90% of a protected investment will be paid to an investor, up to a maximum of £20,000. This money may be recovered by the Board from the liquidators of the society (s. 28).

7. *Is the Act a Success?*

It is not surprising to find that there are problems with legislation which has tried to regulate such a diversity of societies (Melville-Ross 1991), and even though smaller societies are gradually disappearing there are still some 98 in existence (Payne 1991). It has been argued that the 1986 Act has sharpened competition and improved efficiency (Payne 1991), however, there have been many more critics than supporters of the legislation. The critics feel the Act is too restrictive and rigid and fails to meet the current market situation (Sharp 1992). In its definition of societies' powers through the nature limits and Schedule 8 the Act differs sharply from the Banking Act 1987 and the legislation on companies. The Building Society Commission has a reputation for strict enforcement of caution and prudence, which is seen as strangling the ability of the societies to compete and to develop new products (Independent on Sunday, 8 August 1993). Birrell (1991), a director and chief executive of the Halifax Building Society, one of the largest societies, has argued that as a result the societies are more often concerned about issues of legality than banks and other financial institutions, and they are, therefore, at a disadvantage in the market place. To take, for instance, the limit of 40% on funds raised from capital markets (see above), it may be that as competition makes retail funds more difficult to attract and more costly, it is unreasonable to impose such a restriction on societies when it is not one which banks have to face. Unlike banks, building societies are unable to raise money on the international money markets. With deregulation and the development of greater financial sophistication in societies, it is argued that there is the skill to operate with prudence in such fields without the need for these inflexible and expensive limits. Although the societies can become banks and so operate in these areas, it is argued that there should be no need for this (Melville-Ross 1991). In 1992 the Building Societies Association Council asked for an increase from 40% to 50%.

Gilmore (1991, p. 33), who is the chairwoman of the Commission, feels that much of the reform that has been called for could be achieved by amending the 1986 Act so as, for example, to give wider powers to enter corporate banking. Llewellyn and Wriglesworth (1990) go as far as suggesting that the whole structure should be scrapped and the societies brought within the Banking Act 1987 so that banks and building societies can compete on equal terms (see also Boleat 1991; Sharp 1992). Llewellyn and Wriglesworth (1990) argue that the tighter regulation of building societies is making it more difficult for them to compete with the banks in the UK and, more generally, with other deposit taking institutions in the single market. They also argue that, unlike the regulatory structure for banks, the Building Societies Act 1986 is prescriptive rather than discretionary, and as such it lacks the flexibility necessary to allow for the sort of development that building societies need in order to compete with banks. Against the argument that by being prevented from entering the sorts of hazardous areas of business open to banks, building societies avoided the problems faced by the banks over loans to less developed countries and during the recession as companies went into liquidation, Llewellyn and Wriglesworth (1990) argue that forcing building societies to rely on the housing market as their principal source of revenue made them vulnerable to collapses in that market, such as occurred around the time they were writing.

It does seem anomalous to regulate institutions in broadly the same market in a different way, particularly since the tendency of companies to engage in only one part of the financial sector has long since disappeared. The distinctions between banks, building societies, insurance companies, investment firms and so forth are already difficult to make. Certainly there has been some convergence between banks and building societies. One of the leading societies, the Abbey National Building Society converted into a bank some years ago, and the Girobank was bought by the Alliance and Leicester Building Society and the newly-formed Bank of Edinburgh Group was established with the express purpose of acquiring small building societies (The Observer, 28

March 1993). More generally, convergence has resulted from the single market, the wish to reduce distortions in competition, and the attitude that it is the regulation of functions rather than institutions that is important (Building Societies Association 1992a, p. 18).

8. *A Comparison of Banks and Building Societies*

Over the past decade the regulation of financial institutions has, in practice, converged and, as has been mentioned, there is pressure to continue with this process (Ellinger 1987, p. 21). The 1986 Act has brought the prudential requirements for societies more closely in line with those which apply to banks (Nellis and Litt 1990, p. 3). For instance, section 45 of the 1986 Act is very similar to schedule 3 of the Banking Act 1987. In addition, the supervisory duties of the Bank of England and the Commission bear many similarities. The Ombudsman schemes for banking and the societies are also fundamentally the same, even though membership of the scheme is only voluntary for the banks.

9. *The Single European Market and the Building Societies*

This pressure towards convergence of the banks and the building societies also comes from the EC (Building Societies Commission, 1992, pp. 83-85). The directives apply to 'credit institutions' without distinguishing between building societies and banks. Indeed, the European Commission has recently proposed legislation on mutual societies which would allow them to compete on equal terms with companies without having to convert into companies (Boleat et al 1992, p. 85). The UK's initial response has been cool.

The Cecchini Report (1988) identified financial services as one of the EC markets which would gain most from the opening of the single market (Fraser and Mortimer-Lee, p 93), and at the Building Societies Association's 8th Annual Conference, the Secretary of the Woolwich Building Society, Janet Thomson

(1993), argued strongly that the societies could benefit from expansion into Europe (pp 4-5). Apart from the value of spreading resources and commitments over a wide geographical area, she pointed out that the societies had the expertise in the saving and mortgages sector to take advantage of the new market opportunities. However, only the Woolwich has expanded into Europe through subsidiaries, even though such expansion has been permitted since 1988 under the 1986 Act, and even that expansion has been relatively modest. Indeed, in 1990 the Building Societies Association (1990) argued that the expertise in the UK retail savings and mortgages markets does not mean the societies will be able to operate abroad effectively. They did, however, recognize that the single market might increase competition in the UK from institutions operating in other members states. However, this has been played down by claims that national differences in land and tax law, and, more importantly, in saving and house buying habits might inhibit such competition. Perhaps, more convincing is Armstrong's (1992) argument that the single market is unlikely to increase competition since those foreign institutions who wished to set up in the UK market have already done so. Nevertheless, competition in the UK is unlikely to get an easier for building societies and so the pressure to seek new markets in Europe is going to increase.

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INSURANCE REGULATION IN THE UNITED KINGDOM

1. *Introduction*

This paper gives an account of the framework used for the regulation of the insurance industry in the UK. It is clear that in this context the impact of the EC harmonization initiatives has, so far, been limited. The pattern has been one of voluntary reflexive regulation, initiated in response to threats of the imposition of mandatory standards by UK government and law reform agencies. An important focus for future research will be the way in which this reflexive approach reacts to the challenge of the new generation of EC insurance directives, which take the largest step so far towards mobility and deregulation of insurance services across the EC (see Reich).

2. *General Regulation of UK Insurers and Intermediaries*

Despite a tradition of resistance by the insurance industry to mandatory state regulation, there has been statutory control for at least 100 years (Ellis). The 1970s brought increased pressure for such regulation as a result of a general change in the political attitude towards regulation, allied with various high-profile examples of how self-regulation might be said to have failed. Two of the most important examples were the collapse of the Vehicle and General Insurance Company Ltd in 1974 and of the Nation Life in the same year. There was also, of course, an increased impetus towards regulation from membership of the EC in 1973.

3. *Insurers*

The Department of Trade and Industry (DTI) has power under the Insurance Companies Regulation 1981 and the Insurance

Companies Act 1982 to ensure that all non-life, life and reinsurance companies are:

- (a) financially sound;
- (b) managed by fit and proper persons; and
- (c) carry on business in a prudent and responsible manner.

The 1982 Act says that a person can only carry on insurance business if authorized by the Secretary of State. (Lloyds of London is exempted from this requirement because it was traditionally regarded as subjecting its members to a fairly rigorous self-regulatory system.)

The Act also imposes obligations of a continuing nature on insurance business. There are, for example, provisions which are intended to ensure that providers maintain adequate financial reserves (section 32). The purpose of these provisions is, of course, to protect consumers and other clients against the insolvency of the provider. It is not about allocating or re-allocating risks under the insurance contract. This has always been left to the law of contract which has tended to be based on the idea of freedom of contract and to enforce rules which favour the interests of the insurer (see later in UK Report).

In the event that an insurance company does become insolvent further protection is provided by the Policyholders Protection Act 1975, which set up a Policyholders Protection Board. This scheme is financed by a levy upon insurance companies. The Board is in a position to provide assistance to insurance businesses which are in financial trouble, and in the event that an insurer becomes insolvent, the Board will ensure that the policy holder is protected to a minimum of 90% of the entitlement under the policy (see generally, Birds).

EC-inspired harmonization has also played a role. The UK has a minimum legal capital requirement of 800,000 and 400,000 ECUs for new life and non-life insurers respectively, both of which emanate from the 1979 and 1973 directives on Life and Non-Life Insurance Establishment (79/267/EEC and 73/239/EEC).

4. *Intermediaries*

Intermediaries generally fall into one of three categories: those which are full time (for example, insurance brokers); those which are part time (for example, estate agents); and those which are employed as direct sales staff by insurance companies. There are a bewildering array of statutorily-backed self regulatory organizations which are meant to cover such intermediaries. The main organizations are:

1. Insurance Brokers Registration Council (IBRC)
2. Securities and Investment Board (SIB)
3. Life Assurance and Unit Trust Regulatory Organization (LAUTRO)
4. Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA)
5. Investment Managers Regulatory Organization (IMRO).

There are also two voluntary codes of practices issued by the Association of British Insurers. These have no statutory backing, but, nevertheless, they prescribe rules on issues such as the proper explanation of terms to customers, the disclosure of underwriting information, the release of documentation and the general approach to insurance selling.

Finally, there is statutory regulation of intermediaries on issues such as cooling off periods and in the context of 'connected' intermediaries and main agents (Insurance Companies Regulation 1981, and Insurance Companies Act 1982).

5. Conclusion

As with banking, the regulation of insurance emerged from a mixture of domestic scandals, a changing climate within the industry worldwide and efforts at European harmonization. It involves a mixture of self-regulation and statutory regulation, and a confusion of regulatory authorities. As with the banks, this regulation is concerned with prudential supervision, but it is also concerned to control the behaviour of intermediaries in a way which is less evident in the banks (except, of course, when they engage in insurance work).

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CONSUMER CREDIT LICENSING

1. The Background

In 1971, the Crowther Committee (1971) published the results of their detailed analysis of the law relating to credit transactions. The Committee realised that,

the use of consumer credit ... enables individuals to enjoy the services of consumer durable goods sooner than they otherwise would, and... therefore may be said to enhance consumer satisfaction.

However, credit can be dangerous for consumers in two ways. Firstly, since it is attractive to borrowers it sometimes entices them into overborrowing. Secondly, certain lenders take advantage of the demand for credit to force consumers to undertake unreasonably onerous obligations. The Report concluded that there were serious weaknesses in the existing law. Regulation was by form, rather than by substance and function, and there was no distinction between consumer and commercial transactions. There was also inadequate protection for consumers because of a lack of statutory control on credit transactions. The Committee recommended a radical overhaul of existing legislation.

These proposals eventually led to the Consumer Credit Act 1974, which only became fully operational in May 1985. The Act replaced the previous fragmented legislation with a unified code, offering much improved consumer protection, underpinned by powerful enforcement machinery. However, it is a complex and unwieldy piece of legislation, comprising 193 sections and 5 schedules. There are two branches of statutory control contained within it. On a broad level, it is designed to regulate the business activities of the consumer credit and hire industries, through a comprehensive system of licensing. Thus, all those engaged in credit transactions are required to obtain a licence, which entails meeting certain criteria. In order to protect consumers dealing with any unscrupulous traders who manage to slip through the licensing

net, the second branch regulates individual agreements. This ensures that the agreements are properly executed and that the consumer is given an opportunity to resile from a credit commitment. There are also provisions broadening the debtor's rights in the event that the goods acquired through a credit agreement are defective. Other parts of the Act deal with controls on advertising, cost disclosure and the canvassing of agreements.

The Act goes well beyond the EC Directive on Consumer Credit 1977, which required all member states to introduce a prior authorisation system for consumer credit institutions (article 12(1)).

2. *To What Agreements does the Act Apply?*

The Act applies where the debtor or hirer is an individual, a term which, by section 189, 'includes a partnership or other unincorporated body of persons not consisting entirely of bodies corporate.' Most of the statutory controls only apply to 'regulated agreements'. Agreements coming under the definition of a 'consumer credit agreement'¹, which is further divided into fixed-sum credit and running-account credit, or a 'consumer hire agreement' (section 15) are regulated, unless exempted. Consumer credit agreements are defined in section 8(2) as agreements whereby one person (the creditor) provides an individual (the debtor) with credit not exceeding £15,000. An obvious evasion of the Act would be to fix a credit limit above £15,000, so section 10(3) was drafted to avoid this danger. It provides that a running account will still be a consumer credit agreement, and therefore regulated, if the creditor cannot draw more than £15,000 at any one time, and that sanctions are applied if the credit balance rises above this amount, and if, at the time of the agreement, it is unlikely that the balance would exceed this limit. A consumer hire

¹ S.8. Such agreements include hire-purchase, conditional sales, credit sales, personal loans, overdrafts, loans secured by land mortgages, credit card agreements, pledges and budget accounts in shops.

agreement is a bailment of goods by one person the (owner) to an individual (the hirer), which is not a hire purchase agreement, which is capable of lasting for more than three months and which does not require payments by the hirer exceeding £15,000.

Some agreements are partially regulated, being caught by only certain sections of the Act. These include 'non-commercial agreements', which are defined by section 189 as agreements made by the creditor or owner in the course of a business carried on by him, that is, credit given by a business which is not a consumer credit or hire business. The second class of partially regulated agreements - small agreements - prevents the evasion of the Act by the division of the credit transaction into a series of small transactions.

Certain consumer credit or hire agreements are completely exempt from the Act's provisions, under section 16, or The Consumer Credit (Exempt Agreements) Order 1989, for example, if it is running-account credit where the whole of the credit for a period is repayable by a single payment, such as is the case with American Express credit cards.

Agreements are also categorised in a different way, under sections 12 and 13. The distinction often has a bearing upon whether the agreement is regulated or exempted. A 'debtor-creditor-supplier' agreement generally arises when the creditor is connected in some way with the credit transaction, for example, when the creditor and supplier are one and the same, or, if they are different people, where there is a credit arrangement between them. Examples are a hire-purchase agreement, or where a credit card company has arrangements with suppliers. A 'debtor-creditor' agreement is one where there is no arrangement between the creditor and any supplier. An example is a bank overdraft which the customer is free to spend as he or she wishes.

3. *The Scope of the Regulation*

The central licensing system, contained in sections 22-24 and 147-150, is under the control of the Director General of Fair

Trading. The Director also has a duty under the Act to keep under review and advise the Secretary of State for Trade and Industry of any social and commercial developments relating to credit, and associated activities, as well as the working and enforcement of the Act and the regulations and orders made under it.

The Act provides various powerful administrative sanctions. Under sections 29 and 32, the Director has the power to suspend and revoke licences or not to renew them when they expire.

Under the Act, a licence must be obtained by anyone falling into either of two categories. The first covers anyone carrying on a consumer credit or consumer hire business (section 189(1)), and the second, anyone carrying on an ancillary credit business (sections 145 and 146), which might involve credit brokerage, debt adjusting, debt counselling, debt collecting or credit reference services. It is not necessary that these activities are the main business, provided they are regularly carried out during the course of some other business. A licence will not be required by a business which does not engage in regulated agreements, or deals solely in exempt agreements. However, those carrying on an ancillary credit business do need a licence, even if the agreements entered into by the debtor are not regulated. Unfortunately, the Act does not define a 'business', except to say that it is a trade or profession. However, key characteristics of a business, which are discernable in other areas of the law, are the frequency of transaction, the manner of operation and the profit motive (Lowe and Woodroffe 1991).

Licences are not required by certain categories of people. Under section 23(1), agents, such as the part-time employees of mail order companies, are exempt, unless they work for more than one company, in which case they may be classified as being in business in their own right, and therefore require a separate licence. Also, under section 189(2), those conducting occasional credit transactions are exempted. The regularity of the activity is required to equal a business activity.

4. *Types of Licences*

Under section 22(1) there are two types of licence. The standard licence is issued by the Director General. It permits a named person to engage in listed activities, within specified time limits. Standard licences issued after June 1991 expire after 5 years. Those issued earlier than that date last for 15 years. With the exception of partnerships or an unincorporated body of persons, the licence is held individually and requires a separate application from each member of a group.

Group licences can also be issued by the Director General, either on the Director's own initiative, or on the application of the prospective licensee. The group licences fall due for renewal after 10 or 15 years. This licence is intended only for categories of creditor or credit businesses where individual examination of applicants is not considered to be necessary for the public interest. As a safeguard, under section 22(6), the Director General has the power to exclude named persons from a group licence. The Director General is also required to give general notice of all group licences granted in such a manner as to allow it to be seen, within a reasonable time, by all those likely to be affected by it (section 189(1)). Group licencees include UK Law Societies (on behalf of solicitors holding current practising certificates) and the National Association of Citizens Advice Bureaux (for registered local bureaux). An individual may be covered by both types of licence.

Information on licence applications, licence holders, revocations, suspensions or variations of licences and on other licensing decisions by the Director General is held on the Consumer Credit Public Register. This also contains other information, such as exemptions granted from certain parts of the Act and orders in respect of agreements by unlicensed traders. The register is open to public inspection, although a small fee is payable for details of individual licence applications.

5. *Licensing Criteria*

Under section 25(1) a standard licence must be granted by the Director General only if the applicant satisfies the Director General that he or she is a 'fit' person to engage in the activities to be licensed, having regard to any circumstances which appear to the Director General to be relevant. In addition, the business name to be licensed must not be misleading or undesirable. As an alternative to refusing a licence, the Director may decide to limit the licence to specific activities.

The Director General must take into account a non-exhaustive list of factors, set out in section 25, in deciding who is a 'fit' person. Sections 25 (2) and (3) state that the Director must have regard to any circumstances appearing to the Director to be relevant, and in particular any evidence tending to show that the applicant, or any of the applicant's employees, agents or associates² (whether past or present) or, where the applicant is a body corporate, any person appearing to the Director to be a controller of the body corporate or an associate of any of such person, has committed any offence involving fraud or other dishonesty or violence, or has contravened any provision under the Consumer Credit Act or any other enactment regulating the provision of credit to individuals or other transactions with individuals, or has practised discrimination on grounds of sex, colour, race or ethnic or national origins in business, or has engaged in business practices appearing to the Director to be deceitful or oppressive, or otherwise unfair or improper, whether lawful or not. The Director views this last point of discretion as bestowing far reaching powers:

The inclusion of this phrase is a clear indication that I can object to certain trading practices and use the licensing system

² An associate of an individual is either a relative or partner, or the relative of a partner, of that individual. A relative is a husband or wife (including former or reputed spouses), brother, sister, uncle, aunt, nephew, niece, lineal ancestor or lineal descendant.

either to compel a course of conduct which the applicant or licensee may not legally be obliged to adopt at present or to require him to refrain from activities which he is at present legally entitled to pursue.

Examples of unfair and improper practices discussed during the Bill's debate include persistently selling to those who cannot afford it, persistently driving extortionate credit bargains, and deliberate use of salespeople who employ high-pressure sales tactics. Section 170(2) also states that,

In exercising his function under this Act the Director may take account of any matter appearing to him, to constitute a breach of a requirement made by or under this Act whether or not any sanction for that breach is provided by or under this Act and, if it is so provided, whether or not proceedings have been brought in respect of the breach.

It is an offence to engage in any activity for which a licence is required without holding a licence. However, the Director General does have discretion under section 40(2) to make a direction, or, under section 148(2) and section 149(2), an order, that regulated agreements made by a trader whilst that person or the credit broker was unlicensed shall be treated as having been made under the licence. In doing so, the Director General should consider the extent to which the debtors or hirers have been prejudiced, the degree of culpability and whether the creditor would have been eligible for a licence, if he or she had applied for one. Section 149 also provides that an agreement made by a debtor or hirer who was introduced to the owner or creditor by an unlicensed credit broker is not enforceable and section 148 contains a similar provision in relation to ancillary credit businesses. However, consent by the debtor or hirer is as effective as a validating order.

6. *Application Procedure*

An application for a standard licence must be made in writing (section 6(2)). It is an offence to knowingly or recklessly furnish information on a licence application which is false or misleading

(section 7). A licence mistakenly granted on an application which does not conform with this procedure is invalid.

There is no express provision for a third party to oppose the granting of a licence, although the Director can take objections into account. However, it is unlikely, in the absence of supporting evidence, that the objection would lead to the refusal to grant a licence.

7. Minded to Refuse/ Revoke Notice (MTR)

The Director General's duty in relation to the issue, renewal, variation, suspension and revocation of licences is a quasi-judicial function. Thus, procedures designed to ensure fairness are adopted. An investigative team examine all available evidence and if they decide that there is enough material to justify a licensing action, they prepare a draft MTR notice. This is then forwarded together with supporting documentary evidence to the adjudicating officer, who will be the Director General himself or one of a small number of senior staff. He or she will make the decision about whether or not to proceed. If the Director issues a MTR notice, the applicant must be given written notice, including the reasons based on the material provided by the investigation team, and the opportunity to rebut the evidence. Approximately 75% of applicants take advantage of their right to an oral hearing.

Following the hearing, if the application is refused, the decision is placed on the Public Register. However, where the applicant is successful, no details of any hearing are recorded, although, where the case has generated much public interest, the Director can make a public announcement.

The most common groups to be refused a licence are motor dealers, retail traders and finance houses. Typical grounds for refusal include criminal convictions for fraud, dishonesty or violence, or convictions under consumer legislation, such as the Trade Descriptions Acts 1968 and 1972, and also evidence of other criminal, unfair or improper practices, such as improperly commandeering welfare benefit payment books from debtors.

A similar procedure of investigation, MTRs and representations is employed in the granting of a licence on different terms, revocation, suspension or variation. As a safeguard for the applicant, there is a right, under section 41, to appeal to the Secretary of State and a right of further appeal to the High Court on a point of law (section 42). However, the element of discretion vested in the Director General make difficult for applicants, and many are also discouraged by the long and cumbersome procedure involved.

7. Results of Licensing

By 1992, there had been over 300,000 licence applications since the system was introduced. Central to the credibility of the system is the requirement that applicants should be able to demonstrate their 'fitness' to hold a licence. In the period until April 1991, the Director General reported that he had refused or revoked licences in approximately 2,900 cases on this ground. The screening process is only part of the story, however. The Director General has said:

I do not think that the efficiency of licensing control is shown by the number of MTRs issued or the number of final refusals or revocations, etc.

The deterrent effect of such a system is another important, if less tangible, factor. According to the Director General:

Traders who are aware that they are unfit are prevented from entering the credit industry and those who have been granted licences and are dealing in credit are less likely to stray from the straight and narrow. (Director General 1991)

Indeed, the Director General has added that:

Results can often be obtained without going to the extreme of refusing, revoking or suspending a licence, including the drawing up of fairer agreements and the provision of compensation to members of the public who have been overcharged and unfairly treated.

In the Director General's view the threat of sanction has undoubtedly encouraged greater responsibility and better business practice.

In that the use of an unlicensed credit-broker can endanger the enforceability of a creditor's agreements, there is a certain degree of internal policing within the credit industry now that certainly did not exist to any extent before the institution of licensing.

Consumer orientated groups are dissatisfied with the Consumer Credit Act as it stands. They claim that licence applications are more or less rubber stamped and that monitoring of licence holders is almost non-existent, thus failing to deter unscrupulous traders. Those perhaps in most need of the Act's protection - credit users at the bottom of the social scale - appear to be most at risk. A recent report by the Consumer Association, for instance, found evidence of widespread malpractice and extortionate credit lending. They have called for a reform of the current licensing system, with more thorough vetting and tougher, more pro-active policing. Mark Lanyon of the OFT accepts that some unscrupulous traders inevitably do slip through the net, although he says that specific complaints are always investigated. However, he argues that the number of transgressors is comparatively small in relation to the number of licences issued and questions both the practicalities and the financial viability of introducing a more extensive vetting system. According to the Office of Fair Trading's 1991 Report, in 1991, just 220 notices, out of a total of 24,785 standard applications, were served on applicants or licensees concerning their fitness to be granted, or to retain, a licence.

8. *Extortionate Credit Bargains*

(a) *What is an extortionate credit bargain?*

Most of the time, credit causes people no real problems. However, some lending, mainly on the fringe, can be oppressive or exploitive. Those most at risk are the low-income borrowers who cannot meet the credit-worthiness tests of the mainstream

lenders. Low-interest state loans, such as the Social Fund (Social Security Act 1986), might be seen to offer vulnerable borrowers an alternative safer credit source. However, in the case of the Social Fund its restricted budget means tight lending restrictions resulting in many claims being unmet. Moreover, those who might apply for Social Fund loans are fearful of, or simply dislike, the intrusion in their lives by state officials which applications inevitably involve. Thus there is still a market for fringe lending, lending not just by so-called 'loan sharks', that is unregistered lenders, but also by those who charge high rates of interest to people regarded as poor credit risks.

Sections 137 and 138 of the Consumer Credit Act 1974, enable a court to reopen any 'extortionate credit bargain', including hire purchase agreements (but not hiring or rental agreements) 'so as to do justice between the parties'. An extortionate bargain is one which requires an individual to make 'grossly exorbitant' payments or otherwise grossly contravenes 'the ordinary principles of fair dealing'. These provisions have a wider application than the rest of the Act because there is no £15,000 credit ceiling and the total charge for credit must take account of any other transactions involved in the bargain. The extortionate agreement may be brought to the attention of the court by either the debtor, or, in the case of a secured agreement, by the surety. The debtor or surety can apply to the Court at any time. Alternatively, he or she may raise the matter in legal proceedings relating to the credit bargain. In England and Wales the application must be made in the County Court if the agreement is regulated. Applications in respect of exempt agreements must also be brought in the County Court if the amount of credit does not exceed £5,000. In Northern Ireland the application may be brought in the County Court if the credit agreement is regulated, or, in any case, if the amount does not exceed £5,000. In Scotland any application may be brought in the local Sheriff Court for the district in which the debtor or surety lives or carries on business, whatever the amount of credit involved.

In deciding whether a credit bargain is extortionate, the court is required by the Act to have regard to a non-exhaustive list of factors in section 138. These include the debtor's age, experience, business capacity, state of health and the degree and nature of any financial pressure put on her or him when he or she made the bargain. The risk accepted by the creditor (having regard to the value of any security) and the relationship with the debtor must be considered, as must general factors, such as interest rates prevailing at time the credit bargain was made, the degree to which a 'linked transaction'³ was reasonably required for the protection of the debtor or creditor, or the extent that it was in the interest of the debtor, and any other relevant circumstances, into account.

The Court will reopen an extortionate credit agreement to relieve the debtor or any surety from payment of any sum in excess of that considered by the Court to be fairly due and reasonable. The court may set aside the obligations of the surety or debtor (or order sums to be repaid to them), order property given as security to be returned or re-write the terms of any security instrument.

(b) Criticism of the Act

Bently and Howells (1989) argue that sections 137 and 138 have failed to provide adequate protection for borrowers because the onus to raise the issue is on the debtor and the statutory formulation employed is inadequate. The sections are also rendered less effective because of the reluctance of the courts to intervene.

³ Broadly speaking, a transaction is linked if it is entered into to comply with the terms of the agreement, or it is financed by that credit agreement and the creditor is connected with the transaction, or it is entered into by the creditor, his associate or agent or any other person who knows about the credit agreement. The creditor or other person must have initiated the transaction by suggesting it to the debtor for a purpose related to the credit agreement.

An Office of Fair Trading Report in 1991 found only 23 court cases in which the provisions had been mentioned since 1977. Only 15 of those decided an issue of whether a credit bargain was extortionate, and in only 4 cases was the bargain found to be so. Wilkinson (1992) argues that such a small number of reported cases indicates that the number of oppressive bargains is also small, suggesting that the Act has in fact been successful in regulating credit agreements. But there are other equally likely reasons for the figures. Certainly, the Office of Fair Trading's 1991 Report, for instance, lists many prevalent examples of loans containing unacceptable features. Common types of exploitation include locking the debtor into a cycle of debt by reloaning before an existing debt is repaid, targeting needy borrowers to whom cheaper forms of credit are not available, discharging loan balances with a new loan, making no rebate for early repayment and not making clear the true cost of the loan by setting out on weekly payments. In one extreme example, found by the OFT, interest of £37.50 was charged on a three-week loan of £100, giving an APR of nearly 400,000 per cent.

The 1991 report acknowledged the weaknesses in the control of extortionate credit bargains and criticised the 1974 Act for focusing attention primarily on the rate of interest. Consequently, the courts have tended to ignore other types of gross contravention of ordinary principles of fair dealing. The OFT gave many examples of unacceptable dealing practices. Traders often illegally canvass agreements, usually in the individual's home, using high pressure selling techniques. They hold child benefit or social security books as security and keep irregular documentation or make illegal agreements. They also implement unilateral increases in interest rates without reference to market rates.

(c) Reforms

The OFT Report concluded that to impose a ceiling on interest rates, either as a threshold to trigger a presumption that the rate was excessive, as is done in France, or as an absolute limit, would

encourage lenders to push up interest to the maximum. Also this solution fails to take account of the individual circumstances of the transaction. It is important to note, for instance, that high interest rates may fairly reflect a high risk on the part of the creditor and one which the debtor is willing to accept, although the concept of free choice being exercised obviously provides some difficulties in this area.

Instead it concluded that the present provisions should be recast. Reforms should be targeted on the margins of the credit market where competition is least effective. However, the provisions should not be so draconian as to drive lending underground. They should be flexible enough to accommodate the great variety of transactions and concern themselves more with lending practices than interest rates. They must also recognize that borrowers at the fringe are not likely to seek relief from the courts.

Two main proposals, which emphasised the importance of fair and reasonable lending, were made. The first was that the concept of an unjust credit transaction should replace that of an extortionate credit bargain. The excessive nature of repayments should be a factor indicating injustice and a new test of deception, oppression, impropriety or unfairness should replace the reference to 'ordinary principles of fair dealing.' The second is that the factors to be considered in assessing a transaction should remain as listed in ss 138(3) and (4) but it should also be the lender's responsibility to check the borrower's credit-worthiness and capacity to repay the loan. Failure to do so should count against upholding the loan. To supplement these proposals the courts should have power to re-open agreements on their own initiative, and the Director should have the power to intervene on behalf of the borrowers and apply for a declaration that a credit transaction is unjust. The courts should be required to notify the Director of all cases where unjust transactions had been reopened.

The 1991 OFT Report describes unjust credit transactions as those where, the costs of credit (in terms of price and the associated terms and conditions) substantially exceeds levels which

would be generated by a fully competitive market and/or are so oppressive that no sensible person, independently advised, would find them acceptable.

The 1991 Report concluded that the problem of overborrowing was one of income deficiency or poverty and, and thus, the answer did not lie simply in a change in consumer credit legislation.

The OFT's proposals have yet to be implemented. In the meantime it intends to give more publicity to consumers' rights, to use its credit licensing powers to deter unfair practices and to publicise examples of unfair or improper lenders' practices.

(d) Conclusions

Clearly the need for consumer protection must be weighed against the need for free enterprise and choice. Achieving the right balance, however, is not an easy task. Borrowers should have the right to expect fair treatment and reasonable terms but the price to be paid for credit needs to be judged against the risks involved. It remains true that many of those borrowers most at risk from unscrupulous traders are those most desperate for credit and consequently present the greatest risk to the lender. What is fair and reasonable in such cases is not easy to decide.

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Case study: Extortionate credit

In May 1987, the C's were in dire financial straits. The 100% mortgage on their council house was in arrears, as was their second mortgage from First National Securities and they had £4000 of other debts. Their income had been reduced because Mrs. C had been forced to take time off work. First National issued a notice calling in their second mortgage. The C's turned to the Murtagh group of credit brokers, who promised to provide a remortgage to cover all their debts and give them some cash in hand. It would cost them around £180 a month, which was a typical annual percentage rate (APR) of the time. There was nothing to pay until October, although the interest in the meantime would be added to the loan. What they had unwittingly signed up for was an £18,000 bridging loan with North Mount Securities, at an APR of 51.1%, which included fees and interest of £5,520, leaving only £12,480 available to the C's. The remortgage failed to appear and the C's failed to meet the £630 monthly repayments on the bridging loan. A year later, the C's were facing repossession of their home. The judge ruled that the credit bargain was extortionate and that the rate of interest should be halved to 25%. A few months later the OFT revoked the Murtagh companies' credit licence.

Which?

April 1992.

THE BANK-CUSTOMER RELATIONSHIP

1. Introduction

This section examines the legal basis of, and the nature of the duties attaching to, the relationship between banks and their customers.

2. Definitions

There is no single statutory definition of a bank. The key legislation in the field, the Banking Act 1987, provides no definition of a bank, instead, as has been seen, it simply lays down in a loose fashion the general conditions which have to be fulfilled before a company will be authorized by the Bank of England to carry on the business of accepting deposits. Of even less help is the legislation relating to bills of exchange and cheques. In spite of the fact that these statutes impose various obligations on, and provide various protections for, banks they fail to define the term: the Bills of Exchange Act 1882, for instance, refers to a bank as 'any body of persons... who carry on the business of banking'. A similar definition appears in the Moneylenders Acts of 1900 and 1927; under these Acts any 'bank' is excluded from having to register under the Act, but a 'bank' is defined as 'any person bona fide carrying on the business of banking'.

It was the Moneylenders Acts which gave rise to the leading case on the definition of a bank: *United Dominions Trust v Kirkwood* [1966] 1 All ER 969. One of the judges in this case, Mr Justice Mocatta, recognized that there was no single meaning of the words bank and banker that would stand good for all times, for all situations and for all countries. In the Court of Appeal it was decided that United Dominions Trust was carrying on the business of bankers as that business was understood at the time by the banking community. In other words, a bank is a bank if it is recognized by other banks as such. This quality of acceptance by

the general banking community was regarded as crucial. However, the judges did go on to argue that there were also certain functions which distinguished bankers. Lord Denning said that they accept money from, and collect cheques for, their customers and credit these funds to the customers' accounts; they pay out on cheques drawn on them by their customers; they maintain current accounts for customers in which credits and withdrawals are recorded. Despite the narrowness of the circumstances in which the case was brought - and in the absence of any general statutory definition - it has been accepted as providing an authoritative definition of a bank.

The term 'customer' has provided less problems, since, even though there is no statutory definition of the term, there has been a reasonable amount of case law. The judges have decided that there has to be a relationship based on an account maintained by the customer at the particular bank (*Great Western Railway v London & County Bank* [1901] AC 414), although the relationship does not have to be long standing, but will arise as soon as the account is opened (*Commissioners of Taxation v English, Scottish and Australian Bank Ltd* [1920] AC 683; *Ladbroke v Todd* (1914) 30 TLR 433) and indeed will arise at the point when an individual has requested that the bank open an account and the request has been agreed to by the bank, even if no account has as yet been opened (*Woods v Martins Bank* [1959] 1 QB 55).

3. *Legal Basis of the Relationship*

The terms of the relationship between a bank and its customer rests on both contract and statute. However, the relationship is chiefly based on a contract the terms of which are typically not written, but are merely implied (*Joachim v Swiss Bank Corporation* [1921] 3 KB 110, at 117, Lord Justice Atkin). The resultant lack of transparency has recently become a major cause of criticism raised by consumer groups and by the recent Jack Committee (1989) Report. One witness before the Committee said,

We are doubtful if many people have any clear idea of what duties are owed to them by their bankers, or of what remedies are available to them in the event of any of these duties not being performed. By the same token the general public would be unaware of the obligations which they themselves owe to their banker (quoted in Arora 1993, p. 71)

Having said that banks have introduced, or been required by statute to provide, express terms when providing particular services, such as a credit card or a cheque guarantee card. The courts can subject these terms to scrutiny under the Unfair Contract Terms Act 1977 and under the more general requirement that particularly onerous terms which seek to limit the terms that would normally be implied into such a contract must be pointed out to the customer if they are to be enforceable (*Tai Hing Cotton Mill Ltd v Lin Chong Hing Bank* [1986] AC 80). Of course, other people who do not come within the narrow definition of a customer will nevertheless enter into contractual relationships with banks. For instance, when a traveller who exchanges foreign currency at a bank, there is a contractual relationship between the two for the purpose of that transaction. However, these contracts relate only to that specific transaction rather than to the continuing relationship that exists between a bank and a customer.

Between the bank and an account holder the basic obligation is that the bank has the right to use money deposited with it for its own purposes and as if it were its own money. In return the bank promises to repay the money according to the terms agreed when it was originally deposited: for example, on demand or after a specified period of notice (*Foley v Hill* (1848) 2 HL Cas 28). The relationship is one of debtor (the bank) and creditor (the customer), unless the account is overdrawn (that is, the customer has been allowed by the bank to draw out money beyond the amount in the account) in which case the position is, of course, reversed, and the money is due on the terms agreed. Although it owes money to customers who have accounts which are in credit, the bank is not under the normal duty of debtors, which is to seek out and pay their creditors, instead it is up to the customer to apply

to the bank to withdraw funds (*Foley v Hill* (1848) 2 HL Cas 28; *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110). Where the account is overdrawn, then the position is, of course, altered, and the amount is due on demand, unless - as is normally the case - there is an agreement as to repayment. The customer can only demand payment at the branch of the bank at which the account is situated (*R v Lovitt* [1912] AC 212), and indeed it is common practice to make a charge for customers who seek to cash a cheque at another branch, unless they have an adequate cheque guarantee card or have made a prior arrangement with that branch.

The fullest description of the contractual relationship was given by Lord Justice Atkin (*Joachim v Swiss Bank Corporation* [1921] 3 KB 110, at 127):

The bank undertakes to receive money and to collect bills [cheques, cash and other forms of payment] for its customer's account. The proceeds so received are not to be held in trust for the customer, but the bank borrows the proceeds and undertakes to repay them. The promise to repay is to repay at the branch of the bank where the account is kept, and during banking hours. It includes a promise to repay any part of the amount due against the written order of the customer, addressed to the bank at the branch, and as such written orders may be outstanding in the ordinary course of business for two or three days, it is a term of the contract that the bank will not cease to do business with the customer except upon reasonable notice. The customer on his part undertakes to exercise reasonable care in executing his written orders so as not to mislead the bank or to facilitate forgery. (see also, *Space Investments Ltd v Canadian Imperial Bank* [1986] 1 WLR 1072)

The bank also has a duty to provide customers with statements of their accounts periodically - usually, monthly or quarterly - as well as on demand. The bank also has a duty to keep the affairs of the account holder confidential (see below).

If a customer draws a cheque on her or his bank and that bank fails to honour that cheque, even though there are sufficient funds

and the cheque is properly drawn, then the bank will be in breach of its contract with the customer. The customer will only be able to recover nominal damages unless there is proof that the breach caused particular damage to the reputation of the customer, as where the customer is defamed by remarks written on the cheque by the bank (banks usually write the reason for refusal on the cheque), or where he or she is a trader in which case the refusal will be assumed to have damaged the image of that person's creditworthiness without proof being required (*Gibbons v Westminster Bank Ltd* [1939] 2 KB 882; *Davidson v Barclays Bank Ltd* [1940] 1 All ER 499; *Morzetti v Williams and others* (1830) 1 B & Ad 415).

The bank is not authorized to pay where the customer's cheque has been forged (Bills of Exchange Act 1882, section 24), or, more generally, when the customer has asked the bank not to pay a particular cheque (*Westminster Bank Ltd v Hilton* (1926) 43 TLR 124) or has given it a limited authority to pay cheques, as, for instance, is often the case with companies who require that the bank only pays cheques signed by a certain person or certain persons. Banks are also expected to be alert to unusual transactions: for instance, where a sole director paid cheques drawn on the company into his own account (*A.L. Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775). Indeed, there is a general duty on banks implied into the contract to exercise reasonable care in dealing with the customer's affairs (*Westminster Bank v Hilton*; Supply of Goods and Services Act 1982, section 13). Whether or not a bank has exercised the requisite level of care is judged by the standard of a hypothetical 'reasonable bank' faced with the same situation and in possession of the same information as the actual bank. What amounts to the actions of a 'reasonable bank' is, therefore, a question which, ultimately, is decided upon by the judges in any particular case. However, the courts have been reluctant to impose too onerous a duty on the banks through this requirement of reasonableness. The courts do not require banks to advise a customer on the wisdom of a particular transaction (*Williams & Glyn's Bank v Barnes* [1981] o,?) Com. LR 205), or

to decide whether to honour a particular cheque which a customer has properly issued (*Lipkin Gorman v Karpmale Ltd and Lloyds Bank plc* [1988] 1 WLR 987), unless the bank agreed to give such advice or there is, for example, something about the transaction which suggests fraud (*A.L. Underwood Ltd v Bank of Liverpool; Barclays Bank plc v Quincecare Ltd* [1988] 1 FTLR 507).

In fairly restricted circumstances there will be a fiduciary relationship between the bank and the customer. In such cases the bank will be required to go beyond the general duty of reasonable care. In *Lloyds Bank Ltd v Bundy* [1975] QB 326, Lord Justice Sachs in the Court of Appeal said that such relationships will arise only in 'very unusual circumstances', and 'where someone relies on the guidance or advice of another, where the other is aware of that reliance and where the person upon whom reliance is placed obtains, or may well obtain, a benefit from the transaction or has some other interest in it being concluded.' There has to be an element of undue influence and unfair advantage on the part of the bank (*Cornish v Midland Bank Ltd* [1985] 3 All ER 513. See also, *National Westminster Bank Ltd v Morgan* [1985] AC 686).

Where a customer is not an account holder, there will be a much more limited contractual relationship with the bank: so, for instance, someone who exchanges foreign currency for pounds sterling has a contractual relationship with the bank for that transaction.

The duties placed on the customer are more limited. The customer is obliged to pay reasonable charges for the conduct of her or his business by the bank and to repay any amount owed to the bank, either on demand or as agreed between the parties. To the chagrin of the banks, the courts have decided that there is no implied duty on the customer to examine the statements of account which are periodically sent by the bank (*Tai Hing Cotton Mill Ltd v Lin Chong Hing Bank*). Although, as has been mentioned, the bank has not authority to pay forged cheques, the customer may be prevented (estopped) from alleging that forgery as a reason for the account not being debited if he or she was aware of the forgery and failed to inform the bank (*Greenwood v Martins Bank Ltd*

[1933] AC 51). In general terms this does not place the customer under a duty to prevent the possibility of cheques being forged (Kepitigalla Rubber Estates Ltd v National Bank of India Ltd [1909] 2 KB 1010). An allegation of a failure by the customer to take reasonable care in the organization of her or his business, so as to prevent forgery, or in the monitoring of bank statements will not allow the bank to debit a forged cheque to o,?) the customer's account (Tai Hing Cotton Mill Ltd v Lin Chong Hing Bank). However, when writing out cheques the customer must take reasonable care to prevent frauds, such as filling in the cheque form in such a way that alteration of the amount of the cheque by another person is not made easy (London Joint Stock Bank Ltd v Macmillan and others [1918] AC 777; Joachimson v Swiss Bank).

Liabilities in the law of tort arise independently of a contractual relationship. A bank is required to exercise reasonable care in transacting business not just with those who are defined as 'customers' within the restricted meaning of that term already discussed, but also with those with whom it has no contractual relationship. For the possibility of liability to arise it must be shown that a reasonable bank in the position of the bank in question could have reasonably foresee that a failure to take reasonable care might cause injury to the person who is in fact injured (Box v Midland Bank [1981] 11 Rep 434). Where a bank is asked for advice and it is clear that the person making the request is relying on the bank's skill, then the bank must exercise reasonable care in giving the advice (Hedley Byrne & Co. Ltd. v Heller & Partners Ltd [1963] 2 All ER 575). Attempts by banks to restrict or to exclude liability for statements or advice (Hedley Byrne v Heller) will be subject to scrutiny under the Unfair Contract Terms Act 1977. Under the Act the reasonableness of the limitation clause will be examined. This comes back to the issue of what can be expected of the hypothetical reasonable banker in the particular circumstances.

Where someone deposits valuable items with a bank, such as jewels, documents and so forth, then the bank takes on the responsibilities of a bailor (that is, someone who has custody of

items that he or she does not own). There are different levels of responsibility where the bailor is paid a fee, as most banks are, than where the bailor is not. The bank must show that any loss was not facilitated by its negligence. Cases typically arise in relation to bank robberies and are generally settled without a court hearing, but, in principle, to make a claim against the bank the client would have to show that the bank's security had been defective in some way: for instance, the alarms had not been switched on, doors had been left unlocked, or items had been handed over to an unauthorized person (this would amount to the tort of conversion: *Langtry v Union Bank of London* 1896)

Outside the law of contract and tort, anyone dealing with a bank has certain protections under the Data Protection Act 1984, which places limitations on the disclosure of information. The Act aims to protect information held about individuals on computers, and, amongst other rights and remedies, it gives the individual concerned the right to damages for the unlawful disclosure of personal information. The Act does not, however, apply to information which is not kept on computers.

4. Jack Committee Report: The Contractual Relationship

Despite the Committee's concern about the lack of knowledge which customers had about the terms of their contracts with the banks, the Report did not recommend the adoption of a written, standard term contract. The absence of writing, it was believed, allowed a necessary element of flexibility. Indeed, the Committee felt that, on the whole, the duties owed by banks to their customers were clear and that there was, therefore, no need for statutory codification (but see below on the confidential relationship). However, in those cases where banks did use written contracts, as for instance with credit card agreements, the Committee felt that the banks should be required to give a reasonable period of notice if they wished to vary the terms.

On the other side, the banks pressed the Jack Committee to overturn the *Tai Hing* decision. The Committee rejected this idea,

but it did decide that legislation should be introduced which would allow a bank to raise the customer's contributory negligence in an action brought against the bank for an unauthorized payment. This would have the effect of reducing the amount which the customer could recover. Although the Committee continued to take the view that mere failure to check a bank statement should not amount to contributory negligence.

5. *The Bank's Duty of Confidentiality*

As has been mentioned, there is implied into the contract between a bank and an account holder a general duty on the bank to keep the customer's affairs secret. The leading case is *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461, in which, according to the Jack Committee (para. 5.03), the duty was said to cover 'all the information which the bank has acquired about the customer in the course of its duties.' The Court of Appeal did, however, decide that there were four circumstances in which the bank could break that duty.

(a) 'where disclosure is under compulsion by law': this does not mean that banks can disclose if asked to do so by the police, there must be a requirement to disclose under some piece of legislation. Courts have always had a limited power to order disclosure under various statutes, such as the Banker's Books Evidence Act 1879, but recently, in common with countries around the world, the British government has enacted a series of statutes to facilitate the discovery of the proceeds of crime. Although in many other countries the focus for such legislation has been the drugs trade, in Britain it has been much more diverse: provisions are included in the Police and Criminal Evidence Act 1984, the Companies Act 1985, the Drug Trafficking Offences Act 1986, the Financial Services Act 1986, the Insolvency Act 1986, the Building Societies Act 1986, the Banking Act 1987, the Criminal Justice Acts 1987 and 1988, and the Prevention of Terrorism (Temporary Provisions) Act 1989. These statutes give powers to apply to the courts for orders, not only to the police, but also to other agencies,

such as the Serious Fraud Office (a state police agency which deals with major fraud) and the inspectors of the Department of Trade and Industry (who deal with a variety of matters relating to the running of companies).

In cases involving the Police and Criminal Evidence Act 1984, section 9, the courts have held that the special procedure which the police must go through before the bank has to disclose information is there to protect the bank not the customer (*R v Manchester Crown Court, ex parte Taylor* [1988] 1 WLR 705; also, *R v Leicester Crown Court, ex parte Director of Public Prosecutions* [1987] 3 All ER 654), and that the bank has no duty either to tell the customer of the procedure or to seek to resist a section 9 application by the police (of which the customer will usually be unaware) (*Barclays Bank v Taylor* [1989] 3 All ER 563). The courts have also said that if, during a search of a customer's records by the police under an order, they find information relating to the suspected criminal activities of another person, the police may use such information and may divulge it to another country: this happened during investigations into the Bank of Credit and Commerce International when information was discovered about General Noriega (*R v Southwark Crown Court, ex parte Customs and Excise*; *R v Southwark Crown Court, ex parte BCCI* [1989] 3 WLR 1054).

More generally, the courts seem to have cast off some of their previous reluctance (*X AG v A Bank* [1983] 2 All ER 464) to breach banking confidentiality when requested by a foreign court (*Re State of Norway's Applications* [1989] 1 All ER 745).

In practice, in cases where the police could obtain a court order, the banks will cooperate without requiring such an order on the understanding that should the police find information which is useful for a prosecution they will then obtain a court order. The reason for the police pursuing this strategy is doubtless that the courts have expressed their unwillingness to allow them to engage in a 'fishing expedition' (that is, seeking an order without any other evidence of criminal activity in the hope of finding such evidence: *Williams v Summerfield* [1972] 2 QB 512; *R v*

Nottingham City Justices, *ex parte* Lynn 1984). The reasons why banks cooperate are less obvious.

In some of the statutes (for example, the Drug Trafficking Offences Act 1986) there is not only a power for the police to apply to a court for an order to require disclosure by a bank (section 27), but also the Act places a duty on anyone to disclose information to the police if he or she has reasonable grounds to suspect that funds are derived from drug trafficking, even if that person has not been approached by the police (section 24, but see section 24(3)). Similarly, Prevention of Terrorism (Temporary Provisions) Act 1989, section 18. Also, Taxes Management Act 1970, section 17(1)). The problem for banks is that what constitutes such reasonable grounds is not made clear by the Act, so that it is not certain how far a bank needs to go in checking not only the background of a new customer, but also the affairs of an existing customer. There also the problem of deciding how to train staff to meet this legislation (see generally, Levi 1991; South 1991). Moreover, the cost of compliance falls on the bank. At the same time, the banks are sensitive about being seen either to break the duty of confidentiality or to assist in crime since both could be damaging to a bank's reputation.

The Jack Committee expressed concern about the cumulative effect of all this legislation. The Report pointed to the uncertain nature of the requirements placed on bankers (para. 5.08), but more serious was the way in which the legislation undermined the principle of confidentiality: one witness said, 'The continuing computerisation of the personal data held by government... must make the personal account information stored by banks a tempting target.' The Committee argued that secrecy was fundamental to the confidence which people felt in the banking system without which the system would suffer: 'in the interests of the banks and their customers alike, the duty of confidentiality must in future be given the weight it deserves as a pillar of the banking system of this country, if the integrity of that system is to be preserved.' (para. 5.48) The Committee, therefore, appealed to the government not

just to consider the issue of crime detection when drawing up future legislation.

(b) 'where there is a duty to the public to disclose': Lord Justice Bankes said in *Tournier* that, 'Danger to the state or public duty may supersede the duty of the [bank] to the [customer]'. But what this means in practice is unclear and seems never to have been tested in the courts. Bankes said that it did not place a duty on the bank to break the confidential relationship where, for instance, a customer was engaged in crime. However, both he, and later the Jack Committee, felt it would cover circumstances such as where there was reason to believe that a bank's customer was trading with an enemy during time of war.

(c) 'where the interests of the bank require disclosure': this covers situations where, for instance, the bank's reputation is under attack: in *Sunderland v Barclays Bank* [1938] 5 LDB 163, the bank had refused to allow an overdraft to pay a customer's gambling debts; the customer's husband, unaware of his wife's gambling, protested to the bank and was told the reason. The court decided that the bank could protect its reputation for making rational decisions.

For the most part, the banks seem to have gone beyond such a case and to have used this exception to the *Tournier* rule to disclose information to companies within the same group as the bank. The justification is that because of the general expansion of credit and of default, banks should be able to protect not only themselves, but also companies whose financial plight is linked to their own. The Jack Report (paras. 5.12-5.14) noted that customers are far from happy about this practice, and, in particular, about the way in which such information may be used for marketing purposes: the information on customers' patterns of expenditure is extremely valuable to all sorts of companies.

(d) 'where the disclosure is made by the express or implied consent of the customer': this is the most common justification used by banks. People who rent houses or buy goods on credit often agree to allow their bank to give a reference about their

financial affairs. In addition, the terms attached to the issue of a credit card normally give the bank the power to breach the duty of confidentiality in a fairly wide range of situations, and customers who give the name of their bank to a third party have been taken to imply consent to the bank passing on information about their creditworthiness (*Parsons v Barclays Bank* (1910) 2 LDB 248). It is also a long-standing custom amongst bankers that they will provide general information about the state of a customer's account to another bank without the customer's express consent (*Hedley Byrne v Heller* [1964] AC 465).

The practice of implying consent in such situations has been criticized by the Jack Committee, which suggested that banks should only disclose information where the customer has expressly consented and recommended that legislation to this effect be brought forward - a recommendation that has not been acted on (although see UK Report, 'Code of Banking Practice'). Earlier, the Younger Committee (1972) on privacy had felt that banks did not misuse this practice, however, the Committee saw no reason why customers should not be told when inquiries had been made. But this did not lead the banks to change their behaviour. The expansion of credit and the broadening range of financial institutions has meant that banks are willing to reveal information to an ever-increasing number of institutions, including credit rating agencies (that is, businesses which hold records on the creditworthiness of individuals and companies), indeed the Bank of England, concerned about the spread of bad debts, has positively encouraged the exchange of such information.

(e) The future of confidentiality

Until recently the exceptions to the general rule of non-disclosure in *Tournier* were relatively few and were tightly controlled. During the last two decades legislation and banking practice have cut into that duty in the pursuit of various objectives. The government has sought to tackle crime by gaining access to its proceeds, and in doing so has followed the practice of the broad international community; the banks have tried both to protect themselves and their associated companies from debt defaulters,

and have also sought to expand their information about customers for marketing purposes; and concern for the general health of the financial institutions has led to pressure to exchange credit information.

The Jack Committee in expressing concern at the undermining of confidentiality said that the principle not only went to 'the heart of the banker-customer relationship', but also 'it has to do with the kind of society in which we want to live.' The Committee found:

not so much a concerted assault on the [principle of confidentiality], as an uncoordinated process of encroachment. Such encroachment, often for good enough reasons, may be no less dangerous in its cumulative result. The danger is to customer confidence in the banking system, and that must be very much of concern to Government and banks, as well as to bank customers. Customers may already be forgiven for wondering, at times if the duty of confidentiality has not been replaced by a duty to disclose. (para. 5.26)

The Committee called for greater precision than Tournier provides and recommended a new statute to achieve this. The government rejected much of the Committee's views in this area. The White Paper (HM Government 1990) argued that Tournier worked satisfactorily. It asserted that there was no 'massive' erosion of the principle of confidentiality because legislation like the Drugs Trafficking and Prevention of Terrorism Acts did not apply to the vast majority and because the public interest in achieving the objectives of these statutes overrode the need to maintain secrecy. The White Paper also argued that banks should be able to pass on credit information about people, and that any changes needed to exceptions (c) and (d) should be achieved through a voluntary code of banking practice (see 'Code of Banking Practice').

It is worth mentioning that where a bank is allowed to disclose information under the exceptions to the rule in Tournier there are certain limited protections to ensure that the information given is accurate: for instance, the laws on contract (disclosing inaccurate

information might be a breach of the bank's contract with the customer), fraudulent misrepresentation (where information is given out knowing it is not true or recklessly or not caring whether it is true or false: *Derry v Peek* 1889; *Commerical Banking Co of Sydney v R.H. Brown & Co.* 1972, Australian High Court), defamation (the customer might be able to sue if, for instance, the bank gives out inaccurate information about the customer's creditworthiness: but *London Association for Protection of Trade v Greenlands Ltd* [1916] 2 AC 15), and the Data Protection Act 1984 (although this only covers information held on computers and not, for instance, on record cards). There is also, of course, the possibility that inaccurate information supplied by a bank will cause loss to a third party for which the bank may be liable to be sued in the tort of negligence even though there is no contractual relationship between the bank and that third party - for instance, where someone is seeking credit information about the bank's customer (*Hedley Byrne v Heller* [1964] AC 465) - and the possibility of a bank excluding liability, as happened in *Hedley Byrne* is now restricted by the Unfair Contract Terms Act 1977.

6. *Conclusions*

At the heart of many of the criticisms made by both the Jack Committee (1989) and the consumer groups is the nature of the relationship between banks and their customers. In summary, the relationship is seen as problematic because there is little or no transparency and because the security of the duty of confidentiality has been undermined, as much by the apparent willingness of the banks to release information as by the acquisition of powers by government to gain access to that information. Doubtless it is the criticisms about the lack of transparency which have come to the forefront in the last few years as a result of the Jack Committee (1989) Report, but more obviously as a result of the recession when those with overdrafts and loans found themselves being debited with what they often regarded as excessive fees without being told in advance. The disquiet about such complaints led to

the implementation of the Jack Committee's suggestion for a Code of Banking Practice.

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THE CODE OF BANKING PRACTICE

1. *The Background to the Code*

The Code of Banking Practice, Good Banking, was published in December 1991, in response to the recommendations of the Jack Committee (1989). It applies to banks, building societies and credit card issuers. However, its provisions only concern private customers and it is only a voluntary code of practice.

Many of the problems experienced by customers stem from a lack of transparency in the banker-customer relationship. Often they are kept in the dark about the operation of their accounts and have no knowledge of how much they will be charged or when the account will be debited. Moreover, banks are in a powerful position to levy charges without notice and even vary the conditions of the relationship without warning the customer. During disputes, account holders can rarely withhold payment of charges, and unless they petition the court or go to the relevant Ombudsman, they can exert little sanction other than to move their account to another bank. This is often impossible for small businesses, which rely heavily on bank lending.

These inequalities in the relationship increase the opportunities for abuse by the bank. On top of this there was the development of new technologies for which no legal rules had been formed, a situation which the Committee felt the banks had exploited to their own advantage. These considerations led the Committee to urge the adoption of a code of practice which would blend self-regulation and external sanction. It stated,

there is a legitimate public interest in the standards of banking practice set and applied by the industry, which should be reflected in some form of external assessment. The Committee cited the Australian Code on electronic funds transfer (EFT), which rests on the threat of legislation should it be flouted, as a successful model of such an initiative.

The Committee wanted the Code to improve the flow of information to customers, and also to introduce rules for the new

technology such as electronic transfer of funds. The Code, it was proposed, would be used by the Banking Ombudsman as a guideline for decisions. If the industry failed to produce a Code then the government should introduce legislation. However, the Committee favoured a voluntary code because such an arrangement would be more flexible and so more able to keep up with changes in banking.

2. *The Development of the Code*

The first Draft Code was devised by the British Bankers' Association (BBA), the Building Societies' Association (BSA) and the Association for Payment Clearing Services (APCS). Published in December 1990, it called for strict confidentiality and the publication of tariffs. It also required card issuers to bear the full loss when a card failed to be received by the account holder, and placed the burden of proof on them in cash dispenser disputes. Furthermore, in the case of lost or stolen cards, if there was no negligence on the part of the customer, it limited card holders' liability for unauthorised withdrawals prior to notifying the issuer of the theft to £50.

This Draft was strongly criticized as merely a public relations exercise at a time when the recession had brought with it strong criticism of the banks. It was described as 'a grudging response to public concern and official pressure over high charges, high interest rates and a lack of transparency illustrated by the failure to provide detailed breakdowns of such charges.' (Observer, 15 December 1991) The Consumer Association believed that it lacked sufficient monitoring procedures, and, in particular, criticised the failure to require prior notification of the deduction of charges (Observer, 15 December 1991). The fundamental problem was that the Draft's objectives differed from the Jack Report's recommendations. Whilst the latter was an attempt to improve standards for customers, the Draft Code was mainly concerned with explaining current practice. For example, the Committee recommended that customers should be able to block certain

functions on multi-function cards and that the bank should be liable for losses due to unauthorised functions; the Draft merely required banks to inform customers of the range of functions on their cards, and stated that the customer would be liable for losses. George Blunden, chair of the Committee established to oversee the preparation of the Code, recognized that,

the Code, for the most part, reproduces what is currently the best practice on the part of the leading institutions. Accordingly, it is not expected that the Code will lead to a major upheaval in the way that banks, building societies and card issuers behave. (Banking World, March 1991)

Sir Gordon Borrie, Director-General of Fair Trading, felt that, although the Code was an advance, it fell far short of ensuring complete fairness and transparency (Observer, 15 December 1991), and the Banking Ombudsman, Lawrence Shurman, regarded the Draft as 'in many respects deficient.' (Banking World, July 1991) Shurman drew particular attention to the fact that it failed to state explicitly that banks have a duty to act fairly in all circumstances. He also noted,

The draft Code requires banks to provide information to customers usually at the time when an account is opened. This is helpful but does not go far enough. Personal customers should be provided with a full explanation of such matters as the clearing cycle and the main terms and conditions of the banker-customer relationship. It should be in plain language, it should be in writing and it should be furnished not only at the commencement of the relationship but also at regular intervals thereafter, for instance, once every three years, in order to remind and update the customer. ... [It is also] unsatisfactory that ... the draft Code ... fails ... to oblige banks to ensure maximum privacy and, in particular, to aim to ensure that it is physically impossible for a customer's PIN [personal identification number] to be read by anyone when he is keying it in. Even more unsatisfactory ... is the failure to adopt the requirement for acknowledgement of safe receipt of both card and PIN before electronically activating the

card." (Banking World, July 1991. See also Jack Committee 1989.)

Another criticism was that instead of applying to all accounts, as the Jack Report had envisaged, the Code related only to personal customers.

On the other hand, around this time, the major retail banks did begin to develop their own codes of practice for customers, including those business customers not covered by the Banking Ombudsman Scheme (see UK Report below).

3. *The Code of Practice*

The general criticism of the Draft Code caused the bankers to think again, and in December 1991, a revised edition was circulated. This was eventually adopted as the Code, Good Banking, by participating banks on 16 March 1992. This version was much better received by Shurman (Banking World, January 1992) and also by Borrie, who described it as,

... a useful step forward - a considerable improvement on the first draft - and most of the basic recommendations made by the Jack Committee in 1989 have been incorporated. (Banking World, February 1992)

The amendments made include the addition of an overriding principle that banks will deal fairly and reasonably with customers, and a provision that all card holders whose cards are stolen will benefit from the £50 liability limit, notwithstanding the fact that they were negligent. However, they remain liable in excess of that figure if they were "grossly negligent", for example, by writing their PIN on the card itself. An important concession made by the banks concerns marketing. Under the Code, they will not disclose account details for marketing purposes to any third party, including companies in the same corporate group as themselves, without express consent from the customer. This means that the banks have partially surrendered their legal right to make such disclosures under an exception to the confidentiality rule, which

allows them to do so if it is in their best interests (*Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461). The banks will also refrain from imposing penalty charges on accounts which either become overdrawn, or exceed their overdraft limit without prior agreement having been obtained. A second concession on charges is that the banks will no longer impose charges if the account becomes overdrawn purely as a result of charges previously imposed. However, this "no charges on charges" rule will not apply if customers are notified before the deduction of the charge and are given reasonable time to restore the account to credit. The Code also requires banks to subscribe to the Ombudsman scheme (building societies are already required to belong to their own Ombudsman scheme by the 1986 Act), and to install proper internal complaints procedures.

Good Banking is not a solution for all the customers' problems, but there will be an opportunity to correct its failings when the Code is revised. This is the task of a Review Committee, which is composed of representatives from the Banking, Building Societies and Insurance Ombudsmen schemes, the Director General of the BSA, the Chief Executive of the APCS, and a representative of the BBA. The Committee is required to publish lists of those who adhere to the Code, to appraise the observance of the Code and to keep it up to date by reviewing it at least every two years. On the receipt of complaints of repeated violations by an institution, it must 'offer advice and comment to the institution ... or to take such further action as may be deemed appropriate'. This may take the form of publishing a report or informing the appropriate Ombudsman. However, the Review Committee depends on reports, it has no proactive capability. The first review is currently underway and the Committee aim to produce an updated version of the Code by December 1993, to come into force in March of the following year.

4. *Criticisms of the Code and Recommendations for the Future*

The Times (5 March 1993) has recently commented that Good Banking, 'has failed to stop a flood of complaints from customers', mainly concerning excessive or unexplained charges⁴. The National Consumer Council (1993) discovered in a survey that the number of customers who expressed themselves to be 'very satisfied' with their bank had nearly halved since their last survey in 1983 (National Consumer Council 1983). More than one person in every five questioned reporting having had problems with banks in the preceding year: 9% of these problems concerned automatic teller machines (ATM); 7% had discovered inaccuracies in the payment of standing orders or direct debits; 5% had experienced problems in transferring money; and 4% had found errors in the calculation of charges or in their statements. Of those that had faced problems, 80% had complained, but of these only 28% were "very" or "fairly" dissatisfied with the way in which the complaint was handled, whilst 61% were not even provided with information about complaints procedures. Lady Wilcox, the NCC Chairman commented,

Our 1983 report concluded that existing banking practice did not serve fairly the interests of customers ten years later, and one year after the introduction of the Banking Code of Practice, consumer satisfaction with banks has worsened. (Consumer Affairs, July-August 1993)

Of course, the argument might be made that the recent survey came during a severe recession when banks are likely to be at their least popular. However, even if this were part of the explanation for the poor ratings, it hardly seems a reason for not regarding them as serious. An increase in complaints might be taken to

⁴ These include a £90 charge for a 30 minute meeting with a branch manager and a £200 administrative charge incurred after being persuaded to convert an overdraft into a loan facility: The Times 5/3/93.

demonstrate the success of the Code and of the banks in making people aware of their rights and the available remedies, rather than an absolute increase in the number of complaints: in other words, people are reporting their complaints. Yet, this fails to explain the survey evidence of a general and increasing dissatisfaction with the performance of the banks.

There is plenty of scope for criticism of the Code. The banks resisted the suggestion that customers should be notified of the deduction of charges before they are deducted, as they claim the costs would be prohibitive. It is estimated that it would cost £100 million for the first year and £50 million in each year following that. Therefore, the Code merely requires them to publish tariffs covering basic account services. This information must be supplied on opening an account, on request at any time, or when changes are made. The Treasury Committee (1992) recommended that the Code should permit customers to opt to pay for prior notification should they wish to do so. Having said that it is the policy of the TSB and Barclays Bank to give advance warning to their business customers, with the latter intending to extend the practice to personal customers if the policy is a success. The Bank of Scotland now notifies all its customers of charges to be deducted before the event.

Another area of controversy is that of accounts which lay unused. The Code has been criticised for not encouraging banks to take the initiative in advising these customers of better investment opportunities. The Consumer Association note that the Code is also weak on fraud prevention (Which?, March 1992). It includes no right to select a PIN, elect to lower the daily withdrawal limit on a card, or collect cards in person from the issuer. There is also no stated intention to improve PIN security and safety at automated teller machines (ATMs) as suggested by the Jack Committee (1989). The Consumer Association also complain that the two-year period granted to banks to implement the Code is too generous, considering the length of time which the document has already spent in public debate.

The Treasury and Civil Service Committee (1992) identified other areas of criticism. For instance, the Jack Committee (1989) required the banks to explain to customers the clearing system and state their holding periods, that is the period for which a bank treats a cheque as uncleared and, therefore, not available to draw against. However, the Code does not require the banks to point out if there is a difference between the normal delay in clearing cheques and their own holding period. The Committee (Treasury Committee 1992), therefore, recommended that the revised Code should include a maximum holding period. Furthermore, despite the fact that both the Jack Committee acknowledged the importance of showing both cleared and uncleared balances on a customer's statement of account, the Code does not require it.

The NCC made several recommendations for the revised Code. They urged that all banks should be required to notify customers in advance of charges to be deducted, and that tariffs should be sent out with every statement. All banks and building societies should display leaflets advertising complaints procedures and the Review Committee should initiate surveys to check compliance (see discussion of survey in sections on the Building Societies and the Banking Ombudsman Schemes). Such literature should indicate to whom a customer may complain and include brief details of the Ombudsman scheme. The Ombudsman should publish information about comparative performance of member institutions. The NCC also advised that the Review Committee should publicise its activities and reports more widely. Finally they recommended that if there is no improvement, the Government should press ahead with a statutory Code.

5. Conclusion

It remains to be seen whether these criticisms will influence the revised Code. However, it should be remembered that no matter how comprehensive the Code becomes, it is not law, and whilst the banks might be wise to adopt and abide by it, in their own commercial interests, they are under no obligation to do so. It is

unlikely that the present government will be inclined to put the Code of Practice into a statute, since its ideological commitment is to reducing state intervention in the market and this leads it to prefer voluntary codes. The use of the Code by the Banking Ombudsman does provide some element of sanction. Moreover, the prospect of increased competition within Europe may provide consumers with a greater choice and so pressurize the banks into giving a better service and improving consumers' rights.

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THE BANKING OMBUDSMAN SCHEME

1. *Background and Formation of Banking Ombudsman Scheme*

As has been seen, the banker-customer relationship is essentially contractual. There are two problems with the nature of this relationship. The ordinary account holder will probably have little opportunity to negotiate the terms of the contract; her or his options are either to accept what is offered by the bank, or to go to a competitor (this may not be a possibility for someone who is in debt to the bank), whose terms, in practice, are likely to be comparable. This inequality of bargaining power is exacerbated by the lack of transparency in the terms of the relationship.

The tremendous inequality between the banks and their customers permits the former to impose terms which are greatly to their own advantage. A notorious area of controversy is the extent of charges imposed by the banks for services and transactions, particularly for accounts in debit. For example, when a large cheque is paid into an account, banks often offer a "special presentation" service, which should mean (although there is no guarantee) that within 48 hours the payee will be able to discover whether or not the cheque has been dishonoured. The banks charge roughly £12, but the service merely involves mailing the cheque by first class post. Thus, it effectively costs them only the price of a first class stamp, plus some administrative costs (Which?, March 1992). Another difficulty experienced by many customers involving the clearing system is that the balance given in statements is the "uncleared" balance, but most banks and building societies use the "cleared" balance to decide whether an account is overdrawn. The cleared balance excludes recent credits because there is a delay of three to five, or more, working days before cheques clear, and for most banks (although not all building societies), there is a similar delay for cash as well. Thus, a customer may well be overdrawn, and thereby incur charges, even

when the account appears to be in credit. Other irritations expressed by customers, which do not necessarily stem from the terms of the contract, or transparency problems, include mistakes made by banks concerning standing orders, direct debits and statements (Which?, March 1992).

Such disputes between banks or building societies and their customers should be discussed bilaterally between the parties, initially at branch level, and then, should the problem remain unresolved, at head office. It has been reported (Which?, March 1992) that the Bank of Scotland, Girobank and the Royal Bank of Scotland all rated better than average in dealing with enquiries, while Midland Bank was rated poorly, but that no bank or building society emerged as more helpful than the rest in dealing with mistakes. The National Consumer Council (1983) similarly found dissatisfaction amongst customers over the way in which complaints were handled, in spite of a general approval of the quality of services offered by banks. The Jack Committee (1989) was also critical of the treatment of customers in respect of such matters as banks charges and automatic teller machines.

One response to such criticisms was the establishment by the banks of a Banking Ombudsman scheme, which began operations in 1986, and another has been the Code of Banking Practice, which will be examined later in the UK Report.

According to Bell and Vaughan (1989, p. 1) ombudsman originated in Sweden in the early nineteenth century, when they were appointed by the king to watch over state officials. Bell and Vaughan argue that as democracies grew and the state has assumed wider functions so wider powers have been given to state agencies. As a result, individuals needed to be protected against 'administrative mistakes and the abuse of power' (Bell and Vaughan 1989, p. 1). However, it is not just the state which has substantial power over the lives of citizens: 'most banks, insurance companies and building societies are large bureaucracies whose decisions can have a profound effect on the lives of their customers.' (Bell and Vaughan 1989, p. 2) Not only do the ombudsmen extend the supervision of these large public and

private bureaucracies, they also provide greater access to justice for individuals by providing cheaper and quicker remedies than the courts.

Since the early 1970s many ombudsmen schemes have been set up in the UK. The first examples were in the public sector: such as the Parliamentary Commissioner for Administration (Parliamentary Commissioner Act 1976) and the Local Government Ombudsman (Local Government Act 1974). But during the 1980s the idea has spread to the private sector (Morris 1987). In the financial services sector we have the Insurance Ombudsman, the Banking Ombudsman, the Building Societies Ombudsman and the Investment Referee. Although all of these models have different institutional and practical features (Hodgin), they are all based on the well known limitations of the formal courts in providing access to justice. Apart from anything else, therefore, they provide useful models for the European Commission in the context of their concern with improving consumer redress (see 1990-92 Three Year Action Plan for Consumer Protection Com (90) 98 final; see also Goyens).

Unlike the Building Societies Ombudsman scheme (see later), which was established under the Building Societies Act 1986, the Banking Ombudsman is a voluntary scheme, sponsored by the banking industry. In this respect, it is much like the Insurance Ombudsman system (see below). It may seem anomalous that statutory and non-statutory schemes should be in operation side by side, but this may be explained by the very different types of change which the two industries were simultaneously undergoing in the mid-1980's. Both transformations were set against the background of the Conservative Government's policies for financial deregulation which paradoxically spurred a drive for closer supervision in order to strengthen consumer protection. The building societies rejected the idea of a voluntary scheme, and the fact that one was then imposed through the 1986 Act may have encouraged the banks to voluntarily adopt an Ombudsman scheme (James and Seneviratne 1991; Morris 1987). So, like the Insurance

Ombudsman, the scheme was established as an attempt to avoid what was seen as a greater evil.

Arguably, the conditions which made led to its creation might have been expected to mean that the banks would make strenuous efforts to ensure that the voluntary scheme was a success. However, it will be shown below that many features of the Banking Ombudsman scheme reduce its value to consumers, and that the banks actually have a strong hold over its activities. Indeed, the Jack Committee (1989) suggested that in both its structure and its terms of reference the scheme was weighted in the banks' favour.

2. The Structure of the Banking Ombudsman Scheme

The scheme is constituted as an unlimited company, called the "Office of the Banking Ombudsman", with no share capital, and is financed by levies on participating banks in proportion to the number of personal accounts held. Although the scheme is therefore entirely self-financing, the costs of the levy are inevitably passed on to the customers, but the service itself is free to complainants. The 1990-91 budget increased to £1,067,500 from £784,350 for the previous year (Hodgin). In October 1990, there were 23 member banks, together with the Bank of England and 21 designated associates, including finance and insurance branches of major banks (Hodgin). The Ombudsman's Report for 1991-92 stated that 36 banks were members of the scheme, the increase being due to the requirements of the Code of Banking Practice. The Office of the Banking Ombudsman has a three tier structure, which is headed by a Board of Directors, whose members are appointed by the banks from among their full time executives. The Board's tasks are to channel funds from industry, to approve the budget, to appoint Council members (with a final say in the appointment of the Ombudsman himself), and approve his terms of reference (Jack Committee 1989). This means that bankers control the scheme's finance, membership and the extent of the Ombudsman's jurisdiction. Under the Board is the Council

of the Banking Ombudsman. This has eight members, five of whom are independent, including the chairman, with the remaining three representing member banks. Its duties are to appoint the Ombudsman and monitor his terms of reference (subject to the Board's approval), give him continuing assistance and guidance, receive his annual report and approve a final budget for recommendation to the Board (Jack Committee 1989). Under the Council is the Ombudsman.

The system should be seen to be fair, so as to promote consumers' and banks' confidence in its independence and objectivity. The predominantly independent Council is supposed to distance the Board from the Ombudsman and thereby ensure his impartiality. However, the terms of reference and their amendments must be approved by the Board, and whilst amendments originate in the Council and are usually passed, there is a danger that only amendments likely to be passed by the Board will be proposed. The Jack Report (1989) drew unfavourable comparisons with the Building Societies' ombudsman scheme, which entrusts the approval of the scheme as a whole, including terms of reference, to the Ombudsman's Commission, an independent statutory body established to supervise the implementation of the Building Societies Act 1986.

3. *The Ombudsman's Jurisdiction*

The function of a private sector ombudsman scheme "is to resolve disputes between... members [of the scheme] and their private customers by an informal process of arbitration, which is provided free of charge." (Jack Committee 1989) The Banking Ombudsman's main object is to receive unresolved complaints about the provision of banking services and "to facilitate their satisfaction, settlement or withdrawal whether by agreement, by his making recommendations or awards, or by such other means as seem expedient." (clause 1, see Jack Committee 1989)

(a) The parties and complaints

As with the Building Societies Ombudsman Scheme the bank's internal complaints process must have been exhausted before a complaint can be made to the Banking Ombudsman. Paragraph 19 of the Banking Ombudsman's Terms of Reference states that the Ombudsman can only consider claims if the senior management of the bank have had the opportunity to consider the complaint, but nevertheless, deadlock has been reached. Each bank is expected to make clear the point at which internal procedures are to be considered exhausted, and the complaint must be taken to the Ombudsman within six months of this occurring. The act or omission leading to the grievance must have occurred on or after 1/1/86 and within the six years preceding the first written complaint to the bank. The aggrieved customers have direct access to the Ombudsman and, so as not to exclude the illiterate or inarticulate, the complaint can be made not only in writing, but also by telephone or personal appearance at the Ombudsman's office.

However, the Ombudsman route is open only to individual customers, including sole traders, partnerships and clubs, and is limited to banking services within the UK (unlike the Insurance Ombudsman scheme, this is taken not to include the Channel Islands and the Isle of Man). This is an extensive restriction considering the vast use of travellers cheques and credit cards abroad, not to mention the extent to which UK banks have opened branches abroad for their customers. The last resort for business account customers, or for those private customers who are not satisfied with the Ombudsman's decision, is to take their case to the courts, with all the attendant costs and delays which this implies.

The powers of the Ombudsman (which are under the control of the Board) are limited by paragraphs 16 to 19. The Ombudsman cannot investigate a complaint relating to the bank's commercial judgement in decisions about lending or security, unless there is evidence of maladministration, or policies on interest rates. Also

excluded are decisions taken by banks in connection with wills or trusts, unless maladministration is alleged, or special services extended to present or former employees or their spouses. Complaints relating to bank charges can be investigated, but the Ombudsman cannot dispute the scale of charges published by the bank.

The Ombudsman may also decide not to investigate a case because it is felt to be more appropriate for the issue to go before a court or an alternative complaints procedure, such as arbitration. The Ombudsman cannot investigate if the complaint is within the jurisdiction of any complaints, conciliation or arbitration procedure of the Securities and Investment Board or Recognised Self Regulatory Organisation (Financial Services Act 1986). Complaints involving claims for an award over £100,000 may be rejected. However, the Ombudsman has made clear that the exclusions in the Terms of Reference will not be read as a statute, and will be considered with a degree of flexibility (Jack Committee 1989).

Paragraph 20 relates to "test cases". This is quite different from the test case procedure created by the Building Society Ombudsman, and there is no similar procedure in the Insurance Ombudsman scheme. The bank may give the ombudsman written notice that in its opinion, the complaint involves an issue which has important consequences for the bank or banks generally, or involves a novel point of law. The bank must give a written undertaking that if, within the following six months, either the bank or applicant institutes court proceedings, the bank will pay the applicant's costs. On receipt of such a notice, the Ombudsman must cease to investigate the matter and inform the claimant of the right to take the case to court. There have been no test cases to date. The right of the banks to remove the complaint from the Ombudsman's jurisdiction at their own instance could be fairly damaging to the perceived independence of the scheme. Therefore, the Jack Committee (1989) recommended that this power should only be capable of being invoked with the concurrence of the Ombudsman.

(b) Procedure

Paragraphs 3 to 9 cover the procedure of considering a complaint. Paragraph 3 gives the Ombudsman some latitude in the procedure which may be adopted. If the parties are in agreement, the Ombudsman will seek to reach a resolution by informal conciliation and may promote the settlement or withdrawal of the complaint. The Ombudsman "pro-actively encourages early settlements... We are, therefore, in some cases able to help sooner, without incurring the expense and trouble of a full investigation, the same result as would have been reached later." Where agreement cannot be reached, the Ombudsman essentially acts as an arbitrator.

The Ombudsman will launch a formal investigation of the matter during which the bank may be asked to provide any information relating to the complaint. If it fails or refuses to do so, the Ombudsman must give notice of this to the Council and the Board, which can exert pressure. However, if the bank provides information it can insist that it be kept confidential. The Jack Committee (1989) reported with concern that the Banking Ombudsman, unlike the Insurance Ombudsman, lacks powers to compel production of documents by a bank. They also felt that, as an added deterrent for the banks, the Ombudsman, with the consent of the complainant, should be permitted to publish information about the case.

The Ombudsman may make recommendations in a formal report, but must give the bank and customer one month's notice of his intention to do so. During this time, the parties may make further representations to him. The recommendation may direct the bank to make an apology, reverse or re-consider a decision, or pay compensation. Under paragraph 12, the Ombudsman can enforce a recommendation which has been accepted by the applicant, even if the bank does not agree to it, and may make an award of up to £100,000 in the customer's favour, but must give reasons for doing so. The size of the award should, in the Ombudsman's opinion, "compensate the applicant for loss or damage suffered by

him by reason of the acts or omissions of the bank" (clause 12, see Jack Committee 1989).

If the Ombudsman is minded to make a recommendation, this will state that it is only open for acceptance by the applicant as a full and final settlement of the complaint. If the complainant is dissatisfied with the recommendation and decides not to accept it, he or she has the right to initiate court proceedings.

(c) The standards used by the Ombudsman

In arriving at a decision, the Banking Ombudsman is much more fettered by the law than the Insurance Ombudsman. Although required to bear in mind what is 'fair in all the circumstances' and having regard to any maladministration or inequitable treatment by the bank, clause 14 states that the Ombudsman:

shall observe any applicable rule of law or relevant judicial authority (including but not limited to any such rule or authority concerning the legal effect of the express or implied terms of any contract between the applicant and any bank named in the complaint); and have regard to general principles of good banking practice and any relevant code of practice applicable to the subject matter of the complaint.

In establishing 'good practice' the Ombudsman must consult with banks and will consider what is required of banks by the Code of Banking Practice. The Ombudsman is not bound by his or her previous decisions. Morris (1987) points out that,

The duty imposed on the [Banking] Ombudsman to consult banking interests prior to determining principles of good banking practice strongly implies that his basic role is to monitor and promote compliance with existing standards of good banking practice as formulated by the banking community, rather than to act as innovator charged with responsibility for designing new, perhaps more exacting, standards where this is adjudged appropriate in the public interest. Admittedly, the wording of the

terms does not point inexorably in this direction but the first holder of the office ... indicated quite clearly that he did not perceive it a part of his proper function to fashion fresh, more onerous principles of good banking practice.

Since the publication of Morris's article, the Ombudsman has made a few recommendations to industry, for example, on the overselling of multipurpose cards, the availability of cleared balance data, and bank charges (see Jack Committee 1989). However, like the other ombudsmen, the Banking Ombudsman can only suggest changes in practice in response to complaints which have been made. Furthermore, under paragraph 17, the Ombudsman cannot make a recommendation in respect of a claim concerning a bank's practice or policy which is not in breach of any obligation or duty owed to the customer. In contrast to the Insurance Ombudsman, but like the Building Societies Ombudsman, this makes it highly unlikely that the Banking Ombudsman will come to a decision, based on fairness, which contradicts the law. Thus, the law dictates the customers' position, and if it is prejudicial to them, there is nothing that the Ombudsman can do to redress the unfairness. Where the law has nothing to say on the matter, there is some scope for fairness considerations. However, it would appear that since the Ombudsman is only directed to "have regard to" any Code of Practice, but must "observe" a rule of law, that a law, even if unfair, will override the Code of Practice. Weight is added to this interpretation because a special point is made of the fact that the practice or policy complained of must be in breach of the law (paragraph 17) and the case studies (see the appendix) illustrate how this influences the Ombudsman's decisions.

The Jack Report (1989) criticised the restriction on the fairness requirement, but the Banking Ombudsman has commented,

In every complaint we seek to determine what is fair. ... The question of fairness cannot, however, be considered in isolation. It must be remembered that at the end of the day banks cannot operate at a loss. As with other services, customers should

expect to receive what they pay for, not more.
(Banking Ombudsman 1992)

In following legal precedent, the Ombudsman believes the customer is being provided with a free alternative to going to court, and to proceed on a different footing from the courts would be to introduce an undesirable degree of uncertainty.

4. *The Future and Possible Reforms*

Despite the flaws in the Ombudsman scheme, it provides the banking customer with a better deal than previously available, if only because it has forced banks to improve internal complaints procedures. Indeed, when suggesting the establishment of the Ombudsman, the National Consumer Council (1983) remarked,

[A Banking Ombudsman] would be an effective means of improving and maintaining public confidence. It could provide banks with valuable information about the causes of dissatisfaction amongst their customers. It could enable them to improve their services.

The ever-present threat of redress to the Ombudsman may have a deterrent effect on banks and may have an impact on banking practice.

Unlike the Building Societies scheme, membership of the Banking Ombudsman scheme is voluntary. The Code of Banking Practice does require banks to set up internal complaints procedures and to provide details of the Ombudsman Scheme, using leaflets, notices in branches, or other appropriate literature. But, of course, the Code of Practice itself has no legal force.

It seems that many banks have failed to comply with the requirements of the Code of Practice. In a major survey, Graham et al (1993) showed that, whilst banks were better than building societies at providing accessible information on both internal complaints and ombudsman schemes, both were short of perfection, particularly when it came to advertising the ombudsman schemes (see UK Report, 'The Building Society Ombudsman Scheme'). A small survey of the major retail banks

and building societies in Uxbridge (the results of which can be seen in the chart below) shows that many failed to advertise the fact that they belonged to the Ombudsman Scheme, or to provide adequate information about their own complaints procedures. With the exception of the Royal Bank of Scotland, even where there were notices on display, they were home made rather than printed, and were both small and difficult to find - in marked contrast to posters which the banks use to advertise the bank's profit-making services. Where information was available on request, the cashier often had to search for quite some time to find it.

BANKS	Ombudsman Scheme Membership Notice on Display	Customer Complaints Information on Display	Ombudsman Information on Request	Customer Complaints Information on Request
Royal Bank of Scotland	Yes	Yes	N/A	N/A
Lloyds Bank	No	No	No	No
Midland Bank	No	No	Yes	Yes
NatWest Bank	Yes	Yes	Yes	Yes
Barclays Bank	Yes	No	No ¹	No
BUILDING SOCIETIES				
National & Provincial	No	No	Yes	Yes
Halifax	No	Yes ²	N/A	N/A

- 1 Despite the fact that the Ombudsman notice stated that a leaflet was available.
- 2 Included information about the Ombudsman.

A 1990 survey by the Office of Fair Trading showed that only 24% of consumers had heard of the Banking Ombudsman. This compared to 27% and 22% for the Insurance and Building Societies Ombudsmen (cited in National Consumer Council 1993).

The Jack Committee (1989) rejected the idea of merely improving upon the voluntary scheme and suggested that it should be replaced by a statutory structure. They stressed that for the majority of private customers, who cannot afford to take the case to court, the Ombudsman is their last form of redress. Therefore it is vital that there is no hint of bias in the scheme, and the Committee believed that only a statutory system, with an independent element of objective assessment by the Bank of England, would satisfy the public of its impartiality. A further advantage of a statutory scheme is that membership could be made compulsory, and this would facilitate any future alliance between the Building Societies and Banking Ombudsmen.

Although a statutory scheme might introduce greater independence, a concern simply with the framework would not address the other issue of the standards used in decision making. For instance, it would not of itself require that the Banking Ombudsman follow the example of the Insurance Ombudsman by giving greater weight to the issue of fairness.

5. Conclusion

The Ombudsman scheme, whatever its faults, is a good method of resolving disputes between banks and personal customers. It is informal and accessible. The disputes usually concern small amounts of money which would not justify the trouble and expense of going to court (Jack Committee 1989). The Ombudsman is able to offer specialised knowledge of banking matters, which is particularly useful in the resolution of the many complaints concerning automated teller machines (ATM). The Ombudsman scheme benefits member banks because it allows disputes to be resolved in private and avoids the expense of court action.

Yet the problems are also clear. The importance of the scheme to customers emphasises the necessity of strengthening its effectiveness and making its existence better known to the public. Like the other ombudsman schemes, the Banking Ombudsman's core objective is the resolution of disputes which are brought for investigation. Such a scheme is not the ideal method for instituting changes in banking practice. There are also the difficulties of enforcing the Banking Ombudsman scheme within the single market. Banks coming into the UK are not obliged to become members - nor, of course, are UK banks. Moreover, the operations of UK banks abroad are not covered by the schemes, and corporate customers have no access to the Ombudsman.

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Statistics

During the year ending 30/9/92 (Banking Ombudsman 1992), the Ombudsman's office dealt with 2,316 general enquiries in writing (compared with 1,413 the previous year) and received a further 1,704 general enquiries over the telephone (compared to 2,273 the year before). Specific enquiries, made by telephone, relating to customer complaints numbered 11,219 (an increase of 97.5% on the previous year) although a minority concerned financial institutions which are not members of the Banking Ombudsman Scheme. The total number of new complaints received in 1991-1992 was 10,109, and 1,948 were carried forward from 1991. This was a 60% increase on the previous year's figure, which, in turn, had been a 62% increase on the year before that. The total number of "immature" complaints (those which have not gone forward for investigation) considered against member banks was 11,373, 2,011 of which were outside the Ombudsman's terms of reference. Of the 9,326 eligible complaints, 1,580 were discovered to involve no breach of duty. 7,782 were returned to the banks, after further screening revealed that deadlock had not been reached. Of these 761 are known to have been settled, 1,305 are "estimated" as settled and the outcomes of 3,229 are unknown. Out of the original 11,373 complaints, 956 went forward for a full investigation (an increase of 28% on the previous year) and 2,836 were carried forward to the next year. The lower rate of increase for mature, compared with immature complaints was explained by the Ombudsman as reflecting the banks' greater success in resolving immature complaints after they have been returned from him.

In addition to the 956 mature complaints, 561 were brought forward from the previous year. In 9 cases it was decided that they were better dealt with by the courts or other complaints procedures. After the investigation, 58 were settled and 44 were not pursued further. After the preliminary assessment, 152 were settled and 336 were not pursued. After further investigation and a

formal recommendation, 165 were settled and 762 were carried forward to 1993. In no case did the bank refuse to accept the final recommendation, so it was not necessary to enforce it by re-issue. Of all the immature and mature complaints known to have been settled, 1,022 can "definitely be regarded as successfully resolved in favour of the complainant". Of the 772 "mature" complaints resolved during the year, after investigation, roughly 36% resulted in compensation being awarded to the complainant. Most awards were between \$100 and \$10,000. The average time taken to progress through the mature stage was 270 days; five days less than in the previous year. The target is six months. The largest categories of immature complaints were those concerning charges and interest (19.2%), lending (14.5%), automated teller machines (8.7%), account errors (6.7%), credit/debit cards (6.4%) and negligence (5.6%). The most common mature complaints received were about automated teller machines (36.2%), cheque guarantee cards (9.9%), negligence (6.4%), lending (6.1%), dormant accounts/destroyed records (4.7%), and account errors (4.4%). The Ombudsman explains the disproportionately high number of complaints relating to cash cards in the mature stage as a result of a feeling that it is unfair that banks should be entitled to rely on standard terms and conditions enabling them to charge customers for withdrawals which they did not make. The Ombudsman anticipates a decline in this category of complaints once the Code of Practice begins to take effect.

INSURANCE COMPANIES AND THE CONSUMER: THE INSURANCE OMBUDSMAN

1. Legal Deficiencies: the need for regulation

Apart from questions of insolvency and fraudulent or negligent advice or application of assets, the main forum for dispute between consumers and insurance companies will be the substance and conduct of the contractual relationship between them. The law applicable to this relationship has been criticised by academics, the courts, the Law Commission and consumer groups (Birds; Law Commission). The main criticism is based on the fact that the balance of the relationship still, in principle, rests on the standard form contract, and so involves an inherent doctrinal bias towards the interests of the insurer (Cadogan and Lewis). This is because insurance contracts are regarded as forming part of the general principles of contract law, which still have at their core the notion of freedom of contract. However, in reality consumers are normally in too weak a bargaining position to be able to negotiate a change in these terms. Yet there is no doctrine of fairness or inequality of bargaining power, which could be used to question the enforceability of terms in an insurance contract. The doctrine of precedent in the English common law makes the development by the courts of new doctrines that might be used to regulate the insurance contract a very difficult - even impossible - process. As we will see below, the typical reaction of the common law courts to perceived injustices associated with freedom of contract doctrine is to attempt to use covert tools, such as rules of construction, to restrict the enforceability of harsh terms in a contract. Even insurance companies have conceded that, 'in practice they do not take advantage of their full legal rights' (Law Commission). Such practices may become more important with the introduction of the single market and the need to compete with non-UK insurance companies whose terms may be more favourable to consumers.

There are three key problems associated with the freedom of contract regime. First, there is the use of terms in the proposal

form which hold that any statements made by the insured on the proposal form will be taken to be important terms of the contract - 'warranties'. This is done by the use of 'basis of the contract' clauses. The implications are that if the insured has made a false statement on such a matter the insurer may be able to repudiate the contract, irrespective of whether the false statement was made innocently and was, in substance, immaterial to the conduct of the relationship. In *Dawsons Ltd v Bonnin* [1922] 2 AC 413, a proposal form for the insurance of a lorry contained a basis-of-the-contract clause in respect of the insurer's answer to the question as to where the lorry was to be garaged. The insurer did not give the correct address. It was held that the insurer could terminate the policy and thereby avoid liability for the loss, despite the fact that the inaccurate statement was immaterial and unrelated to the loss. At common law the only weapon against this immersion of substance by form is the use of rules of construction, principally the *contra proferentum* rule. In *Houghton v Trafalgar Insurance Co. Ltd.* [1985] IBQ 24, Lord Justice Somervell said, 'if there is any ambiguity since it is the insurers' clause, the ambiguity will be resolved in favour of the assured'. Apart from operating 'after the fact', and, therefore, only protecting the minute percentage of consumers who would ever challenge such a clause in court, rules of construction suffer from the malaise so eloquently described by Karl Lewellyn:

First, since [rules of construction] all rest on the admission that the clauses in question are permissible in purpose and content they invite the draftsman to return to the attack. Give him time, and he will make the grade. Second, since they do not face the issue, they fail to accumulate either experience or authority in the needed direction: that of marking out for any given type of transaction that the minimum deficiencies are which a court will insist upon as essential to an enforceable bargain of a given type, or as being inherent in a bargain of that type. Third, since they purport to construe, and do not really construe, nor are they intended to, but are instead tools of intentional and creative misconstruction, they seriously embarrass later efforts to true construction, later efforts

to get at the truth of those wholly legitimate contracts and clauses which call for their meaning to be got at instead of avoided. The net effect is unnecessary confusion and unpredictability... Covert tools are never reliable tools (cited in Hondius).

The second problem traditionally associated with the freedom of contract regime is that presented by the duty of disclosure. This emanates from the fact that an insurance contract is *uberrimae fidei* (of utmost good faith. Although it is a mutual duty (see *Banque Financiere de la Cite v Westgate Insurance Co Ltd* [1990] 2 All E.R. 947; [1990] 2 W.L.R. 3640, in practice it applies most prejudicially to the insured customer. It means that there must be full disclosure of all material facts relating to the insurance and that failure to make such disclosure will make the contract voidable at the option of the insurer. The rule is justified on the basis that,

As the underwriter knows nothing and the man who comes to him to ask him to insure knows everything, it is the duty of the assured... to make a full disclosure to the underwriter without being asked, of all the material circumstance (Lord Justice Scrutton, in *Rozannes v Bowen* (1928) 32 Ll. L. Rep. 98, at 102)

The problem, of course, with this reasoning is that the insured customer who 'knows everything' is not necessarily to be taken to assume that something about which he or she has not even been asked will be regarded as material, especially given the resources open to the insurer to decide what is likely to be important and to put it on the proposal form. However, despite proposals for the reform of the disclosure rule by the Law Reform Committee in 1957 and the Law Reform Commission in 1980 (see above), no substantive change has been made to the law.

The third problem associated with the freedom of contract regime is the generally one-sided terms which it allows to be introduced.

2. *Statutory or Self-Regulation*

In 1977 the UK Parliament passed the Unfair Contract Terms Act (UCTA), which regulates contractual terms and notices that attempt to 'exclude or restrict' various types of liability (UCTA, section 13 for definition of 'excluding or restricting liability'). The main feature of this Act is to subject such terms to a reasonableness test, which effectively looks at the market and bargaining circumstances surrounding the conclusion of the contract - was there a choice of terms available from that supplier or in the market generally? How clearly was the clause worded and communicated to the consumer? Was the customer offered any particular inducement to accept the term in question? (schedule 2, UCTA; Woodroffe and Lowe; Willett and O'Donnell). It is clear that these sorts of controls would have implications for 'basis of the contract' clauses and some of the other rather one-sided terms in contracts of insurance.

The insurance industry vigorously resisted being covered by UCTA and in exchange for being exempted they adopted a Statement of Insurance Practice (1977) which has been revised in 1981 and 1986. This is a voluntary code of practice. However, it is a condition of membership of the Association of British Insurers (ABI) that an insurer complies with the Statement. However, the ABI does not have any mechanism for monitoring compliance, instead it relies on complaints that a company has failed to comply. The ultimate sanction for failure to comply is expulsion from the ABI which, although it would not directly affect the ability to do business, would, presumably, create adverse publicity and so damage the company's reputation (see Cadogan and Lewis).

The Statement says that neither the proposal form nor the policy shall contain any term which converts statements about past or present fact into warranties (paragraph 1(b)). It also says that the insurer: must draw the duty of disclosure to the attention of the insured customer in the proposal form (paragraph 1(c)(i), (ii)); must ask specific questions about matters which 'insurers have found generally to be material' (paragraph 1); and should not

repudiate liability to indemnify the insured on the grounds of non-disclosure of a fact which the insured could not reasonably be expected to have disclosed (paragraph 2(b)(i)). If the insurer follows the Statement then there is clearly an impact on the relationship between the parties. The Statement is about the terms and practices which should be introduced into the relationship, and which, if they are introduced, become part of the legal relationship. What the courts will not do is to adopt the Statement in cases where it has not been introduced by the parties.

There seem to be two main problems associated with the Statement of Insurance Practice. First, it is difficult to know how many insurers adhere to it, although most claim to do so (Lewis and Cadogan). This problem will become considerably more acute when the third generation of EC directives begins to impact upon the provision of insurance services in the UK. These proposed directives (Com (90) 348 final and Com (91) 57 final) will allow the provision of insurance services across borders of through the establishment of branches in other member states. The responsibility for licensing and control will mainly lie with the home state and not the host state. The host state will not be allowed to adopt a prior vetting procedure in relation to contracts of insurance offered by insurance companies from other member states. This will mean that the UK will find it difficult to force such companies to adopt the Statement. A lot will then depend upon the pressure exerted by the sectors of the industry which do adhere to the Statement.

The second difficulty with the Statement is that it relates mainly to the issues of warranties and disclosure ;and does not require fair dealing or good faith in other aspect of the relationship. Although such principles may be applied by the Insurance Ombudsman this will be too late in most cases. The consumer will have suffered detriment at the stage of the dispute as a consequence of the failings in the contractual allocation of risks and/or the presentation of the situation by the insurance company. This is the crucial stage for the consumer - the front line gatekeeper has tremendous power to present to the consumer the fait accompli that

his cause is lost. The ombudsman is another obstacle, which first must be known about and then scaled. This problem could have been addressed by the Unfair Terms directive, which could have been used to require minimum standards of fairness in insurance contracts. However, due to the lobbying of the industry it may be that the effect of Article 4 is to exempt many terms in insurance contracts from the control of the directive. Viewed more positively these circumstances might be used to bargain with the industry for a better Statement.

Attention must be given to these difficulties soon. The Statement has the potential to be a valuable piece of reflexive regulation which attempts to harness good practice in the insurance sector. However, while remaining semi-autonomous it should, perhaps, be referenced in its drafting to systematic participation by consumer groups and principles of consumer welfare. Thought should also be given to incentives for incoming insurance providers to joining the scheme. Alternatively, the Commission should be persuaded of the dangers to consumer welfare if significant deregulation of access to other member states is met by almost wholly autonomous regulatory processes within the member states to which only some adhere, that is, the Commission would be persuaded to allow some form of vetting by the host states. In the case of the UK this would most sensibly involve being able to insist on adherence to the Statement.

3. *The Insurance Ombudsman: Context and Structure*

The Insurance Ombudsman (IOB) was established in 1981 on the initiative of the General Accident Insurance and Guardian Royal Exchange companies. It was created in response to growing difficulties over the technicalities of insurance law, which seemed to many to have led to unfair results. By 1990 there were over 300 member companies. This includes Lloyds who joined in 1989, despite having their own alternative dispute resolution process (see Lloyds bye-law number 1 of 1989). The IOB has a Memorandum which sets out its objectives. The objectives are to receive

references as to disputes over insurance policies such that the dispute is either settled or withdrawn. As well as retaining staff, the IOB may encourage research and commission investigations in connection with its function. The costs of the IOB are met by levies on the members. The service is free to the consumer. Like the Banking Ombudsman, the IOB operates on a three-tier structure. The IOB is subject to the supervision of the Council, which consists of ten members, only two of whom are linked to insurance companies, giving it a more independent membership than the Banking Ombudsman scheme.

The Ombudsman may adopt the role of counsellor, conciliator, adjudicator or arbitrator and can appoint assistants to carry out such roles. Awards of up to £100,000 can be made by the IOB against any member of the scheme. The members cannot appeal against the award. The consumer, on the other hand, is not bound by the award and may choose to initiate legal action.

4. *The Insurance Ombudsman:*

The Development of Standards Paragraph 2(a) of the terms of reference is crucial, setting out, as it does, the criteria and methods to which the IOB refers in making decisions:

The Ombudsman may, in relation to any complaint, dispute or claim comprised in a reference, make an award against any member named in such reference and in making any award he shall have regard to the terms of the contract, and act in conformity with any applicable rule of law or relevant practical authority, with general principles of good insurance practice, with these terms of reference and with the statement of insurance practice and codes of practice issued from time to time by the Association of British Insurers and the Life Offices Associations but shall not otherwise be bound by any previous decision made by him or any predecessor in his Office. In determining what are the principles of good insurance practice he should where he considers it appropriate consult with the industry.

This set of criteria is fairly open textured if not confusing. It would seem to be open to the Ombudsman to place the stress where he or she considers it appropriate. He or she is expected to have regard to a range of factors. If, however, one of more of these factors came into conflict the Ombudsman can presumably pay more attention to one or more over the others. The most obvious difficulty is posed by a case where the law and/ or the contract comes into conflict with 'fairness'. The current ombudsman has been very clear that he feels entitled to prioritize fairness as a general principle. In paragraph 2(1) of his 1989 Report he said: 'I am... entitled to reach a fair and commonsense conclusion whatever may be the strict position.' This makes an interesting contrast with the deference of both the Banking Ombudsman and the Building Societies Ombudsman to the legal situation. It seems probable that the IOB has taken this approach as a result of the long history of concerted criticisms about the lack of fairness in the legal structure of the contractual relationship, and a desire to be seen to applying rigorous standards to insurance contracts in exchange for exemption from regulation such as UCTA. The banks, on the other hand, have only recently been subjected to criticism over their contractual relationships with customers, nor did they avoid the application of UCTA, and this may help to explain some of the difference between the two ombudsman's use of fairness as a standard in spite of similar terms of reference. In any event, the IOB's philosophy has informed the approach to four notable areas of decision making.

5. *The Insurance Ombudsman: The Standards*

(a) *Use of UCTA criteria*

Where it is considered appropriate, the Ombudsman has been applying the reasonableness criteria set out in UCTA and in the cases decided under UCTA. This involves looking at the clause in the light of the bargaining strengths of the parties at the time when the contract was made. This enables the IOB to bring into the

decision-making process a degree of concern for the welfare of the consumer.

(b) Reversal of law

The IOB has, on occasion, been prepared to ignore established principles of law which are prejudicial to the consumer. For example, it is clear from the case law that an insurance company is not normally liable for the negligence of an intermediary (Hodgin). This would mean, for example, that the insurance company would not be liable for negligent misrepresentations made by the intermediary as to the benefits of taking up the policy. The reason for this is that the intermediary is regarded in law as the agent of the insured customer and not of the insurer. The Law Reform Committee suggested reform of this rule in 1957 (Law Reform Committee 1957). This suggestion was ignored in the UK, although it was acted upon in Australia and New Zealand (Insurance (Agents and Brokers) Act 1984 and Insurance Law Reform Act 1977). The current state of the law in the UK has been criticised by the Court of Appeal in *Roberts v Plaisted* [1989] 2 Ll Rep 341. The IOB has carried this criticism into practice, saying in his 1989 Report that:

Pending legislation it seems impossible to assume that the legal positions will necessarily produce an equitable outcome. Accordingly, I am not prepared, in appropriate cases, to hold insurers responsible for the defaults of intermediaries.

(c) Proportionality and the disclosure rule

Despite requirements in the Statement of Insurance Practice that insurers should be more explicit about the duty of disclosure it is clearly still possible that a customer will innocently or negligently fail to disclose what is later found to be a material fact. In law the whole policy may be invalidated by such a failure to disclose. From an equitable or welfare approach it is clearly rather

opportunistic of the insurance company to take advantage of such circumstances to avoid paying out. It has been argued that there should be proportionality principle which would allocate losses equitably between the parties (Birds). A similar approach is taken in France and Sweden, but has been rejected by the Law Commission. The IOB has, nevertheless, said that,

the basic solution adopted as equitable was that the claim should be met proportionately taking into account the relative amounts of the actual premium and the appropriate premium. For example in one case had the business use of a house (seasonal bed and breakfast been disclosed the premium would have been increased by approximately one quarter (say, from £100 to £125). The proportionality solution meant that the insurer should be liable for 80% of the claim (because £100 is 80% of £125). Similar results have been reached with motoring policies where increased premium rates (e.g. in the light of the policyholders claim record) are easily ascertainable (1989 Report, paragraph 2.16)

(d) Approach to certain types of investigation

The Ombudsman has shown himself to be prepared to insist upon minimum standards of decency where investigations are being carried out to verify claims. It is common for insurance companies to investigate whether insured customers are actually disabled before paying out on health insurance policies. They will often use private detectives to carry out these investigations. More contentious, however, is the use of trained nurses who pose as 'counsellors' and call upon the claimant without an appointment to verify the validity of the claim. Understandably, this causes distress and anger among many claimants. The IOB has considered several such cases and ruled in the Annual Report for 1991 that, in principle, the insurers are entitled to make enquiries, but that the nature of the enquiry must be made clear at the outset. In several cases where this has not been done the IOB has ruled that, although the claimants had not suffered any financial loss as a

result of the visits, they should be compensated for the 'upset and distress' caused.

6. *Conclusions*

It is clear that the IOB is adopting a robust attitude in applying principles of consumer welfare to the relationship between the insurer and the insured. The difficulties are not with the IOB scheme itself, but rather with the fact that it only operates after the fact, and that (as with the Statement of Insurance Practice and other ombudsman schemes) there is a danger in the further reduction of its sphere of influence if prior vetting of new providers, such as those from other EC states, is not allowed or if significant market pressure cannot persuade these new providers to join up to the scheme. This, of course, assumes that the home countries of these new providers do not have superior consumer interest regulation.

Of course, the first focus should be on making sure that the internal complaints mechanisms of all insurers are adequate. Next there must be a system of independent investigation for those complainants who still feel dissatisfied. The ombudsman idea provides a rapid and cheap form of dispute resolution for those who have not the funds or the inclination to go to court or whose claim does not warrant such an action. The success of ombudsman schemes depends on companies joining the schemes and this may require pressure from within the industry, as with the IOB and the Banking Ombudsman, or from legislation, as with the Building Societies Ombudsman. Success will also depend on consumers being aware of them and willing to use them. Whilst the statistics indicate a willingness to use the IOB, even amongst those whose claims failed and in spite of the tendency not to believe that such schemes are very independent, it seems that only a minority of the general public are aware of the existence of the scheme, and this is true also of the other ombudsman schemes (see Statistics in the appendix). The IOB scheme should also be more widely advertized.

The National Consumer Council (1993), in a report on the Insurance and Building Society Ombudsman schemes (see Statistics appendix), recommended more openness by all ombudsmen, an independent body to supervise all the ombudsmen schemes with a majority of its members representing the public and consumer interest. The first joint UK ombudsman conference, held in 1991, set up a working party to lay down suggestions for greater uniformity in the structure and jurisdiction of the various schemes. The working party established a UK Ombudsman Association which seeks to define which bodies can call themselves ombudsmen, draws up standards of good practice, encourages effectiveness and efficiency, promotes public awareness, and develops and safeguards the role of both private and public sector ombudsmen. Although this Association has now official or legal status, it might well provide the model for a supervisory body for such schemes.

Statistics

The number of new cases taken on by the IOB more than doubled in 1992. There were 13,899 written inquiries, 28,048 telephone inquiries, and these led to 4,334 new cases (Gazette, 90/17, 5 May 1993). In 1992, 65% of the Ombudsman's decisions were in the insurers' favour, so although customers avoid the costs and delays of a court hearing there is still a good chance that they will lose their case.

According to the National Consumer Council (June 1993), most complaints which were made to the IOB concerned life assurance or pension policies (which include unit trusts, investment plans, etc.) at 38% of all complaints. Next was motor insurance (15%), then household contents or all risks insurance (14%), building insurance (12%) and travel insurance (11%). The average time from complaint to award is 52 weeks, although many cases are actually settled between the insured and the insurer before an award is made. Although this is a long period, it is considerably shorter than a court hearing would take and far quicker than the Building Society Ombudsman, where the average time, according to the NCC, is 91 weeks. Only 29% of people who complained to the IOB used a lawyer (only 14% of those who went to the Building Society Ombudsman used a lawyer); this relatively high figure may be because the amounts being claimed were typically quite high, with an average of £13,218 where it was a life assurance claim and £4,497 for other forms of insurance claim.

In 1990 the Office of Fair Trading (1990) found that only 29% of people had heard of the IOB. The National Consumer Council 1993 survey found that 39% of those who used the IOB thought it was 'very approachable' (as against 43% for the Building Society Ombudsman) and 25% found the IOB 'fairly approachable' (as against 28%). Complainants' rated the fairness of the IOB on a scale where 4 was 'very fair' and 2 was 'not very fair': the IOB was rated as 2.32 (as was the Building Societies Ombudsman). Interestingly, it rated 2.68 for independence (where 4 was 'very

independent'), whilst the Building Society Ombudsman, which has statutory independence, rated only slightly better at 2.75. Although the ratings were not particularly good, nevertheless 68% of those who had used the IOB said they would use it again (71% in the case of the Building Societies Ombudsman), including a majority of those who had lost their cases.

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THE BUILDING SOCIETIES OMBUDSMAN SCHEME

1. The Development of the Scheme

In the building society sector there has been a statutory scheme of dispute resolution which provided the parties with an alternative to court proceedings since 1874. Under this the complainant had to be a member of the building society complained against and the rules which determined the dispute were those of that building society. This method of dispute resolution seems to have been little used, and during the passage of the 1986 legislation through Parliament an amendment was introduced which created the Building Society Ombudsman Scheme.

2. The Structure of the Scheme

The 1986 Act was 'the first statutory introduction of the ombudsman principle into the private sector' (Lloyd, Waters and Over, para. 15.01). Section 83(1) provides that:

An individual shall, by virtue of and in accordance with schemes under this section, have the right, as against a building society, to have any complaint of his about action taken by the society in relation to a prescribed matter of complaint which affects him in prescribed respects investigated under the scheme.

The section states that all authorized building societies shall be members of a recognized scheme (section 83(4)), and that only the regulatory authority - the Building Societies Commission - can approve a scheme (section 83(8)). So far, only the Building Societies Ombudsman Scheme has been recognized. It came into operation on 1st July 1987.

The Scheme was set by the Building Societies Association and is funded by contributions from authorized building societies. The Association created the Building Society Ombudsman Company Limited as a means of establishing the scheme, and ultimately it is the company which can extend the jurisdiction of the Ombudsman.

The Building Societies Commission has the power to withdraw recognition from the Scheme if it fails to conform with the requirements of the Act. The Scheme is actually administered by a council made up of not more than eight members, a majority of whom represent public or consumer interests. The council appoints the ombudsmen and monitors the operation of the Scheme. At present there are three ombudsmen (Boleat, Armstrong, French and Coogan 1992, p. 81).

3. *Jurisdiction*

The Scheme must investigate a complaint where certain conditions are fulfilled (clause 15 of the scheme, see McGee 1992):

- the complaint relates to action taken by a building society or associated body in the United Kingdom;
- the society participates in the scheme (a requirement for authorization is, however, membership of the scheme);
- the action relates to one of the activities specified in clause 17. This restates schedule 12 of the 1986 Act, in which the minimum requirements of the Scheme are laid out: the activities are the operation of share accounts, deposit accounts, secured and unsecured advances, loans for mobile homes, money transmission services, foreign exchange facilities, agency payments and receipts, and the provision of credit. 'Thus, the scheme covers only the absolute minimum of ground. It does not cover all the services which a building society can provide.' (McGee 1992, p. 35, see later);
- the grounds of the complaint are that there has been: a breach of the society's obligations under the 1986 Act, its rules or any other contract; an associated bodies' breach of the rules of the society or of the terms of a contract; unfair treatment; maladministration;
- the complainant alleges the action has caused her or him pecuniary loss, expense or inconvenience.

Even if the above conditions are met, there are situations when the ombudsman must or may decline to investigate under clause 15

of the scheme (McGee 1992). The ombudsman must decline where:

- the complaint is frivolous or vexatious, or is subject to court proceedings in the UK, or a court has given a judgment on the matter; or, after the ombudsman's investigations have begun, one of these situations arises; - the complaint does not come from the injured party or an authorized representative;
- the complaint relates to the complainant's creditworthiness, unless maladministration is alleged.

The ombudsman may decline to investigate where (clause 16):

- the society's internal complaints procedure has not been invoked or exhausted;
- there has been a delay of six months in complaining to the ombudsman (1986 Act, schedule 12, part II, paragraph 2);
- the complaint has been, or is, the subject of court proceedings outside the UK.

In November 1992 the Alliance and Leicester Building Society instituted a legal challenge of the ombudsmen's jurisdiction to investigate complaints about changes in investment interest rates (see next section) on the grounds that policy decisions by a society about the interest rates they offer are outside the terms of reference. The ombudsman's response was that, whilst they had no jurisdiction to inquire into the level of interest rates set, they could inquire into allegations from individuals that they had been unfairly treated in connection with a change in interest rates. The Society withdrew their action before the hearing and the ombudsman has continued to investigate such complaints (Building Societies Ombudsman Scheme 1993, p. 25).

The ombudsmen see the main difficulty as the exclusion of most of those complaints which relate to events that occurred before the mortgage or investment concerned was completed (see section 6 below). This is not a restriction that is placed on, for instance, the Insurance Ombudsman, who will investigate complaints made about, for instance, the way in which a policy is sold. It is odd that where a building society sells an insurance policy - as most do - the Building Society Ombudsman has no jurisdiction to inquire into

events before the completion of the transaction, whereas if the policy had been sold by an insurance company, the individual could have complained to the Insurance Ombudsman, who does have the power to investigate. It has been announced that discussions are taking place between the Council and the Building Societies Ombudsman Company Limited, with whom the power to extend the jurisdiction rests, in order to give the ombudsmen the right to inquire into 'precompletion' events (Building Societies Ombudsman Scheme 1993, p. 25-6), although with regard to negligent valuations the Building Societies Commission rejected a proposal to extend the jurisdiction to pre-completion valuations (James and Seneviratne 1991, p. 163). Meanwhile, the Building Society Ombudsman does in practice investigate such events, but only if the society concerned consents.

4. Procedure

Clause 24 of the scheme allows the ombudsman to decide the procedure that will be adopted for dealing with complaints. In the first Annual Report the procedure that has been adopted was set out (McGee 1992, pp. 40-1).

The society's internal complaints procedure must normally have first been exhausted. The complainant then fills in a form stating the nature of the complaint and enclosing any relevant documents. The ombudsman will ask the society for its comments on the complaint, and the complainant may respond to these comments. The ombudsman will next write a draft decision (the provisional notification) in which, if appropriate, the level of compensation is indicated. The parties must respond within fourteen days. After this time the ombudsman will make a determination. Any compensation awarded cannot exceed £100,000, and the ombudsman cannot require the complainant to do anything or to pay any money. If the society refuses to accept the ruling, it is required to publish the reasons for not doing so in the next directors' report. Of course, refusal to accept such decisions may be an issue of interest to the regulatory authority, the Building

Societies Commission. If the complainant dislikes the decision then he or she may pursue the matter through the courts.

5. *Standards*

The ombudsman is required by clause 29 to make a determination on the basis of what is fair in all the circumstances. In determining this issue the ombudsman must have regard to the rules of the society, contractual obligations, statute law, the provisions of any relevant code of conduct (such as the Code of Banking Practice), the wording of any advertisement issued by the society and communication with the complainant, and any other relevant matter. Maladministration by a society, which may or may not amount to a breach of a legal obligation, is often a crucial determining factor: see case studies 4 and 7. The ombudsman is not bound by previous decisions made under the scheme, but, like the Insurance Ombudsman, is keen for principles to emerge, and these are published in the annual reports.

Where there is a contract, which has been entered into with full knowledge, then the ombudsmen 'need to be persuaded that it is unfair to enforce its terms': the ombudsman have so ruled in some of the cases on investment interest rates to savers (see next section). The Ombudsman will also consider the application of the Unfair Contract Terms Act 1977: see case study 6. Moreover, where the courts have already laid down a rule which covers a complaint before the ombudsman, the ombudsman will apply that ruling. Legal rulings in two key areas have affected the decisions of the ombudsmen: where the complaint concerns negligent valuations by surveyors (see next section), the ombudsman will follow the principles laid down by the courts in *Smith v Eric S Bush and Harris and Another v Wyre Forest District Council and Another* [1989] 2 All ER 514, and in *Watts v Morrow* [1991] 4 All ER 937; and where a borrower can no longer afford the mortgage repayments and seeks to sell the house, but the society refuses to consent to such a sale on the ground that it will not bring in sufficient to cover the mortgage, the ombudsman will follow *Palk*

and another v Mortgage Services Funding plc (1993) 25 HLR 56, which allowed the sale in certain circumstances (but see case study 2).

Fairness is, however, the guiding consideration (generally, Building Societies Ombudsman Scheme 1993, p. 30). As Case Study 1 shows, even if the ombudsman rejects the substance of a complaint because it is covered by a court ruling on a similar set of facts, that will not preclude the possibility of some compensation for inconvenience. During the debates before the enactment of the 1986 Act, it was argued that using such a concept as fairness would create uncertainty. There are no specific guidelines and the ombudsmen have merely said that the notions of fairness applied are 'those of the fair-minded man in the street'. This does mean that the ombudsman is not considering merely a standard of conduct which could be expected of the reasonable building society. The industry's normal practice is not, therefore, in itself sufficient to determine the issue if, on a broader view, that practice is deemed unfair. In this way the ombudsman's decisions may lead to changes in the practices of the societies (for example, case study 5). Unfairness is not simply treating an individual differently from the way in which other similar individuals are treated; it may be unfair to treat an individual in a particular way, even though he or she is treated in the same way as many other individuals.

Case study 3 illustrates the way in which the ombudsman will use the concept of fairness to find against a society even though the error that it made was only part of the reason for the complainant suffering a loss. Moreover, the ombudsman will make awards to compensate for inconvenience caused by the building society even if there is no financial loss suffered: see, for instance, Case Study 1.

6. *The Operation of the Scheme*

The Building Societies Ombudsman Scheme Annual Report for 1992-93 shows a 29.2% increase in the cases received as against the figures for 1991-92. The National Consumer Council's Report

on Consumer Experience of the Insurance Ombudsman Bureau and the Office of the Building Societies Ombudsman (April 1993) has found that those likely to complain were typically older, male and from the professional and managerial classes. There are several types of matters which are common sources of complaints:

(a) Home income plans and equity release schemes: in 1992-93 there were 112 initial complaints and 17 investigations. Most complaints are outside the scheme's jurisdiction because they involve an assertion that the Society acted unfairly in granting the loan in the first place and this is a 'pre-completion' event (unless the borrower was a borrowing member of the society before that event took place). The Ombudsman has had to obtain the consent of the complainant, the society (not all give their consent), the Building Societies Ombudsman Council and the Building Societies Ombudsman Company Limited before undertaking investigations in to such cases.

(b) Mortgage protection insurance cover: the recession has increased the interest in, and claims on, insurance policies taken out to cover against the possibility of, for example, unemployment or illness making mortgage repayments difficult. Many complaints are outside the scheme's jurisdiction because the event (unemployment or illness) took place after the mortgage was completed (see case study 7).

(c) Negligent valuations and surveys: a recent High Court decision (*Halifax Building Society and Others v Edell and Others* [1992] Ch. 436) has held that complaints can only be made about valuations or surveys of properties if the valuer is an employee of the society and the complainant was an existing borrower at the time of the valuation. So, for instance, a first-time borrower could not complain to the ombudsman (the only remedy would be to sue the surveyor), but a person who already had a mortgage with the society and was seeking to increase the size of the loan could complain. Only 10% of initial complaints under this heading were within the scheme's jurisdiction, and, indeed, the Annual Report 1992-93 of the scheme argued that the restrictions on their

jurisdiction in this area could not be logically justified. On this area see case study 1.

(d) Negative equity: complaints arise where a house is repossessed then sold by a building society because the mortgage repayments have not been made, and the amount realized in the sale does not cover the original loan, so that money is still owed to the society by the person who took out the mortgage. This is not covered by the Palk case (section 5; see also, case study 2). This has become a particular problem in the last few years as the recession has brought unemployment and falling house values. Complaints typically arise where borrowers consider that the society has not taken all the steps it could to get the best price or has delayed unduly in selling the house. However, McGee (1992, p. 42) has commented that complaints under this heading have not generally fared well before the Ombudsman.

(e) Mortgage interest rates: between 1990-91 and 1991-92 complaints on this issue rose from 50 to 271 and then in 1992-93 to 367. The main complaint is that societies postpone reductions in interest rates, particularly to existing borrowers, for an excessive time after a general fall in interest rates.

(f) Investment interest rates: this has been the dominant area of complaints in 1991-92 and 1992-93. Usually complaints arise when someone has money invested in a type of account which has then been closed to new investors and a new type introduced without the individual saver being notified of the change. Typically, such a change means that the old accounts receive a substantially lower rate of interest. Moreover, the old accounts may have a condition requiring a long period of notice to be given before withdrawal can be made and the money shifted to the new accounts. The view of the ombudsman has generally been 'that societies must be free to compete in the market place, and that it is therefore not generally proper for him to intervene in decisions about investment rate.' (McGee 1992, p. 44) However, the ombudsman does consider that 'societies should ensure that relevant information about all accounts... is reasonably accessible', through, for instance, a combination of 'personal notice to the investor, adverts in the

press, notice in branches, interest rate leaflets, other methods of information with account statements' (Building Societies Ombudsman Scheme 1993, p. 21; case study 3).

(g) Automatic teller machines: as with the Banking Ombudsman, complaints are commonly made about such machines, such as the account being debited when no withdrawal has been made or the correct amount of cash has not been delivered. Typically, such complaints do not succeed because the terms of the use of such cards excludes the societies from liability, although the possibility of fraudulent withdrawal having been raised by both the police and the Jack Committee (1989) apparently stirred the Ombudsman to be more willing to allow complaints from 1990-91 (James and Seneviratne 1991, p. 169-70; McGee 1992, p. 43; but see case study 4). The number of complaints about unauthorized withdrawals in 1992-93 has, however, decreased by 46.9% over those in 1991-92 (Building Societies Ombudsman Scheme 1993, p. 23). This is most probably due to the effect of the Code of Banking Practice, Good Banking, which came into effect in March 1992, and which puts a limit of £50 on an investor's liability, unless there has been fraud or gross negligence on the investor's part.

(h) Current account facilities: this is the second largest source of complaints. Most complaints are about the time taken in the clearance of cheques drawn on other banks or building societies and paid into accounts; the problem being that customers draw cheques on their accounts which are then dishonoured because insufficient uncleared funds are available. It is claimed that the fact that building societies are not part of the banks clearing system means that the clearance of cheques takes longer for them. Most building societies, therefore, require seven or ten days for clearance and the ombudsman has said that this is reasonable, if it is brought to the attention of the account holder (McGee 1992, pp. 45-6; contrast case studies 5 and 6).

7. *How Useful is the Scheme?*

According to the National Consumer Council (1993), 'From the consumer perspective the ombudsmen have a twin role... resolving individual disputes... [and] raising industry standards'. Bell and Vaughan (1988, p. 1480) have argued that, 'The ombudsman scheme is clearly an improvement on the situation which existed prior to [the 1986 Act]... but it is clear that it is not perfect.' There are four main areas of concern. (See generally, National Consumer Council 1993, discussed in 'Insurance Companies and the Consumer: The Insurance Ombudsman' section of this Report.)

(a) Jurisdiction: 'The limits on an ombudsman's jurisdiction can cause significant problems for consumers - especially where there appears to be no mechanism for resolving particular types of complaint with the result that consumers may fall through the redress net', as, for instance, where the complaint concerns matters before the completion of a mortgage agreement or an investment (National Consumer Council 1993, p. 62; Building Societies Ombudsman Scheme 1993). The terms of reference of the scheme are based on the minimum requirements in the 1986 Act, which even the members of the scheme do not think are satisfactory (Building Societies Ombudsman Scheme 1993, p. 25). Of particular concern is the exclusion of complaints about valuations where the act of valuation occurred before the loan was completed, which, of course, is typically the case. Although, as has been mentioned, negotiations are being conducted to extend the jurisdiction in this area, it has been suggested that if the ombudsman's terms of reference are not extended then a surveyor's ombudsman scheme should be created. This may be the best solution, since it would also tackle the issue of the independent surveyor who is not employed by the society, and certainly it is an idea which is supported by the Building Societies Association and the Ombudsman. Criticism has also been made that complaints relating to the repossession of houses where borrowers have defaulted on loans are outside the ombudsman's jurisdiction.

The National Consumer Council (1993, p. 85) has recommended that the ombudsman be given the power 'to decide disputes about jurisdiction... [and] consumer organisations should be consulted about changes to the terms of reference of the schemes.' The Building Society Ombudsmen themselves feel that they 'would be able to devote more of [their] resources to the real task of deciding disputes if [they] did not have to spend so much time considering in great detail the problems thrown up by the exact drafting of the 1986 Act.' In cases of doubt or where jurisdiction clearly does not exist, the ombudsman has either to reject the complaint or engage in negotiations with the relevant society and the Council to deal with the matter on a consensual basis.

(b) Delay: The average time taken to dispose of cases was 14 months at the end of 1991, 11.3 months at the beginning of 1992 and 8-9 months in 1992-93. This compares favourably with other schemes, but it is still not satisfactory (Building Societies Ombudsman Scheme 1993, p. 12). However, these official figures seem rather conservative when compared with those of the National Consumer Council (1993, pp. 25, 27, 28, 30). They found that the average time taken from dispute to award was 91 weeks, compared with 52 weeks for the Insurance Ombudsman. This includes the time taken by the internal complaints procedure through which the complainant must normally pass before going to the Ombudsman. Part of the problem was the delay caused at this first stage and the National Consumer Council (1993, p. 85) has argued for target times to be imposed on internal complaints mechanisms. The Annual Report 1992-93 of the Ombudsman announced the creation of a pilot scheme which seeks to speed up these mechanisms (p. 30). The time taken between contacting the ombudsman and the decision was 52 weeks, compared with 25 weeks for the Insurance Ombudsman. Surprisingly, though, the National Consumer Council found that most of the complainants were content to wait if they felt that something was being done.

To alleviate some of these problems, and because complaints from different individuals often cover substantially the same issues

(this is common in cases involving investment interest rates), the scheme has evolved a system of test cases whereby a couple of similar cases are investigated in great depth and the principle of the outcome is then applied in similar cases 'in the absence of good reasons to the contrary' (Building Societies Ombudsman Scheme 1993, p. 26).

(c) Independence and impartiality: Not suprisingly, perhaps, the societies' own internal complaints mechanisms have been criticized as being neither fair nor impartial (National Consumer Council 1993, p. 34), and, because of the close links between the ombudsman and the societies, similar criticisms have been levelled at the ombudsman. According to Ellis (1992, p.926), 'Ombudsmen in financial services are widely presented as consumer champions... but the ombudsmen's claims to be independent and impartial sometimes look unconvincing to the public'. There are the independent members of the Council who try to represent consumer interests, but, although in practice they may achieve this independence, the public perception of their role may be quite different since they are appointed by the building societies.

One step towards the greater independence of all ombudsmen has been taken by the setting up of the UK Ombudsman Association (see section of UK Report on 'Banking Ombudsman'), although the National Consumer Council (1993, p. 82) has urged that any controlling authority for ombudsmen should include a majority consumer or public interest representation.

(d) Publicising the scheme: As Graham et al (1993, p. 85) have pointed out, one of the objectives of an ombudsman scheme is to offer a cheap, efficient and above all accessible alternative to the courts. Accessibility, of course, depends in part on consumer awareness. Studies have highlighted problems in this respect, although Graham claims that the Code of Banking Practice's requirements about the advertising of internal complaints procedures and the ombudsman schemes has improved this. The National Consumer Council (1993, p. 87) was critical of the way in which the Code left the method of advertizing up to the banks and building societies rather than specifying how it should be

done. The brief Uxbridge survey (see UK Report 'The Banking Ombudsman') also raises concern that banks and building societies may be failing to fulfil even the most basic requirements of the Code. In a longer study Graham et al (1993) found that 79% of banks, but only 35% of building societies had notices about the schemes in their branches, and that, in fact, the practice of the building societies had deteriorated since the introduction of the Code. Even this fairly low level of advertising has been forced on reluctant societies by threats from the Council (James and Seneviratne 1991, p. 171). On the other hand, advertising of internal complaints procedures, which had been rare perhaps on the ground that it increased complaints (see James and Seneviratne 1991, p. 174), had dramatically increased since the Code. On the whole, banks performed better than building societies, with Graham et al (1993) finding a more negative attitude amongst the latter. The societies commonly argued that information merely confused people and led them to go directly to the ombudsman or else it encouraged complaints.

The Building Society Ombudsman has now agreed to report to the Banking Code's steering committee 'any regular flouting' of the Code by a society (Building Societies Ombudsman Scheme 1993, p. 28). This is not entirely satisfactory since the Ombudsman is not proactive, but depends on complaints being made and this, in turn, relies on people being aware of the existence of a complaints mechanism.

The Office of Fair Trading (1991) has argued that ombudsmen's decisions should be given greater publicity so that 'any company persistently guilty of malpractice' will be exposed, as happens with the Advertising Standards Authority through its monthly case report. The National Consumer Council argue that this would reassure the public by showing that the scheme was working for them.

8. *Conclusion*

Like the other ombudsman in the financial services industry, the Building Society Ombudsman Scheme undoubtedly provides a useful cheap alternative to the courts, but the ability of the scheme to achieve its potential in this role depends on it having a jurisdiction that reflects the issues about which people complain, and also on accessibility and speed. Moreover, the precondition to complaining to the ombudsman is that the societies' internal complaints procedures, and this makes it important that those procedures should also be accessible and quick. The evidence suggests that the creation of the Ombudsman Scheme may have prompted some societies to improve and to regularize internal complaints mechanisms (James and Seneviratne 1991, p. 173). Certainly increasing numbers of complaints are being settled at an early stage (James and Seneviratne 1991, p. 174).

As is the case with the other ombudsmen, there is the problem of societies from elsewhere within the EC ignoring the ombudsman scheme, although it might be that consumers would find those societies which have fair complaints procedures more attractive. This would suggest the value for the societies themselves of advertising the availability of consumer redress mechanisms, but, if this is an argument, it has not apparently found favour with the building societies. Actions by UK building societies outside the UK do not come within the ombudsman scheme. The importance of this restriction for the future is difficult to assess since there seems little prospect of large scale expansion outside the UK, even into Europe, especially since the effect of the 1986 Act continues to mean a concentration of the societies on the business of individuals rather than companies.

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Case Studies

(Source: Building Societies Ombudsman Scheme 1993)

1. A husband and wife, Mr and Mrs X, obtained a valuer's report through the Society. The Society were told that Mrs X was asthmatic and, therefore, that it was important that the house did not have cavity wall insulation. The Society told the valuer that they were concerned about cavity wall insulation, but did not explain why. The property did have such insulation, but the valuer failed to inform Mr and Mrs X. The Ombudsman decided that the Society had been guilty of maladministration in not telling the valuer of the reason for the concern over the insulation and the valuer had broken his contract in failing to exercise reasonable care in preparing his report. In the Court of Appeal case of *Watts v Morrow* (see section 5) it was decided that the amount of loss is to be calculated by reference not to the cost of putting the property into the condition which conforms with the report, but to the difference between the value of the property as estimated by the valuer and its true market value. Since the Building Society Ombudsman applies the principles devised by the courts, it was decided that in Mr and Mrs X's case there was no loss, because the house was worth the same amount as the valuation. However, they had suffered severe inconvenience through their disappointment and through the worry about the effect of the insulation on Mrs X's health. It was, therefore, decided to order £1,000 compensation.

2. X wished to sell a property at a price below the mortgage, but the Society refused to consent to the sale. The Society later sold the house, but at a price below that which X had originally negotiated. X complained. The Society proposed a settlement under which X would be allowed the difference between the two prices, in return for an agreement to pay the balance of the mortgage over a five-year period. The Ombudsman viewed the proposal as fair in view of both the amount of money which the Society was forgoing and the proposal to allow repayment of the rest by instalments.

3. X put money into a two-year bond which required a minimum investment of £10,000 and which provided a higher rate of interest than any other account on offer at the time of the investment. The Society then closed the bond to new investors, and subsequently reduced the interest rate to below that offered on other types of accounts which had more favourable terms for withdrawal. The Ombudsman decided that, although the terms of the original bond offer legally allowed the Society to take the course of action that it had, the Society had acted unfairly and was ordered to compensate X for the loss of interest.

4. The Society had sent X an unsolicited personal identification number (PIN) for use with a card in an automatic teller machine. X never used the card, but there were several withdrawals from his account whilst the card was missing - it later turned up. The card had probably been taken by someone who knew the PIN, even though X said he had destroyed the letter on which the PIN had been notified to him. The Ombudsman decided that the Society had been guilty of maladministration in sending the PIN even though X had not requested one and because this action had been one of the factors leading to the loss. X recovered the full amount of the lost money and a sum for inconvenience caused.

5. X had a current account at the Society. The Society had a rule which stated that cheques paid into accounts could only be drawn against once the Society had deemed that the cheque had been cleared. The Ombudsman decided that the Society was at fault when it failed to meet a cheque drawn by X against a cheque paid into the account, where the latter cheque had, in fact, been cleared. 6. X had a current account with a Society which had a rule that stated a clearance period of 10 days. The Ombudsman considered that the rule did not breach the Unfair Contract Terms Act 1977, nor was it unusual or onerous, and the refusal to honour a cheque drawn by X within the 10-day period was not unfair treatment. The distinction between this case and case 5 was that in case 5 the Society's power to set a time period was unspecified and, therefore, amounted to unfair treatment.

7. X applied for a loan. One of the terms of the loan was that the Society required X to take out insurance cover for accident, sickness and unemployment and that this should 'be in force for at least the first two years of the mortgage term'. The insurance was arranged through the Society. The mortgage was completed on 15 December 1989, but, as was normal practice for the Society, the cover only began at the beginning of the next month, that is on 1st January 1990. Liability was excluded where unemployment occurred within 90 days of the start of the policy. X became unemployed more than 90 days after 15th December, but within 90 days after 1st January. The Ombudsman decided that there had been maladministration and a breach of contract by the Society in its failure to arrange insurance cover from 15 December. Compensation was awarded to cover the amount that X would have received under the policy plus an amount for inconvenience and to part payment of legal costs incurred.

MONEY ADVICE SERVICES

PART I

1. Background: The Growth of Personal Debt

Over the last 10 to 12 years personal borrowing in the United Kingdom has increased rapidly with many people taking on several credit commitments simultaneously. This trend accorded with the political policies of the 1980's, during which the Conservative Government took steps to liberalise the financial services sector and to increase the availability of credit by eliminating many of the restrictions previously in place. A notable example is the Building Societies Act 1986, which allowed these institutions to compete more freely with banks in the unsecured credit market and to offer similar financial services, including credit cards, loans and overdrafts. In 1982, the Bank of England ceased to impose interest rate and lending ceilings on the clearing banks, and in July of that year, hire purchase controls on minimum deposits were lifted. In addition, the abolition of foreign exchange controls and a higher sterling rate has attracted potential lending capital to Britain. This was channelled primarily to British borrowers, as creditors shied away from international lending after defaults by less developed countries on loans from British banks.

All these factors combined to increase the availability of credit dramatically. This escalation was matched by a rising demand for borrowed funds. In 1980, the Housing Act (and its Scottish equivalent) enabled tenants to buy their publicly-owned homes at drastically reduced prices, which tempted them into borrowing funds. The Housing and Building Control Act 1984 gave impetus to this trend by increasing the maximum discount available on these homes from 50% to 60%, and reducing the qualifying period from three to two years' residence. Consequently, over 1,000,000 people were able to buy their own homes in England and Wales (Central Statistical Office 1990, cited in Mannion 1992). Credit also replaced government grants in some areas. For example, the

Social Security Act 1986 replaced the grants available to those on low incomes for certain items of capital expenditure with loans.

The 1980s also saw demographic changes which added to the demand for housing and associated credit and consumer goods (National Consumer Council 1990a). As a consequence of the rise in the number of births in the 1960s, there was an increase in young households in the 1980s, and these are traditionally associated with high credit usage. Finally, the increase in credit can also be attributed to a change in consumer attitudes. Credit is now viewed as an acceptable and convenient method of obtaining discretionary goods, although low income households still use it as a budgeting device to acquire essential items. Unfortunately, readily obtained and enticing credit is all too easily translated into severe debt problems. Recent economic policy has focused on interest rates as the main fiscal control on spending. Rates have been increased in attempts to stifle consumer demand and decrease inflation. Such escalations inevitably take their toll on those already paying off loans. Debt, and particularly multiple debt, is widely agreed to be a problem for many households. In 1989, almost 75% used at least one form of consumer credit and 20% were heavy users, having four or more credit commitments (Berthoud and Kempson 1990). In that year, £265 billion was owed in personal credit commitments, £222.8 billion of which was mortgage borrowing, with £42.2 billion owed on other types of credit agreement, such as those with finance companies, banks, retail stores and credit card companies (Mannion 1992). By 1990 2.5 million households faced debt problems of some kind (Berthoud and Kempson 1990). At the end of 1987 the average household credit commitments of £1,800 represented 8 weeks of the average household's disposable income, compared with 4.3 weeks in 1976 (Berthoud 1989). By mid 1990, the number of borrowers who were six months or more in arrears stood at 95,030, compared with only 17,000 in 1979 (Building Societies Association 1990, cited in Mannion 1992). The effect of the recession has been to spread the problem of debt to a wider range of social classes. A recent NACAB study revealed that mortgage

commitments and unemployment had impacted universally, with significantly more clients now coming from the under-25 year-old age group and from the middle-class professional categories (National Association of Citizens Advice Bureaux 1989).

Debt is not only costly in individual terms. In addition to the administrative and legal costs of the debt recovery process, there are likely to be the costs of supporting and rehousing debtors as well as the provision of debt counselling services. Creditors also suffer, and the costs involved in both recovering debts and writing off irrecoverable debts are passed on by creditors to other borrowers in the form of more expensive credit. Debt can also cause personal distress and hardship. Shame and anxiety may lead to mental and physical illness, marriage break-ups and disruption of families. Debtors risk imprisonment, the loss of their home or possessions, and may have essential services, such as gas and electricity, disconnected. This suffering must be endured over a long period of time. In 1987, it took debtors an average of nine years to clear their debts (National Association of Citizens Advice Bureaux 1987), and for the unemployed this figure rose to 30 years (Jubilee Research Centre 1988, cited in Mannion 1992).

2. *The Growth of Money Advice Services for Debtors*

The sheer scale of debt problems in Britain highlights a need for some kind of assistance to be provided for the many people sinking deeper into the quagmire of financial difficulties. 'Money advice' is a systematic way in which advisers can help people who are in debt. Such assistance can stabilise a rapidly deteriorating situation and help the parties reach an affordable and realistic repayment programme. The term is a broad one and might be understood to include all types of financial guidance. In the present context, however, there are two restrictions on its scope. Firstly, it concerns only that advice which relates to debt problems. Consequently, the service is also known as 'debt-counselling', but as this term carries with it a certain stigma for the counselled, it is generally avoided. Secondly, it includes only advice given in

connection with those debts which have become difficult to repay. Strictly speaking, whenever a consumer buys credit, he or she becomes a debtor, but debt itself is not automatically a problem. It is only when a certain level of repayment arrears is reached, and the amount of money owed increases uncontrollably, that debt becomes dangerous, making money advice a wise option. Thus, 'debt', in this case, is rather more narrowly defined than 'money owing' and will be taken to mean 'arrears'. The National Consumer Council (NCC) distinguished problematic from non-problematic credit by identifying four levels of financial commitment (National Consumer Council 1990a). They range from manageable to the extreme of insolvency. 'Over-commitment' is an intermediate category which is generally safe, unless circumstances change. A sudden variation of circumstances can push the debtor into the next, more precarious level, termed 'unmanageable'. Critical events might include unemployment, divorce or bereavement. A CAB study (Citizens Advice Bureaux 1990) showed that this category was the largest, indicating that the cause of debt is a more complex issue than merely poor money management, or fecklessness.

3. The Money Advice Process

In 1988, it was estimated that the whole process of money advice lasted approximately nine months (Hinton and Berthoud 1988), with each adviser handling 30 to 50 files at any one time.

There are various stages in the advice process (Money Advice Project 1989, cited in Mannion 1992). At the first meeting, the adviser performs a diagnosis and investigation of the problems. Unfortunately, debtors are often too embarrassed to admit the full extent of their commitments, a reluctance which serves only to compound the problem. The extent of clients' ignorance of their legal rights and obligations and of the nature and costs of credit is often staggering. Even the more educated find situation bewildering (Parker 1990). Confused by an avalanche of creditors' demands, clients frequently promised all their available income to

each of their creditors. When their promises remained unfulfilled, lenders begin to view them as dishonest, and this causes the debtor-creditor relationship to deteriorate, which, in turn, increases the pressure on the debtor (Berthoud 1989).

The second stage is that of assessment and planning. The debtor's income is maximised by, for example, alerting the client to state benefits or tax concessions to which he or she is entitled, but has hitherto left unclaimed. The adviser must also deal with imminent crises, for example, notices of disconnection. The next stage is to prepare the case. The adviser produces a financial statement of the client's income and outgoings, and on this basis a realistic and effective repayment plan is drawn up. A good repayment scheme will protect the client from immediate sanction, reduce her or his commitments by negotiating 'write-offs' or interest freezes, and leaving sufficient income for day-to-day living requirements.

In order to produce such a plan, it is essential to prioritise the debts (a task which clients are often unable to do for themselves). Some creditors threaten severe sanctions (such as loss of home or disconnection of essential services) and are in a position to implement them. The devastating nature of such actions means that these creditors - which are likely to be the larger, wealthier companies - must be treated preferentially in the allocation of the debtor's available income. Despite the fact that advice is often sought only when sanctions are in the process of being implemented (Parker 1990), advisers are generally successful in averting these immediate crises. However, under this system the more menacing the creditor, the more likely he or she is to receive repayments, giving little incentive for lenders to pursue a co-operative and equitable debt collecting strategy. The NCC (1990b) has argued that this system is inefficient, and recommends that all consumer debts below £25,000 should be dealt with through the county court.

The remaining non-priority debts can be dealt with in one of two ways. Voluntary repayments may be made according to individual agreements with each of the creditors, or an agreement

may be made through the court under an administration order. In this case, a single sum is paid into the court on a monthly basis and divided among the creditors. Default is an issue for the court. The penultimate stage in the advice process is the implementation of the strategy, which might involve assistance with court appearances and negotiation with creditors. The final stage is to monitor the progress of the case.

4. *The Effectiveness of Money Advice*

It is difficult to measure the efficiency of money advice. The criterion is not necessarily the number of repayment plans successfully implemented, nor even the achievement of a debt-free future for the client. Successful money advice must account for the short and long term requirements of both the debtor and creditor. Creditors' interests are served by debt recovery and also allowance for the continued provision of credit. Similarly, the debtors' short term concern is repayment, but their future borrowing needs must also be considered. As Ford (1991) noted,

... 'effective' money advice should strive towards re-establishing routine, unproblematic borrowing, via recovery regimes that are neither socially nor economically punitive.

This criterion, which advocates the continued use of credit, seems to fit in with the views of Gordon Borrie, former Director General of Fair Trading. In his 1989 Report (Office of Fair Trading 1989), he quoted from the Crowther Report (Crowther Committee 1971), which had led to the introduction of the Consumer Credit Act 1974:

It remains a basic tenet of a free society that people themselves must be the judge of what contributes to their material welfare. Since the vast majority of consumers use credit wisely and derive considerable benefit from it, the right policy is not to restrict their freedom of access by administrative and legal measures but to help the minority who innocently get into trouble to manage their affairs more successfully.

5. The Benefits of Money Advice

There is some controversy about whether money advice services actually produce any benefit at all. For the debtors, advisers can give non-judgemental support and counselling and ease pressures by maximising income, organising repayments, helping with court appearances and negotiating with creditors. However, there is little research into the long term effects of money advice. It may even be the case that it reduces the incentive to seek employment and lures the clients into a poverty trap of endless repayments by giving them confidence in their capacity to deal with debt (Hinton and Berthoud 1988; Mannion 1992).

For the creditor, money advisers can open up channels of communication with the debtor, make her or his financial position more easily discernable, and also enable the creditor to decide, for example, whether it is cost effective to write off a debt, or to pursue it through the courts, or to come to an arrangement. Although Mannion (1992) shows that money advice does not affect the overall amount received by creditors, it may minimise their debt recovery costs and ensure a well-structured repayment programme.

However, for priority creditors, especially the banks, who have direct access to the debtors money, the equitable repayment level may be less than they could extract by their own negotiations. Also, any advantages for the creditor may be outweighed by dissatisfaction with fewer or smaller payments and by suspicions that the counselling is really a stalling device, or that advisers are consumer-biased. Such concerns are not necessarily unreasonable, particularly since the repayment plan is not legally binding and is dependant on clients' good will and honesty.

Mannion (1992) argues that in cases where the creditor is the local government the potential advantages are substantial. Debts generally involve rent, local taxes and mortgages. These are viewed as priority debts by advisers, whereas clients tend to give priority to debts owed to commercial companies, such as credit

card companies. Housing departments are also likely to benefit from a lower level of abandonment of properties and homelessness. On the other side, it is true that advisers are likely to alert clients to the possibility of claiming housing benefit from local government, but the cost of this is likely to be exceeded by additional rent revenue generated by keeping people in their homes. Finally, social service departments benefit from the improvements to an individual's mental and physical well being and the removal of at least part of the strain which debt can place on families. The problem is that such benefits are often not appreciated by local authorities, especially those which run their different departments along the lines of semi-autonomous companies with their own budgets, or those, mainly non-metropolitan, areas in which different authorities are responsible for housing and social services.

PART II: The Provision of Money Advice Services

6. Who Provides Money Advice?

Originally, if the relationship between the creditor and the debtor broke down, the only solution to debt problems was to turn to the courts. County courts still play an important role in the debt collecting process, although usually as a last resort for creditors and a last defence for debtors. Once a creditor obtains judgment against the debtor, the latter can apply to the court for an administration order. In this case, the court will assess the debtor's total available income and set a monthly repayment rate. This sum is paid into court and divided between all the creditors on a pro rata basis. Such an order is useful in that it requires only a single monthly payment from the debtor, which is adjusted to her or his available income, and yet it provides protection from creditors, providing the payments are kept up. However, administration orders cannot come into operation until proceedings have been initiated by a creditor. The NCC recommend that the order should be available to the debtor before this crisis point has been reached.

The position began to change after the Payne Report on the enforcement of debts in 1969 (Payne Committee 1969). This suggested that it would be appropriate to separate the judicial function of deciding liability from the task of implementing a suitable arrangement for collecting debts, and emphasised that a social welfare (rather than a judicial) approach to dealing with debt may be more beneficial. More recently, money advice services have been provided by a range of agencies. There is, however, no single central organization and no national framework of money advice services. Advice may come from public, private or voluntary agencies, although voluntary sector advice is the most common form. Perhaps the most striking distinction is between independent advisers, (such as the Citizens Advice Bureaux (CAB)⁵), and creditor-biased services, (such as those provided by banks and building societies⁶). Certain advisers deal solely with specific sectors of the population, whilst others assist the general public. For example, while the Birmingham Settlement Money Advice Centre offers advice to anyone with debt problems, probation officers give money advice but only to the offenders with whom they work. Some services specialise in money advice, whereas for others, including the CABx, who are the main providers of debt advice, it is only a part of their workload.

There are arguments for and against specialist and general advisers. Because of working constantly in the field of debt advice, specialists offer high expertise, and are most competent to deal with multiple debt problems. They have strong contacts with the courts, creditors and other relevant bodies. Dealing with an expert may give debtors an extra incentive to keep up the repayments.

⁵ Independent and semi-independent advisers also include Consumer Protection/Trading Standards Departments, Department of Social Security, members of the Federation of Independent Advice Centres, Housing Aid Centres, Legal Advice Centres, Social Work Departments, the Probation Service and charities.

⁶ Similar advice is also given by Finance houses, Fuel boards, Local Authorities, retail lenders and other lenders.

However, such specialist advice is costly and scarce. General advisers offer basic information. They are able to prevent more serious debt problems from arising and they are also usually more accessible because there are more of them. Perhaps the ideal organisation would employ some specialist workers attached to a general advice agency. This system would take advantage of the benefits of both types of advisers, whilst facilitating support for frontline staff and easy referral.

Following the Payne Committee Report (1969), the Birmingham Settlement Money Advice Centre (the first specialist service, employing trained advisers) was established in 1971. The Centre pioneered money advice for low income groups, which involved negotiation with creditors and representation in court. It is disappointing that following this initial project, there was little expansion in services. In 1982 there were just 16 money advice services in Britain (National Consumer Council 1990b). By 1988, six high profile, specialist voluntary sector units had been established. Two of these are sited Birmingham, with the rest in Brighton, Leicester, Lewes and Sheffield (Hinton and Berthoud 1988). Nevertheless, the Ezra Committee (1990) stated that there was a seven- to ten-fold under provision of advisers. In 1984, the Money Advice Association was established to encourage and provide a central focus for such services. It is a forum for exchange of information and experiences. Its aim is to train advisers, give back up advice and to influence relevant policies.

The debt advice services can be roughly divided into three parts. 'Front line' services are provided mainly as part of the work of the CABx and specialist money advice centres. Such services involve day-to-day debt casework, and may provide help-lines and self-help packs. 'Support' services for certain geographical areas are provided by Money Advice Support Units (MASU). These can give specialist advice, training and backup to the front line advisers and provide assistance with court representation. However, there are few such centres and they are particularly lacking in Northern Ireland and Scotland. There are also two national services - the National Association of Citizens Advice

Bureaux (NACAB) and the Money Advice Association (MAA), and their Scottish and Irish equivalents. These promote development, training and research.

In 1990, the NCC identified 243 outlets providing specialist money advice, employing an equivalent of 295 full-time staff. These included the CABx (with 189 outlets and 130 staff), MASUs (with 19 outlets and 39 staff), local authorities (with 29 outlets and 96 staff) and other voluntary agencies (with 6 outlets and 30 staff) (National Consumer Council 1990b). However, these centres are not uniformly distributed, with large metropolitan regions being better served.

The difficulty is that demand for advice far exceeds supply. Moreover, the true need for advice is likely to be higher than the number of clients going to advice centres would suggest since many who require help are reluctant to seek it because of fear or embarrassment, or simply because they are unaware that it is available. Delays are not uncommon and it has become the regrettable, but necessary policy of some centres to introduce eligibility hurdles: for example, some advisers will only see those with prior appointments or multiple debt problems. The introduction of a telephone-based service - the National Debtline - (a joint initiative of the Birmingham Settlement and the MAA) has relieved some of the pressure.

7. Citizens Advice Bureaux

The local CAB network is the linchpin of the money advice framework. Not only do they provide the main source of advice, they are also seen by people as the most obvious place seek guidance on meeting borrowing commitments (Office of Fair Trading 1989). The first CAB was established in 1939 to give emergency help during the war. There are now 1,346 outlets, with approximately 23,000 advisers, 90% of whom are trained volunteers (National Association of Citizens Advice Bureaux 1991). The CAB service is an independent organisation which 'provides free, confidential and impartial advice to everybody,

regardless of race, gender, sexuality or disability.' (National Association of Citizens Advice Bureaux 1991) The CAB aims:

to ensure that individuals do not suffer through ignorance of their rights and responsibilities or of the services available, or through an inability to express their needs effectively,

and to

exercise a responsible influence on the development of social policies and services, both locally and nationally. (National Association of Citizens Advice Bureaux 1991)

However, CAB volunteers are not specialist debt counsellors. In 1990/91, over 7 million enquiries were handled, 1.5 million being consumer and debt related, which was an increase of 9.2% on the previous year's figure (National Association of Citizens Advice Bureaux 1991).

Local bureaux rely on local authorities for their funding and the NACAB receives private sector donations and a core grant from the Department of Trade and Industry (DTI). However, many bureaux are clearly underfunded. Over 340 do not have a full-time manager, although this is an Association policy and over 500 do not have a full-time deputy manager. In over 200 non-metropolitan areas the total CAB grant is less than £30,000 per annum and in four NACAB areas they receive less than £20,000 per annum (National Association of Citizens Advice Bureaux 1991).

PART III: The Future

8. The Future Development of Money Advice Services

There is general agreement that advice services should be expanded, but there are various arguments about how this should be achieved and how the necessary funding should be raised. Presently, most funding is received through central and local

government, with a small percentage from the private sector⁷. Other funding sources are urban programmes, the NACAB, community programmes and charitable trusts (National Consumer Council 1990b). The Government has made clear that it perceives its funding role as confined to the grants made to the NACAB⁸. Although total local authority funding increased by £4 million between 1989/90 and 1990/91, some authorities withdrew all funding, resulting in bureaux closures. A survey in 1989 (Stephens 1989) revealed that 71% of private sector creditors believed central government should fund advisory services. This was echoed in a NCC report (National Consumer Council 1992b; see also National Consumer Council 1992a) where creditors, not suprisingly perhaps, blamed political and economic policies for the debt problem rather than the creditors themselves.

In the current political climate, increased funding from either central or local government is unlikely, and, therefore, any further money must be come from the private sector. It could be argued that creditors have a moral and social responsibility to finance assistance for consumers in difficulties due to the product which they have sold to them. Francis Maude, then Minister for Corporate Affairs, now Financial Secretary to the Treasury, stated,

It is not only part of the responsibility of the private sector but it is very much in its commercial interest to provide support for money advice services. (Hansard 1988)

Similarly, Robin Leigh-Pemberton, then Governor of the Bank of England, urged in 1988, 'all those concerned with granting of consumer credit to consider whether they are doing enough, either themselves or by supporting those agencies which advise the borrower.' (Leigh-Pemberton 1988) In 1989, in his annual report,

⁷ In 1989/90 almost £1.5 million was devoted to money advice services, 50% from Local Authorities and 16% from the private sector.

⁸ In 1990/91 the grant in aid from the Department of Trade and Industry was £10.346 million (Ezra Committee 1990).

the Director of Fair Trading appealed to the private sector for more 'material assistance', especially from the credit providers.

Not surprisingly, these suggestions stirred opposition from the credit industry. In the NCC's 1992 report (National Consumer Council 1992b), creditors were at pains to emphasise the initiatives they were already taking, such as, the banking information service, which promotes the understanding of credit, financial and economic matters amongst school age students, although a cynic might see this as merely a good way in which banks can introduce their services to a new generation of potential clients. In the wake of the pleas for more private sector funding, the Money Advice Funding Working Party was set up. Its 1990 report recommended that a money advice trust should be established, and in September that year, its proposal was implemented. The Money Advice Trust is a charitable institution, which receives, disburses and monitors private sector funding. Its aim was to raise £9 million in private sector donations during the first three years of its life. Unfortunately, it appears that it has failed to achieve this target. The National Consumer Council have identified the Trust's failure to devise an equitable formula for contributions as an important part of the reason for its lack of success. Building societies in particular have shown a reluctance to contribute (National Consumer Council 1992a).

Meanwhile, in 1990, the NCC continued to highlight the flaws of the money advice services available by publishing two papers - Credit and Debt: The Consumer Interest and Debt Advice Provision in the UK. The former emphasised the urgent need to secure long term funding and the latter was a survey of the woefully inadequate services provided. Then, in February 1992, the NCC published a consultation paper Funding Money Advice Services. A Statutory Levy on the Credit Industry: The Options (National Consumer Council 1992a), and in August 1992 that year it made its report (National Consumer Council 1992b). These two papers led to the establishment of a pilot money advice scheme in Leeds in March 1993. This differs significantly from orthodox advice services in its funding strategy.

9. *Consumer Credit Counselling Service: The Leeds Pilot Scheme*

(a) Introduction

The Leeds pilot scheme aims to help clients by producing a financial statement to be used by them to make their own offers of repayment and by operating a debt management plan through which the scheme deals with creditors on the clients' behalf. The Centre seeks to provide a non-profit making community service, which is financed by creditors, and which aims to rehabilitate the financially distressed (including those who cannot offer repayments), to conduct consumer educational programmes on money management, and to maintain good relationships with the credit industry, consumer interests and local government.

(b) Structure of the Leeds Scheme

Roger Lees is General Manager of the Leeds pilot Consumer Credit Counselling Service (CCCS)⁹. Accountable to the General Manager are eight counselling staff. Because the scheme is relatively small, some of the counsellors take on other roles. One of them acts as a head administrator and another as a personal relations or marketing contact. There are two further members of staff at this rank, who are on secondment to the Service from Girobank and Barclays Bank and who are used largely for liaison because of their useful links with other creditors. There are also two, lower ranking administrative staff. All are full-time and salaried.

The General Manager is accountable to a Board of Trustees, which, like a company's board of directors, makes all the policy decisions and has overall responsibility for the CCCS. The

⁹ Much of the following text is based on an interview with Mr Lees: 15 October 1993. The writers of the UK Report wish to thank Mr Lees.

Trustees initially appointed a project team to adapt the US model (see Appendix), find suitable premises, set up the systems and appoint staff. There are currently six trustees, two of whom represent creditor interests. The status of the present chairperson is slightly more ambiguous. He is Jeremy Burton, who, although a businessman, is on the Board because of his local connections and in his capacity as a member of the local community. Another trustee, Bill Cotton is also a member of the local community and a local employer. There are plans to expand the Board, and creditor representation could rise to a maximum of 40%.

The National Consumer Council (NCC) foresaw certain problems arising from significant creditor representation on board (National Consumer Council 1992b). However, far from marring the independence of the CCCS, Roger Lees believes their involvement shows creditor support for the system and provides reassurance for the clients about the validity of the scheme. He argues that, generally, by the time advice is sought, the interests of the clients and the creditors coincide, in that they both wish the money to be repaid. Creditor representation is also useful in building relationships with other creditors, and enables counsellors to consider the creditor's viewpoint when giving advice to clients, thereby improving the likelihood of an agreement being reached. The CCCS counsellors also visit creditors, and run education courses for their debt collecting departments. In this way, both sides learn to appreciate the other's work.

The CCCS is not a member of the Money Advice Association, however, a national body, The Foundation for Credit Counselling (FCC) has been established, which is the counterpart of the National Foundation for Consumer Credit in the USA, and which ultimately will assume the steering role from the Leeds Board, once more CCCSs are set up around the country. For the moment, the chairperson of the CCCS Board of Trustees also chairs the FCC.

The FCC has produced a Code of Ethics. Its principles include to 'provide a non-profit community service dedicated to providing confidential and professional financial and debt counselling' and

'to develop and foster community educational programmes on family money management, budgeting and the intelligent use of credit'. The Code demands equitability as between the creditors (National Consumer Council 1992a). It also requires the Board to include members with 'a broad community based representation', and not more than 40% of the trustees are to be representatives of the creditors. The CCCS must 'refrain from giving general legal advice', so it does not provide court representation, although counsellors will assist with the completion of court forms and so forth. If the client is in need of counselling in areas in which the CCCS does not deal, he or she will be referred to a more appropriate counselling service, such as the Citizen's Advice Bureau (CAB). Roger Lees also emphasises the importance of the CCCS' role in establishing and maintaining close relationships with creditors, local authorities, consumer interest groups and trading standards departments.

The Leeds pilot project will be reviewed, probably in Spring 1994, in order to assess the viability of founding similar centres in other parts of the country. The criteria of review will be determined by the trustees, but they will consider, not just the important issue of the financial viability of the CCCS, but also the quality of both the service and the contacts which have been built up. If the pilot is considered to be successful, the scheme will be expanded to other areas under franchises. It is hoped that eventually there will be more than twenty CCCSs across the country.

Individual CCCSs in this national network, under the auspices of the FCC, will adhere to the same Code of Ethics and will benefit from a consistency of paperwork and operating systems. This consistency is an expected advantage by which Roger Lees sets great store, since he feels that one of the major problems faced by creditors is the disparity in the presentation of information, caused by the various budget forms and computer packages currently used by different advice centres. This makes the comparison and fair treatment of cases very hard.

(c) Funding

The CCCA is a registered charity. It received an initial start-up capital from sponsoring commercial organisations, including Barclaycard, Leeds Permanent Building Society, Kingfisher plc, G E Capital Retailer Financial Services Ltd., Registry Trust Ltd., Equifax plc and Portland International Management Consultants Ltd.. Unlike some of its American counter-parts, which, where appropriate, charge clients a consultation fee, CCCS is funded solely from contributions made by creditors. Subscribing creditors donate 15% of the money recovered from their debtors by the Service. The funds raised are used both to run the CCCS and to advertize its services. It was decided by the CCCS that no payment would be required from the debtor-clients, even to the extent that it will cover the cost of phone calls from clients using the Service from outside the Leeds area. As Roger Lees put it, 'We're not trying to put other cost barriers in their way.' The only things required of clients are honesty and an undertaking to refrain from the use of any form of credit whilst the repayment plan is in operation. The CCCS also excludes some creditors from the contribution requirement, aside from those who simply refuse to make a donation. They do not collect contributions on priority debts, such as mortgage arrears, nor on local tax or central government income tax arrears.

The NCC (National Consumer Council 1992b) feared that in return for their contributions, the creditors would exercise a greater degree of scrutiny over the CCCS. It is indeed the case that the same creditors ask more of the Leeds pilot than they might do in the US, but Roger Lees believes this unrelated to their contributions. The Leeds CCCS is merely having to succumb to the same standards of scrutiny as all UK advice centres. In the US, none of the information on the clients' budget form is passed on to the creditors. All that they are told is the debt owed to them, the total debt, how many creditors there are and the proposed payment to themselves. The Leeds CCCS was originally intending to follow this model, but staff in UK debt collecting departments are

accustomed to a full disclosure of information. Therefore the CCCS is having to provide full information to about 60% of creditors. Some have agreed to put a six-month review on the situation, after which, if they are satisfied with the CCCS' budgeting mechanisms, they will dispense with the requirement¹⁰.

Roger Lees argues that independence is not threatened by creditor financing. In fact, creditors contribute to most schemes. For example, the local authorities fund CABx, but are also the largest creditors of some of their clients. Moreover, any suggestion of undue influence might compromise the creditor's image, and, in view of the small sums which are typically involved, this would not be worth their while, when placed against the large amounts spent by companies on advertising a clean, friendly image for their products and services.

(d) Client base and reasons for debt problems

It has been reported that the CCCS' average client is male, 38 years old, married, with a total debt of £18,704. His mortgage averages at an additional £35,500 (Yorkshire Evening Post, 2 July 1993; see also, Financial Times, 4 October 1993). His monthly income is £1,180 and his living expenses are £963. He has eight creditors.

The centre does not exclude anyone or operate any filtering process, even on a geographic basis. The CCCS has had almost 800 clients to date, with a large proportion of this figure representing continuing cases. For example, it was only recently that the twenty-fourth client found employment and was, therefore, in a position to begin repayment.

¹⁰ Although it is obviously the creditors' choice not to require full information, it does mean that another disparity will be introduced in the way that they are treated by their not insisting on full information, whilst other creditors continue to do so.

It has been the CCCS's experience (also National Consumer Council 1990) that the majority of debt problems are caused by an unexpected change in circumstances. Many clients have some surplus income and are usually in employment. However, the problems can typically be traced back to a period of difficulty, often as short as six months, when both partners were unemployed and the breadwinner had to settle for a cut in salary in order to find new work. During that six months they perhaps did not really accept their new circumstances and chose to continue a lifestyle which they could no longer afford. Alternatively, they may have been locked into previously undertaken credit, the most common example being a mortgage. Whilst searching for a job, it was an unrealistic option to sell the house, because it might become necessary to move again very soon. Apart from this 'pit of debt' everything else is usually stable. The function of the CCCS programme, in this typical sort of case, is to formalise the position and enable the debtors to live within their new circumstances.

(e) The advice process

The CCCS is usually first approached by clients over the telephone. Although occasional consultations can be carried out by telephone, debtors are encouraged to come to the centre in person. This is important, not only because counselling is better face to face, but also because the CCCS has found that seeing both partners leads to a higher degree of success. Typically one partner, usually the woman, is conscious of the debt problem and is the main driving force behind the request for advice, whereas the man is often reluctant to admit that he cannot cope. When the couple do attend the CCCS for interview, he often takes the attitude that he has only come along to keep his partner happy. Clients are frequently advised to go to the CCCS by the Samaritans, Mind and similar advice and counselling organisations, or by employers and even creditors themselves. Some local branches of banks and building societies have allowed leaflets which advertise the CCCS to be displayed. A growing number of clients are persuaded to

approach the Service by the personal recommendations of previous clients. This is certainly the case in the US, where about 40% of clients enter by this route. In September 1993, 6% of the total number of the Leeds CCCS' clients came by way of personal recommendation and Roger Lees is confident that once more people successfully complete their repayments through the Service's programme, this category will increase. The CCCS also places advertisements in local newspapers and on radio, and has had some national press coverage. Radio advertising has been found to bring a much more instant response, but these respondents tend to miss their appointments more frequently than those attracted by other means. This may be because the medium encourages a more impulsive response which is later regretted or vetoed by the other partner. In other cases, clients tend to cancel in advance and reschedule the appointment. Sometimes the cancellation is due to difficulty in completing the required paperwork before the interview, but in many cases, it is because they do not want to face the problem. An appointment is sometimes rescheduled up to two or three times. If anyone fails to appear, without prior notice, the CCCS will write to them, if the address has been disclosed, to encourage them to get in contact at any time in the future.

The whole system is computerised, using a specially designed software package. When fresh clients contact the receptionists, initial details, such as names, contact addresses and telephone numbers for both partners are taken. The receptionist also notes from where the client was referred, to which adverts he or she responded (so as to identify the most successful) and the details of any mortgage or other secured debt, although it is the CCCS' experience that clients are often confused about which debts are actually secured.

The first interview, which usually lasts about 90 minutes, is arranged over the telephone, and the client is assigned a case number. There are four scheduled appointment times during each working day, although if there is an emergency, clients will be seen as soon as possible. Unless there is a personality clash, the

same counsellor deals with the case throughout the course of the CCCS programme, both to enable a relationship of trust to be built up and so that a certain continuity is achieved.

In most cases, a letter of appointment and forms, which the clients are required to complete before the interview, are mailed on the same day as the first appointment is fixed over the telephone, although in urgent cases, these forms are dispensed with. Together with the completed forms, the debtors are asked to bring proof of their regular income to the counselling session.

It is the CCCS' philosophy that the completion of the forms is an essential learning process for clients. They are required to fill in personal details including income, type of employment, savings, assets, rent or mortgage payments, the name of any mortgagees, and the number of months' arrears. Included in the form is a personal budget for the clients to complete by inserting figures for their "fixed expenses", including mortgage repayments and life insurance, and "variable expenses", such as food and clothing. There is also a section for expected "future expenses", such as quarterly and annual bills for essential services, community charge or telephone calls. In the next section, debtors are required to itemise their credit commitments. They are also asked to sign a statement authorising the CCCS to discuss their financial position with relevant third parties. Clients often fail to fill out the budget. Great emphasis is placed on the importance of this part of the form because it drives home the severity of the problem.

(f) The first counselling session

In the first interview the counsellor will go through the form with the client and perform a benefits check to maximise income. It is very rare that debtors calculate the total amount owed, which is another symptom of the denial of the problem. When this is done in the interview, it is often the first time that both partners realise the extent of their debt. The counsellor may feel it is appropriate to leave the room at this point, to allow the partners

discuss their difficulties privately and come to terms with the problem. Until that moment, it is normally one partner who has taken the lead, while the other ignores the problem.

In the interview, the counsellor prioritises the debts, using a numbered scaling system, with anything below 2 indicating a priority debt. Priority debtors, such as Yorkshire Electricity and British Gas are telephoned during the interview and a payment figure calculated on a monthly account is arranged. These creditors will also allow for repayment of any arrears at the same rate as they would recover from customers on benefit. This flexibility on their part often enables the repayment programme to be put in place. The only debts with which the CCCS will not become involved are those to other members of the family.

The counsellor fills in the information provided by the client into an official budget sheet. The parties then set about adjusting the figures to increase the disposable income. This negotiation with both the client and the creditors is a unique aspect of the CCCS approach, since most advice centres treat the client's estimated budget as sacrosanct. After this negotiation process, it is often the case that the dismal position of clients showing more outgoings than income can be turned around and repayments to creditors can be made. However, in extreme cases, where there is no hope of repayment, the CCCS will seek write-off from the creditors. This will become easier as more clients successfully pay off their debts through the programmes leading creditors to become better disposed to the CCCS's requests. If the client is in need of legal advice on insolvency, the CCCS may refer her or him to a local firm of solicitors, specialising in insolvency, which will see CCCS clients free of charge.

Priority debts are accounted for first and these are usually dealt with by the clients themselves, rather than through the Service, by the means of direct debits from the client's bank account. If, after paying the priority monthly payments, there remains a surplus income, the clients can, if they wish, be put on the "debt management programme". Alternatively, they may feel able to

negotiate their own repayment plan without the further involvement of the CCCS.

At the end of the first interview an action plan is drawn up. This may include tasks such as completing direct debit arrangements with priority debtors, advising charities of the cancellation of contributions, and informing all creditors of the CCCS's involvement, quoting the assigned counsellor and client number. The Service advises all clients to write to creditors for its educational value and as a way of fostering a feeling of responsibility, although of course, the CCCS also officially introduces itself to the creditors involved in the case.

(g) The second counselling session

The second appointment is usually scheduled for 2 weeks later, or after the action plan has been completed. During the intervening period, the CCCS will contact creditors if there is a possibility of a debt management plan being installed, and send out proposal letters. In the session, those clients wishing to embark on the debt management programme, sign a "debt adjustment agreement", which is not intended to be legally binding. This lists the client's responsibilities (including an obligation to notify the counsellor immediately if there is any problem about meeting the monthly payment and refraining from taking on any more credit commitments) and empowers the CCCS to negotiate on the client's behalf. It also states that any interest earned on monies held by the CCCS before payment to creditors can be used to fund the Service. The agreement can be terminated in writing without notice by either party. However, the clients are warned that if they should withdraw from the programme, it is likely that creditors will pursue their debts more promptly. It is also made clear that counsellors, whilst not performing the function of a debt collecting service, will chase payments that do not materialise. (h) The CCCS's debt management programme

Through the CCCS's repayment programme, any surplus income is made available to non-priority creditors on a pooled basis. Unlike other advisory services, which make individual offers to each creditor, the CCCS is unique in that the pooled funds are allocated on a pro-rata basis. The usual target is to pay off all non-priority debts within four years. However, where there are particularly large sums owed, repayment can take longer: in one case of an £80,000 debt, the estimated time is eight years. In such extreme cases, bankruptcy may have been a more usual option. Where full repayment will take more than four years, the CCCS always attempts to persuade creditors to give complete forbearance on interest. If the plan is for less than four years, the CCCS advises clients that at least a proportion (perhaps 25%) of the interest should be paid. The General Manager views this as 'part of the quid pro quo of the arrangement.'

Under the debt management programme, a single amount equalling the sum of monthly payments owed to all the client's creditors, is paid to the CCCS by the debtor, and the CCCS then makes the payments to each creditor. It may be quite a while before creditors receive any money, but they are generally understanding because they are kept informed by the CCCS and can be sure of contacting the counsellors, rather than having to chase the debtors.

The operation of client accounts was opposed by the NCC (National Consumer Council 1992b), but Roger Lees does not accept that they are a problem. The clients still take responsibility for performing the act of payment, even if it is to the CCCS rather than creditors. Moreover, this system reduces the costs of multiple payments and ensures that if, for some reason, the full payment is not available, debtors are prevented from making unwise decisions as to the distribution of their available income and creditors are informed of the situation.

Clients are provided with an information sheet which suggests how to deal with creditors. It warns them that some may still pester them after they join the scheme and advises that, as most will accept the CCCS programme, the clients should inform them

of the repayment plan, their case number and account details. Above all, they should not promise any other money to them without the approval of counsellors, as this would jeopardise the repayment of other creditors. It is emphasised that the debt management programme does not alter the clients' legal obligations to their creditors.

(i) Continuing contact

The policy of the CCCS is to treat the clients as customers. Thus, contact is maintained throughout the repayment schedule, so that changes in circumstances can be incorporated into the plan. Three months after the second meeting, there is a debriefing session and a six and twelve month review on the budget. A statement of the CCCS account is mailed to the clients every month. This continued contact allows scope for appropriate increases in payments if, for example, employment has been found. Roger Lees has found that once clients are committed to the scheme, they are usually eager to pay off the debts as rapidly as possible. He also believes that clients are able to repay within their own limits, however, the National Consumer Council remains concerned about the standards of advice given, and that the clients are being pushed into levels of repayment which are too high (The Times, 24 July 1993).

The programme aims to enable clients to overcome their present difficulties and pay back at least the principle sum on all their loans. They should also have rehabilitated their credit record, so that at the end of the programme, although the CCCS cannot guarantee anything, if all payments have been made, and they would like to once again take advantage of new credit agreements, the Service will help to reintroduce them to the creditors involved in the scheme. Credit card companies, such as Visa and Mastercard, will usually offer a new credit facility with a modest limit because completing the four-year repayment structure, in their view, proves much more about the customer's responsible attitude than any credit-rating system. Moreover, the surplus

income, which has previously gone into the programme, will in the future be available to finance credit agreements. The official budget also continues to provide guidance after the programme has finished and having been through the counselling, should another crisis occur, clients have the skills to adjust to it and face up to the problem, either by quickly seeking help, or by dealing with it themselves.

(j) Reponse of the creditors

The CCCS claims to have received an encouraging degree of support from the credit industry. Almost all creditors that have been approached have approved the scheme of the repayment programmes and are willing to accept payments on a pro rata basis. However, negotiations concerning the 15% contribution are still continuing with a minority of creditors, although Roger Lees separates this question of finance from the service provided to the client. Even if none of the client's creditors are willing to contribute, almost all will agree to the repayment programme, so the client's problem is solved regardless. This allays the fear of the NCC (National Consumer Council 1992b) that debtors whose creditors refuse to contribute would be prejudiced. In Lees words:

In the final analysis, if a client walked through the door, ... and we found that none of his creditors would pay us anything, we would still put the plan in place because we're sorting out his problem.

However, it has been complained that the CCCS 'will only help people who have a regular income, not the really poor.' (Spokesperson from the National Consumer Council, Today, 10 August 1993.)

In the main, because of the nature of the UK market, the same 80-85% of creditors appear consistently in clients' credit

profiles¹¹. The majority of these creditors cooperate with the CCCS, and so future CCCSs will be able to benefit from the foundations laid by the Leeds pilot, leaving them to concentrate on building relationships with their own local credit market.

Building societies, in particular, have been responsive to the new scheme. Each organisation has its own methods of recovering their money, but most now encourage customers in the early stages of arrears to come into the branch to discuss their problems. The CCCS have built such close links with certain branches in the Leeds area, that if the building society discovers the existence of other unsecured debt, it will advise the customers to contact the Service. Very often they also allow the mortgage arrears to be included in the repayment programme, or knowing that a programme will be installed, give latitude in the repayment period.

Roger Lees believes the helpful attitude adopted by the building societies stems from the recognition of the benefit to themselves of the counselling received by clients. It is usually the unsecured debts which cause the building societies' own arrangements to collapse. Debtors can live only so long with the pressure of creditors continually demanding their money, and it is usually the unsecured ones that make the most threatening demands because they have nothing else to support their claim. A debtor's mortgage is likely to be the single largest payment and this often leads her or him to default on that obligation, in order to give something to clamouring non-priority creditors. This is even more true if the mortgagee is a building society, as most market themselves as friendly institutions, which are less intimidating than an angry fringe creditor. The debtors do not seem to appreciate the risks involved in defaulting on secured loans. As Roger Lees states,

I don't believe that most people really believe or understand the risk they are running by not paying a mortgage or a secured loan. ... They do tend to make poor quality decisions because of ... stress.

¹¹ This trend is reversed in the US, where most creditors operate only in one State, rather than on a nation-wide basis.

Building societies see the benefit in having these unsecured debts taken out of the equation by the CCCS programme, so that stability is restored.

The CCCS also issues information leaflets to creditors, which outline its advantages to them. These include improved ultimate recoveries, due to a realistic repayment plan, association with a 'positive, exciting, high profile initiative', provision of a professional independent review of the debtor's financial position, a service to which customers can be referred, introduction to clients, who, having completed the programme are ideal customers for new credit facilities, and education courses for debtors on the handling of credit.

(k) Conclusions

All the indications are that the Leeds pilot scheme has made an encouraging start, although the 1994 review will be crucial to its continuation and expansion. The CCCS appears to have established a strong presence and is enjoying a good degree of success in its financing. It has built up useful contacts with many creditors, and the national nature of the majority of these organisations means that any CCCSs established in the future will benefit from the ground work conducted by the Leeds Service. Eventually, Roger Lees envisages a possibility of an international network of CCCSs, mirroring the international presence of some creditors, with which the Service will nurture a relationship.

The CCCS has adopted all that is beneficial in the American model, including a viable funding strategy, excellent computerisation, and (provided the technology is utilised as planned) reduced administrative costs to creditors, debtors and the Service itself as a switch is made to electronic transfers of funds from the CCCS to creditors. Once more CCCSs are established, they will benefit from consistency, a shared Code of Ethics, a national co-ordinating body and an improved and better known profile, all of which are likely to persuade more creditors to

sanction the 15% contribution. However, the Service may also have imported some of the American system's faults. It concentrates mainly on those debtors with some disposable income, and there are several problems with the equal treatment of the creditors. There is also the substantial creditor representation on the board of trustees. There are no plans to establish a central body to collect the contributions and simultaneously to act as a buffer to protect the CCCSs' independent image. (Obviously, whilst there is only one CCCS in existence in the UK, such a central body would be redundant).

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Case Study 1

Mr. X had started his own business in 1955. He was earning about £35,000 a year and had taken on commitments he could easily afford. However, in 1990, business began to trail off and he found he could no longer meet the repayments. When he turned to his bank for help, it withdrew its support, forcing him to close down his business, owing the bank £70,000. The Xs remortgaged their home for £100,000 to pay off the bank debt, leaving them a small amount of equity in the house. However, the credit commitments amounted to £18,000 over the £100,000, including an overdraft, credit card bills, loans and a new car. The Xs also had to support their son at University and Mr. X remained unemployed for 9 months. In early 1993, the creditors began to press Mr X, despite the fact that Mr. X had written to them to explain his position. Some accepted solely interest payments, but Mr. X could not even keep up with these. The desperate family was considering selling their house when they approached the CCCS. The Service negotiated a package whereby the X's paid them £480 a month on a debt management plan. They also negotiated an interest freeze, so that progress could be made on paying off the debts. All commitments should be cleared within three years. Mr. X is now in relatively secure job, earning £25,000 a year and is free of the danger of losing his house.

Daily Express (Money Section) 21/7/93.

Case Study 2

J and his partner, who are both in their mid-20's, got into financial problems after buying their first house. Although they kept up their mortgage repayments, they overestimated their income and let other debts pile up. In the end they owed £16,500. The CCCS persuaded the creditors to stop threatening court action and give them breathing space. The CCCS suggested paying off some of the smaller debts to reduce the number of creditors. J feels an advantage of going through the CCCS is knowing that everyone is getting paid. "We don't worry about what comes through the letter box any more".

"Today" 10/8/93.

APPENDIX TO THE REPORT ON MONEY ADVICE SERVICES:

ALTERNATIVE FUNDING OPTIONS

1. Alternative Funding Options

The NCC's February 1992 consultation paper (National Consumer Council 1992a) was an examination of various ways of raising funds from the private sector by means of statutory levies. It was emphasised that this money would be in addition to contributions currently received from local and central government, and the possibility of a combination of funding options was stressed. The NCC identified five characteristics of an ideal scheme. It should apply universally to all credit providers and be equitable between them. The failure of the Money Advice Trust to devise an equitable formula for contributions was identified in the NCC's report as part of the reason for its lack of success. There may be a role in the future for the Director General of Fair Trading, who has a responsibility to review social and commercial developments relating to the provision of credit, to liaise with the Trust's board and resolve this difficulty. A simple levy of a proportion of the credit each institution has outstanding would not recognise the debt problems associated with certain types of credit and would penalise large lenders, such as mortgagees. A more equitable method would be to link the levy to cash arrears, but this would require a greater provision of transparent data by the credit industry. An attractive option may be to link the levy to lending rates, on the assumption that higher rates are likely to cause more default. Therefore the largest contributors would be those whose debtors are most likely to become clients of advice services. However, this underlying assumption is challenged by some, and it would be administratively unworkable to link levies to constantly fluctuating interest rates. An ideal levy should be cheap and easy to collect and should enjoy political acceptability, receiving support from industry, advice services and the Government.

Finally, the scheme should not jeopardise the independence of money advisers.

Six funding options were analysed. Three were variations on a theme - an addition to the licence fee, which has to be obtained by all those operating under the Consumer Credit Act 1974 (including British Gas and the electricity boards, which were previously excluded), a direct statutory levy or a trade association levy. The first two options are attractive in that they would utilise administrative machinery already in place, that is, the Office of Fair Trading and the Money Advice Trust respectively. However, the first alternative would not be politically acceptable because it is essentially a hypothecated tax (a tax which is collected for a specific purpose rather than placed into a general fund) and the Government is opposed to such taxes. The difficulty with the third option is that it merely displaces the problem of devising an equitable levy to the trade body; moreover, not all creditors are members of any such association.

The fourth proposal is similar to that which is used by the Association of British Travel Agents to raise funds in the event of the collapse of a tour operator. The NCC's suggestion is a compulsory bonding scheme, whereby all creditors would be required to pay an annual lump sum which would be drawn upon when their debtors made use of the advice services. This may operate as useful barrier to under-capitalised creditors and would be an incentive to avoid giving problematic credit. Unfortunately, this option demands detailed information about usage from the advice services, which, given their staffing shortages and work pressures, is likely to be unreliable. An alternative approach is similar to the Civil Aviation Authority's suggestion that every passenger entering the country should be charged a fee of £1 to cover the aftermath of an airline collapse; that is to levy the customers of credit by making a charge on every credit transaction or on each credit account. The NCC preferred the latter, because the necessary levy on each transaction would be unworkably small. A more sophisticated levy would take account of the risk of debt associated with different types of lending. Such contributions could

be viewed as compulsory insurance in case the consumer needs to use the advice services. Ethical objections to the levying of customers might be met with the argument that, in any event, the consumer would ultimately pay for levies on the industry through slightly increased interest rates. The drawback of the last two methods is that new administrative machinery would have to be installed.

The final option is that of a charge made to the creditor, related to money recovered from clients of money advice services. It is by a similar method that 60% to 70% of debt counselling is funded in the USA. The estimated annual charge for each creditor would be in the region of £400.

All these methods are statutory and therefore necessitate the establishment of statutory frameworks and lines of accountability. Therefore, extra funding might only be obtained at the cost of the loss of some autonomy for advisers and constraints on how the funds are spent. The responses to the consultation paper showed that creditors, particularly the banks and building societies, strongly opposed a statutory levying scheme. They thought it inequitable to force the private sector to fund a particular charity. They were also reluctant to contribute to such a disorganised structure of advice services, devoid of a central controlling body. Money advice was perceived to be an unnecessary intervention, given the care with which creditors claim to give loans and their own support systems for those in debt. However, some building societies recognised that where mortgages were only part of multiple debt problems, they were less able to advise debtors themselves. Money advisers, on the other hand, were in favour of a statutory levying system, particularly given their general disappointment at the failure of the Money Advice Trust to meet its target. They also argued that contributions from central government were "minimal".

No consensus on the benefits of the statutory method was, therefore, forthcoming. So, the NCC were forced to explore the possibility of a voluntary scheme, based on the American model, namely, a charge made to creditors based on a percentage of

money recovered from money advice clients. However, should this also fail, the NCC stated that they would have no hesitation in pressing the Government to establish a statutory scheme.

2. *The USA: The Structure*

The money advice framework in the USA is very different from that in the UK. The American system is divided into budgeting advice, credit counselling and debt counselling functions, with less emphasis on debt counselling (money advice).

There are about 500 advice agencies and most are members of the National Foundation for Consumer Credit. This body sets standards and guidelines for advisers, assists in the establishment of new services, circulates training manuals and runs courses. It also makes an annual inspection of each member. Membership entails adherence to the Foundation's Code of Ethics. This Code demands that all creditors are treated equitably, and it excludes advice on rent and mortgage arrears and fuel bills. It also prohibits the giving of legal advice. Each member has a board of which up to 40% can be credit grantors, the rest being members of the local community. In practice, as the credit industry representatives are the most active, it is hard to adopt policies which they oppose, even if they are in the consumers' best interests.

A report conducted for the Birmingham Settlement (Andrews 1991) concluded that the services offered in the USA were not comprehensive, and excluded those areas on which most advice was needed in the UK. It did not help the poor, unemployed and homeless, but concentrated mainly on middle-income debtors with a disposable income. Most counselling services were too financially dependant on the credit industry, which exerted too great a degree of control over them. However, some advantages were discovered. In particular, an efficient computerised system and the high degree of preventative work conducted during budgeting and credit counselling was praised.

An exception which is more akin to the UK advice system is the New York Budgeting and Credit Counselling Service. It offers a

full range of advice and has a creditor-free board. Approximately 50% of its funding is received from payments from creditors, although mortgagees are excluded. NCC representatives also explored another type of counselling model. The Houston Credit Counselling Service is a member of the Foundation. It has a headquarters and central administration, with eleven satellite units connected by on-line computer systems. The service is free and covers similar aspects of work, advises similar client groups and uses similar processes as the UK advice centres, although it operates client accounts to facilitate repayment to creditors.

3. The USA: The Operation and Funding of Advice Centres

The funding system in the USA operates on a voluntary basis, with 15% of money recovered being contributed to advice centres, although, in practice, usually only 10% is received. Contributions are not made via a central body, but directly to each centre. Payments according to the client's financial plan are received by the centres, and paid into client accounts. They are then forwarded to the creditors, either after deduction of the charge, or in full, in the hope of recovering the donation. Although the private sector come under moral pressures to assist advice services, it is also commercially viable, as private debt collectors charge commissions as high as 30 to 50%. In 1989, 314,000 debtors sought advice in the US: \$414 million were repaid, generating about \$40 million for advice services. Many centres supplement their funding by charging clients from \$30 to \$270 a year for their services.

4. Using the USA Model in the UK

It would be possible to adapt such a funding system to the UK scenario. However, there are some problems. Although a proportional charge seems fair, it may be more burdensome on priority creditors. Also, if debtors of some creditors often find it impossible to make any repayments at all, those lenders would

seldom make any contributions. Moreover, it is always open to creditors to ignore the advisers' intervention and pursue their own recovery methods, in which case no contribution would have to be made for the advisers' services.

However, evidently the most serious reservation about this scheme is that the independence of the advisers may be compromised and the clients' and public perception of the centres would be damaged. There are concerns that advisers will effectively be providing a debt recovery service for contributing creditors and that those clients able to make repayments (translating into funding for centres) would be favoured over the utterly destitute. As has been mentioned, in the USA the middle-income debtors are the most frequent clients. Luther Gatling, director of the New York centre believes that counsellors can cope with the conflicts of interest, especially as it is the centre's policy that all creditors should be treated equally, whether or not they contribute to the scheme. Independence is the main responsibility of the governing body and therefore, creditors are strictly prohibited from sitting on the board.

The NCC see this alternative as complementary to other levying systems, and therefore the danger to independence is not so strong. If the American model is implemented in the UK, it may be necessary for advice centres to take on client accounts. This conflicts with the UK policy of encouraging clients to deal with their own repayments, for its educational value, and simply because there are insufficient resources to operate accounts. Client accounts could be seen as a beneficial part of the continuing process of assistance, and payments by creditors could be viewed as fees for this service alone, thus reducing the risk to impartiality. However, an administrative drawback is that systems to combat fraud would have to be installed along with such accounts.

An alternative adaptation is for creditors to make payments to a central body, constituted especially for that purpose. This may be preferable as it would allow rational allocation of funds between centres and provision for the establishment of new services. It would also act as a bulwark between the centres and the

contributing creditors. Whichever payment system is used, suitable auditing procedures would have to be devised. Such a levying scheme is likely to be politically acceptable, particularly on a voluntary basis.

The NCC recommended the establishment of a pilot system along the lines of the Houston Centre for the purpose of more research into this method of funding. The voluntary nature of the scheme was appealing to creditors, but most disappointing for advisers.