

Consultation on SME access to the Financial Ombudsman Service and Feedback to DP15/7: SMEs as Users of Financial Services

Consultation Paper

CP18/3

January 2018



How to respond

We are asking for comments on this Consultation Paper (CP) by 22 April 2018.

You can send them to us using the form on our website at: www.fca.org.uk/cp18-03-response-form.

Or in writing to:

James Tallack
Financial Conduct Authority
25 The North Colonnade
London E14 5HS

Telephone:

020 7066 0324

Email:

cp18-03@fca.org.uk

How to navigate this document onscreen



returns you to the contents list



takes you to helpful abbreviations

Contents

1	Summary	3
2	The wider context	8
3	Consultation: Expanding the definition of an eligible complainant and extending eligibility to guarantors	13
4	Discussion: SME disputes not covered by our consultation proposals	20
Annex 1	Questions in this paper	30
Annex 2	Cost benefit analysis	31
Annex 3	Compatibility statement	48
Annex 4:	Feedback to Discussion Paper 15/7: Our approach to SMEs as users of financial services	54
Annex 5	List of respondents to DP15/7	61
Annex 6	Abbreviations in this document	63
Appendix 1	Draft Handbook text	

1 Summary

Why we are consulting

- 1.1** Small and medium sized enterprises (SMEs) are businesses employing under 250 staff, or with an annual turnover of under €50m.¹ When things go wrong, some SMEs, particularly smaller businesses, struggle to resolve disputes with financial services firms through the courts and have few alternative routes to seek redress. We propose changing our rules to allow more SMEs to refer disputes to the Financial Ombudsman Service ('the Ombudsman'). Our consultation proposals are in Chapter 3.
- 1.2** Our proposals are not designed to cover all disputes involving SMEs. Disputes not covered include those involving SMEs above our proposed eligibility threshold for the Ombudsman, as well as disputes where redress sought would be significantly in excess of the Ombudsman's binding award limit of £150,000.
- 1.3** In general, larger SMEs will have the bargaining power, organisational resources and understanding of financial services to protect their interests in disputes with firms. We therefore believe the courts remain the most appropriate place for larger SMEs to resolve financial services disputes. However, given the diverse nature of the SME population we want to explore if there is anything else that might be done for those businesses and disputes not addressed by our consultation (see above). This could include greater scope for voluntary codes. We discuss and seek views on these issues in Chapter 4.
- 1.4** We believe our proposals will lead to more SMEs receiving appropriate redress when they have suffered harm due to the actions of a financial services firm. Over time, we hope the changes will contribute to better services to SME customers in the first place, leading to fewer complaints and better outcomes for SMEs, as well as contributing wider benefits to the real economy.

Who this applies to

- 1.5** The consultation and discussion chapters of this paper will be of direct interest to:
- providers of regulated and unregulated financial services, including advisers to SMEs, credit providers and intermediaries dealing with SMEs
 - consumers who are self-employed, own or manage SMEs, provide guarantees for SME loans, or contribute to a family business
- 1.6** Our proposals may also be of interest to those who provide business support to SMEs and to organisations that represent businesses and self-employed individuals.

¹ The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50million, and/or an annual balance sheet total not exceeding €43million. EU Recommendation 2003/361. See also House of Commons Library Standard Note SN/EP/6078.



The wider context of this consultation

- 1.7** In November 2015, we published a Discussion Paper, 'Our approach to SMEs as users of financial services' (DP15/7). We reviewed the regulatory protections available to SMEs and asked whether and how we could improve them. Our analysis and the feedback we received suggest that our rules broadly strike the right balance between protecting businesses and ensuring SMEs can access financial services. However, they also confirmed that many SMEs struggle to resolve disputes with financial services firms and seek redress.
- 1.8** In Chapter 2 we discuss the wider context to our consultation proposals to improve outcomes for SMEs who struggle to resolve disputes with firms.
- 1.9** A summary of feedback to our Discussion Paper can be found at Annex 4.

The Financial Ombudsman Service

- 1.10** The Ombudsman provides an independent dispute resolution service. It is free for those making a complaint.
- 1.11** The Ombudsman can consider disputes about financial products and services we regulate ('regulated activities') and activities that support the delivery of regulated activities. In practice, this includes a number of services that SMEs use regularly including, for example, complaints about banks' business support services.
- 1.12** The Ombudsman can also consider disputes about some financial products and services we do not regulate ('unregulated activities'), including lending to businesses. Most SMEs use a combination of regulated and unregulated financial products and services.²

What we want to change

Definition of an eligible complainant

- 1.13** The rules for complaints handling are published in the 'Dispute resolution: complaints' (DISP) section of the FCA Handbook.
- 1.14** In Chapter 3, we consult on changing our definition of an 'eligible complainant' in DISP to allow larger SMEs, charities and trusts to refer complaints to the Ombudsman. Our proposals will provide access to the Ombudsman for more than 80% of the approximately 200,000 SMEs who are not currently eligible.³ We are also consulting on rules which will allow individuals who have provided personal guarantees or security for certain SMEs' or micro-enterprises' liabilities to refer complaints to the Ombudsman.

² Most unregulated financial services are outside the FCA's remit. However, since 1 April 2015 we have had powers to enforce against breaches of competition law under the Competition Act 1998 and conduct market studies under the Enterprise Act 2002 (our concurrent competition powers). These are not limited by reference to the regulatory perimeter and instead can be applied in relation to the provision of 'financial services'. This term is not defined in legislation, but in our view this includes any service of a financial nature such as banking, credit, insurance or investments.

³ See Annex 1 of DP15/7.

How we will define 'small businesses'

- 1.15** We propose to change the definition of an 'eligible complainant' so that it includes a new category – 'small businesses'. We propose to define this as businesses that are too large to be 'micro enterprises'⁴ but have annual turnover below €6.5m, an annual balance sheet total smaller than €5m and fewer than 50 employees. We explain why we have chosen these eligibility thresholds in Chapter 3. We also propose to expand the eligibility thresholds for charities and trusts so that they are similar to those for the new small business category.

How we will define guarantors

- 1.16** We propose to define guarantors specifically for the purposes of our complaints handling rules in DISP. Our proposed definition is: individuals who are not consumers and who have given a guarantee or security for an obligation or liability of a micro-enterprise or small business. This business will have to have been a micro-enterprise or small business on the date that the guarantor gave the guarantee or security.

Impact on the Financial Ombudsman Service's voluntary jurisdiction

- 1.17** We are responsible for setting the rules for the complaints the Ombudsman must consider by law (the 'compulsory jurisdiction'). The Ombudsman also has its own 'voluntary jurisdiction', which covers some types of complaints which are not covered by the compulsory jurisdiction, by agreement with financial services firms. Some businesses can refer complaints to the Ombudsman under its voluntary jurisdiction. The Ombudsman's view is that it would be appropriate for the changes we propose making to the compulsory jurisdiction to apply to the voluntary jurisdiction as well. This will help to minimise confusion for SMEs and financial services firms, provide operational simplicity, and increase access to redress for SME's whose complaints fall outside the compulsory jurisdiction. As a result, we are issuing this consultation jointly with the Ombudsman.

Unintended consequences of our intervention

- 1.18** We have considered whether our proposals might harm competition by making it more expensive for new firms to enter markets that provide financial services to larger SMEs, or to provide them with new, innovative products.
- 1.19** Increasing regulation also increases the minimum cost to existing financial services firms of serving their SME customers, many of whom, individually, generate relatively little revenue for the firms that serve them. Expanding access to the Ombudsman might therefore reduce SMEs' access to services such as lending.
- 1.20** As discussed in our cost benefit analysis, we believe these outcomes are unlikely. However, we will continue to engage widely to assess the impact of our proposals and welcome feedback on this issue.

Disputes outside the scope of our consultation proposals

- 1.21** Some SME disputes will remain outside the scope of our consultation proposals. These include disputes from SMEs above our proposed eligibility threshold for the Ombudsman, and disputes involving dissolved businesses or businesses subject to insolvency proceedings.

⁴ Micro enterprises have fewer than 10 employees and either turnover or a balance sheet of no more than €2m. These businesses are already eligible to complain to the Ombudsman.



- 1.22** Some disputes will be caught by our proposals; but they will have only a limited impact. In particular, where the amount in dispute significantly exceeds the Ombudsman's binding award limit. In such cases businesses may not receive the full amount of redress recommended by the Ombudsman. This might also make it is less likely in practice that the business will refer the complaint to the Ombudsman in the first place.
- 1.23** In Chapter 4 we discuss in more detail SME disputes not covered by our proposals.

Outcome we are seeking

- 1.24** If our intervention is successful then, over time, it should improve the way financial services businesses handle SME complaints. This may in turn lead to fewer complaints in the first place, and a better standard of service for SME customers in this space.
- 1.25** In the short term, the number of SME and guarantor complaints considered by the Ombudsman will increase. Some complainants will receive redress when they previously would not have.
- 1.26** To comply with our rules firms will also have to change the way they handle complaints from newly-eligible SMEs and guarantors. We expect our proposals to give firms greater incentives to handle complaints well and provide redress when necessary. Additionally, firms should take the relevant Ombudsman decisions into account and outcomes for SMEs are likely to improve as a result.⁵

Next steps

How to respond to our consultation

- 1.27** Regarding our consultation proposals in Chapter 3, we ask whether:
- you agree with the proposed changes and think that the proposed size thresholds and criteria for small businesses are appropriate,
 - you agree that changes to DISP in respect of the relevant size thresholds and the definition of a small business should come into effect on 1 December 2018 and should apply only to complaints made to a firm about the firm's actions, or failure to act, which occur from 1 December 2018, or if you think there should be a different transitional period,
 - you agree that the changes introducing guarantors as eligible complainants should come into effect on 1 December 2018 and that they should apply only to complaints made to a firm regarding guarantees or security given on or after 1 December 2018, or if you think there should be a different transitional period,
 - you agree with our cost benefit analysis in Annex 2, and
 - there are other costs or benefits we should have considered.

⁵ Under DISP 1.4.2G factors that may be relevant to the fair assessment of a complaint include appropriate analysis of Ombudsman decisions concerning similar complaints received by the firm.

1.28 Regarding our discussion of SME disputes not covered by our consultation proposals, or where we think our proposals will have limited impact, we ask whether:

- you have any views on whether further changes to access to redress for SMEs are necessary and how these could be achieved without the need for changes to legislation
- without legislative change, you think the Ombudsman might be an appropriate body to consider a greater share of complex or higher value complaints from SMEs than it would under our consultation proposals

1.29 Please send us your responses by 22 April 2018. You can use the response form on our website or email us at cp18-03@fca.org.uk.

What we will do

1.30 We will consider feedback to this consultation and will publish a Policy Statement with our final rules later this year.

1.31 We will approach the wider question of redress for users of financial services, including our involvement in redress schemes, based on the framework we set out in our Mission.⁶ In our detailed feedback statement⁷ on our Mission, we give more detail on our approach to redress for financial services activities that are outside our regulatory perimeter (remit).

6 www.fca.org.uk/publication/corporate/our-mission-2017.pdf

7 www.fca.org.uk/publication/feedback/fs17-01.pdf



2 The wider context

The harm we are trying to address

- 2.1** Businesses generally have greater resources than individual consumers, and their owners often have limited liability.⁸ They also tend to have more experience of assessing their product needs, negotiating with suppliers and reviewing contract terms. As a result regulators, the courts and the law have traditionally treated them differently from individual consumers. In practice, this means that, across the economy, protections available to businesses are often more limited than those for individual consumers. For example, a business might not be protected by our rules on banking business conduct.
- 2.2** Policy on dispute resolution for businesses reflects tensions between multiple objectives. In the case of financial services, protection for business owners needs to be balanced against freedom of contract to ensure continued availability and affordability of business finance.
- 2.3** However, not all businesses are the same, and SMEs often have more in common with individual consumers than larger businesses. Many SMEs that buy or use financial products behave similarly to individual consumers, and can experience harm in similar situations. We have seen this happen because of:
- differences between what an SME expects from a financial services firm and what the firm believes is required of them
 - a gap between the capabilities and resources that firms assume SMEs have and their actual financial and legal expertise
 - a lack of accountability for the way products perform between the firms that manufacture products and those that sell ('distribute') them
 - gaps in the protection that regulation provides, including access to redress
- 2.4** When things go wrong the impact on businesses and their owners can be severe. Where they have suffered harm, SMEs have fewer options than individual consumers for pursuing redress, relying primarily on the courts.
- SMEs' access to the courts**
- 2.5** Relatively few SMEs have the necessary bargaining power to negotiate contract terms with large financial services firms. For example, research shows that only commercial banking customers with 50 or more employees feel they can negotiate contract terms with a bank.⁹ Such businesses account for just 0.7% of the business population by number. This is symptomatic of the significant imbalance ('asymmetry') in bargaining power that exists between businesses and their financial services providers.

⁸ The liability of shareholders in a company is generally limited to their investment in that company, even if the company subsequently becomes bankrupt and has remaining debt obligations.

⁹ ResearchWorks (2015) 'SME Customer Research into the Retail Banking Market', CMA, July.

- 2.6** When things go wrong only a very small proportion of SMEs take their disputes with financial services firms to court.¹⁰ The World Bank estimates that taking a dispute to court might cost an SME in the UK up to 44% of its claim.¹¹ Not all legal action requires a court hearing, or costs this much, but even starting legal proceedings can be very expensive. Businesses gave us examples where simply starting proceedings for a medium-sized commercial insurance claim might cost about 5% of the claim's value. The court fee alone for starting a claim of over £10k is 5% and fees are only capped (at £10k) once the value of the claim goes over £200k.¹² SMEs might also be discouraged from taking issues to court by the prospect of having to cover the other party's legal costs.
- 2.7** Even well-resourced businesses might find it difficult to take legal action. This is because financial services disputes often coincide with cash flow stresses and other threats to the business. In these circumstances the cost and speed of redress is often critical to an SME's ability to stay in business.
- 2.8** SMEs that do take disputes to court have more limited grounds to do so than individual consumers. For example, a private person who has suffered loss as a result of a firm breaching our rules generally has a right of action for damages under section 138D of the Financial Services and Markets Act 2000 (FSMA). A company acting in the course of business does not. Instead companies must rely on the general law or contract terms.
- 2.9** Taken together these issues mean the practical barriers to SMEs seeking redress through the courts are significant.

Access to redress and changes in firm conduct

- 2.10** The fact that SMEs have less access to redress than individual consumers and micro-enterprises may have led to poorer outcomes in the past, and may continue to do so in the future.
- 2.11** According to the Legal Services Board's (LSB) studies of the legal needs of small businesses, the percentage of businesses with fewer than 50 employees that have had a dispute involving financial services fell from 3.4% in 2013 to 2% in 2015.¹³ The only category of businesses which didn't see this improvement were businesses close to, or just outside, the headcount and turnover thresholds that would allow them to refer complaints to the Financial Ombudsman Service ('the Ombudsman').
- 2.12** While other factors might explain this discrepancy, differences in access to redress could have played a role. Where firms are required to handle complaints according to our rules, and review the performance of products they sell to businesses, this can help to improve their conduct towards their customers.

10 Fewer than 0.5% of financial services disputes in the Legal Services Board's surveys and our SME complaints survey resulted in a court hearing. In the limited Legal Services Board sample SMEs used arbitration or conciliation services about as often as the courts in order to resolve financial services disputes. As of October 2015 only about 300 court cases involving IRHPs were active with the courts – about 1% of customers in scope of the IRHP redress scheme.

11 World Bank Group (2016) Doing Business 2017 United Kingdom Country Profile.

12 The 5% fee is reduced to 4.5% for online claims of up to £100k. Fee data from HM Courts Service.

13 Respondents to the LSB surveys were asked whether they had experienced one or more of 85 potential 'problems' – defined as disputes ongoing in the last 12 months which required them to divert resources from the normal operation of their businesses. We treated a respondent as having had a financial services dispute if they reported a dispute regarding any of the following: mortgage arrears, mandatory insurance, mismanagement of business funds by a financial services provider, or refusal of credit due to incorrect information.



Responses to our SME Discussion Paper

- 2.13** Our 2015 Discussion Paper (DP15/7) explored whether our rules strike the right balance between providing protection for SMEs and avoiding unnecessary requirements on regulated firms. The paper took into account the findings of the Parliamentary Commission on Banking Standards (PCBS) and the Treasury Select Committee (TSC), both of which have suggested that we review SMEs' access to the Ombudsman.
- 2.14** We received 44 responses to DP15/7. Respondents included bodies representing businesses, independent standard-setters, individual SMEs, industry associations and regulated firms. In summary, respondents:
- suggested areas where smaller businesses might be exposed to harm
 - asked for guidance on how we carry out our work and on our expectations of how firms should treat SMEs
 - asked us to identify parts of the business population which we should generally treat more like individual consumers
 - supported self-regulation, but felt that voluntary standards need to be rigorously supervised by their owners to deliver good outcomes
 - supported giving more businesses access to the Ombudsman although only a small number of respondents supported increasing how much it could award in redress
- 2.15** Further detail on what stakeholders told us and our responses can be found at Annex 4.

Our response

- 2.16** Following our review, we believe that our current 'conduct of business' rules strike the right balance – as did most respondents to our discussion paper. However, we have found that many SMEs have limited options for resolving complaints and seeking redress.
- 2.17** In Chapter 3 we propose changes which will allow a broader range of small businesses to refer complaints against financial services firms to the Ombudsman.
- 2.18** In many cases, the courts will continue to be the most appropriate place for larger SMEs to resolve disputes. However, even allowing for the changes we propose in Chapter 3, some SME disputes may continue to fall between the Ombudsman and a realistic possibility of court action. We think this is likely to be because the SME is:
- above the new eligibility threshold for the Ombudsman
 - within the threshold but has a claim significantly in excess of the Ombudsman's binding award limit
 - within the size threshold, but its dispute is unsuitable for the Ombudsman for other reasons

- 2.19** Various stakeholders have called for SMEs in this position to have better access to alternative dispute resolution (ADR) services. They have made suggestions ranging from a new statutory code of conduct for the treatment of business customers, through to an entirely new and dedicated body to consider complaints from small businesses. Changes like these require legislation, and only the Government is in a position to bring this about.
- 2.20** We have considered our role in delivering better outcomes for SMEs carefully. We think our proposals go as far as is appropriate within the powers that we have. However, there might be more that could be done both within and outside of FCA regulation for SME disputes not covered by our proposed changes. We discuss and invite feedback on these issues in Chapter 4.

How the harm we are trying to address links to our objectives

- 2.21** The FCA's strategic objective is to ensure the relevant markets work well. We also have an operational objective to secure an appropriate level of protection for consumers. Consumers' access to redress is part of this objective. It strengthens firms' incentives to resolve disputes quickly and informally, or to avoid them altogether. This in turn helps build consumer trust in the industry. If some consumers have limited access to redress compared to their resources and level of knowledge, then they are likely to be at an increased risk of harm.

Wider effects of this consultation

How our complaints handling rules will apply

- 2.22** Our proposed changes will also affect how some of our DISP rules apply. These rules govern firms' obligations on complaint handling, resolution, recording and reporting, and on publishing data about complaints.
- 2.23** As we explained in Chapter 1, our proposals only cover the Ombudsman's compulsory jurisdiction. The Ombudsman proposes to mirror our final changes in its voluntary jurisdiction.

Equality and diversity considerations

- 2.24** There is substantial academic evidence that female and ethnic minority entrepreneurs are more likely to start businesses with limited resources and avoid borrowing. As a result, they tend to own or run businesses that remain small when they might be able to grow faster.¹⁴ Improving access to dispute resolution may, along with other measures, lead to a change of firm culture and business perception, which will help these SMEs.

¹⁴ Carter et al (2013) 'Diversity and SMEs' Enterprise Research Centre White Paper no 3, April.
www.enterpriseresearch.ac.uk/wp-content/uploads/2013/12/ERC-White-Paper-No_3-Diversity-final.pdf



2.25 In developing our proposals we have modelled the age, disability, gender and race of business owners. We do not believe that our proposals will negatively affect any groups with these protected characteristics. We have also considered the potential equality and diversity implications on people with other protected characteristics, including pregnancy and maternity, religion and belief, sexual orientation and transgender. We believe our proposals do not adversely affect any of these groups of people.

3 Consultation: Expanding the definition of an eligible complainant and extending eligibility to guarantors

Introduction

- 3.1** In this chapter we consult on changes to the definition of an 'eligible complainant'. These changes will mean that more businesses, charities and trusts will be able to refer complaints to the Financial Ombudsman Service ('the Ombudsman').
- 3.2** We also consult on changes which will allow guarantors of micro-enterprise or small business liabilities to refer complaints to the Ombudsman.

Access to the Financial Ombudsman Service: the current position

Businesses

- 3.3** At present only consumers and the smallest businesses (micro-enterprises) are able to refer complaints against financial services firms to the Ombudsman.¹⁵ Micro-enterprises have been 'eligible complainants' since 2009.¹⁶
- 3.4** The Ombudsman receives an average of around 4,000 complaints a year from micro-enterprises. This represents a very small percentage of its overall caseload (between 0.9% and 1.4% since 2013/14). We estimate that another 2,000 complaints per year to the Ombudsman from self-employed individuals are business related.
- 3.5** A review of micro-enterprise complaints carried out by the Ombudsman found that 26% of insurance complaints (excluding payment protection insurance) and 52% of banking complaints by micro-enterprises are upheld.

Personal guarantors of corporate loans

- 3.6** Guarantors of non-corporate loans are able to refer their complaints to the Ombudsman.¹⁷ However, personal guarantors of corporate loans who are involved in the business are generally not able to as they would fall outside of the definitions of both a 'micro-enterprise' and a 'consumer'.¹⁸

How the Financial Ombudsman Service resolves disputes

- 3.7** The Ombudsman is intentionally different from a court. In particular its statutory remit is to resolve disputes 'quickly and with minimum formality'¹⁹, with determinations

¹⁵ Small charities and trusts are also able to refer complaints to the Ombudsman.

¹⁶ A 'small business' category existed before 2009, however it only included businesses with a turnover of up to £1m.

¹⁷ See DISP 2.7.6(10)R.

¹⁸ The rules in DISP consider 'consumers' as individuals acting for purposes outside their trade, business, craft or profession. Some personal guarantors, such as family members of business owners, may meet the consumer definition.

¹⁹ FSMA section 225



based on what, in its opinion, is 'fair and reasonable in all the circumstances of the case'.²⁰ The Ombudsman is also required to resolve disputes at no cost to the complainant. The Ombudsman's operational costs are met by the industry through the imposition of a levy and through case fees paid by respondent firms.

3.8 DISP sets out the factors the Ombudsman must take into account when deciding what is 'fair and reasonable'. DISP requires the Ombudsman to take into account not only relevant law and regulations, but also relevant regulators' rules, guidance and standards, relevant codes of practice, and (where appropriate) what the Ombudsman considers to have been good industry practice at the relevant time.²¹

3.9 The Ombudsman can make financial awards against financial services firms. When a complaint is determined in favour of the complainant, the Ombudsman can make a money award against the firm of such amounts that it considers fair compensation for the loss or damage suffered. The Ombudsman can also direct that the financial services firm take such steps in relation to the complainant as it considers just and appropriate. The Ombudsman can recommend any amount of redress, but its recommendations are only binding and enforceable up to its award limit. Any amounts above this limit are voluntary and it is up to firms whether or not they pay the higher amount. The current award limit is £150,000 and has been in place since the beginning of 2012.²²

Our proposals in detail

Businesses

3.10 We propose to amend DISP 2.7.3R to introduce a new category of eligible complainant, called 'small businesses.'

3.11 We intend to define a small business for the purposes of DISP as an enterprise, up to a given size threshold, that is not a micro-enterprise.

Reasons for our proposed thresholds

3.12 To help us decide on the appropriate thresholds we modelled a number of scenarios that took into account SMEs' relative bargaining power, organisational resources and level of knowledge about financial services. We also considered any existing precedents in law or self-regulatory codes, and the likely value of disputes. More detail on our analysis is provided in the next section.

3.13 Based on this analysis we propose the following 3 criteria:

- annual turnover of less than £6.5m
- annual balance sheet total of less than £5m
- fewer than 50 employees.

20 FSMA section 228

21 DISP 3.6.4 R

22 The Ombudsman can also make interest and costs awards against financial services firms. Any interest awarded on the amount payable under an award, any costs awarded, and any interest awarded on costs, are excluded for the purposes of calculating the £150,000 award limit. In practice this means the total amount a financial services firm is bound to pay may exceed £150,000 in some cases.

- 3.14** We are proposing that all 3 tests need to be met for the Ombudsman to consider an SME a 'small business'. We welcome views on whether this is the right approach, or whether the tests should act independently.
- 3.15** Our analysis below shows that businesses within these thresholds are the most likely to have a dispute with a financial services firm and not have access to dedicated legal resources. The headcount and turnover thresholds also broadly match the corresponding qualifying conditions for ring-fenced deposits in the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 ('the Ring-fencing Order'). The thresholds in the Ring-fencing Order provide a logical precedent as they represent the size at which a business can choose to opt out of the protections provided by the ring fencing regime. They also have the practical benefit of being thresholds that banks will already be using, making implementation of our proposals easier for firms as a result. No other set of thresholds would overlap as much with the SME customer segmentations already used by firms.
- 3.16** We propose amending DISP 2.7.3R(3) and (4) so that charities with income up to £6.5m and trusts with net assets up to £5m at the time they make a complaint to a firm would also become eligible complainants.
- 3.17** The proposals do not alter the scope of the Ombudsman's compulsory jurisdiction in any other way.

Small businesses that are authorised firms, professional clients or eligible counterparties, or part of a larger corporate group

- 3.18** We do not propose to change our rules and guidance in DISP 2.7.6R through to DISP 2.7.10G. This sets out the relationships that the complainant must have with a firm to be considered an eligible complainant. We are also not proposing to change the exclusions in DISP 2.7.9R, which already apply to micro-enterprises.
- 3.19** This means that:
- a small business that is an authorised firm would not be an eligible complainant if its complaint is about regulated activities for which the firm also has permissions
 - a small business would also not be an eligible complainant if its complaint is about activities where the business is acting as a professional client or an eligible counterparty.²³
- 3.20** Where a business that meets our proposed financial thresholds is part of a larger group it is likely to have access to greater resources than its size would suggest. As a result, it might not be appropriate for such a business to be able to refer complaints to the Ombudsman. Whether a micro-enterprise meets the criteria for eligibility already depends on its ties to potentially ineligible businesses within the same group of businesses (that is, whether it is a 'partner' or 'linked' enterprise). We propose to amend DISP 2.7.4G to apply the same treatment to small businesses.

23 See COBS 3.5 for a definition of 'professional client' and COBS 3.6 for a definition of 'eligible counterparty'. In practice, only a very small minority of SMEs will be eligible counterparties in relation to the financial products and services they use, and most of those will be authorised firms in their own right.



Complaints about payments

- 3.21** Complaints about payments are dealt with differently as they are subject to specific provisions in the EU Payment Services Directive (PSD) and the revised Payment Services Directive (PSD2).
- 3.22** A business that is not a micro-enterprise has a specific right under the PSD to opt out of some of the Directive's protections, and will keep this right under PSD2. If a business has used that right and then takes a complaint to the Ombudsman, then the Ombudsman will take this into account when determining what is fair and reasonable in all the circumstances of the case.
- 3.23** Since micro-enterprises will remain a distinct category of eligible complainant in DISP 2.7.3R we do not propose to change the rules that cover this in DISP 2.7.3R(2).

Personal guarantors of corporate loans

- 3.24** We also propose to introduce rules that will make a guarantor a new category of eligible complainant. This will allow those who have provided a security or guarantee for a micro enterprise or small business to refer a complaint to the Ombudsman whether or not they are also a 'micro-enterprise' or a 'consumer'.
- 3.25** We propose to define a guarantor for the purposes of DISP as an individual who is not a consumer (as defined in DISP) and who has given a guarantee or security for certain obligations or liabilities of a person who was a micro-enterprise or a small business on the date the guarantee or security was given. A guarantor would be an eligible complainant if their complaint involves matters that are relevant to a guarantee or security they have given for the liabilities of a micro-enterprise or small business under a mortgage, loan, actual or prospective regulated credit agreement or regulated consumer hire agreement, or a linked transaction (as defined in the Consumer Credit Act 1974). For example, a person who has given a personal guarantee or security will be an eligible complainant even if they did so for an unregulated loan (for example a loan to a corporation).

When our changes will come into effect

- 3.26** We propose that these changes to DISP will come into effect on 1 December 2018. Adding small businesses as eligible complainants will apply only to complaints made to a firm for its actions or failure to act that occurred on or after 1 December 2018. Adding guarantors as eligible complainants will apply for guarantees or security given on or after the same date.
- 3.27** We consider that this strikes a fair balance between allowing firms time to prepare for the changes, with the interests of those who will become eligible complainants under our proposals. We welcome feedback on our proposed implementation dates.

Selecting a new eligibility threshold

- 3.28** As respondents to DP15/7 acknowledged, setting the thresholds for newly-eligible complainants is a matter of judgment. It is always possible that some individual businesses within the proposed thresholds will have greater expertise, resources or bargaining power than we assume, while some larger businesses will remain ineligible despite having limited expertise and resources.
- 3.29** To help decide the appropriate threshold for our proposals we considered how we could maximise the benefit to SMEs of broader eligibility, considering the costs involved. Based on the responses to DP15/7 and our own analysis we also considered

whether any businesses that might become eligible have the following characteristics, as these might indicate that we had broadened access too far:

- had significant bargaining power
- had significant organisational resources and knowledge of financial services
- were from a part of the SME sector which reported improvements in firms' conduct in recent years, for example in surveys
- were particularly likely to refer disputes significantly in excess of the Ombudsman's binding award limit of £150,000
- were already identified by firms as segments of the SME market that were causing them specific business or compliance problems

Bargaining power

3.30 There is some evidence (see 2.5) that businesses with 50 or more employees consider themselves better able to negotiate contract terms with firms. Hardly any respondents to DP15/7 supported access to the Ombudsman for these businesses. We agree and believe that these more sophisticated businesses should be better able to protect their own interests and so do not need recourse to the Ombudsman.

Organisational resources and sophistication

3.31 Evidence from the Legal Services Board's (LSB) Legal needs of small businesses survey and BDRC's SME Finance Monitor surveys' suggests that businesses are significantly more likely to spend money on financial and legal resources when their annual turnover reaches £5m-£10m. Our own modelling suggests that a turnover threshold close to £6.5m means that the majority of newly-eligible complainants will not have regular access to significant legal resources, and so would particularly benefit from access to the Ombudsman.

Experience of improvements in firm conduct

3.32 The LSB surveys suggest that businesses outside the micro-enterprise thresholds have not seen such a large reduction in disputes with firms (see 2.11). The turnover and employment thresholds for eligibility would need to extend towards £5m turnover and 50 staff to ensure that those businesses would become eligible to refer complaints to the Ombudsman. We expect our proposals over time to reduce the harm to smaller business customers improving outcomes for these customers.

High-value disputes

3.33 Other things being equal, businesses with larger balance sheet totals are likely to have insured more valuable assets, or to have taken out larger credit facilities in the past, than businesses with smaller balance sheet totals. On average, the value of complaints relating to such products is likely to be higher and the disputes in question are likely to be more complex or technical. We therefore consider it is appropriate to use a relatively restrictive annual balance sheet total threshold of £5m, alongside the turnover and headcount thresholds already discussed. This will make it more likely that complaints from the newly-eligible businesses will be within, or close to, the Ombudsman's binding award limit, and the nature of the complaints will be consistent with the Ombudsman's remit to provide quick, informal redress.



Existing segmentations

3.34 A number of respondents to DP15/7 suggested that implementing our proposed rules might be easier for firms that already apply the proposed size thresholds in their operations for other reasons. A £6.5m turnover and 50 employee threshold is relevant to all banks that will be subject to the Ring-fencing Order and to all lenders who sign up to the Lending Standards Board's Standards of Business Lending Practice. Signatories to the Asset Based Finance Association's Standards Framework are already subject to an Alternative Dispute Resolution process (ADR), available to businesses with turnover of £6.5m. No other turnover threshold would overlap as much with the SME customer segmentations already used by firms.

Maximising the number of newly-eligible complainants with limited resources

3.35 We used data from BDRC and the LSB to model different eligibility thresholds for annual turnover and balance sheet total (gross assets) for businesses with between 10 and 50 employees.²⁴ Our modelling looked primarily at the relationship among these businesses between different levels of turnover and access to legal resources. We consider this appropriate because the turnover of a business (rather than its headcount or balance sheet total) is likely to be the key factor in whether it will be able to fund legal advice during a transaction, or legal action in the event of a dispute.

3.36 We found that an annual turnover threshold of £6.5m maximises the number of newly-eligible SMEs that are both likely to have a dispute with a financial services provider in any given year and not have access to legal resources. Our modelling also found that businesses with these characteristics are likely to have a balance sheet total of no larger than £5m. As we explain in paragraph 3.33, a relatively restrictive balance sheet total threshold will help ensure the nature of complaints is consistent with the Ombudsman's remit to provide quick, informal redress.

3.37 Given these considerations, we believe that an annual turnover threshold of £6.5m, an employment threshold of 50 employees, and an annual balance sheet total threshold of £5m best balances our competing considerations.

Q1: Do you agree with our proposed changes to the definition of an eligible complainant? Are the proposed size thresholds broadly correct or would different thresholds or criteria be more appropriate?

Q2: Do you agree that all 3 tests (employees, turnover and balance sheet) would need to be met for the Ombudsman to consider an SME a small business?

Q3: Do you agree with our proposal to make guarantors eligible complainants?

Q4: Do you agree that the changes introducing small businesses as eligible complainants should come into effect on 1 December 2018 and that they should apply only to complaints made to a firm regarding acts or omissions of the firm which occur from 1 December

²⁴ Businesses with 50 or more employees consider themselves better able to negotiate contract terms with firms. Hardly any respondents to DP15/7 supported access to the Ombudsman for these businesses (see 3.31). Businesses with fewer than 10 employees are likely to be micro-enterprises and are therefore already have access to the Ombudsman.



2018? If not, what transitional period do you consider appropriate?

- Q5:** Do you agree that the changes introducing guarantors as eligible complainants should come into effect on 1 December 2018 and that they should apply only to complaints made to a firm regarding guarantees or security given on or after 1 December 2018?
- Q6:** Do you agree with our cost benefit analysis? Are there other costs or benefits we ought to have considered?



4 Discussion: SME disputes not covered by our consultation proposals

Introduction

- 4.1** In Chapter 3 we are consulting on changes to allow a broader range of SMEs to complain to the Financial Ombudsman Service ('the Ombudsman'). Our consultation proposals will make a significant difference to a large number of SMEs who may currently have difficulty resolving disputes with financial services firms. The proposals should result in around 160,000 more SMEs being able to refer unresolved disputes with financial services firms to the Ombudsman. We estimate this could mean up to 1,500 more disputes involving SMEs being considered by the Ombudsman each year.
- 4.2** We believe our proposals strike an appropriate balance between the needs and capabilities of SMEs and the purpose of the Ombudsman to provide quick, informal redress. However, our proposals will not cover the resolution of all (or all aspects of) disputes between SMEs and financial services firms. We discuss the likely reasons for this below. In summary, these are:
- the business in dispute with a firm is too large to meet our proposed criteria for eligibility for the Ombudsman
 - the value of the dispute significantly exceeds the Ombudsman's binding award limit (even if the business is not too large)
 - the business in dispute with a firm has been dissolved or is in insolvency proceedings
- 4.3** We also discuss a less obvious dimension of access to redress. This is the possibility that businesses that are eligible for the Ombudsman may be unhappy with the approach it takes to certain disputes, in particular disputes about unregulated products, or 'commercial decisions' by firms.
- 4.4** We do not have powers to make further changes in all of these areas. However, where we do have powers, we recognise stakeholders may disagree with the judgements we have made in Chapter 3, particularly on thresholds for eligibility. In this chapter, we discuss and invite feedback on what more could be done to improve access to redress for SME disputes (or aspects of SME disputes) that are not covered by our proposals.
- Limits to our powers**
- 4.5** Our powers to make rules only cover the Ombudsman's compulsory jurisdiction, and are relatively limited. Of greatest relevance to SME redress are our powers to set the Ombudsman's eligibility thresholds and its award limit²⁵.

25 We also have powers to make rules on the activities covered by the Ombudsman and time limits within which complaints must be made in order to be within the compulsory jurisdiction, although the feedback we have received does not suggest changes need to be considered in these areas.

- 4.6** More material changes to the Ombudsman— such as changing the basis on which the Ombudsman resolves complaints from its current 'fair and reasonable' standard – would require changes to legislation. Legislation would also need to be changed for the Ombudsman to be able to provide redress free from the claims of other creditors to directors of dissolved businesses or businesses in insolvency proceedings.

Why we are focusing on the Financial Ombudsman Service

- 4.7** We have limited our discussion of options to possible changes to the Ombudsman. This is because of its role as the statutory alternative dispute resolution body (ADR) for the financial services industry, and our statutory role in relation to it.
- 4.8** We do not discuss alternative approaches in detail in this chapter. However, we note the work of the All Party Parliamentary Group (APPG) for Fair Business Banking on developing a proposal for a separate, specialist tribunal for SME disputes.²⁶ We also note the work of industry body UK Finance²⁷ which has commissioned an independent review into SMEs' access to ADR. UK Finance has said it is open to the establishment of an industry led ADR body if the independent review recommends this. Both of these initiatives could increase the redress options available for SME disputes not covered by our proposals.

Options within our powers

Raising the size threshold for SMEs

- 4.9** Only 'eligible complainants' can refer complaints to the Ombudsman.
- 4.10** We have powers to change the eligibility criteria for the Ombudsman's compulsory jurisdiction and think there is a strong case for doing so. This is why we are consulting in Chapter 3 on giving access to the Financial Ombudsman Service for around 160,000 additional 'small businesses'.²⁸
- 4.11** Setting eligibility thresholds for the Ombudsman is a matter of judgement. We could have chosen to consult on higher thresholds that would provide access to the Ombudsman for larger SMEs than we have proposed. However, as set out in Chapter 3, we generally consider that businesses above the small business threshold should, on average, be sufficiently sophisticated and resourced to negotiate material contract terms with firms and protect their interests in disputes with financial services firms through the courts.
- 4.12** Our proposals in Chapter 3 could, however, indirectly benefit the approximately 40,000 medium-sized businesses that will remain ineligible for the Ombudsman on grounds of size alone. More business complaints being referred to the Ombudsman could, over time, provide a range of decisions which financial businesses will need to consider taking into account. Financial services firms might reflect this deeper understanding of the Ombudsman's expectations through changes to their conduct (for example, in the

26 All-Party Parliamentary Groups (APPGs) are informal cross-party groups that have no official status within Parliament. They are run by and for Members of the Commons and Lords, though many choose to involve individuals and organisations from outside Parliament in their administration and activities. They should not be confused with select committees.

27 Previously the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association.

28 As explained in Chapter 3, these are business with under 50 employees, annual turnover under £6.5m, and balance sheet total under £5m.



design of products) when dealing with all business customers regardless of whether they are eligible complainants.

4.13 We have invited views on our proposed thresholds for small businesses in Chapter 3.

Raising the Financial Ombudsman Service's award limit ***Value of disputes involving SMEs***

4.14 Even where a dispute is within the Ombudsman's jurisdiction, the Ombudsman may not be able to provide adequate redress in all cases. This is because the financial value of some claims is significantly above the maximum £150,000 that the Ombudsman can order financial services firms to pay.

4.15 We have analysed the value of disputes involving financial services firms and SMEs based on FCA SME complaints survey data.²⁹ Our analysis suggests around a fifth of all SME disputes by number are above the current award limit. However, these 'high value' disputes account for around 90% of the total value of SME disputes. This reflects the high concentration of possible redress in a small number of very high value disputes. We estimate around three quarters of these high value disputes are worth £250,000 or more meaning that at least a third of the firm's liability is removed by the current award limit. The decisions of individual businesses will of course vary, but there will come a point where the cap on the amount of redress a business can receive via the Ombudsman will affect whether they decide to refer the complaint in the first place.

4.16 We hold very limited data on the value of disputes involving medium-sized businesses as the majority of businesses responding to our survey were micro-enterprises and small businesses.³⁰ However, the value of financial services and products used by medium-sized businesses is likely to be higher. We therefore think it is reasonable to assume that, on average, the value of disputes about such products and services is also likely to be higher.

Whether we think the award limit should change

4.17 We have powers to change the limit on the awards the Ombudsman can make within its compulsory jurisdiction. The current limit of £150,000 was increased from £100,000 in 2012.³¹

4.18 The aim of the Ombudsman is to provide quick, informal redress and its processes are designed to meet this need. For example, outside of judicial review, financial services firms have no right of appeal against an Ombudsman decision once it is accepted by the complainant and becomes final and binding. If the Ombudsman were able to make substantially higher binding awards, it might be appropriate to give financial services firms a way to appeal against its decisions.

4.19 As we explain in more detail below, the award limit would need to be increased very substantially in order to make a material difference to the position of SMEs with high value disputes. For example, some disputes exceed £1 million. An increase of this magnitude, even considered in isolation, would need to be weighed carefully as it would be likely to have a much greater impact on the supply and pricing of financial services for businesses than our proposals in Chapter 3.

29 The FCA SME Complaints survey covered businesses across the entire SME population, including a very small sample of medium-sized businesses.

30 This is not surprising as the vast majority of businesses are micro-enterprises and small businesses.

31 https://www.fca.org.uk/publication/consultation/cp10_21.pdf

4.20 Any increase in the limit must also be seen in context. The limit applies to all complaints, including from individual consumers. While we have powers to set different limits for different categories of complainant or for different products or services we would want to consider this carefully as we would need good reasons to favour one type of harm over another. For example, if we set a higher limit for business complaints, consumers with high value disputes, for example relating to pensions, might call for a similar increase. Similarly, raising the limit across the board would be a major change and we would need to weigh the costs and benefits of doing so carefully. However, considering changes to the Ombudsman's award limit is within our existing powers and might contribute to better outcomes for SMEs, as well as other types of complainant. We welcome views on the limit, whether it should change and if so on what basis and by how much.

Consequential loss

4.21 A key point in any discussion of a higher award limit is that a significant proportion of the value of SME disputes with financial services firms relates to 'indirect' or 'consequential' loss. Claims for consequential loss can often be many times the value of the 'direct' loss from the product or service being complained about. A simple example of direct loss would be the payments made by an SME to a financial services firm for a mis-sold product. However, the SME's assessment of harm might be significantly higher if, for example, it considered the mis-selling caused it to miss a profitable investment opportunity. This might be because the mis-selling deprived the SME of funds, or caused it to waste management time dealing with the dispute.

4.22 It is an established legal principle that consequential loss should be limited to losses that were caused by the actions or omissions of the firm and were a reasonably foreseeable outcome of the firm's conduct. This is the approach taken by the courts and also by the Ombudsman, which considers consequential loss as part of its assessment of financial loss (subject to the overall award limit). This principle is important because it means that even a substantial increase in the award limit may not necessarily mean a complainant will receive all of the redress they believe is due to them.

How much the award limit might need to be increased by

4.23 We used our SME complaints survey data to model the difference between the awards the Ombudsman might recommend and the amounts firms would be liable for under the £150,000 award limit.³² As Table 1 shows, quadrupling the current limit to £600,000 would cover around 60% of the potential redress outside the current limit.

4.24 The reason such large increases would be needed to have a meaningful impact is because the total value of SME disputes is largely driven by a small number of outliers, ie claims typically in the low millions.

32 The FCA SME complaints survey included responses across all different size SMEs, including some medium-sized SMEs.

Table 1: Impact of raising the Financial Ombudsman Service's award limit on high value disputes

New limit ³³	Share of potential redress outside the current limit that would be covered under the new limit
£250,000	7%
£400,000	16%
£600,000	59%

4.25 Our modelling is based on limited data. However, it is broadly in line with experiences in Australia, where the government recently adopted an independent review's recommendation that a new, single external dispute resolution body be created. In our view, Australia is a relevant comparator as it, like the UK, has a common law legal system.

4.26 The recommended award limit for the new Australian body is no less than AUD500,000 (£295,000) for most disputes, and AUD1million (£589,000) specifically for small business lending disputes, reflecting the sometimes high value of these disputes.³⁴ An earlier review by the Australian Government and the Small Business and Family Enterprise Ombudsman recommended that the banking industry create an alternative dispute resolution service for small business loans up to AUD5m (£3m), with an award limit of AUD1m (£589,000).³⁵

4.27 Award limits such as those being implemented in Australia would be a significant increase on those currently in place in the UK. We would need to balance the potential benefit to SMEs of a significantly higher award limit against Parliament's intention that the Ombudsman resolves disputes 'quickly and with minimum formality', and the relative costs and benefits of the change.

Implications of a significantly higher award limit for the Financial Ombudsman Service's approach

4.28 The Ombudsman's statutory remit to resolve disputes 'quickly and with minimum formality', with determinations based on what, in its opinion, is 'fair and reasonable in all the circumstances of the case' may be less appropriate and more difficult to achieve for the resolution of some high value SME disputes. In particular, financial services firms have highlighted the following issues:

- the absence of appeal mechanisms (other than judicial review)
- decisions being binding on the firm but not the complainant
- firms' inability to recover costs incurred as a result of complaints the Ombudsman does not uphold

33 These estimates assume that all complaints are eligible and would be upheld. Even if all complaints by eligible complainants were upheld, only the proportions shown in the table would be covered by raising the award limit. Moreover, we know from a report by FOS that only 26% to 52% of complaints by micro-enterprises are upheld by FOS. All figures should be treated with caution, because survey data are likely to significantly undercount outliers. We can't reliably estimate the incremental impact of raising the limit to £800,000, due to the small number of disputes worth £600,001 to £800,000 in our sample.

34 Australian Government (Treasury) (2017) 'External dispute resolution and complaints framework' June <https://treasury.gov.au/consultation/external-dispute-resolution-and-complaints-framework/>

35 ASBFEO (2016) 'Inquiry into Small Business Loans', December www.asbfeo.gov.au/sites/default/files/030217-ASBFEO_Report.pdf

- 4.29** If the Ombudsman had a significantly higher award limit, then the parties to the highest value complaints might expect the basis for decision making and the investigation process to more closely resemble those of a court, perhaps with representation, hearings and appeals etc. For example, the Pensions Ombudsman has no award limit, but parties have the right to appeal to the courts where there is a disagreement on a point of law. This reflects the requirement that the Pensions Ombudsman decides disputes in accordance with the law, rather than by reference to what it considers to be fair and reasonable.³⁶
- 4.30** These issues represent an important balance between securing fair outcomes for consumers when things have gone wrong, and the supply and pricing of financial products and services. The Ombudsman's award limit and its approach to dispute resolution are factors in financial services firms' willingness to do particular kinds of business, and to serve particular types of customers. A higher award limit, particularly without changes to its approach, may reduce the supply of financial products and services that benefit SMEs.³⁷
- 4.31** We have no powers to introduce the fundamental changes set out in paragraph 4.29 as these require changes to primary legislation. Further investment in the Ombudsman's skills and specialisms might also be required and the cost of this would be borne by the industry (and ultimately its consumers) through higher fees or levies.
- 4.32** Moreover, a more legalistic approach is unlikely to be appropriate for lower value disputes. The Ombudsman would, therefore, need to be able to take different approaches to disputes of different complexity and value. There are several risks associated with such a business model:
- Resources could be diverted away from lower value disputes to deal with high value ones. This could have a negative impact on the speed and simplicity with which lower value disputes are resolved.
 - Different approaches could confuse complainants and firms. They could also result in challenges to the Ombudsman's determinations on the basis that a different approach should have been taken. This could undermine confidence in the Ombudsman among both complainants and respondents.
 - As an alternative, specific products, services or types of complainant that are more likely to generate high value SME claims could be identified. A higher award limit and different process could be applied only to these disputes. However, this could result in accusations of unfair discrimination, for example between an entrepreneur with the benefit of limited liability and an individual with a pension mis-selling claim which involved their life savings.
- 4.33** The Government has not prioritised changing the primary legislation stipulating the basis on which the Ombudsman resolves complaints. Even if this were not the case, for the reasons set out above, it may not be possible for the Ombudsman to manage two very different approaches to dispute resolution within the current single compulsory jurisdiction. As such, a new compulsory jurisdiction for the Ombudsman may be necessary, with a different award limit, a more legalistic approach, and different eligibility criteria. The benefits of such an approach would need to be weighed against

³⁶ www.pensions-ombudsman.org.uk/guidance/appealing-a-determination/

³⁷ www.fca.org.uk/publication/consultation/cp10_21.pdf



other, alternative approaches, such as the establishment of a separate, specialist tribunal.

Options not within our powers

Enabling directors of dissolved companies and companies in insolvency proceedings to obtain redress through the Financial Ombudsman Service

- 4.34** If a company is in insolvency proceedings or has been dissolved its directors or former directors are generally no longer able to refer complaints on its behalf to the Ombudsman. This applies to any company that would have been eligible as a going concern (ie micro-enterprises at present and, assuming implementation of our consultation proposals, small businesses).
- 4.35** Based on around 6,000 micro-enterprise disputes being resolved by the Ombudsman each year, around 700 are rejected for reasons other than the business being too large.³⁸ This would include businesses that have been dissolved or are in insolvency proceedings, although we do not have specific data on how many of these disputes relate to such businesses.³⁹
- 4.36** It is likely a significant number of directors or former directors of SMEs that have been dissolved or are in insolvency proceedings might approach the Ombudsman. This is because they will often consider it a result of a financial services firm's misconduct that the business went into insolvency proceedings in the first place. For example, misconduct may have meant the SME was no longer able to service a loan.
- 4.37** To enable the former directors of a business that has been dissolved to complain to the Ombudsman on its behalf, the company would need to be restored to the companies register after it has been dissolved. This is possible under a process known as 'administrative restoration'. Changes to our rules would not be required to make such 'administratively restored' companies (acting through their directors) eligible complainants. This is because restoration puts the company back in the position it was in before dissolution.
- 4.38** However, where a company is in insolvency proceedings it is a decision for the insolvency practitioner whether complaints should be made or claims pursued on the company's behalf, bearing in mind the assets available to the insolvency practitioner. Similarly, obliging insolvency practitioners to pursue some claims (and not others) would require legislative change.
- 4.39** Under insolvency law any redress from complaints made on behalf of a restored company or a company subject to insolvency proceedings would generally be due to the company and therefore available to meet outstanding liabilities to creditors. In the case of a complaint against a financial services firm, the firm may set off the amount of any redress due against any outstanding debt owed by the failed business. This may result in no redress being paid by the firm.

38 For every 100 micro-enterprise disputes the Ombudsman resolves, we estimate it receives 6 disputes from businesses that it cannot consider because they are too large and a further 12 that are ineligible for other reasons.

39 We understand from the Ombudsman that around 33 of these disputes are from personal guarantors of corporate loans (see Annex 2, paragraph 69).

4.40 Changes to the corporate insolvency regime are a matter for the Government, who need to ensure the regime strikes an appropriate balance between the needs of debtors and creditors. SMEs can, of course, be either. We note that responses to the 'Red Tape Challenge'⁴⁰ under the 2010-2015 Coalition Government indicated stakeholders believe UK insolvency law 'broadly strikes the right balance between the interests of debtors and creditors'.⁴¹ Furthermore, the UK's corporate insolvency regime is well regarded internationally and is currently ranked 14th in the world by the World Bank.⁴²

4.41 However, once an SME's liabilities have crystallised, redress for firm misconduct may in any case be insufficient to remedy the position. It would be preferable for firms not to call in loans or take actions that result in SMEs becoming subject to insolvency proceedings where there is an outstanding (cause for) complaint. As an alternative, or in addition, to firms treating SMEs with greater forbearance, there could be a role for 'real time' third party mediation to prevent harm arising in the first place.

Disputes where detailed conduct rules do not apply

4.42 Many disputes between SMEs and financial services firms will relate to unregulated activities, such as corporate loans. Detailed FCA conduct rules don't apply to such activities because they are unregulated. In addition, contracts between businesses are, generally, not subject to consumer law. For example, we do not have powers under the Consumer Rights Act 2015 to challenge unfair terms in financial services firms' contracts with SMEs in the way we can for individual consumers.

4.43 Complaints about alleged firm misconduct in relation to certain unregulated products and services, including corporate loans, are within the Ombudsman's remit. However, the absence of an 'external benchmark', such as FCA conduct rules or consumer law protections, might mean SMEs and financial services firms challenge the basis upon which the Ombudsman has decided what, in its opinion, is 'fair and reasonable' in the circumstances. This is more likely to be the case where disputes are complex or technical.

4.44 We believe the Ombudsman takes an appropriate approach to disputes about unregulated products. At a high level this starts with the contractual agreements between the parties, the rights and obligations these grant, and whether they have been adhered to. The Ombudsman will, if appropriate, consider the firm's internal processes and procedures and whether these have been followed. The Ombudsman will also take into account relevant legal precedents and any relevant industry standards or codes that firms have chosen to apply, as well as matters which in its view represent good industry practice. This will inform an ultimate judgement as to what, in the view of the Ombudsman, is 'fair and reasonable' based on all the facts.

4.45 The fact the Ombudsman's standard is one of 'fair and reasonable' provides for the possibility it could uphold a complaint even where contracts and processes have been followed. Where this happened the Ombudsman would need to explain why this was the right decision.

4.46 Legislative change would be required to apply detailed conduct rules and other requirements to unregulated financial services. Government could change

40 The Red Tape Challenge was introduced to give business and the general public the opportunity to challenge the Government to get rid of burdensome regulations, to boost business and economic growth and to save taxpayers money.

41 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/244904/rtc-consultation.pdf (p6)

42 <http://www.doingbusiness.org/data/exploretopics/resolving-insolvency>



the Regulated Activities Order 2001 to make the provision of certain, currently unregulated products or services regulated activities. However, even if the boundary of regulation were expanded we would still need to exercise our own judgement on the extent to which we impose requirements in rules.

4.47 This is because our objectives under FSMA require us to consider what degree of regulation is appropriate. We must also have regard to the proportionality of our policy proposals. As part of preparing a cost benefit analysis we consider whether the costs of imposing new rules are, in our view, outweighed by the likely benefits; and more generally how regulation and the costs of complying with it affect the supply and pricing of financial products and services.⁴³ This is particularly relevant if a previously unregulated product or service is brought within regulation for the first time and there would inevitably be a period of adjustment to both pricing and supply.

4.48 An alternative to detailed regulation, which we explore below, might be voluntary codes of conduct. Where firms choose to sign up to such codes these could set standards against which conduct could be assessed by the Ombudsman. Voluntary codes would not require legislation, and would be given added emphasis under our new Senior Managers and Certification Regime (SM&CR).

The potential role of industry codes

4.49 It is important that any voluntary agreements on standards for unregulated products and services are set appropriately. Done well, such codes ensure a set of standards to address poor practices but don't reduce the 'headroom' above those standards, allowing firms to innovate and compete. As we noted in our Discussion Paper, voluntary agreements among existing firms could harm SMEs by having a dampening effect on competition by increasing the minimum cost to firms of serving an SME customer.⁴⁴ This includes limiting the range of product features or terms on offer, or reducing the supply of services, eg credit to SMEs.

4.50 There is also a risk that voluntary agreements could harm competition by unduly raising barriers to entry. This will depend on the cost of adhering to any minimum standards and on whether involvement in the voluntary agreement is seen as important to the success of a new entrant.

4.51 Despite these considerations we believe industry codes could have a valuable role to play in raising standards in unregulated markets. Where effective industry codes articulating proper standards of market conduct are developed, they are reinforced by the SM&CR. For banks and other large financial services firms they are required under the SM&CR to ensure Senior Managers are clearly accountable for decisions and conduct that fall within their areas of responsibility across all business areas, including unregulated activities. The SM&CR also provides a link between the individual conduct of Senior Managers and other financial services staff, and any relevant market codes the firm has decided to apply.⁴⁵

4.52 The FCA's approach to unregulated market activities and market codes is discussed in a recent consultation.⁴⁶ That consultation also proposes a new process whereby the FCA could recognise certain industry codes in unregulated markets as a way to

43 The exception to this would be if the Government passed legislation requiring us to make rules in a certain area.

44 <https://www.fca.org.uk/publication/discussion/dp15-07.pdf>

45 COCON 2.1

46 <https://www.fca.org.uk/publication/consultation/cp17-37.pdf>

encourage their take up, where in our view they genuinely reflect proper standards and it further advances our statutory objectives.

Disputes about 'commercial decisions' on provision of service

4.53 A potentially contentious issue among business complainants about the ongoing supply of a product or service where the financial services firm has taken what it considers to be a 'commercial decision'. For example, if overdrafts are revoked or loans not renewed, this can have a significant impact on an SME, but this alone may not be legitimate grounds for complaint. In practice, the Ombudsman will consider whether SMEs have been treated fairly and reasonably when a firm has withdrawn a service from them. This might, for example, involve considering whether the firm has adhered to the terms of a contract, has communicated the decision clearly and fairly, and otherwise acted fairly in all the circumstances. However, outside of inappropriate decisions (eg discriminatory or arbitrary decisions) or some other unfairness, the Ombudsman is unlikely to uphold complaints where products or services are legitimately removed.

4.54 Furthermore, even if the activity in question were a regulated activity, we could not make rules compelling a firm to provide a particular product or service. In a market-based economy, consumers (including business consumers) do not have an automatic right to receive products and services. Similarly, firms do not have an obligation to provide them unless the Government creates specific universal obligations, such as with post or telecoms, or in the context of financial services, basic bank accounts.

Q7: **Do you have any views on how access to redress might be improved for SMEs without the need for changes to legislation, including but not limited to the areas where we have powers to make changes?**

Q8: **Without legislative change, do you think the Ombudsman might be an appropriate body to consider a greater share of complex or higher value complaints from SMEs than is implied in our proposals for consultation in Chapter 3? What changes would be needed to make this effective? What risks might this introduce?**



Annex 1

Questions in this paper

- Q1:** Do you agree with our proposed changes to the definition of an eligible complainant? Are the proposed size thresholds broadly correct or would different thresholds or criteria be more appropriate?
- Q2:** Do you agree that all 3 tests (employees, turnover and balance sheet) would need to be met for the Ombudsman to consider an SME a small business?
- Q3:** Do you agree with our proposal to make guarantors eligible complainants?
- Q4:** Do you agree that the changes introducing small businesses as eligible complainants should come into effect on 1 December 2018 and that they should apply only to complaints made to a firm regarding acts or omissions of the firm which occur from 1 December 2018? If not, what transitional period do you consider appropriate?
- Q5:** Do you agree that the changes introducing guarantors as eligible complainants should come into effect on 1 December 2018 and that they should apply only to complaints made to a firm regarding guarantees or security given on or after 1 December 2018?
- Q6:** Do you agree with our cost benefit analysis? Are there other costs or benefits we ought to have considered?
- Q7:** Do you have any views on how access to redress might be improved for SMEs without the need for changes to legislation, including but not limited to the areas where we have powers to make changes?
- Q8:** Without legislative change, do you think the Ombudsman might be an appropriate body to consider a greater share of complex or higher value complaints from SMEs than is implied in our proposals for consultation in Chapter 3? What changes would be needed to make this effective? What risks might this introduce?

Annex 2

Cost benefit analysis

Introduction

1. Section 138I(2)(a) of FSMA requires us to publish a cost benefit analysis (CBA) of our proposed rules.
2. As part of this CBA we provide monetary values for the costs and benefits where it is feasible to do so but also discuss non-quantifiable costs and benefits. Our proposals are based on carefully weighing up the various impacts.
3. The one-off costs are negligible and we estimate that the quantifiable net benefits (quantifiable benefits less costs) are likely to amount to between £0.92m and £6.71m per year if redress to SMEs is excluded and between £2.03m and £14.25m per year if the redress is taken into account (the redress paid to SMEs could be interpreted as an illustration of the benefits of 'righting wrongs' that our proposals should bring about).
4. We also expect some non-quantifiable benefits, in particular greater trust in financial markets, which may lead to a greater use of financial services by SMEs. In turn this will likely contribute to SMEs', and hence economic, growth. The non-quantifiable costs appear very small. Overall we conclude that the proposals are net beneficial for society.
5. The remainder of this Annex is structured as follows. We discuss
 - the market failure which our proposals aim to remedy
 - our proposed interventions

Then we estimate, firstly for our proposal on the size threshold and secondly for our proposal on personal guarantors:

- the costs to financial services firms
- the costs to SMEs
- the costs to the Financial Ombudsman Service ('the Ombudsman') and the Financial Services Compensation Scheme (FSCS)
- the benefits to financial services firms
- the benefits to SMEs

We conclude with a summary of the costs and benefits and the net benefits of the proposals.



6. Our approach to quantifying the costs and benefits of our proposals broadly consists of estimating how many newly-eligible complaints financial services firms and the Ombudsman will receive under each of the proposals. Using average per-complaint costs or benefits we estimate the total costs or benefits implied by these new complaints. We discuss details of our calculations below. We present our estimates used to calculate the costs and benefits as rounded to the nearest 5 significant figures in the text, but use figures before rounding in our calculations. All costs and benefits are rounded to the nearest £10,000 in the text and are per year (unless specified as one off).

Market failure analysis

7. The market failure we have identified is based on an imbalance ('asymmetry') of information between SMEs and financial service firms, and an inability to address harm that might arise from this information asymmetry.

Information asymmetries

8. SMEs procuring financial services are often not able to assess the quality of the product or service, or the quality of complaints handling, before they purchase a product or service or experience a problem. In the case of services for larger SMEs, financial services firms may also not become aware quickly enough of problems with the financial service they provide. This is because services are often tailored to the client, the client population is small, and the distribution chain (eg in the case of commercial insurance or specialist commercial lending) is complex. These factors, combined with high levels of market concentration or client inertia in some markets for financial services for SMEs mean that competition alone is unlikely to address poor product or service quality or poor complaint handling.

Access to redress

9. The paper sets out that SMEs, for a range of reasons, have generally fewer options for seeking redress where they are dissatisfied with how a financial services firm has handled their complaint. The proposed rules partially address this, by giving more businesses recourse to the Ombudsman.

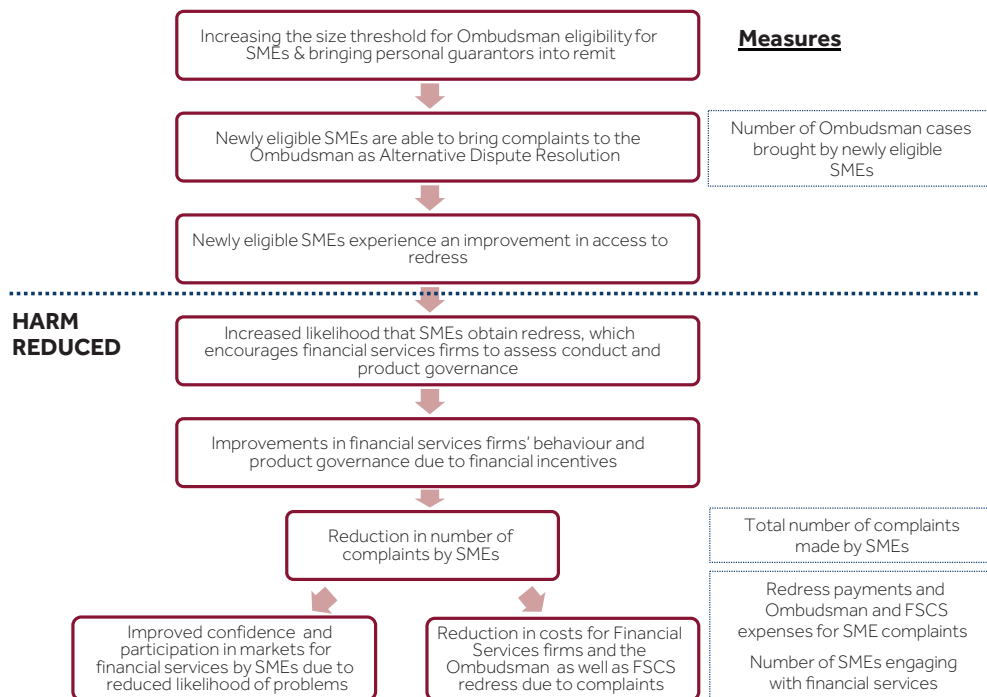
Our intervention

10. Our proposals aim to address those market failures by increasing access to the Ombudsman for SMEs by:
- increasing the size threshold for eligibility
 - bringing personal guarantors for loans into its remit
11. To be eligible under the new size thresholds an SME would need to have an annual turnover of less than £6.5m, a balance sheet total below £5m and fewer than 50 employees. Larger firms will remain ineligible. Currently, only individuals and micro-enterprises, which employ fewer than 10 persons and have an annual turnover or

balance sheet which does not exceed €2m are eligible to make complaints to the Ombudsman.⁴⁷

- 12. We are not aware of other planned policy interventions or market developments that may materially change the aspects of the market relevant for this proposal. Therefore we use the current situation as our counterfactual (what would happen if the proposal did not go ahead) for the assessment of the costs and benefits of the policy.
- 13. The diagram below summarises the rationale for our proposal.

Figure 1: Causal pathway of our proposals and their expected benefits



Proposals in relation to the size thresholds for eligibility

Baseline

- 14. The costs and benefits of the proposal depend on the number of complaints made to firms and then to the Ombudsman. To estimate these numbers, we start from available data on expected complaints by newly-eligible SMEs to the Ombudsman per year and then use that data to estimate the larger number of complaints to financial services firms (ie before referral to the Ombudsman as only a subset of complaints are referred).

Number of complaints to the Financial Ombudsman Service

- 15. We use the average number of recorded complaints by micro-enterprises to the Ombudsman over the last 3 financial years (3,960 complaints) and include an additional 2,000 complaints per year that are likely business complaints⁴⁸ but were not classified as such, to arrive at an estimated total of 5,960 complaints. We then apply a range of assumptions on the likelihood that these complaints relate to newly-eligible SMEs

47 See the definition in the FCA Glossary. The amount is set in Euro because it is derived from a recommendation by the European Commission, 2003/361/EC, Article 2(3).

48 Data on complaints by micro-enterprises from the Ombudsman's 2015 report 'micro-enterprises and financial services a review of complaints', p.33.



to generate a number of between 370 and 1,255 complaints to the Ombudsman by newly-eligible SMEs.⁴⁹ This estimate includes complaints likely to relate to loans.

16. We expect that only about 4% to 7% of complaints by newly-eligible SMEs are likely to involve high-value awards (ie awards greater than the Ombudsman's award limit of £150,000⁵⁰), which SMEs may decide to take directly to court.

Number of complaints to the financial services firms

17. Based on our SME Complaints Survey, only 4.7% of SME complaints are referred to the Ombudsman. However, our survey is likely to have attracted responses from more dissatisfied SMEs on average. In its response to DP15/7, one firm said that fewer than 2% of the business complaints it received were referred to the Ombudsman. Assuming that about 2% to 4.7% of all complaints by SMEs are referred to the Ombudsman (as per the numbers in paragraph 15) we estimate that the newly-eligible SMEs will make between 7,830 and 62,630 complaints to financial services firms.⁵¹ Complaints relating to loans are again included.

Costs

18. The proposal is likely to affect financial service firms, SMEs, the Ombudsman and the FSCS. We consider costs for each of these in turn. The costs are summarised in Table 2 later in this Annex.

Costs to financial service firms

19. We expect that firms will face the following costs due to our proposals:

- a. redress payments awarded to newly-eligible SMEs
- b. reimbursement of costs to the Ombudsman (case fee and levy) and the FSCS (levy)
- c. administrative complaints handling costs
- d. non-quantifiable costs

We discuss these in turn.

A. Redress awarded to newly-eligible SMEs by the Financial Ombudsman Service

20. We estimate the total value of redress which the Ombudsman may award to newly-eligible SMEs. We do this by first considering the number of complaints about financial services upheld by the Ombudsman and the average value of such a complaint. We then also consider additional costs for insurance redress, assuming the limit of

49 We derive the lower bound by multiplying the estimated 5,960 complaints by micro-businesses by the proportion of business and complaints which the Ombudsman currently rejects based on size criteria alone (ca. 6%) and adding additional 3.4% complaints to account for newly-eligible charities. The proportion of newly-eligible charities is estimated based on data from Charity Financials. For the upper bound we estimate the proportion of the 3,960 complaints by micro-enterprises that are likely made by enterprises with employees (ca. 58% based on the report 'micro-enterprises and financial services a review of complaints', p.5) and multiply by the ratio of newly-eligible SMEs to micro-enterprises of ca. 19.1% calculated from the SME Finance Monitor survey and by the greater likelihood of newly-eligible SMEs to have a problem with financial services (The Legal Service Board survey data suggests that newly-eligible SMEs might be ca. 2.76 times more likely to experience such problems than micro-enterprises). We then add 3.4% additional complaints to account for newly-eligible charities.

50 Based on the Legal Services Board (LSB) Legal Needs of Small Businesses Survey and FCA SME Complaints Survey.

51 Where 7,830 is 368 divided by 4.7% and 62,630 is 1252.6 divided by 2%.

£150,000 for redress awarded by the Ombudsman does not apply because the cost of policy reinstatement exceeds the limit (see paragraphs 24 to 28).

Redress awarded to newly-eligible SMEs by the Financial Ombudsman Service, assuming no redress above the Ombudsman's award limit

21. The Ombudsman's review of micro-enterprise complaints found that 26% of insurance complaints (excluding payment protection insurance) and 52% of banking complaints by micro-enterprises are upheld. We therefore assume that between 26% and 52% of complaints by newly-eligible SMEs will be resolved in the complainants' favour. These assumed uphold rates suggest that between 95 and 650 complaints by newly-eligible SMEs are likely to be upheld each year.⁵²
22. Based on our SME Complaints Survey and the Legal Service Board (LSB) surveys, the average value of a complaint by a newly-eligible SME is around £11,570 (assuming no value is higher than the Ombudsman award limit of £150,000).
23. Combined with our estimate of the number of upheld complaints (see paragraph 21), this suggests a range of £1.11m to £7.54m in redress paid to newly-eligible SMEs.

Additional estimate of total redress, assuming pay-outs above the Financial Ombudsman Service award limit for insurance complaints

24. In some cases the Ombudsman may recommend firms uphold the policy rather than to require the firm to pay redress. The pay-out under the policy may be higher than the Ombudsman's award limit. Therefore, we have considered an additional estimate for insurance-related complaints.
25. To estimate the likely number of complaints by product, we used the Ombudsman's data on micro-enterprise complaints by type of service and adjusted it to account for the fact that larger SMEs which will become eligible for Ombudsman use some products more often than micro-enterprises and others less often.⁵³ This suggests that an additional 145 to 500 complaints about insurance a year might be made to the Ombudsman under the proposal (and 40 to 130 upheld considering the uphold rate for insurance complaints of 26%).
26. We use the estimated average value of business disputes from our surveys (£86,920). This assumes, among other things, that such high value complaints would not be heard by the courts if the complainants could not access the Ombudsman and that firms will generally comply with the Ombudsman's recommendations where the value of redress is more than the award limit. Sampling of SME claims by Quadrangle for our thematic review on the subject⁵⁴ suggested that, of all SME claims in excess of £5,000, only 20% involved sums in excess of £100,000. Considering this, the average value of business disputes of £86,920 does not appear unduly small.
27. Applying this average value of £86,920 to the 40 to 130 upheld insurance complaints, gives a total estimated value of redress of ca. £3.32m to £11.25m (an increment of

52 Calculated by multiplying the estimated number of complaints by newly-eligible SMEs to the Ombudsman by the uphold rate, ie $368 * 0.26 = 96$ and $1,252.6 * 0.52 = 651$.

53 We multiplied the proportions of micro-enterprise complaints about a given product (bank accounts, loans, insurance etc) with a factor reflecting the extent to which the newly-eligible SMEs used this product relative to micro-enterprises. (Eg 44% of financial products used by newly-eligible SMEs are commercial insurance products, while the corresponding figure for micro-enterprises is 23%. The multiplication factor is hence 1.91.) From these adjusted proportions of complaints for each product we calculate a ratio of insurance complaints over all complaints about financial products of ca. 40% (data from the FCA's 2015 SME complaints survey).

54 See p.44; <https://www.fca.org.uk/publication/research/quadrangle-commercial-insurance-claims-research.pdf>



between £2.88m and £9.76m over the total value of insurance-related complaints assuming no redress above the Ombudsman award limit).⁵⁵

28. Taking the estimates with and without the award limit (paragraphs 23 and 27) together, the estimated total redress for newly-eligible insurance and non-insurance complaints is £3.99m to £17.29m.

***B. Reimbursement of costs to the Financial Ombudsman Service and the FSCS
Financial Ombudsman Service case fee and levy***

29. Additional costs will accrue to firms from case fees paid to the Ombudsman and the cost of funding newly-eligible complaints.
30. Based on the range of estimates of newly-eligible complaints of 370 to 1255, the Ombudsman's case fee of £550 per complaint, and assuming that all complaints from newly-eligible SMEs involve firms that would otherwise have met or exceeded their allowance of 25 free cases (a conservative assumption, which is likely to over-estimate the costs), the total cost to the industry could range from £0.20m to £0.69m per year.⁵⁶
31. However, the Ombudsman's estimated unit cost for resolving complaints is, at £619⁵⁷, higher than its standard case fee. Some of the cost of resolving newly-eligible complaints will not be covered by case fees. The difference is covered by a levy on the industry. If complaints from newly-eligible complainants require more resources than those of already eligible complainants, the total cost of complaints handling will be higher, but we do not believe that this will be the case. Applying the standard unit cost to the estimate number of newly-eligible complaints would imply a cost of between £0.23m and £0.78m per year. We use this estimate in our analysis.⁵⁸

Financial Services Compensation Scheme levy

32. Where the Ombudsman has ordered a firm in default to pay awards to newly-eligible SMEs, the complainant may instead be able to claim using the Financial Services Compensation Scheme (FSCS). Redress awarded by this scheme is covered by a levy on the industry. Financial services firms will therefore also have to cover additional redress awarded by the FSCS to newly-eligible SMEs through a higher levy.
33. Our proposed changes are unlikely to significantly increase the number of these cases, which usually involve intermediaries. We estimate that between 130 and 445 newly-eligible complaints about intermediaries⁵⁹ might be referred to the Ombudsman each year in total, with between 35 and 230 upheld.⁶⁰ The number of these complaints that will be followed by the dissolution of a firm is likely to be very small in absolute terms. For example, Office for National Statistics data suggests that about 9% of insurance intermediaries failed in the years 2013 to 2015.⁶¹ This suggests that just over 3 to 21

55 The increment over the redress under the previous assumptions is calculated as that total redress for insurance complaints minus the value of these insurance complaints using the assumptions in paragraphs 25 and 26 (eg the lower bound is calculated as £3,322,080 minus £1,106,871*38/96=£2.88m, with 38/96 being the ratio of newly-eligible insurance complaints upheld over all newly-eligible complaints upheld).

56 The total value of the case fees are calculated as the per-case fee of £550 times the estimated number of newly-eligible complaints of 368 to 1253.

57 See the Ombudsman consultation 'Our plans and budget for 2016/7'.

58 The total costs to the Ombudsman are calculated as number of complaints times the average cost per case of £619.

59 We use the same approach as for insurance complaints, see paragraph 26.

60 As before we use the uphold rate for insurance related complaints of 26% and the uphold rate for banking related complaints of 52% to calculate the lower and upper bound of upheld complaints; see also paragraph 22.

61 ONS (2017) 'Business Demography – 2015: Enterprise Births, Deaths and Survivals' for SIC2007 66.2.

complaints⁶² may be awarded redress by the FSCS. Given that larger firms account for a greater share of complaints and are less likely to fail in a given year than smaller firms, this is an upper bound of the share of awards to newly-eligible SMEs that are likely to result in claims against the FSCS.

34. Applying this to the average value of awards of £11,570, we arrive at an estimate of approximately £0.04m to £0.24m per year.⁶³

C. Administrative complaints handling costs

35. Firms will incur direct costs in handling complaints by newly-eligible SMEs due to our rules in DISP. Two types of obligations in particular are likely to result in compliance costs for firms, in proportion to the number of newly-eligible complaints referred to firms

- obligations under DISP 1.2.1.R and DISP1.2.2R to increase consumer awareness of the protections available to them, including making complaints to the Ombudsman
- obligations under DISP 1.4.1R to investigate, assess and resolve complaints

One-off administrative costs

36. A number of large firms responding to DP15/7 suggested that they apply the same complaint-handling procedures to smaller and larger SMEs, and even to their unregulated dealings with business clients.
37. We believe it is reasonable to assume that financial services firms that already deal with at least some eligible complainants are familiar with the requirements in DISP and investigate, assess and resolve SME complaints in a similar way, regardless of whether the complainant is eligible. In fact, many firms already use our proposed eligibility threshold for business purposes.⁶⁴
38. Moreover, we believe that familiarisation costs for financial services firms will be negligible because the amount of additional information to be considered to understand the change in the rules regarding Ombudsman eligibility is minimal.
39. Given the above, we expect the one-off costs for financial services firms due to the change in the eligibility for the Ombudsman to be negligible.

Ongoing annual administrative costs

40. For the reasons above (see paragraph 37), we believe that financial services firms which already serve SMEs currently eligible to complain to the Ombudsman will not face higher complaints handling costs. However, we received feedback from the Smaller Business Practitioner Panel and our roundtable with general insurance firms and intermediaries, held in November 2016, that this might not apply to all firms. Therefore, we have also considered whether smaller, specialist firms that have previously only dealt with SMEs too large to be eligible might incur additional administrative costs because of our proposals.

62 Rounded to full complaints (rather the nearest 5) to avoid almost doubling the lower bound by rounding.

63 E.g. the lower bound is calculated as $130 \times 0.26 \times 0.09 \times \text{£}11,570$.

64 This is for example because they have signed up to the voluntary Standards for business lending practice, which apply to businesses with a turnover threshold of less than £6.5m. Our proposed size threshold also matches the thresholds below which SMEs cannot opt out of having their deposits ring-fenced. The Order provides that the deposits of organisations with a turnover greater than £6.5 million, more than 50 employees or a balance sheet total greater than £5 million will be able to choose to bank outside the ring-fence. See Article 4 of the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.



41. We estimate that between 7,830 and 62,630 complaints referred to firms by newly-eligible SMEs would now be subject to DISP rules each year (see paragraph 17).
42. In CP14/30⁶⁵, we estimated that the cost of handling a consumer complaint (including its investigation, assessment and resolution) was between £20 and £330. This range narrows to between £54 and £186 for complaints escalated to some extent and after stripping out the cost of redress. Based on interviews with large firms, Real Assurance Risk Management (2006) estimated that about 10% of the administrative cost of complaints handling goes above and beyond what firms would do voluntarily without regulation.⁶⁶ This suggests an additional cost of £5.40 to £18.60 per complaint. In CP14/30 we also estimated a unit cost of £1.74 for complying with our consumer awareness rules.⁶⁷ Applying these incremental complaint-handling costs to complaints that are newly subject to DISP suggests an incremental administrative cost of £0.05m to £1.25m per year.⁶⁸

D. Non-quantifiable costs for financial services firms

43. We have considered several additional non-quantifiable costs.
44. First, respondents to DP15/7 raised concerns about the additional cost of insuring firms against an increase in Ombudsman awards. To attempt a quantification exercise we would need to identify insurers' underwriting and pricing approach to a new category of complaints for which there is no history of claims. We don't believe it is feasible to estimate this cost (which is also a transfer between firms).
45. Second, we have considered whether the proposed changes put financial services firms serving eligible SMEs at a competitive disadvantage, including by reducing their ability to innovate. Since all firms serving newly-eligible SMEs have to comply with the same rules, the proposal does not distort competition.
46. Third, we believe it is possible that new-to-market innovators focusing on newly-eligible SMEs will see a greater impact from our proposal because they don't already have experience with complaints from eligible complainants. New products are likely to be least familiar to SME buyers and so may give rise to a greater number of problems and complaints. The additional cost due to a higher number of Ombudsman complaints must be balanced against a higher chance of harm from such new products.
47. We don't believe that new entrants or specialist providers of services to SMEs will be disproportionately affected by Ombudsman fees. Because of their limited client numbers, they should be much more likely to stay within their quota of 25 free complaints.

Costs to SMEs

48. We have considered whether newly-eligible SMEs might incur incremental familiarisation costs as a result of our proposals. We believe that such costs will be

65 <https://www.fca.org.uk/publications/consultation-papers/cp14-30-improving-complaints-handling>

66 Real Assurance Risk Management (2006) 'Estimation of FSA Administrative Burdens', June www.fsa.gov.uk/pubs/other/Admin_Burdens_Report_20060621.pdf

67 Since the Payment Service Directive 2 (PSD2) already requires firms to inform their customers about alternative options for dispute resolution we have not included the £1.74 for complaints relating to bank accounts or card payment services. Based on data from the FCA's SME complaints survey we estimate that 25% of complaints related to bank accounts and card services (in scope of the PSD2).

68 For example, the lower bound is calculated as $7,828 \times (0.1 \times £54 + 0.75 \times £1.74)$.

negligible. Generally, businesses don't consider their status as eligible complainants unless and until they experience an unresolved dispute with a firm. For an SME in this position, our proposals don't affect any of the actions it would take to assess its eligibility – only the outcome of its assessment.

Costs to the Financial Ombudsman Service

49. The additional case fees and higher levy will cover the costs of ca. £0.23m and £0.78m per year which the Ombudsman faces to deal with the additional complaints (estimated at paragraph 31).
50. We have considered whether there are other consequential costs arising from the increased number of complaints the ombudsman will have to handle.
51. Impact on quality of service: Our range of estimates for the number of complaints from newly-eligible SMEs would represent a 0.1% to 0.3% increase in the overall annual caseload of the Ombudsman of ca. 439,000 cases in 2015/6.⁶⁹ Based on the Ombudsman's evidence we believe that this will not present problems to the Ombudsman's operations and is unlikely to affect the service levels given to micro-enterprises and individual consumers who are already eligible complainants. Such an increase would be small compared to the annual fluctuation in the Ombudsman's caseload and would unlikely need significant resources to be redirected from the resolution of already-eligible complaints to that of newly-eligible ones.
52. Impact on speed of resolution: It is possible to resolve even complex business disputes promptly. Micro-enterprise complaints are as likely to be resolved within 3 months as complaints from individual consumers. Even in extreme cases, such as IRHP mis-selling, resolution within 6 months has been possible,⁷⁰ and firms participating in our SME claims Thematic Review (TR15/6) were able to resolve more than half of all claims exceeding £5,000 in value within the same period. We therefore believe our proposals will not affect the Ombudsman's ability to meet its other obligation under the Alternative Dispute Resolution Directive to resolve complaints from individual consumers within 90 days.
53. Need for additional skills and resources: Respondents to DP15/7 have raised questions about the Ombudsman's access to appropriate skills in the case of, for example complex insurance complaints. The Ombudsman already has experience of dealing with complex complaints including those involving micro-enterprise complaints about IRHPs, commercial lending and commercial insurance.

Costs to the Financial Services Compensation Scheme

54. As explained above the FSCS will likely pay out redress of ca. £0.04m to £0.26m per year which is covered by a levy on the industry. Considering the small additional number of newly-eligible complaints about failed firms we don't expect significant additional complaints handling costs for the FSCS.

69 See the Ombudsman's annual review 2015/6, p.3.

70 For example, the Ombudsman has been able to resolve about half of all IRHP related complaints it received in 2015/16 within a six-month period.



Benefits

- 55.** We expect improved access to redress for newly-eligible SMEs to generate benefits in the form of improvements in financial services firms' behaviour, culture and product governance. It is difficult to establish the scale of this benefit. We can, however, provide an illustration of scale by estimating the savings to financial services firms and SMEs.
- 56.** To estimate these savings, we need to understand how much problems with financial services are likely to reduce due to the proposal. Our best approximation of the micro-enterprise and medium-sized enterprise samples used by the LSB saw the frequency of reported problems with financial services fall by more than 40% between 2013 and 2015. However, considering only survey respondents which are similar to the newly-eligible SMEs, we found that these experienced a much smaller reduction, of between zero and 10%, in the number of problems experienced. Since not all of the implied ca. 30% difference between both types of firms can be attributed to access to the Ombudsman, we use 5% as an illustrative reduction in problems with financial services, which the policy proposal may achieve, to illustrate the possible benefits to firms and SMEs.
- 57.** A 5% reduction in complaints by newly-eligible SMEs would remove between 390 and 3,130 complaints to financial services firms, and between around 20 and 60 complaints to the Ombudsman (see paragraph 17).⁷¹

Benefits to financial services firms

- 58.** The benefits to financial services firms relate to redress avoided, case fees and levies saved, complaints handling costs saved and greater levels of trust.
- 59.** Redress avoided: We use the median value of an avoided dispute to larger SMEs of £5,250 in the LSB and FCA surveys as an estimate of the value of these complaints to reflect that it might not be the complaints that would give rise to high redress which might be avoided due to our proposal. This is a very conservative estimate, much lower than the average value assumed in calculating awards to SMEs (£11,570). Considering the proportion of complaints escalated to the Ombudsman and upheld (26% to 52%), we estimate that firms may avoid paying redress of between £0.03m to £0.17m.⁷² Additionally, for redress for insurance, firms will avoid paying £0.14m to £0.49m.⁷³
- 60.** Case fees and levies saved: Firms will also save 5% of the case fees and levy they would pay to the Ombudsman and the FSCS for newly-eligible complaints; see paragraphs 31 and 34 (ca. £0.01m to £0.04m and £0.002m to £0.01m, respectively).
- 61.** Complaints handling costs saved: We assume that firms would have incurred the average complaint handling costs estimated in CP14/30 (see paragraph 42), hence we estimate ongoing savings for firms of ca. £0.02m to £0.59m.⁷⁴
- 62.** Greater levels of trust: New entrants focusing on larger SMEs are also likely to benefit from greater levels of trust and confidence from their target customers as a result of

⁷¹ Based on the estimated 7,828 to 62,630 complaints to firms and the estimated 368 to 1255 complaints made to the Ombudsman.

⁷² Eg the lower bound is calculated as the lower bound of the number of ombudsman complaints times the uphold rate of 26% times the median value of a complaint times the percentage of complaints avoided ($368 * 0.26 * £5,252 * 0.05$).

⁷³ The lower bound, for example, is calculated as $£2.88m * 0.05$, with £2.88m as the lower bound of the possible additional redress for insurance complaints; see paragraph 28.

⁷⁴ Eg the lower bound is calculated as $391 \text{ complaints} * (£54 + £1.74)$, with $7828 * 0.05 = 391$ as the number of avoided complaints to firms.

our proposals. Newly-eligible SMEs may be more willing to use financial services or to trust unfamiliar brands if they can expect the same standards of redress and complaint handling as more established firms. However, we don't believe it is feasible to quantify this benefit.

Benefits to SMEs

- 63.** Keeping the same assumptions, we estimated the ongoing benefits to SMEs from a 5% reduction in complaints that are unsatisfactorily resolved, considering the conservative typical value of a complaint of £5,250 and that around 44% of all complaints by SMEs aren't informally resolved to the satisfaction of the SME.⁷⁵ On that basis, the estimated value of avoided complaints by newly-eligible SMEs ranges from £0.90m to £7.24m.⁷⁶
- 64.** There might also be further benefits because businesses become more willing to engage with the industry or with unfamiliar brands and will likely benefit from using additional financial services. For example, Fraser (2014) finds that increasing SMEs' awareness of the Independent Loan Appeals process or the Lending Code might have encouraged tens of thousands of additional SMEs per year to apply for finance.⁷⁷ Since access to finance is beneficial for the growth of small businesses, this will also benefit the economy overall.⁷⁸ SMEs will also benefit from greater restitutive justice (compensation) and from avoided distress when dealing with problems and complaints.
- 65.** Moreover, Ombudsman decisions might alert both firms and the FCA to problem products or contract terms. Early intervention can reduce their impact by limiting the number of SMEs affected.
- 66.** Similarly, the additional complaints might alert the financial services firms (or the FCA) to problems soon after they emerge and allow for early intervention. It is not feasible to reliably estimate how often high-impact failures occur which might be avoided.

Proposals in relation to personal guarantors

- 67.** As for the analysis of increased size threshold, we discuss:
- the baseline
 - the costs to financial service firms, SMEs, the Ombudsman and the FSCS
 - the benefits for firms and SMEs

75 Our SME complaints survey suggests that 56% of complaints by larger SMEs that were not still ongoing had been resolved to the respondent's satisfaction. Data provided to us by UK Finance also suggest that 61% of complaints against banks by larger SMEs are resolved internally by the firms in favour of the SME.

76 Eg the lower bound is calculated as the number of avoided complaints to financial services firms of 391*£5,252*0.44.

77 Fraser, S. (2014) 'Back to borrowing? Perspectives on the 'Arc of discouragement' Enterprise Research Centre White Paper no. 8, March.

78 See for example 'SME Access to External Finance', BIS economics paper No.16, Jan. 2012, p.7 and the references quoted there.



Baseline

68. As with the proposals to change the size threshold, the costs and benefits of the proposal for personal guarantors depend on the number of complaints made to firms and then to the Ombudsman. To estimate these numbers, we have again started from available data on expected complaints from personal guarantors to the Ombudsman per year and then used that data to estimate the bigger number of complaints to financial services firms.

Number of complaints to the Financial Ombudsman Service

69. The Ombudsman does not have specific data on the number of complaints it has received about personal guarantees. Some informal sampling shared by the Ombudsman suggests that they have received in the region of 130 complaints since 2014 in relation to personal guarantees for micro-enterprise loans which they have been unable to consider because the complainant was an individual acting in the course of their business or trade.⁷⁹ This is equivalent to 0.7% of the volume of micro-enterprise complaints currently resolved by the Ombudsman. While not all of these complainants were individual guarantors, we believe that the majority were. We therefore assume that in a typical year the Ombudsman will receive 33 additional complaints in relation to micro-enterprises as a result of our proposals.
70. The Ombudsman doesn't record an equivalent figure for complaints in respect of 'small business' loans, as these are outside its jurisdiction because of the size of the complainant. To estimate this, we first calculate the proportion of facilities backed by a personal guarantee taken out by larger SME.⁸⁰ Multiplying the estimated 370 and 1,255 additional ombudsman complaints by newly-eligible SMEs by the estimated 0.7% share of loans with personal guarantee in the ombudsman cases and accounting for the higher proportion of newly-eligible SMEs using such loans (77% more than micro-enterprises⁸¹), we estimate that between around 5 and 15 of complaints by newly-eligible SMEs per year will involve personal guarantees.⁸²
71. In total, therefore, we expect between ca. 35 and 50 additional complaints involving personal guarantors to be referred to the Ombudsman each year. Considering the average uphold rate of 52% for banking-related complaints, we expect that the Ombudsman will uphold between about 20 and 25 complaints by all eligible complainants per year.⁸³

Number of complaints to financial service firms

72. As before, we assume that only between 2% and 4.7% of complaints are referred to the Ombudsman, while most others are resolved informally by firms. Given our estimates above, this means that between around 790 to 2,400 complaints to financial services firms in relation to personal guarantees are likely to be within scope of DISP.⁸⁴

79 Since the estimate is based on decisions it is a lower bound for the number of such complaints.

80 We used information from the SME Finance Monitor on the proportion of secured overdrafts and secured loans and on the proportion of secured overdrafts and loans involving a personal guarantee for different types of business.

81 Based on data from the SME finance monitor H2 2016.

82 The lower bound is calculated as $368 * 0.007 * 1.77$.

83 That is the lower bound, for example, is calculated as $(33 + 368 * 0.007 * 1.77) * 0.52$.

84 This is calculated as the number of complaints to the Ombudsman divided by the estimated proportion of complaints to firms that reach this service; for the lower bound as $37 / 0.047$ and for the upper bound as $48 / 0.02$ where 37 and 48 are the lower and upper bound of additional complaints prior to rounding.

Costs

73. As for the new size threshold proposal, the proposal is likely to affect financial service firms, SMEs, the Ombudsman and the FSCS.

Costs to financial services firms

74. We believe the same types of costs as for the new size threshold proposal: redress, reimbursement of costs to the Ombudsman and FSCS, and complaints handling costs.

Redress

75. The amounts paid in redress are likely to be driven by the value of the personal guarantees or security in question. It is not usual industry practice for lenders to require unlimited personal guarantees and the best estimates suggest that personal guarantees for UK SME loans only cover on average 13% of the borrower's securitised liability.⁸⁵ We have combined this estimate with the average value of an SME facility (across loans and overdrafts) as established by the SME Finance Monitor for the 18 months to end 2016 – this was £76,180 for micro-enterprises and £352,020 for small businesses, implying an average personal guarantee worth ca. £9,900 to £45,760 respectively.

76. Based on the above estimates we expect redress recommendations by the Ombudsman of ca £0.28m to £0.54m per year.⁸⁶ In theory, the ombudsman's award limit should apply to these recommendations. However, where the Ombudsman finds that a firm should not have accepted a personal guarantee, it is likely that the firm will repay, or relinquish its claim on, the total amount in question. We therefore assume that firms will be liable for the full amounts estimated above even if they exceed the ombudsman's award limit.

Reimbursement of costs to the Financial Ombudsman Service and the FSCS

77. Financial services firms will also have to pay additional case fees and higher levy to the Ombudsman. The additional case fees and higher levy paid by firms will likely cover the costs the Ombudsman faces to deal with the additional complaints. Using the Ombudsman's unit cost of £619 and assuming as before that all complaints will be against firms that have already exceeded their quota of 25 free complaints, we estimate the total cost to the Ombudsman of bringing personal guarantees into scope will be £0.02m to £0.03m per year.⁸⁷

78. Based on ONS data⁸⁸, around 10% of banks, building societies and firms in monetary intermediation failed in the years 2013 to 2015. Considering the likely number of newly-eligible complaints (ca. 35 to 50) we estimate that around 2 upheld complaints involve failing firms.⁸⁹ This is again an upper bound for firms involved in claims by personal guarantors against the FSCS because larger firms account for a larger share of complaints and are less likely to fail. Multiplying by the average value of likely awards of £11,570, we arrive at an estimate of ca. £0.02m to £0.03m per year.⁹⁰

85 Using as a proxy the proportion of 13% of personal guarantees in loans, from table VI in Davydenko, S. A. and Franks, J. R. (2008) 'Do bankruptcy codes matter? A study of defaults in France, Germany and the UK' *The Journal of Finance* 63:2, pp 565-608.

86 Eg the lower bound is calculated as $33 * 0.52 * £9,903 + 4.5 * 0.52 * £45,763$.

87 The lower bound, for example, is calculated as $37 * £619$.

88 ONS (2017) 'Business Demography – 2015: Enterprise Births, Deaths and Survivals' for SIC2007 64.1.

89 Both the lower bound and the upper bound round to 2.

90 The lower bound, for example, is calculated as $37 * 0.10 * 0.52 * £11,570$.



Complaints handling costs

79. There is no evidence that firms treat complaints by personal guarantors to corporate loans differently from eligible complaints. It is likely that many firms do not realise that the position of personal guarantors may be different. So there could be little or no incremental compliance costs to firms apart from ombudsman awards. Even so, we have estimated additional complaints handling costs assuming that all firms will escalate complaints by eligible complainants internally.
80. We use the same assumptions as before to calculate administrative costs (see paragraph 42). Adjusting for the proportion of administrative costs that are truly incremental to good business practice and multiplying by the number of complaints received gives an estimated annual compliance cost of £0.01m to £0.05m across all newly-eligible complaints.⁹¹
81. Since the amount of additional information to be considered to understand the change in the rules regarding Ombudsman eligibility is minimal, we believe that one-off familiarisation costs for financial services firms will be negligible.

Costs to SMEs

82. As for the proposals to raise the size threshold, we have considered whether newly-eligible SMEs and guarantors might incur incremental familiarisation costs as a result of our proposals. We believe that SMEs or their guarantors don't consider their status as eligible complainants until they experience an unresolved dispute with a firm. The steps they will take and the costs incurred to assess their eligibility will not be affected by our proposal.

Costs to the Financial Ombudsman Service and the FSCS

83. As explained at paragraph 77 we estimate the additional annual costs to the Ombudsman of ca. £0.02m to £0.03m per year to be covered by the case fees and levy paid by firms and additional annual total redress awarded to the FSCS also covered by a levy of £0.02m to £0.03m. Because of the small number of additional complaints we are not expecting significant additional complaints handling costs for the FSCS (see paragraph 78).

Benefits

84. As in the analysis regarding an increased size threshold, we consider again an illustrative 5% reduction in the number of disputes between SMEs and firms, which we assume would result from cultural change, improved product design and governance, and improved conduct (see also paragraph 56). We consider 5% to be a conservative estimate because the potential for improvements resulting from better access to redress will be greater than in unregulated services such as corporate lending, where there is no compulsory standard of conduct. In the case of personal guarantors, a 5% reduction would correspond to between 40 and 120 fewer complaints to financial services firms and around 2 fewer complaints to the Ombudsman per year.

Benefits to financial services firms

85. The benefits to financial services firms again relate to redress avoided, case fees and levies saved and complaints handling costs saved.

91 The lower bound, for example, is calculated as $790 * (\text{£}54 * 0.1 + \text{£}1.74)$.

- 86.** Redress avoided: Financial services firms will save costs associated with resolving avoided complaints. To account for the fact that a resolution by the firm is more likely with lower-value disputes, we apply the median value of personal guarantees (13% of the value of the median facility), which is £1,510 for micro-enterprises and £5,810 for newly-eligible SMEs.⁹² In total, firms will not have to pay redress awarded by the Ombudsman for the avoided complaints, corresponding to a saving of ca. £1,970 to £3,620.⁹³
- 87.** Case fees and levies saved: Firms will save 5% of the ombudsman case fee and levy and of the FSCS levy (£1,150 to £1,500 and £1,110 to £1,450, respectively).
- 88.** Complaints handling costs saved: Using the administrative cost estimates in paragraph 42, we estimate a small additional saving of between £2,195 and £22,540 in complaints handling costs across the sector, due to a 5% reduction in complaints.⁹⁴

Benefits to SMEs

- 89.** We have calculated the benefit for SMEs as the estimated value of the unsatisfactorily resolved complaints which are avoided under our proposal. To this end we multiplied the estimated median value of personal guarantees (£3,065) by the number of avoided complaints (40 to 120). Assuming again that 44% of the complaints would not have been resolved by firms informally to the SME's satisfaction (see paragraph 63), this results in an estimated benefit to SMEs of £0.05m to £0.16m per year.⁹⁵

Non-quantifiable costs and benefits

- 90.** The non-quantifiable costs and benefits to financial services firms and the non-quantifiable benefits for SMEs are qualitatively the same as those due to the proposal to increase the size threshold, but apply only to firms involved in lending. Since the estimated number of new complaints and the redress due to bringing personal guarantees into the scope of the Ombudsman are smaller, these impacts are less important here.

Net costs and benefits for both proposals

- 91.** We have considered i) the costs to different market participants as well as cost savings due to a reduction in the number of complaints by newly-eligible SMEs from the proposals (see Table 1) and ii) the net benefit to society (see Table 2). We use the net benefits for society in deciding whether the proposal will be beneficial.

Costs and cost savings for different market participants

- 92.** Table 1 summarises our estimates of the quantifiable costs and costs savings from the proposals. These costs arise directly to financial services firms or are recovered from them through case fees and levies. Based on our estimates the proposals will result in a negligible one-off cost (see paragraphs 36 to 39). As we explained above, the non-quantifiable costs to financial services firms will also be very small (see paragraphs 43 to 47 and 90). We do not expect a negative effect on the FSCS, on the Ombudsman's

92 Calculated from Davyenko and Franke, 2008, table VI.

93 Eg the lower bound is calculated as $(33 * £1,513 + 4.5 * £5,811) * 0.52 * 0.05$, with 33 and 4.5 the number of additional complaints by micro-enterprises and newly-eligible SMEs, 52% as uphold rate and 5% as proportion of complaints avoided.

94 Eg the lower bound is calculated as $40 * (£54 + 1.74)$ with 40 being the number of avoided complaints to financial services firms.

95 For the lower bound this is calculated as $40 * £3,065 * 0.44$.

ability to deal with complaints, nor on the ability of financial services firms to enter the market or innovate.

Table 1: Annual ongoing costs and savings for financial services firms (£m)

Cost/saving	lower	upper
New size threshold – costs		
Redress	1.11	7.54
Additional insurance redress*	2.88	9.76
Ombudsman costs	0.23	0.78
FSCS levy	0.04	0.24
Complaints handling costs	0.05	1.25
New size thresholds – savings		
Redress	(0.03)	(0.17)
Additional insurance redress*	(0.14)	(0.49)
Ombudsman costs	(0.01)	(0.04)
FSCS levy	(0.002)	(0.01)
Complaints handling costs	(0.02)	(0.59)
Personal guarantors – costs		
Redress	0.28	0.54
Ombudsman costs	0.02	0.03
FSCS levy	0.02	0.03
Complaints handling costs	0.01	0.05
Personal guarantors – savings		
Redress	(0.002)	(0.004)
Ombudsman costs	(0.001)	(0.001)
FSCS levy	(0.001)	(0.001)
Complaints handling costs	(0.002)	(0.02)

Source: FCA analysis. *The additional insurance redress is calculated assuming that the limit of £150,000 for redress awarded by the Ombudsman does not apply (see paragraphs 24 to 27 for details).

Net benefits to society

93. To assess the proposals we have considered their net benefit to society. The ombudsman case fee and levy and the FSCS costs are transfers from firms to the Ombudsman (ie costs to firms, but benefits to the Ombudsman) so we have netted these out. The redress payments by financial services firms to newly-eligible SMEs are also transfers because they are costs to some market participants, but benefits to others. Yet, they show the extent to which the proposal is likely to increase restitutive justice. Table 2 shows the additional or saved complaints handling costs for financial service firms, the benefit of fewer complaints and the additional redress to newly-eligible SMEs.

94. We summarise costs and benefits with and without the redress payments to newly-eligible SMEs. Based on our estimates we expect a net benefit of between £0.92m and £6.71m (if excluding the redress payments), and between £2.03m and £14.25m (if including these), due to the proposal leading to an improvement in the conduct of firms and hence to a 5% reduction of complaints by newly-eligible SMEs to firms

and the Ombudsman (see paragraph 56). Additional calculations show that under our assumptions the policy is still net beneficial for just a 1.5% reduction in the number of complaints.

Table 2: Net annual ongoing benefits for society (£m)

Cost/benefit	lower	upper
New size thresholds		
Cost: firms' additional complaints handling costs	(0.05)	(1.25)
Benefit: complaints handling costs saved by firms (due to fewer complaints)	0.02	0.59
Benefit: SMEs' avoided unsatisfactorily resolved complaints	0.90	7.24
Redress	1.08	7.37
Net benefit excluding redress (A)	0.87	6.58
Net benefit including redress (C)	1.96	13.94
Personal guarantors		
Cost: firms' additional complaints handling costs	(0.01)	(0.05)
Benefit: complaints handling costs saved by firms (due to fewer complaints)	0.002	0.02
Benefit: SMEs' avoided unsatisfactorily resolved complaints	0.05	0.16
Redress	0.27	0.53
Net benefit excluding redress (B)	0.05	0.14
Net benefit including redress (D)	0.07	0.30
Total net benefit excluding redress (A+B)	0.92	6.71
Total net benefit including redress (C+D)	2.03	14.25

Source: FCA analysis. Totals do not add up precisely due to rounding.

95. Considering the non-quantifiable benefits of the policy, SMEs will benefit from distress avoided, as well as greater restitutive justice and because they have to deal with fewer problems and complaints with financial services providers. Increased trust in financial services should increase SMEs' use of financial services – to the benefit of SMEs and the benefit of the firms providing those services, in turn benefiting the economy.
96. Overall, we believe that our proposals in relation to the size thresholds for eligibility and to personal guarantors will result in a net benefit, both individually as well as in the aggregate.



Annex 3

Compatibility statement

Compliance with legal requirements

1. This Annex records the FCA's compliance with a number of legal requirements that apply to the proposals in this consultation. It includes an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the Financial Services and Markets Act 2000 (FSMA).
2. When consulting on new rules, we are required by section 138I(2)(d) FSMA to include an explanation of why we believe making the proposed rules is (a) compatible with our general duty, under s. 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with our strategic objective and advances one or more of our operational objectives, and (b) its general duty under s. 1B(5)(a) FSMA to have regard to the regulatory principles in s. 3B FSMA. We are also required by s. 138K(2) FSMA to state our opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.
3. This Annex also sets out our view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (s. 1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.
4. This Annex also explains how we have considered the recommendations made by the Treasury under s. 1JA FSMA about aspects of the economic policy of Her Majesty's Government to which we should have regard in connection with our general duties.
5. This Annex includes our assessment of the equality and diversity implications of these proposals.
6. Under the Legislative and Regulatory Reform Act 2006 (LRRRA) we must have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRRA.

The FCA's objectives and regulatory principles: Compatibility statement

7. The proposals set out in this Consultation Paper (CP) are primarily intended to advance our operational objective of securing an appropriate level of protection for

consumers.⁹⁶ Based on our review of the regulatory protections available to small and medium sized enterprises (SMEs), we believe that there is a gap in SMEs' access to redress. Some SMEs are not small enough to be eligible complainants and so able to refer complaints to the Financial Ombudsman Service ('the Ombudsman'), but do not have the resources and bargaining power that would allow them to protect their interests by negotiating contract terms and by taking firms to court. Additionally, individual guarantors of business loans are not generally eligible complainants. We believe that some types of businesses that have had a wider range of options in seeking redress have also seen a greater improvement in firm conduct in recent years. Our proposals provide more enterprises, charities and trusts, and personal guarantors of business loans with an additional option for seeking redress, with the protection of our complaints handling rules. This will result in more redress being paid to newly eligible SMEs, charities and trusts and guarantors. Our proposals might also improve firms' incentives to resolve these complaints quickly and informally or to avoid them by improving product design and customer service.

8. In considering what degree of protections for consumers may be appropriate, we have also had regard to the 8 matters listed in section 1C of FSMA.
9. We believe that these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well. As a result of market failure, firms don't have adequate incentives to improve newly eligible complainants' access to redress without our proposals. As discussed in our cost benefit analysis, firms have commercial disincentives to advertise that they are willing to pay redress. They also have incentives to make sure that details of disputes resulting from poor product design and governance or poor sales practice are not made public. Our proposals improve firms' incentives to resolve complaints and pay redress by applying complaints handling rules to newly-eligible complaints and giving newly-eligible SMEs and personal guarantors access to the Ombudsman. For the purposes of the FCA's strategic objective, 'relevant markets' are defined by s. 1F FSMA.
10. In preparing the proposals set out in this CP, we have had regard to the regulatory principles set out in section 3B of FSMA. In particular:

The need to use our resources in the most efficient and economic way

11. Our proposals should improve incentives for firms to improve complaints handling, customer service and product design. Without such incentives the alternative would be more intensive supervision which, given the relatively small number of consumers affected, would be less efficient. Where products within the ombudsman's jurisdiction (such as loans to corporations) are unregulated, our powers to pursue the same outcomes through supervisory action are more limited.
12. Our proposals provide a less costly and formal alternative to the creation of one-off redress schemes for SMEs, including voluntary schemes whose operation we might have a role in overseeing.

⁹⁶ The definition of a consumer in the Financial Services and Markets Act 2000 (FSMA) for the purposes of our consumer protection objective, as discussed in DP15/7, in practice includes almost all SMEs that use regulated financial services.



The principle that a burden or restriction should be proportionate to the benefits

13. We believe that the proposals in this CP impose burdens or restrictions that are proportionate to the benefits. Their impact on firms is primarily driven by the transfers from the firms to SMEs and personal guarantors whose complaints have been upheld. These costs are, therefore, equal to the resulting benefits. There will be further costs from fees paid to the Ombudsman and administrative costs to firms of handling newly-eligible complaints according to our rules. These costs are in direct proportion to the number of newly-eligible complaints. Both firms and SMEs will see benefits as a result of changes in firms' conduct. This will reduce the number of complaints – and therefore the cost to firms of handling these complaints and the impact on SMEs from the acts or omissions that cause these complaints.

The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term

14. Larger SMEs are a significant driver of economic output and employment. Our proposals will help improve outcomes for this sector. They should therefore support the sector's growth without compromising its access to financial services. We discuss our rationale further in paragraphs 28 and 32 of this Statement.

The general principle that consumers should take responsibility for their decisions

15. We have considered in detail what organisational resources newly-eligible complainants are likely to have to ensure that our approach is proportionate to their sophistication as users of financial services. The Ombudsman is able to take the relative sophistication of complainants into account when it considers their complaints.
16. The Ombudsman takes a broadly similar approach to the courts where a firm is reckless, careless or fails to mitigate loss by the consumer. Because newly-eligible SMEs and personal guarantors that behave in this way are less likely to benefit from our proposals, we believe that our proposals provide incentives for newly-eligible complainants to take responsibility for their decisions. Our proposals for personal guarantors will not affect the liability the guarantor takes on, unless the Ombudsman decides in the particular case that it was not fair or reasonable for the firm to obtain or enforce against the particular guarantee or security in the first place.

The responsibilities of senior management

17. We do not believe that our proposals alter the responsibilities of senior management.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

18. We do not believe that our proposals discriminate against any particular business model or approach. In developing our proposals we have modelled the outcomes in the specific sectors (such as general insurance) where firms are likely to see a greater impact from our proposals and consulted with practitioners in those sectors. The prospect of an inconsistent impact across sectors has been a factor in our proposing a relatively tight balance sheet threshold for eligible complainants and in

our decision to propose no change to the ombudsman's award limit. Where a greater impact is nevertheless felt, this will be driven by either a) larger ombudsman awards, which are equal to the benefits to complainants and proportionate to the impact of firms' actions or omissions or b) the Ombudsman upholding a higher proportion of complaints, suggesting a greater need for firms to improve their conduct.

The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information

19. We have the power to publish information about our investigations into firms and individuals. However, as set out in section 8 of the Enforcement Guide, we will only make our investigations, findings or conclusions public in exceptional circumstances. Our proposals will result in firms reporting to us increased volumes of complaints in aggregate, which we may publish. However they will not mean we make additional information about individual complaints or complainants public.

The principle that we should exercise of our functions as transparently as possible

20. We believe that by consulting on our proposals we are acting in accordance with this principle. We have developed the proposals in this CP following feedback to DP15/7, which explicitly discussed the potential for changes to the jurisdiction of the Ombudsman. When modelling the SME population we have, where possible, used publicly available datasets which allow stakeholders to replicate our analysis.
21. In making these proposals, we have had regard to the importance of taking action meant to minimise the extent that a business carried on (i) by an authorised person or a recognised investment exchange or (ii) in contravention of the general prohibition, can be used for a purpose connected with financial crime (as required by s. 1B(5)(b) FSMA). The market failures identified in this CP that we want to address do not make it more likely that a firm or its products might facilitate financial crime. We also do not believe that our proposals will make this more likely.

Expected effect on mutual societies

22. We do not expect the proposals in this paper to have a significantly different impact on mutual societies. The relevant rules we propose to amend will apply equally, according to the powers exercised and to who they are addressed, regardless of whether the business is a mutual society or another authorised body.

Compatibility with the duty to promote effective competition in the interests of consumers

23. In preparing the proposals in this consultation, we have had regard to the FCA's duty to promote effective competition in the interests of consumers. We believe that, as a result of market failure, even firms in highly competitive segments of the market do not have adequate incentives to improve newly-eligible complainants' access to redress without our proposals. Firms have commercial disincentives to advertise they are willing to pay redress. They also have incentives to make sure that details of disputes



resulting from poor product design and governance or poor sales practice are not made public.

24. We believe that our proposals will help ensure that complaints referred by newly-eligible SMEs, charities and trusts and personal guarantors will receive the same minimum standard of complaints handling. This will promote effective competition in the interest of consumers by giving newly-eligible complainants greater confidence to deal with recently-founded, small or unfamiliar firms.

Equality and diversity

25. We are required under the Equality Act 2010 to 'have due regard' to the need to eliminate discrimination and to promote equality of opportunity in carrying out our policies, services and functions. As part of this, we conduct an equality impact assessment to ensure that the equality and diversity implications of any new policy proposals are considered.
26. The outcome of this assessment in this case is stated in paragraphs 2.24 to 2.25 in this CP.

Legislative and Regulatory Reform Act 2006 (LRR)

27. We have had regard to the principles in the LRR and the Regulator's Compliance Code for the parts of the proposals that consist of general policies, principles or guidance. Our proposals have been developed following feedback to our Discussion Paper, 'Our approach to Small and Medium sized Enterprises (SMEs) as users of financial services'. We are now seeking feedback from this consultation on whether stakeholders agree with our proposed approach. We believe that our proposals are proportionate and will result in an appropriate degree of consumer protection with a sufficient balance between the interests of SMEs as users of financial services and those of firms. Our proposals will apply to all SMEs that meet our proposed threshold when they receive relevant financial services from firms. We consider that there is a strong case for acting to extend the definition of 'eligible complainant' to SMEs that meet that threshold, and also to extend the same protection to personal guarantors of business loans where the borrower meets that threshold.

Treasury recommendations about economic policy

28. Section 1JA of the Act allows the Treasury to make recommendations to the FCA about aspects of the Government's economic policy to which the FCA should have regard. In preparing the proposals set out in this CP, we have had regard to the Treasury's recommendations of 8 March 2017.

Competition

29. We have considered the impact of our proposals on competition across the financial services industry and in retail banking in particular. We believe that there are unlikely to be adverse impacts on competition as a result of our proposals and consider that there

may be some benefits to competition. We set out our rationale in paragraphs 23 and 24 of this Statement.

Growth

30. We estimate that newly-eligible SMEs account for about 16% of the UK's economic output. We consider that our proposals will achieve a greater degree of consumer protection for newly-eligible SMEs without restricting their access to financial services. We therefore believe they might result in higher survival and growth rates for these SMEs, which would marginally improve UK economic growth.

Competitiveness

31. Our proposals will apply to firms that deal with complaints from small businesses. Our eligibility criteria are meant to reduce the number of high-value, complex complaints referred to the Ombudsman, so our proposals will not be generally relevant to firms that provide wholesale financial services. We have consulted specifically with the Lloyd's Market Association to consider the impact on wholesale insurance and have seen no evidence of a particular impact on the attractiveness of the London Market.
32. We do not believe that our proposals will affect internationally active financial institutions significantly, or differently, from domestically focused ones, or that they will influence London's position as an international financial centre.

Innovation

33. Our cost benefit analysis considers the likely impact of our proposals on innovation in the supply of financial services to SMEs. Newly-eligible SMEs are likely to be an important market for innovative products in, for example, credit and insurance. So we have considered whether firms might become reluctant to bring new products to the market and whether innovative new entrants will be disproportionately affected. We do not believe that our proposals are likely to affect the market in this way.

Trade

34. We do not believe that our proposals will risk reducing trade and inward investment to the UK. However, we note that newly-eligible SMEs lead the rest of UK industry in the percentage of their income made from exports (around 29%). We also note that UK SMEs' share of total exports is lower than the EU average. Because we consider that our proposals will achieve a greater degree of consumer protection for newly-eligible SMEs without restricting their access to financial services, we believe they might therefore produce higher survival and growth rates within this group. This would marginally increase export volumes and competitiveness across UK business.

Better outcomes for consumers

35. We believe that our proposals will deliver better outcomes for consumers. We outline the reasons for this in paragraphs 7-9 and 22-24 of this statement.



Annex 4: Feedback to Discussion Paper 15/7: Our approach to SMEs as users of financial services

1. We received 44 responses to DP15/7 from bodies representing businesses, independent standards bodies, individual SMEs, industry associations and regulated firms. Here we summarise the feedback we received to DP15/7 and answer to the points respondents made.

Key risks for SMEs and trends in consumer outcomes

Q1. Are there specific products, services or distribution channels that are particularly associated with poor outcomes for SMEs?

2. We received 32 responses to this question, 14 of which mentioned specific products or services.
3. Table 1 summarises the risks highlighted by respondents, many of which are similar to those faced by individual consumers.

Table 1: Sources of risk to SMEs according to respondents to DP15/7

Product features	<ul style="list-style-type: none"> • complex, expensive or inflexible products (eg alternatives to overdraft) • products the firm has an option to withdraw altogether • products with a complex regulatory perimeter (ie where it is difficult to say whether they are regulated by us) • bundled services with diverse regulations • personal products purchased for business purposes • highly innovative, niche or new-to-market products
Distribution channels	<ul style="list-style-type: none"> • sales by those not expert in financial services (eg credit sold by equipment manufacturers) • non-interactive channels where firms restrict users' ability to question or challenge the information they are given (eg direct/online sales of complex insurance products) • sales in which SMEs expect advice, but intermediaries' responsibility is unclear and multiple parties are involved in transactions
Quality and service levels	<ul style="list-style-type: none"> • lack of products catering to the self-employed • firms' poor understanding of self-employed people's income and needs – potentially limiting the supply of products such as personal mortgages • poor complaint handling • poor communication and lack of access to relationship managers
Specifics of firm or market conduct	<ul style="list-style-type: none"> • abrupt changes to terms or cancellation of facilities (eg overdraft) • poorly communicated product features/risks • opaque pricing • inappropriate/undeclared incentives (for those selling products) • insurance or hedging products sold as a condition of supplying a customer

4. Some respondents were concerned that firms and regulators might assume that businesses generally have more knowledge, experience and expertise than they actually do. These respondents questioned whether firms that failed to consider the different capabilities of different businesses were treating customers fairly.

Our response

Understanding emerging risks

5. We are grateful for the detailed feedback we received from respondents. We are using this in our continuing policy-making and supervisory work, particularly to improve our assessment of risks in the retail banking, lending and insurance markets.
6. Many of the responses to DP15/7 discussed unregulated activities, such as lending to corporations. We can't generally apply conduct standards to, supervise or enforce against unregulated activities. However, we will work with firms, owners of self-regulatory codes and the major UK business representative bodies to make sure we are aware of risks to SMEs in both the regulated and unregulated areas. We are considering the application of the Senior Managers & Certification Regime alongside industry codes in CP17/37.

Making risks transparent to firms' business clients

7. Firms must consider the risks that the products they manufacture or sell might pose to their customers. We have published guidance on applying particular Principles for Businesses for providers and sellers of regulated products and services in certain circumstances.⁹⁷
8. Since the beginning of this year new product governance provisions apply to products and services that come under the recast Markets in Financial Instruments Directive (MiFID II). They will also apply to insurance products under the Insurance Distribution Directive (IDD), which will come into force during 2018. These new rules require firms to identify a target market for their products, make sure that their products meet the needs of the appropriate target market and that they are distributed accordingly.
9. We consulted on the product governance and oversight requirements in the IDD in CP17/23⁹⁸ and provided feedback on the consultation in PS17/27.⁹⁹ We also consulted on the product governance requirements in MiFID II in CP16/29 and provided feedback on this consultation in PS17/14.¹⁰⁰

Improving access to financial services

10. We have already considered a number of issues that are relevant to SMEs' access to financial services. This includes clarifying our expectations around firms' 'de-risking' their customer base in response to concerns about financial crime and publishing research on considerations that might restrict small business' access to banking services.^{101 102} We also considered access to mortgages for self-employed people as

97 www.handbook.fca.org.uk/handbook/RPPD/link/?view=chapter

98 www.fca.org.uk/publications/consultation-papers/cp17-23-idd-implementation-ii

99 www.fca.org.uk/publications/policy-statements/ps17-27-insurance-distribution-directive-implementation-feedback-cp17-23-and-near-final-rules

100 <https://www.fca.org.uk/publications/policy-statements/ps17-14-mifid-ii-implementation>

101 <https://www.fca.org.uk/firms/money-laundering/derisking-managing-risk>

102 Artlingstall et al (2016), 'Drivers and Impacts of De-risking' (February 2016): www.fca.org.uk/publication/research/drivers-impacts-of-derisking.pdf



part of our Responsible Lending Review (TR16/4)¹⁰³ and concluded that our rules do not prevent responsible lending to the self-employed.

Applying consumer protections to SMEs

Q2: How and where should we draw the line between SMEs that should benefit from the consumer safeguards in our Handbook and those that should not? Should we aim to treat all SMEs in the same way where possible?

11. We received 38 responses to this question, with most arguing that micro-enterprises are likely to act in similar ways to individual consumers and so should receive similar treatment under our rules.
12. Respondents suggested various criteria we could use to decide which kinds of businesses should be treated more like individual consumers under our rules. These ranged from headcount and balance sheet thresholds, through to the client categorisation rules in our Conduct of Business Sourcebook (COBS). One respondent suggested thresholds based on the value or volume of financial services used. These thresholds could be based on, for example, a maximum account balance, investment portfolio or level of insurance cover.
13. Five respondents argued that sole traders and other individuals whose personal finances are closely linked to those of the business will need to have more consistent access to the same protections that individual consumers have.
14. Almost all respondents agreed that there are at least some circumstances in which a business might need comparable protections to those of individual consumers. However, some argued that businesses should be capable of assessing and negotiating their contract terms and may not want the extra costs that increased regulation can bring.

Our response

15. Overall, we agree with respondents that micro-enterprises often behave like individual consumers when using some financial services. Many micro-enterprises do not separate their finances from those of their owners, and most don't have dedicated finance or legal functions.
16. When we consider new rules and guidance in future we will consider whether there is a case for micro-enterprises to be treated differently to larger businesses, or similarly to individual consumers. However, it would not be appropriate to extend all of the protections that individual consumers currently have to all micro-enterprises. In some cases, the costs of doing this are likely to outweigh the benefits. In others, legislative change would be needed if we are to treat micro-enterprises as individuals.¹⁰⁴

103 TR16/4, 'Embedding the Mortgage Market Review: Responsible Lending Review' (May 2016): www.fca.org.uk/publications/thematic-reviews/tr16-4-embedding-mortgage-market-review-responsible-lending-review

104 This might be the case, for instance, where UK or EU law reserves certain protections for those not acting in the course of business, or does not extend them to bodies corporate.

Achieving more proportionate protection for businesses

Q3: Is the current treatment of SMEs in our rules broadly correct? What do you see as the most important benefits and shortcomings of our current approach?

Q6: Should we make our rules more consistent, to the extent possible, across the products and services used by SMEs?

17. Twenty nine respondents gave a view on our overall approach to SMEs. Views were evenly split on whether protections should be more consistent across the market or remain different depending on the type of customer, product or service.
18. Ten respondents said we should provide a more consistent level of protection for SMEs throughout the Handbook.
19. Some respondents, especially insurers and non-bank lenders, felt that our approach to SMEs should depend more on how businesses access financial services. Firms suggested that those buying products through some intermediaries can have expectations of the advice and guidance they will get that do not match what firms expect to provide to business clients. Others argued that the act of seeking out a specialist intermediary may in itself show a higher level of capability.
20. Respondents from the insurance, banking and credit sectors felt that our approach to SMEs was broadly appropriate. They said that a range of important initiatives, including implementation of remedies recommended by the Competition and Markets Authority (CMA) in the retail banking sector, are underway which should be allowed to take effect before we introduce additional protections for businesses.
21. Respondents acknowledged that changes to the regulatory perimeter require changes in the law. However, some noted our review of the retained provisions of the Consumer Credit Act 1974 (CCA) and said this offered an opportunity to make broader changes to the CCA regime.
22. A small number of respondents suggested that our approach to SMEs relies too much on redress as opposed to FCA supervision. Some were critical of our treatment of interest rate hedging product (IRHP) sales and the relevant voluntary redress scheme.

Our response

23. For regulated products and services, we believe that our conduct of business rules broadly strike the right balance for SMEs – and most respondents to DP15/7 agreed.
24. We will consider changes to our rules where appropriate, in light of our strategic and operational objectives. In some high-profile cases – eg the conduct of RBS' Global Restructuring Group (GRG)¹⁰⁵ – because firms provided unregulated services we couldn't apply detailed conduct rules to them. However, we note that complaints about the conduct of banks' turnaround divisions are already likely to fall within the Financial Ombudsman Service's ('the Ombudsman') jurisdiction. Our proposals in Chapter 3 would mean that more SMEs could refer such complaints to the Ombudsman.
25. We have powers under the Competition Act 1998 and can carry out market studies under the Enterprise Act 2002. These powers apply broadly to 'financial services', including for SMEs.

¹⁰⁵ GRG was the specialist restructuring division of the Royal Bank of Scotland Group, to which distressed businesses that had borrowed from the bank would be transferred. Lending to corporates is generally not regulated.



26. As well as changes from implementing MiFID II and the IDD, other ongoing regulatory initiatives should improve outcomes for consumers, including SMEs:
- The Senior Managers and Certification Regime (SM&CR) will come into force for all authorised persons. The new regime is intended to deliver greater accountability among firms' senior management and raise standards of conduct at all levels.
 - From this year the implementation of the revised Payment Services Directive (PSD2) will improve the rights of micro-enterprises and, subject to their right to opt-out, larger businesses when using payment services.
 - The ring-fencing regime for the UK's largest banks will be established from 2019. The legislation aims to isolate retail banking from investment banking and so reduce the likelihood of disruption to key retail services, including, for example, payments services or overdrafts used by SMEs.
 - We will be undertaking a range of work in response to the CMA's investigation into the retail banking sector, much of which will benefit SMEs.
 - We are conducting a strategic review of retail banking business models. This will evaluate the impact of business model changes on competition and conduct across the full range of personal banking products/services and SME banking.
 - We are required to review the retained provisions of the CCA, and to report to HM Treasury by 1 April 2019. The provisions include disclosure requirements that are relevant to businesses that use regulated credit and protections, such as cancellation rights, which currently only apply to individual consumers. We will publish an interim report in summer 2018.
27. There are also industry-led initiatives to address risks to SMEs. For example, in response to our thematic review into SME claims (TR15/6), the British Insurance Brokers' Association has developed a guide for SMEs to avoid underinsurance.

Access to the Financial Ombudsman Service

Q4: Should we expand the eligibility criteria of the Ombudsman? How and where should the line be drawn?

Q5: Should the Ombudsman's award limit be increased from its current value of £150,000 for some or all SME complainants? Would it be fair for different award limits to apply to eligible complainants depending on whether the complainant is a business or an individual consumer?

28. Thirty-seven respondents responded to these questions. On balance, both industry and consumer responses supported some larger SMEs having access to the Ombudsman. The case for a higher award limit was more strongly opposed by industry respondents and received limited, but not universal, support from other stakeholders.

Our response

29. We consult on expanding eligibility for the Ombudsman to small businesses in Chapter 3, and discuss the award limit in detail in Chapter 4.

Voluntary codes of practice

Q7: Should we encourage the development of voluntary codes of practice in the manner discussed in DP15/7.

- 30.** There were 32 responses to this question. In light of these responses, we believe that the vast majority of SME-firm relationships with a self-regulatory code of practice will come under one of the following:
- the Lending Standards Board's Standards of Lending Practice (formerly the Lending Code)
 - the National Association of Commercial Finance Brokers' (NACFB) Code of Practice
 - the UK Finance Standards Framework for Asset Based Finance
 - the Finance and Leasing Association's Business Finance Code
 - the Institute for Turnaround's Principles for Business Support Banking
- 31.** Seven respondents were sceptical of voluntary codes. They doubted that voluntary standards would be supervised and enforced as strongly as legislation or the FCA's rules. They were concerned that not all firms and industries would voluntarily sign up to the same standards of conduct.
- 32.** However, most respondents thought we ought to encourage the development of voluntary codes.
- Our response**
- 33.** We see a role for self-regulatory initiatives in highlighting good and bad practice, and in helping firms monitor risks to SME clients.
- 34.** Voluntary conduct standards are created by the industry and independent standards bodies; we do not seek to influence their detailed requirements. But we will continue to work with self-regulatory bodies and note that a number are working on improving their standards.
- 35.** The Ombudsman will take into account a number of factors when deciding what is, in its opinion, fair and reasonable in all the circumstances of the case. These factors include relevant codes of practice and, where relevant, what the Ombudsman considers to have been good industry practice at the time. As voluntary codes and standards develop and become more widely adopted, they will help deliver better redress for SMEs. This is particularly relevant to credit-related complaints, which come under the Ombudsman's jurisdiction even if the underlying loans are unregulated.
- 36.** Even where the products or services SMEs use are outside our regulatory perimeter, authorised firms still have obligations under our regime. Firms must meet core requirements as part of the Threshold Conditions and, likely later this year, the new SM&CR.
- 37.** The SM&CR incorporates high-level Conduct Rules that reflect the core standards we expect of all staff. These focus on acting with integrity, skill, care and diligence, and having regard to the interest of customers. These Conduct Rules will apply to both



a firm's regulated and unregulated financial services activities, including any related support activities.

Guidance on our approach and our expectations

Q8: Should we issue guidance to firms on particular aspects of their dealings with SME clients, and, if so, which aspects?

38. We received 30 responses to this question. Most asked for additional guidance in the following areas:
- **Our expectations on product governance:** respondents asked for guidance on the fairness of contractual terms where firms and their clients agree to opt out of certain protections, identifying and communicating risky product features and the design and disclosure of costs.
 - **Specific business products:** respondents asked for product-specific guidance, mostly related to credit products and how to treat businesses in distress. They also asked for clarity over the level of Ombudsman and FSCS cover for specific activities.
 - **Our approach to our objectives and accountability:** including guidance to SMEs on the available protections, a commitment to transparency and accountability, and guidance on how businesses can use products and services most appropriately.
39. However, some industry responses stressed that firms tend to interpret guidance as rules and were concerned that the Ombudsman might use additional guidance as a test in evaluating a complaint.
- Our response**
40. Having considered both this feedback and our current work to improve outcomes for consumers, clarify our approach to SMEs and our expectations of firms, we do not believe it would be proportionate to produce further guidance at this stage.
41. We gave an overview of our approach to SMEs in DP15/7 which many respondents found useful. We will continue to consider the need for specific guidance on firms' dealings with SMEs on a case-by-case basis when we propose to introduce or change our rules or guidance.

Annex 5

List of respondents to DP15/7

AFS Compliance Ltd

Aldermore

Arkle Finance Ltd, Maxxia Ltd and Syscap (responding jointly)

Asset Based Finance Association

Association of British Insurers

Association of Independent Professionals and the Self Employed (IPSE)

Association of Mortgage Intermediaries

Banking Standards Board

Barclays

British Bankers Association (now part of UK Finance)

BFC Exchange Ltd

Bibby Financial Services

Civilised Investments Ltd

Collyer Bristow LLP Solicitors

Dual Corporate Risks

Federation of Small Business

Finance and Leasing Association

Forum Chambers

Financial Services Consumer Panel

Funding Circle

Growth Street

HSBC



Investment & Life Assurance Group

Lending Standards Board

Lloyds Banking Group

Lloyd's Market Association

Managing General Agencies' Association

Mercer

Min Hafan Estates

Money Advice Trust

Mr David J Miller Insurance Brokers Ltd

National Association of Commercial Finance Brokers

Nationwide

Professor Russel Griggs OBE

Professional Standards Council

PwC

Royal Bank of Scotland

Royal Sun Alliance

RPC on behalf of the International Underwriting Association Professional Indemnity Forum (IUA PIF) Committee

Society of Chief Officers of Trading Standards in Scotland (SCOTTSS)

Virgin Money

Annex 6

Abbreviations in this document

ADR	Alternative Dispute Resolution
APPG	All Party Parliamentary Group
ASBFEO	Australian Small Business and Family Enterprise Ombudsman
BSB	Banking Standards Board
BCOBS	Banking: Conduct of Business sourcebook
CBA	cost benefit analysis
CBTL	consumer buy-to-let
CCA	Consumer Credit Act 1979
CMA	Competition and Markets Authority
COBS	Conduct of Business sourcebook
CONC	Consumer Credit sourcebook
CP	Consultation Paper
DISP	Dispute Resolution: Complaints sourcebook
EIA	Equality impact assessment
FSCP	Financial Services Consumer Panel
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
IDD	Insurance Distribution Directive
IRHP	interest rate hedging product
LSB	Legal Services Board
MiFID	Markets in Financial Instruments Directive
NACFB	National Association of Commercial Finance Brokers
Ofgem	Office of Gas and Electricity Markets
PPI	payment protection insurance
PCBS	Parliamentary Commission on Banking Standards
PSD	Payment Services Directive
PSD2	Second Payment Services Directive



SBPP	Smaller Businesses Practitioner Panel
SME	Small or Medium Sized Enterprise
TSC	Treasury Select Committee

We have developed the policy in this Consultation Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

All our publications are available to download from www.fca.org.uk. If you would like to receive this paper in an alternative format, please call 020 7066 9644 or email: publications_graphics@fca.org.uk or write to: Editorial and Digital team, Financial Conduct Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS



Appendix 1

Draft Handbook text

SMALL BUSINESS (ELIGIBLE COMPLAINANT) INSTRUMENT 2018

Powers exercised by the Financial Ombudsman Service

- A. The Financial Ombudsman Service Limited makes and amends the Voluntary Jurisdiction rules and guidance, and fixes and varies the standard terms for Voluntary Jurisdiction participants as set out in the Annexes to this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 227 (Voluntary Jurisdiction);
 - (2) paragraph 8 (Guidance) of Schedule 17;
 - (3) paragraph 18 (Terms of reference to the scheme) of Schedule 17; and
 - (4) paragraph 22 (Consultation) of Schedule 17.
- B. The making and amendment of the Voluntary Jurisdiction rules and guidance and the fixing and varying of the standard terms for Voluntary Jurisdiction participants by the Financial Ombudsman Service Limited is subject to the approval of the Financial Conduct Authority.

Powers exercised by the Financial Conduct Authority

- C. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions of the Act:
- (1) section 137A (The FCA’s general rule-making power);
 - (2) section 137T (General supplementary powers);
 - (3) section 139A (Power of the FCA to give guidance);
 - (4) section 226 (Compulsory jurisdiction); and
 - (5) paragraph 13(4) (FCA’s rules) of Schedule 17.
- D. The rule-making powers listed above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.
- E. The Financial Conduct Authority approves the Voluntary Jurisdiction rules and guidance made and amended and the standard terms for Voluntary Jurisdiction participants fixed and varied by the Financial Ombudsman Service Limited under this instrument.

Commencement

- F. This instrument comes into force on *[date]*.

Amendments to the Handbook

- G. The Glossary of definitions is amended in accordance with Annex A to this instrument.

- H. The Dispute Resolution: Complaints sourcebook (DISP) is amended in accordance with Annex B to this instrument.

Notes

- I. In Annex A to this instrument, the “notes” (indicated by “**Note:**”) are included for the convenience of readers but do not form part of the legislative text.

Citation

- J. This instrument may be cited as the Small Business (Eligible Complainant) Instrument 2018.

By order of the Board of the Financial Ombudsman Service Limited
[*date*]

By order of the Board of the Financial Conduct Authority
[*date*]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text unless otherwise stated.

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

enterprise any *person* engaged in an economic activity, irrespective of legal form, including, in particular:

- (a) self-employed *persons* and family businesses engaged in craft or other activities; and
- (b) *partnerships* or associations regularly engaged in an economic activity.

[Note: article 1 of the Annex to the *Micro-enterprise Recommendation*]

Amend the following definitions as shown.

guarantor (1) ...

(2) (in *DISP*) an individual who:

- (a) is not a *consumer* (as defined in *DISP*); and
- (b) has given a guarantee or security in respect of an obligation or liability of a *person* which was a *micro-enterprise* or *small business* as at the date that the guarantee or security was given.

micro-enterprise an ~~enterprise~~ *enterprise* which:

...

~~In this definition, “enterprise” means any *person* engaged in an economic activity, irrespective of legal form and includes, in particular, self-employed *persons* and family businesses engaged in craft or other activities, and *partnerships* or associations regularly engaged in an economic activity.~~

...

small business (1) (in *COMP* and in the definition of *relevant credit union client*) a *partnership*, *body corporate*, unincorporated association or mutual association with an annual turnover of less than £1 million (or its

equivalent in any other currency at the relevant time).

- (2) (in *DISP*) an *enterprise* which:
- (a) employs fewer than 50 *persons*;
 - (b) has an annual turnover of less than £6.5 million (or its equivalent in any other currency);
 - (c) has a balance sheet total of less than £5 million (or its equivalent in any other currency); and
 - (d) is not a *micro-enterprise*.

Annex B

Amendments to the Dispute Resolution: Complaints sourcebook (DISP)

In this Annex, underlining indicates new text and striking through indicates deleted text.

2 Jurisdiction of the Financial Ombudsman Service

...

2.7 Is the complainant eligible?

...

Eligible complainants

2.7.3 R An *eligible complainant* must be a *person* that is:

(1) a *consumer*; or

(2) a *micro-enterprise*;

...

(b) otherwise, at the time the complainant refers the *complaint* to the *respondent*; or

(3) a charity which has an annual income of less than ~~£1~~ £6.5 million at the time the complainant refers the *complaint* to the *respondent*; or

(4) a trustee of a trust which has a net asset value of less than ~~£1~~ £5 million at the time the complainant refers the *complaint* to the *respondent*; or

(5) (in relation to *CBTL business*) a *CBTL consumer*; or

(6) a *small business* at the time the complainant refers the *complaint* to the *respondent*; or

(7) a *guarantor*.

2.7.4 G In determining whether an ~~enterprise~~ enterprise meets the tests for being a *micro-enterprise* or a *small business*, account should be taken of the ~~enterprise's~~ enterprise's '*partner enterprises*' or '*linked enterprises*' (as those terms are defined in the *Micro-enterprise Recommendation*). For example, where a parent company holds a majority shareholding in a *complainant*, if the parent company does not meet the tests for being a *micro-enterprise* or a *small business* then neither will the *complainant*.

[~~Note: Articles~~ articles 1 and 3 to 7 of the Annex to the *Micro-enterprise*

Recommendation]-

...

2.7.5A **R** A guarantor shall be an eligible complainant only to the extent that their complaint arises from matters relevant to the relationship with the respondent referred to in DISP 2.7.6(10)R.

...

TP 1 Transitional provisions

1.1 Transitional provisions table

(1)	(2) Material provision to which transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
...					
<u>44</u>	<u>DISP 2.7.3R(6)</u>	<u>R</u>	<u>DISP 2.7.3R(6) applies only in relation to a complaint concerning an act or omission which occurs on or after 1 December 2018.</u>	<u>From 1 December 2018</u>	<u>From 1 December 2018</u>
<u>45</u>	<u>DISP 2.7.3R(7)</u>	<u>R</u>	<u>DISP 2.7.3R(7) applies only in relation to a complaint concerning a guarantee or security given on or after 1 December 2018.</u>	<u>From 1 December 2018</u>	<u>From 1 December 2018</u>

...

