

Firms' Cooperation with Third-Party Complaint handling:

The Case of the UK Financial Ombudsman Service

Sharon Gilad, the Department of Management, King's College London

sharon.gilad@kcl.ac.uk; s.gilad@lse.ac.uk

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ABSTRACT

The article analyzes the role of third-party complaint handling in the regulation of private firms. It predicts a cooperative relationship between third-party complaint handling agencies and firms inasmuch as the former assume a narrow role of settling complaints individually and confidentially with no implication for firms' other complaints and transactions. In contrast with this expectation, the case study of the UK Financial Ombudsman Service's (FOS) interaction with retail financial firms manifests an adversarial relationship. I suggest that financial firms' conflict with the FOS resulted from the latter's inability to limit the utilization of its individual decisions by other actors in the regulatory regime. Firms faced the risk that their agreement to redress an individual complainant will be used by the regulator (the Financial Services Authority), and even more so by the media, in order to compel them to compensate all other consumers in similar circumstances. Consequently, firms were in a paradoxical position wherein they had to choose between applying individual Ombudsman decisions to all similar complaints (beyond their legal obligation) and fighting each and every case. To this extent, while the FOS declared and perceived its role in terms of individual and confidential dispute resolution, its decisions had significant unintended regulatory impact. The analysis is based upon a one year non-participant observation at the FOS, including systematic sampling of complaint files and interviews.

I am indebted to the executive management team of the Financial Ombudsman Service and to several anonymous interviewees for their time and their invaluable insights into the organization's work, and for the generous access which I was granted to data. The interpretation is solely mine. I am thankful to Christopher Hood for his helpful comments on a chapter that formed the basis for this article.

Introduction

This article employs a case study of firms' adversarial interaction with a public agency that handles consumer complaints to challenge predictions based on rational-choice cooperation theory. It argues that a two-actor cooperation model fails to explain complaint handlers' adversarial relationship with firms as manifested in the examined case. This interaction is better analyzed as a multi-actor game, which further involves other regulatory bodies, the media and politicians. The paper contributes to the study of a neglected, yet prevalent, phenomenon: third-party complaint handling organizations in regulatory regimes. The research findings bear upon regulatory theory, beyond the specific context of third-party complaint handling.

Applications of rational-choice cooperation theory to the field of regulation predict the emergence of cooperation between regulators and regulated firms in iterated games. Axelrod (1984) proved, on the basis of computer simulation, that in a Prisoner's Dilemma game cooperation is likely to emerge in iterated interactions if players adopt a *tit-for-tat* strategy. That is, if they cooperate as long as the other player cooperates, defect if the other player defects, and resume cooperation once the other player does. He further established that once cooperation emerges it is likely to be stable. Scholz (1984; 1991; 1997) applied Axelrod's analysis to the propensity of firms' cooperation with regulatory obligations. He claimed that if regulators adopt a strategy according to which they punish firms for substantial non-compliance, while shying away from sanctions in cases of technical rule breaking, firms are likely to engage in substantive compliance beyond technical requirements. Ayres and Braithwaite (1992) argued that a *tit-for-tat* approach is likely to enhance cooperation in regulatory fields even if regulators and firms are not strictly rational and self-interested. However, these models have difficulty to explain domains wherein regulators and regulatees interaction is continually adversarial as manifested in a number of empirical studies (e.g. Bardach and Kagan, 2002; Lofstedt and Vogel, 2001). One way to explain such phenomena, within the boundaries of rational-choice theory, is to take account of environmental impediments to regulators and regulatees' strategic cooperation. The other is that adversarial relationship may be rooted in regulators and regulatees' 'irrational' behavior. For example, Nielsen's (2006) analysis questions the universality of regulatory agencies' propensity to employ a *tit-for-tat* approach to regulation.

This article examines both of the above explanations in a new context: third-party handling of consumer complaints. Setting out from cooperation theory, I hypothesize that, in order to attain firms' support and to lower the costs of complaint handling, rational complaint handlers would focus on individual and confidential conciliation of complaints, rather than upon utilization of complaints as a means for detection, exposure and rectification of systemic problems. I further hypothesize that complaint handlers' access to reputation-sensitive information about consumers' dissatisfaction with firms' selling and complaint handling practices should render firms amenable to informal settlement of complaints. Hence, application of cooperation theory to the context of third-party complaint handling suggests that in iterated games firms and complaint handlers will cooperate in low-cost conciliation of individual disputes outside the public sphere.

In contrast, empirical investigation of the UK financial Ombudsman Service (FOS) – a public body that handled consumer complaints against retail financial firms – challenges the expectations of rational cooperation theory. The data, which is presented in this article, depicts the FOS's adversarial interaction with some large financial firms. As a result, complaint handlers often had to engage in time-consuming investigation and formal decision making with regard to analogous complaints, rather than swift informal conciliation of disputes.

I argue that understanding firms' adversarial relationship with the FOS entails situating their interaction in the context of a multi-actor game. This included the media, politicians and the Financial Services Authority (FSA) (The latter being an independent regulatory agency that regulated the UK financial sector). While the FOS expressed a preference for individual and confidential conciliation of disputes, as predicted by cooperation theory, it had limited control over other actors' usage of its decisions. Firms were especially resistant to informal conciliation when a complaint was part of a larger set of cases because of their concern that agreement to redress individual complainants would be interpreted by the FSA as admitting a systemic problem, which could thereby result in large-scale compensation. Additionally, firms faced the risk that individual FOS decisions would be picked up and 'enforced' upon them by the media as *de facto* precedents. The FOS was constrained in its response to

firms' uncooperative behavior due to the financial industry's capacity to call for political intervention that could have put the organization's powers at risk.

In addition, I show that complaint handlers were not fully 'rational' in their pursuit of firms' cooperation, and that a 'logic of appropriateness' (March and Olsen, 1989) is called upon to understand some of the FOS's adversarial relationship with firms.

Section A of the article develops a game-theory model of complaint handlers' likely interaction with firms in a regulatory context. Section B elaborates the research methodology. Section C analyzes the FOS's adversarial relationship with financial firms in two representative case studies of the Ombudsman's handling of complaints of a systemic nature. Sections D and E build on these case studies and upon additional data to explain the FOS's adversarial interaction with retail investment firms.

A. Application of cooperation theory to third-party complaint handling

Below I develop a game-theory model of rational interaction between complaint handlers and firms in a regulatory context. I propose that in search of firms' support and cooperation, complaint handlers will be inclined to focus upon case-by-case resolution of disputes, rather than delineation of general principles, so as to lower the stakes of their decisions for firms. Moreover, they will abstain from supplying regulators and/or the public with information about possible systemic failures in firms' practices with regard to cooperative firms. In order to make sense of complaint handlers' alternative strategies, I begin with an analytical demarcation of four ideal-type third party complaint handling institutions. The aim of the typology is to portray the variety of interaction patterns that complaint handlers *could* adopt in their interaction with firms.

Third-party complaint handling in regulatory regimes

This sub section delineates a typology of third-party complaint handling institutions in regulatory regimes. The proposed ideal-types vary along two dimensions. One is the intended scope of complaint handling; i.e. whether complaint handlers expect firms to apply their decisions only to the individual complaints that reach the agency or to all similar transactions that the firm conducted. The second dimension regards the complaint handling agency's inclination to share information from complaints with

other actors in the regulatory regime. Presumably these dimensions shape the extent to which complaints serve as a regulatory tool for detecting and responding to systemic problems in firms' selling and/or complaint handling practices.

The typology draws upon Mashaw's (1983) administrative justice models,¹ upon the scholarship that analyses the variety of ombudsman organizations (e.g. Harlow and Rawlings, 1997; Hill, 1974, 1976, 2002; James, 1997; Seneviratne, 2002) and my own research experience. Mashaw distinguishes between *bureaucratic*, *professional* and *moralistic* models of administration. To this I add a fourth *conciliatory* model, which builds upon my inductive research experience. (The models and their scholarly embedding are elaborated in another article, which is currently under review.)

Bureaucratic: In this ideal-type, the complaint handling body closely collaborates with the regulator. The handling of complaints involves strict application of general regulations to individual cases. Regulators encourage consumer complaints as a source of intelligence regarding firms' adherence to standards. Complaint handlers assemble and regularly report information from complaints to the regulator.

Professional: The assumption of this model is that the complaint handling body and the industry share common professional knowledge and client-serving values. Complaint handlers' decisions are a source of learning for the industry and a guide to its future practices and handling of similar cases. Learning from complaints is conducted in a confidential manner within the professional community, and complaint handlers normally avoid furnishing information to either the regulator or the media.

Fairness: The aim of the complaint handling process in this model is to publicly attribute blame in particular instances. Complaint handlers' decisions are guided by their *ad hoc* moral judgment of firms' actions and of complainants' deservingness for redress. Complaint handlers do not expect firms to apply their decisions to other complaints and transactions, since each case is perceived as inherently distinct.

¹ Mashaw's typology was developed in the context of administrative adjudication of claims. This context makes it germane to regulatory complaint handling.

Conciliatory: The goal of the complaint handling process in the conciliatory model is to resolve those complaints that reach the agency swiftly and informally to the satisfaction of the individual complainant. Decisions are confidential and firms are not expected to apply them to similar complaints and transactions.

The above models may be summarized by reference to complaint handlers' perception of the scope of their decisions ('scope'), and their inclination to share information from complaints with the regulator and/or the media ('exposure').

		Scope	
		<i>Universal</i>	<i>Individual</i>
Exposure	<i>Public</i>	Bureaucratic	Fairness
	<i>Confidential</i>	Professional	Conciliatory

Which of the above models are *rational* complaint handlers likely to pursue? How are firms expected to respond to complaint handlers' decisions? To this I turn now.

The expected cooperation equilibrium

Complaint handling, like any caseload-processing domain, is a labor-intensive task. Attaining firms' cooperation with swift, informal, conciliation of disputes is a rational complaint handling strategy since it minimizes complaint handlers' individual workload.² I predict that complaint handlers are likely to enlist such cooperation from firms by strategically adhering to a conciliatory approach inasmuch as firms cooperate with them, while switching to a bureaucratic line in their interaction with uncooperative firms.³ By cooperation I mean firms' amenability to quick, informal, conciliation and redress in the management of those complaints that reach the complaint handling agency.

A conciliatory approach (i.e. a confidential, case-by-case, resolution of disputes) is likely to appeal to firms since it both restricts redress to individual cases, even when these are indicative of systemic problems, and protects their reputation. Rational firms

² Lipsky, 1980, stresses the salience of caseload and workload mitigation as the logic of street-level bureaucrats' management of case-processing tasks

³ This argument is comparable to the familiar distinction between a 'deterrence' and 'compliance' models of inspectors' interaction with firms (e.g. Hawkins, 1984; Hutter, 1997). I am using a different terminology since the context of third-party complaint handling is nevertheless distinct.

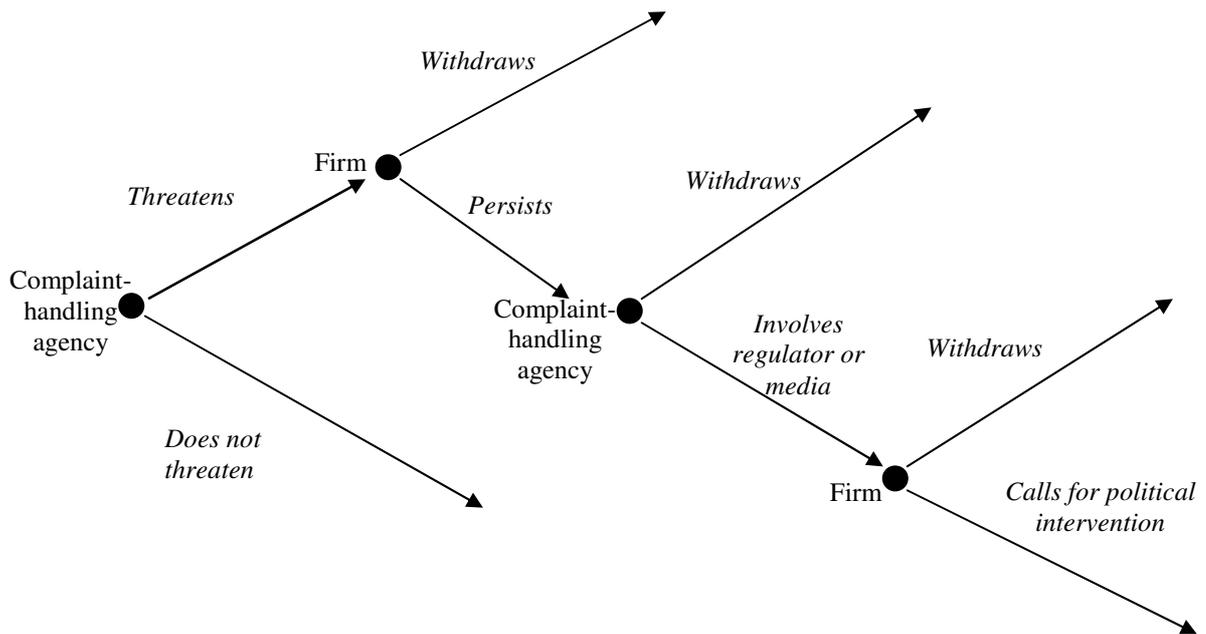
are thereby likely to accept informal conciliation and even to voluntarily apply complaint handlers' adverse decisions to similar complaints that reach the complaint handling body, while not to other similar complaints and transactions.

Complaint handling bodies, and ombudsmen in particular, are typically devoid of formal sanction powers. However, complaint handlers have access to abundant information indicating firms' failure to satisfy their customers, which is likely to be valued by regulators, by the media and the public at large. Cooperation theory would suggest that *rational* complaint handlers are *unlikely* to disclose information from complaints with regard to *cooperative* firms to the regulator, to the media or to the public. Providing such information would divest them of their power to target the disclosure of damning information in order to discipline *uncooperative* firms. Rather, cooperation theory predicts that complaint handlers are likely to focus upon confidential conciliation of disputes and to resist universal provision of information from complaints to the regulator or the media. Under these conditions, complaint handlers' *ad hoc* power to pass information to the regulator with regard to uncooperative firms, or to name and shame these firms in the public domain, turns into a threat and penalty. Complaint handlers' access to such information is potentially a powerful disciplinary tool against uncooperative firms given the value that most firms attach to their reputation.

Yet, it should be emphasized that it is not only the complaint handling agency that can appeal for the intervention of a third party (i.e. the regulator and the media). Firms can avoid cooperating with informal conciliation by calling for external support, for example by protesting to the agency's political principals. However, if the predictions of cooperation theory are correct, firms would use this sanction only when complaint handlers defect while firms cooperate.

Figure 1 depicts firms' predicted interaction with the complaint handling body, wherein the latter can punish uncooperative firms by appealing for the intervention of the regulator and/or the media. It further portrays firms' ability to expand the conflict by appealing for the intervention of a third party (e.g. politicians).

Figure 1: Firms' interaction with complaint handlers



The above discussion therefore predicts that by limiting their role to individual and confidential conciliation of disputes, and targeting specific firms' uncooperative behavior, complaint handlers are likely to attain firms' cooperation. The empirical analysis below seeks to explain the failure of these predictions.

B. Methodology

Research design

The case of the FOS merits attention because it challenges the theoretical expectations of the above analysis, which predicts a cooperative relationship between third-party complaint handling institutions and firms in iterated games. The data, upon which the article is grounded, was gathered during a non-participant observation research at the FOS, conducted between November 2003 and December 2004, including: (a) random sample of complaint files regarding the selling of retail investment products, sampled from all cases handled by twelve FOS adjudicators in two teams over a period of over three years. This offered a rare insight into complaint handlers' interaction with firms and consumers, beyond the usual focus of previous studies upon a biased sample of highly-celebrated cases, (b) interviews (including thirty-four FOS officials, four FSA officials, one Treasury official, one representative of the Association of British

Insurers, and interviews with a number of former financial ombudsmen) and (c) observation of internal talks and training sessions. In line with conventional ethics requirements the identity of interviewees is anonymized.

Background

The FOS was created by statute in 2000, merging five previous separate self-regulatory financial ombudsmen schemes. The article focuses upon the FOS's handling of complaints regarding the selling of packaged investment products by the financial institutions that designed them (mainly life assurance firms and investment trusts) and/or by their distributors (banks, building societies and Independent Financial Advisers). The FOS's board was nominated by the FSA, which regulated the financial industry. The FOS was financed by the financial industry through levies and case fees, the level of which was yearly authorized by the FSA. The Financial Services and Markets Act (2000) empowered the FOS's ombudsmen to determine complaints "by reference to what is, in the opinion of the ombudsman, fair and reasonable in all the circumstances of the case" (sec. 228). The majority of the FOS's complaint handlers were recruited from within the retail financial industry. When handling complaints regarding the sell of retail investments, complaint handlers relied upon their professional interpretation of what constituted suitable investment advice. This entailed analyzing the match of investment products to complainants' 'attitude to risk', financial needs and financial capacity.⁴ The FOS's interpretation of its mandate, which I have analyzed elsewhere (Gilad, 2006), was that firms were not legally required to apply its decisions to other complaints and transactions.

A complaint against a financial firm was first submitted by the complainant to the firm for its consideration. A complainant, who was dissatisfied with the firm's decision, could request its review by the FOS. The FOS operated a two-tier complaint handling process. All complaints were initially handled by low-level complaint handlers ("adjudicators"), who had no formal legal authority. Firms and consumers were entitled to challenge adjudicators' informal conciliation proposals by requesting their review by one of few "ombudsmen". Ombudsmen had the formal authority to require firms to compensate complainants. Finally, both firms and complainants could

⁴ For analysis of the retail investment sector and its regulation, including the requirements of 'advice suitability', see Black (1997) and Clarke (1999).

appeal for a judicial review of an ombudsman's decision. It is noteworthy that judicial reviews were issued against ombudsmen individually, rather than against the FOS.

Firms and consumers' request for an ombudsman's review of an adjudicator's informal decision involved further investigation and doubled the time it took to settle the case. Consequently, resistance to accept an informal conciliation and requests for reviews burdened the FOS's resources and required complaint handlers to engage in time-consuming investigation and formal decision making. Thus, complaint handlers had an interest that firms and consumers accept informal conciliation and forgo their right for an ombudsman's decision. This was especially the case given the FOS's rapidly escalating caseload during the research period.

Between 1999 and 2004 the yearly number of complaints reaching the FOS escalated from 25,000 to 100,000. Most of these complaints were part of either industry-wide or firm-specific systemic problems, rather than one-off complaints. While the FOS underwent a rapid increase in staffing, from 390 employees in March 2000 to over 900 by the end of 2005, this did not fully match the increase in its caseload. Yet, it should be emphasized that the number of complaints that filtered through to the FOS were less than 1% of retail financial sales and about 10% of the complaints to firms.

The increase in the number of complaints, as mentioned above, may be attributed to two factors. One was consumers' loss on investments as a result of the collapse of financial markets, which started on September 11 2001 and persisted throughout 2002-3. The other was vigorous media coverage of retail investment scandals and of the FOS's decisions when these were in favor of complainants.

C. Adversarial relationship between firms and the FOS

Below I describe the FOS's adversarial interaction with firms in two case studies of the Ombudsman's handling of complaints of a systemic nature. The case studies were representative of the FOS's interaction with firms when handling complaints of this kind. They portray the FOS's inclination to standardize its handling of wide-scale complaints, rather than resolve complaints on a case-by-case basis. They manifest firms' inclination to insist upon ombudsmen's review of adjudicators' decisions in analogous complaints. The case studies further depict the FOS's inclination to

discipline firms' uncooperative behavior by reporting systemic problems to the FSA, but *not* to the media. Contrary to the expectations of the game-theory model, the FOS's inclination to report uncooperative firms to the FSA did not render firms cooperative. Finally, the case studies reveal the risk of political intervention that the FOS faced as a result of its adversarial relationship with firms.

*Risk rating of firms' funds*⁵

In 2002 the FOS identified a wide-scale selling of certain single-premium bonds, which firms marketed as low-risk investments. According to normal practices, as understood by the FOS, these products should have been marketed as high-risk investments to consumers with a corresponding high-risk profile. Few ombudsmen centrally analyzed the products' investment structure and guided adjudicators as to what they perceived to be the correct risk rating. The result was consistent upholding of these complaints on the grounds that the products' risk was incorrectly evaluated by the firms. In response, firms, persistently requested ombudsmen's review of adjudicators' decisions and protested to the FOS's senior executives. Interviewees explained that firms were disinclined to accept informal conciliation because they were concerned that, in the event of an FSA inspection, their agreement, in an individual case, that their risk rating was flawed might result in the FSA requiring them to apply the decision to a larger set of similar complaints, or even to all their past sales. An ombudsman put it like this:

“If we say [to the firm that the risk of] this fund is not this risk [as claimed by the firm], then they [the firm] come across a problem that we're saying that to them, issuing hundreds of decisions to them, and the FSA [might] walk in the next day and say, ‘So, is this fund not this risk?’ And then they've got a hundred thousand other cases, which they might have to proactively review, which costs them a fantastic amount of money.”

The same point was made by another ombudsman in an internal talk to complaint handlers:

⁵ The discussion is based on analysis of seventeen complaint files from within my case complaints' sample and interviews with eight participants.

Most firms accept our [risk] rating scale. But ...some ...do not...they have sold thousands of products to low-risk consumers. If they agree with us, the FSA may come round and say, 'You agreed with the ombudsman on this case, so why don't you compensate all those who bought it.' And they'll say 'Right' and go bust (paraphrase, field notes).

In practice, however, when the FOS reported a few of the resisting firms to the FSA, seeking its intervention, the latter was disinclined to intervene. Following negotiations between firms and the FOS, the latter agreed that in future complaint handlers would restrict themselves to judging whether the marketing of products was suitable to the needs of individual complainants, rather than assess their absolute risk. Thus, the wording of future decisions was adjusted: instead of assertions regarding the risk rating of firms' funds, adjudicators were guided to focus their analysis upon firms' assessment of the complainants' individual risk profiles and financial needs. This approach was eventually successful in enlisting at least some firms' cooperation. Analysis of complaint files shows how one firm adopted a strategy according to which it rejected complaints that reached it, but voluntarily offered compensation to those complainants who referred their case to the FOS. Another firm still tended to request ombudsmen's review in these cases.

The FOS's adversarial relationship with firms in the above case seems to have been a result of two factors: (a) the FOS's formulation of general principles to guide its assessment of complaints, in lieu of case-by-case dispute resolution, and (b) firms' concern that their agreement to redress in an individual case, if transpired in the course of an FSA supervision, would result in the regulator requiring them to apply the decision to all similar cases. Cooperation was partially gained once the FOS particularized its decisions, and after the FSA's manifested disinterest to intervene.

*Dual Variable Rate Mortgages*⁶

The above case study suggests that the risk of regulatory intervention was one cause for firms' disinclination to accept informal conciliation of disputes. However, as

⁶ The description of this case is based on public FOS press releases and newsletters, media analysis (LexisNexis) and interviews.

revealed from the analysis below, firms' adversarial relationship with the FOS was not restricted to those areas that were regulated by the FSA.

In mid-2001 the FOS received some six hundred complaints alleging unfair and unequal treatment by a few major banks and building societies – Halifax, Nationwide, HSBC, Abbey National and Cheltenham & Gloucester – which offered low mortgage rates to new customers while tying some of their existing clients to higher rates. At the relevant time the selling of mortgages was not regulated by the FSA.

As the FOS was in the process of assessing the relevant cases these were already widely covered by the press. In September 2001 the FOS made an initial decision in favor of the complainants in two cases. It subsequently announced that it would handle subsequent complaints by employing Lead Cases with regard to each firm, operating as *de facto* precedents, while allowing firms and individual complainants to argue that their case differed from the Lead Case. The media closely covered both the FOS's decisions and firms' 'compliance' with them. Consequently, the number of similar complaints to the ombudsman rapidly escalated (from 570 in 2001 to 6500 in 2002).

Nationwide building society made a first move to restore its reputation and announced its intention to apply the FOS's decision to all its customers who were in a similar position, resulting in some ninety million pounds of compensation. Consequently, pressure was put by the media on its competitors to follow, which they did reluctantly in varying speeds and degrees, incurring both high redress and reputation damage.

While the FOS's decisions in favor of complainants were rewarded with strong consumer and media support, the financial burden of its decisions created a backlash. The Building Societies Association, together with some other industry bodies, pleaded to the Treasury to limit the FOS's powers by introducing a judicial appeal mechanism over its decisions and for the FSA to take over the handling of complaints of a systemic nature. In response to firms' criticism, the Treasury initiated a review to assess the need for change in the regulatory framework. This was followed by a consultation with firms issued by the FOS and the FSA. The consultation resulted in a compromise that required relatively minor changes to the FOS's processes.

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The FOS's adversarial relationship with firms in this case can be similarly attributed to two factors: (a) the FOS's formulation of general Lead Cases, rather than case-by-case dispute resolution and (b) the media's pressure on firms to apply the FOS's decisions across the board to all similar cases.

Consequently, the above case studies indicate two possible explanations for the FOS's adversarial relationship with firms. One roots the failure of cooperation in the apparent 'irrationality' of the FOS. This suggests that in contrast with the expectations of the game-theory model, as delineated in section A above, complaint handlers tended to adopt a *bureaucratic* approach to the handling of wide-scale complaints, rather than a *conciliatory* approach. Bureaucratization (or standardization) increased the stakes of complaint handlers' decisions for firms and apparently resulted in adversarial relationship. A second explanation proposes that the FOS's adversarial interaction with firms was rooted in the context within which this interaction took place. According to this second explanation, while complaint handlers were strategic in their interaction with firms, they were unable to offer cooperative firms an environment of individual and confidential resolution of disputes. In sections D and E below I rely upon the above case studies and additional data to further analyze both hypotheses.

D. The 'irrational' intra-organizational dynamics hypothesis

The above case studies indicate that a possible explanation for the FOS's adversarial relationship with firms was complaint handlers' *bureaucratic* approach to the handling of complaints of a systemic nature. In the above cases, as well as with regard to the FOS's handling of other high-profile cases (e.g. Split Caps,⁷ Precipice Bonds⁸ and Equitable Life⁹ complaints), adjudicators' decisions were shaped by their strict application of ombudsmen-elaborated guidance in lieu of individual conciliation of complaints. Typically, guidance from an ombudsman was sought by team managers, who directly supervised teams of adjudicators, after identifying a trend in a firm's complaints. As manifested in the above case studies, such standardization exacerbated

⁷ In 2002 the shares of 19 investment trusts were suspended from the London stock market as a result of their dramatic drop in their value, and others faced major difficulties. This resulted in massive losses to the owners of these investments and in a large number of complaints.

⁸ Precipice Bonds was a nick name attached to high-risk single-premium bonds.

⁹ Equitable Life was a life assurance firm that was closed to new business in 2000 as a result of an adverse court decision, which rendered it unable to fulfil its responsibilities to its policy holders.

the FOS's conflict with firms. The question therefore arises as to why such standardization was adopted. Efficiency considerations – i.e. quick decision making by reference to general standards – cannot adequately account for the emergence of the FOS's standardized approach to complaints of a systemic nature since the resulting conflict with firms inhibited speedy and informal conciliation of disputes. The data below suggests that while standardization was 'irrational' as an *organizational* strategy, it was nevertheless driven by individuals' rational attempt to mitigate the potential for individual blame.¹⁰ As evident from the following discussion, the potential for blame was rooted in contextual factors outside the FOS's control. Hence, while the FOS's 'irrationality' goes some way to explain its conflict with firms, the 'contextual hypothesis', as elaborated in the next section, offers a more robust explanation.

The intra-organizational dynamics that led complaint handlers to standardize their approach to complaints of a systemic nature is illustrated below through micro-analysis of one complaint. This analysis depicts complaint handlers' concern that inconsistency in their handling of similar complaints would be used by firms to undermine the soundness of their approach. It further demonstrates that firms tracked inconsistency in complaint handlers' decisions and invoked it in order to challenge adverse decisions.

In this instance an adjudicator was allocated a complaint while the FOS was in the course of a fierce dispute with another firm with regard to the risk rating of its investment funds. The adjudicator was inclined to endorse the complaint. However, before doing so, he requested advice from an ombudsman, writing "I am mindful of the situation with [another firm's] fund and so would like to be sure of my ground before writing to the firm." The ombudsman replied that he believed that *this* firm adequately risk rated the product, but suggested that the adjudicator gather further information from the firm and thereafter seek advice from two additional senior ombudsmen. In reply to the adjudicator's request for further information the firm's complaints administrator pointed out that in the past the FOS decided five similar cases in its favor. Yet the two ombudsmen, from whom the adjudicator was guided to

¹⁰ For 'blame avoidance' and reputation-protection as the logic underlining regulatory behavior see, for example, Carpenter (2002), Hood *et al* (2001) and Maor (2006).

seek further advice, proposed that the firm's risk rating of the fund was incorrect and that the complaint should be upheld. The adjudicator therefore issued a decision in favor of the complainant, and sent out an email notification to all his team members to ensure future consistency. Four additional similar adjudications were issued to the firm. The firm appealed for an ombudsman's review in all five cases. In its application for an ombudsman review the firm once again contended that in the past the FOS decided similar cases in its favor, including one decision by an ombudsman. Prior to the ombudsman's review of the pending decisions a meeting was held between the ombudsman, the firm's head compliance officer and the fund manager. Following this meeting, a compromise was reached between the FOS and the firm regarding the future handling of these cases. The compromise, as mentioned in section C above, entailed particularization of the FOS's adjudication of future complaints.

Similarly, during the research period, the FOS coordinated its internal approach to the handling of Precipice Bonds complaints, which attracted intensive press coverage. To maximize internal consistency, the handling of Precipice Bonds complaints was allocated to a small number of specialized teams of adjudicators, who were required to closely coordinate their approach. Adjudicators were provided with product-specific training and guidance from the ombudsmen. Additionally, following requests from the FSA, there was also close cooperation and exchange of information between the two agencies. Interviewees explained that Precipice Bonds were handled by specialized teams, because of the high media coverage that was associated with them. For example, a senior FOS official explained that because of the high media coverage around Precipice Bonds, the FOS both internally standardized its approach and closely coordinated with the FSA.

“[In precipice bonds] we [the FOS and the FSA] have got a coordinated approach to all the Precipice Bonds stuff ...In fact we [the FOS] are aiming to deal with them on a very coordinated approach, such that if we find issues with a certain firm...we would actually then batch all those cases and deal with them on a very quick follow through...it's probably politics as much as anything...it was very high profile. FSA were always in the press about 'Are you looking to make sure that people are OK with Precipice Bonds?' 'What were you doing about it in terms of regulation?' ...it certainly became the case that very quickly

the FSA and the FOS...needed to have...some kind of coordination about it. And indeed we have our own [internal] coordinated approach to dealing with Precipice Bonds as well.” (Support unit manager)

The analysis above, and additional data, suggests that standardization of the FOS’s handling of complaints of a systemic nature was induced by complaint handlers’ expectation of firms’ resistance and/or in response to media coverage of the FOS’s decisions. Under these conditions, adjudicators anticipated firms’ appeal for an ombudsman review if the complaint was upheld and they wanted to commit the ombudsmen to their position in advance. Standardization was self-reinforcing. It aggravated firms’ resistance to adjudicators’ informal decisions and therefore fortified adjudicators’ strict following of ombudsmen guidance in order to prevent firms’ allusion to exceptions to challenge the FOS stance. Similarly, ombudsmen operated under the assumption that a judicial review was likely in these cases and they were therefore eager to avoid inconsistent decision making that would render their approach vulnerable to judicial scrutiny. Finally, the FOS’s executives anticipated political and media scrutiny of the FOS when handling high-profile cases and therefore wanted to be able to explain the logic of the organization’s decision making. Hence, standardization was primarily driven by intra-organizational defensive response to external scrutiny.

In conclusion, the above data suggests that while standardization *aggravated* firms’ adversarial relationship with the FOS, it was not the *initial* cause for conflict. Rather, the underlying cause for conflict was rooted in the context of the FOS’s interaction with firms. Below I turn to analyze this context.

E. The contextual hypothesis: cooperation as a multi-actor game

The above suggests that the FOS’s standardization of its decision making was a *response* to adjudicators’ anticipation of firms’ resistance and media converge, rather than the primary cause for adversarial relationship. The case studies, and further data from interviews below, suggest that firms’ adversarial relationship with the FOS is best explained by reference to complaint handlers’ inability to control the scope of their decisions. Thus, in contrast with the expectations of a two-actor cooperation game, even if complaint handlers were fully strategic in their interaction with firms,

they were unable to exchange individual and confidential dispute resolution against firms' cooperation. Firms were disinclined to accept informal conciliation, especially with regard to complaints of a systemic nature, because they were uncertain of the FSA's reaction. In addition, firms faced the risk that publicity to the FOS's individual decisions would damage their reputation. The paradoxical outcome was that risk-averse firms both fiercely fought individual complaints that reached the FOS and sometimes complied with its decisions beyond their legal obligation.

Regulatory Intervention

In accordance with the expectations of cooperation theory, the FOS was normally reluctant to provide the FSA with general comparative information regarding its reversal rate per firm (i.e. the ratio of cases which it decided in favor of complainants). An explanation that came up in interviews for this policy, which is compatible with a rational-choice hypothesis, was that passing such statistical information would discourage firms' cooperation. This was because a firm's acceptance to apply an ombudsman's decision to all its pending complaints at the FOS would have resulted in abnormal upholding rate, which could have put the firm at risk of FSA scrutiny. For example, a senior executive explained:

“If we just passed unqualified data to [the FSA], supervisors ... might suddenly jump on some aspect and say ‘oh goodness you seem to uphold a lot more complaints against this [firm]’ and ...rush off to the firm saying ‘oh, you’ve been behaving badly here’ ”

Equally, as predicted by the game-theory model, the FOS was inclined to report *uncooperative* firms to the FSA in seek of the latter's assistance. However, reporting firms to the FSA was frequently ineffective in mobilizing FSA enforcement. While the FSA supervisors were interested to know about firms' complaints performance, a prominent theme in the above and other case studies was the FSA's reluctance to initiate enforcement as a result of information provided by the FOS. Complaint handlers were skeptical of the FSA's propensity to respond to information provided by the FOS. Complaint handlers were therefore slow to threaten uncooperative firms in reporting them to the FSA. For instance, a team manager contended:

“I could think of one firm that was pushing everything to a final decision [by an ombudsman] and we issued a bundle of decisions in one go, with a covering letter from the ombudsman saying, ‘Right, now, if you don’t start falling into line, we’ll tell the FSA you’re not being fair to your customers.’ So, we do use it sometimes as a threat...that we will...say to the FSA, ‘There’s a problem here and they’re [the firm] not being fair to their customers, it’s causing us a problem, something needs to be done here.’ I’m not sure there’s a great faith, always [at the FOS], that the FSA is that interested or willing to sort some of the problems out...So...you don’t know if it’s worthwhile [to report firms].”

When the FOS did threaten to report firms to the FSA, firms were uncertain whether resistance to cooperate with informal FOS decisions would put them at risk of FSA enforcement. For instance, an FOS executive explained that it was unclear to firms that they had anything to gain from applying an FOS decision to other complaints:

“For firms, it was always a gamble...There was always the hope [on the firm’s side] that... maybe the FSA wouldn’t think it was as serious as we did, or maybe that wasn’t number one on the FSA’s priorities that year... So, maybe, when it came to the crunch of having to deal with the FSA about it, they could get their lawyers involved... they might be able to find a way through it or it wouldn’t come out...Just because we reported it ...didn’t necessarily mean that something absolutely terrible was going to happen.”

Moreover, the FOS could not assure cooperative firms that cooperation with informal conciliation of complaints would not put them at risk of regulatory intervention in the future. The manager of an FSA supervision team explained that if a supervisor realized that a firm voluntarily agreed to apply an FOS decision to all its pending complaints at the Ombudsman, the firm would have to explain why it did not follow the same principle when complainants did not insist on an FOS review. Consequently, according to this interviewee, firms had little to gain from voluntary conciliation of complaints:

“If I was a firm, I would be reluctant to accept that [an ombudsman’s decision] would automatically apply to all my outstanding complaints [at the FOS],

because I know that the FSA would think, ‘Ah, there’s a systemic issue at this firm,’ and then I would come under even more regulatory scrutiny... as a supervisor, you would ...think, ‘OK, now this firm, there’s an admission of guilt, they’ve accepted that in a number of cases, well, we’ve got a systemic issue at the firm.’...I would say... [as a firm] I’m incentivized...to fight each case. There’s little to gain from early acceptance.”

As a result, the logical option that risk-averse firms faced was to either systematically apply the ombudsman’s decision to all similar complaints which reached them (in addition to those that were filed with the FOS), or to fight each and every case that reached the FOS. In contrast, other firms were inclined, under certain conditions, to offer redress to those complainants who appealed for an FOS review, while rejecting similar complaints of those who did not. Thus, firms’ amenability to informal conciliation was shaped by their inclination to take the risk of applying the FOS’s decisions only to those complaints that reached the Ombudsman.

The above discussion therefore suggests that the FOS’s adversarial relationship with firms was rooted in a contextual factor – the risk of regulatory intervention irrespective of firms’ cooperation with the FOS. Yet, this explanation does not utterly encapsulate the data. If the FOS was fully strategic, it would have been neutral about firms’ decision whether or not apply its decisions to their other complaints and transactions as long as they were cooperative in handling those cases that reached the FOS. However, interviewees suggested that the FOS *would* report to the FSA a clear breach of regulations, even with regard to a firm that was amenable to informal conciliation of those complaints that reached the FOS. A senior FOS executive explained this, noting that passing information to the FSA was perceived as an exception to the FOS’s general preference for preserving firms’ confidentiality:

“We ...balance the firm’s right to privacy, and the fact that we see ourselves as an organization that is involved in private dispute resolution...we are not in the business of naming and shaming firms, we are not in the business of shopping them to the regulator for minor things...our business is dispute resolution. If we can resolve disputes that’s fine...Unless there is something of a public interest ...something that any regulator ought to be looking at...If it’s not a matter that

instinctively calls for ...regulatory intervention ...we don't want to pass information to the regulator...Broadly, we expect them [the FSA] to go and find their own evidence, but sometime we think it's necessary to tell them."

Yet, other interviewees explained that while, in theory, the FOS would report a 'cooperative' firm that systematically rejected complaints but thereafter upheld them once they reached the FOS, it did not proactively compile information to expose such action. In practice, adjudicators were unlikely to probe behind the reason for firms' voluntarily offer to redress a complainant, because it was in their interest for cases to be closed as quickly as possible. Ombudsmen and executives asserted that the FOS should (and would) report a firm that systematically rejected its complaints, while offering to redress the complainants once they appealed to the FOS. Yet, none of my interviewees could think of a case where a 'cooperative' firm was reported to the FSA, other than with regard to Endowment Mortgage complaints.¹¹ In the latter case, it was the sheer volume of complaints that strained the FOS's resources, creating a special incentive for the FOS to monitor firms' handling of their own complaints. In other cases, a firm's tendency to offer redress once complaints reached the FOS, while rejecting other similar cases, was likely to go undetected since there was little incentive for either adjudicators or their team managers to raise it.

Media Coverage

While the FOS was unable to secure FSA enforcement against uncooperative firms, it could have presumably threatened firms with naming and shaming them in the public domain. Given financial firms' sensitivity to adverse publicity, naming and shaming would have been a greater threat than reporting them to the FSA.

In accordance with the expectations of the game-theory model, the FOS was reluctant to publish comparative information regarding the volume of complaints and its upholding rate in relation to individual firms. However, in contrast to the model's predictions, the FOS further resisted employing naming and shaming as a targeted sanction against uncooperative firms.

¹¹ Endowment mortgages were with-profit life assurance policies that became popular in the 1980s as a means for returning mortgage loans. As a result of low investment returns during the 1990s onwards most of these policies did not grow enough to allow policy holders to repay their mortgages. This resulted in massive rise of consumer complaints and in the FOS's caseload.

The FOS's resistance to name and shame firms in the public domain was, in part, due to its executives' normative position that naming and shaming was an inappropriate strategy for an ombudsman. For instance, an executive maintained that naming and shaming was a distinct regulatory function, which the FOS should thereby avoid:

“[Naming and shaming] could start confusing us with the regulator. We are always keen to point out that all we do is organizing redress for consumers, we don't punish firms and why would naming and shaming firms achieve redress for consumers? It's something completely separate. Clearly that is punishment of retribution and that is not what the ombudsman is here for then. That's what the regulator is here for...Unless our board can be convinced that that wouldn't be just us trading into the regulator's patch and could be creating all sorts of problems as to 'what exactly does the ombudsman do? Why have you been telling us for the last 10 yrs 'we are not a regulator, we provide redress not regulation' when you suddenly do something which is quintessentially regulatory. That is one of the most powerful weapons the regulator has.”

However the FOS's reluctance to name and shame uncooperative firms, while articulated as a requisite of appropriate behavior of an ombudsman, could be explained in strategic terms by reference to the industry's capacity to retaliate by appealing to the Treasury and/or its political executives to curb the FOS's powers. As discussed in section C above, the Treasury's review of the FOS's handling of complaints of a systemic nature was prompted by firms' allegations that some of the FOS's decisions, most prominently regarding Dual Variable Rate mortgages, caused them considerable financial and reputation damage. Thus, it is possible that the FOS avoided using the media as a means for disciplining firms because of its executives' concern that such action would result in the industry's call for reduction in the organization's discretion to handle future complaints.

While not naming and shaming uncooperative firms, the FOS was unable to fully protect cooperative firms against the risk of adverse publicity. Complaint handlers noted with contempt the media's, and especially the Daily Mail's, monitoring of their decisions. The power of the media to enforce individual FOS decision upon firms is well illustrated in the case of Dual Variable Rates as discussed in section C.

Consequently, despite the FOS's preference for confidentiality and its avoidance of naming and shaming, firms were exposed to the risk that accepting an FOS decision in an individual case would result in media pressure that they offer similar compensation to all their relevant customers. This again explains firms' disinclination to cooperate with informal conciliation when cases were part of a larger set of similar transactions.

In summary, firms' conflict with the FOS was primarily a result of the FOS's limited control over the individuality of its decisions. Firms were disinclined to cooperate with informal conciliation due to their concern that their agreement to redress only those cases that reached the FOS would transpire in an FSA supervision and/or result in adverse media coverage. Thus, the context of firms' interaction with complaint handlers – the risk of regulatory intervention and publicity irrespective of firms' cooperation – offers a robust explanation for the FOS's adversarial relationship with retail investment firms.

Conclusion

Rational cooperation theory suggests that in iterated games regulators and regulatees exchange reasonable regulation in exchange for compliance beyond legal requirements. Building on this theoretical approach, I hypothesized that, in order to attain firms' cooperation with low-cost conciliation of complaints, third-party complaint handling agencies will focus upon individual and confidential resolution of disputes, rather than upon identification and rectification of systemic issues. I further proposed that complaint handlers will selectively disclose information from complaints in order to penalize firms' uncooperative behavior. Hence, it was hypothesized that equilibrium is likely to emerge wherein complaint handlers would restrict themselves to individual and confidential dispute resolution and firms would be amenable to swift and informal settlement of complaints.

In contrast to these expectations, the FOS's interaction with retail investment firms was frequently adversarial. This manifested itself in firms' inclination to require formal decisions in analogous complaints and in the industry's appeal for a Treasury review of the FOS's powers. Equally, the FOS tended to adopt a bureaucratic, rather than a conciliatory, approach to handling complaints of a systemic nature.

One way to account for this adversarial interaction was to question the FOS's 'rationality' in seeking firms' cooperation with informal conciliation of disputes. It would seem that some of the FOS's decisions in favor of complainants, such as with regard to Dual Variable Rate mortgages, were over ambitious and misjudged the actual limitations of ombudsman's powers. In addition, whilst cooperation theory would expect the FOS to avoid reporting firms to the FSA as long as they cooperated in handling those cases that reached the Ombudsman, the FOS's executives and ombudsmen further expected firms to adequately handle their *own* complaints. This is not to say that they expected firms to apply the FOS's decision across the board. However, they were unwilling to be rendered accomplice to firms' strategic rejections of complaints, while upholding those few cases that reached the FOS.

However, the above analysis has shown that the prime explanation for firms' adversarial relationship with the FOS was firms' reputation sensitivity. This compelled risk-averse firms to perceive ombudsmen's decisions as having a general applicability. This was a consequence of media scrutiny of the FOS's decisions and firms' concern that their voluntary agreement to redress individual complainants could be interpreted by the FSA as admission of a systemic problem. This explanation highlights the importance of analyzing regulatory cooperation as a multi-actor game, in contrast to the common tendency (e.g. by Scholz) to limit the analysis to the interaction of regulators and regulatees. The findings of the current study share some commonalities with those of Bardach & Kagan (2002) and Vogel (1986, 2003), which explain regulatory rigidity as a response to contextual crises and changes in public opinion. However, the analysis in this paper suggests that it was both firms' and regulators' sensitivity to external scrutiny, rather than top-down political control, that hindered their informal cooperation.

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