

# Economic Insight



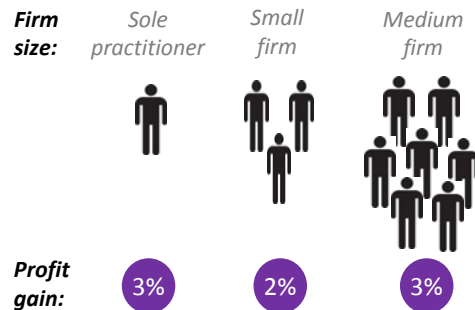
## The business case for good complaints handling in legal services

Summary report  
November 2013

# The business case for good complaints handling in legal services

Summary report – our key findings

For individual law firms and other providers of legal advice, good complaints handling could increase operating profits by between 2% to 3%.

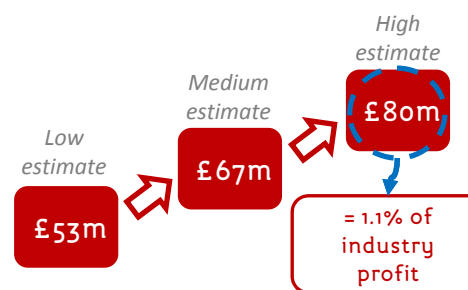


For individual firms, improved complaints handling should have a modest, but important, positive impact on profit.

The impact is likely to vary across different firm types, due to differences in: (i) existing approaches to complaints handling; (ii) cost structures; and (iii) the differing options for improving existing processes.

Our firm level analysis relates to improvements in tier 1 complaints.

At a total industry level, good complaints handling could generate net benefits of between £53m and £80m over a 10 year period.



The extent of the total industry net benefit depends on:

- How many firms we assume make improvements to complaints handling; and
- The extent to which improved complaints handling: (i) grows overall demand for legal services; versus (ii) improves the competitive position of some firms relative to others.

Our total industry figures include an approximation of tier 2 related benefits.

These benefits would be shared between firms and consumers.

Across the industry as a whole, firms could benefit from:

- Increased overall demand for legal services; and
- Cost efficiencies.

Consumers could benefit from:

- Improved quality of service from legal services firms; and
- Lower prices.

Any individual firm – or group of firms – could also benefit as a result of having superior complaints handling relative to rivals:

- Improved customer retention and acquisition;
- Potential price premium;
- Improved customer intelligence.

# The business case for good complaints handling in legal services

## Introduction

It is well established that reputation or brand value can generate increased profitability for firms across a range of industries.

Consequently, to the extent that how firms manage customer complaints can impact their reputation, then clearly there is a natural commercial incentive to have complaints handling processes that meet customer needs.

Given the importance of ‘reputation’ with respect to the provision of legal advice, one might expect these incentives to be particularly relevant to legal services.

However, research by the Legal Ombudsman published in 2012 found that there is significant scope to improve complaints handling within the industry (although it is important to note that the study also found examples of good practice).

Given that there are strong in principle reasons to believe that the commercial incentives exist for law firms to have good complaints handling, it is important to consider why this is not universally the case. One possible explanation is that some firms may underestimate the extent of these commercial

incentives, because they do not appreciate the importance customers attach to complaints handling (and so only see complaints handling as a cost to their business).

It is therefore **important** to:

- seek to understand what the business case for good complaints handling might be, from a law firm’s perspective; and
- communicate that business case so that the scope for providers underestimating the potential benefits is reduced.

In the above context, the Legal Ombudsman commissioned Economic Insight to undertake an analysis to determine the business case for good complaints handling in the legal services industry. This summary report sets out our key findings and conclusions.

*A fuller, long report, which sets out the details of our methodology and approach, has been provided separately to the Legal Ombudsman.*

***“Every hour spent dealing with complaints is an hour of billable time lost, but we need to do it.”***

Medium sized law firm

## The existing evidence base suggests strong 'in principle' reasons to believe there is a business case

Our work included a review of the existing evidence base relating to the potential impact of complaints handling on firm financial performance. We find that both economic theory – *and evidence* – is consistent with there being a business case for good complaints handling.

No improvement to complaints handling is costless – and so it is important that any analysis includes appropriate costs. Improvements in complaints handling may result in firms incurring costs associated with:

- *a reduction in utilisation rates, as internal fee-earning staff have to spend more time handling complaints processes;*
- *a re-allocation of resource away from other commercially useful activities such as marketing;*
- *incremental resource costs if the improvement in complaints handling is sufficiently material to demand dedicated resource; and*
- *up-front set-up and investment costs associated with designing and implementing a more robust approach to complaints handling (which could include modest investment in customer relationship management software).*

But evidence shows that there are also clear financial benefits. In particular:

- *complaints handling can enhance a firm's reputation, which is an asset on which it can earn a return – this can increase customer retention, acquisition and/or allow a firm to charge a price premium;*
- *the data firms collect from complaints is a valuable source of management information that can be used to identify areas for commercial improvement – such as cost efficiencies; and*
- *a robust approach to complaints handling can help reinforce a firm's internal culture, increasing staff retention rates (and thus reducing costs).*

We asked Dr Andrew Mell, a leading academic economist, to give us his expert opinion on the likely business case for good complaints handling in legal services. Dr Mell's view is that there are strong theoretical grounds to suppose that good complaints handling will be financially beneficial to firms.



“A good system for handling complaints from customers can help a law firm to ensure that more of their customers now and in the future are satisfied customers. This will improve the firm's reputation and lead to more repeat business.”

**Dr Andrew Mell**, fellow of Corpus Christi College, Oxford and expert in reputational economics.

We reviewed 25 academic studies within the scope of our work, of which 19 were empirical. All of these were supportive of a positive relationship between complaints handling and financial / operational performance.

## We have evaluated the business case for good complaints handling from a commercial perspective

Given that the primary issue we wish to address relates to the incentives faced by the providers of legal advice to improve their complaints handling, we have developed the business case from a *commercial perspective*.

### Potential financial impacts

We have sought to identify – and then quantify – the potential financial impacts (both costs and benefits) on law firms (and other providers of legal advice) of developing good complaints handling processes. This is to ensure that the business case for improving complaints handling is evaluated in the same way that law firms would evaluate any business opportunity in the real world.

### Financial model

To implement this approach in practice, we developed a financial model that estimates the profitability and cash flows of ‘stylised law firm types’ both under a base case, and for a scenario in which we assume improvements are made to firms’ complaint handling processes.

The stylised law firms we have modelled are not intended to represent any individual firm, nor an ‘average’ of all firms. Rather, they are designed to be broadly representative of the different ‘types’ of firms that operate in the market, to reflect the diversity of legal services providers that exist.

*As direct client access to barristers increases, so the key costs and benefits identified for **sole practitioners** will become increasingly relevant to these legal services professionals.*

#### A sole practitioner

– likely to have a turnover of <£100k pa, with a relatively narrow service offer, operating in a town or village high street.

#### A small firm

– likely to have up to 5 fee earners with a turnover of between £600k to £800k pa with a somewhat broader service offering, operating in a town centre or high street.

#### A medium sized firm

– likely to have between 30 and 40 fee earners with a turnover of between £5m and £6m pa, with a broad service offer (including material commercial and corporate work).

*The characteristics of stylised firms were informed by: **financial accounting data, ONS labour market data, the Law Society's survey of firm salaries, qualitative interviews with legal services providers, and advice from the Legal Ombudsman.***

## For law firms and providers of legal advice, good complaints handling can boost profitability

Our modelling suggests that for law firms (and other providers of legal advice) good complaints handling could increase operating profits by between 2% to 3% in our central case (see chart).

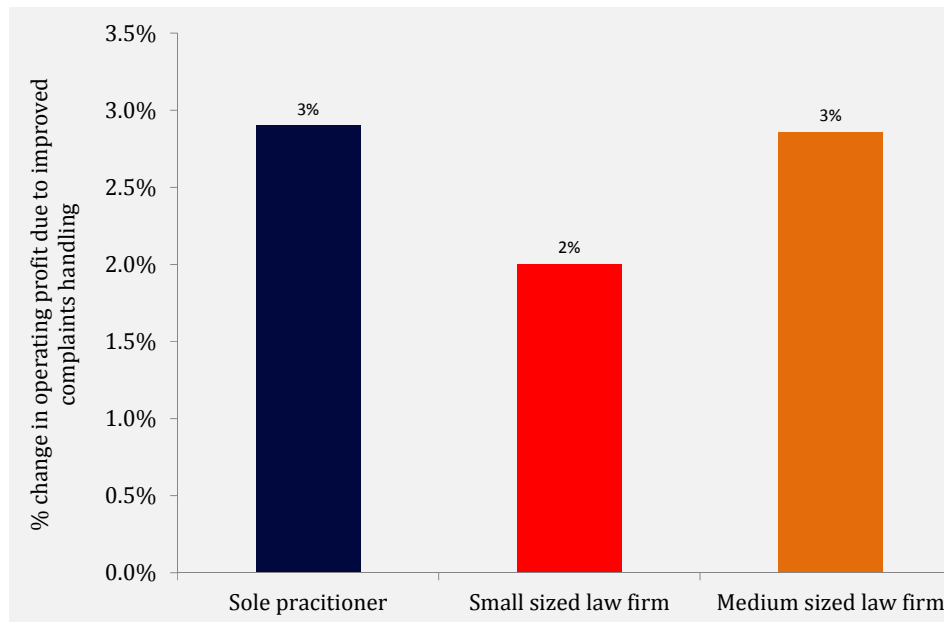
The scenarios we modelled varied across the three types of law firm, to reflect differences in how they might reasonably improve their complaints handling process.

Across all three firm types, we assumed that more resource would be required to achieve the improvement (with a corresponding cost in terms of reduced billable time and incremental admin support).

For small and medium firms, we also assumed a modest upfront investment in CRM would be needed to achieve the improvement (we considered this to be inappropriate for sole practitioners).

*“There is a positive effect on profit... [but it]... is not massive.”*

Town centre based law firm



- Both costs and benefits are subject to uncertainty. Sensitivity analysis suggests a slightly wider range for the expected increase in profits of between a 1% and 4%.
- This is consistent with studies of the impact of complaints handling on profitability in other industries. For example, a study by Estelami (2013) reported that complaints handling could typically impact profit by around 1%, but up to 5%.<sup>1</sup>
- Our analysis relates to improvements in first tier complaints. There may be additional net benefits associated with reduced costs at tier 2 (complaints referred onto the Legal Ombudsman) We have included an approximation of tier 2 benefits within our scaled industry estimates, however.
- We cannot comment on the statistical likelihood of our findings, but they are strongly consistent with there being a good commercial business case.

<sup>1</sup> 'The Profit Impact of Consumer Complaint Solicitation Across Market Conditions.' Estelami, Journal of Professional Services Marketing (2013).

## The profitability gain occurs because the benefit of increased customer retention and acquisition offsets the costs

Our analysis breaks down the overall expected gain in profitability from improved complaints handling into its component parts.

This shows that the financial benefit of increased customer retention and acquisition – and cost efficiencies – offsets the higher on-going and initial costs of complaints handling (see chart).

### The red bar

- Under our scenarios, we assume that improving complaints handling requires firms to incur some 'set up' costs in order to deploy the new process. This is primarily the cost of staff time, but also includes training costs. For small and medium firms, it also assumes a modest capital investment.

### The orange bar

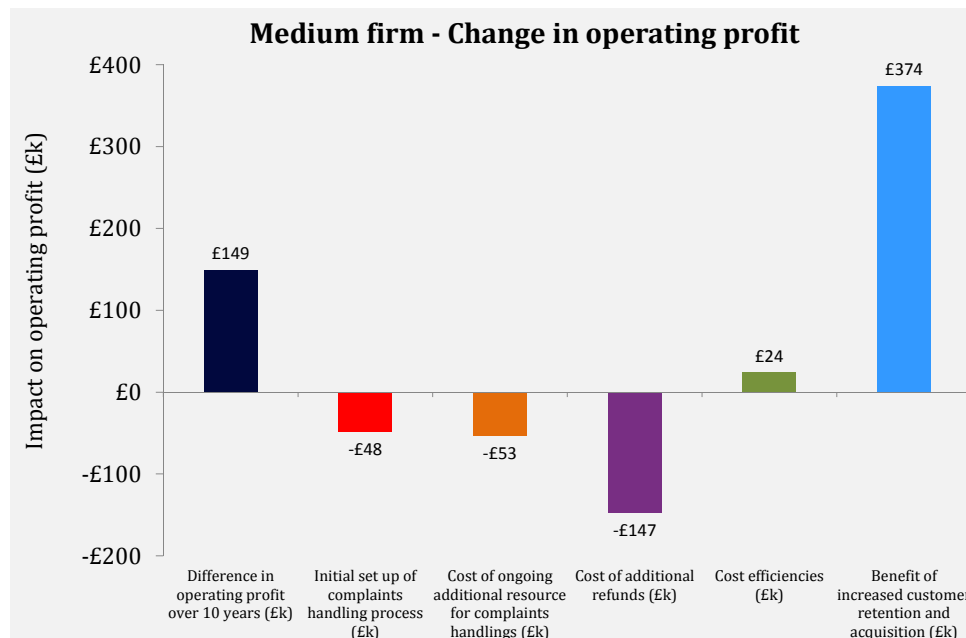
- We further assume that to achieve the improvement, firms need to invest more time on complaint handling on an on-going basis. For fee earners, this is a reduction in billable hours – incremental cost of additional administrative resource is also included.

### The purple bar

- As part of an improved complaints process, firms may choose to have more generous client refund policies.

### The green bar

- The existing evidence base suggests firms may be able to identify operational efficiencies as a result of good complaints handling.
- Finally, through reputational effects, firms may benefit from increased customer retention and acquisition. Our retention benefit is based on published empirical research. The acquisition benefit assumes a 1% uplift in acquisition in the central case (and no acquisition gain in the low case).



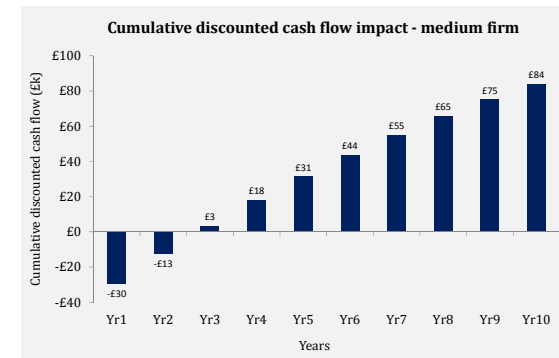
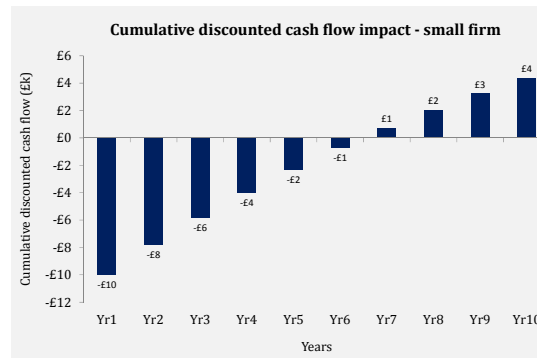
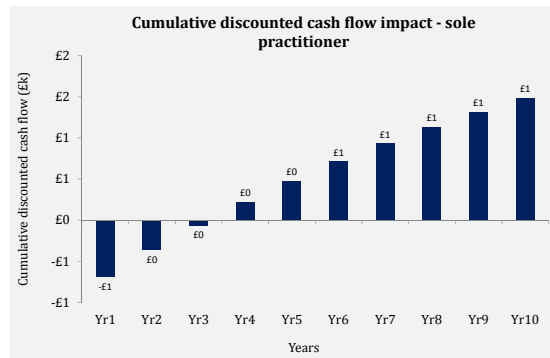
Although the absolute profit gain varies across our three stylised firms (here we show the results for the medium sized firm), in percentage terms the gain is similar, as shown on the previous page.



## Investment in improved complaints handling is cash flow positive with a quick expected pay back

Improving complaints handling may require legal services providers to incur some upfront costs – both in terms of:

- (i) administrative, training and time costs associated with designing and implementing a new process; and
- (ii) potentially modest incremental investment in customer relationship management (CRM) systems - although these are unlikely to be relevant for sole practitioners.



- Across all our modelled scenarios, improved complaints handling is cash flow positive, as shown in the charts above.
- In addition, the upfront costs typically payback relatively quickly – within just a few years.

This means it would be commercially beneficial for law firms to make these investments.



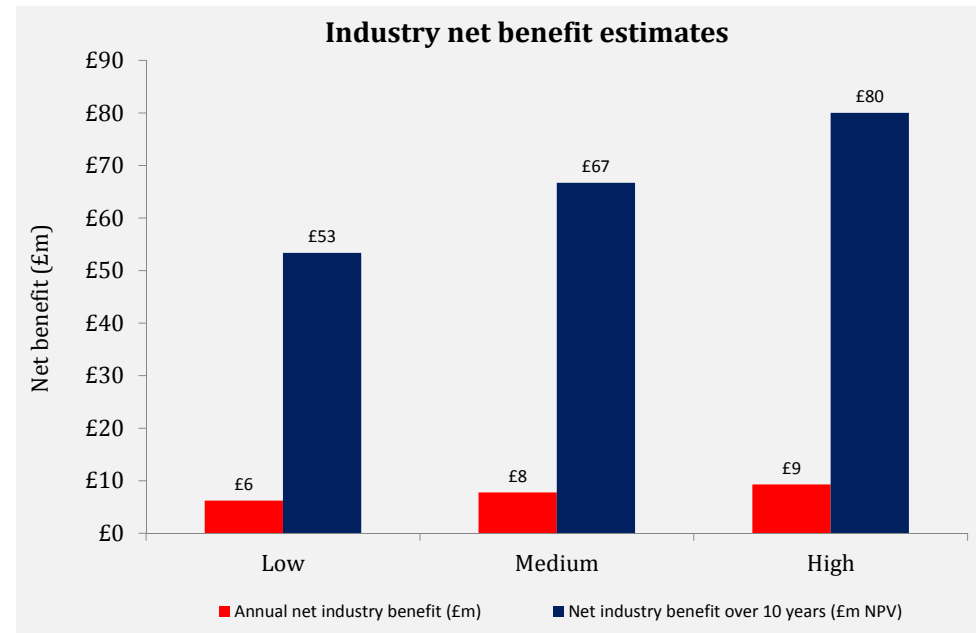
## Across the industry as a whole, the net benefit to consumers and firms could be material – and up to £67m in present value terms over 10 years

In addition to estimating the total net benefit of good complaints handling for individual firms, we have assessed the potential net benefit to consumers and firms across the industry as a whole. This shows that **over 10 years, the total net benefit could be between £53m and £80m in present value terms.**

Scaling firm level costs and benefits to the industry level is complex, as there is uncertainty as to:

- Which costs and benefits at a firm level arise through complaints handling enabling the firm to perform better than rivals (such impacts should not be scaled) as opposed to complaints handling driving increased value for the industry as a whole (which should be scaled).
- Over what base of firms the expected net benefits should be scaled by. Assuming that all firms could make the improvements to complaints handling included in our modelling would be inappropriate as:
  - some firms will already have good complaints handling processes; and
  - some firms might not be able to achieve the improvement.

To address the above uncertainty, we developed a sensitivity analysis to provide low, medium and high case estimates of the total industry net benefit (see chart). Our industry figures also include an approximation of potential tier 2 benefits.



The red bars show the annual net benefit in absolute £m to the industry of good complaints handling. However, it is best practice, from a policy evaluation perspective, to also measure total societal benefits over time (typically 10 years) where those expected net benefits are 'discounted' by an opportunity cost (the social discount rate) in order to give the 'present value.' We have therefore also calculated this (the blue bars).

## Conclusion

### We consider that there is likely to be a strong business case for good complaints handling

Our key findings and conclusions are as follows:

#### Strong business case

Economic theory and evidence provides strong grounds to believe that there is a Business Case for improved complaints handling in the legal services industry.

#### Underestimated importance

The fact that existing evidence indicates that there is scope for improvement in complaints handling in legal services may, in part, be because firms underestimate the importance that customers attach to complaints handling.

#### Risk of under provision of quality

The above means that a robust assessment of the business case for good complaints handling – and a communication of that to industry stakeholders – is critical to reduce the scope for an under provision of quality (arising from an underestimation of the benefit).

#### Increase profitability

Our analysis shows that law firms may be able to increase their profitability by around 2%-3% as a result of having good first tier complaints handling (although the likelihood of this is unknown).

#### Net benefit to industry of £80m

At a total industry level, the overall net benefit (to both firms and consumers) could be material, and up to £80m in present value terms over 10 years.



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