Treasury Committee

Restoring confidence in long-term savings: Endowment Mortgages Report

Response by the Financial Services Authority

Introduction

1. This note is submitted in response to the Committee's fifth report of the 2003-04 session on mortgage endowments. A number of recommendations were directed at the FSA. In response to these we refer to the relevant paragraphs in the report.

With-Profits policies – Paragraph 12

2. We agree with the Committee's conclusion that the development of simpler, more transparent products is a big challenge for the industry. In terms of our actions, we are introducing a series of changes which will benefit with-profits policyholders. One of the key components of the programme of reform for with-profits is for firms to articulate and publish the degree of discretion that they are allowed to exercise in the management of funds and to disclose how discretion has been exercised.

3. Improving transparency for existing and potential policyholders and treating customers fairly are the cornerstones of the changes being introduced. These include:

   - giving informed users, including those who advise consumers on their investments, a better understanding of the way in which the with-profits fund is run, through the production of a document called the Principles and Practices of Financial Management (PPFM). We will also require firms to produce consumer friendly PPFMs later this year ;

   - giving policyholders greater confidence in how firms will meet, and have met, the obligation to treat customers fairly through, for example, the report that firms are required to give to policyholders on their compliance with PPFM obligations;

   - providing clearer and more transparent information for customers at - and post - point of sale on the nature and risks of their investment, and how it is performing, in relation to the published principles and practices applied in managing the fund; and

   - providing informed users, including those who advise customers on their choice of investment, with improved access to information on the financial condition of firms and their with-profits funds (including the firms' ability to meet discretionary benefits such as terminal bonuses) through the publication of realistic balance sheets.

The Role of Actuaries – Paragraph 18

4. The Committee states that it is important that the FSA's reforms of the actuarial process within insurance companies are effective. We believe that they will be and we have already sent the Committee evidence on our reforms of the role of actuaries in life insurers, which will come into effect at the end of this year. The advisory and reporting duties being placed on the actuaries performing both of the new actuarial functions should produce more proactive actuarial input to the firm's decision-making and earlier warning of any emerging problems. More independent-minded actuarial advice should also be encouraged by the steps we have taken to address the potential for conflicts of interest arising from these actuaries holding certain other positions within firms (for example, in future neither will be permitted to be chairman or chief executive, and the with-profits actuary must not sit on the board).

Paying for financial advice – Paragraph 30

5. Our work on the new disclosure regime to accompany depolarisation is aimed at aligning the interests of customers and advisers in terms of paying for financial advice. In the past, advice has normally been paid for out of the commission paid on sales via intermediaries, or from an equivalent margin for a direct sales force. Our research indicates that customers think that paying a fee for financial advice is the best way of avoiding the potential for the advice being biased by commission. However, the research also shows that few customers are prepared to pay by fee instead of commission.

6. Our proposals for a disclosure document entitled 'Key facts: A guide to the cost of our services' – also commonly known as the 'menu' – make clear to customers that both fee and commission options are available. They also include prescribed wording explaining the pros and cons of each. We propose that, in future, advisers who want to call themselves 'independent' must offer advice across the whole market and must always give their clients the opportunity to pay for the advice by fee (though they may offer a fee/ commission choice).

Asset Allocation – Paragraph 33

7. The Committee recommends that the FSA should make it a basic principle that all investors in long-term savings products are given regular information on the asset allocation policies of the product provider and how this is added to, or detracted from, the performance of the investment fund. Under our existing rules, policyholders are already provided with a range of information and we believe that the further disclosure required under the new 'Principles and Practices of Fund Management' (PPFM) documents will enhance the information available to policyholders' advisers (as well as policyholders themselves through consumer friendly PPFMs). There will be increased disclosure on, for example, a firm's investment strategy, charges to asset share, approach to payouts and how the with-profits fund is managed.

"Red" reprojection letters – Paragraph 38

8. We have agreed with the ABI that the revised ABI Code on mortgage endowment reprojection letters will include a recommendation that firms use red ink or other

similarly striking means to draw to attention the key risk warning in "red" reprojection letters. For "red" letters, the risk warning should also be headed up with the words "Red Alert: High risk of shortfall".

Realistic reprojection rates - Paragraph 41

9. We agree that it is important for customers to receive realistic reprojections of the likely future value of their policy. We have made clear that it is the responsibility of firms to ensure that the reprojection rates used are a realistic reflection of the nature and composition of the underlying funds and of the asset share of any particular policy in those funds. This is a complex judgement, and so we expect firms to keep the assessments and assumptions they use under constant challenge and review. This is the message we communicated to them in our Dear CEO letter of June 2003. We highlighted a range of factors that we expect firms to consider when deciding their reprojection rates. These include the ratio between equities and non-equity assets in the underlying funds and any guarantees or bonuses attached to a particular policy that may impact upon its value.

10. We will be carrying out focused periodic reviews and sampling of firms' methods during 2004-05 on a risk assessed basis.

Policyholders in closed funds – Paragraph 51

11. The Committee has highlighted its concern for policyholders in closed with-profits funds. There are a number of steps that we have taken or are in the process of taking to help address this. It is worth noting, however, that the fact that a fund has closed does not of itself mean that policyholders are being treated unfairly - some closed funds have performed well and closure has in fact been in the interests of policyholders. Questions of fairness have more to do with the financial strength of a firm and how the management have responded to this rather than closure itself, although we appreciate that financial weakness has in some cases resulted in closure.

12. Our programme of reform of the with-profits sector addresses both closed and open funds, and some of our proposals were designed specifically with closed funds in mind. Our recent consultation - *Treating with-profits policyholders fairly*[1] - made a number of proposals on the treatment of policyholders in closed funds. These include better communication with policyholders (particularly in terms of explaining why the fund has closed and setting out policyholders' options) and better planning for the run-off of the fund. The consultation also contains proposals that are designed to ensure surrender values are fair – both to policyholders surrendering their policies and those who remain in the fund.

13. The Committee recommends that policyholders should be given the opportunity to switch without penalty to another similar fund when their fund closes - as opposed to taking a surrender value or continuing to maturity – and that shareholders should bear the costs. As noted above, closure is not always detrimental to policyholders' interests and similarly closure is not itself evidence of the mismanagement of a fund for which shareholders may be liable. It is unlikely that a shareholder could therefore be

[1] CP 207 (December 2003).

compelled to fund the these proposals, and even if there were a case for shareholder support it is difficult to see why only policyholders choosing to switch should benefit from this.

14. There are a number of further considerations that must be taken into account with the proposal of a policy by policy move even if FSA could require it. These include, for example, the willingness of another provider with a fund to take on these policies and the administrative costs associated with them, and the differences between with-profits contracts (for example, the type of guarantees and bonus policy offered in the fund that closes may be hard, and costly, to replicate in the receiving fund). A policy by policy transfer would also require clarity on any future liabilities for any mis-selling of the contract in the first place.

15. There is, however, scope for market-based solutions to address concerns about closed funds and we are encouraged that the industry is actively exploring innovations in this area. Chief amongst these is the sale of closed funds, effectively transferring a whole fund to another firm through a sale rather than on a policy by policy basis. This would involve firms that are interested in divesting their with-profits business selling their closed books to new or established players in the market. Although there is increasing interest among market participants in developing such solutions for some closed funds, this is not straightforward as it requires some careful balancing between the discount the vendor is willing to accept; the equity return that the purchaser requires; and the regulatory imperative for companies to treat their customers fairly.

16. The sale of an entire fund also addresses some of the difficulties associated with the Committee's proposed transfer solution. For example, economies of scale may be achieved through the sale of a complete book which would not be achieved on a policy by policy basis. This too is not without its difficulties as with-profits contracts and the legacy systems which support them differ across the sector and cannot simply be merged. These are significant obstacles that would need to be overcome to derive the full benefits. A sale may also mean that the fund is able to maintain the same terms and guarantees for policyholders, or alternatively the fund could be restructured. Finally, responsibility for mis-selling liabilities could be made clear before any deal was finalised. We cannot, however, require closed funds to be sold.

17. In the past, the lack of clarity and transparency surrounding the risks carried by some life funds has made them relatively unattractive to potential purchasers. However, greater transparency brought about by the recent introduction of PPFM (which closed funds are also required to produce) and the new capital adequacy reforms has meant that purchasers can quantify and price such risks more accurately. We would expect to see some consolidation among closed funds, with policyholders standing to benefit even if their fund remained closed.

Aligning company and consumer interests (commission and fees) – Paragraph 53

18. The Committee points out that a structure in which the fees charged by product providers are tied to the product meeting set investment targets would service the consumer better and recommend that the industry and the FSA investigate this.

19. We place a clear responsibility on the senior management of firms to treat their customers fairly. We are engaged in a series of studies with a range of companies about how best to encourage them to deliver on these responsibilities. The Committee will also be aware that the ABI has commissioned Charles River Associates to look at the way in which long term savings are sold, and in particular the role of commission. Our interest is to find ways of encouraging and rewarding best practice as a constructive means of making progress – a much more productive relationship between the FSA and a regulated company than one based on failure to comply with rules accompanied by enforcement action.

Advice on financial services generally – Paragraph 60

20. We welcome the Committee's reference to the Financial Capability Steering Group. On 27 May 2004 it published a document, *Building financial capability in the UK,* which sets out a shared approach being taken by a wide range of national strategy partner organisations.

21. The Steering Group has identified seven priorities in order to improve people's ability to make financial decisions. One of these is a project to examine how to make the provision of accessible and affordable generic advice more widespread. This project is being lead by the FSA, and an Advisory Group of key stakeholders has begun this work. The others areas the Group will be looking at are: schools, young adults, work, families, borrowing and retirement.

22. The FSA also continues to stress the need for the financial services industry to treat their customers fairly and explain what they are selling in terms that buyers will understand.

Complaints and Factsheet on complaints – Paragraphs 63 and 64

23. Our research[2] indicated that 86% of endowment policyholders recalled receiving a re-projection letter, rising to 99% among those people who had, according to firms' own records, received a re-projection letter in the last six months. With each of these letters, policyholders will have received an FSA factsheet 'Your endowment mortgage – time to decide' which will have helped them to decide whether they needed to take action and what they might do. The leaflet also provided information to help customers determine whether they should make a complaint and provided information on how to do this.

24. We are again updating our literature and policyholders will receive further information from us with the next round of reprojection letters. This will include further information for customers to explain what they can complain about and how they would go about making a complaint.

25. Under the revised ABI Code, the reprojection letters will include clearer, crisper text. The wording of the shortfall risk warning has been made more punchy and given greater visual impact through the use of red ink or other similar measures.

[2] FSA's Consumer Research Paper 16 "Mortgage Endowments : the consumers' view" (December 2002)

26. Our original consumer awareness research quoted above was undertaken about 18 months ago. Since then further reprojection letters, growing shortfalls and the awareness initiatives by us and other bodies may have changed many consumers' intentions, appetite for action and general awareness. We are undertaking further research to quantify and characterise these developments more precisely. The results will help us gauge the effectiveness of our past actions and guide us in refining our ongoing programme of work.

Time bars – Paragraph 65

27. Our message to customers has always been to 'Act Now' - for example to take action to ensure that they will be able to repay their mortgage and/or to make a complaint. Our literature has reflected this, coupled with warnings of the consequences of delay.

28. In Phase 2 of the reprojection exercise (from Feb 2002) all reprojection letters included an FSA factsheet containing the warning, "*If you think you have a valid complaint, take action now – if you delay, you could lose the right to some or all of any compensation…*"

29. In Phase 3 (from Dec 2003) a revised FSA leaflet was sent with the warning, *"If the risks relating to your endowment mortgage were not explained….you may have a valid complaint. But time may be running out. If you want to complain – do it now. Otherwise, you may be too late or the amount of compensation you can claim might be reduced…."*

30. We have introduced new rules to ensure that all customers are fully aware of the time limits that apply to making complaints if they feel they have been mis-sold, as suggested by the Committee.

31. From 1 June 2004, our new rules mean that before they can be time barred, customers will receive letters which make clear what their position is and the final date before which a complaint must be made to prevent time barring. This notice must be given at least six months in advance.

32. We have also introduced transitional arrangements to protect consumers who have already received information from their providers and could, potentially, be time barred in the coming period. Firms will be required to provide these consumers with two months notice that time is about to expire. We have engaged in close dialogue with the ABI to achieve simultaneous changes to their mortgage endowments Code.

33. These measures will not be retrospective and will not affect consumers who are already time barred. A number of firms have decided not to impose time bars for these customers and others. We have discussed with the industry what more can be done on this and other voluntary initiatives (such as the reduction or waiving of charges normally entailed by switching a mortgage or paying off the outstanding balance early). We will be following up these discussions in the coming months.

Companies' handling of complaints – Paragraphs 69 and 71

34. We note the Committee's recommendation that the FSA needs to be more rigorous in ensuring that its policies and strategies are being effectively implemented by the financial services industry. Our general policy is that firms' senior management should take responsibility for compliance with regulatory requirements. We have said on a number of occasions - for example in our Business Plan for 2004/05 – that many firms still do not give sufficient priority to the regulatory requirement to treat customers fairly. We regard it as a core part of senior management's responsibility to embed this principle throughout firms' culture and to implement it in their strategies. Checking that firms do this is an important focus of our supervision of firms selling to retail customers. Where we discover firms seriously failing to treat their customers fairly, we take enforcement action.

35. The FSA continues to monitor firms' complaints handling performance very closely and we will not hesitate to take action where we believe that firms' complaints handling processes are inadequate or unsatisfactory. For example, we fined Allied Dunbar £725,000 in March this year and Friends Provident £675,000 in December last year for mishandling mortgage endowment complaints.

Cases prior to 1988 – Paragraph 73

36. Pre-1988 sales made by most major endowment providers are covered by the FOS's current jurisdiction since they agreed when joining the PIA Ombudsman scheme that pre-1988 complaints could be considered under the then voluntary jurisdiction. When the Financial Services and Markets Act 2000 took full effect in 2001 the existing scope of jurisdiction of the former ombudsman schemes was fixed and rolled over into the FOS's Compulsory Jurisdiction. But IFAs in the main did not sign up to this previously voluntary arrangement and so their pre-1988 complaints are not now covered by FOS.

37. Since this issue arises from the way the original regulatory regime was put in place, it is not something the FSA can change. Any effort to address this issue in a mandatory way would require significant change to the legislation setting the scope of the FOS Compulsory Jurisdiction in relation to pre-N2 complaints. We are, however, in dialogue with the industry to explore whether there is scope for some non-mandatory action that might help in cases prior to 1988.

2 June 2004