

ENDOWMENTS – THE FACTS

A new Report by Former Housing Regulator says

- FSA's limited powers have led to regulation without common sense.
- Millions worried by one sided publicity.
- Total picture is much brighter. Most well in pocket overall.
- Compensation rules absurd.
- No one identifies those genuinely in loss.
- Better off borrowers can benefit.
- If worse off they often cannot.
- 85 per cent of costs can be ignored in disputes.
- FSA to blame for not exposing its own limitations.
- Mis-selling. Some yes. But many, including Consumers Association, recommended low cost endowment as a good buy.
- Full report follows: facts were verified by those listed in introduction.

From A. W. Tait, O.B.E.

**Orchard Croft
Grimms Hill
Great Missenden
Bucks HP16 9BA
Tel: 01494 862061
Fax: 01494 867111**

Home Buyers' Advisory Service
18 Seymour Place
London W1H 7NQ

INTRODUCTION

You invited me to report on recent claims by the Financial Services Authority that up to five million endowment borrowers are facing losses, a statement by the Consumers Association that compensation of billions of pounds is needed, and newspaper publicity that four million homes may be at risk of repossession. Most current cases, you recently advised, relate to individuals who took out endowment mortgages in the period 1987-1993.

My report is attached. The results of my investigations came as a considerable surprise. The facts do not support any of the above. It was also difficult to believe that claims for compensation were being considered without anyone seeking to establish if the claimant's costs had gone up or down.

An endowment mortgage, as you know, is made up of two parts. It was again surprising that all attention was focused on the part which cost only 15 per cent of the whole, and that the 85 per cent was ignored. This was almost bound to mislead. FSA statistics conceal, I fear, more than they reveal.

I am most grateful to those who have helped me by checking facts, reading drafts, and putting forward suggestions. These include Michael Hall, a former member of the Council of Insurance Ombudsmen, the Association of British Insurers, Scott Bell, former Chief Executive of Standard Life, and Archie Rennie, former Secretary of the Scottish Home and Health Department.

For the record my own relevant qualifications include that I have been a Regulator of private house-building, chairman of a specialist insurance company with long-term liabilities, and adviser on long-tail insurance problems to National bodies and State Governments in Australia, Canada and the USA.

4 November 2002

MOST ENDOWMENT “VICTIMS” ARE IN PROFIT

Contrary to recent publicity, most of the five million endowment “victims” have made a net gain, often thousands of pounds a year, from the steep fall in interest rates and in stock market prices. Some have nevertheless received compensation for “loss.”

How can this be? The Financial Services Authority has misled itself, and the public, because it has powers to look only at investments, a small part of the total cost of an endowment mortgage.

An Endowment mortgage has two parts. One is a loan of the amount borrowed. The other is an investment to pay off the loan. The FSA has had to ignore the cost of the loan though this was often over 85 per cent of the total. Patently, figures based on much the smaller part can produce an absurd result. It is almost like judging the score of a cricket team on the performance of two of the eleven players.

No one can criticise the FSA for the limits imposed on it, but they should have highlighted how this creates a false picture. They should have acknowledged that the savings from lower interest rates have usually far exceeded the amount needed to compensate for any shortfall in the investment element.

A typical borrower of £50,000 in, say, 1990 now saves over £2800 a year on his total borrowing costs compared with what he originally paid and budgeted to go on paying, even after doubling the investment premium of £800 keep it on track.

All endowments have this “belt and braces” protection. When interest rates fall it costs more to keep the investment (the belt) on track, but it costs very much less for the loan (the “braces”). Good advisers foresaw this and took account of it in recommending endowments.

The following table shows the picture. Figures are before tax relief and any special discount.

Date	Loan	Annual Cost of Repayment of Interest	Annual Cost of Investment Premium	Total Annual Cost
1990	£50,000	£6,500	£ 800	£7,300
2002	£50,000	£2,875	£1,600	£4,475

The endowment borrower is £2,825 better off. Despite this under existing FSA rules he can obtain compensation for “loss”.

Of course the exact figures vary with each case. Some borrowers may be £5000 a year better off. Others may be only £1000 a year or less. There may be some who are in real loss. No one knows because the FSA never asks whether a claimant’s total borrowing costs have gone up or down.

THE COMPENSATION MUDDLE

Who deserves compensation? Common sense may suggest that those who are genuinely out of pocket should be first in the queue. The FSA unfortunately has not tried to find out who they are. Under FSA rules a claimant is in “loss” if the investment faces a shortfall of £100, even if the loan interest cost falls by one thousand pounds. A claimant can be £1000 or even £5000 a year better off overall and still receive compensation for “loss.”

It gets worse. If steep inflation returned, with interest rates of ten per cent or more, endowment borrowers would be thousands of pounds a year worse off overall. Despite this they would no longer be in “loss” because the investment element would be back on track.

In short, a better off borrower can be in “loss” and can be compensated. A worse off borrower will not be in “loss” and cannot. Does this make sense? Does Parliament understand what is going on?

The FSA may plead that the endowment borrower deserves compensation because, although not in loss overall, he is doing less well than with repayment. He may save, say, £2000 a year after topping up his investment but the repayment borrower saves £2600. So he has “lost” £600.

There are two arguments against this. First, payment for absence of gain takes the compensation culture into new areas. Not even the US has gone this far.

Second, what of the millions of repayment borrowers who made a “loss” because they lost out on the high bonuses paid to endowment borrowers? Were they warned of the risk?

Are we to have a permanent compensation industry where payments are made alternatively to endowment and repayment borrowers?

THE MIS-SELLING MUDDLE

Was there mis-selling? The hype says “yes” but what are the facts? Some were mis-sold by being given false guarantees that endowment investments would hit their target. Beyond this, the arguments were much more balanced than is now understood, e.g. The Consumers Association, contrary to their present stance, concluded that repayment and low cost endowments were ‘neck and neck’ as best buys, and that the correct choice would often be which was cheaper. In a high inflation era this was usually endowment.

It is also the case that in this era lenders often insisted that loans of over 95 per cent were endowments. Also contrary to current probability, endowments and repayments involved roughly equal risk.

The main risk - a rise in interest rates in the critical years – applied equally to endowment and repayment borrowers, thousands of whom were subsequently repossessed. Those who chose repayment faced the additional risk – a probability on the evidence available – of missing out on a high terminal bonus. If endowment was chosen and unexpectedly inflation fell to a low level, repayment borrowers would do better; but endowment borrowers would benefit too. The savings on the loan costs would far exceed any extra needed to keep the investment on track. The risk of the borrower being out of pocket was minute.

It is not surprising, therefore, that most of those employed in financial services, including the risk adverse, opted for endowments.

What of the Regulator? Did he then say that endowments should never be sold to cautious borrowers? He did not. On the contrary he allowed insurers to illustrate future benefits on assumptions of annual investment growth of 7.5% and 10.5% every year for 25 years. This helped to promote sales.

Against this background, except where guarantees were falsely given, charges of widespread mis-selling are not supported by the evidence. Undoubtedly many sales were commission influenced but this does not prove that the advice then was wrong. As Equitable Life has shown absence of commission is no sure guide to correct choice. On the evidence available in 1987-1992 endowments had many advantages and as explained above and in Appendix B involved risks similar to repayment.

DISCUSSION

Initially FSA, new to the mortgage business, may not have understood that an endowment mortgage is in two linked parts, or that their remit was going to be limited to dealing with only one part which, as judged by cost, was much the smaller. By now they should have grasped this, and that it has led to the absurdity of “better off - compensate” “worse off - no compensation”, as well to the inherent injustice of ignoring 85 per cent of relevant costs in deciding who is in “loss”. They should, therefore, have advised Ministers that the present nonsense should end, and that immediate action should be taken to enable and require FSA to look at all relevant costs. If they have not done this they have been negligent: if they have, what are Ministers doing?

Meanwhile these questions are relevant. Obviously mis-selling did take place where false promises of a guaranteed outcome were made. Obviously the borrowers deserve compensation if they are out of pocket. But what if they are not? Do we wish the compensation culture to extend further?

Where does blame lie if figures based on the assumptions allowed by the regulator influenced the borrower, but were later found to have been too optimistic? Should the borrower use some of the savings on loan interest to ensure that the loan is paid off at the end of the term. He will after all be still be in pocket. Should the insurer pay? Or the lender who often offered best terms on an endowment only basis. Or should the adviser who took account of this, and used the illustrations approved by the

Regulator have to pay? Or should the Regulator pay? Will the current Regulator, who with hindsight, is taking a different view, sue the former Regulators?

FSA has lately pointed out that many investors are not numerate. It is regrettable that FSA has shown little regard for probabilities and quantification of risk in its approach to risk assessment. If all the risks were fairly explained to borrowers it is nonsense to conclude that a particular borrower, cautious or not so cautious, would have opted for endowment or for repayment. The choices were balanced. Some would have chosen one, some another. Human beings are like that. This subject is further discussed in Appendix B.

Meanwhile it should be recorded that the mantra “repayments were the only safe way of ensuring that the loan was repaid” is misleading, unless it is supplemented by “if, and only if payments were kept up, which could and did vary unpredictably, and which later might rise to levels the borrower could not afford.”

A fairer statement would be that repayment and endowment were equally exposed to far and away the biggest risk – that interest rates would rise. This led later to thousands of repossessions. So far as is known no one has been repossessed because of endowment investments falling short. The “belt” of investment may have failed but the “braces” of lower interest costs has put the borrowers well in pocket.

RECOMMENDATIONS

1. In 2004 FSA will be given power to look at loans as well as investments. It seems unlikely that this will apply retrospectively. In any event it is suggested that the FSA should meanwhile concentrate on cases where the borrower was given false “guarantees” that the endowment would meet its objectives.
2. Beyond this, the argument for different choices was evenly balanced and it will usually not be possible to decide fairly which choice an individual would have made, had he or she been given a totally fair presentation of all the pluses and minuses. It is wrong to assume that a cautious investor would have opted for repayment or even on the evidence then available have been wise to do so.

3. The question of where the line should be drawn in obtaining compensation for individuals is a big subject, well beyond the scope of this report. However, the current practice of compensating individuals for “loss”, when in fact their total borrowing costs have been reduced, sets dangerous precedents and should be reviewed.
4. Mis-selling is not confined to companies and individuals or endowments. If bad advice or actions by Government Departments or Regulators in any area lead to losses by individuals should the individual be able to seek compensation.
5. All current problems could have been prevented if endowment policies had been kept on track by automatic switching of a small part of the loan savings from lower interest rates to top up the endowment premiums. This solution would not work well in our low inflation era, but would make endowments an ideal product if there was a return to high inflation.
6. Now that borrowers have become used to enjoying all the savings from lower interest rates it is more difficult to persuade them to help themselves by switching some of the savings to ensure the loan is repaid at the end of term. Every effort should focus on this.
7. Top priority . FSA should explain to Ministers how its limited powers have led to the absurdity of “better off = in “loss” and compensation” “Worse off = no “loss” no compensation” and to ignoring the most relevant costs in disputes. Immediate remedies are needed.

APPENDIX A
OMBUDSMAN'S ROLE

1. An Ombudsman was originally an official who was free to investigate complaints against the Government or its servants.

2. The FSA Ombudsmen are seen to have no such freedom. They are required to have regard to the FSA Rules, even if these conflict with common sense. The dictionary definition of "loss" is the amount by which the total of a transaction exceeds the total income. Despite the, the FSA does not allow its Ombudsmen to ask claimants for details of their total borrowing costs.
Example: The total annual cost of an endowment loan of £50k in, say 1990 was usually £7,300 made up of £6,500 for repayment of interest plus £800 investment premium to enable the loan to be repaid at the end of the term. Because of its limited powers the FSA Rules provide that the £6,500 must be ignored, and only the £800 considered. If the £800 has gone up, the claimant is in "loss" even if the £6,500 has fallen (as it has) to £2,825, and the total annual costs have fallen by £3,000 a year, or more.

3. Ironically, if steep inflation returned, and with it, interest rates of 10% or more, endowment borrowers would be much worse off than they are now. FSA would, however, rule that most borrowers were not in loss because the investment part of the loan would be back on track to meet its objective.

4. In short, a better off borrower can be in "loss". A worse off borrower, even if facing repossession, will probably not be in "loss".

5. Does this make sense? No. Parliament may be blamed for limiting FSA powers to look at investments only. (This changes in 2004.) FSA and its Ombudsmen may be blamed for not bringing the nonsense to public attention and pressing for change.

APPENDIX B

Assessment of Relative Risks facing Mortgage Borrowers in high inflation era.

This does not include personal risks, from health, loss of job, couples splitting up.

A. Higher Interest Rates

This risk applied almost equally to endowment and repayment borrowers. Because it was the only risk which seriously threatened affordability and might lead to repossession (thousands were repossessed) it is assessed as 80 per cent of the total.

B. Other Risks

(a) The Repayment borrower loses out on the terminal bonuses which had almost invariably been paid to endowment borrowers. Risk. 9 per cent of the total.

(b) The Endowment borrower has to lose a percentage, usually 10 to 40 per cent, of the savings from lower interest rates to keep the endowment investment on track. Risk. 11 per cent of the total.

In contrast to A, neither of the above involved a serious threat to affordability or of repossession. It is more a matter of the repayment borrower losing out to the endowment borrower on the one hand, and the endowment borrower to the repayment on the other. On the evidence available B(a) was more likely to happen but B(b) was arguably more important. The careful borrower would weigh both how likely each is to happen, and how important. The percentages allotted take account of this.

CONCLUSION

Endowment borrowers 91 per cent. Repayment borrowers 89 per cent. Obviously these figures are based on subjective judgement but they do reflect fairly that whatever choice the borrower made, repayment or endowment, he did face real risks. There was no "safe" option and the Consumers Association estimate of "neck and neck" seems fair.