

# False premises

Are red warning letters being sent to endowment mortgage policyholders when no real risk exists? Yes, says **Alan Lakey** of Highclere Financial Services, and it's mainly because of bad rules, not bad products

**T**HE PERSONAL INVESTMENT Authority (PIA) announced the issuing of mortgage endowment re-projection letters in January 1999 within Regulatory Update 62 (RU62). Originally an Association of British Insurers' (ABI) initiative, these have since been adapted and modified by the Financial Services Authority (FSA). The ABI also issued an amended Code of Practice in June 2004.

What began as an exercise designed to advise policyholders of the probable maturity values of their plans, and the possible need to take remedial action, has since turned into a major bloodletting. Compensation frenzy has ensued with the industry cursed by a proliferation of 'claims experts', many having devolved from a previous advisory capacity. The popular press, parading its consumer champion hat, has boosted the notion that most endowments were unsuitable and therefore mis-sold.

At one point, endowment mortgages accounted for more than 80% of all mortgage applications but, inexorably, their appeal has ebbed and few are now bought. Indeed, most insurers have removed low cost endowments from their product list.

## Current position

The typical re-projection letter appears to show the with profit endowment as off track and unlikely to hit the relevant target. Why is it that, in just six years, these plans appear to be so poisonous?

The consumer section of the FSA website [www.fsa.gov.uk/consumer](http://www.fsa.gov.uk/consumer) explains that falling projection rates are "because funds supporting your endowment policy are mainly invested in shares". This viewpoint is at best outdated and at worst disingenuous. As the April 2005 *MM* points out, the average equity content of with profit life funds is 41%. **Scottish Equitable** held only 17% equities and **Royal London** none.

Until the mid-1980s, the traditional with profits low cost endowment comprised a guarantee augmented by annual bonuses

and a terminal bonus. This type of plan was considered safe because the guarantee was typically based around an assumption that 80% of the then current annual bonuses would be paid. This style of traditional with profits plan was considered low risk, a view recently endorsed by the Financial Ombudsman Service.

Between 1995 and July 1999 the standard annual growth assumptions were 5%, 7.5% and 10%. The default rate for most providers was the middle growth figure of 7.5% and the majority of plans were written on this basis. In 1999 the growth assumptions were reduced to 4%, 6% and 8%. Therefore, even if an existing plan was achieving the targeted 7.5% annual growth, and consequently was on course to repay the loan, the assumed 6% figure would trigger an 'amber' warning implying a significant risk of failure.

Some providers did not allow a choice of growth assumption, basing their plans on the established practice of projecting 80% of the then current reversionary bonus and making no allowance for a terminal bonus.

With profit funds enjoy operating profits but also suffer the consequences of new business costs, system upgrades, regulatory expenses – including fines – and also the cost of compensation payments.

The reduction in the equity content of these funds is not entirely due to the 2000/2002 market crash but to the 'realistic' accountancy principles mandated by the FSA, a requirement which cost **Standard Life**, and by default its with profit policyholders, incalculable billions when they were constrained to sell shares early in 2004 when the FTSE100 stood at 4,500.

Consistently low interest rates over the past 10 years have also had an effect. More importantly, the adverse impact of insurers using the erroneous Life Assurance and Unit Trust Regulatory Authority (LAUTRO) expense assumptions has diverted many plans off course from day one, a travesty that is sure to have legal ramifications.

**Box 1** : Current re-projection rates

|                      | Lower growth rate % | Medium growth rate % | Higher growth rate % |
|----------------------|---------------------|----------------------|----------------------|
| Alba Life            | 3.00                | 6.00                 | 8.00                 |
| Axa                  | 4.00                | 6.00                 | 8.00                 |
| Clerical Medical     | 4.00                | 6.00                 | 8.00                 |
| Friends Provident    | 4.00                | 5.50                 | 8.00                 |
| Guardian             | 4.00                | 6.00                 | 8.00                 |
| Legal & General      | 4.00                | 6.00                 | 8.00                 |
| Norwich Union        | 4.00                | 5.00                 | 6.00                 |
| Prudential (Scot Am) | 4.00                | 6.00                 | 8.00                 |
| R&SA - conventional  | 3.75                | 4.50                 | 5.50                 |
| R&SA - unitised      | 4.00                | 4.50                 | 5.25                 |
| Scottish Equitable   | 3.50                | 5.50                 | 7.50                 |
| Scottish Life        | 4.00                | 6.00                 | 8.00                 |
| Scottish Mutual      | 3.50                | 4.75                 | 6.00                 |
| Scottish Provident   | 3.50                | 4.75                 | 6.00                 |
| Scottish Widows      | 4.00                | 5.00                 | 6.00                 |
| Standard Life        | 4.00                | 5.50                 | 7.50                 |
| Zurich (Eagle Star)  | 3.00                | 3.75                 | 5.00                 |

## Traffic light system

Re-projection letters are traffic light coded. Projected failure using the higher growth rate prompts a red letter with notice of a high risk of non-repayment. Failure at the middle growth rate signifies significant risk and an amber warning. Apparent failure at the lower growth rate means a green letter.

Now this may seem unambiguous and for some a very sound basis for relating a complex issue in a way that the layman can understand. Of course, in financial services nothing is ever so straightforward.

For instance, what growth assumption generates a red letter? **Alba Life**, **Axa**, **Clerical Medical** and **Prudential**, among others, all confer red status on plans that appear off target assuming future annual growth of 8%. **Norwich Union** and **Scottish Widows**, companies generally viewed as more financially sound than **Alba Life**, issue red letters when the plan is off target at 6% future growth.

**Norwich Union** explained that it uses a lower growth assumption to cover the cost of the guarantees as an alternative to reducing the equity content of the with prof-

**Box 2** : Various calculation methods

|                      | Traditional with profits  | Unitised with profits   |
|----------------------|---|---|
| Alba Life            | Current guarantee plus assumed bonuses  | Current plan value plus earned TB   |
| Axa                  | Surrender value   | Surrender value   |
| Clerical Medical     | Unsmoothed net asset value projected forward                                    | Surrender value   |
| Friends Provident    | 95% of asset share plus earned TB   | Current value plus + TB less any MVA  |
| Guardian             | Asset share with TB at date of calculation                                      | SV including any TB or MVA applicable   |
| Legal & General      | Premiums paid less expenses projected forward – effectively the surrender value | Premiums paid less expenses projected forward – effectively the surrender value |
| Norwich Union        | Premiums paid less expenses projected   | Premiums paid less expenses projected   |
| Prudential (Scot Am) | Current value based on investment performance to date                           | –   |
| Royal & SunAlliance  | Sum assured + bonuses projected using supportable rates of bonus.               | Asset share projected forward less assumed expenses                             |
| Scottish Equitable   | Asset share with TB at date of calculation. Broadly similar to SV               | SV including any earned TB  |
| Scottish Life        | Not advised   | Not advised   |
| Scottish Mutual      | Sum assured + bonuses projected using rates of supportable bonus                | Current value less any MVA projected forward                                    |
| Scottish Provident   | Sum assured + bonuses projected using rates of supportable bonus                | –   |
| Scottish Widows      | Underlying asset value – effectively the surrender value                        | –   |
| Standard Life        | Asset share   | Asset share   |

**Note:** TB – Terminal bonus; SV – surrender value; MVA – market value adjustment

its fund. This reprojection exercise reaches its nadir with **Eagle Star**, which issues red letters if off course using 5% future growth.

Similar variations abound in the issuing of amber and green letters. The FSA allows such discrepancies because each insurer is able to choose a lower growth assumption if it considers such a rate more realistic.

**Box 1** shows the current reprojection rates being used.

This must be confusing to the average policyholder. Imagine a client holding low cost endowments with both Prudential and Eagle Star where the anticipated future growth is 5.5% pa. Prudential will issue a green letter whereas Eagle Star generates a red letter. Was it the regulator's intention that such a veil of confusion be draped across the question of mortgage repayment?

**Further concerns**

There is also a disturbing, aspect to many of the reprojection letters and it centres on the mechanism that insurers use to project future growth. RU62 stated that the basis of calculation should be “the full value of the policy, taking into account the underlying assets and an allowance for any accrued miscellaneous surplus”. It also noted that “the use of a surrender value, if lower than the current value, would produce a conservative rather than a realistic result”.

The RU62 guidance appeared to balance achieved returns against the need for prudence and was issued a full year before the bear market of 2000. In reality, it allowed much latitude and the insurers have devised various calculation methods, impacting on the projected values. In many cases these serve to mislead the policyholder.

Purposely misinforming the policyhold-

er, whether through corporate arrogance, altruism or simply system convenience, fails to satisfy the FSA's treating the customer fairly initiative. Conversely, many argue that the whole reprojection exercise is the regulator's subtle method of appeasing the consumer lobby by effectively instigating an industry-wide review without fielding the same level of flak as with the pension reviews, a view reinforced by evidence from the recent FSA v Legal & General mis-selling case.

**Methodology**

It is in the interests of policyholders, advisers and the insurers for rejections to be fair and honest without provoking undue alarm or overestimating future growth prospects, which is precisely what happened in the late 1988/1995 period with the LAUTRO prescribed projection rates and synthetic expense assumptions. After all, an apparently poor performing plan is more likely to cause alarm and is also more likely to be surrendered.

From an adviser's perspective there is the alarming consequence that whilst the investment return within these plans is not in itself cause for a compensation claim, it is this implied lack of growth that serves as the catalyst for such complaints and fuels the tanks of the burgeoning bands of ambulance chasers. Variations of these reprojection calculations can be seen in

**Box 2.**

**Axa, Guardian, Legal & General, Scottish Equitable and Scottish Widows** have all chosen to reproject from what, effectively, is the surrender value. It defies logic as to why a value based on penalised early encashment should be used to establish a possible maturity figure. Perversely, the FSA is fully aware of this because the consumer

section of its website advises that the starting point for rejections is usually the surrender value. This folly, and the use of other dubious reprojection methods, has the ability to mislead in a major way.

Insurers are desperately trying to rebuild their reserves. This exercise involves limiting current bonus payments, which is then reflected in the projections. This further develops the reliance on terminal bonus and of course further diminishes the current plan values for reprojection purposes.

**Axa** asserts that it “only makes sense... to use the surrender value as a proxy for the value of the underlying assets”. **Friends Provident** accepts that the application of a market value adjustor (MVA) penalty will show the reprojection in an unfavourable light but explains that it produces the same result as a true value projected at a lower growth rate. The logic seems nebulous and such an explanation will prove beyond the understanding of most policyholders.

**Legal & General** asserts that “there is nothing to be gained from having a full and detailed breakdown of the projection calculation”. Advisers and policyholders will surely disagree. It is one of the providers using surrender values, which may explain its reticence. **Scottish Provident** uses a concept called ‘supportable bonus’ where different levels of terminal bonus are assumed for the three growth assumptions. **Eagle Star** failed to respond to enquiries. However its calculations raise numerous questions, as shown in **Box 3**.

Laudably, **Prudential** uses conventional mathematics to project future growth and whilst its growth rates of 4%, 6% and 8% may or may not prove reasonable they are dealing from the top of the pack and in the process not adding to policyholders' woes.

Tellingly, **Standard Life** asserts that a projection is only an estimate as was the original illustration because charges can change during the life of the policy. It further asserts that, regardless of whether the charges were true calculations or LAUTRO inventions, the onus for the advice remains with the adviser!

**Traditional with profit plans**

The concept of projecting these plans using annualised growth rates is doomed from the outset. The very nature of these plans and the concept of smoothing fails to lend itself to assumed level growth.

A typical 25 year low cost endowment maturing this year with a £50,000 target may show a guarantee of £13,500 together with annual bonuses of £25,000 and a terminal bonus of £19,000. It is manifest that a plan offering a guarantee, augmented by further bonuses with the additional potential for a terminal bonus on maturity, cannot be conceived in terms of consistent growth. It is only at maturity, when the ter-

**Box 3 : Illustrations of flawed rejections**

| Company & plan details   |                   | Current position | Rejection advice |
|--|-------------------|------------------|------------------|
| 1 <b>Eagle Star</b><br>Traditional with profit endowment,<br>25 year plan with 10 years remaining        | Initial guarantee | £19,886          | 3.00% = £32,500  |
|  | Current bonuses   | £7,319           | 5.00% = £38,300  |
|  | Total guarantee   | <u>£27,205</u>   |                  |
| 2 <b>Friends Provident</b><br>Traditional with profit endowment,<br>21 year plan with 8 years remaining  | Initial guarantee | £4,338           | 4.00% = £5,790   |
|  | Current bonuses   | £1,373           | 5.50% = £6,400   |
|  | Total guarantee   | <u>£5,711</u>    | 8.00% = £7,550   |
| 3 <b>Scottish Provident</b><br>Traditional with profit endowment,<br>17 year plan with 5 years remaining | Initial guarantee | £16,013          | 3.50% = £21,600  |
|  | Current bonuses   | £5,407           | 4.75% = £23,400  |
|  | Total guarantee   | <u>£21,420</u>   | 6.00% = £25,200  |
| 4 <b>Standard Life</b><br>Traditional with profit endowment,<br>25 year plan with 6.5 years remaining    | Initial guarantee | £10,860          | 4.00% = £20,040  |
|  | Current bonuses   | £9,180           | 5.75% = £22,000  |
|  | Total guarantee   | <u>£20,040</u>   | 7.50% = £24,400  |

**Box 4 : Terminal bonus additions as a percentage**

| Additional terminal bonus on a: | 10 year plan | 15 year plan | 20 year plan | 25 year plan |
|---------------------------------|--------------|--------------|--------------|--------------|
| Axa                             | n/a          | n/a          | n/a          | n/a          |
| Clerical Medical                | 4.0          | 0.0          | 3.0          | 34.7         |
| Friends Provident               | 0.0          | 7.3          | 3.4          | 48.2         |
| Guardian                        | n/a          | 29.4         | 41.8         | 76.5         |
| Legal & General                 | 0.5          | 9.0          | 17.9         | 23.9         |
| Norwich Union                   | 6.5          | 11.2         | 9.8          | 32.2         |
| Prudential (S Am)               | 10.0         | 16.0         | 16.3         | 31.0         |
| Royal & SunAlliance             | 0.0          | 12.0         | 18.0         | 41.0         |
| Scottish Equitable              | 16.5         | 25.1         | 24.7         | 40.6         |
| Scottish Life                   | 3.0          | 10.0         | 15.0         | 40.0         |
| Scottish Mutual                 | 0.0          | 0.0          | 9.7          | 24.2         |
| Scottish Provident              | 0.0          | 0.0          | 0.0          | 16.0         |
| Scottish Widows                 | 1.0          | 7.0          | 12.0         | 34.0         |
| Standard Life                   | 0.0          | 0.0          | 12.0         | 47.0         |

Terminal bonus on maturity as a % of the existing guarantees as at February 2005.

terminal bonus may have been paid, that a yield can be measured.

The smoothing process cannot, in every instance, allow for large market fluctuations as evidenced by events in recent years. This lack of transparency has been the undoing of the with profit concept and has never been more obvious than in the reprojected exercise.

**Unitised with profit plans**

These plans offered no guarantees at the outset and relied on the compounding of annual bonuses and the expectation of a terminal bonus. As such they are similar to unit linked plans apart from the gradual build up of bonuses guaranteed at maturity. Although boosted by providers as no different from the traditional variety (**Standard Life** again) it is fact that, by removing the guarantee and assumption of bonuses and moving to a growth assumption, the onus was switched from the provider across to the adviser.

Some plans have guarantees higher than the underlying asset value and on surrender a market value adjustor (MVA) is applied. Given that the penalty only applies if the plan is surrendered, logic dictates that such a penalty should not be applied when reprojecting maturity values. However, **Clerical Medical**, **Friends Provident**, **Guardian** and **Scottish Mutual** all use such a device to diminish the current plan value and consequently the projected values.

Many of these plans were based on low allocation rates in the early years. Typical was **Standard Life** where only 50% of the premium was invested during the initial 24 month period with 103.5% invested thereafter. Unsurprisingly these plans will show a low value in the early years as they play catch up until maturity. A low value that is then used to produce flawed rejections.

**Flawed rejections**

As stated, the effect of the various calculations is often one of misinformation. Box 3 shows examples of this. Such misinforma-

tion can have the consequence of turning what would have been a green letter into amber and an amber letter into red. RU62 advised, "an appropriate assessment of the current policy value in respect of premiums paid to date is critical in ensuring that the projection is realistic". The examples in Box 3 are anything but realistic.

In March 2004, Prudential advised a planholder that his policy, due to mature in March 2005, would suffer shortfalls at 4%, 6% and 8% annual growth – a 'red letter'. With a year to maturity Prudential advised that "6% each year is currently a reasonable assumption". This would have produced a £400 shortfall. In March 2005 the plan actually matured with a £1,243 surplus, implying final year growth in excess of 20%. What could have been a disappointed client and a possible complaint turned into satisfaction and a happy client.

The first example in Box 3 highlights the bizarre scenario of 4% growth over a six and a half year period achieving no additional growth. Such a projection confirms the folly of using a surrender value, or equivalent, as the base figure. Some might suggest that the current guarantee is higher than the asset share and therefore has yet to be earned. However a bonus of £72.69 has recently been added to this policy and one assumes that a terminal bonus of some kind will be added on maturity. Currently, a maturing 25 year **Standard Life** plan receives a terminal bonus equating to 47% of the guarantee and attaching reversionary bonuses. This may be significantly different in the future, but...

**Friends Provident** projects 95% of the calculated asset share on traditional plans, which is effectively a 5% penalty and therefore a projected £19,000 maturity would really be £20,000. One client has a **Friends Provident** plan which has a guarantee and accumulated bonuses of £5,711. The client pays £19.18 pm and has just over eight years to maturity. His reprojected letter advises that over this period 4% annual growth will add £79 to his pot. How

can this be? How can eight years of growth at 4% equate to £79?

**Terminal bonus**

Most insurers include an element of terminal bonus within their base value. The method of allocating any such bonus again militates against fairness, however.

**Standard Life** is not atypical here. In arriving at a base value for a policy currently in the 15th year of a 25 year term, it uses the amount of terminal bonus accumulated thus far. This may appear reasonable but terminal bonuses on maturing 25 year plans are higher than those on maturing 15 year plans. As a result, using the notional 15 year terminal bonus effectively understates the potential return.

The FSA, in its summary of responses to CP158, rejected claims that terminal bonuses were not being taken into account within rejections stating that "explicit guidance" was provided within RU62. The guidance confirmed the incremental nature of terminal bonuses but the reality has always been that terminal bonuses on 25 year endowments have been higher than those on maturing 10, 15 and 20 year plans due to the build up of surplus assets.

**Box 4** shows the percentage addition to the guarantee and accumulated bonuses as shown in the April 2005 *Money Management* with profits survey.

**The future**

The with profits concept seems to be mortally wounded. Are insurers losing interest in these funds now that they are no longer sold in volume? In the 1980s and 1990s, they were eager to project forward using the maximum allowed growth assumptions to many policyholders' disadvantage.

They now appear diffident and apologetic, choosing to use lower rates than required – again to policyholders' disadvantage. Formerly providers overstated the potential of their endowments, now their reprojected mechanisms are such that the future growth is being understated. **M**