HANDLING ENDOWMENT COMPLAINTS

by Adam Samuel

This paper was updated most recently in April 2004. It was originally written in 2002. Updating long papers like this is not the easiest of tasks. There is the inevitable risk that old references have been left unaltered and others not inserted. Adam Samuel provides an information and consulting service to go with case-based endowment complaint handling courses. Each are provided as part of firms' obligations to review their procedures regularly to ensure compliance with the standards laid down in the Tiner letter of April 2002.

I: INTRODUCTION

Before its Regulatory Update 72 came through the letter box on Christmas Eve 1999, the regulator had kept very quiet about endowment sales complaints. There was the odd LAUTRO Enforcement Bulletin relating to advanced endowment sales, roll-up mortgages and churning.[1] PIA had never done anything in its first five years. Since then, however, it has been difficult to avoid the various forms of Guidance from regulators and the Ombudsman scene.

As with so many things, it all goes back to the Pension Review. The vastness of that process surprised many of those who brought it into being. This has scared the regulators off organizing an endowment review in spite of widespread evidence of misselling. There is a clear attempt to justify avoiding a review by doing everything to encourage people to complain about endowments. The regulator has effectively moved a great deal of business review work to the complaint handling function. The latter had better be ready for it. Already, the FSA, in its Final Notices explaining fines imposed on Allied Dunbar and Friends Provident, has expressed its upset that firms have abused its decision not to hold a full-scale endowment review.[2]

The early signs have not been good. The last couple of years have seen horrific rises in the number of complaints reaching the PIA Ombudsman Bureau. That organization has bee[3]n consistently upholding about half of the complaints that reach it. Something has had to give.

In October 2000, the Financial Ombudsman Service issued "A briefing note for firms: complaints about mortgage endowments". This was followed a month later by the FSA Consultation Paper 75 on the subject of compensation. In May 2001, the order was reversed with the FSA issuing its Policy Statement on endowment redress (now

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[1] LAUTRO EBs 2, 5 & 13.

[2] FSA Final Notice to Friends Provident Life and Pensions Limited, 15 December 2003 at p. 3.

incorporated in the rules as DISP Appendix 2) and the next month the Financial Ombudsman Service issued a Mortgage endowment complaints assessment guide including decision trees covering both whether to uphold a complaint and the compensation payable.

The last couple of years have seen a new source of information emerging on endowments: Final Notices. The FSA issues these to explain disciplinary action. Since N2 (30th November 2001), it has issued three fines for misselling and two for bad complaint handling. All five Notices represent reasonably authoritative guidance on what the regulator expects. The complaints notices are also based around the Tiner letter sent to firms in April 2002. A failure to do a Tiner review, by checking procedures off against the key points in that letter has become a clear ground for disciplinary action.

This paper is written against that background in an attempt to get to grips with the latest material.

II: THE BACKGROUND

In the early 1980s, endowments were a good product to sell because of LAPR through which the Government essentially gave tax relief of half the basic rate of income tax to anyone who took one of these policies out. Mick Newmarch of the Prudential described it as a Government "licence to print money" given to the industry. The abolition of LAPR for policies taken out after 17th March 1984 followed by lower investment returns in the 1990s have given us the crisis we have today. They also render almost irrelevant to the misselling discussion, the returns on plans maturing at the current time.

Nevertheless, there has always been one constant feature of these policies, the lapse rate. About one in four people who take out endowments stop them in the first four years.[4] With early surrender penalties, they will have lost out by going down the endowment route.

The Institute of Actuaries in its October 1999 report put it all very simply. "The repayment method is the most straightforward and low risk method of repaying a mortgage and any proposed alternative needs to be demonstrably better..."[5] In other words, there is an assumption that the sale of an endowment is not best advice unless the company can show that such a product was demonstrably better in the circumstances.

III: GROUNDS FOR UPHOLDING THE COMPLAINT

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[4]PIA, Fifth Survey of the Persistency of Life and Pensions Policies, October 1999 at p. 18.

[5]Report of the Endowment Mortgages Working Party, Faculty and Institute of Actuaries, October 1999.

(i) The Law

Since at least 1766, insurers have had a duty to give full disclosure of the risks and disadvantages of the policy of insurance and to avoid misleading customers.[6] The consequences of such non-disclosures and misrepresentations generally were to allow the client to avoid the contract and receive a refund of contributions without any deductions for the cost of life cover.[7] (Judgements only refer regularly to interest later in the 20th century.)

Similarly, since at least the 19th century and probably before then, assurers could be held liable for causing someone to enter into a contract by a fraudulent statement.[8] In the 1960s, the Courts decided that anyone who offered expertise to another person would have to pay damages if they acted negligently in providing that expertise.[9] Section 2(1) of the Misrepresentation Act 1967 allowed a person who induced another to contract with him, by a misleading statement, to be liable for any resulting damages unless he could prove that the statement was not careless. Section 2(2) of the Act also allowed the court in its discretion to award damages to a person who could otherwise avoid a contract for misrepresentation so as to keep the contract in force. It reads:

> "Where a person has entered into a contract after a misrepresentation has been made to him otherwise than fraudulently, and he would be entitled, by reason of the misrepresentation, to rescind the contract, then if it is claimed, in any proceedings arising out of the contract, that the contract ought to be or has been rescinded, the court or arbitrator may declare the contract subsisting and award damages in lieu of rescission, if of the opinion that it would be equitable to do so, having regard to the nature of the representation and the loss that would be caused by it if the contract were upheld, as to the loss that rescission would cause to the other party."

It will be noted that this does not apply to contracts voidable for non-disclosure.

Since the Middle Ages, people have been able to sue for breach of contract. This, though, raises a question: what terms are in the contract(s) made during the sales or advice process. If it appeared from the parties' conduct that they intended something to be part of their agreement, it was. Contractual promises have to be unequivocal to be binding. Essentially, if an adviser promises something if only the client will sign

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[6] Carter v. Boehm (1766) 3 Burr. 1905 at p. 1909.

[7] Refuge v. Kettlewell [1909] A.C. 243

[8] Derry v. Peek [1889] App.Cas. 337

[9] Hedley Byrne v. Heller [1964] A.C. 465

the proposal, that promise will either become part of the contract or form a collateral agreement with the same effect.[10] If the firm then fails to deliver on the promise and causes a loss as a result of that failure, the client can sue for damages.

The position with IFAs is a little more straightforward. There are two grounds for concluding that the IFA has a duty to exercise reasonable care in advising and making statements to his client.[11] First, it is implied into the contract with his or her client that the adviser will exercise reasonable care. (A similar obligation was imposed on a solicitor in 1939.[12]) The other way of analysing the situation, reached by the 1960s, was that the IFA by offering expertise to the client become subject to a duty to exercise care in exactly the same way as the life assurer salesman.

Section 62 of the Financial Services Act gave an extra weapon to policyholder against life assurers and IFAs alike. Section 62(1) gave customers of firms directly regulated by SIB the right to sue the firm for any losses caused by a breach of the SIB Conduct of Business Rules. Subsection (2) then extends this right to any lay client of a self-regulating organization with respect to breaches of its conduct of business rules. Section 62 has effectively been reproduced in section 150 of the Financial Services and Markets Act 2000.

There is no significant difference between the various conduct of business rules. They can be summarised very simply. When selling endowments, the adviser must take all reasonable steps to gather all relevant information to enable him to recommend only products suitable to his clients needs[13] and then give suitable advice.[14] He must also disclose the risks and disadvantages of the transaction and take reasonable care to ensure that the client has understood this.[15]

The impact of these Financial Services Act rules was to give the client a claim for damages for non-disclosure which he never had under the ordinary law.[16] (Under that he was only entitled to avoid the contract and had no remedy at all against an IFA.)

Regardless of the cause of action concerned, firms always had one argument. It

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[10] Sun Life of Canada v. Jervis [1943] 2 All ER 425

[11] Henderson v. Merrett [1995] 2 A.C. 145

[12] Groom v. Cocker [1939] 1 K.B. 194

[13] E.g. LAUTRO Code of Conduct, Annex II to the LAUTRO Rules, para 12.

[14] E.g. LAUTRO Code of Conduct, para 8(1)(a).

[15] E.g. LAUTRO Code of Conduct, para 6.

[16] Banque Keyser Ullman S.A. v. Skandia (U.K.) Insurance Co Ltd [1991] 2 A.C. 249

could always argue that its non-compliance, negligence, non-disclosure or misrepresentation had neither caused the client any financial loss nor had induced him to enter into the contract. To succeed here, though, the IFA or assurer had to show that the client was absolutely hell-bent on taking out the policy so that a compliant sale would still have resulted in the client going ahead with the relevant contract. Alternatively, firm would succeed here if the endowment was so clearly the right product for the client that if the adviser had conducted the sale perfectly, it would still have been sold.[17]

However, where, as often happens with endowments, there is an alternative method of mortgage repayment that was equally suitable, this argument will not work except where there has been a staff sale. There, the incentives given to staff to take out these contracts may sometimes lead one to conclude that couple for whom an endowment was suitable would have taken one out had the sale been conducted in a compliant way.[18]

Still, as this last example illustrates, the emphasis is unsurprisingly on the suitability of the sale in most cases. If the client can show that the recommendation was not the right one, he will win the case. (It is almost impossible anyway to give someone bad advice without failing to disclose the facts that make it bad.)

(ii) Endowment Best Advice and Know Your Customer

As PIA Regulatory Update 72 and the Institute of Actuaries both point out, endowments are only suitable for those who are happy with the level of risk involved in the underlying investment vehicle. So, cautious investors should not have endowments.[19] Endowment mortgages involve two different risk elements. First, there is the uncertainty in relation to the investment fund selected. Secondly, one does not know whether even if the investment grows, it will do so sufficiently to repay the mortgage (mortgage risk). So, people who would be quite content with some risk in relation to investments not targeted at any precise obligation will be much more cautious in relation to their mortgage. A year's poor investment performance from a unit trust will usually generate far less anxiety than the same level of growth from an endowment being used to repay a home loan.

The failure to record and give suitable advice based on the client's attitude to mortgage, rather than investment risk, lies at the root of the problems identified in

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[17] DISP App 2.1.2.

[18] FOS, Mortgage Endowment Complaints Assessment Guide at p. 52. Note that the overall arrangement must have been suitable.

[19] Ombudsman News, February 2001 at pp. 4 & 7-10; FOS, A Briefing Note for Firms: Complaints about mortgage endowments, 2000 at pp. 4-5; FOS, Mortgage Endowment Complaints Assessment Guide at p. 35.

RU72, the Tiner letter and the two complaint handling fines. John Tiner's letter of April 2002 has never been officially published in full. Like a reformation tract or perhaps a Communist manifesto, it consists of the 3 observations and then the 9 points. The latter appear in the Annex to the letter and represent the most important part of the document. To begin with the "three observations":

> 1. .. There are some firms who are not assessing some or all of their consumer complaints fairly... The most common area where issues of unfair treatment arises is in the assessment of a consumer's understanding and acceptance of risk at time of sale - a factor which is central to the suitability of the policy for the consumer. We have come across a number of features of firms' handling of complaints which in our view have weighted the balance of assessment of this factor unfairly against the consumer. ..
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> 2. Complaint handlers in many firms are using the decision trees process for complaints published by the Financial Ombudsman Service in June 2000, but there seems to be some misunderstanding about how to interpret and apply this material. The decision trees were developed by the FOS as a skeletal route map to supports its own needs, although they also issued the trees to firms as a contribution to development of firms' own procedures. They were not intended to be applied in isolation nor were they designed to cover every possible situation, whether for the entirety of firms' processes or for resolution of individual cases. By their very nature the trees require at each stage the use of judgement in the light of the facts of each individual case. In addition the trees are not mutually exclusive so, for example, cases running into retirement would need to consider both affordability and suitability in terms of risk.
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> 3. Firms rely, as a guide to their general approach, on reasoning and explanations given in final decision letters issues by the Ombudsman. It is entirely proper and reasonable that firms should be informed by Ombudsman decisions, both for and against the firm, and should absorb any lessons to be learned. However, the Ombudsman makes specific decisions in individual cases, based on the circumstances of each case. What is said ina decision letter does not, and is not meant to be, a generic ruling to be applied indiscriminately to other cases which may be broadly similar but which on closer examination may not be on all fours with the decided case. I am sure you will agree that, as in other spheres of activity, application of precedent without due regard to the facts of the individual case represents poor complaint handling."

These can be summed up as indicating that there were major problems with firms' approach to the attitude to risk and slavish over-application of the FOS decision-trees and Ombudsman decisions. Annex 1 to the letter develops the first of these points further in the "nine points":

> "1. The need to recognise in the assessment of the complaint that the key risk

for the consumer is that the endowment may not repay the mortgage loan; and that if that were to happen the consumer would need to make good the difference from other sources of capital if available.

Looked at from the perspective of the consumer, this risk is different in nature and consequence from the usual investment risk of an endowment policy as a long term regular savings vehicle (where the issue is not usually about capital deficiency on maturity but about the size of the prospective gain).

The magnitude of the key risk posed by the specific endowment policy recommended and whether that particular degree of risk was suitable for (and explained to) the particular consumer, are issues for assessment.

2. The need to avoid too narrow a view of the scope fo the advisory duty in the context of mortgage advice, in particular by automatically taking the consumer’s choice of an interest only mortgage as a given when assessing the suitability of an endowment policy rather than considering the circumstances of the case.

When assessing the suitability of an endowment policy the adviser would normally have had regard to the purpose which it would fulfil and have taken account of the other options available to the consumer in respect of the underlying mortgage transaction, including the option of a repayment mortgage.

3. The need to recognise that oral evidence can be good and sufficient evidence, avoiding too ready a dismissal of evidence from the consumer which is not supported by documentary proof.

This frequently arises in relation to what degree of assurance the adviser did or did not give the consumer at point of sale tha tthe policy would pay off the mortgage debt on maturity. (It can plausibly be assumed that in most if not all advisory sales the advisor would have said something about the likelihood of the policy producing sufficient at maturity to repay the loan, and that most consumers would have asked about and sought answers to this point.)

4. The need to investigate the issues diligently, in particular so as to take into account the selling practices at the time, the training, instruction, sales scripts and incentives given to advisers at the time and the track record of the particular adviser.

This and the next point are partcularly relevant to a fair reconstruction of what might have been said to the consumer on the issue in point 3 above, having regard to what the consumer says now and to all fo the contemporaneous avidence.

5. The need to go the extra mile to clarify ambiguous issues or conflicts of

evidence before finding against the consumer.

6. The need to avoid making a conclusive assumption that a pre-existing endowment held at time of sale, whether for purposes of savings or mortgage repayment, is sufficient evidence of understanding and acceptance of the key risk.

7. The need to avoid making too literal and narrow an interpretation of the issue of the complaint, as expressed by the consumer. Consumers rarely have the knowledge and capacity to express their complaints in language which can be related directly to a duty on the firm at time of sale. This can give rise to unfair handling of the particular case and to anomalies and inconsistencies of treatment as between cases.

8. The need to avoid rejecting complaints on the basis that the consumer signed a proposal form or failed to exercise the cancellation right, and so must be presumed to have been satisfied with the advice and the product at time of sale.

9. The need to avoid claiming the following as evidence of risk warning at time of sale so as to justify rejection of the complaint:

the absence of a statement in product literature that repayment of the mortgage was guaranteed; or

a statement in product particulars that the firm will monitor the plan and advise the consumer if the level of contribution is sufficient for the target amount to be repaid."

One can see the heavy emphasis on mortgage risk. A point, not appreciated by FOS, is that existing endowments or other investments are almost irrelevant in determining attitude to the risk of the loan not being repaid at maturity. This point again emerges in both Friends Provident and Allied Dunbar fines.

There is a broader point, though. All this creates a nasty problem for with profits endowment sales. If these were sold because the investor had a cautious risk profile, complaints about these sales should succeed. It is difficult (although theoretically not impossible) to imagine a customer who wants enough risk to have a post 1984 endowment but not enough to have a unit-linked policy. Very few fact-finds and reason-why letters are well-enough drafted to justify this awkward risk balance. All in all, it should be noted that the risk profile of the client not only has to be high enough to justify the use of an investment backed loan but also correctly calibrated against the fund selected.[20]

[20] FOS, Mortgage Endowment Complaints Assessment Guide at p. 36.

PIA Ombudsman Bureau (and now FOS) have commented regularly on the assumption that an endowment sold past normal retirement age is not acceptable.[21] The customer is expected to have less income to live off in retirement. If the customer really cannot afford a mortgage with a shorter term, he should have a capital repayment loan. This enables the client to use lump sums received from occupational pension schemes, redundancy and any inheritances to reduce or repay the mortgage at any time, thus making it affordable. If he does the same with an endowment, he will still be left with the policy premiums at their original level or risk losing a substantial part of his previous payments. The client who really cannot afford future payments on retirement has the option of selling the home with a capital repayment loan. This is particularly important where an elderly couple has exercised the right to buy their council home. After three or five years, they can sell the property and recover the full market value. More typically, the rest of the family will help with the mortgage payments in exchange for inheriting a valuable property. Again, for reasons already indicated, this level of flexibility is not feasible financially for the endowment customer because of early surrender penalties.

Patterns of work behaviour have meant for some years that normal retirement age must be regarded as being 60, not 65. Large numbers of people are not still in full-time work after age 60. Some have an earlier expected retirement age where the rules of their occupational scheme indicate this. Either way, where the client's mortgage has to run close to retirement, the factors indicated above strongly favour a capital repayment loan.

There is a tendency in Ombudsman and regulatory circles to be fairly rigid when dealing with endowments sold into retirement. Perhaps, it reflects a lack of confidence in staff that both organisations have gone for an unimaginative, but strangely different approach. FOS looks at retirement ages under occupational schemes however early. They miss the fact that many people change jobs and actually work later, notably in the police and armed forces. They also disregard the high numbers of people who do not remain in work until the normal retirement date of their employer's scheme.

The FSA by contrast has been happy in its regulatory work to allow firms not to take too seriously cases sold into retirement so long as the date is not exceeded by two years. It is unclear why two years was chosen. The idea that a man can be sold an endowment mortgage to run to age 67 is preposterous and irresponsible. The FOS approach is much to be preferred. Both, though are too rigid. It would probably make sense to use age 60 as a starting point. Then, use an earlier date where the person's profession leads one to believe that they will give up work at a later date through subsequent job changes. In this sense, there would be a difference between policies sold to soldiers (who tend to seek gainful employment after leaving the services) and policemen who may genuinely stop work at 50. Either way, selling an endowment to

[21] FOS, A Briefing Note for Firms: Complaints about mortgage endowments, 2000 at p. 6; Ombudsman News, February 2001 at pp. 7-9.

either armed forces personnel or policemen is fraught with dangers. Would it not be better to recommend a capital repayment loan which can easily be adjusted to suit the different work patterns of people in this type of work? The length of term can be the one that would be most affordable for the client. The compensation should be based on that term rather than the retirement age of the scheme.

The Institute of Actuaries commented that 10 year endowments were unlikely to be good value because of the charges involved and hinted that this might be true for policies up to 15 years in length. This reduces to age 45 the maximum age for customers taking out endowments. This is tricky. Any generalisation about charges risks looking foolish. If a firm wishes to avoid paying compensation on all its endowments of between 10 and 15 years, it should have to prove that the premium using a reasonable growth rate was cheaper than that for a capital repayment loan. In such a case, the objection about cost and charges should be overcome. This ground for upholding complaints has been left off the FOS Decision Trees. However, it shows up on the Royal & Sun Alliance misselling Final Notice. So, the FSA at the very least is worried about this.

Single people without dependants tend to be mobile, erratic in their spending and employment habits and face the prospect of meeting the person of their dreams in due course. For them, the life assurance element of the endowment is wasted except to the extent that their lenders insist on it (very few actually do).[22] They tend to lapse long-term savings commitments being not unreasonably unable to predict their financial future over more than ten years and often less. They should never have been sold endowments after 1984. The Allied Dunbar complaints final notice explicitly criticises the firm for not upholding complaints where there was no demonstrable need for life cover. This also puts in an appearance in the Royal Final Notice.

Much the same, except for the point about life cover, applies to foreigners who typically return home after an average of about 5 years.

Decision Tree 2 on this[23] is curious. The right hand column is reasonably accurate. Where there was no requirement for life cover + it was not a condition for an equivalent repayment mortgage + there is evidence that the client would have favoured a repayment loan had it been indicated to him that life cover was included in a policy but none was needed, the complaint is to be upheld. That last part of the test is only a causation one. Unfortunately, the left hand column can (and has been interpreted by a PIAOB adjudicator) be read as meaning that where the client was told that an endowment included life cover for which there was a charge and the client was happy to proceed anyway, the complaint should be rejected.

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[22] FOS, Mortgage Endowment Complaints Assessment Guide at p. 34 for a very watered down version of this.

[23] See p. 34.

> "Despite there being no requirement of life cover, there is evidence that the customer was made aware that the endowment policy included life cover that was additional to his needs, and that a charge for this was included in the premium and the customer was happy to proceed with the arrangement ≡ Reject complaint"

This is not coherent. The question is whether the policy was unsuitable as the right-hand column indicates. Consent to receiving unsuitable advice does not render that advice compliant. The correct way to understand this is that where a client who already has enough life assurance to cover his mortgage may still properly be sold an endowment if he plans to use his existing cover for other protection needs with respect to his dependants. Clearly, if a client has a wife and children and existing term assurance to cover them in the event of his death greater than the amount to be borrowed, he can be sold an endowment, assuming that all the other compliance requirements are met.

Informal indications from the FSA early on was that it was not concerned about endowments sold to single people without dependants. Its view seemed to be that the life cover charge is so small as to be insignificant being of the order of 1% of the premium. Using a typical premium of £60 a month, that amounts to £12 a year or £180 + interest over 25 years throughout the life time of a 25 year policy. Personally, I would be happy with the extra £12 a year! For the older or infirm customer, the cost issue was more significant.

More worryingly, the regulator was missing the point about the ability of most single people without dependants to maintain payments over a 25 year term. That is the reason why the basic idea of decision tree 2 if properly interpreted is correct. It has nothing to do with the modest sums expended on life cover. After all, we would all be prepared to pay for an unnecessary product if it gave us a beneficial one in exchange. The currrent FSA position is quite different (based on the March 2004 Allied Dunbar Final Notice). People who do not need life cover should not be sold endowments and complaints made by such customers should succeed. It looks like a case of the right result for not necessarily the right reasons.

Above all else, though, the adviser needs to have established that the customer can handle the commitment of regular payments into a policy over a long period of time.[24] Some people are just not good at handling regular payment commitments. The threat of repossession tends to keep their capital repayment mortgage account in reasonable shape. If a customer has lapsed a previous endowment or similar type of contract, they must be assumed to be unsuitable for another one.

This general question of affordability raises difficult questions for firms specialising in

[24] FOS, Mortgage Endowment Complaints Assessment Guide at p. 10. Logically, this should apply even more forcefully to sales after 29th April 1988.

poorer customers. How can one really arrange an endowment loan for someone living off very modest state benefits. You are taking away their ability to trade down if things become really hard. High surrender rates for industrial branch policies[25] show the difficulty that many financially strapped people have maintaining payments. Of course, rich people can have the same problems when over-extending themselves.[26] The adviser's challenge in that situation is either to persuade the client not to over-extend themselves or to walk away from the business. If they fail to do so, they will be blamed if and when everything goes wrong.

One of LAUTRO's earliest Enforcement Bulletins, no. 5, stressed the need not to put the endowment into force before the loan it is designed to repay has actually come into existence. Nevertheless, the PIAOB has still regularly had to remind firms that endowments for "deferred house purchase" are not acceptable.[27]

LAUTRO also tried clamp down on roll-up mortgages in Enforcement Bulletin 13 stating that the customer has to have been likely to receive a significant increase in their earnings by the end of the roll-up period to justify this. Clear risk warnings are required. The Assessment Guide makes a similar point about low-start arrangements.[28]

Endowment selling has historically involved more than its fair share of churning. This was mentioned in LAUTRO's second Enforcement Bulletin. The adviser should have obtained an accurate projected maturity figure for the existing policies and then taken them into account in fixing the sum assured. Any failure to do that is a breach of the Know Your Customer rule (para 12 LAUTRO Code of Conduct).

If it causes the customer to be under-insured the adviser is liable.[29] He is also responsible if the customer is over-insured. The existence of life policies to cover parts of the new loan should reduce the endowment amount unless the policies are really needed for other purposes and the extra money can be spared. Under the Conduct of Business Rules, the adviser must take all practicable steps to check all the critical facts such as the existence and values of other policies. One has to bear in mind that only the adviser has a motive for fabricating this information. He is also the person making money by offering his expertise. This is particularly the case where the customer during the year following the advice has encashed an existing

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[25] PIA, Fifth Survey of the Persistency of Life and Pensions Policies, October 1999 at p. 35 showing only 62% of IB endowments still in force after four years.

[26] FOS, Mortgage Endowment Complaints Assessment Guide at p. 38.

[27] FOS, Mortgage Endowment Complaints Assessment Guide at p. 48.

[28] FOS, Mortgage Endowment Complaints Assessment Guide at p. 48

[29] FOS, Mortgage Endowment Complaints Assessment Guide at p. 41.

endowment. This is a “phantom churn” and should be treated like the real thing. [30]

Under the intended guise of giving both sides of the same story, the Mortgage Assessment Guide[31] may be misinterpreted to allow firms to reject justified complaints in this area. Correctly, if the adviser could not reasonably have discovered the existing contract, a complaint that the client was over-insured or that that contract was churned should not succeed. However, that begs the question. In practice, as already indicated, the client has no motive for hiding the existence of the other contract. The adviser does. If the client already had a mortgage, he must ask what type it is and if it is an interest-only loan, he must enquire whether the client has or recently had an endowment. Once that has been established, the Know your customer rule requires the adviser to obtain at least the policy schedule.

The same page of the Guide suggests that the complaint would fail if the customer wanted to cancel the policy and have a new one despite being told the disadvantages of this course of action. Again, this is technically correct. However, as pension and FSAVC review specialists[32] know, regulators take a very sceptical view of “insistent customer” cases into which category such cases fall.[33] In fact, it is all but unheard of for the disclosure requirement to have been properly fulfilled. It is hard to imagine a client going through with a transaction when he has been told not only not to do it but in a detailed way, why.

There are a string of important, if apparently mundane, further grounds for upholding endowment complaints. The most common are that the term of the endowment does not match the length[34] or size[35] of the loan or the parties to it.[36] The crowning embarrassment is when there is no interest only loan to cover (either because the loan is a capital repayment one or it is a figment of the adviser’s imagination).[37]

Some firms have the problem that they sold endowments with a view to using them

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[30] LAUTRO EB 20 at para 1.10 (e-f); FOS, Mortgage Endowment Complaints Assessment Guide at p. 55.

[31] P. 46.

[32] FSA, FSAVC Model Guidance, May 2000 at p. 43 requires a corroborating letter in the investor’s own handwriting in such a case.

[33] See eg. PIA RU33 at p. 10.

[34] FOS, Mortgage Endowment Complaints Assessment Guide at p. 39.

[35]FOS, Mortgage Endowment Complaints Assessment Guide at p. 42.

[36] FOS, Mortgage Endowment Complaints Assessment Guide at p. 43.

[37]FOS, Mortgage Endowment Complaints Assessment Guide at p. 33; A Samuel, “The Ombudsman is not always wrong”, 7 Financial Planning 3, 9 (1998).

to repay the mortgage early. Assuming that their policies are front-end loaded or suffer from early-surrender penalties, this represents bad advice. Clients wanting that option should have selected a capital repayment loan where their plans could be more economically accommodated. Otherwise, the client is being charged for a longer term than he is actually enjoying and too high a charge is, therefore, being extracted from him. If the contract is a with profits one, any policy bias towards a terminal bonus will result in the client receiving a similar poor deal. Although the new Mortgage Endowment Complaints Assessment Guide deals with customers who were guaranteed to have their mortgages paid off early by their endowments,[38] it is curiously silent for those who were just told that their policies would be useful for this purpose.

We have to note that if the original sale was bad, any subsequent one is likely to be too. However, where the original sale was fine, it does not mean that any subsequent amendment or increment to it was satisfactory. Essentially, the adviser had to re-do the fact-finding and everything else.[39]
To conclude, though, this is the list of best advice problems on the FOS decision trees:

Decision Trees
1 Mortgage repayment vehicle not required
2 Life cover not required
3 Policy not consistent with attitude to risk
4 Fund choice not consistent with attitude to risk
6 Policy not affordable[40]
7 Policy term not consistent with term of mortgage
8 Policy term extends beyond normal retirement date[41]
9 Guaranteed death benefit not consistent with mortgage loan amount
10 Targeted maturity value not consistent with mortgage loan amount
11 Policy not written on the correct lives
12 Complainant advised to increase premiums in the past without due consideration of the alternatives
13 Complainant advised to amend the policy inappropriately
14 Churning of an existing policy[42]

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[38]FOS, Mortgage Endowment Complaints Assessment Guide at p. 54.

[39]FOS, Mortgage Endowment Complaints Assessment Guide at p. 44.

[40]"The policy is low start and... there is no evidence of an expected increase in available income to meet the increased payments over the full term of the policy": see also LAUTRO Enforcement Bulletin 13 paras 2.01-5; PIAOB Annual Report 1995-1996 at p. 45 on deferred interest and roll-ups.

[41]PIAOB Annual Report 1995-1996 at p. 46 & 1996-1997 at pp. 48-49 1997-1998 at pp. 72-74.

16 Forward sale of the policy[43]
23 Low start policy recommended without necessity
25 Inappropriate charges used in setting the premium

(iii) Disclosure

When selling endowments, the adviser has to discuss properly the alternatives and disclose the risks and disadvantages inherent in the policy being recommended. As already mentioned, it is impossible to give bad advice while disclosing all material facts. To some extent, the reasons why endowment sales may be bad turn up again as classic reasons to uphold disclosure complaints. It is the firm's duty anyway under rule 7.2.1(3)(c) PIA Rules to look generally at every sale about which the customer has complained. So, if the customer raised a question about disclosure, the sale should be considered from a best advice angle and vice versa.

The disclosure aspect of the points already made about risk is that, as PIA RU72 points out, an adviser must give clear warnings about the possibility of the policy not repaying the mortgage.

> "Firms are responsible for explaining clearly to the customer the risks he or she will be taking if that customer is considering an interest-only mortgage with an investment as a repayment vehicle. It is also important that firms explain clearly to the customer the implications those risks have for future mortgage arrangements, whether or not endowment-related.
>
> Firms should make sure that the advice they give makes clear to the customer that, unless the sum payable on maturity is guaranteed, that amount will fluctuate in the light of changing market conditions. The policy premium may have to increase if the policy is to deliver the required sum to repay the mortgage.
>
> Firms should ensure that they do not use any language or give any unrecorded/unwritten undertakings that could be taken to suggest that the sum necessary to repay the mortgage is guaranteed when in fact it is not. In particular, firms should pay attention to scripts and sales aids used by their advisers and representatives."

Sometimes, firms just outright mislead their potential clients. One well-known mortgage lender was reported in recent years to have insisted to a single person

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[42]See LAUTRO Enforcement Bulletin 13, paras 4.06-8 on advising customers to surrender where the term of a mortgage can be shortened

[43]PIAOB Annual Report 1995-1996 at pp. 44-45; 1998-1999 at p. 34; LAUTRO Enforcement Bulletins 5, para 3.01-3 & 13, paras 2.08-10.

without dependants that she had to have an endowment policy.[44] The person worked for the CII - ouch!

The investment risk clearly has to be properly explained. The adverse consequences of early surrender must be clearly displayed.[45] The safer alternative, in the form of a capital repayment loan should always have been fully presented to the customer.[46] Similarly, for single people without dependants, the availability of a mortgage repayment method involving less and in some cases, no life cover should have been explained.[47]

The disclosure-related decision trees are the following:

3 "the level of risk attaching to the policy was explained incorrectly"
4 "the level of risk attached to the fund was explained incorrectly"
5 Complainant not made aware of possible alternative arrangements
(Mortgage quotation only covers endowments + other documents do not refer to alternatives + "It appears that an alternative method of repaying the mortgage would have been suitable and is likely to have been effected had the customer been properly informed/advised")
15 Pressurised selling by the adviser
17 Taxation of policy not properly explained
18 Surrender penalties or other charges not explained
19 Complainant led to believe that the endowment policy was guaranteed to pay off the mortgage loan, or the lack of guarantee/risk was not explained
20 Complainant led to believe incorrectly that he had to take out an endowment in order to secure the mortgage loan
21 Complainant led to believe that the policy was guaranteed to produce a lump sum in excess of the loan amount
22 Complainant led to believe that the policy was guaranteed to pay off the mortgage early
24 Mistake in the original quotation/illustration other than in the charges or growth rates used
26 Misrepresentation of policy benefits or conditions other than in connection with the taxation of the policy, policy charges or the size of the lump sum
28 Fraud committed by the adviser for financial gain

IV: COMPENSATION FOR ENDOWMENT MISSALES

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[44] FOS, Mortgage Endowment Complaints Assessment Guide at p. 52

[45] See FSA Discussion Paper, "Treating customers fairly after the point of sale" , June 2001 at pp. 21-26 which actually focusses heavily on the point of sale.

[46] FOS, Mortgage Endowment Complaints Assessment Guide at p. 37.

[47] FOS, Mortgage Endowment Complaints Assessment Guide at pp. 34 & 37.

(i) General Principles

We saw earlier that assurers could be found liable under a number of different headings:

> (i) non-disclosure, misrepresentation or fraud inducing the client to enter the contract
> (ii) negligent or non-accidental misleading information having the same effect
> (iii) negligent advice
> (iv) section 150 Financial Services and Markets Act (formerly section 62 FSA) for breach of the conduct of business rules
> (v) breach of contract

The House of Lords decided in Henderson v. Merrett[48] that the successful litigant was entitled to claim whichever measure of compensation placed him in the best position where he had more than one possible claim.

So, the correct way to handle compensation is to find out which ground for complaint gives the client the best result and give it to him. After all, firms are supposed to handle complaints in a pro-active way rather than waiting for the client to instruct lawyers to formulate their claims in the most advantageous fashion.

Where the client has been induced to enter into a contract by non-disclosure, misrepresentation or fraud[49], he is normally entitled to rescind or avoid the contract.[50] This has the effect of treating the contract as if it had never happened. Each side is now entitled to claim back from the other any benefits paid under the agreement. The House of Lords in 1909 was faced with the argument that with an endowment policy, the company should be entitled to deduct the cost of life cover. It rejected that view.[51] Life cover is not a benefit given under a contract until a claim is made under it. Essentially, the parties recover their property which has never properly been transferred to the other person since the contract is deemed never to have existed. This remedy should not be required of IFAs since the endowment contract is not made with them.

As already indicated, section 2(2) of the Misrepresentation Act 1967 says that where a party had claimed rescission for misrepresentation (not non-disclosure or fraud),

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[48] Henderson v. Merrett [1995] 2 A.C. 145

[49] Redgrave v. Hurd (1881) 20 Ch.D. 1.

[50] This can be seen from the wording of section 2(2) of the Misrepresentation Act 1967 which presupposes that in the ordinary case rescission will be available subject to the need in equity to being able to transfer back property passed under the voidable contract.

[51] Refuge v. Kettlewell [1909] A.C. 243; PIAOB Annual Report 1995-1996 at p. 35; PIAOB Annual Report 1996-1997 at pp. 30-31.

the court may decide to uphold the contract and just award damages. This discretionary power has arguably always existed except in the case of fraud. There, the fraudulent party has no right to have the court declare the contract subsisting although presumably the victim does.

A combination of the ordinary law of negligence, the Misrepresentation Act and section 150 of the Financial Services and Markets Act (items (ii-iv) require the customer to be placed in the position in which he would have been had he received careful and compliant advice.

Finally, where an adviser has guaranteed that a policy will repay a mortgage or that under a roll-up scheme, no premiums will be paid during the first five years, his company must honour those promises even if they contradict the policy conditions and other printed material.[52] An oral promise or a specifically produced term of a contract always overrides a pre-printed form.[53]

(ii) The general approach of the FSA and FOS

The recent approach to all this from the FSA and FOS has been coloured by the different ways in which they perceive their roles. The FSA sees itself as acting under powers in the Financial Services Act and the Financial Services and Markets Act. This simply gives the client his claim under section 62 (soon to be 150) of the relevant legislation. So, the DISP App 2 goes no further than that. Rule 2.1.1 and 2.1.8 make it clear that the proposals do not relieve firms of any obligation to consider other forms of redress. They simply lay down the rules to be applied with respect to a claim under section 62/150 FSA/FSMA.

The Financial Ombudsman Scheme in its Mortgage Endowment Complaint Assessment Guide include the possibility of firms being bound by guarantees and, therefore, liable for breach of contract.[54] However, without explanation, it seems to have gone back on centuries of legal history and reams of Ombudsman Annual Reports[55] by excluding reference to the need for life assurers to offer a refund of premiums plus interest where the contract is voidable for non-disclosure or misrepresentation.

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[52] Sun Life of Canada v. Jervis [1943] 2 All ER 425; Wake v. Renault (UK) Ltd, Times, 1st August 1996; PIAOB Annual Report 1996-1997 at p. 44; 1997-1998 at p. 39. See 2 News from the PIA Ombudsman Bureau, 4, December 1998 at pp. 3-4.

[53] See the FOS, Mortgage Endowment Complaints Assessment Guide at p. 6 which is correct as opposed to the Assessment Guide at p. 51 which wrongly suggests a more rigorous test which contradicts the result in the Wake case.

[54] See p. 53.

[55] See e.g. PIAOB Annual Report 1995-1996 at p. 35 & 1996-1997 at pp. 30-31; News from the Ombudsman Bureau, March 1997, 3.

Fraud receives curious treatment in the Guide.[56] There the client is entitled to a refund plus interest and possibly further sums for distress and inconvenience. This is the wrong remedy against the IFA who holds no premiums that can be refunded. It also curiously excludes the FSA DISP App 2 approach. Perhaps, this is too literal an approach to the Decision Trees. Presumably, an investor can obtain FSA style redress if he wants it by showing that he would have had a capital repayment mortgage had he received compliant advice. Quite, though, why fraud and pressurised selling receive different treatments is baffling.[57]

An informal indication from the Financial Services Authority suggests that the Ombudsman has decided not to award a refund plus interest in a non-fraudulent missale case because a court would in every such situation exercise its discretion in favour of upholding the contract and awarding damages instead. There is no authority for such a strange proposition which under-cuts the clear words of section 2(2) of the Misrepresentation Act.

> "Where a person has entered into a contract after a misrepresentation has been made to him otherwise than fraudulently, and he would be entitled, by reason of the misrepresentation, to rescind the contract, then if it is claimed, in any proceedings arising out of the contract, that the contract ought to be or has been rescinded, the court or arbitrator may declare the contract subsisting and award damages in lieu of rescission, if of the opinion that it would be equitable to do so, having regard to the nature of the representation and the loss that would be caused by it if the contract were upheld, as to the loss that rescission would cause to the other party."

This gives the court a discretion. It must intend the court to use it. Discretions are supposed to be exercised not prescribed in advance. As the leading author on contract law of the past 30 years, Professor Sir Guenther Treitel QC says:

> "The power to uphold the contract and to award damages in lieu of rescission is discretionary; neither party has a right to require its exercise. The concluding words of the subsection specify the factors which the court can consider in deciding whether to exercise the power. It seems that the court can take into account the contents of the representation, and balance the interests of the parties in on the one hand seeking and on the other resisting rescission. Usually the representor will want to resist rescission and a number of factors are likely to affect the exercise of the discretion. On the one hand, the court is likely to uphold the contract (and so leave the representee to his remedy in damages) if the representation related to a relatively minor matter and if the representor was not guilty of fault. On the other hand, the "policing

[56] At p. 60.

[57] At p. 47.

> function" of the remedy of rescission may also be taken into account: this was the ground on which the court refused to uphold a contract of reinsurance which had been induced by a broker's material misrepresentation."[58]

As we can see from this extract, the only insurance case which has ever considered using the power under section 2(2) to declare the contract subsisting rejected it, emphasizing the important policing function of rescission.[59] In the light of the recent Equitable Life case,[60] it is not insignificant to note that Lord Steyn was the judge who refused to exercise his discretion to uphold the contract.

Equally seriously, section 2(2) requires the court to have "regard to the nature of the representation and the loss that would be caused by it if the contract were upheld, as to the loss that rescission would cause to the other party."

The nature of the representation in the type of cases we are considering relates to people's ability to repay their mortgages and remain in their homes. While an innocent or relatively trivial error by the adviser could be the basis for upholding the contract, most endowment cases are not like that. In the vast majority of upheld endowment cases involving insurers, there is at least a negligent misstatement.

The loss to the party unable to rescind the policy is that he or she cannot recover the money paid to a firm which misled him or her to take out the policy. Since the general view is that the FOS approach will save firms significant amounts of money, that is highly relevant. The insurer has anyway had the benefit of the money subject to paying for the costs of setting up the policy. It will not suffer unduly if it has to return its ill-gotten gains.

There are some other reasons why a court would not uphold a contract where the only claim related to non-disclosure, particularly pre-A day. In such a case, the client would have no remedy in damages under the ordinary law.[61] The Misrepresentation Act does not apply to a non-disclosure case. So, the normal principle of voidability comes into play subject to the ability to return any benefits paid under the contract and the absence of unreasonable delay.

Finally, none of the relevant participants have any interest in keeping the endowment

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58 The Law of Contract, 10th ed, Sweet & Maxwell, London 1999. This was the edition that was current when the Guide was issued. (There has been a subsequent one which says the same thing.)I've gone a bit heavy on the author's title in view of the constant claims that the FSA is relying on leading counsel's opinion.

59 Highlands Ins Co v. Continental Insurance Co [1987] 1 Lloyd's Rep. 109.

60 Equitable Life v. Hyman [2000] 3 All ER 961

61 Banque Keyser Ullman S.A. v. Skandia (U.K.) Insurance Co Ltd [1991] 2 A.C. 249

policy in force in the vast majority of cases.[62] Unless a client needs the life cover because of his future uninsurability (which assumes that the assurer is no longer able to issue policies), there is no policy or pragmatic need to keep the contract afloat.

The implications of this bizarre error of the Ombudsman taking away a discretion effectively given to her by Parliament are considerable. Where the mortgage has not been running for very long, very little capital will have been repaid. With life assurance rates generally falling, a quick conversion to a capital repayment loan may under the FSA loss assessment formula may result in a loss far less than the premiums taken by the assurer or indeed no loss at all. Yet, by law, the premiums belong to the customer not the assurer. They should be refunded with interest unless there is a very good reason to reach the opposite conclusion. Curiously, as the Consumer Protection Unit of the FSA shows real concern at the quality of complaint handling in the financial services industry[63], the Ombudsman Bureau is proposing to allow the industry to pocket its ill-gotten gains rather than restore them to its customers.

This can all be justified by the fact that under the new Act, the Ombudsman has the power to reach decisions which she considers to be just and appropriate.[64] However, if the Ombudsman takes away consumer rights, she really ought to give a coherent explanation of her reasons and the scope of their application to other types of complaints. These developments could have a devastating effect on the ability of a customer who is desperate for money to recover pension premiums paid into a missold policy before age 50.[65] It would also stop an insurer avoiding a contract of insurance where the inaccurate statement on the proposal form did not relate to the cause of death.[66] This is not to mention the embarrassing scenario of policyholders obtaining more compensation in court than they could have obtained at the Ombudsman Service. It is indicative of FOS's incoherence in this area that its May 2001 Ombudsman News has happily acknowledged the right to avoid a pension contract while denying this to endowment customers.

The correct position should be that customers missold policies by product providers are entitled to be awarded whatever produces a higher level of compensation

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[62] DISP App 2.3.2.

[63] "Treating customers fairly at the point of sale", June 2001.

[64] Section 229(2).

[65] See PIAOB Annual Report 1996-1997 at p. 42 indicating the Inland Revenue's agreement with the position set out here.

[66] See the ABI Statement of Long-Term Assurance Practice, para 3(a). This gives the court or Ombudsman a discretion in the case of innocent and negligent but not fraudulent non-disclosure. The Statement was produced to stave off the threat of legislation to soften the implications of the general law in relation to consumers.

between a refund of contributions plus interest and being placed in the position in which the customer would have been had he received compliant advice. That is not the Ombudsman's position and will not be until a Court embarrasses her into changing her mind. For IFA sales, the position is very much as stated in DISP Appendix 2.

(iii) The FSA DISP App 2

The FSA's DISP Appendix 2 considers the position under section 150 Financial Services and Markets Act (and its predecessor section 62 FSA) and its views can be applied to pre-A day cases where the claim has to be based on ordinary negligence or the Misrepresentation Act. As such it is a pretty accurate statement of the law. It also correctly states the position with regard to almost all IFA sales. The Statement has to be read on the basis that it lays down minimum not maximum standards to be followed.[67] It does not deal with guarantees or any extra redress required of insurers.

It begins with the assumption that if compliant advice had been given, the client would have ended up with a capital repayment loan. In doing so, it seems to be following an approach which started life off in relation to pension mortgages.[68]

One ends up with a list of losses for which compensation is likely to be payable.

Whatever would have been repaid from a capital repayment loan[69]
Any greater amount of expense from having an endowment rather than a capital repayment loan[70]
The extra cost of decreasing term assurance now caused by the delay in taking out the policy[71]
Any mortgage switching costs at the point of sale or re-mortgage due to the sale[72]

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[67] DISP App 2.1.8.

[68]PIAOB Annual Report 1998-1999 at pp. 29-30 (see also p. 35 for an example); A Samuel, "Pensions Mortgages - Waiting for the Axe to Fall", Money Management July 1999, 36.

[69]DISP App 2.2.1, 2.2.3(1) & 2.2.4; FOS. Mortgage Endowment Complaints Assessment Guide at pp. 7-8

[70]DISP App 2.2.3(2) & 2.2.5; FOS. Mortgage Endowment Complaints Assessment Guide at p. 7

[71] DISP App 2.5.4; FOS, A Briefing Note: Complaints about Mortgage Endowments at p. 9. For some strange reason, the Assessment Guide seems (at p. 35) to leave this out while purporting to apply the DISP App 2 across the board. This item is additional category (a) on page 63. Yet, none of the scenarios point to its application. This is presumably just a slip.

[72] Policy Statement at p. 12, DISP App 2.3.4; FOS, A Briefing Note: Complaints about

You then deduct the surrender value of the policy[73] assuming that the contract has not been traded. Only where the client has consented and the full implications of selling the endowment have been explained, can the endowment be sold.[74] In that case, one uses the re-sale price less any costs incurred.[75] Finally, if the customer would have taken out decreasing term cover with a capital repayment loan because he had dependants, the cost can be deducted. This, though, is effectively set off by the extra cost of the new cover.

The original Consultation Paper 75 argued that where the investor "had sufficient means", firms should be allowed to deduct from the compensation any savings in outgoings caused by the customer having an endowment rather than a capital repayment mortgage. Those sufficient means were difficult to define. All it added up to was whether a deduction was reasonable. This is not actually a correct application of R v ICS ex p Bowden[76]

> "We are satisfied that the common law principles of compensation require that there should in the present case be no deductions for the sums which were paid to the investors in accordance with the transaction which they had entered and which were subsequently disbursed by them. Whether dissipated benefit is a recoverable loss must depend on the circumstances. But **here the very purpose of the transaction.. was the achievement of an increase in income... That being so expenditure of the money, once it had been paid to the investors was plainly foreseeable and if that expenditure was on ephemera so that no lasting benefit accrued there was a loss which**

Mortgage Endowments at p. 8. Again, this is additional category (c) on page 63 of the Mortgage Assessment Guide. The comments on the previous footnote presumably apply here equally.

[73] Policy Statement at p. 8; DISP App 2.2.4-5; Mortgage Asssessment Guide at p. 7.

[74] PIA RU89 at p. 2.

[75] DISP App 2.3.8-10

[76] [1995] 1 WLR 157.

> **sounds in undiminished damages** against the financial advisers." (Emphasis added.)

To enable the firm to make a deduction, it is necessary to show that the money saved was put into an asset or saved as cash in such a way that it can now be realised to reduce the loss otherwise incurred. Being continuous reductions in monthly outgoings, the savings on an endowment sale simply do not fit that model. They are not saved up to buy second-hand cars or yachts.

There is a partial reflection of this in the DISP App. 2 rules.:

> "2.2.8 The circumstances in which it may be appropriate to take some or all of the "savings" into account are those where .. the complainant is of "sufficient means" such that it is **reasonable for a firm to assume that the "savings" have contributed to those means**." (Emphasis added.)

The rest of the rules in this area seem dedicated to stopping firms from making any deductions. Paragraph 2.2.7 seems to knock out any serious prospect of a deduction when it says that it is unlikely to be reasonable to bring savings into account if the client was told that the endowment approach would be cheaper and the customer has "dissipated" the savings on the strength of this. That applies to just about all endowment sales. Any firm thinking of making a deduction has to set out in advance in some detail the basis for its view and then invite the policyholder to challenge it. [77]

The Mortgage Assessment Guide continues the process of making any deductions almost impossible. It adopts the FSA's approach[78] reminding firms that they must carry out a full assessment of the complainant's present financial circumstances if they wish to make any reduction in compensation. They then gently remind firms that the time it will take them to do this assessment will delay the resolution of complaints. This is a fairly unsubtle hint that firms could put themselves in breach of the complaints rules by spending too long gathering the information necessary to be able to justify a deduction.

The Banking and Loans Division of FOS in a March 2001 consultation exercise[79] put things very succinctly:

> "Ordinarily, notional past savings should not be deducted. Exceptionally, notional past savings (without interest) should be deducted if the borrowers are of sufficient means that it is reasonable to assume their means were actually increased by the notional past savings."

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77 DISP App 2.2.11.

78 At pp. 9-11. See the Policy Statement at pp. 6-7.

79 Ombudsman News, March 2001 at p. 7.

In more recent guidance dealing with the problem of banks and building societies who quoted or claimed too low a figure for mortgage payments generally, the Banking and Loans Division confirmed this saying:

> "Ordinarily, we will tell the lender to write off the capital shortfall that has built up to the date the mistake was sorted out - and we will not deduct notional past savings.
>
> Exceptionally, we will deduct notional past savings (without interest) from the capital shortfall:
> - to the extent the lender can show that the past savings are still retained by the borrowers as identifiable and readily-realisable assets;
> - unless the borrowers can show that it would be unreasonable to do so in particular circumstances."[80]

The overall approach should in any event exclude deductions with respect to poorer people who will certainly not have "sufficient means" of the type described. There is clear encouragement from the regulator to adopt the "simplified approach". That involves ignoring customer savings. Probably the best way to analyse this is to say that, in the vast majority of cases, the right result in a difficult area will have been achieved for slightly the wrong reasons.

(iv) The Mortgage endowment complaints assessment guide

(a) The overall approach

The Mortgage Assessment Guide seeks to provide guidance on redress in 29 different cases. The Decision Trees are only designed to be suggestions.[81] The approach is for firms to "consider" certain approaches to the given cases. This presumably does not rule out the development of a more nuanced approach in the future.

Whereas the FSA only used one weapon to consider the problem (the claim for damages under section 150 FSMA), the Ombudsman looks at three. She adds to her armoury a claim for breach of contract. There is only one reference to rescission of the contract, where it is induced by fraud.

We will look here at some of the scenarios described in the Decision Trees. The basic principle is that where the client would have had a capital repayment loan if he had received compliant advice, the FSA Statement is to be applied. Different fact situations may require slight changes to that approach.

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[80] Ombudsman News June 2001 at p. 7.

[81] See p. 32.

(b) The basic scenarios

For example, where no mortgage repayment vehicle was required, firms are advised to consider a refund of contribution plus interest with or without a deduction for the cost of the life cover.[82] That deduction which as we have seen would be quite wrong in relation to a life assurer applying the ordinary law seems to depend on whether the client would have needed the life cover provided by the endowment. If the answer is negative, the correct approach would be to consider where the endowment premiums would have been paid had compliant advice been given. Perhaps, they would have been used to reduce the capital outstanding on the mortgage. Since the client had this money available for this purpose, that would probably be more accurate. However, to use the let-out of all good lawyers, each case turns on its facts. Either way, if a deduction for the cost of life cover is used, the cost of replacement cover should also be provided.

A better display of the Guide is the relatively rare case where the fund choice does not match the client's attitude to risk although an endowment does. There, it tells one just to work out what the appropriate fund would be worth and bring the policy up to that amount.[83] However, as the November 2002 Ombudsman News points out, it is rare for a policy to be suitable as a whole.

Something has gone adrift with the discussion of cases where the policy was not affordable. [84] There the approach is just to obtain an extension to the mortgage loan. If that is not possible, a refund plus interest is suggested. This reflects a misunderstanding of the differences between capital repayment and endowment mortgages. If the client wants a shorter term and wishes to try to cope with what might otherwise be a difficult level of payments, the capital repayment approach is much superior. If things go wrong, the customer can always sell the property and trade down or rent. He can suspend capital payments for a period and has the option of switching to interest-only in the short or long term. So, the standard DISP App 2 approach should apply here also. Having said that, in most of these cases, the attitude to risk will not be appropriate for an endowment anyway.

Where there is a misfit between the policy and the loan, it is good to be able to extend the loan to match the policy if that suits the overall needs of the client. As the Guide correctly says,[85] the adjustment to the term of the policy is difficult to make work if the complaint is against the product provider. It is, though, by means impossible in all cases. The assurer can indicate a sum of money payable to shorten

[82] See p. 33.

[83] See p. 36.

[84] See p. 38.

[85] See p. 39.

the term which the IFA can contribute. A top-up to the policy should actually enable it to reach its intended target early which might solve the problem for unit-linked contracts.

The suggestion that the loan can just be extended is not good enough. Policyholders will rightly complain that they do not want to have to pay an extra year's interest, particularly if their loan already runs close to their retirement. Having said that, there is no easy answer.

DISP App 2 suggests a way round the problem in its paragraph 2.4.9 which requires firm who cannot reconstruct a policy to pay the client the amount that would have had to have been paid to the policy to alter it appropriately.

However, in many of these cases, the client will be annoyed not just at the misfit of the term but at having an endowment in the first place. There is a good case then for doing the conventional FSA DISP App 2 type analysis using the correct terms and not making any deductions for any savings. That at least produces a clean simple answer.

It also avoids a hidden threat lurking around the area of policy reconstructions: tax. There are concerns that a reconstruction could lose an endowment its qualifying status. This is a ferociously difficult subject (at least for me!). The simplest solution would be for the FSA to broker a deal with the Inland Revenue not to make any tax charge where a policy has been altered due to a need to compensate customers. Firms and the Ombudsman Bureau should avoid reconstructions where possible for this reason.

Where the sum assured or targeted maturity value (usually the same thing) is wrong, the Assessment Guide correctly requires life assurers to put it right while refunding any overpayments with interest.[86] It is very unclear as to why IFAs could not be required to do this at least where the sum assured is too high. Where it is too low, the quick approach to this would actually be to apply the basic FSA method to the uncovered part of the loan. This would be more consistent with the approach of FOS's Banking and Loans Division.[87] In June 2001, it confirmed that its approach to cases where lenders failed to quote or claim the right level of payments:

> "Ordinarily, we will tell the lender to write off the capital shortfall that has built up to the date the mistake was sorted out - and we will not deduct notional past savings.
>
> Exceptionally, we will deduct notional past savings (without interest) from the capital shortfall:

[86] Pp. 41-42.

[87] Ombudsman News March 2001 at pp. 7-15; Ombudsman News June 2001 at p. 7.

- to the extent the lender can show that the past savings are still retained by the borrowers as identifiable and readily-realisable assets;
- unless the borrowers can show that it would be unreasonable to do so in particular circumstances."[88]

Instead FOS seems to be requiring IFAs to set up a new policy or a top-up without indicating who pays what towards it.[89] It may just be a question of paying a cash lump sum to the policy or client to ensure that the increase in future premiums over what they would have cost had the increment element of the policy been set up in the first place. That would not be unreasonable. The problem is that, with a widespread loss of faith in endowments, should FOS be one of the few offices actually "selling" them?

Where the policy is written on the wrong lives,[90] life offices can usually re-construct the policy reasonably simply by adding or taking away a life assured from the future policy. Where an IFA is involved, nobody seems to have picked up the fact that the clients will probably have to pay higher life assurance premiums in the future because they were not put on the policy in the first place. The IFA or any assurer unable to re-price the policy to take this into account should have to pay the capital value of the difference in premiums. Where this is not possible, the Guide suggests a refund plus interest. Ironically, where the mortgage has not been running very long, an IFA would be better off showing that the client should have had a capital repayment mortgage in the first place. This will be cheaper than the Assessment Guide's approach to having the wrong lives assured.

One reason why the lives of the policy may be wrong is because, in breach of LAUTRO EB5, the policy was brought into force before there was any mortgage.[91] If never used, the policy payments should be paid to the client with interest. Presumably, the possible reference to a deduction for the cost of life cover relates to the possibility that the client was saved from taking out some life cover by the existence of the contract.

If the policy was later used to cover the mortgage but the term, cover or lives assured were wrong, life offices are required to make the necessary amendment. It is not clear what IFAs are supposed to do if such modifications are not possible. The analysis given above probably applies. Anyway, if the policy was unsuitable (presumably when the loan actually started), one falls back onto the standard FSA approach. Since this will apply to most IFA sales complained about, there is no great

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88 Ombudsman News June 2001 at p. 7.

89 See p. 41.

90 FOS, Endowment Mortgage Complaints Assessment Guide at p. 43.

91 FOS, Endowment Mortgage Complaints Assessment Guide at p. 48.

problem with this.

The Assessment Guide seems to have lost the plot in relation to increments.[92] Where these were sold without appropriate consideration of the alternatives, the Guide simply requires a refund plus interest. There is no reason why the FSA approach to ordinary policies should not be applied here. An increment is only a new endowment sale. If the compliant thing to do would have been to recommend converting the part of the loan not already covered properly to capital repayment, the FSA approach makes perfect sense and can be applied to that part of the loan in exchange for a partial surrender of the policy or full encashment of the increment. If such an encashment is impractical, the life assurer can calculate the increase in policy value caused by the extra contract assuming that it is cancelled for future purposes.

(c) Inappropriate Low Start Policies and Premium Roll-Ups

The Mortgage Assessment Guide simply tells firms to pay a "refund in respect of higher payments made through the low start option (and alter policy to level premium from outset)"[93]. It does not cover premium roll-ups. It is also not very clear what it means anyway. What it should mean is that the firm sets the policy at the correct normal premium level for the future while writing off the shortfall created by the lower payments at the start of the policy. Clearly, if the contract has generated any excess payments into the policy over what should have happened, the firm complained against should pay those amounts with interest to the customer.

Where as a result of advice, sums have been added to the mortgage either in the form of deferred interest or premium roll-up arrangements, it is necessary to bring the loan down to the level at which it would have been had the correct mortgage been set up. In many of these cases, the FSA standard approach will create that result anyway. Any extra mortgage payments that have been paid due to the roll-up or deferred interest period expiring should be paid to the client with interest.

(d) Policies going into retirement

The Mortgage Assessment Guide makes a bit of a meal of policies that go into retirement.[94] As already indicated, if a loan has to go past or near retirement, it should be a capital repayment one. Then, the client can always trade down, obtain help with the payments from children, pay off some of the capital through a pension lump sum or even inheritances. All these factors favour the use of a capital repayment loan. They should all rule out an endowment approach. Therefore, there

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[92] See p. 44.

[93] At p. 55.

[94] At p. 40.

should be no place for reconstructing policies here. It is much simpler and anyway correct just to do the FSA approach using a mortgage term that the client could actually afford at the point of sale. This, as the Guide correctly points out, may take the loan into retirement but that may be the only option.

When doing these cases, you have to start with a benchmark, an assumed age beyond which the client would not wish to extend their mortgage. I use 60 as a representative retirement age unless there is something on file suggesting an earlier date. If the client cannot afford that, you then take a later age that seems more appropriate. Unfortunately, the Ombudsman has yet to commit herself on what is a normal retirement date. It does cause controversies. Sometimes, one sees references to the normal retirement age under an occupational scheme. That, though, misses the point in view of the fact that many people retire early due to redundancy. In some schemes, notably the armed forces, the individuals concerned are expected to do some further work after the relatively young scheme retirement age. Where a scheme has a younger retirement age, it probably should be used if lower than 60 so long as one is not talking about one of the exceptional schemes in this respect. It should not be used if higher.

(e) Churning

Hours of meetings and pages of reports have been done on the subject of compensation for churning without any straightforward sensible approach emerging. Actuaries will often argue that the only loss, when a unit linked policy is churned, is the set up and increased life cover costs on the second contract. This works on the assumption that the investment performance and the maturity dates of the two contracts are identical and that the second one is suitable.

Unfortunately, it is relatively rare that such a fit can be found. So, there is always a temptation to consider what the original policy would have been worth had it been kept going. If it has actually lasted the full term, then this can be used and provides a more accurate than usual basis for calculating any loss.

Most churns, though, relate to policies that have not been in force very long and both sales are usually fairly awful. (The fact that the client was happy to encash the first contract shows how unsuitable both sales were.) There is a case, in that situation, for taking the case back to the sale of the churned policy and doing the FSA approach on it and its replacement up until the current date. Comparing the ultimate surrender value plus the previous encashment amount with what would have been repaid from a capital repayment loan, extra costs of the interest only loan, the increased costs of future life cover and mortgage switches would make a great deal of sense on occasions.

The approach at the Ombudsman Bureau[95] is different. It requires all firms to pay

[95] FOS, Endowment Mortgage Complaints Assessment Guide at pp. 46 & 63.

(i) churned policy premiums plus interest less the surrender value plus interest to date +
(ii) the loss of any LAPR that would have been paid to churned contract
+
(iii) the loss caused by the extra premiums required to be paid under the new contract
+
(iv) any reasonably foreseeable windfall from de-mutualisation

The first item can produce some very strange results if the original policy has performed well over a number of years prior to encashment and the surrender value may exceed the premiums plus interest even as compounded. It is quite inappropriate to allow the second firm to escape liability for the fact that the policy would presumably have continued to grow from its already substantial base value. In that situation, it would be better to compensate the customer for the greater set up and life cover costs.

People often criticise the payment of all the amounts of LAPR that would have been added to the policy after encashment on the basis that it is present compensation for a future loss. Actually, the LAPR is invested and should be expected to produce a return of value. That growth, of course is not taken into account in the formula. Having said that, some of the LAPR is introduced very late in the policy and, therefore, does not benefit greatly from the policy's investment performance. This possible over-compensation is probably cancelled out by the failure to include the LAPR paid into the policy before surrender. The effects of charges and early surrender penalties means that much of that benefit never reaches the client when it should have done.

The third item is presumably designed to pick up the greater cost of life cover. (The refund plus interest compounded effectively picks up the loss of investment performance.) The difficulty is calculating that loss. Does one simply work out what extra premiums have become payable under the new contract that would not have been payable under the old one to produce the maturity value aimed at under the first policy? If so, present compensation is being paid for a future loss and, therefore, needs discounting. To be fair that is not what the Mortgage Assessment Guide suggests. So, an actuarial assessment of the greater cost of the future premiums caused by the fact that the policy has to be taken out several years later than it should be is probably all that is required. Still, it would be good to be told how to do this calculation.

Where the client does not take out a replacement policy or subsequently lapses it, the extra premiums formula does not really work. Here an actuarial assessment of the greater cost of life cover is probably all that is needed.

Finally, there is the issue of demutualisation. If a firm advises a client in such a way as to cause a client to lose demutualisation benefits, the Ombudsman should require it to compensate the client for them where a loss of this type was reasonably foreseeable (legal code for "thought possible").[96] One can argue that advice which results in a loss of membership of a mutual assurer makes the loss of demutualisation benefits automatically foreseeable. Any mutual assurer has by definition always been a possible candidate for demutualisation. This approach seems to be taken by the FSA DISP App 2. That just requires firms to "proceed to assess any direct or consequential loss."[97] In practice, the Ombudsman Bureau has been very erratic.

The situation, though, has been clouded by the recent High Court decision in Needler v. Taber. There, the question was whether a firm that had advised a client to transfer preserved pension benefits to a Norwich Union with profits policy. There are three ways of analysing the result in this case.

First, one ought to start with what the judge said:

> "It is true that but for the negligence of Needler Mr Taber would not have taken out the PPP. It is also true that but for the PPP Mr Taber would not have received any demutualisation benefit. Even allowing for these factors the demutualisation benefit was not caused by and did not flow, as part of a continuous transaction, from the negligence. In causation terms, the breach of duty gave rise to the opportunity to receive the benefit but did not cause it."

This raises the question: when is the point beyond which something does not flow as part of a continuous transaction from the negligence? In some ways, the loss of demutualisation benefits from a churn is more closely connected to the relevant transaction than the Norwich Union shares gained from transferring a pension to that company. The problem with the latter transaction has nothing to do with gaining ownership of Norwich Union. With a churn, the adviser is directly depriving the investor of similar benefits.

The judge then seemed to buttress his argument by saying that at the date of the advice, demutualisation was "highly unlikely"[98] Does this mean that the answer changes where at the point of sale demutualisation was on the horizon? Such a conclusion would fit the existing authorities on the subject.

Finally, we can say that the Needler case cannot be applied to churning since the problem raised in that case was quite different. Needler dealt with the question of whether a benefit received by a policyholder could be set off against a loss caused by negligent non-compliant advice. The claimant in that case had a strong policy

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[96] The Wagon Mound [1961] A.C. 388.

[97] DISP App. 2.1.7.

[98] 31st July 2001 at para 27.

case for being able to ignore the benefit that he had received. After all, he had been the victim of the misselling. There was no reason why the IFA should have had his liability to pay compensation reduced by a fortuitous event outside either of their control. In the churning scenario, it is the non-compliant adviser who is trying to make everyone forget demutualisation. This is a different matter. Certainly, the PIAOB and FOS need not regard themselves as bound by the Needler case to ignore demutualisation benefits. It relates to a different problem.

At the end of the day, the Needler case does not provide an answer to this question. It relates to a different problem. Anyway, after November 30th 2001, the Financial Ombudsman will be free to apply what she considers to be fair and reasonable regardless. My view is that it would be fair and reasonable to compensate people for the loss of their demutualisation benefits. If an adviser churns a policy relating to a mutual assurer, he must know that he runs the risk of costing the client membership rights. He or his firm should not leave the client out of pocket. There is really no reason not to require firms to pay compensation reflecting the value of shares that would have become available on a demutualisation. It is then up to the client to prove on the balance of probabilities what they would have done under the options provided by the assurer: taken the cash option, held the shares or sold them.

The Assessment Guide contains a most unfortunate printing error with the respect to the treatment of the replacement policy. (Actually, assuming that the complaint is to be upheld, the second policy is almost by definition unsuitable. The client should have kept the original contract.) The Guide appears to indicate that items (ii) and (iii) of the churning formula drop out of the picture if the replacement policy is unsuitable. This does not make very much sense. Page 46 then tails off spectacularly with

> "Where the replacement policy is unsuitable, the potential need for further redress must be considered in respect of".

One presumes that this relates to the standard FSA redress. That would make reasonable sense.

(f) Deductions for benefits obtained on demutualisation

We have seen already that customers should be awarded demutualisation benefits lost as a result of being advised wrongly to surrender a policy. The really hot topic at the moment is whether firms should be allowed to deduct shares and other benefits received by policyholders of companies that have since de-mutualised. The argument goes that if the clients had not been sold their endowments, they would not have received the shares or cash concerned.

This whole subject has a very strange history. It starts with the pension review. In 1995, the PIA was faced with some criticism of its Redress Guidance with respect to its treatment of policies taken out to replace occupational scheme benefits lost on opting out of an occupational scheme. The Guidance to this day allows firms to make such a deduction. The PIA Legal Department was told that the Guidance contradicted the House of Lords's decision in Parry v. Cleaver.[99] That decided that no deductions could be made from a damages award with respect to a pay-out under an insurance policy. It was in the public interest that people insure themselves against risks. It could not be held against them if their premium payments produced a reward. A legal opinion was obtained to the effect that Parry v. Cleaver could not apply to pensions. Since the Court of Appeal had applied it to reinsurance in the early 90s[100], this was all very curious.

In May 1997, PIA reversed its position on deductions, not in relation to replacement policies, but when faced with firms de-mutualising. It said:

> ".. We regard the share value purely as the price paid by the demutualising entity for the exchange of membership rights in favour of shareholder rights. The actual value in the hands of the investor is entirely collateral to the value of whatever investment contract he or she may have. It follows, therefore, that the financial impact of demutualisation should be ignored in calculation of loss or redress."[101]

It was difficult to reconcile the PIA's position on the two points.

In December 1999[102], the then PIA Ombudsman decided to part company with PIA's view at least as regards endowments. He said that any shares if not yet sold should be deducted at the date of the Provisional Assessment or Decision of the Ombudsman Bureau. If already sold, the sale price could be deducted with interest. He said that otherwise the customer would clearly be over-compensated.

The weakness in the Ombudsman's argument was that he treated the claim as being purely one for rescission or avoidance of the endowment contract. In that situation, the client has to return all property or benefits passed to him under the contract. As we have seen, he missed the point that the client also has a claim for damages under the ordinary law of negligence and section 150 of the Financial Services and Markets Act. There the argument about deductions is not as straightforward.

In 2000, a PI insurer managed to persuade the PIA Ombudsman to consent to a test case being brought to the courts in relation to a pension transfer complaint. There, the customer had received a windfall payment of around £7,000 on the demutualisation of Norwich Union. The Ombudsman was bound by PIA's Regulatory Update 33 to ignore the windfall. For obvious practical reasons, until the test case

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[99] [1970] A.C. 1

[100] Brown v. KMR Services [1994] All ER 385 at p. 399. This point was not even argued before the Court of Appeal [1995] 4 All ER 498.

[101] RU 33 at p. 6.

[102] 3 News from the Ombudsman Bureau 4, 2 (1999)

was finally resolved, the FSA “hung fire” on the subject in case its approach was severely criticised in court. In May 2001, PIA Regulatory Update 89 said:

> “In these circumstances, we consider it appropriate that firms that wish to do so should be allowed to delay settling mortgage endowment cases where a windfall payment is involved... Firms should progress the complaint as far as possible and should keep the complainant informed as to progress.”

This is a little curious. Did the PIA really mean that firms should be allowed to avoid paying compensation that is due (even allowing for deductions for demutualisation benefits) while awaiting a court decision which could have been appealed to the Court of Appeal and House of Lords? Happily, with the abandonment of the appeal by Needler, this point has presumably become purely of academic interest.

The PIA in the same Regulatory Update continued with some guidance for those firms who wanted to finish these cases without waiting for the High Court’s view.

> “In the meantime, firms that wish to progress windfall cases will want to take into account the way that the Ombudsman will treat mortgage endowment cases referred to the Personal Investment Authority Ombudsman Bureau (PIAOB).
>
> The PIAOB considers that if the allegation is that an unsuitable policy was sold, then the complainant should normally be required to give some credit for any windfall benefit received when assessing the amount of compensation due. The value of cash or shares received from a windfall should be taken into account when quantifying the redress payable. If the complainant states that he has spent the value of the windfall benefit, the Ombudsman will consider the amount of credit that the complainant should be required to give for this benefit.”

This has had the effect of rewarding firms who speeded up their handling of endowment complaints to obtain acceptances of their offers before the High Court’s decision. Against this uncertain background, the Mortgage Endowment Complaints Assessment Guide was silent on the subject. We have the High Court’s decision on the demutualisation test case: Needler v. Taber. This involved a pension transfer. However, the PIA/FSA has made it clear that it expects to apply the same principles to endowments.[103] This is now reflected in DISP App 2.5.13 - 2.6.15.

The PI insurers had one simple point. The IFA’s advice may have resulted in a loss to Mr Taber but it had also caused him to benefit from the shares that he received from the de-mutualisation. They saw no reason why the client should come away better off through the bad advice he had received at their expense.

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[103] RU94 at pp. 2-3

The policyholder had three arguments. First, he said that the windfall gain was unconnected to the non-compliant advice. Secondly, he argued that windfalls should be treated like the proceeds of insurance. Finally, he argued that under the pension review process, the client was entitled to redress calculated in a way prescribed by the relevant regulator and not the law.

He won on his first point and the judge declined to express an opinion on the other two. He made it clear that it made no difference what form any demutualisation benefit took.[104] The key part of the judgement begins:

> "24. The relevant question is whether the negligence which caused the loss also caused the profit in the sense that the latter was part of a continuous transaction of which the former was the inception..."

This, though, rather begs the question: what is part of a continuous transaction that occurs after the original transaction is completed? What is really going on here is that the judge is making a value or policy judgement as to what events are sufficiently closely connected to the negligence that he will take them into account. The judge goes on.

> "26. It is true that but for the negligence of Needler Mr Taber would not have taken out the PPP. It is also true that but for the PPP Mr Taber would not have received any demutualisation benefit. Even allowing for these factors the demutualisation benefit was not caused by and did not flow, as part of a continuous transaction, from the negligence. In causation terms, the breach of duty gave rise to the opportunity to receive the benefit but did not cause it...The link between the negligence and the benefit was broken by all those events in the mid 1990s and later which led to the directors of the Society formulating and the court approving... the transfer of the long term insurance business of the Society to LP."

The judge seeks to put a limit on any deductions to those gains caused by and flowing as part of a continuous transaction from the bad advice to transfer. To return to the strict facts of the case, the court does not explain coherently why the payment of benefits arising from the demutualisation did not flow from the advice to take out a policy with a mutual assurer. Maybe, the case hinges on a factually debatable proposition in the next paragraph:

> 27. The matter may be tested in this way. Would Mr Taber have received comparable benefits from his PPP if there had been no demutualisation? The answer is plainly in the negative. Mr Taber was contractually entitled to share in the profits of the society by way of bonus. Such bonus was likely to provide him with a reasonable return on his asset share in accordance with the PRE. But in the absence of the transfer of the long term business.. or the winding up

[104] Paragraph 25.

> or closure of the Society to new business it was most unlikely that he would ever share in a distribution of the inherited estate. But by virtue of the demutualisation he did..."

This presupposes that de-mutualisation was not considered likely when the pension sale took place. It was clearly an option then. Was it most unlikely? I cannot real say.

Perhaps a better way of looking at this case is that the law puts a cut-off point on the benefits received by a claimant from the defendant's negligence. However, it usually cuts out only events that were unforeseeable when the wrong occurred.

In one case, cited by the High Court, Hussey v. Eels[105], the clients were misled into buying a house which suffered from subsidence. Later, they demolished the house and obtained planning permission to build two new homes on the site. They then sold the property at a considerable profit. The Court of Appeal declined to permit the defendant to take reduce his damages by the profit. It felt that the decision to sell the land for development when they had originally bought it to live on was nothing to do with the original transaction. The idea is that people who give bad advice should not benefit from events which were not foreseeable at the time of the advice. This is particularly the case where the claimant or a third party did something that it could easily not have done.

It all comes down to judicial feel. Strictly speaking, one could run an argument in a case where demutualisation was more likely that a deduction was required. However, the FSA has indicated that it will not create a string of exceptions in this area for different fact situations. Reasonably, it takes the view that if the court approves of RU33's analysis, that will be enough. In regulation, one can create too many exceptions to make things work.

Anyway, the judge concludes:

> "28. For these reasons I conclude that the demutualisation benefit received by Mr Taber was not caused by the mis-selling by Needler of which he complained. Thus, the common law principles for the assessment of damages do not require the value of the benefit of the demutualisation shares issued to Mr Taber to be brought into account in diminution of the compensation to be awarded to him for Needler's breach of duty. It follows that the questions whether if the general rule had applied the demutualisation benefits should be excepted by analogy with the exceptions.. in Parry v. Cleaver.. and whether the Pension Review procedure conferred on Mr Taber an entitlement to compensation in excess of what would have been recoverable at law do not arise."

Since Needler did not appealed the decision which has since been applied in the

[105] [1990] 2 QB 227.

Court of Appeal, one can assume that deductions for demutualisation benefits will not be allowed and that is the end of the story. This applies to payments made to policyholders on demutualisation clearly. There is no reason not to apply it equally to bonuses added to the value of policies. These will have to be deducted for the purposes of loss assessment assuming that the PIA/FSA and FOS propose to apply the full logic of the High Court's decision. As the judge says at paragraph 25:

> "The profit in this case is the holding of demutualisation shares issued to Mr Taber, but it might just as easily have taken the form of a cash payment or an additional bonus. I can see no reason for drawing any distinction based on the form in which the benefit was received."

Overall, the judgement in the Needler case if applied fully by both the PIA/FSA and the FOS prevents some policyholders from being left with a hole in their mortgage arrangements where they have spent the proceeds of a demutualisation. After all, when they did so, they probably did not realise that those amounts would be needed to close a hole in their mortgage arrangements. More generally, firms have been prevented from reducing their redress bill by de-mutualising! Equally, why should IFAs and their PI insurers have to pay less compensation because by a fluke, the former recommended an unsuitable endowment with a company that later de-mutualised? This latter point may have been uppermost in the judge's mind.

Following the abandonment of any possible appeal, the PIA and FSA moved swiftly to a position whereby any windfall had to be disregarded. This was a spectacular example of litigation being brought apparently on behalf of the industry costing it a fortune.

(g) Life cover and critical illness premium deductions

DISP App 2.2.27-28 allows a firm to deduct the cost of decreasing term assurance unless the client had no foreseeable need of the protection (because he was single and without dependants at the point of sales). Intriguingly, 2.2.27 only permits a deduction if the firm is carrying out a comparison of expenses. FOS tends not to interpret this rule in this way allowing an almost automatic deduction wherever the customer needed life cover at the point of sale. This, though, is more than cancelled out usually by 2.5.4's provision of compensation for the extra cost of replacement cover. This produces a fair result.

However, there is no provision anywhere for the deduction of the cost of critical illness cover. The only basis for any such deduction would have to be 2.2.4 which says:

> "In some other cases other factors may be included in the overall calculation, for example if mortgage arrangement fees were waived by agreement on the occasion of the endowment policy being taken out."

This does not cover critical illness cover. Anyway, even if such a deduction was appropriate, one would have to show that it was reasonable to take it into account as savings. We have already seen that it is almost never appropriate to do any such thing. The savings here will not have contributed to the "sufficient means" as required under 2.2.9, particularly if the client does not now want replacement critical illness cover and compensation for the extra cost of it. The only conceivable ground for making a deduction would be if the client wanted to receive compensation for the greater cost of receiving the protection now. Then, the deduction might be reasonable. Otherwise, it is simply non-compliant. A suggestion made by FOS in correspondence to the contrary needs to be corrected promptly either by that organization or the FSA. Firms who make the deduction are taking a significant regulatory risk.

(h) Subsidised mortgages

This is genuinely difficult. If the subsidy is significant, a firm should calculate it and take it into account as being a reasonable deduction under 2.2.3 & 2.2.7 and as an exception to the rule in 2.2.8. Having said that, if an Ombudsman or regulator took the opposite view, one would not be totally surprised. 2.2.8 certainly provides the possible basis for such an answer. If the subsidy or effect of it is modest, it would be best to ignore it.

(i) Breach of Contract and the Mortgage Endowment Complaints Assessment Guide

It is one of the curiosities of complaint handling that breach of contract, the most obvious claim to make about any contract, arouses the strongest emotions. There are, though, some very good reasons for this. Anybody who has friends working at Equitable Life knows someone affected by a promise made by someone or a company that did not really mean it. As the House of Lords decision in that case illustrates, loose words can cost companies their independence.[106]

The FOS, A Briefing Note: Complaints about Mortgage Endowments[107] says correctly that allegations to the effect that adviser promised that the mortgage would repay the loan are "inherently plausible". Bizarrely, the Assessment Guide find that a guarantee will only exist in exceptional circumstances and seems to suggest that confirmation from the adviser or something in writing on company headed notepaper would be required to prove the allegation.[108] If I was a policyholder with a case at the Bureau where this was in issue, I would ask for a hearing.

The Briefing Note goes on to say that such an allegation would not constitute a

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[106] Equitable Life v. Hyman [2000] 3 All ER 961

[107] See p. 6.

[108] See p. 53.

binding agreement where there "was an element of vagueness or lack of specific assurance". The statement has to be in the form of a promise and it is necessary for the promise to have been broken for any damages to be payable in this respect.

For example, the company may have promised its clients that it expected its endowments to repay their mortgages. This could represent a binding promise. However, all that the company needs to show is that the expectation was both held and reasonable and it has not broken any agreement. Assuming that this was not the case, damages will only put the client where he would have been had the promise been honoured.[109] In that case, the premium would have been higher. We have already shown how the effect of the Bowden rule will prevent a firm from relying on savings made by the client in all but exceptional cases. The effect is that the measure of damages provided by the FSA Policy Assessment and the Assessment Guide will be the same as any damages for breach of contract.

Breach of contract causes a problem where the promise is precise and indicates that a particular result will be achieved if certain conditions are fulfilled. The obvious example of such a condition is the premiums being paid. (A less obvious condition might be the achievement of a certain investment performance by the fund.) If the condition is not met, there is clearly no obligation to honour the promise. However, if the condition is met, FOS will require firms to meet such guarantees. Handwritten quotations indicating a certain return presented without any qualification are a good example of this.[110]

It can be argued that such a collateral contract cannot be broken until the endowment fails to reach the maturity level promised. There are two exceptions to this. The first is where the company indicates that it no longer intends to be bound by the obligation.[111] The second case is where it is clear that the promise will not be honoured. In either case, the client is entitled to use that position to escape his side of the bargain and claim damages for breach of contract[112].

Curiously, a firm that receives a complaint and does not deny what its adviser has promised can reject a breach of contract claim on the basis that it is far from clear that the policy will fail to reach the promised level on maturity.

Even if it does not want to take that risk, where the policy is on target to achieve the relevant level of benefits, no contract has been broken in any event.

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[109] See e.g. Esso v. Mardon [1976] Q.B. 801 where damages for breach of contract and negligent misstatement were the same.

[110] Ombudsman News, November 2001 at p. 8 for an example.

[111] The Hermosa [1982] 1 Lloyd's Rep 570 at p. 572.

[112] UCC v. Citati [1957] Q.B. 401 at p. 449.

So, a guarantee claim is only going to come into play in two situations (i) where the guarantee is denied or (ii) where it clearly cannot be fulfilled - in other words on maturity or close to it. In both those cases, the Ombudsman can uphold the complaint and make an award that reflects the loss of the guarantee. In the first case, the Ombudsman can only declare, as the House of Lords did in Equitable Life v. Hyman[113] that the company is bound by the guarantee. In the second example, the firm will have to make up a shortfall.

There is a most interesting development in the area of breach of contract claims when the Assessment Guide deals with "surrender penalties or other charges not explained".[114] The remedy suggested is that some or all of the charges are to be knocked out. There is a great deal of case law on cutting onerous or unusual terms out of contracts where they have not been properly disclosed.[115] This development coincides with an FSA Discussion Paper suggesting a similar approach.[116] It would, though, represent another significant change in policy for the Ombudsman Service and one will wait to see whether it represents a significant development. A problem with decision trees, that have not been backed up by a full commentary, is that one may wrongly identify a substantial change in approach where all that exists is an error.

An issue that brings together the FSA approach and breach of contract issues relates to the mis-pricing of endowments. If the premium has been set at too low a level, we have already seen that the firm must credit to the policy the premiums that should have been paid to it using the FSA statement.[117] If one is not concerned with a breach of contract claim, the firm can now charge the correct premium for the future as a condition of delivering the benefits expected of the policy. However, where the firm promised a particular result from the policy (notably that it will pay off the mortgage), the company is stuck with having to provide those benefits with a lower premium until maturity. This does not make a great deal of difference where the policy is close to its maturity date. It can be expensive if this is not the case.

At the end of the day, though, the issue is purely a matter of interpreting the policy conditions and the material used to sell the policies concerned. This must always be

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[113]Equitable Life v. Hyman [2000] 3 All ER 961

[114] At p. 50.

[115]See on this whole subject PIAOB Annual Report 1995-1996 at p. 43 setting out but then declining without reason to apply this rule, Unfair Contract Terms Regulations (now The Unfair Terms in Consumer Contracts Regulations 1999 & Interfoto v. Stiletto [1988] 1 All E.R 348 The case reported in PIAOB Annual Report 1999-2000 at p. 15 should have been dealt with by reference to the Interfoto principle.

[116] FSA, "Treating customers fairly after the point of sale", June 2001 at pp. 35 & 39.

[117] FOS, Endowment Mortgage Complaints Assessment Guide at p. 42.

construed in the way least favourable to the insurers who drafted it. Then, one has to ask: was the client promised a particular outcome in exchange for paying the premiums collected? If the answer is negative, there is no contractual obligation to deliver that benefit concerned.

(vi) Distress and Inconvenience

The legal position on this subject is that unless the customer can show a physical or mental illness has been caused by the wrong done to him, he is probably not entitled to any compensation for any distress or inconvenience.[118] So, such payments are not the norm.

The Briefing Note provided one of the clearest explanations of the relevant considerations. The relevant passage[119] reads as follows:

> "The circumstances.. will include
> (a) the age, state of health and financial position of the customer;
> (b) the apparent degree of distress and the length of time the distress has been suffered;
> (c) the extent of the financial loss;
> (d) the way in which the complaint has been dealt with."

The Briefing Note then confirms that the bottom end of the scale for these payments is between £100 and £250. In practice, if a reasonable offer is made, it is unlikely to be upset by a case officer who might have taken a slightly different view if no such gesture had been made in advance. The FOS website now contains a more detailed paper on distress and inconvenience and professional fees. Whether it improves on the Briefing Note summary, one doubts.

Some firms only offer payments under this heading where the client has expressly asked for one. This is not correct. The spirit of the complaint handling rules is that firms will reach pro-active principled decisions. The Mortgage Assessment Guide suggests consideration of distress payments where the complaint is upheld on the grounds of pressurised selling,[120] fraud[121] and poor service or administration.[122] One assumes that forgery comes within the definition of fraud. It is not pleasant to have

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[118] Watts v. Morrow [1991] 1 WLR 1421.

[119] At p. 10.

[120] At p. 47.

[121] At p. 60.

[122] At p. 61.

one's signature copied.[123]

V: LIMITATION

One area not covered by the FSA Guidance or the Decision Trees is Limitation. The Insurance Ombudsman Bureau was never bound or particularly concerned by the subject. However, one of Lord Ackner's suggestions when setting up PIAOB was that consumers should not be allowed to bring time-barred complaints to that organization. This seemed a little strange in view of the consumer protection objectives of that organization. Exceptions had to be implemented immediately to protect investors in pensions and FSAVC review cases.

The Financial Ombudsman Service has to have regard to the law in reaching fair and reasonable results. It also, though, has an awkward limitation period of its own which, as will be seen is more restrictive than the law. The way to approach the subject is to recall that in law unless a claim is barred under all the relevant headings, it can be brought. We will begin by looking at the legal position and then finish with the FOS rules.

(i) Basic Limitation period for a claim in Negligence or for Breach of Conduct of Business Rules (Section 150 FSMA) - 6 years from transaction

The first period we need to be interested in is 6 years from the date when the defective transaction was concluded.[124] This means the date when the acceptance of the application was received by the client. Assuming that there has been no loading of the premium, this is the date on which the policy was received by the customer. If the contract has been loaded, the relevant date is that on which the amended terms have been received by the insurer. If the complainant starts his claim within six years of these dates, he will not be time-barred.

If the firm has offered a guarantee, that promise will not be broken until maturity. So, the customer then has a further six months to complain after that.

(ii) Latent Damage Act - 3 years from Discovery of the Problem or when the Customer should have discovered it and should have sued - up to 15 years from the event or transaction

The second period derives from the Latent Damage Act and can be found in section 14A of the Act. Here, the 3-year period runs from the earliest date on which the complainant had both the knowledge required to bring the action and a right to bring

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[123] This is omitted, though, from p. 59.

124 Sections 2 on actions in tort (ie negligence) and 9 on actions under statute (ie s.62 FSA or s.150 FSMA for breach of the conduct of business rules). Glaister v. Greenwood at para 36 makes the primary limitation period run from the transaction.

the action.

The knowledge concerned is of the material facts about the damage in respect of which compensation is being claimed. Those facts are those that would lead a reasonable person to consider it sufficiently serious to justify instituting proceedings. The section then defines knowledge as being what he might reasonably have been expected to acquire from facts observable or ascertainable by him or from facts ascertainable by him with the help of appropriate experts advice. However, where he has taken reasonable steps to obtain and act on the advice, he is not to be taken to have the relevant knowledge if it would have taken an expert's advice to point it out to him.

In Glaister v. Greenwood, an IFA advised Mr Glaister to transfer his preserved OPS benefits to a personal pension. The customer received a SIB factsheet in April 1995 that suggested that he may have suffered a loss from transferring. In February 1996, he told the ICS that he believed that he had a claim because press articles and legal advice suggested that he would have been better off not to transfer. It was only when he received a report in February 1997 from an actuary indicating that there was probably a difference in the value of his personal pension and the preserved benefits of between £600 and £2400 that Mr Glaister had the relevant actual knowledge. The 3-year period ran from that date and so the claim was not time-barred.

To apply the same logic to endowments, section 14A effectively ensures that until the client knows that he has probably suffered a loss judged by the standards of the FSA Statement and that the sale was non-compliant or at least negligent, the 3-year period will not have started. A red letter does not have that effect since it does not tell the client that he has actually suffered a loss. This is reflected in paragraph 3 in the Notes to Editors of the FSA's Press Release of 22nd November 2002. This reads:

> "A red letter is not enough to start time running on its own."

The red letter suggests that his endowment is not likely to repay his mortgage. That is a different issue. If the industry wanted to start time running for limitation purposes, it would presumably have put a clear statement in the letter that the policy may well have been missold and that a loss has probably occurred.

In Oakes v. Hopcroft,[125] the claimant had suffered a work accident. She was wrongly told by a doctor that her injuries were much less serious than they were. She settled the court case against her employer by accepting much too low a payment. The Court of Appeal said that for the three years to start running under section 14A, she had to know not only that the doctor had misdiagnosed her but that she had accepted too low a settlement as a result.

In the textbook red-letter case, the client will sometimes not know of the misselling

125 [2000] Lloyd's Rep. PN 946

and will certainly not know whether they would have been better off with a capital repayment loan from the same provider.

Finally, section 1(2) of the Limitation Act provides that the limitation period of 15 years from the date of the event (often known as the backstop) applies to cases brought under section 14A.

(iii) Breach of Contract - 6 years from breach

There is some further bad news where complainants allege a guarantee or warranty, typically that an endowment will pay off a mortgage on maturity. The six year limitation period for contract claims only starts when the contract is broken.[126] If the firm has never denied the existence of the guarantee or warranty and it is still possible for the guarantee to be met, there is no breach of contract. So, time will not start to run until such events occur.

(iv) Section 32 - 6 Years from the date on which the complainant could reasonably have discovered Negligence or breach of duty and probable financial loss -

(a) Where the wrongdoer takes active steps to conceal his own breach of duty after he has become aware of it; or (ii) where he is guilty of deliberate wrongdoing and conceals or fails to disclose it in circumstances where it is unlikely to be discovered for some time

Section 32(1) says: **"**Where... (a) the action is based upon the fraud of the defendant; **or (b) any fact relevant to the plaintiff's right of action has been deliberately concealed from him by the defendant**... the period of **limitation shall not begin to run until the plaintiff has discovered the** fraud, **concealment** or mistake **or could with reasonable diligence have discovered it."** (Emphasis added.)

Then subsection (2) explains that **"deliberate commission of a breach of duty in circumstances in which it is unlikely to be discovered for some time amounts to deliberate concealment of the facts involved in the breach of duty**.

In Cave v. Robinson Jarvis & Rolf, the House of Lords recently lifted the cloud that hung over professional advisers by rejecting the previous broader interpretation of this section of the Act.

In 1989, the claimants asked solicitors to arrange for the sale of some of their land in exchange for mooring rights over the land. The solicitor left out the mooring rights. Everything went well until 1994 when the purchaser went into liquidation. The receivers then denied the claimants their mooring rights relying on the absence of these rights in the deed. The court found that the 6-year period started to run in 1994.

126 Section 5 Limitation Act 1980

Essentially, the act of the solicitors in producing the defective deed was unlikely to be discovered for some time. It was an intentional act. However, the solicitor had no knowledge or intention of any concealment or any unconscionability at least until after the claimant knew about the problem.

The House of Lords decided that where someone unintentionally commits a breach of duty and does not deliberately conceal that wrong once he discovers it, section 32 does not apply and the usual limitation rules can be used to bar an action.

As Lord Millett put it:

> "25. In my opinion, section 32 deprives a defendant of a limitation defence in two situations: (i) where he takes active steps to conceal his own breach of duty after he has become aware of it; and (ii) where he is guilty of deliberate wrongdoing and conceals or fails to disclose it in circumstances where it is unlikely to be discovered for some time."

However, Lord Millett refers favourably to a passage in King v Victor Parsons[127] and Lord Scott to a much more recent extract from a leading textbook to similar effect.[128] Both added to the notion of a deliberate breach of duty the situation where the defendant is aware that what is doing may be a breach of duty but turns a blind eye to this fact.

Lord Scott makes it clear also that if the defendant knew he was committing a breach of duty that would be the same as if he intended it.[129]

On the meaning of concealment, Lord Scott required the claimant to prove that **"**some fact relevant to his right of action has been concealed from him either by a positive act of concealment or by a withholding of relevant information, but in either case, with the intention of concealing the fact or facts in question.**"**

The significance of all this is that if the complainant can prove intentional or reckless breaches of duty, it is quite likely that the claim will not be time-barred until 6 years after the breach is discovered. Most breaches of duty in the financial services industry are made in circumstances where they are unlikely to be discovered for some time. Proving intention or recklessness will be difficult - but someone will try and succeed.

There should also be a warning to firms who may try to cover up misselling that this could be used against them on an intentional concealment claim. Having said that,

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127 [1973] 1 WLR 29 at pp. 33-34

128 Clerk & Lindsell on Torts, 18th ed at p. 1723

129 Para 60.

the section imposes no duty to be open to clients, just not to conceal actively breaches of duty once the firm has become aware of them.

Incidentally, section 32 applies equally to actions for breach of contract. Finally, the 15-year backstop does not apply to cases coming within section 32.

(v) The Ombudsman has his own Limitation rules anyway

For complaints received before 1st June 2004 - six years after the event complained of or if later) more than three years from the date on which he became aware (or ought reasonably to have become aware) that he had cause for complaint - unless exceptional circumstances - except that cases will be time-barred within 3 years of a first red letter or six months after a second letter of any other colour whichever is later.

In the vast majority of cases, this discussion of the legal position will be largely academic. Under section 228(2) of the new Act and DISP 3.8.1, the Ombudsman is required to reach a fair and reasonable result. She only has to consider the law as part of that process. He does not have to apply it.

For complaints made before 1st June 2004, the Ombudsman will not be able to look at a case if the complaint was made to FOS more than "six years after the event complained of or (if later) more than three years from the date on which he became aware (or ought reasonably to have become aware) that he had cause for complaint"[130]

This is the section 14A Limitation Act position without the 15-year backstop. So, the comments made above about red letters issued to endowment customers not starting time running should logically apply equally here. If the client complains without having suffered a loss, his case will be rejected. So, he has to be aware that one element of his case exists, namely that he has suffered a loss. The red letter does not tell the client that. Indeed, if his mortgage is subsidised, he may not have suffered a loss. It also does not inform him that the adviser missold the contract. He must know both those things before the three year period can start to run.
Limitation should not seriously be an issue in endowment cases unless the company or a third party has told the client that he has probably lost money by taking out the product.

The Consumers Association, after many years of neglecting the issue, suddenly woke up in 2002 to endowment complaints and limitation. Its relations with the FSA have been notoriously difficult of late. One effect of their campaign on limitation being conducted by megaphone without proper legal advice is that they have actually managed to reduce the limitation period applicable to their clients.

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[130] 2.3.1(1)(c).

As already indicated, the FSA was prepared to accept in note 3 to its Press Release that a red letter “was not enough to start time running on its own”.(It repeated this statement in two subsequent releases again in the Notes to the Editors - these are reproduced as an annex to the paper on Limitation on this site.) If the Consumers Association had left the discussion there, the problem would have disappeared. However, the debate seems to have pushed the FSA into the arms of the Association of British Insurers with predictable results.

Under the 2003 amendment to DISP 2.3, cases are time-barred six months after the receipt by the client of a second letter of any colour if this gives the consumer more than 3 years from the date of the first red letter in which to complain. In some cases, this could have shortened the limitation period by decades.

The problem with all this is that, as already indicated, a consumer, notably with a subsidised mortgage, may have received two red letters and not suffered any loss. In that case, FOS is of no use whatsoever.

The Ombudsman can hear a case in exceptional circumstances, typically where the firm failed to tell the client of his services.[131]

There is a further limit on bringing complaints to FOS. It cannot deal with a complaint brought to it more than six months after the client was referred to it in the firm’s final response letter again other than in exceptional circumstances.[132] The importance of this is considerable in pensions and FSAVC review as well as endowment cases. In the latter category, if the client complains too early and no loss is found to exist, the customer has probably lost for ever their right to complain to FOS. A movement in investment conditions is hardly fresh evidence entitling the Ombudsman to consider a case for the second time.

The rules on time-bars in DISP apply to FOS.[133] However, they do not apply to firms. They are required to reach reasonable conclusions on cases which may not be considered by FOS.[134] The regulator has not made it clear whether this involves offering redress on cases that may (but will not necessarily) be rejected by the Ombudsman because of the lateness of the complaint. The November 2003 issue of Ombudsman News told us that the FSA will be “contacting” firms who tried to rely on the 15 year backstop in the Limitation Act to reject complaints. This has not stopped a High Street bank from trying to rely on the Act (inaccurately) on a final response issued since then. Firms must not rely on the legislation to throw out complaints

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2.3.1(2) & 2.3.3.

2.3.1(b) & 2.

133 See DISP 2.3.

134 DISP 1.2.1, 1.2.16 & 1.2.22.

unless they want to attract FSA's attention.

Recently, the Treasury Select Committee issued stinging criticism of the endowment time-bar rules and the way in which the mailings do not explain the complaints mechanism or indicate any time-limit for making one.[135]

The result is the 2004 amendments to DISP 2.3 which were rushed through without consultation.

Complaints made to firms after 1st June 2004 will be time-barred three years after the client received his first red letter so long as 6 months has expired since the firm wrote to him to say that it would be relying on the time-bar or 2 months where the six months expires on or before 30th November 2004

The 2004 version of DISP 2.3 has taken away the requirement of a six months delay from the second mailing,[136] for no apparent reason. Instead, firms have to give a warning six-months ahead if they wish to time-bar endowment complaints.[137] This curiously drops to two months if the 3 years from the red letter expires before the end of November 2004.[138]

The FSA has not laid down the form of the warning. Firms can, therefore, probably print it in small type on the bottom of any subsequent mailings. This raises questions, though, as to whether companies who take such an approach are not in breach of Principle 6 "treating customers fairly". The regulator should have insisted on a separate letter.

Customers who have already complained to firms are left unprotected by the new rules.[139] Their cases are governed by the second version of DISP in this area. The Treasury reckons that this cuts out 700,000 complaints. Predictably, this has not produced a positive reaction from the Treasury Select Committee. In current hearings, they have again urged firms to stop relying on the time-bar. It is rumoured that some companies are taking heed of this or at least considering it.

Presumably, FOS will go back on its earlier view of allowing firms who have issued the equivalent of red letters from relying on DISP 2.3.1 to bar complaints. It would go against the entire thrust and purpose of the 2004 amendments to the rule. This was

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135 "Restoring confidence in long-term savings: Endowment mortgages", HC394, March 2004 at p. 33.

136 DISP 2.3.6(1).

137 DISP 2.3.6(2).

138 DISP TP1.7B

139 DISP TP1.7A.

to respond to the Treasury Select Committee's criticisms that cases should not be barred without the customer being warned about the risk of this.

There is one possible unexpected and undesirable consequence of the new rule. Customers who were told as part of a pro-active business review that they have suffered a loss can now take the case to FOS more than 3 years later. Firms who have done reviews of this type might be wise to consider mailing everyone with an offer outstanding threatening to rely on the time-bar. In many of these cases, the customer will not have complained to the firm as yet. This might represent a good case for the Ombudsman to exercise the power that he has to apply DISP 2.3.1 and bar the claim on the basis that three years have passed since the customer knew that he had cause to complain.

Does the latest change in the rules itself constitute an exceptional circumstances justifying the Ombudsman in hearing all cases received by firms before 1st June 2004 that would otherwise be barred under DISP 2.3.6? I think that it ought to be, particularly where the firm has been fined for misselling or complaint handling problems. More importantly, the whole saga shows the dangers of playing politics with consumer rights. A simple application of 2.3 in line with the one given to the almost identically worded section 14A of the Limitation Act, requiring time to run from the date when the client was told that he had suffered a loss, would have avoided an embarrassing debacle for the FSA.

VI: CONCLUSION

In this most public area of complaint, endowment sales, there are some curious cross-currents. The greater focus on these type of cases means that more complaints are being upheld than in the past. This gives increasing credibility to the Ombudsman Scheme. While results continue to be erratic, there is a greater tendency towards upholding justified complaints than in the past. To the extent that the FOS Briefing Note set off a considerable amount of discussion on when complaints should be upheld, it did nothing but good.

However, currently, the drive towards good quality case handling standards is coming from the FSA, not FOS. Its Final Notices on misselling and complaints are reinforcing standards originally laid down in RU72 and the Briefing Note itself. These, with their correct emphasis on mortgage risk make it increasingly difficult to reject complaints. Few firms ever enquired about the customer's attitude to taking a chance with the repayment of their home loan. They are now paying the penalty. Curiously, FOS is now well behind the FSA in its approach to endowment complaints. It has some serious catching up to do.
On the compensation side, it is very much a case of the good, the bad and the ugly. On the side of the angels is the FSA DISP App 2. That document has to be read in its context. It only seeks to lay down minimum standards and to cover claims for negligence and breach of the relevant conduct of business rules. That is probably all the regulator was allowed to do. Within that scope, the Statement is magnificent. It really does force firms to put clients in the position in which they would have been

had the former acted in a compliant way.

Its approach to deduction of savings by investors is something of which the Captain of the HMS Pinafore would be proud. ("What never? No never. What never? Well, hardly ever.") This reflects the slightly hazy state of the law and one's sense of fairness. Finally, by taking a rigorous approach to the task it set itself, it has freed IFAs from having to pay contributions plus interest in standard missale cases. With relatively few exceptions, this was never correct and forced independent advisers to pay more compensation than they should have had to.

The "bad" is the way in which the Financial Ombudsman Service has not used its powers to build on the FSA DISP App 2. All it had to say to reflect both the law and twenty years of Ombudsman work is that the assurer has an obligation to refund contributions plus interest wherever the customer was induced by non-disclosure, misrepresentation or duress if such a refund was more favourable to the client than the compensation payable under what is now DISP App 2.. It equally had to indicate that where a promise was made to persuade the client to enter to the contract, it would be enforced according to its terms. It did say this in the Briefing Note. However, its Assessment Guide is a bit all over the place on this subject.

It is always open to Ombudsman Bureaux to change their mind. What is irritating is not that but the way in which, when removing the presumed right of the investor to obtain from an assurer a refund of contributions plus interest, the Ombudsman has failed to state clearly what she is doing and why. To find the answer to all these questions buried in a series of Decision Trees that had this author's head spinning in preparing this paper was not amusing. No coherent explanation has been published. That is a shame.

The Decision Tree approach itself represents a dumbing down of the whole subject. Each tree has to symetrically show grounds for rejecting the complaint. This attempt at appearing fair has actually led the Trees to contain a number of potentially misleading comments and some outright mistakes.

As this paper shows, I prefer people to think about what they are doing. Only by setting out coherent principles and then applying them to cases, rather than the other way round, can mistakes be avoided and staff equipped to handle new types of cases. Perhaps, though, the state of the work being done in this field was so poor that the spoon-feeding in the Decision Trees was the only option. Either way, John Tiner's letter of April 2002 urged firms not to rely too heavily on the trees and previous Ombudsman decisions. The best way to use the trees is as a check list to make sure that one has not left out any ground for upholding complaints. They are not, though, either comprehensive or, in places, even accurate.

On the ugly side is the mess on limitation created by a regulator that tried to play politics with the Consumers Association without looking past that organization's arguments to the bigger more principled picture. It fully deserves the condemnation that it has received from the Treasury Select Committee and more.

Equally horrid is the amount of work everyone is going to have to do to make the new approach work. My suggestion of using a standard mortgage index was rejected by the FSA and the Ombudsman Bureau. Expensive computer software and tricky calculations (not to mention an early spat over software providers) bring back happy memories of.... no, no, no, not.....ugh.......the Pension Review!