

Traded Endowment Policies

Product provider firms only

The purpose of this Update is to ask provider firms to take steps to ensure that policyholders considering surrender of a life policy are informed that they may be able to trade that policy instead.

- Some with-profits policies (normally only those that have been in force for at least 5 years) may be traded rather than surrendered. Where this is the case, the policyholder can often expect to get a better cash value for the policy than if it had been surrendered. PIA is of the view that policyholders should not surrender policies without being aware that they may have the option to trade them instead.
- As a matter of principle, it is important that policyholders are always made aware of the financial consequences of surrendering a life policy, an investment that is designed to be held through to maturity.
- Provider firms are reminded of the guidance given in RU81 on the need for customers to be made aware of the consequences of surrendering a life policy and the help and support they might reasonably expect to get from firms in understanding this. Where a customer remains minded to surrender his or her policy, it is just as important that he or she be informed that surrender is not the only way forward and that one of the alternatives, which is to trade the policy, may net them a higher cash sum.
- PIA does not have the powers under the Financial Services Act 1986 to place a specific duty on life offices to inform their policyholders that they may trade their policies rather than surrender them. However, it considers that it is reasonable for policyholders to expect to be informed that, provided their policy is eligible for trading, this option is open to them.
- Some provider firms, of course, already provide this information. Where this is not the case, PIA would ask those firms to take steps to ensure that this information is made available to their policyholders. Precisely when and how this is done is for firms to decide. Clearly, the latest possible time is when firms become aware of the intention to surrender – although even if the information has been given in earlier literature it would still seem appropriate to repeat it. It would not be reasonable to expect policyholders to have to rely on information given when they took out the policy, because of the time that will likely have elapsed before they wish to surrender the policy.
- IFAs are already subject to a Recommendation (Adopted FIMBRA Rules Appendix F6 Note F7) that, when being asked to arrange surrender of a with-profits policy, they should, where appropriate, advise that it may be possible to obtain a higher cash value through trading.
- In the case of friendly societies, policyholders will also need to be made aware of any membership considerations which may affect the ease with which a policy can be reassigned.

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- PIA understands that the FSA plans to consult later this year on rules and guidance relating to the surrender of life policies and the alternatives available to policyholders.

Derivative-linked Investments and Split Capital Investment Trusts

PIA and FSA interim authorised firms

Investment products are increasingly using financial instruments which are less familiar to ordinary investors. Typically, their marketing highlights the high returns that may be achieved. These products may well be designed to be available within an ISA wrapper. It is important that the structure of these products and the risks involved are carefully explained to customers before they commit themselves.

Examples of these products are:

- Offshore closed-ended investment companies using a derivative structure to provide a pre-determined level of 'income' or 'growth', but where return of capital is at risk and is linked to the future performance of one or more indices or shares;
- Income shares of split capital investment trusts;
- Investments directly or indirectly in hedge funds.

PIA has developed detailed guidance for the advertising of such products. This is set out in Appendix 1 to this update. The main points are:

- Care must be taken to ensure that, in advertising and other promotional material, the structure of the product is described and the risks to which the customer will be exposed are explained clearly and in words that the ordinary consumer is likely to be in a position to understand;
- In particular, it is important that there is an explanation of how the rate of return has been calculated and the factors that will influence whether it is achieved must be explained, again in words that the ordinary consumer will understand;
- PIA also reminds firms that where advice is given, particular care must be taken to ensure that the risk profile of the product is carefully assessed in relation to the investment needs and aspirations of the customer. This is especially important where the customer is not familiar with either the type of product or the kind of risks to which he or she would be exposed. To achieve the necessarily high standards, it should go without saying that the adviser must be fully conversant with the type of product on which he is advising and the nature of the risks involved.

Appendix 1

Derivative-linked investments and hedge funds

NB this guidance should be read in conjunction with previous guidance- see PIA Regulatory Update 38, 'The marketing of 'guaranteed products''.

Products using derivatives may be established in various ways. A frequently-seen arrangement is for a firm to establish an offshore closed-ended investment company and to market shares in that company. Such shares will invariably be eligible to be held in an ISA. PIA understands that such companies may be set up offshore to attract particular tax benefits, and they may also be able to participate in investment linkages that would not readily be available to UK-based funds. In addition to the offshore closed-ended investment company, other product structures are available and others can be envisaged. This guidance applies to products, however structured, which provide the benefits described.

Typically, such products are fixed term lump sum investments offering a pre-determined level of returns but where the return of capital is dependent upon a particular formula provided by a package of derivatives. A product might offer regular monthly, quarterly or annual payments for a fixed period of years, or offer a pre-determined lump sum at the end of the investment term. However, the investor's capital is put at risk and the terms of the contract may be such that the final capital return may be less than the original investment. This guidance also applies to products providing a capital return linked directly to derivative-based packages such as hedge funds.

Explaining the product

Firms must ensure that investors are given all the information necessary to understand the nature of the product they are purchasing. That would involve an explanation of the factors affecting the return on a product.

The use of derivatives in a contract can be used to create straightforward and transparent product benefits. Alternatively, the mechanics of the package can lead to a very complicated structure. The benefits on a product can be linked to a stock market index in a geographical or business sector that may be less familiar or unfamiliar to investors. The returns might be linked to two or more indices, and might be linked to the average of those indices or the worst performing of those indices. The returns might be based on the final value of an index over a particular period or on particular days, and might be linked to the average or lowest value of the index over that period. There might be a complicated formula for determining the linkage to an index. The potential losses sustained by investors might be 'geared' to the performance of the index. The returns might be linked not to an index but to the performance of a basket of selected shares, and any of the above conditions may equally be applied to such a basket.

Each of the above conditions (and any others which may be developed) will affect the potential returns to the investor and the risk profile of the product. Product designers should be aware of the effect of the various conditions. PIA considers that firms marketing such products should disclose the different factors affecting return and to explain the effect of those. In the case of a product sold with a Key Features Document, that information could be in the Questions and Answers section of the Key Features. For products subject to alternative regimes, PIA would

expect a clear statement of these factors to appear in marketing literature. Such a summary would be an additional disclosure to the general requirement to explain the product clearly and to disclose the risks fairly.

PIA recommends that a useful method to demonstrate the mechanics of a product is to include a table showing the returns to the investor given various assumptions about the index (or indices or shares) to which benefits are linked. The future levels of the index should be chosen to illustrate the full range of conditions that might apply to the product. However, firms should not use such a device to suggest unreasonable levels of growth. It may be necessary, in order to demonstrate the shape of the returns, to use a growth rate higher than the maximum rate that would be permitted under the projection rules (eg to illustrate a cap on returns). In this event, firms may use those growth rates but should balance that by using equivalent rates below the minimum projection rate. It is important to note that such a presentation may assist the investor in understanding the product, but will not in itself provide information on the level of risk it represents.

Explaining the risks

PIA considers it essential that advertisements for these products should disclose fairly the risks involved. A complicated product structure makes it very difficult for investors to form a view as to the risk profile of a product. Even if an investor is able to understand the mechanics of the product, they may not be able to quantify the risk or to form a reasonable assessment of risk, or to be able to make any sensible assumptions about risk before the purchase decision. PIA considers the onus is clearly on firms to provide an explanation of risk in terms that investors will understand. This will require the firm to make an assessment of the product, its risk profile and the types of risk to which investors may be exposed. The firm must then disclose the risk to investors in suitable terms.

For example, the product might have a high likelihood that the investor will face a shortfall, but the likely shortfall might be relatively small. Another product might have a high likelihood of returning capital in full, but where any losses would be significant. Such characteristics should be clearly explained to investors.

To some extent, the degree of risk reflects the rewards available from the product. For example, a product offering payments at a rate of 9% pa is likely to be more risky than a product paying 6% pa. While PIA accepts that this principle does not hold true in every case, in general terms the PIA would expect more prominent and more detailed explanations of risk to be disclosed in advertisements for products offering higher fixed payments.

The prominence given to the information about risk should reflect the degree of risk posed by the product and the prominence given to marketing information about the benefits. For example, with any product where the investor faces capital loss, PIA's view is that any Specific Investment advertisement/Category B advertisement in a newspaper should disclose the possibility of capital loss as one of the main points in the advertisement. Any brochure or leaflet will probably require disclosure of the possibility of loss on the front cover. In any direct offer pack, the possibility of loss should be disclosed in any covering letter. The wording used in each case should specifically address the possibility of capital loss. Similar disclosure would be expected in other types of advertisement.

Some firms show the result of 'back testing' the investment, ie analysing how the investment would have performed if it had been available at different points in the past, given the then prevailing index levels, interest rates, option prices etc. PIA is concerned that such presentations can give a misleading impression of the risk profile of the product. While some of the data is undoubtedly a matter of historical record, the reliability of other information cannot be guaranteed and, in any event, the performance may have been obtained in substantially different market

conditions than those faced by current investors. PIA would view with concern any presentation which might lead investors to assess the risk profile of an investment by reference to ‘back testing’. Advertisements risk this inference being drawn unless there is a clear separation of the ‘back testing’ information from the assessment of risk, and unless the ‘back testing’ information is accompanied by suitable text to warn investors that the information should not be used for assessing the risk profile of the investment.

Investment term

Some products are designed to provide payments on a monthly, quarterly or annual basis over a set number of years, but require the investor to tie up capital for a longer period. This has the effect of reducing the effective return on the investment. The length of time over which capital is tied up, and the dates when the payments and capital return are made, must be disclosed clearly in the description of the product. Separately, when describing the fixed returns on the product, firms may well need to disclose the investment period in such a way as to ensure investors consider the returns in the context of the investment period. The longer the ‘extra’ period over which capital is tied up, the more prominent that information should be. As a guide, if capital is tied up for more than one month following the last fixed payment, that should be disclosed in the main text of an advertisement, on the front of any brochure, and with similar prominence in any other advertising format.

Income shares of split capital investment trusts

PIA has considered the marketing literature of a range of split capital investment trusts. This has raised concerns about the way the risks of income shares have been described. PIA therefore issues the following guidance for any firm wishing to market these products.

A split capital investment trust is an investment company that is launched with a fixed life span. Different classes of share are available, and the capital growth and income of the company’s assets are allocated to the different classes of share. Typically, income shares benefit from the entire income stream generated by the company’s assets. On the winding up of the company, the assets held at that time are divided between the different share classes according to a pre-determined order of priority. Income shares generally rank at least second in order of priority, so assets can only be allocated to repay the income shares after the trust has met its obligations to repay the higher-ranking shares.

Split capital shares may be advertised at launch, as a public offering of shares, and during their lifetime, typically as an option in an investment trust savings scheme.

Income shareholders must be aware that if the trust does not have enough assets to repay the higher-ranking shares, then they will not receive any capital back at the winding up date. And depending on the performance of the trust, there is also a risk that they will receive less than their original capital.

The growth in the trust’s assets needed to provide income shareholders with any capital return, and full capital return, (the “hurdle rates”) are known at the launch of the trust and can be calculated at any point in the lifetime of the trust.

In return, income shares should benefit from a high and potentially increasing income stream. Depending on the structure of the trust, the income shareholders may also benefit from any extra growth in the trust’s assets.

Typically, trusts may be launched with a hurdle rate for zero capital return in the range –5% pa to –1% pa, and for full capital return in the range 3% pa to 5%pa. These rates may be compared

with the PIA projection rates of 2%, 4% and 6% (ie derived from the projection rates for a fund before taxes and deducting 3% for dividends). This suggests that for many funds, the possibility of total capital loss is low but perceptible and that there may be a real possibility of capital shortfall.

Explaining the product

Any leaflet or brochure produced to accompany the prospectus, which contains a description of the shares, should provide a fair and balanced picture of the investment. That would include a clear and prominent description of the factors affecting the capital return and the risk of partial and full loss of capital. PIA considers that an effective way to alert investors to the risk is by means of an explanation of the hurdle rates which are needed for zero and full capital return, and disclosure of those rates. Similar considerations should be applied to other advertising material that may be used to accompany the launch of shares.

Where income shares are promoted as an option in an investment trust savings scheme, care must again be taken to ensure that the particular risks of the shares are stated. That would require a clear and prominent description of the factors affecting the capital return and the risk of partial and full loss of capital. Again, an effective way to achieve that would be by means of an explanation of the hurdle rates which are needed for zero and full capital return, and disclosure of those rates.

Explaining the risks

PIA is concerned that the risks of capital loss are not adequately disclosed in marketing literature for income shares. PIA is particularly concerned as the risk of capital loss, and full capital loss, may be greater than for many alternative income-generating investments.

A public offering of shares requires the publication of a prospectus or mini-prospectus and that document is intended to form the main source of information for potential investors. The prospectus will contain a section detailing the risks inherent in the purchase of the shares. However firms will usually produce a range of brochures, leaflets and advertisements to accompany the launch. The information in such documents may well have a significant impact in the purchase decision and PIA wishes to ensure that the information provides a fair and balanced description of the investment, in particular highlighting the risk to capital.

PIA considers that press advertisements for such offerings should clearly alert investors to the risks associated with holding such investments and in particular should disclose the risk of potential loss of capital. This statement should be in the main copy of any advertisement. The prominence and tone of the statement should reflect the prominence given to information about the level of income available, and should reflect the relative risk to capital as assessed by the hurdle rates and the proposed investment portfolio. Depending on the nature of the fund, it may also be appropriate to disclose the risk of full loss of capital. These principles would also apply to similar advertisements and to any covering letters issued with a direct offer advertisement.

Advised sales

PIA also reminds independent practitioners and product providers of their obligations in the case of advised sales. In particular, care must be taken to ensure that the risk profile of the product is properly assessed in relation to the investor's needs and that the nature of the product, and the risks are properly explained to the investor. These obligations become increasingly important if the investor is unfamiliar with the type of product being sold. The investor's background and degree of financial knowledge need to be assessed, and particular account needs to be taken of

the nature and risk/reward profiles of other investments held. The advice process needs to at least reflect the explanation of risk given in marketing literature and key feature documents: it should not dilute it. The extent to which these products fit into the investor's overall risk profile should feature in the records made of the investor's attitude to risk and conveyed back through discussion and more formally in reason why letters. In order to fulfil these obligations it is imperative that the adviser is fully conversant with the type of product and the precise details of the contract on offer.

