PIA

REGULATORY Update 72

Interest Only Mortgages

Contents of article

This article reminds PIA-regulated firms of the standards that they should follow when advising a customer to fund the repayment of an interest-only mortgage by means of an investment contract.

IT INCLUDES IMPORTANT INFORMATION ON

- the findings of PIA's themed supervision visits on mortgage-related endowments
- the investigative and supervisory action the PIA will take in the light of these findings
- the action that firms must take now to ensure that any advice they give on mortgage-related endowments meets the standards required by PIA
- the information that firms must give to customers.

It refers principally to mortgage-related endowment policies but it is also applicable, where appropriate, to other repayment vehicles.

Background

Endowment mortgages peaked at more than 80% of all new mortgages in 1988 and have shown a marked decline through recent years. By the third quarter of 1999, CML statistics were showing a fall to 28% of mortgages linked to endowments. (A further 22% of mortgages were reported as "interest only", within which there may be some further proportion of endowments.) This picture is consistent with the progressive removal of significant tax concessions, including the impending abolition of MIRAS from April 2000. However, interest-only mortgages will continue to be attractive to some borrowers and endowment policies may, in some cases, continue to be a suitable vehicle for repaying the capital sum on such a mortgage.

Compared with an ordinary repayment mortgage, endowment-related mortgages are complex products. They have features with which many borrowers will be unfamiliar - especially the nature and extent of their exposure to market risk. Particular care needs to be taken therefore in the marketing of these products to ensure that:

- the customer understands the risks he or she is taking
- the product is suitable having regard to all the customer's requirements and expectations
- the customer is given all relevant information
- a complete and accurate record is kept of the advice and information given to the customer
- the highest standards of professional conduct and competence are maintained.

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Interest Only Mortgages

December 1999

Findings of PIA's themed supervision visits on mortgage-related endowments

PIA recently carried out a series of supervision visits on the theme of mortgage-related endowments in order to assess -

- the quality of the advice and information given to customers
- the quality of firms' records of this advice and information.

In general, the findings of PIA's visits were poor, for both product provider and IFA firms. In particular:

- **it was unclear from many of the files whether sales were suitable**
- **in other cases the information on file raised questions about suitability that did not seem to have been properly addressed.**

The areas that gave rise to particular regulatory concern were -

- *Suitability*

  Failure to demonstrate that an endowment was a suitable mortgage repayment method for the particular customer having regard to his or her circumstances. There were also cases where new policies were sold without recording why any existing endowment policies had not been used as the means to repay (part of) the mortgage loan.

- *Affordability*

  Lack of evidence that the customer had, and would continue to have, the ability to make premium payments into the endowment policy (recognising the possible need for an increase in premiums, in future, if that became necessary to provide the original projected capital sum on maturity). Examples of poor practice revealed by the visits included policies that stretched into retirement with no explanation of how premiums would continue to be affordable once the customer had stopped earning.

- *Attitude to risk*

  Lack of evidence that the risks of mortgage-related endowment policies were clearly and fully explained or that firms had a sufficient understanding of customers' attitudes to taking market-linked risk in the financing arrangements for their homes.

- *Life assurance*

  Failure to demonstrate that the customer needed this additional protection, and doubts over whether he or she even understood that it was included.

Warning to firms

The PIA and the FSA have today issued a public warning to PIA-regulated firms that the general standards of selling practices and record keeping revealed by the themed supervision visits were inadequate. Such poor practices are unacceptable and consideration is being given as to whether firms should be referred for further investigation and possible discipline.

An industry-wide programme of themed supervision visits to examine business done in the fourth quarter of 2000

The regulators will undertake a further detailed examination of selling practices based on business done in the fourth quarter of 2000, by which time they expect to see clear evidence of a marked improvement in sales practices and associated record-keeping. Firms are expected to ensure that compliance with regulatory requirements can be clearly and readily identified from inspection of the relevant records. The regulators will not hesitate to take disciplinary action where appropriate to enforce the relevant standards.

Action to be taken meanwhile by PIA

In the meantime, the PIA will:

- check that firms have reviewed their procedures for providing advice on mortgage-related endowments, and have revised those procedures where necessary; this work will be carried out as part of the continuing programme of supervision visits
- undertake 'mystery shopping' to provide detailed intelligence about the quality of advice that is being given on mortgage endowments
- carry out further investigations in respect of individual firms and take disciplinary action where appropriate.

Action that firms must take now

It is imperative that all firms now review and, where necessary, revise their procedures in relation to advice they give on mortgage-related endowments to ensure that -

- **the advice is suitable**
- **the advice is clearly and properly recorded**
- **this business is undertaken in accordance with the highest professional standards.**

Firms are reminded that they are required by PIA's Rules to establish and maintain a system of internal control appropriate to the size and type of their business (Rule 7.1.5). Firms are also required to keep records that are sufficient to show that they have complied with the requirements of the Rule Book (Rule 5.1.1).

Information and help for existing customers

Firms are also reminded of their responsibilities to customers who contact them about their existing endowment policies. They should try to answer any queries and resolve matters to customers' satisfaction. The FSA factsheet *'Endowment mortgages – what to do if you're worried'* is a useful source of information for customers and firms are encouraged to make use of its contents. Currently some firms are telling customers to contact the FSA helpline, without in the first instance attempting to answer customers' questions. This is not good practice. If a firm is unable to resolve matters to the customer's satisfaction it should explain the firm's complaints procedure to the customer, including the customer's right to take his or her complaint to the ombudsman if not satisfied with the firm's response.[1]

Information at point of sale

PIA expects firms to ensure that customers are given the following information where a recommendation is made to purchase a mortgage-related endowment -

- **Disclosure of all relevant information**

The customer has the right to expect and to be given all the relevant information necessary to enable him to come to an informed decision.[2]

Firms need to ensure that adequate information and explanation is given to the customer in respect of the nature and extent of the risks he or she will take and how these fit in with his general attitude towards taking risks in his personal financial affairs.

Firms also need to explain:

- that the projection used to illustrate the capital sum payable on maturity is no more than a projection designed to illustrate the return a customer may receive based on given market assumptions: there is no guarantee that the capital sum illustrated will be achieved
- that the actual sum payable on maturity will always be dependent upon future market performance
- associated costs and charges and how they are structured
- that it may be necessary for the customer to increase the premium payable (on the occasion of a regular premium review or at some other time) to achieve the required capital sum on maturity
- that if the customer fails to maintain premium payments at the necessary level (or at all) then he or she is responsible for ensuring that an alternative means of repaying the mortgage is in place
- the consequences of surrendering the policy prior to maturity.

- **Understanding of risk**

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.[3]

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.

- **Suitability**

Firms are responsible for ensuring that an endowment-related mortgage is suitable for the customer having regard to his or her current personal and financial circumstances and taking a reasonable view on the customer's continuing ability to fund the premiums (which may increase).[4]

Firms should take particular care when advising customers to switch to an endowment-related mortgage or on re-mortgaging: it is essential that the customer's interest is paramount at all times. For example, the advice must not be driven by any commission that would be payable and should not result in overselling or 'churning' (such as where the customer may already have existing endowment policies that would be suitable to help repay (part of) a mortgage loan).

If at any time a customer indicates that he or she requires a less risky option then firms are expected to respond accordingly. If a customer shows himself or herself to be averse to the risk implied by any of the investment vehicles available to generate the sum required to repay an interest-only mortgage, this will mean that it is unlikely that any such vehicle will be suitable. The investor will need to consider other means of repayment.

Firms must take particular care to ensure that a distinction is clearly drawn between the projected amount payable on maturity to repay the mortgage and any additional lump sum that may be projected.

- **Training and competence**

Firms must adhere to the highest standards of professional and personal conduct and comply with relevant training and competence requirements on a continuing basis.[5]

Initiatives by the ABI

The PIA fully supports the initiatives taken by the Association of British Insurers to ensure that all those with endowment mortgages have their policy premiums reviewed and are further advised on the most appropriate course of action to be taken should a re-projection of maturity values indicate a shortfall.

Responsibilities of lenders

Interest-only mortgage packages will typically involve a lender as well as the endowment provider. Lenders that subscribe to the Mortgage Code (and the great majority of mortgage lenders do so) undertake to provide certain information and explanations (see paragraph 3.2 of the Code) to borrowers considering an interest-only mortgage. Lenders that offer mortgage advice and a recommendation (service level (a) under the Code) also undertake to help borrowers select a mortgage to fit their needs taking account of both the borrower's circumstances and particular requirements, and of market conditions at the time. Clearly lenders that subscribe to the Mortgage Code must play their part by honouring the commitments they have made.

Consumer education

The FSA has published two factsheets:

- *'Is an endowment mortgage right for you?'*
  for people currently considering taking out a mortgage,

and

- *'Endowment mortgages – what to do if you're worried'*
  for those who already have endowment mortgages and are worried about them or who have received a letter saying that their premiums are being reassessed, and may be considering surrender as a result.

A wide distribution of these fact sheets within the industry is encouraged and up to 100 copies can be ordered free from the FSA leafletline on tel: **0800 917 3311**. Firms wishing to order more than 100 copies should contact the FSA Sales and Distribution Department on tel: **0207 676 3298**. Full details of the cost and terms on which FSA leaflets are made available for industry distribution can be found in Regulatory Update 68 issued in August 1999.

Notes

[1] Rule references: Rule 8.2.1, Rule 8.2.4(1)

[2] Rule references: Paragraph L6(a) of Schedule L:2 to the Adopted Lautro Rules, Adopted FIMBRA Rule F29.8.1, Adopted IMRO Rule I:6.2(1), Adopted SIB Rule S5.01

[3] Rule references: Paragraph L6.(aa) of Schedule L:2 to the Adopted Lautro Rules, Adopted FIMBRA Rule F29.5.3, Adopted IMRO Rule I:3.2(1), Adopted SIB Rule S3.03

[4] Rule references: Paragraphs L8.(1)(Schedule L:2.5) to the Adopted Lautro Rules, Adopted FIMBRA Rule F29.5.1, Adopted IMRO Rule I:3.1(1), Adopted SIB Rule S5.01(1)

[5] Rule references: SIB Principles 1 and 9, Rule 2.6.2