FSA 2002/45

COMPLAINTS SOURCEBOOK (TREATMENT OF WINDFALL BENEFITS FOR MORTGAGE ENDOWMENT COMPLAINTS) INSTRUMENT 2002

Powers Exercised

A. The Financial Services Authority amends the Complaints sourcebook in the exercise of the power in section 157(1) (Guidance) of the Financial Services and Markets Act 2000.

Commencement

B. This instrument comes into force on 1 August 2002.

Amendments to the Complaints sourcebook

C. The Complaints sourcebook is amended:

(i) by inserting, after *DISP* Appendix 2 2.5.12G, the provisions in Annex A to this instrument; and

(ii) in accordance with Annex B to this instrument.

Citation

D. This instrument may be sited as the Complaints sourcebook (Treatment of Windfall Benefits for Mortgage Endowment Complaints) Instrument 2002.

By order of the Board
18 July 2002

Annex A

Text inserted into *DISP* Appendix 2

Identification of windfall benefits

2.5.13G Windfall benefits should be determined in accordance with the principle in Needler Financial Services and Taber ('Needler'). The basic legal principle in Needler is that a windfall benefit is not to be taken into account in determining the amount of an investor's recoverable loss. The following paragraphs explain our views as to how *firms* may act in accordance with that principle.

2.5.14G A windfall benefit arises where:

(1) there has been a demutualisation, distribution or reattribution of the inherited estate, or other extraordinary corporate event in a *long-term insurer*; and

(2) the event gave rise to 'relevant benefits', as defined in *DISP* App 2.5.15G.

2.5.15G 'Relevant benefits' are those benefits that fall outside what is required in order that *policyholders'* reasonable expectations at the point of sale can be fulfilled. (The phrase '*policyholders'* reasonable expectations' has been technically superseded. However, the concept now resides within the obligations imposed upon *firms* by *Principle* 6 ('… a *firm* must pay due regard to the interests of its *customers* and treat them fairly ….') Additionally, most of these benefits would have been paid prior to *commencement*, when *policyholders'* reasonable expectations would have been a consideration for a *long-term insurer*.)

2.5.16G The issue of free *shares* or cash on a demutualisation, and additional bonuses and *policy* enhancements given by way of incentive to approve a reattribution or distribution of an inherited estate, should, unless there is evidence to the contrary, be treated as relevant benefits for the purposes of *DISP* App 2.5.15G. Whether additional bonuses and *policy* enhancements on a demutualisation are relevant benefits should be determined by applying the test in *DISP* App 2.5.15G to each benefit.

2.5.17G *Firms* should review the terms on which proposals were put to *policyholders* and the reasons given for a corporate event when determining whether a benefit should be treated as a relevant benefit.

2.5.18G *Firms* should not normally take windfall benefits which are relevant benefits (as defined in *DISP* App 2.5.14G) into account when assessing

financial loss and redress. Where a windfall benefit is in the form of a *policy* augmentation, the benefit should be deducted from the overall value of the *policy* when making this assessment.

2.5.19G A relevant benefit derived from a corporate event should only be taken into account if the *firm* is able to demonstrate, with written records created at the time of the advice, that:

(1) the *firm* foresaw the prospect of the event and the benefit;

(2) the *firm's* advice included a statement recommending the particular *policy* because of the possibility of the benefit in question; and

(3) the statement was a material factor in the context of the advice and the decision to invest.

2.5.20G If a *firm* considers that it can meet this requirement, the *firm* should by letter explain clearly to the complainant the reasons why it proposes that the benefit should not be treated as a windfall and should be taken into account. The *firm* should provide the complainant with copies of the relevant documents.

2.5.21G The letter should also explain how the proposed value of the benefit has been calculated and should inform the complainant that if he does not accept the proposal to take the benefit into account he may tell the *firm*, with reasons. The letter should also say that, if he remains dissatisfied with the *firm's* response, he may refer the matter to the *Financial Ombudsman Service*.

2.6 Valuing Windfall Benefits

2.6.1G If, exceptionally under the *guidance* at *DISP* App 2.5.13G to *DISP* App 2.5.21G, cash or *shares* derived from a corporate event are to be taken into account when assessing loss and redress, cash should be valued at the amount actually received and *shares* should be valued at their issue price. In both cases there should be no addition for interest.

2.6.2G When valuing windfall augmentation benefits for the purposes of calculating loss and redress the objective is to exclude all changes arising from the windfall event. The amount of redress payable will then be equal to the amount that would have been payable if the windfall event had never occurred.

2.6.3G A *product provider* should ensure that the method it adopts for valuing augmentation benefits is consistent with statements made in the documentation published about the windfall event. Relevant documentation for the purpose of valuing such benefits will include (but is not limited to) -:

(1) any description of increases in benefits in any circular to *policyholders* (and any other public information relating to the event);

(2) any principles of financial management established for the management of the fund after the event;

(3) statements in any appointed *actuary* report produced for the event;

(4) statements in any independent *actuary* report produced for the event; and

(5) subsequent statements relating to bonus practice, calculating *surrender values*, or both.

2.6.4G The method of valuation adopted should treat complainants fairly overall.

2.6.5G Where an accurate calculation of the value of an augmentation benefit either cannot be made, or would result in disproportionate expense or delay, *product providers* may adopt a simplified approach or a proxy method for calculating its value.

2.6.6G A simplified approach should treat complainants fairly overall.

2.6.7G The *product provider's* appointed *actuary* should certify that the method adopted by the *product provider* for calculating the value of an augmentation benefit is in accordance with the *guidance* in *DISP* App 2.6.1G to *DISP* APP 2.6.6G.

Implementation

2.6.8G The principles set out in *DISP* App 2.6.1G to *DISP* App 2.6.7G should be applied directly to mortgage endowment complaints where the capital loss is calculated by comparing the *surrender value* of the endowment *policy* with the capital which would have been repaid using a repayment mortgage.

2.6.9G In most cases where there is a loss, the endowment *policy* will be surrendered and put towards the cost of setting up a suitable repayment mortgage. Where this is the case, that part of the *surrender value* relating to the windfall augmentation should be paid as a cash lump sum to the investor or to the investor's order as part of the redress package. Only that part of the *surrender value* which does not relate to the windfall augmentation should be put towards the cost of setting up a suitable repayment mortgage.

2.6.10G There may be some circumstances in which the *policy* will not be surrendered (see *DISP* App 2.2.15G). In these cases, there is no requirement to pay the value of the windfall augmentation as a cash lump

sum since the value of the augmentation will become payable when the *policy* matures. However, any fund value used in the calculation of redress payable should exclude the value of the windfall augmentation.

2.6.11G *Firms* may mitigate losses by making use of the Traded Endowment Policy (TEP) market (see *DISP* App 2.3.8G to *DISP* App 2.3.10G). This allows *firms* to *sell* policies on the TEP market to meet the costs of redress, rather than using the *surrender value*. Where this method is adopted, *firms* should pay to the investor, as part of the redress package, a cash lump sum representing that proportion of the *policy* realised which would have related to the windfall augmentation.

2.6.12G As this windfall amount should be excluded from the fund value used in the calculation of loss and redress it would also be appropriate for this extra payment to be ignored when assessing whether "the net amount realised by the sale of the *policy* on the traded endowment market exceeds the total redress due to the complainant…" (*DISP* App 2.3.10G).

2.6.13G There may be circumstances in which a *policy* needs to be reconstructed (see *DISP* App 2.4). In carrying out the required reconstruction, the windfall augmentation should be ignored in both the existing and the revised *policy*. However, the *policyholder's* revised *policy* should be credited with any windfall augmentation which would have applied if the *policy* had been set up with the revised terms from the original date of advice. This enhancement can be taken into account in assessing a suitable level for future premiums, in line with *DISP* App 2.4.8G.

2.6.14G *DISP* App 2.5.10G provides *firms* with the option of underpinning benefits. *Firms* should satisfy the *FSA* that their proposals provide complainants with a level of redress that is at least commensurate with the standard approaches and, to ensure consistency, windfall augmentations should be excluded when considering whether an underpin will apply. The *FSA* will take this into account when considering proposals put forward by *firms*.

2.6.15G *Product providers* with windfall benefits in the form of *policy* augmentations should tell:

(1) their own relevant *customers* (mortgage endowment complainants); and

(2) independent financial advisers with such *customers* (and any other interested parties);

that they have excluded windfall augmentation benefits from values used or to be used for loss and redress. Firms should provide this information to

the *Financial Services Compensation Scheme* when providing them with a value to be used for loss and redress. Should their own relevant *customers,* independent financial advisers with such *customers* (and any other interested parties), and the *Financial Services Compensation Scheme* request it, the *firm* should provide the value of these benefits and a description of the method used to exclude them.

Annex B

Amendments to the Complaints sourcebook

In this Annex striking through indicates deleted text.

DISP App 2.5.1G:	This section addresses ~~two~~ issues which may be relevant to the standard redress for unsuitability cases, as well as some post-retirement cases upheld on the grounds of affordability.