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Endowment mortgages

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Summary

At one time, mid-1980s to the 1990s, endowment policies used to be by far the most popular mortgage repayment vehicle. Their attraction was that the monthly mortgage cost was little or no higher but that there was a realistic prospect of a large 'bonus' over and above what was needed to pay off the mortgage at the end of its term.

Changing economic conditions and tax law changed this equation substantially against the borrower. Many endowment policies matured well below their target value leaving homeowners with hard decisions to make about what to do.

One route, encouraged by claims management companies, was to seek compensation. Compensation claims for mis-sold endowment mortgages was the first of the mass retail compensation 'scandals'.

This Paper is primarily of historical interest.

1. Background

At one time, mid-1980s to the 1990s, endowment policies used to be by far the most popular mortgage repayment vehicle. In 1988, 83% of new mortgages were endowment linked. Typically, a house buyer would organise an interest-only mortgage with one lender and then take out a matching endowment policy with an insurer which it was hoped would, upon maturity, provide sufficient funds for the mortgage to be repaid.

The big selling point was that, according to past trends, the endowment policy (for the same monthly premium) would generate greater returns than the capital sum promised and this surplus would be available to the borrower. Even by mid-2000 some 23 per cent of new mortgages were still endowment based.[1]

The historical success of endowment policies, and the reason why they ceased to be suitable vehicles, was largely due to the change in the inflation rate over time. The table below illustrates how inflation changed over the period in which endowments first became popular and then less so:

Annual average inflation rate: selected 15 yr period

Period ending	Average inflation rate
1979	15%
1980	16%
1985	17%
1990	14%
1995	8%
2000	6%
2005	4%

Note: simple arithmetic average used.

Source: ONS

In the late 1970s, even if an investment fund only made small real (post inflation) returns, in nominal terms it might be making 18% - 20% a year. It was these sorts of returns which were used in 1980s promotional material to persuade buyers that an endowment policy would be able to meet the capital cost of a mortgage in 20 or 25 years' time, with the hope of a bonus at the end. But then inflation disappeared (relatively speaking). In 1975 annual inflation peaked at 24.2%. From 1982 onwards it never exceeded 10% and never rose above 5% after 1991. In such circumstances the nominal returns of endowment policies collapsed proportionately.

1 HC Deb 14 June 1999 cc 26-7W; *Progress report on mortgage endowments*, Financial Services Authority, October 2000, p 23

Other factors such as the ending of tax advantages also contributed to a less sympathetic landscape for the selling of endowments.

The selling of endowment mortgages was much criticised by the late 1990s with concerns (true in many cases as it proved) that many endowments would not produce sufficient returns to pay off the mortgage balances which they were intended to cover.

Although the selling of mortgages had only been a regulated activity since November 2004[2], investment products which are used to fund some types of mortgages, including with-profits endowment policies, have been subject to regulation for their sale and marketing since 1988. As investment products, the risks associated with the policies should have been explained to potential purchasers at the time, and the suitability of the product for their needs should also have been established. Whether they were or not was at the heart of the enormous endowment compensation 'industry' that emerged in the early part of the 21st century. The first of the truly huge compensation waves. There was comparatively little evidence that the endowments themselves were bad investments. The issue was whether people should have been encouraged to buy them in the first place.

An excellent and very detailed narrative of the endowment story from the perspective of the Financial Ombudsman Service and how it dealt with the problems it threw up, can be found in David Severn's the Financial Ombudsman Service and mortgage endowment complaints.

1.1 When would an endowment mortgage be suitable?

Holders of endowment mortgages pay regular interest on the full outstanding balance of their mortgage loans. They do not, however, pay off the capital debt until the end of the mortgage. They provide for the capital debt by taking out a with-profits insurance policy, for which they have paid regular premiums. The investment performance of those premiums, added both annually and at the end of the policy in the form of a terminal bonus, is designed to produce a capital sum which will discharge the mortgage debt.

The providers of endowment policies – usually insurance companies – often paid commission to the intermediaries who sold these policies. Whilst it is not unreasonable to expect the intermediary to be paid for his work, critics of endowment policies argued that the commission payments provided an incentive to advisers to sell endowment policies rather than other mortgage payment methods which might generate lesser levels of commission or none at all. The argument is that some sales of endowment policies were in the interests of the advisers who sold them rather than of the clients who bought them.

[2] The Financial Services and Markets Act 2000 (regulated Activities) (Amendment) (No 1) Order 2003

The *Guardian* has quoted remarks from the then Trade and Industry Secretary, Stephen Byers, which were critical of endowment policies for this reason:

> Very often endowment mortgages are heavily promoted by advisers who have a financial interest in their sale because they get commission. That is clearly unacceptable, it's bad practice and it needs to stop. That's one of the key issues for us.[3]

However a DTI press release issued on 29 October 1999[4] – the day on which Mr Byers held a so-called 'mortgage summit' – is not so explicit on this point, and nor is a parliamentary question which refers to the summit.[5]

Because commission payments and other charges are typically levied in the early years of the endowment policy, the investment returns of the policy will be diverted in those years to cover these front-loaded costs. This means that if a policyholder cashes in an endowment policy in the early years, he or she may get a very disappointing return in relation to the sums which have been paid as premiums. Unfortunately, although it is generally accepted that endowment policies are long-term saving vehicles, many policies are in fact redeemed well before the end of the policy term. Research by the Office of Fair Trading (OFT) among others has sought to highlight the poor returns which endowment policies yield when redeemed before their term.

The OFT study in 1995, *Mortgage Repayment Methods,* sought to investigate what factors should inform a consumer's decision about a choice of mortgage. One of the aims of the study was to see whether popular conceptions about the strengths and weaknesses of different types of mortgage were in fact true. The aim was explicitly opinion-forming rather than an attempt to judge which mortgage repayment methods were best. That said, the report was written within the context of increasing criticism of endowment mortgages:

> 1.1 … The Office of Fair Trading (OFT) has previously drawn attention to the hundreds of millions of pounds paid to building societies and banks through commissions from insurance companies, and the Director General of Fair Trading has called for a 'best advice type' requirement in the code of Good Banking to apply to the advice on mortgage repayment.
>
> 1.2 In recent years the slower growth of the UK equity market has led several insurance companies to cut their bonuses, reflecting reduced nominal investment returns in a low inflation climate. Furthermore, the fiscal incentives generally regarded as favouring endowments have been reduced. Yet some 60% of new mortgages are still financed by endowments.
>
> 1.3 This report examines whether the dominant position of the endowment mortgage is justified. It looks at the factors relevant to choice of mortgage method, and quantifies their likely effects. These quantifications are then used to compare how the various

3 'Endowments shock for homeowners', *Guardian*, 30 October 1999
4 'Consumer concerns addressed at mortgage summit, Byers', DTI press release P/99/878, 29 October 1999
5 HC Deb 10 November 1999 c 640W

> repayment methods perform when borrowers move house. The investigation also brings out possible developments in practices within the industry that would make the choice of mortgage repayment method more informed.[6]

The OFT concluded that endowment policies were not a bad decision in all circumstances, but this conclusion depended upon the policy not being surrendered early, and on returns from investments remaining healthy over the period of the mortgage:

> 5.1 Our main conclusion must be that the choice of mortgage type depends on weighing risks and returns in the circumstances of the borrower. Fiscal factors have moved against the endowment-linked approach, beginning with the removal of Life Assurance Premium Relief over 10 years ago and continuing with the reductions in MIRAS to only 15% in 1995/96. The ending of the bull markets of the 1980s has demonstrated the risk of endowment mortgages in comparison with straight repayment mortgages. Personal factors, notably less stable employment, higher divorce rates and, for many, limited financial wealth, also emphasise the benefits of repayment methods with more flexibility and fewer penalties. Nevertheless, on the average, over the past 30 years or so, returns on investments have exceeded mortgage interest rates. A borrower who expects this to continue and who attaches low weight to the risks of loss through premature termination can rationally choose the endowment-linked approach. Such a borrower would need to take into account the charges and surrender penalties of his chosen company.[7]

> The actuarial profession has investigated the circumstances in which a recommendation that a client start an endowment mortgage could be considered to be best advice (compared to the alternative option of a repayment mortgage).[8] The report is meant to guide those who sell endowment policies, rather than to adjudicate between these two types of mortgage, but its conclusions suggest that endowment policies can potentially be good value in certain circumstances, particularly if realistic growth projections are used, and the charges on the policy are not too high. They are not likely to be good value if they are set up for a short term (such as ten or fifteen years), or if they are redeemed early.

> […]

> The purchase of a regular premium life assurance or pension’s policy involves a long-term commitment by the investor. The charging structure of most policies means that ceasing to pay premium early often results in a loss to the investor. If investors buy policies on the basis of good advice, therefore, they would not normally be expected to cancel premiums to their policies unless forced to do so by unexpected changes to their personal circumstances.

> This means that persistency can be a powerful indicator of the quality of the selling process. Persistency is taken to be the proportion of investors who continue to pay regular premiums to

6 *Mortgage Repayment Methods: A report by the Office of Fair Trading*, April 1995
7 Ibid.
8 *Report of the endowment mortgages working party*, Faculty of Actuaries and Institute of Actuaries, November 1999

> their life and pensions policies, or who do not surrender their single premium policy.[9]

It is worth stressing that early redemption, or ceasing to pay premiums, does not in itself indicate mis-selling, since changes to the circumstances of the investor (which could not be foreseen) may explain a failure to maintain a policy. In the published figures, endowment policies are less subject to early discontinuance than other types of life and pensions business, but nevertheless almost one quarter of endowment policies (which were sold by company representatives) were no longer in force after just four years. Endowment policies sold by independent financial advisers seem to be more persistent: around 84% of such policies are still active after four years. If one looks at the figures after one year, there has been steady improvement over the five years that persistency figures have been available. For policies sold in 1997 by company representatives, 93.2% lasted the year; 95.8% of policies sold by independent financial advisers were still running after a year.

A fundamental misapprehension held by many is that endowment policeis have not performed as well as competitor investments. Repeated surveys in the financial press conclude that "It is clear that endowments stand up to equities over the long term – when judged on past performance – despite a fall in the average returns in recent years".[10]

Over measured periods from 10 to 25 years, with-profits funds have comfortably out performed unit trust managed funds, the UK all companies index and cash interest accounts. It is the fall in nominal returns and interest rates which has 'undone' the policies as mortgage repayment vehicles.

[9] *Fifth survey of the persistency of life and pensions policies*, Personal Investment Authority, October 1999 p3

[10] *With Profit Endowment Survey*, Money Management, November 2004.

2. The call for a mis-selling review

The experience of mis-selling of personal pensions, which led to a formal review of the selling of such policies from 1994 by the financial regulation authorities, triggered concerns that similar abuses remained to be discovered in the selling of other financial products. A parliamentary question of November 1996 illustrates that this has been an area of concern for many years:

> **Mr. David Nicholson**: To ask the Chancellor of the Exchequer what representations he has received since 1 January 1995, regarding alleged mis-selling of endowment mortgages; what (a) investigations and (b) studies he has commissioned on the subject; and what discussions he has had on this issue with the Securities and Investments Board.
>
> **Mrs Angela Knight**: The Treasury has on a number of occasions received representations about concerns that mortgage advice may be unduly influenced by the commissions available, including suggestion from the Consumers Association for further regulation. New disclosure rules introduced in January 1995 have the effect that commissions on endowment policies must be disclosed to potential clients. The Treasury has not commissioned any investigations or studies on the subject. Discussions with the Securities and Investments Board take place from time to time at ministerial and official level on all issues of regulatory concern.[11]

At the beginning of March 1999 it emerged that the successor to the Securities and Investments Board -the Financial Services Authority (FSA) – was making exploratory investigations to see whether endowment policies had been mis-sold. Little information was made public at this stage:

> Sarah Modlock of the FSA said: "Eight years ago, some 78 per cent of mortgages were sold with an endowment vehicle. That has shrunk to 32 per cent. We are interested in why 32 per cent are still being sold. If a figure drops that dramatically, endowments might not be suitable for a large number of people."
>
> The regulator has begun focus monitoring - looking at the endowment sales practices of a number of financial services providers - and has stepped up anonymous spot checks. It is also producing a consumer leaflet on the issue. If it finds cause for concern, it will expand its work to a broader range of companies.
>
> "It's far too early to pre-empt our findings. We are not talking about disciplines and fines at this stage," said Ms Modlock. She stressed the FSA could do nothing about policy performance related to economic factors such as low interest rates.[12]

A Parliamentary written answer at the end of March 1999 did little more than confirm the fact of an investigation:

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[11] HC Deb 7 November 1996 c 635W

[12] 'Mortgage-linked endowment policies face FSA scrutiny', *Financial Times*, 2 March 1999

> **Dr. Cable**: To ask the Chancellor of the Exchequer if he will establish a review of the estimated £1.5 billion of mis-sold endowment mortgages on the same basis as the recent pensions mis-selling review.
>
> **Ms Hewitt**: The Financial Services Authority has confirmed that it is currently gathering information with a view to considering if such a review is necessary.[13]

Although the FSA issued several advice sheets for investors concerned about their endowment policies, and conducted extensive investigations of its own, an industry-wide review of alleged mis-selling of endowment mortgages was not implemented.

The FSA argued that holders of endowment policies in recent years had fared at least as well as holders of repayment mortgages on average, and had benefited from lower mortgage interest rates. However, the FSA recognised that because investment returns (like interest rates) had fallen over recent years, higher contributions might be needed to pay off their mortgage.[14]

> 4.15 FSA's conclusion was in December 1999, and remains that, on average, people with endowment mortgages have done at least as well to date as they would have done with a repayment mortgage.
>
> 4.16 In addition, unlike pensions opt-out and non-joiner cases, there is no presumption that unsuitability was near universal. The evidence is that endowments have delivered value to consumers. Whilst, because of the shift in economic conditions, many consumers may need to set aside extra amounts to fund a full mortgage repayment, this is evidence neither of mis-selling nor of redressable loss.
>
> 4.17 Given these findings, the FSA's judgement is that there is no evidence of a fundamental problem with mortgage endowments that has led to widespread consumer detriment, as was the case with the pensions review. The key requirements are that consumers receive reliable information; that those who are unhappy with the advice they were given at the time they purchased their policy should be encouraged and helped to come forward to complain; and that their complaints are handled fairly and properly. The FSA's further steps address each of those requirements. An industry-wide proactive review of sales would fail to deliver major benefit but would impose significant administrative and other costs. The existing complaints process is the quickest way of ensuring redress for those consumers who have lost out as a result of mis-selling.[15]

During its investigations the FSA found poor selling practices and inadequate record-keeping among product providers and sellers. It

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[13] HC Deb 30 March 1999 c 668W

[14] 'Endowments: the FSA's conclusions and actions', PN/136/99, Financial Services Authority, 21 December 1999. See also, *Progress report on mortgage endowments*, Financial Services Authority, October 2000

[15] *Progress report on mortgage endowments*, Financial Services Authority, October 2000, pp 19-20. For Appendix 1, see http://www.fsa.gov.uk/pubs/policy/mortgage_endow.pdf

warned the regulated sector that standards must improve 'markedly'. The insurance industry was asked to explain and justify to the regulators the basis on which it sold endowments, and consolidated guidance on such sales was issued by the regulators.

In October 2000, the FSA found that the number of providers active in the endowment mortgage market had halved to just 20 between December 1999 and September 2000. It believed this fall is in part explained by its pressure on providers to justify their strategies for marketing endowment policies. Selling standards remained an area of concern. A mystery shopping exercise in mid - 2000 produced some disappointing results. In October 2000, the FSA noted that the necessary improvements it sought in December 1999 had not been made.

Additionally, in February 2001 the FSA initiated a *With Profits Review.* This was a review of the way that policyholders were treated. It produced several consultation papers and responses and eventually this led to a number of changes being made to the FSA's rule book.[16]

All along the regulator tried to balance the need to have a review – which would delay compensation and divert the industry from dealing with complaints quickly. It should be recalled that all this took place across the hand-over period from one regulation system and regulator to another and the creation of a new Ombudsman system. In many respects the timing could not have been worse.

By April 2002 the FSA recognised that its existing strategy of relying on a combination of consumer information and the complaints regime was not working.

On 4 April 2002 the then chief executive of the FSA, John Tiner, wrote to firms in the mortgage endowment market (the so-called "Tiner letter") with "urgent" guidance. The letter drew to their attention causes of concern about the way in which mortgage endowment complaints were being dealt with. Firms were asked to let the FSA have their views, by the end of that month, and to review their own procedures. The FSA warned that it would be considering "whether there are further measures we should take."

The FSA letter reminded firms that its decision in 2000 not to initiate an industry-wide review depended on:

- consumers having clear information about their position and their options for the future;
- there being help and encouragement for consumer who were unhappy with the advice they received to bring forward their complaints; and
- firms dealing with complaints fairly, effectively and promptly.

2.1 Adequacy of investment performance

[16] For example see newsletter 04/14 for details of the review process.

Endowment policies take a number of different forms, but the type of policy most often sold did not guarantee to generate an investment return equal to the sum borrowed from the mortgage lender. Instead only a relatively small sum was guaranteed, but there was an expectation that investment returns would substantially boost the value of the policy at maturity. The investment returns are added partly in the form of annual bonuses, and partly in the terminal bonus which is paid on maturity.

Since endowment policies are long-term investments, and since the value of the policy cannot be known until the policy matures, estimates must be relied on during the life of the policy as to how well the policy is performing. By definition, an estimate has to make assumptions about the future; the accuracy of the estimate will to a greater or lesser extent depend on the accuracy of those assumptions.

The financial regulators impose controls on what assumptions investment providers can use when they make projections about future investment performance. This is partly to prevent the use of unrealistic estimates before such an estimate has the ability to cause long-term harm. It is also to provide some consistency across the sector, and so allow investors to compare different providers. (Charges and commissions are the other significant determinant of final performance, and there are wide variations in the levels of these charges.)

In January 1999, the FSA altered the rates of investment return which the industry was permitted to use to reflect the new reality of lower overall rates of return.[17]

The new three assumed rates of return were 4%, 6% and 8%, lower than the previous limits (set in January 1995) of 5%, 7.5% and 10%.[18][19] The actuaries, in their 1999 report on endowment mortgages, endorsed the use of the FSA intermediate, albeit partly for practical reasons.[20] One estimate reported that:

> Of the 9 million endowment plans linked to mortgages, an estimated 90% are heading for a shortfall, says Cazalet Consulting, an independent insurance analyst. The average shortfall, it says, is £11,000. The recent upturn in the stock market could lead to a slight improvement, but Ned Cazalet warns borrowers not to be too optimistic.[21]

In October 2000 the FSA estimated that the average scale of the shortfall, in terms of the additional premium that would be required to make good the gap, was in the region of £12 to £18 per month.[22] In its

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17 See FSA Handbook conduct of Business rules 6.6.50

18 History of projection rate changes in FSA Discussion document 04/01, *Projections Review, the case for change* available at : http://www.fsa.gov.uk/pubs/discussion/dp04_01.pdf

19 For tax exempt business slightly higher illustrative rates can be shown.

20 *Report of the endowment mortgages working party*, Faculty of Actuaries and Institute of Actuaries, November 1999 pp 4-5

21 *Endowments, how to plug the gap*, Sunday Times 16 November 2003

22 *Progress report on mortgage endowments*, Financial Services Authority, October 2000, p 8. Note that the regulator is not suggesting that making additional contributions is the most suitable way for investors in every case to address a projected shortfall.

publication the Association of British Insurers (ABI) stated that the average shortfall is £5,500.[23]

The Government's view was set out in a number of Parliamentary written answers, for example:

> **Mr. Cohen**: To ask the Chancellor of the Exchequer what recent representations he has received about the mis-selling of endowment policies; what remedies are available to holders of endowment policies which do not realise sufficient capital on maturity to meet the mortgage repayment commitment; and if he will make a statement.
>
> **Miss Melanie Johnson**: The advice and selling of endowment policies is fully regulated by the Financial Services Authority (FSA). On 21 December, FSA announced the conclusions of recent work on endowments. FSA concluded that on average holders of mortgage endowments have enjoyed returns which mean they have fared at least as well as they would have done with a repayment mortgage, and that there were no grounds for an industry-wide review of all past business. However, targeted visits to product provider and independent financial adviser firms show current selling practices to be poor. As part of its normal regulatory activities, the FSA will make follow-up visits to check for marked improvements in sales practices by the end of 2000. The FSA will not hesitate to take disciplinary action where appropriate if standards remain poor.
>
> For investment business, including the sale of endowment policies, a redress mechanism has been established under the Financial Services Act 1986. Advisers and sellers of financial products, including endowment policies, are obliged to follow rules established under the Act which are designed to protect the financial interests of investors. The rules focus on giving best advice and assessing the suitability of proposed products to the investor's circumstances. An endowment policy holder with a loss resulting from non-compliance with these rules can complain to the firm involved. If the firm cannot settle the complaint, the Personal Investment Authority Ombudsman has the power to require firms to pay compensation in appropriate cases.[24]

2.2 The decisions for policyholders

As part of the 'clear information' requirement of the FSA, most policyholders received (in 2000 or in the first half of 2001) a re-calculation of their policy's estimated performance (known as a re-projection) using the currently approved rates.

Insurers sent out colour-coded letters (green, amber, red) which gave a rough guide as to whether the investor should consider making additional provision to cover any shortfalls which the estimates forecast. These letters were sent to those whose policies are due to mature soonest first. The significance of the colour codes is explained by the regulator in these terms:

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[23] *Endowment Mortgages: the facts*, ABI 2005, http://www.abi.org.uk/BookShop/ResearchReports/31%20Mortgage_Endowments_-_The_Facts_(January_2005).pdf

[24] HC Deb 31 January 2000 c 445-7W

Variant	Criterion	What consumers are told
Green	Future annual investment returns need to be no more than 6% to keep the policy on track for the target maturity value	"We are pleased to confirm that we believe your Plan is currently on track to repay the target amount when it matures. It needs future investment growth towards the lower end of the current rates for projections set by the independent regulator. It is unlikely that you need to take any action now."
Amber	Investment growth needs to be above 6% but not more than 8% to keep the policy on track	"We consider it possible that your Plan may not pay out enough. To repay the target amount when it matures, it needs future investment growth to be towards the top end of the current projection rates set by the independent regulator. In view of this you may wish to think about taking action."
Red	Requires an investment growth rate over 8% to meet the target	"We consider there is now a high risk that your Plan may not pay out enough. To repay the target amount when it matures, it needs future investment growth to be higher than the current projection rates set by the independent regulator. We therefore strongly suggest you consider taking action."

Source: Financial Services Authority

Where there is a potential shortfall based on the re-projection (i.e. amber and red letters), the letter set out the various possible ways that a policyholder might consider making provision for the projected shortfall. These include:

- Increasing savings to make up the shortfall
- Extending the term of the mortgage and the endowment plan
- Repaying some of the mortgage using a lump sum
- Changing part of the mortgage to a repayment loan

- Waiting to see whether a shortfall does emerge (amber letters only).

The regulators and insurers stressed that time is not usually of the essence, and that investors should not act in haste. In particular, investors were warned about the possible financial loss associated with cashing in their endowment policies early, which may make their position worse overall.

3. Compensation

For people with 'underperforming' endowment mortgages, the understandable reaction was to seek compensation for a situation they may feel was not of their causing. In its FAQ *'Do I have a valid complaint'* the FSA outline the steps that policyholders should take if they believed that they had a justified claim for compensation if the provider:

- did not explain that your savings would not necessarily pay off your mortgage in full and that this depended on investment performance.
- did not tell you how your savings would be invested and check you were comfortable with the risks of an investment linked to the stock market.
- did not explain that an endowment policy is a long-term commitment that often gives a poor return if it is cashed in early.
- did not check that there was a reasonable expectation you would be able to keep up payments until the end of the term.
- did not explain any fees and charges and how they affect the return you get on your savings.

One issue that regularly recurs is the question of how far back individuals can have purchased the policy and still be entitled to compensation. The key date to this is the coming into force of the *Financial Services Act 1986* on 29 April 1988. Before then sellers of mortgage products did not need to be registered under the Act and were therefore not subject to the regulations made by it. However, some firms agreed to waive this protection as the FSA makes clear:

> The advice and sales of certain financial products, including mortgage endowments, did not become regulated until 29 April 1988. Customers of regulated activities can appeal to the Financial Ombudsman for compensation. Some firms agreed to allow the Ombudsman to look at complaints about advice given before this date on a voluntary basis - however, not all firms did.
>
> Policyholders who purchased their policies after 1988 are automatically covered by the system; however there are strict rules about making complaints, non-observance of which may result in losing the right to make a claim. The FSA sets out the official time constraints which apply:
>
> You should complain to the firm as soon as possible after you realise that you have cause for complaint. If your complaint has not already been rejected as out of time for making a complaint, then from 1 June 2004, in most cases, a complaint can only be rejected as out of time if you have been advised of a final date for making a complaint by the firm. The firm will normally advise you of this date in their re-projection letter.
>
> From 1 June 2004, you must, in order to protect your right to refer a complaint to the Ombudsman, have made a complaint

> within three years from the time you first received a 'red' letter. (A 'red' letter is the one telling you there is a high risk that the policy will not repay the target sum.) However, the firm must have explained to you at least six months before the end of the three year period that the time to make such a complaint would expire at the end of that time.
>
> If a firm fails to provide that explanation within six months before the end of the three year period, then the time for referring a complaint will be extended to at least six months after such an explanation is given.[25]

For endowment mortgages, the FSA's rules meant that, in general, the three-year time limit ran from the time the policyholder first received the 'traffic light' letter telling them there was a high risk that the endowment would not repay the target sum. However, if it allows more time than three years, the limit is extended to six months after receipt of a reminder of the high risk of a shortfall. The FSA summarised its advice thus:

> If you think you have lost out financially, the law expects you to take reasonable steps to reduce your loss once you become aware you have one. If you don't take action to reduce your loss it may result in you receiving less redress, since any losses suffered after you became aware you had lost out may not be compensated in full or at all.
>
> An endowment holder's first complaint is to the firm direct. If this fails then they should contact the Financial Ombudsman Service (FOS). They should be aware that the level of complaints to the FOS is five times that of anticipated levels and the procedure may well take 6 months to complete.

If the complainant is successful, the FOS will make a binding award on the 'defendant'. The amount of this award though is likely to be much less than the projected shortfall which will have been quoted by the insurance company in its re-projection letter. This is because of the way that compensation is calculated.

An FSA pamphlet explains the methodology:

> How is compensation calculated?
>
> The calculation of any compensation involves comparing:
>
> ■ the mortgage interest and premiums you have *actually* paid on your endowment mortgage, and the current surrender value of your mortgage endowment policy; with
>
> ■ the mortgage interest and capital repayments you *would* have paid on an equivalent repayment mortgage, and how much capital you *would have* paid off the mortgage.
>
> The precise calculation may vary in some cases because of factors like the need for life assurance, or if the policy ran beyond your retirement.
>
> The calculation does not involve, therefore, estimating the likely shortfall. As was stated above the assumption is that individuals will do what they can to limit their losses when they become aware of them. The shortfall is the predicted loss if the financial

[25] http://www.fsa.gov.uk/consumer/01_WARNINGS/endowments/mn_time.html

> circumstances stay as they are; compensation is compensation for past losses.

The compensation 'tsunami' which followed is a case history in how to cope with huge surges in business. The Financial Ombudsman Service emerged with huge credit in its dealings with over a quarter of a million disputes and nearly £3 billion compensation in a five-year period. More controversial was the response of the claims management industry, which switched its attention away from personal accident claims and towards the compensation process within financial services. Mass cold calling and high percentages of compensation diverted from home owners to cover fees for a relatively simple administrative process and where there was little evidence of 'value added by the companies themselves.

The full story of the compensation process and outcomes can be found in the Financial Ombudsman Service and mortgage endowment complaints By David Severn.

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