

Mortgage holders face increases on endowments.

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Endowment mortgage holders are likely to suffer as their policies weaken from exposure to the volatility in world stock markets.

It is not just share portfolios and pension funds holders that are being affected by the slump and volatility in the world stock markets. Anyone with an endowment mortgage - and there are tens of thousands of such policy holders in Ireland - has an exposure to equity markets in the form of the life assurance endowment fund they took out to pay off their loan at the end of their mortgage term.

These funds have performed well over the past four or five years, but would not have done as well in the early 1990's or this year.

The consequence of this latest drop in markets is that homeowners could end up receiving - if they have not already - letters from their lenders suggesting that they increase their monthly endowment payments to ensure there is no shortfall at the end.

These letters are particularly pertinent to anyone who took out their mortgage 10 years ago since all life insurers claim they do 10 year reviews of policies and as it happens, endowments were on the rise in popularity in the late 1980s. (They peaked around 1992-93 when nearly four out of 10 mortgages were endowments, mainly of the more volatile unit-linked variety.)

One commentator who warned homeowners and the building societies against endowment mortgages back in 1989 was Mr Patrick Shallow, who runs the financial consultancy company Finalysis.

Ten years ago in an article which appeared in the specialist magazine, Finance, Mr Shallow, who was then the managing director of the Metropolitan Building Society, argued that the apparent advantage of endowment mortgages over more conventional annuity or repayment equivalents was tenuous, to say the least.

He predicted, correctly as it turns out, that any reduction in mortgage interest and life assurance reliefs, and any fall in investment returns from equities and gilts would result in the net return from endowments being insufficient - after charges were taken into account - to meet the capital payment at the end of the loan.

All of those chickens have come home to roost since 1989. Poor to medium investment returns from the late 1980s to 1993-94 affected fund values; tax relief on life assurance policies was abolished and mortgage interest relief has been clawed back for all but first-time buyers, to 80 per cent of a maximum of £2,500 interest paid for a single person and £5,000 for a married couple.

Back in 1989, Mr Shallow also warned his fellow building society managers that they had a statutory responsibility under the Building Society Act to ensure that they undertook independent valuation of all security accepted in repayment of the mortgage.

"The endowment policy forms part of that security so it is important that the prescribed procedure," - a mathematical formula that compares the projected net returns from the policy with projected net mortgage costs - "be followed in arriving at a conservative valuation of the policy".

In other words, the law required that the lenders deploy the same due diligence on the investment potential of these policies (which was the security for repayment) as they would on the structural integrity of the house before lending out the money.

In an update of that article, Mr Shallow wrote in Finance magazine last April, that the people liable for any shortfall in endowment mortgage contributions should be the lenders, not the policyholders, on the grounds that they ignored all the warning signs about the inherent weaknesses of using life assurance investment policies to repay capital loans.

Mr Shallow claims that the failure of endowment policies over the past 10 years to underpin mortgages - at the rate that was being advertised and promoted - was "professionally foreseeable by the lenders". The lenders, he says, also had considerably more resources, in the form of actuaries and solicitors, than did their ordinary customers "to direct independent professional valuation of policies", whether at the beginning of the term, a few years into it, or now.

He also believes that if the lenders are liable for shortfalls, it should not be just for the loan amount, but also for the surpluses that they so widely advertised and implied would be available at the end of the mortgage term.

Mr Shallow admits that the only way a case like this could be resolved in favour of an aggrieved policyholder is if there were a successful challenge in the civil courts. A spokesman for the Consumers' Association of Ireland said it would consider supporting a consumer with a legitimate case like the one described by Mr Shallow.

"Endowment mortgages were inherently flawed from the start," he said. "Due diligence was not properly undertaken by lenders, who unfortunately were driven by the commissions paid by the insurance companies for selling these policies - which amounted to 90 per cent of the first year's premiums after 1989 - rather than the best interests of their customers." Industry sources say that their legal department's interpretation of the Building Society legislation clearly shows that the lenders are obliged to depend on the security of the value of the freehold or leasehold property itself rather than the adequacy of the endowment policy as security. No society, we were told would depend solely on the endowment policy as security in any lending case. This criteria would also apply in terms of the personal responsibility, under the legislation, that individual managers have regarding the security of loans.

As for the number of policyholders who are facing higher contribution levels, much depends, we were told, on the circumstances and size of the loan. One life assurer we spoke with said that 3,500 endowment mortgage policies, dating back between five and 10 years, have been reviewed so far. All of the policies are on target to repay the loans, though the positive margin of returns appears only to be 12 per cent.

Clients are being given the option to continue at the original projected growth levels or to take a more conservative view of future returns - sound advice in this low interest rate environment - and to increase their contributions

In Britain, where 80 per cent of all mortgages were endowment-based in the 1970s and 1980s, most endowment mortgage holders are receiving letters from their lenders advising increased policy contributions. It is also being recommended that part of the mortgage be converted to a repayment style or that another, standalone savings policy be taken out to cover the shortfall.

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