

UNDER-PERFORMANCE OF ENDOWMENT MORTGAGES IS BUILDING SOCIETIES RESPONSIBILITY

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Patrick Shallow - Managing Director, Finalysis Ltd.

In recent years and months, many policy holders, in Ireland and in the UK, have been receiving carefully worded letters from their life offices expressing disappointment with the performance of funds and advising policy holders/mortgagors that, prudently, they should consider increasing their monthly premiums to avoid threatened shortfalls viz a viz the mortgage advance.

The explanation for this underperformance may, variously, be found in too high a proportion of gilts in the investment funds, unsuccessful fund management, too high cost structures, the removal over time of certain tax reliefs – or a combination of all of these.

Whatever the reason, disappointed life offices are communicating with even more disappointed policyholders who are resignedly but obediently amending their direct debits. But should they?

Back in 1989, shortly after the endowment mortgage was received with some euphoria in Ireland, Finance published an article comparing the sums on the endowment versus the annuity mortgage and suggesting good reasons why many endowment policies might fail to deliver. While interest rates in 1989, also tax rates, were forgettably higher then, the basic arithmetic of the analysis remains valid. Without repeating all the arguments presented there the conclusion then offered was that the failure of many endowment policies was foreseeable at that time.

The article went on to suggest to Building Society providers of the endowment mortgage that, prudently, they might examine the relative merits of the endowment product.

It went on to point out that under section 79 of the 1967 Building Society Act (carried forward by the new Act), societies appeared to have a statutory responsibility – as in the case of mortgaged properties – to obtain independent professional evaluations of all security adopted in relation to mortgage loans. By implication it was indicated that failure to undertake such evaluations might expose the societies to risk, in the event of any failure by the endowment policy itself – in the same way, that a society would, at law, be liable should a house, which it had neglected to have professionally surveyed, developed serious faults thereafter.

Many endowment policies are now under performing their mortgage targets and it is highly arguable that shortfall is the responsibility of the Building Society, rather than of the mortgagor, for the following reasons.

The use of the word security in the Act appears to place an explicit responsibility on Building Societies. The projected failure of (particularly constructed) endowment policies was professionally foreseeable by societies, which also had the resources to direct such independent professional valuations. Valuation of the complex endowment policy – and its relative merits viz a viz the annuity mortgage – could not have reasonably been undertaken by the layman mortgagor.

It might further be argued that the liability of the Building Societies, if established, extends not just to the current threatened shortfall viz a viz the mortgage loan but also to any underperformance viz a viz the surpluses which were, perhaps optimistically, illustrated and implicitly forecast by the life offices and which, importantly, were then tactly endorsed by the Building Societies and relied upon by mortgagors.

Possible advice to any Building Society mortgagor now receiving a notice from a Life Office, suggesting that he increase his endowment policy premium to ensure a sufficient sum on maturity, might, accordingly, be that he redirect the correspondence, under a covering letter, for the attention of the relevant Building Society.

COMPARISION OF PROJECTED NET RETURNS TO ENDOWMENT POLICY HOLDERS WITH PROJECTED NET MORTGAGE COST			
			%
Projected investments returns to life office			14
Gross return projected Less deductions:			
- company overheads (estimated)		2.0	
- brokerage (annualised over 20 years)		1.0	
- 35% tax on net investment income (14%-3%)*		<u>3.9</u>	<u>6.9</u>
Net return to endowment policy holder			7.1
+ This tax may be abated somewhat by allowances for relevant capital gains.			
Projected gross mortgage rate (current & projected)			12
deduct relief for relevant tax brands:	32%	48%	56%
i. tax relief @ 80%	2.5	3.8	4.5
ii. effective relief @ 83% of (i)	<u>2.1</u>	<u>3.2</u>	<u>3.7</u>
Net mortgage rate (12.0%-ii)	9.9	8.8	8.3
Projected potential underperformance of endowment policy (net cost – net return on investment of 7.1%)	<u>2.8</u>	<u>1.7</u>	<u>1.2</u>
* Based on 3 per cent projected differential over mortgage rate.			