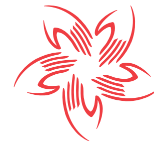
HINDSIGHT



Collegiate
UNDERWRITING

January 2009

Welcome to the return of our Hindsight publication. Collegiate Management Services Ltd have been providing insurance to the IFA market for over 20 years and in this edition we share our experience of defending claims against IFAs by highlighting some case histories which we think you will find interesting and useful. If you have any comments on the content, or suggestions for future issues, please write to us or e-mail us at newsletter@collegiate.co.uk

The last year has seen a marked deterioration in economic conditions as the 'credit crunch' has taken effect. House prices and stock markets have seen significant falls. Against this backdrop we are beginning to see an increase in claim notifications as IFA clients suffer financial losses on their investments or are unable to access savings accounts.

The deadline for registering for primary protection from the lifetime allowance charge is finally approaching on 5th April 2009. If any of your clients had pension rights greater than £1.5m at 5th April 2006 then please ensure that the appropriate notification to HM Customs & Excise has been made prior to this date.

This edition of Hindsight welcomes contributions from Mark Bates and Mark Gibbon supported by Martin Archer.

Mark Bates, a solicitor within the Collegiate Underwriting in-house claims team, has recently been dealing with a thorny issue on Endowment Limitation.

Mark Gibbon is Managing Director of Collegiate. Asked to consider articles that will contribute towards risk management, Mark, a Charted Accountant, investigates the dangers of investment bonds and points out lessons to be learned from Film Finance Schemes.

Martin Archer is the Legal Director in charge of the Collegiate in-house claims team and provides editorial support to the newsletter.

We hope that you will find these articles informative and useful.

Richard Turnbull
Underwriting Director
Collegiate Underwriting

FOS has discretion to dis-apply the "new rule" for endowment time barring. Will the Ombudsman use it?

A first Endowment "Warning" letter was sent to the client in April 2004. In September of that year the client surrendered the policy. In January 2008, the client made a complaint citing the standard claims farmer's list of usual suspects.

The complaint was made some three years eight months after the initial "Warning"(red) letter and three years four months after the surrender of the policy. We raised a limitation defence on the question of jurisdiction given the advice was provided more that six years ago and the client had confirmed on his FOS complaint form that he had been aware of the problem for more than three years.

The FOS adjudicator rejected this on the basis of the "new rules" "implemented by the FSA in June 2004. In particular because the complainant had not received an explanation that his time to refer any complaint would expire at the "final date".

These warnings were generally sent out by product providers in subsequent "Warning" letters, but as the client had surrendered the policies, none were issued in this case. The FOS adjudicator ruled that "even though the policy had been surrendered it did not prevent the IFA from notifying the complainants of the final date by which to make a complaint ". Clearly many hundreds of thousands of policies have been surrendered and as a consequence have not received "the final date" warning. Given the adjudicators current approach this would mean that those cases would never become time barred unless the industry undertook a disproportionately expensive further mass mailing exercise with significant change of address issues in addition.

Collegiate's Legal Director, Martin Archer, had a meeting with the principal Ombudsman to discuss the issue. In that meeting the point was made that the "new rules" by paragraph Disp Rule 2.8.7.R (5) provides the Ombudsman with discretion to dis-apply the requirement for a final date letter. We argued strongly that the "new rules" ought to be seen as an exception to the standard limitation rules specifically introduced to deal with the concern that many clients may have been induced to adopt a "wait and see" approach to the endowment shortfall problem by the literature previously sent, such that it would then be unfair for those consumers to find themselves time barred.

Martin made the point that these "exceptional circumstances" did not apply to clients who had surrendered their endowment as clearly they had not been induced to adopt a "wait and see" approach and therefore there was no good reason for those clients not to be expected to promptly pursue complaints in the same way that all other claimants are.

Whilst the Ombudsman was not prepared to consider a blanket approach to using their discretion to ignore the "new rules" on surrendered policy cases, they were prepared to look at the issue on a case by case basis.

Subsequent to that meeting we have made a further detailed submission addressing the particular aspects of that case and requesting that the Ombudsman considers exercising their discretion. We will report on the outcome in due course, but currently it does seem clear that each case will need to be looked at on its own individual merits.

Investment Bonds – Danger!

In November 2007 the Telegraph reported that over £30bn had been invested in investment bonds in the last year.

The taxation of investment bonds is complicated but briefly UK investment bonds are taxed within the bond on income and capital growth at a rate of 20%. The investor pays higher rate tax on final surrender any gain being subject to top slicing relief rules and being treated as marginal income. For a higher rate taxpayer this equates to a tax charge of 36%.

Top slicing relief works by dividing any gain by the number of years the bond has been in existence and treating that as the taxpayers highest band of income, calculating the tax applicable to that band and then using that tax rate across the whole of the gain. This can be beneficial where the taxpayer is not a higher rate taxpayer or has some unused basic rate band. Offshore bonds have an advantage over onshore bonds because the number of years is always calculated from the gain to the date the policy incepted whilst it is from the gain to the last chargeable event for onshore bonds.

Offshore investment bonds do not pay tax on income and capital growth within the bond, except for some withholding tax, but the investor is liable to the full rate of tax when it is cashed, which is subject to top slicing relief as above in determining any higher rate liability.

Both types of bonds allow a 5% withdrawal per annum with no immediate tax consequences for the investor. This is a cumulative 5%, so if in the first year no withdrawals are made then 10% could be withdrawn in the second year. Tax is deferred until the bond is finally encashed when the gain is calculated by looking at the total withdrawals compared to the original investment.

Investment bonds are normally set up in clusters to give maximum flexibility.

Where an investment bond is partially surrendered there can be disastrous consequences for the taxpayer. This arises because any receipt by the investor over the 5% allowance is taxed as income.

We have recently seen situations where the adviser has completed the form requesting a withdrawal of money on behalf of the investor and ticked the wrong box requesting partial surrender rather than full surrender of one or more of the clusters.

If a partial surrender leads to an income tax charge but overall there is no gain on the investment bond when finally cashed there is an opportunity to claim 'deficiency relief' against other income but this relief will not always be available as it is only offset against higher rate tax. This is an extremely inequitable result for the taxpayer and a windfall for the government.

We have taken this issue up with the Association of International Life Offices and asked that the Life Offices review their own procedures in dealing with surrender situations. Advisers need to ensure that if the investor is withdrawing money in excess of the 5% allowance the correct method of withdrawal is selected.

This could be a very expensive tick!!

Too good to be true!

Under s150 FSMA 2000 a client has a right of action against an IFA for breach of statutory duty e.g. advice on suitability of the investment. Seymour v Ockwell 2005 found that this duty was non delegable. The IFA cannot hide behind reliance on another third party who may have provided support to the IFA in assisting the IFA with the advice given to the client.

It may be that the third party owes a duty of care to the IFA and there will be a claim for contributory negligence. The judge in Seymour considered that normally this would be no more than 20% although in this case because the third party had specific information on the investment, which was not passed on to the IFA, he decided on 66%.

In certain situations the third party may owe a duty direct to the client, but this will be subject to the proximity test. Where the third party does not attend client meetings and only passes information via the IFA, there is unlikely to be any proximity to the client and therefore no liability. Similarly if the third party attends meetings with the client and IFA, but makes his role very clear that he is there to provide technical support to the IFA and sticks to it, then there is also unlikely to be sufficient proximity to the client. However, if the third party goes beyond this and provides advice direct to the client then, there will probably be a duty owed and liability.

Where does that leave the IFA when advising clients on products produced by third parties?

In recent years there have been a number of problems with products which are complex to understand and have not produced the results they said they would, which invariably leads to complaints against the advisor. Film finance schemes were set up to attract significant tax advantages for anyone investing. The tax advantages of some of the later schemes we have seen were larger than the capital investment made by the client. This involved investing in a film production partnership and a film acquisition partnership so that £1 invested in each partnership could provide £4 of tax losses to offset against other income.

The brochure detailing how the scheme worked included Counsel's opinion on the tax effectiveness of the investments. However the brochure also contained a number of risk warnings and advised investors that they could not rely on the opinions given in the brochure but should seek their own specialist tax advice before investing.

A significant amount of money was invested in these schemes. The loss relief claims were challenged by HM Revenue & Customs. Advice had to be taken by investors on whether to fight or accept a compromise. The compromise won but that left the investors significantly out of pocket as the amount of loss relief received was less that the value of investment made and the capital investment itself was likely to be worthless.

What such schemes invariably have in common is a promise that is too good to be true. In Seymour v Ockwell it was the promise of a return of 15% per annum as well as a guarantee of capital. In the film finance cases it was the promise of more tax back than the amount of capital invested.

This should put anyone on their guard. There is no such thing as a free lunch. The Judge in Seymour v Ockwell said the IFA should have realised that an investment with a 15% guaranteed yield was unlikely to be low risk at a time when base rates were 6%. In fact the directors of the offshore company were fraudsters.

In the Stax pension transfer cases, 96 clients transferred £16.5m from client pension funds to pension funds in companies controlled by Stax. The money, less fees payable, went back to the clients by one of two methods, the effect of which was to enable the client to get his hands on pension monies sooner than he should have done without payment of tax. The Inland Revenue Investigator commented 'Anybody who is tempted to use a scheme that offers savings and access that seems to be too good to be true should be very cautious.' Any advisor should be especially cautious before recommending such a scheme to his clients. One of the persons behind this scheme was successfully prosecuted for tax evasion. The Judge commented that everyone has the right to arrange their financial affairs so that they pay the minimum of tax but dishonest tax evasion is obviously unlawful. In this case the employment letters between the clients and the companies controlled by Stax were described as 'brazen fiction' from start to finish'.

When generating a return greater than that available on cash or accessing tax benefits greater than those normally available there is going to be some form of risk and this needs to be understood by the IFA, clearly communicated to the client and reinforced in the reason why letter. The IFA must also assess the suitability of the investment and in particular match the risk of the investment to the profile of the client.

Where the IFA has identified the client as a low risk investor this must be matched against the assessment of the product. The danger is that the product although marketed as low risk is in fact nothing of the sort!

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