Mortgage endowment reserves

Response to October 2014 Discussion Paper by Anthony Pepper ARN6644

I would like my comments to be made public and with my name made public.

PPI complaints have not been done properly because FOS is ignoring a material cause of action--that the premium is out of all proportion to the benefits provided by the policy.

Companies should be setting up appropriate reserves for the compensation bill should high premiums eventually be recognised as a cause of action.

The mortgage endowments complaints have not been carried out correctly. FOS uses a yardstick for the probable maturity value based on endowments maturing in the 1980s. On this basis FOS says the policies are low risk when in fact there is an acute shortfall risk.

Reserves are called for to cater for the compensation bill if mortgage endowment complaints are to be handled properly.

Evidence that FOS uses a yardstick of past maturities is immediately proved by the FOS database of ombudsman decisions, Decision Reference Numbers DRN. The ombudsman Keith Taylor says that the endowments have performed well.

The correct estimate for a policy commencing in 1988 is a projection rate of 8.75%--the middle of the Illustration projection rates of 7% and 10.5%. The maturity values are highly volatile as maturity values are correlated with inflation rates which are unpredictable. However the real rate of interest is less volatile than the nominal yield. Therefore low inflation is likely to mean low interest rates and missed mortgage endowment targets.

Typically a policy written in 1988 had a premium basis of 8.3%. Given that the yardstick should be 8.75% and the maturities are highly volatile, a target based on 8.3% is highly likely to be missed and can easily be missed by some considerable distance.

The high shortfall risks are readily proved by financial models such as the John Hull modification of Black-Scholes, or the Wilkie model.

This is an extremely serious matter as the quantum of mortgage endowments falling short is gigantic.