THE FINANCIAL SERVICES AND MARKETS TRIBUNAL

LEGAL & GENERAL ASSURANCE SOCIETY LIMITED Applicant

-and-

THE FINANCIAL SERVICES AUTHORITY Respondents

Tribunal: Judge David Mackie CBE QC
Ms Sandi O'Neill
Mr Peter Burdon

Sitting in public in London

for the Applicant: Mr Charles Flint QC and Mr Ben Jaffey instructed by Freshfields

for the Respondents: Mr Hodge Malek QC and Mr Simon Hattan instructed by the FSA

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A INTRODUCTION

1. In this case Legal & General Assurance Society Limited ("L&G") challenge a decision of the Financial Services Authority ("FSA") which on 24th October 2003 issued, through its Regulatory Decisions Committee ("RDC"), a Decision Notice imposing a penalty of £1.1 million (reduced from an earlier penalty of £1.3 million) for alleged rule breaches in sales of low cost with-profits endowment mortgage policies under L&G's Flexible Mortgage Plan ("FMP") between 1st January 1997 and 31st December 1999 (the "Relevant Period").

2. FSA makes two claims. First it says that L&G's sales and compliance procedures failed to ensure that their advisers sold FMPs only to those customers for whom they were suitable. Secondly FSA says that FMPs were sold to customers for whom they were not suitable either because those customers were not prepared to accept the risk that the policy might mature with insufficient value to pay off the mortgage ("the capital shortfall risk") or because they did not properly understand the risk. FSA seeks to prove first that L&G's compliance procedures were deficient ("the procedures case") and, secondly that there was actual mis-selling of FMPs by L&G representatives and that the proportion of these was unacceptably high. FSA claims that this mis-selling ("the mis-selling case") was caused by, or contributed to, the deficiencies in L&G's procedures.

3. L&G deny these allegations and maintain that they had proper and reasonable sales and compliance procedures in place during the Relevant Period and that the allegations of mis-selling are flawed. L&G say that they took proper steps in accordance with the rules and followed the guidance of the regulator which in substance approved the very methods of which criticism is now made. L&G claim that they were subjected to an unfair inquiry by FSA and that the Decision of the RDC was unjust.

4. Our task is to decide whether L&G broke the rules and, if they did, what if any penalty should be imposed. As the case has attracted interest it may help if we point out that it is not:-

    (a) an appeal against the FSA decision. It has been a fresh hearing based on all the evidence now available;

    (b) an evaluation of who was responsible for what went wrong with endowment mortgages in general so as to cause so much anxiety and risk of hardship among customers;

    (c) an overall appraisal of the role and performance of L&G as a provider of endowment policies for paying off mortgages or of FSA and its predecessor as regulator. We are concerned only with whether FSA has proved the particular charges it brings against L&G;

(d) a decision about compensation due to customers. That is decided by a separate process which applies standards more favourable to the customer than those which govern a disciplinary case. If FSA does not prove to us to the required standard that L&G have mis-sold a policy this does not mean that the customer is not entitled to a payment under the compensation scheme. Indeed, some of the customers in the cases we considered have already been compensated by L&G.

We do not, when carrying out the limited task entrusted to us, for a moment forget that the endowment mortgage problem which arose in the 1990s involved serious loss and anxiety to many ordinary home owners throughout the United Kingdom. Many people who sought only to borrow money to provide a home for their families found themselves emerging from the process as *'investors'* supposedly willing to take risks with their *'investments'* so that their loans might not be paid off in full. When deciding the allocation of responsibility for one small aspect of the problem we do not lose sight of the fact that many people legitimately feel that they have been badly served by the Financial Services industry.

5. Our Decision follows the order of the Index.

6. The Decision has the following attachments:

I Conclusions about 13 alleged mis-sales about which we heard evidence from customers

II Conclusions about 47 alleged mis-sales about which we did not hear evidence from customers

III Personal Financial Review ("PFR") Form

IV Key Features Document ("KFD") and typical personal illustration

Progress of this case

7. FSA referred what is now this case to Enforcement in July 2000. FSA issued a Warning Notice on 30th April 2003. The FSA Decision Notice was given more than three years after the reference to Enforcement on 25th September 2003 and amended on 24th October. On 20th November 2003 L&G referred the matter to the Tribunal. FSA submitted the Statement of Case on 5th January 2004. The Tribunal made orders, through the Chairman, at hearings on 19th March and 20th May. There was a further pre-trial hearing before all three of us on 16th July. The main hearing began on Monday 13th September and continued until Thursday 21st October. The hearing has involved close examination of about 40,000 pages of documents. FSA's closing argument alone runs to 171 pages with 2 appendices, the first of which contains 17 dividers of further submissions. The Tribunal has heard evidence from 13 customers of FMP products (2 by video link), 5 current or former FSA staff, 8 current or former employees of L&G and from 8 experts in a variety of disciplines. The Tribunal has also reviewed seven further statements

from witnesses who were not called. We have also been asked to decide on the basis of the documents the merits of a further 47 cases of alleged mis-selling.

8. We are extremely grateful to the lawyers for both parties without whose talents and energy it would have been impossible for us to absorb and evaluate the material. Despite this help the case remains a large one. We have done our best to keep this decision as short as possible consistently with doing justice to the extensive and complex cases put by the parties. We have considered all the evidence but we do not refer to it all in this Decision. Much of the evidence consists of material which has been valuable in explaining the background and the context. Apart from some unsurprising differences of recollection about incidents and meetings some years ago when policies were sold there has been little disagreement about the facts. The differences have been about their significance and timing and the interaction of some very complex matters. There has also been a helpful willingness by the experts to reach agreement on many points and to concentrate on what really divides them. In this Decision we therefore describe the issues and the competing submissions referring to the statements and the oral evidence of witnesses only where they are directly relevant. Similarly we have not lengthened the Decision with citations of where particular documents are to be found as the parties will be wearily familiar with most of those.

9. The Decision of the Tribunal is unanimous on every issue.

B JURISDICTION OF FSA

10. FSA has power, under Section 206 of the Financial Services and Markets Act ("FSMA") and its transitional provisions Order, to impose a penalty for the breaches of the regulatory rules of its predecessors which occurred before FSA became sole regulator of the financial services industry on 1st December 2001. The background to the regulation of L&G giving rise to FSA's power is complex. Under the Financial Services Act 1986 financial services were regulated by the Securities and Investment Board ("SIB") which oversaw a number of self-regulating organisations ("SROs") while aspects of insurance company regulation were in the hands of the Department of Trade and Industry, and later the Treasury. Until 1994 L&G's SRO was LAUTRO. In 1994 LAUTRO merged with FIMBRA to become the Personal Investment Authority ("PIA"). SIB was renamed FSA in October 1997 and in June 1998 it took over employment of the staff of, amongst others, PIA. During the Relevant Period (1st January 1997 to 31st December 1999) L&G was regulated by PIA. As a result we have a confusing picture of FSA relying on the Principles of SIB, the Rules of PIA and the "Adopted LAUTRO Rules". But it is common ground that the picture is correct. The parties have referred correctly to L&G and other large companies as "firms" and "members" because these are expressions used in the Rules. We have therefore done the same even though these words are not usually apt to describe such big companies.

11. Advice to customers about the choice of mortgage, including whether to select an interest-only or a repayment mortgage, was unregulated throughout this period and

therefore outside PIA Rules. L&G subscribed to the Mortgage Code, a voluntary scheme operated by the Council of Mortgage Lenders, after 1st May 1998. PIA only became the regulator when the customer was receiving advice about investment. This unnatural division into two stages of what is, at least to the customer and to us, one process, has led to problems as will appear below.

C JURISDICTION AND FUNCTION OF THE TRIBUNAL

12. A party against whom FSA imposes a penalty has a right under Section 208(4) to "*refer the matter to the Tribunal*" i.e. us (see 7 above). The Tribunal (Section 133(4)) must "*determine what, (if any) is the appropriate action of the authority to take in relation to the matter referred to it*". The Tribunal decided, through its Chairman, that "*the matter*" is to be read broadly and covers the FSA decision, the imposition of a penalty and the surrounding facts, not simply the particular facts recorded in the Decision Notice.

13. **Evidence** The Tribunal has a broad power to consider any evidence whether or not admissible in court proceedings and whether or not it was available at the time FSA took its decision (Section 133(3)). It seems common ground between FSA and L&G that each is entitled to rely on evidence which was not available, or which was available but not put forward, at the time the Decision was taken. After much earlier controversy about what evidence should be admitted a truce was reached between the parties although not about the relevance and significance of the material.

14. **Rehearing not appeal** We are not hearing an appeal against FSA's Decision but reviewing from the start the facts and matters which led to it. This case has been a complete re-hearing of the issues which gave rise to the Decision. Once we have reached our own views about the issues we will take into account the RDC Decision and consider L&G's criticisms of that process.

15. **Pleadings** The parties are permitted to raise matters not directly brought before the RDC. This is however a disciplinary matter. As a matter of common sense and fairness we would generally expect FSA with the wide powers open to it, having taken time to evaluate matters, and having carefully reviewed and carried forward charges to the RDC, to bring much the same case when taken to this Tribunal. Of course important new evidence may unexpectedly come to light or there may be in other cases special circumstances which change that general expectation. Similarly it seems to us that FSA, having set out its position in the Statement of Case, should usually be confined to the charges contained in it, perhaps refined as the case moves forward.

16. The Reply of L&G is met by a Response from FSA. These two pleadings raise further issues about which there has properly been extensive evidence from both sides. But this material relating to the grounds of defence raised by L&G should not generally enable FSA to add to the case put forward in its Statement of Case.

17. When we and the parties refer to the pleadings we are dealing not with the principles and practice of civil litigation developed in the High Court but with Tribunal procedure designed to ensure that the Applicant knows the charges it faces and that neither party ambushes the other or unfairly takes it by surprise. It follows that the more technical pleading points have not impressed us.

18. **Expert Evidence** It is important to be clear about the role of expert evidence in this case. Both sides in their closing submissions place weight on the presence or absence of expert evidence. While we have found all the expert evidence helpful we have placed little weight on it when evaluating in its context material such as forms and written guidance intended for consumers. These are matters on which, given the background of two of us in financial services and all of us as consumers, we feel able and obliged to form our own views of the evidence. Similarly, the benefit of hearing evidence from a number of L&G customers outweighs the value of expert conclusions about what the reaction of a consumer might or might not be expected to be, particularly when that expertise is not backed up by consumer research. Further the Endowment Sales Review discussed below had, as one of its features, panels of suitably qualified consultants from a large accountancy firm evaluating material such as interviews with customers, so as to form a view whether or not they may have been sold an unsuitable product. This was careful and skilful work and no doubt in this and other cases valuable in the Regulatory process. But unlike the accountancy and actuarial expertise of these firms, the views of the consultants do not influence us in reaching our own conclusions.

19. **Burden and Standard of proof** FSA has to prove the breaches of the rules that it alleges and to do so on the balance of probabilities applying the considerations encapsulated by Ungoed-Thomas J in *Re Dellow's Will Trusts, Lloyd's Bank Limited v Institute of Cancer Research* [1964] 1 All ER 771 at 773 "*The more serious the allegation, the more cogent is the evidence required to overcome the unlikelihood of what is alleged and thus proven.*" We follow this view which was endorsed by this Tribunal in the case of *Hoodless and Blackwell*. This is common ground, although L&G suggest that the allegations in this case are at the serious end of this range but FSA submits the opposite.

20. **Retrospection** It is also common ground that evaluation of L&G's compliance with PIA rules and principles requires application of the standards of 1997 to 1999 not those which apply today.

21. **Costs of a Tribunal hearing** This case has been conducted at great financial cost to both sides. The length of the hearing was justified by the wide and complex range of disagreement between the parties and their inability to agree much common ground. We should emphasise that this case is very different from most of those with which the Tribunal deals. Most cases are much shorter and cheaper to conduct and parties are often not legally represented. We are a Tribunal not a court. Potential applicants to the Tribunal who come across this Decision should not feel daunted by its exceptional features when considering the exercise of their own legal rights.

D RELEVANT RULES OF REGULATION

22. The parties have listed separately the Rules which each relies on. In view of their importance we now list all these together.

23. **SIB General Principles** These are universal statements of standards expected by regulated firms. They were issued by SIB and applied to PIA members of which L&G was one.

Skill Care and Diligence

"2. *A firm should act with due skill, care and diligence.*

Information for Customers

5. A firm should take reasonable steps to give a customer it advises, in a comprehensible and timely way, any information needed to enable him to make a balanced and informed decision.

Internal Organisation

9. A firm should organise and control its internal affairs in a responsible manner keeping proper records, and where the firm employs staff or is responsible for the conduct of investment business by others, should have adequate arrangements to ensure that they are suitable, adequately trained and properly supervised and that it has well-defined compliance procedures.

Relations with Regulators

10. A firm should deal with its regulators in an open and co-operative manner and keep the regulator promptly informed of anything concerning the firm which might reasonably be expected to be disclosed to it."

24. **PIA Rules**

(PIA Rule 1.3.9)

"*A Member must accept responsibility, to the same extent as if the Member had expressly authorised it, for anything said, written, done or omitted*

(1) by any of its investment staff or other employees in the carrying on of the Member's relevant business;

(2) by any of its appointed representatives or their investment staff or other employees in carrying on the investment business for which the Member has accepted responsibility in writing, or by any person held out by the Member as being its appointed representative".

There was disagreement between the parties extensively canvassed in submissions as to whether this Rule made a Member directly liable in a disciplinary as well as a contractual sense for the acts and omissions of advisers (we refer to "advisers" throughout except where dealing with a Rule or other reference which calls them "representatives"). We express no view on this as it is unnecessary for our Decision. As we understand the position of both parties it would arise only if we made findings of mis-selling independent of the procedures case, and we will not.

(PIA Rule 7.1.2(1))

"*A Member must establish procedures, including procedures for complying with the training and competence requirements in accordance with Rule 2.6, with a view to ensuring that its investment staff and other employees and its appointed representatives and their employees carry out their functions in such a way that the Member complies at all times with the Rules and Principles*".

(Rule 7.1.2.(2))

"*It must keep those procedures under review and revise them as appropriate from time to time*".

(Rule 7.2.1(1))

"*A Member must monitor adequately*

(a) the conduct of its investment staff and other employees, and of its appointed representatives and their relevant employees, with a view to ensuring compliance with the procedures which it has established in accordance with Rule 7.1.2 and its own compliance with the Principles and Rules."

25. **Adopted LAUTRO Rules**

Rule L3.15 requires that when a member recommends a product like the FMP the investor must be given a "*reason why*" letter:

"*A written explanation given to an investor in compliance with this Rule must:*

(a) be signed by a designated individual of the Member;

(b) make clear why the recommendation has been made having regard to the investor's financial and other circumstances of which the Member is aware."

Rule L6

"*A company representative who, in the course of any relevant business, has dealings with an investor:*

(a) *shall give the investor all information relevant to those dealings and that information shall in particular include the information referred to in paragraph 6A below;*

(aa) *shall use his best endeavours to enable the investor to understand the nature of any risks involved.*"

Rule L6A

"... a company representative shall give the investor a Key Features document (i) before the investor completes or signs an application form for any contract ..."

Rule L8

"*(1)* *A company representative shall, in advising an investor as to the suitability for that investor of any investment contract, have regard, in particular, to the investor's financial position generally... and to all other relevant circumstances; and he shall use his best endeavours to ensure-*

(a) *that he recommends only that contract or those contracts which are suited to that investor; and*

(b) *that there is no other contract available from the Member, or, if the Member belongs to a marketing group, from any member of that group, which would secure the investor's objectives more advantageously.*"

Rule L12

"A company representative shall so far as practicable ascertain all details relating to an investor and his particular circumstances as may be required for the purpose of complying with any duty in this Code or to enable the Member to comply with any requirement of these Rules."

Regulatory Guidance

26. In addition to these rules there is a variety of regulatory guidance although less than might have been expected about some important issues. PIA Regulatory Updates ("RUs") to which we refer below were of particular significance. The RUs contained guidance which was not mandatory but which served as a useful indication of standards expected to be applied at the time. The main RUs we are concerned with are RU43 in December 1997, RU47 in February 1998 and RU72 in

December 1999. L&G also rely on Table 5 Part II of PIA Rules which requires advisers to keep records of information given by and collected from a customer.

Approach to the Rules

27. L&G point out that there is no allegation of breach of a number of the particular rules relating to such matters as monitoring, product disclosure, risk warnings and record keeping. Other rules required the adviser to inform the customer of all relevant information, to use best endeavours to enable the customer to understand the nature of the risks involved and to provide a key features document. This is correct and pertinent to ensuring that the Tribunal bears in mind the case L&G have to meet. FSA has chosen to proceed under the more general rules. It may be harder to show a breach of general standards than of specific rules. We consider that FSA is free to bring into this general consideration acts or omissions which might otherwise have been the subject of alleged breaches of more detailed rules. FSA says that L8(1), 7.1.2(1) and SIB principle 2 are informed by obligations which are the subject of those more specific rules. We agree and consider that there is a further justification for the approach adopted by FSA. FSA is free to rely on whichever rule or rules reflect what they perceive to be the gravity and extent of the alleged mischief. It would be undesirable, and potentially oppressive to an applicant, for FSA to be required to "*clutter the indictment*" unnecessarily with a whole range of extra charges. The omission of a particular charge from a case is not to be taken as a concession that FSA accepts that there has not been a breach. L&G also raise a related but different point with which we deal below. L&G claim that if they have complied with all the relevant specific rules it is improbable that they can be in breach of general ones.

28. FSA maintains that the procedures case and the mis-selling case are linked, but stand independently of one another. FSA says "*it would therefore be possible in principle for the Tribunal to find for the authority in relation to the first limb of the case, but for L&G in relation to the second limb, or vice versa*". Like L&G we reject "*or vice versa*". FSA accepts that its primary case is that there were procedural deficiencies and that these caused or contributed to mis-sales. Its claim for an independent mis-selling case is rightly half-hearted and little developed. We reject it and concentrate on the substance of what is claimed in the Decision Notice and the pleaded case.

E GENERAL BACKGROUND

29. This summary is based on material in the documents either agreed or apparently unchallenged. House buyers seeking finance have had a choice of two types of mortgage - a repayment mortgage or an interest-only mortgage. With a repayment mortgage the buyer makes monthly payments to the lender to cover the interest and gradual repayment of the capital. Payments usually rise and fall with interest rates but if they are kept up to the end of the period of the loan the mortgage will certainly be repaid. The buyer will often take out insurance, known as Term Assurance, to pay off the loan in case of death or critical illness. With an interest-

only mortgage the buyer's monthly payments to the lender cover only the interest. Additional and separate payments are made into a "*mortgage repayment vehicle*", usually a with-profits endowment policy but sometimes other investments like PEPs/ISAs, unit-linked funds or pension funds are used to build up a lump sum to repay the mortgage at the end of its term. Endowment mortgages were developed in the 1960s and, according to FSA, 6 million households had taken these out by the year 2000. By 1988 80% of new mortgages were on an endowment basis. During the 1990s tax advantages were gradually removed and inflation, interest rates and expected future investment returns declined. Endowment mortgages became less popular and by 1999 covered only about a third of new mortgage business. Originally, endowment mortgages involved taking out a policy guaranteed to yield a sum equal to or greater than that necessary to repay the mortgage when it matured. But in the 1980s low cost endowment policies became popular. These were cheaper, the premiums being lower because they were guaranteed to repay at maturity only a proportion of what was needed to pay off the mortgage. Payment of the balance was dependent on the level of investment returns achieved during the life of the policy. So there is a risk with low cost endowment policies that on maturity the policy will provide insufficient money to repay the mortgage. While this risk has been given various names we will call it the "capital shortfall risk" as the parties have done for most of this case. We recognise that capital shortfall risk was not an expression in common use during the Relevant Period. The FMP in this case, like many policies issued by other companies, had a low cost endowment option. L&G point out that both repayment and interest-only mortgages have other risks, that the customer may in the future be unable to afford changes in interest rate, or that the market value of the secured property would fall. Our impression of the witnesses was that they were well aware of those additional risks.

30. As we have pointed out in 11 above, advice on a mortgage was not subject to regulation because the PIA Rules only regulated the provision of investment advice. They did not cover the way in which mortgage advice should be given or how records of it be kept. The most relevant investment rules (all of which we have set out in more detail in Section D above) apply to the FMP as follows:

Application of the rules

31. Under PIA Rule 7.1.2(1), (relied on by FSA) a company was required to establish procedures *with a view to ensuring that its Representatives carried out their functions in such a way that they complied at all times with the relevant Rules and Principles*. Rule 7.1.2.(2) required firms *to keep these procedures under review, and to revise them as appropriate*, thus recognizing that changes would be made in light of experience and developing regulatory requirements.

When giving advice to investors, a company was obliged, through its Representatives, *to provide information* (Rule L6(a) Schedule L2 Adopted LAUTRO Rules), *to use best endeavours to enable the investor to understand the nature of any risk involved* (Rule L6(aa) Schedule L2 Adopted LAUTRO Rules)

and *to provide a Key Features document* (Rule L6A Schedule L2 Adopted LAUTRO Rules). FSA does not allege any specific breach of these rules.

Under Rule L5.4 a Member was in its projections issued to customers required *to illustrate the anticipated returns from the investment at a lower rate of 5% per annum, an intermediate rate of 7.5% and a higher rate of 10% per annum.* (When issuing projections to customers, a Member was governed by the general provisions of Rule L5.4 of the Adopted LAUTRO Rules. This Rule stipulates that projections should be calculated by reference to the rates set out in Part III of Schedule L4. In this Schedule, different rates are set out for different categories of business. The with-profits FMP fell into category A, namely "*Ordinary Branch non-pensions and not part of the tax-exempt business of a registered friendly society or an ISA*". Before 1 July 1999, the stipulated rates of return for category A were a lower rate of 5% per annum, an intermediate rate of 7.5% and a higher rate of 10% per annum.) After 1 July 1999 PIA Rules reduced the rates to be used in projections to 4%, 6% and 8% respectively. The purpose of PIA rules requiring Members to provide standardised projections to customers was to assist them "*to make informed decisions by indicating a broad range of the sums that might be built up for a given monthly payment. It does not provide any guarantee about the actual outcome, which could be greater or less than the figures given*". L&G complied with this requirement throughout the Relevant Period.

A company was obliged, through its Representatives, *to have regard to the investor's financial position generally* and to all other relevant circumstances and *to use best endeavours to ensure that it recommended only that contract suited to the investor* (Rule L8(1) Schedule L2 Adopted LAUTRO Rules relied on by FSA). Suitability is required to be determined by reference to the financial position and all other relevant circumstances of the investor.

32. The factors that made endowment mortgages less attractive to house buyers in the 1990s also affected existing policies and it was recognised not least by FSA in 1999 that many mortgage endowments were no longer on track to repay the capital due on maturity. A "*Cross-FSA Mortgage Endowment Working Party*" was set up in February 1999. The Working Party sought to ensure that consumers received good information about the issue, to take action on the endowment mortgage market as a whole, to see whether an industry wide review of all past mortgage endowment sales was required and to counter poor sales practices. This work included "*themed visits*" to firms in the summer and autumn of 1999. FSA chose to visit 11 "*product provider*" firms accounting for over 50% of total endowment mortgage sales in 1996. L&G was one of these firms having about 6% of the market.

L&G's Flexible Mortgage Policy

33. At this point we should explain the activity of L&G which was to be the subject of the themed visit. L&G's FMP offered three repayment policies invested in either a unitised with-profits fund, unit-linked funds or a PEP (now an ISA). The with-

profits fund was the least risky of the three in relation to projected investment returns and the only one which features in this case (to which the letters FMP refer to henceforth in this Decision). Similarly this case is concerned only with those FMP customers graded by advisers as "*low risk*". (In this Decision "customer" means low risk customer except when we indicate otherwise). When a customer purchased an FMP as a repayment vehicle for a mortgage there was no guarantee that it would provide sufficient funds at maturity to repay the capital sum of the mortgage. It was therefore not a suitable product for a customer who required certainty that the mortgage would be fully repaid at maturity and was not willing to take the risk of a capital shortfall. In the Relevant Period L&G sold some 159,000 FMPs including some 41,000 to customers with a "*low*" attitude to risk. Until shortly before the hearing the number was estimated by L&G as 24,000. As a result of an error L&G had omitted about 17,000 policies taken out in the latter part of the Relevant Period. L&G originally identified 21,400 FMPs matching the criteria for the Endowment Sales Review we refer to at 165 et seq below, and the 250 cases were taken from these. In mid 2004 L&G discovered that a completely new FMP series had been excluded from the review. It is very surprising to find such a large error emerging so late in the process. As a result, although the Relevant Period covers three years, none of the 60 cases referred to in Section G below has a Personal Financial Review ("PFR") dated after 1st October 1998. Over the same period L&G sold about 74,000 term assurance policies to accompany conventional repayment mortgages. L&G discontinued the FMP on 1st December 2000.

34. The process by which an FMP was sold to a customer involved three important documents. First there was the PFR completed by the adviser in close consultation with the prospective customer in the course of one or more telephone and personal interviews. The PFR was usually checked by the PFR Checking Unit at L&G and sometimes first by the adviser's supervisor. It was signed by and eventually sent to the customer to serve as a "*reason why letter*", a permanent record for the customer (and for L&G which itself kept a copy) explaining his or her circumstances, the policy and why he or she had been recommended to enter into it. Secondly there was a Key Features Document ("KFD"), a coloured folder containing printed information including prescribed risk warnings for the customer within which would be enclosed a third document, a personalised illustration giving projections of the value of the policy at maturity on the three different growth rate assumptions.

35. L&G describe the sales process broadly as follows. L&G advisers either gave a customer both mortgage advice and financial services advice or only did the latter after a third party (usually an estate agent or a building society) had given the mortgage advice. The adviser would conduct one or more interviews and one of these might be by telephone. Typically there would be a face to face meeting at the adviser's office or at the customer's home or work place. We were told that the process could take two hours or more. Broadly the adviser would introduce him/herself and hand over and explain a business card, written terms of business and status disclosure reference. The adviser would collect personal family

information and establish the customer's aims, financial background and needs. The adviser would begin the process of ascertaining the customer's attitude to risk and start to introduce various options from the different types of mortgage and methods of repayment. From May 1998 employed advisers were required to provide customers with a copy of the Mortgage Guide. Tied advisers could give out either L&G's Mortgage Guide or the Council of Mortgage Lenders' Guide. The adviser was to use visual aids and prepare illustrations and quotations for repayment and interest-only mortgages. If the customer was not prepared to accept the capital shortfall risk he would be advised against an interest-only mortgage. If the customer was so prepared the adviser, having explained the options, would recommend a with-profits FMP for low risk customers. Once a decision had been reached, the KFD including the personalised illustration would be handed over and explained. The customer and adviser would both sign the PFR. A completed PFR, once approved by Head Office, would be sent to the customer. A further copy of the KFD and the personalised illustration was sent to the customer with the letter giving him or her a right to cancel.

36. With this background we now deal, at first separately, with the "*Procedures*" and the "*Mis-selling*" Cases.

F PROCEDURES CASE

FSA's Claims and L&G's Reply

37. FSA alleges that in breach of Rule 7.1.2(1) and/or SIB Principle 2 there were the following defects in L&G's procedures:

(a) L&G failed to put in place adequate procedures to make provision (or adequate provision) for the identification of risk averse customers who were not prepared to accept the risk of a capital shortfall:

(i) L&G's procedures (specifically, the PFR) did not expressly require or provide for the L&G adviser to ascertain whether the customer understood and was prepared to accept the risk of a shortfall.

(ii) Where a third party advised taking an interest-only mortgage, L&G's procedures did not provide for or require confirmation that the customer understood and was prepared to accept the risk of a capital shortfall.

(b) L&G's risk categories were defective because no distinction was drawn between a "*low-risk*" customer and a "*risk-averse*" customer (i.e. a customer not prepared to take the risk of capital shortfall at maturity) in either the PFR form or the guidance provided to L&G's representatives to assist with its completion. In particular, the definition of "*low-risk*" was inadequate in that it specified that it referred to customers "*not prepared to take risks*" with their investment.

(c) The guidance given to advisers about the risks of with-profits endowments was inaccurate or inadequate.

(d) Against the deficiencies in the procedures as a whole, the risk warnings required to be provided to customers were inadequate.

(e) L&G's review procedures were inadequate to ensure that unsuitable sales were detected.

38. L&G deny these allegations, contending that their procedures were properly directed towards compliance with the rules, were reasonable and were, in the material respects, inspected and accepted by PIA/FSA supervision staff during the Relevant Period. In particular, L&G maintain that:

(a) There were proper procedures for the identification of "*risk-averse*" customers. Specifically:

(i) Every customer was required to be given a KFD, containing the risk warnings required by PIA Rules, including that related to the capital shortfall risk, and a personalised illustration, which set out the different sums that would be realised at maturity depending on the growth rates of the investment. Advisers were required to talk through and explain each document. Each customer signed the PFR to confirm that these documents had been received and explained. Customers were sent a second copy of the personalised illustration with a letter giving them a right to cancel before entering into the contract.

(ii) L&G's procedures did require advisers to explain the advantages and disadvantages of repayment and interest only mortgages and that an FMP was an unsuitable choice where the customer was not prepared to accept the risk of a capital shortfall at maturity.

(iii) Where a third party gave mortgage advice, L&G's procedures still required that the shortfall risk be explained and steps be taken to ensure that the customer understood and accepted the risk.

(b) L&G's risk categories were not defective. The relevant documentation was considered and approved by PIA. The risk categories referred to the investment risk associated with selecting a fund, not the risk of a shortfall.

(c) The guidance given to advisers was comprehensive and accurate. Advisers received extensive training and were taught to explain the capital shortfall risk to customers and check that it had been understood. A monitoring, supervision, testing and retraining process was in place to ensure standards were maintained.

(d) L&G's procedures required that full risk warnings were provided to each customer and explained to him or her. The risk warnings complied with all relevant regulatory requirements above.

(e) L&G's review procedures were adequate. Supervisors would check and monitor actual sales meetings. The PFR checking unit checked that the risk category marked matched L&G's procedures and that the customer had signed to confirm that the KFD and personalised illustration had been read and explained.

The approach to Rule 7.1.2

39. Rule 7.1.2 addresses the need to "*establish procedures ... with a view to ensuring ... etc.*". L&G submit that the duty to establish procedures with a view to ensuring compliance is not an absolute obligation. It reflects the recognition, as in Principle 9, that procedures should be reasonably effective but that it would be impossible to construct procedures which would ensure that no individual representative ever acted in breach. Procedures should be reasonably designed to prevent any non-compliance, but not to guarantee that this will not take place. We agree that it would not be enough for FSA merely to prove that in some cases there were breaches of PIA rules.

40. FSA says this obligation is not complied with by a firm simply having an intention that the procedures will have the right result. FSA says the rule imposes on firms an obligation to establish procedures which are effective in ensuring compliance with the rules by representatives. It requires that the procedures established are to be proper and effective (accepting that they are not made ineffective merely by isolated unsuitable sales). These obligations require L&G to take all reasonable steps to ensure that their procedures were adequate and in practice effective. Similarly L&G were obliged not just to train advisers, but to take steps to ensure that instructions have been followed in practice. FSA also rejects the suggestion by L&G that a requirement to have adequate checking procedures in place falls within the monitoring rule 7.2.1 and was not therefore part of 7.1.2. We do not consider that the existence of this independent monitoring obligation precludes aspects of monitoring from falling within 7.1.2(1).

41. The issue is whether we consider that FSA has proved on balance that L&G has not established procedures with a view to ensuring that there is compliance at all times with the Rules and Principles. FSA accepts that reliance on General Principle 2 is a fallback provision which does not add to its case.

42. **The Components of the Procedures Case**

These are:-

(a) The PFR Form

(b) Guidance about the PFR Form

(c) Use of Sample Wording to complete PFR Form

(d) Risk Warnings

(e) KFDs

(f) Training and Supervision

(g) PFR Checking Unit

43. **The PFR Form**

The purpose of the PFR, according to FSA, was to assist the adviser to collect all the information that L&G regarded as necessary to assess the suitability for the customer of a particular product; and to provide a full and complete record of the adviser's discussions with the customer. L&G see the PFR as a record of the customer's personal circumstances and the recommendations made so that it also served the regulatory purpose of a "*reason why*" letter ("RWL") and was sent to the customer. The PFR itself states that it asked questions to "*help our representative to really understand you and give you the most appropriate advice for your aims and means*". Apart from the fact that the PFR could not be a "*full and complete record*" of what might be lengthy discussions between the customer and the adviser, there is no great difference between the parties over the function of the PFR. It is clearly a very important document - see, for example, Section 1 of the December 1996 Guide to which we refer below.

44. During the Relevant Period, different versions were used, and for some periods more than one version was in regular use. The forms relevant to this case were:
Version 1 used between December 1996 and October 1997.
Version 2 used between November 1997 and April 1999.
Version 3 used between April 1999 and July 2000.
Version 4 (a combined Mortgage Questionnaire and PFR form) was used between January 1998 and April 1998 exclusively for mortgage repayment or mortgage protection advice.

45. In addition, between July 1997 and July 2000 a separate Mortgage Questionnaire was available for use where mortgage advice was given.

46. Versions 1 to 4 of the PFR dealt separately with mortgage advice, attitude to risk and advice on financial services products to repay the mortgage.

47. **Mortgage advice** The information relating to a customer's existing mortgage arrangements, details of their new mortgage or requirements and the reason for recommending an interest-only or repayment mortgage were recorded in Section 11 of the form (Version 1, 2 and 3) or Sections 1, 2 and 7 of the form (Version 4). We shall refer to all as "Section 11". In each case the PFR included the statement "*We have discussed the advantages and disadvantages of interest only and repayment mortgages*" and contained a space for the adviser to record whether an

interest-only or repayment mortgage had been recommended and the reason for that recommendation. In the PFR Sales and Completion guide L&G gave the adviser various examples of sample wording for inclusion in this space.

Section 11 and the two stage process was introduced after a PIA Supervision visit and a Report in November 1995. L&G say this change was broadly approved by PIA and the changes to the PFR specifically so.

48. **Attitude to risk.** The customer's attitude to risk in relation to mortgages and loans (Version 1) and mortgage repayment plans (Versions 2, 3 and 4) was addressed in a different section of the form, Section 16 (Versions 1, 2 and 3) or section 6 (Version 4). (We shall refer to all as "Section 16"). L&G say that Section 16 dealt with investment not capital shortfall risk and would only be considered if and when the customer had decided to take an interest-only mortgage.

49. In each case, the customer's attitude to risk was indicated by the ticking of one of three boxes, namely: low, medium or high risk. The definitions given in the PFR for the 3 categories were as follows:

Level of risk

Low means that you are not prepared to take risks with your investment.

Med means that you are prepared to take some risk in the hope of a better return on your investment in the future.

High means that you are prepared to take a higher risk in the hope of a highest possible return on your investment.

50. While the format changed with versions of the PFR the boxes would be surrounded by wording such as "*Please indicate your risk attitude in respect of each need area reviewed*" with boxes for different categories such as "*mortgages and loans*".

51. **Recommendations** were summarised in section 20 of the form (Version 1), section 23 of the form (Versions 2 and 3) or section 14 of the form (Version 4). We shall refer to all as "Section 20". In the case of Versions 1 to 3 this should have included investment advice with recommendations as to mortgage repayment vehicles. Version 4 was concerned only with mortgage repayment and protection products. There was space for the adviser to set out reasons for the recommendations.

52. The form was required to be signed by the customer in each case and included a declaration that the customer had received the KFD for each of the products applied for and that the adviser had gone through and explained that document.

PFR - Discussion

53. The difference between the parties concerns the content of the form and the procedures for completing it. FSA says that these made no proper provision for making or recording an assessment of the customer's attitude to the risk that the FMP would not at maturity pay off the mortgage, a serious failing given that the PFR was used as the RWL. As to the content of the form attention focused on Section 16 and to some extent Section 11.

54. **Section 11** FSA claims, on the basis of the view of their expert Mr Standish, that Section 11 should have required specific recording of the reasons why the customer had accepted the mortgage recommendation. This is not a claim that FSA made in its pleadings. L&G point out that Section 11 was introduced following a requirement made by PIA in a Supervision report in November 1995 and was discussed with and in substance approved by FSA in January 1996 by Mr Brener, Mr Hawtin and Mr Williams of PIA. A "*disadvantage*" (and therefore a risk which the adviser has to explain) of an interest-only mortgage is the risk of the endowment policy not paying off the mortgage at the end of the term. L&G claim that as a result of the first stage having been carried out and Section 11 properly completed the capital shortfall risk would have come to the customer's attention. There is no written evidence that this happened. It is a point in the form where specific information about the customer's attitude to risk is not required and one is left to take it on trust that the discussion between the adviser and the customer took the course necessary for an appropriate recommendation and an informed choice of repayment route. The sample wording (see 91 et seq below) does not indicate the disadvantage of an interest-only mortgage or provide reassurance that the customer has made an informed choice.

55. **Section 16** L&G contend that Section 16 concerns investment risk in the conventional sense of there being risk of loss to the capital invested (less fees and charges). They point out that the Section covers a range of investment products. It is clear from the Completion Guide that L&G saw it that way. They rely on the expert evidence of Mr Jenkins "*The risk is totally clear that the box... is referring to... the investment risk... and not to any other aspect of the risk in relation to the endowment mortgage package overall which was quite clear to me was being covered in a different section on the PFR.*" We do not doubt that it was "*totally clear*" to Mr Jenkins and how L&G intended it. We think it unlikely that most customers would read it in that way. None of us did. L&G chose to use the PFR also as the RWL letter. It would be the permanent record both for the customer and the company of how the transaction came about and in the form it took would suggest to a customer that he or she had taken a step suitable for someone not prepared to take risks in paying off his mortgage.

56. FSA relied upon Mr Standish. Mr Peter Standish is a chartered accountant and was a partner in Ernst & Young and its predecessor firms from 1972 to 2003. He specialised throughout his career in insurance and related financial services and was de facto chief executive officer of a life assurance company with a sales force

of some 1400. He clearly has very extensive knowledge of the insurance and related financial services industries as they have developed throughout his career. He expressed views about the customer's attitude to risk, the use of sample wording, the operation of the PFR checking procedure and the fact, as he saw it, that external reviews and their recommendations were not implemented in a timely manner. Mr Standish adopted the criticisms made of L&G's procedure as set out in the Statement of Case. There was evidence from Mr Standish about alternative ways of grading the risk. He considered that there could have been five investment risk boxes and at least some provision for an investment risk attitude of, for example, "*risk averse*", which would have required an adviser to recommend a repayment mortgage. As we see it the problem lies not only with the numbers of levels of grading of risk or their definition but the lack of clarity on the form. There was considerable potential for the customer to believe that the risk referred to on the PFR was the capital shortfall risk.

57. L&G say that in practice customers would not have been confused by this as they would already have been advised of the disadvantages of an interest-only mortgage at the Section 11 stage. Furthermore, customers would not read Section 16 in isolation. A customer who read Section 16 would almost inevitably have read the KFD and the personal illustration either when handed to him at the meeting or later with the cancellation letter. We consider this point, which applies equally to other aspects of the Procedures case, at 58 below. Further, Section 16 would be filled in by the well trained adviser after an overall picture had been built up carefully as described to us in evidence by Mr Howard Cooke and Mr Philip Cook of L&G. But the PFR would not have been completed without active co-operation from the customer. It is addressed to the customer and gives the appearance of being completed by him (see Attachment III). Two boxes (referring to "*You*" and "*Your partner*") in the "*level of risk*" part of Section 16 refer to "*mortgages and loans*" (1996 & 1997 PFRs) and to "*mortgage repayment plans*" (after early 1998). This, together with the definition of low risk as "*not prepared to take risks with your investment*" would, in our judgment, probably give the non-expert reader a misleading impression. L&G say that no customers have given credible evidence of having been misled by Section 16. We would not expect there to be such direct evidence after this time. We suspect that a number of customers would have made a different decision if taken properly to a box which permitted choice of a risk level which guaranteed repayment of their mortgage. Evidence from L&G that sophisticated individuals like Mr Jenkins would see no contradiction between the risk definition and the recommended product, even if correct, takes the matter no further. The careful views of experienced professionals formed after reading all the surrounding materials not available to a customer seem to us to be beside the point.

58. Although L&G emphasise that the process has two stages, the view of both sides (e.g. Mrs Miller and Mr Folger) was that they cannot be taken in isolation but must be viewed as a whole. Indeed L&G maintain that if, in the course of the second stage, the repayment vehicle initially chosen by the customer begins to seem unsuitable, it will be necessary to go back to the first stage and reconsider this. We

think it illogical for there to be two stages at all. The ordinary customer in these cases is making a choice between a repayment mortgage on one set of terms and an endowment mortgage on another set of terms. Common sense and the law come together (see per Jonathan Parker J in *Martin v Britannia Life Ltd* [2000] Lloyd's Rep BN 412 at 426, para 5.2.5) "*... any advice as to the merits of purchasing or surrendering an "investment" is designed to be based on as full an examination of the client's personal circumstances as the client is prepared to allow. For example, in advising as to the merits of taking out a mortgage-related policy such as the Homeplan Plus Policy it would in my judgment be (at best) wholly unrealistic, and (at worst) positively misleading, to leave out of account the merits or otherwise of entering into the underlying mortgage transaction which the policy is designed to support.*" L&G's argument that capital shortfall risk was out of the way before Section 16 was reached does not convince us. The customer reading the PFR either during the transaction or subsequently would reasonably assume that he or she was in the lowest risk category. The inconsistency in recommending a with-profits policy, in the context of a mortgage as opposed to a savings plan, to a "low risk" customer was denied by Mrs Miller but accepted by, for example, Mr Cooke. It was also accepted in the L&G Compliance News Bulletin of July 1999.
"*The PFR defined 'Low Risk' as "means that you are not prepared to take risks with your investment". The with-profit endowment, whilst not necessarily unsuitable for a low risk investor, does contain an element of risk in that repayment of the mortgage is not guaranteed. Therefore the risk attitude and the recommended product are contradictory*." (We add that this is particularly the case where the purpose of the endowment is not general savings but paying off a mortgage.) Mrs Miller was not correct to suggest that this was L&G simply passing on views of FSA which were not L&G's. By issuing this document L&G adopted the policy as their own.

59. If the box at Section 16 (or perhaps even a box at Section 11) had contained a "risk averse" category for those who required certainty that a specific capital sum would be achieved in a set period, FMPs would have been recommended only to those who ticked a higher risk category. It would also have provided a cross check for the accuracy of the answer to Section 11. The peril of a risk averse customer being recommended an FMP when he or she did not properly appreciate the capital shortfall risk would have diminished.

Guidance about the PFR Form

60. During the Relevant Period, L&G provided its advisers with written guidance on the completion of PFR forms. FSA criticises this guidance but L&G say that it and in particular its classification of risk was in accordance with proper professional and market practice. The adviser was required to complete the PFR in accordance with the requirements set out in this guidance. This comprised, in particular:

- Prior to June 1998: "*A Guide to Financial Reviews*" dated December 1996 ("*the December 1996 Guide*");

- From June 1998 onwards: "*Personal Financial Review Completion Manual*" dated June 1998 ("*the June 1998 Guide*") also amended in April and October 1999.

61. The introductions to the Guides stated that an L&G adviser must, amongst other things:

    - Know the full personal circumstances of the client, including what investments, pension provision and insurances are already held.
    - Establish and prioritise the client's needs.
    - Recommend only products entirely suitable to satisfy those needs.
    - Ensure that the balance between security and risk of the investment contract offered is suitable for the client's personal circumstances and investment attitude.

62. Mortgages and Loans were dealt with in section 14 of the December 1996 Guide. It set out the two-stage process, i.e. the giving, first, of advice on the type of mortgage (in itself unregulated) and secondly on the financial services products related to that mortgage. Sections 14.3-14.4 of the December 1996 Guide stated:

"*14.3 If the new mortgage has already been arranged, it is important to record who made the arrangements and who advised the clients, whether advice was given by you, by a third party or the clients made the arrangements without advice.*

14.4 If you are making the mortgage recommendation, delete the type of mortgage which does not apply in the relevant box at the top of page 9 and give the reason for your recommendation in the space below. Your reason must be appropriate to the circumstances of the clients.

With a repayment mortgage, the client accepts the cost as being the rate of interest charged by the lender on the reducing outstanding balance. With an interest-only mortgage, the cost is the rate of interest on a fixed outstanding balance and the client's hope is that the rate of interest earned on the repayment vehicle will exceed that charged on the mortgage. The risk to the client is that the rate of interest earned on the repayment vehicle will be less than that charged on the mortgage.

Other factors to take into account when giving advice on which type of mortgage is suitable for a particular client are listed below.

Type of mortgage	For	Against
Repayment	Guarantee of repayment if instalments maintained.	No possibility of extra cash sum, nor of early redemption.

	Reducing outstanding balance.	Separate life cover needed.
Interest-only (subject to appropriate funding vehicle)	Possible cash sum or early repayment.	Need to keep under review to ensure repayment."

63. Section 19 of the December 1996 Guide dealt with the section of the PFR form concerning attitude to risk. It stated that the level of risk answers gave an important guide to the type of investment fund it was appropriate to recommend for the client and then referred L&G advisers to the section of the Guide relating to investments, section 29. In that section, guidance was given as to different categories of 'investment attitude' and as to suitable funds for each category. In particular, the lowest risk category was dealt with as follows:

> "*A cautious client (low risk) is one who is averse to taking a capital loss, even if that means accepting a low level of income, growth or both on an investment.*
>
> *Suitable funds are Building Society Linked, Guaranteed Equity Fund, Cash Fund, Unitised With-Profits or Unit Trust equivalents.*"

64. Section 29.9 of the December 1996 version contained a 'Quick Guide' in table form relating different products to risk rating. This too indicated that a Unitised With-Profits fund was suitable for a 'low risk' rated customer.

65. Mortgages and Loans were dealt with in section K of the June 1998 Guide in substantially the same terms. This guidance was unchanged in the April 1999 and October 1999 updates of the June 1998 Guide.

66. The June 1998 Guide also contained a section dealing with investment. This did not contain any definitions of levels of attitude to risk. It did contain a 'Quick Guide' in table form, similar to the previous Guide.

67. **Compliance News Bulletins**

L&G also gave guidance to its advisers through Compliance News Bulletins ("CNBs"). A CNB in November 1995 required mortgage advice to be separated from financial services advice. In February 1996 a CNB introduced the new PFR. New completion Guides were brought in by a CNB on 6th March 1996. There was more guidance in a CNB on 24th April 1996. There were fresh CNBs dealing with changes to the PFR and guidance in November 1996 and September and November 1997 and in March, April, June and August 1998. There were relevant CNBs in March 1999, and in May 1999 a CNB gave effect to changes in the recommended growth rate to be used for illustrations.

FSA contrasts the earlier Guidance with a CNB dated 21st July 1999 issued as a result of a PIA supervision visit. This gave advice about with-profits endowment policies and low risk investors. It stated, in addition to the passage quoted at 58 above:

> "*If this situation arises the representative should be making the low-risk client aware that there are some risks involved with a with-profit endowment. It should be documented on the PFR that these risks have been discussed with the client and pointed out that they are detailed in the Key Features Document which is given to the client.*
>
> *It is very important that representatives are aware of the definitions of the risk categories so the appropriate products can be recommended and any associated risks documented.*"

68. After the Relevant Period, guidance was given in a CNB dated 14th February 2000, which stated, so far as material (original emphasis):

> "*The FSA were additionally concerned that the features of a mortgage-related endowment were not being adequately* <u>*explained*</u> *to a customer when the product was being recommended.*
>
> *All advisers are therefore being reminded that a key features document must be explained to a customer when it is handed over. In particular the following features of an interest-only mortgage must be* <u>*explicitly explained*</u> *to the customer.*

- o *The projection used to illustrate the capital sum payable on maturity is no more than a projection designed to illustrate the return a customer may receive based on given market assumptions; there is no guarantee that the capital sum illustrated will be achieved;*
- o *The actual sum payable on maturity will always be dependent upon future market performance;*
- o *The associated costs and charges and how they are structured;*
- o *It may be necessary for the customer to increase the premium payable to achieve the required capital sum on maturity;*
- o *If the customer fails to maintain premium payments at the necessary level then they are responsible for ensuring that an alternative means of repaying the mortgage is in place;*
- o *The consequences of surrendering the policy prior to maturity.*"

69. The CNB also stated on the third page that:

> *"In order to demonstrate that customers continue to be given advice that is suitable and affordable, PFRs that recommend an endowment product must document, in the recommendation section, the following:*
>
> - *That it has been explained to a customer that provided all payments are made in full, a repayment mortgage guarantees to repay a mortgage at the end of the term and that this is not the case with an interest only mortgage;*
> - *That with an interest only mortgage the customer is exposed to fluctuations in the stock market;*
> - *Why the customer's particular circumstances and attitude to risk make an interest only mortgage the best option. The ABI has stated that for an interest only mortgage to be recommended, it must be demonstrably better than a repayment mortgage…"*

70. At Appendix A was an example of the sort of explanation which ought to be provided in the PFR itself.

> *"I have explained that the illustration/quotation provided is merely a projection and that the performance of this plan is not guaranteed. In the event of the plan performing better than projected there is a prospect of either being able to repay your loan early thus saving in interest or a surplus capital sum at the redemption date of the loan. In the event of the plan not performing as well as projected then there may be insufficient funds to repay your loan at the redemption date. In such circumstances any shortfall would have to be met by you from other sources."*

Written Guidance – Discussion

71. FSA says that the information about capital shortfall risk in the completion guides was inadequate. The 1996 and 1998 guides contain no specific reference to the capital shortfall risk or any other name for it. Mrs Miller identified the following sentence in Section 14.4 as being such a reference: "*The risk to the client is that the rate of interest earned on the repayment vehicle will be less than that charged on the mortgage.*" The two experts Mr Grenville-Jones and Mr Jenkins suggested instead that this sentence referred to a 'value for money' comparison between interest-only and repayment mortgages. It is not clear to us that either view is wholly correct. FSA also criticises tables in the guides for making no reference to the issue as a disadvantage except obliquely in the words "*need to review to ensure eventual mortgage repayment*". FSA contrasts the table with others. In a note dated 6th May 1999 produced for the L&G Endowment Working Party by Mr David Clarke, an L&G actuary, the risk was put as "*potential for shortfall at maturity if investment experience worse than expected or if the market falls close to maturity date*". Mr Clarke's note also states (original emphasis) "*An investment*

repayment route is the riskier alternative to a straight capital and interest repayment route. ***The interest-only route is therefore not the low risk option.*** *Firstly, for an interest only vehicle, there is a very real risk of shortfall at maturity. This is not the case for a repayment mortgage provided that payments are maintained*". FSA also points to L&G's expert Mr Jenkins's suggested table wording "*potential for shortfall at the end of the term, but a number of mitigating product features would normally apply*".

72. FSA also invites us to compare information given to customers about the risk with the contents of Mr Clarke's note. In similar vein there is an e-mail exchange involving Mr Bolton, L&G's then appointed Actuary. L&G say both these need to be seen in their particular context. The e-mail emphasises the pains L&G take to say that an endowment mortgage is not guaranteed to repay the loan and L&G stress that Mr Clarke's memorandum is from a junior product Actuary. We recognise this but, at least by 1999, parts of L&G's product policy areas were expressing the capital shortfall risk more pessimistically than their sales colleagues were to the customers.

73. There was dispute between the parties about whether the completion guides were simply used to help fill out the form or were more significant being the only documentary advice available and readily accessible to advisers out on the road. We see the guidance as being mainly the former. We think, having heard evidence from advisers, that the degree of product knowledge assumed by trained advisers spending much of their working time on FMP products would rarely cause them to consult the guides for advice about the capital shortfall risk as such.

74. L&G say that the general criticisms of the guidance are misplaced. It would be referred to by trained advisers who would not have been misled by a table into believing that there was no shortfall risk. They say that the table is accurate and was only mildly criticised by Mr Standish. They say that no other aspect of the completion guide was criticised by expert witnesses and that these documents emphasised the importance of KFDs referring to them as "*critical*", stressing the need to ensure that the risk warnings have been carefully gone through with the customer and that the customer understood them. We address the KFDs at 79 et seq below. The Written Guidance perpetuates the problems we have identified with the PFR. Selective citation from the Guides which are forty or fifty pages long does not give a fair picture of what these documents contain. We form a view by considering them as a whole. By 1998 we would have expected Guidance to refer more explicitly to the fact that repayment was not guaranteed, as L&G did in other contexts (such as their KFD). Bearing in mind that the Guides would not have been constantly thumbed by advisers they probably made things no worse but they certainly made things no better.

75. **Mortgage Guides and Other Written Guidance**

We referred at 35 above to guidance about mortgages to be given to customers by advisers when related investment advice was also provided. This took the form of

two documents entitled respectively "*Mortgage Maze*" and "*Mortgage Guide*." Those documents included certain risk warnings, for example:

"*Payouts depend upon investment returns over the life of the policy and it's impossible to predict what they will be*" **Mortgage Maze**, Page 19, May 1996, April 1997 and February 1998.

"*Investors should remember that past performance is not necessarily a guide to future performance. For unit-linked investments the price of units can go down as well as up and for with-profits investments the final value cannot be guaranteed.*" This document also indicated, inappropriately unless qualified by a statement that past performance is not necessarily a guide to future performance, in at least one version "*Endowment mortgages have been around for a long time now, and have proved to be very successful for people whose policies have matured*" **Mortgage Guide**, Page 16, July 1997 and April 1999.

76. The "*Mortgage Maze*" and "*Your Mortgage Guide*" which replaced it in May 1998 (see 35 above) were at times given by advisers to customers and were worded in a way which would be likely to downplay the risk. The April 1997 "*Mortgage Maze*" included:-

"*With an interest only mortgage, you just pay interest to your lender and make a separate payment into some sort of savings plan. This builds up a lump sum which eventually leads to pay off the mortgage*".

It also stated:-

"*Some people are concerned that the payout from a low cost endowment may not be enough to pay off the mortgage. Payouts depend upon investment returns over the life of the policy and it is impossible to predict what those will be. The insurance companies generally reduce the risk of this by building safety margins into their policies, basing their premium calculations on conservative estimates of future growth rates and assessing the policy at regular intervals to make sure it is on target to pay the loan. Endowment mortgages have been around for a long time now and have proved to be very successful for people whose policies have matured.*" It was common ground that the last sentence was unacceptable as it referred to past performance in such a way as to suggest to a customer that there was no risk of shortfall in the future.

The CNB of 17th March 1999 required that from 30th April 1999 "*it will be mandatory to issue the 'You & Your Mortgage' leaflet to all mortgage customers at the first point of contact*". The leaflet was a Council of Mortgage Lenders' publication.

It is unclear what proportion of customers were in practice given copies of either of the two L&G documents or how far their contents were read or relied upon. Few of the 13 were aware of them and we have no evidence of what happened following the March 1999 CNB.

77. FSA criticises a note issued in August 1995 "*Mortgage Advice*" intended to help advisers assist clients on mortgages and repayment as it makes no reference to capital shortfall risk beyond "*the current attitude to risk is relevant to the type of mortgage repayment vehicle as well as to any investment fund recommended*". FSA also criticises the CNBs. It was apparently not until the CNB issued in July 1999 that express reference was made to the need to discuss specifically with a customer the fact that an FMP is not guaranteed to provide funds to repay the mortgage.

Mortgage Guides and Other Written Guidance – Discussion

78. FSA submits that these publications downplayed the risk. L&G, through Mrs Miller, rejected this criticism on the basis that these were general documents giving advice in broad terms and customers wishing to purchase an FMP would read either publication only in the context of other sales literature (such as the KFD with its explicit risk warnings) to which their attention and concentration would be more closely addressed.

These publications were unsatisfactory and, if read and absorbed, would have been falsely reassuring. We doubt however that in practice they made much, if any, difference given the timing and limited nature of their distribution and the other materials customers would have received later in the decision process.

Key Features Documents

79. In addition, KFDs were produced for FMPs. As already noted, in Versions 1-4 of the PFR documentation the customer was required to sign a declaration that the KFD had been given and explained to him. The KFD was required to include a personalised illustration for the recommended mortgage repayment product.

80. The KFD for FMPs included a section headed "*Risk factors*". During the Relevant Period, risk warnings contained in that section included the following:

> "*There is no guarantee that the money invested in the plan will be enough to cover your chosen mortgage amount at the end of the mortgage term.*"
>
> "*You may need to increase your payments in order to ensure that the Plan builds up enough money to repay your chosen mortgage amount.*"

81. We do not set out the other contents of this document because FSA accepts that at all times it fully met all regulatory requirements. FSA also accepts that L&G procedures required it to be explained and handed over to the customer. We do bear the importance of these KFDs in mind throughout as they are central to L&G's case.

82. As we have explained, a Reason Why Letter ("RWL") was required to be sent to the customer. During the Relevant Period, L&G's RWL consisted of a standard-form covering letter and a copy of the completed hand-written PFR form. The

covering letter did not repeat the reasons for the recommendations made by the adviser, as these were within the PFR itself.

83. L&G place weight throughout their case on the fact that their written guidance to advisers required them to provide and explain to the customer the KFD and personal illustration. FSA contends that it is not enough simply to hand over the material or to get the declaration on the PFR signed. The process must involve proper explanation from advisers. FSA says that in addition to providing the document the adviser must first bring home that there is a capital shortfall risk and secondly "*make clear that it is a real and significant risk*" (a requirement that appears to have emerged in the course of the hearing and is not pleaded). FSA says that the adviser must also ensure that the customer has understood the nature of the risk, obtain the customer's attitude to it, and then consider this information in the light of the customer's needs before formulating an appropriate recommendation.

84. FSA does not accept that the KFD documents were always provided. As the evidence about this is limited we will assume that the KFDs were generally provided.

85. FSA says that even if it is assumed that the KFD had been provided and explained this is not enough because:-

    (a) less sophisticated customers place more reliance on what they are told by advisers than what they peruse in the documents; (this does not seem a strong point given FSA's concession that L&G's procedures did require the risk to be explained as part of providing the KFD)

    (b) the core document, the PFR, makes no reference to capital shortfall risk;

    (c) other literature gives the impression that the customer can be confident that the mortgage will be paid off at maturity and does not bring home the capital shortfall risk as a real and significant issue.

86. FSA says not only that there should have been risk warnings but also these should have alerted the customer to a "*real and significant risk*" or to a "*50% likelihood of shortfall*". No-one seems to have suggested that a "*50% likelihood of shortfall*" is something which should have been pointed out until Mr Grenville-Jones introduced the concept in his expert report.

87. L&G rightly say that this concept is inconsistent with the rules for producing illustrations and is not reflected in perceptions of the risk at the time, notably:-

    (a) the Rules and Guidance on the KFD and personal illustration;

    (b) the description of the risk in terms of "*absolutely sure*" referred to in FSA's Chronology of Standards as being the criterion applied by the PIA Ombudsman;

(c) FSA's expression of the attitude to risk in June 1999 "*does the client want to be absolutely sure of paying off the mortgage at the end of the term?*";

(d) RU 72 issued as late as December 1999 which puts the risk in terms of "*no guarantee*" (as, frequently, did the advisers when giving evidence); and

(e) an FSA Fact Sheet in December 1999 of which puts the risk in terms of "*generally not guaranteed*".

88. We accept that the deficiencies in the PFR, and the other factors relied upon by FSA taken together resulted in a real possibility that the customer would not understand and appreciate the capital shortfall risk. We do not consider, however, that the nature and extent of the risk to which the customer should have been alerted was as contended by FSA. Expressions Like "*Not Sure*" and "*Not Guaranteed*" seem to us more representative of how the risk was seen and should have been explained. It seems unreasonable to expect L&G to put the level of risk higher than FSA did at the time. Of course "*not guaranteed*" can, depending on emphasis, cover a wide range of meaning. In this context we take it to mean a risk to be considered, not the outside possibility described by some witnesses.

89. The KFD contained the regulatory risk warnings and specific attention is drawn to it in the PFR itself. But it forms part of a package of customer protection. Completion of the PFR involved active dialogue between customer and adviser. If that document had contained entries requiring the customer's attitude to capital shortfall risk to be ascertained, if these had contained no misleading references to risk, and (perhaps or) if recommendations had been balanced and tailored to the personal and financial circumstances of the customer, then it would have been clear that the risk message had been transmitted and received and, through the interview process, so far as was practicable, properly understood. The KFD provided, to a degree, evidence of transmission to, and of reception by, the customer of the existence of the capital shortfall risk. But it did nothing to ensure or demonstrate their understanding of that risk. The fact that the KFD component of the package was itself properly prepared and supplied does not in our view cure the defects in the other components.

Personal Illustrations - Discussion

90. In evidence it emerged that during the Relevant Period the possibility of a cash surplus at the end of the mortgage term was emphasised by the 10% illustration being printed in bold type and the other lower percentage rates having less prominence. This had not been the case when illustrations had been examined by PIA at the time of the 1995 supervision visit. Indeed 50 of the 60 cases which we are asked to examine for ourselves have illustrations with the inappropriate bold type. It is unclear how this error arose. We do not see the error as decisive of anything but it cannot have helped customers to appreciate the capital shortfall risk. L&G maintain that this was not in contravention of PIA rules at the time, but

it acted to emphasise the upside at the expense of the downside. Indeed, this emphasis would seem to have no purpose except to influence customers.

Sample Wording

91. The Guides contained sample wording for reasons recommending a product to a customer, for use by L&G advisers in completing the PFR form. The Sales Guide section of the December 1996 Guide gave the following advice about the use of sample wordings, in section 12:

> "*Remember that this is the section in which it must be clear what advice you have given, and why. You should record the reasons for your advice, the nature of the advice itself and the finally recommended course of action. ...*
>
> *The contracts you recommend should always be affordable, now and in the future, by the client and must be totally suitable to satisfy the client's specific needs at the right time. The investment fund recommended must be consistent with the client's investment attitude as indicated earlier.*
>
> *You should refer to and follow the sample wordings set out in the completion guide as far as possible….*"

92. The Completion Guide section of the December 1996 Guide contained the following guidance about the use of sample wordings, in section 24:

> "*24.1 After assessing the main areas of client needs and priorities, it is essential to show:*
>
> *(a) What you have recommended*
>
> *(b) Why you have recommended it*
>
> *(c) What the benefits are to the client*
>
> *(d) What action has been taken (including, if the action is different from the recommendation, the reason why it differs)*
>
> *(e) Details of any policies sold*
>
> *(f) Examples of suitable wordings are given in an additional section (32) at the end of this Guide. You should note that these are only examples and may need to be adapted to fit clients particular circumstances.*
>
> *24.2 Q: Is it acceptable to give a client a prepared list of caveats/health warnings with the relevant ones ticked in*

order to cut down on the amount which needs to be written on a PFR?

A: *The short answer is "no". However, because it is necessary to go through the Key Features document with the client, it is not necessary to repeat on the PFR those risk warnings which are covered in that document. The function of the PFR, apart from recording information about the client, is to give a satisfactory explanation of the sale, rather than a list of "health warnings."*

93. The sample wording suggested for use in connection with with-profits FMPs was:

"*32.6 Interest Only Mortgage*

(a) Flexible Mortgage Plan

To pay off your mortgage at the end of the mortgage term or if you die before then. The flexible mortgage plan is most suitable for you because it does not detract from pension provision and

(i) you are concerned that PEPs may not always be available

(ii) you do not wish to invest directly into equity based assets

(iii) you wish to use your eligibility for PEPs for other purposes."

94. The June 1998 Guide also contained guidance on the use of sample wordings. At Section W, paragraph 2(a), it stated:

"*The suggested sample wordings are for your guidance. However, they are merely suggestions and must be used with discretion. Each recommendation must cover, in combination with* "*Your Commitment*" *and the Key Features, what has been sold, what alternatives, if any, have been considered and why the recommendation is* "*best advice*" *given the customer's circumstances.*"

95. Similarly, the June 1998 Guide provided at paragraph 1 of section X:

"***Reasons For Recommendation***

The approach to giving reasons for our recommendations is first to describe the financial need(s) identified as of sufficient priority to be met immediately and then to rely to a large extent on the Key Features, personal illustration(s) and/or product literature provided to the client to describe the plans outlined in Section 20 of the PFR.

In many cases, because the plan sold self-evidently meets the identified need and no other would do so, further explanation is unnecessary. However, if the benefit provided by the plan recommended goes beyond the identified need or if there are alternative plans which could meet the identified need, further explanation will be necessary. The further explanation must include details of any alternative investments which have been discussed and why, if it is the case, they have been rejected by you or the customer.

Samples of some of what may be required are given below but you may have to add further explanation in your own words."

The sample wording suggested in the case of with-profits FMPs was:

"*8.2 Flexible Mortgage Plan (With profits)*

To pay off your mortgage at the end of the mortgage term or if you die before then. The Flexible Mortgage Plan is suitable for you because it does not detract from pension provision. The Unitised With Profit investment option is recommended because

(i) you do not wish to invest directly into equity based assets.

(ii) you wish to use (are using) your eligibility for PEPs for other purposes.

(iii) you are not eligible for a general PEP."

Sample wording was also provided for use with Section 11 of the form to explain the choice of interest-only rather than repayment mortgage. The sample wording for an interest-only mortgage was:

"a) The client believes that the return on a suitable repayment vehicle will be more than the mortgage interest.

b) There is a possibility of a spare cash sum at the end of the mortgage term.

c) There is the possibility of early repayment of the mortgage.

d) A suitable repayment vehicle may be used for a future mortgage.

e) A suitable repayment vehicle provides flexibility for the future."

96. PIA Regulatory Update 43 ("RU 43") issued in December 1997, whilst permitting the use of standard paragraphs, stated:

"*The quality control benefits of a standardised approach need to be carefully balanced with the need to provide the customer with as personalised an explanation as possible.*

Standard paragraphs are best limited to descriptions of the most common needs and the products which will satisfy those needs; where they are used to outline advice, care should be taken to ensure that they do link a need to a product and provide an explanation to the individual customer rather than just set out stock motives."

97. On 2nd April 1998 Coopers and Lybrand ("Coopers") produced a report issued as a result of a compliance health check commissioned by L&G and carried out in January 1998. This report stated on page 14:

    "*We recommend that the current use of standard wordings alone as justification for sales should be reviewed and guidance issued to those completing and checking of (sic) PFRs. We would expect the adviser to tailor the reasons why the advice was given to include an explanation of why the product sold was considered appropriate for each particular client's specific needs.*"

    After a presentation to L&G's Group Board, L&G issued guidance in a CNB of 8th April. This indicated that sample wording would not always be sufficient to justify a sale and might need to be supplemented with the customer's specific details. As we have pointed out the 1996 Completion Guide, which was rewritten and reissued as the PFR Completion Manual in June 1998, mentioned the need for advisers to make appropriate use of sample wording. A further CNB was issued on 10th June 1998, making advisers aware of the new Completion Manual and setting out the training arrangements. Supervisors were trained in June 1998 and advisers were trained in July. The new Completion Guide and sample wording guidance were to be implemented by 30th September 1998.

98. PIA Supervision visited L&G in January and February 1999, 3 months after implementation of the new Completion Guide. PIA found that excessive use of sample wording was taking place based on a review of files (although around two-thirds of the PFRs reviewed were dated prior to 30th September 1998 when the new Completion Manual had been implemented). PIA noted the use of standard paragraphs which did not take into account the reasons for recommendations in individual and particular cases. The sample paragraphs had been used regardless of the customer's situation and, in many instances, they were not relevant. The CNB issued in July 1999 required that when a "*low risk*" customer was recommended a with-profits FMP the PFR should show that "*these risks have been discussed with the client and pointed out that they are detailed in the Key Features document which is given to the client and...from 1 October 1999 any sale where a low risk client has been sold an endowment type policy to cover an interest only mortgage will be rejected if an explanation is not included on the PFR.*"

    L&G emphasised that the potential rule breach identified by PIA Supervision was of Rule L3. The section of the report was not printed in bold, nor was there any suggestion that unsuitable sales were resulting. The corrective action required was to "*issue guidance to staff on the use of standard paragraphs taking into*

consideration the points noted opposite". In September 1999 PIA advised L&G that it was satisfied with the timetable for implementation of this new process (by the third quarter of 2000).

99. In February 1999, Deloitte produced a draft report as a result of a review of L&G's PFR Checking Unit. We refer to the Unit at 117 et seq below. This report identified a number of urgent problems and suggested solutions, including:

> *"17. It is not clear that the current interpretation of the completion guidance is consistent with PIA Guidance Note 43, for example in the use of sample wording.*
>
> *The excessive use of sample wording is contrary to the instructions in the Introduction to the Completion Manual which states "it is more important to give a true description of your reason for any advice given to your client than to follow the sample wording" and "the sample wording will not cover all circumstances and may need to be expanded". A more rigorous approach needs to be taken in establishing where sample wording is and is not acceptable, consistent with the Completion Manual. The Completion Manual should be revised as necessary to ensure clarity in this area.*
>
> *18. Almost without exception the sample wording is used to evidence advice. Checkers notes often refer to sample wording being 'missing' and this is the reason for questioning the PFR. Sample wording used by rote should be avoided."*

100. We should point out that wording used in PFRs completed before 1 January 1997 that we saw specifically mentioned the capital shortfall risk. For example, in early cases a typical Recommendation would include explicit reference to the risks inherent in the FMP as follows: "*The Flexible Mortgage Plan recommended is designed to pay off the mortgage at the end of the mortgage term. Depending on what investment returns are the sum available may be more or less than the mortgage amount. However, the plan will be kept under review and we will advise you if you need to increase your premium*". By contrast, later wording is much briefer and less balanced: "*To pay off your mortgage at the end of the mortgage or if you die before then*", although the pre-printed wording at the start of the Recommendations section does state that the plan is described in more detail in the KFD and the personal illustration. It is only in the KFD where the risks are explicitly stated.

Sample Wording - Discussion

101. There are good reasons for using sample wording which can assist the adviser to express a recommendation accurately and promote consistency of approach. But if stock wording is used without being tailored to the particular facts of the customer or bears no relation to the customer's particular circumstances then a recommendation will be of little use either as a record of the transaction, as a reason why letter or as evidence that the customer has understood the risk he or she

is taking on. This should be self-evident. The disadvantages of sample wording were well known to L&G at least by the time of RU43 in December 1997 and clearly drawn to their attention by Coopers a couple of months later.

102. None of the sample wording suggested by L&G for use with an FMP recommendation in the Relevant Period made reference to the capital shortfall risk although there is evidence that wording used in 1996 did refer to it and to the premium review process. Neither side seems to have noticed that until the end of 1996 L&G's wording took this form or to have considered the implications. FSA says that as a result of the use of sample wording the recommendation generally contained no risk warning and that this was particularly important given the nature of the RWL and the absence elsewhere in the document of any section to point out the risk. FSA seeks to rely, in our view unjustifiably, upon an earlier disciplinary matter with LAUTRO in 1994. FSA also relies on a PIA supervision visit in 1995. This showed that there had been a lack of documentary evidence, where FMPs had been sold, to demonstrate that all types of mortgage repayment options had been considered and that consequently the client had made an informed decision. At this point though there was no criticism of sample wording and the visit concentrated on other improvements.

103. L&G point out that FSA accepts that L&G had a better than average compliance record and reputation and say that the sample wordings were appropriate. L&G regularly commissioned external "*compliance health checks*" from outside advisers. When evaluating materials in these reviews relied on by FSA we bear in mind the nature of the exercise which serves little purpose if it does not identify faults and shortcomings. But the reports from Coopers in 1998 and Deloitte in 1999 both saw sample wording as a problem.

104. Prior to RU 43 in December 1997, the only Rule and guidance given to Members was the LAUTRO (Disclosure of Status) Rules 1992 New Rule 3.15 effective from 1st January 1995. This stated that a Member could determine the form of the written explanation of a recommendation to be given to a customer of a regular premium life policy and that:

> *"it may sometimes be sufficient to meet the requirement through the ticking of appropriate boxes on a standard form (supplemented as necessary, by any additional explanatory material which may be required) or through the use of standard paragraphs in a letter. In each particular case, it would be necessary to consider whether the standard material needs to be supplemented by any further material; or whether an alternative form of disclosing the reasons needs to be employed."*

105. RU 43 was issued by PIA in December 1997 "*in response to requests from PIA regulated firms for clarification of the requirements for reason why letters, particularly their format, style, length and context.*" There may have been uncertainty before December 1997, but RU 43 was clear and so was RU 47 in February 1998 which urged that "*reason why letters*" like the PFR "*must ensure*

that the content does not merely confirm what it is that is being recommended, but that the customer is given a proper explanation of why the particular recommendation was made in the light of his financial and other circumstances". Also, "*it is important and helpful both for the customer and the firm for the reason why letter to highlight the needs which have been established and to indicate why the product recommended is considered suitable to meet those needs*" and the "*RWL must relate any recommendation as to the choice of investment fund to the customer's needs and attitude to investment risk*".

106. Relevant sample wording suggested by RU 43 is instructive. This envisages that the RWL would refer implicitly to the capital shortfall risk, which of course the PFR (which formed part of the RWL) did not, relying instead on reference to the separate KFD. RU 43 suggests wording such as "*... recommended the endowment policy because it has the possibility of a surplus cash sum if it performs better than assumed. If it does worse...*". In relation to selection of a with-profits contract (like the FMP) the wording suggested is: "*We talked about other investment choices, such as a PEP, but you rejected these as being too risky, for a substantial commitment such as a mortgage. Instead, I recommended the with profits fund on the endowment policy as it offers a spread [sic] and steady if unspectacular growth with some guarantees……*"

107. L&G also point out that the PFR makes express reference to the KFD and to the personal illustration in the recommendations part of the form and the sample wordings have to be read with those documents. L&G say that it was entirely proper for sample wording not to make reference to the capital shortfall risk which was clearly prominently dealt with elsewhere. L&G submit that the complaints about sample wording are not relevant to the central question which is what advice was given and whether the capital shortfall risk was explained. L&G claim that Mr Standish confirmed their approach to the completion of the PFR. It is true that Mr Standish accepted that it was not necessary to repeat word for word what was in the KFD in the PFR but he went on to say that he thought it necessary that *"the salient points of that discussion* [between the adviser and the customer] *should be recorded"*. He was also of the view that the sample wording needed to be balanced by reference to the downside risk and that L&G advisers should have been doing what was later required by the CNB of 21st July 1999.

108. When we turn to the 60 "*redress payable*" cases the recommendation on 50 of these was in most respects the same. In 49 cases the rationale used sample words "*does not detract from pension provision*" even though further explanation would have been needed to demonstrate its relevance for most customers. In 20 cases the reason for the recommendation was the standard reference to "*portability*" and "*flexibility*" even though repayment mortgages would in practice have the same advantage (as Mr Standish observed and Mr Jenkins accepted).

109. L&G's further justification for the use of sample wording is similar to that used generally to justify the absence from the PFR of identification of the capital shortfall risk. We consider that L&G's procedures were at fault. Sample wording

was widely used without being tailored to the customer's circumstances. Wording was used which did not apply to specific customers. The wording itself drew insufficient attention to the fact that the capital shortfall risk had been discussed or that the customer had understood the risk and the possible need to take remedial action in the future. Sample wording caused difficulty in the checking process of the PFR Checking Unit ("the Unit"). L&G's suggestion that the PFR was consistent with the sample wording included in RU43 is incorrect. As an RWL the PFR should have followed RU43 or L&G should have had some good reason for rejecting that guidance. The changes introduced by L&G in 1998 were inadequate and it seems from the events of 1999 of little practical effect. The Unit continued it seems to check that sample wording had been used. The RU is both clear and relevant. When we consider procedures we need to look at how they operated in practice as well as in theory. Even though a large majority of the PFRs in the 60 cases relied on sample wording none of these were rejected or queried by the Unit on the basis of the wording. The four advisers who gave evidence for L&G (Mr Glendenning, Mr Allan, Mr Little and Mr O'Sullivan) never found that the use of sample wording led to queries from the Unit and there was very little intervention by the Unit in the cases under discussion. FSA contends that the invisibility of the Unit in the 60 cases confirms its contention that the checking process was inadequate and ineffective. In our view, these matters would inevitably have got in the way of L&G ensuring that the customer properly understood the capital shortfall risk. L&G's recognition of the problem and their attempts to correct it are not of themselves evidence that their previous practice was at fault. Neither however are they simply an adoption of an approach as it evolved in the industry over time. L&G had very clear advice and warning in 1998 and 1999 that their procedure was at fault and not acceptable.

Training

110. All advisers selling L&G products were required to complete an L&G training programme. Between 1997 and September 1999, new entrants to L&G were required to go through an initial training course. After September 1999, they were also required to complete an induction course. The evidence shows that the majority of L&G advisers were experienced in the industry before joining L&G. All had the Chartered Insurance Institute's Financial Planning Certificate 1, 2 and 3 and had been through the L&G training course. All had to pass internal examinations and complete mock sales successfully. There was regular re-testing and detailed training on mortgages and repayment vehicles. The training given in relation to the sale of mortgage repayment products was based around the completion of the PFR by reference to the associated Completion Guide.

111. We heard from Mr Howard Cooke, Local Training Consultant, who gave detailed evidence about training and from Mr Philip Cook, Sales Manager, on how supervision works. Both witnesses were convincing about the matters with which they dealt. Mr Cooke's account of how advisers ascertained attitude of risk was consistent with what we have seen to be recommended. Mr Cook is plainly conscientious in checking PFRs, and drew confidence from the fact that many of

his advisers recommended an endowment mortgage in only four or so cases out of ten. Specific training materials were produced, in particular case studies and model answers. FSA drew attention to some of those materials which stated that a unitised with-profits fund would be suitable for low risk or risk-averse customers, for example:

(1) Handout 11 of the Mortgage Protection Products Case Study Correct Answers, dated August 1997: the answer to Question 5 stated that the with-profits fund could be recommended to a couple arranging a joint life FMP who described their investment attitude to risk as 'low';

(2) Handout 9 of the Flexible Mortgage Plan Correct Answers, dated August 1997: the answer to Question 5 stated that the with-profits fund would be suitable for 'cautious investors'.

but these have to be seen in their proper context.

The APE Manual (September 1997 version) is criticised by FSA for placing too much emphasis on there being a cash surplus, the material including an example illustrating that at an assumed growth rate of 7% "*it will be unlikely that there will be insufficient funds to repay the mortgage owing*". However, that criticism is misplaced as the example referred to actually related to a PEP for which growth is gross (without deduction of tax). The 7% growth rate is therefore equivalent to a net rate of 5%. The successor to that document, the FMP Workbook, is criticised in similar terms and for giving no indication to the trainee of the significance or the likelihood of the capital shortfall risk.

112. FSA's case relies on training only in claiming that the L&G training material wrongly showed that the with-profits FMP was suitable for a low risk customer. L&G rely upon their training and assert that they operated a comprehensive testing and licensing programme which ensured, so far as reasonably practicable, that all advisers were trained and competent in L&G's policies and procedures. So in this case training features mainly as part of L&G's defence to FSA's allegations.

113. L&G met suggestions from FSA that the two witnesses, Mr Howard Cooke and Mr Philip Cook, were not representative with the response that FSA could always have interviewed a range of advisers and supervisors for itself if it had so wished. That is correct but not persuasive in an area advanced mainly as a defence from L&G. FSA's criticisms of the training were based not on the ability of particular advisers but on what they saw as the following defects in the procedures:

(a) neither Mr Cooke nor Mr Cook knew of concerns expressed by outside advisers about the PFR unit or about supervision;

(b) the training material did not emphasise the real and significant risk of a shortfall;

(c) advisers were not made aware, as some others in the company were, of increasing uncertainty about anticipated future investment returns and the changed circumstances suggesting growth could be expected to be lower than in the past;

(d) there was discrepancy between the advisers about their understanding of the risk. FSA points to the evidence of Mrs Miller as Head of Compliance who did not consider the risk of shortfall to be significant. FSA compares this with that of Mr Cook who saw it as significant and the four advisers who put different degrees of emphasis on their understanding of the point.

114. FSA submitted above all that a defence based on training could not withstand findings reached about levels of training and competence set out in the Report by Coopers of their compliance health check in January 1998, the main conclusions for which are summarised by FSA in Appendix 2 to their Closing Submission.

115. L&G point out and the materials show that trainee advisers were taught that:

(a) a with-profits FMP provided no guarantee that it would repay the mortgage at the end of the loan term;

(b) an advantage of a repayment mortgage was the guarantee of repayment provided that all payments were made;

(c) a disadvantage of an interest-only mortgage was that repayment depended on the performance of the investment product purchased;

(d) they must hand over and explain the KFD and a personalised illustration; and

(e) they must take steps to check that their advice and explanations are understood by the customer.

Training - Discussion

116. We do not see it necessary or possible on the material we have to make detailed findings about training. It seems to us immaterial how many minutes were given over to a particular aspect of training or to discussing in sessions the advantages and disadvantages of repayment and interest-only mortgages. If there were to have been a detailed evaluation of L&G's training it would have needed a closer examination of how the process operated in practice. The evidence about training seems thin. Although supervisors occasionally observed advisers with customers, Mrs Miller confirmed that L&G did not routinely contact customers to test whether the sales procedures were being followed by advisers and L&G did not introduce 'mystery shopping' until the first quarter of 1999. There was no evidence to demonstrate that the sales procedures laid out in the Guides and in training were systematically followed by all or at least a majority of advisers. Overall the degree of emphasis on capital shortfall risk was broadly consistent throughout the range of

L&G material whether at the level of training, guidance about completing the forms or advice to customers. We are not convinced that the training reflected the benefit of information obtained from above the training level in terms of the increasing perception of risk or from below in the light of every day practical experience of dealing with customers (as may have been obtained as a result of mystery shopping). Mr Cooke did not seem to have been given intelligence from either direction. In short we do not consider that the benefit of L&G's training upon advisers would have overcome the effect of other shortcomings in the procedures.

PFR Checking Unit

117. The Unit checked the suitability of advice given by advisers and whether the PFR complied with L&G's procedures. Before the PFR was sent to the customer the L&G adviser forwarded the form either through his supervisor or, once he had reached a certain standard, direct together with the KFD, personal illustration and any mortgage questionnaire. The checker would then, by reference to the guide, check whether the attitude to risk matched the product that was sold. During the Relevant Period the guide indicated that a with-profits fund was suitable for a low risk customer. The aims of the Unit are set out in Appendix E of a letter from L&G to PIA of 21st February 2001. FSA criticises the operation of the Unit. It says that the information in the PFR did not enable the checker to identify a customer who was not prepared to accept the capital shortfall risk. The Unit operated on the basis that those categorised as low risk would be prepared to accept the risk of an FMP, relying on the advice in the guides. We refer at 99 above to the "health check" by Deloitte in reviewing the effectiveness of the Unit in early 1999. L&G submit that the issue of the Unit adds nothing to either side's case. If there was a fundamental flaw in L&G's sales procedures it would run into the Unit which applied the same criteria as advisers. If there is no such flaw then the Unit becomes irrelevant to the question we are addressing.

118. L&G also claim that any allegation about the operational efficiency of the Unit is irrelevant because fact find checking is part of line management not the sales procedures and therefore falls for regulation under Rule 7.2.1. FSA relies on PIA guidance in particular Enforcement Bulletin number 20 of March 1994. As we have already observed we do not consider that omissions can be neatly compartmentalised so that failings which fall within one paragraph of a regulation cannot also fall within another. It is unrealistic to divorce the effectiveness of procedures from the checking of the forms.

119. L&G say that, if relevant, their checking procedures were appropriate. The checker was required to confirm that a proper and accurate personal illustration was on the file and this would demonstrate the capital shortfall risk. The checker made sure that the illustration was produced on or before the date of the meeting. The checker also had to check that the declaration in the PFR had been signed and dated by both the adviser and customer, and that this declaration confirmed receipt and explanation of the KFD.

120. KPMG, L&G's experts, record in their Report of 23rd December 2002 "*The PFR records held by L&G were, in all cases reviewed, insufficient to demonstrate that the sale was suitable*". Mrs Miller of L&G accepted that "*If you are looking at suitability in specific cases I agree that the reason why letter would not be tailored enough for you to be able to understand that.*"

121. In late 1998 L&G's own compliance department found an error rate of 16-20% on PFRs which as it saw it had been incorrectly accepted by the Unit. L&G Compliance Audit did not break down its monthly PFR checks by product until October 1998. The monthly figures for FMPs (which we assume were low, medium and high risk plans) shows an error rate of 10.6% for the period October 1998 to December 1999. Towards the end of 1999 the number sampled became quite small each month.

122. The Deloitte review of the Unit in February 1999 concluded that it would have rejected 40% of the PFRs submitted directly to the Unit by advisers and 46% of those which had already been checked by supervisors. At the hearing however none of these were shown to be 'low risk'. Deloitte were "*concerned that checks by supervisors were ineffective with the result that the PFR unit was receiving documentation likely to contain errors. Improving the standard of initial PFR completion is highly desirable, and the need for the checking unit results to be fed back directly and to remedial training was critical.*" It seemed common ground that the level of supervisory errors found by Deloitte was much too high.

123. It is right to record that Deloitte also advised L&G that the company's processes were above or just above average for the industry.

124. The issue of the Unit is a limited one in the FSA Statement of Case (para 72-4 and 90). L&G replied by asserting that its review procedures were proper and sufficient. In its response FSA then referred to the concerns expressed above about the adequacy of the PFR review process. Our view of the Unit is that it could not be and was not a check on the sales from the standpoint of the capital shortfall risk as the PFRs did not contain enough details to enable this to be done. The process provided for no check except by reference to the Guides. At times the Unit, far from disapproving sample wording, was concerned by *"its absence"*. In short the presence of the Unit did nothing to alleviate the problems created by the form of the PFR and the wording used to complete it.

Supervision

125. Criticisms of supervision turn similarly on the essential validity of FSA's case on capital shortfall risk. FSA accepts the integrity and ability of the L&G witnesses Mrs Miller, Mr Cooke and Mr Cook who gave evidence on the issue but points out what it says are inherent defects in supervision:

(a) no-one picked up the 60 cases (of course this assumes that most or all should indeed have been picked up);

(b) no-one picked up excessive use of sample wording and the type used. Supervisors checked the product recommended simply by comparing the client's low attitude to risk in Section 16 with the appropriate risk category in the guide;

(c) Clients were not routinely contacted by supervisors to check out what had happened at the point of sale;

(d) external reviews of the competence of supervisors showed up deficiencies as serious as those with training – see Appendix 2 of FSA's closing submissions.

126. We have no criticism of the structure of supervision and the supervisor from whom we heard was clearly able and conscientious. Supervision may well have improved the quality of sales interviews but it would not have been able to improve the demonstration of suitability as recorded on the PFR. That was itself hindered by the form of the PFR and the shortcomings of extensive use of sample wording.

Standards

127. As we pointed out at the start it is common ground that L&G have to be judged against the compliance standards as they applied in the Relevant Period. The fact that procedures are changed and improved as they were in the latter part of 1999 does not mean that prior conduct was necessarily inappropriate or in breach of the rules. Such an approach would inhibit firms from improving their standards. So what were the standards in the Relevant Period? At the hearing we observed that in civil litigation it would be common to prove practice at a particular time with evidence from witnesses from other organisations involved in the industry. We were told that such evidence was not now relied on in financial services discipline cases. In this case there was no evidence to help us judge what other firms were doing or how L&G's performance related to them apart from indirect reports received by Mrs Miller or relayed to L&G by Coopers and by Deloitte. This creates no difficulty when a firm is being judged against an objectively measured standard or where there is explicit guidance indicating in reasonable detail what should or should not be done. It is more of a problem when we are considering the broader requirements of "*best endeavours*", "*due skill care and diligence*" or the obligation to establish procedures directed at all the "*Rules and Principles*" particularly where, as we see it, standards may have changed over the course of the Relevant Period.

128. L&G suggest that Mr Standish, FSA's expert in this area, failed to address properly the rules and guidance applying during the Relevant Period, overlooked the function of the KFD and personal illustration and was unable to point to any guidance or other material which showed how he had reached his understanding of relevant standards between 1997 and 1999. While we do not accept the first criticism Mr Standish's otherwise very valuable evidence did not address standards in detail. Where it did, it seems to us that it may have related more to "*best*

practice" than to "*acceptable practice*" in the industry during the relevant period. L&G assert:

(a) there was no explicit guidance or rule linking suitability under rule L8(1) to the attitude to the "*capital shortfall risk*";

(b) communication to customers relating to risk was perceived to be through the KFD;

(c) the guidance did not suggest that a risk warning needed to go beyond advice that the product was not guaranteed.

129. (a) and (c) seem to us to be fair observations from the materials relied on. Further RU 72 was expressed to "*remind*" firms of standards, but there had apparently been no earlier advice on the specific matters which it addressed. Guidance from the relevant professional body, the Chartered Insurance Institute, in its FPC3 manual included a chapter on how to complete a fact find form. This considered the identification of attitude to risk as being to investment not to capital shortfall risk. Similarly the Institute, in separating the two concepts, saw no difficulty with introducing the issue of investment risk with a question "*what level of risk are you prepared to take to achieve your financial objectives?*" (although, as we see it, FSA itself would have no objection to that question if it included provision for the customer to specify no risk at all or to relate it to a mortgage transaction, because this would then lead to a revisit to Section 11 of the PFR and Stage one of the sale process.)

130. FSA submits simply that "*the evidence*" demonstrates the standards required and relies on the fact that RU 72 is a reminder to firms of pre-existing standards. (Of course, RU 72 itself would have been of no assistance to L&G until December 1999.) FSA made the point that three major firms had been disciplined in respect of matters similar to those with which we are concerned. The firms have accepted the existence of serious deficiencies with details set out in the documents before us. We were not taken to these announcements in detail at the hearing and do not find them persuasive evidence of the standards in place at the time. Those announcements do not support the standard of "*real and significant*" or "*50 per cent. probability*" in explaining the capital shortfall risk to an FMP customer and were, of course, not available to L&G or others during the Relevant Period. It is not easy to relate the limited facts of those cases to this one. The announcement in agreed terms of penalties accepted by others for what may be a mixture of reasons may be very helpful at the penalty stage but may not be a reliable guide to the standards being considered in this case.

131. Overall there is a lack of clarity about the standards which were applicable during the Relevant Period. We bear in mind that appreciation of the potential problem with low cost endowment mortgages was developing. What was known by the end of 1999 may not have been fully appreciated at the start of 1997. We do not, as we have already stated, conclude automatically from decisions to change things for the

better that the previous practice was necessarily unacceptable. Yet there were early signs of changing standards. The 1995/6 Annual Report of the PIA Ombudsman Bureau stated: "*A sale of a low cost endowment to an investor who wants to be absolutely sure that the proceeds will pay off the loan at the end of the term is likely to be a missale*". L&G would (or at least should) have been aware of the Ombudsman's thinking. In contrast the FSA's Progress Report on Endowments October 2000 indicates that it was not until mid-1998 that FSA itself commissioned an economic analysis to assess the impact of lower inflation rates on future investment returns. During the Relevant Period there was no basis for requiring a firm to convey to a customer the standard of "*real and significant*" or "*50 per cent. probability*" of shortfall or for a standard that went beyond repayment not being "*guaranteed*". However the defects we perceive in L&G's procedures seem to us to be basic and not much sensitive to evolving standards. Discussion and completion of Section 16 was apt to mislead and this should have been obvious to L&G and PIA, but was not. It was oversight not lack of evolution in standards which led to this error and to PIA's omission to spot it. Similarly the problems of sample wording had been drawn to L&G's attention by their external advisers and/or by PIA and were covered by guidance such as the RUs. The problem was an obvious one.

PIA Investigation of L&G

132. Some light is cast on the degree of adequacy of L&G's procedures by the approach adopted to these by PIA. FSA is correct to emphasise that firms alone bear the responsibility for their own practices and procedures and for ensuring compliance with the rules. A regulator's position would be made impossible if firms were able to evade their responsibilities by seeking advice at every turn and showering its office with material for which they sought approval. Nothing we say, based on the particular facts of this case, should be taken as indicating that firms can avoid or reduce their responsibilities in such a way. L&G submit that PIA's attitude to the procedures and to the alleged shortcomings on earlier occasions is relevant to the seriousness with which we should view them now. We disagree with FSA that these events are irrelevant.

133. PIA made a supervisory visit to L&G in the summer of 1995 which resulted in the introduction of the two-stage sales process and of a revised PFR. The report in November 1995 noted a problem that there was rarely any documentary evidence to show that all types of mortgage repayment vehicles had been considered and consequently that the client had made an informed decision. The corrective action required was that "*the member should amend its policy for mortgage advice to include evidence of full discussions and all the different types of mortgage repayment vehicles*". L&G promptly issued a CNB, redesigned the PFR form and discussed it with PIA in early 1996. L&G sent PIA a draft for comments to which Alan Brener, then Head of Field Monitoring, replied. The draft was circulated within PIA and no adverse comments were made to L&G about the new form. The correspondence and the memos in January and early February 1996 show that the draft was considered in detail by FSA. If the new PFR form had contained flaws

grave enough to warrant later disciplinary action L&G would reasonably have expected PIA to notice and to inform them.

134. Mr Brener gave evidence about this exercise but unfortunately provided us with little assistance. Unlike other witnesses Mr Brener had apparently not studied the material before giving evidence and seemed unable to reconstruct his recollection when taken to the available documents. Mr Stephen Williams, Group Manager for FSA in the Retail Firms Division, was in 1995 and 1996 Head of Monitoring and in 1997 became Head of Field Monitoring. His evidence covered the broad history of regulation and how it worked in practice for firms like L&G. He was cross examined about L&G's compliance record and reputation, which he described as "*marginally above average*". Mr Williams too had very little recollection of the change to the PFR form resulting from the 1995 visit. He accepted that if he himself had concerns he would have raised them with Mr Salter, who then managed the PIA team responsible for supervising L&G, and that he was unaware of any concerns expressed by PIA about the PFR after February 1996. We therefore conclude from the documents that the PFR was examined by PIA and that it did not criticise either the risk definitions in section 16 or the form and structure of the PFR as a whole. FSA has not suggested that the scrutiny in 1995 and 1996 was incorrect or inefficient. L&G invite us to draw the inference that the revised PFR in 1996 did properly reflect what PIA required. It is correct to draw that inference but we bear in mind that PIA scrutiny was of the form alone, not of how it was to be completed and used in practice. There was, for example, no advice requested or given on the sample wording to be used when completing the PFR.

135. As we have mentioned PIA made another supervisory visit in January and February 1999. There was a debriefing on 22nd February 1999 at which it seems clear that L&G were informed that it generally had a good compliance culture and no "*major*" concerns were identified. But concerns were identified as L&G's note makes clear. Standard paragraphs were seen as inappropriate when the PFR formed the basis of the RWL. There was concern about L&G's risk categories defining low risk as "*the client is not prepared to accept any risk*" and then recommending an endowment mortgage. A visit report was issued with a letter dated 23rd April. This stated that Section 16 of the PFR did not demonstrate that the recommendations to the clients were suitable and that allowing only three definitions of risk was too narrow. The report required L&G to "*revise section 16 of the PFR to include a more comprehensive record of client attitude to risk*". L&G point out that this part of the report was not in bold type, an indication that PIA did not consider that it was a serious issue for concern, and that this was directed to recording of attitude to risk and did not suggest that the procedures led in practice to unsuitable recommendations. FSA says that the absence of bold type was an indication only that these matters were not the "*most serious of breaches*". They were actual or potential breaches of the Rules concerning not just the recording of attitude to risk but the suitability of sales.

136. In 1999 Mr Philip Salter, who is now a Manager in the Major Retail Groups Division of FSA, was responsible for "Team 2" at PIA and in charge of supervision of L&G. He was not called as a witness by either side. He provided a statement to L&G. Neither side has challenged the truth of his witness statement. In short, he says that the 1995 supervision visit showed L&G to be above standards of "*comparative*" conduct used at that time. The comparison was with other major providers and large IFAs. His overall view of the visit in January 1999 was that L&G had deficiencies. Methods used to record attitude to risk were limited and the "*reason why*" letters, largely handwritten PFRs relying heavily on standard paragraphs, were of mixed quality. Concerns were mitigated by the view formed by him and others from the visit team that there was no evidence of mis-selling. His view was reached in the light of the good overall compliance culture observed at L&G and the fact that its advisers recommended relatively more repayment mortgages in comparison with the practice he had observed at other firms. He says this comparatively favourable view may have been coloured by the previous visit to another firm where selling practices "*were very poor indeed*".

137. Mr Salter states that the letter of 23rd April 1999 was the standard form for a visit graded "*green*". In this category "*any failing identified in the course of the visit were set out and the firm was instructed to remedy these usually within a period of two months*". There were two more serious categories. For the "*amber*" category the view had been formed that major failings had been found and the firm would be instructed to carry out urgent corrective action. For the "*Red*" category, the firm would be informed that the visit had revealed major failings and the matter was being referred directly to enforcement. L&G thereupon issued a CNB in May 1999 which provided answers to a customer's potential questions on the capital shortfall risk and a further CNB in July 1999 reminding the adviser to make "*the low risk client aware that there are some risks involved with-profit endowment*". L&G also took other action. PIA and L&G agreed a timetable for improvement over an 18 month period and once L&G indicated that this was in place PIA closed off the file in March 2000.

Referral to Enforcement and Endowment Sales Review

138. On 18 May 1999, L&G were informed that they would be visited again by FSA (by then acting on behalf of PIA), who would be conducting a themed endowment visit. Legal & General were selected because they were one of the largest firms in the market. The 3-day visit consisted of a review of 50 client files covering both with-profits policies sold as mortgage repayment vehicles and as saving products. Far fewer files were reviewed than in an ordinary supervision visit. Cases were graded as "suitable", "unsuitable" or "unclear". The results of the visit were not validated by any interviews with customers although this had been the original plan.

139. The visit took place between 29th June and 1st July 1999. Louise Buckley and Paul Burwood of PIA led the team reporting to a line manager. Mrs Miller and Mr Hallibone dealt with the visit for L&G. As this was not a supervision visit but

part of FSA's endowment mortgage initiative no report was to be issued. The supervision visit in early 1999 had led PIA to conclude that five per cent. of sales were likely to be unsuitable. The themed visit concluded that 35 per cent. of those sales were unsuitable. Yet no change had been observed in the sales process between the two visits. The reason for this change was explained by Miss Buckley. During the Relevant Period she was a member of the team responsible for supervising L&G. It appears that she would have taken a more serious view of the performance of L&G at the 1999 supervision visit because of her personal concerns about L&G's view on "*low risk no risk*". There is no doubt that she genuinely held a strong view about this, but deferred to the conclusion of Mr Salter as expressed above. By the time of the themed visit Miss Buckley was no longer supervised for that purpose by Mr Salter but by another colleague and she applied her own assessment with the result that the figure for unsuitable sales rose from five per cent. to 35 per cent. on the same material. Mr Bibby's evidence shows that the decision to recommend that L&G be referred to Enforcement was taken because L&G was above the average of 18 per cent. emerging from the themed visits to the 11 product providers.

140. Mr Salter's views did not suit the immediate requirements of FSA's case. The candour of his statement was helpful and impressive. Miss Buckley was a frank and straightforward witness with strong and sincerely held views. The themed visit produced such a different conclusion from that of the supervision visit because Miss Buckley was giving effect to her own legitimate views which were supported by her "themed visit" colleagues and superiors.

141. The note of the informal debrief of 1st July 1999 refers to *"the use of standard wordings was, again, raised as a concern"* and *"the risk warnings about the risks associated with endowment mortgaged were often not evident and when they were detailed on the PFR were not "strong" enough"*. Indeed the debrief observes *"all the issues identified during this visit were, to some extent, also identified during their supervision visit in January 1999"*.

142. FSA concluded that 21 (of which 15 were FMPs but not necessarily for low risk customers) out of the 50 endowment cases reviewed in July 1999 were *"deemed unsuitable"*. It is not clear how many of the 50 were low risk FMPs. During an informal debriefing, mention was again made of the insufficiency of endowment mortgage risk warnings but Mrs Miller was under the impression that there were no major issues of concern.

143. On 20th December, Mr Michael Foot, Managing Director and Head of Financial Supervision of FSA wrote to the Chief Executives of firms and independent advisers selling endowments. He said that the themed visits had been poor and an improvement in standards must be applied and circulated a copy of RU 72. On 26th January 2000 Mrs Miller met Mr Philip Salter. Mrs Miller prepared a note of this discussion and gave evidence about it. The relevant part of Mrs Miller's note states:

"*PS started the meeting by confirming that no further action was likely to be taken by PIA following the endowment theme visit to Legal & General ... the Legal & General visit had not been a bad one and had shown similar issues to those arising in the supervision visit which took place a few weeks earlier in 1999. The press release recently issued by PIA stated that there were a number of visits which was unsatisfactory, but Legal & General were not included in that group and consequently he had been informed that we were unlikely to receive an investigation visit as a follow up to the themed visit or any form of disciplinary action. It is also unlikely that we would receive any report as a result of that visit*". We have no reason to doubt that this was a fair and accurate summary of the conversation.

144. Our approach to the seriousness of the shortcomings that we have identified should be coloured by the facts that the PFR form now criticised passed PIA scrutiny in 1996 and that the sample wording problems when identified by PIA in 1999 were seen as attracting limited culpability. PIA recognised that action was needed, required L&G to attend to it, and then satisfied itself that this had been or was being done. Counsel for FSA accepted that his client may have been too lenient in its approach. We agree.

Other Witnesses dealing with the Procedures Case

145. Mr Michael Folger, Director of FSA (Wholesale Policy) was Chair of the Mortgage Endowment Project Board/Cross-FSA Mortgage Endowment Working Party within FSA from late 1999. Mr Folger, like Mrs Miller on behalf of L&G, gave evidence and was extensively cross-examined along the frontier between evidence and submission. L&G's case was put to him and he was required to answer for that of FSA. Mr Folger's evidence has given us considerable background help without being decisive at any point. Mr Folger clearly invested time and effort in reacquainting himself with the relevant material in order to give us maximum assistance. Despite giving evidence for the best part of a day he did not, it seemed to us, duck or seek to evade a single question. Mr Folger was an impressive witness.

146. Mr James Young of L&G is a senior manager experienced in project and programme management of L&G's computer systems. Mr Young gave evidence about the background and about procedures for preparing personal illustrations which we do not now need to review because the faults we find with L&G procedures do not relate to this issue.

147. Mrs Diana Miller is the Director (Compliance) at L&G Group and has held that position since 1999. Between 1994 and 1999 she was responsible for compliance within L&G. Mrs Miller's evidence covers the history of L&G's involvement in with-profits endowment mortgages, the regulatory background, L&G's procedures, training and supervision and the recent history of compliance including external reviews and supervision visits. The evidence also covered events from the referral to Enforcement in July 2000 until the present date. Mrs Miller covered not only all

the relevant facts and events in this case from the standpoint of L&G but also both the justification of their conduct and their criticisms of the regulation and enforcement practised by FSA. We found that Mrs Miller was a truthful and well-informed witness on all matters of fact. As is apparent from our conclusions we disagree with and reject some of the broader points she made on behalf of L&G. Mrs Miller was the only senior member of L&G to give evidence and therefore alone carried the burden of defending in cross-examination the overall position of L&G.

Expert Actuarial Evidence – Policy Review Facility

148. Mr Roger Grenville-Jones of Oxford Actuaries and Consultants and Mr John Jenkins of KPMG gave actuarial evidence for FSA and L&G respectively on the risks associated with the FMP.

149. The FMP includes a policy or premium review facility by which the plan is examined at intervals to check whether it is on target to repay the loan. Customers are sent details of the review and offered advice where necessary. Under a 25-year plan, the first review would take place after 10 years, after every five years thereafter and each year during the last five. This process for FMPs was overtaken by the FSA Endowment Initiative in 1999. There was a dispute between the parties as to whether the policy review facility reduced a customer's risk. On the one hand the facility would identify a problem and result in L&G offering the customer options, most obviously involving increasing the premiums. On the other hand this would raise questions of the ability and inclination of that customer to increase payments at a later stage. These issues rightly became less important in relation to others as the case developed, but they were the principal area of debate between the actuaries. Both reports provided a considerable volume of helpful background material and we refer briefly to the main conclusions of each.

150. Mr Grenville-Jones considers that the repayment mortgage is the most straightforward and has the lowest risk. There is no risk that capital might not be paid off in full by the end of the term if all due payments are made. In contrast, a with-profits FMP or other endowment presents a shortfall risk at the end of the term. The shortfall risk is the critical risk for the customer, not the risk of capital loss on amounts invested. Understanding of risk requires not only awareness of its existence but also consideration of its probability and possible effect. The degree of risk is driven by the prudence shown in setting the level of premiums against the investment returns expected over the life of the endowment policy. Market, fiscal and economic developments have over time reduced the margins for prudence and increased the risk. During the Relevant Period the FMP was not a low risk option having regard to the shortfall risk. That risk was not effectively mitigated by the policy review facility.

151. Mr Jenkins, while agreeing with Mr Grenville-Jones in general terms, expressed matters in terms of the two-stage process. For a customer who, as a result of stage one, required an endowment mortgage, the FMP constitutes a

low risk investment product. Mr Jenkins was not aware of any readily available regular contribution investment product that had the necessary equity or property asset allocation at a lower risk than the FMP or of a similar product from other insurers. As Mr Jenkins saw it, the FMP contained the features and the review process intended to reduce the likelihood and magnitude of any shortfall at the end of the term that he would expect from a with-profits endowment mortgage contract. The features he identified were:

- the capital guarantee in relation to the premiums invested less charges;
- an investment policy which ensures a range of investments held;
- regular bonuses which cannot be removed once declared;
- a terminal bonus smoothed to ensure that final returns do not suffer the full volatility of underlying investments; and
- a regular review process to serve as an early warning mechanism and to seek to keep the policy on target to reach the desired mortgage amount.

152. It may be that the review facility was subjected to closer and more detailed analysis than was necessary for this case. It is clear that the existence of the premium review is potentially of great assistance to a customer if, well into the 25-year term, the prospect of a capital shortfall looms. Against that it is not possible at the time when the policy is taken out to anticipate what the size of any potential capital shortfall will be or to express a view about the likely level of increased premiums that may be required at a later stage. It is true that inflation and, in the case of some borrowers, increased economic prosperity may make it easy for them to afford what might be comparatively minor increases in premium. In short it does not seem to us that the existence of the premium review process has an effect on the central issues of whether the capital shortfall risk is understood and a customer's attitude to it ascertained.

The Procedures Case – Conclusions

153. L&G written sales procedures were intended to require its advisers to explain the capital shortfall risk so that customers would understand it. However, L&G's procedures did not ensure that these instructions were followed in practice. In particular, Section 16 of the PFR was deficient. It did not require the adviser to record whether the customer understood and was prepared to accept the capital shortfall risk. If that record had been required an adviser would have had no option but to engage the customer in informed discussion about the risk. The definition of "low", the lowest level of risk in Section 16, was apt to mislead a customer into believing that the level of risk inherent in an FMP was suitable for the risk averse. The recommendation section, Section 20, was not completed so as to take proper account of the capital shortfall risk. The use of sample wordings masked the ascertainment of attitude to risk, prevented adequate checking of the

customer's appreciation of the capital shortfall risk and may have misled customers. It was not possible to ascertain from the PFRs that the customer had understood the capital shortfall risk and made an informed choice of mortgage repayment vehicle. These difficulties were not overcome by the risk warnings in the Key Features Document and the personal illustrations, which we acknowledge complied with regulatory requirements and were required by L&G's procedures to be given to customers. While these matters were not an express requirement of Rule 7.1.2(1) or SIB Principle 2 they were important parts of any procedure properly designed to be effective. They also need to be considered against the background of our conclusions about the other components of the procedures case. In the respects we have identified and outlined in this paragraph L&G failed to establish procedures with a view to ensuring that their functions complied at all times with the Rules and Principles.

154. These breaches must be seen in proportion. First, the PFR form which we find to be defective had been considered by PIA, the Regulator, in 1996 without any comment or criticism being made to L&G. Secondly, the other defects in procedures were identified by PIA in 1999 as not warranting disciplinary action. L&G had agreed a programme to put them right over an 18 month period and reasonably assumed that no further action would be taken. FSA probably changed its position following a gradual realisation over the Relevant Period that a major and developing problem with low cost with-profits endowments required a different approach.

G MIS-SELLING CASE

FSA's Claims and L&G's Reply

155. The word "*mis-sale*" is undefined and is used to mean different things. Mis-sale in this case is the allegation made by FSA that sales were entered into as a result of recommendations made by L&G advisers in circumstances where the adviser failed to discharge his/her obligations under rule Rule L8(1). FSA says that this would have been the case where an FMP was recommended to a customer who was either not prepared to take the risk of a capital shortfall or did not properly understand that risk. FSA says that where the risk of a shortfall has been understated by the adviser, L&G will not have discharged their duty to use best endeavours to enable the customer to understand all the relevant risks.

156. FSA alleges that in breach of PIA Rule L8(1) and/or of SIB Principle 2 the defects in procedures caused or contributed to an unacceptably high level of mis-selling of FMPs. FSA contends that policies were sold to customers for whom they were not suitable, either:

(a) because the customer was not prepared to accept the risk of a shortfall, or

(b) because the customer did not properly understand the risk of a shortfall.

157. As part of the investigation process, a review was carried out of 250 sales of FMPs made during the Relevant Period. This review was referred to as the Past Business Review or the Endowment Sales Review ("ESR"). PricewaterhouseCoopers ("PwC") were appointed to assist with the ESR and to report on the result of the review. The ESR involved the process described at 165 et seq below. PwC concluded that 60 customers (being 39 per cent. of the 152 respondents) fell into a "*redress payable*" category, being cases where in their view there was "*persuasive evidence to indicate that the policyholders were risk averse and/or did not understand the capital shortfall risk …*".

158. L&G instructed KPMG to report on the results of the ESR. KPMG concluded that:

(a) in no case was there clear and uncontradictory evidence that the customer was risk-averse at the time of sale;

(b) the questionnaire was poorly designed and unfit for its purpose; and

(c) customer answers were affected by poor memory, hindsight and media effects.

159. FSA does not accept these criticisms of the ESR and contends that the conclusion reached by PwC was correct and reliable. L&G reject all the allegations of mis-selling. We must therefore look at matters in more detail.

The Approach to Rule L8(1)

160. L&G submit in an analysis of the framework of the rules and by reference to published materials, that Rule L8(1) deals only with suitability. The rule is not directed to the communication or understanding of information as to risk; those obligations are dealt with under Rules L6 and L6aa – in respect of which no breach is or, L&G say, can be alleged. Rule L8(1) does not impose any obligation to ascertain or record any particular aspect of attitude to risk; the representative has a general obligation to assess suitability and recommend accordingly. The representative must use his best endeavours, taking into account the customer's responses to the entirety of the discussion with the representative, to recommend a suitable investment product. Rule L8(1) is not directed to the content and communication of risk warnings, nor to the understanding of risk, but to the logically distinct question of matching a suitable product to the customer's financial and other circumstances. The suitability rule does not replicate or cover the same ground as the rules relating to risk warnings. So a charge under this Rule cannot cover the mis-selling alleged.

161. FSA submits that a requirement to *"use best endeavours"* and to have regard to *"all other relevant circumstances"* when giving advice, must include the attitude of the customer to the capital shortfall risk. An adviser cannot take account of this, as a matter of common sense, unless he has first given the customer relevant information and established that the customer has understood the capital shortfall risk and he has ascertained the customer's attitude to it. FSA says that it has in the

past issued materials referring separately to the duties to give suitable advice and to provide information, but that is because of specific requirements in the rules. It does not follow from that that the requirement to provide all relevant information is not part of a wide-ranging obligation to use best endeavours. FSA does not submit that SIB Principle 2 imposes any obligation in addition to that which, on its own interpretation, it sees imposed by Rule L8(1). But it relies on it if Rule L8(1) falls short.

162. Despite L&G's attractive submissions and the fact that mis-selling might well have been alleged under Rule 6(aa) we accept the approach of FSA. Rule L8, however it may be placed in context, remains a broad provision sufficiently wide to include the mis-selling alleged. As we see it, an adviser will not have had regard to the customer's financial position generally or to all relevant circumstances or have used his best endeavours to ensure that he recommends only a contract suited to the customer, if a mis-sale occurs and it has been contributed to by the procedural defects we have identified.

Events leading to ESR

163. We have referred to the contact between FSA and L&G up to January 2000. L&G were justifiably surprised when on 14th July 2000 FSA informed them that, despite earlier indications, the matter had been referred to PIA's Enforcement Department because of concerns raised by the themed visit. The investigation was to last three years. These matters proceeded to enforcement not as a result of the usual supervision process but as part of FSA's wider endowment mortgage initiative.

164. This emerges from the evidence, in particular that of Mr Peter Bibby, now a solicitor in private practice who was in 2000 Head of the Enforcement Division, Retail Selling at FSA, and from the documents. An internal FSA note dated 31st March 2000 records that the January 1999 supervision visit was "*closed off*" in March 2000 following L&G assurances. Dialogue continued between L&G and FSA about the proposed revised fact finding and reason why letter process. In April 2000 PIA Supervision and Enforcement agreed to write to a number of firms about further investigation. On 16th May PIA made a visit to the L&G endowment complaints handling area. On 5th June Mr Salter wrote to Mrs Miller about the supervision visit on 16th May and drew attention to a significant backlog and to general delays in investigating complaints by the Business Investigation Unit. While these were serious issues, the decision to ask Enforcement to investigate sprang, as the 14th July letter makes it clear, not from what was disclosed in the May 2000 visit but from the themed visit in June and July 1999. This Investigation got under way in September 2000. FSA interviewed three L&G customers with results it does not rely upon. FSA interviewed L&G staff. FSA also carried out a review of customer files. On 1st March 2001 Enforcement reported to L&G on the review of a sample of 50 customer files, 27 of which were categorised "*low risk*" in the PFR. In 26 out of the 27 cases, details of which are in Appendix 2 to the FSA Statement of Case, the only explanation for recommending an interest-only mortgage and/or a with-profits FMP comprised sample wording

from the guides. L&G say that the review of 50 customer files is irrelevant to the allegations made in this case because the concerns raised were about the recording of explanations and warnings, but not about whether these were in fact given. L&G is correct that the 50 cases have not featured in the evidence. As FSA does not rely on them, neither do we.

The ESR

165. In July 2001, Enforcement, as a result of these perceived deficiencies, asked L&G to carry out a sample review of low risk customers. As we have said, this sample business review was of 250 randomly selected customers described as "*low risk*" in their PFR who had been sold with-profits FMPs. It became apparent during the hearing that these customers were selected not from the whole of the Relevant Period, but excluded policies entered into after October 1998 (see paragraph 33 above). Files of the 250 customers were prepared containing copies of the PFR, the personal illustration issued at the time of sale and other documents.

166. PwC were appointed by agreement between that firm, FSA and L&G to assist with the sample past business review by providing expertise, quality assurance, and guidance.

167. PwC's terms of reference were as follows: "*PwC will then produce its own report to FSA and Legal & General. This report will set out PwC's independent conclusions on Legal & General's findings from the sample review, specifically whether the sample review has indicated that customers who were risk averse may have been sold mortgage endowment policies where such policies were not suitable for them*".

168. At the first stage of the review, a questionnaire (agreed only after much discussion and negotiation between FSA and L&G and before PwC's appointment in March 2002), fact sheet and covering letter were sent to the random sample of 250 customers. The questionnaire asked a number of questions, including:

"*Q5: Did you understand when you took out your endowment policy that the maturity value may vary and that your endowment policy might not provide enough monies to repay your mortgage?*

Q6: Did you understand when you took out your endowment policy that you might need to increase your premiums to ensure that your policy was on target to repay your mortgage?

Q7: At the time that you took out your endowment policy were you prepared to take some risk that your mortgage might not be repaid at the end of the term, even if you paid all your premiums, on the basis that you might obtain a lump sum in excess of the amount of the mortgage?

If you have ticked the box marked "No" above, please explain below why you took out an endowment mortgage."

169. The questionnaire responses were then analysed by PwC and L&G. Of the 152 customers who responded to the questionnaire, 104 indicated that they were not aware of the potential risk of shortfall in the value of the policy on maturity (or did not recollect) and/or had not been prepared to accept the risk that there could be a shortfall in the policy value on maturity (or did not recollect). i.e. 104 customers answered "*No*" or "*Do not recollect*" to one or both of questions 5 and 7. Of those 104 customers, 8 subsequently could not be contacted by telephone. The remaining 96 are identified in the schedule attached as Appendix 3 to FSA's Statement of Case.

170. Between March and May 2002 telephone interviews were conducted by KPMG, who had been contracted by L&G for that purpose, with 90 of those customers. At the end of this telephone contact in June 2002, PwC and L&G analysed the cases and assigned them to one of five agreed categories. In September 2002, a second phase of telephone interviews were conducted with 22 of the customers contacted in the first round of interviews in order to clarify their responses. Prior to the second telephone contact, the customers were sent copies of the PFR, personal illustrations relevant to the sale, the KFD and Mortgage Guide, as appropriate.

171. PwC reviewed each case, taking into account the information on the PFR and other documentation on the case file, the questionnaire response, transcripts of the telephone call(s) made to the customer and the L&G adviser report, where available. During the ESR, 8 cases had been identified as complaints and progressed by L&G's Sales Complaints Department. In those cases, a decision sheet completed by the Sales Complaints Department was also available and, in 2 cases, an endowment questionnaire. These cases were therefore also taken into account by PwC in their final report.

172. PwC produced a Final Report dated 7th March 2003. It placed each of the 250 cases into one of three categories:

(1) Cases closed no further action (including cases in which no questionnaire response received) - 171.

(2) Redress payable - 60.

(3) Inconclusive - 19.

173. They reached the following conclusion:

"*We believe that for those cases we have categorised as redress payable, there exists persuasive evidence for a judgment to be formed on whether the customer was risk-averse and/or did not understand the capital shortfall risk and may therefore have been sold a policy that was not suitable for them.*"

174. PwC took into account the PFR forms and personal illustrations it had available but gave greater emphasis to the customer's recollection (see paragraph 5 of its report). The PwC report contained these reservations:

"*PwC is of the view that it is very difficult to design a review methodology that seeks to gather evidence concerning sales meetings where it is not possible to know with certainty the dialogue that took place between the advisor and the customer.*

Additionally, when much of the information gathered is based on customers' written and oral representations we acknowledge that it may be clouded by the passage of time and by subsequent events.

We accept that the review process may not have allowed L&G to fully challenge the customers' assertions, and this might have led to some distortion in the results of the review."

The Debate about the value of the work done by PwC and KPMG

175. In September 2002 and following the initial categorisation completed by PwC in June 2002, L&G retained KPMG to report on the status of the ESR and to assess specific areas of the review, including the sales assessment categorisation for a limited number of cases selected by L&G. FSA was not involved in KPMG's work.

176. L&G selected 57 cases for KPMG to review. PwC categorised 52 of these 57 cases as 'redress payable'. In their final report of 23 December 2002 KPMG stated that they did not "*believe that this approach should be relied on solely to determine the true circumstances at the time of the endowment sale.*" They also concluded:

- The majority of the written and verbal answers given by customers (in response to the questionnaire and subsequent telephone calls) were either confused, contradictory, affected by the media and/or third parties or displayed hindsight.

- There were no cases where it was possible to conclude that the customers were risk averse at the time of sale.

- To be able to conclude that the systems used by L&G were sufficient to prevent widespread mis-selling would require a wider review of processes in addition to the sampling of customer files.

- It would not be appropriate for the sample ESR results to be extrapolated and used as the sole reason for undertaking a fuller review of past sales.

- The documentation prepared at the time of sale was not sufficient to explain the rationale behind the sale retrospectively – this was common ground between the parties.

177. FSA says that the conclusions reached by KPMG are flawed and are therefore of no practical value, in that KPMG:

- applied too high a standard of proof in reaching a determination whether in a particular case the sale of a with profits FMP was unsuitable;

- failed properly to deal with those customers who did not understand the risk of a shortfall at maturity; and

- failed to have regard to all cases in the sample past business review considered by PwC and consequently could not come to any reliable conclusion as to the effectiveness or appropriateness of the sample past business review or its methodology.

178. L&G respond that KPMG applied the proper standard of proof and did not adopt the approach of assuming that everything said by the customer in the questionnaire should be accepted without question. L&G say that KPMG's sample was sufficient to ascertain whether the methodology and results were accurate or fundamentally flawed.

179. FSA says that in all or a substantial proportion of the 60 cases, on balance, the customer was risk-averse and/or did not understand the capital shortfall risk, that a with-profits FMP was not suitable and should not have been sold and that sufficient evidence is available for that assessment to be made. FSA says that the results of the ESR, taken together with the documentary and oral evidence about the 60 sales available to the Tribunal, show that these were mis-sales and that the proportion of cases in which FMPs were sold to customers for whom they were not suitable is both unacceptably high and also a consequence of the alleged deficiencies in procedures. L&G respond to this by claiming that the PwC report:-

  - does not show that the customers were risk-averse or did not understand the risk;

  - applied the wrong burden of proof;

  - does not demonstrate any deficiency in procedures or that unsuitable sales resulted.

  L&G say that if in a small proportion of cases the customer was given poor advice by an adviser in breach of procedures, then that is a matter for complaint and redress not for the imposition of a disciplinary penalty on L&G.

The Expert Evidence about the ESR

180. The Tribunal heard evidence from experts about the issues raised by the mis-selling case. Mr Simon Chapman, a partner in PwC, and Mr Giles Williams, a partner in KPMG, addressed the ESR in effect supporting the reports their firms had produced. Mr James Rothman and Professor Robert Worcester gave evidence for FSA and L&G respectively about market surveys and the methodology and design of the ESR. Professor David Shanks gave expert evidence on the reliability of memory and recall in the context of surveys such as the ESR. We found

Professor Shanks's evidence an interesting and informative explanation of the scientific processes as they operate on memory and were grateful for his help. We found that his intellectual explanation of the process of evaluating the accuracy of what people can remember was consistent with the less articulated and more intuitive approach which we have applied.

181. We are concerned not just with the 60 cases produced by the ESR but with FSA's submission that the level of mis-sales amongst the cases which formed the ESR is properly representative of the level of mis-sales in the wider population of customers to whom L&G recommended FMPs and that this level is unacceptably high. FSA says that the sample was randomly selected from a broad range of branches across the country and the number of respondents (152) was sufficient to draw conclusions about the wider population and that the level of mis-sales amongst those cases (60 out of 152, i.e. 39 per cent.) is unacceptably high. FSA says that the sample size is adequate to extrapolate to FMP customers generally and that we should see whatever percentage the number of mis-sales we find bears to 152 (those who responded) or 250 (the size of the sample) as a reflection of the pattern of sales generally. (Although the Warning Notice did '*extrapolate'*, the Decision Notice did not, considering only that the evidence was *"indicative of a significant problem"*.) FSA assumes mis-sales in all 60 cases which it presents as 39% of 152 who responded (as opposed to the 250 who were surveyed). Using statistical tolerances given by the two expert witnesses, this means that, at a 95% level of confidence, the percentage of mis-sales in the wider population, according to FSA, is between 32% and 46%.

Adequacy of the sample size

182. Mr Simon Chapman became a chartered accountant in 1979 and a partner in PwC in 1980 and is a specialist in the retail financial services industry who has been involved in many regulatory reviews and investigations. He, like Mr Williams of KPMG, a specialist in this area since 1995 and a partner since 1999, has wide experience of past business reviews of the kind which are the subject of this case. He acknowledged that PwC had weighted its judgement in favour of the customers' recollections of advice given by the L&G adviser and what the customer said in the questionnaire and telephone calls about attitude to risk. PwC did not review sales or compliance procedures, as the object of their review was to determine whether customers who were risk-averse may have been sold endowment policies where these were not suitable for them. What he saw as a failure rate of 60 in a sample of 250 cases was in his view significant and "*would normally lead to an extension of the work to determine the extent which a problem might persist in a wider population*". He emphasised that in other cases companies have accepted the results as being "*sufficiently robust*" to undertake more extensive work and to accept the regulatory consequences.

183. Mr Chapman also gave evidence about the conclusions his firm had reached from the ESR.

184. Mr Williams summarised the conclusions of his firm's original work as we have set out above. He identified the differences in approach between his firm and PwC as arising from having been asked to address different issues and from the question of how much weight should be given to written and oral evidence. While they are no doubt very helpful in the context of the use to which these business reviews are usually put, it is not necessary for us to evaluate the merits of "conclusive evidence" or "persuasive evidence" tests as it is for us to apply the considerations we set out at the start of the Decision to the evidence put before us.

185. Mr Chapman of PwC and Mr Williams of KPMG produced a statement of what they agreed. Paragraph 12 records their agreement that their respective reports highlight that further work would be required before a conclusion could be reached on the issue of systemic mis-selling (however defined). The experts form this view for different reasons. PwC considers, in the absence of an analysis of a review of systems, that the initial sample size of 250 is too small reliably to aggregate and extrapolate across the wider population and that the ESR as conducted by them served as a "*dip test*" to provide an indication of the circumstances at the point of sale and as an indicator that further work was required. KPMG agreed and concluded that other factors such as training, monitoring, product literature, sales process and the Unit would need to be taken into account. Both parties considered in their different way that further work needed to be done. "*options include either, or a combination of both, of the following depending on the outcome .. • a review of relevant systems and controls as noted above; • an extension of the testing sample to (say) 2,000 to 3,000 cases*". These passages are helpful as a recognition by the accountants that the sample size is too small for such conclusions to be drawn but it does not follow from that that the sample size becomes valid once the further work (different in the case of the two firms) was carried out. The next paragraph states:-

> "*14. If the testing was to be extended, the methodology would take account of any learning points from the initial ESR. Both parties recognise the problems with both options and the difficulties of reaching a judgement without incurring significant cost, making significant assumptions and including caveats in the opinion, because of the difficulties of collecting unbiased evidence for the period 1997 to 1999. We agreed that firms like PwC or KPMG are qualified to undertake such assessments subject to defining a proper scope*."

186. This reinforces the frail standing of the ESR if it is used for any purpose other than the "dip test" identified by the two expert accountants. As FSA submits that we can and should extrapolate from our conclusions about the extent of mis-selling among the 60 to the "population" of FMP policyholders as a whole, we need to consider the evidence of Mr Rothman and Mr Worcester in more detail.

187. Mr Rothman, a Fellow of the Royal Statistical Society of high standing and with wide experience, considers that the survey methods were in principle reasonable, although not ideal. He had reservations about the three stages of the ESR, but

overall thought they were fit for the purpose of gathering information to determine whether customers who were risk-averse may have been sold unsuitable policies. The sample size was large enough to provide evidence about how widespread product mis-selling was in the overall population. The sampling procedure was random and avoided bias. He felt that the criticisms made by L&G and KPMG do not mean that the survey should not be used and overall he felt the survey was not unfair. He agreed that the survey was not well-designed and that he had a number of criticisms of it and, in his experience, it was unusual for conclusions to be formed by committee in the way PwC had done in this case.

188. In his witness statement Mr Rothman concludes at paragraph 95 "*that the sample size was large enough to provide evidence about how widespread any product mis-selling was in the overall population and to inform a decision on whether it was above the hypothetical benchmarks*". He points out that 250 was the minimum sample size required by PIA or FSA. Mr Rothman adds "*in my opinion the sample used was adequate to support some, but not all, of the possible desirable analyses. Consequently, leaving on one side constraints on resources, I would have preferred a larger sample. However though desirable these analyses are not essential*". He goes on to point out that marginal increases in sample size do little to improve accuracy but an increase from 250 to 500 or 1,000 questionnaires would be worthwhile. Mr Rothman repeated his view in cross-examination. It is also fair to point out that Mr Rothman, who seemed to us an admirably independent expert witness, said that in general the survey was not well designed and characterised it as "*certainly it is not the worst I have seen, and it is certainly not the best I've seen, it is not even as good as half of them, I am afraid, but it is better than a quarter, say*". FSA says that L&G did not produce an expert statistician to challenge Mr Rothman's work.

189. Professor Robert Worcester is chairman and founder of MORI (Market & Opinion Research International) and a visiting Professor of Government at the London School of Economics. He has over 40 years of direct and practical experience in designing and directing a wide range of market research studies both domestically and abroad. His overall conclusion was that there are flaws in the survey design and the context in which it was carried out sufficient to throw the results into doubt. He believes that the survey is likely to have yielded misleading and unreliable results. He identified four major types of flaw. First he criticised the design of what he saw as a conflation of two different types of investigation, a conventional representative survey and an investigation as to entitlement to redress. Secondly he felt that the lack of respondent anonymity may have significantly affected both the honesty of responses and the representativeness of those who chose to respond at all. Thirdly he felt there was a lack of clarity in the purpose of the survey. Some respondents were likely to have misunderstood its purpose, assuming it to be directly related to the running of their own policy rather than as a sample survey.

Fourthly, and most importantly for the purpose for which FSA seeks to use the ESR, Professor Worcester felt that the report and analysis were based on far too

small a sample size to use as reliable evidence. He considered that the minimum number of FMP respondents should be 600 and that there should also be control groups (each with a minimum size of 300) of L&G customers whose responses would help put the answers of the low risk group into a meaningful context. Professor Worcester identified four specific control groups: customers who had surrendered FMPs, medium risk and high risk endowment mortgage plan policy holders and customers taking out mortgage term assurance products. L&G had themselves wanted to include customers taking out repayment mortgages in the ESR. As he put it in his report "*Putting concerns about the reliability of memory and the passage of time aside, I would recommend a sample size of around 1,800 policyholders (i.e. more than 10 times greater), a far larger sample would be required to produce results which are considered to be reliable and on which conclusions can be based*". Professor Worcester and the two colleagues who assisted him have immense experience in this field and their perception of what is a valid sample size is not, as we see it, invalidated because they lack qualifications as statisticians.

190. FSA also relies on:

- Mr Chapman's evidence that in previous cases when an initial survey had been extended to a larger sample the results had been replicated.

- The fact that at one point in cross-examination Mrs Miller accepted that at the time the ESR was conducted L&G expressed no concerns about the sample size being too small for meaningful conclusions to be drawn.

191. Reliance upon Mr Chapman's anecdotal observation does not advance the position. Observations that L&G had the opportunity to conduct a wider sample survey should they have wished or that they could have proposed other changes seemed to us wide of the mark. It was not recognised at the time the survey was carried out that it would be the basis for conclusions that rules had been broken. L&G, who were paying for the exercise, no doubt wished to save money. The burden is upon FSA to prove its case and if it is the fact that the negotiated outcome of an agreed survey with 250 cases is too small a sample to be reliable, this is a problem for FSA not L&G. If FSA wished to use the ESR in a disciplinary case it was for FSA not L&G to control the process so that it was fair, effective and reasonably prompt. If L&G was not co-operating in securing a review which could be used effectively for enforcement, it was for FSA to impose a suitable exercise.

192. FSA has not convinced us that the sample size is statistically valid to extrapolate the results into the wider population of FMPs, for the purposes of a disciplinary case. The 250 cases were selected at random from a wide choice of FMP transactions excluding those entered into after October 1998. If there are significant numbers of mis-sales amongst the 60 then as a matter of common sense, there are likely to be more across the total population. But we do not think it right to express more confidence than that, given the frailties of extrapolating from the ESR. As recently as February 2004 FSA itself expressed reservations about the

reliability of survey evidence in a letter to a House of Commons Select Committee. FSA observed amongst other things:

"*... we know that consumers' perceptions of events perhaps 10, 15 or more years ago do not always provide a reliable indication of the extent of past mis-selling. For example, we know from cases referred to the Financial Ombudsman Service that there are many instances where a consumer believes they were mis-sold, but after careful independent review, the FOS concludes that in fact the consumer was made aware or ought reasonably to have been made aware of the risks, notwithstanding the consumer's current concern at the position they now find themselves in and their decision to allege mis-selling.*

Accordingly, we believe that survey research cannot be solely relied on to distinguish between those policyholders:

1. who would never have bought an endowment if they had known of the risks and understood them;

2. who did have, or should have had, a reasonable understanding of the risks and opportunities, but now regret the decision given the likelihood of shortfall on their policy; and

3. who have indeed been mis-sold."

193. Our reservations about the ESR are about its particular features not about the use of sales reviews in general. FSA has difficult and important work to do in the public interest. Companies engaged in financial services have to accept that enforcement, particularly in large scale matters, may involve approximation and what is at times a "wholesale" approach to investigating and establishing fault.

The 60 Cases

194. It is common ground that we need to examine each of the 13 cases about which we heard live evidence from at least one party to conclude whether or not there has been a contravention of Rule L8(1).

The 13 Cases about which we heard evidence from customers

195. In carrying out this exercise we have had copies of the following:

- PFR.
- Key Features Document.
- Personalised illustration.
- Completed past business review questionnaire.

- Transcripts of either one or two telephone interviews conducted as part of the ESR (3 witnesses had two interviews, one had none, the remainder had one. Those who had only one interview would not have had access to any documents during that discussion unless they happened to have had them to hand).

- Any information received from the L&G adviser about the sale.

- Witness statements.

- Live evidence from 13 customers (two by video link) and from four L&G advisers.

196. We do not accept FSA's submission that we should place weight on the judgments on each case reached by PwC in their report of 7th March 2003. PwC had less evidence than we have, made the assumptions we have referred to and properly qualified their view.

197. L&G suggest that FSA has been selective in its choice of the 13 customers to give evidence. FSA points out that they had no control over the 250 or the 60. The 13 customers were those available, willing and able to give evidence. FSA in turn suggests there are gaps in L&G's evidence. Both sides have obviously selected those witnesses who are willing to give evidence which they hope may help their case. We gain nothing from speculating why a particular selection was made or why other witnesses were not called.

198. FSA contends that the customers' evidence produces a variety of consistent themes.

- Lack of financial sophistication.

- Modest incomes and future earnings prospects.

- Caution about exposure of risk.

- Reliable recollections.

- Lack of understanding of the capital shortfall risk. Doubts about receipt of or advice concerning the KFD and personal illustration.

- Brief and mechanical nature of meetings with advisers, particularly where customers have previous mortgage endowments.

199. L&G also make general submissions about our approach to the customers' evidence. They remind us that FSA has the burden of proof. L&G make their own submissions about the patterns emerging from the customers' evidence. They submit that most customers were honest and straightforward but honesty should not be confused with accuracy.

- Recall of events five to seven years ago was poor.

- Hindsight and external factors such as changes in economic conditions will have had a significant effect.

- The evidence is generally consistent with advisers following established sales procedures and in every case, a properly dated personal illustration is held on L&G's files.

- Many customers had previously bought an endowment, were familiar with the process and had received earlier risk warnings from other companies.

- It does not appear that any customer was influenced by the wording of section 16 of the PFR when deciding which type of mortgage to choose.

- If there were individual mis-sales they were caused by advisers acting in breach of L&G's procedures, not as a result of the adviser following those procedures. They give as an example an adviser who fails to hand over and explain the KFD and is thus acting in breach of L&G's procedures.

200. It is against that background that we turn to the 13 individual cases and we set out our conclusions in summary form in Attachment I to this decision. This shows that eight transactions were mis-sales and four were not. The evidence on the thirteenth case was equivocal so this does not amount to a mis-sale. As the Attachment indicates the live evidence was important in all cases and was crucial to our Decision that 5 of the transactions were not mis-sales. Witnesses had a good recollection of their house purchase and mortgage transaction as a whole, unsurprisingly given that this was a most important step in their lives. Witnesses were well aware of the risk that they would lose their home if unable to keep up payments and of the risk that the payments would fluctuate with interest rates. This understanding was in contrast to the lack of perception or misperception of the capital shortfall risk.

The 47 Cases about which we heard no evidence

201. FSA submits that we can decide whether or not the other 47 transactions were mis-sales, even though we have heard no evidence from the customers, on the basis of the available written material. It says that the interview transcripts do not amount to cross-examination but they provide a greater degree of interrogation than where a witness statement alone stands as evidence and there is a good volume of material. FSA argues that the Tribunal does not need to decide whether or not the mis-sales would still have occurred but for the procedural deficiencies identified above. FSA says that in terms of "*causation*" we should consider whether the procedural deficiencies increase the risk that unsuitable recommendations will be made and whether the types of deficiencies which existed in procedures are part of the process which led to the mis-sales.

202. L&G dispute this. They say that it should not be necessary for the Tribunal to determine the 47 unless in FSA's case they succeed wholly or substantially in respect of the 13. If FSA's case fails on the best evidence available including live evidence on the 13 it could not succeed on the other 47. L&G argue that:

- The evidence is generally consistent with advisers carrying out the process properly.
- Memory of customers was very poor as both firms of accountants accepted.
- The role of the adviser in the mortgage was an incidental part of what was often a very significant transaction by which a customer bought a home. This will contribute to a lack of recollection on the more peripheral activity of selecting a repayment vehicle.
- The Tribunal has not seen the customers give evidence, only four of the 47 having produced witness statements. None of them have been asked to search for and produce relevant documents which may still exist.
- In the four cases where a witness statement has been served the Tribunal should be circumspect about accepting that statement as true in circumstances where the customers have decided not to give evidence.
- The interview transcripts are unsatisfactory particularly in those cases where there was one interview without the customer being shown any of the point of sale documentation.
- FSA stopped L&G from re-contacting customers to clarify potential ambiguities.
- Where an individual adviser fails to follow procedures that does not help FSA's case because FSA has to prove both that there was a mis-sale and also that it was caused by the alleged deficiency in L&G's procedures.

203. L&G correctly emphasised that examination of these cases is relevant only to alleged unsuitability on the grounds of attitude to the capital shortfall risk. "*Affordability*" or unsuitability on other grounds such as the endowment maturing beyond a customer's retirement age without explanation is irrelevant.

204. As Attachment II makes clear we have examined the materials as FSA has urged us to do. We have found that in view of the poor quality of much of the information gathered during the ESR and the fact that it has not been tested by live evidence or other means we are unable to reach firm conclusions on the question of mis-sales. The evidence, limited though it is in various respects, points to 14 potential mis-sales, with a further 24 cases being undetermined and 9 not mis-sales. Our conclusions are set out in more detail in Attachment II.

The Misselling Case – Conclusions

205. FSA's case to the Tribunal is that there were 60 mis-sales out of the 250 cases in the ESR and that this pattern can be taken as representative of sales of FMPs to low risk customers generally. We find that there were 8 mis-sales with potentially 14 more. We find 25 cases too unclear to decide. We find 4 cases not to be mis-sales with 9 more potentially in the same category. We do not consider that this pattern in the 60 can be taken as representative of sales to low risk customers generally. Common sense suggests that the defects in procedures will have caused mis-sales beyond the 8 established. Except to this limited extent the mis-selling case fails.

H THE DECISION OF THE RDC –THE FURTHER DECISION NOTICE

Should we consider the Decision of the RDC?

206. As this has been a fresh hearing of the issues put before the RDC, evaluation by us of that body's decision is in a sense irrelevant. L&G submit however that the Decision Notice should be reviewed by us. When we asked Mr Flint QC for L&G why we should do this he gave several reasons. First he said that the Tribunal might consider that a reasoned decision of the experienced regulator carries weight but that in his submission the decision of FSA was completely flawed and should be given no weight. As the Act required FSA to take a decision on proper evidence after full investigation, he would expect FSA to be in a position to defend its decision. Secondly he submitted that we should review the Decision in order to consider our power to award costs. Finally, he submitted that this Tribunal is the only check on the extensive powers of FSA. Against that there is no urging by FSA that we should not review the RDC's decision. It is not our role to make a detailed appraisal of the RDC's decision in the manner of a Court of Appeal. We should, however, express some views, so that it is clear why in certain respects we take a different view from the RDC. We recognise that our views are formed after the benefit of more than five weeks of evidence and submissions and that the RDC was in a very different position.

The Further Decision Notice ("The Notice")

207. The Notice must be read as a whole but we identify particular passages.

In its summary at 3.2(c), FSA concluded that "*the size and nature of L&G's business meant that these failures had the potential to expose a large but, as yet, unquantified number of consumers to loss. The FSA has concluded within a limited sample of 250 customers that the rate of mis-selling among the 152 respondents was 39%*".

208. At 3.16 the RDC referred to PwC's conclusion that "*there was persuasive evidence that they **were*** (L&G emphasis added) *risk averse and/or did not understand the capital shortfall risk associated with with-profits FMPs*". The paragraph goes on "*FSA has concluded that these customers **were*** (L&G emphasis added) *sold*

policies that were unsuitable for them and considers this to be a significant proportion of the customer's review". At 4.18 the RDC repeated PwC's conclusions and added "*the FSA has concluded that this evidence is substantiated*".

209. In 3.17 the RDC refers to L&G's refusal to accept PwC's conclusions and adds "*In all the circumstances, particularly the time that has already elapsed and L&G's approach to the question, the FSA has not considered an extension of the sample review to be a realistic proposition. It has, therefore, been obliged to rely on the sample review as being strongly indicative of the potential consequences of L&G's selling practices and has arrived at its conclusions accordingly*".

210. L&G criticise the editing of PwC's report in paragraphs 3.16, 3.18 and 4.25. PwC actually said *"there exists persuasive evidence for a judgment to be formed on whether the customer was risk adverse and/or did not understand the capital shortfall risk and* ***may*** (L&G emphasis) *therefore have been sold a policy that was not suitable for them"* and *"it is our opinion that there is persuasive evidence to indicate that the policyholders were risk adverse, and/or did not understand the capital shortfall risk and* ***may*** *(L&G emphasis) have been sold a policy that was unsuitable for them"*.

In answer to a specific question from L&G's Counsel about FSA's conclusion that the 60 customers were sold policies that were unsuitable for them, Mr Chapman replied *"it is not the PwC conclusion"*. Mr Chapman explained that *"the reason I have said may is because, as I have described throughout the report with the passage of time, with the difficulties of getting information from a sale where we were not present so we cannot understand the absolute dialogue between the adviser and the investor, I would not give an absolute opinion and say: these have been mis-sold"* and that the report had used *"deliberately worded language which tried to convey the balance of judgments."*. FSA has not sought to justify its references in the Decision Notice to the PwC Report which were worded in stronger terms than PwC itself adopted. If, as we assume it to be, this was an oversight it was unfortunate. It suggests a lack of accuracy and may have been part of what led the members of the RDC to conclude that the 60 sales were unsuitable.

211. L&G say that the RDC's conclusions are supported by no further evidence at all. FSA submits that in reaching this particular conclusion "*the RDC had the benefit of evidence in relation to the deficiencies in L&G's procedures*". As we see it there is no indication in the Decision Notice that, on the question of mis-selling, the RDC relied on anything other than PwC's report. Indeed there are indications that the report was the entirety upon which the RDC relied ("*FSA has concluded that this evidence is substantiated*" - 4.18). As FSA is obliged by Section 388 of the Act to give reasons for its decision it seems to us that the RDC would have referred to other evidence if it had had this in mind. The RDC appears to have found L&G guilty of mis-selling by adopting the PwC report which PwC readily accepts did not of itself establish guilt or claim to do so. This appears to have been a significant error.

212. L&G criticise the RDC for apparently presuming in 3.17 that the PwC sample was representative of all endowment sales to low risk customers because L&G rejected the PwC report, maintained that the ESR was unnecessary and did not accept that L&G's procedures were flawed. FSA then rejects doing an extension of the sample review as not being realistic in the circumstances and given L&G's approach to the *"question"*. We would not have taken FSA's position. It is for FSA to establish its case and produce the evidence it relies on. The existence of delays and what FSA may see as unreasonableness on the part of the party challenged are no doubt frustrating if not infuriating. They are not however a justification for reaching a conclusion that FSA is *"obliged"* to rely on evidence as being "strongly indicative" and arriving at its conclusions "accordingly". We see no such obligation. The issue should be - what is the evidence and what conclusions do we draw from it? If more evidence was needed FSA should have obtained it.

213. L&G also criticise the absence from the Decision Notice of any answer to L&G's submissions in its defence based on the risk warnings in the KFD and the personal illustrations. FSA replies that L&G's case had been made very clear on numerous occasions and in particular in the Investigation Report which it had disclosed to L&G to assist them to understand how FSA puts its case. We recognise that the RDC's Decision needs to be concise and to the point. The Decision Notice is not a judgment of a court and there are good reasons why it should not be. The RDC no doubt considered L&G's submissions and gave them careful consideration but there is no indication in the Decision Notice that they did. It is the experience of the courts, tribunals and many disciplinary bodies that it is useful for any judgment or decision to refer to the competing cases of the parties, if only in very brief terms. This has the benefit not only of reminding the tribunal of a party's submissions but also of later demonstrating to it that these were considered when decisions were taken.

214. In our view L&G were justified in feeling aggrieved by these aspects of the RDC's Decision. There are other criticisms by L&G of the RDC decision which seem to us to be immaterial or to relate to questions of a penalty. If these remain live we will deal with them at that point.

I CONCLUSION

215. There have been two limbs to the case brought by FSA. Our conclusions about the 'procedures case' are at paragraphs 153-154 above, and those about the 'mis-selling' case' are at paragraph 205 above.

216. We have concluded that L&G’s procedures failed to ensure that advisers had done enough to satisfy the requirement that customers understood and were prepared to take the risk that their low cost with-profit endowment policies might not produce sufficient investment returns to pay off their mortgages when they fell due for repayment. In particular the use of part of the Personal Financial Review form may well have inadvertently misled customers about the degree of risk of a low cost with-profits policy. The sample wording supplied to advisers for making

recommendations was inappropriate and its use was too widespread and indiscriminate. These rule breaches need to be seen in context. The text of the PFR form had been reviewed by L&G's regulator, PIA, without any adverse comment. The inappropriate use of sample wording had been identified and criticised by PIA in 1999, which had imposed remedial measures on L&G without classifying the matter as particularly serious.

217. These procedural defects will have caused or contributed to mis-sales. We do not however accept FSA's claims about the extent of mis-sales. FSA have proved 8 mis-sales to the required standard from the 13 cases about which we heard evidence. It would not be just for us to find any mis-sales in the other 47 cases for the reasons set out elsewhere. Although a sales review such as that relied on by FSA is a valid and acceptable tool in the vital work of identifying and proving regulatory breaches, the exercise in this case was flawed. We do not accept FSA's case that the conclusions of the sales review and our findings on individual cases can be taken to reflect the pattern of mis-sales generally. Common sense indicates that there will have been a fair number of mis-sales beyond the 8 that have been established. As we point out in our Decision our conclusions should not affect claims for compensation by customers which are dealt with on different principles to those we apply in a disciplinary case.

218. We have had much more time than the RDC to consider all the issues and have had the benefit of much more evidence than they had available to them. In our view the RDC was in error in its approach to the mis-selling case and reached conclusions not justified by the material before it.

219. The question of penalty will be dealt with at a further hearing but our provisional view is that there should be a reduction in the penalty imposed by FSA.

What happens next

220. It is our task, on determining a reference, to remit the matter to FSA with such directions as are appropriate for giving effect to our determination. We have as yet made a determination only about the question of liability, and the penalty remains to be decided. It therefore seems to us, subject to submissions otherwise from the parties, that we should now give directions for deciding penalty. We will welcome within 21 days of today the views of the parties about what those directions should be.

221. We also have the power to make recommendations as to FSA's regulating provisions or procedures under Section 133(8) of the Act. This is not a power which we will exercise unless at least one party urges us to do so and both parties then make submissions about what if any those recommendations should be.

13th January 2005

ATTACHMENT I

CONCLUSIONS ABOUT 13 ALLEGED MIS-SALES ABOUT WHICH WE HEARD EVIDENCE FROM CUSTOMERS

INTRODUCTION

1. 13 of the customers in the 60 cases identified as potential 'mis-sales' of low cost flexible mortgage plans ("FMPs") in the Endowment Sales Review by PricewaterhouseCoopers gave evidence to the Tribunal (two by videolink). They were different ages and had incomes generally around the national average. They included first-time home buyers, movers and individuals seeking finance for other purposes at the time of the sale. We believe they gave honest and straightforward evidence and tried to help the Tribunal. We are grateful for their assistance.

2. FSA has submitted that an FMP was recommended by an L&G adviser to each customer who
   a) was not prepared to take the risk of a capital shortfall *or*
   b) did not understand the risk of a capital shortfall

   and that this was the result of a breach of Rule L8(1) in that the adviser did not have regard to all the relevant circumstances and/or did not use his best endeavours to ensure that he recommended only a contract which was suited to that customer.

3. In coming to our own conclusion, we reviewed the following evidence:
   - Documentary evidence at the time of the sale (the PFR, KFD and personal illustration)
   - Any statement by the adviser submitted by L&G
   - The ESR questionnaire completed by the customer
   - Transcripts of the 1 or 2 telephone interviews
   - Witness statements
   - Oral evidence

   as well as the closing submissions of FSA and L&G.

4. We also heard evidence from three L&G advisers who had sold the FMPs to three of the customers. The advisers also tried to assist the Tribunal but they all said that they did not have good recall of the particular sales meetings.

5. We considered this evidence in the context of two questions:

   - Was the customer told of the risk of a capital shortfall by the L&G adviser and was that risk properly explained to him/her ?
   - Did the customer have an informed understanding and acceptance of the risk ?

We emphasise again that our conclusions apply a disciplinary burden and standard of proof and that a finding that there has not been a mis-sale is not an indication that the customer would not be entitled to redress.

CONCLUSION

6. We conclude that 8 of the 13 customers had been sold an FMP that was a mis-sale. This represented potential mis-sales of 62% in this group of customers. We conclude that 4 of the transactions were not mis-sales. We were not satisfied that the thirteenth transaction was a mis-sale.

7. The oral evidence was important in all cases and was critical in our deciding that 5 of the transactions were not mis-sales.

8. We summarise our findings and conclusions on each of the 13 customers below. (We have referred to each case by an initial because of the personal information that has been revealed).

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1. Mr C

PFR signed in December 1996 – 2 meetings

Personal and financial circumstances

Mr C was aged 33 and an aircraft engine fitter with a working wife. They had no children and had a joint monthly net income of £1,200 at the time the sale. Mr C's income has increased by over 30 per cent.

Mr & Mrs C had already had 2 endowments, one of which had been cashed in leaving an endowment of £13,000 from another provider that was then topped up with a £12,000 FMP from L&G. The endowments have subsequently been surrendered and replaced by a repayment mortgage. Mr & Mrs C are now separated.

Mr C had employee shares but was not an experienced investor.

Did L&G properly explain the capital shortfall risk ?

Mr & Mrs C had signed the PFR. Changes had been made to the PFR which L&G maintain suggests that they had read it carefully. However, Mr C in evidence stated that he was *"guilty possibly of signing a few things that I do not read in detail"*.

There were clear risk warnings on Section 20 of the PFR :

> *" Depending on what investment returns are achieved, the amount may be more or less than the amount of the mortgage; however, L&G will keep your plan under review and advise you if your premiums need to be increased"*

Mr C accepted that he had received the KFD with a personal illustration but admitted that he *"may not have read bits of it"*

Did the customer have an informed understanding and acceptance of the risk ?

Mr C had had an earlier endowment that he had cashed in *"for a couple of thousand"*. He had also experienced a period of high interest rates.

At the time of the sale, Mr & Mrs C had heard conflicting views about the risks of an endowment mortgage. Mr C's father had had an endowment that had paid out a surplus. Mrs C (in her witness statement) had said her brother had *"warned us not to take out an endowment as they don't pay off at the end"*. Mrs C was not called as a witness and Mr C, himself, did not recall this.

Mr C was already aware of the two types of mortgage but he maintained under cross-examination that he believed they were comparable in that both would pay off the mortgage at the end of the term and that the endowment was like an insurance policy.

Conclusion – **not a mis-sale**

We believe that it was more likely than not Mr C was told of the risks by the adviser and that Mr C understood those risks. There is some evidence that Mr C was price sensitive as he took 2 year discounted rate and he said that endowment was cheaper although "not by an awful lot". We do not have evidence of two comparative quotes from L&G. Mr C may not have perceived the risks to be as great in December 1996 as he did later.

2. Mr W

PFR signed in March 1998 – 1 meeting

Personal and financial circumstances

Mr W was aged 27 and was working as a Quality Systems Coordinator, now a Manager. He had a partner, who was a nanny, and no children. They had a joint monthly income of £1,400.

Both lived with their respective parents and were first time buyers together. They took out a mortgage of £33,000 which represented 79% of the purchase price.

Did L&G properly explain the capital shortfall risk ?

Mr W accepted that repayment and endowment mortgages were explained, although he also said *"I know we had a couple of options, but I thought they were all based on endowments "* and that he was "*guided towards an endowment policy"*.

Mr W says risk was not mentioned. He had a copy of the KFD and personal illustration but did not recall going through them *("just another document").* He did not have a copy of the PFR (which in any event contains sample wording only) or the cancellation letter. L&G rely on the fact that Mr W had a poor memory of receiving the documents that they assert would have been sent to him.

Did the customer have an informed understanding and acceptance of the risk ?

The evidence suggests that Mr W believed that the policy would pay the mortgage off and it was the surplus that would not be guaranteed *("there would be money at the end to pay the mortgage of, with an additional lump sum, which was not a guaranteed lump sum", "£33000 plus a variable amount").* Mr W had a monthly bank savings plan of £50 and he likened the FMP to a savings plan *("Money would grow like a savings plan")*

L&G submit that Mr W had a poor recollection of the meeting. They rely on the fact that Mr W stated "*its like a fund that in the end* <u>should</u> *pay the mortgage off*" in his written evidence and changed this to the mortgage *"would"* be paid off in his oral evidence to the Tribunal. L&G also drew the Tribunal's attention to the annotations on Mr W's complaint form, suggesting we infer influence by FSA which FSA disputes.

Conclusion **– a mis-sale**

We believe that the adviser did not take Mr W through the risks at the one meeting that was held. In our view Mr W did not understand the capital shortfall risk. He was a young first-time buyer, still living with his parents, and had little or no awareness of mortgages at the time of the sale. Although he had been introduced to L&G by a distant relative in the estate agency business, we accept that he quite reasonably chose not to ask for this person's comments after receiving recommendations from L&G's adviser.

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3. Mr G

PFR signed in February 1997 – 2 meetings (& 1 possible telephone meeting)

Personal and financial circumstances

Mr G was aged 36, married with 3 dependant children at the time of the sale. He was an engineering director and his wife was a lecturer. They had joint monthly net earnings of £3,300.

He had existing endowment mortgages of £108,000 with L&G and another provider. The 1997 endowment was for a top-up of £5,000 for an extension to his house. He has subsequently cashed in his endowment policies and now has a repayment mortgage (but for a significantly greater sum).

Did L&G properly explain the capital shortfall risk ?

Although the PFR contained sample wording in Section 11, repayment and endowment mortgages were both discussed.

Mr G accepted that he had the KFD and personal illustration at the February meeting. He stated that he was not taken through the KFD but was told to *"read that at your leisure"* and that he *"probably skipped through it very quickly"*. There is some evidence that the adviser discussed the personal illustration. The adviser *" explained that one should look back at previous years' growth and the 7.5 was the real number to look at because of previous performance and look at the upside, you need not worry about the lower side because it has never been down to that level"*. Section 20 of the PFR, however, contains sample wording only.

Did the customer have an informed understanding and acceptance of the risk ?

Mr G had a low cost endowment from another provider and a managed fund endowment from L&G in 1994. That PFR states "*all forms of repayment discussed … explained fully… that units can fall as well as rise. Clients like possibility of earlier redemption or possible cash surplus … asked me to complete forms for them*

which they read carefully before signing them". The fund performed "*in line with expectations*". Sections 11 and 20 in the 1997 PFR contained sample wording only.

In its closing submission, FSA submits both that Mr G did not properly understand the risk and that his attitude to risk had changed because of his wife's reaction to his being made redundant. FSA also submits that Mr G cancelled all his endowments when he became aware of the reality of the shortfall risk. However, the evidence showed that Mr G knew the endowment was an investment product that depended on investment performance and he *"discounted the risk following discussion with adviser"* in 1997. At the Tribunal, he testified to the fact that the potential shortfall illustrated was *"plain as a pikestaff"* as put to him by L&G's Counsel. Under cross examination, Mr G also testified to the fact that his period of redundancy was one or two months. The Tribunal is of the view that Mr G's decision to surrender his endowment policies and take out a larger repayment mortgage in 2001 was probably not a reflection of his not understanding the capital shortfall risk in 1997.

<u>Conclusion</u> – **not a mis-sale**

We believe the risks were explained to Mr G, although there is a possibility they may have been downplayed by the adviser. There is sufficient evidence to show that Mr G did understand, or should have understood, the risks. He was a financially experienced borrower who had had several mortgage-related meetings and this was a small top-up in relation to the value of his existing policies and the equity in his house.

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4. Mr B

PFR signed in October 1996 – 1 meeting

<u>Personal and financial circumstances</u>

Mr B was single, aged 25 and a process operator. He was buying his first home with his then partner, a nursery nurse. The £60,800 mortgage represented almost all of the purchase price. Their joint monthly income was £1,800, which is now lower as Mrs B has recently returned to work after having children.

<u>Did L&G properly explain the capital shortfall risk ?</u>

The evidence suggests that the adviser spent a similar amount of time on repayment and endowment mortgages and explaining the differences between them, although some of Mr B's evidence is contradictory and suggests there was a bias towards endowments. Section 11 of the PFR states *"clients are first time buyers. I have explained the advantages and disadvantages of repayment and*

interest-only mortgages. They want interest-only for flexibility and portability" although Mr B did not recall specifically discussing portability or flexibility or the disadvantages of an interest-only mortgage.

Mr B was provided a copy of the KFD by FSA. He had the PFR and his personal illustration amongst his own records. He remembered seeing projections and later getting the illustration by post and reading it. The PFR stated in Section 20 *"this plan is designed to pay off mortgage at the end of the term and depending on future investment returns a cash sum may also be paid at maturity"*.

<u>Did the customer have an informed understanding and acceptance of the risk ?</u>

Although Mr B understood that there was an investment product associated with the endowment, there was some evidence to suggest that he did not properly understand the risk and that he thought the future investment returns were related to the level of surplus: *("at the time we were told to invest more money and get a nice little nest egg after paying our mortgage off ").*

In oral evidence Mr B stated that he remembered the adviser talking about a growth rate being achieved of 8.5% over the previous year and that even if 5% were reached the mortgage would be still be paid off. Although Mr B paid extra premiums, the 5% projection would still have given a shortfall of over 18 per cent of the mortgage value at maturity.

Under cross examination, Mr B answered "*yes, pretty much, yes*" to Counsel's question that he had *"agreed to take out the endowment mortgage without actually having seen or read the documents"*.

<u>Conclusion</u> – **a mis-sale**

L&G submit that Mr B was made aware of the risks. FSA contends that he was never advised about the possibility of a shortfall and note the fact that Mr and Mrs B have subsequently converted their mortgage to a repayment. In our view this was a mis-sale. Mr B had one meeting (albeit of 1-1.5 hours) in the show home on the estate where he was buying a 3 bed property. He says that if he had been aware of the risks, he would have gone for a smaller repayment mortgage and purchased a starter home on the estate. He agreed to pay in £10 per month extra which would have had the effect of providing him with a larger 'cushion' against a shortfall. Mr B perceived the endowment as a "savings fund" and a way of obtaining a larger cash sum and paying off the mortgage earlier. There is a risk that, as a young buyer keen to acquire his first home, Mr B, himself, may not have been sufficiently questioning of the risks.

5. Ms C

PFR signed in March 1997 – 2 meetings

Personal and financial circumstances

> Ms C was aged 23 and was buying her first home with her future husband. Both were living with their respective parents. Ms C was a self employed beauty therapist and her partner was an HGV driver. Their net joint monthly income was £1,100 and likely to reduce as they had plans to start a family. The £40,000 mortgage represented over 90% of the purchase price of the property.

Did L&G properly explain the capital shortfall risk ?

> Ms C said that she viewed the cost comparisons between a repayment and endowment mortgage on the adviser's laptop. She remembered that the repayment mortgage was more expensive, but she did not recall discussing any other advantages and disadvantages of the two types of mortgage.
>
> She did not recall seeing the personal illustration or the KFD or receiving either of these documents or the PFR through the post. Both Sections 11 and 20 of the PFR contain sample wording only. However, risk was addressed at one of the meetings, which were held at her parents' home, as her father had asked the adviser *"are you sure this is sensible and that it will pay off mortgage?"* Ms C's evidence is that the adviser told her that *"there has never been a time when an endowment hasn't paid off a mortgage"*.

Did the customer have an informed understanding and acceptance of the risk ?

> Ms C's parents had had a problem with an endowment and her father was present for at least part of (one) meeting. In her evidence Ms C said she understood the low value of early surrender and that an endowment policy involved *"some sort of investment risk"* but she maintained that the adviser told her that there was no risk that the endowment would not cover the mortgage. She told the Tribunal *"he said 'you may not get any money at the end of it, but you could. He never actually said you may get a shortfall and, if you did, what money are you going to pay for this'"*

Conclusion – **a mis-sale**

L&G submit that, as Ms C could not recall discussing or receiving the documents, the Tribunal should not rely on her evidence. L&G also say that because of her father's questioning of the adviser, Ms C would have received the relevant risk information. The extent of the involvement of Ms C's father was unclear. In our view, Ms C was not properly told of the capital shortfall risk and we do not believe she understood the risk.

6. Ms D

PFR signed in April 1998 – 3 meetings

Personal and financial circumstances

Ms D was divorced with two dependant daughters aged 11 and 8. She worked as a radiographer in the NHS on a net monthly income of £1,700 but had outgoings that reduced her disposable net monthly income to £400. Ms D is still a radiographer with the NHS and FSA submitted that the nature of her job meant that her gross income was unlikely to show any significant increase.

She had two existing endowment mortgages with other providers of £35,000 and required a top-up of £11,000.

Did L&G properly explain the capital shortfall risk ?

Ms D said that the adviser did not go into the difference between repayment and endowment mortgages *("we may have touched on repayment mortgages but it was not discussed in any depth, only in passing")* and that she was encouraged to take out an endowment *("as I already had two endowment policies, I was advised that it would be easier for me to take out a further endowment policy…. ").*

Ms D recalls seeing the personal illustration including the lower projection that was less than the mortgage value. In her written and oral evidence, Ms D said that the impression given was that you could ignore the lower figure and that she did not remember any specific warnings being given to her. *(" not to worry about the low rate, it would perform well and it should meet your mortgage requirements to pay off …")* . The PFR contained sample wording only.

She said that she assumed the routine reviews were a means of L&G trying to sell their customers another product.

Mr Glendenning, the adviser who sold Ms D the FMP, gave evidence to the Tribunal. He said that he did not remember the meetings with Ms D particularly well, but recalled that she was moving home and was due to exchange contracts within a defined timescale. He gave evidence about how he would undertake a sale *("I can only go on what I did as a practice with every client. …. I had set procedures with clients to make sure everything was discussed with them").* He said he would have given Ms D the Mortgage Guide (at the first meeting) and explained the different types of mortgage and the contents of the KFD and illustration. He said he would have asked Ms D questions about endowments to make sure she understood his explanations and that he would never have told a customer to ignore the lower projections in the illustration. Mr Glendenning signed the PFR the day after Ms D and accepted that he had written the

recommendation in Section 20 (which only contained sample wording) after the meeting. He had joined L&G, as a qualified adviser, two months before meeting Ms D.

Did the customer have an informed understanding and acceptance of the risk ?

In Ms D's written evidence, she had stated that *"if I thought there was a risk... a chance that the mortgage amount at the end of the term wouldn't be covered, I don't think I would have looked at it.."* (i.e. an endowment mortgage)

Ms D accepted at the Tribunal that an earlier endowment (from another provider) had made it clear that an endowment did not provide a guarantee of repaying the mortgage on maturity. She also accepted under cross-examination that she "*knew endowments depend on future investment performance"* although she did not know where and how the funds were invested. She accepted that she understood there was a risk of a capital shortfall but that *"it was a very small risk as I understood it"* and that she *"didn't absorb it at the time"*. She said that *"hindsight is a wonderful thing"*.

Conclusion – **not a mis-sale**

L&G rely on the evidence of their adviser, Mr Glendenning, about the way he would carry out a sale, although he had no recollection of the particular sale to Ms D. In considering Ms D's evidence, we found there was some inconsistency of memory between the interviews, the witness statement and oral testimony as well as there being a possible influence of hindsight. We believe the risks were explained to Ms D. There is a possibility that they may have been downplayed or that Ms D, herself, did not question the shortfall risk sufficiently critically. In our view, Ms D understood, or should have understood, the risks.

7. Mr M

PFR signed in March 1998 – 1 meeting

Personal and financial circumstances

Mr M was 41, an Information Systems Manager and he had a working wife who was a project manager. They had a joint net monthly income of £2,900.

They had three existing endowments totalling £53,000 (of which one was with L&G and taken out in 1996) and were looking for an additional £33,000. They had significant other debts that were not explored at the Tribunal. Mr & Mrs M

have now surrendered their endowments, moved to another part of the country and run a small business.

Did L&G properly explain the capital shortfall risk ?

Mr M had already arranged an endowment mortgage with a mortgage provider by the time of his single meeting with L&G's adviser in 1998. Mr M admitted at the Tribunal that he was wanting to draw the meeting *"to a close as quickly as possible"*.

He was sent the PFR after the meeting. It contained sample wording only. Although signed by both Mr M and his wife, the PFR contained errors, which suggests that Mr M did not read it *("would have just filed it")*. Mr M stated that the risks of the endowment and the review process were not discussed and that the adviser *"never pointed out there could be a shortfall, not verbally*". Mr M recalled receiving a copy of the KFD in 1996 but not in 1998. He did not have a copy of the personal illustration but under cross-examination accepted that the adviser went through an illustration with him in 1998.

The Tribunal heard evidence from L&G's adviser, Mr David Allen, who would have been introduced to Mr M by the mortgage provider. He said he could not remember the meeting with Mr M in detail *"as there was nothing distinctive about the facts"*. Mr Allen said that the errors on the PFR would have arisen because he was not given the correct or full information by Mr M, but he accepted that he may not have asked the questions about Mr and Mrs M's personal and financial circumstances in a direct way. In evidence Mr Allen said that he would have gone through a KFD and a personal illustration on a lap-top with Mr M.

Did the customer have an informed understanding and acceptance of the risk ?

Mr M was an experienced borrower: he had surrendered an L&G endowment in 1996 to make up part of the negative equity he had suffered from a house purchase in 1988 and had experienced high interest rates. Mr M was well able to read and absorb technical information. Mr M understood the investment markets as he had worked for Datastream for a time and he made a reference to "Black Monday". He was also an experienced investor, specifically while at Datastream *("some of us dabbled")*. He told the Tribunal that he was aware of the fall in the investment markets and its impact, but that he expected L&G to make up the shortfall in the endowment value because of *" poor investment decisions by staff*".

Conclusion – **not a mis-sale**

L&G submit that Mr M was not a low risk investor and was aware of the capital shortfall risk. In its closing submission, FSA does not accept that Mr M was prepared to take a risk with his mortgage because he took risks with his investments. There is no evidence that the risks were explained to Mr M in the meeting, but it may be difficult for an adviser to follow procedures if a client wants to cut short a meeting. We believe that there is

sufficient evidence to conclude that Mr M understood the capital shortfall risk so that this sale is not a mis-sale.

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8. Mr H

PFR signed in August 1997 – 1 meeting

Personal and financial circumstances

> Mr H was aged 39, separated and an after-sales manager at franchised car dealer. He had a net monthly income of £2,100. He was seeking an additional £10,500 to top up to a total mortgage of £74,000 on a house purchase.
>
> Mr H took out his first endowment in 1984, had a second endowment in 1996 and third endowment with L&G in 1997. He then had a fourth endowment with another provider in 1999.

Did L&G properly explain the capital shortfall risk ?

> At the Tribunal, Mr H said that he did not have a copy of the personal illustration or PFR but recalled receiving the KFD after the sale. He recalled two projection rates that it would not have been appropriate for L&G to use in August 1997.

Conclusion **– not proven to be a mis-sale**

The Tribunal accepted L&G's submission that while Mr H had tried to assist the Tribunal, his memory of events was imperfect. Mr H had taken out three endowments within a short space of time and as only one was with L&G, we decided that we could not be sufficiently confident that he had not confused meetings in his mind. It was not clear that Mr H had especially and correctly recalled the meeting with the L&G adviser in 1997. Mr H said that that the adviser had drawn two diagrams and produced handwritten projections of two rates of growth but this was not verified at the Hearing as neither party pursued it.

We, therefore, feel we are unable to come to any conclusion about whether Mr H had been told of, or understood, the risks when taking out the L&G endowment in 1997 for the purposes of deciding whether this was a potential mis-sale.

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9. Mrs E

PFR signed in August 1997 – 3 meetings

Personal and financial circumstances

Mr & Mrs E were both aged 37 and had three dependant children. Mr E was a deputy shift manager and Mrs E was a clerical assistant in the NHS, but is now a buyer. They had a joint net monthly income £1,700. Their growth in earnings has been limited.

They had two existing endowments with other providers of £38,000 and were seeking an additional £31,500 to fund a house move.

Did L&G properly explain the capital shortfall risk ?

Mrs E's recollection of the meetings was that they were *"definitely steered towards an endowment"*. She had no recall of any discussion about *"the alternatives of whether we could cash in the endowment and take out a repayment, or any options like that*". A top-up on a repayment basis *"was certainly never mentioned, that I remember"* .

Risk was discussed, although Mrs E does not recall going through personal illustration with the adviser. In oral evidence Mrs E said that projections were handwritten and that *"they were always enough to pay the mortgage"*. She also said that she saw no documents at the meeting and was sure everything was posted to her. The adviser had *"scribbled lots of things on his notepad"*. Mrs E admitted that she had not fully read the KFD.

Did the customer have an informed understanding and acceptance of the risk ?

Mrs E had some understanding of the investment nature of the repayment vehicle: *"we knew you had like an insurance policy and that at the end of that you cashed that in to pay off the mortgage"* and that there were differing levels of risk associated with it: *"understood if prepared to take a higher level of risk.. .. possibility of higher returns but there was also the possibility that the capital sum would not be repaid. We chose the low risk option in the belief that it would definitely repay the capital sum and there might be a little extra if the policy performed well"*. Her father had benefited from a bonus on top of the mortgage value.

Mrs E also stated that, although they knew there was a variable, they had *"stressed that we did not want to take any kind of risk… that we wanted it to just pay off the mortgage.."*. They thought that 7.5% was the minimum return they could get but Mrs E accepted at the Hearing that she had no recall of what the adviser had actually said.

Conclusion – **a mis-sale**

Mr & Mrs E had had three meetings with the adviser of up to hour each in length, although their attention was distracted at times by childcare responsibilities. The number and length of meetings might suggest that the sales procedures were being properly followed. The evidence of L&G's staff witnesses led us to believe that all advisers were using L&G's computer systems and printed outputs. We believe Mrs E when she says that she was shown handwritten illustrations so that we cannot be confident that the proper sales procedures were being followed. Although Mrs E showed some understanding of the product features (and she herself admits she may have been influenced by hindsight), it is our view that she did not properly understand the capital shortfall risk she had taken on.

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10. Mr T

PFR signed in March 1997 – 4 meetings

Personal and financial circumstances

> Mr T was aged 51 and a sales manager. His wife (57) was a sales demonstrator and not in good health. They had grown up children. They had a joint net monthly income of £1,500, but a disposable income of just under £550 per month.
>
> Mr T had an existing endowment of £35,000 that was taken out with another provider in 1993. The 14 year endowment in March 1997 was for £6,800 and he took out another endowment with L&G for £6,500 in June 1998. The latter endowment was invested in the managed fund. Both of these endowments were to assist Mr T to re-organise his existing debts and to reduce his monthly cost.

Did L&G properly explain the capital shortfall risk ?

> Mr T recalls seeing projections with different growth rates but could not recall the risks of the policy being specifically discussed. He stated that he *"did not understand that that if it grew at the lowest rate there was a risk that my policy might not meet its target"*. He also remembered seeing the KFD but did not recall when he received it, or reading or discussing it. The PFR contains sample wording only.

Did the customer have an informed understanding and acceptance of the risk ?

> Mr T's evidence suggests that he had no real understanding of the risk *("all I understood was that it was going to be invested in some way…. cash surplus appealed")*. The adviser *"never mentioned anything about a shortfall or that my monthly premiums might have to increase … never discussed how I might make up*

any shortfall and certainly did not enquire about any salary increases or inheritance ... to meet such a problem".

Mr T also states that *"we were told that the endowment payments were less per month than a repayment mortgage and the endowment payments would pay the mortgage off at the end of the term. We would not have opted for an endowment if we had been aware of the risks involved"*

Conclusion – **a mis-sale**

Although Mr T had four meetings in 1997, we do not believe that Mr T had the risks explained to him or that he understood them. In 1997 (and in 1998) Mr T was partly re-financing existing credit card borrowings and taking out a 14 year endowment (which therefore matured when he was 65) to reduce his monthly outgoings. While we accept that he wanted to re-finance these debts as cheaply as possible, it does not seem likely to us that he would have chosen a low cost endowment to do so if he had understood the risks of a potential capital shortfall.

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11. Mr L

PFR signed in July 1997 – 1 meeting

Personal and financial circumstances

Mr L was aged 26, a postman and a first time buyer purchasing his parent's house. He had a net monthly income £950. His earnings potential as a postman would be limited.

He was seeking a mortgage of £30,500, which represented 95% of the purchase price.

Did L&G properly explain the capital shortfall risk ?

In his oral evidence to the Tribunal (by videolink), Mr L said that the one meeting he had had with the L&G adviser had lasted about 20 minutes. He gave conflicting evidence about whether the adviser had discussed a repayment mortgage as well as an endowment.

He says he was given the KFD at the meeting, but *"we didn't go through document at all and I wasn't even aware that it contained information to read as I thought it was just a folder to put all my papers into".* He accepted that he was handed a personal illustration but said the projections were not mentioned at the meeting. However, the adviser made a number of manuscript comments on the illustration,

which suggests that it was used in some context at the meeting. The PFR Section 20 contained sample wording that Mr L said he did not understand then or now.

Did the customer have an informed understanding and acceptance of the risk ?

Mr L told the Tribunal that his parents had recommended an endowment. There is, however, no evidence that he understood the product: *"I understood you paid your money into an endowment so that the mortgage would be paid off. But how it worked was all a bit over my head"*.

There is also no evidence that he understood the capital shortfall risk: *"I think she said I might get back more than what I paid in. I can't recall whether she said that the endowment would pay less.... I didn't really understand it but I thought that what I paid in would cover the loan"*.

Conclusion – **a mis-sale**

L&G submit that Mr L had no clear recollection of the meeting and that he has since taken out another low cost endowment to cover the projected shortfall, which they maintain is inconsistent with Mr L being classed as risk averse. FSA argues that this has no relevance to the question of whether the 1997 sale was suitable. Mr L was a young, financially unsophisticated first-time buyer who knew little about mortgages. We agree with FSA that if the meeting was as short as Mr L remembers it to be, it is unlikely that the adviser would have had the time to explain the risks and ensure that they were properly understood by Mr L. We consider that this was a mis-sale.

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12. Mr S

PFR signed in January 1998 – 1 meeting

Personal and financial circumstances

Mr S was aged 35 and a car production line worker. His wife was a housewife and he had two dependant children. Net monthly income was £1,200. The nature of Mr S's job means that his earnings potential is limited. His wife now works full time in a school kitchen.

Mr & Mrs S had two existing endowments of £27,800 from the same provider and they were seeking an additional mortgage of £21,300 from L&G in order to move home.

Did L&G properly explain the capital shortfall risk ?

The mortgage provider had originally suggested a top-up to their existing endowments and there is no evidence to show that the L&G adviser discussed the option of a repayment mortgage with Mr S. Mr S did not recall being given or receiving a KFD, the personal illustration or the signed copy of the PFR. He stated that the (sample) wording in Section 20 *"went right over"* his head.

Did the customer have an informed understanding and acceptance of the risk ?

Mr S was keen to complete the paperwork: *"just so desperate to get the house"* . *"I was happy that we could afford this and asked "where do I sign"* . He told the Tribunal that the meeting took 10 to 15 minutes.

There is no evidence that Mr S understood the risk: *"my recollection is that we were shown the (PFR) form and asked to pick the option that was applicable. We chose low risk and I thought this meant that there wasn't any risk. The risk as I understood it was if I didn't keep up with my repayments then I would risk losing the house. I don't take risks with money matters." "I was led to believe that at the end of the mortgage term it would be paid off, boomph, done".*

Conclusion – **a mis-sale**

If, as we accept, the meeting was as short as Mr S remembers, it is unlikely, as FSA submits, that the adviser would have been able to obtain all the information, discuss the options and ascertain Mr S's attitude to risk and to ensure that the risks had been properly understood in 10 to 15 minutes. The adviser would not have been assisted in such a task as Mr S was keen to complete the paperwork in order not to lose the new house. We consider that the sale to Mr S is a mis-sale.

13. Mr R

PFR signed in May 1997 – 2 meetings

Personal and financial circumstances

Mr R was aged 41, a joinery manager, and had Crohn's disease. His wife was an auxiliary nurse and they had three dependant children. Their joint net monthly income was £1,800 but this included a relatively significant element of overtime.

Mr & Mrs R had an existing endowment of £44,000 and sought an additional £24,000.

Did L&G properly explain the capital shortfall risk ?

Mr R had discussed his mortgage with the mortgage provider before meeting the L&G adviser. He did not recall the L&G adviser discussing the two types of mortgage. *("we have since found out that we could have done any number of things, but nothing else was offered. We were led to believe we had to have an endowment"),* although Mrs R's recollection was different when she completed the ESR questionnaire.

The PFR was signed by both Mr & Mrs R and the data protection box had been ticked. However, the PFR contained errors including the number of children Mr & Mrs R had. *"I recall that he completed details about our personal circumstances and the figures sections. We then signed the form and Mr Little said he would then complete the rest of the form later. In particular I do not believe that Mr Little completed the written comments in Section 6, 11 and 20 in front of us"*

Mr R did not recall seeing or going through the KFD at the meeting although he accepted that he received a copy. He had no recall of the personal illustration, which was dated prior to the meeting.

Mr Little, the L&G adviser, who sold the FMP to Mr & Mrs R gave evidence to the Tribunal. He remembered them. He could not recall how much of the PFR he filled in over the phone but said that he completed Sections 6, 11 and 20 in Mr & Mrs R's presence before they signed it. He believed the reason for the errors on the form were because he had been given that information by Mr & Mrs R. Mr Little accepted that Section 20 contained only sample wording and that the PFR *"does not tell the full story of the sale"*.

Did the customer have an informed understanding and acceptance of the risk ?

There is no evidence to suggest that Mr & Mrs R appreciated the risk they were taking on. Mr R accepted at the Hearing that he was told *"bonuses needed to reach the capital sum"*, which suggests that there was some discussion of the repayment vehicle. In his witness statement, Mr R says *"Mr Little told us that the monies that we paid into the policy would be moved around in the stock market so we would never end up with a shortfall. There was a mention that we might not achieve a lump sum at the end of the period, but there would always have been sufficient to meet the capital sum"*.

Conclusion – **a mis-sale**

L&G submit that Mr R's memory of the sales meeting was shown to be poor at the Tribunal. There is also no transcript of the telephone interview that followed up the ESR (as nothing could be transcribed from the conversation that took place). However, the Tribunal had the benefit of a witness statement from Mrs R. We believe that L&G had not properly explained the risks of a capital shortfall to Mr & Mrs R and that Mr & Mrs R did

not have an informed understanding of the risk in May 1997 when they took out the endowment. In our view this was a mis-sale.

ATTACHMENT II: DECISIONS ON THE 47 ALLEGED MIS-SELLING CASES

1. We have considered whether or not each case is a mis-sale by reference to the material provided to us. This comprised the PFR, supporting personal illustration and Key Features Document, ESR questionnaire, transcript of the one or more follow up telephone interviews, and the analyses provided by FSA and L&G. The individual and general testimony of L&G advisers has also been taken into account, although this evidence suggests that in every case the L&G procedures were followed to the letter. Based on the live testimonies from L&G customers, we do not believe this is likely to have been the case consistently.

2. The ESR interviews were of variable quality. There were numerous examples of leading questions and comments (albeit not consistently pointing in one direction). There was inadequate testing of the customer's understanding and follow up of important points that arose during the conversation. The absence of a precise script meant that in some cases little information was gathered, particularly about what the customer remembered the adviser had told them about the features of the FMP and the capital shortfall risk. We therefore consider that we cannot place too much weight on this evidence. We would expect questionnaires and interviews to be of a far higher consistency and quality if they are to be relied on in making a substantive decision.

3. Some clients only had one telephone interview and thus did not have the benefit of being sent copies of their PFR and other documentation to assist memory recall. For two cases no transcript was provided and we have decided that in those cases no decision can be made in view of the lack of evidence. Even where interview transcripts have been provided we have felt it necessary to exercise great caution in determining whether it was a mis-sale. This is because there was no opportunity for cross-examination and challenge of the customer's assertions. By contrast, in the 13 cases we heard, the cross-examination of the witnesses sometimes tended to provide doubt about whether or not a mis-sale had taken place. Indeed in about one-third of those cases we would have determined a mis-sale based on the documentary evidence alone, but we changed our minds after hearing live evidence. It follows that our conclusions in at least some of the 47 might well have been different if we had heard live testimony.

4. In four cases we have witness statements for customers which have not been tested by L&G. Thus we have treated this evidence with caution.

5. For these reasons we have not come to a firm conclusion on any of the 47 cases, but have shown why we consider the evidence points to a potential mis-sale, or is in fact indeterminate because of lack of evidence or conflicting

evidence. The evidence points to there being 14 potential mis-sales, with 24 undetermined and 9 not mis-sales.

6. In five cases sales interviews took place in 1996, even though the policy did not commence until on or after 1 January 1997, the start of the Relevant Period. Neither FSA nor L&G place any weight on this fact, but we noticed that, in relation to completion of PFRs, the practice before and after 1 January 1997 appears to be different.

7. None of the transactions presented to us were based on interviews after 1 October 1998, even though this case concerns sales completed between 1 January 1997 and 31 December 1999. We were thus not able to consider whether the quality of the standard and individually tailored wording used in the PFRs improved in the last fifteen months of the Relevant Period. This could have been an important consideration since L&G issued instructions on this matter in CNBs and training courses, particularly after April 1998. In the nine cases completed from April 1998 onwards, no discernible change of wording on the PFR is apparent. The fact that no cases relate to the period after October 1998 is very surprising.

8. We re-emphasise that our analyses apply a disciplinary burden and standard of proof, and a finding that there has not been a mis-sale is not an indication that a customer is not entitled to compensation.

9. As with the 13 cases, we looked carefully at the evidence for all 47 cases and produced a detailed analysis for each one. In the interest of brevity and in view of the limited degree of confidence that we have in the untested evidence we consider it would serve no useful purpose if we reproduced that detailed analysis here. Instead, we provide brief summaries highlighting the main points influencing our decisions. The summaries may be read in conjunction with the detailed arguments provided by FSA and L&G.

THE 43 CLIENTS WITHOUT WITNESS STATEMENTS:

Customer	Date of PFR	Evidence of potential mis-sale?	Comments
B1	9/96	No	The client accepted the risk, which was not underplayed and in fact had been specifically spelt out on the PFR. The policy had been discussed with the client's family, and the client had some knowledge from an earlier policy
H1	11/96	No	Again the risk was explicitly stated on the PFR. There is evidence of confused memory regarding growth rates, suggesting the customer muddled discussion at the interview with the later review letters. The adviser was remembered as being 'very thorough'. Any misunderstanding was likely to be as a result of the preoccupation with the customer's then current divorce proceedings rather than the adviser's actions.
J1	6/96	No	Again there is wording on the PFR that specifies the risk. There is also specific wording justifying a low start policy and an extended term, suggesting thorough attention to detail by the adviser. The clients also say they would have taken out the policy anyway. We believe they may have downplayed the risk in their own minds.
P	12/96	Indeterminate	The wording on the PFR again specifies the risk, although the writing was difficult to read. The client remembers being told that the policy 'should more than happily meet [6%]', compared to current bonus rate of 9%. (The memory of 6% is possibly indicative of confusion with later review letters, as 6% was not a growth rate relevant to this case.) If the figure quoted was in fact 5%, which we consider more likely, this may have been a reasonable assumption at the time, but could still be construed as underplaying the risk. The customers were unable to get L&G to respond to all their queries at the time. More evidence is needed to determine whether or not this was a mis-sale.
B2	11/96	No	There is balanced PFR wording. The client seems to accept that the risks could have been explained and accepted at the time. There are also five earlier policies, so some knowledge is apparent, and there must be potential confusion about what was explained at the time of this particular sale.
Y	1/97	Yes	This is the first of the cases with poor standard wording on the PFR. There is evidence of the adviser underplaying the risk. The policy was probably not affordable either.

K1	3/97	Indeterminate	The PFR wording states that the premium has been increased to increase the likelihood of surplus, which implies downplay of risk. Nevertheless, the client accepts that risks were explained and that no guarantees were given. However, this was possibly done in an unbalanced manner, on the lines of: "won't say guaranteed, but more or less said, you know that it will pay for your mortgage at the end … and you will get a lump sum". Further examination would be required before determining if this was a mis-sale.
K2	4/97	Yes	The PFR indicates that the term has been chosen to reduce costs. The evidence points clearly to the adviser underplaying the shortfall risk.
W1	4/97	Indeterminate	There is no transcript to assist, so no decision has been made.
O1	3/97	No	There is no evidence of underplay of the risk by the adviser. Rather, the client's own positive experience of such investments meant that the risks were not fully appreciated.
F	5/97	Yes	The reason why the policy was extended into retirement was given in the PFR. However, the client appears to have been financially naïve and there is persuasive evidence that the risks were understated.
J2 & O2	6/97	Indeterminate	The client remembers a drawing being used by the adviser to explain how the policy worked, indicating the adviser was diligent. There was no guarantee given, although possibly in such a way as to underplay the significance of the shortfall risk. "The potential risk was made clear, but we were assured, repeatedly, that the risk of shortfall was very low and were given the impression, orally that endowment providers more or less guarantee a payout". The issue was discussed with a friend at the time, and the clients recall that "[the possibility of shortfall] wasn't considered to be an issue at the time". The client says he would have been willing to take the risk anyway. This case is on the margin and we would require further examination before reaching a decision.
M1	3/97	Yes	This was a poor follow up interview by L&G, with no evidence other than that the client did not understand the risk. "I can't remember because I was so upside down I took what – the cheapest I could afford at the time." There was only one sales meeting and the case seems not to have been affordable. The customer was concerned with covering the risk of illness, and was led to believe (erroneously we think) that this was only possible with an endowment. To reduce costs, the policy was taken out for 25 years, extending well into retirement. This was not justified on the PFR. On balance, it is unlikely that the adviser made sufficient efforts to

			spell out the risks and justify the contract's suitability.
J3	4/97	Indeterminate	There is not enough evidence to decide this case. The sale included discussion of the client's sister's bad endowment, but the adviser said the review procedure overcame this. There is confusion about whether the client would have accepted the risk had she fully understood it.
C	5/97	Yes	This was another poor follow up interview, but we are satisfied that the client was told that the mortgage would definitely be paid off.
M2	7/97	Indeterminate	Client was told 'It's a risky scenario, it might not be'. The client had existing policies, and her father had had a good experience, albeit it appears with a full endowment policy. The client believes she would have taken out the policy anyway if she had understood that the shortfall risk had not been strong. This case is marginal as there is doubt about whether or not the client underplayed the risk in her own mind ("I didn't think it would ever not pay off my mortgage …. I knew the worst case scenario there'd be nothing, but I never had doubts about it paying off my mortgage …. but I thought the best side of things"), or as a result of what the adviser said. This was not picked up by the interviewer. More examination would be needed to determine that.
M3	8/97	Indeterminate	The low start reasoning was spelled out on the PFR. There were two meetings with this young first time buyer couple. There should have been enough time to explain the risks but "showed growth, nothing was shown to us which …. would come to such a shortfall." As L&G's submission says, "so few questions were asked of the customer and little information was obtained from them during the ESR". Further examination would be needed to reach a conclusion.
D1	8/97	Indeterminate	The client presumed the mortgage would be repaid but knew it was not guaranteed. "Hopefully will be invested to pay off the mortgage". There is relatively poor recall by the customer (who cannot remember the personal illustration or any other documents), and thus no persuasive evidence that the risk was or was not sufficiently well explained to be understood. Further examination would be needed to determine if this was a mis-sale.
A1	10/97	Yes	The evidence suggests there was a very short sales interview, in which event it was unlikely that the risks could have been adequately explained or understood. The client remembers being told that 'risk that it doesn't always…..but will [repay]'. This indicates a downplaying of the risk.
J4	7/97	No	Friends of the clients had good results with endowments, and the clients themselves laughed

			at the likelihood of the proceeds not being enough to pay off the mortgage. Any underplay of the risks was therefore as likely as not to come from the clients' own experience rather than the adviser's actions.
B3	10/97	Indeterminate	In this case the Section 20 wording was expanded specifically to show that the extra £10 per month was to help alleviate the shortfall risk and increase prospect of a surplus. However, the client appears adamant that the sum assured was guaranteed and that it is only the surplus that is variable. In view of the contradictory evidence we are not prepared to make a decision in this case without further examination.
M4	10/97	Indeterminate	When telephoned, the client could not even remember completing the ESR questionnaire a few weeks earlier, so that puts in doubt any memory of the sale itself. There was evidence that the clients had been involved in the completion of the PFR, that a computer was used as part of the process, and that the proceeds were not said to be guaranteed. This indicates that the standard selling process may well have been followed. However, the customer's memory may well have been jogged if he had been able to see the documents involved in the case, something that was not possible as only one telephone interview took place. There is not enough evidence either way.
W2	6/97	Indeterminate	There was very little evidence either way in this case either. Again, only one telephone interview took place and this tells us little except "I just liked listening to her really and just said yes" and "I thought if we paid the endowment off we would have some money at the end of it". This tells us nothing about what the adviser actually said, and we would need more examination to make a decision.
M5	10/97	No	The PFR specifically stated that the extra contribution was to reduce the risk of shortfall. The client is also confused between other policies and another adviser seen with this particular case. The client did not remember the extra premium being paid until this was pointed out at the second ESR interview. There is no evidence of underplay of the risk.
K3	11/97	Yes	In contrast to the previous case, here the PFR wording states only that the additional premium is to provide surplus, thus underplaying the shortfall risk. On balance we believe that this was a mis-sale although there was some confusion in the client's evidence.
A2 & S1	10/97	Indeterminate	The PFR has some wording to show why extra protection was included. There is some evidence of a discussion of risk and growth options, but the client's memory seemed vague. There is a possibility that the risk was downplayed, but the evidence is not conclusive.

W3	10/97	Indeterminate	There is confusion here in the client's recollection, which is affected by another policy being taken out only a few months before. The client recalls being told of the risk and of offering to pay more to reduce it, but the adviser said there was no need (thus downplaying the risk). On balance we believe there is not enough evidence either way.
B4	1/98	Indeterminate	The PFR mentions the relatively short 14 year term is to coincide with the maturity of another policy (with which there was a positive client experience). There is some evidence that the risk was downplayed, but not enough to reach a conclusion.
T1	11/97	Indeterminate	In this case the client remembers being told of the risk, but this was possibly downplayed. There is some evidence of knowledge of how with profit policies work, and that some measure of risk was suitable for the client (since the risk category for an earlier policy was medium). On balance, however, we do not believe there is enough evidence either way to make a decision.
D2	2/98	Indeterminate	The PFR explains why the term was chosen. There is confusing evidence in that it appears that the husband completed the ESR questionnaire (saying he knew that the payout was not guaranteed and that there was a premium review process) but the telephone interviews were with the wife. There is some indication that the risk was downplayed, but the clients may not have been prepared to listen. On balance we again do not believe there is enough evidence to make a judgement.
H2	1/98	Yes	The client signed the PFR showing why a low start contract was to be used. The wife filled in the questionnaire, whilst the husband answered the phone. It was obvious to us that there was not an understanding of the shortfall risk. We were also influenced by the fact that existing policies were cancelled as part of this sale, something that does not often form part of a good sale..
D3	1/98	Indeterminate	There is little evidence one way or the other from the transcript, and there was only one telephone interview. There is some evidence of knowledge after the event, but equally it is clear that the risk was not understood. We would need further examination before making a decision.
S2	4/98	No	It seems clear that no guarantees were alluded to, and that the risk of shortfall was mentioned (but possibly downplayed). Documents were provided at the point of sale, and the review process was mentioned. There was plenty of opportunity for the customer to understand the risks. Previous investments included a PEP, so the customer was not totally risk averse.

E1	4/98	Indeterminate	The client's wife made all the financial decisions, but as she has since died there is no way of checking understanding with her. The PFR makes reference to the fact that the clients 'like the workings of' their existing endowment mortgage. The client remembers being told there was no guarantee, and that proceeds could be higher or lower than the mortgage. "I did know, but I didn't really understand". Since we unfortunately do not have evidence from the acknowledged decision maker in the case, we have preferred to leave it undetermined.
J5	6/98	Yes	There is an existing policy with a medium attitude to risk. The transcript is confusing, since one partner answered the questionnaire, the other the follow up telephone conversation, and there was no memory of the adviser. Nevertheless there was no memory at all about any discussion on risk or shortfall, and on balance we are inclined to the view that this was a mis-sale.
E2 (nee T2)	7/98	Yes	This policy had a very short term of ten years, to tie up with an existing policy. This was not explained on the PFR. The client has no understanding at all about endowments, risk and so on, despite saying she had knowledge of finance. This demonstrates a lack of explanation and/or testing of understanding by the adviser.
A3	5/98	Yes	There were three older policies for the client, which in some other cases has caused confusion in relation to what was said and learned during and as a result of each particular sale. However, here we are persuaded by the evidence that the risks for this policy being downplayed by the adviser because of the 13% returns received in the past.
R1	6/98	Indeterminate	There is some evidence here that the adviser explained how endowments worked, but there was no recollection of risk or shortfall being discussed. The personal illustration, which includes the three growth rate assumptions, has been signed by the client, so we can reasonably assume that the different assumptions were actually spelt out during the sale. However, the customer's understanding of the risks is far from complete ("we were left with the impression that it would produce what was left to pay it off") and with there only having been one sales meeting to explain the sale it is unclear where the balance of probabilities lies without further examination.
W4	8/98	Indeterminate	No transcript was available to us, so we have been unable to reach a conclusion on the merits of this case.
M6	7/98	Yes	Comprehensive advice appears to have been given on pensions as well as the mortgage, but it is not clear why the client's existing policy is not being continued. The client remembers

			being told that he would make £20,000 on this policy, but that figure does not appear anywhere in the written documentation. It would appear that it was an example of overstressing the potential benefits.
E3 & I	9/98	No	The client realised that there were no guarantees and that the proceeds could fall below the mortgage amount. It appears that it was the client's personal view that a growth rate as low as 5% was unlikely. The client has other policies and appears confused on what growth rates were illustrated. It appears to us that the correct sales process was followed.
S3	7/98	Indeterminate	The client was aware of the potential shortfall risk but that risk was downplayed by the adviser ('in my eyes it is pretty safe' and 'he can't see them be in a problem'). However there seems much confusion in the transcript so on balance we do not believe there is enough evidence to support the case for a mis-sale without further examination.
M7	10/98	Indeterminate	There were various other policies and PEPs for the client. The term was only 14 years to tie in with one of them. The client is adamant that there was no discussion regarding the shortfall risk, not only in this case, but also for the similar policy taken out two years earlier with another company, which we find surprising. The clients' concern with death and illness cover suggests they may have been risk averse. However, on balance, we do not think there is enough evidence to support the case for a mis-sale without further examination.

THE 4 CLIENTS WITH WITNESS STATEMENTS:

B5	9/98	Yes	We believe the client, a young first time buyer, remembered being told the mortgage was guaranteed to be paid off. It appears that the risks were underplayed and thus not properly explained or understood.
H3	6/97	Yes	There was no transcript here as the case had already been settled. However, we find that the witness statement is sufficient on its own to show that there was an underplay of the risks, even after a telephone call was made to the adviser by the customer about the risk once the personal illustration had been received.
M8	3/98	Indeterminate	There were earlier policies which were surrendered, apparently against the adviser's advice. The client was purchasing a property in haste after a marital separation, and the fact that he did not understand the contract ('over my head') may have been in spite of good sales

			procedures being followed. It appears that the wife had taken the financial decisions. The witness statement is rather more polished in its recollection of events than the ESR telephone conversation had been. On balance, we do not believe there is enough evidence one way or the other without further examination.
R2	2/97	Indeterminate	The clients were young and do not appear to have an understanding of the risks. However, there is evidence of the adviser having a speech impediment. The client therefore is unclear about what was explained but not understood, as compared to what was not explained at all. We are therefore inclined to the view that there is not enough evidence either way in this case without further examination.