



Welcome to the May edition of our Hindsight publication.

In April, Quinn Insurance was placed into administration by the Irish Regulator and was forced to cease writing UK business, including IFA professional indemnity insurance, which the Regulator assessed to be unprofitable. The problems appear to relate to guarantees given by the Insurance Group to other Quinn companies, although the Regulator has stated that his concerns are not limited to this.

Collegiate offers an insurance policy that is backed by Lloyds Syndicate 4444 managed by Canopus. This has a financial rating of A+.

In this edition of Hindsight we have looked at the taxation of investment bonds, unregulated collective investment schemes, investment switches and a review of recent ombudsman decisions. These include FOS comments on the importance of considering clients' experience and wealth when making a suitable recommendation, Lehman brothers backed investments and time limits.

The articles have been produced in collaboration with Mark Gibbon, Managing Director and Martin Archer, Legal Director.

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

If you have any comments on the content, or suggestions for future issues, please write to us or e-mail us at newsletter@collegiate.co.uk



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Investment Bonds

Our January 2009 edition of Hindsight included an article on the taxation of investment bonds. We also met with a number of life offices to highlight the tax problems that can be caused by partial withdrawals. Everyone in the industry was aghast that this could still be happening given the amount of literature that supported how these products worked. Unfortunately this does not appear to have got through to everyone and we have recently seen a small number of complaints where the client has received an unexpected surprise in the form of a tax bill. Fortunately, it would appear that the largest problem has

been averted due to the speedy action of the Collegiate claims handling team.

We had a situation where a client had had an investment bond for three years when they decided to start making withdrawals. For the first withdrawal the IFA contacted the life office and asked how this could be taken from the bond. The amount was under the 5% cumulative allowance, so the IFA was advised that this could be taken as a partial surrender across all the investment bonds held. A month later a further withdrawal was requested. This time it would appear no advice was taken, but





the same procedure as for the first withdrawal was followed. A further five withdrawals were taken prior to the anniversary date of the bond and more were taken after this date. The life office issued a chargeable event certificate showing taxable income based on the excess level of withdrawals over the cumulative 5% allowance. Fortunately the client immediately showed this to their accountant who explained the tax implications. The client complained. The extra tax due on all the withdrawals was in the hundreds of thousands of pounds!

We reviewed this and identified that, if the bond could be surrendered prior to the end of the tax year, then the insurance year would not end on the anniversary date, but would end on the date the bond was fully surrendered. The effect of this would be to calculate the gain on the bond by reference to all the withdrawals made compared to the initial cost of acquisition. A new chargeable event certificate would be issued by the life office and the previous one based on the anniversary date could be ignored. As no overall gain had been made there was no tax to pay saving the original bill of hundreds of thousands of pounds!

As an example, if the original policy inceptioned on 1 May 2009 then the insurance years would run from 1 May to 30 April. The first insurance year would end on 30 April 2010 and any

chargeable event certificate would be dated 30 April 2010 and any income would be taxed as part of tax year 2010/2011. However if the bond was surrendered on 31 March 2011 then the insurance year would be extended to 31 March 2011 and would run from 1 May 2009 to 31 March 2011. A chargeable event certificate would be issued and any income would be taxed as part of tax year 2010/2011. This is because the original anniversary date and the full surrender date fall in the same tax year. This is explained in the HMRC manual section IPTM3505 Chargeable events: calculating gains: 'insurance year'.

It was this rule that gave us the window of opportunity to ensure the client was advised to surrender the investment bond and correct the tax problem caused by taking withdrawals as partial surrenders.

We know that certain life offices have tightened up their internal procedures, but it would appear this is not universal. What we do not understand is why, when life offices issue chargeable event certificates caused by excess withdrawals over the 5% allowance, they do not clearly explain the alternatives available to the client that could help mitigate any tax liability. After all the life office know the value of the bond and whether any gain is due overall, or this tax is just caused by the way the excess income charge is calculated.

Unregulated Collective Investment Schemes

We are often approached by our insureds for views on collective investment schemes ('CIS'). Recently these have included bridging loans, student accommodation, timber and carbon trading. Our view is probably jaundiced by what we do for a living and a healthy degree of scepticism about anything that looks too good to be true.

To comment on an unregulated scheme we think it is helpful to first understand what the requirements are for a regulated scheme. The regulatory status of a 'CIS' can be one of

- UK regulated by FSA
- Overseas regulated recognised by FSA and passported in for promotion in UK
- Overseas regulated not passported in
- Not regulated by anyone

There are three levels of regulation, European, HM Government and FSA. The FSA rules are contained in the 'COLL' section of the handbook.

These rules look at

- Assets
- Liquidity
- Valuation
- Spread/concentration
- Segregation of duties

The assets that a regulated 'CIS' can invest in are transferrable securities, money market investments, derivatives and forwards, deposits and units in other 'CIS'.

The rules on liquidity state that the liquidity of any investment must not compromise the ability of the fund manager to comply with his obligation to redeem units.

The rules on concentration include no more than 20% deposits with one body, no more than 5% in transferrable securities and money market instruments with one issuer, no more

than 20% in transferrable securities and money market instruments within one group, no more than 5% OTC derivative exposure to one counterparty or 10% where the counterparty is an approved bank.

A regulated 'CIS' has to follow rules splitting out the roles between the manager of the fund and the depositary. A depositary must be an authorised person under public control with sufficient financial and professional guarantees. They are responsible for safekeeping assets, collection of income, ensuring sales, cancellations and redemptions are in line with law and rules of the scheme and oversight of the fund manager. The fund manager must be an authorised person and is responsible for management of the scheme in accordance with rules and regulations and making decisions as to the constituents of scheme property to achieve the investment objectives of the scheme.

When a scheme is not regulated it is worth establishing which FSA rules do not apply and

ascertaining what additional risk this involves. When we are asked to look at these schemes we look for:

- What happens when the clients wants to get their funds out of the scheme. How is the value of the investment going to be calculated and who is going to buy it? Will that person be in a position to do it when the time comes? How will the scheme cope if many clients want to exit at the same time?
- Who are you giving your money to and what safeguards are in place? Is the investment in an unquoted company under the control

of a small management team and if so what protection is offered against the clients investment.

- How does this investment fit in the clients overall portfolio? Usually there will be no spread of investment within the scheme which is invested in one asset type. This may be appropriate for a small part of a portfolio but is unlikely to be suitable for anything else. Lack of diversification is one of the problems we continually see with claims.

If an IFA considers these products are a useful tool in any client portfolio, they should carry out

careful due diligence on the scheme that is being proposed, prior to advising any client to invest. A sensible starting point for any Reason Why letter would be to deal with the issues that have been identified as necessary for any regulated 'CIS':-

- Liquidity
- Safekeeping of assets
- Investment spread
- Exit route

You should have confidence in the parties involved and in particular the likelihood of them being around if things go wrong.

Investment Switches

In 2009 we suffered losses due to the failure of IFAs to act upon client instructions to invest in cash rather than equities. In some cases these losses were compounded by the failure to review the transactions post investment in a period when stock markets fell considerably. There is little or no defence to these claims if clear instructions have been provided by the client as to how the money should be invested and an error has been made.

This year we have seen claims going the other way. Clients were invested in cash but decided it was time to switch to equities and instructed their IFA. These instructions were not implemented and the failure to invest was not picked up until much later. During the period markets rose and by the time the

error was discovered, substantial losses had occurred.

Although there were procedures in place to check that switches took place, they were not followed.

One of the problems we identified with these situations, was that only one person was involved in processing the investment switch. Had two people been involved, one to process the switch and one to ensure that it had taken place, then the chance of any error being detected at an earlier stage would have been greatly enhanced. Systems should not be reliant on one person doing it properly. Obviously the smaller the IFA then the harder it is to have a segregation of duties but even then a process that ensures transactions are checked is essential.



Recent cases

Experienced? Wealthy?

We have recently lost some cases at FOS with similar characteristics.

- 100% investment in commercial property fund
- Cautious investors looking for a better return than a deposit account
- Inexperienced investor
- Easy access to funds required

The following comments were made by FOS

'A professional adviser's role is not as simplistic as assessing an investors' attitude to investment risk and then placing the available funds in that area. I believe that the responsibility to give advice extends to making sure that, even if the recommended product matched her attitude to risk, the overall portfolio of investments was well balanced and appropriate to her general circumstances'

'I do not believe that the advice to invest a large proportion of her savings in one fund led to the creation of a well balanced investment portfolio that met her needs and requirements'

'Although it is reasonable to suppose consumers read all the literature given to them, I would not consider it fair to believe that because they have read it, they have a good understanding of financial investments. His previous investment experience had been with profit funds and fixed rate bonds'

This can be contrasted against an FOS decision we won. Here the client was wealthy, had experience of previous high risk investments and did not require any income from the investment. The client had complained about some investment advice which had exposed him to 'medium' risk. FOS considered that the client was aware of the increased level of risk going from with profits to investments with significant equity content and dismissed the complaint.

FOS also dismissed a complaint where capital was exposed to risk that the client said they were not willing to accept. FOS stated they must take account of the evidence provided, circumstances at the time of sale and whether the risk associated with the policy was one that the client would have been willing to accept at the time of sale. FOS found that the complainant's circumstances did allow him to accept a degree of risk, risk warnings were highlighted in clear and understandable terms and the client had some understanding of the fact that investments could go down as well as up, as some market based investments were held at the time of sale. FOS dismissed the complaint stating that they believed it stemmed, in part, from investment performance and poor performance itself will not normally be regarded as a valid complaint because of the subjective nature of investment management and investment selection.



Lehman Brothers

Another wealthy client with previous investment experience over a number of years invested in a Lehman backed product. The client complained that they were not aware they could lose all their capital through counterparty risk. The IFA had stated in his advice letter 'as with all contracts of this type the benefits payable under the plan and indeed the ultimate return of capital are dependent on the ability of the behind the scenes issuer to meet their obligations, which for this plan, the issuer has been rated A+ by leading research agency Standard & Poor'. There were also statements about this in the policy literature. FOS decided this gave sufficient warning regarding counterparty risk. They said 'The advice was prior to the downgrading of Lehman Brothers by Standard & Poor on 2 June 2008. Even then I do not consider it widely expected that there was a significant likelihood that Lehman Brothers would fail.'

FOS did consider that the IFA had a responsibility for independently checking the strength of the counterparty. The client had been given clear warnings regarding the risk and the impact it could have on the return of capital. They dismissed the complaint.



Time limits

The Ombudsman cannot consider a complaint if the complainant refers it to FOS:

- (1) more than six months after the date on which the respondent sent the complainant its final response; or
- (2) more than:
 - (a) six years after the event complained of ; or (if later)
 - (b) three years from the date on which the complainant became aware (or ought reasonably to have become aware) that he had cause for complaint;

unless the complainant referred the complaint to the respondent or to the Ombudsman within that period and has written acknowledgement or some other record of the complaint having been received; unless:

- (3) in the view of the Ombudsman, the failure to comply with the time limits was as a result of exceptional circumstances

This case concerned the transfer of pension rights from an occupational pension scheme in 2001, to take the tax free lump sum and put the balance in income drawdown. The client then moved to another IFA firm when following his adviser. He complained about the product to the adviser who advised him that any complaint would be against the previous firm. In 2004 the adviser looked at the issues and advised the client that it would be difficult to prove that he had received incomplete or misleading information.

FOS found that the client had clearly stated that he was aware that he had cause for concern about the advice he had received and, although he did not complain to the original firm that gave the advice until he changed financial adviser in 2009, this was outside of the time limits laid down. Further, there were no exceptional circumstances that could be considered.

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