The Society of Actuaries in Ireland
Endowment and Other Investment Mortgages

Preamble

The Council of the Society of Actuaries in Ireland has approved the issue of this Position Statement. It is intended as a general expression of the views of the profession on an important topical issue. It is however neither formal guidance nor a definitive expression of the position of the profession as a whole. In particular, it is not intended as individual/specific advice to members of the public, who should take advice as appropriate in the light of their particular circumstances.

Introduction

The sale of endowment mortgages declined rapidly in the early to mid 1990s following significant adverse publicity. However, in recent years, sales of endowment and other investment-backed mortgages, in particular pension mortgages, have begun to increase. The growth in sales of pension mortgages has arisen due to the major changes in pension legislation introduced in recent Finance Acts. The change in the basis of taxation for life assurance business in 2001 may lead to an increase in the sales of endowment mortgages.

This paper sets out the Society's position on whether the sale of such mortgages represents good advice.

In 1999, the Institute and Faculty of Actuaries in the UK set up a Working Party to consider this issue. The report of the Working Party was published in November 1999. The Society's position agrees with the conclusions of this report.

What is an investment mortgage?

All mortgages work on the basis of repaying both interest and capital. Under the repayment method (also known as an annuity mortgage), a customer repays both interest and part of the capital to the lender on an ongoing basis. Under an endowment or investment-backed mortgage, a customer pays interest to the lender but (until maturity) no capital. This means that the loan amount stays constant. The customer also pays a regular amount into an investment oriented life assurance policy or pension plan. This policy aims to build up a fund, which will be sufficient to pay off the mortgage at the end of the term based on certain investment assumptions.

Position of the Society of Actuaries in Ireland

The position of the Society is:

- The repayment method is the lowest risk method of repaying a mortgage.

- An investment-based method should be offered as an alternative only if there is a clear expectation that it will be better.

- Many mortgages do not remain in-force for the full term. When comparing repayment and investment-backed mortgages consideration should be given to the early redemption position.

- A customer's individual financial circumstances should be taken into account when assessing which method is better. A customer's individual attitude to risk is also relevant.

In practice, shorter-term endowment mortgages are unlikely to provide good value. Competitive longer-term endowments may offer good value. Pension mortgages can offer good value. However, as the primary aim of a pension is to provide an income at retirement the amount paid into any pension plan for the purposes of a pension mortgage should be in addition to, not instead of, any payments into a pension plan to secure retirement income.

For an endowment, pension mortgage or other investment-backed mortgage to represent good advice, it must represent good value *and* it must be appropriate to the customer's financial circumstances and attitude to risk.

The repayment method is the lowest risk method of repaying a mortgage.

Under any mortgage arrangement, there is a risk that the customer may not be able to keep up repayments. Under variable interest mortgages these repayments may fluctuate. Under investment-backed mortgages (such as endowments) there is an additional risk that the capital may not be repaid in full at the end of the mortgage term.

An investment-based method should be offered as an alternative only if there is a clear expectation that it will be better.

There must be a reasonable likelihood, based on long-term financial assumptions, that the customer will be better off than with a repayment mortgage.

The expected rate of return under the endowment or investment policy, after tax and charges, should exceed the after-tax cost of borrowing under the mortgage by a margin sufficient to compensate the customer for the higher level of risk inherent in the endowment or investment mortgage.

This can be tested by comparing the total monthly payment under each alternative. The cost of the endowment or investment policy should be based on a projection where there is no surplus or deficit when the policy matures. This means that the after-tax investment return on the endowment or investment plan must exceed the after-tax interest cost under the mortgage by an amount sufficient to cover the charges on the endowment or investment plan.

The comparison should be based on a consistent set of long-term economic assumptions, i.e. based on a long-term mortgage interest rate assumption and investment growth rates consistent with this interest rate. Comparisons should be done on a range of scenarios.

The Society recommends that individual companies should carry out these comparisons. Based on work carried out by the Working Party of the Institute and Faculty of Actuaries in the UK, it is possible to make some broad statements.

- Shorter-term endowment mortgages (i.e. 10 years and possibly 15 years) are unlikely to provide good value.
- Competitive longer-term endowments may offer good value. Less competitive plans do not.
- Pension mortgages can provide good value due to the tax benefits available. However, the primary aim of a pension is to provide an income at retirement. It is therefore very important that, before putting a pension mortgage in place, customers already have pension arrangements that will provide for their retirement needs.

Many mortgages do not remain in-force for the full term. When comparing repayment and investment backed mortgages consideration should be given to the early redemption position.

Different customers will place different relative importance on the early redemption values compared to the full term position. If the early redemption position is significantly worse than under the repayment method, the overall justification for the endowment or investment-backed mortgage is questionable even if it is better at maturity.

A customer's individual financial circumstances should be taken into account when assessing which method is better. A customer's individual attitude to risk is also relevant.

An endowment or investment-backed mortgage will normally involve higher monthly payments than a repayment mortgage. Consideration should be given to whether these additional payments could be better utilised by the customer elsewhere. For example a customer with high levels of unsecured personal debt at high interest rates (e.g. credit card balances) would be better off minimising the mortgage payments and reducing the unsecured debts.

A customer's tax position may also impact on the relative costs of an investment-backed mortgage versus a repayment mortgage. For example, a customer who purchased an investment property prior to 23 April 1998 will be able to offset the interest charged on the loan against rental income. An investor who purchased a property after that date will not be able to do so.

Some customers may accept the higher risk associated with an investment-backed mortgage in return for a potentially higher reward. Customers must be clearly shown the downside associated with the endowment, pension or other investment-backed mortgage. Promotional material should include warnings and comparisons that can be understood by the ordinary non-financially-sophisticated customer.

Recommendations

The Society believes that endowment, pension and other investment-backed mortgages should be sold only where there is a clear expectation that they will be better than repayment mortgages.

The Society therefore recommends that:

- Product providers should review the terms of their contracts to ensure that this is the case.

- All sales material should clearly show the risks attached to investment-backed mortgages. The downside risk and the lower risk alternative options should also be highlighted. If the product is suitable only for particular types of customers, this should be clearly stated in all promotional material.

- Product providers cannot be aware of all customers' individual circumstances. Their review should be based on the 'average' customer. If the product is suitable only in certain restricted circumstances, companies should target only these customers and should put in place procedures to ensure that the product is not sold inappropriately.

- Given the inherent risks associated with investment-backed mortgages, companies should put in place controls to manage these risks. In particular, ongoing customer communication and regular reviews are recommended.

- Advisors should recommend endowment, pension and other investment-backed mortgages only where there is a clear expectation that they will be better than repayment mortgages. Advisors should take into account their customers' specific financial circumstances and their attitude to risk.

26 November 2000