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## FINAL NOTICE

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To: Abbey Life Assurance Company Limited (“Abbey Life”)  
Of: 100 Holdenhurst Road  
Bournemouth  
BH8 8L  
Date: 2 December 2002

**TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS (“ the FSA”) gives you final notice about a requirement to pay a financial penalty:**

### **1. THE PENALTY**

- 1.1 The FSA gave you a decision notice on 7 November 2002 which notified you that, pursuant to Section 206 of the Financial Services and Markets Act 2000 (“the Act”), the FSA had decided to impose a financial penalty on you in the amount of £1 million.
- 1.2 You have agreed not to refer the matter to the Financial Services and Markets Tribunal. Accordingly, for the reasons set out below, the FSA imposes a financial penalty on you in the amount of £1 million “(the Penalty)”.

### **2. REASONS FOR THE PENALTY**

- 2.1 For the reasons set out below the FSA is imposing, pursuant to Section 206 of the Act, the Penalty, on Abbey Life in respect of breaches of PIA Rules 5.1.1, 7.1.2, 7.1.5, 7.2.1, Adopted LAUTRO Rule L3.15(3)(b) and Paragraph L8 of Schedule L2 to the Adopted LAUTRO Rules and SIB Principles 2 and 9.

### **3. RELEVANT STATUTORY PROVISIONS AND REGULATORY RULES**

- 3.1 Section 206 of the Act provides:

*“If the Authority considers that an authorised person has contravened a requirement imposed on him by or under this Act, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate”.*

3.2 The Financial Services and Markets Act 2000 (Transitional Provisions and Savings) (Civil Remedies, Discipline, Criminal Offences etc) (No 2) Order 2001 provides, at Article 8(2), that the power conferred by Section 206 FSMA can be exercised by the FSA in respect of a failure by a firm to comply with any of the provisions specified in Rule 1.3.1(6) of the PIA Rules as if the firm had contravened a requirement imposed by the Act.

3.3 PIA Rule 1.3.1(6) provides that a PIA Member which fails to comply with PIA Rule 1.3.1(2) or any of the SIB Principles is liable to disciplinary action.

3.4 The SIB Principles are universal statements of standards expected by regulated firms. These were issued by the Securities and Investment Board (“SIB”) and applied to PIA members.

3.5 PIA Rule 1.3.1(2) provides that a PIA Member must obey the Rules of PIA.

3.6 PIA Rule 7.1.2(1) provides:

*“A Member must establish procedures..... 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”.*

3.7 Paragraph L8(1) of Schedule L2 of the Code of the Adopted LAUTRO Rules provides:

*“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, to any rights he may have under an occupational pension scheme or the State earnings-related pension scheme, (if such rights are relevant in the particular case) 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.”*

3.8 Adopted LAUTRO Rule L3.15 provides:

“ (1) ..... where a company representative recommends an investor—

(a) to buy a life policy .....

*the Member shall ensure that the investor is sent or given a written explanation which satisfies the requirements of paragraph (3) below.*

(3) *A written explanation given to an investor in compliance with this Rule must— .....*

(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”.*

3.9 PIA Rule 7.2.1 provides:

“(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 ...*

3.10 PIA Rule 7.1.5 provides:

“(1) *A Member must establish and maintain a system of internal control appropriate to the size and type of its business.”*

3.11 PIA Rule 5.1.1 provides:

“(1) *A Member must*

(a) *keep records which are sufficient to show at any time that it has complied with the requirements of the Rule Book, and*

(b) *establish procedures and controls to ensure that those records are made promptly and accurately and, where appropriate, brought up-to-date at regular and frequent intervals.*

(2) *In particular (but without limiting the generality of (1) above) a Member must keep records of the matters specified in column 1 of Table 5 below and include in them the details specified in column 2 of that Table.”*

3.12 Table 5 in Chapter 5 of the PIA Rules includes the following relevant provisions:

## II. Customers

“(c) *[For private customers], sufficient details of the information he has been willing to provide about his personal and financial circumstances, investments and other assets, investment objectives and attitude to risk to provide evidence that recommendations made to him or deals on his behalf are suitable...*”

## III. Transactions

(c) *(where the transaction was arranged or effected for the customer as a result of investment advice given by or on behalf of the Member) sufficient information to show that the transaction was suitable for the investor and, if a transaction in a packaged product, ... (if the Member is a product provider or marketing associate) that the product was as advantageous to the customer as any in the product range of the Member or its marketing group”.*

3.13 SIB Principle 2 provides:

*“A firm must act with due care, skill and diligence.”*

3.14 SIB Principle 9 provides:

*“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”.*

## 4. REASONS FOR PROPOSED ACTION

### Summary

4.1 The FSA is imposing a financial penalty on Abbey Life in respect of breaches of the PIA Rules, the Adopted LAUTRO Rules and the SIB Principles arising from:

- (a) deficiencies identified in Abbey Life’s compliance procedures and controls from 1995 to 1999. These deficiencies included the maintenance of inadequate records, inadequate communication of recommendations to customers and weaknesses in Abbey Life’s monitoring and supervision of its advisers. Abbey Life failed to take adequate steps to correct these deficiencies within a reasonable period, indicating serious weaknesses in Abbey Life’s internal controls.
- (b) its sale of mortgage endowments. In particular, Abbey Life failed to establish adequate procedures in relation to the sale of the mortgage endowments so as to ensure that these were only recommended where they were suitable for the customers concerned. This resulted in the widespread misselling of mortgage

endowments by Abbey Life's advisers.

4.2 Abbey Life's breaches are particularly serious due to the following factors:

- Its failings occurred over a period of at least five years and extended across its business generally. Serious deficiencies in Abbey Life's Sales Verification Department, which was responsible for verifying sales and, therefore, for monitoring Abbey Life's advisers, were identified in three consecutive visits by PIA's Supervision Department in 1995, 1997 and 1999. Similar deficiencies were also identified by Lloyds TSB Group Compliance in 1997 and 1999. Abbey Life failed to take adequate steps to resolve the issues identified in a timely and effective fashion.
- Over the same period weaknesses were also identified by PIA and Group Compliance in the standard of Abbey Life's records and the standard of its Reason Why letters. Concerns were also identified, in a limited number of cases, in respect of the suitability of recommendations made. Abbey Life failed to take sufficient steps to resolve these weaknesses which persisted from 1995 to 1999.
- Specifically, there was a systemic failure in Abbey Life's procedures relating to the sale of mortgage endowments. Abbey Life's procedures failed to ensure that recommendations to purchase mortgage endowments were made only to customers who had an appropriate attitude to risk. As a result Abbey's advisers made widespread unsuitable recommendations of mortgage endowments to retail consumers. A mortgage is, for most people, one of the most significant financial transactions of their lives. Misselling of mortgage endowments can therefore, have the most serious consequences.
- The size and nature of Abbey Life (which had over 1,500 advisers) meant that these failures exposed a large number of consumers to potential loss.

4.3 The failings in this case merit a very significant financial penalty. However, in deciding the amount of the penalty to be imposed, the FSA has recognised that these failings have been substantially mitigated by the extensive and proactive remedial action undertaken by Abbey Life. In particular:-

- Abbey Life has proactively reviewed all areas of its business where potential disadvantage to customers might have arisen from its compliance weaknesses. This review identified certain limited categories of savings and protection business where a further extended review of business needed to be carried out. This may lead to payment of compensation **in the order of £13 million to in the order of 4,000 investors.**
- In addition, Abbey Life cooperated with PIA and subsequently the FSA, in undertaking a sample review of mortgage endowment sales focussing on the assessment of attitude to risk. Abbey Life immediately accepted the results of the sample review and proactively initiated a comprehensive review of all mortgage endowment sales back to 29 April 1988 (when regulation began under the Financial Services Act 1986). This will ensure that mortgage endowment

customers who may have lost out as a result of Abbey Life's failures will be compensated. Remedial work now being undertaken by Abbey Life may lead to payment of compensation **in the order of £130 million to in the order of 44,000 mortgage endowment consumers.**

- The approach Abbey Life has adopted in dealing with these issues has demonstrated a high regard for the priority of the interests of its consumers. Abbey Life has fully recognised its moral, as well as legal and regulatory obligations, to its consumers. Where there has been any doubt or confusion about whether consumers may have been missold, Abbey Life has resolved this in favour of the customer.
- Abbey Life has been open and co-operative with the FSA. Its approach and, in particular, its proactivity in initiating the mortgage endowment review represents a model of the type of senior management co-operation and acceptance of responsibility desired by the regulator and deserved by consumers. This approach has ensured that consumers will receive redress in a timely and effective fashion.

4.4 In the absence of such mitigating factors, and, in particular, without the level of cooperation and proactivity demonstrated in resolving the issues identified and prioritising the interests of its consumers, the penalty imposed would have been very significantly greater.

## **5. BACKGROUND**

### **The Regulated Firm**

- 5.1 Abbey Life is a UK Life office and a wholly owned subsidiary of Lloyds TSB Group plc. It closed to new business on 2 February 2000. Prior to that, its core business consisted of the transaction of UK life and pensions insurance, including mortgage endowments, through a direct salesforce of approximately 1,600 advisers operating from 66 branches across the UK.
- 5.2 Abbey Life was regulated by LAUTRO from 29 April 1988 and admitted to PIA membership on 7 November 1994. It became regulated by the FSA on 1 December 2001.
- 5.3 On 2 February 2000 Zurich Financial Services (part of the Zurich Financial Services Group) acquired, through its wholly owned subsidiary Allied Dunbar, Abbey Life's new business generation capability. Approximately 55% of Abbey Life's direct salesforce were transferred to Allied Dunbar with the agency agreements of its non-transferring advisers being terminated.
- 5.4 With effect from 2 February 2000 Abbey Life therefore closed all funds to new business save for carrying out pipeline business i.e. business which had been transacted but not yet put on risk at the time of the sale. All pipeline business was completed by 14 April 2000.

## **Discovery of Current Issues**

- 5.5 The case concerns general deficiencies in Abbey Life's selling practices, monitoring of advisers and internal compliance controls. These were identified as a result of routine monitoring by PIA's Supervision Department ("Supervision").
- 5.6 It also concerns specific and systemic weaknesses in Abbey Life's procedures relating to the sale of mortgage endowments. These resulted in unsuitable sales being made to consumers. These were identified as a result of remedial action undertaken by Abbey Life during 2001 and 2002.

## **General Compliance Issues**

- 5.7 Supervision carried out regular monitoring visits to firms regulated by PIA to assess their compliance with PIA Rules. Supervision visits took place to Abbey Life in 1995, 1997 and 1999. All three visits identified weaknesses in Abbey Life's systems and controls and selling practices. These are discussed further below (see Section 6). Following the 1999 Visit the matters of concern were referred to PIA's Enforcement Department ("Enforcement").

## **Abbey Life's Response to the 1999 Supervision Report**

### **The Remedial Programme**

- 5.8 After receiving feedback from Supervision following the 1999 Visit Abbey Life embarked on a remedial programme which was intended to identify all areas of potential disadvantage to consumers which might have arisen as a result of its compliance weaknesses.
- 5.9 The first stage of this programme was a review by Lloyds TSB Group Compliance of 500 cases ("the 500 case review"). The 500 case review, which involved the review of files and documentation, identified many potential areas of concern. Abbey Life, therefore, initiated a wider review designed to address and explore these areas of concern in more detail including through customer contact ("the Remedial Programme"). The Remedial Programme was also intended to incorporate all issues which had previously been raised by Supervision as well as any other outstanding compliance issues.
- 5.10 The Remedial Programme involved 30 workstrands considering individual issues ranging from inadequate demonstration of affordability to the assessment of attitude to risk in respect of certain product areas. The Remedial Programme involved the review of just over 8,500 cases and led to Abbey Life paying out compensation of £465,000 to 342 customers.
- 5.11 The Remedial Programme was concluded in June 2001. At that time, based on the outcome of the Remedial Programme, Abbey Life made proposals to PIA to conduct a past business review incorporating the following areas:

- The sale of mortgage endowments into retirement
  - The sale of mortgage endowments to single customers with no dependants
  - The sale of pre-mortgage endowments
  - The sale of critical illness policies with bundled life cover to single customers with no dependants
  - The sale of ten year savings products to minors
  - The sale of long term (over 10 years) savings products to clients under 23
  - A review of savings and critical illness policies which might have been written in trust inappropriately
- 5.12 This work is now underway. It has been agreed with the FSA that it is not necessary to proceed with the workstrands involving sales to customers who are single with no dependants as there is no evidence of material disadvantage in these areas.
- 5.13 PIA conducted a visit to Abbey Life to review the procedures adopted in, and outcomes of, the extended review. Whilst PIA was broadly content with most of the work undertaken it did have concerns about Abbey Life's sales of mortgage endowments and, specifically, with the adequacy of Abbey Life's procedures for the assessment of a potential customer's attitude to risk in respect of these sales.

## **Issues Relating to Mortgage Endowment Sales**

### **Attitude to Risk**

- 5.14 Abbey Life's customers could be classified as having one of three attitudes to risk namely Cautious, Balanced or Adventurous. The definitions varied slightly over time but were, at all times, related purely to risk within a unit linked product.
- 5.15 One of the areas addressed by the Remedial Programme had been whether Abbey Life's advisers had, when recommending products, properly assessed the customer's attitude to risk.
- 5.16 This workstream had been included because PIA had noted, in 1999, that in 98% of the client files reviewed, customers were recorded as having a "balanced" attitude to risk. PIA was concerned as to whether this suggested that advisers were not properly addressing the assessment of attitude to risk. Abbey Life had also considered a number of other issues relating to potential concerns about misselling of mortgage endowments.

### **Abbey Life's Conclusion**

- 5.17 Abbey Life's initial conclusion was that, although these workstrands had identified procedural and documentation inadequacies in relation to these issues, the more detailed review of the files and customer contact during the Remedial Programme had demonstrated that there was not any significant concern over either the assessment of



attitude to risk by advisers or the sale of mortgage endowments generally.

### **PIA's Concerns**

- 5.18 PIA agreed with Abbey Life's conclusion that there was no cause for concern in respect of assessment of attitude to risk in relation to investment products sold for savings/protection purposes. PIA had concerns, however, about Abbey Life's sale of mortgage endowments and, in particular, whether adequate systems had existed to ensure that mortgage endowments were only sold to customers with an appropriate attitude to risk.
- 5.19 Because of the risks inherent in taking out an endowment mortgage it is important that customers are made aware, at the point of sale, that there is no guarantee that the endowment will realise a sufficient sum to repay the mortgage, that there is a risk that premiums may have to increase to cover potential shortfalls and that any shortfall at maturity may have to be paid from other resources. If the customer is unable to find such other resources to repay all of the capital there is a risk that they may have to sell their property in order to make up the difference or extend their mortgage.
- 5.20 It is critical that the customer understands and is prepared to accept this risk. If they are not prepared to accept this risk then the sale of a mortgage endowment is unsuitable.
- 5.21 PIA was concerned that the work undertaken by Abbey Life in the extended review on attitude to risk had not focussed sufficiently on the difference between the purpose of mortgage endowments and other investment products and specifically whether customers understood and were prepared to accept investment related risk in respect of the repayment of their mortgage. Abbey Life's work had focussed on the level of risk that the customer was willing to take once the decision had been made to purchase in a investment product i.e. whether, within that product, they were cautious, balanced or adventurous. It had not attempted to clarify whether the customer had understood, or was advised, that the only way to guarantee repayment was by taking out a repayment mortgage and making all the repayments through the term.

### **250 Case Sample**

- 5.22 It was, therefore, agreed that Abbey Life would undertake a further sample review of 250 mortgage endowment sales made between 1995 and 2000.
- 5.23 An independent firm of accountants was appointed to assist in this process by providing expertise, quality assurance and guidance.
- 5.24 An agreed form of questionnaire together with a fact sheet setting out the differences between repayment and endowment mortgages was sent to customers in December 2001. The questionnaire was designed to identify risk averse customers i.e. customers who were not, at the time of the sale, prepared to accept the risk of a shortfall at maturity.
- 5.25 The results of the sampling process indicated that 50% of responders and 34% of the overall sample were, at the time of the sale, risk averse.

- 5.26 Abbey Life immediately accepted that the sampling process indicated that there was a significant issue in that a large proportion of their customers appeared not to have properly understood the product sold to them. Abbey Life's view was that they had a moral responsibility to those customers.
- 5.27 To their considerable credit Abbey Life immediately expressed to the FSA their commitment to resolving these concerns, identifying all customers who had been disadvantaged and ensuring appropriate compensation was paid to them. Abbey Life, therefore, pro-actively indicated that it was willing to undertake a review of all mortgage endowments sold since A-day (29 April 1988) (when regulation commenced under the Financial Services Act 1986).
- 5.28 Abbey Life deserve considerable recognition for the fact that, despite the initial sample going back only to 1995, they immediately accepted that there were no changes at that date which would lead to a conclusion that the problem would not have been replicated before that date. The total number of policies to be reviewed will be approximately 190,000 of which approximately 67,000 are live policies. Approximately 40,000 of the 190,000 policies are long term savings plans where clients are being asked if the policy was taken out in respect of a mortgage or not. These will only be reviewed if they were in respect of a mortgage or fall within one of the savings workstrands.

### **The Past Business Review**

- 5.29 It was agreed with Abbey Life that a review of this size would inevitably need to be dealt with in stages. It was also agreed that it would be useful to carry out a first tranche review in order to assess trends, refine procedures and, if appropriate, identify branches or particular policy types which may be able to be excluded from the full scale review.
- 5.30 Abbey Life, therefore, commenced in March 2002 a first tranche mailing which ultimately involved Abbey Life mailing 7,111 customers. Whilst Abbey Life's work on this first tranche has not been finalised, it currently appears that between 17% and 32% of the first tranche could be entitled to redress.
- 5.31 On this basis Abbey Life currently estimates that the various mailing exercises, including the first tranche mailing and the 250 case review, will result in redress being paid to **in the order of 44,000 mortgage endowment customers**. Calculations based on the first tranche indicate that, on average, redress amounts to around £2,000 and £4,000. A realistic assumption, at this stage, is therefore that the potential redress payable as a result of the Past Business Review of mortgage endowments business **will be in the order of £130 million**.
- 5.32 Currently, Abbey Life anticipates concluding the full Past Business Review by December 2004. Live cases, where there is a possibility that the customer may adversely alter their position, for example, in response to a reprojection letter, are to be prioritised and the review of these cases is expected to be concluded by December 2003.

- 5.33 In parallel with this work Abbey Life is continuing its review of the other savings and protection areas referred to in paragraph 5.11 above. It is anticipated that this could result in redress of **in the order of £13 million being paid to in the order of 4,000 customers.**
- 5.34 The total costs to Abbey Life of conducting the Past Business Review are likely to be in the order of £8 million.

## **6. CONTRAVENTION OF RELEVANT STATUTORY REQUIREMENTS**

- 6.1 The penalty is to be imposed pursuant to Section 206 of the Act in respect of breaches of PIA Rules, including the Adopted LAUTRO Rules, and the SIB Principles. Details of the breaches are set out below.

### **(1) Failure to make suitable recommendations**

- 6.2 Abbey Life's advisers were obliged to use their best endeavours to make only suitable recommendations to clients by virtue of paragraph L8(1) of Schedule L2 to the adopted LAUTRO Rules. Abbey Life's advisers failed to do so.

#### Facts and Matters Relied On

- 6.3 In 1997 and 1999 PIA identified that a small number of unsuitable sales had been made to customers i.e. customers had been sold products which were not appropriate given their relevant financial circumstances, attitude to risk, needs and objectives. The proportion of such unsuitable sales identified was low (under 4% in 1997 and in the region of 6% in 1999).
- 6.4 Remedial work undertaken by Abbey Life following the 1999 Visit established that in approximately 5% of mortgage and savings cases, recommendations made by its advisers had been unsuitable.
- 6.5 In addition, as set out above, specific remedial work on mortgage endowment sales established that in between 17% and 32% of mortgage endowment sales advisers may not have properly assessed a customer's attitude to risk and, as a result, these sales may have been unsuitable.

### **(2) Lack of procedures for ensuring suitable recommendations.**

- 6.6 PIA Rule 7.1.2 required firms to establish procedures to ensure that, at all times, they complied with PIA Rules and Principles.
- 6.7 Abbey Life's procedures in relation to the sale of mortgage endowments failed to ensure that advisers only made recommendations that were suitable for the clients needs. Accordingly, Abbey Life has breached Paragraph L8(1) of Schedule L2 to the adopted LAUTRO Rules and PIA Rule 7.1.2(1).

### Facts and Matters Relied On

- 6.8 As set out in paragraph 5.19 above, a crucial feature in making a recommendation to purchase a mortgage endowment is the assessment of a customer's attitude to mortgage risk.
- 6.9 Abbey Life's procedures and, in particular, its fact finding processes made no provision for a separate assessment of attitude to mortgage risk. Rather attitude to risk was defined on the assumption that the client had decided to purchase an investment product and addressed only the degree of investment risk a client was prepared to take. This did not enable customers who were risk averse in respect of their mortgage to be identified.

### **(3) Maintenance of appropriate records**

- 6.10 Firms were required by PIA Rule 5.1.1 to gather and retain sufficient information on client files to enable the firm to give advice which is suitable to the customer's circumstances and to demonstrate that the advice given was suitable.
- 6.11 The records on Abbey Life's files, including records of investor's financial and other circumstances were not sufficient to determine whether suitable recommendations had been made. Accordingly, Abbey Life has breached PIA Rule 5.1.1(1).

### Facts and Matters Relied On

- 6.12 The reports issued by PIA following the Supervision Visits in 1995, 1997 and 1999 identified concerns that documentation on client files did not meet PIA's requirements.
- 6.13 In 20 of the cases reviewed by Supervision in 1999 (32%), the records on the client file, including records of the investor's financial and other circumstances, were not sufficient to determine whether a suitable recommendation had been made. The issues that most frequently occurred were:
- the sale of Endowment Mortgages to young, single clients, against the Firm's Best Advice Guide;
  - failure to demonstrate the suitability of the Mortgage Master (an endowment plan) as the most appropriate mortgage repayment vehicle;
  - failure to demonstrate the affordability of the recommended products; and
  - the sale of Protected Savings Plan and Wealth Master Plans where there was no identified need for savings and/or life cover.
- 6.14 Abbey Life's remedial work confirmed documentary weaknesses in approximately 35% of cases across its business.

#### **(4) Communications of Recommendations to Investors**

- 6.15 Regulated firms were required by adopted LAUTRO Rule 3.15(1) to provide investors with a written explanation of the reasons for making a recommendation to an investor to buy a life policy. This explanation is commonly known as a “Reason Why Letter”. Adopted LAUTRO Rule 3.15(3)(b) states that this explanation must make it clear why the recommendation is appropriate having regard to the investor’s financial and other circumstances.
- 6.16 The Reason Why letters issued to investors by Abbey Life were inadequate and failed to comply with adopted LAUTRO Rule L3.15(3)(b). Accordingly Abbey Life has breached LAUTRO Rule L3.15(3)(b).

#### **Facts and Matters Relied On**

- 6.17 Deficiencies were identified in Abbey Life’s Reason Why Letters in all three Supervision Visits and were also highlighted by Lloyds TSB Group Compliance in 1997 and 1999.
- 6.18 In the 1999 Visit, in 25 cases reviewed by Supervision (40%), the Reason Why Letter failed to make clear why the recommendation had been made, with reference to the investor’s financial and other circumstances.
- 6.19 The issues that most frequently occurred were:
- Reason Why Letters did not adequately explain why the recommendation was made, recording instead the client’s ‘choice’ of product. No explanation was given of why the client had made such a choice which in some cases differed from the recommendation.
  - Reason Why letters frequently failed to record whether mortgage repayment options were discussed and/or why they were discounted.
- 6.20 Improvements in the standard of Reason Why Letters occurred between 1995 and 1999 and specific problems identified were addressed by Abbey Life over the period. Overall, however, the problems took too long to resolve. Significant unresolved weaknesses remained in 1999 despite having been highlighted by PIA in 1995 and 1997 and by Group Compliance in 1995 and 1997.

#### **(5) Compliance Monitoring of Financial Advisers**

- 6.21 PIA Rule 7.1.2 required firms to establish procedures adequate to ensure compliance with PIA rules. PIA Rule 7.2.1 required firms adequately to monitor their investment staff.
- 6.22 The monitoring processes adopted by Abbey Life, in particular, its Sales Verification Department did not operate to ensure compliance with Abbey Life’s procedures or with PIA Rules and Principles. As a result Abbey Life’s monitoring failed to identify

unsuitable sales and documentation and record keeping weaknesses. Accordingly, Abbey Life has breached PIA Rule 7.2.1 and 7.1.2.

#### Facts and Matters Relied On

- 6.23 In April 1994, Abbey Life established a Sales Verification Department (“SVD”). Its objective was to check that sales recommendations and the application of best advice by advisers complied with corporate guidelines set out in Abbey’s “Best Advice Guide”. 25% of new business was randomly selected for review by a number of assistant compliance officers within SVD. New business tested in this way was not authorised until passed as compliant by SVD.
- 6.24 As set out below, inadequacies in SVD continued from 1995 to 1999. Abbey Life accepts these failings and has now taken steps to address any areas of potential customer disadvantage arising from these failings.
- 6.25 In 1995 a sample of 54 fact finds which had been checked by SVD were selected for review by Supervision. In eight cases reviewed (14%), problems were identified that had not been identified by SVD.
- 6.26 Abbey Life was required to review the operation of SVD. Particular emphasis was to be given to improving the quality of SVD staff and their ability to identify shortfalls in fact finds, advice given and Reason Why Letters. Abbey Life was also required to ensure that its training department was made aware of the areas of concern arising from SVD.
- 6.27 Abbey Life’s Internal Audit Department reviewed the operation of SVD in October 1996. They stated “a number of weaknesses primarily relating to the training of SVD staff were identified”.
- 6.28 In 1997, Supervision checked 43 client files which had been assessed by SVD. Supervision identified 21 cases (49%) which it considered had been inadequately assessed by SVD.
- 6.29 The Group Compliance Report 1997, which focused on overall standards of compliance within the sales force and the effectiveness of compliance monitoring arrangements, also identified shortcomings in the effectiveness of the verification process carried out by SVD. Group Compliance concluded that there were weaknesses in key areas of SVD resulting in a failure to manage regulatory risks to an acceptable standard.
- 6.30 Steps were taken by Abbey Life to address the issues raised by PIA and Group Compliance. In particular, in December 1997, a 100% check of all fact finds by SVD was introduced. SVD was transferred from Client Services to Compliance in order to enhance its status, SVD staff undertook a programme of field visits to help advisers with PRISM related problems and from August 1998, bulletins were specifically issued by SVD.

- 6.31 Despite the various steps taken by Abbey Life, further internal audits of SVD in May and July 1998 raised concerns over the quality of SVD's work and the maintenance of records and identified a need for the provision of further training particularly in giving guidance to advisers. Around July 1998, SVD was restructured.
- 6.32 Group Compliance undertook a further review of Abbey Life's sales process and SVD in May 1999. Its findings were contained in the Group Compliance Report 1999 and noted significant improvements in the standard of SVD. Nevertheless, random sampling of cases identified some 35% of sales where shortcomings had not been detected by SVD and 4% undetected potential missales. The report went on to note that following the last formal review of SVD standards in July 1998, a regular review programme should have been established "to closely monitor the situation until a fully satisfactory position had been achieved."
- 6.33 Group Compliance concluded that SVD was "essentially well controlled" and that "key systems were operating to a good standard." It also noted, however, that although significant improvements were evidenced, further work was required. The report then outlined further remedial action considered necessary including a recommendation that:
- "The Firm should strengthen its verification arrangements to ensure that all breaches of its own internal rules and procedures are identified and addressed."*
- 6.34 The weaknesses identified by PIA in 1999 in Abbey Life's selling practices and record keeping were repeats of breaches previously identified in 1995 and 1997. These breaches, which had not been identified by SVD demonstrated that the Firm's process for verifying sales and hence for monitoring its advisers, SVD, had serious deficiencies.

## **(6) Internal Controls**

- 6.35 PIA Rule 7.1.5 required firms to establish appropriate internal controls. The internal controls operated by Abbey Life did not operate effectively to ensure compliance with PIA's Rules and Principles. As a result an unacceptable level of documentary and record keeping weaknesses were permitted as well as unsuitable sales over an extended period

### Facts and Matters Relied On

- 6.36 Abbey Life's monitoring of its financial advisers was inadequate. As set out above deficiencies in SVD remained at the time of 1999 Supervision Visit, approximately four years after problems were first identified and highlighted for improvement by Supervision and two years after they were highlighted by Group Compliance.
- 6.37 Similarly, despite Abbey Life's efforts, deficiencies in Abbey Life's selling practices (including its fact finding and reason why letters) first identified in 1995 remained in 1999. Although Abbey Life had improved the quality of its selling practices between 1995 and August 1999 these improvements did not fully address all of PIA's

concerns. Between 1995 and 1999 the quality of Abbey Life's selling practices remained unacceptable.

- 6.38 The failure to remedy fully the issues raised in a timely fashion demonstrates that Abbey Life's internal controls were inadequate.
- 6.39 The remedial work undertaken by Abbey Life has now addressed more fully the issues raised by PIA and Group Compliance.

**(7) Breach of SIB Principle 9**

- 6.40 By reference to the Rule breaches set out above Abbey Life is in breach of SIB Principle 9 as it failed to organise and control its internal affairs in a responsible manner and failed to ensure that its staff were properly supervised.

**(8) Breach of SIB Principle 2**

- 6.41 By reference to the Rule Breaches set out in paragraphs 5.2 to 5.9 Abbey Life is in breach of SIB Principle 2 in that it failed to use due skill, care and diligence to ensure that its advisers only made recommendations that were suitable for investors.

## **7. RELEVANT GUIDANCE ON SANCTION**

- 7.1 The FSA's policy on the imposition of financial penalties is set out in Chapter 13 of the Enforcement Manual which forms part of the FSA Handbook ("ENF"). The principal purpose of the imposition of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefits of compliant behaviour.

- 7.2. Article 8 (4) of the Pre-N2 Misconduct Order provides that, where the FSA proposes to impose a financial penalty it must have regard to:

*"any statement made by the self-regulating organisation ...which was in force when the conduct in question took place with respect to the policy on the taking of disciplinary action and the imposition of, and amount of penalties (whether issued as guidance, contained in the rules of the organisation or otherwise)".*

- 7.3. Relevant PIA Guidance is contained in Annex D of "PIA's Approach to Discipline – Statement of Policy" that was issued in December 1995. In all material respects this required consideration of the same factors as identified in Chapter 13 of the Enforcement Manual. It has been taken into account by the FSA in determining the appropriate sanction in this case.

- 7.4. PIA's Statement of Policy makes it clear however that that the criteria for determining the level of sanction are not to be applied rigidly, as stated in paragraph 2 of Annex D:

*"Each case is different and needs to be treated on its own merits. It is not possible to apply a mechanistic approach to the determination of the circumstances in*



*which disciplinary action should be taken or of the sanctions to be applied. The criteria...should not be treated as exhaustive. Nor should it be assumed that regard would necessarily be had to a particular criterion in any given circumstances.”*

- 7.5. Similarly, it is stated in Chapter 13 of the FSA Enforcement Manual at clause 13.3.4 that the criteria listed in the manual are not exhaustive and all relevant circumstances of the case will be taken into consideration.
- 7.6. In determining whether a financial penalty is appropriate and its level the FSA considers all the relevant circumstances of the case. The FSA considers the following factors to be particularly relevant in this case.

*ENF13: The seriousness of the misconduct or contravention*

*PIA Guidance: The seriousness of the breaches. The scale of any investor losses and/or the extent to which investors were exposed to the risk of such losses.*

- 7.7. The breaches identified in this case are of a serious nature. They reflect systemic weaknesses in Abbey Life’s internal controls extending over a lengthy period.
- 7.8. Specific weaknesses have been identified in relation to the sale of mortgage endowments and, in particular, in respect of Abbey Life’s procedures for assessment of attitude to mortgage risk.
- 7.9. These weaknesses have caused actual or potential disadvantage to significant numbers of consumers in particular **in the order of 44,000 mortgage endowment customers and in the order of 4,000 customers** who have been missold savings products. Between **12,000 and 18,000** customers may currently be in a mortgage product which is unsuitable for them.

*ENF13: The extent to which the contravention or misconduct was deliberate or reckless*  
*PIA Guidance: whether this member intentionally or recklessly failed to meet PIA’s requirements.*

- 7.10. Abbey Life did not deliberately contravene PIA Rules. The inadequacies in the Abbey Life’s systems did, however, continue over a considerable period of time. During that period Abbey Life’s internal controls did not operate effectively to ensure that deficiencies identified by PIA or Group Compliance were remedied in a timely and effective fashion.

*ENF13: The size, financial resources and other circumstances of the Abbey Life*

*PIA Guidance: The Member’s ability to pay: The scale of any investor losses and/or extent to which investors were exposed to the risk of such losses.*

- 7.11. The size of Abbey Life’s salesforce (over 1,500 advisers) added to the seriousness of the breaches in terms of their actual and potential impact on large numbers of investors.

*ENF13: The amount of profits accrued or loss avoided*

*PIA Guidance: the extent to which, as a result of the breaches, the Member gained a*

benefit or avoided suffering a loss.

- 7.12. Abbey Life did not deliberately set out to accrue additional profits as a result of its compliance failings. It is, however, likely that Abbey Life made significantly higher numbers of sales of mortgage endowment policies than were, in fact, appropriate.
- 7.13. As Abbey Life did not offer a decreasing term assurance policy to provide life cover in relation to repayment mortgages until 1997 it would, in the absence of such endowment sales, have had no alternative product to offer a customer seeking a mortgage. The sale of endowments will, therefore, have contributed to Abbey Life's profits.
- 7.14. Abbey Life has now spent significant sums on its remedial work relating both to endowments and other product areas. A realistic assumption, at this stage, is that the overall compensation paid out as a result of the remedial programme (both in respect of mortgage endowments and other products) will **be in the range of £90 million to £165 million**. The costs Abbey Life anticipates incurring will be **in the range of £6 million to £10 million**.

ENF13: Conduct following the contravention

PIA Guidance: The Firm's response once the breaches were identified.

- 7.15. Abbey Life did not identify the breaches and had failed to respond adequately to adverse reports from both PIA and Lloyds TSB Group Compliance. After the 1999 Supervision report, however, Abbey Life and its parent company, Lloyds TSB, acted in a proactive manner to seek out and identify customers who had been disadvantaged. Whilst this initial diagnostic work did not specifically identify the problem in relation to mortgage endowments Abbey Life has, since conducting the sample review of 250 cases, adopted an extremely helpful, positive and pro-active approach to this matter.
- 7.16. It has fully recognised its responsibilities to its consumers and has voluntarily agreed to conduct a full review of its past endowment sales going back to A-day. It has been prepared to accept the veracity of consumer responses and has resolved any doubts in favour of its consumers.
- 7.17. In the FSA's view, Abbey Life's approach is a model of the type of cooperation and acceptance of responsibility by senior management which is desired by the regulator and which consumers deserve. Accordingly, the penalty imposed in this case reflects a very considerable credit for the proactive and co-operative manner in which Abbey

Life has dealt with this issue and the commitment it has shown to identifying and compensating all potentially affected customers.

ENF13: Disciplinary record and compliance history  
PIA Guidance: The Firm's Regulatory History

7.18. Abbey Life did have a series of visits by PIA Supervision which identified concerns. It has, however, not previously been the subject of disciplinary action.

*ENF13: Action taken by other Regulatory Authorities in Relation to Similar Failings*  
*PIA Guidance: The way in which PIA has dealt with similar cases in the past*

7.19. In setting the level of the proposed penalty, the FSA has taken into account penalties levied by previous regulators and by the FSA.

### **MANNER OF PAYMENT**

The Penalty must be paid to the FSA in full.

### **TIME FOR PAYMENT**

The Penalty must be paid to the FSA no later than 17 December 2002, being not less than 14 days beginning with the date on which this notice is given to you.

### **IF PENALTY NOT PAID**

If all or any of the Penalty is outstanding on 18 December 2002, the FSA may recover the outstanding amount as a debt owed by you and due to the FSA.

### **IMPORTANT**

This Final Notice is given to you in accordance with Section 390 of the Act.

### **Publicity**

Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.

The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

Julia Dunn  
Group Leader  
FSA Enforcement Division