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ROBINOMICS

News flash

Precipice Bonds: Teetering on the Brink?

IFAs must be feeling a sense of déjà vu as another popular and apparently safe investment has come under scrutiny following the collapse of stock market values in recent years. Once again, there is widespread talk of another mis-selling scandal, similar to Pensions and Split Capital Investment Trusts.

In this edition, Nicola Blakemore **looks at the issues surrounding the so-called Precipice Bonds.**

What is a Precipice Bond?

For several years, the Financial Services industry has been offering the public a form of capital investment described as a High Income Bond ('Bond(s)'). This is an investment with a life of, usually, three to five years, which offers a guaranteed income at a certain percentage, typically between 8% and 10%, together with a return of the capital invested at the end of the Bond's life. The Bond is linked to a specified share index, such as the FTSE 100, or several indices or specified shares. If the share index falls, the value of the Bond falls and, at the end of the life of the Bond, the investor may lose some or all of his capital investment. In most cases, however, these dire consequences only take effect once the chosen index has fallen a significant number of percentage points. Until that point, the investment may seem protected but then the capital value drops suddenly and spectacularly, hence the nickname: 'precipice bonds'.

The investment has been likened to a bet on the performance of a share index. They were mainly sold at a time when there had been many years of continual growth in stock markets generally, and it may have seemed ridiculously pessimistic at the time to contemplate heavy and sustained falls in stock market values.

What has happened?

Most share prices have fallen dramatically over the last couple of years, as have the relevant indices. While some Bonds have a safety net, for example that the value of the Bond will only fall if the share index falls by, say, over 20%, that safety net has proved insufficient in many cases. As a result, several Bonds matured in 2002 and 2003 and were unable to return all (or, in some cases, any) of the capital to investors.

Some of the Bonds are quite complicated and are linked to foreign and/or volatile share indices, such as the NASDAQ and Eurostoxx.

Further, it is said that Bonds were commonly sold through mailshots, with no bespoke advice geared to the investor's requirements.

It is reported that almost half of investors who purchased Bonds were inexperienced investors who would not usually consider, nor have experience in, investing in the stock market. They will no doubt be keen to contend that they did not understand the risks involved in investing in this type of fund.

To make matters worse, a significant proportion of the investors are pensioners, who invested their life savings in these products and have seen their savings wiped out.

IFAs and product providers have been criticised for not explaining adequately the risks of capital loss, and/or for hiding the risks in the small print. There is strong criticism that those involved in marketing the Bonds failed to identify that these were high risk investments where capital may not be returned.

What is the FSA response?

The FSA first warned investors of the risks of these Bonds in 1999. It most recently issued a consumer alert in December 2002. These warnings, it seems, were largely ignored.

In February 2003, the FSA issued guidance to IFAs (omitting the usual consultation process because of the urgency). The guidance requires IFAs who market or recommend these types of investment to provide clear information to potential investors about the risks involved in this investment, as well as sending investors copies of the FSA fact sheet.

The FSA has launched an investigation into the marketing of Bonds, and in particular, into the marketing material supplied by IFAs and product providers.

As a result, Lloyds TSB has been fined £1.9 million in respect of its marketing of the Scottish Widows Bond and has been ordered to pay investors compensation to the tune of an estimated £98 million.

An IFA, Chase De Vere, has also been fined £165,000 by the FSA for misleading marketing material in relation to the Bonds. The FSA found that it did not highlight the risks involved and was overly optimistic. It will also be required to pay compensation to investors.

The FSA is currently investigating other providers and IFAs and the prospect of further fines and other enforcement action cannot be ruled out.

The FSA is also probing the purchase of the Bonds on an ‘execution only’ basis. This is where an investor makes an investment through a broker or IFA, without receiving any advice from that broker or IFA, e.g. on the strength of a newspaper advertisement or a mailshot.

Some IFAs marketed the Bonds to their clients by way of mailshot and are arguing an ‘execution only’ defence: i.e they gave no advice, so cannot be held responsible for mis-selling the Bonds. The FSA is looking at whether the sales letter gave any advice, whether the risks were clearly stated and whether the claims by IFAs, that they did not give advice, are fair.

What actions is the Financial Ombudsman Service (‘FOS’) taking?

The FOS is investigating thousands of complaints of mis-selling and has already issued decisions against some of the IFAs concerned.

The FOS has issued a statement saying that even though IFAs and product providers can point to risk warnings in the marketing material, they may still be liable as an inexperienced investor may not have fully understood the risks involved and classification of risk attitudes.

Also, the FOS takes the view that investors will be influenced by the advice of an IFA, which may undermine the risk warnings contained in the marketing material.

In respect of ‘execution only’ transactions, the FOS has stated that, if there is any correspondence or discussion which may be construed as advice, the IFA may be liable for mis-selling.

What is the impact on IFAs?

It is likely that IFAs will bear the brunt of mis-selling actions in relation to the Bonds. A firm of solicitors which specialises in class actions involving financial products has already indicated that it will target IFAs. In addition, some product providers have made statements, trying to shift the responsibility onto IFAs, contending that the product providers merely designed the products, and it was the IFAs who had to decide their suitability for the clients to whom they sold them.

Two large firms of IFAs, R J Temple and the David Aaron Partnership, have already been forced into voluntary liquidation or administration because of their exposure to the Bonds.

The FOS is expecting more complaints and as many of the Bonds will not mature for another few years, this is a problem which is unlikely to be resolved quickly. As with Splits, timing can be crucial, and in the meantime, IFAs and their insurers will be keeping a very watchful eye on the recent, and very welcome, signs of growth in stock market values.

Robin Simon will continue to monitor the issues as they develop, and a workshop and seminar will be presented shortly.

Should you require any further information on Precipice Bonds and / or any other regulatory issues please contact any member of the Financial Institutions Team at Robin Simon LLP:

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