under the baobab tree
Issue 5 2014

FAISOmbud
Office of the Ombud for Financial Services Providers

CASE STUDY 1: Mr V vs Respondent

THE IMPORTANCE OF MATERIAL TERMS RELATING TO YOUR INVESTMENT

1. Material terms are generally described as those essential terms which, had you been aware of them, would have the potential to alter your decision prior to entering into a contract.
2. The persons who are designated by law to point out material terms to you are often referred to as financial consultants or financial advisers.
3. They may have their own business or be employees of other private businesses, big insurance companies and banks.
4. It is important to know that regardless of what the law has identified as material in the contract underlying the financial products (as defined in the FAIS General Code of Conduct), it is imperative that your financial consultant must still highlight what would interfere with your goals, plans or needs before recommending a financial product to you.
5. It is always in your interest to enquire about the material terms of the financial product that is recommended to you.
6. Do your homework before signing application forms. This could include speaking to people who understand financial planning and the financial planning process.

Consider the story of Mr V

Mr V sought advice from the Respondents on how best he could invest his money given a need to access his investment on short notice. He was offered an endowment. This is a product that comes with several restrictions and severe penalties in the event of breach of the material terms of the contract.

After having made two withdrawals from his investment, Mr V decided

to increase his monthly contributions in order to make up for the withdrawals.

When he sought access to the investment on a third occasion, he was told that further access would not be possible due to his increased monthly premiums.

According to Mr V, the respondent had failed to explain to him that by increasing his monthly contributions by more than 20% a new restriction period of five years would begin immediately after the increased premium, (where the increase exceeds 20%). This is known as the 20% rule and all endowment products are subject to this rule in terms of Section 54 of the Long Term Insurance Act, Act 52 of 1998.

Our intervention

The 20% rule is material because it bears limitations on the policy owner. This should have been disclosed to Mr V at the time the financial service was rendered. Failure by the respondent to provide documents demonstrating that he had informed the complainant of the 20% rule, the effect that it would have on him and the reasons why an endowment policy was suitable for the complainant resulted in the matter being decided in favour of Mr V. The respondent made an offer to resolve the matter, which was accepted by Mr V.

Lessons

- It is a requirement of the General Code of Conduct (as set out in the FAIS Act) that a financial consultant/ adviser make full and frank disclosures of any information that would reasonably be expected to enable the client to make an informed decision. This includes material terms of a contract underlying the purchase of a financial product.
- Financial services providers may not recommend a product without considering the client's needs and financial goals.

CASE STUDY 2: Mrs K vs the insurer

BE AWARE OF COMMISSION COSTS

Many people who lodge complaints at the FAIS Ombud query fairness about the levying of costs, particularly commission charged by brokers on their clients investments. The clients complain that they were not informed about the costs. Let us look at the following example:

1. An investor makes an investment of R 1 000 000 and the financial adviser tells the client that the costs will be inclusive of a 6% up-front commission and 2.5% trail commission annually. Does this make it clear to the investor what the actual costs are? Absolutely not.We have however found that this is certainly not the case for every investor. Bearing in mind that the General Code stipulates that amongst other material terms, the financial adviser must make the method of calculation of ensuing costs of buying a financial product clear, and must do so by using the rand value.
2. The Code further demands that the financial adviser must be fair and take steps to ensure that the client understands the advice prior to concluding the sale of the financial product.

Mrs K the complainant was dissatisfied with the commission of R11 129.73 charged by the respondent, on the transfer of proceeds from the Government Employees Pension Fund (GEPF) to a Capital Retirement Portfolio.

She claimed that she did not remember signing any documents agreeing to the commission payable to the adviser. She requested that the Office investigate the reason why the representative charged her such an exorbitant commission, which further reduced her already minimal pension.

Upon receipt of the complaint, the respondent advised our Office that the representative reduced his commission on the Capital Retirement portfolio to 2.14% instead of the allowable 3% maximum. Furthermore the consideration amount received by the insurer was a total sum of R 429 283.85 which was used to purchase a living annuity[1].

In addition to this, the respondent highlighted that the adviser took 1.71% commission from the said amount.

From the respondent's response, it was noted by the Office that the complainant's funds, after being transferred to the financial institution, were not used to purchase a Living Annuity, but were initially placed in a Capital Retirement Portfolio and later removed from this portfolio to purchase a Living Annuity.

This unnecessary transfer of funds from the GEPF to the retirement portfolio, and the later one to the Living Annuity, cost the consumer unnecessary commission. Our Office requested the respondent to clarify why the complainant's funds were transferred to the Capital Retirement Portfolio instead of purchasing a compulsory annuity.

In response the respondent stated the following:
The agreement/process, at the time of transfer, between this insurer and the Government Employees Pension Fund was that a member who wished to retire and purchase an annuity with insurer could do so via the Capital Retirement Portfolio. The latter was used as a "parking bay ". The Fund would transfer the full amount into the Capital Retirement Portfolio until such time that the client retires. This was the vehicle through which the GEPF funds could be transferred until the investor reaches his or her retirement date.

When the Office requested a copy of the said agreement it was not provided.

With no clear answers as to why the first transfer to the parking bay was made, including the relevant commission, the respondent agreed to refund the complainant the full commission charged for placing the funds in the so-called parking bay or the Capital Retirement Portfolio.

Lessons

1. It is important to be involved in your financial transactions. Question sharp declines of investment values.
2. Remain in regular contact with your financial adviser and do not be afraid to ask questions.
3. We have noted that in the majority of cases where churning has occurred, financial advisers operate under the assumption that no one is watching. This encourages brazen and unlawful behaviour.
4. Monitoring your investments is the most effective way of timeously identifying abuses, especially churning.

[1] A living annuity is a type of pension which allows flexible withdrawals to suit the investor's needs. It is not suitable for conservative investors as the capital investment is subject to market vagaries and can be reduced according to how markets perform.

CASE STUDY 3: MR P v BANK ADVISOR

CHURNING: BIGGER AND BETTER BENEFITS?

In 2006 the complainant took out a mortgage loan (bond) with the respondent and a life policy as security for the debt. Four years later he was contacted by the respondent informing him that the policy he had taken out in 2006 was being discontinued and that a new offering was on the cards with 'bigger and better' options, in that he would receive more benefits at a lower cost.

Two years after this second interaction the complainant was again contacted by the respondent, once again he was informed that a newer, more improved line of products was being offered and that in order to reap the benefits offered by this new product, he would be required to cancel his old policy and replace it with one of these latest offerings.

The complainant alleged that he was not informed that by replacing an older policy it would attract a penalty.

Our intervention

In our dealings with the respondent we highlighted our concerns regarding what appeared to be 'churning' on their part. It was clear that the first product was appropriate for the complainant's needs. The need identified in the record of advice was simply security for the mortgage loan. Thus the need to constantly change these policies was an exercise in futility since the complainant was paying penalties on each supposed upgrade. With no rational explanation provided for the replacements, the respondent saw its way clear to settling the matter. A reasonable offer of settlement was made, which the complainant accepted.

Lessons

While the financial services industry continues to evolve and bring to life innovative products, caution must still be exercised in replacing a financial product. A thorough exercise of comparing the material terms of the contract underlying the purchase of the replacement products, and explaining this to the client must be undertaken by the adviser.

Finally, the important question of whether the product is likely to meet the client's needs and circumstances must be answered comprehensively.

CASE STUDY 4: Ms L vs Respondent

IS YOUR PROVIDER ACTING IN YOUR INTERESTS?

Mrs LV (the complainant), alleged that her financial adviser with whom she had built up a trusting, long standing relationship, advised her to move some of her funds to an endowment policy, allegedly for tax purposes.

During 2011 she transferred R 460 000, in 2012 a further R 506 000, and in 2013 an additional R 556 600, all of which represented single premium lump sum investments for the respective years. She subsequently learnt that the policies stated that the premiums were meant to be paid annually over a period of 10 years. She would also have to contribute an amount of R 5 808 612 between the years 2014 and 2020. What's more, there was a 10% premium linked to each investment, all of which the complainant alleged was not discussed with her and not within her means.

Mrs LV terminated her investment with the respondent and met severe early termination penalties, which were "clawed back" from her investments. Her efforts to resolve the matter with the respondent were unsuccessful. The complainant states that she had never contemplated investing annual recurring premiums and that she had understood that these were single lump sum premiums. Mrs LV approached the FAIS Ombud's Office for assistance.

In response the product provider was vehement that Mrs LV was, at any given point in time, always placed in a position to make an informed decision. The respondent claimed that he had, at all times, acted in good faith, with due skill, care and diligence and in the best interests of the client. Moreover, that he had, in his dealings, carried out the client's instructions.

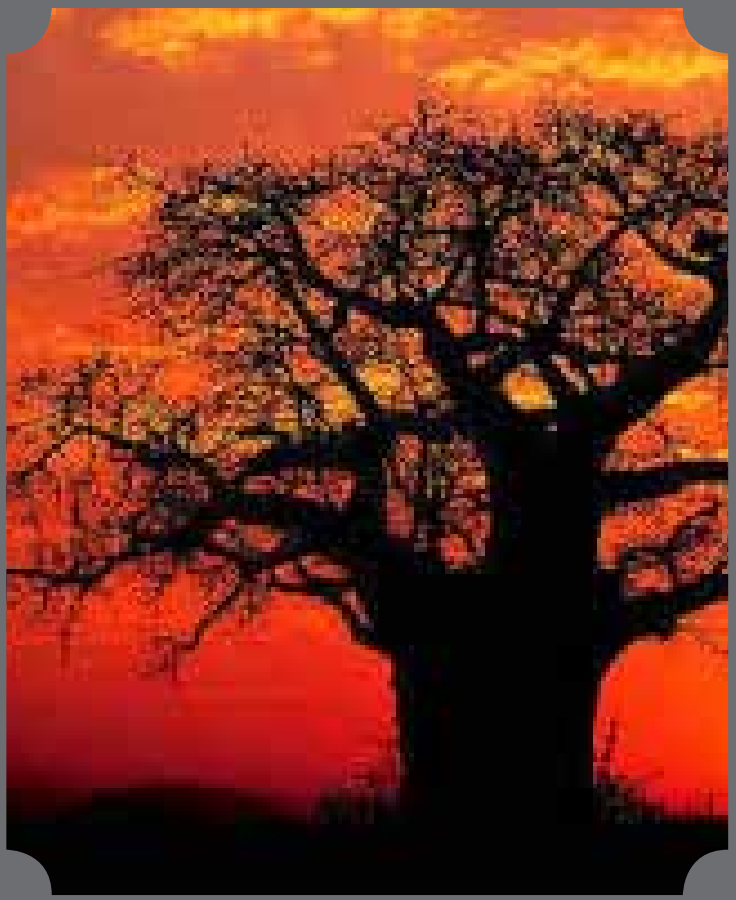
We found the respondent's level of compliance with the Code wanting. There was no clear evidence that the adviser had satisfied himself that the complainant had the means to meet the onerous premiums. It was an inescapable conclusion that the adviser had not applied his mind and/or had acted in complete disregard of the client's interests.

Against mounting pressure to substantiate the claims of compliance with the Code on the part of the provider, the provider opted to resolve the matter without prejudice and refunded all confiscatory penalties with interest.

The offer was accepted by the complainant.

Lessons

- When rendering financial services or advice to clients, financial advisers have a duty to establish their clients' needs prior to providing advice so that the advice is aimed at addressing identified needs.



- All the material terms of the contract must be disclosed to the client, including penalties for early termination.
- A provider must at all times render financial services honestly, fairly, with due skill, care and diligence, in the interests of clients and the integrity of the financial services industry.

CASE STUDY 5:

FUNERAL COVER: WHO CAN YOU INCLUDE IN YOUR FUNERAL COVER? CHECK YOUR INSURER'S TERMS

In advising consumers, financial advisers must disclose who is eligible for cover to the policy holder. Each insurer will have its own rules and the material aspects of these rules must be explained to the policyholder.

Consider the case study below:

In March 2014, Miss A purchased funeral cover for herself through the respondent. She subsequently added her 24 year old, unemployed son.

Her son passed away within three months of the inception of the policy. Labouring under the impression that there was an existing policy to cover the funeral, Miss A duly submitted a claim. To her surprise the respondent rejected her claim on the basis that they do not insure adult dependents unless they are full time students (her son was not), or if they are mentally or physically challenged. The complainant claimed she was not at any stage informed of these conditions. At the time of the claim, the complainant had already added her niece to the policy as an extended family member. What was unbeknown to the complainant at the time, was that her niece would also not be covered as she was listed as Miss A's 'child' as opposed to an extended family member.

Miss A turned to our Office for assistance.

Our intervention

In his response, the respondent stated that the deceased would have never qualified for cover. Given that the financial adviser had failed to inform Miss A about the eligibility criteria, a 'without prejudice offer of settlement' was made through the intervention of our Office.

Miss A accepted this offer of settlement.

Contributors to this newsletter: Phumza Mtshemla, (Co-ordinator) Boitumelo Mtholo, Sinovuyo Puzi, Violet Ricketts, Thobekile Ngcobo, Zethu Kulu.

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Office of the Ombud for Financial Services Providers

Tel: 012 762 5000
E-mail: info@faisombud.co.za
Website: www.faisombud.co.za

Sussex Office Park, c/o Lynnwood Road and Sussex Avenue, Lynnwood, 0081