Section 3

Financial products

Introduction

This section contains a review of the main products designed to help customers to solve their financial problems and to meet their financial needs and objectives.

Here we concentrate on 'packaged' products supplied by product providers such as banks, insurance companies and investment managers. The products considered include collective investments, derivatives, life assurance, general insurance, mortgages and other loans, and pension policies.

Section 3 covers the topics listed in part 3 of the syllabus for Unit 1, ie the main financial services product types and their functions.

3.1 Investments

The main forms of *direct investment,* ie cash, current and deposit accounts, fixed interest stocks, shares and property, are described in Section 2.

3.2 Collective investments

Collective or pooled investments are arrangements whereby individual small investors can contribute – by means of lump sums or regular savings – to a large investment fund. Pooled investments offer a number of advantages to individual investors.

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- The services of a skilled investment manager are obtained at a cost that is shared among the investors. Individual investors do not need to research particular companies – nor do they need to understand and deal with occurrences such as rights issues.
- Investment risk can be reduced because the investment manager spreads the fund by investing in a large number of different companies – so that if one company fails, the whole investment is not compromised. Such a spread could not normally be achieved with small investment amounts.
- Fund managers handling investments of millions of pounds can negotiate reduced dealing costs for their investors.
- There is a wide choice of investment funds, catering for all investment strategies, preferences and risk profiles.

Investment funds can be categorised in a number of ways, for example:

- by *location*, eg UK, Europe, America, Far East;
- by *industry*, eg technology, energy;
- by *type of investment,* eg shares, gilts, fixed interest, property;
- by other forms of *specialisation*, eg recovery stocks, ethical investments.

Many funds are based on more than one categorisation, eg a UK equity fund.

Most companies also offer one or more *managed funds*. This is an unfortunate choice of name, since it seems to imply that other funds are not managed. Nevertheless, the name has become accepted as applying to the type of fund where its managers sometimes invest appropriate proportions in a range of the company's other funds to meet the managed fund's objectives. Most managed funds are middle-of-the-road in terms of risk profile, and are often chosen by people seeking steady market-related growth in situations where risk of loss needs to be kept to a minimum, such as pension provision or mortgage repayment.

A further categorisation is possible: into funds that aim to produce a high level of income (perhaps with modest capital growth); those that aim for capital growth at the expense of income; and those that seek a balance between growth and income.

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The main forms of collective investment are:

- unit trusts;
- investment trusts;
- investment bonds; and
- open-ended investment companies (OEICs).

Although they may appear broadly similar to the unsophisticated investor, they are in fact very different, both in the way they operate and in the taxation treatment of both the fund managers and the investors.

3.2.1 Unit trusts

A **unit trust** is a pooled investment created under trust deed. An investor may contribute to a unit trust by way of a lump sum or regular contributions, or a combination of both. Unit trusts have been particularly successful in attracting investment from individuals in the UK, with total funds under management of the order of £450bn.

The unit trust is divided into units, with each unit representing a fraction of the trust's total assets. A unit trust is *open-ended* in the sense that a manager can, in response to demand, create more units.

The trust deed places obligations on both the manager and the trustee.

3.2.1.1 The role of the unit trust manager

The manager is responsible for:

- managing the trust fund;
- valuing the assets of the fund;
- fixing the price of units;
- offering units for sale;
- buying back units from unitholders.

The manager is obliged, under the terms of the trust deed, to buy back units from investors who wish to sell them, and he will generate profit from charging management fees and dealing in the units.

3.2.1.2 The trustees

The trustees have an overall responsibility to ensure investor protection. To enable this to happen they carry out a number of duties:

- they set out the trust's investment directives;
- they hold and control the trust's assets;
- they ensure that adequate investor protection procedures are in place;
- they approve proposed advertisements and marketing material;
- they collect and distribute income from the trust's assets;
- they issue unit certificates to investors;
- they supervise the maintenance of the register of unitholders.

The trustees have a policing role to ensure that the manager complies with the terms of the trust deed. The role of trustee is often carried out by an institution such as a clearing bank or life company.

3.2.1.3 Authorisation of unit trusts

Unit trusts are primarily regulated in the UK under the terms of the Financial Services and Markets Act 2000, and have to be authorised by the Financial Services Authority (FSA).

3.2.1.4 Pricing of units

To price the fund, the manager will calculate the total value of trust assets, allowing for an appropriate level of costs, and then divide this by the number of units that have been issued. The prices at which units are bought and sold are calculated by the managers on a daily basis using a method specified in the trust deed. The unit prices are directly related to the value of the underlying securities that make up the fund.

There are three important prices in relation to unit trust transactions:

- the *offer price* is the price at which investors buy units from the managers;
- the *bid price* is the price at which the managers will buy back units from investors who wish to cash in all, or part, of their unitholding;

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- the *cancellation price* is the minimum permitted bid price, taking into account the full costs of buying and selling. At times when there are both buyers and sellers of units, the bid price is generally above this minimum level, since costs are reduced because underlying assets do not need to be traded.

Many unit trusts still use bid and offer prices, with the difference between them (known as the *bid offer spread*) being of the order of 5% or 6%. Some unit trust managers, however, are moving to a single-price system because they believe that this is better understood by investors. In this case, they may impose an exit charge if units are sold within, say, three or five years of purchase.

3.2.1.4.1 Historic and forward pricing

A significant change in the pricing of units took place in 1988. Prior to that time, clients bought or sold at prices determined before the start of the dealing period – typically the previous day's valuation. (If a fund's daily valuation takes place, for example, at noon, the dealing period is from midday on one day to midday on the following working day.) This system, known as *historic pricing,* is now considered unacceptable because prices clearly do not reflect what is happening in the market: an investor might telephone for a price and complete a purchase, just before the newly calculated daily price is published, knowing that the market has risen in the meantime.

Concern about historic pricing led to the introduction of the system known as *forward pricing,* which is now standard practice for unitised funds. Under forward pricing, clients buy or sell in a given dealing period at the prices that will be determined at the end of the dealing period. The prices published in the financial press are therefore only a guide to investors, who do not know the actual price at which their deal will be made.

Fund managers are still permitted to use historic pricing if they wish, subject to the proviso that they must switch to forward pricing if an underlying market in which the trust is invested has moved by more than 2% in either direction since the last valuation.

3.2.1.4.2 Buying and selling units

Unit trust managers are obliged to buy back units when investors wish to sell them. There is consequently no need for a secondary market in units and they are not traded on the Stock Exchange. This adds to the appeal of unit trusts to

the ordinary investor, for whom the buying and selling of units is a relatively simple process.

- Units can be bought direct from the managers or through intermediaries. They can be purchased in writing or by telephone: all calls to the managers' dealing desks are recorded as confirmation that a contract has been established.
- Purchasers receive two important documents from the managers:
  - *the contract note:* this specifies the fund, the number of units, the unit price and the amount paid. It is important because it gives the purchase price, which will be needed for capital gains tax (CGT) purposes when the units are sold;
  - *the unit certificate*: this specifies the fund and the number of units held, and is the proof of ownership of the units.
- In order to sell some or all of the units, the unitholder signs the form of renunciation on the reverse of the unit certificate and returns it to the managers. If only part of the holding is to be sold, a new certificate for the remaining units is issued.

3.2.1.5 Charges

There are two types of charges applied to unit trusts:

- the *initial charge* that will cover the costs of purchasing fund assets and the commission payments to intermediaries such as IFAs. The initial charge is typically covered by the bid-offer spread;
- the *annual management charge,* which, as its name suggests, is the fee paid for the use of the professional investment manager. The charge varies but is typically between 0.5% and 2% of fund value. Although an annual fee, it is commonly deducted on a monthly or daily basis.

3.2.1.6 Types of unit

Unit trusts may offer the following units:

- *accumulation units,* which automatically reinvest any income generated by the underlying assets. This would suit someone looking for capital growth;

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- *distribution or income units,* which split off any income received and distribute it to unitholders. The units may also increase in value in line with the value of the underlying assets.

3.2.1.7 Taxation of unit trusts

3.2.1.7.1 Income tax

Authorised unit trusts, other than fixed interest trusts, are treated as companies for tax purposes and, as such, are subject to corporation tax on income (though not on growth within the fund).

Dividend income received by the trust will already have borne tax at 10%; the unit trust has no further liability on such income.

- When the income is paid out to unitholders, it is treated as having borne tax at 10%.
- A non-taxpayer is *not* able to reclaim the 10% tax already deducted.
- Lower rate and basic rate taxpayers need take no further action because the 10% tax already deducted is deemed to satisfy their tax liability on the income.
- Higher rate taxpayers have a further liability of 22.5% of the gross income distribution, ie on the income paid plus the 10% tax deducted at source. Thus the total liability for a higher rate taxpayer is 32.5%.

So, a distribution of £18 net received by a unitholder is equivalent to gross income of £20. If the unitholder is a higher rate taxpayer, a further £4.50 tax will be payable through self-assessment.

Income from overseas securities, cash and fixed-interest securities is subject to corporation tax at a rate of 20%. This will mean that when this income is paid out:

- non-taxpayers can reclaim the tax that has been deducted;
- lower rate taxpayers can reclaim half the tax deducted (ie they are only liable to tax at 10% and therefore can reclaim 10%);
- basic rate taxpayers have no additional liability;
- higher rate taxpayers must pay a further 20% of the gross income.

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So, in this case, a distribution of £40 net received by a unitholder is equivalent to gross income of £50. If the unitholder is a higher rate taxpayer, a further £10 tax will be payable through self-assessment. A non-taxpayer can reclaim the £10 deducted.

3.2.1.7.2 Capital gains tax

No capital gains tax is levied within the unit trust, but the investor may be liable to capital gains tax on any gain made when units are encashed. The annual exemption allowance can be used to reduce any liability to capital gains tax.

3.2.1.8 Risks of unit trusts

The legal constitution of a unit trust helps to mitigate risk of fraud because the trustees have a responsibility to ensure there is proper management.

Given the nature of a unit trust as a pooled investment, the risk will be lower than that of an individual investing directly into equities on their own behalf. Unit trust funds will typically invest in a spread of between 30 and 150 different shares.

The actual risk will depend on the type of unit trust selected. The wide range of choice means that there are unit trusts to match most investors' risk profiles. A cash fund will carry similar risks to a deposit account, specialist funds such as emerging markets are high risk by their very nature and overseas funds carry the added risk of currency fluctuations.

Unit trusts provide no guarantee that the initial capital investment will be returned in full or that a particular level of income will be paid.

3.2.2 Investment trusts

Investment trusts are collective investments but, unlike unit trusts, they are not unitised funds. Furthermore – despite their name – they are not even trusts. They are in fact public limited companies whose business is investing (in most cases) in the stocks and shares of other companies. Investing in an investment trust is achieved by purchasing shares of the investment trust company on the Stock Exchange; similarly, in order to cash in the investment, it is necessary to sell these shares to another investor. As with all companies,

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the number of shares available remains constant, so an investment trust is said to be *closed-ended* (in contrast to the open-ended nature of unit trusts).

The share price of an investment trust obviously depends to some extent on the value of the underlying investments, but not so directly as in the case of a unit trust. The price can depend on a number of other factors that affect supply and demand. In many cases, the share price of an investment trust is less than the *net asset value (NAV)* per share; the NAV per share is the total value of the investment fund divided by the number of shares issued. This situation – referred to as being *at a discount* – means that an investor should achieve greater income and growth levels than would be obtained by investing directly in the same underlying shares.

One advantage of being constituted as a company is that an investment trust can benefit from *gearing*: this means that, like all companies, it can borrow money in order to take advantage of business opportunities (in their case, investment opportunities). This avenue is not open to unit trusts, which are not permitted to borrow. Gearing enables investment trusts to enhance the growth potential of a rising market, but investors should be aware that it can equally accentuate losses in a falling market. This factor led to some high-profile difficulties for certain investment trusts in the volatile stock market of the early 2000s.

3.2.2.1 Taxation of investment trusts

The taxation situation is broadly the same as that described for unit trusts. At least 85% of the income received by investment trust fund managers must be distributed as dividends to shareholders, who receive them net of 10%, with a tax credit. As with all share dividends, lower rate and basic rate taxpayers have no further liability, but higher rate taxpayers pay the balance of the special rate of 32.5% of the grossed-up dividend.

Fund managers are exempt from tax on capital gains, but investors are subject to capital gains tax on the sale of their investment trust shares.

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3.2.2.2 Split-capital investment trusts

Sometimes known as *split-level trusts* or simply as *splits*, split-capital investment trusts are fixed-term investment trusts offering two or more different types of share. The most common forms of share offered by split-level investment trusts are:

- *income shares*, which receive the whole of the income generated by the portfolio but no capital growth;
- *capital shares*, which receive no income but which – when the trust is wound up at the end of the fixed term – share all the capital growth remaining after fixed capital requirements have been met.

Recent innovations have seen the introduction of intermediate types of shares, offering different balances of capital and income.

3.2.2.3 Real estate investment trusts

Real estate investment trusts (REITs – pronounced 'reets' to avoid confusion with rights) are tax-efficient property investment vehicles that allow private investors to invest in property while avoiding many of the disadvantages of direct property investment (see Section 2.4).

REITs became available in the UK from January 2007. Similar schemes operate in a number of other countries, particularly the USA and Australia.

A summary of the main UK features of REITs is as follows.

- They will pay *no corporation tax* on income or growth provided they meet the requirements listed below.
- At least 75% of their gross income must be derived from property rent. The remainder can come from development or other services.
- At least 90% of their net profits must be distributed to their shareholders.
- No individual shareholder can hold more than 10% of the shares.
- Single-property REITs are only be allowed in special cases – such as, for example, a shopping centre with a large number of tenants.
- They can be held in ISAs, child trust funds and self-invested personal pensions.

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It is expected that many property companies will convert into REITs – although this will be subject to a one-off charge of 2% of the value of their assets.

3.2.3 Open-ended investment companies (OEICs)

Open-ended investment companies (OEICs) have been popular in mainland Europe for a number of years and have been available in the UK since 1997. They share a number of characteristics with unit trusts and investment trusts. The similarity with unit trusts is not surprising, as there is a high degree of commonality between the Financial Services Authority's two sets of regulations on OEICs and unit trusts.

OEICs are a pooled investment offered by a company that buys and sell the shares of other companies and deals in other investments. The OEIC will issue shares – typically participating redeemable preference shares – that can be bought and sold by investors.

Although operating as a company, an OEIC cannot borrow money to finance its activities other than for short-term purposes, unlike an investment trust.

3.2.3.1 Legal constitution of an OEIC

An OEIC is established under company law, not under trust. OEICs must be authorised by the FSA.

The role of overseeing the operation of the company and of ensuring that it complies with the requirements for investor protection is carried out by a *depositary*, who will be authorised by the Financial Services Authority. The role of the depositary is much the same as the trustee of a unit trust.

An *authorised corporate director,* whose role is much the same as the manager of a unit trust, manages the OEIC. The role of the corporate director is to:

- manage the investments;
- buy and sell OEIC shares as required by investors;
- ensure that the share price reflects the underlying net asset value of the OEIC's investments.

The range of OEICs is similar to that of unit trusts. OEICs are available that offer: income; capital growth; fixed interest; access to overseas markets; access

to specialist markets (eg commodities, technology or healthcare); index tracking.

3.2.3.2 Investing in an OEIC

As with unit trusts and investment trusts, investments can be made either by lump sum, regular contribution or a combination of both.

Investors buy shares in the OEIC. The number of shares that are available is unlimited so the OEIC is, as the name would suggest, open-ended like a unit trust, rather than closed-ended like an investment trust. The value of the shares vary according to the market value of the company's underlying investments.

An OEIC may be structured as an 'umbrella' company that is made up of several sub-funds. Different types of share can be made available within each sub-fund.

3.2.3.3 Pricing of OEIC shares

The basic procedure for establishing the share price is the same as that for determining the unit price in a unit trust: the total value of OEIC assets is established and then divided by the number of shares currently in issue.

There are, however, some differences in pricing when OEICs are compared to unit trusts. OEIC shares have only one price, not a separate bid and offer price as for units in a unit trust.

3.2.3.4 Charges

- *Initial charge*: as already mentioned, OEIC shares are single-priced so there is no bid offer spread. An OEIC will levy an initial charge, however, normally in the region of 3% to 6% of the value of the individual's investment.
- *Annual management charge*: annual management charges based on the value of the fund are deducted, normally from the income that the OEIC generates. The range of annual management charges is typically between 0.5% for indexed funds and 2% for more actively managed funds.

Other administration costs may also be deducted from the income that is generated.

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3.2.3.5 Taxation of OEICs

The tax treatment of OEICs is exactly the same as that for unit trusts and investment trusts.

Any dividend distribution will be paid net of tax at 10% and:

- a non-taxpayer cannot reclaim the tax;
- lower and basic rate taxpayers have no further tax liability;
- higher rate taxpayers must pay a further 22.5% of the gross dividend.

The fund managers are not subject to tax on capital gains, although a liability to CGT may arise for the investor when the OEIC is encashed. The amount of any CGT liability can be mitigated by use of the annual exemption.

3.2.3.6 Risks

The risks associated with investing in an OEIC are similar to those of investing in a unit trust. As a pooled investment employing the services of professional investment managers, the degree of risk is lower than direct equity investment. Risk is also mitigated by the spread that can be achieved for a relatively small investment. There is, however, no guarantee of the maintenance of the original capital invested or the level of income that will be generated.

3.2.4 Individual savings accounts (ISAs)

In 1997, the government decided that the existing tax-free savings schemes were not sufficiently accessible to a large proportion of the population. It was estimated that 50% of the population of the UK had less than £200 in savings, with about 25% having no savings at all. The government subsequently introduced, from 6 April 1999, the **individual savings account (ISA)**. Its stated objectives are to develop the savings habit and to ensure that tax relief on savings is fairly distributed.

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There are now two possible components of new investments into ISAs:

- *stocks and shares (or equity) ISAs*: this component can include:
  - shares and corporate bonds issued by companies listed on stock exchanges anywhere in the world;
  - gilt-edged securities and similar stocks issued by governments of countries in the EEA;
  - UK-authorised unit trusts that invest in shares and securities;
  - UK open-ended investment companies (OEICs);
  - UK investment trusts;
- *cash ISAs,* including:
  - bank and building society deposit accounts;
  - certain taxable National Savings and Investments (NS&I) accounts – excluding the investment account. NS&I also offers a deposit account-type ISA.

An earlier third type of component – life assurance – is no longer available for new investments, but can be incorporated in the stocks and shares component.

The minimum age for investing in an equity ISA is 18 years, but a cash ISA can be opened by anybody aged 16 or over. An ISA investor must be both resident and ordinarily resident in the UK for tax purposes, and an ISA can only be held in a single name, ie joint accounts are not permitted, although husbands and wives can have one each.

3.2.4.1 Tax reliefs

Investors are exempt from income and capital gains tax on their ISA investments. Prior to 5 April 2004, fund managers of equity ISAs could reclaim the 10% deduction from UK share dividends but this benefit has now been withdrawn. Fund managers are exempt from tax on other income and gains received for the benefit of ISA investors.

3.2.4.2 Subscription limits

With effect from the 2008/09 tax year, the former distinction between mini-ISAs and maxi-ISAs has been removed. The overall annual subscription limit for ISAs is now £7,200, of which up to £3,600 can be in cash. The remainder of the

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£7,200 can be placed in a stocks and shares ISA with the same provider or a different provider. Each individual can therefore have up to two separate ISAs in a tax year.

3.2.4.3 Transfer arrangements

- Existing mini cash ISAs, together with 'TESSA-only' ISAs and cash elements of maxi-ISAs, will become cash ISAs.
- It will in future be possible to transfer funds from a cash ISA to a stocks and shares ISA without contravening the ISA limits (but not vice versa).
- Personal equity plans (PEPs) will automatically become stocks and shares ISAs.

Most other ISA rules will continue to apply, for example:

- the tax benefits remain unchanged;
- ISAs can still be transferred between providers on a like-for-like basis;
- the qualifying investment rules for ISAs are unchanged, and former PEPs now benefit from slightly wider range allowed for ISAs.

3.2.4.4 Withdrawals

Many ISAs allow no-notice withdrawals to be made, although there are now some fixed-rate cash ISAs available that do not permit withdrawals during the fixed-rate period. It is not possible to replenish withdrawals made during a particular tax year. For example, if an investor paid in £3,600 to open a cash ISA on 20 November 2008 and then withdrew £2,000 on 25 March 2009, he could not add any further money to the account during the 2008/09 tax year because he had already invested the maximum allowance of £3,600 during that tax year.

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3.2.5 Life assurance-based investment products

3.2.5.1 Endowments

The most common form of savings contract offered by life assurance companies is **endowment** assurance, which is, broadly speaking, a policy on which the sum assured is paid out at the end of a specified term or on the earlier death of the life assured (although some policies are open-ended and allow policyholders to choose when to receive the proceeds of their investment). The client's investment is made in the form of regular premiums to the life assurance company throughout the term of the policy. There are a number of variations, the most common of which are as follows.

3.2.5.1.1 Non-profit endowment

This policy has a fixed sum assured, which is payable on maturity (ie at the end of the policy term) or on earlier death. Because the return is fixed and guaranteed, the investor is shielded from losses due to adverse stock market movements; on the other hand, he is equally unable to share in any profits the company might make over and above those allowed for in calculating the premium rate (hence the name: 'non-profit'). For that reason, non-profit policies are rarely used today.

3.2.5.1.2 With-profit endowment

Like its non-profit equivalent, a with-profit endowment has a fixed basic sum assured and a fixed regular premium. The premium, however, is greater than that for a non-profit policy of the same sum assured, and the additional premium (sometimes called a *bonus loading*) entitles the policyholder to share in the profits of the life assurance company.

The company distributes its profits among policyholders by annually declaring bonuses that become part of the policy benefits and are payable at the same time and in the same circumstances as the sum assured. There are two types of bonus.

- *Reversionary bonuses*: these are normally declared each year and, once they have been allocated to a policy they cannot be removed by the company, provided that the policy is held until the end of the term or earlier death. Some companies declare a simple bonus, where each annual bonus is calculated as a percentage of the sum assured; others

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declare a compound bonus, with the new bonus being based on the total of the sum assured and previously declared bonuses. Most companies set their reversionary bonuses at a level that they hope to be able to maintain for some time, in order to smooth out the short-term variations of the stock markets, but with the level of interest rates and other investment yields falling in recent years, bonus rates in general have also been falling. In spite of this, with-profit policies have produced much better returns in the long run than non-profit policies.

- *Terminal bonuses*: these are bonuses that may be added to a with-profit policy when a death or maturity claim becomes payable. Unlike reversionary bonuses, a terminal bonus does not become part of the policy benefits until the moment of a death or maturity claim, thus allowing the company to change the terminal bonus rate – or even remove the terminal bonus altogether. Terminal bonuses are intended to reflect the level of investment gains that the company has made over the term of the policy, so the rate of bonus often varies according to the length of time that the policy has been in force. In the current climate of reduced stock market values, many companies have reduced the level of their terminal bonuses.

A variation of the with-profit endowment, known as a *low-cost endowment,* is sometimes used for mortgage repayment purposes (see Section 3.5.1.3.1.1).

3.2.5.1.3 Unit-linked endowment

The first unit-linked policies were issued in the late 1950s and represented a revolutionary change in the way in which policies were designed. The development reflected the desire of many policyholders to link investment returns more directly to the stock market, or even to specific sectors of the market.

Unit-linked endowments work on the basis that, when a premium is paid, the amount of the premium – less any deductions for expenses – is applied to the purchase of units in a chosen fund. A pool of units gradually builds up and, at the maturity date, the policyholder receives an amount equal to the total value of all units then allocated to the policy. Most unit-linked endowments also provide a fixed benefit on death before the end of the term. The cost of providing this life cover is taken from the policy each month by cashing in sufficient units from the pool of units.

Over the longer term, the most successful unit-linked endowments have shown better returns than with-profit endowments. Unlike with-profit endowments, however, unit-linked policies do not provide any guaranteed minimum return at maturity; they are, therefore, a good illustration of the maxim that greater potential return generally goes hand-in-hand with the acceptance of greater risk.

3.2.5.1.4 Unitised with-profit endowments

Unitised with-profit endowments have been available since the late 1980s, when they were introduced in an attempt to combine the security of the with-profit policy with the greater potential for reward offered by the unit-linked approach. As with unit-linking, premiums are used to purchase units in a fund and the benefits paid out on a claim depend on the number of units allocated and the then-current price of units.

The difference from a standard unit-linked policy lies in the fact that unit prices increase by the addition of bonuses which, like the reversionary bonuses on a with-profit policy, cannot be taken away once they have been added. This means that unit prices cannot fall and the value of the policy, if it is held until death or maturity, is guaranteed. If the policy is surrendered (ie cashed in before its maturity date), however, a deduction is made from the value of the units. This deduction, the size of which depends on market conditions at the time of the surrender, is known as a *market value adjustment (MVA).*

3.2.5.2 Investment bonds

Investment bonds are collective investment vehicles based on unitised funds. Because of the unitised structure of their funds, they may appear similar to unit trusts, but they are actually very different.

Investment bonds are available from life assurance companies and are set up as single-premium unit-linked whole-of-life assurance policies. Investing in a bond is achieved by paying the single (lump sum) premium to the life company. The investor then receives a policy document that shows that the premium has purchased (at the offer price) a certain number of units in a chosen fund and that those units have been allocated to the policy. In order to cash in the investment, the policyholder accepts the surrender value of the policy, which is equal to the value of all the units allocated, based on the bid price on the day when it is surrendered.

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Investors are attracted by the relative ease of investment and surrender, by the simplicity of the documentation and also by the ease of switching from one fund to another: companies generally permit switches between their own funds without charging the difference between bid and offer prices.

The range of available funds is similar to those offered by unit trusts and investment trusts. In addition, some companies offer with-profits investment bonds, in which premiums are invested in a unitised with-profits fund (see Section 3.2.5.1.4). If a with-profits bond is cashed in within a specified period after commencement (typically five years), the amount received is likely to be less than the value of the units.

In the event of the death of the life assured, the policy ceases and a slightly enhanced value (often 101% of the bid value on the date of death) is paid out.

3.2.5.2.1 Taxation

The funds in which the premiums are invested are internal life company funds and their tax treatment is different from that of unit trusts. In particular, they attract tax at 20% on capital gains (whereas unit trust funds are exempt) and this tax is not recoverable by investors even if they themselves have a personal exemption from capital gains tax. The taxation system for policy proceeds in the hands of the policyholder is complex but, broadly speaking, because gains have been taxed at 20% within the fund, tax on the gain is payable only by higher rate taxpayers, and then only at 20% – the excess of the higher rate over the 20% already deemed to have been paid within the fund. This is because investment bonds are non-qualifying policies (see Section 1.3.3.2.7).

Since the introduction on 6 April 2008 of a single rate of tax on capital gains of 18%, investment bonds are now less attractive for higher-rate taxpayers. If a higher-rate taxpayer invests *directly* into an 'unwrapped' investment fund, the taxpayer will pay income tax on the income and, after applying their annual CGT exemption, only 18% on gains. If the taxpayer were, instead, to invest in the same fund using an investment bond, they will pay 20% tax on the income and gains at source, without any exemption, then a further 20% when they cash the bond.

Unlike investment trusts and unit trusts, investment bonds do not normally provide income in the form of dividends or distributions, but it is possible to derive a form of 'income' from them by making small regular withdrawals of capital (by cashing in some of the units allocated to the policy.). These withdrawals are tax-free to basic rate taxpayers, and even higher rate taxpayers

can withdraw up to 5% of the original investment each year without incurring an immediate tax liability. This 5% allowance can, if not used, be carried forward and accumulated up to an amount of 100% of the original investment.

3.2.6 Child Trust Fund

The **Child Trust Fund** is a tax-free savings account for children born on or after 1 September 2002. It is automatically available to all children for whom Child Benefit is payable and is an attempt by the government to encourage saving on behalf of (and perhaps, eventually, by) children.

A summary of the main characteristics of the Child Trust Fund (CTF) is as follows.

- Each individual CTF begins with an initial payment of £250 (or sometimes more, see below) provided by the government in the form of a voucher, sent automatically to the Child Benefit claimant, who is usually, but not always, one of the parents. Only children living in the UK are eligible.
- If the child's family is eligible for the full Child Tax Credit (see Section 1.3.5.2.4), the initial payment is increased to £500.
- The parent or carer then uses the voucher to open a CTF account with a CTF provider. The voucher can be used *only* to open a CTF. The account remains in force until the child's 18th birthday, at which point the child has access to the money in the account and can use it for any purpose they wish. There is no access to this money (or any added later) before the child's 18th birthday.
- The parent remains responsible for the CTF until the child is 16, after which the child can manage their own account.
- There is a wide range of CTF providers, including banks, building societies, friendly societies and other financial institutions.
- There are three broad types of CTF:
  1. deposit-type savings accounts;
  2. accounts that invest directly or indirectly in shares;
  3. stakeholder CTF accounts.

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- Stakeholder CTF accounts invest in a range of company shares, subject to certain government rules designed to reduce the risk. From the child's 13th birthday, the money will gradually be moved to lower risk assets to protect it from stock market losses as the child's 18th birthday approaches.
- The maximum annual charge permitted on a stakeholder CTF is 1.5%. There is no limit on charges on other types of CTF.
- Parents have 12 months in which to choose the type of account and the provider. If the voucher has not been used to open an account within 12 months of issue, a stakeholder account will automatically be opened by HM Revenue & Customs on behalf of the child.
- Parents (and other family, or even friends) can make additional investments into a CTF. The maximum additional investment in each CTF is £1,200 per year (ie the year between the child's birthdays).
- Neither the parent nor the child will be subject to tax on income or capital gains from the CTF. There is, however, no tax relief on any amounts invested into the CTF.

3.2.7 Structured products

There is no single accepted definition of a 'structured product'. They take a number of different forms, ranging from one-off investments designed for high net worth individuals to generic products offered by life companies, fund managers, banks, and National Savings and Investments (NS&I).

The defining characteristic of structured products is that they offer an element of protection of the capital invested (up to 100% in some cases) while also enabling participation in underlying assets that may be higher-performing but are also higher-risk (such as ordinary shares). They appeal to investors who are cautious about direct exposure to the possible downside of stock markets but would like to share in the growth possibilities.

A good example of a structured product available to the general public is the Guaranteed Equity Bond (GEB) from NS&I. Issue 14 of the GEB (early 2008) is a five-year bond offering a return that matches the growth in the FTSE-100 index, but with a guarantee of a return of capital if the index falls.

At the other end of the scale of guarantees is a type of three to five year high-income bond now commonly known as 'precipice bonds'. They are structured

to provide a very high-income yield on the capital invested, with the return of capital being linked to the performance of particular stock market index. Many of them specified a particular index level below which the value of the capital fell steeply (hence the name 'precipice'). In the falling markets of the early 2000s, many investors lost heavily, and the Financial Services Authority has been concerned as to whether investors, many of whom were aged over 60, were adequately advised about the risk of loss of capital.

3.3 Insurance

Very few aspects of life are entirely free from some element of risk and most people have some form of insurance to protect them against the financial effects of adversity. In some cases, it is compulsory – for instance, third party liability for drivers of motor vehicles on public roads. In many other cases it is wise to insure against the loss of (or damage to) items that are too valuable to replace out of normal income, such as a house and its contents. Similarly, most families need protection against unforeseen events that would deprive them of their sources of income, such as the untimely death or serious illness of a main breadwinner.

The examples mentioned above illustrate the two main types of insurance available: general insurance and life assurance.

3.3.1 Life assurance protection

3.3.1.1 Whole-of-life assurance

A **whole-of-life assurance** is, as the name implies, designed to cover the life assured for the whole of that lifetime. It will pay out the amount of the life cover in the event of the death of the life assured, whenever that death occurs, provided that the policy remains in force.

Premiums may be:

- payable throughout life (ie for the full term of the policy, whatever that turns out to be); or
- limited to a fixed term (eg 20 years) or to a specified age (such as 60 or 65).

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If limited premiums are chosen, the minimum term is normally ten years.

Because a whole-of-life assurance (unlike a term assurance) will definitely pay out sooner or later, life companies build up a reserve to enable them to pay out when the life assured dies. This enables companies to offer surrender values on whole-of-life policies that are cancelled by the client before death has occurred. These surrender values are, however, generally small in relation to the sum assured. In fact, in the early years of a policy, the surrender value will be less than the premiums paid. This emphasises the fact that whole-of-life policies are protection policies and not investment plans.

Whole-of-life policies can be taken out on a number of different bases:

- non-profit;
- with-profit;
- unit-linked;
- unitised with-profit;
- low-cost;
- flexible;
- universal.

The principles of non-profit, with-profit, unit-linked and unitised with-profit are described in Section 3.2.5.1. The others are described below.

3.3.1.1.1 Low-cost whole-of-life

A low-cost or minimum-cost whole-of-life policy has a sum assured that is payable on death whenever it occurs. It is however, made up of two elements: a whole-of-life with-profits plus a decreasing term assurance.

The basic whole-of-life with-profits sum assured is lower than overall level of cover required, with bonuses being added as the policy continues. A guaranteed death benefit is offered and, while the whole-life with-profits increases with the addition of bonuses, the shortfall is made up by a decreasing term assurance. Once the basic sum assured plus bonuses increases beyond the guaranteed death benefit, the decreasing term assurance element ceases.

This policy is suitable for anyone seeking maximum life cover on a permanent basis at minimum cost.

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3.3.1.1.2 Flexible whole-of-life

When whole-of-life policies are issued on the unit-linked basis, they are generally referred to as *flexible whole-of-life*.

The flexibility to which the name refers lies in the fact that these policies can offer a variable mix between their life cover and investment content. The key to this flexibility is the method of paying for the life cover by cashing in units at the bid price:

- the policyholder pays premiums of an amount that he wishes to pay – or feels that he can afford to pay;
- the premiums are used to buy units in the chosen fund or funds, and these units are allocated to the policy;
- the policyholder selects the level of benefits that he wishes to have:
  - if a high level of life cover is required, a larger number of units will be cashed each month, and a correspondingly lower number will remain attaching to the policy. This means that the investment element of the policy (which depends on the number of units) is also lower;
  - conversely, a low level of life cover means fewer units cancelled and hence a higher level of investment.

The flexibility of the system, under which benefits are paid for by cashing units, means that other options are often available. These include an option to take income, indexation of benefits (for automatic adjustment of death benefits) and the ability to add another life assured.

Although it can have a high level of investment, a flexible whole-of-life assurance should never be thought of primarily as a savings vehicle, but rather as a protection plan that could be adapted to investment if circumstances changed.

Most companies offer three main levels of cover on their flexible whole-of-life policies (although it is usually possible to choose other levels in between):

- *maximum cover*: this is normally set at such a level that cover can be maintained for ten years but, after that point, all the units will have been used up and increased premiums will be needed if the cover is to continue;
- *minimum cover*: a minimum level of life cover is maintained – probably the minimum required for the policy to remain qualifying – and the number

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of units attaching to the policy builds up to a substantial investment element;

- *balanced cover*: this is the level of cover, for a given premium, which the company expects to be able to maintain throughout the life assured's lifetime.

To calculate the various levels of cover, the company makes an assumption about the future growth rate of unit prices.

In all cases, the initial life cover is guaranteed for a certain period, often ten years. Beyond that point, the company reserves the right to increase the premiums or to reduce the cover – to take account of increases in costs or to allow for the fact that unit prices have not grown as quickly as had been assumed. The death benefit is then guaranteed until the next review.

Further reviews are usually undertaken at five-yearly intervals, or even annually with older lives assured, and adjustments may again be made. The need for such reviews is the price that clients have to pay for the flexibility of the system. In fact, the reviews are beneficial to the client because they reveal possible shortfalls at any early stage, when they can be rectified before the cost becomes prohibitive.

3.3.1.1.3 Universal whole-of-life assurance

The flexibility of unit-linked whole-of-life is sometimes extended further by adding a range of other benefits and options to the policy. When that is done, the policy is usually referred to as universal whole-of-life. Benefits and options that may be added include:

- permanent health insurance;
- critical illness cover;
- accidental death benefit;
- total and permanent disability cover;
- hospital benefits or other medical cover;
- guaranteed insurability (to increase cover);
- indexation of benefits;
- flexibility of premium levels;

- waiver of premium during periods of inability to pay due to, for instance, disability or unemployment.

Most of the additional benefits will be at extra cost, the additional cost being met by cashing more units.

3.3.1.1.4 Uses and benefits

Whole-of-life policies are appropriate to those circumstances where the need is for a sum of money to be paid on the death of an individual, whenever that death may occur. Like all protection policies, therefore, their overall benefit is that they provide peace of mind. They can be used in personal and business situations, and for certain taxation purposes.

The uses of whole-of-life policies include the following:

- to protect dependants against loss of financial support in the event of the death of a breadwinner;
- to provide a tax-free legacy;
- to cover expenses on death;
- to provide funds for the payment of inheritance tax.

3.3.1.1.5 Joint-life second-death policies

When a whole-of-life policy is used to provide the funds likely to be needed to pay inheritance tax (IHT), it is normal to use a whole-of-life policy that will pay out on the death of the survivor of the husband and the wife (known as a *joint-life second-death policy* or a *last survivor policy*).

The reason for this is that, in most families, the estate of the first spouse to die passes to the surviving spouse (free of IHT), and the IHT becomes due only when the surviving spouse dies and the estate passes to the family or to others.

3.3.1.2 Term assurance

There is a wide variety of term assurances available, but they all share one common characteristic: that the sum assured is payable only if the death of the life assured occurs within a specified period of time (the term).

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Term assurance is the most basic form of life assurance – pure protection for a limited period with no element of investment. For this reason, it is also the cheapest.

Term assurance can be used for personal and family protection and also for a wide range of business situations. Business use includes the provision of *key person insurance,* to protect against the loss of profits resulting from the death of an important employee, and partnership insurance schemes, to enable surviving partners to buy out the share of a partner who has died.

Other characteristics shared by term assurances are as follows.

- The term can be anything from a few months to, say, 40 years or more (for terms that end after age 65, it may be better to take out a whole-of-life policy instead).
- If the life assured survives the term, the cover ceases and there is no return of premiums.
- There is no cash value or surrender value at any time;
- If premiums are not paid within a certain period after the due date (normally 30 days), cover ceases and the policy lapses with no value. Most companies will allow reinstatement within 12 months provided all outstanding premiums are paid and evidence of continued good health is provided.
- Premiums are normally paid monthly or annually, although single premiums (one payment to cover the whole term) are also allowed.
- Premiums are normally level (the same amount each month or year), even if the sum assured varies from year to year.

There are a number of basic types of term assurance and a number of options that can be included. These are described below.

3.3.1.2.1 Level term assurance

With level term assurance, the sum assured remains constant throughout the term. Premiums are normally paid monthly or annually throughout the term, although single premiums can be paid.

Level term assurance is often used when a fixed amount would be needed on death to repay a constant fixed-term debt such as a bank loan.

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It can also be used to provide family cover, for instance, until the children leave home. If it is used for that purpose, the policyholder should bear in mind that the amount of cover in real terms would be eroded by the effect of inflation.

3.3.1.2.2 Decreasing term assurance

The sum assured reduces to nothing over the term of the policy. Premiums may be payable throughout the term, or may be limited to a shorter period such as two-thirds of the term.

This policy could be used to cover the outstanding capital on a decreasing debt.

Two particular kinds of decreasing term assurance are:

- *mortgage protection assurance*: the most common use of decreasing term assurance is to cover the amount outstanding on a repayment mortgage. It is usually known as a mortgage protection policy. Be careful not to confuse this with short-term sickness and redundancy cover for mortgage repayments, which is sometimes also referred to as *mortgage protection insurance*.

  The sum assured on mortgage protection assurance is calculated in such a way that it is always equal to the amount outstanding on a repayment mortgage of the same term, based on a specified rate of interest. The sum assured (like the mortgage) decreases more slowly at the start of the term than towards the end;

- *gift* inter vivos *cover*: decreasing term assurances can be arranged to cover special requirements, such as 'gifts inter vivos', which are gifts made during a person's lifetime, as opposed to on death. Under inheritance tax rules, no tax is immediately due when such a gift is made from one person to another, but may become due of the donor dies within seven years of making the gift. For inheritance tax purposes, the estate on death includes the value of any gifts that were made in the preceding seven years. If the estate, including the gifts, exceeds the inheritance tax threshold, it is the gifts that are offset against the nil-rate band first. If there is any nil-rate band left, this is then offset against the remainder of the estate. If the value of the gifts alone exceeds the nil-rate band, the portion of the gifts that exceeds the threshold is taxed along with the remainder of the estate, although the tax on the gifts is scaled down if they are made more than three years prior to the date of death (tapering relief).

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So, if a person makes a gift during their lifetime that, either on its own or when added to gifts made in the previous seven years, exceeds the current nil-rate band, provision needs to be made for the tax that may become due in the event of the donor not surviving the whole seven years. 'Gift inter vivos cover' is a term assurance policy designed to provide an amount sufficient to pay the inheritance tax due should the donor die within seven years of making the gift. To achieve this, the sum assured under the policy is set at the start of the policy as the amount of tax that is due. It remains level for three years and then reduces in year four to 80% of the tax due, 60% in year five, 40% in year six and 20% in year seven, after which time the cover ceases as the gift will be exempt. Additional cover should also be arranged to protect the remainder of the estate.

3.3.1.2.3 Increasing term assurance

Some companies offer increasing term assurance policies where the sum assured increases each year by a fixed amount or a percentage of the original sum assured.

This type of policy can be used where temporary cover of a fixed amount is required but where the cover needs to increase to take some account of the effects of inflation on purchasing power.

3.3.1.2.4 Convertible term assurance

A convertible term assurance is a term assurance that includes an option to convert the policy into a whole-of-life or endowment assurance without further evidence of health (or indeed any additional underwriting). This guaranteed insurability means that no medical or other evidence is required and the conversion is carried out at normal premium rates whatever the state of health of the life assured.

The cost of this option is an addition of, typically, around 10% of the premium.

The option is normally included only on level term assurance policies but there is no technical reason why it should not be included on decreasing term assurances and others.

Certain rules and restriction apply to the conversion option.

- The conversion is normally carried out by the cancellation of the term assurance and the issue of a new whole-of-life or endowment policy. A new endowment can extend beyond the end of the original convertible term policy.
- The option can only be exercised while the convertible term assurance is in force.
- The sum assured on the new policy cannot exceed the sum assured of the original convertible term assurance: if a higher level of cover is required after conversion, the additional sum assured will be subject to normal underwriting.
- The premium for the new policy is the current standard premium for the new term and for the life assured's age at the conversion date.

3.3.1.2.5 Renewable term assurance

A renewable term assurance policy includes an option, which can be exercised at the end of the term, to renew the policy for the same sum assured without the need for further medical evidence.

The new term is the same as the previous term and the new policy itself includes a further renewal option, except that there is a maximum age, usually around 65, after which the option is no longer available.

The premium for the new policy is based on the life assured's age at the date when the renewal option is exercised.

Renewable and increasable term assurance: is similar to the renewable policy, with the added option on renewal to increase the sum assured by a specified amount – often either 50% or 100% of the previous sum assured, again without evidence of health.

Some companies offer renewable, increasable and convertible term assurances, combining all three of the options described above.

3.3.1.3 Family income benefits

The aim of family protection is often to replace income lost on the death of the breadwinner. A **family income benefits (FIB) policy** is designed to meet this need by providing income rather than a lump sum.

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The policy pays out a tax-free regular income (monthly or quarterly) from the date of death of the life assured until the end of the chosen term.

Since the cover reduces as time passes, this policy can be described as a form of decreasing term assurance.

As an alternative to regular income payments, beneficiaries may choose to receive a lump sum payment that will be calculated at a discounted value of the outstanding instalments.

Policies can be arranged with escalating instalments, to combat the effects of inflation. Since these provide higher levels of cover than ordinary FIBs, the premiums are also higher.

3.3.1.4 Pensions term assurance

Prior to A-Day (6 April 2006) it had been possible for people with personal pension plans and stakeholder pension plans to take out (within specified limits) term assurance policies for which they could obtain tax relief on the premiums at their highest rate. The new pension regime introduced by A-Day appeared to open the availability of such policies to virtually everyone, whatever their pension arrangements.

The result was that virtually all term assurances could now be issued as pension term assurance and could obtain tax relief. The government considers this to undermine the principles of their new pension regime, and in the Pre-Budget Report of December 2006 announced that it would act quickly to prevent standalone term assurances from being eligible for pensions tax relief.

In all cases where an application applying for life insurance cover was fully completed on or before 6 December, submitted to the insurance company and receipt recorded by that insurance company by midnight on 13 December 2006, the existing tax relief regime will apply, provided that the 'sum assured' issued is no greater than that applied for on or before 6 December 2006. Insurers had until 5 April 2007 to process this business, so that appropriate medical evidence could be checked and an appropriate commencement date for cover settled. Insurers were subsequently given a further period to process this business

For further details of pension products, see Section 3.6.

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3.3.2 Ill-health insurance

3.3.2.1 Critical illness cover

Critical illness cover (CIC) will provide a tax-free lump sum payment on diagnosis of one of a range of specified illnesses. The illness need not be terminal and one significant purpose of critical illness cover is to provide a lump sum to meet the additional costs that someone may face if they are diagnosed with a serious illness.

The range of illnesses and conditions covered varies from one insurer to another but would typically include the following:

- most forms of cancer;
- heart attack;
- stroke;
- coronary artery disease requiring surgery;
- major organ transplant;
- multiple sclerosis;
- kidney failure.

Other conditions that are sometimes covered are:

- paralysis;
- blindness;
- loss of limb(s).

Many policies also make provision for payment of the sum assured in the event of total and permanent disability. Again, the definition of total and permanent disability varies between companies. Some take it as being a total and permanent disability that prevents the policyholder from doing any job to which they are suited by virtue of status, education or experience. Other companies employ a tighter definition that requires that the disability prevents the person from doing any job at all.

Typical uses of critical illness cover are:

- provision of long-term care, either in hospital or in the home;
- alterations to living accommodation;

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- purchase of specialised medical equipment, eg a kidney dialysis machine;
- mortgage repayment;
- improving the quality of life of a terminally ill person.

3.3.2.2 Permanent health insurance (PHI)

Permanent health insurance (PHI) pays an income when accident/illness prevents someone from earning a living by carrying out their normal occupation. It is designed to protect people who are working and who would lose part or all of their income if they were unable to work due to illness or accident.

Many companies also offer PHI to housewives/homemakers. This is because, although they may not actually earn an income, there is usually a clear need to provide income in the event of their illness. The income could then be used to pay for housekeeping or childminding fees if the homemaker is unable to perform these duties due to illness or accident.

3.3.2.2.1 Premium rates

A major factor in determining the premium to be charged is the occupation of the life insured. A typical classification of occupations by a PHI provider might be:

- *Class 1*: the lowest risk covering those in clerical, professional or administrative roles. Examples would include accountants and civil servants;
- *Class 2*: occupations carrying a low risk of an accident. Examples would include hairdressers and pharmacists;
- *Class 3*: occupations carrying a moderate risk of accident or health problems. Examples would be farmers or electricians;
- *Class 4*: occupations with the highest risk of a claim. There will be a substantial risk of health problems or the risk of accident arising from the occupation. Examples would include coal miners and industrial chemists.

Certain occupations will be excluded from PHI cover on the basis that they represent too great a risk.

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The occupation class that a person is deemed to fall within will determine the level of premium (Class 1 occupations get the cheapest rates) and may also influence the terms on which cover is offered.

Other factors that will influence the premium rate are:

- the age of the life insured;
- the amount of benefit;
- current state of health;
- past medical history;
- the sex of the life insured (premiums are higher for women than men due to the fact that women have a higher *morbidity* rate, ie a higher risk of being ill during a specified period of time);
- the length of the deferred period (see below).

3.3.2.2.2 Payment of benefit

The payment of benefits commences after a *deferred period*. This is the amount of time that elapses between the onset of the illness/injury and the point at which benefits payments commence. Typical deferred periods are 4, 13, 26, 52 and 104 weeks. The minimum four-week deferred period is to prevent multiple claims for minor ailments such as colds.

A self-employed person, who typically would suffer a loss of income after a very short period of illness, should opt for a short deferred period. Conversely, an employed person may wish to opt for a long deferred period if they have sickness benefits paid by their employer. If this is the case, the deferred period should be set to match the date at which the employer's sick pay ceases. The longer the deferred period chosen, the cheaper the premium will be.

Benefit levels are set so that the claimant is unable to receive a higher income when not working than they could from working. Typical maximum levels of income benefit are around 60% to 65% of pre-disability earnings less state Incapacity Benefit. These limits apply to total benefits from all PHI contracts held by the individual.

Benefits are paid pro-rata if illness means that a person can work but only part-time.

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Cover is 'permanent' in the sense that the insurer cannot cancel the cover simply because the policyholder makes numerous claims. The policy could be cancelled, however, if the customer fails to keep up their premium payments or takes up a hazardous job or pastime.

Some policies will allow benefits to be indexed either before or during a claim. The rate of increase may be at a fixed rate, perhaps 3% to 7%, or based on a published measure of inflation.

Benefit is normally paid until death, return to work or retirement, whichever event occurs first.

PHI is available as a standalone policy, either as a pure protection plan or on a unit-linked basis. Additionally, PHI can be available as an option on a universal whole-of-life plan.

3.3.2.2.3 Taxation of PHI benefits

Where permanent health insurance is taken out on an individual basis the benefits are tax-free.

Permanent health insurance can be arranged by an employer on a group basis and in this case the income will be taxable as earned income. The employer pays the premium, which is a tax-deductible business expense; the premium paid by the employer is not taxable as a benefit in kind on the employee/scheme member, ie no tax or national insurance is payable by the member on the premium paid, provided that the employer has discretion as to whether to pay the proceeds to the employee. In practice, the employer has such discretion and then pays the proceeds on to the member concerned. The scheme member pays income tax and national insurance on the proceeds.

3.3.2.3 Accident, sickness and unemployment insurance (ASU)

Accident, sickness and unemployment insurance (ASU) plans are a type of general insurance that may be considered as an alternative to PHI.

ASU insurance is typically used to cover mortgage repayments in the event that illness, accident or loss of employment prevents the policyholder from earning a living. A level of income equal to monthly mortgage repayments is paid for limited period, usually a maximum of two years.

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Additional cover can sometimes be included to cover other essential outgoings.

As with permanent health insurance, there will be a deferred period, normally one month, which must elapse before benefit payments can commence. Lump sums may be paid on certain events (death, disablement, and loss of a limb).

In contrast to PHI, these plans should be viewed as short term to protect mortgage payments rather than as providing total protection of earned income.

It would be more accurate to describe these policies as accident, sickness and *redundancy* insurance, as they do not offer protection from unemployment when the insured is sacked, or resigns voluntarily. The policy will often include the following restrictions.

- The proposer must have been actively and continuously employed for a specified minimum period prior to effecting the plan.
- Any redundancy that the proposer had reason to believe was pending when he took the policy out will be excluded.
- No benefit will be payable if redundancy occurs within a specified period of the cover starting.
- A person may have to have been employed for a minimum period either before they can take out this type of plan or before the unemployment element of the plan becomes valid.

ASU policies are annually renewable at the discretion of the insurer. This means that the insurer could increase premiums in light of poor claims' experience or may even withdraw the cover offered. This is a major difference from PHI.

3.3.2.3.1 Taxation of ASU policies

All benefits are tax-free but there is no tax relief on contributions to an ASU plan, regardless of whether it is arranged on a group or personal basis.

If the scheme is set up on a group basis, any employer contribution will be allowed as an expense against corporation tax. Any employer contribution will be classed as a benefit in kind for employees earning in excess of £8,500 pa (including the value of the benefit).

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3.3.2.4 Private medical insurance

Private medical insurance (PMI) is a pure protection plan designed to provide cover for the cost of private medical treatment, thus eliminating the need to be totally dependent on the NHS.

Plans can be arranged on an individual basis or as part of a group scheme established by an employer. Employer-sponsored schemes currently account for the vast majority of PMI provision in the UK.

In a non-emergency situation, PMI can offer the following benefits:

- avoidance of NHS waiting lists;
- choice of hospital where the treatment will take place;
- choice of timing of the treatment (to fit in with work demands, for example);
- high-quality accommodation;
- choice of medical consultant.

The range of cover normally provided includes reimbursement of:

- *inpatient charges* including nursing fees, accommodation, operating fees, drugs, and the cost of a private ambulance;
- *surgical and medical fees* including surgeon's fees, anaesthetist's fees, pathology, and radiology;
- *outpatient charges* including consultations, pathology, radiology, and home nursing fees.

Some policies offer additional benefits such as the payment of a daily rate if treatment is delivered within an NHS hospital and involves an overnight stay.

The way in which benefits are paid varies between providers. Some will offer a full refund of charges with payment direct to the healthcare provider. Other plans impose an upper limit on the amount that can be reclaimed in any one year.

Premium rates depend on a number of factors, including:

- *location* – this is mainly because the cost of medical care varies throughout the country (costs are particularly expensive in London);

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- *type of hospital* to which the individual is allowed access under the terms of the plan – again, treatment in the postgraduate teaching hospitals in London is more expensive and will be reflected in higher premiums;
- *standard of accommodation* available to the patient under the terms of the plan.

A major factor will be the type of scheme that is taken out. For example, many providers offer a budget scheme, which may limit the patient's choice of hospital or require treatment on the NHS if the waiting list does not exceed a maximum period, eg six weeks. Any limit on the range of cover provided will reduce the premium payable. The limit may take the form of a financial limit on the amount of benefit that is provided or limits on the range of treatment covered.

One other significant factor is the age of the person applying for cover. The morbidity risk increases with age and consequently so does the probability of a claim being made under the terms of the plan.

3.3.2.4.1 Underwriting

Certain events will be excluded from cover under the scheme. Cover will not be provided for any pre-existing medical conditions, and other general exclusions are the costs of:

- routine optical care (such as provision of spectacles or lenses);
- routine dental treatment;
- routine maternity care;
- chiropody;
- the treatment of ailments that are self-inflicted, for example, the consequences of drug abuse and alcohol;
- cosmetic surgery;
- alternative medicine.

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3.3.2.4.2 Taxation

Premiums are subject to insurance premium tax but the benefits are paid out tax-free.

Employers who contribute to PMI on behalf of their employees are able to claim the cost as an allowable deduction against corporation tax.

Contributions paid by an employer are regarded as a benefit in kind as far as the employee is concerned and may be taxable if the employee's total income, including the value of *all* benefits in kind, exceeds £8,500 per annum.

3.3.2.5 Long-term care insurance

The purpose of long-term care insurance (LTC) is to provide the funds to meet the costs of care that arise at a point in later life, when a person is no longer able to perform competently some of the basic activities involved in looking after themselves each day and consequently requires assistance.

The need for this cover has increased because families are more spread out than in earlier generations and less able to take care of elderly relatives. The problem has also been increased by the fact that life expectancy has increased and people's expectations for their quality of life in their later years are higher than ever. There has been increasing concern over the standard of care that state support and the NHS can realistically be relied upon to provide.

3.3.2.5.1 Benefits

The amount of benefit paid from a LTC plan will depend on the degree of care required by the insured. This will be established by ascertaining the person's ability to carry out a number of *activities of daily living (ADLs).*

Typical ADLs would be:

- washing;
- dressing;
- feeding;
- using the toilet;
- moving from room to room;
- preparing food.

Each LTC insurer will have its own definitions of what constitutes an inability to carry out an ADL. Many follow the definitions laid down by the Association of British Insurers.

The greater the number of ADLs that cannot be performed without assistance, the greater the amount of care required and, therefore, the higher the level of benefit that will be paid. It is normal for insurers to require that the person must be incapable of performing at least two or three of the ADLs before a claim can be accepted. A person need not be confined to a nursing home to receive LTC benefits: for example, a person may be unable to dress themself in the morning and prepare and eat food without assistance. Therefore, the range of support they would need may be limited to a person coming in at certain points during the day to help with those specific activities.

3.3.2.5.2 Taxation of benefits

If an annuity is purchased for immediate long-term care needs, it must be an 'immediate needs annuity' in order for the benefits to be tax free. An 'immediate needs annuity' is one where the benefits are payable directly to the care provider for the care of the person protected under the policy. Furthermore, the annuity must have qualified as an 'immediate needs annuity' **when it was taken out.** In other words, the benefits from an ordinary 'purchased life annuity' cannot be paid as tax free just because they are being used to fund long-term care.

If an annuity does not qualify as an 'immediate needs annuity', ie its benefits can be paid to the policyholder, it is taxable, but only the interest element (20% tax will be deducted at source, higher-rate taxpayers having a further liability of 20%).

Where an 'immediate needs annuity' is established on a 'life of another' basis, the benefits can still be paid tax free, provided that they are paid direct to the care provider and are used solely for the care of the person protected under the policy. If any part of the annuity benefits are paid to anyone other than the care provider, or for any purpose other than for the care of the person protected under the policy (including payments that may be due on the death of the protected person), that portion of the benefits is taxable, but only the interest element.

Benefits are also tax free if the long-term care policy is 'pre-funded', ie where there is no annuity but, instead, premiums are paid to an insurance company (out of tax-paid income) to insure against a possible future event. For pre-funded long-term care policies, it doesn't matter whether the benefits are paid direct to the care provider or to the protected person.

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3.3.3 General insurance

General insurance includes all types of cover that are not defined as life assurance. The types of losses that are covered by general insurance can be categorised in five broad bands. The first two relate to both personal and commercial situations:

- *property loss:* this is the best-known category, covering loss, theft or damage to static and moveable assets – from diamond rings to houses to supertankers;
- *liability loss*: resulting from a legal liability to third parties, eg personal injury or damage to property.

The remaining three are restricted to commercial situations. They are:

- *personnel loss* (due to injury, sickness or death of employees);
- *pecuniary loss* (as a result of defaulting creditors);
- *interruption loss* (when a business is unable to operate due to one of the other losses occurring, eg because its premises have suffered fire damage).

Some policies may combine protection against two or more types of risk. Comprehensive motor policies, for example, cover damage to the policyholder's property and to third parties' property.

Before looking at some of the common types of general insurance, it is appropriate to mention some important principles and practices that apply to general insurance: these are indemnity, average and excess.

3.3.3.1 Indemnity

Unlike life assurance policies, general insurance policies are contracts of *indemnity*. The principle of indemnity is that 'in the event of a claim, insured persons should be restored to the same financial position after a loss that they were in immediately before the loss occurred'. In particular, this means that an insured person should not be able to benefit from the event that caused the loss.

Life and personal accident policies, on the other hand, are not contracts of indemnity. They are benefit policies since it is much more difficult to measure accurately in financial terms the impact of a loss of life or of a serious injury.

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The choice of the method by which indemnity is achieved in a particular case is normally at the discretion of the insurance company. There are four main methods:

- *cash* (normally a cheque);
- *repair* (used very commonly with motor insurance);
- *replacement* – sometimes, the purchasing power of the insurer can reduce costs;
- *reinstatement*, for instance, where the insurance company may arrange for a damaged building to be restored to its former condition.

3.3.3.2 Average

It is not uncommon for policyholders to *underinsure*: in other words, to insure for a smaller amount than is actually required to replace or repair the lost or damaged property. This may be because they are unaware of the appropriate figure or because inflation has increased the amount required, or it may be deliberate in order to keep the premium down.

In the event of a complete loss, ie where a whole house is destroyed by fire, the amount paid out would be limited to the sum insured, even if the actual cost were considerably more.

Many losses are only partial, however, and in these circumstances it would be unfair if a policyholder who had paid less premium than was really appropriate should be indemnified in full, even where the actual claim amount is less than the overall sum insured. In such cases, the principle of average is applied, which means that the claim is scaled down in the same proportion that the premium actually paid bears to the premium that should have been paid for the full appropriate sum insured.

So, for example, a policyholder who insured his contents for £10,000, when their true insurance value was £15,000, would find that if he claimed £300 for a damaged carpet, the insurer would pay only £200.

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3.3.3.3 Excess

Many general insurance policies are subject to an excess: in other words, a deduction is made from any claim payment. Many motor policies have an excess of, say, £100 on the accident damage part of the cover. This avoids the high administrative costs of dealing with a lot of small claims. An excess can be either compulsory or voluntary in order to obtain a reduction in premium.

3.3.3.4 Buildings insurance

Buildings are defined as 'anything on the premises that would normally be left behind if the property were sold'. This generally includes sheds, swimming pools, walls, fitted furniture and all fittings and decorations.

Cover is normally provided against:

- fire and lightning strikes;
- explosions, subsidence and earthquakes;
- storms and floods;
- damage by vehicles and aircraft, and even by animals;
- damage by falling trees/branches or television aerials.

Policies normally also cover the costs of alternative accommodation during repairs.

Some types of cover are subject to the property not being left unoccupied for more than a specified period, typically 30 days. These include cover against damage caused by:

- riot, civil commotion and vandalism;
- theft or attempted theft;
- burst water pipes or oil leakages.

Most policies also cover property owner's liability.

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3.3.3.5 Contents insurance

Cover is provided for contents, which can be defined as 'anything you would normally take with you if the property were sold'.

Cover would typically be provided against the same events and circumstances as described above for buildings insurance, with a few additions, including:

- accidental damage to goods while being removed by professional removers;
- extended contents cover for specified personal property outside the home;
- damage to freezer contents due to electricity failure.

3.3.3.6 All-risks insurance

The aim of an 'all-risks' policy (sometimes known as *extended contents cover*) is to indemnify the policyholder for loss, damage or theft of items that are regularly taken out of the home. Cover is normally split into two categories:

- *unspecified items*: these need not be specifically named but each item must have a value below a specified amount;
- *specified items*: these items are above the single-item value limit and are individually listed.

Both of the above categories require the policyholder to take reasonable care of the property.

3.3.3.7 Private motor insurance

There are three main types of motor insurance cover: third party only; third party, fire and theft; and comprehensive. There are variations in the exact nature of cover offered by different companies in each category – particularly on comprehensive policies – but a summary of what might typically be offered is shown below.

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3.3.3.7.1 Third party

The Road Traffic Act 1988 makes it unlawful to use a motor vehicle on a public road unless there is in force a policy of insurance in respect of third party risks.

Third party only policies typically provide cover for:

- death or bodily injury to third parties, including passengers in the car – hospital charges and emergency medical treatment charges are also covered;
- damage to property;
- legal costs incurred in the defence of a claim.

Death, injury and damage cover is extended to include occasions when the policyholder is using another vehicle, and also to other drivers using the policyholder's car with his permission.

Motor insurance differs from other personal insurances in that a policy of motor insurance is of no effect unless a *certificate of insurance* is given to the policyholder. The certificate is what provides evidence of the existence of the contract of insurance and, as third party motor insurance is compulsory, this is very important.

3.3.3.7.2 Third party, fire and theft

In addition to third party cover, a third party, fire and theft policy provides cover against:

- fire, lightning or explosion damage to the vehicle;
- theft of the vehicle, including damage caused during theft or attempted theft.

3.3.3.7.3 Comprehensive

In addition to the third party, fire and theft cover, a typical comprehensive policy would include some or all of the following:

- accidental damage to the vehicle on an all-risks basis;
- loss or damage to personal items in the vehicle;
- personal accident benefits;
- windscreen damage.

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The private motor insurance market is large and extremely competitive, and many other extensions to the cover are offered in order to attract business. These may include: roadside breakdown assistance; legal protection services; provision of a courtesy vehicle while repairs are carried out; out-of-pocket expenses resulting from an accident.

3.3.3.8 Travel insurance

Travel insurance cover is available for individual journeys (typically from five days to one month) or on an annual basis. A typical policy might include cover against the following:

- cancellation due to illness or injury of the policyholder or a close relative;
- missed flights due to transport failure;
- delayed departures;
- medical expenses;
- personal accident;
- loss of personal possessions or of a passport;
- personal liability;
- legal expenses.

Because of the increased risk of injury, cover for winter sports holidays is usually more expensive.

3.3.3.9 Insurance premium tax

Some insurance premiums payable in the UK are subject to insurance premium tax (IPT). The rate is 5% of the premium on most general insurance, one exception being travel insurance, on which it is 17.5%. There is no premium tax at present on long term insurance such as life assurance and permanent health insurance.

IPT is paid by the policyholder as part of the premium; it is collected by the insurer and passed on to the tax authorities.

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3.4 Derivatives

A **derivative** is a financial product that is indirectly based on, or 'derived from', another financial product. It is usually related to a commitment to buy or sell that other product at a fixed price on a future date or between two dates. The key factor is that, because they convey rights (such as the right to buy at a price different from the current market price), derivatives themselves have a value and, in most cases, can themselves be traded. The most common products dealt with in this way are ordinary shares, commodities, interest rates and exchange rates. The main forms of derivatives are described below.

- *Options*: options are the best-known form of derivative. An option is the right (but *not* the obligation) to buy or sell a specific amount of an asset – which might, for instance, be a certain number of ordinary shares – at a specified price (the *exercise* price) within a specified period. An option to buy is known as a call option, whereas the equivalent right to sell is referred to as a put option. The buyer of an option contract pays a purchase price, or *option premium*, to the seller (who is also known as the *writer*) of the contract.

- *Futures*: futures are similar to options, except that with futures there is an *obligation* to buy or sell at the specified price on a specified date. Futures are available in a range of financial products as well as commodities (eg coffee) and currencies, for which they can be used as a hedge against movements in exchange rates. Some such deals are contracts directly between two parties and are not traded, in which case they are known simply as *forward contracts*.

- *Warrants*: warrants are similar to call options, except that they are generally issued by companies and give the holder the right to purchase that company's ordinary shares. This allows the company to raise new capital.

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3.5 Lending products

Most large purchases such as houses, cars and holidays, are now made with the aid of borrowed money, and the success of most western economies is based on credit. Financial institutions have not been slow to develop products to satisfy the wide-ranging needs of borrowers.

3.5.1 Mortgages

Since a mortgage loan is such a large, and long-term, transaction the consequences of making a mistake can be very serious. It is therefore particularly important for an adviser to choose wisely and to suit the products chosen to the client's needs.

- Choosing the wrong lender or the wrong interest scheme can lead to the client paying more than is necessary for the loan.
- Choosing the wrong investment product can lead – at worst – to the mortgage not being repaid in full at the end of the term. At best, it will mean that the client misses out on possible surplus funds.
- Failing to protect the outstanding capital or the repayments against sickness, death or redundancy, can leave a client's family destitute or lead to them having to leave their home.

3.5.1.1 Definitions

A house purchase loan is usually known as a *mortgage loan* (or simply a *mortgage*) because the borrower mortgages the property, in other words creates a *legal charge* over the title deeds to the lender as security for the loan.

The parties involved in a mortgage are as follows:

- the *mortgagor*: the individual borrower who transfers his property to the lender for the duration of the loan;
- the *mortgagee*: the lender (bank, building society or other institution) who has an interest in the property for the duration of the loan.

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3.5.1.2 Repayment mortgages

With a *repayment mortgage* (sometimes also known as a *capital-and-interest mortgage*), the borrower makes monthly repayments to the lender and each monthly amount consists partly of interest and partly of capital repayment: the higher the interest rate (for any given mortgage amount and term), the higher the monthly repayment.

The repayment is calculated in such a way that, provided interest rates do not change, it will remain the same throughout the term of the mortgage. If interest rates do go up or down, the repayment is increased or decreased, or alternatively the mortgage term can be extended or shortened.

Because the repayment remains unchanged (ignoring fluctuations in the interest rate), the relative proportions of capital and interest vary throughout the term: for example, at the beginning, when very little capital is repaid, the repayment is mainly interest; then, as more capital is repaid, the interest proportion of the repayment grows less and less.

The result is that the amount of capital outstanding decreases by smaller amounts each month at the start compared with towards the end of the term.

Two important factors that should be noted are the following.

- ♦ The mortgage will be repaid at the end of the term, provided that changes in interest rate have been allowed for and that all repayments have been made when due.
- ♦ If the borrower, or the breadwinner in the borrower's family, dies before the end of the mortgage term, the repayments will have to be continued or the outstanding loan repaid. Separate life assurance is required to cover this eventuality.

3.5.1.3 Interest-only mortgages

In the case of an *interest-only mortgage* loan, the monthly payments made to the lender are solely to pay interest on the loan. No capital repayments are made to the lender during the term of the loan and the capital amount outstanding therefore does not reduce at all.

The borrower still has the responsibility of repaying the amount borrowed at the end of the term, and this is normally achieved through the borrower making regular payments to an appropriate savings scheme, although the loan might be repaid out of other resources, eg from the proceeds of a legacy. The

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main schemes used for this purpose are: endowment assurances of various kinds; individual savings accounts (ISAs); and personal pension or stakeholder pension plans.

Borrowers should be made aware of the risks involved in taking out an interest-only mortgage, in particular that repayment of the mortgage is dependent on the performance of an investment plan achieving a pre-determined rate of return. If this is not achieved, then the borrower will be left with a shortfall: the value of the policy or plan will be lower than that of the total debt.

3.5.1.3.1 Endowment assurances

Both with-profit and unit-linked *endowments* can be used for mortgage purposes. In each case, special adaptations have been developed to take account of the particular needs of mortgage repayment.

One feature of life policies is that they can be legally assigned to a third party, who effectively becomes the owner of the policy and is entitled to receive the benefits in the event of a claim. Some lenders require the endowment to be assigned to them as part of the mortgage deal; others may simply require that the policy document be passed into their possession, without a formal assignment.

3.5.1.3.1.1 Low-cost endowment

Borrowers prefer to use with-profit policies rather than non-profit because of the potentially better returns. The problem is, however, that the premiums are higher – an important consideration for most borrowers, who are seeking to minimise their mortgage costs.

The *low-cost endowment* provides a suitable compromise by basing premiums on a sum assured that is lower than the mortgage loan amount but which, including the bonuses that are expected to be declared over the policy term, should become sufficient to repay the loan. Since bonuses are not guaranteed, the basic sum assured is calculated using a conservative estimate of future bonus rates – often around 75% of the company's current reversionary bonus rate. Terminal bonuses are not taken into account.

If the borrower were to die before the bonuses had reached the required level, the amount paid out would be insufficient to repay the loan. To cover this shortfall, a decreasing term assurance is added to the policy, the additional

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benefit being calculated as just sufficient to make up the difference between the mortgage amount and the current level of sum assured plus reversionary bonuses. Some companies add a level term assurance, or even a level convertible term assurance, in place of the decreasing term assurance.

If the total of sum assured plus bonuses does not reach the amount of the loan at the end of the term, it is, of course, the borrower's responsibility to fund the difference. Life companies help their policyholders to avoid this by including regular progress reviews of mortgage-related endowments, to check whether the policy is on target to reach the required amount by the end of the term. If the policy does not seem to be on target, the company may either recommend an increase in premium, possibly without further medical evidence being required, or suggest other ways of addressing the problem.

On the other hand, if the total benefit at maturity, including bonuses, proves greater than the amount required to repay the loan, the surplus will provide a tax-free windfall for the borrower.

3.5.1.3.1.2 Unit-linked endowment

When used for mortgage purposes, the premium required to fund a *unit-linked endowment* is calculated as the amount that will provide sufficient to repay the loan at the end of the term if unit prices increase at a specified conservative rate of growth. Policyholders can choose which fund or funds to use for their investment, but it is usually recommended that premiums be invested in a managed fund: it would certainly not be wise to use a very speculative fund for mortgage repayment purposes.

The growth rate is not guaranteed, and it is the borrower's responsibility to ensure that the policy will provide sufficient funds to repay the loan. Regular reviews, by the life company, of the policy's progress enable the borrower to increase the premiums (or make other provisions) if the policy is not on target. Most companies also provide the facility to switch to a cash fund, or similar, in order to protect the policy value from sudden market falls towards the end of the term.

One advantage of the unit-linked policy as a repayment vehicle is that, in a strongly rising market, the value of the policy may reach the required amount before the end of the term. In that event, the policy can be surrendered and the loan repaid early – thus saving on future interest, and freeing the repayment amounts for the client to use for other purposes.

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3.5.1.3.1.3 Performance review

The actual performance of endowment plans during the 1990s has led to a major review of this area of financial advice and, during 1999, the regulatory authorities instructed providers of endowment plans to review the actual performance of these products. This was for three main reasons:

- poor performance of endowment plans during the 1990s;
- concern over the standard of advice provided by financial advisers in making sure customers understood the risks involved with investment-backed schemes;
- concern that holders of endowment mortgages would be faced with a large shortfall on the maturity proceeds, leaving them unable to repay their mortgage debt.

3.5.1.3.2 Pension mortgages

One of the benefits of a personal pension plan or stakeholder pension is that up to 25% of the accumulated fund can be taken as a tax-free cash sum when the pension payments commence. This fact means that these plans have the potential to be used as mortgage repayment vehicles, with the loan being repaid out of the cash lump sum.

The plans have other financial benefits.

- Pension contributions qualify for tax relief at a person's highest rate of tax. The practical effect of this for a higher rate taxpayer, for instance, is that each £100 of contribution costs him or her only £60. (There is no tax relief on endowment policy premiums.)
- The fund in which the contributions are invested is not subject to tax on capital gains, meaning that it should grow faster than an equivalent endowment policy fund, which is taxed on both income and capital gains.

On the other hand, there are a number of factors a borrower might feel are possible drawbacks to the use of a pension plan for mortgage repayment purposes.

- There is a minimum age at which the lump sum can be taken: in most cases this is 50, which means, in effect, that the term of the mortgage must run until at least age 50 and the mortgage cannot be paid off earlier, even if the fund has grown to a sufficient value. This minimum age will increase to 55 in 2010.

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- Because only 25% of the fund can be taken in cash, a fund of four times the loan value must be built up, which means that contributions must be four times what is actually required to repay the loan. The remaining 75% is not wasted, of course, because it will provide a retirement pension – nevertheless, it may mean that total contributions are more than the borrower can afford or more than are permitted by the regulations.
- A personal pension or stakeholder pension, unlike an endowment assurance, does not automatically carry with it any life assurance, so a separate policy will be required to cover the repayment of the loan in the event of premature death. As of 6 December 2006, it was no longer possible to obtain pension term assurance for this purpose. See further Section 3.3.1.4.

There is a further characteristic of the use of a pension plan that might be considered a disadvantage by the *lender*: as with all pension contracts, personal pensions and stakeholder pensions cannot be assigned to a third party as security for a loan or for any other purpose. The lender cannot, therefore, take possession of the plan or become entitled to receive benefits directly from it. This fact has not, in practice, prevented the majority of lenders from moving into the pension mortgages market.

3.5.1.3.3 Individual Saving Accounts (ISAs)

ISAs are recognised as an attractive means of repaying an interest-only mortgage. All managers allow investments to be made on a regular monthly basis, provided, of course, that the overall annual limits are not exceeded.

The ISA managers calculate the amount of regular investment that would be required to produce the necessary lump sum at the end of the mortgage term, based on an assumed growth rate and on specified levels of costs and charges.

The main benefits of using an ISA as a repayment vehicle are:

- the funds grow free of tax on capital gains, thus reducing the cost of repaying the mortgage;
- if the fund's rate of growth exceeds that assumed in the initial calculations, the mortgage can be repaid early.

One drawback to the use of ISAs is that they may not be available in the longer term. Since mortgages are generally long-term contracts, this might lead to many borrowers having to change their repayment vehicle 'mid-stream'. In

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November 2006, however, the government stated that ISAs will continue to be available indefinitely.

Other drawbacks associated with the use of ISAs (and other similar investment schemes) are the following.

- If growth rates do not match the initial assumptions, the final lump sum will fall short of the mortgage amount – unless additional investments have been made.
- In the event of premature death, the value of the ISA investment is unlikely to be sufficient to repay the loan. Additional life assurance cover is required to meet this eventuality.

3.5.1.4 Mortgage interest options and other schemes

Regardless of whether a customer chooses a capital-and-interest repayment mortgage or an interest-only mortgage with some kind of a repayment vehicle, there are often a number of different types of mortgage product available. The main variations are described below but remember that these are not necessarily specific products in themselves; they are characteristics of products. Some of these characteristics can be combined within a single product, eg a fixed-rate mortgage with a cashback.

Remember also that how interest is charged will vary from one lender to another: some charge interest on an annual basis; some on a monthly basis; and some on a daily basis.

3.5.1.4.1 Variable rate

A *variable rate* is the basic method of charging interest, with monthly payments going up or down without limit as interest rates change. One disadvantage is that borrowers cannot easily predict the level of future payments, which can cause budgeting problems.

3.5.1.4.2 Discounted mortgage

A *discounted mortgage* takes the form of a genuine discount off the normal variable rate (eg 2% off for three years). It is not a deferment of capital or interest payments. There is usually a restriction on how soon the mortgage can be repaid, or a penalty for repaying within a certain period.

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3.5.1.4.3 Fixed rate

With a *fixed-rate mortgage,* the borrower is able to 'lock in' to a fixed interest payment for a specified period, usually between one and five years. At the end of the period, the rate reverts to the lender's prevailing variable rate. This scheme is popular with first-time buyers and others who want to be able to budget precisely. There is often a substantial arrangement fee, however, and there may be restrictions or penalties on changing to another lender.

3.5.1.4.4 Capped rate

An interest rate might have an upper fixed limit, known as the cap. The lender's normal variable rate will apply to this type of mortgage, but it will be subject to the *capped rate*. Should the variable rate exceed the cap, the borrower will still pay not more than the *capped rate*. If there is also a fixed lower limit, it is known as a *cap and collar* mortgage.

3.5.1.4.5 Base rate tracker mortgages

As the name suggests, *base rate tracker mortgages* are linked to the base rate set by the Bank of England. The base rate is reviewed once a month and reflects the cost of borrowing money from the Bank of England. Base rate tracker mortgages give the borrower the certainty that their payments will rise and fall in line with base rate changes. It should be noted that most lenders offering this type of mortgage do charge a premium above the base rate. A typical example would be a borrower being charged interest at 0.95% above the base rate.

3.5.1.4.6 Flexible mortgages

The *flexible mortgage* is a relatively recent innovation in the UK. It gives the borrower some scope to alter his monthly payments to suit his ability to pay, as well as the opportunity to pay off the loan more quickly. Although there is no precise definition of a flexible mortgage, it is generally considered that such a product should offer the following basic features:

- interest calculated on a daily basis;
- the facility to make overpayments at any time without incurring an early repayment charge;

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- the facility to underpay, but only within certain parameters set out by the lender when the mortgage was arranged;
- the facility to take a payment holiday, again within certain parameters laid down at the outset.

The combination of a daily interest calculation and occasional, or regular, overpayments will result in considerably less interest being paid overall and the mortgage term being reduced.

The ability to reduce monthly payments, or suspend them entirely, for a limited period will benefit the borrower who is experiencing temporary financial difficulties. Such a situation can be further relieved by the borrower being able to 'borrow back' previous overpayments.

Most flexible mortgages allow the borrower to draw down further funds as and when required, although the lender will have set a limit on total borrowing at the outset. Some lenders provide borrowers with a chequebook to enable additional funds to be drawn. Flexible mortgages involve a much easier administrative process than is usual when dealing with further advances. The wording of the mortgage deed generally used for flexible mortgages is such that all additional funds withdrawn, within the limit on total borrowing, will automatically take priority over any other subsequent charges registered against the property.

3.5.1.4.6.1 Current account mortgage

An increasingly popular version of the flexible mortgage is the *current account mortgage*. This enables the borrower to carry out all of his personal financial transactions within the single account. The account is able to receive salary credits and pay standing orders and direct debits in exactly the same way as a conventional current bank account. The borrower will be provided with a chequebook and a debit/credit guarantee card.

The combination of salary credits and the calculation of interest on a daily basis considerably reduces the amount of interest payable and consequently also the mortgage term.

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3.5.1.4.6.2 Offset mortgage

A more recent development is the *offset mortgage*. This requires the borrower to have savings or other accounts with the lender and enables the interest payable on such accounts to be offset against the mortgage interest charged. For example, if a borrower has an offset interest-only mortgage for £80,000 and £25,000 in a savings account with the lender, he can opt to waive payment of interest on his savings, enabling interest to be charged on a net loan of £55,000.This calculation is repeated on a daily basis.

Even more complex offset mortgages are becoming available that enable the borrower to offset interest payable on various savings accounts against interest charged on his mortgage and on any other secured or unsecured loans held with the lender.

Many lenders now offer flexible mortgages with a fixed, discounted or capped rate for an initial period. Early repayment charges do not normally apply to these products but an arrangement fee may be payable and, in some cases, it may be a condition of the loan that a particular insurance product is purchased from the lender.

3.5.1.4.7 Cashbacks

A *cashback* is a relatively common incentive offered by many lenders. A lump sum is paid to the borrower immediately after completion of his mortgage, either as a fixed amount or as a percentage of the advance. Generally, lower loan-to-value ratios will result in higher cashbacks. For example, the cashback may be 3% of the advance for a loan-to-value ratio of up to 80%, and 2% for a higher loan-to-value ratio.

It is usually a condition of the mortgage that some or all of the cashback must be repaid if the loan is redeemed within a specified period.

Discounted rates and cashbacks are sometimes used by lenders either to tempt borrowers away from competitors or as a loyalty bonus to persuade them to stay. Payment of legal fees is another offer that is commonly made to encourage switching of the loan between lenders while incurring minimum costs.

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3.5.1.4.8 Low-start mortgage

The *low-start mortgage* is a repayment mortgage designed to assist borrowers who want to keep down costs in the early years. The low initial repayments are achieved by deferring the capital instalments for the first few years. Borrowers need to be aware that payments will increase at the end of the initial period and that no capital will have been repaid.

3.5.1.4.9 Deferred interest

In the early years of a *deferred interest mortgage*, some of the interest is not paid but is added to the outstanding capital. This is a useful method for those who expect an increasing income, and who wish to maximise the loan while minimising the costs in the early years.

This type of mortgage is not suitable for people who borrow a high proportion of the property price – especially at a time when prices may be falling – because there is an increased danger of negative equity.

3.5.1.4.10 CAT-standard mortgages

The government has introduced specified CAT (charges, access and terms) standards that can be applied to mortgage products, although lenders do not have to offer *CAT-standard mortgages,* and there is no guarantee by either the government or the lender that a CAT-standard mortgage will be the most suitable product for a particular borrower.

CAT-standard mortgages are likely to appeal to borrowers who wish to have clearly stated limits on charges. Examples of the limits set on charges and other costs are the following.

- ♦ The variable interest rate must be no more than 2% above Bank of England base rate and must be adjusted within one calendar month when the base rate is reduced.
- ♦ Interest must be calculated on a daily basis.
- ♦ No arrangement fees can be charged on variable-rate loans and no more than £150 can be charged for fixed-rate or capped-rate loans.
- ♦ Maximum early redemption charges apply to fixed-rate and capped-rate loans.
- ♦ No separate charge can be made for mortgage indemnity guarantees.

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- All other fees must be disclosed in cash terms before the customer makes any commitment.

Other rules relating to *access* and *terms* include the following.

- Normal lending criteria must apply.
- The customer can choose on which day of the month to pay.
- All advertising and paperwork must be clear and straightforward.
- Purchase of related products cannot be made a condition of the offer.

3.5.1.5 Methods of releasing equity

Equity in a mortgage context is the excess of the market value of a property over the outstanding amount of any loan or loans secured against it. There are a number of ways to release the equity in a property. Releasing equity means using the excess value to obtain capital or income, which can then be used for another purpose.

3.5.1.5.1 Home income plans

Home income plans are designed mainly to enable elderly homeowners who do not have a mortgage on their property to release some of the equity in order to supplement their retirement income. Home income plans are categorised as a type of lifetime mortgage by the FSA.

The customer takes an interest-only loan, secured on their property, which is mortgaged in the normal way. The actual amount of the loan depends not only on the value of the property but also on the age of the applicant. This is because many home income plans are arranged on the basis that no interest payments will be made to the lender during the lifetime of the borrower. Instead, interest is allowed to roll up and is repaid, along with the original loan, when the property is sold on the death of the borrower (or second borrower, if a couple). Clearly, a 60-year-old borrower is statistically likely to accumulate considerably more unpaid interest than a 70-year-old borrower. Hence, the 60-year-old will not be able to borrow such a high percentage of the value of his property as the 70-year-old.

The maximum permitted loan varies between lenders but, as a guide, this will range from around 15% to 20% of the property value for a 60-year-old applicant up to around 50% for a 75-year-old. In the case of joint borrowers,

the maximum loan will be based on the age of the younger partner, as the property will not be sold until the second death.

In some cases, the borrower uses the loan to purchase a lifetime annuity. In these cases, the interest is not rolled up but is paid on a monthly basis out of the annuity income. The balance of this annuity payment is used to augment the borrower's retirement income. This type of home income plan allows a higher loan-to-value ratio for the simple reason that the debt is not increasing and is, therefore, not reducing the remaining equity. The major disadvantage of annuity purchase is that annuity rates are currently very low and, once the annuity has been purchased, the borrower is locked into a rate that is fixed for the remainder of his lifetime.

In recent years, the main providers of home income plans have joined together and formed a trade association called Safe Home Income Plans (SHIP). This has established a Code of Practice that is designed to safeguard the interests of borrowers. The main safeguards are as follows.

- The applicant must be encouraged to seek independent legal advice to ensure that he or she fully understands the risks involved and that any children and other beneficiaries will receive a reduced inheritance.
- Any negative equity situation that arises will be funded by the lender, ie the amount that has to be repaid will not be more than the price that is obtained when the property is sold.
- The borrower will be entitled to remain in his home for the rest of his life – in the case of joint borrowers this applies to each of them.
- The plan must be portable, ie the borrower must be allowed to transfer the loan to another property, although part of it may have to be repaid if the value of the new property is insufficient to cover it.

Since 2004, additional protection for customers taking out home income plans has been provided through their regulation under the FSA.

3.5.1.5.2 Home reversion schemes

Home reversion schemes are an alternative to home income plans and involve the homeowner selling all or part of his property to the company in return for an income for life. The customer(s) retains the right to live in the house until their death(s), after which the company sells the property and retains all the proceeds.

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At first, it was believed that home reversion schemes would not be regulated by the FSA because they do not involve a mortgage – but, as of 6 April 2007, the FSA now regulates these schemes.

3.5.1.6 Shared ownership

Shared-ownership mortgages combine owner-occupation with rental. They enable the borrower to buy a stake in the property and rent the remainder. For example, the borrower can purchase a 25% stake in the property, funded by a mortgage, with the option of buying subsequent 25% shares in the future. As the borrower increases his or her share in the property, the mortgage element increases and the rented element reduces. This process of increasing one's share in the property is sometimes called '*staircasing*'.

This type of scheme (usually arranged by housing associations) enables those on relatively low incomes to become owner-occupiers, even though they cannot afford a conventional mortgage.

3.5.1.7 Related property insurance

A lender's security depends on the property being maintained in an acceptable condition. For that reason, borrowers have to *covenant* (ie promise under the terms of the mortgage deed) to maintain the property in good condition.

They also have to covenant to insure the property adequately. A lender is permitted by law to:

- insist that a property subject to a mortgage is continuously insured by means of a policy that is acceptable to the lender;
- have its interest as mortgagee noted on the policy;
- secure a right over the proceeds of any claim and to insist that the proceeds be applied to remedy the subject of the claim or to reduce the mortgage debt.

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3.5.2 Other secured private lending

With all secured loans, the borrower offers something of value as security for the loan so that, in the event of default, the lender can take and sell that asset (ie realise the security) and be repaid out of the proceeds.

The major form of secured personal lending is, of course, the mortgage loan for house purchase, the security being a first charge on the borrower's private residence.

When property values increase significantly, as they have over the last ten years, it is common for people to borrow against the increased *equity* in their property (ie the excess of the property value over the amount owing on the mortgage loan). They then use the loan to fund purchases that are not related to the house purchase but which improve their lifestyle in other ways.

This may be done by way of a further loan from their existing mortgage lender, a second mortgage from a different lender or by remortgaging for a larger amount.

Most secured lending, therefore, is secured on 'bricks and mortar', even where its purpose is not directly – or even indirectly – related to house purchase or improvement.

3.5.2.1 Second mortgages

A *second mortgage* is one that is created when the borrower offers the property for a second time as security while the first lender still has a mortgage secured on the property. The new lender takes a second charge on the property; the original lender retains the deeds and his charge takes precedence over subsequent charges. This means that, in the event of a sale due to default, the original lender's claim will first be met in full (if possible) and, if sufficient surplus then remains, the second mortgagee's charge will be met.

Lenders will, of course, only offer a second mortgage if there is sufficient equity in the property and, since second mortgages represent a higher risk to lenders, they are likely to be offered at higher rates of interest than first mortgages.

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3.5.3 Unsecured loans

In contrast to secured loans, an *unsecured loan* relies on the personal promise, or covenant, of the borrower to repay. Unsecured loans are, therefore, generally higher risk than secured lending, with the consequence that they are subject to higher rates of interest and are normally available only for much shorter terms. For example, while a mortgage secured on a property will be available for 25 years or even longer, a personal loan is rarely offered over much more than six or seven years.

Unsecured loans have long been available from banks and finance houses, but it was not until the passing of the Building Societies Act 1986 that building societies were able to move into this area of business. While societies must ensure that 75% of their lending is in the form of mortgages on residential property, there is no restriction on the remaining 25% that need not be 'secured on property'.

Unsecured personal lending takes a number of forms, the most common of which are described below.

3.5.3.1 Personal loans

These are offered by banks, building societies and by some finance houses. They are normally for a term of one to five years, and the interest rate is generally fixed at the outset and remains unchanged throughout the term. Many of the larger lenders operate a centralised assessment of loan applications through telephone call centres, using a form of credit scoring to assess the suitability of the borrower.

The loan can be used for any purpose by the customer: typically it might be used to purchase a car, fund a holiday, or consolidate an existing higher-cost borrowing such as a credit card balance.

The purpose of the loan determines whether it is regulated under the terms of the Consumer Credit Act 1974. Most such loans of £25,000 or less are regulated by the Act unless they are for house purchase or home improvement. (The Consumer Credit Act 2006 removes the £25,000 ceiling, with certain exceptions. This change comes into force in April 2008.)

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3.5.3.2 Overdrafts

An *overdraft* is a current account facility, offered by all retail banks and some building societies, which enables the customer to continue to use the account in the normal way even though its funds have been exhausted. The bank sets a limit to the amount by which the account can be overdrawn. An overdraft is a convenient form of short-term temporary borrowing, with interest calculated on a daily basis, and its purpose is to assist the customer over a period in which expenditure exceeds income – for instance, to pay for a holiday or to fund the purchase of Christmas gifts.

Because it is essentially a short-term facility, the agreement is usually for a fixed period, after which it must be renegotiated or the funds repaid. Overdrafts that have been agreed in advance with the institution are normally an inexpensive form of borrowing, although there may be an arrangement fee. Unauthorised overdrafts, on the other hand, attract a much higher rate of interest.

3.5.3.3 Revolving credit

Revolving credit refers to arrangements where the customer can continue to borrow further amounts while still repaying existing debt. There is usually a maximum limit on the amount that can be outstanding, and also a minimum amount to be repaid on a regular basis.

The most common way of providing revolving credit is through credit cards, although some institutions do provide revolving personal loans that allow the borrower to draw down funds as the original debt is repaid.

It is hard to believe that plastic cards, now an integral part of most people's financial affairs, have only been around for the last 35 years. Their development and their impact have gone hand-in-hand with the rapid advance of the electronic processing technologies on which their systems now largely depend. Many cards can now hold a wealth of information about cardholders and their accounts, and can therefore interact directly with retailers' and banks' electronic equipment: these cards are often referred to as smart cards.

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3.5.3.3.1 Credit cards

Credit cards enable customers to shop without cash or cheques in any establishment that is a member of the credit card company's scheme.

Originally all credit card transactions were dealt with manually at the point of sale, but most retailers now have terminals linked directly to the credit card companies' computers, enabling online credit limit checking and authorisation of transactions.

As well as providing cash-free purchasing convenience, credit cards are a source of revolving credit. The customer has a credit limit and can use the card for purchases or other transactions up to that amount, provided that at least a specified minimum amount (usually 3% of the outstanding balance) is repaid each month. The customer receives a monthly statement, detailing recent transactions and showing the outstanding balance. If the balance is repaid in full within a certain period (usually 25 days or so), no interest is charged; if a smaller amount is paid, the remainder is carried forward and interest is charged at the company's current rate.

Credit cards are an expensive way to borrow, with rates of interest considerably higher than most other lending products. There is also normally a charge if the card is used to obtain cash either over the counter or from an automated teller machine (ATM), or if the card is used overseas.

Credit card companies charge a fee to the retailers for their service. This is deducted as a percentage (typically around 3%) of the value of transactions when the credit card company makes settlement to the retailer. There are, however, a number of advantages to retailers, in addition to the fact that more customers may be attracted if payment by credit card is available. For instance, payment is guaranteed if the card has been accepted in accordance with the credit card company's rules. Furthermore, the retailer can reduce his or her own bank charges because the credit card vouchers paid into a bank account are treated as cash.

Two other types of card are mentioned below for completeness, although they do not offer credit facilities (except in a very limited sense, in the case of charge cards).

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3.5.3.3.2 Charge cards

Although used by the customer in the same way as a credit card to make purchases, the outstanding balance on a *charge card* must be paid in full each month. The best-known examples are American Express and Diners Club.

3.5.3.3.3 Debit cards

Introduced in the late 1980s, *debit cards* enable cardholders to make payment for goods by presenting the card and signing a voucher, in just the same way as with credit cards or charge cards. In the case of debit cards, however, the effect of the transaction is that funds equal to the amount spent are transferred electronically from the cardholder's current account to the account of the retailer. This is known as *EFTPOS (electronic fund transfer at point of sale)* and the system effectively replaces the use of cheques, leading in the longer term to reduced handling costs.

Debit cards can also be used to withdraw cash from ATMs and many debit cards now also act as cheque guarantee cards.

3.5.4 Commercial loans

There is an extensive market for what might be called 'commercial' lending, ie loans to businesses of all sizes from sole traders and partnerships to family companies to multinational traders. Loans may be required to start up or expand businesses, to purchase shops, factories or hotels, or to refurbish premises.

All the high-street retail banks have departments operating in this field and there is also a wide range of companies specialising in commercial lending.

The lending is normally secured on the company's property or other assets, with the interest rate set at a specified margin above base rate. The exact interest rate will depend on the risk that the lender believes is involved in lending to the particular company; this will be assessed by looking at the company's past performance where applicable, business plans, projected profits and management quality, as well as the business sector in which it will operate.

Investment in commercial property is also described in Section 2.4.3.

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3.6 Pension products

As we have seen in section 1.3.5.5, individuals who have made sufficient National Insurance contributions will be entitled to a basic state pension and, in certain circumstances, additional state pension/pension credit.

However, these are set at a fairly low level and most people would prefer a higher level of income in retirement than the state provides.

Employees may also be members of an occupational scheme although not all employers offer occupational pensions. Occupational schemes fall into two types:

- *final salary (defined benefit)* – the employee will receive a pension that is calculated as a percentage of final salary (the salary on or near retirement). The longer the employee has been a member of the scheme, the higher the percentage;
- *money purchase (defined contribution)* – an agreed contribution is invested for each member. On retirement, the accumulated fund is used to purchase benefits. The level of benefits is not guaranteed by the employer.

As people are now living longer in retirement, employers are finding final salary schemes more expensive. As a result, many are being forced to reduce their commitment and to transfer the responsibility to individuals.

Many individuals may therefore wish to supplement retirement income by contributing to private arrangements. The following are tax-efficient pension arrangements:

- additional voluntary contributions (AVCs);
- free-standing additional voluntary contributions (FSAVCs);
- personal/stakeholder pension plans (PPP/SHPs).

AVCs and FSAVCs are available to employees who are members of occupational schemes. Personal/stakeholder pensions are generally available to anyone under the age of 75.

Some AVCs are final salary arrangements although most are money purchase.

All FSAVCS, PPP/SHPs are money purchase schemes.

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The funds do not pay capital gains tax, pay no income tax on savings income and no higher rate income tax on dividend income. They are, however, unable to reclaim the 10% tax credit on UK dividends.

Any individual, who is a UK resident and under the age of 75, can receive income tax relief at their highest marginal rate on annual contributions to occupational and private pension schemes up to a maximum of the higher of:

100% UK earnings

or

£3,600.

(Before the new regulations came into effect on A-Day, different schemes had different maximum contribution limits.)

However, there is an annual allowance limit (£235,000 in 2008/09). If the combined total of employer and employee contributions in a year exceeds this figure, tax will be charged on the excess.

Benefits can (normally) be taken from the schemes from age 50 onwards. This minimum pension age will rise to 55 on 6 April 2010. 25% of the fund can be taken as tax-free cash and the remainder must be used to provide a taxable income.

The income may be taken by purchasing an annuity with the remaining fund. It is not essential to buy the annuity from the company that supplied the pension plan. An individual can 'shop around' to see if higher annuity rates are available from other providers. This facility is known as an *open-market option.*

As an alternative to purchasing an annuity, an individual can make regular withdrawals of capital from the fund (within certain limits) – this is referred to as *drawdown* or *pension fund withdrawal.*

Before 6 April 2006, it was compulsory to purchase an annuity by the age of 75. However, it is now possible to continue with drawdown beyond 75.

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3.6.1 Additional Voluntary Contributions (AVCs)/Free Standing Additional Voluntary Contributions (FSAVCs)

AVCs are additional contributions to an occupational scheme. Sometimes, this will purchase additional years' service in a final salary scheme. However, most AVCs operate as money purchase arrangements and the employee will only have a limited choice of funds.

The employer will usually cover some or all of the costs.

Contributions to AVCs are deducted from gross salary and the employee therefore receives full tax relief at the same time.

Alternatively, an individual may contribute to a FSAVC which is a money purchase fund provided by a separate pension provider. FSAVCs are available from a range of financial institutions, including insurance companies, banks and building societies.

A FSAVC may be attractive to an employee who wishes to keep financial arrangements independent from the employer. FSAVCs offer a wider range of investment funds than AVCs. However, they tend to be more expensive as the employer is not bearing the costs.

Contributions to FSAVCs are made from taxed income. 20% tax relief is given at the time. Higher rate taxpayers will need to claim additional relief separately.

Note: since April 2006, all employees have been able to contribute to personal/stakeholder pensions. FSAVCs, which are generally more expensive, are expected to become obsolete.

3.6.2 Personal pensions (PPPs)

These are individual money purchase arrangements provided by financial services companies such as life assurance companies, banks and building societies.

Before 6 April 2006, employees who were members of an occupational scheme could only contribute to a PPP/SHP (from the same earnings) if their earnings were no more than £30,000pa.The maximum contribution for such employees was £3,600pa.

However, all employees can now contribute to PPP/SHPs, up to the maximum of the higher of 100% of UK earnings or £3,600 (see Section 3.6).

Contributions receive 20% tax relief at source, even for non-taxpayers. A higher rate taxpayer will need to claim additional relief separately through self-assessment.

3.6.3 Stakeholder pensions (SHPs)

This form of private pension became available from 6 April 2001. The government's aim in introducing it was to take some of the pressure off the state provision of pensions by encouraging more individuals to contribute to their own pension arrangement. They felt that this could be achieved by organising a scheme that is simple and has lower costs.

Although stakeholder pensions are available to most people, they were intended to be particularly attractive to people at lower earnings levels, who traditionally do not have pension provision and who rely on the state pension.

Early indications suggest that this move to include the lower paid has largely failed, with the majority of stakeholder pensions being purchased by people who are financially more sophisticated and who would have been making pension provision anyway.

One common misconception is that stakeholder pensions are state pensions. They are in fact private pensions, although there are certain circumstances in which the government makes it compulsory for stakeholder pension facilities to be provided by employers. Where an employer has five or more employees, but does not provide an occupational pension scheme, the employer must make a stakeholder scheme available to all employees who meet certain criteria. The employees are not obliged to join, but the employer must provide a payroll deduction scheme for those who do join and pass on the employees' contributions to the scheme. The employers themselves are not obliged to contribute to the scheme.

As mentioned earlier, stakeholder pensions are a form of personal pension and, as such, subject to the same rules. In order to encourage those on lower incomes or with limited understanding of pensions, certain standards were introduced for stakeholder pensions. The key standards are:

- charges cannot exceed 1.5% of the fund value per annum for the first ten years of the term and cannot exceed 1% after that time;

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- entry and exit charges are not permitted;
- the minimum contribution required cannot be more than £20.

One effect of the restriction on charges is that the low limit precludes the payment of commission to independent financial advisers – and this may result in people finding it difficult to obtain advice on stakeholder pensions. To overcome this problem, the government has prepared a set of decision-making flowcharts, known as *decision trees,* which people can use to determine whether stakeholder pensions are appropriate to their own circumstances.

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Test your knowledge and understanding with these questions

Take a break before using these questions to assess your learning across Section 3. Review the text if necessary.

Answers can be found at the end of this unit.

1. What are the main advantages to an investor of collective investments?

2. Who owns and controls a unit trust fund's assets?

   (a) The depositary.

   (b) The fund manager.

   (c) The trustees.

3. How would you define 'forward pricing'?

4. How does 'gearing' benefit investment trusts?

5. Michael invests £3,600 in a cash ISA in July 2008 and then withdraws £1,000 in September 2008. How much can he invest in the same cash ISA in December 2008?

   (a) Nothing.

   (b) £1,000.

   (c) £3,600.

6. In what circumstances might a terminal bonus be added to a with-profits endowment policy?

7. What rate of tax would be payable on the proceeds of a non-qualifying policy?

8. How much can parents invest in a Child Trust Fund?

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9. In what circumstances might a gift *inter vivos* term assurance be used?

10. How does the deferred period on a PHI policy affect the premium?

11. Which of the following would NOT normally be excluded from a private medical insurance claim?

    (a) Dental treatment.

    (b) Chiropody.

    (c) Outpatient consultation.

12. What is the definition of 'indemnity'?

13. Which of the following would not normally be covered against damage under a buildings insurance policy?

    (a) Garden shed.

    (b) Fitted wardrobe.

    (c) Dining room table.

14. What is a 'mortgagee'?

15. Whose responsibility is it to ensure that an interest-only mortgage is repaid at the end of the term?

16. A self-employed plumber aged 30 takes out a pension mortgage. What is the minimum term for which his mortgage could run?

17. What is a 'cap and collar' mortgage?

18. Why do mortgage lenders insist that properties on which they lend should be continuously insured?

19. What is the most common form of 'revolving credit'?

20. What is the maximum permissible contribution to a stakeholder pension in 2008/09?

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Answers

1. The services of a skilled investment manager; reduction of investment risk by spreading the fund; reduced dealing costs; wide choice of investment funds.
2. (c) The trustees.
3. Under forward pricing, clients buy or sell units in a given dealing period at the prices that will be determined at the *end* of the dealing period.
4. A company's gearing relates to the amount of borrowing it has taken on. Investment trusts, being companies, are able to borrow in order to take advantage of investment opportunities (whereas unit trusts and OEICs cannot borrow).
5. (a) Nothing.
6. On maturity or on earlier death of the life assured. Terminal bonuses are not usually added to surrender values.
7. Higher rate taxpayers would pay 20% on the gain (policy proceeds less premiums paid). For others there would be no tax due.
8. Up to £1,200 per year.
9. To cover the possible inheritance tax on a gift if the donor dies within seven years.
10. The deferred period is the length of time before benefits commence. The longer the deferred period, the lower the premium.
11. (c) Outpatient consultation.
12. In the event of a claim after loss, insured persons should be restored to the same financial position that they were in immediately before the loss occurred.

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13. (c) Dining room table.
14. A lender (bank, building society or other institution) who has an interest in the property for the duration of the loan.
15. The borrower.
16. 25 years – because the minimum age at which he could take the cash lump sum on his pension plan will be 55 from 2010 onwards.
17. A mortgage where the interest rate cannot rise above a specified maximum rate or drop below a specified minimum rate.
18. Because if the property is damaged, the value of the lender's security is reduced.
19. Credit cards.
20. The greater of £3,600 gross or 100% of UK earnings, with an overall limit of £235,000.

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