

Section 3

Other mortgage-related products

Section 3 describes the products available to protect a mortgage in the event of death or incapacity.

Section 3 covers part 4 of the syllabus for Unit 5.

3.1 Buildings and contents insurance

It is vitally important to both the lender and the borrower that the mortgaged property is adequately insured. For the lender, the property is the prime security for the loan that has been made and it is essential that it is insured against any event that would adversely affect its value. Similarly, the borrower needs to protect his home.

From the lender's point of view, insurance of the property's contents is not so critical. The borrower, however, should insure his contents, although not all do. Combined policies have become much more common in the past 15 years or so.

Many buildings insurance policies are now index-linked. This means that the level of cover that is put in place at the outset is automatically increased annually in line with a recognised index that reflects increases in house-building costs. The chances of underinsurance are therefore considerably reduced.

It is now quite common for a policy not to actually provide a suitable level of cover for a particular property, but instead to insure it for an upper limit, eg £500,000. This will apply to a large number of properties insured by a company and ensures that each property is never likely to be underinsured.

For larger and more expensive properties, it will be necessary to determine a specific level of adequate insurance cover.

3.1.1 The rights of the lender

Because of the importance of buildings insurance, the lender has the right to:

- ◆ insist that a mortgaged property is insured continuously in accordance with its requirements;
- ◆ have its interest noted on the policy by the insurer;
- ◆ secure a right over the proceeds of any claim made by the borrower and insist that they are used either to remedy the subject of the claim, eg repair any damage, or to reduce the mortgage debt.

These rights are usually explained in the mortgage deed.

3.1.2 Risks covered

The following *standard perils* are covered by almost all policies:

- ◆ fire and resultant smoke damage;
- ◆ lightning, explosion and earthquake;
- ◆ storm and flood;
- ◆ subsidence, landslip and heave;
- ◆ impact caused by:
 - any vehicle, train or animal;
 - falling trees, telegraph poles and lamp posts;
 - aircraft and articles dropped from them;
 - television and radio aerials and masts;
 - satellite dishes;
- ◆ theft and attempted theft;
- ◆ vandalism and malicious damage caused by riots, strikes and civil disturbance;

- ◆ escape of oil;
- ◆ escape of water due to freezing or bursting of pipes.

For an additional premium, cover can usually be provided for the accidental breakage of fixed glass and sanitary fittings.

Most policies also cover the cost of:

- ◆ alternative accommodation during the period necessary to make the property fit for habitation;
- ◆ architects' and surveyors' fees incurred in repairing and reinstating the property.

Some of the standard perils carry an excess. This means that the borrower has to pay a specified amount of each claim.

All policies also carry exclusions, ie specific types of damage that are not covered. Standard exclusions include:

- ◆ damage caused by escape of water or oil when the property is unfurnished;
- ◆ damage caused by falling trees and branches to gates, fences and hedges;
- ◆ any theft or attempted theft if the property had been left unoccupied and windows and doors had not been fully secured;
- ◆ damage to a heating system caused by rusting, corrosion or wear and tear.

3.1.3 The principle of averaging

Underinsurance is not as much of a problem now as it has been in the past, particularly with the increasing number of index-linked policies available from insurers.

It may not become apparent that a property is underinsured until a claim is made. In such cases, the insurer is unlikely to meet in full any claim that it has agreed to accept, and will apply the principle of averaging, ie reduce the claim payment in proportion to the level of underinsurance.

Example

A property has an insurance valuation of £180,000 but it is actually insured for £150,000. If a claim for £15,000 is submitted and a standard excess clause of £500 applies, the amount that the insurer will pay will be calculated as follows:

$$\frac{£150,000 \times £15,000}{£180,000} = £12,500 - £500 = £12,000$$

3.1.4 Block insurance policies

Many lenders operate a *block buildings insurance policy* arrangement. The cover provided and premium rate are agreed between the lender and the insurer but, instead of issuing each borrower with an individual policy number, a master policy is set up with copies for both the lender and insurer.

As each mortgage is completed, the relevant property address and borrower details are sent to the insurer. A document setting out which risks are and are not covered, and how to make a claim, is sent to the borrower immediately after the mortgage is completed.

A lender will have a block policy arrangement with a number of different insurers, primarily because the Office of Fair Trading has stated that the borrower must be given a choice of at least three insurers. It is usual that exactly the same standard of cover and premium rates are offered by each insurer.

The block policy arrangement offers benefits to both the lender and the borrower.

For the lender, the advantages are:

- ◆ commission is received from the insurer for each property insured;
- ◆ cover is guaranteed to remain in force because premiums are debited to the borrower's mortgage account and transferred to the insurer;
- ◆ influence can sometimes be used in encouraging the insurer to accept a marginal claim (this is also an advantage to the borrower).

The advantages of a block policy arrangement to the borrower include:

- ◆ the premium can usually be paid on a monthly basis and combined with the mortgage repayment;
- ◆ because the insurer and the type of policy have been selected by the lender, the cover will be comprehensive;
- ◆ the cover will not lapse through non-payment of premiums because these are automatically debited to the mortgage account;
- ◆ any claim will normally be dealt with initially by the lender, who will then send all the paperwork and a recommendation to the insurer – the borrower will not usually need to deal directly with the insurer.

Some properties may be excluded from cover under a block policy, eg those of non-standard construction and those that have a particularly high value. Commercial and semi-commercial properties are also usually excluded.

3.1.5 The borrower's right to choose an insurer

Apart from the choice of block insurer that must be given under the Office of Fair Trading guidelines, the borrower now also has a right to choose his own insurer from the wider marketplace.

Even under these circumstances, the lender has some say in the matter and is entitled to inspect the proposed policy to ensure that it meets its minimum requirements. In addition, the insurer must be one that is recognised as being reputable by the lender. Most lenders will probably not accept a policy issued by an insurer that is not a member of the Association of British Insurers – the official trade body for the insurance industry.

The increasing numbers of borrowers who have exercised their right to choose their own insurer has resulted in the receipt of lower levels of commission by lenders. This is perhaps more serious for the small and medium-sized building societies, but all lenders now generate commission income by selling a whole range of mortgage-related products.

The risk to the lender is increased where it agrees to the borrower arranging his own insurance. The lender will therefore request that:

- ◆ the insurer either notes its interest in its records or actually places the policy into the joint names of the borrower and the lender;

- ◆ it is notified if premiums are not being maintained and before any action is taken to cancel the policy – in these circumstances, the lender is likely to pay the outstanding premiums and debit the borrower's account;
- ◆ it is advised whenever the borrower submits a claim – in the case of a substantial claim, the lender may ask for the claim money and then make the necessary payment to the contractor who carried out the remedial work.

To cover the cost of this additional administration, most lenders charge the borrower a one-off fee, usually around £25.

3.1.6 Leasehold properties

Neither the lender nor the borrower usually have much say in the arrangements made for insuring a leasehold property. This is because the freeholder will probably have organised cover through his own insurer and included all relevant details in the lease. This is more often than not the procedure that is followed by the freeholder of a block of flats. Only one policy is taken out covering the whole building, with the cover relating to each individual flat being shown on the policy schedule.

In the case of an individual leasehold house or bungalow, the freeholder may be content to allow the lender or borrower to arrange insurance cover, although he may want to approve the policy and have his interest noted on it.

Where the freeholder insists on arranging the insurance cover the lender is in a difficult situation if the policy does not meet its minimum requirements. This may mean that any offer of advance made to an applicant has to be withdrawn if the freeholder will not agree to arrange improved cover to satisfy the lender. The wishes of the freeholder take precedence over those of the lender.

If the policy is acceptable, the lender will wish to safeguard its interest in the property by asking for its name to be noted on the policy and to be kept informed in cases of lapse in the payment of premiums or a submission of a claim. The lender will be reassured that the freeholder is equally as concerned that the property is adequately and continuously insured.

The borrower will normally be required to pay buildings insurance premiums on a half-yearly basis direct to the freeholder, along with service charges and ground rent.

3.1.7 Administration of insurance

It was mentioned earlier that claims made under a block policy arrangement are often handled initially by the lender. For all other policies, claims are handled entirely by the insurer.

A borrower whose property is insured under a block policy can elect to switch to an insurer of his own choice at any time. Standard procedures will be followed by the lender; if agreement is given, the lender will probably charge the usual one-off fee.

Occasionally, a borrower may seek confirmation that his property is adequately insured. This will be referred to a valuer for recommendation. If an increase is found to be necessary under a block policy, an appropriate increase will be made to the premium.

Property insurance premiums are subject to a 5% insurance premium tax.

3.2 Mortgage protection products

3.2.1 Life assurance

A *mortgage protection policy* is designed to cover the repayment of a mortgage in the event of a borrower's death. These products are referred to as term assurances, the main ones being *decreasing*, *level* and *convertible*.

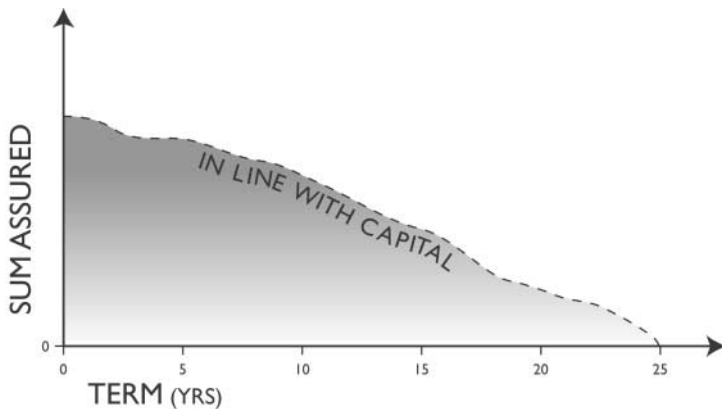
All these products share the same characteristic, ie the sum assured is payable only on the death of the life assured within the policy term. If the policyholder survives to the end of the policy, the policy lapses and there is no return payable. In other words, term assurances provide only protection and do not contain any element of investment.

In general, term assurance provides the most basic and cheapest form of life assurance. Any policy can be taken out on one or more lives and it is quite usual for joint borrowers to arrange a joint policy to pay out the sum assured on first death, so protecting the surviving borrower.

3.2.1.1 Decreasing term assurance

The most common form of *decreasing term assurance* is a mortgage protection policy used in conjunction with a capital repayment mortgage. The sum assured decreases annually in line with the reducing mortgage balance and the policy therefore guarantees to repay the outstanding debt in full, provided that premiums have been maintained and the mortgage account is not in arrears. Premiums are fixed at the outset and remain unchanged throughout the policy term.

Figure 3.1 Decreasing term assurance



The benefit payable under this type of policy is based on a maximum rate of interest being charged on the borrower's mortgage. If this rate is exceeded, there is no guarantee that the loan will be repaid in full on death. Most insurers now set the maximum interest rate at a sufficiently high level so that the chances of a shortfall are extremely remote.

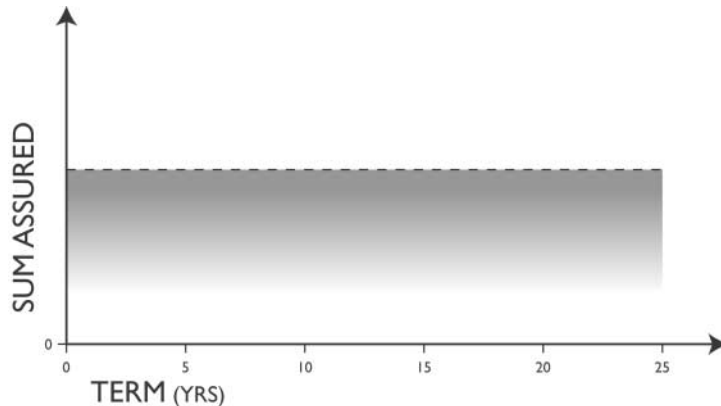
The advantages of using a decreasing term assurance policy to protect a mortgage are:

- ◆ for the majority of people, it is the cheapest form of life cover;
- ◆ it can easily be arranged by the lender, often on a block basis, with the monthly premiums being added to the monthly mortgage payment;
- ◆ a minimal health declaration is required for those under a certain age, usually around 50–55 years.

3.2.1.2 Level term assurance

With *level term assurance*, the sum assured remains constant throughout its term. The premium is fixed at the outset and also remains unchanged.

Figure 3.2 Level term assurance



The cost is marginally more than for a decreasing term assurance policy but some borrowers prefer the level term policy in protecting a capital repayment mortgage. This is because there will be a surplus available after the mortgage has been repaid that will benefit the surviving borrower.

Level term assurance is incorporated in a unit-linked endowment policy and guarantees to repay in full an interest-only loan on the death of the borrower.

Level term assurance will also usually be arranged by a borrower who is using an ISA or personal pension plan as the mortgage repayment vehicle because neither of these products have any built-in life cover.

3.2.1.3 Convertible term assurance

Convertible term assurance is a level term assurance policy that provides an option to convert it into whole-of-life or endowment assurance at a later date, without the need for the policyholder to make a further health declaration. This option means that the premium will be around 10% to 15% higher than for a conventional level term policy.

The option can normally be exercised at any time during the term of the policy. The revised premium will be based on the policyholder's original health declaration, but also on his age at the time the request to convert the policy is made.

The conversion option usually allows the term of the policy to be extended if the policyholder wishes, but the sum assured cannot be increased.

Convertible term assurance policies are now relatively rare, but they can be an attractive option for first-time buyers on limited incomes who cannot afford endowment premiums at present, but who do need to protect their mortgage. There is flexibility in that the option need never be exercised and the policy can simply remain as level term assurance.

3.2.1.4 Personal pension term assurance

It is possible to arrange single-life level term assurance within a personal pension arrangement – known as *personal pension term assurance (PPTA)*. This will allow the plan-holder to benefit from income tax relief on premiums, in the same way as on pension contributions, and can offer a tax-efficient way of protecting a mortgage. From 6 April 2006 the amount of PPTA that can be purchased is not subject to strict limits as before.

There are three factors to consider:

- ◆ in the event of the plan-holder dying, the value of the pension fund and any pension-related life assurance will be added together. Any excess over the lifetime allowance (£1.5 million for 2006/07) will be subject to a tax charge of 55%, unless it is used to buy dependants' pensions. In the vast majority of cases, this means that pension life assurance can be arranged to cover a mortgage, with the entire premium benefiting from tax relief;
- ◆ the combined total of pension and pension life assurance premiums that will qualify for tax relief cannot exceed the greater of £3,600 or the individual's earned income, subject to a maximum contribution equal to the annual allowance – £215,000 for 2006/07;
- ◆ the pension term assurance cannot go past the holder's 75th birthday, and cannot be assigned to a lender.

3.3 Mortgage payment and income protection products

3.3.1 Mortgage payment protection insurance (MPPI)

A **mortgage payment protection insurance (MPPI)** policy covers the borrower's mortgage payments for a period of up to two years if he is unable to work due to accident or sickness, or has been made redundant. It is consequently sometimes called *accident, sickness and unemployment insurance*, although this is not a particularly accurate description because unemployment is only covered if it results from involuntary redundancy.

An MPPI policy does not provide any life cover and usually allows more than one claim to be made provided that premiums are maintained.

Its key features are:

- ◆ benefit is payable after a deferred period, usually 28 days, and for a maximum period of up to two years;
- ◆ the level of benefit is usually sufficient to cover the monthly mortgage payment and any associated insurance premiums, although it may be increased to include an allowance for some essential living expenses;
- ◆ all benefit payments are tax-free.

3.3.1.1 Typical exclusions and restrictions

Typical *exclusions and restrictions* on a MPPI policy include:

- ◆ the proposer must have been continuously employed for a specified period before the proposal can be accepted;
- ◆ any redundancy that the proposer has reason to believe was imminent when the policy is taken out will be excluded;
- ◆ no benefit is likely to be paid if the policyholder is made redundant within a specified period of the date of the policy;
- ◆ no benefit is payable if the policyholder becomes unemployed as a result of disciplinary action;
- ◆ redundancy cover is not always included if the proposer is self-employed.

The earliest MPPI policies contained so many exclusions that it was often difficult to get a claim accepted. The need for mortgage payment protection became more urgent after the Income Support for Mortgage Interest (ISMI) Regulations were amended for all new mortgages completed after 1 October 1995. These borrowers have to wait 39 weeks from the acceptance of a claim before any benefit is payable.

Lenders are not always prepared to wait this length of time before any payments are received and may decide to commence possession proceedings before the 39 weeks have elapsed. The waiting period for borrowers whose mortgages were completed before 2 October 1995 is eight weeks for the payment of 50% of benefit and a further 18 weeks for payment of the full entitlement.

The government strongly encourages borrowers to take out MPPI and discussions with the main providers and the Association of British Insurers has resulted in most policies now having standardised, and fewer, exclusions and restrictions. Although many more borrowers do now have MPPI, there is still a large number who do not.

3.3.2 Permanent health insurance (PHI)

A permanent health insurance (PHI) policy provides a monthly tax-free income when the policyholder is unable to work due to accident or sickness. It does not cover redundancy or unemployment.

It is regarded as being permanent because there is no limit to the number of claims that can be made while the policy is in force. The insurer cannot cancel the policy or increase the premiums simply because several valid claims have been made and met.

Unlike an MPPI policy, the period for which benefit may be paid is not severely restricted. It will continue to be paid until the policyholder is able to return to work, retires or dies, whichever event happens first.

Benefit payments normally commence after a *deferred period* agreed at the outset by the policyholder. The deferred period is usually between 4 and 52 weeks, the longer the period, the lower the premium payable.

The choice of deferred period by an employed person may be influenced by the length of time that his employer will continue to pay his full salary in the event of sickness: if full salary will be paid for the first three months of sickness,

then the minimum deferred period should be for the same period. A longer deferred period will further reduce the premium and may be selected according to the insured's financial situation, and ability to maintain mortgage payments and meet other essential expenditure from savings.

The monthly benefit is not intended to replace lost earned income in full because there would then be no incentive to return to work. The usual maximum level of benefit is approximately 60% of the insured's average net monthly income, allowing account to be taken of entitlement to any state benefits as well as payments received from other income protection policies held. The 60% maximum benefit applies to the total benefit received from all PHI policies held by an individual. The existence of any other policies must be declared when a proposal for a new policy is made and also when any claim is made.

There are occasions where a person returning to work following illness is unable to continue in the same job. This may mean being transferred to less onerous duties on a lower salary and, in such circumstances, a PHI policy will pay a proportion of the maximum possible benefit to make up the reduction in salary. The same principle will be applied if the policyholder were forced to give up full-time employment for part-time employment. These benefits are only available, however, if the policy has been written on an any occupation basis.

The level of premium payable is based on a number of factors:

- ◆ occupation;
- ◆ gender;
- ◆ hobbies and pastimes;
- ◆ exclusions etc.

Some occupations carry a greater risk than others: an office worker will be regarded as a much lower risk by the insurer than a scaffolder. Hazardous pastimes such as parachuting and pot-holing will also have the effect of increasing the premium.

Policy exclusions tend to vary between PHI providers, but the usual *standard exclusions* are:

- ◆ self-inflicted injury, including drug and alcohol abuse;
- ◆ any medical condition of which the insured was aware when the policy was taken out;

- ◆ injury arising from the participation in any criminal act;
- ◆ complications arising from pregnancy and childbirth.

An individual proposer can reduce the premium payable by requesting that other specific exclusions are stated in the policy document.

Many employers now offer **group PHI schemes** and pay the premiums on behalf of their employees. The Inland Revenue regards the provision of such schemes as a taxable benefit-in-kind as far as the employees are concerned. Premiums are generally cheaper under group schemes than they would be if each employee arranged his own individual policy, due to economies of scale. A major advantage of a group scheme is that each member is entitled to a certain level of cover that does not depend on a health declaration and this is particularly beneficial to those who may have difficulty arranging their own policy because of poor health.

3.4 Other insurance

3.4.1 Critical illness insurance

Critical illness insurance pays a tax-free lump sum on the diagnosis of any one of the serious illnesses specified in the policy. These generally include:

- ◆ cancer;
- ◆ stroke;
- ◆ heart attack;
- ◆ kidney failure;
- ◆ multiple sclerosis;
- ◆ rheumatoid arthritis.

It is usually the case, however, that none of these illnesses are covered if they are related in any way to HIV or AIDS. In addition, any illness of which the insured was aware when the policy was arranged would also be excluded.

The lump sum benefit is paid only if the policyholder survives for a specified period, usually 28 days, from the date of diagnosis. The benefit does not have to be repaid even if a full recovery is made from the illness but it can only be paid once, after which the policy is cancelled.

Critical illness insurance can be either a stand-alone policy or an 'add-on' to an endowment or term assurance policy. In the latter cases, the lump sum is payable either on diagnosis of one of the prescribed illnesses or on death, whichever occurs first.

The main benefit of this type of policy is that it can be used either to repay in full or partly repay an outstanding mortgage, or replace lost income during a lengthy period of sickness.

3.4.2 Waiver of premium

Many protection policies now offer a ***waiver of premium*** option. This is designed to ensure that the policy benefits are preserved if the policyholder is unable to continue paying premiums because of ill health. If chosen, this option will mean a slightly higher premium being paid, but it is particularly beneficial for the self-employed whose income is likely to cease almost immediately if they are unable to work.

It is usual that, in the event of a claim being made, a deferred period of at least 13 weeks must elapse before the waiver option takes effect.

3.4.3 Mortgage indemnity insurance (MIG)

Not all lenders take out ***mortgage indemnity insurance (MIG)***. Where they do, the threshold varies between lenders but is usually between 75% and 90%.

The policy is regarded as additional security because it protects the lender in the event of a property being taken into possession and sold for less than the outstanding debt. Although the premium is usually paid by the borrower, the policy does not actually benefit him, except that without it he will be unlikely to be able to borrow a high proportion of the value of the property.

Under the Mortgage Conduct of Business (MCOB) rules the premium for a MIG policy must be explained and described to applicants as a **higher lending charge**, **not** simply as a MIG premium.

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 on page [5] 103.

1. Fill in the table below, which considers life assurance policies that can be used with mortgages. Tick, cross or complete the relevant box if it applies to the product.

Feature	Convertible term	Whole- of-life	Level term	Mortgage protection
Limited term	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Can be investment-linked	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Conversion to whole-of-life or endowment	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Sum assured level	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Sum assured decreases in line with mortgage	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Order of cost – lowest <i>first 1 to 4</i>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

2. Outline the difference between critical illness and permanent health insurances.

Answer true or false to the following statements.

3. Mortgage protection life assurance is appropriate for people with capital and interest mortgages.
4. The minimum deferred period for permanent health insurance is 13 weeks.
5. Accident, sickness and unemployment (ASU) policies do not pay out if redundancy occurs within a specified period after the policy starts.
6. Mortgage lenders can insist on specifying how the money from a claim on the mortgagor's property insurance must be spent.
7. Damage from burst water pipes is normally covered by property insurance policies.
8. Many lenders offer block policies, which can include cover for both property and contents.
9. Block policies are cheaper for borrowers because no commission is paid.
10. Property insurance cover should commence, at the latest, by the completion date.

Answers

I.

Feature	Convertible term	Whole- of-life	Level term	Mortgage protection
Limited term	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Can be investment-linked	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Conversion to whole-of-life or endowment	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Sum assured level	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Sum assured decreases in line with mortgage	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
<i>Order of cost – lowest first 1 to 4</i>	<input type="text" value="3"/>	<input type="text" value="4"/>	<input type="text" value="2"/>	<input type="text" value="1"/>

2. **Critical illness insurance** pays a lump sum on diagnosis of a specified serious (critical) illness. Permanent health insurance pays an income in the event of the insured being unable to work through illness or injury.
3. **True:** the sum assured under mortgage protection life assurance reduces in line with the outstanding capital.
4. **False:** the minimum deferred period for permanent health insurance is four weeks, which may be appropriate for self-employed people.
5. **True:** the suggestion is that the client may have known about a redundancy occurring soon after before starting the policy.

6. **True:** mortgage lenders wish to ensure the insurance money is used to maintain the value of their security.
7. **True:** property insurance claims will cover damage from burst water pipes but it may be excluded if a property is left unfurnished.
8. **True:** contents cover under block policies may be expressed as a percentage of property cover.
9. **False:** commission on block policies is paid by the insurer to the lender.
10. **False:** property insurance should be in place when contracts are exchanged.