Unit 5
Mortgage payment methods and products

After studying this unit, you will be able to demonstrate an understanding of:

- the key features of the different types of mortgage repayment options and their advantages and disadvantages for different types of borrower;
- the key features of the common types of mortgage product and interest rate options;
- the structure and features of other types of mortgage;
- the main features and functions of different forms of life assurance and other insurances (eg mortgage payment protection insurance (MPPI), life, accident and sickness insurance (ASU), building insurance, contents insurance) associated with arranging a mortgage.

Section 1

Mortgage repayment methods

Introduction

Although there are many mortgage products currently available, there are only two mortgage repayment methods: capital repayment (or capital and interest) and interest only. It is, therefore, important not to confuse mortgage products, such as fixed-rate and discounted, with repayment methods.

Section 1 describes the capital and interest and interest-only methods of arranging a mortgage, as well as the different repayment vehicles for interest-only mortgages.

Section 1 covers part 1 of the syllabus for Unit 5.

1.1 The capital repayment method

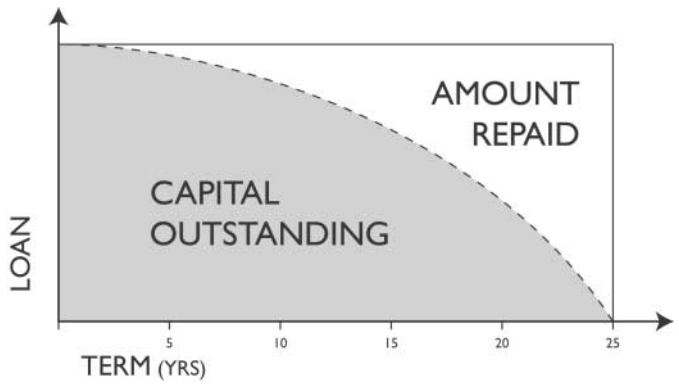
Until the mid 1970s, **capital repayment** – or *capital and interest* – this was the conventional method of repaying a mortgage. Interest-only loans then became prevalent, but, in the past two or three years, the capital repayment method has again become more popular.

Under this method, each monthly payment consists of a capital element and an interest element. If the borrower makes all monthly payments when they fall due and adjusts them in line with changes in the interest rate charged, the loan is guaranteed to be fully repaid at the end of the mortgage term.

At the beginning of the mortgage term, the monthly payment consists largely of interest. The amount of capital owed gradually reduces as the term progresses; the interest part of each monthly payment decreases, while the capital element increases.

It does take several years before there is any noticeable reduction in the amount of capital owed and this can cause concern to some borrowers who may feel that their loan will never be repaid.

Figure 1.1 The capital repayment mortgage



Example

The monthly payment on a new capital repayment loan of £60,000, spread over 25 years, at an interest rate of 5.0% is £354.78. This is taken from computerised repayment tables.

Assuming that the interest rate remains unchanged for the whole of the first year, the amount of interest payable in that year is:

$$\frac{60{,}000}{100} \times 5 = £3{,}000$$

The interest element of each monthly payment in the first year is:

$$\frac{3{,}000}{12} = £250$$

The amount of capital repaid in the first year is therefore:

(£354.78 – £250.00) x 12 = **£1,257.36**

If the interest rate were 10.0%, the monthly payment on £60,000 over 25 years would be £550.86.

The interest element of each monthly payment in the first year is:

$$\frac{60{,}000}{100 \times 12} \times 10 = £500.00$$

The amount of capital repaid in the first year is therefore:

(£550.86 – £500.00) x 12 = **£610.32**

The above example illustrates that the higher the interest rate charged, the smaller the amount of capital that is repaid during the early part of the mortgage term.

The capital repayment method has inbuilt flexibility. The borrower may be permitted to maintain his existing monthly payment when the interest rate is increased; this will have the effect of extending the mortgage term, although probably only marginally, but this may help him through a short period of

financial difficulty. Similarly, the borrower may decide to maintain his existing monthly payment if the interest rate is reduced. This will shorten the mortgage term, although again perhaps for a temporary period only.

The following table shows the capital outstanding at points in the term of a 25-year £100,000 repayment mortgage. The figures assume interest rates will not change over the term.

Figure 1.2 Debt reduction table

Interest rate	Monthly	Capital outstanding at years into term (£)				
		5	10	15	20	22
3%	479	85,400	68,600	49,000	26,300	16,200
5%	591	88,400	73,600	54,800	30,700	19,300
7%	715	90,900	78,200	60,300	35,200	22,500
9%	848	92,900	82,100	65,300	39,600	25,800
11%	990	94,600	85,400	69,900	43,900	29,000

Example

A borrower who has £52,000 outstanding on his capital repayment mortgage is paying £373.36 per month. The current interest rate is 5.5% and there are 19 years remaining on the mortgage term.

If the interest rate is increased by 0.5% to 6.0%, his monthly payment will increase by £15.03 to £388.39.

If he chooses to maintain his existing payment, the mortgage term will be increased by just less than two years. The lender may be quite happy to accept this situation. It might be only a temporary increase in the mortgage term because the interest rate may fall back to 5.5% within a few months. If the interest rate were to increase again, however, then it may not be possible for the existing monthly payment to continue to be maintained if the lender considers that the mortgage term will be unduly extended.

1.1.1 Advantages and disadvantages

The main disadvantage to capital repayment is that there is no built-in life cover. This must be arranged separately, although decreasing term assurance cover is generally inexpensive. The main advantages are as follows.

- *Flexibility*. The capital repayment method has in-built flexibility and the borrower usually has the option to maintain his existing monthly payment when the interest rate is increased or decreased.

  If he maintains the payment when the rate decreases, he will shorten the mortgage term because each overpayment will reduce the capital outstanding, assuming it is applied to the account immediately. If he maintains the payment when the rate increases, he will lengthen the term because he will not be paying off the required capital each month. In both cases, the change to the term is likely to be quite short-lived, because the next rate change may alter the required payment again.

Example

John has a repayment mortgage with a term of 19 years remaining. His lender's rate decreases by 0.5%, reducing John's required payment by £42 a month. John decides to maintain his existing payments, which means he will overpay by £42 each month, reducing the capital more quickly and reducing the interest charged. The lender calculates that if this overpayment continues for the rest of the mortgage term, the mortgage will be repaid two years early.

Six months later, the lender's rate increases to the original level and John decides to maintain his existing payment. He will have paid off a very small amount of additional capital by overpaying for a short period, but not enough to make a significant difference. As a result, the lender's recalculation will show that, if this payment continues for the rest of the mortgage term, the mortgage is now likely to be repaid only a month or so before the original end date, now 18 years and six months away.

The same principle as that in the above example will apply where the borrower chooses to maintain or reduce payments when rates increase, although underpayments will result in an extended term. This will be of benefit to those who are struggling to meet their mortgage payments and cannot afford an increase. Alternatively, reducing the payments and extending the term can be of temporary benefit to those who are finding it hard to meet their mortgage payments, perhaps through unemployment or ill health.

- *Debt reduction*. Many borrowers find comfort in the knowledge that they are reducing their mortgage debt over time.
- *Guaranteed repayment*. The repayment method guarantees that the loan will be repaid by the end of the term, as long as the required payments are made on time.
- *No investment link*. The mortgage repayment is not dependent on the performance of an investment vehicle.

1.2 The interest-only method

With an **interest-only** mortgage, the borrower makes monthly mortgage payments consisting of interest only. The full capital amount remains outstanding during the mortgage term and is repaid in one lump sum at the end of the term. This means that the mortgage payments each month will be lower than those of a repayment mortgage for a similar amount. The borrower usually arranges an investment vehicle to build up the capital needed to repay the mortgage at the end of the term. The investment runs alongside the mortgage but is separate from it; the cost should be taken into account when calculating the overall costs of the mortgage arrangement.

In most cases no guarantee is given that the investment will be sufficient to repay the debt in full. The most common repayment vehicles are low-cost with-profit and unit-linked endowment policies.

Many endowment policies taken out in the past appear increasingly unlikely to produce enough to repay the associated mortgage in full. For this reason, interest-only loans have become increasingly unpopular with borrowers, although some lenders allow interest-only loans to be taken out without any supporting repayment vehicle in place.

This effectively puts the responsibility on the borrower to ensure that he has the means to repay the loan in full at the end of the mortgage term. He may,

of course, arrange some form of investment product or simply rely on accumulated savings.

Some people are quite happy to borrow on this basis, particularly as the monthly mortgage payment on an interest-only basis is considerably less than that using the capital repayment method.

Example

Consider a loan of £70,000 at an interest rate of 6.0% over a 25-year term.

On an interest-only basis, the monthly payment will be £350, while that using the capital repayment method will be £456.33.

The saving of over £100 per month would be particularly useful to a first-time buyer who has borrowed the maximum his income will allow, but who expects to earn considerably more within the next two or three years when some form of professional training is completed. At that stage, it may well be possible to switch to a capital repayment mortgage, removing the need to worry about how the capital will be repaid at the end of the mortgage term.

1.3 Mortgage repayment vehicles

Mortgage repayment vehicles include:

- full with-profit endowment policy;
- low-cost with-profit endowment policy;
- unit-linked endowment policy;
- individual savings account (ISA);
- personal pension plan.

While information on these investment-backed products can be given by mortgage advisers, only those who are authorised under the Financial Services and Markets Act 2000 can give advice and make a recommendation.

An endowment policy, whether with-profit or unit-linked, serves two purposes:

- it guarantees to repay the loan in full if the borrower dies during the mortgage term, though this depends on all policy premiums having been paid and the mortgage account being up-to-date;
- it will, hopefully, provide a maturity value that is sufficient to repay the loan in full at the end of the mortgage term and also provide a surplus for the borrower.

In other words, an endowment policy provides both protection and investment elements for the borrower.

Personal pension plans and ISAs, on the other hand, provide investment but do not include built-in life cover. This must be purchased separately, usually as level term assurance.

1.3.1 With-profits endowment policies

With-profits endowments offer policyholders a degree of guarantee with the potential for capital growth. Regardless of the type of with-profits endowment, the basic structure is:

- the plan has a *guaranteed sum assured (GSA)*. This is a guaranteed sum that will be paid on the earlier of death or maturity, assuming premiums are paid as required;
- the policy is invested in a *with-profits fund*. The fund invests in a spread of investments, typically blue-chip shares, gilts, bonds and cash. Due to the guarantees provided on maturity, the fund manager will take a relatively cautious approach to investment;
- the company will assess the fund each year. It will set aside money to cover current and future liabilities, like death benefits, guaranteed sums assured and bonuses already declared, and will set aside a further amount to provide a *reserve*. Finally, it will take out an amount to cover the expenses of running the fund and the associated policies. The balance of the fund will represent the 'profits', some of which may be distributed to policyholders;

- *profits* can be distributed in two ways:

  1 through *reversionary (annual) bonuses*, which are usually added to the policy each year as a percentage of the plan's GSA. Once added, the reversionary bonus is guaranteed to be paid on maturity, providing the plan remains in force and premiums are paid.

  For example, if a policyholder has a plan with a GSA of £50,000 and the company declares a reversionary bonus of 2% on its with-profits policies, this means that he will receive a bonus of £1,000, increasing the GSA to £51,000.

  Reversionary bonuses can be calculated in a number of ways. They can be calculated on a simple basis: this means that they will always represent a percentage of the original GSA. They can also be calculated on a *compound basis*; this means they will represent a percentage of the original GSA plus bonuses already added. Some companies declare a bonus based on the initial GSA and a further sum based on accrued bonuses;

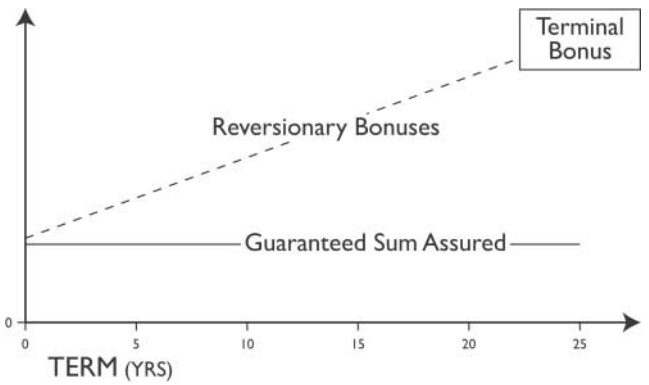
  2 through *terminal bonuses*, which are usually added at maturity, or sometimes on earlier death. They can represent a large proportion of the final policy value, perhaps as much as 40%. They are designed to reward long-standing policyholders.

- while the company will seek to declare bonuses, there is no guarantee that they will be declared or that a certain amount that will be paid, and neither will the bonuses necessarily represent the full growth of the fund. Some will be held back in reserve;

- the *reserve* allows the company to maintain bonuses in years when the fund performance would not normally justify such payments. This means that the policyholder will see smoother performance from his plan – hence the term *smoothing*. If the fund were to return growth of 11% in a year, the company may only pass on the equivalent of 6%. The rest will be held in reserve. If the fund achieves no growth, or even a loss, the following year, the company may still be able to pass on a bonus by using these reserves. The problem in recent years has been that fund growth has been poor and reserves have been run down. Many companies have added little or no reversionary bonuses and terminal bonuses have been dramatically reduced;

- if the plan is surrendered before the end of the term, actuaries will calculate the surrender value. This is unlikely to represent the full value of the plan at the time of surrender, and may result in a significant loss for the policyholder. The guaranteed death benefit and reversionary bonuses are not guaranteed in the event of early surrender.

Figure 1.3 With-profits endowment



1.3.1.1 Calculation of reversionary bonuses

1.3.1.1.1 Simple basis

On a guaranteed sum assured of £50,000, with an end of year 1 bonus declared at 3%, the reversionary bonus added will be £1,500. GSA is now £51,500. At the end of year 2, a bonus is declared 2% – reversionary bonus added will be £1,000, and the GSA now be £52,500.

1.3.1.1.2 Compound basis

On a GSA of £50,000, with an end of year 1 bonus declared at 3%, the reversionary bonus added will be £1,500. The GSA is now £51,500. At the end of year 2, a bonus declared of 2% – reversionary bonus added will be £1,030 (£51,500 x 2%) and the GSA is now £52,530.

1.3.1.1.3 Separate bonuses basis

On a GSA of £50,000, with an end of year 1 bonus declared at 3%, the reversionary bonus added will be £1,500. The GSA is now £51,500. At the end of year 2, a bonus is declared of 2% on GSA and 1.5% on accrued bonuses. Bonus – on GSA, £1,000; on accrued bonuses £22.50.

1.3.1.2 Full with-profits endowment

The **full with-profits endowment** is the original interest-only product, introduced over 40 years ago.

The full endowment is a with-profits plan with a guaranteed sum assured (GSA) equal to the mortgage amount. This means that the mortgage is guaranteed to be paid off by the GSA, with added bonuses providing a cash surplus.

All this comes at a cost, however: the premium will be calculated based on the need to pay the guaranteed sum assured at the end of the term. This makes the full endowment much more expensive than the low-cost versions. Although there is the guarantee that mortgage will be paid off and the probability of a surplus at the end, the overall cost is unlikely to make it a practical choice. For those wanting guarantees, a repayment mortgage in an easier and more cost-effective choice.

If the full endowment is cashed in before the end of the term, the surrender value may not represent the fair value of the plan at that point.

If a with-profit policyholder wishes to discontinue his policy, but not actually surrender it, then he can make it paid up. This means that no further premiums are paid and the policy has a reduced guaranteed sum assured and death benefit. Reversionary bonuses added to date are unaffected and remain attached to the policy. The value of the policy will continue to grow, although at a much lower rate, because no further premiums will be paid.

1.3.1.2.1 Advantages and disadvantages

The advantages of the full with-profits endowment are that:

- the guaranteed sum assured will be paid on maturity, providing premiums are paid and the plan remains in force. This means the mortgage will be paid off;

- the guaranteed sum assured will be paid on death during the term, meaning the mortgage can be paid off;
- there is likely to be a significant surplus over the mortgage amount;
- the policy combines investment and life cover.

The disadvantages of the full with-profits endowment are that:

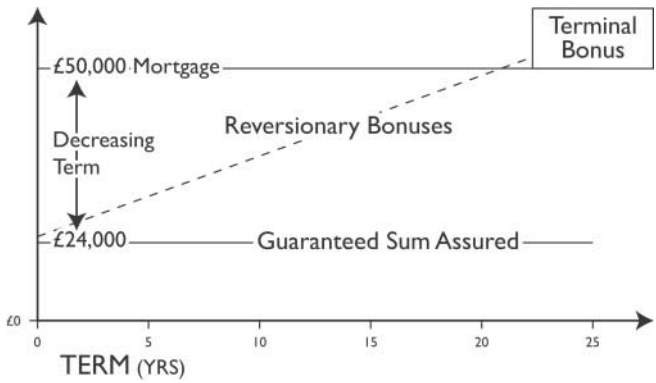
- full endowments are expensive;
- with-profits endowments are inflexible. The term cannot be extended and early surrender is likely to result in a payment below the plan's real value.

1.3.1.3 Low-cost with-profits endowment

The **low-cost with-profit endowment policy** was developed in the 1970s as a more affordable alternative to the full with-profit policy. Over the next two decades, it became a very popular mortgage repayment vehicle. The low-cost with-profits policy operates on a similar principle to the full endowment, but with some significant differences.

- The *guaranteed sum assured (GSA)* is typically 30 to 40% of the mortgage amount. As with the full endowment, the GSA is payable on the earlier of maturity or death during the term. This is significant, in that the plan does not guarantee to repay the mortgage at the end of the term.
- The *premium* is worked out by assuming that the guaranteed sum insured *plus* a percentage of the anticipated reversionary bonuses (typically 80%) will provide sufficient capital on maturity to repay the loan. If these assumptions prove to be wrong and the terminal bonus is not sufficient to plug the gap, the maturity proceeds will not repay the loan: the final sum is not guaranteed.
- In the event of death during the term, the guaranteed sum assured *plus* accumulated reversionary bonuses will be paid. A form of *decreasing term assurance (DTA)* is built in to plug the gap between the value of the guaranteed sum insured plus accrued bonuses and the mortgage. This ensures that the mortgage can be repaid on death before the end of the term.
- A low-cost low-start endowment works on similar lines but the premiums in the first five years are lower. The premiums increase by 20% in each of the first five years, leading to a doubling of the premium by that stage. From then onwards the policyholder is paying a higher premium than would be the case with a low-cost endowment.

Figure 1.4 Low-cost with-profits endowment



Example

A borrower has a mortgage of £75,000 and has arranged a low-cost endowment policy to support it. The policy is targeted to provide £75,000 at maturity, with a guaranteed sum assured of £24,000 and a guaranteed death benefit of £75,000.

1. Assume the policyholder dies after ten years, reversionary bonuses accrued to that point equal £8,000 and a terminal bonus of £14,000 has been declared. This will give the plan a value of £46,000. The death benefit will comprise £46,000 from the GSA plus £29,000 from the decreasing term element.

2. Assume the policyholder dies after 20 years, reversionary bonuses accrued to that point equals £30,000 and a terminal bonus of £25,000 has been declared. This will give the plan a value of £79,000. The death benefit will be the full value of the policy – £79,000 – but no DTA would be included.

1.3.1.3.1 Advantages and disadvantages

The advantages of the low-cost with-profits endowment are that:

- the guaranteed sum assured will be paid on maturity, providing premiums are paid and the plan remains in force. This means there is at least a partial guarantee of the final value;
- the premiums are significantly lower than a full endowment;
- the guaranteed sum assured will be paid on death during the term, meaning the mortgage can be paid off;
- providing the policy remains in force to maturity, any gains made are locked in and cannot be lost;
- there is the possibility of a surplus over the mortgage amount;
- the policy combines investment and life cover.
- no tax is payable on the maturity value.

The disadvantages of the low-cost with-profits endowment are that:

- the final value is not guaranteed to pay off the mortgage;
- it is often difficult to identify product charges;
- the policies are inflexible. The term cannot be extended and increasing premiums may not be possible.

1.3.2 Unit-linked endowment policies

Unit-linked endowment policies were introduced as an alternative to with-profit policies. Although they carry a greater risk, they also provide the possibility of much higher returns than with-profit policies.

The unit-linked endowment is designed to accumulate capital by the end of a set term. It differs from the with-profits endowment in the way that the fund is built up.

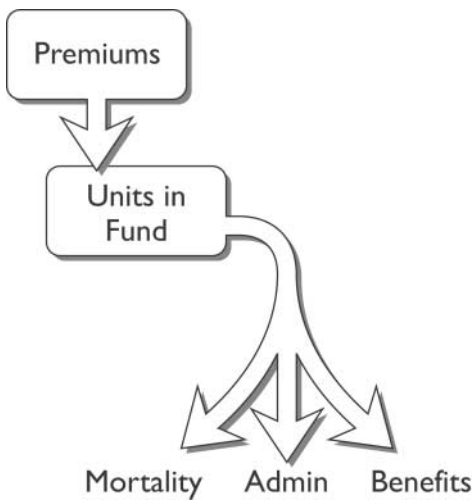
Premiums buy units in one or more of a range of unit-linked funds. Not all of the premium is invested because some is taken to cover expenses. The value of units is directly related to the performance of the fund, so there is no smoothing effect, because growth (or loss) is directly reflected in unit prices. The value of the plan is simply the number of units held in the plan multiplied by the current fund price. There are no bonuses.

The premium is calculated so that, if investment funds grow at a specified annual rate, typically 7.5%, the maturity proceeds should be sufficient to repay the loan.

The only guarantee offered is that the loan will be repaid in the event of death during the term; the maturity value depends entirely on fund performance. Unit prices can, and do, fluctuate.

The guaranteed death benefit is provided through a combination of the plan's value and decreasing term assurance. For example, assume a plan has been in force for ten years, has a death benefit of £75,000 and a current unit value of £25,000. If the policyholder dies, the death benefit will comprise a return of the fund (£25,000) plus a DTA payment of £50,000, giving a benefit of £75,000. Units are deducted from the fund each month to pay for the cost of the life cover (a *mortality charge*), which will always be the difference between the sum assured and the fund value. A unit-linked policy may include either a level term or decreasing term policy; this decision rests with the policyholder.

Figure 1.5 Unit-linked endowment



Units have two prices – an *offer price* at which units are purchased by the client and a *bid price* at which units are bought back by the fund – the bid price is lower than the offer price.

The plan will be taken out with a set term and a premium calculated to achieve the target maturity amount. The plans are flexible, however, and it may be possible to increase or decrease the premiums, or to extend the term, subject to the policy rules and qualifying rules.

The charges on a unit-linked plan are clearly laid out in the policy document. Typically, they will include:

- an initial charge – an amount taken from the premium when it is paid;
- a monthly management or policy fee deducted from the premium before investment;
- an annual fund management charge taken from the fund. Typical charges range from 0.5% to 1.5% of the fund value;
- an early surrender charge on surrender in the first ten years;
- charges deducted from units to cover the cost of the death benefit.

Mortgage-related unit-linked endowments are subject to policy reviews, where the insurer checks the plan's progress in relation to the maturity target. Where the plan is not on track, the insurer is likely to recommend an increase in premiums. On a typical 25-year policy, reviews would take place after ten, 15 and 20 years, becoming annual after that.

When a policy is taken out the investor can choose how much of each premium is invested in each of the available individual funds.

The range of funds offered will include high, medium and low-risk investments, and the policyholder can base his selection on his overall attitude to risk. This represents an advantage over a with-profits policy where the policyholder has no say over how premiums are invested – they are invested in the company's with-profit fund.

The range of funds include:

- *cash* – these funds are available on the money markets and through building societies. They represent a very low risk and provide virtually a 100% guarantee that all money invested will be returned. However, they earn relatively low rates of interest and are seldom used for mortgage purposes, although they can be useful in the last few years of a policy when growth has been good and the investor wants to consolidate gains made;

- *fixed-interest* – these are mainly gilt-edged government securities. Again, these are relatively low risk but do not offer significant growth and are rarely used for mortgage purposes;
- *managed (or balanced) fund* – this is the choice of most mortgage investors. The fund mandate is to produce reasonable capital growth without taking excessive risks. The manager will hold most of the assets in blue-chip equities and gilts, adjusting the balance and selection as appropriate.
- *UK equities* – these are investments in the shares of blue-chip companies that trade on the London Stock Exchange. They represent a medium risk in the short term, but in the medium to long term they can be expected to produce a reasonable level of dividend income as well as capital growth;
- *specialist equities* – these are investments in the shares of companies that operate in a specific sector such as technology or pharmaceuticals. They represent a medium to high risk;
- *property* – these are investments in commercial property. They can be volatile in the short term but can normally be relied upon to provide healthy returns in the medium to long term;
- *international* – these are investments in the shares of companies throughout the world. They carry a much greater risk than UK equities.

1.3.2.1 Advantages and disadvantages

The advantages of the unit-linked endowment are that:

- the policy is flexible, in that premiums can be increased or decreased, depending on the policy conditions and qualifying rules, and it may be possible to extend the term, subject to the policy conditions and qualifying rules;
- the investor has a wide range of funds to choose from;
- the plan's charges are clearly stated and it is simple to value the policy;
- the plan combines investment and life cover.
- no tax is payable on the maturity value.

The disadvantages of the unit-linked endowment are that:

- The final value is not guaranteed, and unit values can go down at any time as well as up;
- High charges on some policies can reduce the growth made.

1.3.3 Unitised with-profit endowment

Unitised with-profit endowment policies combine the security of a with-profit policy with the greater growth potential of a unit-linked policy.

The investor buys units in a with-profits fund. As bonuses are declared, the value of each unit will increase proportionately and cannot be reduced in future. Most unitised with-profits policies allow the investor to switch into and out of other unit-linked funds. Switches out of the unitised with-profits fund might incur a *market value adjuster (MVA)*, which means that the company will reduce the value of units transferred to protect the interests of other investors. This is usually invoked in times of poor fund performance. MVAs are also used on encashment before maturity.

1.3.4 Endowment shortfalls

The performance of many low-cost with-profit and unit-linked plans has been very poor since the mid 1990s. The reasons for this are:

- inflation and interest rates have been much lower than for many years – most life insurers invest heavily in gilt-edged securities and these have produced returns that have steadily fallen in line with long-term interest rates;
- in the early 2000s, the situation was made worse by falling share prices, not only in the UK but also across the world.

There has also been much concern over the standard of advice given by some financial advisers, with the risks associated with investment plans not being adequately explained to clients.

In 1999 the Financial Services Authority (FSA) instructed endowment providers to review the performance of all endowment plans that were being used as mortgage repayment vehicles. Each plan must be reviewed at least

every two years and the policyholder must be provided with an illustration of the maturity value based on annual growth rates of 4%, 6% and 8%.

Where the annual rate of growth required to repay the mortgage in full on maturity is 6% or less, then the policyholder is advised that no action is necessary, but if an annual rate of growth of more than 6% is needed to reach the target amount, then the policyholder must be advised that some form of action needs to be taken.

The endowment provider's letter to a policyholder is classified as being 'red, amber or green'.

- A *red letter* indicates that there is a high risk that the policy will not pay the target amount at the end of the mortgage term. A strong recommendation to take some form of action is made.
- An *amber letter* indicates that there is a significant risk that the target amount will not be met and recommends that some action should be taken if the policyholder is concerned. If he is not too worried about the risk, then the advice given is to check future projection letters carefully.
- A *green letter* states that the policy is on track to meet the target amount but warns that there is no guarantee that it will stay on track in the future. Again, the advice is to carefully check subsequent projection letters.

The various courses of action that the policyholder can consider are detailed in a FSA Factsheet that accompanies the letter from the endowment provider.

- *Switch the amount of the projected shortfall from interest-only to capital repayment*. This will guarantee that the projected shortfall figure will be repaid, but only if all future monthly payments are made on time. However, should another projected shortfall materialise, then it will be fairly easy to increase further the capital repayment part of the loan.
- *Repay some, or all, of the mortgage early, either by means of a lump sum or by making additional payments each month*. This is an easy option to manage, although the lender may impose a redemption penalty on overpayments. In this case it might be better to place the overpayment amounts into a savings account and then transfer the total to the mortgage account when the redemption penalty period has expired. If interest is calculated on an annual basis, it will certainly be more cost-effective to accumulate savings and make a capital reduction shortly before the date on which annual interest is debited to the account.

- *Convert the whole mortgage to a capital repayment basis*. This will guarantee that the loan will be repaid by the end of the mortgage term in full if all future monthly payments are made on time. However, the monthly payment will increase considerably, particularly if the remaining term is 20 years or less.

  The endowment policy can either be maintained or surrendered. In the latter case the surrender value can be used to reduce the mortgage balance and total outgoings will probably be much the same as, or even less than, before. It is important that the borrower obtains advice from a qualified financial adviser before taking this course of action.

  If the endowment policy is surrendered, alternative life assurance cover may need to be arranged. An early repayment charge may also be payable on any capital reduction made with the surrender proceeds.

- *Accumulate savings and use these to reduce the mortgage debt.* The savings might be put in an ordinary deposit account, cash ISA or equity ISA. However, this is probably best as a short-term measure, eg to cover a period during which a redemption penalty applies. As soon as the penalty period expires, the savings can be used to reduce the debt.

  If an equity ISA were chosen, this should be regarded as more of a long-term investment, ie five years or more. The risk involved is much the same as for the endowment policy itself and the borrower will need to take this into consideration.

- *Extend the term of the endowment policy and the mortgage*. The permission of both the endowment provider and the lender will be required, and this action will only be possible on a unit-linked policy. Extending the term of the policy may have taxation implications if it ceases to be classed as a qualifying policy and will still not guarantee that its maturity value will be sufficient to fully repay the loan.

  Extending the term of the mortgage and the policy will also result in additional interest and premiums being paid.

- *Increase the endowment premiums*. It may be possible to increase premiums into the endowment in order to boost the maturity value. If this facility is available, charges may be levied for varying the policy and there may also be taxation implications. The additional premiums will still not guarantee that the policy will fully repay the loan at the end of the term.

The choice of option depends on the individual policyholder. The guidance issued by the FSA in its Factsheet gives a clear indication of the relative merits of each option and explains the risks involved.

The FSA Factsheet strongly recommends the policyholder to take action sooner rather than later if a shortfall looks likely. It also recommends that immediate action must be taken if it is felt that there are grounds for a valid complaint. These grounds are if:

- the adviser did not explain that an endowment policy would not necessarily mature with sufficient funds to repay the mortgage in full, and that the policyholder would not have accepted this risk if he had known about it;
- the maturity date of the endowment policy is after the agreed redemption date of the mortgage;
- the maturity date of the endowment policy is after the policyholder's selected retirement date and the adviser did not specifically check that the premiums would be affordable after retirement;
- the adviser recommended that an existing endowment policy be surrendered and replaced with a new one.

1.3.5 Unit trusts and open-ended investment companies (OEICs)

Although relatively uncommon, it is possible to use unit trusts and OEICs as mortgage repayment vehicles. As both these vehicles can be held within an ISA, it is more tax efficient, and more common, for them to be used as part of an ISA repayment 'package'.

1.3.5.1 Unit trusts

A **unit trust** is a pooled (or collective) investment created under trust deed. The term *pooled* is used because money from a large number of investors is pooled together and then invested. An investor can invest in a unit trust through a lump sum, regular contributions or both.

The unit trust is divided into units, with each unit representing a fraction of the trust's total assets. In simple terms, the value of each unit is the value of all of the trust's assets divided by the number of units issued. A unit trust is *open-*

ended in the sense that a manager can, in response to demand, create more units. He is also obliged to buy units back from investors wishing to sell.

The unit trust is set up under a *trust deed*, which means that the assets are separate from the company that runs it. The deed specifies the types of investment the manager can use, the broad principles on which it can operate and whether it pays income or aims for growth: this is referred to as the *mandate*. For example, a typical Japanese unit trust's deed might specify that at least 85% of the fund must be invested in Japanese shares.

The main role of the unit trust *trustee* is to hold the fund assets on behalf of investors and to ensure that the trust runs in line with its deed.

The role of the *unit trust manager* is to manage the investments, value units and buy and sell units on demand. Most unit trusts are *actively managed*, which means that the manager carries out research on suitable investments and buys and sells investments to achieve the required fund objective.

There are over 2,000 unit trust and OEIC funds available in the UK. The Investment Management Association (IMA) has defined three broad categories.

- *Income funds* – funds that aim principally to provide income, although many also aim to produce some capital growth in order to provide a growing income.
- *Growth funds* – funds that aim principally to provide capital growth.
- *Specialist funds* –funds that do not really fit into the other sectors due to the nature of their underlying investments.

1.3.5.1.1 Growth (accumulation) unit trusts

The objective of *growth unit trusts* is capital growth. The underlying investment is in shares and other assets likely to benefit from growth, while not likely to produce significant income. Any income received from underlying assets is automatically reinvested into the fund, thus increasing the value of each unit – hence the term *accumulation*.

1.3.5.1.2 Income (distribution) unit trusts

Distribution unit trusts have a different investment objective. They are geared to produce a degree of capital growth, but primarily to produce a high level of income (relative to other unit trusts) that is distributed to unit-holders as dividends.

Typically a distribution unit trust's underlying investments will feature high-yielding shares, gilts, bonds and cash.

The individual investor can choose to take the dividends or reinvest them by purchasing new units, as opposed to increasing the value of existing units.

1.3.5.1.3 Tracker funds

Tracker funds aim to track (match) the performance of a stock market index, eg FTSE100. The manager attempts to buy the shares appearing in the index, in the proportion (weighting) in which they appear.

The fund is not actively managed as such; the manager only needs to make sure the index is replicated in the shares held. This keeps the fund charges down compared to actively managed funds.

1.3.5.1.4 Prices and charges

Units are purchased at the *offer price*. An *initial charge* is taken from the units when they are purchased, typically 3–5% of the purchase value. The charge is taken to cover, among other things, the cost of purchasing assets and paying commission to advisers.

Once units have been purchased and the initial charge taken, they are valued at the *bid price*, which is the price at which they can be sold back to the manager. The difference between the bid price and the offer price is known as the *bid-offer spread*.

To give a simplified example, an investor invests £1,000 pounds in a unit trust with a unit offer price of £1 and an initial charge of 5%. Once the initial charge has been taken he will still own 1,000 units, but the bid price will be £0.95, leaving him with a holding worth £950.

Unit trusts are subject to a *fund management charge* – the fee paid for the services of the professional investment manager. The charge will vary but is typically in the region of 0.5% and 1.5% of fund value.

1.3.5.1.5 Taxation

Dividends from a unit trust are taxable as non-savings income, depending on the source of the underlying income.

- *Share based unit trusts* – dividends are paid with a tax credit of 10%. This settles the basic rate tax liability, although lower (10%) rate and non-taxpayers are not able to reclaim the tax credit. Higher rate taxpayers will be required to pay a further 22.5% of the gross dividend. This gives a total tax charge of 32.5% of the gross dividend.
- *Cash and fixed interest trusts* – where more than 60% of the fund's assets are held in cash or fixed interest securities, the position is different. 20% tax is deducted at source. This settles the basic rate liability, but non-taxpayers can reclaim the tax deducted and lower rate taxpayers can reclaim 10%. Higher rate taxpayers have to pay a further 20%.

Gains made on disposal of a unit trust holding are subject to capital gains tax.

1.3.5.2 Open-ended investment companies (OEIC)

OEICs have been popular in mainland Europe for a number of years and have become increasingly popular in the UK since their introduction in 1997. They share a number of characteristics with unit trusts. The similarity with unit trusts is not surprising, because there is much commonality between the Financial Services Authority's two sets of regulations on OEICs and unit trusts.

OEICs are pooled investments that operate in a similar way to unit trusts. However, their legal status is different – they are set up as *limited companies*. This means that investors buy and sell shares in the OEIC. As with a unit trust, the share price represents the value of the fund assets divided by the number of shares in issue. The OEIC manager is obliged to buy back shares from investors who wish to sell, and is able to create more shares on demand. This makes the OEIC an open-ended fund, in line with unit trusts.

As OEICs are similar to unit trusts, the Investment Management Association (IMA) uses the same categories as for unit trusts. Most investment performance-rating organisations combine unit trusts and OEICs in the same tables.

The *depositary* carries out a similar role to the unit trust trustee.

Day-to-day management of the OEIC funds is the responsibility of the *director*.

1.3.5.2.1 Pricing and charges

OEIC shares are *single-priced* – which means that the buying and selling prices are the same.

Initial charge – OEICs are usually subject to an *initial charge*, usually between 3–6%. However, the charge is taken directly from the investor's capital rather than through an adjustment in the share price.

To give a simplified example, an investor invests £1,000 in an OEIC with a share price of £1 and an initial charge of 5%. He will actually receive 950 shares valued at £1 each, giving him a holding worth £950.

An OEIC is subject to a *fund management charge* – the fee paid for the services of the professional investment manager. The charge will vary but is typically in the region of 0.5% and 1.5% of fund value.

1.3.5.2.2 Taxation

Dividends from an OEIC are taxable as non-savings income, depending on the source of the underlying income.

- Share-based OEICs – dividends are paid with a tax credit of 10%. This settles the basic rate tax liability, although lower (10%) rate and non-taxpayers are not able to reclaim the tax credit. Higher rate taxpayers will be required to pay a further 22.5% of the gross dividend. This gives a total tax charge of 32.5% of the gross dividend.
- Cash and fixed-interest OEICs – where more than 60% of the fund's assets are held in cash or fixed-interest securities, the position is different. 20% tax is deducted at source. This settles the basic rate liability, but non-taxpayers can reclaim the tax deducted and lower rate taxpayers can reclaim 10%. Higher rate taxpayers have to pay a further 20%.

Gains made on disposal of an OEIC holding are subject to capital gains tax.

1.3.5.3 Advantages and disadvantages

The advantages of unit trusts and OEICs are that:

- they are flexible investment products; there is no contractual term, which means contributions can be varied and made either regularly or infrequently, and with no penalties for early closure or encashment;

- they offer a wide choice of funds and investment types;
- charges are generally lower than those of endowments;
- they offer the potential for capital growth over the medium to long term.

The disadvantages of unit trusts and OEICs are that:

- no guarantee is given that the fund will be sufficient to fully repay the mortgage at the end of the term;
- no life cover is included – this must be arranged separately, usually as level term assurance.

1.3.6 Individual savings accounts (ISAs)

Individual Savings Accounts (ISAs) were introduced on 6 April 1999. They replaced personal equity plans (PEPs) and tax-exempt special savings accounts (TESSAs) from that date, although existing PEP holdings are not affected. Essentially, an ISA is another, well established investment product in a tax-free wrapper. It is important to realise that the underlying investment risk depends on the underlying product and fund.

For the purposes of mortgage repayment, equity ISAs replaced PEPs in a relatively seamless transition.

The characteristics of an ISA mortgage are:

- interest only is paid to the lender; the entire capital remains outstanding throughout the term;
- investment is made into an ISA on a regular basis;
- separate life cover will usually be needed to repay the loan on early death;
- at the end of the mortgage term the ISA fund is used to repay the capital.

There are two types of ISA.

1.3.6.1 Equity ISA

An ***equity ISA*** can contain any or all of the following investments:

- shares;
- unit trusts;
- investment trusts;
- open-ended investment companies;
- life assurance (previously a separate ISA category);
- gilts;
- corporate bonds.

1.3.6.2 Cash ISA

Cash ISAs are deposit accounts offered by banks, building societies and National Savings. They pay interest on capital invested, which may be variable or fixed, depending on the product. It is not common for cash ISAs to be used for mortgage repayment due to the low relative returns.

ISAs are further divided into maxi- and mini-ISAs.

1.3.6.3 Maxi-ISA

A ***maxi-ISA*** is one where all of the investment is under the control of one manager (the provider). The maximum investment is £7,000 each year, of which up to £3,000 can be held in cash. The manager must offer an equity option.

1.3.6.4 Mini-ISA

With a ***mini-ISA***, each ISA category can be held with a different manager. For example, the investor may hold a mini-cash ISA with a building society and a mini equity ISA with a unit trust manager. The investment limits are £4,000 for equity mini-ISAs and £3,000 for mini-cash ISAs.

An investor cannot invest in a mini- and a maxi-ISA during the same tax year.

1.3.6.5 The main rules

The main ISA rules are as follows.

- Individuals must be aged 18 or over (16 or over for cash ISAs), and resident and ordinarily resident in the UK for tax purposes. ISAs are available in single names only and it is not possible to take out an ISA for another person.
- The government has guaranteed that ISAs will be available for at least ten years, although there will be a review in 2006 to formulate any changes to be made at the end of that ten years.
- ISA income and capital growth will be free from income and capital gains tax, although managers are unable to reclaim tax credits on share dividends.
- ISAs can only be offered by approved ISA managers – life insurance and unit trust companies, stockbrokers, banks, building societies, etc.
- Withdrawals can be made from the account at any time without affecting the tax-free status of the ISA. There is no statutory lock-in period, although ISA providers can impose their own minimum investment period if they wish.
- There is no limit on the total value of ISA holdings.

An equity ISA carries a similar risk to that of an endowment policy.

1.3.6.6 Advantages and disadvantages

The advantages of an ISA are that:

- there is no liability to income tax on interest, or capital gains tax on any gains made;
- an ISA is a flexible investment product; there is no contractual term, which means contributions can be varied and made either regularly or infrequently, and with no penalties for early closure or encashment.

1.3.6.7 Disadvantages

The disadvantages of an ISA are that:

- no guarantee is given, even with a cash ISA, that the fund will be sufficient to fully repay the mortgage at the end of the term;

- no life cover is included – this must be arranged separately, usually as level term assurance;
- no guarantee is given that the product will be available beyond 5 April 2009;
- investment limits might not be sufficient for larger mortgages or those arranged over a relatively short term.

1.3.7 Personal pension plans

A **personal pension plan** can be arranged by, or for, almost any person under the age of 75 who is resident in the UK. This means that personal pensions are available to children!

Reference in this section to personal pensions includes stakeholder pensions. In essence, ***stakeholder pensions*** are personal pensions, the only difference being rules relating to charges and policy terms imposed by the provider.

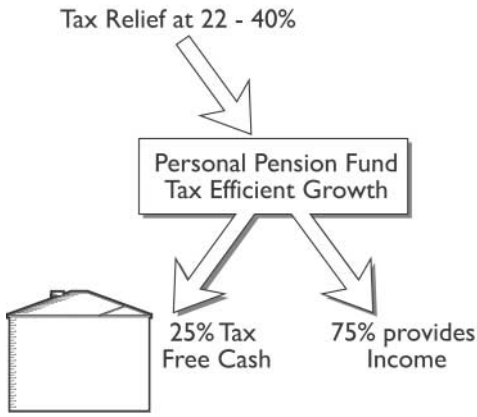
Pension simplification brought in a new set of rules from 6 April 2006. In summary, the rules are:

- it is now possible to contribute any amount to a pension. However, tax relief is only available up to specified limits as shown below;
- individual annual contributions are limited to the greater of £3,600 or the individual's earned income for the year. There is an overall maximum contribution, referred to as the *annual allowance*, which is £215,000 for the 2006/07 tax year. The allowance will increase each year. Some examples:
  - Jamal earns £45,000 a year from his job in marketing. He will be able to pay £45,000 a year into a pension and receive tax relief on his contributions;
  - Jane earns £350,000 as a successful lawyer. She will only be able to pay in £215,000 a year and receive tax relief on her contributions, because the annual allowance will apply;
  - Judy does not work. She would be able to pay in £3.600 a year and receive tax relief on her contributions.
- there is a *lifetime allowance* – a maximum amount that can be held in pension funds by an individual. For 2006/07 the allowance is £1.5 million; again, the allowance will be increased each year. If the fund exceeds the

lifetime allowance on taking the benefits, the amount over the allowance will be taxed at 55% if it is taken as a lump sum, or 25% if it is used to provide an income;

- benefits can be taken at any time from the age of 50 to the 75th birthday. It is not necessary to retire in order to take the benefits. The minimum age increases to 55 in 2010;
- up to 25% of all pension funds can be taken as a tax-free lump sum, with the balance used to provide an income. With a pension mortgage the tax-free cash is used to repay the mortgage. This means that the projected fund must be at least four times the mortgage amount;
- eligible contributions qualify for income tax relief at the individual's highest marginal rate;
- contributions are paid net of basic rate tax, regardless of the individual's employment or tax status. This means a gross contribution of £100 will require an actual payment of £78. Employers can contribute to an employee's personal pension but will pay gross contributions and claim the payment as a business expense. Higher rate taxpayers can claim an additional 18% through self-assessment;
- as an alternative to buying an annuity, it is possible to take income directly from the fund, although this may be too risky for the majority of people, as the fund will remain invested and subject to market performance. Income received will be taxed as non-savings income through the PAYE system;
- personal pensions belong to the individual and cannot be assigned to a lender; neither can they be arranged in joint names.
- If an employer contributes to an employee's pension, the maximum combined contribution is equal to the annual allowance of £215,000, with the employee's contribution limited, as above.

Figure 1.6 The pension mortgage



1.3.7.1 Advantages and disadvantages

The advantages of a personal pension plan are:

- tax relief on contributions to the plan and premiums for personal pension plan term assurance;
- tax-free lump sum;
- fulfilment of three financial needs simultaneously – pension, mortgage repayment and life assurance;
- wide fund choice;
- choice of schemes.

1.3.7.2 Disadvantages

The disadvantages of a personal pension plan are:

- there are limits on the amount that may be paid into a pension scheme and this may make the product inappropriate for larger mortgages;
- it is impossible to predict the eventual worth of the product;

- funds needed to repay the mortgage will result in a lower pension being received;
- there is no guarantee that the final lump sum will be sufficient to pay off the mortgage;
- if the borrower decides to discontinue the premiums, the funds are locked in until retirement;
- benefits are not available until age 50 (55 from 2010). This may result in a term longer than 25 years for younger borrowers;
- annuity rates for those under 60 are low, which means it may not be prudent to buy an annuity until then. This may result in a long-term mortgage.

1.4 The calculation of mortgage interest

Mortgage interest can be calculated in one of three ways: on an annual basis; on a monthly basis; on a daily basis.

1.4.1 Annual basis

Until relatively recently, it was usual for all lenders to calculate mortgage interest on an annual basis, the actual calculation date normally being 1 January.

This method is easy to operate and benefits the lender because on a capital repayment mortgage, interest is charged on the balance outstanding at the beginning of the year and no adjustments are made for the capital that is paid off with each monthly repayment in the ensuing 12 months. Consequently, a borrower will be no better or worse off if he makes only one substantial mortgage payment shortly before the year-end. In fact, he might argue that he will actually benefit from such an arrangement because the money that would otherwise be used to make monthly payments can earn him interest in a savings account. The lender, of course, will almost certainly not approve of such an arrangement.

1.4.2 Monthly basis

Calculation of interest on a *monthly basis* has become more common in recent years, although it does not benefit the lender because less interest is received on a capital repayment mortgage.

The borrower, of course, does benefit. For example, the monthly payment made in March is made up partly of capital that reduces the outstanding debt. This reduced figure is used to calculate the interest to be charged for the following month, April. Over the whole mortgage term the borrower pays considerably less interest than would be the case on the annual calculation basis. Any overpayments that are not subject to an interest penalty will also almost immediately reduce the amount of interest charged to the account.

1.4.3 Daily basis

The calculation of interest on a *daily basis* has become quite common with the introduction of flexible mortgages into the UK. Once again, the lender receives less interest over the term of the mortgage, while the capital repayment borrower is even better off than under the monthly method of calculation. Any overpayments result in an immediate reduction in the amount of interest charged, encouraging borrowers to make additional payments whenever possible to reduce the term of their mortgage considerably.

Of course, whichever method of calculating interest is used will make no difference to the interest-only borrower unless additional payments are made to reduce the outstanding debt.

1.4.4 Annual review schemes

The purpose of an *annual review scheme* is to enable the borrower to fix his monthly payment for a 12-month period based on the interest rate being charged at the beginning of the period. This is particularly beneficial to a borrower on a tight budget.

The account is either debited or credited with interest in line with any changes to the interest rate charged during the 12-month period.

The account is then reviewed at the end of the period to enable a new monthly payment to be set for the next 12-month period. This payment will be based on the capital outstanding and the interest rate applicable at the time. The

balance will be more than at the beginning of the previous period if there has been an overall increase in the interest rate, resulting in more interest being charged to the account than has actually been paid by the borrower.

Conversely, if there has been an overall reduction in the interest rate, then interest will have been overpaid during the year. This overpayment will have had the effect of reducing the capital debt.

Lenders will normally only allow borrowers with a capital repayment mortgage to participate in an annual review scheme. Interest-only borrowers must usually amend their monthly payments in line with interest rate changes.

The advantage of being able to fix the monthly repayment for 12 months is offset to some extent because either:

- the monthly repayment cannot be reduced immediately following an interest rate reduction; or
- if the interest rate has increased substantially, this will mean an equally substantial increase in the revised monthly payment, due not only to the new higher rate but also to the increase in the capital balance.

1.5 The annual percentage rate (APR)

The concept of the *annual percentage rate (APR)* was introduced in the Consumer Credit Act 1974. Its purpose is to enable a prospective borrower to compare the true cost of borrowing from different lenders.

The APR is not actually a rate of interest. It is regarded as a *rate of charge* because it takes into account some, but not all, of the costs involved in setting up and administering a loan. It is therefore usually higher than the advertised *flat rate*.

In calculating an APR, the following assumptions must always be made by the lender:

- the same interest rate will apply throughout the entire period of the loan;
- the borrower will make all payments on the due dates;
- no life assurance premiums are included in the monthly payment;
- the loan will not be redeemed early, ie it will run for its full term.

The true cost of borrowing is arrived at by calculating a *total charge for credit (or TCC)*. It is this figure that is then converted into the APR.

The following costs and charges are included in the TCC calculation:

- the total interest payable;
- arrangement and administration fees;
- valuation fees;
- conveyancing fees relating to the mortgage transaction;
- higher lending charges;
- redemption fees, eg a fee for sealing the mortgage deed on redemption;
- buildings insurance premiums where no choice of insurer is offered by the lender to the borrower.

The following costs and charges are excluded from the TCC calculation:

- redemption interest penalties;
- endowment and other life assurance premiums;
- charges levied in respect of any default by the borrower.

The usefulness of the APR has been increasingly questioned, particularly with the growth in the number of fixed-rate mortgages in recent years.

An advertisement that gives the 'flat' rate of interest for a loan must also show the equivalent APR. It is also a requirement that the APR is shown more prominently than the flat rate. A general advertisement that does not include a 'flat' interest rate does not need to show an APR.

Test your knowledge and understanding with these headings

Take a break before using these questions to assess your learning across Section 1. Review the text if necessary.

Answers can be found on page [5] 41.

1. Explain the differences between a 'full' endowment and a low-cost endowment in relation to mortgage repayment.

2. In what ways does a unit-linked endowment differ from a with-profits endowment?

3. Clara would like to repay her £100,000 interest-only mortgage with the proceeds of her personal pension plan. What will the fund value need to be in order for her to be able to do so?

Answer true or false for each of the following statements

4. In the first year of a capital and interest mortgage, repayments are mainly interest.

5. Repayment mortgages offer borrowers the possibility of a capital surplus at the end of the term.

6. One advantage of an interest-only mortgage is that the capital is guaranteed to be repaid at the end of the term.

7. If a borrower's endowment policy seems likely to result in a shortfall, the mortgage can be converted to the repayment method.

8. If an endowment policy is assigned to a lender, the lender can surrender the policy.

9. A low-cost endowment guarantees to repay the mortgage on the death of the borrower.

10. The full endowment method is the cheapest way of guaranteeing repayment of the mortgage.

11. The low-cost endowment has reduced premiums for the first five years.

12. Unit-linked endowment policy funds grow at a specified annual rate.

13. Unit-linked endowments can usually be extended to a longer term if there is a shortfall in the amount needed for repayment.

14. Joint mortgage applicants can take out a joint ISA to repay their mortgage.

15. A unit trust ISA must have at least half of its investment in shares issued on EU stock exchanges.

16. If an investor contributes £2,000 to a mini cash ISA in the current tax year, the most he can invest in an equity ISA is £5,000.

17. A PEP can be used to repay an interest-only mortgage.

18. A pension mortgage cannot normally be repaid until the borrower reaches the age of 50.

19. The contributions to a pension mortgage are four times greater than the actual amounts needed to fund the mortgage repayment.

20. The daily basis of calculating interest methodology is advantageous to people who are often late with their mortgage repayments.

Answers

1. A full endowment has a sum assured equal to the mortgage amount on death or maturity. This means that the loan is guaranteed to be repaid as long as premiums are paid and any bonuses added will provide a surplus at the end of the term.

   A low-cost endowment has a sum assured lower than the mortgage amount – typically 50% to 60%. It relies on (usually) 80% or so of the anticipated reversionary bonuses to make up the shortfall. The shortfall in the death benefit is covered by decreasing term assurance, the amount of which decreases as the bonuses are added each year. As reversionary and terminal bonuses are not guaranteed, there is a significant risk that the policy will not pay off the loan at maturity.

   Although the full endowment guarantees to pay off the mortgage, it is much more expensive than the low-cost version.

2. The unit-linked endowment does not have a guaranteed sum assured at maturity. The maturity value is the bid value of the units, which may or may not be enough to repay the mortgage. With-profits plans have a guaranteed sum assured, although in the case of the low-cost version it will not be as much as the mortgage.

   The unit-linked endowment is flexible, in that the premiums and sum assured can be changed (within limits). The with-profit endowment sum assured and premium are fixed at the start and cannot be changed.

   The unit-linked endowment allows the investor to select from a range of funds, while the with-profit endowment offers only the with-profits fund.

   In the event of early encashment, the unit-linked plan will pay the bid value of units. There will sometimes be a surrender penalty in the early years, as stated in the policy terms. The with-profits plan's early surrender value is worked out by actuaries and is unlikely to represent the plan's value at the time or include the bonuses added to date. The company might also impose a market value adjustment.

The charges on a unit-linked endowment are 'transparent' – that is, clearly stated in the policy terms. Other than a policy administration fee, the charges on a with-profit fund are taken from the fund and are worked out by the actuaries.

3. £400,000.

4. ***True***: gradually the proportion of capital repaid increases as the term of a capital interest mortgage progresses.

5. ***False***: repayment mortgages simply repay the borrowed capital over the term.

6. ***False***: no guarantees are provided.

7. ***True***: converting a mortgage to repayment is the safest method of ensuring a full repayment, but may be expensive.

8. ***True***: the lender may surrender an endowment policy if a mortgage is in default.

9. ***True***: a low-cost endowment guarantee to repay the mortgage on the death of the borrower though the automatic inclusion of sufficient life cover.

10. ***False***: a full endowment mortgage is expensive. A repayment mortgage is a cheaper way of guaranteeing mortgage repayment.

11. ***False***: the low-start endowment has reduced premiums for the first five years.

12. ***False***: a specified rate is used (assumed) in determining the premium level of a unit-linked endowment policy, but it is not guaranteed.

13. ***True***: most unit-linked policies can be extended to compensate for a shortfall, subject to qualifying rules.

14. ***False***: ISAs can be in single names only – but they can have one each.

15. ***True***: although there is no such limit for unit trusts that are not in ISAs.

16. ***False***: he can only invest in a mini equity ISA, so the maximum is £4,000.

17. ***True***: many PEPs still exist, although no new investment can now be made into them.

18. ***True***: 50 is the current minimum age at which personal/stakeholder pension benefits can be taken.

19. ***True***: only 25% of a pension fund can be taken as a lump sum to repay a mortgage.

20. ***False***: the daily calculation of interest benefits early payers, because their total interest is reduced.

