Lifting the lid on financial services

A brief guide to financial services
These boxes throw more light on what’s been said, with examples and so on.

These boxes provide extra technical detail. You can ignore them if you wish!
The CII is the world’s leading professional organisation for insurance and financial services. It maintains the professional, ethical and technical standards of the industry.

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Individually, qualified CII members commit to Continuous Professional Development (CPD) through enhancing their knowledge to maintain their professional standing. Its 90,000 members in 150 countries make up the largest professional body in the financial world.

As a society, we all rely on professionals to maintain accurate and relevant knowledge and to give appropriate and unprejudiced advice. The CII ensures that we can trust in the competence and conduct of insurance and financial services professionals the world over.

The knowledge, and how
Financial services is an industry that encompasses a wide range of activities related to personal and commercial finance.
1 Financial services in general

Financial services is an industry that encompasses a wide range of activities related to personal and commercial finance. However, this guide concentrates on certain activities that interface directly with the public: life assurance, health insurance, investment products, pensions and mortgages. Other forms of personal insurance are also briefly covered.

The guide describes law and practice in the UK.

The need for financial services

Because the lives and goals of people are so different, there is no single solution for managing their finances and meeting their financial goals. It is, however, possible to identify a financial life cycle that almost everyone goes through, with typical needs at different life stages:

- the need to protect yourself against risk;
- the need to protect a family against risk;
- the need to accumulate wealth;
- the distribution of wealth.

Unexpected events, however, can occur at any time and while the general concept of a life cycle can be used as a guide, the need for financial services must always relate to an individual's own unique circumstances.

Most people will have a need for a variety of financial services products as they progress through their lives, and may often have a need for more than one product at the same time.

A financial life cycle

Although every individual has his or her own financial goals, some basic financial objectives apply to most people as they progress through life.
Protecting an individual against risks
The first way to protect against the unexpected is to set up an emergency fund such as a savings account, which can give immediate access to money held on deposit. This can cover unexpected short-term needs without your having to take out costly loans.

The second way is by arranging an adequate mix of insurance that will cover your life, health and property. This can compensate for the financial hardship resulting from the death or disability of a wage earner, or from damage caused to a home or car. These are types of loss that can seldom be planned for through personal savings.

Providing financial security for a family
Providing financial security for a family may include the purchase of a house, providing for the education of children and making provisions for the financial security of individual family members. This is a time when most people face their greatest need for protection – when they find a partner and raise a family.

If either partner dies or is disabled, a large amount of money would be needed to preserve the family’s standard of living for a long period of time. The problem is that there is often little spare income after existing liabilities, such as paying the mortgage and normal living expenses, have been met. Adequate financial protection needs to be provided in the most cost-effective way without placing too great a strain on the family budget.

Accumulating wealth and providing for a comfortable retirement
When outgoings have reduced, perhaps after a mortgage has been paid off or a family has grown up and become financially independent, it may be possible to begin to accumulate wealth and enjoy a more comfortable standard of living. People may decide to take more holidays, buy a second car or pursue hobbies or other leisure interests.

They may also decide to begin saving for their retirement, with the objective of providing for a financially independent and comfortable retirement, with the same standard of living as they enjoyed during their working years.

Distributing wealth
The distribution of wealth should be arranged in an orderly way, and this process is usually called estate planning. It can be an important objective, whether or not you have accumulated a large estate.

By making a will you can ensure that any assets held at death are distributed as you wish. Those who have built up substantial assets to provide an inheritance for their family may find it more reassuring to give away assets during their lifetime, when the process can be controlled, rather than leaving them as part of their estate when they die. Individuals who might have a liability to inheritance tax on their death may decide to arrange life assurance to fund it.
Product providers

There are a variety of organisations that provide financial products. Many of these organisations offer a range of financial products to customers, with some operating as both a product provider and an adviser on money and investment-related matters.

A bank is a profit-making company, owned by shareholders. Banks have traditionally accepted deposits from customers and made loans. Many now also offer other financial services, for example selling insurance, pensions and investment products.

A building society is a mutual organisation run for the benefit of its members. Building societies specialise in providing mortgages and other savings products, and often compete with banks to supply other banking services.

Insurance companies provide a wide range of financial products, from general insurance such as car and household insurance, to life and health cover, pensions and savings products. The insurance industry helps individuals and businesses to manage their risks and recover from losses.

Friendly societies were established as mutual self-help groups in the 19th century, with no shareholders taking any of their profits. Their self-help status was assisted by exemption from taxation, although the size of tax-exempt policy they can now issue is quite limited. Today there are various societies specialising in different areas. Some provide health care products to fund the cost of medical treatment or provide an income in the event of illness, while others offer savings products such as unit trusts or credit cards.

Distribution channels

Product providers will generally use one or more of the following distribution methods or channels to sell to customers:
- independent financial advisers (IFAs);
- multi-tied advisers;
- single-tied advisers;
- direct marketing.
The distribution channel chosen by the provider depends on a number of factors. For example, providers can control the training, compliance and selling methods used by a tied adviser, but they would also be responsible if that person gave poor advice. On the other hand, IFAs are directly authorised by the regulator and do not require support in terms of training and compliance, but they have no particular loyalty to any one provider.

What category an adviser falls into is determined by the rules of the industry regulator. For more on this see page 7.

Many product providers have expanded their activities by direct marketing personal financial products to the general public. The methods used include newspaper and magazine advertisements containing coupons for obtaining quotes, television commercials and mailshots.

Some other organisations

Stockbrokers buy and sell stocks and shares (see page 26) for clients, charging a fee for the service. They might also provide advice relating to the purchase or sale of individual shares. Many stockbrokers offer investment management services, under which they will analyse a client’s financial position, select appropriate investments for the client and monitor the investments on an ongoing basis.

Fund managers are the organisations that provide investment management services or the individuals who make fund management decisions. The term is often also used to refer to the providers of collective investments such as unit trusts and investment trusts.
Regulation

The financial services industry is regulated by the Financial Services Authority (FSA) under the Financial Services and Markets Act 2000. This act brought together the regulation of all parts of the industry under one statutory system with the FSA as the sole regulatory body.

The FSA authorises firms that wish to undertake financial services business, approves key individuals within these firms to undertake specific tasks and provides an online register of this information for anyone to check. It vets businesses and individuals for honesty, competence and financial soundness. Where serious problems arise, the FSA can take disciplinary action or institute criminal proceedings against those responsible, and has the power to order compensation for customers.

All of the rules, guidance and principles of the FSA are contained in the FSA Handbook.

The FSA’s approach to regulation is based on 11 high-level principles combined with the detailed rules that are contained in the Handbook. The high-level principles describe the outcomes firms should aim to achieve and the ways in which the FSA expects firms to behave, for example treating customers fairly.

The FSA has for some time been moving towards a more principles-based approach to regulation and away from detailed prescriptive rules, as it wants to focus more on the outcomes for customers rather than the particular ways in which firms do things.

Types of financial adviser

Financial advisers can operate as one of three types.

Independent financial advisers (IFAs) must have access to the whole market, or a segment of it, and must regularly analyse the market to make sure their advice remains suitable. An IFA can, however, use a “panel” of product providers, provided this is regularly reviewed. An IFA must offer customers the option of paying fees rather than taking commission.

The job of an IFA is to search the market for the most suitable product for the client’s needs, from the best product provider. The IFA is, in legal terms, the agent of the client, not the product provider.
Multi-tied advisers can only advise on the products of a limited range of providers, to which they are tied. Multi-tied advisers can be tied to one provider for each type of product they deal in – one provider for life assurance, a second for pensions and a third for unit trusts – or they can be tied to more than one provider for a particular product type, for example they could deal with five providers for unit trusts.

The job of a multi-tied adviser is to find the most suitable product for the client’s needs from the limited range of providers to which the adviser is tied.

Single-tied advisers can only advise on the products of the one provider to which they are tied and their job is to find the most suitable product for a client’s needs from that one product provider’s range.

Both multi-tied and single-tied advisers are representatives of the product providers to which they are tied and the product providers are responsible for their actions. They are the agents of the product providers, although only for advising on their particular products and not necessarily for any other purpose.

When the FOS finds in favour of a customer, the usual remedy is to require the firm to make good any loss the customer has suffered. The findings of the FOS are binding on the authorised firm, which must pay any compensation awarded by the FOS up to a maximum of £100,000. The customer making the claim is, however, free to reject a finding and take the complaint further through the courts if he or she wishes.

Compensation

If an authorised UK financial services firm is no longer trading and is unable to meet claims made against it, customers may be able to get compensation from the Financial Services Compensation Scheme (FSCS). However, the FSCS can only pay compensation for financial loss and there are limits on the amount of compensation. Unlike the FOS, the FSCS itself makes compensation payments, recovering the total amounts paid out by means of levies on all authorised firms.
2 Life assurance

A contract of life assurance (known as a life assurance policy) is designed to provide financial protection by paying out a lump sum or an income in the event of death. It can also provide a way to save for the future, with some policies paying out on survival to the end of an agreed period.

We talk about life assurance but health insurance because, unlike other forms of insurance, which insure against an event that may or may not happen, life assurance is effectively insuring against death, something that will definitely happen. However, the term “life insurance” is often used to refer to the same thing.

The cost of life assurance will depend on:

- the sum assured (the amount payable on a claim);
- the type of cover required;
- the age, sex, state of health, occupation and lifestyle of the life assured (the person whose death triggers payment under a policy);
- any other factors that may affect the policy.

Life assurance is provided by a life assurance company, also known as a life office.

Basis of cover

Policies can be arranged on the life of one person on a single-life basis, or on the lives of two or more people on a joint-life or multiple-life basis.

Single-life policies can be:
- own-life policies where the policyholder and the life assured are the same person; or
- life-of-another policies where the policy is taken out on the life of another person.

Joint-life policies can be arranged to pay out on either the first or second death:
- A joint-life first-death policy pays out on the death of the first of the two lives assured.
- A joint-life second-death policy (also referred to as a joint-life last-survivor policy) pays out when the second life assured dies.

Multiple-life policies will pay out on either the first or last life assured to die. While they are life assurance policies, they are typically used for specific investment purposes.

Insurable interest

The principle of “insurable interest” requires that the proposer of a life contract (the party to whom the benefits will be payable) must have some financial interest in the life assured (the person on whose death the policy benefits will be payable). This interest must arise through some legal obligation or liability, capable of being valued in money terms.

Note in particular:
- An individual has an unlimited interest in his or her own life.
- In the case of husband and wife, each spouse has an unlimited insurable interest in the other’s life.
- Civil partners have an unlimited insurable Interest in each other.

In all other cases insurable interest is limited to the proposer’s financial interest, for example a creditor can insure the life of a debtor for the amount of the debt.
Underwriting

Underwriting is the process by which a life office assesses the information given on an application form (called a proposal in insurance) in order to decide whether to accept the application, and if so at what price (or premium as it is called in insurance). If a proposal cannot be accepted immediately at ordinary rates, an underwriter may:

- obtain further information on which to make a decision;
- impose some form of special terms; or
- decline the proposal.

Assessing risk

Whether the application is for life assurance or some other kind of insurance, one of the basic principles is that the premiums paid for each policy should reflect the degree of risk each individual represents. When assessing an application for life assurance it is the likelihood that the individual might die that is important. This is called mortality risk. When assessing an application for health insurance it is the likely incidence of sickness or disability that is important. This is called morbidity risk.

Most offices have what are described as non-medical limits, under which proposals will be considered without further medical information being required. However, if a proposal form reveals any medical factors about which an underwriter would like more information, there are in general two methods of obtaining this: a general practitioner’s report or a medical examination. An underwriter can use either or both of these, depending on the circumstance of each case.

Some offices operate guaranteed acceptance or limited underwriting schemes for certain classes of business up to a certain level of cover. A proposal form is used with no medical questions or just one or two simple questions. Acceptance would be guaranteed provided the answer was no to the questions, which typically ask about attending hospital or receiving any treatment for a heart condition.

Claims

In order to claim the proceeds of a life policy a claimant must prove that they are the person who is entitled to the policy proceeds. There are however two different types of claims: maturity claims and death claims.

Maturity claims

When an endowment policy (see page 17) matures, the life office will usually write to the policyholder a month or two before the maturity date. The policyholder will have to sign a form of discharge and return the policy document before the office releases the settlement cheque.

Death claims

When a death claim occurs, the correspondence will usually be initiated by the person entitled to the policy proceeds or solicitors for the estate of the insured, who will write to the life office informing it of the death and requesting the amount payable. The life office will need to obtain proof of death (usually a copy of the death certificate) to assess the validity of the claim. Once satisfied that the claim is valid, a form of discharge must be signed by the person legally entitled to the proceeds and the policy document returned to the life office before it pays out the claim.
Key stages in life assurance

![Diagram of life assurance process]

**Term assurance** policies are solely for the purpose of providing protection, and since the cover is for a limited period, a payout by the life office is not inevitable. There is no investment element in the premiums.

Both **whole-life** and **endowment** assurance are considered to be investments that will be repaid at a future date, either on death or at an earlier time. The premiums pay for a mixture of life cover and investment, and over the years the investment portion builds up an investment reserve that allows these policies to acquire a **surrender or cash-in value**. This would be payable by the life office if the policyholder decided to cancel the policy before the end of its term.

Unless a policy is a single-premium contract, regular premiums will usually be payable for the duration of the contract. The most common method of payment is by direct debit from the policyholder’s bank account on a monthly basis, although premiums can be paid quarterly, half-yearly or annually in advance.

**Term assurance**

Term assurance is the simplest and usually the cheapest form of life assurance.

The policy only pays out if death occurs within the chosen term of the policy. This might be 10, 15 or 20 years, although policies can be arranged for periods as short as a few days.

There is no investment element in the premium and if the individual stops paying premiums the cover ceases and there is no surrender value or return of any premiums paid. If the individual survives to the end of the term no benefit is paid out and the policy ends.

The main types of term assurance are outlined below.

**Types of life assurance**

Life assurance policies fall broadly into three main types:
- term assurance;
- whole-life assurance;
- endowment assurance.
**Level term assurance**

Under a level term policy, the benefit payable on death (the sum assured) remains the same throughout the term of the policy. At the end of the term the policy expires and has no value.

A level term policy could be used to repay an interest-only loan, or provide a lump sum for dependants in the event of death.

**Decreasing term assurance**

Under decreasing term assurance the initial sum assured decreases at a predetermined rate (usually annually), until by the end of the term the cover is zero. The premium usually stays the same throughout the term.

A decreasing term policy can be used to pay off the outstanding capital balance on a repayment mortgage should the mortgagor die before the end of the mortgage term. This type of policy is often referred to as mortgage protection assurance.

**Convertible term assurance**

Convertible term assurance is a variation on level term assurance. It contains an option to convert the policy into a permanent policy – a whole-life or endowment assurance – at any time before the expiry date of the policy.

The option can be exercised without any further evidence of health, provided the new policy is for no more than the original sum assured.

A convertible term policy provides guaranteed insurability. This means the life assured has the right to take out a new policy (within the terms of the option), regardless of his or her state of health.

This can be particularly useful to an individual with a young family and limited resources who may require more permanent life cover in later years.

**Family income benefit**

Family income benefit is a special type of decreasing term policy, where the sum assured is designed to be paid out in instalments rather than as a lump sum. The instalments can be paid monthly, quarterly or annually from the date of death until the end of the selected policy term.

Some policies can be arranged where the income benefit increases each year at a prearranged rate, for example 3% or 5%, to help offset the effects of inflation.

A family income benefit policy is a good way to replace the income of a family breadwinner for a specified period. Typically the term of the policy is linked to the age at which the youngest child will leave full-time education.
Renewable term assurance
Renewable term assurance is similar to convertible term assurance, except that the option is to replace the original policy with another term assurance at the expiry date, without the need for evidence of health.

This type of policy typically has a five-year term and each subsequent policy will have the same renewable option, so long as it does not continue beyond the upper age limit set by the life office (often 65).

When each policy is renewed, the premiums on the new policy will depend on the age of the life assured at the time of renewal.

A renewable term policy can be useful for a young person who needs life cover but has limited resources. The initial premium will be low, but it has the added benefit of guaranteed insurability irrespective of future state of health.

Increasing term assurance
Increasing term assurance is a policy where the sum assured and premium automatically increase during the life of the policy, unless the policyholder requests otherwise.

An increasing term policy allows individuals to protect the real value of their life cover against the effects of inflation and may reduce the need to take out additional life cover later in life when the cost would be greater.

Whole-life assurance
A whole-life policy provides permanent protection. It pays out the sum assured on the death of the life assured, whenever this occurs.

Because these policies are guaranteed to pay out at some time in the future the premiums are higher than for term assurance, where a claim may not arise if the life assured survives beyond the term of the policy.

The premiums contain an investment element, and over the years an investment reserve builds up that will allow the payment of a surrender value.

Policies can be taken out with regular premiums payable throughout life, or with premiums ceasing on reaching a given age, such as 65 or 85, although the cover will continue.

Whole-life policies are used for the permanent protection of a family or other dependant against the loss of financial support on the death of the life assured. Although cover for a growing family can be provided adequately by term assurance, provision for a dependant spouse or partner may need to be lifelong.

A whole-life policy is also necessary where cover is required for funeral expenses or the payment of any potential inheritance tax liability and any debts outstanding on death.

The main types of whole-life policy are outlined below. The most common is now unit-linked. Life assurance investment bonds are a special kind of whole-life policy which are essentially investments rather than life assurance and these are dealt with on page 32.
Without-profit whole-life policies
Without-profit (or non-profit) policies provide a guaranteed sum assured at death. The amount of cover chosen at the start of the policy remains the same throughout the life of the policy. Few policies of this type are now issued.

With-profits whole-life policies
With-profits whole-life policies provide a guaranteed sum assured on death plus a share of any profits from a special “with-profits fund”, which are added to the sum assured in the form of bonuses. There is, however, no guarantee of what bonuses might be added to a policy over the years.

Low-cost whole-life policies
Low-cost whole-life policies are with-profits contracts with a guaranteed level of life cover, but with cheaper premiums than traditional with-profits policies. This is achieved by combining a with-profits whole-life policy with a decreasing term assurance.

The whole-life component has a basic sum assured that is lower than the guaranteed level of life cover. Initially this component provides only part of the guaranteed sum assured, with the balance being provided by the decreasing term assurance.

Bonuses are calculated on the basic sum assured. This means that over the years the cover from the whole-life policy will increase as bonuses are added. Meanwhile the cover provided by the decreasing term assurance will go down.

Unit-linked whole-life policies
Unit-linked policies combine a guaranteed level of life cover with an investment element, and the policyholder has the flexibility to vary the life cover and investment mix to reflect his or her needs.

The returns on unit-linked policies are not, however, guaranteed and depend on the performance of the fund to which they are linked. The death benefit provided by a unit-linked whole-life policy is the guaranteed sum assured or the cash value of the units held, whichever is greater.

Many offices offer a range of additional benefits that can be added to a unit-linked whole-life policy. These can include critical illness cover, waiver of contribution benefit in the event of ill health, income protection benefit, permanent total disability benefit, accidental death benefit and hospital income benefit.

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**With-profits bonuses**
There are two basic types of with-profits policy: conventional with profits, and unitised with profits.

Virtually all with-profits policies currently available are written on a unitised basis, although there are a significant number of conventional contracts in force.

A conventional with-profits policy starts with a particular sum assured. This is then increased throughout the duration of the policy by the addition of regular bonuses, usually annually, called reversionary bonuses. Once added to the policy these bonuses permanently increase the sum assured and cannot be subsequently removed or reduced. There will usually be a discretionary terminal bonus as well.

A unitised with-profits policy is a type of unit-linked policy that provides regular bonuses, which are declared in advance. The main difference from other unit-linked funds is that the price of the units is guaranteed not to fall. A terminal bonus may also be added at the time of a claim or early surrender.
This type of policy allows individuals to build up a tax-free lump sum over the longer term and would be suitable where individuals wanted to ensure that their savings goals will be achieved whether they live or die.

These policies have been widely used as a means of repaying a mortgage or funding school fees. However, they are now under challenge from other forms of savings such as unit trusts and investment trusts.

Endowment assurance

An endowment assurance policy provides protection, but often these policies are used primarily for long-term savings.

The sum assured is payable on a fixed maturity date or on the death of the life assured, if earlier. The policy builds up a surrender value and level premiums are payable throughout the term of the policy.

Endowment policies are the most expensive form of life assurance and are not usually suitable as a means of providing significant amounts of life cover. Most of the premium is directed towards the investment element of the policy with relatively little used to pay for life cover.

Like whole-life policies, endowment policies can be non-profit, with profits, low cost or unit linked, although few non-profit policies are now written.

The tax treatment of life policies

Provided a life assurance policy is a qualifying policy the benefits paid on death or maturity are free of income tax and capital gains tax.

To qualify a policy has to satisfy certain conditions, which include the need to pay premiums annually or at shorter intervals for at least 10 years or until earlier death.

There is a potential liability to income tax if a policy is surrendered within 10 years or three-quarters of the policy term, whichever is shorter, where the policyholder is a higher-rate taxpayer.
3 Health insurance

Death is not the only event that can trigger financial hardship, as any disability caused by illness or injury could also bring financial problems. The risk of being off work due to sickness is in fact much greater than the risk of death. You only die once, but you can be off work any number of times. Anyone who is dependent on earnings faces this risk and needs to protect themselves against it.

This protection might be provided as a replacement income to maintain outgoings or by payment of a lump sum.

Some illnesses such as cancer, heart attack or stroke can be life threatening. However, many people affected by such an illness will often survive for a number of years. In these cases, not only is there a need to replace income, but a home may need to be adapted to meet special needs and make quality of life more bearable.

In these circumstances, a lump sum would be beneficial as it could be used to meet the cost of adapting a home to the needs of the individual, or used to pay off outstanding debts such as a mortgage.

When elderly people are unable to look after themselves, they may not receive the financial assistance they expect from their local authority. If they need care in their own home, or in a residential or nursing home, they may be asked to contribute to the cost of those services.

In these circumstances a regular additional income would be required as long as the person needed care.

There are a number of health insurance policies that individuals can take out to protect themselves in the event of a disability resulting from illness or injury. These are outlined below. Each type of policy provides benefits under different circumstances and they should not be viewed as alternatives or substitutes, but rather as complementary to each other.

Health policies can be long-term (income protection, critical illness, long-term care) or short-term, generally renewable annually (accident, sickness and unemployment; private medical; hospital cash plans). Long-term policies are generally provided by life assurance companies, short-term policies by general insurance companies.
**Types of health insurance**

![Diagram of health insurance types]

**Income protection insurance**

Income protection insurance is used to protect earned income in the event of long-term illness or disability. It is usually taken out to replace income that is lost and not replaced by either an employer or the state.

The policy pays out a regular income when the policyholder is unable to work due to illness or injury. This income is free of income tax.

The income is paid after a **deferred period**, which may be one month, three months, six months or a year.

Premiums are calculated according to age at entry, term of contract and the sex, health and occupation of the policyholder. They can be reduced by accepting longer deferred periods.

The policy is considered permanent, as the insurer cannot cancel it no matter how many claims are made, as long as premiums continue to be paid.

Insurance companies have different definitions of what constitutes a long-term illness or disability. Some policies use the inability to follow one’s own occupation whereas others insist that the policyholder is unable to follow any occupation. There are many variations in between and it is becoming increasingly common for disability to be defined in terms of **activities of daily living** (ADLs).

Some insurers also offer a reduced level of disability income insurance benefit to housepersons and those who become disabled whilst unemployed. Claims on these policies are normally triggered by the inability to perform ADLs.
**Claims**

The insured must give notice of any claim as soon as possible, then the life office will send out a claim form for completion by the insured and the insured’s doctor. This will give the life office the information it needs to decide whether the claim is valid.

Once the claim is accepted by the office, and the deferred period has expired, the office will start to pay the benefit.

The office will usually monitor claims to make sure that the insured is still incapacitated. If the incapacity ceases benefits will stop, otherwise benefits will continue until death or the expiry of the policy.

For employed individuals, the benefit should start when any sick pay from an employer ceases. Self-employed individuals on the other hand will need the shortest possible deferred period.

**Critical illness insurance**

Critical illness insurance pays out a tax-free lump sum on diagnosis of one of a list of life-threatening conditions like cancer, heart attack and stroke. The types and definitions of illnesses covered vary quite widely between different insurers and each policy will specify what illnesses are covered.

In addition, many policies cover conditions that, although not immediately life threatening, are very serious, such as loss of hearing, loss of sight, loss of speech, loss of limbs or total permanent disability.

In most cases it is necessary to survive for a period of 28 days after diagnosis to qualify for a critical illness payment.

The cost of cover depends on age, sex, amount of cover required and medical history. The term of the contract can be either life or a specified period.

Critical illness insurance is available in two forms:

- on a stand-alone basis, with no other benefits, when they provide only protection and there is no savings element or surrender value;
- as an additional benefit under a whole-life, term or endowment life policy, in which case the sum assured will be paid on diagnosis of a specified critical illness or on death.

There are no restrictions on the ways in which policyholders can spend their lump sum. They may decide to pay off outstanding debts, such as a mortgage, or use it to pay for adapting a house, specialist nursing care or a recuperative stay in a better climate.
The cost of care is expensive, and any funding by a local authority is based on a means-tested assessment of an individual's income and assets. A long-term care insurance policy helps reduce the financial burden on families caring for elderly relatives. It allows individuals to retain their assets and home, which might otherwise have to be sold to pay for care fees. It allows a choice over the type and quality of care.

This type of policy provides financial support upon diagnosis of certain specified critical illnesses, and pays out a tax-free lump sum at a time when it is most needed, regardless of whether the illness prevents the individual from working.

Critical illness cover is an important form of protection needed by single people as well as those with dependants.

For single people with no dependants, critical illness cover that pays off a mortgage is more important than life cover.

It can also be useful for a couple, since as well as paying off a mortgage or other outstanding debts, it provides a financial boost at times of emotional stress and financial hardship.

**Long-term care insurance**

Long-term care insurance is designed to pay for some or all of the costs of long-term care required as a result of long-term illness or extreme old age. Although the provision of long-term care is typically associated with the elderly, younger people may require it because of an accident or some disabling illness.

The benefit can provide for care in the individual's own home or in a residential or nursing home.

The policy pays a regular income to either the individual or a provider of care when the insured is unable to perform a specified number of activities of daily living (ADLs), for example, washing or dressing, without assistance from another person, or is suffering from cognitive or mental impairment.

It is common for the level of benefit to be linked to the number of ADLs failed. For example, to qualify for a minimum amount of assistance, for example home care, it might be necessary to fail two ADLs, but failing three or four might be needed to qualify for full nursing care.

No tax liability arises if payments are made direct to the care provider.

Long-term care policies fall into two categories, pre-funded plans and immediate care plans.

**Pre-funded plans**

A pre-funded policy is taken out before care is needed. It will pay out a monthly sum if long-term care is needed in the future.

The policy is underwritten at outset, and is paid for by regular or single contributions.

If no claim is made, or the insured dies or cancels the policy, there is usually no benefit payable or refund of contributions.

**Immediate care plans**

Immediate care plans are arranged once the need for care has arisen, when the key issue is how long the insured will live.

A single premium is paid to a life office, which then provides a regular monthly benefit for as long as the insured is alive, usually directly to the care provider. The amount of benefit depends on the life expectancy of the insured, and the poorer the health of the insured the greater the monthly benefit will be.

The cost of care is expensive, and any funding by a local authority is based on a means-tested assessment of an individual's income and assets. A long-term care insurance policy helps reduce the financial burden on families caring for elderly relatives. It allows individuals to retain their assets and home, which might otherwise have to be sold to pay for care fees. It allows a choice over the type and quality of care.
Accident, sickness and unemployment insurance

Personal accident and sickness insurance and unemployment insurance are two types of general insurance that are marketed by many financial services groups. Accident and sickness cover can be arranged separately or combined with redundancy cover in a single policy. Policies with the redundancy option are typically linked to mortgages.

Both types of policy provide, at relatively low benefit levels, a package of benefits that can include accident insurance, life cover, income replacement and redundancy cover.

The main features of this type of product are typically as follows:

- The policies are renewable on an annual basis.
- Lump sum benefits are usually provided for death, loss of sight or loss of limbs, and permanent total disability.
- A weekly income is paid if the insured is unable to work through sickness or redundancy, usually for a maximum of two years.

A common form of accident, sickness and unemployment insurance is mortgage payment protection insurance. This typically covers mortgage payments for a maximum of two years in the event of accident, sickness or redundancy, usually with a waiting period of either 30 or 60 days.

Private medical insurance

Private medical insurance provides cover for the cost of private medical treatment. Plans can be arranged on an individual basis, or by employers on a group basis for their employees.

Private medical plans are usually one of three types:

- **budget plans**, with low costs and limits on the amount of cover for different types of treatment;
- **standard plans**, which cost more than budget plans but give wider cover;
- **comprehensive plans**, which are the most expensive but provide the greatest cover.

This kind of insurance is primarily aimed at covering the cost of short-term, curable medical conditions. In general, it is not designed to cover the cost of long-term, incurable conditions (known as chronic illnesses) such as diabetes and dementia.

This type of policy can enable you to get private medical treatment when you need it, with a consultant and in a hospital of your choice, with the insurer paying all or most of the cost.

This means you can avoid lengthy hospital waiting lists and choose a time and place for treatment that is suitable to you. It can be particularly useful for the self-employed, who need to get back to work quickly to maintain their income.

Hospital cash plans

Hospital cash plans are designed to pay a fixed cash sum for each day spent in hospital. They are not a substitute for private medical insurance as the payments are typically not enough to cover the cost of private treatment. They can, however, contribute towards out-of-pocket expenses.
4 Investment products

As well as arranging financial protection in the event of death or ill health to preserve a current standard of living for themselves and any dependants, people need to arrange savings and investments to meet the financial goals and aspirations they may have for the future. The future, however, could range from a few weeks to many years and distinctions need to be made between short-term and long-term needs.

Short-term needs are typically those anticipated within the next five years. These might include the need to build up an emergency fund for unexpected expenses, or saving for a deposit on a home or new car or the purchase of a holiday.

These types of short-term savings should be easily accessible, without risk of capital loss whenever the money is withdrawn. Consequently the best home for such savings is some form of deposit account.

While it is difficult to put a timescale on exactly what is long-term, it is reasonable to view it as five years and beyond. Long-term needs are typically individuals’ ambitions for the future, such as establishing their financial security or comfortable retirement.

The choice for long-term investment needs is much wider, and it may be more effective to use asset-backed investments such as shares, which are capable of producing capital growth as well as a growing income over the longer term. However, with this type of investment there is always the possibility of a capital loss when money is withdrawn.

Almost everyone has a need for savings and investment products throughout their lives. Those who do not already have capital need to build it up by saving from income. Those with existing capital need to invest it to fulfil their investment objectives at an acceptable level of risk.

The range of savings and investment products available is enormous. Each has its own unique combination of investment medium, level of risk and tax treatment. Each will be suitable for some people but not for others.

Deposit accounts

A deposit account holds money on behalf of the account holder and pays interest on it. The main institutions offering deposit accounts are banks, building societies and the UK government (through National Savings and Investments).

Cash deposits offer a high degree of financial security. There is, however, a risk that the real value of the capital will be eroded by inflation over the longer term. Investors could even lose money if the institution were to fail, but there is a compensation system in place which covers UK institutions. For more on this see page 8.
Banks and building societies
Banks and building societies provide a range of accounts for investors. The interest rates on most are tiered according to the size of the balance held. These accounts are generally available as either:
- **instant access accounts**, which provide investors with immediate access to their money; or
- **restricted access accounts**, which require a period of notice before funds can be withdrawn, for example 30, 60 and 90 days.

National Savings and Investments
National Savings and Investments products are government investments. They are all secure investments as they are guaranteed by the government. There are a number of different products, some with fixed rates of interest and others with variable rates.

Fixed-interest securities
Fixed-interest securities, or **bonds** as they are also known, are issued by governments, companies and other official bodies as a method of raising money to finance their longer-term borrowing requirements. In return for lending money to these institutions, the owner of a bond is entitled to receive regular interest payments and normally a repayment of capital at the end of a pre-determined period (known as the redemption date).

Bonds cannot be cashed in before their official redemption date. However, investors can sell them on the stock market at any time without needing to refer to the original borrower.

Types of fixed-interest securities
Many different organisations use fixed-interest securities to raise money. Fixed-interest securities issued by the UK government are called **gilts**. Fixed-interest securities issued by companies are referred to as **corporate bonds**.

Gilts
Gilts are securities issued by the UK government when it needs to borrow money because it has insufficient income to meet its expenditure. They are considered to be the safest type of fixed-interest securities, as both the regular income and the repayment of the nominal value at the redemption date is guaranteed by the government. This level of security does, however, mean that the yields on gilts are lower than on other types of fixed-interest securities, issued by companies.

Corporate bonds
Companies, as well as the government, often want to borrow money at fixed rates of interest for long periods of time. Just like the government, companies can issue fixed-interest securities, which are referred to as corporate bonds.
The tax treatment of equities

Dividends paid by a company represent a distribution of some of its profits to shareholders. When shareholders receive a dividend, this is treated as though the basic rate of income tax has already been paid, since the dividend is paid from profits on which the company has already paid tax. Higher-rate taxpayers will have to pay additional tax.

Capital gains tax may also be payable on any profits made by a taxpayer who disposes of shares.

Equities

An equity represents a part ownership of a company and is the same thing as an ordinary share. When investors buy shares directly in a company, they become shareholders, which usually gives them the right to vote on certain matters.

Investors buy shares because they expect to receive income in the form of dividends, usually twice a year. They also expect their capital to grow. They hope rising company profits will lead to increasing dividends and/or growth in the value of the shares.

The value of shares is dependant on the price investors are prepared to pay for them, and this can be influenced by a number of factors including how well the company is performing.

Fixed-interest securities are attractive to investors who require a fixed income. They usually generate a higher return than cash deposits, and are less volatile than equities.

Index-linked stocks can provide a return that matches inflation, but long-term protection against inflation is more usually provided by asset-backed investments, such as equities or property.

The tax treatment of fixed-interest securities

Interest payments from gilts and corporate bonds are usually paid gross, without the deduction of any income tax. Basic-rate taxpayers will have to pay 20% tax and higher-rate taxpayers 40%.

If you make a gain on disposing of gilts or qualifying corporate bonds this is exempt from capital gains tax, so any profits are tax-free.

Although corporate bonds are very similar to gilts, the risk attaching to them is greater, since companies might fail to meet the regular income payments or default on the repayment of the capital at redemption. As a result, the interest rates and yields on corporate bonds are generally higher than gilts to compensate investors for the additional risk.

Buying and selling shares

Shares can be bought and sold through stockbrokers. Investors can either approach a broker directly or they can deal through a bank or building society, which will either own or have links with a stockbroker.

Stockbrokers charge commission on both purchases and sales of shares. This can be either a flat fee or a percentage based on the size of the deal. In addition, stamp duty, which is a government tax of 0.5%, is also charged on purchases.

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The tax treatment of equities

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Capital gains tax may also be payable on any profits made by a taxpayer who disposes of shares.
Equity-based investments are attractive to those prepared to see fluctuations in the value of their investments in exchange for the prospect of longer-term growth. In general, the longer the time scale, the greater the probability that you will make a higher return than you would from cash or fixed-interest alternatives. But there is no guarantee and equity investors could lose all or part of their money.

Other ways to invest in equities
For investors who lack the time, expertise or inclination to handle the administrative burden and investment decision making involved in buying and selling individual shares, an alternative way to invest is via a collective or pooled investment scheme. These provide access to stock market investments with professional managers making the investment decisions. They are less risky than direct investment in equities. For more on collective investments see the separate section on this page.

Investment in property
When you invest in property you are investing in physical assets and this can therefore provide long-term protection against inflation. Property investment has characteristics that make it different to equities and so offers investors the opportunity to diversify a portfolio, while offering the prospect of reasonable long-term growth and regular income in the form of rent.

Direct investment in property can be through either residential or commercial property. There are, however, a number of drawbacks to direct property investment:

- Property is an illiquid asset, meaning it may not always be easy to sell.
- Unless investors manage their own properties, they will need to use a letting agency and pay agency fees.
- There may be periods when a tenant cannot be found, resulting in a loss of rent.

The tax treatment of investment in property
Rental income is taxable, but tax relief is allowed on most expenses incurred in letting the property. Such expenses include insurance, agents' fees, repairs and redecoration and interest on loans to buy or improve a let property.

On eventual disposal of the property, any gain will be subject to capital gains tax.

Other ways to invest in property
Given the high cost of property, it is often impossible for an individual investor to acquire sufficient properties to create a balanced portfolio. The alternative is to consider an indirect investment through shares in property companies or property-based funds.

Collective investment schemes
A collective, or pooled, investment scheme allows investors to participate in a large portfolio of securities or other assets with many other investors. The contributions of the different investors are combined to form a large investment fund. This fund is used to invest in a wide spread of different investments in order to minimise the risk of loss to the contributors.

Each fund has its own investment objective and a defined range of investments that it can hold. There are schemes available to meet the investment objectives and personal preferences of most private investors.
These schemes are run by full-time professional investment managers, who constantly monitor markets and undertake research into the outlook for different sectors of industry and individual companies within those sectors.

There are schemes available which allow investors to access markets not only in the UK but also worldwide, thus providing access to investment areas from which they might otherwise be excluded.

**Types of collective investments**
The main types of collective investment scheme are:
- unit trusts;
- open-ended investment companies (OEICs);
- investment trusts;
- life assurance investment bonds.

**Unit trusts**
A unit trust operates under a trust deed, which sets out the investment objectives of each fund and any restrictions that may be placed on the choice of underlying investments. A manager is responsible for administering the assets of the trust and making investment decisions, and there is an independent trustee whose key role is to hold the trust assets and look after the investors’ interests.

Investors buy units from the fund manager when they invest, and sell units back to the fund manager to realise their investment. The sale of units back to the fund manager is referred to as a *repurchase* by the fund manager.

Unit trusts are **open ended**. This means that the manager can create more units to meet investor demand and cancel units when repurchases exceed purchases. As a result, the number of units in issue changes and the unit trust will expand or contract depending on the level of demand. There is a direct relationship between the price of the units and the value of the underlying investments in the unit trust.

**Open-ended investment companies**
An OEIC is structured as a company with variable capital, and issues shares to investors. It can adjust the number of shares in issue by creating or cancelling them according to supply and demand.

An OEIC is run by an **authorised corporate director**, who carries out the same function as the unit trust manager, with an **independent depositary**, who holds the assets of the OEIC and carries out the same role as the trustee of a unit trust.

Like unit trusts, OEICs are open-ended investments so that the number of shares in issue will increase or decrease depending on the level of demand. The value of each share represents an equal fraction of the value of the assets of the fund.

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**Unit trust pricing**
Each unit in a unit trust represents an equal share of the underlying securities held by the trust. Traditionally, unit trusts have operated a dual pricing system, quoting two prices to the public.

The higher price is known as the **buying or offer price**, and is the price at which units are sold to investors. The lower price is known as the **selling or bid price**, and is the price at which units are repurchased from investors by the fund managers. The difference between the two prices is known as the **bid/offer spread**. This spread or difference includes the fund’s initial charge, which covers commission payable to an introducing intermediary and distribution costs.

Unit trusts may also be single priced, in the same way as OEICs.
The tax treatment of unit trust and OEIC distributions

Unit trusts and OEICs make income distributions to investors usually, but not always, twice yearly. This income is taxable, but the tax treatment depends on whether the fund invests predominantly in equities or predominantly in interest-bearing securities such as gilts and corporate bonds.

Dividend distributions from equity funds are taxed in the same way as dividends paid by UK companies. Interest distributions from gilt and corporate bond funds are paid net of 20% income tax and taxed in the same way as interest from bank and building society accounts.

Capital gains tax may also be payable on any profits made by a taxpayer who disposes of a unit trust or OEIC holding.

Investment trusts

Investment trusts are public limited companies, quoted on the stock exchange.

Like other public companies they have a fixed number of shares and cannot easily increase or decrease the number of shares in issue. Hence they are described as closed-ended funds.

Shares in an investment trust company are bought and sold on the stock market, just like other company shares, and their price is determined by supply and demand. The shares can be bought and sold through stockbrokers, although many investment trusts now operate savings schemes for investors, which allow them to deal through the investment trust managers themselves as an alternative to using a stockbroker.

Like other public companies, investment trusts can borrow money if they see an investment opportunity but do not have sufficient free capital to take advantage of it. This is known as gearing. Unit trusts and OEICs do not have the power to borrow for investment purposes.

Not all investment trusts are geared, although trusts that are geared are regarded as more risky investments than those that are not.

Some investment trusts operate as split-capital investment trusts. These have a limited lifespan, typically five to ten years, after which they will be wound up and the assets distributed to the shareholders entitled to them.

A split-capital trust has one portfolio of investments, but can have two or more different classes of shares, which are entitled to different returns and so appeal to the needs of different investors. The shares have varying levels of risk, as they are ranked in a particular order of priority for repayment when the trust is wound up.

The tax treatment of investment trusts

Income and gains from investment trusts are taxed in the same way as income and gains from other equities (see page 26).
Life assurance investment bonds

Life assurance investment bonds (often called investment bonds) are single-premium life assurance policies. They are written as whole-life policies with no specific maturity date and no obligation to pay any more contributions for the duration of the plan. They are structured primarily as investments and provide only nominal life cover, typically just in excess of the value of the fund on death – 101% of the value of the units.

Most investment bonds are unit-linked. When an investment is made, the premium is used to purchase units in funds of an investor’s choice.

Investment income and capital gains (or losses) accumulate within the fund to increase the value of the units.

Most life offices offer a range of unit-linked funds, with different risk and growth prospects. These commonly include equity, international, gilt, property, cash and managed funds, and a number of offices also offer a with-profits fund. Bondholders are able to switch their investment from one fund to another within the bond, usually at little or no cost and without incurring any personal tax liability at the time of the switch.

The tax treatment of investment bonds

Life assurance companies pay tax on both the income and gains on their funds. Therefore a bondholder has no liability to basic-rate income tax or capital gains tax on the policy proceeds. Any gains on a bond are, however, liable to an additional 20% income tax if the bondholder is a higher-rate taxpayer. Non-taxpayers cannot reclaim any tax.
**Individual savings accounts**

An individual savings account (ISA) is not itself an investment, but a “wrapper” within which a wide range of savings and investments can be held, free of UK income tax and capital gains tax.

To be eligible to take out an ISA, an individual must be:

- aged 18 or over if investing in stocks and shares, 16 or over if investing in cash deposits;
- “resident and ordinarily resident” (that is, on a regular basis, year after year) in the UK for tax purposes, or a Crown employee, such as a diplomat or member of the armed forces, who is working overseas and paid by the government.

If an ISA holder ceases to be resident and ordinarily resident in the UK, he or she can keep the ISA and retain the tax benefits, but cannot pay in any further money.

**ISA structure**

ISAs can hold cash, which includes bank and building society accounts, and stocks and shares, which include individual shares and collective funds.

Up until 6 April 2008, these investments could be held within two types of ISA account: a **maxi ISA**, which could hold both cash and stocks and shares, and a **mini ISA**, which could hold either cash or stocks and shares, but not both. This distinction has now been removed.

**Investment limits**

You can invest £7,200 a year in ISAs. Up to £3,600 of that allowance can be saved in cash with one provider. The remainder can be invested in stocks and shares, with either the same or a different provider.

Under the new rules you can transfer some or all of the money saved in a cash ISA into a stocks and shares ISA, but you cannot transfer from a stocks and shares ISA to a cash ISA.

<table>
<thead>
<tr>
<th>Cash ISA</th>
<th>(max £3,600 a year)</th>
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<tbody>
<tr>
<td>Stocks and shares ISA</td>
<td>(the remainder)</td>
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** ISA investment limits**

Maximum £7,200 a year
5 Pensions

A pension is a long-term method of saving for retirement – to ensure that you have enough income in retirement to enjoy a comfortable lifestyle.

Pension schemes can be:

- set up by employers for the benefit of their employees (occupational schemes);
- set up on an individual basis.

The largest occupational pension schemes will often manage their own investments to provide future benefits to their members. These schemes can either employ their own investment specialists or use the services of professional firms such as stockbrokers and investment managers.

As an alternative, an employer may use the services of an insurance company or a specialist pension consultancy to design and operate an occupational scheme.

Most individual pensions are provided by insurance companies.

Occupational schemes

There are two main types of occupational pension:

- **salary-related** (or defined benefit) schemes;
- **money purchase** (or defined contribution) schemes.

Both have trustees to look after the members’ interests and a registered scheme administrator.

Since an occupational scheme is connected to your employment, if you leave that employment you will not be able to continue to contribute to the scheme.

Salary-related schemes

In a salary-related (defined benefit) scheme, the amount you receive at retirement depends on:

- How long you have been a member of the scheme. This is known as **pensionable service**.
- Your **pensionable earnings**. These can be your earnings at the time you retire or leave the scheme (final salary schemes), or your average earnings during the time you were a member of the scheme.
- The proportion of pensionable earnings you receive as a pension for each year of membership. This is called the **accrual rate**. The most common accrual rates are 1/60th or 1/80th of pensionable earnings for each year of pensionable service.

The pension benefits are linked to earnings, and are not dependant on the performance of the stock market or other investments.

Some schemes do not require the member to contribute, but usually the member has to pay contributions in addition to those paid by the employer.

Money purchase arrangements

A money purchase (defined contribution) scheme does not provide a pension based on your salary or pensionable service. Instead it builds up a personal fund that is converted into income when you retire.

The amount of pension you will get at retirement will depend on:

- how much you paid into the fund;
- how much your employer paid in (if anything);
- how well the investments performed;
- the charges taken out of the fund by the pension provider;
Annuities
An annuity is like a whole-life assurance policy in reverse. Instead of paying an insurance company regular premiums in return for a guaranteed sum payable on death, you pay a lump sum in return for regular payments from the insurance company every year you are alive.

When you buy an annuity you have a number of options in terms of:

- how often payments are made, for example, monthly or annually;
- how the payments will increase, if at all (it could remain level, increase by a fixed percentage each year or be linked to inflation);
- if any payment will continue to a spouse on your death.

The amount that will be payable for a given sum depends on your age and sex and any options that you choose. The more options you choose, the lower the initial payment to you will be.

Individual pension arrangements
There are now two main types of individual pension arrangement that you can take out:

- personal pensions;
- stakeholder pensions.

These schemes are usually run by financial institutions such as banks, building societies, insurance companies and unit trust and OEIC fund management groups.

Personal pensions
A personal pension is a money purchase arrangement where contributions are invested in a fund, which is usually either with profits or unit linked. You use the fund to purchase benefits at your chosen retirement date.

Stakeholder pensions
Stakeholder pensions became available on 6 April 2001. A stakeholder pension is a type of low-cost personal pension which is subject to certain minimum standards. These relate to charges, contributions and investment choice.

Stakeholder pensions – minimum standards
Stakeholder pensions only differ from personal pensions in that they have to meet certain minimum standards. These include the following:

- The minimum contribution cannot be higher than £20.
- The annual management charge must be no more than 1.5% a year for the first 10 years, after which it must reduce to 1.0%.
- A default investment option must be included for customers who do not wish to choose their own investment funds.
Group personal and stakeholder pensions
An employer may wish to set up a group personal pension or stakeholder pension rather than an occupational arrangement. Although these may look similar to an occupational scheme, they are a series of individual policies taken out by each employee and the benefits they will receive are identical to other individual personal and stakeholder pensions.

If a member of a group personal pension or stakeholder pension changes jobs, he or she can continue to pay contributions independently.

Self-invested personal pensions
A self-invested personal pension (SIPP) is a pension “wrapper” that can hold a range of investments. Under a SIPP, you can take direct control of your pension and make all of the investment decisions yourself, or you can appoint a professional investment manager. A SIPP may have higher charges than other personal pensions or stakeholder pensions, and is generally more suitable for large funds and for people who have experience in investing.

One of the key advantages of a SIPP over other forms of retirement saving is the wider range of assets that can be held. In addition to most types of collective funds a SIPP can hold individual equities (both UK and overseas) as well as gilts and other fixed-interest securities. A SIPP can also hold commercial property and borrow money for investment purposes.

Tax advantages of a pension
A pension has a number of tax advantages in terms of the treatment of contributions, investment income and gains accruing to the fund as well as the eventual pension benefits.

Since 6 April 2006, the rules relating to contributions and benefits have been the same for all types of registered pension scheme arrangements.

Contributions
Pension contributions benefit from tax relief at the highest rate of tax you pay. There is no overall limit on the amount you can contribute to a registered pension scheme, but there are limits on the amount of tax relief given.

Investment income and gains
Income and gains arising within a pension fund are not subject to any tax.

Pension benefits
You can take a tax-free lump sum of up to 25% of the value of your pension fund when the payment of benefits commences. The remainder of the fund has to be used to provide an income. Benefits can be taken from age 50 onwards, although the minimum age for taking benefits will increase to 55 on 6 April 2010.

Benefits paid out on the death of a member do not usually become part of the member’s estate or incur inheritance tax.

The main types of pension
The tax treatment of pension contributions

You can contribute to any number of registered pension schemes. For example, if you are a member of a scheme run by your employer you can also contribute to a personal pension scheme.

The maximum contribution that is eligible for tax relief is £3,600 a year, or the whole of your earnings each year if that is greater. You can pay more than this, but no tax relief will be given.

Tax relief on contributions may be awarded in two different ways, as follows:

Relief at source allows you to make contributions to a personal or stakeholder pension after first deducting basic-rate tax (22%), even if you are not a taxpayer. The pension administrator then claims a repayment of the basic-rate tax from HM Revenue and Customs, to top up the pension. Up until April 2008 the basic rate of income tax was 22%, but it was then reduced to 20%. For contributions made after April 2008:

- Total pension contribution is £100.
- You contribute £80 (£100 minus 20%).
- The government adds £20.

If you are a higher-rate taxpayer you have to claim any additional higher-rate tax relief via your self-assessment tax return. Thus:

- Total pension contribution is £100.
- You contribute £80 (£100 minus 20%).
- The government adds £20.
- You claim an additional £20 tax relief.
- Total cost to you is therefore only £60.

The net pay arrangement applies to contributions made by employees to an occupational pension scheme. The contributions are deducted from your gross pay before income tax is calculated. For example:

- £100 is deducted from your salary and paid into the scheme.
- If you are a basic-rate taxpayer you pay £20 less income tax and so have £80 less in your take-home pay – the cost of the pension contribution.
- If you are a higher-rate taxpayer you pay £40 less income tax, so you have £60 less in your take-home pay.

You therefore receive immediate tax relief at your highest marginal rate and do not have to claim any tax relief.
6 Mortgages

A mortgage is a special kind of loan, typically taken out to buy a home. It can be for any length of time agreed between the borrower and the lender. The loan is usually based on:

- how much the borrower can afford to borrow;
- the value of the property.

The main lenders are banks, building societies and specialist mortgage lenders. Mortgages can be arranged directly with lenders or through mortgage intermediaries, who are able to provide advice to borrowers on the best mortgage for their needs.

A mortgage is secured against the borrower’s home. This means that if the borrower has difficulties making the payments and gets into arrears the lender can, as a last resort, sell the home to recover its money.

Borrowers have two main options concerning the method of repaying the loan:

- a repayment mortgage;
- an interest-only mortgage.

### Repayment options

If you take out a **repayment mortgage** (also called a “capital and interest” mortgage) your monthly repayments gradually pay off the amount owed to the lender as well as paying the interest on the loan. During the early years of the loan most of the monthly repayment is interest and it is only in the later years that the amount of the loan is significantly reduced. Provided the borrower makes all of the agreed payments, the loan will be paid off by the end of the mortgage term.

If you have an **interest-only mortgage** your monthly payments only cover the interest on the loan. They don’t pay off any of the capital. The borrower needs to arrange a “repayment vehicle” such as an investment or savings plan to provide the funds needed to repay the loan at the end of the mortgage term.

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<thead>
<tr>
<th></th>
<th>Capital repaid?</th>
<th>Interest paid?</th>
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<tbody>
<tr>
<td>Repayment mortgage</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Interest-only mortgage</td>
<td>✗</td>
<td>✓</td>
</tr>
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Repayment options
Interest rate options

The interest charged on the loan is usually based on the Bank of England “base rate” and the monthly repayments will fluctuate up and down in relation to the prevailing interest rate. As an alternative to a variable interest rate, a borrower could arrange a fixed, discounted or capped interest rate for the loan.

**Standard variable rate.** The payments move up and down in line with the lender’s mortgage rate, which usually follows base rate changes announced by the Bank of England.

**Base rate tracker.** A variable-rate mortgage where the interest rate is set at a fixed amount above or below the Bank of England or some other base rate. It then tracks that rate for the life of the mortgage and the payments will move up or down as the rate changes.

**Fixed rate.** The payments are set at a certain level for an agreed period. At the end of the period the interest rate usually reverts to the standard variable rate.

**Discounted rate.** The standard variable rate is reduced by a certain percentage for a set period. At the end of the period the interest rate usually changes to the standard variable rate.

**Capped rate.** The payments are variable and often linked to a base rate, but will not rise above a set level (the cap) for an agreed period. At the end of the period the lender’s standard variable rate will be charged. Sometimes these capped rate mortgages also have a “collar”. This means the lender has set a minimum level that the rate will not fall below.

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**Graph:**

- **Standard variable rate**
- **Fixed rate**
- **Discounted rate**
- **Capped rate**

*Base rate tracker would follow a similar pattern.*
A fixed-rate mortgage would be useful for borrowers who wanted the stability of fixed payments for a set period of time.

A discounted-rate mortgage starts off with cheaper repayments, perhaps at a time when money might be tight, but will become more expensive when the discount ends.

A capped mortgage rate would be useful for borrowers who wanted the security of knowing that their payments couldn't rise above the set level but still wanted to benefit from any fall in rates.

This type of mortgage has tax advantages, particularly for a higher-rate taxpayer, since the savings will not generate any investment income to be taxed. Instead, less interest will be payable on the mortgage.

Suppose you have a £100,000 mortgage, with £10,000 in an offset savings account. You would pay interest only on the balance of £90,000.

A current account mortgage works in a similar way. But instead of having different accounts for savings and a mortgage, only one account is used. The single account works like a current account with a very large overdraft facility, with the interest rate charged being at mortgage loan levels.

Special types of mortgage
Some mortgages are designed to provide additional flexibility for borrowers.

Flexible mortgages
A flexible mortgage gives borrowers some scope to vary their monthly payments if their financial circumstances change:

- Overpayments can be made by paying more than the normal monthly amount, or by paying a lump sum off the loan, or both.
- Underpayments can be made by paying less than the normal monthly amount for a limited period (typically six or twelve months), or a payment holiday can be taken, when payments stop altogether for a time.
- Extra funds can be borrowed without further approval from the lender, provided the total loan doesn’t exceed an overall limit.

Offset or current account mortgages
With an offset mortgage borrowers have their mortgage account linked to their current account or savings account. Any money in these accounts is offset against the mortgage balance before the interest on the loan is worked out.

A current account mortgage works in a similar way. But instead of having different accounts for savings and a mortgage, only one account is used. The single account works like a current account with a very large overdraft facility, with the interest rate charged being at mortgage loan levels.

Lifetime mortgages
A lifetime mortgage enables older homeowners to unlock money tied up in their homes. A loan is secured against the value of the home and is designed to run for the rest of the borrower’s life. There are generally no monthly repayments and the borrower continues to own the house and occupy it for as long as he or she wishes. The amount borrowed is paid out as a cash lump sum or a monthly income (or both). The loan is repaid to the lender, together with the accumulated interest owing, when the homeowner dies or when the property is sold if earlier.

Buy-to-let mortgages
A buy-to-let mortgage is specifically designed to finance a property that is to be rented out. Mortgage lenders will take into account the rent a property is expected to produce as well as the borrower’s income and creditworthiness when assessing a mortgage application. Buy-to-let mortgages can be fixed, capped, discounted or variable. Some may be base rate trackers, or have flexible features.
7 General insurance

In addition to providing financial protection in the event of death or ill health, most people also need to protect themselves and their property against other adverse events. There are a number of personal insurance policies an individual can arrange to provide peace of mind. Insurance like this is covered by the term general insurance, to distinguish it from the various life and health insurances we have considered in more detail in this guide.

Some of the most important categories of general insurance are considered briefly below.

Motor insurance

Motor insurance is compulsory for anyone who drives a motor vehicle. There are three different levels of cover you can choose from:

- **third party**, which is the minimum legal requirement, covering injury to third parties and damage to their property, but not damage to the insured's own vehicle;
- **third party, fire and theft**, which adds fire damage and theft of the insured's own vehicle, but not accidental damage to the vehicle;
- **comprehensive**, which covers accidental and malicious damage to the insured's vehicle in addition to third party, fire and theft.

Buildings insurance

Buildings insurance covers the structure of your home, together with its fixtures and fittings, against damage caused by fire, storm, flood, subsidence and other events. Some policies also include accidental damage cover.

Contents insurance

Contents insurance covers loss or damage to the contents of a home. Different policies offer different levels of cover, and generally include cover against theft, fire and accidental damage. Some policies offer **new-for-old cover**, which means they will replace damaged possessions with new items in the event of a claim. Contents insurance is often combined in a single policy with buildings insurance.

Travel insurance

Travel insurance covers you when you are travelling within the UK or abroad, either for specific trips or on an annual basis to cover all trips during the year. The policies typically cover medical expenses, loss of baggage, loss of deposit, and pay compensation for travel delays.
These boxes throw more light on what’s been said, with examples and so on.

These boxes provide extra technical detail. You can ignore them if you wish!
Lifting the lid on financial services

A brief guide to financial services