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Acknowledgements

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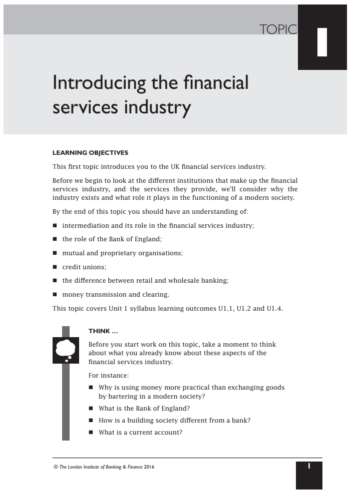
Contents

About this book

This book has been developed specifically to support you in your studies for UK Financial Regulation (UKFR). In each topic there are features to help you to break down your studies, absorb information and prepare you for your exam.

Learning objectives


TOPIC 1

Introducing the financial services industry

LEARNING OBJECTIVES

This first topic introduces you to the UK financial services industry.

Before we begin to look at the different institutions that make up the financial services industry, and the services they provide, we'll consider why the industry exists and what role it plays in the functioning of a modern society.

By the end of this topic you should have an understanding of:

- intermediation and its role in the financial services industry;
- the role of the Bank of England;
- mutual and proprietary organisations;
- credit unions;
- the difference between retail and wholesale banking;
- money transmission and clearing.

This topic covers Unit 1 syllabus learning outcomes U1.1, U1.2 and U1.4.

THINK ...

Before you start work on this topic, take a moment to think about what you already know about these aspects of the financial services industry.

For instance:

- Why is using money more practical than exchanging goods by bartering in a modern society?
- What is the Bank of England?
- How is a building society different from a bank?
- What is a current account?

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1

These set out what you will be learning in each topic and how the topic content links to the syllabus requirements.

THINK . . .

This feature, which appears at the start of each topic, is especially helpful if you are new to the financial services sector. It helps to provide a context for your studies by suggesting how the topic content might relate to your own experiences, to products and services that might already be familiar to you, or to your previous studies.

INFORMATION PANELS

These provide background or additional information. Content that appears in these panels may be covered in your exam, so you must make sure you read them.

Calculate

Worked examples help you to understand how to carry out calculations.

KEY TERMS

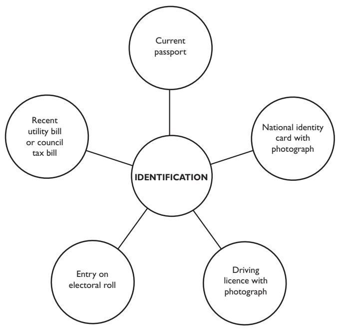
Key terms are explained alongside the content in which they are used.

Notes

These draw attention to important information, usually relating to your preparation for your exam.

Figures

Most of the figures in this book provide visual summaries to help you to absorb information quickly. Try creating your own diagrams to help you with your revision. The source for all figures is The London Institute of Banking & Finance unless otherwise stated.



FACTFINDS

These provide useful links to authoritative sources of information where you can check current details, particularly relating to tax and benefit rates and to the progress of legislation that had not been implemented at the time this book was written. They also provide pointers to further information if you would like to find out more about a particular topic.

IN BRIEF

These provide short summaries of a process or issue.

✓ Check your understanding

These help you to make sure you understand what you have just read. Alternatively, they help you to check whether you can recall information from an earlier topic that is relevant to the current topic. Referring back to your earlier work and applying your learning in a different context helps you to assimilate the information. Where appropriate, answers are provided in the back of the book.

THINK AGAIN . . .

This feature encourages you to reflect on how much you have learned in each topic and to make sure you have really understood what you have been reading. It does not cover all the content of the topic but it prompts you to check your understanding.

? Test your knowledge

Confident you have understood and can recall the topic content? Test yourself before you move onto the next topic. Answers are provided at the back of the book. A good score will be a great confidence boost! If you don’t do as well as you’d hoped, revisit the content areas where you got the answers wrong.

TOPIC 1

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THINK ...

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For instance:

- Why is using money more practical than exchanging goods by bartering in a modern society?
- What is the Bank of England?
- How is a building society different from a bank?
- What is a current account?

You won't always know much about the content of a topic before you start work – if you already knew everything, there would be no point in studying this qualification! – but if you pause to think about what you *do* already know it will boost your confidence and help to focus your thoughts.

1.1 Why do we need money?

In earlier civilisations, the process of bartering was adequate for exchanging goods and services: a poultry farmer could exchange eggs or chickens for carrots and cabbages grown by a gardener. In modern society, people still produce goods or provide services that they could, in theory, trade with others for the things they need. The complexity of life, however, and the sheer size of some transactions make it virtually impossible for people today to match what they have to offer against what others can supply to them.

What is needed is a separate commodity that people will accept in exchange for any product, which forms a common denominator against which the value of all products can be measured. These two important functions (defined technically as being a medium of exchange and a unit of account respectively) are carried out by the commodity we call money.

In order to be acceptable as a medium of exchange, money must have certain properties. In particular it must be:

- sufficient in quantity;
- generally acceptable to all parties in all transactions;
- divisible into small units, so that transactions of all sizes can be precisely carried out;
- portable.

> **INFLATION**
>
> A sustained increase in the general level of prices of goods and services.

Money also acts as a store of value. In other words, it can be saved because it can be used for separate transactions in time: money received today as payment for work done or for goods sold can be stored in the knowledge that it can be exchanged for goods or services later when required. To fulfil this function, money must retain its exchange value or purchasing power; inflation has a negative impact on the exchange value of money.

'Money' comprises much more than cash. It includes amounts held in current accounts and deposit accounts, and other forms of investments.

The financial services industry exists largely to facilitate the use of money. It 'oils the wheels' of commerce and government by channelling money from those who have a surplus, and wish to lend it for a profit, to those who wish to borrow it, and are willing to pay for the privilege.

Of course, most financial services organisations want to make a profit from providing this service. In order to do this, they provide the public with products and services that offer, among other things:

- convenience (eg current accounts that enable people to make and receive payments);
- a means of achieving otherwise difficult objectives (eg mortgages that enable people to fund the purchase of a home); and
- protection from risk (eg insurance to protect people from the financial consequences of adverse life events).

CHECK YOUR UNDERSTANDING 1

Money is:

- a medium of exchange – it can be exchanged for goods and services;
- a unit of account – a common denominator against which the value of goods and services can be measured; and
- a store of value – money received as payment today can be stored until required.

Which of these important functions enables a person to work out that they can rent four DVDs for the same price as buying one?

1.2 What is intermediation?

In any economy there are surplus and deficit sectors.

The surplus sector comprises individuals and firms that are cash-rich, ie they have more liquid funds than they currently wish to spend. They want to lend out their surplus funds to earn money.

FINANCIAL INTERMEDIARY

An entity that acts as the middleman between two parties in a financial transaction. Banks and building societies are the best-known examples.

The deficit sector comprises individuals and firms that have fewer liquid funds than they wish to spend. They are prepared to pay money to anyone who will lend to them.

In this context, a financial intermediary is an institution that borrows money from the surplus sector of the economy and lends it to the deficit sector. It pays interest to the person with the surplus but it charges a higher rate of interest to the person with the deficit. An intermediary's profit margin is the difference between the two interest rates.

DISINTERMEDIATION

Why do the surplus and deficit sectors need the services of a financial intermediary? Why can they not just find each other and cut out the intermediary's profit?

Actually, there are some cases where this does happen, and the process is known as disintermediation. It involves lenders and borrowers interacting directly rather than through an intermediary. An example of disintermediation is 'crowdfunding', where a company that is looking to raise funds to invest in the business establishes a website to promote itself and find investors who are willing to lend money to it.

1.2.1 The four elements of intermediation

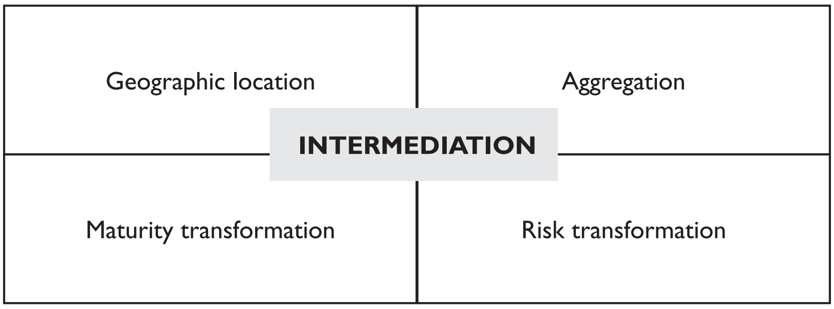
There are several reasons why both individuals and companies need the services of intermediaries. The four main reasons relate to the following factors.

- **Geographic location** – first, there is the physical problem that individual lenders and borrowers would have to locate each other and would probably be restricted to their own area or circle of contacts. A small business in Surrey that wants to borrow money is unlikely to be aware of a person in Edinburgh with money to lend, but each may have easy access to a branch of a high-street bank.
- **Aggregation** – even if a potential borrower could locate a potential lender, the latter might not have enough money available to satisfy the borrower's requirements. The majority of retail deposits are relatively small, averaging under £1,000, while loans are typically larger, with most mortgages being for £50,000 and above. Intermediaries can overcome this size difference by aggregating small deposits.
- **Maturity transformation** – even supposing that a borrower could find a lender who had the amount they wanted, there is a further problem. The borrower may need the funds for a longer period of time than the lender is prepared to part with them. The majority of deposits are very short term (eg instant access accounts), whereas most loans are required for longer periods (personal loans are often for two or three years, while companies

often borrow for five or more years and typical mortgages are for 20 or 25 years). Intermediaries are able to overcome this mismatch by offering a wide range of deposit accounts to a wide range of depositors, thus helping to ensure that not all of the depositors' funds are withdrawn at the same time.

- **Risk transformation** – individual depositors are generally reluctant to lend all their savings to another individual or company, mainly because of the risk of default or fraud. However, intermediaries enable lenders to spread this risk over a wide variety of borrowers so that, if a few fail to repay, the intermediary can absorb the loss.

FIGURE 1.1 FOUR ELEMENTS OF INTERMEDIATION



1.2.2 Risk management

Risk transformation is one way of minimising (or 'mitigating') risk. Another way is insurance, which can be defined as "a means of shifting the burden of risk by pooling to minimise financial loss". Insurance involves individuals contributing – via their insurance premiums – to a fund from which the losses of the few who experience certain adverse circumstances are covered. Without the services of a central organisation – the insurance company – individuals would struggle to find a convenient way of sharing their risks in this manner. Insurance companies therefore provide another form of intermediation.

1.2.3 'Product sales' intermediaries

There is a further type of intermediation, slightly different in nature from those defined above. This is the intermediation that brings together the product providers (such as banks and insurance companies) and the potential customers who wish to purchase the providers' products and services. These product sales intermediaries include financial advisers, insurance brokers and mortgage advisers.

1.3 Financial institutions

This section introduces some of the types of financial institution that make up the financial services industry in the UK. Regulatory organisations are mentioned only briefly here because they are described in more detail in Unit 2.

Prior to the 1980s, there were more clearly defined boundaries between different kinds of financial organisation. Some were retail banks; others wholesale banks. There were life assurance companies, providing term or whole-of-life assurance, and general insurance companies, providing household and motor insurance (although a few offered both types of insurance and were known as composite insurers). There were also investment companies.

Today, many of the distinctions have become blurred, if they have not disappeared altogether. Increasing numbers of mergers and takeovers have taken place and now even the term bancassurance, which was coined to describe banks that own insurance companies (or vice versa), is inadequate to describe the complex nature of modern financial management groups. For example, a provider might offer the range of services illustrated in Figure 1.2.

KEY TERMS

RETAIL BANKS

Banks that provide payment services and savings and loans to personal customers or smaller businesses.

WHOLESALE BANKS

Banks that provide funding for other financial institutions or very large corporate clients.

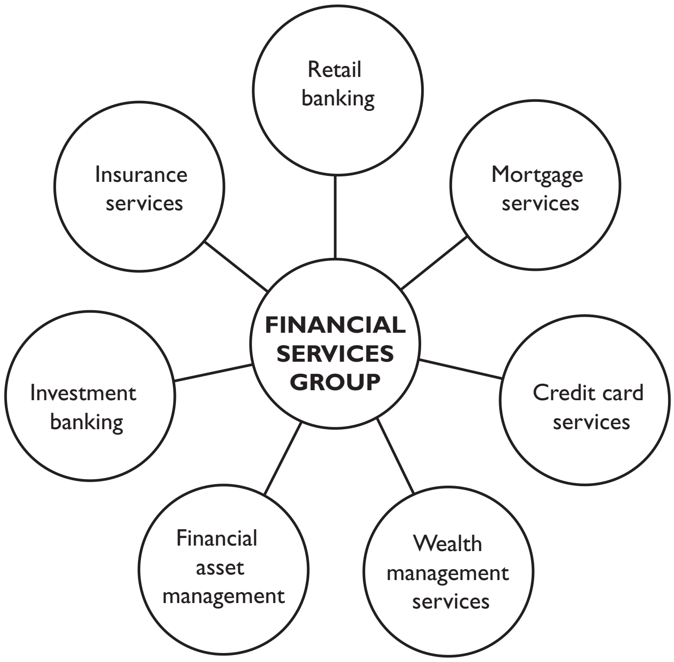
LIFE ASSURANCE

Insurance that provides payment, generally as a lump sum but possibly as an income, on the death of the person covered by the policy. It is sometimes referred to as life insurance or life cover.

GENERAL INSURANCE

Insurance designed to protect policyholders from the financial consequences of adverse life events. Examples include household insurance, motor insurance, travel insurance and commercial property insurance.

FIGURE 1.2 POTENTIAL RANGE OF SERVICES OFFERED BY FINANCIAL SERVICES GROUP



1.3.1 The Bank of England

A central bank is an organisation that acts as a banker to the government, supervises the economy and regulates the supply of money. In the United States, for example, these tasks are the responsibility of the US central bank, which is known as the Federal Reserve. Within the European Union, the European Central Bank (ECB) acts as central bank for those states that belong to the eurozone (ie use the euro as their currency). In the UK, the central bank is the Bank of England.

The Bank of England has a mission "to promote the good of the people in the United Kingdom by maintaining monetary and financial stability"; in pursuing this mission, it performs a number of important roles within the UK economy. Its main functions are as follows.

- **Issuer of banknotes** – the Bank of England is the central note-issuing authority and has a duty to ensure that an adequate supply of notes is in circulation.
- **Banker to the government** – the government's own account is held at the Bank of England. The Bank provides finance to cover any deficit by making an automatic loan to the government. If there is a surplus, the Bank may lend it out as part of its general debt management policy.
- **Banker to the banks** – all the major banks have accounts with the Bank of England for depositing or obtaining cash and other transactions. In this capacity, the Bank can wield considerable influence over the rates

of interest in various money markets, by changing the rate of interest it charges to banks that borrow or the rate it gives to banks that deposit.

- **Adviser to the government** – the Bank of England, having built up a specialised knowledge of the UK economy over many years, is able to advise the government and help it to formulate its monetary policy. The Bank's role in this regard was significantly enhanced in 1997, when full responsibility for setting interest rates in the UK was given to the Bank's Monetary Policy Committee (MPC). This committee meets eight times a year and its mandate in setting the base rate is to ensure that the government's inflation target is met.
- **Foreign exchange market** – the Bank of England manages the UK's official reserves of gold and foreign currencies on behalf of the Treasury.
- **Lender of last resort** – the Bank of England traditionally makes funds available when the banking system is short of liquidity, in order to maintain confidence in the system. This function became very important in 2007-09 following a run on Northern Rock and subsequent liquidity problems for a number of other banks.
- **Maintaining economic stability** – the Financial Policy Committee sits within the Bank of England. It looks at the economy in broad terms to identify and address risks that affect economic stability.

The Bank of England was also formerly responsible for managing new issues of gilt-edged securities. This function has now been transferred to HM Treasury's Debt Management Office in order to avoid conflicts of interest that might arise from the Bank's responsibility for setting interest rates.

LIQUIDITY

Assets (eg cash) that can quickly be made available to meet an institution's liabilities, without affecting the market price of those assets.

GILT-EDGED SECURITIES

Gilt-edged securities, commonly known as gilts, are loans to the government. There is a wide variety of gilts in issue offering loans at different rates of interest and for varying periods. These securities are called gilt-edged because they used to be issued in the form of paper certificates with gilt edging.

There is more information about gilts in Topic 6.

THE BANK OF ENGLAND'S ROLE AS A REGULATOR

The Bank of England previously held responsibility for the supervision and regulation of the UK banking sector; in 1998 this responsibility was transferred to the Financial Services Authority (FSA). The financial crisis that began in 2007–08 brought the UK banking system close to collapse, and as a result the government took steps to strengthen regulatory structures.

The Financial Services Act 2012, effective from 1 April 2013, divided responsibility for financial stability between the Treasury, the Bank of England and two new regulators: the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

The Bank of England and Financial Services Act 2016 modified the Financial Services Act 2012 to give more powers to the Bank by bringing the PRA within it, ending its status as a subsidiary, and establishing a new Prudential Regulation Committee (PRC). You will find out more about these regulatory bodies in Topic 17.

1.3.2 Proprietary and mutual organisations

The great majority of the large financial institutions are proprietary organisations, which means that they are limited companies. They are owned by their shareholders, who have the right to share in the distribution of the company's profits in the form of dividends. They can also contribute to decisions about how the company is run by voting at shareholders' meetings.

By contrast, a mutual organisation is one that is not constituted as a company and does not, therefore, have shareholders. The most common types of mutual organisation are building societies, friendly societies and credit unions; some life assurance companies are mutual, too.

A mutual organisation is, in effect, owned by its members, who can determine how the organisation is managed through general meetings similar to those attended by shareholders of a company. In the case of a building society, the members comprise its depositors and borrowers; for a life assurance company, they are the policyholders.

DEMUTUALISATION

Since the Building Societies Act 1986, a building society has been able to demutualise – in other words, to convert to a bank (with its status changed to that of a public limited company). Such a change requires the approval of its members, but this approval has generally been readily given, not least because of the windfall of free shares to which the members have been entitled following the conversion of the building society to a company.

A number of building societies demutualised in the late 1980s and early 1990s as a result of the change in the law. Among some of the most well-known were:

- Abbey National and Alliance & Leicester, which were eventually taken over by Santander;
- Halifax, which initially merged with Bank of Scotland to form HBOS and then became part of Lloyds Banking Group; and
- Woolwich, which was taken over by Barclays.

The possibility of a windfall for members led to a spate of 'carpetbagging' in the 1990s. This refers to the practice of opening an account at a building society that is expected to soon convert, purely to obtain the subsequent allocation of shares. In response, societies considering conversion sought to protect the interests of their long-term members by placing restrictions on the opening of new accounts.

In the past, some mutual life assurance companies, including Aviva and Standard Life Aberdeen, have also elected to demutualise.

1.3.3 What is a credit union?

A credit union is a mutual organisation. Credit unions are run for the benefit of their members. In the past, the members had to be linked in a particular way – in other words, they had to share a 'common bond', for example, by working for the same organisation, living in a particular area or belonging to a particular club or other association. Changes to the Credit Unions Act 1979 that came into force on 8 January 2012 mean that credit unions no longer have to prove that all members have something in common with each other. As a result, they can now provide services to different groups of people, such as housing associations and employees of a national company, even if some of the tenants/employees live outside the geographical area that the credit union serves.

In order to join a credit union, the member must meet the membership requirements, pay any required entrance fee and buy at least one £1 share in the union. Credit unions can choose whether to offer ordinary shares (which are paid up and bring all the benefits of credit union membership), or deferred shares, which are only payable in special circumstances. All members of the credit union are equal, regardless of the size of their shareholding.

Traditionally, credit unions operated in the poorer sections of the community as an alternative to 'loan sharks', providing savings and reasonably priced short- and medium-term loans to their members. In more recent years it has been recognised that credit unions have a strong role to play in combating financial exclusion and delivering a range of financial services and financial education to those outside the mainstream. The government has therefore supported a number of initiatives and enacted legislation to widen the scope of the movement.

Credit unions are owned by the members and controlled through a voluntary board of directors, all of whom are members of the union. The board members are elected by the members at the annual general meeting (AGM). Although the directors control the organisation, the day-to-day management is usually carried out by employed staff. Credit unions are authorised and regulated by the Financial Conduct Authority (FCA), and savers are protected through the Financial Services Compensation Scheme.

What products and services does a credit union offer?

Credit unions offer simple savings and loan facilities to members. Savers invest cash in units of £1, with each unit buying a share in the credit union. Each share pays an annual dividend, typically 2–3 per cent. The maximum rate of 8 per cent for dividends was removed by the 2012 changes to the Credit Unions Act; these changes also allowed credit unions to pay interest on savings instead of dividends. Credit unions that choose to pay interest must show that they have the necessary systems and controls in place and have at least £50,000 or 5 per cent of total assets (whichever is greater) in reserve.

Members' savings create a pool of money that can be lent to other members; the loans typically have an interest rate of around 1 per cent of the reducing balance each month (with a legal maximum of 3 per cent of the reducing balance).

In order to compete in today's financial services marketplace, many credit unions offer additional services, often in conjunction with partners, including basic bank accounts, insurance services and mortgages.

LIFE ASSURANCE

A unique feature of credit unions is that members' savings and loan balances are covered by life assurance.

This means that any loan balance will be paid off on death, and a lump sum equal to the savings held will also be paid, subject to overall limits.

1.3.4 Retail and wholesale banking

The main distinction between retail and wholesale transactions is one of size, wholesale transactions being generally much larger than retail ones. Because of this, the end-users of retail services are normally individuals and small businesses, whereas wholesale services are provided to large companies, the government and other financial institutions.

Retail banking is primarily concerned with the more common services provided to personal and corporate customers, such as deposits, loans and payment systems. It is largely carried out by high-street banks and building societies, which deliver their products through traditional branch networks, call centres or the internet.

These institutions are acting as intermediaries between people who wish to borrow money and people who have money that they are prepared to deposit. The price of borrowing and the reward for investing is, of course, interest.

INTERBANK MARKET

A very large market which recycles surplus cash held by banks, either directly between banks or more usually through the services of specialist money brokers.

Wholesale banking refers to the process of raising money through the wholesale money markets in which financial institutions and other large companies buy and sell financial assets. This is the method normally used by finance houses, but the main retail banks are also heavily involved in wholesale banking in order to top up deposits from their branch networks as necessary. For example, if a bank has the opportunity to make a substantial profitable loan but does not have adequate deposits, it can raise the money very quickly on the interbank market.

Wholesale banking operations are more risky than retail banking. Following the 2007–09 financial crisis, regulators sought to ensure that banks involved in both retail and wholesale banking did not expose their retail customers' deposits to risk as a result of their wholesale operations. This approach is referred to as ‘ring fencing’ and was implemented in the UK banking sector on 1 January 2019.

Building societies are also permitted to raise funds on the wholesale markets, but are restricted to 50 per cent of their liabilities; the remainder must come from deposits. For banks, there is no restriction.

Some organisations are clearly based at the wholesale end of the market, notably product providers such as life assurance companies and unit trust managers. Other organisations and individuals, such as insurance brokers and financial advisers, are purely retailers of the products and services offered by the providers. That said, the distinction between ‘retail’ and ‘wholesale’ in financial services is much less obvious than it used to be, with many institutions operating in both areas. Product providers that sell direct to the public or through their own dedicated sales forces are, in effect, operating in both a wholesale and retail capacity.

1.3.5 What is Libor?

The rate of interest charged in the interbank market is the London interbank offered rate (Libor). It acts as a reference rate for the majority of corporate lending, for which the rate is quoted as Libor plus a specified margin. Libor rates are fixed daily and vary in maturity from overnight through to one year.

Libor is an average calculated using the information submitted by major banks in London regarding the interest rates they are paying to borrow from other banks. It is supposed to be an assessment of the health of the financial system, and the confidence felt by the banks as to the health of that system is reflected in the rates they submit.

THE LIBOR SCANDAL

In the summer of 2012, it was discovered that banks were falsely inflating or deflating the rates they claimed to be paying so as to profit from trades, or to give the impression that they were more creditworthy than they were.

A review of Libor was carried out by Martin Wheatley, managing director of the then regulator, the Financial Services Authority. The review recommended that banks submitting rates to Libor must base them on actual interbank deposit transactions, and not on what rates should be or are expected to be. It also recommended that banks keep records of the transactions to which the rates relate and that their Libor submissions be published.

The activity of "administering and providing information to specified benchmarks" came under the regulation of the Financial Conduct Authority (FCA) from April 2013. Under the Financial Services Act 2012, knowingly or deliberately making false or misleading statements in relation to Libor-setting became a criminal offence. Responsibility for administering Libor passed from the British Bankers' Association to Intercontinental Exchange Benchmark Administration in 2014.

UK authorities have planned a timeline for the shift to Sonia (Sterling Overnight Index Average) as the primary interest rate benchmark in sterling markets to replace Libor in 2021. The BoE, the FCA and the Working Group on Sterling Risk-Free Reference Rates (RFRWG) have issued various documents setting out the move to Sonia.

CHECK YOUR UNDERSTANDING 2

How can a bank involved in wholesale banking raise money quickly in order to finance business activities?

a) By a further issue of shares.

b) By borrowing from the Bank of England.

c) By calling in their debts.

d) From the interbank market.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the functions that money performs in society and the economy?
- explain what is meant by 'intermediation'?
- summarise the different roles carried out by the Bank of England?
- outline the differences between a retail bank, a wholesale bank, a building society and a credit union?
- explain what is meant by the London interbank offered rate (Libor).

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 1. Review the text if necessary.

Answers can be found at the end of this book.

1) What are the four main reasons why individuals and companies need financial intermediation?

2) What is the key difference between a mutual organisation and a proprietary organisation?

3) A financial transaction that is carried out directly between an organisation with surplus funds to lend and one that needs to borrow is an example of:

    a) demutualisation.

    b) disintermediation.

4) Which one of the following is not a role of the Bank of England?

    a) To regulate the supply of money and manage gold reserves.

    b) To act as financial ombudsman in resolving customer complaints about banks.

    c) To act as adviser to the government.

    d) To set interest rates.

5) Which institution issues UK banknotes?

    a) The Bank of England.

    b) The Treasury.

    c) The Royal Mint.

6) Credit unions cannot pay interest on savings. True or false?

7) Freshfood Ltd supplies fruit and vegetables to market traders and small shops. The banking transactions it carries out are an example of:

    a) wholesale banking.

    b) retail banking.

8) The setting of Libor is a regulated activity. True or false?

TOPIC 2

Economic policy and financial regulation

LEARNING OBJECTIVES

Government policies affect the financial services industry in many ways, both directly and indirectly. Regulation and legislation affect the way in which the industry operates, and may be imposed by the European Union or other international bodies, as well as by the UK government. Economic policies might have a more indirect effect, for example by making personal saving or business investment more appealing, or by making borrowing cheaper.

In this topic we will outline some key economic objectives that governments generally share, whichever political party is in power, before introducing the regulatory environment within which financial services organisations operate.

By the end of this topic, you should have an understanding of:

- key macroeconomic objectives:
  - price stability;
  - low unemployment;
  - stable economic growth;
  - balance of payments equilibrium;
- monetary policy and the impact of interest changes;
- fiscal policy;
- the role of the European Union in regulating financial services;
- the different levels of regulatory control in the UK.

This topic covers Unit 1 syllabus learning outcome U1.3 and U8.1–8.3.

THINK . . .

What do you already know about economic policy and regulation? Issues relating to this topic are in the news almost every day, and the state of the economy affects your daily life in numerous ways.

For instance:

- Have you heard or read news reports about the decisions the Bank of England makes on raising interest rates, lowering them or keeping them the same?
- Do you know what effect high inflation might have on your savings?
- Have you ever had to decide between a fixed-rate or variable-rate mortgage?
- Do you know which bodies impose the regulations that financial services institutions have to follow?

2.1 What are the key macroeconomic objectives?

Most governments aim to achieve four key economic objectives; their political beliefs shape the way they go about achieving these objectives and the relative importance they give to each. They are known as macroeconomic objectives because they concern economic aggregates, ie totals that give us a picture of the economy as a whole, as opposed to microeconomic objectives that concern individual firms or consumers.

KEY TERMS

INFLATION

A general rise in prices, resulting from "too much money chasing too few goods". In more formal economic terminology, it can be defined as a situation where the rate of growth of the money supply is greater than the rate of growth of real goods and services.

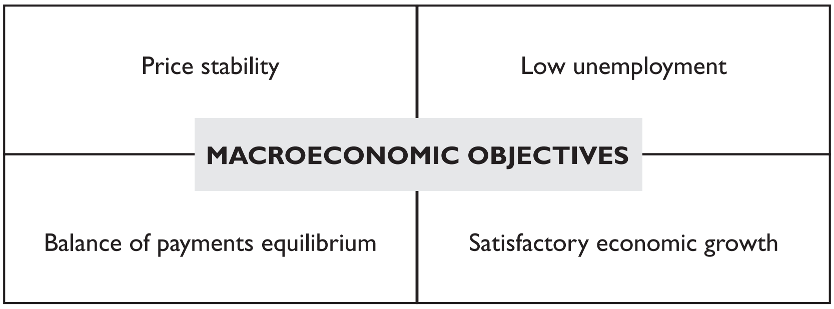
DISINFLATION

A fall in the rate of inflation, ie prices are still rising, but less quickly than they were.

DEFLATION

A general fall in the price of goods and services. In other words, the inflation rate is below zero per cent – a negative inflation rate.

FIGURE 2.1 KEY MACROECONOMIC OBJECTIVES



- **Price stability** – involves a low and controlled rate of inflation. It does not mean, however, that zero inflation is desirable and there is a body of economic opinion that believes that moderate inflation can stimulate investment, which is good for the economy.
- **Low unemployment** – involves expanding the economy so that there is more demand for labour, land and capital.
- **Balance of payments equilibrium** – a situation in which expenditure on imports of goods and services and investment income going abroad is equal to (ie in equilibrium with) the income received from exports of goods and services and the return on overseas investments. The exchange rate of the country’s currency is linked to the balance of payments, and most governments aim to keep the price of currency stable at a level that is not so high that exports will be discouraged but not so low as to increase inflation.
- **Satisfactory economic growth** – the output of the economy is growing in real terms over time and standards of living are getting higher.

In practice, it has proved impossible to achieve all of these objectives simultaneously, as the history of the British economy shows. For example, if a government tries to reduce the rate of unemployment by means of expansionary measures such as lower interest rates and lower taxation, there is an increase in demand for goods and services. As a result, inflation begins to rise. At the same time, people buy more imports and the balance of payments suffers, although the economy will probably grow.

The four objectives given above tend to fall into two pairs:

- policies to reduce unemployment will also boost growth;
- measures to reduce inflation will also help to improve the balance of payments.

Governments generally have to trade off objectives against each other, ie they want price stability but know that the price of getting rid of inflation altogether would be very high unemployment, so they accept a low inflation rate to avoid pushing the economy into recession.

KEY TERMS

RECESSION

A significant decline in economic activity over a sustained period. Technically, it is two consecutive quarters of negative economic growth as measured by a country's gross domestic product (GDP).

GROSS DOMESTIC PRODUCT (GDP)

GDP is a measurement of a country's overall economic activity. Technically it is the monetary value of all the goods and services produced within the country (ie 'domestically') in a given period, eg one year.

Over time, economies typically go through four main phases:

- recovery and expansion;
- boom;
- contraction or slowdown; and
- recession.

Economic activity is measured by the fall and rise in GDP. When GDP in one quarter falls compared to the previous quarter, the economy is said to be contracting or slowing down. When it rises, it is said to be expanding or in recovery. Two successive quarters of declining GDP signals that the economy is in recession. When GDP is at its highest level, the economy is said to be booming.

Each phase of the cycle is characterised by fluctuating patterns of economic activity.

TABLE 2.1 ECONOMIC ACTIVITY

Phase of cycle	Pattern of economic activity
Recovery and expansion	Interest rates, inflation and unemployment are low. Consumers have money to spend. Demand for goods and services rises, pushing prices up. Share prices improve as businesses flourish.
Boom	To prevent the economy from overheating, the Bank of England may intervene by putting up interest rates to control consumer spending and dampen inflation.

Contraction or slowdown	Once the interest rate rises start to bite, consumer spending falls. Demand for goods and services falls, profits fall (as do share prices) and unemployment rises. Inflation slows down.
Recession	As the economy heads towards its lowest level of activity, the Bank of England may intervene to reduce interest rates in a bid to stimulate demand and set the economy on the path back to recovery.

The approach to economic policy in the UK from the beginning of the 1960s until the 1990s is often described as 'stop-go': successive governments accelerated and decelerated the economy in turn. This led to a situation in which periods of fast growth, high employment and high inflation were followed by a slowdown, resulting in high unemployment and lower inflation.

CONSUMER PRICES INDEX

A measure of the change in price of a 'basket' of consumer goods and services over a period. Items to be included in the 'basket' are reviewed regularly to ensure it provides an accurate reflection of consumer spending. It is the equivalent of the Harmonised Index of Consumer Prices (HICP) used within the eurozone.

Since the 1990s, the approach in both the UK and Europe has been to keep inflation steady at a low rate, in the hope that price stability will provide the certainty that leads to sustained economic growth. The aim is to keep aggregate demand in line with the productive capacity of the economy.

In order to achieve this objective, successive UK governments have set an official direct target, which is to keep inflation, as measured by the Consumer Prices Index (CPI), at an average annual rate of 2 per cent, with a maximum divergence either side of 1 per cent. The main method used to control inflation is by manipulating interest rates (see section 2.2).

There are two major types of policy used by governments in their attempts to achieve long-term economic objectives: monetary policy and fiscal policy. Both types of policy try to influence the level of aggregate demand in the economy and therefore the level of output, unemployment and prices. Fiscal policy and monetary policy are closely linked, and governments generally use a combination of the two to try to achieve their economic goals.

2.2 Monetary policy

Monetary policy is based on the ideas of the monetarist school of economic theory and particularly on those of the American economist Milton Friedman (1912–2006). Monetary economists believe that inflation is caused by an increase in the money supply. Broadly speaking, they conclude that, since most of the growth in the money supply is caused by an increase in the amount of credit created by banks, a government that wants to control the growth of the money supply must control the amount of credit that banks create. A common way to do this is by manipulating interest rates, which in turn influences the demand for credit by customers.

MONETARY POLICY

Measures taken to control the supply of money in the economy (eg by raising or lowering interest rates) in order to manage inflation.

Other methods can be used, and they have been used in the past. For example, restrictions can be imposed on the amount that banks can lend, or borrowers can be required to provide a minimum cash deposit when borrowing to make a purchase.

Neither of these approaches is currently in use in the UK, where the favoured method of monetary policy is the manipulation of interest rates. The Monetary Policy Committee (MPC) of the Bank of England decides on the rate of interest at which the Bank of England will lend to banks and other financial institutions, and it is this official rate (Bank rate) that determines all the other interest rates charged to borrowers and paid to lenders.

The Treasury retains the right to give instructions to the Bank of England regarding its monetary policy in "extreme economic circumstances"; otherwise the Bank acts independently of the government.

KEY TERMS

BANK RATE

The rate at which the Bank of England lends to other financial institutions. In this text the term 'Bank rate' is used, but you might also see it written 'Bank Rate' or referred to as 'base rate'.

INFLATION TARGET

The level of inflation that economists judge is appropriate to keep the national economy functioning efficiently. As we have seen, in the UK the inflation target (at the time of writing, February 2019) is 2 per cent, as measured by the Consumer Prices Index, with a 1 per cent maximum divergence either way. The Bank of England has responsibility for achievement of the government's inflation target. Current and predicted future levels of inflation are a key consideration in setting the Bank rate.

THE MPC AND INTEREST RATES

Interest rates are set by the Bank of England's Monetary Policy Committee (MPC).

Each member of the MPC has expertise in the field of economics and monetary policy. The MPC usually meets eight times a year over three days to set the interest rate that it judges will enable the inflation target to be met. The minutes of the meetings are published simultaneously with the interest rate decision.

To help produce its projections, the MPC uses a model of the economy that provides a framework to organise thinking on how the economy works and how different economic developments might affect future inflation.

Every quarter, the Bank publishes its Inflation Report, which gives an analysis of the UK economy and the factors influencing policy decisions.

2.2.1 The impact of interest rate changes

If the MPC decides to change the Bank rate, the effect is that banks and similar deposit-takers tend to follow suit and alter the interest rates at which they lend and borrow by something close to the same amount. Whether lending or taking deposits, a bank will apply a margin between the rate at which it borrows money and the rate at which it lends the money out, in order to cover costs and generate a profit. Adjusting rates in this way means that margins are maintained and the lender or deposit-taker can continue to cover its costs and generate profit.

This means that banks' base rates are inevitably variable because they follow the rate of the Bank of England, which is adjusted as necessary to implement the monetary policy used to control the UK's economy. However, in the difficult financial conditions since the financial crisis of 2007–09, bank interest rates (particularly the variable rates charged to borrowers) have not followed the Bank rate as closely as they did in more stable times. Due to concerns about the fragile state of the economy, the Bank rate was maintained at 0.5 per cent between 2009 and 2016, and was then cut further to 0.25 per cent in August 2016. Since then, interest rates have been on the way up, having increased to 0.5 per cent in November 2017 and to 0.75 per cent in August 2018. With the rate still at a low level, it remains difficult for banks and building societies to make a reasonable profit on their lending activities without setting their lending rates at a higher margin above the Bank rate than they would normally charge.

!

KEEPING UP TO DATE

You should keep up to date with changes in the economic situation; if you are working in the financial services industry, you need to make sure you understand the current situation.

Until relatively recently, most loan interest rates, including mortgage rates, were variable rates. A major disadvantage of variable rates, particularly in relation to a large transaction such as a mortgage, is that it is difficult for borrowers to budget for the likely future cost of repaying their loan. Sudden, large interest rate increases can lead to borrowers being unable to make their mortgage repayments; in the worst cases, some borrowers may even lose their homes if the lender has to take possession.

With the development of a large and active wholesale money market, it is now possible for lenders to obtain large amounts of money at fixed rates, which they can in turn lend out to their mortgage borrowers and others. The majority of fixed-rate mortgages in the UK still tend to be fixed only for a short initial period, with the rate reverting to the variable rate for the remainder of the term. Longer-term fixed rates are available in many other European countries, and it has been suggested that a greater use of long-term fixed rates in the UK would assist in stabilising the UK housing market, which is sometimes very volatile.

Fixed-rate mortgages do have their own disadvantages, however:

- There is a danger that a borrower will lose out if the variable rate falls and they are locked into a higher fixed rate.
- There is normally a penalty for paying off the mortgage within the fixed-rate period, too, in order to protect the lender. This is because the funds used to subsidise fixed-rate loans are normally raised in the money markets on terms that bind the lender to the medium/long term. If there were no early repayment penalties attached to the mortgages funded by this borrowing, and the mortgages were redeemed early, the lender would earn less interest than anticipated and thus face a potential financial loss. There may also be an arrangement fee, charged by the lender for reserving sufficient funds at the fixed rate.

2.3 Fiscal policy

Fiscal policy (which is sometimes called budgetary policy) involves influencing the money supply and the overall level of economic activity, including consumption and investment, by manipulating the finances of the public sector (which comprises central government, local authorities and public corporations).

The public sector has a responsibility to provide certain services that are of national or regional importance, such as education, healthcare and transport.

To pay for these services, the government must raise funds from the private sector, ie from individuals and firms, in the form of direct and indirect taxes.

Because the public sector is responsible for taking a large amount of money from the private sector and for making large amounts of expenditure on its behalf, any changes in either side of the account and thus in the balance have a significant effect on the economy as a whole. There are three general outcomes, as illustrated in Figure 2.2.

KEY TERMS

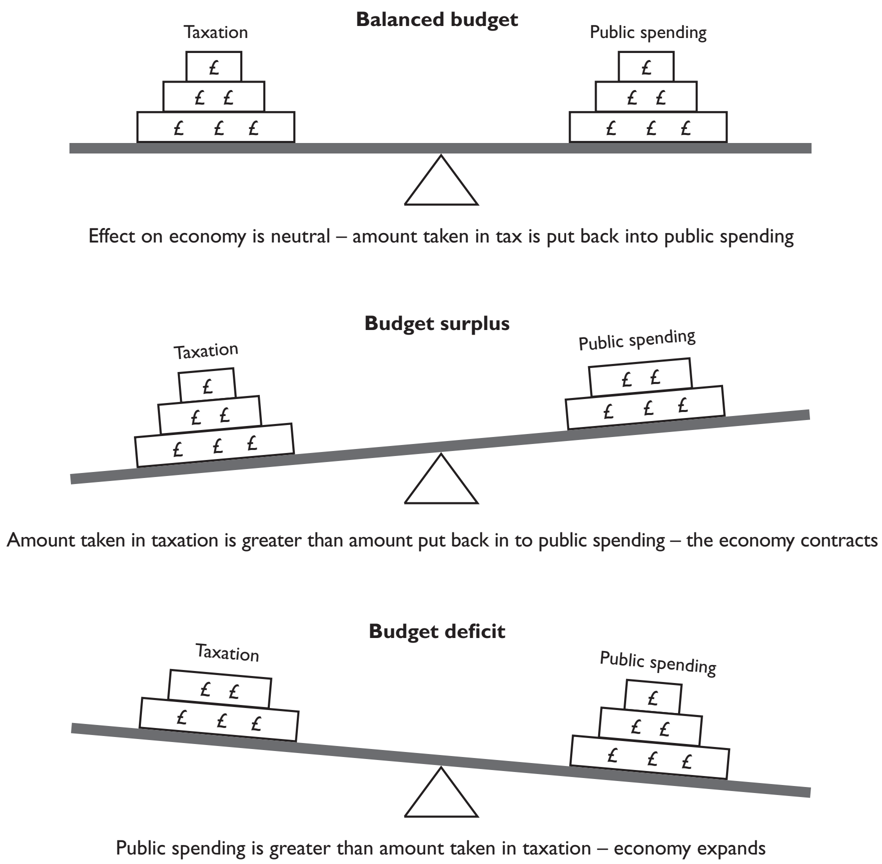
DIRECT TAXES

Apply to individuals and their assets (income tax, capital gains tax, inheritance tax, National Insurance).

INDIRECT TAXES

Applied to goods and services at the time they are purchased (eg VAT, stamp duty).

FIGURE 2.2 BALANCED BUDGET, BUDGET SURPLUS, BUDGET DEFICIT



KEY TERMS

FISCAL POLICY

The adjustment of levels of taxation and public spending in a way that is intended to achieve the government's macroeconomic objectives.

PUBLIC SECTOR NET CASH REQUIREMENT

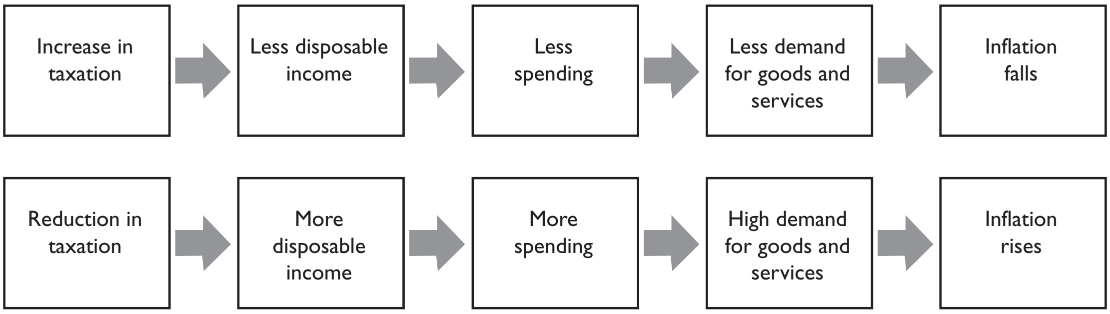
A government that has a deficit must borrow to finance it. The public sector net cash requirement (PSNCR) is a cash measure of the public sector's short-term net financing requirement.

THE BUDGET

The government outlines its fiscal policy in the annual Budget statement made by the Chancellor of the Exchequer. Traditionally, this has been in March but, since 2017, it changed to the autumn to give the government more time to legislate for changes before the start of the next fiscal year. The Budget statement includes revenue plans (including taxation of individuals and companies) and the government's planned expenditure. Prior to the Budget, the government publishes a Pre-Budget Report that allows it to consult the public on specific policy initiatives. Since 2018, the Spring Statement became a response to the Office for Budget Responsibility's (OBR) economic forecast, rather than a major fiscal event but the government is reserving the right to make tax changes if the economic circumstances demand it. The proposals in the Budget are detailed in a Finance Bill which, if approved, is then passed into law via a Finance Act, with different provisions taking effect at dates specified in the Act.

Monetary policy acts on the economy as a whole, currently through changes in the general level of interest rates. Fiscal policy can have a macroeconomic effect on the level of activity in the economy, too, as Figure 2.3 indicates.

FIGURE 2.3 USING TAXATION TO CONTROL INFLATION



Fiscal policy also has microeconomic effects and can be targeted on particular areas of the economy. For example, tax incentives can be given to manufacturing industries to boost employment in what is a declining sector, or government grants can be given to firms that move to particular areas of the UK, thus helping to develop local economies.

Changes in taxation affect the market for financial services and products in two main ways:

- Increased general taxation reduces the amount of money available for investment or to fund loan repayments.
- Tightening of the taxation regime in relation to particular products or activities makes them less attractive to investors. For example, in April 2016 a 3 per cent stamp duty land tax supplement was introduced in respect of the purchase of second properties. This followed concern that first-time buyers were being priced out of the housing market as a result of demand from buy-to-let landlords.

2.4 How does the European Union regulate financial services?

So far in this topic we have been focusing on the UK government's economic policy objectives and how the decisions that government makes affect the financial services industry. We are now going to look briefly at the role of government in the regulation of financial services. Regulation will be covered in much more detail in Topics 17–25.

THE IMPACT OF BREXIT

On 23 June 2016, the British public voted in a referendum for the UK to leave the European Union (referred to as Brexit).

Brexit will most likely mean significant changes in the regulatory landscape for financial service organisations. At the time of writing (March 2020), the timing of changes, if there will be any in the immediate future, is still uncertain.

The UK stopped being a member of the EU on 31 January 2020. During a transition period that will run until 31 December 2020, the UK will continue to follow all the EU's rules and its trading relationship will remain the same (BBC, 2020).

Students are reminded that the legislation and wider issues relating to the UK, and its legacy of membership of the European Union covered in this text, remain important areas within the syllabus for this qualification.

You might find this link on the FCA's website a useful resource: https://www.fca.org.uk/brexit [Accessed: 17 February 2020].

Much of the regulatory regime for financial services in the UK is determined at European Union level. This includes regulation relating to banking, investment, life assurance, general insurance, operating as a financial adviser, compensation for losses, money laundering, data protection and many other areas.

The European Parliament and the Council of Ministers share the power to adopt European laws, often acting on suggestions from the European Commission. These laws can take a number of forms, of which the two most common are regulations and directives.

IN BRIEF

REGULATIONS

- Have general application.
- Are binding in their entirety, both in respect of what is to be achieved and how it is to be achieved.
- Are directly applicable in all member states (unless particular states have specific dispensation).

DIRECTIVES

- Are binding upon each member state to which they are addressed as to the result to be achieved.
- Each member state has discretion as to how they go about achieving the stated aim of the directive.
- The directive objectives must be achieved within a specific timescale (typically two years) but exactly how they are achieved is left to the authorities within each member state to determine.

IMPACT OF EU LEGISLATION ON THE FINANCIAL SERVICES SECTOR

An example of an EU directive is the EU Mortgage Credit Directive (MCD). The MCD aimed to harmonise regulation of the EU mortgage credit market and promote competition. As the system of mortgage regulation in the UK was already robust, the FCA decided to make certain changes to the rules set out in its Mortgages and Home Finance: Conduct of Business Sourcebook to accommodate the changes required by the directive.

You will find out more about the FCA's regulations in relation to mortgage advice and product sales in Topic 21. You can find out more about the Mortgage Credit Directive at: https://www.cml.org.uk/policy/policy-updates/all/european-mortgage-credit-directive/ [Accessed: 17 February 2020].

Another example of how EU directives affect the financial services sector is the changes to the deposit protection limits in the UK. Until 31 December 2015, the UK's Financial Services Compensation Scheme (FSCS) guaranteed deposits up to a maximum of £85,000 per depositor per institution. At the time the FSCS was established, £85,000 was the sterling equivalent of €100,000, the level of depositor protection provided for under the European Deposit Guarantee Schemes Directive. The directive requires that the sterling scheme is revalued every five years to make sure that the level of protection remains in line with the €100,000 provided for under the EU-wide scheme. In the UK the revaluation is carried out by the Prudential Regulation Authority (PRA). Changes in currency values meant that in January 2016, the level of protection under the FSCS was reduced to £75,000 per depositor per institution. Following the decision to leave the EU in June 2016, the value of sterling fell and the level of protection provided for deposits by the FSCS was restored to £85,000 in January 2017.

You will find out more about the FSCS in Topic 25. You can find out more about the European Deposit Guarantee Schemes Directive at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/deposit-guarantee-schemes_en [Accessed: 17 February 2020].

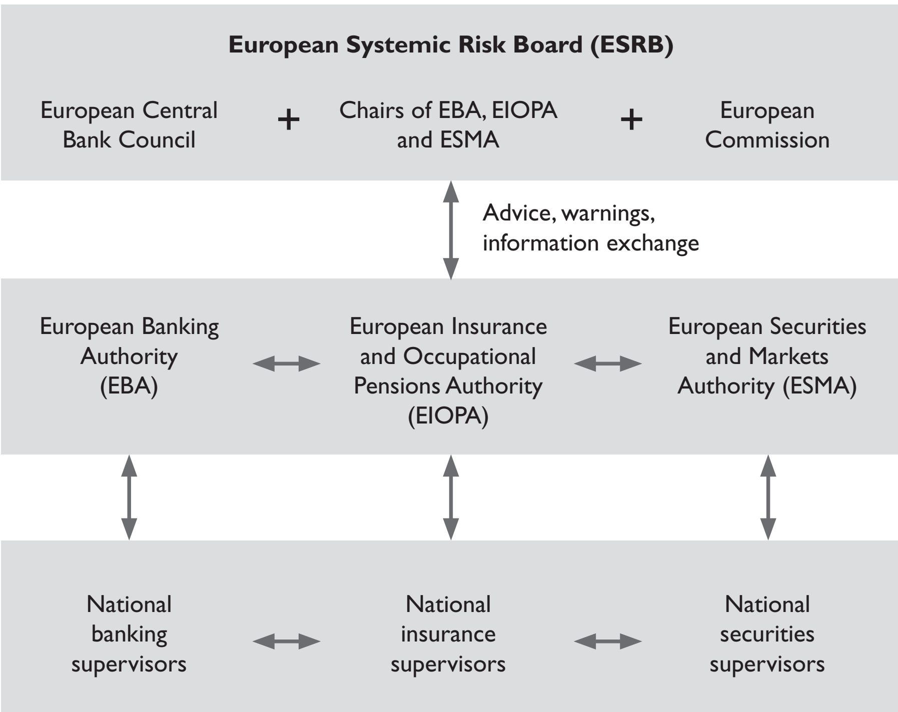
An example of an EU regulation that has implications for the financial services industry is the General Data Protection Regulation (GDPR). This has strengthened existing data protection rules and created a consistent set of data protection rules for citizens in the EU. It was adopted by the EU in April 2016, with full implementation in May 2018.

You will find out more about the regulations surrounding data protection in Topic 24. You can find out more about the General Data Protection Regulation at: https://ico.org.uk/for-organisations/guide-to-data-protection/guide-to-the-general-data-protection-regulation-gdpr/ [Accessed: 20 April 2020].

2.4.1 The European System of Financial Supervision

The financial crisis of 2007–09 exposed significant weaknesses in Europe's financial regulatory systems and highlighted the need for reform of virtually every area of EU-wide financial services. In response, the EU set up the European System of Financial Supervision (ESFS); its aim is to ensure consistent financial supervision across the member states.

FIGURE 2.4 THE EUROPEAN SYSTEM OF FINANCIAL SUPERVISION



Source: European Securities and Markets Authority (no date)

As Figure 2.4 indicates, the ESFS is decentralised, operating via three supervisory authorities and a network of national regulators. The European Supervisory Authorities (ESAs) are the:

- European Securities and Markets Agency (ESMA);
- European Banking Authority (EBA); and
- European Insurance and Occupational Pensions Authority (EIOPA).

The ESAs have significant powers to propose new rules and make decisions that are binding upon national supervisors, such as the FCA, and firms. The aims of the ESAs include:

- creating a single EU rule book by developing draft technical standards, which will then be adopted by the European Commission as law;
- issuing guidance and recommendations with which national supervisors and firms must comply;
- investigating national supervisory authorities that are failing to apply, or are in breach of, EU law;
- in a crisis, providing EU-wide co-ordination and, if an emergency is declared, making decisions that are binding upon national supervisors and firms;
- mediating in certain situations where national supervisory authorities disagree and, if necessary, making decisions that are binding on both parties to ensure compliance with EU law;
- conducting reviews of national supervisory authorities to improve consistency of supervision across the EU;
- considering consumer protection issues.

ESMA has direct supervisory responsibility for credit reference agencies.

Another key organisation is the European Systemic Risk Board. Its role is to prevent and mitigate systemic financial risk across the EU. Its responsibilities include:

- identifying and prioritising risks;
- issuing warnings and recommendations and monitoring their follow-up;
- co-operating with other members of the ESFS; and
- co-ordinating action with other international financial organisations, such as the International Monetary Fund (IMF).

2.4.2 The Single Supervisory Mechanism

The Single Supervisory Mechanism (SSM) is the name for the mechanism by which the European Central Bank holds responsibility for the supervision and monitoring of banks in EU member states.

The SSM provides a common approach to banking supervision. The ECB is supported by national regulators and it is the ECB that has the final decision on supervisory matters.

CHECK YOUR UNDERSTANDING

The European Union has issued a new regulation. This means that each member state:

a) has the choice whether or not to adopt the regulation.

b) must pass legislation to implement the regulation within two years.

c) is bound by the regulation in its entirety regardless of existing legislation.

d) has the choice of how to adopt the regulation's objectives.

2.5 What are the levels of regulatory oversight in the UK?

Regulation of the financial services industry in the UK is, broadly speaking, a five-tier process.

1) European legislation that impacts on the UK financial industry. The two main types of European legislation are regulations and directives (see section 2.4).

2) Acts of Parliament that set out what can and cannot be done. Examples of legislation that directly affect the industry are the Financial Services and Markets Act 2000 and the Financial Services Act 2012. The requirements set out in an Act of Parliament are often put into effect through subsidiary legislation known as statutory instruments.

3) Regulatory bodies that monitor the regulations and issue rules about how the requirements of the legislation are to be met in practice. The main regulatory bodies in the UK are the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

4) Policies and practices of the financial institutions themselves and the internal departments that ensure they operate legally and competently, eg the compliance department of a life assurance company.

5) Arbitration schemes to which consumers' complaints can be referred. In most cases, this is the Financial Ombudsman Service.

FIGURE 2.5 THE FIVE TIERS OF REGULATORY OVERSIGHT IN THE UK

Fifth Level
Arbitration schemes (eg Financial Ombudsman Scheme)

Fourth Level
Policies/practices of the financial institution (the bank's own procedures)

Third Level
Regulatory bodies (monitoring regulations and issuing rules and requirements)

Second Level
Acts of Parliament (eg Financial Services and Markets Act 2000)

First Level
European legislation (regulations and directives that impact on the UK financial services industry)

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- summarise the four key macroeconomic objectives?
- explain the difference between inflation, disinflation and deflation?
- explain how decisions made by the Monetary Policy Committee affect banks and consumers?
- describe the different effects of a budget surplus or deficit on employment?
- explain how an EU directive differs from a regulation in the way that it is applied?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

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Test your knowledge

?

Use these questions to assess your learning for Topic 2. Review the text if necessary.

Answers can be found at the end of this book.

1) What is meant by a 'macroeconomic objective'?

2) What are the four key macroeconomic objectives that UK governments generally seek to achieve?

3) What is a potential negative consequence of expanding economic growth to reduce unemployment?

4) All governments aim to achieve zero inflation. True or false?

5) What is the UK government's inflation target and how is it measured?

6) Disinflation means that:

   a) prices are rising faster than previously.

   b) prices are falling.

   c) prices are rising but more slowly than previously.

   d) prices are staying the same.

7) In June, the Monetary Policy Committee (MPC) decides to raise the Bank rate by half a percentage point. In August, Paul and Amanda's mortgage payments increase. Explain how these two events are likely to be linked.

8) Which of the following economic measures taken by a government would not help to achieve a budget surplus?

   a) Increasing taxation.

   b) Increasing public spending.

   c) Reducing public spending.

9) A new piece of EU legislation is being introduced. It is being implemented at the same time and in exactly the same way across all member states. This indicates that the legislation is in the form of:

   a) a directive.

   b) a regulation.

10) Which EU body is responsible for monitoring the financial system for systemic risk and taking steps to reduce it?

UK taxation I

LEARNING OBJECTIVES

In this topic we begin to look at the main taxes relevant to financial services in the UK, starting with income tax. In particular, we will look at income tax on earned income and savings. In later topics we will look at how income from investments such as shares and unit trusts is taxed.

By the end of this topic, you should have an understanding of:

- the concepts of residence, domicile and reciprocal tax treaties;
- income tax and how to work out taxable income;
- income tax bands and rates;
- the different ways in which employed and self-employed people pay tax;
- tax and allowances relating to savings and dividends;
- deduction of income tax at source;
- National Insurance contributions.

This topic covers Unit 1 syllabus learning outcomes U7.1, U7.2, U7.7 and U7.8.

THINK . . .

This is probably an aspect of financial services that is only too familiar to you! Everyone in the UK who has an income – whether from earnings, property, savings or investments – has to consider whether they are liable for income tax.

- If you are employed, have a look at your most recent pay slip to see the difference between your gross and net pay and what deductions were made for income tax and National Insurance.
- If you are currently self-employed, you might be familiar with the self-assessment system, under which you potentially pay income tax twice a year.

- You might have seen media coverage around the time of the Chancellor's annual Budget statement, discussing the likelihood of a rise in income tax rates.

3.1 Tax legislation

The main statute relating to taxation is the Income and Corporation Taxes Act 1988 but there are other sources of tax law. Some of these take the form of statutes (ie legislation passed by Parliament), while others are case law (ie law established by the decisions made by judges in court cases).

Each year, following delivery of the Budget, a Finance Bill is published containing the government's taxation proposals. When the Bill is approved by Parliament and becomes a Finance Act it becomes law, the new tax measures take effect at the dates set out in the legislation.

The new Act (a Bill that has gone through Parliament and has received Royal Assent) becomes a part of the substantial body of legislation that relates to income tax and other taxes. In the UK, a tax year (also known as a fiscal year) runs from 6 April in one calendar year to 5 April in the next.

3.2 What are residence and domicile?

Whether or not a person is liable to pay income tax, capital gains tax and inheritance tax will depend on their residence or domicile according to UK law.

3.2.1 Residence

Residence mainly affects income tax and capital gains tax. Any person who is present in the UK for at least 183 days in a given tax year is regarded as automatically UK resident for tax purposes. Where someone is not resident for at least 183 days in a tax year, the statutory residence test is applied (unless they are regarded as automatically not UK resident). This determines whether or not they will be treated as resident for a particular tax year. The nature and conditions of the tests are complex.

A person who is resident and domiciled in the UK will be subject to UK income tax on their worldwide earned and unearned income, whether or not such income is brought into the UK. Similarly, capital gains tax is charged on the realisation of gains anywhere in the world. (There are separate, more complicated rules for those who are UK resident but not UK domiciled.)

The UK, however, has reciprocal tax treaties (more commonly known as double taxation agreements) with many other countries, the purpose of which is to ensure that individuals are not taxed in full twice on the same income or gains. Some income will only be taxed in one of the two countries covered by the agreement. In other cases, income will be taxed in both countries but, for a UK resident, any overseas tax that has been paid will be deducted from the UK tax liability. Such reciprocal tax treaties often contain agreements to exchange information in order to combat tax evasion.

KEY TERMS

CAPITAL GAINS TAX

Tax payable on the gain made when certain assets (eg personal property above a specific value, or business assets) are disposed of, usually by selling them.

EARNED INCOME

Income from employment or self-employment (profits, salary, tips, commission, bonuses and pension benefits).

UNEARNED INCOME

Income that is not derived from employment or self-employment (interest/dividends from investments, rental income, trust income, etc).

3.2.2 Domicile

Domicile is best described as the country that an individual treats as their home, even if they were to live for a time in another country. Everyone acquires a domicile of origin at birth. This is the domicile of their father on the date of their birth (or the domicile of the mother if the parents are not married).

A person can change to a different domicile (known as domicile of choice) by going to live in a different country, intending to stay there permanently and showing that intent by generally 'putting down roots' in the new country and severing connections with the former country. There is no specific process for this.

WHY IS DOMICILE IMPORTANT?

Domicile mainly affects liability to inheritance tax (IHT).

If a person is domiciled in the UK, inheritance tax is chargeable on assets anywhere in the world, whereas for persons not domiciled in the UK, tax is due only on assets in the UK.

People who are not UK-domiciled but have been resident in the UK for tax purposes in at least 15 of the previous 20 tax years are deemed to be UK-domiciled for inheritance tax purposes.

We will look at inheritance tax in more detail in Topic 4.

CHECK YOUR UNDERSTANDING 1

Which of the following people would be most likely to be a 'UK resident'?

a) Susan, who normally lives in Spain but spends three months a year working for the family business in England.

b) Antoine, a French surveyor, whose eight-month contract in Devon with a construction company started in May.

c) Max, who moved to London from Cologne on 6 January for a seven-month teaching contract.

d) Brenda, who spends 180 days a year in the UK and the remainder in the USA.

CHECK YOUR UNDERSTANDING 2

Which of the following will **not** be subject to UK inheritance tax upon death?

a) UK property owned by Paolo, who has lived in the UK for three years but is not UK domiciled.

b) Overseas property owned by Kavita, who was born in the US (to American parents) but has lived in the UK for the past 18 years.

c) Overseas property owned by Helena, who is UK resident but not UK domiciled nor deemed domiciled.

d) Overseas property owned by David, who is UK domiciled but resident in France.

3.3 Taxable income

Income tax is one of the main sources of government revenue. Liability for income tax is based on income received in a tax year.

Income tax is due from individuals on their income from employment (including benefits in kind, such as company cars), self-employment, pension income, rental income and also on interest and dividends they receive from investments. All UK residents, including children, may be subject to income tax, depending on the type and amount of income they receive.

The income of a child that arises from a settlement or arrangement made by the parents is normally treated as the parents' income for tax purposes. In this situation, the child's unused allowances cannot be set against this income.

Not all of the income that an individual receives is taxable. Examples of types of income that are taxable and those that are not are given here.

Income **assessable** to tax includes:	Income **not assessable** to tax includes:
▪ salary/wages from employment, including bonuses and commissions, and taxable benefits in kind; ▪ pensions and retirement annuities, including state pension benefits; ▪ profits from a trade or profession; ▪ inventor's income from a copyright or patent; ▪ tips; ▪ interest on bank and building society deposits; ▪ dividends from companies; ▪ income from government stocks, local authority stocks and corporate bonds; ▪ income from trusts; ▪ rents and other income from land and property; ▪ the value of benefits in kind, such as company cars or medical insurance.	▪ redundancy payments and other compensation for loss of office (if total receipts exceed £30,000, then the excess is assessable. Any payment in lieu of notice is fully taxable); ▪ the first £3,600 of shares given to an employee in their employer's company as part of a Share Incentive Plan; ▪ interest on NS&I Savings Certificates; ▪ income from ISAs (in most circumstances); ▪ certain covenanted or Gift Aid payments; ▪ proceeds of a qualifying life assurance policy; ▪ casual gambling profits (eg football pools); ▪ lottery prizes; ▪ wedding presents and certain other gifts from an employer that are not given in return for service as an employee; ▪ certain retirement gratuities paid by an employer (within limits); ▪ any scholarship or other educational grant that is received if one is a full-time student at school, college, etc; ▪ certain grants received from an employer solely because an individual has passed an examination or obtained a degree or diploma (certain criteria need to be satisfied); ▪ war widows' pensions; ▪ certain state benefits; ▪ housing grants paid by local authorities; ▪ the capital part of a purchased life annuity (but not the interest portion); ▪ interest on a tax rebate.

CHECK YOUR UNDERSTANDING 3

On which of the following would a child be subject to income tax?

a) All earned income.

b) An educational grant.

c) Any earned income that exceeds their personal allowance.

d) A settlement from their parents.

!

KEEPING UP TO DATE

The rules relating to tax change very frequently and it is essential that you, as a financial services professional, keep up to date.

The rates, allowances and other taxation arrangements described in the remainder of this topic relate to the 2020/21 tax year and are provided for illustrative purposes only. You can find the latest information about tax at https://www.gov.uk/browse/tax [Accessed: 17 February 2020].

3.3.1 Allowances

All UK residents, including children from the day of their birth, have a personal allowance, ie an amount of income that can be received each year before income tax begins to be charged.

- **Personal allowance** – in the 2020/21 tax year, the personal allowance is £12,500. People whose annual income exceeds £100,000 have a restricted personal allowance. The allowance is reduced by £1 for every £2 they earn above the £100,000 limit.
- **Marriage allowance** – it is possible for spouses and civil partners to transfer up to 10 per cent of the basic personal allowance, providing the transferor is not liable to income tax, and the recipient is not liable to income tax at the higher or additional rate.
- **Married couple's allowance** – this allowance is available if one partner in a marriage or civil partnership was born before 6 April 1935. In 2020/21, the minimum amount is £3,510, and the maximum is £9,075 but the relief is limited to 10 per cent. This means that a couple's tax bill could be reduced by between £351 and £907.50.

- **Blind person's allowance** – this allowance of £2,500 is available to those registered as blind with a local authority for the 2020/21 tax year. If the allowance cannot be used by the individual, it can be transferred to their spouse or civil partner.
- **Personal savings allowance (PSA)** – this enables savers to receive a certain amount of interest tax-free. For the 2020/21 tax year, the first £1,000 of savings interest is tax-free for basic-rate taxpayers. The first £500 of savings interest is tax-free for higher-rate taxpayers and there is no tax-free interest allowance for additional-rate taxpayers.
- **Dividend allowance (DA)** – where an individual's aggregate dividend income in a tax year falls within the DA, no tax is payable. In the 2020/21 tax year the DA is £2,000.
- **Allowances for property and trading income** – so-called 'micro-entrepreneurs' who supplement their main income with property or trading income are entitled to an additional allowance. There are two separate allowances of £1,000, one for trading income and one for property income. The allowances apply to those who, for example, make small amounts of money by selling on e-bay or by renting a room in their house or a parking space. If trading/property income is less than £1,000 then no tax is payable on that income; if more than £1,000 then the individual has the choice to either deduct the allowance from trading/property income or calculate profit in the usual way and deduct allowable expenses.

FACTFIND

For the latest rates and allowances, check:

https://www.gov.uk/income-tax-rates [Accessed: 17 February 2020].

3.3.2 Deductions

In addition to these allowances, taxpayers are permitted to make certain deductions from their gross income before their tax liability is calculated.

These deductions include:

- **certain pensions contributions** – (within specified limits), for example a scheme set up by an employer;
- **certain charitable contributions**;
- **allowable expenses** – such as costs incurred in carrying out one's employment.

For self-employed people, allowable expenses can only be incurred "wholly and exclusively for the purpose of trade", while for employed persons they must be incurred "wholly, exclusively and necessarily" while doing the job.

When all the relevant deductions have been made from a person's gross income, what remains is their taxable income. This is the amount to which the appropriate tax rate(s) is applied in order to calculate the tax due.

3.3.3 Income bands and tax rates

Income tax rates and the bands of income to which they apply are reviewed by the government each year. Any changes are announced in the Budget and included in the subsequent Finance Act.

As an example, the rates and bands for most of the UK for 2020/21 are as follows.

		Income band (£)
Basic rate	20%	0–37,500
Higher rate	40%	37,501–150,000
Additional rate	45%	150,001+

In addition, there is a starting-rate band of £5,000 for those who receive savings income, including interest from bank and building society accounts; the tax rate on this band is nil. Section 3.4.4 explains how the starting-rate band works.

In Scotland, different rates and bands of income tax are applied.

If someone's income comes from different sources, there is a set order in which income tax is applied. First, tax is calculated on non-savings income, such as earned income, self-employed net profits, pension income and rent received. Second, it is applied to savings income, ie interest received. Third, income tax is calculated on dividends.

Finally, any chargeable gains on non-qualifying life assurance policies are brought into the calculation.

3.4 Paying income tax

3.4.1 Income taxed at source

In some cases, HMRC collects income tax at source, ie from the person who makes the payment, not the recipient.

An example of where tax is deducted at source is PAYE (see section 3.4.2). Employers deduct tax weekly or monthly (as appropriate) from wages and salaries, which are then paid to the employee net of tax.

Some other types of income are taxed at source, such as income from certain trusts.

3.4.2 How do employees pay income tax?

Employees pay income tax under the pay-as-you-earn (PAYE) system. Employers use tables supplied by HM Revenue & Customs (HMRC) to calculate the tax due from each employee; they then deduct the appropriate amount from their wages or salary and pass it to HMRC. In order to deduct the right amount of tax, the employer is supplied with a tax code number for each employee: the tax code relates to the amount that the employee can earn without paying tax, taking account of allowances, exemptions, and adjustments for taxable employee benefits (commonly referred to as benefits in kind) and for amounts overpaid or underpaid from previous years.

A P60 is issued to each employee by the employer in May each year. This shows, for the previous tax year, total tax deducted, National Insurance contributions (NICs) and the final tax code.

On leaving an employer, an employee should be provided with a form P45 showing their name; district reference; code number; week or month of last entries on the employee's deductions working sheet; total gross pay to date and total tax due to date. A copy is sent to HMRC. The P45 provides the new employer with all the information they require to complete a new tax deductions working sheet for the employee.

%

INCOME TAX LIABILITY – EMPLOYEE

Saira (24) is employed. She has a salary of £27,430. Her personal allowance is £12,500.

Income:	£27,430
Less personal allowance:	£12,500
Taxable income:	£14,930
	£14,930 x 20% = **£2,986**

Saira's employer will collect this tax monthly under the PAYE scheme.

3.4.3 How do self-employed people pay income tax?

People who are self-employed (including partners in a business partnership) pay income tax directly to HMRC on the basis of a declaration of net profits calculated from their accounts. For a self-employed person, net profits are broadly the equivalent of the gross income of an employee, ie they are the amount on which income tax is based. They are calculated by taking the total income of the business and deducting allowable business expenses and capital allowances.

Taxpayers are expected to calculate their own liability and submit their figures to the tax authority for approval (although taxpayers who submit their returns promptly can ask HMRC to do the calculation for them). This process is called self-assessment. Some self-employed people use an accountant to prepare their accounts and to deal with HMRC on their behalf.

Self-employed people pay their income tax and Class 4 NICs in two equal parts. The first payment is due on 31 January of the tax year in which their business year ends; the second is due on 31 July, six months later. Any under or overpayment is then rectified on the 31 January following the end of the tax year. Class 2 NICs are also due in one lump sum on this date.

Self-assessment may apply to (among others):

- the self-employed;
- those with investment income in excess of relevant allowances;
- those who receive rental income from land and property in the UK;
- trustees;
- personal representatives of deceased persons.

%

INCOME TAX LIABILITY – SELF-EMPLOYED

Michael (36), who is based in Wales, is self-employed with gross profits of £240,000. His allowable business expenses are £40,000. His personal allowance would have been £12,500 but because his income is so high, the allowance is reduced by £1 for every £2 that his income exceeds the £100,000 threshold. As a result the personal allowance is reduced to nil.

Income	£240,000
Less allowable deductions	–£40,000 (business expenses)
Net profits	£200,000
Taxable income	£200,000
Taxable income broken into tax bands:	
	£37,500 x 20% = £7,500
	£112,500 x 40% = £45,000
	£50,000 x 45% = £22,500
Income tax due	**£75,000**

As Michael is self-employed, he will calculate his own tax and pay HMRC in instalments.

3.4.4 How do people pay tax on their savings and investment income?

As well as paying tax on their income from employment, people also have to pay tax on the income they get from their savings.

Since 6 April 2016, interest on deposits has been paid gross to all customers, and individuals have to advise HMRC to deduct tax via their tax code, or pay via self-assessment.

For those on low incomes a starting rate of 0 per cent applies to the first £5,000 of savings income. However, for every £1 of taxable non-savings income, the starting-rate band reduces by £1. Therefore, if someone has non-savings income of £13,500 in 2020/21, they have taxable non-savings income of £1,000 (£13,500 less the £12,500 personal allowance), so their starting-rate band is reduced to £4,000 (£5,000 – £1,000).

The starting rate, therefore, does not apply where income exceeds an individual's personal allowance plus the starting-rate band of £5,000.

Additionally there is a personal savings allowance (PSA) of £1,000 for basic-rate taxpayers and £500 for higher-rate taxpayers: savings income falling within these limits is subject to 0 per cent tax. In calculating eligibility for the PSA, all of an individual's income is taken into account in assessing whether they are a basic- or higher-rate taxpayer.

This is probably best explained with an example of three individuals, who each have savings income of £2,500 but have different levels of earned (non-savings income).

%

APPLYING THE STARTING-RATE BAND AND PSA

Jamie

Earned income	£12,650
Taxable earned income (£12,650 – £12,500 personal allowance)	£150
Savings income	£2,500
Savings income falls within starting-rate band and total income is less than £17,350 (£12,500 plus the available starting-rate band of £4,850)	
Tax due on savings income	Nil

Roisin

Earned income	£29,500
Taxable earned income (£29,500 – £12,500 personal allowance)	£17,000
Savings income	£2,500
No starting-rate band as total income is above £17,500	
Total earned and savings income is within the basic-rate tax band so Roisin is eligible for a PSA of £1,000	
Thus £1,000 of her savings income is subject to 0% tax and £1,500 of her savings income is taxable at 20%	
Tax due on savings income	£1,500 x 20% = **£300**

Jodie	
Earned income	£49,000
Taxable earned income (£49,000 – £12,500 personal allowance)	£36,500
Savings income	£2,500
There is no starting-rate band as total income is greater than £17,500	
Total income is £51,500 (£49,000 + £2,500) meaning Jodie pays higher-rate tax. She is eligible for a PSA of £500, so the first £500 of her savings income is subject to 0% tax	
Her taxable earned income is £36,500	
£500 of her savings income is subject to 0% tax. A further £500 falls within the remaining basic-rate tax band (£37,500 – £36,500 – £500 = £500)	
The balance of £1,500 is in the higher-rate tax band	
Tax due on savings income	£500 x 0%
	£500 x 20% = £100
	£1,500 x 40% = £600
	Total = **£700**

In general, savings income will fall into one of two categories:

- **Tax-free** – including income from ISAs and some National Savings and Investments accounts.
- **Paid gross without deduction of tax but subject to tax in the hands of the individual** – including interest from bank and building society accounts – if in excess of the personal savings allowance.

People may also receive dividend income, from shares, investment trusts and equity-based unit trusts/open-ended investment companies. Dividends are paid without deduction of tax. If dividend income exceeds the dividend allowance (£2,000 in 2020/21), it is taxed at different rates depending on the tax band into which it falls. For example, in 2020/21 the rates are:

- 7.5 per cent on dividend income falling in the basic-rate tax band;
- 32.5 per cent on dividend income falling in the higher-rate tax band;
- 38.1 per cent on dividend income falling in the additional-rate tax band.

IN BRIEF

The calculation of personal liability to income tax is broadly a four-stage process.

1) Work out the total income.
2) Make appropriate deductions, eg allowable expenses or certain pension contributions.
3) Deduct the personal allowance and other reliefs (eg blind person's allowance) to arrive at the taxable income.
4) Apply tax at the current rates to the appropriate bands of income.

Remember:

If a person's income comes from several different sources, it is taxed according to a set order of priority:

1) Non-savings income.
2) Savings income.
3) Dividends.
4) Chargeable gains on a non-qualifying life assurance policy.

3.5 Charitable giving

Making gifts to charity can be beneficial for the charity and reduce an individual's income tax liability.

3.5.1 Gift Aid

When a gift is made using Gift Aid, the charity can recover the basic-rate tax (20 per cent) that is assumed to have been paid on the amount of the gift, increasing the value of the net gift by 25 per cent. For example, a gift of £80 is treated as a £100 as it comes from income that has already been taxed on the individual. The donor pays £80 and the charity reclaims £20 from HMRC in order to receive £100. Effectively, this is an uplift of 25 per cent (as £20 is 25 per cent of £80).

The donor making the gift has their basic- and higher-rate tax thresholds extended by the value of the gross gift.

%

The following example uses the income tax bands and rates for 2020/21.

Ruben is a higher-rate taxpayer who makes a gift of £800.

The gross value of the gift is £800 ÷ 0.8 = £1,000.

As a result of making the gift, Ruben's basic-rate income tax band is extended by £1,000 to £38,500.

3.5.2 Payroll giving

This enables employees to make tax-efficient gifts by having a charitable gift deducted from their salary before income tax is charged. By making a gift in this way, tax relief is granted on the value of the gift at the individual's highest rate of income tax. So, someone who earns £60,000 annually and gives £1,000 to charity via payroll will only be deemed to have a gross income of £59,000.

3.6 National Insurance contributions

National Insurance contributions are a form of taxation in everything but name. They are in effect a tax on earned income and are payable in different ways according to whether the earner is employed or self-employed.

They are classified as follows.

CLASS 1

- Paid by employees at 12 per cent on earnings between certain levels, known as the primary threshold and the upper earnings limit with a reduced level of 2 per cent payable on earnings above the upper limit.
- They are also paid by employers at 13.8 per cent on most employees' earnings above a lower limit called the secondary threshold – but with no upper limit.
- No employer NICs are paid in respect of employees aged under 21 and apprentices under 25 on earnings between the primary threshold and the upper earnings limit.

CLASS 2

- Flat-rate contributions paid by the self-employed if their annual profits exceed the small profits threshold.
- They are quoted as a weekly amount.
- They are collected through self-assessment.

CLASS 3

- Voluntary contributions that can be paid by people who would not otherwise be entitled to the full state pension or sickness benefits.
- This can occur because a person has, for instance, taken a career break or spent some time working overseas.
- They are flat-rate contributions.

CLASS 4

- Additional contributions payable by self-employed people on their annual profits between specified minimum and maximum levels, with a reduced rate payable above the upper limit, as for Class 1.
- They are paid to HMRC in half-yearly instalments by self-assessment.

FACTFIND

For current rates and thresholds, go to:

https://www.gov.uk/national-insurance/how-much-you-pay [Accessed: 17 February 2020].

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the difference between residence and domicile?
- name three sources of income that are assessable to tax and three that are not?
- explain who issues individuals with their tax code and how the tax code is used?
- describe how a self-employed person pays income tax?
- explain how the starting-rate band and personal savings allowance work?
- outline the different classes of National Insurance contributions?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 3. Review the text if necessary.

Answers can be found at the end of this book.

1) A person who is UK resident for tax purposes only pays income tax on earnings generated in the UK. True or false?
2) A person may become UK domiciled once they have been settled in the country for a number of years. True or false?
3) Which of the following is **not** assessable for income tax purposes?
   a) Tips.
   b) Interest from bank and building society deposits.
   c) Lottery prizes.
   d) Rents from land and property.
4) In what order of priority is income taxed?
5) Blind person's allowance can be transferred to a spouse or civil partner if the blind person does not use the allowance. True or false?
6) Emma worked abroad for five years but is now back working in the UK. What class of National Insurance contributions could she pay to improve her contribution record for the state pension?

For the following questions, use the tax rates, bands and allowances for 2020/21.

7) Mike earns £22,000. He also receives £500 interest on his savings from a building society deposit account. Calculate the income tax payable.
8) Roopa is a company director. In 2020/21 she draws a salary of £12,500. She has dividend income of £27,000. Calculate the income tax payable.
9) Jemma is self-employed and is in receipt of blind person's allowance. In 2020/21, her gross profit is £20,000 and she has allowable expenses of £2,500. She has to pay Class 4 NICs at 9 per cent on her taxable profit above £9,500. Calculate the income tax and Class 4 NICs payable.
10) Ashok's salary is £75,000 and he is paid savings interest of £650. He also has dividend income of £7,000. Calculate the income tax payable.

TOPIC 4

UK taxation II

LEARNING OBJECTIVES

In Topic 3 we focused on income tax and National Insurance. In this topic our focus turns to other taxes, particularly capital gains tax and inheritance tax.

By the end of this topic you should have an understanding of:

- capital gains tax and the reliefs available;
- inheritance tax, potentially exempt transfers and chargeable lifetime transfers;
- how to calculate liability to capital gains tax and inheritance tax;
- value-added tax (VAT);
- the different forms of stamp duty;
- corporation tax;
- withholding tax.

This topic covers the Unit 1 syllabus learning outcomes U7.3–U7.6.

THINK ...

Some of the taxes in this topic might be less familiar to you than income tax but you might already be aware of others.

For instance:

- You have paid VAT on goods and services. If you are self-employed, you might have had to register for VAT if your turnover is above the VAT threshold.
- If you have ever bought a property, you might have had to pay stamp duty land tax on the purchase.
- If you have ever sold a valuable item of personal property, you might have had to pay capital gains tax on it.

- You might have thought about inheritance tax and how to minimise any liabilities for it.

4.1 What is capital gains tax?

Capital gains tax (CGT) is payable on a gain made on the disposal of certain assets. Examples include:

- personal property worth more than £6,000;
- a property or land that is not the individual's main home;
- the individual's main home if it has been let out or used for business, or if it is very large;
- the sale of shares, if they are not held in an ISA;
- business assets, such as land, buildings, machinery or registered trademarks.

The tax is payable on net gains made in the tax year, after deducting any allowable capital losses that were made in the same year or carried forward from previous years.

Each individual has an annual CGT allowance, referred to as the annual exempt amount; rather like the personal income tax allowances, this is the level of gains that can be made in the tax year before CGT starts to be payable. For example, in 2020/21 the annual exempt amount is £12,300.

The full CGT allowance also applies to a bare trust (which has a specified beneficiary who will have absolute entitlement to assets at 18), trustees of a trust for a vulnerable beneficiary, and to personal representatives. A maximum of half the amount (£6,150) applies to the trustees of most other types of trust. The annual exempt amount cannot be carried forward to subsequent years if it is unused in the year to which it applies.

DISPOSAL

For CGT purposes, a disposal can be the sale of an asset, transferring ownership to another party, giving it away, or receiving compensation for its loss or destruction.

'BED AND BREAKFASTING'

One constant source of complaint about the capital gains tax regime is that CGT is due on the whole gain in the year in which the gain is realised, even where that gain has actually been made over a longer period. This means that only one annual exempt amount can be set against what may be many years' worth of gain.

In the past, some holders of shares and unit trusts sought to minimise the effect of this by selling their holding each year and repurchasing it the following day, thus realising a smaller gain that could be covered by that year's allowance. This was known as 'bed and breakfasting'.

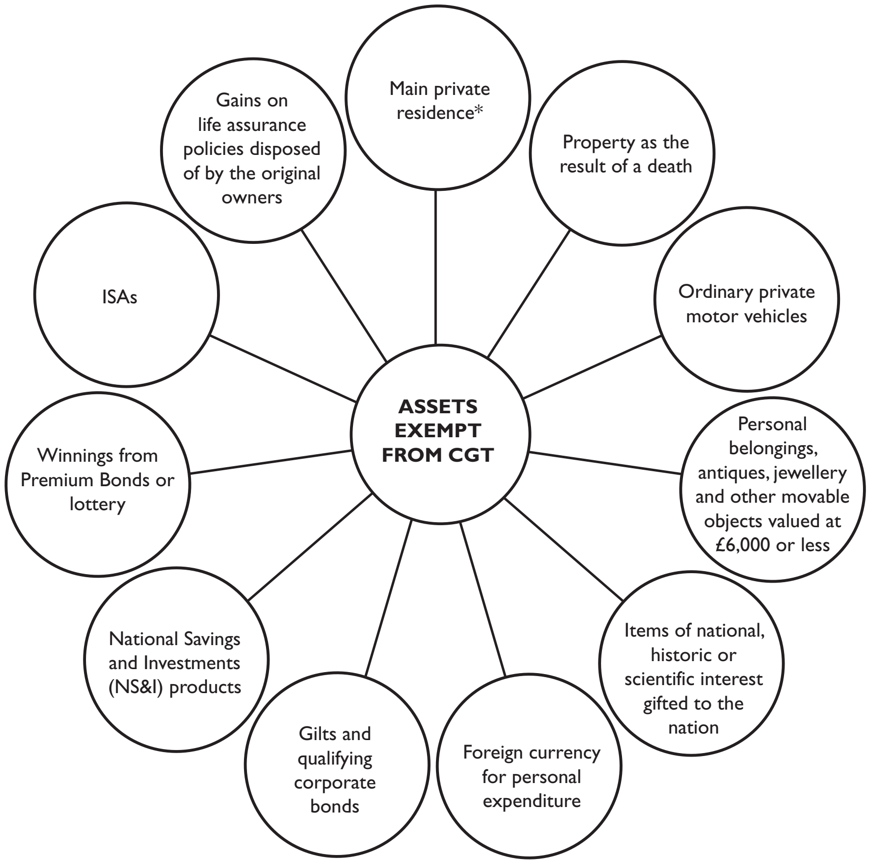
'Bed and breakfasting' was effectively outlawed in the 1998 Budget. Since then, any shares and unit trusts that are sold and repurchased within a 30-day period are treated, for CGT purposes, as if those two related transactions had not taken place.

4.1.1 What kinds of asset are exempt from CGT?

There are some circumstances in which CGT is not due (see Figure 4.1). In particular, it is not payable when property changes hands as the result of a death (although there may be inheritance tax to pay – see section 4.2).

There is a deemed disposal of assets on death, when the assets are deemed to be acquired by the personal representatives at their market value at the time of death. This is to establish the cost of acquisition, so that if the person who inherits the asset later decides to dispose of it, it is possible to work out the gain since the time of inheritance, and thus calculate the CGT due at that point.

FIGURE 4.1 ASSETS EXEMPT FROM CGT



* Subject to private residence relief

CGT applies to gains made since 6 April 2015 by individuals or trustees who are not UK resident on residential property located in the UK. Gains made during ownership prior to this date are ignored.

Gains that accrue to non-UK residents on non-residential property have been subject to tax since 6 April 2019.

A non-resident individual might still be able to claim private residence relief (see section 4.1.4) if they live in the property for at least 90 days during a tax year.

4.1.2 What happens if a loss is made on disposal of an asset?

If an individual makes a loss on disposal of an asset, the loss can generally be offset against gains made elsewhere. It must be offset first against gains in the year the loss occurred. Residual losses may then be carried forward to future years. A capital loss cannot, however, be carried back to a previous year.

Given that capital losses can be carried forward but the annual exempt amount cannot, capital losses brought forward are used only to the extent necessary to reduce gains to the level of the annual exempt amount. Residual losses are then carried forward.

4.1.3 How is CGT calculated?

The rules relating to calculation of taxable gains include the following:

- The costs of purchase can be added to the purchase price and selling costs can be deducted from the sale price (thus reducing the size of the gain).
- The cost of improvements to an asset can be treated as part of its purchase price (but costs of maintenance and repair cannot).
- Capital gains made prior to 31 March 1982 are not taxed so, for an asset acquired before that date, its value on that date must be substituted for the actual purchase price.
- CGT is charged on gains arising from disposals in the period 6 April in the current tax year to 5 April in the following year.
- It is normally payable on 31 January following the end of the tax year in which the gain is realised. For example, CGT for 2020/21 would normally be payable on 31 January 2022.
- Details of chargeable assets disposed of during the tax year must be included in an individual's tax return.

IN BRIEF

Calculating CGT liability involves the following:

1) Calculate the amount of the gain.
2) Deduct the CGT annual exempt amount (if this has not been used against other gains in the same tax year).
3) Deduct any losses that can be offset against the gain.
4) What remains is the taxable gain.
5) Add taxable gain to taxable income to establish what rate(s) of CGT should be paid.
6) Apply tax at appropriate rates. In 2020/21, for example, the rates are: 10 per cent for taxable gains falling in the basic-rate income tax band; 20 per cent otherwise, with an 8 per cent supplement where the gain results from the sale of property not subject to private residence relief.

Check the current tax rates and allowances at: https://www.gov.uk/capital-gains-tax [Accessed: 12 October 2020].

CAPITAL GAINS TAX

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Vanessa, who earns £15,000 per year and is a basic-rate taxpayer, bought units in a unit trust for £49,900 in May 2009 and sold them for £80,900 in June 2020. At the same time she sold some shares for £10,000 that she had bought for £12,000.

What capital gains tax will she pay? (*Note*: this calculation uses the tax rates and allowances for the 2020/21 tax year.)

Gain on unit trust	£31,000
£80,900 sale price – £49,900 purchase price	
Deduct loss on shares	(£2,000)
	£29,000
Deduct annual exempt amount	(£12,300)
Taxable gain	£16,700
Tax @ 10%	£1,670

4.1.4 What reliefs are available?

Private residence relief

Private residence relief is available when someone sells the property they have lived in as their main or only residence. The 'main residence' does not have to be a house or flat – it could be a houseboat, or a fixed caravan. If someone has more than one property and shares their time between each, they may nominate the property on which they want to claim private residence relief.

There are rules relating to how long an individual may spend away from the property and still be eligible for the full relief. For example, if someone owns a house but spends part of the year living away in accommodation provided with their job, the house is treated as their main residence for private residence relief purposes.

There are also rules relating to the use of the property for business purposes and to the size of the garden on which full relief can be claimed.

FACTFIND

To find out more about private residence relief, go to:

https://www.gov.uk/government/publications/private-residence-relief-hs283-self-assessment-helpsheet/hs283-private-residence-relief-2018 [Accessed: 17 February 2020].

Entrepreneurs' relief

A lower rate of 10 per cent is applied to a lifetime limit of £1m of cumulative gains arising from the disposal of trading businesses and from certain disposals of shares in trading companies. This is commonly known as entrepreneurs' relief. In order to claim this relief, the individual must generally own at least 5 per cent of the ordinary share capital of the business, which enables them to exercise at least 5 per cent of the voting rights in that company. In addition, they must also be entitled to at least 5 per cent of the distributable profits and net assets of the company. Most property letting businesses do not qualify for this relief. Entrepreneurs' relief also applies to gains resulting from investment into unlisted companies.

Roll-over relief

Business assets are chargeable to CGT. However, roll-over relief may be claimed if the assets disposed of are replaced by other business assets. This means that, instead of CGT falling due on the original disposal, it is deferred until a final disposal is made.

The replacement asset must be bought within a period of one year before and three years after the sale of the original asset.

Relief can be claimed up to the lower of either the gain or the amount reinvested.

Hold-over relief

Similarly, CGT on any gain arising on the gift of certain assets can normally be deferred until the recipient disposes of it.

Gains may be wholly or partly passed on to the recipient in the case of gifts (or sale at under value) of the following broad categories of assets:

- assets used by the donor in their trade or the trade of their family company or group;
- shares in the transferor's personal company or in an unlisted trading company;
- agricultural property that would attract relief from inheritance tax;
- assets on which there is an immediate charge to inheritance tax.

FACTFIND

To find out more about CGT, go to: https://www.gov.uk/capital-gains-tax [Accessed: 12 October 2020].

4.2 What is inheritance tax?

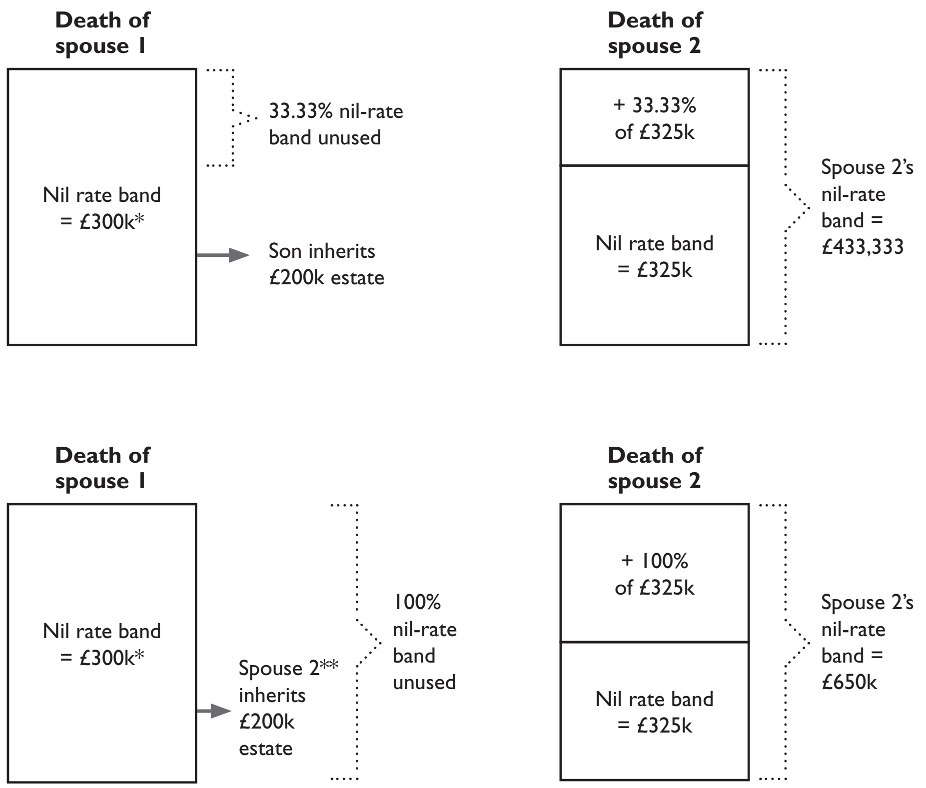
Inheritance tax (IHT), as its name suggests, is levied mainly on the estates of deceased persons and is charged following an individual's death. The tax is charged on the amount by which the value of the estate exceeds the available nil-rate band at the date of death.

NIL-RATE BAND

The amount on which a nil rate of IHT applies; in other words, the amount is liable to tax but the rate that applies is 0 per cent.

Surviving spouses and civil partners can increase their own nil-rate band by the proportion of unused nil-rate band from the earlier death of their spouse/civil partner.

FIGURE 4.2 TRANSFERRING UNUSED PORTIONS OF THE NIL-RATE BAND



* In the example above the nil-rate band was £300,000 when spouse 1 died.

**Transfers between spouses and civil partners are exempt from IHT.

In order to prevent avoidance of tax by 'death-bed' gifts or transfers, the figure on which tax is based includes not only the amount of the estate on death but also the value of any money or assets that have been given away in the seven years prior to death.

4.2.1 Residence nil-rate band (RNRB)

The IHT threshold has been frozen until the tax year 2020/21. So the thresholds of £325,000 up to £650,000 apply to deaths from 6 April 2009 to 5 April 2021.

If part of the estate includes a residence that is being left to a direct descendant, then since 2017/18 an additional residence nil-rate band has been applied. That was £100,000 in 2017/18 and is rising by £25,000 a year to £175,000 in 2020/21. This is in addition to the nil-rate band.

- For 2017/18, the value of the RNRB was £100,000.
- For 2018/19, the value of the RNRB was £125,000.
- For 2019/20, the value of the RNRB was £150,000.
- For 2020/21, the value of the RNRB is £175,000.
- From tax year 2021/22, the RNRB will be increased in line with the Consumer Prices Index (CPI).

The RNRB can be used on death against the value of a property owner's interest in property that, at some point, they occupied as a residence and where the interest in the property is bequeathed to a direct descendant. The property need not have been the individual's main residence.

Where the RNRB is unused, in full or in part on death, the unused balance can be carried forward for use upon the death of a surviving spouse or civil partner. As with the main nil-rate band, it is the unused percentage that is carried forward rather than the unused value. For example a married man dies in 2020/21 and leaves his share in the residence he co-owns with his wife to his children. His share in the residence is valued at £125,000. The balance of his estate is left to his wife. The RNRB can be used in respect of the share of the property left to the children. Only 71.43 per cent of the RNRB has been used at this stage (£125,000 ÷ £175,000), so 28.57 per cent is available to potentially be used on the widow's subsequent death. Carrying forward the percentage of the RNRB unused on the first death is allowed even if the spouse or civil partner of the individual died before the introduction of the RNRB.

This means that the maximum amount exempt from IHT between married couples or civil partners is effectively £1m (ie £175,000 × 2RNRB and £325,000 × 2NRB).

For example, Samir dies in July 2020 leaving an estate of £1m which is made up of the house he lived in, valued at £650,000, and investments with a value of £350,000. Samir was pre-deceased by his wife who died in 2014; she did not use any of her IHT allowances.

100 per cent of the RNRB was unused when Samir's wife died so a total RNRB of £350,000 is available on his death: £175,000 in respect of Samir's wife and £175,000 in respect of Samir.

The RNRB is used against the property leaving £300,000 (£650,000 less £350,000) within the estate. The total remaining estate is therefore £700,000 and the nil-rate band of £650,000 from his wife and himself can be offset against this to leave £50,000 subject to inheritance tax.

If Samir had been single and leaving his property to lineal descendants, the calculation would be £1m estate less £175,000 RNRB (deducted from the property value) and £325,000 NRB resulting in a taxable estate of £500,000.

Where the total value of the estate, less liabilities, exceeds £2m the value of the RNRB is tapered away at a rate of £1 for every £2 in excess.

If the RNRB is not used in full against the value of property any unused portion cannot then be used against other assets in the estate. It can, as stated above, be carried forward.

4.2.2 What is a potentially exempt transfer?

IHT is also payable in certain circumstances when assets are transferred from a person's estate during their lifetime (usually in the form of gifts). Most gifts made during a person's lifetime are potentially exempt transfers (PETs) and are not subject to tax at the time of the transfer.

If the donor survives for seven years after making the gift, these transactions become fully exempt and no tax is payable.

If the donor dies within seven years of making the gift, and the value of the estate (including the value of any gifts made in the preceding seven years) exceeds the nil-rate band, inheritance tax becomes due.

The gifts are offset against the nil-rate band first and, if there is any nil-rate band left, this is offset against the remainder of the estate, the balance being subject to tax. If the value of the gifts alone exceeds the nil-rate band, the portion of the gifts that exceeds the threshold is taxed along with the remainder of the estate (although the amount of tax on the gifts is scaled down by taper relief over the final four years of the seven).

TABLE 4.1 PETs AND TAPER RELIEF

Death within	Tax due on gift
1 year of gift	100% of the tax
2 years of gift	100% of the tax
3 years of gift	100% of the tax
3–4 years of gift	80% of the tax
4–5 years of gift	60% of the tax
5–6 years of gift	40% of the tax
6–7 years of gift	20% of the tax
7+ years	no tax

✓

CHECK YOUR UNDERSTANDING

In July 2016, Joan made a gift to her daughter of £350,000. She has made no other gifts in her lifetime. Joan died in October 2020 leaving a total estate worth £420,000. The full rate of IHT in 2020/21 is 40 per cent on estates over £325,000. How much IHT is applied to the value of the gift that is in excess of the nil-rate band (£25,000)?

a) £5,000

b) £6,000

c) £8,000

d) £10,000

4.2.3 What is a chargeable lifetime transfer?

Some lifetime gifts – notably those to companies, other organisations and certain trusts – are not PETs but chargeable lifetime transfers, on which tax at a reduced rate of 20 per cent is immediately due. This 'lifetime' tax is only payable if the value of the chargeable lifetime transfer, when added to the cumulative total of chargeable lifetime transfers over the previous seven years, exceeds the nil-rate band at the time the transfer is made. The 20 per cent tax is only applied to the excess over the nil-rate band. As with PETs, the full tax is due if the donor dies within seven years (subject to the same taper relief) and any excess over the 20 per cent already paid then becomes payable.

4.2.4 What gifts and transfers are exempt from inheritance tax?

There are a number of important exemptions from inheritance tax:

- transfers between spouses and between civil partners both during their lifetime and on death, provided that the receiving spouse/civil partner is UK domiciled;
- small gifts of up to £250 (cash or value) per recipient in each tax year;
- donations to charity, to political parties and to the nation;
- wedding gifts of up to £1,000 (increased to £5,000 for gifts from parents or £2,500 from grandparents);
- gifts that are made on a regular basis out of income and which do not affect the donor's standard of living;
- up to £3,000 per tax year for gifts not covered by other exemptions. Any part of this £3,000 that is not used in a given tax year can be carried forward for one tax year, but no further.

ASSESSING AN ESTATE FOR INHERITANCE TAX

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The following example demonstrates how different types of lifetime gifts are treated and how an estate is assessed for inheritance tax. 2020/21 tax rates apply throughout so IHT is 40 per cent on anything over £325,000. It is assumed that, at outset, no gifts had previously been made.

Year 1 – gift of £20,000 to daughter	£20,000
Annual exemption (current tax year)	(£3,000)
Annual exemption (previous tax year)	(£3,000)
Value of transfer for IHT purposes	**£14,000 (PET)**

Year 2 – gift of £40,000 to son on wedding day	£40,000
Annual exemption (current tax year)	(£3,000)
Marriage exemption	(£5,000)
Value of transfer for IHT purposes	**£32,000 (PET)**

Year 4 – gift of £5,000 to the Macmillan cancer charity	
Exempt as gift to a registered charity	0
Year 6 – gift of £20,000 to daughter on wedding day	£20,000
Annual exemption (current tax year)	(£3,000)
Annual exemption (previous tax year)	(£3,000)
Marriage exemption	(£5,000)
Value of transfer for IHT	**£9,000**
Year 7 – 2 x £250 gifts to grandchildren	
Exempt as 'small gifts'	0
Year 8 – year 1 gift now fully exempt as donor has survived 7 years	
Year 9 – year 2 gift now fully exempt as donor has survived 7 years	
Year 11 – donor dies leaving an estate of £600,000, of which £200,000 goes to his wife with remainder (which does not include a residence) to children	
Transfer to wife is exempt leaving taxable estate of £400,000	
Year 6 gift is added into estate as made less than 7 years before death; no tax is payable but this gift uses £9,000 of nil-rate band	
Nil-rate band: £325,000 – £9,000	£316,000
Inheritance tax: £400,000 – £316,000	£84,000
Tax @ 40%	**£33,600**

FACTFIND

If you would like to find out more about IHT, go to:

https://www.gov.uk/browse/tax/inheritance-tax [Accessed: 17 February 2020].

4.3 Value added tax (VAT)

Value added tax (VAT) is an indirect tax levied on the sale of most goods and the supply of most services in the UK. Some goods and services are exempt from VAT, including certain financial transactions such as loans and insurance. The supply of financial advice is not exempt and advisers who charge a fee for their service are subject to VAT in the same way as solicitors or accountants.

The supply of health and education services is exempt, as are e-books, and a number of related goods and services are currently zero-rated. This is not technically the same as being exempt: zero-rated goods and services are theoretically subject to VAT but the rate of tax applied is currently 0 per cent (although this could change). Zero-rated items include food, books, children's clothes, domestic water supply and medicines. Domestic heating is charged at a reduced rate.

FACTFIND

For current VAT rates and thresholds, go to:

https://www.gov.uk/vat-registration [Accessed: 17 February 2020].

Businesses, including the self-employed, are required to register for VAT if their annual turnover (not profit) is above a certain figure. Businesses with turnover below this figure can choose to register for VAT if they wish, but are not obliged to.

An advantage of registering is that VAT paid out on business expenses can be reclaimed. Two disadvantages are:

- the fact that the firm's goods or services are more expensive to customers (by the amount of the VAT that the firm must charge);
- the additional administration involved in collecting, accounting for and paying VAT.

If a business is registered for VAT but its turnover has fallen below a certain threshold, it can apply to HMRC to be deregistered.

4.4 Stamp duty

Certain transactions, notably purchases of securities and of land, are liable to stamp duty. Stamp duty is actually a tax imposed on the documents that give effect to the transaction – for example, conveyances of property or stock transfer forms.

4.4.1 Stamp duty and stamp duty reserve tax

Stamp duty is payable on paper documents that transfer the ownership of financial assets, such as shares and bearer instruments. As an example, in 2019/20 it is payable at a rate of 0.5 per cent of the market value of shares (rounded up to the nearest £5), on transactions of more than £1,000. For bearer instruments, the stamp duty rate is 1.5 per cent of the market value. It is important to ensure that the documents are stamped by HMRC within the permitted time period.

Stamp duty reserve tax (SDRT) is charged on transfers that are completed electronically, at a rate of 0.5 per cent, rounded up or down to the nearest penny. If the transaction is carried out through CREST, which is an electronic settlement and registration system, SDRT is deducted automatically and passed to HMRC. For other transactions, the buyer has to notify HMRC and make the payment.

There are some exemptions from stamp duty and stamp duty reserve tax. For example, it is not chargeable on transactions in eligible securities on the London Stock Exchange's AIM and High Growth Segment. No stamp duty is payable on a transfer of shares in a property authorised investment fund (PAIF) and there is no stamp duty reserve tax payable on surrenders of units. Real Estate Investment Trusts (REITs), on the other hand, pay stamp duty or stamp duty reserve tax at the usual rates.

FACTFIND

For more information about stamp duty and details of current rates, go to:

https://www.gov.uk/guidance/stamp-duty-on-shares [Accessed: 15 February 2019].

For more information on SDRT, go to:

https://www.gov.uk/tax-buy-shares/overview [Accessed: 17 February 2020].

4.4.2 Stamp duty land tax

Stamp duty land tax (SDLT) is paid by the purchaser of property and there are different rates of SDLT which apply to different portions of the purchase price. Figure 4.3 is based on the rates for residential properties in 2019/20 for illustrative purposes.

FIGURE 4.3 SDLT RATES

Purchase price	SDLT rate
Above £1.5m	12%
£925,001–£1.5m	10%
£250,001–£925,000	5%
£125,001–£250,000	2%
Up to £125,000	Nil

For certain types of purchaser, including corporate bodies, if the purchase price exceeds £500,000 the rate of SDLT is 15 per cent of the whole purchase price.

A 3 per cent supplement applies to the rates above if the property purchased is an additional residential property (ie where the purchase means that the purchaser will own more than one).

Note: SDLT does not apply to the purchase of properties in Scotland or Wales, which are subject to Land and Buildings Transaction Tax (LBTT) and Land Transaction Tax (LTT) respectively.

STAMP DUTY LAND TAX RELIEF FOR FIRST-TIME BUYERS

First-time buyers can claim a discount (relief) and do not pay any SDLT where their residential property costs less than £300,000.

If they pay over £300,000 but under £500,000, they pay 5 per cent on the excess over £300,000 only.

> The relief is not available on properties worth in excess of £500,000.
>
> The relief was extended to qualifying shared ownership property purchasers in the 2018 Budget.

> **FACTFIND**
>
> For more information on SDLT, go to:
>
> https://www.gov.uk/stamp-duty-land-tax/overview [Accessed: 17 February 2020].

4.5 Corporation tax

Corporation tax is paid by limited companies on their profits. It is also payable by clubs, societies and associations, by trade associations and housing associations, and by co-operatives. It is not, however, paid by either conventional business partnerships or limited liability partnerships, or by self-employed individuals: these are all subject to income tax.

Companies are taxed on all their profits arising in a given accounting period, which is normally their financial year. Companies resident in the UK pay corporation tax on their worldwide profits, whereas companies resident elsewhere pay only on their profits from their UK-based business.

> **PROFITS**
>
> For corporation tax purposes, profits include: trading profits (less allowable expenses such as labour and raw materials); capital gains; income from letting; interest on deposits.

For companies with profits up to £1.5m, corporation tax is normally due nine months after the end of the relevant accounting period. For those with profits over £1.5m, corporation tax is due in quarterly instalments beginning approximately halfway through the accounting period.

FACTFIND

For corporation tax rates, go to:

https://www.gov.uk/corporation-tax-rates [Accessed: 17 February 2020].

4.6 Withholding tax

The phrase 'withholding tax' refers to any tax on income that is levied at source before that income is received. So, technically, income tax paid by UK employees is a withholding tax.

However, the phrase is normally understood to apply to tax that is levied in a particular country on income received in that country by those who are non-resident in that country; this could be earned income or investment income.

The aim is to ensure that the income does not leave the country without being taxed. In the UK, for example, withholding tax of 20 per cent (2019/20 figures) is levied on the earnings of non-resident entertainers and professional sportspeople. The UK has reciprocal tax treaties (double taxation agreements) with over 100 other countries to prevent the same income from being taxed twice.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain how capital gains tax is calculated?
- describe what is meant by 'private residence relief'?
- explain the difference between a potentially exempt transfer and a chargeable lifetime transfer?
- list gifts and transactions that are exempt from inheritance tax?
- explain the difference between stamp duty, stamp duty reserve tax and stamp duty land tax?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

? Test your knowledge

Use these questions to assess your learning for Topic 4. Review the text if necessary.

Answers can be found at the end of this book.

1) Melanie bought a painting in a charity shop for £40. It turned out to be by a well-known artist, and she sold it three years later for £2,000. She had to pay CGT on the gain she made. True or false?

2) For how many years can the annual exempt amount for CGT be carried forward?

3) To qualify for roll-over relief, a business must replace an asset not more than five years from the date of disposal. True or false?

4) Inheritance tax would be charged on which of the following?

   a) The total value of the deceased's estate.

   b) The total value of the estate above the available nil-rate band.

   c) The value of the estate less any gifts that have been made in the previous seven years.

5) Tax on a chargeable lifetime transfer in excess of the available nil-rate band is payable:

   a) immediately, at the full rate.

   b) only if the transferor dies within seven years of the transfer.

   c) immediately, at a reduced rate.

6) What kind of tax is payable when shares are purchased electronically?

7) Sanjay, a basic-rate taxpayer with taxable income of £12,000, purchased UK listed company shares for £11,300 in May 2014. He sold them for £25,400 in August 2020. He has no other gains or losses (current or carried forward) in the tax year 2020/21. Ignoring any costs, calculate his capital gains tax liability.

8) Sarah, a basic-rate taxpayer with earned income of £17,000 in 2020/21, bought some shares in May 2016 for £15,000 and sold them in October 2016 for £10,100, making her a loss of £4,900 in the tax year 2016/17. She made no gains in the same tax year. In June 2020 she sold her holiday flat in Devon, which made her a profit of £47,600. She had spent £14,000 on renovations,

and it cost her £3,500 in estate agent's commission to sell it. Calculate the capital gains tax due for the tax year 2020/21.

9) Luis sold his studio flat and bought an apartment (his only property) for £325,000. How much stamp duty, if any, will he pay?

   a) £6,250.

   b) £2,500.

   c) £3,750.

   d) £0.

10) A company makes an annual profit of £1.2m. When would the company's corporation tax normally be payable?

TOPIC 5

State benefits and HMRC tax credits

LEARNING OBJECTIVES

This topic outlines the main state benefits and HMRC tax credits and the way in which they can affect financial planning.

By the end of this topic, you should have an understanding of:

- the main state benefits and HMRC tax credits for people on low incomes;
- the main state benefits and HMRC tax credits for people with children;
- the main state benefits for people who are sick or disabled;
- retirement benefits, including the state pension;
- how these benefits and tax credits affect financial planning.

This topic covers the Unit 1 syllabus learning outcome U7.9.

THINK . . .

What do you already know about welfare provision in the UK? For instance:

- Have you claimed state benefits yourself?
- Do you understand how your National Insurance contributions record affects your entitlement to state benefits?
- Do you know why someone might have to attend a work capability assessment?
- Do you know if you are eligible for a state pension and when you will be able to claim it?

When people think about the role of a financial adviser, they might not immediately think about the need to understand state benefits, but such provision is often an important element of an individual's overall financial situation.

5.1 How do state benefits affect financial planning?

In the UK, the government plays a vital role in providing assistance to people in need. Although some people criticise aspects of the welfare state, it still remains the envy of many other nations. It should be remembered that its main purpose is to act as a safety net in times of need, rather than to support a comfortable standard of living.

State benefits can affect financial planning in two main ways.

1) State benefits can affect the need for financial protection. The amount of additional cover needed by a client can be quantified as the difference between the level of income or capital required and the level of cover already existing. Existing provision includes not only any private insurance that the client already has, but also any state benefits to which they or their dependants would be entitled.

2) Financial circumstances can affect entitlement to benefits. Certain benefits are means-tested – in other words, the amount of benefit is reduced if the individual's (or sometimes the household's) income or savings exceed specified levels. This might mean, for example, that a financial plan that increased a person's income or the value of their assets might be less attractive than it seemed at first sight, if it also had the effect of reducing entitlement to, for instance, Income Support.

There is a wide range of state benefits covering many different circumstances. Many of them, however, are small in amount and can do little more than prevent people from suffering extreme poverty.

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KEEPING UP TO DATE WITH STATE BENEFITS

The benefit structure is very complex and it is not possible to cover every detail here. Rules surrounding eligibility for state benefits, rates of payment and even the names of the benefits change regularly.

The intention of this topic is to alert you to the main benefits available, so that you can seek further information if you think they may be relevant to a particular client. One source of such information is https://www.gov.uk/browse/benefits [Accessed: 18 February 2020].

5.2 What support is available for people on low income?

5.2.1 Universal Credit

Universal Credit is a means-tested benefit for people of working age. The upper age limit is at the point where people qualify for Pension Credit.

Universal Credit is not specifically an ‘in work’ or ‘out of work’ benefit; it is one benefit for people whatever their employment status. The intention is that people will not need to keep transferring from one type of benefit to another as their circumstances change. The structure is intended to be much simpler than that of the current system, where separate benefits (which often overlap) are administered by different agencies, with different methods of means testing.

From April 2013, Universal Credit began to replace the following benefits:

- Income Support;
- Income-based Jobseeker’s Allowance;
- Income-related Employment and Support Allowance;
- Working Tax Credit and Child Tax Credit;
- Housing Benefit.

The amount of Universal Credit awarded to claimants depends on their income and personal and financial circumstances. There is a basic allowance with different rates for single claimants and couples (and a lower rate for younger people), and additional amounts available for those with a disability, caring responsibilities, housing costs, and children and/or childcare costs.

There is an ‘earnings disregard’, which is based on the claimant’s needs. For example, a couple with children have a higher earnings disregard than a couple without children. As earnings increase, entitlement to Universal Credit is reduced, and there is a maximum cap on the total amount of state benefits that a household can receive (based on the average earnings of a working family); this maximum includes any Child Benefit that they receive.

The benefits that will remain outside of Universal Credit include:

- Carer’s Allowance;
- Contribution-based Jobseeker’s Allowance and Contribution-based Employment and Support Allowance;
- Disability Living Allowance/Personal Independence Payment;
- Child Benefit;
- Statutory Sick Pay;

- Statutory Maternity Pay;
- Maternity Allowance;
- Attendance Allowance (as this is for claimants over 65 anyway).

Full implementation of Universal Credit may not be complete until 2021 at the earliest. You should therefore be aware of the benefits that Universal Credit will ultimately replace.

5.2.2 Working Tax Credit

Working Tax Credit is designed to top up the earnings of employed or self-employed people who are on low incomes; this includes those who do not have children. There are extra amounts for:

- working households in which someone has a disability; and
- the costs of qualifying childcare.

5.2.3 Income Support

Income Support is a tax-free benefit designed to help people aged between 16 and the qualifying age for state Pension Credit whose income is below a certain level and who are working less than 16 hours per week (or where the partner works for less than 24 hours on average per week). It can be claimed by people with no income at all or can be used to top up other benefits or part-time earnings.

Eligibility for Income Support is not dependent on the claimant having paid National Insurance contributions (NICs). It is, however, means-tested on both income and savings.

The range of people who can claim Income Support includes those who are:

- aged between 16 and the qualifying age for Pension Credit;
- pregnant or a single parent with a child aged under five;
- unable to work because they are sick or disabled;
- caring for a disabled or elderly person;
- unemployed;
- only able to work part-time.

5.2.4 Jobseeker's Allowance

Jobseeker's Allowance (JSA) is a benefit for people who are unemployed or working less than 16 hours and actively seeking work. There are two forms of JSA: contribution-based and income-based. Income-based JSA is being replaced by Universal Credit.

People are eligible for contribution-based JSA only if they have paid sufficient Class 1 National Insurance contributions. It is paid at a fixed rate, irrespective of savings or partner's earnings, for a maximum of six months. Payments are made gross but are taxable. Claimants are usually credited with National Insurance contributions (NICs) for every week that they receive JSA.

5.2.5 Support for Mortgage Interest loan (SMI)

Those in receipt of Income Support, Jobseeker's Allowance, Universal Credit or Pension Credit can apply for assistance to pay the interest on their mortgage. Support for Mortgage Interest was a pure state benefit until April 2018 but now takes the form of a loan that must be repaid.

For eligible claimants, SMI will pay interest on a mortgage of up to £200,000 (£100,000 if a claim is being made for Pension Credit). SMI does not pay for associated mortgage costs, such as the repayment of capital, insurance premiums or mortgage arrears. Payment is made direct to the mortgage lender at a standard mortgage rate that may be more or less than the actual rate on the mortgage.

The SMI loan is secured on the property by way of a second charge and is subject to interest. The loan is repaid when the property is sold or ownership of the property is transferred.

THE BENEFITS CAP

An often-voiced complaint about the benefits system is that people can be better off out of work (by claiming state benefits) than in work. In response to this, a cap on the maximum weekly income that can be received from benefits was introduced in 2013. In broad terms, the intention is to limit the maximum paid to the level of the average UK wage.

The following benefits are subject to the cap.

- Employment and Support Allowance (work-related activity group)
- Income Support
- Jobseeker's Allowance
- Housing Benefit
- Maternity Allowance
- Child Benefit
- Child Tax Credit
- Guardian's Allowance
- Bereavement Support Payment
- Incapacity Benefit
- Severe Disablement Allowance
- Universal credit (unless deemed unfit for work)
- Widowed parent's allowance

FACTFIND

Universal Credit: https://www.gov.uk/universal-credit

Income Support: https://www.gov.uk/income-support

Working Tax Credit: https://www.gov.uk/working-tax-credit

JSA: https://www.gov.uk/jobseekers-allowance

The benefit cap: https://www.gov.uk/benefit-cap

[All accessed: 18 February 2020].

5.3 What support is available for those bringing up children?

Benefits related to bringing up children fall into two categories: benefits payable during pregnancy and benefits payable as the children are growing up.

5.3.1 Statutory Maternity Pay

Women who become pregnant while employed may be able to receive Statutory Maternity Pay (SMP) from their employer, providing that:

- their average weekly earnings are above a certain threshold;
- they have been working for their employer continuously for 26 weeks prior to their 'qualifying week', which is the 15th week before the week in which their baby is due.

SMP is payable for a maximum of 39 weeks. The earliest it can begin is 11 weeks before the baby is due and the latest is when the baby is born.

There are two rates of SMP: for the first six weeks, the amount paid is equal to 90 per cent of the employee's average weekly earnings; after that, the remaining payments are at a standard flat rate or 90 per cent of the employee's average weekly earnings, whichever is the lower.

SMP is taxable and NICs are due on the amount paid.

5.3.2 Maternity Allowance

Some working mothers who become pregnant are not able to claim SMP. These will include those who are self-employed or have recently changed jobs. They might be able to claim an alternative benefit called Maternity Allowance. This is paid by the Department for Work and Pensions (DWP) and not by employers.

Maternity Allowance is not a benefit available to all women who become pregnant; an individual must meet the relevant eligibility criteria in order to claim.

Maternity Allowance is paid at a lower rate than SMP but it is not subject to tax or NICs on the amount paid. Like SMP, it is payable for a maximum of 39 weeks. The earliest it can begin is 11 weeks before the baby is due and the latest is when the baby is born.

5.3.3 Child Benefit

Child Benefit is a tax-free benefit available to parents and others who are responsible for bringing up a child. It does not depend on having paid NICs. It is not affected by receipt of any other benefits.

Child Benefit is available for each child under age 16. It can continue up to and including age 19 if the child is in full-time education or on an approved training programme. A higher rate is paid in respect of the eldest child and a lower rate in respect of every other child.

Child Benefit is means-tested in the form of an income tax charge if either of a couple has individual adjusted net annual income of more than £50,000 (2020/21 figures). If both have adjusted net income above £50,000, it is assessed on the higher of the two incomes. The tax charge is applied at a rate of 1 per cent of Child Benefit for every £100 of adjusted net income above £50,000 and is collected through self-assessment. The effect is that where adjusted net income is £60,000 or more, the tax charge equals the Child Benefit paid.

FACTFIND

More information about financial help for people with children is available at:

https://www.gov.uk/browse/childcare-parenting/financial-help-children [Accessed: 18 February 2020].

5.3.4 Child Tax Credit

Child Tax Credit is designed to provide financial assistance to people who are responsible for bringing up children and are on low incomes. A claim may be made by an individual who is responsible for:

- a child aged under 16;
- a child under 20 in eligible education or training.

The claimant does not have to be working to claim Child Tax Credit. There is no set income threshold; eligibility and the amount awarded are determined based on personal circumstances. If all of the claimant's children were born before 6 April 2017, a child element could be payable for each child on top of the basic amount, known as the 'family element'. If one or more of a claimant's children was born on or after 6 April 2017, the child element is generally restricted to two children and the family element is only payable if one of the children was born before 6 April 2017. Additional amounts are payable for each disabled or severely disabled child.

Where an individual lives in an area where Universal Credit can be claimed, they will apply for Universal Credit rather than Child Tax Credit.

✓

CHECK YOUR UNDERSTANDING 1

Jane and John have two young daughters and claim Child Benefit. If John earns £48,000 per year and Jane earns £57,000 per year, they will be subject to a Child Benefit tax charge of:

a) Nil.

b) 100 per cent.

c) 70 per cent.

d) 7 per cent.

5.4 What support is available for people who are sick or disabled?

There is a wide range of benefits for people who are sick, injured or disabled, or who need constant care.

5.4.1 Statutory Sick Pay (SSP)

Statutory Sick Pay (SSP) is paid by employers to employees who are off work due to sickness or disability for four days or longer, providing their average weekly earnings are above the level at which NICs are payable.

SSP is paid for a maximum of 28 weeks in any spell of sickness. Spells of sickness with less than eight weeks between them count as one spell. Amounts paid as SSP are subject to tax and to NI deductions, just as normal earnings would be.

5.4.2 Employment and Support Allowance

People who are ill or disabled may be able to claim Employment and Support Allowance (ESA). There are two forms of ESA. Contribution-based ESA, also referred to as 'new-style' ESA where the individual is eligible for Universal

Credit, depends on a person's National Insurance contributions (NICs). Contribution based ESA is not means tested and the payments are taxable. In contrast, income-based ESA does not depend on NICs, is means-tested but not taxable.

A key feature of this benefit is the work capability assessment, which looks at the impact that a claimant's health condition has on their ability to work. As a result of the assessment, people are put in either a work-related activity group or a support group. Those in the former group are deemed capable of working in some capacity and required to take steps to help them move into employment. For those in the support group, it is recognised that their health condition severely limits their capacity to work. Different rates of benefit are payable to the two groups; there is also a lower rate during the initial assessment period of up to 13 weeks.

ESA replaced Incapacity Benefit, although its introduction has been delayed and some clients might still be eligible for Incapacity Benefit. Income-based ESA is itself in the process of being replaced by Universal Credit, but people can still claim contributions-based ESA if they have made enough NI contributions. (Note that the introduction of Universal Credit is on a phased basis so some individuals retain entitlement to income-based ESA.)

5.4.3 Attendance Allowance

Attendance Allowance is a benefit for people aged 65 or above who need help with personal care as a result of sickness or disability. This benefit is not means-tested and it does not depend on having paid NICs.

There are two levels of benefit: a lower rate for people who need help with personal care by day or by night and a higher rate for those who need help both by day and by night. Some other state benefits (ie Pension Credit, Housing Benefit and Council Tax Reduction) are paid at a higher rate if the claimant is also receiving Attendance Allowance.

5.4.4 Disability Living Allowance and Personal Independence Payment

Disability Living Allowance (DLA) is a tax-free benefit for people who need help with personal care and/or need help getting around. It is currently being replaced by Personal Independence Payment (PIP) for people aged 16–64.

There are two components to both benefits, and people may be eligible for either or both:

- Care component: this component is for people who need help in carrying out daily tasks such as washing, dressing, using the toilet or cooking a meal.
- Mobility component: this component applies if a person has difficulty in walking or cannot walk at all.

5.4.5 Carer's Allowance

Carer's Allowance (CA) is a benefit for people who are caring for a sick or disabled person; they do not have to be a relative of the patient in order to qualify.

The right to receive CA does not depend on having paid NICs. It is taxable and must be declared on tax returns.

It is important to be aware that claiming CA can affect the other benefits the claimant receives, as well as the benefits the person they are caring for receives.

FACTFIND

More information about financial support for people who are ill or have a disability is available at:

https://www.gov.uk/browse/benefits/disability [Accessed: 13 October 2020].

5.4.6 People in hospital or receiving residential/nursing care

When people are in hospital, some of the needs normally met by state benefits or pensions are instead met by the NHS. In general terms, state benefits that were being claimed will continue to be paid when someone goes into hospital.

FACTFIND

Further details of how benefits are affected by a temporary or permanent stay in a residential care or nursing home are available at:

https://www.newham.gov.uk/health-adult-social-care/paying-residential-nursing-home-care [Accessed: 13 October 2020].

CHECK YOUR UNDERSTANDING 2

Which form(s) of Employment and Support Allowance is/are means-tested?

a) Contribution-based ESA only.

b) Income-based ESA only.

c) Both contribution-based and income-based ESA.

d) Neither contribution-based nor income-based ESA.

5.5 What support is available for people in retirement?

State pensions are payable from state pension age (SPA), which is currently 65 for both men and women.

The government plans to increase the state pension age for both men and women to 66 by 2020 and to 67 by 2028. State pension age is subject to a system of regular reviews based on changes in life expectancy. The basis of the reviews is the principle that people should spend one-third of their adult life (regarded for these purposes as beginning at age 20) in retirement. The first review was published in March 2017 and recommended that state pension age be increased from age 67 to age 68 between 2037 and 2039.

The system of state pension benefits changed from April 2016 with the introduction of the new state pension. Before this date, state pension provision consisted of a basic state pension with an additional earnings-related element for those who were employed. The new state pension is a single-tier pension with no earnings-related element.

Those reaching SPA before 6 April 2016 have their state pension benefits paid under the system of basic + additional state pensions. Those reaching SPA on or after 6 April 2016 receive the new state pension, with an adjustment paid to compensate them if they would have been better off under the previous system.

State pensions are designed to provide little more than a basic standard of living in retirement. The system operates on a pay-as-you-go basis, with National Insurance contributions from the current working population being used to pay pensions to those entitled to receive them. It is readily apparent that, with the number of pensioners increasing and the numbers in employment decreasing, there is little scope for making generous increases to state pensions.

5.5.1 The basic state pension

When introduced in something like its current form after the Second World War, the basic state pension was paid only to employed people on their retirement and was not related to their earnings. It was later extended to include self-employed people and others who have made sufficient National Insurance contributions – which means that they have contributed for at least 30 years. Benefits are scaled down for lower contribution rates.

Those who had not made enough NI contributions of their own to qualify for a full basic state pension might have received a ‘Category B’ pension based on their spouse or civil partner’s pension entitlement.

5.5.2 Additional state pension

Some employees who reached state pension age before 6 April 2016 are entitled to an additional state pension, in addition to their basic state pension. The first earnings-related state pension scheme was the graduated pension scheme that operated from 1961 until 1975. It was replaced by the state earnings-related pension scheme (SERPS), which came into operation in 1978. SERPS was itself replaced in 2002 by the state second pension (S2P). These schemes are now collectively referred to as the ‘additional state pension’.

Unlike the basic state pension, additional state pension was available only to employed people who paid Class 1 National Insurance contributions. Self-employed people could not build entitlement to additional state pension benefits. Employed people had the option to ‘contract-out’ of SERPS/S2P and have the National Insurance contributions that would have been used to provide SERPS/S2P reduced or redirected to an alternative form of pension.

PENSION CREDIT

Pension Credit is made up of two elements:

- Guarantee Credit – this tops up an individual’s weekly income to a specified minimum amount.
- Savings Credit – this is an additional payment for people aged 65 and over who have saved some money towards their retirement.

Pension Credit is not taxable. People who reach state pension age on or after 6 April 2016 are not usually eligible for Savings Credit.

5.5.3 Single-tier state pension

The complexity of the state pension system led to the introduction of a new, simplified state pension for those reaching retirement age on or after 6 April 2016. There is a single level of benefit with no additional earnings-related element. Pension benefits are determined by a person’s National Insurance contribution record. To be eligible for the maximum pension, an individual needs to have made or been credited with 35 years' NI contributions; those with under 10 years' NI contributions are not usually eligible for any state pension. Carers are credited with NI contributions.

One of the features of the new state pension is that it is based solely on an individual's personal National Insurance record. It is not possible for those reaching state pension age on or after 6 April 2016 to claim a Category B pension.

Anyone who reached state pension age before 6 April 2016 will continue to receive benefits according to the old system, with transition to the new system taking place over five years to 2021.

THE 'TRIPLE LOCK GUARANTEE'

Once in payment, both the basic state pension and the single-tier state pension increase each year by the higher of:

- earnings (measured by the Average Weekly Earnings Index);
- prices (as measured by the Consumer Prices Index); or
- 2.5 per cent.

This is referred to as the 'triple lock guarantee'.

CHECK YOUR UNDERSTANDING 3

A major difference between the basic state pension and the single-tier state pension is:

a) The basic state pension is paid at a later age than the new state pension.

b) The new state pension is paid at a later age than the basic state pension.

c) The new state pension has no facility for an individual to claim a state pension based on National Insurance contributions paid by the spouse or civil partner.

d) Lower levels of National Insurance contributions are required to claim a full single-tier state pension.

FACTFIND

Go to this link for more information on the basic state pension and follow links from this page to find out further details on the new state pension, additional state pension and Pension Credit:

https://www.gov.uk/state-pension [Accessed: 17 February 2020].

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- list the benefits that are available to people on low incomes who have made sufficient National Insurance contributions?
- explain the difference between Statutory Maternity Pay and Maternity Allowance?
- explain what would happen to a person's state benefits if they had to spend time in hospital?
- describe the key features of the single-tier state pension?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 5. Review the text if necessary.

Answers can be found at the end of this book.

1) Why is it important for a financial adviser to know about state benefits?

2) Once Universal Credit is fully implemented, parents who are eligible for Child Benefit will have to claim Universal Credit instead. True or false?

3) Which of the following is **not** a feature of Income Support?

   a) It is only available to claimants who have made National Insurance contributions.

   b) It is available for claimants aged between 16 and the qualifying age for Pension Credit.

   c) Benefits are tax-free.

   d) Both income and savings are subject to means testing to determine eligibility.

4) James has been working in IT support for twelve years. His current job is a fixed-term contract and ends next month. Assuming James has made NI contributions throughout his working life, what benefit is he likely to be able to claim while he is unemployed?

   a) Working Tax Credit.

   b) Income Support.

   c) Contribution-based Jobseeker's Allowance.

   d) Employment and Support Allowance.

5) Aliyah has been working for Abbots Transport for 16 weeks. She is 24 weeks pregnant. Which of the following state benefits may she be entitled to?

   a) Statutory Maternity Pay.

   b) Income Support.

   c) Child Tax Credit.

   d) Maternity Allowance.

6) When is the earliest that Aliyah can begin claiming this benefit?

7) Malcolm, who is 42 and self-employed, has fallen ill and cannot work. Which benefit might he be entitled to?

   a) Disability Living Allowance.

   b) Statutory Sick Pay.

   c) Employment and Support Allowance.

   d) Attendance Allowance.

8) Lucy earns £52,000 per year and her partner Howard has an annual salary of £29,000. They have three children, one at primary school and two at secondary school; their eldest son, Ethan, is 18 and studying for three A levels. For how many children are Lucy and Howard able to claim Child Benefit?

   a) Two: they cannot claim for Ethan because he is over 16.

   b) All three, because Ethan is still in full-time education.

   c) None, because Lucy earns more than £50,000 a year.

   d) None, because their combined household income exceeds £50,000 per year.

9) Ian retired in July 2020 at the age of 65. He had made NI contributions for 33 years while he was working but he had had a career break of three years to care for his sick partner. Is Ian eligible for a full, new state pension?

   a) No, because he was not continuously employed throughout his working life.

   b) No, because he retired too early to claim the new state pension.

   c) Yes, because he had paid NI contributions for more than 30 years.

   d) Yes, because he was credited with NI contributions while he was a carer.

10) Lydia is 22 and has just begun a new job on a permanent, full-time contract. Her employer will offer her the opportunity to contract-out of the state second pension. True or false?

TOPIC 6

Direct investments: cash and fixed-interest securities

LEARNING OBJECTIVES

When people have more money than they need to spend immediately, they tend to invest it with a view to making a return. In Topics 6–10 we are going to look at different ways of investing, beginning with a look at direct investments.

By the end of this topic, you should have an understanding of:

- the main asset classes;
- the difference between direct and indirect investment;
- bank and building society deposit accounts and interest-bearing current accounts;
- National Savings and Investments products;
- offshore accounts;
- gilts;
- other fixed-interest investments including local authority bonds, permanent interest-bearing shares, corporate bonds and Eurobonds;
- 'alternative finance', such as peer-to-peer lending.

This topic covers Unit 1 syllabus learning outcomes U2.1, U2.2 and part of U7.7.

THINK ...

Some of the products covered in this topic will probably already be familiar to you. For example:

- Do you have savings in a building society or bank deposit account? Why did you choose that type of account?
- Have you ever bought Premium Bonds, or any other product from National Savings and Investments? What was it about these products that appealed to you?

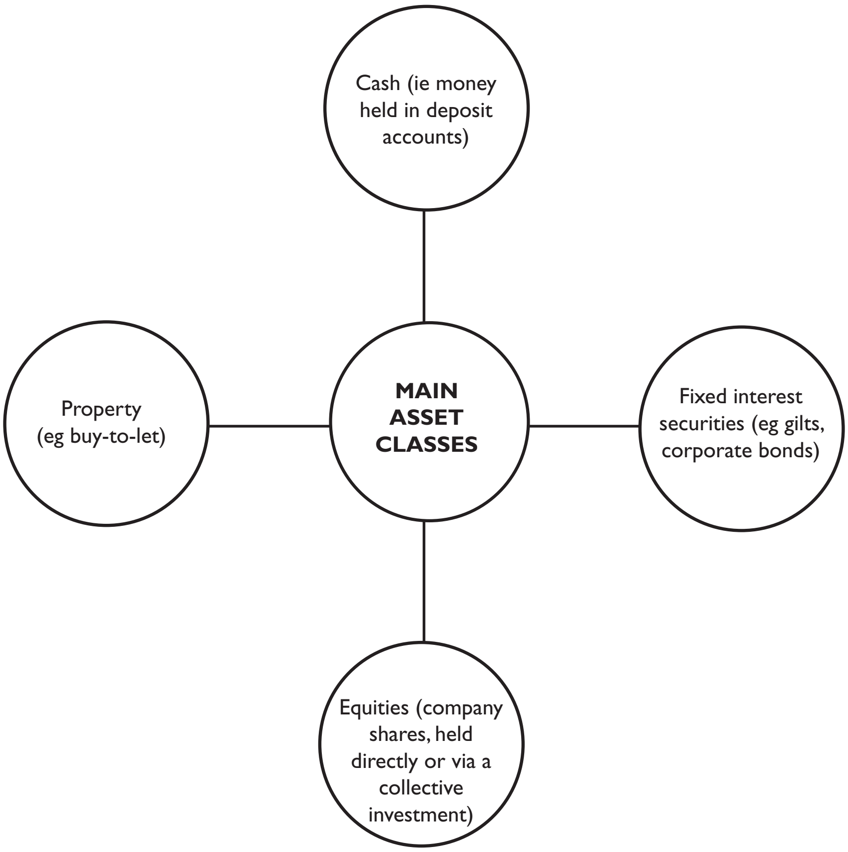
Investments such as gilts or corporate bonds might be less familiar, but you might have seen references to these products in the financial media.

6.1 What are the main financial asset classes?

Investments can be separated into a number of main asset classes according to their underlying characteristics.

The main asset classes are shown in Figure 6.1.

FIGURE 6.1 MAIN ASSET CLASSES



A possible fifth asset class comprises so-called 'alternative investments', which would include things such as fine wine, works of art or antiques.

A generally accepted principle of investment is that the greater the risk presented by an investment, then the greater the potential return. Each of the asset classes listed above will offer differing levels of potential return and different levels of risk. For example:

- cash can offer variable but generally low levels of return, through interest, with limited risk to capital;

- shares offer no guarantee with regard to either income payments or future capital values – at the extreme, an investor could lose all their money.

A further consideration is that different asset classes will tend to perform better at different stages of the economic cycle.

It is generally advised that investors who have sufficient funds to do so should diversify their holdings between different asset classes to balance different risk and reward profiles.

6.2 Why do people choose deposit-based investments?

The most widely used type of direct investment is a deposit account and the most familiar example is the bank or building society savings account.

Investors place money in deposit-based savings accounts for a number of reasons.

- **Security of capital** – some investors choose deposit-based investments because they do not want to put their capital at risk. However, inflation reduces the value of capital over time and, in periods of high inflation, this erosion in value can happen very quickly. There is also the risk of loss of capital if the institution becomes insolvent. This is rare with banks and building societies, but is not unknown. In the event of insolvency, investors may be able to reclaim some of their funds through the Financial Services Compensation Scheme (see Topic 25 for more information).

> **CAPITAL**
>
> In the case of a savings account, capital is the cash that is deposited. It differs from 'money' in the sense that it is being used to generate wealth rather to purchase goods and services.

- **Convenience** – banks and building societies are readily accessible; it is believed that, to some extent, inertia inhibits investors from looking for a more rewarding home for their deposits.

For short-term savings (eg next year's holiday or a new car), few would argue that a deposit-based savings account is a sensible place in which to invest the money. It is prudent to have part of an investment portfolio that is easily accessible in, for example, a no-notice deposit account; this is often referred to as an emergency fund. Institutional investors (eg pension funds or life assurance companies) maintain a part of each of their funds in readily accessible form.

6.3 Bank and building society accounts

Banks and building societies offer a similar range of accounts, which fall into two basic categories:

- current accounts, for everyday money needs;
- savings accounts, where money not required for day-to-day spending is set aside.

Savings accounts and some current accounts pay interest, which tends to vary according to the amount invested and whether there are restrictions on access to the money. Savings accounts provide the holder with a passbook or cash card as the 'token' to enable withdrawals to be made.

6.3.1 Traditional current accounts

A current account is a transactional account into which an individual can have their salary or wages paid. There are then a range of ways in which money can be drawn from the account or used to pay regular bills; these include a debit card (which can also be used to withdraw cash), a cheque book, electronic transfer such as faster payments, standing orders and direct debits.

It may be possible to arrange an overdraft and to operate the account via the internet or phone, without the need to visit a branch office.

6.3.2 Basic bank account

A basic bank account is a simplified current account designed to encourage people who have not previously had an account to open one. These accounts are aimed at people (typically those on low income or receiving state benefits) who might not otherwise be able to open a current account.

The accounts are able to receive money by a wide variety of methods but the methods of withdrawing money are limited. Cash can be obtained with a card from ATMs and from post offices. Payments can be made by direct debit but no cheque books are issued on these accounts and there is no overdraft facility.

6.3.3 Interest-bearing current accounts

Interest-bearing current accounts have developed as a result of increased competition between the banks and building societies. They provide investors with immediate access to their funds without loss of interest, in addition to the usual current account services such as a cheque book, ATM facilities and overdrafts.

More sophisticated versions of interest-bearing current accounts are available. It can be possible to earn interest and receive cashback on spending on household bills. To earn these benefits there are normally requirements in terms of a minimum amount to be paid into the account each month and a certain number of direct debits being paid out. Such accounts may also carry a monthly fee.

Many banks have, for several years, offered high-interest cheque accounts. As the name implies, higher rates of interest are available with these accounts that, as a consequence, have higher minimum levels of investment, typically from £1,000 to £10,000. These accounts are normally free of charges, subject to the minimum balance being maintained. Some accounts, however, allow only a limited number of cheques to be drawn in a given period without charge.

PACKAGED CURRENT ACCOUNTS

A packaged current account offers the holder a range of ancillary benefits such as breakdown cover, mobile phone insurance and travel insurance in return for a monthly or annual fee. A packaged current account may also enable the holder to open other accounts that offer preferential rates of interest.

6.3.4 Instant access savings accounts

An instant access account can normally be opened with as little as £1 and the account holder can have immediate access to their savings. As there are few limitations on the account, the interest rate paid is comparatively low and is usually linked to the bank's base rate. Such accounts may be suitable for short-term 'emergency' funds.

Interest rates are usually variable. Interest may be tiered, with higher levels of deposits paying increasingly higher rates. Higher rates are also paid when the account can only be operated via the internet or ATM, or by post or phone. The higher rates reflect the fact that much of the administration is performed either by the account holder and/or by a centralised function, thus costs are lower.

6.3.5 Restricted access accounts

If access to an account is restricted, the provider has certainty that the funds are available to it for a longer period. Rates are therefore higher on this type of account than on an instant access account.

Access may be restricted by:

- limiting the number of withdrawals that can be made each calendar year;
- requiring a minimum period of notice be provided before funds can be drawn (a notice account);
- specifying an agreed period during which the saver may not access their money (a term account).

In respect of a notice account it is generally possible to breach the notice requirements if access to funds is urgently required, but a charge is normally applied in the form of a much-reduced (or even zero) rate of interest.

With a term account the money may be locked away for a period of between one and five years, sometimes in return for a fixed interest rate. Generally, the longer the term and/or the higher the amount held in the account, then the higher the rate of interest.

A further variation is the fixed-term bond, which offers a fixed rate of return if money is saved for a fixed term. Typically there is no access at all to savings during the term. In return, a higher rate of interest is offered than would be available on an account that allowed access.

DEPOSITOR PROTECTION

Savings in bank and building society accounts are protected by the Financial Services Compensation Scheme (FSCS), up to a level of £85,000 per investor per financial services provider. You will find out more about the FSCS in Topic 25.

CHECK YOUR UNDERSTANDING 1

Can you remember how interest from savings is taxed? Write a brief summary to check how much information from your earlier studies you have retained. Look back to Topic 3 to see how well you have done.

6.4 What is National Savings and Investments?

National Savings and Investments (NS&I) offers a range of saving and investment products backed by the government. The risk associated with the products is very low because the government guarantees the return of capital invested.

There are NS&I products to suit most types of investor, with different terms, interest rates and taxation. A comparison table is included here.

TABLE 6.1 COMPARISON TABLE OF NS&I PRODUCTS

Investment	Term	Tax	Limits	Additional information
Direct Saver	None	Taxable	£1–£2m	Min. age 16. Managed online or over the phone. Interest variable.
Investment account	None	Taxable, paid gross	£20–£1m	Min. age 16. Interest variable. Investment into an NS&I investment account can be made on behalf of someone under 16.
Income bonds	None	Taxable, paid gross	£500–£1m	Min. age 16. Interest variable (paid monthly).
Direct ISA	None	Tax-free	£1–£20,000 (2019/20)	Min. age 16. UK residents only. Interest variable. Managed online or over the phone.
Premium Bonds	None	Tax-free	£25–£50,000	Min. age 16 (can be bought on behalf of under-16s). No interest paid, monthly prize draw. Max. winnings £1m.
Junior ISA	None	Tax-free	£1–£9,000 (2020/21)	Min. age 16. No access before age 18.
Guaranteed Income Bonds	1 year and 3 years	Taxable	£500–£10,000	Fixed monthly interest available to those aged 16 and over.
Guaranteed Growth Bonds	1 year and 3 years	Taxable	£500–£10,000	Fixed rate of annual growth. Min. age 16.

FACTFIND

NS&I products are reviewed regularly. For the latest information refer to the following website: https://www.nsandi.com/ [Accessed: 18 February 2020].

CASH ISAs

Individual savings accounts (ISAs) are a form of tax-free personal savings scheme. ISA investment can take a number of forms, and we will look at these in more detail in Topic 9. One form of ISA investment is cash (also known as a cash ISA): it is basically a means of obtaining tax-free interest on a bank or building society deposit account, subject to certain limits and regulations.

6.5 What are offshore accounts?

The term offshore is usually applied to any investment medium, whether it is a bank or building society account or some other form of investment, which is based outside the UK in a country that offers a more advantageous taxation of investments. Such countries (sometimes referred to as tax havens) include the Channel Islands, Luxembourg and the Cayman Islands.

HMRC AND OFFSHORE ACCOUNTS

Offshore accounts are often perceived as a vehicle to hold monies that are not declared to the tax authorities. Under legislation introduced to support implementation of the US Foreign Account Tax Compliance Act, and effective from 2016, British Crown dependencies and overseas territories exchange financial information with HMRC. This includes the names and financial details of those holding accounts.

Offshore investment can potentially expose an investor to greater risk than a similar onshore investment:

- The account might not be denominated in sterling; if the investment is to be converted back to sterling at some point, its value might be affected by unfavourable exchange rates.

- Not all offshore accounts are protected by investor protection schemes. Investors should check what protection is available through local regulatory regimes.

Offshore investments may be useful to an investor who needs money to be available outside the UK, for example someone who owns a property abroad or plans to move abroad in the future.

The interest on an offshore deposit is paid gross. A UK resident must declare the income to HMRC and may have to pay tax on it. However, if the country where the investment is held has a reciprocal tax treaty (double taxation arrangement) with the UK, and the interest has already been taxed overseas, tax relief may be available on some or all of it.

There are specific rules governing whether or not an individual is resident or non-resident as far as their liability to UK taxation is concerned. Care should be taken to determine an investor's residence status.

CHECK YOUR UNDERSTANDING 2

Can you remember the rules relating to residence and domicile? It's important for financial advisers to understand these rules. Try to write a brief summary of the rules and then check back to Topic 3 to refresh your memory.

6.6 What are gilts?

'Gilts' belong to a category of direct investment called 'fixed-interest securities'. Their full name is 'gilt-edged securities', and they are a form of borrowing by the UK government. Gilts are regarded as safe investments because the government is not expected to default on capital repayments or interest.

KEY TERMS

REDEMPTION DATE

The date on which the government must redeem the gilt by paying back its original issue value or par value, normally quoted as a nominal £100. This works in the same way as redeeming an interest-only mortgage.

COUPON

The interest rate payable on the par value of a gilt. It is a fixed rate, paid half-yearly, gross but taxable.

A gilt is categorised primarily according to the length of time left to run until its redemption. All gilts currently in issue have a specific redemption date, although, in the past, there have been undated gilts, with redemption at the discretion of the government, and also dual-dated gilts with redemption between two specified dates. A gilt with a coupon of 5 per cent and a redemption date in 2021 might be designated as Treasury 5% 2021.

FIGURE 6.2 CATEGORIES OF GILT

Short-dated gilts	• Also known as 'shorts' • Less than 5 years to run to redemption
Medium-dated gilts	• 'Mediums' • 5 –15 years to run to redemption
Long-dated gilts	• 'Longs' • More than 15 years to redemption

The definitions used in Figure 6.2 are those typically used in the financial press. The UK Debt Management Office, which issues gilts, defines short and medium gilts slightly differently, as follows:

- **Short-dated gilts**: less than 7 years.
- **Medium-dated gilts**: 7–15 years.

Index-linked gilts are gilts where the interest payments and the capital value move in line with inflation. For the investor, this means that the purchasing power of their capital and interest received remain constant, unlike all other fixed-interest investments where inflation erodes the purchasing power of fixed-interest payments.

The government will, periodically, make new issues of gilts, often when an existing issue has reached redemption date. When a new issue is made, investors can purchase those gilts. Once issued, gilts cannot be redeemed by investors prior to the redemption date but can be sold to other investors. The price at which they are sold depends on a number of factors:

- the level of market rates of interest;
- the amount of time left to the redemption date;
- supply and demand.

Gilt prices are quoted either 'cum dividend' or 'ex dividend'. If a stock is bought 'cum dividend', the buyer acquires the stock itself and the entitlement to the next interest payment. If, however, the stock is bought 'ex dividend', then while the buyer acquires the stock itself, the forthcoming interest payment will be payable to the previous owner of the stock (ie the seller).

Gilt interest is normally paid gross without deduction of tax , although investors can elect for net payment. The income is classed as savings income so would be free of tax if it fell within an individual's starting-rate band for savings income or their personal savings allowance (see Topic 3, section 3.4.4).

If the interest, when added to other savings income, falls outside the starting-rate band for savings and exceeds an individual's personal savings allowance it will be taxed at 20 per cent, 40 per cent or 45 per cent with the actual rate determined by the individual's gross income.

Many investors who buy gilts do not intend to keep them until their redemption date. They buy them because they believe that, by speculating on future movements in interest rates, they can sell them for a profit. Alternatively, they may be able to buy gilts for less than par and then make a gain upon redemption. Any capital gains made on the sale or redemption of gilts are entirely free of capital gains tax (CGT).

BUYING AND SELLING GILTS

A higher-rate taxpayer buys £100,000 par value of Treasury 5% 2021 at a price of 80.0, ie she pays £80,000 for the stock.

She receives annual interest of £5,000 (actually £2,500 per half year), which represents a yield of 6.25 per cent on her investment of £80,000.

The interest is paid gross but she must pay tax of 40 per cent on any interest in excess of her personal savings allowance of £500.

Later she sells the stock for £90,000. There is no capital gains tax to pay on her gain of £10,000.

HOW DO INTEREST RATE MOVEMENTS AFFECT GILT YIELDS?

Rising interest rates

Robert owns £10,000 of gilts with a coupon of 3 per cent. This means that he receives £300 per year interest.

He wants to sell the gilts, which have six years to run until their redemption date. However, interest rates have risen since he bought them and new six-year gilts are now being offered with a coupon of 5 per cent.

Carmen offers to buy Robert's gilts from him, but she won't offer him £10,000 for them because she can buy new six-year gilts for £10,000 that gives her a coupon of £500 per year, instead of the £300 that Robert's pay.

She offers him in the region of £9,000 for his gilts. The effect of rising interest rates is that the price on Robert's gilts has fallen. Although a price of £9,000 would reflect a return of 3.33 per cent (ie £300 interest on £9,000 invested) in terms of the income provided by the gilts, it is important to remember that if Carmen buys the gilts and holds them until redemption she will also make a capital gain of £1,000 as £10,000 is returned on redemption.

Falling interest rates

Imagine if, instead of rising, interest rates have fallen and new six-year gilts are only paying a coupon of 2 per cent. An investment of £10,000 would only return £200 per year, compared with the £300 per year that Robert's gilts are paying.

Carmen may therefore pay Robert substantially more than £10,000, in which case Robert will make a profit (which is exempt from capital gains tax).

Carmen will need to bear in mind that if she pays more than £10,000 she will make a loss if she holds the gilts to redemption.

%

CALCULATE

Mark is considering buying gilts and is attracted to 5% Treasury 2025. He finds that this gilt is currently trading at a price of £130.73. Mark understands that, should he buy this gilt, he will get income of £5 per year (par value of £100 x 5%) every year to 2025. He also understands that, should he hold the gilt until redemption date, he will suffer a loss of £30.73 on each one as only £100 will be paid on redemption.

To understand whether the income offered is a good rate it is necessary to calculate the running yield as follows.

Running yield = coupon ÷ price paid

£5 ÷ £130.73 = 3.82%

The 3.82% rate of income looks attractive, based on current interest rates, but it should be remembered that if the gilt is held to redemption it will lose £30.73 of capital value, which reduces the overall return.

6.7 What other kinds of fixed-interest stocks are available?

6.7.1 Local authority bonds

Like the government, local authorities can borrow money by issuing stocks or bonds, which are fixed-term, fixed-interest securities. They are secured on local authority assets and offer a guaranteed rate of interest, paid half-yearly. The bonds are not negotiable and have a fixed return at maturity.

Return of capital on maturity is promised, but these are not quite as secure as gilts since there is no government guarantee.

6.7.2 Permanent interest-bearing shares

Permanent interest-bearing shares (PIBS) are issued by building societies to raise capital. They pay a fixed rate of interest on a half-yearly basis. Interest is paid gross, although it is taxable as savings income according to the investor's tax status.

Investors should note that PIBS rank below ordinary accounts in priority of payment, should a building society become insolvent. As a result, they are higher risk, because depositors will be paid before shareholders.

If a building society converts to a bank by 'demutualising', the PIBS it has issued are converted to perpetual subordinated bonds (PSBs). Perpetual subordinated bonds have similar characteristics to PIBS in that they have no redemption or maturity date and will provide a fixed income stream.

6.7.3 Corporate bonds

Generally, a company will seek to finance its activities by using its profits, but there are situations in which profits, even if retained over many years, will not be sufficient to meet the company's requirements and it has to seek other sources of finance. The two main ways in which a company might seek to raise additional money are by issuing shares and/or by borrowing. It can, of course, borrow from banks or other lenders. It can also issue corporate bonds to meet its long-term financing needs, or commercial paper if funds are needed over a shorter period. We will look at commercial paper in section 7.8.3.

Corporate bonds are similar to gilts issued by the government. The bond is issued with the promise to pay a fixed rate of interest until redemption date, with the loan repaid in full at redemption date. The borrowing is usually over the longer term, which helps the company to make long-term business plans.

The bonds can be bought by institutional investors (such as life companies and pension funds) and by private investors.

A bond may be secured or unsecured. If it is secured, a charge is made on company assets. This means these assets could be taken by the creditor and sold in the event that the company defaults on interest payments or repayment at redemption date.

A bond that is backed by security is typically referred to as a debenture. The security is provided by a charge over company assets. A bond that is not backed by security is generally referred to as loan stock.

Some corporate bonds are convertible, giving the holder the right to convert the loan into ordinary shares of the issuing company. There is no obligation to do so and if the option is not exercised, the loan continues unchanged.

Interest, rather than dividends, is payable and the company is obliged to pay the interest promised, whether or not sufficient profit has been made by the company. Whether the bond is secured or not, the holder is a creditor of the company so, in the event of the company being wound up, would have priority over shareholders. If the lending is unsecured, the bondholder ranks with ordinary creditors. As mentioned, a corporate bond that is secured on company assets is referred to as a debenture and the holder has the extra security of the assets on which it is secured.

The risks associated with corporate bonds relate to the viability of the issuing company, its prospects and financial strength. Corporate bonds are riskier than gilts because gilts are backed by the government. Corporate bonds will therefore pay higher rates of interest than similar gilts. A bond that is unsecured presents a greater level of risk to the investor than one that is secured.

CHECK YOUR UNDERSTANDING 3

Why does the fact that corporate bonds are regarded as riskier than gilts mean that they generally pay higher rates of interest than similar gilts?

6.7.4 Eurobonds

A Eurobond is a bond issued or traded in a country that uses a currency other than the one in which the bond is denominated. This means that the bond operates outside the jurisdiction of the central bank that issues that currency.

Eurobonds are a form of borrowing used by multinational organisations and governments. For example, a UK company might issue a Eurobond in Germany, denominating it in US dollars. It is important to note that the term has nothing to do with the euro currency, and the prefix 'euro' is used more generally to refer to deposits outside the jurisdiction of the domestic central bank.

6.7.5 Taxation of income

Local authority bonds, corporate bonds, PIBS and Eurobonds pay interest gross (without deduction of tax).

The income is classed as savings income so would be free of tax if it fell within an individual's starting-rate band for savings income or their personal savings allowance (see Topic 3, section 3.4.4). If the gross interest, when added to other savings income, falls outside the starting-rate band for savings and exceeds an individual's personal savings allowance it will be taxed at 20 per cent, 40 per cent or 45 per cent with the actual rate determined by the individual's gross income. Where tax has been taken at source, this can be deducted from the amount owed.

6.8 What is a structured deposit?

The return from a bank account is generally in the form of interest and linked to general interest rates. With a structured deposit, the return paid is linked to the performance of an index measuring the performance of equities, such as the FTSE 100. The investment is normally arranged over a fixed term, five years for example.

Unlike a traditional fixed-rate savings account, the return generated through a structured deposit is variable because it is linked to the performance of a particular stock market index or indices. The benefit of using structured deposits is access to equity-based returns with a promise that, regardless of stock market performance, depositors will always get back their initial investment. This reduction in risk is offset by the lowered potential for reward, meaning investors probably will not receive the full benefit of any index rise and they will not receive dividend payments. Structured deposits are complex and are normally purchased via a financial adviser.

6.9 What is 'alternative finance'?

Alternative finance or peer-to-peer lending (P2P) involves a saver placing their money with a P2P lender who will then lend the money out to businesses that are seeking funding. This type of lending is usually arranged via aggregating companies, examples of which include Wellesley & Co, Zopa and Funding Circle.

P2P lending is not a deposit proposition but has a number of elements in common with deposit-based savings, notably that funds are aggregated and distributed, normally for a return, and it is possible to arrange both on an easy access and fixed-rate basis over an agreed term. P2P lenders are regulated by the FCA.

In some cases, returns can be very competitive with traditional deposits but there are more risks. While the lender will perform due diligence on the businesses to which funds are being lent, there is a risk that loan repayments might be missed, in which case the returns to the saver would reduce. Importantly, P2P lenders are not covered by the Financial Services Compensation Scheme (see Topic 25).

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the four main asset classes – and a possible fifth one?
- explain why deposit-based savings might appeal to an investor over other forms of investment?
- explain why an offshore investment is potentially riskier than an onshore one?
- describe how a gilt works?
- explain what a corporate bond is?
- explain how a structured deposit differs from an ordinary bank or building society deposit account?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 6. Review the text if necessary.

Answers can be found at the end of this book.

1) A bank deposit account is a good place to hold a 'rainy day fund'. True or false?
2) What, if any, is the minimum age at which a person can take out an NS&I Direct Saver?
   a) There is no minimum age.
   b) 16.
   c) 18.
3) Interest on NS&I Income Bonds is tax-free. True or false?
4) State two reasons why offshore bank accounts might be more risky than similar UK deposit accounts.
5) In relation to gilts, what is the 'coupon'?
6) Jane has invested in short-dated gilts. According to the UK Debt Management Office (DMO) definition, this means that:
   a) the gilts will have a redemption date within the next seven years.
   b) interest on the gilts will not be paid to her until the end of the term.
   c) the gilts will have a redemption date within the next ten years.
   d) she will be unable to access her capital until the end of the term.
7) Rubina is considering buying a gilt, 3% Treasury 2025. The gilt is currently trading at a price of £107. What is the running yield?
8) The main difference between corporate bonds and gilts is that corporate bonds:
   a) usually pay a variable rate of interest.
   b) are usually for larger amounts of money.
   c) normally have no specified redemption date.
   d) are considered to be higher-risk investments.

9) The main difference between a debenture and other types of corporate bond is that a debenture:

   a) carries the right to vote at the company's annual general meeting.

   b) is usually secured on the assets of the company.

   c) can be converted to ordinary shares of the company.

   d) pays a fixed rate of interest.

10) A Eurobond is the equivalent of a gilt, but issued by a government within the eurozone. True or false?

11) Jack opens an account so that his wages can be paid into it. He can use his account to pay bills such as utilities and rent via direct debit, and he can use his debit card to make purchases online and in shops, but he cannot have an overdraft. What kind of account does Jack have?

   a) Packaged account.

   b) An interbank account.

   c) A basic bank account.

   d) A debit account.

TOPIC 7

Other direct investments

LEARNING OBJECTIVES

Topic 6 introduced the main financial asset classes and some forms of direct investment. In this topic we continue to explore direct investments.

By the end of this topic, you should have an understanding of:

- what equities are and how they are traded and taxed;
- how the returns on equities are assessed;
- other methods of financing companies that provide investment opportunities, including rights issues, scrip issues and preference shares;
- the advantages and disadvantages of investment in property, both residential and commercial;
- ways of investing in the money market.

This topic covers Unit 1 syllabus learning outcomes U2.3, U2.4, and parts of U3.1 and U7.7.

THINK . . .

Some of the asset classes and forms of investment covered in this topic might be new to you. But you will almost certainly have come across share dealing and property investment before. For instance:

- Do you or your friends or family members own shares in an individual company? Do you know why they chose to buy those particular shares?
- Have you heard or read news reports about significant falls or rises in stock market indices around the world, such as the FTSE 100, the Dow Jones or the Nikkei?
- Have you seen or heard reports about the share price of a particular company rising or falling dramatically in response to a news event that affects them?
- Do you own a property that you rent out?

The investments covered in this topic receive a lot of attention in both the financial and mainstream media; your studies for UKFR should help you to understand these reports better.

7.1 What are equities?

Equities, also known as ordinary shares, are the most important type of security that UK companies issue. They can be, and are, bought by private investors, but most transactions in equities are made by institutions and by life and pension funds.

Holders of ordinary shares (shareholders) are in effect the owners of the company. The two main rights that they have are to:

- receive a share of the distributed profits of the company as income in the form of dividends;
- participate in decisions about how the company is run, by voting at shareholders' meetings.

KEY TERMS

SECURITIES

Financial assets that can be traded. They can be divided into two broad classes: those that represent ownership (equities) and those that represent debt (such as gilts and corporate bonds).

DIVIDEND

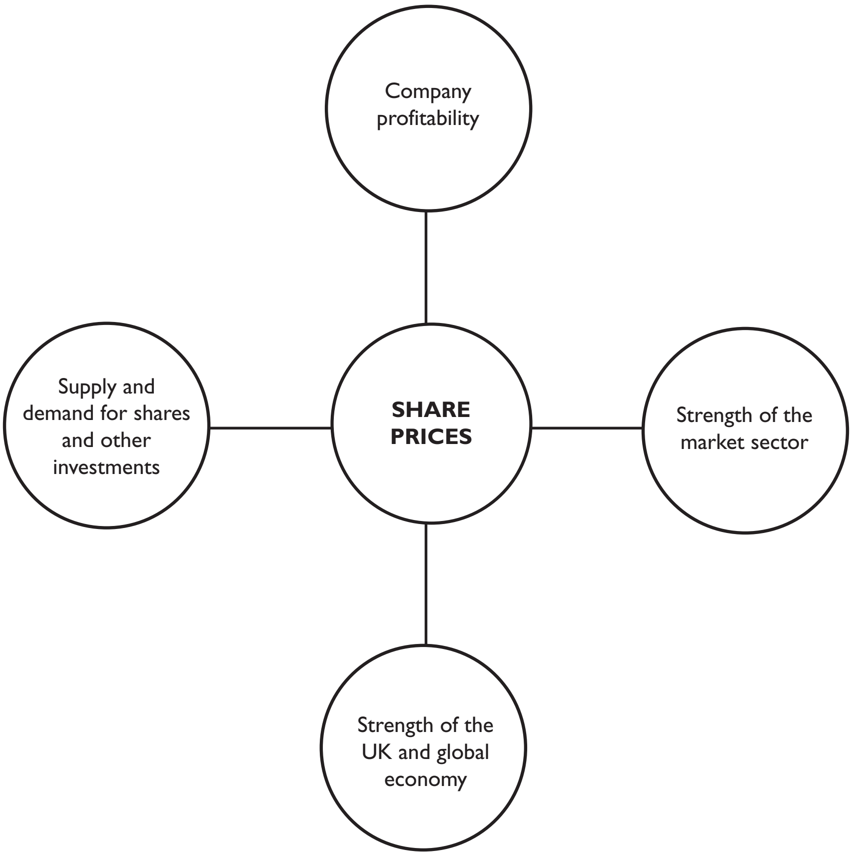
A portion of a company's profits that is distributed to shareholders. The level of dividend available is dependent on the profitability of the company and strategic decisions such as the need to reinvest profits to expand the business.

The rights attaching to shares of the same class can sometimes differ from company to company, even though the shares normally have the same major characteristics. It is therefore prudent for investors to find out precisely what rights attach to a particular share. These rights are set out in the company's articles of association; this is a public document and can be examined at the registered office of the company or at Companies House.

Direct investment in shares is considered to be high risk because the failure of the company can result in the loss of all the capital invested. This risk can be mitigated by investing across a range of shares in different companies operating in different sectors. There are a number of products to enable investors to do this, such as unit trusts. We will be focusing on these in Topic 8.

The prices at which shares are traded depend on a range of factors, as indicated in Figure 7.1.

FIGURE 7.1 FACTORS AFFECTING SHARE PRICES



In the short term, share prices can fluctuate both up and down – sometimes quite spectacularly – but in the long term, investment in equities and equity-linked markets has outpaced inflation and has provided higher growth than deposit-type investments.

7.2 How are shares bought and sold?

The Stock Exchange has been London's market for stocks and shares for hundreds of years. Shares, issued by UK and overseas companies, gilts, corporate bonds and options are all traded on this market. There are two markets for shares: the main market (for which full listing is required) and the Alternative Investment Market.

7.2.1 The main market

In order to be listed on the main market, companies must conform to the stringent requirements of the Listing Rules laid down by the Financial Conduct Authority (FCA), acting in its capacity as the UK Listing Authority (UKLA).

For a full listing, a considerable amount of accurate financial and other information must be disclosed. In addition:

- the applicant company must have been trading for at least three years;
- at least 25 per cent of its issued share capital must be in the hands of the public.

The London Stock Exchange, like most stock markets, is both a primary and secondary market.

- **The primary market** is where companies and financial organisations can raise finance by selling securities to investors. They will either be coming to the market for the first time, through the process of 'going public' or 'flotation', or issuing more shares to the market. The main advantages of listing include greater ease with which shares can be bought or sold, and the greater ease with which companies can raise additional funds.
- **The secondary market** is where investors buy and sell existing securities. It is much bigger than the primary market in terms of the number of securities traded each day.

7.2.2 Alternative Investment Market

The Alternative Investment Market (AIM), which started in 1995, is mainly intended for new, small companies with the potential for growth.

Its purpose is to enable suitable companies to raise capital by issuing shares, and it allows those shares to be traded. In addition to the benefit of access to public finance, companies will enjoy a wider public audience and enhance their profiles by joining the AIM.

Rules for joining the AIM are fewer and less rigorous than those for joining the official list (the main market) and were designed with smaller companies in mind.

SHARE INDICES

It is possible to measure the overall performance of shares by using one or more of the various indices that are produced. These include the following:

- **FTSE 100 Index** (commonly known as the Footsie) – this is an index of the top 100 companies in capitalisation terms; each company is weighted according to its market value.
- **FTSE 250 Index** – the next (after the FTSE 100) 250 companies by market capitalisation.

- **FTSE 350 Index** – the FTSE 100 and FTSE 250 companies combined.
- **FTSE All-Share Index** – this is an index of around 600 shares, split into sectors. It measures price movements and shows a variety of yields and ratios as well as a total return on the shares.

MARKET CAPITALISATION

The market value of a company, calculated by multiplying the number of shares in issue by the share price.

FACTFIND

There are numerous websites that provide up-to-date information on share prices, including the website of the London Stock Exchange itself:

http://www.londonstockexchange.com [Accessed: 13 October 2020].

FIGURE 7.2 PARTICIPANTS IN THE MARKETS

Individual and institutional investors eg pension funds, life assurance companies	**Banks and other traders**	**Governments, public institutions, corporations**	**Investment banks**
• Invest money	• Issue, buy or sell shares or derivatives	• Issue securities eg gilts, corporate and local authority bonds	• Facilitate issues of new securities

OVER-THE-COUNTER (OTC) TRADING

OTC trading is not very common between individual private investors, but is common between institutions. They trade large blocks of securities with little publicity about the price paid or the company(ies) whose shares are being traded. This form of trading is sometimes called 'dark pools'.

MiFID II introduced stricter requirements for all trading venues to ensure the fair and orderly functioning of financial markets. New reporting requirements have increased the amount of information available and are expected to reduce the use of dark pools and OTC trading. More information can be found at: https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir [Accessed: 21 April 2020].

7.3 Returns from shares

Shareholders in a limited liability company do not have a liability for the debts of the company. The company is, legally, a separate entity from its owners and is liable for its own debts. Shareholders do, however, run the risk that the value of their investment in the company could go down; if the company goes into liquidation they could lose their investment altogether.

So, given that those who invest in equities run the risk of potentially losing all their investment, we might expect that they would also expect to receive higher returns than they could get from investing in deposit-based investments, where their capital is protected. It is certainly true that, on average and over the longer term, equity markets have generally outpaced the returns available on secure deposit-based investments.

EX-DIVIDEND SHARES

Dividends are usually paid half-yearly. Because of the administration involved in ensuring that all shareholders receive their dividends on time, the payment process has to begin some weeks before the dividend dates. A 'snapshot' of the list of shareholders is made at that point, and anyone who purchases shares between then and the dividend date will not receive the next dividend (which will be paid to the previous owner of the shares). Once the date has passed when the administrative process of paying the dividend starts, the shares are said to be ex-dividend (or xd). The share price would normally be expected to fall by approximately the dividend amount on the day it becomes xd.

Alternatively a share may be paid cum-dividend, which means that it is purchased before it goes xd, and the purchaser receives the next dividend payment.

7.3.1 Assessment of returns

The financial returns that shareholders hope to receive from their shares take two forms:

- the growth in the share price (capital growth); and
- the dividends they receive as their share of the company's distributable profits (income).

There are a number of measures that can be used to assess the success of investment in a company's shares and to predict future performance. Some of these measures are as follows.

Earnings per share

This is equal to the company's post-tax net profit divided by the number of shares, but it is not normally the amount of dividend to which shareholders are entitled on each of their shares. This is because a company may choose not to distribute all of its profits: some profits might be retained in the business to finance expansion, for instance. This in turn leads to the concept of dividend cover.

Dividend cover

This factor indicates how much of a company's profits are paid out as dividends in a particular distribution. If, for example, 50 per cent of the profits are paid in dividends, the dividend is said to be covered twice. Cover of 2.0 or more is generally considered to be acceptable by investors, whereas a figure below 1.0 indicates that a company is paying part of its dividend out of retained surpluses from previous years.

Price/earnings ratio

As its name suggests, the price/earnings (P/E) ratio is calculated as the share price divided by the earnings per share. It is generally considered to be a useful guide to a share's growth prospects. If the market is operating in an efficient manner, then the P/E ratio should give an estimate of a company's future potential to generate returns for shareholders.

As P/E ratios vary between market sectors, the P/E ratio should only be used to compare shares in the same or similar categories. Where a share has a high P/E ratio compared with those of other shares in the same category or in comparison with the sector average, then this indicates that the shares are in demand. Such a share is likely, as a result, to be relatively more expensive than others within the same market sector while offering the prospect of higher-than-average earnings in the future. A comparatively low P/E ratio indicates that the share is not in high demand.

The P/E ratio should be viewed in conjunction with other indicators; a share with a high P/E ratio is not necessarily a good purchase as expectations of future earnings growth may already have been factored into the share price, and a share with a low P/E ratio may have been overlooked.

IN BRIEF

Earnings per share (EPS) = post-tax net profit ÷ number of shares

Dividend cover = how much of company profits are paid as dividends

Price/earnings (P/E ratio) = share price ÷ earnings per share

You can find more information on tax legislation and rates at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/872423/Overview_of_Tax_Legislation_and_Rates_2020.pdf [Accessed: 21 April 2020].

7.3.2 Taxation

As we saw in Topic 3, dividends are paid without deduction of tax but are subject to income tax. Everyone is entitled to a dividend allowance (DA); in 2020/21 the DA is £2,000. If an individual's aggregate dividend income in a tax year falls within the DA, no tax is payable. If dividend income exceeds the DA, it is taxed at different rates depending on the tax band into which it falls.

Gains realised on the sale of shares are subject to capital gains tax (CGT), although investors may be able to offset the gain against their annual CGT exemption.

✓

CHECK YOUR UNDERSTANDING 1

What are the rates at which dividend income is taxed? We covered the rates applicable in 2020/21 in Topic 3, but you need to know the current rates.

%

TAXATION OF DIVIDEND INCOME

This example is based on 2020/21 tax bands and rates. You must check the rates that apply at the time you are studying.

Sophie has taxable earned income of £31,500 and receives dividend payments of £9,000 in 2020/21.

The tax payable is worked out in a set order of priority:

1) Earned income.

2) Dividend income.

Higher-rate income tax is paid on taxable income above £37,500.

Sophie's tax is calculated as follows. (Remember that taxable income is after the personal allowance has been deducted.)

Her earned taxable income all falls within the basic-rate tax band and there is £6,000 of the basic-rate tax band remaining (£37,500 – £31,500 = £6,000).

So the first £6,000 of her dividend income falls in the basic-rate tax band. However, the first £2,000 is covered by the DA, so no tax is payable on that amount.

The remaining £4,000 within the basic-rate band is taxed at 7.5 per cent = £300.

This leaves £3,000 in the higher-rate tax band, which is taxed at 32.5 per cent = £975.

The total tax payable on Sophie's dividend income is £1,275.

Note that the dividend income falling within the basic-rate band, even where covered by the DA and not taxed, does use up a portion of the basic-rate band. Therefore, in the example above, £3,000 is subject to higher-rate tax rather than all of Sophie's dividend income above the DA being taxed at the basic rate.

FACTFIND

Check the current arrangements for taxation of dividends at:

https://www.gov.uk/tax-on-dividends/overview [Accessed: 18 February 2020].

Check the current CGT rates and exemptions at:

https://www.gov.uk/capital-gains-tax/overview [Accessed: 18 February 2020].

7.4 What other ways of investing in companies are there?

7.4.1 Rights issues

Stock Exchange rules require that, when an existing company that already has shareholders wishes to raise further capital by issuing more shares, those shares must first be offered to the existing shareholders. This is done by means of a rights issue offering, for example, one new share per three shares already held, generally at a discount to the price at which the new shares are expected to commence trading. Shareholders who do not wish to take up this right can sell the right to someone else, in which case the sale proceeds from selling the rights compensate for any fall in value of their existing shares (due to the dilution of their holding as a proportion of the total shareholding).

7.4.2 Scrip issues

Scrip issue, also known as a bonus issue or a capitalisation issue, is an issue of additional shares, free of charge, to existing shareholders. No additional capital is raised by this action – it is achieved by transferring reserves into the company's share account. The effect is to increase the number of shares and to reduce the share price proportionately.

7.4.3 Preference shares

As with ordinary shares, holders of preference shares are entitled to dividends payable from the company's profits. They differ from ordinary shares in that they are generally paid at a fixed rate, and holders of preference shares are eligible for any dividend payout ahead of ordinary shareholders. Many preference shares are cumulative preference shares, which means that if dividends are not paid, entitlement to dividends is accumulated until such a time as they can be paid.

Preference shares do not normally carry voting rights, although in some cases holders may acquire voting rights if their dividends have been delayed.

If a company has to be wound up, there would generally be only a limited amount of money available to repay debts and shareholders. In this situation, the claims of creditors are repaid in a set order of priority. Shareholders rank lowest in the order of priority and are therefore most at risk of receiving nothing at all; however, holders of preference shares have a higher claim than holders of ordinary shares.

7.4.4 Convertible preference shares

Convertibles are securities that carry the right to be converted at some later date to ordinary shares of the issuing company. Traditionally they were issued as corporate bonds (with a lower rate of interest than conventional corporate bonds because of the right to convert to equity). In recent years, they have been increasingly issued as convertible preference shares.

CHECK YOUR UNDERSTANDING 2

Convertible preference shares were traditionally issued as corporate bonds – can you recall what a corporate bond is? Try to write a brief summary that includes:

- why companies issue bonds;
- the form in which an investor receives income from a bond; and
- what the risks are to the investor.

Look back to Topic 6 to see how accurate your summary is.

7.4.5 Warrants

Warrants give the holder the right to buy shares at a fixed price at an agreed future date. The attraction is that they give the holder rights at a fraction of the cost of the shares themselves. At the date when the warrant can be exercised, it will be exercised if the share price is above the price at which the shares can be bought under the terms of the warrant. If the share price is at or below the terms offered by the warrant, it will not be worth exercising the warrant and it will lapse.

7.5 Residential property

The vast majority of investors will only ever own residential property. For most people this does not extend beyond the purchase of their own home, although an increasing number of people are buying residential properties specifically as an investment.

Property investment has a number of benefits and advantages, including the following:

- Property is a very acceptable form of security for borrowing purposes.
- The UK property market is highly developed and operates efficiently and professionally.

On the other hand, there are a number of pitfalls and disadvantages of which inexperienced investors in particular should be made aware, including the following:

- Location is of paramount importance and a badly sited development may prove a problem.
- The property market is affected by overall economic conditions – in times of recession, letting properties may be difficult and property prices may fall.
- Property is a less liquid form of investment than most others.

As with direct investment in shares, direct investment in property can be a risky business for the small investor, although the advent of buy-to-let mortgages (see section 7.6) has made it easier. For those with smaller amounts of capital and those who wish to spread the risk, property bonds might be appropriate: the underlying fund is invested in a range of properties and shares in property companies.

The purchase of property is subject to stamp duty land tax and a 3 per cent premium to SDLT applies where the property is not the only one owned.

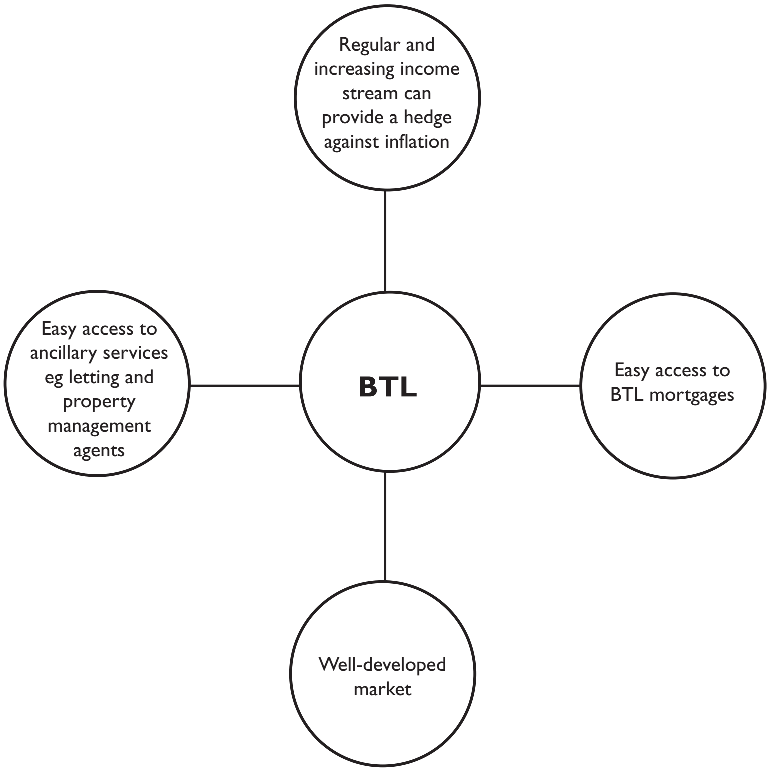
Income from property, after deduction of allowable expenses, is subject to income tax. It is treated as non-savings income for tax purposes. On the disposal of investment property, any gain is liable to capital gains tax (CGT), but any capital expenditure on enhancement of the property's value can be offset against taxable gains.

7.6 Buy to let

Recent tax crackdowns have had a significant impact on the once buoyant buy-to-let (BTL) market in the UK, although a number of landlords hold portfolios of BTL properties.

Benefits offered by BTL investment, beyond the general benefits conferred by property ownership, are summarised in Figure 7.3.

FIGURE 7.3 WHAT MAKES BUY TO LET ATTRACTIVE TO INVESTORS?



There are also a number of risks:

- Accessing the market can be difficult, as investment costs are high and there are additional costs associated with arranging a mortgage, legal fees and stamp duty land tax.
- Property is an illiquid investment, meaning that it may be difficult to generate funds if they are required at short notice.
- There may be void periods when the property is untenanted, meaning that income is reduced or ceases.
- There is the risk that tenants may damage the property, leading to additional costs.
- Legal fees may be incurred to remove unsatisfactory tenants.
- The property will require ongoing management and maintenance; these services can be outsourced but the costs would reduce overall yield.

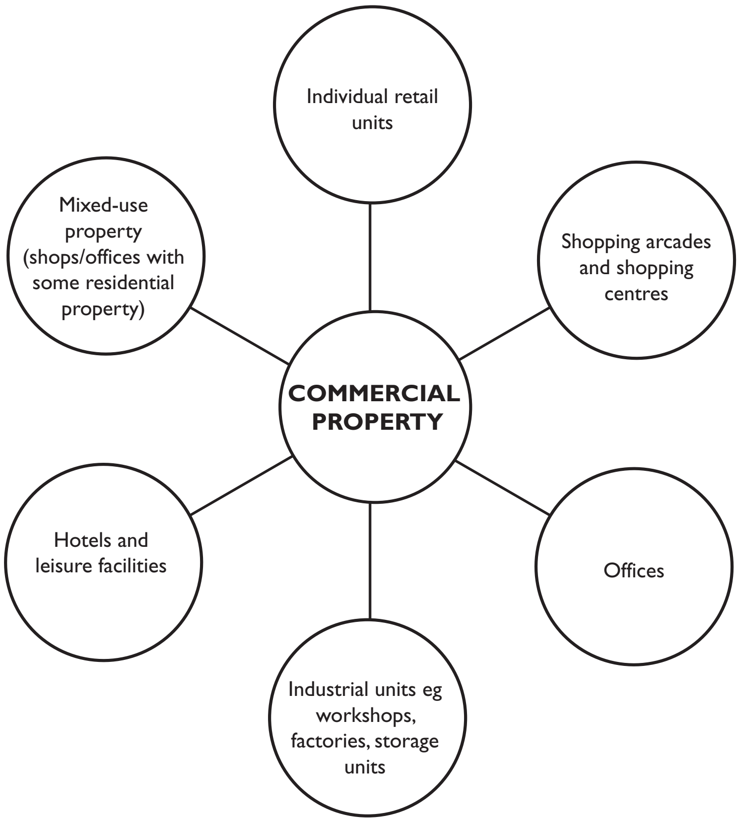
The government became increasingly concerned at the growth of the BTL sector and the way in which this reduced the availability of affordable housing for first-time buyers. Consequently, a number of measures were put in place that reduced the attractiveness of BTL as an investment.

- **Tax relief** – previously, a BTL landlord could deduct the full cost of mortgage interest from their BTL income when calculating profits. This effectively gave tax relief at the landlord's highest marginal income tax rate in respect of the interest costs. Changes have been phased in over three years from April 2017 which mean that tax relief is limited to a tax credit at the basic rate only in the 2020/21 tax year.
- **Wear and tear** – up until April 2016, landlords were able to claim an annual wear-and-tear allowance on the cost of furnishings in the property. This has been replaced by a furniture replacement relief that only allows the actual cost of replacing furnishings to be offset against profits.
- **Stamp duty land tax** – as mentioned in section 7.5, second properties are now subject to a 3 per cent stamp duty land tax surcharge when purchased.

7.7 Commercial property

Investment in commercial property covers almost anything that is not defined as wholly residential (see examples in Figure 7.4).

FIGURE 7.4 WHAT IS COMMERCIAL PROPERTY?



Commercial property tends to provide reasonably high rental income together with, in general, steady growth in capital value. The main advantages are:

- regular rent reviews, with typically no more than five years between each;
- longer leases than for residential property;
- more stable and longer-term tenants;
- typically lower initial refurbishment costs.

Drawbacks may include the following:

- the higher average value means that spreading the risk is more difficult;
- commercial property does not generally show the spectacular growth in value that can sometimes be achieved in residential property;
- if the investment is to be funded by borrowing, interest rates may be higher than for residential loans.

Lenders often carry out detailed investigations before lending for the purchase of commercial property, checking on the:

- quality of the land and property;
- reputation of builders, architects and other professionals involved;
- suitability of likely tenants.

AGRICULTURAL PROPERTY

A further category of property investment is agricultural property – farmland. An investor may buy the land and run the farm themselves to generate income or let out all or some of the land to a third party, thus providing rental income. There is the prospect of capital growth but the market for agricultural land is highly specialised and demand limited; liquidity is therefore a major concern.

One of the benefits of owning agricultural property is agricultural relief for inheritance tax. This relief applies to the land, growing crops and farm buildings. Relief is available for up to 100 per cent of the inheritance tax liability for owner-occupied farms, or 50 per cent where the owner has let out the land.

7.8 Money-market instruments

'Money-market instruments' is a generic term used to describe a number of forms of short-term debt. Interest is not normally paid during the term of the transaction, the rate of interest being determined by the difference between the amount invested/borrowed and the amount repaid.

In order to illustrate the nature of these instruments, we will describe three of them: Treasury bills, certificates of deposit, and commercial paper.

7.8.1 Treasury bills

Treasury bills are short-term redeemable securities issued by the Debt Management Office (DMO) of the Treasury. Like gilts, they are fundraising instruments used by the UK government, but they differ from gilts in a number of ways. Two major differences are:

- Treasury bills are **short term**, normally being issued for a period of 91 days, whereas gilts can be long term or even undated;
- Treasury bills are **zero-coupon securities**, ie they do not pay interest. Instead, they are issued at a discount to their face value or par value (the amount that will be repaid on their redemption date).

As with gilts, Treasury bills are considered to be very low-risk securities, the risk of default by the borrower (the UK government) being so low as to be effectively zero. For example, a Treasury bill may be issued for £9,850 with a 'par value' of £10,000. The investor makes a guaranteed £150 on their £9,850 investment over 91 days, representing just over 6 per cent pa return, with no risk (£150 ÷ £9,850 x 100 = 1.52% over three months).

Because they are such short-term securities, changes in market rates of interest have little impact on the day-to-day prices of Treasury bills unless the changes are significantly large.

Throughout their term, Treasury bills can be bought and sold, and there is a strong secondary market, provided mainly by financial institutions as there is no centralised marketplace. The price tends to rise steadily from the issue price to the redemption value over the 91-day period, but prices can also be affected by significant interest rate changes, or by supply and demand.

TREASURY BILLS

Short-term redeemable securities issued at a discount to their face value. Also known as T-bills.

Treasury bills are purchased in large amounts, and they are not, therefore, generally of interest to small, private investors. They are held in the main by large organisations (particularly financial institutions) seeking secure short-term investment for cash that is temporarily surplus to requirements.

7.8.2 Certificates of deposit

Certificates of deposits (CDs) are issued by banks and building societies. They are in effect a receipt to confirm that a deposit has been made with the institution for a specified period at a fixed rate of interest. The interest is paid with the return of the capital at the end of the term. Terms are typically three months or six months, although depositors who require a longer term can often obtain CDs that can be 'rolled over' for a further three or six months on specified terms. The amounts deposited are typically £50,000 or more.

There are significant penalties for withdrawals before the end of the term. However, because certificates of deposit are bearer securities, they can be sold to a third party if the depositor needs the funds before the end of the term.

Banks may also hold CDs issued by other banks, and they can issue and hold CDs to balance their liquidity positions. For example, a bank would issue CDs maturing at a time of expected liquidity surplus, and hold CDs maturing at a time of expected deficit.

KEY TERMS

CERTIFICATE OF DEPOSIT

A 'receipt' confirming that a (substantial) deposit has been made with a bank or building society for a fixed period at a fixed rate of interest.

BEARER SECURITIES

Securities that are deemed to be owned by whoever physically possesses the document that confers ownership, rather than ownership being determined by an entry on a register, etc.

7.8.3 Commercial paper

Businesses need to borrow for a variety of purposes. When they need funds for investment in their longer-term business plans, they may issue corporate bonds. When they wish to borrow for working capital purposes, however, they can issue commercial paper. The transactions are for very large amounts, with most purchasers being institutions such as pension funds and insurance companies. Commercial paper can be placed directly with the investors, or through intermediaries.

The commercial paper market offers cheaper borrowing opportunities for companies that have good credit ratings, but even companies with lower credit ratings can issue commercial paper if it is backed by a letter of credit from a bank that guarantees (for a fee) to make repayment if the issuer defaults.

KEY TERMS

COMMERCIAL PAPER

An unsecured promissory note – ie a promise to repay the funds that have been received in exchange for the paper.

WORKING CAPITAL

Funds available for the day-to-day running of the business, calculated as current assets minus current liabilities.

Most commercial paper is issued for periods of between five and 45 days, with an average of around 30 to 35 days. Firms that need to retain funds for longer than this regularly roll over their commercial paper – the advantages of this are:

- flexibility; and
- the fact that the rate of interest is not fixed for a long period.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain what shares are and two ways an investor can expect to make money from investing in shares?
- describe three ways of assessing the performance of shares?
- summarise the measures the government has taken to make buy to let a less attractive option for investors?
- describe the main features of Treasury bills, certificates of deposit and commercial paper?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 7. Review the text if necessary.

Answers can be found at the end of this book.

1) Direct investment in shares is low risk for individual investors because, over the long term, equity markets have outpaced inflation. True or false?
2) Name three factors that can affect share prices.
3) What are the implications for the purchaser of buying shares ex-dividend?
4) A share with a low P/E ratio is likely to be more expensive than other shares in the same market sector. True or false?
5) If a company distributes 25 per cent of its profits in the form of dividends to its shareholders, what would the dividend cover be?

   a) 4.

   b) 8.

   c) 10.

   d) 25.
6) What is the difference between a rights issue and a scrip issue?
7) Elliott is considering investing in a buy-to-let property. He thinks this is a good way to achieve a high return. What are the main drawbacks that Elliott should be aware of?
8) How can a buy-to-let investor claim relief for wear and tear on furniture?
9) Treasury bills are zero-coupon securities. What does this mean?
10) Commercial paper is generally issued for a term of between three and six months. True or false?

Collective investments

LEARNING OBJECTIVES

Topics 6 and 7 focused on direct investments in financial assets. In this topic we are looking at indirect forms of investment known as collective (or pooled) investments. Collective investments are arrangements that make it possible for individual small investors to invest in a large investment fund.

By the end of this topic, you should have an understanding of:

- why collective investments appeal to investors;
- unit trusts;
- investment trusts;
- open-ended investment companies (OEICs);
- investments based on life assurance products, including endowments and investment bonds;
- friendly society plans;
- non-mainstream pooled investments (NMPIs);
- structured products;
- wraps and platforms.

This topic covers Unit 1 syllabus learning outcome U3.2 and part of U7.7.

THINK . . .

An investor who lacks the knowledge, confidence or experience to invest directly into the types of asset covered in Topics 6 and 7 might choose to use a collective investment instead. You may have used a collective investment yourself or you may have read about them in the media. For instance:

- Do you have a stocks and shares ISA that holds unit trusts, investment trusts or open-ended investment companies?

- Have you considered using one of the collective investment types listed in the learning objectives above? What made you consider this type of investment?
- Have you read media reports about the high levels of investment returns produced by some fund managers?

If the answer to all of these questions is "no", don't worry – this topic provides a good introduction!

8.1 Why do collective investments appeal to investors?

The main forms of collective investment are:

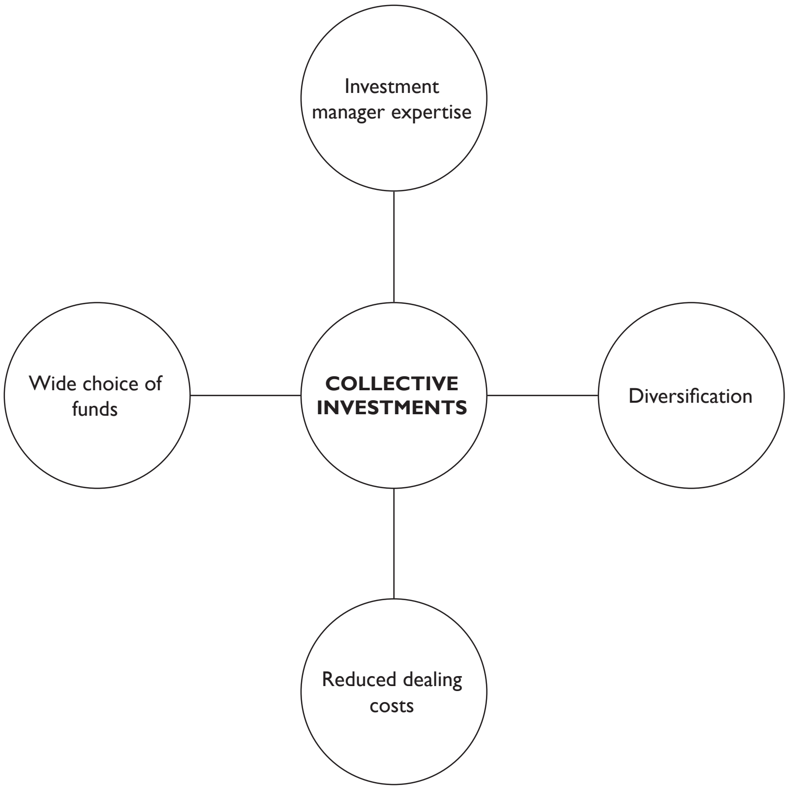
- unit trusts;
- investment trusts;
- investment bonds; and
- OEICs.

We look at each of these in more detail below.

For individual investors, collective investments offer a number of advantages, summarised in Figure 8.1 and outlined below:

- The services of a skilled investment manager are obtained at a cost that is shared among the investors. Individual investors do not need to research particular companies – nor do they need to understand and deal with the decision-making and administrative work arising from events such as rights issues.
- Investment risk can be reduced because the investment manager spreads the fund by investing in a large number of different companies; thus if one company fails, the investor loses only a small part of their investment, rather than all of it. This is referred to as 'diversification'. Such a spread of investments could not normally be achieved with small investment amounts.
- Fund managers handling investments of millions of pounds can negotiate reduced dealing costs for their investors.
- There is a wide choice of investment funds, catering for all investment strategies, preferences and risk profiles.

FIGURE 8.1 KEY ADVANTAGES OF COLLECTIVE INVESTMENTS



DIVERSIFICATION

Diversification is an important concept for investors. It involves creating a portfolio of investments that are spread across different geographical areas, asset classes and sectors of the economy. The aim is to spread risk, in the hope that poor performance of one investment will be offset by better performance in another. It is the opposite of 'putting all your eggs in one basket'. For example, if you only hold shares in a company that sells sunscreen, you are likely to make most money in a hot summer. If you only hold shares in a company making umbrellas, you will make most money if it rains. By diversifying to hold shares in both companies, you would have the opportunity to make money whatever the weather.

8.1.1 How are investment funds categorised?

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

- location, eg UK, Europe, America, Far East;

- industry, eg technology, energy;
- type of investment, eg shares, gilts, fixed interest, property;
- other forms of specialisation, eg recovery stocks, ethical investments.

Many funds are based on more than one categorisation; for example, a UK equity fund is categorised by both location and type of investment.

A further categorisation is possible:

- funds that aim to produce a high level of income (perhaps with modest capital growth);
- those that aim for capital growth at the expense of income; and
- those that seek a balance between growth and income.

Funds can also be categorised according to their management style:

- Actively managed funds (sometimes referred to simply as 'managed funds') use the services of a fund manager(s) to make decisions on asset selection and when holdings should be bought or sold.
- Passively managed or tracker funds will seek to replicate the performance of a particular stock market index, such as the FTSE All-Share. A manager may be used but it is also possible that asset selection is computerised.

MANAGED FUNDS

The term 'managed' fund can also be used as a marketing term to describe a fund that is comprised of holdings allocated across some or all of the other funds a company offers. Most companies offer one or more managed funds – for example, 'managed growth' or 'managed income'. In this context the manager's role in a company's managed fund tends to involve deciding on the way fund investments should be allocated between the company's other funds.

8.2 What are unit trusts?

A unit trust is a pooled investment created under trust deed. An investor will generally consider a unit trust as a means of trying to produce a better return than could have been achieved elsewhere. They can invest a lump sum in the unit trust, make regular contributions, or a mixture of both.

Depending on the proportion of funds held in equities and in cash or fixed-interest stock, a unit trust is categorised as an equity trust (where the underlying assets are mainly shares), or a fixed-interest trust (invested mainly in interest-yielding assets). An equity trust pays a dividend, while a fixed-interest trust pays interest.

A unit trust is divided into units, with each unit representing a fraction of the trust's total assets. It is 'open-ended', so if lots of investors want to buy units in it, the trust manager can create more units. (Not all types of collective investment are 'open-ended'; investment trusts, for example, which we look at later in this topic, are 'closed-ended'.)

Unit trusts may offer the following units:

- **Accumulation units** automatically reinvest any income generated by the underlying assets. This would suit someone looking for capital growth.
- **Distribution or income units** split off any income received and distribute it to unit holders. The units may also increase in value in line with the value of the underlying assets.

The unit trust aims to produce a return by selecting investments that will grow in value and/or generate income. If this happens, the unit price will increase, meaning that the investment, when encashed, will be worth more than it was at outset. A key role of the manager is to select investments that will achieve the trust's objectives in terms of income and/or growth.

WHAT IS A TRUST?

In general law a trust is an arrangement whereby one person gives assets to another (the trustees) to be looked after in accordance with a set of rules (specified in the trust deed). A unit trust is similar in that the trust deed details the investment rules and objectives of the scheme. The investor effectively gives their money to the trustees who will in turn allow the fund manager to use it so as to meet the trust's objectives. The trustees will ensure that the manager is fulfilling their obligations under the trust deed.

8.2.1 How are units priced?

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

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

- The **offer price** is the price at which investors buy units from the managers.
- The **bid price** is the price at which the managers will buy back units from investors who wish to cash in all, or part, of their unit holding.
- The **cancellation price** is the minimum permitted bid price, taking into account the full costs of buying and selling. At times when there are both buyers and sellers of units, the bid price is generally above this minimum level, since costs are reduced because underlying assets do not need to be traded.

Some unit trusts use bid and offer prices, with the difference between them (known as the bid–offer spread) being between 3 per cent and 5 per cent. Some unit trust managers, however, have moved to a single-price system with no bid–offer spread and charges to cover management costs because they believe that this is better understood by investors. In this case, they may impose an exit charge if units are sold within, for instance, three or five years of purchase.

BID–OFFER SPREAD

The difference between the price at which a unit is offered to an investor (offer price) and the price at which the fund manager will buy it back (the bid price).

FORWARD AND HISTORIC PRICING

When buying or selling shares directly, the process is instant: the stockbroker quotes a price based on the current market and, if the investor accepts, the deal is done at that price. There is no such market for unit trusts as units are sold by/sold back to the fund manager themselves. At the end of each dealing period, usually daily, the manager will value the fund and determine the unit price.

The purchase of units in a unit trust is not an instant process as application forms need to be completed, sent off or emailed, and then administered before the investment is made. Units are generally priced on a forward pricing basis. Under forward pricing, clients buy or sell in a given dealing period at a price that will be determined at the end of the dealing period. The prices published in the financial press are therefore only a guide to investors, who do not know the actual price at which their deal will be made.

Before forward pricing became standard practice there was a system of historic pricing: the price of units was determined by the closing price at the end of the previous dealing period. Fund managers are still permitted to use historic pricing if they wish, subject to the proviso that they must switch to forward pricing if an underlying market in which the trust is invested has moved by more than 2 per cent in either direction since the last valuation.

8.2.2 How are units bought and sold?

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

Units can be bought direct from the managers or through intermediaries. They can be purchased in writing, by telephone or online: all calls to the managers' dealing desks are recorded as confirmation that a contract has been established.

Purchasers may receive two important documents from the managers:

- **The contract note** – this specifies the fund, the number of units, the unit price and the amount paid. It is important because it gives the purchase price, which will be needed for capital gains tax (CGT) purposes when the units are sold.
- **The unit certificate** – this specifies the fund and the number of units held, and is the proof of ownership of the units.

Some holdings are non-certificated. Instead, investors receive a regular statement outlining the number of units held and their current value.

In order to sell units, the holder signs the form of renunciation on the reverse of the unit certificate and returns it to the managers. If only part of the holding is to be sold, a new certificate for the remaining units is issued. If the holding is non-certificated, the investor may be asked to sign a separate form of renunciation.

8.2.3 How are unit trusts regulated and managed?

In the UK, unit trusts are primarily regulated under the terms of the Financial Services and Markets Act 2000, and must be authorised by the Financial Conduct Authority (FCA). The FCA specifies rules aimed at reducing the risks associated with unit trusts. The rules require that a unit trust fund is suitably diversified and specify that the fund cannot borrow an amount of more than 10 per cent of the fund's net asset value and, even then, only for a temporary period.

The trust deed places obligations on both the manager and the trustees. The manager aims to generate profit for the unit trust provider from the annual management charge and dealing in units. The trustees' overall role is to ensure investors are protected and that the manager is complying with the terms of the trust deed. The role of trustee is usually carried out by an institution such as a clearing bank or life company.

Manager's responsibilities

— Managing the trust fund in line with the trust deed

— Valuing the assets of the fund

— Fixing the price of units

— Offering units for sale

— Buying back units from unit holders

Trustees' responsibilities

— Setting out the trust's investment directives

— Holding and controlling the trust's assets

— Ensuring that adequate investor protection procedures are in place

— Approving proposed advertisements and marketing material

— Collecting and distributing income from the trust's assets

— Issuing unit certificates (if used) to investors

— Supervising the maintenance of the register of unit holders

CHARGES

Two types of charges are applied to unit trusts:

- The **initial charge** covers the costs of purchasing fund assets. The initial charge is typically covered by the bid–offer spread.
- The **annual management charge** is the fee paid for the use of the professional investment manager. The charge varies but is typically between 0.5 per cent and 1.5 per cent of fund value. Although it is an annual fee, it is commonly deducted on a monthly or daily basis.

8.2.4 How are unit trusts taxed?

Authorised unit trusts fall into two main categories:

- Fixed-interest trusts are those holding at least 60 per cent of their assets in interest-bearing assets such as gilts and corporate bonds.
- Where a trust does not meet this definition it is classed as an equity unit trust.

In both cases there is no tax on gains within the fund, meaning that the investor may be liable to capital gains tax if they make a gain when encashing the investment.

The tax treatment of income depends on whether the trust is classed as equity-based or fixed-interest.

Equity-based trusts

For equity-based trusts, the tax treatment is the same as for shares. Income is paid without deduction of tax. Where an investor's total dividend in a tax year is less than the dividend allowance (DA), there is no income tax on the dividend.

Where dividend income is in excess of the DA, then the income is taxed at rates of:

- 7.5 per cent for a basic-rate taxpayer;
- 32.5 per cent for a higher-rate taxpayer;
- 38.1 per cent for an additional-rate taxpayer.

Fixed-interest trust

Interest from a fixed-interest trust is classed as savings income. The income is paid gross, without deduction of tax. Where the interest is received by a non-taxpayer, falls within the starting-rate band for savings, or falls within the PSA of a basic- or higher-rate taxpayer, then no tax is payable. Taxpayers who have used their PSA are taxed on the excess income and are required to declare the income to HMRC through self-assessment.

%

TAX PAYABLE ON DIVIDEND INCOME FROM A UNIT TRUST

These calculations are based on rates and bands for the 2019/20 tax year for illustrative purposes.

John has earned income of £39,850 and receives a unit trust dividend of £14,150 in 2019/20, giving him a total income of £54,000. His personal allowance is £12,500. His dividend income is taxed as follows.

Dividend income is taxed after earned income so the personal allowance is deducted first from John's earned income:

£39,850 – £12,500 = £27,350

Basic-rate income tax band is £37,500 and £27,350 of this is used up by the earned income. This leaves £10,150 of the basic-rate income tax band.

Dividend income is £14,150 and so £10,150 of this falls into the basic-rate income tax band. The dividend allowance covers the first £2,000, leaving £8,150 on which tax is due at the basic rate of 7.5 per cent.

The remaining £4,000 of the dividend income falls into the higher-rate tax band.

Thus the total tax due on John's dividend income is:

£2,000 @ 0% = £0

£8,150 @ 7.5% = £611.25

£4,000 @ 32.5% = £1,300

Total tax on dividend = £1,911.25

TAX PAYABLE ON INTEREST FROM A FIXED-INTEREST TRUST

%

These calculations are based on rates and bands for the 2020/21 tax year.

Jane has earned income of £39,000 and receives interest from a fixed-interest unit trust of £13,000 in 2020/21.

Total income = £39,000 + £13,000 = £52,000

Interest is classed as savings income and is taxed after earned income so personal allowance is deducted first from Jane's earned income:

£39,000 – £12,500 = £26,500 taxable income.

Her taxable earned income uses up £26,500 of the £37,500 basic-rate tax band. This leaves £11,000 of the basic-rate band and so the first £11,000 of savings interest falls into this.

Of this £11,000, the first £500 is covered by the personal savings allowance (note that Jane is a higher-rate taxpayer) and the remainder is taxed at the basic rate of 20 per cent.

The remaining £2,000 interest falls into the higher-rate band and is taxed at 40 per cent.

Thus total tax on interest =

£500 @ 0% = £0

£10,500 @ 20% = £2,100

£2,000 @ 40% = £800

Total = £2,900

Jane will declare this income on her self-assessment tax return.

!

Remember – information such as income bands, tax rates and allowances change regularly. You must make sure you are using the current information, for example at:

https://www.gov.uk/government/publications/rates-and-allowances-income-tax [Accessed: 15 March 2020].

8.2.5 What are the risks of investing in a unit trust?

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

The risks involved in investing in a unit trust are lower than those for an individual investing directly into equities on their own behalf because a unit trust is a pooled investment. Unit-trust funds will typically invest in a spread of between 30 and 150 different shares.

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

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

8.3 What are investment trusts?

Investment trusts are collective investments but, unlike unit trusts, they are not unitised funds. In fact, despite their name, they are not even trusts. They are public limited companies whose business is investing (in most cases) in the stocks and shares of other companies. As a company, an investment trust is established under company law and operates as a listed plc; its shares are listed on the stock exchange. A unit trust and an OEIC (see section 8.4) must be FCA authorised. An investment trust, by contrast, must meet FCA requirements to gain a stock market listing, and it is governed by rules in its memorandum and articles of association.

As with all companies, shares are sold to investors. The number of shares available remains constant – the company does not create more just because investors want them – so an investment trust is said to be 'closed-ended' (in contrast to the open-ended nature of unit trusts and OEICs).

8.3.1 Investing in an investment trust

Investing in an investment trust involves purchasing shares in the investment trust through:

- a stockbroker;
- a financial adviser; or
- direct from the investment trust manager.

Similarly, to cash in the investment, it is necessary to sell these shares, via a stockbroker or back to the investment trust manager directly.

The shares trade at a single price but dealing fees are added to any purchase and deducted from any sale. An annual management charge is also payable, typically between 0.5 per cent and 1.5 per cent.

The share price of an investment trust depends to some extent on the value of the underlying investments, but not so directly as in the case of a unit trust: the price can also depend on a number of other factors that affect supply and demand.

NET ASSET VALUE PER SHARE

Total value of the investment fund divided by the number of shares issued.

The share price of an investment trust may be more or less than the net asset value (NAV) per share. Where the share price is less than the NAV the trust is said to be trading at a discount, meaning that an investor should achieve greater income and growth levels than would be obtained by investing directly in the same underlying shares. Where the share price is higher than the NAV, the trust is said to trade at a premium.

8.3.2 Gearing

Because investment trusts are constituted as companies, they can borrow money to take advantage of investment opportunities – this is known as gearing. This facility is not open to unit trusts or OEICs, which are only permitted to borrow money over the short term and against known future cash inflows.

GEARING

The level of debt as a percentage of a company's equity. It is a way of measuring the extent to which a company's operations are funded by borrowing rather than by shareholder capital.

Gearing enables investment trusts to enhance the growth potential of a rising market, but investors should be aware that it can equally accentuate losses in a falling market. The ability to 'gear up' is one of the reasons why investment trusts are viewed as being riskier than a similar unit trust or OEIC. Some investment trusts are described as being 'highly geared', which means they have a high level of borrowing relative to the assets they hold; the investment trust will be pursuing high returns but there is the risk of being unable to service interest and/or repayments on borrowings.

8.3.3 How are investment trusts taxed?

At least 85 per cent of the income received by the fund managers of investment trusts must be distributed as dividends to shareholders. As it is constituted as a company, an investment trust pays income in the form of dividends. The taxation situation is broadly the same as that described for equity unit trusts.

As with unit trusts, fund managers are exempt from tax on capital gains. Investors are potentially liable to capital gains tax on the sale of their investment trust shares, in the event that their gain, when added to the value of their other gains realised in a tax year, exceeds the CGT annual exempt amount.

8.3.4 What is a split-capital investment trust?

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

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

Most companies will also offer shares with differing balances of income and growth, so as to meet different investor objectives.

8.3.5 What is a real estate investment trust?

Real estate investment trusts (REITs) are tax-efficient property investment vehicles that allow private investors to invest in property while avoiding many of the disadvantages of direct property investment (see Topic 7). One particular advantage is that stamp duty reserve tax is charged at 0.5 per cent on purchase; the rates of stamp duty for direct property purchase are much higher.

REITs (pronounced “reets” to avoid confusion with rights) became available in the UK from January 2007. Similar schemes operate in a number of other countries, particularly the USA and Australia.

In the UK, REITS pay no corporation tax on income or growth, provided they meet the requirements listed in Figure 8.2.

FIGURE 8.2 QUALIFYING FEATURES OF REITS

R	• At least 75 per cent of their gross income must be derived from property rent. • The remainder can come from development or other services.
E	• At least 90 per cent of their profits must be distributed to their shareholders. • Dividends can be paid in cash or as stock dividends, ie the allocation of further shares.
I	No individual shareholder can hold more than 10 per cent of the shares.
T	Single-property REITs are only allowed in special cases – such as, for example, a shopping centre with a large number of tenants.
S	They can be held in ISAs, Junior ISAs, Child Trust Funds and self-invested personal pensions.

CHECK YOUR UNDERSTANDING 1

Some students find it challenging to get to grips with these products. To help you, note down at least three ways in which an investment trust differs from a unit trust.

8.4 What is an OEIC?

An OEIC is an 'open-ended investment company' – a limited liability company that pools the funds of its investors to buy and sell the shares of other companies and deal in other investments.

To invest in an OEIC, the investor buys shares in the company; there is no limit to the number of shares that can be issued, which is why it is described as 'open-ended'. The open-ended nature of an OEIC means that the fund can expand or contract, depending on whether new shares are being issued in response to demand, or being redeemed if investors wish to sell. The value of the shares varies according to the market value of the company's underlying investments. An OEIC may be structured as an 'umbrella' company that is made up of several sub-funds. Different types of share can be made available within each sub-fund.

OEICs have been popular in other parts of Europe for many years and have been available in the UK since 1997. They share a number of characteristics with unit trusts and investment trusts. For instance, as with unit trust and investment trusts, investments can be made by lump sum, regular contribution or a combination of both. One difference to note, however, is that while both investment trusts and OEICs operate as companies, an investment trust can borrow money to finance its activities but an OEIC can only borrow for short-term purposes.

8.4.1 How are OEICs regulated and managed?

An OEIC is established as a limited liability company under a structural framework set by HM Treasury, not under trust. Unlike an investment trust, OEICs must be authorised by the FCA; there is a great deal of common ground between the FCA's regulations for OEICs and those that apply to unit trusts.

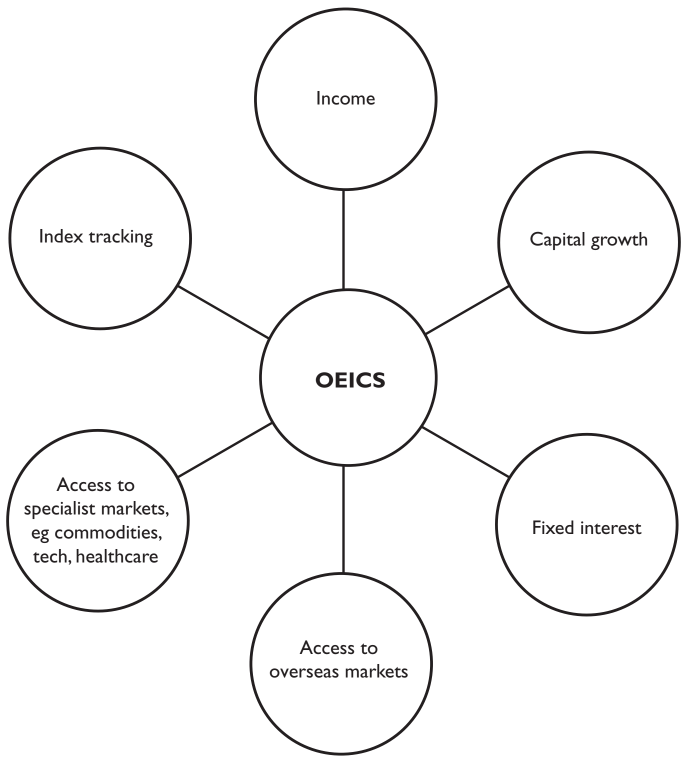
The role of overseeing the operation of the company and ensuring that it complies with the requirements for investor protection is carried out by a depositary, who is authorised by the FCA. The role of the depositary is similar to that of the trustee of a unit trust.

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

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

The range of OEICs is similar to that of unit trusts, as Figure 8.3 indicates.

FIGURE 8.3 TYPES OF OEIC



SINGLE PRICING

The share price of an OEIC is established by dividing the total value of its assets by the number of shares currently in issue. This is, essentially, the same approach as that used to establish the unit price of a unit trust.

In many unit trusts, the units have a different bid and offer price. Shares in an OEIC are single priced. You might recall from your reading on unit trusts that some of these now offer single pricing, too.

CHARGES

In addition to the cost of buying the shares, the OEIC will levy:

- **an initial or buying charge** – which is added to the unit price and is normally in the region of 3 per cent to 5 per cent of the value of the individual's investment;
- **annual management charges** based on the value of the fund – the range of annual management charges is typically between 0.5 per cent for indexed funds and 1.5 per cent for more actively managed funds;
- **a dilution levy** – this may be added to the unit price on purchase of shares or deducted from the price on sale of shares in situations where there are large flows of funds into or out of the OEIC.

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

8.4.2 How are OEICs taxed?

The tax treatment of UK-based OEICs is exactly the same as that for unit trusts. In terms of income, an OEIC will be classified as either fixed-interest or equity-based. If it is fixed-interest, the interest is paid without deduction of tax but is subject to income tax as savings. If an OEIC is equity-based, a dividend is paid, again without deduction of tax. There will be a further liability for income tax for basic-, higher- and additional-rate taxpayers if total dividend income exceeds the investor's dividend allowance.

Fund managers are not subject to tax on capital gains, although individual investors may be liable to pay CGT when their shares in the UK OEIC are encashed.

Where an OEIC is based offshore (an offshore fund), a UK resident investor will still be liable for taxation on income and gains.

If the offshore fund reports all the annual income attributable to an investor, whether the income is distributed or not, it is referred to as a 'reporting fund'. The tax treatment is as above: the investor will be liable for income tax on the income and CGT on any gain on disposal.

If the offshore fund does not report the attributable income, it is referred to as a 'non-reporting fund' and the investor will pay income tax, rather than CGT, on any gain on disposal.

8.4.3 What are the risks of investing in OEICs?

The risks associated with investing in an OEIC are similar to those of investing in a unit trust:

- An OEIC is subject to the same FCA rules on diversification and fund borrowing as apply to unit trusts, and these rules help to reduce risk.
- As an OEIC is a pooled investment employing the services of professional investment managers, the degree of risk is lower than it would be for an individual investing directly in equities.
- Risk is also mitigated by the spread that can be achieved for a relatively small investment.

There is, however, no guarantee that the value of the original capital investment will be maintained, nor is there any guarantee as to the level of income that will be generated.

CHECK YOUR UNDERSTANDING 2

Make sure you understand the key differences between unit trusts, investment trusts and OEICs. Create a table like the one below and fill in the missing information. You will find a completed version at the back of this book.

Name	Constituted as . . .?	Investment type?	Open/ closed?	Borrowing allowed?	Pricing	Initial charge	Annual charge	Control
Unit trust								
Investment trust								
OEIC								

CHECK YOUR UNDERSTANDING 3

Unit trusts, investment trusts and open-ended investment companies are most suitable for which profile of investor?

a) A long-term investor who would like reasonably easy access to their funds.

b) A long-term investor who is happy to give notice to withdraw funds.

c) A low-risk investor who requires a guaranteed income.

d) A high-risk investor who likes to play the stock market.

8.5 Endowments

Endowments are a type of investment based on life assurance. They combine life assurance and regular savings. A lump sum is either paid if the life assured dies during the term or, if they survive to the end of the term, it is paid at maturity.

In the 1970s and 1980s endowments were very popular, being used both as repayment vehicles alongside interest-only mortgages or as savings schemes in their own right. The introduction of schemes such as ISAs reduced their popularity but many plans remain in existence.

Endowments vary according to the nature of the underlying investment structure, and common types are with-profits and unit-linked. As long as premium payments are maintained, with-profits endowments are comparatively low risk as they offer the guarantee of at least a minimum value at maturity. Unit-linked plans do not carry such a guarantee and the value at maturity depends on how the underlying investments perform.

Because endowments are commonly encountered as a repayment vehicle for an interest-only mortgage, these products are detailed as part of the coverage of mortgages in Topic 13.

8.5.1 Friendly society plans

Friendly societies date from the eighteenth century when they were established as mutual self-help organisations. Over time they have evolved, with many now offering a range of financial services.

A friendly society is able to market a tax-exempt savings plan, effectively an endowment with tax benefits, because the friendly society pays no tax on its investment returns. This can be compared with a conventional endowment on which the life assurance company would pay tax on some income and gains within the fund.

As there is preferential tax treatment, the amount that can be saved is limited to £270 per year (as a lump sum)/£25 per month or £75 per quarter. The plan is set up over an initial ten-year term and there is no tax upon encashment.

Friendly society plans are often marketed as savings plans that enable parents and grandparents to save on behalf of their children and grandchildren.

8.6 Investment bonds

Investment bonds are collective investment vehicles based on unitised funds; although they often appear similar to unit trusts because of their unitised structure, they are actually very different.

Investment bonds are available from life assurance companies and are set up as single-premium, whole-of-life assurance policies. An individual who wants to invest does so by paying a single (lump sum) premium to the life company.

If an investment bond is unit-linked, the investor then receives a policy document showing that the premium has purchased (at the offer price) a certain number of units in a chosen fund, and that those units have been allocated to the policy. In order to cash in the investment, the policyholder accepts the surrender value of the policy, which is equal to the value of all the units allocated, based on the bid price on the day when it is surrendered.

Investment bonds are attractive to investors because of the:

- relative ease of investment and surrender;
- simplicity of the documentation; and
- ease of switching from one fund to another – companies generally permit switches between their own funds without charging the difference between bid and offer prices.

The range of available funds is similar to those offered by unit trusts and investment trusts.

As an alternative to a unit-linked structure, some companies offer with-profits investment bonds, in which premiums are invested in a with-profits fund (see section 11.5.2 for more information about with-profits funds). If a with-profits bond is cashed in within a specified period after commencement (typically five years), the amount received is likely to be less than the value of the units.

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

8.6.1 How are investment bonds taxed?

The funds in which the premiums are invested are an insurance company's life funds and their tax treatment is different from that of unit trusts. In particular, they attract internal tax at 20 per cent on capital gains (whereas unit trust funds are exempt) and this tax is not recoverable by investors even if they themselves would not pay capital gains tax.

The taxation system for policy proceeds in the hands of the policyholder is complex. Broadly speaking (and using tax rates for 2020/21), because most income and gains are deemed to have been taxed at the basic rate (ie at 20 per cent) within the fund:

- basic-rate taxpayers have no further liability;
- higher-rate taxpayers (who are liable to income tax at 40 per cent) pay further tax of 20 per cent;
- additional-rate taxpayers (who are liable to income tax at 45 per cent) pay further tax of 25 per cent.

The tax due from higher- and additional-rate taxpayers reflects the excess over the 20 per cent already deemed to have been paid within the fund that is required to take them up to the higher or additional rate of tax. This is because investment bonds are non-qualifying policies.

QUALIFYING AND NON-QUALIFYING LIFE POLICIES

Life assurance policies are designated as 'qualifying' or 'non-qualifying' policies for tax purposes. The benefit of a qualifying policy is that there is no tax liability on the proceeds of the plan on death or maturity; a non-qualifying plan may result in a tax liability for higher- and additional-rate taxpayers. The criteria for qualifying policies is summarised in Figure 8.4.

FIGURE 8.4 QUALIFYING CRITERIA FOR TAX PURPOSES

Premiums

Must be payable annually, half-yearly, quarterly or monthly and set up for at least ten years

Discontinuing payment of premiums

If premiums cease within ten years, or three-quarters of the original term if this is less than ten years, the policy becomes non-qualifying

Sum payable on death

Must be at least equal to 75 per cent of the total premiums payable

Balance of premiums

Premiums in any one year must not exceed twice the premiums in any other year, or one-eighth of the total premiums payable

CHECK YOUR UNDERSTANDING 4

What is the key feature of investment bonds that makes them non-qualifying policies?

Any tax liability at the end of the bond's life is determined by 'top slicing'. Top slicing is the way of determining what tax is due for UK residents by calculating the average return over the term of the bond, so that the whole gain is not taken into consideration in one single year. If top-slicing were not permitted then the whole gain, built up over the term of the policy, would be added to income in the year the policy ends and taxed accordingly. Top-slicing allows the gain to be averaged over the term. It is not exact as gains do not build in an even manner year on year, but it is a fair system of assessing any tax liability.

IN BRIEF

TOP SLICING

1) The gain on the policy (surrender value + withdrawals that have not already been taxed – original investment) is calculated.

2) This gain is divided by the number of complete policy years the investment has been in place.

3) This gives the top-sliced gain, which is the average gain for each policy year that the plan has been in place.
4) The average gain is multiplied by the number of complete policy years and added to the planholder's taxable income in the year of surrender to establish whether or not any tax beyond the 20 per cent taken within the fund is due.
5) There are several possible outcomes when the top-sliced gain is added to taxable income:
   - If the individual's taxable income remains in the basic-rate band, then no tax is due on the gain as the 20 per cent deemed to have been deducted within the fund satisfies the individual's personal liability.
   - If taxable income exceeds the basic-rate band, then tax is due at 20 per cent on the portion of the top-sliced gain falling into the higher-rate band (this means that the higher-rate taxpayer is paying tax at 40 per cent on the gain once the 20 per cent deemed to have been deducted within the fund is taken into account).
   - Tax of 25 per cent is charged on any portion of the top-sliced gain falling in the additional-rate band (this means that the additional-rate taxpayer is paying tax at 45 per cent on the gain once the 20 per cent deemed to have been deducted within the fund is taken into account).

If, in the year when the plan is surrendered, the planholder is a higher-rate or additional-rate taxpayer (or becomes a higher- or additional-rate taxpayer by virtue of the addition of the top-sliced gain to other income), the gain may be subject to tax. The gain will be the surrender value plus any withdrawals previously made that have not already been taxed, less the original investment.

Unlike investment trusts and unit trusts, investment bonds do not normally provide income in the form of dividends or distributions, but it is possible to derive a form of 'income' from them by making small regular withdrawals of capital (ie by cashing in some of the units allocated to the policy). Investors can withdraw up to 5 per cent of the original investment each year without incurring an immediate tax liability, regardless of whether the investor is a basic-, higher- or additional-rate taxpayer. This 5 per cent allowance can, if not used, be carried forward and accumulated, up to an amount of 100 per cent of the original investment.

These withdrawals are tax-deferred, not tax-exempt: when the investment ends, on maturity, death or encashment, a tax liability may arise.

8.7 Non-mainstream pooled investments

Collective investment schemes may only be sold to the general public in the UK if they adhere to regulations relating to investment and promotion set out in the FCA Handbook (the content of the FCA Handbook is covered in Topic 17).

Schemes that do not fulfil the criteria for regulated collective investment schemes are classified as non-mainstream pooled investments (NMPIs). The FCA Handbook defines an NMPI as:

- a unit in an unregulated collective investment scheme (UCIS);
- a unit in a qualified investor scheme;
- a security issued by a special vehicle, unless an excluded security;
- a traded life policy;
- rights or interest in any of the investments listed above.

NMPIs may invest in non-traditional assets. Such investments carry a higher risk. Also, if the provider is based abroad, an investor may have limited recourse to the Financial Ombudsman Scheme and the Financial Services Compensation Scheme (see Topic 25). For these reasons, NMPIs are only considered suitable for a very small group of high-net-worth individuals. The FCA does not generally permit the marketing of NMPIs to retail customers.

8.8 Structured products

The defining characteristic of structured products is that they offer some protection of the capital invested (up to 100 per cent in some cases), while enabling investment in underlying assets that have the potential for higher returns but are also higher risk (such as ordinary shares). They appeal to investors who are cautious about direct exposure to the possible downside of stock markets but who would like to share in the growth possibilities.

The FCA classifies structured products as either deposits or investments in its Handbook in a number of ways.

✓

CHECK YOUR UNDERSTANDING 5

We have already covered structured deposits. How much can you remember about them? Try to write a brief summary that includes:

- how a structured deposit differs from a deposit in an ordinary savings account;
- what benefit structured deposits offer to investors.

Then look back to Topic 6 to see how accurate your summary is.

8.8.1 Structured capital-at-risk products (SCARPs)

A SCARP is defined as a product other than a derivative that provides an agreed level of income or growth over a specified investment period and displays the following characteristics:

a) The customer is exposed to a range of outcomes in respect of the return of initial capital invested.

b) The return of initial capital invested at the end of the investment period is linked by a pre-set formula to the performance of an index, a combination of indices, a 'basket' of selected stocks (typically from an index or indices), or other factor or combination of factors.

c) If the performance in b) is within specified limits, repayment of initial capital invested occurs. If it is not, the customer could lose some or all of the initial capital invested.

8.8.2 Non-SCARP structured investment product

A non-SCARP investment is one that promises to provide a minimum return of 100 per cent of the initial capital invested as long as the issuer(s) of the financial instrument(s) underlying the product remain(s) solvent. This repayment of initial capital is not affected by the market risk factors in b) above.

8.8.3 The risks associated with structured products

There are a number of risks associated with structured products including:

- counterparty risk;
- market risk;
- inflation risk.

The products are also complex, with terms varying widely between providers.

Before investing in a structured product, an individual should ensure they understand the risks involved and how the product works, particularly in terms of the returns offered and the conditions that need to apply for specific returns to be provided.

8.9 Wraps and platforms

Wrap accounts are a long-established feature in the US and Australia, and were introduced into the UK in the early 2000s. The basic premise of a 'wrap' account is that one provider sets up an internet-based platform to hold all of the investor's investments within one framework, enabling the investor to see all relevant information in one place. The wrap account allows the investor to analyse and quantify the holdings according to value, tax treatment and product type.

Wraps are generally offered by independent financial advisers, who levy charges in addition to any individual fund management charges that apply to the investments held in the framework. Most wraps are able to hold any class of asset or fund on behalf of the investor.

A fund supermarket is designed to provide access to a wide range of funds, such as OEICS, unit trusts and ISAs, but not investment trusts. The investor has a 'general investment account', which is exposed to the UK tax regime (apart from any ISAs that are included, as they are tax-free). The investors pay a charge for the service: either a flat fee or a percentage of funds held – this is how the fund supermarket makes its money.

Both wraps and fund supermarkets are often referred to as 'platforms', but they are different. A wrap offers all the same investments as a fund supermarket, plus a range of other investments, such as investment trusts, offshore investments and direct equities (shares).

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- for unit trusts, investment trusts, OEICS and investment bonds:
  - describe how the product works?
  - explain how it is taxed?
  - explain what the key risks are?
- summarise the features that make a life assurance policy a qualifying policy for tax purposes?
- explain what 'top-slicing' is and how it works?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 8. Review the text if necessary.

Answers can be found at the end of this book.

1) With regard to unit trusts, what does the term 'open-ended' mean?

   a) Clients can buy more units.

   b) The fund manager can create an unlimited amount of units according to demand.

   c) The fund manager does not need to value the units.

   d) There is flexibility in the taxation of units.

2) A unit trust fund's assets are owned and controlled by the fund manager. True or false?

3) Who is responsible for payment of capital gains tax on any gain realised on the encashment of a unit trust?

   a) The unit holder.

   b) The trustees.

   c) The unit trust company.

   d) The fund manager.

4) An investment trust is best described as:

   a) a unit-linked, single-premium whole-of-life policy investing solely in shares.

   b) a trust that invests solely in fledgling companies.

   c) a company that invests in the shares of other companies.

   d) a partnership that invests in gilts.

5) How can a private individual invest in an investment trust?

   a) The investment trust manager creates more units.

   b) By purchasing shares of the investment trust company on the stock exchange.

   c) The fund manager issues new shares.

   d) By completing an application form for a share account and submitting it to the investment trust trustees.

6) What potential benefit does gearing offer to an investment trust that is not available to a unit trust or OEIC?

7) How are shares in an open-ended investment company priced?

   a) There is a bid and offer price based on the underlying value of the shares.

   b) Shares are based on a historic valuation.

   c) There is one price, based on the value of the assets divided by the number of shares.

   d) There is a cancellation price at which all shares are traded.

8) What rate of tax is deemed to have been deducted from the investment fund underlying an investment bond?

   a) 0 per cent.

   b) 10 per cent.

   c) 20 per cent.

   d) 40 per cent.

9) Investment bonds are attractive to investors because withdrawals are tax-free. True or false?

10) Noah is a higher-rate taxpayer and is considering a range of investments. He wants to know which investment, out of unit trusts, investment trusts or OEICS, would be most likely to help him meet his objective of achieving capital growth. What would you advise?

    a) A unit trust.

    b) An investment trust.

    c) An OEIC.

    d) Any of the above.

TOPIC 9

Tax wrappers

LEARNING OBJECTIVES

In this topic we look briefly at the way that the investment products we have considered in previous topics can be held within different tax wrappers. A tax wrapper is simply a tax shelter around an underlying investment that changes the way the investment is taxed. The most familiar of these is the individual savings account (ISA) in its various forms. Pensions are a form of tax wrapper too, but, as they are a topic in their own right, we cover them in Topic 10.

By the end of this topic you should have an understanding of:

- ISAs;
- Child Trust Funds and Junior ISAs;
- Venture Capital Trusts (VCTs);
- Enterprise Investment Scheme (EIS).

This topic covers the Unit 1 syllabus learning outcome U3.1 and 3.4.

THINK . . .

ISAs are one of most popular forms of savings account, so you have probably come across these before.

- If you have an ISA, do you hold your investments in cash or in stocks and shares? Or a combination of the two? Why did you make these decisions?
- Have you seen media coverage of the newer types of ISA, such as the innovative finance ISA, Lifetime ISA or Help-to-Buy ISA? What do you think of these initiatives?

Venture Capital Trusts and the Enterprise Investment Scheme are probably less familiar to you than ISAs, but you might have seen coverage in the financial media.

TAX WRAPPERS

In considering the different types of investment that can be held, either directly or indirectly, through collective investments, the tax treatment is an important factor. Tax can be charged at two stages in an investment's life:

- while the funds are invested;
- when funds are drawn or income is paid out.

The main taxes that affect investments are income tax and capital gains tax.

Using a tax wrapper, such as an ISA, changes the way the investor is taxed on income and gains from the underlying investment.

9.1 Individual savings accounts (ISAs)

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

9.1.1 Types of ISA

There are different types of ISA, with different types of underlying investment that can be held in each.

- A **stocks and shares ISA** can include:
  - — shares and corporate bonds issued by companies listed on a recognised stock exchange anywhere in the world, including Alternative Investment Market (AIM) shares;
  - — gilt-edged securities and similar stocks issued by governments of countries in the EEA;
  - — UK-authorised unit trusts and OEICs;
  - — UK-listed investment trusts;
  - — life assurance policies on the sole life of the ISA investor;
  - — units in a stakeholder medium-term investment product;

- shares acquired in the previous 90 days from an all-employee savings-related share option scheme (SAYE).

- A **cash ISA** can include:
  - bank and building society deposit accounts;
  - units or shares in UK-authorised unit trusts and OEICs that are money-market schemes;
  - stakeholder cash deposit products.
- An **innovative finance ISA** involves investing via a peer-to-peer (P2P) lender (P2P lending was discussed in Topic 6).

ELIGIBILITY RULES FOR ISAS

- The minimum age for investing in a stocks and shares or innovative finance ISA is 18 years; a cash ISA can be opened by anyone aged 16 or over.
- An ISA investor must be generally resident in the UK for tax purposes.
- An ISA can only be held in a single name, ie joint accounts are not permitted.

9.1.2 Subscription limits

The purpose of granting tax benefits on investments held within an ISA is to encourage people who might not otherwise have saved funds to do so. To ensure that the tax benefits meet that objective, there are limits on the maximum amount that may be saved each tax year. The limit means that those who already have adequate savings cannot benefit further by switching their savings into ISAs to gain greater tax benefits.

For the tax year 2020/21, the ISA subscription limit is £20,000.

Provided the overall annual subscription limit is not exceeded, an individual investor can choose to invest the full annual amount into a stocks and shares ISA, or a cash ISA or an innovative finance ISA, or split their investment in any proportion they wish.

ADDITIONAL PERMITTED SUBSCRIPTIONS

On death, ISA holdings are designated as a "continuing account of a deceased investor" and remain so until the earlier of the:

- administration of the estate;
- closure of the account; or
- third anniversary of death.

While no further funds can be added, the holding continues to benefit from the tax advantages of an ISA.

An 'additional permitted subscription' (APS) allowance applies when an individual's spouse or civil partner dies. The purpose of the APS is to protect the tax benefits around savings held within an ISA. It allows the surviving spouse/civil partner to make an additional ISA subscription to the value of the deceased's ISA holdings.

The right to make a cash APS applies for three years from the date that the person died, or 180 days after administration of the estate is complete, whichever is later. For stocks and shares, the time limit is simply 180 days after administration of the estate is complete. The additional subscription can be made with the manager who held the deceased's ISA or with another manager who agrees to accept the subscriptions. Its value can either be the value of the deceased's ISA at the date of their death or at the point the ISA ceased to be a continuing account of a deceased investor.

FACTFIND

Details on the ISA subscription limits can be found here:

https://www.gov.uk/individual-savings-accounts [Accessed: 18 February 2020].

9.1.3 Withdrawals and transfers

ISA providers have the option to offer flexibility, allowing funds withdrawn from a cash or innovative finance ISA, or the cash element of a stocks and shares ISA, to be replenished during a tax year. However, providers are not obliged to offer this flexibility.

Many ISA providers allow no-notice withdrawals to be made, although there are some fixed-rate cash ISAs that do not permit withdrawals during the fixed-rate period.

Funds may be transferred between different types of ISA without contravening the ISA limits. ISAs can be transferred between providers.

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ISA WITHDRAWALS

John invests £12,000 in a cash ISA on 6 April 2019, when the full annual subscription limit is £20,000. On 1 July 2019 he withdraws £7,000, leaving a balance of £5,000.

If the ISA offers flexibility he could still invest £15,000 in the remainder of the 2019/20 tax year (ie £20,000 – £5,000).

If the ISA does not offer flexibility, then the maximum he could pay in, following the £7,000 withdrawal, would be £8,000 (£20,000 – £12,000).

9.1.4 Tax reliefs

Investors are exempt from income tax and capital gains tax on their ISA investments.

As a comparison, an investment held in a unit trust is potentially liable to capital gains tax on encashment. If the unit trust is held within an ISA there is no liability to capital gains tax.

9.1.5 Help-to-Buy ISA

The Help-to-Buy ISA is a cash ISA that was available from 1 December 2015 until 30 November 2019. It was designed to help those saving for their first UK home by adding a bonus to any savings they make. The scheme was open to those aged 16 or over, and joint purchasers were able to open individual accounts that each earn a bonus payment. Anyone who opened an account by 30 November 2019 will be able to use the funds invested and the bonus payment towards the purchase of a first home by 1 December 2030.

Account holders could make an initial deposit of up to £1,200. Monthly savings of between £1 and £200 can be made until 30 November 2029. Each £200 paid in attracts a bonus payment of £50, subject to the ISA being worth at least £1,600 when funds are withdrawn for home purchase. The minimum bonus size is £400 and the maximum £3,000. The bonus is available on purchases of up to £450,000 in London and £250,000 elsewhere in the UK and is paid when the home purchase is completed.

Savings into a Help-to-Buy ISA form part of the annual ISA allowance, rather than being in addition to it.

9.1.6 Lifetime ISA

A Lifetime ISA was introduced from 6 April 2017, with the aim of encouraging younger people to save for their first home in the UK, to a value of up to £450,000, and/or for their retirement. The main rules are as follows:

- A Lifetime ISA can be opened by those aged between 18 and 40.
- Savings made before the age of 50 attract a bonus of 25 per cent (paid by the government).
- In 2017/18, the bonus was paid annually but since 6 April 2018 it is paid monthly, which enables interest to be earned on the bonus.
- A maximum of £4,000 may be saved per tax year; there is no monthly savings limit.
- The underlying investment choices are the same as those in the cash and stocks and shares ISAs.
- Savings into a Lifetime ISA form part of the annual ISA allowance, rather than being in addition to it.
- Savings can be used to purchase a first home and/or retained to provide benefits in retirement from the age of 60.
- Savings, including the bonus, can also be withdrawn when the accountholder is terminally ill.
- A 25 per cent penalty is applied if funds are withdrawn for reasons other than the purchase of a first home, the holder reaching age 60 or the holder suffering a terminal illness.
- An individual may contribute to both a Help-to-Buy ISA and a Lifetime ISA, but the bonus payment from only one of these ISAs can be used towards the purchase of a first home.

FACTFIND

Lifetime ISA accounts have been available to people under the age of 40 since April 2017. Keep up to date with latest developments by searching GOV.UK. The following document provides some useful further detail:

https://www.gov.uk/lifetime-isa [Accessed: 18 February 2020].

9.2 Child Trust Fund

The Child Trust Fund (CTF), a tax-free savings account for children, was introduced in 2005 to encourage savings on behalf of children, and was available to children born on or after 1 September 2002. When Child Trust Funds were introduced, the intention was that the government would make contributions to them; however, government contributions ceased in 2011.

CTFs are no longer available to new savers, although existing CTFs can be retained as a vehicle for family and friends to save for a child. Alternatively, a CTF may be transferred into a Junior ISA (see section 9.3).

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

- At the time the CTF was introduced, each individual CTF began with an initial payment provided by the government in the form of a voucher, sent automatically to the Child Benefit claimant. If the child's family was eligible for the full Child Tax Credit, the initial payment was £500; for others, it was £250.
- The government payment was reduced to £50 for children born on or after 1 August 2010 (or to £100 for those in families eligible for full Child Tax Credit). Government payments were withdrawn altogether on 1 January 2011.
- The parent or carer used the voucher to open a CTF account.
- The account remains in force until the child's 18th birthday, at which point the child has access to the money in the account and can use it for any purpose they wish. There is no access to money in the account before the child's 18th birthday.
- The child's parents remain responsible for the CTF until the child is 16, after which the child can manage their own account.

9.2.1 Types of Child Trust Fund

There are three general types of CTF:

- deposit-type savings accounts, which are bank and building society accounts that offer fixed or variable rates of interest;
- share accounts that can hold a range of investments similar to those available in a stocks and shares ISA;
- stakeholder CTF accounts.

Stakeholder CTF accounts invest in a range of company shares, subject to certain government rules designed to reduce the risk. Originally, from the child's 13th birthday, the money had to be gradually moved to lower-risk assets to protect it from stock market losses closer to the child's 18th birthday. This restriction no longer applies.

The maximum annual charge permitted on a stakeholder CTF is 1.5 per cent. There is no limit on charges on other types of CTF.

9.2.2 Subscription limits and taxation

Parents (and other family members or friends) can make additional investments into a CTF, up to an annual maximum. The subscription year for CTFs is slightly different from that for ISAs, as it runs from the child's birthday to the day preceding their next birthday. As with ISAs, there is no tax on income or capital gains from the CTF.

9.3 Junior ISAs

Junior ISAs (JISAs) became available in November 2011 for all children who do not have a Child Trust Fund (CTF). JISAs confer the same tax benefits as an adult ISA. Stocks and shares and cash JISAs are available, and investment can be made into one type or split between each. As with ISAs and CTFs, there is a maximum annual investment limit.

Where a child is aged under 16, a JISA can only be opened and managed by the child's parent (or another adult with legal responsibility for the child). An eligible child aged 16 or over can open and manage a JISA on their own behalf; if a JISA has already been opened for them, they become responsible for managing it.

Funds cannot be accessed until the child reaches 18; once the child is 18, the account becomes a conventional adult ISA.

FACTFIND

Check the current annual investment limits for CTFs and JISAs at:

https://www.gov.uk/child-trust-funds

and:

https://www.gov.uk/junior-individual-savings-accounts [Both accessed: 18 February 2020].

9.4 Venture Capital Trusts and the Enterprise Investment Scheme

Newly established companies, particularly those not listed on a stock exchange, can find it difficult to raise the funds they need to grow. To encourage private investors to provide funds to such companies, the government offers various schemes that incentivise investment through the award of tax benefits. The two main types of scheme are Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS).

The main difference between the two types of scheme is that a VCT is an investment in its own right, a collective investment, whereas the EIS is a system of tax reliefs that an individual company applies for; if a company is eligible for the EIS an investor in the company can claim the available tax reliefs.

9.4.1 Venture Capital Trusts

A Venture Capital Trust (VCT) is a company whose shares are listed (and can therefore be traded) on the stock exchange; it is run by an investment manager. The VCT normally spreads the monies raised from investors over a range of different companies.

Investment into a VCT is normally viewed as high risk, so income tax reliefs are granted to make the proposition more attractive:

- Income tax relief at up to 30 per cent is given on an investment of up to £200,000 per tax year.
- Any dividends paid by the VCT (from the £200,000 per tax year tax relieved investment) are free of tax.
- Any capital gains are exempt from capital gains tax.
- A VCT must be approved by HMRC and must meet certain conditions to gain approval.

FACTFIND

To find out more about VCTS, including the current rules relating to tax relief, go to:

https://www.gov.uk/guidance/venture-capital-schemes-raise-money-by-offering-tax-reliefs-to-investors#venture-capital-trust-vct [Accessed: 18 February 2020].

9.4.2 Enterprise Investment Scheme

In a similar way to a VCT, the Enterprise Investment Scheme (EIS) is designed to encourage investment in certain smaller, high risk companies by the provision of tax relief. The main difference is that whereas a VCT is a listed company that undertakes the investment on the behalf of the investor, the EIS involves direct investment in a company that is eligible for the scheme.

As with VCTs, EIS investment is seen as high-risk so tax reliefs are offered:

- Income tax relief at up to 30 per cent is given on an investment of up to £1,000,000 (£2,000,000 if the amount invested in excess of £1,000,000 is made in knowledge-intensive companies) per tax year.
- The CGT on any capital gains that are reinvested is deferred.
- Capital gains from investment in the EIS are exempt from CGT, provided that the EIS shares have been held for at least three years.

As with the VCT there are a number of conditions that must be met for the tax reliefs to be granted.

There is also the Seed Enterprise Investment Scheme (SEIS), which offers even higher tax reliefs than the EIS, as it is targeted at raising funds for small start-up companies.

FACTFIND

Further information is available on the GOV.UK website.

https://www.gov.uk/guidance/venture-capital-schemes-apply-for-the-enterprise-investment-scheme

https://www.gov.uk/hmrc-internal-manuals/venture-capital-schemes-manual/vcm35010 [Both accessed: 18 February 2020].

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the different types of ISA?
- outline the rules relating to subscription limits, withdrawals and transfers?
- describe the key features of the Help-to-Buy and Lifetime ISAs?
- explain the rules relating to Junior ISAs?
- describe VCTs, the EIS and SEIS and the key differences between them?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 9. Review the text if necessary.

Answers can be found at the end of this book.

1) Stella, aged 24, has invested £4,000 into a Lifetime ISA (LISA) in 2020/21. How much, if anything, can she invest into other ISAs in the current tax year?

2) In what circumstances is an additional permitted subscription (APS), over and above the usual investment limit, allowed in respect of an ISA?

3) Following someone's death the right to make an additional permitted subscription (APS) lasts for a period of up to:

   a) 6 months.

   b) 12 months.

   c) 2 years.

   d) 3 years.

4) In May 2020, Jane invested £10,000 into a stocks and shares ISA that does not offer a flexible investment facility. In July 2019, she withdrew £1,760. Given an annual ISA investment limit of £20,000, how much would Jane be able to pay into ISAs during the remainder of 2019/20?

   a) £10,000.

   b) £12,240.

   c) Nil.

   d) £20,000.

5) The advantage of holding investments in a stocks and shares ISA, rather than holding collective investments directly, is that the investment is free of what taxes?

6) Existing Help-to-Buy ISA customers can continue saving up to £200 per month until:

   a) 30 November 2021.

   b) 30 November 2024.

   c) 30 November 2026

d) 30 November 2029.

7) What is the purpose of the Lifetime ISA?

8) An investor can increase their annual ISA investment limit by taking out a Lifetime ISA, a Help-to-Buy ISA and a standard ISA. True or false?

9) Aaron, aged 12, has a stakeholder Child Trust Fund. What is the maximum annual management charge that can be applied to the fund?

   a) 0.75 per cent.

   b) 0.5 per cent.

   c) 1 per cent.

   d) 1.5 per cent.

10) Which type of investment normally represents a higher risk: an investment trust or a venture capital trust?

Pension products

LEARNING OBJECTIVES

We saw in Topic 5 that people who have made sufficient NI contributions are entitled to a state pension. However, most people require a higher level of income in retirement than is provided by the state pension. In this topic we explore the two main types of private pension: occupational schemes and personal pensions.

By the end of this topic, you should have an understanding of:

- the tax reliefs relating to pension products;
- the difference between defined-benefit and defined-contribution (money-purchase) schemes;
- occupational pensions;
- auto-enrolment into workplace pensions;
- personal pensions including stakeholder products;
- different ways of accessing retirement benefits from a personal/stakeholder pension.

This topic covers Unit 1 syllabus learning outcome U3.4.

THINK ...

Pensions are often in the news, so even if you aren't a member of a pension scheme yourself, you probably know a bit about them. For instance:

- Are you a member of a pension scheme? Is it an occupational scheme or a personal pension?
- Have you heard news reports about companies that are experiencing difficulties in funding their defined-benefit pension schemes?
- Do you know what auto-enrolment is and whether it affects you?
- Are you aware of the different ways in which people can access their pension benefits?

10.1 Introducing pensions

Whenever the government wants to encourage people to take action in respect of their finances, they will often grant tax reliefs that are targeted at producing the desired outcome. A good example is saving for retirement. As detailed in Topic 5, state pensions provide only a modest level of income, and with people living much longer in retirement now than they did when pensions were introduced in the twentieth century, there is a need for people to make their own provision. To encourage this, there are generous tax reliefs on pensions.

While a pension plan will usually be the first solution considered when seeking to make financial provision for retirement, it is not the only one. The tax reliefs come at a price in terms of investment limits and rules about access to pension funds. This is because, although the government does want to encourage people to save for retirement, it also has an obligation to manage the country's finances and be as fair as possible to all members of society. It therefore implements allowances and restrictions on incentives to ensure they are used equitably. These restrictions mean that other sources of savings and investment can be appealing in terms of people's retirement planning.

There are two main ways in which pension schemes can be set up: defined-benefit schemes, which can only be offered by employers, and defined-contribution schemes that can be offered by employers or set up as individual pension arrangements.

CHECK YOUR UNDERSTANDING 1

Can you remember who is entitled to a state pension and how state pension provision changed from 6 April 2016? Try to write a brief summary and then check back to Topic 5 to see how accurate your summary is.

10.1.1 What tax reliefs and allowances are available?

Any individual who is a UK resident (or is non-resident but has UK earnings) and is under the age of 75 can receive income tax relief at their highest marginal rate on annual contributions to occupational and private pension schemes, up to a maximum of the higher of 100 per cent of UK earnings or £3,600. So, by way of comparison, £1,000 paid into an ISA is £1,000, while £1,000 paid into a pension is worth £1,250 for a basic-rate taxpayer.

As the tax reliefs on pensions could encourage people to invest large sums of money, there is a limit on the gross amount that can be saved into a pension each tax year. This is called the annual allowance (for the 2020/21 tax year it is £40,000). If the combined total of contributions exceeds this figure, tax is charged on the excess.

If an individual has income in excess of £150,000, the annual allowance is reduced: £1 of allowance is lost for each £2 of income over £150,000, down to a minimum allowance of £10,000.

ANNUAL ALLOWANCE REDUCTION

Omar has income of £180,000.

His annual allowance is £40,000 – (£180,000 – £150,000 ÷ 2) = £25,000.

An individual can carry forward any unused annual allowance from the previous three tax years to the current tax year, so in these circumstances a contribution in excess of £40,000 can be made. The unused allowance is added to the current year's annual allowance and only if pension contributions exceed this amount is the annual allowance charge payable.

Two further allowances are important:

- **Lifetime allowance** – if the total value of an individual's pension benefits exceeds the lifetime allowance at the point when benefits are taken, there is a lifetime allowance tax charge (in 2020/21 it is 55 per cent on lump sums and 25 per cent on income taken from the portion of a pension pot above this amount). For 2020/21, the lifetime allowance is £1,073,000.
- **Money purchase annual allowance (MPAA)** – this applies where a pension scheme member draws benefits from their pension using flexi-access drawdown income or takes an uncrystallised funds pension lump sum (UFPLS). In 2020/21, the MPAA is £4,000. (Find out more about this in section 10.5.4.)

In respect of contributions to personal pensions, tax relief is given at source at the basic rate with any higher-/additional-rate relief claimed via an individual's self-assessment tax return. Marginal higher-rate relief is given at source on contributions to occupational pensions as any pension contribution is deducted from gross, pre-tax, income.

Within a pension fund there is no capital gains tax on gains and no income tax on savings or dividend income.

WHAT IS THE 'MARGINAL RATE' OF TAX?

A person's highest marginal rate of tax is the highest rate that they pay on their income. For example, at the rates applicable in 2019/20, a person whose taxable income is £42,600 would pay 20 per cent on the first £37,500 and 40 per cent on the £5,100 that lies above the basic-rate threshold. As they only pay higher-rate income tax on £5,100 of their earnings, they would only receive tax relief at the highest rate (40 per cent) on that portion of their pension contributions. Any contribution in excess of £5,100 would receive tax relief at the basic rate.

FACTFIND

You can check current reliefs and allowances at:

https://www.gov.uk/tax-on-your-private-pension [Accessed: 18 February 2020].

10.1.2 When and how can benefits be taken?

Benefits can generally be taken from normal minimum pension age, which is currently age 55 (expected to rise to 57 in 2028). When benefits are drawn the scheme member can usually take up to 25 per cent of the fund as a tax-free cash sum, referred to as a pension commencement lump sum (PCLS).

The rules with regard to taking the remainder depend on the type of scheme.

- **Defined-benefit scheme** – the balance over and above any tax-free cash must be used to provide an income, typically as a scheme pension direct from the pension fund.
- **Defined-contribution scheme** – the balance once tax-free cash has been taken can be used to provide income in the form of an annuity or flexible access drawdown (FAD). An alternative is to take an uncrystallised funds pension lump sum (UFPLS) – we cover these options in more detail in section 10.5. Providers are not obliged to provide customers with the option of taking UFPLS, but customers have the option of switching providers should they wish to do this.

KEY TERMS

ANNUAL ALLOWANCE

Maximum amount that can be contributed to a pension during a tax year without a tax charge being applied.

LIFETIME ALLOWANCE

The total amount that an individual may hold in tax-privileged pension schemes at the point where the benefits are taken, without incurring a tax charge.

DEFINED-BENEFIT SCHEME

A scheme in which the pension benefits the individual will receive are specified from the outset. Also referred to as a final salary scheme.

DEFINED-CONTRIBUTION SCHEME

A scheme in which an agreed level of contributions is paid but the benefits that the individual ultimately receives depend on the performance of the investments into which the contributions are paid. Also referred to as a money-purchase scheme.

PENSION COMMENCEMENT LUMP SUM

The sum (up to 25 per cent of the individual's pension fund) that may be taken at retirement tax-free.

10.2 Occupational schemes

Employees may be members of an occupational scheme. Occupational schemes fall into two main types, depending on how benefits are arranged:

- **Defined benefit** – the employee may receive a pension that is calculated as a percentage of final salary (the salary at or near retirement). The longer the employee has been a member of the scheme, the higher the percentage. Alternatively, the scheme may be a career average scheme within which pension benefits are based on a proportion of earnings averaged over the period an individual has been employed by a particular employer.
- **Defined contribution** – an agreed contribution is invested for each member. On retirement, the accumulated fund is used to purchase benefits. The level of benefits is not guaranteed by the employer and will depend on the size of the fund which, in turn, depends on how much is paid in and on investment performance.

BENEFITS AT RETIREMENT FROM A FINAL SALARY SCHEME

%

Tom worked for Shaw Components for 25 years. He paid into their 1/60th pension scheme for 23 of those 25 years. His final salary when he left the company was £20,000.

He then worked for ten years at Brooks Bakery until his retirement and paid into their 1/60th scheme. His final salary with Brooks was £25,000.

How much will Tom receive at retirement?

From Shaw Components

23/60ths of £20,000 = **£7,667** (however, this final salary pension will increase in line with inflation from the date he left to the date of his retirement)

From Brooks Bakery

10/60ths of £25,000 = 10/60 x £25,000 = **£4,166.67**

However, there is a demand for a third type of scheme, which is able to provide more predictability for scheme members than defined contribution, without the cost volatility for employers associated with defined benefit. The Pension Schemes Bill 2019–20 provides a framework for the operation and regulation of collective money purchase schemes (commonly known as collective defined-contribution pensions) in the UK. At the time of writing (April 2020) the Bill was in the early stages of the legislative process. Find out more about the Pension Schemes Bill 2019–20 at: https://commonslibrary.parliament.uk/research-briefings/cbp-8693/.

As people are now living longer and spending a longer period in retirement, employers are finding defined-benefit schemes increasingly expensive to run. As a result, many are reducing their commitment and transferring responsibility for pension provision to individuals. Many people may therefore wish to supplement their retirement income by contributing more to their occupational schemes, or contributing to private arrangements. The following are tax-efficient pension arrangements:

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

AVCs and FSAVCs are available to employees who are members of occupational schemes. Personal/stakeholder pensions are generally available to anyone under the age of 75. We look at personal/stakeholder pensions in section 10.3.

Funds do not pay capital gains tax or income tax.

10.2.1 Additional voluntary contributions

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

The employer will usually cover some or all of the administration and fund management costs. Contributions to AVCs are deducted from gross salary and the employee therefore receives full tax relief at the same time.

10.2.2 Free-standing additional voluntary contributions

As an alternative to an AVC, an individual might choose to contribute to a free-standing additional voluntary contributions (FSAVCs) money-purchase fund provided by a separate pension provider. FSAVCs are available from a range of financial institutions, including insurance companies, banks and building societies.

Contributions to FSAVCs are made from taxed income. Tax relief at the basic rate of 20 per cent is claimed by the pension provider and added to the individual's pension fund. Higher- and additional-rate taxpayers need to claim additional relief separately through their income tax self-assessment.

Up until 2006, FSAVCs were potentially attractive to employees who wished to keep their financial arrangements independent from their employer and because they offer a wider range of investment funds than AVCs. Their drawback is that they tend to be more expensive than AVCs because the employer is not bearing the costs, and once personal/stakeholder pensions became available to all employees in April 2006, FSAVCs became much less popular.

10.2.3 Workplace pensions

Successive UK governments have been concerned that people are not saving enough for retirement. In 2009, for example, only 50 per cent of UK employees were members of their employer's pension scheme, and not all employers offered a pension scheme. Workplace pensions and auto-enrolment, introduced in 2012, are an attempt to address this problem.

Under auto-enrolment, employers must enrol 'eligible' workers in a qualifying workplace pension and contribute a specified minimum amount to the scheme. Many existing occupational pensions already qualified as a suitable pension scheme for this purpose; those employers who did not have a scheme already could set one up, or enrol their employees in NEST.

NEST

As an alternative to setting up or using their own pension scheme, employers can meet their obligations by enrolling their employees in the National Employment Savings Trust (NEST).

NEST is a trust-based occupational pension scheme established to support the workplace pension provisions; it can be used by an employer either alongside or instead of its own occupational pension scheme.

NEST offers a range of investment funds from which the member can choose, and there are default fund selections for members who do not wish to make their own choice. Charges are capped. Benefits can be taken from age 55 and must be taken no later than age 75.

The criteria for auto-enrolment are that the employee:

- is not already in a pension at work;
- is aged 22 or over;
- is under state pension age;
- earns more than £10,000;
- works in the UK.

An employee can choose to opt out of the scheme, but only after they have automatically been made a member.

By April 2019 a minimum of 8 per cent of an employee's earnings will have to be paid into the scheme, made up of an employer contribution of 3 per cent, an employee contribution of 4 per cent and tax relief of 1 per cent.

Auto-enrolment has been phased in since October 2012: each employer had a 'staging date' determined by the number of employees they have. Larger employers entered the scheme first, and since April 2017 employers with fewer than 30 employees are included.

FACTFIND

You can check current information about workplace pensions at:

https://www.gov.uk/workplace-pensions [Accessed: 18 February 2020].

CHECK YOUR UNDERSTANDING 2

Pat has been employed by Telephonics plc for just over 35 years and has been a member of the company's 1/60th pension scheme for the whole of that period. His salary is now £81,000 and he is due to retire next month. What will his pension entitlement be?

a) £54,000.

b) £28,350.

c) £47,250.

d) £81,000.

10.3 What is a personal pension?

All forms of non-occupational pensions are arranged on a defined-contribution basis. Personal pensions are individual arrangements provided by financial services companies such as life assurance companies, banks and building societies. Contributions receive basic-rate tax relief at source, even for non-taxpayers. A higher- or additional-rate taxpayer needs to claim additional relief separately through self-assessment.

10.3.1 What is a group personal pension?

Providing an occupational pension is expensive and may be unaffordable for a small/medium-sized employer that lacks the financial resources to set up and run a scheme. An alternative is to arrange a group personal pension (GPP): a collection of individual personal pension plans all administered by an insurance company on behalf of a single employer.

The arrangement is very much the same as each employee arranging a personal pension individually with access to the insurance company's range of pension funds. Each member has their own plan, which they can take with them if they leave the employer. However, as there are a number of members, the insurance company normally offers a discount on the set-up and management charges, meaning each employee gets better value than setting up a scheme on an individual basis. It is also possible that the employer will enter into a 'direct pay' arrangement whereby they collect pension contributions from each employee's gross salary and pay them over in bulk to the pension provider.

10.3.2 What is a self-invested personal pension (SIPP)?

A SIPP is a personal pension arrangement that gives access to a wider range of investment options than would be available through a conventional personal pension. For example, it may be possible to hold a direct shareholding or commercial property within a SIPP. While access to a wide range of investments is permitted, a SIPP will also allow a scheme member to use the provider's range of conventional pension funds.

A SIPP may appeal to someone who has the confidence to make their own investment decisions.

10.3.3 What is a stakeholder pension?

The stakeholder pension has been available since 6 April 2001 and is a type of personal pension. The government's aim in introducing it was to encourage more individuals to contribute to their own pension arrangement, particularly those at lower earnings levels, who traditionally did not have pension provision and relied on the state pension.

In order to encourage those on lower incomes or with limited understanding of pensions, stakeholder pensions were designed to be simple, low-cost options. Key standards that a product must meet in order to be designated a stakeholder pension are as follows:

- Charges cannot exceed 1.5 per cent of the fund value per annum for the first ten years of the term and cannot exceed 1 per cent after that time.
- Entry and exit charges are not permitted.
- The minimum contribution required cannot be more than £20.

Efforts to target the stakeholder pension at the lower-paid largely failed, with the majority of stakeholder pensions being purchased by people who were financially more sophisticated and would have been making pension provision anyway.

The restriction on the level of charges meant that advisers generally found it uneconomic to give advice on stakeholder pensions. To overcome the lack of access to advice, the government prepared a set of decision-making flowcharts, known as decision trees, which people can use to determine whether stakeholder pensions are appropriate to their own circumstances.

It was partly because of the failure of stakeholder pensions to achieve a large-scale take-up that auto-enrolment into qualifying workplace pensions was introduced in 2012.

10.4 How are pension contributions invested?

Retirement planning has two phases:

- an **accumulation phase** when savings are made into a pension to build up a fund;
- a **decumulation phase** when benefits are drawn.

The way in which pension contributions are invested during the accumulation phase very much depends on the type of scheme.

10.4.1 Defined-benefit schemes

In respect of a defined-benefit scheme there is, generally, a pension fund operated by or on behalf of the employer into which contributions are paid. Investment decisions are taken at scheme level, with the objective being to ensure that the scheme can continue to pay pension benefits already in payment and the benefits of current members who will reach retirement age/draw benefits in future. The scheme will usually be invested in a mixture of equities, gilts, corporate bonds and cash; individual members are unable to make decisions on how their contributions are invested but have the reassurance of the promise of a certain level of pension benefits.

PUBLIC SECTOR/PUBLIC SERVICE SCHEMES

These schemes are operated by the government and most of them are 'unfunded'. There is no pension fund as such and contributions form part of general government revenues. The schemes do provide a promise in terms of pension benefits and this is provided by the government out of its funds.

10.4.2 Defined-contribution schemes

Within defined-contribution arrangements, the scheme member has much more choice and control over how their contributions are invested. The pension provider usually offers a wide range of investment funds from which the member can select, and pension benefits depend, in part, on the value of the fund when benefits are taken.

When an individual is many years from taking benefits they may choose investment funds aimed at maximising growth, such as equity funds; as retirement approaches the preference may be for lower-risk funds such as cash or fixed interest. The member is able to choose a mix of funds to meet their needs, objectives and circumstances.

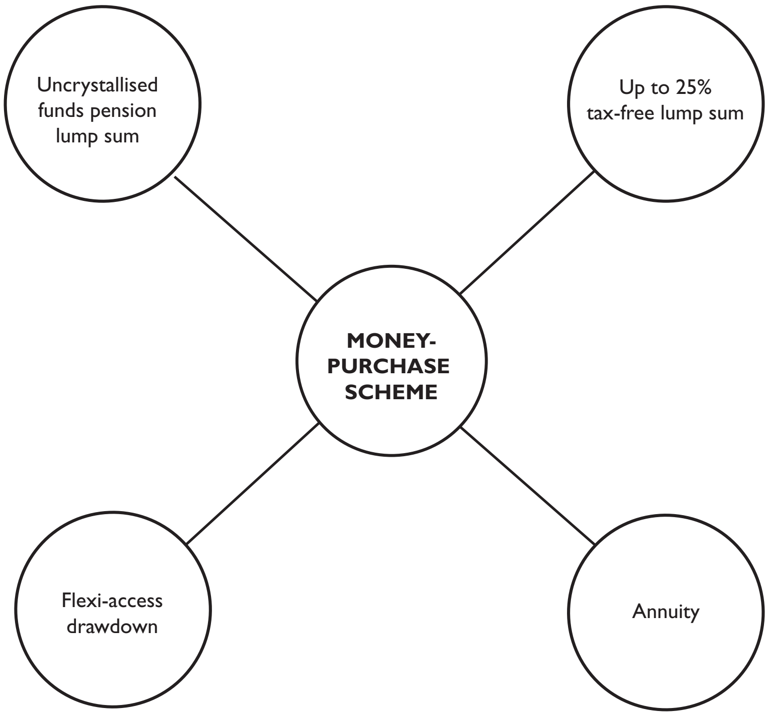
If the pension is an individual arrangement, such as a personal pension, a financial adviser can guide on fund choice. Where a defined-contribution pension is an occupational scheme there may be a more limited range of funds to choose from, with the employer selecting what they believe to be the most suitable funds.

10.5 How can benefits be taken from a pension?

A member of a defined-benefit occupational pension has an option to take a pension commencement lump sum, with income in retirement generally provided by a scheme pension paid direct from the pension fund.

There are a number of ways in which benefits can be taken from a defined-contribution pension such as a personal/stakeholder pension. While a defined-contribution pension fund remains invested, it is referred to as 'uncrystallised'; once benefits are taken, in full or in part, the portion of the fund providing retirement benefits is referred to as 'crystallised'. Figure 10.1 provides a summary of the options.

FIGURE 10.1 TAKING BENEFITS FROM A PERSONAL/STAKEHOLDER PENSION



There is an option to take up to 25 per cent of the accumulated fund as a tax-free pension commencement lump sum. As all personal/stakeholder pensions are money-purchase schemes, there might (subject to the scheme rules) be a range of options as to how the balance of the fund is used to provide income, and/or further lump sums (which would be taxable).

10.5.1 Annuity purchase

Annuity purchase involves the payment of a lump sum from the pension fund in exchange for an income.

The benefit of an annuity is certainty: the annuity provider promises a guaranteed rate of income – an annuity rate – based on the annuitant's circumstances. It is not necessary to buy the annuity from the company used during the accumulation phase: pension providers must inform their clients that they can 'shop around' for the most appropriate benefits structures and/or higher annuity rates. This is known as the open-market option.

Once an annuity has been purchased, investment risk is removed but there is no longer any prospect of further investment growth.

10.5.2 Flexi-access drawdown

Flexi-access drawdown (FAD) involves drawing the pension fund, after any pension commencement lump sum has been taken, and reinvesting it into a fund to provide income. The fund remains invested so there is potential for further growth but there is also the risk that the fund value might fall and, consequently, income levels may not be maintained.

The withdrawals can be structured however the member wishes: as smaller, regular payments to provide an income, or as larger, perhaps one-off payments. As any payment beyond the pension commencement lump sum is taxable, care must be taken not to trigger a large tax charge.

IN BRIEF

FAD

- The pension fund is moved to a designated drawdown account.
- The planholder can take 25 per cent of the value of their pension fund as a tax-free cash sum (as long as they have available lifetime allowance).
- While only tax-free cash is taken, the annual allowance will remain at £40,000.
- Access to income can be through a lump sum and/or flexible income and is subject to the marginal rate of income tax.
- The balance of the fund remains invested.
- Benefits in excess of the 25 per cent tax-free cash are subject to income tax.
- Once any benefits in excess of the tax-free cash are drawn, the £4,000 money purchase annual allowance (MPAA) is triggered.

10.5.3 Uncrystallised funds pension lump sum

Opting for an uncrystallised funds pension lump sum (UFPLS) means the pension fund remain invested. Unlike FAD, none of the fund is drawn or reinvested and no pension commencement lump sum is drawn. The member is able to use their pension fund to draw a series of lump sum payments from the fund to meet their income/capital needs.

IN BRIEF

UFPLS

- The pension fund is not moved into a drawdown account.
- No pension commencement lump sum is drawn.
- The member simply draws lump sums from their pension as they require, with the balance remaining in the pension fund.
- Twenty-five per cent of each payment is tax-free with the balance subject to income tax.
- When a UFPLS is taken, the money purchase annual allowance (MPAA) is triggered.

10.5.4 The money purchase annual allowance

Pensions are almost unique as an investment because of the tax relief they offer on contributions: tax relief that is provided to encourage people to save for retirement. With the ability to draw sums from a defined-contribution (ie money-purchase) pension via FAD or UFPLS, there is a risk that those who already have adequate retirement income draw funds and then reinvest them into a money-purchase pension to benefit from tax relief, effectively getting two lots of tax relief.

To limit the extent to which people can do this, a lower annual allowance applies once an individual has started to access their funds via FAD income or UFPLS. Instead of being able to receive tax relief on pension contributions up to £40,000, they have a money purchase annual allowance (MPAA) of £4,000. The MPAA only applies to contributions to defined-contribution (money-purchase) schemes: a member can still pay up to £40,000 into a defined-benefit pension scheme (although that total is reduced by the amount of any contribution into a defined-contribution scheme).

CAPPED AND FLEXIBLE DRAWDOWN

Capped drawdown was an option for those who reached pension age before 6 April 2015. Income benefits were drawn direct from a designated drawdown fund, with an upper limit (ie a cap), on the amount that could be drawn. Capped drawdown is no longer available for those reaching minimum pension age, but those already using a capped drawdown arrangement can add further pension funds. Alternatively, they can convert to FAD.

Flexible drawdown was another option available until 6 April 2015. This form of drawdown allowed unlimited withdrawals. All flexible drawdown arrangements have been converted to FAD.

10.6 Death benefits

Pensions can provide a range of benefits when a member dies, with the options available depending on the type of scheme and whether death occurred before or after retirement. When seeking to understand the nature of death benefits provided, it is always important to check the scheme rules.

10.6.1 Defined-benefit schemes

If a member dies before retirement age, referred to as death in service, a lump sum death benefit is usually available. This can be a multiple of earnings or a fixed sum. Additionally, there might be a spouse's and/or dependant's pension, paid from the scheme to the spouse, civil partner or dependants of the deceased. This can be a proportion of the member's pension rights.

On death after retirement, a defined-benefit scheme may:

- continue to pay the pension income for a period of time, a 'guaranteed period'; or
- pay a spouse's/dependant's pension as a proportion of the pension that was being paid to the member.

10.6.2 Defined-contribution pensions

On death before crystallisation, the pension fund can be used to provide income and/or lump sum benefits.

On death after retirement, there are a range of ways in which a defined-contribution scheme will be able to provide benefits to the spouse/civil partner or dependants of the deceased:

- continuing scheme pension;
- lifetime annuity continuing for an agreed period post-death;
- lifetime annuity paying an annuity protection lump sum – this would be the balance of the funds used to buy the annuity as compared with how much had already been paid out as income at date of death; or
- continuing drawdown income.

10.7 Pension scams

While pensions confer a number of tax benefits, there are limitations in terms of the benefits not being accessible until age 55 and only 25 per cent of the fund value being available as a tax-free lump sum. The large sums of money invested in pensions have proved attractive to criminals who attempt to 'scam' people out of their pensions.

An approach will often be made via a cold call or text message on the pretext of an offer to transfer the pension to a scheme that will enable all funds to be drawn immediately as a tax-free lump sum. The reality is that no such type of scheme exists and the intention is to take control of the pension.

Pensions are by no means the only area in which attempts will be made to scam people out of money. Criminals are also active in promoting investment schemes that promise high rates of return, the sale of shares that in reality do not exist and in taking fees to arrange consumer credit which is never provided.

An adviser's role is to be aware of such schemes and to advise a customer considering one to be mindful of the potential risk. The general rule is that, if it looks too good to be true, it probably is.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the difference between a defined-contribution and a defined-benefit pension scheme?
- describe the tax reliefs and allowances available on contributions to personal and occupational pension schemes?
- explain the difference between an AVC and an FSAVC?
- summarise the eligibility rules for a workplace pension?
- outline the options for taking benefits from a personal pension?
- explain how FAD differs from UFPLS?
- describe the various options that might apply when a pension scheme member dies?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 10. Review the text if necessary.

Answers can be found at the end of this book.

1) Marta is 37 and pays 3 per cent of her salary into a pension scheme each month. The benefit that she will receive at retirement depends solely on the investment performance of the fund. Marta's pension scheme is:

   a) a defined-benefit personal pension.

   b) a final-salary occupational pension.

   c) a defined-benefit occupational pension.

   d) a defined-contribution occupational or personal pension.

2) Explain what is meant by the term 'lifetime allowance'.

3) What rate of tax relief is applied to contributions to an individual's pension plan?

   a) Basic, higher or additional rate depending upon the contributor's marginal rate of tax.

   b) Always basic rate.

   c) Always higher rate.

   d) Basic, higher or additional rate depending upon the pension provider's own rules.

4) Contributions to AVCs are deducted from gross income. True or false?

5) Which of the following statements is correct?

   An individual may be auto-enrolled in a workplace pension scheme providing they:

   a) were born in and are currently working in the UK.

   b) are aged between 18 and 55.

   c) earn in excess of £10,000 a year.

   d) are not liable to higher-rate tax.

6) Since April 2015 personal pension providers have been obliged to allow scheme members to access their retirement benefits

in the form of an uncrystallised funds lump sum (UFPLS) if the member wishes to do so. True or false?

7) Which of the following in relation to stakeholder pensions is correct?

   a) Charges must not exceed 2 per cent of the fund.

   b) There must not be any entry or exit charges.

   c) The minimum monthly contribution is £50.

   d) The maximum contribution is £3,600 per annum in all cases.

8) John is using an uncrystallised funds lump sum to provide his pension benefits. The amount of each payment he takes that is free of tax is:

   a) 50 per cent.

   b) 100 per cent.

   c) 25 per cent.

   d) Nil.

9) What previous form of income drawdown was converted to flexi-access drawdown from 6 April 2015?

10) Nicky is 60 years old and has a low appetite for risk. She is considering options for taking benefits from her pension fund and would like to be able to receive a guaranteed income, with her pension fund no longer exposed to any investment risk. Which method of providing retirement benefits should Nicky take?

TOPIC 11

Life assurance

LEARNING OBJECTIVES

Very few aspects of life are entirely free from some element of risk and most people have some form of insurance to protect them against the financial effects of adversity. In this topic our focus will be on life assurance – products that are designed to provide financial protection when someone dies. In Topic 12 we will be looking at general insurance – products that provide financial protection in situations such as illness, unemployment, a house fire or a car accident.

By the end of this topic you should have an understanding of:

- term assurance, including:
  - decreasing term assurance;
  - level term assurance;
  - convertible, increasing and renewable term assurance;
  - family income benefit;
- whole-of-life assurance, including:
  - non-profit;
  - with-profits;
  - unit-linked;
  - unitised with-profits;
  - low-cost;
  - flexible;
  - universal;
- endowments.

This topic covers part of the Unit 1 syllabus learning outcome U3.5.

THINK . . .

There's a good chance that you have some life assurance products. For example:

- Do you have a repayment mortgage? Most lenders will require you to have life assurance to cover the outstanding balance if you die before the mortgage loan is repaid. Do you know what kind of life assurance you have?
- If you have an interest-only mortgage, you might have an endowment policy designed to build up funds to pay off the loan at the end of the mortgage term. We look at endowment policies in Topic 13, but endowments are a type of life assurance, too.
- Do you have children? It's common for people to buy life assurance to cover their family's living costs in case one of the family wage earners were to die.
- If you are concerned about inheritance tax, you might have taken out a life assurance policy that could be used to meet any tax due from your estate on your death.

THINK . . .

Insurance or assurance?

There is a difference between the meaning of assurance and insurance. Assurance means protection against the effects of an event that will happen at some point, such as death. Insurance is protection against the effects of an event that may or may not happen; such as death within a specific period of time or a person falling ill. This section uses the terminology of assurance but, technically, term policies are insurance rather than assurance.

11.1 What is term assurance?

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

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

IN BRIEF

KEY FEATURES OF TERM ASSURANCE

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

KEY TERMS

SUM ASSURED

The amount that will be paid out under the terms of the policy.

LIFE ASSURED

The person whose life is covered by the policy, ie the policy is designed to pay out if this person dies while the policy is in place.

POLICYHOLDER

The person who owns the policy and pays the premiums. Often this is the same as the life assured.

TERM

The period for which cover is provided under the policy.

SURRENDER VALUE

The sum payable by the insurance company to the policyholder if the policyholder chooses to terminate the policy before the end of the term, or before the insured event occurs.

11.1.1 What is the difference between level term and decreasing term assurance?

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

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

It can also be used to provide family cover; in these circumstances, the term might run until the children are expected to have completed their full-time education, for example. If it is used for this purpose, the policyholder should bear in mind that the amount of cover in real terms would be eroded by the effect of inflation.

With decreasing term assurance, the sum assured reduces to nothing over the term of the policy. Premiums may be payable throughout the term, or may be limited to a shorter period such as two-thirds of the term. This policy could be used to cover the outstanding capital on a decreasing debt.

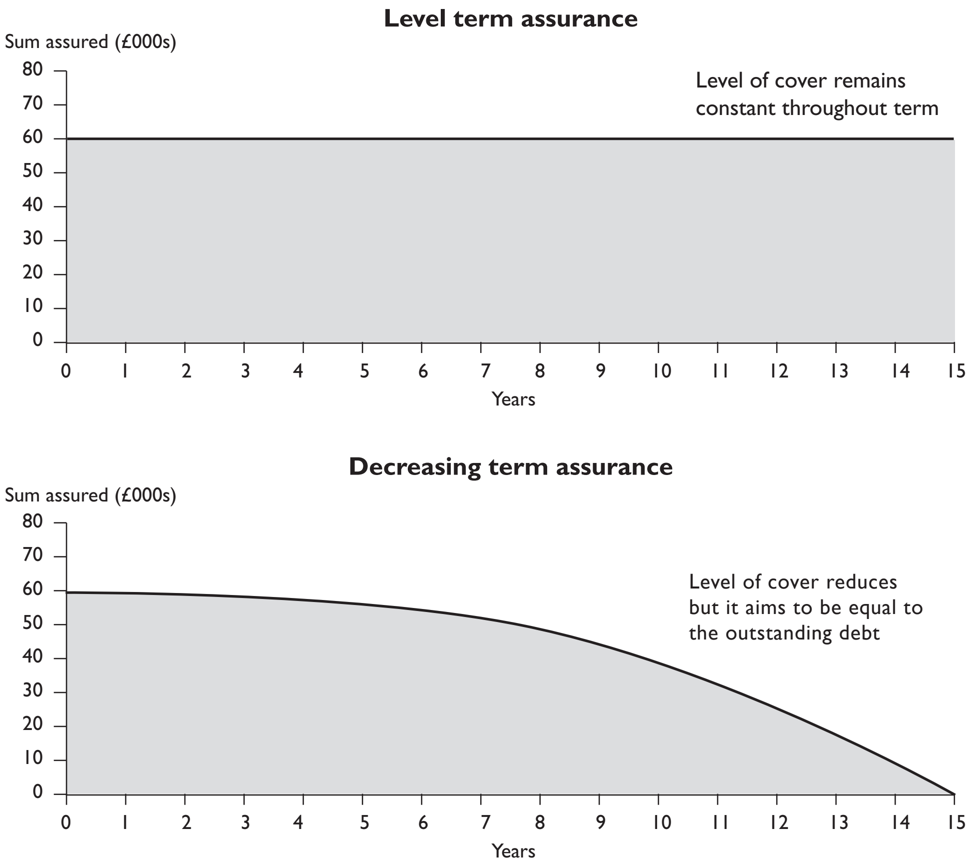
The most common use of decreasing term assurance is to cover the amount outstanding on a repayment mortgage. It is usually known as a mortgage protection policy, or mortgage protection assurance. The sum assured is calculated in such a way that it is always equal to the amount outstanding on a repayment mortgage of the same term, based on a specified rate of interest. The sum assured (like the mortgage) decreases more slowly at the start of the term than towards the end.

!

TERMINOLOGY

Be careful not to confuse mortgage protection policies or assurance with policies designed to cover mortgage repayments in the event of short-term sickness and redundancy – these are often referred to as mortgage payment protection insurance.

FIGURE 11.1 LEVEL TERM *V* DECREASING TERM ASSURANCE



11.1.2 What is gift inter vivos cover?

Gift inter vivos cover is a term assurance policy designed to cover certain inheritance tax liabilities. Gifts inter vivos are gifts made during a person's lifetime, as opposed to on death.

CHECK YOUR UNDERSTANDING 1

Gifts inter vivos, gifts made during a person's lifetime, are usually classed as potentially exempt transfers (PETs). You studied PETs in Topic 4 – can you remember the rules that relate to them? Make notes on the key points to check your understanding. Look back to Topic 4 if you need to refresh your memory.

If a person makes an outright gift during their lifetime that, either on its own or when added to gifts made in the previous seven years, exceeds the current nil-rate band for inheritance tax, provision needs to be made for the tax that may become due if the donor does not survive for seven more years. Using a gift inter vivos policy, the sum assured is set at the outset as the amount of tax that is due. It remains level for three years and then reduces in line with the tapering relief on taxation of gifts; seven years after the gift has been made it becomes exempt from tax and so the cover ceases.

Additional cover should also be arranged to protect the remainder of the estate.

11.1.3 What is convertible term assurance?

Convertible term assurance includes an option to convert the policy into a whole-of-life or endowment assurance, at normal premium rates, without the life assured having to provide evidence of their state of health at the time of conversion (indeed, there is no requirement for any additional underwriting).

This option is normally included only on level term assurance policies but there is no technical reason why it should not be included on decreasing term assurances and others. The cost is an addition of, typically, around 10 per cent of the premium.

Certain rules and restrictions apply to the conversion option:

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

11.1.4 What are increasing and renewable term assurances?

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

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

Renewable term assurance includes an option to renew the policy at the end of the initial term for the same sum assured, without the need to provide further medical evidence.

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

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

Renewable and increasing term assurance is similar to the renewable policy, with the added option to increase the sum assured by a specified amount on renewal. The increase is often either 50 per cent or 100 per cent of the previous sum assured, and again no further evidence of the life assured's state of health is required.

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

11.1.5 What is family income benefit?

Often, when people are seeking to protect their family finances, taking out life assurance that provides a lump sum on death of a wage earner might not be ideal. Such a sum might quickly be spent outright, or it might have to be invested and managed to provide an income. A more useful solution might be a product that is designed to provide a regular income to replace the income lost on death. Family income benefit (FIB) policies are designed to meet this need.

Usually, these policies pay a tax-free regular income (monthly or quarterly) from the date of death of the life assured until the end of the chosen term. As an alternative to regular income payments, beneficiaries may choose to receive a lump sum payment, which is calculated as a discounted value of the outstanding regular instalments due.

Since, usually, the cover reduces as time passes, this policy can be described as a form of decreasing term assurance. However, policies can be arranged with escalating instalments, to combat the effects of inflation; the premiums for these policies are higher, to reflect the higher level of cover provided.

%

FAMILY INCOME BENEFIT

Stephanie takes out a family income benefit (FIB) policy, which is set up to provide a monthly income of £2,000 to her husband Mark in the event of her death. The policy is taken out when her children are aged two and four, and she wants the policy to provide cover until her youngest child is 18 years old (ie with a 16-year term):

Death in year 1 – the policy pays £2,000pm for 16 years (£384,000).

Death in year 2 – the policy pays £2,000pm for 15 years (£360,000).

Death in year 3 – the policy pays £2,000pm for 14 years (£336,000).

Death in year 12 – the policy pays £2,000pm for 5 years (£120,000).

Death in year 16 – the policy pays £2,000pm for 1 year (£24,000).

PENSION TERM ASSURANCE

Pension term assurance was a type of policy that people could take out at the time they set up a personal or stakeholder pension plan. It offered the advantage of tax relief on the premiums at the policyholder's highest rate. A new pension regime introduced in April 2006 created a loophole that meant virtually all term assurances could be issued as pension term assurance and obtain tax relief. Sales of the product increased very rapidly. By December 2006 the government had acted to close the loophole and no pension term assurances have been issued since then. However, some people will still hold this product, so financial advisers need to be aware of it.

11.2 What is whole-of-life assurance?

Whole-of-life assurance is designed, as the name implies, to cover the life assured for the whole of their lifetime. It will pay out the amount of the life cover in the event of the death of the life assured, whenever that death occurs, provided that the policy remains in force. Like all protection policies, therefore, the overall benefit of this type of assurance is that it provides peace of mind. It can be used in personal and business situations, and for certain taxation purposes. Examples include to:

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

Premiums may be:

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

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

Because whole-of-life assurance (unlike term assurance) will definitely pay out sooner or later, life companies build up a reserve to enable them to pay out when the life assured dies. This enables companies to offer surrender values on whole-of-life policies if the client cancels them during their lifetime. These surrender values are, however, generally small in relation to the sum assured.

In fact, in the early years of a policy, the surrender value will be less than the premiums paid. This emphasises the fact that whole-of-life policies are protection policies and not investment plans, even though they have often been used for investment purposes.

JOINT-LIFE SECOND-DEATH POLICIES

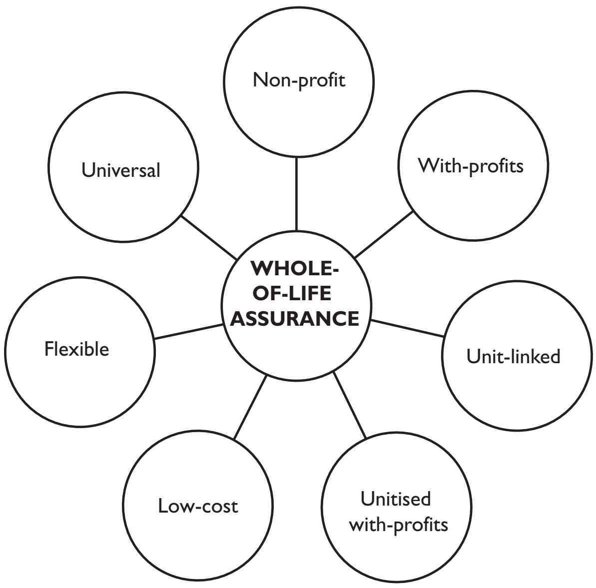
When a whole-of-life policy is used to provide the funds likely to be needed to pay inheritance tax on the death of a married couple or civil partners, it is normal to use a policy that will pay out when the second spouse or partner dies. These types of whole-of-life policies are known as 'joint-life second-death' or 'last survivor' policies.

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

These policies are 'written under trust': ownership passes to the trustees to ensure that the proceeds of the policy are used to meet the IHT liability and do not pass into the value of the estate, thus becoming liable for IHT in their own right. (The way that trusts work is covered in more detail in Topic 16.)

There is a wide range of whole-of-life policies that are distinguished by the way the underlying investment is structured, the investment base, and the features they offer. Figure 11.2 provides a summary.

FIGURE 11.2 TYPES OF WHOLE-OF-LIFE ASSURANCE POLICY



The different investment structures offered are non-profit, with-profit, low-cost, unit-linked and unitised. These investment bases also apply to endowments, the main difference being that an endowment is set to run for a specific term, whereas a whole-of-life policy is open-ended. Each of these approaches is explained in full in section 11.5. Figure 11.3 provides a brief summary.

FIGURE 11.3 FEATURES OF WHOLE-OF-LIFE ASSURANCE POLICIES

Non-profit

Fixed level of life assurance in return for payment of a fixed premium.

With-profits

Fixed minimum level of cover to which bonuses are added to reflect investment profits.

Low-cost

Promise a certain level of cover which is provided by the combination of with-profits and a decreasing term assurance. As bonuses are paid to the with-profits element, the decreasing term element reduces.

Unit-linked

Units issued to the planholder. A minimum level of cover is set at outset which is increased when the value of the units held rises above that amount.

Unitised with-profits

Issues units with a guarantee that unit prices will either never fall below a certain level or will increase by at least a stated minimum amount.

All policies offer the prospect of a surrender value, subject to investment performance. The tax treatment of proceeds under the plan will depend on whether it is classed as ‘qualifying’ or ‘non-qualifying’ under the tax rules applying to life assurance. Tax at the rate of 20 per cent is deemed to have been deducted from most income and gains on life assurance funds. For qualifying policies there is no further liability to tax. For non-qualifying policies there is the possibility of higher-rate income tax at 20 per cent or additional rate income tax at 25 per cent. (Refer back to Figure 8.4 to remind yourself of the criteria for qualifying policies.)

11.3 Flexible whole-of-life

When whole-of-life policies are issued on a unit-linked basis, they are generally referred to as ‘flexible whole-of-life’. Their flexibility lies in the fact that they can offer a variable mix between their life cover and investment content.

IN BRIEF

The key to flexibility is the method of paying for the life cover by cashing in units at the bid price:

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

Other options are often available. These include an option to take income, indexation of benefits (for automatic adjustment of death benefits) and the ability to add another life assured.

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

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

- **Maximum cover** – this is normally set at such a level that cover can be maintained for ten years. After that point, all the units will have been used up and increased premiums will be needed if the cover is to continue.
- **Minimum cover** – a minimum level of life cover is maintained (probably the minimum required for the policy to remain qualifying) and the number of units attaching to the policy builds up to a substantial investment element.
- **Balanced cover** – this is the level of cover, for a given premium, that the company expects to be able to maintain throughout the life assured's lifetime.

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

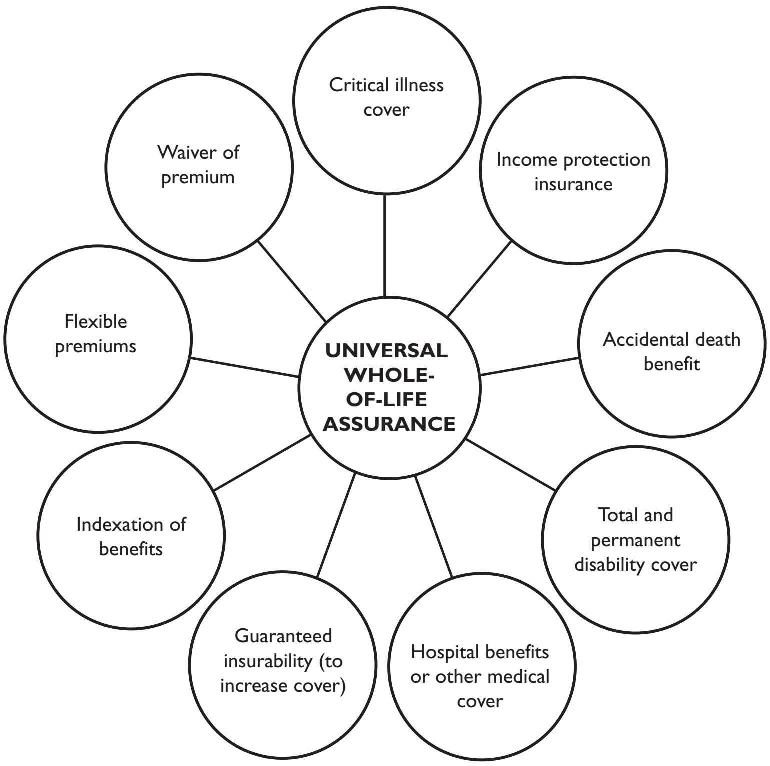
In all cases, the initial life cover is guaranteed for a certain period, often ten years. Beyond that point, the company reserves the right to increase the premiums or to reduce the cover – to take account of increases in costs or to allow for the fact that unit prices have not grown as quickly as had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

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

11.4 Universal whole-of-life assurance

The flexibility of unit-linked whole-of-life assurance is sometimes extended further by adding a range of other benefits and options to the policy. When that is done, the policy is usually referred to as universal whole-of-life assurance. Figure 11.4 summarises other benefits and options that may be added. Most of the additional benefits will be at extra cost, the additional cost being met by cashing more units.

FIGURE 11.4 UNIVERSAL WHOLE-OF-LIFE ASSURANCE OPTIONS



WAIVER OF PREMIUM

A policy provision that allows the policyholder to suspend paying premiums but retain their policy cover if they are unable to work due to sickness or disability.

CHECK YOUR UNDERSTANDING 2

Create a table like the one below and try to complete the missing entries, to check your understanding of the different products. A completed table is provided at the end of this book.

Type of policy	Fixed term?	Death benefit	Surrender value?	Tax treatment of benefits
Level term assurance	Yes	Level	No	Only pays on death – tax-free
Non-profit whole-of-life		Level		Must 'qualify' to be tax-free on surrender (always tax-free on death)
Decreasing term assurance				
With-profit whole-of-life		Increasing		Must 'qualify' to be tax-free on surrender (always tax-free on death)
Unit-linked whole-of-life		Level until value of units exceeds death benefit		
Increasing term assurance		Increasing		Only pays on death – tax-free
Convertible term assurance				Only pays on death – tax-free
Low-cost whole-of-life				Must 'qualify' to be tax-free on surrender (always tax-free on death)

Renewable term assurance			No	
Flexible whole-of-life	No			
Family income benefit (FIB)		Decreasing		
Pension term assurance	Yes	Level or increasing		Only pays on death – tax-free
Universal whole-of-life		Level until added units exceed death benefit		Must ‘qualify’ to be tax-free on surrender (always tax-free on death)

11.5 Endowment policies

Endowment policies are life-assurance products that combine life assurance and savings. In the past they were often used as savings plans and were very popular as a method of funding interest-only mortgages because the savings element can be used to build a fund to repay the mortgage, while the life cover provides a lump sum if the borrower dies during the mortgage term.

There are various types of endowment, with the plans varying according to the underlying investment structure.

The range of investment structures is similar to those for a whole-of-life plan; the difference between an endowment and a whole-of-life plan is that an endowment runs over an agreed term. If death occurs during the term, life cover (the sum assured) is paid out, while if the plan runs for the full term and ‘matures’ an investment value is paid out. During the term, the policyholder undertakes to maintain payment of regular premiums.

11.5.1 Non-profit endowment

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

11.5.2 Full with-profits endowment

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

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

- **Reversionary bonuses** – these are normally declared each year and, once they have been allocated to a policy, they cannot be removed by the company, provided that the policy is held until the end of the term or earlier death. Some companies declare a simple bonus, where each annual bonus is calculated as a percentage of the sum assured; others declare a compound bonus, with the new bonus being based on the total of the sum assured and previously declared bonuses. Most companies set their reversionary bonuses at a level that they hope to be able to maintain for some time, in order to smooth out the short-term variations of the stock markets. A trend of falling bonus rates over a number of years means that bonus rates are much lower now than they were in the 1980s and 1990s.

- **Terminal bonuses** – these are bonuses that may be added when a death or maturity claim becomes payable. Unlike reversionary bonuses, a terminal bonus does not become part of the policy benefits until the point of a death or maturity claim, thus allowing the company to change the terminal bonus rate – or even remove the terminal bonus altogether. Terminal bonuses are intended to reflect the level of investment gains that the company has made over the term of the policy, so the rate of bonus often varies according to the length of time that the policy has been in force. Since the 1990s, many companies have reduced the level of their terminal bonuses.

The term ‘with-profits’ is used generally to describe a policy that pays bonuses to the plan. In the context of mortgages, a full with-profits policy describes a policy set up with an initial sum assured equal to the mortgage debt. On death or at the end of the term, the worst-case scenario is that the mortgage is repaid in full. If bonuses are added then these will generate an additional sum over and above the mortgage when the policy pays out.

PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT

The FCA requires life companies that carry out with-profits business to publish a document called Principles and Practices of Financial Management (PPFM). This sets out how a firm manages its with-profits business. Each year, the insurance company has to certify to the FCA that its with-profits funds have been managed in accordance with the PPFM.

11.5.3 Low-cost with-profits endowments

The guarantees offered by a full with-profits policy mean that it has high premiums. A low-cost or minimum-cost endowment overcomes this by having a sum assured that is payable on death, whenever it occurs, that is made up of two elements:

- with-profits; and
- decreasing term assurance.

The policy offers a guaranteed death benefit equal to the mortgage, ensuring that it is fully protected. The basic with-profits sum assured is lower than the overall level of mortgage to be funded, meaning that full repayment is not guaranteed. Bonuses are added over time with the aim of building a sum equal to the mortgage by the end of the term. Until the with-profits sum assured plus the bonuses are equal to the mortgage amount, any shortfall on death of the life assured is made up by a decreasing term assurance. Once the basic sum assured plus bonuses increases beyond the mortgage amount, the decreasing term assurance element ceases.

This policy is suitable for anyone seeking a with-profits plan but finding that the costs associated with the full with-profits plan are prohibitive.

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PAY-OUT ON DEATH FROM LOW-COST ENDOWMENT POLICY

For example, let's look at a low-cost endowment policy with a 'minimum death benefit' of £100,000 and a 'basic sum assured' of £45,000. The table shows how the pay-out on death may be made up.

Death occurs	Whole-of-life element	Decreasing term element	Total
During year 1	£45,000	£55,000	£100,000
During year 2	£47,025 (including first year bonus)	£52,975	£100,000
During year 3	£49,435 (including second year bonus)	£50,565	£100,000
During year 4	£52,278 (including third year bonus)	£47,722	£100,000
During year 21	£98,126 (including 20 years' bonuses)	£1,874	£100,000
During year 22	£102,542	£0	£102,542

The policy will pay out a minimum of £100,000 on death. It is not until the value of the with-profits element part of the policy reaches £100,000 with bonuses that this figure starts to grow (whereas with a full with-profits policy, the £100,000 would increase after one year).

ENDOWMENT MIS-SELLING

Mis-selling of endowment policies linked to interest-only mortgages was a significant problem for the financial services industry, particularly in the 1980s and 1990s. The following problems recurred:

- The inherent risks of this type of policy were not adequately explained.
- The plans were sold to people with a low/cautious attitude to risk.
- Prospective investment returns were overstated and/or customers were promised that the plans were guaranteed to repay their mortgage in full.

These issues were brought to light partly as a result of falling bonus payments leaving many borrowers with an actual or prospective shortfall when the investment return was compared to the mortgage. Many customers complained, and insurance companies were required to contact all endowment customers and advise them whether or not their endowment was on target to repay their mortgage. If it was not, they were required to outline corrective action that could be taken.

Where mis-selling was proven, the customer could claim compensation from the insurance company.

If the total of sum assured plus bonuses is not equal to the amount of the loan at the end of the term, it is, of course, the borrower's responsibility to fund the difference. Life companies help their policyholders to avoid this situation by including regular progress reviews of mortgage-related endowments, to check whether the policy is on target to reach the required amount by the end of the term. If the policy does not seem to be on target, the company may either recommend an increase in premium, possibly without further medical evidence being required, or suggest other ways of addressing the problem. On the other hand, if the total benefit at maturity, including bonuses, proves greater than the amount required to repay the loan, the surplus will provide a tax-free windfall for the borrower.

11.5.4 Unit-linked endowments

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

The value of the plan is determined by the value of the underlying units; this in turn depends on the investment returns produced by the fund. Each unit-linked fund is run by a fund manager whose role it is to select investments and invest the policyholders' premiums. Unit-linked policies have the potential to produce higher returns than with-profits policies as the manager can be more adventurous when selecting investments. Unlike with-profits endowments, however, unit-linked policies do not provide any guaranteed minimum return at maturity; they are, therefore, a good illustration of the maxim that greater potential return generally goes hand-in-hand with the acceptance of greater risk.

When a unit-linked endowment policy is to be used for mortgage purposes, the premium required is calculated as the amount that will prove sufficient to repay the loan at the end of the term if unit prices increase at a specified rate of growth. This rate of growth is usually set at quite a conservative level and features on illustrations provided at the point of sale. Policyholders can choose which fund or funds to use for their investment. Should the life insured die before the end of the term, the full amount of the mortgage is protected. This is normally achieved by building in a variable term assurance plan which adjusts in line with the value of the underlying units.

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

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

VARIABLE TERM ASSURANCE

A variable term assurance works by the value falling and rising to compensate for changing investment values. For example, if a customer has a £100,000 mortgage and the investment value of the unit-linked endowment is £30,000, then the variable term assurance is £70,000. If, a month later, the plan value is £29,900, then the variable term assurance increases to £70,100 to ensure the full value of the debt is always protected on death.

11.5.5 Unitised with-profits

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

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

ASSIGNING POLICIES

One feature of life policies, such as endowments, is that they can be legally assigned to a third party, who effectively becomes the owner of the policy and is entitled to receive the benefits in the event of a claim. If an endowment is being used as the repayment vehicle for an interest-only mortgage (see Topic 13), some lenders require the endowment to be assigned to them as part of the mortgage deal; others may simply require that the policy document be passed into their possession, without a formal assignment.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the key features of term assurance?
- explain when a client might need level term assurance, and when they might opt for decreasing term assurance?
- explain the advantages of a family income benefit policy?
- describe the key features of whole-of-life assurance?
- explain how a joint-life second-death policy can be used in relation to IHT?
- describe the different types of endowment policy?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

?

Test your knowledge

Use these questions to assess your learning for Topic 11. Review the text if necessary.

Answers can be found at the end of this book.

1) Where a claim is made on a term assurance policy the benefits payable are always free of income tax. True or false?

2) What is the main benefit of a convertible term assurance?

3) Which of the following statements relating to term assurance is correct?

   a) A decreasing term assurance will pay benefits only if the insured dies within the policy term.

   b) Gift inter vivos cover is maintained at the same level for seven years.

   c) A convertible term assurance policy can be converted to an endowment or whole-of-life assurance only within two years of the date of the original policy.

   d) If a convertible term assurance policy is converted to an endowment, the maturity date of the new policy must not be more than five years later than that of the original policy.

4) Which of the following is true of a whole-of-life policy?

   a) It is designed to provide protection rather than investment.

   b) Premiums are always payable throughout the full term of the policy.

   c) It can only be used on a with-profits basis.

   d) It will pay out only on the death of the insured and cannot be surrendered.

5) Duncan and Alice, who are married, are taking out a whole-of-life plan to provide for payment of inheritance tax liabilities on their deaths. The policy would normally be set up in which of the following ways?

   a) Two single lives.

   b) Single life.

   c) Joint-life first-death.

   d) Joint-life second-death.

6) The main advantage of writing a life assurance policy in trust is to:

   a) increase personal allowances.

   b) ensure the policy obtains qualifying status.

   c) create a tax-exempt fund.

   d) 'ring-fence' the proceeds outside the individual's estate.

7) Which type of whole-of-life policy offers a fixed level of life cover at outset that may be increased by the addition of bonuses?

   a) With-profits.

   b) Non-profit.

   c) Unit-linked.

   d) Low-cost.

8) What other type of life assurance is combined with a with-profits plan in a low-cost whole-of-life plan?

   a) Non-profits.

   b) Decreasing term assurance.

   c) Level term assurance.

   d) Increasing term assurance.

9) If a policy benefits from 'waiver of premium', what does it mean?

   a) No premiums are paid for the first 12 months of a life assurance plan.

   b) Reduced premiums are paid for the first 12 months of a life assurance plan.

   c) No premiums are payable if the life assured is unable to work as a result of accident or sickness.

   d) Any increase in premium as a result of medical underwriting is added as a debt to the policy.

10) Which of the following is **incorrect** in respect of low-cost endowment policies?

   a) The basic sum assured increases with the addition of bonuses.

   b) The basic sum assured is lower than the amount borrowed.

   c) The policy is made up of a with-profits endowment and a decreasing term assurance.

   d) The policy is guaranteed to repay the mortgage in full at the end of the term.

TOPIC **12**

Health and general insurance

LEARNING OBJECTIVES

In this topic we begin by focusing on insurance products that can mitigate the financial impact of ill health. We will then look at general insurance – these are mainly products that cover loss of property, or damage to it, and legal liabilities.

By the end of this topic, you should have an understanding of:

- critical illness cover;
- income protection insurance;
- accident, sickness and unemployment insurance;
- private medical insurance;
- long-term care insurance;
- key principles of general insurance;
- buildings and content insurance;
- motor insurance;
- travel insurance;
- payment protection insurance.

This topic covers part of Unit 1 syllabus learning outcome U3.5.

THINK . . .

Many of the types of insurance we are looking at in this topic will probably be familiar to you. For example:

- have you had to buy motor insurance and choose between different types or levels of cover?
- have you been offered critical illness cover or private medical insurance as an employee benefit?

- have you been involved in organising the funding of long-term care for a relative?
- have you taken out travel insurance for a holiday?

The challenge in this topic may be distinguishing between the different types of health and income protection insurance.

12.1 What is critical illness cover?

Life assurance can mitigate the financial impact of someone dying, but serious illness can also create a significant financial burden. Critical illness cover provides a tax-free lump sum to meet the additional costs that someone may face if they find themselves in this situation. The illness need not be terminal.

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

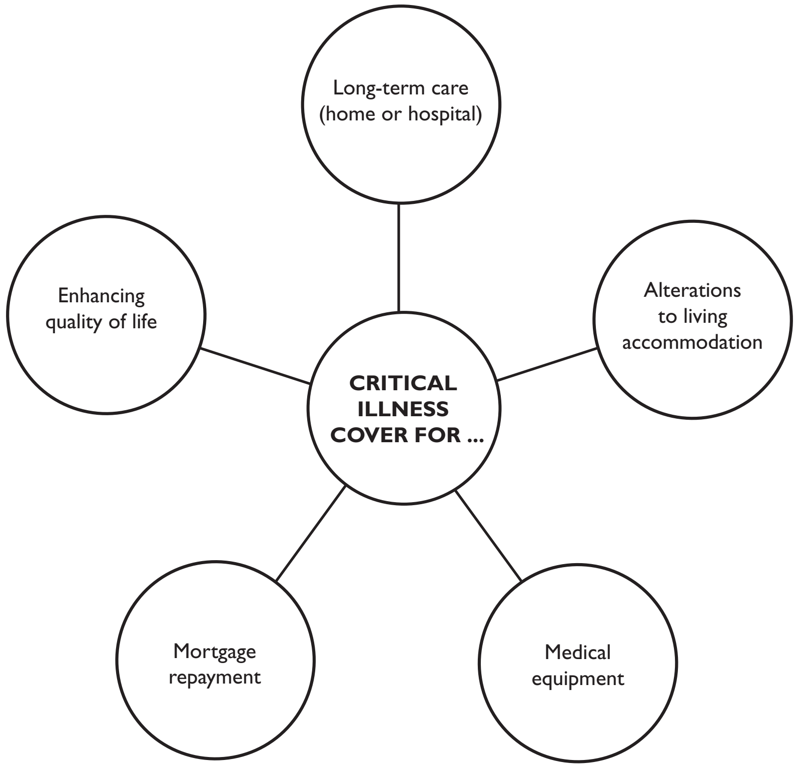
- most forms of cancer;
- heart attack;
- stroke;
- coronary artery disease requiring surgery;
- major organ transplant;
- multiple sclerosis;
- kidney failure.

Other conditions that are sometimes covered are:

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

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

FIGURE 12.1 TYPICAL USES OF CRITICAL ILLNESS COVER



12.2 What is income protection insurance?

Income protection insurance (IPI) pays an income when accident or illness prevents someone from earning a living by carrying out their normal occupation. Many insurers also offer IPI to people whose main responsibilities are in the family home, for example looking after children, rather than earning money outside it. This is because, although they may not actually earn an income, costs may be incurred if they are ill or injured – for example, childcare fees or payment for housekeeping services.

12.2.1 What factors affect premium rates?

A major factor in determining the premium to be charged is the occupation of the life insured. Table 12.1 provides an example of a typical classification of occupations by an IPI provider.

TABLE 12.1 EXAMPLE OF OCCUPATION CLASSIFICATION FOR IPI PURPOSES

Class 1	Lowest risk, covering those in clerical, professional or administrative roles, eg accountants and civil servants
Class 2	Occupations carrying a low risk of an accident, eg hairdressers, pharmacists
Class 3	Occupations carrying a moderate risk of an accident, eg farmers, electricians
Class 4	Occupations with highest risk of a claim because of risk of health problems or accident, eg manual labourers, industrial chemists

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

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

Other factors that will influence the premium rate are:

- the age of the life insured;
- the amount of benefit;
- current state of health;
- past medical history;
- the length of the deferred period (see section 12.2.3).

12.2.2 How are premiums on IPI structured?

There are two types of income protection premiums available – reviewable and guaranteed.

- **Reviewable premiums** – a reviewable premium means that premiums may start off relatively low, but will be reviewed in the future and may go up every few years or so. In some cases, the premium may be reviewable every year, or every five years, to take into account changing circumstances.
- **Guaranteed premiums** – the nature of guaranteed premiums means that these tend to be more expensive than the other two options, but the premiums are guaranteed for the life of the policy, which may be 25 years or even longer.

It is the insurer's choice as to what premium charging methodology is used. Some may only offer one type, others a range.

A waiver of premium option may also be provided whereby premiums for the IPI policy are not paid while benefits are being paid from the policy, but the policy cover continues as normal. The premiums are 'waived'.

12.2.3 When and how are benefits paid?

A period of time, called the deferred period, must elapse between the onset of the illness/injury and the point at which benefits begin to be paid. Typical deferred periods are 4, 13, 26, 52 and 104 weeks. The minimum four-week deferred period is to prevent multiple claims for minor ailments such as colds.

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

DEFERRED PERIOD

The period that must elapse between the onset of the illness/injury that gives rise to the claim and the first payment of benefits.

Benefit levels are set so that the claimant is unable to receive a higher income when they are not working than they could from working. The maximum benefit payable from an IPI policy varies between providers, but is normally in the range of 50 per cent to 65 per cent (individual policies) or 75 per cent (group policies) of pre-disability earnings. If the provider allows a benefit level towards the top end of this range, they are more likely to make a deduction to allow for any state benefits to which the claimant may be entitled. These limits apply to total benefits from all IPI contracts held by the individual.

Benefits are paid pro-rata if illness means that a person can work but earns less than they did before they suffered illness/disability. For example, they might be able to work only part-time, or in a lower-paid job.

The proportionate benefits will be paid until retirement, death or at the end of the policy.

Cover is permanent in the sense that the insurer cannot cancel the cover simply because the policyholder makes numerous claims; in fact IPI used to be known as "permanent health insurance". The policy can be cancelled, however, if the customer fails to keep up their premium payments or takes up a hazardous job or pastime.

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

Benefits are normally paid until death, return to work or retirement, whichever event occurs first.

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

12.2.4 How are IPI benefits taxed?

Where income protection insurance (IPI) is taken out on an individual basis the benefits are tax-free.

IPI can be arranged by an employer on a group basis and in this case the income is taxable as earned income. The employer pays the premium, which is a tax-deductible business expense. From the employee's point of view, the premium paid by the employer is not taxable as a benefit in kind, ie they do not have to pay tax or National Insurance on the premium paid, provided that the employer has discretion as to whether to pay the proceeds to the employee. In practice, the employer does have such discretion and pays the proceeds to the member concerned. The scheme member pays income tax and National Insurance on the proceeds.

12.3 How does ASU insurance differ from IPI?

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

ASU insurance is typically used to cover mortgage repayments if illness, accident or loss of employment prevents the policyholder from earning a living. A level of income equal to monthly mortgage repayments is paid for a limited period, usually a maximum of two years. Additional cover can sometimes be included to cover other essential outgoings.

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

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

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

- The proposer must have been actively and continuously employed for a specified minimum period prior to starting the plan.

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

ASU policies are renewable annually at the discretion of the insurer. This means that the insurer could increase premiums if a policyholder makes a large number of claims, or might even withdraw the cover offered. This is a major difference from IPI.

PROPOSER

The individual who is applying for cover under the insurance policy and will pay the premiums, also referred to as the policyholder. The proposer is often the same as the person(s) covered under the policy, the life assured, but can be different.

12.3.1 How are ASU benefits taxed?

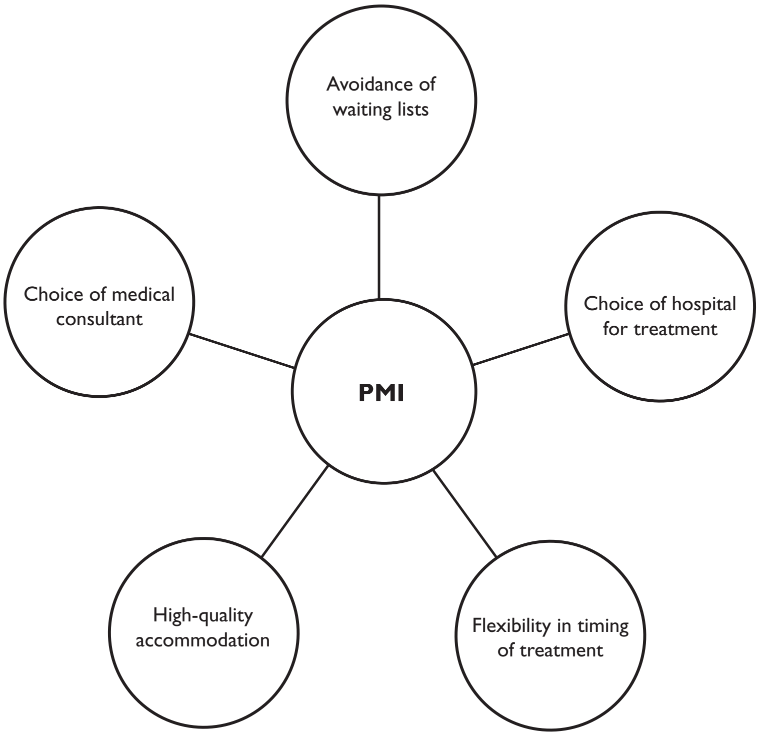
All benefits are tax-free, but there is no tax relief on contributions to an ASU plan when it is arranged on a personal basis.

If the scheme is set up on a group basis, any employer contribution will be allowed as an expense against corporation tax. Any employer contribution will be classed as a benefit in kind.

12.4 Private medical insurance

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

FIGURE 12.2 BENEFITS OF PMI



The range of cover normally provided includes reimbursement of:

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

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

Plans can be arranged on an individual basis or as part of a group scheme established by an employer. Employer-sponsored schemes currently account for the vast majority of PMI provision in the UK. The way in which benefits are paid varies between providers. Some will offer a full refund of charges with payment direct to the healthcare provider. Other plans impose an upper limit on the amount that can be reclaimed in any one year.

12.4.1 What factors affect the cost of cover?

Premium rates depend on a number of factors, including:

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

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

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

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

EXCLUSIONS

PMI cover will not be provided for any pre-existing medical conditions. Other general exclusions are the costs of:

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

12.4.2 How are premiums and benefits taxed?

Premiums are subject to insurance premium tax but the benefits are paid out tax-free. Employers who contribute to PMI on behalf of their employees are able to claim the cost as an allowable deduction against corporation tax. Contributions paid by an employer are regarded as a benefit in kind as far as the employee is concerned and are taxable.

12.5 What is long-term care insurance?

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

The need for this cover has increased because:

- families are less able to take care of elderly relatives than they were in earlier generations (eg because they live further away from each other, there are competing pressures on their time, or because their accommodation is unsuitable);
- people are living longer;
- expectations in relation to quality of life in later years are higher;
- some people are concerned about the standard of care that the state and the NHS can realistically be relied upon to provide.

12.5.1 How is the level of benefits determined?

The amount of benefit paid from an LTC plan depends on the degree of care required by the insured. This is established by ascertaining the person's ability to carry out a number of activities of daily living (ADLs). Typical ADLs would be:

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

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

The greater the number of ADLs that cannot be performed without assistance, the greater the amount of care required and, therefore, the higher the level of benefit paid. It is normal for insurers to require that the person must be incapable of performing at least two or three of the ADLs before a claim can be accepted.

A person need not be in a nursing home to receive LTC benefits: for example, they might need help with dressing and with preparing and eating meals. In this situation, the support they would need might be limited to a person coming in at certain points during the day to help with those specific activities.

12.5.2 How are benefits taxed?

If an annuity is purchased for immediate long-term care needs benefits will be tax free if paid direct to the care provider. Furthermore, the annuity must have qualified as an immediate needs annuity when it was taken out.

KEY TERMS

ANNUITY

A financial product purchased with a lump sum, which then pays out a regular income, potentially for the lifetime of the annuity holder (the annuitant).

IMMEDIATE NEEDS ANNUITY

An annuity from which the benefits are used to pay for care needs that the insured already has.

DEFERRED NEEDS PLAN

An investment designed to build up funds that can then be drawn on to pay for care needs as and when required.

In other words, the benefits from an ordinary purchased life annuity cannot be paid tax-free just because they are being used to fund long-term care.

If an annuity does not qualify as an immediate needs annuity, ie if its benefits can be paid to the policyholder, only the interest element is taxable as savings income. Tax rates applicable are as follows (these are the rates for 2019/20 for illustrative purposes):

- Tax at a rate of 20 per cent is deducted at source.
- Non-taxpayers or individuals not liable to tax on their savings income can reclaim any overpaid tax.
- Higher-rate taxpayers having a further liability of 20 per cent.
- Additional-rate taxpayers have a further liability of 25 per cent.

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

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

CHECK YOUR UNDERSTANDING 1

Julie wants to make sure that she can meet all of her essential outgoings if she is unable to work due to medium- or long-term illness. Which of the following products would be most suitable for her?

a) Accident, sickness and unemployment insurance (ASU).

b) Critical illness cover (CIC).

c) Income protection insurance (IPI).

d) Private medical insurance (PMI).

12.6 What is general insurance?

The types of loss that are covered by general insurance can be categorised in five broad bands. The first two relate to both personal and commercial situations:

- **property loss** – loss, theft or damage to static and moveable assets (from diamond rings to houses to supertankers);
- **liability loss** – resulting from a legal liability to third parties, eg personal injury or damage to property.

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

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

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

INDEMNITY

General insurance policies are contracts of indemnity. The principle of indemnity is that:

> *in the event of a claim, insured persons should be restored to the same financial position after a loss that they were in immediately before the loss occurred.*

In particular, this means that an insured person should not be able to benefit from the event that caused the loss.

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

It is usually up to the insurer to determine how to restore the claimant to the financial position they were in before the loss occurred.

There are four main methods:

- **cash** (normally by cheque or electronic transfer);
- **repair** (used very commonly with motor insurance);
- **replacement** – this can be a cost-effective option for the insurer as it has greater purchasing power than an individual consumer and so can negotiate better prices;
- **reinstatement** – for instance, where the insurance company arranges for a damaged building to be restored to its former condition.

AVERAGE

It is not uncommon for policyholders to underinsure: in other words, to insure for a smaller amount than is actually required to replace or repair the lost or damaged property. This may be because:

- they are unaware of the appropriate figure;
- inflation has increased the amount required;
- they are deliberately understating the figure in order to keep the premium down.

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

Many losses are only partial, however. In these circumstances, it would be unfair if a policyholder who had paid less premium than was really appropriate were indemnified in full, even if the actual amount claimed were less than the overall sum insured.

In such cases, the principle of average is applied, which means that the claim is scaled down in the same proportion that the premium actually paid bears to the premium that should have been paid for the full appropriate sum insured. So, for example, a policyholder who insured contents for £10,000, when their true insurance value was £15,000, would find that if they claimed £300 for a damaged carpet, the insurer would pay only £200.

EXCESS

Many general insurance policies are subject to an excess: in other words, a deduction is made from any claim payment. For instance, a homeowner might have an excess of £100 on claims for accidental damage under their contents insurance policy. For the insurer, this avoids the high administrative costs of dealing with a lot of small claims, since there is no point in a policyholder claiming for an amount less than the excess. Sometimes, an excess is a compulsory element of the policy; policyholders might also choose a voluntary excess or an excess above the compulsory level in exchange for a reduction in premium.

12.7 What is buildings insurance?

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

Cover is normally provided against:

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

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

Some types of cover are subject to the property not being left unoccupied for more than a specified period, typically 30 or 60 days. These include cover against damage caused by:

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

Most policies also cover property owners' liability.

UNDER-INSURANCE

Harry insured his property for £100,000 when he bought it in 2000. He has never increased his insurance. In 2019, his house is completely destroyed in a fire. The 'reinstatement value' of his property is £150,000. However, the maximum that the insurance company will pay out is £100,000. (Note that if the property had a mortgage on it, the lender would have required adequate buildings insurance.)

If a smaller claim were made, the claim would be averaged. If Harry were to lose roof tiles in a storm and claim £1,000 for the cost of replacing them, then the claim would be reduced as follows.

The value of the insurance cover taken out is divided by the actual value:

£100,000 ÷ £150,000 = 66.67%

This calculation shows that Harry's property is only insured for 66.67 per cent of its true value and so Harry's premiums are less than they should be. The insurance company would only pay 66.7 per cent of his claim, ie £667.

12.8 What is contents insurance?

Contents can be defined as "anything you would normally take with you if the property were sold". Cover would typically be provided against the same events and circumstances as described above for buildings insurance. Additional cover might include:

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

12.8.1 What is all-risks cover?

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

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

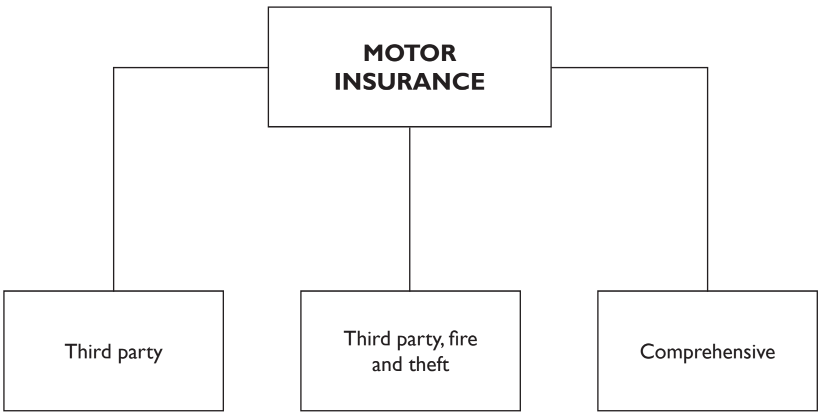
Both of the above categories require the policyholder to take reasonable care of the property.

CHECK YOUR UNDERSTANDING 2

The contents of Charlene's home are insured for £25,000 when they are actually worth £50,000. She is burgled and loses £2,000-worth of computer equipment. Using the 'average principle', calculate how much the insurance company will pay her.

12.9 What types of private motor insurance are available?

There are three main types of motor insurance cover:



There are variations in the exact nature of cover offered by different companies in each category – particularly on comprehensive policies – but a summary of what might typically be offered is shown as follows.

12.9.1 Third party cover

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

Third-party-only policies typically provide cover for:

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

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

CERTIFICATE OF INSURANCE

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

12.9.2 Third party, fire and theft cover

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

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

12.9.3 Comprehensive cover

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

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

The private motor insurance market is large and extremely competitive, and many other extensions to the cover are offered in order to attract business. These may include:

- roadside breakdown assistance;
- legal protection services;
- provision of a courtesy vehicle while repairs are carried out;
- out-of-pocket expenses resulting from an accident.

12.10 What cover does travel insurance provide?

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

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

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

INSURANCE PREMIUM TAX

Some general insurance premiums payable in the UK are subject to insurance premium tax (IPT). The standard rate of IPT is currently 12 per cent of the premium on most general insurance which relate to risks for which the period of cover under the terms of an insurance contract begins on or after that date.

Travel insurance premiums are taxed at a higher rate of 20 per cent. There is no premium tax at present in respect of long-term insurance such as life assurance and income protection insurance.

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

Arrangements and rates for insurance premium tax changed in both the 2015, 2016 and 2017 Budgets. Check the GOV.UK website for further updates: https://www.gov.uk/government/publications/rates-and-allowances-insurance-premium-tax/insurance-premium-tax-rates [Accessed: 18 February 2020] .

12.11 What is payment protection insurance?

Payment protection insurance (PPI) can cover monthly loan repayments if the policyholder's salary is reduced due to accident, sickness or unemployment. The policy will pay out only for a fixed period of time, usually 12 months.

This insurance is linked to the repayments of a specific lending product and may be offered at the same time as the loan itself.

PPI can be extremely useful, although many PPI policies have been mis-sold alongside loans, credit cards and mortgages over the years to people who did not need it, were ineligible to claim its benefits, or did not even realise it had been included as part of their loan repayments. Some lenders developed sales scripts for their customer services advisers that included a statement that the loan was 'protected', without mentioning the fact that this protection was in the form of an insurance policy – a policy that the customer should have been given the opportunity to opt out of taking.

A number of companies, including high-street lenders, have incurred fines for mis-selling this product; compensation for customers runs into billions of pounds. Many customers have been encouraged (mainly through TV advertising campaigns or cold-calling) to make a claim against their lender if they feel they were wrongly sold this product. People whose claims are successful are not only given back the insurance premiums they have paid, they are also able to claim the interest that this money would have earned had it been in a savings account.

A deadline of 29 August 2019 was applied to PPI claims against companies that are still trading. However, customers may still be eligible to claim compensation with the Financial Services Compensation Scheme (FSCS) for when financial firms have failed. The FSCS can only accept a PPI claim if the advice was received on or after 14 January 2005. Read more on this area at: https://www.fscs.org.uk/what-we-cover/ppi/ [Accessed: 13 October 2020].

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- summarise the key features of and differences between critical illness cover, income protection insurance and accident, sickness and unemployment benefit?
- describe the factors that generally affect the cost of PMI cover?
- explain the different tax treatments that apply to different types of annuity under long-term care insurance?
- explain what is meant by a ‘contract of indemnity’?
- explain why an insurance claim might be subject to ‘averaging’?

Go back over any points you don’t understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 12. Review the text if necessary.

Answers can be found at the end of this book.

1) When Gary was diagnosed with bowel cancer at the age of 50, he was able to use the lump sum he received under his insurance policy to pay off his outstanding mortgage. Which of the following types of insurance did Gary have?

   a) Private medical insurance.

   b) Income protection insurance.

   c) Critical illness insurance.

   d) Long-term care insurance.

2) Marco, a self-employed painter and decorator, is considering taking out income protection insurance. He should opt for as short a deferred period as possible. True or false?

3) Marco's partner Lydia, an HR manager, already has income protection insurance. If she claims under her policy, she will have to pay tax and NICs on the income she receives. If Marco goes ahead and buys income protection, he will not pay tax or NICs if he has to claim benefits under the policy. This is likely to be because:

   a) Marco's earnings are below the personal allowance for income tax.

   b) Marco's policy will be arranged on an individual basis whereas Lydia's policy has been arranged as part of a group scheme.

   c) Marco is self-employed whereas Lydia is an employee.

   d) The insurance provider from whom Marco is thinking of buying his policy has different rules to Lydia's insurance provider.

4) Adaeze, an office administrator, hurts one of her hands, causing permanent damage, and has to be re-employed on a lower salary. What effect would her return to work have on her IPI benefits?

   a) Full benefits would be paid until Adaeze has fully recovered.

b) Proportionate benefits would be paid, but no other claims under the policy would be accepted by the insurance company.

c) Benefits would cease immediately.

d) Proportionate benefits would be paid until retirement, death or the end of the policy.

5) Annette, who retired last year, has developed arthritis and needs a hip replacement. Under which of the following types of insurance policy might she be eligible to claim benefits?

a) Critical illness cover.

b) Accident, sickness and unemployment insurance.

c) Private medical insurance.

d) Income protection insurance.

6) Vanessa is unhappy in her current job and has decided to resign. She will be able to claim benefits under her ASU policy to tide her over until she finds a new post. True or false?

7) Roger, who is 78, is finding it difficult to look after himself at home and is planning to move into residential care next month. He has purchased an immediate needs annuity so his fees will be paid direct to his care provider, once tax has been deducted. True or false?

8) General insurance policies operate on the principle that policyholders should be restored to the position they were in before the event occurred that led to their claim. True or false?

9) Steve's home contents were insured for £25,000. Last winter his kitchen was flooded and he claimed under his contents insurance for £6,000 damage to kitchen appliances and contents. His insurers established that his home contents should have been insured for £32,000. Calculate how much Steve actually received once his insurers had taken account of the fact that he was underinsured.

10) It is illegal to drive a vehicle on public roads in the UK unless you have insurance that covers damage to your car or injury to yourself. True or false?

TOPIC 13

Secured and unsecured lending

LEARNING OBJECTIVES

In this topic we are looking at secured and unsecured lending. The most well-known example of secured lending is the mortgage loan used to finance the purchase of a residential property. Examples of unsecured lending include overdrafts and credit cards.

There are two basic types of mortgage:

- a repayment mortgage, sometimes known as a capital-and-interest mortgage;
- an interest-only mortgage.

A number of different methods can be used to repay an interest-only mortgage and we will be looking at these. Later in the topic we will focus on equity release schemes, which are methods people can use to release the value that is 'locked up' in their homes.

By the end of this topic you should have an understanding of:

- repayment mortgages;
- interest-only mortgages and the different products that can be used to fund the capital repayment;
- the range of interest rate options available;
- different ways of charging interest on a mortgage;
- equity release;
- other types of secured lending, including bridging loans;
- unsecured lending including personal loans, overdrafts and credit cards.

This topic covers part of Unit 1 syllabus learning outcome U3.3.

THINK . . .

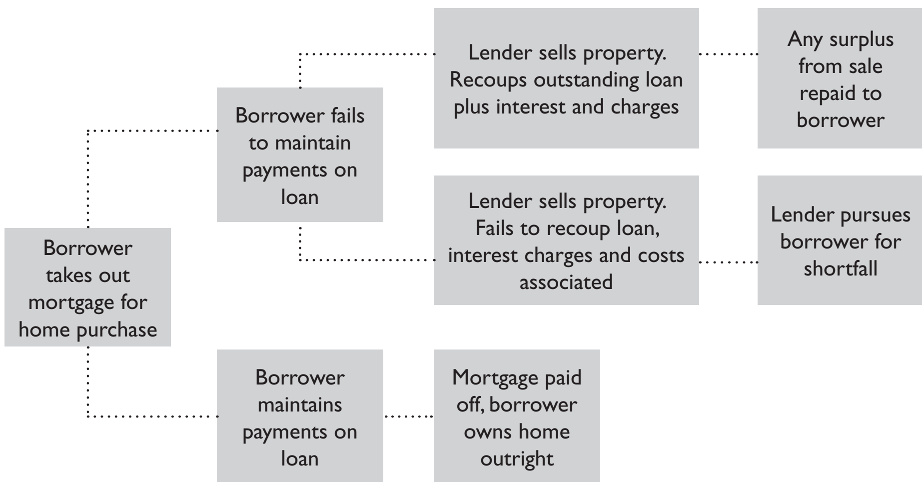
Many of the products we focus on in this topic will be familiar to you. For instance:

- Do you have a mortgage? If so, is it a repayment mortgage or an interest-only product?
- If you have a mortgage, how is interest charged on it? At a fixed rate? A variable rate? A capped rate?
- Do you have older relatives who have investigated releasing the equity tied up in their home to fund their daily living costs?
- Have you ever taken out a personal loan, or used an overdraft facility on your current account? How does the repayment of those types of borrowing differ?

13.1 How does secured lending differ from unsecured lending?

Lending is 'secured' when the borrower gives the lender the right to take possession of a specific asset if they (ie the borrower) fail to keep up repayments on a loan. In the event that repayments are missed and the matter cannot be resolved in any other way, the lender can then sell the asset to recoup the money it is owed. Figure 13.1 outlines the process in relation to lending secured on a home.

FIGURE 13.1 SECURED LENDING



Security for a loan does not always take the form of a property. With commercial loans, the loan might be secured on business premises or equipment. It could also be a financial asset such as shares or other investments.

With unsecured borrowing, the lender does not have the reassurance of an asset that they can sell to recoup the loan if the borrower fails to repay it. The lender has to rely on the borrower's agreement to repay. For this reason, unsecured borrowing represents a greater risk to the lender, and thus interest rates on unsecured loans tend to be higher than those for secured loans.

13.2 What is a repayment mortgage?

With a repayment mortgage, the borrower makes monthly repayments to the lender. Each monthly amount consists partly of capital repayment (ie the original amount borrowed) and partly of interest on the amount borrowed. The higher the interest rate (for any given mortgage amount and term), the higher the monthly repayment.

The repayment is calculated in such a way that it is evenly spread throughout the term of the mortgage. Thus if interest rates do not change over the whole term, the repayment will be the same each month. However, if interest rates do go up or down, then the monthly repayment increases or decreases, or alternatively the mortgage term can be extended or shortened.

KEY TERMS

MORTGAGOR

The individual borrower who transfers their property to the lender for the duration of the loan.

MORTGAGEE

The lender (bank, building society or other institution).

The relative proportions of capital and interest vary throughout the term. At the beginning, when most of the original amount borrowed has yet to be repaid, most of the monthly repayment is just paying the interest on the loan. Later in the term, when more of the capital has been repaid, the interest proportion of the repayment grows less and less and a larger proportion of the repayment goes towards repaying the capital.

Providing that all the repayments have been made when due, and that the repayments have been adjusted to reflect changes in the interest rate, the mortgage will be repaid at the end of the term.

If the borrower dies before the end of the mortgage term, either the repayments still have to be made, or the loan has to be repaid in full. Borrowers need to take out life assurance cover to make sure these conditions can be met.

COVENANTS

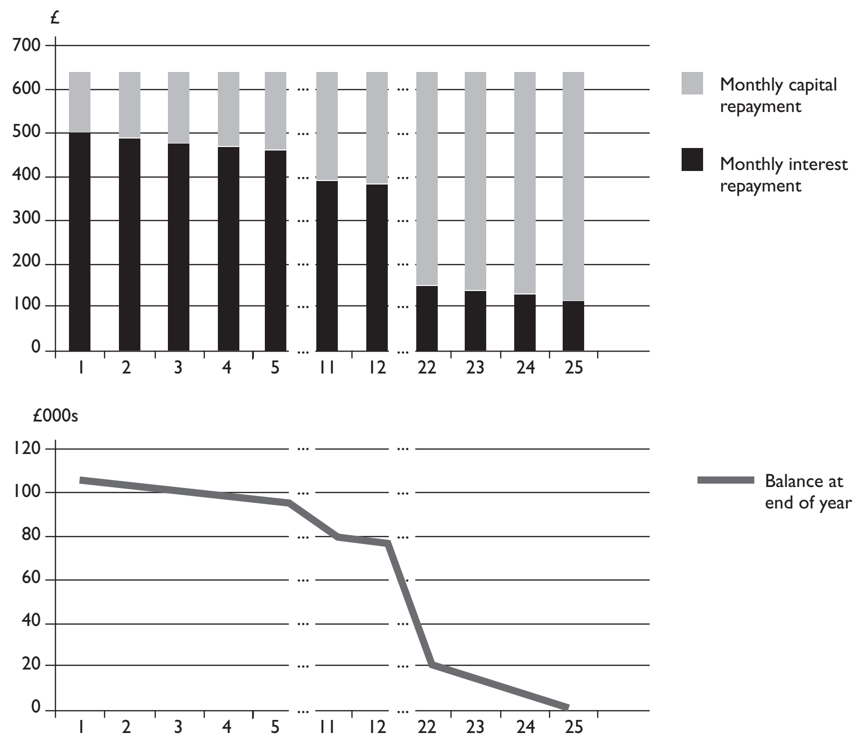
A lender's security depends on the property being maintained in an acceptable condition. For that reason, borrowers have to covenant (ie promise under the terms of the mortgage deed) to maintain the property in good condition.

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

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

FIGURE 13.2 EXAMPLE BREAKDOWN OF CAPITAL AND INTEREST ON REPAYMENT MORTGAGE

£100,000 repayment mortgage over 25 years, average 6% interest per year.



Note that the time period on the graph is not continuous, ie the rapid falls occur over several years, not single years.

13.3 What is an interest-only mortgage?

With an interest-only mortgage, the monthly payments made to the lender are solely to pay interest on the loan. The capital amount outstanding therefore does not reduce at all. For this reason, the monthly payments are lower than those for a repayment mortgage. However, the borrower still has to repay the original amount borrowed at the end of the term.

The FCA's Mortgages and Home Finance: Conduct of Business (MCOB) Sourcebook rules relating to interest-only mortgages changed in April 2014, following the Mortgage Market Review, which was a major investigation into the mortgage market by regulators. New rules were introduced following concerns that, among other issues, people were being encouraged to borrow more than they could afford and borrowers were able to arrange an interest-only mortgage without being required to make arrangements to fund repayment.

An interest-only mortgage can now only be arranged if the lender has obtained evidence that the borrower has a credible repayment strategy in place. A credible repayment strategy would be, for instance, a savings scheme guaranteed to provide the borrower with the sum needed to repay the mortgage at the end of the term. In addition, lenders must contact the borrower at least once during the term of the mortgage to establish whether the repayment strategy remains in place and still has the potential to repay the capital.

In response to these changes, many lenders stopped offering interest-only mortgages to new borrowers. More recently, lenders have started offering interest-only mortgages again, and there are many borrowers who have interest-only mortgages that were taken out before the MCOB rules changed.

> **!**
>
> **MORE ABOUT MCOB**
>
> You will find out more about mortgage regulation and the MCOB rules in Topic 21.

When an interest-only mortgage is taken out, the two main issues to be addressed are:

- putting in place a funding mechanism to repay the debt at the end of the term; and
- ensuring there is sufficient protection to enable the debt to be repaid should the mortgagor die before the end of the term.

Popular methods of funding interest-only mortgages are endowments, ISAs and pensions. Level term assurance is a popular way of providing protection in the event that a borrower dies during the mortgage term. We covered level term assurance in section 11.1 and endowments are detailed in section 11.5. ISAs and pensions are described below.

CHECK YOUR UNDERSTANDING 1

How much can you remember about the different types of endowment policy we looked at in Topic 11? Try to write brief notes explaining the main features of the following products:

- non-profit;
- full with-profits;
- low-cost with-profits;
- unit-linked;
- unitised with-profits.

Look back to Topic 11 to check how accurate your notes are. Work through the section again if you don't feel confident about these products.

13.3.1 Pension mortgages

One of the benefits of a personal pension plan or stakeholder pension is that up to 25 per cent of the accumulated fund can be taken as a tax-free cash sum when the pension payments commence. Depending on the rules of the pension provider, it may also be possible for holders of a personal or stakeholder pension plan to draw an additional amount, over and above the 25 per cent tax-free cash, as a taxable sum. The availability of a lump sum from normal minimum pension age (usually 55) means that these pension plans have the potential to be used as mortgage repayment vehicles.

KEY TERMS

PERSONAL PENSION

A pension product that is arranged on an individual basis (ie rather than a pension scheme run by an employer). The benefits eventually received depend on the performance of the funds into which the individual's pension contributions are invested.

STAKEHOLDER PENSION

A simple, low-cost pension product that meets government standards on charges and levels of contribution.

The plans have other financial benefits in comparison with endowment policies:

- Pension contributions qualify for tax relief at a person's highest rate of tax, up to the annual maximum contribution limit. There is no tax relief on endowment policy premiums.
- The fund in which the contributions are invested is not subject to tax on income or capital gains, meaning that it should grow faster than an equivalent endowment policy fund, which is taxed on both income and capital gains.

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

- **Lifetime allowance** – this is the maximum tax-privileged pension investments an individual is able to accrue during their lifetime. It effectively limits the amount of tax-free cash that can be taken to 25 per cent of the lifetime allowance. For example, in 2020/21 the lifetime allowance is £1,073,000, so the maximum tax-free cash that can be taken is £268,275. Therefore, someone who wants to use a pension plan for mortgage repayment must either restrict themselves to a capital repayment of no more than £263,750, or be prepared to take a further taxable lump sum beyond the 25 per cent from their pension.
- **Minimum pension age** – in most cases, the minimum age at which benefits can be taken from a pension is 55, and the normal minimum pension age is expected to increase in the future. This means that the term of the mortgage must run until the mortgagor reaches pension age and the mortgage cannot be paid off earlier, even if the fund has grown to a sufficient value. A longer mortgage term will add to the total cost of the mortgage as a result of the additional interest payments incurred.
- **Provider restrictions** – not all providers offer the facility to take a taxable lump sum in excess of the 25 per cent tax-free amount (although it is possible to switch to a provider that does). If only 25 per cent of the fund can be taken as a tax-free cash sum, a fund of four times the loan value must be built up. This may mean that total contributions are more than the borrower can afford or more than are permitted by the pension scheme regulations.
- **Impact on income in retirement** – using a portion of the pension fund to repay a mortgage means there is less money available to provide an income in retirement.
- **Need for separate life assurance** – a personal pension or stakeholder pension, unlike an endowment assurance, does not automatically carry with it any life assurance, so a separate policy will be required to cover the repayment of the loan in the event of death during the term.

- **Assignment** – as with all pension contracts, personal pensions and stakeholder pensions cannot be assigned to a third party as security for a loan or for any other purpose. The lender cannot, therefore, take possession of the plan or become entitled to receive benefits directly from it, as it can with an endowment policy. This is a potential disadvantage to a lender but has not, in practice, prevented the majority of them from moving into the pension mortgages market.

13.3.2 Individual savings accounts mortgages

In order to use an ISA as a mortgage repayment vehicle, ISA managers calculate the amount of regular investment that would be required to produce the necessary lump sum at the end of the mortgage term, based on an assumed growth rate and on specified levels of costs and charges. All managers allow investments to be made on a regular monthly basis, provided, of course, that the overall annual limits are not exceeded.

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

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

If, on the other hand, growth rates do not match the initial assumptions, the final lump sum will fall short of the mortgage amount. Performance needs to be monitored and adjustments made to the amount of regular investment if necessary.

Another drawback of using an ISA is that, should the borrower die during the mortgage term, the value of the ISA investment is unlikely to be sufficient to repay the loan. Additional life assurance cover is required to meet this eventuality.

The limits on annual contributions can make it difficult to build a sum sufficient to pay back a large loan or one with a short term. This is less of an issue for couples, as each individual has an ISA allowance. However, given the rate of contribution limit of £20,000 for 2020/21, achieving a lump sum of around £200,000 in ten years is now a realistic possibility. Also, as we saw in Topic 9, the government has introduced both Help to Buy ISAs and Lifetime ISAs that are intended to help those looking to purchase a property to fund their deposit.

13.4 Mortgage interest rate options

A distinction can be made between the way a lender charges interest to the mortgage account and the different interest rate options that can be applied to the mortgage.

For both repayment and interest-only mortgages, there is a variety of ways in which interest can be charged to the mortgage account. For instance, some lenders charge interest on an annual basis, some on a monthly basis, and some on a daily basis. Generally it is the lender who decides how interest is charged, although this may vary between different mortgage products.

Lenders will generally offer a range of different interest rate options or 'mortgage products' such as fixed or variable rates, and the ability to defer interest or take an interest payment 'holiday'. The main types are summarised in Table 13.1.

TABLE 13.1 MORTGAGE INTEREST OPTIONS

Product	Description	Notes
Variable rate	Monthly payments rise and fall in line with interest rate changes.	Hard to predict what future payments will be, making budgeting difficult.
Discounted rate	Interest rate is a discount from the standard variable rate.	May be penalties for early repayment.
Fixed rate	Interest rate is fixed for a specific period (usually between one and five years), then reverts to the standard variable rate (SVR).	▪ Makes it easier for borrowers to budget. ▪ May be a substantial arrangement fee and penalties or restrictions on switching to another lender.
Capped rate	Interest rate is variable but cannot rise above a specified upper limit (the cap). Products that also have a specified lower limit are 'cap and collar' mortgages.	▪ Allows borrowers to budget within set parameters. ▪ Borrowers can benefit from falls in interest rates down as far as any collar limit set.
Base-rate tracker	Interest moves up and down in line with (ie 'tracks') changes in Bank rate.	Note that a tracker mortgage rate is not the *same* as Bank rate – the lender's rate will be slightly higher.

Flexible	Facility to overpay, underpay and/or take payment holidays without incurring penalties.	▪ Interest calculated on daily basis. ▪ Options include current account and offset mortgages.
Low start	▪ Repayment mortgage with lower initial payments during which capital is not repaid. ▪ Higher payments required after the initial period to achieve repayment of capital.	Suits borrowers keen to keep outgoings low in the early years.
Deferred interest	Interest payments deferred until later in the term.	▪ Suits borrowers who expect their income to increase over the term of the mortgage. ▪ Not suitable for those who borrow a high proportion of the property value because of the increased risk of negative equity.
CAT-standard	Charges, Access and Terms (CAT) meet standards set out by government.	Likely to appeal to borrowers who want clearly stated limits on charges.

13.5 Flexible mortgages

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

- interest calculated on a daily basis;
- the facility to make overpayments at any time without incurring an early repayment charge;
- the facility to underpay, but only within certain parameters set out by the lender when the mortgage was arranged;

- the facility to take a payment holiday, again within certain parameters laid down at the outset.

Two key benefits of these features are as follows:

- The combination of a daily interest calculation and occasional, or regular, overpayments will result in considerably less interest being paid overall and the mortgage term being reduced.
- The ability to reduce monthly payments, or suspend them entirely, for a limited period will benefit a borrower who is experiencing temporary financial difficulties. If required, a borrower in this situation can borrow back overpayments made earlier in the term.

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

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

CURRENT ACCOUNT AND OFFSET MORTGAGES

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

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

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

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

CASHBACK

Cashback is a relatively common incentive offered by many lenders. A lump sum is paid to the borrower immediately after completion of their mortgage, either as a fixed amount or as a percentage of the advance. Generally, the lower the loan-to-value ratio (LTV), the higher the cashback, as the risk of the lender losing money is reduced and a lower LTV makes the borrower a more attractive proposition for the lender. For example, the cashback may be 1 per cent of the advance for a loan-to-value ratio of up to 80 per cent, and 0.5 per cent for a higher loan-to-value ratio.

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

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

LOAN-TO-VALUE (LTV) RATIO

The amount of the loan in relation to the value of the asset used for security, expressed as a percentage. For a mortgage loan of £80,000 on a property valued at £100,000, the LTV is 80 per cent.

13.6 CAT-standard mortgages

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

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

- The variable interest rate must be no more than 2 per cent above Bank rate and must be adjusted within one calendar month when Bank rate is reduced.
- Interest must be calculated on a daily basis.
- No arrangement fees can be charged on variable-rate loans and no more than £150 can be charged for fixed-rate or capped-rate loans.
- Maximum early redemption charges apply to fixed-rate and capped-rate loans.
- No separate charge can be made for mortgage indemnity guarantees (see below).
- All other fees must be disclosed in cash terms before the potential borrower makes any commitment.

Other rules relating to access and terms include the following.

- Normal lending criteria must apply.
- The borrower can choose on which day of the month to pay.
- All advertising and paperwork must be clear and straightforward.
- Borrowers cannot be required to buy associated products from the lender in order to receive a mortgage offer.

MORTGAGE INDEMNITY GUARANTEES AND HIGHER LENDING CHARGES

A mortgage indemnity guarantee (MIG) is an insurance policy that protects the lender in situations where the loan has a high loan-to-value ratio (generally over 75–80 per cent). If the borrower defaults on repayments and the property is sold, the lender might not get back the full amount that it lent. The insurance is designed to make up any shortfall in these circumstances.

Although the lender is the beneficiary of the policy, it is the borrower who pays the premium; it can either be a one-off payment when the loan is taken out or can be added to the amount borrowed. Note that, even if the lender fully recoups the money owed by claiming under the MIG, the insurance company (MIG insurer) is still entitled to pursue the borrower for the shortfall arising from the default.

MIGs are a form of higher lending charge (HLC) or mortgage insurance. 'Higher lending charge' is the term the FCA requires providers to use in explaining a MIG to a customer, but the term is not exclusive to MIGs. Some lenders will, for example, make a higher lending charge but, rather than arrange a MIG, simply place the money into a fund that can be drawn upon if required.

13.7 Shared ownership

Shared-ownership schemes are designed to help people on relatively low incomes to become owner-occupiers, even though they cannot afford a conventional mortgage. These schemes are usually arranged by housing associations.

Shared-ownership schemes enable a borrower to buy a stake in the property and pay rent on the remainder. For example, a borrower can purchase a 25 per cent stake in the property, funded by a mortgage, with the option of buying further 25 per cent shares in the future. As the borrower increases their share in the property, the mortgage element increases and the rental element reduces. This process of increasing the mortgage element is sometimes called staircasing. Note that not all lenders offer mortgages for shared-ownership arrangements.

CHECK YOUR UNDERSTANDING 2

There are several products that cover mortgage payments in circumstances where the borrower finds themselves unable to make repayments. This is potentially confusing, so check your understanding by matching the terms below to their **correct** definition.

Accident, sickness and unemployment insurance	Provides a lump sum that can be used to repay the outstanding mortgage loan if the life assured dies.
Income protection insurance	Covers the difference between the sale proceeds after a lender has taken possession of a property and the amount outstanding on the loan.
Mortgage protection insurance	Provides a regular income for an indefinite period if the beneficiary is prevented by illness from working.
Mortgage indemnity guarantee	Covers mortgage repayments, usually for a maximum of two years, if the beneficiary is prevented from earning an income.

13.8 What is equity release?

In a mortgage context, 'equity' is the excess of the market value of a property over the outstanding amount of any loan or loans secured against it. Equity release plans are designed to enable homeowners who do not have a mortgage on their property to release some of the equity in order to provide capital or supplement their income. The schemes are commonly used by older homeowners who may have limited pension income, but own a property. A homeowner with a small mortgage would also be eligible; the existing mortgage would have to be paid off as part of the arrangement. Most of the schemes are available only to property owners over the age of 60, and many have a minimum age of 70.

EQUITY RELEASE COUNCIL

The Equity Release Council represents all participants in the equity release market including product providers, advisers, lawyers and surveyors. Its Standards Board formerly existed as a body called SHIP – Safe Home Incomes Plans, which was incorporated into the Equity Release Council. The Council's role is to ensure that equity release products are safe and reliable for customers. Members sign up to its Statement of Principles, which sets out standards of conduct, particularly in relation to product standards and the information provided to customers, and to its Rules and Guidance.

FACTFIND

More information about the role of the Equity Release Council is available at:

https://www.equityreleasecouncil.com/ [Accessed: 18 February 2020].

13.8.1 How does a lifetime mortgage work?

For a lifetime mortgage, a lender will usually be prepared to lend up to a maximum of 55 per cent of the property value, depending on the borrower's age. The majority of lifetime mortgages are on a fixed-rate basis and take into account the fact that, unlike with a standard mortgage product, the term of the loan is unknown.

Interest is charged at the lender's lifetime mortgage rate, but generally no regular payments of capital or interest are made. Instead, the interest is added to the loan (rolled up). When the borrower dies or moves, the property is sold and the mortgage loan plus rolled-up interest is repaid to the lender. If any of the sale proceeds remain once the loan has been repaid, the borrower, or their estate, receives the balance. If the property is owned jointly, the mortgage continues until the second death or vacation of the property.

Most lenders provide a 'no-negative-equity' promise, which means that the borrower cannot owe more than the value of the property when the loan is due to be repaid.

A lifetime mortgage can be arranged on a drawdown basis. The lender agrees a maximum lending limit and the borrower can borrow an initial minimum loan and subsequently draw down lump sums as they wish, subject to a minimum withdrawal, typically £2,000 to £5,000. Interest is charged on the amount outstanding, but is rolled up rather than paid each month. The benefit of this type of loan over a standard lifetime mortgage is that interest only accrues on the amount actually borrowed, so the borrower has a degree of control and the debt will not increase as rapidly. It will allow the borrower to provide an annual 'income' while maintaining control over the speed at which the debt builds up.

13.8.2 How does a home reversion plan work?

Home reversion plans involve the homeowner selling a percentage or all of their property to the scheme provider. The customer(s) retains the right to live in the house, rent-free (or for a nominal rent), until their death(s) or until they move into permanent residential care. At that point the property is sold and the provider receives a share of the proceeds equivalent to their share of ownership. Thus if they owned 40 per cent of the property, they would receive 40 per cent of the sale proceeds.

HOME INCOME PLANS

Home income plans were launched in the 1980s. A homeowner could release equity from a property by taking out an interest-only mortgage. The funds released were used to buy a lifetime annuity (some schemes allowed homeowners to take some of the funds released as cash). The provider deducted the monthly mortgage interest from the annuity payment and paid the remainder to the homeowner as an income. The benefit of this approach over the lifetime mortgage was that interest was not rolled up, so the equity was not reduced further, and it also provided an income.

Unfortunately, as annuity rates fell, these products became increasingly unattractive. Few, if any, plans are sold today.

13.8.3 How are equity release schemes regulated?

Equity release schemes, defined as lifetime mortgages and home reversion plans, are regulated by the FCA under the Mortgages and Home Finance: Conduct of Business (MCOB) rules. MCOB 8 and 9 are the sections of MCOB specifically directed at equity release and lifetime mortgages, although the general MCOB rules regarding suitability and affordability also apply.

Anyone who advises on or arranges equity release must hold a specialist qualification. The requirements are detailed in the FCA Training and Competence sourcebook.

13.9 Other secured private lending

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

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

When property values increase significantly, it is common for people to borrow against the increased equity in their property. For instance, they might take out a further loan from their existing mortgage lender (ie a further advance), arrange a second mortgage from a different lender or remortgage for a larger amount. They then use the loan to fund purchases that are not related to the house purchase but which improve their lifestyle in other ways.

Sometimes, bridging finance is required to enable a homeowner to bridge the funding gap that arises when they complete on the purchase of a property before they have received the funds from the sale of their existing property.

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

KEY TERMS

BRIDGING FINANCE

Can be used by those arranging a loan to finance a new purchase before they have sold their existing property in order to 'bridge' the finance gap.

FIRST CHARGE

A legal right to have 'first call' on a property if a borrower defaults on repayment of the mortgage loan.

SECOND CHARGE

A legal call on a property after all the liabilities to the holder of the first charge have been settled.

13.9.1 Second mortgages

A second mortgage is one that is created when the borrower offers the property for a second time as security while the first lender still has a mortgage secured on the property. The new lender takes a second charge on the property;

the original lender retains the deeds and its charge takes precedence over subsequent charges. This means that, in the event of a sale due to default, the original lender's claim will first be met in full (if possible) and, if sufficient surplus then remains, the second mortgagee's charge will be met.

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

Second charge mortgages have been regulated by the FCA under MCOB since 21 March 2016; prior to that date they were regulated under the Consumer Credit Acts.

13.9.2 Bridging finance

Bridging finance may be required when a borrower wishes to move house but has not managed to sell their existing property, or the funds from the sale will not be available at the time completion of the new purchase is due. It is short-term lending that is repaid when the original property is sold and the owner is able to secure a mortgage on their new home.

There are two types of bridging finance:

- **Closed bridging** – the borrower has a feasible plan for repaying the loan within an agreed timescale. Typically, this is through the sale of the existing property and requires the borrower to have a firm buyer.
- **Open bridging** – the borrower needs finance to buy the new property, but does not yet have a firm buyer for their existing property.

Open bridging represents a higher risk to the lender than closed bridging. Interest rates for open bridging are therefore higher than those for closed bridging.

13.10 Commercial loans

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

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

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

13.11 Unsecured borrowing

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

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

13.11.1 Personal loans

Personal loans are offered by banks, building societies and some finance houses. They are normally for a term of one to five years; the interest rate is generally fixed at the outset and remains unchanged throughout the term. Many of the larger lenders assess loan applications on a centralised basis, using a form of credit scoring to assess the suitability of the borrower.

A customer can use a personal loan for any (legal) purpose: typically, it might be used to purchase a car, fund a holiday, or consolidate existing higher-cost borrowing such as a credit card balance.

The purpose of the loan determines whether it is regulated under the terms of the FCA's Consumer Credit (CONC) rules. Most loans are regulated under CONC unless they are for house purchase or home improvement, and therefore subject to FCA regulation under MCOB rules. (You will learn more about MCOB in Topic 21 and about CONC in Topic 22.)

13.11.2 Overdrafts

An overdraft is a current account facility that enables the customer to continue to use the account in the normal way, even though its funds have been exhausted (although the provider does set a limit on the amount by which the account may be overdrawn). It is a convenient form of short-term temporary borrowing, with interest calculated on a daily basis, and its purpose is to assist the customer over a period in which expenditure exceeds income – for instance, to pay for a holiday or to fund the purchase of Christmas gifts.

Overdrafts are offered by all banks and some building societies. Because it is essentially a short-term facility, the agreement is usually for a fixed period, after which it must be renegotiated or the funds repaid. Overdrafts that have been agreed in advance with the provider are normally an inexpensive form of borrowing, although there may be an arrangement fee. Unauthorised overdrafts, on the other hand, attract a much higher rate of interest. The typical fee for an unauthorised overdraft can vary depending on the amount of the overdraft and time it runs for, but it can be anything from around £1 to £5 a day (some banks have transaction fees during an overdraft period and monthly charge caps).

As part of its 2016 market investigation into the banking market in the UK, the Competition and Markets Authority published a number of remedies to make fees transparent and open up bank data for other parties to help them enter the market. It also recommended that banks should set a monthly maximum charge for unauthorised overdrafts on personal current accounts, and send alerts to people before they breach their limit.

Since April 2020, banks can only charge overdraft users a single annual interest rate without additional fees and charges. The Money Advice Service explains the three main changes in the following link: https://www.moneyadviceservice.org.uk/blog/what-the-changes-to-overdraft-fees-mean-for-you.

13.11.3 Credit cards

Credit cards enable customers to shop without using cash or cheques in any establishment that is a member of the credit card company's scheme. Most retailers have terminals linked directly to the credit card companies' computers, enabling online credit limit checking and authorisation of transactions.

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

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

Credit card companies charge a fee to retailers for their service. This is deducted as a percentage (typically around 3 per cent) of the value of transactions when the credit card company makes settlement to the retailer. Despite the fee, credit cards offer a number of advantages to retailers:

REVOLVING CREDIT

An arrangement whereby the customer can continue to borrow further amounts while repaying existing debt.

- the retailer might achieve more sales if the convenience of payment by credit card is available to customers (and facilities to accept card payments of some kind are of course essential for most online retailers);
- payment is guaranteed if the card has been accepted in accordance with the credit card company's rules;

- the retailer can reduce their own bank charges because the credit card vouchers paid into a bank account are treated as cash.

CHARGE CARDS AND DEBIT CARDS

Although a charge card is used by the customer in the same way as a credit card to make purchases, the outstanding balance on a charge card must be paid in full each month. The best-known examples are American Express and Diners Club. Thus a charge card is a form of unsecured lending only in a very limited sense.

Like credit cards, debit cards can be used to make payments for goods and services, and to withdraw cash from ATMs. They are operated in the same way: a cardholder makes a payment by inserting the card into a card-reader and entering a PIN (alternatively, for small-value transactions, most debit cards can be read by contactless card-readers). However, a debit card is not a credit facility. The effect of the transaction is that funds equal to the amount spent are transferred electronically from the cardholder's current account to the account of the retailer. This is known as EFTPOS (electronic fund transfer at point of sale).

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the difference between secured and unsecured lending?
- describe how capital repayment and interest-only mortgages work?
- summarise the different interest options for mortgage repayment?
- describe two types of equity release product?
- explain what is meant by 'revolving credit'?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 13. Review the text if necessary.

Answers can be found at the end of this book.

1) Define a) a mortgagor and b) a mortgagee.

2) Which of the following is not true in relation to a repayment mortgage?

   a) The higher the interest rate, the higher the monthly repayment to the lender.

   b) Life cover is built in.

   c) The loan is guaranteed to be fully repaid at the end of the term, providing monthly repayments are maintained.

   d) At the beginning of the term most of the monthly repayment is paying interest on the loan.

3) For what reason might an ISA not be suitable for someone who is arranging an interest-only mortgage of £300,000 over a five-year term?

4) It is not the responsibility of the lender to ensure that a borrower has a repayment vehicle in place for an interest-only mortgage. True or false?

5) Chris is 53 and is pleased to see from his annual personal pension statement that his pension pot has grown enough to enable him to take a tax-free lump sum and pay off his interest-only mortgage. Will this be possible?

6) An advantage of a flexible mortgage is the ability to take further advances up to the lender's prearranged limit. True or false?

7) What is the main advantage of a capped-rate mortgage?

   a) If interest rates go up, the mortgage interest rate will not exceed a prearranged limit.

   b) The mortgage interest rate will never exceed Bank rate.

   c) The amount payable is fixed for the duration of the capped rate.

   d) There is a discount off the normal variable mortgage interest rate.

8) Describe how a home reversion plan works.

9) Which form of borrowing is likely to have the highest interest rate: a 25-year repayment mortgage or a personal loan with a 5-year term?

10) What is revolving credit?

TOPIC 14

Understanding and satisfying customer needs

LEARNING OBJECTIVES

Up until now we have concentrated on understanding the economic context within which financial advisers operate and the range of products available. Our focus now turns to the process of giving financial advice. This process is tightly regulated, and we will look at the regulatory requirements in Topic 20. At this point, we are going to look at the different stages involved and how advisers gather the information they need in order to formulate recommendations and (hopefully) obtain business.

By the end of this topic, you should have an understanding of:

- typical financial needs at different stages of the life cycle;
- the ‘hard facts’ recorded in a factfind;
- how to establish a client’s plans, needs, attitudes and preferences;
- preparing and presenting recommendations;
- how to complete a sale;
- after-sales care.

This topic covers the Unit 1 syllabus learning outcomes U5.1–U5.7.

THINK . . .

The process of buying a financial product might be familiar to you from the client’s perspective. Have you ever had a meeting with a financial adviser and completed a factfind? If so:

- What kind of information were you asked to provide? Were you surprised by the amount of detail required?
- Did you feel confident that the adviser understood you and your circumstances? What did the adviser do to gain your trust? If you didn’t feel confident, why was that?

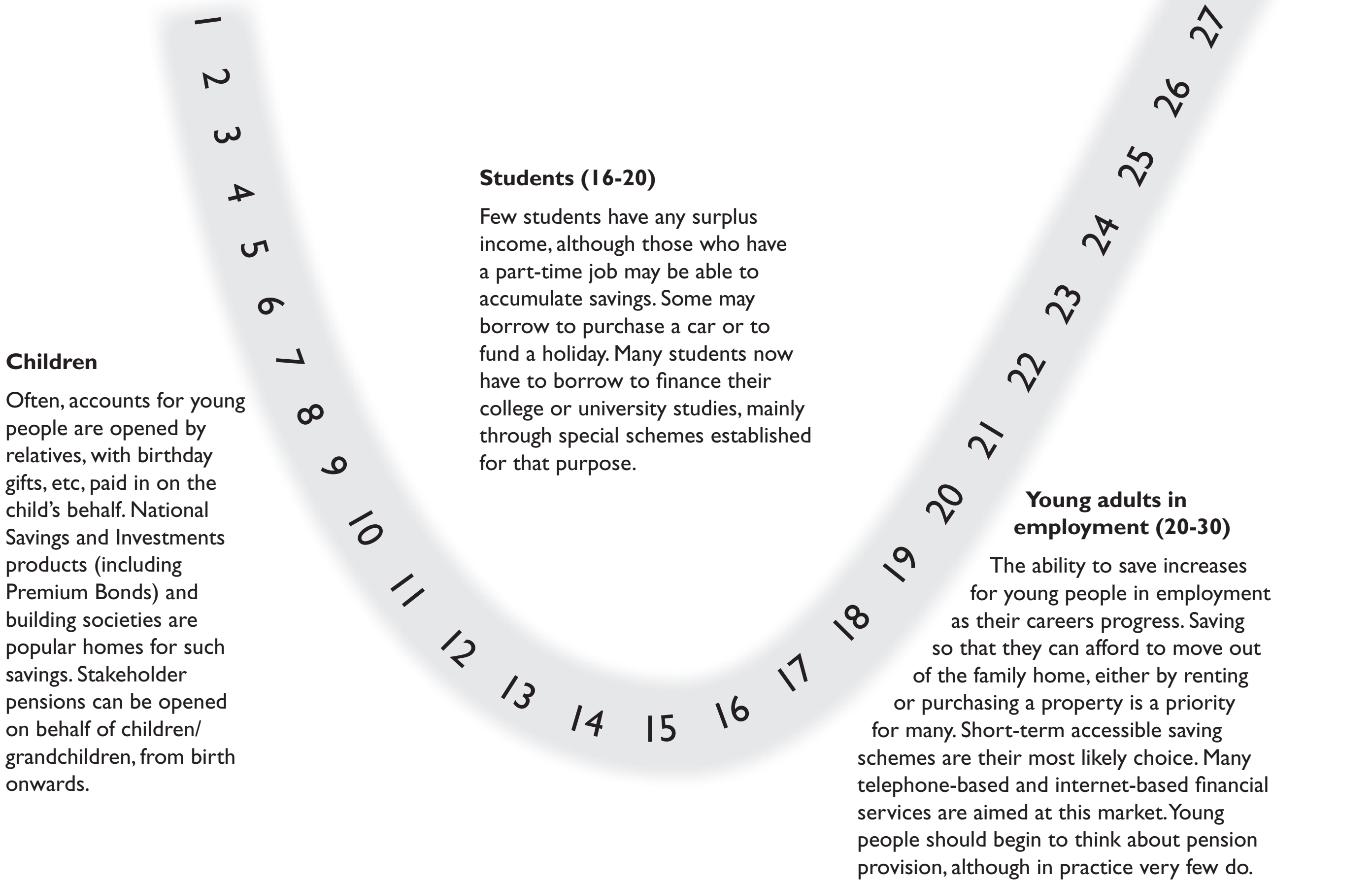
If you've never been in this situation, think about the kind of information that you would need to know to gain a clear picture of a client's financial situation and objectives.

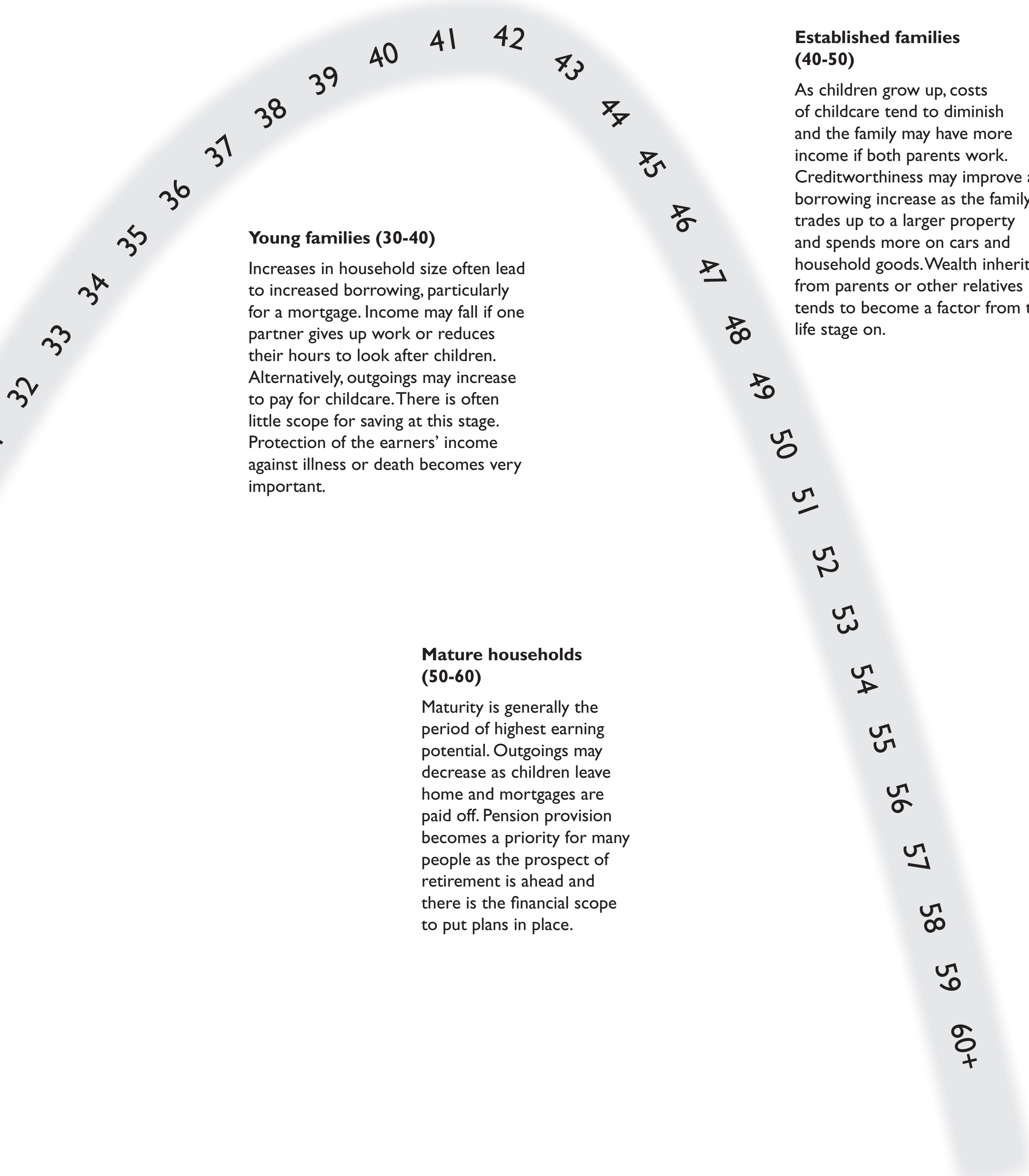
14.1 Beginning the process

Providing appropriate, ethical financial advice is not simply a matter of understanding the features of all the products that we have studied so far in this course – although product knowledge is important. An understanding of the regulatory and legal duties imposed on financial advisers is critical too: later in your studies, we will look at contract law and agency law (Topic 16), data protection (Topic 24) and consumer protection (Topic 25). The regulation of firms, individuals and the advice process is covered in Topics 18, 20 and 21.

The precise financial needs of clients vary from person to person, but it is possible to identify financial needs that are typically associated with the life stage that an individual is in, and from there to establish the type of products that might be relevant to them. Demonstrating an understanding of the situations in which clients might find themselves over the course of their life, and the real or perceived financial needs that they might have as a result, is an important factor in developing the client's trust. Maintaining confidentiality is another.

FIGURE 14.1 THE FINANCIAL LIFE CYCLE





Young families (30-40)

Increases in household size often lead to increased borrowing, particularly for a mortgage. Income may fall if one partner gives up work or reduces their hours to look after children. Alternatively, outgoings may increase to pay for childcare. There is often little scope for saving at this stage. Protection of the earners' income against illness or death becomes very important.

Established families (40-50)

As children grow up, costs of childcare tend to diminish and the family may have more income if both parents work. Creditworthiness may improve and borrowing increase as the family trades up to a larger property and spends more on cars and household goods. Wealth inherited from parents or other relatives tends to become a factor from this life stage on.

Mature households (50-60)

Maturity is generally the period of highest earning potential. Outgoings may decrease as children leave home and mortgages are paid off. Pension provision becomes a priority for many people as the prospect of retirement is ahead and there is the financial scope to put plans in place.

Retirement (60+)

Prior to retirement, most people's financial planning is centred on converting income into lump sums (or increasing lump sums into bigger lump sums). At retirement, when income from employment ceases, the focus changes: the requirement is now to produce income from capital. The need to prepare for possible inheritance tax liabilities should be considered. The cost of healthcare, and possibly of long-term care in old age, may become an issue.

CHECK YOUR UNDERSTANDING 1

Use the knowledge of financial products that you have gained so far in your studies to complete the table below.

Stage in life	Financial needs	Suitable products
School-age young people	Somewhere to save their pocket money and gifts from relatives.	
Teenagers and students	Somewhere to put their earnings from a part-time job. Borrowing to buy a car. Borrowing to fund education.	
Post-education young people	Savings for a deposit for a house. Protection against loss of income due to illness. Loan to buy house.	
Young families	Protection against loss of income due to illness. Life cover protection for dependants. Bigger house. Provision for retirement.	
Established families	Planning for retirement. Protection against loss of income (bigger mortgage and pension commitments). Life cover protection (for children still at home). Savings/investments over long term for surplus income and/or inheritances.	
Mature households	Planning for retirement. Savings and investments over the medium term to be accessible at retirement.	
Retirement	Creating as much income as possible from pension plans and savings policies. Realising capital from property. Possible long-term care needs.	

There is a well-established pattern to the way in which most savers and investors build up and hold their assets (summarised in Figure 14.2). It begins with savers' attitudes to the need for liquidity and safety and then, as income and savings grow, moves gradually away from liquidity and towards an acceptance of greater risk.

The first stage in the saving pattern is cash; after that, a current account with a debit card is virtually as good as cash. People do not generally hold any other form of asset until their cash requirements are met. The next stage is secure, short-term investment such as instant access (or short-notice) bank and building society deposits.

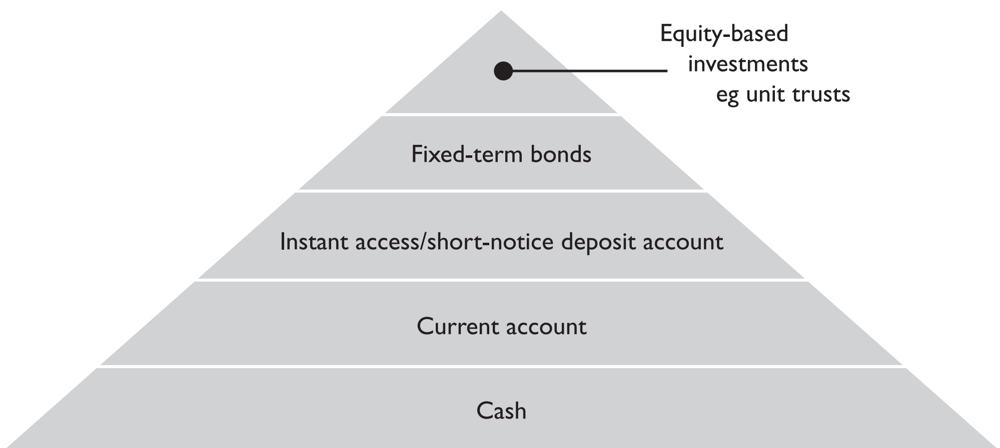
With a sufficient balance in short-term savings, investors look next at products with less flexibility but a greater return, such as fixed-term bonds.

Further down the line, individuals may be attracted to products that offer greater long-term potential but at the risk of short-term loss. Shares and other equity-linked investments, such as unit trusts, are good examples. In times of stock market volatility, however, these investments may prove considerably less popular.

Similar patterns can be recognised in relation to other types of financial products, though perhaps to a less pronounced extent: for example, the first type of bank account that most people open is a personal current account, often out of necessity to enable receipt of their wages or salary. It is only later, as their financial situation improves, that they begin to use a wider range of accounts and other banking products; similarly with insurance products, where the first experience is often of compulsory cover, particularly for motor insurance, and of holiday insurance.

In terms of borrowing, many people begin with short-term unsecured borrowing, by way of credit cards or personal loans, to pay for holidays or a car.

FIGURE 14.2 THE SAVINGS PATTERN



14.2 What is a factfind?

Advisers must ensure that any advice offered is suitable for the client, based on the client's circumstances, experience, needs and objectives. This requirement was first established by the Financial Services Act 1986 and continues under the Financial Services and Markets Act 2000.

To gain a clear picture of the client, most, if not all, advisers will complete a comprehensive computer-, or paper-based factfind. Prior to commencing a factfind, fees for the services provided to the client must be disclosed and agreed.

To gather appropriate information, it is necessary to ask questions in respect of the client's:

- financial situation;
- existing and future needs;
- ability to provide for them;
- attitude towards providing for them;
- objectives;
- knowledge and experience of investment (where relevant to the service the adviser will provide). This will support an assessment of the client's ability to understand and accept investment risks.

This means, in practice, that any factfind should look at both the client's circumstances and their preferences.

14.3 Establishing the customer's situation

The following basic information is needed.

14.3.1 Personal and family details

- **Full name, address and telephone number**.
- **Date and place of birth** – dates of birth for all those included in the factfind. The client's place of birth may be important for underwriting or to establish domicile.
- **Marital status** – single, married, civil partners, cohabiting, divorced, widowed, etc. It is usually preferable to have both partners of a relationship involved in the financial planning process, since the decisions made will often affect both partners. Some couples, however, prefer to keep their financial affairs separate.

- **Family details** – the client's family details are important for a number of reasons:
  - there may be family members who are, or will be, financially dependent on the client;
  - the client may become the beneficiary of gifts or trusts;
  - the client may wish to become a donor, now or in the future;
  - from a marketing viewpoint, there may be an opportunity for referrals to family members.

The most important group of family members is usually the children. In order to give appropriate advice about protection against death and disability, as well as about savings for school or university fees for example, it is necessary to know how old the children are. This may include children from previous relationships.

14.3.2 Financial situation

- **Employment status** – is the client employed, self-employed, unemployed or retired? If the client is a director or a partner, it may be necessary to delve deeper and establish basic information about their business arrangements.

  It also helps to know whether their status is part-time or full-time, temporary or permanent, as well as gaining details of the client's profession or trade.

- **Income and benefits** – it is often useful to establish an exact breakdown of income by its component parts, eg basic, commission, bonus and overtime, together with the average level of overall earnings (net profits in the case of self-employed clients). Similarly, an adviser must establish the exact nature of benefits provided, eg private medical insurance, company cars, pension and/or death-in-service details, subsidised loans, etc.

- **Previous and/or additional employment** – details of previous employment (especially if the client has preserved pension entitlement), share-option schemes, profit-related pay schemes, details of additional employment. It may be helpful to obtain copies of payslips, P60s, tax returns and notices of tax coding.

- **Income and expenditure** – analysing a client's income and expenditure makes it possible to identify more easily the implications of, for instance, premature death on the family income and spending patterns. It is also possible to identify any surplus income that could be used to fund the purchase of any additional products recommended.

  Calculating a household's income is usually relatively straightforward. Analysis of clients' expenditure can be more difficult. Certain items are easily determined, ie those paid by standing order, such as rent and some household bills. It is usually more difficult to pin down how much is spent on, for example, food and drink, holidays or cars.

Assets

The adviser should obtain details of all the client's assets, from their home (if they own it) to all their various bank accounts. Depending on the type of asset, the following details are required:

- ownership, ie single ownership or jointly owned;
- purpose of the investment;
- type of investment, eg property, deposit in a bank account, pension policy or fund;
- size of original investment and date;
- current value and/or projected future value;
- rate of return (if any);
- type of return, eg capital growth or income, and whether that return is fixed, guaranteed or variable;
- tax status of the investment or other asset;
- options available and/or penalties;
- sum assured and/or lives assured and maturity dates;
- name of the institution providing the asset.

Liabilities

The following information should be obtained in relation to the client's borrowing:

- lender;
- amount of loan;
- balance outstanding;
- original term and term remaining;
- type of loan, eg secured, unsecured (and if secured, on what);
- amount of monthly or other periodic payment;
- rate of interest;
- repayment method;
- protection of capital or payments.

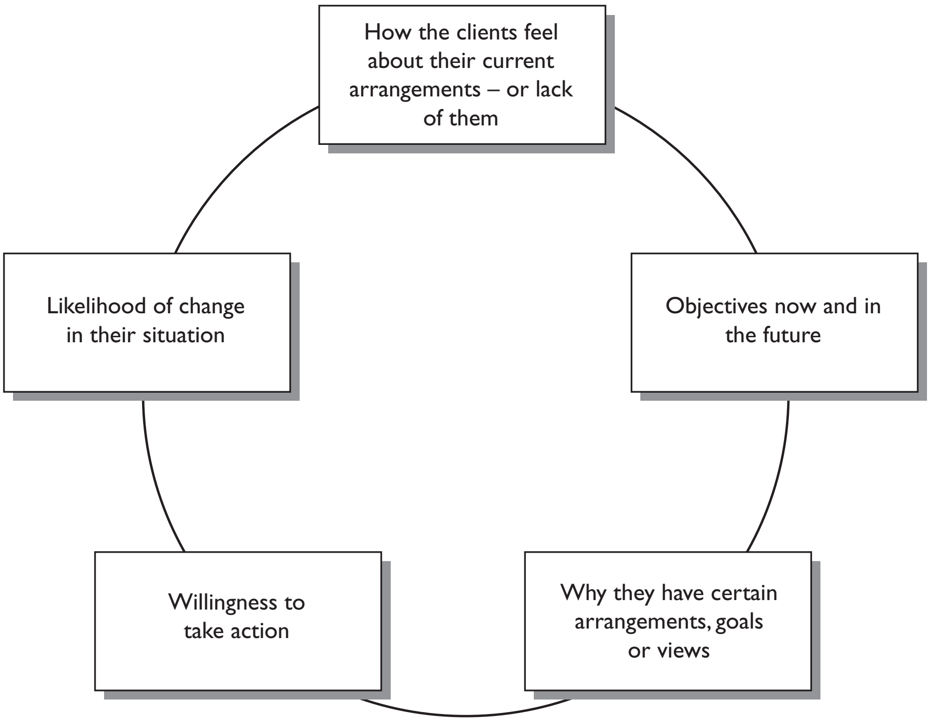
Clients are often unaware of the details of any arrangements that they have. It is an adviser's responsibility to try to obtain this information, and clients should be asked to bring full details with them.

14.4 Understanding plans and objectives

Completing the first two sections of the factfind – the personal and family details and the financial situation – involves gathering hard facts, ie about tangible items and people. The client's plans and objectives tend to be more intangible; here the aim is to find out "why?", "how?" or "do you feel that?"; in other words, to discover the client's feelings about what they have, what they want and where they want to go from a financial point of view. These are known as soft facts.

Figure 14.3 summarises the soft facts that the adviser needs to establish for each area.

FIGURE 14.3 KEY 'SOFT FACTS' REQUIRED IN A FACTFIND



In order to find out about a person's plans and objectives, the adviser needs to ask the following kinds of question.

What are your plans for retirement? What provisions have you currently got in place?	How do you feel about current levels of performance from your investments?
What savings goals do you have?	What are your views about making financial gifts to your family?

Knowing the client's feelings about their situation, their aspirations for the future and their existing arrangements will help build understanding in a number of ways:

- Discovering the reasons behind the client's existing arrangements may in turn indicate the client's level of understanding of their finances.
- Determining the level of the client's interest in their situation will indicate their motivation to improve their situation and the likelihood of their taking action.
- Ascertaining the client's views on a number of possible alternative solutions will help in constructing acceptable recommendations.

In order to find out how a person feels about improving their financial situation, the adviser needs to ask questions like these:

Based on the arrangements you currently have, how would your partner manage financially in the event of your death?	If accident or illness prevented you from working for a period of time, how would that impact on your financial plans?

14.5 Establishing attitudes and preferences

It is essential to establish the client's attitude to risk when making recommendations. The client must understand what the risk involved in a proposal is. This may involve providing explanations to distinguish between the degrees of risk – for example, whether there is a risk to the capital that is invested, the fact that the value of an investment may fall as well as rise, and that the amount of income or capital growth may not be guaranteed. Historically, many so-called low-risk investments, such as bank or building society accounts, have provided a safe haven and a relatively stable level of income, but the adviser must make sure the client is aware that inflation will cause the value of the investment to fall and explore their attitude towards this risk. A client's attitude to risk is often assessed by psychometric testing, with a risk score being allocated from the answers given.

Another important factor, linked to risk, is a client's 'capacity for loss'. The FCA describes this as "the client's ability to absorb falls in the value of their investment". If any loss of capital would have a materially detrimental effect on the client's standard of living, this should be taken into account in assessing the risk that they are able to take.

It is important to take note of a client's stated preferences, but advisers have a duty of care: this means recognising that, while a client may have a clear view on what they want to do, their appreciation of what they ought to do can be less than clear. This means that an adviser may have an educational role in helping a client to explore their own financial circumstances and make the right choices.

14.6 Identifying needs and objectives

Clients often have a range of financial needs, even when they approach an adviser with one particular need in mind. In order to give the most appropriate advice, advisers must be aware of the broad range of needs that clients might have – and must be able to recognise those needs even where clients themselves are not aware of them.

The FCA describes a vulnerable customer as someone who is especially susceptible to detriment as a result of their personal circumstances, particularly when a firm is not providing appropriate levels of care.

An individual may be vulnerable because of a wide range of circumstances including (but not limited to) physical or mental disability, poor health, or weak numeracy and literacy skills. Their vulnerability might be short term, for example because of a job loss, a recent bereavement or release following a prison sentence.

Firms have a responsibility to identify and deal appropriately with vulnerable customers, tailoring their service provision and the way they communicate to meet the specific needs of each vulnerable customer.

We can categorise an individual's financial needs and objectives into the five areas, summarised in Figure 14.4.

FIGURE 14.4 FIVE AREAS OF FINANCIAL NEED

1	Protecting dependants from the financial effects of either a loss of income or a need to meet extra outgoings in the event of premature death
2	Protecting self and dependants from the financial effects of losing the ability to earn income in the long term
3	Providing an income in retirement, sufficient to maintain a reasonable standard of living
4	Wanting to increase and/or to protect the value of money saved or invested; wanting to increase income from existing savings or investments; wanting to build up some savings in the first place
5	Saving tax

Every client is different but, in general terms, an adviser should first seek to ensure that there is adequate protection of their lifestyle in the event of death or illness. Retirement planning would then be the next priority as it is effectively protecting income for a time when a person either does not want to or is no longer capable of working. Once the client's current and future positions are protected, attention can then be made to enhancements through savings and investment planning.

In seeking to assess any of these areas, an adviser should look for examples of typical things that clients either do wrong or fail to do at all. This might include the following:

- A young family, with little or no savings, relying solely on mortgage protection cover as their only form of life assurance. It would repay the mortgage but is not designed to meet the ongoing costs of running the house and bringing up the family.
- A low level of life assurance premiums being paid, suggesting that cover might need to be increased for the required protection to be adequate.
- Unnecessarily large amounts being held on deposit in bank and building society accounts over the long term and so not gaining access to better returns available elsewhere.
- Substantial taxable savings/dividend income, in excess of allowances, being received by an individual who pays higher-rate income tax.
- A non-taxpayer holding investments where tax is taken while funds are invested and where the tax deducted cannot be reclaimed.

- A client with many small holdings of shares over a wide range of companies, causing administration and monitoring difficulties.
- A married couple owning most of their assets in an individual's sole name and paying more tax as a result.
- A client not making any pension contributions, or making only very small pension contributions as a percentage of total earnings, which will mean being dependent upon state benefits unless action is taken.
- People who have not made a valid will, whose assets on death may, therefore, not be distributed as desired.

The adviser's role is to define the client's needs and objectives accurately, to enable the client to see the key issues facing them and to recommend and discuss a priority order for action.

14.7 Agreeing order of priority

Failing to establish a priority order with the client can result in a client ignoring an adviser's recommendations. The client's priorities may well differ from those that the adviser feels appropriate, and so the process is one of discussion and agreement rather than straightforward selection by any single person. In the end, however, deciding a plan of action and agreeing its priority order remains the client's decision, assisted by the adviser's recommendations.

CHECK YOUR UNDERSTANDING 2

Read through the problem areas that an adviser might encounter, listed in column 1 below, and try to **match** them to the potential consequences for the client. The answer is provided at the back of this book.

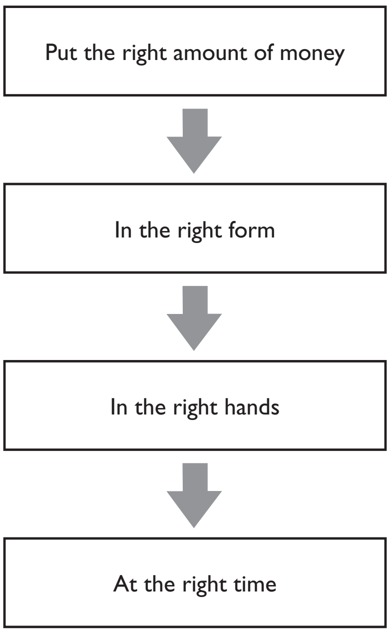
Problem relating to	Potential consequences
Income protection	Lack of diversification. Too much on deposit. Interest received less than inflation. High admin charges through too many small shareholdings. Failure to take advantage of tax-free alternatives.
Life assurance protection	Not taking advantage of tax reliefs, allowances and tax-free investments. Estate subject to IHT. Gifts not documented.

Pension provision	Employer will only pay income for a short period. Have to rely on savings and state benefits to pay mortgage and other borrowing, household expenses and living expenses, etc. May lose property if mortgage not paid. Credit record adversely affected if debts not paid.
Savings and investments	Low standard of living in old age. May have to sell house and trade down or move into rented property. Income from state benefits inadequate for heating, food bills, etc.
Tax planning	Mortgage may be paid off but fall in income may impair ability to meet household and living expenses; alternatively outgoings might increase to pay for childcare, housekeeping, etc.

14.8 Recommending solutions

Once an adviser has gathered all of the necessary information about the client's circumstances and preferences, has a clear appreciation of their ability to pay, and has obtained agreement on priorities, then the process of matching solutions to requirements can begin. The adviser's objective is summarised in Figure 14.5.

FIGURE 14.5 THE ADVISER'S OBJECTIVE



In practice, these four aims mean that advisers will look in detail at a number of specific areas:

- **State benefits** – the nature and level of state benefits to which a client may be entitled.
- **Existing arrangements** – there is no point in recommending products that satisfy needs already met by the client's existing arrangements or by state provision.
- **Affordability** – any recommendations made must not, in terms of total cost, jeopardise the client's current and likely future financial situation.
- **Taxation** – one purpose of the recommendations may be to mitigate tax but it is also important to ensure that any course of action recommended does not unnecessarily add to or create a tax burden.
- **Risk** – there must be a close correlation between the risk inherent in the product recommended and the client's risk profile and capacity for loss.
- **Timescale** – the product recommended should meet the client's needs within a defined timescale.
- **Flexibility** – recommendations should display the flexibility to deal with possible changes in the client's circumstances.

It is a good idea to have a clear plan for how to present each recommendation to the client, not least because some details may be mandatory under the Financial Services and Markets Act 2000.

Explanations that should always be included are:

- the purpose of the product and the client's needs that the product will address;
- the benefits that the client will enjoy;
- the risks and limitations inherent in the product;
- any options that exist within the product that may be appropriate to the client;
- a summary of reasons why the product is being recommended.

For each product, part of the presentation should involve a features and benefits analysis. This means going through the product and identifying each of its features, and then putting into simple terms what specific benefits these features provide to the client. The adviser should check that the client understands, perhaps by asking a few simple questions.

14.9 Completing the sale

Obtaining a commitment from the client in the form of a completed application form will depend on how effectively all of the earlier stages of the sales process have been carried out. Attempting to close a sale too early is clearly not sensible, and deciding when to close a sale is determined by two factors:

- the reaction of the client; and
- their understanding of the proposal.

HANDLING OBJECTIONS

The first point in handling an objection is to qualify it. This means finding out whether it is a genuine statement of concern about the recommendation or whether it is masking another issue that is on the client's mind. For example, if a client states "that is too expensive", is that the real issue or is it that the adviser has not really explained the need or the benefits of the recommendation?

If an objection is made, it is essential to understand how important it is. This can be done by trying to understand the objection as specifically as possible, ie by clarifying exactly what the client means by what they are saying. A good way of doing this is by paraphrasing what the client has said: "So what you're saying is . . .?"

Once the nature of the objection and its importance are clear, then an attempt can be made to solve the problem. If the problem lies in the client's understanding or interpretation of what they have heard, then it should be straightforward to solve. If the problem lies in something specific and the client is not willing to move, then the obstacle should be put into perspective and other compensating factors stressed.

The handling of objections or queries is another step in helping the client to buy something for which they have seen a clear need and of which they can now see the full benefit.

Closing the sale simply involves asking the client if they are happy to set the wheels in motion and complete the application. Sometimes the client may expect the adviser to complete the form on their behalf. It is permissible to do this, but only with the client's permission. If the adviser does complete the proposal form, the client must read it thoroughly, checking what has been written before signing it.

In particular, the client must be made aware of the consequences of deliberate or reckless misrepresentation. If the contract is later made void because of information that the client misrepresented then the client may not be protected and could also incur a loss of premiums.

A key features document (or key information document or key investor information document, depending on the product sold), together with a key features illustration (for some products), must be given to the client before the sale is closed. These documents provide the client with all the information they need in order to make a decision. The client should also be provided with a product brochure explaining product details and features in full. The adviser must also explain the cancellation notice, which sets out the client's right to withdraw from any arrangements within a defined period.

The adviser should provide the client with their business card during the meeting. This gives the client a clear route back to the adviser should there be any queries later on.

RETENTION OF RECORDS

Once the arrangements have been put in place there is a regulatory requirement to keep records to demonstrate what advice and information was given and why.

Product type	Retention period
Life policies, pension contracts	5 years
Pension transfers, opt-outs, FSAVCs	Indefinite
MiFID-related business	5 years
Other	3 years

These retention periods relate to the FCA's conduct of business requirements, which we cover in more detail in Topic 20. There are other retention rules relating to the prevention of money laundering and to complaints handling – we look at these in Topics 23 and 25 respectively.

14.10 After-sales care

Providing a professional service means more than selling a product to meet needs: it means ensuring that proper after-sales care is given and that reviews are carried out. This will include ensuring that, where the acceptance procedure involves any delay, the client is kept fully informed. It will also mean dealing with other related matters such as direct debits, policy delivery, cancellation notices, standard reviews and any requests to alter the plan.

After these general areas, client servicing falls into two categories: proactive and reactive servicing.

14.10.1 Proactive servicing

Proactive servicing involves instigating action by contacting the client to discuss further needs. This might be on a matter previously agreed, such as the next salary review, a job change, or even the taking up of recommendations of which the client was unable to take advantage originally.

Even where there is no known future event or requirement, it is a good idea to agree a time to review the client's position. At a review, an adviser can find out if there have been any changes to the client's circumstances and can update the appropriate records. By doing this, an adviser is in a strong position to identify opportunities to recommend new products appropriate to the client's needs, or to recommend changes to existing products.

14.10.2 Reactive servicing

Reactive servicing happens as the result of a request from the client, for example a request to discuss the recommendation after comments made in the media or by competitors. The client's circumstances might change unexpectedly, resulting in a request for advice. The request might not be received directly from the client: it might be notification of non-payment of premiums or a request by the next of kin to sort out a death claim.

In order to be fully prepared for all eventualities, clear and concise records must be maintained. Keeping appropriate records will not only comply with the requirements of the Financial Services and Markets Act 2000, but may also lead to more business.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe how financial needs typically change over the life cycle?
- outline the 'hard facts' that an adviser needs to obtain via a factfind?
- explain what other information an adviser needs to establish at the factfind stage?
- explain why it is important to understand a client's attitude to risk?
- list five areas of financial need that should generally be explored?
- list the explanations that should always be included when presenting a recommendation?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 14. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following would usually be a priority need for a client taking out their first mortgage?

   a) An emergency fund.

   b) Income protection.

   c) Medium-term investments.

   d) Pension planning.

2) Why is it important to establish a client's place of birth as part of the factfind?

3) Which of the following would normally be regarded as the priority financial need for a client who has surplus cash for the first time?

   a) A unit trust.

   b) An emergency fund.

   c) A stocks and shares ISA.

   d) A pension plan.

4) When completing a factfind for a client in relation to investment advice, which of the following should always be taken into account?

   The client's:

   a) levels of indebtedness.

   b) employment details.

   c) attitude to risk.

   d) mortgage arrangements.

5) Which of the following ought to be the highest financial priority for a retired couple?

   a) Pension accumulation.

   b) Protection advice.

c) Generating income.

d) Mortgage advice.

6) What is meant by ‘capacity for loss’ and why is it important?

7) List the factors that an adviser might take into account when deciding on an appropriate solution for a client.

8) List five points that should be included when presenting a recommendation to a client.

9) For how long must records relating to pension transfers be retained?

10) What is the difference between proactive and reactive servicing?

TOPIC 15

The main advice areas

LEARNING OBJECTIVES

In Topic 14 we considered the adviser's role in identifying the client's needs and objectives. This topic looks in a little more detail at the main areas of financial need and the issues the adviser needs to consider. It covers many of the product areas that you have already studied, so it provides a good opportunity to review and assess your knowledge and understanding.

By the end of this topic, you should have an understanding of the main areas of financial advice:

- budgeting;
- protection;
- borrowing;
- savings and investment;
- later life planning;
- estate planning;
- tax planning and offshore considerations.

This topic covers Unit 1 syllabus learning outcomes U4.1–U4.7.

THINK ...

The focus in this topic is on exploring and addressing clients' financial needs. To get you started, think about your own circumstances and your stage in the financial life cycle.

- Looking at the main areas of financial advice listed above, what order of priority would you put them in for yourself?
- Do you have appropriate financial products to address your own financial needs?
- If you do, how did you select them? What factors did you take into account (eg level of cover, cost, flexibility, level of risk)?

- If you don't have such products, why is that? Affordability? Lack of knowledge or confidence?

It is important to appreciate that every client's specific needs are different, but by thinking about your own attitudes and actions in relation to financial planning, you should gain an insight into the different drivers for individual decisions.

15.1 Why is budgeting important?

The need to budget underpins all other forms of financial planning. At its simplest, it reflects the need to have sufficient funds to purchase the necessities of daily living. It also enables people to determine how much they can spend on other items, for instance large-scale purchases, leisure pursuits and holidays, and provision for a secure retirement.

Many savings products can be used to help people to budget for future expenditure, whether this is for a major purchase or to provide regular income. However, advisers must be careful not to put pressure on the client's current and future income when selling products paid for out of that income. An increase in mortgage interest rates, for example, could push a family's expenditure beyond its means.

It might be argued that the need to balance the budget on a weekly/monthly basis is not as great as it once was, as a result of the easy availability of credit. Nevertheless, all borrowing must be repaid at some point, and advisers should exercise caution when considering clients' likely future income and expenditure levels.

15.2 What family protection needs might clients have?

Life involves exposure to many risks and it is not possible to avoid all the dangers and difficulties that it can bring. It is, on the other hand, possible to take sensible precautions against the impact of the risks that affect people, their lives, their health, their possessions, their finances, their businesses, and their inheritances.

Many people, however, make little or no provision for minimising the financial consequences of death or serious illness. This may be because they are not aware of the size of the risk or because they believe that they cannot afford to provide the cover, not realising how cheap it can be, especially if taken out when young.

15.2.1 Protection against the financial impact of death

For most families, it is income rather than savings that enables them to enjoy their standard of living. Loss of that income on the death of an earner usually causes a reduction in a family's standard of living.

State benefits may be available but they generally do little more than sustain a very basic lifestyle, and increasing pressure on funding means that they are more likely to reduce than increase in real terms in the future. The surviving spouse/partner may, therefore, have to increase their income, for instance by working full-time instead of part-time. If they have young children, they may have to fund the cost of childcare.

Another consequence of the death of an earner is that surviving family members may no longer be able to maintain loan repayments, particularly mortgage repayments. If the mortgage cannot be serviced, the property might have to be sold and the family rehoused in less suitable circumstances.

It is equally important for the life of a financially dependent spouse/partner to be insured, even though they are not in paid employment. In the event of their death, the surviving spouse/partner may have to give up work in order to look after any young children, or may have to pay the cost of full-time childcare. There might also be additional housekeeping costs.

CHECK YOUR UNDERSTANDING 1

How might you advise a client to address the protection issues outlined above? What protection products might be suitable?

15.2.2 Protection against accident, sickness or unemployment

Many of the arguments for protection against the adverse financial consequences of death apply equally to the need for protection against the impact of long-term illness. In fact, there may be an even stronger argument for protection against financial loss as a result of sickness, not just because the likelihood of suffering a long-term illness is greater than that of premature death, but also because the financial impact on a family of long-term sickness can be even more severe than that resulting from a death.

Protection against the impact of sickness may fall into a number of categories:

- an income to replace lost income (for instance when the main earner suffers a long-term illness);
- an income to pay for someone to carry out the tasks normally undertaken by a person who is ill;

- an income to pay for continuing medical attention or nursing care during an illness or after an accident;
- a lump sum to pay for private medical treatment;
- a lump sum to pay for changes to lifestyle or environment, such as alterations to a house or a move to a more convenient house.

As in the case of protection against death, there may be a requirement to cover not just a main breadwinner, but also a dependent spouse.

Questions to consider in relation to the amount and type of cover required include the following:

Is the client likely to be eligible for any state benefits? If so, what would be the amount available?

Is the client employed? Would their employer continue to pay their salary if they were sick, and if so, for how long and at what level (eg 100%, 90%, etc)?

How many dependants does the client have and how old are they?

What kind of support (financial or practical eg help with childcare) could the client rely on from family and friends?

The problems resulting from unemployment/redundancy are, in many ways, similar to those caused by illness, but it is much more difficult for insurers to predict statistically the likelihood of loss of employment than it is to predict loss of health or loss of life. Unemployment cover is, consequently, much more difficult to obtain as a stand-alone insurance and, when it is available (normally only in conjunction with sickness cover and often only in relation to covering mortgage repayments), it is usually subject to a number of restrictions.

15.3 What protection needs might businesses have?

Loss of a colleague as a result of death, injury or long-term sickness can have severe implications for the financial health of a business. Life or sickness insurance can be used to mitigate the financial loss that may result. Some of the more common circumstances are described below.

15.3.1 Death of a key employee

The death of an important employee, particularly in a small company, can have a devastating effect on a business's profits. Key personnel can be found at all levels of a business, not just within senior management. For example, they might be a:

- managing director with a strong or charismatic personality;
- research scientist with specialised knowledge;
- skilled engineer with detailed understanding of the company's machinery;
- salesperson with a wide range of personal contacts.

Determining the level of cover that is required can be difficult. A simple method is to use a multiple of the key person's salary, say five or ten times. Another method is to relate the cover to an estimate of the key person's contribution to the business's profits. This contribution can be calculated by multiplying the amount of current annual profit by the ratio of the key person's salary to the business's overall wage bill. This estimate of the key person's contribution is then multiplied by the length of time that the business would take to recover from the loss, often assumed to be five years.

The business would then take out a term assurance on the life of the employee, for the period during which the employee is expected to be a key person. This may be until retirement, or until the end of a contract or a particular project. If a term assurance of five years or less is chosen, the premiums are likely to be allowed as a business expense, which the business can set against corporation tax. In the event of a claim, however, the policy proceeds will then be taxed as a business receipt and subject to corporation tax.

%

COVER REQUIRED FOR A KEY EMPLOYEE

Goran is the production director of a firm whose last published gross profits were £4m.

Goran is paid £50,000 pa. The firm's total wage bill is £2m.

The length of time that the business would take to recover from the loss of Goran is assumed to be five years.

The sum assured for a policy on Goran's life could be calculated as:

$(50{,}000 \div 2{,}000{,}000) \times 4{,}000{,}000 \times 5 = £500{,}000$.

15.3.2 Death of a business partner

A partnership is defined in the Partnership Act 1890 as "the relationship that exists between persons carrying on a business in common with a view to profit". Groups of professionals such as solicitors and accountants normally work together as partners.

In the absence of any formal partnership agreement, the Partnership Act stipulates that a partnership is dissolved upon the death of a partner, with the business assets realised and distributed to the remaining partners and the beneficiaries of the deceased partner's estate. The surviving partners might want to carry on the business but might find that they lack the funds to do so, particularly if much of the business's value is in the form of goodwill.

The solution is to put in place an arrangement that specifies what should happen to each partner's share of the business on death. The arrangement needs to be supported by an appropriate level of life insurance, to provide the required funds, and a suitable trust detailing distribution of the proceeds from the life assurance (see Topic 16 for more information about trusts).

There are three main types of scheme that are used for this purpose.

- **Automatic accrual method** – all partners enter into an agreement under which, on the death of a partner, his or her share is divided among the remaining partners in agreed proportions. The deceased partner's family is compensated by the proceeds of a life policy written in trust for their benefit. Where automatic accrual is used there is normally 100 per cent business relief for inheritance tax in respect of the deceased partner's share of the business.
- **Buy-and-sell method** – all partners enter into an agreement under which, on the death of a partner, the deceased's legal representatives are obliged to sell the partner's share to the other partners, who are obliged to buy it. To enable them to do so, each partner takes out a life policy on their own life in trust for the other partners. One problem is that the person who inherits the share is deemed to receive cash rather than business assets, so in that situation business relief from inheritance tax is not available.
- **Cross-option method** – this is basically the same as the buy-and-sell method, except that the agreement specifies that the deceased partner's estate has the option to sell their business share to the remaining partners, who have the option of buying it. There will almost always be an agreement for the deceased's estate to sell the business share and the remaining partners to buy it but because there is no legal obligation to do so, those who inherit are deemed to receive business assets, and relief from inheritance tax may be available.

SHAREHOLDER PROTECTION

Small businesses are often run as private limited companies with a small number of shareholders, who are often family members or friends. In the same way that partners may wish to buy out the share of a deceased partner, surviving shareholders in a small business will probably want to buy the shares of a deceased shareholder to prevent the shares from going out of the close circle of existing shareholders. The same types of scheme available for partnerships can be used for shareholder protection.

15.3.3 Sickness of an employee

If sickness prevents a key employee from working, the effect on profits can be just as serious as in the case of that employee's death. The company may need funds with which to recruit and pay the salary of a replacement who can supply the skills and attributes lost through sickness. A critical illness cover plan can be used.

15.3.4 Sickness of a business partner

If a partner falls ill, they may be able to continue to draw income from the partnership for some time, even if not contributing their skills to the partnership's earning capacity. There will be a need to provide a replacement income to avoid the partner becoming a drain on the partnership's resources. This need could be met by income protection insurance. In the event of the partner being unable to return to work, the remaining partners may even wish to buy the sick partner's share of the business. Depending on the nature of the illness, critical illness cover could be used to generate the lump sum required.

15.3.5 Sickness of a self-employed sole trader

Although sole traders may employ others to work for them, they often do much of the key work themselves, including accounting and decision-making. If a sole trader ceases working, their income is likely to stop very quickly. Worse still, their customers may be lost to competitors, causing the business to collapse. The pressure and anxiety resulting from such a situation is likely to hinder recovery from the very illness by which it was caused. For a sole trader, income protection with a short deferred period can ensure that an income continues to be received.

15.4 What are the key considerations in relation to borrowing?

House purchase is, for the majority of people, the largest financial transaction of their lives and, since most people are not able to fund the price of a house out of their own capital, a loan from a bank, building society or other source is normally required. Since a mortgage is such a large and long-term commitment, the consequences of making a mistake can be very serious. It is therefore particularly important for an adviser to choose wisely and to match the products chosen to the client's needs. The regulations relating to mortgage advice are contained in the FCA's Mortgages and Home Finance: Conduct of Business (MCOB) Sourcebook, and we look at them in more detail in Topic 21.

The primary consideration is that the mortgage is affordable. If a borrower fails to maintain payments on a loan secured on their property then they risk the lender taking possession of the property and losing their home. The MCOB rules make clear that the affordability of the mortgage is a key element in determining whether the product recommended is suitable. Nor is it enough to establish that a mortgage is affordable in the client's current circumstances: mortgage payments must be stress tested over at least five years to ensure their ongoing affordability in light of expected interest rate changes.

Beyond ensuring that the mortgage is affordable, there are further considerations. Choosing the wrong lender or the wrong interest scheme could lead to the borrower paying more than is necessary for the loan. Choosing the wrong investment product as a vehicle for repaying an interest-only mortgage can lead, at worst, to the mortgage not being repaid in full at the end of the term. At best, it might mean that the client misses out on possible surplus funds.

The exact nature of what constitutes good advice in a particular case will depend on a variety of factors, including the term for which a loan is required and the tax situation of the borrower.

CHECK YOUR UNDERSTANDING 2

Thinking back to your studies in Topic 13, what type of mortgage product might be suitable for the following clients?

- Kenesha, who often receives overtime payments and an annual bonus and is keen to pay off her mortgage as soon as possible.
- Jacob, a recently qualified solicitor, who is in a position to put down a large deposit on his new house as a result of an inheritance; the loan-to-value is 60 per cent.

Failing to protect the outstanding capital or the repayments against sickness, death or redundancy can leave a client's family destitute or lead to them having to leave their home. Many clients are unaware of the magnitude of the risk or of the ease with which it can normally be mitigated.

A low level of interest rates coupled with strong house price inflation has led to a large increase in individual and family indebtedness in the UK, with many people increasing the proportion of their net income that they spend on mortgage and other loan repayments. Any increase in interest rates or reduction in income can leave people unable to service the high levels of debt that they have taken on.

A number of products and services are available to assist people who can no longer afford their loan repayments. A consolidation loan usually takes the form of a remortgage for an increased amount, the new loan incorporating the existing mortgage plus the individual's unsecured loans, such as personal loans and credit card balances. The advantage of this is that the overall monthly repayments are reduced, because the unsecured loans are now subject to a lower rate of interest and a longer repayment term. There is also, however, a serious downside to the arrangement, which is that the formerly unsecured loans are now secured against the property, adding to the borrower's problems if the borrower defaults on the repayments of the consolidated loan.

Various options are available for clients who are unable to maintain payments in respect of their liabilities, including debt relief orders (DROs), individual voluntary arrangements (IVAs) or, in extreme circumstances, bankruptcy. Advice on dealing with debt is available from a number of agencies, and clients should be advised to consult a specialist in this area, such as Citizens Advice or StepChange Debt Charity. Further information on the legal aspects of IVAs and bankruptcy is outlined in Topic 16.

Citizens Advice

The stated aim of Citizens Advice is "to provide the advice people need for the problems they face, and improve policies and practices that affect peoples' lives". Citizens Advice gives advice on a wide range of different matters, the most relevant to financial services being state benefits, debt and money, and consumer law. Advice is provided online, over the phone and through an extensive branch network. More information is available online at: https://www.citizensadvice.org.uk/ [Accessed: 15 March 2020].

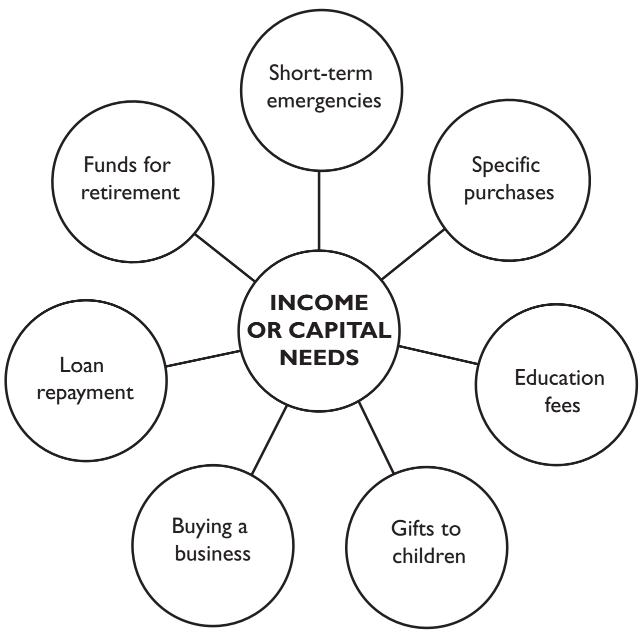
15.5 What are the key considerations relating to investment?

Broadly speaking, there are two reasons why people invest:

- to provide income (either now or in the future); or
- to provide a capital sum.

The reasons why people might need income or capital are varied but some of the most common are shown in Figure 15.1.

FIGURE 15.1 COMMON REASONS FOR REQUIRING INCOME OR CAPITAL



Saving and investment needs change over the course of a lifetime, as explained in Topic 14. The financial services industry provides a very extensive range of savings and investment products to meet the needs of a wide spectrum of customers, and these products can be categorised in a number of different ways. Some of the categories are outlined here.

15.5.1 Regular savings or lump sum

Most people build up their savings by small regular amounts from their disposable income. They may use regular savings schemes such as deposit accounts, ISAs or unit trusts, pay regular premiums to endowment policies, or make contributions to pension plans.

The need to invest a lump sum may arise from the receipt of a legacy or other windfall, or it may result from the desire to move money from one form of investment to another.

15.5.2 Level of risk

The level of risk ranges from products where there is virtually no risk to the capital, such as bank deposit accounts, to those where the customer accepts the risk of loss of some or all of the capital in the hope of achieving higher returns. Most stock-market-related investments fall into the latter category to some degree. The relationship between risk and reward is very important. As a general rule, products that carry a greater risk also have a greater potential for higher returns.

15.5.3 Accessibility

Many deposit accounts offer instant access or require only short notice of withdrawal. At the other end of the scale, some investments are not directly accessible until a fixed maturity date: most gilt-edged securities fall into this category, although they can be sold prior to their redemption date (but without any guarantee of the price that may be obtained). Shares and some gilt-edged stocks (and other investments) are irredeemable, ie they have no maturity or redemption date. Where an investment is irredeemable, an investor who requires access to their money must sell the securities to an investor who wishes to buy.

15.5.4 Taxation

The main UK taxes affecting investors are income tax and capital gains tax. With many investments, tax is payable by investors both on the income received and on any capital gain made on eventual sale. Shares and unit trusts fall into this category. Some investments, eg gilt-edged securities, are taxed on income but are exempt from capital gains tax.

It is important to consider the tax regime of the product in conjunction with the tax position of the investor: for instance, an investor who does not pay income tax will not benefit from the tax advantages of taking out an ISA, but a taxpayer will.

15.5.5 The effect of inflation

One of the factors that is least understood by clients is the impact of inflation on investment returns. As long as there is inflation, the purchasing power of a given amount of money will fall. For example, the purchasing power of £1,000 after ten years of 3 per cent inflation will have fallen to under £750. Before an investment can grow in real terms it must first increase in line with inflation: the aim of any investment should be to provide a real return. Over the long term, equity-linked and property-based investments have proved most likely to offer growth rates over and above the rate of inflation.

> **PURCHASING POWER**
>
> If £1,000 is invested in a savings account and the interest rate is 5 per cent, the interest will be £50. The account will have £1,050 in it at the end of 12 months.
>
> If, before the money was invested, £1,000 would buy a three-piece suite, but after one year, the same three-piece suite costs £1,100, then the money hasn't increased in real terms. It has increased in 'actual' terms by £50 to £1,050 but it is actually worth less in 'real' terms because the effects of inflation have eroded its purchasing power.

Inflation in the UK is currently running at a relatively low rate and this is expected to continue for the foreseeable future. It is important that advisers educate customers about the impact of low inflation on potential returns from investments. The significant measure for an investment is the real rate of return, which reflects the extent to which the purchasing power of invested funds is maintained.

The real rate of return can be approximated by subtracting the rate of inflation from the interest/growth rate obtained on the investment: an investment paying 4 per cent interest at a time when inflation is 3 per cent is providing a real rate of return of only about 1 per cent. If the rate of interest is less than the rate of inflation, the real rate of return will be negative and the purchasing power of the invested funds will fall in real terms.

> **REAL RATE OF RETURN**
>
> Nominal interest/growth rate *minus* inflation rate.

Low inflation and low interest rates tend to go together, and one effect of this is that people tend to suffer from the so-called money illusion, ie they tend to think of interest rates in terms of the headline rate only and fail to adjust their thinking to allow for inflation. Both savers and borrowers can be affected.

Savers

Savers feel that the low interest rates currently being paid on savings are a poor return for their money. They may, therefore, react to lower inflation by putting their money into riskier assets in order to seek higher returns. But if people on average incomes lose money as a result of riskier investments, it may have a very detrimental impact on their financial security – retirement planning, for example. If large numbers of people find themselves in this position, it may have adverse effects on the wider economy and society.

Borrowers

Borrowers (particularly those repaying mortgage loans) feel that they are gaining from the lower monthly repayments that have resulted from interest rate falls. This may persuade them to take out a larger mortgage since they feel they can more easily afford the monthly repayments. This is a misconception as, although less cash flows out in interest payments at the start of the mortgage term, a higher proportion of cash flow will be necessary to repay the capital. Again, problems may be stored up for the future as people take on debt they cannot afford, especially if interest rates rise again. In the meantime, an increased demand for houses can push up house prices and threaten price stability.

15.6 Why is retirement planning so important?

Changes in the demographic structure of the population make it increasingly difficult for the state to provide pensions at the level needed to maintain people's lifestyles but at a realistic and acceptable cost to the taxpayer. Encouraging people to save more for their retirement is one of the great challenges facing the UK government in the early twenty-first century.

State pension – set at about one quarter of the level of national average earnings – is clearly inadequate for anything more than subsistence living, yet many people are continuing to reach retirement age with little or no pension provision apart from a state pension. This is particularly – although by no means exclusively – true of people at the lower end of the earnings scale. There is an added risk that they are financially unsophisticated and unaware of products such as stakeholder pensions that could be used to boost their pension. Even when they are aware of retirement solutions, people in the lower earnings brackets generally have more immediate demands on their income and, moreover, may have been put off by talk of high charges or product mis-selling.

The inability of many people in the UK to make adequate provision for their retirement has been referred to as a 'pensions crisis'. The problem has been accentuated by the accelerating trend for employers to move away from final salary schemes (also known as defined-benefit schemes) and towards money-purchase (or defined-contribution) schemes, where the size of the individual's pension pot is based on the performance of the assets in which the pension funds are invested.

Successive governments have introduced measures to attempt to address the savings gap, for example, with the introduction of stakeholder pensions and the rules requiring that certain employees are automatically enrolled in a workplace pension.

CHECK YOUR UNDERSTANDING 3

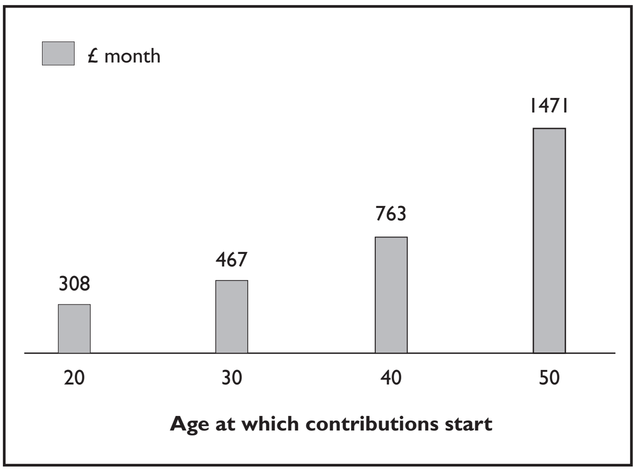
Stakeholder pensions were targeted at individuals earning between £9,000 and £20,000 per annum, on the basis that this was the group considered to contain the highest proportion of people who were not making adequate provision for their retirement.

Can you recall from your studies in Topic 10 why the stakeholder pension failed to fulfil the government's intentions?

For the adviser, then, exploring the client's retirement provision is a key element in addressing their financial needs. The new state pension, introduced in April 2016, was intended to be a much-needed simplification of the system, but those who retired before 6 April 2016 will continue to be paid a range of additional state pension benefits. Since April 2015 members of defined-contribution (money-purchase) schemes have had much greater flexibility to choose how to access their pension benefits, but with wider choice comes a greater need for advice. The role of the financial adviser is to help clients to understand this complex area of financial planning in order to have the best prospects of achieving an adequate income in retirement.

THE NEED TO START SAVING EARLY FOR RETIREMENT

In order to provide a pension at age 65 worth £1,000 pm (£12,000 pa) in today's terms (ie taking account of inflation), the following table shows how much an individual would need to save into their pension plan each month.



The above figures assume that the contributions are maintained at the same level every year.

A monthly contribution of £308 would only cost a basic-rate taxpayer £246.40 because the contribution would attract tax relief at 20 per cent: £308 – (20% × 308) = £246.40.

A net cost to a higher-rate taxpayer would be £184.80: £308 – (40% × 308) = £184.80.

As well as retirement planning, other key issues in later-life planning may be:

- long-term care insurance (see section 12.5);
- estate planning (see section 15.7);
- power of attorney (see section 16.7).

15.7 How can the adviser assist with estate planning?

There are two main questions to consider in advising on estate planning:

- Has the client made a (valid) will?
- Has the client taken steps to mitigate inheritance tax liabilities?

Financial advisers should not generally become involved in writing a will, but should strongly advise that the client consult a legal adviser to ensure that a will is in place. If necessary, the financial adviser can provide a document explaining any financial objectives that the will should help to achieve.

In relation to inheritance tax, there are basically two approaches that people can take:

- try to avoid having to pay it; or
- make provision for paying it when it is due.

To avoid paying IHT, it is necessary to reduce the value of the estate to below the nil-rate thresholds. This can be done by making use of the various exemptions described in Topic 4 to make tax-free, or potentially exempt, gifts during one's lifetime. Another method is to place assets in trust, since trust property no longer forms part of the settlor's estate.

✓

CHECK YOUR UNDERSTANDING 4

Can you recall from your studies in Topic 4 what gifts and transfers are exempt from IHT?

The largest component of most people's wealth is the property in which they live. It is not possible to avoid IHT by giving the property away while continuing to live in it, as this would be caught by HMRC's gift with reservation rule.

In the past, many people avoided this restriction by the device of placing their property (known technically as a pre-owned asset) in a trust. The tax authorities closed this loophole by means of Schedule 15 of the Finance Act 2004, which introduced rules for the taxation of pre-owned assets that came into force from 6 April 2005. Under these rules, people are liable to an income tax charge each year on the benefit of occupying or using any asset previously owned but disposed of after 17 March 1986.

The tax charge is based on a realistic annual rental for the property they occupy, although if the deemed rental amount is less than £5,000 per annum, no tax charge is levied. Some people may decide that cancelling their schemes (with the loss of the benefits and some, or all, of the set-up costs) is better than paying the future tax bills.

Married couples and civil partners are now able to use the whole of both their nil-rate bands to pass property tax-free to their relatives or others. The percentage of nil-rate band unused on the first death can be carried forward and used to increase the nil-rate band on second death. The residence nil-rate band, introduced on 6 April 2017, also helps to further mitigate the impact of IHT if the property is passed down to lineal descendants.

If avoiding the tax is not a realistic option, a life assurance policy for the anticipated amount of the IHT should be taken out. To avoid the policy proceeds becoming part of the deceased's estate – and therefore themselves subject to IHT – the policy should be written in trust for the benefit of the beneficiaries of the will.

CHECK YOUR UNDERSTANDING 5

From your studies in Topic 11, can you recall what type of life assurance policy is generally used for IHT purposes?

15.8 What is the role of the adviser in tax planning?

The recommendation of a financial product should always take account of the product's impact on the client's tax situation, but not in isolation: it should be considered in context, in conjunction with other features of the product. For instance, contributions to a pension arrangement are often the most tax-efficient way for an individual to invest, but this should never be the main reason for recommending a pension product.

Just as it is wise to leave the writing of wills to solicitors, complex tax-planning schemes should be left to taxation experts. However, it is important to be able to choose appropriate products that can complement and improve a client's current tax situation:

- Clients should normally consider the use of ISAs, pensions and friendly society policies to maximise the advantage of tax-free income or growth.
- Clients who are non-taxpayers may consider investing in funds such as offshore bonds, which are free from UK tax.
- Clients who expect to exceed their CGT annual exempt amount might consider investments that are CGT-free, such as gilts.

Advisers should be aware of circumstances where tax that has been paid (in effect on behalf of the investor) cannot be reclaimed even if the investor is not a taxpayer. An example of this would be an endowment policy or a UK investment bond, where gains made within the life company's funds are taxed at 20 per cent: a policyholder who is not a taxpayer cannot reclaim this deduction. An offshore bond (which is free from UK tax on its fund) may be more attractive to a non-taxpayer.

Unit trust managers are not taxed on gains within their funds; holders of units are liable for CGT if they sell their units at a profit but they may be able to avoid this by use of their CGT annual exempt amount.

15.8.1 Offshore considerations

Where an individual is either leaving the UK (emigrating) or coming to live in the UK (immigrating), consideration should be given as to whether existing investments should be encashed before the move or retained. The decision could be driven in part by which option results in the more favourable tax treatment.

15.9 Why are regular reviews important?

At any given time, one or more of the advice areas described above might be the most significant for a particular client. However, circumstances can change very quickly and the financial needs of a client and their family may change dramatically. Births, marriages (and divorces), deaths, moving home, changing jobs, losing a job and many other events can change people's attitudes and objectives, as well as their assets and liabilities. Advisers should take account of this by allowing (as far as possible) flexibility in the products recommended and also by making plans to review the client's situation at regular intervals.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the financial impact that death or long-term sickness of a wage earner might have on a family?
- describe three approaches a partnership could put in place to protect the business in the event of the death of one of the partners?
- summarise five approaches to categorising savings and investment products that would help a client to identify the products that best suit them?
- explain the two fundamental approaches to managing an inheritance tax liability?
- explain why it is important for an adviser to understand the tax treatment of different products, even though they are not tax specialists?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 15. Review the text if necessary.

Answers can be found at the end of this book.

1) What main factors affect the calculation of the level of sickness cover needed by a working parent with children?

2) What is the purpose of key person insurance?

3) Hegley Surveying Services wants to take out key person insurance on their senior surveyor, Simone. Her annual salary is £47,000. The company's total annual salary bill is £400,000 and its latest published gross profit was £1.5m. Calculate the appropriate sum assured, assuming the estimated time to recover from the loss of Simone would be five years.

4) How does the cross-option method differ from the buy-and-sell method of partnership protection?

5) For which of the following borrowers might a fixed-rate mortgage be most suitable?

   a) Ruth, who feels that interest rates will stay the same for the next few years.

   b) Sean, who feels that lenders should never charge arrangement fees.

   c) Aditya, who is convinced that interest rates will fall sharply in the short term.

   d) Nigel, who believes that interest rates will rise significantly in the near future.

6) Which one of the following repayment vehicles would be suitable for a client who wants an interest-only mortgage, but insists that the product must guarantee to pay off the mortgage at the end of the term?

   a) Full with-profits endowment.

   b) Low-cost endowment.

   c) ISA.

   d) Unit-linked endowment.

7) If the cost of living is rising, what is likely to be the main priority of a customer making an investment?

   a) To avoid incurring any further income tax liability.

   b) To protect money against the effects of inflation.

   c) To be able to access it immediately.

   d) To invest money securely.

8) If the rate of inflation is 2.5 per cent, what yield must an investor obtain on their deposit account in order to achieve a real return of 3 per cent?

   a) 0.5 per cent.

   b) 2.5 per cent.

   c) 5.5 per cent.

9) Nina is a basic-rate taxpayer. She pays £162 pm by direct debit into her personal pension plan. How much is actually invested in her plan each month including tax relief?

   a) £194.40.

   b) £202.50.

   c) £283.50.

   d) £270.00.

10) What rule does HMRC apply in relation to gifts with reservation?

TOPIC 16

Key legal concepts

LEARNING OBJECTIVES

This topic provides an introduction to basic legal concepts that underpin the provision of financial services, as well as outlining some key legislation that has particular relevance to financial services. Legislation that relates specifically to the regulation of financial services is covered in more depth in Topics 17–25.

By the end of this topic, you should have an understanding of:

- the meaning of the term 'legal person';
- features of limited companies, partnerships and limited liability partnerships;
- the requirements for a binding contract;
- aspects of agency law relevant to financial advisers;
- key concepts relating to property;
- powers of attorney and substituted decision making;
- wills and the distribution of estates;
- trusts and the role of trustees;
- insolvency; and
- scams.

This topic covers Unit 1 syllabus learning outcomes U6.1–U6.7.

THINK ...

The phrase 'legal concepts' might sound off-putting but at least some of the ones outlined in this topic are likely to be familiar to you from your work or family experience. For instance:

- If you are an employee, what kind of business do you work for? A partnership, a limited liability partnership (LLP) or a limited company (Ltd)? Have you ever thought about what that designation means?

- Have you been involved in negotiating a contract – for example, perhaps when purchasing a home?
- Have you applied for or used a power of attorney – perhaps for a sick or elderly relative?
- Have you made a will or been appointed an executor?

16.1 What is a 'legal person'?

A 'legal person' is a body that has a legal existence and can, therefore, enter into contracts, sue or be sued in a court of law. It is important to remember that this includes not just an individual acting in a personal/private capacity but also an individual acting in a formal capacity such as that of executor, as well as groups of individuals such as trustees. It also includes bodies such as limited companies.

16.2 Key features of companies

As noted in section 16.1, a company is a legal person (although, often, the term 'legal entity' is used instead). In other words, the company is legally separate from its shareholders and its individual employees.

The certificate of incorporation provides evidence of the company's formation, and details about the company are held on the central registry at Companies House. The information held includes the shareholding and shareholders, as well as listing the names and addresses of the directors and company secretary.

The nature of the company, and the rules about what it can and cannot do, are set out in its memorandum and articles of association. For example, the memorandum normally includes the power to borrow, but may place limits or restrictions on that power in terms of amounts or purpose. Such limits will be significant if the company is considering taking out a mortgage or other form of loan.

When entering into a contract with a company, it is prudent to check that the persons entering into the contract are authorised and empowered to do so. For example, when a company director is seeking to raise funds for the company, it would be advisable to check that the company is able to borrow and also that the director in question is able to arrange a loan on the company's behalf.

Shareholders of a limited liability company cannot be held personally responsible for the debts of the company, the limit of their liability being the amount that they have invested in company shares. This is the most they could lose if the company were to become insolvent.

16.3 Key features of partnerships

A partnership is an arrangement between people who are carrying on a business together for profit. Unlike a company, a partnership is not a separate legal entity and the partners jointly own the assets and are responsible for the liabilities of the partnership.

Partnerships should have a written agreement that sets out in detail the relationship between the partners, including proportions in which they share the partnership's profits and what will happen when a partner leaves, retires or dies.

16.3.1 Limited liability partnerships

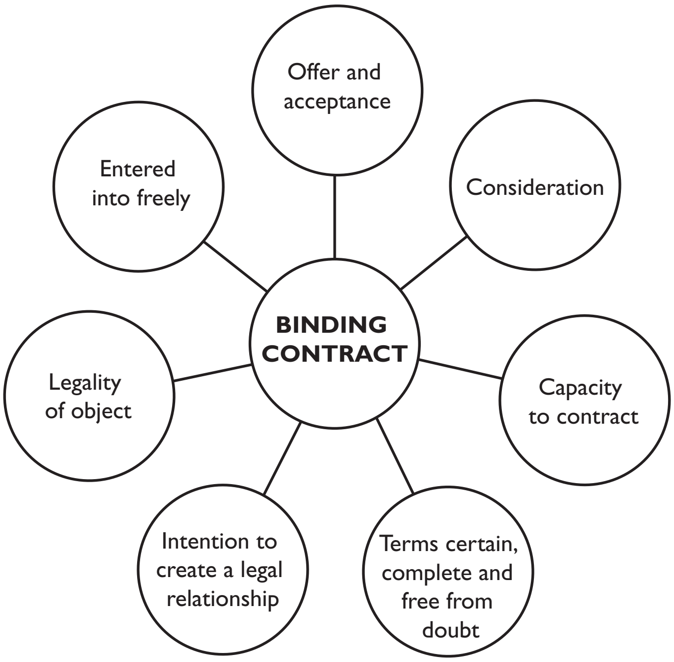
Since 2001, it has been possible to run a business as a limited liability partnership (LLP). This means that partners have a limited personal liability if the business should collapse: their liability is limited to the amount that they have invested in the partnership, together with any personal guarantees they have given – for example, to a bank that has made a loan to the business.

As with companies, LLPs have to be registered with Companies House; they are clearly more like companies than they are standard partnerships, but the taxation of LLPs is not the corporation tax regime that applies to companies. LLPs are taxed in the same way as other partnerships: each partner is taxed on a self-employed basis, with their individual share of the profits being treated as their own personal income and subject to income tax.

16.4 What are the requirements for a binding contract?

Most business agreements, particularly in the world of financial services, are established as legally binding contracts. Some are made orally, some in writing and some by deed. Not all contracts can be made orally but all contracts generally are subject to certain basic requirements for them to be binding. Figure 16.1 summarises these, and an explanation of the terms is provided.

FIGURE 16.1 REQUIREMENTS FOR A BINDING CONTRACT



- Offer and acceptance – there must be an offer made by one party (the offeror) and there must be an unqualified acceptance by the other. This acceptance must be communicated to the other party. In practice there may be a number of counter-offers before agreement is reached.
- Consideration – the subject of the contract (often a promise to do something or supply something) must be matched by a consideration (which is frequently, but not necessarily, the payment of money). A promise to pay is valid consideration.
- Capacity to contract – each of the parties to the contract must have the legal capacity, or power, to enter into the contract. Certain parties have only limited powers to enter into a contract, for example, minors and those of unsound mind. For financial institutions such as insurance companies, capacity to contract depends on being authorised by the FCA/PRA.
- Contract terms – these must be certain, complete and free from doubt. For example, when a customer engages an independent financial adviser (IFA), the IFA's commitments are detailed in a terms of service agreement.
- Intention to create a legal relationship – as distinct from a merely informal arrangement.
- Legality of object – contracts cannot be made for illegal or immoral purposes.
- Misrepresentation, duress or undue influence – if any of these factors are involved in leading someone to enter into a contract, the contract is not binding.

CONTRACTS INVOLVING LAND

Note that all agreements for the sale of land must be made in writing and conveyances of land (the actual transfer of ownership) must be performed by deed.

16.4.1 Disclosure of information

Generally, there is no duty of disclosure between parties to a contract; most contracts are based on the principle of *caveat emptor* ('let the buyer beware'). In other words, it is the responsibility of each prospective party to the contract to satisfy themselves that they have all the information they need on which to base their decision to enter into that contract.

However, there are exceptions. For example, insurance contracts were, for many years, based on the principle of 'utmost good faith' (*uberrima fides*), whereby all material facts had to be disclosed by both parties. For an insurance policy, this meant that the person applying for the policy was required to supply all the facts that a prudent underwriter would need to decide the terms on which the policy could be issued. Non-disclosure by the customer rendered the contract voidable at the option of the insurance company.

From 2000 onwards there was growing concern from regulators and consumer groups that some insurers were rejecting claims on the basis that the policyholder failed to disclose information that they should have realised was relevant and important, even though no direct question asked for the information. The problem was exacerbated by a growing tendency for insurers to reduce the level of pre-application underwriting and effectively ask medical underwriting questions when a claim was made, at which point problems might arise.

REJECTION OF CRITICAL ILLNESS CLAIMS

Many of the cases in which insurance companies rejected claims on grounds of non-disclosure involved critical illness policies where applicants failed to disclose a condition for which they had previously visited a doctor. In many cases the doctor had confirmed that there was not a problem, or had diagnosed a minor problem that was successfully treated. On later suffering from a specified critical illness, the policyholder's claim was declined due to the non-disclosure at the application stage, even when the condition not disclosed was unconnected to the illness that prompted the claim.

> In many cases, the Financial Ombudsman determined that the insurance company's rejection was unreasonable and found in favour of the policyholder. One major issue was the reliance on the applicant to decide what was relevant to disclose. Typical questions on the application form would be along the lines of: "Have you ever visited a doctor or suffered from a medical condition requiring treatment?" This required the applicant to remember all such occasions and decide which, if any, to include.

The situation regarding rejection of claims eventually led to the Consumer Insurance (Disclosure and Representations) Act 2012, which came into force on 6 April 2013. In simple terms the Act more clearly defines the responsibilities of insurance customers. It abolishes the duty of consumers to volunteer material facts when applying for insurance and instead requires them to take reasonable care to answer the insurer's questions fully and accurately. If they do volunteer information, they must take reasonable care to ensure that the information is not misleading or misrepresented.

For example, section 2(2) of the Act states that "it is the duty of the consumer to take reasonable care not to make a misrepresentation to the insurer". The representations will be based on responses to specific insurer questions, because there is no duty on the consumer to volunteer information that is not asked for. The Act defines, as far as possible, the meaning of "reasonable" in this context, which depends on a number of factors including, "how clear, and how specific, the insurer's questions were". Section 2.3 states that "a failure by the consumer to comply with the insurer's request to confirm or amend particulars previously given is capable of being a misrepresentation".

In the case of misrepresentation, the Act also indicates what actions the insurer may take:

- If the consumer has taken reasonable care, and the misrepresentation was honest and reasonable, the insurer has no right to refuse a later claim.
- In the case of misrepresentation due to carelessness, detailed rules allow the insurer to apply a 'compensatory remedy' to the claim, based on what the insurer would have done had the applicant answered all questions completely and accurately. So, for example, if the insurer would have refused cover completely if it had been in full possession of all the facts, the claim could be rejected; if it would have excluded certain illnesses, then claims relating to those illnesses would not be met. If the claim is rejected, then the insurer must refund the premiums paid.
- If careless misrepresentation is identified in situations other than a claim, the insurer and the policyholder have the right to terminate the contract

with reasonable notice. However, the insurer cannot cancel a life insurance policy in this situation.

- In the case of deliberate or reckless misrepresentation, the insurer may reject the claim completely as if the contract never existed and is not required to refund premiums paid, unless there is a good reason to do so.

16.4.2 Remedies for breach of contract

Breach of contract occurs when a party fails to perform its side of the contract and does not have a legal justification for doing so. Several court remedies are available in these circumstances; the most common ones are as follows:

- **Damages** – the injured party seeks to obtain financial compensation for their loss. The intention is to put them in the position they would have been in had the contract not been breached by the other party, insofar as it is possible to do so with money.
- **Order for specific performance** – such an order compels the other party to complete the contract.
- **Injunction** – this is a court order preventing someone from doing something.

Of these, by far the most frequently sought is damages.

16.5 What is the law of agency?

An agent is a person who acts on behalf of another, who is called the principal. The agent can conclude contracts on behalf of the principal. In law, the acts of the agent are treated as being those of the principal. In the context of financial services, an IFA is an agent of their client and given specific powers under the terms of engagement. Another example is an estate agent, who is the agent of a person looking to sell their property.

In any kind of agent–principal relationship, it is important to ascertain how much power and authority has been granted to the agent, just as it is important that the agent is fully aware of what they can and cannot do. Some agents are given very wide authority while some are severely restricted. For example, an IFA may only be required to give advice, on which their client can choose whether or not to act; alternatively, they may be given discretionary investment powers to buy and sell investments on the client's behalf.

An agent should only act within the authority given to them by their principal. This should be strictly observed, because, if an agent exceeds their power, it could result in their principal being liable on the contract. This happens when, although the agent acts outside of their actual authority, they act within what is known as their *apparent authority*.

Another result is that the agent may be made liable. This protects the third party to the agreement, who – if they are unable to rely on the agent's claim to have authority – must be able to hold the agent personally responsible. It would otherwise be unfair to the third party, who would have entered in good faith into the contract only to find themselves without recourse either to the principal (if there is no apparent authority) or the agent.

KEY TERMS

AGENT

Acts on behalf of the principal, within specific boundaries, to conclude contracts.

APPARENT AUTHORITY

Something either done or said by the principal that leads to the impression that they have authorised the agent's actions.

PRINCIPAL

The party granting permission to the agent to act on their behalf.

RATIFICATION

A retrospective agreement by the principal to actions taken by the agent that exceed the latter's authority.

If the agent does exceed their authority, the principal can, if they choose, agree after the event to what the agent has done. This is called ratification.

This very brief introduction cannot cover all the detail of agency law but serves to illustrate how important it is for advisers to know, understand and act within the extent of their authority.

CHECK YOUR UNDERSTANDING 1

Joanne lives in London and her property in Brighton is on the market for £300,000. The property is currently unoccupied. Joanne is going away on business for six weeks and explains to her estate agent, Martin, that it might be difficult to contact her during that time. She tells him to do whatever is necessary to sell the property, as she is desperate for the money.

While Joanne is away, Martin receives an offer of £285,000 on the property from Mr and Mrs Peters. They explain to Martin that they are moving from Devon because Mrs Peters is starting a new job; they need to move immediately and will rent a property until they can sell their Devon home and buy in Brighton. In Joanne's absence, Martin accepts their offer on Joanne's flat and arranges for them to move in immediately as tenants until the purchase can go ahead.

Did Martin have authority to make this decision?

16.6 Property and property ownership

The law of England and Wales defines two distinct types of property; in this context, the word 'property' is used to refer to all types of asset, rather than its more narrow sense of 'land and buildings'. The two types are as follows:

- **Realty** – property is deemed to be real if a court will restore it to a dispossessed owner and not merely provide compensation for loss. Real property tends to be distinguished by being immovable, eg land and what is attached to it, also known as real estate.
- **Personalty** – all other property is called personalty.

In relation to joint ownership of property, there are two types:

- **Joint tenants** – each joint owner owns 100 per cent of the property – there is no division of the property. On the death of any joint owner, the surviving joint owner(s) will take over legal ownership of the property. The transfer is automatic and cannot be overridden by any provisions made by a joint tenant in a will or through the laws of intestacy.
- **Tenants in common** – the joint legal owners are regarded as one single owner but are trustees of the land. However, each legal owner is also the beneficial (or equitable) owner of a defined interest (share) of the equity in the property, as agreed between them. If one owner dies, their share of the property passes to whoever is entitled to inherit it under the terms of their will or the law of intestacy.

RESPONSIBILITY FOR DEBTS

The terms 'tenant' and 'tenancy' here have nothing to do with renting property. The phrases refer to the joint ownership of any form of asset. The terms can equally apply to debts, such as mortgages. In the case of joint tenants, all borrowers are equally liable for the whole debt, while tenants in common are each responsible for a portion of the debt. Banks, building societies and other commercial lenders always insist that joint mortgages are written on a joint tenancy basis.

16.7 What is power of attorney?

An attorney is a person who is given the legal responsibility to act on behalf of another person. Examples of situations in which the need for an attorney might arise include:

- a person who, while currently in good health, is concerned about how their affairs will be run should they become unable to manage their own finances (for instance if they develop an illness such as dementia); or
- someone with affairs in the UK who is moving abroad.

A person who does not have the legal capacity to enter into a contract (eg a minor or a mentally incapacitated person) cannot appoint someone else as their attorney.

16.7.1 What is an enduring power of attorney?

An ordinary power of attorney automatically ceases if a person becomes mentally incapacitated. This can create problems for those responsible for managing the individual's affairs. An enduring power of attorney (EPA) can continue if the donor becomes mentally incapacitated, although it has to be registered with the Office of the Public Guardian if the attorney believes that the donor is losing mental capacity. An EPA can be revoked only with the consent of the Court of Protection.

KEY TERMS

DONOR

Person who makes a power of attorney.

DONEE

Person who is given power of attorney. Often, they are simply referred to as the attorney.

16.7.2 What is a lasting power of attorney?

From 1 October 2007, under the provisions of the Mental Capacity Act 2005, enduring powers of attorney were replaced by lasting powers of attorney (LPAs). EPAs made before that date can remain in force, but all new arrangements must be lasting powers of attorney.

There are two types of LPA:

- **Health and welfare** – this gives the attorney power to make decisions over issues such as medical care or moving into residential care. It can only be used once the donor can no longer make decisions for themselves.

- **Property and financial affairs** – this gives the attorney power to manage the donor's bank accounts, collect benefits and sell property. It can be used even if the donor has mental capacity, as long as the donor gives permission.

In both cases, the LPA must be registered with the Office of the Public Guardian before it can come into effect.

> **FACTFIND**
>
> There is more information about dealing with powers of attorney at:
>
> https://www.gov.uk/power-of-attorney [Accessed: 18 February 2020].

16.7.3 What happens if no power of attorney is in place?

The Mental Capacity Act 2005 supports and protects individuals who lack the capacity to make their own decisions. It promotes supported decision-making, which is the process of providing support to those who need help making their own decisions. It also makes provision for substituted decision-making, where decisions are made on behalf of the individual in their best interests (for instance, by a court appointed deputy).

If a person loses mental capacity and does not have a valid LPA or EPA in place, the Court of Protection can appoint a deputy. This process can take some time and a deputy's powers are much more restricted when compared to those of an attorney. It is for these two reasons that all clients should be encouraged to draw up an LPA if they have not done so already.

16.8 Wills

A will is a written declaration of an individual's wishes regarding what they want to happen after they have died. Although primarily concerned with how the person wishes to dispose of their assets, a will can also deal with other matters, such as giving instructions about burial.

In the UK, approximately seven out of ten people die intestate, meaning that they die without leaving a valid will. Writing a will is the first step in gaining control over an estate and is, therefore, a vital part of financial planning. it is important that clients understand the benefits of a valid will and the risks of not having one. If the client has no will, the financial adviser should recommend that they seek professional advice from a solicitor; the adviser should not become involved in writing the will themselves.

To make a valid will, two formalities must be followed:

- the will must be in writing;
- the will must be properly executed.

The minimum age for making a valid will under English law is 18.

The will should be a clear and unambiguous statement of the deceased's wishes in respect of their estate, and must be signed by the testator in the presence of two witnesses.

It is important that the witnesses chosen must not be beneficiaries under the will (or the spouses of beneficiaries). If a beneficiary were to be a witness, they would not be able to inherit under the terms of the will.

The terms of a will only take effect on the death of the testator, the person who made the will. Before then, the testator can revoke (cancel) or modify the will at any time. Modifications are recorded in a document known as a codicil. In the event of marriage, remarriage or entering into a civil partnership, a will is automatically revoked, unless specifically written in contemplation of the change of status.

KEY TERMS

TESTATOR

Person who makes the will.

BENEFICIARY

A person or organisation that receives benefits under the terms of a will.

CODICIL

Document that formally amends a will.

16.8.1 Distribution of the estate

The people who carry out the procedures necessary to distribute the estate of someone who has died are known as the deceased person's legal personal representatives. The exact procedure depends on whether or not there is a valid will. The following comments apply to the law of England and Wales (Scottish law differs both in the procedures involved and in the terminology used).

If there is a valid will, it will name the person or people the testator has chosen to be executors. The role of the executors is to ensure that the actions specified in the will are carried out. The duties of an executor can be time-consuming and onerous and it is not uncommon for executors to appoint a solicitor to carry out all or part of their duties. Note that an executor can also be a beneficiary of the will.

Before they are able to distribute the estate, the executor(s) must apply for a grant of probate. This gives them legal authority to carry out the testator's instructions, as set out in the will.

If there is no will (or the will is invalid), an appropriate person (such as a spouse or other close relative) acts as an administrator and applies for the grant of letters of administration, rather than probate. The administrator's responsibility is to deal with the estate as prescribed by the rules of intestacy (see section 16.8.2).

In certain circumstances it may be advantageous, following the death of the testator, for the beneficiaries under a will to vary the way the estate has been allocated. This can be achieved by executing a deed of variation. All those who would be affected by the deed must be over 18 years of age and must be in agreement on the terms of such a variation. A deed of variation is often executed for tax purposes: a change in beneficiaries or in the relative shares received that could reduce the inheritance tax liability, for example. In order to be effective for tax purposes, the deed of variation must be executed within two years of the death, and HMRC must be informed within six months of its execution. The variation must not be entered into for any consideration of money or money's worth.

KEY TERMS

EXECUTOR

Person named by the testator as being responsible for carrying out the wishes expressed in a valid will.

GRANT OF PROBATE

Legal authority for executors to distribute an estate according to the terms of a valid will.

DEED OF VARIATION

Legal agreement by the beneficiaries to alter the terms of a will, after the death of the testator.

MONEY'S WORTH

Provision of goods/services in lieu of a cash payment.

16.8.2 Intestacy

A person who has died without having made a valid will is said to have died intestate. This includes the situation where the deceased has left a will that turns out to be invalid. If a will makes valid provision for the distribution of some of the assets of the estate, but not of others, this is referred to as partial intestacy.

The distribution of the estate of a person who has died intestate is determined by a complex set of rules known as the rules of intestacy. They are very specific and there is no flexibility or discretion for their variation by the person dealing with the estate. In many cases – especially if the estate is a large one – the distribution of the assets may not be as the deceased would have wished. In particular, it is not necessarily true – as many people believe – that a surviving spouse or civil partner will receive the whole estate.

The main rules are as follows. Please note that for the purpose of these rules, the word 'spouse' includes civil partner and 'children' includes more distant descendants, eg grandchildren or great-grandchildren, and so on.

- **If the deceased leaves a spouse but no children** – the spouse inherits the deceased's entire estate.
- **If there is both a spouse and children** – the spouse inherits the deceased's personal chattels, plus the first £270,000, plus half of the residue above £270,000 absolutely; the other half of the residue in excess of £270,000 is divided equally between the children.
- **If there are children but no spouse** – the estate is shared equally among the children.
- **If there is neither spouse nor children** – the estate goes to the parents of the deceased, or (if they are dead) to the deceased's brothers and sisters.

This is just a summary of the main rules (Figure 16.2 provides further details) and, ultimately, if no blood relative can be found, the estate will pass to the Crown.

KEY TERMS

INTESTATE

Having died without leaving a valid will.

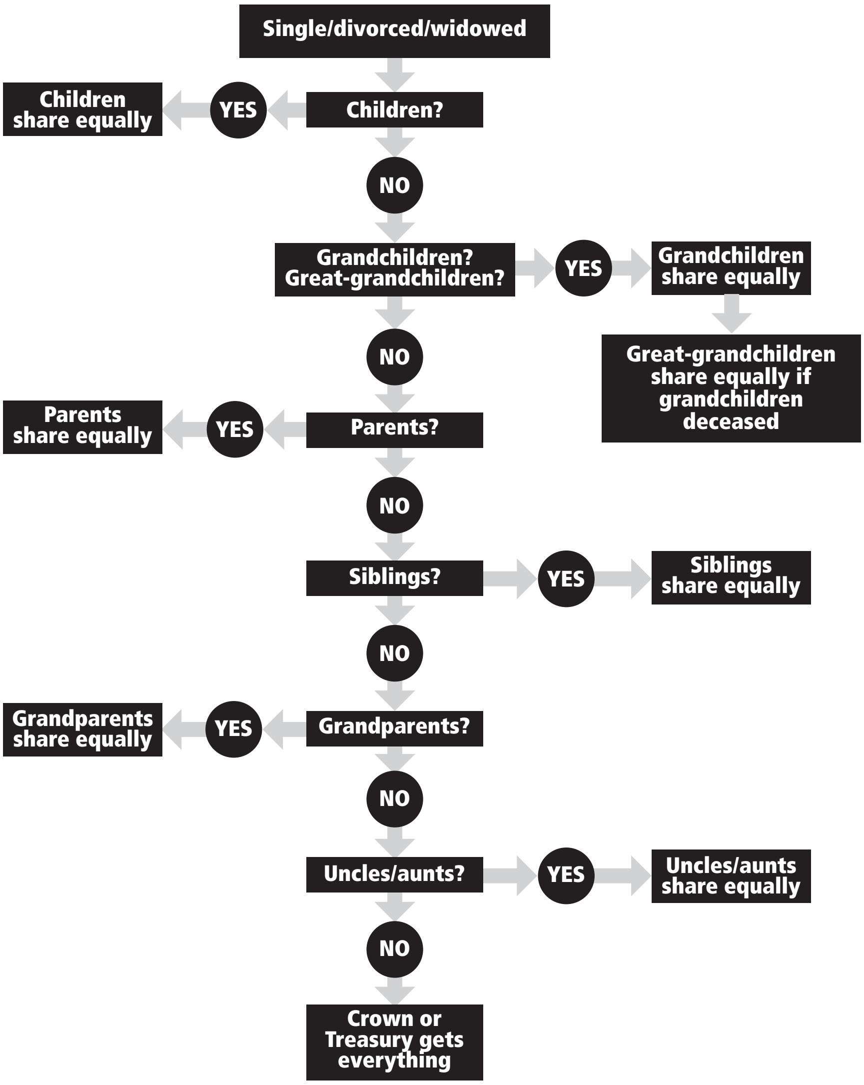
ADMINISTRATOR

Person given the role of distributing the estate according to the rules of intestacy.

LETTERS OF ADMINISTRATION

Legal authority to distribute the estate of a person who has died without leaving a valid will.

FIGURE 16.2 INTESTACY RULES – SUMMARY



CHECK YOUR UNDERSTANDING 2

a) Marian was married but had no children, although her parents were still alive. She died without leaving a will. The value of her estate was £600,000. How much did her husband inherit?

b) Ian, who made no will, left an estate of £350,000. How much did his wife and each of his two children inherit?

16.9 Trusts and trustees

A trust (also known as a settlement) is a method by which the owner of an asset (the settlor) can distribute or use that asset for the benefit of another person or persons (the beneficiaries) without allowing them to exert control over the asset while it remains in trust. Depending on the nature of the trust, the beneficiaries may eventually become the absolute owners of the asset.

The settlor is the person who creates the trust and who originally owned the assets placed in the trust (the trust property). Once it is placed in trust, the asset is no longer owned by the settlor (unless the settlor is also a trustee – see below).

The beneficiaries are the people or organisations that will benefit from the trust property. They may be named individually or referred to as a group, eg "all my children".

The trustees are the people, appointed by the settlor, who take legal ownership of the trust property and administer the property under the terms of the trust deed. The trustees, who can include the settlor, are named in the trust deed. Trustees must be aged 18 or over and of sound mind. If a trustee dies, the remaining trustees, or their personal representatives, can appoint a new trustee.

KEY TERMS

SETTLOR

The person who creates the trust and originally owned the assets held within it.

TRUST DEED

Document that sets out how the trust is to be managed, by whom and for whose benefit.

TRUSTEE

Person named in the trust deed as legal owner of the trust property, with responsibility to look after and distribute the trust property in line with provisions in the trust deed.

Trustees have a number of duties:

- They must act in accordance with the terms of the trust deed. If the trust deed gives them discretion to exercise their powers (eg discretion over which beneficiaries shall receive the trust benefits), the agreement of all the trustees is required before a course of action can be taken.
- They must act in the best interests of the beneficiaries, balancing fairly the rights of different beneficiaries if these should conflict. For example, some trusts provide income to certain beneficiaries and, later, distribution of capital to other beneficiaries; in such a situation the chosen investment must preserve a fair balance between income levels and capital guarantee/capital growth.

Under the Trustee Act 2000, trustees who exercise investment powers are required to:

- be aware of the need for suitability and diversification of assets;
- obtain and consider proper advice when making or reviewing investments;
- keep investments under review.

CREATING AND ADMINISTERING A TRUST

George is 65 years old. He has two grandchildren, Chloe aged seven and Mark aged five. He puts £500,000 in trust for his grandchildren's education. Once the money has been put into the trust, it no longer belongs to him – he has made a gift. He names his daughter Sue and his friend Bob as trustees. The money has got to last a long time (16 years until Mark finishes university) so it must be invested and used wisely. Sue and Bob will decide how to invest the money (shares, property, gilts, accounts, etc) and what it is spent on (school fees, uniform, books, school trips, etc). They must agree all their decisions together.

16.10 Insolvency and bankruptcy

Insolvency arises when:

- a person's liabilities exceed their assets; or
- a person cannot meet their financial obligations within a reasonable time of them falling due.

Bankruptcy takes the position a stage further and arises when a person's state of being insolvent is formalised under the terms of a bankruptcy order.

The primary UK legislation on insolvency is the Insolvency Act 1986, but this has been subject to amendments over the years. An EU Regulation on Insolvency Proceedings came into force in 2002; to clarify the position in the UK, a number of statutory instruments were issued including, for example, the Insolvency (Amendment) Rules 2002.

16.10.1 Bankruptcy

A person can petition to have themselves declared bankrupt, or a creditor may petition to have someone else declared bankrupt if they owe (or are owed jointly with other creditors) £5,000 or more. Most bankruptcy orders remain in force for 12 months, during which time the person is said to be an undischarged bankrupt. If individuals do not comply with the terms of the bankruptcy order it may remain in place until the official receiver or insolvency practitioner is satisfied that their requirements have been met.

During the period of bankruptcy, the individual's possessions are, in effect, surrendered to an official receiver, who can dispose of them and use the money raised to pay off the creditors. The only exceptions are clothing and household items, and work-related items.

Although bankruptcy cancels most kinds of debt and allows people to make a fresh financial start, it comes at a price: it normally makes it more difficult to obtain credit in the future and it can affect employment prospects. Bankrupts are unable to borrow, other than nominal amounts, during the period that the order is in force. An undischarged bankrupt will be unable to open a current account, but may be able to open a basic bank account.

Even after the end of the period, the person must, by law, disclose the existence of a previous bankruptcy when applying for a mortgage. This may mean that it will be more difficult for them to obtain a loan or that they may be charged a higher rate of interest to cover the greater perceived risk.

16.10.2 Individual voluntary arrangements

An individual voluntary arrangement (IVA) is an alternative to bankruptcy, under which the debtor arranges with the creditors to reschedule the repayment of the debts over a specified period. An IVA can be set up only if creditors who represent at least 75 per cent of the debt agree to the arrangement. The scheme must be supervised by an insolvency practitioner.

In recent years, a large market has arisen for firms that assist individuals with significant personal debts to enter into IVAs. In most cases they are able to arrange for interest to be frozen, for a reduction in the amount of the debt, and for legal protection from creditors if the terms of the IVA are met. The firms are generally able to persuade lenders to write off part of the debt in exchange for a reasonable guarantee of receiving repayment of the remainder. In many cases this is better for the lender than simply writing off the debt or selling it to a debt recovery firm.

An individual with an IVA will find it difficult to obtain credit while the IVA is in place, and creditworthiness is likely to be impaired even after the end of the arrangement.

KEY TERMS

INSOLVENCY

A situation in which liabilities exceed assets or an organisation or individual cannot meet their liabilities within a reasonable period of them falling due.

BANKRUPTCY

Legal process triggered by the insolvent individual or by creditors where the individual owes a minimum of £5,000. A bankruptcy order usually lasts 12 months.

INDIVIDUAL VOLUNTARY ARRANGEMENT

Agreement by creditors who represent at least 75 per cent of the value of the debt to reschedule an individual's debt repayments.

COMPANY VOLUNTARY ARRANGEMENT

Agreement by creditors who represent at least 75 per cent of the value of the debt as to how to manage company liabilities, with the aim of avoiding the business going into administration.

OFFICIAL RECEIVER

Official appointed by the court to identify and distribute the assets of a bankrupt individual or business and investigate the reasons for the bankruptcy.

INSOLVENCY PRACTITIONER

Appointed by the court or by the official receiver (in consultation with creditors) to identify and manage the distribution of an individual's or company's assets. Insolvency practitioners must be licensed to practise.

16.10.3 Company voluntary arrangements

The company equivalent of an IVA is the company voluntary arrangement (CVA). Under the terms of the Insolvency Act 1986, a company that is in temporary financial difficulties (but which its directors believe to have a viable long-term future) can make a binding agreement with its creditors – including the tax authorities – about how its debt and liabilities will be dealt with.

In this way, the directors retain control of the company and it can continue to trade. A CVA can be proposed by the directors of the company, or by a liquidator if one has been appointed, but not by the creditors. However, many creditors may feel that it will be to their advantage for the company not to go into administration. As with IVAs, creditors representing 75 per cent of the company's debt must agree to the CVA being set up.

16.11 Scams

In 2017, a total of more than £23m was lost by the 253 people who reported being victims of pension scams to Action Fraud. As mentioned in Topic 10, an adviser's role in relation to scams is to be aware of such schemes and to advise a customer to be mindful of the potential risk.

The FCA operates ScamSmart, a website designed to help consumers protect themselves against pension and investment scams. In addition to providing information on how to spot a scam, the website informs consumers how to avoid them.

If a consumer is unsure as to whether a pension or investment opportunity is a scam or not, they can complete a short questionnaire on the website. The questionnaire asks them about the type of opportunity they are considering, how they found out about it and whether the promoter mentions money from their pension pot. On submitting their answers, the FCA will then confirm whether or not the opportunity is regulated or not and whether or not they suspect it is a scam. The consumer can then check if the promoter is in the list of firms to avoid.

Consumers can also report a scam or an unauthorised firm via the website.

SCAMS

Full details of ScamSmart are available at:

https://www.fca.org.uk/scamsmart

For more details on how consumers can protect themselves from scams you can visit:

https://www.fca.org.uk/consumers/protect-yourself-scams

[Both accessed: 18 February 2020].

In the past, where a victim of a scam had been deemed to have been negligent by their bank or pension provider, perhaps because they had been tricked into providing their personal details by what appeared to be a genuine employee and then had their money taken from them, or because they transferred their pension into what they believed was an FCA-regulated pension fund, it was very unlikely they would see their money again.

However, the Financial Ombudsman has recently raised the bar on what it views as negligence to counteract increasingly sophisticated banking scams. This means it will be harder for banks and building societies to reject complaints and may mean refunds for many who have lost money in the past.

Now, if a scam victim has been tricked into handing over details that enabled someone else to take money from their account, the financial institution needs to be able to demonstrate that the victim was ‘grossly negligent’ in doing so in order to refuse a refund. This is a much higher standard than simply being careless or negligent. If they cannot prove this, then the victim must be refunded with interest.

For pension transfers, the Pensions Ombudsman is now likely to side with the victim if the firm that transferred the pension did not have sufficient warnings and checks in place to protect the member from such scams.

OMBUDSMAN RULINGS

For full details of these two recent Ombudsman rulings you can go to:

https://www.internationalinvestment.net/internationalinvestment/news/3501908/hope-pension-scam-victims-ombudsman-ruling

https://www.thisismoney.co.uk/money/beatthescammers/article-6595823/Join-fraud-fightback-Landmark-ruling-paves-way-bank-scam-victims-money-back.html

[Both accessed: 18 February 2020].

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain what is meant by the term ‘legal person’?
- describe how liability for debts differs between a limited company, a partnership and limited liability partnership?
- summarise the requirements for a contract to be legally binding?
- outline how agency law affects financial advisers?
- outline the process for distributing an estate, both where there is a valid will and in cases of intestacy?
- explain the general duties of a trustee?
- describe the financial restrictions imposed on a person declared bankrupt?

Go back over any points you don’t understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 16. Review the text if necessary.

Answers can be found at the end of this book.

1) Jagdeep is a partner in Pascoe & Partners. In the event that the business becomes insolvent, her liability is limited to the amount she has invested in the partnership, together with any personal guarantees she has given. True or false?

2) Jagdeep is also a shareholder in Allenton Engineering Ltd. If the company were to become insolvent, what personal liability would she have for its debts?

3) For a contract to be valid, there must be consideration. What does this mean?

   a) There must be payment or a promise to provide payment.

   b) Both parties to the contract must be aged 18 or over.

   c) Both parties must be open and honest in their dealings with each other.

   d) There is a right to cancel the contract.

4) Rebecca owns a small paddock that she no longer needs for her horses. The neighbouring farmer has offered to buy it and they shook hands on the sale over a drink at the pub. Later, the farmer changed his mind and tried to withdraw from the purchase. Rebecca argued that their agreement in the pub constituted a contract and he must honour it. Was she right?

5) Which is true of independent financial advisers in terms of agency law?

   a) They act on behalf of a network.

   b) They act on their own account.

   c) They act as agents of their client.

   d) They act as agents of their company.

6) Why do mortgage lenders insist that joint mortgages are always on a joint tenancy basis?

7) Which of the following statements about the requirements for a valid will is correct?

a) An executor cannot be a beneficiary.

b) There must be a minimum of one witness.

c) A witness cannot inherit.

8) Harry has died without leaving a will. His estate will be distributed by:

a) an administrator.

b) a solicitor.

c) an executor.

d) an official receiver.

9) What role does the Court of Protection play in relation to enduring powers of attorney?

a) Enduring powers of attorney must be registered upon execution with the Court of Protection.

b) Any action taken by attorneys must be agreed by the Court of Protection.

c) The Court of Protection retains a list of all those qualified to act as attorneys.

d) Enduring powers of attorney can only be revoked with the consent of the Court of Protection.

10) One of the financial restrictions placed on undischarged bankrupts is that:

a) they are only able to borrow nominal amounts of money.

b) they are unable to buy goods, except for their own consumption.

c) they are unable to contribute to protection policies.

d) they are only able to work on an employed basis.

TOPIC 17

The FCA's aims and activities

LEARNING OBJECTIVES

From this topic onwards, our focus changes to the regulation of the financial services industry. We begin with an overview of the role of the Financial Conduct Authority (FCA).

By the end of this topic, you should have an understanding of the:

- drivers for increasing regulation of the financial services industry since the 1980s;
- changes to regulatory bodies in the aftermath of the 2007–09 financial crisis;
- role and powers of the FCA;
- main sections of the FCA Handbook;
- Principles for Businesses;
- fair treatment of customers.

This topic covers Unit 2 syllabus learning outcomes K1.1–K1.3, K1.6, K2.3 and part of K2.6.

THINK . . .

The need to comply with regulation affects every aspect of an adviser's work. Even the fact that you are studying this qualification may be as result of regulatory requirements! If you are already working in an administrative or paraplanner role in a financial services business, you might be familiar with some FCA requirements. For example:

- What kind of information must be provided to a client before and after a meeting?
- What kind of records of transactions must be kept, and for how long?

If you aren't yet working in the sector, you might have heard or seen references to the FCA or PRA in the financial media.

17.1 Introduction

Many people believe that, as commercial organisations have grown through mergers and acquisitions, they have become more remote from their customers and more concerned with their own financial results than with customer satisfaction. This belief is reflected in the emergence of government-sponsored organisations, such as the Competition and Markets Authority, consumer bodies such as Which?, and websites such as Money Saving Expert.

One of the primary objectives pursued by most modern governments is an economic and legal environment in which a balance is established between the need for businesses to make a profit and the rights of customers to receive a fair deal. This has led to the regulation, to some degree, of most industries in the UK. At the same time, the government recognises the right of companies to make a profit and does not want rules and regulations to become a burden that prevents this. Indeed, the government recognises that it is essential that companies be permitted to make a reasonable profit; it would otherwise be impossible to attract the investment that sustains the industries on which the UK economy depends.

These twin objectives of a free market for business enterprise and the protection of the consumer are among the principles on which the European Union is based, and are promoted largely through European legislation – most of which impacts, either directly or indirectly, on the UK. The force of European law can be seen in most recent major developments in the regulation of UK financial institutions.

Because the financial services industry deals with money – vital both to individuals and to the national economy – it has become one of the most regulated sectors of all. In the context of financial services, key aims of regulation include:

- ensuring that those businesses operating in the industry are authorised to do so and conduct their business in a manner that ensures the fair treatment of their customers;
- ensuring that businesses have the necessary financial arrangements in place to minimise the risk of loss to their customers;
- establishing and understanding accountability at a senior level within financial service organisations;
- ensuring that individuals carrying out defined regulated activities have the competence and capability to do so;
- the ongoing development of the skills and knowledge of individuals working in the industry;
- ongoing supervision to ensure that regulatory requirements are adhered to and to try to prevent problems;
- actions to be taken when problems arise.

KEY TERMS

REGULATION

The body of rules created by the various regulatory bodies, to which participants in the financial services industry must adhere.

SUPERVISION

The range of activities undertaken by regulators to ensure that participants adhere to the regulatory requirements.

PREVENTION OR CURE?

Although governments try to foresee problems and to introduce legislation as a means of 'prevention rather than cure', most regulatory legislation in the past has been reactive rather than proactive, ie it has been passed in response to problems, rather than designed to foresee and prevent them. Legislation has often resulted from:

- **Particular scandals or crises** – for example, the events leading up to the credit crisis from 2007. This showed the need for more diligent financial regulation of banks and for tighter rules on lending activities.
- **An increase in consumers' financial awareness and a demand for a more customer-focused business approach** – demands for a 'one-stop shop' approach to financial services sales were instrumental in the deregulation of banks and building societies.
- **The need to respond to changes in lifestyle** – more relaxed attitudes to marriage and divorce have led to a strengthening of the rights of divorcees to share in former spouses' pension benefits; the introduction of marriage for same-sex couples and civil partnerships has extended the scope of some tax benefits and other financial and state benefits.
- **Developments in business methods** – technological advance, in particular, has transformed business processes at every level of the sector; for instance, many customers of banks and building societies now carry out many of their transactions electronically and rarely visit a branch office.

- **Innovation in product design** – rapid expansion has been seen in the ranges of certain products, particularly in mortgage business and, more recently, in the pensions arena in response to freedoms introduced in 2015. This has made it more important than ever that a consumer should be provided with sufficient clear information about the features and benefits of the products they are buying.
- **The increasing number and complexity of financial products** has made it necessary to provide customers with more information and advice.

17.2 How did regulation of financial services change in the 1980s?

Since the 1970s, some areas of the financial services industry have become less regulated while others have been subject to closer regulation. Whatever the approach, the aim is always to benefit the consumer through greater choice, better service and stronger protection.

Up until the mid 1980s:

- banks were subject to government credit controls that limited the amount of mortgage lending they could carry out;
- building societies could make mortgage advances but were limited to offering only simple savings products.

However, the increase in home ownership was creating a huge demand for mortgages, and customers were demanding a much wider range of products and services from their chosen financial providers.

The Building Societies Act 1986 and the Banking Act 1987 enabled both banks and building societies to offer a wider range of services and move into new markets. Increased competition was beneficial for customers who, in addition to having a much wider choice of both products and providers, saw a reduction in the cost of many products. The increased size and complexity of the financial marketplace, however, quickly revealed the inadequate protection afforded to customers by existing legislation.

17.3 How has regulation of financial services changed since the 1980s?

During the 1980s and 1990s, a number of new pieces of regulatory legislation were introduced. These included the Financial Services Act 1986, which had elements of self-regulation whereby participants in the financial services industry were responsible for the regulation and policing of their own operations.

By the mid-1990s it was becoming clear that the self-regulatory aspects of the system had not been wholly successful. The overall regulatory structure was too fragmented for the increasingly integrated world of financial services. This led to some confusion over where regulatory responsibility lay. The collapse of Barings Bank in 1992 highlighted many of these anomalies, with both the Bank of England and the Securities and Futures Authority (the body then regulating firms that dealt in stock-market-based investments) being criticised.

The first major step in the development of a new regulatory regime came in June 1998, when responsibility for the regulation of the UK banking sector was transferred from the Bank of England to a new single regulator, the Financial Services Authority (FSA). The next stage was achieved in December 2001, when the FSA assumed regulatory responsibility for almost all of the financial services industry. A wide-ranging new Act, the Financial Services and Markets Act 2000, gave effect to the new regulatory regime.

This Act provided the legislative framework through which the FSA was able to regulate the professional and business behaviour of all parts of the industry, from the largest institutions, such as banks and insurance companies, to individual employees and sole traders. The Act is wide ranging.

Two sectors of the industry that did not come under the remit of the FSA in 2001 were mortgages and general insurance. The FSA took over responsibility for mortgage regulation in 2004, with general insurance following in 2005.

17.4 How did regulation change after the financial crisis?

The financial crisis of 2007-09 was essentially caused by a failure of prudential regulation. A number of firms were found to have inadequate management systems and financial safeguards. Events leading up to and after the crisis led to concerns about the effectiveness of the regulatory system and its ability to prevent and then deal with a similar situation in the future. There was particular concern that the responsibility of each of the regulatory bodies for dealing with the specific issues that arose was not clear.

In the years following the financial crisis there have been a number of issues related to the conduct of firms in the financial services sector, including the mis-selling of payment protection, the Libor rate-fixing scandal and the sale of interest rate hedging products to corporates.

These concerns resulted in the Financial Services Act 2012, which modified the Financial Services and Markets Act 2000 to enable changes to the regulatory system to be made under existing legislation. The Act saw the creation of a number of new regulatory bodies and the abolition of the FSA, with many of its powers handed to the Bank of England. Most of these changes came into effect on 1 April 2013 and established the regulatory system that is in place today.

- The **Bank of England** is responsible for protecting and enhancing monetary and financial stability, broadly speaking, maintaining economic stability. The Bank has a central role in the regulation of financial services in the UK. Up until April 2015, it was also responsible for payment systems, settlement systems and clearing oversight; from that date, these responsibilities passed to the Payment Systems Regulator.
- The **Financial Policy Committee (FPC)** is a committee of the Bank of England. The FPC looks at the economy in broad terms to identify and address risks that may threaten the stability of the whole (or large parts of the) economy. The FPC has no direct regulatory responsibility for particular sectors of the financial services industry, but has various powers to take action where it sees threats to economic stability.
- The **Prudential Regulation Authority (PRA)**, has sole responsibility for the day-to-day prudential (financial) supervision of banks and other financial institutions. The PRA is within the Bank of England, although it is operationally independent. The PRA authorises large, systemically important providers of financial services such as banks, insurance companies and building societies.

KEY TERMS

CONDUCT REGULATION

Regulation requiring firms that provide products and services to consumers to ensure that those products and services meet the consumer's needs, and to act appropriately and to deal fairly with consumers.

PRUDENTIAL REGULATION

Regulation aimed at ensuring that a business is established and run on a sound financial basis. This aims to limit the risk of that business failing and, if a failure does occur, to limit any adverse impact on consumers and the wider economy.

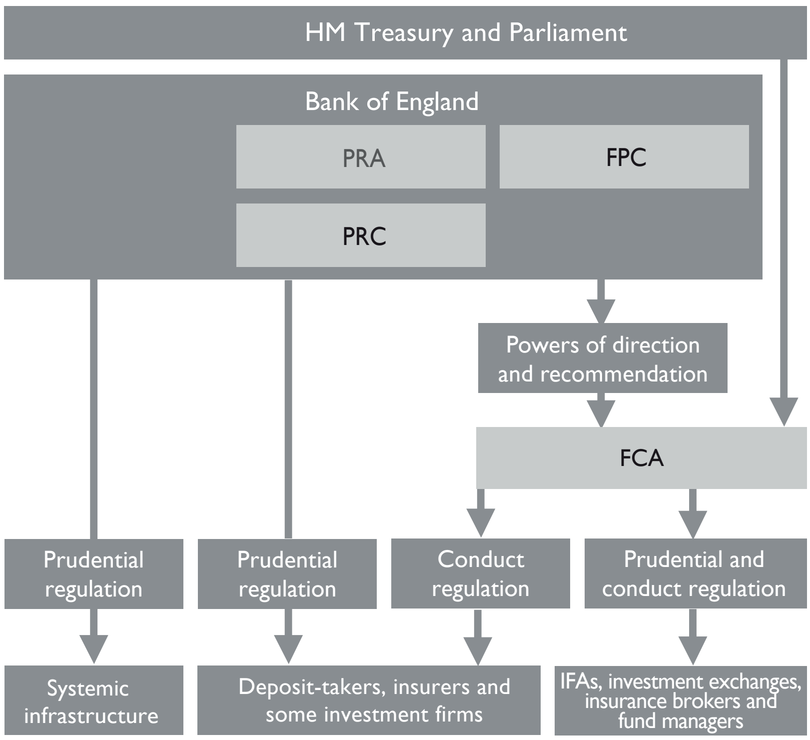
SYSTEMICALLY IMPORTANT PROVIDERS

Providers whose failure would have a significant adverse impact on the national or global financial system. Generally these would be providers with a large customer base.

The powers of the PRA are exercised by the Prudential Regulation Committee (PRC) which is also within the Bank of England. The PRA's primary objective is to promote the safety and soundness of the firms it regulates. It has further objectives to secure an appropriate degree of protection for insurance policyholders and to facilitate effective competition.

- The **Financial Conduct Authority (FCA)** has responsibility for the conduct of all retail and wholesale financial firms. The FCA also undertakes prudential supervision of firms that are not regulated by the PRA. The FCA is a quasi-government department with statutory powers given to it under the Banking Act 1987, the Financial Services and Markets Act 2000, and the Financial Services Act 2012 (the Act that created the FCA).

FIGURE 17.1 THE UK REGULATORY STRUCTURE

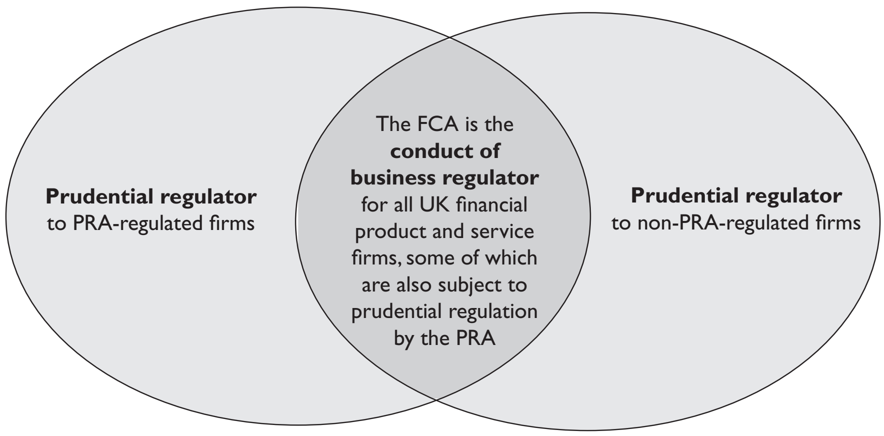


Source: Bank of England (2012)

17.5 What is the FCA's role?

The FCA is an independent financial regulator that reports to the Treasury and Parliament. The FCA and PRA oversee the regulation of the financial services industry in the UK. As noted above, the FCA is responsible for conduct regulation of all firms, and also for the prudential regulation of firms that are not considered to be systemically important. Thus some firms are regulated solely by the FCA, in relation to both prudential and conduct matters, while others are regulated by the PRA in respect of prudential matters and the FCA in respect of conduct.

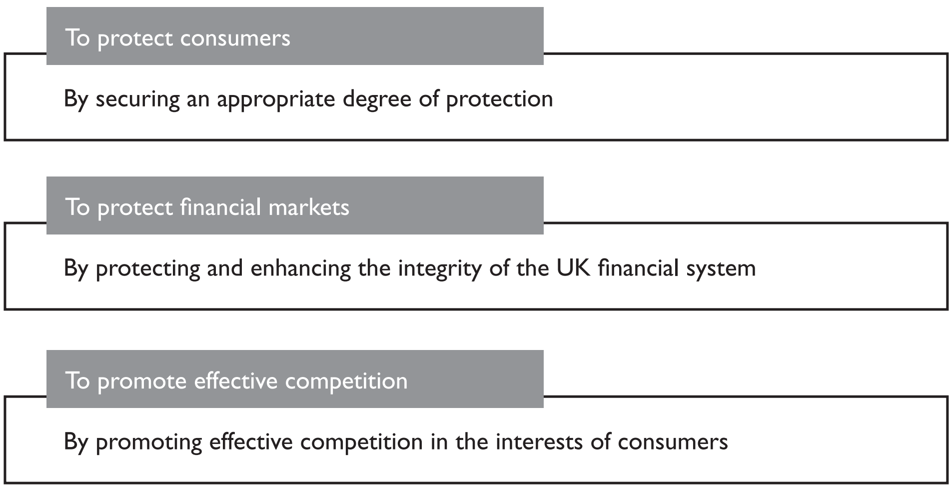
FIGURE 17.2 PRA AND FCA SPHERES OF RESPONSIBILITY



The FCA's strategic objective is to ensure that relevant financial markets work well so that consumers get a fair deal.

To do this, the FCA pursues three operational objectives, as defined in the Financial Services Act 2012 (Figure 17.3).

FIGURE 17.3 OPERATIONAL OBJECTIVES OF THE FCA



In seeking to promote competition, the FCA uses its powers to ensure that:

- there are no undue barriers to entry – in other words, to ensure that the required regulatory standards are not set so high that new providers are unable to enter the market;

- consumers are empowered to engage in such a way as to drive competition – for instance, by being able to switch providers easily if a product they hold becomes uncompetitive;
- no single firm or small group of firms dominates the market; and
- firms focus on consumers' genuine needs and ensure that recommendations made are suitable.

WORKING TOGETHER: THE FCA AND PRA

The FCA works closely with the PRA to exchange information that is relevant to each regulator's objectives, but acts as a separate entity when engaging with firms. A memorandum of understanding sets out two key principles for co-operation between the two regulators, which are that:

- each regulator's supervisory judgements will be based on all relevant information; and
- supervisory activity will not usually be conducted jointly.

One example where the co-operation between the FCA and the PRA is particularly important is in the supervision of insurers with with-profits business, because the returns from such investments are not well defined and impact on, or depend on, prudential as well as performance criteria.

As part of its continuous assessment of an insurer's financial soundness, the PRA ensures that any discretionary benefit allocations (such as discretionary bonuses) are compatible with the firm's continued safety and soundness.

The FCA monitors whether the proposed allocations are consistent with the insurer's previous communications to policyholders; that conduct in communicating and administering such payments is in line with the FCA's conduct rules; and that the insurer's overriding obligation to fair treatment of customers (see section 17.8.1) is maintained.

CHECK YOUR UNDERSTANDING 1

✓

Can you recall what is meant by 'with-profits business', referred to in the information panel on PRA and FCA co-operation?

CHECK YOUR UNDERSTANDING 2

A major clearing bank has its headquarters in London but operates in many other countries. It is regulated by:

a) the PRA.

b) the PRA and the FPC.

c) the FCA.

d) the PRA and the FCA.

17.6 What powers does the FCA have?

The FCA has powers to enforce the prohibitions in the Competition Act 1998 on anti-competitive behaviour in relation to the provision of financial services. It also has powers under the Enterprise Act 2002 to carry out market studies and make market investigation referrals to the Competition and Markets Authority (CMA) relating to market studies. The competition powers held by the FCA in respect of financial services are the same as those held by the CMA, so the FCA and the CMA are concurrent regulators.

The FCA has product intervention powers, which means that it is able to act quickly to ban or impose restrictions on financial products if it thinks that they are not in the best interests of consumers because of their complexity or suitability. It can disclose details of warning notices issued in relation to disciplinary action. It can take formal action in response to misleading financial promotions and publicise the fact that it has done so.

In discharging its powers, the FCA adopts a “proportionate” approach, focusing its resources on those areas of the industry and firms that pose the greatest risk to its objectives.

The PRA and the FCA are jointly responsible for the Financial Services Compensation Scheme (FSCS), and the FCA is responsible for the Financial Ombudsman Service (FOS).

IN BRIEF

THE FCA'S POWERS

- **Competition powers** to open up competition, carry out market studies and make referrals to the CMA.
- **Product intervention powers** to ban or restrict financial products.
- **Power of disclosure** to publish details of warning notices issued and disciplinary action taken.
- **Power to take formal** action against misleading financial promotions.

COMPETITION AND MARKETS AUTHORITY

In April 2014 the Competition and Markets Authority (CMA) replaced the Competition Commission and took over the competition powers formerly held by the Office of Fair Trading. Like the FCA, the CMA aims to promote competition for the benefit of consumers. It is responsible for investigating mergers that could restrict competition, carrying out investigations into markets where competition may not be working effectively and enforcing consumer protection legislation. It has powers to impose financial penalties and, in the case of cartels, is able to bring criminal proceedings.

17.7 What is in the FCA Handbook?

The FCA Handbook details the FCA's requirements of firms that operate in the financial services industry and consists mainly of rules and guidance:

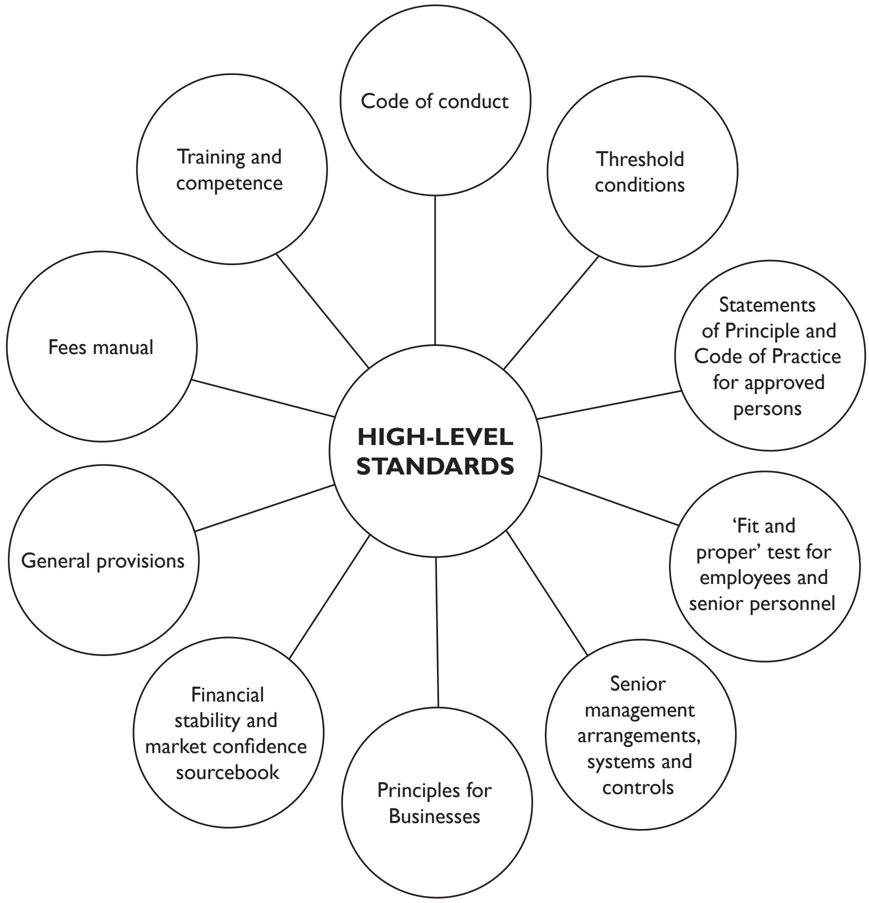
- **Rules** – most of the rules in the Handbook create binding obligations on authorised firms. If a firm contravenes a rule, it may be subject to enforcement action and, in certain circumstances, to an action for damages.
- **Guidance** – the purpose of guidance is to explain the rules and to indicate ways of complying with them. The guidance is not binding, however, and a firm cannot be subject to disciplinary action simply because it has ignored the guidance; compliance with the rules is the key consideration, and firms have discretion as to how they achieve this.

In this text, we cover the areas of the FCA Handbook of greatest interest to financial advisers and mortgage advisers, to enable advisers to carry out their activities in an efficient, safe and well-regulated manner.

17.7.1 High-Level Standards

The High-Level Standards section of the FCA's Handbook details overarching standards applying to all firms and authorised individuals. The areas it covers are outlined in Figure 17.4.

FIGURE 17.4 FCA HIGH-LEVEL STANDARDS



17.7.2 Prudential standards

For those firms regulated solely by the FCA, prudential standards are detailed in the prudential sourcebooks. They deal with the financial soundness and management of firms, and cover issues such as the valuation of a firm's assets and liabilities, its reserves, and financial reporting. The PRA establishes and monitors prudential requirements for dual-regulated firms; we look at the role of the PRA in more detail in Topic 19.

17.7.3 Business standards

Business standards are described in the following sourcebooks:

- **Conduct of Business sourcebooks** comprising the:
  - the Conduct of Business Sourcebook (COBS), which sets general conduct standards;
  - Banking: Conduct of Business Sourcebook (BCOBS);
  - Insurance: Conduct of Business Sourcebook (ICOBS);
  - Mortgages and Home Finance: Conduct of Business sourcebook (MCOB).

  These individual sourcebooks set out the standards that apply to the marketing and sale of financial services products. We look at them in greater detail in Topic 21.
- **Market Conduct Sourcebook** – this concerns investment markets and is therefore primarily of interest to investment firms. It covers such issues as insider dealing.
- **Client Assets Sourcebook** – contains the requirements relating to holding client assets and safe custody of client assets.

17.7.4 Regulatory processes

This section of the Handbook covers regulatory processes, including rules and guidance for firms wishing to seek authorisation. It also includes the Supervision manual, which sets out the way that the FCA regulates and monitors the compliance of authorised firms.

17.7.5 Redress/specialist sourcebooks

The two remaining sections of the Handbook cover:

- **redress** – including regulatory standards for dealing with complaints and the provision of compensation; and
- **specialist sourcebooks** – including arrangements for credit unions, professional firms such as solicitors and accountants, collective investments (COLL), consumer credit (CONC), investment funds, recognised investment exchanges and regulated covered bonds.

CHECK YOUR UNDERSTANDING 3

Getting to grips with the different sections of the FCA Handbook can be a challenge! To check your understanding of what you have read so far, in which sections of the FCA Handbook would you look for information on each of the following?

a) Training and competence requirements.

b) Rules surrounding the sale of mortgages.

c) General rules about conduct of business.

d) Rules relating to consumer credit.

e) Rules relating to compensation and complaints.

17.8 What are the Principles for Businesses?

The FCA's regulatory regime is based on a set of 11 'Principles for Businesses', from which all of the more precise rules and regulations follow. They apply to the behaviour of firms and of the individuals who carry out the firm's activities. The Principles, which are set out in the PRIN subsection of the High-Level Standards in the FCA Handbook, are shown in Figure 17.5.

KEY TERMS

SENIOR MANAGEMENT FUNCTIONS

Key individuals within a firm who perform significant roles. Individuals must be pre-approved by the FCA/PRA before they are appointed.

CERTIFICATION FUNCTIONS

Individuals who must be certified as fit and proper to carry out their role. Also known as significant harm functions, this includes mortgage and investment advisers.

FIGURE 17.5 FCA PRINCIPLES FOR BUSINESSES

1. Integrity
A firm must conduct its business with integrity

2. Skill, care and diligence
A firm must conduct its business with due skill, care and diligence

3. Management and control
A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems

4. Financial prudence
A firm must maintain adequate financial resources

5. Market conduct
A firm must observe proper standards of market conduct

6. Customers' interests
A firm must pay due regard to the interests of its customers, and treat them fairly

7. Communications with clients
A firm must pay due regard to the information needs of its clients and communicate information to them in a way that is clear, fair and not misleading

8. Conflicts of interest
A firm must manage conflicts of interest fairly, both between itself and its customers and between one customer and another

9. Customers: relationships of trust
A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely on its judgement

10. Clients' assets
A firm must arrange adequate protection for clients' assets when it is responsible for them

11. Relations with regulators
A firm must deal with its regulators in an open and co-operative way, and must disclose anything of which the FCA or PRA would reasonably expect notice

There is a set of conduct rules that apply to all individuals working in the financial services industry, except for those in certain 'ancillary' roles.

There is also a set of senior management conduct rules for those who carry out a senior management function.

We look at the Senior Managers and Certification Regime and the codes of conduct in more detail in Topic 18.

17.8.1 Fair treatment of customers

In order to ensure that regulatory principles are translated into a practical, properly controlled regulatory regime, the FCA has established a very large body of rules, many of which are found in the sourcebooks listed in section 17.7.

The establishment of rules and regulations can, however, have serious drawbacks. People and organisations may make it their aim to comply with the letter of the law rather than to operate according to its spirit. There is also the danger firms might be able to hide behind the rules, using loopholes or technicalities to their own advantage.

The former regulator, the FSA, was aware of these potential drawbacks, so it introduced an initiative known as treating customers fairly (TCF), which the FCA has continued to pursue. Among the FCA's Principles, Principle 6 states that "a firm must pay due regard to the interests of consumers and treat them fairly". The FCA expects that all firms must be able to show consistently that the fair treatment of consumers is at the heart of their business.

17.8.2 What does fairness mean in practice?

The FCA does not provide a definition of 'fair'; its view is that fairness is a concept that is "flexible and dynamic", which can "vary with particular circumstances". Firms must decide for themselves what fair treatment means within the context of their own business. What is clear is that the FCA intends fair treatment to apply at every stage throughout the life cycle of financial products, such as:

- product design;
- sales and marketing;
- advice and selling;
- administration; and
- post-sales activities, including claims handling and dealing with complaints.

The FCA provides some guidance on the types of behaviour it wishes to see and suggests a number of areas that a firm should consider. These include:

- considering specific target markets when developing products;
- ensuring that communications are clear and do not mislead;
- honouring promises and commitments that it has made;
- identifying and eradicating root causes of complaints.

Responsibility for the fair treatment of consumers lies with a firm's senior management, which is required to ensure that fair treatment is "built consistently into the operating model and culture of all aspects of the business".

17.8.3 Clarity in sales

A key issue the former regulation, the FSA, intended to address when it launched the original TCF initiative was the extent to which customers are helped to understand the financial products they are buying. Firms are expected to be clear about the services they offer and about the true cost to the customer. Information must be provided to customers in a way that is clear, fair and not misleading. Firms should always consider the ways that the customer will assess their product against others in the market, and ensure that a fair comparison can be made. This means not only that product literature should be clear and appropriate to the target customer group's expected financial sophistication, but also that the advice given should be of a sufficiently high quality to reduce the risk of mis-selling.

17.8.4 The FCA's 'six outcomes'

The FCA defines six outcomes (see Figure 17.6) that a firm should strive to achieve in order to ensure the fair treatment of its consumers, and makes it clear that these are at the core of what it expects from firms.

FIGURE 17.6 SIX OUTCOMES TO ENSURE FAIR TREATMENT OF CUSTOMERS

1	Consumers will be confident that the firms they are dealing with are committed to fair treatment of customers.
2	Products are designed to meet the needs of properly identified customer groups.
3	Consumers are provided with clear information at all stages, before, during and after a sale.
4	Any advice given is suitable for the customer, taking account of their circumstances.
5	Products perform as customers have been led to expect, and associated services are of an acceptable standard.
6	There are no unreasonable barriers to switching product or provider, making a claim, or complaining.

Since 2009, firms have had to demonstrate to the regulator that they are consistently treating their customers fairly. This can be done by using management information (MI) that shows how they are delivering the six consumer outcomes or, in areas of the business where outcomes are below standard, what action the firm is taking to address the issues.

MANAGEMENT INFORMATION (MI)

Data or statistics used to measure business performance and drive necessary change.

IN BRIEF

FAIR TREATMENT OF CUSTOMERS

- Due regard for the fair treatment of customers must apply at every stage of a product's life cycle.
- Information provided to customers must be clear, fair and not misleading.
- Firms should honour promises and commitments they make.
- Root causes of complaints should be analysed and eradicated.
- Senior managers are responsible for ensuring that fair treatment of customers is built into the operations and culture of the firm.
- Firms should seek to achieve the six outcomes for customers, as set out by the FCA.
- Firms must demonstrate to the FCA (eg through use of MI) that they are consistently treating customers fairly.

17.9 The prevention of financial crime

The FCA has an operational objective to enhance the integrity of the financial system and is therefore committed to reducing financial crime of all kinds, in particular:

- **market abuse**, which is separated (under EU definitions) into two aspects:
  - insider dealing, where a person who has information not available to other investors (eg a director with knowledge of a takeover bid) makes use of that information for personal gain;
  - market manipulation, where a person knowingly gives out false or misleading information (for instance about a company's financial circumstances) in order to influence the price of a share for personal gain;
- **money laundering**, which is dealt with in Topic 23.

WHISTLE-BLOWING

Firms should have whistle-blowing procedures in place to enable employees to report serious inappropriate circumstances or behaviour within the firm, which they believe are not being addressed. Workers who wish to report their knowledge or suspicions regarding, for example, a failure by the firm to comply with legislation, have a right to protection under the Public Interest Disclosure Act 1998. The firm's procedures should assist staff and not hinder them in the whistle-blowing process.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain why regulation of the financial services sector is necessary?
- define 'conduct regulation' and 'prudential regulation'?
- describe how the Bank of England, FPC, PRA and FCA together provide regulatory oversight of the sector?
- summarise the FCA's objectives?
- explain the difference between rules and guidance in the FCA Handbook?
- list the eleven Principles for Businesses?
- list the six outcomes that firms should seek to achieve to ensure the fair treatment of customers?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 17. Review the text if necessary.

Answers can be found at the end of this book.

1) The main driver for changes to the regulatory structure governing financial services that were introduced in 2013 was:

   a) the collapse of Barings Bank.

   b) the weaknesses exposed by the 2007–09 financial crisis and a number of mis-selling scandals.

   c) the deregulation of banks and building societies.

   d) the need to respond to changes in lifestyle.

2) The FCA's role is to identify and address risks that may threaten the stability of the economy as a whole. True or false?

3) The FCA is the conduct regulator for all firms within the financial services industry and the prudential regulator for firms that are not considered systemically important. Explain what is meant by:

   a) conduct regulation.

   b) prudential regulation.

   c) systemically important.

4) Name the three operational objectives of the FCA.

5) What is the difference between 'rules' and 'guidance' in the FCA Handbook?

6) Name four powers that the FCA can exercise in its regulation of business conduct.

7) Which one of the following is **not** one of the FCA 'Principles for Businesses' with which a firm must comply?

   A firm must:

   a) communicate with customers in a clear manner.

   b) conduct its business with integrity.

   c) maintain an independent compliance function.

   d) observe proper standards of market conduct.

8) The FCA Handbook contains a section on redress. This section of the Handbook is primarily concerned with:

   a) sales policy.

   b) recruitment standards.

   c) maintaining and developing skills and knowledge.

   d) complaints and compensation.

9) Which of the following is the phrase used by the FCA to summarise its requirements for effective communication designed to ensure the fair treatment of customers?

   Information must be:

   a) accurate, up to date and detailed.

   b) clear, fair and not misleading.

   c) brief, clear and accurate.

   d) concise, written in plain English and truthful.

10) What are the six outcomes for retail customers that a firm must aim to deliver to demonstrate that it is providing fair treatment to its customers?

TOPIC 18

Regulating firms and individuals

LEARNING OBJECTIVES

In Topic 17, we looked at the main aims and objectives of the FCA. In this topic we focus on how the FCA goes about supervising firms and individuals in order to fulfil its broader objectives.

By the end of this topic you should have an understanding of:

- regulated activities and investments;
- the responsibilities of senior managers and the Senior Managers and Certification Regime (SM&CR);
- the 'fit and proper' requirements;
- how the FCA categorises the supervision of firms;
- training and competence requirements;
- the FCA's enforcement and disciplinary powers.

This topic covers the Unit 2 syllabus learning outcomes K1.4, K1.5, U1.1, U1.3, U1.4, U2.1 and U2.3.

THINK ...

Many of the FCA's rules are designed to ensure that individuals who look after other people's money have the appropriate character and integrity to do so, are properly trained for their role, and their performance monitored.

If you are already working in the financial services sector, think about how you are supervised and who takes ultimate responsibility for the work you do.

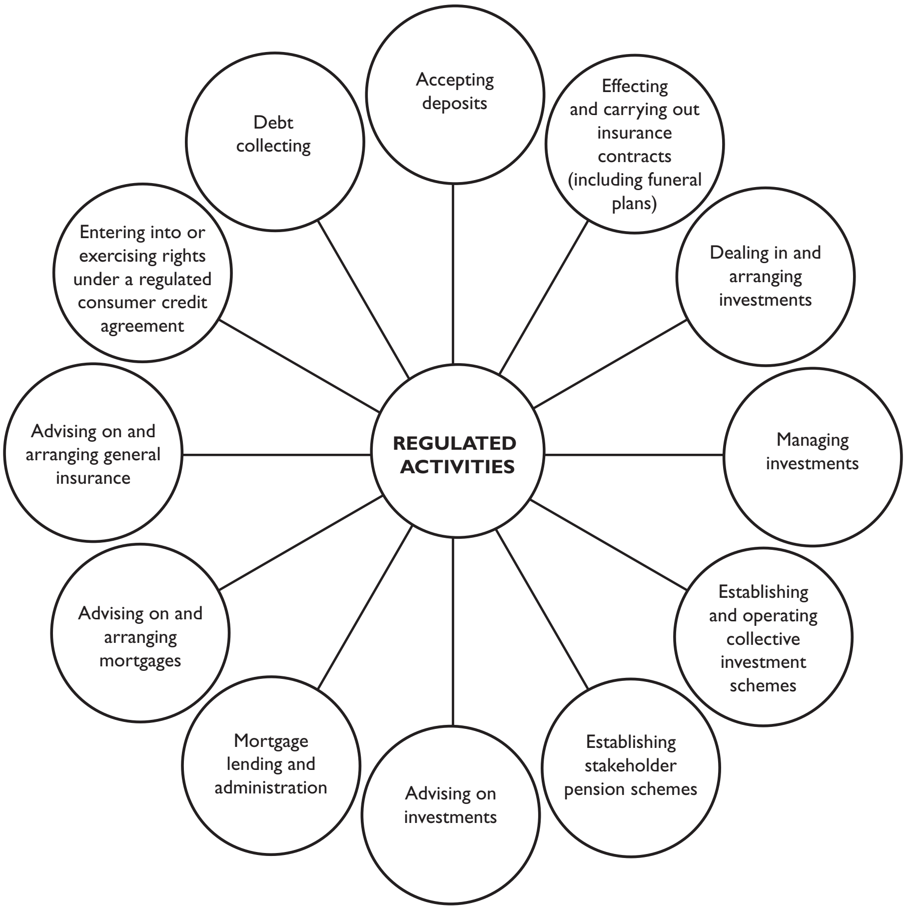
If you are not yet working in the sector, think about what characteristics would make an individual suitable to be responsible for other people's money. What information would you want to know to give you confidence in their integrity?

18.1 What are regulated activities and investments?

Any financial services business that carries out a regulated activity in relation to a regulated investment in the UK must be authorised – by the PRA (if it is a systemically important business) or the FCA (for smaller businesses).

Figures 18.1 and 18.2 provide examples of regulated activities and regulated investments, respectively.

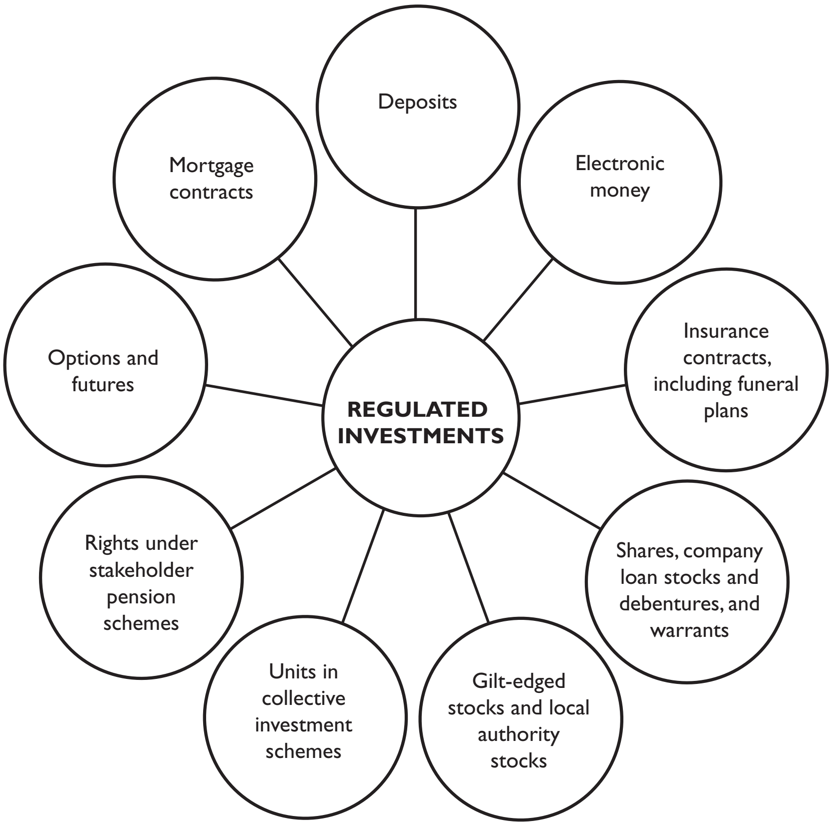
FIGURE 18.1 EXAMPLES OF REGULATED ACTIVITIES



The FCA defines two key categories of regulated investment:

- securities (such as shares, debentures and gilts); and
- contractually based investments (including life policies, personal pensions, options and futures).

FIGURE 18.2 EXAMPLES OF REGULATED INVESTMENTS



REGULATED ACTIVITIES: LEGAL BASIS

The activities for which firms must be authorised were first listed in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, often referred to as the Regulated Activities Order (RAO).

The section of the Financial Services and Markets Act (FSMA) 2000 under which permission may be granted to a firm to carry out regulated activities is Part 4A – so this form of permission is often known as Part 4A permission. Permission is granted in the form of a list of regulated activities that the firm is allowed to carry out; it also shows the regulated investments with which the firm is allowed to deal.

The range of regulated activities covered by FSMA 2000 changes periodically as new activities fall under FCA and/or PRA regulation. For example, with effect from April 2014, the provision of consumer credit came within FCA regulation.

18.2 What is the Senior Managers and Certification Regime (SM&CR)?

In addition to regulating the activities of firms, the FCA also regulates the appointment and activities of individuals within the firm. The rules relating to this aspect of its work are set out in the High Level Standards section of the FCA Handbook.

FACTFIND

You can access all the High Level Standards in the FCA Handbook at:

https://www.handbook.fca.org.uk/handbook [Accessed: 18 February 2020].

Two particular issues the regulators had to address in the aftermath of the 2007–09 financial crisis were criticism of its approved persons regime by the Parliamentary Committee on Banking Standards, and difficulties in identifying which individual or individuals are responsible for a business's failings. In response, the FCA and PRA introduced a Senior Managers and Certification Regime (SM&CR) for banks, building societies and credit unions from March 2016. This framework establishes an individual accountability framework and regulates individual conduct and standards in the financial services industry. The FCA extended the SM&CR regime to FCA solo-regulated financial services firms on 9 December 2019. This includes appointed representatives.

APPOINTED REPRESENTATIVES (ARS)

An appointed representative (AR) is a firm or person who runs regulated activities and acts as an agent for a firm, which is known as the AR's 'principal'.

The principal firm is the regulated entity, not the AR, and the principal takes full responsibility for ensuring that the AR complies with FCA rules.

18.2.1 The SM&CR framework

There are three tiers under the SM&CR:

- **Core** – firms in this tier will have to comply with the baseline requirements outlined in the rest of this section.

- **Enhanced** – only the firms representing the greatest risk to consumers or markets will be classed as enhanced firms. These firms will have additional requirements.
- **Limited scope** – this will apply to firms that are already exempt under the approved persons regime. They will be exempt from some baseline requirements and will generally have fewer senior management functions.

The core regime will apply to the majority of these firms, and will consist of three key elements:

- The Senior Managers Regime.
- Certification Regime.
- Code of Conduct.

18.2.2 What is the Senior Managers Regime (SMR)?

The SMR focuses on individuals in key roles in relevant firms. The FCA has a number of designated senior management functions for core SM&CR firms (see Table 18.1). These are the functions the regulator feels pose the greatest risk to either customers or market integrity if the person conducting them is not fit to do so. There is also a range of prescribed responsibilities that must be allocated among the senior management of a business.

Where an individual applies for a senior management role or moves to a different senior manager role that is materially different from their current one, they must be pre-approved by the regulator. Their application must be accompanied by a "statement of responsibilities", detailing the aspects of the business for which they will take responsibility. The regulator can then compare the personal capabilities of the individual with the nature of the role they will be performing. Once an individual is appointed, firms must have robust procedures to equip the senior manager to carry out their role effectively. Firms are also required to ensure the ongoing fitness and propriety of their senior managers.

Enhanced firms have two additional requirements in which they must:

- maintain a "responsibilities map", which details the way responsibilities are allocated between the senior management should problems arise, the "responsibilities map" enables the regulator to more easily identify which person is responsible.
- ensure that each activity, business area and management function is allocated a senior manager with overall responsibility.

There is a statutory duty for senior managers to take "reasonable steps" to prevent regulatory breaches in their area of responsibility. If a breach occurs, then, in order to take action against an individual, the regulator must be able to prove that the senior manager failed to take reasonable steps to prevent the breach occurring.

The penalties for senior managers are wide and potentially severe. The FCA is empowered to instigate criminal proceedings against a senior manager whose action or inaction has led their business to fail, through "reckless misconduct". If an individual is found guilty, the maximum punishment is a prison sentence of up to seven years and/or an unlimited fine.

TABLE 18.1 FCA-DESIGNATED SENIOR MANAGEMENT FUNCTIONS FOR CORE SM&CR FIRMS

SMF 1	Chief executive
SMF 3	Executive director
SMF 27	Partner function
SMF 9	Chair
SMF 16	Compliance oversight function
SMF 17	Money laundering reporting function

A more comprehensive list applies to enhanced firms, and a condensed one for limited scope firms. For further information you can visit: https://www.fca.org.uk/publication/policy/guide-for-fca-solo-regulated-firms.pdf [Accessed: 13 October 2020].

18.2.3 What is the Certification Regime (CR)?

The regulator recognises that the actions of those in more junior roles, below senior management level, could still cause major damage to a business and its customers. The FCA therefore defines a number of "certified" functions. A certified function is one involving aspects of the firm's business where there is a potential risk of significant harm to the firm or its customers.

Individuals in certified functions are subject to the Certification Regime (CR): they are not required to secure direct approval from the FCA but the firm, in effect, certifies their fitness and propriety to carry out the role. Each firm must take reasonable care to ensure that no employee carries out a role for which certification is required until they have been assessed as "fit and proper". Their continued fitness and propriety must be assessed on an ongoing basis, at least annually.

The FCA certification regime applies to the following functions:

- Significant management function.
- Proprietary traders.
- CASS operational oversight functions.
- Functions subject to qualification requirements, eg mortgage advisers, retail investment advisers and pension transfer specialists.

- Client dealing function, eg financial advisers and investment managers.
- Anyone supervising or managing a certified function who is not themselves a senior manager.
- Material risk takers.
- Those with responsibility for algorithmic trading.

A designated senior manager must be responsible for each firm's certification regime.

18.2.4 What is the Code of Conduct?

Under SM&CR, the regulator has the power to make rules of conduct that apply to senior managers, certified persons and other employees. Conduct rules set expectations about standards of behaviour for those employed in firms covered by the Senior Managers Regime, other than ancillary staff (ie those performing a role that is not specific to financial services, such as security staff, IT support, etc).

The tier one individual conduct rules are:

- **CR1** – you must act with integrity.
- **CR2** – you must act with due skill, care and diligence.
- **CR3** – you must be open and co-operative with the FCA, PRA and other regulators.
- **CR4** – you must pay due regard to the interests of customers and treat them fairly.
- **CR5** – you must observe proper standards of market conduct.

The tier two conduct rules for senior managers are as follows:

- **SM1** – you must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
- **SM2** – you must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system.
- **SM3** – you must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.
- **SM4** – you must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

Firms must:

- make individuals who are subject to the rules aware that this is the case, and provide training on how the rules apply to them;

- take effective action where staff fall below required standards.

18.2.4.1 Reporting

The FCA requires firms to report to it within seven days if they take disciplinary action against a senior manager as a result of a breach of one or more rules of conduct. For all other staff, an annual report suffices. The FCA itself may take disciplinary action against an individual found to be in breach of the conduct rules; however, it is only likely to do so in extremely serious cases.

18.2.5 What are the rules on fitness and propriety?

An individual subject to the SM&CR must be deemed "fit and proper" to carry out such a role. The FCA sets out the following criteria.

- **Honesty, integrity and reputation** – these can be judged from a number of factors, including:
  - criminal record;
  - disciplinary proceedings;
  - known contravention of FCA (or other) regulations or involvement with companies that have contravened regulations;
  - complaints received, particularly about regulated activities;
  - insolvency, or management of companies that have become insolvent;
  - dismissal from a position of trust or disqualification as a director.
- **Competence or capability** – in terms of meeting the FCA's training and competence requirements (these are discussed in section 18.8).
- **Financial soundness** – as indicated by:
  - current financial position;
  - previous bankruptcy or an adverse credit rating.

In addition to the requirements detailed above, the FCA requires that, when assessing whether a person is fit and proper to perform a senior management function, particular consideration must be given to whether that individual:

- has obtained a relevant qualification;
- has undergone or is undergoing training;
- possesses a relevant degree of competence;
- has the personal characteristics required by the FCA.

Despite the FCA's emphasis on fitness and propriety there is a risk that an individual with a poor conduct/disciplinary record could gain continued employment in the financial services industry by moving from firm to firm if each new employer remained unaware of past issues. To counter the risk, the FCA requires that before an individual can be appointed to a senior manager role:

- they must be verified as being "fit and proper" to exercise their duties;
- the prospective employer carries out checks in respect of any criminal record and a credit check;
- references are provided from the individual's current and former employers covering the last six years. The reference should include details of any disciplinary action taken against the individual over the last six years due to breaches of the conduct rules and any findings that the person was not fit and proper. Any other information relevant to assessing whether they are fit and proper covering the previous six years should also be provided.

Prior to being appointed to a certificated function an individual must also be verified as fit and proper, have their last six years' references checked, and have a certificate for their function. There is, however, no requirement for a criminal record check.

The Financial Services Register is a public record of firms, individuals and other bodies that are, or have been, regulated by the PRA and/or FCA.

Under SM&CR, the FCA will publish and maintain a directory of certified and assessed persons on the Financial Services Register so consumers and professionals can check the details of key individuals working in financial services. Firms will be responsible for submitting and maintaining a person's data using the FCA's Connect system. You can find out more at the following link: https://www.fca.org.uk/firms/directory-persons [Accessed: 13 October 2020].

18.3 What are the responsibilities of senior managers?

Senior managers must take responsibility for a firm's compliance with FCA regulations and produce relevant management information (MI). This is to demonstrate that their advisers give quality advice and treat customers fairly, and there are three particular ways in which they are required to achieve this. They must ensure that:

- the firm embodies a compliance culture, with senior managers using MI to drive forward the firm's fair treatment of customers and the quality of their advice process;
- all staff have clearly defined responsibilities and are monitored appropriately;
- monitoring and compliance procedures are regularly reviewed and updated.

18.3.1 Systems and controls

A firm must implement systems and controls that are "appropriate to its business", and it must be able to demonstrate that such systems and controls are appropriate. Systems and controls must be clearly documented and regularly reviewed. They will relate to a wide range of the firm's activities, including:

- the establishment of clear chains of responsibility, delegation and reporting;
- compliance;
- assessment and reporting of risk;
- reporting of other management information;
- competence and honesty of staff, particularly those who are subject to the SM&CR, with senior management applying the 'competent employee' rule, ie employees must have the necessary skills to carry out the job for which they are employed;
- a strategy for controlling business risks and for recovering from serious problems such as fire or computer failure;
- adequate and readily accessible records (with backup) of systems and controls must be securely kept;
- an audit of the systems and controls must be made independently of the persons who normally operate them.

18.4 What is the FCA's approach to supervising firms?

The FCA seeks to ensure that firms are complying with regulatory requirements through a programme of supervision, based on ten principles (see Figure 18.3).

FIGURE 18.3 TEN FCA PRINCIPLES FOR SUPERVISION

1	Ensuring fair outcomes for consumers and markets
2	Being forward-looking and pre-emptive – identifying potential risks and taking action before they have a serious impact
3	Being focused on the big issues and causes of problems – resources are focused on issues that may significantly impact the FCA's objectives
4	Taking a judgement-based approach
5	Ensuring firms act in the right spirit – not just complying with the letter of the law but with a focus on considering the impact of their actions
6	Examining business models and culture and the way they impact on consumer and market outcomes
7	An emphasis on individual accountability
8	Being robust when things go wrong, making sure problems are fixed, consumers are protected and compensated, poor behaviour is rectified and root causes eliminated
9	Communicating openly with the industry, firms and consumers
10	Having a joined-up approach to ensure that messages provided are consistent

CHECK YOUR UNDERSTANDING 1

Can you recall from your studies in Topic 17 what the difference is between regulation and supervision? It is important for your understanding of this topic, so look back to the definitions in Topic 17 if you aren't sure.

18.4.1 How does the FCA prioritise its supervisory activity?

We saw in Topic 17 that the FCA adopts a "proportionate" approach to supervision, focusing its resources on those areas of the industry and firms that pose the greatest risk to its objectives. Firms are categorised according to their potential impact on the FCA's objectives. The category in which the FCA places a firm determines the style of supervision carried out (see Figure 18.4).

The FCA's system of categorising firms uses a combination of factors with reference to the number of customers a firm has and the likely impact of a firm's failure on the financial services sector and the economy as a whole.

- 'Fixed portfolio' firms are a relatively small number of firms that, based on size, customer numbers and market presence require the highest level of supervisory attention.

- The vast majority of firms present a lower level of risk and are classed as 'flexible portfolio' firms. These firms are supervised through a mixture of targeted supervisory work depending on the markets they operate in and programmes of communication and education.

Figure 18.4 summarises the categories and levels of supervision.

FIGURE 18.4 FCA FIRM CATEGORISATION AND LEVELS OF SUPERVISION

Fixed portfolio

- Banking and insurance groups with a very large number of retail customers and investment banks with very large assets and trading operations
- Subject to the highest level of supervision
- Supervised using continuous assessment
- Have a named supervisor

Flexible portfolio

- Can include a wide variety of firms across all sectors with retail customers and / or a significant wholesale presence
- Also includes smaller firms eg almost all intermediaries
- Their business models are analysed, but the FCA is more interested in firms that are 'outliers' compared with their peers
- The first contact point is the FCA's customer contact centre

CHECK YOUR UNDERSTANDING 2

Why is regulatory attention focused on fixed portfolio firms?

18.5 The FCA supervision model

The FCA's supervision model is based on three pillars (see Figure 18.5). These pillars draw on the ongoing analysis of each industry sector and the risks within them.

FIGURE 18.5 FCA SUPERVISION MODEL: THREE PILLARS

Pillar 1 Proactive firm or group supervision	Pillar 2 Event-driven, reactive supervision	Pillar 3 Issues and products
• Assessment asks whether the interests of customers and market integrity are at the heart of how the firm is run • Approach is forward looking • FCA will use judgement to address issues that could lead to damage to consumers or markets • Does not apply to flexible portfolio firms	• Responding swiftly and robustly when becoming aware of significant risks and where damage has already been done • Ensuring that risks are mitigated, further damage prevented and root causes addressed • If necessary, the FCA will use its powers to hold the firm and individuals to account and gain redress	• Each sector of the market is examined as a whole to analyse current events and to identify drivers of poor outcomes • Carried out on an ongoing basis to identify common issues before they cause widespread damage • For example, issues with a particular business practice or product

As well as focusing regulatory resources on those businesses posing the greatest risk to its objectives, the FCA focuses its supervision on the areas that have the greatest impact on consumers and market integrity. It examines different parts of a business's operations, and will be in direct contact with a number of people within the business in order to understand how it is run.

Areas of particular interest include the following:

- **Business model and strategy** – the FCA is aware that business strategy can drive behaviours that lead to poor customer outcomes. It seeks to ensure that a business has assessed and mitigated any risks to customers arising from its strategy, as part of its objective to ensure customers get products and services that meet their needs from providers they trust.
- **Culture** – culture underpins everything a business does and an appropriate culture will ensure the fair treatment of customers. The FCA will want to understand:
  - the way business is conducted;
  - expectations of staff; and
  - attitude to customers.
- **Frontline business processes** – this involves understanding the extent to which business processes are designed to give customers what they need and meet their expectations.
- **Systems and controls** – this aspect of supervision focuses on the extent to which culture is reinforced by effective systems and controls designed to identify and deal with risks in areas such as conduct and financial crime.

- **Governance** – the FCA expects senior management and the board within a firm to understand and be able to explain the conduct risks in their strategies. It pays particular attention to the way the governance of a business implements consumer- and market-focused strategies.

18.6 Training and competence

The FCA aims to be proactive rather than reactive, preventing problems from arising rather than simply dealing with them when they do. Ensuring high levels of knowledge and ability among financial services staff is key to achieving this objective. Consequently, the FCA places high importance on training and competence.

The FCA's Training and Competence (TC) sourcebook requires firms to make certain commitments regarding the competence of anyone within the remit of the SM&CR. It is particularly prescriptive in relation to three types of employee:

- financial advisers and those who deal in, or manage, investments;
- supervisors of those advisers, dealers or fund managers;
- supervisors who oversee certain 'back-office' administrative functions, particularly within a product provider (eg supervisors of the underwriting or claims functions in a life assurance company).

At the start of 2011, the TC sourcebook was moved into the High Level Standards part of the Handbook to reflect its increased importance.

TC rules cover the following areas. Note that they do not apply to firms transacting wholesale business with non-retail clients.

18.6.1 Training

Firms must, at appropriate intervals, determine each employee's training needs and organise training that is appropriate and timely. The success of the training in achieving its objectives must be evaluated.

18.6.2 Assessing initial competence

Investment advisers must not be allowed to commence activities until the employer is satisfied that an adviser has:

- achieved an adequate level of knowledge and skill to operate under supervision; and
- passed the regulatory module of an appropriate qualification for investment advisers at RQF Level 4 (such as the Financial Services Regulation and Ethics unit as part of the Diploma for Financial Advisers).

Individuals must work under close (direct) supervision until they have been assessed as competent to work under indirect supervision. Individuals must not be assessed as competent until they have:

- passed all modules of an appropriate examination (such as the Advanced Financial Advice unit as part of the Diploma for Financial Advisers); and
- demonstrated a consistent ability to act competently under minimum supervision.

Supervisors should have coaching and assessment skills as well as technical knowledge.

For investment advisers, the regulatory module of an appropriate qualification must be achieved prior to commencing the activity and the remaining modules must be achieved within 48 months of commencing the activity.

There are different examination standards for those in different roles: mortgage advisers must achieve an appropriate qualification in mortgages at RQF Level 3, such as the Certificate in Mortgage Advice and Practice (CeMAP®).There are no formal requirements for those working as overseers.

18.6.3 Appropriate examinations

The role of investment adviser comes within the remit of the SM&CR, and investment advisers are required to achieve a pass in an appropriate examination as demonstration of their competence. The Financial Skills Partnership publishes lists of appropriate examinations for investment advisers and other functions. Awarding bodies submit proposals for particular examinations; when these are accredited, they are added to the lists.

18.6.4 Maintaining competence

As well as ensuring that employees become competent, firms must have definite arrangements in place for ensuring that they maintain that competence. A review must take place on a regular and frequent basis to assess the employee's competence, and appropriate action must be taken to ensure that they remain competent for their role. Matters that must be taken into account include:

- technical knowledge and its application;
- skills and expertise;
- changes in the market and to products, legislation and regulation.

A retail investment adviser who has been assessed as competent must complete a minimum of 35 hours of appropriate continuing professional development (CPD) in each 12-month period; 21 hours of that CPD must be 'structured CPD'.

- Examples of **structured CPD** include attending courses, seminars, lectures, conferences, workshops or e-learning activities which entail a contribution of 30 minutes or more.

- **Unstructured CPD** includes conducting research as part of the adviser's role, reading industry or other relevant material, and participating in coaching or mentoring sessions.

Under the terms of the Insurance Distribution Directive, which took effect from 1 October 2018 (see section 24.4), advisers selling protection policies (if they are not subject to the FCA Training and Competence Regime) will be required to undertake a minimum of 15 hours' CPD each year.

RECORD-KEEPING

Firms must maintain records showing how and when employees' competence is being assessed. All records relating to the training and competence of individual employees must be retained for specific minimum periods of time after the person ceases to carry out the activity or leaves the company. The time limits are:

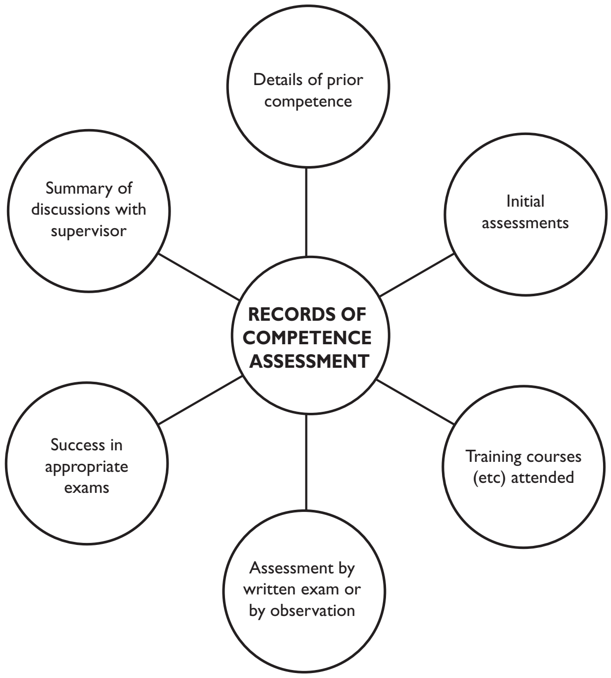
- at least three years for individuals carrying out non-MiFID business;
- at least five years for individuals carrying out MiFID business;
- indefinitely for individuals carrying out pensions transfer business.

Typical records might include some, or all, of the examples shown in Figure 18.6.

Since January 2013, advisers have been required to obtain a Statement of Professional Standing (SPS) each year from an FCA accredited body.

In order to receive an SPS, an adviser must meet the professional standards of the professional body and declare that they adhere to its code of ethics. They must also confirm that they hold the required qualifications to give retail investment advice.

FIGURE 18.6 RECORDS OF COMPETENCE ASSESSMENT



18.7 What enforcement action can the FCA take?

The FCA takes action when it considers that particular aspects of a firm's business model or culture (such as products, training, recruitment procedures or remuneration policies) are likely to harm consumers. It places emphasis on securing redress for consumers who have suffered harm.

The circumstances that may lead to an investigation cover a wide range of situations including, for example, suspicion that an authorised person is:

- contravening regulations;
- providing false information;
- falsifying documents;
- acting outside the scope of their Part 4A permission;
- participating in money laundering;
- allowing persons who are not approved or certified to carry out functions within the remit of the SM&CR;
- falsely claiming to be authorised;
- undertaking insider dealing or market manipulation.

The person appointed to carry out the investigation on the FCA's behalf has the power to:

- demand that the person being investigated or anyone connected with them:
  - answer questions;
  - provide information;
- demand that any person (whether or not they are being investigated or are connected with the person under investigation) provide documents. In the case of a specific investigation, any person can also be required to answer questions or provide information.

If the FCA is satisfied that it has discovered a contravention of its rules, there are a number of steps that it can take, depending on its view of the nature and/or the severity of the contravention. Some of these are described in Figure 18.7.

FIGURE 18.7 FCA ENFORCEMENT POWERS

Variation of a firm's permissions

This may involve removal of one of the firm's permitted regulated activities or a narrowing of the description of a particular activity

Withdrawal of approval

The FCA might withdraw or suspend a person's approval or certification to carry out some or all of their role

Injunction

If a person has contravened a regulation, the FCA can apply for an injunction to prevent that person from benefiting from the action, for instance by selling assets that they have misappropriated

Restitution

If a person has benefited from a contravention of a regulation, the FCA can ask the court for an order requiring that person to forfeit to the FCA any profit made from the activity

Redress

- If it can be shown that losses have been made by identifiable customers as a result of the contravention of a rule, the FCA may be able to obtain a court order requiring such losses to be made good
- However, there may be more appropriate ways for that customer to pursue such claims, such as through the Financial Ombudsman Service or the Financial Services Compensation Scheme (see Topic 25)

Disciplinary action

If an approved person or an authorised firm is judged to be guilty of misconduct, the FCA has a range of options regarding the sanctions it might apply. These are to:

- issue a 'warning notice'
- publish a statement of misconduct
- impose a financial penalty

Disclosure

The FCA can announce that it has begun disciplinary action against a firm, although it must consult the recipient of the warning notice before making such an announcement

Enhanced supervision

- This is an intensive supervisory regime designed to deal with issues in firms that are considered to have serious governance failings
- The FCA can enforce a range of actions, which include requiring the firm's board to commit to specific remedial action, progress on which will then be reviewed
- As an alternative, the FCA can impose binding requirements on a firm in respect of certain actions it must take

Before taking action against a dual-regulated firm, the FCA will consult with the PRA. If the decision is relevant to both regulators, they will decide whether it is best to pursue a joint investigation or for one of them to act alone, keeping the other informed of developments and findings.

CHECK YOUR UNDERSTANDING 3

Over the last two topics, you have covered a lot of information on the FCA, its role as a regulator and its approach to supervision. To check how much of the detail you have taken in, try to **match** the statements in the first column below with the FCA principle, objective or activity to which it relates.

A firm must pay due regard to the interests of its customers, and treat them fairly	One of ten key FCA principles for supervision
Consumers are provided with clear information at all stages, before, during and after a sale	A TC requirement for demonstrating initial competence
Ensuring that relevant financial markets work well so that consumers get a fair deal	One of the FCA's enforcement powers
Ensuring firms act in the right spirit – not just complying with the letter of the law but with a focus on considering the impact of their actions	One of the Principles for Businesses
Removal of one of the firm's permitted regulated activities or a narrowing of the description of a particular activity	FCA strategic objective
An employer must be satisfied their employee has achieved an adequate level of knowledge and skill to operate under supervision	One of six FCA outcomes for fair treatment of customers

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- list six examples of regulated activities?
- list six examples of regulated investments?
- describe the key elements of the Senior Managers Regime?
- summarise the FCA criteria for assessing whether individuals are 'fit and proper persons'?
- explain the difference between a fixed portfolio and a flexible portfolio firm?
- outline the steps that a firm must take to demonstrate that its employees are maintaining competence?
- outline the FCA's enforcement powers?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 18. Review the text if necessary.

Answers can be found at the end of this book.

1) What is Part 4A permission?

2) One of the reasons why direct investment in shares is considered higher risk is because it is not classified as a regulated investment. True or false?

3) When assessing whether a person is fit and proper to perform a senior management function, the FCA requires that particular attention be given to certain factors. Which of the following is **not** a factor that the FCA requires to be considered?

    a) Whether the person has obtained a relevant qualification.

    b) Whether the person has undergone or is undergoing training.

    c) Whether the person possesses a relevant degree of competence.

    d) Whether the person has worked in the financial services industry for at least five years.

4) Which one of the following job applicants is least likely to meet the FCA 'fit and proper' requirements?

    a) George, who has recently been made redundant from a firm of independent financial advisers.

    b) Irene, who currently has an authorised overdraft limit of £2,000.

    c) Francois, whose father's house was taken into possession by the lender three years ago.

    d) Yvette, who has missed her last two mortgage payments following a divorce.

5) What was the main reason behind the introduction of the Senior Managers and Certification Regime in 2016?

6) An employee is being reviewed to ensure they are maintaining their competence, as required by the TC sourcebook. What three areas will the review focus on?

7) What is a 'fixed portfolio' firm?

8) If the FCA discovers a contravention of its rules, one of the steps it may take is to vary a firm's permissions. This means that:

    a) the firm may no longer be able to carry out one or more of its regulated activities.

    b) the firm will be required to sell assets to provide restitution.

    c) the firm will need to seek authorisation from a different regulator.

    d) the firm will be required to submit each sale to the FCA for approval.

9) In relation to the FCA's enforcement powers, what is the difference between 'restitution' and 'redress'?

10) Whose rights are protected by the Public Interest Disclosure Act 1998?

    a) Shareholders who oppose directors' remuneration packages.

    b) Employees who raise concerns about breaches of regulation or other misconduct.

    c) Bank/building society deposit account holders in the event of a provider becoming insolvent.

    d) MPs who raise concerns about financial services providers in Parliament.

TOPIC 19

Prudential supervision

LEARNING OBJECTIVES

In Topic 18, the main focus was on how firms and individuals are regulated and supervised, to protect consumers and make sure the market operates efficiently. In this topic we will explore the regulations that are designed to ensure firms, large and small, are run prudently, are financially sustainable and do not expose their customers to undue risk.

By the end of this topic, you should have an understanding of:

- the international regulators that set prudential standards;
- the key concepts of capital adequacy, liquidity and operational risk;
- the requirements of the Basel Accords;
- the Capital Requirements Directive (CRD IV);
- Solvency II;
- the FCA and PRA prudential sourcebooks.

This topic covers Unit 2 syllabus learning outcomes U1.2.

THINK …

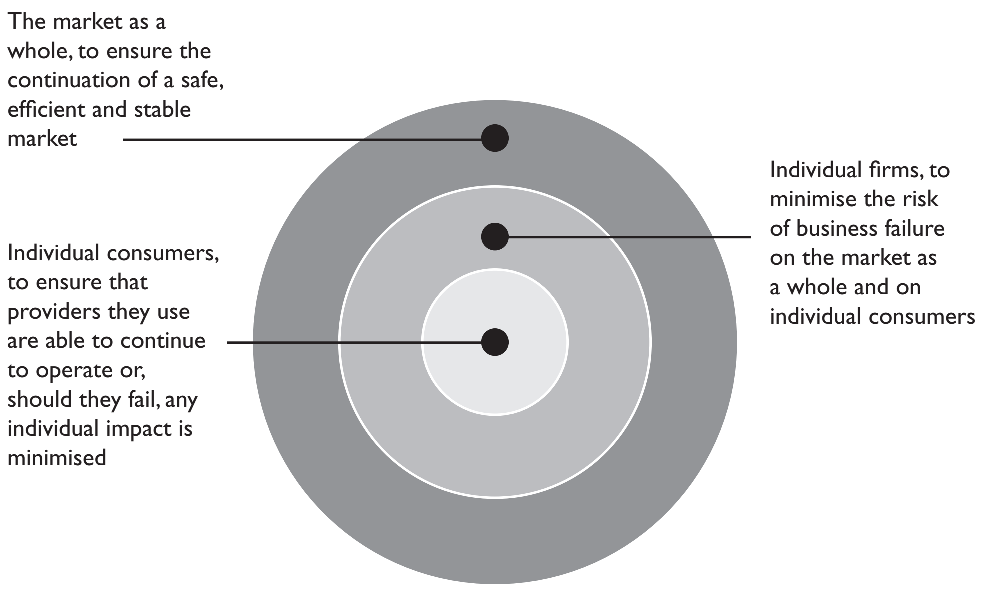
This area of financial services may well be new and unfamiliar to you. To give you a sense of the need for effective prudential regulation, search for information on the events of the 2007–09 financial crisis. During that period, weaknesses in prudential regulation saw the failure of financial institutions and the global financial system brought close to collapse. The following article, for example, gives you a sense of the enormity of the crisis:

Mathiason, N. (2008) Three weeks that changed the world. *The Guardian* [online], 28 December 2008. Available at: https://www.theguardian.com/business/2008/dec/28/markets-credit-crunch-banking-2008 [Accessed: 19 February 2020].

19.1 What is prudential management?

A vital element of the work of the industry regulators is to ensure that firms have adequate risk management systems in place, particularly in relation to financial risks. This is referred to as prudential management. Prudential standards operate at various levels, as indicated in Figure 19.1.

FIGURE 19.1 LEVELS OF OPERATION OF PRUDENTIAL STANDARDS



The majority of the prudential rules are the remit of the PRA; it is responsible for the prudential regulation of all deposit-takers, insurers and significant investment firms. The FCA is responsible for the prudential regulation of firms for which it is the sole regulator, typically smaller businesses.

The FCA's general approach to prudential supervision is to manage failure when it happens, rather than focusing valuable resources on reducing its probability. Remember that, in respect of prudential regulation, the FCA regulates smaller firms. Therefore the FCA's approach has to be seen in context, that the failure of a smaller firm would generally not present a risk to the integrity of the whole financial system. There are exceptions, and where failure of a particular firm is likely to have a wider impact, the FCA will focus on reducing the impact on customers and the integrity of the financial system.

19.1.1 International prudential regulation

It is important to understand that the UK's regulators do not operate in isolation; their work is driven by regulatory requirements at an international level. Trade is conducted on a worldwide basis, and the economies of many different countries are highly interconnected: problems in one economy or with a single large financial services provider can cause problems across the world. Such problems were seen following the collapse of Lehman Brothers in the United States in 2008, an event widely believed to have triggered the ensuing financial crisis. The Basel Committee on Banking Supervision sets standards for the prudential regulation of banks globally. The EU sets out detailed requirements for banks, building societies and investment firms within the member states. We will look at standards set by the Basel Committee in section 19.5 and the EU requirements in section 19.6.

WHAT IS THE BASEL COMMITTEE ON BANKING SUPERVISION?

The Basel Committee is a multinational body acting under the auspices of the Bank for International Settlements, and is based in Basel, Switzerland. Its role is to strengthen the regulation, supervision and activities of banks to enhance financial stability; many of the people who work for it are on secondment from central banks and national regulatory bodies. It first established an international framework for deposit-takers (ie principally banks) in 1988. This framework, which – among other things – set out minimum capital requirements for banks, was known as the Basel Accord. It was superseded by the expanded Basel II, itself superseded by Basel III in 2010.

19.2 What is capital adequacy?

One of the key areas of prudential control for financial institutions relates to their capital adequacy. There are different rules for deposit-takers (such as banks and building societies), investment firms and life assurance companies.

Regulations about capital adequacy broadly state that, should a business run into difficulties, the business must have sufficient capital to make it very unlikely that deposits will be placed at risk. Capital in this context is often referred to as the own funds of a business, ie those obtained from shareholders and related sources, as distinct from funds deposited by customers. The business aims to make a profit for its shareholders, and it is the shareholders who are expected to bear the risks in pursuit of the financial reward. Thus although a bank's lending is generally financed by deposits, any losses made (for instance if a loan is written off because the borrower does not repay it) should be borne by shareholders rather than by depositors. Minimum requirements for capital adequacy are set to protect a bank's depositors so that they do not lose money.

The minimum capital that a business must hold is expressed in the form of a solvency ratio: that is, capital as a proportion of the value of the bank's assets (ie mainly its loans). The solvency ratio takes account of the fact that some assets represent more of a risk to the bank than others, because the level of capital that must be held reflects the perceived risk level of the different assets.

KEY TERMS

CAPITAL ADEQUACY

Ensuring that a business holds sufficient reserves of capital to ensure it is sustainable.

SOLVENCY

The extent to which a business's assets exceed its liabilities. An example from the financial services industry would be mortgage lenders whose assets are the loans made to consumers; liabilities are the funds borrowed to facilitate those loans, from deposit-taking or from the money markets.

SOLVENCY RATIO

Capital as a percentage of the risk-adjusted value of assets.

19.3 What is liquidity?

Liquidity can be defined as the ease and speed with which an asset can be converted into cash – and thus into real goods and services – without significant loss of capital value. It must not be confused with solvency, or with capital adequacy, which are different issues. In relation to banks, the definition of liquidity is a measure of a bank's ability to acquire funds immediately at a reasonable price in order to meet demand for cash outflows.

The regulators define liquidity risk as the risk that a firm, though solvent, does not have sufficient financial resources available to enable it to meet its obligations as they fall due. Problems could, for example, arise when a bank that has committed a large volume of its assets to long-term mortgage advances is faced with an unexpectedly high number of its savings account holders wanting to withdraw funds; the bank may have the assets to enable the withdrawals but the mortgage loans are too illiquid. In assessing liquidity risks that they may face, banks need to consider the timing of both their assets and their liabilities, and endeavour to match them as far as possible.

LIQUIDITY

The ease and speed at which an asset can be converted to cash.

A firm's assets can provide liquidity in three main ways: by being sold for cash, by reaching their maturity date, and by providing security for borrowing. Asset concentrations, where a large number of receipts from assets are likely to occur around the same time, should be avoided. Similarly, banks try to avoid liability concentrations, where a single factor or a single decision could result in a sudden significant claim. A wide spread of maturity dates is one obvious way to achieve this.

LIQUIDITY RISK

The situation of the UK bank Northern Rock in 2007 illustrates liquidity problems that can arise.

The bank had a business plan that involved borrowing money short term on the money markets on a regular basis to fund a proportion of its (much longer-term) mortgage lending. The success of the plan depended on the continuing availability of short-term interbank lending. When this dried up as a result of escalating economic problems in the USA, the bank's liquidity quickly disappeared. It was forced to approach the Bank of England for assistance.

At that point, a different aspect of liquidity risk appeared. When concerns about the stability of the bank became widely known, large numbers of depositors sought to withdraw their savings (a so-called 'run on the bank'). Banks do not retain all the funds deposited with them in a readily accessible form – as we have already learned, most of their deposits are lent to customers who wish to borrow. Only a small proportion is kept in cash or assets convertible into cash. If a run on the bank occurs, its liquidity can quickly be used up. In the case of Northern Rock, the government stepped in to guarantee deposits, which halted the bank run.

✓

CHECK YOUR UNDERSTANDING 1

It's quite a while since you studied the role of the Bank of England in the UK financial system. Can you recall its key functions and explain the main reason why Northern Rock approached the Bank for assistance?

19.4 What is operational risk?

The way in which a business is run and managed is another area in which prudential risk can arise. Operational risk is the risk of loss as a result of failed or inadequate internal processes, people and systems (eg staff fraud, or a computer failure), or as a result of external events, such as a natural disaster.

Capital requirements for operational risk were included for the first time in Basel II (see section 19.5.1). The basic approach to calculating the capital required is to multiply the institution's gross annual income (averaged over the past three years) by 0.15. Insurance held against the events happening cannot be offset against this. For large institutions with different business lines, a more sophisticated system (called the standardised approach) can be applied, using different multiplying factors for each line.

19.5 What are the Basel Accords?

The Basel Committee on Banking Supervision first issued minimum capital requirements for banks in 1988. The rules set out in the Basel Accord were adopted by the G10 group of countries, including the UK.

19.5.1 Basel II

Basel II was published in 2004 and superseded the original Basel Accord. It requires banks to hold levels of capital appropriate to the risk presented by their lending and investment practices: as risk increases, so do the associated capital requirements.

Basel II consists of three 'pillars', as shown in Figure 19.2.

FIGURE 19.2 THE THREE PILLARS OF BASEL II

Pillar 1	Pillar 2	Pillar 3
Details capital requirements in respect of three aspects of a bank's operations: credit risk, operational risk and market risk	Gives banking regulators more effective supervisory tools and enables them to deal with the individual components of risk	Contains a set of disclosure requirements so that the capital adequacy of an organisation can be properly assessed

In relation to supervision and disclosure, Basel II introduced a requirement for banks to carry out 'stress tests', ie the use of computer simulations to understand the effect of particular events on the firm. Stress tests ascertain the extent to which a firm would have sufficient capital in certain adverse economic conditions.

These supervisory processes are backed by a set of disclosure requirements to ensure that banks publish sufficient information to enable market participants to assess a bank's risk profile and the extent of its capitalisation (ie its capital assets and reserves in relation to its risks and commitments). The disclosure requirements enable a distinction to be made between those banks that are managing their risks in a prudent manner and those that are not.

19.5.2 Basel III

Even before Basel II had been fully implemented, the events of the 2007–09 financial crisis highlighted the need for additional regulation. Basel III was agreed by members of the Basel Committee in 2010–11 and implementation was phased in up to 31 March 2019.

Basel III covers two main areas:

- regulatory capital;
- asset and liability management.

Regulatory capital

Basel III requires banks to reach a minimum solvency ratio of 7 per cent. Regulatory capital is the amount of capital that a bank is required to hold in order to meet regulatory requirements. There are precise definitions as to what can be counted as regulatory capital and there are two broad classes of capital:

- **Tier 1** capital, which includes share capital and disclosed reserves (ie profits retained in the business rather than being paid as dividends);
- **Tier 2** capital, which is known as supplementary capital.

The value of a bank's assets is adjusted to take account of the risk that those assets present. So, for example, loans to governments (such as a bank holding UK government gilts) have a risk weighting of zero as they are considered to be very secure; personal loans, conversely, are unsecured lending so carry a risk weighting of 100 per cent. A general theme is that the higher the risk presented by the business a bank is carrying out, the higher the level of capital it is required to hold. In practice, institutions normally keep more than the minimum solvency ratio required by Basel III.

Basel III also introduced a minimum leverage ratio, which is a bank's Tier 1 capital divided by its average total consolidated assets. Banks are expected to maintain a leverage ratio in excess of 3 per cent.

Asset and liability management

Basel III introduced two new ratios that banks must comply with in respect of asset and liability management:

- liquidity coverage ratio (LCR);
- net stable funding ratio (NSFR).

The LCR requires that high-quality liquid assets available to the bank exceed the net cash outflows expected over the next 30 days. In assessing a bank's ability to meet the LCR, different weightings are attached to different types of asset according to their liquidity. The LCR was phased in between January 2015 and January 2019.

While the LCR is aimed at ensuring a bank's short-term liquidity, the NSFR aims to protect its longer-term position. The NSFR requires that long-term financial resources exceed long-term commitments; long term in this context is taken as being more than one year. NSFR requirements had to be met from 2018.

FACTFIND

For further information on the phasing in of Basel III, check:

http://www.bis.org/bcbs/basel3.htm [Accessed: 18 February 2020].

19.6 What is the Capital Requirements Directive?

In the EU the requirements of Basel I, II and III are implemented by the Capital Requirements Directives (CRDs). CRD IV, which implements Basel III, came into effect on 1 January 2014, with the capital requirements being phased in over a number of years. The CRDs establish a supervisory framework that aims to minimise the effects of a firm failing. They do this by ensuring that firms hold sufficient financial resources to cover the risks that their business activities present.

CRD IV builds on existing rules and introduces new prudential requirements. Notably, the quality of capital that firms are required to hold has been improved and new capital buffers have been introduced for some firms. CRD IV applies to banks, building societies and investment firms.

19.6.1 Total loss-absorbing capacity (TLAC)

There are additional capital requirements for banks deemed systemically important or too big to fail. The Financial Stability Board (FSB), an international organisation consisting of national regulators and central banks, issued a minimum total loss-absorbing capacity (TLAC) standard on 9 November 2015 for 30 banks identified as global systemically important banks (G-Sibs) that the Basel Committee on Banking Supervision (BCBS) deems at risk from being too big to fail. The TLAC requirements aim to bolster G-Sibs' capital and leverage ratios, ensuring these banks are equipped to continue critical functions without threatening financial market stability or requiring further taxpayer support. The minimum TLAC requirement is in addition to minimum regulatory capital requirements, but qualifying capital may count towards both requirements, subject to conditions.

Since 1 January 2019, the minimum TLAC requirement for G-Sibs has been at least 16 per cent of the resolution group's risk-weighted assets (RWAs), increasing to at least 18 per cent from 1 January 2022.

CHECK YOUR UNDERSTANDING 2

CRD IV consists of two pieces of legislation:

- the Capital Requirements Regulation (CRR);
- the Capital Requirements Directive (CRD).

There is a key difference in the way the CRR has been implemented compared with the CRD. Can you explain what it is? Think back to your studies of the EU's role in regulation and legislation in Topic 2.

19.7 What is Solvency II?

The failure of an insurance company presents a number of risks for consumers and, as with the banks, there are rules relating to the amount of capital a business must hold to mitigate the risk of insolvency. In the EU, a Directive that focused on the capital adequacy of insurers was introduced in the early 1970s; this is now referred to as Solvency I. A new Directive, Solvency II, came into effect on 1 January 2016. At an international level, the European Insurance and Occupational Pensions Authority (EIOPA) is responsible for its implementation. Within EU member states, national supervisory authorities will implement the requirements of the Directive.

The main aims of Solvency II are to:

- reduce the risk of an insurance company being unable to meet its claims;
- reduce losses suffered by policyholders should an insurer be unable to meet all claims in full;
- establish a system of information disclosure that makes regulators aware of potential problems at an early stage;
- promote confidence in the financial stability of the insurance sector.

Solvency II aims to harmonise regulation of the EU insurance industry and is primarily focused on the amount of capital an insurer must hold to reduce the risk of insolvency. It is based on three main 'pillars' (see Figure 19.3).

FIGURE 19.3 THE THREE MAIN PILLARS OF SOLVENCY II

Pillar 1	Pillar 2	Pillar 3
Capital requirements and the valuation of assets	Governance and risk-management requirements	Disclosure and transparency rules

The capital requirement is expressed in terms of a solvency capital requirement (SCR) which comprises a basic SCR, plus an allowance for operational risk, less an amount for adjustments. Insurers are required to complete and submit an Own Risk & Solvency Assessment (ORSA). The PRA has made changes to its Handbook to reflect the new requirements.

The regime applies to almost all EU insurance firms; some insurance firms are not subject to Solvency II requirements, depending on the amount of premiums they write, the value of technical provision, or the type of business written.

19.8 What are the FCA/PRA prudential standards?

The FCA and PRA are responsible for establishing rules that translate EU legislation into practical standards that apply to regulated financial services providers. The FCA and PRA Handbook's 'Prudential Standards' section details prudential requirements. This section is made up of several subsections that detail requirements for different types of firm.

FIGURE 19.4 OVERVIEW OF PRUDENTIAL STANDARDS SOURCEBOOKS

GENPRU

- The general prudential sourcebook for banks, building societies, insurers and investment firms
- Details the way that the rules apply to different firms, rules and guidance on minimum capital requirements, and the definitions of different types of capital

BIPRU

The prudential sourcebook for banks, building societies and investment firms, and details the rules applying to these firms

IFPRU

The prudential sourcebook for investment firms and details the capital requirements for such firms

INSPRU

The prudential sourcebook for insurers details the capital requirements and technical provisions for insurance companies

MIPRU

The prudential sourcebook for mortgage and home finance firms, and details requirements in respect of capital and professional indemnity insurance

GENPRU

GENPRU is made up of three main sections:

- GENPRU 1 details the general requirements for a firm to maintain adequate resources and how financial resources are valued.
- GENPRU 2 details the minimum amount of capital a firm should hold, referred to as the capital resources requirement (CRR). It also details the different types of eligible capital that make up a firm's capital base.
- GENPRU 3 details the rules for financial conglomerates, ie businesses that operate in a number of different areas of financial services.

BIPRU

The prudential sourcebook for banks, building societies and investment firms has fourteen sections and details the rules required as a result of the Capital Requirements Directives.

BIPRU contains standards firms must adhere to, including those in relation to:

- capital requirements;
- credit risk;
- credit risk mitigation;
- market risk;
- group risk;
- liquidity.

BIPRU contains specific requirements in respect of liquidity to ensure that a business is able to continue if exposed to certain external factors.

IFPRU

IFPRU is a sourcebook specifically created to implement CRD IV. It is the prudential sourcebook for investment firms and contains standards that are derived from CRD IV. Some investment firms continue to be regulated under the requirements in GENPRU and BIFPRU, rather than IFPRU.

IFPRU has eleven sections, which cover rules in respect of a number of areas including:

- credit risk;
- operational risk;
- market risk;
- liquidity;

- capital buffers;
- recovery and resolution (processes to be followed if a business runs into problems or fails).

As with BIPRU, IFPRU contains specific requirements relating to liquidity to ensure that an investment firm is able to continue if exposed to certain external factors.

CRD sets minimum capital requirements for investment firms. The actual level of capital required depends on the category of the firm:

- **An IFPRU 730k firm** is an IFPRU investment firm that is not a collective portfolio management investment firm, an IFPRU 50k firm or an IFPRU 125k firm. Such a firm is required to hold capital of at least €730,000.
- **An IFPRU 125k firm** is an IFPRU investment firm that does not deal on its own account or underwrite issues of financial instruments, offers certain specified services, is authorised to hold client money in connection with the services it provides, is not a collective portfolio management investment firm and does not operate a multilateral trading facility or an organised trading facility. Such a firm is required to hold capital of at least €125,000.
- **An IFPRU 50k firm** is an IFPRU investment firm that does not deal on its own account or underwrite issues of financial instruments, does not hold client money, is not a collective investment management firm and does not operate a multilateral trading facility or an organised trading facility. Such a firm is required to hold capital of at least €50,000.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the roles played by the PRA, the FCA, the Basel Committee on Banking Standards and the EU in prudential management?
- explain what is meant by 'capital adequacy'?
- explain what is meant by 'liquidity risk'?
- describe what is addressed by each of the 'three pillars' of Basel II?
- explain what is meant by the 'liquidity coverage ratio'?
- outline the main aims of Solvency II?
- outline the main areas addressed by IFPRU?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 19. Review the text if necessary.

Answers can be found at the end of this book.

1) Who is responsible for the prudential regulation of deposit-takers and insurers?

   a) Financial Conduct Authority (FCA).

   b) Prudential Regulation Authority (PRA).

   c) Monetary Policy Committee (MPC).

   d) Financial Policy Committee (FPC).

2) Why does the FCA concentrate on managing the failure of an individual firm if it happens rather than proactively seeking to prevent its failure in the first place?

3) Capital adequacy requirements are based on the principle that in the event of a firm making a loss:

   a) it can approach the Bank of England for additional funds.

   b) its depositors, not its shareholders, should bear the loss.

   c) the Basel Committee will determine whether the firm has sufficient capital to continue trading.

   d) its shareholders, not its depositors, should bear the loss.

4) What is a bank's solvency ratio?

5) How did Basel II seek to ensure that capital adequacy requirements more accurately reflected the risks represented by a firm's assets?

6) Under Basel III, banks in the EU must work towards a minimum solvency ratio of what level?

   a) 7 per cent.

   b) 8 per cent.

   c) 5 per cent.

   d) 4 per cent.

7) Basel III introduced new measures with regard to a bank's capital and asset liability management. Which of these measures is aimed at protecting the long-term financial stability of a bank?

   a) The liquidity coverage ratio.

   b) The net stable funding ratio.

   c) The Tier 1 capital measure.

   d) The Tier 2 capital measure.

8) What are the key aims of Solvency II?

9) Which of the following sections of the FCA Handbook contains details of the prudential requirements applying to banks, building societies and investment firms?

   a) BIPRU.

   b) IFPRU.

   c) MIPRU.

   d) IPRU-INV.

10) In the EU, the requirements of the various Basel Accords are implemented by which legislation?

TOPIC 20

Conduct of business requirements I

LEARNING OBJECTIVES

In Topics 14 and 15, we explored the process of advising clients: the main areas in which clients are likely to require advice, the need to gather detailed information and the factors to consider in formulating a recommendation. In this topic and Topic 21 we are going to consider the advice process from the regulatory perspective.

By the end of this topic, you should have an understanding of:

- the types of client identified in the FCA's Conduct of Business Sourcebook;
- the difference between independent and restricted advisers;
- execution-only business;
- rules relating to financial promotions, adviser charges, suitability of recommendation, and product disclosure;
- information that must be provided to clients regarding the firm, its services and charges;
- cooling-off periods, cancellation rights and reflective periods.

This topic covers Unit 2 syllabus learning outcomes U2.2 and U3.1–U3.10.

THINK . . .

The FCA's Conduct of Business rules are designed to ensure that customers get clear and accurate information that is appropriate to them, and that they are treated fairly. To focus your thoughts before you start work on this topic, think about the following:

- Customers for financial advice and products range from major businesses to an individual seeking advice on their pension. How might the different circumstances of clients affect the type of service and support that they need?
- Whenever you make a purchase, there is particular information that you need about that transaction before you commit to it. For

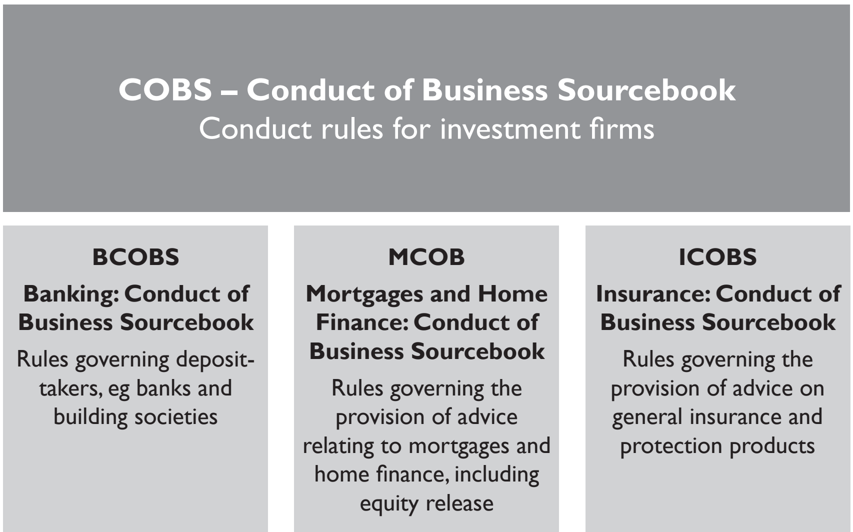
example, what would you want to know if you were arranging for some building work to be done? When would you need to have that information in order to make an informed decision?

The same broad categories of information are required to help with most purchasing decisions, but a financial product that does not meet a client's need can prove even more costly in the long term than a building project that goes wrong. Hence the need for regulation at all stages of the advice and purchase process.

20.1 What are the Conduct of Business sourcebooks?

Regulations relating to the way in which advisers interact with clients are set out in the Business Standards section of the FCA Handbook. Within this section, there are a number of sourcebooks detailing the rules governing advice in specific areas. Figure 20.1 summarises the sourcebooks we will be considering. The remainder of this topic addresses the provisions of COBS, with Topic 21 considering BCOBS, MCOB and ICOBS.

FIGURE 20.1 CONDUCT OF BUSINESS SOURCEBOOKS



20.2 What are the types of client?

COBS sets out three types of client:

- eligible counterparties;
- professional clients;
- retail clients.

Different rules apply to dealings with each of these client groups.

20.2.1 Eligible counterparties

This category includes governments, central banks and financial institutions authorised by an EEA state – the latter including firms such as banks, insurance companies, investment firms and collective investment funds. The eligible counterparty definition only applies to eligible counterparty business, which would include situations such as straightforward execution of transactions received or the purchase of shares, by a firm, for onward sale to the firm's clients. Due to the assumed level of knowledge and experience, clients in this category receive the lowest level of investor protection.

20.2.2 Professional clients

This category includes all the bodies that would otherwise be eligible counterparties, except for the fact that they require a higher level of service than would apply to 'eligible counterparty business' – for example, they require advice, in addition to execution of transactions.

It also includes other types of large client, particularly institutional investors whose main activity is investing in financial instruments. When dealing with professional clients, advisers can assume an adequate level of experience and knowledge and an ability to accept financial risks.

20.2.3 Retail clients

This category provides the highest level of investor protection and comprises customers who do not fall into either of the previous two categories – especially customers who might be described as 'the person in the street' and who cannot be expected to have anything more than a basic general understanding of financial services.

It is expected that most financial services customers will fall into this category.

FIGURE 20.2 CLIENT CATEGORIES

20.3 What are the different categories of adviser?

Advisers are grouped into one of two categories: independent advisers and restricted advisers.

In order to inform a client that it provides independent advice, a firm must assess a sufficient range of relevant products available on the market that must:

- be sufficiently diverse with regard to their type and issuers, or product providers, to ensure that the client's investment objectives can be suitably met; and
- not be limited to relevant products issued or provided by the firm itself or by entities having close links with the firm, or other entities with which the firm has such close legal or economic relationships, including contractual relationships, as to present a risk of impairing the independent basis of the advice given.

Source: FCA (no date)

Any firm or adviser that does not meet the requirements to be 'independent' will, by default, be providing advice that is 'restricted'. This is designed to reflect the idea of genuinely independent advice being free from any restrictions that could impact on the ability to recommend whatever is best for the customer. The restrictions may relate either to the range of product providers that an adviser can recommend, or the range of individual products.

20.3.1 Independent advice

Before 3 January 2018, in order to describe themselves as providers of independent advice, firms needed to make recommendations on all retail investment products, based on a comprehensive and fair analysis of the relevant market, and provide unbiased, unrestricted advice.

However, since 3 January 2018, as part of MiFID II, the FCA has clarified its rules around independent advice to confirm that an advice firm can call itself independent even if it only offers advice on a certain area.

For example, a firm could call itself independent while only offering advice on pensions. The firm would have to be able to advise on all pension product types and "would need to consider a sufficient range of pension products which were sufficiently diverse, in terms of their type and provider, to suitably meet the client's objectives".

The FCA Glossary defines a 'personal recommendation' as advice on investments, advice on conversion or transfer of pension benefits, or on a home finance transaction that is presented as suitable for the person for whom it is made, or is based on consideration of the circumstances of that person.

DETERMINING WHICH REGULATORY RULES APPLY

Firms that advise retail clients on any retail investment products are subject to the FCA rules that apply to those operating in a particular area of financial services. For instance, a firm that only advised on mortgages would fall under the FCA's COBS and MCOB rules. If the firm decided to start advising on protection products that could be used in conjunction with mortgages, they would also be subject to ICOBS rules, and their sales processes would need to be amended.

The use of panels

The rules do not prohibit, or even restrict, the use of panels by firms wishing to operate as 'independent', but any panel should be sufficiently broad in its composition to enable the firm to make personal recommendations based on an assessment of a sufficient range of relevant products on the market that are sufficiently diverse. Any panel should be reviewed regularly and updated as necessary. The use of a panel must not materially disadvantage any client.

PANEL

A selection of providers who are known and trusted, based on their product range, charges and service level.

The firm must recognise that there may be clients for whom the panel does not work. It should therefore be possible for advice 'off-panel' to be available, where a different product or product provider would provide a more suitable outcome for that client.

The role of specialists

The rules relating to independent advice apply both at the level of the firm and of the personal recommendation. Every adviser working in a firm that describes its advice as independent needs to ensure that each personal recommendation meets the definition of independence.

This does not, however, prohibit firms from having advisers that specialise in certain areas, for example, investments, pension transfers or long-term care. The key point to note is that specialists working for a firm that claims to offer independent advice must meet the independence rule in every personal recommendation they provide. If any specialists within a firm do not meet this requirement, the firm should not call itself independent.

> **EXAMPLE: SPECIALISTS PROVING INDEPENDENT ADVICE**
>
> A firm providing independent advice has three advisers, each with their own specialist area. The IHT specialist has a client for whom a personal pension might be appropriate. They consult the pension expert to seek their advice and guidance.
>
> The personal recommendation provided to the client by the IHT expert would meet the independence rule provided that the recommendation of the pension expert would also meet the independence rule, as defined in section 20.3.

20.3.2 Restricted advice

Restricted advice could be summarised as anything that is not independent advice or basic advice.

Basic advice means providing advice on stakeholder products using a process that involves putting scripted questions to a retail client (we cover this in more detail in Topic 21).

> **PENSION AND INVESTMENT SCAMS**
>
> The subject of pension and investment scams is detailed in section 10. One of the ways an individual can seek to protect themselves against a possible scam is to seek qualified financial advice from a financial adviser, whether independent or restricted. An accomplished financial adviser would be able to identify the warning signs of a scam and advise accordingly.

20.4 What is execution-only business?

The FCA expects that the majority of retail customers will receive qualified investment advice, involving a recommendation based on analysis of their needs and circumstances. There are situations where a customer may feel equipped to make their own investment decisions and proceed without advice – to proceed on an execution-only basis. Execution-only involves the customer telling the firm what they wish to do and the firm executing their wishes; no advice is given.

The FCA defines execution-only business as “a transaction executed by a firm upon the specific instruction of a client where the firm does not give advice on investments relating to the merits of the transaction and in relation to which the rules on the assessment of appropriateness do not apply".

This can be contrasted with:

- **qualified investment advice** – where an adviser makes a recommendation based on a full analysis of a customer's needs and circumstances; and
- **simplified advice** – where a streamlined or automated process is used to gather the personal and financial information on which advice is given.

Where investment business is undertaken on an execution-only basis, the customer instructs the adviser to effect a specific transaction on their behalf, detailing in full the nature of the product required.

For an execution-only transaction, the adviser's duty of care to fully explain the nature of the transaction and risks involved does not apply. The customer is entirely responsible for their own choice.

EXECUTION ONLY

A transaction executed upon a client's specific instruction, where the firm gives no advice and the rules on assessing appropriateness do not apply.

It is expected that only a small proportion of any adviser's cases would be on an execution-only basis.

THE NEED FOR CLEAR AND CREDIBLE EVIDENCE

The Financial Ombudsman Service (FOS) has highlighted that complaints relating to execution-only business often result from the customer believing they had received advice and not realising they have taken out an investment on an execution-only basis. The FOS has indicated that it expects firms to be able to provide 'clear and credible' evidence that a transaction was conducted on an execution-only basis. This would involve obtaining a signed statement from the customer confirming that:

- they are aware that business is being transacted on an execution-only basis;
- they have not asked for or received advice;
- the decision to take out the investment is theirs alone;
- the adviser (and/or the firm they represent) takes no responsibility for the suitability of the investment.

A different situation arises where an adviser provides advice to a client, but the client wishes to carry out a transaction that contravenes the advice given (sometimes referred to as an 'insistent' customer). In this situation, the adviser should require the client to sign to confirm that they are acting against the advice provided.

MiFID introduced an 'appropriateness' test for 'non-advised sales'. This means that in some cases, even for execution-only investment sales, the business has to ask the consumer for more information to help it decide whether the consumer has the necessary 'knowledge and experience' to understand the risks involved in the transaction. This applies in the case of 'complex' products (for example, some structured products or spread-betting contracts). It also applies where the financial business, rather than the consumer, has initiated the sale in the case of some 'non-complex' products and also where a specific warning has not been given that the financial business is not required to assess the suitability of the product. Under MiFID and COBS 10, a financial business is taken to have initiated the sale if it has sent a consumer a personalised communication. Under these circumstances, the business would need to carry out an appropriateness test. However, where a consumer has seen a product advertised, for example in a newspaper, the appropriateness test is not triggered.

Under MiFID II, which took effect on 3 January 2018, the format of the test is largely unchanged, but the range of complex products to which the appropriateness testing requirement applies has increased.

20.5 What are the rules relating to financial promotions?

A financial promotion is defined in COBS as an "invitation or inducement to engage in investment activity". This includes:

- advertisements in all forms of media;
- telephone calls;
- marketing during personal visits to clients;
- presentations to groups.

Financial promotions can be 'communicated' only if they have been prepared, or approved, by an authorised person.

There is a distinction between:

- **real-time financial promotions** (non-written financial promotions), such as personal visits and telephone conversations; and
- **non-real-time financial promotions** (written financial promotions), such as newspaper advertisements and those on internet sites.

The overall principle is that financial promotions to retail clients and professional clients must give a clear and adequate description of the product or service and be clear, fair and not misleading. In the case of retail clients, this means specifically that information supplied must:

- be accurate, including the requirement not to emphasise potential benefits without giving a fair and prominent indication of the risks;
- be understandable by an 'average' member of the group it is aimed at;
- not disguise or obscure important terms or warnings;
- contain the name of the conduct regulator (the FCA) in the case of direct offer advertisements.

FINANCIAL PROMOTION

An invitation or inducement to engage in investment activity.

Figure 20.3 sets out the rules relating to financial promotions.

FIGURE 20.3 RULES RELATING TO FINANCIAL PROMOTIONS

Comparisons

- Comparisons with other products must be meaningful, and presented in a fair and balanced way.
- Markets in Financial Instruments Directive (MiFID) firms are subject to additional requirements to detail the source of information and the assumptions made in the comparison.

Past performance

- Past performance information must not be the most prominent part of a promotion.
- It must be made clear that it refers to the past, and it must contain a warning that past performance is not necessarily a reliable indicator of future results.
- Past performance data must be based on at least five years (or the period since the investment commenced, if less, but must not relate to a period of less than one year).

Unsolicited promotions (ie non-written 'cold calls')

- Permitted only in relation to certain investments, including packaged products, such as life assurance policies and unit trusts. Not permitted in relation to higher-volatility funds (which use gearing) or life policies with links to such funds, due to the increased investment risk involved. Cold calls are not permitted in relation to mortgage contracts.
- Unsolicited telephone calls or visits must only be made at 'an appropriate time of the day'. Within the industry, this is generally taken to mean between 9am and 9pm Monday to Saturday.
- The caller must check that the recipient is happy to proceed with the call.
- The caller must also give a contact point to any client with whom they arrange an appointment.

ADVERTISING STANDARDS AUTHORITY

In addition to abiding by the rules laid down in industry-specific regulations, advertisements for financial services and financial products (whether delivered via print, broadcast media, eg TV and radio, or non-broadcast media, eg online) must meet the standards laid down by the Advertising Standards Authority (ASA). There are two Codes, one dealing with broadcast advertising, the other with non-broadcast advertising, sales promotions and direct marketing.

Aspects of the Codes that are particularly relevant to financial services include the requirements that all advertisements should be:

- **legal**, ie containing nothing that breaks the law, or incites anyone to do so, and omitting nothing that the law requires;
- **decent**, ie containing nothing that is likely to cause serious or widespread offence, judged by current prevailing standards of decency;
- **honest**, ie not exploiting the credulity, lack of knowledge or inexperience of consumers;
- **truthful**, ie not misleading by inaccuracy, ambiguity, exaggeration, omission or any other means.

In relation to 'decency', account is taken of the context of the advertisement, the medium used and the likely audience. Particular care should be taken with sensitive issues such as race, religion, sex or disability.

The Advertising Codes require that advertisements should be prepared with a sense of responsibility to consumers and society, and should respect the generally accepted principles of fair competition in business. Advertisers are permitted to express opinions, including opinions about the desirability of their products, provided that it is clear that it is opinion and not a statement of fact. Assertions or comparisons that go beyond subjective opinion must be able to be objectively substantiated.

The ASA can take action against individuals and organisations whose advertising contravenes the Codes, from requiring an advertisement to be amended or withdrawn, to taking legal action.

FACTFIND

If you would like to know more about the provisions of the Advertising Codes, go to:

https://www.asa.org.uk/codes-and-rulings/advertising-codes.html [Accessed: 18 February 2020].

20.6 What are the rules relating to adviser charges?

Traditionally many investment advisers charged for their services, in full or in part, through the receipt of a commission payment from the providers of products they recommended. This led to concerns that advice could be 'skewed' in favour of providers or products that offered the highest commission rates.

Since 1 January 2013, a firm advising on investment business must only be remunerated for its services by adviser charges; it is no longer allowed to receive commission from the product providers for the products it recommends.

!

COMMISSION ON INSURANCE SALES

While commission is not permitted in relation to investment business, an insurance company can still pay commission in relation to sales of insurance such as term assurance and income protection.

Furthermore, it must not accept any other commissions or benefit of any kind from any other party, even if it intends to refund the payment or pass some or all of the benefits to the client.

- The charging structure should be based on the service provided, rather than the product/provider recommended.
- Charges should be explained as part of the initial disclosures to a customer.
- Any continuing charges can only be made where the customer has agreed to these and where the service for which these charges are levied is actually provided.

The firm can determine its charging structure for its services. This can be a standard charging structure that applies to all clients, based on an hourly rate, or can be based on a percentage of the amount being invested, but the firm must pay due regard to the client's best interests.

The charging structure must be clear, fair and not misleading and not conceal in any way the amount or purpose of any of its adviser charges from the client. For example, a firm cannot make arrangements for amounts in excess of its adviser charge to be deducted from a client's investment, even if it is with the intention of making a cash refund of some or all of it to the client at a later date.

The firm must ensure that the charging structure it discloses to its client at the outset reflects as closely as possible the total charges that are to be paid. If the firm's charging structure is based on hourly rates, it must state whether the rates are 'indicative' or actual and provide an approximate indication of the number of hours that the provision of each service is likely to require.

A firm cannot use an adviser charging structure that entails payments by the client over a period of time unless the service being provided is ongoing and this is disclosed to the client at the outset. The client must be provided with a right to cancel the service, without penalty and without having to give a reason. The FCA is eager to ensure that any ongoing service that is charged for is actually delivered by the adviser.

The firm must provide details of its charges during the initial disclosures and, once the final charges are known, it may include the information about total adviser charges in a suitability report.

20.7 What information must be provided at the outset?

Before any business is discussed, the adviser must disclose to the client certain information about themselves, the services they provide and the costs of those services. The information which must be provided and confirmed in writing includes the following:

- **Contact information** – the name and address of the firm and contact details necessary to enable a client to communicate effectively with the firm.
- **Communication** – the methods of communication used between the firm and the client.
- **Authorisation** – a statement of the fact that the firm is authorised and the name of the regulator that has authorised it (the FCA if in the UK; otherwise, the name of the competent authority that has authorised the firm – ie in relation to MiFID business).
- **Advice type** – whether the advice being provided is independent or restricted, and if restricted, the nature of the restriction. If a firm offers both, it must clearly explain the different nature of the independent advice and restricted advice services.
- **Investment management** – if the firm manages investments on behalf of a client, the method and frequency of investment evaluation, details of any

delegation of the discretionary management of all or part of the client's portfolio, and the types of designated investments that may be included in the client's portfolio.

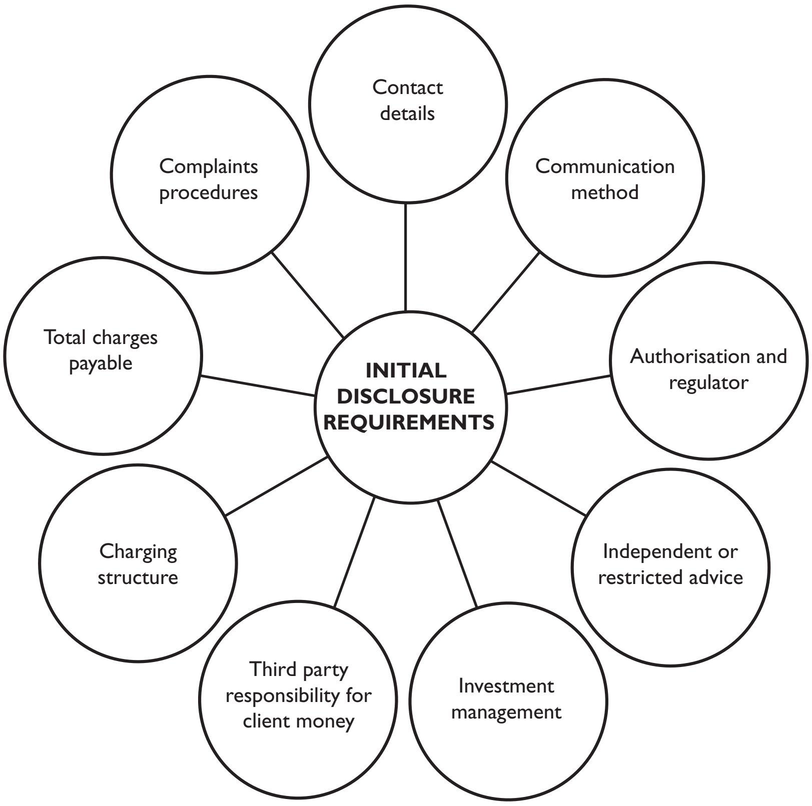
- **Client money or investments** – if the firm holds designated investments or client money for a retail client, that that money may be held by a third party on behalf of the firm, responsibility of the firm for any acts or omissions of that third party, and the consequences of the insolvency of that third party.
- **Charging structure/method** – this may be in the form of a list of the advisory services offered with the associated indicative charges which will be used for calculating the charge for each service.
- **Charges payable** – the total adviser charge payable by a client in cash terms (or equivalent). If payments are to be made over a period of time, the firm must include the amount and frequency of each payment due, and the implications for the client if a retail investment product is cancelled before the adviser charge is paid.
- **Details of complaints procedures, including FOS and FSCS** – the firm must make available to a client who has used or intends to use their services details of their complaints procedures and explain the protections offered by the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS). We cover both of these in Topic 25.

To provide a format for supplying the required information, the FCA created a document known as the services and costs disclosure document (SCDD). This document, and the combined initial disclosure document (CIDD), was used if the adviser was advising on more than one product. However, firms were not obliged to use the SCDD; they could develop their own disclosure material provided that it satisfied the FCA's disclosure requirements.

However, on 27 March 2017 the FCA removed the templates for the initial disclosure document (IDD), CIDD, and SCDD from its handbook as part of a smarter consumer communications initiative. Firms are still required to disclose key information to customers – the IDD, CIDD and SCDD were simply one way that they could have addressed this need. It is still possible for firms to issue a disclosure document that uses the same format as the IDD, CIDD or SCDD, but if a firm chooses to do so it must no longer use the FCA's key facts logo on the document.

Clients must be notified in good time of any material change to the services the firm is providing to that client. For existing clients, the firm need not treat each of several transactions as separate, but does need to ensure that the client has received all relevant information in respect of a subsequent transaction, such as details of product charges that differ from those disclosed for a previous transaction.

FIGURE 20.4 SUMMARY OF INITIAL DISCLOSURE REQUIREMENTS



20.8 When is a written client agreement required?

If a firm carries out designated investment business, other than advising on packaged investment products, the firm must enter into a written basic agreement with the client, setting out the essential rights and obligations of the firm and the client.

Designated investment business is dealing in investment assets directly on behalf of a client, as opposed to selling packaged investment products. It often involves making investment decisions on behalf of the client, exercising discretion as to investment choice and switching from one to another without having to gain the client's individual agreement for every separate transaction.

The types of product involved may include equities, options and futures contracts. A client agreement is not usually required for packaged investments, such as life assurance policies and personal pensions, although these may well be utilised as part of the whole arrangement alongside the higher-risk instruments. In addition to providing the client with information about the firm and its services (as listed in section 20.7), the client must be given, in

> **DESIGNATED INVESTMENT BUSINESS**
>
> Dealing in investment assets directly on behalf of a client.

the form of a client agreement, the terms upon which the adviser is to operate in respect of the client's investments. This will include investment range and limits.

✓ **CHECK YOUR UNDERSTANDING 1**

Thinking back to Topic 16, which of the legal concepts you studied is particularly relevant to the process of carrying out designated investment business, ie acting on the client's behalf?

20.9 What are the suitability requirements?

An adviser, whether independent or restricted, will make a personal recommendation. They must not make a personal recommendation unless they are satisfied that the recommendation is suitable. This means the adviser must have fully ascertained the client's personal and financial circumstances relevant to the services that the adviser has agreed to provide.

20.9.1 Establishing the client's circumstances

As we saw in Topic 14, the start point is to complete a confidential client information questionnaire or 'factfind', which will capture a range of information. That information must be retained for a specified period of time, depending on the nature of the product recommended. In practice, advisers retain information in all cases for as long as they believe they might be required to justify the advice and recommendations given. Retaining the information will help the firm to deal with complaints, provide an audit trail for advice and provide evidence of compliance with regulatory requirements.

Once the factfind is completed, the adviser can formulate their recommendations. In order to ensure that recommendations are suitable, the adviser needs to consider a number of factors, such as ensuring that the recommendation:

- meets current and likely future needs;
- is affordable, both initially and on an ongoing basis;
- is consistent with the customer's risk profile;
- is flexible, to take account of future changes.

✓ **CHECK YOUR UNDERSTANDING 2**

How well can you remember the information that needs to be collected in a factfind and the reasons for it? Try to answer the following questions – you'll need to think back to the topics you studied earlier.

a) Why is it important to know the country where a person was born?

b) Why is it important to find out how many dependants a client has, and their ages?

c) What does an adviser need to know in relation to a client's plans and objectives?

20.9.2 Risks

The suitability rules specifically require advisers to take all reasonable steps to ensure that the client understands the nature of any risks implicit in the product proposed. Examples of risks that might need to be discussed include:

- whether or not the customer's capital will be returned in full;
- the extent to which income levels from an investment may vary or the circumstances in which no income may be paid at all;
- the factors on which a customer's income from a pension product will depend;
- any factors that might affect a customer's ability to make a claim on a protection product;
- whether or not the level of life cover is sustainable for the duration of the term without an increase in premiums.

The nature and extent of the discussion will depend on the client's experience and knowledge of the type of product under consideration. In assessing the suitability of any recommendations, the adviser must be sure to first establish the client's attitude to and ability to tolerate risk.

KEY TERMS

ATTITUDE TO RISK

The extent to which a customer can cope with a lack of guarantees in respect of capital values and their feelings on fluctuating returns/income levels.

TOLERANCE OF RISK

The extent to which a customer's finances could cope with a loss of capital and/or income.

CHECK YOUR UNDERSTANDING 3

✓

In Topic 14 (section 14.5), we introduced the concept of the customer's 'capacity for loss'. Can you remember what this means and why it is important in the context of a discussion about the customer's risk appetite?

20.9.3 Suitability reports

Advisers must recommend the product or service that is most suitable for the client, based on the information supplied by the client and on anything else about the client of which the adviser should reasonably be aware. The recommendation must be solely in the best interests of the client and no account should ever be taken of the remuneration that may be payable to the adviser.

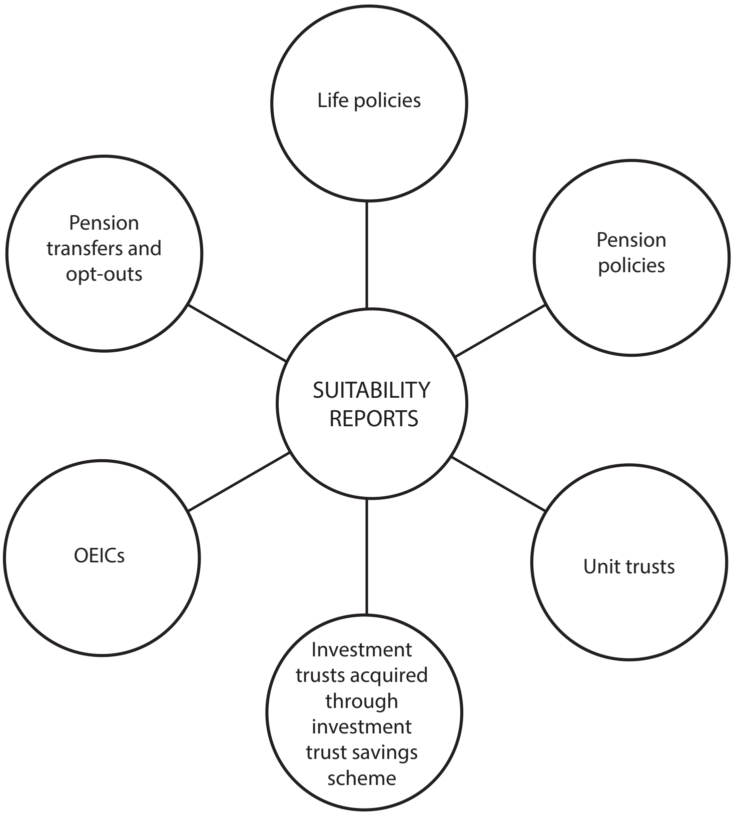
A suitability report explains why the particular product recommended is suitable for the client based on:

- their particular personal and financial circumstances;
- their needs and priorities as identified through the fact-finding process; and
- their attitude to risk (both in general terms and in relation to the specific recommendations made).

Figure 20.5 shows the products for which a suitability report is required. Note that the FCA does not require a suitability report to be provided in respect of mortgage advice, although many lenders will prepare one.

The report should also identify any potential disadvantages of the transaction for the client, such as any 'lock-in' period during which an investment cannot be encashed. It should be clear, concise and written in plain English, in line with the general FCA requirement for any communications to be clear, fair and not misleading.

FIGURE 20.5 PRODUCTS FOR WHICH SUITABILITY REPORTS ARE REQUIRED



SUITABILITY REPORT

Explains clearly why a recommended product is suitable for a specific client, based on information identified through the factfind.

TIMESCALES FOR ISSUING SUITABILITY REPORTS

When providing investment advice to a retail client and in the case of life policies, a firm must, before the transaction is concluded, provide the client with a suitability report.

In the case of telephone selling, if, prior to the conclusion of the contract, the information is provided orally or in a durable medium other than paper, the suitability report for a life policy must be provided immediately after the conclusion of the life policy.

For a personal pension or stakeholder pension, where cancellation rights apply, the report must be sent no later than the fourteenth day after the contract is concluded.

In any other case, the report should be provided when or as soon as possible after the transaction is effected or executed.

20.10 Product disclosure

Advisers who advise on or sell packaged products (such as life policies, pension policies, unit trusts and investment trust saving schemes) must provide clients with written details of the key features of the product before the sale is concluded. Although it is the adviser's responsibility to provide the documents, the product providers usually prepare the papers. It is a requirement that key features documents should be of the same quality as the materials used for marketing purposes.

The rules on what must be included are very detailed, but, as a broad guide, a key features document must provide information about:

- the nature and complexity of the product;
- how it works;
- any limitations or minimum standards that must apply; and
- the material benefits and risks of buying or investing.

The purpose is to enable the client to make an informed decision about whether to proceed.

IN BRIEF

CONTENT OF A KEY FEATURES DOCUMENT

A key features document must include:

- a brief description of the product's aims;
- a brief description of how the product works;
- the key terms of the contract, including any consequences of failing to maintain the commitment or investment;
- the material risks involved;
- the arrangements for handling complaints about the product;

- that compensation is available from the FSCS;
- that a right to cancel or withdraw exists (or does not exist), and if it does, its duration, the conditions for exercising it, any amount the client might have to pay, and where the notice must be sent.

20.10.1 What are key information documents?

Since 1 January 2018 a key information document (KID) must be provided if a customer is buying a packaged retail and insurance-based investment product (PRIIP). A PRIIP is defined as an investment where the amount repayable to the retail investor is subject to risk and fluctuation as a result of exposure to reference values or the performance of assets not directly held by the client; or an insurance based product that is exposed to market fluctuations. Table 20.1 summarises the types of product classified as PRIIPs.

TABLE 20.1 PRODUCT TYPES – IS A KID REQUIRED?

Product type	Classified as PRIIP?
Derivatives	✓
Non-UCITs retail schemes (unit trusts, OEICs)	✓
Insurance-based investments eg unit linked and with profit endowments	✓
Investment trusts	✓
Structured products and structured deposits	✓
Pension products	✗
Deposits with no investment risk (eg bank and building society savings accounts)	✗
Directly held shares, gilts and bonds	✗
General insurance and protection-based insurance products with no surrender value	✗

The aim of the PRIIPs regulation is to encourage efficient EU markets by helping investors better understand and compare the key features, risks and rewards of different PRIIPs. The purpose of the requirements is to ensure that:

- there is consistency between the information that different providers make available to their customers;
- the information provided covers certain key relevant areas;
- the information is presented in an easy-to-understand manner;
- it is easier for investment customers to make meaningful comparisons between providers.

The KID must be no longer than three sides of A4 and the language used must be plain, concise and easy to understand. It must contain certain key information about the investment including:

- product name;
- name of the provider;
- main features;
- any possible risks;
- any return that could be gained by investing;
- costs and charges;
- details of the complaints procedure.

20.11 Cooling off, cancellation rights and reflective periods

When a client buys a regulated packaged or insurance product, they have the right to change their mind and withdraw from the contract within a specified period, known as the cooling-off period. The provider is required to send the client a statutory cancellation notice, which explains the process.

The time period is usually either 14 or 30 days depending on the product type:

- For life and pensions policies, and contracts of insurance that are, or have elements of, a pure protection contract or payment protection, the period is 30 days.
- For investments or deposits and other insurances, the period is 14 days.

Binding mortgage offers trigger a seven-day reflection period. During this time the offer is binding on the lender, but the consumer can accept or reject the offer at any time.

The cooling-off period runs from the date when the contract begins or from the date on which the client receives contractual terms if this is later. The client can withdraw from the contract without penalty at any time during the cooling-off period, without any commitment or loss, by signing and returning the cancellation notice to the product provider.

Generally, the client will receive a full refund of any premiums paid if they cancel the contract during this period and this must be provided within 30 days of receipt of the cancellation notice. The exception to this is if the client invests in a lump-sum unit-linked investment (such as a unit trust, OEIC or investment bond), the money has been invested and the value of the investment has fallen. Under these circumstances, the client is entitled to a refund of the reduced investment; no charges can be taken but an adjustment can be made to reflect the fall in value of the investment. The aim is to prevent people cancelling due to falls in the market. This risk should be explained to the client before they enter into the contract.

At the time the product purchase is made, the adviser must also explain whether the client is liable to pay any outstanding adviser charges if they decide not to proceed with the product and send back the signed cancellation notice.

> **COOLING-OFF PERIOD**
>
> A limited time during which a client can withdraw from the contract without penalty.

It is important that a firm can evidence that a cancellation notice is issued to a customer since, if they fail to do so, the customer can choose to cancel at any time and will not be liable for any loss (including a fall in investment value).

RECORD-KEEPING

The maintenance of clear and readily accessible records is vital at all stages of the relationship between financial services professionals, their clients and the FCA, from details of advertisements to information collected in factfinds, to the reasons for advice given and beyond. Record-keeping requirements for the different stages can be found at appropriate points within the Conduct of Business Sourcebook, with details of what must be kept and the minimum period for which it must be retained. The minimum retention period varies according to the type(s) of product recommended.

Records can be kept in any appropriate format, which includes computer storage, although the rules say that records stored on computer must be "capable of being reproduced on paper in English". Firms are expected to take reasonable steps to protect their records from destruction, unauthorised access and alteration.

In addition to the record-keeping requirements that firms must observe to comply with COBS, there are rules relating to the prevention of money laundering and to the Data Protection Act 2018 (and General Data Protection Regulation). We will look at these in Topics 23 and 24 respectively.

CHECK YOUR UNDERSTANDING 4

For how long must records be retained for the following types of business? You will have to think back to the information you were given in Topic 14.

a) Pension transfers/opt-outs and free-standing additional voluntary contributions (AVCs).

b) Life policies, pension contracts and MiFID business.

c) All other products.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the difference between an eligible counterparty, a professional client and a retail client?
- explain the difference between independent advice and restricted advice?
- outline the rules relating to financial promotions?
- outline the rules relating to adviser charging?
- summarise the information that must be given to a client at the initial disclosure stage?
- describe the key considerations that must be taken into account in determining the suitability of a recommendation for a client?
- explain the client's statutory cancellation rights?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

FCA (no date) *COBS 6.2B Describing advice services* [online]. Available at: https://www.handbook.fca.org.uk/handbook/COBS/6/2B.html [Accessed: 18 February 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 20. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the three categories of investor identified in COBS is provided with the highest level of regulatory protection?

2) If a client intends to purchase an investment product on an 'execution-only' basis, then:

   a) no recommendation is provided.

   b) no charges will be payable.

   c) they can only use an independent adviser.

   d) they will have to complete all the paperwork themselves.

3) A restricted adviser is one who:

   a) can only make recommendations based on the products of a single provider.

   b) has not passed all of the relevant exams to enable them to give independent advice.

   c) does not meet the FCA criteria to be considered 'independent'.

   d) can only give basic advice on stakeholder products.

4) A firm is keen to develop its mortgage business and has acquired a list of potential new customers from a marketing company. It plans to call the listed individuals in the evenings and at weekends. In what respects would this plan breach COBS rules on financial promotions?

5) Which of the following reflects the FCA's rules on adviser charging?

   a) Advisers may minimise the upfront cost of their services to clients by charging in instalments over a number of years.

   b) Advisers' charges must be based on hourly fees.

c) Advisers have discretion to determine their charging structures but they must pay due regard to the best interests of the client.

d) It is accepted that it is not possible to provide an estimate in advance of chargeable hours because of the potential complexity of some transactions.

6) When an adviser transacts designated investment business for a client, the basis or amount of the charges would normally be disclosed in which document?

a) The key features document.

b) The statutory cancellation notice.

c) The suitability report.

d) The client agreement letter.

7) For existing clients, a services and costs disclosure document (SCDD) (or the equivalent used by a particular firm) must be provided every time an adviser carries out a new transaction for them. True or false?

8) An adviser must issue a key features or key information document and illustration prior to a sale being concluded for all of the following products, **except**:

a) gilt-edged securities.

b) life assurance.

c) stakeholder pensions.

d) unit trusts.

9) How long is the cooling-off period for pension policies?

a) 30 days from the date when the contract begins or from the date on which the client receives contractual terms, if this is later.

b) 14 days from the date when the contract begins or from the date on which the client receives contractual terms if this is later.

c) 14 days from the date when the cancellation notice is issued.

d) 30 days from the date when the cancellation notice is issued.

10) An adviser would not be required to prepare a suitability report in respect of a recommendation for a:

    a) personal pension.

    b) life insurance product.

    c) mortgage.

    d) unit trust.

11) Jane has cancelled a unit trust within the cancellation period but received less back than she invested. Why is this?

    a) A withdrawal charge has been applied to her plan.

    b) She invested a lump sum into a unit-linked plan.

    c) A surrender charge has been applied to her plan.

    d) She invested into a regular premium unit-linked plan.

TOPIC 21

Conduct of business requirements II

LEARNING OBJECTIVES

In Topic 20 we focused on the requirements of the Conduct of Business Sourcebook, which applies to all firms that carry out regulated investment business. In this topic we are going to look more closely at the rules surrounding the provision of mortgage and insurance advice, and banking conduct and lending requirements. We will also consider other categories of advice and the circumstances in which they are appropriate.

By the end of this topic, you should have an understanding of:

- the rules relating to the provision of mortgage advice;
- the rules relating to the provision of insurance advice;
- the provisions of BCOBS, the Payment Services Regulations and the Standards of Lending Practice;
- the rules relating to the provision of basic advice;
- generic, focused and simplified advice, and when they may be appropriate.

This topic covers Unit 2 syllabus learning outcomes U3.11–U3.14.

THINK ...

If you have ever applied for a mortgage, especially if you have done so since the 2007–09 financial crisis, you might have been surprised – or even irritated! – by the lengthy application process. Much of the information gathered is used to assess whether or not the prospective borrower can really afford the mortgage they are applying for.

If significant numbers of people find that they can't keep up repayments on their mortgage, what do you think the implications might be for:

- individual borrowers;
- lenders;
- the UK economy?

21.1 How is the provision of mortgage advice regulated?

The FCA's rules on mortgage advice are detailed in the Mortgages and Home Finance: Conduct of Business (MCOB) sourcebook. The rules cover lending, administration, advice and the arranging of loans. Banks, building societies, specialist lenders and mortgage intermediaries must be authorised to carry out these activities.

In terms of training and competence requirements, every seller must hold a relevant mortgage qualification (such as CeMAP®). Mortgage advisers, arrangers and lenders fall within the remit of the Financial Ombudsman Service and the Financial Services Compensation Scheme.

When the FCA's predecessor, the FSA, began regulating mortgage advice in 2004, its rules covered loans taken out by individuals or trustees that were subject to a first charge on the borrower's property. This included not only mortgages but also other loans where the security was a first charge on residential property.

As a consequence of the way the provisions of the EU Mortgage Credit Directive were implemented in the UK, the scope of MCOB was extended in March 2016 to cover second charge loans.

A regulated mortgage, subject to MCOB is defined as a contract that satisfies the following conditions:

- lender provides credit to an individual or trustees (the borrower);
- the contract provides for the obligation of the borrower to repay to be secured on land in the European Economic Area (EEA); and
- at least 40 per cent of that land is used or intended to be used, as or in connection with a dwelling.

KEY TERMS

FIRST CHARGE

If a lender has to take possession of a property and sell it as a result of the borrower defaulting on the loan, the holder of a first-charge loan has the right to be repaid ahead of other chargeholders from the proceeds of the sale.

SECOND CHARGE

In the event of a property being possessed by a lender and sold as a result of default by the borrower, the holder of a second-charge loan ranks behind the first-charge lender for repayment; they will only have a claim on the proceeds of the sale once the first-charge lender has been repaid in full.

This means that the regime covers home improvement loans, debt consolidation loans and equity release schemes such as lifetime mortgages and home reversion schemes.

The Mortgage Credit Directive (MCD) introduced a new category of consumer buy to let (CBTL). Advising on, arranging, lending and administering CBTL mortgages is subject to a legal framework detailed in the MCD Order 2015, rather than the MCOB rules.

The FCA is responsible for regulating, supervising and, if necessary, taking action against firms engaged in CBTL activity. Whilst the MCOB rules do not apply in full, the government has prescribed rules in respect of the sale, underwriting and administration of CBTL mortgages. The rules include requirements in respect of:

- pre-contract disclosure;
- assessing creditworthiness;
- arrears management.

IN BRIEF

APPLICATION OF MCOB

MCOB applies to:

- first-charge loans secured on residential property;
- second-charge loans secured on residential property.

21.1.1 What is 'consumer buy to let'?

To understand what is meant by 'consumer buy to let', it is helpful to compare it to 'business buy to let', which is not regulated. Business BTL activity is carried out by professional landlords who, typically, have a portfolio of BTL properties that they run as a business to generate profit. A consumer BTL mortgage is defined as one where the mortgage has not been entered into wholly or predominantly for the purpose of a business carried out by the borrower.

The regulation of consumer BTL mortgages is aimed at providing protection for those who have taken out a BTL mortgage more as a result of circumstances than from a particular desire to operate a BTL business.

CONSUMER BUY TO LET

A transaction where the mortgage has not been entered into wholly or predominantly for the purpose of a business carried out by the borrower.

Such scenarios could include a person who needs to relocate for their job but is unable to sell their property, or someone who has inherited a property that they have opted to rent out because it proves difficult to sell. In such circumstances it would be reasonable to assume that the individual would not have the same experience or expertise as a person who owns a portfolio of BTL properties; hence the additional protections provided by the conduct standards applying to CBTL mortgages.

Lenders can use their own procedures to establish whether a borrower is a business and therefore not subject to the conduct standards applying to CBTL mortgages; they can also rely on the customer completing a declaration to confirm they are a business borrower.

If a mortgage is taken out to support the purchase of a property that is to be let out to a close relative then, unless the mortgage meets the criteria to be classed as a business buy to let, the mortgage is regulated under the MCOB rules, rather than the CBTL regime. MCOB defines a close relative as being a spouse, civil partner, parent, brother, sister or grandparent of borrower.

CHECK YOUR UNDERSTANDING 1

Ella and Martin's daughter, Lydia, is in the first year of her three-year university degree; she is currently in halls of residence but will need to rent accommodation privately next year. Ella and Martin are planning to buy a four-bedroom house in the university town; Lydia will be able to live there until she completes her degree, and they will get rental income on the other rooms. If they apply for a mortgage to buy the property, will it qualify as a consumer buy to let?

21.2 What are the key elements of MCOB?

A summary of the provisions of MCOB is provided here.

MCOB 1: Application and purpose

Explains the scope of the rules, ie to whom they apply and for what types of mortgage.

MCOB 2: Conduct of business standards: general

Includes:

- the use of correct terminology ('early repayment charge' and 'higher lending charge');
- the requirement for communications with customers to be 'clear, fair and not misleading';

- rules about the payment of fees/commission and the accessibility of records for inspection by the FCA.

MCOB 2A: Mortgage Credit Directive:

Includes rules on a range of matters that apply to a lender classed as a Mortgage Credit Directive mortgage lender, including:

- remuneration;
- the tying of products (making a mortgage conditional on the purchase of other products);
- foreign currency loans; and
- early repayments.

MCOB 3A: Financial promotions and communications with customers

Distinguishes between 'real-time' promotions (by personal visit or telephone call) and non-real-time (by letter, email, or advert in newspapers, magazines, or on television radio or the internet).

- Unsolicited real-time promotions are not permitted.
- Non-real-time promotions must include the name and contact details of the firm. They must be clear, fair and not misleading. If comparisons are used, they must be with products that meet the same needs. They must state that "your home may be repossessed if you do not keep up repayments on your mortgage". Records of non-real-time promotions must be retained for one year after their last use.

MCOB 3B: MCD general information

Specifies the requirements relating to information that must be provided to customers, for lenders who make mortgage advances regulated under the Mortgage Credit Directive.

MCOB 4 and 4A: Advising and selling standards

It must be clear whether advice is based on the products of the whole market, a limited number of home finance providers, or a single lender.

- Independent advisers are not required to be able to access all products from all providers: they can source products from a panel of lenders as long as the panel is representative of the market.
- Any mortgage recommended must be suitable for the customer and appropriate to their needs and circumstances; records to demonstrate this must be kept for three years. However, there is no requirement to issue a suitability report to the client.

- Special requirements apply if the mortgage will be used to consolidate existing debts.

On first making contact with a customer, certain information must be disclosed prominently and clearly to the customer. An initial disclosure document (IDD) can be given to detail the required information, but this is not a formal requirement as long as the required information is clearly communicated. The customer must be provided with the following information:

- name and contact details;
- whose mortgages are offered;
- details of any limitations in service;
- details of any fee payable for the mortgage advice;
- the firm's FCA registration details;
- how to complain; and
- details of the compensation scheme.

MCOB 5 and 5A: Pre-application disclosure

Details the information that must be provided at the point at which a personal recommendation is made and before an application is submitted to the lender. This must include:

- the annual percentage rate of charge (APRC), which shows the interest rate with any fees added;
- the amount of the monthly instalment; and
- the amount by which the instalment would increase for each 1 per cent rise in interest rates.

The required information must be provided via a European Standardised Information Sheet (ESIS). The contents of the ESIS are set out in the rules, and variations from the prescribed format are not permitted.

MCOB 6 and 6A: Disclosure at the offer stage

If a mortgage offer is made, the lender must provide a detailed offer document. This is based on the information given at pre-application stage, subject to any changes between application and offer illustration. The offer is binding on the lender but can be made conditional on the confirmation of certain details. The offer must also:

- state how long the offer will remain valid;
- point out that there will be no right of withdrawal after the mortgage has been completed; and

- include or be accompanied by a tariff of charges.

The borrower must be granted a period of reflection of at least seven days to consider whether to accept the offer or not.

MCOB 7 and 7A: Disclosure at start of contract and after sale

Before the first mortgage payment is made, the lender must confirm:

- details of amounts, dates and methods of payment;
- details of any related products such as insurance;
- (for interest-only mortgages) the responsibility of the borrower to ensure that a repayment vehicle is in place; and
- what the customer should do if they fall into arrears.

Annual statements must be issued, showing:

- the amount owed and remaining term;
- what type of mortgage it is;
- for interest-only mortgages, a reminder to check the performance of the repayment vehicle;
- interest, fees or other payments made since the last statement;
- any changes to the charges tariff since the last statement.

If the mortgage is arranged on an interest-only basis, then the lender must contact the borrower at least once during the term to confirm that a credible repayment vehicle remains in place.

If a change is to be made to the monthly payment, the customer must be informed of the new amount, revised interest rate and date of the change.

MCOB 8 and 9: Equity release – advising and selling standards, and product disclosure

Details the FCA's requirements in respect of lifetime mortgages and home reversion schemes. Special rules apply to equity release in relation to advising and selling standards, and to product disclosure. The FCA Training and Competence rules require that anyone giving advice on equity release must hold a specialist qualification in this area of business.

MCOB 10: Annual percentage rate (APR)

Describes how to calculate APR (see section 22.1.1).

MCOB 10A: Annual percentage rate of charge

Describes how to calculate APRC (see section 22.1.1).

MCOB 11 and 11A: Responsible lending

Lenders must put in place a written responsible lending policy, and must be able to show that they have taken into consideration a customer's ability to pay when offering a mortgage.

MCOB 12: Charges

Excessive charges are not permitted. Early repayment charges must be a reasonable approximation of the costs incurred by the lender if the borrower repays the full amount early. Similarly, arrears charges must be a reasonable approximation of the cost of additional administration as the result of a borrower being in arrears.

MCOB 13: Arrears and repossessions

Firms must deal fairly with customers who have mortgage arrears or mortgage shortfall debt. This includes:

- trying to reach an agreement on how to repay the arrears, taking into account the borrower's circumstances;
- liaising with third-party sources of advice;
- not putting unreasonable pressure on customers in arrears;
- repossessing a property only when all other reasonable measures have failed;
- only applying arrears charges that are a reasonable reflection of the costs of the work involved in dealing with the arrears.

Records must be kept of all dealings with borrowers in arrears.

Customers in arrears must be given the following information within 15 working days of the lender becoming aware of arrears:

- the Money Advice Service information sheet 'Problems paying your mortgage';
- the missed payments and the total of arrears including any charges incurred;
- the outstanding debt;
- any further charges that may be incurred unless arrears are cleared.

> **FACTFIND**
>
> MCOB is available on the FCA website:
>
> https://www.handbook.fca.org.uk/handbook/MCOB/ [Accessed: 18 February 2020].

21.3 Providing mortgage advice to clients

The MCOB rules specify that one of two different levels of service can be provided:

- advice;
- execution only.

There is no scope to offer an information-only service, whereby the borrower selects their own mortgage based on information provided.

The execution-only service can only be provided in a limited range of situations defined in the MCOB rules, ie for transactions involving business borrowers, high-net-worth individuals and mortgage professionals. Evidence that the individual falls into one of these categories must be retained. In the case of joint applications where only one party is a mortgage professional, advice has to be given to the non-professional. Should a customer opt for execution only, then the lender is required to make customers aware of the consequences of proceeding on an execution-only basis.

VULNERABLE CUSTOMERS

In Topic 14 we explained that firms have a responsibility to identify and deal appropriately with vulnerable customers, tailoring their service provision to customer needs.

In respect of mortgages, the FCA views the following as being vulnerable customers on the basis of the financial arrangement they are considering:

- those buying a property using the statutory Right-to-Buy;
- those entering a sale-and-rent-back agreement;
- equity-release applicants.

Because of the additional risks posed by these types of arrangement, the FCA requires that an individual falling into any of the categories above must, in the first instance, be given advice. Should they subsequently wish to proceed on an execution-only basis, then they can do so.

If you would like to find out more about the FCA's guidance in relation to vulnerable customers, go to:

https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-8-consumer-vulnerability [Accessed: 18 February 2020].

A mortgage adviser must take reasonable care to:

- establish (from the prospective borrower) all information that is likely to be relevant;
- ensure that the advice they give is suitable given the customer's circumstances and needs.

Determining the suitability of a mortgage involves three stages (see Figure 21.1).

FIGURE 21.1 DETERMINING SUITABILITY OF A MORTGAGE

If it is established that a mortgage is suitable, then the next stage is to recommend a suitable mortgage contract. The following questions must be considered:

- Which mortgage type is most suitable? Repayment, interest only or a combination of the two?
- Which interest rate option is most suitable? Fixed, variable, capped, etc?
- Over how long a term should the mortgage run?
- What are the costs involved? Are they affordable?

There is no requirement under MCOB to issue a suitability report although many lenders will do so.

21.3.1 Assessing affordability and verifying income

Mortgage lenders must verify income for every mortgage application, and verification must be provided from a source independent of the borrower. This means that self-certification and fast-track mortgage products are no longer allowed, although such products were permitted prior to the introduction of new rules in April 2014.

A lender must be able to demonstrate that the mortgage it is proposing is affordable, taking into account specific categories of expenditure (committed expenditure and basic essential expenditure). In assessing long-term affordability, lenders can take into account positive expected changes, if they have evidence to support such changes.

In respect of interest-only mortgages, the lender must be satisfied that there is a clear and credible alternative source of capital repayment in place; if not, affordability must be assessed on a repayment basis.

Lenders must take reasonable steps to ensure that the mortgage proposed is affordable not just at the time the application is assessed but on an ongoing basis. This is achieved by means of a stress test, which involves checking that an applicant will be able to afford the payments if interest rates should rise.

KEY TERMS

COMMITTED EXPENDITURE

Repayments on credit agreements or other contractual arrangements.

BASIC ESSENTIAL EXPENDITURE

Expenditure on food and other housekeeping costs, utilities, telephone, council tax, buildings insurance, ground rent and service charges for leasehold properties, and essential travel to work and school.

21.4 What are the Insurance: Conduct of Business rules?

Firms and individuals working in the areas of general insurance, protection, critical illness, long-term care and income protection insurance have to be authorised through the same processes of permission and approval as those that apply to the rest of the industry.

Rules applicable to intermediaries who sell, administer or advise on general insurance are contained in the Insurance: Conduct of Business Sourcebook (ICOBS). The ICOBS rules are split into eight sections, which are summarised here.

ICOBS 1: Application

Explains that the rules cover firms that deal with retail and commercial customers for the sale of non-investment insurance products. The activities regulated by these rules include:

- insurance distribution activities;
- effecting and carrying out contracts of insurance;
- managing the underwriting capacity of a Lloyds syndicate as a managing agent at Lloyds;
- communicating or approving a financial promotion.

ICOBS 2: General matters

Covers categorisation of clients:

- policyholders (anyone who, upon the occurrence of the contingency insured against, is entitled to make a claim);
- customers (anyone who makes arrangements preparatory to concluding a contract of insurance, ie a prospective policyholder).

Customers are further categorised as:

- consumers (natural persons for purposes outside his or her profession);
- commercial customers (anyone who is not a consumer).

ICOBS 2 also covers:

- communications (which must be clear, fair and not misleading);
- inducements (managing conflicts of interest fairly, and not soliciting or accepting inducements that would conflict with a firm's duties to its customers);
- record-keeping; and
- 'exclusion of liability' (a firm must not seek to exclude or restrict liability unless it is reasonable to do so).

ICOBS 3: Distance communications

Covers rules that ensure compliance with the EU Distance Marketing Directive, which include the following:

- A firm must provide a consumer with distance marketing information before the conclusion of a distance consumer contract.
- The identity of the firm and the purpose of the call must be made explicitly clear at the beginning of any telephone communications.
- Contractual obligations must be communicated to a consumer during the pre-contractual phase, and these obligations must comply with the law presumed to apply to a distance contract.
- Terms and conditions must be communicated to a consumer in writing before the conclusion of a distance contract.
- The consumer is entitled to receive a copy of the contractual terms and conditions in hard copy on request.

ICOBS 3 also covers e-commerce activities and states that a firm must make the following information easily, directly and permanently accessible:

- name and address;

- details of the firm (including email address) that allow it to be contacted in a direct and effective manner;
- status disclosure statement, and confirmation that it is on the FCA Register, including its FCA register number.

Other rules include that any:

- prices advertised must be clear and unambiguous, and the firm must indicate whether the price includes relevant taxes; and
- unsolicited commercial communication sent by email must be clearly identifiable as such as soon as it is received.

ICOBS 4: Information about the firm, its services and remuneration

States that a firm must provide a customer with at least the following information before the conclusion of an initial contract of insurance and, if necessary, on its amendment or renewal:

- its identity, address and whether it is an insurance intermediary or an insurance undertaking;
- whether it provides a personal recommendation about the insurance products offered;
- the procedures for making complaints to the firm and the FOS or, if the FOS does not apply, information about the out-of-court complaint and redress procedures available for the settlement of disputes.

An insurance intermediary must also provide the customer with the following information:

- the fact that it is included in the FCA Register and the means for verifying this;
- whether it has a direct or indirect holding representing 10 per cent or more of the voting rights or capital in a given insurance undertaking (that is not a pure reinsurer);
- whether a given insurance undertaking (that is not a pure reinsurer) or its parent undertaking has a direct or indirect holding representing 10 per cent or more of the voting rights or capital in the firm; and
- whether it is representing the customer or is acting for and on behalf of the insurer.

Where an insurance intermediary proposes or advises on a contract of insurance then before the conclusion of the initial contract, the intermediary must provide information on whether the firm:

- gives a personal recommendation on the basis of a fair and personal analysis; or

- is under a contractual obligation to conduct insurance distribution exclusively with one or more insurance undertakings; or
- neither of the above apply.

In which case it must provide its customer with the name of those insurance undertakings with which the insurance intermediary may, and does, conduct business.

Where a firm has given the above information, before the conclusion of an initial contract of insurance with a consumer, a firm must also state whether it is giving:

- a personal recommendation, but not on the basis of a fair and personal analysis;
- other advice on the basis of a fair analysis of the market;
- other advice not on the basis of a fair analysis of the market; or
- just information.

A firm must provide details to a customer of any remuneration, including fees, commission and economic benefits of any kind given in connection with the contract in good time before the conclusion of the initial contract of insurance, amendment or renewal. The firm must inform its customer of the amount of any fee, where payable.

An insurance intermediary must, on a commercial customer's request, promptly disclose the commission that it or any associate may receive in connection with a policy.

ICOBS 5: Identifying client needs and advising

States that:

- a firm should take reasonable steps to ensure that a customer only buys a policy from which they are eligible to claim benefits;
- if a firm finds that parts of the cover do not apply, they should inform the customer so that they can make an informed choice;
- a firm should explain the duty not to misrepresent information, what this includes, and the consequences of deliberate, reckless or careless misrepresentation;
- prior to the conclusion of a contract a firm must specify, on the basis of information obtained from the customer, their needs;
- a statement of demands and needs must be communicated in writing to the customer in a clear and accurate manner, comprehensible to the customer;

- the firm must take reasonable steps to ensure the suitability of its advice to any customer who is entitled to rely upon its judgement, taking account of level of cover and cost, relevant exclusions, excesses, limitations and conditions – it must inform the customer of any demands and needs not met.

ICOBS 6: Product information

An insurer is responsible for producing, and an insurance intermediary for providing to a customer, the product information required by ICOBS 6.

ICOBS 6 states that a firm must take reasonable steps to ensure a customer is given appropriate information about a policy so that they can make an informed choice about the arrangements proposed.

The information given will vary according to matters such as:

- knowledge, experience and ability of a typical customer for the policy;
- policy terms, benefits, exclusions, limitations, conditions and duration;
- the policy's complexity;
- whether the policy is purchased in connection with other products and services;
- distance communication information requirements; and
- whether the same information has been provided to the customer previously.

When dealing with a consumer, a firm must provide an Insurance Product Information Document (IPID) in a durable medium. The IPID is drawn up by the manufacturer of the policy.

A firm should provide evidence of cover promptly after the inception of a policy.

Information disclosed 'pre-contract' includes the arrangements for handling complaints and the right to cancel.

Before a pure protection contract is concluded, a firm must provide the customer with information, including:

- the name of the insurance undertaking and its legal form;
- address of its head office;
- the definition of each benefit and option;
- contract term;
- the means of terminating the contract;
- means of payment and duration of premiums;

- tax arrangement for benefits under the policy;
- cancellation information;
- arrangements for handling complaints.

ICOBS 7: Cancellation

States that a consumer has the right to cancel without penalty, and without giving a reason, within:

- 30 days for a contract of insurance which is, or has elements of, pure protection (eg critical illness) or payment protection;
- 14 days for any other contract of insurance or distance contract (such as home insurance).

Firms are free to offer more generous cancellation terms than this, provided they are favourable to the consumer.

The right to cancel does not apply to the following:

- travel policies of less than one month;
- policies the performance of which has been fully completed;
- pure protection policies of six months or less, which are not distance contracts;
- pure protection policies effected by trustees of an occupational pension scheme, or employers (or partners) for the benefit of employees (or partners);
- general insurance (which is not a distance contract or payment protection contract) sold by an intermediary who is an unauthorised person; and
- a connected contract which is not a distance contract.

On receipt of the cancellation notice, the insurance company must return all premiums paid within 30 days, and the contract is terminated.

ICOBS 8: Claims handling

If claims are handled by an intermediary, the insurance company must ensure that the rules are complied with, ensuring no conflict of interest. Claims must be handled promptly and fairly, and the firm must provide reasonable guidance to help the policyholder make a claim. The firm must not unreasonably reject a claim.

Rejection of a claim is considered unreasonable if it is for:

- non-disclosure of a material fact which the policyholder could not reasonably have expected to have disclosed;

- non-negligent misrepresentation of a material fact;
- breach of a condition of the contract unless the circumstances of the claim are connected to the breach.

FACTFIND

Full details of ICOBS are available at:

https://www.handbook.fca.org.uk/handbook/icobs/ [Accessed: 18 February 2020].

21.5 What are the Banking: Conduct of Business rules?

The Banking: Conduct of Business Sourcebook (BCOBS) applies to firms accepting deposits from UK banking customers in the UK, for example by providing savings and current accounts. The BCOBS rules came into effect from 1 November 2009 and introduced principles-based regulation to the deposit-taking products and services for consumers.

BCOBS complements the Payment Services Regulations, which were introduced at the same time to implement in the UK the EU Payment Services Directive. The Payment Services Regulations prescribe the way that payments are to be undertaken within the European Economic Area (EEA).

The BCOBS rules are designed in such a way as not to overlap with the provisions of the Payment Services Regulations. Those areas of the Payment Services Regulations not covered by BCOBS are addressed by the Standards of Lending Practice (see section 21.7), overseen by the Lending Code Standards Board.

BCOBS has six chapters, which are summarised here.

BCOBS 1: Application

BCOBS applies to firms that accept deposits from banking customers, if such activities are carried on from an establishment maintained by the firm in the UK, and activities connected with accepting such deposits.

BCOBS 2: Communications with banking customers and financial promotions

Requires a firm to pay regard to the information needs of banking customers when communicating with, or making a financial promotion to them, and to communicate information in a way that is clear, fair and not misleading.

BCOBS 2A: Restriction on marketing or providing an optional product for which a fee is payable

Details the rules applying to marketing or providing an optional product (linked to a current account or savings account) for which a fee is payable.

BCOBS 3: Distance communications and e-commerce

Applies to a firm that carries on any distance marketing activity from an establishment in the UK, with or for a consumer in the UK or another European Economic Area state. It contains many of the provisions of the Distance Marketing Directive.

BCOBS 4: Information to be communicated to banking customers and statements of account

Details how a firm must provide or make available to banking customers appropriate information about a retail banking service and any deposit made in relation to that retail banking service.

BCOBS 5: Post-sale requirements

A firm must provide a service in relation to a retail banking service that is prompt, efficient and fair to a banking customer and which has regard to any communications or financial promotion made by the firm to the banking customer from time to time. This includes dealing with customers in financial difficulty, those that wish to move bank accounts, and lost and dormant accounts.

BCOBS 6: Cancellation

Sets out a customer's rights to cancel in various circumstances, and when there are no rights to cancellation.

BCOBS 7: Information about current account services

Requires a firm to publish information about its provision of personal current accounts and business accounts.

FACTFIND

Full details of BCOBS are available at:

https://www.handbook.fca.org.uk/handbook/bcobs/ [Accessed: 18 February 2020].

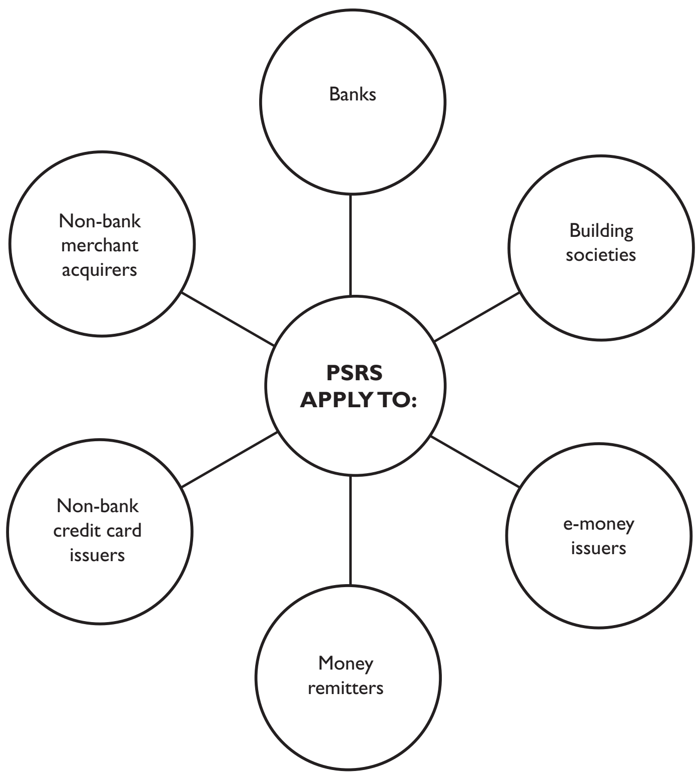
21.6 What are the Payment Services Regulations?

The Payment Services Regulations (PSRs) cover most payment services, including the provision and operation of 'payment accounts'. Payment accounts are accounts on which payment transactions may be made and where access to funds is not restricted (a fixed-term deposit is an example of a restricted account). The regulations extend from the information that is to be provided before a payment is made to the remedial action a firm must take if a payment goes wrong.

The PSRs' conduct of business provisions only apply to payment services made in euros or sterling, so primarily to sterling and euro-denominated accounts.

The PSRs affect firms providing payment services, and their customers (see Figure 21.2).

FIGURE 21.2 FIRMS COVERED BY PSRs



The PSRs introduced a new class of regulated firms known as payment institutions (PIs). These are businesses authorised to process payments by card, credit transfer or direct debit, to issue or acquire payment instruments and to remit money. If not exempt, a PI must either be authorised or registered by the regulator. Authorised PIs are subject to prudential requirements. Conduct of business requirements apply to all payment service providers, including banks, building societies, e-money issuers and PIs.

KEY TERMS

MONEY REMITTER

A payment services provider that accepts funds for payment without necessarily holding an account with either the payee or payer. It enables one party to send money to another using its services to get the money to the required destination.

NON-BANK MERCHANT ACQUIRERS

A financial institution other than a bank that processes credit or debit card payments.

21.6.1 Payment Services Directive (PSD2)

PSD2 came into effect on 13 January 2018 and is a significant evolution of existing regulation for the payments industry. It aims to increase competition in the payments industry, brings into scope new types of payment services, enhance customer protection and security, and extend the reach of the Directive.

The key changes introduced by PSD2 can be grouped into four main themes: market efficiency and integration; consumer protection; competition and choice; and security.

PSD2 increases consumers' rights in a number of ways. For example:

- Payments sent or received where one of the payment service providers (PSPs) is located outside the EEA are covered, as are payments in non-EEA currencies.
- The amount a payer can be obliged to pay in an unauthorised payment scenario has reduced from €150 to €50, except in cases of fraud or gross negligence by the payer.
- PSD2 bans surcharging for the use of payment instruments covered by the Interchange Fee Regulation and payment services covered by the SEPA Regulation.
- PSPs must put in place dispute resolution procedures and are required to respond to payment complaints within 15 business days of receipt. In exceptional circumstances, a holding reply can be provided, explaining the reasons for the delay, with the final response being received within 35 business days.

To facilitate competition, banks must give third-party providers access to their account in order to carry out the transactions. There are two key types of organisation involved in providing the services, often referred to collectively as third-party providers or TPPs:

- An account information service provider (AISP) is defined in PSD2 Article (16) as an "online service to provide consolidated information on one or more payment accounts held by the payment service user".
- Payment Initiation Service Providers (PISPs) are service providers that carry out transactions for the account holder, which could include person to person (P2P) transfers – an online technology that allows customers to transfer funds from their bank account or credit card to another person's account via a mobile device using the internet – and general bill payments.
- In addition, PSD2 introduces another new definition: "account servicing payment service provider" (AS PSP) to distinguish the provider where the customer's payment account is held. The PSD2 text makes it clear that customers have a right to use PIS and AIS where the payment account is accessible online and where they have given their explicit consent.

There are further technical standards relating to strong customer authentication, and common and secure communication which, at the time of writing (February 2019), are expected to be effective on 14 September 2019.

21.6.2 Payment Systems Regulator

The Payment Systems Regulator (PSR) is a subsidiary of the Financial Conduct Authority (FCA). It oversees all domestic payment systems that are brought into the regulator's scope by HM Treasury. The PSR has authority:

- over requirements regarding system rules; and
- to give directions to participants in designated payment systems.

It has further specific powers to:

- require access to designated payment systems for a payment services provider;
- vary agreements relating to designated payment systems (including fees and charges); and
- require owners of payment systems to dispose of their interests in them, subject to the satisfaction of certain preconditions and subject to HM Treasury approval.

FACTFIND

You can find further information about the Payment Services Regulations at:

https://www.fca.org.uk/firms/payment-services-regulations [Accessed: 18 February 2020].

21.7 The Standards of Lending Practice

Lending is not covered by BCOBS. Although the FCA's CONC sourcebook applies, there is also a degree of self-regulation by the industry in this area. The Lending Standards Board (LSB) publishes standards to which firms that are registered with the LSB must adhere.

The Standards of Lending Practice for personal customers set out a number of principles, covering six main areas:

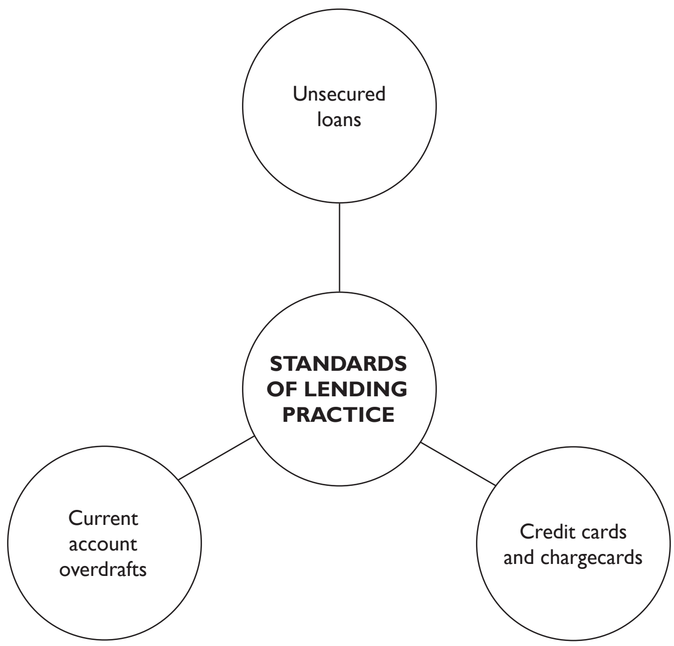
- financial promotions and communications;
- product sale;
- account management and servicing;
- money management;
- financial difficulty;
- customer vulnerability.

The key requirements are shown in Figure 21.4.

A separate set of Standards apply to business customers.

The Standards of Lending Practice also have a section on governance and oversight, which sets out the framework that registered firms should have in place to ensure effective implementation of the standards.

FIGURE 21.3 PRODUCTS COVERED BY THE STANDARDS OF LENDING PRACTICE



Registered firms must at all times comply with the Consumer Credit Act 1974, the Consumer Credit (EU Directive) Regulations 2010, the FCA's Consumer Credit Sourcebook (CONC), the Equality Act 2010 and other relevant legislation. Compliance is monitored and enforced by the Lending Standards Board.

CHECK YOUR UNDERSTANDING 2

The Standards of Lending Practice do not apply to mortgages. What is the regulation that covers mortgages?

FIGURE 21.4 KEY REQUIREMENTS OF THE STANDARDS OF LENDING PRACTICE

Financial promotions and communications
Must be clear, fair and not misleading.

Product sales
Customers will only be provided with a product that is affordable and meets their needs.

Account maintenance and servicing
Customer requests will be dealt with in a timely, secure and accurate manner. Information provided will be clear and detail any action required by the customer.

Money management
Customers will be helped to manage their finances through proactive and reactive measures designed to identify signs of financial stress and help avoid financial difficulties.

Financial difficulty
Customers in financial difficulty will receive appropriate support and fair treatment.

Customer vulnerability
Firms are expected to provide inclusive products and services that take account of the broad range of customers and are flexible enough to meet the needs of customers who are classed as vulnerable. Firms are expected to have a formal strategy for dealing with vulnerable customers.

Governance and oversight
Firms are expected to put in place policies and procedures that ensure customers receive a fair outcome when taking out a consumer credit product and throughout all their dealings with the firm.

21.8 What are the other categories of advice?

We looked earlier in this topic and in the previous topic at the principles and regulations governing the provision of advice on regulated products such as mortgages and insurance contracts. There are a number of other categories of advice that apply in certain limited circumstances:

- basic advice;
- generic advice;
- focused advice;
- simplified advice;
- robo advice.

21.8.1 Basic advice

Basic advice is a limited form of advice that applies to stakeholder products. It is focused on one or more specific client needs; it does not involve an analysis of the client's circumstances that are not directly relevant to those needs. It involves the use of a set of scripted questions to establish whether a stakeholder product within the firm's range is suitable for the customer.

STAKEHOLDER PRODUCTS

We looked at stakeholder pensions and the reasons for their introduction in Topic 10. When first introduced in 2001, stakeholder pensions were a popular option, and this encouraged the government to extend the range of savings and investments products. As with the stakeholder pension, the idea was that customers who might be deterred from making appropriate savings provision through a lack of confidence, lack of understanding or concerns about risk and cost would be attracted by a simple, low-risk product with transparent charges.

A suite of products was introduced, covering short- and medium-term investment needs, along with the stakeholder pension and a Child Trust Fund. Charges were capped: the maximum permitted annual charge for the investment products is now 1.5 per cent for the first ten years of the life of a product and 1 per cent thereafter. For stakeholder pensions arranged prior to 6 April 2005, charges are capped at 1 per cent throughout.

As stakeholder products were designed to be simple, the expectation was that they would be straightforward to sell and regulation could therefore be less complex. The 'basic advice' process was less costly for providers to deliver and it was hoped that that would encourage take-up. The reality was that, in light of the capped charges, providers showed little appetite to enter this market and the enhanced suite of stakeholder products never took off. Nonetheless, the products remain available from some providers, and advisers may encounter clients who already hold products bought under the 'basic advice' regime.

When a firm first has contact with a client with a view to giving basic advice on a stakeholder product, the client must be provided with the basic advice initial disclosure information in a durable format together with an explanation of the information.

When giving basic advice, the firm must do so using a sales process that includes putting scripted questions to the client.

A stakeholder product can only be recommended if:

- reasonable steps have been taken to assess the client's answers to the scripted questions and any other facts disclosed by the client during the basic sales process;
- there are reasonable grounds for believing that the stakeholder product is suitable for the client; and
- the firm reasonably believes the client understands the basis upon which the advice has been provided.

IN BRIEF

WHEN IS BASIC ADVICE APPROPRIATE?

Basic advice is appropriate for clients who:

- have their priority needs met (ie they do not need to reduce existing debt, have adequate access to liquid cash, and have their core protection needs met);
- have some disposable income or capital that they wish to invest;
- do not want a holistic assessment of their financial situation, just advice on a specific investment need.

The client must be provided with enough information about the nature of the stakeholder product, including its aims, commitment and risks, to make an informed decision about the recommendation being made to them. While a full suitability report is not required, a recommendation summary is. The client must be provided with a copy of the completed questions and answers as soon as possible after concluding the sale.

A record must be kept of the fact that the firm has chosen to give basic advice to a particular client, including the range of stakeholder products used. This record must be retained for five years.

21.8.2 Generic, focused and simplified advice

Figure 21.5 describes generic, focused and simplified advice and when they may be used. Note the key difference between focused and simplified advice: for focused advice, the customer determines the boundaries within which the advice is to be focused; with simplified advice, it is the firm that sets out the parameters of the advice that it is providing.

Where a customer has been provided with information about a product or products, or has had technical terms explained to them, then it is likely they have received guidance rather than advice. This is also referred to as an 'information only' service. Such an approach can be contrasted with the provision of advice, which involves a recommendation to take, or avoid taking, a particular course of action.

FIGURE 21.5 GENERIC, FOCUSED AND SIMPLIFIED ADVICE

Generic advice

- Advice or information that does not relate to a particular product or investment and does not meet the characteristics of regulated advice
- For example, 'for most people it is sensible to have adequate financial protection in place'

Focused advice

- Where, at the request of the customer, advice and recommendations relate to specific needs or investments
- Also referred to as limited advice

Simplified advice

- Advice that is limited, by the firm providing it, to one or more of a customer's needs
- Does not involve analysis of the customer's circumstances that are not directly relevant to those needs
- This type of advice may be provided face to face, over the phone or online

21.8.3 Robo advice

Robo-advisers are a class of financial adviser that provide financial advice or portfolio management online with minimal human intervention. They provide digital financial advice based on mathematical rules or algorithms. This innovation is intended to provide a low-cost alternative to face-to-face advice and go some way to address the advice gap left by the cost of the traditional advice model. The Treasury and FCA have been monitoring the development of this approach and in April 2017 published guidelines, making it clear that any funds offered to investors by robo-advisers offering 'streamlined advice' are to be suitable for customers' risk tolerance and investment objectives. The guidelines advise companies on the information they need to collect about investors, and warn on the importance of forming "clearly worded" risk questionnaires that do not assume "a high level of financial capability". The FCA has suggested that robo-advice companies could use consumer testing and web analytics to monitor how long customers spend on each page of their websites.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the situations in which MCOB rules apply to mortgage transactions?
- explain the difference between a first and second charge?
- explain how 'buy to let' differs from 'consumer buy to let'?
- outline the main areas covered by MCOB?
- describe the rules relating to affordability and verification of income for mortgage purposes?
- outline the main areas covered by ICOBS?
- list the key requirements of the Standards of Lending Practice?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 21. Review the text if necessary.

Answers can be found at the end of this book.

1) A mortgage arranged for which of the following mortgagors would not be a regulated mortgage?

    a) Terry and Angel, who are joint borrowers buying their first home.

    b) Laszlo and Yuri, who are creating a mortgage in their capacity as trustees.

    c) John, who is a sole borrower, trading up to a bigger property.

    d) Décor Plus, which is a public limited company.

2) Which of the following methods of obtaining new business is not permitted for a regulated mortgage?

    a) Cold calling.

    b) Mortgage introducers.

    c) Radio advertising.

    d) TV advertising.

3) Maurice wants to use the equity in his property by arranging a lifetime mortgage. He wants exactly the same product that his brother has and does not want to waste time considering other options. Why would it not normally be possible for Maurice to proceed on an execution-only basis, even though he knows exactly what he wants?

4) Which of the following statements is **untrue** in relation to the offer document that is produced following a mortgage application?

    a) It must contain details of the monthly payments.

    b) It must state how long the offer is valid for.

    c) It must explain how the customer can withdraw from the contract once the mortgage is completed.

    d) It must be accompanied by an up-to-date tariff of charges.

5) When assessing affordability for a mortgage application, which of the following is regarded as committed expenditure?

   a) Repayments on a personal loan.

   b) Council tax.

   c) Water bills.

   d) Costs of travel to work.

6) To ensure that there is no danger of misrepresenting the policy benefits, an adviser must always provide the product information published by the product provider and allow the customer to make their purchasing decision on the basis of that information. True or false?

7) Eva has just taken out an income protection policy. If she changes her mind and decides she no longer wants this policy, what cancellation rights does she have?

8) The Standards of Lending Practice are an example of self-regulation. True or false?

9) A customer who wishes to buy a stakeholder pension product may receive:

   a) focused advice.

   b) generic advice.

   c) information only.

   d) basic advice.

10) What is the key difference between focused advice and simplified advice?

TOPIC 22

Consumer credit

LEARNING OBJECTIVES

This short topic focuses on the rules surrounding the provision of consumer credit. 'Consumer credit' includes personal loans, hire purchase, credit cards and store cards. It has only been regulated by the FCA since 2014, but it is an area of financial services that has been subject to legal requirements since 1974.

By the end of this topic, you should have an understanding of:

- the provisions of the Consumer Credit Act 1974;
- the provisions of the Consumer Credit Act 2006;
- the changes resulting from the Consumer Credit Directive;
- activities subject to full FCA authorisation; and
- the provisions of the Consumer Credit sourcebook (CONC).

This topic covers part of the Unit 2 syllabus learning outcome K2.1.

THINK ...

Even if you have no other experience of FCA regulation, it's likely that you have encountered the rules that apply to the provision of consumer credit: many of us have a personal loan, overdraft, hire-purchase arrangement, credit card or store card.

If you have any of these products, have a look at your credit agreement before you start studying this topic.

- What issues are covered by the agreement?
- How clearly is the key information, such as how much you have to pay, presented?

Keep the agreement by you as you are studying, so that you can look at how the legislation and regulations are applied in practice.

Another area of consumer credit regulation that you might have seen reports about in the media involves payday lenders.

- Do you know what these are and why some of their activities were considered to be a problem?

22.1 What are the Consumer Credit Acts?

The main legislation governing the provision of consumer credit in the UK is the Consumer Credit Acts of 1974 and 2006. The 1974 Act established the basic principles of consumer credit regulation, many of which are still in force today. The 2006 Act consolidated, expanded and brought up to date the earlier Act. The FCA is responsible for enforcement of the Consumer Credit Acts.

22.1.1 Consumer Credit Act 1974

The purpose of the Consumer Credit Act 1974 is to regulate, supervise and control certain types of lending to individuals and to provide borrowers with protection from unscrupulous lending practices. The Act sets out standards by which lenders must conduct their business. It includes a number of safeguards under which potential borrowers must be made aware of the nature and conditions of a loan, and of their rights and obligations.

The Act applies to:

- those providing credit;
- advice on obtaining credit;
- advice on repaying debts.

The provision of credit includes:

- personal loans;
- overdrafts;
- hire purchase;
- credit cards;
- store cards.

Regulated mortgages are exempt from the Consumer Credit Acts as they are covered by MCOB. Therefore further advances are exempt, regardless of the purpose for which they are required.

The Act regulates credit agreements not exceeding £25,000 and the main provisions are outlined in Figure 22.1.

FIGURE 22.1 MAIN PROVISIONS OF CONSUMER CREDIT ACT 1974

FCA licensing

Suppliers of loans and credit as defined in the Act must be licensed by the FCA.

Advertisements and credit agreements

The form and content of advertisements and credit agreements must meet specified standards.

APR

The total cost of credit must be shown as the annual percentage rate (APR). The Act contains the formula for calculating the APR.

Loan agreement

Clients must receive a copy of the loan agreement for their own records, to be provided when they receive the credit agreement to sign.

Cooling-off period

Prospective borrowers have a cooling-off period during which they can review the terms of the loan and, if they wish, decide not to proceed with the transaction. This applies to all loans regulated by the Act, unless the loan agreement is signed on the lender's premises.

Credit reference agencies

Credit reference agencies must, on request, disclose information held about individuals and must correct that information if it is shown to be inaccurate.

Default, termination or early settlement

Defined procedures to be followed in the event of default, termination or early settlement of an agreement.

'Extortionate' rates of interest or charges

Powers for the courts to grant relief to borrowers who have entered credit agreements with 'extortionate' rates of interest/charges.

THE IMPORTANCE OF APR

One of the 1974 Act's most significant innovations was a system for comparing the price of lending. This is the annual percentage rate (APR), which must be quoted for all regulated loans. The APR represents a measure of the total cost of borrowing and its aim is to allow a fair comparison, between different lenders, of the overall cost of borrowing.

The calculation of the APR is specified under the terms of the Consumer Credit Act 1974 and it takes account of two main factors:

- the interest rate – whether it is charged on a daily, monthly or annual basis;

- the additional costs and fees charged when arranging the loan, such as an application fee.

The result is that the APR is higher than the interest rate being charged on the loan.

!

ANNUAL PERCENTAGE RATE OF CHARGE (APRC)

Under the provisions of the EU Mortgage Credit Directive, a new annual percentage rate of charge (APRC) was introduced from 21 March 2016. The APRC is similar to the APR and applies to first- and second-charge mortgage lending. APR applies to personal loans, credit cards and hire purchase agreements.

22.1.2 Consumer Credit Act 2006

Following a three-year review of consumer credit law, the government decided to reform the Consumer Credit Act 1974, to offer better protection to consumers and create a fairer and more competitive credit market. The 2006 Act was introduced in stages between April 2007 and 1 October 2008, and modified the 1974 Act in a number of ways:

- The definition of 'individuals' covered under the Act was widened from 'natural persons' to include unincorporated associations, small partnerships (with three partners or fewer) and sole traders.
- The scope of the Financial Ombudsman Service (FOS) was expanded to cover consumer credit agreements.
- An Unfair Relationships Test was introduced, enabling borrowers to challenge a credit agreement in court, on the basis that the nature of the relationship between borrower and lender is unfair. This replaced the concept of 'extortionate' credit. Courts were given the power to vary a credit agreement if it was deemed unfair to the borrower. When introduced in April 2007, the Unfair Relationships Test only applied to new loans taken out from that date; it was extended a year later to cover new and existing loans.
- The upper limit of £25,000 on the size of loans regulated by the Act was removed, meaning all new credit agreements entered into by individuals are regulated.

- An exemption from CCA provisions was introduced for high-net-worth borrowers, with the definition of a high-net-worth individual detailed in the Act.
- It improved the regulation of consumer credit businesses by ensuring fair practices and taking action to remove dishonest providers.
- Additional rules required lenders to provide borrowers with more information about their accounts on an ongoing basis, such as annual statements and, if applicable, arrears notices.
- Consumer credit regulation was extended to debt administration services and credit information services.

22.1.3 The Consumer Credit Directive

The Consumer Credit Directive was adopted by the European Council in May 2008, and legislation implementing its provisions came fully into force on 1 February 2011.

In the UK, the Directive was implemented by six sets of regulations (some of which have since been repealed as part of the changes in the regulation of consumer credit). The implementing regulations apply to all consumer credit agreements regulated under the Consumer Credit Acts (CCAs), other than agreements secured on land, although there are modifications for certain types of agreement.

The changes primarily affect creditors, but also have an impact on credit brokers and credit intermediaries.

The key changes brought about by the EU Credit Directive are as follows:

- A representative example must be included as part of any advertisement that shows an interest rate or a figure relating to the cost of credit. This example must include a 'representative' APR.
- Creditors must assess a borrower's creditworthiness before granting credit or significantly increasing the amount of credit.
- 'Adequate explanations' must be provided in respect of a proposed credit agreement, to enable the borrower to assess whether the agreement meets their needs.
- Certain information must be provided to a borrower before they enter into a credit agreement, and there are standards for the way in which that information must be provided. Pre-contractual information must be given in good time before the borrower enters into the agreement, and the information must be clear and easily legible.

- The borrower has the right to withdraw from a credit agreement within a period of 14 days from the conclusion of the agreement, or from the point the borrower receives the agreement, if this is later.
- The borrower must be notified, in writing, of changes to the interest rate under the agreement, before the change takes effect.
- The borrower is able to seek redress from the creditor in certain circumstances if they are unable to obtain satisfaction from the supplier of the goods or services. This applies in cases where the CCAs would not normally provide for such redress, and where the value of goods or services is more than £30,000 and the credit does not exceed £60,260.
- The borrower can terminate an open-ended agreement at any time, subject to giving one month's notice. The creditor must give two months' notice of termination of credit and must give justified reasons for termination.
- The borrower must be informed if the debt is to be sold to a third party.
- Credit intermediaries must disclose the extent to which they are acting independently or work exclusively with one or more creditors. Any fee payable to the intermediary must be disclosed up front.
- Where an application for credit is declined based on information supplied by a credit reference agency, the creditor must notify the borrower and provide contact details of the credit reference agency.

KEY TERMS

REPRESENTATIVE APR

An APR that applies to 51 per cent or more of successful applicants for the credit product.

CREDIT INTERMEDIARY

Helps an individual to obtain credit, eg by helping them to complete a loan application, or find the lender offering the best rates or willing to lend to those with a poor credit history.

22.2 FCA consumer credit regulation and authorisation

The FCA took over responsibility for consumer credit regulation from the Office of Fair Trading (OFT) on 1 April 2014, and enforces the CCAs and related legislation. A Consumer Credit sourcebook (CONC) details the FCA's rules.

The FCA has applied certain aspects of its regulatory approach to consumer credit. While the general scope of CCA provisions remains unchanged, some aspects of the FCA's approach are more rigorous.

- Consumer credit firms must be authorised by the FCA.
- The FCA maintains a register of firms that have been granted a consumer credit licence.
- FCA conduct rules apply, such as the high-level Principles for Businesses – for example, financial promotions must be clear, fair and not misleading.
- The FCA expects firms that offer consumer credit to demonstrate how they ensure the fair treatment of their customers.
- The FCA has greater supervisory powers than the OFT had. The FCA uses its senior managers and certification regime for individuals performing roles that require FCA approval or certification.
- The FCA also has much greater powers than the OFT had with regard to investigation, enforcement and redress. It has dedicated supervision and enforcement teams to tackle poor practice in the industry.

HIGH-COST, SHORT-TERM CREDIT

One area on which the FCA has focused is the high-cost, short-term lending market, such as 'payday' lenders. Such lenders provide loans on what is intended to be a very short-term basis: for example to cover a shortfall in funds between one payday and the next. Prior to the FCA's intervention, interest rates on these types of loan were very high; borrowers who were unable to repay the loan in full at the original due date and had to 'roll over' the loan for an extended period found themselves having to repay far more than they had originally borrowed.

Following a review of this sector of the market, the FCA introduced a cap on high-cost, short-term credit from 2 January 2015. Interest and fees charged must not exceed 0.8 per cent per day of the amount borrowed, default fees cannot exceed £15, and borrowers must never be required to repay more than 100 per cent of the amount borrowed by way of fees and charges.

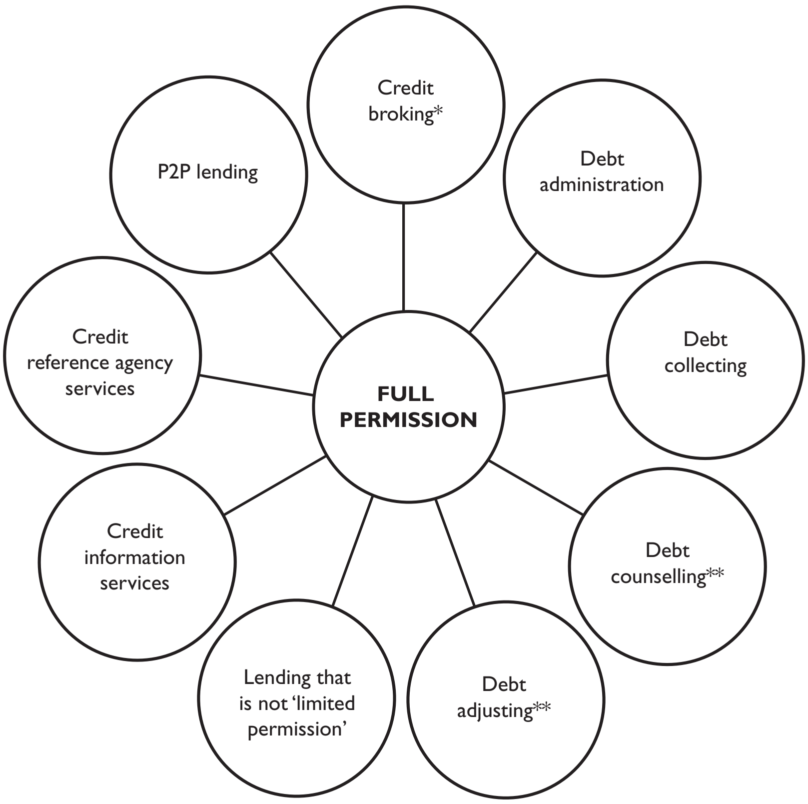
CHECK YOUR UNDERSTANDING 1

Can you recall the FCA's objectives from your studies in Topic 17? Which of its objectives does the restriction on high-cost, short-term lending best demonstrate?

22.2.1 FCA authorisation

The FCA's authorisation structure for consumer credit activities comprises full and limited permission tiers. Most activities covered by the full permission regime are summarised in Figure 22.2.

FIGURE 22.2 ACTIVITIES REQUIRING FULL PERMISSION FROM FCA



*Where introducing customers to a lender is the main business activity or where the sale of goods or services takes place in the customer's home (a domestic premises supplier).

**Where carried out on a commercial basis.

The limited permission tier covers 'lower-risk' activities. It is aimed at businesses outside financial services that are caught by the consumer credit legislation and regulations. Firms carrying out lower-risk activities cannot apply for full FCA authorisation and are required to supply less information to the FCA in comparison with firms that require full authorisation.

FACTFIND

If you wish to find out more details about businesses within the limited permission tier, check:

https://www.fca.org.uk/firms/authorisation/consumer-credit/regulated-activities [Accessed: 19 February 2020].

22.2.2 Consumer Credit sourcebook (CONC)

The FCA has not made substantial changes to the provisions of the CCAs, which continue to provide the main framework for UK consumer credit regulation. The relevant details are contained within the Consumer Credit sourcebook (CONC), which was introduced in April 2014. A summary of the provisions of CONC is provided here.

CONC 1: Application and purpose and guidance on financial difficulties

Explains the purpose of CONC as a specialist sourcebook for credit-related regulated activities, and reminds firms that the eleven Principles for Businesses apply. There is also guidance on the FCA's indicators that a customer is in financial difficulty.

CONC 2: Conduct of business standards – general

In respect of their credit-related activities, all providers are expected to treat customers fairly and not mislead them. Examples of activities that may contravene these rules are:

- targeting customers with offers of credit that are unsuitable for them;
- high-pressure selling, aggressive or oppressive behaviour or coercion;
- not allowing sufficient and reasonable time to make repayments;
- taking steps to repossess a customer's home other than as a last resort.

CONC 3: Financial promotions and communications with customers

Much of the earlier legislation relating to the provision of quotations and advertisements was repealed and included in this section of CONC.

This section details what is considered to be a 'communication' with a customer in relation to a credit agreement, and advises that communications should be fair and not misleading. Providers must ensure they use plain and understandable language, specify who is making the offer of credit and only make credit available based upon the consumer's financial circumstances.

CONC also introduces new rules relating to risk warnings for high-cost, short-term credit, such as that offered by payday lenders. Any such lending must carry the message: "Warning: Late repayment can cause you serious money problems. For help, go to moneyadviceservice.org.uk" (FCA, 2014).

CONC 4: Pre-contractual requirements

Deals with the content of quotations for credit and the relevant 'health warnings' that must be included. This is particularly significant when the customer's home is to be used as security. In such circumstances the lender must include the statement: "Your home is at risk if you do not keep up repayments on a mortgage or other loan secured on it" (FCA, 2014).

CONC 4 also details the information a lender must provide about interest rates, charges and costs should the borrower be unable to pay.

CONC 5: Responsible lending

Details what a provider must do before making credit available in order to ensure that the customer can afford to maintain payments in respect of their borrowing. Creditworthiness must be confirmed based on information obtained from the prospective borrower and from a credit reference agency. The rationale behind this explicit requirement is that there was concern that some lenders of short-term funds (such as payday lenders) were not undertaking adequate checks.

CONC 5A: Cost cap for high-cost, short-term credit

Details the maximum charges that can be applied for high-cost, short-term credit (such as that provided by payday lenders). Broadly speaking, the payment of any charge, when combined with other charges applied under the terms of the agreement, cannot exceed an amount more than that borrowed.

CONC 6: Post-contractual requirements

Covers the checks a lender must undertake if they significantly increase the lending to a customer under a regulated agreement, eg increasing an overdraft or the credit limit on a credit card. Creditworthiness must be assessed if there is a significant increase in lending.

This section also details the action a lender must take if a customer exceeds their overdraft limit, which is to contact the customer in writing without delay.

CONC 7: Arrears, default and recovery (including repossessions)

A long and detailed section, as the FCA regards the manner in which lenders deal with borrowers in arrears as a significant matter.

CONC 7 states that providers must have appropriate policies and procedures for dealing with customers whose accounts fall into arrears, and must treat such customers fairly and reasonably. This includes being aware of customers who are considered vulnerable, for example, customers with mental health difficulties.

Another aspect of this regulation is that it covers debt collection and debt administration activities, and the organisations that undertake such work. This area of consumer credit was previously unregulated.

CONC 8: Debt advice

Debt advice can be undertaken by third-party debt counsellors and other organisations that provide information. Failure to pay proper regard to the different debt-solution options available to consumers, or to the differences in enforcement actions and procedures available, is likely to contravene the Principles for Businesses. Examples include recommending a debt solution that is unaffordable to the consumer, or discouraging a consumer from seeking an alternative source of debt counselling.

CONC 10: Prudential rules for debt management firms

Details the rules for debt management firms (those that manage repayments to creditors on the behalf of an individual) and small, not-for-profit debt advice bodies to ensure that the relevant financial and management resources are in place.

CONC 11: Cancellation

Covers the cancellation rights of peer-to-peer lenders and those providers that make services available over the internet.

CONC 12–15 and Appendix 1

Deal with some of the less common areas of consumer credit. Appendix 1 contains the rules relating to the total charge for credit, what it applies to and how it is calculated.

CHECK YOUR UNDERSTANDING 2

Firms providing consumer credit are required to adhere to the FCA's Principles for Businesses. Can you remember what they are? See if you can list them and then look back to section 17.8 to check your answer.

THINK AGAIN . . .

Now that you have completed this topic, can you:

- describe the main provisions of the Consumer Credit Acts?
- describe the changes that resulted from the Consumer Credit Directive?
- identify the activities that require full FCA permission?
- outline the provisions of the Consumer Credit sourcebook (CONC)?

Write notes to help you revise the key points.

Test your knowledge before moving on to the next topic.

?

Test your knowledge

Use these questions to assess your learning for Topic 22. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following is exempt from the Consumer Credit Acts?
   a) A credit card account with a limit of £5,000.
   b) A further advance for house repairs of £15,000.
   c) A loan for £20,000 secured on property for car purchase.
   d) An unsecured personal loan of £10,000.
2) How does providing an APR in relation to consumer credit help consumers?
3) Businesses are not protected by the provisions of the Consumer Credit Acts. True or false?
4) How long is the cooling-off period for a customer once they have signed a consumer credit agreement?
5) If a lender rejects an application on the basis of information from a credit reference agency, what must the lender do?
   a) Ensure the applicant is not made aware of the reason for the rejection to protect the confidential nature of the lender’s relationship with the credit reference agency.
   b) Advise the applicant of the reason for rejecting their application.
   c) Advise the applicant of the reason for rejecting their application and provide details of the credit reference agency used.
   d) Advise the applicant of the reason for rejecting their application and provide details of a debt counselling service.
6) A charity that provides debt counselling services must have full permission from the FCA. True or false?
7) What is the maximum that a borrower can be required to repay to a high-cost, short-term lender in fees and charges?

8) Interest rates provided in an advertisement for consumer credit must include what?

9) Providers of consumer credit must check that the applicant can afford the repayments and must check the applicant's status with a credit reference agency. True or false?

10) Which previously unregulated area of consumer credit now falls under the provisions of CONC 7?

TOPIC 23

Anti-money-laundering

LEARNING OBJECTIVES

People working within the financial services sector can find themselves unwittingly aiding and abetting financial crime simply by processing transactions on behalf of clients. To discourage involvement in money laundering activities the penalties for individuals of failing to comply with the law in this area can be severe. It is therefore essential that you understand the rules that may apply to your daily work. In this topic our main focus is on money laundering, although we will also look briefly at the provisions of the Bribery Act 2010.

By the end of this topic you should have an understanding of:

- what money laundering is;
- the provisions of the Proceeds of Crime Act 2002;
- the provisions of the EU's Money Laundering Directives;
- the FCA's role in preventing money laundering;
- the penalties for breaching money-laundering offences;
- the provisions of the Bribery Act 2010.

This topic covers the Unit 2 syllabus learning outcomes U4.1–4.9.

THINK . . .

If you are already working in the financial services sector, you might be aware of the role of the money laundering reporting officer, or MLRO; you might also have carried out customer due diligence procedures to confirm a customer's identity.

If you don't yet work in financial services, you might have heard of money laundering in relation to crime reports in the media, or in TV and film dramas.

To start you off on this topic, think about what kind of customer behaviour might make you suspicious. Money launderers don't turn up with a large bag marked "swag" – it is a sophisticated crime – but frontline financial services staff identify thousands of potentially suspicious transactions every year and thus play a key role in crime prevention.

23.1 What is money laundering?

Money laundering involves filtering the proceeds of any kind of criminal activity (including terrorism) through a series of accounts or other financial products in order to make such funds appear legitimate or to make their origins difficult to trace. It will generally not be easy to spot someone who is trying to launder money; criminals carrying out money laundering will use sophisticated techniques. Examples of where the financial services industry has been used in an attempt to launder money include:

- opening an account with a small initial deposit and then adding large sums in cash;
- making an investment into a collective investment which is then encashed within a short period of time;
- arranging a mortgage or loan that is then quickly paid off using cash.

A significant proportion of transactions that are identified as suspicious take place in banks and reports of suspicious transactions also come in from building societies, finance companies, credit card providers, money service businesses such as bureaux de change, accountants, tax advisers, solicitors and estate agents, among others.

Financial services firms have a legal duty to take steps to mitigate the risk of money laundering; in the UK, the key legislation is the Proceeds of Crime Act 2002, the Terrorism Act 2000 and the EU's Money Laundering Directives.

THE NATIONAL CRIME AGENCY

The National Crime Agency (NCA) works to combat serious and organised crime. Although it is a UK body, it works in partnership with law enforcement agencies internationally; the nature of serious and organised crime makes such cross-border co-operation essential. Its Economic Crime Command is responsible for tackling money laundering, fraud, bribery and corruption, and counterfeiting of currency.

23.2 What are the requirements of the Proceeds of Crime Act 2002?

Under the Proceeds of Crime Act 2002, there are three principal money laundering offences.

FIGURE 23.1 PRINCIPAL MONEY LAUNDERING OFFENCES

Concealing criminal property	Arranging	Acquiring, using or possessing
• Criminal property is property that a person knows, or suspects, to be the proceeds of any criminal activity • It is a criminal offence to conceal, disguise, convert or transfer criminal property	Arranging occurs when a person becomes involved in a process that they know or suspect will enable someone else to acquire, retain, use or control criminal property (where that other person also knew or suspected that the property derived from criminal activity)	It is a criminal offence for a person to acquire, use or possess any property when that person knows or suspects that the property is the proceeds of criminal activity

23.2.1 Failure to disclose

All suspicions of money laundering must be reported to the authorities. The Proceeds of Crime Act 2002 introduced the requirement for a person to disclose information about money laundering if they have reasonable grounds for knowing or suspecting that someone is engaged in money laundering.

23.2.2 Tipping off

It is also an offence to disclose to (ie tip off) a person who is suspected of money laundering that an investigation is being, or may be, carried out.

23.3 How does the Terrorism Act 2000 relate to money laundering?

The Terrorism Act 2000 defines 'terrorism' as the use or threat of serious violence against a person or serious damage to property or electronic systems, with the purpose of influencing a government, intimidating the public or advancing a political, religious or ideological cause.

The Act specifically mentions as an offence "the retention or control of terrorist property, by concealment, removal from the jurisdiction, transfer to nominees or in any other way" – in other words, money laundering.

'Terrorist property' is defined as:

- money or other property that is likely to be used for terrorism purposes;

- proceeds of the commission of acts of terrorism;
- proceeds of acts carried out for the purposes of terrorism.

23.4 What are the Money Laundering Regulations?

The key EU legislation relating to money laundering is the Money Laundering Regulations, which implement the EU's Money Laundering Directives.

23.4.1 Third Money Laundering Directive

The EU's Third Money Laundering Directive (2005) repealed and consolidated two earlier directives. The Directive defines money laundering in some detail. It comprises "the following conduct when committed intentionally:

- the conversion or transfer of property, knowing that such property is derived from criminal activity or from an act of participation in such activity, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such activity to evade the legal consequences of his action;
- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to or ownership of property, knowing that such property is derived from criminal activity or from an act of participation in such activity;
- the acquisition, possession or use of property, knowing, at the time of receipt, that such property was derived from criminal activity or from an act of participation in such activity;
- participation in, association to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the actions mentioned in the foregoing paragraphs".

Three more important definitions are included, in order to clarify this definition of money laundering:

- **property** is assets of every kind, tangible or intangible, movable or immovable, as well as legal documents giving title to such assets;
- **criminal activity** is a crime as specified in the Vienna Convention (the United Nations Convention Against Illicit Traffic in Narcotic Drugs) and any other criminal activity designated as such by each member state;
- **criminal property** is defined as property that consists, directly or indirectly, wholly or in part, of a benefit from criminal conduct, where the alleged offender knows or suspects that it constitutes a benefit.

The Directive specifies that money laundering that takes place within the EU will be treated under EU money laundering rules, even if the activities that generated the property to be laundered took place in a non-EU country.

23.4.2 Fourth Money Laundering Directive

In response to recommendations made by the FATF, the European Commission adopted a fourth Money Laundering Directive on 26 June 2015. The provisions of the directive were implemented in the UK in June 2017 and the Money Laundering Regulations and the Proceeds of Crime Act were updated. The aim is to strengthen the anti-money-laundering (AML) regime.

Key elements of the Money Laundering Regulations 2017 include:

- a requirement to adopt a risk-based approach to the implementation of AML measures such as customer due diligence (ie to understand the nature of the threats faced and devote most resources to the areas of greatest risk). A relevant person must produce a written AML risk report and translate its findings into written policies to be approved by the firm's senior management;
- a widened definition of 'politically exposed persons', including those holding prominent positions in their home country. Politically exposed people are those individuals who, because of their position, are considered to be more vulnerable to corruption;
- the introduction of a new criminal offence. An individual found guilty of recklessly making a statement in the context of money laundering that is false or misleading may face a fine and/or a maximum two-year jail sentence.

The fourth Money Laundering Directive also:

- includes 'tax crimes' within EU legislation for the first time;
- strengthens co-operation between member states;
- increases transparency around the beneficial ownership of legal entities – each member state must maintain a central register of the beneficial owners of legal entities (beneficial owners are those who own or control 25 per cent of a legal entity).

In the UK, legislation requiring businesses to maintain a register of individuals having significant control came into effect in April 2016. This had to be strengthened as it only applied to companies, not to other legal entities such as trusts and therefore did not fully meet the requirements of the Fourth Money Laundering Directive.

HM Treasury's draft Money Laundering and Transfer of Funds (Information) (Amendment) (EU Exit) Regulations 2018, published on 13 November 2018, ensures that the UK's anti-money-laundering regime and counter-terrorism financing legislation continues to work effectively once the UK has withdrawn from the EU.

FINANCIAL ACTION TASK FORCE

The Financial Action Task Force (FATF) is an inter-governmental organisation established in 1989 to co-ordinate the international fight against money laundering. In 2001, the remit of the FATF was expanded to include terrorist financing. It is a policy-making body: it does not become involved in law enforcement (that is the responsibility of local authorities in individual countries, such as the National Crime Agency in the UK). In addition to member nation states, the European Commission and the Gulf Co-operation Council also belong to the FATF.

The work of the FATF falls into three main areas:

- setting appropriate standards for national anti-money-laundering programmes, set out in a list of 40 recommendations incorporating minimum standards for the measures that countries should have in place within their own criminal justice and regulatory systems;
- evaluating the extent to which individual countries have implemented these standards;
- identifying trends in money-laundering methods.

The FATF also maintains a list of "non-co-operative countries and territories", which it considers do not have adequate anti-money-laundering measures.

23.5 Customer due diligence

One of the most important elements in the financial service industry's action against money laundering is the process of confirming the identity of customers, referred to as 'customer due diligence' or CDD. CDD is required in relation to transactions that are seen as higher risk. Figure 23.2 summarises the circumstances in which evidence of identity is required.

FIGURE 23.2 CIRCUMSTANCES REQUIRING IDENTIFICATION PROCEDURES TO BE CARRIED OUT

New business relationship

When entering into a new business relationship (particularly when opening a new account, or selling a new investment or policy).

Occasional transaction exceeding €15,000

When the value of an 'occasional' transaction exceeds €15,000, whether as a single transaction or as a series of linked transactions. Note that for a business trading in goods and services the threshold is €10,000.

Life assurance policies

When the value of annual premiums exceeds €1,000, or €2,500 for single premiums.

Suspicion

In every case where there is suspicion of money laundering or terrorist financing. If there is suspicion that the applicant may not be acting on their own behalf, reasonable measures must be taken to identify the person on whose behalf the applicant is acting.

Doubts

Where there are doubts about proof of identity that has previously been obtained.

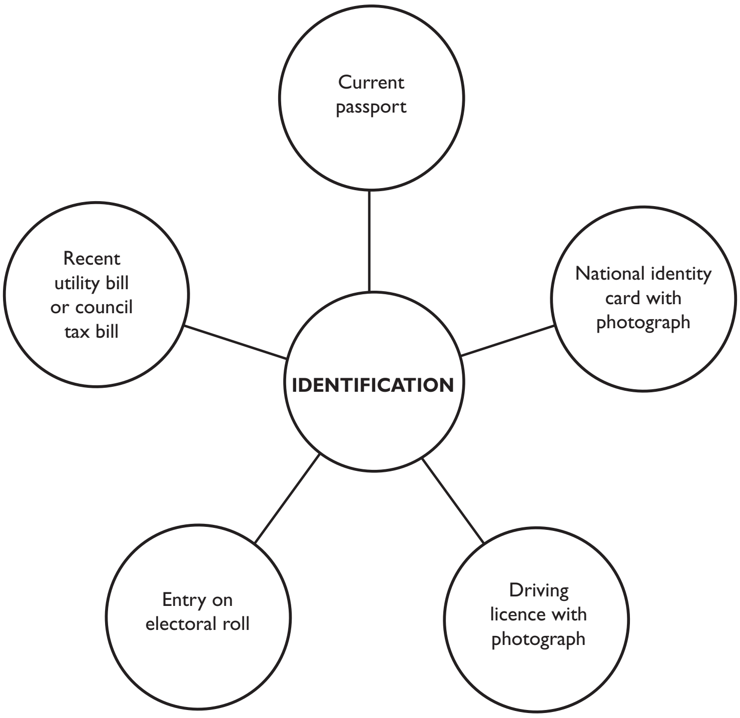
Change of circumstances

Where a change in the circumstances of an existing customer requires new evidence to be obtained.

If a client is introduced to the firm by a financial intermediary or another authorised firm, it is permissible for the firm to rely on identification carried out by the intermediary or other firm. This is important to, for instance, financial advisers and mortgage advisers. Under the terms of the Money Laundering Regulations 2017, an intermediary must provide the customer with the due diligence information it has obtained.

The definition of what constitutes satisfactory evidence of identity is rather vague – evidence should be reasonably capable of establishing that the applicant is the person they claim to be, to the satisfaction of the person who obtains the evidence. Acceptable forms of identification are shown in Figure 23.3.

FIGURE 23.3 ACCEPTABLE FORMS OF IDENTIFICATION



23.5.1 Preventing financial exclusion

Some people's personal circumstances are such that they are unable to provide any of the documents included in Figure 23.3. For instance, a person who has never travelled abroad, does not drive a car and is not responsible for household bills may well be unable to produce a passport, driving licence or utility bill bearing their name. Nevertheless, it is important that people in these situations are not denied access to appropriate financial services. In such circumstances, the FCA considers that a firm may accept, as evidence of the customer's identification, a letter or statement from a person in a position of responsibility (such as a solicitor, doctor or minister of religion) who knows the client.

RECORD-KEEPING REQUIREMENTS

Institutions must keep appropriate records in respect of customer due diligence for use as evidence in any investigation into money laundering. This means that:

- evidence of identification must be retained until at least five years after the relationship with the customer has ended;

- supporting evidence of transactions (in the form of originals or copies admissible in court proceedings) must be retained until at least five years after the transaction was executed.

Remember also that there are record-keeping requirements that relate to COBS (see Topic 21), and we will look in Topic 24 at the requirements in relation to GDPR.

23.5.2 Credit reference agencies

Anti-money-laundering checks are often carried out by credit reference agencies on behalf of financial institutions. While the search leaves an anti-money-laundering ID footprint, this will not show up in a credit search, nor will it affect an individual's ability to obtain credit.

23.6 What is the role of the FCA?

The FCA has an operational objective to ensure the integrity of financial markets. To help achieve this, the FCA requires that all authorised firms must have systems and controls in place which mitigate the risk that the firms may be used to commit financial crime, including money laundering.

The FCA details its requirements in the Senior Management Systems and Controls (SYSC) section of the Handbook and requires that all authorised firms:

- establish accountabilities, procedures and systems to minimise the risk of money laundering;
- give responsibility for anti-money-laundering systems and controls to a senior manager;
- appoint a money laundering reporting officer (MLRO) (see section 23.6.1);
- have a documented risk policy related to money laundering;
- give regular training to staff about what is expected of them under the money-laundering rules, including the consequences for the firm and for themselves if they fail to comply;
- educate their staff about potential problems;
- take reasonable steps to ensure that procedures are up to date and reflect any findings contained in periodic reports on money-laundering matters issued by the government, by the Financial Action Task Force (FATF) and the FCA's own guidance on financial crime;

- requisition a report at least once in each calendar year from the MLRO;
- take appropriate action to strengthen its procedures and controls to remedy any deficiencies identified by the report.

The FCA expects that firms have procedures in place to ensure that individuals working within the firm:

- report suspicious circumstances by completing 'suspicious activity reports' (SARs);
- refrain from alerting persons being investigated.

The FCA has the power to take enforcement action against firms and to impose sanctions on them for non-compliance with Money Laundering Regulations.

When assessing a firm's compliance with its money-laundering requirements, the FCA will take into account the extent to which the firm has followed the:

- **Joint Money Laundering Steering Group's guidance notes** for the financial sector – these describe the steps that firms should take to verify the identity of their customers and to confirm the source of their customers' funds;
- **publications of the FATF** – these highlight any known developments in money laundering and any deficiencies in the money-laundering rules of other jurisdictions;
- **FCA's own guidance on financial exclusion** – see section 23.5.1.

JOINT MONEY LAUNDERING STEERING GROUP

The Joint Money Laundering Steering Group is made up of the leading UK trade associations in the financial services industry. Its aim is to promote good practice in countering money laundering and to give practical assistance in interpreting the UK money-laundering regulations. This is primarily achieved by the publication of guidance notes.

FACTFIND

If you are interested in finding out more about the FCA's guidance to firms on preventing financial crime, go to:

https://www.handbook.fca.org.uk/handbook/document/fc/FC1_FCA_20160703.pdf

You might also find the following link useful:

https://www.handbook.fca.org.uk/handbook/SYSC/6/3.html

[Both accessed: 19 February 2020].

23.6.1 What is the role of the MLRO?

Each firm must appoint a money laundering reporting officer (MLRO) with responsibility for co-ordinating all the firm's AML activities. The MLRO must be a person of 'appropriate seniority'.

All members of staff must make a report to the MLRO if they know or suspect that a client is engaged in money laundering. The MLRO will then determine whether to report this to the National Crime Agency, using known information about the financial circumstances of the client and the nature of the business being transacted. Such reports are known as 'suspicious activity reports' (SARs).

At least once in each calendar year senior management of the firm must requisition a report from the MLRO. This report must:

- assess the firm's compliance with the Joint Money Laundering Steering Group guidance notes;
- indicate how Financial Action Task Force findings have been used during the year;
- provide information about reports of suspected money-laundering incidents submitted by staff during the year.

A firm's senior management must consider this report and must take any action necessary to solve any problems identified.

23.6.2 What training is required?

Training should be given on a regular basis throughout the time that an individual handles transactions that could facilitate money laundering.

FIGURE 23.4 AML TRAINING REQUIREMENTS

Firms must ...	Staff must be made aware of ...
Take appropriate measures to make employees aware of money-laundering procedures and legislation	The law relating to money laundering
Provide training in the recognition and handling of money-laundering transactions	The firm's procedures and staff individual responsibilities
	The identity of the firm's MLRO and what their responsibilities are
	How any breach of money-laundering rules can impact on the firm and on themselves, ie the consequences of committing what may be a criminal act

PENALTIES FOR MONEY-LAUNDERING OFFENCES

The FCA can discipline firms and individuals for breaches of money-laundering rules, as described in section 23.6. It also has the power to prosecute anyone who breaks the Money Laundering Regulations established under UK law to give effect to the EU Money Laundering Directives.

Anyone convicted under the Proceeds of Crime Act 2002 of concealing, arranging or acquiring (see section 23.2) could be sentenced to up to 14 years' imprisonment or an unlimited fine, or both. The offence of failing to disclose or of tipping off carries a prison sentence of up to five years or an unlimited fine, or both.

A partner or director who fails to comply with money laundering regulations can be fined, receive up to two years in prison (or both) or be subject to appropriate civil penalties.

23.7 The Bribery Act 2010

The Bribery Act 2010, which came into effect in July 2011, created an offence of offering, promising or giving "financial or other advantage" to another where the advantage is intended to bring about improper performance by another person of a relevant function or activity, or to reward such improper performance.

An offence is also deemed to have been committed if the person offering, promising or giving the advantage knows (or simply believes) that acceptance of the advantage itself constitutes improper performance.

IMPROPER PERFORMANCE

Performance that amounts to a breach of an expectation that a person will act in good faith, impartially or in accordance with a position of trust.

The test used is what a reasonable person in the UK would expect of a person performing the relevant function or activity.

The offence applies to bribery relating to any function of a public nature, connected with a business, performed in the course of a person's employment or performed on behalf of a company or other body.

The function or activity may be carried out either in the UK or abroad, and need have no connection with the UK.

The Act also makes it an offence to request, agree to receive, or accept "financial or other advantage", where the person requesting the 'bribe' performs their function or activity improperly (or intends to) as a result of the 'reward' requested or received.

The maximum penalty in the UK for an individual convicted of a bribery offence is an unlimited fine and imprisonment for up to ten years.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved? For instance, can you:

- name the three principal money laundering offences?
- explain what is meant by 'failure to disclose' and 'tipping off'?
- describe the role of the money-laundering reporting officer?
- explain the circumstances in which you would be required to carry out customer due diligence?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 23. Review the text if necessary.

Answers can be found at the end of this book.

1) If a staff member of a financial services organisation were to be accused of 'arranging' under the Proceeds of Crime Act 2002, it could mean that they:

   a) had knowingly become involved in the process of converting criminal property.

   b) personally owned the proceeds of criminal activity.

   c) had unwittingly failed to report a potentially suspicious transaction.

   d) had personally used the proceeds of criminal activity.

2) Transferring criminally obtained money through different accounts is an offence only if the funds derive from drug dealing or terrorist activity. True or false?

3) The FATF's role is to establish a broad policy framework at an international level for the prevention of money laundering. True or false?

4) In order to be required to report a transaction to the money laundering reporting officer, a member of staff first needs to:

   a) be certain that the person is involved in money laundering.

   b) advise the person that they may be investigated.

   c) review the circumstances of the case with other experienced staff members.

   d) have reasonable grounds for believing that a person is involved in money laundering.

5) A bank cashier notices that a customer is paying an unusually large sum of money into their account in cash. The cashier advises the customer that they regard the transaction as suspicious and calls a supervisor to discuss the matter further with the customer. What offence has the cashier potentially committed?

   a) Data protection breach.

   b) Tipping off.

c) Failure to disclose.

d) Arranging.

6) When accepting an investment into a savings account at what transaction value will it become necessary to obtain evidence of the customer's identity?

a) €15,000.

b) €10,000.

c) £10,000.

d) £15,000.

7) The EU Fourth Money Laundering Directive contains a provision requiring member states to maintain a register of the beneficial owners of legal entities. A beneficial owner is one who controls what percentage of a legal entity?

8) A new client has invested £12,000 in the forms of stocks and shares in an ISA product offered by Forward Bank. The bank did not carry out any client identification procedures. This is most likely to have been because:

a) investments into ISAs are exempt from money-laundering identification requirements.

b) the client is only temporarily resident in the UK.

c) investment amounts of less than £15,000 are exempt from money-laundering identification requirements.

d) the client was introduced by an intermediary who obtained the necessary evidence.

9) If a money laundering reporting officer (MLRO) suspects a case of attempted money laundering, to whom must this be reported?

10) A firm's senior management is required to request a report from the money laundering reporting officer at least once a year. What action should they take on receiving the report?

a) Forward it to the FCA.

b) Include the total number of SARs in the firm's annual report and accounts.

c) Review and if necessary improve the firm's processes and training.

d) Retain the report indefinitely.

TOPIC **24**

Other regulation affecting the advice process

LEARNING OBJECTIVES

In this topic we are going to look at other important legislation and regulations that affect the advice process. Some, such as the General Data Protection Regulation (GDPR), are relevant to everyone working in the sector, while others, such as the Directives on life and general insurance, relate to specific areas of business.

By the end of this topic, you should have an understanding of:

- the provisions of the General Data Protection Regulation (GDPR), including the data protection principles;
- how the GDPR is enforced;
- the role of the Pensions Regulator and the Pension Protection Fund;
- the Investment Services Directive (ISD);
- the Markets in Financial Instruments Directives (MiFID I and II);
- Undertakings for Collective Investment in Transferable Securities (UCITS);
- directives relating to life and general insurance;
- the role of oversight groups.

This topic covers the Unit 2 syllabus learning outcomes U5.6, U6.1–U6.3, part of K2.1, K2.4, K3.1 and 3.2.

THINK . . .

The aspect of this topic that is likely to be most familiar to you is data protection. Occasionally there are reports in the media about serious breaches of data protection legislation by companies and government departments. The fact that such breaches make the news indicates how serious they are considered to be.

Before you start working through this topic, think about:

- the kind of personal data you have to provide every time you buy a product online, apply for a job or take out any kind of contract, such as a mobile phone contract;
- what assurances you recall from the other party about how they will keep your personal data secure;
- what the implications for you might be if that data became available to fraudsters.

24.1 What are the rules relating to data protection?

Interacting with a financial services institution inevitably involves the customer providing personal information; in Topic 23, for example, we looked at the process of customer due diligence, which requires the customer to prove their identity in order to complete a transaction. If such information is not handled appropriately and stored securely, then not only does the firm breach the customer's right to privacy, it also exposes the customer to the risk of becoming a victim of crime as a result of identity theft.

IDENTITY THEFT

Personal data is valuable to fraudsters. Details such as an individual's name, address and date of birth – sometimes pieced together and supplemented from a number of sources – can be used to open bank accounts, take out credit cards, order goods, take over the victim's original accounts or apply for key documents such as a passport or driving licence. The latter items can then be used to facilitate further criminal activity.

The prevention of fraud arising from identity theft falls within the remit of the FCA, as part of its objectives to reduce financial crime and enhance consumer protection.

FACTFIND

If you are interested in finding out more about how the FCA seeks to combat fraud, go to:

https://www.fca.org.uk/firms/financial-crime/fraud [Accessed: 18 February 2020].

Until May 2018, the EU data protection legislation was the Data Protection Directive of 1995. The primary UK legislation in relation to data protection was the Data Protection Act 1998.

To update the EU legislation, particularly in relation to online activity and the rise of social media, a General Data Protection Regulation came into force in May 2016 and each member was required to adopt its provisions by 25 May 2018. The primary UK legislation became the Data Protection Act 2018.

CHECK YOUR UNDERSTANDING 1

Think back to your previous work on EU Directives and regulations. What impact does the fact that the new EU data protection legislation is in the form of a regulation rather than a Directive have upon the way it is implemented by member states?

24.1.1 The General Data Protection Regulation

On 25 May 2018, the General Data Protection Regulation (GDPR) came into effect in the UK. It applies to 'personal data', which is information relating to an individual who can be identified (for example, by name, identification number, location data or online identifier). This reflects changes in technology and the way information is collected.

The GDPR applies to both automated personal data and to manual records containing personal data.

24.1.2 What are the data protection principles?

The basis of the GDPR is a set of six data protection principles, which all relate to the processing of personal data. The data must be:

1) Processed lawfully, fairly and in a transparent manner in relation to individuals.

2) Collected for specified, explicit and legitimate purposes and not further processed in a manner that is incompatible with those purposes; further processing for archiving purposes in the public interest, scientific or historical research purposes or statistical purposes shall not be considered to be incompatible with the initial purposes.

3) Adequate, relevant and limited to what is necessary in relation to the purposes for which they are processed.

4) Kept accurate and up to date. Every reasonable step must be taken to ensure that personal data that are inaccurate, having regard to the purposes for which they are processed, are erased or rectified without delay.

5) Kept in a form which permits identification of data subjects for no longer than is necessary for the purposes for which the personal data are processed, although archiving is allowed in certain circumstances.

6) Processed in a manner that ensures appropriate security of the personal data, including protection against unauthorised or unlawful processing and against accidental loss, destruction or damage, using appropriate technical or organisational measures.

24.1.3 GDPR requirements

Some of the relevant definitions are as follows:

- **Data subject** – an individual (a natural person) whose personal data is processed.
- **Personal data** – information that can directly or indirectly identify a natural person. This information can be in any format.
- **Special categories of personal data** – this data is more sensitive and so needs more protection. Generally (although there are exceptions) such data can only be processed if the individual has given explicit consent. Sensitive data includes information about an individual's:
  - race;
  - religious beliefs;
  - political persuasion;
  - trade union membership;
  - sexual orientation;
  - health;
  - biometric data;
  - genetic data.
- **Processing** – this has a very broad meaning, covering all aspects of owning data, including:
  - obtaining the data in the first place;
  - recording of the data;
  - organisation or alteration of the data;
  - disclosure of the data, by whatever means;
  - erasure or destruction of the data.
- **Data controller** – this is the 'legal' person who determines the purposes for which data are processed and the way in which this is done. The data

controller is normally an organisation/employer, such as a company, partnership or sole trader. They have prime responsibility for ensuring the requirements of the Act are carried out.

- **Data processor** – this is a person who processes personal data on behalf of the data controller.

An organisation must have a lawful basis for processing data. At least one of the following must apply when processing personal data.

1) Consent – clear consent has been given by the individual to process their personal data for a specific purpose.
2) Contract – the processing is necessary for a contract between the organisation and the individual, or because the individual has asked for certain steps to be taken before entering into a contract.
3) Legal obligation – the processing is necessary for the organisation to comply with the law.
4) Vital interests – the processing is necessary to protect someone's life.
5) Public task – the processing is necessary for the organisation to act in the public interest.
6) Legitimate interests – the processing is necessary for the organisation's legitimate interests or the legitimate interests of a third party, unless there is a good reason to protect the individual's personal data which overrides those legitimate interests.

A data subject has a number of rights, including the right to:

- access personal data through subject access requests (under GDPR, no charge can generally be made for this);
- correct inaccurate personal data;
- have personal data erased, in certain cases;
- object;
- move personal data from one service provider to another.

In order to demonstrate compliance with the GDPR, an organisation must:

- establish a governance structure with roles and responsibilities;
- keep a detailed record of all data processing operations;
- document data protection policies and procedures;
- carry out data protection impact assessments for high-risk processing operations.

Processing of personal data by businesses established in more than one EU country will be monitored by one single data processing authority (DPA) – the 'lead authority'. The lead authority will be the DPA of the country where the business has its main offices, ie where it carries out its central administration or where the majority of management decisions take place.

The new rules also apply to businesses based outside the EU that offer their goods and services to EU customers based in the EU. For example, a US company with a subsidiary in the EU has to comply with the EU data protection law as well as local US laws.

FACTFIND

To find out more details about the General Data Protection Regulation, go to:

http://ec.europa.eu/justice/data-protection/reform/index_en.htm [Accessed: 18 February 2020].

24.1.4 How is the GDPR enforced?

The Information Commissioner is responsible for overseeing the application of the GDPR. Firms should report significant personal data breaches to the Information Commissioner. There are several courses of action the Commissioner can take if there has potentially been an infringement of the terms of the Regulation (see Figure 24.1).

FIGURE 24.1 INFORMATION COMMISSIONER'S POWERS TO ENFORCE GDPR

Serve information notices
Requiring organisations to provide the Information Commissioner's Office with specified information within a certain time period

Issue undertakings
Committing an organisation to a particular course of action in order to improve its compliance

Serve enforcement notices, and 'stop now' orders where there has been a breach
Requiring organisations to take (or refrain from taking) specified steps in order to ensure they comply with the law

Conduct consensual assessments (audits)
To check organisations are complying

Serve assessment notices
To conduct compulsory audits to assess whether organisations' processing of personal data follows good practice

Issue monetary penalty notices
Notification that the organisation is to be subject to a financial penalty as a result of a serious breach of the GDPR

Prosecute
Those who commit criminal offences under the Act

Issue a ban
A temporary or permanent ban on data protection can be imposed

CRIMINAL OFFENCES UNDER THE GDPR

The following are criminal offences.

- For a data controller to fail to comply with an information or enforcement notice.
- Failure to make a proper notification to the Information Commissioner. 'Notification' is the way in which a data controller effectively registers with the Information Commissioner's Office by acknowledging that personal data are being held and by specifying the purpose(s) for which the data are being held.
- Processing of data without authorisation from the Commissioner.

- Intentionally or recklessly re-identifying individuals from pseudonymised or anonymised data.

The maximum fine for these offences is the higher of €20m or 4 per cent of an organisation's worldwide turnover.

24.2 What is the role of the Pensions Regulator?

The regulation of work-based (ie occupational) pension schemes remains separate from the regulation of other financial services – separate even from the regulation of private pension arrangements such as personal pensions and stakeholder pensions. Nevertheless, financial advisers should have a good knowledge of matters relating to work-based schemes, in order, for instance, to be able to advise individuals who are members of such schemes or employers who may be considering establishing a scheme.

The Pensions Regulator (TPR) is responsible for the regulation of work-based pension schemes (as well as some personal pension schemes), and it aims to:

- protect the benefits of occupational pension schemes;
- protect the benefits of personal pension schemes where there is a direct pay arrangement;
- promote good administration of work-based schemes;
- reduce the risk of situations arising that might lead to claims for compensation from the Pension Protection Fund;
- maximise employer compliance with duties and safeguards under the Pensions Act 2008;
- minimise any adverse impact on the sustainable growth of an employer.

The Pensions Regulator aims to identify and prevent potential problems rather than to deal with problems that have arisen, and takes a risk-based approach to its work. It assesses the risks that might prevent it from meeting its statutory and operational objectives, such as inadequate funding, inaccurate record-keeping, lack of knowledge or understanding on the part of the trustees, or even dishonesty or fraud. The regulator considers the combined effect of:

DIRECT PAY ARRANGEMENT

A direct pay arrangement is one where the employer collects an employee's pension contributions from their gross salary and pays them over to the pension provider.

- the likelihood of the event occurring; and
- the impact of the event on the scheme and its members.

Schemes that are judged to have a higher risk profile will be more closely monitored than those that represent a lower risk.

To protect the security of members' benefits, the TPR has a range of powers, and these fall broadly into the three categories shown in Figure 24.2.

The Pensions Act 2004 requires the Pensions Regulator to issue voluntary codes of practice on a range of subjects. The codes provide practical guidelines for trustees, employers, administrators and others on complying with pensions legislation, and set out the expected standards of conduct.

FIGURE 24.2 POWERS OF THE PENSIONS REGULATOR

Investigating schemes	Putting things right	Acting against avoidance
• Identifying and investigating risks • Requiring all schemes to make regular returns to the regulator • Requiring trustees or scheme managers to give notification of any changes to important information, such as the types of benefit being provided by the scheme • Requiring that the regulator be informed quickly if the scheme discovers that it cannot meet the funding requirements, so that remedial action can be taken at an early stage	• Requiring specific action to be taken to improve matters within a certain time • Recovering unpaid contributions from an employer who does not pay them to the scheme within the required period (by the 19th day of the month following that in which they were deducted from the member's salary) • Disqualifying trustees who are not considered fit and proper persons • Imposing fines or prosecuting offences in the criminal courts	• Preventing employers from deliberately avoiding their pensions obligations and so leaving the Pension Protection Fund to cover their pension liabilities • Issuing: – *contribution notices,* requiring the employer to make good the amount of the debt either to the scheme or to the Pension Protection Fund; or – *financial support directions,* which require financial support to be put in place for an underfunded scheme

The Act also introduced requirements for trustees to have a sufficient knowledge and understanding of pension and trust law, and of scheme funding and investment. Trustees must also be familiar with the trust deed and other important documents such as the scheme rules and the statement of investment principles.

24.3 What is the Pension Protection Fund?

The Pensions Act 2004 established the Pension Protection Fund (PPF) to protect members of private sector defined-benefit pension schemes in the event that a firm becomes insolvent with insufficient funds to maintain full benefits for all its scheme members. The PPF is also responsible for the Fraud Compensation Fund, which provides compensation to occupational pension schemes that suffer a loss as a result of dishonesty.

The role of the PPF has been brought into focus in recent years with a growing number of occupational pension schemes encountering financial problems.

The Pension Protection Fund provides varying levels of compensation, depending on the circumstances of the member. There are only limited circumstances where the compensation paid is 100 per cent of the benefits being drawn or to which the member would have been entitled had the scheme remained solvent.

The PPF funds the compensation payments it makes in several ways:

- It imposes a levy on defined-benefit schemes (there are exceptions for some schemes in certain circumstances).
- It takes on the assets of schemes that are transferred to the fund.
- It seeks recovery of assets from insolvent employers.
- It seeks to grow its funds through investment.

FACTFIND

To find out more information on the Pension Protection Fund, including arrangements for dependants on the death of the scheme member, for sharing compensation with a former spouse or civil partner, and the current level of the cap on overall annual compensation, go to:

https://www.ppf.co.uk [Accessed: 18 February 2020].

24.4 EU Directives affecting regulation of the financial services sector

In Topic 2 we explored the role of the EU in financial services and the differences between directives and regulations. In Topic 19 we looked at the provisions of the Capital Requirements Directive and Solvency II. In this section we are going to look at some other examples of how EU legislation affects the provision of financial services and advice.

24.4.1 Electronic Money Regulations 2011

The second Electronic Money Directive (2EMD) was implemented in the UK on 30 April 2011, in the form of the Electronic Money Regulations 2011.

> **ELECTRONIC MONEY (E-MONEY)**
>
> Electronically stored monetary value issued on receipt of funds for the purpose of making payment transactions, including prepaid cards and electronic prepaid accounts for use online.

The issuance of e-money has been regulated since 2002; the Electronic Money Regulations 2011 introduced new requirements for all electronic money issuers (EMIs), and new authorisation/registration and prudential standards for electronic money institutions.

24.4.2 Investment Services Directive (ISD)

The 1993 Investment Services Directive (ISD) came into force at the beginning of 1996. Its aim was to enable investment firms to operate in different European states, in much the same way as other directives broadened the markets for banks and for the insurance industry, by providing direct access to well-regulated markets across the EU.

In the same way as with credit institutions, firms that provide certain specified investment services must first be authorised in their own home state. They can then operate in the other member states without requiring further authorisation from the authorities in those states.

In order to obtain and retain authorisation in their home state, investment firms must comply with certain prudential rules drawn up by the authorities in the home state. The general nature of these prudential rules was first specified in the ISD, and later incorporated in the Markets in Financial Instruments Directive (MiFID), which replaced it.

24.4.3 Markets in Financial Instruments Directive (MiFID)

The ISD was revised by the Markets in Financial Instruments Directive (MiFID). MiFID applies to firms that provide services to clients in relation to tradeable financial instruments, which include shares, bonds, units in a collective investment, and derivatives. Life assurance, pensions and mortgages are outside the scope of MiFID.

In the UK, MiFID became effective from November 2007. It is a key element of the EU Financial Services Action Plan and aims to harmonise the regulation of investment services across the EU. MiFID has the main objectives of increasing both competition and consumer protection by setting requirements in three main areas:

- conduct of business;

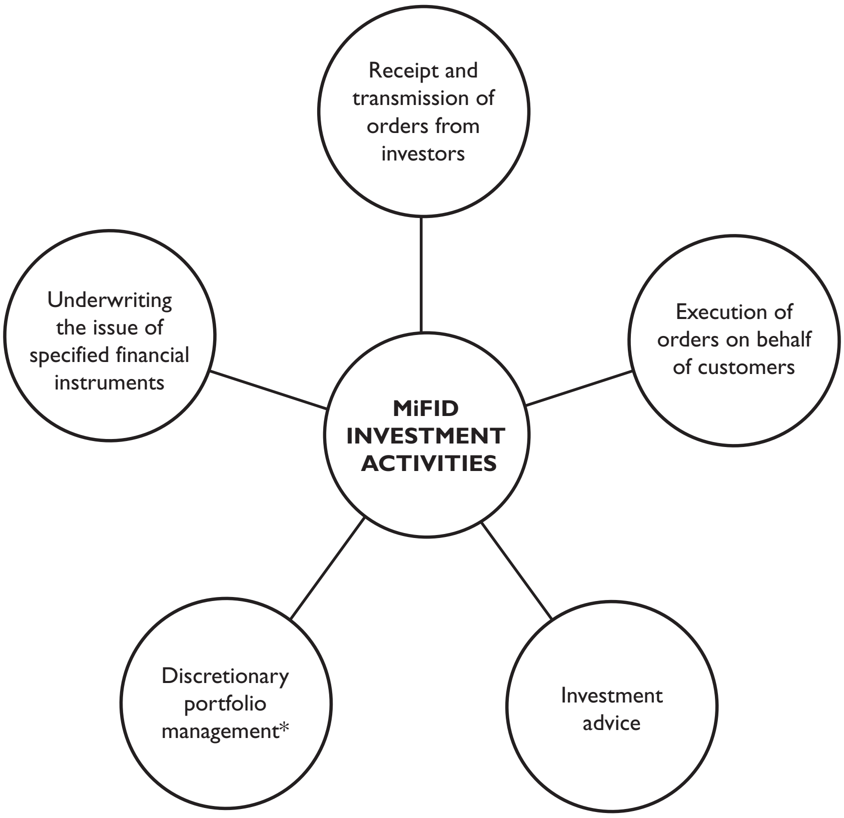
- organisation;
- market transparency.

MiFID distinguishes between core and non-core activities: core activities are "investment services and activities" and non-core activities are "ancillary services". Where a firm performs both core and non-core activities, MiFID applies to both aspects of its activities. A firm that only performs non-core activities is not subject to MiFID.

MiFID retained the principle of an EU 'passport' that was introduced by the ISD, meaning that a firm subject to MiFID has the right to operate throughout the EEA on the basis of a single authorisation in its home state. The aim of the directive is to make cross-border activity easier to conduct by imposing a single set of rules across the EEA.

The FCA, as the body responsible for the securities industry in the UK, has written MiFID into its Handbook. Firms affected include securities and futures firms, banks conducting securities business, recognised investment exchanges and alternative trading systems. The types of investment activity covered by MiFID are summarised in Figure 24.3.

FIGURE 24.3 INVESTMENT ACTIVITY SUBJECT TO MIFID



*on a client-by-client basis, in accordance with mandates given by investors

Given that MiFID does not apply where a business only carries out 'non-core activities', UK firms are exempt from MiFID if they do not hold client money and do not advise on or arrange complex investments such as derivatives. However, any firm making use of the exemption in respect of 'non-core' activities will not be able to engage in cross-border business on the basis of home state authorisation.

MiFID II

The European Commission launched proposals for reform in 2010. These were intended to improve the functioning of financial markets in light of what was learned from the financial crisis, improve investor protection and tackle some of the issues that were missed in the original MiFID.

MiFID II represents a comprehensive set of reforms covering eight main areas (see Figure 24.4). The legislation was published in June 2014 and generally applies within EU member states since 3 January 2018.

FIGURE 24.4 REFORMS UNDER MIFID II

Conduct of business rules
Enhancing the level of protection for different types of investor

Transparency
The MiFID pre- and post-trade transparency regime for shares is extended to non-equity investments

Development in market structures
Designed to produce comprehensive regulation of secondary trading

Organisational requirements
Enhanced requirements in respect of the management of firms; explicit organisational and conduct requirements relating to product governance

Commodity derivatives
Refinement of and augmentation of existing MiFID requirements

High-frequency trading
Measures to ensure that high-frequency trading does not adversely impact on markets

Disclosure
Requirement for aggregated cost disclosure, detailing all adviser and product charges

Suitability
The requirement to assess suitability when recommending an investor, buys, holds or sells (rather than buys or sells)

24.4.4 Undertakings for Collective Investment in Transferable Securities

Undertakings for Collective Investment in Transferable Securities (UCITS) legislation applies to regulated investment funds that can be sold to the general public throughout the EU. UCITS aims to provide a common framework of investor protection and product control.

The legislation lays down the principle of mutual recognition of authorisation that facilitates free circulation within the EU of the units of funds covered by the Directive. The funds must comply with various requirements, which include having an adequate spread of risk among their underlying investments, and a high degree of liquidity to enable investors to redeem their units on demand. Since July 2011, management companies established in any EU state have been able to operate UCITS funds established in another state.

UCITS V was implemented in the UK from March 2016 and aims to increase standards of investor protection and customer confidence.

24.4.5 Life assurance

The two main objectives of a European single market for insurance are to:

- provide all EU citizens with access to the widest possible range of insurance products, while ensuring the highest standards of legal and financial protection; and
- enable an insurance company authorised in any of the member states to pursue its activities throughout the EU.

In setting out to achieve these objectives, the EU has always dealt with life assurance and non-life insurance separately, in order to take account of their different characteristics and also in acknowledgment of the close ties that life assurance has with the long-term savings industry.

EU legislation on life assurance evolved over a number of years and the Consolidated Life Directive (2002) sets the framework for the regulation of life assurance in the EU. The Consolidated Life Directive brought together the provisions of three previous EU Life Directives and includes the following:

- Definitions of what constitutes life assurance – in addition to life insurance the definition also includes annuities and income protection insurance.
- The rules applying to an insurer that wishes to provide life assurance services on a ‘cross-border’ basis.
- Requirements that must be adhered to for a life assurance company to be authorised.
- Requirements in respect of the ongoing supervision of a life assurance company, with specific rules with regard to financial supervision. The

responsibility for the financial supervision of an assurance company is that of the regulator in its home state.

- A requirement for policyholders to be provided with clear and accurate information about the essential features of products offered to them. As a consequence, the FCA requires that life assurance customers are provided with a key features document.
- Cancellation rights – in the UK, FCA rules require that those applying for life assurance are granted a statutory 'cooling-off period'.

As with other EU legislation, the aim is to harmonise laws throughout the EU with the objective of promoting competition.

CHECK YOUR UNDERSTANDING 2

From your studies in Topic 21, can you recall where:

a) the requirement to provide insurance policyholders with clear and accurate information about the essential features of the products offered to them; and

b) the rules relating to cancellation rights are addressed in the FCA Handbook?

24.4.6 General insurance

In 1988, the Second Non-Life Council Directive laid down rules for cross-frontier non-life insurance that balance the needs of freedom of service and consumer protection. This allowed companies to supply insurance in another member state without having to establish a branch or subsidiary in the other state.

The Third Non-Life Council Directive, issued in 1992, completed the process and now any insurance company whose head office is in one of the member states can establish branches, and carry on non-life insurance business, in any other state. That activity will be under the supervision of the competent authorities of the member state in which the insurance company's head office is situated.

Authorisation to carry out insurance business under the terms of this directive is granted for a particular class of insurance (or even, sometimes, for some of the risks relating to a particular class). General insurance risks are classified into a large number of categories or classes; companies can, of course, be authorised for more than one class.

Directive on Insurance Mediation

As well as ensuring that insurance companies can operate throughout the EU, the EU also wants to ensure that retail markets in insurance are accessible and secure. To this end, a Directive on Insurance Mediation (IMD) came into force in January 2003, the purpose of which is to establish the freedom for insurance intermediaries to provide services in all states throughout the EU.

The Insurance Distribution Directive (IDD) was introduced on 1 October 2018 and is intended to strengthen and consolidate the existing rules of IMD.

A key aim of the IMD has been to regulate the sales standards of insurance brokers and intermediaries.

Insurance mediation is defined in the Directive as "the activities of introducing, proposing or carrying out other work preparatory to the conclusion of contracts of insurance, or of concluding such contracts, or of assisting in the administration and performance of such contracts, in particular in the event of a claim". When an employee of the insurance company, or someone acting under the responsibility of the insurance company (a tied agent), carries out such activities, they are not included in the definition of insurance mediation.

The Directive has established a system of registration for all independent insurance (and reinsurance) intermediaries. They must be registered with a competent authority in their home state: independent financial advisers based in the UK who are selling life assurance or general insurance must be registered with the FCA.

Registration is subject to strict requirements regarding professionalism and competence: intermediaries must have the necessary general, commercial and professional knowledge and skills. Exactly what this means depends on the relevant national authority.

CHECK YOUR UNDERSTANDING 3

Which section of the FCA Handbook do you think addresses the requirements for intermediaries to have the necessary general, commercial and professional knowledge and skills?

Insurance intermediaries are also required to be "of good repute". Again, local interpretations of this may vary, but minimum requirements are that an intermediary must not have been:

- convicted of a serious criminal offence relating to crimes against property or other financial crimes;
- declared bankrupt.

The latest Directive requires that insurance intermediaries should hold professional indemnity insurance of at least €1,300,380 per case and €1,924,560 in total per annum.

Rules are also included to protect clients' funds, including the requirement to keep client money in strictly segregated accounts. This is backed up by a requirement for intermediaries to have financial capacity of an amount equal to at least 4 per cent of premiums received per annum, subject to a minimum of €15,000.

The regulations specify in some detail what information an intermediary must give to a customer. In relation to the intermediary, the following information must be supplied:

- name and address;
- details of registration and means of verifying the registration;
- whether the intermediary has any holding of more than 10 per cent of the voting rights or capital of an insurance company;
- conversely, whether any insurance company has a holding of more than 10 per cent of the voting rights or capital of the intermediary;
- details of internal complaints procedures and of external arbitrators (eg ombudsman bureaux) to which the customer could complain;
- whether the intermediary is independent or tied to one or more insurance companies.

In relation to the advice offered and products recommended:

- independent intermediaries must base their advice on analysis of a sufficiently large number of contracts available on the market to enable them to recommend, in accordance with professional criteria, a product that is adequate to meet the customer's needs;
- the intermediary must give the customer (based on the information supplied by the customer) an assessment of the customer's needs and a summary of the underlying reasons for the recommendation of a particular product. This requirement is satisfied in the UK by the use of a confidential client questionnaire, or factfind, to obtain the necessary information, and by the issue of a suitability letter to justify the specific recommendation.

All information provided by an intermediary to a customer must be set out in a clear and accurate manner, and must be comprehensible to the customer.

✓

CHECK YOUR UNDERSTANDING 4

Where does the FCA Handbook address the requirements relating to:

a) the information the intermediary must provide to the customer regarding how to complain, and whether the intermediary is independent or restricted?

b) the assessment of the customer's needs and the summary of reasons for recommending a particular product?

Insurance Distribution Directive

The existing IMD was replaced with effect from 1 October 2018 under the terms of the Insurance Distribution Directive (IDD). The aim is to address issues of inconsistency with regard to the way the IMD was adopted across member states and provide better consumer protection and greater legal clarity and certainty.

FIGURE 24.5 REFORMS UNDER THE IDD

Extension of the scope of IMD
to cover direct insurance sales and some aspects of price comparison websites

Enhanced professionalism requirements
formal requirement for intermediaries to undertake at least 15 hours continuing professional development each year

Conduct of business rules
requirement that insurance distributors must always act 'honestly, fairly and professionally in the best interests of customers'

Mandatory disclosures
before an application for insurance is made to ensure that customers receive clear information

Requirement for a standardised 'insurance product information document'
for non-life insurance contracts

Stricter requirements
for the sale of life insurance products with investment elements

Additional information requirements
for the sale of bundled products

Simplified procedure for cross-border entry to insurance markets across the EU
through the use of a single electronic database of cross-border insurance intermediaries

24.5 What is the role of oversight groups?

In addition to the regulation of the financial services sector set out in EU Directives and carried out by bodies such as the FCA, there are also a number of other ways in which the activities of financial services institutions are kept under review. It is important to ensure that the investments of both shareholders and customers are being handled safely and honestly and that the institution is abiding by all the applicable laws and regulations, in the best interests of all its stakeholders. This oversight of an institution's business can be carried out by different individuals and groups, such as auditors, trustees or compliance officers.

24.5.1 Auditors

External auditors

External auditors are concerned particularly with published financial statements and accounts. They are independent of the business whose accounts are being audited; they are normally firms of accountants, and it is their responsibility to provide reasonable assurance that published financial reports are free from material mis-statement and are compiled in accordance with legislation and with appropriate accounting standards. They must conform to the professional standards of the Auditing Practices Board and the Accounting Standards Committee.

External auditors may also be members of professional bodies, such as the Institute of Chartered Accountants in England and Wales (ICAEW) or the Association of Chartered Certified Accountants. Both of these bodies publish ethical codes that their members are expected to adhere to.

Internal auditors

Internal auditors may be in-house members of staff, or the process may be outsourced. Their basic task is to:

- review how an organisation is managing its risks;
- ascertain whether appropriate controls have been established; and
- evaluate and suggest improvements to control and governance processes.

They check that operations are being conducted effectively and economically in line with the organisation's policies, and that records and reports are accurate and reliable. It is not the responsibility of internal auditors to put controls and systems in place; that remains the responsibility of management. The role of the internal audit is to inform management decisions by identifying problems and recommending possible solutions.

Internal auditors may be members of a professional body, such as the Institute of Internal Auditors.

24.5.2 Trustees

A trustee is a person (or in some cases an organisation) whose responsibility is to ensure that any property held in trust is dealt with in accordance with the trust deed for the benefit of the trust's beneficiaries. Examples of trusts can be found throughout the financial services industry. For instance, unit trusts are investment schemes set up under a trust deed and the trustees are the legal owners of the trust's assets on behalf of the unit-holders. Similarly, most occupational pension schemes are set up under trust: this is important for the security of members' benefits because it enables the pension assets to be kept separate from the employer's business assets. The rights and duties of pension scheme trustees are set out in the Pensions Acts of 1995 and 2004.

Trustees are subject to statutory requirements in respect of the way they carry out their duties. The key legislation is the Trustee Act 1925 and the Trustee Investment Act 2000. The former is concerned with the general duties of trustees, the latter with the way in which trustees deal with the investment of trust assets.

24.5.3 Compliance officers

Firms that are authorised by the Financial Conduct Authority (FCA) or the Prudential Regulation Authority (PRA) should appoint a compliance officer to have oversight of the firm's compliance function, in other words to ensure compliance with all relevant legislation and regulations. Responsibilities of a compliance officer will include:

- production and publication of a compliance manual;
- maintenance of compliance records such as complaints register and promotions records;
- responding to and corresponding with the FCA on compliance matters;
- ensuring that staff meet FCA requirements as regards recruitment, training, supervision and selling practices.

Compliance officers may be members of a professional body, such as the Compliance Institute.

CODES OF CONDUCT

Many professional bodies and trade associations have codes of conduct to which their members must adhere. For example, we saw in 18.6.4 that in order to receive an SPS, an adviser must meet the professional standards of their professional body and declare that they adhere to its code of ethics.

Other examples of codes of conduct include:

- The Advertising Standards Authority (described in 20.5);
- The Standards of Lending Practice (described in 21.7).

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved? For instance, can you:

- explain what is meant by the terms 'data subject', 'personal data', 'sensitive personal data' and 'data controller'?
- describe the role of the Pensions Regulator?
- outline the areas of financial services that are covered by, respectively, the Investment Services Directive, MiFID, the Insurance Mediation Directive and the Insurance Distribution Directive?
- describe the different types of oversight group that play a role in the financial services industry?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 24. Review the text if necessary.

Answers can be found at the end of this book.

1) What is the difference between a data controller and a data processor?

2) What does GDPR define as 'sensitive data'?

3) Which of the following is **not** one of the GDPR principles?

    a) Data must be adequate (but not excessive) and relevant to the purpose for which it is processed.

    b) Data controllers must take appropriate technical and organisational measures to keep data secure from accidental or deliberate misuse, damage or destruction.

    c) Data must not be kept for longer than five years from the point at which it is gathered.

    d) Data must be kept accurate and up to date.

4) What is the penalty for committing a criminal offence in relation to GDPR?

5) The Pensions Regulator is responsible for the regulation of occupational pension schemes only. True or false?

6) What is the role of the Pension Protection Fund?

7) Which of the following products are **not** subject to MiFID?

    a) Units in a collective investment.

    b) Shares.

    c) Life assurance.

    d) Bonds.

8) What investment activities are subject to MiFID?

9) A general insurer with a head office in one of the member states may set up branches in other member states; these branches will be regulated by the national regulator of the state in which the head office is situated. True or false?

10) With which regulator must UK-based IFAs who sell life assurance or general insurance be registered?

a) The FCA.

b) The PRA.

c) The CMA.

d) The IDD.

TOPIC 25

Consumer rights, complaints and compensation

LEARNING OBJECTIVES

All your studies up to this point have been focused on developing your product knowledge, explaining how to establish customers' needs and formulate sound advice, and making you aware of the regulatory framework within which financial services businesses must operate. In other words, to put you in a position where your customers have no reason to complain. Nevertheless, sometimes things do go wrong, and this final topic covers the customers' rights and how to deal with complaints.

By the end of this topic, you should have an understanding of:

- the broad scope of the Consumer Rights Act, alternative dispute resolution and unfair contract terms;
- the range of protection that exists for financial services customers;
- the complaints procedures that financial services firms must follow;
- the role of the Financial Ombudsman Service and Pensions Ombudsman Service; and
- the Financial Services Compensation Scheme.

This topic covers the Unit 2 syllabus learning outcomes U5.1–U5.5, K2.2, and K2.5.

THINK ...

Even if you have never been involved in handling complaints relating to financial services, you will almost certainly have been dissatisfied with a product or service at some time. If you have had to make a complaint:

- were you aware of what your legal rights were in that particular situation?
- did the business involved respond to your complaint in a satisfactory way?

- did you have to escalate the complaint and was the process for doing this clearly explained to you?
- did you have to involve a third party such as Trading Standards, a regulatory body or the courts?

The basic principle of trying to resolve a complaint at the earliest opportunity but escalating through various stages if necessary applies to financial services just as it does to other consumer products and services.

25.1 Consumer rights legislation

We begin this topic by looking at consumer rights legislation that applies to all UK consumers, not specifically financial services customers.

IN BRIEF

KEY CONSUMER RIGHTS

Consumers have the right to buy products and services with confidence and have rights when things go wrong. In particular, they have the right to:

- clear and honest information before they buy;
- get what they pay for;
- be supplied with goods that are fit for purpose and services that are performed with reasonable care and skill;
- have any faults corrected free of charge, or get a refund/ replacement.

25.1.1 What is the Consumer Rights Act 2015?

For many years consumer law in the UK was governed by the Supply of Goods and Services Act 1982 and the Unfair Terms in Consumer Contracts Regulations 1999. From 1 October 2015 the Consumer Rights Act 2015 took effect. It gives consumers enhanced and easier-to-understand rights that change the rules applying when things go wrong in relation to goods and services.

The Act covers:

- what to do when goods are faulty;
- what should happen when digital content is faulty (the first time that digital content has been covered in consumer rights legislation);

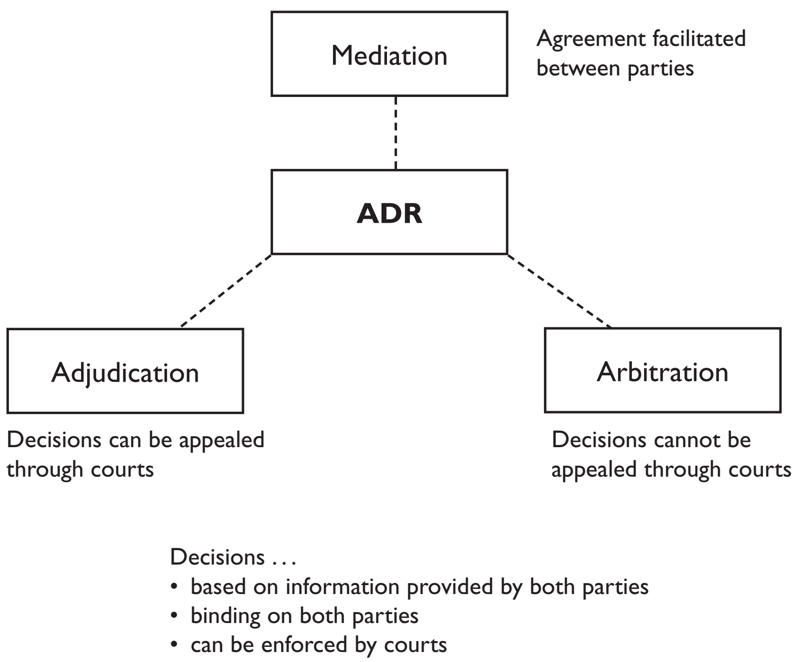
- how services should match up to what has been agreed, and what should happen when they do not;
- what should happen when goods and services are not provided with reasonable care and skill;
- unfair terms in contracts;
- greater flexibility for organisations such as the FCA or Trading Standards to respond to breaches of consumer law.

The Consumer Rights Act 2015 is the first piece of consumer rights legislation to detail what should happen if a service is not provided in the manner agreed or with reasonable care and skill. Essentially, the business that provided the service must align it with what was agreed or, if this is not realistic, provide a refund.

25.1.2 Alternative dispute resolution

An aim of the Consumer Rights Act 2015 is to reduce the incidence of disagreements between businesses and consumers and to reduce the number of such disputes ending in court action. It is also hoped that the speed with which disputes are resolved will be improved and the associated costs reduced. In pursuit of these goals, the application of alternative dispute resolution (ADR) has been broadened and is now open to all business. ADR aims to help when a dispute with a consumer cannot be settled directly. The business involved in the dispute will engage the services of a certified alternative dispute resolution provider and must find out whether or not the consumer is willing to use the service.

FIGURE 25.1 ALTERNATIVE DISPUTE RESOLUTION OPTIONS



25.1.3 Unfair contract terms

The Unfair Terms in Consumer Contracts Regulations 1999 were revoked by the Consumer Rights Act 2015, which reforms and consolidates the previous regime.

The legislation in respect of unfair contract terms applies to consumer contracts between a business and a consumer, and to any notice that relates to the rights and obligations between a business and a consumer or purports to exclude or limit a business's liability to a consumer.

The main areas covered by the legislation are as follows.

Fairness

- All terms in regulated contracts should be fair, with a contract or notice being deemed to be unfair if it causes a significant imbalance in respect of the rights and obligations of the various parties to the contract to the detriment of the consumer.
- All terms should adhere to the requirement of good faith (see below).
- Any unfair term or notice will not be binding on the consumer unless they choose to be bound by it. Where an element of the contract is deemed to be unfair then the rest of the contract can continue to take effect, as long as this is practicable.
- Terms that may be deemed unfair include:
  - disproportionately high charges where the consumer decides not to proceed with services that have yet to be supplied;
  - terms allowing the business to determine the characteristics or subject matter after the consumer is bound;
  - terms allowing the business to determine the price after the consumer is bound.

Transparency

- The written terms of a contract should be transparent and expressed in clear, easily understood language. If there is any doubt about the meaning of a written term, the interpretation most favourable to the consumer will be adopted.

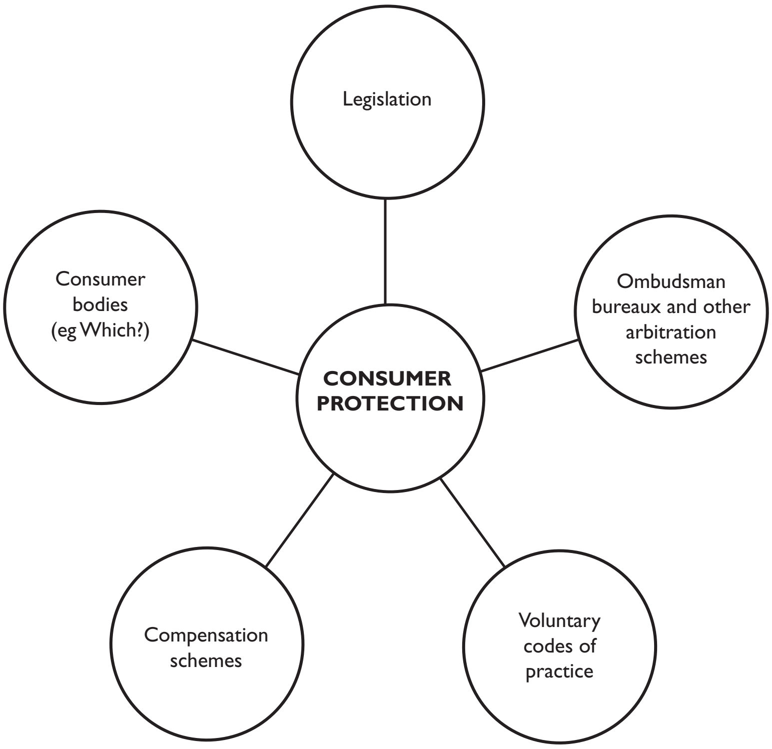
Good faith

- A term that causes a significant imbalance between the rights and obligations of the various parties to the contract to the detriment of the consumer will be deemed to be in breach of good faith.

25.2 How are customers protected within the financial services sector?

Many financial services products are, by nature, technical and not easy for the average customer to understand; there is a reliance on the provider and the adviser to give the customer full, accurate information that is easy to understand. It is easy to see that providing a customer with a financial product that does not meet their needs has considerably more serious implications than providing them with, say, an unsuitable lawnmower. These are among the reasons why the sector is so tightly regulated.

FIGURE 25.2 CONSUMER PROTECTION WITHIN THE FINANCIAL SERVICES SECTOR



One of the FCA's operational objectives (see Topic 17) is to protect consumers of financial services and products. A step towards achieving this is to make it easier for customers to know how to complain when they feel that they have been badly treated by a financial institution or by an individual working in the industry. Customers who are not satisfied with a firm's response to their complaint can refer the matter to a dedicated independent ombudsman bureau. In some circumstances, customers who have lost money can receive compensation. We look at these options in further detail here.

It is important to note that consumers are expected to take some responsibility for the purchasing decisions they make – there can never be 100 per cent protection from the impact of making poor decisions. For instance, the FCA:

- makes it clear that it cannot protect investors from falls in stock market values (although it will attempt to educate consumers about the risks involved); and
- sets limits on the amounts of compensation the Financial Services Compensation Scheme can offer.

25.2.1 The role of government departments

The activities of various government departments affect firms within the financial services industry and the process of advising clients:

- HM Treasury – the government's economic and finance ministry, maintaining control over public spending, setting the direction of economic policy and working to achieve strong and sustainable economic growth. It is the department responsible for the regulation of financial services under the direct authority of the Chancellor of the Exchequer. The Chancellor is also responsible for the Budget.
- HM Revenue and Customs (HMRC) – the UK's tax, payments and customs authority. It collects the money that pays for the UK's public services and helps families and individuals with targeted financial support. The self-employed and those who have further income tax to pay on their savings, capital gains or who have inheritance tax liabilities have direct contact with HMRC via the self-assessment system. Pension providers also have dealings with them, as they need to reclaim tax taken at source from personal pension contributions.
- The Department for Work and Pensions (DWP) – responsible for welfare, pensions and child maintenance policy. It administers the state pension and a range of working age, disability and ill-health benefits. It also provides a useful website outlining the benefits payable and how they can be claimed: https://www.gov.uk/browse/benefits [Accessed: 19 February 2019].
- The Claims Management Regulator – a unit of the Ministry of Justice. It regulates the companies that offer a service for people hoping to claim compensation for personal injury, mis-sold financial products and services, employment and redundancy, criminal injury, industrial injury and housing disrepair. It is responsible for licensing firms and individuals to provide claims management services, for taking action when firms break their rules, carrying out regulatory and criminal investigations, and providing guidance and advice to consumers, organisations and regulated firms.
- National Crime Agency (NCA) – the role of the NCA is to protect the public by disrupting and bringing to justice those serious and organised criminals who present the highest risk to the UK. As we learned in Topic 23, it tackles money laundering, fraud, bribery and corruption, and counterfeiting of currency.

25.2.2 The role of guidance services

Earlier in this section we highlighted that consumer bodies have a role to play in consumer protection. Some of these are industry-specific, such as the the

Money and Pensions Service (previously the Single Financial Guidance Body), whereas others have a broader remit such as Which? and Citizens Advice. We will consider each of these bodies in more detail, starting with the Money and Pensions Service.

25.2.3 The Money and Pensions Service

The Money and Pensions Service, previously the Single Financial Guidance Body, brought three providers of government guidance together into one organisation:

- the Money Advice Service;
- The Pensions Advisory Service; and
- Pension Wise.

It is sponsored by the Department for Work and Pensions, with funding through levies on the financial services industry and pension schemes.

Its mission is to help individuals to manage their personal finances as well as their circumstances allow. Its aim is to deliver a more streamlined service than the three previous providers by offering people easier access to the information and guidance they need to help them make effective financial decisions throughout their lives.

The Money and Pensions Service (2019) has five core functions:

- **Pensions guidance**: provision of information for the public about workplace and personal pensions.
- **Debt advice**: providing people in England with information and advice on debt.
- **Money guidance**: provision of information to enhance people's understanding and knowledge of financial matters and day-to-day money management skills.
- **Consumer protection**: working with the government and the FCA to protect consumers.
- **Strategy**: working with all bodies involved in financial capability to drive significant, coordinated change over the longer term.

25.2.4 Which?

Which? has, for more than 50 years, championed the causes of consumers in a wide range of areas, including financial services. It campaigns to protect consumers' rights, reviews products and services, and offers independent advice on a variety of subjects.

Which? has campaigned on many occasions for fairer treatment for financial services customers, to the extent that it is now involved with the regulator in many consultations and is seen as a stakeholder on issues relating to the industry.

Which?, along with other consumer bodies including Citizens Advice, has been granted 'super-complaint' status for the financial services sector, meaning that they have the power to make complaints direct to the FCA.

In many cases, the individual consumer may not be aware of a problem because they are not able to see the 'bigger picture' and so are unlikely to challenge the provider. The role of Which? is to identify such issues and take action on behalf of the consumer.

25.2.5 Citizens Advice

Like Which?, Citizens Advice has 'super-complaint' status. It provides free, confidential and independent advice to help people overcome their problems. It is a voice for clients and consumers on the issues that matter to them. It values diversity, champions equality and challenges discrimination for everyone. Help is available online, via telephone and face-to-face.

25.3 What complaints procedures must be followed?

The FCA has rules for dealing with complaints and compensation. These rules are set out in:

- the Handbook called 'Dispute Resolution: complaints' (more commonly referred to by its FCA reference code of 'DISP'); and
- the 'Compensation' Handbook, referred to as 'COMP', which details the rules governing eligibility under the Financial Services Compensation Scheme and the levies payable by firms.

DISP covers how complaints are to be dealt with by firms, payment providers and the Financial Ombudsman Service (FOS).

The FCA defines a complaint as "any oral or written expression of dissatisfaction, whether justified or not, from or on behalf of an eligible complainant about the firm's provision of, or failure to provide, a financial service" and involves an allegation that the complainant has suffered, or may suffer:

- financial loss; and/or
- material distress; and/or
- material inconvenience.

25.3.1 Eligibility

The FCA defines an eligible complainant as:

- a private individual, including individuals acting as personal guarantors for loans to businesses they are involved in and consumer buy-to-let consumers;
- a business with an annual turnover below £6.5m and fewer than 50 employees, or an annual balance sheet below £5m;
- a charity with an annual income of less than £6.5m when the complaint is made; or
- a trustee of a trust that has a net asset value of less than £5m when the complaint is made.

25.3.2 Key requirements

The FCA places a significant emphasis on the fair treatment of customers, and the rules and guidance on complaint handling aim to ensure that complainants are dealt with promptly and fairly. Firms must have appropriate and effective complaints-handling procedures and make consumers aware of these procedures – this is normally done through the client agreement or initial disclosure document.

When a complaint is received, a firm must take the steps summarised in Figure 25.3.

FIGURE 25.3 COMPLAINTS-HANDLING PROCEDURE

Acknowledge	Acknowledge receipt of a complaint promptly, in writing
Investigate	Ensure complaints are investigated by a person of sufficient competence who, wherever possible, was not directly involved in the matter under complaint
Resolve	Aim to resolve complaints promptly, within eight weeks
Inform	Keep the complainant updated on progress
Advise	Advise the customer that they can refer the matter to the Financial Ombudsman Service (FOS – see section 25.4), where a resolution cannot be found within eight weeks
Provide	Provide the complainant with a final response letter, which must 'adequately address the subject matter of the complaint' and notify complainants of their right to approach the FOS within six months of the date of the letter if they are not satisfied

Payment services providers must give a full response to a complaint within 15 days. This can be extended to 35 days in exceptional circumstances, with a holding letter sent in the interim.

Firms are also required to:

- report to the FCA on their complaints-handling on a six-monthly basis;
- investigate the root cause of complaints and take action to prevent the recurrence of similar issues in future.

The FCA requires financial services firms to appoint an individual at the firm, or in the same group as the firm, to be responsible for oversight of the firm's compliance with the complaints rules. The individual appointed must be carrying out a governing function. Firms are not required to notify the individual's name to the FCA or FOS but are expected to do so promptly on request.

25.3.3 Complaints resolved quickly

Firms are able to adopt a less formal approach to resolving a complaint where the complaint can be resolved by close of business on the third working day following receipt. This may apply to relatively minor service issues such as rudeness by a staff member or the misspelling of a name or address on a communication. More significant matters, such as an allegation of poor advice or mis-selling, would generally take longer to investigate.

Where a complaint can be resolved quickly in this way, there is no need for the firm to provide a final response letter. However, the firm must provide a summary resolution communication to the complainant. Situations might arise in which the firm believes the matter has been resolved, but the customer does not agree; the summary resolution communication will explain that, should the complainant remain dissatisfied, they can still refer the matter to the FOS. The format of the summary resolution communication is prescribed in DISP.

25.3.4 Root cause analysis

As well as dealing with individual complaints in a prompt, fair and consistent manner, firms are expected to put in place appropriate management controls and take reasonable steps to ensure that they identify and remedy any recurring or systemic problems, for example by investigating the root causes of complaints to identify any weaknesses in their procedures. In this way, they should be able to improve their service to customers.

RECORD-KEEPING

Firms have to keep records of all complaints. Records have to be retained for at least three years from the date a complaint is received.

Where the complaint relates to collective portfolio management services for a UCITS scheme, the minimum period for which records must be retained is five years. Where the complaint relates to MiFID business, there is no minimum retention period stated since 3 January 2018.

25.3.5 Reporting

On a six-monthly basis, firms are required to report to the FCA the following information:

- total number of complaints received;
- total number of complaints closed:
  - within four weeks or less of receipt;
  - within more than four weeks and up to eight weeks of receipt; and
  - more than eight weeks after receipt;
- total number of complaints:
  - upheld in the reporting period; and
  - outstanding at the beginning of the reporting period;
- total amount of redress paid in respect of complaints during the reporting period; and
- the root causes of complaints and corrective action taken to prevent recurrence.

There are simplified reporting requirements where a firm receives fewer than 500 complaints in a six-month period.

Publication of complaints information

In the interests of transparency, firms are required to publish complaints information if they receive 500 or more complaints over a six-month period.

Both the FCA and FOS publish complaints data.

SUPER-COMPLAINTS

The Financial Services and Markets Act 2000 (FSMA) gives designated consumer bodies the right to make a 'super-complaint' to the FCA where they consider that there are features of a financial services market in the UK that are or may be significantly damaging the interests of consumers. The FCA super-complaints regime for financial services markets is distinct from the cross-sectoral super-complaints regime provided for in the Enterprise Act 2002.

Under the Financial Services Act 2012, designated consumer bodies, regulated persons and the FOS can make a super-complaint to the FCA.

The FCA is required to respond to a super-complaint within 90 days, setting out how it proposes to deal with the complaint and any possible actions. The FCA's response might, for example:

- announce plans to consult on an issue;
- set out a timetable for regulatory action which would allow the FOS to consider whether or not to place a hold or stay on complaints;
- explain how the FCA is already taking action to address an issue; or
- explain why it is not taking any action.

It can also carry out wider enquiries – such as internal research or public requests for information – with a view to testing the evidence. It can carry out a review of the relevant regulated firms.

25.4 What is the role of the Financial Ombudsman Service?

A customer who is dissatisfied with the actions of a firm must first complain to the firm itself, as explained in section 25.3. If the customer is still not satisfied once the firm's internal complaints processes have been completed, they can take their complaint to the Financial Ombudsman Service (FOS). Certain types of pension and aspects of pension arrangements are dealt with by the Pensions Ombudsman (see section 25.5).

FINANCIAL OMBUDSMAN SERVICE

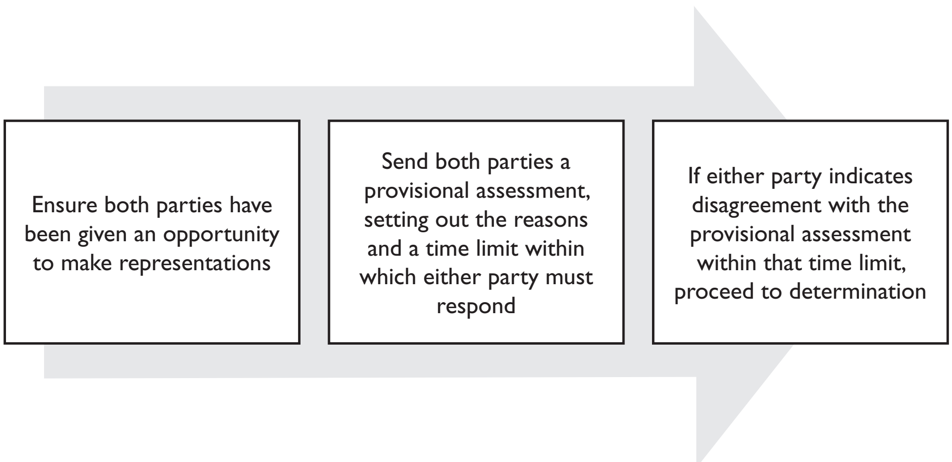
The Financial Services and Marketing Act (FSMA) 2000 provides for a mechanism under which "certain disputes may be resolved quickly and with the minimum of formality by an independent person". The Financial Ombudsman Service took over from several existing ombudsman schemes in 2001.

The FOS is able to deal with complaints brought by eligible complainants, as defined by the FCA (see section 25.3). It does not make the rules under which firms are authorised, nor can it give advice about financial matters or debt problems. A team of assessors and adjudicators investigate and aim to resolve cases. Formal decisions are taken by senior members of staff called the ombudsmen. Their decisions are binding upon firms, but not upon customers, who have the right to take their case to court if they reject the FOS decision.

Membership of the Financial Ombudsman Service is compulsory for all organisations that are authorised under the FSMA 2000. The service is funded through a general levy on members, plus case fees for the 26th and subsequent cases per year.

The FOS attempts to resolve complaints at the earliest possible stage and by whatever means appear to be most appropriate, including mediation or investigation. The process for investigation is outlined in Figure 25.4.

FIGURE 25.4 FOS PROCESS



The FOS will determine a complaint by reference to what is, in its opinion, fair and reasonable in all the circumstances of the case, taking into account:

- the relevant:
  - law and regulations;
  - regulators' rules, guidance and standards;
  - codes of practice; and
- where appropriate, what they consider to have been good industry practice at the relevant time.

25.4.1 What are the time limits?

Complaints to the FOS must be made within six months of receiving a final response, six years of the event that gives rise to the complaint, or within three years of the time when the complainant should have become aware that they had cause for complaint, whichever is the later.

If a firm receives a complaint which is outside the time limits for referral to the FOS, it may reject the complaint without considering the merits. In a 'final response', the firm must explain to the complainant that the complaint is 'time barred', and indicate that the Ombudsman may waive the time limits in exceptional circumstances.

> **TIME-BARRED COMPLAINT**
>
> A complaint made outside the time limits for referral to the FOS; a firm may reject such a complaint, via a final response, without considering its merits.

In addition, the FOS will not usually consider any complaint that is the subject of a court case.

25.4.2 What are the compensation limits?

The maximum compensation the FOS can award for complaints about acts or omissions by firms on or after 1 April 2019 is £350,000 plus interest and the complainant's reasonable costs. For acts or omissions by firms before 1 April 2019 that are referred to the FOS after that date, the limit will be £160,000. From 1 April 2020, the limits will be adjusted annually in line with the Consumer Prices Index (CPI).

Awards are binding on the firm but not on the complainant, who is free to pursue the matter further in the courts if they wish. The award is not intended to punish the firm, but to restore the complainant to the financial position in which they would have been had the event complained about not taken place.

25.5 What is the role of the Pensions Ombudsman Service?

The Pensions Ombudsman Service deals with complaints and disputes relating to the running of personal and occupational pension schemes, and also with complaints about the Pension Protection Fund. Complaints relate to cases of maladministration, and complainants need to show that this has led to injustice (financial loss, distress, delay or inconvenience). Disputes are disagreements about facts or about law.

The service does not deal with complaints about the sales and marketing of pension schemes – these are the province of the FOS (see section 25.4) – or with complaints about state pensions.

Complaints and disputes can be made by a wide range of people: individuals, managers, trustees or employers. They are commonly made by:

- members or ex-members of schemes;
- spouses of members or ex-members of schemes;
- widows or dependants of members who have died;
- solicitors or others representing the interests of such people.

Complaints or disputes should first be addressed to the pension scheme's managers or trustees. If this does not result in agreement, the next step is to contact The Pensions Advisory Service (TPAS) (now part of the Money and Pensions Service), which tries to resolve the dispute through conciliation and mediation. TPAS decisions are not legally binding; cases that cannot be agreed are normally then referred to the Pensions Ombudsman Service.

Complaints and disputes must be communicated to the service in writing within three years of the event being complained about. Any time spent trying to resolve the matter using the scheme's internal complaints procedures, or through TPAS, is normally excluded from this time period.

A team of assessors and adjudicators review and seek to resolve cases; final, binding decisions are taken by the individual Ombudsmen, who are appointed by the Secretary of State for Work and Pensions.

An Ombudsman's decision is binding on all parties and can be enforced in the courts.

25.6 The Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) provides compensation for customers who have lost money through the insolvency of an authorised firm. The PRA and the FCA are jointly responsible for the rule-making and oversight of the FSCS.

The FSCS's costs are made up of management expenses and compensation payments. The scheme is funded by levies on firms authorised by the FCA and the PRA. Levies are split into five broad classes corresponding to the sub-schemes outlined below, and contributions are based on the class and specific activities each firm undertakes.

To qualify for compensation, a claimant must be eligible under rules outlined in the FCA Handbook. The main points are as follows:

- Compensation can only be paid when an authorised firm is in default. Claims cannot be made against the FSCS for other losses, ie losses due to negligence, poor advice or a fall in stock market values.
- Compensation can only be paid for financial loss and there are limits to the amounts of compensation payable.
- The FSCS was set up mainly to assist private individuals, although smaller businesses are also covered. Larger businesses are generally excluded, although there are some exceptions for deposit and insurance claims.
- The FSCS does not cover firms based in the Channel Islands or the Isle of Man.

25.6.1 FSCS sub-schemes

The FSCS is made up of five sub-schemes relating to different default situations.

DEPOSITS

This sub-scheme covers claims made against failed deposit-taking firms, for example banks, building societies and credit unions. The FSCS is triggered when a firm authorised to accept deposits by the PRA goes out of business, eg if the firm goes into administration or liquidation, and is unable to repay its depositors. The FSCS can also be involved if the PRA considers that an authorised firm is unable, or likely to be unable, to repay its depositors.

Maximum claim

Generally 100 per cent of £85,000 per person per firm, although there is cover of up to £1m for 'temporarily high' deposit balances. The £1m limit applies to balances that are held for less than six months and provides additional protection where a person's savings are temporarily boosted by certain life events such as:

- sale of a house;
- divorce settlement;
- taking pension benefits;
- receipt of inheritance;
- redundancy payment;

- criminal injuries compensation.

To claim under the higher £1m limit, a person would have to provide proof that the money was only held temporarily as a result of a relevant life event.

DEBT MANAGEMENT

Customers with money held by debt management firms may be covered in relation to client money they held with a failed debt management firm of up to £85,000.

INVESTMENTS

The FSCS is triggered when a firm authorised to advise on or arrange investments goes out of business, and is considered by FSCS to be unable, or likely to be unable, to pay claims made against it. This will generally be because the firm has stopped trading and has insufficient assets to meet claims, or is insolvent.

Maximum claim

100 per cent of £85,000 per person per firm.

HOME FINANCE

Customers of authorised mortgage firms are protected by the FSCS for business conducted on or after 31 October 2004. FSCS can provide protection if a mortgage firm is unable, or likely to be unable, to pay claims against it. FSCS is triggered when a firm authorised to advise on or arrange mortgages by the FCA goes out of business, eg if the firm goes into administration or liquidation.

Maximum claim

100 per cent of £85,000 per person per firm.

INSURANCE COMPANIES

This sub-scheme covers claims for compensation that arise following the failure of an authorised insurer (life and general).

Maximum claim

- For all long-term insurance and for certain types of general insurance, compensation is 100 per cent of the value of the policy with no upper limit. (Policies with 100 per cent protection include long-term and general insurance that provide benefits on death/disability only.)
- Where a long-term policy includes a savings as well as a protection element, the protection element has 100 per cent protection.
- Annuities that are being used to provide an income also receive 100 per cent protection.
- If the insurance is compulsory (such as employers' liability cover or motor insurance), the figure is 100 per cent of the whole amount.
- For other types of insurance the compensation limit is 90 per cent of the claim with no upper limit.

INSURANCE BROKERS

The FSCS will safeguard policyholders if an authorised firm is unable, or likely to be unable, to pay claims against it, eg if it has been placed in provisional liquidation or administration.

Maximum claim

Compensation is 90 per cent with no upper limit.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the options for alternative dispute resolution under the Consumer Rights Act 2015?
- summarise the main areas covered by the legislation relating to unfair contract terms?
- explain who is an 'eligible complainant' according to the FCA definition?
- summarise the steps that a firm must take when it receives a complaint?
- describe the roles of the FOS, the Pensions Ombudsman Service and the FSCS?

Go back over any points you don't understand and make notes to help you revise. Then test your knowledge.

References

Money and Pensions Service (2019) *Introducing the Money and Pensions Service* [online]. Available at: https://moneyandpensionsservice.org.uk/who-we-are/ [Accessed: 14 October 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 25. Review the text if necessary.

Answers can be found at the end of this book.

1) In situations where alternative dispute resolution is being used, which of the following options allows for appeal through the courts?

   a) Arbitration.

   b) Mediation.

   c) Adjudication.

   d) Conciliation.

2) In summary, in what circumstances is a contract or notice deemed to be unfair?

3) Which of the following would **not** be classed as an eligible complainant according to the FCA's definition?

   a) A private individual.

   b) A business with an annual turnover below £6.5m and fewer than 50 employees, or an annual balance sheet below £5m.

   c) A charity with an annual income of less than £6.5m when the complaint is made.

   d) Trustee of a trust that has a net asset value of less than £6.5m when the complaint is made.

4) Which of the following is a step that must be carried out when a firm receives a complaint, if it cannot be resolved within three working days?

   a) Call the complainant to discuss the matter.

   b) Advise the customer that they can refer the matter to the FSCS.

   c) Refer the complaint to an individual in an FCA governing function.

   d) Ensure the complaint is investigated by a person of sufficient competence, who, where possible, is not someone directly involved in the matter under complaint.

5) Within what period of time does the FCA expect firms to resolve the majority of complaints?

6) Once a firm has completed its procedures for resolving a complaint, it must always issue the complainant with a final response letter. True or false?

7) For how long must records of complaints involving MiFID business be retained by the firm?

   a) One year.

   b) Three years.

   c) Five years.

   d) Indefinitely.

8) Within what time limits must a complaint be made to the Financial Ombudsman Service?

9) Which organisation is responsible for dealing with complaints relating to the sale of pension products?

   a) The Financial Ombudsman Service (FOS).

   b) The Pensions Ombudsman Service.

   c) The Pensions Advisory Service (TPAS).

   d) The Financial Services Compensation Scheme (FSCS).

10) What is the maximum permissible compensation payable by the FSCS for a term assurance policy that provides £100,000 cover over a 20-year term?

Answers to knowledge and understanding questions

Topic 1

✓ CHECK YOUR UNDERSTANDING

1) The answer is unit of account – this is the function that allows the price of one item to be compared with the price of another.
2) Answer d) is correct. Answer b) is incorrect because the Bank of England only lends to the banks in its capacity as lender of last resort, eg when there is a run on its deposits. It does not lend to finance normal business activity.

? TEST YOUR KNOWLEDGE

1)
   - Geographic location – lenders and borrowers are not necessarily able to find each other and deal directly with each other.
   - Aggregation – an individual lender might not have enough funds to fulfil a borrower's requirements.
   - Maturity transformation – the borrower might need funds for longer than the lender is prepared to lend.
   - Risk transformation – the lender might be reluctant to lend all their funds to one borrower, in case that borrower is unable to repay.
2) A mutual organisation is owned by its members – in the case of a building society, these are savers and borrowers; for a life assurance company they are the policyholders. A proprietary organisation is owned by its shareholders and is a limited company.
3) b) Disintermediation.
4) b) To act as financial ombudsman in resolving customer complaints about banks.
5) a) The Bank of England. The Royal Mint issues coins.
6) False. Credit unions can pay interest on savings as long as they have the necessary systems and controls in place and have at least £50,000 or 5 per cent of total assets (whichever is greater) in reserve.

7) b) Retail banking. Wholesale banking involves providing funds to other financial institutions or very large corporate clients.

8) True.

Topic 2

✓ CHECK YOUR UNDERSTANDING

Answer c) is correct. Each member state is bound by the regulation in its entirety regardless of existing legislation. Answers a), b) and d) relate to directives.

? TEST YOUR KNOWLEDGE

1) An objective that relates to the economy as a whole, rather than to a specific sector or individual company.

2) Price stability, low unemployment, a balance of payments equilibrium and satisfactory economic growth.

3) Measures taken to expand the economy (eg reducing interest rates and taxation) increase the demand for goods and services, which is likely to result in a rise in inflation.

4) False. They aim to keep prices stable, but seeking to reduce inflation to zero is likely to increase unemployment.

5) The UK government's inflation target is 2 per cent with a maximum divergence either side of 1 per cent. It is measured by the Consumer Prices Index.

6) c) Prices are rising but more slowly than previously.

7) Paul and Amanda must have a variable-rate mortgage, so the amount they pay each month is likely to rise and fall broadly in line with changes in the Bank rate.

8) b) Increasing public spending. To achieve a budget surplus a government must cut public spending, raise taxes, or both.

9) A regulation. Member states have flexibility in the way they introduce directives.

10) The European Systemic Risk Board (ESRB).

Topic 3

✓ CHECK YOUR UNDERSTANDING

1) Answer b) Antoine is correct. Answer c) is not correct because three months of Max's contract are in one tax year and the rest in the following year. He will not spend 183 days in either tax year in the UK.

2) c) As Helena is not UK domiciled she will not pay IHT on overseas assets.

3) c) Any earned income that exceeds their personal allowance. The settlement from their parents (answer d) will be taxed as the parents' income, the educational grant (answer b) is tax-free, and they would not pay tax on all of their earned income (answer a), only that which exceeds their personal allowance.

? TEST YOUR KNOWLEDGE

1) False. They are liable for income tax on income generated anywhere in the world, but the UK has reciprocal tax treaties (double taxation agreements) with many countries to ensure that people are not taxed twice on the same income.

2) True, as long as their actions indicate that their change of residence is permanent and they have severed links with their original country of domicile.

3) c) Lottery prizes.

4) Non-savings income, then savings income, then dividend income.

5) True. Blind person's allowance can be transferred to a spouse/civil partner if the original recipient does not pay tax or use all their allowance.

6) Class 3.

The following answers use the tax rates, bands and allowances for 2020/21.

7) On earnings:

   £22,000 – £12,500 (personal allowance) = £9,500

   £9,500 × 20% = £1,900

   There is no tax on savings income because, as a basic-rate taxpayer, Mike has a personal savings allowance of £1,000.

8) Total income is £39,500

   Salary falls within personal allowance of £12,500 so no tax is paid on this.

   £2,000 of dividend income is taxable at 0 per cent.

   The remaining £25,000 all falls within the basic rate tax band and is taxed at 7.5 per cent.

   Total tax is £1,875 (£25,000 × 7.5%).

9) Income tax:

   £20,000 Gross profit

   (£2,500) Allowable expenses

(£12,500) Personal allowance

(£2,450) Blind person's allowance

Taxable income: £2,550

Tax: £2,550 × 20% = **£510**

Class 4 NICs:

£20,000 – £2,500 = £17,500 taxable profit

£17,500 – £9,500 × 9% = **£720.00**

10) Tax on earned income:

£75,000 Income

(£12,500) Personal allowance

£62,500 taxable earned income

£37,500 × 20% = £7,500

£62,500 – £37,500 = £25,000 × 40% = £10,000

Savings interest:

£500 (PSA) × 0% = £0

£150 × 40% = £60

Dividend income:

£2,000 (DA) × 0% = £0

£5,000 × 32.5% = £1,625

Topic 4

✓ CHECK YOUR UNDERSTANDING

The answer is b) £6,000. In the first instance, the gift uses the available nil-rate band of £325,000, there is then an excess of £25,000 above the nil-rate band. Joan died between four and five years after the gift, so the £25,000 excess is liable for IHT at 60 per cent of the full rate (ie 40% × 60%).

? TEST YOUR KNOWLEDGE

1) False. Gains made on 'chattels' (movable objects such as jewellery, antiques and paintings) are exempt from CGT if their value is £6,000 or less.
2) The CGT annual exempt amount cannot be carried forward at all.
3) False. Assets must be replaced within three years after the date of disposal.

4) b) Inheritance tax would be payable on the total value of the estate above the available nil-rate band.

5) c) Immediately, at a reduced rate of 20 per cent.

6) Stamp duty reserve tax.

7) Gain: £25,400 – £11,300 = £14,100

   Taxable gain: £14,100 – £12,000 = £2,100

   Capital gains tax payable: £2,100 × 10% = £210

8)

Gain on flat	£47,600
Less cost of renovations	(£14,000)
Less cost of disposal (commission)	(£3,500)
Less annual exempt amount (2019/20)	(£12,000)
Less carried-forward loss from 2016/17	(£4,900)

   Taxable gain = £13,200 × 18% = £2,376 capital gains tax

   Note that a rate of 18 per cent applies as the gain arises from the disposal of property.

9) a) £6,250. No tax is payable on the first £125,000. Tax is payable at 2% on the portion between £125,001 and £250,000 (£125,000 × 2% = £2,500). Tax is payable at 5% on the portion between £250,001 and the purchase price of £325,000 (£75,000 × 5% = £3,750). Total SDLT due = £6,250.

10) Nine months after the end of the relevant accounting period.

Topic 5

✓ CHECK YOUR UNDERSTANDING

1) The correct answer is c). The tax charge is 1 per cent for each £100 of income above £50,000.

2) The correct answer is b). Income-based ESA is means-tested; contribution-based ESA is based on National Insurance contribution record so is not means-tested.

3) The correct answer is c). With the basic state pension it is possible to claim a 'category B' pension based on the NICs of a spouse or civil partner, but this is not possible with the new state pension.

? TEST YOUR KNOWLEDGE

1) Financial advisers need to understand what state benefits a person is entitled to or already claiming in order to give appropriate financial

advice. For instance, when working out the level of life assurance cover that a family needs, the income that would be available from state benefits if a family wage earner were to die has to be taken into account.

2) False. Universal Credit will eventually replace Child Tax Credit, not Child Benefit.

3) a) is the correct answer, in that the statement is untrue. Income Support is available to people who have not made National Insurance contributions.

4) c) Contribution-based Jobseeker's Allowance.

5) d) Maternity Allowance. She is not entitled to Statutory Maternity Pay because she will not have been with her employer for 26 weeks by her qualifying week.

6) Eleven weeks before the baby is due.

7) c) Employment and Support Allowance. He cannot claim Statutory Sick Pay because he is not an employee.

8) b) All three: they will be able to claim for Ethan up until his 20th birthday while he remains in full-time education.

9) d) Yes. Although 35 years' NI contributions are needed to be eligible for the full new state pension, Ian would have been credited with NI contributions for the three years that he was a carer.

10) False. The state second pension is available only to those who reached state pension age before 6 April 2016. Lydia's National Insurance contributions will build entitlement to the new state pension, which has no additional earnings-related element, therefore it is not possible for Lydia to choose to contract out.

Topic 6

✓ CHECK YOUR UNDERSTANDING

1) Refer to Topic 3.

2) Refer to Topic 3.

3) Corporate bonds pay higher rates of interest than similar gilts because of the relationship between risk and reward – the more risky the investment is considered to be, the greater the reward the investor expects for taking the bigger risk.

? TEST YOUR KNOWLEDGE

1) True. Deposit accounts allow instant access to funds and they are low risk because savings are protected by the Financial Services Compensation Scheme up to a limit of £85,000.

2) b) 16.

3) False, interest is paid gross but is taxable.

4) If the investment is held in a currency other than sterling, its value might be affected by adverse exchange rates if it has to be converted to sterling. Accounts held offshore might not be covered by investor protection schemes to the same extent as onshore UK investments.

5) The coupon is the interest rate payable on the par value of a gilt.

6) a) The gilts will have a redemption date within the next seven years.

7) The running yield is £3 ÷ £107 = 2.8%.

8) d) Corporate bonds are considered to be higher-risk investments.

9) b) A debenture is usually secured on the assets of the company.

10) False. A Eurobond is a bond issued or traded in a country that uses a currency other than the one in which the bond is denominated, and they can be issued by large companies, not just governments.

11) c) A basic bank account.

Topic 7

✓ CHECK YOUR UNDERSTANDING

1) For 2020/21 the rates are:

   - 7.5 per cent on dividend income falling in the basic-rate tax band;
   - 32.5 per cent on dividend income falling in the higher-rate tax band;
   - 38.1 per cent on dividend income falling in the additional-rate tax band.

   You can check the current rates at: https://www.gov.uk/government/publications/rates-and-allowances-income-tax/income-tax-rates-and-allowances-current-and-past [Accessed: 18 February 2020].

2) Refer to section 6.7.3.

? TEST YOUR KNOWLEDGE

1) False. Direct investment in shares is regarded as high risk because if the company fails, the entire investment is at risk. It is difficult for most investors to spread the risk effectively between a large number of companies and sectors.

2) Factors include company profitability, the strength of the global and UK economy, the strength of the market sector and the supply of and demand for shares.

3) They will not be eligible for a dividend payment in the first distribution of shares following their acquisition of the shares. The previous owner of the shares will receive this dividend payment.

4) False. A low P/E ratio indicates that the share is not in high demand and it is likely to be less expensive than other shares.

5) a) 4 – the profit is four times the dividend paid out.

6) A rights issue involves offering existing shareholders the opportunity to buy additional shares in order to raise additional capital. A scrip issue involves issuing additional shares to shareholders free of charge, the effect being to increase the number of shares in issue and reduce the share price proportionately; no additional funds are raised.

7)
- Suitable tenants may be hard to find.
- Properties must be in desirable locations (eg good transport links, access to local amenities, etc).
- In times of recession, letting properties may be difficult and property prices may fall.
- Property is less easy to realise than most other forms of investment.
- Investment costs tend to be high and can include management fees, legal charges and stamp duty.
- Government measures to discourage BTL have made the tax position less advantageous.

8) They are allowed a furniture replacement relief, which allows the actual cost of replacing furnishings to be offset against profits.

9) They do not pay interest; instead they are issued at a discount to their par value.

10) False. Commercial paper is generally issued for between 5 and 45 days, with 30–35 days being typical. Certificates of deposit are generally issued for between three and six months.

Topic 8

✓ **CHECK YOUR UNDERSTANDING**

1) There are several answers to this question:
- A unit trust is constituted as a trust; an investment trust is actually a company.
- A unit trust is subject to FCA rules on diversification; an investment trust is not.

- A unit trust issues units to customers and these represent the customers' holdings of the assets in the pooled fund. An investment trust issues shares in a fund.
- Units must be bought back by the fund manager so no secondary market is needed; shares in an investment trust must generally be sold via a stockbroker.
- An investment trust can borrow funds to take advantage of investment opportunities whereas a unit trust cannot.
- Unit trusts are open-ended (ie the unit trust manager can create more units to meet demand); an investment trust is closed-ended (ie the number of shares available is fixed).
- A unit trust can be established as an equity trust paying dividends or a fixed-interest trust paying interest. As an investment trust is a company, it only issues shares and pays income as dividends.

2)

Name	**Constituted as**	**Type of Investment**	**Open/ closed?**	**Long-term borrowing**	**Pricing**	**Initial charge**	**Annual charge**	**Control**
Unit trust	Trust	Units (bought from and sold to unit trust manager)	Open	No	Offer–bid price or single price	Bid–offer spread 3–5%	0.5–1.5%	Unit trust manager (subject to approval by trustees)
Investment trust	Company	Shares (bought and sold on the stock market)	Closed	Yes	Single price	Dealing fees	0.5–1.5%	Directors of the company
OEIC	Company authorised by FCA	Shares (bought from and sold to the corporate director)	Open	No	Single price	Initial charge 3–5%	0.5–1.5%	Corporate director (overseen by the depositary)

3) The correct answer is a). Answer b) is incorrect because there is no requirement to give notice to withdraw money from unit trusts, investments or OEICS. Answer c) is incorrect because, although collective investments offer reduced risk, they cannot be considered 'low risk'. They are 'medium

risk'. Answer d) is incorrect because investors who like to 'play the stock market' will usually buy and sell shares directly in their own name.

4) To be a qualifying policy for income tax purposes, premiums would have to be paid annually, half-yearly, quarterly or monthly over a period of at least ten years. Investment bonds involve making a single lump sum payment at the outset. As regular premiums are not made, an investment bond will be non-qualifying.

5) Refer to section 6.8 to check your summary.

? TEST YOUR KNOWLEDGE

1) b) The fund manager can create an unlimited amount of units according to demand.

2) False. They are owned and controlled by the trustees.

3) a) The unit holder.

4) c) A company that invests in the shares of other companies.

5) b) By purchasing shares of the investment trust company on the stock exchange.

6) An investment trust can borrow in order to take advantage of investment opportunities. Unit trusts and OEICs cannot do this.

7) c) There is one price, based on the value of the assets divided by the number of shares.

8) c) 20 per cent is deemed to have been taken within the investment with a potential further liability of 20 per cent for higher-rate taxpayers or 25 per cent for additional-rate taxpayers.

9) False. The investor may withdraw up to 5 per cent of the value of the original investment per annum without paying tax at the time of withdrawal but a tax liability may arise when the bond matures, on encashment of the bond or on death of the bondholder.

10) d) Noah could choose any of the above. The fact that he is a higher-rate taxpayer has no bearing on his decision – they are all taxed in the same way.

Topic 9

? TEST YOUR KNOWLEDGE

1) £16,000. She has the remainder of her annual subscription limit available.

2) An APS is allowed for someone who has died: the spouse/civil partner of the deceased is able to make an additional ISA contribution to the value of the ISA holdings of the deceased.

3) d) The right to make a cash APS lasts for three years from date of death, or 180 days from grant of administration, whichever is later. For stocks and shares, the time limit is simply 180 days after administration of the estate is complete.

4) a) The withdrawn amount counts towards Jane's ISA allowance so she could invest a further £10,000 (£20,000 less the £10,000 initially invested).

5) Investments held within an ISA are free from income tax and capital gains tax.

6) d) Customers who owned Help-to-Buy ISAs before 30 November 2019, can save a maximum of £200 per month until 30 November 2029.

7) The Lifetime ISA aims to encourage people to save for the purchase of their first home and/or for their retirement.

8) False. The annual investment limits for Lifetime and Help-to-Buy ISAs count towards the overall annual ISA investment limit; they are not in addition to it.

9) d) The maximum annual management charge that can be applied to a stakeholder CTF is 1.5 per cent.

10) A Venture Capital Trust would normally represent a higher risk to the investor than an investment trust because VCTs invest in newly established companies, which tend to be higher risk.

Topic 10

✓ **CHECK YOUR UNDERSTANDING**

1) Refer to Topic 5.

2) The correct answer is c) £47,250. Answer a) is not correct because £54,000 represents 40/60ths of his final salary, which is what Pat could have earned under the scheme had he worked for Telephonics for 40 years, not 35. Answer b) is not correct because £28,350 represents 35 per cent of his final salary, not 35/60ths. Answer d) is not correct because, although he can pay in to his pension a maximum of 100 per cent of his UK earnings, his pensionable service does not justify that level of pension.

? **TEST YOUR KNOWLEDGE**

1) d) Marta's scheme is a defined-contribution scheme, which could be either an occupational or a personal pension.
2) The lifetime allowance is the total amount that an individual may hold in retirement benefits at the point where the benefits are crystallised without incurring a tax charge.
3) a) Basic, higher or additional rate depending upon the contributor's marginal rate of tax.
4) True.
5) c) Individuals must earn in excess of £10,000 per year to be auto-enrolled into a workplace pension scheme.
6) False. Pension providers are not obliged to offer this facility, although scheme members are free to move to a different provider if they wish to access their funds in this way.
7) b) There must not be any entry or exit charges.
8) c) 25 per cent of each UFPLS payment is tax-free.
9) Flexible drawdown arrangements were all converted to FAD on 6 April 2015.
10) Annuity provides a guaranteed income and there is no investment risk, so this would be a suitable option for Nicky.

Topic 11

✓ **CHECK YOUR UNDERSTANDING**

1) Refer to Topic 4.

2)

Type of policy	Fixed term?	Death benefit	Surrender value?	Tax treatment of benefits
Level term assurance	Yes	Level	No	Only pays on death – tax-free
Non-profit whole-of-life	No	Level	Yes	Must 'qualify' to be tax-free on surrender (always tax-free on death)
Decreasing term assurance	Yes	Decreasing	No	Only pays on death – tax-free
With-profit whole-of-life	No	Increasing	Yes	Must 'qualify' to be tax-free on surrender (always tax-free on death)
Unit-linked whole-of-life	No	Level until value of units exceeds death benefit	Yes	Must 'qualify' to be tax-free on surrender (always tax-free on death)
Increasing term assurance	Yes	Increasing	No	Only pays on death – tax-free
Convertible term assurance	Yes	Level	No	Only pays on death – tax-free
Low-cost whole-of-life	No	Level until added bonuses exceed death benefit	Yes	Must 'qualify' to be tax-free on surrender (always tax-free on death)
Renewable term assurance	Yes	Level	No	Only pays on death – tax-free
Flexible whole-of-life	No	Level until value of units exceeds death benefit	Yes	Must 'qualify' to be tax-free on surrender (always tax-free on death)
Family income benefit (FIB)	Yes	Decreasing	No	Only pays on death – tax-free
Pension term assurance	Yes	Level or increasing	No	Only pays on death – tax-free
Universal whole-of-life	No	Level until added units exceed death benefit	Yes	Must 'qualify' to be tax-free on surrender (always tax-free on death)

? TEST YOUR KNOWLEDGE

1) True – term assurances have no investment element so proceeds are paid tax-free.
2) A convertible term assurance allows conversion of some or all of the plan to a different type of plan, at a later date, without the life assured having to provide evidence of their state of health.
3) a) A decreasing term assurance will pay benefits only if the insured dies within the policy term.
4) a) It is designed to provide protection rather than investment.
5) d) Transfers between husband and wife are free of IHT so any liability generally arises on second death. A plan being set up to provide the funds to pay IHT would be set up on a joint-life second-death basis.
6) d) 'Ring-fence' the proceeds outside the individual's estate.
7) a) A with-profits whole-of-life plan has a certain level of life cover at outset which can then be increased as bonuses are added during the term.
8) b) A low-cost whole-of-life plan combines with-profits with a decreasing term assurance.
9) c) Waiver of premium cover means that premiums are not payable (ie they are waived) in the event that the insured is unable to work due to accident or sickness.
10) The answer is d). The policy is not guaranteed to repay the mortgage in full at the end of the term.

Topic 12

✓ CHECK YOUR UNDERSTANDING

1) The correct answer is c) income protection insurance. Answer a) is incorrect because ASU cover is usually designed to cover only mortgage repayments and usually for a maximum of two years. Answer b) is incorrect because critical illness cover is restricted to specific conditions and is usually paid as a lump sum, which may not cover outgoings over a prolonged period of time. Answer d) is incorrect because PMI only covers costs directly associated with medical treatment.
2) The insurance value is divided by the actual value, then multiplied by the value of the claim:

   (£25,000 ÷ £50,000) × £2,000 = £1,000 (less the 'excess' under the policy).

? TEST YOUR KNOWLEDGE

1) c) Critical illness insurance. Private medical insurance covers costs associated with treatment while income protection insurance pays a regular income rather than a lump sum. Long-term care insurance is designed to meet the costs of care in later life.
2) True. Marco's income will reduce very rapidly if he is unable to work. He should opt for a short deferred period rather than a long one.
3) b) Marco's policy will be arranged on an individual basis whereas Lydia's policy has been arranged as part of a group scheme.
4) d) Proportionate benefits would be paid until retirement, death or the end of the policy.
5) c) Private medical insurance, to cover the cost of treatment. Critical illness cover would not cover a hip replacement, while accident, sickness and unemployment insurance and income protection insurance provide cover for people who are working.
6) False. ASU benefits are not available to policyholders who resign voluntarily.
7) False. With an immediate needs annuity, the benefits are paid directly to the care provider but they are tax-free.
8) True. This is the principle of indemnity.
9) (£25,000 ÷ £32,000) × £6,000 = £4,687.50 (less any excess).
10) False. It is a legal requirement to have third-party motor insurance, which covers injury to other people and their property.

Topic 13

✓ CHECK YOUR UNDERSTANDING

1) Refer to Topic 11.

2)

Accident, sickness and unemployment insurance	Covers mortgage repayments, usually for a maximum of two years, if the beneficiary is prevented from earning an income
Income protection insurance	Provides a regular income for an indefinite period if the beneficiary is prevented by illness from working
Mortgage protection insurance	Provides a lump sum that can be used to repay the outstanding mortgage loan if the life assured dies
Mortgage indemnity guarantee	Covers the difference between the sale proceeds after a lender has taken possession of a property and the outstanding amount on the loan

? TEST YOUR KNOWLEDGE

1) The mortgagor is the borrower and the mortgagee is the lender.

2) b) Life cover is not built in, therefore a separate life assurance policy would be needed to ensure that the mortgage could be repaid if the borrower were to die before the end of the mortgage term.

3) An ISA has an annual investment limit which might make it difficult to fund a large mortgage and/or one arranged over a short term.

4) False – MCOB rules require the lender to confirm at the outset that a credible repayment strategy is in place and then reconfirm this at least once during the mortgage term.

5) Not yet, because Chris cannot access his pension funds until he is at least 55.

6) True.

7) a) If interest rates go up, the mortgage interest rate will not exceed a pre-arranged limit, in other words, the 'cap'.

8) Home reversion plans involve the homeowner selling a percentage or all of their property to the scheme provider. The customer(s) retains the right to live in the house, rent-free (or for a nominal rent), until their death(s) or until they move into permanent residential care. At that point the property is sold and the provider receives a share of the proceeds equivalent to their share of ownership.

9) The personal loan – interest rates on unsecured borrowing are generally higher than on secured borrowing because it represents a greater risk to the lender.

10) A facility that allows you to borrow more before you have paid off the initial amount borrowed. Credit card borrowing is the most common example.

Topic 14

✓ CHECK YOUR UNDERSTANDING

1)

Stage in life	Financial needs	Suitable products
School-age young people	Somewhere to save their pocket money and gifts from relatives.	Building society accounts, CTF account, Junior ISA, friendly society bond.
Teenagers and students	Somewhere to put their earnings from a part-time job. Borrowing to buy a car. Borrowing to fund education.	Bank current account, personal loan, student loan/ overdraft facility.
Post-education young people	Savings for a deposit for a house. Protection against loss of income due to illness. Loan to buy house.	Building society account, IPI, mortgage.
Young families	Protection against loss of income due to illness. Life cover protection for dependants. Bigger house. Provision for retirement.	IPI, life assurance, bigger mortgage, pension (with employer or via personal provision).
Established families	Planning for retirement. Protection against loss of income (bigger mortgage and pension commitments). Life cover protection (for children still at home). Savings/ investments over long term for surplus income and/or inheritances.	Increased pension contributions, IPI, life assurance, savings and investment products (unit trust, bonds, etc), tax planning (IHT).
Mature households	Planning for retirement. Savings and investments over the medium term to be accessible at retirement.	Increased pension contributions, savings and investment products (unit trust, bonds, etc), tax planning (IHT).
Retirement	Creating as much income as possible from pension plans and savings policies. Realising capital from property. Possible long-term care needs.	Annuities, investments that provide income, equity release, long-term care annuities.

Problem	Potential consequences
Income protection	Employer will only pay income for a short period. Have to rely on savings and state benefits to pay mortgage and other borrowing, household expenses and living expenses, etc. May lose property if mortgage not paid. Credit record adversely affected if debts not paid.
Life assurance protection	Mortgage may be paid off but fall in income may impair ability to meet household and living expenses; alternatively, outgoings might increase to pay for childcare, housekeeping, etc.
Pension provision	Low standard of living in old age. May have to sell house and trade down or move into rented property. Income from state benefits inadequate for heating, food bills, etc.
Savings and investments	Lack of diversification. Too much on deposit. Interest received less than inflation. High admin charges through too many small shareholdings. Failure to take advantage of tax-free alternatives.
Tax planning	Not taking advantage of tax reliefs, allowances and tax-free investments. Estate subject to IHT. Gifts not documented.

? TEST YOUR KNOWLEDGE

1) b) Income protection, to ensure that they can continue to make their mortgage repayments if they are unable to earn an income. An emergency fund would be useful but, at least at the beginning, would be unlikely to be big enough to cover mortgage repayments except in the very short term.

2) It is important to establish the client's domicile for tax purposes and it may be a factor in underwriting decisions.

3) b) An emergency fund. Once people have enough cash to cover their day-to-day needs, the usual approach is to build up savings in an easy-access deposit account.

4) c) Attitude to risk.

5) c) Generating income. It is not a) pension accumulation as this would take place before retirement.

6) ‘Capacity for loss’ is the extent to which the client would be adversely affected should they make a loss on their investments. This must be taken into account when assessing attitude to risk.

7) Eligibility for state benefit; existing arrangements; affordability; taxation; attitude to risk; capacity for loss; anticipated changes in circumstances; timescale; flexibility.

8) The purpose of the product and the needs that it will address; the benefits to the client; risks and limitations inherent in the product; any product options that might be appropriate; a summary of reasons for recommending that product.

9) Indefinitely.

10) Proactive servicing is instigated by the adviser, perhaps on the basis of information obtained during the factfind about a forthcoming promotion or inheritance. Reactive servicing is instigated by the client in order to address a need, or by the client’s representatives, eg the executors of an estate.

Topic 15

✓ **CHECK YOUR UNDERSTANDING**

1) In relation to the protection of debts, term assurance (level term for an interest-only mortgage; decreasing term for a repayment mortgage) would provide a lump sum to pay off the outstanding mortgage loan.

   - Family income benefit could provide a monthly income to replace that lost or to cover additional expenditure; alternatively the benefit from this type of policy could be taken as a lump sum.
   - A level term assurance can also be used to protect living standards but would pay a lump sum which would then have to be invested in order to provide the required income.

2) A flexible mortgage might be appropriate for Kenesha – it would allow her to make overpayments to reduce the balance and help meet her stated aim of repaying the mortgage as soon as possible. An offset mortgage is another option, as placing the overtime/bonus payments in a savings account would reduce interest on the mortgage.

   A deferred-interest mortgage might suit Jacob – his earnings are likely to increase significantly as he becomes established in his career, so a product that allows him to minimise his outgoings now and pay more in interest later in the term might be appropriate. As the LTV on his property is not high, he should be eligible for this type of product.

3) Stakeholder pensions failed to secure the widespread take-up that the government hoped they would because the restrictions on charges meant

that advisers found it uneconomic to give advice on stakeholder products. Those who did take out such products tended to be people who were relatively financially sophisticated and would have made private provision for retirement anyway.

4) ■ Transfers between spouses and between civil partners both during their lifetime and on death.

■ Small gifts of up to £250 (cash or value) per recipient in each tax year.

■ Donations to charity, to political parties and to the nation.

■ Wedding gifts of up to £1,000 (increased to £5,000 for gifts from parents or £2,500 from grandparents).

■ Gifts that are made on a regular basis out of income and which do not affect the donor's standard of living.

■ Up to £3,000 per tax year for gifts not covered by other exemptions. Any part of this £3,000 that is not used in a given tax year can be carried forward for one tax year, but no further.

Other transfers may be 'potentially exempt transfers' (PETs) or 'chargeable lifetime transfers' (CLTs), depending on whether the donor survives for a full seven years after making the gift.

5) A whole-of-life policy on a joint-life second-death basis.

? TEST YOUR KNOWLEDGE

1) The extent of any sickness benefit from an employer; the nature and amount of available state benefits; the number and ages of the children; and the availability of any help from family and friends with childcare and housekeeping.

2) To mitigate the adverse impact on a business's profits caused by the death or long-term illness of an important member of staff.

3) (47,000 ÷ 400,000) × 1,500,000 × 5 = £881,250

4) It comprises an option to purchase the deceased partner's share rather than a binding contract; as a consequence, the deceased's family or heirs are deemed to receive business assets rather than cash, so business relief from inheritance tax can be claimed.

5) d) Nigel – a fixed-rate mortgage is most suitable for ensuring that, over a specific period, repayments do not increase as a result of interest-rate rises.

6) a) The sum assured on a full with-profits endowment is set at a level equal to the mortgage debt so, as long as payments are maintained, it will guarantee to repay the mortgage at the end of the term.

7) b) To protect money against the effects of inflation.

8) c) 5.5% (5.5 – 2.5 = 3%)

9) b) £202.50. The £162 is the 'net' contribution. To work out the 'gross' contribution, divide the net contribution by 80 and multiply by 100 (do not add 20 per cent to the net contribution).

   £162 ÷ 80 × 100 = £202.50

10) If a donor receives any benefit from a gifted asset, the asset is treated for IHT purposes as remaining in the donor's estate.

Topic 16

✓ CHECK YOUR UNDERSTANDING

1) There is no cut-and-dried answer to this question. Martin certainly didn't have 'actual authority' to make that decision, but he might have had 'apparent authority'. Would it be reasonable to assume that in saying "do whatever is necessary" Joanne accepted that this might include creating a tenancy and accepting an offer that is £15,000 less than the asking price? If the property had been on the market for a long time, Joanne might decide to ratify Martin's decision. If, on the other hand, this was the first offer, or she had already rejected an offer around £285,000, she might feel differently about the way Martin acted.

2) a) Marian's husband inherited her entire estate. Parents only inherit if there is no spouse or children.

   b) Ian's wife inherited £310,000 (ie the first £270,000 plus half the excess above that figure); Ian's children inherited £20,000 each (ie the remaining £40,000 of the estate shared between them).

? TEST YOUR KNOWLEDGE

1) False. There is no information here to suggest that the partnership is a limited liability partnership (LLP) so Jagdeep has unlimited personal liability.

2) None. As a limited company, Allenton Engineering Ltd is a separate legal entity and shareholders would not be liable for its debts.

3) a) There must be payment or a promise to provide payment. In a contract, one party provides goods or services, the other makes payment or a promise to pay.

4) No. Contracts for sale of land must always be in writing and the transfer effected by deed.

5) c) They act as agents of their client.

6) The use of joint tenancy reduces the prospective risk to the lender. A joint tenancy means that each of the mortgagors has a stake in the entire property. Thus if one borrower should default on the mortgage, the lender will be able to pursue repayment from the remaining borrower(s). If the mortgage were on a tenants-in-common basis, the lender would only be able to pursue the borrower who had defaulted for the value of that borrower's share of the property.

7) c) A witness cannot inherit under the terms of a will.

8) a) An administrator. (An executor distributes the estate of a person who has made a valid will.)

9) d) Enduring powers of attorney can only be revoked with the consent of the Court of Protection. They must be registered with the Office of the Public Guardian.

10) a) They are only able to borrow nominal amounts of money.

Topic 17

✓ CHECK YOUR UNDERSTANDING

1) With-profits business relates to certain life policies issued by life assurance companies. In addition to the sum assured under the policy, the policyholder receives a share of the profits of the life company, payable either during the term (reversionary bonuses) or at maturity or on death of the life assured (terminal bonuses).

2) d) A financial provider of this nature would be regarded as systemically important. It would be regulated by the PRA in relation to its prudential status and the FCA in relation to its conduct of business.

3) a) High-Level Standards.

   b) Business standards – specifically, the Mortgages and Home Finance: Conduct of Business Sourcebook (MCOB).

   c) Business standards – specifically, Conduct of Business Sourcebook (COBS).

   d) Specialist sourcebooks – specifically, the Consumer Credit sourcebook (CONC).

   e) Redress.

? TEST YOUR KNOWLEDGE

1) b) The weaknesses exposed by the 2007–09 financial crisis and a number of major mis-selling scandals drove the changes to regulatory bodies in 2013.

2) False. This is the key role of the FPC, the Financial Policy Committee.

3) a) Conduct regulation requires firms to ensure that products and services they supply to consumers meet the consumers' needs, and to act appropriately and deal fairly with consumers.

   b) Prudential regulation aims to ensure that businesses are established and run on a sound financial basis, to limit the risk of a business failing and to minimise the impact on consumers and the wider economy if a business does fail.

   c) 'Systemically important' refers to financial institutions that play a key role in the national and global economy. If they were to fail, it would have a significant adverse impact on the national or global financial system.

4) i) Protecting consumers by securing an appropriate degree of protection; ii) Protecting financial markets, by protecting and enhancing the integrity of the UK financial system; iii) Promoting effective competition by promoting effective competition in the interests of consumers.

5) Rules impose binding obligations and firms can face sanctions for not complying with them. Guidance explains the rules and indicates ways in which firms can comply but is not binding and firms are not required to follow it.

6) Competition powers; product intervention powers; power of disclosure; power to take formal action against misleading financial promotions.

7) c) The FCA principles do not specifically require a firm to maintain an independent compliance function.

8) d) The redress sourcebook is concerned with complaints and compensation.

9) b) Information must be clear, fair and not misleading.

10)
- Consumers will be confident that the firms they are dealing with are committed to fair treatment of customers.
- Products are designed to meet the needs of properly identified customer groups.
- Consumers are provided with clear information at all stages, before, during and after a sale.

- Any advice given is suitable for the customer, taking account of their circumstances.
- Products perform as customers have been led to expect, and associated services are of an acceptable standard.
- There are no unreasonable barriers to switching product or provider, making a claim, or complaining.

Topic 18

✓ CHECK YOUR UNDERSTANDING

1) See Topic 17.
2) Fixed portfolio firms are those that have the greatest impact on consumers and the financial services marketplace; therefore, the FCA directs most of its resources to supervising these firms.
3)

A firm must pay due regard to the interests of its customers, and treat them fairly	One of the Principles for Businesses
Consumers are provided with clear information at all stages, before, during and after a sale	One of six FCA outcomes for fair treatment of customers
Ensuring that relevant financial markets work well so that consumers get a fair deal	FCA strategic objective
Ensuring firms act in the right spirit – not just complying with the letter of the law but with a focus on considering the impact of their actions	One of ten key FCA principles for supervision
Removal of one of the firm's permitted regulated activities or a narrowing of the description of a particular activity	One of the FCA's enforcement powers
An employer must be satisfied their employee has achieved an adequate competence level of knowledge and skill to operate under supervision	A TC requirement for demonstrating initial competence

? TEST YOUR KNOWLEDGE

1) Permission under Part 4A of the Financial Services and Markets Act 2000 to carry out specified regulated activities.

2) False. Investment in shares is a regulated investment.

3) d) There is no need to pay attention to how long someone has worked in the industry; an individual may have worked in the industry for many years but have a poor track record, while an individual who is new to the industry may have good credentials.

4) d) Yvette. The 'fit and proper' requirements include a check of financial soundness, and missing mortgage payments would have adversely affected Yvette's credit rating.

5) The regime was introduced in order to clarify responsibilities within a firm, thus making it easier to hold individuals to account for a particular failing. Prior to its introduction, the FCA and PRA had found it difficult to determine individual responsibility when seeking to take action against firms in the financial services industry.

6) The employee's:

   - technical knowledge and application;
   - skills and expertise;
   - understanding of changes in the market and to products, legislation and regulation.

7) A 'fixed portfolio' firm is one that has a large number of customers and the potential to have a major impact on the market; it receives the highest level of supervision, involving continuous assessment and a designated individual supervisor.

8) a) The firm may no longer be able to carry out one or more of its regulated activities.

9) Restitution refers to the FCA's power, with a court order, to require an person or firm to forfeit any profit made as a result of contravening an FCA rule. Redress applies to a situation in which an identifiable customer has made a loss as a result of a contravention of an FCA rule; the FCA, with a court order, can require that the loss be made good.

10) b) Employees who raise concerns about breaches of regulation or other misconduct.

Topic 19

✓ CHECK YOUR UNDERSTANDING

1) The main functions of the Bank of England are:
   - issuer of banknotes;
   - banker to the government;
   - banker to other banks;
   - adviser to the government;
   - manager of the UK's gold and foreign currency reserves;
   - lender of last resort.

   The main reason why Northern Rock approached the Bank for assistance was because of the Bank's role as lender of last resort; Northern Rock could not obtain the funds it urgently needed on the interbank market so it had to ask for emergency funding from the Bank.
2) The CRR is a regulation so all its terms are binding in full on all the UK businesses to which it applies. The CRD is a Directive so the UK government had some discretion as to how best to implement its requirements within the UK. The CRD requirements have been included in the PRA and FCA Handbooks.

? TEST YOUR KNOWLEDGE

1) b) Prudential Regulation Authority.
2) The FCA is the prudential supervisor for smaller firms that, in general, would not present a risk to the wider financial system if a particular one were to fail. Therefore, the regulator concentrates its resources on managing a firm's failure in an orderly way to mitigate the impact on its customers.
3) d) Capital adequacy requirements are based on the principle that shareholders, not depositors, should bear any loss.
4) Capital as a percentage of the risk-adjusted value of assets.
5) Under Basel II, instead of simply calculating their capital requirement as a percentage of the total value of their assets, firms were required to categorise each asset according to the risk it represented and hold more capital in relation to the riskier assets.
6) a) 7 per cent.
7) b) The net stable funding ratio.

8) To reduce the risk of an insurance company being unable to meet its claims; to reduce losses suffered by policyholders should an insurer be unable to meet all claims in full; to establish a system of information disclosure that makes regulators aware of potential problems at an early stage; and to promote confidence in the financial stability of the insurance sector.

9) a) BIPRU details the prudential rules for banks, building societies and investment firms.

10) Within the EU the requirements of the various Basel Accords are implemented by the Capital Requirements Directives, with Basel III being implemented by CRD IV.

Topic 20

✓ CHECK YOUR UNDERSTANDING

1) The law of agency. When carrying out designated investment business, the adviser acts as the agent of the client.

2) a) Place of birth generally determines a person's domicile for tax purposes, which might be a consideration in relation to choice of investments.

   b) The number and ages of any dependants the client has will inform recommendations relating to protection needs, estate planning and perhaps planning for school or college fees.

   c) Advisers need to know the following:

   — how the clients feel about current arrangements (or lack of them) in each area;

   — their objectives within each area, now and in the future;

   — why they have certain arrangements, or goals or views;

   — their willingness to take action in each area;

   — the likelihood of change in their situation.

3) 'Capacity for loss' means the customer's ability to absorb falls in the value of their investment without it having a material impact on their standard of living. It is important to take account of this when discussing the risks involved in particular products and the customer's willingness to accept such risks.

4) a) Indefinitely.

   b) Five years.

   c) Three years.

   Refer back to Topic 14 for further information.

? TEST YOUR KNOWLEDGE

1) Retail clients are assumed to have least expertise in relation to financial services and consequently require more support from the adviser. Dealings with retail clients are more highly regulated than those with eligible counterparties or professional clients.

2) a) No recommendation is provided.

3) c) A restricted adviser is one who does not meet the FCA criteria to be considered 'independent'.

4) As the individuals are not existing customers, contacting them by telephone would constitute cold calling, which is not permitted in relation to mortgage contracts. Additionally, cold calls may only be made at an 'appropriate time of day' – evenings (to 9.00pm) and Saturdays would be permissible but not Sundays.

5) c) Advisers have discretion to determine their charging structures but they must pay due regard to the best interests of the client.

6) d) The client agreement letter.

7) False. Where several transactions are carried out for an existing client, an SCDD or equivalent need only be provided if any of the information previously provided is different.

8) a) Gilt-edged securities. Key features or key information documents must only be provided in relation to packaged products, and gilt-edged securities are a direct investment rather than a packaged product.

9) a) 30 days from the date when the contract begins or from the date on which the client receives contractual terms, if this is later.

10) c) Suitability reports are not required for mortgages, although many lenders do issue them.

11) b) She invested a lump sum into a unit-linked plan. The value of the investment fell between the date of her original investment and her cancelling the bond.

Topic 21

✓ CHECK YOUR UNDERSTANDING

1) No – although Lydia will be living in the house initially, Ella and Martin's primary motivation in purchasing the property is as a business investment. Additionally, if they buy a four-bedroom house, Lydia will presumably be occupying less than 40 per cent of the property.

2) Mortgages are regulated under the Mortgages and Home Finance Sourcebook (MCOB).

? TEST YOUR KNOWLEDGE

1) d) The mortgage arranged for Décor Plus would not be a regulated mortgage.
2) a) Cold calling, because it is an unsolicited real-time promotion.
3) Execution-only transactions are permitted only for business borrowers, high-net-worth individuals and mortgage professionals. Even if Maurice were a high-net-worth client, it would not be possible to carry out the transaction on an execution-only basis because it is not possible to opt out of advice for an equity release scheme such as a lifetime mortgage.
4) c) This statement is untrue because it is not possible for a customer to withdraw from the contract once the mortgage is completed.
5) a) Repayments on a personal loan. The others are examples of basic essential expenditure.
6) False. ICOBS 6 requires firms to ensure customers are given appropriate information about a policy; what is appropriate may vary depending on the customer's knowledge, experience and ability, and the complexity of the product.
7) Eva may cancel her policy within 30 days as it is a protection policy.
8) True.
9) d) Basic advice may be provided for stakeholder products.
10) Focused advice is provided when the customer has set parameters for the areas they wish to discuss. Simplified advice is provided when the adviser sets out specific areas of a customer's needs for which they are providing advice.

Topic 22

✓ CHECK YOUR UNDERSTANDING

1) This initiative is a good example of the FCA's strategic objective to ensure that markets work well so that consumers get a fair deal, and also of its operational objective of securing an appropriate degree of protection for consumers.
2) Refer back to section 17.8.

TEST YOUR KNOWLEDGE

1) b) A further advance for house repairs of £15,000. Regulated mortgages, including further advances for any purpose, are exempt from the CCAs. Rather, these loans would be regulated under MCOB.
2) It allows consumers to compare products more accurately, as the APR includes not only the interest rate but also any fees and charges that apply to the product.
3) False. Partnerships with three partners or fewer and sole traders are covered by the CCAs, as well as ‘natural persons’ and unincorporated associations.
4) Fourteen days from the conclusion of the agreement, or from the point the consumer receives the agreement, if this is later.
5) c) The lender must advise the applicant of the reason for rejecting their application and provide details of the credit reference agency used.
6) False. Full permission is required for debt counselling services that are carried out on a commercial basis.
7) One hundred per cent of the original amount borrowed.
8) A representative example that includes a representative APR.
9) True. These provisions are included under CONC 5: Responsible lending.
10) Debt collection and debt administration.

Topic 23

TEST YOUR KNOWLEDGE

1) a) It could mean that they had knowingly become involved in the process of converting criminal property.
2) False. Transferring, disguising, concealing or converting criminal property is an offence, no matter what form of criminal activity the funds derive from.
3) True.
4) d) A member of staff who has reasonable grounds for believing that a person is involved in money laundering is obliged to report the suspect transactions.
5) b) By alerting the customer to the fact that they were suspicious about the unusual transaction, the cashier potentially committed the offence of ‘tipping off’.

6) a) The threshold is €15,000, meaning that customer due diligence will be carried out in a greater number of situations.

7) 25 per cent.

8) d) Identification procedures must always be carried out for new clients, so the most likely reason why Forward Bank did not carry them out in this case is that the procedures were carried out instead by an intermediary.

9) The National Crime Agency.

10) c) The firm should review and if necessary improve the firm's processes and training in the light of the report.

Topic 24

✓ CHECK YOUR UNDERSTANDING

1) Member states have discretion as to how they implement a Directive: it is binding as to the outcome that must be achieved, but member states can implement it in the way that best fits their national circumstances and existing legislation. A regulation sets out the rules that must apply across all the member states (ie it is binding as to the outcome *and* to the means of achieving the outcome).

2) a) The requirement to provide insurance policyholders with clear and accurate information about the essential features of the products offered to them is addressed in ICOBS 6.

   b) The rules relating to cancellation rights are addressed in ICOBS 7.

3) The requirements for intermediaries to have the necessary general, commercial and professional knowledge and skills are covered in the Training and Competence section of the High Level Standards area of the FCA Handbook.

4) a) The information the intermediary must provide to the customer regarding how to complain, and whether the intermediary is independent or restricted is covered in ICOBS 4.

   b) The assessment of the customer's needs and the summary of reasons for recommending a particular product are addressed in ICOBS 5.

? TEST YOUR KNOWLEDGE

1) A data controller is legally accountable for the purposes for which data is processed and the way such processing is carried out. A data controller is a 'legal person' but not necessarily a 'natural person', ie it might be an organisation rather than an individual.

A data processor is a person who processes personal data on behalf of the data controller.

2) Sensitive data includes information about an individual's:

- race;
- religious beliefs;
- political persuasion;
- trade union membership;
- sexual orientation;
- health;
- biometric data;
- genetic data.

3) c) This statement is incorrect. The principle actually states that data must not be kept for longer than is necessary. In a financial services context, this will be determined by the record-keeping requirements relating to specific products or to money-laundering rules.

4) The maximum fine for a criminal offence is the higher of €20m or 4 per cent of the organisation's worldwide turnover.

5) False. The Pensions Regulator is responsible for occupational pension schemes and for personal pension schemes where the employer has a direct pay arrangement.

6) The Pension Protection Fund provides compensation payments to members of defined-benefit pension schemes if a firm becomes insolvent with insufficient funds to maintain full benefits for scheme members.

7) c) Life assurance is not subject to MiFID.

8) Receipt and transmission of orders from investors, execution of those orders on behalf of customers, investment advice, discretionary portfolio management (on a client-by-client basis, in accordance with mandates given by investors), and underwriting the issue of specified financial instruments.

9) True.

10) a) The FCA. Note that d) the IDD is the abbreviation for the Directive that governs insurance distribution, not for a regulatory body.

Topic 25

? TEST YOUR KNOWLEDGE

1) c) Adjudication. Note that option d) conciliation is not one of the options available under alternative dispute resolution.

2) A contract or notice is deemed to be unfair if it causes a significant imbalance in the rights and obligations of the various parties to the contract to the detriment of the consumer.

3) d) The net asset value must be less than £5m, not £6.5m.

4) d) A firm must ensure the complaint is investigated by a person of sufficient competence, who, where possible, is not someone directly involved in the matter under complaint.

5) Eight weeks.

6) False. For complaints that are resolved by close of business on the third working day following receipt, the firm must provide a summary resolution communication to the complainant, advising them of their right to refer the matter to the FOS should they remain dissatisfied with the firm's response.

7) c) Five years.

8) Complaints to the FOS must be made within six years of the event that gives rise to the complaint, or within three years of the time when the complainant should have become aware that they had cause for complaint, whichever is the later.

9) a) The Financial Ombudsman Services (FOS). The Pensions Ombudsman Service only deals with complaints relating to the running (ie administration) of personal and occupational pension schemes.

10) One hundred per cent of the value of the policy with no upper limit.

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