TOPIC 21

Using endowment policies for mortgage repayment

LEARNING OBJECTIVES

In this topic and Topic 22 we are going to explore the different repayment vehicles that can be used for interest-only mortgages. We begin by looking at the use of endowment policies.

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

- with-profits endowment policies;
- the differences between full with-profits and low-cost with-profits policies;
- unit-linked endowment policies;
- unitised with-profit policies;
- rules affecting endowment policies as qualifying life policies.

THINK ...

Before you start work on this topic, take a moment to think about what you already know. We introduced endowment policies in UK Financial Regulation. Can you recall, for instance:

- what an endowment policy is?
- different types that are available?
- the benefits of a life policy being a ‘qualifying’ policy for tax purposes?

21.1 What is an endowment policy?

An endowment policy, whether with-profit or unit-linked, comprises two elements:

- **Life assurance** – guarantees to pay the sum assured if the borrower dies during the policy term. This means that, as long as the policy sum assured is the same as the mortgage and all policy premiums are paid, the mortgage will be repaid on death.

- **An investment element** – targeted to provide a maturity value sufficient to repay the loan in full at the end of the mortgage term and possibly provide a surplus for the borrower.

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

Mortgages that used endowments as their repayment vehicle were the most common type chosen by borrowers until the late 1990s. However, many endowments fell short, or were projected to fall short, of the returns expected, many had been mis-sold and they rapidly became unpopular, to the extent that endowment mortgages are very rare in today's market.

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PROVISION OF ADVICE

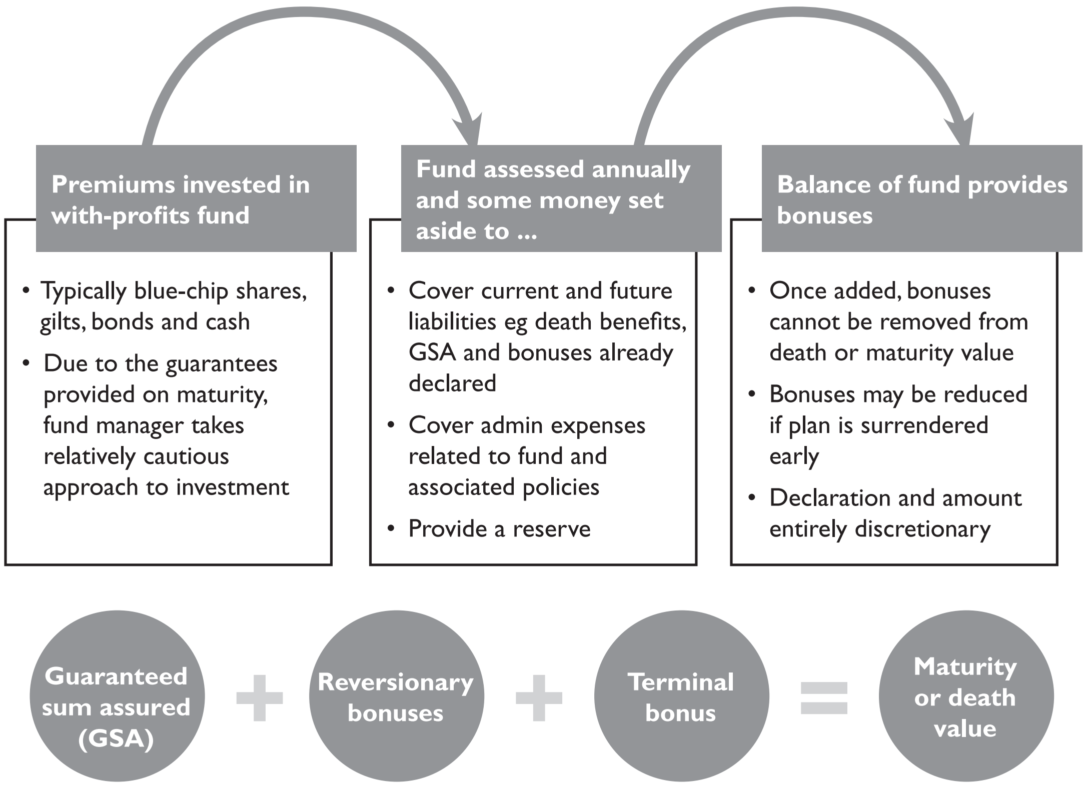
While information on these investment-backed products can be given by mortgage advisers, only those who have approved-person status in a customer function and have appropriate qualifications can give advice and make a recommendation regarding investment products.

21.2 What is a with-profits endowment policy?

With-profits endowments offer policyholders a degree of guarantee with the potential for capital growth. There are two forms of with-profits endowment – the full with-profits version and the low-cost with-profits version (see sections 21.2.5 and 21.2.6).

The basic way in which both types of with-profits endowment work is outlined here.

FIGURE 21.1 HOW A WITH-PROFITS ENDOWMENT WORKS



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

WHAT HAPPENS IF THE PLAN IS SURRENDERED BEFORE THE END OF THE TERM?

If the plan is surrendered before the end of the term, actuaries will calculate the surrender value. This is unlikely to represent the full value of the plan at the time of surrender, and may result in a significant loss for the policyholder, although there are FCA rules designed to ensure the calculations are fair to all parties. The guaranteed death benefit and reversionary bonuses are not guaranteed in the event of early surrender.

While the company will seek to declare bonuses, there is no guarantee that they *will* be declared or that a certain amount will be paid, and neither will the bonuses necessarily represent the full growth of the fund. There are two types of bonus – reversionary and terminal.

KEY TERMS

GUARANTEED SUM ASSURED (GSA)

The amount that will be paid on maturity (or death if this occurs earlier), assuming premiums are paid as required.

SMOOTHING

Creating a reserve in years of good fund growth rather than paying all the growth out in bonuses, so that in poorer years it may still be possible to pay a bonus.

SINGLE LIFE AND JOINT LIFE FIRST DEATH

Endowments can be held on a **single life** basis, where the policy is owned by one person who is the life assured. The policy will pay out on maturity or their earlier death. With a **joint life first death** policy, two people are joint owners and lives assured. The policy pays out on maturity or when the first of the lives assured dies during the term.

21.2.1 Reversionary bonuses

Reversionary (or annual) bonuses are usually added to the policy each year as a percentage of the plan's GSA. Once added, the reversionary bonus is guaranteed to be paid on maturity or death, providing the plan remains in force and premiums are paid to that point. Reversionary bonuses can be calculated in a number of ways.

21.2.2 Terminal bonuses

Terminal bonuses are usually added at maturity, or sometimes on earlier death. They can represent a large proportion of the final policy value, perhaps as much as 40 per cent. They are designed to reward longstanding policyholders. As with reversionary bonuses, terminal bonuses are at the discretion of the company and can vary from year to year. Although insurers strive to pay a terminal bonus, it is entirely possible that in years of poor performance they could decide not to do so. During times of volatile investment performance, the level of most terminal bonuses reduces significantly, which in turn reduces maturity values.

21.2.3 Charges

You will see later that the majority of charges for unit-linked endowments are clearly stated as part of the policy terms. With-profits policy charges are not so transparent.

- Usually, a stated monthly policy fee, often in the region of £2–£3 a month, is taken from the premium to cover some of the administration of the policy.
- The costs of managing the investment fund, providing the life cover and general administration are taken from the investment fund, as noted in Figure 21.1, and are not specifically detailed in the policy terms.

If the policyholder cashes in the plan early, the policy might incur a market value adjuster (MVA) where the company will reduce the value of units transferred to protect the interests of other investors. This is usually invoked in times of poor fund performance when the value of the underlying with-profits fund assets is lower than the value of the plan built up, although some insurers apply some form of MVA in most encashment situations.

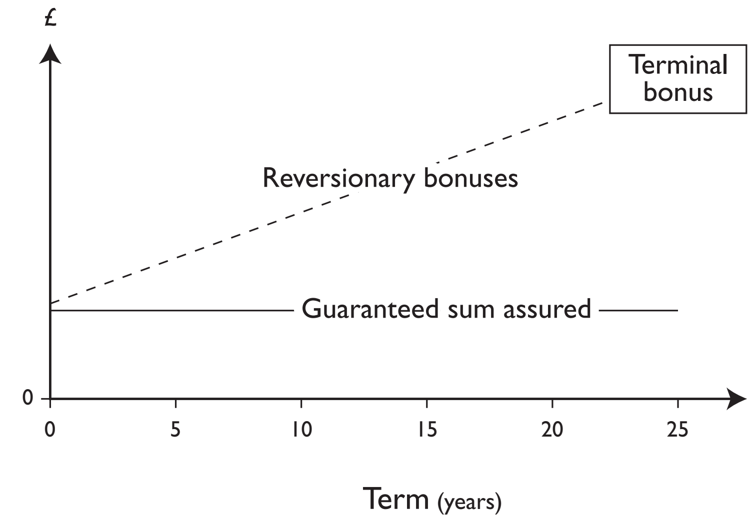
21.2.4 Paid-up policies

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

21.2.5 Full with-profits endowment

The full with-profits endowment is the original product designed to support interest-only mortgages. The GSA is equal to the mortgage amount, which means that the mortgage is guaranteed to be paid off by the GSA. Any bonuses added provide a cash surplus over and above the mortgage. The premium is calculated based on the need to pay the GSA at the end of the term. This makes the full endowment much more expensive than the low-cost versions.

FIGURE 21.2 WITH-PROFITS ENDOWMENT



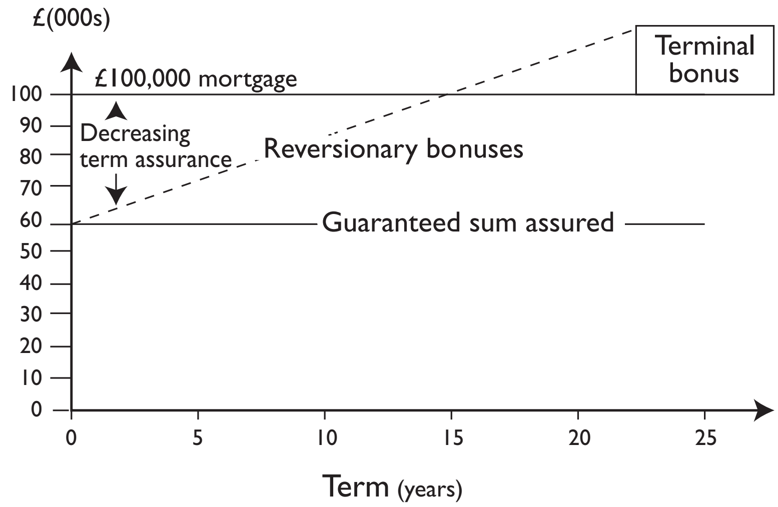
21.2.6 Low-cost with-profits endowment

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

- The GSA is typically 50–60 per cent of the mortgage amount. As with the full endowment, the GSA is payable on the earlier of maturity or death during the term. However, unlike the full endowment, the low-cost with-profits endowment plan does not guarantee to repay the mortgage at the end of the term.
- The premium is worked out by assuming that the guaranteed sum assured plus a percentage of the anticipated reversionary bonuses (typically 80 per cent) will provide sufficient capital on maturity to repay the loan. If these assumptions prove to be wrong and the terminal bonus is not sufficient to plug the gap, the maturity proceeds will not repay the loan; the final sum is not guaranteed.
- In the event of death during the term, the GSA plus accumulated reversionary bonuses and a potential terminal bonus will be paid. A form of decreasing term assurance is built in to plug the gap between the value of the guaranteed sum insured plus accrued bonuses and the mortgage. This ensures that the mortgage can be repaid on death before the end of the term.

A low-cost, low-start endowment works on similar lines but the premiums in the first five years are lower. The premiums increase by 20 per cent in each of the first five years, leading to a doubling of the premium by that stage. From then onwards the policyholder is paying a higher premium than would be the case with a standard low-cost endowment.

FIGURE 21.3 LOW-COST WITH-PROFITS ENDOWMENT



> **CASE STUDY**
>
> Will has a mortgage of £75,000 and has arranged a low-cost endowment policy to support it. The policy is targeted to provide £75,000 at maturity, with a GSA of £40,000 and a guaranteed death benefit of £75,000.
>
> 1) Assume Will dies after ten years, reversionary bonuses accrued to that point equal £8,000 and a terminal bonus of £14,000 has been declared. This will give the plan a value of £62,000. The death benefit will comprise £62,000 from the accrued GSA plus £13,000 from the decreasing term element.
>
> 2) Assume the policyholder dies after 20 years, reversionary bonuses accrued to that point equal £15,000 and a terminal bonus of £25,000 has been declared. This will give the plan a value of £80,000. The death benefit will be the full value of the policy – £80,000 – but no decreasing term assurance would be included.

TABLE 21.1 ADVANTAGES AND DISADVANTAGES OF LOW-COST WITH-PROFITS ENDOWMENTS

Advantages	Disadvantages
▪ GSA will be paid on maturity, providing premiums are paid and plan remains in force. This means there is at least a partial guarantee of the final value	▪ Final value not guaranteed to pay off mortgage. Bonuses are not guaranteed and if they are below the assumed rate, the final value will be less than predicted
▪ Combines investment and life cover. In the event of death during the term, GSA will be paid, which together with a decreasing term assurance enables mortgage to be paid off	▪ As a result of market volatility and poor investment returns, majority of low-cost with-profit endowments maturing in recent past have failed to reach their target
▪ Provided policy remains in force to maturity, any gains made are locked in and cannot be lost	▪ Often difficult to identify product charges
▪ Possibility of a surplus over the mortgage amount	▪ Inflexible policies: term cannot be extended and increasing premiums may not be possible
▪ No tax payable on maturity value, assuming the plan remains qualifying	▪ Poor recent past performance and availability of more flexible investment products has resulted in fewer providers offering the product and limited consumer choice

21.3 Unit-linked endowment policies

Unit-linked endowment policies were introduced as an alternative to with-profit policies in the 1980s. Although they carry a greater risk, they also provide the potential for higher returns than with-profit policies.

The unit-linked endowment is designed to accumulate capital by the end of a set term, but differs from the with-profits endowment in the way that the fund is built up. The policy value is linked directly to the performance of the policyholder's chosen investment funds, which can result in higher returns if the funds perform well, but there is no 'bottom line' guarantee such as the GSA provided by a with-profits policy. The only guarantee is that the policy will pay a guaranteed death benefit equal to the mortgage amount if the insured dies during the term.

Premiums buy units in one or more of a range of unit-linked funds. On a monthly basis, enough units are encashed by the company to cover the cost of the mortality risk (life cover), administration and other benefits selected; the remaining units remain invested to build up the fund value. The value of units is directly related to the performance of the fund, so there is no smoothing effect because growth (or loss) is directly reflected in unit prices.

The value of the plan is simply the number of units held in the plan, multiplied by the current fund price. There are no bonuses.

At the start of the plan, the company sets out assumptions about annual fund growth (typically 6 per cent), the cost of running the plan, the cost of providing the death benefit and any other benefits selected. The premium for the target maturity amount (the mortgage) is then calculated based on those assumptions. If the investment funds grow at the assumed rate and all other assumptions prove correct, the target maturity value will be achieved. If fund growth is lower than estimated, or the costs of running the plan or providing the death benefit prove higher than anticipated, the maturity value is likely to be lower than the target. Unit prices can, and do, fluctuate.

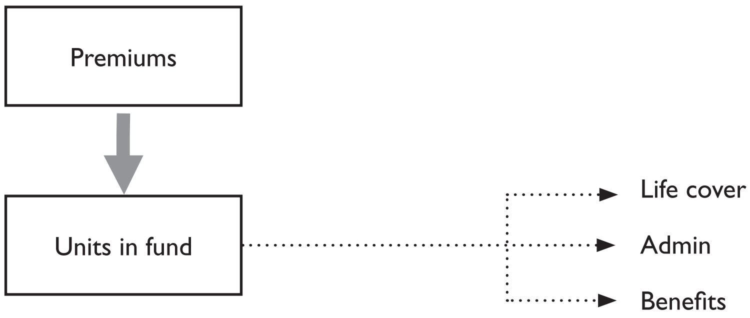
One potential advantage of a unit-linked endowment is that, if growth exceeds expectations, the plan could hit its target earlier than the end of the term. In this case, the planholder could cash in the plan and there may be enough in the plan to repay the mortgage early and save interest charges. As explained in section 21.3.3, early surrender may be subject to charges that need to be taken into account.

HOW IS THE GUARANTEED DEATH BENEFIT PROVIDED?

The guaranteed death benefit is provided through a combination of the plan's value and variable term assurance. On death, the plan's investment value is topped up to the guaranteed death benefit by the term assurance. The amount of that life assurance will vary from month to month as the value of the fund varies, and units are cancelled from the fund each month to pay for the cost of the life cover (a mortality charge), which will always be the difference between the sum assured and the fund value.

For example, Roisin's plan has been in force for ten years, has a death benefit of £75,000 and a current unit value of £25,000. If Roisin dies, the death benefit will comprise a return of the fund (£25,000) plus a payment of £50,000 from the variable term assurance, giving a benefit of £75,000.

FIGURE 21.4 UNIT-LINKED ENDOWMENT



Units have two prices:

- the **offer price** – the price at which the policyholder buys units;
- the **bid price** – the price at which units are bought back by the fund: the maturity or surrender value.

The bid price is lower than the offer price because the initial charge is deducted from the offer price and there are other relatively small charges involved in buying the units. The bid–offer spread is not a charge, but reflects the difference in price between the bid and offer prices. A typical bid–offer spread would be between 5 and 6 per cent.

21.3.1 Flexibility and fund choice

We mentioned earlier that the plan will be taken out with a set term and a premium calculated to achieve the target maturity amount. Unlike with-profits policies, unit-linked policies are flexible, and it may be possible to increase or decrease the premiums or sum assured, or to extend the term, subject to the insurer's rules and qualifying rules.

When a policy is taken out the investor can choose how much of each premium is invested in each of the available individual funds. The range of funds offered will include high-, medium- and low-risk investments, and the policyholder can base their selection on their overall attitude to risk. This represents an advantage over a with-profits policy where the policyholder has no say over how premiums are invested: they are invested in the company's with-profit fund.

TABLE 21.2 EXAMPLES OF UNIT-LINKED FUNDS

Type	Invested in . . .	Advantages/notes	Disadvantages
Cash	Money markets and deposit accounts	Very low risk Provide virtually 100% guarantee that all money invested will be returned	Earn relatively low rates of interest – seldom used for mortgage purposes. Can be useful in last few years of a policy when growth has been good and investor wants to consolidate gains made
Fixed interest	Gilts and corporate bonds	Relatively low risk	Do not offer significant growth – rarely used for mortgage purposes
Managed (or balanced) fund	Mostly blue-chip equities and gilts	The choice of most mortgage investors. Fund mandate is to produce reasonable capital growth without taking excessive risks Manager adjusts balance and selection of assets as appropriate	
UK equities	Shares of blue-chip companies that trade on London Stock Exchange	Medium to long term, expected to produce reasonable level of dividend income for the fund as well as capital growth	Medium risk in short term
Property	Commercial property	Normally provide steady returns in medium to long term	Can be volatile in short term

Specialist and international equities	Shares of companies that operate in a specific sector, eg technology, pharmaceuticals, or in companies across the world	More risky than UK equities

IN BRIEF

CHARGES ON A UNIT-LINKED PLAN

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

- an initial charge – an amount taken from the value of the units when they are purchased (typically 5 per cent);
- a monthly management or policy fee – deducted from the premium before investment;
- an annual fund management charge – this is taken from the fund and typical charges range from 0.5–1.5 per cent of the fund value;
- an early surrender charge – charged on surrender in the first ten years;
- charges deducted by cancelling units – to cover the cost of the death benefit and other costs.

21.3.2 Policy reviews

Borrowers need reassurance that their policy is on track to achieve the target maturity amount; if it is not on track, they need to be aware that action is required.

Mortgage-related unit-linked endowments are subject to policy reviews, where the insurer checks the plan's progress in relation to the maturity target. Where the plan is not on track, the insurer is likely to recommend an increase in premiums. On a typical 25-year policy, reviews would take place after 10, 15 and 20 years, becoming annual after that.

21.3.3 Early surrender

Most unit-linked endowments impose some sort of charge for cashing in the plan before the end of the term, usually within the first ten years of the plan.

The most common method is to deduct a certain percentage of the units on encashment, with the percentage reducing each year during the penalty period.

TABLE 21.3 ADVANTAGES AND DISADVANTAGES OF UNIT-LINKED ENDOWMENTS

Advantages	Disadvantages
▪ Flexible policy: premiums can be increased or decreased, depending on policy conditions and qualifying rules; may be possible to extend term, subject to policy conditions and qualifying rules ▪ Wide range of funds to choose from ▪ Charges clearly stated and policy is simple to value ▪ Combines investment and life cover ▪ No tax payable on maturity value	▪ Final value not guaranteed, and unit values can go down at any time as well as up ▪ In times of poor investment returns or market volatility, many unit-linked endowments have failed to meet targets ▪ High charges on some policies can reduce growth made

21.4 Unitised with-profits endowment

Unitised with-profits endowment policies combine the security of a with-profits policy with the greater growth potential of a unit-linked policy. There are a number of ways in which this type of policy can work, so we will look at the basic principles rather than every potential variation. Each premium buys units in the with-profits fund at a set price, perhaps with a value of £1. Once invested, the price is the minimum that is guaranteed to be paid at maturity.

There are two types of units in a unitised with-profits fund, which is a sub-division of the firm's main with-profits fund and is invested in exactly the same way.

- **'Variable' units** – the value of each unit is set when it is purchased, based on the performance of the with-profits fund at the time. As bonuses are declared, the value of each unit will increase proportionately and cannot be reduced in future.
- **'Fixed' units** – the value of each unit is fixed when it is purchased and does not increase. Bonuses are added by crediting more units to the policy at the current price

Most unitised with-profits policies allow the investor to switch into and out of other unit-linked funds. If the policyholder switches out of the unitised with-profits fund or cashes in the plan early, the policy might incur a market value adjuster (MVA). As with other unit-linked policies, the plan's performance will be subject to regular reviews.

21.5 Endowments as qualifying life policies

One traditional advantage of endowment policies is their 'qualifying' life policy status. However, in 2012 measures were introduced to limit the premiums payable on qualifying endowments issued on or after 21 March 2012.

CHECK YOUR UNDERSTANDING 1

From your studies in UK Financial Regulation, can you recall:

a) what is meant by a 'qualifying' life policy and the advantages it offers over non-qualifying policies?

b) the criteria a life policy must meet in order to be a qualifying policy?

POLICIES ISSUED BEFORE 21 MARCH 2012

Policies issued before 21 March 2012 and taken out to repay a mortgage are not affected by the change to the rules, even if the premium is increased as a result of a review in order to ensure the mortgage amount is achieved.

Under the updated rules, premiums to qualifying policies are limited to £3,600 per year. The limit applies to all policies held by the same individual, not per policy. In the case of joint owners, each is limited to £3,600 per year.

Policies taken out from 6 April 2013 are totally non-qualifying if the premium exceeds £3,600 at the start, or if the premium increases above £3,600 at any point during the term, regardless of the reason.

Policies issued between 21 March 2012 and 5 April 2013 are known as 'restricted relief' policies. The £3,600 limit applies to premiums paid from 6 April 2013 and, if premiums exceed the £3,600 limit, the part of any gain attributable to the excess premiums will be treated as a non-qualifying policy and may be subject to income tax. If the premiums are subsequently increased to more than £3,600, the whole policy will become non-qualifying.

21.6 Endowment shortfalls

As we have seen, only a full with-profits endowment is guaranteed to pay the agreed maturity sum assured at the end of the term and therefore pay off the mortgage. All other forms of endowment carry the risk of the final value not meeting the target, and that is not now unusual.

FCA regulations require insurers to review the performance of mortgage endowments on a regular basis, and to inform the policyholder if the endowment is unlikely to meet its target maturity amount. In the event that a policy is likely to result in a shortfall, early action is the best approach. Potential actions include:

- **Switch the amount of the projected shortfall from interest-only to capital repayment.** This will guarantee that the projected shortfall figure will be repaid if all future monthly payments are made on time.
- **Repay some, or all, of the mortgage early**, either by means of a lump sum or by making additional payments each month.
- **Convert the whole mortgage to a capital repayment basis.** This will guarantee that the loan will be repaid by the end of the mortgage term, but the monthly payment will increase considerably, particularly if the remaining term is 20 years or less.
- **Build up savings** and use these to reduce the mortgage debt.
- **Extend the term of the endowment policy and the mortgage.** This will require permission from the endowment provider and the lender and it is only possible on a unit-linked policy. Extending the term of the mortgage and the policy will also result in additional interest and premiums being paid.
- **Increase the endowment premiums** to boost the maturity value if possible. The additional premiums will still not guarantee that the policy will fully repay the loan at the end of the term, and it may not be seen as a sensible approach given the plan's performance to date.

If the policyholder decides to switch the whole mortgage to a repayment basis, the endowment may become superfluous. It can then either be maintained as a general savings plan or surrendered. The surrender value can be used to reduce the mortgage balance and may have a positive impact on the future total outgoings. It is important that the borrower obtains advice from a qualified financial adviser before taking this course of action.

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

THINK AGAIN . . .

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

For instance, can you:

- describe the basic structure of a with-profits endowment policy?
- explain when terminal bonuses are usually added?
- outline the advantages and disadvantages of a full with-profits and a low-cost with-profits policy?
- describe how a unit-linked endowment policy works?
- explain one key advantage and one potential disadvantage compared with a with-profits 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 21. Review the text if necessary.

Answers can be found at the end of this book.

1) Once added to the guaranteed sum assured on a with-profits endowment, reversionary bonuses are added:

    a) annually and are guaranteed to be paid when the policy ends in all circumstances.

    b) annually but can be reduced if investment performance is lower than expected.

    c) annually and guaranteed to be paid on maturity or death, assuming all premiums are paid.

    d) on maturity and are guaranteed to be paid once declared.

2) 'Smoothing' refers to the building up of a reserve when fund performance is poor. True or false?

3) A low-cost with-profits endowment guarantees to repay the mortgage on the death of the borrower. True or false?

4) The low-cost with-profits endowment has reduced premiums for the first five years. True or false?

5) In what ways does a unit-linked endowment differ from a with-profits endowment?

6) Unit-linked endowments can usually be extended to a longer term if there is a shortfall in the amount needed for repayment. True or false?

7) Which of the following types of unit-linked fund is **most commonly** used for investment for mortgage repayment purposes?

    a) Fixed interest.

    b) UK equities.

    c) Managed.

    d) Property.

8) If a borrower's endowment policy seems likely to result in a shortfall, the mortgage can be converted to the repayment method with the agreement of the lender. True or false?

9) George's insurer has warned him that his mortgage-related unit-linked endowment is unlikely to meet its target maturity amount. What would be the most sensible action George could take?

   a) Increase the endowment premiums.

   b) Switch the projected shortfall to a capital repayment basis.

   c) Convert the mortgage to a capital-repayment basis.

10) A paid-up with-profit policy means that no further premiums are paid and the policy will cease growth entirely. True or false?