TOPIC 11

Life assurance

LEARNING OBJECTIVES

Very few aspects of life are entirely free from 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 protect their family's living costs in case one of the family wage earners were to die.
- If you are concerned about inheritance tax (IHT), you might have taken out a life assurance policy that could be used to meet any IHT due on 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 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.
- 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. Some 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.

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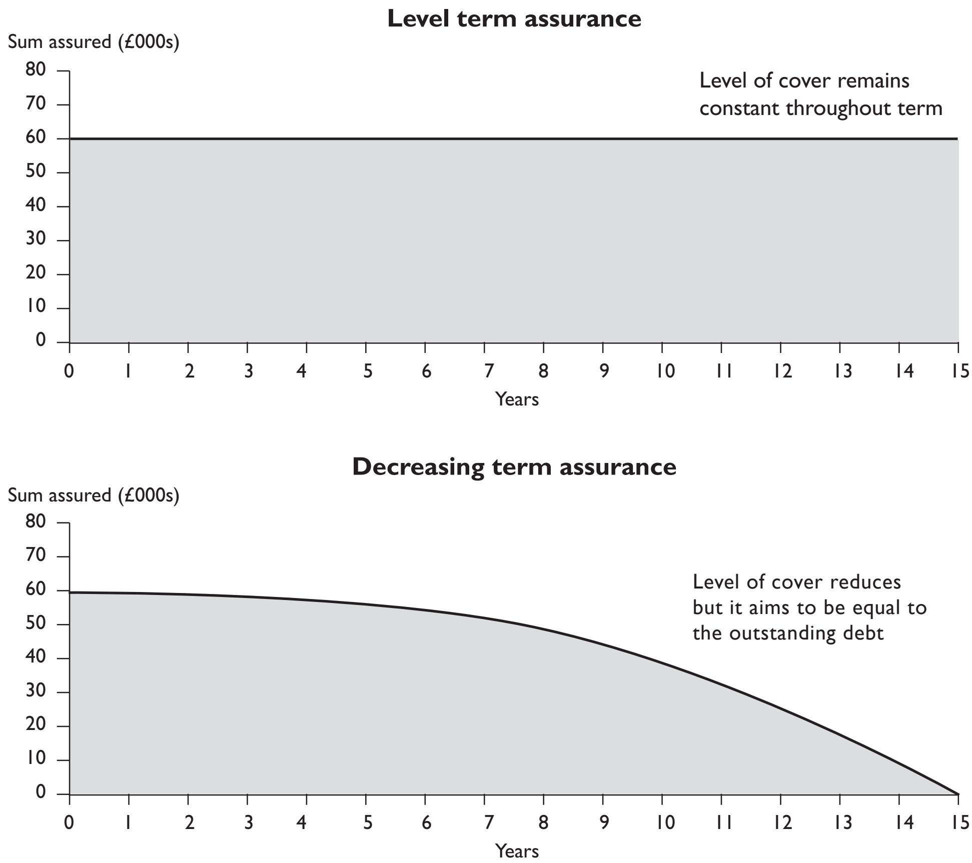
TERMINOLOGY

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 IHT 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 IHT, 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.

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, or it might have to be invested and managed to provide an income. A more practical 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.

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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).

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 wage earner;
- provide a tax-free legacy;
- cover expenses on death;
- provide funds for the payment of IHT.

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.

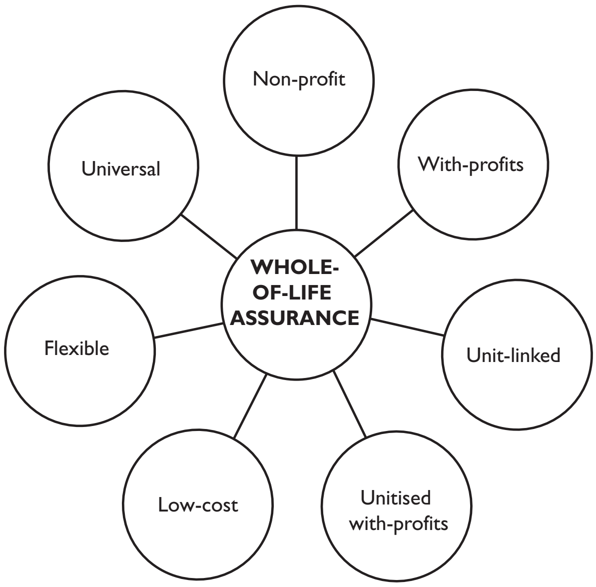
JOINT-LIFE SECOND-DEATH POLICIES

When a whole-of-life policy is used to provide the funds likely to be needed to pay IHT on the combined estate 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 should be 'written under trust': ownership then 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 8.5 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.

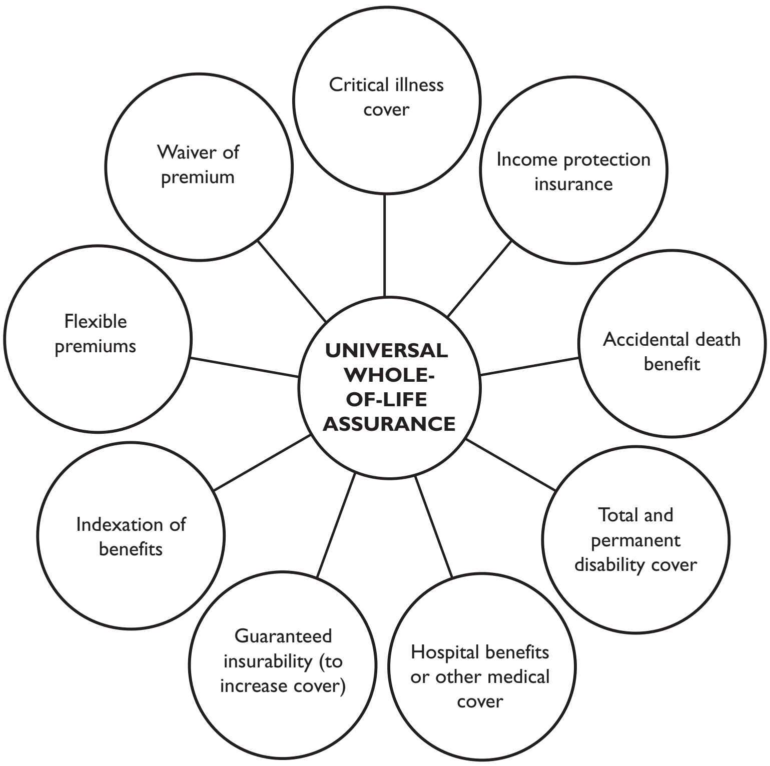
In all cases, the initial life cover is guaranteed for a certain period, often ten years. Beyond that point, the company reserves the right to increase the premiums or to reduce the cover – to take account of increases in costs or to allow for the fact that unit prices have not grown as quickly as had 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		
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 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, 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.
- **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.

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 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 on death. The basic with-profits sum assured is lower than the overall level of mortgage to be funded, meaning that full repayment is not guaranteed at maturity. 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.

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, 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 were introduced 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 IHT 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.