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LIBF

Certificate in Mortgage Advice & Practice (CeMAP®)

Module 1: UK Financial Regulation

Study Text 2024/25

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This learning support is recognised by the London Institute of Banking and Finance as an appropriate additional resource for students taking its CeMAP® qualification.

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INTRODUCTION

We are delighted that you have chosen Simply Academy as your training provider, and we are extremely proud of our record in helping our students to become successful, trusted advisers.

To enjoy the privilege of becoming your clients trusted source for mortgage or financial advice, you must achieve a relevant qualification as part of a journey that builds your knowledge, skills and behaviours to enable you to deliver support to your customers competently. Our mission is to assist you in your journey towards competency and beyond so that you can truly stand out from the crowd.

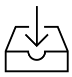
A key milestone in your journey starts here with developing the specific knowledge to achieve an industry qualification. We know from experience that this can be challenging and at Simply we develop our study materials with this in mind. Our primary aims are to assist you in building a thorough understanding of the syllabus that you will be assessed against in a way that simplifies subjects and focuses on key areas, then, enable you to apply your knowledge in the context of your daily routines to help you develop your reputation for excellence and create long-lasting customer relationships.

The Certificate in Mortgage Advice and Practice (CeMAP) qualification is provided by the London Institute of Banking Finance (LIBF) and this study text is based on the corresponding LIBF syllabus. In developing this study text, we have mirrored the expected learning outcomes detailed in the LIBF qualification specification for units 1 and 2 of the qualification.

This study text is broken down by topic areas with each topic focusing on the knowledge needed to help you be successful in each of the syllabus units examined. Each topic is introduced with an overview of the expected learning outcomes relevant to the syllabus together with an explanation of the specific topic subjects that support the expected learning outcomes.

Within topics there are suggested activities to help you develop and embed key learning points. Ideally, you should aim to complete these activities as part of your study.

Activities throughout the study text are indicated by the following icons:



Suggested activity.

Check your LIBF tax table provided in your course pack.

UNIT 1 – TOPIC 1

INTRODUCTION TO THE FINANCIAL SERVICES INDUSTRY

Learning Outcome	Assessment Criteria
1. Understand the purpose and structure of the UK financial services industry	U1.1 The function of the financial services industry in the economy – transferring funds between individuals, business and government. U1.2 The main institutions/organisations – markets/retail institutions, wholesale institutions, market participants

KEY TERMS:
- Medium of exchange
- Legal tender
- Store of value
- Unit of account
- Intermediation & disintermediation
- Demutualisation

WHY DO WE NEED MONEY?

Money is used as a ‘medium of exchange’ in a transaction and has properties that allow it to be used to pay for goods and services. These properties are:

Important!
The acronym PADS is a useful way of remembering these properties.

1. **P**ortable
2. **A**cceptable
3. **D**ivisible
4. **S**ufficient in quantity

Money is often classed as **legal tender**, which relates to the notes and coins backed by the Government and by the Bank of England. If individuals and businesses continue to accept it as payment for goods or services, then money can be kept today for use in the future. Money therefore acts as a **store of value**.

Another term relating to money is **unit of account**, which means that it can be used to measure the value of goods and services in an accounting system.

A problem with money is that it may not always maintain its value. For example, **inflation** can reduce its purchasing power or exchange value.

In an alternative system, individuals could ‘barter,’ but this is not very practical as both parties are then dependent on the wants and resources of each other.

Can you find a definition of ‘inflation’? Add this definition to your own notes.

WHAT IS INTERMEDIATION?

The primary function of money is a **medium of exchange**, but since some individuals have a surplus of money while other individuals have a deficit, financial services intermediaries facilitate the transfer of money between the surplus and deficit sectors and make a profit in the process.

The main financial intermediaries in this context are banks and building societies, although the term intermediary is also used to describe firms that bring together providers of financial products and services with those individuals who require access to them, for example, mortgage intermediaries.

Since the intermediary acts as an entity between the surplus a deficit sectors and is able to make a profit, those that wish to borrow and those that wish to lend may find ways of cutting out the intermediary by finding each other through systems like crowd funding. This is called *disintermediation*.

Elements of intermediation

There are four main reasons why financial intermediaries exist (GRAM).

Important!
The acronym GRAM is a useful way of remembering these elements.

Geographic Location	**Risk Transformation**
Aggregation	**Maturity Transformation**

Geographic Transformation

Intermediaries overcome the challenge of both sectors needing to find each other.

Risk Transformation

The main risk when lending is the risk of the borrower defaulting. By lending to lots of different borrowers, intermediaries reduce the risk to depositors by spreading the risk and absorbing defaults, thereby protecting depositors from suffering a loss.

Aggregation

This involves putting together lots of small deposits to match a larger loan.

Maturity Transformation

Borrowers often require loans for longer periods than depositors are prepared to tie up their funds for. Intermediaries offer a wide range of term accounts to a wide range of depositors. This way, there are sufficient numbers of depositors' funds available to match the loans made to borrowers over long periods of time, as would be the case with a mortgage for example.

FINANCIAL INSTITUTIONS

Financial institutions have traditionally operated in a more siloed way than they do today. For example, retail and wholesale banking, investments and insurance firms specialised within their sectors.

The rise of the 'financial services group' in more recent times means that large firms have multiple types of products and services to offer customers in different markets. These include retail banking products, credit card services, mortgages, general insurance, investment and wealth banking services and other insurance services.

THE BANK OF ENGLAND

The Bank of England was originally founded in 1694 to act as banker to the Government. Today, it has several additional important roles:

- Set interest rates through the Monetary Policy Committee (MPC).
- Advisor to the Government.
- Banker to the Banks.
- Issuer of bank notes.
- Lender of last resort.
- Manage foreign exchange and gold reserves.
- Helps to maintain economic stability through the Financial Policy Committee (FPC).

Based on the responsibilities listed above we can see that the Bank of England help to supervise the economy, particularly in relation to their responsibility to set interest rates (we will explore this in more detail later.)

At one stage The Bank of England issued government debt in the form of "gilts", but this task is now the responsibility of the Treasury and is undertaken by the **Debt Management Office** (DMO). We explore "gilts" and how these work in more detail in topic 6.

PROPRIETARY & MUTUAL ORGANISATIONS

Financial institutions tend to be mainly **proprietary**, i.e., they are owned by shareholders and are run for the benefit of their owners. Shareholders are usually entitled to receive dividends as well as voting rights. Banks are the most notable examples of **proprietary organisations**.

Mutual organisations operate on a different basis as they are run for the benefit of their members, who are the organisations customers and effectively, the owners.

Individuals with savings accounts or mortgages for example, enjoy a right to contribute to how the organisation is run through voting rights. The profits of mutual organisations are re-invested to improve the products and services offered. Building Societies are the best known examples of mutual organisations.

Another form of mutual organisation is a Credit Union. Originally, credit unions were created around a particular association or group of people with a common bond. Nowadays, there does not need to be a common bond such as living within a certain area.

Members are given equal status through the purchase of a single £1 share and either pay interest or share their profits in the form of dividends to members.

In terms of products offered, these include simple bank accounts, loans and savings products as well as insurance services. They help to combat financial exclusion by providing financial education to individuals who may be “left behind” by more mainstream financial service providers.

Members of a credit union have their savings and loans protected by life assurance (subject to limits).

One rule that applies to Credit Unions is that they must have at least £50,000 or 5% of their assets in reserve (whichever is higher). The cost of loans to members will typically have an interest rate of between 1% - 3% of the reducing balance).

Now research “Friendly Societies” to discover another example of a mutual organisation.

DEMUTUALISATION

Some mutual organisations have converted their status to proprietary organisations through **de-mutualisation**. After conversion to a proprietary firm, an organisation is no longer bound by funding restrictions placed upon them (via the Building Societies Act 1986).

A mutual that converts to a Public Limited Company (PLC) are not restricted by the act, allowing organisations to potentially become more profitable and resulting in a windfall for members who become shareholders.

RETAIL AND WHOLESALE BANKING

Retail banking refers to the market offering everyday banking products and services to individuals and corporate bodies. Traditionally these products and services were offered through retail branch networks and were managed on a de-centralised basis. This involved risk decisions being taken at a local level by individual branch managers.

Wholesale banking on the other hand, refers to the market where the participants are the financial institutions themselves. A bank, for example, can raise funds in the wholesale markets to facilitate loans in the retail markets. Most large organisations operate in both markets at the same time.

The **interbank market** is an example of wholesale market where the participants are large banks. This is a short-term money market enabling banks to rapidly adjust their financial positions as and when needed.

More recent changes to legislation have introduced the need for organisations to ‘ring-fence’ their wholesale and retail businesses. This was largely in response to the financial crisis of ‘08-09 and is designed to ensure retail consumers are protected from the riskier activities of those organisations who trade in the wholesale markets.

Now do some further research on the terms below to gain a better understanding of the wholesale market, the participants, financial assets, and key interest rates used.

Research terms:

- Wholesale lending / Interbank market / LIBOR / SONIA / Money markets

UNIT 1 – TOPIC 2

ECONOMIC POLICY AND FINANCIAL REGULATION

Learning Outcome	Assessment Criteria
1. Understand the purpose and structure of the UK financial services industry	U1.3 The role of the EU and of the UK government – regulation, taxation, economic and monetary policy, provision of welfare and benefits.
2. Understand the impact of inflation, interest rate volatility and other relevant socio-economic factors on personal financial plans.	U8.1 Definition and common measure of inflation, deflation, disinflation and relevant indices. U8.2 The different types of interest rates and what factors they impact over time. U8.3 Economic cycles and market volatility.

KEY TERMS:

- Inflation
- Deflation
- Disinflation
- Gross Domestic Product (GDP)
- Consumer Prices Index (CPI)
- Regulations
- Directives
- Dispensation

As government policies and legislation effects financial markets and the financial services industry as a whole, it is important to have a basic understanding of what economic objectives the government of the day will have for managing the economy.

MACROECONOMIC OBJECTIVES

The macroeconomic (big picture) goals of the Government are:

Price Stability	**Low Unemployment**
Payments Equilibrium	**Satisfactory Growth**

Price Stability (inflation)

When this goal is achieved, there is confidence about the rate at which prices will rise. Stability of prices is important to a well-functioning economy as it delivers certainty for individuals and business. To support this goal the government set an inflation target of 2%, as measured by the Consumer Prices Index (CPI). It is a Monetary Policy Committee (MPC) function to help the government meet this target. While the target is 2%, CPI between 1% - 3% is considered to be acceptable.

Low Unemployment

Higher levels of employment leads to higher tax revenues for the Treasury. Lower levels of unemployment results in reduced demand for welfare state benefits. The more people there are in employment, the more demand there is for goods and services and the more investment there is in the economy.

Payments Equilibrium

This is concerned with the levels of imports and export trade with other countries. The aim here is to have an acceptable balance between the two. The UK tends to have a deficit in that we import more goods and services than we export to other countries around the world.

Satisfactory Economic Growth

One measure of success of a government is the performance of the economy. The key performance indicator used is Gross Domestic Product (GDP), which helps to measure if the economy is expanding or contracting. Gross Domestic Product is essentially the total value of the economic output from goods and services and is measured quarterly. If the quarterly measure shows the total value of goods and services going up, this means the economy is expanding. If the value decreases, the economy is contracting.

If the UK has 2 consecutive quarters of negative economic growth, the economy will be described as being in a "recession."

MONETARIST VIEW OF ECONOMICS

The monetarist view is that inflation is caused by an increase in the supply of money, resulting from increased lending and borrowing. Therefore, by controlling interest rates the amount of money in the system is regulated and thus inflation can be controlled.

The basic principle is that increases in the central bank base rate (BoE base rate) are passed on to borrowers, this reduces demand in the economy and theoretically, prices begin to fall.

If businesses have to pay more to borrow, they may delay investment decisions, which also reduces economic demand. At the same time, individuals and businesses delay spending, with increases in interest rates attracting more savers as intermediaries compete for their deposits.

When the level of economic growth is less than desired, interest rates can be reduced to encourage individuals and businesses to borrow and spend in order to stimulate growth. This was the aim of reducing interest rates after the "credit crunch" and recession of 2008, which saw interest rates fall from over 5% to 0.5% in a little over a year.

Responsibility for setting interest rates rests with the **Monetary Policy Committee** who are employees of the Bank of England and who meet 8 times per year (every 6 weeks) to set the base rate.

Although the Bank is independent in making interest rate decisions, the government reserves the right to give instructions to the bank if the circumstances dictate.

Now research and make note of the definitions of the following terms:

Inflation is…	
Disinflation is…	
Deflation is…	

INTEREST RATES IN DETAIL

In recent times we have witnessed that increases in the BoE's base rate can have quite a dramatic effect on borrower's finances, particularly when rates are raised quickly. One of the most direct ways this happens is through increases in mortgage payments. This is because mortgage lenders pass on interest rates rises as and when they occur, so as to maintain their profit margins.

If the economy is regarded as being unstable, as was witnessed after the "mini-budget" of September 2022, upward pressure can be placed on interest rates, and this could well lead to increases in payments for mortgage holders.

Between 2009 and 2021 interest rates were kept below 1% in order to help stimulate economic growth. While this was good news for borrowers, it was not so good for savers. However, as the UK started to experience higher levels of inflation from around 2021 (a period dubbed the "cost of living crisis") interest rates began to rise at an incredibly steep rate and wage increases were generally not keeping pace. This placed a huge amount of pressure on people's finances, with the interest rate hikes seen as being necessary to bring inflation back to target.

The effect on the economy of raising interest rates for mortgage holders and businesses is that there is less demand created in the economy as householders and businesses have less available cash to spend. Increases in interest rates also make saving more attractive as already mentioned. Both of these effects are intentional and are designed to control inflation.

Some economic experts argue that raising interest rates is not the best way to control inflation and that it can be damaging to the housing market and the economy - house prices start to fall, and rents are increased by landlords passing on the increases in mortgage payments.

Monetary policy can be a delicate balancing act made more complex due to the government's need to combine fiscal policy measures to achieve long term economic objectives.

FISCAL VIEW OF ECONOMICS

Fiscal policy is concerned with taxation and spending and the way in which decisions affecting tax and spending affects the economy. The income the government receives is mainly from taxes and this income is then spent on public services like the National Health Service and education and defence. The welfare state also accounts for a large amount of the overall spending whereby the government supports the incomes of families and individuals through welfare state benefits such as universal credit and the state pension.

When the government takes tax and spending decisions each year, there are three general budget outcomes.

Budget Outcomes:

1. Balanced budget: The same amount of tax taken is put into spending (neutral effect on the economy).
2. Budget surplus: The amount of tax taken is more than the amount put into spending

   (Contractionary effect on the economy).
3. Budget deficit: The amount of tax taken is less than the amount put into spending

   (Expansionary effect on the economy).

The basic principle is that spending in the economy is increased when taxes are lower. Conversely, when taxes are higher there is less investment by businesses and general spending by the public is reduced creating less demand for goods and services.

Fiscal policies can also therefore be used to control inflation and to stimulate economic growth.

Governments generally use a combination of both monetary and fiscal policies to manage the economy.

When the government has a budget deficit it needs to borrow to meet its spending requirements. This borrowing will produce debt interest payments that must be met from future tax income (see topic 6 for more details about the financial instruments the government use and how the interest payments work.)

EUROPEAN UNION

European legislation comes in two main forms, Regulations & Directives. Although the UK are no longer a member of the EU, regulations and directives remain embedded in UK law.

REGULATIONS

Regulations are **binding in their entirety** in what is to be achieved and how it is to be achieved. They are highly prescriptive. Member states may be able to arrange specific **dispensations** to avoid having to implement the directives in full, although these tend to be exceptional as the general rule is that all member states are required to fully implement the regulation.

DIRECTIVES

Directives are only binding as to the **result to be achieved** and allow greater flexibility for how members states achieve the desired outcome. Directives are usually accompanied by a two-year timescale for implementation.

EUROPEAN SUPERVISORY AUTHORITIES

As a result of the financial crisis, there was a need for reform of virtually every area of EU wide financial services. There are three main supervisory authorities today are:

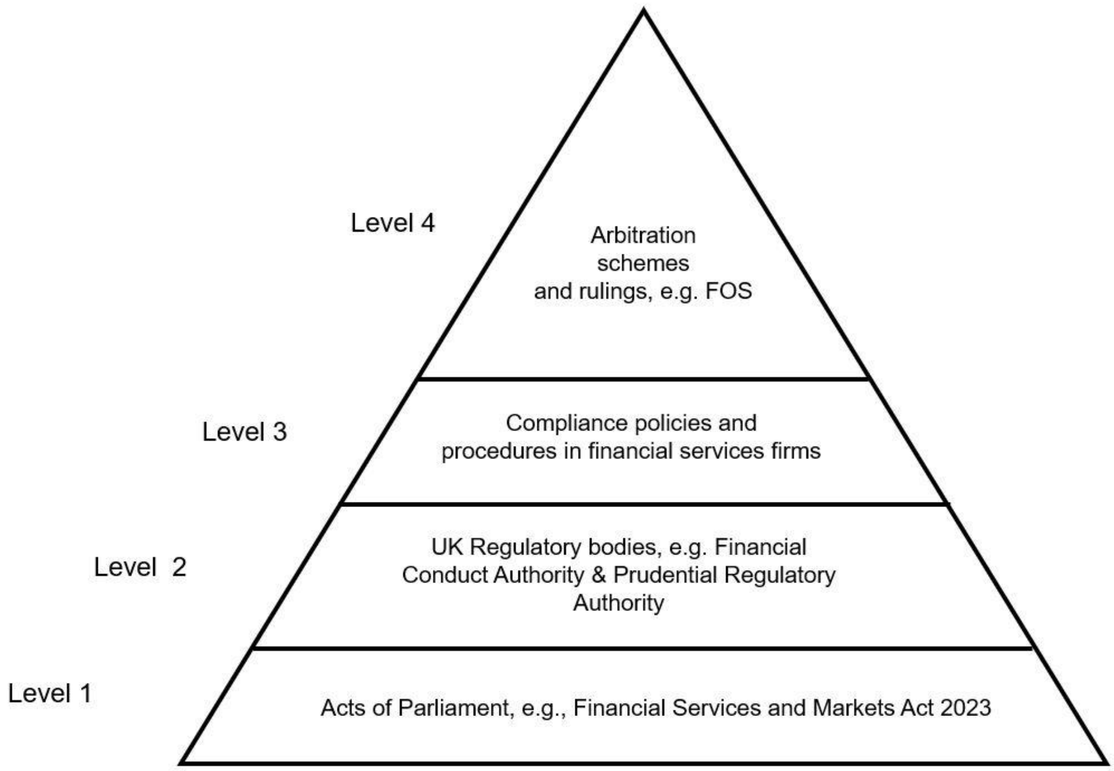
- European Banking Authority.
- European Insurance and Occupational Pensions Authority.
- European Securities and Marketing Agency.

These authorities work together to harmonise the rules and create a “level playing field.” They are also responsible for assessing financial risks that exist across the markets.

The Single Supervisory Mechanism (SSM) refers to the system of banking supervision in Europe with all countries that have the euro participating in this system of supervision. The SSM is comprised of the European Central Bank (ECB) and the main supervisory authority from each participating country.

FOUR TIERS OF UK REGULATION:

This diagram explains that the UK government create acts of parliament. Rules and regulations are formed, and firms create policies to ensure compliance. An arbitration scheme like the Financial Ombudsman Scheme exists to protect consumers when things go wrong.


Level 4
Arbitration schemes and rulings, e.g. FOS
Level 3
Compliance policies and procedures in financial services firms
Level 2
UK Regulatory bodies, e.g. Financial Conduct Authority & Prudential Regulatory Authority
Level 1
Acts of Parliament, e.g., Financial Services and Markets Act 2023

UNIT 1 – TOPIC 3

UK TAXATION (PART 1) – INCOME TAX

Learning Outcome	Assessment Criteria
7. Understand the UK taxation and social security systems and how they affect personal financial circumstances.	U7.1 Concept and importance of residency, domicile, and reciprocal tax treaties U7.2 UK Income tax system – liability to income tax, allowances, reliefs, rates, employed and self-employed income and priorities for taxing different classes of income U7.7 Taxation of investments and property U7.8 National insurance

KEY TERMS:

- **Domicile & Residence**
- **Taxable Income**
- **Dividends**
- **Tax at Source**
- **Earned and Unearned income**
- **Self-Assessment**
- **Deductions and Personal Allowance**
- **Fiscal tax year**

This topic focuses on the main taxes and issues that are relevant to individuals who are subject to tax in the UK.

TAX LEGISLATION

The government's 'budget' is normally delivered in the Autumn, and following this a finance bill is published containing the taxation proposals of the government.

The bill is approved and receives Royal Assent, and the contents then form part of the Finance Act, which is an ongoing piece of legislation.

DOMICILE

Domicile refers to the country that a person treats as their **permanent home** or to which they plan to return.

Domicile of origin is determined at birth as the domicile of the father or if they are unmarried, the mother.

Deemed domicile is when a person is not UK domiciled but has lived in the UK for 15 out of the last 20 years.

Domicile of choice is when a person chooses a new domicile by showing an intention to settle there permanently, severing their former connections. There is no specific process for this.

If a person is either UK domiciled or deemed domiciled their estate for **inheritance tax** purposes includes all worldwide assets.

If a person is neither UK domiciled nor deemed domiciled at death the estate for inheritance tax purposes **only includes assets held in the UK.**

RESIDENCE

Residence is the place where you are currently living (residing). The rules for residency for tax purposes can be complex, but in simple terms, if you are classed as a UK resident for tax purposes this could mean you have to pay tax on your **worldwide earned income**.

The first test to determine if a person is UK resident for tax purposes is to check how many days the individual has spent in the UK during the tax year.

An individual that has spent 183 days or more is classed as a UK resident for tax purposes.

Residency affects a person's liability to pay **Income Tax** and **Capital Gains Tax (CGT)**.

If a person is classified as resident or 'ordinarily resident', they are liable for income tax and capital gains tax on income and capital gains made worldwide.

INCOME TAX

Income tax is based on income received throughout the whole tax year 6th April – 5th April.

Income from employment/self-employment/pensions is often referred to as 'earned income'.

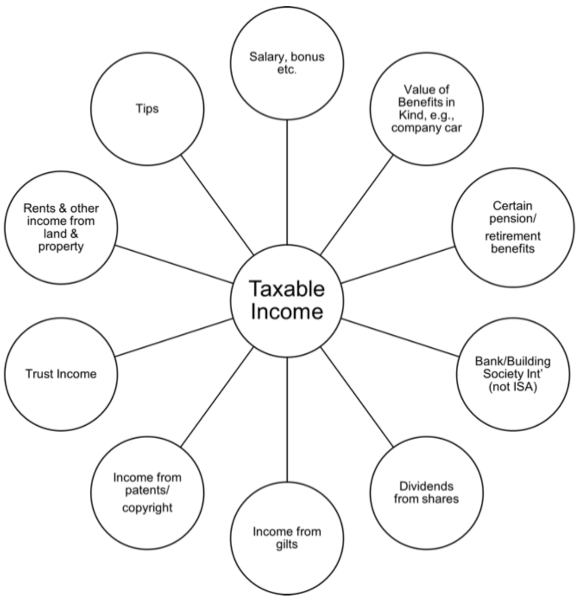
Income that hasn't come from your employment/self-employment e.g., interest from savings, dividends from shares, rental income, trust income is referred to as 'un-earned income'.

The diagram below shows sources of income which are subject to income tax

Important!

It is useful to know what forms of income are subject to tax and which are not.

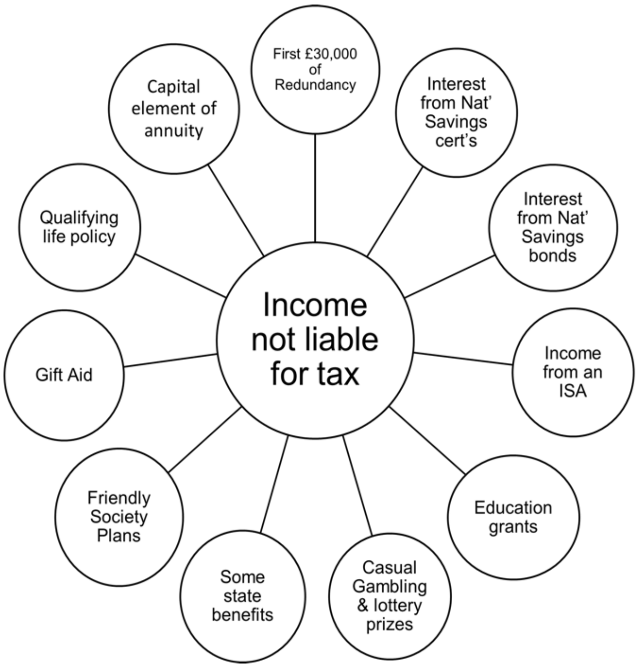
The tax tables contain details of the allowances available for each area of tax.



The diagram below shows sources of income, which are not subject to tax

Important!

It is key to understand how some financial assets are treated for tax purposes – the tax treatment will be covered in later topics.



WHO IS LIABLE FOR INCOME TAX?

Simply put, everyone, regardless of age.

If a child receives income via a trust settlement or other arrangement from parents, this income will usually be treated as the parent's income for taxation purposes.

PERSONAL ALLOWANCES

The personal allowance is the amount you can earn before you start paying tax.

Check your tax table to find the personal allowance for this tax year!

Currently, the personal allowance begins to taper off on income above £100,000. The allowance reduces by £1 for every £2 earned above £100,000.

The personal allowance disappears entirely once an individual has earned £125,140 (as the £12,570 has been reduced at a rate of £1 for every £2 earned).

Taxpayers are allowed to make certain deductions from their gross income before assessing their tax liability, including pension contributions, effectively reducing the tax that is payable.

Some business expenses can also be used to reduce the tax payable.

For employed people, those business expenses must be:

- wholly, exclusively, and necessarily for the job.

For Self-employed people, business expenses must be:

- wholly and exclusively for the trade.

Look at the tax table again for details of the allowances for married couples and civil partners. These allowances are designed for some individuals to keep more of their income.

It is also possible to claim an allowance for property and trading income. This is a relatively small value of £1,000 and can be used by individuals to supplement their main income. This might be achieved by renting a parking space or by making small amount of profit through an ebay transaction for example.

Once all the available allowances have been deducted from an individual's gross income, what is left is referred to as '**taxable income**.'

Taxable income can then be applied to the relevant tax bands to determine what tax liability exists.

So, the basic process to calculate an individual's tax liability is to:

1. Ascertain the total income (gross income) before tax.
2. Deduct any allowances, including the personal allowance if it applies.
3. What you are left with is the 'taxable income'.
4. Apply the income to the relevant tax band, starting at the lowest band and working your way up through the bands (if the income exceeds the basic rate.)

For example:

Tom earns £55,500 gross in 2023/2024 tax year. He has no other income and does not qualify for any other allowance other than the personal allowance.

1. £55,500 gross income
2. £55,500 - £12,570 (personal allowance)
3. £42,930 'taxable income'
4. £37,700 @ 20% = £7,540

   £5,230 @ 40% = £2,092

   Total tax = £9,632

Using the tax table and the following example, calculate the tax liability based on the 'taxable income'.

Maria earns £85,500 gross. She is unmarried and has no other income from other sources.

INCOME TAX ON SAVINGS INTEREST

To support those on low incomes there is a potential rate of 0% on the first £5,000 of savings interest (unearned income). This is called the Starting Rate for Savings.

The rate is a potential rate because whether an individual qualifies for it, depends on the non-savings taxable income the individual receives. For example, if a person earns between £12,570 (the personal allowance limit) and £17,570 (£12,570 plus the starting rate for savings) then 0% will apply. However, it only applies to the amount that falls between £12,570 and £17,570.

To illustrate how this works, consider this example:

Meera earns £14,570 from employment, which is £2,000 above the personal allowance. This means she qualifies to pay 0% on savings that fall between £14,570 and £17,570 (so Meera would not pay any income tax on her first £3,000) of savings.

On incomes between £12,570 and £17,570 the starting rate for savings reduces by £1 for every £1 above £12,570. As the starting rate applies to the first £5,000 of savings, incomes above £17,570 do not qualify for this reduced rate.

If an individual does not qualify for the starting rate for savings, and provided they are not additional rate taxpayers, they will benefit from the Personal Savings Allowance (PSA).

PERSONAL SAVINGS ALLOWANCE

Basic rate taxpayers receive a Personal Savings Allowance (PSA), which is an extra £1,000 allowance on interest from savings.

Going back to our example above, as a basic rate taxpayer Meera would pay 0% tax on her next £1,000 of savings interest, meaning she would not actually pay any tax on her first £4,000 of savings interest, not £3,000.

For higher rate taxpayers, this £1,000 is reduced to £500. As stated earlier, additional rate taxpayers do not qualify for a PSA.

Note: Higher rate taxpayers must reclaim their £500 allowance via self-assessment.

INCOME TAX ON DIVIDENDS

The term 'dividend' is used to describe the payment a shareholder receives when the issuing company distributes profits. These payments are received without the deduction of income tax. It is left to the individual to declare taxable income and calculate the tax payable to HMRC. This is achieved through self-assessment.

The first £500 of dividend income is not taxable. This is called the dividend allowance.

Check your tax table to find the rates that are payable on dividends above the £500 dividend allowance.

COLLECTING TAX AT SOURCE

This refers to the process of the government collecting the tax due from the body that is making the payment, for example employees of a firm receive their income net of tax as the accounts payable department are responsible for settling the tax on the employee's behalf. This system of paying tax is referred to as PAYE (Pay as You Earn).

If an employed individual has income from other sources that doesn't get taxed at source, it is the individual's responsibility to inform HMRC of the additional income so that any further liability can be calculated by submitting tax return.

EMPLOYED

As we have seen, the employee of a company is usually taxed at source. The employee is given a tax code that indicates their taxpayer status for the tax year.

The HMRC forms P45 (issued when leaving an employer) shows total gross pay to date and total tax due and can help a new employer calculate a new employee's tax liability under their new employment. A P60 (issue in May) form confirms the total tax deducted, National Insurance Contributions (see below) and final tax codes for the last tax year.

SELF EMPLOYED

Typically, self-employed people are sole-traders or individuals working in a partnership.

The self-employed are expected to pay income tax on their net profits, which can be thought of as being equivalent to the gross pay of an employee.

The tax due is calculated based on the declared net profits, which is what is left from the gross income after costs and allowable expenses have been deducted.

Costs can be both fixed and variable and may be described as capital allowances where assets have been bought to be used in the running of the business, e.g., vehicles.

In most arrangements the tax itself is settled on two payment dates. The first date is January 31st and the second is July 31st. Both payments represent half a year's worth of tax. Any over or underpayment from the previous year is then corrected at the following January deadline.

Note:

Income is taxed differently depending on the source of the income:

1 Earned income.

2 Interest from savings.

3 Dividend income.

GIFTS TO CHARITY

Gift Aid is the ability to make gifts to charities that benefit both Giftor and charity. As the gift is usually made from taxed income, the charity can recover the basic rate of tax paid on the value of the gift. The Giftor pays a reduced level of income tax as their income tax band increases by the value of the gross gift.

NATIONAL INSURANCE CONTRIBUTIONS (NIC'S)

In its original form National Insurance was designed as a national scheme for working individuals that would provide protection in the event of illness and unemployment. It is still linked to some of the state benefits that individuals can receive today and helps to pay towards the cost of the National Health Service.

There are four classes according to the circumstances of the individual paying them:

- Employed (and employers) – Class 1
- Self-Employed - Class 2 (voluntary class for self-employed with very low profits, abolished in April 2024, but previously paid weekly at a flat rate on earnings above the "small profits threshold")
- Self-Employed people - Class 4 (paid annually via Self-Assessment and based on profits)
- Employed & Self-Employed – Class 3.

Class 3 is specifically for voluntary contributions. It can sometimes be beneficial to make additional contributions to qualify for certain benefits e.g., where someone has worked outside the UK for some time and had not been paying contributions during that time. It is mainly used to secure entitlement to the state pension.

UNIT 1 – TOPIC 4

UK TAXATION (PART 2)

Learning Outcome	Assessment Criteria
7.	U7.3
Understand the UK taxation and social security systems and how they affect personal financial circumstances.	Capital gains tax – liability to CGT, disposals, death, deductions, losses, main reliefs and exemptions and basic calculation of chargeable gains.
	U7.4
	Inheritance tax – liability to IHT, main exemptions and calculation of IHT liabilities.
	U7.5
	Corporation tax.
	U7.6
	Stamp duty on securities, including real estate and real estate funds.

KEY TERMS:

- **Disposal**
- **Annual Exempt Amount**
- **Estate**
- **Potentially Exempt Transfer**
- **Chargeable Lifetime Transfer**
- **Bearer Instrument**

This topic follows on from part 1 and looks at all the other main areas of tax.

CAPITAL GAINS TAX

This is a tax that is payable on gains or profit made on the disposal of certain assets.

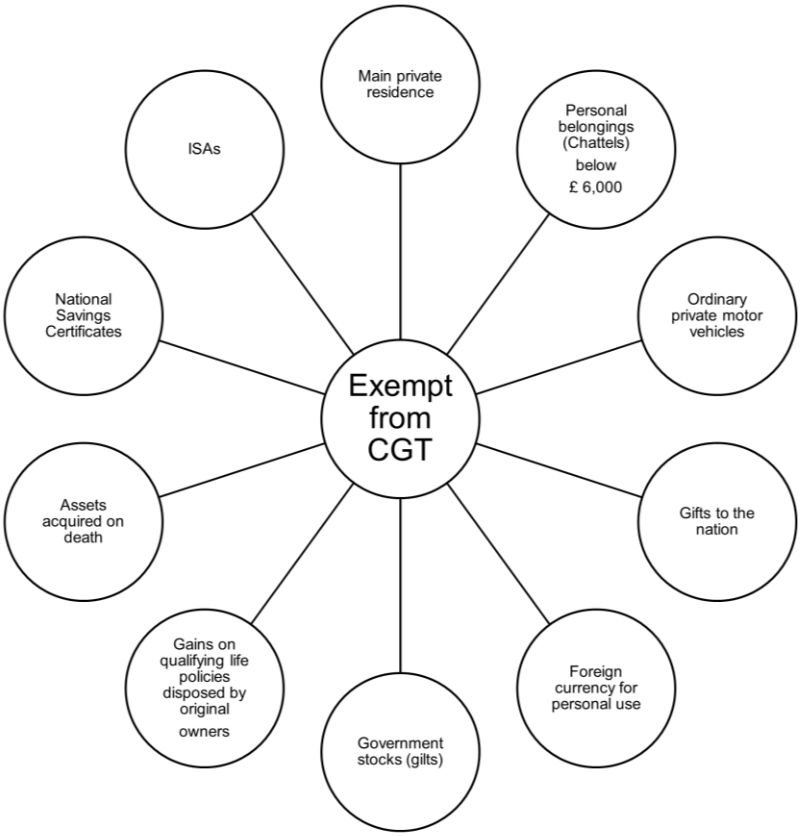
The word **disposal** is used as the tax arises on sale or transfer of ownership, such as with a gift.

Capital Gains Tax is paid by individuals, not companies who pay corporation tax on their profits.

Individuals can make an amount of gains each year before a tax liability arises. The principle is similar to the personal allowance for income tax. Tax is charged on net gains that are made in the tax year. Net gains refer to gains after the deduction of losses and other allowances (see below).

Now look up the **Annual Exempt Amount** shown on your tax table. Notice the different rates of tax charged depending on the tax status of the individual/asset type.

This diagram shows the assets that are exempt from Capital Gains Tax - you need to know these and the tax treatment will be covered in later topics.



Where assets are bought and sold within a trade, for example if an art dealer buys and sells art and makes a profit, there is no liability for CGT, but the profits are dealt with via income tax.

Since April 2015, non-UK residents are also potentially liable for gains made on UK residential property.

ANNUAL EXEMPTION AMOUNT

The annual exemption may also be applied in the use of a trust, although only bare trusts qualify for the full allowance (half of the annual exemption applies to most other trusts).

Now look up the definition of a 'bare trust'. We will learn the basics about trusts later.

When an individual dies, their chargeable assets are deemed to have been transferred. Initially, this is to their personal representative. The personal representative can therefore claim the annual exemption amount when calculating any tax liability on the estate of the deceased.

Important!

A personal representative is called an executor if there is a valid will.
If there is not a valid will, the personal representative will be called an administrator.

OFFSETTING LOSSES

The annual exempt amount can only be used in the year, but losses suffered in previous years can be used to offset gains made in the current tax year. It is the net gains that are taxable.

There are no limits to the number of losses than can be carried forward to future years. There is also no time limit on carrying forward losses. The main requirement, however, is to first offset losses **in the year they first occur.**

CALCULATING CGT

When calculating the actual capital gains tax liability an individual can reduce the gain by the following:

- The cost of **acquisition** (if the asset was acquired before 31st March 1982) is its value on this date.
- The cost of any **improvements** (but not repair)
- Any **sale** costs

The annual exempt amount further reduces the resulting gain with any residual losses reducing the gain still further. What is left is called the **taxable gain.**

The following is an example of how a liability would be calculated when considering losses.

Maria bought some shares for £50,000 and sold them several years later for £80,000. At the same time however, she sold some other shares at a loss of £5,000. There were no other losses or gains.

Gain = £80,000 - £50,000
= £30,000

Loss = £5,000

In this example there were no acquisition costs or other means of reducing the gain.

The taxable gain is therefore:

£30,000 - £5,000 - £6,000
= **£19,000**

The amount of tax Maria would pay would depend on her income for the year. Simply put, if Maria's taxable income, including the gains all fall within the basic rate, she will be charged CGT at the basic rate (10%). Maria could however, pay some of the tax at a higher rate if the gains were to take her beyond the basic rate of tax and into the higher rate bracket.

Remember, if there are acquisition, improvement **(not repairs)** and sale costs these can also be deducted from the gain to reduce the taxable gain!

PAYING CAPITAL GAINS TAX

Gains arising during the tax year are to be paid by the 31st of January in the following year. The exception to this is for gains made on the sale of non-exempt residential property where the gains must be paid within 60 days.

RELIEFS

Various reliefs are available that effectively delay the payment of capital gains tax. The main reliefs are hold over relief, roll over relief, business asset disposal relief and private residence relief. Hold over and roll over relief are discussed briefly below.

HOLD OVER RELIEF

This is sometimes called **gift relief** because the gain is passed on to the recipient of the asset when it is transferred. The tax is then paid when the recipient disposes of it. The tax due would include any tax due at the first transfer, plus any liability arising since.

ROLL OVER RELIEF

This is also known as **business assets roll over relief** because an individual who is a sole trader or partner in a partnership may be required to pay CGT on gains made when business assets are disposed of (assuming a gain is made). The criteria for delaying the tax is achieved by replacing the business assets that have been disposed of (this must be done within 3 years of disposal of the original assets).

Now using the *www.gov.uk* website research **private residence relief** and **business asset disposal relief** and make a note of the purpose of the relief in your own notes.

Note: “Bed & Breakfasting”. If shares are sold and re-purchased within a 30-day period, the transaction is deemed to have never taken place. This rule effectively reduces the likelihood of an investor selling shares to bank the gains on those shares using the annual exemption amount, only then to re-purchase the shares shortly afterwards for the same price they were sold at. Although this may seem like an odd thing to do it may reduce a future tax liability because the new acquisition price of those shares may have now increased.

INHERITANCE TAX

Inheritance (IHT) is designed as a ‘wealth tax’, rather like CGT. It is a tax that is levied on the value of an estate where the value of the assets within the estate exceeds a specific value.

Whether assets form part of the estate depends on the circumstances because on an individual’s death, there is always a deemed transfer of a person’s assets. The transfers will either be **exempt**, **potentially exempt,** or **chargeable**.

What is an estate?
Your estate is all your money, property and possessions left when you die.

Using your tax table, look up Inheritance tax to identify the current value at which IHT potentially applies. This value is called the nil rate band (NRB).

EXEMPT TRANSFERS

There is no tax to pay of gifts between spouses and civil partners. This is sometimes referred to as the **spousal exemption**.

POTENTIALLY EXEMPT TRANSFERS (PET)

When you make a gift to someone during your lifetime, and you survive for seven years or more the gift is exempt. If you die within seven years of making the gift, and the value of the estate and gifts made in the preceding seven years, then tax will be payable on the gift according to the taper relief available:

Years between gift and death	Taper relief available	Rate of tax due
1-3	0%	40%
4	20%	32%
5	40%	24%
6	60%	16%
7	80%	8%
7+	100%	0%

TRANSFERS TO TRUSTS/CLUBS/COMPANIES

The taxation of trusts can be complicated, but a basic rule is that if an individual makes a transfer of assets to a trust during their lifetime (sometimes referred to as a **Chargeable Lifetime Transfer - CLT)** a charge is payable immediately. This happens when the value of the transfer and any transfers made in the previous seven years exceeds the NRB. The immediate chargeable amount is **20%** and if the settlor does not survive for more than seven years then a further liability arises, according to the table above.

HOW THE NIL RATE BAND WORKS

The principle of the nil rate band is that a rate of zero is charged on the first portion on a solely owned estate. Once this zero, or nil rate, band has been used up, tax is charged on the remaining value of the estate.

When assets pass to anyone other than a spouse or civil partner following a death (see exempt transfers above), some or all of the nil rate band may be used up on transfer. If only a portion of the nil rate band is used in the transfer, for example 50%, the remaining 50% can be claimed by the spouse or civil partner of the deceased. The un-used portion then increases the spouse's or civil partner's nil rate band by the un-used percentage on their eventual death.

Note: as the nil rate band is subject to change, the un-used percentage is based on the nil rate band at the time of their death.

The nil rate band is often used against the family home, however, because property values have gone up so much in recent years the government introduced the residence nil rate band to limit the number of properties that are likely to suffer an IHT liability.

RESIDENCE NIL RATE BAND (RNRB)

The residence nil rate band can only against a family home where it is bequeathed to direct descendants (a child, legally adopted child or grandchild for example).

Like the nil rate band, it can be transferred between spouses and civil partners. As the RNRB cannot be used to offset a liability on other assets it is used against the home first when calculating the value of the estate that is subject to the tax.

With a jointly owned property (a family home) where the RNRB is £175,000, the ability to transfer 100% of this to a spouse or civil partner means that the RNRB can be increased to £350,000. This value is applied to the property and if the property is worth more than this, the NRB can then applied to the rest.

Assuming that the NRB has not been used bequeathing other assets then 100% of this also transfers to the surviving spouse or civil partner, leaving a NRB of £325,000 x 2 = £650,000.

If the remaining value of the estate is below £650,000 then none of the estate is taxable. Put another way, the ability to transfer both the NRB and RNRB effectively means that a family home valued up to £1million can be left to direct descendants free of IHT.

ALLOWANCES

There are various allowances available to reduce an IHT liability and are discussed briefly below**.**

ANNUAL GIFT ALLOWANCE

This annual allowance is a total for gifts to one or more individuals every year. The allowance currently stands at £3,000 and may be carried forward by one year.

SMALL GIFT ALLOWANCE

This can be used to make unlimited amounts of small gifts up the value of £250 (you cannot use this to gift to an individual who has received a gift using your annual allowance).

GIFTS IN CONSIDERATION OF MARRIAGE/CIVIL PARTNERSHIPS

The tax-free gift limits are:

- £5,000 to children.
- £2,500 to grandchildren.
- £1,000 to others.

REGULAR PAYMENTS

If you are making gifts out of regular income to help another with their living costs these are tax free.

The gifts must come out of regular income and must not affect the giftor's standard of living.

They do not affect the annual gift allowance.

VALUE ADDED TAX (VAT)

This is classed as a business tax and is charged on some, but not all, goods and services. Businesses registered for VAT must charge it on chargeable items and can reclaim VAT incurred in the production of its's products or services. This is due to the concept that the tax is based on the value that a business adds to a product or service when it is provided.

VAT is attracted at one of the following:

- Standard rate.
- Reduced rate.
- Zero rate.

Check the rates are using the *www.gov.uk* website.

Not all items are chargeable to VAT. The table below gives a list of items that are exempt and items that are currently charged at 0%.

Items Exempt from VAT	Zero Rated Items
Insurance and the arranging of insurance and pensions	Children's clothes
Supply of health & care services, e.g., dentist & nursing home	Most food (unprocessed) and medicines
Supply of education services	Domestic water supply
E-books	Books

The provision of financial advice where the main service is advice, the advice itself attracts the standard rate of VAT. The provision of accountancy or legal services also attract VAT.

STAMP DUTY RESERVE TAX

This is paid on the paperless purchase of shares.

The payment is usually accounted for automatically when the shares are purchased through the CREST electronic trading system.

A bearer instrument could be a share issued by a company where the trade is based on a physical delivery of the share certificate, however the issuing company does not keep a record of the registered share owner.

HEADS OF CHARGE	CHARGED ON	RATE
Bearer Instruments	Market Value	1.5%
Purchase of shares	Market Value (only if market value of shares is greater than £1,000)	0.5%

STAMP DUTY LAND TAX

On the value up to £250,000	0%
On the value between £250,000 and £925,000	5%
On the value between £925,000 and £1.5M	10%
On the value above £1.5M	12%

An example:

If you bought land with a value of £275,000 the Stamp Duty Land Tax would be:

The first £250,000	@	0%	=	£0
The next £25,000	@	5%	=	£1,250
Therefore, SDLT in total			=	£1,250

Please note that there is a 3% addition to these rates if the property purchased is an additional residential property e.g., buy to let. In this case 3% is charged on the whole value in addition to the standard rates.

STAMP DUTY LAND TAX AND FIRST TIME BUYERS

If you are a first-time buyer, buying a property for £425,000 or less then no stamp duty land tax is payable.

If you are a first-time buyer, buying a property for between £425,000 and £625,000 then there is a 5% charge on the excess above £425,000.

CORPORATION TAX

Corporation tax is payable by limited companies and is paid based upon their profits:

Companies that are resident in the UK pay tax on their worldwide profits.

- Companies with profits up to £1.5m the tax is paid within 9 months of their business tax year ending.
- Companies with profits over £1.5m can pay their tax in quarterly instalments.

Do you know what the current rate of corporation tax is? Research this online and compare this rate of tax to corporation tax in other some other countries around Europe/the world.

WITHHOLDING TAX

Withholding tax is necessary to ensure that taxable income or interest earned by a non-UK resident does not leave the country without being taxed. The tax may not be chargeable if there is a double-taxation agreement in place.

Income tax could be thought of as a withholding tax as it is usually paid directly by the employer to the tax authorities, however, a form of withholding tax is aimed at non-UK resident entertainers or performers such as athletes or musicians and is charged at 20%.

Now take some time to research the occupations and forms of income that are subject to withholding tax.

UNIT 1 – TOPIC 5

WELFARE STATE BENEFITS

Learning Outcome	Assessment Criteria
7.	U7.9
Understand the UK taxation and social security systems and how they affect personal financial circumstances.	State Benefits and HMRC Tax Credits

KEY TERMS:

- **Means-Tested**
- **Benefits cap**
- **Contribution-based**
- **Income-based**
- **Triple Lock**

The Department for Work and Pensions (once known as the Department for Social Security - hence the term "social security benefits") is responsible for policy relating to welfare, pensions and child maintenance policy. It provides the state pension and a range of working age, disability and ill health benefits.

The level of state benefits available to an individual could affect the individual's need for protection. It can affect the level of income protection required for an individual who would be entitled to receive ill health benefits if they were out of work due to an illness.

State benefits consider an individual's circumstances when an individual makes a claim for a benefit. The term **means-tested** is used to describe the assessment of the individual's eligibility based on savings and income, the basic principle being that if savings are held and/or income is received, this may preclude the claimant from receiving the benefit.

A further concept sometimes used to determine the eligibility for, and level of payment a claimant receives, is the claimant's previous levels of national insurance contributions (NIC's). Some benefits are therefore payable at a **contribution-based** level (higher) or **income-based** level (lower).

Finally, there is something called a **benefits cap**, which was introduced to limit the total amount that an individual could receive from state benefits. This was introduced to ensure that there are no perverse incentives to being out of work.

State benefits can be broken down into four distinct categories:

1. Support for people who have a low level of income.
2. Support for people raising children.
3. Support for people with ill health or the disabled.
4. Support for people in retirement.

1 Support for people who have a low level of income

Universal Credit

Universal Credit was introduced to simplify the benefit system. The main benefits it replaces are:

- Income Support.
- Housing Benefit.
- Working tax Credit.
- Child Tax Credit.
- Job Seekers Allowance (income-based).
- Employment and Support Allowance (income-based).

If an applicant in receipt of any of these benefits experiences a change of circumstances, they will be assessed against their entitlement to Universal Credit. In terms of the assessment, the general principle applied is one that looks at the household income and/or savings to determine the level of benefit that is paid. This benefit is then means tested on an ongoing basis to determine ongoing entitlement.

Working tax Credit

- Designed to supplement the incomes of the employed and self-employed.

Income Support

- A tax-free benefit for people between 16 and pension age.
- Must have low income and be working less than 16 hours per week.
- Means tested (savings and income).
- Not dependent on previous NIC's.

Job Seekers Allowance

- A benefit for those working less than 16 hours per week.
- Must be actively seeking work.
- The contribution-based form is dependent upon previous class 1 NIC's and is payable for up to 6 months.
- Paid gross but taxable.

Support for Mortgage Interest

For those already in receipt of, or new claimants of certain benefits, a loan is available to help cover the interest costs of a mortgage up to the value of £200,000. The loan is secured against the property and must be repaid when the property is sold or transferred to a new owner.

2 Support for People Raising Children

Statutory Maternity Pay

- Payable to women who have been with their employer for 26 weeks.
- Taxable pay for up to 39 weeks at two rates:
- Weeks 1-6 = 90% average weekly earnings.
- Weeks 7-39 Flat rate or 90% overage weekly earnings (whichever is lower).
- Paid by the employer.

Maternity Allowance

- For those working mothers who don’t qualify for SMP, including the self-employed.
- Paid by the Department for Work and Pensions.
- Not means tested.

Child Benefit

- A tax-free benefit not dependent upon NIC’s.
- Not dependent upon being in receipt of other benefits.
- Payable for each child up to age 16 or 19 if in full time education.
- Means tested by way of income tax where income exceeds £50,000 up to £60,000.

Child Tax Credit

- Payable to those on low incomes.
- Claimant does not need to be in work.

3 Support for people with ill health or the disabled

Statutory Sick Pay

- For employees who are off sick for 4 days or more.
- Employers pay the employee and then reclaim from the DWP.
- Paid for a maximum of 28 weeks.
- Employees earnings have to be above the lower earnings threshold.
- After 28 weeks, you may be able to apply for short term incapacity benefit.
- Benefits are taxable.

Employment and Support Allowance

- Eligibility involves a work capability assessment; outcome will affect the level of benefit payable.
- Contribution-based is not means-tested but is taxable.
- Income-based is not means-tested and is not taxable (now replaced by Universal Credit).

Attendance Allowance

- Payable to those over 65 needing help with personal care.
- Two levels of benefit payable, lower (day or night) and higher (day and night).
- Not means tested and is not taxable.

Disability Living Allowance / Personal Independence Payments

- Being replaced with Personal Independence Payments this is a tax-free benefit for help with personal care and/or mobility.
- Care component – the activities of daily living.
- Mobility component – for those with difficulty with walking.

Carers Allowance

- A taxable benefit payable to someone who is caring for another.
- Not means tested.

4 Support for People in Retirement

The basic state pension is currently available to men and women who have contributed national insurance contributions. For men they must have been born before 1951 and for women before 1953. If born afterwards you may get the single tier state pension (see below).

Basic State Pension

- Payable to the employed and self-employed.
- The number of qualifying years of national insurance contributions required for the basic state pension was 30 years.

From 2028, the state pension age will then increase to 67. In future there will be regular reviews of state pension age, the principle being that people should spend a third of their life in retirement.

Do you know how much single people and couples receive through the basic state pension?
You can find the details here https://www.gov.uk/state-pension

PENSION CREDIT

If you have reached state pension age and you are on a low income, you may be entitled to receive pension credit which tops up your income to a minimum level. If in receipt of pension credit, you may have additional entitlements to other forms of government support.

ADDITIONAL STATE PENSION

These are historic and in essence was known as the state second pension or SERPS, which was replaced by the state second pension (S2P). This was for employees who could opt out of the scheme if their employer ran a contracted-out pension scheme.

SINGLE TIER STATE PENSION (NEW STATE PENSION)

For people reaching retirement age on or after April 2016, a new state pension system has been introduced which will end the system of additional state pensions with a single benefit determined by national insurance contributions.

The maximum benefit is given if you have 35 years' worth of NICs and no pension if you have less than 10 years NICs.

TRIPLE LOCK

This guarantees to ensure that pensioners in receipt of the state pension receive an increase in line with the higher of:

- Consumer Prices Index.
- Average Weekly Earnings Index.
- 2.5%.

UNIT 1 – TOPIC 6

DIRECT INVESTMENTS CASH & FIXED INTEREST SECURITIES

Learning Outcome	Assessment Criteria
2. Understand the main financial asset classes and their characteristics.	U2.1 Cash deposits and money market instruments.
	U2.2 Government securities and corporate bonds and Eurobonds.
7. Understand the UK taxation and social security systems and how they affect personal financial circumstances.	U7.7 Taxation of investments and property.

KEY TERMS:

- **Real rate of return**
- **Fixed interest security**
- **Secondary market**
- **Par Value**
- **Coupon**
- **Cum Dividend / Ex-Dividend**
- **Gilt yield**
- **Debenture**
- **Loan stock**
- **Peer to peer**

This topic looks at the variety of ways that people can invest. There are different levels of risk and reward involved in different financial assets. The principle of risk vs reward applies – the more risk an investor is prepared to take the greater the potential for reward.

The term direct investment means the investor is directly holding the asset as opposed to holding it via a pooled investment (covered in detail in topic 8).

When investing it is important to consider the impact of inflation – the **real rate of return** describes the rate of return after the effect of inflation has been considered. For example, if an investment returns 6% per year, but general inflation is running at 2.5% then the real rate of return is only 3.5%.

BANK AND BUILDING SOCIETY ACCOUNTS

Banks and building societies offer accounts that fall into two main categories, current accounts, and savings accounts.

CURRENT ACCOUNTS

Some banks offer current accounts with additional benefit packages such as breakdown, travel insurance etc. for a monthly fee, called a packaged account. Interest can also be paid on current accounts.

BASIC BANK ACCOUNTS

People who are on low incomes or have very poor credit history may be refused a normal current account, but they will be able to take out a basic bank account.

The major difference with these is that there is usually no borrowing facility, such as an overdraft.

SAVINGS ACCOUNTS

A suitable account to have for short-term providing easy access to savings. This would be particularly useful for an 'emergency fund' which could be called upon to cover unforeseen financial problems.

This sort of account might be desirable for an individual who has spare money for the first time in his/her life.

Term accounts involve the money being locked away for a period of between 1-5 years, sometimes in return for a fixed rate – the longer the term and/or higher the amount held, the higher the rate of interest paid.

Fixed term bonds offer a fixed rate of return if money is saved for a fixed term. Typically, there is no access at all during the period, although these may offer a higher rate of interest.

Interest paid on savings accounts is taxable. However, due to the way savings income is taxed, if you have a low income, you may not pay any tax at all (see topic 3).

OFFSHORE DEPOSITS

These accounts are based outside the UK in places such as the Channel Islands.

These offer the potential of a higher return if saving in a strong currency, but they are also higher risk. One reason for this is that if there is a depositor protection scheme, it may not offer the equivalent level of protection as offered by the Financial Services Compensation Scheme (FSCS). The investment also carries a currency risk due to potential movements in currencies.

Overseas interest is taxable for UK residents, so individuals are required to declare the income to HMRC and pay tax at their marginal rate, or in other words their highest rate of income tax.

It may be possible to claim relief from some or all of this if it has been taxed at source overseas under the double taxation rules.

Do you know what the FSCS is and the levels of protection? You can look them up here https://www.fscs.org.uk These are also covered in Unit 2.

CASH ISAS

- Available to UK residents 16 and over and can only be held in a single name.
- Interest is paid tax free on the current investment limit of £20,000 per annum.

- There is no fixed term and withdrawals can be made at any time.

NATIONAL SAVINGS & INVESTMENTS (NS&I)

National Savings are backed by the treasury and are therefore all low risk. The range of products offered are subject to change.

Check the following website to identify what products are available currently. How are the products described as meeting the needs of different needs or groups of investors? https://www.nsandi.com/

NS&I – DIRECT SAVER

Available for individuals	: minimum age 16.
Minimum investment	: £1 - £2M.
Interest	: variable.
Tax treatment	: interest paid gross but taxable.

NS&I - INVESTMENT ACCOUNT

Available for individuals	: minimum age 16.
Term	: No penalty for withdrawal.
Interest	: variable rate, tiered rates.
Investment	: £20 to £1M.
Tax treatment	: interest paid gross but taxable.

NS&I INCOME BONDS (REGULAR MONTHLY INCOME)

Available to individuals	: minimum age 16.
Investment	: £500 minimum to £1M maximum.
Term	: No penalty for withdrawal.
Interest rate	: variable.
Tax treatment	: interest paid gross but taxable.

NS&I – GUARANTEED INCOME BONDS (NO LONGER FOR SALE)

Available to individuals	: minimum age 16.
Term	: 1 and 3 years.
Investment	: £500 to £1M.

Interest	: fixed.
Tax treatment	: interest paid gross but taxable.

NS&I – GUARANTEED GROWTH BONDS (NO NEW BONDS FOR SALE)

Available for	: minimum age 16.
Term	: 1 and 3 years.
Investment	: £500 to £1M (£2M joint).
Interest	: fixed rate of annual growth.
Tax treatment	: interest paid gross but taxable.

NS&I – GREEN SAVINGS BONDS (USED TO FUND GREEN SPENDING)

Available for	: minimum age 16.
Term	: 3 years.
Investment	: £100 - £100,000.
Interest	: fixed rate of annual growth.
Tax treatment	: interest paid gross but taxable.

NS&I - PREMIUM BONDS (TAX FREE)

Potential gain through a regular tax-free prize draw with prizes of up to £1million per month.

Investment	: £25 minimum and £50,000 maximum.
Interest	: no interest is paid.
Available	: Anyone.
Withdrawal	: anytime but 8 working days' notice should be given.
Tax	: winnings are tax free.

FIXED INTEREST SECURITIES

The name fixed interest security means that a form of contract exists where a **bond** or other **debt instrument** is acquired by an investor in exchange for a fixed rate of interest for the duration of the bond/debt instrument, along with the return of the capital at the end of a period of time.

These instruments are offered by different institutions as a means of raising capital.

Depending on the type of instrument, gains can be made on their sale where they are traded at a profit (negotiable). Gilts for example are bought and sold multiple times in a secondary market where they have already been purchased for a first time and being sold again to a different investor.

GILTS

Gilts are used by the government to raise money. They are very safe as the government is unlikely to default in its payments or the return of capital.

Important!

The Debt Management Office (DMO) issue the gilts and administer the interest payments (coupon) and return of capital at the end of the term (Redemption date). The capital and coupon returned is linked to the face value of the gilt – this is called the par value.

The coupon is paid to the investor twice a year and when gilts are being offered in the secondary market the prospective purchaser will want to know if they will receive the next coupon payment (**cum dividend**) or not (**ex-dividend**).

Gilts can be sold for amounts above or below their par value.

WHAT AFFECTS THE PRICE OF A GILT?

Generally, if a gilt is quoted as Treasury Stock 2020 @ 5%, when interest rates are low, the guaranteed 5% rate is likely to be attractive to investors and they would be prepared to pay more than the face (par value) of the gilt. Therefore, all of the following will affect the price of a gilt:

- movements, or anticipated movements in interest rates.
- the amount of time left on the gilt (the closer to the redemption date the price is likely to move towards par value).
- supply and demand.

As rising and falling interest rates affect the price of a gilt, an investor will be interested in the **gilt yield**. Put simply, this is the total return the gilt will produce taking into account the price paid to purchase the gilt.

Conventional gilts are fixed interest, but **index linked gilts** adjust the coupon and par values according to movements in inflation.

Gilts can be offered over a range of terms, which fall into the categories short, medium, long, and undated.

Depending on where the gilts are being advertised the actual terms for short medium and long will differ as per the table below:

Debt Management Office define as…		Financial Press define as…	
Short	0 – 7 years	Short	0 – 5 years
Medium	*7 – 15 years*	*Medium*	*5 – 15 years*
Long	15 years +	Long	15 years +

Undated gilts have no redemption date and may need to be sold on the open market to recover the capital. The Government have the discretion but no obligation to redeem (repay) the capital at any point.

Remember, when the redemption date is reached the government will only pay the par value of the gilt (plus inflation if linked).

TAXATION OF GILTS

Gains made on the sale of a gilt are **exempt** from CGT.

Interest is paid **gross**, (although you can choose for the interest to be taxed at source).

Gilt interest is taxed as savings income so:

- BRTP pay 20%.
- HRTP pay 40%.
- Additional Rate taxpayer pays 45%.

LOCAL AUTHORITY STOCKS/BONDS

These are similar to gilts except they are issued by a local authority where your investment is secured on local authority assets.

- Term is fixed as is the rate of interest paid half yearly.
- These are **not negotiable** and cannot be sold on the open market.
- Not quite as risk free as gilts and no government guarantee is provided.
- Interest is paid gross but potentially subject to income tax at your normal rate e.g. BRTP 20%, HRTP 40% and ARTP 45%.

PERMANENT INTEREST-BEARING SHARES (PIBS)

PIBS are from **Building Societies** to raise capital, although new PIBS can no longer be issued:

- PIBS not covered by the Financial Services Compensation Scheme and therefore rank behind account holders in priority of payment should the building society become insolvent.
- Interest is fixed and paid half yearly.

- Interest is paid gross and is potentially subject to income tax as with gilts at either 20%, 40% or 45%.

CORPORATE BONDS

These are issued by companies to raise money. There are different grades of bond depending on the credit rating of the issuing company. To offer investors greater security they can be secured against the company's assets. This is referred to as a **debenture**. Debenture holders have priority over other creditors on liquidation.

Unsecured bonds are often referred to as **loan stocks.** Whether the bond is secured or not, the holders of these type of debt instruments take priority over the shareholders on liquidation.

- Fixed rate of interest, a fixed redemption date and a fixed return.
- Like gilts, they can be bought and sold for amounts above their 'face value'.
- A much higher risk than gilts but potentially a higher reward.
- The interest payment is paid gross but is subject to normal income tax rates as with gilts.
- Some corporate bonds give the holder the right to convert the loan to ordinary shares but there is no obligation to do so.

EUROBONDS

These are usually issued by multi-national companies or governments who want to raise capital in a different currency. They do not refer to the euro currency.

A U.K. company might raise some capital in U.S. dollars; however, it will issue that bond to an investor in dollars. This may be a cheaper alternative to borrowing directly from a U.S. bank.

ALTERNATIVE FINANCE

Sometimes called **peer to peer lending** (P2P), this investing involves a saver placing their money with a lender who will then lend out money to businesses that are seeking funding, e.g., Funding Circle.

The returns can be very good, but the risks are that the returns would reduce if repayments on the loan by the business are missed. Also, there is no Financial Services Compensation Scheme protection for these schemes. Peer to peer lending can be both deposit based, where funds are aggregated and then borrowed by businesses or investment based, where investors receive a number of shares in the start-up business.

Another form of alternative finance is **crowdfunding**. This is where individuals can contribute towards a specific charity or business venture without expecting anything in return. Some crowdfunding campaigns fund business start-ups and may result in the contributor receiving a free trial, service or product.

UNIT 1 – TOPIC 7

EQUITIES & OTHER COMPANY FINANCE

Learning Outcome	Assessment Criteria
2. Understand the main financial asset classes and their characteristics.	U2.3 Equities U2.4 Real estate – residential and commercial.
3. Understand the main financial services product types and their functions.	U3.1 Direct investment – cash, government securities and corporate bonds, equities and property, commercial money market instruments, enterprise investment schemes (EIS) and venture capital trusts (VCT).
7. Understand the UK taxation and social security systems and how they affect personal financial circumstances.	U7.7 Taxation of investments and property.

KEY TERMS:

- Equities
- Diversification
- Over the counter
- Market Capitalisation
- Alternative Investment Market
- Primary and secondary market
- Floatation
- Dividend cover
- Price/earnings ratio
- Money market instruments
- Zero-coupon security

This topic looks at more direct investments. By owning equities (shares) the investor usually has a controlling interest in the issuing company. The main market participants are institutions like life assurance companies and pension funds. Individual investors also participate in the markets.

ORDINARY SHARES

Individuals holding ordinary shares have two main rights:

- To receive a share of the profits through dividends.
- To vote at shareholders' meetings.

Investment in shares is **high risk** as there is a danger of losing all the capital investment. This risk can be reduced through **'diversification'**. This strategy mitigates the risk of investing in shares as the investment is spread across a number of companies or sectors so the chances of a fall in the value of those shares as a result of companies failing is vastly reduced.

THE STOCK MARKET

The Stock Exchange is the market for selling shares and it is both a primary and secondary market.

- A primary market is when shares are created originally, usually via a **flotation.**
- A secondary market is where investors buy and sell existing shares.

The individual price of a given share is based on supply and demand where the share price can move quickly in upward and downward directions. Share prices can be described as being volatile with many potential factors affecting share values.

THE MAIN MARKET

A full listing in the main market is only available to very large companies able to meet certain requirements, such as having at least 25% of the share capital in public hands and having been trading for at least 3 years.

Now research the term **Market Capitalisation** and make a definition of this in your notes.

THE ALTERNATIVE INVESTMENT MARKET (AIM)

This is for newer, smaller companies where the membership rules are less strict. As the companies are less well established there is **greater growth potential** in investing in these companies. Listing shares in the AIM market can help raise the company profile.

Investing in these companies is considered higher risk than investing in the main market.

MARKET INDICES

It is easy to follow the overall performance of shares by following one or more of the various indices. The main index is operated by the Financial Times Stock Exchange (FTSE) via the London Stock Exchange, which is both a primary market and secondary market.

- FTSE 100 – top 100 companies measured by market value.
- FTSE 250 – the next 250 companies in the list.
- FTSE 350 – FTSE 100 and FTSE 250.
- FTSE All Share – approximately 600 companies split into sectors.

Please note that anyone can participate and invest in the stocks and shares market, however large institutions most commonly engage in **over the counter** (OTC) trading where large amounts of shares are bought and sold with very little publicity about the transaction.

RISK AND REWARD

As we have said, shares are considered high risk-high reward. The shareholder will lose what they have invested if the company goes into liquidation.

Shareholders have no liability for the debts of the company. The company itself is liable for those debts as it is a separate legal entity.

Over time, shares and other asset backed investments have outperformed deposit-based investments, attracting investors who are aiming for capital growth as well as investors who are looking for an income. Shares are generally considered to be best suited to investors wishing to invest over the medium to long-term.

FINANCIAL RETURNS FROM SHARES

There are 2 ways in which people are interested in investing in shares:

- Income – in receiving an annual income through distribution of dividends.
- Capital – through seeing the growth of the share price leading to eventual encashment for a profit.

Companies however are not obliged to distribute dividends to shareholders. Apart from paying dividends to reward their owners, they may choose to pay dividends to generate interest in that company by other prospective investors.

When dividends are to be paid there are ways of judging the success of that investment:

- **Earnings per share** – net profit divided by the number of shares.
- **Dividend Cover** – where a company pays 25% of its profits in dividends that dividend is said to be covered 4 times. Where a company pays 50% of its profits in dividends it is said to be covered 2 times. A dividend cover of 2.0 or more is considered acceptable. A dividend cover below 1.0 could be indicating that the company is paying dividends from profits from previous years from retained surpluses (company reserves).
- **Price/Earnings Ratio** – Share price divided by earnings per share. Shares with a low P/E Ratio (less than 4) have poor growth prospects. Shares with a P/E Ratio of 20 or more are considered growth stocks, so the indicators are showing that these shares with a high P/E ratio are likely to continue to rise.

TAXATION OF SHARES

Gains made on the sale of shares are subject to CGT.

Dividends received from the profits of company to shareholders are paid without deduction of income tax.

Can you recall what the dividend allowance is from the tax table?

If dividend income exceeds the allowance, further tax would have to be paid via self-assessment (see topic 3).

RIGHTS ISSUE

When a company issues more shares to existing shareholders at a discount. The existing shareholder does not have to take up the option. Stock Exchange rules require that when a company has shareholders and they are looking to raise capital by issuing more shares, those shares must be offered to existing shareholders first.

SCRIP ISSUE/BONUS ISSUE/CAPITALISATION ISSUE

This is where a company issues new shares to existing shareholders for free. It is paid from by the company capitalising its profits, so this may also be referred to as a capitalisation issue, though more usually it is referred to as a scrip issue.

There is no additional capital raised here, but the number of shares is increased. They are awarded to existing shareholders at a given ratio, for example 1 new share for every 4 held. As the number of shares is increased the share price is reduced and this can encourage further investment in the shares.

PREFERENCE SHARES

These shares rank above ordinary shareholders when dividends are paid out and on liquidation.

Dividends are **generally,** but not always fixed.

These shares do not usually carry voting rights, but holders could acquire them if dividends have been delayed.

CUMULATIVE PREFERENCE SHARES

Preference shareholders rank above ordinary shareholders for the payment of dividends and on liquidation.

The level of dividend can be, but is not always, fixed.

If dividends are not paid, potentially due to low levels of profit, the entitlement to dividends rolls over to future years until they can be paid (cumulative preference shares). These give an investor more certainty of receiving a future dividend payment.

CONVERTIBLE PREFERENCE SHARES

Traditionally these were corporate bonds issued by a company when they want to raise capital which carry the right to be converted later to ordinary shares.

In recent years however, they have been increasingly issued as convertible preference shares that carry the right to be converted to ordinary shares later, for example when the company offers shares to the public for the first time (floatation).

WARRANTS

Warrants are usually issued to seed investors as a sweetener, and they give the holder a right to buy the company's ordinary shares in the future at a fixed price.

The holder has the possibility therefore of buying the shares at a fraction of their true worth on or before an agreed future date.

If the prevailing share price is higher than the warrant price at the time of the purchase, the warrant holder can realise a profit.

If the share price on that future date is below the price offered by the warrant, then it will not be worth exercising the warrant, in which case the right lapses and nothing is lost.

INVESTMENT PROPERTY AND BUY TO LET (BTL) MORTGAGES

Investment in property is popular as rents and house values tend to move in line and often above the rate of inflation providing built in indexation. As returns are often above inflation this means property can provide a useful way of reducing losses with the investment (hedging).

Property has the added benefit of being acceptable as a form of security when used to borrow money.

Some of the disadvantages are:

- Periods without tenants.
- Recessions can make that property difficult to let.
- Investment costs can be high e.g., Stamp Duty, legal fees.
- Property may not be as easily marketable as other investments, or in other words it may take time to sell that property (illiquid).
- As with shares, investment property could be seen as risky for the small investor. For those with smaller amounts of capital, property bonds might be appropriate whereby the fund is invested in a range of properties and shares in property companies, which means you are spreading the risk.

TAXATION

Income from property is subject to income tax after deduction of allowable expenses.

On disposal, any gain is potentially subject to CGT. Any CGT liability must be settled within 60 days.

Can you remember the rate of CGT on residential property?

MORTGAGES FOR INVESTMENT PURPOSES

Historically, lenders viewed these as commercial loans and are usually charged at higher interest rates.

The Government has introduced some measures that could limit the attractiveness of the buy to let market which include:

- Second properties are now subject to a 3% stamp duty surcharge.
- The wear and tear allowance of 10% has been replaced. The rules for the deduction of expenses allow only the actual cost of replacement of furnishings to be offset against profits.
- Previously, a BTL landlord could deduct the full cost of mortgage interest from the rental income when calculating profits. This has now changed to a tax credit of 20% instead.
- There is also the option to invest in commercial property which is defined as any property that is not wholly residential.
- Commercial properties tend to provide high rental income with normally steady growth in capital value. However, interest rates may be higher than for residential loans.

OVER THE COUNTER TRADING

This refers to the trading of a range of different types of securities in large quantities, often between firms rather then individual investors. The trades take place with very little publicity and is sometimes referred to as “dark pools”.

MONEY MARKET INSTRUMENTS

This is the generic term to describe a number of forms of short-term investment. Interest is not normally paid during the term of the transaction, but there will be a form of interest in the difference between the amount invested and the amount repaid.

There are various types – see below:

TREASURY BILLS

Like gilts, these are issued by the Treasury’s Debt Management Office, but they differ from gilts in that:

- They are for short terms normally 91 days.
- They are **‘zero coupon’** securities so no interest is paid and are instead issued as a discount to the **par value**.

Like gilts, these are very low risk as the government will not default on the return. These are usually purchased in exceptionally large amounts and therefore are of little interest to the small investor. As with gilts, they can be bought and sold on the **secondary market**.

CERTIFICATES OF DEPOSIT

These are short term investments typically for periods of 3-6 months for larger amounts of money usually more than £50,000.

They are issued by **banks** and **building societies** on a **fixed rate of interest** which will be paid along with a return of capital at the end of the term.

COMMERCIAL PAPER

This is used by some businesses that are looking to raise money to get some **working capital**.

The commercial paper is an unsecured ‘promissory note’ to repay the capital plus interest.

The transactions are usually for very large amounts and may well be accompanied by a letter of credit from a bank, which guarantees to make repayment if the borrower defaults.

The terms are short, for example 45 days.

UNIT 1 – TOPIC 8

COLLECTIVE INVESTMENT SCHEMES

Learning Outcome	Assessment Criteria
3.	U3.2
Understand the main financial services product types and their functions.	Collective investments – structure, tax, and charges – OEICs / unit trusts, investment trusts, life assurance contracts, offshore funds, and structured products.
7.	U7.7
Understand the UK taxation and social security systems and how they affect personal financial circumstances.	Taxation of investments and property.

KEY TERMS:

- **Open-ended**
- **Closed-ended**
- **Unit-linked**
- **Actively managed funds**
- **Passively managed funds**
- **Accumulation funds**
- **Distribution funds**
- **Offer/Bid prices**
- **Gearing**
- **Qualifying life policy**

In the last topic we looked at direct investments. A collective investment is classed as an indirect investment because rather than buying shares or gilts directly the investor buys units or the shares of a company that has invested in shares of other companies or gilts etc. This allows the investor to achieve a greater amount of diversification than they would be able to achieve by holding investments directly.

With collectives investors pool their own funds with other investors. There are a range of different types explored in this topic.

Collective investments are categorised as having a 'medium risk profile'. The main benefits that relate generically to collective investment schemes are:

- Access to a skilled professional investment manager with the cost of this service shared by all investors.
- Minimal research is needed by the investors.
- The risk is spread through investment in a wide range of funds (diversification.)
- Investment managers can negotiate reduced dealing costs due to the scale of sums being invested.
- Wide choice of funds to cater for risk profiles and investment preferences.

UNIT TRUSTS

At the time of writing there are over 300 separate unit trusts operating in the UK. These are collective investments set up under trust law. When the investor buys into the fund, they receive units in the fund.

WHAT IS A UNIT?

In a collective, the principle is that securities/assets are amalgamated into one fund. The fund is then split according to the number of units held by investors with each unit representing a proportionate value of the total value of the fund.

As we have stated, large numbers of investors contribute to a large single fund and the fund value is divided into units with the unit price being a small fraction of the total value in the fund.

As more people invest the fund gets bigger. The price of the units varies as the size and value of the assets within the fund changes.

Unit trusts are classed as **open-ended**, which means there is no limit to the number of new investors that can participate in the fund.

TRUST DEED

The unit trust is created under a trust deed, which sets out the terms of the unit trust including the powers of the trustees & the fund manager. The trust deed places legal obligations on both trustees & fund manager (see trusts in topic 16) which affords security to the investors (unit holders.)

MANAGED FUNDS

An **actively managed** fund is where a fund manager is intervening and making individual decisions on a regular basis as to the buying and selling of assets.

A **passively managed** fund, which might be set up just to follow a stock market index such as the FTSE All share where the asset selection will be determined by algorithms.

You can have collective investments where the primary objective is **capital growth** at the expense of **income,** or you can have a collective investment which aims to produce a **high level of income** with **modest capital growth.** It is possible also to have a **balance** between income and growth.

UNIT TYPES

- **Accumulation** – where the objective is capital growth – any income/gains are **reinvested in the fund.**
- **Distribution –** designed to produce income through **distributions** to the investor.

Because investment is spread among between 30 and 150 companies and are created under the structure of a trust, unit trusts are classed as medium risk.

To understand how it works in more detail, consider the roles of the key parties involved.

ROLE OF THE FUND MANAGER:

- The fund manager is responsible to the trustees.
- Manages the trust fund and values the assets.
- Sets the price of the units.
- Sells units to investors at the **offer price.**
- Buys back units from unit holders at the **bid price.**
- Issue the **contract note** (useful for calculating tax liabilities.)

The fund manager is obliged to buy back units from investors when the investor wants to sell. This feature can make unit trusts particularly attractive to investors.

ROLE OF THE TRUSTEES:

- Trustees are often high street banks and have a role to ensure fund managers comply with the Trust Deed.
- Trustees must ensure that there is sufficient investor protection in place to comply with the FCA.
- Approve marketing materials.
- Collect and distribute income.
- Keep the register of unit holders (investors).
- Issue the **unit certificate** (proof of ownership).

Pricing of Units

There are four important unit prices:

1. **Creation Price –** This is the price of creating new units determined by the fund manager and includes dealing costs.
2. **Offer Price –** fund manager sells to investors at this price.
3. **Bid Price –** fund manager buys back from unit holders at this price.

The difference between the offer and bid prices (3-5%) represents the management charge for the fund manager. This is called the **bid/offer spread.**

4. **Cancellation Price** - when there are investors, both buying and selling the bid price will generally be higher than this. If there are more people selling than buying the cancellation price may be used. This effectively becomes the minimum permitted bid price when invoked.

Please note that most unit trusts are now set up without a bid/offer price to avoid confusion with investors, but there may be an exit charge with these if they are sold within 3-5 years.

HISTORIC AND FORWARD PRICING

- Historic – units are sold at the previous day's valuation (rarely used).
- Forward – units are sold at the next valuation (at the end of the day).

CHARGES

- Bid/Offer Spread (this can be seen as an initial charge).
- Annual Management Charge e.g., 0.5 to 1.5% (although annual charge it may be paid monthly).

TAXATION OF UNIT TRUSTS

Unit trusts can be **equity unit trusts** where the underlying investment is predominantly in shares and therefore any income that comes from the unit trust is treated as dividend income and subject to dividend taxation rules.

Income received from equity unit trusts is classed as dividend income and is subject to dividend taxation rules.

A **fixed interest unit trust** however is where the underlying investment is in interest bearing securities such as gilts and stocks.

Any income is treated as interest and subject to the savings interest taxation rules. Interest is paid gross and may be taxable (through self-assessment according to the tax-payers tax band).

Note:

A fixed interest unit trust is defined as having at least 60% of the investment in interest bearing investments such as gilts, corporate bonds, interest bearing accounts.

CAPITAL GAINS

Gains within the fund are exempt from CGT. However, when the unit holder sells their units, gains are subject to CGT at the investors prevailing rate. The tax liability therefore is in the hands of the investor.

OPEN ENDED INVESTMENT COMPANIES (OEICS)

This is another type of collective investment that has many similarities with Unit Trusts.

As an OEIC is a company it is set up under company law. OEIC's may be structured as an umbrella company made up of several different funds.

The investments are managed by an **Authorised Corporate Director (ACD)** who is overseen by a **Depositary**.

The authorised corporate director performs the same role as the fund manager for a unit trust and the Depositary is independent and fulfils a similar role to that of the Trustees of a unit trust. As the ACD must buy shares back from investors it is relatively easy for investors to get access to their capital.

Like unit trusts, OEIC's are unable to 'gear' (unless this is for short term needs only where there is known cash-flow to match the borrowing to.)

INVESTING AND PRICING

Investors buy shares in the OEIC, which is **open-ended,** the company can issue more shares according to demand. The value of the shares is based on the value of the underlying investments (as is the case of unit trusts).

The OEIC can invest in a variety of funds and switches between funds are common.

OEIC shares are single priced, which means they are bought and sold at the same price on any given day.

There is **no bid/offer spread** and OEIC shares tend to be priced on a **forward** basis.

OEIC CHARGES

- An Initial Charge is between 3 - 6% of the investment.
- The Annual Management Charge is between 0.5% to 2%.
- A **dilution levy** (charged on large flows of funds in or out of the OEIC).
- Other administration charges may also be deducted from income.

TAXATION OF OEICS

Taxation of OEICs is identical to unit trusts and investment trusts. If the OEIC is based offshore a UK resident is still liable.

Depending upon whether the OEIC is fixed interest or equity based, tax liabilities will arise under the savings tax system or the dividend tax system (depending on the investors tax status.)

INVESTMENT TRUSTS

Despite the name, these are **not** actually trusts at all but investment companies whose business is to invest in stocks and shares of other companies.

The investment trust is governed by the **company memorandum and articles of association**, just like other companies.

Important!

What a company does and what powers it has are set out in the Company Memorandum. The ownership and powers of the Directors are set out in the Articles of Association.

Investors buy shares in the investment trust company, which is not actually FCA authorised like a Unit Trust is but must meet FCA requirements to be listed on the stock exchange.

The share price can sometimes be sold at a **discount** to its **net asset value** (NAV), which gives the potential for greater returns.

As an investment trust invests in the shares of other companies, if shares are trading at a **discount** (to the NAV) the cost of the individual shares is lower than the cost of buying the shares directly.

Net Asset Value (NAV)

Total value of investment fund divided by the number of shares

The number of shares with an investment trust remains constant, so an investment trust is **closed-ended.**

GEARING

One advantage is that investment trusts are able to benefit from 'gearing' which is the ability to borrow to further investment aims. This gives the ability to enhance the growth potential in a rising market. However, in a falling market, losses can be increased.

INVESTMENT TRUSTS AND SPLIT CAPITAL INVESTMENT TRUSTS

With investment trusts, the **standard rule** is that at least **85% of the income generated** must be passed on to the shareholders as **dividends**. The exception to this rule is if it has been set up as a split capital investment trust.

Split capital trusts or **splits** are **fixed term** investment trusts offering two or more different types of shares:

Income shares – receive the whole of the income generated but no capital growth.

Capital shares – receive no income but receive all the capital growth.

TAXATION OF INVESTMENT TRUSTS

Investment Trusts from a dividend taxation point of view are treated exactly the same way as Unit Trusts and stocks and shares. CGT would potentially apply on the sale of the shares in the normal way.

REAL ESTATE INVESTMENT TRUSTS (REITS)

A REIT (pronounced 'reet') is another form of collective that allows private investors to invest more tax efficiently in property in the form of an investment trust, without the risks associated with direct property investment.

REIT's do not have to pay corporation tax provided that:

- At least 75% of income is from rent.
- At least 90% of net profits go to the shareholders.
- No individual shareholder to own more than 10% of the shares.

NON-MAINSTREAM POOLED INVESTMENTS

The previous examples of collective investments can be sold to the public, if they adhere to the rules set out in the FCA handbook.

There are, however, some unregulated collective investments (UCIS) that have the freedom to invest in non-traditional schemes such as wine, classic cars, crops etc.

These are only considered suitable for a very small group of high-net-worth individuals.

FRIENDLY SOCIETY PLANS

These are also collective investments and they do have tax advantages, but the maximum investment is **£270 per year** lump sum or £25 per month or £75 per quarter for a 10-year term. There is no tax on encashment.

INVESTMENT BONDS

These are **single premium**, unit linked, **non-qualifying** whole of life policies.

WHAT IS A QUALIFYING LIFE POLICY?

If a life policy is "qualifying" it means the policy proceeds are paid tax free on death or maturity, but since some life policies contain an investment element there are rules that determine if the life policy can qualify for this advantageous tax treatment.

The rules are as follows:

- Premiums must be payable for at least 10 years or three quarters of the original term if cancelled.
- The premium must be a regular premium, at the very least payable annually.
- Premiums in any one year must not exceed twice the premiums in any other year, or one eight of the total premiums payable.
- The sum payable on death must be at least equal to 75% of the total premiums payable.

As we can see, because the investment bond is a single premium, it is designated as non-qualifying.

HOW DO INVESTMENT BONDS WORK?

Premiums paid into investment bonds are invested into different assets such as property, shares etc.

The investor is allocated units in their chosen fund and can switch funds easily, usually without charge. The investor can redeem the investment bond by surrendering it and the value received will depend on the value and number of units held.

In the event of the investor's death the policy ceases and pays out 101% of the bid value.

All the benefits that come out of the policy are deemed to have already been taxed at 20% on income and gains within the fund (the life assurance company pays tax at a rate of 20% on returns within the fund.)

An additional tax liability may arise if the policy holder is a higher rate taxpayer (see below).

TAKING AN INCOME FROM INVESTMENT BONDS

Although investment bonds are intended for capital growth, it is possible to take an income through 'partial surrenders 'of capital.

Up to 5% of the original investment may be withdrawn each year up to a total of 100% of the original investment without incurring an immediate tax liability. This is because the tax is **deferred** (not exempt.)

Five per cent can be taken for up to a total of 20 years (100% of the investment.)

This tax deferred feature is particularly attractive to higher rate taxpayers as deferring any liability to retirement may result in there being no further liability, assuming that the bond holder has become a basic rate taxpayer (income and gains have been taxed at 20% within the fund already.)

STRUCTURED PRODUCTS

A structured product could be deposit or investment based. A characteristic is that they offer protection (in some cases up to 100% return of the original capital) alongside the chance to benefit from the growth in the stock market.

They appeal to investors who are wary of the downside of the stock market but who would like to share in stock market growth possibilities. One unusual feature is that Structured products can be contract based, so there is an agreed level of return known at the outset. This means that provided the investment returns fall between agreed parameters, the investor will know in advance what level of return will be received.

The downside is that while the capital is less at risk, the investor is only exposed to modest returns.

STRUCTURED CAPITAL AT RISK PRODUCTS (SCARPS)

These are other types of structured products where the return of capital is not guaranteed if a stock market index such as the FTSE fell sharply. These are higher risk than non-SCARPs.

NON-SCARP STRUCTURED INVESTMENT PRODUCT

Provides a minimum return of 100% of the capital provided the issuer of the financial instrument does not become insolvent.

SUSTAINABLE FINANCE

Some individuals have a preference towards investing with an ethical and/or environmentally conscious approach. This is achieved by selecting assets that are marketed as "socially conscious" or "sustainable" taking into account environmental, social and governance factors (ESG). Material factors marketed in this way might refer to the way firms treat their employees, how sustainable they are in their processes or whether they are recognised for paying a fair amount of tax.

"Greenwashing"

Potentially mis-leading claims by firms who exaggerate environmental credentials when marketing their investments

Although the ability to invest taking account of ESG issues is a positive factor for some investors, there is a risk that claims made by related firms are not substantiated in reality. This has led to the regulator introducing labelling requirements so investors can rely upon the validity of the claims when products are being marketed.

In recent times firms that have adopted ESG measures have done better than their competitors with socially responsible funds generally having performed well. On the other hand, these firms tend to be smaller and less established which makes them more volatile. Funds are likely to have higher costs as they tend to be actively managed and therefore there is less opportunity for diversification for ESG minded investors.

CRYPTOASSETS

Many people have heard of Bitcoin. This is because it is by far the most popular version of cryptocurrency having been first introduced in 2008. Since its introduction however, many other types of cryptoassets that have come into existence. We explore some of the basics of cryptoassets here:

CRYPTOASSETS

A store of value which can be exchanged or transferred digitally

Cryptoassets are held either in a wallet or via a platform. The ownership of the assets is proven using computer code. They do not exist in physical form. A qualifying cryptoasset is a digital representation of value or contractual right that can be transferred or stored electronically, however, the management of cryptoassets systems are outside of central banking systems and so do not offer the same security as other forms of currency.

There are three officially recognised forms of crypto asset:

- Exchange tokens
- Utility tokens
- Security tokens

Central to the operation of cryptoassets are the exchanges where they are bought and sold.

Currencies can be acquired with simple credit card or bank transactions. Transactions using cryptoassets then take place via a system of Distributed Ledger Technology (DLT) such as "Blockchain". Participants called "nodes" compete to solve computational puzzles which validates and creates audit trails of transactions.

Investing in Crypto assets is considered to be very high risk mainly due to the volatility in values they can experience.

As cryptoassets cannot be easily relied upon to act as a store of value, a newer form of cryptoassets called "stablecoin" has become popular. Stablecoins are a form of cryptoasset that can exist in the same ecosystems as other cryptocurrencies, offering more stability when pegged to fiat currency. Central banks and regulators have begun to look into how to integrate "stablecoins" within the regulated ecosystem.

REGULATION OF CRYPTOASSETS

Until recently the FCA had minimal involvement in the trading of cryptoassets, restricting their involvement to overseeing AML and terrorist financing controls. However, from October 2023 the FCA have overseen qualifying cryptoassets for financial promotions and require firms who market to UK consumers to be authorised.

Additionally, firms must provide first-time investors with a 24-hour cooling off period, client appropriateness tests and offer client categorisation features.

UNIT 1 – TOPIC 9

TAX WRAPPERS

Learning Outcome	Assessment Criteria
3.	U3.1
Understand the main financial services product types and their functions.	Direct investment – cash, government securities and corporate bonds, equities and property, commercial money market instruments, enterprise investment schemes (EIS) and venture capital trusts (VCT).
	U3.4
	Tax incentivised savings.

KEY TERMS:
- **Additional Permitted Subscription**
- **Annual contribution limit**
- **Stakeholder**
- **Start-up company**

The government has a long history of offering tax incentives designed to encourage people into a savings and investment habits. In this topic we will look at some of the main ways in which these incentives are offered.

INDIVIDUAL SAVINGS ACCOUNTS (ISAS)

This is the government's tax efficient saving scheme and is available to UK residents on an **individual basis only**.

There is a **cash ISA** where your money is invested into an account with an interest rate and there is also a **stocks and shares ISA** where your money is invested into different stocks and shares.

You must be 18 or over to invest in the equities element of an ISA and 16 or over for the cash ISA.

A stocks and shares ISA could also include gilts, corporate bonds, unit trusts, OEICs, investment trusts and life assurance policies.

An innovative finance ISA can include peer to peer lending and long-term asset funds made up with property and open-ended property funds.

An **annual contribution limit** applies, and this can be split in any way between cash and stocks and shares. The contribution limit may be subject to change but is currently set at £20,000 per tax year.

The main benefit of an ISA is that it protects any returns from the effect of tax. The investor also has the flexibility to make payments as and when they want.

Transfers between ISA's are usually possible, and providers sometimes offer the flexibility to withdraw and replenish contributions within the same tax year, although they are not obliged to do so.

Research the annual contribution limit online. When was this last increased? Why has it increased in the past?

ADDITIONAL PERMITTED SUBSCRIPTION

On the death of an ISA holder the deceased person's spouse or civil partner can invest inherited funds for a maximum period of 3 years without it affecting their own annual contribution allowance.

HELP TO BUY ISA

A Help to Buy ISA was available from December 2015 up to 30 November 2019 and was designed to help the purchase of a first home. Account holders that opened before the end of November 2019 can retain the HTB ISA, but no new accounts were allowed after that date. Home purchases must be made by December 2030.

The HTB ISA enabled a deposit of £1,200 initially and then up to £200 per month could be added. Each £200 deposited gives a further £50 bonus (25%), which is paid when the house purchase completes. The maximum bonus overall is £3,000 and savings of £12,000 would produce a maximum government bonus of £3,000.

The minimum bonus is £400, and you must have at least £1,600 in the Help to Buy ISA to be eligible for the 25% bonus.

LIFETIME ISA (LISA)

This was introduced in April 2017 with the aim of encouraging people to save for their first home in the UK up to a value of £450,000 and/or for their retirement on reaching 60.

A lifetime ISA can be opened by anyone between the ages of 18-39.

A maximum of £4,000 per year can be saved and there is no monthly savings limit.

Savings made before the age of 50 attract a 25% bonus paid by the government, which is paid monthly so you can get interest on this. The 25% bonus is lost, and a penalty is also applied to part of the saver's own contributions if withdraw for any other reason other than purchase of a first home, reaching 60 or the holder suffering a terminal illness.

You can contribute to both a Help to Buy ISA and a Lifetime ISA, but the bonus payment to purchase your first home can only come from one of them.

It is possible to transfer funds from a Help to Buy ISA to a Lifetime ISA, subject to the annual allowance contribution of £4,000.

CHILD TRUST FUND (CTF)

This is a tax-free savings account for children born on or after 1 September 2002 where the government provided an initial voucher of £250 to open an account.

It was withdrawn in the 2010 emergency budget, but existing accounts can continue although no further government contributions will be made.

There are several types of CTF including:

- Deposit,
- Stock and shares,
- Stakeholder (charges are restricted to 1.5% of the fund),

In response to the CTF being withdrawn, Junior ISAs became available in 2011 for all children who do not have a child trust fund account.

At age 16 the holder of the junior ISA can become responsible for the ISA, but they cannot access the fund until they become 18 at which point it turns into a normal adult ISA.

Just as with normal ISAs, cash and stocks and shares elements can be combined.

Use the following link to read up on **stakeholder products**. Make a note about why they were introduced and at whom they were aimed. *Stakeholder Products*

VENTURE CAPITAL TRUSTS (VCT)

A VCT works like a standard investment trust. When you invest you are buying shares in the VCT company rather than the shares of the companies the VCT invests in.

The VCT usually invests in start-up companies (young or early-stage companies) with good growth prospects. The VCT might sell the shares in the companies it has invested in when they become more established, and when the shares have increased in value.

Due to the risk element and to make it more attractive to support investment in these companies, income tax relief may be claimed upfront at 30% on investments up to **£200,000** per tax year (investment must be held for 5 years).

There is **no CGT** if you sell your shares and no tax due on the first £200,000 of **dividends**.

ENTERPRISE INVESTMENT SCHEMES (EIS)

This is a similar scheme to VCT, but the main difference here is that the investor is buying shares directly in one specific company, usually a start-up company. **Income tax relief** is awarded at 30% on investments up to **£1,000,000 per tax year**. To achieve this tax relief, it is set against an income tax bill.

Investments in an EIS company are exempt from CGT, provided the shares are held for at least 3 years, the company maintains its EIS status and the income tax relief has been claimed.

Both VCT's and EIS must be approved by HMRC.

UNIT 1 - TOPIC 10

PENSION PRODUCTS

Learning Outcome	Assessment Criteria
3.	U3.4
Understand the main financial services product types and their functions.	Tax incentivised savings.

KEY TERMS:

- **Defined contribution**
- **Defined benefit**
- **AVC & FSAVC**
- **Annuity**
- **Open Market Option (OMO)**
- **Pension Commencement Lump Sum (PCLS)**
- **Money Purchase Annual Allowance (MPAA)**
- **Lifetime Allowance**

As we saw in the previous topic, the government are keen to encourage individuals to save and this is especially the case when it comes to saving towards retirement. It is widely accepted that the level of income provided by the state pension alone is rarely sufficient for most people to enjoy a comfortable standard of living during their retirement. In this topic we will explore the tax incentives offered by the government to encourage individuals to make separate provisions.

One of the main attractions of pension funds which include personal pension plans, stakeholder pension plans, AVCs and FSAVCs is that, like an ISA, the fund does not have to pay CGT whatsoever, no income tax on savings income and no higher rate or additional rate income tax on dividends.

The advantage that a pension has over an ISA is that a pension fund benefits from the tax relief given on pension contributions, which is not available on an ISA.

We will look at the two main types of private pension; occupational (work related) pensions and personal pensions, as well as some of the ways in which pension benefits can be accessed at the relevant time.

OCCUPATIONAL PENSION SCHEMES

There are 2 main types:

Defined Contribution.

With this type of pension scheme a fund is built up through investment based on agreed contributions, but the actual level of income provided in retirement depends on how well the investment has performed.

Final Salary Scheme – this is also known as **Defined Benefit.**

This type of pension provides a defined level of income based on a fraction, the number of years worked for the employer and the final or average salary.

An example based on a 1/60th scheme: if the number of years worked was 20 with a final salary of £40,000 the pension at retirement would be £13,333 (20 / 60 = 0.33 x £40,000).

Note: If the employee took a cash lump sum this would reduce the level of pension received.

Final salary schemes are expensive for employers due to the need to ensure sufficient funds are available to meet the costs of the pension liabilities. Increased life expectancy has exacerbated the cost issues with most occupational pension schemes now operating on a defined contribution basis.

As occupational pensions have not always provided an adequate level of pension there are ways individuals can contribute more to their pension arrangements (see below).

ADDITIONAL VOLUNTARY CONTRIBUTIONS (AVC)

Employers who provide occupational schemes are obliged to also provide facilities such as AVCs to help employees increase their pension fund (less often these could be used to buy added years on a defined benefit scheme.)

AVC's are made from the employees' gross salary so receive full tax relief.

Free Standing Additional Voluntary Contributions (FSAVC)

This is where an individual makes additional contributions to a different fund provided by a different pension provider than the one the company uses while still receiving the same tax advantages as with the employer scheme.

One advantage of this is that you are keeping this fund separate from your employer, but a disadvantage is that it can be more expensive.

As the contributions are made from taxed income the tax relief has to be reclaimed through a self-assessment tax return.

WORKPLACE PENSIONS – AUTO-ENROLMENT

From October 2012 the rollout of workplace pensions commenced whereby larger employers had to automatically enrol their employees into a workplace pension and contribute to the scheme.

It applies to all employers for employees:

- Not already in a pension.
- aged 22 or over.
- under state pension age.
- earn in excess of £10,000.

- working in the UK.

The employee can choose to opt out but only after they have automatically been made a member.

A minimum of 8% of the employee's salary is paid into the scheme, which is split between 4% from the employee, 3% from the employer and 1% from the government in tax relief.

As an alternative to auto enrolment the employer can meet its obligations by enrolling its employees into a trust based occupational scheme called the National Employment Savings Trust or NEST.

PERSONAL PENSION PLANS (PPPS)

These are money purchase arrangements (defined contribution) and the pension achieved is dependent on the level of contributions and investment performance.

The main tax advantages are:

- Contributions attract tax relief initially at the basic rate 20% (even for a non-taxpayer).
- HRTP can claim an additional 20% through self-assessment so the HRTP gets tax relief at 40%.
- Additional rate taxpayers who pay tax at 45% can claim an additional 25% back through self-assessment so they get tax relief overall at 45%.
- Tax free lump sum up to 25% of the fund value available from the minimum pension age (currently 55 but this is due to rise to 57 from 2028).

OPTIONS AT MINIMUM PENSION AGE

The 25% tax free cash is called the **Pension Commencement Lump Sum (PCLS)**. This could be used for anything the plan holder wishes, for example to repay the capital element of a mortgage. The remainder of the fund may then be used to buy an **annuity,** which is a product that provides a guaranteed income for life.

The **open market option** provides the individual at retirement the ability to shop around to get the best annuity rates.

Annuity income is taxable as earned income although there are alternative options available that could be better suited to the individual, depending on their personal circumstances.

FLEXI-ACCESS DRAWDOWN (FAD)

Take the 25% tax free cash and then do **flexi access drawdown** where the rest of the pension fund stays invested in a draw down account. Any further withdrawals are potentially taxable at the marginal rate.

Once benefits beyond than the 25% tax free cash are drawn down, a £4,000 **Money Purchase Annual Allowance (MPAA)** is triggered, which means that any future pension contributions will only receive tax relief up to this amount.

UNCRYSTALISED FUNDS PENSION LUMP SUM

This option does not involve moving the funds to a drawdown account. The funds remain invested.

The Pension Commencement Lump Sum is not taken with this option. Instead, the ability to take withdrawals of any size is possible (potentially up to 100% of the fund in one go) with 25% of each withdrawal being tax free and the other 75% of the withdrawal being taxable at the marginal rate.

PERSONAL PENSION PLAN RULES

Since April 2006, the maximum annual contribution, which is the aggregate of all pension arrangements, including occupational pensions is the higher of:

- Up to 100% of their UK earnings or
- £3,600 (for a non-tax payer)

There is however an overall maximum annual allowance which is currently **£60,000**. This can be exceeded, but tax will be charged on the excess.

If an individual has income above £240,000 the annual allowance is reduced at a rate of £1 for every £2 of income over £240,000, which could reduce the annual allowance down to a minimum of £4,000.

In April 2024, changes were made to the **lifetime allowance (LTA**). This was the maximum available that could be saved across all pensions before tax became payable.

Although the LTA no longer applies there is a **lump sum allowance (LSA)** which restricts the maximum that an individual can take as a lump sum tax free to £268,275 (a quarter of the old lifetime allowance).

There is also **a lump sum and death benefit allowance (LSDBA)** of £1,073,100, which is the maximum tax free amount that can be received on death by nominated beneficiaries.

TAX RELIEF ON CONTRIBUTIONS

As stated above, contributions are paid net of basic rate tax, so an actual contribution of £100 into a pension fund would cost £80.

Higher rate taxpayers would be able to reclaim a further 20% through self-assessment. Additional rate taxpayers will get a further 25% self-assessment.

These additional amounts can be claimed against contributions made within the higher and additional rate thresholds.

STAKEHOLDER PENSION

Designed to encourage individuals to make pension provision and to particularly attract those on low earnings.

They do have restrictions in terms of:

- Charges cannot exceed 1.5% of the fund value for the first 10 years and 1% thereafter.
- Exit and entry charges are not allowed.
- Minimum contribution required cannot be more than £20.

SELF-INVESTED PERSONAL PENSION (SIPP)

A SIPP gives greater individual control over the pension as well as access to a wider range of funds than conventional pension schemes.

A SIPP allows a wider variety of assets within the fund, e.g., commercial property, unit trusts or a REIT for example.

When commercial property is purchased through a SIPP the business pays rent, which can go into the pension pot. This makes a SIPP beneficial for business owners.

GROUP PERSONAL PENSION

This a collection of individual personal pension plans arranged by an employer for their employees all administered by the same pension company.

Each member has their own plan and the advantage of this is that they can take this plan with them if they were to leave that employer.

UNIT 1 – TOPIC 11

LIFE ASSURANCE

Learning Outcome	Assessment Criteria
3.	U3.5
Understand the main financial services product types and their functions.	Life, health and general financial protection.

KEY TERMS:

- **Term assurance**
- **Sum assured**
- **Mortgage protection policy**
- **Gift inter-vivos**
- **Surrender value**
- **Ring-fencing**

This topic looks at the types of financial protection available to people who have a desire and/or need to protect loved ones against the adverse effects that can be caused as a result of death.

The terms assurance and insurance are sometimes used interchangeably, but they do have different meanings. Insurance protects against the effects of an event **should** that event occur, whereas assurance protects against the effects **when** the event occurs (as with life assurance death will inevitably occur at some point). With term assurance plans the policies are assured to pay a specific amount (sum assured) if death occurs during a given term of years.

There are 2 main categories of life assurance are **term assurance,** can be considered as being temporary life cover, whereas **whole of life assurance** is more permanent.

TERM ASSURANCE (IN GENERAL)

This is technically insurance, but as mentioned before, it is often called assurance. A term assurance policy only pays out if death occurs in a specific term of years (hence **term** assurance). The main aim of the policy holder (the assured) is to survive the term! If the assured does survive the term, there is no pay out and the policy ceases.

There is no investment element to these policies; they do not have a surrender value and they do not refund any premiums if the assured survives the term.

Premiums are usually paid monthly and are fixed at the outset, although some policies do offer these policies with reviewable premiums.

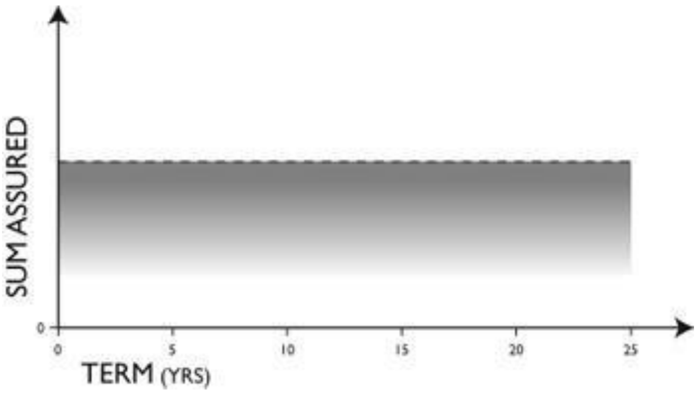
The policies can be set up in single names or joint names. This means the policy would pay out on death following the death of either party. It is normally the case that joint policies are set up to pay out on first death. Having then paid out the policy usually ceases.

LEVEL TERM ASSURANCE (LTA)

This describes a term assurance policy where the **sum assured** (the value the policy pays out on a successful claim) is fixed at the outset and remains fixed at that level for the duration of the term.

It is usually used in conjunction with an interest only mortgage or where an individual wishes to guarantee a fixed amount to be paid out on their death, should that occur at any point during the term.

Level Term Assurance



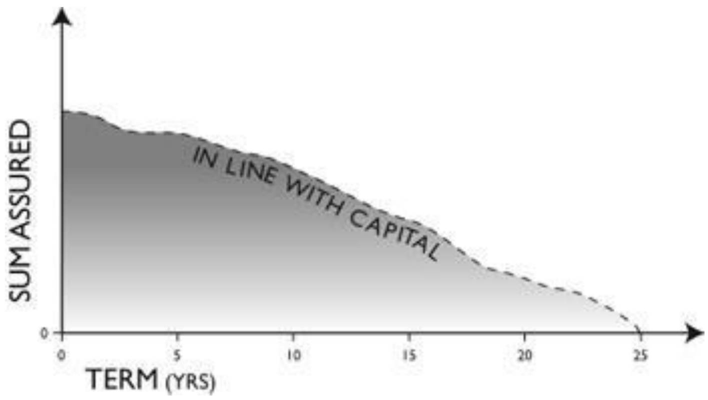
The sum assured is based on the amount the client would require to be paid out in the unfortunate event of their death.

The term chosen will match the need of the client. For example, if it is being taken to protect a mortgage the term chosen usually mirrors the mortgage term.

DECREASING TERM ASSURANCE (DTA)

Unlike a level term policy where the sum assured stays constant, a decreasing term assurance policy has a sum assured that reduces over time. The primary use of a decreasing term policy is to ensure there are funds to repay the outstanding capital balance on a capital and interest mortgage (repayment mortgage) and for this reason, they are sometimes called a **mortgage protection policy** or mortgage protection assurance.

As the amount that the insurer would have to pay out on a successful claim reduces over time, these policies are cheaper than level term policies.



Can be used to protect a specific mortgage loan for a specific term and are designed so that if interest rates do not go above a certain limit, and the borrower fulfills their repayments in full and on time, the sum assured on death should cover the outstanding mortgage balance.

GIFT INTER VIVOS COVER

This is a decreasing term assurance contract to cover a potentially exempt transfer (PET). It will provide an amount to pay the reducing IHT liability when a person dies within 7 years of making a gift. The cover will remain level for 3 years and then reduces each year after that until the policy ends at the end of year seven.

Can you recall the topic on IHT and how taper relief is applied to gifts? Remind yourself about this now to understand how a gift inter-vivos policy could provide funds to settle an IHT liability should a Giftor die within 7 years of making the gift (see page 27.)

INCREASING TERM ASSURANCE

This is a feature that attempts to allow the sum assured to keep pace with inflation. The increases are applied annually and either by a fixed amount or a certain percentage.

CONVERTIBLE TERM ASSURANCE

This is usually an option on a level term life assurance policy, which includes an option to convert the policy to either an **endowment** or **whole of life** plan at any stage during the term. This feature may be a useful for a couple with a young family who need protection now but want the option to convert a plan later when affordability is less of an issue.

At the point of conversion there is **no need** for further medical assessment. The lack of a medical assessment provides an individual the option to acquire a whole of life assurance policy with more affordable premiums than taking a new policy based on their current heath, although the age of the assured will be considered at the point of conversion.

Due to its convertible status premium costs are around 10% - 15% more than for level term assurance.

RENEWABLE TERM ASSURANCE

This feature allows the term to be renewed at the end of the original term, without further medical evidence.

The sum assured will be the same, but the premiums will consider the age of the assured at the renewal stage.

FAMILY INCOME BENEFIT (FIB)

With this type of life assurance, a series of instalments are paid out starting from the date of death of the assured and ending at the end of the policy term.

The payments are usually made monthly and stay the same until the end of the term, but as the total amount paid out would be lower the later a successful claim is made, it can be thought of as a form of decreasing term assurance.

Payments may be converted to a lump sum with the agreement of the insurer, but in this case the total amount payable would be reduced.

A FIB policy is not subject to income tax, and they can also be arranged with escalating benefit to help combat the effects of inflation.

PENSION TERM ASSURANCE (PTA)

This describes a life insurance policy that is taken in conjunction with a personal pension plan or a stakeholder plan. The policies were attractive because tax relief was available on the premiums making them a cheap form of life assurance.

No new policies were available after December 2006.

WHOLE OF LIFE ASSURANCE (WOL)

As mentioned before this can be thought of as a permanent policy as it will pay out on the death of the assured whenever it occurs. There is a guaranteed pay out!

Because the policy is certain to pay out on death (unless surrendered before) the insurer must ensure there are funds required to pay the sum assured and the insurer may therefore need to review the levels or premiums regularly to ensure they can be increased if investment returns are insufficient.

Premiums are payable until death life or up to a specified age, e.g., age 90 and can be written on single or joint basis – payable on first or second death.

The main use for WOL is to provide protection for dependents but they can also be used to cover an IHT bill following death.

Important!

When a client surrenders their policy, they will be entitled to its surrender value (the amount the policy will provide to the insured if it is terminated early.)

In the early years of an investment linked life assurance policy surrender values tend to be low, often less than the premiums paid.

A **Flexible Whole of Life** policy is issued on a unit linked basis. It is flexible because units are cashed in at the bid price to buy more, or less, life cover should the policyholder's needs change.

Initially, the policyholder selects the monthly premium according to affordability and the required level of life cover. If a higher the level of life cover is needed later, more of the units are needed to pay for the increased cover.

A Flexible Whole of Life is primarily a **protection policy** but if the policyholder did not require as much life cover later in life, more of the units could be used towards investment.

There are three main levels of cover:

- **Balanced Cover** – at a given premium this offers the level of cover the insurer expects to be able to maintain throughout the lifetime of the assured.

- **Minimum Cover** – low protection amount, and a substantial investment element.
- **Maximum Cover** – the level of cover that the premiums could afford for typically 10 years, after which time premiums would need to be increased for the cover to continue.

With all levels of cover there is guaranteed cover for at least 10 years, which helps to keep the policy qualifying.

UNIVERSAL WHOLE OF LIFE POLICIES

This is an extension of a flexible WOL policy that can include a range of other options. In addition to life cover you can add any of the following:

- Income Protection insurance.
- Critical Illness Cover (CIC).
- Accidental death benefit.
- Total and permanent disability.
- Indexation of benefits.
- Hospital benefits.
- Flexible premium levels.
- Waiver of premium (WOP) – allows the policy holder to stop paying premiums if they are unable to work due to sickness or disability.

Any of these benefits are paid for by cashing in or cancelling units at the **bid price**.

USES OF WHOLE OF LIFE POLICIES

The main use of a WOL policy is protection, for example to protect dependents following the death of a breadwinner/parent.

They can also be used to:

- cover funeral expenses following death.
- provide funds to pay an IHT bill following death.

If the WOL policy is being used to cover an IHT liability, it is common to set it up to pay out on **a joint life, second death basis** – also known as a last survivor policy.

It is usual to set up these policies in trust so that the proceeds are not paid to the estate but can be used instead to pay the IHT liability. This is referred to as **ring-fencing**.

UNIT 1 – TOPIC 12

HEALTH AND GENERAL INSURANCE

Learning Outcome	Assessment Criteria
3.	U3.5
Understand the main financial services product types and their functions.	Life, health and general financial protection.

KEY TERMS:
- **Deferred period**
- **Insurance Premium Tax (IPT)**
- **Occupation class**
- **Activities of Daily Living (ADL)**
- **Averaging**
- **Long-term insurance**

The last topic looked at policies that helped to protect individuals against the effects of death. This topic looks at some of the different policies that can be used to help individuals deal with suffering with ill health.

CRITICAL ILLNESS COVER (CIC)

This is a policy that is taken over a term of years where the insured would receive a tax-free lump sum on diagnosis of a specified critical illness. The illness must meet the specific policy definition for a successful claim.

On payment, the funds can be used for anything the insured requires, such as clearing debts or other liabilities, making changes to the home or even paying for treatment.

Typical conditions covered are:

- Heart attack and coronary disease requiring surgery (core critical illness).
- Stroke (core critical illness).
- Most cancers (core critical illness) but there are some exclusions with less serious cancers.

There are a range of other less common illnesses covered, which is not limited to but often includes:

- Kidney failure.
- Multiple sclerosis.
- Major organ transplant.
- Paralysis.
- Blindness.
- Loss of limbs.

Each provider includes a list of specific illnesses that are included in their policies.

Many policies will pay out in the event of total and permanent disability, but the definition of total and permanent disability varies between providers. Some providers take it as meaning the disability prevents them from doing any job suitable by virtue of their education, status, and experience.

Other companies have a tighter definition that requires that the disability must prevent them from doing any job.

Any pre-existing conditions are taken into account when the insurer is underwriting the policy. Depending on the condition these are often excluded when the policy is accepted.

INCOME PROTECTION INSURANCE

This is a type of insurance that pays a regular incomer, rather than a lump sum when the policy holder has suffered accident or sickness.

The amount claimed cannot usually be more than 50% to 75% of that person's gross income, less state benefits the insured is in receipt of. The income is paid until the policy holder returns to work or reaches retirement age, usually at around 60 years of age. It is a suitable policy for someone looking to arrange protection of income over the long-term, however, policyholders can select the income protection to last for a limited number of years, e.g. 2 years to keep the premiums affordable.

If the illness means that the policyholder can still work on a reduced number of hours, then policies can allow payment to be paid on a proportionate basis.

Homemakers may also be able to take out this sort of cover where the amount of cover provided is based on the degree of help that the individual requires to perform their role.

The plan holder will select a **deferred period**, which is the amount of time following a claim the policyholder is required to wait before receiving payments. The longer the deferred period the cheaper the premiums will usually be.

Deferred premiums are typically 4,13,26, 52 or 104 weeks. A policy holder will often set a deferment period to tie in with any employer benefits they are entitled to.

Insurers cannot cancel the policy, regardless of the number of claims made. The insurer could, however, cancel the policy if there is a change in employment that significantly increases the risk of a claim.

A waiver of premium option is a common feature and a useful one when the policyholder's income has reduced. This option when taken means that the insurer covers the ongoing cost of the policy premiums following a claim.

Some policies will allow the benefits to be indexed each year so the pay out each year could go up each year in line with inflation.

Premiums are either guaranteed or reviewable depending on the insurer.

Premiums for those who have a high-risk occupation are greater the risk of accident or illness increases.

- Class 1 - lowest risk – accountants, civil servants, clerical and administrative jobs
- Class 2 - lower risk - hairdressers or pharmacists
- Class 3 – moderate risk – farmers or electricians
- Class 4 – highest risk – manual labourers and industrial chemists

The benefits are **tax free** if the policy is held on a **personal basis**, but if the policy is provided through an **employer** (many are on a group basis) the payments are usually **taxable**.

EXCLUSIONS

Research the following document provided by an insurer. *Guide to Occupational Classes*
The document shows a list of occupations starting on page 4 that are either acceptable (A) or unacceptable (U) based on the nature of the work. What occupation(s) are deemed as being unacceptable?

ACCIDENT, SICKNESS & UNEMPLOYMENT (ASU) INSURANCE

This is an alternative to IPI and is typically offered to provide protection alongside a mortgage where the policy will pay out enough for a borrower to cover their mortgage and related costs for up to a maximum of one or two years. A person may have to be employed for a minimum period before they can take out this policy (usually six months).

There are further features to be aware of:

- The insurer can fail to renew the policy if there are large numbers of claims (a significant difference to IPI) and effectively means the insurer can cancel the policy.
- The unemployment aspect only covers **involuntary redundancy** (redundancy not opted for) or where it was not anticipated before the policy commenced.
- Payments start after a deferred period (often 28 days, especially for the self-employed.)
- Benefits are tax free. If provided by an employer as a tax-deductible expense for the company, it will be treated as a taxable benefit in kind for the individual.

EXCLUSIONS AND RESTRICTIONS

The main exclusions are:

- Any redundancy known about at the time of the taking out a policy or that the insured has any influence over.
- For unemployment cover, no claim is considered at the start of the policy and for a specific period, for example 6 months.

PAYMENT PROTECTION INSURANCE (PPI)

These policies were linked to the sale of another product such as an unsecured loan or mortgage (MPPI). They were designed to pay out for a fixed period, typically 12 months.

Many policies were mis-sold over the years and compensation claims have run into billions of pounds and many firms have been fined for the mis-selling.

PRIVATE MEDICAL INSURANCE

These policies provide cover for private medical treatment and the benefits include:

- Avoidance of NHS waiting lists.
- Choice of hospital/consultant.
- May pay a daily rate of income if there is an overnight stay in NHS hospital.
- Choice of timing of care.
- Better quality room.
- In patient charges, outpatient charges and surgical and medical fees.

The premium will be influenced by age, quality of room required and the type of hospital.

GENERAL EXCLUSIONS

- Pre-existing medical conditions.
- Routine eye and dental treatment.
- Self-inflicted problems.
- Cosmetic surgery.
- Alternative therapies.

Premiums are subject to **Insurance Premium Tax,** but for employers it is a deductible expense.

LONG TERM CARE POLICIES

These policies are designed to provide funds to cover the cost of long-term care in later life, whether that is needed in the policy holders home or within another care setting.

There will be an assessment on the insured's ability to complete everyday tasks called **Activities of Daily Living (ADLs)**, such as washing, dressing, feeding, toileting, mobility, and food preparation.

If the benefits are paid to the organisation providing the care, the benefits are tax free.

CATEGORIES OF GENERAL INSURANCE

There are 5 categories of general insurance:

Property loss	loss, theft or damage to objects
Liability loss	legal liability to 3rd parties e.g., personal injury
Personnel loss	injury, sickness or death of employees
Pecuniary loss	Insurance which mitigates financial loss
Interruption loss	business unable to operate due to fire for example

Research online and make a note of at least one form of each category of general insurance. The principle of indemnity applies to general insurance – find out and make a note of what this means.

THE PRINCIPLE OF AVERAGING

This can occur at the time of a claim if the insurer discovers that the property is under insured.

The under-insurance could have resulted from a deliberate attempt to keep the premiums low, or it could be that inflation has increased the amount required.

The insurer may as a penalty for this, reduce the amount they pay out to the insured through **averaging.**

In other words, someone who was under insured should not be indemnified in full. In this case, the claim is scaled down in the same proportion by the amount they were uninsured.

Here is an example:

> Adam has contents insurance for £10,000 when the true insurance value should have been £15,000.
>
> If Adam made a claim for £300 for a damaged carpet, he would only get a pay-out of £200 as he was only insured for 2/3 of the amount that he should have been insured for.

BUILDINGS INSURANCE

Building insurance usually covers anything that would be left behind if the building was sold.

It normally insures against certain dangers known as **standard perils.**

These could include damage caused by**:**

- Fire and explosions.
- Lightning, earthquake, subsidence.
- Riot or civil commotion.
- Storm and flood.
- Damage by vehicles or falling trees.

If the property is vacant (left unoccupied for more than 30 or 60 days) the insurer may refuse a claim. Usually this follows claims for:

- Theft and attempted theft.
- Burst pipes.

CONTENTS INSURANCE

This covers anything that you would normally take with you should the property be sold.

It is possible to include accidental damage, which is damage not caused by normal wear and tear.

You can usually also increase the scope of the cover to include things like the cost of replacing property freezer contents if there is an electrical fault or extended cover for items taken outside the home, such as bicycles (sometimes known as **all risks insurance.**)

PRIVATE MOTOR INSURANCE

There are three levels of cover

- Third party only.
- Third party, fire and theft.
- Comprehensive.

TRAVEL INSURANCE

Cover usually includes:

- Cancellation due to illness, injury.
- Missed flights due to transport failure.
- Delayed departures.
- Medical expenses.
- Personal accident.
- Loss of possessions.
- Personal liability.
- Legal expenses.

INSURANCE PREMIUM TAX

This is only applicable to general insurance and is charged on premiums at the rate of 12%. The exception is travel insurance, which is charged at the rate of 20%.

There is no insurance premium tax on **long term insurance** such as life assurance and critical illness cover.

UNIT 1 – TOPIC 13

SECURED AND UNSECURED LENDING

Learning Outcome	Assessment Criteria
3.	U3.3
Understand the main financial services product types and their functions.	Mortgages and other secured and unsecured loans, bridging finance, personal and commercial loans.
	U3.5
	Life, health and general financial protection.

KEY TERMS:

- **Repayment strategy**
- **Pure interest only**
- **Endowment**
- **Death benefit**
- **Smoothing**
- **Reversionary bonus**
- **Terminal bonus**
- **Clawback**
- **Rolled up interest**
- **Stair-casing**

This topic will look at the different ways in which mortgage borrowers repay the capital on their mortgage, part of which will involve looking at endowments, which were common during the 1980's and 1990's with some types of endowment still existing today.

Also, in this topic we will consider mortgage interest rate options, mortgage schemes, equity release and some regulatory and other mortgage related issues.

MORTGAGES

In a mortgage contract there are two parties: the **mortgagee** and the **mortgagor**.

- The lender is sometimes referred to as the mortgagee.
- The borrower is sometimes referred to as the mortgagor.

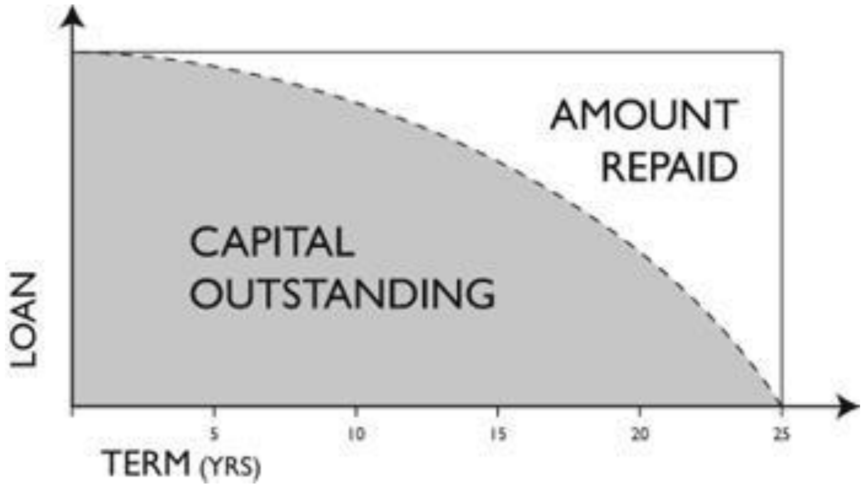
Important!

Lender = Mortgagee

Borrower - Mortgagor

Do you know the definition of a mortgage?
Take some time to research this and make a record of it in your notes – you will find this useful!

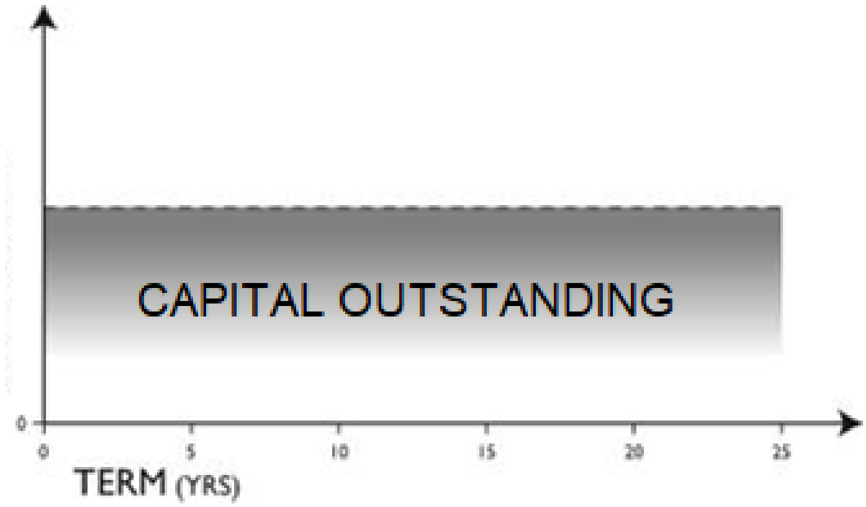
Capital and Interest Mortgage (Repayment)



- Each monthly payment involves an element of **interest** and an element of **capital**.
- It is a reducing loan with the balance outstanding decreasing all the time.
- The shorter the term of the loan the less interest repaid in overall.
- In the early years, the biggest element of the payment is interest with an imbalance of elements being reversed over time.
- The capital decreases slowly at first, but towards the end of the term the rate of capital decrease speeds up.
- If all the monthly payments are made in full and on time, the loan will be repaid in full at the end of the term.

Advantages	Disadvantages
Easy to understand.	This method does not automatically include life insurance which must be taken separately – usually decreasing term assurance.
Easy to borrow more as the loan is reducing, especially if the house value is rising.	No chance of a surplus at the end of the term.
Good method if you have a risk averse attitude	
Quite flexible in that the term can be extended if the borrower suffers hardship.	

Interest Only



- Each month the payment only involves interest.
- The lender does not require capital to be repaid during the term.
- The repayment of the capital is usually achieved at the end of the term with a repayment vehicle such as an endowment, ISA or other investment vehicle.
- Endowments are not popular these days due to poor performance.
- Interest only mortgage rules were tightened in 2014 over concerns about high levels of borrowing that were being agreed in the absence of a suitable repayment strategy.

Advantages	Disadvantages
For endowment options only life insurance is included in the plan.	There is no guarantee that the mortgage debt will be cleared at the end of the term so not good for the risk averse.
Some products such as ISAs, Personal Pensions have tax advantages.	The ability to repay the loan and receive a surplus at the end of the term is dependent on the performance of the investment vehicle.
There is the possibility of a surplus at the end of the term.	The borrower does not get to see the loan reducing during the term, so they gain less equity over time compared to repayment mortgages

INTEREST ONLY

Under MCOB rules, an interest only mortgage can only be taken if the lender has obtained proof of a **credible repayment strategy.** The lender must also contact the borrower **at least once** during the term to check that the strategy remains in place and the vehicle will plausibly repay the loan. In practice, lenders check more regularly than this.

ENDOWMENTS

An endowment policy is essentially a savings plan where regular payments are made into the policy (where it is used to support the repayment of a mortgage these payments are in addition to the monthly mortgage payments on an interest only mortgage.) It has some similarities to a whole of life policy, but a fundamental difference is that it has a specific term, whereas WOL has no policy term.

The idea is that by the end of the mortgage term, the savings plan will be at least equal to the mortgage balance on **maturity** (when the policy ends).

In addition, all endowments have built in life insurance so that if the policy holder dies during the term, the full mortgage balance will be paid off. This is called the **death benefit**.

NON-PROFIT ENDOWMENT POLICIES

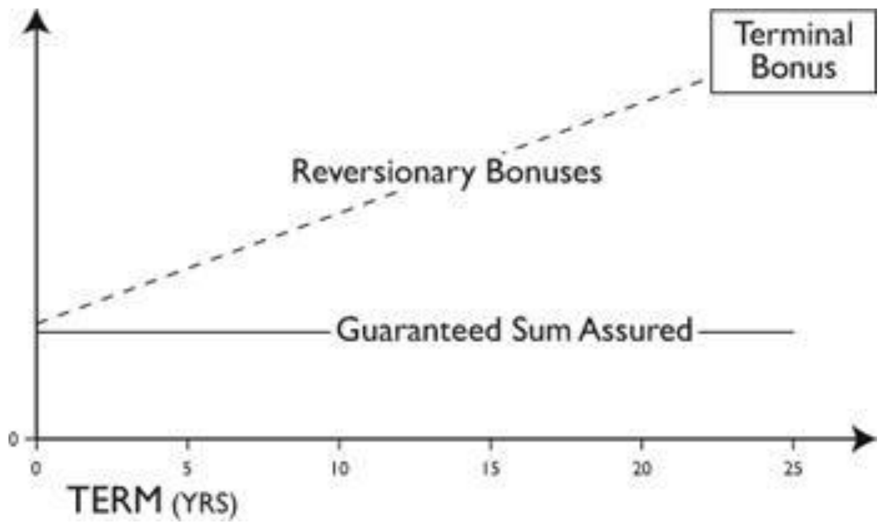
This policy guarantees to pay the **sum assured** on the earlier of death during the term of the policy or maturity.

The premiums ensure that the savings plan pays out the sum assured. However, the policy holder does not share in any of the profits that the life company gets.

FULL WITH PROFITS ENDOWMENT POLICIES

This policy guarantees to pay off the mortgage debt on the earlier death during the term of the policy or maturity, provided the sum assured is equal to the mortgage.

This version is more expensive than the non-profit version due to the ability of the policy holder to share in the company with profits plan. However, the advantage here is that the policy holder has the chance to receive bonuses, which may provide a surplus by the end of the plan.



BONUSES ON WITH PROFITS PLANS

There are two types of bonuses that can be added: a **reversionary bonus** (annual) and a **terminal bonus** (on maturity).

The reversionary bonus is paid at the provider's discretion, but once added, cannot be taken away. This annual bonus would be kept at a consistent level (**smoothing**), which was achieved by the provider keeping back profits in good years, for use in in years when profits were not so good.

The **terminal bonus** was also discretionary, but depending on when the policy was taken out, often added significant values to the policy at maturity, helping the policy to provide a surplus.

LOW COST WITH PROFITS ENDOWMENT

This policy addressed the fact that full with profits policies were expensive and consequently provided a more affordable alternative, which led to them becoming very popular. However, this policy **did not** guarantee to pay off the mortgage in full on maturity, only on death. This is because the policy began with a basic sum assured of around half of the mortgage balance.

It was hoped that through the addition of bonuses, by the end of the term the fund would be large enough to fully clear the mortgage.

As the death benefit with the endowment is equivalent to the basic sum assured, additional life assurance was necessary and because in theory the fund value was increasing all the time, the amount of additional life assurance needed to clear the mortgage on death reduced periodically.

In effect the endowment had a decreasing term assurance built in that ceased when the policy value reached the level needed to repay the outstanding capital on the mortgage.

Due to the basic sum assured being reduced to start with, the performance and addition of a terminal bonus, often determined whether there was enough to pay off the mortgage at maturity.

An especially important note – all With Profits plans have a fixed maturity date which **cannot** be reduced or extended.

UNIT LINKED ENDOWMENT POLICIES

This is a different policy to the with profits plans in that there is **no fixed basic sum assured** and the range of underlying investment choices was wider. Inherently therefore, these policies carry a greater but involve a greater potential reward – the chance of a surplus.

This time the premiums are used to purchase units in a chosen fund. The value of the policy and death benefit depends on the total value of the units based on the value of the underlying fund.

In terms of guaranteeing to repay a mortgage on death, this could be achieved by **cashing in some of the units** to buy additional life cover.

As there is no guarantee of what the fund will be on maturity, the flexibility of the unit-linked endowment means that if the policyholder reaches their target early, they can surrender the policy without penalty, pay off the mortgage before the end of the mortgage term and have no further need to pay the premiums.

The units in a unit linked endowment have two prices (the offer and BID price).

UNITISED WITH PROFITS ENDOWMENTS

This is most easily understood as being a combination of the with profits and unit linked endowments.

ENDOWMENT PERFORMANCE

The low-cost endowment performance has been very poor in recent years due, mainly to low interest rates and poor stock market performance.

Performance and advice issues led to the regulator ordering endowment providers to review all endowments used for mortgage repayment to write regularly to policyholders to provide an update on the projected maturity values of customers policies. This was aimed at ensuring policyholders were kept informed about any investment shortfalls in order to make alternative arrangements to repay the capital on their mortgages.

One other feature of endowments is that they can be **legally assigned** (transferred) to someone else who will then receive the benefits on death or maturity. Some lenders insisted on the endowment being assigned to them if the endowment was being used as a repayment vehicle for an interest only mortgage.

PENSION MORTGAGE

A personal pension plan or a stakeholder pension (SHP) can be arranged for anyone under the age of 75, including children. To encourage individuals to make provisions for their retirement, the government contributes towards people’s pensions by providing tax relief. As a reminder, the maximum annual contribution is the higher of:

- Up to 100% of their UK earnings, or
- £3,600 for non-taxpayers.

Whether the individual has retired or not, benefits can be taken at any time after age 55 (rising to 57 in 2028).

Up to 25% of the fund can be taken as tax free cash and it is this tax free cash that could be used to repay the capital balance of the mortgage. However, with the introduction of the LSA this restricts the maximum amount of capital that can be repaid to £268,275.

A mortgage borrower should consider the probable effect this would have in reducing their retirement provision.

One advantage that a pension has over an endowment is that the fund itself does not have to pay any tax, which theoretically means the pension fund could grow more efficiently.

One disadvantage for the lender is that the pension **cannot be assigned** to them unlike an endowment. The lender cannot therefore become entitled to the proceeds from the pension, and there is **no life cover** automatically built into the pension fund, so level term assurance may be necessary.

INDIVIDUAL SAVINGS ACCOUNT MORTGAGE (ISA)

It is possible to use an ISA account as a repayment vehicle for a mortgage by investing in funds that provide tax free returns

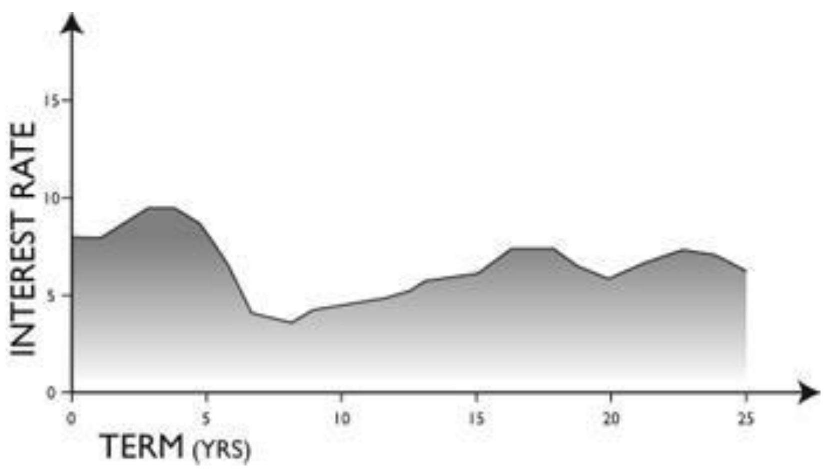
Investing in an ISA can be made with regular or lump sum amounts, but they cannot exceed the current limits considered earlier. In recent years ISA's have become a viable option as a mortgage repayment vehicle.

The main benefits are that the fund is **tax efficient** and if the growth exceeds expectations, then it is possible to repay the mortgage early.

The main disadvantages are that there are **no guarantees** of repaying your mortgage and that there is no built-in life cover, so level term assurance should be arranged

MORTGAGE PRODUCTS

Standard Variable Rate (SVR)



- This is the rate of interest set by each individual lender as their standard product.
- It will vary from lender to lender – some will be lower than others.
- It is a variable rate of interest so that when rates go up the SVR will tend to go up and vice versa according to the wishes of the lender.

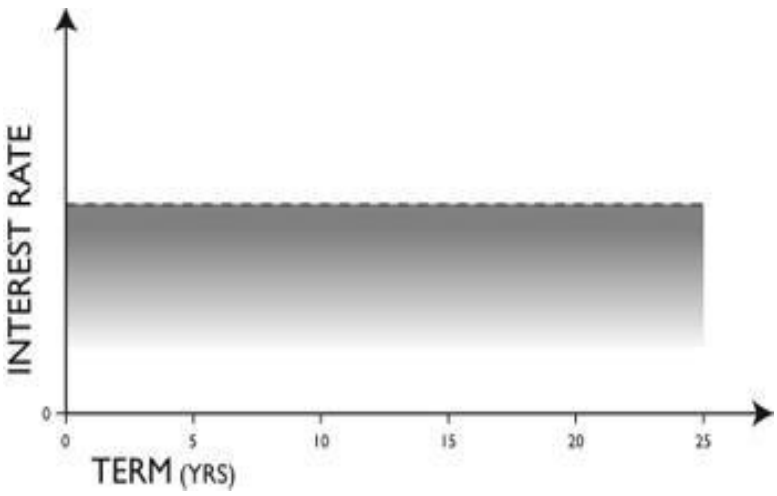
DISCOUNTED RATE

This works by offering a discount from the SVR for a specific period – e.g., 2% off SVR for 2 years. It is a variable rate so if interest rates rise or fall, the rate that the borrower will pay will change. The discount applies throughout the duration of the product term and will always be at the agreed margin below the SVR, whether the SVR rises or falls.

As there is a discount from the SVR there may be an arrangement fee to pay, and early redemption penalties are likely to apply during the discounted period.

After the discounted rate ends, the rate will revert to SVR, which will always be felt by the borrower as an increase in their rate. At or just before this stage a borrower is likely to have a need for a new interest rate product.

Fixed Rate



- The rate remains fixed for a certain period, typically for 2, 3 or 5 years. If interest rates rise or fall, the rate will always stay the same for that period. At the end of the fixed period the rate reverts to the SVR.
- An arrangement fee sometimes called a booking or reservation fee is usually payable.
- Early Repayment Charges (ERC's) are usually payable during the fixed rate.
- ERCs are often charged at a percentage of the loan or sometimes they are expressed as a number of months' worth of interest payments.

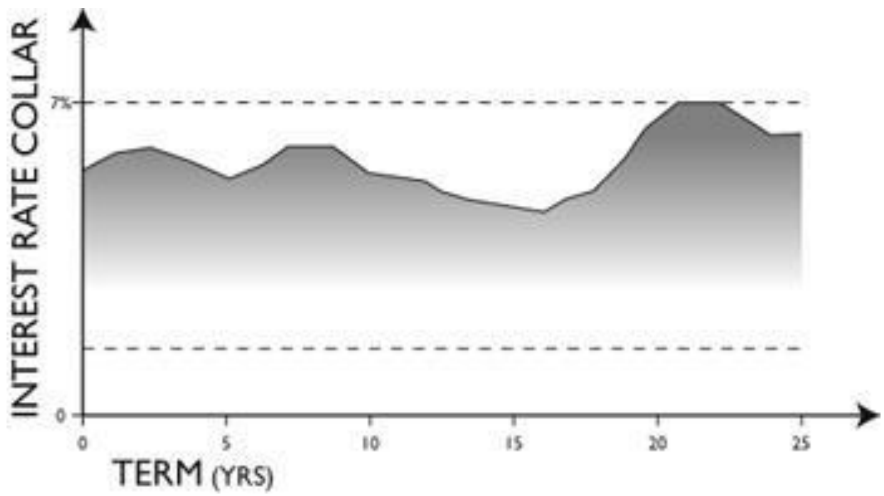
BASE RATE TRACKER

Here the interest rate is variable, which moves in line with changes in the Bank of England Base Rate (BoEBR) who announce any changes in interest rates immediately. Lenders often increase their variable rate trackers shortly afterwards.

An example would be BoEBR + 0.50%. So, the rate paid would be the current BoEBR plus 0.50% for the period of the tracker.

Whenever the BoEBR goes up or down, the rate changes by the same amount.

Capped Rate & Collared Rate



- With this option, you benefit from falls in interest rates, and at the same time you are protected against rises in interest rates above a certain level.
- For the period stated a cap or ceiling is set, above which the interest rate will not exceed.
- This option may be a good idea for people who believe that interest rates are likely to rise in the short term.
- Some lenders insist on a collared rate, which represents the lowest level the rate cannot go below.

PRODUCT INCENTIVES

Incentives could be available on any mortgage, some are more commonly used by lenders to generate new business

- Free valuation.
- Free legal fees.
- No arrangement fees.
- No Early Repayment Charges.

- Cash Back – the higher the LTV the lower the cashback. Note that when the mortgage is redeemed early the cashback may be required to be paid back. This is known as **clawback**.

OFFSET MORTGAGE

The basic principle is that a borrower pays interest on the balance of their mortgage, less their savings balance (the savings would need to be held with the lender.)

FLEXIBLE MORTGAGES

Where a mortgage is described as being flexible, this usually refers to the ability to make overpayments, or where there is the possibility of taking further withdrawals from a drawdown facility. Interest would most likely be calculated on a daily basis.

GREEN MORTGAGES

Advantageous terms, such as reduced interest rates, fees or cash-back may be available for borrowers whose properties meet certain energy efficiency standards. These terms are most likely to apply to newer properties.

CAT STANDARD MORTGAGES

This was a government backed initiative where providers would offer mortgages that met certain criteria designed to benefit consumers. In practice, very few mortgages met all of the criteria and could not therefore be marketed as CAT Standard.

CHARGES

- Must be daily interest
- No separate charge for a higher lending charge.
- All other fees disclosed as up-front cash.
- Intermediaries cannot charge fees.
- Arrangement fees.
- No arrangement fee for a variable rate mortgage.
- Maximum arrangement fee of £150 for a fixed or capped rate.
- Interest rate cannot be more than 2% more than the BoEBR on a variable rate mortgage.
- Maximum redemption charges apply to fixed or capped rate mortgages.
- No early redemption charges on a variable rate.

ACCESS & TERMS

- No compulsory products.
- Lender's normal lending criteria must apply.
- All advertising and paperwork must be clear and in plain language.
- Customer chooses the monthly repayment date.

LIFETIME MORTGAGES (FORMERLY KNOWN AS HOME INCOME PLANS)

Allows a person usually retired and over a certain age who own their home outright to mortgage their property.

Traditionally, no repayments are made to the lender during the lifetime of the borrower.

The interest is **rolled up** and added to the capital, which is repaid after the death of the borrower when the property is sold or if the borrower goes into long term care.

The lender will place a limit on the LTV – 25% to 55% and the younger the person applying the lower the maximum LTV available. This is because a person who takes it out at 60 will accrue more unpaid interest than an 80-year-old, as they are likely to live longer.

Due to the vulnerable nature of the equity release client, the main lenders in this area have formed the **Equity Release Council** who insist on consumer safeguards for registered providers:

- applicant must receive Independent Legal Advice (ILA).
- any negative equity situation is to be funded by the lender.
- the borrowers will be entitled to stay in the home for the rest of their lives e.g., until the death of the second party on a joint mortgage.
- the plan must be portable although part of the loan may have to be repaid if the next property is insufficient security.

Home Reversion Schemes

This is a different scheme and one in which the owner sells part or all of the equity to a provider, in return for a lump sum.

As the property is sold there is no mortgage involved. The provider allows the previous owner to remain in the property rent free (or for a peppercorn rent). A key consideration is that the property is sold at a significant discount.

The provider will take life expectancy into consideration before deciding how much of a lump sum to award for what proportion of equity.

The provider will have to wait until the death, or second death in the case of joint owners, before they can recover their capital after the property is sold.

RETIREMENT INTEREST ONLY MORTGAGES

These are similar to equity release schemes in that the borrower is only expected to repay the capital on death or moving into long term care. As the borrower makes payments to cover the interest the borrower must have the income in retirement to support this affordability must be demonstrated.

SHARED OWNERSHIP MORTGAGE

This scheme combines rental with owner occupation to help those on who have a low level of deposit get on the property ladder by purchasing a property in stages. It typically involves a borrower, a lender to provide a mortgage and a housing association to provide the property.

To begin with a borrower may only purchase a 25% share in a property and pay rent on the remaining 75%, which remains in the ownership of the housing association. The borrower can buy further shares in the property from the housing association until the whole property is owned. This is called **'stair-casing'.** Recent rule changes mean that buyers can now acquire an initial share of 10% and can staircase with additional shares of 5% each time.

When the property is sold the equity is split according to the proportion of ownership that each party holds.

SECOND MORTGAGES/SECURED LOANS

This is where a borrower uses their property as security a subsequent time for an additional loan to a new lender, while the existing 1st charge remains in place.

If the property is sold the first lender has the first claim to the proceeds, passing any surplus onto the second lender.

As there is a higher risk of the second lender not recovering their loan, higher rates of interest are charged on second and subsequent mortgages.

As of March 2016, under the Mortgage Credit Directive, these second charges became regulated under the Mortgage Conduct of Business rules (MCOB).

BRIDGING FINANCE

This is a short-term finance arrangement obtained through a specialist provider. They are arranged to bridge a short period of time, usually until a conventional mortgage can be arranged. Typically, people use these loans in the purchase of a property at auction, or to secure a new property if they are in a chain that has fallen through.

If the plan involves a clearly defined plan with an expectation of when the loan will be repaid this is called a **closed bridge** (less risk.)

If it is not known precisely when the loan is going to be repaid is not yet known, this is called an **open bridge** (more risk.)

COMMERCIAL LOANS

This is where the purpose of the loan is linked to a commercial activity, such as to fund a business or purchase commercial property. Borrowers are usually self-employed, and the interest rates charged are linked to the lenders variable rate or LIBOR/SONIA.

PERSONAL LOANS

This is a form of unsecured borrowing offered by many lenders providing funds to borrowers who want to borrow for periods between 1 and 7 years for a wide range of reasons. Rates of interest charged vary and are usually determined on a centralised basis through a system of credit scoring.

REVOLVING CREDIT

This is where a borrower can continue to borrow while repaying existing debt. A credit card is a good example of revolving credit.

A charge card is a little different in that the full balance must be repaid each month.

MORTGAGE INDEMINTY GUARANTEE (MIG) / HIGHER LENDING CHARGE (HLC)

Traditionally, it was not uncommon for lenders to charge borrowers a higher lending charge if their loan was above 75%-80% loan to value. This charge paid for an insurance policy called a mortgage indemnity guarantee. The insurance policy protected the lender if there was a shortfall on the loan if the property had to be sold following non-payment.

Occasionally lenders may still operate a higher lending charge although this money may be pooled to cover losses rather than to purchase insurance.

UNIT 1 – TOPIC 14

UNDERSTANDING AND SATISFYING CUSTOMER NEEDS

Learning Outcome	Assessment Criteria
5. The process of giving financial advice, including the importance of regular reviews of the consumer's circumstances	U5.1 The nature of the client relationship, confidentiality, trust and consumer protection U5.2 Assessing attitude to risk U5.3 Factors determining how to match solutions with consumer needs and demands U5.4 Assessing affordability and suitability U5.5 The effective use of communication skills in giving advice and how to adapt advice to customers with different capacities and needs U5.6 The importance of monitoring and review of consumers' circumstances U5.7 The Information for consumers must be given under current regulatory requirements

KEY TERMS:

- **Financial lifecycle**
- **Attitude to risk**
- **Capacity for loss**
- **Hard & soft facts**
- **Psychometric testing**
- **Vulnerable customer**
- **Proactive & reactive servicing**

In this topic you will find out about the process for giving financial advice around many of the different products that we have looked at so far. We will look at what is involved in the different stages. We will look at some of the regulatory requirements in this topic and then again in topic 20 (Unit 2.)

THE FINANCIAL LIFE CYCLE

Having an awareness of typical needs of customers depending on the stage of life a customer is at is an important consideration for advisers as this knowledge can help to develop trust and confidence in the adviser/client relationship.

CHILDREN

- Attracted by small savings schemes, such as National Savings & Investments.

- Stakeholder pensions.

STUDENTS

- Borrowing to fund college/university (usually in the form of government loans.)
- Bank accounts (although there may not be much opportunity to accumulate savings.)

YOUNG ADULTS IN EMPLOYMENT

- Short term easy access accounts (this may be to help save towards a deposit towards property ownership.)
- Pension provision.

YOUNG FAMILIES

- A mortgage may be required to help purchase the first family home.
- If one party raises the family, there may be less disposable income so savings may not be easily achieved.
- It is crucial to ensure the family members are protected against the effects of death.
- Protection of the income and activities of the homemaker.
- Any available savings should be directed towards pensions.

ESTABLISHED FAMILIES

- Money is perhaps less tight if there is increased earning potential – there may now be two incomes.
- A larger mortgage may be required if the family is upsizing.
- There is usually more disposable income and families may find it easier to borrow and save.
- Inheritances may be received and therefore there may be a need for savings or investment accounts.

MATURE HOUSEHOLDS

- If children are no longer financially dependent then this period could see the highest levels of disposable income, particularly as earnings have increased.
- Pension provision will now be a priority. As retirement draws nearer it will be important to divert more towards retirement income.
- At or around retirement individuals will often convert income into lump sums for retirement.

RETIREMENT

- The requirement now is to produce income from capital (especially if not working at all.)
- In retirement, people tend to take a more cautious approach to the money that they've saved.
- IHT mitigation could now also be a priority.
- Long-term care could be an option as families consider how best to deal with the costs of care in old age.
- Some asset rich and cash poor people in retirement consider equity release schemes.

SAVING PATTERNS

The general approach to building up assets often starts with the need for liquidity and safety e.g., being able to get your hands on savings to cover an unwelcome event. An **emergency fund** is therefore a priority once an individual's cash needs have been met.

The size of the fund will depend on a number of factors, but a rule of thumb is that it should be between 3-6 months' worth of expenses. Once that has been established and maintained, there is often a gradual move away towards accepting greater risk through products like fixed rate bonds that come with less flexibility but greater reward.

Products that offer even greater risk and reward, for example shares or other equity-based investments may become attractive later on.

GATHERING INFORMATION

The Conduct of Business rules require that advisers must '**know your customer'**. This helps to ensure that advice provided is suitable based on the client's needs and circumstances.

Fact finds are used to build up a picture of the clients existing position as well as current and future needs.

- Current and future needs across a range of product areas.
- Financial capacity to meet these needs.
- Attitude to their importance.
- Objectives.
- Preferences

A client's fact find will be made up of both hard and soft facts. Hard facts are the basic facts that are indisputable, such as date of birth or income, whereas soft facts are less tangible, relating for example to the client's aspirations and goals, or beliefs and attitudes.

Personal details (hard facts) are likely to include as a minimum:

- Financial details (hard facts.)

- Occupation.
- Income & expenditure.
- Assets.
- Liabilities.

Objectives (soft facts – subjective) are likely to include as a minimum:

- Hopes and aspirations.
- Goals in the future.
- Views on alternatives.
- Whether they are willing to take action (motivation.)

The adviser should always give priority to a hard fact over a soft fact.

ATTITUDE TO RISK (RISK TOLERANCE)

Before a solution can be recommended, the adviser must establish their client's attitude to risk (tolerance to risk). This will involve explaining the risks that a client would be exposed to as well as understanding how the client feels about the risks and whether the client is prepared to accept them in view of the benefits on offer.

Another important area of risk is the client's **capacity for loss**. This involves considering what level of risk the client can afford before there is a detrimental impact on the client's financial position should the risk occur.

There are various ways of assessing the client's attitude to risk, but one way is through psychometric testing using a questionnaire where the client responds to a series of questions resulting in a risk score attributed to the client that would be along a scale, e.g., cautious to adventurous.

CLIENT PREFERENCES

When acknowledging a client's preferences about a particular course of action, if the client's preferences are based on an incorrect assumption, for example showing a lack of understanding about the potential implications, the adviser has a duty of care to educate the client and correct any misunderstandings to help the client make appropriate decisions.

IDENTIFYING AND AGREEING NEEDS AND OBJECTIVES

The following table showing the PIPSI mnemonic can help to remember the order of priority an adviser should look to help their client.

P	Protection in the event of death
I	Mitigate the effect of **Illness** through protection policies
P	**Pension** provision for retirement planning
S	**Savings** and **Investmen**t
I	**IHT** planning and tax savings

VULNERABLE CUSTOMERS

The FCA also expects advisers to pay attention to customers who may be termed 'vulnerable' and have policies in place to prevent or exacerbate customer detriment.

Do you know what the definition of a vulnerable customer is? Look this up now and make a note of it in your own notes.

RECOMMENDING SOLUTIONS

The adviser needs to be aware of the following issues when recommending solutions.

- Any state benefits the client may be entitled to improve the client's financial position.
- Affordability – recommendations should improve the client's financial position and not place any undue stress on the client's finances.
- Taxation – this reflects the need for an advisor to avoid creating a tax liability unnecessarily as well as to determine how to mitigate tax liabilities with any recommendations made.
- Risk – are recommendations aligned to the client's risk profile?
- Timescales – the client's needs should be met within specific timescales.
- Current arrangements – does the client already have needs met through policies or benefits available?
- Income or capital (or both) – what is the client looking for from their investments?

When presenting the recommendation to the client the adviser must communicate as a minimum the following:

- How each recommendation fulfils identified needs.
- The specific benefits the client will get from products recommended.
- Any specific product options that are available to tailor the product to the client's requirements.
- Risks and limitations of the proposed solution.
- A summary of why that product has been recommended.

A features and benefits analysis (a summary of what is recommended and why) is required for each product recommended. By asking the client questions, the adviser can check the client has understood all aspects of the recommendations.

HANDLING OBJECTIONS

An important step in the process is to clarify any concerns the client may have about recommendations made, this gives the adviser an opportunity to check their client fully understands the recommendations and understands precisely how they match their client's needs.

OBTAIN A COMMITMENT TO BUY

The client must be made aware of the effects of non-disclosure of material information.

Completing an application form is the responsibility of the client, but the adviser can complete it with the client's permission, as long as the client checks the application for accuracy.

Once the client has read the application, they must sign it before it can be submitted to the provider.

DOCUMENTATION

At the start of the meeting the adviser must provide a business card. This will show the advisers credentials. Initial disclosure is next, and this is a key business rule (see details of this in topic 21.)

At the point of recommendation advisers must provide a Key Features Document (KFD), Key Illustration Document (KID) or Key Investor Illustration Document (KIID), depending on the product recommended. This must be provided before an application can be made.

When explaining the product, the cancellation rights or notice periods must be highlighted to the client.

The adviser must retain all records relating to the transacted business for three years except for:

- Life Policies, Pensions contracts and MiFID business - **5 years** – 7 years max
- FSAVCs, pension transfers & opt outs - **indefinitely**

ONGOING CLIENT SERVICING

As part of the initial meeting, it is important for the adviser to recommend further meetings at regular intervals to see if the client's circumstances have changed, for example a change in job role or other life event.

Ideally, the adviser will seek agreement for a **proactive servicing** approach where the adviser initiates contact with the client to discuss any changes in circumstances.

If the client is willing to review their objectives in the future this will better enable the adviser to improve the client's position on an ongoing basis.

A **reactive servicing** approach would not usually involve regular contact. An example would be where the adviser responds to an ad-hoc request from their client or where they are prompted to contact a customer by a product provider for missed premiums that could lead to the client's policy lapsing.

UNIT 1 – TOPIC 15

THE MAIN FINANCIAL ADVICE AREAS

Learning Outcome	Assessment Criteria
4. Understand the main financial advice areas.	U4.1 Budgeting U4.2 Protection U4.3 Borrowing and debt U4.4 Investment and saving U4.5 Retirement planning U4.6 Estate Planning U4.7 Tax planning and offshore considerations

KEY TERMS:

- **Key Person Cover**
- **Ring fencing**
- **Last survivor policy**
- **Real rate of return**

Following on from the last topic this one looks at the main areas that advisers need to focus on with their clients. It will help to think about all of the products that you have read about so far when looking at each of these areas.

BUDGETING

An understanding of the client's financial expenditure and priorities allows the adviser to establish what level of budget the client can afford towards meeting immediate and future needs. When recommending a product to a client the cost should be affordable and should not put any pressure on the household income.

PROTECTION

This is the concept of protecting against various risks such as death or illness. There are different types of protection products used to mitigate the effects of different types of events.

FAMILY PROTECTION

The main priority here is to protect against the impact of death. A further priority would be to protect the family from the effects of a loss of income. One serious implication of having a lack of adequate protection could be that existing liabilities could become unaffordable. This may even result in a family home being lost.

Income protection policies can be used to protect loans and/or protection policies that pay lump sums can be used to clear loan balances on death or serious illness.

PROTECTING AGAINST ILLNESS OR UNEMPLOYMENT

If a family member suffers a serious illness which prevents them from working, or if they are made unemployed, income protection policies can be used replace the lost income.

Individuals who suffer serious illnesses may have a need to make adaptations to the home or even pay for treatment. In these scenarios policies can provide lump sums can prove very useful.

BUSINESS PROTECTION (DEATH OF KEY EMPLOYEES)

Key person cover can help to protect a business against the effects of death of key personnel that make significant contributions to the running of the business.

Calculating the level of cover required used is to multiply the key person’s salary 5 or 10 times.

The company would then take out a term assurance policy on the life of the employee for the period that the employee is expected to be a key person.

Policies taken for 5 years or less may be classed as a business expense with premiums set against corporation tax. Any claim proceeds would be subject to corporation tax where policies have been arranged in this way.

With all protection policies, it is important to consider whether the potential pay out from the policy will keep pace with inflation (see the effect of inflation below).

DEATH OF A BUSINESS PARTNER

It is important that the surviving partners of a business insure against the death of a business partner with a view to covering the claims of a deceased’s partner’s beneficiaries. There may be business asset disposal relief from IHT depending on whether there is a deemed transfer of assets or not.

THE AUTOMATIC ACCRUAL METHOD

- With this approach the deceased’s share is automatically shared among surviving partners with no deemed transfer.
- Proceeds of a life policy paid to deceased’s beneficiaries, which is regarded as compensation.
- Normally, 100% business asset disposal relief for IHT is available as the deceased’s shares will automatically pass to the surviving partners and not to the deceased’s estate.

THE BUY AND SELL METHOD

- In this arrangement, the deceased's executors are **obliged** to offer the deceased's share of the business to the surviving partners.
- The surviving partners are **obliged** to buy the deceased's share. This is funded by each of the partners taking out life policies for the benefit of the surviving partners.
- As the share of the business passes to the estate there is no business asset disposal relief.

THE CROSS OPTION METHOD

- The deceased's estate has the **option** to sell the deceased's share to the partners.
- The surviving partners have the **option** to buy (either side can trigger the transfer.)
- As the transfer is an option rather than an obligation, business asset disposal relief is available.

THE EFFECT OF INFLATION

Inflation reduces the purchasing power of a capital sum over time.

Advisers should be aware of this and consider products for clients that grow above the level of inflation in order to generate a real rate of return. The **real rate of return** is therefore the interest rate of the investment return minus the rate of inflation during the period of the investment.

Equity or shares-based investments (over the long-term) are proven to be effective in achieving this.

RETIREMENT PLANNING

Because the State Pension alone is unlikely to provide a comfortable standard of living, most people should consider how to supplement this income with income of their own. The government encourage people to do this by providing tax relief and other tax benefits through occupational and private pensions.

Stakeholder Pensions are private pensions introduced in 2001 and were designed to encourage people to make personal pension provision as well as provide employers with schemes for employees. They were designed to be easy to understand with low maximum charges. These charges are a maximum of 1.5% of the fund for the first 10 years and 1% thereafter.

This imposed maximum 1.5% charge has made stakeholder plans unattractive for the pension fund manager as they can make more on other pension schemes. This has resulted in lower than expected take-up rates on stakeholder plans.

ESTATE PLANNING

This area of advice is concerned with addressing the potential tax liabilities that may arise on death given the value of the client's chargeable assets. Remember, beyond the allowed threshold IHT is payable on the deceased's estate at a rate of 40%.

The main focus here is to consider how to deal with the tax liability that would arise. This may involve the use of policies to cover the tax liability that will arise (since this can be calculated in advance).

It is also possible to reduce an IHT liability by making use of the allowances and by making Potentially Exempt Transfers (PETs).

Other important concepts that are relevant here are the nil rate band and residence nil rate band as these can be used to mitigate an IHT liability as discussed in topic 4.

Another option is to place assets in trust since trust property does not become part of the deceased's estate. This is known as **'ring fencing.'**

Life Assurance Policies can also be used to cover an IHT liability. Usually this is done on a joint life, second death basis – last survivor policy. On the first death the spouse exemption applies and on the second death, if the policy is written in trust, it will pass direct to the beneficiaries.

GIFT WITH RESERVATION OF BENEFIT

If you give property away while continuing to live in it, this is covered by the 'gift with reservation of benefit' rule with the asset being treated as never having been given away at all.

In the past many people avoided this problem by placing their property in trust. The tax authorities have closed this loophole by introducing new rules for the taxation of 'pre-owned assets' such as properties. This involves an annual tax charge, which is based on a realistic annual rental for the property that they occupy.

WILLS AND POWER OF ATTORNEYS

Although not usually an area of an adviser's expertise, it is important to give consideration to making a valid will and any power of attorneys that may become necessary in the future.

TAX PLANNING

While this area is best left to tax experts, a financial adviser must always consider the tax implications of any product recommendation so as not to increase the client's tax burden and to ensure recommend products are suitable for the client's current tax status.

UNIT 1 – TOPIC 16

KEY LEGAL CONCEPTS

Learning Outcome	Assessment Criteria
6.	U6.1
Understand the basic legal concepts relevant in financial advice.	Legal persons – individuals, wills, intestacy, personal representatives (and administration of estates), trustees, companies, limited liabilities and partnerships
	U6.2 Contract, capacity to contract
	U6.3 Agency
	U6.4 Real estate, personal property and joint ownership
	U6.5 Power of attorney and substituted decision making
	U6.6 Insolvency and bankruptcy

KEY TERMS:

- Testator
- Settlor
- Codicil
- Deed of variation
- Intestate
- Company memorandum
- Articles of association
- Partnership deed
- Legal capacity
- Actual authority
- Apparent authority
- Ratification

This topic focuses on a number of legal concepts relevant to financial services. The terminology relating to each area is important to remember for anyone wanting a career within the industry.

Important!

You may want to keep adding to your definitions log to avoid being confused by the many different terms used in this topic

PERSONAL REPRESENTATIVES

This is the term used to describe those who represent deceased people when a person dies. The personal representative will be responsible for distributing the estate.

Exactly how the estate is distributed depends on whether there is a valid will or not.

- If there is a will, they are called **Executors** nominated by **Grant of Probate**
- If there is not a valid will, they are called **Administrators** nominated by **Grant of Letters of Administration**

WILLS

The person who makes a will is called a **Testator.** Individuals who receive assets from the estate are called **beneficiaries.**

You must be aged 18 to make a Will in English law and aged 16 in Scotland.

For a will to be valid it must be:

- Written.
- Signed by the Testator.
- 2 witnesses to the testator's signature (not beneficiaries or spouses of beneficiaries.)
- The Testator must witness the witnesses' signatures.

A Will becomes invalid if:

- It is destroyed with the intent to revoke it.
- A later Will is made.
- The Testator marries or remarries (unless the will is made in contemplation of the marriage.)

CHANGING A WILL

Modifications to a Will **during** the **testator's** lifetime are recorded on a **codicil.**

A codicil is used for a small change, for example to update the beneficiaries.

Modifications made **after** the **testator's** lifetime are achieved through a **deed of variation.**

DEED OF VARIATION

A deed of variation enables beneficiaries of a deceased's estate to alter the distribution of an estate after the testator has died. This often, but not always, results in the re-distribution of assets that may or may not have the effect of reducing a tax liability.

In order to do it all beneficiaries under the existing will must be over 18 and all must be in agreement to the variation.

It must be done within 2 years of death and HMRC must be informed within 6 months of the variation.

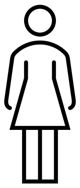
Although a deed of variation is extremely useful, it should not be relied upon as part of an individual's estate planning.

INTESTACY

A person has died **intestate** it means that there is either no will, or the will is invalid.

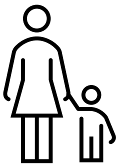
As above, the **Administrator** applies for **Letters of Administration**. When the estate is ready for distribution, the rules of intestacy dictate how the estate is shared out:

Spouse but no children



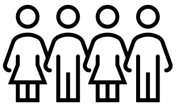
Spouse receives all of the estate absolutely.

Spouse and Children



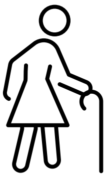
Spouse receives **the first £322,000** plus **half** of anything above £322,000.

Children but no spouse



The estate is shared equally among the children.

Neither spouse nor children



Estate goes to the deceased’s parents or if dead to the siblings.

If no blood relative can be found, then the Crown will inherit the estate.

Example:

If an individual dies leaving a spouse and children and the estate is valued at £550,000, then the spouse receives £436,000, which is the first £322,000 plus £114,000.

The remaining £114,000 is divided equally between the children.

TRUSTS

Different types of trusts can be used for different purposes. The basics are covered here.

A trust is created by the **settlor** and is therefore sometimes known as a **settlement**. The settlor is able to place assets into trust for the benefit of others while exerting some control over the use of those assets through the Trust deed.

Usually, the settling of assets in this way means the settlor is no longer the owner of the assets, the assets are now trust property with trustees appointed to take legal ownership of the trust's assets.

A trust deed is created naming the trustees and any specific conditions attached to the trust. Those benefitting from the trust (beneficiaries) have a legal interest in the trust's assets and may eventually gain absolute entitlement to the trust assets (depending on the type of trusts used.)

TRUSTEES

Individuals who act as trustees must be of sound mind and aged 18 or over. If a trustee dies the remaining trustees can appoint a new trustee. A minimum of two trustees are usually recommended.

There are a number of requirements on trustees:

- Trustees must act in accordance with the trust deed.
- If they have discretion in exercising their powers, then all trustees must agree.
- Trustees must act in the best interests of all beneficiaries.

Under the **Trustee Act (2000)** trustees also need to:

- Obtain proper advice when reviewing investments.
- Be aware of the need for suitable and diversified assets.
- Regularly review investments.

COMPANIES

Limited companies are distinct 'legal entities. As the company is an entity in its own right the owners (shareholders) are not liable for the debts of the company. Any personal losses sustained by the owners are therefore limited to the amount of capital invested.

Companies have a **Memorandum**, which sets out the powers of the company and an **Articles of Association,** which records the directors of the company and any powers they have to act on behalf of the company. These documents must be registered with Companies House.

PARTNERSHIPS

A partnership is not a separate legal entity and therefore the partners (sole traders) are responsible for the liabilities within the partnership.

The **Partnership Deed** is a written agreement which specifies how profits and liabilities are allocated amongst the various partners.

A Limited Liability Partnership (LLP) is one where each partner's liability is limited to the amount they have invested into the partnership. In this sense, an LLP is more like a company than a partnership. As an LLP is still a partnership, each partner would be taxed as though they are self-employed on an income tax basis. The process to create an LLP is similar to the process for setting up a limited company.

SOLE TRADERS

Individuals that run a business in their own name are referred to as sole traders. Unlike directors of limited companies or partners of limited liability partnerships, these business owners are responsible for the debts of the business, but they are entitled to keep all profits made.

LAW OF CONTRACT

There are various contracts within financial services and there is usually a need for these to be binding (whether made orally or in writing).

To be valid the following must exist:

- All parties must have **legal capacity** – this means being of "sound mind" and being over the age of 18.
- An **offer** and **acceptance** of the offer.
- **Consideration** – what each party exchanges – usually this is money (or a promise to pay money in return for a product or service.)
- Intention to create a legal relationship.
- Contract must not be illegal.
- Terms must be clear and unambiguous.
- Contract must not have been coerced through misrepresentation, duress or undue influence.

If one of the parties to a contract does not perform its side of the contract, that person is then in breach of contract.

If it was to go to court damages would be sought and if proven awarded to indemnify the claimant or to reinstate him for his loss – this will include legal expenses.

BUYER BEWARE AND UTMOST GOOD FAITH

Most contracts are based on the assumption of ***caveat emptor*** which means 'buyer beware'.

Life assurance contracts in the past were based on the principle of ***uberrimae fides***, meaning 'utmost good faith', which meant that all material facts relevant to the application needed to be disclosed by the applicant.

However, some life assurance companies in the past relied upon this principle when rejecting a claim, stating that the policy holder had not disclosed all medical information, irrespective of whether it was relevant or not.

This concern led to the introduction of the Consumer Insurance (Disclosure and Representations) Act 2012.

The act clarifies that duty of utmost good faith doesn't require customers to volunteer information, but it does require them to take reasonable care in relation to answering the insurer's questions truthfully on the application form.

The policy holder must take reasonable care in answering questions that they don't make a deliberate 'misrepresentation' to the insurer. If there is a dispute between the insurer and the claimants following death of a policy holder a dispute about non-payment of a claim may need to be resolved through mediation, where the ombudsman may side with the insurer.

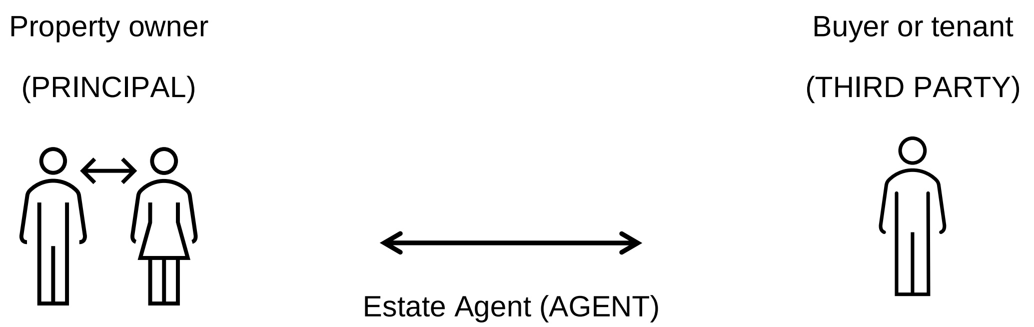
If the insurer wants to reject the claim under the belief that the policyholder was **careless** in answering those questions, they will want to **reject the claim**, but may need to **refund the premiums**.

If the insurer was of the opinion that the policyholder was **reckless** in answering the questions, then they may be allowed to **reject the claim** and **wouldn't have to refund any premiums**.

LAW OF AGENCY

An agent is a person who acts on behalf of another person. The person he is acting for is known as the principal.

Example:



Key terms

- Actual authority.
- Apparent Authority.
- Ratification.

The fundamental rule is that agents can conclude contracts on behalf of the principal and in law the actions of the agent are considered to be those of the principal.

An agent should only act in accordance with the power and authority that they have been given. This is called "**actual authority".**

If the agent exceeds their authority and this could be proven, the principal would not necessarily be held liable for the actions of the agent, and the agent could be sued for breach of contract.

Should a legal dispute arise between the agent and the principle where the agent claims to have acted in good faith having been under the impression of acting within their authority, a court may rule in the agents favour. The actions would have therefore been deemed to have been with **"apparent authority"**.

"Apparent authority" occurs when the principal has done or said something, which a reasonable person would conclude represented a further granting of authority. As outlined, a court would have to decide or rule on this.

If the agent has indeed acted outside their authority and it can be proven, then the agent could be held liable for his actions by a third party.

Where the agent has exceeded his authority, but the principal subsequently approves the actions of the agent, this is called **"ratification"**.

OWNERSHIP OF PROPERTY

Property falls into one of two categories:

- **Realty**, which describes land and any property that is attached to land.
- **Personalty**, which describes every other type of property.

Jointly owned Property

When property is owned jointly it can be owned in two ways, either on a joint tenants basis or on a tenants in common basis. The maximum number of co-owners possible is 4. Beyond this number the property ownership would need to be set up under a trust.

When arranging a mortgage, lenders usually insist on a joint tenancy and both borrowers will be jointly liable for the entire mortgage (jointly and severally liable.)

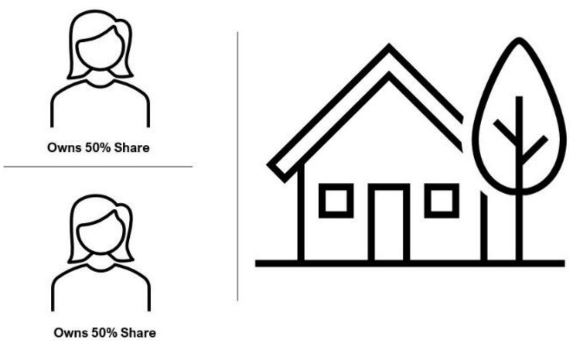
Joint Tenants Basis

Each joint owner owns 100% of the property – there is no division in percentage terms between them.

Where one of them dies, the property passes to the surviving joint owner automatically.

This is irrespective of any provisions made in a will **(Right of Survivorship)**

Tenants in Common Basis



This time each tenant in common owns a specific share of the property which may or may not be 50/50, it can be any amount as defined by the tenants.

On death the deceased's person's share is passed via their estate e.g., will or intestacy.

POWER OF ATTORNEY (POA)

An attorney is a person who can legally act on behalf of others. The person who is granting authority is called the **donor**, the person who can now legally act for the donor is called the **donee (or attorney)**.

To create a power of attorney the donor must be of sound mind.

An ordinary power of attorney might be used in situations where temporary decision-making capacity is needed, such as in the event of travel abroad, but this type of POA expires if the donor becomes of unsound mind.

For a POA to continue once a person loses mental capacity there must be either:

- an Enduring Power of Attorney (EPA), or
- a Lasting Power of Attorney (LPA).

Note: no new registered EPOA after 2007 though existing registrations can continue beyond this date.

Lasting powers of attorney can also cover **personal and health matters** whereas an enduring power of attorney can only cover **finance and property** issues.

The POA can be used for finance and property issues while the donor has capacity or when they have lost capacity.

All new lasting powers of attorney must be registered with the **Office of the Public Guardian**.

If a person of unsound mind does not have a valid lasting power of attorney in place, no decisions can be made regarding their affairs until an application can be made to the **Court of Protection** to appoint a deputy. This process can take some time and can be expensive.

Lasting Powers of Attorney can only be revoked by the **Court of Protection.**

INSOLVENCY AND BANKRUPTCY

Insolvency occurs when the value of a person's liabilities is greater than their assets or they are unable to meet their financial obligations in a timely manner.

Bankruptcy occurs when an insolvent person is subject to a bankruptcy order by the court.

An individual can petition for their own bankruptcy, or a creditor can petition for it if they are owed £5000 or more.

During the first 12 months of a bankruptcy order the person is known as an **undischarged bankrupt** and cannot borrow more than nominal amounts of money. After 12 months, provided the official receiver or insolvency practitioner is satisfied all the conditions have been met, the bankrupt becomes a **discharged bankrupt.**

Following discharge, a person is referred to as a discharged bankrupt and though now is legally able to borrow, must always disclose the existence of the bankruptcy in any credit or mortgage application. This can make it difficult or expensive to arrange any form of credit.

An individual voluntary arrangement (IVA) is an alternative to bankruptcy. The debtor will arrange with the creditors to re-schedule debts over an agreed period often 5 years.

An IVA can only be achieved if creditors holding **75% of the aggregate debt are in agreement**.

An individual with an IVA will find it difficult to obtain credit while the IVA is in force and is likely to be impaired even after the end of the arrangement.

For a company in financial difficulties with money owed to creditors, they can take out a Company Voluntary Arrangement (CVA) which operates in a similar way.

SCAMS

A recent development in the prevention of fraud by the FCA is the ScamSmart tool, which is a website where consumers can help to protect themselves against fraudulent schemes.

Take a look at the website here and familiarise yourself with the content and tools available. *www.fca.org.uk/scamsmart*

UNIT 2 – TOPIC 17

UK FINANCIAL REGULATION

Learning Outcome	Assessment Criteria
1. Understand the purpose and structure of the UK financial services industry 2. Understand how legislation (other than tax legislation) and regulations impact upon firms and the process of advising clients.	K1.1 The role, activities and statutory objectives of the FCA and PRA. K1.2 Key features of the FCA's principles for businesses. K1.3 The approach to and requirements for the fair treatment of customers, conduct risk and customer outcomes. K1.6 Arrangements, systems and controls for senior managers. K2.3 The role of the Competition and Markets Authority (CMA). K2.6 The role of guidance services including statutory and third sector guidance services.

KEY TERMS:

- Prudential regulation
- FSMA 2000
- Prudential Regulatory Authority
- Financial Policy Committee
- Dual and solo regulated firms
- Competition and Markets Authority
- Rules, guidance, and evidential provisions
- Whistle-blowing

The focus in this unit is regulation within the financial services industry. We begin by exploring how things have worked historically, and this helps us to understand the regulatory approach today.

INTRODUCTION

A fundamental aim of many modern governments, including our own, is to support the needs of businesses to make a profit. This is crucial for a healthy economy. History has however, shown that consumers require an element of protection afforded through regulation; the lack of which can result in the undermining of public trust and confidence in the sector. Take the Payment Protection Insurance (PPI) mis-selling issue for example; the mis-selling of PPI was hugely damaging to consumers and the profits of the firms who were guilty of mis-selling.

The government must therefore **balance the needs** of **both consumer and business**.

THE FINANCIAL SERVICES AND MARKETS ACT 2000

As already mentioned, regulation benefits consumers by offering them protection, but they also benefit the industry and the economy more widely by enabling a framework within which firms can operate safely.

Past regulatory changes have often been triggered by scandals or crises where a lack of adequate regulation has resulted in the financial ruin of individuals and firms. Significant regulatory changes followed the financial crisis of 2007-2009, which was in part caused by a lack of adequate regulation.

Throughout the 1980's-1990's there was an attempt at self-regulation by the markets. To support the development of the financial markets and consequently the economy, the government introduced a series of legislative changes designed to relax the rules for investment firms, banks and building societies.

Consumers began to demand a wider range of products in greater numbers and the UK financial services industry went through a period of significant growth. However, the approach led to a number of collapses of financial services firms, a notable example being that of Barings Bank in 1995, where a single trader was able to hide losses from their trades, bringing down the entire investment bank in the process. A more rigorous approach to regulation was required.

An important milestone was reached with the introduction of the Financial Services and Markets Act 2000 (FSMA 2000). The effect of this legislation was to piece together what was seen as a fragmented regulatory regime and to consolidate the regulation of the industry under a single regulator, the newly created Financial Services Authority (the FSA are now defunct having been replaced by the FCA and PRA).

Between 1998 and 2005 a number of important changes took place:

- In June 1998 regulation of the banking and building societies was transferred, including products from National Savings & Investments.
- In December 2001 under The Financial Services & Markets Act 2000, the FSA took over the regulation of virtually the whole financial services industry.
- On 31 October 2004 the regulation of mortgages was transferred from the voluntary Mortgage Code Compliance Board (MCCB) to the FSA.
- In January 2005 the regulation of general insurance was transferred to the FSA.

In the run up to the financial crisis, the UK economy had been experiencing sustained economic growth, but the lack of adequate financial regulation became evident as many of the household names had to be bailed out by the Bank of England.

HOW DID REGULATION CHANGE AFTER THE FINANCIAL CRISIS?

The financial crisis of 2007- 09 was essentially caused by a failure of prudential regulation. Institutions had been allowed to take too many risks.

Research online at least two definitions of the word “prudential”. Make a note of this and how it might relate to firms operating within the financial services industry.

It wasn’t just a lack of prudential regulation that led to the financial crisis in the UK, however. In the wake of the crisis, it became clear that firms had not always been conducting their business ethically, as was observed in the LIBOR rigging scandal. The government rowed back on the idea of having a single regulator and implemented a review of the markets and how to regulate them going forward.

REGULATORY REFORM – THE FINANCIAL SERVICES ACT 2012

A number of significant changes were implemented following the financial crisis 2007 – 2009.

The FSA were replaced by two new regulators. The **Financial Conduct Authority (FCA)** were created and given responsibility for the conduct and behaviour of all financial services firms and the prudential supervision of smaller firms.

The **Prudential Regulatory Authority (PRA)** were incepted and given responsibility for the prudential supervision of bigger firms including the banks, building societies, insurance companies and other significant financial institutions. The powers of the PRA are given effect through the **Prudential Regulation Committee** that operates within the Bank of England.

As well as promoting the financial soundness of the firms it supervises, the PRA has additional objectives, which are to ensure consumer protection for insurance policyholders and to facilitate competition both domestically and internationally

The formation of a new committee, the **Financial Policy Committee (FPC)** that look at potential risks that could threaten the wider economy.

It is worth noting that some firms are regulated by both FCA and PRA (large firms are dual regulated) and some firms are regulated solely by the FCA (smaller firms are solo regulated). Both regulators work together sharing information, but when it comes to supervisory activity (carrying out activity to ensure firms are complying with the rules) the regulators tend to act independently and not at the same time.

One area where there is joint accountability is the Financial Services Compensation Scheme (FSCS). The FCA is solely responsible for the Financial Ombudsman Service.

THE FINANCIAL SERVICES AND MARKETS ACT 2023

When the UK left the European Union (EU) it passed an act of parliament that facilitated the “onshoring” of EU derived law (the European Union Withdrawal Act (EUWA).

The Financial Services and Markets Act 2023 (FSMA 2023) permits the repealing of any onshored EU based legislation and enables greater control over the laws embedded within the UK financial regulatory framework. There are many different measures the FSMA 2023 introduces, amongst which are:

- A smarter regulatory framework (amending or restating existing laws).

- The Designated Activities Regime (DAR) e.g. rules covering short selling.
- Oversight of critical third parties (CTP's) e.g., cloud server providers.
- Digital settlement of assets, e.g. stablecoins/cryptoassets.
- A financial promotions gateway (for approval of financial promotions).
- Improved access to cash (applying to withdrawals and deposits).

More information can be found out about the details of the act online.

THE FCA'S OBJECTIVES

The FCA's **single strategic objective** is to ensure the relevant financial markets work well so customers get a fair deal.

Additionally, the FCA has three operational objectives:

- **Protect** consumers
- **Enhance** the integrity of UK financial system
- Help maintain and promote effective **competition**

ACRONYM

P….Protect consumers

E….Enhance integrity

C….Competition (maintain and promote)

With regard to competition the following will apply:

- There are no undue barriers to entry to enable new providers to enter the market
- Consumers are able to drive competition by being able to easily switch providers
- No single firm is able to dominate the market

The FCA now also share the same secondary objective as the PRA, which is to facilitate the UK's economic competitiveness to help grow the UK economy over the medium to long term.

This shared objective was introduced by the FSMA 2023 and means that both regulators must consider the impact on the UK's competitiveness abroad and favour policy approaches that are beneficial for economic growth and access to the UK financial markets.

THE COMPETITION AND MARKETS AUTHORITY (CMA)

The Competition & Markets Authority is an independent non-ministerial government body. It exists to facilitate competition for the benefit of consumers. It has the same regulatory powers as the FCA in this respect so can be seen as a concurrent regulator with regards to competition.

THE FCA HANDBOOK

The FCA provides a Handbook which gives **guidance (G)** on the **rules (R)** and regulations for authorised firms and individuals.

The rules in the Handbook are **binding obligations**. Guidance explains the rules but does not have to be followed.

The handbook also contains **evidential provisions (E).** These can help to establish compliance or contraventions of the rules by providing specific examples of behaviour, for example.

The handbook is divided into sections. The main ones are:

1. High Level Standards (over-arching requirements).
2. Prudential Standards.
3. Business Standards.
4. Regulatory Processes.
5. Specialist Sourcebook.

WHAT CAN BE FOUND IN THE HIGH-LEVEL STANDARDS?

- Code of Conduct.
- Threshold conditions.
- Statements of Principle and code of practice for approved persons.
- Fit and Proper test.
- Senior management arrangements, systems and controls.
- Principles for Business.
- Financial Stability and market confidence sourcebook.
- General provisions.
- Fees manual.
- Training and Competence.

WHAT CAN BE FOUND IN THE PRUDENTIAL STANDARDS?

This book details what firms need to do in order to maintain financial soundness. It describes how firms should value their assets, liabilities, and financial reporting but only applies to solo-regulated firms.

WHAT CAN BE FOUND IN THE BUSINESS STANDARDS?

These describe the specific rules that apply to each sector. The specific rules are documented in the relevant sourcebook, e.g., mortgage rules are detailed in Mortgage Conduct of business Rules (MCOB).

Rules covering investment markets and issues such as insider dealing can also be found in this section under the **Market Conduct Sourcebook**.

WHAT CAN BE FOUND IN THE REGULATORY PROCESSES?

If a firm wants to become authorised this section covers the processes involved. It also contains the Supervision Manual describing how the FCA will regulate and oversee firms' compliance.

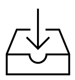
WHAT CAN BE FOUND IN THE SPECIALIST SOURCEBOOK?

There are two other sourcebooks in this section. They cover **redress**, which is related to standards for **complaints and compensation**. The other section is the **Specialist Sourcebook,** and this details the rules for professional firms such as credit unions, accountants, and collective investment schemes.

PRINCIPLES FOR FIRMS & APPROVED PERSONS

The **Principles for Business** underpin the FCA's regulatory regime. They apply to both firms and individuals.

Number	The Principle	A firm must…	What this looks like…
1	Integrity	conduct its business with integrity	
2	Skill, care and diligence	conduct its business with skill, care and diligence	
3	Management and Control	take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems	
4	Financial Prudence	Maintain adequate financial resources	
5	Market Conduct	Observe proper standards of market conduct	
6	Customers' interests	pay due regard to the interests of its customers, and treat them fairly **(TCF)**	
7	Communications with clients	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: Relationship of trust	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	arrange adequate protection for clients' assets when it is responsible for them	
11	Relations with regulators	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	
12	Consumer Duty	A firm must act to deliver good outcomes for retail customers	



Can you think about how firms interpret and evidence the principles? Consider one example of each and make a note of it in the table above to help consolidate your understanding.

PRINCIPLE 6 - CUSTOMERS' INTERESTS

In order to encourage firms to enter into the spirit of the rules, the previous regulator, the FSA, created an initiative called Treating Customers Fairly. This was designed to promote an approach where firms would consider for themselves how to deliver positive outcomes for customers, as opposed to simply following the rules, which could potentially allow them to hide behind the rules if things went wrong.

Responsibility for embedding TCF within firms lies with senior managers, although all employees are expected to follow the principles.

THE 6 TCF OUTCOMES:

- Consumers will be confident that the firm is committed to fair treatment of the consumer.
- Products are designed to meet the needs of customer groups.
- Consumers are provided with clear information at all stages.
- Any advice given is suitable for that client's circumstances.
- Products perform as customers have been led to expect.
- There are no unreasonable barriers to switching product or provider or making a complaint.

Firms must be able to demonstrate that they are consistently treating their customers fairly and delivering the six consumer outcomes. It is a fundamental expectation that where firms fall short of these standards, they must be able to demonstrate what they are doing to address known issues.

CONSUMER DUTY

The FCA introduced a twelfth principle for business in July 2023. It builds upon and goes further than the fair treatment of customers (principle 6) and aims to improve consumer protection (for retail consumers only) by requiring firms to put customers at the heart of everything they do. Where the new principle applies, principles 6 & 7 are no longer applicable, although these two principles remain relevant for firms outside the scope of principle 12.

Consumer Duty is focused on delivering better customer outcomes in the following areas:

1. Products and Services:

- these should be designed to meet consumer needs and sold to customers whose needs they meet.

2. Price and Value:

- products and services must represent fair value for consumers.

3. Consumer Understanding:

- consumers must be given the information they need to make effective, timely and properly informed decisions regarding products and services.

4. Consumer Support:

- consumers must be enabled to realise the benefits of products and services without undue hindrance through support that meets their needs and interests.

There are three “cross-cutting rules” that require firms to:

- Act in good faith.
- Avoid causing foreseeable harm.
- Enable and support retail customers to pursue their financial objectives.

ENHANCING INTEGRITY AND PREVENTION FINANCIAL CRIME

As we have seen one of the FCA’s operational objectives is to enhance the financial system. Financial crime undermines the not just the industry but is detrimental for the wider economy.

The FCA are committed to reducing financial crime, especially Money Laundering, which is covered in more detail in topic 23. The FCA are also committed to reducing **Market Abuse**, such as **insider dealing** and **market manipulation**.

MARKET ABUSE

Which is which? Can you match the crime to the descriptor? Do you know of any examples of either? Can you find any reported examples of these crimes online?

Where a person gives false or misleading information with the intention of influencing the share price for personal gain	Insider Dealing Market Manipulation	Taking advantage of information not yet known to the public, for personal gain, e.g., knowledge of a merger/acquisition

WHISTLEBLOWING

Under the **Public Interest Disclosure Act 1998** employees have a right to protection when reporting serious breaches within their firms, e.g., when there is knowledge of laws being broken.

UNIT 2 – TOPIC 18

REGULATING FIRMS AND INDIVIDUALS

Learning Outcome	Assessment Criteria
1. Understand the main aims and activities of the Financial Conduct Authority (FCA)/PRA and their requirements for ethical conduct by firms and individuals.	K1.4 Arrangements, systems and controls for senior managers. K1.5 Authorisation, supervision, appointed representatives and the fit and proper test for senior managers and certified persons under the approved persons (APER) or Code of Conduct (COCON) as appropriate.
4. Understand the regulator's approach to regulating firms and individuals.	U1.1 Authorisation of firms, regulated activities and regulated investments, firms' status. U1.3 Regulatory approaches to supervision. U1.4 Discipline and enforcement including notification requirements and Statements of Professional Standing (SPSs).
5. Understand how the regulator's rules affect the control structures of firms and their relationship with the regulator.	U2.1 Approved persons and controlled functions. U2.3 Training and competence rules.

KEY TERMS:

- Part IV permission
- Authorised
- Appointed
- Approved
- Fixed vs flexible portfolio
- Representative
- Restitution
- Redress
- Senior manager
- Significant harm role
- Whistleblowing

Authorised, Appointed, Approved – what's the difference? In this section we look at the answers to these questions as well as what it means to be regulated and the requirements for both firms and individuals within the Financial Services industry. We explore the Senior Managers Regime, the Certification Regime and Codes of Conduct to understand how firms and individuals are accountable to their stakeholders.

FCA REGULATION OF FIRMS AND INDIVIDUALS

All financial services firms need to be **authorised** by either the FCA, PRA or both in the case of dual regulated firms. Once a firm is authorised it can conclude business relative to the specific permission obtained (firms must have permissions for each area of business it wishes to conduct.)

The permission sought is called part 4 permission as this is covered in part IV(a) of the FSMA 2000.

Under the General Prohibition contained in section 19 of the act a criminal offence for anyone (including corporate body) to carry out or claim to carry out regulated activity unless they are an **authorised** or exempt person.

THE SENIOR MANAGERS REGIME, CERTIFICATION REGIME AND CODE OF CONDUCT

In response to the problems caused by the financial crisis the government set up a panel to look at how to introduce greater accountability within financial services firms. It was felt that increased accountability will lead to enhanced consumer protection and greater integrity of the financial system.

Individuals within firms that perform significant management roles must be **approved** by the FCA. These individuals are initially selected by the firm and then recommended to the regulator who then approve the individuals to undertake the nominated role. The FCA must approve each senior to ensure they are fit and proper before they are officially appointed.

The Senior Managers Regime (introduced in 2016) sets out the requirements for these individuals, we will take a look at the requirements in more detail later.

Another move to improve individual accountability was to introduce the Certification Regime. This applies to individuals who perform roles that could cause significant customer harm, and typically apply to advisers, significant back-office functions as well as the supervisors of those individuals amongst others.

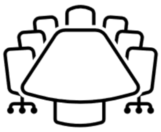
The two levels of accountability work in tandem, with overall responsibility for the Certification Regime resting with senior management functions.

Covering other roles within firms is a code of conduct, which applies to everyone. Different firms will have different codes of conduct, but they are largely based on the FCA's requirements. These three tiers are designed to improve overall accountability at all levels within financial services firms.

The details describing the authorisation and appointment of individuals can be found in the "High Level Standards" section of the FCA handbook.

A summary of the three tiers of accountability:

Senior Managers – individually Approved (vetted)
- Fit & Proper Test
- Responsible for implementing the certification regime
- Responsible for embedding TCF



Senior Managers Regime
- Chief Executive
- Chair
- Executive Director
- Partner
- Compliance oversight function
- Money laundering reporting function

Roles subject to Certification Regime
- Tend to be roles that could cause significant customer harm
- Must meet the requirements for Training and Competence
- Will need to maintain their competence and undertake regular review of their professional standing

Certification Regime
- Anyone who supervises or manages a certified person
- Material risk takers
- Proprietary traders
- Significant management functions
- Roles involved in algorithmic trading

Code of Conduct
- Designed to ensure that everyone who works in the firm understands the ethics and values required in their professional lives

Code of Conduct
- These are based on the “Principles for Business” and apply to everyone

Consider the three levels of accountability within your own place of work. Does your financial services firm have an appointed Senior Manager? Who are they and what are their responsibilities?
If you work in financial services, make a note of who is responsible for your firms Training and Competence Scheme (do you know what one is and what is required?)
Do you know your firms code of conduct? Make a note of it and compare it to the FCA's 11 Principle for Business - do you see any similarities?

THE SENIOR MANAGERS REGIME (SMR)

As well as needing to be individually vetted and **approved**, firms must ensure ongoing fitness and propriety of Senior Managers they appoint.

As part of the initial appointment the Senior manager must pass a fit and proper check that looks into the individual's honesty and integrity. The test involves a review of:

- Criminal records (for Senior Managers only).
- Disciplinary proceedings.
- Any previous record with regard to FCA rules.
- Complaints record.
- Insolvency record.
- Dismissal from a position of trust.
- Competence and capability in meeting FCA's training and competence requirements.
- Financial soundness based on current financial position.
- Any previous bankruptcies and credit rating.
- References from current and former employers over the last 6 years must be provided.
- Any disciplinary action taken against the individual also covering the last 6 years.

When the firm applies for a Senior manager to be **appointed**, the application for the FCA approval of the senior manager, must also be accompanied by a 'statement of responsibilities" so the individual can be compared against the responsibilities they will hold. This statement of responsibilities will form part of the firm's library of responsibilities maps, designed to ensure there is full transparency and records kept of who is responsible for what in the organisation.

Senior Managers must take 'reasonable steps' to prevent regulatory breaches in their area of responsibility. Failure to do this could result in the FCA/PRA prosecuting a senior manager for 'reckless misconduct' if that misconduct has caused the institution to fail. The maximum punishment is a prison sentence of 7 years and/or an unlimited fine.

Depending on the type and size of a firm, different tiers of application of the Senior Managers Regime apply.

The three tiers are:

Core – firms in this tier will have to follow the basic requirements outlined in the rest of this section.

Enhanced – firms representing the greatest risk to consumers will have additional requirements to fulfil.

Limited – these will be exempt from some requirements.

The core element consists of the three levels of accountability we have discussed (Senior Managers Regime, Certification Regime and Code of Conduct).

RESPONSIBILITIES, SYSTEMS & CONTROLS FOR SENIOR MANAGERS

A fundamental principle of the SMR is that senior managers are responsible for the firm's compliance culture. This involves ensuring:

- Management Information is used to ensure the firm treats customers fairly.
- Staff are competent and are monitored.
- Procedures are regularly reviewed and updated where necessary.

Firms need to manage their business appropriately. To achieve this, they must have systems and controls that are regularly reviewed. The systems and controls cover the range of activities the firms carry out. These can include:

- Chains of responsibility.
- Delegation and Reporting.
- Compliance.
- Risk reporting.
- Competence of staff (particularly Advisers).
- Business risks such as IT failure.
- Adequate record keeping systems.
- An audit of all controls.

"Enhanced firms" will need to maintain a list of responsibilities for senior managers to ensure individuals can be identified where they have failed to take **reasonable steps** to avoid regulatory breaches. A senior manager will have overall responsibility for their business area.

Under the SMR it is now possible for the FCA to initiate criminal proceedings against a manager who has contributed to the failure of a firm where the manager is deemed to have been guilty of "reckless misconduct".

The SMR also applies to Appointed Representatives, see below.

Definition: "Appointed Representative"

A firm or individual who carries out regulated activity as an agent rather than principal.

The regulated firm is responsible for the activities of the AR and ensuring compliance with the rules.

A designated senior manager must be responsible for each firm's certification regime.

THE CERTIFICATION REGIME

As we have seen the Certification Regime applies to employees in a firm who could pose "significant harm" to customers through poor advice, decisions or practices. To prevent this from happening, the certification regime was introduced to enhance the capability and ongoing competence of individuals in relevant roles. Their competence must be annually assessed, and the firm must ensure they are fit and proper to fulfil their roles (see honesty and integrity test above).

It is common for such individuals to undertake qualifications and complete a training and competence journey within their organisation.

THE CODE OF CONDUCT

The FCA define the code of conduct that all employees are expected to uphold. These are derived from the principles for business:

CR1 - You must act with integrity

CR2 - You must act with skill, care and diligence

CR3 - You must be open and co-operative with the regulators

CR4 - You must pay due regard to customers and treat them fairly.

CR5 - You must observe proper standards of market conduct.

CR6 - You must act to deliver good outcomes for retail customers.

For senior managers, there are specific conduct rules that they must follow:

SM1 - You must take reasonable steps to ensure that the business that you are responsible for is controlled effectively.

SM2 - You must take reasonable steps to ensure that the business that you are responsible for complies with the regulatory system.

SM3 - You must take reasonable steps to ensure that if any roles are delegated, they are delegated to an appropriate person and that you oversee the discharge of the delegated activity.

SM4 - You must disclose any information to the PRA/FCA that they would reasonably expect notice of.

Firms must make individuals aware of these rules and provide appropriate training and act if staff fall below the required rules.

The FCA also requires firms to report to them if they take disciplinary action against a member of staff as a result of breaching the conduct rules.

- Senior manager breach of conduct rules = report to the FCA within 7 days if they take disciplinary action against a senior manager for breach of the conduct rules.
- For all other staff = an annual report is sufficient.

THE FCA APPROACH TO SUPERVISION

The FCA seeks to ensure that firms are complying with regulatory requirements through a programme of supervision based on 8 principles.

- Being pre-emptive – identifying potential risks before they impact
- Focusing on firms' business models
- Focusing on firms' culture and governance
- Emphasis on individual accountability
- Being proportionate and risk based (matching resources to biggest risks)
- Communicating with consumers and firms (two-way approach)
- Being joined up with other regulatory bodies, e.g. PRA, CMA
- Identifying and fixing system risk and ensuring consumers are compensated

The starting point in relation to how they will supervise a firm is assessing which of the supervision categories a firm falls into:

Dedicated supervisory oversight: there will be a named FCA/PRA supervisor (banking and insurance groups with a very large number of retail customers).

Supervised as a portfolio: the first contact point would be the FCA customer contact centre (firms with smaller numbers of retail customers).

PRIORITISING SUPERVISORY ACTIVITY

The FCA's supervision model is based on 3 pillars, which are constantly under review based on the supervisory work the regulator undertakes.

Pillar 1: **Proactive firm or group supervision** - pre-emptive risk identification and assessment of business models and business culture.

Pillar 2: **Event driven reactive supervision** – dealing with problems that are emerging to limit risks or dealing with issues that have already emerged.

Pillar 3: **Issues and products** – Diagnostic work or remedial activity where harm has occurred across firms.

TRAINING & COMPETENCE (T&C)

The T&C rules are an example of where the FCA is pre-emptive in its approach. The rules set out the minimum requirements to ensure competence of staff. There are three categories of employees with detailed competency and training rules:

- Financial advisers and those dealing in or managing investments
- Supervisors of those advisers
- Supervisors who oversee certain ‘back office’ functions such as supervisors of underwriting or claims staff in a life insurance firm

TRAINING

Firms must determine each employee’s training needs and arrange training. The success of the training in meeting its objectives must be **evaluated.**

Investment advisers must not be allowed to begin advising until the employer is satisfied that they have the knowledge and skills to operate under supervision and that they have passed the relevant modules of an appropriate examination, e.g., DipFA for financial advisers.

Individuals must work under full supervision until they have achieved an appropriate qualification and have evidenced their ability to work independently with minimal supervision.

MAINTAINING COMPETENCE

A firm must also have arrangements to ensure staff maintain competence. A review must take place on a regular basis to assess this competence.

Continuing Professional Development ensures that employees not only maintain their competence but that they stay up to date with industry changes as well as having the core knowledge required for their roles.

For retail investment advisers, a minimum of 35 hours per annum is required in any 12-month period, of which 21 hours must be ‘structured CPD. Protection advisers must complete 15 hours of CPD.

Structured CPD could include seminars, lectures, conferences, workshops, eLearning activities of 30 mins or more.

Unstructured CPD could be independent research, reading industry publications, coaching sessions.

RECORD KEEPING

Employers must retain records showing how an employee’s continuing competence is being assessed.

These training records must be kept for a certain period after an employee has left the firm or ceased a particular role. The periods are:

- 3 years for non-MiFID business
- 5 years for MiFID business (higher risk investment business)
- indefinitely for pension transfer staff

Since January 2013, advisers have been required to obtain a ‘Statement of Professional Standing’ (SPS) each year (this is usually arranged by the employing firm.

DISCIPLINE AND ENFORCEMENT POWERS

The FCA may instigate an investigation of a firm if they believe that the rules have been broken.

Prior to taking against a dual regulated firm, the FCA will consult with the PRA. The FCA may decide to pursue a joint investigation or one of the bodies may act alone.

The regulator has the power to demand information, documentation and that questions are answered.

The FCA might sometimes make a public announcement about their intention to take disciplinary action (usually on a "quiet news day").

Other actions could include:

- Issue a private warning
- Enhanced supervision – make various binding measures
- Publish a statement of misconduct
- Make a financial penalty
- Varying the firm's permissions – removal of a specific permission, e.g., mortgages
- Withdrawal of approval/authorisation – an approved person being struck off
- Seek an injunction – assets of the firm are prevented from being sold
- Seek restitution – FCA applies for a court order to have proceeds forfeited to them
- Seek redress – this time the court order forces the gains to be returned to clients

Firms should also have 'whistle blowing' procedures in place to enable employees to report serious inappropriate circumstances or behaviour within the firm.

Any employees who do report misbehaviour have a right to protection under the Public Interest Disclosure Act 1998.

UNIT 2 – TOPIC 19

PRUDENTIAL SUPERVISION

Learning Outcome	Assessment Criteria
4	U1.2
Understand the regulator's approach to regulating firms and individuals.	Capital adequacy and liquidity

KEY TERMS:

- **Capital adequacy**
- **Solvency ratio**
- **Operational risk**
- **Liquidity risk**
- **Prudential**
- **Risk Weighted Assets (RWA)**
- **Total Loss Absorbing Capacity (TLAC)**

In this topic we look at prudential management and how the regulator seeks to protect the integrity of the industry and wider economy by implementing rules that are designed to mitigate the risks that firms are inherently exposed to. The word prudent means "acting with care" and it is this principle that helps to ensure that consumers and financial markets are not exposed to systemic risks that threaten the very markets and economy in which they operate.

As was witnessed during the financial crisis, there is a risk that a firm could become insolvent (that is their assets are outweighed by their liabilities and/or they are unable to meet liabilities when they are due). Should such a risk materialise, it could put consumers in jeopardy, either through the loss of products, services or even their own capital. Prudential management seeks to reduce this and other risks through the use of systems that protect consumers and markets from the failure of deposit taking, insurance and investment firms.

The chief prudential regulator is the Prudential Regulatory Authority (PRA) who set the standards for large firms, smaller firms must meet the prudential standards set by the Financial Conduct Authority (FCA).

GLOBAL CONTEXT

You only have to consider the global nature of the financial crisis of 2008-2009 to realise that financial markets are international in reach and the failure of a major institution in one country can affect the markets in another. Prudential requirements for organisations are agreed at an international level.

THE BASEL COMMITTEE

This is an international committee based in Switzerland that established the international framework for deposit takers (mainly banks) which oversee the implementation of the agreed laws in this area.

We are now on the third version of the agreement (Basel III 2010.)

CAPITAL ADEQUACY

The purpose of capital adequacy regulation is to ensure that institutions have sufficient funds of their own that any losses they sustain are borne by the institution itself thereby protecting the funds of their customers (shareholders take the risks). A loss might arise for example, from defaulting debtors.

MINIMUM CAPITAL REQUIREMENTS

This can be a complex area to understand, and you must take some time to understand the basics.

The overarching statutory requirements for minimum capital requirements (capital buffers) for all types of financial services firms stem from EU legislation in the form of regulations and directives, the main piece of legislation being the Capital Requirements Directive.

The amount of capital that banks must hold has changed over time, and generally reflects the risks that the institution is exposed to (banks should hold sufficient capital to protect against the various risks they face).

Institutions hold different assets, which can carry different levels of risk depending on the type of asset held (different risk weightings) and the level of capital held is defined as a proportion of the overall value of those assets, e.g., unsecured loans are riskier than government loans (both are assets) and so the risk weighting is different for each type of asset (100% and 0% respectively.)

The weighting is classed as a proportion of the total value of the assets held and this amount is called the **solvency ratio**, which is currently 10.5%.

In brief, assets that have a weighting of 100% dictate that the institution must hold 10.5% of the total value of those assets. An asset that carried less risk, such as mortgages (50% risk weighted), less capital would need to be held (where an equal value of assets was held for each type for example).

TOTAL LOSS ABSORBING CAPACITY

Because of the global nature of banking, there are numerous banks that are not permitted to fail (so called “too big to fail”) and a body of central banks and regulators called the Financial Stability Board (FSB) dictate that those institutions must hold at least 18% capital based on the risk weighted assets they hold. The banks are referred to as G-Sibs (Global Systemically Important Banks).

LIQUIDITY RISK

On the liabilities side, there are additional requirements for institutions to ensure they can meet their cash liabilities when they fall due. This is not the same as capital adequacy, what we are talking about here is the ability of an institution to turn its assets into cash at a reasonable time and cost, so as to ensure it can meet its liabilities when necessary. An institution could be solvent, but technically insolvent, as was the case with the Northern Rock during the credit crunch (the Northern Rock was unable to meet its liabilities without help from the Government as although it had assets in the form of loans, it could not realise those assets quickly in order to meet its own liabilities to creditors.)

A key requirement to counteract liquidity risk is to avoid having a high concentration of liabilities at the same time (achieved in part by spreading maturity dates). Cash flow can be well managed by an institution timing both assets and liabilities, so they are as closely matched as possible.

Additional cash requirements have been introduced by Basel III, which dictate how much cash an institution should be holding to ensure they can meet them.

Now take some time to research the term "stress testing", this video is a good place to start *https://www.bankofengland.co.uk/stress-testing*

OPERATIONAL RISK

A significant risk that financial institutions must mitigate is Operational Risk. It is a broad category of risk that can result from a failure of processes, people or systems. An example might be a failed computer system, losses resulting from staff fraud or even problems caused by environmental issues or natural disasters.

Operational risk can result in a business being unable to operate as normal and consequently institutions must have plans in place to ensure that there is a continuity of service should an operational risk materialise.

Additionally, capital must be held to deal with costs incurred resulting from operational risk events. The basic approach to calculate the amount of capital required is to multiply the institutions average gross income over the last 3 years by 0.15.

FCA/PRA PRUDENTIAL STANDARDS

There are different prudential standards for different firms, most of which are found in the subsections of the FCA handbook and the PRA rulebook, e.g., GENPRU, INSPRU, MIFIDPRU and MIPRU.

SOLVENCY

The capital requirements for most insurance firms are covered by the EU Solvency directives. Solvency I is superseded by Solvency II.

SOLVENCY II

A new directive came into effect in 2016 with the aim of enhancing the requirements for insurance firms to:

- Reduce the risk of claims being unable to be met due to funding shortfalls
- Reduce losses by policy holders if claims aren't fully met

- Ensure early notification to regulator where insurers discover problems likely to result in unmet claims
- Promote confidence in the insurance sector

The solvency II approach is founded upon 3 pillars:

Pillar 1 – How much capital insurers must possess and how their assets should be valued

Pillar 2 – How they are governed (managed) and risk management requirements

Pillar 3 – Rules relating to transparency and disclosure

For now, the UK has implemented Solvency Directives, although the PRA have begun the process of gathering information in order to develop “solvency UK”.

UNIT 2 – TOPIC 20

CONDUCT OF BUSINESS REQUIREMENTS (PART ONE)

Learning Outcome	Assessment Criteria
Understand how the regulator's rules affect the control structures of firms and their relationship with the regulator.	U2.2 Capital adequacy and liquidity U3.1 Advertising and financial promotion rules
Understand how the regulator's Conduct of Business Rules apply to the process of advising clients and customers.	U3.2 Types of customer U3.3 Terms of business and client agreements. U3.4 Status of advisers and status disclosure to customers U3.5 Suitability of advice U3.6 Advice and know your customer rules / robo-advice. U3.7 Execution only sales, appropriateness and insistent clients. U3.8 Fees, charges and commissions U3.9 Cooling off, cancellation and reflective periods. U3.10 Product disclosure and risk disclosure statements.

KEY TERMS:

- **Packaged product**
- **PRIIP**
- **Eligible Counterparty**
- **Professional Client**
- **Retail Customer**
- **Execution Only**
- **Attitude to risk**
- **Capacity for loss**
- **Independent advice**
- **Restricted advice**
- **Designated Investment Business**
- **Real-time vs non-real time promotions**

This section compliments topic 14 & 15 where we looked at the way in which clients are given advice and the areas it is received in. In this section we focus on the regulatory aspects of that process.

A primary requirement for firms when dealing with their customers is to identify which rules apply to their customers. This is to ensure that the appropriate rules and protections are applied.

There are 3 categories of customer:

- Retail Customer (most customers)
- Professional Client
- Eligible Counterparty

Most Protection

↓

Least Protection

Retail Customer – Describes the person on the street and will account for most individuals where advice is required.

Professional Client – Describes an individual who has experience in the industry and is able to accept certain risks. Advice may still be provided.

Eligible Counterparty – typically refers to an organisation or an individual in a very senior position. Banks and other financial institutions class each other as counterparties. In a regulated environment counterparties would have no requirement for advice as there is a high degree of financial knowledge.

DIFFERENT CATEGORIES OF INVESTMENT ADVISER

Investment advisers fall into one of two categories:

- Independent
- Restricted

From a customer's perspective an adviser of a retail investment product undertakes a comprehensive and fair review of the whole market (the review simply needs to be from a diverse range of suppliers and products to ensure the customer's needs can be met.)

An adviser who is restricted however, is one who does not meet the requirement to be independent, which is generally because they are only reviewing providers/products only from firms where there are close links and therefore challenges the independence of the advice on offer.

A firm that specialises in one area can also be classed as independent (focused advice) if they meet the criteria above and make it clear in its firm literature that it is independent in that one area.

For clarity, it is important to understand that the term "Retail Investment" covers the following:

Retail investment products covers:

- Life policies
- Personal and stakeholder pensions
- Other packaged investments such as investment trusts, unit trusts,
- OEICs

- Structured capital at risk products

USE OF PANELS

Firms may wish to use panels of providers that they have approved based on product ranges, charges and service provided. The use of a panel does not inhibit the form from offering independent advice so long as the panel is diverse enough so that any review of the panel can be seen as being a broad review of the market.

SIMPLIFIED ADVICE

This is a form of restricted advice that is either automated or where a decision tree is used. Advisors are only able to offer generic information as part of the sales process.

EXECUTION ONLY

This is a level of service that requires the adviser to execute a specific instruction at the request of the client. The rules regarding appropriate advice do not apply. The client must be able to provide full details of the transaction and accepts that there are no requirements for any risks to be explained. The regulator expects that execution only would be likely to represent only a small proportion of an adviser's business.

A signed statement is required from the client to evidence that the customer had not received advice and waived the protections this affords.

If a customer has received advice but has subsequently rejected that advice in favour of another course of action (perhaps a customer who is insistent on a specific transaction) then the adviser should ask the client to sign to confirm that they have acted against the advice.

ADVERTISING AND FINANCIAL PROMOTIONS RULES

There are some general points to be aware of when it comes to financial promotions or inducements (to persuade a client into entering into a specific contract) for investment activity:

- For retail and professional customers promotions the description of the product must be clear, fair and not misleading.
- They must have been prepared or approved by an authorised individual
- For retail customers the promotion must be understandable by an average target client
- Important terms should not be disguised
- Must always show the name of the regulator
- Be accurate and balanced in describing benefits as well as risks
- Comparisons must be meaningful, fair and balanced
- Sources used and assumptions made in competitor comparisons
- Past performance should not be the most prominent feature

- Past performance data can be used but it must be clear that "past performance is not necessarily a guide to future performance"
- Past performance data at least 5 years, or the period available if less than 5 years of data (subject to minimum of 1 year)

Financial promotions can be divided into two types, **real time** and **non-real time**

Can you match the financial promotion to the correct type? Can you think how to categorise the promotion type?

Real time financial promotions

Financial Promotions

Personal visit

emails

Phone call

Social media

Conference

TV advert

Webchat

Non-real time financial promotions

Real time financial promotions will usually be non-written and involve dialogue in "real time".

A real time promotion could be solicited (asked for) or unsolicited (also known as a cold call). Some types of promotions unsolicited approaches are permitted:

- Life assurance policies
- Unit trusts
- Some investments (lower risk investments)
- Packaged products (e.g., shares, stakeholder pension)

When telephone calls are made the caller must check the recipient of the call is happy to proceed before continuing and provide contact details if making an appointment. Calls are to be made in sociable hours, e.g., between 9am – 9pm, Monday – Saturday.

Unsolicited approaches are not permitted for mortgages.

Non-real time financial promotions are generally written and can take many forms.

ADVERTISING STANDARDS

There are industry specific rules for advertising, all of which are overseen by the Advertising Standards Board. There are two forms of advertising, Broadcast advertising and non-broadcast advertising. Non broadcast advertising essentially involves a firm marketing directly to a customer rather than through general media (direct marketing). There is a code for each type.

The Advertising Standards Authority (ASA) is an, independent, body that administers the British Code of Advertising and Sales Promotion.

The code relating to financial services promotions mainly requires that adverts be **legal, decent, honest and truthful**. They should be prepared in accordance with acceptable principles of fair competition in business and should for example only provide opinions about desirability if it is made clear that it is a statement and not a fact.

Individual adverts to not need to be approved by the ASA although adverts are usually monitored.

ADVISER CHARGES

Until 2013 financial advisers were able to receive commission and as such consumers did not always have to pay out of their own pocket for the advice they received. This changed under the Retail Distribution Review (RDR) due to concerns about the potential for “commission bias” and consequently advisers of investment business must now charge a fee for their service.

The charging structure must be clear, fair and not misleading, based on the service provided and must be disclosed to the client at the outset. If the charges are ongoing the firm must provide an ongoing service and allow the customer to cancel the service at any time without having to give a reason.

Charges must be included in the initial disclosure and may also be contained in the suitability report.

The receipt of commission is still allowed for term assurances or income protection policies.

INITIAL DISCLOSURE REQUIREMENTS

It is very important that before any business is discussed that advisers inform their client about the service they provide, including but not limited to the costs involved. How the firm provides that information is down to the firm (there is no set template for this) but it must be confirmed in writing. In the past firms have used a document titled Services and Costs Disclosure Document (SCDD) or simply Initial Disclosure Document (IDD).

For some types of investment business, where the firm makes decisions about a client’s assets without the need for authorisation each time (designated investment business) a client agreement is used, which sets out the rights and obligations of both parties and is a signed agreement.

Initial Disclosure will need to cover the following:

I.D.D or S.C.D.D.

- Contact Information
- Methods of communication
- Authorised status of the firm and name of regulator
- Independent or Restricted advice
- Approach to evaluating managed investments
- Arrangements for holding client monies
- Charging Structure (indicative)
- Charges payable
- How to complain
- Details of FOS and FSCS

Do you work for a firm that uses an IDD or SCDD? Can you locate a copy and match the information to the above? If you don't have access to a copy, you can find an example one here: *https://www.handbook.fca.org.uk/form/cobs/cobs6_annex_1_010110.pdf*

SUITABILITY REQUIREMENTS

Before a recommendation can be made an adviser must be satisfied that it is suitable having undertaken a review of the clients personal and financial circumstances. This review is often captured in the client fact find document or another questionnaire.

Only when the fact find stage has completed is the adviser then able to begin the shaping of the recommendations ensuring that any recommendation is; consistent with the clients existing and future needs and is affordable now and on an ongoing basis; consistent with the client's risk profile and can be adjusted to meet the clients' future circumstances should they change.

Retaining the fact find information for certain periods of time helps the firm to deal with complaints and provides an audit trail as required under the Conduct of Business Sourcebook.

ATTITUDE TO RISK (RISK TOLERANCE)

The risks the client will need to appreciate include the risks associated with a loss of capital, fluctuations in the levels of income provided through an investment, performance of a pension product, sustainability of life cover for a given premium, ability to make a claim on a protection policy due to personal factors.

Prior to making any recommendation the adviser must establish the clients risk profile. This involves ascertaining their underlying attitude to taking risks, as well as the extent to which the client could deal with a financial loss (capacity for loss).

There are different ways of establishing attitude to risk, one way is to use a risk questionnaire (a form of psychometric testing used to match an individual's traits and psychological preferences against an agreed risk profile) to help determine suitable investments/pensions etc.

SUITABILITY REPORTS

The purpose of a suitability report (or letter) is to provide a written summary of exactly what has been recommended but more importantly, why.

As it is a written document that carries huge importance in helping the client to make informed decisions, it must be written in **plain English.** It must also be clear, fair and not mis-leading.

They must be issued for:

- Pension policies
- Pension opt-outs and transfers
- Collective investments
- Life policies

They are not required for mortgage contracts (although many firms choose to provide them anyway.)

The timescales for issuing the reports are as follows:

- Life policies – before the contract is concluded (started)
- Telephone sales – immediately after the contract has concluded (so long as it has already been provided orally or in any other durable form)
- Personal pension / Stakeholder pension – no later than 14 days after the contract has concluded (in line with the cancellation rights)
- Anything else – as soon as possible after the transaction is affected.

PRODUCT DISCLOSURE REQUIREMENTS

An adviser must provide their customer with a copy of the Key Features Document (KFD) for the product recommended. These are usually produced by the product provider. They are required for all "packaged products" and must be provided before the sale is completed to help the customer decide whether to proceed.

Now take a look at some Key Features Documents to ensure you are familiar with what information is provided at the point of sale. Make a note in your notes section of the common areas, you should have things like "risks", "limitations", "terms" etc listed in your notes.
https://www.mandg.com/dam/pru/shared/documents/en/isak10081.pdf
https://www.lvadviser.com/service/documentlibrary/get/dc645cfbb5324c8d9fde2a807e62033f/flexible-protection-plan-key-features

For a Packaged Retail and Insurance based Investment Product (PRIIP) a Key Information Document (KID) must be provided. A PRIIP is a product where the amount repayable to a customer is at risk from asset or market fluctuations (where assets are not held directly). Examples of PRIIP's include:

- Insurance based investments, e.g., with profits/unit linked endowments
- Structured Products
- Unit Trusts / OEIC's / Investment Trusts
- Derivatives

A KID is brief pre-sale disclosure given to the customer. The purpose of the KID is to allow the consumer to understand the features, risk profile, whether the capital is at risk and relevant performance information. It is provided in a standardised format to allow easy comparison between products and rewards and to compare between providers more easily (based on standardised information requirements).

KIDs would not be required for pensions, shares, bonds, gilts or general and protection-based insurance products that have no surrender value.

THE RIGHT TO CHANGE YOUR MIND OR WITHDRAW

The process for withdrawing from a contract is described in a cancellation notice. The time within which a customer can change their mind is known as the colling off period and the timeframes depend upon the nature of the contract:

- Life (pure protection) and pension contracts = 30 days
- Investments, deposits and other insurances = 14 days

The timeframe begins from the point at which the contract starts, or from when the customer receives confirmation of the contractual terms if this is received later.

The customer is entitled to a full refund (unless they have made a lump sum unit-linked investment where the investment has since fallen in value, in which case they will receive back the value of the investment at the time of cancellation.) This point must be specified in the contract.

There are no colling off periods for mortgage contracts, although a reflection period is available following issue of the mortgage offer, which allows the consumer to consider whether to accept the offer. The customer can reject the offer at any time, although the lender is bound by the offer once made.

Firms must be able to evidence they have issued the cancellation notice or this may result in the customer being able to cancel at any time and not be liable for any loss.

UNIT 2 – TOPIC 21

CONDUCT OF BUSINESS REQUIREMENTS (PART TWO)

Learning Outcome	Assessment Criteria
Understand how the regulator's Conduct of Business Rules apply to the process of advising clients and customers.	U3.11 Regulatory rules for mortgage advice (MCOB) – status disclosure, initial disclosure document, charges, suitability, product disclosure and cancellation. U3.12 Regulatory rules for general insurance advice (ICOB) – status disclosure, initial disclosure document, charges, suitability, product disclosure and cancellation. U3.13 Banking Conduct of business (BCOB) and Payment Services Directive.

KEY TERMS:

- Regulated Mortgage Contract (RMC)
- Consumer BTL
- Committed expenditure
- Self-certification
- Second charges
- Initial interest
- Reflection period
- Basic advice
- Robo advice

In this topic the focus moves to looking at the key requirements for the advising and provision of mortgage contracts, as well as general insurance and other areas of lending practices.

A good place to start this topic is by looking at how a regulated mortgage is defined. Most mortgages in the retail sector are Regulated Mortgage Contracts (RMC), but not all of them. In practice, a regulated mortgage is one that is subject to the Mortgage Conduct of Business rules (MCOB).

Before we explore some of the key requirements (these are covered in more detail in unit 4 of CeMAP 2) we first outline the tests to determine if a specific mortgage proposition meets the strict definition of an RMC:

- The borrower (mortgagor) is an individual or trustee
- The loan is secured by way of a legal charge taken over land
- A minimum of 40% of the land is proposed to be used as a residential dwelling by the borrower or borrower's immediate family

With respect to the land itself, the following applies:

- The land is in the UK, or
- If the contract was entered into after 1st March 2016 the land was in the UK or EEA

This last point is a result of the UK leaving the EU, prior to which the land had to be based in the European Economic Area (EEA).

Any mortgage that fails one of the above criteria will mean that it is not an RMC and the MCOB rules do not apply – typically a corporate mortgage (where the borrower is a company) is not regulated under MCOB or any other mortgage specific regulation.

MORTGAGE CONDUCT OF BUSINESS RULES

The rules were introduced on 31st October 2004 by the then regulator, the Financial Services Authority (FSA). From that date all new mortgage contracts had to adhere to the new rules. Although there have been some new additions to the rules since they were implemented, they have remained largely unchanged.

MORTGAGE CREDIT DIRECTIVE

One of the most significant regulatory changes since 2004 was the introduction of the Mortgage Credit Directive (MCD) in March 2016. There were various effects of the directive, one of which was to extend regulation to second charges (where security is offered a second time typically with a different lender). A further effect of MCD for second charges was that any consultants providing customers with access to second charge loans needed to be qualified to an acceptable level (previously all mortgage advisers providing personal recommendations needed to have achieved CeMAP or equivalent.)

MCD also introduced a new form of BTL (Consumer BTL) which sought to regulate certain BTL mortgages, which up until that point had always been classed as commercial mortgages.

A Consumer BTL can be defined as one where the borrower has not acquired the property specifically with the intent of letting it out for business reasons. This reflects that some BTL customers find themselves in a position of becoming a landlord, rather by accident than intention (hence the term “accidental landlord”.)

The following loan types are all subject to MCOB:

- First and Second charges
- Home Purchase Plans (Sharia Compliant mortgages)
- Debt consolidation or home improvement loans
- Lifetime mortgages and Home Reversion Schemes (Equity Release)

The key areas of MCOB are:

MCOB 3 FINANCIAL PROMOTIONS

- A copy of the non-real time promotion must be kept for a minimum of one year after it was last used and must be approved by a permitted approver or be exempt from approver permission.
- The statement “Your home may be re-possessed if you do not keep up repayments on your mortgage” must be used
- Non real time promotions must include contact details of the firm and they must be clear, fair and not misleading

MCOB 4 ADVISING AND SELLING RULES

An Initial Disclosure must be provided at the start showing if the adviser is a whole of market, limited to a number of providers or restricted to a single lender.

- Records relating to recommendations, e.g., customer fact finds, must be kept for at least 3 years.
- Any mortgage recommended must be suitable and special requirements apply if the mortgage is being used to consolidate debt (suitability reports are not required)

The customer must be provided with certain information at the very outset of the relationship and certainly before any advice is provided. How the firm provides this is not prescribed but many firms issue the client with an Initial Disclosure Document (IDD) that contains:

I.D.D

- Name and Contact Details
- Whose mortgages are offered
- Any limitations of service provided
- Any fees payable for advice
- FCA Registration details
- Details of complaints process
- Details of the financial services compensation scheme

MCOB 5 PRE-APPLICATION DISCLOSURE

It is essential for a customer to have been provided with important information before they apply for a mortgage. The technical term for the illustration used at this juncture is a European Standardised Information Sheet (ESIS). Some firms may simply refer to this as a mortgage illustration. It will contain a full breakdown of the mortgage being recommended, but there are a few important pieces of information listed here:

- Monthly payment
- What the monthly payment amount would increase by for every 1% increase in interest rates
- The Annual Percentage Rate Charge (APRC)

The illustrations are in a standardised format, which makes it easier for consumers to compare different products.

MCOB 6 DISCLOSURE AT THE MORTGAGE OFFER STAGE

The mortgage offer, for all intents and purposes, is an additional illustration containing all of the same information provided previously, but with important additional details. For example, the offer document will confirm that the lender is willing to lend a specific amount and under what conditions:

- One condition contained in the offer is the length of time the offer will remain valid
- No right of withdrawal after the mortgage has completed and include a tariff of charges
- The borrower has a **reflection period** (that cannot be less than 7 days) within which to decide to accept or decline the offer at any time.

Although the offer is binding on the lender the offer will be made subject to certain conditions, designed to protect the lender and consumer. For example, the offer may state that any existing mortgage might need to be repaid to ensure affordability of the new loan once it is in force.

MCOB 7 DISCLOSURE AT THE START OF THE CONTRACT

Before the first payment is made on the mortgage, the lender must confirm the details of the first payment and subsequent payments (due to **initial interest** the customers first payment to the lender will include a number of days' worth of interest payments in addition to the first full monthly payment amount.)

Annual mortgage statements remind the interest only borrower to ensure that there is a repayment vehicle in place. A tariff of charges is also sent.

At least once during the mortgage term (although most tend to do this more regularly) lenders must contact the borrower to check that a credible repayment vehicle is still in place.

MCOB 8 & 9 EQUITY RELEASE SCHEMES

There are special rules apply to the area of equity release, for example the disclosure requirements are enhanced. Additionally, anyone providing advice in this area will need to hold a specialist qualification reflecting the potentially vulnerable nature of the typical client.

MCOB 12 - CHARGES

Early repayment charges must be a reasonable approximation of the costs incurred by the lender as a result of the borrower repaying early.

MCOB 13 ARREARS

Lenders must deal fairly with customers in arrears and must be given within 15 working days of the lender becoming aware of the arrears, the following:

- The Money Helper information sheet ("Problems Paying Your Mortgage")
- The missed payments and total arrears figure including charges
- The outstanding debt
- Any further charges that are likely to be incurred unless the arrears are cleared

ASSESSMENT OF AFFORDABILITY AND VERIFICATION OF INCOME

Affordability rules mean that it is always the lender that is responsible for evidencing that a mortgage it has granted is affordable.

Lenders must be able to evidence their lending decisions and the verification of the client's income must have come from an independent source (payslips are usually accepted if the income can be observed being paid into a bank account in the customer's name.)

For interest only mortgages, lenders need to ensure there is **a credible repayment strategy** in place to repay the loan and include any associated costs of that vehicle in the affordability assessment (or alternatively, they can calculate the affordability in a repayment basis.)

INCOME AND EXPENDITURE

Lenders must take account of any changes to known changes on the customers income or expenditure when assessing affordability, e.g., if a customer is planning on taking maternity leave in then the lender will assume the lower income in the assessment.

When looking at expenditure there are two categories a lender will review; committed expenditure and basic essential expenditure. The former relates to any contractual commitment the client has. The latter includes everything else, such as council tax, childcare, utilities etc.

MORTGAGE SUITABILITY

This is a significant area of MCOB and as such it is covered in more detail in Unit 4 of CeMAP 2. To summarise, a mortgage recommendation must only be recommended if one is suitable for the client and the product recommended must be the most appropriate based on what is known about the client's circumstances and needs at the time. If an appropriate mortgage cannot be identified, then no recommendation should be made.

IMPORTANT NOTE REGARDING STRESS TESTING

At the time of writing a previous requirement to stress test the mortgage payments at a higher rate (to take account of future interest rate rises) has been scrapped by the BoE, however, it is important to have an understanding that this rule was introduced to help prevent high levels of borrowing that may only be deemed affordable as a result of low interest rate environments, in the absence of which risks to borrowers and lenders could arise if interest rates rise to higher levels, as was experienced in the past.

Justification to the scrapping of this requirement is based on limits to how much lenders can agree to as part of their overall mortgage book, but at the time of writing many lenders have opted to retain the test regardless.

LEVELS OF SERVICE

MCOB stipulates that a client must either receive advice or transact on an execution only basis. Historically, information-only was an option, but regulators felt it was too confusing for some customers as mortgage professionals providing a service to clients were unable to provide any recommendations in respect of the customers circumstances.

Execution only is designed for only a small minority of customers:

- Business customers
- Mortgage professionals (for joint applications advice must be provided to any none mortgage professional)
- High net worth clients

VULNERABLE CUSTOMERS AND ADVICE

The FCA regards the following as being vulnerable and therefore these customers must be given advice in the first instance. Should a customer reject the advice given, they may proceed on an execution only basis. Examples the FCA provide as falling into this category include:

- Customers buying a property under the ‘right to acquire scheme’
- Customers entering into a ‘sale and rent back’ scheme
- Equity release applicants

INSURANCE CONDUCT OF BUSINESS (ICOBS)

These rules apply to the advising and administering of non-investment related insurance products and are split into 8 sections which are covered only very briefly here:

ICOBS 1 Application

- Explains what firms and contract types are covered by the rules

ICOBS 2 General Matters

- Covers categories of clients, communications, inducements and record keeping requirements

ICOBS 3 Distance Communications

- Amongst many communication and disclosure requirements, covers the compliance of EU Marketing Directive that ensures clear fair and unambiguous terms for any advertising as well as rules relating to promotions

ICOBS 4 Information About the Firm its Services and Remuneration

- Minimum information that must be provided before a contract can be concluded, mainly covering costs, status of recommendation and that of the provider to the recommending firm.

ICOBS 5 Identifying Client Needs and Advising

- Ensuring suitability of advice and that customers only buy products from which they can make a claim
- Includes the fact that a firm must provide a Statement of Demands and Needs (SODN) to evidence why a product has been recommended.

ICOBS 6 Product Information

- Covers what information a client must be provided with in order to make an informed decision as to whether to proceed or not.

ICOBS 7 Cancellation

- Covers the rights to cancel and time frames
- 30 days for pure protection-based policies
- 14 days for other insurance contracts
- Companies must return premiums within 30 days of the contract being terminated.

ICOBS 8 Claims Handling

- Claims must be handled promptly and fairly.

Grounds on which a claim can reasonably be rejected

BANKING CONDUCT OF BUSINESS RULES (BCOB)

This sourcebook details 6 chapters of rules in relation to firms that accept deposits from UK banking customers in the UK e.g., savings and current accounts. They are designed to not overlap but compliment Payment Services Regulations

PAYMENT SERVICES REGULATIONS

These rules which were updated in 2018 (PSD2) compliment the BCOBS and cover businesses referred to as payment institutions who are authorised to process payments by card, credit transfer or direct debit and include banks, building societies, money remitters, e-money issuers, credit card issuers, merchant acquirers. PayPal is a well-known example of a Payment Services Provider who is subject to the Regulations.

One rule relates to timing of resolving disputes, which dictates that firms have 15 days to respond to complaints, or 35 days in exceptional cases.

The rules over overseen by the Payment Services Regulator, which is a subsidiary of the FCA.

THE STANDARDS OF LENDING PRACTICE

Lending such as unsecured loans, overdrafts and credit cards are not covered by BCOB or MCOB. The Standards of Lending Practice is essentially a means of self-regulation relating to:

- Financial promotions
- Product sale
- Account management/servicing
- Money management
- Financial difficulty
- Customer vulnerability

The standards are published by the Lending Standards Board (LSB.)

BASIC ADVICE & STAKEHOLDER PRODUCTS

You will recall that we looked at Stakeholder products in unit 1. Basic advice was a level of service that applied to these products as it was thought to be less costly for providers to implement. Basic advice relies on a series of scripted questions.

The adviser must explain the nature of stakeholder products and must make it clear that only basic advice will be given. A 'basic advice' initial disclosure document must be provided.

The basic advice process could be appropriate for consumers who have their priority needs met, i.e., they do not need to reduce debt or have some disposable income or capital to invest or have a specific investment need.

A record must be kept of the fact that the firm has chosen to give basic advice on the stakeholder products, and this must be kept for 5 years.

ROBO ADVICE

This is a class of advice that relies upon digital platforms (using algorithms) to provide customers with a low or no cost way of receiving financial advice. This has been particularly important in seeking to address the gap in the lower end of the financial advice market because of the changes in the funding of advice introduced in 2013.

Advice must be consistent with a consumer’s objectives and risk profile.

UNIT 2 – TOPIC 22

CONSUMER CREDIT

Learning Outcome	Assessment Criteria
1.	K2.1
Understand how legislation (other than tax legislation) and regulations impact upon firms and the process of advising clients.	UK legislation and EU directives.

KEY TERMS:
- **Representative APR**
- **APRC**

The following topic covers the regulation first introduced in 1974 that covers many forms of consumer credit.

CONSUMER CREDIT LEGISLATION

The Consumer Credit Act (CCA) is the main legislation in the UK, and it is overseen by the FCA. Prior to 2014 however, the act was enforced by the Office of Fair Trading (OFT).

The act of 1974 introduced a number of safeguards to protect consumers from poor lending practices.

PROVISIONS OF THE CONSUMER CREDIT ACT 1974

Can you match the main provisions on the left to the descriptors on the right?

Credit Reference Agencies	Unless signed on the premises,14 days given to change mind
APR	Must on request disclose and correct wrong information held
Cooling Off Period	Defined procedures to be followed for these given events
Default, termination, settlement	Must have the relevant authorisation by the relevant authority if supplying loans or credit
FCA Licensing	These must meet specific standards
Extortionate Rates or charges	Courts granted powers to provide relief to assist borrowers who have entered into unfair agreements
Advertisements & Agreements	Clients must receive a copy for their own records
Loan Agreement	Total cost shown and method of calculation

Although the Acts affected most lending including personal loans, HP agreements and credit card agreement, regulated mortgages are exempt from the Consumer Credit Act as they are covered by MCOB. This is true of further advances from the original lender (any additional loan for any reason).

An important caveat is that the 1974 Act only regulates credit agreements up to £25,000.

APR & APRC

An Annual Percentage Rate (APR) must be shown for all regulated loans. This will usually be higher than the flat rate as it includes the other charges included in setting up the loan e.g., application fees etc.

A result of the Mortgage Credit Directive, a new APR called Annual Percentage Rate of Charge (APRC) was created. This applies to 1st and 2nd charge mortgages, specifically for mortgage contracts.

PROVISIONS OF THE 2006 ACT

Changes were made to the 1974 Act to offer better protection:

- The scope of who the act protected was broadened and now includes sole traders and partnerships (of 3 or fewer) as well as other syndicates and clubs etc.
- High net worth borrowers can opt to be exempt.
- The act contains provisions to increase the fair treatment of borrowers.
- The scope of the Financial Ombudsman Service (FOS) was expanded to cover credit agreements.
- Courts were granted the power to vary credit agreements if they were deemed to be unfair.
- The upper limit of £25,000 was removed completely, which results in all credit agreements being regulated.
- Loans to small businesses over £25,000 for business purposes are exempt.
- Lenders must send cooling off notices with the credit agreement.

It is thought that the act will be updated again in the future to enhance the provisions even further.

THE CONSUMER CREDIT DIRECTIVE

This EU directive affects mainly credit brokers and credit intermediaries as well as creditors

- The term ‘representative APR’ was introduced and means the rate quoted must have been applied to at least 51% of successful applicants
- Creditworthiness must be assessed by a lender before granting credit

- Pre contract information must be provided in good time before the borrower enters into an 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
- Any interest rate changes must be notified in writing before they take effect
- The borrower can terminate any open-ended credit agreement by giving one months' notice. If the creditor is terminating, the notice period is 2 months and must be justified with reasons

FCA CONSUMER CREDIT REGULATION

The FCA took over this area of regulation from the Office of Fair Trading from April 2014 and adopted a more rigorous approach to enforcement of the regulations. It can for example, apply the Principles of Business to ensure the fair treatment of customers.

Consumer Credit firms must be authorised by the FCA, and the Consumer Credit sourcebook (CONC) is applicable.

UNIT 2 – TOPIC 23

ANTI MONEY LAUNDERING

Learning Outcome	Assessment Criteria
Understand how the Anti Money Laundering regulations apply to dealings with clients and customers.	U4.1 Definition of financial crime and proceeds of crime U4.2 Money Laundering Regulations U4.3 Money laundering offences and the Terrorism Act U4.4 Client Identification procedures and credit reference agencies U4.5 Record keeping requirements U4.6 Reporting procedures U4.7 Training requirements U4.8 The role of the Financial Action Task Force. U4.9 Anti-Bribery and Corruption

KEY TERMS:

- **Money laundering**
- **Concealing**
- **Acquiring**
- **Arranging**
- **Subject Access Request**
- **Property**
- **Financial exclusion**
- **Bribery**

Financial crime imposes costs to the UK that run into the billions of pounds. Those that work in the financial services industry have a key part to play in helping to combat financial crime. In this topic we explore the main crimes, focusing mostly on Money Laundering, the offences and penalties as well as the institutions that work to reduce it.

MONEY LAUNDERING

How would you define money laundering? Have a think now and write a definition in your notes before comparing it with one on the following page

Definition of 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."

Source: LIBF CeMAP 1 text 2022

A basic example of how money laundering might work in financial services is that proceeds from crime can be used to purchase a life assurance policy only for that to be cancelled and the funds returned. Another might be to arrange a mortgage only to repay it early with cash. These acts have attempted to disguise the origins of the criminal proceeds by making them harder to trace.

The key legislation is **the Proceeds of Crime Act 2002**, the Terrorism Act 2000 and EU's Money Laundering Directives.

The National Crime Agency, through their National Economic Crime Command teams work to combat economic crime

Take a look at the National Crime Agency website, there are some great educational videos available to help explain what they are and how they work
https://www.nationalcrimeagency.gov.uk/what-we-do

DEFINITIONS OF PROPERTY

Under EU rules, the definition of property includes all assets of every kind including legal documents and criminal activity is any criminal activity specified in the Vienna Convention or by a member state of the EU.

A GLOBAL RESPONSE

Due to the global nature of money laundering a global response is required. The EU directives are key in this fight.

Under the EU Money Laundering Directives, money laundering within the EU will be treated under EU rules regardless of whether the original crime took place outside the EU.

One method used by criminals to hide the proceeds from crime is to set up shell companies (companies with no employees or trades) to hold assets acquired illegally. The ownership of these companies may be opaque; therefore, each state must maintain a central register of the owners of legal organisations who own or control at least 25% of the organisation.

An organisation called the Financial Action Task Force (FATF) acts as a global money laundering and terrorist activity watchdog. FATF make recommendations to strengthen the standards and address the risks posed by organised crime. It is important to note that while they work to provoke governments to introduce laws and policies, they are not a law enforcement organisation and have no powers of investigation.

The remit of the FATF was expanded to include terrorist financing. FATF maintain list of 'non-co-operative' countries, which it considers having inadequate anti money laundering rules (these countries will often be the target of criminals to reduce detection.)

MONEY LAUNDERING OFFENCES

There are three main offences that apply when people are dealing with the proceeds of crime. Punishment if convicted of any of the main offences is a prison sentence of 14 years and an unlimited fine (or both)

- **Concealing criminal property** (conceal, disguise or transfer)
- **Arranging** (becoming involved in acquisition, retention, use or control)
- **Acquiring or using criminal property** (even suspecting the property is related to criminal activity)

For the lesser offences relating to money laundering the maximum punishment is a 2-year prison sentence or an unlimited fine (or both):

- Failing to disclose
- Tipped off

Partners or Directors that fail to comply with regulations can be fined, receive a 2-year prison sentence (or both).

As the implications for staff are very serious implications, persons working in the industry must ensure they do not become involved either deliberately or by being manipulated. It is incumbent upon firms to train their staff as well as establish procedures to comply with the legislation:

All authorised firms must:

- Provide training to staff about money laundering laws, procedures and individual responsibilities (to report instances or suspected instances of money laundering knows as Suspicious Activity Reports – SAR's)
- Appoint a Money Laundering Reporting Officer (MLRO), which must be someone of appropriate seniority
- Give regular training to staff including warnings about the consequences to themselves and the firm if they fail to follow the rules
- Request a report from the Money Laundering Reporting Officer each year and provides details on any incidents reported by staff (this then gets reported to the National Crime Agency)
- Take action to strengthen procedures and controls and to remedy any deficiencies highlighted in the report.

The FCA can also discipline firms and individuals for breaches of the rules on money laundering. It also has the power to prosecute anyone who breaks the EU Money Laundering Directives.

JOINT MONEY LAUNDERING STEERING GROUP

Firms are expected to consider guidance provided by the FCA as well as that provided by the Joint Money Laundering Steering Group. The Joint Money Laundering Steering Group are a trade association and produce guidance notes to help firms understand the steps they should take in verifying the identity of customers and confirming the source of deposit funds.

Firms also consider the Financial Action Task Force's publications which will highlight any known developments in money laundering.

CUSTOMER DUE DILIGENCE (CLIENT IDENTIFICATION)

A key area is determining the identity of a customer, and this is required:

- When opening a new account, investment or policy
- When the value of an 'occasional transaction' exceeds €15,000. For a business, this figure is reduced to €10,000
- For life assurance, where the annual premiums exceed €1,000 or
- €2,500 for single premium policies.
- Where a change of circumstances of an existing customer requires new evidence to be obtained.
- In every case regardless of the amounts, where there is suspicion or doubts about the proof of identity previously obtained.

THE FIFTH EU MONEY LAUNDERING DIRECTIVE

Since January 2020 virtual currency providers and art traders fall into scope of the law, which applies to occasional transactions of €10,000 or more. Also included are estate agents who act as intermediaries for properties let at €10,000 or more per month.

The directive introduced the right for members of the public to access beneficial ownership information relating to legal entities such as corporations, a move designed to make ownership structures more transparent.

IMPORTANT NOTE FOR MORTGAGE INTRODUCERS:

Where a client is introduced to a firm by an intermediary, it is allowed to accept that intermediary's written assurance that sufficient evidence of identity has been obtained.

- Typical forms of acceptable ID include:
- Current passport
- Driving licence with photo,
- Entry on electoral roll,
- National ID card or

- Recent utility
- Council tax bill.

The Association of Independent Financial Advisers have a standard document that can used to evidence that identity has been confirmed.

FINANCIAL EXCLUSION

Where people cannot produce this evidence, the FCA has guidance to ensure that these people are not excluded from financial services. In this instance, a letter from a person of authority, such as a solicitor or doctor may be acceptable to the provider, but this should be checked with the individual institution ahead of time

MONEY LAUNDERING RECORD KEEPING REQUIREMENTS

Customer ID Records should be retained for at least 5 years after the relationship has ended.

CREDIT REFERENCE AGENCIES

Although no footprint is left on the customer file, Credit Reference Agencies conduct Anti-Money Laundering (AML) checks on behalf of financial institutions.

THE BRIBERY ACT 2010

The act makes it an offence to request, agree to receive, or accept financial or other advantage that is designed to bribe a person into performing an activity improperly

It is also a criminal offence for the employee/official to agree, request or accept ‘financial advantage’.

The offence applies to bribery of employees or officials in any business or other body. This relates to activities in the UK or abroad.

The maximum penalty in the UK for an individual convicted of a bribery offence is an unlimited fine and imprisonment for up to 10 years.

UNIT 2 – TOPIC 24

OTHER REGULATIONS AFFECTING THE ADVICE PROCESS

Learning Outcome	Assessment Criteria
Understand the main features of the rules for dealing with complaints and compensation.	U5.6 The Pension Protection Fund. U6.1 Definitions in the Data Protection Act
Understand the role of the Information Commissioner's Office (ICO).	U6.2 The Data Protection Principles U6.3 Enforcement of the Data Protection Act
Understand how legislation (other than tax legislation) and regulations impact upon firms and the process of advising clients.	K2.1 UK Legislation and EU Directives K2.4 The Pensions Regulator's rules K3.1 Internal and External Auditors
Understand the role of oversight groups and other influencing bodies.	K3.2 Codes of Conduct, Professional Bodies and Trade Associations

KEY TERMS:

- **Data subject**
- **Data processing**
- **Personal data**
- **Sensitive data**
- **Data controller**
- **Data processor**
- **Oversight groups**

The main focus in this topic is the General Data Protection Regulation as this is fundamental to individuals and firms operating in the financial services industry. We will take a brief look at some of the EU directives that are also relevant.

PERSONAL DATA

The safeguarding of individuals data is paramount in financial service, as it is elsewhere. Identity theft has become a significant issue as individuals have begun to be more and more exposed to the risk of fraud over recent years.

UK legislation has been based on EU directives in this area for some time now, the most recent UK Act was the Data Protection Act 1998. The latest regulation of course, is the General Data Protection Regulation, which has remained in full in full in the UK post-Brexit.

The legislation contains 6 principles that apply to the processing of personal data. Data must be (these are paraphrased from the legislation):

1 Processed fairly and lawful and in a transparent manner

2 Collected for legitimate and specific purposes

3 Adequate and relevant and not excessive

4 Data must be accurate and kept up to date

5 Data must not be kept for longer than necessary (subject to record keeping rules)

6 Protected from unauthorised use, damage, loss or destruction.

DEFINITIONS

The following are important terms to understand in relation to GDPR:

“Data subject”: individual (natural person) whose data is processed

“Personal data”: information relating to a “natural person”

“Sensitive personal data”: such data can only be processed with consent, and this includes:

- Racial origin
- Religious beliefs
- Political persuasion
- Sexual orientation
- Health
- Biometric data
- Genetic data

“Data controller”: the legal ‘person’ who determines the purposes for which data is processed and who has overall responsibility for complying with the rules.

“Processing”: covers obtaining the data, recording it, organisation or alteration of that data, disclosure of it or erasure of the data.

There must be specific criteria met before data can be processed (this is usually that consent is given or where a legal obligation exists).

“Data processor”: this is the individual who processes the data on behalf of the data controller

In order to demonstrate compliance with GDPR, an organisation must:

- Establish a governance structure with roles and responsibilities
- Keep a detailed record of all data processing operations
- Document policies and procedures relating to data protection
- Carry out data protection impact assessments for high-risk processing

DATA SUBJECT RIGHTS

- To correct inaccurate personal data
- Have personal data erased in certain situations
- Object to personal data
- Move personal data from one provider to another
- To make a subject access request and to receive this within one month (free of charge)

Processing of personal data by businesses established in more than one EU country will be monitored by one data processing authority which will be in the country where its main offices are registered.

GDPR ENFORCEMENT AND FINES

The **Information Commissioner** oversees GDPR, and breaches should be reported directly to the Information Commissioners Office (ICO.)

The Commissioner can take several courses of action if the rules are broken.

1. Serve Information Notices
2. Issue Undertakings
3. Serve enforcement or “Stop Now” notices
4. Conduct audits to check for compliance (consensual audits)
5. Conduct assessments on compliance with data processing good practice (compulsory audits)
6. Issue financial penalties
7. Prosecute under the legislation
8. Issue a temporary or permanent ban on collecting data

Under the legislation is it a criminal offence to:

- Fail to make a proper notification to the Information Commissioner. This is the process of registering and confirming that personal data is being held and also specifying the purpose for which that data is being held.
- For a data controller to fail to comply with an enforcement or information notice.
- Process data without authorisation from the Commissioner.

The maximum penalty for these offences is a fine of the higher of £17.5m or 4% of worldwide turnover in the previous year.

THE PENSIONS REGULATOR (TPR)

The regulator is chiefly concerned with ensuring firms comply with the terms of the Pensions Act 2004 and 2008. The Act covers work-based schemes only and aims to promote good practices by employers and protect the interests of employees.

The regulator issues codes of practice and works with employers and trustees of schemes to reduce risks to employee pension schemes.

The Pensions Regulator takes a risk-based approach when deciding its supervisory activities. It will consider the combined effect of the **likelihood** of the event occurring and the **impact** of the event on the scheme in order to allocate resources most efficiently.

THE PENSIONS ACT 2004

Introduced through the Pensions Act 2004, the Pension Protection Fund (PPF) provides protection against fraud and insolvency of a firm that would then struggle to maintain the pensions of a scheme.

The amount the fund would cover depends largely on whether the pension is being drawn already or not, but there will only be limited circumstances where a scheme member would receive 100% of the expected benefits.

There are a range of powers available to the Pensions Regulator. Some of these include:

INVESTIGATING SCHEMES

- Identifying and investigating risks
- Requiring notification of changes to benefits
- Requiring immediate notification of underfunding issues

PUTTING THINGS RIGHT

- Issuing specific actions with timeframes
- Any employee contributions must be paid into the fund by the 22nd day of the month following the contribution (employees will receive notification if this doesn't happen)
- Disqualifying trustees if not fit and proper
- Imposing fines or prosecuting via the courts

ACTING AGAINST AVOIDANCE

- Preventing employers from relying on the PPF
- Issuing contribution notices to make good on debts to the scheme or PPF

EU DIRECTIVES

There are a number of EU directives that are embedded into the UK's financial services sector.

The underlying principle, or benefit of the directive is the idea that if a firm is compliant with the regulations in one-member state then it is free to conduct business in any other member state – this is the basis of the EU and essential freedoms.

Very few rules to date have been repealed following the UK's exit from the EU. In fact, the UK have formally "onshored" many of the rules to that they are intended to be permanent arrangements.

The main directives are listed below:

Markets in Financial Instruments Directive (MiFID), which covers:

- Stocks and shares
- Collective investments
- Futures and options
- Currency speculation
- Underwriting the issue of any of the above

ELECTRONIC MONEY REGULATIONS

Covers authorisation and prudential standards for e-money issuers.

Undertakings for Collective Investment in Transferable Securities & Alternative Investment Fund Managers Directive

Both regulations regulate investment funds and managers with the aim of providing investor protection and product control.

One effect of the UK now we are no longer members of the EU is that UK Collective Investment in Transferable Securities (UCITS) that want to market in the EU must now be authorised by the individual EU state. This is because there is no longer the ability to "passport" under a streamlined process.

MIFID II

MiFID II is an EU directive implemented in 2018 that broadens the scope of what investments are covered and enhance investor protection by introducing more rules for how firms are governed.

INSURANCE MEDIATION DIRECTIVE

Main aim is to regulate the sales standards of insurance intermediaries and means they must be authorised in their home state.

Indemnity insurance must be held at either €1,300,380 per case and €1,924,560 in total per annum or an amount equivalent to 10% of annual income or £30m, whichever is higher.

Firms must have financial capacity equal to at least 4% of premiums received, subject to a minimum of €18,750

OVERSIGHT GROUPS

Different groups can contribute to overseeing the way the financial services industry is working to ensure stakeholders including shareholders and customers are being treated correctly.

EXTERNAL AUDITORS

External auditors are primarily concerned with the published financial statements and accounts, and they are primarily qualified chartered or certified accountants.

They are independent of the institution whose accounts are being published.

External auditors are subject to ethical codes of conduct laid out by Institute of Chartered Accountants in England and Wales (ICAEW).

INTERNAL AUDITORS

Are employees of a firm that are independent from the function they are auditing. They will review policies and procedures and ensure that Senior Managers are aware of any remedial activities or improvements that are needed, Ultimately, they help to keep the firm safe by ensuring compliance with all relevant rules.

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.

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.

UNIT 2 – TOPIC 25

CONSUMER RIGHTS, COMPLAINTS AND COMPENSATION

Learning Outcome	Assessment Criteria
Understand the main features of the rules for dealing with complaints and compensation Understand how legislation (other than tax legislation) and regulations impact upon firms and the process of advising clients	U5.1 Consumer rights and remedies, including awareness of their limitations. U5.2 Firms' internal complaints procedures. U5.3 The Financial Ombudsman Service (FOS). U5.4 The Financial Services Compensation Scheme (FSCS). U5.5 The Pension Ombudsman K2.2 The role of relevant Government departments, including the Treasury, HM Revenue and Customs, the Department of Work & Pensions, (Ministry of Justice, CMCs) and the National Crime Agency. K2.5 Unfair contract terms and Consumer Rights Act.

KEY TERMS:

- Unfair terms (in a contract)
- Alternative Dispute resolution
- Mediation
- Eligible Complainant

If you think back to topic 2 of unit 1, we reflected on the 5 different tiers of regulation. Tier 5 was the arbitration schemes and rulings, so in this final topic we look at the complaint's framework. The ability to process by which customers can complain is a key focus for regulators and we look at what consumers can expect from product providers when things go wrong.

CONSUMER RIGHTS

Consider the following scenario.

You are shopping for a new appliance for your kitchen. When browsing in the store you rely on the product information to understand the product details to know how it will perform and what functionality it will provide you with. You decide on a particular item and pay the price listed and receive a receipt and guarantee which ensures that the product is fit for purpose and manufactured to an acceptable standard. After taking the item home and using it for the first time, it develops a fault and no longer operates so you take it back to the store and receive a refund after declining the offer of a replacement.

Within the UK individuals have certain key rights irrespective of whether they are financial services customers or not and the scenario reflects the fact that as consumers we have the right to:

- Get clear and honest information before they buy
- Get goods or services that we pay for
- Get goods that are fit for purpose and services performed with reasonable care and skill
- Have faults corrected free of charge or get a refund/replacement

THE CONSUMER RIGHTS ACT 2015

This legislation replaced some long-standing legislation and for the first time introduced what should happen when digital content is faulty, e.g., the downloading of music or video content.

The Act covers also covers:

- What to do when goods are faulty
- What should happen if goods and services don't match up with what was agreed
- Unfair terms in contracts

Although rights in the above areas existed before the Consumer Rights Act 2015, the Act makes it easier to pursue these rights, which is useful as it keeps legal disputes out of the courts.

To further support the resolution of disputes, consumers are encouraged to make use of Alternative Dispute resolution services, such as OFGEM or OFCOM, which are essentially industry specific organisations that aim to resolve a disagreement for businesses and consumers.

UNFAIR TERMS IN CONSUMER CONTRACTS

The Consumer Credit Act 2015 applies to contracts between consumers and a seller of goods or services, where the consumer has no power to change the terms of the contract.

The core principles of the Act involve **fairness**, **transparency** and **good faith**.

The FCA have powers in this area to challenge terms if they can be shown to be unfair. An example of an **unfair term** is where a provider can alter the terms of the contractual pricing or characteristics when a customer is bound to the contract terms. What this means in practice is that an unfair contract term can be removed from the contract allowing the rest of the contract to remain in force.

GOVERNMENT DEPARTMENTS AND GUIDANCE SERVICES

We have seen throughout this study text that there are many ways in which governmental departments have a roe to play in the financial services industry. Additionally, there are plenty of other services available to support consumers.

Spend some time considering how the main way in which either the government department support consumers and research the main aim of the support services listed in the table on the following page

Government Department / Guidance Service	Role in Financial Services / How Supports Consumers
HM Treasury	
HM Revenue & Customs	
The Department for Work and Pensions	
National Crime Agency	
Money Helper	
Which?	
Citizens Advice	

STEPS FOR FIRMS WHEN HANDLING COMPLAINTS

The following steps must be implemented into a firms' processes so that when it receives a complaint from an eligible complainant (see box below)

The Acronym **AIRIAP** may help to recall the steps:

A – Acknowledge a complaint in writing

I – Investigate (usually by an someone not involved in the cause)

R – Resolve – Promptly (within 8 weeks)

I – Inform the customer during the process (keep informed on progress)

A – Advise the customer of their right to refer to the Financial Ombudsman if unresolved in 8 weeks.

P – Provide a final response letter with an outcome decision on the complaint

Eligible Complainant

- A private individual including one acting as a guarantor for business loans.
- Trustee (trust assets valued less than £5m).
- A personal guarantor (for business loans) or a business with an annual turnover of less than £6.5m or annual balance sheet below £5m that has fewer than 50 employees.
- Charities with income of less than £6.5m.
- A micro enterprise employing fewer than 10 people and with a turnover or balance sheet of less than £2m.

TIMESCALES FOR COMPLAINTS

For a complaint in relation to a payment service the service provider has 15 days, unless in exceptional circumstances this can be extended to 35.

As we have seen above, firms have 8 weeks to resolve a complaint. Only after the 8 weeks have elapsed can the customer raise the complaint to the Financial Ombudsman Service (FOS).

Once a firm has issued a resolution letter, the client has 6 months to decide to elevate the complaint to the FOS.

For complaints that arise because of historic issues, such as was observed with PPI complaints, the customer has 6 years to raise the complaint, or 3 years from when the customer became aware that they had cause for complaint (whichever is the later.)

REPORTING OF COMPLAINTS

Firms must report to the FCA on a 6-monthly basis, breaking down the complains data into those that have been resolved and those which haven't. Firms that receive less than 500 complaints in a six-month period have a different set of requirements.

Firms are expected to undertake root cause analysis of complaints to prevent future complaints.

RECORD KEEPING

Records relating to complaints must be kept for 3 years from the date of complaint, unless the complaint is in relation to MIFID business, where the requirements are a minimum of 5 years and a maximum of 7.

FINANCIAL OMBUDSMAN SERVICE

Since December 2001 the Financial Ombudsman Service (FOS) consolidated a range of other ombudsman schemes. The FOS is an example of a Dispute Resolution Service, which is designed to help resolve fairly and impartially. They have powers granted by the Financial Services and Markets Act enabling them to put things right individuals and small businesses. They are a limited company that do not operate for profit and are funded by authorised firms through a levy.

The FOS can deal with complaints from eligible complainants (see above) and will investigate the complaint with a view to making a ruling, which will be **binding on the firm**, but not on the customer (who can take the matter to the courts if they wish).

The FOS can make financial awards that are designed to restore the customer to their original financial position (plus interest and costs.) The maximum compensation limits are as follows:

Date of act/omission	Date of referral to FOS	Compensation limits
On or after 1st April 2019	On or after 1st April 2020	£355,000
	Between 1st April 2019 and 31st March 2020	£350,000
Before 1st April 2019	After 1st April 2019	£160,000
	Before 1st April 2019	£150,000

THE FINANCIAL SERVICES COMPENSATION SCHEME

The scheme, which is run jointly by the FCA, and PRA is designed to protect consumers who have lost money as a result of a firm becoming insolvent. It is funded by authorised firms through a levy. It is important to reiterate that the scheme is designed only to cover losses resulting from insolvency, it will not pay to consumers for poor advice or a loss resulting from falling stock values. Large business is excluded from the scheme.

The limits of the scheme depend on the sub-scheme, as follows:

DEPOSITS

100% of the first £85,000 or £170,000 in a joint account.

For temporary balances resulting from a life event such as sale of a house, inheritance, divorce settlement, pension, redundancy, criminal injury compensation then the limit can be expended to £1m.

DEBT MANAGEMENT

100% of the first £85,000.

INVESTMENTS

100% of the first £85,000 (per firm.)

MORTGAGES

100% of the first £85,000 (per firm.)

INSURANCE COMPANIES

100% of the value of the policy with no upper limit (for all long-term insurance contracts that pay on death or disability.)

Annuities which provide income also receive 100% protection.

Also 100 % for compulsory insurances such as employer's liability and motor insurance.

For other types of insurance, the compensation limit is 90% of the claim.

INSURANCE BROKERS

90% of the claim value with no upper limit.

THE PENSIONS OMBUDSMAN (POS)

The POS deals with complaints about how pensions are run and managed (for both personal and occupations pensions.) For complaints in relation to the sales and marketing of pensions these are dealt with by the FCA.

In the first instance complaints should be raised with the pension scheme manager. Trustees may also become involved. Cases that are not resolved to the client's satisfaction can be referred to POS.

The decision of the POS is binding on **both client and firm**, which is a departure from the decision of the FOS where decisions are only binding on the firm.