Long-term insurance business

P63 November 2012 edition

Web update 1: May 2013

Please note the following update to your November 2013 edition of the P63 study text.

Regulation of the UK insurance industry

Following the implementation of the Financial Services Act 2012 on 1 April 2013, the regulatory reforms referred to in Chapter 11, section D1 have now come into force and the FSA has been replaced. References in the P63 text to the Financial Services Authority (FSA) should therefore be read in the light of the following update:

The Financial Conduct Authority (FCA) www.fca.org.uk

The FCA is a separate, independent regulator responsible for the regulation of conduct of business and market issues for all firms. It takes responsibility for the prudential regulation (capital adequacy/solvency) of small firms such as insurance brokers and financial advisory firms. Its focus is on taking early action, before consumer detriment occurs. It will conduct thematic reviews and market-wide analysis to identify potential problems in such areas, such as financial incentives. It will review the full product life cycle from design to distribution and has the power to ban products if necessary.

The Financial Services Act 2012 gives the FCA an overarching strategic objective to ‘ensure that the relevant markets function well’. It also has three operational objectives:

• Consumer protection: securing an appropriate degree of protection for insurers.
• Integrity: protecting and enhancing the integrity of the UK financial system.
• Competition: promoting effective competition in the interests of consumers in the markets for:
  – regulated financial services; and
  – services provided by a recognised investment exchange.

The Prudential Regulation Authority (PRA) www.bankofengland.co.uk/pra

The PRA sits within the Bank of England and is responsible for the prudential regulation, stability and resolvability of systemically important financial institutions, such as banks, building societies and insurers (i.e. institutions that would pose a risk to the financial system if they were to fail). It will therefore authorise, and regulate for prudential matters, all UK domiciled insurance companies. It will not seek to prevent the failure of firms but will seek to ensure that firms can fail without bringing down the whole financial system.

The emphasis is on a ‘judgment-based’ approach to supervision focusing on the external environment, business risk and risk management, management and governance, and capital and liquidity.

The PRA’s objectives are:

• primary objective: to promote the safety and soundness of PRA-regulated persons; plus two secondary objectives:
  (i) to ensure that PRA authorised persons carry on in a way which avoids adverse effect on the stability of the UK financial system; and
  (ii) to minimise the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system.
• The PRA also has a specific insurance objective: to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.
• In addition to this additional objective, the PRA also has a specific responsibility to secure an appropriate degree of protection for the reasonable expectations of policyholders as to the distribution of surplus under with-profits policies.
Financial Policy Committee (FPC) [http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx](http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx)

A committee within the Bank of England responsible for watching for emerging risks to the financial system as a whole and providing strategic direction for the entire regulatory system.

Insurance companies (both general and life) will therefore be subject to prudential regulation by the PRA, and conduct of business and market issues regulation by the FCA.

The FSA Handbook has been split between the FCA and PRA to form new Handbooks which reflect the new regulatory structure – for example references to FSA have been replaced with the appropriate regulator. Both the FCA and PRA Handbooks can be accessed from [www.fca.org.uk](http://www.fca.org.uk).

**Activity**

Take a look at the FCA and PRA websites to familiarise yourself with the new regulators: [www.fca.org.uk](http://www.fca.org.uk) and [www.bankofengland.co.uk/pra](http://www.bankofengland.co.uk/pra)

Please note the following amendments/additions to your copy of the study text.

**Chapter 1**

Section D1, page 1/7

2nd sentence of 2nd paragraph – amend the text as indicated in bold type:

From 1 January 2013, it **was** no longer possible to receive commission on investments and the cost of the advice **must** be agreed between the adviser and the client before a recommendation is made.

Section D4, page 1/8

Please add the following sentence to the 2nd paragraph:

Where they are not involved in advising on investments they may still rely on sales commission rather than fees as advisers selling general insurers might. There is more about the distinction between the regulations for selling investment products and ‘pure protection’ products in chapter 11.

**Chapter 2**

Section C3, page 2/10

4th sentence of 1st paragraph – amend the text as indicated in bold type:

... should not exceed **50–65%** of the insured’s average monthly earnings...

Section C6, page 2/11

4th sentence – delete the text in bold:

This modifies the usual principle of utmost good faith for long-term insurances, although some companies...

**Chapter 4**

Section A5, page 4/3

1st sentence of 4th paragraph – amend the text as indicated in bold type:

... capped drawdown is limited to **120%** of the relevant annuity...

Section A8, page 4/4

3rd paragraph in callout box – amend the text as indicated in bold type:

Following consultation, the standard lifetime allowance was reduced to £1.5 million from tax year 2011/12 **and reducing again from tax year 2014/15 to £1.25 million**.

6th paragraph in callout box – add the following text as indicated in bold type:

... the lifetime allowance is exceeded **if it is taken as a lump sum, or 25% if taken as pension income**.

7th paragraph in callout box – add the following sentence:

From the tax year 2014/15 the allowance is reduced to £40,000.

**Section C, page 4/5**

2nd paragraph – delete the 2nd sentence beginning ‘In some schemes...’.
Section F, page 4/7
2nd paragraph – amend the text as indicated in bold type:
Companies with five or more employees were required to provide access to a stakeholder pension unless they already had a suitable alternative pension scheme in place. The criteria for minimum employee numbers changed in October 2012 with the advent of compulsory workplace pensions (see section 4H).

Section H, page 4/8
2nd paragraph, 1st sentence – amend the text as indicated in bold type:
Many workers have historically failed to take up pension benefits because they did...

2nd paragraph – add the following text:
Individual employers’ duties will be introduced gradually and will be based on the employer’s size with the largest employers required to take action first. All employers are expected to comply by 2018.

4th bullet – change £7,745 to £8,105.

4th paragraph – delete 2nd sentence beginning ‘Individual employers’ duties...’.

6th paragraph – amend the text as indicated in bold type:
... a minimum limit (£5,564*) up to a maximum limit (£42,475*). (*figures current April 2013)

Section I, page 4/9
The ISA limits have changed for the 2013/14 tax year, as follows:
Maximum annual contribution for a stocks and shares ISA is £11,520.
Maximum annual contribution for a cash ISA is £5,760.

Self-test questions, page 4/16
Change question 4 to:
How much are the current annual allowance and lifetime allowance?

Chapter 5
Section B4B, page 5/5
3rd paragraph, 2nd sentence – amend the text as indicated in bold type:
The lifetime allowance is £1.5m for tax year 2013/14 reducing to £1.25m in tax year 2014/15.

Section C1, page 5/5
2nd paragraph, 3rd sentence – amend the text as indicated in bold type:
Statutory sick pay for 2013/14 is £86.70 per week.

Section C1A, page 5/6
Last paragraph – replace the 2nd sentence with:
The 2013/14 basic ESA is £71 per week if you are aged 25 or over, or £56.25 if under 25. This is payable for the first 13 weeks. After that it may rise to a maximum of £105.05 per week, depending on the claimant’s circumstances.

Chapter 6
Section B1, page 6/3
Last paragraph, 1st sentence – amend the text as indicated in bold type:
...notice procedure under FCA rules.

Section D4, page 6/4
Replace the paragraph with the following text:
The Financial Services Act 2012 gives the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) powers of regulation over life offices. The insurer must be authorised by these regulators to do long-term insurance business (life assurance, annuities, income protection insurance) in the UK.

Section E
The Consumer Insurance (Disclosure and Representations) Act 2012 came into effect on 6 April 2013. All brokers and insurers now need to comply with its requirements as described in this section.
Section E3A, page 6/7
1st paragraph – amend the text as indicated in bold type:

**A general principle of insurance is that** the proposer must disclose all material facts known by them to the insurer.

Self-test questions, page 6/11
Delete question 2

Insert new question 4:
How did the Consumer Insurance (Disclosure and Representations) Act 2012 modify the doctrine of utmost good faith?

Replace question 5 with the following:
What remedy does the insurer have where it encounters careless misrepresentation by the life assured?

Replace question 8 with the following:
What burden did the case of Pan Atlantic Insurance Co. Ltd v. Pine Top Insurance Co. Ltd place on the underwriter when wishing to act on misrepresentation?

Chapter 7
Introduction, page 7/2
2nd paragraph – amend the 1st and 2nd sentences to read:

An underwriter must bear in mind that the proposer is in possession of all material facts relating to the risk and has a duty to disclose them in answer to insurer’s questions on the proposal form.

Section F2, page 7/17
Replace paragraph with the following text:

Moral hazard and anti-selection are behaviours where consumers suppress or provide misleading information to insurers. The Consumer Insurance (Disclosure and Representations) Act 2012 requires proposers to answer questions honestly that are asked by the insurer. Where the insurer is not given all the information it asks for by the proposer the insurer may be ‘selected against’, which means it may accept a risk on terms it had not intended to. This can have an effect on the risk profile of the insurer’s portfolio and affect its profitability. The insurer will monitor its proposal form questions to ensure they capture the information the insurer wants to know. Poorly worded questions can also result in anti-selection where proposers unwittingly do not answer in the way the question is intended.

Chapter 8
Section A4, page 8/4
Last paragraph – add the following sentence at the end:

It does not prevent premiums being rated individually based on an applicant’s medical history.

Chapter 9
Section B3, page 9/11
1st paragraph, last sentence – amend the text as indicated in bold type:

...typically of **less than 12** months

Self-test questions, page 9/35
Replace question 10 with the following:

What is the insurer’s remedy for deliberate misrepresentation under the Consumer Insurance (Disclosure and Representations) Act 2012 when it is found during the assessment of a claim?

Chapter 11
The new regulatory regime came into effect on 1 April 2013. As outlined on page 1 of this update, the FSA has been replaced by two new regulatory bodies: the PRA and the FCA.

Chapter 12
Section A1A, page 12/3
1st bullet point – add the following statement at the end:

(£9,440 for the tax year 2013/14)
The income tax rates and bands have been updated for the tax year 2013/14, as follows:

<table>
<thead>
<tr>
<th>Income tax rates and taxable bands</th>
<th>2011/12</th>
<th>2012/13</th>
<th>2013/14</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Starting rate for savings:</strong> 10%*</td>
<td>£0–£2,560</td>
<td>£0–£2,710</td>
<td>£0–£2,790</td>
</tr>
<tr>
<td><strong>Basic rate:</strong> 20%</td>
<td>£0–£35,000</td>
<td>£0–£34,370</td>
<td>£0–£32,010</td>
</tr>
<tr>
<td><strong>Higher rate:</strong> 40%</td>
<td>£35,001–£150,000</td>
<td>£34,371–£150,000</td>
<td>£32,011–£150,000</td>
</tr>
<tr>
<td><strong>Additional rate:</strong> 50%</td>
<td>Over £150,000</td>
<td>Over £150,000</td>
<td>N/A</td>
</tr>
<tr>
<td>45% from 6 April 2013</td>
<td>N/A</td>
<td>N/A</td>
<td>Over £150,000</td>
</tr>
</tbody>
</table>

*The 10% starting rate applies to savings income only. If, after deducting your personal allowance from your total income liable to income tax, your non-savings income is above this limit then the 10% starting rate for savings will not apply. Non-savings income includes income from employment, profits from self-employment, pensions, income from property and taxable benefits.

The rates available for dividends are the 10% ordinary rate, the 32.5% dividend upper rate and the dividend additional rate of 42.5% (the dividend additional rate is 37.5% from 2013/14).

Broadly speaking basic rate taxpayers can earn up to £32,010 based on 2013/14 rates. Higher rate taxpayers earn more than £32,010.

A five-year endowment policy was taken out on 1 May 2008 with a single premium of £10,000. The policy matures on 1 May 2013; maturity value £15,000.

Maturity of a non-qualifying policy is a chargeable event.

\[
\text{Chargeable gain} = \text{maturity value} - \text{the single premium paid}.
\]

\[
\begin{align*}
\text{Chargeable gain} &= £15,000 - £10,000 = £5,000 \\
\text{Top-slicing: number of full years is five.}
\end{align*}
\]

\[
\text{Top-sliced gain} = \frac{£5,000}{5} = £1,000
\]

Individual’s other earned income is £50,000. Thus total income is £51,000.

1) Income tax with gain

\[
\begin{align*}
\text{£32,010} \times 20% &= 6,402 \\
\text{£18,990} \times 40% &= 7,596 \\
\text{Total} &= 13,998
\end{align*}
\]

2) Income tax without gain

\[
\begin{align*}
\text{£32,010} \times 20% &= 6,402 \\
\text{£17,990} \times 40% &= 7,196 \\
\text{Total} &= 13,598
\end{align*}
\]

\[
\begin{align*}
\text{Difference between (1) and (2)} &= 400 \\
\text{Less basic rate tax on top-sliced gain} &= 200 \\
\text{Tax on top-sliced gain} &= 200 \\
\text{Therefore tax liability on whole gain} &= 1,000 \\
\text{£1,000} \times 20% &= 200
\end{align*}
\]

It will be seen that the effective rate of tax on the gain is thus:

\[
\begin{align*}
\text{Top rate of tax} &= 40 \\
\text{Less basic rate tax} &= 20 \\
\text{Effective rate on gain} &= 20
\end{align*}
\]
Section C1, page 12/13

1st paragraph

The annual exempt amount has changed in tax year 2013/14 to £10,900.

Section C1A, page 12/14

1st paragraph – the CGT tax rates remain the same for tax year 2013/14.

Example 12.4 should be updated as follows to reflect the tax year 2013/14, as indicated in bold type:

The following example demonstrates CGT liability where an investor buys an endowment policy. Tax will be payable on the profit made when the investor disposes of the traded policy, for example when a death claim arises, the policy matures, or the policy is surrendered or re-sold.

Details of the policy:
Endowment policy commenced on 1 July 1986.

Paula bought the traded endowment on 1 February 2003 for £15,000.

The policy matured on 1 July 2013 paying a maturity value of £29,000.

The monthly premiums paid by Paula since purchase until the maturity date total £2,000.

The calculation of CGT is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount received on disposal (maturity)</td>
<td>£29,000</td>
</tr>
<tr>
<td>Less purchase price</td>
<td>£15,000</td>
</tr>
<tr>
<td>Less premiums paid</td>
<td>£2,000</td>
</tr>
<tr>
<td>Taxable gain</td>
<td>£12,000</td>
</tr>
<tr>
<td>CGT exemption amount for 2013/14 (the year in which the asset was disposed of)</td>
<td>£10,900</td>
</tr>
<tr>
<td>Balance</td>
<td>£1,100</td>
</tr>
<tr>
<td>CGT payable at rate of 18% (£1,100 x 18%)</td>
<td>£198</td>
</tr>
</tbody>
</table>

In the above example the CGT tax rate of 18% was used. This is based on the assumption that Paula is a basic rate taxpayer.

Section C2, page 12/15

1st paragraph – the inheritance tax threshold remains the same for tax year 2013/14.

Section C3B, page 12/19

The tax rates in this section remain the same for the tax year 2013/14.

Section C3C, page 12/19

Table, 2nd row should be updated as follows:

Dividends and distributions – the rate is 37.5% (dividend trust rate).

Other income – 45% (trust rate).

Self-test answers

Chapter 4, page iv

Answer 4 should be updated as follows:

The annual allowance for 2013/14 is £50,000 and the lifetime allowance is £1.5m.

Chapter 6, page vi

Delete answer 2

Insert new answer 4:

Proposers only need to reasonably disclose information asked for by the insurer rather than all material facts.

Replace answer 5 with the following:

If the insurer would not have entered into the contract on any terms, had the consumer disclosed the information, it can avoid the policy and refuse any claims but must return the premium to the policyholder. If the insurer would have applied different terms, such as an exclusion, it may apply the exclusion but allow the contract to continue. If the exclusion prevents a claim being paid, the insurer is entitled to refuse the claim. Where the insurer would have charged a premium rating, any claim under the policy would be paid subject to a lower sum assured proportionate to the actual premium that had been paid. If misrepresentation arises not connected to a claim, the insurer may choose to charge the consumer the correct higher premium rather than reduce the sum assured.
Replace answer 8 with the following:

The underwriter must be able to show that, without the misrepresentation, it would not have entered into the contract or would have done so only on different terms.

**Chapter 9, page ix**

Replace answer 10 with the following:

The insurer may decline the claim and avoid the policy.