

August 2003

FSA Factsheet

With-profits bonds



This factsheet is for you if:

- you already hold a with-profits bond; or
- you are thinking of buying a with-profits bond.

It explains:

- how a with-profits bond works;
- what you get for your investment;
- what happens if you want to cash in the bond; and
- key points on the taxation of with-profits bonds.



With-profits bonds are often marketed and described as low to medium risk investments. It is important to understand that they do carry some investment risk and your capital (original investment) is not guaranteed. The level of risk depends on the type and proportion of assets that are in the bond.

This factsheet explains how with-profits bonds work, what you might get back, and what happens if you decide to cash in the bond. If you want information about with-profits policies generally, please read the **FSA Factsheet With-profits policies** – see Useful contacts on page 5.

What are with-profits bonds?

A with-profits bond is a long-term (10-20 years) investment that you buy with a lump sum. It is most often used to pay you an income over a long period of time and it includes some life insurance. For example, on your death it might pay your estate the value of the bond at that time plus 1% of its value. But it is normally used as an investment rather than an insurance product.

How do you buy a with-profits bond?

You pay a one-off lump sum (single premium), usually £5,000 or more. Some bonds may allow more money to be paid in at regular intervals but the requirement is that you pay one big lump sum at the start.

You can either buy your bond direct from an insurance company (by replying to an advertisement) or through an independent financial adviser (IFA). You should be aware that there are charges for setting up the bond. If you use an IFA, some charges will represent the commission paid to the IFA for advice on your bond. For more information about financial advisers and commission payments see the **FSA guide to financial advice** – see Useful contacts.

The FSA's Comparative Tables give details of charges that are deducted from investment bonds, including with-profits bonds. You can see the tables at www.fsa.gov.uk/tables

What happens to your lump sum?

The insurance company puts your lump sum - after a deduction for expenses - with those of other with-profits bondholders into one big pool, called a pooled fund, with the intention of making it grow over time. The pooled fund is invested in a range of ways – typically this is a mix including shares on the stockmarket, commercial property, **gilts** (loans to the government) and **corporate bonds** (loans to companies). These are known as assets. The insurance company decides on the exact balance of assets. **With-profits bonds do carry some investment risk and your capital is not guaranteed.**

What do you get in return?

Each year the insurance company will value the fund and will normally declare bonuses. Companies do not guarantee to pay bonuses every year but, once added, they cannot be taken away. Any growth is paid by adding bonuses to your bond.

These are often called *regular* or *annual* or *reversionary bonuses*. An extra bonus may be added at the end of the bond's term. This is often called a *final* or *terminal* bonus.

A benefit of your with-profits bond is that you can take payments of up to 5% of your original investment every year without any tax consequences at the time of the payment.

Instead the payments are taken into account for tax when the policy ends – see “What about tax?” on page 4. You can defer tax on payments of 5% a year for up to 20 years.

If your capital does not grow by 5% in any one year and you take out 5%, then you will be reducing your capital. As a general rule, if your insurance company announces that your bonus is below 5%, then it is likely that your capital has not grown by 5% that year. Check with your insurance company, your IFA or look at your annual statement to find out what your annual bonus is.

If you don't need to take income every year from your bond, there is more chance that your bond value will grow, though this is not guaranteed.

Where do the bonuses come from?

The profits earned from investing in the pooled fund are shared between the investors in the form of a bonus. This is normally done once a year.

As mentioned earlier, normally some of your capital will be invested in the stockmarket. If the stockmarket is doing badly one year, then the underlying assets may not grow as much as they would in a good year. They may not grow at all, or even fall in value. The same can be true of property investments or of the returns on gilts or corporate bonds.

With-profits bonds try to ‘smooth out’ the ups and downs in the markets. In part, investing in all these different assets does this. If one area of investment (for example the stockmarket) has a bad year, then this may be offset by good performance in another (for example property). Very occasionally they might all do badly. Smoothing is also achieved by taking a percentage of the profits from a profitable year and paying it out as bonuses in a less profitable year. If there are a number of poor years, then the company may not pay a bonus at all. This can have a big effect on the value of your bond if you are making withdrawals from it to supplement your income.

What else affects the bonuses?

Some with-profits funds are affected by more than just the investment profit and losses of the pooled fund.

They may also share in the profits and losses that arise from running the business as a whole – *business risk*. So how well the company is run and whether or not it follows a profitable business strategy could directly affect the bonuses added to your bond.

If the company is owned by shareholders, some of the money earned by investing the pooled fund may have to be shared with them. This will either be taken as part of the charges deducted from your bond or by giving shareholders a share (normally no more than 10%) of the total profits available for distribution.

What happens if you want to cash in the bond?

With-profits bonds are intended to be medium to long term investments. Deciding after a short time that you don't want it any more can cost you money.

Setting up your bond costs the insurance company money, and it will have to pay this whether you hold your bond for one year or 20 years. This cost will be passed on to you.

If you cash in your bond early (particularly within the first five years), the return on your money will be poor. The company might impose an early *surrender penalty* or *discontinuance charge*. **You may get back less than you paid in.**

On some with-profits bonds, if you cash in the bond the company may apply another type of exit penalty called a *Market Value Reduction (MVR)*. The MVR can also be called a *Market Value Adjustment (MVA)* or *Market Level Adjustment (MLA)*. This will reduce the surrender value of your bond to reflect poor investment performance. The purpose of the MVR is to ensure that your surrender value is

not unfairly higher than the market value of the bonds' assets, and that a fair share is left for the remaining bondholders.

Some bonds specify certain periods where they will definitely **not** apply an MVR. If your bond does this, it will often be on the 10th anniversary of taking out the bond. MVRs are applied from time to time but you should check before surrendering.

What happens to my bond if my insurance company closes to new business?

If the insurance company closes to new business, this does not mean that the company is closing down. The company will continue to run your bond until the end of its term, unless you cash it in, but it will not accept any new investors. You need to assess whether the bond continues to meet your original needs and expectations. For example the fund you have invested in may contain a lower proportion of shares (which tend to go up and down in value more than other investments) than when it was open to new business. You may need to take advice to help you to decide. Please see the [FSA guide to financial advice](#) – see Useful contacts.

What about tax?

If you cash in all or part of your bond you may make a *gain*. This is potentially liable to income tax. The rules for calculating the gain are different depending on whether you cash in all or only part of the bond. If you make a gain, the insurance company will issue a certificate telling you how much the gain is.

Since the investment returns from the underlying assets of your bond are taxed on your insurance company, the Inland Revenue treats any gains arising from your bond as if they have already been taxed at the basic rate of income tax. For most **basic rate taxpayers**, this is the end of the story.

However, if you are:

- a basic rate taxpayer close to the threshold of higher rate tax;
- a higher rate taxpayer;
- eligible for age-related personal allowances or tax credits; or
- if your bond was issued by an insurer outside the UK,

then the tax situation is more complicated. You may need to report the gain on a Self-Assessment return using the information you get from your insurer. More self-assessment information is available from the **Inland Revenue** – see Useful contacts.

If you **do not pay tax**, you should be aware that you cannot reclaim any tax charged on the assets held in your bond. This is a disadvantage and is something to consider if you are thinking about buying a with-profits bond. **Whatever your tax position**, if you get less money back from the bond than you put into it, there is no tax relief for the loss.

Points to consider

- With-profits bonds are meant to be medium to long term investments (10-20 years); if you cash in the bond early, your return is likely to be poor.
- If you need to take out all of your money, then it's sensible to check whether you will be charged an exit penalty. You may be better off delaying surrendering if you can.
- If you take income at a faster rate than your investment grows, then the value of your bond will reduce, possibly to below its original value.
- Your bond will be affected by changes in the stockmarket, as it will be invested in a range of assets, including company shares (the percentage will depend on the fund manager). **This means that with-profits bonds do carry some investment risk – your capital is not guaranteed.**

- Bonuses may be affected by the cost of guarantees available on both new and existing bonds. Examples of guarantees include a guarantee of payment on death and allowing you to withdraw a certain percentage of your bond each year without penalty.
- Regular and final bonus rates may be changed at any time. Future bonuses cannot be guaranteed, and may not be paid in some years, as they come from profits not yet earned.
- The bonus rates quoted in the company's literature may or may not take into account all the set up charges.

Protect yourself

If you have any questions about your bond you should ask the insurance company or your IFA for an explanation.

Read the company's Key Features Document properly and make sure you understand it.

Ask questions about anything you are not sure of - remember it's your money - you should make sure you understand what you are buying and the possible benefits and risks involved.

Complaints

The fact that investments grow at unpredictable rates, and can fall as well as rise in value, is not a valid reason for complaint, unless this was not explained to you before you bought your bond.

In some cases though, a financial product turns out badly because the firm you dealt with did something wrong. Problems can arise for many different reasons, for example;

- incorrect or misleading information about a product;
- failure of a firm to adequately warn about the risks of a product;

- failure of a firm to draw attention to a particular strict condition in the contract; or
- unexpected or excessive charges.

Whatever the reason, you will want to get matters put right by firstly taking the matter up with the firm that sold you the product. If you are not happy with their answers, you can take the matter to the Financial Ombudsman Service - see Useful contacts. See also the **FSA guide to making a complaint** for useful tips – see Useful contacts.

Useful FSA publications

FSA guide to financial advice

With-profits policies

High-income products - make sure you understand the risks

FSA guide to making a complaint

All are available free from our Consumer Helpline - see below.

Useful contacts

Financial Services Authority (FSA)

Consumer Helpline: 0845 606 1234

Website: www.fsa.gov.uk/consumer

Inland Revenue

Helpsheet IR 320 to help individuals complete their Self-Assessment Returns.

Orderline: 0845 900 0404

Financial Ombudsman Service

Tel: 0845 080 1800

Website: www.financial-ombudsman.org.uk

The Association of British Insurers (ABI)

for factsheets on insurance

Tel: 020 7600 3333

Website: www.abi.org.uk



The Financial Services Authority (FSA) is the independent watchdog set up by government to regulate financial services and protect your rights.

We produce a range of user-friendly factsheets and booklets which are available from our website and helpline.

If after reading this factsheet, you have any general queries, our helpline will try to clarify things for you.

We can tell you if a firm or individual is authorised and help you if you have a complaint and don't know who to contact. But as the regulator, we can't recommend firms or advisers, or tell you whether a particular investment is right for you.

To help us maintain and improve our service, we may record or monitor calls.

If you have difficulty with this material in its current format or language, please call the Consumer Helpline.

FSA Consumer website:
www.fsa.gov.uk/consumer

FSA Comparative tables website:
www.fsa.gov.uk/tables

FSA Consumer Helpline:
0845 606 1234
(calls charged at local rates)