Guide to an Endowment Policy

What is an Endowment policy?

Although most people come across a Life Assurance Endowment policy as a means of repaying a mortgage, the policy is in fact a savings plan, the proceeds of which are used, on it reaching the end of its term, to repay the outstanding mortgage.

It is not uncommon for endowments to be established purely as a method of saving for the long term. Prior to March 1984 endowment savings plans were very popular as the government gave tax relief on the premiums paid to the policy. Policies started before this date still receive this Life Assurance Premium Relief.

The premiums paid into the policy have a dual purpose. Firstly they cover the cost of the Life Assurance protection offered within the policy. The person insured under the terms of the policy is called the Life Assured. The balance premiums are invested by the Life Assurance Company to increase the value of the policy.

Secondly, over the term of the policy the value of the savings element grows and over time the value of the policy exceeds the total of the premiums paid. This provides the growth on your money.

What are the different types of Endowment policies?

Most Endowment policies are established for a set period (the policy term) of 10 years or more, this is because advantageous taxation rules apply to Life Assurance policies with terms of 10 years or more. These taxation rules (called the Qualifying rules) allow for any investment gains made within suitable policies, called Qualifying policies, to be paid to the policyholder without any personal tax being deducted.

As endowment policies are Life Assurance policies then a term for the policy must be established at outset. Although it is possible for policies to have terms of less than 10 years, this is quite rare.

Most Endowments sold in the UK have traditionally been used as mortgage repayment vehicles, and so the term of these policies would normally be the same term as the owner's original mortgage term (frequently this is 25 years).

Where the policy premiums are invested will differ in accordance with the policy type. The majority of such policies are 'With Profits'. In these instances the policy premiums are invested in the With Profits fund of the Life Assurance company.

With Profits type policies have been popular for decades. Under these policies the Life Assurance Company makes all the investment decisions. They use any investment profits gained to provide bonuses, which are added to the policy, normally on an annual basis, to increase the policy's value.

The amount of bonuses added year on year is at the discretion of the Life Assurance company. Often some of the profits made in years of high investment returns are held in reserve, and not distributed as bonuses. This allows the Life assurance company to maintain the level of bonus during years of less attractive investment gains.

This smoothing of investment returns has, in the past, proved popular with savers. However more recently With Profits type investments have witnessed a series of reductions in bonuses. These have been triggered because the investment reserves built up during years of generous investment profits have been reduced as lower investment returns have become more common during the late 1990's and through into the new century.

What is a With Profits Investment?

The term 'with profits' refers to a form of investment available from Life Assurance products whereby the policy shares in the profits generated by the life insurance company on the money invested in the 'with profits' fund. This investment fund contains a mixture of shares, commercial property, government loans (gilts) and loans to large businesses (corporate bonds).

A With Profits policy grows through the addition of bonuses. These are calculated by the Life Assurance Company and take into account the investment returns made within the fund. The bonus system allows Life Assurance Companies to smooth out stock market fluctuations, this helps With Profit Endowment policies to produce steady growth.

To state that in the event of early surrender in adverse market condition the provider may make a Market Value Reduction. This is a reduction in the amount you receive to product the remaining policyholders from the impact of withdrawals made when the markets, and therefore the fund value is at a low point.

How are bonuses calculated?

There are normally two types of bonus. The first is the annual (reversionary) bonus which is guaranteed and once added cannot be taken away so long as you maintain your policy to the end of its term. However most Life Assurance Companies have the right to recalculate the value of annual bonuses on cancellation of the policy before the end of its term.

In addition to the annual bonuses many With Profits policies can also benefit from final (terminal) bonuses which are only available at the end of the policy term and are not guaranteed.

To calculate the value of any bonuses, the Life Assurance Company has to reflect factors such as past investment returns, future predictions of likely investment gains and an estimate of the expenses for running the investment fund. In times of strong investment gains, rather than paying out large bonuses, providers will store up profits to compensate for years when investment returns are lower. This is the smoothing effect offered by With Profits investments.

What are my options if I need money from my policy?

Although it is not generally a good idea to cash a policy early, there can be times during a person's life when money is in short supply and the value of savings plans, like endowment policies, could help to tide you over. As endowment policies are normally established as long term savings (or mortgage repayment) plans, the money invested in in them may not be immediately available. You should contact the policy provider for details of what is available from your plan.

If you need to draw money from the policy prior to the end of its established term (maturity date) you may find that the terms of the policy restrict you from doing so. There are however instances where you may be able to gain access to some money by electing for one of following:

1. Take a loan from the Life Assurance company based upon the value of your policy.
2. Surrender all or part of the policy by arranging for the policy to be closed before the end of its normal term.
3. Sell your policy to someone else

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Can I take a loan against the value of my policy?

Some endowment policies contain an option that allows the owner to take a small loan from the Life Assurance Company that holds the endowment. The amount of any loan available would be calculated by the company and based on the policy’s value.

Any loan taken would normally be repaid at the end of the policy term from the maturity proceeds. If a loan is available you will be required to pay interest on the loan amount until it is repaid.

If a loan is available and you elect to take one, it is likely that you will be expected to maintain policy premiums until such time as the loan is repaid.

In recent years the number of Life Assurance Companies offering such loan facilities has reduced sharply. It is unlikely that any loan facility will be available on Unit Linked policies.

What happens if I surrender my With Profits policy?

At the time the policy is first created its term is established (i.e. the number of years it is expected to run). However, many endowment policies are cancelled before they reach the end of this original policy term. The Life Assurance company closes the policy, stops the collection of premiums and makes a cash payment to the owner based on the policy's value. This process is known as surrendering the policy.

Although the process can be relatively simple, the true impact of surrendering should be considered carefully before you decide to take this approach. The manner in which the charges are collected under Life Assurance policies often means that the values available on early surrender can be very small by comparison to actual premiums paid and the investment returns achieved.

The charges under a life assurance policy are normally spaced out throughout the whole of the expected term (e.g. 25 years). Should a policy be cancelled before the end of its term, most Life Assurance companies recoup their expenses from the amount available at the time of surrender.
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Do I have to surrender the whole of my policy?

Under the tax rules that govern the majority of Life Assurance policies it is not possible to surrender part of a policy, therefore it is likely that you will have to surrender the entire policy. This means you will cease to benefit from the Life Assurance cover held within a policy. You should consider this aspect of surrender carefully if you have held the policy for a long time and your health is not what it was when you first effected the policy.

There are certain types of endowment plans that contain an alternative to surrendering the whole policy. Under these plans you may draw benefits from a part of the plan whilst maintaining the rest of the plan. These plans work by the Life Assurance Company clustering together a series of small identical policies.

This clustered policy approach could mean that you can withdraw money from some of the policies, either because they have reached the end of the original term or alternatively by choosing to surrender them. You would only need to pay the future premiums on the policies that continue.

For details of whether your policy is clustered you may wish to refer to the original policy documents or to contact your Life Assurance company.

Will I pay any tax if I surrender a policy early?

Most endowment policies are subject to special tax rules known as the ‘Qualifying Rules’. Under these rules where premiums have been paid to the policy for a period of 10 years or more then any ‘gains’ you make from the policy are free of tax.

The ‘gain’ in a policy is the difference between the amount you receive on surrender and the total premiums paid since the policy’s start.

Where a policy has been running for less than 10 years and has not been maintained for a period greater than ¾ of its original term, there is the possibility that any ‘gains’ made within the policy could be subject to tax. If you fall into this category you should seek advice on the taxation position. You can contact us for assistance by clicking the ‘Make contact now’ button shown on the right.

What are the benefits by selling my endowment policy?

The amount available from the Life Assurance Company on the surrender of an endowment policy has to take into account a number of different considerations. These include the expenses that would be collected over the policy term, investment conditions that prevail at the time you surrender and those that have occurred over the period you have held the policy.

If you were to sell the policy, the circumstances are different. The policy is continued by the new owners, which allows the Life Assurance Company to collect their charges in the normal way. The price offered by the purchaser normally reflects the ongoing investment opportunities for them and the fact that a good deal of the policy charges have already been paid.

Accordingly the amount the purchaser may be willing to offer you to buy the policy, rather than surrender it to the Life Assurance Company, could be significantly higher than the value available on surrender of the policy.

What happens if I decide to sell my endowment policy?

If you sell your policy then you will no longer be the owner (called a grantee) even though the Life Assurance cover will continue to be based on your life.

It is possible to change the legal owner of an endowment policy and for the policy to continue totally unaffected by this change. This process is known as ‘assignment’.

If you sell your policy and it is assigned to new owners and you should die during the term of the policy, the proceeds of the policy are paid to these new owners. Also when the policy reaches the end of its term, the value on maturity will be paid to the new owners.

Can I sell my endowment policy?

Although it is possible to assign most types of Life Assurance policy, not all of them are attractive to the investors that buy existing policies (known as second-hand policies). Therefore before you consider the option of selling your policy you must establish what type of policy you own.

If you own a Unit Linked Endowment policy then it is unlikely that you will be able to sell it on. In these instances you should consider how much is available on surrender. The method of charging under unit linked policies normally mean that the value available on surrender is similar to the investment value of the policy.

If you own a With Profits policy it is possible that this policy will be suitable for sale as opposed to surrender. There are businesses that specialise in arranging the purchase of With Profits policies. These are called market makers and are often advertised in telephone directories like Yellow Pages.

What is a traded endowment?

A traded endowment is the name given to an endowment policy, normally a With Profits policy, which has been sold onto another person by the original owner rather than being surrendered.

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