

Financial Regulations

Easily Understood

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The Financial Regulations Easily Understood guide is to be used in addition to the main accredited Textbook and will never replace the detail contained there.

It was written with an intention to support the reader's understanding of the main aspects of the text, and will serve as an appropriate revision guide to understanding investments and the risks involved.
A thorough analysis, the detailed document could also provide clarity and understanding to an individual who needs a basic understanding of investments and risks.

The Financial Regulations Easily Understood Book published in September 2010 provides information for the 2010/11 financial year. While the author has used all her efforts in preparing this book, there are no promises or warranties in respect of the accuracy or completeness of the content of this book with updated changes from the appropriate financial bodies.

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Abbreviation Table

ADL	Activities for Daily Living
APACS	Association for Payment and Clearing services
APR	Annual percentage Rate
ARLA	Association of Rental Letting Agents
ASU	Accident, Sickness, Unemployment
AVC	Additional Voluntary Contributions
BACS	Banking Automated Clearing Services
BOE	Bank of England
BRT	Basic Rate Tax Payer
CAD	Capital Adequacy Directive
CAT	Charges Access and Terms
CCJ	County Court Judgement
CD	Certificate of Deposit
CeRCC	Certificate in Regulated Customer Care
CGT	Capital Gains Tax
CHAPS	Clearing House Automated Payment System
CIDD	Combined Initial Disclosure Document
CPD	Continuous Professional Development
CPI	Consumer Price Index
CRD	Capital Requirement Directive
CTF	Child Trust Fund
EEA	European Economic Area
EFTPOS	Electronic Fund Transfer at the Point of Sale
EPA	Enduring Power of Attorney
EPS	Earnings Per Share
EU	European Union
FATR	Financial Services Task Force
FIS	Fixed Interest Securities
FSA	Financial Services Authority
FSAVC	Free Standing Additional Voluntary Contributions
GDP	Gross Domestic Product
GEB	Guaranteed Equity Bond
Gilts	Gilt Edged Securities
GSA	Guaranteed Sum Assured
HRT	Higher Rate Tax Payer
IDD	Initial Disclosure Document
IFA	Independent Financial Advisor
IFA	Independent Financial Advisor
IHT	Inheritance Tax
ISA	Individual Savings Account
ISD	Investment Services Directive
IVA	Individual Voluntary Arrangement
LIBOR	London Interbank Offered Rate

LPA	Lasting Power of Attorney
LTC	Long Term Care
LTR	Lower Rate Tax Payer
LTV	Loan to value Ratio
MCCB	Mortgage Code Compliance Board
MCOB	Mortgage Conduct of Business Rules
MiFLD	Markets in Investment Services Directive
MIG	Mortgage Indemnity Guarantee
MLRO	Money Laundering Reporting Officer
MPP	Mortgage Protection Policy
MPPI	Mortgage Payment Protection Insurance
MPPP	Mortgage Payment Protection Plan (same as above)
MVA	Market Value Adjuster
NAV	Net Asset Value
NIC	National Insurance Contribution
NS & I	National Savings and Investment
NTP	Non Tax Payer
OEIC	Open Ended Investment Company
OPAS	Office of Pensions Advisory Scheme
PA	Personal Allowance
PAYE	Pay As You Earn
PE Ratio	Price Earnings Ratio
PEP	Personal Equity Plans
PETS	Potentially Exempt Transfers
PHI	Permanent Health Insurance
PIBS	Permanent Interest Bearing Shares
PMI	Private Medical Insurance
PPP	Personal Pension Plan
PSNB	Public Sector Net Borrowing
PSNCR	Public Sector Net Cash Requirement
REIT	Real Estate Investment Trust
RPI	Retail Price Index
S2P	Additional State Benefit
SDLT	Stamp Duty land Tax
SHEP	Second Hand Endowment policies
SHIP	Safe Home Income Plans
SHP	Stake holder Pension Plans
SOCA	Serious Organised Crime Agency
SVR	Standard Variable Rate
TCF	Treating Customers fairly
TEP	Traded Endowment Policies
VAT	Value Added Tax

UNIT 1: FINANCIAL SERVICES ENVIROMENT AND PRODUCTS

Money

In earlier civilisation exchange was by Barter. However, as transactions became bigger and complex, it became difficult for people to trade goods they had to offer against what other people had to supply them; hence a need arose for Money, which is a Common Denominator against which the value of all products could be measured.

- Money is a medium of exchange – It must be sufficient in quantity, generally acceptable to all parties in the transaction, divisible into small parts and must be portable.
- Unit of Account – All goods and services are valued at a particular price, this is only possible because of money. Moreover, money can also be used as a measure of payments of debts made in the future.
- Store of value – Money serves as a store of value. For example, a thousand pounds stored in the house today remains a thousand Pounds next year. The purchasing power of the money could have decreased because of inflation, but that is another matter, the money is still £1,000.

Inflation

Definitions

- Steady increase in prices.
- Decrease in the purchasing power of money.
- Too much money in circulation.
- Too much money chasing few goods.
- The rate of inflation is the rate at which price levels increase.
- Inflation is measured by the Consumer Price Index (CPI).

Example

If inflation were to run at 10% over an item of clothing that cost £100 at the start of 2008, at the start of 2009 the same item of clothing would cost £110. If the £100 were kept in a bank instead at the rate of 3% interest, the interest over the year would be £3 (total £103).

This means that in 2009 the funds would be insufficient to purchase that item of clothing, indicating a decrease in the purchasing power of the money.

- The Government's target is to keep Inflation at an annual rate of 2% with maximum divergence either side of 1%.

Money illusion

- Savers and borrowers think of the interest rate as a standalone entity without considering inflation.
- An investor must aim to achieve a rate of growth that exceeds the rate of inflation.
- Low inflation and low interest rates are directly related.
- Savers can react to low interest rates by putting their funds into riskier instruments such as shares and bonds because of low inflation.
- Borrowers repaying loans react to lower monthly repayments (lower interest rates by borrowing more money). Unfortunately, increased demand on borrowing may even push up interest rates.

Real Rate of Return

- Rate of Interest minus Rate of Inflation.
- If the rate of inflation is 5% and the interest received on the investment is 3.75%.
- The rate of return is $3.75\% - 5\% = -1.25\%$
- The rate of return here is negative 1.25% as the rate of interest is lower than the rate of inflation, so in real terms the purchasing power of the funds have fallen.
- Where the rate of interest is higher than the rate of inflation there is a positive rate of return, which means the purchasing power of the funds is higher in real terms.

Policy Challenges for Macroeconomic Theory

These are the long-term objectives that the Economic Policies of Governments try to achieve.

- Long term Economic Growth
- Lower Unemployment
- Higher Employment
- Balance of payment Equilibrium
- Price Stability

These are the present challenges in policy as the Government strives to attain them simultaneously. Unfortunately, the UK has suffered a balance of payments deficit (foreign expenditure outweighing receipts) and a fall in GDP (economic growth) in recent years.

These objectives sometimes conflict with each other. The Government will often employ tools to try to control them through regulation, taxation and spending. Moreover these targets are continuously being affected by the world economy, which is not under the control of a particular Government.

Two Types of Policy to achieve Long Term Objectives

Monetary Policy

The school of thought was initiated by Milton Friedman, a monetary theorist who believed inflation was caused by an increase in the money supply (credit creation by banks).

Therefore, a Government, which employs this tool, will seek to control the money supply usually through the manipulation of the interest rates. In the UK interest rates is set by the Monetary Policy Committee (MPC) monthly. The outcome of the meeting is announced immediately with the minutes available a fortnight afterwards.

This in turn will influence the demand of credit by consumers. Monetary policy is used as a macroeconomic control (to control the economy as a whole).

Influences on Interest Rates

- Level of Government Borrowing
- Level of Individual Borrowing
- Monetary Policy
- Foreign Exchange rates
- Fiscal Policy

Fiscal Policy (Budgetary Policy)

Government manipulates the finances of the public sector spending, revenue, borrowing and saving to influence the overall level of money supply and economic activity. Fiscal policy is used as a macro or micro economic control tool, and could be targeted to parts of the economy or the economy as a whole.

The Chancellor of Exchequer outlines the Fiscal Policy in the annual budget statement in March.

- The public sector is responsible for providing education, healthcare, transport, social security amongst other things in the economy. This has to be funded by the government raising funds from the private sector in form of direct/indirect taxes.

Three Outcomes

Balanced Budget - Taxation = Public Spending

Budget Surplus - Taxation exceeds Government Spending

- Amount of money taken out (taxes) is more than the amount put in (public spending).
- This is contractionary in terms of employment, and deflationary in terms of the money supply.

Budget Deficit - Government Spending exceeds Taxation

- Amount of money put in (public spending) exceeds the amount of money taken out (taxation). The difference is the amount borrowed.

- This is expansionary in terms of employment and inflationary in terms of the money supply.
- A Government in deficit will usually borrow.

Deficit is expressed in 2 Identities

1) Public Sector Net Borrowing (PSNB)

Current Public Spending plus Net Public Investment less Total Public Revenues

2) Public Sector Net Cash Requirement (PSNCR)

PSNB Plus Financing Requirements arising from Financial Transactions.

Golden Rule

The Government's golden rule is to borrow only to invest and not to fund current government spending. This implies that funding of public spending is nil (been impossible since 2007).

Sustainable Rule

Public Sector Net Debt as a proportion of Gross Domestic Product (GDP) will be stable and prudent over the economic cycle.

Gross Domestic Product

Total value of goods and services produced in a country in a fiscal year.

The Bank of England (BOE)

The Bank of England is UK's Central Bank owned and backed by the UK government, which has the sole authority for issuing money (notes and coins).

Other functions

- Banker to the Government (also advises the Government).
- Banker to all the banks.
- Sets Interest rates monthly, through the MPC.
- Lender of last resort (if banks are short of liquid funds).
- Issuer of bank notes.
- Manager of UK's official reserves (gold and foreign currencies).

Note – The Chancellor of Exchequer (June, 2010) has stated that regulation and supervision of the banking sector, which is currently the role of the FSA is to be transferred to the BOE by 2012. It is interesting that the FSA had taken this role over from the BOE in 1998.

Financial Intermediaries

These institutions receive deposits from individuals, firms or other financial institutions and give out these deposits as loans or use for purchase of financial assets. Examples of intermediaries are banks, building societies, insurance firms and brokers.

They are called intermediaries because they act as middlemen by borrowing from the surplus sector of the economy and lending it to the deficit sector of the economy. They make a profit margin between the two rates.

- Financial Intermediaries create liquidity, minimize costs of borrowing funds, minimize costs of monitoring borrower's pool risks

Four Outcomes of Intermediation

Geographical Location – The physical location of individual borrowers differ, an access to a high street bank solves the problem.

Aggregation – Retail deposits are relatively small while loans are typically larger (mortgages); intermediaries overcome this size mismatch by aggregating small deposits.

Maturity Transformation – A borrower may need funds for longer than a lender is willing to lend, intermediaries are able to bridge this gap because they borrow from a large number of people who deposit funds and draw them at different times. (Different maturity dates).

Risk Transformation – A lender does not lend all his funds to one borrower, he spreads the risk, so if one borrower defaults, it is not the end of his business.

Disinter Mediation

The opposite of intermediation. Lenders and borrowers come together without a middleman (e.g. a company floating shares directly to the public).

Building Societies and Banks

- The difference between a building society and a bank is in the legal structure.
- Building Societies are mutual organisations owned by the Members.
- Building Societies are permitted to borrow up to 50% of their liabilities from the wholesale market.
- Banks are limited liability companies owned by shareholders (proprietary organisations).
- A building society is able to convert to a bank status. This process is known as demutualization.
- Where a building society converts to a bank status it will allocate free shares to its members (depositors and borrowers).
- To this end, an individual may open an account in a building society, hoping that it will convert to a bank status for the free shares; this is known as "carpet bagging".
- Friendly societies are also mutual organisations.
- Certain life assurance firms are also mutual organisations

Deposit Based Investments

- They are emergency funds put away for a rainy day (new car, holiday).
- It is essential to have some of your investment portfolio in readily accessible funds.
- The capital element is fixed but the income from the investment may vary.
- They are secure investments but inflation reduces the value of capital in real terms.

- Unattractive when compared to asset backed investments in the medium to long term.
- Interest paid on the accounts has tax deducted at 20% at source.
- Starting rate taxpayers can reclaim 10%, and basic-rate tax payers (BRT) have no further liability. Higher rate taxpayers (HRT) have to pay an extra 20%.
- Tiered interest rates are also available on bank and building society accounts. This indicates that the larger the investment, the more the interest paid. Where the interest falls below the set band, the rate is reduced.
- Non-taxpayers (NTP) can have interest paid gross if they fill out a form R85.

Interest Bearing Current Accounts

- Has evolved in recent years due to increased competition among the banks.
- Although the interest rates are relatively low, instant access is allowed without loss of interest.
- Where the individual seeks higher interest, it is possible to consider Internet accounts, accounts processed through call centres or person must be prepared to maintain a higher minimum balance (£1,000 to £10,000).
- Accounts with a higher minimum balance are also free from charges.

Money Market Deposits Accounts

- It is a good arrangement where there are a lot of funds to place in the short term.
- They could be fixed accounts or notice accounts.
 - a) Fixed Accounts – Term deposits accounts with fixed interest rates. The term will range from overnight deposits to 5 years.
 - b) Notice Accounts – The individual must give adequate notice to access the funds otherwise a penalty is charged. Notice that must be given can range from 7days to 12 months.

Building Society Accounts

- Ordinary share accounts – Paid at a lower interest rate than notice accounts as it allows for instant access without penalty.
- Notice accounts - Subject to 7, 30, 60 or 90 days notice period. A penalty that is equal to the notice period interest is charged where the notice is not given.
- Tiered interest rates.
- Monthly income facilities subject to a minimum level of investment.

Credit Unions

- Authorised and regulated by the FSA and protected by the Financial Services Compensation Scheme (FSCS).

- Member savings and loan balances are also covered by life assurance policies, which will pay out in the event of death of the depositor or borrower.
- A credit union is a mutual organisation, run as financial cooperatives to assist their members who are linked by similar attributes, which may be cultural, social or economical.
- Traditionally the premise of the poor, but in recent years the Government has widened the scope and improved the image by funding initiatives to include a wider scope of clients.
- Every member must purchase shares worth at least £1, but have the same rights irrespective of their share holding.
- Each share will pay dividends of 2-3% (usually) to 8% (maximum permitted) yearly. Proposed amendments (2010) will remove this 8% cap and allow unions to make a small charge for ancillary services provided to members as well as offer interest on deposits.
- Interest rate on the loan is 1% of the reducing balance monthly; the maximum interest rate permitted is 2% of the reducing capital.
- They also offer additional services, such as mortgages, insurance services and bank accounts on a partnership basis.
- Other proposed amendments to the credit union act 1979 which will be introduced in 2010 relaxes the membership requirements, to include partnerships, corporate bodies and associations

Savings Gateway

- A cash savings incentive initiated by the Government for those on low income.
- Contributions are at 50 pence on every £1 saved.
- The arrangement is for two years.
- To qualify, the individual must be in receipt of a qualifying benefit such as income support or incapacity benefit and tax credits.

Clearing

- The clearing process results from the use of chequebooks; direct debits debit cards and all other types of banking transactions, which involve transfer.
- At the end of each day banks will need to pay each other the net debt owed or the net amount due, between the cheques/monies drawn on them and those drawn in favour of them. This is usually settled through their accounts with the BOE.
- The process is coordinated in the UK by the UK Payments Administration Limited which used to be Association for Payment and Clearing Services (APACS) that manages the system through three clearing firms.

Three Clearing Firms

- 1) Cheque and Credit Clearing Company – Oversees the clearing of cheques, which takes three days. As we move on in time, technology will systematically aid the disappearance of a cheque system. Most transactions are presently carried out electronically as people are

slowly but surely abandoning the cheque writing process, which is expected to phase out by 2018.

- 2) Banking automated clearing services (BACS), which deals with the electronic clearing (e.g direct debits) carried out by Voca-link ltd.
 - 3) Clearing House Automated Payment System (CHAPS) – The daily Inter bank transfer system.
- Kindly note that not all banks are clearing banks. Building societies do not go to clearing houses. However all banks and building societies must be represented at the clearinghouse.

Offshore Deposits (Tax Havens)

- They are deposit accounts held in banks or building societies outside the UK, in countries with a more advantaged tax system.
- The investments are available in countries such as Gibraltar, Channel Islands, Luxembourg, and Cayman Islands.
- Offshore deposits are usually domiciled in a foreign currency e.g. US\$, as such, they are at risk to currency movements because when they converted back to sterling at a later date the rate could have changed.
- Deposits are usually attractive to people who want money available outside the UK, or those who want to retire abroad.
- Although the interest is paid gross a UK resident is liable for tax and must declare the funds on the tax return.
- If the interest has been taxed overseas tax relief could be given under the double taxation regime.

National Saving and Investments (NS&I)

These savings and investments products are offered at the post office on behalf of the Government.

They are low risk products, which are certain to return the capital sum, invested, even on Premium Bonds.

Easy Access Savings

- New card and pin.
- Tiered interest rates
- Must be over 11 to open the account.
- Minimum balance is £100.
- Interest is paid gross but tax liable.

Investment Account

- Must be 7 years and over to open account.
- Tiered interest rates at 7 levels (50-50,000 and beyond)
- Minimum deposit is £20.
- Interest is paid gross but liable to income tax.

Income Bonds

- Interest rate is variable.
- The bonds have no term.

- Capital can be withdrawn at any time, without penalty.
- Interest is paid up to, but not including the day capital it is withdrawn.
- Tiered.
- Minimum investment is £500.
- Interest is paid gross but is liable to income tax at the investor's tax rate (10%, 20%, 40%)

Guaranteed Income Bonds

- Must be 16 to take out the bond
- Lump sum investment for a fixed term.
- Guaranteed interest rate for 1,3,5 year term.
- Post July 2009 there will be a 2year term bond available online or by telephone.
- Bonds pay a monthly income.
- Interest is paid net (20% tax at source), HRT pay an additional 20%.
- Bonds will be available in July 2010.

Guaranteed Growth Bonds

- Must be 16 to take out the bond.
- Lump sum investment for 1, 3 or 5 year term.
- Lump sum investment for a fixed term.
- Interest is added to the bond at end of term (calculated yearly).
- Interest is paid net (20% tax at source), HRT pay an additional 20%.
- Post July 2009 there will be a 2year term bond available online or by telephone.
- Bonds will be available in July 2010.

Guaranteed Equity Bonds

- Must be 18 to take out the Bond.
- Lump sum investment for a fixed term.
- Issues are only available for a limited period.
- Growth of bond depends on FTSE 100 index.
- Investment is secure, as the capital invested will certainly be returned.
- Interest payable depends on growth of underlying asset.
- Interest is paid gross but is liable to income tax.
- Bonds will be available in July 2010.

Savings Certificates

- They can be fixed or Index linked (value increases with inflation).
- Certificates are available from £100 -£15,000.
- Fixed Rate certificates have a 2 or 5-year term.
- Index linked certificates have a 3 or 5 year term.
- Interest is paid gross and there is no liability to capital gains tax or income tax.
- Most attractive to higher rate taxpayers.

Premium Bonds

- Regular tax-free prizes can be won, of up to £1m.
- Minimum amount is £100 to £30,000 maximum.
- Capital is safe but the investor must give 8 days notice to cash a bond.

Children Bonus Bond

- Must be 16 to buy a bond.
- Bond can be purchased for those aged under 16.
- It is a single premium investment, which must be retained over a minimum period of 5 years.
- Bonus is added to bond after 5years.
- Interest paid on bond ceases on the bondholder's 21st birthday.
- Latest age bond can be purchased is 16 ($16 + 5 = 21$).
- Bonus is added to bond on the 21st birthday.
- Interest earned is tax-free.

Individual Saving Accounts (ISAS)

- Tax efficient personal savings certificates with an aim to encourage savings for UK residents.
- An ISA is not transferable and can only be held in one name.
- ISAS will now be available indefinitely.
- Although it is still possible to have the ISA with 2 different providers the former Maxi and Mini ISAS have now been scrapped.

The following rules apply:

- Going forward it will be permitted for cash ISAS (within ISA limits) to be moved to equity ISAS.
- It will not be permitted for equity ISAS to be moved to cash ISAS.
- Cash mini ISAS and cash elements of maxi ISAS can be moved to cash ISAS .The same applies for TESSA –only ISAS.
- Personal Equity Plans (PEPS) have now become Equity ISAS.

Cash ISAS

- Tax efficient savings accounts for UK residents.
- They can be opened by anyone who is 16 and above.
- They are classified as deposit type accounts.
- ISAS can be held with a Bank, Building society or Post-office (NS&I).
- A maximum of £5,100 can be held in a Cash ISA.
- Cash ISAS are tax – free.

Equity ISAS

- Can be opened by anyone who is 18 or over
- They can be held in Shares and/or Stocks.
- The shares in the ISA fund can be held in unit trusts, open-ended investment companies or investment trusts in the UK (pooled/collective investments).
- Alternatively they can be shares listed anywhere in the world.
- The stocks (fixed interest securities) held could be corporate bonds issued by firms listed on the stock exchange world wide, gilts and other fixed interest securities issued within the European Economic Zone.
- A maximum of £10,200 can be held in shares/stocks

Terrorism Act 2000	Money Laundering
The Finance Act 1987	FSAVC Schemes
Unfair Terms in consumer Credit Legislation 1999	Contracts Between a Supplier of Goods And Services and a Consumer

European Directives Table

Directive	Coverage
Capital Adequacy Directive (CAD)	Worked in conjunction with the ISD.
Capital Requirement Directive	Works with the MiFID.
Directive on Insurance Mediation	Freedom for Insurance intermediaries to provide their services in all EU states.
First Life Directive	Adopted to put into context the "treaty of Rome".
Fourth Life Directive	Replaces all 3 directives. Set up to make a "single licence system work".
Investment Services Directive (ISD)	Freedom of Investment firms around the EU.
Market in Financial Instruments Directive (MiFID)	Updates the ISD.
Second Banking Directive	Freedom of Credit institutions around the EU.
Second Life Directive	To allow cross frontier services for Life Assurance Firms.
Second Non Life Council Directive	Freedom to carry out General Insurance business across the EU without setting up subsidiary or branch.

Third Life Directive	Life Framework Directive.
Third Non – Life Council Directive	Concluded the process. Insurance firms can set up branches in other states with supervision from the home state.