Topic 3: Understand the sources of personal financial protection

After completing this topic, you will be able to:

- understand the ability to pay for a financial product;
- appreciate what can go wrong that could affect the ability to pay;
- describe protection products for the financial consequences of:
  - sickness;
  - redundancy; and
  - death;
- understand protection for deposits in a bank, savings, investments, poor financial advice and fraud, including:
  - the Financial Ombudsman Service (FOS); and
  - the Financial Services Compensation Scheme (FSCS); and
- understand consumers' responsibilities, including 'buyer beware' (*caveat emptor*).

Ability to pay for a financial product

Customers should plan their finances carefully, including their income and expenditure, and prepare a budget. No one wants to get into financial difficulties and, although it can sometimes happen through no fault of your own, many instances of financial difficulty arise because of bad planning – or because there has been no planning at all.

Budgeting is very important. Making a list of essential expenditure and making sure that you pay for these items *before* you decide to treat yourself is the best way in which you can avoid getting into trouble with your money.

Activity 3a

There are many things for which we have to pay. List as many types of financial payment that an individual may make in a year as you can.

Borrowing money is an important financial decision and the loan always has to be repaid to the lender. Before deciding to borrow a sum of money, you should always work out if you can really afford the repayments on top of all of the other essential expenses for which you already have to pay, and in addition to any other borrowings that you may already have.

You also have to look to the future and be quite sure that you can afford the repayments not only now, and next month, and the month after, but for the whole term of the borrowing.

- Is your job secure?
- Is your income likely to continue at the same level as it is at now?
- Will you have additional expenses in the future that you do not have now?

Regardless of how well we plan ahead and budget for the short, medium and long terms, sometimes we are taken by surprise by an unexpected event that changes everything. These unplanned events can affect our ability to pay for a financial commitment and may also affect others.

In this topic, we are going to remind ourselves briefly about protection for the financial consequences of three unplanned events:

- sickness;
- redundancy; and
- death.

Sickness and redundancy

Payment protection insurance (PPI) can cover your mortgage, credit card borrowing or your personal loan repayments if your income drops as a result of accident, sickness or unemployment. The policies will pay out only for a fixed period of time, such as 12 months.

The insurance is linked to the repayments of the actual credit card or loan that is being covered and may be offered at the same time as the lender agrees to make the credit available.

For example, you may want to protect the repayments on a credit card. You will need to think carefully about the extra premium that you will be paying and whether the risk of losing your job or of being so ill that you cannot work is worth the extra payments.

PPI is not automatically arranged with all types of credit and, even if you do buy it, it does not cover all types of sickness. You need to check the policy before you buy it to make sure that you think it is worth the money.

Also, if you are sacked, rather than made redundant, your policy will not pay out – nor will it pay out if you knew that redundancy was likely when you took out the insurance.

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Payment protection insurance can be extremely useful, although many PPI policies have been mis-sold alongside loans, credit cards and mortgages over the years to people who did not need them, were ineligible to claim the benefits for one reason or another, or did not even realise that the policy had been included as part of their loan repayments. Some lenders developed sales scripts for their customer services advisers to follow that included a statement that the loan was 'protected', but did not explain that this protection took the form of an insurance policy – a policy that the customer should have been given the opportunity to opt out of taking.

Several companies have been fined for mis-selling this product and many customers are being encouraged (by means of advertising campaigns and telephone calls) to make a claim against their lender if they feel that they may have wrongly been sold this product. Those whose claims are successful are not only given back the insurance premiums, but are also able to claim the interest that this money would have made had it been in a savings account.

Death

There are a number of insurance policies that pay out a lump sum when you die. This money can be used to pay off loans that may still be outstanding at the time of your death, making sure that your family is not left with a debt to repay after you are gone.

A 'whole-of-life policy' is a policy that pays out the 'sum assured' when you die, whenever that happens. In other words, the cover is available for the whole of your life (as long as you keep paying the premiums). The sum assured might, for example, be arranged to match the amount that you owe in loans, overdrafts, mortgages and other borrowing exactly, plus an additional amount to cover your funeral expenses.

Another type of policy is a 'term assurance' policy. This one is much cheaper, but it provides cover only for a fixed period of time – that is, it pays out only if your death occurs within a specified period of time, such as 15 years. This type of policy might be arranged to cover one particular loan, in which case the sum assured will be fixed at the same as the amount that you borrowed and the term will be the same as the term of the loan.

Term assurance is an effective way for providing death cover for a mortgage, which is usually for a larger amount of money.

Protection in cases of poor financial advice and fraud

As a consumer of financial products and a customer of the various financial institutions that offer them, there are a number of risks to which you are subject that are completely out of your control. Examples include losing money because you were given bad advice or the wrong product for your needs, or because you have a disagreement with your financial provider. It might even be that the organisation in which you invested your money goes bust.

For these eventualities, there is a range of services and compensations schemes that are available to you. You can apply for financial compensation – that is, money to ease your loss.

The Financial Ombudsman Service (FOS)

The government set up the Financial Ombudsman Service (FOS) as an independent expert to settle disagreements between a financial provider and a customer. The FOS is paid for by all of the providers, which are required to pay a fee every year to cover the costs of this service. It is free to customers.

The FOS will look at complaints about mortgages, insurance, bank accounts and bank charges, and lending, including pawnbroking and credit cards.

A consumer with a complaint must complain to the firm first – that is, they must give the firm a chance to put things right at an early stage. If this does not work and the consumer is still not happy, the next stage is to go to the FOS.

The FOS will look at the case impartially, which means that it will not take sides. It aims to make a fair and balanced decision based on the facts of each individual case. If it decides that the financial firm has acted wrongly and that the customer has lost out, it will tell the firm how to put things right.

The aim is to put the customer back in the financial position in which they would have been had things not gone wrong.

If the FOS thinks that the firm has treated the customer fairly, however, it will say so.

The Financial Services Compensation Scheme (FSCS)

The Financial Services Compensation Scheme (FSCS) is another organisation set up by the government. The FSCS will pay if a business regulated by the Financial Conduct Authority (FCA) owes a customer money and is unable to pay. It is said to be the 'scheme of last resort' – that is, it pays when everything else has failed. For example, a financial adviser may have recommended an incorrect mortgage to one of their clients resulting in that client suffering a financial loss. If the adviser has gone out of business, it is the FSCS that will pay compensation to the customer.

The FSCS covers savings, insurance policies, investments and mortgages.

The largest area of work recently undertaken by the FSCS was as a result of the failure of a number of banks, building societies and credit unions during the financial crisis of 2008–09.

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There is a limit on the compensation that the FCSC will pay to a single person or firm. The maximum compensation paid out is £85,000, which means that if you were to have deposited £90,000 with a bank that went bust, you would get back only £85,000. If you were to have deposited only £10,000, however, you would get it all back.

Activity 3b

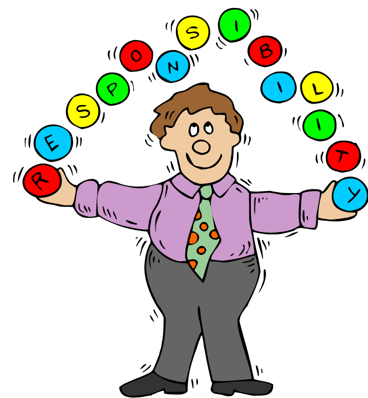
Work out how much compensation the following investors would receive if their bank were to go bust.

a) Joan has £48,000 in her savings account.

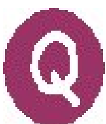
b) Lionel has £105,000 in his investment bond.

c) Desmond and Ruby have £130,000 in their joint savings account.

Responsibilities of consumers



Although protection is available for consumers for the events mentioned above, buyers of financial products are still expected to take some responsibility for their financial decisions. They need to ask questions and think carefully before committing to a new financial product.



We ask questions and think carefully before buying other products – should it be any different for financial products and services?

Case study

Nyree has bought a new dress. She spent ages in the shop trying it on and getting the opinion of the sales assistant. She wears it a couple of times and still feels good about it. Then she stops liking it: the colour was really suitable only for the summer.

- Does Nyree take the dress back? Of course not: she simply accepts that she has made a mistake – and decides to put the dress away until next summer.

Nyree then buys a really nice linen jacket. It goes with all of her clothes and fits her really well, but when it is washed, she finds that it takes ages to iron.

- Does she take it back? Once again, no: Nyree may be annoyed that she failed to realise that linen fabrics crease easily – but she knows that this is her own fault, not the shop's.

Buying financial services is slightly different from buying clothes: mistakes can be very costly and it can be many years before you discover that you have made a mistake. This is why consumers are protected through the FOS and the FSCS.

Did you know?

Consumers are responsible for asking questions. The FCA, in one of its leaflets, suggests that you ask the following.

- Does the product meet my needs?
- What are the charges and how are they paid?
- If there are regular payments, what happens if I cannot keep them up?
- Is this the best deal?

Consumers are also responsible for reading all of the paperwork and signing it only if they are happy. If there are any words or phrases that they do not understand, they should ask for an explanation. They should not feel pressurised to sign straight away.

The following is the experience of a person who did not find out enough about the products to which she was agreeing.

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When we were given a mortgage, I was so delighted that I didn't read the small print...

A couple of years later, our repayments increased by £150 per month. What I didn't realise was that our mortgage deal included a special discounted interest rate for the first couple of years. Now the discount is over, we're paying the normal lending rate. This is a lot of extra money to find each month, so we hardly ever go out any more because we can't afford it.

I should have asked more questions at the time.

Caveat emptor

Caveat emptor is a Latin phrase meaning 'let the buyer beware'.

This is a very old legal principle. It means that a buyer of an item should make enquiries and fully understand about the product that they are purchasing before they hand over their money; once the purchase is completed, they cannot complain later.

In the context of financial services, this principle is of less effect – that is, the government insists that the providers of financial products do their utmost to help consumers to understand what they are buying. The Consumer Credit Act 1974 set up the annual percentage rate (APR) system, for example, and regulations made under the Act dictate the way in which interest rates must be quoted so that the consumer does not have to work them out.

Although consumers have this and other consumer protection available to them, however, they are still expected to take some responsibility for the decisions that they make.

Review questions

1. Name three unplanned events that can result in a person experiencing financial difficulty.

2. What is the typical payment period for payments protection insurance (PPI)?

3. For what purpose might a person buy term assurance?

4. What is the purpose of the Financial Ombudsman Service (FOS)?

5. Should a customer go straight to the FOS if they have a complaint about their bank?

6. What is the maximum compensation for a person who has savings with a bank that goes bust?

7. What is meant by *caveat emptor*?

8. Why is this principle of less effect in financial services?

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Learning activities

Internet

- Visit www.fos.org.uk, click on 'How to complain' and view the video clip. There are also some video clips about how people were helped by the FOS.
- Visit www.fscs.org.uk and explore the information available.

Group

Make a list of complaints that you think a person might make to their bank. You might include things such as not being told about interest rate changes, being charged for an unauthorised overdraft, or bouncing a cheque (sending it back unpaid) a day before their wages were paid into their account.

Individual

Visit some banks in town and ask them for a leaflet telling customers what to do if they have a complaint. What do you notice about all of the leaflets that you collect?

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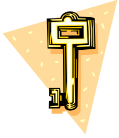

Key points for Topic 3

You should now understand:

- ❑ protection policies for the financial consequences of sickness, redundancy or death – that is, term assurance and payment protection insurance (PPI);
- ❑ the role of the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS);
- ❑ consumers' responsibilities for their financial decisions, including *caveat emptor*.

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