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AJBell Investcentre

News & Views

In this month's issue

Welcome

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Well it's been a little while since my last News & Views with minor events like the aftermath of the Brexit vote, a very busy tax year end, and the small matter of a snap General Election keeping us all on our toes.

Within the industry we have also seen regulatory interventions in the 'Advising on Pension Transfers' consultation and the final report from the FCA's Asset Management Market Study. We also now know that the FCA will launch a market study on platforms very soon.

So, plenty to cover in this edition of News & Views. I hope you enjoy reading it.

Defined benefit transfers – a tectonic shift in the right direction

The FCA's consultation paper '17/16 – Advising on Pension Transfers', has been expected for some time. When you consider the amount of time we've been working with the behaviours associated with the pension freedoms then there's an argument we've been waiting too long, and that the proposals now don't go far enough.

The FCA's acceptance that the DB transfer rules are no longer relevant to today's market is welcome. The previous starting assumption that defined benefit transfers were unsuitable, was a view from a bygone era and does not reflect the reality of many people under the pension freedoms. Removing this assumption is therefore a positive development, though I note the FCA has indicated that its Handbook will contain a statement that for most people retaining safeguarded benefits will likely be in their best interests. In spite of this I believe it is right that advisers should be able to begin from a more neutral starting position.

Defined benefit pension scheme members who have left their employer are now being offered previously unseen multiples of their deferred pension, so many people will see transferring as a sensible option. Extremely high transfer values, poorly funded schemes and the vast improvement in death benefits post transfer are still uppermost in many

people's decision to transfer – though we would urge caution in relation to basing a decision on the taxation of death benefits, as the beneficial position we currently see may not be around forever.

Whilst it is good that the consultation will be reviewing the TVAS process, it appears that the proposed transfer value comparator (TVC) shares the same flaw as the current transfer value analysis (TVA). They put annuity rates at their heart, when annuities are just not as relevant as they once were, unless perhaps someone wants to take a DB transfer value now in order to buy an annuity in the future, which would typically be perverse.

The analysis needs to reflect the substance of the transaction in hand. Our preference would be to project the income that can be generated from the transfer value from normal retirement age, using sensible growth rates and a standard table of sustainable income drawdown rates and then compare this level of income with that being foregone.

It will be genuinely interesting to see the spread of responses to this consultation paper, and how the FCA reacts to them. It feels as though the pressure from the Treasury to loosen the rules on DB transfers is starting to tell but that the FCA is still hesitant. Whether or not the focus of most responses is on loosening, or tightening, the controls may have a significant impact on how far the FCA is prepared to go.

Whilst on the subject of DB transfers, we continue to see high levels of new business and we regularly see cases submitted that are close to the end of the guarantee period. If you have cases like this, please help us to avoid problems by ensuring they are submitted to us more than two weeks before the end of the guarantee.

Pension freedoms ... into the terrible twos!

Just a few months ago, pension freedoms celebrated their second birthday. Readers who have had the pleasure of bringing up small children will be familiar with the period known as the terrible twos. Well, the pension freedoms are well into that stage in their development!

The changes may not have had the same scope as A-Day, but have undoubtedly had a greater impact for a larger number of savers as hundreds of thousands were given more flexibility and choice about how they could withdraw their hard-earned pension savings.

Having had a couple of years now to bed in, I think most would agree that they have been a positive addition to the pensions landscape. Flexibility is rarely a bad thing, and a lot of clients have been able to achieve some really positive outcomes by freeing up cash from their pension savings.

The position on death benefits is also now very favourable – whisper it quietly, perhaps a bit too favourable?

However, freedom is a double-edged sword. There is a risk that the removal of limits is potentially dangerous for some if it will leave them with less money in later life than they need. The annuity market has also taken a beating, and while you could argue that annuities had ceased to be good value some time ago, they do offer a clear and worthwhile alternative to drawdown. Could the decline in annuities perversely lead to less choice at retirement?

The pension freedoms have also contributed to the current spike in defined benefit transfers. The real driver of increased demand for these transfers has clearly been the dramatic increase in transfer values being offered. Many of the transfers we see are coming from financial services schemes where the schemes are in relatively good financial health and the underlying scheme investment strategy is likely to be at the low-risk end of the spectrum. This means that the discount factor used to calculate the transfer value is relatively small and this drives up the transfer value. You may also see some pension schemes in deficit using transfers as a way to reduce their future liabilities. In addition, the generous death benefits within a DC environment will certainly be a reason to transfer for some people.

Two things are clear. From a consumer perspective, there has never been a greater need for quality advice for clients in the at-retirement bracket. And from a policy perspective, the watchword for me has to be 'stability'. Following recent political events, we now have a Government that we will be looking to challenge on its long-term pensions policy. This policy would ideally be framed by an independent commission with cross-party consensus but, sadly, I don't have much confidence that the new Government feels secure enough for such bold thinking. We can but try.

AJ Bell appoints architect of pension simplification

Having mentioned A-Day in each of the last two articles, it feels appropriate to announce that Peter Hopkins, formerly of HMRC and the DWP, joined us on 3 July as Technical Director.

Many of you will remember Peter as the person who led the HMRC pension simplification project. I locked horns with Peter on many a technical issue as we moved from Green paper, to White paper, through draft legislation and into the implementation stage. More often than not I came out on the wrong side of the technical argument – though Peter had the advantage that he was making up the rules!

I first offered Peter a job at the time, but he decided to go off and change PAYE instead. I was persistent though, and I am delighted that this has finally been rewarded.

Lifetime ISA – thoroughbred savings product or a bit of an ass?

The Lifetime ISA (LISA) has arrived with considerably less fanfare than George Osborne may have anticipated when he first announced the proposals in what was to be his final Budget. The LISA was conceived at the time changes to pension tax relief were being considered. Further pension changes were ruled out (for the time being at least), but an ISA begins to look suspiciously like a pension when one of only a handful of ways to make penalty-free withdrawals is reaching the age of 60.

For many years ISAs were generally seen as a success story; positively received by the public and easy to understand - you put money in up to your subscription limit each year, pay no tax on your investments and no tax when you take money out. However, this initial simplicity has gradually been eroded over time in the same way it has for pensions post A-Day.

We now have six types of ISA – Cash, Stocks and Shares, Help-to-Buy, Innovative Finance, Junior and Lifetime. Add to the mix features such as flexible ISAs, additional permitted subscriptions and tax advantages during administration of estates, and things don't feel so straightforward anymore.

There is also the potential for more mess when you look at the LISA transfer rules. You can transfer a Help-to-Buy ISA into a LISA in this tax year only and claim the 25% bonus on the value built up to 5 April 2017 without this counting towards the LISA limit. You can also transfer funds built up after this date, and funds from other ISA types, but these do count towards your annual LISA limit, but not your overall ISA subscription limit.

This means under 40's can theoretically set up a LISA, transfer in £4,000 from an existing ISA and claim the bonus, and still subscribe £20,000 to the original ISA. In practice, partial transfers from current year's subscriptions are not permitted under HMRC rules and often aren't allowed from previous years' subscriptions under provider rules due to the complex nature of trying to differentiate between one year's growth and the next.

If we are to avoid the need for 'ISA simplification' in a few years' time, then a single 'Master ISA' that could adapt to a saver's needs would be preferable. Where the qualifying criteria are met a bonus could be applied, funds could be used to purchase a first home and savers could keep everything in one place without building up a collection of ISA products.

The prime market for LISAs could well be wealthier parents/grandparents helping their descendants to get on the property ladder. At the other end of the scale, and much more the target in the LISA policymakers' minds, are those who have not historically saved enough. The 25% bonus is the carrot to encourage savings, and the possibility of being able to use the funds to one day purchase a first house is more tempting than some distant retirement age.

However, unlike pension savings, anything in an ISA, including a LISA, will count towards means testing for benefits. Under an ordinary ISA this may be fair game, when the funds are readily accessible. But when you consider the whopping 25% exit penalty on LISA withdrawals prior to age 60 (other than for first house purchase or ill health) this feels distinctly unfair. You can easily envisage scenarios where savers fall on hard times and are forced to make the withdrawals, and the biggest beneficiaries will be the Treasury as they get back not only the bonus awarded plus compound growth, but more besides.

The fact advisers can't take their charges from a LISA may be less of an issue for those wealthier families funding for their children and grandchildren. Where family wealth is being looked after fees can be taken from elsewhere. 20- and 30-somethings who are funding the LISA themselves are less likely to have alternative options, and explicit advice charges which have to be paid alongside the LISA payments (and, of course, not benefiting from any bonus) will be less appealing. Without advice these less confident investors may end up leaving funds in cash LISAs at rock bottom rates for many years.

AJ Bell's new low-cost fund range

As I'm sure you'll have seen in recent editions of Insider, we are pleased to have launched a range of five AJ Bell Passive funds in response to growing demand for low-cost, passive investment solutions that can form a core holding in client portfolios.

In line with our mantra of making investing easy, a key challenge I set for us when launching the funds was to be able to offer a clean, transparent and competitive charging structure with no hidden surprises. With this in mind each fund has an ongoing charges figure (OCF) capped at 0.5% per annum, with AJ Bell absorbing any fees that would cause the OCF to go above this figure.
To make the overall charges even more attractive, any investment in the AJ Bell Passive funds will not attract a platform custody charge from the point of purchase until January 2019.

Each of the funds actively targets a different level of risk and will be managed to generate consistent investment returns that are commensurate with that level of risk. The asset allocation of each fund has been formulated with a long-term global perspective in mind, enabling short-term sector or geographic volatility to be filtered out.

Our overall objective is to give you a range of passive funds that are suitable for a wide range of your clients, and that will 'do what they say on the tin', at a competitive price.

The funds are in the process of being mapped to the Dynamic Planner and FinaMetrica risk profiling tools so you can easily incorporate them into your existing business processes and match them to your clients' needs.

Full details of the fund range can be found here https://www.investcentre.co.uk/ajbell-passive-funds

The value of investments can go down as well as up and your client may not get back their original investment.

Asset Management Market Study

The final report from the FCA was another widely anticipated regulatory event but in many ways it was a bit of an anti-climax.

The interim report was fiercely critical of an industry that it saw as hugely profitable but uncompetitive. So it was slightly underwhelming to see the final report being conspicuously lacking in specific actions. However, the direction of travel is quite clear and the regulator clarified in the press that it expects to see the cost of active fund management come down as a result of its package of reforms.

Many would argue that this is long overdue. Both the financial advice and platform markets had to deliver greater transparency under the RDR but the asset management market went largely untouched. At the time the regulator expected fund costs to come down but actually the unbundling of fund charges has had virtually no downward impact.

The asset management industry therefore remains ripe for reform. Some of the measures confirmed in the final report should improve transparency of charges and make it easier for investors to judge whether they are receiving good value and, if they aren't, switch to a better option.

However, whilst the FCA has clearly lifted the lid on the asset management industry, the focus must now turn to the implementation. An awful lot of what was in the final report is still up for further consultation, so there is going to be little immediate change. The key now is how long the additional consultations take and how quickly the proposed reforms are implemented.

One of those additional pieces of work is going to be another study of the platform market by the regulator. We are due to get further detail on that later this month but it seems clear that one area of focus will be the extent to which platforms can influence fund pricing.

Whilst the asset management study highlighted that fund charges on platforms are likely to be lower than those levied directly by fund groups, the FCA said that it believes platforms could do more to use their scale to negotiate discounts on fund charges.

What the report neglects to mention is that cash rebates - the main mechanism that would enable this influence on fund charges to be exerted - were banned by the FCA itself as part of the Retail Distribution Review (RDR).

Despite the assumption that the greater transparency created by the RDR would lead to a reduction in fund charges, when you actually look back at how the market has evolved it is clear that more was done to remove or reduce fund costs before the RDR than after it. A key driver in this was platforms having the ability to negotiate and reduce those costs by rebating the charges levied by the fund managers back to customers in the form of discounts.

Following the banning of adviser commission by the Retail Distribution Review in 2012, the regulator introduced a similar ban on payments from fund groups to platforms in April 2014. The objective was to prevent undisclosed payments from fund groups being retained by platforms but by introducing a blanket ban, including on cash rebates being paid to customers, the regulator cut off one of the main mechanisms platforms had to negotiate with fund groups.

Whilst unit rebates are still allowed these are generally too small to have any real impact for investors and the move to clean pricing has all but removed any ongoing negotiation between platforms and fund managers.

The main lever for platforms to influence fund pricing is through persuading the managers to introduce cheaper share classes on funds. However, introducing multiple share classes, some of them exclusive to certain platforms, increases complexity and costs. It also makes it significantly harder for advisers to move client assets between platforms.

Allowing cash rebates, as long as they are paid in full to the customer, would enable platforms to more easily negotiate discounts for your clients, increase competitiveness in the market and enable the industry to simplify the share class mess left behind by the RDR.

Given that we warned the regulator at the time that banning cash rebates would not result in good customer outcomes, the platform market study is something I begrudgingly welcome. When we reach a position where it is recognised that the interests of the customer would be best served by permitting cash rebates to be re-introduced, I'm sure we won't be the only platform that sees it as an opportunity to re-energise our negotiations with fund managers.

Finding benefits taxing

When the pension freedoms were launched back in April 2015, one minor change introduced by HMRC which flew somewhat under the radar was the removal of a concession regarding how pension payments need to be taxed.

For around twenty years, HMRC has granted a concession to pension providers allowing them to use a 'Month 12' tax code on drawdown payments where the provider expects the payment to be the only one taken by a client in a tax year.

This means that if you've had a client who has wanted to take a one-off or annual payment in, say, April or May, the pension provider has been able to work out the tax payable on the basis that the tax allowances on the full year are granted.

When it came to the 2015 launch of the pension freedoms, HMRC refused to grant an equivalent concession for flexi-access drawdown (or UFPLS) payments, and has refused to listen to calls for change since. Instead, HMRC has repeatedly said that it does not recognise the possibility that a pension freedoms payment can be an 'annual' payment.

So for pension freedoms payments, if your client wants to receive all of their annual pension early in a tax year, they're only going to benefit from one or two months' tax allowances.

HMRC has introduced a mechanism to allow clients to claim the extra tax back. Depending on their exact circumstances your clients can fill in either a P50Z, P53Z or P55Z and receive the over-taxation back within a reasonable timescale – HMRC claim that all tax reclaims are paid out within 30 days of the relevant form being submitted.

In spite of this option of recovering the tax, the whole situation seems completely unnecessary to me and is just one more example of HMRC choosing to make a situation more complex than it really needs to be.

We've been dealing with the 'Month 12' concession rules for more than 20 years now and, whilst the rules can lead to circumstances where clients have an extra tax liability at the end of the year, I'm not aware of a single client or adviser who has ever complained about this.

Contrast this with the current situation where, every April and May, we still see clients and advisers who are unhappy at the taxation rules which HMRC forces us to apply – even though they have now had three years to get used to the pension freedoms rules.

The position is made even more ridiculous by the fact that the old rules can still be applied in relation to capped drawdown payments. So, even though there is nothing fundamentally different between an annual capped drawdown payment of £10,000 and a flexi-access drawdown payment of the same amount, we're allowed to give a full year's tax allowance for the capped drawdown payment, but not the flexi-access payment. Ridiculous!

We have also looked at the amount of tax that HMRC gets from payments received under the pension freedoms, and the amount of overpaid tax recovered using the various forms made available by HMRC. The difference is staggering and, of course, the main beneficiary of all this extra tax is the taxman himself. If individuals receiving pension freedoms payments are going to need to complete forms to recover the extra tax within a reasonable timeframe of paying it, HMRC needs to do more to promote use of the forms.

Many people will, of course, be able to recover the tax through their tax returns. Hopefully those who don't complete the forms or an annual tax return will automatically receive a refund from HMRC after the tax year has ended, though I for one wouldn't want to have to rely on that.

The simple answer is to allow providers to process payments in the way they were able to for 20 years without issue. However, I don't hold out too much hope. Although HMRC denies that anyone ends up paying too much tax because of the recovery mechanisms in place – something I'd probably dispute – the low usage of the forms which allow quick recovery of tax means that HMRC gets to keep the extra tax for almost two years.

HMRC tells us that tax doesn't have to be taxing, but apparently that doesn't apply to tax when it's applied to pension freedoms payments!

The MPAA - the mostly painful Money Purchase Annual Allowance

The issue of reducing the Money Purchase Annual Allowance has been a bone of contention for some time. As you will be aware, the MPAA limit applies to savers who have flexibly accessed their pension benefits. The limit of £10,000 was only introduced in April 2015 and is due to be cut to £4,000. Despite this change being removed from the Finance Bill, it is still expected to apply from April 2017 and we expect the Government to legislate for it at the earliest opportunity now that the General Election is out of the way, probably in a Summer Finance Bill.

So, now more than ever it is vital that clients consider their future retirement plans in great detail, as triggering the MPAA could severely hinder their ability to make contributions in later life. For example, taking an income payment or taking a penny more than your tax-free lump sum at age 55 will mean limited opportunities to make further pension contributions. This is particularly important as working patterns change and the retirement age continues to rise to cope with an ageing population.

The introduction of the MPAA and now a further drop in its level completely contradicts George Osborne's notion of 'pension freedom', by removing the 'freedom' for your clients to contribute into their own retirement pot at the level they would choose.

The rationale behind the cut is to stop people recycling money into their pension and benefiting from tax relief twice, but we have seen no evidence of this type of abuse taking place.

Reducing the MPAA not only creates a barrier to pension savings for some of your clients by limiting their contributions, but it is also sending out the wrong message to the masses. Why should contributions be limited in later life?

Retirement is no longer perceived as a final destination. It is a process that takes place over many years. Working full- or part-time into old age will become increasingly common and the ability to stagger retirement will be a necessity.

Not only is the MPAA unjust, it is also confusing. We have already experienced clients accidently triggering the lower allowance by taking taxable income, not knowing the consequences of doing so in advance. Some may then contribute more than the reduced allowance. The problems this creates are significant, as contributions cannot ordinarily be reversed or refunded. This makes it even more important that the allowance is fully considered during retirement planning because of the Government's unsympathetic attitude to over contributions caused by a lack of understanding of the limits in place.

The delay in implementing any drop in MPAA creates problems in itself. If clients are advised to contribute £10,000 and face an annual allowance charge because the reduction to £4,000 takes effect from 6 April 2017 they are not going to be happy.

Almost as bad could be a situation where a client is advised to restrict contributions to £4,000, and the reduction only takes effect from the date that the legislation is enacted. That client potentially loses out on the chance to receive tax relief on a contribution of £6,000.

Sadly, while pensions are crying out for simplification, the Government seems intent on making life more complicated for ordinary savers and their advisers.

Due diligence on the due diligence tools

When due diligence services and tools are genuinely independent, there is no doubt that they can be extremely valuable to the adviser market. I'm sure readers will have their own views of the services that are out there and will be able to work out for themselves which of the services genuinely are independent.

One of the obvious indicators of independence is how comprehensive the services are in covering the whole platform market. If the due diligence provider covers the whole market then, at least in my view, that's a much stronger indication of independence than if significant platforms are not included.

The business models behind the due diligence services vary. Most of them charge providers, some of them charge advisers and some of them charge both.

I'm sure that the level of charge the different services asks of both providers and advisers varies to one degree or another. You probably won't be surprised to hear that the variance can be significantly higher when it comes to the charge levied on providers, often based on their size. Perhaps more surprising is the fact that some due diligence services operate on a 'pay-to-play' model where the platform won't even feature unless a, sometimes significant, charge is paid.

The more often I encounter this 'pay-to-play' model, the more I fear its potential to distort the platform market, unsurprisingly not in a way that is of benefit to your clients.

Choosing which platform or SIPP provider to use is a big decision. With most advisers adopting a primary and secondary preferred provider approach there are likely to be tens or hundreds of millions of pounds of your clients' money tied up in those decisions.

Comparison tools are increasingly relied upon by advisers as part of their due diligence. Many would naturally be concerned to find that results may be flawed as a result of the business model behind the comparison service.

At a time when so much regulatory focus is on adviser due diligence, it is a reasonable challenge to ask whether it is right to build comparison services on a 'pay-to-play' basis, meaning that if a platform is not prepared to pay the fee, they don't feature at all in the output.

Clearly, this gives advisers an incomplete picture and could lead to poor outcomes for their clients. It is particularly sharp practice if the adviser is also paying for a comparison tool that does not cover all available providers – something which I've heard quite a bit about in relation to one or two of the services in recent months.

In its recent Asset Management Market Study, the FCA has focused on the role that third party investment consultants play in influencing purchase decisions in the asset management industry in order to ensure there is no bias or market distortion caused by the commercial models in place.

The role of comparison services for platform due diligence is exactly the same and I for one will welcome the day when we see a similar level of regulatory oversight given to that part of the market. In the meantime I would encourage you to look closely at the provider coverage on any tools that you use and possibly challenge the commercial model if you find that you are not benefiting from full coverage.

Techie corner (or Tinker's corner?)

This edition's Techie Corner has been renamed Tinker's Corner as there have recently been a few tweaks to existing rules that are worth having a quick glance over.

QROPS

First off the bat are the changes to the QROPS regulations. From 6 April 2017, the rules are more stringent for overseas pension schemes that want to qualify for QROPS status. The chief purpose of this is to align the regulatory requirements of overseas schemes with UK schemes.

The key change is that the overseas personal pension scheme must be regulated by a regulator of pension schemes if there is one in that jurisdiction. If there is no regulator, the pension scheme must be based in the EU, Norway, Lichtenstein or Iceland. Failing that, the pension scheme provider must be regulated by a regulator of pension scheme providers. If there is no such regulator, it will not qualify as a QROPS.

Overseas occupational pension schemes must simply be regulated by a regulator in that jurisdiction, but only if there is one in that jurisdiction. No regulator, no QROPS.

Furthermore, where the member is resident in the UK when they take income from their QROPS, it is now the case that 100% of the income is subject to tax rather than 90%.

In addition, Chancellor Philip Hammond announced in his Spring Budget on 9 March 2017 that a transfer to an overseas pension scheme will be subject to a 25% tax charge if the client is transferring to one country but moving to another. It's important to note that the EU is treated as one country for this purpose though we will have to see if that survives Brexit!

The charge will also apply if the client transfers and moves to the same country but then some time down the line transfers or moves to a different country, such that they are resident in a different country to their pension. Here the charge would apply on the second transfer.

HMRC asked QROPS providers to re-notify them by 13 April 2017 that they wanted their schemes to retain QROPS status. HMRC suspended their QROPS list on this date while they accumulated the responses, and they re-published the list on 18 April. Unsurprisingly, the list post-suspension is about a third shorter than it was before suspension, though it has expanded a little since.

The upshot of these measures is that we seem to be moving towards a position where the intention is that QROPS are only used for genuine migration purposes and not for pensions offshoring or tax-planning purposes. This was the original intention of the QROPS regime, so it is good to see the Government finally getting close to achieving what it set out to do.

GAD

The next tweak relates to how you calculate the maximum income limit under capped drawdown. Part of the calculation uses the yield on 15-year UK gilts, which is then rounded down to the nearest 0.25%.

Under the current rules, there is a floor of 2.00%. So if the yield is lower than that, you can simply use 2.00% instead.

With effect from 1 July 2017, the 2.00% floor is being scrapped. In addition, the Government Actuary's Department (GAD) has published new mortality tables that go down to 0.00% to accommodate calculations involving gilt yields lower than 2.00%.

So how will this affect your clients? Looking back over previous months, the rounded yield has been under 2.00% since May 2016, and in September 2016 was as low as 1.00%. The May 2017 yield was 1.50%. Therefore, the likely result of the rule change is that maximum income limits will be lower under the new rules.

For example, a client aged 65 with a £300,000 drawdown fund would have a maximum income of £23,800 under the current rules. This is based on a 2.00% gilt yield. Under the new rules, and working from a yield of 1.50%, the maximum income drops to £22,500.

In the grand scheme of things, the effect isn't seismic (only 5% in that example), but it's the latest in a string of changes to the maximum income calculation, principally in the form of new GAD tables and amendments to the GAD uplift percentage.

Given the flexi-access cat is out of the bag, it makes you wonder what the purpose of capped drawdown is and how that purpose is served by constant tinkering with the limits. Simpler just to get rid of capped drawdown, a call I made at the time flexi-access drawdown was introduced.

Follow Andy Bell @Snooper66