

ISA Reforms: Final Regulatory Impact Assessment

July 2007



HM TREASURY



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Final Regulatory Impact
Assessment**

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PURPOSE AND INTENDED EFFECT OF THE MEASURES

BACKGROUND

1.1 When Individual Savings Accounts (ISAs) were introduced in 1999, the Government undertook to review the regime after seven years. This review concluded in Autumn 2006. Aside from highlighting the importance of certainty about the future of ISAs, evidence collected during the process suggested scope for simplification and greater flexibility for savers. A package of reforms to the ISA regime designed to deliver this was published alongside the 2006 Pre-Budget Report. Budget 2007 confirmed that these changes would come into effect in April 2008 and a set of draft amending regulations was published for comment.

1.2 This Full Regulatory Impact Assessment examines the impact of the following package of reforms, which will come into effect on 6 April 2008:

- All Personal Equity Plans (PEPs) will become stocks & shares ISAs;
- A new ISA structure: there will be two types of ISAs, cash ISAs and stocks & shares ISAs. The Mini/ Maxi distinction will no longer exist.
- Allowing investors to transfer existing savings from their cash ISAs to stocks & shares ISAs.

SECTORS AND GROUPS AFFECTED

1.3 This package of reforms will affect the following groups:

- Savers (17.3 million ISA holders and 3.8 million PEP holders);
- ISA and PEP providers (452, of which 324 provide ISAs and PEPs, 116 provide ISAs only, 12 provide PEPs only, 137 offer both cash and stocks & shares ISAs, 97 offer cash ISAs alone and 206 offer stocks & shares ISAs alone);
- Her Majesty's Revenue & Customs (HMRC).

CONSULTATION

1.4 The Government received 77 responses to the consultation on this package of reforms, including from ISA providers, their representatives and private individuals. The reaction to the proposals was positive, with almost all respondents welcoming them. The main issue raised was that of the timing of the implementation of the reforms, and an overwhelming majority favoured an April 2008 start date. Respondents also expressed a strong preference for minimising bureaucracy in the transition to the new regime, for example through the grandfathering of existing rolling ISA applications into the new regime. In response to this, the Government has minimised transitional costs where ever possible: rolling applications will be allowed to continue and there will be no additional reporting requirements on providers upon an ISA transfer. In light of stakeholder views expressed during the consultation, the Government has extended the measure to allow transfers from cash into stocks & shares to include all cash held in ISAs, not just that subscribed in previous tax years. This will provide greater flexibility for savers at no additional cost to providers or HMRC. A summary of consultation responses is available at Annex A.

2

COSTS AND BENEFITS

ALL PEPS TO BECOME STOCKS & SHARES ISAS

2.1 All PEP accounts will automatically become stocks & shares ISAs on 6 April 2008, and become subject to the ISA rules. The qualifying investment rules for the PEP and ISA schemes will be aligned and former PEP holders will be able to invest in the full range of ISA qualifying investments, including insurance and stakeholder products.

Benefits

2.2 For savers:

- The potential to amalgamate PEP and ISA investments within one tax-advantaged wrapper, enabling more effective management of funds (for example, only having to pay a single set of charges)
- Holders of former PEPs will have access to a wider range of investments, such as insurance and stakeholder products.
- Potential for lower account charges.

2.3 For providers:

- Cost savings for those who currently offer both PEPs and ISAs, as they will be able to operate them on the same system.
- Cost savings for those who currently offer both PEPs and ISAs, as they will only have to conform to one set of HMRC reporting requirements.
- Reduction in the cost of administering the more straightforward ISA treatment of interest earned on uninvested cash held in a former PEP.

2.4 For Government:

- Cost savings for HMRC from being able to shut down the PEP reporting system and run only one system going forward.

Costs

2.5 For savers:

- After a PEP has become a stocks & shares ISA it will be subject to the ISA scheme rules and so a 20% flat rate charge will be applied to interest earned on uninvested cash.
- However, the sums involved should be relatively small given that PEPs were designed for stocks & shares investments, not cash, which should be re-invested at the earliest opportunity.

2.6 For providers:

- Providers who operate PEPs and ISAs on separate systems will incur costs in having to change their reporting systems to align them with the ISA reporting requirements. PEP-only providers will incur costs in embedding a

new reporting system. Indications from providers suggest that any costs will be outweighed by the benefits.

2.7 For Government:

- Some cost for HMRC due to required systems changes.

NEW ISA STRUCTURE

2.8 Mini and Maxi ISAs will no longer exist, instead, under the new regime; every adult will have an annual ISA investment allowance of £7,200. Up to £3,600 of that allowance can be saved in cash with one provider. The remainder of the £7,200 can be invested in stocks and shares with either the same or another provider. Therefore, those wanting to invest more than £4,000 and also save cash in an ISA will no longer be tied to one provider. For example: An investor saves £1,200 in a cash ISA at the beginning of the tax year. In the same tax year they could invest up to another £2,400 in the same cash ISA or up to £6,000 in a stocks & shares ISA with either the same or a different provider.

Benefits

2.9 For savers:

- Investment rules that are easier to understand, which will reduce the possibility of breaking the ISA rules without breaking the ISA limits (for example, subscribing to a Mini and a Maxi ISA in the same tax year).
- Greater flexibility and choice: for example, an individual will be able to save £1,000 in cash with one provider and £6,200 in stocks & shares with a different provider.

2.10 For providers:

- Investment rules that are easier to administer.

Costs

2.11 For savers:

- Need to monitor the amounts they subscribe to their ISA(s) so that they remain within their annual investment limit.

2.12 For providers:

- Potential for additional administrative costs of unwinding ISA subscription errors if there are more breaches of the investment limit as the new rules bed in.
- Cost of changing the marketing literature around ISAs.

2.13 For Government:

- A potential increase in costs for HMRC if there are more breaches of the investment limit as the new rules bed in.

ALLOWING TRANSFERS FROM CASH INTO STOCKS & SHARES

2.14 Savers will be able to transfer some or all of the money saved in previous tax years from cash ISAs to stocks & shares ISAs without affecting their annual ISA investment allowance. During the consultation period, representations from ISA providers and their representatives suggested that allowing transfers of cash from current as well as past year subscriptions would give useful added flexibility for savers. Since this measure would impose no additional costs on providers or HMRC, the Government will take it forward.

Benefits

2.15 For savers:

- The ability to diversify assets within their ISA wrapper and benefit from the potentially higher returns offered by stocks & shares over the medium to long term.

Costs

- None

QUANTIFYING THE COST OF THE PACKAGE FOR BUSINESSES

2.16 'One-off' costs

- ISA and PEP providers may incur some 'one off' costs as a result of the reform package announced at Budget 2007. There may, for instance, be a need for providers to revise their IT software in order to comply with the new ISA rules. Providers may also need to update their marketing literature, and staff training. Financial advisors will have to update their advice. In practice, some of these changes may be accommodated as part of the regular revisions to product information and processes that ISA and PEP providers already engage in.
- The consultation has not provided any substantive information on the likely scale of 'one off' costs that providers may face in meeting their obligations under the new ISA rules. However, given the changes contained in the ISA reform package, we expect that additional 'one off' costs should be relatively low.

2.17 Ongoing costs:

- The reforms will generate a net reduction in ongoing administrative burdens for providers, estimated at around £150,000 per annum.

2.18 The majority of this cost saving stems from the fact that providers of ISAs and PEPs will no longer be required to fulfil separate PEP and ISA reporting requirements, and will therefore only have to make one return. Offsetting this reduction, the reform package will also generate a small increase in administrative burdens for a small number of companies currently providing only PEPs (of which there are 12), who will be required henceforth to comply with the ISA regulations.

3

SMALL FIRMS IMPACT TEST

3.1 The small businesses that are likely to be affected by this package of measures are small PEP and ISA providers.

3.2 In order to implement the change whereby PEPs become stocks & shares ISAs, PEP providers will need to change their reporting systems and administrative procedures e.g. on the treatment of interest earned on uninvested cash. Although all PEP providers will be affected by the costs that this will involve, those incurring the greatest impact may be the small PEP providers, as they will have to absorb the costs or spread them over a smaller customer base. However, following the initial one-off costs arising from the changes, most providers will make savings from only having to maintain and report on one system rather than the existing two. The exception will be PEP-only providers, who currently only run one system. Providers should also benefit from the ability to integrate their systems for managing clients' accounts.

4

COMPETITION ASSESSMENT

4.1 This package of reforms will have a positive effect on competition overall as it will remove the following restrictions on savers and providers:

- PEPs becoming stocks & shares ISAs should lead to greater alignment of fee structures, as investors will be able to take advantage of the wider range of ISA funds available, often at lower charges;
- The new ISA structure will increase competition between providers, since savers will no longer be tied into one provider if they wish to save in cash and more than £4,000 in stocks & shares; and
- Allowing transfers from cash into stocks & shares will promote competition between cash ISA providers and stocks & shares ISA providers.

5

ENFORCEMENT, SANCTIONS AND MONITORING

5.1 PEPs becoming stocks & shares ISAs will have a minimal effect on HMRC's compliance regime. The ISA will be subject to the same rules as it is now and the qualifying investment regimes will be aligned. PEPs will become subject to the same compliance rules as stocks & shares ISAs.

5.2 The new ISA structure may have an impact on investor compliance with the ISA rules, as the investor will have more responsibility for ensuring that they remain within the annual investment limits. It is possible that this will cause a small initial increase in breaches, with a resulting increase in the number of interventions required by HMRC.

5.3 Allowing transfers from the cash component to the stocks & shares component of the ISA will have a negligible effect on HMRC's compliance regime. Investors will still have responsibility to ensure that their current year ISA subscriptions remain within the overall and cash ISA annual investment limits.

5.4 HMRC will continue with its investor compliance programme and monitor the investment limits and the mix of ISAs held by individuals to ensure that individuals comply with the ISA scheme rules.

6

DECLARATION

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed,

A handwritten signature in black ink that reads "Kitty Ussher". The signature is written in a cursive style with a large initial 'K' and a long tail on the 'y'.

Kitty Ussher, MP
Economic Secretary to the Treasury
23rd July 2007

A

SUMMARY OF CONSULTATION RESPONSES

GENERAL

HM Treasury received 77 responses to the consultation on the ISA reforms. As a package, the reforms were well received, with a large number welcoming them explicitly. While a few providers indicated that some or all of the reforms could be implemented in the 2007-2008 tax year, some of these suggested that to do so would require a transitional period between the current and the new regimes. The overwhelming majority of respondents favoured an April 2008 start date. A few suggested that April 2009 would be a more practical date for implementation. Taking into consideration the responses received, the Government decided to bring the changes into effect in April 2008. This was confirmed at Budget 2007. There will be no transitional period, in order to avoid investor confusion.

ALL PEPS TO BECOME STOCKS & SHARES ISAS

Many correspondents welcomed this measure, but some questions and concerns were raised. Some providers requested that the Government allow a transitional year, which would allow them to report former PEPs held by them under either the PEP or ISA reporting requirements. Some providers also requested that the Government would impose no requirement to re-brand all PEPs under their management as ISAs as soon as they became subject to ISA rules. While the Government understands these concerns, it is keen for an instant transition between the PEP and ISA regimes to avoid confusion among investors. There will therefore be no transitional year. On 6th April 2008 all remaining PEPs will become stocks & shares ISAs and be subject to ISA rules and their reporting requirements. The continued existence of the term 'PEP' in the description of any live account after this time will be a source of unhelpful ambiguity and the Government discourages providers from using this term to describe their products after 6th April 2008.

Questions were raised about the different treatments of interest on uninvested cash in the PEP and ISA regimes. Some providers wanted clarity on how the ISA treatment would be applied to interest earned on uninvested cash in PEPs when they became stocks & shares ISAs. One private individual expressed disapproval of the 20% charge. All interest on uninvested cash held in a PEP will be subject to the ISA 20% charge as soon as the PEP becomes an ISA on 6th April 2008.

One respondent wished to highlight the need to ensure that PEP investors be given clear information about how the treatment of interest on uninvested cash held in their PEP would change when it became an ISA. They also suggested that a de minimis limit before applying the charge be considered. The Government also wishes to ensure that PEP investors understand how the transition to ISAs will affect them, and will issue updated guidance on this matter early next year. The Government encourages providers to address this issue clearly in their promotional literature. In order to encourage re-investment of uninvested cash there will be no de minimis limit before the 20% charge is applied to interest on this cash, as is the case with stocks & shares ISAs now.

Some respondents raised the issue of whether providers should be required to merge former PEPs with any other ISA investments that investors may hold with them. Differing opinions were expressed: that there should be no such requirement; that all providers should be required to consolidate accounts in this way by a certain date; that the merging of accounts should be a decision for providers to make without the active consent of investors (perhaps giving them the option to opt out of any such account consolidation). The Government will give providers the option to merge or not merge former PEP investments with other ISA holdings that they manage for the same investor as they see fit.

Respondents were also concerned about what paperwork PEP investors would be required to fill in to turn their PEP into an ISA. Investors will not need to take any action. Their PEP will automatically become a stocks & shares ISA on 6th April 2008. Many providers requested clarity on how the Government would require the transition to be reported. The Government requires no additional reporting. PEPs will be reported on under the current regime until 5th April 2008. From 6th April 2008 they will be subject to the same reporting requirements as ISAs. HMRC will not require information on which stocks & shares ISAs held from April 6th 2008 were previously PEPs.

NEW ISA STRUCTURE: MINI AND MAXI ISAS WILL NO LONGER EXIST

This reform was also widely positively received, but again some questions were raised. Many providers requested that current ISA holders with rolling annual applications be grandfathered into the new regime with no requirement to fill in a new application form. The Government confirms that no such re-application process will be necessary.

Some respondents were concerned that breaches of the annual investment limits may occur more frequently under the reformed ISA structure, and requested that HMRC make the new rules regarding limits clear to investors, and monitor subscriptions by individuals closely for any such breach. There was also a request that the Government make clear that the onus is on the investor to ensure that they remain within the annual investment limits, and that ISA applicants be required to declare any ISAs already subscribed to in the current tax year. One respondent suggested that should an overpayment occur, the investor should be refunded the excess subscription, with growth on that amount. Tax due could then be returned to HMRC, and growth would be declared on the investor's self-assessment form. The Government does not want to increase the burdens on managers and investors associated with unwinding invalid subscriptions, and feels a requirement to fill in a self-assessment return in such cases would be unduly burdensome on individuals. The Government will continue to monitor all ISA subscriptions. Investors will be responsible for their compliance with the annual investment limits, and, as under the current system, will be responsible for ensuring that they do not subscribe to an invalid combination of ISAs.

Questions were raised about what reporting requirements the new structure would require. The industry wished to know whether they would have to re-report past years' Mini and Maxi subscriptions as cash and stocks & shares subscriptions when the new structure comes into effect. The Government

confirms that there will be no such requirement and existing information requirements regarding past years will remain the same as now.

The industry appealed to the Government to allow ISA investors subscribing to both a cash and stocks & shares ISA with a single provider to be able to do so on one application form. Cash and stocks & shares ISAs will be separate products, and investors will need to make a different declaration for each due to the limits involved. A separate application form will therefore be required for each, even if they are held with the same provider.

There was a recognition that the new ISA structure would need to be communicated clearly to investors, and that this should be a joint undertaking between providers and the Government. Some providers requested direction on how to describe the new structure to their clients. The Government will be updating its ISA guidance to reflect the changes, and are working with the financial services industry to ensure that the changes are described in a clear and consistent manner.

A few respondents called for the Government to remove the cash limit, allowing savers to subscribe their full annual allowance into a cash ISA. The Government wishes to encourage savers to diversify their assets and benefit from the potentially higher returns offered by stocks and shares in the medium to long term. Allowing savers to subscribe their full ISA allowance in cash would be detrimental to this aim. Nevertheless, the Government has raised the cash limit by 20%, since cash is most popular with those on more modest incomes.

ALLOWING TRANSFERS FROM CASH INTO STOCKS & SHARES

This reform was generally welcomed as delivering additional flexibility. There were occasional exceptions: one provider thought that this move may confuse investors. The Government believes that the flexibility benefits offered by this reform outweigh any potential confusion it may cause, which can be mitigated by clear guidance from HMRC and providers. One private individual felt that this move would encourage individuals to take on an inappropriately high level of risk, and some respondents called for transfers from stocks & shares to cash to also be permitted, particularly as investors near retirement. The Government's aim in allowing transfers from cash to stocks & shares is to promote share ownership by encouraging savers to diversify their assets and benefit from the potentially higher returns offered by stocks & shares in long term. Allowing transfers the other way would not meet this objective. Investors wishing to reduce the risk in their stocks & shares ISA portfolios (for instance, as they approach retirement) will continue to be able to shift their funds within the ISA wrapper into less risky investments such as bonds.

Some respondents argued that investors should have the freedom to transfer the entirety of cash held in their ISAs to stocks & shares, including current tax year subscriptions. The Government agrees that this would be a useful refinement of the original proposal, and confirms that subscriptions made in the current tax year will also be eligible for transfer.

A question was raised about whether this reform would allow investors to make a one-off transfer from cash to stocks & shares, or whether it was a flexibility which would be offered on an ongoing basis. The Government confirms that this

feature will be offered indefinitely, and investors will be able to make as many transfers per year as they wish.

Providers enquired about what reporting requirements this reform would introduce. One respondent suggested that providers be required to capture the source and type of transfer made. Concerns were raised by providers about whether they would have to report the value and number of transfers from cash to stocks & shares. Providers asked whether the provider releasing the money from a cash ISA or the provider receiving it into a stocks & shares ISA would be responsible for reporting the transfer, with some expressing a preference for the onus for reporting lying with the receiving provider. In order to limit administrative burdens, reporting requirements for transfers from cash to stocks & shares will mirror those currently in place for the process for reporting cash to cash or stocks & shares to stocks & shares transfers. There will be no need to report the value and number of transfers from cash to stocks & shares.

One provider highlighted the need to make clear to investors that in order to directly transfer money from their cash ISA to their stocks & shares ISA without affecting their subscription limits they must ask their stocks & shares provider to arrange for the transfer with their cash ISA provider. An investor should not withdraw the money and invest it in the stocks & shares ISA themselves, otherwise it will count against their annual investment limit. The Government will be working with providers to ensure that this reform is accurately and clearly explained to investors.

ALLOWING CHILD TRUST FUNDS TO ROLL-OVER INTO ISAS ON MATURITY

This announcement was welcomed by many respondents who expressed keen interest in being involved in discussions on how this would be implemented. One provider suggested that Child Trust Fund holders should be required to make an active decision about what account to open, whilst another favoured an automatic rollover. One respondent queried how lifestyling in some CTFs would affect the account rolling over into an ISA. The first CTF accounts will not mature until 2020. The Government will consult on these and other issues raised by this announcement in due course, and welcomes any input the public and CTF providers and their representatives may have.

ANNUAL INVESTMENT LIMITS

Many respondents appealed for an increase in the annual investment limits for ISAs, and for both limits to be easily divisible by 12, for the purpose of monthly payments. The Government responded to this at Budget 2007 by announcing that it will raise the overall annual investment limit from April 2008 to £7,200, of which up to £3,600 can be in cash.

B

ORGANISATIONS RESPONDING TO THE CONSULTATION

In addition to several responses from private individuals, the Government received representations from the following organisations:

Trade bodies

The Association of Friendly Societies
Association of Private Client Investment Managers and Stockbrokers
Association of British Insurers
Association of Investment Companies
British Bankers' Association
Building Societies Association
Institute of Chartered Accountants in England and Wales
Investment Management Association
Institute of Directors
Investment and Life Assurance Group
PEP & ISA Managers Association
UK Shareholder's Association

Providers

Bank of New York
Baillie Gifford
Barclays stockbrokers
Barratt and Cooke
BlackRock Investment Management (UK) Limited
BNP Paribas
Brewin Dolphin Securities Ltd
Brown Shipley
Capita Financial Group
Cofunds
Co-operative Financial Services
Co-operative Insurance Society
F&C Fund Management
Family Investments
Fidelity International
Halifax
Hargreaves Lansdown Asset Management Limited
HBOS
HSBC
International Financial Data Services
JP Morgan
Jupiter Unit Trust Managers Ltd
Killik & Co
Kingdom Bank

Legal & General
Lincoln UK
Lloyds TSB Registrars LMS holdings Ltd
M&G Securities Ltd
Marks & Spencer Money
Mellon Fund Managers Ltd/ Mellon Investment Manager Solutions
MLC Savings
National Savings & Investments
NatWest
Newton Investment Management Ltd
Northern Trust
Pershing
Rathbone Investment Management
Redmayne-Bentley Stockbrokers
Rensburg Sheppards
Rhyme Systems Ltd (IT systems)
Royal Bank of Scotland
Royal London Asset Management
Santander Asset Management
Scottish Widows/ Lloyds TSB
Selftrade
Skandia
Standard Life Investments
T. Bailey Fund Managers Limited
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