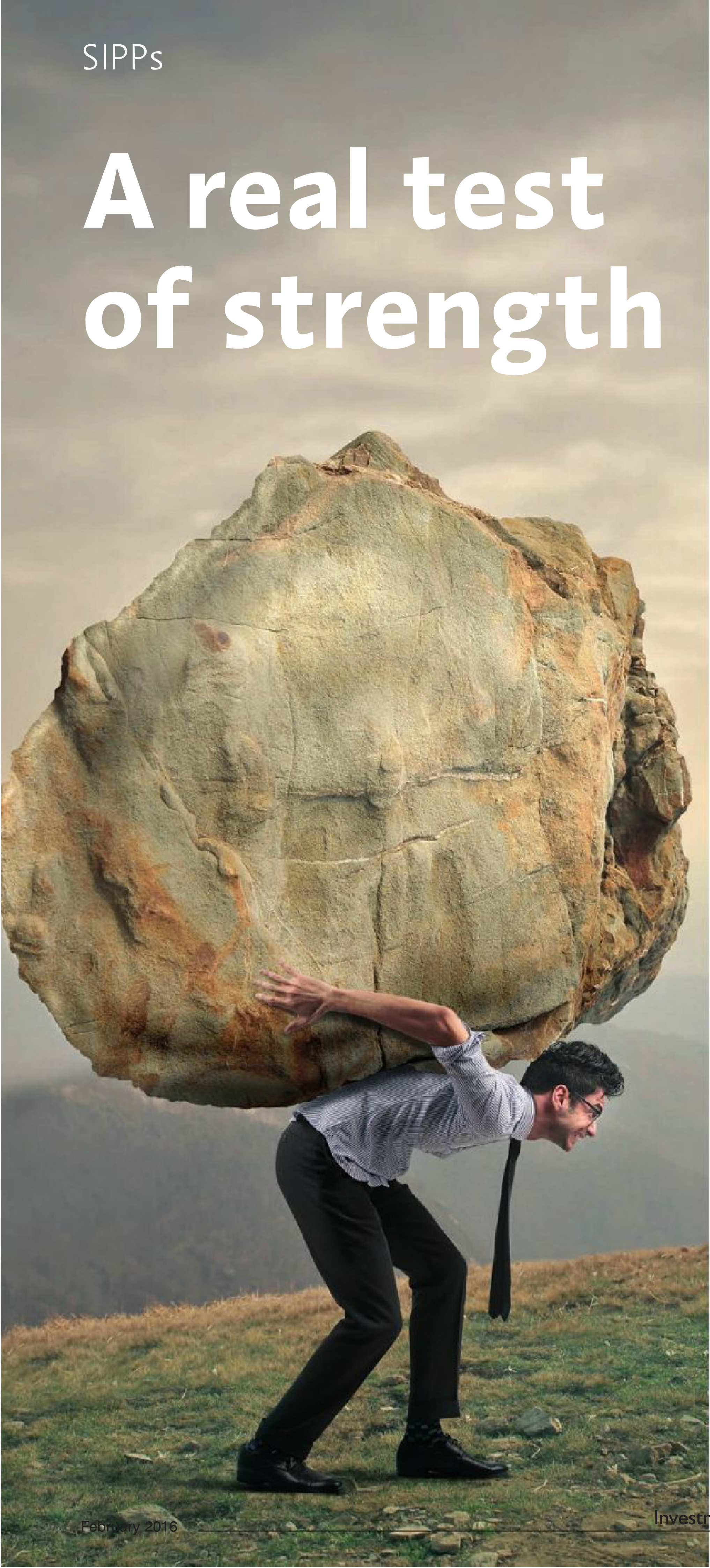
A real test of strength



Richard Eagling reports on the strain being felt by SIPP providers as they prepare for the impending new capital adequacy requirements

The Self Invested Personal Pension (SIPP) market has generally gone from strength to strength since pensions A-Day boosted its fortunes back in April 2006. Indeed, the thriving SIPP market has been one of the few modern day pension success stories, with an impressive range of products and providers catering for those individuals who are looking to take greater control of their pension savings. However, 2016 could give SIPPs its sternest test yet.

Regulatory pressure

Success in the financial services arena inevitably attracts greater regulatory scrutiny and it is fair to say that SIPPs are currently under unprecedented pressure from the regulator. "2015 was a tough year for the SIPP market, but one that should lead to a stronger industry as we move through the 2016 capital adequacy changes into a new era, probably with fewer but stronger providers," says *Andy Bowsher, Director of Self Invested Pensions at Xafinity*. "Continuing regulatory pressures have added to this."

The FCA has already undertaken extensive work on SIPPs, with its Thematic Review in 2014 stressing that despite previous warnings some firms are still not fulfilling their regulatory obligations. Its key findings included the fact that many firms did not have the expertise to assess high risk and non-standard investments and often failed to understand and identify the correct prudential rules that apply to their business. The FCA's subsequent Dear CEO letter, sent to all SIPP firms warning them of the failings uncovered by its Thematic Review, was a clear attempt at encouraging the SIPP market to up its game.

The suitability of SIPP advice has also increasingly occupied the thoughts of the FCA, the regulator having undertaken a number of enforcement actions against individuals for SIPP advisory failings over the past year. Meanwhile, the Financial Services

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Compensation Scheme (FSCS) recently stressed in its Plan and Budget for 2016/17 that it expects to see further claims from retirement savers who have been wrongly advised to hold risky investments in their SIPPs or to transfer from existing pension schemes to SIPPs.

"A number of SIPP operators still appear to have issues around esoteric investments," says *Nigel Bennett, Sales & Marketing Director at InvestAcc Pension Administration Limited*. "Although this is something that affects only part of the market, it was obvious in 2012 that the FSA, the regulator at the time, was seeking to tackle this issue when it proposed a new capital adequacy regime with enhanced requirements for SIPP operators holding non-standard assets. Despite this, we still hear of the SIPP market being linked to scams and yet more compensation falling on the FSCS; this may well be old news in a lot of cases but it would concern us if there was to be a regulatory knee-jerk reaction, particularly one that did not recognise good firms and practices, or have clients in mind."

Countdown to capital adequacy

There can be little doubt that preparing for the new capital adequacy requirements, which will come into effect from 1 September 2016, is exerting the greatest pressure on the SIPP sector. The underlying aim of the new capital adequacy rules is to ensure that SIPP providers hold sufficient capital reserves to facilitate an orderly wind-down of their business should they fail. Under the new framework the amount of regulatory capital required will be determined by the provider's total assets under administration (AUA), with an additional capital surcharge for firms that administer non-standard assets such as unlisted shares or unregulated collective investment schemes (UCIS).

The capital adequacy rules have not been without their controversies, with some significant adjustments along the way, most notably the FCA's decision in August 2014 to perform a U-turn and re-classify commercial property as a standard asset. Further refinements to the rules followed in June last year in CP15/19, mainly involving the frequency of asset valuations for AUA calculations, technical changes to the standard asset list and guidance on the requirement for standard assets to be realisable within 30 days.

"Clarity from the FCA on the requirements seemed to take forever," says Andy Bowsher. "Our compliance team have worked tirelessly on seeking clarity and applying what we know to our book - right down to individual investigations into every asset our clients hold. The work involved in getting this far has been really extraordinary, much of it difficult because of the doubt as to what is actually a 'non-standard' asset. Let's hope all this detailed asset-level validation proves worthwhile. I personally would have voted for a simpler calculation that accounts for the non-standard investments risk but in a more general way. If this was felt more risky, then add a premium of say 10%. This is better than imposing micro-level work and, of course, extra cost to business."

Latest update and clarification

Although most of the SIPP capital adequacy details have been known for a while, as recently as December 2015 the FCA felt the need to issue further clarification on some of the rules in its Handbook Notice No. 28, mainly around commercial property investments and standard assets.

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"The update was helpful in that it gave some further guidance but it was far from being definitive and is still open to interpretation by SIPP operators, so could lead to concerns as to whether a correct interpretation has been made," says *Robert Graves, Head of Pensions Technical Services at Rowanmoor Group plc*. "The difficulty for both the FCA and for SIPP operators is that commercial property investments are very varied and therefore a definitive rule could have been a worse outcome than the guidance we currently have. One would hope that in any follow-up FCA thematic review, if the findings reveal any misinterpretations, then allowances will be made and lessons can be learnt from this."

On the important issue of determining whether an asset is capable of being readily realised within the 30-day period, the latest FCA update says that firms should consider whether the transaction can be concluded within that time limit in the ordinary cause of business. It notes: " For example, such a date can be the date of exchange of contracts or any other date when both parties have unconditionally agreed to undertake their contractual obligations to realise the asset."

Meanwhile, the provision that defined the date of land registry notification as the end date for realising a commercial property transaction has been removed. The FCA said that the 30-day period will start and end on the dates when the transaction is initiated and concluded respectively, but assets could still be classified as standard if the realisation time period goes beyond the permitted 30 days due to delays in receiving information from third parties. Here the regulator acknowledges that third party permissions can often be a major cause of delays, particularly for commercial property transactions where delays can occur due to waiting for the consent of mortgage lenders, joint owners or lease holders.

"We were happy to receive further FCA clarification, which confirmed our own views on the treatment of commercial property under the new capital adequacy rules," comments Nigel Bennett. "We will still look at individual properties on their own merits, but we feel they are likely to be standard assets in most cases and market conditions."

Gaining a clear understanding of how commercial property will be treated under the capital adequacy rules has been particularly important to many SIPP providers as not only is the ability to invest in commercial property an attractive feature of SIPPs, but it is also one that is becoming increasingly popular. Indeed, Xafinity SIPP and SSAS recently reported a 25% increase in commercial property investment over the last year.

"Commercial property remains an attractive investment for SMEs, the self employed and partnerships," says Andy Bowsher. "Bricks and mortar with sitting tenants can provide consistent growth for a SIPP through rental income as well as capital growth. The stock markets have been very volatile recently and the key markets are down as much as 15% in 12 months. Compare this to a solid 8% or so average yield on a commercial property and you can see why clients continue to invest directly into commercial property."

Standard assets

As well as providing some clarification on commercial property, the FCA Handbook Notice No. 28 also addressed some queries on standard assets. For instance, there has been uncertainty over whether discretionary fund management portfolios could be deemed to be standard assets. According to the FCA, this is possible where the asset can be accurately valued and readily realised within 30 days, with the added proviso that the SIPP operator has arrangements in place to ensure that the portfolio comprises standard assets only.

By contrast, the FCA has rejected industry calls to include crowdfunding and peer-to-peer assets in the standard asset list, citing that it did not obtain "convincing evidence that these markets will generally have the necessary characteristics that standard assets should have". Less clear, however, is the situation regarding whether unbreakable deposits can be treated as standard assets, with the FCA conceding that the variety of industry practices means it is unable to provide any additional guidance. The FCA explains: "There are examples of unbreakable deposits capable of being realised within 30 days because, for example, the deposit provider has flexible practices that would allow realisation of the deposit, regardless of penalties or charges. Equally, there may be cases with obvious obstacles to realisation, where the deposit will not be capable of being realised within 30 days."

According to Andy Bowsher, a number of other uncertainties regarding the capital adequacy rules also persist. "In our response to the proposals we raised a couple of anomalies with the FCA that haven't been resolved - in particular the treatment of 'life policies' (including bonds) and the lack of a definition of 'managed pension funds'," he says. "The old HMRC permitted investment list was much clearer in this regard."

Behind the curve

So given the fact that the new capital adequacy framework is less than seven months away, how prepared is the SIPP sector for this monumental change?

While there is no requirement for SIPP providers to have the necessary capital ready yet, collecting data on their assets under administration has been a more pressing issue. "SIPP operators should already have systems in place to value their assets under administration within a 12-month period, and if they have not, they are already behind the curve," suggests Robert Graves. "The main challenges arise for SIPP operators obtaining these valuations from third parties in a timely manner in order to meet the 12-month valuation period. Coupled with that, operators will have to conclude their interpretation of non-standard assets and be able to identify these assets in their SIPP portfolios, ready for the September 2016 calculation."

Even once the required capital reserves are in place there will be no-let up in the work facing SIPP providers. "Having put in place systems for September 2016, a SIPP operator must then have a process for continued collection of data, to provide future assets under administration and assess the proportion of SIPPs that contain non-standard assets, to update its capital adequacy requirement and, of course, make appropriate financial reserves to meet it," adds Robert Graves.

Given the contrasting size of SIPP providers and their available resources, there will inevitably be variations in their preparedness for the 1 September deadline. "While finding the capital was never an issue for us, the work involved in interrogating and classifying our assets has been significant," explains Andy Bowsher. "And I'd say our controls and systems are generally in very good order. I think it likely that some, if not many providers, are behind the curve on meeting the requirements. We wait to see what the FCA approach to auditing the industry will be."

A change as major as the capital adequacy rules will undoubtedly have a big impact on the SIPP sector. Some providers have already revised the types of assets they will accept, most notably stepping back from offering unquoted shares, while others will be contemplating exiting the market entirely.

"A challenge will occur for smaller bespoke SIPP operators whose capital adequacy position and finances mean that they can no longer participate in the bespoke SIPP market due to the costs of accepting non-standard assets," predicts Robert Graves. "Re-engineering their business and products to have a unique selling point in the straight-through processed, simplified, mass market SIPP sector could prove difficult against the already established larger players."

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Consolidation talk

Initially, the FCA estimated that between 14% and 18% of SIPP firms could exit the market as a result of the new capital framework, but this has been downgraded to less than 10% in view of the less burdensome requirements it has since published. But although there has been much talk about the capital adequacy rules driving SIPP consolidation, little has taken place so far. Indeed, the biggest acquisition, Curtis Bank's purchase of Suffolk Life, stemmed from Legal & General's desire to sell a non-core element of its business rather than capital adequacy concerns.

"If there is to be any significant consolidation in the SIPP market due to capital adequacy, then our expectation is that it will take place in the six or so months prior to September 2016," says Robert Graves. "Although the capital adequacy proposals have been known for some time, it is only relatively recently that any further change to the formula has effectively been ruled out and final guidance issued on non-standard investments. Now that this is known, businesses with SIPP propositions, which are not core to their activity, may conclude that it is no longer economic to operate and look for an appropriate exit from the market. Alternatively, where the SIPP is a core function, some operators may want to exit after realising that they will not have the financial means to meet the requirements."

There is also a sense that the new capital adequacy rules and other regulatory pressures could put SIPP providers under pressure to raise their fees in 2016. The FCA has acknowledged that its capital adequacy policy could increase fees but its stance is that this is an acceptable price to pay for the greater protection brought by better capitalised SIPP operators.

"Capital adequacy provision and other regulatory pressures are an expense of doing business, as are, for example, payroll and IT costs, which all contribute to the upward pressure on SIPP fees," says Robert Graves. "However, the upward pressure is currently held in check by a very competitively priced marketplace, where at any one time, one SIPP operator or more may be offering special pricing deals to gain more market share. It will be interesting to see, if the anticipated SIPP market consolidation does occur, whether this in fact reduces the downward pressure on fees and we see them rising more substantially in future years."

There is also the likelihood that those SIPP providers who administer non-standard assets will be under the greatest pressure to raise fees. "An under-reported aspect of the capital adequacy rules is the anomaly that should a provider have a high proportion of non-standard assets then there is less of an incentive to reduce that, compared to a provider that has a very small amount of non-standard assets," says Nigel Bennett. "So, there is an argument to say that a provider with lots of non-standard assets may as well keep accepting them, and it's very likely they will charge a premium for that service. "

Further pressure points

As well as dealing with the new capital adequacy rules, SIPP providers also face greater FCA scrutiny in the coming months over the need to ensure that retained interest charges are included in their projections and charges information. Adding to these challenges is the uncertainty surrounding further pension reform, and the expectation that the March 2016 Budget could see the end of higher rate pension tax relief in favour of flat-rate tax relief on pension contributions.

"Anything that reduces the incentive to save is likely to have a knock-on effect on the size of our market, although this may not be felt until several years down the line," says Nigel Bennett. "We are more concerned about the incentive to save generally, and this needs to be considered not just from the point of view of the rate of tax relief, but also the effect of annual contribution limits and the severe reductions applied to the Lifetime Allowance. However, many of our SIPPs are established via pension switches, rather than contributions and tend to be individuals in their early 50s who have already accumulated sufficient pension savings to make it worthwhile having a SIPP."

The scale of the challenge facing SIPPs in 2016 may be big, but if the regulatory pressures ultimately lead to a leaner, fitter and stronger market, then the added strain of recent years will have been worthwhile.