Self-invested personal pensions (SIPPs)

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Author: Djuna Thurley

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Self-Invested Personal Pensions (SIPPS) were introduced by the *Finance Act 1989*. They are a form of personal pension which allows the individual pension holder to decide how the contributions are invested, subject to HMRC requirements and any restrictions in the rules of the scheme. In recognition of the role that the member plays in investment decisions, SIPPS were, historically, subject to stricter regulation of investment than other types of pensions schemes.

The Labour Government introduced a new pension tax regime under the *Finance Act 2004.* The intention was to replace the eight different tax regimes with a single set of rules applying across pension schemes. The initial intention was to have a common set of investment rules, which would have meant enabling SIPPS to invest in assets previously prohibited, such works of art, fine wine and residential property. However, in the December Pre-Budget Budget Report published in December 2005, the Chancellor announced that to prevent potential abuse, SIPPS would not after all be able to invest in residential property and other high value personal chattels. In the 2013 Budget, the current Government said it would explore whether the conversion of unused space in commercial properties in high streets and town centres to residential use could be encouraged by amending Investment Regulated Pensions Schemes rules.

In October 2012, the Financial Services Authority published the results of a thematic review of SIPPS. It found that SIPP operators had the "potential to lead to significant consumer detriment through a failure to adequately control their businesses." In November 2012, the FSA published proposals to strengthen capital standards for SIPP operators. In April 2013, the Financial Conduct Authority took over responsibility for the regulation of SIPPS.

This notes looks at some of the issues raised in connection with SIPPS, such as the restrictions on investments and the regulatory framework.

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1 Background

Self-Invested Personal Pensions (SIPPS) were introduced by the *Finance Act 1989*. They are a form of personal pension which allows the individual pension holder to decide how the contributions are invested, subject to HMRC requirements and any restrictions in the rules of the scheme. In recognition of the role that the member plays in investment decisions, SIPPS were, historically, subject to stricter regulation of investment than other types of pensions schemes.[1]

2 Investments

2.1 Pension tax simplification – consultation on removing restrictions

In recognition of the role that the member plays in investment decisions, SIPPS were, historically, subject to stricter regulation of investment than other types of pensions schemes.[2] The legislation in place before the *Finance Act 2004* prohibited certain investments for SIPPs. Inland Revenue guidance explained:

> a25.1 PROHIBITED INVESTMENTS FOR SIPPS INCLUDE
>
> - Premium bonds
> - Loans to any party
> - Milk quotas

1 Pensions Law Handbook, Tenth Edition, para 14.22
2 Pensions Law Handbook, Tenth Edition, para 14.22

- Fishing quotas
- Residential property (except as an element of commercial property as specified in 11.17 of Part 11)
- Gold bullion
- Shares traded on OFEX
- Unlisted shares (except in a site maintenance company, for the necessary extent needed to purchase a commercial property (see 11.15) and those received as contributions in accordance with paragraph 4.32).
- Personal chattels (e.g. paintings, antiques, fine wine and jewellery)
- Borrowing other than that specified in 11.25,11.28 or 11.29 of Part 11[3]

As part of the pension tax simplification reforms developed from a discussion paper issued in December 2002 and legislated for in the *Finance Act 2004*, the Government decided that all pension schemes would be governed by the same investment rules.[4] This would mean that personal pension schemes would be able invest in works of art, fine wine and residential property. However, any non-commercial use of an asset by a scheme member would incur a benefit in kind tax charge. The Treasury's December 2003 document, *Simplifying the taxation of pensions: the Government's proposals*, explained:

> **The benefit in kind charge**
>
> A40 Where a member or an associate has use of a scheme asset on a non-commercial basis, there will be a tax charge in respect of this. The amount of tax to be charged will generally be quantified in the same way that benefits in kind are taxed on employees. Examples would be members living rent free in property owned by the scheme or where a painting owned by the scheme was kept in a member's home. There will be additional rules for certain wasting assets.[5]

The Regulatory Impact Assessment on *Simplifying the taxation of pensions,* published in April 2004, described the new approach to investment:

> 22 There will be a single set of investment rules for all pension schemes, removing a complicated set of prohibitions and restrictions for small schemes, used mainly by small businesses. It will set limits on holding shares in the sponsoring employers' company, and loans to employers, and prohibit loans to scheme members. The new rules will allow all schemes to invest in assets, formerly barred to small schemes, such as residential property or works of art, from which members may derive a benefit. Such benefit, if not paid for by the member at a commercial rate, will be taxed on the member as an unauthorised payment, at 40%.[6]

It emphasised the benefits for SIPPs:

> 35 Those small businesses using small self-administered pension schemes (SSASs), and self-invested personal pensions (SIPPs) will be able to benefit from the more liberal investment rules e.g. investing in assets currently barred, such as works of art and residential property (see paragraphs 55 and 56). There are almost 38,000 SSASs,

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[3] Inland Revenue's *Personal Pension Schemes: Guidance Notes,* IR76 (2000), Appendix 25; *Personal Pension Schemes (Restriction on Discretion to Approve) (Permitted Investments) Regulations 2001*, SI 2001/117

[4] For fuller details see Library standard note, *Pension Tax Simplification,* SN/BT/2984

[5] HM Treasury and Inland Revenue, Simplifying the taxation of pensions: the Government's proposals, December 2003

[6] HM Treasury, Simplifying the taxation of pensions – regulatory impact assessment

with almost 90,000 members. And there are estimated to be over 100,000 SIPPs, many of which will have been taken out by individuals running small businesses.[7]

It discounted fears that this more liberal approach would distort the residential property market by encouraging a significant flow of pension money into this asset class:

Unintended consequences

55 Residential property: The greater investment freedom for SSASs and SIPPs (see paragraph 35) stems from a fundamental principle of simplification: to have a single set of rules for all types of scheme. Although this does deliver a relaxation that many in the SSAS/SIPP sector have lobbied for over many years, it is not the Government's intention to steer scheme investment into any particular type of asset. It has been suggested in some quarters that allowing these small schemes to invest directly in residential property will cause a significant inflow of pension scheme money into this asset class, distorting the residential property market.

56 Many pension funds can already invest in residential property assets. Simplification changes the current position significantly only for around 200,000 members of SSASs and SIPPS, (about 1.3% of total pension scheme membership of over 15 million) though even they can already invest in residential property via authorised property unit trusts. From April 2006, these schemes will be able to invest directly. But the investment can be leveraged only up to 50% of the value of the funds assets under the new borrowing rules. And the property would need to be sold before an annuity could be purchased. Any income from the property would have to remain in the pension fund (or be liable to tax charges as an unauthorised payment) and any personal benefit on a non-commercial basis, would incur a personal tax charge. Evidence on the distribution of pension fund values at retirement shows that about three-quarters of pension funds annuitised are less than £40,000 in value. These facts, taken together, suggest that it is unlikely that there would be a significant inflow of pension capital into the residential property market from 2006, and any impact of these changes is likely to be small.[8]

Finance Bill 2004

Nevertheless, articles in the financial press predicted a boom in the use of SIPPS to buy residential property as a result of the changes and the issue was raised during the debates on the *Finance Bill 2004.* For example, then Shadow Chief Secretary to the Treasury, George Osborne said:

The clause deals with pension benefits in kind, and ensures that they are subject to tax. The provisions are quite a departure, in that under current rules no, or very few, benefits in kind are allowed; but the clause opens up the possibility of the pension penthouse, the pension Porsche and the pension Picasso, and that is something that people might exploit, in the best sense of the word. (…)

My second question is broader: what assessment has the Treasury made of the likely take-up of those benefits in kind? The provisions make a substantial change to the investment rules and mean, for example, that pensions can now be invested in residential property. Can we expect large numbers of people to use pensions to buy their homes, and then to pay rent to the pension scheme in order to avoid an unauthorised benefit in kind? Of course, if a scheme buys the home and one pays rent to the scheme, one also avoids inheritance tax.

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[7] Ibid
[8] Ibid

> Could the measure thus be used as a form of equity release? People might use their pension pots to buy their homes, and give themselves a large tax-free sum. For example, if one had a pension pot of £100,000, one could use it to buy a house worth £80,000, and suddenly get an £80,000 tax-free sum, provided that one then pays rent to the pension scheme. I make the point because the pension companies that advertise throughout the day on Sky and other channels are already proposing such equity release options. People may find themselves tempted into using their pension to invest in their home. That is not an idle threat: I have already been told of companies in Glasgow that are developing right-to-buy schemes for council properties and encouraging people to use their pension pots to exercise their right to buy. It is important that we are aware of such schemes, and I would be interested to know whether the Treasury is aware of them, and if so, what view it takes. What consumer protection issues exist as a result of them? In short, I want to know whether the Treasury has thought the matter through.[9]

The then Financial Secretary to the Treasury, Ruth Kelly, remained sceptical about claims that the change would lead many people to switch their pension saving into residential property and works of art:

> The new regime will provide tax-favoured pension schemes with a much freer choice over what investments they make. I hope not to anticipate a debate, which I believe we will have later, about whether there should be greater restriction on the use of pension fund assets. We believe that schemes should, as far as possible, be left to decide in the light of market developments their own investment strategy and choice of investment assets. The new, simplified regime significantly reduces the current number of restrictions on the investments that can be held by pension schemes.
>
> In the new, simplified regime, a registered pension scheme may invest in an asset that may be used to provide a benefit to a member, their family or household. However, if a benefit is provided in that way, clause 162 deems an unauthorised payment from the scheme to have arisen, and that will attract an income tax charge. The clause provides for the amount of an unauthorised payment of this type to be valued for tax purposes in the same way as amounts under the existing benefits-in-kind tax legislation, which applies where an employee obtains a non-monetary benefit from their employer. It is an integral part of the more flexible approach to investments in the new, simplified regime.
>
> The hon. Gentleman called it a Picasso clause and tried to understand the rationale behind schemes investing in works of art or in other assets such as yachts or houses. There may be sound reasons why pension schemes invest in a variety of assets and diversify their investment portfolio. It is a judgment for the scheme trustees or managers to make themselves, bearing in mind the requirement to act in the best interests of the beneficiaries of the scheme and provide pension benefits for members.
>
> In the current regime, only certain types of scheme have restrictions placed on the type of asset in which they can invest. A small scheme is not allowed to purchase a work of art, whereas larger schemes are. In the new regime, we want to reduce complexity by applying the same criteria to all registered schemes. That will give schemes the same opportunity to take advantage of potential growth in a wider range of assets.
>
> I do not accept that suddenly to start investing in the housing market will prove a particularly attractive option for people who are in small, self-administered schemes. The motivation is not to increase incentives for people to invest in particular forms of

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[9] SC Deb (A) 15 June 2004, cc 531-2

equity investment, as the hon. Gentleman said. There are buy-to-let investments and others have mentioned holiday homes in hot spots and different parts of the country.

Most pension funds, covering 14 million active members, are free to invest in residential property, and many of them do. The relaxation of the rules covers only those who have self-invested personal pensions and those with small, self-administered schemes. They are specialised products typically taken out only by very wealthy individuals and held by about 200,000 people, compared with the 15 million people who contribute to pensions overall.

There are already certain restrictions that make it much less attractive than one might initially think for people holding small self-administered pensions and self-invested personal pensions to invest in property. First, a tax charge will be levied on personal or non-commercial use of the property. For example, if it is a holiday home in Wales or Cornwall, a person using it for their personal use will have to pay a tax charge. Secondly, if they rent out the house on a buy-to-let basis they will be required to put all the rental income secured from the property into the pension fund, which may be unsuitable for people who need the money to fund repaying a mortgage on the property. Thirdly, pension schemes will be allowed to borrow only up to 50 per cent. of the scheme's assets to finance the purchase of a property, so anyone who wants to take advantage of this would have to have 50 per cent. of the assets in cash to put into that property, which would rule out a lot of people in the categories to which the hon. Gentleman referred. Lastly-and this is a huge disincentive-the property will be owned by the pension fund rather than the individual, and in most cases it will need to be sold for income in retirement, and it will definitely need to be sold at the age of 75 in order to buy an annuity.

Therefore, the case that has been raised is not likely to be attractive to many people, although there may be some individuals for whom it is an attractive investment to secure income in retirement-which is, of course, the intended purpose of our giving tax relief in the first place.

Mr. Osborne: I mentioned the Picasso and the house in Cornwall-or wherever-but my alarm bells started ringing when I heard that a company in Glasgow was using this to allow people to exercise the right to buy council properties. All the disadvantages that the Financial Secretary has set out merely reinforce my concern that people may be led down this route. The flexibility of the pensions regime allows people to transfer out of pensions such as company pensions into specially designed self-invested pension schemes. If it is the case that the market is already coming up with such schemes, I suggest that she at least investigates that and takes a view on what is actually happening, because whatever we debate in this Committee it seems that out in the real world other things are afoot.

Ruth Kelly: When our initial proposals were announced, there was a little flurry of press interest about the possible consequences-and opportunities, for some people-with regard to people buying their own home under the right to buy or buying a second home or holiday home. I think that almost all of that has now evaporated as people have come to realise the disincentives that are built into the system.

Tax relief is provided for a purpose: to allow people to secure their income in retirement. I do not think that huge numbers of people will suddenly want to exercise the right to buy in this way when they are allowed to borrow only up to 50 per cent. of the value of the property, when they will be taxed if they make personal use of the property, and when they will have to sell the property by the age of 75 at least, if not before then, to secure an income in retirement.

> I do not know of the particular scheme that the hon. Gentleman mentioned and whether it is still expecting to continue to promote that offer. I would be very surprised if that were possible. Indeed, I would ask whether the company would be mis-selling to that particular category of people. It is not for me to stand here and make judgment. It is more for me to say that the principle behind our tax regime is not to use the tax system to distort investment decisions that are rightly made by the members or trustees of a scheme, and that tax relief should be used to secure an income in retirement.
>
> There may be further prudential rules and considerations that mean that others, including the Financial Services Authority or the pension protection board, may well take an interest in these areas. They may well have a view on some of these issues.
>
> I stand here as the Minister with responsibility for the taxation of pension funds. To a large degree, we have anticipated later debates on whether the tax system should be used to direct particular investment decisions or whether that task should fall to others. However, I hope that I have made my case clear on this point.[10]

Finance Bill 2005/06

The issue was raised again in the debate on the *Finance Bill 2005/06* - which did not make any change to the provisions of the *Finance Act 2004* removing the restrictions on SIPP investments. On Second Reading, Liberal Democrat MP, Andrew George, asked:

> Has the Minister had the opportunity to reflect on Government proposals to extend self-invested personal pensions to residential properties from April next year? Is she aware of the tidal wave of interest in moving money in that direction and of the impact that that will have on tax avoidance and the availability of affordable housing in constituencies such as mine, which already have high levels of second and holiday homes?[11]

The then Paymaster General, Dawn Primarolo, repeated the argument that the rules were tight enough to prevent a wide-scale movement of funds:

> **Dawn Primarolo**: I am certainly aware of the press speculation pointing to the sort of trends that the hon. Gentleman identifies, but the pension schemes that use property as part of a pension fund are very tightly controlled. Only 50 per cent. of the current value of the pension fund can be raised as a loan to fund a property purchase. The property becomes an asset of the pension fund, and there is a requirement to put all rental income into the pension fund and to lock it away. Any currently owned property that is placed in the pension fund is subject to the normal constraints. On maturity, when the pension fund needs to be drawn on, that property is deemed part of the pension fund and not the individual's. Therefore, much of the press speculation is based on a misunderstanding of how the clauses work. If the hon. Gentleman serves on the Committee, I am sure that by probing the clauses he will be able to assure himself and the House that that is so. However, I am following carefully the speculation and ensuring wherever I can that it is speculation and not the actual result of the proposals.
>
> **Adam Price** (Carmarthen, East and Dinefwr) (PC): Has the Treasury come up with its own estimate of the tax revenue that will be forgone as a result of these new measures. Standard Life has suggested something in the order of £4 billion. Can we take it from the Paymaster General's remarks that the Government have no plans to introduce any amendments on this matter during the later stages of the Bill?

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[10] SC Deb (A) 15 June 2004, cc 532-534
[11] HC Deb 7 June 2005, c 1135

> **Dawn Primarolo**: I can tell the hon. Gentleman that there are no plans for the Government to make changes to these particular provisions. I have seen the speculation about the amount that a particular organisation is suggesting. There has been correspondence with that organisation to explain to it why we believe that that figure is totally incorrect. Given the very tight controls that will exist on property transferring into a pension fund, and what happens when that property comes out of it, I do not recognise the points that are being made by that organisation. We need to be clear that this is part of—the property of—a pension fund, and the pension fund decides how it is used. Much as I pay a great deal of attention to any suggestions that this will be used as an avoidance vehicle, such suggestions are at present unfounded.[12]

On 23 June 2005, the Liberal Democrat team on the *Finance Bill* tabled an amendment to the Bill designed to prevent SIPPS from investing in directly-owned residential property and in assets such as wine or gold bullion that are not capable of producing an income return to the fund.[13] However, it was not debated.

On 10 October 2005, in response to a PQ from Danny Alexander, Ivan Lewis, the then Economic Secretary to the Treasury, set out the consequences of using a SIPP to invest in residential property:

> **Mr. Ivan Lewis:** Pension tax simplification replaces the numerous existing tax regimes with a universal regime for tax-privileged pension savings providing greater flexibility to some 15 million pension savers. Currently most pension funds may invest in property, and many do. Under the new simplified regime self-invested personal pensions (SIPPs) and small self-administered schemes (SSASs) may invest in all types of property including residential property from 6 April 2006. Around 200,000 people, compared to over 15 million pension scheme members, hold these specialist pension vehicles. Creating a single set of allowable investments across all pension schemes fits the requirement to create a single regime for tax privileged pension saving and corrects an existing distortion by giving investors greater choice.
>
> Using a SIPP to invest in a buy to let residential property or holiday home will have the following consequences:
>
> - the property becomes an asset of the pension fund and there is a requirement to put all rental income into the pension fund so it is locked away and cannot be accessed until retirement;
> - if the property is made available to a member of the scheme or members of their family it will give rise to a benefits in kind tax charge if a market rent is not paid (even if they choose not to use it);
> - any property bought by the pension fund in most cases will need to be sold before the pension can be drawn, to provide a secured income in retirement;
> - only 25 per cent. of the capital in the property will be able to be extracted as a lump sum, the remainder will be locked in the pension to be drawn out over the period of retirement;

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[12] HC Deb 7 June 2005, c1135

[13] "Lib Dems Try To Close Jet-to-Let Loophole - Huhne" , Liberal Democrats Press Release, 23 June 2005

- the restriction on borrowing of 50 per cent. of the value of the scheme's assets will limit the numbers who have or are able to build up sufficient funds in their SIPP to purchase a property;

- although any rental income or capital gains from the disposal of the property will be tax free in the pension fund when the money is extracted it will be taxed at 30 per cent. (higher rate tax at 40 per cent. on 75 per cent. of the gain assuming 25 per cent. is taken as a tax free lump sum) which is higher than the rate under the CGT regime payable after the property has been held for seven years;

- putting any previously-owned property into the SIPP will trigger any unrealised chargeable gain on the property, and transaction costs such as stamp duty;

- maximum tax relief on contributions made in any year is 100 per cent. of UK chargeable earnings, subject to an annual allowance set initially at £215,000. Tax relieved pension savings are also subject to a lifetime allowance initially set at £1.5 million.

Therefore, although the measure will increase the number of pension funds that can invest in residential property, these factors will mean that for most people (including the relatively few affected by the liberalisation) residential property will not be an appropriate investment.

The regulatory impact assessment (RIA) "Simplifying the Taxation of Pensions" published in April 2004, which can be found at http://www.hmrc.gov.uk/ria/simplifying-pensions.pdf set out an assessment of the potential impact of the whole pensions simplification package, including the changes to the lifetime allowance and ages at which pensions can be taken, together with allowing residential property into SIPPs and SSASs. These elements cannot easily be separated and therefore the RIA estimates the overall cost of the pensions simplification package to the Exchequer at around £¼billion within four years. Paragraphs 55 and 56 deal specifically with the potential consequences of allowing residential property into SIPPs and SSASs.

The Government will keep this aspect of the tax system, as with all others, under review.[14]

Decision to retain restrictions

The Pre-Budget Report, published on 5 December 2005, announced that SIPPS would <u>not</u> after all, be able to invest in residential property and other high value "personal chattels":

> 5.63 A small part of the proposed [pension tax] simplification would allow all registered pension schemes to invest directly in residential property. To prevent the potential abuse of the simplification rules, where people could claim tax relief in relation to pension contributions into Self Invested Personal Pensions (SIPPs) for the purpose of funding purchases of holiday and second homes for their or their family's personal use, **from 6 April 2006 SIPPs and all other forms of self-directed pensions will be prohibited from obtaining tax advantages when investing in residential property, and certain other assets such as fine wines.** This action will ensure that tax relief is only given to those whose purpose in making the contribution is to provide themselves with a secure retirement income. However, the Government remains committed to encouraging investment in a range of assets as part of pensions saving and is

[14] HC Deb 10 October 2005, cc 314W-315W

therefore minded to allow SIPPs to invest in genuinely diverse commercial vehicles that hold residential property, such as the proposed Real Estate Investment Trust model (detailed further in Chapter 3). The Government will not hesitate to take action if it becomes clear that people are trying to use collective vehicles to get around the rules for prohibited assets.[15]

Legislation was to be included in the *Finance Bill 2006*. There would be limited transitional protection for schemes which had already made certain purchases (for example, off-plan purchases) in anticipation of the April 2006 change before midnight on 5 December 2005. A technical note produced by HMRC explained:

To whom will the legislation apply?

The legislation will apply to all registered pension arrangements where the pension scheme member can direct which investments the scheme makes. This will include those currently categorised as Self Invested Personal Pension Schemes (SIPPS) and Small Self Administered Schemes (SSAS) as well as a number of other schemes. The intention is that the new legislation will cover investments made by all registered pension schemes that are not occupational pension schemes where there is any element of self direction and to a slightly wider class of occupational pension scheme than the current SSAS definition – together referred to as "self-directed pension schemes".

The legislation will apply to direct investment in residential property and in most forms of tangible moveable property (similar to what are currently called personal chattels in the regulations covering SSAS and SIPP investments at SI 1991/1614 and SI 2001/117 respectively) – these are collectively referred to as "prohibited assets". It will also apply to indirect investment in prohibited assets that are a close proxy for direct investment and to other forms of indirect investment that could be used to get around the new rules for prohibited assets. An example of this would be residential property owned by a company in which a SIPP held 100% of the shares.

The legislation will define what is meant by "residential property" and how the rules will apply to property that is used for more than one purpose. This will ensure, for example, that if a pension scheme buys a commercially used property – such as a shop – this will not be classed as a residential property merely because there is an unconnected flat above the shop.

However in line with the Government's commitment to encourage investment in a diverse range of assets as part of pensions saving, certain products offering indirect investment in prohibited assets will not be subject to the new rules and will therefore continue to benefit from the tax advantages in the new pensions tax regime. To this end the Government is minded to allow self-directed pension schemes to invest in genuinely diverse commercial vehicles that hold residential property or other prohibited assets. An example here would be the proposed Real Estate Investment Trust model on which the Government will be consulting shortly. (…)

How will the legislation work?

The legislation will be designed to remove all tax advantages from holding prohibited assets directly or indirectly in self-directed pension schemes and will broadly mean that it is at least no more advantageous to hold such assets in a pension scheme than it is to hold them personally.

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[15] HM Treasury, *Pre-Budget Report,* December 2005

If a self-directed pension scheme directly or indirectly purchases a prohibited asset the purchase will be subject to the *unauthorized member payments charge* in Section 208 FA 2004. This will recoup all tax relief given on the amounts used to purchase the asset.

This means that:

- the member will be subject to an income tax charge at 40% on the value of the prohibited asset
- the scheme administrator will become liable to the *scheme sanction charge* in Section 239 FA 2004, which will usually be a net amount of 15% of the value of the prohibited asset
- if the *set limits* are exceeded the cost of the asset may also be subject to the *unauthorised payments surcharge* in Section 209 FA 2004, which is a further charge on the scheme member of 15% of the value of the asset
- if the value of the prohibited asset exceeds 25% of the value of the pension scheme's assets, the scheme may be de-registered under Section 157 FA 2004, which would lead to a tax charge on the scheme administrator on the value of the scheme assets at the rate of 40% under Section 242 FA 2004. (…)

Investments in certain prohibited assets held by certain self-directed pension schemes will receive transitional protection from the new rules, though this may be conditional on not improving or developing the assets. The table … provides more detail.[16]

Giving evidence to a Treasury Committee session on the Pre Budget Report, a Treasury official explained why it had not been possible to prohibit investment in a more limited class of investment, for example property for personal use:

Q235 Mr Fallon: Can I turn now to your hand-brake turn on SIPPs, where you have prohibited all investment in residential property. This obviously has caused a fair amount of turmoil, both amongst the industry and people who were making preparations for 1 April. Why did you choose such a sweeping prohibition? Could you not have considered prohibiting certain classes of investment?

Mr Orhnial: I think again we need to be clear about what it was we were trying to do with pension reforms, of which SIPPs will form part. What we were trying to do was to sweep away a great deal of complexity through eight different regimes for pensions and one small part of that reform related to self-invested pension plans. As compared to the present, where you are not allowed to invest residential property in a SIPP, what we did was to plan on removing that prohibition. The Chancellor, as you know, announced on Monday that we would return to a prohibition on the investment in residential property.

Q236 Mr Fallon: Forgive me but we know that, that was announced. What I am asking you is why you chose to prohibit all property investment rather than to consider prohibiting certain classes of property investment, for example, property for personal use?

16 http://webarchive.nationalarchives.gov.uk/20060217231219/http://www.hmrc.gov.uk/pbr2005/pensions-simplification.pdf

Mr Orhnial: The reason for that is that it is well nigh impossible to design a system that actually achieves that.

Q237 Chairman: You should have known that months ago. You have done a U-turn.

Mr Orhnial: No. The question was, why did we not isolate this particular ---

Q238 Mr Fallon: You define in tax law what a main residence is, you even define second homes, why would it have been impossible to prohibit property investment in a home you own or you use yourself?

Mr Orhnial: Simply because we cannot guarantee or police rules where you do indeed make that distinction but then you find people change the use to which they put their home. So you may well buy it for the SIPP on the basis you were not going to use it for your personal use, and then choose to use it for your personal use a year or two years later. These are very long-term investments where you are locked in. We could not practically construct a rule which would do it. We could write a rule but we could not construct a rule.

Q239 Chairman: This was left to debate in public for about six months, it was in all the newspapers and people were talking about second homes, fine wine and goodness knows what else. There was a hare chasing for months and months and months and then, all of a sudden, we get a panic decision.

Mr Orhnial: I do not think it was a panic decision, actually it was a very considered decision.

Q240 Chairman: A slowly considered decision?

Mr Orhnial: The reason I brought you back to first principles was essentially to say what we had been trying to do at the outset was to strike a balance between simplicity and complex rules that tried to rule out certain types of investments. We did that on the basis of the information that we had available at the time, and our judgment at the time ----

Q241 Chairman: But there were representations from industry, the ABI and others, on the issue of investors placing deposits on investment properties on the understanding, quite reasonably, it would be possible to benefit from tax relief as a result of including it within a SIPP from next April. That has changed dramatically. So there is industry representation to us on that.

Mr Orhnial: I am aware of the representations they made to us as well.

Chairman: Okay, so that was a U-turn.[17]

2.2 Comment

Expert views on the Finance Act 2004 change

Experts appeared to be divided over the likely impact of the original change. The *Financial Times* quoted John Lawson, a senior technical manager at Standard Life, as arguing that the Treasury could face a £4 billion bill if only 10% of the £100 billion buy-to-let market migrated

[17] Uncorrected transcript of oral evidence to be published as HC 739-ii, 7 December 2005, http://www.publications.parliament.uk/pa/cm200506/cmselect/cmtreasy/uc739-ii/uc73902.htm

to SIPPs.[18] On the other hand, Barry Bolland, chairman of the SIPP Provider Group said that "the suggestion that thousands of people are out there waiting to pile large sums of money into Sipps is fanciful to say the least".[19]

A previous chairman of the SIPP Provider Group, Martin Cadman, set out the reasons why he did not think moving pension money into residential property or fine wine would prove particularly attractive in an article in Pensions Management Institute News, in December 2004:

> The investment changes which have generated the most excitement are those which allow residential property and 'pride of possession' items to be held in a fund. Residential property falls into three categories; main residences, buy to let (including student accommodation) and holiday homes.
>
> Taking them in order; there doesn't seem to be much point buying your principal residence in your SIPP as, if you own it yourself, 100% of any gain is tax free. Put it into a SIPP and you will get 25% tax free and the balance as taxed income. "Buy to let" has been very popular over the last few years but the market appears to have peaked with yields dropping and plenty of vacant properties around. We have to remember the fact that you can invest in a certain asset does not necessarily make it a good idea.
>
> Holiday property and or second homes are relatively attractive. However, many of the people whose funds are large enough to buy such a property may already have one or simply use their pension to buy a property which they would have bought themselves anyway. In summary, I don't think that there will be a huge rush into residential property but the publicity will increase the awareness of Self Invested Pensions.
>
> Pride of possession investments which have aroused some excitement are works of art, fine wine, vintage cars, yachts etc. For the sake of this discussion I will assume that the work of art is a good investment for the pension fund, but is it worth doing?
>
> Under the new regime a member who benefits from an asset held by a pension scheme will pay tax on this in the same way as a director of a company would. This is all contained in Section 205(2) ITEPA 2003 which says: "Where the benefit is an asset placed at the disposal of a director or employee (the "cash equivalent") to be charged is the 'annual value of the use of the asset' or, if greater, the rent or hire charge paid for it".
>
> The tax charge is 20 per cent of the market value of the asset at the time it was first used to provide a benefit. The meaning of market value is "The market value of an asset at a particular time is defined in Section 208 Income Taxes (Earnings & Pensions) Act 2003 as the price that it might reasonably have been expected to fetch on a sale in the open market at that time". On the purchase of an asset this would normally be the price paid, in other cases this would be determined by the Shares Valuation Office.
>
> Furthermore, that a tax charge arises "if the asset is available for the use of the director or employee". Whether or not it is used is immaterial. This is because the legislation refers to the benefit as being an asset "placed at the disposal of the employee". Given that the reporting and taxation of benefits for members is being fitted into the existing

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[18] "Aladdin's cave opens for the wealthy as Brown simplifies tax regime", *Financial Times,* 6 June 2005
[19] ibid

framework I think it is fair to assume that we can replace the words 'director or employee' with 'member'.

So, my answer to the question posed above is no, it isn't worth putting such assets in a pension fund and making them available for a member's use. By all means buy a painting and hang it on the wall of an art gallery, but having it at home or in the office doesn't look attractive to me. My guess, then, is that there will be little change to the investment profile of most schemes but, again, that the publicity surrounding the new investment possibilities will generate a lot more interest in Self Invested Pensions.[20]

Tax practitioner and lecturer Dean Wootten echoed some of these conclusions in an article for the technical journal *Taxation* in August 2005, though he still thought SIPPS post-April 2006 "an extremely attractive proposition":

In my opinion, SIPPs are an extremely attractive proposition post 5 April 2006. I would, however, express a word of caution and would definitely recommend a mix of holding vehicles for a client's investment portfolio.

Purchasing UK buy to let properties via a SIPP would seem to be the most sensible option. These are very straightforward to hold in a SIPP and the full effect of the tax-free environment is enjoyed. Overseas property can be bought via the SIPP but it is necessary to find a low rate country to maximise the advantages. I favour holding overseas properties in the individual's name, but appreciate clients may disagree. I would not buy UK furnished holiday lets via a SIPP as these already enjoy favourable UK tax treatment. I would also not recommend the transfer of existing buy to let portfolios into a SIPP. The transfer would result in a capital gains tax and stamp duty land tax liability and would reduce the advantages of SIPP ownership.

Hence I would advocate holding some properties in a SIPP and some in the individual's name. I would restrict SIPP ownership to a small number of UK buy to let properties and maybe one or two overseas properties in the right circumstances.

Clients should be wary of the 55% SIPP tax charge where the total funds exceed £1.5 million on death. Hence they should not buy a significant number of properties via their SIPP as the limit could easily be exceeded.[21]

The Actuarial Profession also warned that residential property held in a SIPP may only be a suitable pension vehicle for the most financially secure investors:

The Actuarial Profession today warned that people should think very carefully before placing their incomes in retirement at the mercy of the buy-to-let property market.

The warning comes as product providers gear up for changes to the rules for Self-Invested Personal Pension Plans (SIPPs). From 6 April 2006 SIPPs may, for the first time, invest directly in residential property. This may at first sight appear to offer an attractive income and capital tax shelter for buy-to-let properties inside a pensions wrapper.

But the Actuarial Profession cautioned that there are a number of reasons why residential property may not be suitable for many peoples' pension investments prior to retirement, or for a fund which is being drawn down in order to provide an income:

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[20] "All set for A-day? 4. SIPPS in the new simplified regime", *Pensions Management Institute News*, December 2004

[21] "SIPPing pretty", *Taxation*, 18 August 2005

> 1. The initial outlay is likely to be substantial in relation to the existing savings. Existing property cannot be injected directly into a pension fund, and investors should consider the cost of rearranging existing pension investments, and the balance of their revised portfolio.
> 2. Savers are permitted to borrow part of the cost of the property, leading to an element of gearing which increases the overall level of risk, especially if interest rates were to rise.
> 3. Most people need to draw their pensions as soon as they retire, and may have little discretion about when this happens. If the property market is not performing well at that time, a forced sale may be required at a relatively low price.
> 4. Overseas property investments may be subject to local legislation that inhibits dealing with them, and in some circumstances they may prove extremely difficult to sell.
> 5. Residential property can be a volatile investment. Rental income (which cannot be guaranteed) represents a large part of the return, and letting voids and/or marketing costs can quickly erode estimates or rental returns. Properties come in relatively large units and cannot be subdivided; and the property cycle (the period over which values rise and fall) is very long; all one's eggs are in one basket.
> 6. Uncertainty over rental income is especially risky if the property is retained after the retirement as part of a "drawn down" arrangement, and the investor relies upon the income to fund his or her pension.
>
> Only more financially-secure investors, such as those who already own a buy-to-let property and who wish to ensure that future rises in value are free from CGT, or those who have large existing pension funds and who perceive property to offer high returns for acceptable risk, should consider buy-to-let property. [22]

Initial reaction to Pre-Budget Report "u-turn"

Some providers and pension holders expressed concern that, after they have devoted a large amount of time and money to developing new SIPPS to take advantage of the expected change to investment rules in April 2006, the change had been revoked with only four months to go.[23]

The Treasury Select Committee recommended that the Treasury look into why the likelihood of misuse had not been more apparent at an earlier stage:

> In view of the concern voiced by our predecessors and others about the possible impact on the housing market of the previous proposals to permit investment in individual residential property by SIPPs, the revised policy appears appropriate, but the reversal came very late in the day. We recommend that the Treasury examine this episode to ascertain why the likelihood of misuse was not more apparent to it at an earlier stage and whether any unnecessary costs were incurred by the timing of the change of policy. We further recommend that the Treasury report on the outcome of this examination and any lessons it has learned for the future conduct of tax policy in its reply to this Report.[24]

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[22] Actuarial Profession press release, 7 November 2005, "Beware putting all your pension eggs in the residential property basket, warn actuaries", http://www.actuaries.org.uk/Display_Page.cgi?url=/pr-rels/2005/051107propertymarket.html

[23] See, for example, "Pensions U-turn puts industry in a spin" by Nichola Ross Martin, AccountingWEB, 8 December 2005, "Lost tax breaks hit pensions industry", *Financial Times*, 7 December 2005

[24] Treasury Committee, The 2005 Pre-Budget Report, 2nd Report of 2005-06, HC 739. December 2005

The Government responded that it had "acted as soon as at it became clear that, despite the checks and balances built into the system, a large groundswell of interest had built up with the intention of using tax relief for purchases of property for personal use."[25]

2.3 Budget 2013

In its 2013 Budget Report, the Government said it would look at consider amending the Investment Regulated Pension Schemes rules:

> **2.18 Changes to pension investment rules to encourage the conversion of unused space in commercial properties** – The Government will explore with interested parties whether the conversion of unused space in commercial properties in high streets and town centres to residential use could be encouraged by amending Investment Regulated Pensions Schemes rules. Any amendments would need to be consistent with sound public finances and the Government's wider pensions strategy.[26]

The *Financial Times* reported that many in the pensions industry had welcomed the news. However, some suggested the rules would need to be tightly drawn to avoid the possibility of mis-interpretation and abuse.[27]

3 Regulation

3.1 Consultation

Before the announcement on 5 December 2005, there had been some concern that residential property SIPPS were being aggressively marketed.[28] In September 2005 the Treasury issued a consultation paper on proposed changes to:

> 1. the Financial Services and Markets Act (FSMA) Regulated Activities Order (RAO), to include a new regulated activity of setting up and running a personal pension scheme; and
>
> 2. the *Finance Act 2004* (FA 2004), so that any person with permission to carry on this activity is eligible to establish a tax-privileged pension scheme. [29]

This would bring all SIPP providers, then outside the regulatory framework, within its scope – although not until April 2007. Responses to the consultation were requested by 23 December 2005.

While some industry experts warned that regulation could mean more work for providers and did not want to see "doubled-up regulation such as that faced by investment managers", others argued that regulation before A-day was key to protecting consumer interests:

> For the purpose of consumer protection, it could present a conflict of interests if property companies were able to offer SIPP wrappers and property to go in them, without any kind of FSA regulation. The high levels of gearing involved would mean that in the wrong hands or with bad advice, pension holders would be at risk.[30]

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[25] 2005 Pre-Budget Report, Government response to the Committee's 2nd report of2005-06, Third Special Report of 2005-06, March 2006

[26] HM Treasury, Budget 2013, HC 1033, March 2013, p71

[27] Josephine Cumbo,' Door ajar to put property in SIPPS', *Financial Times,* 21 March 2013

[28] See, eg, Norwich Union press release, 27 September 2005, "Residential property and SIPPS – risks and rewards must be made clear says Norwich Union",

[29] HM Treasury, *Proposed changes to the eligibility rules for establishing a pension scheme,* September 2005

[30] "SIPPs costs set to soar if FSA regulates sector", *Professional Pensions*, September 2005

Another alternative, mooted by the Liberal Democrat peer, Lord Oakeshott, was to postpone the changes in SIPP investment rules until April 2007:

Lord Oakeshott of Seagrove Bay asked Her Majesty's Government: Why self-invested pension plans (SIPPs) will be allowed to invest in assets, including individual houses and fine wines, from 6 April 2006 when SIPPs will not be regulated before 2007.

Lord McKenzie of Luton: My Lords, pension simplification replaces the numerous existing tax regimes for pensions, creating a single unified regime for tax-privileged pension savings, including a common set of investment rules. The Government are also consulting on widening the definition of persons eligible to establish a tax-privileged pension scheme and extending the existing regulatory regime. Subject to consultation, these proposals, designed to open up the personal pension market within a full regulatory framework, will be in place from April 2007.

Lord Oakeshott of Seagrove Bay: My Lords, I thank the Minister for that reply. Can he not see the serious concern in the City and the pension fund world about opening up self-invested pension plans to tax-sheltered investments in second homes, fine wines and the like? On Thursday, the Financial Times, under the heading, "Sipping and guzzling", stated:

“The unregulated nature of SIPP investments raises fears of another mis-selling scandal. The tax breaks may also be too good to last".

Why not announce now that the SIPP rules will not be relaxed until 2007, so that proper regulation can be in place and we can avoid the nightmare of a regulatory gap year?

Lord McKenzie of Luton: My Lords, the Government are aware of that gap and the concerns that have been expressed, and we are keen to work with the pensions industry to find ways to ensure that consumers are provided with advice for making decisions about investing in SIPPs. Guidance is already available on the FSA and HMRC websites, but I should stress that these investments are not a new class of privileged investments for pension schemes. Most pension schemes already have these investment opportunities. Some 15 million people are already in schemes that are covered by them, but there has been a great deal of unjustified hype about these proposals and we think that, for many people, putting such assets into SIPPS would be inappropriate. [31]

The 2005 Pre-Budget Report announcement on the tax treatment of SIPP investments had some impact on this ongoing consultation, so HM Treasury issued an update:

The current ‘live’ consultation

1.5 To receive the generous tax relief afforded to pension savings in the UK, a pension scheme must have been established by a person eligible under tax law. The current consultation exercise primarily addresses concerns that the statutory categories of eligible person may be unduly restrictive, and that there may be firms that would be competent to operate pension schemes but which are effectively prevented from doing so. Page 18 sets out the main drivers for change in the pensions market.

1.6 The Government’s preferred option (number 3) outlined in the consultation document is to create, from April 2007, a new FSA regulated activity of setting up and

[31] HL Deb 16 November 2005, cc 1065-1066

running a personal pension scheme. The advantages associated with this option are documented at length in Para 3.17, Page 7 and 8 of the document. One of the seven advantages cited for this option (third Bullet in Para 3.17) states:

'Scheme members would have clear protection, as the professional operators of all types of personal pension schemes would be regulated by the FSA regardless of the type of investment that the scheme held (at present the protection afforded is partial depending, to a great extent, on the nature of the underlying investment.'

1.7 Paragraph 17(b) of the Consultation on page 15 goes on to note in more detail that:

b) 'there are also gaps in the FSA's regulation of investment activity. Although pension operators will generally have permission to carry on the regulated activity of managing investments, there are certain investments - such as cash, residential property and antiques - that are not covered by that permission. This means, for example, that a SIPP operator investing a client's contributions by purchasing a particular residential property is not regulated in respect of that investment, and the SIPP holder would have no statutory protection in the event of that investment going wrong.'

Impact on the Consultation

1.8 Those planning to respond to the consultation may wish to note the following. The regulation of pension investments was not the prime advantage associated with option 3, or indeed the main reason for the consultation. While the removal of tax privileges for SIPPs investing in certain assets will diminish the case for regulation, the rationale still exists. There remain good reasons why consumers would benefit from closer regulation of personal pensions after April 2007. In particular,

There would still be some existing unregulated investments – most notably commercial property – for which tax privileges would remain. There would be a wider range of persons able to provide personal pensions, creating a greater range of choice for consumers, and the measure would ensure proper regulatory supervision of these new providers.

1.9 References in the consultation to SIPPs being able to invest in residential property (and certain other assets) from April 2006 become largely redundant.[32]

3.2 The regulatory approach

In April 2006, the FSA published a consultation paper setting out its approach to take to the regulation of personal pension schemes including SIPPS from April 2007:

Actions the FSA will take to ensure consumer protection before regulation starts in April 2007 include:

- Encouraging all firms to adopt regulatory standards prior to formal regulation;
- Monitoring the way SIPPS are promoted;
- Liaising with trade bodies to encourage member firms to behave appropriately.[33]

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[32] HM Treasury, *Proposed changes to the eligibility rules for establishing a pension scheme: consultation update*, 5 December 2005

[33] FSA press release, FSA proposes regime for SIPP and other personal pensions, 4 April 2006

In October 2006, the FSA published its policy statement on how it would regulate all personal pensions including SIPPS from 6 April 2007.[34]

In October 2012, the Financial Services Authority (FSA) published the results of a thematic review of SIPPS. It found that SIPP operators had the "potential to lead to significant consumer detriment through a failure to adequately control their businesses":

> Poor firm compliance with regulatory requirements, particularly in the area of risk planning and mitigation, has significantly increased the risk posed by SIPP operators.
>
> In addition to generally poor systems and controls, the majority of SIPP operators we visited were unable to articulate accurately the application of CASS to their business structure. This led in some cases to a failure to protect clients' assets, adequately putting clients at risk of loss if a non-compliant SIPP operator were to fail.
>
> We also found inadequate controls over the investments held within some SIPPs.
>
> Together, these findings make it clear that SIPP operators have the potential to lead to significant consumer detriment through a failure to adequately control their businesses.[35]

Among other things, the review found evidence of "firms holding insufficient capital to absorb unexpected liabilities, risking the ongoing viability of the firm."[36] A case which the regulator cited as a "graphic illustration" of the reasons for its concerns, was that of the managing director of Montpelier Pension Administration Services Limited, who was banned from performing "any significant influence function at any regulated firm" on 18 April 2013.[37]

In April 2013, the FSA was replaced by two new regulatory bodies - the Financial Conduct Authority (FCA) and the Prudential Regulation Authority. The FCA is now responsible for the regulation of personal pensions, including SIPPS.

3.3 Proposal to increase capital requirements

On 22 November 2012, the FSA published proposals to strengthen capital standards for SIPP operators:

> The proposed regime reflects the growing popularity of SIPPs as a way to invest, the wide range of assets that can be placed within them, and will help protect consumers should the operator have to be wound down.
>
> The absolute minimum capital a SIPP operator must hold will increase from £5,000 to £20,000 because experience has shown the cost of winding down an operator is unlikely to be less than this amount.
>
> In addition to the minimum capital requirement, the FSA is proposing that an operator's total capital requirement should take into account two further key elements:
>
> the amount of assets under administration (AUA); and

[34] FSA 06/7, Financial Services Authority, The regulation of personal pension schemes including SIPPs: Feedback on CP06/5 and made text, September 2006

[35] FSA, SIPP thematic review findings and guidance, GC12/12, 23 October 2012

[36] FSA, Self-Invested Personal Pensions (SIPP) operators. A report on the findings of a thematic review, October 2012

[37] FCA bans and censures managing director of SIPP operator Montpelier Pension Administration Services Limited, 18 April 2013

an additional capital surcharge for operators that hold non standard asset types (i.e. assets that will take longer to deal with during a wind down).

Broadly speaking, the more assets an operator holds the more capital it will need - but this will only apply up to a point. While the FSA recognises that higher AUA also means greater potential risk for investors, it also offers an economy of scale in that SIPP operators can transfer some schemes (with the same assets) in bulk. See Figure 1 in the consultation paper for further explanation.
An additional capital surcharge will be applied where the operator holds non-standard assets (such as some Unregulated Collective Investment Schemes) because they will take longer to transfer in a wind-down situation. Non-standard assets can be identified by referring to a list of defined standard assets (see Notes to Editors 2).

Finally, the FSA is also proposing that core capital must be held in a form that is realisable within a year, while capital held against the surcharge must be realisable within 30 days.

David Geale, the FSA's head of investment policy, said:

> "While the SIPP market has grown substantially over time, the capital regime has not changed and needs bringing up to date. These proposals reflect the volume, range and complexity of assets now being put into SIPPs and – ultimately – will protect investors better in the unfortunate event an operator is wound down.
>
> "Put simply: the more assets you have under administration – the more capital you will need; and if some of those assets happen to be more risky you will need even more.
> "We believe these proposals are pragmatic and proportionate, but this is a consultation so we want to hear from the industry and consumer groups to ensure they are also balanced."

The FSA recognises that the proposals will require some operators to raise significant new capital, so there will be a transitional period of one year between the publication of final rules and implementation. The consultation closes on 22nd February 2013

Notes for editors

The consultation paper.

All assets that do not appear on the FSA's defined list of standard assets will be classed as non-standard. The list of standard assets includes:

- Cash
- Cash funds
- Corporate bonds
- Exchange traded commodities
- Government and local authority bonds and other fixed interest stocks
- Investment notes (structured products)
- Investment trusts
- Managed pension funds
- Open-ended investment companies
- Permanent interest bearing shares

- Real estate investment trusts
- Shares listed on: the Alternative Investment Market; the London Stock Exchange; and recognised overseas stock exchanges
- Unit trusts

> The FSA recently published new rules requiring SIPPs operators to provide Key Features Illustrations to consumers and show how charges impact upon a consumer's investment return.
>
> The FSA recently published the findings of a thematic review that looked at compliance of SIPP operators with FSA requirements.
>
> The FSA regulates the financial services industry and has four objectives under the Financial Services and Markets Act 2000: maintaining market confidence; securing the appropriate degree of protection for consumers; fighting financial crime; and contributing to the protection and enhancement of the stability of the UK financial system.
>
> The FSA will be replaced by the Financial Conduct Authority and Prudential Regulation Authority in 2013. The Financial Services Bill currently undergoing parliamentary scrutiny is expected to receive Royal Assent in late 2012 or early 2013, subject to the parliamentary timetable.[38]

The FSA expected to publish a policy statement on the issue, including final rules in the second half of 2013. It is proposing a "one-year transitional period between publishing the Policy Statement and the date on which the rules are implemented."[39]

A report in the *Financial Times* said:

> More than £88.6 billion is invested in SIPPS, but a substantial share of that money is in plans that are managed by larger institutions such as brokers or investment managers. The new capital proposals are aimed at the 75 independent operators and were prompted in part by the collapse of the Freedom SIPP, which was wound up for non-payment of taxes in 2009. [...] Consultation on the proposals will now take place and comes a month after an FSA review chastised the pensions industry for "generally poor systems and poor controls" – which in some cases led to a failure to protect client assets. The watchdog recently fined an executive at Montpelier Pension Admiistration Services for allowing the firm to operate with inadequate capital". [...]
>
> David Cox of SIPP provider Hargreaves Lansdown said the capital changes have come about "largely as a result of Sipp firms who were not used to operating in the regulated world, becoming regulated. He added: "Investors should always consider the financial strength and resilience of their pension provider – the return of an investment is more important than the return on an investment."[40]

In its response to the FSA consultation, the Association of Member-Directed Pension Schemes has argued that "assets under administration should not be used for calculating a

[3838] FSA press release, FSA publishes proposals to strengthen capital standards for SIPP operators, 22 November 2012

[39] FSA, CP 12/33, p5

[40] Brooke Masters, Lucy Warwick-Ching and Josephine Cumbo, 'New rules to protect Sipps investors', *Financial Times,* 23 November 2012

self invested personal pension operator's capital requirements as this would increase the risk of consumer harm." It has suggested two alternative models.[41]

4 Protected rights

Initially, it was not possible for a SIPP to hold "protected rights" (i.e. rights which arise in a money purchase pension scheme used to contract-out of the additional State Pension).[42] The intention was to protect people from the chance of a reduced State pension and a small protected rights fund arising from poor investment returns. However, the new regulatory regime introduced by the FSA in April 2007 was considered to have reduced the risks involved. Following consultation, the Labour Government introduced regulations – the *Personal and Occupational Pension Schemes (Amendment) Regulations 2008* (SI 2008 No. 1979) - permitting SIPPS to hold protected rights from October 2008. The Explanatory Memorandum said:

> 7.1 Individuals who contract out of (i.e. leave) the additional State Pension by taking out a private pension in its place, build up contracted-out rights. If the private pension is a money purchase arrangement (i.e. a personal pension, a stakeholder pension, or money purchase occupational pension) the contracted-out rights are known as protected rights. Any personal pension scheme holding protected rights must satisfy certain conditions set out in Regulations.
>
> 7.2 Currently, protected rights cannot be invested in a SIPP (a type of personal pension which allows individuals to be more involved in decisions about how their contributions are invested). Therefore, individuals have only the limited choice available from the pension provider's in-house funds. This restriction exists because protected rights are derived mainly from the National Insurance contribution rebate intended to replace the State pension foregone. The intention was to reduce the risk that can arise from self-investment so individuals had less chance of a reduced State pension and a small protected rights fund arising from poor investment return.
>
> 7.3 In April 2007, the Financial Services Authority (FSA) introduced their new regulatory regime. The new regime brings all personal pensions, including SIPPs, within their regulatory control. The changes brought consistent treatment and protection for consumers across all types of personal pension schemes.
>
> 7.4 Although allowing SIPPs to hold protected rights does carry some risks, they are mitigated to a large extent by the FSA's new regulatory regime. In light of this and in the spirit of deregulation, the Government decided that SIPPs should be allowed to hold protected rights.

The consultation documents preceding these regulations were:

Pensions: contracting out: self invested personal pensions and other changes: consultation on draft regulations: the Personal Pension Schemes (Appropriate Schemes) (Protected Rights) (Amendment) Regulations 2008; and

Pensions: contracting out - self invested personal pensions and other changes: government response to the consultation on the Personal Pension Schemes (Appropriate schemes) (Protected rights) (Amendment) Regulations 2008

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[41] Donia O'Loughlin, 'Sipps trade body slams plans to base capital needs on assets', *FT adviser,* 21 February 2013

[42] See SN 4822 Contracting out of the State Second Pension 23 March 2011