Child Trust Fund Consultation,
Pensions and Savings Team,
1 Horse Guard's Road,
London,
SW1A 2HQ

25 July 2013

Dear Lauren,

AFM Response to Child Trust Fund consultation

1. I am writing in response to this discussion paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

- Signify, as the sector that manages a majority of child trust funds, our continued commitment to supporting an effective market for child savings;
- Explore in detail the proposed approach in the consultation and explain why the proposals are inconsistent with the objective of an effective market for child savings.

2. The Association of Financial Mutuals (AFM) represents 53 member companies, most of which are owned by their customers. Between them, AFM members manage the savings, protection and healthcare needs of 20 million people, and have total funds under management of £100 billion. The nature of their ownership and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion.

3. When the previous government launched the Child Trust Fund, mutuals quickly dominated the provider market. This partly reflected the low value nature of the product, which meant the returns were not large or immediate enough to satisfy the expectations of shareholder owned organisations. But it also reflects the long-established

commitment to the sector of supporting saving for the family in general, and for children in particular.

4. Today more than 8 in 10 CTFs are held with a mutual, with friendly society members of AFM responsible for over a half of all CTFs. Thirteen AFM members managed CTFs before the product was curtailed; since then all have had to critically assess their strategy, and we have seen a number forced to merge- to ensure that policyholders continue to get optimum returns from an effective and solvent provider.

5. The key issue we are seeking to address in our response though is not protectionist- our key focus is on establishing what is best for the six million children that have a CTF, and how government and industry can best work together to create a savings culture that improves the prospects of young citizens to better manage their finances and achieve financial independence. We first wrote to Treasury on this issue in May 2011, and a copy of that correspondence, which highlighted why a vibrant CTF market remained the optimal position for most consumers and for providers, is included as an Annex to this paper.

6. Part of that challenge is that currently the Junior ISA market is still in its fledgling stage[1], and the product has proved a poor substitute for the CTF. This is perhaps to be expected, due to the removal of the government incentive. We recognise that the CTF voucher was an easy target for the new government which was sceptical about the social value of using child savings as an educational and welfare tool, and we also recognise that government departments continue to face tough scrutiny on spending, whilst at the same time economic theory favours consumption rather than saving at a time of low growth. But in contrast as welfare dependency shows no signs of falling away dramatically, a radical re-think is needed of how some sections of our community become less financially dependent, and begin to recognise the value in accumulating assets.

7. We therefore conclude that the key issues are broader than any administrative expedience in merging the CTF and Junior ISA. We would therefore be very keen to work with government to explore how people can be more effectively nudged into saving for their and their children's future. In this respect we propose that the government takes

[1] Based on the number of policies opened (based on 71,000 in the period 1 November 2011 to 5 April 2012, the annualized volume of 160,000 is just over one-fifth that for CTFs at their peak), and the lower take-up of the product amongst people looking to accumulate assets compared to those wealthy individuals seeking to shield more of the investments from tax. http://www.hmrc.gov.uk/statistics/isas/statistics.pdf

account of the following principles in determining future policy for child savings:

<u>Principles for future child savings strategy</u>

a. Government should ensure there is an effective strategy for encouraging young people and their parents to save for their financial future;
b. Future policy must centre on securing the best deal for all children;
c. Children and parents must continue to see active and effective choice and competition for their savings;
d. Providers of children's savings must not discriminate against people who can only afford to put aside a small amount for child savings;
e. Government must ensure it does not create unnecessary costs and uncertainty for providers where these fail to support the other principles.

8. As regards the specific points raised in the consultation, we have sought to achieve a consensus across our members on what is the optimum position for the majority of accountholders. In particular we have explored which of the three options AFM members favour from those that can be derived directly from the HM Treasury consultation; that is: do nothing; allow voluntary transfers; and merge CTF into Junior ISA.

9. We have seen different views from members, reflecting the nature of the different constitutions, markets and scale of their businesses, as well as the relative practicality of the proposals, and the specific features and dispensations within the CTF which vary significantly from the Junior ISA. However, as most of our CTF providers and some other AFM members also manage Junior ISAs, we can focus on the best interests of customers as well as the costs and benefits of transfers.

10. Our members with CTFs are concerned about the costs of change and the potential impact on their business and customers, and **our conclusion is that we would like to see government maintain the Child Trust Fund and Junior ISA as separate schemes**. We consider that where legislation is provided to migrate CTFs into adult ISAs at age 18, this will provide the most appropriate point of alignment.

11. We believe that given our prominence in the CTF market, this raises real concerns about the viability of the government's preferred route. We have explored this proposal, and addressed the specific questions below, and would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Responses to specific questions

Question 1: Do respondents believe that the transfer of funds from a CTF to a Junior ISA should be permitted?

No. Our over-riding consideration is whether children whose CTF was transferred to a Junior ISA would lose benefits or be disadvantaged if their account was transferred. Because the products are different in nature and form, there will certainly be some losers, and these would be most concentrated amongst the most vulnerable. This is because:

a) Benefits, such as those included within the stakeholder variant, would be lost, including the social welfare elements and Lifestyling.

b) Costs of providing the product would be increased as accounts would fall subject to MiFID.

c) The cap on charges would be removed, and a number of providers have already indicated that they will not be able to continue cross-subsidising low value accounts.

d) Accountholders could find themselves abandoned, as some CTF providers do not have ISA permissions, and many Junior ISA providers insist on higher minimum opening balances or regular premium levels.

e) In such circumstances there is an acute risk that some accountholders will be mis-sold where a system of voluntary transfers is permitted.

There is meanwhile no clear evidence that CTF accounts are the poor relation to the Junior ISA as the bullet points below illustrate:

- Charges (equity):
  - some of the non-stakeholder providers have begun to levy annual charges on CTFs, e.g. F&C now charge their 60,000 policyholders £30 a year
  - stakeholder accounts have maximum charge of 1.5%, so with average holding of £750 this means the average charge is around £10 per annum. CTF providers continued to offer new accounts when the government reduced the value of vouchers to £50, meaning that the provider was collecting charges of just 75p.

- Restricted choice- journalists describe a concern about money being trapped in accounts with low returns. There are 71 CTF providers listed on the HMRC website, which is a higher than for JISA. There is a range of specialist CTF products, designed to meet the needs of niche audiences, such as ethical or shariah-compliant investments.

- Returns of equity products: equity based CTFs and Junior ISAs tend to invest in the same underlying funds, so not surprisingly the gross returns are broadly similar.

- Interest rates on cash savings: up to 3.25% is possible for a Junior ISA (as at 22 July), though rates for both products are low and subject to short-term competitive changes- in June we found a CTF rate higher than the best Junior ISA.

- The Child Trust Fund market remains stable and there is little evidence that consumers seek change or complain about poor returns or unfair conditions.

- As is illustrated in the box below, the CTF remains a significant product in its own right.

CTFs today

There are 6.1 million CTFs, investing in total £4.9 billion. Over a third of policies are held by low-income families. The table below picks out some data about the market today:

	Stakeholder	Non-stakeholder (equity)	Non-stakeholder (cash)
Number of policies (million)	4.84 (79%)	0.26 (4%)	1.04 (16%)
… of which, to low income households (million)	1.85 (83%)	0.05 (2%)	0.33 (15%)
… of which, to low income households and were revenue allocated (million)	0.9	0	0
Accounts with additional contributions	0.96 (20%)	0.1 (38%)	0.23 (22%)
Total invested, to 31.12.12 (£Ms)	3,665 (75%)	391 (8%)	837 (17%)
Average holding (£s)	757	1503	805
Change in value since 31.12.11	+ 13%	+ 12%	+ 12%

Source: HMRC website

Only 2% of revenue allocated accounts have made additional contributions, and this falls to 1% for those that were revenue allocation and from low-income families.

This tends to suggest that the stakeholder group- where AFM member holdings are most concentrated- in general exhibits different behaviours, in particular amongst the most vulnerable (where the child is from a low income household and the parent did not execute the purchase).

So a more appropriate question for Treasury to ask is*: is there any reason to change?* It is not clear, from the consultation paper, or considering the evidence we present above, what the over-riding objective is of allowing transfers, or whether the benefits that result outweigh the costs and loss of critical features.

We could see some merit in allowing cash CTFs and non-stakeholder CTFs to transfer to Junior ISAs, as there are fewer differences between these and the equivalent Junior ISA. However these only make up one-fifth of all CTFs, and we do not consider a fragmented approach will benefit consumers.

Amongst the stakeholder CTF accountholders, the situation is less clear-cut, as we explored above, with the risk that many consumers would be disadvantaged by transferring. For this reason, we reject the proposal to allow transfers between CTF and Junior ISAs, and we believe that if there are any valid concerns about the performance of the CTF market, the government has the powers to address them. For example, HMRC can remove Revenue Allocated Accounts from a CTF provider if it believes their performance is poor. Equally the government might do more to promote features of the product, such as the ability to transfer and lifestyling, at the same time as finalising legislation for age 18.

Question 2: Would allowing CTF funds to be transferred to Junior ISA have any significant impact upon the viability of the wider CTF market, including on the availability of suitable products for children whose funds remain with CTF?

Yes- a detrimental impact.

Clearly the viability of some providers is put at risk where they witness losses of accounts and income. This is particularly the case where the focus for transfers will be on higher value accounts- as these meet the marketing profile of many Junior ISA only providers, and offer an attractive return for intermediaries and platforms. Currently higher value CTFs effectively cross-subsidise lower value accounts, so if these are lost to the CTF provider the per policy cost on remaining accounts will increase significantly.

We have already seen some consolidation in the sector as a result of the demise of the CTF; we believe a significant market for CTF transfers is likely to lead to further contraction of the friendly society market, and a reduction in choice for consumers. This is of course inconsistent with the coalition agreement commitment to 'promote diversity and strengthen mutuals'.

However, where a friendly society book of business is unprofitable as a result of transfers of more high value CTFs, there is likely to be little or no appetite from other providers to take on a book of CTFs. There is as a result a real risk of lack of continuity of provision for some consumers. Similarly there is a risk that returns suffer for those who cannot transfer, particularly in non-stakeholder (equity or cash) CTFs where it is easier either to impose new charges, or reduce interest rates.

As the evidence in the box above demonstrates, a significant number of CTFs were opened on a Revenue Allocated basis, and where there remains little or no take up by the parent or guardian. We see no evidence that in these cases the account will become active or the parent engaged.

Question 3: Would the proposed approach outlined above under 'voluntary transfers' provide a workable basis to allow the transfer of funds from CTF to Junior ISA?

No. Our greatest concern is that the registered contact is encouraged or advised to transfer to a Junior ISA, and that as a result the child loses valuable benefits.

As Junior ISAs are regulated under MiFID (which CTFs are not) the process to transfer between the two will increase the administrative cost of managing the account, and regardless of whether the transfer is advised or not, proposed rules for IMD2 should require the customer to undertake an appropriateness test, to show that they understand the consequences and loss of protections that result from a transfer. As very few consumers currently complain about their inability to transfer this process can only serve to create greater uncertainty.

Question 4: What would be the impact of the proposed approach, including one-off or ongoing costs and benefits for accountholders and providers?

We consider the costs will be significantly greater than the benefits. We have set out some of the costs and benefits in the table, and elaborate some of these further below.

	Accountholders	Providers
Costs	• possible loss of benefits • transfer/ advice costs • possible higher charges • lower valuable accounts squeezed out	• new system developments • transfer costs • additional MiFID related costs • loss of income from lost accounts
Benefits	• access to new providers, • lower costs for some • can stay with CTF if it has superior benefits	• single market for child savings • cheaper sources of new business for non-CTF providers

At present the number of transfer of CTFs is very low. For this reason firms have not invested in automated systems. Our members estimate that the average time taken to undertake a manual transfer is 45 minutes. If there is a spike of transfer activity shortly after any legislation to allow voluntary transfers is passed, CTF providers will need to take on extra staff to meet reasonable transfer times, and to ensure service standards in other parts of the business are maintained. Larger CTF providers will seek to offset this manual work by investing in new automated systems. We assess the average cost per transfer to CTF providers as £30.

CTF providers that also have a Junior ISA will also experience similar costs on internal transfers, covering the internal administration, customer communication and additional requirements of MiFID. In most cases the customer will remain in the same fund, and see no benefit.

The costs of transfer will be borne by the CTF provider, who will either have to find some mechanism for sharing the costs across the remaining customer base, or where charges are capped, by reducing service levels to the remaining customers.

The provider will also suffer a loss of income. This is exacerbated where transfers are disproportionately from the most valuable accounts. So even a 3% reduction in the number of accounts could result in a loss of income of as much as 10%. This loss of income is in addition to the severe adjustment that CTF providers suffered to their business plans when the CTF was axed.

Inevitably this will mean the equal status that the two products currently have will dissolve. Policies remaining in the CTF could become a proxy, similar to free school meals, for poverty and/ or neglect.

Taking these points, we provide an assessment of some of the costs:

- If only 3% of CTFs are transferred in the first few weeks, at £30 a time, this equates to £ 5.4 M initial costs.

- If 10% of balances are transferred, this equates to loss of annual income (assuming 1.5% charge) of £7.2 M (some of this will be saved where internal transfers are possible).

- If extra MiFID requirements are imposed for transferred accounts, the additional mailing cost of £5 per account will increase ongoing costs by £1 M per annum, and similar costs will be incurred in changing computer systems and mailing new terms and conditions (for example in lifestyling, age 16 requirements and changing anniversary dates).

- CTF providers will see changes to their capital costs in addition, due to the new risks to the stability of their business.

These figures are not insignificant, particularly for smaller providers, and represent around 20% of the income expected to providers each year. Clearly if transfer rates are higher this burden becomes greater, and can only result in higher charges to customers and/ or poorer service. In other words, the problem some Junior ISA providers and journalists ascribe to CTF- of which there is no clear evidence now- become more much likely should the government pursue its preferred route.

We do not believe the current impact assessment reflects these costs and risks, nor is it clear that given the extra costs that providers will pass onto accountholders, that the presumed benefits are of a similar value, or that they are likely to materialise for the vast majority of consumers.

Question 5: If the Government proceeds with changes to the current rules on transferability, do respondents agree that its proposal to allow the transfer of funds on a voluntary basis is the best course of action?

No- this is bad for consumers who will suffer extra costs for no apparent benefits, and bad for providers of CTFs.

Question 6: Are there any circumstances under which a merger of CTF into Junior ISA would be preferable?

No- given our views above, we are concerned that more of the costs outlined above will be incurred in facilitating a merger, for no apparent benefit.

History of the CTF indicates that firms should be wary about assuming any Treasury policy decision has an unlimited timespan, and so we have assumed that whilst the current preference is for voluntary transfers this may change in the future. For example, the government might decide to undertake a move to full merger at a later time for a number of reasons, including:

- if some providers obstruct an effective transfer market,
- if some consumers find they are unable to elicit a transfer,
- should a number of CTF providers collapse,
- conversely if the volume of voluntary transfers is very high, or
- a new government savings policy or product is introduced.

The prospect of this uncertainty in the future stresses the need for caution, as well as the risks inherent in any move from the current position.

Compared to voluntary transfers and future political uncertainty, it could be argued that a full merger might give the government and industry more confidence in promoting the child savings market than is currently the case. As we indicate in our opening comments, the lack of promotion of child savings has contributed to the sharp decline in savings since the demise of the CTF.

Treasury might also consider that moving to a full merger:

- would remove the risk of individual's being mis-sold a transfer; and
- HMRC would also be able to divert attention and staff from maintaining the CTF regime more quickly.

However, for many CTF providers, a full merger would significantly increase costs, and accelerate many of the concerns we outline above.

Question 7: Do respondents agree with the approach to legislate to allow voluntary transfers in the first instance, but also to provide scope for further intervention at a later date, should this prove necessary as a result of developments in the CTF market?

See answer above. We suggest this will increase instability in the market, but also lead to further complications if there is a change in savings policy after the next general election.

Annex

Madeline Graham
HM Treasury
1 Horse Guards Road,
London
SW1A 2HQ

27 May 2011

Dear Madeline

CHILD TRUST FUNDS

During discussions earlier this year, industry asked that the issue of what happens to existing Child Trust Fund accounts (CTF) was parked- firms need the time between now and November to focus on launching the new Junior ISA.

Since then there has been new speculation, including a campaign in the Daily Mail, encouraging the transfer of funds from the CTF to the Junior ISA. We are concerned that this important issue is given proper and balanced treatment before any decision is made, to avoid the risk that an ill-informed campaign prompts early action that may be to the detriment of many CTF holders. Treasury has committed to a consultation on this in the second half of 2012, when the remaining CTF vouchers will have been allocated.

With that in mind and in the interests of balance we briefly highlight a series of reasons, form the perspective of consumers and providers, why we believe it would be better to retain the CTF:

Consumers

1. The fundamental purpose of opening and contributing to a CTF was to accumulate a fund over the long-term; the vast majority of existing ISAs are held by people who seek to reduce the tax they pay on previously accumulated wealth;
2. CTF has a recognised social welfare element, that has earned it special dispensation that ISAs do not have; so customers could be worse off if forced to transfer to the Junior ISA: this includes stakeholder aspects, but also MiFID rules which will prevent some CTF holders from having a JISA;
3. Many CTF providers do not have ISA permissions, so a very large number of consumers would be forced to transfer supplier- many consumers would be unwilling or unable to do this;
4. Transfer from CTF to Junior ISA would restrict age 16 options without compensating changes to the legislation;
5. The underlying funds in a CTF and JISA are likely to be the same
6. It is not clear how children in care would be affected by a transfer;
7. For revenue-allocated accounts (RAA), vouchers will remain in the system for a time;
8. The majority of equity-based CTFs are not topped up, and the balance available to transfer would be below the minimum many provider will accept;

9. The majority of people saving into CTF's are paying in £10 per month: this is less than the minimum premium many providers will be prepared to accept into Junior ISAs;
10. Customers with a stakeholder CTF have considerable benefits not available under JISA which they might unwittingly lose by moving across to a JISA: this includes life styling, a charge cap and the ability to pay in low sums of just £10.

Providers

11. Investment into the CTF assumed that the product would run for a long-period and would only make a satisfactory return after many years;
12. CTF providers have a commercial interest in fund performance and fund growth on the CTF's they manage: there is no reason why a firm would want or benefit from mediocre performance;
13. The Daily Mail has reported (as a negative) that the rates available within cash CTF's were 1% to 2%. We undertook a quick trawl of the cash rates available on standard children's savings accounts from five of the main brands (Nationwide, Halifax, Santander, Britannia and Barclays); the average rate on those accounts was only 0.54%;
14. Some of the firms that have been most publicly arguing for a switch from CTF to Junior ISA do not have a CTF book, and their view might therefore be biased by commercial interests;
15. There is an active market for switching on CTF's and a range of funds from different providers to choose from. This is very different from less recent legacy products (such as mortgage endowments), and the comparison with PEPs and TESSAs is meaningless because of the nature of the product;
16. A number of CTF providers are small firms with a concentration on this product and would be vulnerable to a) the costs associated with converting accounts and communicating to customers, b) managing low value CTF's, such as £50 accounts, under an ISA regime requiring two statements, and c) losing higher value accounts 'cherry picked' by new entrants into JISA. Any or all factors which could lead to a destabilisation of certain firms, and this has been previously recognised by the Government when it granted the recent concessions around not needing to send every CTF customer an annual statement.

The theme of some of the concerns expressed is that providers will levy increasing charges and provide worsening performance through a reduced range of fund options. AFM and its members would be very happy to benchmark and self-regulate these aspects of the CTF amongst our members, and to work with other providers. That said, Treasury has the power, and has used it, to facilitate transfers of accounts held in care by the Government.

We hope that these notes are useful and provide some balance to this issue. Whilst many AFM members are focusing heavily on getting their systems ready for the Junior ISA on time for launch, we would be happy to meet to discuss this issue further.

Yours sincerely

Martin Shaw
Chief Executive
Association of Financial Mutuals