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Provident Money

Your independent window on financial issues **Summer 2004**

Mortgages; to fix or not to fix

With interest rates rising over the past few months, it is difficult to comment on individual mortgage deals too far in advance. However, many people thinking of moving home, or re-mortgaging, face a number of choices and a 'snapshot' taken in mid summer might help.

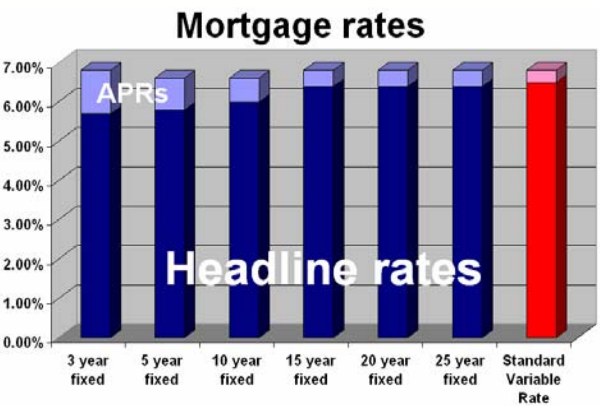
There is considerable appeal in looking at fixed rate mortgages, not least of which is that they offer certainty over the level of outgoings for an agreed period. This can be as little as two or three years, or as long as the entire term of the mortgage.

Conversely, many fixed rate deals—like other non-standard mortgages—can include penalties that can last longer than the fixed, discounted or 'special offer' period.

More importantly, to many people, tying yourself in to a fixed rate could mean that you end up paying more than necessary, later on, should mortgage interest rates generally fall below the level at which your rate is fixed. It is here that the existence of a tie-in can be critical.

What's more, at the end of the fixed rate period, you will usually find that you are tied in to the then current Standard Variable Rate; which may or may not be competitive.

Looking at a range of mortgages on offer from just one society, it is possible to see that headline rates range from 5.69% for a three year fix, to 6.39% for a 25 year fix. This might be taken to indicate that the lender does not expect interest rates to rise significantly in future—otherwise they could find themselves charging far too little in later years.



Source: Leeds and Holbeck Building Society July 2004

On the other hand, all lenders operate in a competitive environment and it could be considered that they are prepared to offer lower long term interest rates than might be indicated by the expectation of future rises in general interest rates, simply in order to retain market share, today.

Buying your home is the largest single investment you may ever make

Similarly, provided sufficient profits can be made in the early years of a loan, making a modest loss later on could be sustainable.

It is important to look beyond the headline rate, to see what the typical APR rate is, as this is the only fair basis for comparison. As the above chart shows, deals with varying headline rates can often have similar APRs.

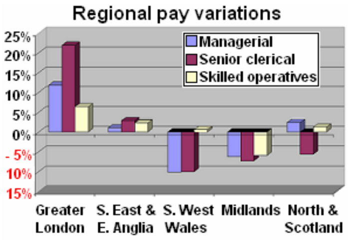
Selecting the right mortgage deal for you, whether it is a fixed rate, tracker, capped, variable or one of the new 'offset' mortgages, it is important to ensure that you are fully aware of any terms that apply. Taking a view on future interest rate movements becomes slightly less daunting, if there are no major tie-ins that prevent you from switching to a more beneficial basis of borrowing later, should interest rates move significantly against you. Most importantly, taking independent financial advice is essential, if you are to come to the right decision.

How much life cover?

Investing for the future to cover education costs, holidays and provide for a comfortable retirement are all very important. Failure to adequately protect the family against the death of, or long-term incapacity of, a breadwinner can have devastating results.

Protecting the family; how much is enough?

Recent research undertaken on behalf of the *Daily Telegraph* gives details of average earnings, throughout the UK, for people in different types of employment. What is most revealing is the dramatic margin by which some incomes vary from the average. For example: in Greater London, clerical staff earn a fifth above the national average, while in the South West and Wales, both management and clerical staff earn ten percent less than the average.



Source: Daily Telegraph - Cronor Reward Index - 11/03

The smallest deviation from the average is in the South East and Anglia, where most earn within 3% of the UK average.

The importance of this becomes clear when considering what level of life assurance is appropriate to each individual because, at the most basic level, many people consider that ten times income is the minimum for which a life should be insured.

This is not unreasonable, as a starting point. After all, a senior manager earning, on average, £49,000 can be expected not only to wish to provide for his family in the event of his death, but also to ensure his mortgage is redeemed. On the assumption that the typical mortgage might be between two and three times' earnings, it is likely he will require at least £100,000 to £150,000 to clear the mortgage. A lump sum death benefit of say, £350,000 in excess of this – together with a two times' salary death benefit – could be invested to produce an income of perhaps, £15,000 a year which, when added to a possible widows' pension of say, £22,000 (based on a scheme offering widows two-thirds of their husband's expected pension for death-in-service) could go a long way towards making up the loss in family income.

Where earnings are considerably higher, as in London, house prices also tend to be greater and the rule of thumb may hold true.

Serious injury can be financially devastating

As far as income protection is concerned, a lump sum payable on the diagnosis of a critical illness can be helpful, but other forms of health insurance can be more flexible and cover incapacity following injury and most forms of illness, rather than just "dread diseases". The impact of Statutory Sick Pay can also be taken into account, although this is modest – at about £65 per week for employees – and operates only for a short period, after which incapacity benefits operate. The self-employed fare even less well.

As a general rule, an income of about two-thirds of earnings is a useful starting point and – once again – the regional income variations tend to favour those in the Midlands and West, who have lower incomes and can thus afford to purchase lower levels of cover.

It is important to remember these figures are only a "rule of thumb".

In order to assess the actual level required for each individual, a number of other factors should be taken into account, such as alternative sources of income and additional liabilities, like credit card balances, personal loans and so on.

Key points:

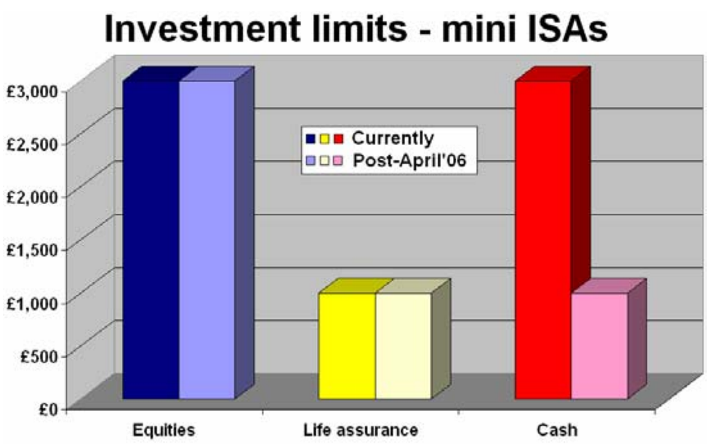
- Assessing levels of life insurance needed to protect your family requires care.
- A useful starting point can be earnings, which show strong regional variations.
- It is also important to think about protecting income in the event of serious illness or injury.
- Taking professional advice is essential.

Is there a future for ISAs?

For five years, ISAs have been an investment of choice for many people, but several changes on the horizon will make this a more difficult decision in future.

From last April, the 10% tax credit reclaim available in respect of dividends received by ISAs from UK companies disappeared. This will reduce the net return available to investors and, some argue, reduces the attraction of this form of investment to anyone other than higher rate tax payers, and those basic rate taxpayers who already make use of their £7,900 a year Capital Gains Tax free allowance. In essence the playing field has been re-leveled, compared with pension funds, which lost the ability to reclaim tax on 'franked' investment income some years ago.

What's more the maximum limit that can be invested in ISAs is set to be reduced in April 2006, from its current level of £7,000 to just £5,000. This date coincides with the introduction of the new 'simplified' pension regime, which will allow many people to make much larger contributions than previously.

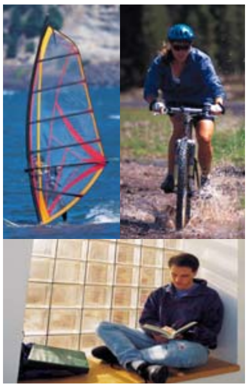


Within the new lower limit, the cash component of a maxi ISA, or the investment into a Mini-Cash ISA, is reduced to £1,000, from £3,000. This could have the effect of forcing more people into the more volatile equity sector, or using the life assurance option.

For those who wish to maximise their ISA investments, it will therefore be a good idea to ensure that they use up their limits for the current tax year and also 2005/6 – a potential maximum for a couple of £28,000, over the period.

And just to complete the picture, the last TESSAs (Tax Exempt Special Savings Accounts) reached maturity by April 2004. Those wishing to convert the proceeds into a TESSA only ISA must do so within six months of maturity—i.e. up to October this year.

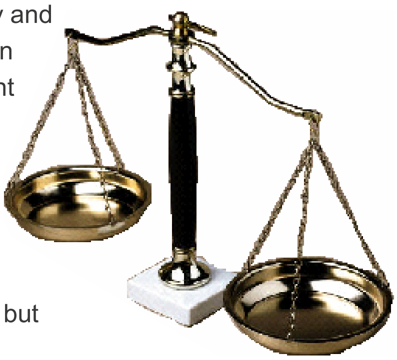
For many people, these changes could create the opportunity to re-think their investment strategy and (to borrow a phrase) get back to basics. After all, we invest in order to provide ourselves and our families with a more secure and enjoyable financial future. But nobody has one single investment aim; instead, we all have a number of different – and often conflicting – sets of requirements.



We invest for many reasons, to pay for holidays and children's education

For example, we may require some money for identifiable short term needs, such as annual holidays and household goods, as well as medium term requirements including a replacement car, school fees or university education costs. But for many of us, it is the longer term – retirement and old age – that demands our keenest attention. As a result, we might feel tempted to look at a long term investment strategy without considering the need for short to medium term access to capital.

But this can be a high risk strategy. In most cases, we should be looking at an investment programme that gives us easy access to money at different times and adopting asset allocations that fit in with the flexibility we require. Only then should we move on to consider our attitude towards different types of risk – underperformance, volatility and so on – in order to decide on the actual type of investment we require to meet each 'time related' need.



Successful investment is about balancing risk with reward

Tax efficiency might well be an important aspect, when selecting the actual investments to be adopted, but charges and performance are also critical. After all, any tax saving on income and even growth can be outweighed by high charges, or poor performance.

The decision many investors will now face is whether they feel equities are a good investment class now – and over the longer term – and whether they need to adopt a more diverse approach to future asset management.

You should always take independent professional advice before making any investment decision, as the value of investments can go down as well as up and is not guaranteed.

Key points:

- The amount that can be invested in an ISA will be reduced in 2006.
- The tax reclaim on franked investment income has already disappeared.
- Always consider the balance between risk and the reward available.
- Take professional advice.

Money laundering regulations

It can be irksome to be asked to prove who you are, when making an investment, but there are good reasons why the government insists on this as part of its fight against organised crime and terrorism.

Money laundering is broadly defined as converting or facilitating the conversion of criminal property—that is property partly or wholly derived from crime.

Crime and terrorism make proving identity important

Legislation that came into effect last March broadly extends the number of people to whom the regulations apply to include accountants and auditors, tax advisers, estate agents, legal advisers and other professionals, as well as dealers in 'high value goods'. The rules require anyone in the 'regulated sector' to have procedures in place to detect and report money laundering or even anything that could be deemed to be money laundering.

Having to confirm your identity to a 'new' professional adviser of any sort might appear intrusive and unnecessary, but they have no choice and both your identity and current address must be established from documents such as passports and recent utility bills.

Anyone identifying an act that might constitute money laundering is obliged to report this to their MLNO, who will decide if the National Criminal Intelligence Service needs to be notified.

Interestingly, the definition of a criminal offence could, technically, include writing off an overpayment, or evading (as opposed to avoiding) tax. Either of these actions could give rise to a report being made.

Key points:

- If you make an investment, or even take out life assurance, you could be asked to prove your identity.
- Many people running businesses that involve handling large amounts of cash can become involved in the 'money laundering' regime.
- Even minor infringements of regulations could bring about the need for an accountant or other adviser to make a report.

Family pension trusts

The new pension regime that comes into effect in April 2006 has thrown up some interesting and unexpected opportunities.

While those between the ages of 50 and 75 can currently draw an income directly from their pension fund, the rules insist that once you reach 75, you must buy an annuity. This means that your family can no longer access any surplus, when you eventually die.

However, the new regime includes the facility to take an "Alternatively Secured Income" from age 75 that is similar to drawdown for younger people, but includes the option to transfer any unused funds, on death to the pension fund of another person, with the same scheme administrator.

Death need no longer mean the end of pension planning

This effectively means that family pensions can be set up that will allow money to pass down the generations, free of tax. We will provide more information, as and when it becomes available.

Back page briefing

Every so often we come across an "investment opportunity" that might better be filed under "S" for scam. Many of these come through the Internet and we look at some of the most prolific in circulation, today.

Are you the lucky recipient of an e-mail from the Lottery Coordinator at the International Promotions/Prize Award department of Protea Games South Africa announcing that you have "emerged a winner under our Third Category Draws, which is part of our promotional draws …" and "… have therefore been awarded a lump sum pay out of US$2,500,000 in cash, which is the winning payout for Third Category winners"? This is apparently part of a total prize pot of US$12,500,000 shared between 5 international winners in this category. All you have to do is contact "your" claims agent immediately, to begin the claims process, supplying your bank account details at the same time.

Interestingly, "any breach of confidentiality on the part of the winners will result to (sic) disqualification." In other words, please don't tell anyone. Now why might that be, one wonders? Could it possibly be that, unlike the National Lottery, which craves to create maximum impact (for its good causes), this body is so charitable that it wishes to do its good works away from the glare of publicity? Or might it be that this is yet another scam, seeking to obtain bank details so that it can build a spurious relationship, leading to the emptying of honest peoples' coffers.

We don't really know is the answer, but few of us would, on reflection, be willing to find out, either. The old adage that "if a deal looks too good to be true, then it probably is" has much good sense in it; there is no such thing in life as a free lunch.

This brings us to the latest crop of scams; sorry, offers.

Best known of these is that originating from Nigeria, which offers a percentage of a massive "hidden cache" of money, if you are prepared to allow it to be passed through your bank account, breaking a large number of laws including currency dealing regulations in several countries. This one is fairly well known and easy to spot (since starting to write the article, the author has been offered a 30% share in US$30 million; so there is plenty of money about!).

More worrying is the so called "Phishing" expeditions undertaken by criminals who can replicate very convincing looking Bank websites and then e-mail you asking you to log on with your personal information, so that you can update it. Of course, it is a bit of a give-away, when you don't have an account with the bank concerned, but that does not worry the originators of the scam, they only need a few people to give their bank details, in order to empty the account and even run up debts for the account holders.

A variation of this has also been the e-mail purportedly from eBay, asking the reader to

"update" his or her Credit / Debit card details, and threatening to bar future transactions if you fail to follow a link and re-input the data. Again, never having dealt with eBay is a bit of a give-away.

Some other deals are more difficult to spot, including tips on "hot" penny shares, where current investors try to talk up the price, so that they can off-load their holding – before they finally collapse. Another to watch out for is cheap software, where you buy on line – giving your Credit / Debit card details, of course – and then find that nothing ever arrives, other than a multitude of unexplained items on your account.

The key point is that only investments offered by companies and individual registered and regulated in the UK – like Independent Financial Advisers – are covered by the Financial Services Compensation Scheme. Any investment offered by a non-regulated person is illegal and exposes you to risk of loss, without compensation.

It is important to seek independent financial advice before making any decision regarding your family finance, because the value of investments is not guaranteed but will fluctuate and tax rules can change.