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## Could young people benefit by borrowing money to invest in a pension?

It is usually considered by IFAs to be better for people to pay off existing debts before starting long-term savings.

For younger savers, this is relevant advice as many have student debts, or are finding it difficult to get on the housing ladder. Also, it is generally thought that as younger savers, they can make up any retirement savings in later years.

This concept has been reinforced by the A-Day changes to contribution rates, as it is now possible to contribute up to £225,000 a year to a

pension.

The effect of compound growth on investments is well known and below is an example to illustrate the idea. If a fresh university graduate borrowed up to one year's salary, for example £20,000, this would gross up to £25,641 with the tax incentives. If this grew at 6% per annum, it would grow to be just over £314,000 by age 65.

To qualify this, you reduce the figure for inflation. The investment could be worth around £108,000 in today's terms.

With a guaranteed loan

over 20 years at the best rates currently available, you would pay back £26,059 at £217.16 a month.

Consider that a large number of people pay similar sums or more every month later on in life to try to catch up on the contributions they have missed, this approach starts to make sense.

The only issue is affordability; you have to be able to make repayments. Also, it has been cautioned that many people struggle when juggling  
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*Careful planning can minimise the eventual costs such as a sizeable tax bill liable for beneficiaries*

## Discretionary trust are a finer part of IHT planning

As house prices in the UK, especially in the South-East continuing to rise above the nil-rate band of £285,000, inheritance tax is a growing issue for many of us. Careful planning can minimise the eventual costs such as a sizeable tax bill liable for beneficiaries of even the most ordinary homeowner on their death.

Good tax planning has always included life insurance as a major part of it. Whole-of-life plans can deliver the appropriate sum of money to meet an IHT liability and, provided the policy is written in trust, it will fall outside the deceased's estate and any tax liability.

It is often an affordable way of achieving the aim and writing a policy in trust (typically joint lives, last survivor) means waiting on probate for the insurer to pay out is not needed. Just a death certificate, proof of ownership, and the signature of the trustees are needed. The bare trust is a useful tool for this.

Guaranteed insurability options are included in some products, allowing cover to be increased without underwriting on certain events, such as an increase in an IHT liability. Providers serious about serving this market sector will use experienced underwriters who understand the issues in

dealing with higher sums assured and older lives.

New whole-of-life policy sales in 2005, were down by 6.5% on the previous year. The majority of sales were guaranteed acceptances, usually sold to consumers on a direct-offer basis, normally to cover funeral expenses.

Halifax Financial Services predict that the value of housing assets inherited each year will more than double from £14bn in 2003, to £32bn (in today's money) in 15 years time.

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## Could young people benefit by borrowing money to invest in a pension? (cont.)

money between different obligations.

A lot of people struggle when they don't equate the relationship between the different rates of interest or rates of return of different products. They could be getting a rate of X on their savings, but paying X+1 on your borrowing, and this is sometimes catching people out. Taking on this amount of debt is not practical for many people.

Also, the rising house prices have made property purchase a priority and so people in their early 20's are considering or are already have high levels of

debt.

Borrowing to fund investments, or gearing is a high-risk investment strategy, and with people talking on increasing levels of personal debt, this additional burden could prove too much for savers. If it comes down to personal bankruptcy, any pension contributions paid for out of personal borrowing can be clawed back on a court's direction.

Overall, this is an interesting planning abstraction but its unlikely to be of great interest to many people. The situation also depends on market condi-

tions remaining favourable. If all works well, and if you have low interest rates and the market performs well, then it's a good idea. However if we could guarantee the market returns, we'd all be doing it.

It's possible for this investment to work even if the pension is invested in gilts but the returns are incomparable. They are nowhere as impressive. With gilt rates at 4.5%, you could expect to get around £59,000, which may almost be twice what it would cost to borrow that money.

It comes down to how many people are suitable for this

investment. If you know what you are doing, and can afford to lose some, or even all of the investment, then it's OK. However, if you cannot afford it, then most IFAs will be unwilling to advise cautious to take this route.

For those lucky enough to be able to afford it, or even aggressive investors, bank loan rates are currently low enough for this strategy to pay off handsome dividends, for anyone who gets it right that is.

## Discretionary trusts are finer part of IHT planning (cont.)

However this years Budget proposals caused confusion by recategorising certain trusts as discretionary. What trust should be used?

Discretionary trusts and interest in possession trusts are the two main trusts used to offer flexibility (leaving aside accumulation and maintenance trusts).

*Discretionary trusts* – No beneficiaries are entitled to a current right to income and the trustees can choose who they pay the benefits to.



*Interest in possession trusts* – Specify beneficiaries who have the current right to income but also usually give the trustees or settlor power to assign benefits to others from a usually smaller class.

The Chancellor's projected recategorisation of interest in possession trusts as discretionary trusts for IHT purposes has caused a considerable slowdown in IHT planning. Subject to a few exceptions, all new trusts other than bare trust come under the discretionary trust rules from 22<sup>nd</sup> March.

The new rules could run to impose a 20% tax liability on assets which are made subject to a discretionary trust if the nil-rate band is exceeded. After every 10 years the trust is revalued and up to a further 6% tax charge could be levied. A further charge on any distri-

bution from the fund could also be a possibility.

It is expected that no liability will arise for many life policy policies. In a majority of cases, the premiums and the policy value at 10-year anniversaries may be low or non-existent.

*We will have to inform ourselves on how the charging rules apply for discretionary trusts.*

A feasible alternative to discretionary trusts is the bare trusts. Beneficiaries cannot be changed but bare trusts are not subject to any entry, periodic or exit charges. Many may now reassess the value of flexibility against the possible tax cost.

Policies subject to flexible trusts created before 22<sup>nd</sup> March 2006, can continue to be treated under the old rules provided they remain unchanged. Apart from maintaining premiums, they cannot be added to, nor the beneficiaries changed after 5<sup>th</sup> April 2008.

There are often clients who require more intense underwriting and higher sums assured.

An insurer which understands the issues and offers a level of service, underwriting and support this sector deserves often makes a complex, time consuming area of financial planning easier.

## Is ignorance getting in the way of a mortgage?

Many potential homebuyers do not know what deposit they need or how much they can borrow. This suggests that there is a vast, untapped market for mortgage lenders.

A great percentage of prospective homebuyers are currently unaware of their eligibility for a mortgage, the cost of borrowing, requirements for a deposit and the fact that 100% home loans are available to them.

According to research, many would-be homebuyers think a minimum deposit of 10% is required for a mortgage, and that the maximum loan is three times salary.

Figures suggest that there may be a misinformed and untapped market for mortgage lenders in the UK.

Consumers are not aware of how the mortgage market has changed in recent years, as well as the extent and range of mortgage products available to them. So there may be millions of people across the UK who are under the impression that they cannot afford to buy their own homes when, in fact, it is possible.

Most first-time buyers will not be aware that you can currently borrow up to five-times salary. Parents are likely to have given them this impression, as they may not have taken out a new mortgage in recent years, and so may still think in terms of a maximum of three-times salary.

First-time buyers are inexperienced with the market and tend to pick up information from their parents. However, the market is now

hugely different from when parents borrowed, and so first-time buyers are ill informed.

Some intermediaries prefer writing a few larger loans rather than a number of small ones, so first-time buyers are not as well served by the broker community, as they ought to be.

The mortgage broking community needs to do more to highlight the benefits of independent advice and help to educate first-time buyers. However, the whole intermediary industry is underfunded in terms of its trade associations. The market is still incredibly fragmented and self-centred.

*..there may be millions of people across the UK who are under the impression that they cannot afford to buy their own homes when, in fact, it is possible.*

Affordability for first-time buyers is at its worst level since 1992. At that time, the mortgage rate stood at 10.95% and borrowing £100,000 would cost £912 a month in interest charges alone – compared with about £400 a month today. However, the homebuyer who borrowed £100,000 in 1992 would most likely need to borrow £200,000 today to purchase the same property.

The cost of becoming a homebuyer and the ongoing cost of housing are the worst for more than twenty years and will worsen. The

Royal Institution of Chartered Surveyors (RICS) predicts that house prices will rise by 10% in the next two years, putting further pressure on buyers. RICS says homeowners are struggling to service mortgages.

A two-person household on average incomes would have to spend 22% of their take-home pay to service their mortgage, which is a significant increase from the low rate of 14.1% in 1996.

People will continue to find it difficult to access the housing market unless home building levels improve and keep pace with population growth and rising income and wealth.

Lenders must also continue to offer generous funding levels and the government should promote a large increase in the housing stock.

Lenders have already adjusted their income multiples and in many cases have moved to affordability models that often produces larger maximum borrowings.

The lenders' use of affordability models has led to strong growth in mortgage lending, which has led to people being able to borrow increasingly larger sums of money. It remains to be seen if they modify the models in response to the recent rate rise or of any future rises.

If they do modify the models, it could lead to them agreeing smaller loans and could lead to a slowing in house-price inflation when coupled with the public's lack of appetite for higher rates.

This would not be good



news. However, why are the changes in the market thought to be unknown to so many would-be homebuyers? The fact is, a great number of buyers have already done some research and what they want is some idea of whether they are in the right ball park.

However, many are surprised to know that with a clean credit track record, loans of four or five times earnings are available. First time buyers are simply waiting longer to buy and when they make up their mind to move into the property market, they have looked things up on the internet.

With so many mortgage calculators on the internet so when people want to buy they can generally find out how much they could be able to borrow. It could be that first-time buyers are hoping that prices are going crash. For some though, it's about their priorities and they would prefer to have more spending money and the flexibility of renting rather than becoming homeowners.



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*Kassius Financial Planners was incorporated in 2002 by Chirag Shah and Andrew McGovren, who between them have nearly 40 years experience in the Financial Services industry. **We are totally independent, dealing with every provider in the market.** In 2003 Chirag Shah achieved Certified Financial Planner status, the highest and most respected qualification within the UK market, with only 500 practitioners in the country.*

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*Our aim is to bring a common sense approach to financial planning, offering **clarity, focus and value**, whether it is a simple protection matter, or a more complicated portfolio construction or tax matter.*

## Interest Only Mortgages

We have noticed an increasing amount of press coverage of 'interest only' mortgages - citing this type of mortgage as being the most common for first-time buyers.

We believe the Financial Services Authority will visit this matter by way of a review to ensure those taking out interest only mortgages have been given appropriate advice and understand the risks involved.

Interest only mortgages have been popular with:

1. First-time buyers who expect their income to substantially increase in the near future allowing them to start to repay capital
2. Borrowers who expect

significant bonuses that can be used to pay down debt.

3. Those expecting an inheritance.
4. But the most common being – those who wish to keep mortgage costs as low as possible.

We have noticed that many interest only borrowers often forget they are not repaying principle.

*...it is vital borrowers put into place a suitable way to pay down this debt*

The repayment of mortgage principle can be achieved by

switching the mortgage to capital interest repayment or from lump-sum payments. A switch-to repayment in the later years of a mortgage could mean monthly repayments become too high and therefore unaffordable.

As interest only mortgages have no element of capital repayment, it is vital borrowers do not forget this part and put into place a suitable way to pay down this debt.

Failure to do so could result in the property being repossessed by the lender in order to repay the debt. If you are unsure of your mortgage type or would like some advice to set up an appointment strategy to repay an interest only mortgage please contact us.

