THE 2019 GUIDE TO INNOVATIVE FINANCE ISAs

Written by:

GOOD WITH MONEY

MORE MONEY, FEWER PROBLEMS

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What is an Innovative Finance ISA?

You have an annual tax-free ISA allowance of £20,000.

It's tax-free because no capital gains are due on the sale of stocks, shares or bonds held in an ISA and no income tax is due on income earned from investments held in an ISA (this last point is especially important if you are planning on using ISAs to supplement retirement savings).

An IFISA (Innovative Finance ISA) is a relatively new kind of ISA.

It's a way to invest in debt-based securities such as bonds or make peer to-peer (P2P) loans to people and businesses, including property. Investments in IFISAs typically pay between 3 to 7% a year over the short to medium term – that is 1-3 years.

Unlike a cash ISA, where you get a single fixed interest rate on your savings, an IFISA allows you to create an account and then choose which bonds or loans you want to invest in. So, in that respect, it is more like a stocks and shares ISA.

The borrower (the business or project) should have the means to pay the interest quoted and a clear plan to repay capital.

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The IFISA can be a worthwhile addition to your portfolio for several reasons:

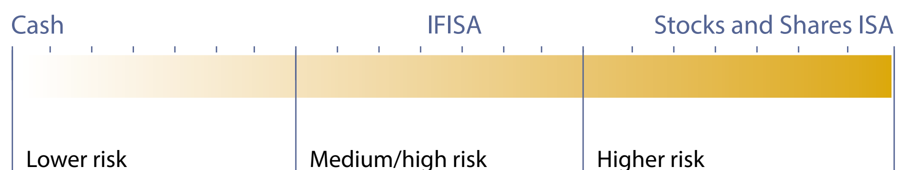
1. IFISA investments are a kind of halfway house on the risk spectrum, sitting somewhere between cash and stocks and shares. That's because unlike cash, there is some risk of capital loss (if the borrower fails to pay you back) or lower than forecast returns (for example if a business doesn't meet its forecast profits). However, unlike stocks and shares, IFISAs do not carry the daily risk of fluctuations in value, either of an individual stock or an index.

2. IFISAs offer control. You can choose which businesses and projects you want to back. Unlike a fund, where a fund manager does it for you, or a savings account, where you have little visibility over what's happening to your money.

3. They are usually uncorrelated from the stock market, and so are unaffected by market volatility.

4. They can offer a dependable, decent return over a fixed time period, allowing you to plan more easily.

5. In a continued low interest rate environment, they offer some of the benefits of cash savings, i.e. interest payments, but at a rate that unlike cash, typically beats inflation.



Please note:
When you lend or invest with an IFISA, your capital is at risk, returns are not guaranteed, and there is No FSCS cover once your funds are lent or invested.

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But do I need to invest in an ISA if my savings are tax-free under the Personal Savings Allowance?

The personal savings allowance means that for basic rate taxpayers, the first £1,000 of interest earned on any savings, including bonds, and P2P loans, is tax-free anyway, regardless of whether it is held in an ISA or non-ISA account. For higher-rate taxpayers, it's the first £500.

As a result, in any given year the need to keep money in a cash ISA or a bond-based IFISA only kicks in once the personal savings allowance has been exhausted.

To work this out, calculate how much interest you are due to earn in the year, based on the sum you are planning to invest and the interest rate you are expecting to earn.

For example:

If you were earning 5% interest and are a basic-rate taxpayer, you could invest £20,000 a year before the interest you earn would become taxable.

For a higher-rate taxpayer, the maximum amount you could invest at this interest rate before you exhaust the personal savings allowance is £10,000.

But take note:

If you choose not to protect your money in an ISA this year, and interest rates go up and/or your capital grows, you will pay tax in future.

A return on P2P of 4% p.a. would mean a higher-rate taxpayer would start paying tax once they have more than £12,500 invested.

So a better strategy might be to ask: are there ways to stash your cash away AND earn a better return over the long term?

There is always the chance, if you leave money in regular savings or bonds that are not within an ISA wrapper, that you could end up being liable for tax without realising.

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How do I decide between different types of ISA?

Your tax-free allowance can be split between the main types of ISA (see table on page 12) or invested into one type only. You can invest the whole £20,000 into cash, stocks and shares or innovative finance, or any split across the range.

There are also Help to Buy ISAs for first-time buyers only (can only invest up to £3,400 a year and receives a 25 per cent government bonus), Lifetime ISAs, which are for under 40's for retirement or buying a first home and attract a bonus on the first £4,000 invested a year (although you can put up to £20,000 in per year) and Junior ISAs, which you can invest up to £4,260 a year into, but are your childrens' responsibility when they reach 18.

Until recently, most people still stuck with Cash ISAs for the security, despite the very low returns. Around 60% of all ISA money was held in cash. For these investors, stocks and shares seem too risky.

There is clear evidence this preference is changing. Last year, figures from HMRC showed the number of cash ISAs subscribed to fell by 697,000 and the number subscribing to stocks and shares ISAs rose by 246,000.

Around £28.7 billion was subscribed to adult stocks and shares ISAs in 2017-18, an increase of more than £6 billion compared to 2016-17.

Moreover, average subscriptions to stocks and shares ISAs in 2017-18 were £10,124, a 17 per cent increase on the 2016-17 figure..

Example of tax saving in Cash versus an Innovative Finance ISA

	Cash ISA	IFISA
Amount invested	£20,000	£20,000
Interest rate	1%	5%
Interest earned	£200	£1000
Tax savings: A basic rate Taxpayer would save:	£40	£200
A higher-rate Taxpayer would save:	£80	£400

Please note:
When you hold cash in an ISA your capital is protected in the FSCS deposit scheme. Investments in an IFISA are not covered by the FSCS deposit scheme and your capital is at risk.

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Why did the Government introduce IFISAs?

The Government could see that bonds and peer to peer (P2P) lending was a cost effective way for small to medium sized businesses to raise money – the platforms connecting these businesses with retail investors were cheaper than the banks.

The Government could also see that in a low interest rate/ relatively high inflation environment, retail investors who did not want the risk of investing in stocks and shares were being poorly served by regular savings accounts and cash ISAs, with the returns on offer looking very unattractive.

By making investments in debt-based securities and P2P lending tax-free, the government wanted to boost investment in SME's – the lifeblood of the economy – and to increase the options for savers wanting better returns.

IFISAs by numbers

89
Number of authorised IFISA managers

£9,355
Average amount invested in an IFISA in 2017/18

£290m
Total amount invested in IFISAs in 2017/18

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Can I use IFISAs for retirement planning?

Yes, you can. Income you take from ISAs is tax-free. With pensions, while you receive tax-relief on the contributions (20% for basic-rate taxpayers and 40% for higher-rate), income you take from your pension when you retire is taxable. For this reason, many investors like a mix of ISAs and pension for their retirement.

The maximum amount you can contribute to your pension each year is £40,000. So after this point, OR if you start to earn more than £150,000, when the amount tapers down to £10,000, an ISA could make sense.

Some IFISA investments pay interest six-monthly. This can be used to boost your annuity income for example.

If you are tax planning, it's also worth bearing in mind that if your ISA makes a loss, this can't be used to offset taxable gains elsewhere.

Mr Smith is in his 50s and is thinking about how to fund his retirement. He is a bit worried about the effect of stock market volatility on both his pension (to which he contributes £15,000 a year) and his stocks and shares ISA portfolio. He decides this year to put his £20,000 into an IFISA instead, with the intention of keeping it until he retires, and re-investing the proceeds every year in the meantime. When he is retired, he thinks, he might start drawing down some of the proceeds as income.

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Can I transfer my existing ISA funds to an IFISA?

Yes. You can withdraw some or all cash currently held in your Cash ISA or Stocks and Shares ISA and put it towards an IFISA instead.

Although if you are transferring from Stocks and Shares to an IFISA, the only way to do this currently is to liquidate the assets and transfer cash. This could be problematic, not because of capital gains tax due (within the ISA wrapper, this won't apply), but because there may be fees. You should also consider if this is a good time to sell because share prices are high, or if it is a bad time to sell and you could incur losses if the market just happens to be low at that moment).

Can I have more than one IFISA with more than one platform this year?

No. The current rules are that you can only have one IFISA with one platform in the tax year. Although you can transfer to a new IFISA provider come April 5 or leave your existing one where it is and open up a new one in the next tax year.

How do I transfer funds to an IFISA?

Simply register with the IFISA platform, grab the details of your new account and instruct your current savings provider or bank to transfer the funds on your behalf. Cash transfers normally take about 1to 2 weeks and when the funds arrive you can start lending and investing tax-free.

What happens if it goes wrong?

Good providers should take precautions to help manage risk. Both P2P lending and crowd bonds may be secured against the assets of the borrower. The terms of any security and the loan-to-value ratio are vital and details of these should be offered by the platform.

When it comes to the FSCS, deposit protection only applies to either P2P loans or crowd bonds when your money has been deposited and you are waiting to invest and/or when you get paid interest or your capital back.

Loan-to-value ratio (or LTV)

Loan-to-value ratio is the amount of the loan expressed as a percentage of the value of the asset against which the loan is secured.

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Your money is not protected once you have lent it out, for the duration of that bond or loan, your capital is at risk and you could lose some or all of your money. If this were not the case the rates on offer would be much lower.

The FSCS investment protection scheme can apply to crowd bonds, but not P2P lending. There may be circumstances where crowd bond investors can claim up to £50,000 in compensation if a firm is unlikely or unable to honour legally enforceable obligations against it (e.g. claims for fraud or misrepresentation).

It is important to note that investors will not be able to claim under FSCS simply because a Bond fails to repay capital or pay interest.

How can I tell how risky an IFISA is?

Generally speaking, the higher the rate of return, the higher the risk level.

You should always research the particular risks of what you are investing in. You may decide, on further investigation of a higher-rate offer, that the specific risks involved are risks you are prepared to live with.

And remember that the IFISA itself does not have a fixed return: it is just a special type of account or 'wrapper' that allows you to pick bonds or loans that may offer a fixed return. Again, in that respect, it is more like a stocks and shares ISA than a Cash ISA.

For bonds, there should be an offer document that clearly lays out what the risks are. Platforms usually also state how much due diligence and credit checking they perform but should be happy to answer questions directly.

For P2P platforms, where loan sizes are much smaller, the platform does a risk assessment and often offers a rating of risk OR you can pick a fixed rate of target return and the platform will pick the loans for you.

One good question is to find out what fees the platform takes and what they are charging the borrower - if you find the borrower's rate is much higher than the returns you are being offered, you may not think you are getting a fair return for the risks involved (see below).

Why are rates of return on an IFISA typically higher?

1. There is always the risk that a project or business could fail, for whatever reason, even if its historical cash flow has indicated a decent credit risk. The risk of failure of the company or the individual that you are lending to is one reason for the higher return. Bear in mind that risk levels vary between companies, even when returns are the same.

2. Lower overheads. Innovative finance platforms are reinventing the wheel. They are powered by the latest technology and are relatively new, so they do not have the legacy of cumbersome overheads, such as big back offices, that larger, more traditional investment platforms have. They can pass on the savings from lower overheads to customers, in the form of higher returns. Just like a bank would lend to a business – you become the banker.

3. Lower fees. Partly because of the lower overheads, innovative finance platforms can afford to operate on lower profit margins than older businesses, so they can also afford to charge lower fees for arranging finance deals between lenders and borrowers than banks.

Bank of England Base Rate = 0.75%
Typical cash ISA rate = 0.5 to 2%
Typical IFISA rate = 3 to 7%

£20,000 limit per tax year

Can I transfer an existing ISA into an IFISA and vice versa?

Transferring your existing Cash ISA funds into an IFISA is really easy. You can find a form on the platform you want to transfer your funds to. Print this off, fill it out and send it to the NEW platform at the address provided.

Despite the platforms being modern and technology-based, the rules state that a real signature is required before anyone starts moving your money around.

They will then instruct your old ISA provider to move the funds across, once these arrive you can start lending and investing.

Note that in most cases you will earn little to no interest on money sitting in your IFISA account before it is invested.

And take care when transferring from a Stocks and Shares ISA to an IFISA. You will have to sell your holdings, possibly crystallising any losses, and you may have to pay a charge to the platform you are leaving.

You can also get money out of your IFISA at a later date, for example if bank interest rates go up. As your bonds or loans pay back you can transfer the cash back into a cash ISA, a stocks as shares ISA or another IFISA and this won't effect future years allowances.

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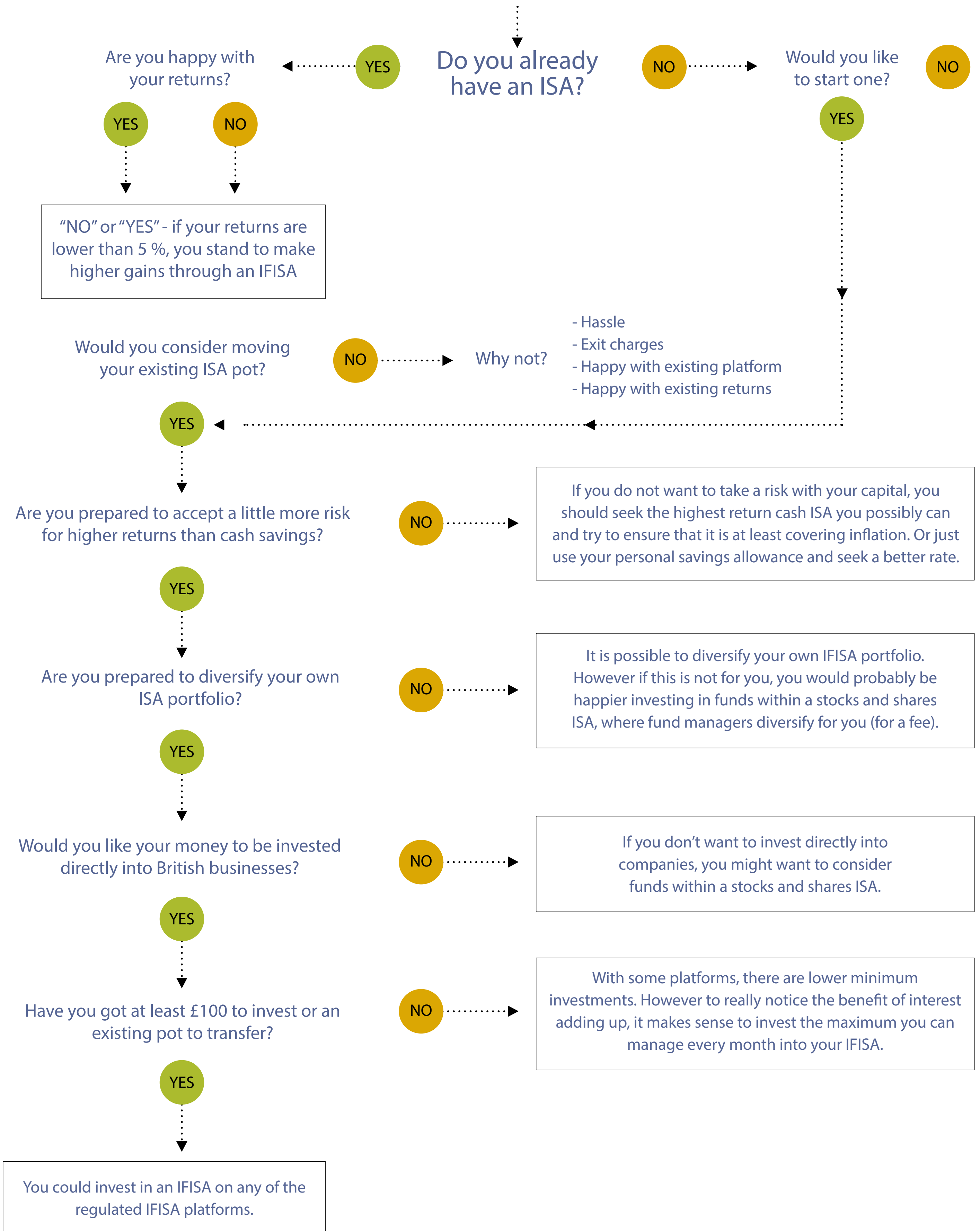
What are the different types of ISA?

	Limit	Risk level	Typical interest/return	Features
Cash ISA	£20,000	Low	Low <2%	Allows savers to deposit savings up to the annual limit in accounts covered by the Financial Services Compensation Scheme.
Stocks and Shares ISA	£20,000	Low to high depending on type of fund	Varies depending on risk level, performance and fees. Equity not debt and therefore capital growth rather than interest	Up to £20,000 can be mix of stocks and shares and cash, can be "flexible" so you can take money out and put it back in without losing the tax-free status of that bit of your allowance.
Innovative Finance ISA (P2P)	£20,000	Medium to high depending on diversification/ interest rate	Can vary significantly according to the bonds or loans you select.	Loans to individual borrowers, small businesses or property developers who are credit-scored. Loans to groups of borrowers with good credit ratings can offer lower rates of return for lower risk. Platforms often grade loans according to their credit risk assessment and most of the larger platforms will pick loans for you.
Innovative Finance ISA (Debt-based)	£20,000	Medium to high depending on diversification/ interest rate	Typically between 4 to 7% a year over short to medium term. Debt-based, therefore pays interest not capital growth. Income can be reinvested	Loans to businesses that are secured against assets owned by the business. Only one innovative finance platform per ISA per year. Can invest in a range of businesses on the same platform to diversify. Good transparency – you can see how your money is being used. Can also invest in other types of ISA alongside, up to the maximum annual limit.
Lifetime ISA	Up to £20,000 (but only first £4,000 eligible for the bonus)	Cash or stocks and shares. Low to high	Varies depending on type/ risk level, performance and fees. Equity not debt, therefore pays capital growth not interest	Government will top up up to £4,000 of annual tax-free savings with 25% contribution. You must have been under 40 on April 6 2017 to be eligible. The Government bonus is paid to a maximum age of 50. Savings in the LISA must be used either to buy a house or towards a pension. Pension can be accessed from age 60. Part of annual £20,000 allowance (giving £16,000 left over). Cannot have one of these and a Help to Buy ISA.

Is an IFISA right for me?



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Taking risk for safety in uncertain times

By Rebecca Jones, editor of Good With Money

More than any other period since the global financial crisis, 2018 demonstrated with undeniable clarity the importance of having a diverse range of investments.

As concerns over Brexit and the US China trade war mounted, respective UK, European and US markets tumbled. In the UK, the index tracking our biggest companies – the FTSE 100 – shed 16 per cent from its May peak to its December trough, while the US's respective benchmark, the Dow Jones Industrial Average, plummeted 18 per cent from January to December.

The beginning of 2019 saw a notable rally in both markets, particularly in the US. However, even as I type, Prime Minister Theresa May has just suffered the worst defeat in Parliamentary history and Labour is calling a general election. Meanwhile in the US, a sitting President is under investigation by the FBI as a suspected Russian agent.

And so, it is perhaps safe to say that we are living in very uncertain times; and faced with such uncertainty, investments in sectors that have nothing to do with main markets become some of the safest around – turning the traditional idea of risk on its head.

And these are just the types of companies and projects that investors can hold within an Innovative Finance ISA. From short term bonds in an established solar farm, to a twenty year investment in the UK's first ever offshore tidal project, to lending to a community impact project: the IFISA gives investors access to a range of projects that are anything but normal.

As debt investments that target a return over a period of time, IFISA holdings can also provide some regularity, helping those that need an income to plan their money over coming years. This is one of the reasons the IFISA has proved so popular with retirees – again defying old rules and definitions around 'de-risking' when we reach 65.

Indeed – market volatility aside – in a decade when interest rates have remained glued to the floor, the biggest risk for many has been inflation, with the rising cost of living eating away at cash balances and portfolios stuck in government bonds. Again, this isn't a situation that looks set to change anytime soon, with Bank of England Governor Mark Carney warning he may have to slash rates and turn the money taps on again in a disorderly Brexit.

And so, as we head into another uncertain, rock bottom interest rate period, an IFISA bond paying 5 per cent or more remains highly attractive to income seekers, longer-term investors and, of course, those that want to do Good with their money.

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Things to remember

- As long as you don't invest more than £20,000 in an ISA in a tax year, your savings will be tax-free. The first £1,000 of interest for basic rate taxpayers and £500 of interest for higher-rate taxpayers from savings or bonds, is tax-free anyway, through the personal savings allowance, so if you have less than £10,000 to invest and you don't want to take any risk with your money then you may be better off ignoring the ISA and just getting the best saving rate you can
- You can only have one IFISA in the tax year, with one provider
- You can use your ISA allowance in a combination of Cash or Stocks and Shares, Innovative Finance or Lifetime
- The £4,000 you can put in a Lifetime ISA (the maximum amount that is eligible for the bonus) is part of the £20,000 maximum, so you still have £16,000 to invest or save tax-free before you reach the limit
- You can invest lump sums or monthly in an IFISA
- You normally only start earning a return in an IFISA once you have lent your money to a business or project, so don't leave it hanging round too long.
- IFISAs are a kind of account or wrapper – the interest rate you earn will depend on which bonds or loans you choose

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About the Downing Innovative Finance ISA

A Downing Innovative Finance ISA can be opened online in two minutes.

You can then make a deposit of up to £20,000 or transfer an unlimited amount of existing ISA money.

New deposits have to be made by midnight on 5th April to count towards this year's allowance - you can then go on to pick your bonds at leisure.

Crowd bonds offer fixed rate returns of 3-7.5% p.a., typically secured against real assets such as freehold property and solar farms.

Bonds go through an internal due diligence process and an investment committee with external advisers and are submitted for an independent analysis by in:review.

There are no fees to open an IFISA, but equally investors only start to earn interest once they make investments.

Downing's monitoring fee is contingent on you being paid your interest and capital back.

Capital and returns are at risk. Terms and Conditions apply.

Want to get in touch with Downing?

Visit:
www.downingcrowd.co.uk

Or call:
0207 416 7780