IIFA Country report UK 2015/16

1. Economic and Financial Background

Table 1: Key Economic and Financial Indicators		
	2015	**2016**
Population (mid year, million)	65.1	n/a
GDP (GBP billion)	1,788	n/a
Real GDP growth (%)	2.2	n/a
Inflation rate (%)	0.2	0.5
Unemployment rate (%)	5.1	4.9
Stock market capitalisation (end year, GBP billion)	2,268	2,301
Stock market capitalisation (% of GDP)	126	n/a
Bond market capitalisation (EUR billion)	-	-
Bond market capitalisation (% of GDP)	-	-
Household gross savings ratio (%)	3.8	n/a
Household financial wealth[1] (end year, GBP billion, net)	4,314	n/a
Average per capita financial wealth (GBP)	66,369	n/a

[1] Includes non-profit institutions serving households

In 2015 the UK recorded the largest current account deficit as a percentage of GDP among the G7 economies, 5.4%. The decline in the primary income balance in recent years has been due to both; the stock of assets that the UK holds abroad falling relative to the stock of assets held by foreign investors in the UK; and the rate of return the UK receives on its assets abroad slightly falling while the rate of return earned by foreign investors in the UK has risen slightly. Roughly 45% of the UK's investment abroad is in Europe, with around 35% of holdings in the Americas. UK liabilities show a similar picture with just over half of investment into the UK coming from Europe, and around 33% coming from the Americas. UK exports grew faster than global exports in 2015 for the first time since 2006.

The UK economy grew by 2.2% in 2015, which is lower than the 3.1% growth experienced in 2014, but only slightly below the long term average of 2.6%. There has been positive year on year growth in GDP since 2009. The most recent estimates indicate GDP in Q1 2016 was 0.4% and 0.6% in Q2 2016. Across the four main industrial outputs - Manufacturing, Production, Construction and Services – only manufacturing contributed negatively to GDP growth in 2015. All indices contributed positively as at Q2 2016, both year-on-year and year to date. The services sector continues to contribute most to the UK economy.

Inflation, as measured by the Consumer Prices Index (CPI) was 0.2% in 2015. Increased prices at restaurants and hotels were the biggest contributor to the rise however falling food prices kept the headline inflation measure low. This trend continued through the first half of 2016 as prices in the services sector increased but food prices fell year-on-year. Looking at the Retail Prices Index - Jevons (RPIJ), which includes housing costs, we saw greater inflation (albeit still low) in the year to end of December 2015 at 0.5%. Annual inflation by this measure increased again when measured at June 2016 to 0.9%.

The end of June saw the UK vote to leave the EU which led to significant market volatility. Domestic and global equity markets sold off sharply, particularly the FTSE 250 which has a high proportion of domestic companies as constituents. The FTSE 100 recovered quickly, and indeed surpassed its previous high, as companies that have significant international operations benefited from the weaker pound. Sterling fell to a 30-year low against the US dollar, and against the euro the pound fell to its lowest level since the financial crisis. Bond yields also fell as investors moved toward less risky assets.

As at the end of June 2016 the Bank of England's (BoE) Asset Purchase Facility (APF) maintained stock to the value of £375 billion, this has been consistent since mid-2012. Following the UK decision to leave the EU the BoE introduced further monetary stimulus by reducing the bank rate to 0.25% from 0.5% and increased the APF to £435 billion. In addition to purchasing gilts, the BoE will also purchase Corporate Bonds.

2. Data on funds under management and portfolios

Table 2: Net Assets of the Funds Industry in the United Kingdom[1,2]

(GBP billion)

	2012	2013	2014	2015	2016
Home-domiciled UCITS & AIF[1]	663.9	762.9	832.1	871.2	911.9
Funds domiciled abroad and promoted by national providers[3]	52.9	66.7	77.2	88.0	97.5
Total AuM	716.8	835.7	909.3	959.2	1,009.4

[1] Fund of funds (other than funds of overseas funds) are not included in order to avoid double counting of the same assets. The totals differ from the data presented in tables 4 – 8 due to the exclusion of FOF.

[2] Excludes (closed-ended) investment trust companies, which are not within The Investment 's statistics.

[3] Overseas funds are open-ended funds domiciled outside the UK, FCA-authorised and sold into the UK with reporting status.

Table 3: Net Sales of Investment Funds in the United Kingdom[1,2]

(GBP million)

	2012	2013	2014	2015	2016
Home-domiciled UCITS & AIF	22,855	23,565	32,755	18,197	-6,320
Funds domiciled abroad and promoted by national providers[3]	3,466	2,144	3,519	5,524	1,938
Total Net Sales	26,321	25,709	36,274	23,721	-4,382

[1] Includes sales of funds of funds (FOFs) but not sales by funds to FOFs (other than overseas FOFs) in order to avoid double counting.

[2] Excludes (closed-ended) investment trust companies, which are not within the Investment Association statistics.

[3] Overseas funds are open-ended funds domiciled outside the UK, FCA-authorised and sold into the UK with reporting status.

Table 4: UCITS Assets by Fund Type
(GBP billion)

	2015	2016
Equity funds	488.22	467.31
Bond funds	128.48	143.15
Multi-assets funds	64.63	54.18
Money market funds	6.56	4.41

Guaranteed/protected funds	0.49	0.44
Absolute Return Innovative Strategies (ARIS) funds	54.91	52.12
Other	42.07	96.92
Total	800.96	818.54
of which		
ETFs		
Funds of funds	20.51	22.87

Excludes (closed-ended) investment trust companies, which are not within The Investment Association's statistics.

No significant ETFs are domiciled in the UK though many have their primary listings in London.

Table 5: Net Sales of UCITS by Fund Type (GBP million)		
	2015	**2016**
Equity funds	6,475.34	-9,833.30
Bond funds	-4,482.08	-480.91
Multi-asset funds	1,584.84	-1,258.77
Money market funds	612.10	1,247.09
Guaranteed/protected funds	-221.60	-42.05
Absolute Return Innovative Strategies (ARIS) funds	9,986.62	4,933.82
Other funds	-5,716.54	2,321.03
Total	8,383.38	-3,113.11
of which		
ETFs		
Funds of funds	-5,571.84	1,436.17

Includes sales of funds of funds (FOFs) but not sales by funds to FOFs (other than overseas FOFs) in order to avoid double counting.

Excludes (closed-ended) investment trust companies, which are not within the Investment Associations statistics.

Overseas funds are open-ended funds domiciled outside the UK, FCA-authorised and sold into the UK with reporting status.

3. Key trends in flows and assets under management

2014-2015

UK domiciled FUM of UCITS and AIF grew to £871.2bn at the end of 2015 from £832.1bn at the end of 2014 - an increase of 4.7%. Net Sales over the same period were £18bn which implies underlying asset values grew over the period. Overseas domiciled funds grew from £77.2bn to £88bn an increase of £10.8bn, or 14%. Net sales of Overseas domiciled funds were £5.3bn in 2015, the highest in the past five calendar years. The growth in sales of Overseas domiciled funds to UK investors can be attributed to the popularity of Absolute Return funds. The introduction of UCITS III led to a proliferation of Absolute Return funds which are largely domiciled in Ireland and Luxembourg.

Total FUM of funds operated in the UK was £959.2bn at the end of 2015, up from £909.3bn at the end of 2014; growth of 5.5%. Growth of FUM has been declining over the past five years as net sales have remained consistent but the asset base has become larger, since 2011 the UK funds industry has grown by more than 50%. Total net sales in 2015 were £23.4bn a decrease of 35% on 2014 figures, however 2014 was a particularly strong year as net sales were 41% larger than 2013.

Equity funds remain the largest asset class amongst UCITS funds with £496bn in funds under management. Fixed income was the second largest asset class as at the end of 2015 with £129bn under management, multi-asset funds followed with £69.6bn closely followed by absolute return strategies at £55bn. Net sales of absolute return funds was just under £10bn, the best-selling asset class in 2015. Equity funds were next best-selling with £6.5bn driven by UK Equity Income and Europe ex-UK sectors. Asia Pacific ex Japan proved unpopular with investors as they turned their backs on China. Multi asset funds saw inflows of £612m with the riskier 20-60% shares and 40-85% shares sectors receiving inflows whilst the less risky 0-35% shares sector suffered outflows. Fixed Income funds proved to be unpopular with investors in 2015 as they pulled £4.5bn from the asset class. Outflows were experienced across all sectors except Strategic Bonds which received a modest net inflow of £91m. Other funds, which includes unclassified funds and specialist funds that do not match the traditional asset class breakdown saw outflows of £5.7bn, again this was driven by fixed income funds amongst the unclassified sector.

Other funds and mixed asset funds were the largest asset classes amongst AIFs with £180bn and £51bn respectively. This is due to risk targeted ranges classified across both asset types. Other funds received inflows of £2.9bn and multi-asset funds gathered £2bn in net sales. Equity funds had £28bn under management at the end of 2015 and received net sales of £2.2bn. Bond funds make up a small part of the AIF universe with only 33bn under management, they also experienced an outflow of £154m.

The number of UK domiciled UCITS funds fell in 2015 to 1,962 from 1,977 in 2014, however the number of UK domiciled AIFs increased from 1,007 to 1,033. There were 130 fund launches in 2015, a small increase on 2014 and the highest number of launches since 2012. Fund closures amounted to 97, a slight decrease from 2014.

Household financial assets in the UK amounted to £6,324bn at the end of 2015; investment funds made up £565bn, or 9%, of the total. Life and pension funds stood at £3,557bn or 56% of the total. The proportional representation of these assets has been stable over recent years.

2015 – June 2016

Despite net sales of -£6,320 million in the year to end of June 2016, UK domiciled funds under management increased to £911.9 billion due to rising asset values. There was also an 11% increase in overseas domiciled funds to £97.5 billion from £88 billion, which led to total UCITS funds under management in the UK increasing beyond £1 trillion.

Equity funds still dominate the UK market, accounting for 57% of UCITS funds, £467 billion. As such equity funds experienced the largest outflows year to date on an absolute basis, £9.8 billion. UK focused equity funds make up 45% of the universe and also experienced 46% of the net outflow in equity funds. Whereas European equity strategies only account for 12% of assets but were responsible for 24% of sales outflows. This shows that investors redeemed relatively more from European funds than other strategies. Conversely Global equity funds hold 24% of assets in the equity sector, but only account for 8% of the year-to-date outflow, which shows investors preference for Global strategies.

Fixed Income funds made up 17.5% of UCITS fund assets at the end of June 2016, £143 billion, and £821 million was redeemed from the asset class in the first six months of 2016. Investors sought safety in government bonds as gilt and index linked gilt funds received positive inflows, £294 million and £118 million respectively. They sold out of the riskier sterling fixed income strategies as strategic bond funds suffered the largest outflow, -£1.3 billion, followed by high yield, -£573 million, and sterling corporate bond -£41 million. Global bond funds received a net inflow of £679 million and emerging market bond funds had a small positive net flow at £11 million, suggesting investors were concerned about a weaker pound.

Multi Asset funds also experienced a net outflow in the first half of 2016 of -£1.4 billion. The outflows were predominately seen in funds with higher equity exposure, which follows the general view that UK investors were cautious in their asset allocation decisions so far in 2016. Absolute return funds saw strong sales of £3.7 billion, however assets in these funds fell from £55 billion to £52 billion suggesting negative performance across the sector.

4. Product Developments

ELTIF:

To date, no ELTIFs have yet been launched in the UK. The result of the EU referendum leaves the outlook for ELTIFs in the UK uncertain. The UK already has a significant number of Infrastructure Funds, which are usually established as listed closed-ended investment companies, and the ELTIF model may struggle to compete against these more established models. Existing legislation and regulation has been modified to allow ELTIFs to be set up in the UK as investment companies or limited partnerships.

5. Regulatory and self-regulatory developments (including tax)

UK Authorised Funds

UCITS V

The focus of the UK regulator's funds policy work in 2015-16 has been on the implementation of UCITS V. The FCA took an 'intelligent copy-out' approach. This means that it adhered as closely as possible to the UCITS L1 wording, whilst using an alternative wording where needed to align with UK law and practice. The implementing regulations and legislation came into force on time -18 March 2016.

With regard to the UCITS V Level 2 Regulation, the FCA issued its consultation paper in May 2016. As the Level 2 Regulation has direct effect, the FCA is proposing to make minimal changes to its rules. It does, however, intend to maintain the UK's current approach to ensuring that the management company and depositary act independently. It does this through retaining its current guidance regarding depositary independence. In taking this approach, the FCA comments as follows:-

"These requirements have for many years delivered a high level of investor protection by minimising the risk that the depositary will face a conflict of interest between the performance of its duties and its involvement, directly or through associates, in a wider range of activities where the fund manager also has a commercial interest. Structural independence allows the depositary to carry out a broad function of oversight, delivering an appropriate degree of independent governance for the fund on behalf of its unitholders……we propose to retain the existing guidance in COLL 6.9 which relates to those provisions. This will result in stricter independence standards than those required under the UCITS Directive that we consider are justified by the increased investor protection benefits."

The FCA has published its finalised rules and they come into force on day from which the UCITS Level 2 Regulation applies - 13 October 2016.

EU Funds Framework

In response to the Commission's Call for Evidence on the overall functioning of the EU regulatory framework for financial services in September 2015, The Investment Association highlighted a number of areas which could enhance the EU Funds Framework. This includes the need to make a technical amendment to the UCITS Directive in relation to master-feeder arrangements as well to address some of the barriers hampering cross-border distribution (eg appointing a paying agent, providing KIIDs to professional investors, notifications to regulators, different marketing rules and different regulatory fees.)

Fund Standards and Distribution

Distribution

The UK market will be slightly less impacted by MiFID II than most other Member States because UK regulators commenced a period of rule changes in the area of retail distribution in January 2013. This regulatory initiative, commonly known as the Retail Distribution Review, or RDR, pre-empted some of the MiFID II measures, particularly in the area of inducements. The UK, therefore, already has a commission ban, for both independent and non-independent advice, although these rules currently only extend to retail clients. That might change with the introduction of MiFID II. The last measure of the RDR rules came in in April 2016 banning all commissions/inducements for legacy business on platforms. As a result of that most platforms now only hold unbundled share classes. Since then managers have been left with legacy bundled share classes and in some cases a number of these share classes have shrunk to sizes which are non-viable. This issue may intensify with an increasing number of "old" share classes being left with just a few unitholders.

Main implementation challenges from MiFID II for UK asset managers will be in the areas of costs and charges and product governance. Because it is still not clear to what extent the requirements of the UCITS, PRIIPs and MifID II regarding disclosure will be the same, additional systems might have to be built to calculate costs and charges and share the information with distributors. While older FCA rules had introduced the concept of product governance, target market definition and distributor oversight principles already, codification via MiFID II will require firms to revisit their arrangements and process. Current practices will have to be enhanced and better recorded. Engagement with distributors regarding target market oversight and due diligence will have to be further formalised. Firms are currently busy changing their processes and relations with distributors.

Tax Rules, VAT Rules and Double Tax Treaties

Investors

New tax rules affecting investors were introduced on 6 April 2016:

Taxation of dividends

The taxation of dividends received by individuals has been reformed. Basic rate taxpayers previously had no tax to pay on dividends received whilst higher rate and additional rate taxpayers were taxed at 25% and 30.56% respectively. All individuals now receive £5,000 of dividends each year tax free. Dividends received in excess of that limit are taxed at 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers and 38.1% for additional rate taxpayers. The effect is that those with less dividend income may pay less tax (depending on their tax rate) whilst those with significant dividend income will pay more tax.

Taxation of savings income

A personal savings allowance was introduced on 6 April 2016. This exempts from tax the first £1,000 of savings income for basic rate taxpayers and the first £500 for higher rate taxpayers. Additional rate taxpayers are not eligible.

Banks and building societies are no longer required to deduct tax from interest payments as the new allowance will eliminate tax on interest for most savers. Funds will no longer need to deduct tax from interest distributions from 6 April 2017. This means that investors in funds may need to reclaim tax deducted at source, until April 2017.

Therefore, from April 2017, all distributions from UK funds (whether treated as dividends or interest) will be free from any withholding taxes.

Capital gains tax rates

The higher rate of capital gains tax was cut from 28% to 20%, whilst the basic rate was cut from 18% to 10%, with effect from 6 April 2016. The old rates continue to apply for carried interest and residential property.

Funds, fund managers and asset management activities

Funds will no longer need to deduct tax from interest distributions from 6 April 2017. This will be a significant simplification.

Anti-avoidance and similar measures are being brought in:

- Following the OECD's base erosion and profit shifting project, the government is consulting on the detailed design of new rules to limit base erosion involving interest deductions and other financial payments. The new rules will be introduced in April 2017.
- A new corporate offence of failure to prevent the criminal facilitation of tax evasion is to be introduced. The offence may be committed in relation to either UK or overseas tax and is expected to come into effect by September 2017.

New rules have been introduced for fund managers:

- New rules have tightened the amounts fund managers can deduct from sums received in respect of carried interest, where those sums are subject to capital gains tax. These took effect on 8 July 2015.
- A statutory test determines the vehicles in which performance-related interests give rise to income rather than capital gains for fund managers. The interests are then subject to a higher rate of tax. The test focuses on the average holding period of the fund's investments, and took effect on 6 April 2016.

A new relief from stamp duty land tax (SDLT) for property authorised investment funds (PAIFs) and co-ownership authorised contractual schemes (CoACSs) will be introduced during summer or autumn 2016. This seeding relief will allow properties to be transferred into a PAIF or CoACS over an 18 month period (or until external investors are accepted into the fund, if sooner) without a charge to SDLT. SDLT rules for CoACSs will be introduced at the same time. These will clarify the SDLT treatment of property transactions entered into by CoACSs and of transactions in units in a CoACS holding property. The lack of specific rules to date has meant that CoACSs have been an unattractive vehicle for holding property.

6. Corporate governance - major developments

No update at this time

7. Fund governance

No further update

8. Other major issues and developments

EU Referendum

On 23 June 2016 the UK voted to leave the European Union, creating uncertainty about the future of the UK outside of the EU.

Fund exports from the UK during 2015 were around £28bn, but the UK exports far more in portfolio management services, which include significant delegation from EU-domiciled funds, particularly those domiciled in Dublin and Luxembourg.

The Investment Association is confident our industry will be able to continue to compete overseas, both in the EU and the rest of the world. Our objective remains to play a positive role within the UK economy as a source of funding for companies, a major contributor to export earnings and as a centre of investment excellence that serves both domestic and overseas clients successfully.