

Public Sector Pension Changes

As you may have seen on the television and read in the newspapers, public sector pension schemes are currently the subject of calls for radical reform, largely because of the increasing cost to the public purse of funding these schemes - There are seven main schemes currently being reviewed: the Armed forces, Civil service, Fire service, Local government, NHS, Police and Teachers schemes.

These schemes vary widely in terms of the contribution rates and benefits payable, although the most common feature that they all share is the fact that they all currently offer an annual pension benefit linked to the member's number of year's service and final salary at retirement.

All these schemes have also been subject to some significant changes already in recent years, most notably:-

- An increase in retirement ages (in some cases, like the Police, to tie in with the new minimum age of 55, and in others to move the normal pension age from 60 to 65);
- Changes to the schemes benefit structure (such as the rate at which the pension is accrued on a year by year basis); and
- Some schemes introducing different contribution rates depending on how much the member earns.

Analysis by the Independent Public Service Pensions Commission, however, has found that the current final salary structure of these schemes unfairly favours higher



earners, even where there are tiered contribution rates in place. This is because higher earners are likely to benefit from increasing income as they progress through their careers, whereas lower earners are much less likely to experience such increases.

So what are the proposed changes?

The Coalition Government set up the Independent Public Sector Pensions Commission to look at reforms to public sector pensions that would be "fair but affordable" and the Commission's report, published in March 2011,

contained 27 recommendations, with the key ones being:-

- For future service, all public sector schemes should move to a "career average revalued earnings" (CARE) basis as soon as possible, with revaluation in line with average earnings - The net effect of moving from a "final salary" to a "career average revalued earnings" basis is likely to mean a lower figure (for most people) on which future pension entitlement will be calculated.
- With exceptions for certain schemes, the Schemes Normal Retirement Age (NRA) should be

linked to the State Pension Age (which will rise to 66 in 2020).

- Contribution rates should be on a tiered basis, increasing with earnings - Effectively meaning that contributions overall will be at a higher level than they are currently (the Government has estimated an overall average increase of 3.2% pa); and
- There should be a cost ceiling on the tax payer's contribution to public sector pensions, with changes to the scheme needing to be made if that ceiling is breached.

The Government is now proposing that approximately

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one million public sector workers who are due to retire in the 10 years from 1 April 2012 will no longer have to move to a CARE basis for their future accrual or have a later NRA – although they will still have to contribute more if they earn over £15,000 a year and they will remain impacted by the change in the inflation measure used for increasing pensions in payment from the (higher) retail price index to the (lower) consumer price index.

In addition, it has been proposed that contribution increases will not be spread uniformly, with those earning under £15,000 a year, or serving in the armed forces,

seeing no increase at-all and those earning between £15,000 and £18,000 having any increase capped at 1.5% p.a.

The bad news for the highest earners though is that they could see a 6% increase by 2015, and if this applies to the NHS scheme, some members could end up having to pay a 14.5% contribution each year.

What have been the reactions to the proposals?

It is perhaps unsurprising that there has been considerable opposition to the changes, given that the 'triple whammy' blow will involve

higher contribution rates, later retirement ages and lower benefits – especially now – increases to public sector pensions in payment will use the (lower) CPI, rather than the RPI, as the inflation measure. And, the fact that these changes are being proposed to happen all at once – rather than staggered over time – probably doesn't help matters much either.

It mustn't be forgotten though that even if the changes are implemented as proposed, public sector schemes will remain among the most generous available, and will still represent very good value for member contributions.

So what are the implications if you are a member of one of the schemes affected?

If you are a higher earner faced with significantly increased contributions to pay, you may be considering whether you should opt out of the scheme. However, given the inflation linked guaranteed benefits you would be giving up and how much it would cost to replace them if contributions were made to a money purchase scheme instead, any decision to opt-out of the

scheme will almost certainly result in you losing out at retirement.

Given that the difference between a 'career average' salary pension and a 'final salary' pension can be significant for higher earners, you may wish to seek advice regarding how best to make up a possible shortfall in your expected pension at retirement. For example, a scheme member averaging salary increases of 2% a year above inflation with 40 years' service in a career average scheme could expect to receive around 30% less as a pension than on a 'final salary' basis.

It is impossible to quantify in advance the precise impact on any individual cases, but subject to affordability there will probably be a strong case for making additional pension contributions to help reduce any potential shortfall. If you can afford to make them, the merits of paying into an 'in-house' additional voluntary contribution scheme would need to be compared against the merits of paying into an individual personal pension or stakeholder instead – an area that we will be more than happy to provide guidance on.

Safe as houses?

It has been fairly well documented in recent years that a future pensions crisis is in store for the UK given the reduction in the number of final-salary pension schemes, the effects of the financial crisis on investment returns, and (more pertinently) the fact that most of us do not save enough towards our retirement.

A recent survey highlighted a frightening statistic that UK adults need to save, on average, £10,300 every year in order to ensure they plug this gap and have an adequate income in retirement, with the 'pensions gap' in the UK now the worst in Europe* This is against a current backdrop of economic uncertainty, and wages failing to keep pace with a rising cost of living (with inflation running at over 5%) – Inevitably, many people are focusing simply on making ends meet and saving (for retirement or otherwise) currently looks like 'luxury' expenditure.

The survey also highlighted that middle-income earners are particularly likely to feel the pinch, with a significant element of the gap comprising individuals who

are close to retirement and who will need to consider utilising non-pension assets. The bad news is that, on average, income from such assets is only likely to provide approximately somewhere between £350 and £1,100 per annum* with many people not realising how little income they will be able to generate from other elements of their wealth.

One common objection often made against pensions is that alternative methods of saving for retirement offer an adequate (or better) solution – In particular many people put off saving more towards retirement as they see their home as a valuable, steadily appreciating asset which can be used to release funds to use for this purpose, negating the

requirement for making substantial further provision elsewhere.

It is important to consider how realistic it really is that your home will be able to support you in retirement:-

1. Property prices are not guaranteed to keep rising

The average UK house price in September 2007 was around £181,933 – However, the average price was just £151,987 in April 2009, which was a fall of nearly £30,000 (or over 16%) in just over 18 months** Regionally many people may have seen even bigger falls in the value of their main asset over that period.

Whilst, before the recent economic



turmoil, we had enjoyed a decade of rising property prices there have also been long periods where prices have remained relatively flat or even fallen. Notably, Bank of England Monetary Policy Committee member David Miles recently stated that the housing market is “unlikely” to ever recover from the financial crisis and that it may actually prove economically beneficial for fewer people to own property (Source: Daily Telegraph).

Whilst price volatility over the longer term may appear favourable this is of scant compensation if the timing of your retirement coincides with a lull in property markets. Regardless of this, property is an illiquid asset and (if there is an absence of other suitable means of releasing equity) there is no guarantee that selling to downsize will be quick or easy.

2. The numbers don't stack up

Lets assume a house price of £200,000 (marginally above the national average) which, based on current annuity rates (the amount of pension you could buy with that amount) would give a 65 year old male £240 per week* – doesn't sound too bad does it?

However this assumes a level pension which may not keep pace with inflation. Remember that RPI inflation is currently running at around 5% and pensioners are often the worst hit in high-inflationary periods as typically it is items such as fuel and food which see the highest rises. Assuming the same £200,000 is available to buy a pension guaranteed to rise in line with RPI this would result in the same 65 year male receiving just £150 per week*

Of course, this is also academic, as we all need somewhere to live. In reality it is just not going to be practical to utilise the full value of this asset to generate an income. So, assuming we could release 50% of the value (either through downsizing or equity release), following the example above this would result in generating an inflation-proofed income of just £75 per week*

3. Consider the practical issues

It is easy to focus on the numbers, but what about the practical issues? We all need somewhere to live when we retire and there are a number of important considerations in respect of the 'property as a pension' idea. Most

importantly, your property first and foremost is your home – Would you really want to downsize? For example, you may want to keep a large garden for grandchildren to play in, or when you actually come to trade-down, the properties you find you can afford may be in an area you don't like – You may find you simply don't have the choices you would have had with a proper retirement nest-egg

Summary

Whilst non-pension assets can form part of financial planning for your retirement, hopefully the above gives some food for thought in respect of how much you can realistically expect by relying solely on your home as a pension . It is important not to 'put all your eggs in one basket' and your home – regardless of house price inflation – should not be a substitute for a genuine financial plan to save adequately for retirement.

Importantly saving for retirement does not necessarily just mean pensions – Other tax-efficient vehicles such as ISAs can also have their place. The key, however, is to understand and quantify your own 'pension gap' and look at putting an action plan in place as

early as possible – We can help you with this process and explore the options for planning for a more financially secure retirement.

* Source: www.aviva.com/europe-pension-gap/downloads/regional_uk.pdf Please note that the figures quoted in this article were in Euros and we have converted then to assuming an exchange rate of 1 GBP=1.19252 EUR

** Source: www.landreg.gov.uk , taken from House Price Index – Custom Report 01/06 – 09/11.

*** Figures based on Pension Annuity Comparative tables at www.moneyadviceservice.org.uk Please note that these figures are before deduction of any income tax and are only approximations – The amount of income you could buy would depend on annuity rates prevailing at the time.

**** Figures obtained from Nationwide's HPI calculator

The value of your investment can go down as well as up and you may not get back the full amount invested.

Levels and bases of and reliefs from taxation are subject to change and their value depends on the individual circumstances of the investor.

The Silent Erosion

Over the past couple of decades inflation has been both stable and low, but recent government figures show inflation has now peaked above five per cent with RPI (Retail Prices Index) inflation running at around 5.4% in October.



Rising inflation causes us all problems, not only increasing our household expenditure but also eroding the 'real' value of

our savings and investments, this article looks to explain this further and at ways of trying to combat the effects.

Why has inflation been on the increase?

A key reason for this has been the increase in VAT to 20% as shops and service providers inevitably passed this 2.5% increase on to the consumer, meaning that the impact on the price index was almost immediate.

This, however, does not account for the full increase in inflation which has persistently run above target. Part of the reason for the increase has been due to high utility, transport, and clothes costs which pushed up the overall cost of living.

To further compound the issue research by Saga shows that the “real” inflation rate for the over-65s is running close to 6.4 per cent. This is due to the

disproportionate amount of income that pensioners spend on food and fuel.

The immediate impact for households is that based on just 12 months ago and assuming household expenditure was £20,000, to maintain the same standard of living now you would need to spend £1120 more - for the over-65s this figure is even higher at £1280.

Although inflation is unpredictable, there is still light at the end of the tunnel. The Bank of England's latest inflation indicate a fall to below 2% by the end of 2013 – One of the reasons for this is that, as inflation is measured over a 12 month period, the effects of the 2.5% VAT rise will soon 'fall out' of the equation. However, despite expectations that inflation will fall in

2012, there are all kinds of factors which contribute to the headline rate and, if inflation remains high, the Bank of England may find tightening monetary policy will be too little too late.

What steps can be taken to ease the impact of inflation?

Make cash-savings work harder

Basic-rate taxpayers need a savings rate of at least 6.5% to be earning a real rate of return on their deposits after tax and inflation.

This is difficult to achieve in the current market, where even the best tax-free cash ISAs pay only 3.3%. Even in this climate, however, savers should consider maximising their tax free ISA allowances of £5,340 in a cash Isa (these limits rise to £5,640 for cash from April next year) rather than leaving savings in accounts paying even lower rates of taxable interest.

Also, fixed-rate bonds tend to offer higher rates of interest. A handful of providers offer index-linked bonds that can shelter savings from inflation. These are designed to pay the annual rate of RPI plus a certain additional percentage per year if kept for the full term, although it should be remembered that RPI can fall and there are likely to be restrictions on being able to access your money – In addition interest is usually only paid on maturity (rather than monthly or annually).

Review Household Expenses

Gas and electricity price rises are behind the most recent spike in inflation. It is a double whammy because fuel bills are more expensive and higher inflation erodes the value of the income or savings used for monthly bills.

To counter this you may wish to consider:

- The various grants for energy efficiency and therefore reduce ongoing usage
- Shop around for a different energy provider to obtain a lower rate or even enter into a fixed price contract so that bills will not increase for a set period. The down side of the fixed deals is that you will not benefit from any potential falls in the cost of raw materials i.e. Gas, although many contracts would allow you to pay to exit them should this be desirable.
- Change your payment method or combine the utilities you purchase to obtain discounts.

There is no perfect answer but, although many of us look to shop around for food or clothing to reduce our outgoings we do not often consider whether we are getting the best deals on things like utilities, insurance plans and other such expenditure.

Pensions

The recent Quantitative Easing

programme undertaken by the Bank of England has caused pension annuity rates to fall. This is because annuity rates are linked to the yields on Government bonds - When the Bank of England buys Government bonds this has the effect of pushing up bond prices and reducing the yield on them, and unfortunately, these are also the bonds annuity providers buy to supply annuitants with an income.

For example, a £100,000 pension pot could have bought an income for a 65 year old male of about £7,000 in March this year with the best provider.

By September this had fallen to £6,500 and October it had slipped again to £6,250. But delaying buying an annuity and hoping rates will improve is often simply not an option.

Those retiring may need to look at all the options. With inflation forecasts uncertain it may be that (depending on your circumstances) a combination of retirement income options are appropriate in order to “hedge your bets” and provide a decent level of starting income whilst factoring in some protection against inflation. As ever it is important that you seek financial advice in respect of the best solution for you.

Investments

As well as cash savings, you

may wish to consider the long-term effects of inflation on your investments. What matters is planning for future inflation expectations – it is important to remember the ‘headline’ inflation figures represent past inflation. For example, exposing part of your portfolio to a well-diversified portfolio of equity funds (paying strong dividends) can be a good hedge against inflation, although these types of investments do not include the same security of capital which is afforded with a savings account.

It is important to stress, however, that inflation, is not the only (or necessarily the most important factor) when making investment decisions – For example, certain investments may carry more risk than you are willing to take and therefore financial advice is essential.

Whether you are looking for advice on the most appropriate retirement income options, looking to make your saving work harder, or just general advice on how best to arrange your finances please feel free to contact us for further guidance.

The value of your investment can go down as well as up and you may not get back the full amount invested.

Levels and bases of and reliefs from taxation are subject to change and their value depends on the individual circumstances of the investor.

Don't forget

– Self Assessment deadline approaching!

Although we are now entering the festive period, for those individuals who need to complete Self-Assessment returns the **31 January 2012** deadline for online returns is nearer than you might think!

Returns for tax year ending 5 April 2011 must be received by HMRC by this date, or a late-submission fixed penalty of £100 could apply. This penalty applies even if you have no tax to pay and there are further charges if the return is still outstanding 3 months later.

Where any tax is due this must also be paid by this date or HMRC will charge interest on any amount outstanding and also

a 5% late payment fee (again further fees may apply if the tax still remains unpaid).

There is also an earlier deadline of 30 December 2011 if you want HMRC to collect any tax you owe through your tax code. You can now request this if you owe less than £3,000, although HMRC cannot always collect tax due via this method (you would have to make this request clearly on your tax return).

