

THE STATE PENSION – PART VI 2007 AND BEYOND

Each year Forrester-Hyde publish a Fact Sheet and to avoid covering old ground reprint last year's Fact Sheet which will lay the foundation for this year's review.

Going forward, contracting-out Rebates are recalculated every five years by the Government Actuary's Department, GAD. GAD were criticised for setting the Rebates too low for the five years ending 5 April 2007. The Rebates were low because GAD made over optimistic assumptions. Firstly, GAD assumed Index-linked Gilt real yields would rise steadily to 3.5% by 2017. In the event they have remained stubbornly below 2.0% and have been trending downward. Second, longevity, how long people live, has improved more quickly than forecast.

The Financial Services Authority commissioned Oxford Actuaries and Consultants, OAC, to report on contracting-out. The OAC report concluded that Rebate levels should be 40% - 50% higher to ensure financial parity with Additional State Pension, ASP, benefits foregone.

GAD have now reported Rebates for five years from 6 April 2007 and when calculating Rebates have conceded that Index-Linked Gilt real yields will stay constant at 2%. Rebates for younger ages are increased between 0.5% and 1.9% a year. However, the cap on age related Rebates as a percentage of band earnings has reduced from 10.5% to 7.4%. This means on GAD assumptions, which I still consider optimistic, anyone over 43 is likely to suffer financially from being contracted-out after 2007; if they take their pension from age 65 in the same form as the ASP benefit given up.

As I have said repeatedly, people should review their decision to contract-out and should certainly do so before April 2007. However, to complicate matters further the Government have also published a White Paper. If the proposals contained in the White Paper are implemented there will be no increase in net Government spending on Pensions until 2030 and even then any additional cost will be minimal, around 0.1% of Gross Domestic Product, GDP. Part of the reason for this is the huge saving the Government will make on the partial abolishment of contracting-out, effective from 2012. This will release an estimated £4bn annually.

So what are the White Paper proposals?

- Abolish contracting-out for Defined Contribution Schemes from 2012
- Revalue the Basic State Pension in line with earnings and not prices from 2012, subject to affordability
- Reduce the number of years to qualify for a State Pension to 30 years
- Raise State Pension Age to 66 by 2024, 67 by 2034 and 68 by 2044
- Introduce a national, low cost Pension Scheme, the National Pension Savings Scheme, NPSS, from 2012, or 2015 at the latest, subject to affordability

To summarise, Rebates will go up from 2007 but not by much and contracting-out is, in any event, likely to be abolished from 2012. So, should you rejoin the ASP or should you continue to pack away as much Rebate cash in your Appropriate Personal Pension, APP, by continuing to contract-out for the next six years? Clearly, this Government is capable of reducing State Pensions retrospectively. So, do we, in fact, trust the Government to provide ASP, at the level promised? In theory our NI Contribution is supposed to be funding our ASP entitlement but in reality it is not because this week's NI Contribution pays next week's State Pension for someone else.

A little Government honesty would be appreciated. All Government Pension Schemes are unfunded; they are simply a promise to pay from future revenues. All across Europe Governments are struggling with the legacy of State run Pay-As-You-Go Schemes where promises are made about the amount of State Pension when the tab is picked up by future taxpayers.

Contracting-out has enabled many Pension savers to trade political promises for hard cash invested in their Pension with the additional flexibility of:-

- Access from age 50, increasing to 55 from 2010
- 25% of contracted-out fund as tax-free cash
- A contracted-out fund can be left as part of an Estate if the individual does not have a spouse or civil partner
- From April 2007 the facility to self-invest may be permitted

Contracting-out was sound advice in 1988 when a thirty year old could have received a Rebate of over 9% of band earnings compared with just 4.8% this year. Despite the marginal increase in Rebate contracting-out cannot be justified on the basis that the Rebate will outperform the State Second Pension given up. So, the decision to contract-out should be client led. The risk adverse and those who will rely on State Pensions to form a large part of their retirement income should contract-in. However, those who do not trust the Government to deliver on its promises may consider the "bird in hand," of Rebate in their fund, to be worth all the "promises in the bush." In addition the lure of tax-free cash, access before age 65 and the opportunity to manage one's own fund may well be sufficient incentive for many people to disregard the financial case and continue to contract-out.

To conclude, I have two quotations for you, one from the current Minister for Pensions Reform, James Purnell, and one from Frank Field who was Minister for Welfare Reform in Tony Blair's first Cabinet and who now Chairs the Pension Reform Group. James Purnell explained why the Department for Work and Pension had abandoned the project to build an internet based Retirement Planner, and I quote "Delivering accurate online information about State Pensions would become increasingly difficult, given the uncertainty about the exact shape of future pension provision." While Frank Field, in a speech to the Merseyside Life and Pension Society, said "The Government's proposed Pension Reforms are not so much preposterous, as positively dangerous." To finish on this point Christine Farnesh, the former Chief Executive of The National Association of Pension Funds, NAPF, is on record as saying "Under the White Paper proposals we are still going to have one of, if not the most complicated pension systems in the world, as there will still be ninety-five factors which will determine what State Pension each individual will get."

In our opinion the primary goal of any serious Pension Reform should be to simplify the system and make certain that it "Pays to Save." The Reforms proposed do not. If the current Minister for Pensions Reform is uncertain about the shape of future pension provision, how can we advise our Clients? What is fact, is that we are living longer and there will not be enough people paying Income Tax and National Insurance to fund the promises this Government have made, so either taxes must rise or benefits will be cut.

Further publications:-

- Contracting-Out of SERPS/S2P to an Appropriate Personal Pension – 08/2005 Oxford Actuaries and Consultants
www.fsa.gov.uk/pubs/pensions/oac2005.pdf
- Pensions: The Basics – A Guide from the Government – 09/2006
The Pension Service
www.thepensionsservice.gov.uk/serps/home
- Pensions: Contracting-Out
"Which?"
www.which.net/campaigns/personalfinance/savingsandpensions/contractingout
- State Second Pension and Contracting-Out – May 2006
Financial Services Authority
www.fsa.gov.uk/consumer/pensions/one_review/contracting_out
- Review your Pensions, State Second Pension and Contracting-Out - July 2006
Financial Services Authority
www.fsa.gov.uk/consumer/pensions/one_review/contracting_out
- The State Pension – should you be Contracted-Out - November 2006
Financial Services Authority
www.fsa.gov.uk/consumer/pensions/one_review/contracting_out
- Contracting-Out of the State Second Pension – Some Important Q&As - 2005
Association of British Insurers
www.abi.org.uk/publications/pensions

This Fact Sheet is prepared by Forrester-Hyde LLP and is based on our understanding of the Law as at November 2006.

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