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Provident Money

Your independent *window on financial issues*

Spring 2007

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- Budget overview: the impact on families and businesses.
- Inflation alert: Inflation recently hit 3%. Even if it should subsequently soften, there could be worse to come.
- Interest rates: it is unlikely that recent increases will be the last. We consider some ideas about how to manage debt.
- Long term care can be stressful enough without the associated concerns over how it can be funded. We look at some options.
- National Pensions Savings Scheme: will they offer a lifeline to those with inadequate pension provision, or is this a false dawn?
- Back page briefing: Some good news for the long term future of ISAs. But not yet.

Gordon Brown's final budget?

In what is planned to be his last outing in this role, the Chancellor promised a budget for "families, for fairness, and for the future".

The result is a budget that is not entirely helpful to many sectors of society and business. What he most certainly has not done is to help small businesses. In pandering to the large corporations that shout loudest, by reducing their tax rate to 28% *for 2008/9*, he has quietly not only removed the £10,000 profit that small companies could make before paying tax (which he did in the 2006 budget) but has also decided to increase the rate of tax they pay from 19% this year to 22% gradually over the next three years. So much for building up reserves within a small business!

Families fare no better. The headline reduction in the basic rate of tax from 22% to 20% *in 2008/9* is accompanied by the stealthy removal of the 10% tax rate that applies to earnings and pensions up to £2,230 for 2007/8 (£2,150 for 2006/7). The lower rate remains for income on savings and capital gains.

However, taxes generally on smoking, drinking and driving – especially for those with larger cars, which actually includes most medium sized cars, too – all go up *this year*.

It is also likely that, for most middle income families, the effect of homogenising the national insurance and income tax bands will, at best, reduce any benefit from the lower headline rate.

There are some changes for investments. The Cash ISA limit will rise by 20% to £3,600 *in April 2008*, but the overall limit will only be increased to £7,200; this effectively *reduces* the equity content, so the Chancellor appears to be trying to alter the balance of equities and cash.

Enterprise Investment Schemes and Venture Capital Trusts also come in for some changes. Principally that the number of employees within investee companies has been limited to 50. A maximum of £2 million now applies to the amount of capital (from any relevant scheme) that can be raised within a 12 month period, by each investee company. He has also relaxed the time-frame for EIS managers to invest their cash from six to 12 months, which

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Chancellor uses sleight of hand, as usual

may help them to be more selective.

There was very bad news for anyone wishing to take out term assurance using the pension rules introduced just last year. As announced in December's Pre-Budget Report, this facility is being withdrawn, other than for employer contributions. Any payments on death continue to count towards the lifetime allowance.

The vexed question of Alternatively Secured Pensions was also disappointingly handled with the government insisting that it will tax any funds "left over" on death after age 75 at up to 82% or more. This is despite thousands of people having signed a petition to argue against it. However, the minimum level of income that must be drawn has been slightly reduced.

A major missed opportunity was, of course, the Chancellor's failure to do anything at all about Stamp Duty. This, like inheritance tax, affects an increasing number of families each year.

The consequence of this budget means that obtaining financial advice is even more important to help ensure you minimise your tax liabilities.

Prepare for inflation

Inflation hit 3% by the end of last year – just below the level at which the Bank of England's Governor has to write a letter explaining why we are more than 1% above target.

But this rate of inflation does not necessarily accord with individual experience because the Consumer Price Index (CPI), which is the favoured measure, excludes mortgages and council tax. The Retail Price Index (RPI) hit 4.4% last year; and if you want to see your personal rate of inflation, visit a government website (www.statistics.gov.uk/pic/). The chances are that most of our clients will experience a rate far higher than the headline. In some cases, it can be as high as 7.5% or more.

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Inflation hits some harder than others

Rising inflation can be a problem for many people, especially those on a fixed income. In particular, because headline inflation almost always lags behind increases in earnings, pensioners can find themselves progressively worse off than those in work. The government has announced its intention to link the basic state pension to National Average Earnings from 2012 – provided it is deemed affordable by whoever is then in power – but this is too little, too late for many people.

Saving for retirement is even more important now than ever, especially as those aged under 47 will now probably have to wait beyond age 65 in order to get a state pension – rising to 68 for younger people.

Recent research by **Which? Money** suggests that people estimate their income needs, in today's terms, to be £312 a week. With today's state pension at £84.25 for a single person, this leaves a gap of £227.75 a week, or almost £12,000 a year. Based on annuity rates at the start of 2007, a fund of more than £225,000 would be needed to provide a 65 year old man with an income of that size (increasing at 3% a year).

Pensions are a natural way of planning for retirement. They can, however, be rather inflexible even after the relaxations introduced in April 2006, which allow individuals to access a pension commencement lump sum (currently free of tax) of up to 25% of their total pension fund without having to draw an income – or even to retire.

The principal benefits of pensions are that:

- Tax relief is allowed on contributions up to your entire earnings (other than from investments and rental income), subject to an annual allowance of £215,000 for 2006/7 (£225,000 for 2007/8 and rising thereafter); and
- Investments grow free of UK tax (other than the 10% withholding tax on dividends from UK companies).

The principal disadvantages are that:

- Funds are not available before age 50 (rising to 55 in April 2010); and
- Only a quarter of the fund can be taken as a lump sum – the rest must be taken as some form of income which is subject to tax.

There are however other investments that are not quite as tax efficient but are far more flexible, such as Individual Savings Accounts (ISAs) which, it has recently been announced, will become a permanent feature of the investment landscape (see back page briefing). ISAs are particularly flexible since although the contributions are limited to £7,000 per person each year, money can be taken out as a lump sum or an income totally free of UK tax at any time. In addition, the tax status of money within the fund is broadly the same as for pensions.

There are other investments that can be equally tax efficient such as Venture Capital Trusts, Enterprise Investment Schemes and Enterprise Zone Property Trusts, but these tend to involve substantially higher risk and are not suitable for many investors.

Key points:

- For many, inflation is rising faster than headline figures suggest.
- Younger people will be retiring later than expected.
- There are alternatives to pensions which should be considered.

Rising interest rates – what can borrowers do?

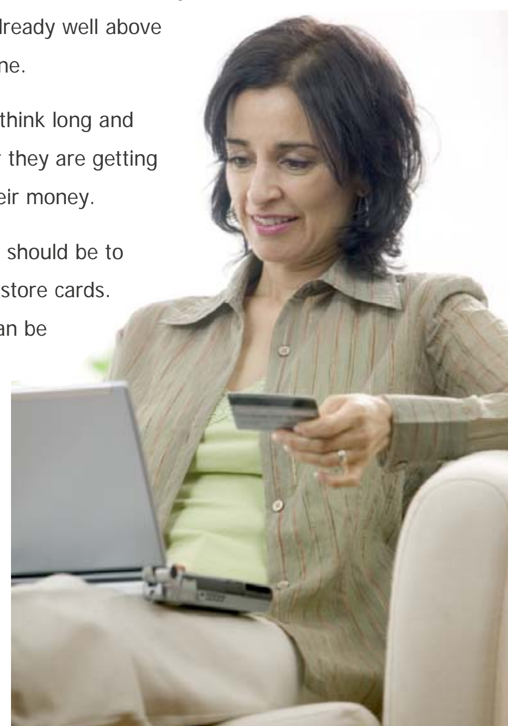
At the time of writing, interest rates had just been increased to 5.25%. But few people believe this is the end of the story.

Indeed, there is a widely-held view amongst economists that there is still some way to go before we reach a peak. The Bank of England claimed that the step was intended to help fight inflation – presumably by reducing demand as consumers have to tighten their belts to accommodate higher borrowing costs. But since the next round of wage bargaining is now in full progress, pay claims could escalate now, before higher interest rates actually bite, leading to "cost push" inflation.

Whatever the reasons, we are unlikely to see interest rates fall in the short term – despite forecasts that they will soften in the US and the fact that our rates are already well above those in the Eurozone.

So borrowers must think long and hard about whether they are getting the best deal for their money.

The first port of call should be to consider credit and store cards. The cost of these can be astronomical, yet for many people there is a simple option of consolidating the borrowings into their mortgage, where interest rates are usually much lower. All it requires is a little time in making the arrangements. Most lenders today are only too pleased to facilitate re-mortgages; they know it is good business for them and as loans are secured on the home, their risk is relatively low.


Credit and store cards are expensive

The same applies to any other unsecured borrowing; rates tend to be higher than for secured loans yet, while your home may not be directly used as security, a lender can certainly expect you to use all your assets to clear the loan should you default (although they are lower down the pecking order than secured lenders).

Savings could also be made on ordinary mortgages, simply by looking for the best deal around. If you are approaching the end of a "special deal" then now could be the time to consider switching, because your rate might well be just about to revert to the Standard Variable Rate – just when interest rates generally are rising. Going for a fixed or capped rate mortgage now could carry you over (what we hope will be) a peak in interest rates and you can re-arrange the loan again later, when rates have (hopefully) softened again.

One point to remember is that, if there is an exit penalty that "overhangs" the "special deal" period, you could end up out of pocket, so you need to be aware of the costs involved and the potential savings that they are balanced against.

Key points:
- Interest rates have probably not yet finished rising.
- Unsecured borrowings should be reviewed to find better options.
- Mortgage arrangements should be reviewed to find a better deal.

Paying for long term care

There are two sides to every coin and on the "other side" of increasing life expectancy is the likelihood that more of us will need care later in life as we are no longer able to look after ourselves.

Throughout the UK the average cost is £526 a week – that is more than £27,000 a year – if nursing care is required. There are, of course, regional variations. For example, if nursing care is *not* required the cost can be as low as £298 a week – even less in Scotland – while accommodation plus nursing care can cost as much as £705 per week in Greater London.

Long term care is very expensive

Paying for a nursing home, whether or not care is required, will therefore be a challenge for many people; if you spend just three and a half years in care in the West Midlands, the cost could be as much as £90,000 – that is without allowing for inflation between now and the time when care is first needed ... and beyond.

The problem is that while nursing care is generally (meant to be) covered by the state, all other costs are subject to means testing, so above a fairly modest asset level (about £20,000), individuals will probably have to fund most or all of the cost themselves. For those with parents already approaching the need for full time care, this can be of concern right now.

One good thing is that rising house prices mean many older people have considerable equity within their homes and this can be used to pay for long term care. During the last ten years, average house prices have almost trebled from £62,453 to £186,954, according to Halifax Bank of Scotland. From one perspective this growth can be seen as being adequate to cover the cost of long term care for some years.

There is, however, no guarantee that the money will last out, or that costs will not escalate to an unmanageable level; and if there is a surviving partner when care is needed, then the house cannot be sold as it is still required. So relying on the home may not be an option.

Your home could help

One alternative to selling the home is to use an equity release or lifetime mortgage scheme. There are, however, downsides to the different schemes on offer and you should certainly obtain a personalised illustration and seek professional independent advice before going down this route.

For many people, it will be their pensions and investment arrangements that are ultimately used to meet the cost of long term care. Using an unsecured pension at retirement (rather than purchasing an annuity) whereby a lower level of income is taken at retirement in order to leave more in the fund for use later on, is an option for some. However, the maximum income that can be drawn is 120% of the annuity rate at the time, so unless the fund is very large, this may be inadequate.

In addition, the rules change at age 75, when long term care is more likely to be required, and an alternatively secured pension must be used. This is currently subject to a maximum income of 70% of the annuity for a 75 year-old, although this is set shortly to be increased to 90%, with a minimum of 55%.

It may therefore be easier to consider using other investments (including the tax free lump sum under any pension arrangements) in order to generate an income to cover the cost of long term care. It is important to consider the most appropriate investment strategy, since volatile and high risk investments are unlikely to provide the stability necessary to provide a reliable income stream.

Key points:
- Care for the elderly is expensive, especially if nursing is needed.
- Prices vary throughout the UK.
- Funding options include equity release and pensions.

Will the proposed new NPSS help?

Recognising that the state pension system is inadequate to provide a decent standard of living, the government has proposed the introduction of some changes.

To add to the problem, the government has announced that state pensions will be deferred, for anyone currently under age 47, increasing in stages from 65 to 68.

In order to help people plan better for retirement, the government

proposes a new National Pensions Savings Scheme (NPSS). In outline, the scheme (probably to be introduced in 2012) will involve a 4% member contribution, 3% from employers and 1% from the government, all based on earnings between lower and upper limits. It is unclear whether employer contributions will qualify for tax relief.

It is expected that those who do not belong to a workplace pension scheme will be automatically enrolled into the NPSS unless they opt out, and that employers will be compelled to contribute to their workers' NPSS. However, employers who offer a pension scheme can opt-out of the NPSS provided their scheme operates auto-enrolment and the level of contributions match those under the NPSS. One fear that has already been expressed is that some employers operating more generous schemes may decide to close them, auto-enrolling employees in the NPSS instead, in order to save money.

There are several potential problems with the NPSS. In the first place, it is feared that those on lower incomes – the very people the government wishes to help – will actually be worse off in some cases, because the benefits they use their hard-earned cash to build up, will actually **reduce** their means-tested benefits in retirement, especially the pension credit. This means that they will effectively be reducing their income today, for little long term benefit.

Secondly, the government does not have a good track record in creating administration systems to handle such large numbers of small records, nor does it have any experience in investments. In effect it will need to out-source these functions, but the costs "cap", which is expected to be 0.3% of fund values, is unlikely to allow administrators and fund managers to make any profits and will certainly not cover the cost of advice.

The Treasury has recently announced that it will provide free financial advice to every adult in the UK, although this will not cover the advisability or otherwise of contributing (or not) to the NPSS. However, if each adviser spends just three hours including preparation time with each of 20 million adults in the UK then, based on a 35-hour week and a 47-week working year, we will require at least 36,000 qualified and authorised advisers to provide this service!

State 'advice' will not cover NPSS

One interesting point is that it appears that the government wishes it to be possible for money saved in the NPSS to be inherited, which is directly contrary to its arguments for seeking to stifle Alternatively Secured Pensions within a year of their birth.

The plans are, at least, a response to a real problem; that too few people make sufficient provision for their retirement. The response is probably, however, too little and will depend on a degree of good will from many parties to make it work. In practice, it may often be better to rely on personal pension planning, including good occupational schemes, than to depend on the state to provide a reasonable standard of living in retirement.

Key points:

- The NPSS could lead to more scheme closures.
- Cost constraints may limit investment in systems and active fund management.
- Personal provision is essential.

Back page briefing—Good news for ISAs… but not quite yet …

Individual Savings Accounts (ISA) are an excellent way of protecting your money against tax.

Money invested in ISAs is protected against UK income and capital gains tax (except the 10% withholding tax on dividends) and when the money comes out, either as a lump sum or an income, it is totally free of tax, under current regulations.

The problem has always been that this was seen as a temporary arrangement, nobody knew what would happen after ten years. Going on past performance they could easily have been withdrawn or replaced with something less beneficial.

It was therefore pleasing to hear in the December 2006 Pre-Budget Report that ISAs are finally to become a permanent feature of the financial landscape.

More importantly, there are a number of changes to be implemented – probably from April 2008 – that will make them simpler. From then Personal Equity Plans (PEPs) which still exist for investments made prior to 1999, will be integrated into the ISA regime, making it far easier to move money between managers, if required. In addition, the distinction between mini- and maxi- ISAs will disappear.

Currently investing as little as £1 in a cash mini-ISA would instantly reduce the maximum you could put into a maxi-ISA from £7,000 to £4,000 because you could not invest in a mini- and maxi- ISA during the same year.

Under the new rules, it will be possible to invest up to £3,600 (for 2008/9) in cash and the balance up to £7,200 in equities but there will be no distinction between the actual arrangements used. An added bonus is that you will be able to switch money from cash to equities (but not *vice versa*) if you wish to. So cautious investors who wanted to build up a cash reserve no longer have to keep it there but can gradually, as funds grow, move some cash over to equities.

By using the maximum investment, husbands and wives (or civil partners) can invest as much as £14,000 (for 2006/7 and 2007/8) between them. But beware, if you do not make your investment before the close of business on the last working day of the tax year (Thursday 5th April, this year) you lose that year's allowance for good and have to count investments towards the next tax year.

This publication does not provide individual tailored investment advice and is for guidance only. Always seek independent advice from a qualified financial adviser.

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We cannot assume legal liability for any errors or omissions it might contain. Levels and bases of, and reliefs from taxation are those currently applying or proposed and are subject to change; their value depends on the individual circumstances of the investor. The value of land and buildings is generally a matter of a valuer's opinion rather than fact. The value of investments can go down as well as up and you may not get back the full amount you invested. The past is not necessarily a guide to future performance and past performance may not necessarily be repeated. If you withdraw from an investment in the early years, you may not get the full amount you invested. Changes in the rates of exchange may have an adverse effect on the value or price of an investment in sterling terms if it is denominated in a foreign currency.

Your home may be repossessed if you do not keep up repayments on your mortgage. Loans are subject to status and written details are available on request.

Think carefully before securing other debts against your home. Fees for mortgage advice maybe charged and for details of these please contact us.

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