

Why Did My Pension Shrink?

Introduction

This Fact Sheet contains **important information for all those who have one or more 'money purchase' pension plans**. This includes all forms of private pension plan such as a personal pension, stakeholder pension and retirement annuity contract, as well as many types of group pension and money purchase pension schemes provided by employers.

It concerns the fact that, with effect from 1st April 2003, the illustration of your projected pension benefits from these types of plan are affected by the innocuous sounding **Statutory Money Purchase Illustrations (SMPIs)** rules.

These SMPIs, at a stroke, **halve the amount of projected pension** that you might have been expecting based on pensions statements produced for your plan(s) prior to April 2003.

What are SMPIs?

Put simply, Statutory Money Purchase Illustrations have **to show the real value in today's prices, of the income that you can expect to buy with your pension fund at retirement**.

This income is normally provided by the purchase of an annuity, which is a guaranteed income for the rest of your life.

SMPI illustrations assume 2.5% inflation between now and retirement and a maximum return of 4.5% a year for equity (ie stocks and shares) linked funds and less for other types of investments.

These restrictions make a big impact on an otherwise healthy looking pension fund. For example, if you have fifteen years to go to retirement **it will reduce the pension figure you were previously shown by around a third**.

However, there is more. Previously, your annual pension statement assumed that you would purchase a level pension at retirement, that is, one which does not increase with inflation.

In the 'good old days' **an average man would retire at 65 and be dead by 76** so inflation proofing was not so necessary.

However, we are all living a lot longer and we should expect to have to live on our pension and investment income for 20 or 30 years or more. Level pensions do not make sense for these periods even if inflation remains below 3% which, of course, is not inevitable.

The SMPI therefore **assumes that you will purchase an annuity which will provide an income that increases in line with retail prices**. On top of the reduction for inflation this will mean a further reduction of around 30% in your perceived pension.

However, there is even more. Previously, your annual pension statement assumed that you will be single when you retire. This is simply not the case for many people who retire with a spouse or partner who is dependent on their income in retirement to some extent.

The SMPI therefore **assumes that you will purchase an annuity which will provide an income on your death to a spouse or partner of 50% of the level of your pension**. This will mean a further reduction of around 15% in your perceived pension.

It should be stated that there is no requirement for you to purchase an inflation linked pension, or to have one that provides a pension to your spouse on your death but even if you ignore these factors the effects of inflation are real enough.

Has My Pension Really Reduced?

The real answer, of course, is no. However, it will certainly seem to have reduced if you were lulled into a false sense of security by the previous annual pension statements.

This is a **deliberate shock tactic on the part of the Government**. It hopes that these new style statements will act as a clarion call to prompt people to increase contributions to a more realistic level.

From 'A-Day', the 6th April 2006, the Government is scrapping various existing maximum pension contributions and replacing them with a **lifetime maximum tax exempt fund limit of £1.5m**, which will be linked to inflation.

This figure of £1.5m is apparently based on **the fund that is currently required to provide an inflation linked pension of two thirds of the average wage**.

Pension funding **has therefore come down to a very simple calculation**. How far short are you of the Government's calculated pension fund of £1.5m to enjoy a financially secure retirement?

What if I Have 'Final Salary' Pension Benefits?

You should count yourself lucky that someone else (ie your employer) is taking the investment risk for part of your pension at least.

However, **the days have gone when you could work out your expected pension at retirement by simply counting the number of years of service you will have completed.** Over the past few years many defined benefit (also known as 'final salary') pension schemes have closed their doors to new members.

According to the latest figures from a top actuarial firm, this has saved employers around 5% of the annual pension bill. However, it is estimated that employers need to reduce their annual pension bill by some 30% and **that, for many schemes, will mean future promised benefits will have to be reduced.** All you can really rely upon in such schemes is the pension you have earned by your service to date.

What Do I Do Now?

We hope that you have now recovered from the shock of the new style statement, and that you will want to sit down with an independent financial adviser and **work out a financial plan to make sure** that, as far as possible, your retirement is financially secure.

We can take account of your various existing pension plans, whether they are occupational pension schemes or personal pension plans, and add them to your projected State Pension benefits, **to give you a clear idea in today's terms of your likely pension in retirement.**

If you are a member of a 'final salary' pension scheme you should **start directing your attention to the pension actually earned** and start ignoring the projected figure at your normal retirement age.

How Much Can I Set Aside From Now On?

Once you have decided that urgent action is required you will need to know what you can set aside for your retirement. In the comments that follow we are assuming that you are not currently a member of an occupational pension scheme that provides benefits on a defined benefit basis (ie a 'final salary' scheme). If you are we can still advise you but our advice will take a different path to the following.

First of all **there is the current position.** If you will be, say, **age 36 on 6th April next, you can contribute 20% of your income** to a personal or stakeholder pension plan. If you will be **age 46 you can contribute 25%** and so on.

Even if you are currently on a very low income, or no income at all, you can contribute up to £3,600 (ie £2,808 net of tax) without any requirement to prove your income.

However, from 'A-Day' **the pension contribution limit will be raised to 100% of your income irrespective of your age**, up to a maximum contribution of £200,000 a year.

Suddenly a £100 to £200 a month pension contribution **will look ridiculously low** and be shown as incapable of providing a proper level of income in retirement.

Is a Pension Plan the Only Answer?

In essence the Government is saying that we all need to build up an extremely large capital sum to provide ourselves with a proper level of income in retirement. **Contributing to a pension plan is certainly not the only way to achieve this.**

However, the advantageous tax treatment of both the pension contributions and the resultant pension fund, and the ability to take 25% tax free cash from that fund at retirement, make **a strong case for making a pension the foundation of your pension planning.**

Once a properly funded pension plan is in place, then by all means use other investment vehicles. Most people find a good alternative in **Stocks and Shares ISAs.**

We would encourage you to invest in these via a fund supermarket for ease of administration and ease of receiving fund valuations from us. For those who can cope with a higher element of risk, for which they will receive even more tax benefits, **we recommend building up a portfolio of Venture Capital Trusts VCTs.**

Risk Factors

An investment into a Stakeholder Pension or other Personal Pension Plan is intended as a long-term investment. Where past performance is mentioned please note that the past is not necessarily a guide to future performance.

An investment into a Stocks and Shares ISA, VCT, or other collective investment scheme is intended as a long-term investment. Because this investment may go down in value as well as up, you may not get back the full amount invested.

For Further Info

If you would like a review of your pension planning please ask your usual Arch adviser or contact us via one of the following:

Tel: **01483 204600**

Email: **enquiries@arch-fp.co.uk**

Online: **www.arch-fp.co.uk**

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