Annuity rates hit 25-year record low

Annuity rates hit their lowest level since 1994 in September, with implications for those making retirement decisions.

Since the introduction of pensions flexibility in 2015, annuities have become much less popular as a way of converting a pension fund into income. The most recent figures from the Financial Conduct Authority show that over five times as much money is placed in income drawdown now as goes towards annuity purchase.

Now annuity rates have been back in the news, with several press reports citing calculations from the Moneyfacts comparison website that rates had hit their lowest level in 25 years. According to the data, a 65-year-old purchasing an ordinary pension annuity, with no increases in payment and no minimum payment period, could expect to receive just 4.1% – £410 a year per £10,000 of investment. That was a significant drop from the start of 2019, when an extra £58 a year was on offer.

In the short term, the cause of the annuity rate decline has been the drop in long-term interest rates since January. For example, the yield on a 15-year UK government bond fell from 1.56% at the start of the year to 0.86% by mid-September. This fall in long-term rates has been a global phenomenon, resulting in negative interest rates spreading to many international bond markets.

The longer term fall in annuity rates also reflects declining interest rates, which have been on a multi-decade downward path. In addition, increased life expectancy has put downward pressure on annuity rates, although this effect has receded latterly as recent statistics have suggested life expectancy improvements are flatlining.

The preference for drawdown, however, comes with investment and mortality risks – investment returns may be below expectations and/or you may outlive your pension pot. If nothing else, the annuity rate can provide a benchmark against which to consider the rate of income withdrawals.

If you are approaching retirement, make sure you take advice before dismissing annuities completely, especially if you are risk averse or will have few other sources of retirement income.

If you are some way from retirement, remember that 4.1% figure when you think about how much you want to contribute to your pension. After all, at 4.1% a £25,000 pension annuity – with no inflation protection or spouse's benefits – will cost about £610,000…

Interest rates back on the slopes

In September the US and European central banks cut interest rates, again.

When the US central bank, the Federal Reserve, cut its main interest rate by 0.25% at the end of July, it was the first reduction in over 10 years. Less than two months later, the Fed announced a second cut by another 0.25%.

The Fed's move followed on from a rate change at the European Central Bank (ECB). Here, the main rate was left unchanged (at 0.0%), but the *negative* rate applied to deposits made by commercial banks was moved from -0.4% to -0.5%. A bank leaving €1m with the ECB for a year will have to *pay* €5,000 for the privilege.

The Bank of England kept its interest rate unchanged at 0.75% in September, not least because, like the rest of the UK, it is waiting to see what happens on the Brexit front. Investors in government bonds appear to be expecting further rate cuts as the return available on gilts maturing in six months to 12 years' time is less than the current base rate.

The central banks are worried about a slowing global economy and the risk of a recession. They are less concerned about their nations' savers. This stance was highlighted in a headline in *Bild*, Germany's best -selling newspaper, which took aim at Mario Draghi, the head of the ECB: “'Count Draghila is sucking our accounts dry'.

Depositors in the UK are not yet facing negative interest rates, although there are plenty of bank and building accounts (including ISAs) closed to new business which pay next to nothing (e.g. 0.1% for the Halifax Bonus Gold account). At the time of writing, the best rate available for instant access was 1.61% from a sharia account, compared with the latest published CPI inflation rate (for August) of 1.7%.

There are still income yields of 4% and more available – for example the average UK share dividend yield at the time of writing was 4.23%. However, the higher income comes with greater risk to capital, making independent investment advice essential. There has been evidence enough just this year, in the problems at London Capital and Finance, that chasing the highest yields without advice can be a dangerous strategy.

Blue chips take a knock as Marks & Spencer relegated

Marks & Spencer was demoted from the FTSE100 in September.

Source: London Stock Exchange

The FTSE100 is subject to a quarterly review of its 100 constituents. The process is not quite as simple as picking the 100 largest companies listed on the London Stock Exchange, but it's not far off. The latest review took effect on 23 September 2019 and received more attention than normal because it marked the ejection of one of the founder members of the index in 1984, Marks & Spencer (M&S).

The demotion – M&S is now a member of the FTSE250 – came as no surprise to market followers as the retailer had only just avoided the axe at the June review. As the graph highlights, over the last four years M&S has underperformed the index, with its latest decline prompted by the February 2019 announcement of a dividend cut and a rights issue to raise more capital.

M&S was one of three companies that left the FTSE100 in September – the others were Direct Line and Micro Focus. Its departure means that just over 25% of the FTSE100's original members remain. Over 300 companies have entered or exited the FTSE100 since 1984, sometimes on an almost revolving basis.

The index itself has changed considerably over the years, often as the result of takeovers and mergers. But the landscape has shifted too. At its launch, the index's two largest sectors in terms of company numbers were financials (banks and insurers) and industrials. The financial sector remains the biggest, but unsurprisingly the representation of industrials has shrunk.

Consumer services now match financials for the number of companies in the index. The sector included M&S, but after its exit only four of the original fifteen FTSE 100 consumer services constituents are still index members (Sainsbury's, Tesco, Whitbread and Pearson).

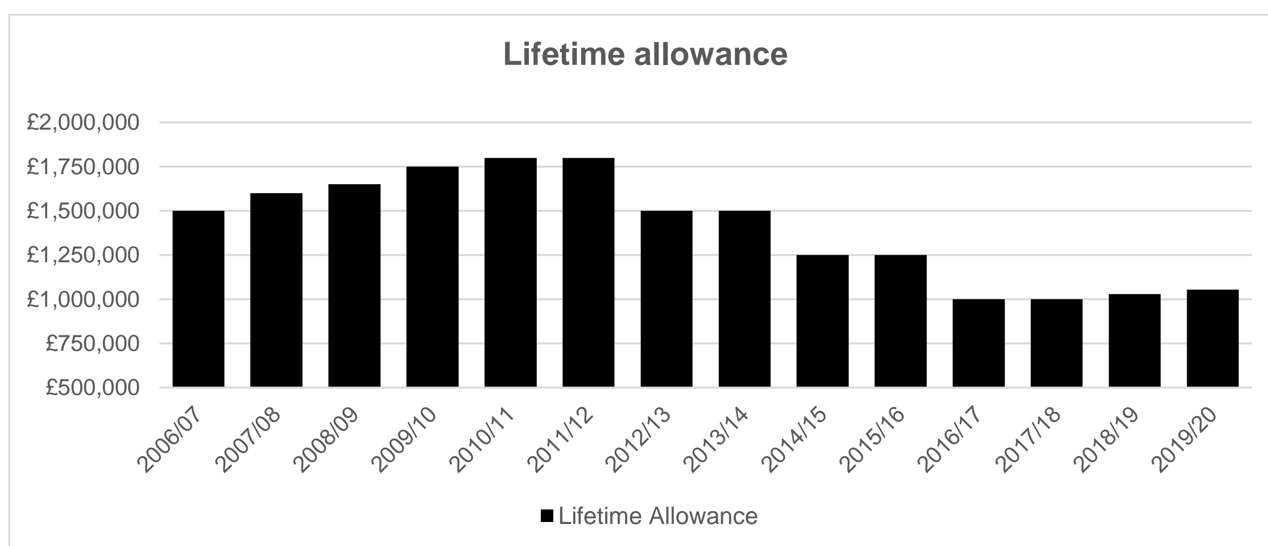
The gradual decline of M&S, which has been evident for some years, echoes many similar events over the years – British Home Stores was also once a member of the FTSE100. It is a reminder that as a long-term strategy, buying and holding 'blue chip' shares carries risks. The world changes: if your investments stand still, they may be left behind.

Could your protected pension allowance tip over the edge?

An obscure adjustment to old pension benefits, mandated by the courts, might cost some pension owners many thousands in additional tax.

The problems caused by the tapering of the annual allowance have been making the pension headlines for some time. Whereas the original focus was on NHS consultants and doctors, the issue is now rippling through other higher paid parts of the public sector, such as the senior levels of the armed forces and civil service. The government has started to suggest reforms, but these have concentrated on tweaking membership of the pension schemes involved rather than reforming the pension tax legislation.

Another pension allowance conundrum is now looming, this time involving the *lifetime* allowance, which effectively sets the maximum tax-efficient value of all your pension benefits. The lifetime allowance has been reduced on three occasions, bringing it down from £1.8m in 2011/12 to £1.0m in 2016/17.



On each occasion the cut was accompanied by the launch of a ‘fixed protection’ option, allowing those affected to retain the existing allowance. So, for example, the 2012 version of fixed protection allowed the £1.8m lifetime allowance to be retained.

However, there was an important condition attached to all these fixed protections: they are lost if any additional contributions are made or any benefits are increased beyond the pension scheme’s normal indexation rules. At worst, an extra £1 of pension could see a fixed protected lifetime allowance of £1.8m reduced to the current standard lifetime allowance of £1.055m. In an extreme case, that could create an extra tax liability of over £400,000.

In theory the restriction means anyone with fixed protection should studiously avoid any risk of falling into that extra pension trap. In practice, some people – particularly the non-advised – forget or are unaware of the pitfall.

Now there is another potential danger, even for the diligent. An arcane 2018 High Court ruling on how to deal with equalisation of certain state-related pension benefits from the 1990s threatens to make automatic small increases to the benefits of some members of final salary pension schemes. Potentially enough to tip some over the threshold.

The situation now is that:

- The law, as interpreted by the High Court, says these 'GMP equalisation' adjustments must be made.
- Many pensions schemes have been, or are in the process of, calculating what those payments should be; but
- Everything has gone on hold for fear of the tax consequences. HMRC has not issued any guidance on the matter and is still 'carefully considering' what to do.

If nothing else, the problem is a reminder that if you have any form of pension protection, it can be highly valuable and advice should always be sought before any changes are made.

New thinking for Labour on taxes?

New proposals for reforming capital gains and income tax have been published by an influential think tank which could make their way into an election manifesto.

The Institute for Public Policy Research (IPPR) is "the UK's pre-eminent progressive think tank", according to its website. This may sound like boasting, but it is probably a fair description of the IPPR's position in the nerdy world of political think tanks.

Unsurprisingly, its thoughts regularly work through to become Labour Party policy and, less frequently, are also 'borrowed' by other political parties. It is therefore worth taking note when the IPPR publishes proposals on personal tax reform, which it did in September. With an election apparently drawing ever closer, the IPPR's ideas assume even greater relevance.

Its latest proposals, in a paper entitled, "Just tax: Reforming the taxation of income from wealth and work" focus on two areas.

Taxing capital gains

The IPPR starts from the premise that "that income from wealth should be taxed the same as income from work". This translates into a plan to:

- tax capital gains as income;
- scrap the capital gains tax (CGT) annual exemption of £12,000 and replace it with a minimal allowance of perhaps £1,000;
- remove the CGT exemption which currently applies on death; and
- withdraw most CGT reliefs, other than those for an individual's main residence.

The IPPR floats the possibility of reintroducing some allowance for inflation (remember indexation relief?) or a minimum rate of return linked to 10-year bonds (which currently yield about 0.6%).

Income tax and National Insurance Contributions (NICs)

The IPPR proposal here is more radical and will affect many more taxpayers:

- Income tax and NIC rates should be merged to produce one rate, which applies to all income, from whatever source;
- The personal allowance should be reduced to bring it into line with the starting point for NICs (about £8,600); and
- Tax rates should rise gradually, rather than using the current band approach. For example, the IPPR suggests the rate could start at 2% and rise to 50% on income above £100,000.

If this system were adopted on a tax-neutral basis, that is, producing the same income for the Exchequer as the current structure, the IPPR says that "around 80%" of taxpayers would see a rise in take home pay. The obvious corollary goes unmentioned.

If you needed a reason to revisit your tax planning now rather than later, the IPPR may have just supplied it…