

Pension savers 'short-changed by £7bn a year'

MILLIONS of workers in final-salary pension schemes are being short-changed by up to £7 billion a year because their companies are offering them derisory lump sums when they retire.

Members in private-sector final-salary schemes can typically take a tax-free lump sum worth one-and-a-half times their earnings on retirement, but they must give up part of their pension income in return.

The vast majority take the cash, often to pay off their mortgage or fund a once-in-a-lifetime holiday, but many do not realise that the pension they have given up is worth far more than the lump sum — even though the cash is tax-free.

Standard Life, the insurer, has calculated that workers are missing out on between £5 billion and £7 billion a year. It said that about 250,000 people retired from private-sector final-salary schemes every year, taking an average lump sum of £20,000 — or £5 billion in total. But, it said, they gave up pensions worth £10 billion to £12 billion.

John Lawson, head of pensions policy at Standard Life, said: "The decision to take a tax-free lump sum is one of the worst choices most people can make. Members who opt for the cash are being treated unfairly and, if more people realised this, the trustees of company pension schemes could find themselves in court."

The problem is confined to the private sector: public-sector workers have the luxury of being able to take a tax-free lump sum without a corresponding cut in their pension income.

Private-sector workers are generally left in the dark about the true value of the pensions they have given up. Companies simply give staff the options — a full pension or a tax-free lump sum plus a reduced pension — with no explanation.

Standard Life says workers are losing a fortune by taking lump sums in final-salary plans.

By Kathryn Cooper

Gareth Jones of Punter Southall, a firm of actuaries, said: "Schemes do not advise members about the relative merits of the cash or pension option because this would need to be handled by an adviser regulated by the Financial Services Authority, the City watchdog."

However, company pension schemes have an interest in members opting for a lump sum. They are grappling with the rising costs of regulation and longer life expectancy, and if more people took their full pensions it would simply add to the burden.

Mike Sarjeant of PPM, a pension consultant, said: "If all those eligible stopped taking their tax-free cash and opted for their full pensions instead, the solvency position of pension funds would be much worse."

Suppose you retire at 60, after 40 years' service, on earnings of £45,000. If your pension is credited with 1/60th of final salary for every year of service, your expected pension would be £30,000 (40/60th of £45,000). You could take a maximum tax-free lump sum of one-and-a-half times your final earnings, or £67,500. But you would have to give up some pension income in return.

The amount of pension given up is calculated using "commutation rates". Most schemes have commutation rates of about 12, which means that for every £12 of tax-free cash,

members must give up £1 of annual pension income.

So, in this example, if you took the maximum £67,500 tax-free cash, you would have to give up pension income of £5,625 a year (£67,500 divided by 12).

However, this calculation understates the value of the pension income, according to Standard Life. If you wanted to purchase an annuity of £5,625 a year in the open market, you would need a lump sum of £163,125. This is 29 times the pension income given up, whereas the company is giving you only 12 times.

The figures assume that you buy an index-linked annuity, and that your spouse will get 50% of your pension when you die. Rates on this type of annuity are about 3.5%.

Lawson said: "Put another way, you are giving up a pension worth £163,125 in return for just £67,500. This is an amazingly poor deal."

Even if you take account of the tax break, it remains a poor deal. A cash sum of £67,500 is effectively worth £112,500 to a higher-rate payer because there is no tax to pay — still less than the market value of the pension income you have given up.

And if you put your £67,500 lump sum in a savings account at 4%, you would earn a gross income of £2,700, or £1,620 after higher-rate tax.

You would also get a gross pension income of £24,375 from your final-salary scheme (£30,000 minus the £5,625 you have given up), which would be worth £14,625 after top-rate tax. This gives you a total post-tax income of £16,245.

But if you took your full £30,000 pension, your net income would be £18,000.

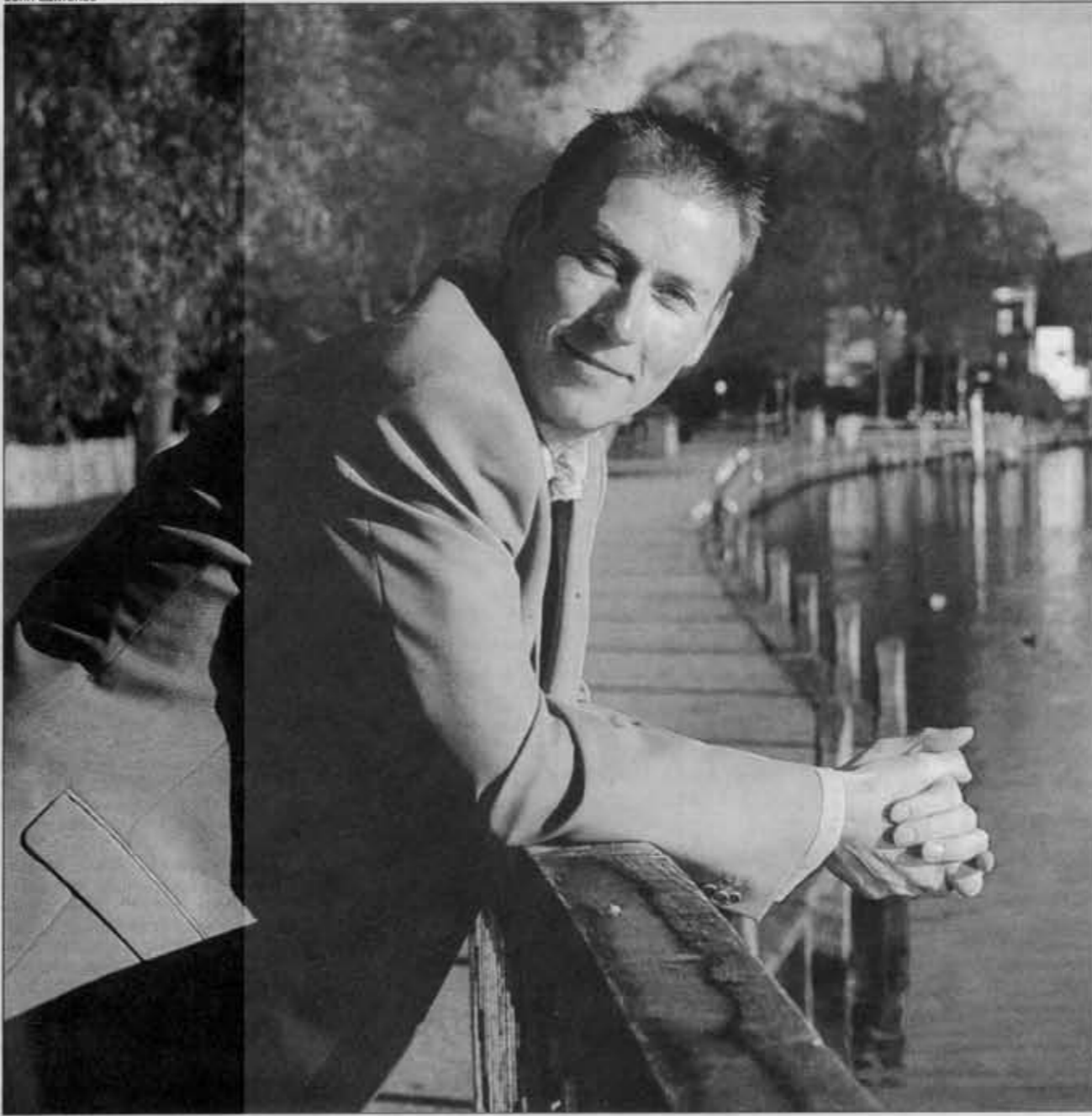
Alternatively, you could invest your lump sum in a purchased life annuity, which would leave you slightly better

off than a savings account. This is because purchased life annuities are free from tax if you buy them with your own lump sum. But you would still be better off taking your full pension.

Actuaries admit that there is a problem. Bob Scott of Lane Clark & Peacock said: "Annuity rates and commutation rates have moved way out of line and this needs to be addressed."

"We are writing to all our pension-scheme clients to highlight the issue and I think that most will look to change their commutation rates to coincide with A-day on April 6 next year. Rates of 16 to 18 might be more fair."

John Lawrence



THE LUCKY FEW

STEVE COLLINGE, 37, is one of the dwindling band of British workers who belong to generous final-salary pension schemes.

A business director at ICI, the industrial group that owns Dulux paints, he has been a member of its final-salary scheme for 10 years. The scheme was closed to new members about five years after he joined.

Collinge, who lives in South Bedfordshire, near Tring, said: "I do feel lucky to be in a final-salary scheme — it does act as a sizeable incentive to stay with ICI because it's extremely unlikely that I would get such generous benefits elsewhere. My father, who was an independent financial adviser before he sold his business, has always said I should think very carefully before leaving the firm."

"However, I am concerned that my benefits will change over time because of the size of the problems that final-salary schemes such as ICI's face in future."

A SCANDAL IN THE MAKING

COMPANIES are dreaming up new ways to cut the costs of their final-salary schemes. The latest trend is for them to offer retired members a tax-free lump sum if they give up their right to an inflation-proof income.

Some firms have even offered tax-free bonuses to 25-year-old workers who are happy to forsake their final-salary scheme. But experts warn that such payments could become the industry's next mis-selling scandal as it is hard for members to work out if they are getting a good deal.

So far, such deals have occurred where the final-salary scheme was in danger of

being wound up unless costs were cut. But they are likely to become more common as even relatively healthy schemes grapple with the growing burden of government regulation and longer life expectancy.

Companies usually offer to buy a member's entitlement to annual pension increases only if they were accrued before April 1997 because these increases would not be covered by the government's Pension Protection Fund if the scheme were wound up. You might therefore be better off taking a lump sum if you think your scheme is on the brink of collapse.

Most are unlikely, however, to offer rates as high as you could get in the open market. Jones said: "Trustees might not view market rates as fair because schemes would be paying out their full reserves at the expense of people who are still in the scheme."

From April 6, the maximum you will be able to take from an occupational pension is 25% of the value of your fund compared with one-and-a-half times your final salary at present. For many workers, this will mean they can take more cash. But if commutation rates stay the same, these lump sums will still represent a poor deal.