

Stakeholder Pensions Supplement

The Pensions Credit

2008

Introduction

When the pension Minimum Income Guarantee was introduced in 1999, there was considerable press comment about whether it was worth some people saving via a personal pension at all. In particular, people on low earnings could be put off saving for their retirement because by having their own pension plan they may have lost out on means-tested state benefits, leaving them no better off than if they had not saved at all. The dilemma was often referred to as the "savings trap".

Many Financial Advisers were naturally cautious of arranging pensions for low-to-average earners because they could be accused of mis-selling if the individual effectively lost benefits under the Minimum Income Guarantee as a result – damned if you do, damned if you don't.

In November 2000 the Chancellor unveiled proposals under the name of the "Pension Credit" to alleviate the problem of the savings trap. This Guide provides a summary of how this benefit works as well as considers the interaction between Government benefits and personal retirement planning.

The State Retirement Pension

Payment of the full basic state pension (£90.70 a week for one person and £145.05 for a couple in 2008/09) depends on the payment of, or being credited with, National Insurance contributions for most of a person's working life. Currently men normally need 44, and women normally need 39 qualifying years to get the full basic State Pension. However, if you reach State Pension age on or after 6 April 2010, you will need 30 qualifying years for a full basic State Pension.

A reduction in the required number of 'qualifying years' is also allowed for people unable to work because of 'home responsibilities' - caring for children under 16 or the disabled. In general, payment of insufficient National Insurance contributions means payment of less than the full BSP (Basic State Pension) or even none at all. Married women, divorced people, widows and widowers may be able to claim a pension based on their spouse's or ex-spouse's record.

The Pension Credit

The Pensions Credit came into force for the 2003/04 tax year to increase the pension for those with a low income, and to remove the problem whereby an individual who has saved for retirement loses a government benefit that would have been available if that saving had not been made (due to means testing).

There are two parts, the Guarantee Credit and the Savings Credit. The "Guarantee Credit" aims to top up the total income received to £124.05 a week for a single person and £189.35 for a couple. The person who applies for the credit must be over 60 (but their partner can be under 60). The level of your existing savings and income will affect the entitlement to this credit, including other pension plans, savings, some investments and employment earnings.

For people over the age of 65, the "Savings Credit" gives some reward for having made your own personal savings. This is a maximum of an additional £19.71 a week if you are single, and £26.13 a week if you are a couple (on top of the Guarantee Credit). For each one pound of income that you may have over the basic state pension amount, you will receive a further 60p as Savings Credit, up to the maximum outlined above.

Consider the following examples:

- (a) Mr Single has no additional retirement provision other than the basic state pension, and no savings. At age 60 he can expect to receive £90.70 per week plus a Pension Credit and apply for a top-up of £33.35 per week to bring total income to £124.05 – this amount is referred to as the maximum “Guarantee Credit”.
- (b) Suppose he has saved sufficient, via a Stakeholder Pension, to provide an extra £10 per week income (£100.70 in total). His overall income would still be topped up to £124.05, but from the age of 65 he would also receive an additional £6 per week “Savings Credit” (a total of £130.05).
- (c) Miss Single has contributed to a Personal Pension Plan and expects her total income from age 65 to be £144.05 per week. As this is £20 more than the maximum Guarantee Credit of £124.05 per week, no Guarantee Credit is available. However, she will be entitled to Savings Credit because of her additional savings, but the maximum rate is reduced by 40p for every £1 of income. As she has saved enough to receive £20 per week, the maximum Savings Credit of £19.71 is reduced by £8 (40% of £20), and she will receive £156.76 (£144.05 plus £11.71).

Simple isn't it.... One of the main points to note is that for small savings amounts the additional saving has produced a benefit worth only 60%. Therefore, many people who can only save a small amount for their pension may consider it better not to save, and spend the money or give it away to their children. The 60p-for-£1 benefit will apply whether income is derived from occupational pensions, SERPS, the state second pension, individual private pensions or other savings.

In addition, the Department for Work and Pensions (DWP) looks at the amount of savings you have and assume £1 a week income from every £500 of savings over £6,000. This includes cash savings, investments, some lump sum payments and the value of property owned but not occupied by the claimant. For example, someone with £10000 savings is assumed to have an additional income of £8 per week.

Entitlement to Housing Benefit and/or Council Tax Benefit will still depend on total income being less than the amount of the Pensions Credit. Increasing income from below to above this amount could therefore result in loss of these benefits (as now), but Savings Credit can still be earned.

Obviously, these comments are based on the current Government intentions. Future increases in the benefits will be reliant upon Government policy and could change from one term to the next, as well as from one Party to the next. The problem with planning for one's retirement is that it is usually far enough away for many things to get in the way – and this includes Government policy.

For a 30-year-old to totally rely on the existence of the Pensions Credit and other State benefits when they are 65 could be considered naive at best. 35 years ago we had a small Basic State Pension and the Graduated Pension. SERPS was a glint in Barbara Castle's eye and Personal Pensions would have been thought impossible. Who knows what the next 35 years will bring? Well, at Ethical Investors we can be confident of one thing – the future will bring change, but we are not quite sure what sort of change!

Financial Advice

Without an effective and reliable crystal ball, financial advisers are placed in a position of being unable to give clear and reasoned advice to those on low to moderate incomes. If we do not know how big your private pension will be when you reach retirement age, how can we advise you on investing in a Stakeholder or ISA, when this may have the effect of reducing your state pension benefits?

Perhaps one way to deal with the matter is to look at the level of income above which the Guarantee Credit is not paid and one loses entitlement. For an individual, this is £124.05 per week (£6450.60 per annum). Investors need to ask themselves whether their target is to retire on £6450.60 per annum, or more. If the answer is more, then funds must be put aside to build a pot of money from which to draw in retirement.

This pot of money could be accumulated within a Stakeholder pension, where tax relief is granted on each payment made (whether you pay tax or not). Alternatively, using an Individual Savings Account (ISA) may be more effective for some. In reality, a combination of the two is probably the best way of constructing a balanced long-term financial plan.

This is where independent financial advice is so important. With both Stakeholders and ISAs offering low cost and flexibility, it is possible to change one's arrangements over the years to meet changing financial needs. In addition, investors will never be locked in to plans that may not perform as hoped, or which change their ethical profile.

Appointing an independent financial adviser to look after your financial arrangements and to recommend changes as appropriate will be a sound investment for everyone. Of course, we would say that, but the alternative is for individuals to undertake the research, education and constant monitoring themselves. Fine if you have the time, but impossible to do effectively if you have an already busy and hectic lifestyle.

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