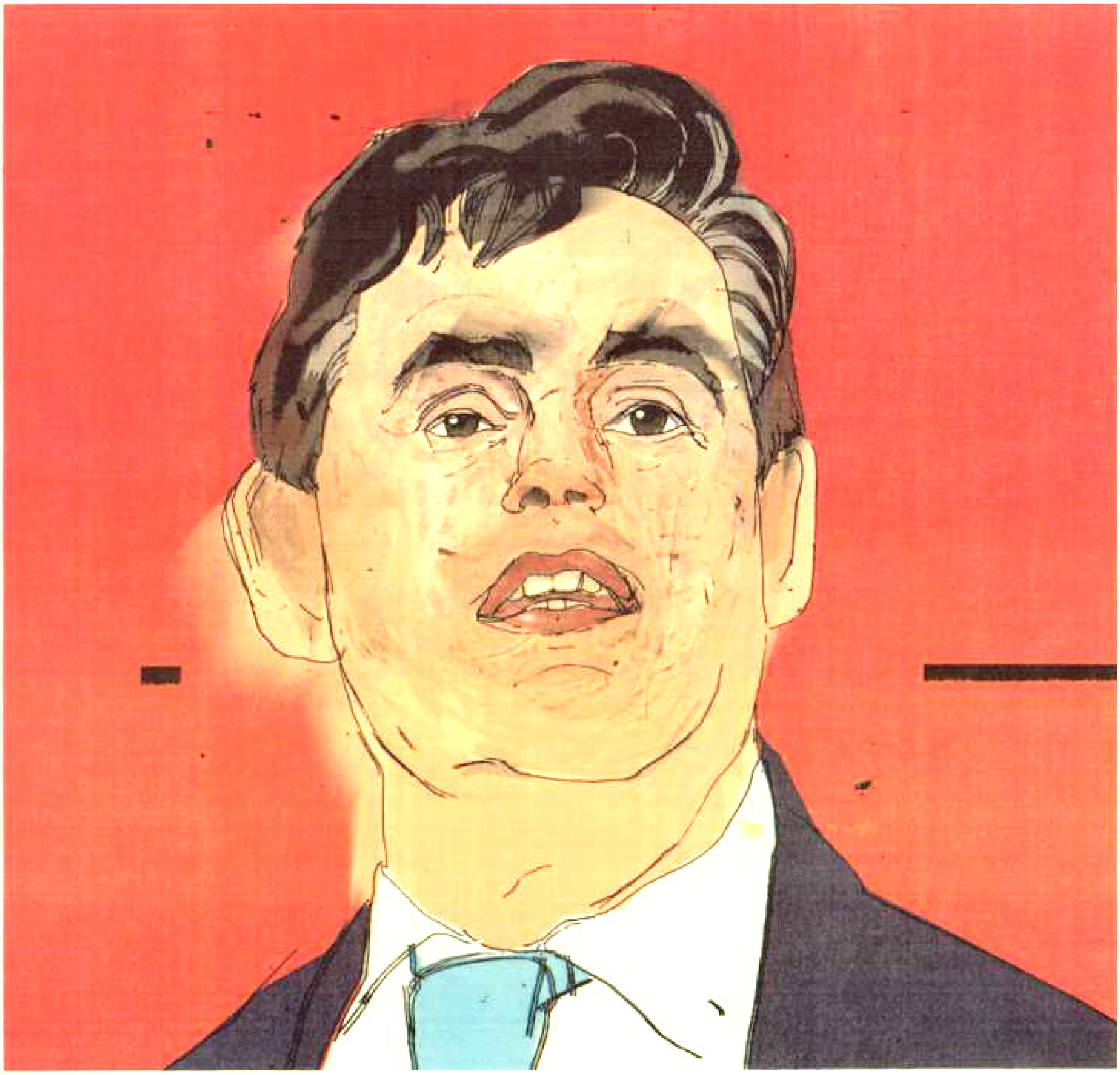
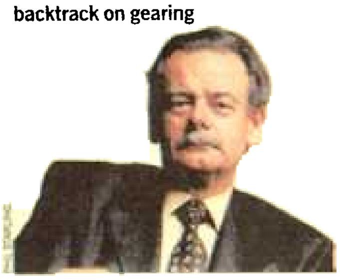


Get it right, Gordon

Anthony Ratcliffe: urges chancellor to backtrack on gearing



On 6 April, new rules come into play for self-invested pension plans. Until recently, these new rules allowed residential property and exotic investment asset classes – from classic cars to fine wines – to be part of SIPPs. Then the chancellor, in his pre-Budget statement last December, knocked these ideas on the head. Now, only commercial properties, not residential, can be included in a SIPP.

But not everyone in the commercial property industry is celebrating. Many feel strongly that the chancellor is not providing the industry with an attractive investment vehicle.

The author of this open letter to the chancellor is Anthony Ratcliffe, one of the partners in Ratcliffes – a firm with more than 30 years of experience in creating specialised small property investment funds – and an occasional contributor to *EG*. In the letter, he explains why the proposed gearing level allowed in the new SIPPs will make them an inferior investment vehicle to that which existed before.

18 February 2006

The Rt Hon Gordon Brown M
Chancellor of The Exchequer
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Dear Chancellor

Pension fund reforms April 2006

I last wrote to you on 29 July 2005 asking the government to reconsider and amend the proposed regulation reforms in those areas where I considered them to make no sense.

I was therefore delighted by your Damascene conversion and decision to maintain the exclusion of direct residential investment and other unsuitable assets, such as holiday homes, classic cars, fine art and wines.

We now have a position where the previous eight regulatory regimes will be unified. But the most popular and effective personal investment structure, the SIPP, will be seriously emasculated if the proposal to reduce gearing from 75% of gross investment cost to 50% of net fund asset value is retained.

As private pension schemes will continue to be restricted to investing in commercial property, there is absolutely no logical reason why the existing 75% gearing structure cannot and should not be retained.

In discussions with ODPM officials last year about the proposed amendments, I was informed that the gearing reduction was proposed precisely because it was acknowledged that residential investment was a higher category of risk.

Now that you have sensibly confirmed that residential prohibition will be retained, please look again at the gearing provisions.

An example here might be helpful:

Bill the baker leases his business premises and pays a rent of £35,000. He faces a rent review two years hence and the property has a rental value of £40,000 pa exclusive. His landlord is prepared to sell the freehold at a price of £400,000.
Bill has a SIPP with £110,000 cash in it. His surveyor calculates that with stamp duty and professional fees the gross investment costof his bakery will be £420,000. Under current regulations, his SIPP can borrow 75% thereof, viz £315,000 with the balancing £105,000 from the SIPP moneys. On acquisition, the trustees accept a surrender of the existing lease, grant Bill a new 15-year lease at the open market rental value of £40,000 and arrange a 15-year mortgage. With capital and interest payments of around £35,000 pa, the mortgage will be redeemed and the property owned free of debt at the lease expiration.

When Bill is ready to retire, he can sell the business and his lease, taking the rent as pension. His SIPP will have been a simple, attractive and efficient structure, helping him to secure the freehold of his premises and develop his business, while building an attractive future pension income stream.

If the proposed gearing reform is implemented, in the same scenario Bill the baker will need £280,000 cash in his SIPP to permit a borrowing of £140,000 to purchase the freehold of his business.

Why should he be so penalised?

One further point is that the imposition of a ceiling on pension funds, above which they will be taxed, is a flawed concept. The culture of saving for future self-reliance should be vigorously encouraged. The lifetime cap you propose will do nothing to assist that, not only at the suggested cap figure, but indeed at any figure and for the following reasons.

- This proposal breaks faith with the existing generation of middle and senior management who have prudently foregone expenditure during their working lives to save for a retirement without becoming a burden to the state.

- Any form of cap will inevitably result in erosion by inflation and dissuade junior executives from entering into a commitment to establish suitable pension provisions, thus leading to their future state pension dependency on retirement.

- If future senior management has been discouraged from making appropriate pension provisions, that attitude will inevitably permeate through all levels of their organisations, further discouraging pension establishment and increasing the need for state-funded provision.

- If investment performance is capped, any incentive on the fund managers to excel in their investment strategies once the lifetime cap has been reached is removed. This cannot be a sound discipline for either the pensions or the investment industry.

What is a pension? It is the income for the years between retirement from employment and death. It should be regular, reliable and, ideally, inflation-proof.

As our political masters, you and your colleagues have voted just such a pension structure for yourselves. It is only equitable that personal pension schemes should operate under a regulatory framework that gives the beneficiaries a chance to create something similar for themselves.

I strongly urge you to reconsider both the proposals for reducing the present level of gearing and the imposition of the lifetime cap.

Yours sincerely

Anthony H Ratcliffe