October 2009

The Royal National Pension Fund

The Government needs to repair its finances and the Nation needs to save, so why not harness the two?

The National Debt stands at a staggering **£800 billion**, whilst **75%** of the work-force retires with less than **£30,000** in their retirement fund. The basic State Pension for **2009/10** is **£95.25** per week, at which level a Pensioner solely reliant upon it, lives in penury; a stark contrast with the pensions our Members of Parliament have awarded themselves, enabling retirement after just **26** years of service on an index-linked pension at two-thirds of final salary – a validation of Dr. Samuel Johnson's famously acerbic definition in his Dictionary, published in 1755, of pension as 'pay given to a state hireling for treason to his coutntry'.

The Pension Act 2008 should be repealed and a new statutory body established - **The Royal National Pension Fund (RNPF)**, to which **all** full-time employees would be required to contribute, for a defined tax-free rolled-up return. Existing Pension Schemes would rank behind this, with the option to fully, or partially, convert and participate.

To build public confidence and support, the **RNPF** would be a non-governmental organisation, established with a strong body of independent Trustees drawn from the elite of the financial services industry. Management could be out-sourced to the leading Institutions such as Prudential, Standard Life, Legal & General, Aviva, etc.

All employees would be required to make a tax-deductible minimum contribution of **7.25%** of their salary into the **RNPF**, which their employers would be required to match, with mutual options to increase the contribution percentages in later working years.

With some **30 million** people in full-time work in the UK, presently earning an average wage circa **£500** per week, full implementation of the scheme, at the minimum contribution of **14.5%,** would harvest some **£115 billion** per annum, which, at a coupon of **3.5%,** would cost the Government some **£4 billion** in annual interest. Assuming tax relief at **20%** all round, the cost to the Exchequer would be a further **£23 billion**.

If the employee and the employer jointly pay **14.5%** of the salary into the **RNPF**, assuming salary inflation at **3%** per annum and earning a tax-free coupon of **3.5%** per annum compound thereon, after **40** years of contributions, the employee could retire on a tax-free pension at **one-third** of final salary, which paid out as a salary-linked pension, should self-fund for **20** years.

In the event of early death where Pension monies were not yet drawn, or were still in surplus, these would subject to a **33.33%** levy by the **RNPF**. This Levy would be used to fund pensions beyond the self-funding **20** year period, where required for the longer living. A surviving spouse would receive a pension paid at two-thirds of the entitlement, or the monies would pass to nominated beneficiaries, exempt from inheritance tax.

The equity cult has proved a false god for pensions, despite an initial allure in the late **1950's**, when the traditional source of Pension savings, fixed interest securities had been ravaged by post-war inflation. A fast growing stock market with attractive corporate dividend income then offered a better hedge against inflation and higher returns.

Nevertheless, a fixed-interest scheme is far better suited to pension provision than an equity-based scheme because, whilst usually providing more pedestrian performance, its very predictability is preferable to the vagarious performance of the stock market.

For example, during the last nine years, the FTSE All Share Index soared by **28.05%** in **1999** and plunged by **32.78%** in **2008**.

Over the last fifteen years the IPD Index showed commercial property out-performance of **20.3%** in **1993** and a value crash of **22.6%** in **2008**. Whilst still volatile, it is buttressed by a more reliable income stream, due to the upward only rent review provisions in commercial property leases, and some **70%** of the total return being income driven.

However, both these alternative investment sectors demand active and high quality management, which itself demands high reward. The 2009 Pensions for the People Report commissioned by the RSA has found that average UK fund management fees are excessive by international standards at **1.5%** per annum of gross funds under management.

So if a UK fund manager were to achieve an averaged annual return over the **40** year investment cycle of say **6%**, a swingeing **25%** thereof would be consumed by management fees. On a **7%** return, the fees would reduce to **21.4%,** but should the investment returns average only **5%,** management fees would consume an outrageous **30%** thereof.

With no need for expensive hot-shot fund mangers, the fixed–interest structure of the proposed Royal National Pension Fund could be administered at a small fraction of a per cent per annum, and everyone would have a fairly accurate idea of the eventual amount and the purchasing power of their pension.

After all, what is the purpose of a pension? Not to further enrich a retiree in the years of retirement, but to fund a lifestyle commensurate with that enjoyed during the working years, sustained by a pension which retains its purchasing power.

By the time of retirement, Mr & Mrs. Britain will have typically fully furnished their home, paid off their mortgage, seen their children into independent adulthood, and established a way of life commensurate with their salaried income. Major capital expenditure will be a thing of the past, with increasing expenditure for medical and care costs their principal concern in the years ahead and for which sufficient income, rather than capital, will be required.

A pension based on a fixed interest return avoids the lottery of retiring in a year when the stock market has either peaked or troughed, and the risk of capital deficit within the pension fund at the point of retirement.

Because the **RNPF** would be tax neutral, the yield at **3.5%** would be competitive against other taxable instruments and because the pension at one-third of final salary would be both salary index-linked and paid free of income tax, thereby equating to a near **50%** taxable pension, this should suffice. The pension purchase power would be preserved in the years of retirement by the salary index link, with the reducing retirement fund continuing to earn **3.5%** per annum compound tax-free.

Over the last twenty-five years, UK salaries have increased by an average **3.97%** per annum. In times of high inflation, the salary link and interest earned could be adjusted, provided that the ratio at **3:3.5,** viz. one-sixth above the salary inflation rate, was maintained, thereby acting as a brake on inflationary pressures.

Should employees wish to enhance their pension provisions at retirement, they would have the option to increase or extend their contributions, by agreement with their employer, at any time over the **40** year contribution period. The minimum retirement age would be set at age **65** for both male and female workers.

To widen the appeal of the **RNPF** no maximum contributions or pension limits would be imposed. Were high net worth individuals to see it as an attractive tax shelter, that would be in the public interest, as the larger and faster the RNPF grew, the greater would be the advantage to the Nation. Tax sheltered monies would surely be better lodged legitimately in the **RNPF** than in tax havens such as the Cayman Islands and the exemption from inheritance tax would further enhance its appeal to the wealthy.

Regrettably, this scheme could not benefit existing retirees suffering inadequate pensions. Only younger employees who, by transfer of existing pension savings or with **40** years of employment through to age **65** ahead of them, could meet the minimum contributions required, would be eligible to join.

The Royal National Pension Fund is intended to place pensions on a sound fiscal footing for the next and future generations.

Most public sector pensions have been traditionally funded from Government current account income, i.e. today's pensions are paid by today's taxpayers. This is no longer sustainable due to increasing longevity rates, the growing number of pensioners and the reducing number of workers. By **2025** it is estimated that the UK's dependency ratio will have risen from **24%** today to **45%**, and that survival rates for pensionable years will be **23** years for a male and **25** years for a female.

Urgent action is required to correct the imbalance resulting from this growing demographic trend. From now on, workers **must** take responsibility during their working years for the provision of their own pensions.

Increasing longevity rates will be addressed by raising the minimum retirement age for all to **65** years; creating a retirement fund structure which self-funds for **20** years thereafter; and imposing the **one-third** levy on pension estate monies to fund pensions required beyond **20** years of retirement.

Over time, it should be possible to redeem all Gilts, whilst also utilising the **RNPF's** burgeoning resources to finance major national capital projects such as Crossrail, an Olympics, a new estuary airport to replace Heathrow, road and rail infrastructure, new schools, hospitals, housing or defence procurements, through loans at near commercial rates of interest to the various Government Departments responsible for such projects. Furthermore, the interest margin will create an additional income stream to help fund pensions required beyond the **20** years of self-funding.

Within a generation, the National Debt could be eliminated; income tax rates significantly reduced; State pensions, costing **£90 billion** in **2008/9**, almost eradicated; unsustainable pension liabilities would not burden future generations of workers; and most importantly, the British people would retire on fair tax-free salary-linked pensions, ensuring a prosperous and comfortable retirement.

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October 2009

Average UK salary 2008/9 of **£26,000**. Minimum pension contribution at **14.5%** thereof over **40** years, with salary inflation assumed at **3%** per annum compound and tax-free interest earned at **3.5%** per annum compound

Year	Contribution at 14.5% (inflating at 3% per annum)	Retirement Fund	Total Fund with interest at 3.5%
1	£3,770	£3770	£3902
2	£3,883	£7785	£8058
3	£4,000	£12,058	£12,480
4	£4,120	£16,600	£17,181
5	£4,244	£21,425	£22,175
6	£4,371	£26,546	£27,475
7	£4,502	£31,977	£33,096
8	£4,637	£37,733	£39,054
9	£4,776	£43,830	£45,364
10	£4,919	£50,285	£52,043
11	£5,067	£57,110	£59,108
12	£5,219	£64,337	£66,579
13	£5,376	£71,955	£74,473
14	£5,540	£80,013	£82,814
15	£5,706	£88,520	£91,618
16	£5,877	£97,495	£100,908
17	£6,053	£106,961	£110,705
18	£6,235	£116,940	£121,033
19	£6,422	£127,455	£131,916
20	£6,615	£138,531	£143,379
21	£6,814	£150,193	£155,449
22	£7,018	£162,467	£168,154
23	£7,229	£175,383	£181,521
24	£7,446	£188,967	£195,581
25	£7,660	£203,251	£210,364
26	£7,899	£218,263	£225,902
27	£8,136	£234,038	£242,229
28	£8,380	£250,609	£259,380
29	£8,631	£268,011	£277,392
30	£8,890	£286,282	£296,302
31	£9,157	£305,459	£316,150
32	£9,432	£325,582	£336,977
33	£9,715	£346,692	£358,826
34	£10,007	£368,833	£381,742
35	£10,307	£392,049	£405,771
36	£10,616	£416,387	£430,961
37	£10,935	£441,896	£457,362
38	£11,363	£468,625	£485,027
39	£11,601	£503,545	£521,169
40	**£11,949**	**£525,959**	**£544,368**

Assume **20** years pension payments from the retirement fund earning **3.5%.** Annual pension paid at one-third of final salary, increasing in line with salary increases, at say **3%** per annum compound.

Year	**Retirement Fund**	**Pension at one-third of final salary, with 3% annual increases**	**Reducing Retirement Fund after pension payment**	**Reducing Retirement Fund plus 3.5% interest**
1	£544,368	£27,448	£516,920	£535,012
2	£535,012	£28,271	£506,741	£524,477
3	£524,477	£29,119	£495,358	£512,695
4	£512,695	£29,997	£482,703	£499,598
5	£499,598	£30,892	£468,706	£485,111
6	£485,111	£31,819	£453,292	£469,157
7	£469,157	£32,774	£436,383	£451,656
8	£451,656	£33,757	£417,899	£432,526
9	£432,526	£34,770	£397,756	£411,678
10	£411,678	£35,813	£375,865	£389,020
11	£389,020	£36,887	£352,133	£364,458
12	£364,458	£37,994	£326,464	£337,890
13	£337,890	£39,134	£298,756	£309,213
14	£309,213	£40,308	£268,905	£278,317
15	£278,317	£41,517	£236,800	£245,088
16	£245,088	£42,763	£202,325	£209,406
17	£209,406	£44,046	£165,360	£171,148
18	£171,148	£45,367	£125,781	£130,183
19	£130,183	£46,728	£83,455	£86,376
20	£86,376	£48,120	£38,246	£39,585
21	£39,585	£49,573	(£9,988)	Zero

Thereafter pension payments required beyond age 85 are funded by the RNPF Levy and the interest margin on Government Department loans.

<u>APPENDIX</u>

1. A "Royal" prefix would engender a greater degree of trust from the contributing work-force, than if the Fund was to be simply entitled The National Pension Fund.

2. Interest rolled-up at **3.5%** per annum compound over **40** years will build a retirement fund of almost **seven** times annual salary. In the drawdown years the reducing retirement fund would continue to earn **3.5%** interest tax-free, whilst paying out a salary-linked tax-free pension at **one-third** of final salary. Assuming salary-linked inflation at **3%** per annum, this will self-fund for **20** years of pension, thus sufficing to age **85** for an employee retiring at **65**, who has fully contributed from age **25**.

   The **33.33%** levy on pension estate monies would fund pensions required beyond the **20** year self-funding period.

3. All figures assume inflation at **3%** per annum compound and statutory minimum **14.5%** contributions throughout, building from the average wage in **2008/9** of **£500** per week, viz. **£3,770** per annum, over the **40** years of contributions.

   N.B Over the last twenty-five years UK wages have increased by an average **3.97%** per annum. When inflation is higher rates can be adjusted but should retain the **3.3.5** ratio, viz. a net one-sixth return above salary inflation, as a brake on inflationary pressures.

4. Dependency ratios are the proportion of the population which is under **15** or over **65** as against the proportion that is between **16** and **65**. The UK's 2050 projection is **45%**, but it is worse for France, Germany, Italy and Spain which are projected at **48%, 55%, 66%** and **68%** respectively.

5. <u>Supporting Schedules</u>

   a. Table of annual pension contributions at **14.5%** of salary with **3%** annual inflation, earning **3.5%** per annum compound, over **40** years.

   b. Table of annual tax-free pension, at **33.33%** of final salary, index-linked thereto with an assumed **3%** per annum increase, and the reducing retirement fund still earning **3.5%** per annum tax-free.