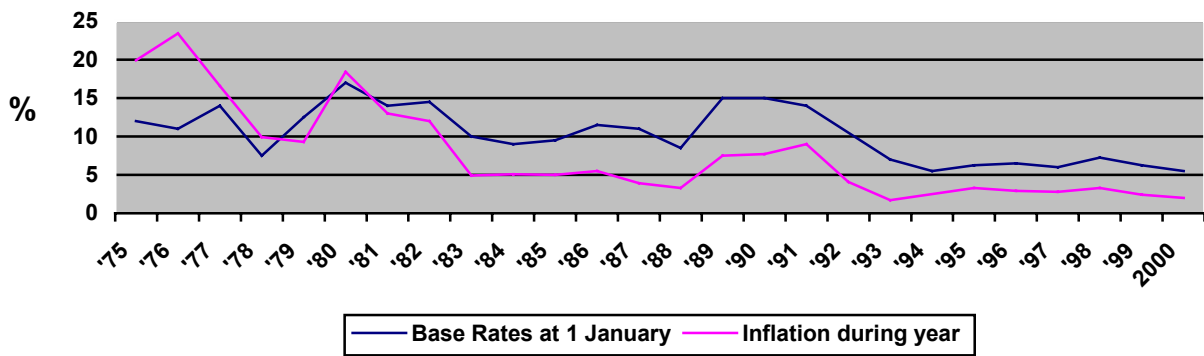


THE EFFECT OF LOW INFLATION AND LOW INTEREST RATES ON PENSIONS

In recent years UK inflation and interest rates have steadily fallen and stabilised after periods of very high inflation in the 1970's and 1980's. There are views that inflation and interest rates will remain low for the foreseeable future. This note considers the implications of low inflation and interest rates for pension provision.



Cost of Annuities

Insurance companies base the cost of their annuities on bonds as this is the investment which most closely matches the annuity payments. Low interest rates result in lower bond yields and higher bond prices and this results in higher annuity costs. The cost of purchasing an annuity in 2000 was approximately 60% greater than in 1985.

However, lower inflation means that an annuity which does not increase in line with inflation is now holding its value much better than it was before. Purchasing power has fallen much less in real terms. For example, after 10 years a non-increasing pension has lost about 25% of its purchasing power if inflation averages 3% but would have fallen by more than 60% if inflation averages 10%.

The cost of purchasing a pension which increases every year in line with inflation has also increased but only by around 25%. This change arguably gives a better measure of the increased costs of providing a pension in the current climate.

Implications for Money Purchase Schemes

For Money Purchase pension schemes which include Stakeholder schemes, Group Personal Pensions and many additional voluntary contribution arrangements, the increasing cost of annuities means that higher contributions have to be paid to provide a desired level of benefit than in the past. The effect of low inflation and interest rates has also been compounded by evidence of improving life expectancy which is also resulting in higher annuity costs.

There is also an argument that recent sustained economic expansion, particularly in the 1980's led to strong growth in company profits. With lower inflation this has encouraged investors in the stockmarket to anticipate future profit growth to the extent that stockmarket valuations have become high by historical reference. If company profits and returns on shares simply reflect growth in the UK economy then investment returns are likely to be lower than in the last 20 or 30 years. This factor also means that current investors may have to invest even more than those who have retired recently.

Defined Benefit Pension Schemes

Similar implications apply to Defined Benefit schemes where employers' costs are increasing. The increased cost can be particularly large for pension schemes which provide commitments to increase pensions in payment or pensions in deferment by fixed rates (e.g. 3% p.a. or 5% p.a.).

Provided that additional costs are met by the company, individual members are only affected to the extent that cost pressures may eventually lead to a change in the scale of future benefits.