

27/May



**REVENUE**

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**CHANCELLOR**

**COMPANY TAXATION: PENSIONS AND TAX CREDITS**

1. This paper provides some further information on:
    - the extent of pension scheme surpluses, and
    - the impact of a fall in share prices on people who are due to retire shortly after the Budget.
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### Summary

2. **Surpluses** are, if anything, looking healthier than we have assumed. The latest work by the Government Actuary's Department (GAD) needs to be treated carefully (see paragraph 5 below), but it suggests that **total** actuarial surpluses could be as much as **£60 billion**. Some of this is already financing employer contribution reductions or holidays. But it should mean that the immediate impact on employer costs would be substantially cushioned.

3. The impact on pensioner incomes will depend on stock market reactions to the company tax package. We estimate that up to **17,000** members of money purchase schemes could be affected, with an average pension being reduced by about **£150** a year.

### Limitations

4. The results shown in this note need to be treated with some caution. While we have done our best to give a reasonable picture, there are a number of important limitations.

5. In the case of **surpluses**, the GAD have looked only at some of the very big schemes. Much of the data is quite old and GAD have had to use some rough and ready assumptions to update it. Also we do not know whether the performance of the very big schemes is typical of those at the smaller end of the range.

6. Similarly, with the impact of share prices on pensioners' income, we have no reliable information about the numbers of people potentially affected or the size of their pensions. We have therefore made some broad guesses based on the limited details at our disposal.

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### Surpluses

7. Since my note of 21 May, GAD have been doing further work on the size of surpluses. They have looked at the most recent actuarial valuations of 32 very big pension schemes with assets ranging from £1 billion to £17 billion. The results of the valuations have been updated to reflect likely growth in the value of assets (and the size of liabilities) to give a current estimate of the position. These schemes represent nearly one-quarter in value of total pension scheme assets.

8. The results of this work are at Annex A. It confirms that surpluses are likely to be much larger than they were a few years ago because investment returns have been high while earnings growth and inflation have been low.

9. The overall actuarial surplus in the schemes surveyed has grown from £9 billion at the previous valuation to £21 billion currently. This is a big number and although there must be caveats about drawing wider conclusions, it could suggest that total actuarial surplus in pension schemes could be up to £60 billion. This is a much larger figure than assumed for the costings in my note of 21 May and so should be seen as an extra comfort factor. It means that surpluses could cover almost the whole effect on existing actuarial values of abolishing tax credits (and not just the one-half assumed for costing purposes).

10. But it is important to remember that surpluses will not be uniform. Some schemes - which will be given a high profile by the pensions industry - will be pushed into actuarial deficit by the loss of tax credits. The pensions industry can be relied on to parade these "bad news" cases as proof of their arguments.

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### Pensioners' Income

11. There are about 8 million people who are members of money purchase pension schemes (where the investment risk is passed on to the individual member). But most of these (over 5 million) are people who have contracted-out of SERPs through a personal pension. They are not likely to be close to retirement age and only a small proportion of the remainder are likely to retire in the near future.

12. In order to develop a picture of the numbers of people at risk and the extent of their potential loss we have looked at the number of people retiring each year and available data on levels of new pensions. For simplicity we have also assumed that, for example, a 10 per cent fall in share prices would result in a 5 per cent reduction in pension (on the basis that one-half of the pension fund was invested in UK equities).

13. We cannot give a firm figure for the number of people who might lose out if share prices fell. We have made a rough estimate that up to about 34,000 people will have money purchase pensions. But, in practice, we would expect only one-half of this number (i.e. 17,000) to be potentially affected because many personal pension schemes include a facility to switch from equities into less risky investments as people get within a few years of retirement.

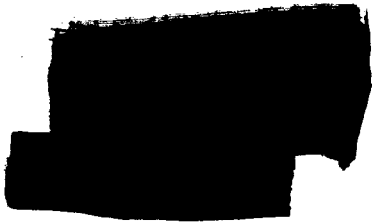
14. Consequently, many of those still invested in equities at retirement will be doing so by choice and they generally will have an option to draw an income from the retirement fund for a few years instead of buying an immediate annuity.

15. As regards the financial impact, the table at Annex B shows the possible loss of income in a range of situations. But these are very simplified examples and the actual position would depend on how far (if at all) stock markets fell and the extent of the exposure to equities. On our central estimate of a 6 per cent fall in

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share prices, the amount of an average new pension (currently about £5000 a year) might fall by about £150 a year. At the extreme if share prices fell by a full 20 per cent and the fund was wholly invested in UK equities a pension of £5,000 a year could fall by around £1000 if annuity rates were unaffected by changes in market sentiment.

16. Quite clearly, any loss of pension could be difficult for someone with a small income to cope with. But the outcome on our central assumption is likely to be comfortably within the normal range of differences between the best and worst annuities offered by insurance companies if people were to shop around for the best deal on their retirement fund.



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**ANNEX A**

**PENSION SCHEME SURPLUSES**

- (i) GAD have reviewed the most recent actuarial valuations of 32 large pension schemes holding assets with a market value between £1 billion and £17 billion.
- (ii) The effective dates of the valuations ranged from March 1993 to December 1996. In each case GAD have adjusted the original valuations for:
- investment growth, and
  - prices and earnings movements
- between the valuation date and end-March 1997.
- (iii) The results are as follows:

|                                | <b>Original valuation</b> | <b>Projection to 31 March 1997</b> | <b>Difference</b> |
|--------------------------------|---------------------------|------------------------------------|-------------------|
|                                | £bn                       | £bn                                | £bn               |
| Actuarial value of liabilities | 117                       | 127                                | + 10              |
| Market value of assets         | 135                       | 180                                | + 45              |
| Actuarial value of assets      | 126                       | 148                                | + 22              |
| <b>Total surplus</b>           | <b>9</b>                  | <b>21</b>                          | <b>+12</b>        |

**PENSIONERS' INCOME****Assumptions**

- (i) 300,000 people will retire within 6 months of Budget Day.
- (ii) 46% will have a private pension = 138,000 people.
- (iii)  $\frac{1}{4}$  x 138,000 with money purchase pensions = 34,000 people.
- (iv)  $\frac{1}{2}$  x 34,000 = 17,000 people will have switched from equities before retirement.
- (v) **Potential losers** if stock markets fall = 17,000 people.

**Effect on income**

(Assuming 50 per cent of retirement fund invested in UK equities)

| Pension income                    | Effect on pensions of change in Stock Market Values |             |             |              |
|-----------------------------------|---|-------------|-------------|--------------|
|                                   | + 6%  | - 6%        | - 10%       | - 20%        |
| £ 2,500 p.a.                      | + £ 75 p.a.   | - £ 75 p.a. | - £125 p.a. | - £ 250 p.a. |
| £ 5,000 p.a.<br>(average pension) | +£150 p.a.  | - £150 p.a. | - £250 p.a. | - £ 500 p.a. |
| £ 7,500 p.a.                      | + £225 p.a.   | - £225 p.a. | - £375 p.a. | - £ 750 p.a. |
| £10,000 p.a.                      | + £300 p.a.   | - £300 p.a. | - £500 p.a. | - £1000 p.a. |

**NB:** 25% of new pensioners have private pensions of less than £2,500 p.a.  
 45% of new pensioners have pensions between £2,501 and £5,000 p.a.  
 30% of new pensioners have pensions over £5,000 p.a.