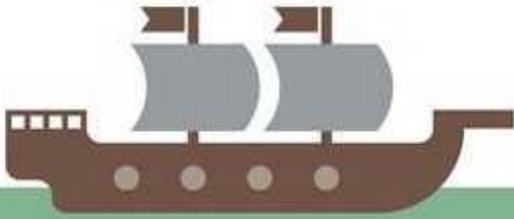


CHARLOTTE DAVIS



What do low
**interest rates
mean for your
retirement?**



About the author

Charlotte Davis is an undergraduate student on a summer internship at Informed Choice. She is studying BSc Economics (with industrial placement) at the University of Exeter.

Charlotte has a keen interest in exploring the effects of monetary policy on the economy, and as such wanted to carry out research to understand what low interest rates could mean for those in or approaching retirement.



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We are a firm of Chartered Financial Planners. This means we have satisfied rigorous criteria relating to professional qualifications and ethical good practice. It means you can be confident that you are dealing with one of the UK's leading firms that is wholly committed to providing you with the best possible advice, service and support.

To find out more about our advisory and planning services, please visit www.icfp.co.uk or follow us on Twitter @InformedChoice. You can call us on 01483 274566 if you have any questions.

Please note that this briefing note is provided for information-only and does not constitute financial advice. You should seek professional independent financial advice before making any important decisions about your money.

Introduction

Since March 2009, the Bank of England has maintained interest rates at the historic low of 0.5%. Rates subsequently fell to a new historic low of 0.25% in August 2016, in response to a perceived economic slowdown following the referendum decision for the UK to leave the European Union.

A number of leading economists, including Adam Posen of the Peterson Institute of International Economics, have recently called for zero or even negative interest rates. Posen said:

“I think what [the MPC] should do is cut rates to 0% in one fell swoop and thereby [show] that they are prepared to stimulate the economy.”

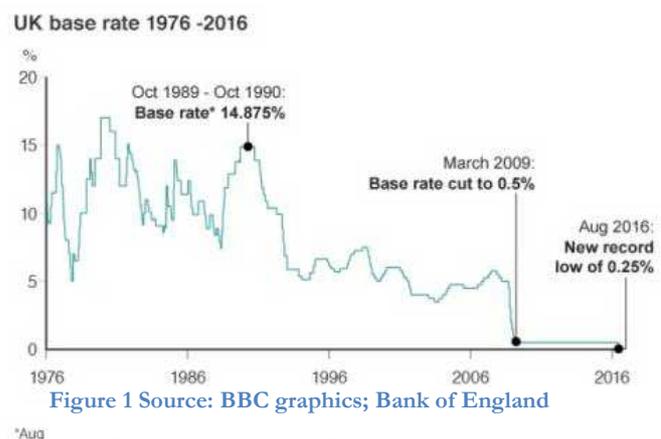
The low interest rates we are currently experiencing are the result of a number of factors. These include fragile economic growth and low price inflation.

The Bank of England and other central banks globally have been seeking to

encourage investment and consumer spending in order to support economic growth. Lower interest rates can however be a cause for concern for people approaching or living in retirement.

At a recent press conference, President of the European Central Bank, Mario Draghi, delivered a statement commenting “It's pretty evident that pension funds and other actors are significantly affected by the low level of interest rates.”

With no reasonable expectation of an interest rate rise in the near term, retirees face an important question: what do low interest rates mean for your retirement plans?



In an attempt to answer this important question, we have taken a closer look at the impact of low interest rates on pensions, cash savings, investments and mortgages.

We hope that you find this briefing note useful. If you have any questions, do call us on 01483 274566, email hello@icfp.co.uk, or follow us on Twitter [@informedchoice](https://twitter.com/informedchoice).

Pensions

“We've had more than half a decade of very low interest rates and that means someone who has been putting money into a savings account or into a pension fund - the value of their lifetime retirement is about half the value of someone who retired in 2000," said Catherine Mann, the OECD's chief economist.

Low interest rates mean lower investment returns for large pension funds, which typically hold 40% or more of their assets in fixed income securities. These assets include lower yielding government bonds, including those issued by the UK government, Gilts.

Fixed interest securities are considerably more likely than company shares to be adversely affected by price inflation and changes in interest rates.

Investment market valuations often change when interest rates change. If a security's fixed interest rate is higher than the return generally available on other investments like savings or shares, the security's price will go up. The greater the price, the lower the yield. The lower the future expected returns, the more money that must be contributed today. As a result both defined benefit (DB) and defined contribution (DC) pensions have become more expensive in this period of low interest rates.

The low interest rate environment has contributed to the estimated £52 billion pension deficit held by FTSE 100 companies, according to research at SIPP provider AJ Bell ¹.

Low interest rates could deteriorate the solvency of defined benefit plans as long term government bond yields affect assets as well as liabilities. Sensitivity analysis by academics and the Bank of England show that for a one percentage point fall in gilt yields, pension liabilities are inflated by 18-20%, while asset values increase by only 6-10% ².

Hymans Robertson estimated that deficits of UK defined benefit schemes currently stand at £935billion, with a further fall in interest rates pushing this figure further towards the £1trillion mark ³.

The impact of low interest rates on defined contribution pension schemes operates through a reduction in the amount of assets accumulated and to finance retirement and an increase in annuity prices.

Annuity rates are linked to the Bank Rate through its effect on gilt yields. Annuities are typically financed by buying up government bonds. Consequentially annuity rates are priced according to the yield on low risk long dated gilts (government bonds) and other fixed interest investments, which are linked closely to the base interest rate.

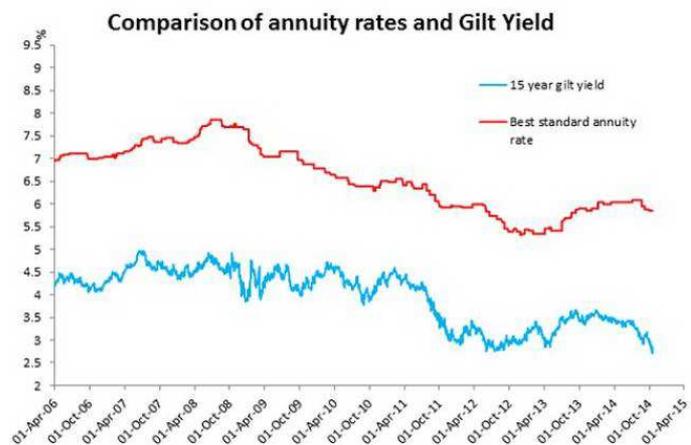


Figure 2 Source: Hargreaves

When the Bank of England base interest rate move up, annuity rates are also typically climb.

Annuities purchased when long-term interest rates are low will provide lower incomes than when interest rates are higher. Once you buy an annuity the rate is fixed so even if rates go up in the future your annuity payments stay the same.

Rules exist that require these firms to invest your money in low risk interest-bearing investments such as bonds. When rates fall, pension companies lower payment guarantees on new accounts.

Annuity rate changes are closely linked to the 15-year gilt yields. 15 year gilt yields reached an all-time low of 1.13% on 5th August 2016. Gilt prices increase when the Bank Rate decreases, reducing their yield meaning gilt yields rise and fall with interest rates.

Gilt prices are also affected by the market's expectations of interest rates, with longer maturing gilts being most sensitive to this duration risk.

Tom McPhail, a pension's expert at Hargreaves Lansdown quotes recent research indicating that "The declining gilt yield of the past year has fed through into declining annuity rates. A 65-year-old today is getting a lower rate than a 60-year old would have done just six months ago."

Research by sharingpensions.co.uk concludes a general rule a 30 basis point rise in yields would increase annuities by 3.0%⁴ although the providers may take time to introduce these changes depending on their own strategies.

However at the moment with interest rates still very low following the recession, annuity rates for people retiring now are much lower than they were a few years ago. This is because the return on investment on government bonds, closely tied to interest rates as mentioned, is currently fairly weak.

"Sustained quantitative easing combined with continued low interest rates is one of the main factors keeping annuity rates low and further action by the Bank of England could have added to the downward pressure," according to the Association of British Insurers director of long-term savings and protection policy, Yvonne Braun.

As interest rates hopefully begin to eventually rise over the coming years, those considering purchasing an annuity will be hoping annuity rates move up too. However "after 7 years of low rates, there's no guarantee we'll see any significant improvement in interest rates or annuity terms in the short term," says Steven Cameron, Pensions Director at Aegon. He suggests those not ready to lock themselves in at low rates "could consider deferring their retirement date or alternatively keeping their pension fund invested and drawing a retirement income direct from their funds."

Savings

Aviva published data revealing that nearly three in 10 people plan to supplement their retirement income with interest earned from a cash savings account.⁵

Lower interest rates are one mechanism used by the Bank of England to encourage households to boost the economy by spending money and increasing demand. Lower interest rates result in a worsening return on cash savings, theoretically encouraging people to spend rather than save.

Following changes to the central bank's base rate, changes to interest rates available to savers are not automatic, although they do tend to follow in time.

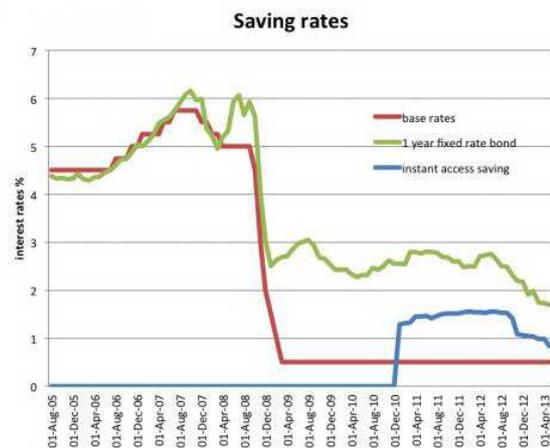


Figure 3 Source: economicshelp; Bank of England

The savings rate offered by banks has been falling, even as the official base rate remained flat, at least partially in anticipation of early August's base rate cut to 0.25%.

The average interest rate on an easy access savings account is currently 0.65%. If that average mirrors a change in the Bank Rate, this could drop to just 0.4%.

According to financial information firm Moneyfacts, there are 385 savings accounts that could end up offering no interest at all to savers, should banks and building societies choose to pass on the entire interest rate cut. Moneyfacts also found that in July 2016, 13 of the best saving deals⁶ were withdrawn from the market and have yet to be replaced.

Rachel Springall, finance expert at Moneyfacts says "Savers are facing never-ending cuts to multiple types of accounts, which results in many investors jumping ship from one provider to another to get a more competitive return," however in response "providers are resorting to pulling the deals out of the market altogether."

Jeremy Roberts, Head of UK Retail Sales at Blackrock, when commenting on the recent Bank of England base rate decrease, says “Now, more than ever, people need to put their hard earned cash to work so they can be on track to meet their retirement goals.”

Investments

Interest rates can affect aspects of your investment portfolio in different ways; it is important to understand the changes to all asset classes to stand the best chance to maximise your investment returns.

However, pensions and other investments are, of course, a long-term consideration, so the long-term prosperity of the economy is arguably the most important element to consider when deciding what to do with your money.

Bonds

Rising interest rates are generally bad news for fixed interest investments. With higher interest rates, the fixed interest offered by bonds looks less attractive, so prices are likely to fall and yields rise to compensate. This is particularly true for government bonds, such as UK gilts.

Older investors, in particular, may have large bond holdings, as they are considered lower risk than equities as retirement approaches. It is a common rule of thumb to consider investing a percentage in fixed interest securities equivalent to your age in years, resulting in higher bond allocations for older investors.

Bonds are inversely related to interest rates. Certain types of bonds—such as high-quality corporate bonds and Treasury bonds—are more sensitive to rising rates than others. Relative to government bond yields that have remained extraordinarily low for several quarters, corporate bonds can provide an option of higher yield, albeit with greater risk to capital and income.

Fixed interest securities are most likely to suffer when interest rates rise. Investors might therefore want to consider gradually moving away from gilts and opting for higher-yielding corporate bonds which will be less sensitive to rate rises. However, Bruckman of Citrin Cooperman says that the rise in interest rates is less important if buyers of individual bonds plan to hold them to maturity.

Commercial property

In the UK, the historic relationship between interest rates and property yields has shown a fairly weak correlation. For real estate, interest rates affect the availability of capital and the demand for investment. These capital flows influence the supply and demand for property and, as a result, affect property prices. A rise in bond yields does not necessarily mean that real estate yields will rise in tandem every time, but a relationship between the two has been found to exist.

Theoretically with higher interest rates, the discounting reduces the present value of those future income streams. A simpler way to think of it is that at higher interest rates, investors are less likely to see a property's cash-on-cash return as justifying the investment. Rising interest rates in the future could cause a slowdown in the property market with fewer projects being started and fewer people able to afford loans and mortgages.

However Manish Chande suggests property yields are affected much more considerably by other factors apart from interest rates; "With rents in certain UK regions and sectors still to see rental growth following the last downturn, we expect the continued improving economy to result in further rental growth in these areas, which will support property yields at current levels, even if interest rates rise."

Falls in the interest rate should, by decreasing the rate of borrowing, lead to more projects being taken underway and greater demand through decreased mortgage rates. Commercial property ought to therefore benefit from this period of low interest rates.

Company shares/equities

It's more difficult to predict the impact increasing interest rates will have on equities, since so many factors influence how the market behaves. Interest rates and company shares do not have a direct relationship; however they are generally inversely related.

Within hours of the Bank of England’s decision in August to reduce the Bank Rate to 0.25%, the FTSE 100 index swung from small losses on the day to a gain of 1%.

The reduction in interest rates means that investors have a decreased opportunity to make income from interest. If we assume investors are rational, a decrease in interest rates will prompt investors to move money away from fixed income securities to the equity market.

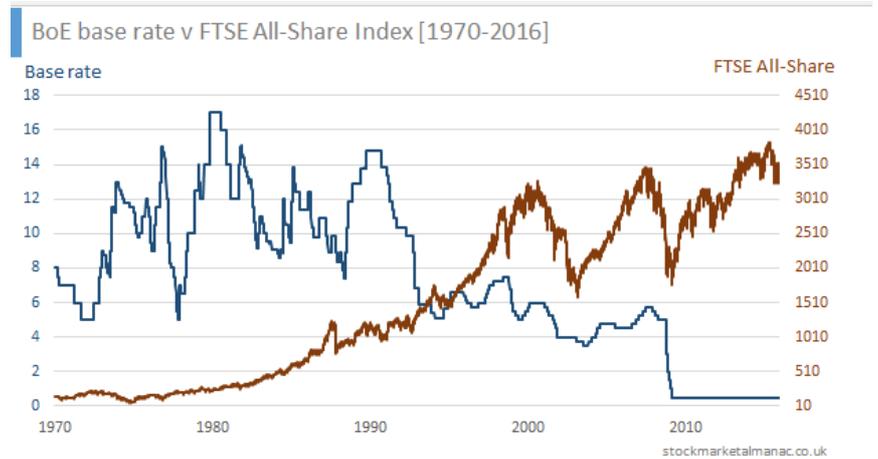


Figure 4 Source: <http://stockmarketalmanac.co.uk>

Additionally businesses are able to finance expansion at a cheaper rate, thereby increasing their future earnings potential, which, in turn, leads to higher stock prices.

Similar to bond funds, different types of equity funds are expected to perform differently in periods of rising interest rates. For example, growth stocks—companies whose earnings are increasing relatively quickly—should outperform value stocks with slower earnings growth.

Research, quoted by Tom Stevenson from Fidelity International, suggests £15,000 invested in the FTSE All Share Index 10 years ago would result in £23,323 today. Yet £15,000 invested in the average UK savings account over the same period would give an investor a mere £15,976⁷—a £9347 difference, that ought not be ignored by those looking to get the most from their money.

Mortgages

According to Aviva, one in ten retiring people, aged 65 to 74, still have an average mortgage of £55,625.⁸

As the average age of a first-time buyer increases, borrowing into retirement is becoming the "new normal", rather than a niche form of lending,' says Paul Broadhead, head of mortgage policy at the BSA.

Mortgages in retirement are often on an interest-only basis to minimize monthly payments. Rather than setting up an investment vehicle to ensure the mortgage is cleared at the end of the term, or on the death of the mortgage holder, the idea is that the property is sold with the debt cleared from the proceeds.

In fact there are some good financial reasons for maintaining some of your mortgage into your retirement; home owners may be able to use this as a method of estate planning, enabling them to mitigate the inheritance tax paid by their beneficiaries after they pass.

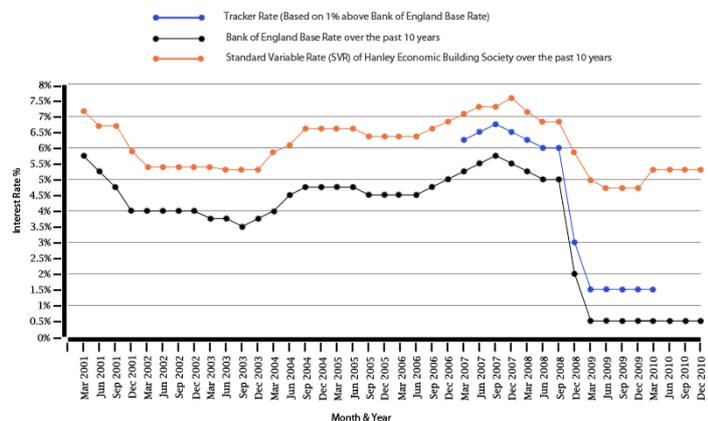


Figure 5 Source: KeyStone Mortgages

Lower interest rates do not affect those borrowers with a fixed-rate mortgage. However, those operating on a mortgage that tracks the base rate can expect to see their monthly repayments fall.

A BBC report, using Office for National Statistics (ONS) house price data, states a cut to 0.25% means a £22 monthly reduction in the bill for a variable 25-year repayment mortgage on a typically priced home of £211,000 having taken a 20% deposit into account. That is a £22 cut on a monthly mortgage bill of about £779.⁹

Conclusions

Gareth Shaw, head of consumer affairs at Saga Investment Services, commenting on August's decrease in the Bank Rate, said:

“Retirees in particular must now be thinking about moving up the risk ladder with their savings to help deliver the income they need. They should consider building a diverse portfolio of shares and bonds, which can help pensioners, get the yields they need.”

“This doesn't mean piling all your money into the stock market. Our research suggests that a small shift of 10% of your money from cash products to financial assets can boost income by 76%.”

Further, with savings rates so low it may be worth paying off any debts, or your mortgage, presumably owed at higher rates than your money could make in savings account, in order to make the most effective use of your money.

Low interest rates can spell financial trouble for those approaching or in retirement. It can be damaging for pension wealth, result in lower annuity rates, reduce interest from cash savings, and influence investment returns.

That said, lower interest rates are not necessarily a disaster for retirement planning.

With careful consideration and long-term financial planning, a sustained period of low interest rates can create opportunities for people in retirement.

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