

## Briefing Note:

### Interest Rate on Special Account Falls to 3% per annum Gross

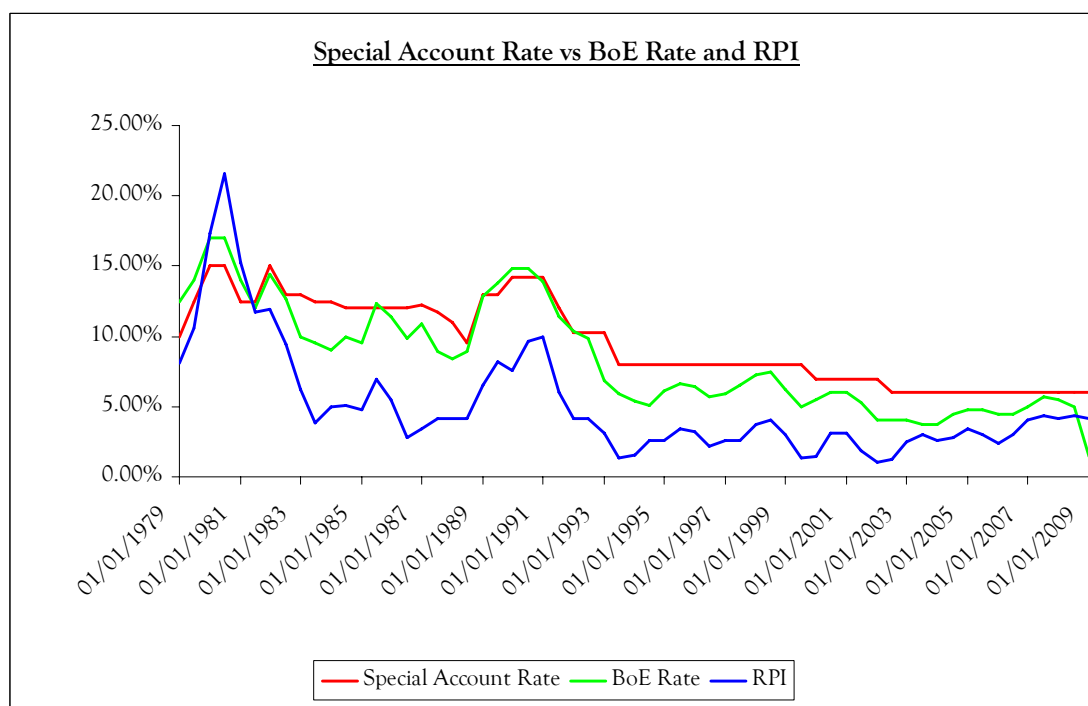
Richard Cropper and James Rooney, 2<sup>nd</sup> February 2009

From 1<sup>st</sup> February 2009 the rate of interest paid on the CFO Special Account will decrease from 6% gross per annum to 3% gross per annum.

Whilst this is clearly a disappointment, it oughtn't be a cause for panic or 'knee jerk' reactions.

Firstly, the fact that the rate has been cut is not particularly surprising given the recent aggressive cuts in the Bank of England base rate.

The Special Account Rate has tended to average around 2% higher than the BoE base rate, certainly over the course of the last 30 years. The chart below shows the trend of the rates on a six monthly basis between January 1979 and January 2009.



The UK government has alluded to the fact that the Bank of England base rate is likely to stay at historically low levels for some time to come, in an attempt to stimulate the economy and breathe life back into stalled credit markets.

The rate of inflation, whilst causing concern mid-2008 as it breached 5.00%, has now started to fall significantly following sharp falls in commodity and energy prices.

It is perhaps therefore understandable that the rate of interest on the Special Account was unsustainable at 6% gross per annum.

The issue now facing Deputies is whether the new interest rate of 3% is a sufficient return considering the investment objectives, and whether alternative investments should be sought.

In summary:

- Special Account is a deposit account which pays interest at a single variable rate, irrespective of the sum invested.
- Interest is paid gross, without deduction of tax, so non-tax payers do not need to reclaim the tax. However, those liable to tax still have tax to pay.
- Interest is credited to the account every six months, at the end of May and November each year, or on withdrawal of monies at any other time.
- It has no fixed term of investment. Monies may be withdrawn with no loss of interest or notice period.
- Assets are protected in their entirety by a Government guarantee.

It therefore follows that any directly comparable alternative would share these very attributes. This would likely be a cash deposit-type account with a bank, building society or other financial institution.

However, this presents a number of issues:

- **Rate of return** – The rate of interest available in commercially available accounts is very likely to be below that of the Special Account. As at January 2009 it is rare to see an account offering a rate higher than 2.50-3.00%
- **Availability** – It is possible there maybe somewhat of a limitation in terms of the number of accounts which can be operated by Deputies. Most banks and building societies offer accounts to individual investors, however, the eligibility criteria may be restrictive when trying to open an account as Deputy.
- **Access** – Generally speaking, the better rates of interest are to be found in accounts which do not offer instant-access to the capital invested. In many cases, the best rates of interest offered by an institution will be those in ‘fixed term bonds’ which essentially lock the capital away for a pre-defined period of time, usually a year or longer. The Special Account on the other hand still offers a relatively attractive rate of interest whilst maintaining instant-access status.

- **Security** – The capital held in the Special Account benefits from a 100% government guarantee. Capital held in bank and building society accounts do benefit from some degree of security but not nearly as much. Under the Financial Services Compensation Scheme (FSCS) deposits of up to £50,000.00 held with an institution are covered 100% by a government-backed guarantee. However, any sum in excess of this is potentially at risk in the event of that institution failing.

The most similar product which combines all elements of the above is National Savings and Investments' Income Bonds. All savings held with National Savings and Investments are backed by HM Treasury so the entire capital is effectively underwritten by the UK government. But the annual rate of interest paid is just 2.00% gross and there is a maximum investment limit of £1,000,000.00.

One can see that, from the perspective of directly comparable products, it is a commercial reality that nothing is available which offers the same combination of return, access and protection than the Special Account currently does.

That said, a rate of return of 3.00% gross will not be sufficient to achieve a 2.50% real and net return in a catastrophic case over the next 12 months, unless we see deflation. But is that really a reason for considering this safe-haven to be an inappropriate investment over the short-term in the present economic environment?

The alternative is to opt for non-comparable investments which have the potential to offer greater returns, but carry the risk of lower returns, or even capital loss. These include gilts, corporate bonds, property and equities.

This raises the fundamental issue of risk.

Let us not forget the wise words of Lord Lloyd of Berwick in the case of *Wells v. Wells*:

*“For the problem with equities lies elsewhere. Granted that a substantial proportion of equities is the best long-term investment for the ordinary prudent investor, the question is whether the same is true for these plaintiffs. The ordinary investor may be presumed to have enough to live on. He can meet his day-to-day requirements. If the equity market suffers a catastrophic fall, as it did in 1972, he has no immediate need to sell. He can abide his time, and wait until the equity market eventually recovers.*

*“The plaintiffs are not in the same happy position. They are not "ordinary investors" in the sense that they can wait for long-term recovery, remembering that it was not until 1989 that equity prices regained their old pre-1972 level in real terms. For they need the income, and a portion of their capital, every year to meet their current cost of care. A plaintiff who invested the whole of his award in equities in 1972 would have found that their real value had fallen by 41 per cent. in 1973 and by a further 62 per cent in 1974.*

*The real value of the income on his equities had also fallen.”*

*“So it does not follow that a prudent investment for the ordinary investor is a prudent investment for the plaintiffs. Equities may well prove the best long-term investment. But their volatility over the short term creates a serious risk. This risk was well understood by the experts. Indeed Mr. Coonan conceded that if you are investing so as to meet a plaintiff's needs over a period of five years, or even 10 years, it would be foolish to invest in equities. But that concession, properly made as it was on the evidence, is fatal to the defendants' case. For as Mr. Purchas pointed out in reply, every long period starts with a short period. If there is a substantial fall in equities in the first five or 10 years, during which the plaintiff will have had to call on part of his capital to meet his needs, and will have had to realise that part of his capital in a depressed market, the depleted fund may never recover.”*

It would be audacious to suggest that simply because Special Account interest has fallen, this signals that equity-based investments are automatically a more appropriate option.

Special Account, even paying this reduced amount of interest, offers benefits which simply cannot be matched by similar products for short-term investment. It offers a secure home for capital, particularly in times of volatility and negative returns in other asset classes.

However, as cash should form part of a well-balanced portfolio, so too should these other asset classes. Some Claimants are forced into a deposit-based investment strategy, for example because life expectancy is short or highly uncertain. Others, who have been relying solely on Special Account, but could take a long-term view, may well need to reconsider that arrangement. Those who already have appropriate long-term investment plans, which include exposure to a range of asset classes, are likely to be wise to continue monitoring the position with appropriate professional advice, balancing risk and reward with certainty and security, according to their individual needs.

In conclusion, the rate cut is not a reason to panic or make spontaneous decisions. However, it would be prudent to carry out a reasoned and practical assessment of the portfolio in light of this change.

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