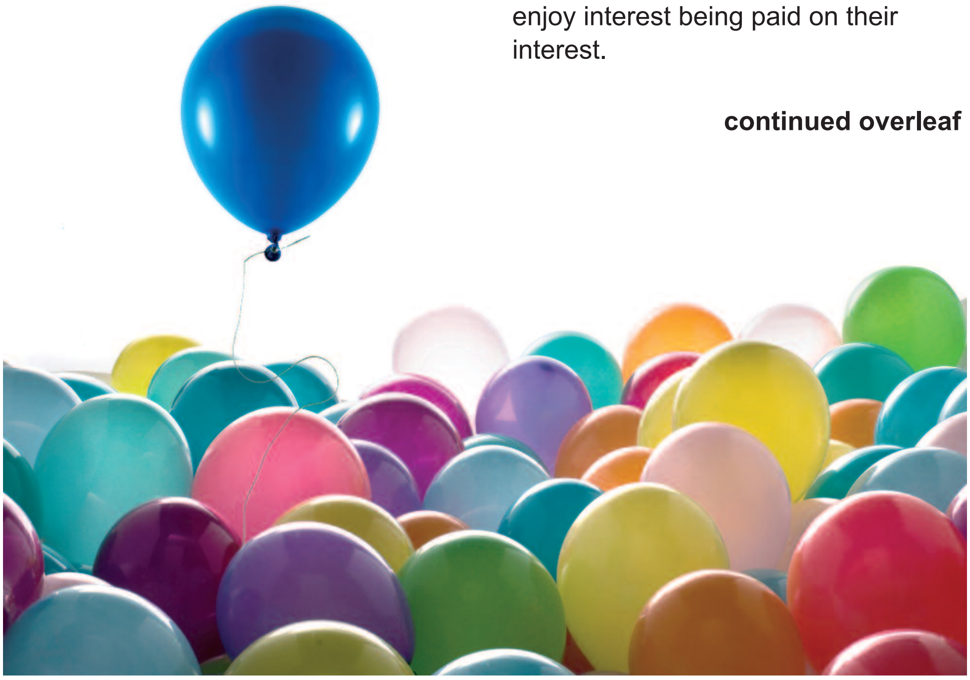
Inflation-Linked Savings **Guide**

It seems illogical to suggest that at the same time that the amount of money in a savings account is rising, a saver could actually end up worse off. Unfortunately, this is the effect that inflation can have on a nest egg.

Inflation is the term used to describe the general rise in the price of goods and services over a period of time. It has also been the bane of many a saver's life of late. Problems arise when inflation outstrips the rate of interest paid on savings accounts. Effectively this means prices are rising at a faster rate than savings are growing, and the purchasing power of money shrinks.

With interest rates at a record low, savers have faced an uphill challenge to stop the gradual erosion of their wealth. However, a small band of accounts have been on hand to offer some respite. Inflation-linked savings promise to track or beat inflation. This relatively simple premise should not, however, be taken as a sign that the accounts themselves are all straightforward.



How returns are calculated and paid, the fixed term nature of the accounts and their likely competitiveness going forward are just some of the factors that merit attention.

Calculating returns

Inflation-linked accounts usually operate in a similar fashion to fixed rate accounts, with money having to be locked away for a set period of time. As to how the rate of return is calculated, accounts tend to adopt one of two approaches.

Under the first approach, accounts will pay the percentage change in inflation plus a set amount of interest on top. This method normally involves the inflation change being calculated each year, meaning a three year account would have three calculations made over the term. It also means savers should be able to benefit from compound interest, and enjoy interest being paid on their interest.

continued overleaf

Key Facts

- **Inflation-linked accounts can help preserve the purchasing power of savings when interest rates are low.**
- **Accounts typically link returns to RPI inflation, but also add a further fixed amount of interest on top.**
- **Money normally has to be locked away for a set term. If early access to funds is allowed, considerable penalties are usually payable.**
- **Savers should consult the small print to work out how interest is paid and what might happen if deflation occurs.**
- **Some inflation-linked accounts are available in a tax-free ISA wrapper.**

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As an example of this approach, an account might promise to pay the annual growth in inflation plus 0.5%. So if the rate of inflation between, say, July 2011 and July 2012 is 5%, an investment of £10,000 will earn £500 in the first year, plus £50 (the extra 0.5% interest), making a total of £550. For the second year, the increased balance of £10,550 should provide the basis for the next interest calculation, and so on until the end of the term.

Under the second commonly used approach, an account will promise to pay a percentage of the growth in inflation over the whole term of the account. This means only one calculation is made, with an inflation reading being taken at the start of the account term and at the end. If inflation does not increase by a certain amount within the term, a minimum percentage return will normally be applied to the original investment.

For example, an account might promise to pay 110% of the growth in inflation over the next five years, but at the same time guarantee to pay a minimum return of 15%. So if inflation rises by 20% between July 2011 and July 2016, the saver can expect to receive a return of 22% overall (110% of 20%). In this instance, the minimum return guarantee has not come into play; however, if the final payout had worked out less than 15%, the saver would still receive their original investment back plus 15%.

Small print

The returns on inflation-linked accounts are usually linked to Retail Prices Index (RPI) inflation rather than the Consumer Prices Index (CPI). As the method of calculating the two rates of inflation means RPI is typically higher than CPI, this is a definite plus.

However, scrutiny of the small print attached to the accounts is a must, as some will be subject to finer detail which might not always work in the favour of a saver. Most accounts pay interest annually, so it is the rate of inflation in a year's time that will be relevant, rather than what it is today.

As money tends to have to be pledged to an account for a set period of time, it makes it essential that the funds will not be needed during the term. If early access to money is allowed, the severity of the penalties imposed is likely to significantly reduce any return. The worst case scenario is ending up with less than was originally invested.

> **"If interest rates start to rise, ordinary savings accounts could quickly end up paying more than inflation-linked accounts."**

At present, it is worth considering that being locked into an inflation-linked account might not be the best option. If interest rates start to rise, ordinary savings accounts could quickly end up paying more than inflation-linked accounts. Should this happen, anyone effectively tied into an inflation-linked account for a significant length of time might have little option but to sit tight and miss out on better returns elsewhere.

It should also be checked what happens if deflation strikes, and the rate of inflation turns negative. On the majority of accounts, inflation will be counted as zero, rather than negative, meaning money will not be deducted from an account. Indeed, if the account promises to pay inflation plus a set amount, the investment should continue to grow.

In respect of fixed interest add-ons, however, it is important to clarify exactly how this is paid. In some instances, rather than it being a yearly amount, it will be a one off payment over the whole term. Furthermore, if interest is paid annually, some providers arrange to pay this into a separate account, thus denying savers of the greater returns apparent through compound interest.

Tax-free accounts

Some inflation-linked accounts are available in an ISA wrapper. Another tax-free alternative are Index-Linked Savings Certificates from National Savings and Investments (NS&I), which pay a fixed rate of interest above RPI inflation. However, the promise of an inflation-beating rate has meant index-linked certificates have proven hugely popular.

And under rules designed to prevent NS&I dominating the savings market, the provider is only permitted to take in a certain amount of money each year. As a result, the last issue of certificates was withdrawn in September 2011, with no indication as to when a further issue can be expected.

Safety

As to the safety of savings, as long as an account is provided by a UK regulated bank or building society, it is protected under the Financial Services Compensation Scheme (FSCS). This means savers are guaranteed to receive the first £85,000 of their investment back should the institution fail.

Importantly, however, it should be noted that some inflation-linked accounts (usually those which offer a guaranteed minimum return) are likely to be structured products. In this instance, the account will be backed by a third party, which is usually an investment bank. As this can affect the safety of a deposit, it is best to check whether money invested into such an account is fully protected under the FSCS.

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