

# Introduction

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National Savings has its origins in 1861, as the Post Office Savings Bank. It was not until 1969 that the National Savings name was adopted. In 2002, National Savings rebranded itself as National Savings and Investments (NS&I), although the institution is still commonly referred to by its old name.

In its current form, NS&I has two main features that attract investors:

- Security – all National Savings products carry a government guarantee, which means that they rank alongside government bonds (gilts) and, for the time being, Northern Rock accounts, as the most secure investments available. There is virtually no risk of default because the government can always raise taxes to repay debts falling due if they cannot simply be refinanced.
- Tax efficiency – National Savings products have distinct attractions for taxpayers at opposite ends of the income spectrum:
  - Some National Savings products pay interest without deduction of tax at source (although the income is fully taxable). Gross payments of interest are useful not only to non-taxpayers, but also to those who pay a little income tax and are therefore unable to qualify for gross interest payments from banks and building societies. Such marginal taxpayers may pay little or no tax on their interest (see example below).
  - A limited range of National Savings products are tax-free. However, National Savings admits that the rates on offer are set to reflect the absence of tax. Thus they will generally only be of interest to higher rate taxpayers.

From the government's viewpoint, NS&I is an alternative to the gilts market as a means of raising finance. At 30 December 2008, the total sum held in NS&I amounted to £94.9bn.

Traditionally, NS&I has been viewed as being a safe but relatively uncompetitive home for money. The falling interest rates of the 1990s had their inevitable effect. So too did the government's strong financial position, which saw the Treasury repaying debt rather than raising money in the late 1990s. The profile of NS&I has been raised in recent years for three main reasons:

- The government's finances have moved heavily into the red, which has increased the Treasury's need to raise funds via NS&I.
- NS&I has revised its product range, eg by increasing investment limits for premium bonds, National Savings certificates and children's bonus bonds, and removing some old products.
- Concerns about the financial security of banks in the wake of the credit crunch have encouraged many cautious savers to seek the government-backed safety of NS&I.

## Example

Joan is 62. She currently receives gross pensions of £5,500 and net dividends of £270 from a handful of shares.

She also has £20,000 in a building society instant access account earning 1.5% gross.

Joan's total income is:

	£
Pensions	5,500
Dividends (gross)	300
Interest	300
<b>Total</b>	<b>6,100</b>

She cannot register with her building society as a non-taxpayer because her total income exceeds her personal allowance of £6,475 (2009/10).

This is the case even though she cannot reclaim tax on her dividends and therefore her pension and interest income is more than covered by her personal allowance.

If Joan invested in a gross interest paying National Savings product, such as the income bond, she would have no tax to pay on the interest and would avoid the hassle of tax reclaim that she currently faces with her building society account.

## Tax-free products

The range of NS&I tax-free products has expanded over the years, although maximum investment levels and fixed terms have generally restricted their usefulness.

### NS&I fixed rate certificates

There are now two terms for National Savings fixed rate certificates: two years and five years. At the time of writing, the current offers were:

Issue	Term	Return	Equivalent return for 20% taxpayer	Equivalent return for 40% taxpayer
	years	% pa	% pa	% pa
95th	5	1.90	2.38	3.17
46th	2	0.95	1.19	1.58

The maximum investment in each issue is £15,000, with no limit on reinvestment from previous matured issues. As an individual may invest in certificates as a trustee for someone else, in theory a married couple could invest a total of £120,000, of which £60,000 would be directly held and £60,000 in trust for each other.

Although certificates can be cashed before maturity, returns will be lower than the figures above. For example, there is no interest paid on certificates cashed in the first twelve months of their life. Nevertheless, it may be worth cashing in certificates early if interest rates rise and new issues are sufficiently more attractive.

Fixed interest certificates that matured before 8 October 2001 (7th–43rd issues) and have not been encashed or reinvested earn interest at the common extension rate. While this rate is tax-free, it is pitched at a level to encourage reinvestment: since 1 April 2009 it has been just 0.09% (worth 0.15% gross to a higher rate taxpayer).

A point to note is that the interest is credited at the end of each quarter after maturity, so a few weeks' delay before reinvestment will produce no extra interest. Fixed interest certificates

maturing since 8 October 2001 are automatically reinvested in a new issue with the same duration unless the investor takes action, eg encashment.

### Alternatives

For higher rate taxpayers it will usually be difficult, but not impossible, to beat the rate on offer by using bank or building society term deposits. Unusually, at present it is also possible to beat the two-year term certificate with one of NS&I's own products – its newly launched two-year (taxable) growth bond. This is available online or by phone, or by post for reinvesting NS&I investors only. It pays a fixed 3.75% gross (3% net to a basic rate taxpayer and 2.25% net to a 40% taxpayer).

Fixed term cash ISAs may, however, offer better rates, and at the time of writing a three-year fixed rate ISAs paying 4.20% was available. Non-NS&I ISAs do not, however, carry the same level of security. Guaranteed growth bonds from insurance companies may offer superior returns because of their taxation treatment, which does not involve grossing up.

### National Savings index-linked certificates

There are also two terms for index-linked certificates, although following a change in June 2003, the shorter term is now three years rather than two. Both terms of certificate provide a return at a pre-set level above the growth in the retail prices index (RPI). At the time of writing, the current offers were:

Issue	Term	Return	Equivalent return for 20% taxpayer	Equivalent return for 40% taxpayer
	years	% pa + RPI	% pa	% pa
46th	5	1.00 + RPI	1.25 + RPI	1.67 + RPI
19th	3	1.00 + RPI	1.25 + RPI	1.67 + RPI

The investment rules are the same as for fixed rate issues. The common extension rate does not apply to index-linked certificates. Instead, the rate is determined at maturity: typically just RPI is paid for issues that matured before 8 October 2001. Automatic reinvestment normally applies for later maturities, with two-year certificates maturing now earning RPI + 1.00% if held for a further two years.

Investors may face a choice between buying fixed rate and index-linked certificates. Ultimately the decision is a judgment on inflation, ie whether the fixed rate certificate's return less the index-linked certificate's margin will be greater than RPI growth. For example, the current terms for the five-year issues mean that in theory, inflation (as measured by RPI) must average more than 0.90% a year over the next five years for index-linked certificates to be a better bet (1.90% – 1.00% = 0.90%).

As RPI inflation is likely to remain negative during the second half of 2009, it is worth noting that the calculation of the value of index-linked certificates is on an annual basis and that the value at the end of each year cannot be below that at the previous anniversary. Thus one year of falling RPI will mean no inflation-linked growth for that year, rather than a loss to be offset against future inflation. As a result, in a year of negative RPI the investment return would be the guaranteed 1% interest.

### Alternatives

The only obvious competitor to index-linked certificates is index-linked gilts. As National Savings uses index-linked gilt yields to set its rates, any margin for a higher rate taxpayer is likely to be

small while inflation is positive. However, index-linked gilt values do not have the same no-loss treatment as the NS&I certificates.

## **National Savings individual savings accounts**

National Savings has three cash individual savings accounts (ISAs), subject to the usual ISA rules (see page 1, "Tax-Efficient Investments"). They are each variable rate, with no penalties on encashment or withdrawal. Interest is added annually on 5 April. However, only the Direct ISA is still on sale.

The Direct ISA may only be operated by phone or online and has a minimum investment of £1,000. It has a guaranteed minimum rate of 0.3% above Bank of England base rate until 5 April 2009, and currently pays 1.30% (0.8% above base rate). No transfers in can be made from other ISA providers, although NS&I will accept transfers from its own cash mini-ISA provided this was started before 6 April 2006.

### **Alternatives**

The ISA market is fiercely competitive, and until the launch of the Direct ISA it was usually possible to beat National Savings' ISA rates by at least 1%. While the Direct ISA did offer a market-topping rate at launch, it is now possible to find ISAs offering higher rates on either a variable or fixed basis. Some of these will also accept transfers in.

## **Children's bonus bonds**

The children's bonus bond is a five-year fixed rate bond designed for investment by parents (and others) on behalf of children under the age of 16. All interest is rolled up until the maturity date, at which stage the bond can be reinvested for another five years, provided the child is still under age 16.

The return is tax-free (currently 2.30% a year for Issue 33, including the fifth anniversary bonus), so there is no liability for tax if a child's parent supplies the capital. Income from other investments made by parents on behalf of their unmarried minor children is potentially taxable on the parents.

The maximum investment is now £3,000 per issue, per child. New issues generally appear when there is a change in medium-term interest rates. Although designed as a five-year investment, the bond can be cashed at any time. However, the rate of interest earned is just 1.65% (as a maturity bonus is paid at the fifth anniversary), and if the bond is cashed in the first year, no interest at all is payable.

### **Alternatives**

If the investment is made by a higher rate taxpaying parent, in the past it has often been impossible to match the return available from National Savings. For basic rate taxpayers, better returns are available elsewhere. However, at the time of writing it was possible to obtain 5.4% on five-year fixed rate deposits, which is equivalent to 4.32% net for a basic rate taxpayer and 3.24% net for a higher rate taxpayer. If a non-taxpaying parent or anyone else makes the child's investment, the children's bonus bond is uncompetitive. In such cases interest from conventional deposits will normally be higher because there is no tax liability.

## **Premium bonds**

Premium bonds offer purchasers the chance to win a variety of monthly tax-free jackpots from £25 up to £1m. The maximum amount that can be invested is £30,000. The prizes are heavily weighted towards small sums. For example, in the July 2009 draw there were 1,084,424 £25 prizes, but only 77 prizes of over £1,000, including one £1m prize. The chances of any £1 bond winning a prize in any one month are currently 36,000 to 1.

The prize money represents interest on the total amount invested in premium bonds. The rate normally varies in line with short-term interest rates and on 1 April 2009 was cut to 1.00% (worth 1.25% gross to a basic rate taxpayer and 1.67% gross to a higher rate taxpayer).

In theory, a basic rate taxpaying investor with average luck can earn more by choosing more conventional investments, including other National Savings products. At current rates, even a higher rate taxpayer can more than match the theoretical net return from premium bonds with the market-leading internet no-notice accounts.

## Taxable fixed rate products

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NS&I has a range of taxable bonds, although higher rate taxpaying investors will generally find the tax-free products offer superior net returns.

### Guaranteed growth bonds

These were introduced in February 2008 as a replacement for the fixed rate savings bonds and the capital bond. The bonds offer fixed rates for one, three or five years. Interest is accumulated throughout the term and is paid at maturity. The interest is subject to 20% tax, deducted at source, which is wholly or partly reclaimable by 10% and non-taxpayers.

Bonds can be cashed before the end of their term, subject to 90 days' loss of interest. The minimum investment is £500 and the maximum investment in all guaranteed growth bonds and guaranteed income bonds is £1,000,000. The current issues are:

Term	Issue	Gross rate annual interest	Return to basic rate taxpayer	Return to higher rate taxpayer
years		% pa	% pa	% pa
1	47	1.00	0.80	0.60
2**	40	3.75	3.00	2.25
3	41	1.75	1.40	1.05
5	38	2.60	2.08	1.56*

\* 95th Issue Five Year Fixed Rate Certificates offer marginally better net return, but maximum investment is £15,000.

\*\* Exclusively available online or by phone, or by post for reinvesting NS&I investors only.

### Alternatives

As the table above demonstrates, NS&I may itself offer better returns than its fixed rate certificates. Elsewhere, fixed rate deposits from banks and building societies will generally be superior. For example, at the time of writing the best gross fixed rates for £10,000 were 4.35% over two years, 5.00% over three years and 5.40% for five years, with up to 3.85% available for a one-year term. Higher rate taxpayers may find insurance-based guaranteed income and growth bonds offer superior returns because of their tax treatment.

### Guaranteed income bonds

These bonds were introduced alongside guaranteed growth bonds in February 2008 as a replacement for the pensioners bond and the income version of the fixed rate savings bonds. The bonds offer a fixed rate of monthly income, paid over terms of one, three and five years. All interest is subject to 20% tax, deducted at source, which is wholly or partly reclaimable by 10% and non-taxpayers.

The minimum investment is £500 and the maximum investment in all guaranteed income and guaranteed growth bonds is £1,000,000. Bonds can be cashed before maturity subject to 90 days' lost interest.

Term	Issue	Gross rate annual interest	Return to basic rate taxpayer	Return to higher rate taxpayer
years		% pa	% pa	% pa
1	47	1.00	0.80	0.60
2*	40	3.65	2.92	2.19
3	41	1.70	1.36	1.02
5	38	2.55	2.04	1.53

\* Exclusively available online or by phone, or by post for reinvesting NS&I investors only.

### Alternatives

The National Savings income bond is an obvious competitor, but its rates are not fixed. At present the income bond offers 1.70% monthly interest (paid gross) for investments of less than £25,000 and 2.00% for larger sums. Banks and building societies will usually offer better rates for non- and basic rate taxpayers, while higher rate taxpayers can generally obtain higher income from insurance-based guaranteed income bonds.

### Guaranteed equity bonds

This is one of NS&I's more modern products, the launch of which marked a significant change of approach from its familiar deposit-based investments. However, in the marketplace as a whole, the guaranteed equity bond was nothing new. The last issue (Issue 18) closed on 11 August 2009. It had a five-year term, at the end of which the investor was guaranteed the return of their original investment plus 100% of any growth in the FTSE 100 index, subject to a maximum return of 40%. The index was averaged over five days at the start and each day over the final six months.

As index measures are used, no account is taken of dividends (worth about 4.3% a year at present). Interest at 0.50% gross was earned between the date of investment and 26 August 2009. All returns are paid gross, but at maturity profits are subject to income tax, not capital gains tax (CGT). The maximum investment was £1,000,000, or £2,000,000 for joint investors. Issue 18 was very similar to the previous issues and further issues along the same lines are expected.

### Alternatives

The nature of this type of investment makes direct comparison difficult. Other providers use different averaging periods, different indices, different structures and different durations. Investors attracted to this type of product should also look at the guaranteed equity plans offered by some product providers (onshore and offshore), which can have tax advantages over the simple deposit structure. The guaranteed equity plans structured as medium term notes (MTNs) can be highly tax-efficient, as profits are treated as capital gains or can be completely sheltered in an ISA.

Investors who are not concerned about the underlying capital guarantee would be well advised to consider investment in an index tracking fund, where there will be no loss of dividend income, no averaging, and CGT treatment will apply.

## Taxable variable rate products

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### Income bonds

Income bonds are open-ended deposits that pay a variable interest rate monthly, without deduction of tax. Interest rates are variable at six weeks' notice and move broadly in line with bank base rates. Bonds can be cashed at any time, with no notice or interest loss. The maximum total investment is £1,000,000.

Amount of investment	Gross rate monthly interest	Return to basic rate taxpayer	Return to higher rate taxpayer
	% pa	% pa	% pa
£500 – £25,000	1.70	1.36	1.02
£25,000 +	2.00	1.60	1.20

### Alternatives

The income bond was originally created as a rival to the building society 90-day notice account and itself originally had a 90-day notice requirement. The 90-day notice account is now a rarity, and those that still exist can often be beaten by instant access postal/internet accounts on offer from banks and building societies. For example, at the time of writing 2.47% was on offer for a £10,000 investment in a no-notice internet account paying interest monthly.

### Investment account

The investment account is a deposit account, with variable rate interest paid annually on 31 December. Withdrawals can be made without notice or penalty. All interest is paid gross.

Amount of investment	Gross rate	Return to basic rate taxpayer	Return to higher rate taxpayer
	% pa	% pa	% pa
Under £25,000	0.20	0.16	0.12
£25,000 +	0.30	0.24	0.18

### Alternatives

The investment account is an old-fashioned passbook account. Its rate of interest can be easily beaten by telephone, postal or internet accounts. Even NS&I's easy access savings account (see below) offers better rates for £100+. For example, at the time of writing, the leading no-notice online accounts were offering around 3.00% for a £10,000 deposit.

### Easy access savings account

This is NS&I's latest account and has replaced the ordinary account, which was phased out in 2004. All interest is paid gross. Withdrawals may be made without notice and the account can be operated by phone and cash card, as well as at post offices. Interest rates are tiered.

Amount of investment	Gross rate % pa	Return to basic rate taxpayer % pa	Return to higher rate taxpayer % pa
£100 – £9,999	0.30	0.24	0.18
£10,000 +	0.45	0.36	0.27
£50,000 +	0.70	0.56	0.42

## Alternatives

The easy access savings account is a more modern type of account than the ordinary account, and shows NS&I starting to take on the banks and building societies. However, even though it is more competitive than the investment account, its rate of interest can be easily beaten by telephone, postal or internet accounts.

## The Post Office is not National Savings

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Although National Savings and the Post Office appear at times to be synonymous, they are two completely separate organisations. Application forms for National Savings products are generally available from local post offices, but the Post Office is now also promoting its own investment products. Some of these are very similar to the National Savings offerings, eg a guaranteed equity bond. However, the Post Office branded products are not Treasury-backed, but instead are underwritten by a commercial bank. Investors who want the security of National Savings should bear this in mind.

## Northern Rock is not National Savings, but it is close

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Northern Rock is now a government-owned bank, so the security it offers investors is equivalent to that provided by National Savings. However, Northern Rock's interest rates still to some extent reflect its previous private sector existence and are currently much higher than NS&I's. For example, Northern Rock's one-year fixed rate bond currently pays 3.60% gross against 1.00% from the National Savings one-year guaranteed growth bond.

Over the last year Northern Rock's variable interest rates have become less competitive as the bank's loan book has shrunk, but they still usually beat NS&I easily.

However, the government's backing of Northern Rock deposits will disappear as and when the bank is returned to the private sector, which some reports suggest may be by the end of 2009.

## Conclusion

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For the investor seeking the ultimate security, National Savings has only two real competitors: gilts and, for the time being, Northern Rock. However, the safety of National Savings has tended to come at a high price. With a few niche exceptions, eg savings certificates for higher rate taxpayers, the net returns available from National Savings can be easily beaten elsewhere in the market.

The NS&I website, [www.nsandi.com](http://www.nsandi.com), has a quick guide to National Savings, continuously updated, which gives the latest interest rates on offer, at: [www.nsandi.com/pdf/ifa\\_quick\\_guide.pdf](http://www.nsandi.com/pdf/ifa_quick_guide.pdf).

*This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.*