MODULE 9 Pensions

Learning objectives	Activity
By the end of the session you will understand…	
The differences between Defined Contribution Pension Schemes (Money Purchase) and Defined Benefit Schemes (Final Salary), Stakeholder Schemes and Personal Pensions	*9.1 Looking at Pension types*
How Defined Contribution Pensions schemes work	*9.2 Looking at DC schemes*
That you have investment options in most Defined Contribution Pension Schemes	*9.3 Looking at options*
That the responsibility and risk building up an adequate pension fund rests with you	*9.4 Responsibilities and Risks*
The ways of taking your pension: Small Pension Funds, Lump Sum Payments, Annuities, Larger Pension Funds.	*9.5 Taking your Pension*

Currently, many organisations are changing their pension schemes and Money Purchase Schemes often referred to as 'Defined Contribution Pension Schemes' are being favoured. In many cases these are replacing final salary pension schemes, often referred to as 'Defined Benefit' schemes, which are being closed or phased out.

This module looks at the way Defined Benefit and Defined Contribution Schemes work and what this means for the individual employee.

9.1 Looking at Pension Types

An occupational pension scheme is an arrangement set up by a company or other organisation (sometimes called the scheme's 'Sponsor') to give its employees a pension income when they retire.

For people in work, occupational pensions are usually a good way of providing pension income to supplement the State pension.

Most employers who provide occupational pension schemes will make some contribution to the employee's fund. This will increase the employee's final pension at retirement. There are two main types of Pension Scheme – Defined Benefit and Defined Contribution.

In both Defined Benefit and Defined Contribution Schemes, although the pension arrangements are set up by the employer, and normally the cash paid into your pension fund is managed by an insurance company or pension provider, the Pension Scheme is run by a Board of Trustees (with the exception of most public sector schemes). This is because to obtain 'tax exempt status' Pension Schemes must be set up as a Trust with the assets held quite independently of the Employer's organisation. The Trustees have certain powers, responsibilities and duties, which are governed by the Law relating to Trusts and the Trust Deed for the Pension Scheme.

Salary–related schemes (also known as Defined Benefit Schemes)

These come in several forms, but the two main kinds are Final Salary and Average Salary Schemes

Final Salary Schemes

Here the pension received on retirement is based on:
- The number of years you have belonged to the pension scheme, and
- How much you earn, either at or shortly before retirement.

All pension schemes have their own rules about the way in which your pension is calculated and the age from which it is payable. In many schemes, for every year you belong to the scheme you earn 1/60th of your final salary.

> **Example**
> Jacob is aged 65 and has belonged to his employer's Pension Scheme for 30 years. The pension scheme rules grant him a pension equal to 1/60th of his final salary for each year he has been in the pension scheme. His pension therefore would be 30/60ths of his final salary.
>
> His "final salary" may be what he has earned in his last year, or the average of his earnings over three or even five years – the actual amount will be set out in the scheme's booklet and rules.
>
> However it is defined, his final salary is £20,000. He would therefore get 30/60ths x £20,000 = £10,000 per year as a pension (Note : this will reduce if he takes a lump sum).

Some public sector pension schemes provide a final salary pension scheme, but based on 1/80th of your final salary rather than 1/60th. In these schemes, a lump sum is provided in addition, rather than by giving up part of your pension.

Career Average Schemes

Although many defined benefit pension schemes base the calculation of your pension on your final salary, some schemes base it on your 'career average' salary. Your career average salary will depend on the rules of your pension scheme but it will normally be based on your earnings over a number of years. Your earnings in each year may be revalued up to retirement but, again, this will depend on the scheme rules.

The example below provides a simple illustration but it does not include a revaluation of Jack's salary: you will need to check the rules of your pension scheme to see how the revaluation works in your case.

> **Example**
> Jack has been in his company pension scheme for 20 years. The rules of his pension scheme base his pension on 1/60th of his salary in each year of his membership. Jack's pension will therefore be 20/60ths of the average of his salary over the last 20 years. During these years his pay started at £10,000 and increased by £500 a year to £20,000. In simple terms, his average salary over the period was £15,000. So he could expect a pension of 20/60ths x £15,000 = £5,000 per year. (Note this will normally reduce if he takes a lump sum).

Money Purchase Schemes (also known as Defined Contribution Schemes)

In a Money Purchase Scheme, as the title suggests, the employee's contributions, together with the employer's contributions, are invested to build up a pension fund for you. Instead of defining the pension you will get, the scheme rules will set out the contributions that you (and possibly your employer) will pay. This means that the amount of your pension will not be guaranteed.

Instead, the amount of your pension at retirement will depend on the size of your pension fund. This will be determined by:
- The total of the payments made by both yourself and your employer into the pension fund, and
- How well this fund has been invested, i.e. the extent to which the investments held on your behalf have grown.

When you retire, the fund accumulated on your behalf is used to provide your pension, normally by using it to purchase an annuity, although you may also opt for a 'drawdown' arrangement.

Your annuity will be based on the amount in your pension fund and the annuity rate the insurance company is prepared to offer.

This rate offered by the insurance company is calculated using several factors including interest rates and your age, gender and sometimes health. It will also depend on the options (see page **9**/6) you choose when you take out the annuity.

Annuity rates vary from company to company and on the market conditions at the time you buy the annuity. There are no guarantees as to the annuity rate that will be on offer at the time you buy your annuity. However, once bought, the amount of your annuity will normally be guaranteed.

Other Types of Defined Contribution Pension Schemes

Stakeholder Pensions and Personal Pensions that are explained in Module 8 work on the same principle of making contributons to build up a pension fund that will then be used to provide your pension.

Self Invested Investment Plans (SIPPs)

These are also pension plans that an individual can open with a financial service company. They provide a "wrapper" in which to build up a pension fund. You can contribute regular monthly amounts, or lump sums, and your employer may also contribute. The advantage of SIPPs is that you can invest in a wider range of assets and have control over which investments are purchased. You can invest in individual company shares, unit trusts, investment trusts or even commercial property. The Government set the rules on the types of assets that you can include in your SIPP.

However, the financial services company will charge for setting up and managing your SIPP, for selling or changing assets within the fund and, possibly, when you convert the Plan into a pension at retirement.

Differences between the Types of Pensions

In a Defined Benefit Scheme the pension you will receive is based on your salary and ultimately it is your employer's responsibility to decide on the benefits offered and, even more importantly, to ensure the scheme has enough money to provide them.

The pension you will get from a Defined Contribution (Money Purchase Scheme) is NOT related to your salary. Instead it depends on the pension fund you have been able to accumulate and the terms you can find for converting this into a pension (i.e. buying an annuity). It is therefore your responsibility to ensure your fund can provide you with an adequate pension.

9.2 Looking at Defined Contribution Schemes

This type of scheme is based on the accumulation of contributions from the Employee (and Employer) to create a pension fund for the individual: it is important to understand the Contribution rules which apply in your Scheme.

Contributions

In April 2006, many of the tax rules relating to pension contributions were relaxed.

You can now contribute almost any amount each year towards a pension, and you can pay into as many pension schemes as you like, although there are still limits for tax relief on contributions and about the size of your pension fund. The rules of the pension scheme may also have limits which allow lower sums.

The HMRC rules will allow you tax relief on contributions up to 100% of your annual earnings in the tax year, up to a maximum of £50,000 in 2011/12. There is also a "lifetime limit" on the value of your total fund at retirement from all pension schemes combined without paying tax – this is a sum of £1.8 million in 2011/2012. High earners should be aware tax relief on pension contributions is under review.

In most company schemes the Employer will pay contributions into your pension fund equivalent to a percentage of your salary.

These employer contributions are not deducted from your salary, but are additional payments made directly into your pension fund.

The Employee decides how much to contribute from their salary. This is deducted from salary and paid into the fund.

The Effects of Tax Relief

Unless you are a very high earner (£130,000 per annum) your contributions paid into the scheme are 'fully deductible' for tax purposes. This means that, if you are a basic rate taxpayer, every £100 you pay into your Pension Scheme will cost you just £80.

If you are a 40% rate tax payer, the £100 contribution will cost you only £60.

In a company pension scheme, you will pay the full contribution to the scheme and receive tax relief through your payslip.

In Stakeholder and Personal Pension schemes, you will pay your contribution net of basic rate tax, and the provider will receive the balance direct from the tax authority (HMRC). If you are a higher rate taxpayer, you will need to reclaim the additional tax relief at the end of the tax year.

Case Study

Example 1

Gill is a basic rate taxpayer who earns £21,000 per annum. She and her employer both contribute 6% into a Personal Pension fund.

Thus each year Gill's pension fund receives the following contributions:

Employers contribution		
6% of £21,000 =		£1,260
Gill's contribution is:		
her own contribution	£1,008	
tax relief claimed for her by the pension provider	£ 252	
Total		£1,260
Total Contribution		£2,520

Because Gill's employer is contributing and because she can claim tax relief on her own contribution it costs her £1,008 each year, but the pension fund benefits by £2,520.

Example 2

Mary is a higher rate taxpayer who earns £45,000 per annum. She and her employer both contribute 6% into a Personal Pension fund.

Thus each year Mary's pension fund receives the following contributions:

Employer's contribution		
6% of £45,000 =		£2,700
Mary's contribution is:		
her own contribution	£2,160	
tax relief claimed for her by the pension provider	£ 540	
Total		£2,700
Total Contribution		£5,400

In addition Mary will claim additional tax relief through her tax return at the end of the year amounting to £540.

Everyone, whether they are working or not, can pay £3,600 gross into a Stakeholder, Personal or SIPP pension scheme. This means that an individual can make a contribution of £2,880 each year into a pension plan and the pension provider will reclaim tax of £720, so providing the total contribution of £3,600.

Additional Voluntary Contributions (AVCs) and Freestanding AVCs

These are ways of 'topping up' your pension income and enjoying the same tax concessions as on your other pension contributions. Module 8 provides more information on AVCs and Freestanding AVCs.

Protection of the Pension Scheme

Over the last 15 to 20 years, a number of safeguards have been put in place to protect pensions. These are too numerous to mention in detail, but the following are worthy of mention:

- The Pension Protection Fund was set up from April 2006 and relates primarily to Defined Benefit Schemes. It is designed to protect your pension (dependant upon status and service, and up to an upper limit) if your employer becomes insolvent.

- The Financial Services Authority oversees providers of Stakeholder, Personal Pensions and investment managers of Defined Contribution employer schemes.

Annual Statements

If you contribute to a Defined Contribution Scheme you MUST be given an annual benefit statement showing contributions paid and the current value of your fund, together with an illustration of the pension income you might expect in retirement. This should take into account how inflation between the date of the statement and your expected retirement date could reduce the buying power of your pension income.

Changing Jobs

Should you leave your employer's Defined Contribution Scheme you will normally have a choice of moving the value of the fund to your new employer's chosen scheme, or to a personal pension plan or stakeholder pension, or of leaving it in the scheme. If you leave your fund in your old employer's scheme it will benefit from any growth in the investments, but you may also have to meet some annual costs which will be deducted from your fund.

If you have a Personal or Stakeholder Pension, you can continue paying contributions to it. If your former employer also paid contributions, these will stop. In some circumstances your new employer may agree to contribute.

9.3 Understand your investment options (Defined Contribution (Money Purchase) Pension Scheme)

The first decision is how much to contribute although, in some schemes, there may be only one contribution rate.

Your decision may be influenced by the % the employer is prepared to contribute. In some pension schemes the employer will match your own contribution up to a specified limit.

You will need to decide how much a month you can afford to contribute. You may have other savings for retirement and you will have an eye on the size of pension fund you are aiming to build up. As a very rough rule of thumb a pension fund of £50,000 used to purchase an annuity for someone at age 65 will provide a pension of about £60 a week, depending on the type of annuity you choose.

Your second decision is to select suitable investments for your contributions. As a contributor to a Defined Contribution Scheme you usually have options as to how the contributions are invested. Your employer may arrange for the pension provider to discuss the various choices with you. If this does not occur you will need to look at the choices being offered to you and, perhaps, seek independent financial advice.

Usually the Scheme will have a selection of different 'Funds'. A 'Fund' in this context contains a variety of investments, which are combined to meet a particular need. Each will have its own aims in terms of investment returns and investment risks.

For instance a 'Cautious Fund' will hold a group of investments within the Fund which are expected to grow at a fairly modest rate but do not carry high risk. These would be likely to include some UK 'blue chip companies', some cash and some bonds including Government Bonds. As it is a Cautious Fund the proportion of Bonds, both Corporate and Government, will be higher. It would be expected to have a low risk that your investment will fall in value but, because of the cautious type of investments, it might not grow quickly.

An alternative is a 'Balanced Fund' in which the investments it holds will have a higher risk/return profile. These may have European investments and Bonds, some UK Companies and some Corporate Bonds offering higher interest rates. The Balanced fund will have a higher proportion of equities (shares) than the Cautious fund. If you choose this type of fund you can expect to take more risk but, in return, you are hoping for a higher rate of growth.

'An Aggressive Fund' would have an even higher risk/return profile as the investments would have a higher still proportion of equities often in smaller companies in diverse locations e.g. global or international connections. You are accepting greater risk in return for the hope that the fund will grow more quickly.

You may be offered choices such as those described above or your pension provider may offer you individual funds that invest in only one category such as cash, bonds, property or equities of small companies, large companies, European or American or Japanese or Asian companies.

Within this range of funds there is also a range of risks which you need to understand before investing in any of them.

Generally, the younger you are the more likely your holdings should be biased towards equities and as you approach retirement you may want to change into Bonds or Cash carrying a lower risk profile. This will help to ensure you do not suffer a last minute fall in the value of your pension fund as a result of any sharp falls on the stock market.

It is up to you to decide how your contributions are invested. You will normally specify what percentage of your total monthly contribution is to be allocated to the various funds. Your decision will affect the growth in your fund and it is an important decision for you to think about. It should reflect your attitude to risk and you will wish to take into account the length of time before you need your pension. You can change your allocation and usually you can switch your money from one fund to another. You might want to think about doing this as you get nearer to your date of retirement.

If you don't make any decision about how your contributions are to be invested, they may be allocated to a 'Default' Investment choice. This is often called the Lifestyle option.

This means that the fund (or combination of funds) will not be your choice, but that of the Pension Scheme Manager, who may have it in place for just that eventuality. The fund may be suitable for you, but you should investigate, as it may not be ideal for your circumstances.

In any event, the more information and knowledge you have about how your contributions are invested the more aware you will be as to whether contributions need to be increased or investments changed to suit your risk profile, which may have changed over time.

9.4 Responsibilities and Risks

In a Defined Contribution (Money Purchase) Scheme, including a company arrangement or a stakeholder, personal pension or SIPP scheme, it is entirely your responsibility to ensure you have an adequate pension fund to generate the amount of pension you will require after retirement.

You have to make decisions about how much income you will need for your retirement and how this is to be obtained. You need to decide how much of your income will come from your pension, how much from your state pension, and how much from other investments you might have.

You also have to decide the amount you need to contribute and how that is invested. There are risks about investments – investments can go down as well as up – and you must decide how much risk you are willing to take in growing your pension fund.

9.5 Taking your Pension

When you decide to take your pension, your pension fund is used to provide your pension. In a Defined Contribution Scheme you may take up to 25% of your pension fund as a tax free lump sum. If you do take this lump sum, your pension fund will be reduced by that amount and it will provide a smaller pension.

You can provide your pension either by purchasing an annuity, or by withdrawing income from your pension fund although this second option is really only suitable for larger pension funds.

There are special rules for small pension funds that do not exceed £18,000.

Small Pension Funds

If your pension fund is less than £18,000 you can take all the fund in one cash payment. You must be between the age of 60 and 75 and, if you have more than one fund, the total of all the funds must be under £18,000. One quarter (25%) of the payment is tax free and income tax is payable on the residual 75% at your marginal rate of tax. The 2008 Budget introduced a concession whereby pension funds of less than £2,000 can be taken in cash even though your other funds might exceed £18,000.

Lump Sum

Between the ages of 55 and 75 you can take 25% of your pension fund as a tax free lump sum.

Example

Simon is 65 and his pension fund amounts to £70,000. He can take 25% of £70,000 i.e. £17,500 as a tax free lump sum leaving £52,500 in his pension fund.
The remainder of his pension fund, i.e. £52,500, is used to provide his pension.

Annuity Purchase

An annuity is, essentially, a pension which is guaranteed to be paid for the rest of your lifetime or, sometimes, for a fixed period of time. The advantage of an annuity is that the income can continue however long you may live. The disadvantage is that, should you die early, any balance of the money you have paid is not returnable. An annuity is a form of insurance, which spreads the risks over a lot of individuals.

You can use your pension fund at retirement to purchase an annuity. There are different types of annuity but in return for your pension fund an insurance company or annuity provider will provide you with an income for life. You will normally have a 'menu' of options from which to choose. For example:

- you may choose an annuity that does not increase, but remains the same for the rest of your life, sometimes called a 'level pension', or
- you may want to choose an annuity that increases each year to help it keep pace with price inflation; this will mean you get a lower starting pension.
- you can choose an annuity that has a minimum guaranteed period so that, if you were to die shortly after retirement, your dependents would benefit from it, or
- you can elect for one that would give your widow / widower a pension if you were to die first.

If you are not sure which type of annuity is right for you, a pension adviser or an Individual Financial Adviser (IFA) may be able to help. You should be able to find a local adviser from the website **www.unbiased.co.uk.**

The pension provider who has been looking after your pension fund will normally offer to provide your pension. However there are many other insurance companies who will provide you with an annuity (pension) and some of these may offer different rates of pension in return for your pension fund. It is important to check that you are getting:

- an annuity that suits your needs e.g. a level pension allowing for a widow / widower element if you die first; or one that increases to protect you against inflation
- the best rate of pension you can get

Do check the market – you don't have to purchase your annuity from the insurance company holding your pension fund. You may want to consult a pension adviser to help you with your choice.

If you are in poor health or are a smoker you may be able to get a higher annuity - do check.

It is no longer required that you purchase an annuity by the age of 75. New drawdown and tax arrangements were introduced in April 2011.

Larger Pension Funds: Capped and Flexible Drawdown

You are not required to purchase an annuity to gain your pension although, in some circumstances, it may be the best option. Those with larger pension funds – typically above £100,000 or even higher – can take an income from their pension fund by drawing down annual or monthly payments. The charges for this service generally make it uneconomic for pension funds below £100,000.

Under a drawdown arrangement, your pension fund remains invested and you take an income from it. The advantages are that you get to choose the level of income, within limits set by the Government Actuary, and your pension fund will remain within your estate for the benefit of your dependants. For those with a guaranteed lifetime income of £20,000 per annum may opt for 'flexible drawdown that will enable them to take unlimited amounts from their pensions.