Your essential guide to a more prosperous retirement

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1.0 Introduction

This guide aims to improve your understanding of the ever-changing world of pensions and retirement. It will begin by giving some background to pensions. It will then go on to highlight the different types of pensions and their benefits. Finally, it will explain the various ways of accessing pensions and the important considerations which must be made when transferring a pension.

2.0 The wonderful world of pensions

Pensions can sound a bit dull and dreary and it can be very tempting to put off properly saving into them. It is well documented that UK workers are notorious for failing to save for the future.

When people are young it is very easy to dismiss pensions as not important, as retirement seems a distant consideration.

When the expenses of life encountered in your thirties and forties arrive such as buying a home, paying for a wedding and raising children, saving for retirement can feel a long way down the list of priorities.

Then into your fifties, with retirement approaching fast, it can be all too easy to decide that as you have not saved enough yet, there is no point bothering now. However, saving and making the most of a pension is vital and provides your best chance of securing a decent income when you retire. After you finish working, you will still need to pay for bills, accommodation, food - and the occasional treat. To afford all of this and live the life you want to live in retirement it is very important you plan ahead.

When you plan to retire and take your pension benefits, there is now far more options and more flexibility with the way in which you can access your pension benefits and the importance of considering these options and selecting the right option for you is more important than ever.

When it comes to pensions, there is much to digest and many factors to consider. However, there are people and resources available to help guide you whether it be financial advisors, charities, and government resources.

What is a pension?

A pension is a financial product which works by investing money into it over a number of years. The money saved into a pension gets a boost from tax relief, which effectively means you are saving out of untaxed earnings.

When you retire, you can then access your pension and there are now many different ways you can do this. The next section will outline the two main types of pension and the different ways in which they work.

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3.0 The two main pension structures

There are two main types of pension that people use to save for their retirement.

A defined benefit (DB) pension scheme pays you a set annual income in retirement. They are often referred to as final salary schemes as they usually pay you an income based on your earnings at the end of your employment with a company. Those that are invested are known as funded schemes, those that are not are considered unfunded. In either case, the main features of the DB pension are as follows:

- Pension contributions may or may not be invested.
- Pension pots do not rise or fall based on the performance of investments.
- Members are not given a choice as to how their money might be invested.
- Provides a guaranteed income at retirement.
- Pensions are not eligible for most of the freedoms introduced in 2015.
- Allows PCLS (Tax Free Cash).

Participating in the DB scheme allows you to put money away for the future with the understanding that your payments and other benefits should be guaranteed. Any investments made by the pension operator have absolutely no bearing on benefits received. The amount a worker receives in retirement is calculated using a mathematical formula, which accounts for pensionable years, pensionable earnings, and accrual rates.

These promises made to workers by company Defined Benefit Schemes have proved very expensive to fund and the shortfalls have to be made up by the employer. As a result of this, these schemes have become rare in private businesses and are now more commonly offered to people working in the public sector.

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A defined contribution (DC) pension scheme is one that relies solely on investments and investment return to determine how much you will receive in retirement. The main features of the DC pension are as follows:

- Contributions receive tax relief at your highest marginal rate of income tax.
- Pension operators invest contributions on behalf of members.
- Pension pots rise or fall based on investment performance.
- Members are often given a limited choices regarding how money is invested.
- Allows you to take advantage of the new pension flexibility rules recently introduced.

Participating in a DC pension allows you to put money away for the future with the understanding that the pension scheme should grow your money by investing in a fund of your choice although the investment options are usually limited. You receive benefits and retirement funds based on how well those investments perform. A scheme that enjoys substantial growth should pay quite well in retirement while one that does not perform as well will pay a lot less.

If you are currently participating in an occupational or personal pensions scheme you are on the right track. It is important however, that you pay attention to your scheme to ensure it is performing and will provide you with the income you require in your retirement. If a pension is not performing then it can be reviewed and transferred to another pension scheme that is more suitable to you.

By 2018, all employers must provide a workplace pension scheme. This is called 'automatic enrolment'. Your employer must automatically enrol you into a pension scheme and contribute to your pension if all of the following apply:

- You are classed as a 'Worker'.
- You are aged between 22 and State Pension age.
- You earn at least £10,000 per year.
- You ordinarily work in the UK.

Due to the prohibitive costs associated with final salary schemes, you are unlikely now to be offered this type of scheme unless you work within the public sector. If you are not entitled to access to a final salary scheme then it is in your best interest to join your companies auto enrolment or company defined contribution scheme.

4.0 Don't forget your State Pension

The Government provides income in retirement through the basic State Pension. There is often a misconception in the public realm that they do not have to save for their retirement, as they believe it will be funded by the government. However, as the figures below highlight, the amount of money a person will receive from a state pension is currently well below the amount people would like to receive as an income in their retirement.

The new flat-rate state pension currently £159.55 a week was introduced from April 2016, although not everyone will be entitled to receive this. This equates to an annual pension of £8,093.80 if you qualify for the full state pension, which is well below the income many people would hope to live on in retirement.

The state pension age is being increased over the next few years due to the pressures on funding from people living longer. To calculate when you will receive your state pension you can visit the HMRC website.

Furthermore, not everyone is entitled to the full state pension. Eligibility depends on you meeting a certain criteria, which is to do with the relevant years you have paid or accrued National Insurance benefits.

Based on the new state pension eligibility criteria you will usually need at least 10 qualifying years on your national insurance record to get any State Pension. You will need 35 qualifying years to get the new full State Pension and you will get a proportion of the new State Pension if you have between 10 and 35 qualifying years which is illustrated below:-

Example

You have 20 qualifying years on your National Insurance record after 6 April 2016.

To work out what pension you would receive - you divide £159.55 by 35 and then multiply by 20.

Your new State Pension would be approximately £91.17 per week.

Although it's not a huge amount, the state pension is a valuable foundation on which to build your retirement income, alongside a pension of your own.

5.0 Tax relief on your pension

When you or your employer contribute money into your pension, the investment receives tax relief which increases the amount that is invested. This effectively means that you are investing into your pension out of untaxed income.

Everyone gets basic rate tax relief of 20 per cent automatically; higher and additional rate taxpayers must claim the balance of their 40 or 45 percent tax relief themselves.

Because of the way the maths work, you actually get more than 20, 40 or 45 percent tax relief added to contributions. This is because the sum added has to take you back up to 100 per cent from either 80 per cent or 60 per cent.

If you are a basic rate taxpayer, for every £100 you save into pension, the Government adds £25 in tax relief, making a total of £125. If you are a higher rate taxpayer, for every £100 you save, £66.67 is added, making a total of £166.67.

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It is important to note that the tax relief you receive on pension contributions is not unlimited. The annual allowance is a limit on contributions for tax relief purposes that can be paid to defined contribution pension schemes, or the total amount of benefits that you can build up in defined benefit pension scheme each year.

The limit is currently the lower of £40,000 or your current annual earnings. However, you are also able to carry forward unused allowances from the previous 3 years.

There is also a total lifetime allowance limit on total pension pots of £1million. If you build up benefits beyond this figure in a defined contribution scheme, then you will receive tax charges, which make putting more into a pension uneconomical and other ways of investing should be considered. For people who have accrued greater benefits in previous years when the lifetime allowance was higher, there are forms of protection available to avoid the tax charges which would be imposed.

6.0 Starting a pension – Sooner rather than later!

When it comes to saving for retirement, time is your friend. The earlier you start investing the more you are likely to get when it comes to retirement and even starting with just a small amount at first can make a big difference.

Investing £100 a month for 20 years with 5 per cent growth per year would deliver £41,000. Save for just ten years longer at the same rate and your pot will be worth more than twice as much at more than £83,000.

This is because your pot will have benefited from compounding, where your returns build up on returns that you have already received. It allows your retirement pot to grow like a snowball rolling down a hill, picking up extra little bits as it trundles along.

The other great advantage is that with time on your side, you have more breathing space to regain lost ground if your investments fall in value.

Over the short-term, this is likely to happen throughout your retirement saving lifetime.

How much should I put into my pension?

Just as starting a pension early means you can ensure a comfortable retirement, you are also likely to get a bigger pot by contributing more over time.

Most schemes will ask you to set a percentage, such as 2 or 5 per cent. An employer may also match this; so if you put in 2 per cent they will add the same to give you a 4 per cent contribution, while if you save 5 per cent, the total going in could be a much bigger 10 per cent. Sometimes generous employers will more than match contributions, perhaps doubling them.

Employers usually place a limit on your contributions that they will match or beat, for example 5 per cent of your salary. If you decide to pay in any more than this, it will only be your own money going in from your personal contributions and not from your employer.

If you do want to increase your contributions to a pension, then it is often a good idea to set up your own personal pension to run alongside your workplace pension, as you will still receive tax relief at your highest marginal rate of income tax and it will give you more oversight over your investments.

7.0 Accessing your pension

The earliest you can access a pension is currently age 55 (57 from 2028) which can seem like a long time away if you are only just starting a pension in your twenties, but it keeps your retirement pot safe from any temptation to spend it.

It also reflects the value of the tax relief the Government gives on pension contributions - and a tax break on the way out. Ultimately, the deal is that you get these in return for the restrictions placed on you.

There are a number of choices when it comes to retirement, which became much more flexible at the start of April 2015.

For some years everyone has had the choice of taking a lump sum of up to 25 per cent of their pension pot tax-free.

Those with defined benefit pensions then got their income paid out by their previous employer, with a reduction that took into account how much they took as a lump sum.

Those with defined contribution pensions had to use the remainder of their pot to provide their retirement income. For most people this was done by buying an annuity, otherwise they faced restrictions on how much they could withdraw each year if they kept their pension invested.

New pension freedom rules changed this:-

You can still take a 25 per cent lump sum tax-free, but you can then either buy an annuity or keep the rest of your pension invested through a process called drawdown and take money out when you want - with tax at your usual income tax rate.

Alternatively, you can also now forgo the 25 per cent tax-free lump sum in one big chunk and keep a pension invested and draw on it as you choose, with the first 25 per cent of each withdrawal tax-free and the rest taxed at your usual income tax rate.

There are several factors that will determine your financial choices at retirement, such as your age, health and spending plans so it may be best to consult an independent financial adviser as they can walk you through any financial or tax implications.

Although this might seem like an unnecessary cost, investing in decent advice could save you a huge amount long-term.

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8.0 Transferring a pension

The demand for transferring pensions and particularly workplace pensions into private arrangements has shot up since new pension freedoms were introduced in 2015.

The pension rules changed which enables savers in employer schemes to transfer to personal plans and access their funds from the age of 55 if they choose – rather than being tied to the rules and retirement age, often 65, attached to the old arrangement.

Another key advantage is that personal pensions can now be passed on tax efficiently to the next generation rather than die with the owner.

The employer schemes involved are 'final salary' defined benefit **(DB)** pensions where retirement income is based on how long a person has worked for an employer and their pay as outlined earlier on. These pensions are considered the 'gold standard' as the pension lasts as long as the scheme member lives. Annual increases to offset inflation are provided whilst a spouse's pension is also available. By transferring a pension, a saver has more control over their retirement money but loses all guarantees – and must accept more risk.

In the past, transferring out of DB scheme offered much lower values and people would often need to buy an annuity, which represented worse value than their scheme benefits. However, in the new pensions landscape, people have more flexibility and choice as to how they use and access their pension funds. This is coupled with record high transfer values being offered to employees, due to low gilt yields and the desire by employers to stifle the ballooning cost of their pension schemes as members live longer.

The culmination of these factors are now making more people assess their options and consider which is the most appropriate retirement vehicle for them.

It is important to note that serious thought should be applied before giving up a defined benefit pension as they provide certainty, risk free income and a degree of inflation protection.

Remember - Once a transfer has been completed, it cannot be undone.

The final section outlines reasons to consider transferring and staying in your final salary scheme. Also, we have taken a passage from Ros Altmann, the former pensions minister's recent article - Transferring Out Of 'Guaranteed' Employer Pensions Can Be A Good Idea' where she outlines 12 Questions to consider before transferring your defined benefits pension to a defined contribution pensions.

Reasons to consider transferring

- Your current pension scheme is too inflexible or your retirement age too high.
- If you are single or widowed and a widow's pension is of no importance.
- You would like access to a potentially larger tax-free lump sum.
- You would like to be able to pass on your pension pot (or what is left of it) to your chosen beneficiaries tax efficiently.
- You are ill and have below average life expectancy.
- You are worried about your employer's financial strength.

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Reasons to stay

- Certainty that you will not run out of money in retirement.
- You will continue to receive employer pension contributions while working.
- Protection against inflation as your scheme will provide a level of indexation.
- Benefits for dependants if you die before them such as a spouse's pension.
- You want to avoid a tax penalty for breaching the £1 million lifetime pension savings limit when transferring.
- You have a dependent who is under age 18 or age 23 and in further education, or who is physically or mentally impaired.

Ros Altmann the former pensions minister states 12 of the questions to consider before transferring from DB to DC:

1. Is this just one of a number of pensions and I want to cash some in and leave the rest as income?
2. Do I have other secure pension income?
3. Am I in poor health and not expecting to draw the guaranteed pension income for very long?
4. Am I still working and intending to keep on doing so?
5. Will I pay higher rate tax on my pension income?
6. Do I want to pass pension assets on tax free to the next generation if I don't need them myself?
7. What will I live on for the rest of my life?
8. Do I need a guaranteed income for myself or a partner?
9. Do I have other monies that could help fund care or might I want to use this?
10. Do the DB pensions I have offer inflation protection (not all pensions accrued before 1997 will have inflation linking)
11. Am I happy to pay fees and keep investing to grow my fund further in future?
12. Do I understand the tax implications of transferring out (BEWARE, this is complex!)

Read the full article ‚Transferring Out Of 'Guaranteed' Employer Pensions Can Be A Good Idea' from Ros Altmann here:-

http://pensionsandsavings.com/pensions/transferring-out-of-guaranteed-employer-pensions-can-be-a-good-idea/

If you have any questions regarding this article or you want to start having a conversation about your retirement contact JM wealth.

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