

# OCCUPATIONAL AND PERSONAL PENSIONS

Employers pension schemes normally fall into two types. The first type is Defined Benefit schemes, sometimes called Final Salary Pensions. The second type is Defined Contribution schemes, often called Money Purchase schemes, Stakeholder Pensions or Group Personal Pension Plans.

For those in work, a company pension is usually a good way of providing your pension. Although both types of scheme will provide you with a pension, and both give you tax relief on your contributions, they work in very different ways.

## Defined Benefit schemes

In this type of scheme the pension you receive on retirement is based on:

- the number of years you have belonged to the pension scheme, and
- your salary at or shortly before retirement.

Every pension scheme has its own rules about the way 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. In some public sector schemes your pension is based on 1/80th of your final salary because in addition to your pension you also receive a lump sum.

In these schemes it is the employer who has to ensure there is adequate funding to pay all the pensions of employees in the scheme. Now that we are living longer and pensions will be paid for more years, the cost of these schemes is increasing. Some employers are changing the rules of these schemes by, for example, increasing the age from which pensions can be taken; or basing the pension on your average salary over a period before retirement rather than your final salary; or increasing the amount the employee has to contribute. Some employers are closing this type of scheme and changing to Defined Contribution schemes.

## Defined Contribution schemes

In this type of scheme you and normally your employer will make contributions that are invested to build up a pension fund for you. The rules of the pension scheme will set out the contributions you can make from your salary each month together with the contributions from your employer. When you retire your pension fund is normally used to

purchase an annuity and the amount of pension you receive is determined by the size of your pension fund and the annuity rate offered by the insurance company.

In this type of pension scheme you have some important choices to make. These choices will determine the size of your pension. Firstly you need to decide how much to contribute. The more you contribute each month from your salary the larger will be your pension fund and the larger your pension will be – size matters! Obviously the sooner you join the pension scheme and start making contributions, the larger your pension fund will grow. Your second choice is to decide where your pension fund will be invested; your pension fund holder will usually offer you a range of funds in which to invest. You will want your pension fund to be invested so that it grows. You need to consider the level of risk you are willing to accept and invest to optimise the growth of your fund.

When you come towards retirement you have further important choices. Your pension will be determined by the size of your fund and also the annuity rate offered by the insurance company. Annuity rates vary from company to company and you do not have to buy your annuity from your employer's pension provider. You should compare the rates offered by a number of insurance companies and choose the one that is best for you. The rate offered will depend on several factors such as interest rates, your gender, age, and sometimes health. It will also depend on the type of annuity you choose. The main types of annuities are those that remain level throughout your life or those that increase each year so that your pension keeps pace with inflation. The level annuity provides the highest immediate pension and if you have a pension fund of say £30,000, a man aged 65 could expect to receive a pension for the rest of his life of approaching £200 a month. Annuity rates are shown in newspapers such as the Daily Mail or Telegraph – usually in the money pages at the weekend.

There are some things that you cannot control or change. You can not control interest rates or your gender. You can make a difference to the pension you can buy by determining the age at which you retire. The longer you work the greater your pension.

### How retiring at different ages affects your defined contribution pension

The later you claim your pension the more you will receive. Partly this is because your pension fund builds up – you pay in longer and the invested money goes on growing. But even the same sized pension fund pays a smaller pension at 60 than it would at 65.

Imagine a man earning £25,000 a year who has been putting 8% of his earnings into his pension scheme each year of his working life. The chart below shows the amount of pension he is likely to get if he starts drawing his pension at different ages. The exact amount of pension would vary from person to person and the type of annuity he purchased, but the way the amount grows is likely to follow this pattern.

|       |         |
|-------|---------|
| at 60 | £6,100  |
| at 63 | £7,800  |
| at 65 | £9,100  |
| at 68 | £11,700 |
| at 70 | £13,800 |

If he worked on for three years from 65 to 68 he would get £2,600 a year more than he would if he retired at 65 – almost 30% more. Similarly if he worked on from 60 to 63 he would get £1,700 a year more – almost 28% without taking any account of the extra contributions or the growth in his pension fund.

### Extra pension contributions

Members of occupational pension schemes can increase their pension fund or buy “added years” by paying Additional Voluntary Contributions (AVCs). Another way of topping up your pension provision is through a personal pension.

### Personal pensions

Personal pensions are pension schemes that an individual can open with a financial services company. They provide a ‘wrapper’ with tax benefits; you can contribute regular monthly amounts or lump sums and they are frequently called Self Invested Investment Plans (SIPPs). They operate in the same way as Defined Contribution schemes in that you build up a pension fund and then you buy an annuity when you wish to draw your pension.

You can open a personal pension at the same time that you are in your employer’s pension scheme. Personal pensions are useful for the self employed, those with no opportunity to participate in an employers scheme or as a ‘top up’.

### The pensions problem

Pensions were invented to protect people from poverty in old age. The basic principle is simple – pensions are a way of putting money aside out of earnings so that a person will have enough money to live on when they retire. The problem is that as we are all living longer we need to put aside more money to see us through our retirement. The reality is that over 10 million of us are not doing so. In 2006 a Scottish Widows report found only 41% of women and 54% of men were preparing adequately for retirement. The Government is aware of the problem and has introduced flexibilities to help you.

### New pension flexibilities

The Government introduced new flexibilities in 2006 that affect the way you can contribute to a pension and the way that you can take your pension. The previous limits on how much you could contribute to a pension were replaced by much simpler and more generous arrangements. There is now no limit on how many different pensions you can have and you will receive tax relief on your contribution up to 100% of earnings to an upper limit of £225,000 which will rise to £255,000 by 2010/11 and subject to a total Lifetime Allowance limit of £1.6 million which rises each year.

When it comes to taking your pension:

- everyone will be able to take a 25% tax free lump sum from their pension fund
- pension funds of less than £16,000 can be taken in cash and spent on whatever you wish. 25% is tax free
- those in company pension schemes no longer have to leave their job to draw their pension. Subject to the rules of your company pension scheme it is possible to take all or part of your pension whilst still working for your employer
- the Government also introduced in 2006 the Pension Protection Fund which is designed to protect your Defined Benefit scheme pension if your employer becomes insolvent.

### How to use the new arrangements

When you think about your retirement you will need to think about the lifestyle you want in retirement and whether you have adequate pension and financial provision. This requires some planning and the sooner you start the greater will be your options to achieve an adequate retirement.

If you are one of the 10 million who are not making adequate financial preparation, there are a number of options:

- If you can join your employer's pension scheme and have not done so, you might consider this
- If you need to 'top up' your pension contributions, you may:
  - ask your employer if you can 'top up' your pension through the company scheme by paying more or through an Additional Voluntary Contribution
  - consider starting a personal pension

- Consider at what age you want to retire; should you work a little longer to increase your pension. Remember you cannot be forced to retire on age grounds until age 65
- Explore whether your employer will let you draw your pension and continue working. This could open up the possibilities of working on a little longer say on a part-time basis or allow you to 'downshift' where you continue working in a less responsible or stressful role.

When you are considering your financial position, it is worth remembering that if you have no pension provision or savings and are close to retirement, you are unlikely to build up a significant pension. If you are likely to receive means-tested benefits such as Pension Credit, it is unlikely to be worthwhile starting a pension although you might receive your small pension fund in cash – do take advice from your local advice centre.

# GUIDANCE NOTES



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