Protecting your pot

Crystal clear communications

Plain English Campaign

with unbiased pensions expertise from

annuity direct ltd
The Retirement Income Specialists

your plain English guide to pensions

Foreword

I was delighted to accept the invitation from Plain English Campaign to write this new version of their pensions guide. It is an exciting project which we believe will go some way to helping people understand the many complexities of the retirement-planning process.

Many 'private-sector' employers have already stopped providing guaranteed pensions for their staff. These types of pensions are too 'hot to handle' for even the biggest companies who have access to the best expert help available.

The responsibility for making pension decisions will increasingly be passed to workers to deal with.

Research shows that people do not want this responsibility and many are afraid to even start thinking about the issues involved. However, people are going to have to face this responsibility or they may have a very small income when they retire.

There isn't anything that can be done about pensions being complicated. Over the years different governments have added their own rules and requirements and the situation has become more and more complicated. A whole new language of pensions has developed which acts as a major barrier to people who are trying to work out what is best for them.

At Annuity Direct we help people make the most of their pension 'pots' when they reach retirement. On average, we find they can be 20% better off by making the best choice. We believe that making the best choice starts with a clear understanding of the information.

Alan Higham, Chairman, Annuity Direct

Contents

1 - Introduction

What is a pension?

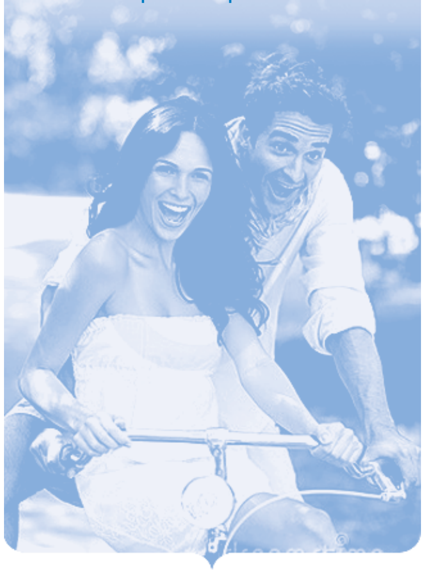
A pension is a way of saving money to provide you with an income when you retire. There are many different names for pensions - schemes, plans and policies for example. Confusingly, the way in which you save money for retirement is known as a pension, but so is the income you receive when you retire.

Pensions can be complicated but that doesn't mean you should ignore them. People are living longer and that means we will be spending more and more time 'being retired'. You need to take time to understand pensions to make sure you will have enough money to live on when you retire.

This guide should help you make more informed decisions about your pension options.

"What and how we will be in the future depends on what we do now."

Daisaku Ikeda
Buddhist philosopher



General information about pensions

Pensions generally fall into one of two types:

- a personal or individual pension; or
- a company pension (provided by an employer).

Most people save into a personal pension (which might also be known as an individual pension or stakeholder pension). This is a pension that belongs to you.

Your employer might put some money into it, you might put some money into it, and the Government might put some money into it by giving you tax relief on your payments. Payments into a pension are also known as contributions.

"Everyone gets interested in pensions in their fifties which is too late.

Do not believe the propaganda about pensions – learn what it is all about so that you make good decisions about retirement."

Bob Bullivant,
Fellow of the Chartered Insurance Institute

Tax relief

When you pay a personal contribution to a UK pension scheme, the Government will give you tax relief on the contribution, depending on the amount of tax you pay. So, if you pay basic-rate tax (in other words, you pay UK income tax at 20%), the Government will increase the personal contribution you make to a pension scheme by this amount. They do this at the time you actually make the contribution.

For example, if you pay £80 a month into a personal pension with an insurance company, the Government make this up to £100 a month (£20 a month in tax relief) immediately. The insurance company collects this £20 from the Government. You do not need to do anything to make this happen. This is known as receiving basic-rate tax relief at source.

To work out the tax relief in your contribution, divide the tax you have paid by 0.8. In this example, £80 divided by 0.8 = £100. The £80 that leaves your bank account is your ‘net contribution’. The £100 (which includes your tax relief) is your ‘gross contribution’.

If you pay tax at the higher rate, you will pay income tax at either 40% or 50%. The Government will increase your personal contribution by 20% at the time you actually make the contribution as in the example above. You need to claim any extra tax relief you are entitled to direct from H M Revenue & Customs (HMRC) by filling in a self-assessment tax return.

There is a limit to the amount of pension contribution you can make and still receive tax relief. For the tax year 2011/12, this is:

- your total earnings for the year (in other words, the amount you pay income tax on); or
- £50,000;

whichever is lower.

You can make pension contributions higher than this, but you will not receive any tax relief on them and you may end up having to pay a tax charge. If you think you may be in this position, you should get advice from a tax or pension specialist.

If you do not pay tax, or you only pay tax at 10%, the Government will still increase your personal contributions by the tax relief. However, they will only do this on contributions up to £2,880 a year (making £3,600 a year after you add in the tax relief).

Most pensions are looked after by an insurance company who will set a pension up for you. If you want to pay into your pension regularly, the company can arrange a direct debit for you. The insurance company may also invest your pension money on your behalf. However, you have to choose which of their pension funds you want to invest in. Different insurance companies all charge very different amounts to run these schemes for you. There will be a wide range of funds that you can choose to invest your savings in. The insurance company should be able to give you more information about this. You may also want to get independent advice to make sure you don’t pay more than you need and that you invest your savings sensibly.

There are other types of pension schemes run by employers or specialist pension companies – for example, small self-administered schemes (SSAS) or self-invested personal pensions (SIPPs). With these, the arrangements for making payments may be different, but the company or employer responsible will tell you about these.

Over the years your pension fund will grow through a combination of the contributions paid into it (including tax relief) and growth in the funds you have invested in. Every year your insurance company should send you a statement to show how the value of your pension is changing. It is a good idea to review your pension at least once a year, when you receive your statement. This is to make sure you are paying the right level of contributions and that your investment funds are still appropriate for you. It is important to remember that most pension investment funds invest partly in shares, so their value will go down as well as up.

Despite the fact that your pension belongs to you, the Government have decided you are not allowed to take any money out of it until you reach age 55. The Government also have other restrictions on how you can take money out of your pension. We cover some of these later in the guide. When you do come to retire, under current rules you are entitled to take 25% of the value of your pension fund as a tax-free lump sum. You can do pretty much anything you like with this money, although you are not allowed to pay it back into a pension scheme to get tax relief on it. You must use the rest of your pension fund to buy a product that will give you an income when you retire. There are a number of different ways to achieve this which we discuss later on in this guide.

There are other types of pension schemes around which you may have, especially if you have been saving into a pension for many years. We are not looking at these in detail in this guide, but they may have some valuable benefits attached to them. An independent financial adviser would be able to help identify these for you.

> “Always start out with a larger pot than what you think you need.”
>
> **Julia Child**
> American chef

2 - The structure of a pension scheme

Most pension schemes are set up under ‘trust’. This means that the pension scheme and its assets are protected by law and cannot be touched by an insurance company or employer. People known as ‘trustees’ are responsible for looking after the pension scheme and its assets for the future benefit of all the members.

This protection means that even if an insurance company or employer went into liquidation, the assets of the pension scheme should be safe from creditors. Another advantage of setting a pension scheme up under trust is that your beneficiaries do not have to pay inheritance tax on benefits paid after your death.

“Put not your trust in money, but put your money in trust.”

Oliver Wendell Holmes Senior

3 - Company pension schemes

Your employer will generally have either:

- a final-salary pension scheme
  (also known as a defined-benefit scheme) ; or
- a money-purchase pension scheme
  (also known as a defined-contribution scheme).

Final-salary pension schemes will give you an income and a lump sum when you retire based on a combination of your salary and number of year you have been a member of the pension scheme. Very few final-salary pension schemes are still available outside the public sector as employers are finding it very expensive to provide all the promised benefits. If you are offered the opportunity to join a final-salary pension scheme, you should seriously consider it.

A money-purchase pension scheme is much more like a savings account. You (and possibly your employer) make contributions to the scheme. The provider of the scheme takes their charges out of your savings and invests what is left. Once you come to take your income when you retire, the amount you receive will largely depend on how well your investments have performed.

“The challenge of retirement is how to spend time without spending money.”

Author unknown

Personal pensions or stakeholder pensions are a common example of this type of scheme. A group personal pension is basically a collection of personal pensions that has been set up by your employer. A good employer should make sure that the insurance company has a good track record and is offering the pension on good terms. Your employer will not usually give you any advice on this. You will have to decide whether it is good value for you or arrange your own advice.

What should I think about if I'm in or about to join an employer's pension scheme?

A pension scheme offered by your employer will be a valuable benefit. Often the employer will make a contribution to it and there may be important life assurance and sickness benefits that come with it. You should have a very good reason not to join an employer's pension scheme as you will lose valuable benefits if you do not join one.

“He that has a penny in his purse, is worth a penny.”

Petronius

Below are some of the things to consider when joining a scheme.

- When can you join the scheme? Don't forget to join as soon as you can if this doesn't happen automatically when you first start your job.
- How much are you expected to contribute towards the cost of the pension scheme? Is this an affordable amount for you? You should also look at other benefits such as those paid if you die or get sick.
- Make sure you get enough information about the pension scheme from your employer to make an informed decision. You have a right to full information.

From 2012 onwards, new government rules will mean employers automatically have to include employees aged between 22 and State Pension age in either their (the employer's) pension scheme or the National Employment Savings Trust scheme (NEST). This is called 'auto-enrolment'. Your employer will have to contribute and you will also have to make contributions that will be taken from your pay automatically unless you actively opt out of your employer's pension scheme.

> "The question isn't at what age I want to retire, it's at what income."
>
> **George Foreman**

What if I am thinking of leaving, or have left, my employer?

You don't have to stay in a pension scheme. You can choose to leave. But, you should have a very good reason for leaving an employer's scheme as you will lose valuable benefits. If you leave your employer, you will stop earning any more benefits in their scheme.

The value of your pension when you leave will be 'preserved' for you until you retire. If you were a member for less than two years, in some pension schemes run by trustees the scheme rules may only refund your own contributions.

Depending on what you do next in terms of getting a new job, you might be able to transfer the value of your old employer's pension into a new employer's pension, or into a personal pension of your own. This is a complicated area and you should really consider getting independent financial advice to help you understand your options.

Chrissie says – " Don't sign anything that you don't understand. Ask for a plain English explanation – it's your right. "

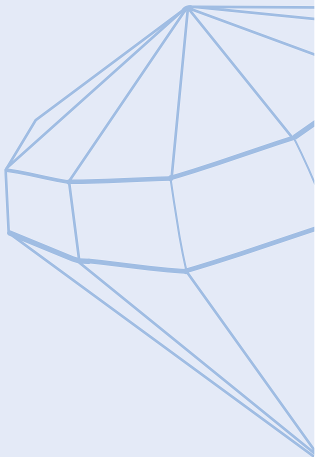
What if I become self-employed, or stop working altogether?

If you become self-employed, you will only be able to make contributions to a personal pension. You can also make contributions to a personal pension if you don't work at all. However, there are restrictions on the amount you can pay in, and the amounts on which you may receive tax relief, if any.

If you cannot afford, or want to stop making, pension contributions for any reason, you just need to tell the insurance company who looks after your pension. (Or, if you are in a company pension scheme, tell your Human Resources department.) You should also cancel any direct-debit arrangements. But check first that the insurance company won't charge you for doing this.

"Life is what happens to you while you're busy making other plans."

John Lennon

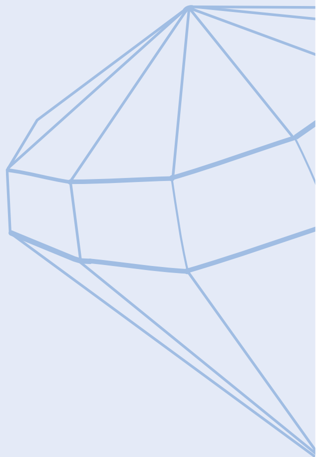


4 - How much should I pay into a pension?

There is no easy answer to this question as it depends on your circumstances. Consider the following.

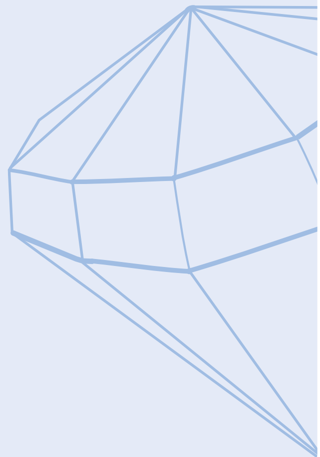
- How much do you think you would need to live on each year when you retire? Ideally, you should aim to build up savings around 20 times that amount by the time you retire.
- How much can you afford to pay now without leaving you short each month? Don't save so much in a pension that you need to go into debt regularly.
- Money put into a pension scheme can't come out until you are at least 55.
- The earlier you start to save, the more you will have.
- Do you have other savings or assets that can give you an income when you retire? How much will the Government provide?
- How much risk are you prepared to take with the investments? The safer investments usually grow more slowly which means you may need to save more to reach your goals.

> "The importance of money flows from it being a link between the present and the future."
>
> **John Maynard Keynes**



For example, if you decide you need £16,000 each year to live on when you retire and your State Pension is going to be £6000 each year, you will need £10,000 each year from pensions and other savings. To provide this you should be aiming to build up a pension fund of at least £200,000. If you are not sure what to do for the best, you should consider getting independent financial advice to help you decide on the most appropriate strategy for you.

> “A penny saved is a penny earned.”
>
> **Benjamin Franklin**



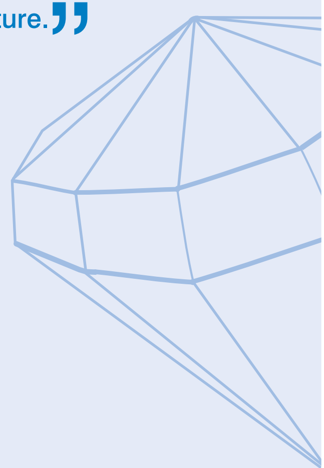
5 - What if I don’t want a pension at all?

You don’t have to have any sort of pension at all if you don’t want one. But, remember that because contributions into a pension scheme either from an employer or from you can receive tax relief from the Government, they are the most tax-efficient way of saving for your retirement.

“I never think of the future – it comes soon enough.”

Albert Einstein

Chrissie says – “It doesn’t take a genius to sort out the future.”



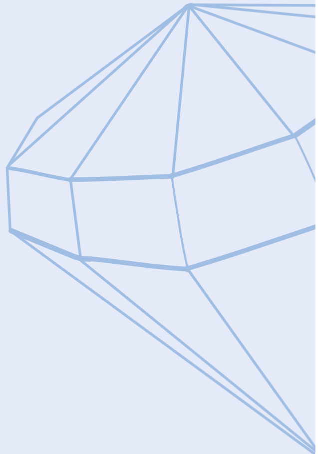
6 - Won’t the state provide?

The state will give you a basic weekly pension amount (currently £97.65 each week for a single person) when you reach state retirement age as long as you have paid enough National Insurance contributions for at least 30 years. You can get a forecast or estimate of what your basic State Pension might be by visiting www.direct.gov.uk or calling 0845 3000 168 and asking for a State Pension forecast. (But, remember, these can be complicated.) You can also use the website to find out what your state retirement age will be.

If you find you do not need your basic State Pension when you first become entitled to it, you are allowed to defer it. This means you can delay taking the money from it. Your pension entitlement will increase by 0.2% for each week you do decide to defer it. This is based on simple interest , rather than compound interest (interest charged on interest) and is the same as 10.4% each year. If you defer your basic State Pension for at least a year, you can then swap the amount it has increased by for a lump sum. But remember you will have to pay tax on this. Full details of how to defer your basic State Pension will be in the information the Government sends you as you get nearer to your state retirement age.

“Getting money is like digging with a needle; spending it is like water soaking into sand.”

Japanese proverb



Because we are all living longer and the number of retired people is increasing, the cost of providing the basic State Pension is becoming a real financial burden on the Government. Governments have often changed the terms which apply to state pensions. You should not rely on the current State Pension system alone to provide your income when you retire.

There is also an earnings-related element to the State Pension known as the additional State Pension. (This used to be called SERPS and is now called the State Second Pension or S2P.) This is only if you are employed. The calculations are highly complicated, and your best bet is to contact the Department for Work and Pensions (DWP) as mentioned above and get a State Pension forecast.

You may be eligible for other state benefits when you retire. We do not cover them in this guide. State pensions are currently being reviewed by the Government and you should try to keep up to date with the latest changes.

“Make sure your pensions adviser checks all the pension companies so that you get the best quote for you rather than the just best commission for the adviser.”

Chrissie Maher

7 - What happens to my pension if I die?

If you die before you have taken an income from your pension, the total value of your pension fund can be paid out to someone else as a tax-free lump sum. Most insurance companies or company pension schemes will ask you to nominate (choose) someone to receive these benefits. If they do not ask you to nominate anyone, you should ask your insurance company or employer for a nomination form. You can change your nomination at any time, as your circumstances change – so you should keep it under review regularly. As the pension scheme is written under trust, your beneficiaries will not have to pay inheritance tax on any lump-sum death benefits (no matter how much you have in other assets).

If you die after you have started to take an income from your pension, the death benefits will depend on the product you bought with your pension fund and options you have chosen (see next section).

“There are necessary evils. Money is an important thing in terms of representing freedom in our world. And now I have a daughter to think about. It’s really the first time I’ve thought about the future and what it could be.”

Johnny Depp

8 - Retirement

Congratulations! You have reached the current minimum retirement age of 55 (or more) and you feel ready to start taking an income from the pension (or pensions) you have built up over your working life.

With most pension schemes you are free to take the benefits you have built up away from the employers or insurance companies they are with, and use them to buy the most appropriate pension income for you. This is known as 'exercising your open-market option'. This is a highly specialist area and in most cases you would benefit from getting independent financial advice to make sure you make the most of your pension income in the most appropriate way. This is very important because once you have started to take a pension income you cannot ever change it or move it to another company. It is a 'once only' decision and so you must have enough information to make the right decision.

“I'm retired - goodbye tension, hello pension!”

Author Unknown

Final-salary pension schemes

If you have any pension benefits in a final-salary pension scheme, the trustees for that scheme will write to you when you are getting close to the retirement date set under the scheme. If you want to take retirement benefits earlier than the date set under the scheme, you will need to write to the scheme trustees. There may be penalties for taking your retirement benefits early, so you should investigate this carefully.

The trustees will tell you how much pension income and how much tax-free cash you are entitled to from the scheme. The pension income may increase every year generally in line with inflation and this is an extremely valuable benefit to have. There will also be benefits built into the scheme to provide a pension for a husband, wife or other dependants when you die. It is usually much better value to take final-salary pension benefits direct from the scheme. This is because providing death benefits and an increasing pension is very expensive.

Personal pensions

You are normally entitled to take up to 25% of the value of your fund as a tax-free cash sum to invest or spend as you want. You must use the rest of your pension to provide you with some sort of income when you retire, although there are a lot of different ways of doing this.

“I was planning on my future as a homeless person. I had a really good spot picked out.”

Larry David

Chrissie says – “However modest your plans for the future – give them the best chance starting today.”

Exercising your open-market option

When you reach retirement, the insurance company you have your pension with will write to you and offer you a pension income. You do not have to take your pension income from your existing provider. You can take the value of your pension fund and find the most appropriate product for you which will give you the highest income. This is known as 'exercising your open-market option'. It is very rare for your existing insurance company to be offering the highest amount of income on the market for your particular circumstances. And, remember that they will not offer you any independent advice on whether or not their income is the most appropriate choice for your circumstances. For example, they may not take account of any of your health, lifestyle or medical conditions.

The first and most important question for you to answer is how much risk do you want to take with your pension? If the answer is none – you want an absolute guarantee that your pension income will not fall, the only option is to buy an annuity.

However, if you are prepared to accept some risk that your income may fall, or rise, depending on the performance of an investment fund, there are options including annuities that link to the stock market or with-profit funds (where bonuses may be added to increase your income every year).

“My problem lies in reconciling my gross habits with my net income.”

Errol Flynn

You use your pension funds to buy an annuity from an insurance company (the annuity provider) who will give you a guaranteed income for the rest of your life. You can add lots of different options to an annuity – for example you can include a pension for your husband or wife after you die, or you can choose an income that increases every year.

When the annuity provider works out how much they will pay you, they are making an assumption about how long they think you will live. This is because your pension funds have to last until that point. An increasing number of annuity providers now take health and lifestyle conditions (for example smoking) into account and this can lead to a larger income as they assume that someone who smokes will die sooner than someone who doesn’t, so they will be paying the annuity for a shorter period.

“Take your time to make those decisions that you cannot change. It’s never too early to prepare for the future.”

Chrissie Maher

Enhanced annuity

If you take prescribed medication, smoke or have a recognised medical condition that is statistically more likely to shorten your life expectancy, you may be entitled to an enhanced annuity (in other words, more income). Put bluntly, this is because the annuity provider is not expecting to have to pay you an income for as long as someone who does not have any medical conditions. Because of this, they can afford to pay you a bit more. Some annuity providers also offer different levels of income depending on your postcode. This is because they believe that people who live in more wealthy areas are statistically more likely to live longer than people who live in more deprived areas.

Buying an annuity – example case study

Mr Marks is 65 years old and has a personal pension plan, worth £40,000, with a fictional company, 'Simple Life'. He wants to start receiving an income from his plan. His independent financial adviser tells him he can take £10,000 from his fund as a tax-free lump sum (25% of the value), and use the other £30,000 to buy an annuity. 'Simple Life' have offered him an income of £1,782 each year based on his age and the size of his fund.

Mr Marks takes two tablets a day, one for high blood pressure and the other for high cholesterol. This entitles him to what is known as an enhanced annuity as he has conditions which may well shorten his life. A standard enhanced annuity might offer him an income of £2,120 each year for the rest of his life – an increase of £338 each year over what 'Simple Life' were offering.

annuity direct ltd
The Retirement Income Specialists

9 - Conclusion

We hope this guide has given you some useful information about the world of pensions. Because pensions and the law surrounding them are so complicated, we cannot cover everything. As such, this is just an overview of some of the products and options available to you. Wherever possible, you should get independent financial advice from a pension expert. To find an independent financial adviser near you, go to www.unbiased.co.uk.

– and from Plain English crusader, Chrissie Maher.

“I'm a scouser from post-war Liverpool who had little hope of a decent education, never mind a pot of gold at the end of my working life, whenever that might happen! My time spent fighting jargon and gobbledygook hasn't been just about words, but rather the rights and responsibilities that words bring us.

This guide will be a new education to many of us, and I hope these plain words make that knowledge useful in using your rights and taking on your responsibilities.

I never set out to be a crusader – I just wanted people to be able to read and understand, and act on clear advice and information.

Here's to a healthy and happy retirement for us all - we've worked for it!”

Chrissie Maher

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