Quick guide to pensions

Introduction

A pension is an arrangement whereby a person puts aside money during their working life to provide an income in retirement.

There are many types of pension, but they can conveniently be split into three categories according to who organises the pension:

- the government, as state pension
- the employer, as an occupational pension
- yourself, as a private pension.

It is possible to receive a pension from two or all three of these categories.

State pensions

State pensions are funded from part of the national insurance you pay.

There are two elements to the state pension:

- state retirement pension (SRP) or old age pension, and
- additional pension.

In addition, a pensioner with low income and capital may be able to claim **pension credit.**

State retirement pension

The **state retirement pension** is payable from **state retirement age (SRA).** This is currently 65 for men and somewhere between 60 and 65 for women. An explanation with tables of these ages is given in a separate article entitled *When may a woman retire?*

The pension becomes payable once a person has reached the SRA. They do not have to retire, and may continue working and earning an income.

Entitlement depends on having an adequate **national insurance (NI) record.**

The rules on this were considerably relaxed for those who retired from 6 April 2010. A full pension is payable provided you have at least 30 years full NI record. This means that for at least 30 years you must have paid or been credited with sufficient class 1, class 2 or class 3 national insurance. This is easily achieved.

People who reach SRA before 6 April 2010 had to have a full record for nine out of every ten years of working life. Working life usually meant 49 years (age 16 to 65) for a man, and 44 years (age 16 to 60) for a woman. So the national insurance record usually had to be 44 years for a man or 40 years for a woman.

If you do not have a full NI record, you will receive a proportionate pension. So someone with 20 years of NI record, will receive a two-thirds pension.

There are three **categories of state pension**:

- category A, based on your own national insurance record
- category B, based on your husband's, wife's or civil partner's record
- category D, payable from the age of 80 if you have no national insurance record.

(In case you are wondering, category C was paid for people who had retired before 6 April 1948 and is now extinct.)

The **amount of pension** is reviewed every year, usually in April. The 2011/12 rate for a full category A pension is £97.65 a week. Category B and D pensions are set at about 60% of the category A pension, which for 2011/12 is £58.50 a week.

When someone receiving a category B pension is **widowe**d on the death of the partner, the pension usually switches to category A.

Once you have reached the age of 80, you receive an extra 25p a week on your pension. Every Christmas, you receive an extra one-off payment of £10. These figures have not changed since 1971. Spend it wisely.

The pension is not paid automatically; it must be **claimed**. This is usually down by completing form BR1 that should be sent four months before reaching state retirement age.

Payments are usually made by credit transfer into a bank account.

It is possible to **defer** payment of a category A or B pension. This means that you do not receive your state pension when you reach the SRA. Instead you receive it at a later date, but at a greater amount. The rate of deferral is one fifth of one percent (0.2%) for every week of deferment. So defering your pension for one year will increase your pension by 10.4%.

Additional pension

Additional pension is paid by the state as an addition to the state retirement pension.

With one exception, it is paid only in respect of periods of employment.

There are three types of additional pension, depending on when you were employed:

- graduated pension: 1961-1975
- State Earnings-Related Pension Scheme (SERPS): 1978-2002
- State Second Pension (S2P): from 2002.

The one exception is that S2P can be earned in respect of time working as a carer.

For **graduated pension,** the employee acquired units according to how much you earned between April 1961 and April 1975. No new units can be earned, but those already acquired attract an additional pension of so much per unit per week. The amounts are small, and are unlikely to add even £10 a week to the pension.

SERPS is as generous as graduated pension is mean. As originally devised in 1978, someone who stayed in SERPS for the whole of their working life would have received an additional pension equal to 25% of their "band earnings". This was the amount by which your earnings exceeded the lower earnings limit for national insurance but did not exceed the upper earnings limit.

Had someone still been able to earn a pension on the original SERPS basis at 2011/12 rates, they could have accrued an entitlement that would have trebled their state retirement pension!

In 1988, it was realised that SERPS was too generous and unaffordable, so it was scaled back. The main change was that the accrual rate was reduced from 25% to 20%.

Those who had built up an entitlement to SERPS keep that entitlement. Payments of SERPS and S2P are increased each year in line with inflation.

State Second Pension (S2P) has two stages. The first stage is really just a rebranding of SERPS with a few new rules. It was introduced immediately in 2002.

The first new rule is that the band earnings do not have a single accrual rate of 20%. The band is skewed in favour of the lower paid.

The second new rule is that the upper limit for band earnings is now replaced by an upper accruals point (UAP) which is frozen indefinitely at £770 a week. It is expected that the band earnings will disappear to zero by 2030 or 2035. By then S2P should have moved to a second stage where it is replaced by a fixed sum regardless of earnings.

The third new rule is that S2P entitlement does not accrue only in employment. You also establish an entitlement for years when you are:

- looking after a child under 12 and claiming child benefit,
- caring for a sick or disabled person for at least 20 hours a week and claiming carer's credit,
- a registered foster carer and claiming carer's credit, or
- receiving certain other benefits in respect of an illness or disability.

Broadly, anyone earning less than the lower earnings threshold is treated as though they had earned an amount equal to the threshold for S2P. This figure is £14,100 for 2011/12.

Inheriting partner's SERPS or S2P

The suriving partner of a marriage or civil partnership can inherit a share of their deceased partner's SERPS or S2P entitlement.

The amount that can be inherited depends on the sex of the deceased person and when they were born, as shown in this table:

Percentage	Man (when born)	Woman (when born)
100	Before 6 October 1937	Before 6 October 1942
90	6 Oct 1937 to 5 Oct 1939	6 Oct 1942 to 5 Oct 1944
80	6 Oct 1939 to 5 Oct 1941	6 Oct 1944 to 5 Oct 1946
70	6 Oct 1941 to 5 Oct 1943	6 Oct 1946 to 5 Oct 1948
60	6 Oct 1943 to 5 Oct 1945	6 Oct 1948 to 5 July 1950
50	After 5 October 1945	After 5 July 1950

Checking your pension entitlement

The Department of Work and Pensions offers a free service where you can check your entitlement to the state retirement pension and all forms of additional pension.

You complete form BR19 available from any Jobcentre. Alternatively it can be downloaded from the Department of Work and Pensions (DWP) website. This is submitted to the DWP who send you a form explaining your entitlements, and saying how much these are worth at current rates.

It is always advisable to check your national insurance record. If it seems that you may not have 30 years' national insurance record, it may be possible to pay class 3 contributions for the previous six years, and either class 2 or class 3 for future years to make up the record. It is almost always advisable to do so.

Pension credit

Pension credit is a means-tested social security benefit, and is therefore not a pension at all. However it is convenient to consider it here.

The pension credit has two elements:

- a guarantee credit, and
- a savings credit.

The **guarantee credit** is paid to someone who reached the relevant state retirement age and whose pension and income from *all* sources (with a few exceptions) is below the **standard minimum guarantee.**

The **savings credit** does the opposite. It provides an addition to claimants who have managed to save some money.

Occupational pension schemes

An employer may choose to operate an occupational pension scheme. No employer has to do so, and no employee has to join a scheme if the employer does. An employee can only be a member of an occupational pension scheme if both the employer and employee wish this.

There are two types of occupational pension scheme. To add to the confusion, each one has at least two names:

- defined benefit, or final salary scheme, or average earnings scheme, and
- defined contribution, or money purchase scheme.

Defined benefit schemes

In a defined benefit scheme, the employee knows how much he or she will receive in retirement. This is usually calculated as a fraction of final salary or average salary (as defined).

The fraction relates to length of service. The pension is this fraction multiplied by a measure of "salary".

To get the full tax relief, these are the *maximum* pay-outs such schemes may offer:

- pension of two-thirds final salary,
- lump sum payment of 1½ times final salary (which reduces the pension),
- dependant's pension of two-thirds the member's pension (four-ninths salary),
- death in service benefit of four times salary.

A calculation is done on how much the scheme needs to meet its commitments. As the employees' contributions are usually fixed in advance, any deficit in the pension fund becomes a liability of the employer.

Suddenly companies found that these schemes were a huge liability. As a result, companies have been closing down these schemes as fast as they can, and replacing them with defined contribution schemes, as explained below.

Defined contribution schemes

A defined contribution scheme avoids the problems of defined benefit schemes.

Under the scheme, the employer or employee, or (usually) both of them contribution an amount every pay day into a fund. This is invested, earning dividends and gains. It also attracts tax relief. So over the employee's working life, the fund builds up into a big "pot" until the employee retires.

This pot is then turned into a pension under the **money purchase** principles explained later.

Contracting-out

An occupational pension scheme may “contract-out” of part of the state scheme. It should be noted that this decision is the employer’s and not the employees’s.

The effect of contracting out is that the employer and employee pay a little less national insurance but the employee stops building up an entitlement under SERPS or S2P. Any entitlement that has already built up remains. Contracting out does not affect entitlement to the state retirement pension nor does it affect the employee’s right to rejoin SERPS and S2P.

Until 5 April 2012, either type of occupational pension scheme may contract out.

From 6 April 2012, it is no longer possible to contract out under a money purchase scheme.

Tax and national insurance relief for occupational schemes

An advantage of occupational pension schemes for the employees is that the tax relief and any national insurance relief is given immediately through the payroll.

The employee’s contributions to an occupational scheme attract income tax relief but no national insurance relief. Suppose an employee earns £2,000 in a month and pays £100 into an occupational pension scheme. The employee will have their income tax calculated under PAYE on £1,900 but have their national insurance calculated on £2,000.

Private pension schemes

Since 1988, individuals (including employees) have been able to make their own pension arrangements. In effect, they could do something similar before with retirement annuities.

All private pensions work on the **money purchase** principle. This is the same principle used by defined contribution occupational pension schemes.

A private pension scheme attracts certain reliefs from income tax and national insurance. These are similar to those enjoyed by occupational pension schemes, but the method of administering them is different. The full amount of income tax and national insurance is paid. Income tax relief is then claimed by the person, and is either reflected in the employee’s tax code or otherwise in the self-assessment of income tax.

The full rate of national insurance is paid. For an employee, the bit of national insurance that relates to the SERPS or S2P pension is then paid into the pension fund directly, further adding to the “pot”.

Stakeholder pensions

Stakeholder pensions were introduced in 2001 . They were part of an attempt to force all employees into making some kind of pension provision. The government estimates that about seven million workers are under-providing for their pension.

In the course of their introduction, their scope was watered down considerably. All that is left is a requirement for an employer with five or more employees to offer such a scheme. The employer does not have to contribute anything. In reality, the employer is doing nothing more than acting as an introductory service to a pension provider.

NESTs

A second attempt has been made with what is now called the National Employment Savings Trusts, with the appropriate acronym NESTs. NESTs are introduced between October 2012 and 2017, starting with the larger employers.

All employees are **auto-enrolled.** This means that an employee becomes a member of a NEST unless they specifically opt-out. Auto-enrolment applies to employees between the ages of 21 and state retirement age. Someone between the ages of 16 and 20, or between state retirement age and 74 may join voluntarily.

The employer contributes 3% of the employee's eligible earnings to the NEST. The employee contibutes a further 4%. There is also 1% tax relief, so the total amount put into a NEST equals 8% of earnings. Eligible earnings are basically the same as band earnings for SERPS and S2P.

These are minimum contributions. The employer and employee may pay more if they wish. The employer may also choose to pay all or some of the employee's contribution.

Between 2012 and 2017, the level of employer and employee contributions is being phased in:

Period	Employer pays	Employee pays
Before October 2016	1%	1%
Oct 2016 to Oct 2017	3%	3%
From October 2017	5%	3%

If an employer already operates an occupational pension scheme that is equal to or better than a NEST, the employer does not have to operate a NEST at all.

Why not just invest the money?

When money is put into a pension fund, it becomes restricted. You cannot help yourself to it at the age of 40 if you want to move house or help your child. Some people prefer simply to put the money into a building society or other investment fund where they can get it.

It is sensible to have fund readily available in this way, but not as an addition to pension provisions, not instead of them. There are two sets of benefits that a pension funds has over most other forms of investment:

- tax relief, and
- higher returns.

Contributions to a pension fund generally attract relief from income tax. There are limits, explained later, and the relief is given in different ways.

If you pay the basic rate of income tax and earn £100, you will have £80 to put in a building society. However you will have £100 to put into a pension fund. One way or another HMRC will usually refund the £20 tax you paid. You have done nothing other than start a pension fund and already your investment has increased by 25%!

Pension funds tend to grow at a faster rate than other investments. This is mainly because of the tax advantages that the funds enjoy. Suppose that savers' interest rates are 4%. You will probably find that the equivalent pension fund rate is around 6.5%. Remember that we start with a 25% advantage from day 1. This is how the two investments of £100 of earnings will compare over 40 years:

Period from initial investment	Building society (4%)	Pension (6.5%)
Year 0	£80	£100
Year 1	£83.20	£106.50
Year 2	£86.53	£113.42
Year 10	£118.42	£187.71
Year 20	£175.29	£352.36
Year 30	£259.47	£661.44
Year 40	£384.04	£1,241.61

It can be seen that the pension is worth twice the building society figure after 20 years and nearly four times as much after 40 years. This is the wonder of compound interest.

Money purchase

Money purchase is the process by which a pension fund builds up a "pot". This is used to buy a pension and similar benefits. This is usually done when you "retire", but is generally whenever the member wishes to do so. The process is known as **crystallising** or **annuitising.**

Money purchase is the method used by:

- defined contribution occupational pension schemes, and
- all private pension schemes.

From 6 April 2010, you may crystallise your pension fund at any age from 55 (previously 50). There was an upper age limit of 75 at which the fund must have been crystallised, but that condition has now been partly relaxed.

It should be remembered that you do not have to use the same company that managed the pension fund to provide the pension. Under the **open market option (OMO),** you have the right to shop around other pension providers to see who offers the best deal.

This means that you have these choices:

- when to crystallise your pension fund,
- what type of pension and benefits to take, and
- which provider to use.

When to crystallise your fund will depend on your circumstances. This depends on your need for funds at the time.

Every extra year that you defer has two advantages:

- the fund grows by one more year, and
- the annuity rate improves to reflect that you are one year older.

What type of pension to take means choosing from the various options.

The first choice is whether to take a **lump sum**. The law allows you to take out up to one quarter of the pension fund tax-free. You can do what you like with it. Pay off your mortgage, have a holiday, give it your children, invest it, or even (if within the age range) use it to buy another pension.

The amount of lump sum you take will reduce the amount of pension you receive. Suppose your pot is big enough to give you a pension of £400 a month, but you decide to take the maximum lump sum. Your pension simply reduces by one quarter to £300 a month. This is still an advantage in that the lump sum is tax free but the pension payment is taxable.

Annuitisation

Whether or not you take the lump sum, we now come to the clever bit of pensions called **annuitisation.** All this means is that you turn a lump sum into a regular stream of income.

Suppose you are a man aged 65 and your pension fund has £100,000. How much pension will a pension providee pay you for the rest of your life?

The problem is that we do not know how long you will live. However we do know the average time that a man of that age will live. Suppose we find it is 20 years. The pension provider will then calculate your pension on the basis that you will live for 20 years. If you die sooner, you lose out. If you live longer, you benefit. It is a principle of pensions that those who die young subsidise those who die old.

So for a £100,000 we might assume that the provider will give you an income of £5,000 a year for the rest of your life.

However in reality, you will do better than that. Any pension provider should give you at least £7,000 a year. This is because your pension fund does not stop growing just because you have reached a particular age.

In your first year of retirement, he pays you £7,000 so there is still £93,000 left in the fund. This carries on earning interest at, say, 6.5%. So at the end of the year, there is still £99,045 in the fund.

The rate assumes a healthy man who does not smoke. If you do smoke or you have an **impaired life,** such as suffering from an illness, you are likely to live less long and may therefore get a better pension.

Main pension choices

We now look at the different types of pension you can choose. We consider a man of 65, married to a woman aged 62, and with £100,000 in his pension fund (after taking any lump sum).

The choices are broadly:

- whether to take a pension guarantee,
- whether to index the pension, and
- whether to have a dependant's pension.

Please note that the figures used below are illustrative only. Although they are credible figures, they will not represent the actual benefits you will receive. These depend on the rates being offered at the time you crystallise your pension.

The simplest form of pension is the **level pension.** You receive the same amount of money each month for the rest of your days. You may receive a pension of say £616 a month.

Suppose you die the day after you retire, you will receive a pension for one day of about £20 and the other £999,980 is lost. So your first decision is whether to have a **pension guarantee.**

This means that the pension provider will guarantee that your pension will be paid for a minimum time, usually five years.

This may reduce your monthly pension to £611 for a five-year guarantee or to £565 for a ten-year guarantee. In other words you pay £5 a month premium to insure your pension for five years, but about £50 a month to insure it for ten. If you die in the guarantee period, your next of kin will continue to receive your pension until the period ends.

A sum of £616 now is worth more than £616 will be in 20 years' time. A level pension will gradually lose value. So you may want **indexation** so that your pension increases each year.

If you want indexation, you have a choice. You could choose to increase it each year by a fixed amount, say 3% or by the whole retail prices index (RPI), or by a limited prices index of saying RPI up to 3%.

The more generous the indexation, the lower is the starting pension. For 3% indexation, the value of the pension falls to £419 a month. Nearly a third is lost. However after 20 years, that 3% a year increase will have increased the monthly pension to £756, more than the £619 you would otherwise have received.

For indexation to the full RPI, the pension would fall to £392 a month.

Third, you may wish to provide for your wife with a **dependant's pension.** This means that when you die, your wife will continue to receive a pension for the rest of her life. The younger your wife, the less will be your starting pension.

Next you need to consider how much pension to provide. The commonest figure is two-thirds. To provide for a two-thirds pension would reduce the pension to £501 a month. A 50% pension would provide a pension of £519, while 100% pension would provide £473.

These three options are not mutually exclusive. You may have two or all three of these choices reflected in your pension. Suppose our man wants a five-year pension guarantee, a two-thirds survivor's pension for his wife, and 3% indexation. His starting pension would be £342. This is just over half a level pension.

Please remember that these figures are illustrative only. Rates offered by pension providers change daily. Also remember to shop around, particularly if you want some of these options. It is common to see some providers offering monthly pensions up to 16% higher than others.

There are other many other pension choices such as fixed-term annuities and drawdown.

Contribution limits

There are no limits to the amount you may contribute to a pension fund. There are however limits to the amount of tax relief you may claim.

There are broadly two limits: a lifetime limit, and an annual limit. Since 6 April 2011, the annual limit is £50,000, having been much higher.