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What is a Pension? How Do I Get a Pension?

BACK TO BASICS: An overview of the different kinds of pensions available to British investors

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Q:
What is a pension? How does it work? How do I get a pension?

A:
Simply put, a pension is a tool that people use to save money for their retirement. There are different kinds of pensions available, which can be classified into the following categories:
- State Pensions
- Work Pensions
- Personal Pensions

In the UK and many other countries, pensions offer tax relief to contributors.

"One of the things that attracts people to pensions is the tax treatment," says Martin Bamford, a chartered financial planner and managing director at Informed Choice in Surrey, UK.

You will get income tax relief when you put money into your pension; then as your investments grow within the pension, income and capital gains are tax-free; and at the end when you withdraw the money from your pension, ¼ of your pension is not taxed at all, though the remainder is subject to income tax, explains Bamford.

Ultimately, if you are saving for retirement, this could be the best vehicle to use from a tax perspective.

State Pensions:
UK taxpayers contribute to the State Pension through their national insurance contributions. Then, when they reach retirement age, they receive weekly payments from their State Pension. Currently, most people can start receiving State Pension payments at the age of 65, though that age is being raised by the government since people are living longer and tend to work for more years. Generally, a single person receiving a State Pension will receive roughly £100 per week, and that amount can rise over time based on inflation.

Residents should keep in mind that the State Pension should not be relied upon to provide them with enough money to cover their living expenses in retirement. The State Pension provides a bit of money, but not quite enough.

“£100 a week is not much to live on,” says Lee Robertson, an independent financial adviser (IFA) and CEO at Investment Quorum. “People should make their own provisions to achieve the lifestyle in retirement that they wish for,” he says.

It’s also worth noting that there is a State Second Pension that is currently being phased out by the government. It was a complicated pension that only some people were entitled to, explains Robertson.

Work Pensions:
In addition to the mandatory State Pension, IFAs recommend that people contribute to a work and/or personal pension.

In terms of Work Pensions, there are pensions offered in both the private sector and public sector. Most private sector employers offer **defined contribution schemes** and many public sector employers offer **defined benefit schemes**. They operate differently:

Defined Contribution vs. Defined Benefit
Many private workplace pensions are run as **defined contribution schemes** (aka money purchase schemes) where individuals contribute money to their pensions and put that money into investments that they hope will grow over time. The amount you receive upon retirement is based on how much money was paid into your pension and how well your investments performed over time.

There are many benefits to contributing into this kind of work pension scheme:

- In general, for every contribution you make, your employer will also make a contribution. “Unlike other ways of saving, a workplace pension means you aren’t the only one putting money in. Your employer has to contribute too, as long as you earn over £5,564 a year,” according to the Direct.gov.uk website. Many employers will match their employees contributions, up to a certain threshold.

- Contributors will get a tax break from the government. This means that when you make a contribution, the government will refund the tax you paid on that contribution and put that refund into your pension pot.

- Using a work pension plan usually means reduced charges and fewer administrative hassles compared to a personal pension plan.

Many government workers’ pensions are run as **defined benefit schemes** (aka final salary schemes). These plans are run in different ways, but generally, the amount you are paid when you claim your pension is based upon your salary and the number of years you have been in the scheme.

For example, some government workers could be part of a defined benefits scheme that stipulates that for every year an employee works, they will receive 1/80th of their final salary during each year of their retirement. So a government employee taking part in this scheme who has worked for 10 years between the ages of 55-65 and makes £100,000 in his final year on the job will receive: 10/80 x £100,000 = £12,500 per year during his retirement.

This pension scheme is considered to be very generous, and the government is trying to phase it out over time because it has become expensive to maintain as people live longer. In some cases, employers using this “final salary” scheme are now trying to introduce a “career average” scheme, where pension payments are based on an employee’s average career salary instead of their final salary.

Work Pension Safety
People contributing to a work pension don’t have to be concerned about the security of their money. Even if your employer goes bust, the company won’t be able to touch your pension pot. And if you leave your employer, you can take your pension money with you.

However, the rules are slightly different for people taking part in a defined benefit scheme. If the scheme is run poorly and the pension plan goes into a deficit, then there is the risk that recipients will not be given the total amount promised to them.

Auto-Enrolment
Starting in October 2012, the government is directing employers to begin enrolling their workers automatically into workplace pension plans so it will be easier for people to start saving. The auto-enrolment will begin with large UK employers and will eventually be rolled out to smaller employers. For more information, visit the Direct.gov.uk website page.

Personal Pensions:
People can choose to open their own personal pension plans, however, IFA Jonathan Davis from Jonathan Davis Wealth Management says that it is generally better for people to consider a workplace pension ahead of a personal pension because they can benefit from employer contributions.

Within a personal pension, contributions are capped at £50,000 per year and the maximum pot that you can achieve is £1.5 million. Once you go above these thresholds, there will be punitive tax charges applied, explains Robertson.

There are three different categories for Personal Pensions:
- **Stakeholder Pension Plan**
- **Self-Invested Pension Plan (SIPP)**
- **Personal Pension Plan**

The Stakeholder Pension Plan was created to encourage less sophisticated investors to begin saving, explains Robertson. These plans have a limit on annual management charges and allow savers to stop and restart payments whenever they wish.

SIPPs are generally for more sophisticated investors, giving them access to many different kinds of investments such as funds and property. SIPP investors are given more flexibility to choose investments within their pension, but they may also be charged higher fees by SIPP providers.

“In the broadest sense, (Stakeholder Pension Plans) are for new pension savers while the SIPPS are for more developed pension savers,” says Robertson.

Then there are the regular Personal Pension Plans, which are considered to be the “middle ground,” he says.

“With a personal pension you pay regular monthly amounts or a lump sum to the pension provider who will invest it on your behalf. The fund is usually run by financial organisations such as building societies, banks, insurance companies or unit trusts,” explains a page on the Direct.gov.uk site.

When choosing which personal plan is suitable for you, “it’s about charges, flexibility and your investment experience,” says Robertson.

When choosing a personal pension, you should also be sure the costs are transparent and you have access to a suitable number of investments, warns Davis. And once you’ve set up your pension plan, be careful about how you’re investing within your pension “because that is going to determine what your retirement is going to look like,” says Davis.

Is a Pension Scheme Right for You?

If you are wondering whether a pension is right for you, contact the Pensions Advisory Service or an independent financial adviser before making a decision.