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On Track For The Future

How pensions work

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1 How Pensions Work – an overview

We all know that saving for a retirement is a good thing to do – however far off that may be. In this article we provide a basic explanation of the main different types of pensions

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Defined Benefit Pensions

A Defined Benefit pension is, very simply, a pension where you can work out to a fair degree of accuracy exactly what your pension income will be every year once you start taking it – the “benefit” you will receive is “defined”. But it should be noted that whilst relatively few organisations still offer Defined Benefit pensions you could have built up a Defined Benefit pension from a previous employer.

How it generally works is that while you are a member of the pension scheme you will “accrue” entitlement. So a defined benefit pension might have a defined accrual rate of 1/60th: meaning that for each year you are a member of the scheme your pension income increases by 1/60th of your final salary.

A simple example: let’s assume a person has a literal Final Salary pension, with an accrual rate of 1/60th, they’ve been in the same scheme for 20 years, and their Final Salary at retirement is £30,000 pa. For each year they have worked they are entitled to £500 pension, so on retiring after 20 years they will have a guaranteed income from this pension of £10,000pa (if we assume this scheme does not permit them to take a lump sum at retirement, reducing the income element).

Defined Contribution Pensions

Unlike defined benefit pensions, with a Defined Contribution pension you know how much you, and your employer if it’s a workplace pension, are paying in each month – your “contribution” to your eventual pension pot is “defined” but how much income it might provide in retirement will depend on a range of factors.

Typically you’ll see these contributions expressed as a percentage of current salary, and taken monthly – so if your salary is £30,000 and your contribution is 5%, you’ll know that you are contributing £125 to your pension each month (£1,500 each year assuming your salary doesn’t change in that period). If your employer has chosen to match your contribution then they will pay an additional £125 each month into your pension pot themselves.

It’s actually better than that it seems though. Your pension contributions receive special tax reliefs, to encourage you to save for your retirement, so in this example putting £125 into your pension won’t actually cost you £125.

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Putting a Pension into Payment

When it comes to putting your pension into payment there two main “categories”, within which there are many options which won’t be discussed here in any detail.

One category is purchasing an annuity – an annuity is essentially a set payment for life that you purchase with all of your accumulated pension funds. Factors like your lifestyle and health can have significant impacts on the annuity you are offered. There are also options to consider around any annuity beyond the direct annual payment value, like whether it’s protected against inflation or whether it continues to pay benefits to a spouse or partner on your death. Taking options like these will naturally reduce the nominal annual amount you receive but the value of the protections they offer is something you will need to consider. It’s important to note that there is an open market in annuities so you do not have to accept any offer from your current pension provider.

Another option is putting your pension into “drawdown” – this means that your accumulated pension pot remains invested, and thus potentially growing (though also potentially losing value), while you draw funds from the pot, typically on an annual basis. The amount you draw down can be flexible so you can adjust to your current needs. It’s important to note that while an annuity offers a guaranteed income for the rest of your life, if you haven’t purchased an annuity you will be reducing your remaining pot every time you draw from it and thus it is entirely possible for your pension pot to run out before you die, leaving you reliant on the State pension and any other income sources remaining to you.

Don’t forget that whilst you get tax-relief on your contributions whilst you’re saving for retirement, the income you draw in retirement will become subject to tax. However, you will have to option to take up to 25% of your fund (or give up some income under a Defined Benefit scheme in exchange) as a tax-free cash sum.

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The effects of inflation will reduce the future spending power of money.

Note that the government is continuing to introduce further measures to support individuals and families with the cost of living, through a number of financial initiatives. This document summarises, or provides links to further information available up to 30 August 2022.

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