A guide to...
Pensions.

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What is a pension?

Firstly, it's important to know that when we talk about pensions, we mean your pension plan. This is the way in which you invest for retirement rather than the income you get. Basically, a pension is a long term investment that helps you save for your retirement.

Payments into your pension are collected together and invested to build up a pot of money known as your pension fund. When the time comes to retire, it is the money built up in the plan that will be used to provide you with a regular income.

As the government is keen to encourage us all to put money away for our retirement, they've made pension plans tax efficient and you can benefit from basic rate tax relief on your payments. This means that, currently, for every £80 you pay in, the government will add a further £20 to your pension fund, and, if you pay income tax at more than the basic rate, you may be able to reclaim further tax relief when you complete your tax return (which does not get added to your pension fund).

Many employers will also make a payment into your pension fund. They'll contribute money to your pension on top of paying your salary. If you work for a company or small business, you should talk to your manager or Human Resources department to find out what you may be entitled to. It may not be immediately obvious, so it's always worth asking the question.

With the government and possibly your employer adding to your pension fund every time you pay money in, you're effectively getting extra money added for free.

When you retire, the money built up in your pension fund is used to buy an annuity or another product which provides you with an income in your retirement. Your pension income will be taxed as earned income.

The money in your pension plan is invested with the aim of growth and the final sum is used to buy an income when you retire. However, you need to be aware that tax rules may change in the future, and the value of your investment can go down as well as up and the value of the pension fund may be worth less than has been invested.

Pension types

There are a number of different types of personal pension, ranging from stakeholder pensions to standard personal pensions to self-invested personal pensions. You should talk to a financial adviser to be certain which one is right for you. Here's a quick rundown of the types of personal pension plans available.

Personal pensions

With a personal pension, you pay money into a pension fund. In some cases, employers who don't offer an occupational scheme may make payments into the personal pensions of employees. These plans are provided by financial institutions with professional fund managers who will invest money on your behalf so that it has the potential to grow in value. Please note the value of your investment can go down as well as up and the value of the pension fund may be worth less than has been invested. When you retire you can normally take up to 25% of your fund as a tax-free lump sum and use the rest to provide an income. Tax rules may change in the future.

Stakeholder pensions

Stakeholder pensions are personal pensions that have to meet certain minimum standards set by the Government, and have a maximum charge. They are designed to help people with a low income start investing towards their pension.

These plans are provided by financial institutions with professional fund managers who will invest your money to build up a pension fund for you. When you take your benefits, you can normally take up to 25% of your fund as a tax-free lump sum and use the rest to provide an income. However, tax rules may change in the future and the value of your investment can go down as well as up and the value of the pension fund may be worth less than has been invested.

Self Invested Personal Pensions

A Self Invested Personal Pension (SIPP) could be right for you if you are experienced and confident in making your own investment decisions. It allows you to build up a fund in a tax efficient way and brings with it greater investment choice and flexibility than most personal pensions. With a SIPP, you can choose, and move between, a wide selection of funds and permitted investment types to meet your own investment goals. When you take your benefits you can normally take up to 25% of your fund as a tax-free lump sum and use the rest to provide an income. However, the value of your investment can go down as well as up and the value of the pension fund may be worth less than has been invested. To find out more details and if this is the right choice for you, you need to speak to a financial adviser. Tax rules may change in the future.

Company pensions

There are two types of occupational pensions:

Final salary scheme

If you are in a salary related scheme, such as a final salary scheme, the income you receive in retirement will be based on either the length of time you have worked for your employer, or been a member of the scheme, as well as your salary. You can only join these schemes if your employer provides one – you cannot pay into one privately. The scheme's trustees and manager make all the investment decisions for you.

Final salary schemes are most common in the public sector for example teachers, nurses and local government employees usually benefit from these schemes. Some private sector employers also provide final salary schemes but recently many have closed due to the high cost of the guaranteed benefits. These schemes provide a defined amount of pension that is independent of market performance and usually adjusted for inflation. They also provide tax-free lump sums that are related to your salary and the number of years in the scheme.

Workplace pensions

You are in a workplace defined contribution scheme if you join your employer's trust-based money purchase scheme or a group personal pension arrangement (such as a group stakeholder scheme).

- You make regular payments during your working life.
- Your payments are then invested in your choice of one or more of a range of professionally managed funds and remain invested until you retire.
- The investment performance of the fund(s) will determine how much money you may have available when you are ready to retire. Charges and investment performance will affect the fund value. The value of your investment can go down as well as up and the value of the pension fund may be worth less than has been invested.
- The money built up is used to buy an annuity or another product which provides you with an income in your retirement. Your pension income will be taxed as earned income.
- You can usually take up to 25% of your pension fund as a tax-free lump sum, which means you will receive a smaller pension income. Tax rules may change in the future.

  Usually, your employer also pays into the scheme. If you can join your employer's scheme, it's usually a good idea to do so, particularly if the employer pays towards your pension fund – some schemes are very generous. You can still take out a personal pension if you need to top up your pension fund.

  Unfortunately, no one can know how much your fund will be worth when you retire or how much income you will receive each month. Although saving in a bank has its advantages (you have access to the money, you will at least get back the amount you paid in and any interest, once earned, is guaranteed), it is generally accepted that investing in a pension is a more effective way of planning for your retirement. A pension scheme lets you invest in a range of funds, so your money has a chance to achieve better growth than it would in a savings account. You need to understand more about the funds to make the best choices about where to invest your pension payments. You should also talk to a financial adviser.

What are funds?

Funds are a way for you to pool your money with other investors so you can:

- Take advantage of buying in bulk.
- Spread your money across lots of different investments.
- Get the services of an expert who you wouldn't normally have access to.

You can usually choose which funds to put your money in and change the funds you invest in. There are lots of different types of fund and there are many options to choose from; if you're not sure which one(s) to pick a financial adviser will be able to make recommendations for you.

The differences between funds are usually in the:

- Way they're managed.
- Assets they invest in.
- Level of risk they take and the amount of reward they're aiming for.

Different funds take different levels of risk. A lower risk fund might aim for steady growth over a long period of time with a low risk of losing money. A high risk fund will usually be aiming for higher long term growth but there is more risk that you might lose money.

The types of assets that a fund invests in are an important factor in the returns you're likely to get and the amount of risk that you're taking. A high risk fund might invest in shares of companies in either the UK or overseas which have the potential to provide good long term returns but are also likely to see large ups and downs in value. A low risk fund might invest in government bonds which normally offer lower returns but should be more secure.

What can I do with my pension at retirement?

Pensions can be quite confusing and many people find it difficult to understand them. It's important to remember that there are two separate elements to a pension. The first is the amount of money you build up from investing into a pension plan throughout your working life, which is known as your pension fund. The second is the income you take at retirement. When you retire, you can usually take up to 25% of your pension fund as a tax-free cash lump sum. The rest of the money in your pension fund is used to buy a product that will provide you with an income during your retirement. You don't have to take a tax-free cash lump sum, you could choose to use all of your fund to provide you with an income during your retirement.

Once you've paid money into your pension, you will be unable to access it before you retire. A pension is designed specifically to provide for your retirement, so you can't draw it out if you're a bit short one month. The government insists on this to balance out the tax savings they give you.

However, just because you can't spend it, doesn't mean you can't control it. Many pension providers now have online services similar to online banking that let you see where your money is and what it is worth. You can also choose where you want your pension provider to invest your money.

In the 2014 Budget it was announced that from April 2015 pension plan holders may be able to access all of their pension fund as a lump sum at retirement. This could have a major impact on any pension planning you make.

However, tax rules may change in the future and the value of your investment can go down as well as up and the value of the pension fund may be worth less than has been invested.

Can I retire early?

Taking the decision to retire early is a big step. Your pension fund will have had less time to grow, and you're likely to be retired for longer so your money has to stretch a little bit further.

If you're in a company pension, the rules of the scheme will determine whether you can retire early or not.

If you've got a personal or stakeholder pension the earliest you can usually retire is age 55. If you want to change your chosen retirement date you'll need to check with your pension provider. They'll be able to tell you what you need to do and whether there are any special circumstances you need to think about.

People in some occupations, or people who can't carry on working because of ill-health, may be able to use their pension fund to buy a retirement income earlier than age 55. For further information contact your pension provider.