



# clarityRESEARCH

## Types of Pensions

### Summary

1. Major changes to the pensions landscape in 2006 affected the rules under which all types of pension schemes operate, in most cases bringing these into line with each other. This Research Note concentrates on the main types of pension schemes; if you have queries regarding a SSAS, UURBS, FURBS, s615 plan etc. please contact your usual adviser.
2. It is no longer the case that being a member of an occupational scheme precludes membership of a personal scheme, and individuals now have much more freedom to decide how to manage their pension assets. This is a desirable change in the pensions arena, as pension assets are likely to be, if not the largest part, a very significant part, of an individual's wealth. Individuals therefore need to be aware of all the different types of pension contract available to them.
3. The basic reasons for selecting a pension remain the same as always: charges, choice and quality of management. It is simply a matter of matching the type of pension contract to your own particular circumstances.
4. Basic rate tax relief can be obtained on contributions up to £3,600 p.a. even for non-earners, so, for example, pensions can be increased for non-earning spouses or children/grandchildren.

### Selecting a Pension

The selection criteria for pension arrangements remain, as always: -

- Investment options available.
- Quality of administration and fund management.
- The effect of charges for administration and fund management.

### Types of Pension Scheme – an Overview

There are two main types of pension schemes – defined benefit (final salary) schemes, which are only run as company schemes (occupational pension schemes) and defined contribution (money purchase) schemes, which are run on both an occupational basis and a personal basis.

A defined benefit scheme, as the name implies, is where the eventual pension income is known, but the level of payments into the pension plan to produce this income are not known. The company makes a promise to pay a pension income based upon length of service and salary. The payments into the scheme are usually fixed for members, but the company payments will vary according to the variable market cost of funding the pension promise. The company therefore suffers the risk of underperforming investments and declining annuity rates, which is why these types of pension scheme are often seen as preferable, for individuals, to defined contribution schemes.

A defined contribution scheme is where the level of payments by the individual and/or their employer into the pension scheme is known, but the level of the eventual pension is not known. This is because the investment return on the fund between payment and retirement is not known, and the eventual cost of purchasing an annuity (pension) is also not known. This type of pension is increasingly favoured by employers, as costs are defined. However, the individual takes on board the risk of investment underperformance and annuity rate changes.

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## Types of Personal Pension Scheme

### Stakeholder Pensions (SPP)

Pension providers who want to offer access to their pension funds via Stakeholder policies as opposed to PPPs have to meet certain criteria, mainly: -

- Pension providers cannot charge more than 1.5% per annum of the funds under management for the first 10 years of the plan, then falling back down to 1%. For policies taken out before 6 April 2005, this maximum remains at 1% for the life of the policy.
- They must accept one off contributions, which can be as low as £20 gross.
- Transfers into and out of Stakeholder Pension schemes must be without cost.

Due to the cost limitations, the choice of funds is often limited to a number of mainstream funds, e.g. managed funds, UK equity funds etc. However, this type of pension is ideal where a relatively simple investment mandate is required, together with the confidence of a restricted charging structure and no penalties for moving providers in the future.

### Personal Pensions (PPP)

Personal Pensions are not subject to the same criteria, and so old style PPPs (those taken out before the introduction of stakeholder pensions in April 2001) may have a higher charging structure. Many Personal Pension providers have cut the cost on existing plans but by no means all have done so. You should check the terms with your existing provider before adding payments to an existing policy. It may pay you to take out a new policy with the same company and possibly even transfer existing funds to a new policy to take advantage of lower ongoing charges (bearing in mind charges for doing so, and possible Guaranteed Annuity Rates provided by the old style policy).

New Personal Pension contracts may offer a wider choice of funds than Stakeholder Pensions (e.g. external fund links, for a higher annual management charge). Where contracts are transacted on a nil commission basis (i.e. through a fee based adviser), charges can be competitive with Stakeholder Pensions, however, initial, annual and potential exit charges should always be checked before proceeding.

### Self-Invested Personal Pensions (SIPP)

A SIPP is simply a PPP where the functions of pension administration and pension investment are separated, rather than both functions being performed by an insurance company. A provider can be chosen purely on the basis of cost and administrative quality, and the member can choose the underlying investments from the wider market. Alternatively the member can appoint an external investment manager to direct investments on his/her behalf.

The administration charges on most SIPPs are transparent. There are two main ways of charging fees – by percentage of fund, or as a set amount regardless of size of fund. We would generally recommend the latter for most clients with larger (£100,000+) fund values. Typically there is a set establishment fee and a set annual fee. As the fees are not based on fund value SIPPs become far more cost efficient the larger the underlying fund, and many providers waive fees entirely for larger fund values where the investments are held on their platform.

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## **Why are SIPPs becoming more popular?**

It is difficult, or some would say impossible, to find an insurance company who offers the best fund management in all areas, e.g. gilts, high yield bonds, UK equities, US smaller companies. In the past, the only solution has been to have a number of pension plans with different providers, and aim to take advantage of the areas in which these companies offer expertise. However, the complexity of pensions legislation, and the cumbersome administration of insurance companies, means that funds cannot be easily or cheaply moved around between providers.

SIPPs were introduced in 1989 as a way of enabling individuals to manage their own pension funds with greater ease, by separating the pension administration from investment. In addition to enabling selection of the best collective investment fund (e.g. unit trust, OEIC) provider in individual areas, SIPPs have also enabled individuals to manage individual share portfolios within their pensions, or to purchase futures and options, or commercial property.

With the higher contributions that have been possible in recent years, individuals have also become more interested in the management of their pension portfolios. The increased investment control available within a SIPP can also help to manage a pension fund within the lifetime allowance. Please see our Research Note on Pension Rules for further details.

## **Who offers SIPPs?**

Most insurance companies offer SIPPs, however many insist that a large portion of the funds are invested in their own funds, which somewhat defeats the object of the exercise. There are a number of companies who offer the SIPP administration services only, and our clients generally (although by no means exclusively) use one or more of the main fund platform providers – for example Cofunds or FundsNetwork. These companies simply provide a framework within which you can choose your own investments or managers.

## **How much do SIPPs cost?**

If you have a large fund, the administration percentage costs of the SIPP itself would be competitively low. Indeed, there may be no charge at all for a SIPP where funds are held solely on the provider's platform, and the fund size is large (e.g. over £150-£275k). For smaller funds, the initial set up charge may be around £100 and annual charges may be around £200. The majority of the charge suffered is the initial and annual management charges (AMC) of the underlying investments made, as it would be for the same investment made in a non-pension environment.

The AMC will vary according to the fund selected, for example an index-tracking fund may have an AMC of as little as 0.25%, and an actively managed fund of around 1 – 1.5%. The mathematical objective is to be comfortable that the funds selected in the SIPP can outperform the current funds by any margin between the AMCs (and additional administration charges if relevant).

For smaller pension funds, stakeholder or personal pensions may offer a more attractive charging structure than a SIPP, and will generally be more suitable unless a particular investment strategy is desired (e.g. frequent individual share trades).

## **Retirement Annuity Policies (RAP)**

The differences between RAPs and PPPs have now disappeared, and contributions to an RAP after 6 April 2007 must now be paid net of basic rate tax, rather than gross. It should be noted that RAPs are structured differently to Personal Pensions, and consideration should be given to placing these within a trust in order for any death benefits to pass to beneficiaries free from Inheritance Tax.

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## **Types of Occupational Pension Scheme**

### **Defined Benefit (Final Salary) Occupational Pension Schemes**

Final Salary pension schemes are the oldest variety of scheme, where the benefits are based upon the number of years service, the accrual rate, i.e. the percentage of final remuneration for each year's service, and the person's final remuneration, as defined by the pension scheme (note: some schemes have changed from a final salary to a career-average salary basis, to reduce costs and maintain the viability of the scheme). The pension fund is responsible for the income payments in retirement. If the pension fund does not have the resources the employer is liable for the additional costs.

Increasing regulation is making final salary schemes progressively more expensive to administer. Additionally, the recent falls in equity values has meant that a number of final salary arrangements are now so under-funded that employers have decided they must close the scheme, although legislation has now been introduced to try and prevent solvent employers from winding up under-funded schemes.

Many schemes have already been closed whilst in deficit, which means that the scheme has insufficient funds to meet its liabilities. The scheme members are currently treated in strict priority order with benefits for existing pensioners taking precedence over benefits for current members. This often comes as a considerable shock for the scheme members, many of whom will have considered the final salary benefit to be guaranteed. If the scheme is in deficit then the transfer value will often be considerably less than the full value of the member's pension.

The current turmoil in this area is likely to cause a great deal of concern among those who remain in final salary arrangements, and many may be tempted to make alternative arrangements. This course of action should be very carefully considered as a fully funded, well run, final salary arrangement is a significant benefit.

For further details of protection in a wind-up situation, please see our Research Note on the Pension Protection Fund.

### **Defined Contribution (Money Purchase) Occupational Pension Schemes**

A money purchase scheme is subject to much of the same regulation as final salary schemes, but can be far simpler to administer. Each member has his or her own "pot" of money, which accrues until retirement date and then is used to provide an income. This means that the employer no longer takes liability for providing a promised amount based upon salary at retirement as is the case with final salary schemes, but passes this risk onto the employee. The value accrued by the employee will depend upon investment performance, contributions and costs, and the level of annuity rates at the time of purchasing a retirement income.

Historically, money purchase schemes have been seen as more advantageous to the employee whose earnings remain level throughout their career, whereas final salary schemes have been seen as generally favouring those whose earnings increase, as their contributions (if any) will be based upon the earnings at the time, but their benefit will be based upon their higher earnings at retirement. However, other factors will also affect the relative advantage of one type over the other, including the respective level of employer contributions and the length of service with the employer, investment performance achieved and costs.

In addition, members of occupational schemes may find that their employers offer matching contributions, which may make contributing at least up to the matching limit very attractive.

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