a members' guide to

defined contribution pension schemes

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Contents

Introduction

Defined contribution (DC) schemes have become the most common form of pension provision for workers in the private sector.

This guide aims to help Prospect members in DC schemes understand the main issues facing them in planning for retirement. It also sets out simple steps they can take that could have a positive impact on their income in retirement.

The information here is not exhaustive and more details are available on our website or from the links provided at the end of this guide. Of course, your employer also provides information about your pension scheme and some queries must be referred to scheme administrators for a definitive reply.

Nothing in this guide is, or should be construed to be, independent financial advice.

If you have any questions about the content of this guide or other pensions issues, please contact your local Prospect representative in the first instance.

1. Prospect and pensions

1.1 Your pension is one of your most important terms and conditions and as your trade union, Prospect is there to protect and improve it.

1.2 One way we can do this is to help members learn about the key aspects of their pension provision and how they can maximise the value of any pension on offer from their employer. Information is available on Prospect's website and officers and representatives can help with your pension queries.

1.3 Part of Prospect's job is to negotiate to protect and, where possible, improve the pension provision offered by employers. In many cases Prospect has been successful in negotiating increases to the employer contribution rate or implementing other improvements to DC schemes.

1.4 Prospect also works to ensure that schemes are working well for members. How this is achieved depends on the type of scheme. Some schemes are run by a trustee body to which Prospect members are often elected or appointed. We provide training and other support to members who do this work.

1.5 Other schemes are run directly by a pension provider under contract, without a trustee body to provide oversight. Prospect encourages branches in these schemes to be actively involved in their governance to ensure members get the maximum possible benefit from their contributions.

1.6 As a democratic organisation, Prospect responds to the wishes of its members. If you would like your branch or officers to focus on a pension issue it is important to raise it directly with them. You may even consider getting personally involved.

1.7 Previous generations often had the luxury of joining their final salary pension scheme when they started work and not thinking about their entitlement until they retired. Members of DC schemes today have to be more active in managing their pension arrangements than ever before. And new entrants to DC schemes have to track the performance of their pensions if they are to retire at the time they want, with the income they want.

2. Your pension and you

2.1 Your pension is important. Usually it is the income you will depend on from the day you retire until your death. A good pension can mean the difference between a comfortable and active retirement or a struggle to keep above the poverty line. Your dependants may also rely on your pension after you are gone.

2.2 Despite its importance, many people at work put off planning for their pension. But some simple decisions can have a huge impact on the quality of your final pension provision.

2.3 That is why we advise you to take the time to focus on a small number of key issues, in order to help you maximise the benefit you will get from your pension scheme. Getting things right now can greatly benefit you and your family for the rest of your life.

Your needs in retirement

2.4 The next sections outline the main issues you need to consider when assessing your pension provision, in particular the main sources of pension income and the main features of occupational pension schemes.

2.5 First is the level of income you will require in retirement. This will depend on many factors, including your expected outgoings, your aims and your ambitions. You should set against this target the level of pension income you expect your current level of savings to provide. This income will depend on the different pensions to which you are entitled and the level of contribution you, your employer and the state make to them.

2.6 The form of benefits you choose to take, and when you choose to take them, will also affect the level of pension income. The certainty or security of the level of pension income is another important consideration.

Required level of pension income

2.7 Only you can judge the level of pension income you will need in retirement. This has traditionally been expressed as a proportion of earnings before retirement. Most people aim for a level of income of half or two-thirds of their salary at retirement.

2.8 The ratio has usually been lower than one because outgoings are lower in retirement. For example, costs associated with travel to work are lower, mortgage or other debt has been paid off, children have become financially independent and there is no need to save for retirement any more. In addition, the overall tax treatment of retirement income is generally more favourable than when working. Hence a drop in required income at retirement is not unusual.

2.9 The desired level of income in retirement will partly depend on the expected level of outgoings. It will also depend on income from other sources such as state benefits, savings, or earnings from part-time or other work. The easiest way to assess the level of income needed in retirement is to examine your current outgoings and judge what changes and new outgoings you might have by the time you retire.

Expected level of pension income

2.10 Pension income can come from different sources and can be calculated in different and complex ways. However, the providers of different types of pension, from the state to employers to insurance companies, can and do provide illustrations of the expected level of pension income in retirement.

2.11 These illustrations are the best source of information on expected income and hence very important to those seeking to assess their pension provision. But projections are subject to a lot of uncertainty because they are based on assumptions. Like overall pension planning, they need to be kept under regular review.

2.12 There are many risks associated with pension provision, including increasing longevity, investment risks and uncertainty over inflation. This means that the expected level of pension income can fluctuate greatly and you may have to take significant action as a result.

Consequences

2.13 Having assessed the income you will require in retirement and your expected level of income there are a number of potential outcomes.

2.14 It may be that projected pension income meets or exceeds the level of income you will require. In this situation, your pension planning is meeting its aims and further action (besides keeping the situation under regular review) may not be necessary.

2.15 But if projected pension income falls short of the level of required income, further action will be necessary. One option would be simply to put up with the lower level of income and adjust expectations for your lifestyle in retirement.

2.16 Other options are to increase the level of your pension contributions or to defer drawing pension income to a later date. You can also press your Prospect branch to seek higher pension contributions from your employer.

2.17 The next sections outline the main issues you need to consider when assessing your pension provision, in particular the main sources of pension income and the main features of occupational pension schemes.

3. State pensions

3.1 Most members will receive a pension from one or more of three main sources: the state, their employer or themselves. Over a long career, you may well accumulate several pensions under these different headings. The relative importance of the main sources of pension income will depend on each individual's circumstances and pensions history.

3.2 Most members of defined contribution schemes will qualify for two main types of state pension provision. Both are payable from State Pension Age (although they do not have to be taken then).

State Pension Age

3.3 The State Pension Age (SPA) equalised at 65 for men and women in November 2018. It is now increasing for men and women to 66 by October 2020 and 67 by March 2028. There is an increase to 68 legislated for by 2046.

3.4 The Pensions Act 2014 introduced State Pension Age reviews that will take place at least every five years. The reviews will make recommendations to the government to either increase SPA or bring forward planned increases. The first review in 2017 recommended that the government should bring forward the increase to state pension age to 68.

3.5 It's important to be aware of your own SPA and you can check this at https://www.gov.uk/state-pension-age

New state pension

3.6 The New State Pension, introduced in April 2016, is paid to all people who have contributed (or been credited with contributions) for at least 10 years during their working lifetime, with 35 years needed for the full rate.

3.7 A qualifying year is one where a member has been:

- employed and had a minimum level of earnings over the financial year (£8,632 in 2019-20) and is paying national insurance contributions
- self-employed and paying Class 2 national insurance contributions
- making voluntary national insurance contributions, or
- receiving national insurance credits (for example, for receiving child benefit).

3.8 The full new state pension is £168.60 a week (2019-20). The current policy is for this to be increased by the 'triple lock' which is the greater of: increases in earnings, prices or 2.5%. However, legislation only mandates a minimum increase in line with increases in earnings. This means that the value of the basic state pension should be maintained over time.

Before April 2016

3.9 The New State Pension, introduced in April 2016, replaced the Basic State Pension, State Second Pension and Pension Credit.

Transitional arrangements apply to members with national insurance contributions before April 2016.

3.10 The transitional arrangements calculate the amount of pension individuals were entitled to under the arrangements that were in place in April 2016. This amount is protected if it is greater than the full rate of the New State Pension. If this amount is below the full rate of New State Pension, members will build up entitlement to the New State Pension from April 2016 until they reach the full rate. This is to ensure that individuals do not unfairly benefit or lose out as a result of the reforms.

3.11 The state pension is not a sufficient income on which to retire, but is a very useful foundation on which to base overall pension provision.

State pension statement

3.12 You can apply for a forecast of your state benefits from the Department for Work and Pensions at any time. These can usually be provided online, by post or over the telephone.

3.13 You can request your state pension statement online at: www.gov.uk/check-state-pension

Security of state pensions

3.14 The state pension is paid by the state and hence should be secure. There is no investment, economic or longevity risk to the member. However, there is a slight political risk as these pensions are not backed by actual funds and depend on the political will of future governments to continue paying them.

3.15 In theory, a future government might change the terms on which it pays these benefits. But this would be most unlikely to involve a reduction in the value of pensions in payment. Most changes to pension provision only affect future service and do not reduce pensions service already earned.

3.16 The most likely political risk would be around the terms on which these pensions are increased in future or the age at which they are payable (very young members may see state pension ages even higher than 68).

4. Occupational pension schemes

4.1 Pensions schemes offered by employers are called occupational pension schemes and come in a variety of forms. The expected levels of benefit and risk borne by members vary greatly with the type of pension offered. Different types of scheme have different relative advantages and disadvantages.

4.2 The main forms of occupational pension scheme are defined benefit schemes and defined contribution schemes. These are discussed in detail later in this guide.

4.3 The key issues around occupational pensions are the expected level of benefits, the level of employer contributions to the scheme and the risks borne by the member.

Auto enrolment

4.4 Since 1 October 2012, employers must ensure their workers are enrolled into a workplace pension (which meets minimum standards) and pay mandatory contributions into it. The introduction of auto enrolment was staged and applies to all employers since 1 February 2018.

4.5 Before auto enrolment, the only requirement was for employers with more than five employees to provide access to a pension but they did not have to contribute to it.

4.6 The Pensions Act 2008 defines 'worker' as an individual who has entered into, or works under, a contract of employment or any other contract by which the 'individual undertakes to do work or perform services personally for another party to the contract (excluding contracts where the other party is a client of customer of the individual's profession or business undertaking).

4.7 Employers are obliged to immediately auto-enrol new workers who are eligible jobholders. They are also obliged to enrol entitled workers who request to be enrolled. Employers are not obligated to contribute to a pension for workers who have earnings below the lower earnings limit for national insurance or are over 75.

4.8 Eligible jobholders:

- ordinarily work in the UK
- are aged between 22 and state pension age
- have qualifying earnings over £10,000 – the 'earnings trigger'.

4.9 Entitled workers:

- ordinarily work in the UK
- are aged under 22 or over state pension age (subject to maximum age of 75)
- earn more than the lower earnings limit for national insurance.

4.10 In 2017 the government announced its intention to reduce the age for auto enrolment from 22 to 18.

4.11 The mandatory minimum employer contribution is 3% of qualifying earnings (earnings between £6,136 and £50,000 for 2019-20). The minimum total contribution is 8% of qualifying earnings. The required employer and total contributions depends on the definition of pensionable pay used by an employer. This table sets out the alternative thresholds.

Pensionable	Minimum total contribution	Minimum employer contribution
Qualifying	8%	3%
Basic pay	9%	4%
Basic pay	8%	3%
Gross earnings	7%	3%

4.12 Most employers, particularly in the private sector, already offered defined contribution pension schemes to new employees before auto-enrolment. While some employers pay the statutory minimum employer contributions, most offer maximum employer contributions that are greater than this.

4.13 It is important to understand your occupational scheme and how to maximise the employer contribution, tax and other benefits it offers. As with state pensions, it is important to obtain projections of the likely benefits at regular intervals and to keep these under review. You will usually be provided with an annual benefit statement within 12 months of the end of the scheme year.

5. Personal pensions

5.1 Many people make their own pension provision on top of that offered by the state and their employer. This may be because they want to top up their occupational pension or because they are making up for previous periods when they were not covered by an adequate employer pension. Current tax rules allow most people to contribute up to 100% of salary, or £40,000, whichever is lower, to a personal pension.

5.2 Personal pensions are defined contribution arrangements and are generally provided by insurance companies.

5.3 As with all DC pension provision, you bear a good deal of risk with personal pensions. The main variables are the performance of the investments and the price of buying a pension at retirement.

5.4 People with personal pensions need to consider the choice of investment fund, the choice of pension provider when turning the accumulated pension pot into pension income, and the form of pension purchased. These issues are largely the same for members of occupational DC schemes and are discussed later in this guide.

5.5 As with all pensions, it is important to keep an eye on the expected level of benefits from a personal pension. Your provider should supply projections at regular intervals.

6. Defined benefit schemes

6.1 There are two main types of employer pension scheme: defined benefit (the most common form is known as final salary) and defined contribution. Each type has its advantages, disadvantages and special features. It is useful to study the benefits offered by defined benefit schemes as a benchmark against which to assess your own scheme.

6.2 A defined benefit pension scheme pays a pension according to a formula set by the rules of the scheme. The pension is unrelated to the contributions paid by the member or the performance of any investments held by the pension fund.

Final salary pensions

6.3 A final salary pension scheme is a specific type of defined benefit scheme which is based on the member's salary on leaving the scheme.

6.4 The benefit formula is often expressed in the following terms:

$$\text{Pension} = \frac{\text{years in the scheme x final salary}}{80}$$

6.5 The above scheme would be called an 80ths pension scheme as it is divided by a factor of 80, known as the accrual rate.

6.6 Members also often qualify for a tax-free lump sum payable on drawing the pension. The lump sum can be in addition to the pension or in exchange for some pension (or a combination of both).

6.7 As with all types of pension provision, the key issues for defined benefit schemes are:

- the expected level of benefits
- the level of employer contributions
- the risk borne by members and
- how to maximise the benefits payable.

6.8 Many final salary schemes offer an 80ths final salary pension plus a tax-free lump sum of three times the pension. Therefore a worker spending 40 years in such a scheme could be expected to retire at normal pension age with a pension of half salary, with an additional tax-free lump sum of one and a half times final salary. Most people would consider this level of benefit, together with any state or personal pension, to be sufficient to provide for a comfortable retirement.

6.9 The level at which the pension typically increases in retirement can vary but is usually in line with inflation measured by Retail Price Index or the Consumer Price Index.

6.10 As well as a pension and lump sum, final salary schemes often provide illness and death benefits and pay a spouse or partner's pension.

6.11 Final salary schemes are often considered to be the gold standard of pension provision and indeed the benefits payable from these schemes can be among the highest of all pension schemes.

Contributions

6.12 Members of these schemes might typically contribute 5 to 10% of their salary. The employer pays the balance of the estimated cost of providing the benefits. Estimating this cost can be difficult and depends on the assumptions made, but recent estimates show that the cost to the employer is typically in excess of 20% of members' salaries.

6.13 These benefits are relatively secure. The risks inherent in providing pensions, such as poor investment returns and increasing life expectancy, are borne by the employer. If the cost of providing the pension turns out to be higher than expected, any shortfall is made good by the employer rather than the member.

6.14 The main risk for members in final salary schemes is that their employer is unable to pay the required contributions. In the relatively unlikely event of the failure of a scheme's sponsoring employer, the scheme's trustees and the regulatory authority will have ensured that the scheme holds assets to offset the pension liabilities. If the assets held are not sufficient, the Pension Protection Fund, the lifeboat for pension schemes, may step in to pay some of the promised benefits.

7. Defined contribution schemes: introduction

7.1 A defined contribution pension scheme is one where contributions are paid into a pension pot, which accumulates with investment returns and is used at retirement to purchase a pension. The contributions are known, but the investment returns and the price of pensions at retirement are not; hence the benefit offered by the scheme at retirement is uncertain.

7.2 Employers use two main types of DC scheme to meet their auto-enrolment obligations: Group Personal Pension Plans which are contract based and Master Trusts which are trust based.

7.3 If the contribution rate to a DC scheme was the same as a final salary scheme and if investment returns, mortality improvements etc were exactly as assumed in setting the contribution rates, then the benefits from a DC scheme and a final salary scheme would be similar.

7.4 In practice, however, employer contributions to DC schemes are typically lower than employer contributions to final salary schemes. This is why the benefits provided by DC schemes are usually lower than those provided by final salary schemes.

Risks of DC schemes

7.5 As well as lower benefits, DC schemes have a very different risk profile to final salary pension schemes. In a final salary scheme your benefits do not depend on the performance of investments, mortality expectations on retirement or any other variable factors. As long as the employer remains solvent and/or the pension scheme has sufficient assets to pay the benefits, you will receive the promised pension regardless of the cost of providing it. Therefore the level of future benefit is very secure.

7.6 The opposite is the case in DC schemes. Most of the risks of providing benefits fall on the member and this can lead to great uncertainty in the level of benefit provided. Although the scheme provides annual projections of benefits, these depend heavily on the underlying assumptions and the actual benefit can vary greatly from the projections.

7.7 Placing the risk on members can result in higher than expected benefits (if, for example, investment returns are higher than assumed). But they can also lead to benefits that are lower than expected.

7.8 Generally, members prefer to have less risk associated with a long-term benefit as important as their pension. The greater uncertainty associated with DC schemes is therefore a further disadvantage compared to final salary schemes.

Involving members

7.9 These features of DC schemes tend to require members to take a more active role in managing their pension provision. Because

DC scheme members bear many of the risks of providing their own pension, they need to keep their pension arrangements under review, as changes in investment outlook or mortality expectations can cause the pension goalposts to shift radically.

Other benefits

7.10 Defined contribution schemes may also have additional features that pay out on contingencies other than retirement. For example, dependents may receive their accumulated pension pot plus any additional life assurance cover when the member dies. Likewise, the pension may be paid early, together with any insured level of benefit, if the member has to retire due to ill-health.

8. DC pensions: contribution rates and benefit levels

8.1 This section outlines the main features of defined contribution pension schemes and the key issues members of these schemes should consider in order to make the most of them.

8.2 Prospect is not authorised to give independent financial advice but members are strongly advised to speak to a Prospect representative and/or obtain independent financial advice before opting out of an occupational pension scheme.

Level of contributions

8.3 One of the most important features of an occupational DC pension scheme is the level of contributions.

8.4 Most employers make pension contributions on behalf of their employees above the minimum level. As pensions have gained in prominence and trade unions have prioritised better quality provision, average employer contributions to DC schemes have gradually increased.

8.5 Employer contributions can be structured in a number of ways:

- a flat-rate contribution
- a matching contribution (based on the member's own contribution rate)
- an age-related contribution
- a service-related contribution
- a combination of two or more of the above.

8.6 The most common structure is a matching contribution where employers contribute more (up to a specified maximum) as members contribute more.

8.7 A matching contribution structure is illustrated in the table below. Members pay contributions of at least 3% of pensionable pay. The more members pay into the scheme, for instance up to 6% of pensionable pay, the more the employer will contribute.

Member contribution	Employer contribution	Total contribution
3%	3%	6%
4%	4%	8%
5%	5%	10%
6%	6%	12%

8.8 In this structure, the employer pays more as the member pays more, up to a maximum of 6%. As well as higher employer contributions, members also benefit from more tax relief the more they contribute to their scheme.

Tax relief

8.9 Tax relief is available on most member contributions, up to 100% of pensionable pay. Tax relief reduces the cost of contributions by the level of your marginal tax rate, usually 20% or 40%. If a salary sacrifice scheme is in operation, members may also benefit from lower national insurance contributions if they contribute more to their pension scheme.

Review of contributions

8.10 The nature of a defined contribution scheme means that it is hard to set out how much you will need to contribute to have an adequate income at retirement. The effect of compound interest means that the earlier you save into a pension the more affordable it will be to save an adequate amount for retirement.

8.11 We think most members would be unlikely to have their desired standard of living in retirement without total contributions in excess of 15% of salary over their career.

8.12 Whatever the contribution structure, it is advisable to review the level at which you contribute to see if you are maximising your potential benefits.

8.13 Statistics show that a large proportion of members fail to decide how much to contribute to their scheme and end up contributing at the default level provided for in the rules. It is much better to make an informed decision on the amount to contribute rather than let this be determined by scheme rules.

8.14 If you cannot contribute up to a maximum matching level but would like to in future, you could allocate part of your annual pay increase to increasing your member contributions until you reach the desired level.

Level of benefits

8.15 The expected level of pension will depend on a number of factors. Assumptions about length of career, salary growth, investment returns, mortality rates and other inputs have to be made to produce a forecast of future pension income from the scheme. The forecast can only be as reliable as the underlying assumptions. As there is a great deal of uncertainty about each of these, you need to keep track of changes in your projected benefits over time.

8.16 Your scheme will provide you with an annual projection of benefits This is the most important tool for assessing your plans for retirement.

8.17 You can also use tools like online pension calculators – of which there are many – to make projections on alternative bases (for example, if you increase your contribution rate or delay drawing your pension).

Effect of different contributions

8.18 The level of contributions is a key factor in determining the ultimate level of benefits. The difference between projected benefits at retirement after a career contributing at minimal or acceptable levels of contributions is large.

8.19 A member spending a full career contributing at a level that attracts generous matching employer contributions can have a reasonable expectation of benefits that are similar to those enjoyed by final salary scheme members. A member making minimal contributions with no or low employer contributions would accumulate a relatively paltry pension.

8.20 The following table shows the projected level of benefits built up by a member and employer contributing jointly at fairly minimal (6%) and adequate (20%) total contribution levels. These calculations take the example of a man joining the scheme at age 23 and taking pension at age 63.

Total contribution rate	Pension as a percentage of salary
Contribute 6%	Less than 15%
Contribute 20%	More than 45%

Consequences

8.21 If you are unhappy with your projected level of benefit, or feel that even with other sources of pension income it is unlikely to meet your income needs in retirement, the options are to:

- put up with this lower level of income
- work longer and retire later
- contribute more towards your pension.

8.22 Those who are not contributing at a maximum matching level for their scheme may find that the best option is to raise their contributions. Delaying retirement can also have a significant effect – pension income can be more than 5% higher for every year extra worked.

8.23 The earlier you start to contribute towards your pension, the lower the ongoing contributions needed to attain a given level of benefits. It is also usually easier to start contributing at a higher level and to switch to a lower level of contributions at a later date, than to start at a lower level and eventually have to increase contributions.

9. DC pensions: choice of investment fund

9.1 The rate of return achieved by your pension fund has a significant effect on final benefits earned in the scheme. Your pension scheme may offer a number of different fund choices which will be set out in the scheme's literature.

9.2 Prospect is not authorised to advise on your choice of investment fund but aims to help you with the decisions you need to make.

Investment risk

9.3 Investment risk can cover a number of different features but is often used to refer to the likelihood of investments going down as well as up. If the price of a particular investment varies like this, it is said to be volatile. The more volatile an investment, the riskier it is.

9.4 Less volatile funds generally have lower long-term growth potential and are more at risk of having their value eroded by inflation, but generally offer more safety for savings. Pension saving is for the long term. Volatile funds are more likely to achieve better growth in the long term but are usually not as safe.

9.5 It is important to understand the volatility of the different funds in your pension scheme. If the scheme literature does not cover this, ask your normal scheme contact for information.

9.6 Different classes of investment are often viewed as a trade-off between growth potential and volatility. To achieve better growth, investors often have to accept higher volatility or risk (though there is no guarantee that past performance will be repeated).

9.7 The most suitable mix of growth potential and volatility will depend on a number of factors. The younger you are and the longer the timescale over which you invest, the more likely it is that higher growth will be attractive. Conversely, fluctuations in asset values may become less acceptable as you get older. However, if you have other investments that are lower risk this may mean you can accept more volatility. You should also consider the general economic situation when choosing investment funds.

Fund charges

9.8 The charges levied by a fund are important. Although they are often expressed as a fraction of a per cent of fund value, these charges accumulate over a career and can amount to a significant proportion of your total pension pot.

9.9 For even a moderate saver, a reduction in annual management charges of just 0.1% can increase pension income in retirement by hundreds of pounds a year. This does not necessarily mean that higher charges are always worse but you may want to check whether a fund with higher charges offers greater growth potential to justify the extra costs.

9.10 A statutory cap on member charges in the defaults available in defined contribution schemes used to comply with automatic enrolment has been in place since April 2015. This cap is 0.75% of funds under management. The charge cap applies to all costs and charges associated with scheme and investment administration.

9.11 The only charges outside the cap are transaction costs (the variable costs incurred as a result of buying, selling, lending and borrowing investments) and a number of ad hoc charges that can arise in certain circumstances. Members can opt in to paying for additional services that can bring the overall charge above the level of the cap.

9.12 The above cap applies to default options in schemes used for automatic enrolment purposes. Other options and schemes not used for automatic enrolment purposes are not covered by the cap.

Default investment funds

9.13 Schemes often have a default investment fund and statistics show that the vast majority of scheme members end up in the default fund. The default fund is usually chosen to suit as many people as possible but it may not be suitable for everyone. Think about whether its investment aims match your own before opting for the default investment fund.

9.14 Default funds often have a lifestyle option, or a lifestyle option is included in the fund choice. This means that investments are moved into less volatile funds as you get closer to retirement. This may protect you from unexpected falls in the value of investments just before retirement but also carries the risk that funds are moved at difficult times. This feature also means you should think about whether the age you have decided to retire is appropriate.

9.15 Whatever investment fund you choose it is important to keep it under review as your circumstances and the general economic environment change. Before making any changes to your fund choice, consider whether there are charges for doing so and what their impact might be.

10. DC pensions: drawing your pension

10.1 It may be years or even decades off, but the decision on how to convert your pension pot into income when you retire will probably be one of the most important financial decisions you ever make.

10.2 While it may seem like something you can put off considering until closer to retirement, a few basic points are well worth taking on board early on as they may significantly boost your quality of life in retirement.

10.3 You might be prompted to start investigating your options when your scheme sends you details of the choices you have. Regulations currently require this to happen no later than six months before you are due to retire.

10.4 Pension Wise is a service provided by the government to give individuals over 50 guidance on the options available to members of defined contribution pensions at retirement. This service offers guidance and information and not financial advice. Visit www.pensionwise.gov.uk/en.

10.5 Pension Wise outlines four main options for members of defined contribution schemes at retirement:

- taking a guaranteed income
- taking an adjustable income
- taking ad-hoc withdrawals and
- taking a cash lump sum.

Members can choose a mix of these options.

Guaranteed income

10.6 An annuity is a financial product that provides you with a guaranteed income for the rest of your life. You can take up to 25% of your pension pot as a tax free lump sum and purchase an annuity with the remaining funds. It is useful to know something about annuities – of which there are many different types – and some alternatives.

10.7 You can buy a single life annuity (which pays an income to you for the rest of your life) or a joint life annuity (an income to you for the rest of your life which then continues to be paid to a surviving partner or financial dependant until they die).

10.8 Annuities can be level or increase yearly. Level annuities pay the same income throughout retirement. Increasing annuities either rise in line with inflation or at a fixed rate (eg 3% or 5%) each year. A level annuity will initially pay more than an equivalent increasing annuity. But as the amount you receive stays the same (and falls in real terms), it will eventually fall below the amount paid by the increasing annuity.

Adjustable income

10.9 Flexi-access drawdown is a type of product that allows you to take an adjustable income from your pension pot. This typically involves taking a tax free, commencement lump sum of up to 25% of the value of the pension, with the remaining pension pot funding an adjustable income for life. The level of pension drawn will need to be regularly reviewed to ensure that the funds are not completely spent before the end of your retirement.

Ad-hoc withdrawals

10.10 Uncrystallised funds pension lump sum is the name for making a single ad-hoc withdrawal from a pension pot. This can be a one-off lump sum or could be regular ad-hoc lump sums. While 25% of the lump sum is tax free, the remaining 75% would be taxable at your marginal rate.

Small pots lump sum

10.11 Members with small pension pots of under £10,000 may be able to take them as a single lump sum under trivial commutation rules. Your pension administrator will be able to provide you with information on trivial commutation.

Shopping around

10.12 You have the right to shop around with your investment fund. You do not have to buy the annuity or drawdown product offered by your own pension scheme. This is important for annuities because the price offered by providers varies greatly. The difference in price between the cheapest and most expensive annuities can be up to 30% at any one time. This could mean the difference to an average scheme member of an income in retirement of £10,000 or £13,000.

10.13 Statistics show that a significant majority of defined contribution scheme members do not exercise their right to shop around. This is likely to be because they do not fully understand the nature of the decision or its importance. A little research and effort at this stage can have a big effect on your income in retirement.

Making a decision

10.14 The price of an annuity will depend on a number of factors:

- **type of annuity**: single or joint life, level or increasing, etc
- **age**: annuity rates tend to increase with age, so the older you are when you buy an annuity, the higher the income will generally be
- **gender**: women live longer and therefore it is more expensive to provide them with an annuity
- **health and lifestyle**: smokers may get a better deal on annuity rates
- **provider**: different companies offer different prices which is why it is worth shopping around for the best deal possible.

11. Further information

The information provided in this guide is a brief summary of the features of defined contribution pension schemes and the issues members of these schemes need to bear in mind when planning for retirement. You should not base any financial decisions solely on the information in this guide.

You should familiarise yourself with literature provided by your scheme and/or employer about your pension – this is the best source of information.

You can also raise any issues with your local Prospect representative. The union's website has further information on general issues relating to pensions:

- **www.prospect.org.uk/help-at-work/pensions-retirement/index**

The Department for Work and Pensions has comprehensive information on workplace and state pensions:

- **www.gov.uk/browse/working/workplace-personal-pensions**
- **www.gov.uk/browse/working/state-pension**

The Pensions Advisory Service, an independent, non-profit organisation, provides free information and advice: www.pensionsadvisoryservice.org.uk

The Pension Tracing Service may be able to help you if you have lost touch with your pension scheme. **www.gov.uk/find-pension-contact-details**

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