The Investment
COACH

KEY GUIDE

Saving for retirement

Introduction

THE VALUE IN THINKING AHEAD

Retirement is something most of us look forward to – particularly on a Monday morning. However, those thoughts are often little more than a whimsical cocktail of not having to work and prolonged holidays. The reality could be rather different, particularly if your retirement date is some way off.

For a start, retirement is now often not the sudden change from work to enforced idleness that it used to be. It has increasingly become a gradual process, with part-time work playing an important role. The latest data from the Office for National Statistics (ONS) show that 13.8% of men and 8.6% of women aged 65 and over are still in employment.

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A gradual process

The blurring of the work/retirement boundary is being accompanied by changes to the state pension age (SPA). The process of equalising the SPA for men and women started in 2010, and both sexes have shared a common SPA since November 2018. Another phased SPA increase ended on 6 October 2020, with the SPA for both sexes now at 66. More increases are planned for the future:

State pension age increase	Phasing-in starts	Phasing-in ends
66 to 67	6 April 2026	5 April 2028
67 to 68*	6 April 2037	5 April 2039

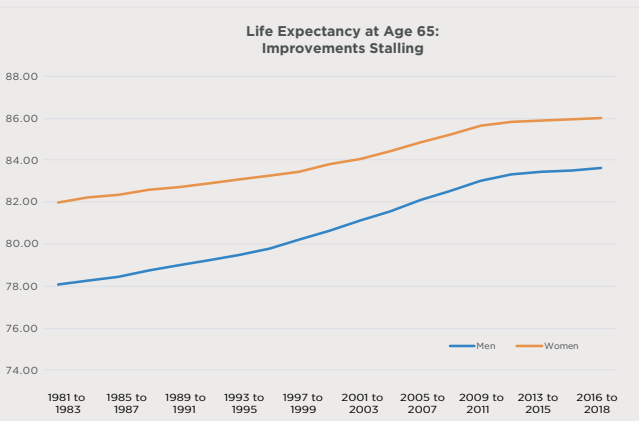
**Not yet legislated for, but announced in July 2017. This may be changed due to a stalling in the rate of mortality improvements.*

Planning point

Life expectancies have increased significantly over recent years so your plans for saving should allow for a longer retirement than you may have anticipated.

At the current rate that SPA is rising, you may need to have reached age 70 by around 2060 before you can start to draw your state pension – food for thought if you were born after 1989.

Until recently, the rise in SPA has reflected some good news for retirees: the increase in life expectancies. Between 1981–83 and 2009–11 the average life expectancy in the UK at age 65 rose by over five years for men (to 83.0 years) and a little under four years for women (to 85.7 years). Since then, as the graph shows, the pace of improvement has virtually stalled. These are average numbers based on historical data, so they don't tell the whole story. Other calculations made by the ONS suggest that a man aged 65 today has a one-in-four chance of reaching age 92, while a woman of the same age has the same odds of reaching age 94.



Source: Office for National Statistics, 2019

YOUR PENSION OPTIONS

Today's pension offerings are best considered in two parts: state provision and private provision. These remain complementary elements, with the state providing a base/subsistence level of income on which private provision is built.

Since 2010, a raft of pension changes has been introduced. The reforms have had a variety of goals, but two key points stand out:

- The state's role in retirement provision is shrinking. There is now no earnings-related link to state pensions, other than in terms of the eligibility threshold. The subtext is to limit the burden of an ageing population on the Treasury.

- In parallel with the declining relevance of the state, there is greater emphasis on private pension provision and individual responsibility. The introduction of automatic enrolment and the increased flexibility in drawing benefits from pension arrangements are both moves away from state responsibility.

State pension

The state pension is now a single-tier arrangement, meaning that there is no longer any earnings-related element. In 2021/22, the theoretical maximum new state pension is £179.60 a week – about 58% of what the National Living Wage would provide for a 35-hour week. In practice, few people currently reaching their SPA receive this precise amount. The differences stem from the arcane transitional adjustments made to take account of the old state pension regimes, including the option to opt out (technically 'contract out') of the earnings-related element.

Unlike the old state pension regime, the new state pension is a purely individual benefit and does not incorporate any widow's or widower's pension. However, under the transitional provisions in respect of national insurance contributions (NICs) made or credited before 6 April 2016, some widow or widower's payments may be included. Once payment starts – and don't forget that moving SPA – the state pension currently increases by whichever of the following is greater: average earnings, price inflation (as measured by the consumer prices index) and 2.5% (hence the 2.5% rise in April 2021).

Most experts believe this so-called 'triple lock' should be replaced, with the costly guarantee of the 2.5% floor removed. The 2019 Conservative party manifesto pledged to retain the 'triple lock', but it could become a victim of Covid-19 because of the distortions to the pattern of earnings growth created by the pandemic.

To find out your projected state pension entitlement, start by visiting www.gov.uk/check-state-pension. Then you will need to consider your private provision.

Planning point

If you are still working, you can opt to defer the state pension to increase the amount you receive when you start to take it.

Final salary pensions

Final salary pension schemes, often referred to as defined benefit schemes, generally offer a pension benefit related to your salary around the date of retirement and the number of years of service with the scheme's sponsoring employer. In the private sector, the cost of running final salary schemes has prompted their widespread closure: as at 31 March 2020 only 11% of schemes were open to new members and 46% were no longer accruing further benefits for existing members.

The public sector has continued to offer defined benefit pension schemes, which are largely funded on a pay-as-you-go basis, unlike their pre-funded private sector counterparts. Even so, these schemes have been subject to various cost-saving measures, such as higher member contributions and moving towards benefits based on career average earnings rather than final salary.

If you are a member – past or present – of a defined benefit pension arrangement, you should probably consider yourself lucky. Do make sure you understand what your eventual benefits should be and seek expert advice before taking any action, such as drawing benefits early or transferring to another pension arrangement.

Defined contribution pensions

At their simplest, defined contribution pensions, sometimes called money purchase pensions, are similar to savings plans. Contributions made by you, your employer (if you have one) or even third parties are invested in your chosen investment

iStock/Donald_greuner

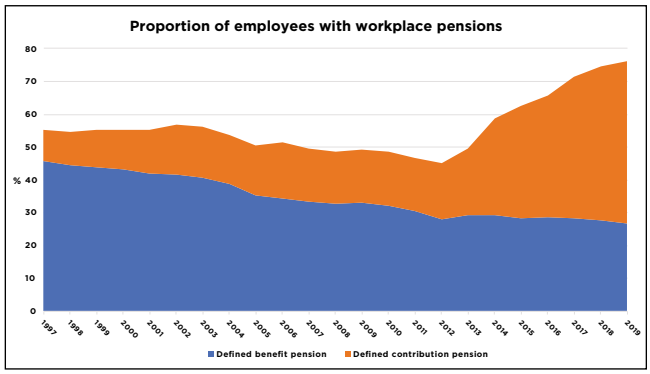
funds. When you want to draw benefits, you cash in part or all of your fund, either buying a pension annuity or directly withdrawing the cash. Reforms that took effect in April 2015 mean that there are virtually no restrictions on how you take your benefits, provided you have reached the minimum pension age (currently 55, but 57 from April 2028 and then increasing in line with SPA).

Defined contribution pension arrangements take a variety of forms, from highly tailored individual plans, such as self-invested personal pensions (SIPPs), to large multi-employer arrangements, such as the government-established National Employment Savings Trust (NEST).

The growth of defined contribution schemes has been given a boost by auto-enrolment of employees for workplace pensions, as the graph below demonstrates. Auto-enrolment was phased in from October 2012 and is now fully in force. The first round of contribution increases took effect from 6 April 2018 and further significant increases to employer and employee contributions took the total to 8% from April 2019. If you have been auto-enrolled into a pension in the past nine years, the chances are you became a member of a defined contribution arrangement. The importance the government attaches to auto-enrolment can be seen by the fact that it included ongoing payments of employer contributions in the benefits given to furloughed workers under the Coronavirus Job Retention Scheme during the Covid-19 outbreak.

Planning point

Defined contribution pensions have largely replaced final salary schemes and allow you to cash in all or part of your fund as an annuity or cash withdrawal.



Lifetime ISAs

Lifetime ISAs (LISAs) are not pension arrangements, but a variant on the individual savings account (ISA) that was launched in April 2017. Their structure looks like a pension because there is a form of tax relief on contributions and a minimum age of 60 for drawing out funds without penalty, unless the cash is used for purchase of a first home. In some circumstances, a LISA is preferable to a pension arrangement, but the choice is best made with advice.

YOUR PENSION CONTRIBUTIONS

Contributions to private pensions generally attract full income tax relief, so if you are a higher rate taxpayer in England, Wales or Northern Ireland, a contribution of £100 will cost you a net £60 (it is £59 in Scotland where the higher rate on earnings is 41%). The income tax relief is so generous that there is a raft of legislation which places limits upon it.

Annual allowance

One such limit is that your total pension contributions, including employer contributions, must be kept within an annual allowance to avoid tax charges. For 2020/21, the basic annual allowance is £40,000, but it is gradually reduced if you are a high earner. As a very broad guide, tapering starts to bite if your income (not just earnings) plus your employer pension contributions exceed £240,000, and at £312,000 or more hits a £4,000 contribution floor.

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Until the March 2020 Budget lifted the thresholds by £90,000, the tapering of the annual allowance had caused major problems for many higher earners in the NHS and other parts of the public sector. For example, some medical consultants who failed to take advice had been faced with five figure tax demands.

Carry forward

There are some special rules that may allow you to catch up on the pension contributions you could have made in the previous three tax years, and thus contribute more than one year's annual allowance. This process is known as 'carry forward' and in 2020/21 you can exploit it to mop up your unused annual allowance dating back to 2017/18. The rules are relatively complicated in their application, but, in theory at least, if your earnings are high enough and you have not paid into a pension in recent years, it would be possible to make up to £160,000 of pension contributions in 2020/21 with full tax relief.

EXAMPLE
Maximising contributions

Bill is a self-employed consultant with a total income of £105,000 a year, meaning he is unaffected by the rules for tapering the annual allowance. For the last five years he has contributed £25,000 a year to his SIPP, well below the annual allowance he could have paid. In 2020/21 he could in theory pay £85,000:

Tax year	Amount contributed	Balance of annual allowance available
2020/21	–	£40,000
2019/20	£25,000	£15,000
2018/19	£25,000	£15,000
2017/18	£25,000	£15,000
TOTAL		**85,000**

In practice, Bill might choose to set his contribution at £55,000 for this and the next two years, as that level would allow him to take advantage of his unused allowance and receive higher rate tax relief on all his contributions. If he made a one-off payment of £85,000 in this tax year, about £30,000 of this would only attract basic rate relief.

Lifetime allowance

Alongside the annual allowance, there is an effective limit on the tax-efficient value of your overall pension benefits. If this is breached, then a tax rate of 55% could apply to the excess. The standard lifetime allowance is currently £1,073,100. That may sound more than enough, but at current annuity rates £1.0731 million would only provide a non-smoking 65-year-old with an RPI-inflation-proofed pension of about £2,500 a month (before tax).

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You may be entitled to a higher lifetime allowance, thanks to one or more of several sets of transitional rules. These have a labyrinthine complexity and advice is vital to maximise tax savings and avoid losing any entitlement.

Expert advice is also essential if the lifetime allowance and/or annual allowance mean that you cannot build up an adequate pension fund for your retirement. There are many ways to create retirement funds outside of the pensions arena, some of which offer tax reliefs similar to those provided by pensions.

Planning point

The lifetime allowance is now £1,073,100, down from £1,800,000 in 2011/12, but transitional protections with higher limits may be available.

Making contributions

Whether or not you wish to maximise your pension contributions, it is well worth taking some trouble to decide how they should be made. If you are an employee, then you (and your employer) can save NICs. The secret is for you to reduce your salary or your bonus and ask your employer to use the money, including the NIC saving, to make the pension contributions for you. The technical name for this is salary or bonus sacrifice and it is all perfectly legal, provided you do it correctly. If you pay basic rate tax, the result could be an increase of nearly 34% in the amount being paid into your pension. If you are a higher rate taxpayer, the uplift is nearly 18%.

You should note that this reduction in your salary would not have the same effect as asking your employer to make the contributions on your behalf. Your cash salary will be reduced and replaced with the pension benefit.

Before taking this out you should consider the effect this may have on:

- your ability to borrow money, for example for a mortgage;
- your entitlement to redundancy payments or other benefits such as statutory maternity pay, working tax credit, universal credit or child tax credit;
- any life insurance or income protection where the amount paid is linked to your salary.

INVESTMENT DECISIONS

Unless you only have defined benefit pension arrangements, your pension will require you to make and regularly review investment choices.

Default funds

All auto-enrolment pension arrangements and some other pension plans offer 'default' funds or investment strategies, designed to spare you the task of making investment choices. The simplicity may appeal to new investors, who aren't ready to make such investment decisions.

Research has shown that as many as 90% of newly auto-enrolled savers opt for their provider's default investment solution. If you do the same, remember:

- You are still making an investment choice, which is to follow the decisions made by the manager of the default fund or strategy.
- By definition, the default option is not personalised to your particular circumstances. For example, it takes no account of your other investments.
- There is no such thing as a standard default fund or strategy: a 2019 survey found one large pension provider holding 85% of its default fund in shares, while a competitor had just 35%.

The tailored approach

As an alternative to the default 'choice' you can actively take investment decisions designed to match your retirement goals. Many people who adopt this route rely upon their financial adviser either to make fund recommendations, manage the whole process or appoint a specialist external investment manager. You always have the option of DIY management, but in practice this requires time and expertise to avoid serious mistakes.

A major advantage of the tailored approach is that it allows your pension investments to be integrated into your overall investment portfolio. Otherwise you could find yourself, for example, selling Japanese funds from your portfolio while your default investment manager buys into Japan.

The more refined the tailored approach, the more likely it is that a pension plan should be a SIPP. The key difference compared to other defined contribution arrangements is the range of investments available under a SIPP, which vary among providers. Insurance companies typically offer a relatively limited range that will suit most investors, while specialist providers may offer the full range. Investment options include:

- a very wide range of investment funds;
- direct investment in stocks and shares;
- cash deposits;
- commercial property.

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Planning point

You can take a more tailored approach to integrate your pension investments with your portfolio, but without advice this can be risky and time-consuming.

THE NEED FOR REGULAR REVIEWS

If you were to wait for a time when pension rules remain constant, your retirement date would be likely to arrive first. Governments of all hues have regularly revised the tax and other rules surrounding pensions. Often the motivation has been to save money, either by reducing the tax relief cost (estimated at £39.9 billion in 2019/20) or by cutting expenditure on the state pension.

Government changes to pension taxation have meant that, for some people, there is no longer any financial sense in making pension contributions, a reminder of how important reviews can be. For others, reforms have transformed pensions into a key estate planning tool.

Aside from government interventions, regular reviews are also necessary for other reasons:

- Your circumstances could change. For instance, you may want to alter your retirement date, use an inherited lump sum to make a one-off contribution or move to a new employer offering a different pension arrangement.
- If you have a defined contribution plan, the underlying investments will need to be reviewed in the light of market conditions and any changes in your circumstances. Usually it is best to do this as part of an overall portfolio review.
- As you approach retirement your pensions will usually need to be recast as plans to provide income rather than build up wealth. This could mean a different investment strategy and/or in some cases a switch of pension provider.

Planning point

Given the frequency of government reforms to pensions, plus your own changing circumstances, regular reviews should be built into your financial planning.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice.

The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investment in a registered pension fund is subject to many restrictions on access and on how the funds can be used.

HOW WE CAN HELP

Retirement planning is complicated and has been made even more so by constant changes to the rules. We make it our business to stay up to date with the latest developments, and to help clients take full advantage of the available tax breaks. In particular, we can:

- Assess your financial priorities and choose suitable ways of saving for retirement.
- Integrate any auto-enrolment pension provision from your employer with your own private provision.
- Maximise pension contributions, using carry forward where appropriate.
- Advise whether salary sacrifice could increase the amount invested in your pension, at no extra cost to you or your employer.
- Consider the appropriateness of a SIPP, and the right investment strategy.
- Deal with pension arrangements from previous employments.
- Manage the move from saving to withdrawing from your pension.
- Keep you informed on how any new government legislation could affect your retirement planning.

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