SOVEREIGN

WHAT IS A PENSION?

OVERVIEW OF PENSIONS

Most people associate the term pension with the States Pension, which is the State run pension funded by Social Security contributions paid during an individual's working life.

Historically it was typical that people relied upon State or Government funded pensions with very little else to provide them with an income in their retirement, but in many countries worldwide that model has changed due to increasing pressure and burden on State or Government funded arrangements, primarily due to people living longer.

There are three main "pillars" in terms of pension types:

- **Pillar 1** = State or Government funded pension to provide a basic income.
- **Pillar 2** = Funded occupational/workplace pension plans that accept contributions from employers and employees.
- **Pillar 3** = Private arrangements, including individual personal pension plans.

WHAT IS A DEFINED CONTRIBUTION PENSION?

A defined contribution pension is a type of pension that doesn't offer a guaranteed level of income in retirement, but rather the amount an individual receives is based on the total value of their pension pot.

The amount that an individual will have in their pension pot will be based on the total contributions they and/or their employer has paid in, plus any investment gains or losses and minus any fees paid.

The amount an individual can receive will typically be determined by an actuarial calculation taking into account the overall value of their pension pot, their age and seeking to ensure they are provided with an income for life.

WHAT IS A PENSION?

A pension is a way of saving money for retirement.

There are different types of pension, but often they will offer tax incentives to encourage people to save.

WHAT IS THE PENSION POT?

The term 'pension pot' refers to the actual amount of money held on behalf of an individual, i.e., their pot.

The amount that an individual and/or their employer contributes into a pension, plus any investment gains or losses, minus any fees, will be ring fenced for that individual and will be their total pot value.

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WHAT ARE THE 3 MAIN TYPES OF PENSIONS?

What is a state pension?

State or Government funded pensions are arrangements that are paid to residents of a certain country in return for social security contributions paid during their working life.

In most countries pressure on funding of State pensions due to increasing life expectancies is resulting in increasing state retirement ages and lower income amounts in real terms.

The purpose of a State pension is to provide a basic level of income to support someone in their retirement.

What is a workplace pension?

Workplace pensions are arrangements setup by an employer for the benefit of their employees.

Typically a workplace pension will allow for contributions to be paid by both the employer and the employee, via the employer's payroll. The employee will generally receive tax-relief on contributions paid into this type of arrangement, subject to any relevant limits.

The adoption of workplace pensions is increasing significantly across the world, with mandatory auto-enrolment regimes being introduced in various countries which is making it a legal obligation for employers to provide access to a suitable pension arrangement and to automatically enrol their employees into it.

What is a personal pension?

A personal pension is a pension arrangement voluntarily set up and funded by an individual, to allow them to make additional savings for their retirement.

The individual will generally receive tax-relief on contributions paid into this type of arrangement, subject to any relevant limits.

EMPLOYER-RELATED PENSIONS

What is a final salary pension?

A final salary pension is a type of defined benefit pension offered by employers that provides individuals with a guaranteed income in retirement, with the amount being linked to their final salary earnings at the point they retired.

These arrangements were commonplace many years ago, however due to the funding requirements for employers to meet a guaranteed income until the day someone dies and with average life expectancies increasing significantly, these became unaffordable for most businesses.

In most cases upon the death of the member, their spouse may be entitled to a reduced amount on an ongoing basis. For example 50% of what the member previously received.

What is a defined benefit pension?

A defined benefit pension is a type of pension offered by employers that provides individuals with a guaranteed level of income in retirement.

The amount that an individual receives may be based on their length of service, career average earnings or final salary earnings.

These arrangements were commonplace many years ago, however due to the funding requirements for employers to meet a guaranteed income until the day someone dies and with average life expectancies increasing significantly, these became unaffordable for most businesses.

In most cases upon the death of the member, their spouse may be entitled to a reduced amount on an ongoing basis. For example 50% of what the member previously received.

SPECIFIC PENSION MECHANISMS

What is a drawdown pension?

A drawdown pension is a type of pension that allows individuals to receive a regular income paid from the pension, calculated based on actuarial rates or advice to ensure they are provided with an income for life.

Some pension arrangements are set up to provide accumulation only, meaning that at the point an individual reaches retirement they are required to transfer into an alternative arrangement. A drawdown pension will allow income to be paid directly from the scheme at the point an individual reaches retirement.

What is a deferred pension?

A deferred pension is a pension that an individual chooses to take later than they are entitled to, for example if they continue working and do not need the income.