My Personal Circumstances:

Security and Risk

For Preserved Members of
Money Purchase Schemes

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Security and Risk – Preserved Members

This Factsheet briefly discusses some of the main issues relating to security and risk and how these can have an effect upon your retirement planning.

It is written for people who are **preserved members** of an **employer sponsored money purchase pension scheme** (‘money purchase’ is sometimes called ‘defined contribution’).

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Introduction

There is a degree of risk in all aspects of life and everything we do, and this is especially true of your pension benefits. There is no such thing as ‘no risk’ and no such thing as an absolute guarantee.

For money purchase schemes there are extra risks associated with the investments which underpin the benefits. This will affect what you will get when you retire and means that the timing of events which lead to a benefit being paid is critical to what is paid, to you and your dependants.

It is essential that you understand the main issues associated with security and risk as they will affect YOU and your dependants, and your retirement planning. This Factsheet is designed to make you think about the various issues associated with security and risk, WHY these occur and HOW these could have a bearing upon your pension benefits. Some of the points are more obvious than others, but they are all important.

If you are intending to get advice from a Financial Adviser these are some of the things you should be discussing with them.

Security of your employment (risk of tenure)

You will be a preserved member for one of several reasons, the likely ones being:

- You ceased to be employed by your employer.
- You chose to opt out of active membership for your own personal reasons.
- You continue to be working but your employer closed your pension scheme so that you cannot contribute future monies to that particular arrangement (even though you may have been offered an alternative pension arrangement). This is often called a ‘closed scheme’.

The suggestion of a ‘job for life’ seems to be an unrealistic ideal. Businesses are constantly changing and most employment sectors, from manufacturing to finance, retail to transport have suffered large-scale redundancies. Even with the same employer, change is now the norm and unless we as individuals are able to respond to these changes, we can be affected adversely by the change.

Job security has an important impact upon your retirement provision as your current income may allow you to build upon the foundations of your preserved pension to fulfil your retirement financial planning objectives.

Your ability to be able to invest for a decent standard of living in retirement may depend upon a stable income stream. Money purchase schemes provide benefits based upon the amount of money that is in YOUR own pension ‘pot’ when benefits are due to be paid. This means the longer you work and the longer you and your employer contributed the more chance you have to achieve a worthwhile pension.

The amount that will be in your ‘pot’ when benefits arise will depend upon the payments made into your ‘pot’. The benefits you or your dependents will get from a money purchase scheme will come entirely from your ‘pot’. The bigger the better!

Security of your employer (covenant risk)

If your former employer continues to pay all or part of the cost of running your former scheme this will ensure that your ‘pot’ achieves its maximum value. If it ceases to do so the full cost may fall upon your investment and limit your final pension.

Increasing life expectancy (mortality risk)

We're living longer – and that's a fact. But it's not all good news. With longer life expectancy come greater costs. The cost of buying a pension usually depends upon annuity rates. These rates are what an insurance company needs to cover the commitment to pay the pension for your remaining lifetime.

A key element of the insurance cost is how long an insurer expects to have to pay the pension payments to you. Pensioners, as a whole, are living longer, so insurers need more money to pay to those pensions. This means you now need a bigger 'pot' at retirement to provide a similar pension than a 'pot' would have secured 10 years ago. Adding a provision to pay a dependant's pension on death after retirement, adds to the period of time a pension is potentially payable and so reduces the pension you will get.

The longer this aging trend for pensioners continues, the more expensive pensions will become in terms of providing the actual pension income at retirement. The implications of living longer are something employers, schemes, members, government and society must all face up to.

Greater life expectancy will also mean an increase in **State Pension Age**, which has historically been 65 for males and 60 for females. From 6th April 2010 over a 10-year period, State Pension Age for women will gradually increase to age 65. Women born after 5th April 1955 now have a State Pension Age of 65.

Find out how long your Life Expectancy is.

Legislation, Regulation and Governments (political risk)

Current and future burdensome legislation and regulation has meant that more employees like you must depend upon money purchase arrangements to provide the core of their pension planning.

State Pensions will also increase for many in the future but for others, particularly higher earners, they will reduce in real terms.

The use of Pension Credits to top up state benefits can make small pensions ineffective. The more this method is used by the Government to relieve poverty in old age the less attractive it will continue to be to make small pension contributions.

Under the Pensions Act 2007, the State Pension Age for men and women is to rise gradually over a period of 22 years between 2024 and 2046:

- The first rise from 65 to 66 will be phased in between 2024 and 2026,
- The second rise from 66 to 67 will be phased in between 2034 and 2036, and
- The third rise from 67 to 68 will be phased in between 2044 and 2046

From 6th April 2046 both men and women will have a State Pension Age of 68.

The creation of **The Pensions Regulator** provides some comfort for money purchase schemes with more control over schemes and the employer contribution.

Political change also includes the risk associated with a change in Government, as political parties have different agendas and priorities. Pensions and security in retirement continue to be a political 'hot potato'.

Inflation and interest rates (economic risk)

Inflation and interest rates play an important role and therefore there is a risk element involved with them both. Low inflation and low interest rates have reduced the amount of the pensions payable to members for a given amount of retirement pension fund. Unless the increased cost of buying a pension is offset by the size of the retirement fund being bigger, pensions paid ***will*** be lower.

High inflation that leads to high interest rates will tend to have the opposite effect. High interest rates reduce the cost of members' pensions.

To protect the value of pensions the key element in the cost is the real rates of return being paid on Government Index Linked investments. Currently these are still low (around 1.5% p.a.) so the cost of an inflation-protected pension is high.

Market and exchange rates (investment risk)

The security of your pension benefits will rely on market conditions and the investments underpinning your pension pot. Pension benefits are paid from the employee and employer contributions and from the investment returns on these assets.

The higher the return on the assets, the better the benefits will be for members. The value of assets will go up and down dependent upon the nature of those investments and with the confidence that investors have in the world investment markets. Consequently, your security is influenced by market sentiment and also exchange rates if some of your scheme pot is invested in assets which are traded outside the United Kingdom.

In terms of your own pension 'pot', the skill of the investment manager in dealing with the state of the economy and markets is important. A weak economy or stock market can lead to reduced investment returns. A strong economy and buoyant investment returns can significantly increase you pension 'pot'.

A skilled investment manager can add value in any situation but can only buck the market trends by taking bigger risks. It is vitally important that you understand the nature of your investments and the risks associated with those investments. If you have any concerns, you should seek financial advice.

Personal circumstances, age, health, income, assets (personal risk)

Your personal circumstances play an important part in your retirement planning:

Age: Your age is important. The closer you are to retirement, the less time you have to make further investments in another arrangement and the more critical timing will be in aligning your pension investments to fit your future pension plans. It could be that you might want a more secure investment with less exposure to risk as you approach retirement. Conversely, the younger you are, the more speculative you are likely to be, and so you may not be as concerned about taking a risk.

Health: If you are in good health, you will be able to work longer and therefore have the opportunity to contribute more to your pension plans than if you are in poor health. The risk of deteriorating health is therefore very important.

Poor health: – with a lower future life expectancy - might give you a better pension if the insurer providing your pension takes this into account in working out the cost of your pension. Some pension arrangements are set up specifically with that in mind and the resulting pension is sometimes called an impaired life annuity.

Income and assets: The greater your current income and assets, the more options you will have to plan for a comfortable retirement. The lower your current income and assets, the more difficult it will be for you to invest to achieve the standard of living you would like for your retirement. In this case, the State Pension and Pension Credits might be the primary source of pension for you and your dependents. Dependants: If you have dependants (e.g. spouse, civil partner, children) your spendable income will probably be lower than a single person without dependants on the same income. This may affect your ability to fund for an adequate retirement.

Inertia: it is so easy to leave pension planning until it is too late: Unless you are low paid (earning well below National Average Earnings), the onus is upon YOU to take responsibility for your pension provision. This means you should make sure you have adequate pension provision and that you and your advisers regularly review its performance.

These factors are important. You need to engage in the concept of active pension planning. Before you take any action in relation to your benefits, you should take financial advice, as the benefits payable by your scheme can be very valuable. Your response to the advice will depend greatly on your attitude to risk, discussed in the following section.

Your attitude to risk (financial risk)

In dealing with any of your financial arrangements, you should consider your attitude to security, risk and reward. Each of your investments should be classed as a separate item (e.g. housing, pensions, and investments).

If you seek financial advice, you should be asked what your attitude is to security, risk and reward. Pension and Financial Advisers will usually have standard forms to gather information about you, so that they may advise you according to your personal circumstances.

It is important therefore, that you make certain when discussing your attitude to risk, that you are specific about what this relates to. Your attitude to risk will probably differ when focusing upon your pension provision compared to your risk profile when investing in different assets (e.g. stocks and shares, property). Make sure that the attitude to risk used in any advice process, relates to your retirement provision and planning.

You may be asked to select your 'risk profile' from a list. An example would be a scale of 1 to 5, 1 to 10 etc. or choosing a sentence such as "My attitude to risk is conservative" or "My attitude to risk is balanced/medium". When selecting a risk profile from a scale of 1 to 10 for example, make sure you know which is the low-risk end of the scale – obvious maybe – but important nevertheless.

Be sure to select the one that best fits you – not one you think will impress the adviser. If what you are presented with does not adequately reflect YOU – discuss this with the adviser – and make sure this is carefully noted in his records.

Your attitude to risk will probably change the closer you get to retirement age as you seek to protect the benefits you have built up.

Re-assess your risk profile from time to time. You maintain your house and car. Take time to maintain your retirement provision.

There is no such thing as 'no risk' – whatever pension benefit you have there will be a degree of risk attached to it. Regular careful management of those benefits will ensure that those risks are minimised.

Summary and Key Points

When making enquiries about your **pension benefit** it is very important that you make it clear that you are a **preserved member**.

- Risk comes in many forms – you should consider what risks YOU face in terms of your retirement provision.
- Is your pension scheme secure?
- Do you keep abreast of changes – legislation and regulation may affect your pension benefits?
- Are you affected by the increase in State Pension Age?
- Have you considered how your personal circumstances may affect your retirement provision?
- Keep informed. Your scheme may modify benefits and Rules. Legislation may change. Your circumstances may alter.

This is not an authoritative document. Seek professional advice from an appropriately experienced and qualified adviser.

Security and risk Pre v1.3 MP
Last reviewed 22/01/2009

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