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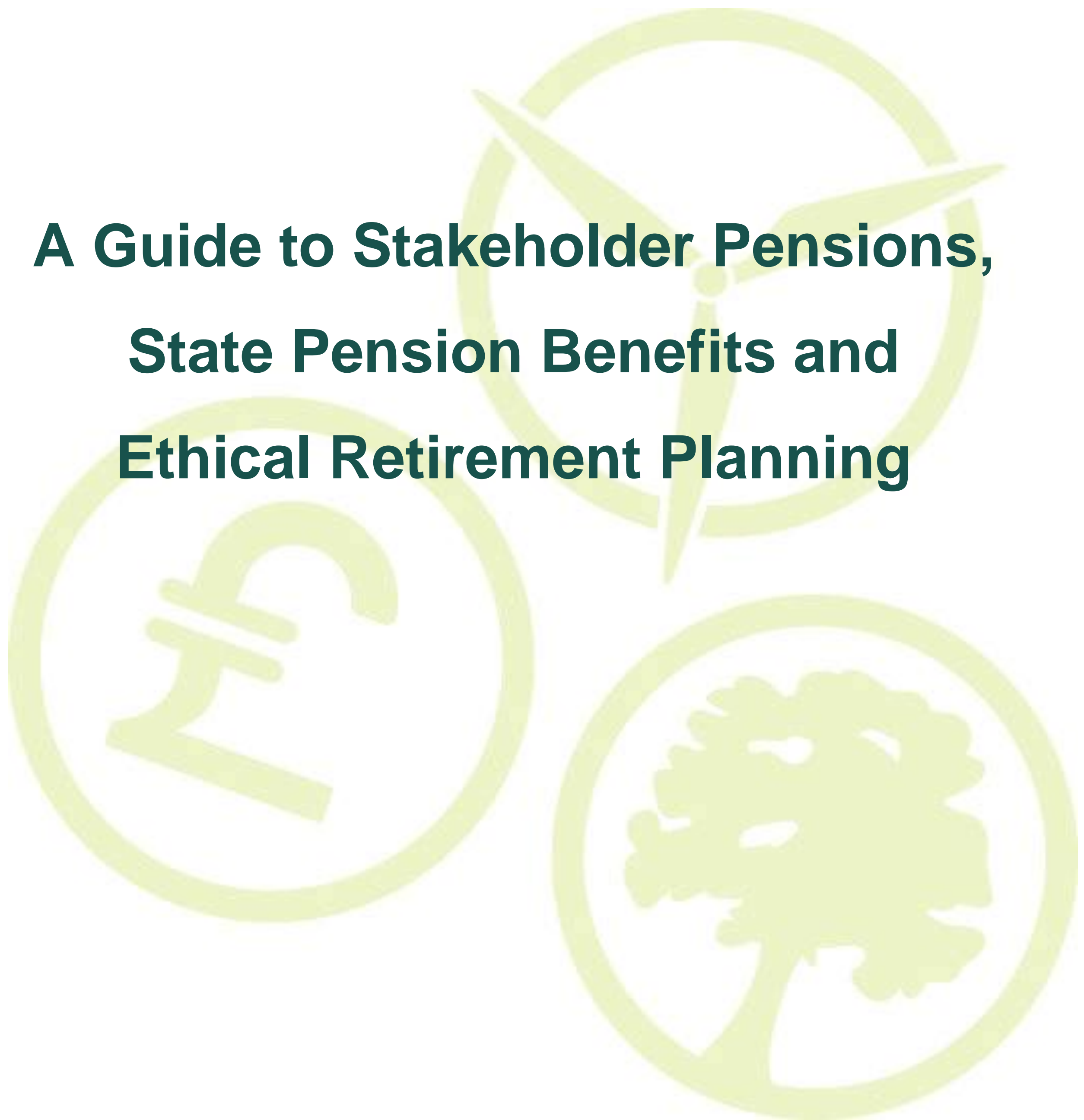
ETHICAL FINANCIAL MANAGEMENT



A Guide to Stakeholder Pensions, State Pension Benefits and Ethical Retirement Planning

Introduction

On 6 April 2001, the then government introduced a new type of pension plan for all those with no access to an employer's pension scheme. The plan is known as a **stakeholder** pension.

This plan has fundamentally changed the way in which individuals plan for their retirement. At the heart of the plan is a charging structure set by government. Instead of insurance and investment companies charging what they want for their personal pensions, if a company is to offer a stakeholder plan, they must conform to the charges and flexibility rules contained within the legislation.

At Ethical Investors, we wholeheartedly support the stakeholder pension plan, and are keen to advise individuals as well as groups of employees to establish their own ethical stakeholder plan. Although the government feels that pensions are so simple that no advice is needed (see later), the reality is that without advice, one cannot be sure that one's most valuable long-term asset is invested to meet one's social and environmental concerns, as well as maximise the financial returns.

What is a Stakeholder Pension?

A stakeholder pension is not a State Pension - it's a private pension into which you pay your own contributions. Stakeholder pensions are available to people in employment, fixed contract workers, the self-employed and people who may not be working but can afford to contribute. For example, those who care for relatives, are starting a family, or simply taking a break from work can also contribute to a stakeholder pension, without having to have any earnings. Whether you pay tax or not, tax relief is still given to everyone paying into a stakeholder, subject to certain limits discussed below.

As with most other pension plans, you can pay in contributions regularly to build up your own pension fund and/or can make lump sum contributions. When you retire, or decide to draw benefits, your stakeholder fund is used to buy a pension, usually in the form of an annuity (although increasingly flexible options are becoming available). You do not have to buy the annuity from the same provider with whom you hold your stakeholder pension fund. Your pension income in retirement will depend on the size of your fund and the annuity rates available at the time you take your pension. You cannot withdraw any part of your fund before you retire, but you can move the fund to another provider and convert part of it to a tax-free lump sum when you take your pension.

The manager of your stakeholder pension fund can invest your contributions and the tax relief in assets such as shares, bonds, cash, gilts and property. This is why it's important to start investing early if you can - the longer your contributions are invested the greater opportunity they have to grow.

Stakeholder Standards

Pensions and investment companies will provide stakeholder pensions and they must make sure that these pensions meet strict standards laid down by the government. The standards include:

Charges: there is a limit on the management costs which stakeholder pension providers can charge - this is **1.5%** of the value of your fund each year. The fund manager takes these charges from your fund. There can be no other setting up or exit costs, nor any other charges associated with you increasing, decreasing or stopping your payments or switching funds at any time.

Flexibility: Stakeholder pension plans are flexible and you can make contributions regularly or occasionally. It is usually best to discipline oneself to make regular monthly contributions but you can change the amount you pay in if you need to. All stakeholder pension plans will accept contributions of as little as £20 gross (£16 net). You can stop paying in for a while if you need to, without having to pay any penalty. If you are employed and your employer provides a stakeholder pension they will, if you wish, deduct your contributions direct from your pay.

Information: Your stakeholder pension plan provider must give you regular information about the plan you have joined. This information will include an annual statement to let you know how much you have paid in and details of how your fund is doing. It may also include a forecast of your pension on retirement.

Stakeholder Pension Contributions

Income tax relief - The Inland Revenue will add tax rebates to the contributions you make to your stakeholder pension plan. Under present tax arrangements, for each £1 you pay in to your stakeholder pension fund, the Government will add 25p to your fund.

Example: *If you pay in £100 a month, the income tax rebate would increase the total contribution to your stakeholder pension fund to £125.00. If you want to add £100 in total, you only need pay in £80, as the government will add £20 to the plan (as basic rate tax is 20%)*

If you pay income tax at the higher rate (40%) you will be able to claim back extra tax rebates from the Inland Revenue at the end of the tax year, via your tax return.

The tax advantages of pensions are therefore extremely favourable. You receive tax relief on the contribution you make, the investment fund grows virtually free of tax and when you come to retirement you can choose to receive 25% of the fund as a tax free cash lump sum.

With effect from 6 April 2006, the old limits/caps on the amount you can save were removed. The new limits are very simple, albeit quite theoretical for most individuals: the maximum that any individual can pay into their pension arrangements, and still receive tax relief, is now 100% of gross earned income subject to a maximum payment of £50,000. In reality of course, the amount that you save in your pension will be capped by what you can afford to save, but at least you are now free to choose what you want to pay towards your retirement. Your total retirement savings are also not allowed to go over £1.6 million pounds, which clearly will not affect too many people.

For those with no income at all, it is still possible to invest up to £3600 per annum into a stakeholder pension and still obtain tax relief. Payments are made net of basic rate tax.

The State Pensions

Won't the State Pension be enough for me to retire on?

The government reviews the level of the basic State Pension every year and usually increases it in line with the increase in retail prices. From 2012 it will be increased in-line with average earnings. The full basic State Pension at age 65 is currently £102.15 a week for one person and £163.35 for a couple. It is highly unlikely that this will be enough to maintain a decent lifestyle for the majority of people, compared to their position whilst they were working. The retirement age for men is still 65, and women born after 6 April 1950 cannot draw their State Pension until age 65, instead of age 60.

Everyone retiring after 6 April 2010 will only need 30 qualifying years for the full basic State Pension. National insurance contributions must be made over a period in excess of 10 years (over the working life of the individual) or no state pension benefits of any sort will be paid.

The Pensions Credit

Additional benefits are available that increase the weekly income for those receiving the basic State Pension - for a detailed explanation of this benefit please refer to our separate supplement.

Finding Information on your State Pensions

You can get a forecast of your Basic State pension, State Earnings Related Pension (SERPS) and the Second State Pension (S2P) from The Pensions Service by filling out a form called **BR19,** or online at www.thepensionservice.gov.uk. Changes to state pension ages are explained on the www.direct.gov.uk website. Changes to the retirement age for women are explained on form EQP1a, which can be requested from HMRC on 0845 731 3233

The Additional State Pension

The additional State Pension, or State Second Pension (S2P), is related to earnings from employment and, as the name suggests, provides additional income from the government in retirement. It was previously called the State Earnings Related Pension Scheme (SERPS) which started in April 1978 for those in employment. The self-employed are not eligible for SERPS or S2P as they do not pay the relevant National Insurance Contributions.

SERPS was replaced by the State Second Pension from 6th April 2002. It is still based on a combination of earnings and National Insurance Contributions, but aims to give a more generous additional State Pension to low and moderate earners, and certain carers and people with a long-term illness or disability. Employees should initially get the same level of benefit as currently available under SERPS.

It is also proposed that in the future the State Second Pension will become a simple, flat-rate weekly top-up to the basic State Pension.

Any SERPS entitlement you have is protected, so if you built up an entitlement to additional State Pension before April 2002 you will keep it, whether or not you've already reached State Pension age.

Contracting Out

Before reading the notes below, please be aware that the subject of contracting out is now somewhat complicated and there are very few hard and fast rules. In addition contracting out will no longer be allowed past 2012.

What is Contracting-Out?

As discussed above, the State Pension Scheme is made up of both a basic pension and an earnings related portion, supported by National Insurance Contributions. Everyone must have the basic element paid by the state but can "contract-out" of the earnings related element. This means, each year an employee can ask the Department of Work and Pensions to pay a rebate of their National Insurance into their own pension plan. The hope is that the pension available at State Retirement age saved via the personal pension plan, will be greater than the S2P pension for that year.

The accumulated fund at retirement from the process of contracting-out is called "protected rights". There are certain rules that accompany the money designated as protected rights – for example; whilst 25% of the fund can be taken as tax-free cash (as with the normal pension money), the remainder must buy a pension based on unisex rates and must allow for a spouses pension if the policyholder is married.

Is it in my best interest?

Whilst the state pension will undoubtedly change in the years to come, it should be remembered that the S2P scheme is by and large guaranteed, whereas contracting out through a personal pension plan involves risk. The return is dependent on stock market performance, meaning the benefits received at pension age under the personal pension could be lower than the S2P pension.

The government has made the contracted out decision extremely complicated and it is difficult, if not impossible, for pension companies and financial advisers to give a firm recommendation. It is, however, likely that anyone earning below £10,000 will be better off by staying in S2P.

Once you make your decision to contract out, you can elect to contract back in at a later date and from that point accumulate S2P entitlement with the government again. The money already transferred to the pension company remains invested until you retire, at which time you'll get a payment from the government and a payment from the pension company.

Giving advice

The complexities of S2P and the mix of rebates and top-ups make it difficult to give clear guidance to individuals about whether or not they should contract out. If you trust the government (whatever party) to provide you with the additional pension benefits when you retire, and you prefer certainty, then you should probably decide to stay with S2P.

If, on the other hand, you prefer to take the money that you are paying towards S2P now and have it invested in your own name, then you should choose to contract out. The assessment of the attractiveness of contracting out is therefore not an exact science as it depends on various factors including, in particular, the member's attitude to investment risk.

Stakeholder Pension FAQs

Should I take out a stakeholder pension?

You need to make your own judgement on whether the retirement benefits provided by the state would be enough for you to live on (and enjoy life) when you retire.

Whilst the state does provide a pension for all, and a number of other means-tested benefits on retirement, it is not likely that these will be enough to provide a similar standard of living to that you are currently enjoying.

Although contributing to a pension scheme is an important consideration for the long-term, contributions should not be made if they will prevent you meeting other financial commitments - including mortgage or rent, hire purchase, credit card debts (and possibly life assurance depending on your circumstances).

You should be aware that there are other ways of saving for the longer-term, which do not necessarily need to be within a pension plan. For example, the ISA (Individual savings Account) offers flexibility and tax efficiency outside of the pension rules. We can advise on alternative savings plans, upon request.

What else should I check?

If you are employed:

- Does your employer provide a pension plan?
- If yes, check you are a member of this plan. If not you should be able to join after a brief period of employment.
- Employers' pension plans are always worth checking first as they often have extra benefits, such as added contributions from your employer, free life assurance or nil charges.

It is a legal requirement that your employer provides access to a stakeholder pension scheme, (but they do not have to contribute to it on your behalf or offer an ethical option). Note, that there are certain rules, for example there must be more than 5 employees. If your employer does not offer a pension scheme, you can ask if they intend to start one - and if they intend to contribute to it. You may also wish to ascertain if they intend to have an ethical option. If they are prepared to contribute then it may be better to join the scheme rather than selecting one of our stakeholder plans.

If you are self-employed:

- Look into your existing pension arrangements, if any, for example getting a valuation and an illustration of the pension you may receive.
- Check how much you are you currently paying into the plan. It may be appropriate to set up a new stakeholder pension in addition and benefit from tax rebates on the contributions you pay in. Irrespective of the rate of tax you pay, you can make your payments net of basic rate tax (20%).

Existing pension arrangements (and finding lost plans)

- Do you have any other existing pension plan benefits, from personal plans or previous employers? Check the pension plans you have contributed to in the past but no longer pay into today.

- It is well worth tracing pension that may exist from previous employers. If you have lost track of previous pension arrangements, the Pension Tracing Service may be able to help. All you need is the name of your previous employer or the pension company. Contact 0845 600 2537 or see www.thepensionservice.gov.uk/atoz/atozdetailed/pensiontracing.asp
- Ask for an illustration/projection of the retirement income you might get from an old pension plan.
- If you are not in an ethical plan, check if your provider has launched an ethical fund since taking out the plan. It may be possible to switch funds internally free of charge. If no ethical option is offered under your existing arrangement, we can arrange to transfer your pensions to an ethical stakeholder plan, usually at NO cost. However, we must first check that your existing provider does not apply a penalty on transfer.
- You may have a number of existing plans, from a variety of sources - Ethical Investors can also advise on consolidating such plans, upon request.

Can I pay into someone else's pension?

The new tax regime allows individuals to contribute up to £3,600 a year to a personal or stakeholder pension regardless of their earnings, including into someone else's plan. This creates opportunities for relatives, such as parents, grandparents, godparents or aunts and uncles, to contribute to younger family member's pension arrangements. Alternatively, a working spouse could contribute for a non-working spouse.

Minors - There are a number of rules regarding how a pension contract for someone under 18 is set up, and the payments made, as contracts with a minor are not legally enforceable. Hence, the Inland Revenue requires that the pension contract is taken out by their legal guardian, and that they are responsible for the contract.

Once the contract is set-up with the legal guardian, usually the parents, then other family members can make contributions to the plan. The tax relief is that which applies to the member, not the contributor (for example higher rate tax relief would only be obtainable by the minor if the minor was paying higher rate tax, an unlikely situation).

You should be aware that there may be inheritance tax implications where a person, such as a grandparent, makes a contribution to another person's pension. There are exemptions under the normal inheritance tax rules, for example there is an annual gift exemption of £3,000.

If you would like to pay into a pension plan on someone else's behalf, we will be delighted to guide you through the options and implications, including inheritance tax and details of setting up the contract.

Do I need advice?

The Government and the Financial Services Authority (FSA) feel that the low charges leave little room for paying for advice. The FSA has introduced ***Decision Trees***, which are essentially flow charts that will act as a guide to retirement planning under the stakeholder regime. These flow charts are available from the FSA's website, www.fsa.gov.uk.

Once the desired retirement age is reached an annuity may be purchased, but does not have to be bought from the company providing the pension investment funds – this is called the Open Market Option and to get the best available annuity rate an independent adviser could help.

So, you can go it alone, do your research on fund performance and company stability, as well as research the ethical criteria to come up with your chosen plan. Alternatively, for the same ongoing charge, or less, you can receive advice from Ethical Investors. The choice is yours.

Investment Performance & Ethical Criteria

Ethical Investors has access to the best of the ethical stakeholder pension plans currently available. Indeed, some of the plans we are able to offer to our clients are not available direct from companies and some are not available through other advisers. As the leading ethical stakeholder adviser in the UK, our clients benefit from the broadest range of funds and the best financial advice.

As the charges on different stakeholder plans are capped at a maximum of 1.5%, for most investors the two main factors are financial performance and ethical criteria. Ethical Investors monitors both these areas, as described below: -

Performance - we meet with the investment managers on a regular basis, to discuss their performance compared to the overall market, as well as other ethical fund managers. If it were felt to be in the best interests of our clients, we would recommend that their funds be switched to another manager. Therefore, our clients have the peace of mind that comes from knowing that we are constantly monitoring the performance of their pension fund and that it is always in the best place for long-term growth.

Ethical Criteria - we believe our service to clients in this area is unique amongst UK financial advisers. Instead of relying on the general information provided by pension companies, we are able to undertake a far more critical analysis of the ethics of each of the funds we recommend to our clients. Ethical Investors has access to three full-time ethical researchers, something that no other adviser in the UK can claim. These researchers can verify the investments made by the pension companies, to ensure that they are adhering to both the letter and the spirit of their published ethical criteria.

Behind the scenes, we are in regular dialogue with the pension fund managers, passing on the views of clients and discussing individual investment selections. Therefore, our clients can be assured that the funds we recommend really do meet their ethical needs, not just at the point they start their stakeholder pension, but right through until retirement.

Via our regular Newsletter, you will be kept up to date with the wider investment market, pension legislation changes and developments within the ethical investment area. We encourage our clients to enter into dialogue with us over developing ethical issues, in order that this can be fed back to the investment managers. The managers welcome this feedback from investors, as it does help to shape the ongoing development of their ethical funds.

The ethical stakeholder pension specialists

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Regulated by the FSA

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