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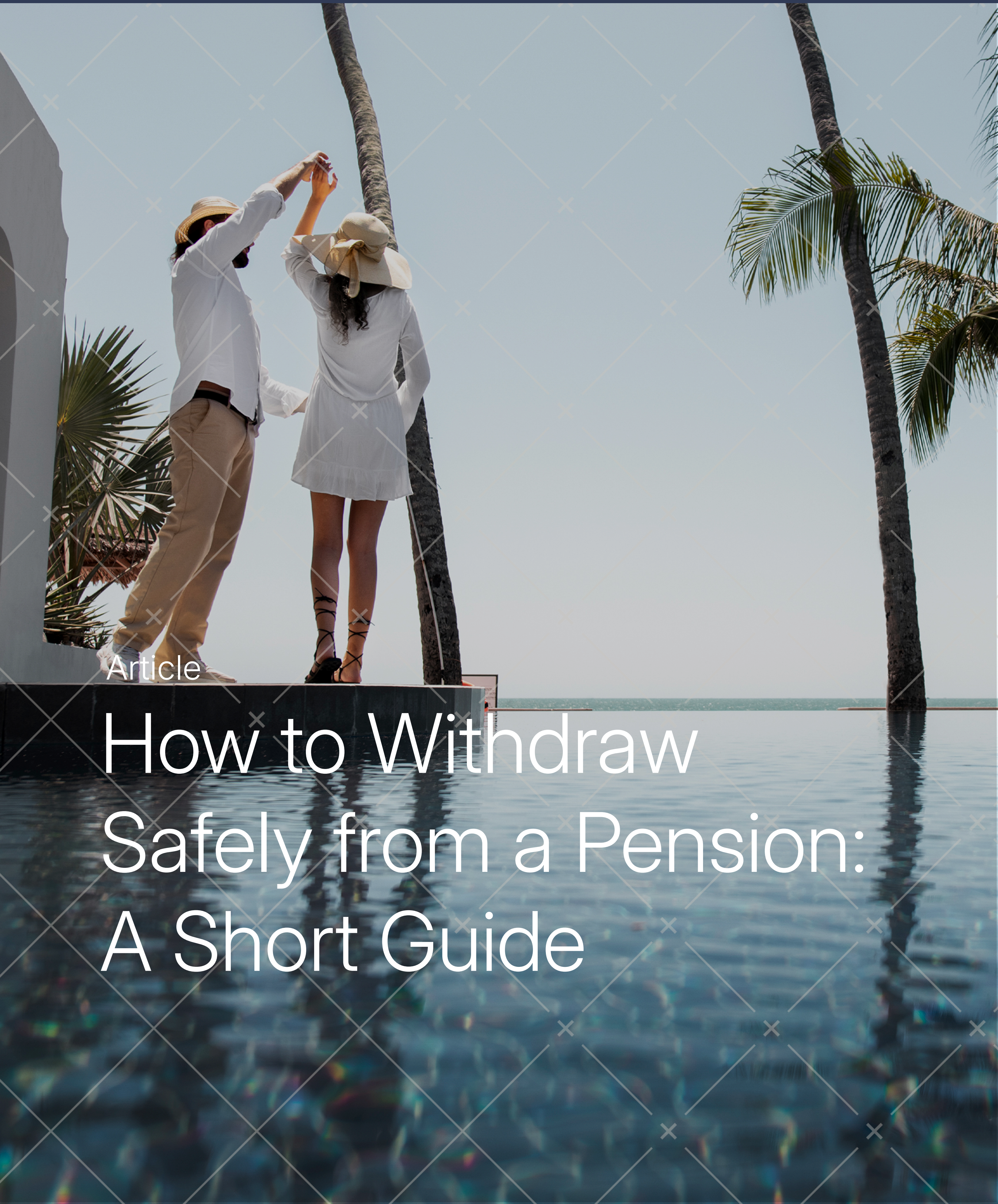

Article

How to Withdraw Safely from a Pension: A Short Guide

Pension freedoms have changed the conversation around retirement planning. People have more choice and control over their pension funds than ever.

But this also means they have more decisions to make and greater responsibility for their own retirement security.

As the cost of living increases and people are living longer, how can you make sure that you don't run out of money?

How Retirement has Changed

When the State Pension was introduced in 1908, it was intended to provide a basic standard of living for people who were too old to work, and only expected to live for a few more years.

Retirees claiming the State Pension today can easily expect to live for another twenty years, and many will still be in good health. Clearly, the State Pension, despite its guarantees and inflation protection, is not enough to provide a comfortable retirement.

Many people are reliant on occupational pension schemes, but generous defined benefit schemes are increasingly rare unless you work in the public sector.

Money purchase schemes and personal pensions are now far more commonplace. The default option was to use your pension pot to buy an annuity, guaranteeing an income for life.

But over time, and with the introduction of pension freedoms, drawdown became the more popular option. This offered greater flexibility over retirement benefits, but without any guarantees.

It was once common to work for the same company until retirement. Workers today are more likely to change jobs over the course of their careers, which can lead to gaps in their pension provision.

However, they are also more likely to retire gradually or to continue working to supplement their pension income.

Your Retirement Income Options

When you retire, you have the following options:

- Use your pension pot to buy an annuity (after any applicable tax-free lump sum is paid to you).
- Opt for a fixed-term annuity, which uses some of your pension pot to provide a guaranteed income for a few years.
- Set up a drawdown plan – see below for more details.
- Leave your pension fund invested and use other sources of income and capital first. As there are tax implications for drawing your pension (and the funds grow tax-free) sometimes it can be more efficient to keep it and use other assets instead.

How does Drawdown Work?

Drawdown works similarly to other investments. Your funds remain invested, and you can make withdrawals as you wish. You can take up to 25% of your pot as a tax-free lump sum (or more if you were a member of certain occupational schemes set up before 2006), and the remainder is designed to provide you with an income. This income is taxed at your personal rate.

Before 2015, drawdown was capped at a rate set by the Government Actuarial Department (GAD). This was based on life expectancy and gilt yields.

This was replaced by flexi-access drawdown (FAD), removing all caps on pension income. Some capped drawdown contracts do still exist, but most providers will allow them to be moved into FAD contracts on request.

When you take drawdown income for the first time, or move from capped drawdown to FAD, this triggers the Money Purchase Annual Allowance (MPAA). This limits future pension contributions to £4,000 per year.

When you die, you can pass on your drawdown pot to your beneficiaries. This will not affect their income tax bill if your death occurs before age 75. Otherwise, beneficiaries will pay tax at their marginal rate on any withdrawals they make.

With drawdown (or any capital that you are using to fund your retirement), there is a risk that you will overspend and run out of money.

You don’t necessarily know the level of investment return you will receive, how much you will spend, or how long you will live.

Additionally, annuities and scheme pensions take into account the fact that some members will not live long enough to claim their full pension.

This means they may provide higher income than if based solely on the life expectancy of a single person. This ‘mortality drag’ is another risk of drawdown.

How to Avoid Running Out of Money

Many factors could lead to you running out of money in retirement. For example:

- Investment returns may be lower than expected. You could even lose money if the market falls.
- The cost of living could rise more than predicted, which means that you need to withdraw more to maintain your standard of living.
- You might have unexpected bills or need to help out a family member.
- You might live longer than the average life expectancy.
- You could simply overspend if you don’t keep track of your budget.

We can’t predict how these factors will affect you, but there are several ways in which you can future-proof your retirement pot:

- Aim for a ‘safe withdrawal rate.’ This is a rule of thumb, which means that you don’t withdraw more than a set percentage of your current fund value in any given year. This will depend on your fund value and investment profile, so it may be different for everyone. Generally, 3-5% of the fund value is typical.
- Construct a cashflow model. This is a more sophisticated method of calculating how much you can withdraw, and it builds in projected income, expenditure, investment returns and inflation. You can even account for ad hoc spending or build different scenarios, e.g. paying care costs.
- Try to underestimate investment returns and overestimate inflation rates. It is better to make conservative assumptions than optimistic ones.
- Invest appropriately. If you take too much risk, your fund may fluctuate excessively and lose money. If you take too little risk, your returns might not keep pace with inflation. It’s a good idea to diversify your investments, as this can help to smooth some of the risk.
- Keep plenty of cash. It’s sensible to keep enough cash to cover your planned spending for up to five years. This is usually enough time for the market to recover from any short-term volatility.
- Aim to clear any debt before you retire.
- Stick to your budget and make sure any ad hoc spending is planned in advance.
- Most importantly, you should review your plan at least once a year. There will be times when you overspend, or when the markets don’t work in your favour. The key is to make small adjustments early on rather than waiting until it is too late.

A financial planner can help you, not only to make sure your funds are invested appropriately, but also to encourage you to plan ahead and make good decisions.

Please don't hesitate to contact a member of the team to find out more about your retirement options.

Please note:
This article is provided for general information only and does not constitute personal financial advice. The content is not intended to recommend any specific investment or pension strategy. Pension rules, tax treatment and allowances depend on individual circumstances and may change in future. The value of pension investments can go down as well as up, and you may not get back the amount you originally invested. Access to pensions is normally from age 55 (rising to 57 in 2028). Making retirement decisions without advice carries risk — we strongly recommend consulting a regulated financial adviser or using the government's free guidance service, Pension Wise, before taking any action. Past performance is not a reliable indicator of future results.

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