Briefing

How much can I withdraw from my drawdown?

RISK | **PENSIONS** | INVESTMENT | INSURANCE

The last in our series of drawdown briefing notes tackles the most common and difficult question: "Just how much income can I withdraw from my pension drawdown?"

There is no simple answer as it depends on many variables. Understanding what these variables are, and how they affect the sustainability of your income withdrawals, is essential.

You will need to keep your drawdown under regular review. You may need to adjust your income withdrawals. Using a financial adviser should bring a robust approach to this.

The impact of the 'Pension Freedoms' on income amounts

Prior to April 2015, the type of pension arrangement that an individual held typically dictated the amount of income they received throughout their retirement.

For example, those in a 'defined benefit' occupational pension scheme received an income amount based on a specific formula. This related to their salary and the number of years of scheme membership.

Individuals purchasing an annuity received an income amount derived from the rate offered by the annuity provider and the chosen 'shape' of the annuity[1].

Those going into income drawdown were also subject to restrictions. For example, those in 'capped' drawdown were – as the name suggests – limited to a maximum income amount per drawdown year.

This was calculated by a formula, based on the individual's age and prevailing gilt yields. It was roughly equivalent to annuity rates.

Even flexible drawdown required the initial securing of an annual guaranteed pension income, before the individual was allowed unfettered access to their remaining drawdown fund. This income was usually comprised of state pension and annuities.

The introduction of Pension Freedoms on 6 April 2015 ('the Freedoms') removed this income discipline. Overnight, individuals aged 55 and over could now withdraw as much or as little of their defined contribution pension fund, as and when they wanted to, without restriction[2].

However, people still need to know how much they can withdraw. Perhaps the requirement for this is even greater, now there are no guidelines.

1. The 'shape' of an annuity is determined by the features that are added to it, from the range of options available from the chosen annuity provider, at the point of purchase. Examples include a guaranteed payment period, a surviving beneficiary's pension and an increase in the amount of (taxable) annuity income every year.
2. Albeit with at least 75% of the withdrawn amount potentially subject to income tax at the individual's marginal rate, which could be better managed with less haste and more effective prior financial planning.

Key factors that influence the income amount

There are three key factors which influence the amount of income that an individual may want to draw from their flexi-access drawdown (FAD) fund:

1. The underlying portfolio and investment performance of their FAD fund
2. How much money the individual needs from their FAD fund
3. How long the income is needed for

Let us consider each of these factors in turn.

1. The underlying portfolio and investment performance of their FAD fund

The growth potential of the fund will be dependent upon the types and proportions of assets held within it. For example, this could include cash, bonds, property and equities – which in turn would depend upon the individual's 'attitude to investment risk' and their 'capacity for loss'[3].

Clearly, the larger the size of the pension fund, the more income can potentially be taken from it, where required (see (2) below). However, the fund value will not remain static once drawdown commences. Indeed, it may be possible for the individual to continue to contribute to the fund, subject to any earnings, albeit with two important caveats:

- Firstly, as soon as taxable income is taken from the fund, the Money Purchase Annual Allowance (MPAA) is triggered. This means that the maximum annual contribution into defined contribution pensions is then limited to £4,000 gross per tax year from all sources – a significant reduction to the 'standard' Annual Allowance of £40,000
- Secondly, 'recycling' tax-free cash as a tax relievable contribution is prohibited by HMRC

2. How much money the individual needs from their FAD fund

Everyone's personal circumstances and objectives are different and determine the amount of income that is required from their FAD fund.

A significant factor underpinning this is what other sources of wealth, income and/or earnings an individual has. For example, other forms of savings may include ISAs and bonds, rental income from privately-held properties or dividend income from a stocks and shares portfolio.

It is also important to factor in future sources of income, such as the State Pension, and from what age that additional income will start.

This introduces another component to the overall answer. Consideration needs to be given to whether an individual should draw down from their private capital first and leave their pension fund untouched for the time being.

> The advantage of leaving SIPP or SSAS funds untouched for as long as possible is that the fund sits outside an individual's estate for inheritance tax purposes, whereas ISA funds, for example, do not.

However, not everyone will have the luxury of choosing between drawing down income from private capital or from pension funds.

This depends upon how much an individual relies upon extracting income from a pension fund in the absence of other privately held savings or earnings. The more this is the case, the more important the ongoing investment management of the fund, which is addressed below.

3. We explored the concepts of 'attitude to investment risk' and 'capacity for loss' in another of our drawdown briefing notes, which can be accessed here.

In addition, expectations of income from the FAD fund must be reasonable too. For example, an annual income requirement of £20,000 gross is not going to be available from a FAD fund of just £20,000.

Drawdown is an investment-based decumulation option. However, it may be more appropriate to use the annuity income that a drawdown fund could purchase as an initial benchmark when working out how much income to draw. This assumes, however, that you are taking an income for life, whilst annuities are backed by a diverse range of investments that may not necessarily be replicated within the drawdown fund itself.

3. How long the income is needed for

Defined benefit pensions and lifetime annuities provide an individual with an ongoing, known income stream from a particular age for the remainder of their life.

However, for those with defined contribution pensions (and the options now available to them arising from the Freedoms) their biggest concern will be running out of money whilst still in retirement.

> By contrast, some individuals may only require an income stream for a finite period of time. For example, they will use this to act as a form of 'bridging pension' ahead of their State Pension and/or other defined benefit pensions becoming payable from a specific future age.

We looked at the question of how long a drawdown fund needs to last in another of our drawdown briefing notes, which can be accessed here.

Ways of managing your income withdrawals

Taking into account the key factors outlined above, the income amount being withdrawn from an 'unbridled' FAD fund should be, and must remain, sustainable.

What constitutes a 'prudent' or 'reasonable' income withdrawal rate has been the subject of detailed statistical research and analysis. This has resulted in 4% a year being cited as a 'Safe Withdrawal Rate' ("SWR") by some.

It should be noted, however, that this was based on US data and made various significant assumptions for the purposes of the research.

However, deciding upon a reasonable withdrawal rate at the outset of taking drawdown income may not allow for the effects of the unexpected. This could include future economic 'shocks', unanticipated life-changing events and the ongoing management and performance of the underlying investment portfolio.

Indeed, there could be market conditions in the future that sit outside the historic data, meaning that the SWR 'rule' will fail. Therefore, individuals who want absolute certainty and cannot bear the thought that their withdrawal plan has the potential to fail, should arguably not be in drawdown.

Therefore, engaging with a regulated financial adviser who specialises in retirement or decumulation advice provides an individual with an experienced 'partner.'

This partner will construct and manage a suitable investment portfolio, control for things like 'sequence risk'[4], have strategies for adjusting income up or down and keep an eye on fundamentals like whether drawdown remains the best option.

To address this, one of our other drawdown briefing notes asks the question, "How long should I stay in drawdown?" and can be accessed here.

4. See our drawdown briefing note here.

BARNETT WADDINGHAM
beyond the expected

Can we provide a retirement income strategy?

No, Barnett Waddingham are pension administrators and trustees, not financial advisers.

We provide generic information to help you understand the issues, but only a regulated financial adviser can tell you what to do.

Conclusion

Drawdown is arguably more attractive now than before the Pension Freedoms were introduced, due to its increased flexibility.

However, drawdown is also potentially riskier as there is no longer any inherent discipline in the form of income limits. Clearly, a fund can only sustain a certain income over time.

The most reliable way to set and adjust an appropriate income amount, relative to the size of the drawdown fund, is to use a regulated financial adviser who specialises in this field.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

info@barnett-waddingham.co.uk   0333 11 11 222

www.barnett-waddingham.co.uk