Pension Freedoms

April 2019

5 years ago George Osborne introduced pension freedoms, for the over 55s. Here we answer some of your questions on how pension freedoms work, how they might be beneficial and the pitfalls to look out for.

Q. What are pension freedoms and how do they differ from what went before?

A. Pension freedoms enable those over age 55 to access their pension funds on a flexible basis, lump sums can be withdrawn alone, or with a regular income, or periodic lump sums, which may be varied to meet changing needs.

Before pension freedoms, most pensions paid a lump sum at retirement which was tax free and a regular taxable income thereafter. In an employer sponsored final salary scheme the lump sum and income would be fixed under the scheme rules. The income was guaranteed by the employer sponsoring the scheme or by an insurance company which exchanged pension savings for a lifelong income, known as an annuity.

From 1998 capped drawdown was introduced. This still required the tax-free lump sum to be taken at outset but buying an annuity could be postponed until age 75. A capped amount of income could be drawn from the fund in the interim.

These approaches see retirement as a one-off event, rather than a process, which may last a decade or more of transition to full retirement and last several decades beyond.

By 2006 it became illegal to dismiss someone on grounds of age. So, more people worked beyond age 60. Many wanted to ease themselves into retirement and start to draw on their pension savings while still working, perhaps reducing hours or changing career. Pension freedoms, allowing unlimited access to pension funds from age 55, without any requirement to secure a guaranteed income was designed for this.

Q. How has pension freedom been used so far?

A. Popular uses include paying off debt before retiring, tenants withdrawing lump sums to buy a

home, helping other family members, paying for private medical treatment or care, funding a special holiday or celebration, providing an income top up before state pension age, funding retraining, a new business or hobby.

Q. What are the risks with pension freedoms?

A. The greatest risk is that the invested fund will not grow sufficiently to meet lifetime income needs and the funds will run out when there is still a need for income. This could happen if withdrawals are taken too soon or too often or if investment returns fall.

Q. How can these risks be managed?

A. It is essential to have a cashflow plan in place which considers all the assets and sources of income available in retirement and matchers these to the income and capital likely to be needed, adjusting for inflation and events. This maps out the sustainability of the required income from the invested pension fund. It enables retirement plans to be sense checked before decisions are made. The growth assumptions used will be determined by the individual's capacity for loss and attitude to risk. This in turn will inform decisions about the investments to be selected to produce the income and growth needed. By updating the cash flow report with changes in circumstances and needs and investment values, the plan can be adjusted to meet ongoing needs. This may include reducing income withdrawn if investments fall or increasing it if there is surplus capital.

Ideally essential spending should be funded by guaranteed sources of income, such as State pension, final salary pensions or an annuity. It can also be underpinned by maintaining accessible cash for emergencies. Income for non-essential spending or one-off purchases can be more easily adjusted.

Q. How can investments be selected to make the income sustainable?

A. We offer investment portfolios which have targeted income yields and growth objectives. The investments are not guaranteed to deliver these, and investments may fall or rise and may not always meet the stated objective over every period. Matching the mix of investments to these objectives, we believe gives a greater prospect of achieving them over the medium to long term. Our investment committee review the investments selected for each objective every quarter and are informed by independent research.

Q. Are there any other pitfalls with pension freedoms?

A. The taxation of the funds withdrawn needs to be understood to avoid paying too much tax by making large one-off withdrawals, when other income is high. Withdrawing more than the tax-free lump sum can also trigger restrictions on future pension saving. On the other hand, a careful tax strategy can enable the retiree to maximise the income which can be withdrawn tax free, thus extending the sustainability of the pension fund.

If you are unsure of the suitability of any investment or product for your circumstances, please contact an adviser. All information is based on our current understanding of taxation legislation and regulations. Any levels and bases of, and reliefs from, taxation, are subject to change. Taxation advice is not regulated by the FCA.

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