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FSA Financial Services Authority

FSA Factsheet

Income withdrawal – a retirement option for you?

This factsheet is for you if:

- you are approaching or have reached retirement age;
- you have a pension fund and you want to take a tax-free lump sum or start drawing an income from it, instead of buying an annuity;
- you have substantial assets to provide an income in retirement; and
- you are prepared to take some risks with your pension fund to achieve greater flexibility and a higher return.

It sets out:

- how income withdrawal works;
- the advantages and disadvantages;
- how to get the advice you need to help you decide; and
- where to get further information.

Plain Language Commission Clear English Standard Winning Document

A retirement option for you?

This factsheet explains how an unsecured pension using income withdrawal (sometimes called income drawdown or pension fund withdrawal) works and whether it might be right for you.

Before reading this factsheet you will find it helpful to read the **FSA guide to pensions 3: Annuities and other retirement options**. This gives you detailed information about your options at retirement. See *Useful contacts* on page 11 for how to get your free copy.

The FSA's consumer publications aim to give you general information to help you make financial decisions. The information does not constitute financial or other professional advice; for advice about your own circumstances, you should consult a professional adviser.

Retirement

In this factsheet, we use 'retirement' to mean the time from when you start to take the benefits from your pension. You don't have to stop work to start drawing your pension.

You can retire from age 50 but this is going up to 55 between 2006 and 2010. Check with your plan provider to find out when they are making this change.

See page 10 for a brief explanation of certain terms used in this factsheet.

Your pension fund

You may already know there are several ways of turning your pension fund into a regular income for your retirement, and the government sets rules about how you can do this.

The usual way is to buy a **lifetime annuity** from a life insurance company. This turns your pension fund into a pension income for the rest of your life however long you live.

There are different types of lifetime annuity to suit your needs and circumstances. You can choose between an annuity just for you, if you don't have a spouse or partner, or a joint life annuity that will pay out to your spouse or partner after your death. You can also choose whether you want your single- or joint-life annuity to be a level or escalating annuity.

A level annuity pays out the same income year after year. An escalating annuity starts at a lower rate than a level annuity but will increase annually and can be either at a fixed rate or linked to the Retail Prices Index. For detailed information see the **FSA guide to pensions 3: Annuities and other retirement options**.

Once your lifetime annuity payments start you can switch annuity providers only if you can find a provider willing to take it on. You cannot change the type of annuity even if you do switch providers.

If, for whatever reason, you decide you don't want to buy a lifetime annuity straight away, one option is an unsecured pension using **income withdrawal**.

What is an unsecured pension?

If you are under 75 an unsecured pension allows you to draw an income from your pension fund by either using income withdrawal or buying a short-term annuity.

This factsheet covers only income withdrawal. For other options see the **FSA guide to pensions 3: Annuities and other retirement options**.

What is income withdrawal?

It is an alternative to buying a lifetime annuity. It allows you to draw an income from your pension fund while the fund remains invested.

The maximum level of income you can draw is equivalent to 120% of the income you would get from a level single-life lifetime annuity. There is no minimum amount.

You can stop the income withdrawal arrangement at any time and use your remaining fund to buy a short-term or lifetime annuity.

By age 75 you must secure an income from your pension funds, which generally means buying a lifetime annuity. A variant to this is an alternatively secured pension, which works in a similar way to an unsecured pension but has slightly different rules.

However, the Government has indicated that alternatively secured pensions are only intended for a small group of people who have a principled religious objection to buying an annuity. You should take this into account when making a decision on how to secure your pension. Also, inheritance tax may apply to any leftover funds on your death.

Who can use income withdrawal?

Anyone in a personal or stakeholder pension scheme can use income withdrawal. However, some pension schemes will not normally operate income withdrawal for small funds.

If you're in an occupational money purchase scheme, you may be able to use income withdrawal. If you're in a scheme that doesn't offer it and you want to use income withdrawal, you must first transfer your pension rights from that scheme to a personal pension scheme. Your financial adviser will probably charge you for making this transfer. Your adviser will be able to discuss income withdrawal from occupational pensions with you in more detail.

This factsheet only covers income withdrawal from personal pensions. All references to personal pensions apply equally to stakeholder pension schemes.

Who is it suitable for?

Income withdrawal plans are complex and are **not suitable for everyone**. They are usually not suitable if you have a small pension fund and if you have no other assets or sources of income to fall back on. And even if you have a large pension fund, and other assets or income, income withdrawal may still not be suitable. **It depends, among other things, on the risks you are prepared to take.**

It is important to understand the advantages and the risks and to **get expert advice from an authorised financial adviser before you buy**.

The decisions you make now will affect your pension income for the rest of your life (and that of any partner and other dependants).

How does income withdrawal work?

You may be able to stay with your existing pension provider, who will convert your personal pension fund into an income withdrawal contract. Or you can consider moving to another provider and shopping around for the best deal before making a final decision, bearing in mind that some firms specialise in income withdrawal contracts.

You can take part of your pension fund as a tax-free lump sum. The maximum you can have is 25% of your fund. You then draw a regular income from what is left and this income is subject to tax.

As you don't have to draw an income from it straight away, you may be tempted to take income withdrawal if you need a cash lump sum. But make sure you fully understand how income withdrawal works and whether it is right for you.

Meanwhile your pension fund remains invested in a favourable tax environment. Bear in mind that you will be taking an income from a fund that remains invested in asset-backed investments, such as the stock market, property or gilts.

This means that:

- the fund value could fall (as well as rise); and
- the income you take plus the charges will reduce the value of your fund if they are greater than the investment growth.

There may be initial and annual charges levied by the underlying investments. Some funds have set-up charges and some charge an additional fee for paying out income withdrawal, so make sure you find out what the charges are for.

The hope is that the returns on your invested fund will make up for all or most of the charges, any 'mortality drag' (see page 10), and be enough to sustain your income.

If investment returns are lower than expected, you may find that your fund has fallen in value which may mean you have to accept a lower income in future.

The amount of income you withdraw must not be above the set limit. The provider of your plan calculates this limit under rules set by HM Revenue & Customs (HMRC) (formerly the Inland Revenue) and standard actuarial tables prepared by the Government Actuary's Department. You can choose an income anywhere below this limit, but the provider recalculates the limit every five years until you buy an annuity.

Other points to consider

- After each review your provider will tell you the new limit, which may mean that you have to lower your income to keep within the limit. Five years is a long time so you should also review your plan each year with your adviser to check that the growth of your fund is making up for the income you are taking from it.
- You can make changes to your plan such as varying the amount of income you are withdrawing or changing the funds your pension is invested in.
- If you and your adviser decide the time is right, you can use the money that is left in your pension fund to buy a lifetime annuity from which you will get your pension income. The income withdrawal plan stops at this point.
- As annuity rates usually rise with age, if you delay buying an annuity you may expect a slightly higher annuity rate than if you had bought a lifetime annuity when you retired. But because people are on average living longer it could be risky to assume that annuity rates will be higher in future. And of course annuity rates could fall or rise for various reasons.
- You do not have to use all your pension fund at once. You can split most personal pension funds into many smaller slices and you can decide to use just some of these, allowing you to continue to invest the other slices without drawing an income from them. This is a combination of **phased retirement** and income withdrawal and you should discuss this with your financial adviser.
- If you die before you reach age 75 and haven't bought a lifetime annuity, you can leave your pension fund to your partner and any dependants. They will be able to:
  - take some or all of the remaining fund as a lump sum, which is taxable – currently at 35%;
  - carry on with income withdrawal;
  - take the fund and buy a lifetime annuity with it.

These are the main options. Speak to your financial adviser about all your options or any limits that may apply.

Example of income withdrawal

The following assumes that the annuity provider will pay commission to your adviser. However, you could pay them a fee instead of commission. The figures used are for illustration only and are based on current limits.

James has built up a personal pension fund of £200,000 with Company A. After discussion with his financial adviser he decides to take out an unsecured pension using an income withdrawal plan by transferring his pension fund to Company B.

Company A pays the £200,000 directly to Company B. Company B then gives James a cheque for £50,000, which is the maximum tax-free lump sum he is allowed under tax rules.

Company B takes out 3% of the remaining £150,000 (£4,500) to pay commission to the adviser. That leaves £145,500 which the company invests for James, paying him some money out of it each year (his pension income).

Company B also takes charges of 1% each year of £145,500 (which in the first year will be £1,455) from the fund for managing James's money. It pays part of this to the adviser for the regular reviews.

The scheme administrator of Company B sets the maximum amount that James can draw following rules set by the government. This is about 120% of the basic lifetime annuity. There is no minimum amount.

After a year James reviews his fund with his financial adviser. His original fund has reduced by the amount he has taken out in income and what the company has taken out in charges. The value of the fund will also have increased or decreased depending on the performance of the investments chosen.

If James decides to buy his lifetime annuity with the remaining fund, he can choose another company if it gives him a better annuity rate. This is known as the **open-market option**.

What are the advantages and disadvantages?

Your financial adviser can tell you how income withdrawal could help you. See below for the main advantages and disadvantages.

The advantages may make income withdrawal sound attractive, but there are risks you should consider carefully before you make a decision.

Advantages	Disadvantages
You don't have to buy a lifetime annuity straight away, say if annuity rates are low. Annuity rates may improve over time.	There is no guarantee that annuity rates will improve in the future – they may go down. So you should not assume that you will get a higher income by waiting to buy an annuity. By delaying buying a lifetime annuity you lose the cross-subsidy generated by the annuitants who die before you buy an annuity (see page 10). To compensate for this, your investments need to grow by an additional amount. This is called mortality drag.
Your pension fund remains invested in a favourable tax environment. Your adviser can explain further.	Despite the favourable tax treatment there are still risks as you are taking money out of your pension fund and relying on investment growth to replace part or all of what you have taken. If investment returns are lower than expected, you may find that your fund has fallen in value which means that you may have to accept a lower income in future. You also bear the risk that you may use up your fund before you have time to buy a lifetime annuity.
You could reduce the amount of income tax you pay by adjusting the timing of your payments.	Not normally possible for basic-rate taxpayers. This is mainly of benefit to the higher-rate taxpayer.
While you are drawing an income, you gain the flexibility to vary your income and you control where you invest your funds.	You may have to check regularly how the level of income you take is affecting the value of your fund, and make decisions on how the fund is invested. High income withdrawals may not be sustainable and you may need to take advice more regularly.
You are able to transfer your plan to another provider and continue income withdrawal.	▪ The provider may charge for making this transfer. ▪ The provider may set conditions that you will have to meet before and after transfer. ▪ Not all providers accept transfers.
When you die you can leave your pension fund to your partner and any dependants. They will have some choices about how to take the money.	There will be tax implications. Some options are subject to higher taxation than others.

Not all of the advantages and disadvantages may apply to you – it all depends on your personal circumstances.

What next?

There are many issues to consider, as your decision will affect your income for the rest of your life.

You will need to get advice from an authorised financial adviser. For information about the different types of financial adviser and how to find one, see the **FSA guide to financial advice** – See *Useful contacts* on page 11.

What you need to consider

Before you see an adviser, make a note of some of the things that will affect your decision. For example ask yourself:

- How much do I need to live on now?
- How much will I need in five years' time, ten years' time and so on?
- How much do I have in my pension fund now?
- Do I need a lump sum, if so how much?
- What other income have I got?
- Am I willing to risk some of my money in the hope of a better income in the future?
- Am I happy to keep a close eye on my pension fund and continue to make investment decisions?
- Am I happy to continue paying for financial advice on a regular basis?
- Who else is financially dependent on me now, and in the future?
- What is my state of health and that of my partner?

When you see your adviser, make sure:

- that your adviser is knowledgeable in this area;
- that the adviser understands your financial and personal circumstances, and what your future needs will be;
- that the adviser tells you why any recommended product is suitable for you and gives you the recommendation and reasons in writing;
- that you understand how the product works and the risks involved;
- that you know how the adviser will be paid for the advice and how much it will cost you, including the cost of any regular meetings;
- that you know when you have to make a decision and what happens next;
- that you arrange when you are going to see your adviser again.

Your adviser should give you information to take away and read about the product, including a personal quotation. This quotation may include details of the **critical yield**, which tells you either:

- how much your pension fund needs to grow to keep paying you the income you want. The rate of growth will increase with age; for example a critical yield of 7% means your fund must grow by 7% from its investments over a year, so you are not 'out of pocket'; or
- how much your pension fund needs to grow for you to receive an income at least equal to the amount you would have received if you had bought an annuity straight away.

Remember that, in general, the higher the income you take, the higher the critical yield must be and the higher the risks you are taking with your money.

Income withdrawal needs regular reviews

The decision to start an income withdrawal plan is not a one-off; you will need to reassess your situation regularly. You should see your adviser at least once a year to:

- review your financial circumstances;
- check whether you are taking too much income out of your plan and are reducing its value;
- see how your pension fund is progressing, including the investment strategy;
- find out how much your fund needs to grow to keep paying the income you want (the critical yield);
- consider your state of health as this may affect future decisions; and
- decide whether you want to buy a lifetime annuity.

When you set up your plan, you should discuss with your adviser how he or she expects to be paid for these annual reviews. Your provider may be paying the adviser commission each year to pay for them.

If you don't keep a close eye on these things you run the risk of losing out financially. You may notice that things are not going as well as you had expected only when it is too late. You could miss out on buying an annuity when rates are good or when the investment growth on your fund has been very good. An income withdrawal plan needs constant attention!

You have read about one retirement option – income withdrawal – and considered whether it may be what you want. Before you make a final decision, it may be helpful to read the **FSA guide to pensions 3: Annuities and and other retirement options** for a general overview of your options.

Some technical terms you may come across

Alternatively secured pension	It works in a similar way to a unsecured pension but has slightly different rules. However, the Government has indicated that alternatively secured pensions are only intended for a small of group of people who have a principled religious objection to buying an annuity.
Annuity	An investment product sold by insurance companies which converts your pension fund into a pension income. There are different types to suit different circumstances. See the **FSA guide to pensions 3: Annuities and other retirement options**.
Annuitant	The person who is receiving annuity payments.
Commission	The payment that a financial adviser gets from an insurance company for arranging your plan. The insurance company deducts commission from your investment. Alternatively, your adviser may offer you the option of paying a fee instead of commission.
Critical yield	For income withdrawal plans, this is how much your fund needs to grow to keep paying you the income you've chosen.
Five-year review	A review every five years – this is how often the scheme administrator has to look at the maximum amount you can withdraw from your income withdrawal plan each year.
GAD	The Government Actuary's Department – responsible for setting some of the rules for pensions and life assurance products.
HMRC	HM Revenue & Customs, the new name for the Inland Revenue.
Mortality cross-subsidy	Insurance companies set their annuity rates knowing that some annuitants will die before their average life expectancy and some will live beyond it. Lifetime annuities are able to provide annuitants with an income for life because the unused funds of those who die earlier than expected help to pay the annuities of those who live on. This process is called mortality cross-subsidy.
Mortality drag	To compensate for losing the cross-subsidy if you delay buying an annuity, your investments need to grow by an extra amount. This is called mortality drag.
Open-market option (OMO)	Your right to shop around and buy your annuity from the company offering the best deal for you.
Pension income	The income you get from your pension savings either by buying an annuity or through income withdrawal or phased retirement.
Phased retirement	Most personal pension funds are split into many smaller segments. You can decide to use just some of these, allowing the others to continue to stay invested without converting them into income.
Short-term annuity	A type of unsecured pension that allows you to use part of your pension fund to buy an annuity lasting up to five years, while the rest of your pension fund remains invested. A short-term annuity must end before the annuitant reaches the age of 75.
Tax-free cash or tax-free lump sum	HMRC rules allow you to have some of your pension fund as a tax-free lump sum. Normally it is 25% of your fund but the amount may be different for some pension plans.
Unsecured pension	An alternative to buying a lifetime annuity. It allows you to draw an income from your pension fund up to age 75 while leaving the fund invested. There are two types of unsecured pension – income withdrawal and short-term annuity.

Useful FSA publications

- **FSA guide to financial advice**
- **FSA guide to pensions 3: Annuities and other retirement options**
- **Factsheet: Retiring soon – what you need to do about your pensions**

Useful contacts

0845 numbers will be charged at the locaL rate based on current charges from BT landlines. Charges for calls from mobile phones and other networks may vary.

For free FSA consumer publications or to check that a firm is authorised

FSA Consumer Helpline: 0845 606 1234
Minicom/Textphone: 08457 300 104
www.fsa.gov.uk/consumer

For pension enquiries

The Pensions Advisory Service
Tel: 0845 601 2923
www.pensionsadvisoryservice.org.uk

An independent organisation providing help on pension and annuity queries.

Financial advice

IFA Promotion
Tel: 0800 085 3250
www.unbiased.co.uk
Can provide a list of three independent financial advisers in your local area.

The Personal Finance Society
Tel: 020 8530 0852
www.thepfs.org
Has an online Find an Adviser service.

To trace old pensions

The Pension Tracing Service
Tel: 0845 6002 537
Textphone: 0845 3000 169
www.thepensionservice.gov.uk

The Financial Services Authority (FSA) is the independent watchdog set up by government to regulate financial services and protect your rights.

We produce a range of user-friendly factsheets and booklets which are available from our website and helpline.

If, after reading this factsheet, you have any general queries, our helpline will try to clarify things for you.

We can tell you if a firm is authorised and help you if you have a complaint and don't know who to contact. But as the regulator, we can't recommend firms or advisers, or tell you whether a particular product or investment is right for you.

If you would like this factsheet in Braille, large print or audio format, please call our Consumer Helpline on 0845 606 1234 or Minicom/Textphone 08457 300 104 (call rates may vary).

To help us maintain and improve our service, we may record or monitor calls.

Our website, www.fsa.gov.uk/consumer, aims to help you understand financial services and get a fair deal.

Use the site to:

- shop around with our comparative tables – including mortgages, pensions and ISAs;
- check a firm is authorised by the FSA, or is the agent of an authorised firm. If they are not authorised you will not have access to complaints procedures and compensation schemes if things go wrong.
- order any of our wide range of consumer publications;
- report any misleading financial advertising;
- see explanations of financial products in plain English;
- read recent alerts that we have issued.