Cambrian

Flexi-access drawdown

What is it?

Drawdown pension is a method of withdrawing benefits from your pension fund without purchasing a lifetime annuity.

Holders of money purchase pension plans can defer taking their pension in the form of an annuity and instead make withdrawals directly from the pension fund. This will first require the funds to be moved into a flexi-access drawdown plan or converted to flexi-access drawdown. [Any flexible drawdown plans that were in place before 6 April 2015 automatically became flexi-access drawdown plans on 6 April 2015 and capped drawdown plans in existence before 6 April 2015 can be converted to flexi-access drawdown.]

The main purposes of drawdown pension can be summarised as follows:

- Deferral of annuity purchase, thus avoiding being locked into low annuity rates which may apply at the time of retirement.
- The drawdown pension option enables the policy holder to buy an annuity at a time that is best suited to them and hopefully when annuity rates are more favorable or provides an opportunity to avoid purchasing an annuity altogether where appropriate.
- The option enables investors to retain control over their pension investments and allows them to continue to be invested in the markets.
- It postpones the decision of deciding which type of annuity to lock into, for example providing a contingent pension for a wife or husband and selecting a level or increasing pension.
- With flexi-access drawdown the amount of income that can be taken from the fund is not subject to any specific limits therefore this method offers great flexibility. This can be useful for tax planning or where other sources of income are available.

Eligibility

From 6 April 2011 rules were introduced such that anyone with a defined contribution (money purchase) pension arrangement (not final salary) who had not, before that date, taken a pension, could postpone the decision to take benefits from their scheme indefinitely (the previous requirement was that an income had to be secured by age 75 at the latest).

From 6 April 2015 the rules relating to defined contribution pension arrangements were relaxed further, meaning that from age 55 an individual is given unlimited access to their defined contribution pension funds and can withdraw as much or as little as they like. Any amounts withdrawn in excess of the tax free Pension Commencement Lump Sum are subject to tax. The rate(s) of tax payable will depend on the level of the individual’s total income including the amount withdrawn from the pension fund.

Critical yield

The critical yield calculation is an attempt to show the investment returns required from a drawdown pension arrangement to match the income that could be provided by a traditional annuity. The critical yield takes into account mortality drag and the additional costs involved in a drawdown pension plan. Crucially, it assumes that throughout the period of withdrawal the underlying annuity interest rate and mortality basis will not change.

The critical yield is an important consideration in deciding whether or not drawdown pension is an appropriate investment vehicle or not. Once established it is then necessary to decide how the funds will be invested to achieve the critical yield. Generally, if long term income is the requirement, the drawdown pension route will only prove to be more effective in total income terms if the investment return generated is sufficient to cover:

- The investment return on current annuity rates, plus
- Mortality drag, plus
- The additional costs involved in a drawdown pension arrangement as opposed to an annuity

Mortality drag

Annuity providers know that not all annuitants will live as long as expected. The providers use this ‘mortality gain’ to subsidise current annuity rates. Therefore those clients who die earlier than expected subsidise the remaining annuitants. If you choose an alternative to annuity purchase, such as drawdown pension then you do not benefit from this cross subsidy and effectively take on the ‘mortality risk’ yourself. The longer you delay annuity purchase, the less you will benefit from the cross subsidy when you eventually buy an annuity. This is known as ‘mortality drag’.

Main features of flexi access drawdown pension

Age and health	For flexi-access drawdown you can choose how much income you want to withdraw without reference to any rates or limits other than the size of your pension fund. If you or your spouse is relatively young, a secured pension (lifetime annuity or scheme pension) would be less attractive due to the lower mortality factor and, in addition, there is a longer timescale to take advantage of the potential investment rewards and risks of Drawdown Pension. You can delay purchasing a Lifetime Annuity if you think annuity rates will improve.
Investment risk	Investing in relatively safe areas such as cash and gilts is unlikely to enable a higher lifetime income to be achieved than with a secured pension therefore investing in the type of assets that might achieve the extra returns necessary will involve risk. The shorter the term to the intended date of purchasing a secured pension, the greater the risk. The value of your pension fund may go down as well as up and investment returns may be less than those shown in the illustrations. The levels of income provided may not be sustainable, so in other words your pension fund may run out. Taking withdrawals may erode the capital value of the fund, especially if investment returns are poor and a high level of income is being taken. This could result in a lower income if / when an annuity is eventually purchased. If investment returns do not at least match the critical yield (in simple terms, the value of growth required to provide an equivalent income at the age you intend to purchase an annuity), your eventual income is likely to be less than that which could have been available via the annuity route.

	Please be aware that there may be occasions when an individual fund or funds may have a higher risk rating than your overall stated attitude to risk. If this is the case, then the overall risk rating applied to all of the combined funds being recommended is still designed to meet your stated tolerance.
Other risks	Annuity rates may be at a lower level if / when annuity purchase takes place and there is no guarantee that your income will be as high as that offered under the other options referred to earlier. There is no guarantee that annuity rates will improve in the future. They could be lower if / when you decide to purchase an annuity than they are currently. Your pension may be lower than if you bought a lifetime annuity now. High levels of drawdown pension may not be sustainable in the longer term. If you intend to invest some or all of your pension fund there may be charges involved with the new investment. If you withdraw large amounts of capital from your drawdown fund these may impact on any means tested benefits you are in receipt of. Any monies drawdown from an existing Flexi-access drawdown plan and not spent as intended, could create an Inheritance Tax issue.
Flexibility	You can take your tax free cash lump sum immediately to spend or invest as you wish without the need to take any income at all if this suits your circumstances. You will be able to plan in advance the level of income that you wish to take each year, so that you can take into account any other sources of income which may become available to you. There are products available which offer a level of guaranteed income which is paid regardless of the performance of the investments in your pension fund thereby removing some of the risk involved with Drawdown Pension (albeit at a price and subject to specified conditions being met). If the Drawdown Pension product is set up within a Self Invested Personal Pension (SIPP) wrapper, this will permit access to a wide range of investments and enable the investments to be rearranged easily if required (and usually more cost effectively than switching between product providers).
Taxation	You can usually take up to 25% of your pension fund as a tax free lump sum. The provider of your pension plan will deduct tax from any withdrawals you take through the PAYE system and you should be aware that if they do not hold your correct tax code, an emergency code will be used and you may need to reclaim or pay additional tax through your self-assessment tax return or by way of a separate claim. The income you draw will be taxed as earned / pension income, with tax deducted at source in the tax year in which it is withdrawn. This could mean income tax of up to 45% (46% in Scotland) depending on your circumstances. You can structure your income to mitigate liability to personal income tax. By reducing your income in some years you may be able to avoid a higher rate tax liability. If in flexi-access drawdown you may withdraw an unlimited amount from your pension fund, although all amounts withdrawn will be taxed as income at your marginal income tax rate(s).

	All statements concerning the tax treatment of products and their benefits are based on our understanding of current tax law and HM Revenue and Customs' practice. Levels and bases of tax relief are subject to change.
Transfers & withdrawals	It is possible to transfer your drawdown plan from one provider to another. You can make ad hoc withdrawals instead of, or in addition to, taking a regular income from your fund. The flexibility over income levels offered by flexi-access drawdown pension can be useful for tax planning purposes. You can decide at any time to buy a lifetime annuity with all or part of your fund. Having entered flexi-access drawdown there will be no restriction on the income you are able to draw – anything from zero income to the entire fund in one go is allowable. All income taken is taxable as earned / pension income.
Availability	There are many drawdown providers in the market and you should ensure you consider costs, service standards and investment choice before selecting a provider.
Long term care	Your income payments will be taken into consideration should you require long term care in the future. If greater than the actual income being taken, an income in line with that available from an annuity based on your age at that time will be taken into account.
Treatment after death	Your beneficiaries can continue to take withdrawals from any remaining drawdown fund on your death (annuity purchase is also an option) or take the remaining fund as a lump sum. If you die before age 75 any income or lump sums taken by your beneficiaries will be tax free. If you die after age 75, any income or lump sums taken by your beneficiaries will be taxed at the recipient's marginal income tax rate(s).
Type of charges	Drawdown Pension products tend to have higher charges than Secured Pension products due to the greater amount of administration and advisory input they involve.
Future planning issues	If you decide to move abroad after retirement, you can arrange to have your pension paid to an overseas bank account if you wish to. If your health / circumstances change, you may change the amount of income you are drawing and or / purchase an annuity. Further tax-relievable pension contributions may be made before age 75. If you have taken some income from your flexi-access drawdown plan or withdrawn an Uncrystallised Funds Pension Lump Sum under a different arrangement you will be subject to the £4,000 money purchase annual allowance (MPAA). When you first flexibly access your pension, the scheme administrator has to provide a statement to you within 31 days. You must then notify any other schemes that you are an active member of (i.e. where contributions are being paid to a money purchase scheme or you are accruing benefits under a cash balance or hybrid scheme) within 91 days of receiving their statement, so that they're also aware that the £4,000 MPAA will apply.