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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, but don't want to buy an annuity straight away;
- you want to start drawing an income from your pension fund; and
- you have substantial assets in addition to a pension fund and are prepared to take some risks to achieve greater flexibility and 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.

A retirement option for you?

This factsheet explains how 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 annuities and income withdrawal**. This gives you detailed information about annuities and how they work. See Useful contacts on page 7.

You may decide that you don't want to buy an annuity at your retirement date. **Income withdrawal** is one alternative you might consider.

Your pension fund

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

The usual way is to buy an **annuity** from a life insurance company. This turns your pension fund into a pension income for the rest of your life. Once you have bought an annuity, you cannot change your mind and switch to a different type of annuity or another annuity provider. The decision is final.

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

Pension providers use a lot of technical terms to describe their products. See page 7 for a brief explanation of what they mean.

What is income withdrawal?

Instead of buying an annuity, income withdrawal allows you to draw an income from your pension fund until you decide to buy an annuity (you have to buy an annuity by the age of 75).

This factsheet explains how income withdrawal works under personal pensions. All references to personal pensions apply equally to stakeholder pension schemes.

Income withdrawal is also an option with some occupational money purchase schemes. If you want to use income withdrawal and you are in an occupational scheme that doesn't offer it, you must first transfer

your pension rights from that scheme to one which does offer it, such as a personal pension. If you transfer your funds from an occupational scheme, you may find your tax-free lump sum is restricted to less than 25% of the fund (the normal lump sum payable from a personal pension). There will probably be charges for making this transfer.

There are a number of differences between income withdrawal from personal and occupational pensions, but this factsheet only covers income withdrawal from personal pensions. Your financial adviser will be able to discuss income withdrawal from occupational pensions with you.

Income withdrawal plans are complex and are **not suitable for everyone**. They are not usually a good idea if your pension fund is under £100,000 (after you have taken any tax-free lump sum) and 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 all depends 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?

Firstly, you may be able to take part of your pension fund as a tax-free lump sum. The maximum you can have is 25% of your fund, but it can be less – check with your financial adviser. You then draw a regular income from what is left and this income is subject to tax.

The amount of income you withdraw must be between certain upper and lower limits. The provider of your plan calculates these limits in accordance with rules set by the Inland Revenue and standard actuarial tables prepared by the Government Actuary's Department.

You can choose an income anywhere within this range, but the range has to be recalculated every three years (called a **triennial review**) until you buy an annuity.

After each triennial review your provider will tell you the new limits, which may mean that your income has to be increased or lowered to keep within the range. Three years is a long time and you should review your plan each year with your adviser.

Meanwhile your pension fund remains invested. It will decrease by the amount you are taking out in income and the charges you have to pay for fund management and financial advice. The hope is that the returns on your invested fund will make up for all or most of the charges, mortality drag (see page 7), and the amount you are withdrawing as 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.

Because annuity rates usually rise with age, by postponing buying an annuity you could benefit from slightly higher annuity rates than you would have got if you had bought an annuity when you retired. But this cannot be guaranteed as annuity rates generally could fall.

You can make changes to your plan such as varying the amount of income you are withdrawing, changing investment funds or buying an annuity.

When you and your adviser decide the time is right, you use the money that is left in your pension fund to buy an annuity from which you will get your pension income. The income withdrawal plan stops at this point.

You do not have to use all your pension fund at once. Most personal pension funds are split into many smaller segments and you can decide to use just some of these, allowing the others to continue to be invested. This is a combination of **phased retirement** and income withdrawal and should be discussed with your financial adviser.

In any event, you must buy an annuity by age 75 at the latest.

Example of income withdrawal

The following assumes that the adviser will be paid by commission. However they could be paid on a fee basis. The figures used are for illustration only and are based on current limits – which are subject to change.

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 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 that he is allowed by the government.

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 (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 annual/triennial reviews.

The scheme administrator sets the amount that James can draw following rules set by the government. This is about the same as the basic annuity that could be paid to someone of his age.

The minimum amount is 35% of the maximum. So, if the maximum he could withdraw was £10,000, the minimum would be £3,500 per year.

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 fund will also have increased or decreased depending on investment growth.

When James decides to buy his 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 very attractive, but there are risks you should consider carefully before you make a decision.

Advantages	Disadvantages
<p>You don't have to buy an annuity straight away, say if annuity rates are low. But you must buy one by the age of 75. Annuity rates may increase with age.</p>	<p>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 better income by waiting.</p> <p>By delaying buying an annuity you lose the cross-subsidy generated by those who die before you buy an annuity. To compensate for this, your investments need to grow by an additional amount. This is called mortality drag.</p>
<p>Your pension fund remains invested in a favourable tax environment. Your adviser can explain further.</p>	<p>Remember that with income withdrawal, you are taking money out of your pension fund and relying on investment growth to replace part or all of what you have taken.</p> <p>If the growth is not as high as you hoped for, your fund may get smaller and you will have less money to buy your annuity with, so you may get a lower pension income from it.</p>
<p>If you die before you buy an annuity, you can leave your pension fund to your partner and any dependants. They would be able to:</p> <ul style="list-style-type: none"> ■ take some or all of the remaining fund as a lump sum; → ■ carry on with income withdrawal until they are 75 or you would have been 75 – whichever is earlier; or → ■ take the fund and buy an annuity with it. → <p>These are the main options. Speak to your financial adviser for full options or any limitations that may apply.</p>	<p>Each option should be considered against the points below:</p> <ul style="list-style-type: none"> ■ The lump sum taken would be subject to a tax charge of, at present, 35%. ■ As with an annuity, the income they get may be subject to income tax depending on their circumstances. ■ The income they get from the annuity may be subject to income tax depending on their circumstances.
<p>You could reduce the amount of income tax you pay by adjusting the timing of your payments.</p>	<p>Not normally possible for basic-rate taxpayers. This is mainly of benefit to the higher-rate taxpayer.</p>
<p>While you receive the income, you gain the flexibility to vary income and the ability to control where the funds are invested.</p>	<p>You may have to monitor your fund more closely and make decisions or take advice more regularly.</p>
<p>You are able to transfer your plan to another provider and continue income withdrawal.</p>	<ul style="list-style-type: none"> ■ There may be charges for making this transfer. ■ There will be conditions that need to be met before and after transfer. ■ Not all providers accept transfers.
<p>Your fund remains invested.</p>	<p>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 an annuity.</p>
<p>Some of the advantages and disadvantages may not apply to you – it all depends on your personal circumstances.</p>	

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 7.

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 5 years' time, 10 years' time and so on?
- How much do I have in my pension fund?
- How much lump sum do I need?
- 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?
- 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 of the following:

- that your adviser is knowledgeable in this area;
- that the adviser understands your financial and personal circumstances, and knows what your requirements in the future 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 is to 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.

You should be given information to take away and read about the product, and should also receive a personal quotation. This quotation may include details of the **critical yield**, which tells you either:

- 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; or
- how much your pension fund needs to grow in the next three years to keep up the level of income you have chosen.

Remember that, in general, the higher the critical yield, 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;
- 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;
- decide whether it is time to buy your annuity.

When you set up your plan, you should discuss with your adviser how they expect to be paid for these annual reviews. Your adviser may be taking 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 not spot that things are not going as well as you had expected. 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 care!

Is income withdrawal the right choice for you?

Check your answers to the questions below:

Is your pension fund currently more than £100,000, after taking out any tax-free cash you are entitled to, or do you have other income so that you don't entirely have to rely on money from your income withdrawal plan?	Yes/No
Are you able to delay buying an annuity until it makes financial sense for you? This must be before you reach the age of 75.	Yes/No
Do you understand how income withdrawal works and why it is suitable for you?	Yes/No
Do you accept the risk that your pension fund and income may go down in value?	Yes/No
Are you happy to keep a very close eye on how it is going? This will include checking it again once a year, and continuing to make investment decisions in the future.	Yes/No
Are you happy to continue to seek financial advice on a regular basis? You will have to pay for this.	Yes/No
Do you really need to take an income from your pension fund now? Or do you have other less tax-efficient investments that could provide you with an income instead of using your pension fund?	Yes/No
Do you want to leave your heirs the bulk of your pension fund (though a tax charge would be liable)? As well as income withdrawal, there may be other options. Speak to your financial adviser.	Yes/No

As this is a difficult decision, even if you answered yes to most of the questions you may want to consider seeking financial advice.

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

Some technical terms you may come across

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 annuities and income withdrawal .
Annuitant	The person who is receiving annuity payments.
Commission	The payment that a financial adviser gets from an insurance company for arranging your plan. This amount is deducted from your investment. Alternatively, your adviser may work on a fee basis.
Critical yield	For income withdrawal plans, this is how much your 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'.
GAD	The Government Actuary's Department – responsible for setting some of the rules for pensions and life assurance products.
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. Annuities are able to guarantee all annuitants 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	By delaying buying an annuity, you lose the mortality cross-subsidy generated by those who die before you buy an annuity. To compensate for this, your investments need to grow by an additional 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 be invested.
Tax-free cash or tax-free lump sum	The Inland Revenue allows 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 other types of pension plan.
Triennial review	A review every three years – this is how often the scheme administrator looks at the maximum and minimum amounts you can withdraw from your income withdrawal plan each year.

Useful FSA publications

- **FSA guide to financial advice**
- **FSA guide to annuities and income withdrawal**
- **FSA Factsheet: Retiring soon – what you need to do**

Useful contacts

For free FSA publications and general information

FSA Consumer Helpline
Tel: 0845 606 1234
Web: www.fsa.gov.uk/consumer

For pension enquiries

Pensions Advisory Service (OPAS)
Tel: 0845 601 2923
Web: www.opas.org.uk

OPAS is an independent organisation providing help on pension and annuity queries.

Financial advice

IFA Promotions
Tel: 0800 085 3250
Web: www.unbiased.co.uk

Can provide a list of three independent financial advisers in your local area.

Society of Financial Advisers
Tel: 020 7417 4442
Web: www.sofa.org

To trace old pensions

The Pension Schemes Registry
Tel: 0191 225 6316
Web:
www.opra.gov.uk/registry/regmenu.shtml



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We also produce a range of user-friendly factsheets and booklets available from our website, helpline and offices.

If, after reading this factsheet, you have further questions, please call us on 0845 606 1234 and we'll try to help. But remember that, as the regulator, we can't recommend firms or advisers or tell you whether a particular investment is right for you.

FSA Consumer Helpline:

0845 606 1234

(calls charged at local rates)

FSA Consumer fax:

020 7676 9713

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Financial Services Authority

25 The North Colonnade

Canary Wharf

London E14 5HS

