INCOME DRAWDOWN

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The Continuing Evolution of Drawdown Advice

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Four years ago I had the pleasure of working with Paradigm to author an e-Book considering Drawdown advice considerations and client issues.

As you will recall this was just after the Covid period which had been a reset moment for many clients as they re-evaluated their financial plans. The impact of a market downturn and continued investment volatility at that time created an environment that many clients (and advisers) had not experienced before. My article was designed to consider some of the challenges client's faced, potential advice strategies to be considered and the regulatory backdrop at this time.

So that was then – what about now?

Now does feel like the ideal opportunity to bring this article up to date (March 2025) to reflect on events we have experienced over the last 4 years and how drawdown advice has continued to evolve to meet the needs, objectives and aspirations of advised clients.

This article aims to remind you of some of the key planning issues for drawdown advice. Because the focus is on clients in drawdown I will not be commenting in detail on non-drawdown solutions like annuity purchase for example, although this will naturally be part of your overall consideration and recommendation to a client.

I won't be going into all the technical detail on the topics included, but rest assured, we have full technical support available if you would like more in depth information. Alternatively please get in touch with your usual M&G contact if you would like to discuss this further.

What's been happening lately?

Over the past four years, a lot has happened that's changed how we think about pension drawdown advice. Policymakers and financial advisers have had to adapt to these changes, shaping how we plan for retirement. Here's a look at some of the key events and what they mean for pension drawdown advice:

Economic ups and downs

The financial markets have been on a rollercoaster ride in the past few years. This volatility comes from various things like the global pandemic, political tensions, and changes in monetary policy. Because of this, advisers have had to rethink their strategies, focusing more on flexibility and staying nimble with pension drawdowns.

COVID-19 pandemic

The COVID-19 pandemic hit the global economy hard. The market crash in early 2020 led to big losses in pension funds, forcing a re-evaluation of drawdown rates and investment strategies. Advisers are now considering the long-term impacts of the pandemic, such as changing life expectancy and work patterns, which affect retirement planning.

Political tensions

Events like Brexit and ongoing trade disputes have added to market instability. These issues have created uncertainty, impacting currency values and global trade. Pension drawdown advice has had to adapt, in many ways now focusing on protecting assets against political risks and currency fluctuations.

Monetary policy changes

Central banks have been adjusting their policies to match economic conditions, causing interest rates to fluctuate. These changes affect the returns on pension investments, so Advisers have had to navigate these shifts to keep clients' pensions sustainable despite varying interest rates.

Taxation rule changes

Adjustments to taxation rules have impacted pension drawdown strategies. Changes in tax relief and annual allowances mean advisers have to update their approaches, balancing tax efficiency with sustainable withdrawal rates:

- The Lifetime Allowance (which had been with us since 2006!) was removed to be replaced with the Lump Sum Allowance and Lump Sum and Death Benefit Allowance.
- In addition to this the Chancellor has announced the intention to bring unspent pensions in to the reckoning for IHT from April 2027. This is likely to invoke strong emotions in clients as they seek to understand how this will affect their legacy planning.
- On the horizon we also have the Chancellor's Mansion House Speech (expected July 2025) which is likely to include an update to the Mansion House Compact around investing in UK productive assets as well as progress with the ongoing Pension Investment Review which may both have further impact on the at retirement market.

Major FCA policy interventions

There has been plenty from the Regulator that has kept you busy over the last few years. We had Finalised Guidance on the Consumer Duty in July 2022 and the Retirement Income Advice Thematic Review in March 2024 – both of which would have had significant impact on your advice process.

Technological advances

Advancements in technology have transformed how financial advice is given, with new tools and platforms offering better ways to manage pension drawdowns.

Changing behaviours

Client behaviour has also influenced pension drawdown advice. As retirees' preferences and expectations evolve, advisers must adapt their strategies accordingly.

Many retirees now want flexible drawdown options that allow for adjustments based on changing circumstances. Advisers have had to create more adaptable strategies to meet these desires for flexibility in retirement plans.

There's been a growing interest in sustainable and ethical investing among retirees. This trend has led advisers to include environmental, social, and governance (ESG) factors in their drawdown strategies, aligning investment choices with clients' values.

Conclusion

The past four years have brought many events that significantly impacted pension drawdown advice. Economic ups and downs, new laws, technological advances, and changing client behaviours have all played crucial roles. Financial advisers have had to continuously adapt to ensure retirees receive sound, sustainable, and personalised drawdown advice. As things keep changing, staying informed and responsive will be key to effective retirement planning.

What advised clients want in pension drawdown – and how advisers can help

The first thing to remember is all clients are unique and there is no 'one size fits all' solution.

Having said that, I am reminded that many clients have a relatively simple request for their retirement pot: 'Please may I have the largest income this fund can provide and that it lasts for as long as I need it!'

This is where the challenge arises. In the world of defined contribution pensions, investment risk sits with the client. In order to help your client better understand these risks you will need to make assumptions about the future (rate of return, inflation, longevity etc, etc). The one certainty about these assumptions is that they won't be borne out in practice, so perhaps the name of the game is 'closest to the truth' assumptions. In other words; why do I think any assumption I use is more likely to deliver the required outcome and on what evidence is that based. In essence, an evidence based retirement strategy. Within the Thematic Review and associated papers the Regulator suggested, amongst other things, that assumptions should be based on a 'reasoned and reasonable' basis and be forward looking in nature. It would be prudent to ensure this methodology is baked into your process and evidenced through your due diligence of product provider/fund manager etc.

Figuring Out What Clients Really Need

Pension drawdown is a big deal in retirement planning, and clients have some specific wants and needs when it comes to managing their pension money. Knowing what they want helps advisers give better services and make sure clients feel secure about their finances during retirement.

Flexibility

The top thing clients want is flexibility in their pension drawdown plans. They want to tweak their income levels based on what's happening in their lives, whether it's changing living costs, healthcare expenses, or lifestyle choices. This flexibility makes them feel more in control and ready for whatever comes up.

Income Stability

Clients also worry about having a steady income. They want to know their pension drawdown will give them a reliable income stream throughout their retirement. A stable income helps them plan better and cuts down on financial stress.

Growth Potential

Even in retirement, clients are looking for ways to grow their remaining pension funds through investments. This growth potential helps make sure their funds last longer and adds extra financial safety as they get older.

Tax Efficiency

Nobody likes paying more taxes than they have to, so tax efficiency is a big deal for clients in pension drawdown. They want strategies that lower the tax hit when pulling money from their pension. Advisers need to give clear advice on how to optimise their drawdown plans to minimise taxes and maximise their take-home income.

Transparency

Clients want to know exactly what they're paying for. Transparency in fees and charges is key. They don't want any hidden costs eating into their savings. Clear communication about all costs involved builds trust and confidence in their advisers.

Personalised Advice

Clients appreciate advice that's tailored to their unique financial situations, goals, and risk tolerance. They want recommendations and strategies that fit their specific needs. Personalised advice makes them feel more confident about their retirement planning.

Regular Reviews

Clients want their pension drawdown plans reviewed regularly. They need ongoing support and updates from their advisers to make sure their plans stay in line with their needs and market changes. Regular reviews help them stay on track with their financial goals and make necessary adjustments.

Security and Peace of Mind

At the end of the day, clients want security and peace of mind in their pension drawdown plans. They need to feel confident that their retirement savings will cover their needs throughout their retirement. Advisers play a big role in providing this reassurance through solid planning, clear communication, and ongoing support.

By understanding these wants, advisers can create pension drawdown plans that meet their clients' needs, giving them the financial security and peace of mind they're looking for in retirement.

Regulatory Context

The FCA has highlighted the risk of running out of money in defined contribution drawdown. Important areas previously highlighted by the FCA for clients in drawdown include questions such as:

- How has the level of income the client is taking been justified?
- Is this income sustainable and how is this quantified?
- What measure of stress testing has been used and why?

The FCA thematic review and retirement income advice assessment tool guidance emphasise the importance of:

- Justifying the level of income taken by the client.
- Quantifying the sustainability of the income.
- Stress testing measures used to ensure the client's financial stability.

Given the continuing investment challenges in the world today, it is crucial to consider how clients are treated during periods of uncertainty. Ensure the file demonstrates that these have been considered and understood by your client, particularly income sustainability and the concept of managing future risk in uncertain times.

What the Regulator says about 'process'

To put it simply, they've said a lot!

Paradigm has significant resource available to help in this regard so I don't propose to repeat it all here. The Thematic Review, and in particular the Retirement Income Advice Assessment Tool (RIAAT), has been very informative in setting out the Regulator's requirements and expectations. Both are required reading for any practitioner in the at retirement market.

Within the RIAAT tool the Regulator considered in some detail how an income may be delivered to a client and distinguished between withdrawal types and withdrawal strategy which is worth reflecting on how this is delivered within your own process. Some of this detail I have included below.

Withdrawal considerations

This considers whether the recommended withdrawal strategy is likely to be suitable for the client's investment objectives for their retirement savings. A withdrawal strategy is not the same as a withdrawal type:

- The withdrawal type is the method(s) by which the client withdraws funds from their retirement savings.
- The withdrawal strategy is the overall strategy that a firm puts in place to manage the client's withdrawals over their lifetime or investment horizon (if sooner). A withdrawal strategy may include multiple different withdrawal types from the client's retirement savings.

For example, a sustainable withdrawal rate strategy is likely to fluctuate overtime and need both monitoring and ongoing reviews. Whether or not such a strategy is suitable will depend on the client's objectives and needs etc.

Withdrawal type

Within the RIAAT guide the following withdrawal types were detailed, none of which would be a surprise to a financial planner:

- Flexi-access drawdown (with all its variants: PCLS and taxable withdrawals, full/partial PCLS only, taxable withdrawals only);
- Phased/Partial flexi-access drawdown (part of pot, not entire fund);
- UFPLS (regular payments, monthly or less frequently);
- UFPLS (part of pot, not entire fund);
- Full encashment and small pots e.g. paid under the small lump sum regime.
- Fixed term annuity (full or partial pot)
- Pension annuity purchase (full/partial pot)

As we know, pension legislation can be quite complex, so I'll remind you of some of the technicalities to consider for some of the different withdrawal types that I've just covered

Drawdown for clients is a generic term. So we need to be mindful of the type of plan the client has. Specific approaches include capped drawdown, flexi-access drawdown, uncrystallised fund pension lump sum (UFPLS) and optional short-term or fixed term annuities. The most appropriate method will depend on whether your client's scheme was in place before 6 April 2015, and their particular aims and objectives.

Capped drawdown

I'll start by looking at capped drawdown. I'm not going to cover all of the technical issues, but rather think about and remind you of the key aspects that may affect the outcome for your client.

Post 6 April 2015 capped drawdown is no longer available for new arrangements.

If on 5 April 2015 a capped drawdown fund was already in place, this arrangement can be retained. So under that arrangement, if the scheme allows, new funds can be designated to the existing capped arrangement and income can be drawn under this arrangement as per capped drawdown rules, or the existing capped drawdown arrangement can be converted into a flexi-access drawdown.

The key point to consider is that staying within the capped limits for income will not trigger the Money Purchase Annual Allowance (MPAA).

If the maximum capped drawdown amount is exceeded, the capped drawdown fund will automatically be converted to a flexi-access drawdown fund and as such future defined contribution pension contributions will be liable to the MPAA.

For clients under 75 the income cap is calculated every 3 years under the reference period rules.

Flexi-access drawdown

Flexi-access drawdown pension replaced flexible drawdown on 6 April 2015 and I'm sure you are all very familiar with it.

It can provide great flexibility in terms of how the income is taken but of course where an income is being drawn, this is a trigger event for the money purchase annual allowance.

Short term annuities

If the client wanted to secure some income, then annuities clearly have a role to play. If this was being done on a temporary basis then the use of short term annuities may be appropriate as they can be used in combination with both flexi-access and capped drawdown, so it makes sense to cover them here.

Instead of drawing an income directly from the drawdown funds, drawdown funds can be used to purchase a short-term annuity to provide the required level of income.

Short-term annuities can be purchased from an insurance company and the term can't exceed a maximum of five years, and pays a set amount over the set period. However, once a short-term annuity has been purchased the income amount can't normally be changed.

So the point to note is that if arranged in connection with a capped drawdown case, the total amount of income payable from short-term annuities and drawdown mustn't exceed the maximum income defined by GAD.

As covered earlier a review must take place every three years and a short-term annuity may last for a maximum of five years, so there can be an issue if the maximum drawdown reduces in the middle of the term of the short-term annuity and any excess income would be an unauthorised payment and force the plan to be switched into a flexi access arrangement and once again trigger the MPAA.

Uncrystallised fund pension lump sum

Utilising uncrystallised fund pension lump sum is another method to take an income from the pension and was introduced to give greater flexibility in retirement benefit choice to clients. The key point again to remember is that using this method is also a trigger event for MPAA.

Withdrawal Strategies

Turning to withdrawal strategies, the point was made that several different strategies may be used at different points in the retirement journey. A further summary of the principle strategies was provided in the RIAAT guide (not an exhaustive list). Again none of these strategies will be alien to you, the point to consider is how the strategy is supported and evidenced within your process.

Sustainable withdrawal rate strategy

This aims to set a fixed level of withdrawals (possibly subject to adjustment for inflation) to enable the client to make withdrawals from their pension every year over the course of their retirement, or over a set period of time, without running out of money. It is based on the assumption that a client should only withdraw a relatively small percentage of their pension portfolio every year. Care should be taken to evidence what is reasonable and justifiable based on client's position.

Natural income or natural yield strategy

This involves the client holding income-generating assets and living off the income or dividends produced. In theory this should preserve the capital invested in the assets (at least in the sense that the client is not withdrawing capital; the capital value may still fluctuate). So long as the income produced meets the client's needs and objectives, fluctuations in the capital value are less important. This assumes the client has the required risk tolerance to "ride out" these capital fluctuations. Consideration also needs to be given to the impact of ongoing costs on this strategy and whether they reduce the level of income provided, or reduce the capital.

Multiple pots strategy

Involves a client investing money in a variety of assets to manage long-term investment risk. For example, the client may invest 10% of their retirement savings in cash or cash-like assets to cover 2 years of income, with the remainder invested in longer-term growth assets (e.g. bonds, equities, property, etc). These strategies may involve more than two investment 'pots'. The point is to manage risk, so that the client does not have to withdraw from equities to fund income at a point when equity markets are low. By holding a buffer of cash assets, the client can withdraw from these instead of equities and wait for the markets to pick up again.

Bridging strategy

Whereby a client takes short-term withdrawals from their retirement savings to 'bridge' until a later date when another income becomes payable – typically this is a secured income when the client becomes eligible to receive their state pension, or when a DB pension becomes payable.

Withdrawal minimisation strategy

Is designed to ensure that the client preserves the value of their pension for an aim unrelated to provision of an income. For example, some clients' objective is to pass on the maximum possible inheritance. In such circumstances, the client's assets are likely to be invested in a way that maximises growth over the long term.

Fixed term annuity strategy

This relies on drawdown products that pay a fixed level of income for a fixed period of time. It should be noted that technically this is a drawdown arrangement and not an annuity product. There are many different products available in this space which may return some or all of the capital at the end of the term, provide guarantees and provide death benefits. Once the fixed term annuity has ended, the client has the option to purchase another fixed term annuity, purchase a pension annuity or withdraw assets via drawdown.

Ad hoc withdrawals only strategy

This is designed for clients who wish to access their retirement savings on an ad hoc basis. In this case, the pension scheme will typically not be needed for income. Investment strategies may vary. Some investment may be in assets for long term growth. Cash or cash like assets may also be held for short term, ad hoc withdrawals.

Applying the type and strategy to your process

The reason I have included this detail from the RIAAT tool is that the whole theme from the Thematic Review is ensuring all risks relevant to any particular type or strategy are considered, explained and where appropriate, managed. So you may wish to consider your process and the due diligence that supports this as an Evidence Based Income Strategy.

You can review the tool for the Regulator's view of the detailed steps you should take, but as a flavour here's their view on the key points to identify and consider for a sustainable withdrawal rate strategy (each strategy has its own set of further steps to identify and consider):

- the recommended withdrawal rate
- the allocation of recommended investments
- how long the client requires their retirement savings to last
- the client's attitude to risk
- the client's knowledge and experience in relation to this type of investment and the impact it will have
- how the firm has mitigated the risks associated with this strategy, including sequencing risk, inflation risk, and longevity risk
- the impact of costs and charges
- the client's willingness and ability to change the level of their withdrawals depending on the performance of their investments.

Technical Considerations and Planning Issues

Having discussed the structural side of taking an income, I would now like to consider some of the planning issues associated with pensions and drawdown. In simple terms, can I draw down from a pension and then reinvest into a pension?

Pension Recycling

Pension recycling is where a pension commencement lump sum (PCLS), or flexible pension income, is recycled back into a pension as a tax relievable contribution.

There is legislation is in place to ensure the system that provides tax relief on pension contributions is not abused, so we have PCLS recycling rules and the Money Purchase Annual Allowance to be mindful of.

PCLS recycling

There are various conditions that need to be met for PCLS recycling to apply. If one of the conditions can be discounted PCLS recycling rules don't apply.

If a contribution is classed as PCLS recycling the PCLS will be treated as an unauthorised payment and charged accordingly. This would be a minimum of 40% and possibly up to a maximum of 70%, so clearly a thorough understanding of the rules is very important.

These lump sum recycling rules consist of six conditions; all conditions must be met for a tax charge to apply. So provided I can discount at least one of these rules then I know that the PCLS recycling charge will not apply.

The six conditions are:

1. **the individual receives a pension commencement lump sum**
2. **because of the lump sum, the amount of contributions paid in respect of the individual is significantly greater than it otherwise would be**
3. **the additional contributions are made by the individual or by someone else, such as an employer**
4. **the recycling was pre-planned**
5. **the amount of the pension commencement lump sum, added to any other PCLS received in the previous 12 month period, exceeds:**
   - **£7,500 for events on or after 6 April 2015, or**
   - **1% of the standard lifetime allowance for events before 6 April 2015**
6. **the cumulative amount of the additional contributions exceeds 30% of the pension commencement lump sum.**

Income recycling

Turning now to income recycling, why may this be appropriate for my client? (Mindful if it's from a flexi-access drawdown or UFPLS the MPAA rules will apply).

It is generally accepted that unvested benefits are 'better' than vested benefits due to the availability of tax free cash and potentially small pots planning.

In terms of how it works, contributions are made on a 'gross to gross' basis so the gross pension contribution is made equal to the gross income amount. This is tax neutral as the marginal rate tax on the income is offset by the marginal rate relief on the pension contribution. Clearly there can be a real benefit here if a non-taxpayer is drawing benefits as the maximum contribution of £3,600 can attract tax relief, but there is no tax to pay on the pension.

As with all planning the current and future tax position of the member should be factored, as the key position for recycling should be that this makes the client richer than if they left the money crystallised.

Pensions and IHT

At the time of writing this (March 2025) we understand the policy intent: pensions should not be used as an intergenerational wealth transfer vehicle. Unused pension funds and death benefits payable from a pension are to be included in the value of estates from 6th April 2027.

What we don't yet have is the detail of how this will be implemented.

For clients who viewed their pension as a legacy asset this has become an emotive issue and they may consider drawing on their pension more quickly and perhaps more deeply. In the absence of even draft legislation I would not wish to speculate on specific strategies clients may consider, other than remind you of existing strategies that may be appropriate to contemplate; namely third party pension contributions and, for IHT purposes, normal expenditure out of income exemption.

Third party pension contributions

As we know pension death benefits for those who die after the age of 75 may suffer income tax in the hands of the beneficiaries (and IHT if death occurs after April 2027), so a strategy that removes some or all of this potential tax with appropriate pre death planning may be very useful.

For some clients the conversation around pre death wealth transfer may be very relevant as part of their overall strategy and also very tax efficient, and this is where third party contributions may have a role to play.

As we know, for third party contributions, tax relief is given to the recipient of the contribution not the donor. There is the de-minimus contribution of £3600 for tax relief, but this can be much higher if the recipient has sufficient net relevant earnings, so in effect up to the standard annual allowance, and the tax efficiency can be very high for the family as a whole. Of course if the recipient was a very high earner then you would also need to consider the impact of the tapered annual allowance rules.

Considered the overall tax efficiency on the contribution where the donor is using the annual IHT exemption of £3,000.

This contribution is paid into another person's pension and receives 20% tax relief at source. If the recipient is a higher rate taxpayer they are able to claim back higher rate tax relief via their tax return, thereby creating wealth to that individual.

And the overall effect is that for the contribution in this instance the 'family' gets 90% relief on the contribution (being the sum of IHT tax saved, pension relief at source tax relief and higher rate tax reclaim). Naturally the income tax position of the donor will also need to be factored in to determine the overall tax efficiency.

Of course higher contributions could be made and still be IHT exempt under the gifts made as part of normal expenditure out of income rules.

Normal expenditure out of income exemption

Section 21 of the Inheritance Tax Act 1984 deals with the normal expenditure out of income exemption. It is an extremely important exemption for IHT planners.

For the exemption to apply, it must be shown that a transfer of value meets three conditions:

- It formed part of the transferor's normal expenditure
- It was made out of income (taking one year with another), and
- It left the transferor with enough income to maintain his/her normal standard of living.

So will pensions count as income for the normal expenditure out of income exemption?

In a word, yes. Although we have never seen categoric confirmation on the HMRC website, contemporaneous evidence tells us that pensions, whether tax free or taxable, PCLS or UFPLS, all count as income for the exemption.

The other point to be aware of is that HMRC expect the normal expenditure to be at least 3 or 4 years to show an established pattern for the exemption.

Another key time period is 2 years. Broadly speaking income does not stay income forever and will become capital if it just sits in your estate, as a rough rule of thumb HMRC state income becomes capital after two years. In the context of gifting pensions this means the pension withdrawal needs to be phased and gifted regularly not taken as a lump sum and then gifted regularly.

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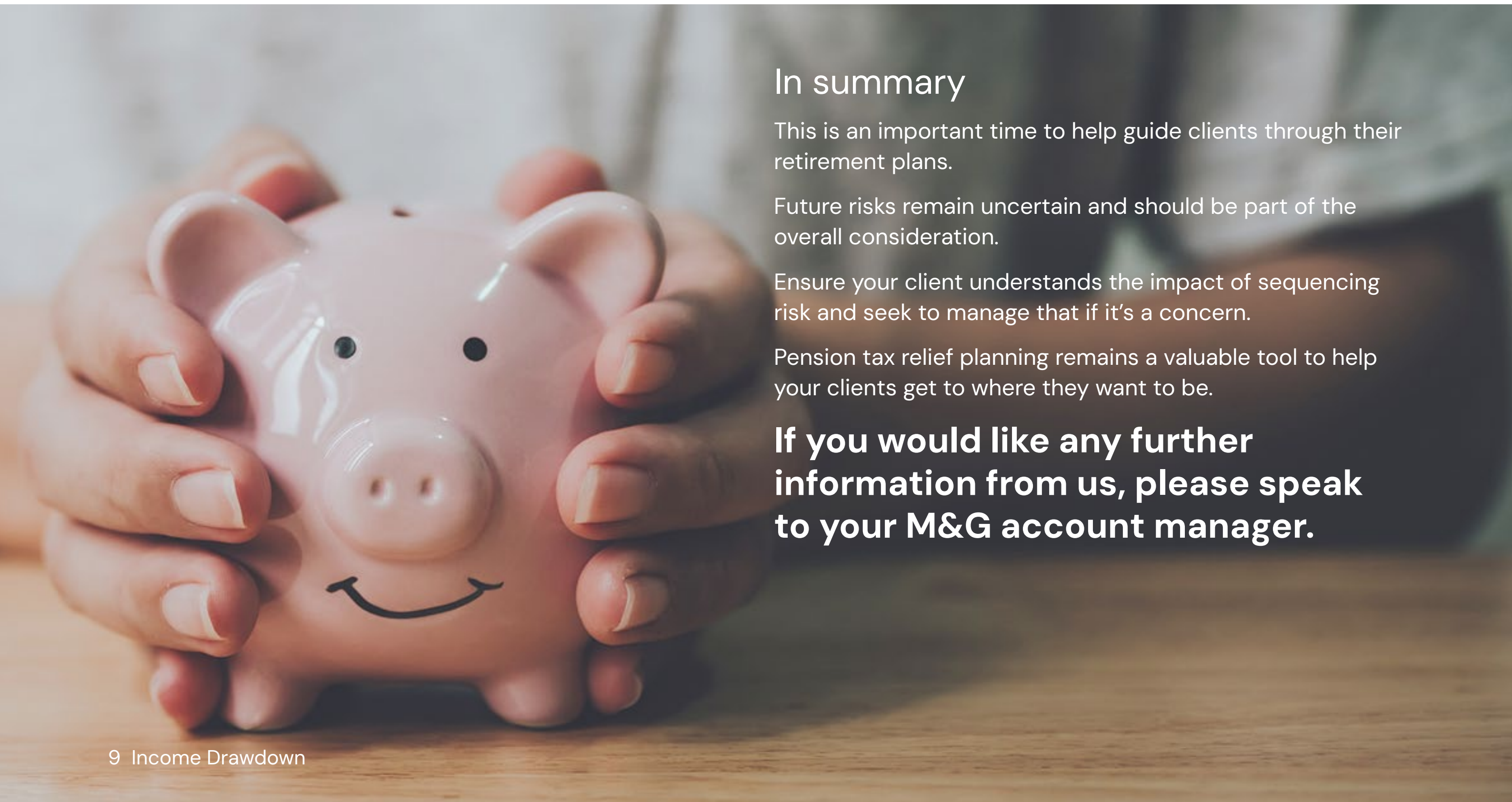

In summary

This is an important time to help guide clients through their retirement plans.

Future risks remain uncertain and should be part of the overall consideration.

Ensure your client understands the impact of sequencing risk and seek to manage that if it's a concern.

Pension tax relief planning remains a valuable tool to help your clients get to where they want to be.

If you would like any further information from us, please speak to your M&G account manager.