Summary
- Drawdown product purchases have outstripped annuities by two to one since the pension freedoms were launched.
- Thirty per cent of users have bought a drawdown product without advice.
- Drawdown users run the risk of running out of money due to poor investment decisions, high fees and unnecessarily accessing their 25 per cent tax-free lump sums early.
- Drawdown users also need to become more aware of the tax implications of withdrawing large sums and moving them into other investment vehicles or bank accounts.

Hazards of the highway

Flexi-access drawdown was heralded by its government engineers as a route that allows people to spend their own money how they see fit. But are drawdown customers fully aware of the risks they may be taking with their savings?

Since the expansion of the retirement financial planning highway in 2015, savers have been veered towards one particular lane.

Figures from the Association of British Insurers (ABI) have shown that £6.1 billion was invested into drawdown products just a year after they were introduced. To help absorb the figure, a total of 90,700 new drawdown products were released into the market at the same time. The attraction shows no signs of letting up either. In April this year the ABI revealed that £1.67 billion was invested in 22,000 income drawdown products in the third quarter of 2016. The average fund size was just over £76,000.

This has translated into demand for flexi-access drawdown outstripping annuities by two to one, as stated in the FCA's *Retirement Outcomes Review,* which came out in July.

But popularity has come with a price. The FCA says that before the freedoms, 5 per cent of drawdown was bought without advice, compared to 30 per cent now. This has exposed many drawdown users to the dangers of a bumpy ride in retirement. In some circumstances, it may even end up with them having to get out of the proverbial car and trudging along the state pension hard shoulder.

"More people don't want to pay for advice, they believe they can make the decision all for free and they're DIY-ing it," says Broadstone's corporate benefits director Brett Smith.

"But most people going into drawdown don't understand how complex it can be.

"People just haven't been given the tools to make those decisions themselves. I don't think people are currently ready necessarily to make such calls without having had more time to understand the concepts and decisions they're trying to make."

This lack of advice, coupled with pension freedoms, has accentuated four main risks on the drawdown road.

Running on empty

The clearest risk, says Ascot Lloyd's head of advice Jade Connolly, is running out of money.

"Investment returns not keeping pace with the amount that you're taking out of the pot has become more of an issue as we don't have caps anymore," she explains.

"People take out what they think is realistic with very little appreciation of what that might look like in 20 years' time."

Intelligent Pensions' technical director Fiona Tait says that the difficulty for many in this situation is that there is

little general advice available that shows how much they can afford to spend.

"We used to have GAD rates – which were quite generous – but at least they gave consumers a ball park figure. That just doesn't exist anymore; you can take the entire fund out."

Barnett Waddingham's self-invested technical specialist, James Jones-Tinsley, says that it was politically short sighted to not make capped drawdown available to new retirees from April 2015.

"Capped drawdown engenders discipline in income withdrawals by limiting what can be drawn during a drawdown year," he says.

"Instead, everyone going into drawdown from April 2015 is shepherded into the flexi-access version, with its unfettered access to money, a potential initial overpayment of income tax, and automatic imposition of the money purchase annual allowance, which restricts ongoing contributions to 10 per cent of the annual allowance at a stroke.

"The likelihood of retirees running out of money will only increase in the future, unless legislation is passed to prevent this."

A taxing drive

To date, there has been very little evidence of people cashing in their savings to buy Lamborghinis and subsequently getting hit by income tax.

Royal London's director of policy Steve Webb, who famously coined the Lamborghini quip as Pensions Minister to demonstrate the then-coalition government's commitment to personal financial responsibility, argues that HMRC has acted as a natural deterrent to frivolous expenditure.

'There is little evidence of people recklessly spending their pension pots, and it tends to be the smaller pots that are fully cashed in," says Webb.

"The fact that tax is charged on withdrawals and that large lump sum withdrawals can take people into higher tax brackets tends to act as a brake on excessive withdrawals."

Nevertheless, says Connolly, a lot of people have misunderstood the tax treatment of taking money out of a pension.

"Many people without advice are taking money to pay off a mortgage, or go on a large holiday, and they don't understand the tax implications. Particularly if they're still working or have other income coming in from elsewhere," she says.

"You pay income tax when you take it out if you're drawing a high sum. And if you don't spend it, invest it, or you die, then you're either paying capital gains tax and income tax on any growth that you get. Or you're paying inheritance tax."

In the view of many commentators, a significant proportion of savers are also too quick to access their 25 per cent tax-free lump sums.

Smith says that mistrust of the government features highly in people's rationale for withdrawing their 25 per cent as early as possible. Fearing that the government may close the option in the future, they act as soon as they can to withdraw their cash. Smith sees it as an emotional decision as opposed to a financial one. It is also, as Better Retirement's retirement director Billy Burrows highlights, probably the wrong one.

"Many people don't realise that if they leave their money in their pension, then as the pot increases in value they will be able to access more tax-free cash because it will be 25 per cent of a higher amount," says Burrows.

Investment risk

Portafina's managing director, Jamie Smith-Thompson, says that after excessive taxation and the potential of running out of money too soon, the next biggest risk in drawdown is a market crash that crystallises losses.

Long-time DC savers who move into drawdown may be comfortable with the fact that the investment risk remains with them as individuals rather than with an annuity provider, but they may still get caught out through complacency, says Jones-Tinsley.

"When coupled with the ability to draw down whatever level of income they wish, as opposed to the regularly-reviewable maximum amount inherent within capped drawdown, a potentially toxic mix of large withdrawals during periods of investment underperformance could result in the drawdown fund depleting rapidly," he says.

The wrong vehicle

According to the FCA's report, most consumers choose the path of least resistance when it comes to selecting a drawdown product and accept the option offered by their pension provider. And data from the ABI shows that 94 per cent of non-advised drawdown sales are made by companies to existing customers, while only 35 per cent of advised sales are made to existing customers.

This opens up the possibility of retirees driving down the drawdown lane in a gas-guzzling SUV when all they really need is compact three-door city ride. Research from LV= has found that people could lose out on around £4,000 over the course of their retirement by sticking with their existing provider.

Burrows believes that the potential loss of income by getting the wrong drawdown product could be much higher than the income lost from not shopping around for the best annuity.

"Although it is difficult to compare annuities to drawdown because one is an insurance policy and the other an investment plan, we can say that if the charges for a £100,000 pot were reduced by 1 per cent, i.e. from 2 per cent to 1 per cent, then this amounts to £1,000 per annum," he says.

Equally, if inappropriate investments are chosen, which underperform by 1 per cent, then that can be enough to significantly reduce the amounts that can be withdrawn.

"A combination of high charges and poor investment returns produces a double whammy and will seriously reduce the value of the pension drawdown plan," adds Burrows.

Thankfully, as Standard Life's head of pensions strategy Jamie Jenkins underlines, a drawdown decision is not one that is made for life. Unlike an irreversible annuity purchase, with drawdown, retirees can change the amount they are withdrawing, switch their investments and move to a different provider as many times as they like.

"Shopping around remains important for drawdown, and can be revisited at any time – should someone see a better deal elsewhere."

Written by Marek Handzel, a freelance journalist