Avoiding pitfalls

Jonathan Watts-Lay explains how to help members avoid the pension pitfalls in 2021

2020 was certainly one of the most turbulent years on record and led to many more scheme members accessing their pension for the first time than perhaps would have in normal times.

The pandemic saw a surge in the over 55s withdrawing from their pension early as a way of alleviating pressure on household income. It was also attributed to many deciding to retire early due to being discouraged about finding employment again when faced with redundancy.

However, others have put their retirement plans on hold, with a poll by YouGov finding that 13 per cent of the over 55s are planning on delaying their retirement due to the crisis. This may be because of the effect of the stock market falls on pension wealth, and members therefore needing more time for their savings to recover.

Although the situation is likely to improve due to the roll out of a vaccine programme, it will take some time for the economy to recover and so further redundancies are likely and the pressures on household income will continue. This will no doubt lead to more scheme members accessing their pension early.

However, many members do not realise the significant risks surrounding pension withdrawals and without support, could be set to make costly mistakes in the year ahead. To help with this, Jonathan Watts-Lay has outlined some of the common pension pitfalls and what trustees can do to help.

Paying unnecessary tax

There are a number of important tax considerations that everyone should be aware of prior to taking money from their defined contribution (DC) pension. Firstly, up to 25 per cent of a pension pot can be received as tax-free cash, however any withdrawals beyond this are potentially taxable.

There can be a huge difference in the income tax due when withdrawals beyond the tax-free entitlement are received. For example, an individual who receives small amounts from a pension whilst receiving no other income may be able to ensure these withdrawals are within their personal allowance. This could mean they pay no tax at all on their pension withdrawals.

However, if they were to draw large sums from a pension, they may find they pay tax at 20 per cent, 40 per cent or possibly 45 per cent on these withdrawals. Members need to ensure if they are withdrawing money from their pension that they actually need all the money they are withdrawing, as merely taking money out to put in a bank account can be a costly transaction.

Underestimating how long retirement savings may need to last

Research has found that most people live longer than they expect, and so members could easily underestimate how long they think their savings will need to last. For example, The Institute for Fiscal Studies found that those in their 50s and 60s underestimate their chances of survival to age 75 by around 20 per cent, and to 85 by around 5-10 per cent. Men interviewed at age 65 believed they had just a 65 per cent chance of reaching age 75, but the official estimate is 83 per cent. Before accessing their pensions, members will need to think about if they will have enough money to last the duration of their retirement.

Falling for a scam

Pension scams is not a new issue and more than £30 million has been lost to fraudsters since 2017. However, unfortunately, scammers often see turbulent times like these as an opportunity.

Since the virus emerged, the Financial Conduct Authority and The Pensions Regulator (TPR) have issued comprehensive guidance on what employers and trustees should be doing to help deal with the increasing risk of scams and are expecting them to step up to the task.

TPR has advised trustees to urge members 'not to rush decisions and provide them with clear, relevant and timely information so they can make informed decisions'. They also instruct trustees to follow the Pension Scams Industry Group (PSIG) code of good practice – Combating Pension Scams, which is based on three key principles which include; raising awareness of pension scams for members and beneficiaries; having robust processes for assessing whether a scheme may be operating as part of a scam; and being aware of the known current scam strategies.

DB pension transfers

According to a pensions consultancy firm, some schemes are seeing an increase in defined benefit (DB) transfer requests in the wake of Covid-19. However, members need to realise that there are many things to consider before deciding on a DB transfer, such as if it is really in their best interest and that they understand any associated risks including paying too much tax and managing income throughout retirement. DB transfers are also a target for fraudsters and almost two-thirds (64 per cent) of them showed at least one sign of being a potential scam in November according to XPS Pensions Group.

Although regulated financial advice must be sought for DB pension transfers valued at £30,000 or above, the FCA has warned that pension transfer advice is often substandard. Rather than leaving individuals to go it alone when sourcing DB transfer advisers, many trustees are now facilitating member access to reputable advisory firms that have appropriate qualifications, an exemplary regulatory record and transparent and fair pricing.

Failing to consider all sources of income

Whilst some members may really need the cash now, any benefits to accessing a pension early should be weighed up with the potential drawbacks such as paying significant tax on the withdrawals and drawing money from investments whilst markets are depressed.

It is important that members consider all other options first such as using non-pension savings, cutting back on expenditure or taking debt payment holidays through the government-backed recently extended mortgage holiday and debt repayment deferrals, and weigh up the best option for them to get through this difficult period.

Unable to build pension funds back up

When someone draws money from their pension beyond their tax-free cash entitlement, in most cases a money purchase annual allowance is introduced. This means an annual limit of £4,000 will apply to all future pension contributions, instead of the usual £40,000. If contributions beyond this limit are made, a tax charge will be due. This could be particularly significant for members who are not yet retiring and continue working and contributing into their workplace pension scheme.

The effect of the money purchase annual allowance will typically mean that it would not be practical for an individual to repay money back into their pension once they have withdrawn it, so it could be difficult to build it back up.

What can trustees do?

Trustees are the first line of defence in protecting retirement funds and have a key role in ensuring members make informed choices. Providing financial education and guidance to members before they reach age 55 can help them understand their options and avoid the pension pitfalls. It can also help members to decide if they need further support such as regulated financial advice.

Trustees are currently under no legal obligation to provide access to regulated financial advice to its members and for a long time there has been a concern that it carries risk for the trustee. However, a discussion paper from Eversheds Sutherland and Royal London suggests that this theory only looks at 'the risk of doing something and not at the risk of doing nothing'.

It highlights that simply referring members to a list of advisers for them to choose from can lead to significantly poor member outcomes and therefore member distrust. In some cases, this can result in reputational damage as seen with British Steel.

If done correctly, facilitating access to regulated financial advice does not carry the risk that many presume. However, there are several tasks that trustees can carry out to make the process far more thorough and robust. This includes checking whether the firm is regulated, researching experience, reviewing compliance processes and checking pricing structures.

Trustees can then feel confident that the responsibility for the regulated financial advice given to members, and the consequences of that, rest with the chosen provider and not the trustee.

Ultimately, ensuring robust processes and providing members with access to appropriate support before they access their pensions, will lead to better outcomes for all.

Written by Wealth at Work director, Jonathan Watts-Lay