Former pensions minister Steve Webb reveals how you can avoid going broke in retirement

Exactly how much you have to save, how to pay as little tax as possible when you take your money out and why our state pension is among the lowest in Europe

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Steve Webb explains everything you need to know about pensions (Steve Webb)

Steve Webb may be the person to thank for having a pension, as, during his time in charge of retirement savings for the country, he rolled out auto-enrolment. This is where an employer has to open a pension for an employee, and contribute to it. Webb was the pensions minister from 2010 to 2015 and is now a partner with pensions consultants LCP. Here he explains

everything you need to know about saving for our retirement: how do you access your money when you retire while paying as little tax as possible? How good are civil servants' pensions? And how does our state pension compare with other countries? (Spoiler alert: very badly).

How much do I need to save into my pension?

A simple rule of thumb is that for every £1 a week income you require in retirement, you need £1,000 in your pension. This means that, if you want £200 a week income, you need a £200,000 pot.

Now, £200,000 sounds horrifically scary – but remember, if you're doing this through a workplace pension, you only have to save half of that. The other half comes from your employer and tax relief. You therefore only have to save £100,000. And if you have 40 years of working life to go, you need to save £2,500 a year, even ignoring the returns on your investment. Breaking it up this way makes it feel more achievable.

It used to be said that the percentage of your pay you save should be half of the age at which you start, but this isn't true if you save late, so there's no right answer. It depends what your target is and how much you have already saved – but 12-15 per cent, for most people, is the space you want to be in, and that includes the employer contribution. However, this is premised on starting in your 20s and not having a mortgage in retirement.

A moderate retirement – which gives you two weeks' holiday in Europe and a long weekend every year, as well as money to maintain your home and £800 to spend annually on clothes – costs around £23,000 if you are single, and £34,000 if you are a couple (these figures assume you have paid off your mortgage). As the state pension is likely to stay around £10,000, this means you need an extra £13,000 a year.

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How to access your pension when you are retired

Draw-down is when you take some money out of your pension but keep the rest invested, hopefully earning you more money. There are two main draw-down options. One is you take your tax-free cash – which is 25 per cent of your pension – and everything else is taxable at your usual rate (if you are a basic rate taxpayer you pay 20 per cent tax; a higher rate taxpayer pays 40 per cent; additional 45 per cent).

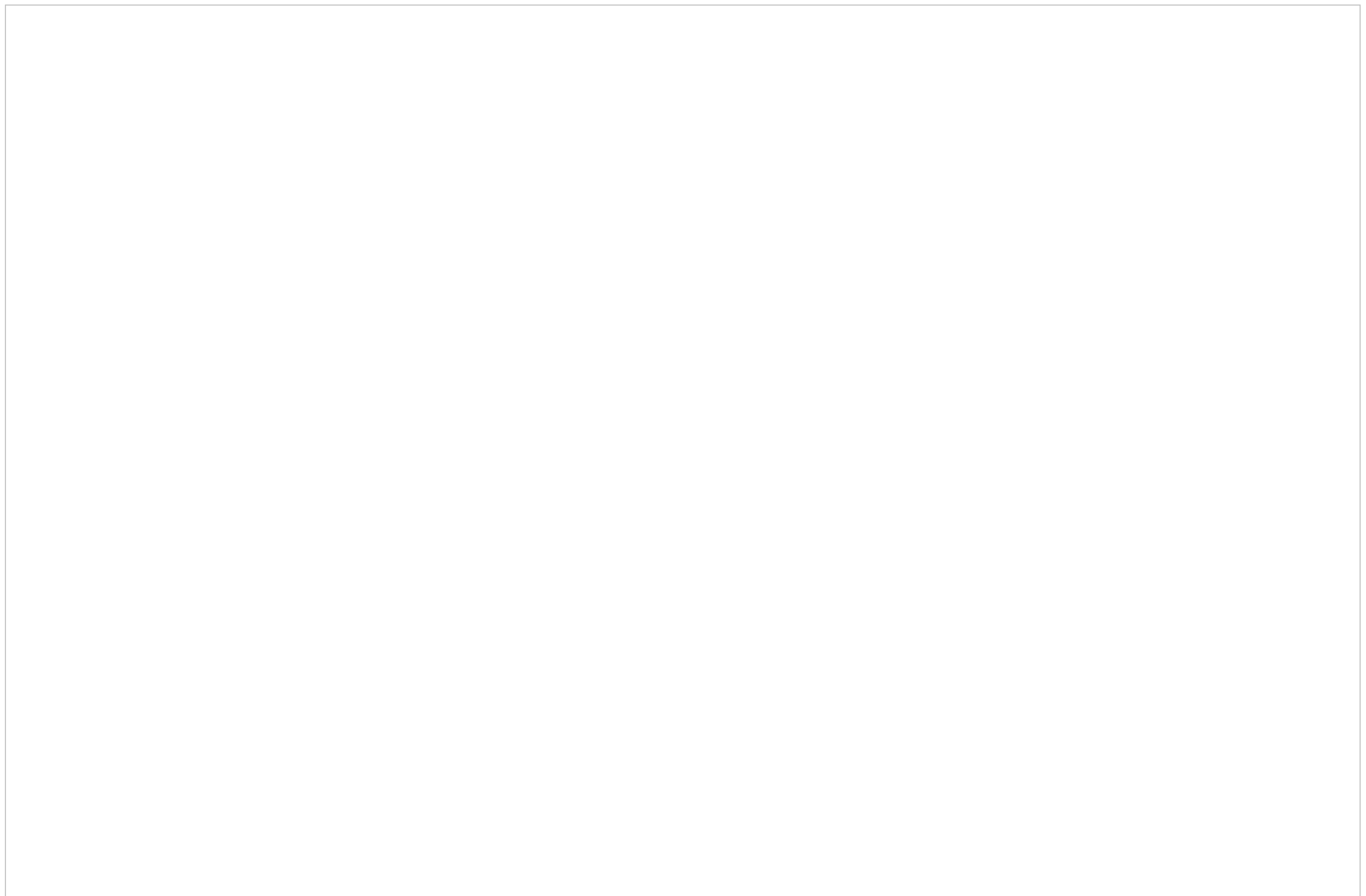
Or, you can get 25 per cent tax-free every time you take money out and then pay tax on the other 75 per cent. You might do that because you're going to keep it invested to grow your fund. So basically: do you take all the tax-free cash at the start, or do you take tax-free cash on every little chunk?

When you take your money out, your pension company becomes a bit like an

employer as they deduct the tax at source. Before they pay you the money, they get a tax code from HMRC. The first withdrawal is horrible, because the pension provider is told by HMRC to assume you may take lots of withdrawals in a year, which triggers an emergency rate of tax – but you will get a rebate. So the first time you draw down, you should anticipate a shock when you see how much you get back. You then either fill in one of three different forms to claw it back, or wait till the end of the tax year.

People who have small pots tend just to cash out and take the tax hit, but you have to be careful not to trigger a higher tax band. For example, if you want to take a £51,000 pot in one year (excluding tax-free cash), suddenly you will have to pay a 40 per cent rate of tax for example, whereas if you take £40,000 you will only pay 20 per cent. Essentially, the more gradually you take it, the less tax you'll pay.

But one thing you have to be careful of is the dreaded money purchase annual allowance. This allowance means that, as soon as you've started taking taxable cash out of your defined contribution pension, the amount you can save in a year tax-free goes down from £40,000 to £4,000. It's a bit of a niche issue, but the classic person impacted would be someone who is 57 who has been made redundant and raids their pension pot. This then triggers the money purchase annual allowance. They then get a new job with a decent pension and suddenly they can't save more than £4,000 – and that's including what their employers put into it – without paying lots of tax.



Steve Webb now works as a volunteer debt adviser (Photo by Matt Cardy/Getty)

How does our pension system compare to other countries?

You have to see the system as a whole, and it is designed on the assumption that you have a state pension and a workplace one. In terms of how much we receive in state pension versus other countries, it's very low – one of the lowest relative to wages in Europe.

And it's low because the assumption is that the state pension is only part of what you get. If you look at what pensioners actually live on, on average, they've got a significant chunk of money on top of the state pension – the average pensioner income is about the same as the average person working now.

So, the state pension income part is pretty terrible, but then people are given a lot of tax relief to build other income through their workplace pension. Then we created auto enrolment and made employers put money in too. So I

think that, for most people, the system works reasonably well.

But there are gaps. People who fall through the net include the self-employed, or people with erratic income. Lots of self-employed people haven’t got anything other than the state pension to rely on, and people who worked much of their career before auto-enrolment (which came in 10 years ago) may struggle. They are going to have to work longer, put more money in or retire poor.

What are defined benefit salaries?

Also known as final salary pensions, this is a type of workplace pension that will pay you a retirement income for life. The amount you will receive in retirement is calculated using your salary when you retire or your average salary. You will get this amount regardless of what the stock market is doing, and the risk is the company’s and not yours.

There are over seven million people building up defined benefit (DB) pensions – mainly public sector workers. Very few people in the private sector are getting a new one. The important thing to know with these pensions is that they are really valuable. If you’re a teacher or a nurse, and your union keeps telling you how badly you are being treated, you may have this perception that it’s hardly worth it. But what people don’t see is the money their employers are putting in. It may be that you are putting in 10 per cent, but your employer is putting 20 per cent on top.

So for a teacher or a nurse, there might be 30 per cent of salary their going in, including the employer’s contribution, while in the private sector the minimum is eight per cent. The employer contribution in the public sector is often at least double that of the private sector.

If you’re in a private sector DB pension, you should be very wary about transferring out. There’s a few specific circumstances where it makes sense to transfer out, but for most people, most of the time, being in it is the best

thing to do.

.. and defined contribution pensions?

This is a type of pension where you control your money and where it's invested. This is the most common pension. In the defined contribution (DC) world, the risk is all on you. If you live a long and happy, healthy life, you have the worry about how long your money is going to last. You've got the investment risk – your pot could go down – and you've got inflation risk.

So, you can either work out how much you can take out a year, and hope it lasts long enough, or you can buy an annuity – an income for life. This is where you give your pot of money to an insurer and it gives you, say 5 per cent, back a year.

With an annuity you don't need to worry how long you live, or how the money is invested. And for most of us – Warren Buffet excepted – looking after our investments in old age is a hassle.

So the annuity is an important product, but it is more attractive in late retirement because there's much greater uncertainty about how long you will live as you get older – you could easily live half the average or double the average and it's hard to manage an investment pot with that uncertainty.

But if you just want a quiet life and a secure income, they are fine – just make sure you shop around for the best rate. And when you speak to an insurer about the rate, tell them you smoke – tell them everything. People get so used to lying on forms about their health. This is the form to tell them everything as you may get a higher rate if, to put it bluntly, they think you're not going to live as long.

KHB0XF pensioners sitting on british pound coins

Because the Government tops up pension contributions, limits are placed on how much you can contribute each year and receive ‘tax relief’, (ACORN 1 / Alamy Stock Photo)

Should I ‘de-risk’ as I get older?

De-risking means investing in safer assets, which generally produce lower returns. But the problem is, even if you are 66 and retiring, you’re potentially going to be invested until you are 85 or more until you die. I’m not convinced you should be de risking pre-retirement at all. If you’ve got your state pension, which is £10,000 a year, you may be able to afford to take a bit of risk to try and get some growth on your defined contribution pot, assuming you have other savings.

But if you’re the type of person lying awake at night sweating about the stock market and what’s happening to your pot of money and all that kind of thing, it’s probably best to recognise that you will want lower risk. You will

get lower return, but more security.

You have to remember that retirement is not the end of the journey. The investment journey, historically, used to be when you retired, and then that's it. But now we're living longer and you're potentially going to live for another 20-plus years. So taking risk off the table too early is just going to cost you money.

There used to be a fun website, called 'When Will I Die?' Now there is a 'Life expectancy calculator' via the Office for National Statistics (ons.gov.uk). You put in your age, and it tells you, on average, how long you might live – so it gives you a number, and it's always going to be higher than you are expecting.

What are the other advantages of defined benefit pensions?

Perhaps surprisingly, the other good thing is their flexibility. You can start drawing on your DB pensions when you get to 60 or 65, but you can't get to your state pension until you are 66 (at the moment).

Many of these schemes offer inflation protection and if you don't want this, that can be swapped for extra cash in your pension when you start it. It's called a "pie" – a pension increase exchange. The pension increase exchange would suit someone in poor health who wants the money early at a generous rate, because, frankly, 30 years of price protection is not going to be much use to them.

You can also get what are called bridging pensions with DB schemes – where you take more money at, say, 60 – and then when your state pension kicks in, you lower how much money you take. This suits someone who perhaps wants to retire before state pension age, so they need more income now, and they can let it drop when the state pension kicks in.

So to a certain extent you can customise it to fit you. If you're going to a

coffee shop, you can have your mocha latte with your oat milk and all the rest of it and you can do this with DB pensions too.

Should I leave my firm's default fund?

Most of us have our pension in the company's default fund. These are designed to be steady. You won't see spectacular growth, but the aim is steady growth.

Some people will want to chose their own investments so they can earn more – but these people need to be aware that there is a cap on fees charged by pension providers for default funds that doesn't apply outside of it. So if you say: 'I want to be invested in, you know say, Latin American growth', these funds often come with expensive fees.

The beauty of the default fund is it is very closely monitored, with the asset managers having to explain to trustees why they've done what they've done. If you make your own choice, you need to be confident you can do better and you have to know what you're doing.

But if you just pop after some commodities fund, do you remember to keep that under review? Are you making sure you're diversified? It's not for the unsophisticated.