How do I get the most income out of my pensions in retirement?

[Tanya Jefferies]

I am near to retirement and will receive a full state pension at age 66.

I have a defined contribution pension pot worth about £100,000 and an old defined benefit pension which will pay out about £4,000 a year from 66.

I plan to take tax-free lump sums from my pensions. But what's the best strategy to max out my income after that?

Income strategy: What are the options to get the most from your savings in old age

Tanya Jefferies, of This is Money, replies: We asked a financial expert to run through the options, though as he stresses below there is not one 'right' way but a number of strategies you might pursue depending on your circumstances.

You can also check out our general guide on what to do with your pensions at retirement, and our pension jargon buster as there are often some baffling financial terms thrown around about when you stop work and are sorting out your finances.

If you start hearing about things like UFPLS or MPAA, we decode these for you.

Tax can get complicated at retirement, when many people who have never filled in a self-assessment form find they have to start doing so, and there are a number of serious and expensive pitfalls for the unwary.

Read our guide to defending your pension from the taxman as a starting point. However, helping you avoid tax traps when you start drawing a pension is one area where paying for independent financial advice can really be worthwhile.

A decent financial adviser can also set you up with a suitable investment portfolio at the outset of retirement.

If you want their services to start you off, but don't want to pay hefty ongoing fees throughout old age, an industry expert explains how to ditch your financial adviser if they have served their purpose or aren't providing value for money.

The best ones are worth continuing to pay the annual fee for though, as they will keep your income on track and let you know of important tax and legislative changes.

Mark Futcher, partner and head of defined contribution at pension consultant Barnett Waddingham, replies: Retirement is often seen as a distant event, but when the time approaches good planning will help to maximise your income.

Regarding your overall strategy, there are two aspects to consider when you

get close to retirement.

First, how much income you need to meet your financial needs and wants. Second, how your spending may change over the course of your retirement.

While many of us would like to maintain our current lifestyle in retirement, the reality is that most could struggle to meet their basic housing, food, and utilities costs.

Industry group the Pensions and Lifetime Savings Association publishes an annual 'retirement living standards' study to help people understand what their retirement income needs could be.

This sets a minimum income of £12,800 a year for a basic lifestyle. A moderate income is £23,300 a year and a comfortable retirement income is £37,300 a year.

Those figures are for an individual and do not include housing costs, which you need to factor in if you are renting or still paying off a mortgage. Couples will need less, and will potentially have two state pensions.

On how your income needs might change over time, research on this tends to find spending decreases as you get older, so you may need less later into your retirement. However, that excludes healthcare and care costs, which might be required in later life.

Defined contribution vs defined benefit

Defined contribution pensions take contributions from both employer and employee and invest them to provide a pot of money at retirement.

Unless you work in the public sector, they have now mostly replaced more generous gold-plated defined benefit - or final salary - pensions, which provide a guaranteed income after retirement until you die.

Defined contribution pensions are stingier and savers bear the investment risk, rather than employers.

What are your main income options at retirement?

The key factors that determine your income in retirement are: when you retire; the level of tax-free cash you take; and how you access your defined contribution pots - in other words, do you stay invested and draw an income from your funds, or buy an annuity.

There are some important levers available to you in planning your income for retirement - though bear in mind there is unlikely to be one best solution.

But generally speaking the two main options you have to increase the level of income you receive at the point of retirement are either to defer taking the income to a later date or reduce the level of your tax-free lump sum.

Tax-free lump sums: You mention that you intend to take the maximum tax-free lump sums available to you.

If you do not need all of this lump sum then it usually works out better for you in the longer term to reduce the level of tax-free lump sum from your defined benefit pension and take a higher income, albeit that income will be subject to income tax rules.

Your state pension and defined benefit pensions: Income from these two arrangements can be considered reliable.

There are strong protections in place to protect the level of income from these two arrangements and generally they will keep pace with inflation.

If we use the PLSA retirement income standards explained above, your full state pension which is currently worth £10,600 a year and defined benefit pension of £4,000 a year will together provide an income which is likely enough to cover your minimum income needs.

You could consider deferring this income if you are willing and able to work a little longer, or have other assets you could use for spending in the meantime, and you are in good health so likely to see the financial benefit.

The current state pension rules increase the income by 5.8 per cent each year you delay which means that if you deferred your state pension income for one year until you are 67 then the income would commence at £11,214 per annum.

There could be a similar option on your defined benefit pension and these are often more generously revalued than the state pension.

Your defined contribution pot: From a £100,000 pot, you would be able to take £25,000 of that as a tax-free lump sum if you wish to do so.

You do not have to take this all in one go unless you need the money and could, for example, take £8,333 for each of the first 3 years to top up your income in a tax efficient manner. No investment growth is assumed during this period to keep the example clear.

By adding this to your income from your state and defined benefit pension, you could receive £22,933 a year in the first three years. This figure is very close to the moderate income standard above.

In this scenario you would have a £75,000 pot left over which you could keep invested in an income drawdown arrangement or buy an annuity with from age 69.

Income drawdown depends on investment performance, and though this is more likely to be successful the longer you are invested, the returns to your fund will be volatile from one year to the next.

There are no guarantees, but you have control over the level of income you receive and can vary it over time.

From a £75,000 fund you could expect a drawdown policy to provide an annual income from age 69 of around £6,100 which may last until 90 if investment performance is good.

An annuity does provide a guaranteed level of income until you die, but the annual figure would likely be lower at around £5,750 per annum at current rates.

What else should you consider at retirement

The options above are not the only ones available to you. There are a wide range of alternative plans to meet your spending needs in retirement, and if you are unsure you should consider paying an independent financial adviser to tailor a solution to your individual circumstances.

For instance someone with a particularly large debt burden may wish to take more tax-free cash to pay this off.

You should also consider any additional assets you may have, such as a home that could be used to fund retirement through equity release, and the retirement income of a spouse.