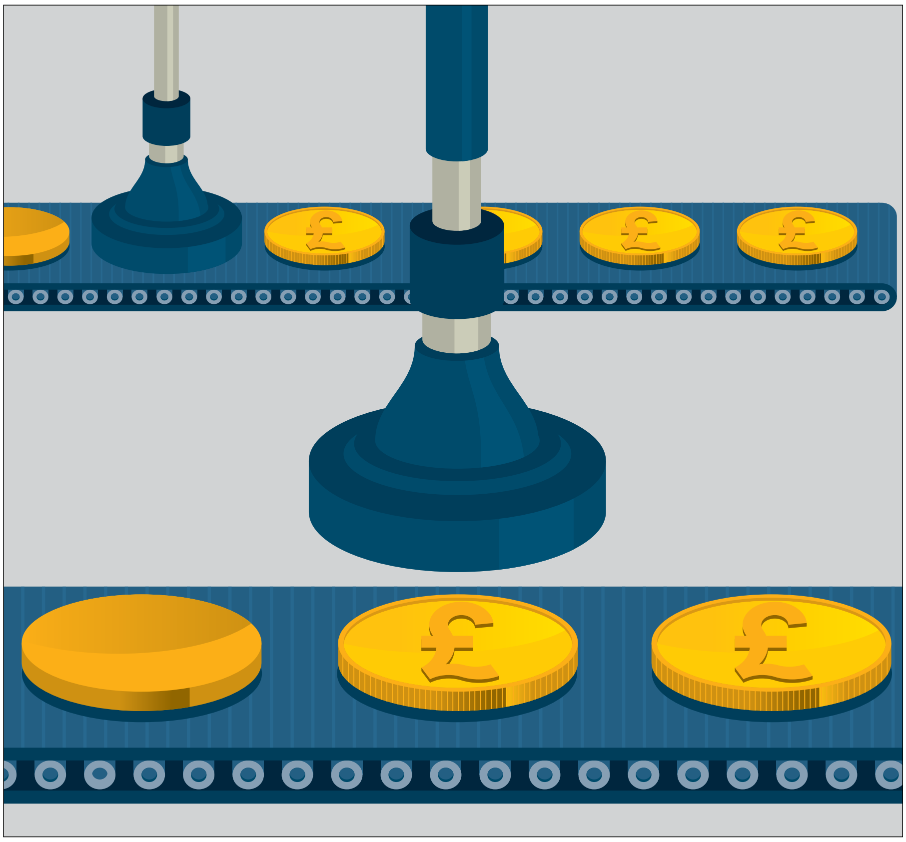
Why your living costs might be less than you expect

By Ruth Jackson

It's easy to dutifully pay money into your pension each month without thinking about how much income you will need when you retire.



"One of the hardest – and essentially most important – calculations that someone can make is how much do they need in retirement," says Mark Stopard, head of product development at Partnership.

The good news is that while it can take some time working out the maths, you may be pleasantly surprised to find you need a lot less income than you thought.

"Once you retire, your day-to-day costs will likely change," says Jonathan Watts-Lay, director of Wealth at Work. "You will often be paying significantly less income tax, have no national insurance or pension contributions to make, and often mortgages and loans are paid off."

Crunching the numbers

Mr Stopard says: "Determining how much you might need in retirement is generally a matter of reviewing your existing outgoings, identifying which of those will cease when you stop work (for example, train fares to work), taking into account your aspirations (for instance, holidays) and building in some protection for inflation."

The first step is to sit down and work out what your outgoings will be. Take a couple of bank statements and make a spreadsheet, or list, of all your regular outgoings from mortgage payments to phone bills.

"Start with what you spend your money on today and then deduct things you know you won't have to cover. Then make additions for where you think your spending might go up a little," says Teresa Fritz, pension and retirement expert for the Money Advice Service.

So, for example, while you might save on commuting costs, you might find that your utility bills or weekly shop go up if you are spending more time at home. Then there may be some new costs to consider. "Have you worked golf club fees into your numbers?" asks Mr Watts-Lay.

If you need a little help, the Money Advice Service has budgeting tools in the retirement section of its website.

Don't forget to factor in that you can take 25% of your pension pot as a tax-free lump sum. It might be that you use that to clear the last of your mortgage or any other debts so they won't be a factor in your retirement income calculations.

You also need to consider your tax position. Will you still be in the same income tax band or will your tax bill fall? Factor in that you'll no longer be making national insurance contributions and you will probably stop paying into your pension as well (although you don't have to).

As such, Mr Watts-Lay says that some retirees may be able to have a similar amount of disposable income, with a pension income that is equivalent to half the salary they received in work. (See case study, below.)

"We want to raise awareness that you may not need the same income as you had when you were working," he says. "If the predicted income on your pension statement is much lower than expected, do not bury your head in the sand believing that you will never be able to save enough for retirement. Instead, work out how much you really will need and you may find that is significantly less than your present income."

Where will your income come from?

Once you have calculated the income you think you'll need in retirement, it's time to work out how you will create that income.

"Potential sources of income in retirement include defined benefit pension, defined contribution pension, state pension and income from investments, savings and assets," says Mr Stopard.

Start off by calculating the state pension you will be entitled to. You can ask for a state pension forecast by calling 0345 3000 168.

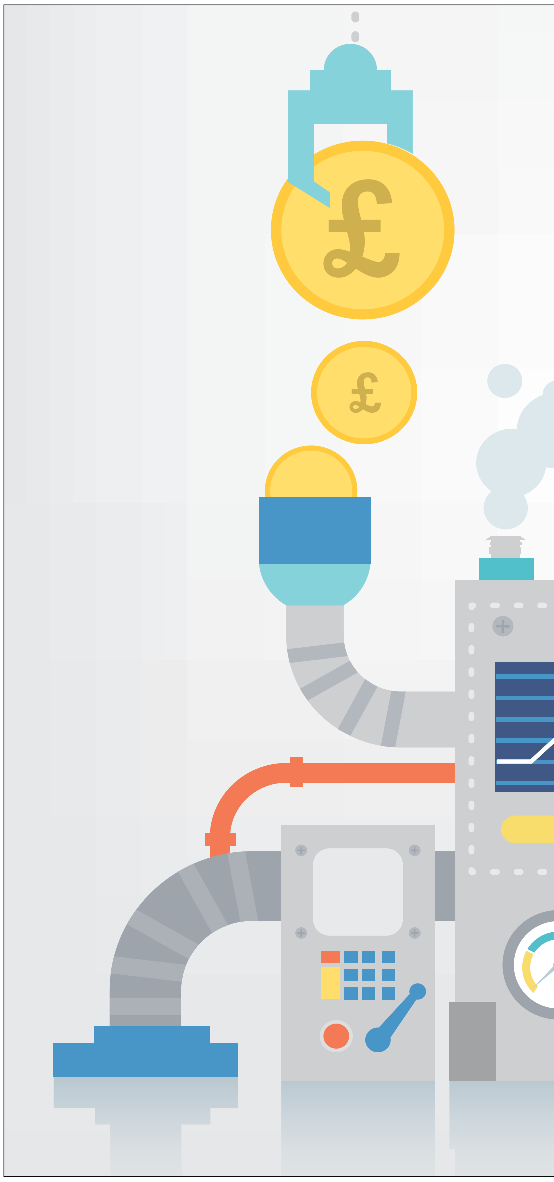
Now take a look at your pension provisions. Have you got a defined benefit pension? If you have, take this sum and the amount you'll receive in state benefit and deduct it from the total income you want to receive when you retire. What is left over is the income you need to generate from any private pension, savings and investments you may have.

Turning your pot into income

The next step is deciding how you will turn your savings and or pension into an income. To do this, you need to consider your original income figure again.

"Once you have determined how much annual income you need, you then need to identify how much of it needs to be guaranteed," says Mr Stopard. "If you think of this as essential income (food and heating) versus luxuries (for example, holidays), you can then start to build up a picture of how to manage your retirement assets."

Your essential income should be covered by guaranteed income. This is money you will receive regardless of what happens in life. There are three guaranteed incomes you can earn in



retirement – your state pension; a defined benefit pension; and annuity income.

"If the guaranteed income from the state pension and defined benefit pension schemes isn't enough to cover your basic living costs, we recommend you use part or all of your pension fund to buy an annuity to make up the shortfall," says Patrick Connolly, a certified financial planner at Chase de Vere. "Buying an annuity ensures you will receive a guaranteed income for the rest of your life."

How much money you need to buy an annuity depends on a number of factors. Index-linked annuities that pay out an income that increases with inflation are more expensive than an annuity that pays a level income. Equally, an annuity that includes provision for your spouse once you have died is more expensive than one

Budgeting for retirement

If you are about to retire, an important part of the budgeting process is making sure you don't spend more than you need on utilities so shop around for the best deals. A recent report from the Competition and Markets Authority found that 70% of customers with the Big Six energy suppliers are on default standard variable tariffs and could be paying as much as £300 a year more than those who regularly switch. Before switching to the cheapest deals, make new contracts match your changed lifestyle, too – for example, you may now need a landline deal that includes daytime calls.

• See our budget planner on page 81.

Living well for less

Joanne will live on half her working salary when she retires, but will have the same disposable income.

Joanne earns £40,000 a year as a university lecturer and her disposable income is £17,567. She currently puts 10% of her salary into her pension. By the time she retires, Joanne intends to have paid off her mortgage, which currently costs her £10,000 a year. She will also no longer have to pay £5,080 a year in income tax, £3,353 National Insurance and £4,000 in pension contributions.

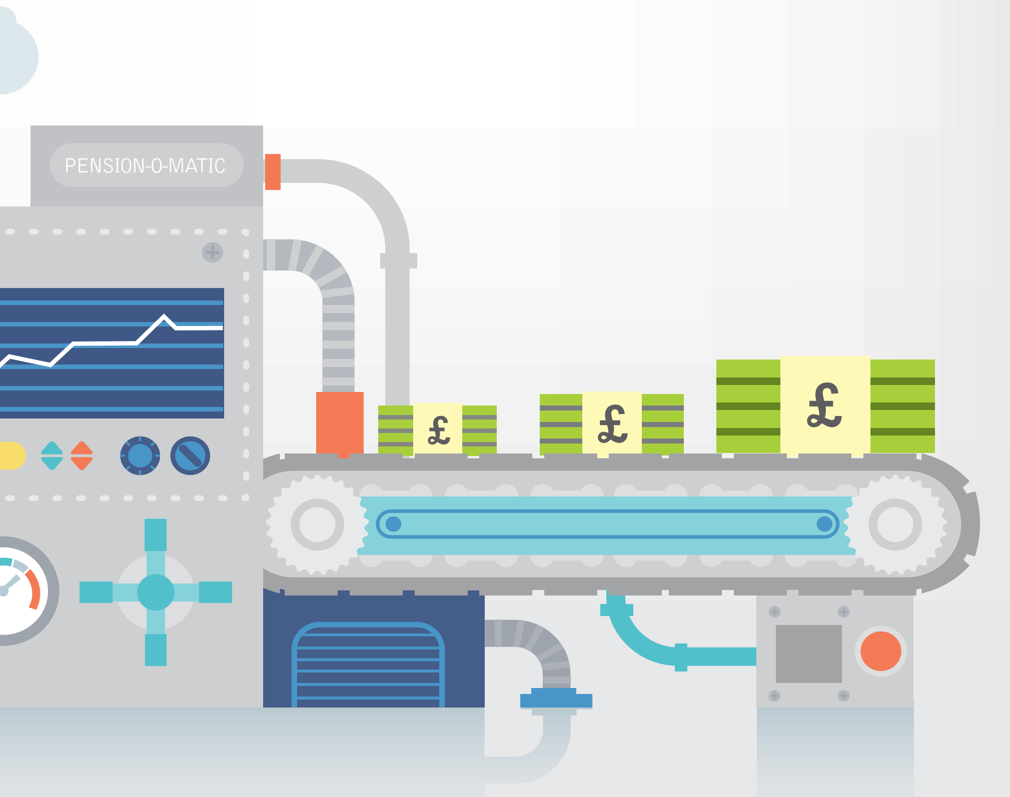
This means that in retirement Joanne only needs an annual income of £19,309 to give herself a disposable income of £17,567 after tax – the same level as she enjoyed when she was working.

Source: Wealth at Work

How much will an annuity cost?

Annuity options for 65-year-old	Amount needed to generate £10,000 a year
Single life – level income	£173,882
Single life – index-linked income	£274,876
Spouse's pension included – level income	£178,826
Spouse's pension included – index-linked income	£275,862

Note: Prices correct 14 March 2016. Quotes assume spouse is 65. Source: Chase de Vere



Once you know the income you need, you can work out how much to save

that just pays you an income. Your age will also be taken into account – the older you are, the better the rate you get – and if you have any health problems, you may be able to get an enhanced annuity.

"Annuity rates also vary from provider to provider, so you should look around to find the best deal for you," says Mr Connolly. "If you don't know what you are doing, then you should take independent financial advice."

Taking financial advice at this stage can give you an idea of how much money you will need in your pension to buy an annuity to cover that essential income part of your hoped for retirement income. That then gives you the base amount that you need to have saved in your pension.

The chances are, though, that you don't just want your retirement income to cover the essentials. You want to be able to go on holiday, treat your grandchildren or indulge your love of fine food. This is your non-essential income. Now you've covered your essential spending with guaranteed income streams, you can use the remainder of your pension pot to supplement your income.

Since pension freedoms came in last year, many people are "either taking money out of their pension or going into drawdown and taking an income from their fund while remaining invested", says Mr Connolly. "These approaches are more risky than buying an annuity, and there is a chance that people will run out of money when they still need an income."

But by combining an annuity with income drawdown, you can ensure you will always be able to pay the bills.

In order to generate a large income in drawdown, you need to have a very sizeable pension pot. For an income of £10,000 a year, you would need a £250,000 pot if you are taking 4% a year. And remember that your pension remains invested so if the stock markets tank, you could find you can't take the income you had hoped for.

Doing the sums to calculate how big a pension you need, to provide the income you want is complicated. You need to allow, generously, for how long you hope to live and allow pessimistically for how your investments might grow, then see how much money you can realistically take out of your pot each year. Again, a good financial adviser can help you with the sums.

Once you've worked out how much income you need in your retirement and how you will generate it, you should have a much better idea of how big your pot needs to be.

Now it's time to look at whether you are on track to save that much money. If you aren't, don't panic. "Even if it's not great news, it's better to know where you stand early enough to do something about it," says Ms Fritz.

Start thinking about how you can increase your retirement savings. Can you afford to put aside a little more each month? Alternatively, do you want to downsize when you retire and release some money from your home? Or could you re-think your retirement age? Maybe you want to retire from your career but take up a part-time job instead?

"Although traditionally people retired at 65, the retirement age is rising and you generally don't have to retire unless you want to," says Mr Stopard. "This means that if you are still enjoying your role, you can delay retirement – and taking your pension – which means you'll have a higher income when you do eventually finish work."