



think

Time to get real: building guided retirement in a world with inflation

by **Glyn Bradley FIA C.Act, Chair of the IFoA Pensions Board**

Independent thinking from the IFoA

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Our 'think' series seeks to promote debate on topics across the spectrum of actuarial work, providing a platform for members and stakeholders alike and sharing views that may differ from the IFoA's house view. In doing this, we hope to challenge the status quo, question the orthodoxy, and shine a light on complex or under-examined issues, thereby stimulating discussion and dialogue to help tackle issues in a different way.



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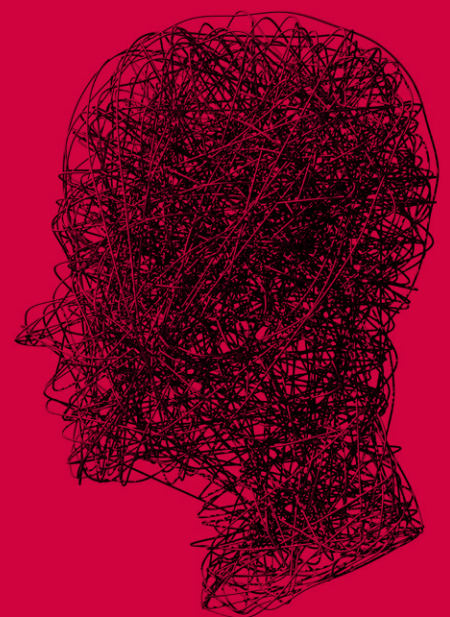
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Time to get real: building guided retirement in a world with inflation

This article offers my personal view to stimulate debate at the outset of guided retirement about suitable default retirement products for ordinary money purchase savers and how we illustrate projected benefits during working life. The system must work as a whole. Guided retirement is too important to address piecemeal or set in the wrong direction. It must reflect behaviour: pension freedoms show that too many people, when left unaided, choose poorly. Get the framework wrong and we lock in poorer outcomes for millions; get it right and we have a once-in-a-generation chance to build something that works.

Imagine trying to sell a 65-year-old the following retirement product: a £10,000 guaranteed income in the first year, but reducing thereafter. Your first question would be: how does it reduce? By random amounts each year, hard to predict in advance and sensitive to market shocks and geopolitical events. So, based on past experience, what sort of income would one have at age 80? Well, about half the time it would have fallen to between £3,333 and £6,375 — but it has been as high as £6,732 and as low as £1,949. And at age 95, usually between £1,134 and £3,436, but it has been as low as £968.

How does that sound? Is that a sustained income for the whole of retirement?

It's not appealing — but apparently, in the world of annuities, the flat rate is king. You will probably have twigged by now that I have reduced the figures for the effect of inflation during the buyer's retirement. I've described a flat-rate annuity in terms of prices at its commencement (the "past experience" used the **Retail Price Index** for 15- and 30-year periods since 1948).

Was that income sustained? Only in a nominal sense — at £10,000 p.a. in our example — but not in any meaningful sense for our typical retiree, because their cost of living continues to rise. Deep into retirement, annual income could easily be under 10% of its initial value in real terms.

In my view, as a practical matter, an income in retirement is only sustained to the extent that it retains its value in real terms until death. An income that runs out before death hasn't been sustained throughout retirement, and one that falls during retirement has only been partially sustained, at best. In this article I argue that both guided retirement and benefit illustrations should be built around retirement incomes that will grow with inflation. I also consider the contrary arguments. A flat real-terms income does not exactly match spending patterns but is a close practical approximation and the easiest pattern to understand.

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But don't spending needs decline in retirement?

The 'go-go, go-slow, no-go' theory suggests retirees spend freely in early retirement, taper off as they slow down and spend least in their final years. The related 'retirement spending smile' or 'U-curve'— well-rehearsed in **US financial planning circles** — suggests spending dips in the middle years before rising again because of care costs. If spending naturally declines, why design products that maintain income in real terms?

It's hard to disentangle the spending required to maintain a standard of living from pensioners' actual spending. Some spend more or less at particular points because of what they have available to spend, rather than by choice. I think of pensioners with pre-1997 accrual receiving no increases on their workplace pensions, and the decline in their living standards. Generational effects matter: today's 60- and 80-somethings will experience different standards of living throughout their retirement, reflecting changes in the state pension, the decline of defined benefit (DB) and the rise of auto-enrolment.

The **Institute for Fiscal Studies (IFS) report** *How does spending change through retirement?* suggests a complex picture, with spending at different ages heavily influenced by different generations' incomes. Its key finding was: 'On average, retirees' total household spending per person remains relatively constant in real terms through retirement, increasing slightly at ages up to around age 80 and remaining flat or falling thereafter.' Its conclusions were clear: a flat profile in real (CPI-adjusted) terms, no evidence for average spending falling after a certain age, and no strong evidence of people wanting to front-load spending. Although holidays, leisure and motoring spending fall at older ages, basic household bills do not.

Other studies found that more affluent homeowners spent more on luxuries earlier but could often fund this from tax-free cash or other savings. Accelerated spending in early retirement by those who can afford it does not imply that they wish their *regular* income to decline.

I am wary of arguments suggesting that lower-income retirees need less inflation protection than others, when they are least able to absorb a fall in living standards.

For people of more modest means — including most of those relying on their money purchase pots — constant real-terms spending appears a sensible starting point. The **Pensions Commission** notes that: "Since the number of renters in retirement is expected to grow over time and given fixed costs such as housing or bills form a larger proportion of renters' income, expenditure seems unlikely to reduce significantly over time for all pensioners." The variation in spending patterns does not mean there is a 'better shape' that could be reliably planned for. **US research** suggested a 1% per annum reduction in real spending — but it's not easy to communicate a 1% p.a. decline relative to unknowable future inflation. A 1% p.a. real reduction, even if correct, could be well approximated by an inflation-targeting income alongside 25% of the pot taken as a tax-free lump sum.

Guided retirement: the policy direction

In a few years' time, most members of money purchase schemes will be steered towards 'default pension benefit solutions' by their trustees or scheme providers. The **Explanatory Notes to the Pension Schemes Act 2026** go further, asserting that they should provide a regular income for "the whole of" retirement. The Government's **Guided Retirement guiding principles** are clear: "The government therefore considers protection against longevity risk to be a crucial element of default pensions, and so they must provide a retirement income that lasts throughout that retirement." More broadly, "Guided Retirement ... will ensure the vast majority of people are offered default pensions which are designed to provide a sustainable pension income."

So guided retirement seems (with reasonable exceptions) to steer members towards a sustainable income throughout retirement. That means the default should at least aim to maintain purchasing power over the whole of the member's retirement — plausibly past age 100, even if that is not the likely outcome. Life expectancy is a distribution, not a destination: many individuals (including many on low incomes) will live many years beyond their life 'expectancy' and will still need an income.

Accelerated spending in early retirement by those who can afford it does not imply that they wish their regular income to decline.

Aiming at inflation protection in product design

Does that mean inflation-linked annuities for all? No, but that's one way of doing it, and a good benchmark because it's the only widely available product to money purchase savers that will deliver a guaranteed income (and from an FCA-regulated provider) over the entirety of the member's retirement.

But we don't need to guarantee full inflation protection. There will be reasonable trade-offs that increase the expected income, albeit with additional risks. One approach would be to target a certain level of increases, with a mechanism that gives the product a fighting chance of responding to changes in inflation.

A collective pension bought at retirement (previously known as a 'retirement collective defined contribution' or 'R-CDC' pension) is one such way. By remaining significantly invested in growth assets and adjusting annual increases over time, it can target increases to maintain purchasing power, with a decent chance of providing at least some of them. Those increases aren't guaranteed, but it would at least be 'pointing in the right direction'. Neither do increases necessarily need to be directly linked to an inflation index: a product targeting 3.5% per year would also be 'pointing in the right direction'. It might be suggested that my opening figures are 'distorted' by the 1970s and that we don't expect this again. Perhaps not — but I don't think retirees of the 1950s and 1960s were expecting the 1970s either. As recent years have shown, inflation can spike to unexpected levels, driven by real-world events rather than mathematical models.

What about 'flex and fix' products? If designed to increase with inflation before locking into an inflation-indexed annuity, they're likely to provide a sustainable income. A product that locks into a flat-rate annuity at age 80 is not. Similarly, individual drawdown could provide an inflation-adjusted income — but without pooling mortality risk, it would have to assume the member lived to a reasonably foreseeable maximum age, or fall short on the 'throughout retirement' requirement.

Behavioural biases: why defaults must do the heavy lifting

The 'annuity puzzle' refers to the well-known contrast between consumers' desire for secure lifelong incomes and their failure to purchase them. **FCA data** shows that most purchased annuities are not escalating. Yet **research into mid-retirees** shows that an overwhelming majority thought the security of an income for life was important and becoming more so as they aged. Only 2% said they were very comfortable with a "fluctuating" income.

This doesn't suggest people secretly want their purchasing power front-loaded and declining by random amounts every year. It suggests a problem with the choice architecture: people taking actions for short-term reasons to their long-term detriment. **A report sponsored by the IFoA from the Behavioural Insights Team (BIT)** highlights how present bias can cause an immediate and certain benefit to outweigh a larger but more distant cost.

The BIT report describes "inflation blindness": a third of people holding at least £10,000 in cash without financial advice did not know that cash savings tend to lose value over time. It concludes: "There is a significant risk that the public does not sufficiently understand longevity risk, does not sufficiently understand inflation risk, and does not sufficiently understand that inflation risk is also a longevity risk."

Default design must address these behavioural tendencies. If people struggle to weigh the present against the future, understand inflation erosion and distinguish good from bad, the answer is not just to give them more information. Defaults should take these tendencies into account by pointing in the right direction on inflation, while communications make the trade-offs legible. Those with the least time, money and cognitive bandwidth have the least capacity to navigate complex retirement choices and the smallest margin for error.

Talking in today's money

In *The Life and Opinions of Tristram Shandy, Gentleman*, Uncle Toby inherited "a small estate of about one hundred pounds a-year." My first house had a 70p a-year ground rent, dating to the early 19th century, that the freeholder no longer bothered to collect. Those were once significant amounts, but not anymore.

Few of us, even actuaries, can think clearly about how much £10,000 in today's money would be worth in ten, twenty, thirty, forty years. We can only really understand a future amount if we can 'currency convert' it to today's prices. BIT draws an important distinction between financial literacy

The public does not sufficiently understand that inflation risk is also a longevity risk.

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and financial “legibility”: whether people can readily understand their options, compare them and tell good from bad. We should not expect members to reconstruct the real value of a nominal income by applying uncertain future inflation over several decades. An income maintained in real-terms is simple to understand: if it starts at £10,000 a year and increases with inflation, it should retain roughly the same purchasing power throughout retirement.

The illustration problem

Before 2014, the statutory money purchase illustration standard (SMPI, under ‘TM1’) required that projected benefit illustrations assume pots would be used to buy index-linked annuities. In 2022, the **Financial Reporting Council (FRC)**, prompted by the approach of pensions dashboards, consulted on a single approach. It decided to “prescribe the form of annuitisation to be a level annuity without attaching spouse or partner benefits so [as] to align with current market practice.” It noted that the “vast majority of annuities actually purchased are level in monetary amounts (i.e., not including any increases in payment) and do not include attaching spouse or partner benefits.”

Moving from joint-life, index-linked pensions to single-life pensions typically led to an increase of about 80% in the annuity shown — but it didn’t make members (or their partners) any better off. Our member, previously shown a £10,000 p.a. income with inflation increases, was now shown an £18,000 income that would likely be worth around half of that a couple of decades into retirement — and nothing for a surviving spouse. Worse, it makes the member contemplating a £10,000 p.a. index-linked annuity, or provision for their spouse, feel those choices would make them worse off than the income they’ve been led to expect.

If decisions reflect present bias, loss aversion and inflation blindness, reproducing the most common purchase risks embedding the behavioural problem.

I understood the FRC’s reasoning when members were mostly responsible for their own choices. But the world is moving on. Trustees and providers will have a big impact on retirement outcomes. With the Government’s heavy steer towards a sustainable income throughout retirement, some level of expected inflation protection — however approximate — ought to become much more common. The logic of 2022 now leads in a different direction. We should think about dependants too.

Nor should observed purchasing behaviour determine the illustration standard. If decisions reflect present bias, loss aversion and inflation blindness, reproducing the most common purchase risks embedding the behavioural problem. Does this mean trustees should steer members towards index-linked annuities? No — but the old TM1 approach, lightly updated, would illustrate a guaranteed income for life with inflationary increases. It is a fair, readily understood benchmark: ‘The insurer will pay you this income every month for life and increase it as general prices rise.’ Members might take income differently — through flat-rate annuities, collective pensions, flex-and-fix or drawdown — usually with a higher initial income but with additional risks. But explanations of those risks should be tested with members, not assumed to work for them.

Matching illustrations to defaults and dashboards

How do we square index-linked annuity illustrations against likely guided retirement defaults? I think we can distinguish between illustrations provided many years before retirement and those provided as members approach retirement. For the former, it’s too far away to know what the default will be, and a consistent benchmark is helpful. For ‘approaching retirement’, the emphasis could switch to the default: there’s already a longstanding statutory exemption for members within two years of their retirement date. Assuming the default involves more risk than an index-linked annuity, we’d expect illustrated incomes to increase — not ideal, but better than the other way round. And if that default targets inflation increases, the step-up should be much less than the 80% jump we saw in 2023/24.

Pension Dashboards will show Estimated Retirement Incomes (ERIs) for members’ future benefits; for money purchase benefits, that illustration will be based on the SMPI. The FRC said that “As such it is important that illustrations presented on the pension dashboard are shown on a common basis to facilitate this comparison being made fairly in a way that does not mislead the individual.” I agree — but that won’t work when money purchase benefits sit next to DB benefits, since most of these increase in payment. Illustrating money purchase benefits assuming inflation increases would make them more comparable. The comparison doesn’t have to be perfect to be better.

Conclusion: the public interest case

We are designing the default retirement income for millions of ordinary savers — people who will not read the small print, will not shop around and will not realise their income is quietly collapsing in real terms until it is too late. If we build defaults that ignore inflation, we are building a system that looks generous on day one and lets people down by year twenty. That is not a technical detail. It is a public interest failure waiting to happen.

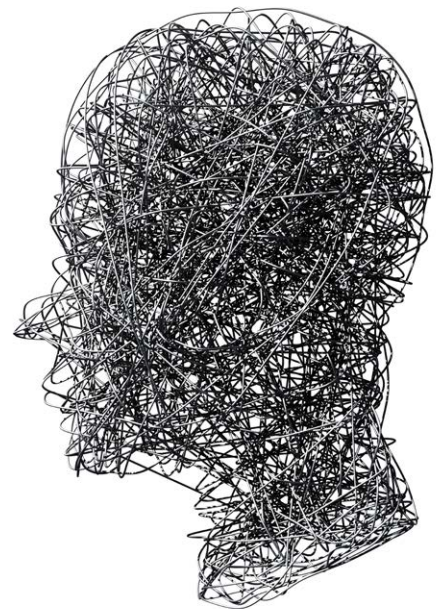
My case is simple:

- **Inflation protection is longevity protection.** A retirement income that doesn't keep pace with prices is not sustained — it is in slow-motion decline. Calling it 'sustainable' doesn't make it so.
- **Defaults must be built around how people actually behave, not how we wish they would.** Pension freedoms gave us the evidence: when left to choose, most people take the higher number today and pay for it tomorrow. Defaults should push back against that bias, not reinforce it.
- **Illustrations must be in today's money.** Showing a flat £18,000 that will be worth £9,000 in real terms two decades later is not information — it is misdirection. A real-terms, index-linked benchmark is immediately understandable in full.
- **Design for the people with the smallest margin for error.** The affluent will muddle through. The people on modest means — for whom the pension is not discretionary wealth but their principal retirement strategy — are the ones who will be hurt by a framework that treats inflation as an afterthought. Consider a Makerfield Test (or, more philosophically, drawing on the ideas of John Rawls): what policies and rules are going to help make a positive difference to the lives of ordinary people, particularly those least well-off? If we have to choose between something that works better for those on modest means and something that works better for the more affluent, we should choose the former.

This is my personal view, offered not as a settled answer but as a provocation for a proper debate while we are still in the policy-making phase for guided retirement. We have a chance to build a system where defaults point in the right direction, illustrations tell the truth and inflation is treated as the longevity risk it truly is. We should debate it now, while the framework is still being shaped.

Let's have this argument now and build guided retirement on the right foundations.

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