Here's why we're not protecting our pensions from inflation

An inflation-proof retirement income could cost you a fortune. Imogen Tew considers whether it would be money well spent

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Many savers think that the second option would be better, particularly in a time of rising inflation. But the difference between the two incomes is so large (a level annuity is typically 30-40 per cent higher) that you would have to live way past the average life expectancy or experience many years of high inflation to make the index-linked option worth taking, according to the Retirement Planning Project, an advisory service.

A £100,000 pension pot at age 65 could buy you a level annuity paying about £5,580 income a year, according to the broker Retirement Line.

You could get a starting income of £3,680 a year if you opted for an annuity that increased 3 per cent a year, or £2,950 from one linked to the retail prices index (RPI). By age 90, the level annuity at £5,580 a year would pay you £145,080. The escalating annuity that started at £3,680 would give you £141,875. But the RPI-linked annuity starting at £2,950 would pay out £113,731 if RPI was 3 per cent a year, (roughly the rate it would be if inflation was 2 per cent, the Bank of England's target). That's £31,349 less than the level annuity.

Even with higher inflation — five years of RPI at 6 per cent, five years at 4 per cent and then 15 years at 3 per cent — the annuity pay-out would be £134,827. That's £10,253 less than the level annuity.

Women aged 65 now can expect to live to 87 and men to 85, according to the

Office for National Statistics.

Annuities are insurance products that offer a set payout for life in exchange for a lump sum, so you can buy yourself a guaranteed income in retirement. How much you get depends on interest rates at the time, your age, your health and the type of annuity you choose.

Before the rules on accessing your pension changed in 2015, an annuity was the only option for most pension savers. The changes, known as pension freedoms, allowed all members of defined contribution (DC) schemes (where the amount you get in retirement depends solely on the amount saved and the performance of your investments) to get at their pension from the age of 55.

Annuity sales fell off a cliff, but they had already been losing popularity. Ultra-low interest rates meant that the yearly income you could get from your lump sum was unattractive, and a misselling scandal that resulted in thousands swapping their lifelong savings for unsuitable annuities put off many people. More than 400,000 annuities were sold in 2012 but only 60,000 last year.

As fears of high inflation have grown, however, many analysts have begun to worry that savers are not protecting themselves from the rising cost of living.

The disparity between the incomes offered by level and escalating annuities means that most people opt for the higher-paying product. About 86 per cent of those who bought an annuity between 2016 and 2021 chose a level version, according to the Financial Conduct Authority (FCA), the City regulator.

“The fact that you need high inflation and to live for a long time to make an escalating annuity worthwhile is bound to put people off,” said Tom McPhail from the financial consultancy the Lang Cat. “People tend to underestimate how long they are going to live by several years, so it would be a surprise if anyone did buy an index-linked annuity.”

A review of consumer behaviour in 2014, published by the FCA, found that while there was high awareness of the risk posed by inflation and a general preference for protection from it, most pensioners were unwilling to pay the price. The FCA said: “When faced with the trade-off between the two options, a bias or need for more money today prevails.”

Should you inflation-proof your pension? You should look at your entire pension provision and work out how much of your income will be eroded by inflation.

If you qualify for the full state pension, which is partly linked to inflation, and you have a final-salary (defined benefit) pension that pays out a fixed income that typically rises in line with inflation, then you may be better off using any other pension savings to buy a level annuity.

But if you are relying on investments for most of your income, you might feel more comfortable taking an index-linked annuity to form a small part of your pension and boost your income in times of particularly high inflation. It also depends on whether you think your spending will decrease over the years.