Book review

Pension design and structure: New lessons from behavioural finance

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This book is a collection of fifteen essays by researchers in the USA, where participant-directed money purchase or defined contribution (DC) schemes — particularly so-called 401(k) plans — are already the dominant type of employer-provided pension. Employers in the UK are also moving towards DC. For UK readers in particular, this is an important and extremely timely publication. Many recent studies have shown we are not saving enough to fund the standard of living to which we aspire when we shall no longer be economically active.

About many factors in the UK's 'pensions crisis' there is growing consensus: among them the unanticipated rate of increase in longevity; falling interest rates and consequently also annuity rates; inadequate supply of long-dated and index-linked gilts; serious underfunding of some defined benefit (DB) schemes; inadequacy of state pension provision; the three-year equity bear market (2000–2003); and falling participation rates in occupational pension schemes. The amounts being paid into UK pension arrangements are inadequate, it is generally recognised: but why are individuals reluctant to contribute more to pension

arrangements? One very obvious reason, which is probably true of a much wider cross-section of the population than is generally acknowledged, is that they simply cannot afford to.

Making private pension provision compulsory continues to be regarded by the government as undesirable and the last resort if all other measures fail. The Pensions Act 2004 contains measures such as the new Pension Protection Fund to improve security of DB schemes. That, however, is dealing largely with problems created in the past. Hardly any new DB schemes are likely to be set up now: the burden of cost, risk and uncertainty is simply too great for employers to carry. For money purchase pensions, where the reduction in yield arising from commission and charges has acted as a disincentive to save and probably contributed to poor persistency rates, the government's solution was Stakeholder pensions. The resulting '1 per cent world', however, while delivering reduced charges, has not been accompanied by the substantial quantum leap in participation expected by the government.

Apart from security and the impact of charges, another generally acknowledged disincentive is the byzantine complexity

of UK pensions legislation. The Finance Act 2004 will radically simplify the taxation of pensions after April 2006, but on the social security side, politicians have so far proved largely unable to deal with the problem. This is exacerbated by an unwillingness to consider radical reform of the state pension system, widely agreed outside government as an essential starting point.

Aside from the admitted complexity of the UK state benefits system and the perceived disincentive effect of means-testing, however, limited research has been done into the real reasons why people aren't saving for retirement. The Consumers' Association — now called *Which?* — has shown that security of their benefits is one paramount concern of savers. Another is the general inability to access pension savings before retirement, a concern which illustrates the modern absence of a commitment culture. With money purchase pensions, particularly among the more well-heeled, there is a persistent and very vocal objection to the obligation to convert most of the fund into an annuity, no later than age 75. (This is not an issue in the USA, where 75 per cent of company pensions are paid as a single lump sum.)

All these factors suggest that if it wishes to avoid making third-tier pension provision compulsory, the UK government needs to provide more attractive incentives to save. The much-vaunted tax relief on contributions is actually tax deferral, as UK pensions are taxed on payment: arguably, it is only a real incentive for the minority of individuals paying higher-rate (40 per cent) income tax who expect to be basic rate (currently 22 per cent) taxpayers in retirement. Any new initiative should be founded partly upon a more sophisticated knowledge of individual psychology, which is why the relatively new field of behavioural finance — sometimes termed

behavioural economics — is relevant.

Too often it has been assumed that individuals are well-informed economic agents who act rationally to maximise their self-interest. Fifty years ago, however, the eminent economist Herbert Simon explained that in the real world, people's decisions are subject to 'bounded rationality'. People simply aren't very good at the extremely complex problem of planning retirement savings. There's far too much to take into account, a great deal of which cannot be known with certainty, as it lies in the future. Apart from that, people do not behave rationally: we lack willpower, display inertia and procrastination, make decisions 'anchored' strongly to where we started, rely too much on past performance and tend to see patterns in small series of random numbers. We are overconfident in investing, too quick to lock in gains while unwilling to cut our losses.

After summarising these research findings in their keynote opening chapter, the editors discuss the lessons learned from behavioural finance. The research challenges some of the most central assumptions of decision making. The thrust of their argument is that pension plan design decisions in favour of automatic enrolment, automatic saving, or default investment options are particularly critical. Supporting this, Gary Selnow suggests in Chapter 2 that behavioural change must precede education, rather than the other way round. The reason many education programmes fail is that they make unwarranted assumptions about workers' motivations and rationality. After all, saving for retirement is a gamble on the future. The distant date of retirement means, Elke Weber argues, that the consequences of inadequate pension saving create no great anxiety and thus no strong impetus to take action.

Retirement is also closer to death, which is unpleasant to contemplate.

In company with several contributors to this volume, Selnow commends the 'Save More Tomorrow' (SMT) approach.¹ The SMT plan, which has proved very successful in early trials with 401(k) plans in the USA, is that employees agree in advance to earmark a portion of their future pay increases for retirement savings. The pain is deferred, and it involves money the employee never actually has in their hand anyway. UK readers will see a similarity with 'salary sacrifice' and 'bonus sacrifice' arrangements, although the link is not made in this book.

Also unmentioned by contributors is the connection with the well-known Australian Superannuation Guarantee. This stemmed from the 1986 National Wage Case, in which employers and trade unions agreed that half of an annual inflation-linked pay rise would be paid in the form of a 3 per cent employer superannuation contribution, to individual accounts in industry funds. It was later agreed that this would gradually rise to 9 per cent over 10 years from 1992. Although some employees apparently have regarded this 9 per cent as adequate cover for retirement, reportedly contributing to a depression in the individual savings ratio, superannuation coverage of the population has massively increased to 92 per cent of employees in 1999².

One of the great 'motherhood' statements in the investment world is 'choice is good': the more, the better, many marketing campaigns imply. Sethi-Iyengar, Huberman and Jiang disagree. A California grocery store offered 250 different varieties of jam. Two tasting tables were set up, one with 6 and the other with 24 different jams. Sixty per cent of passers-by went to the one with more extensive choice, but

only 3 per cent of them bought.

Contrastingly, of the rest who were more attracted by the limited selection, 30 per cent made a purchase. Results from a similar experiment with chocolates suggested that choosers may experience frustration with complex choice-making processes. The same authors cite research showing that if a 401(k) plan offered more funds, this reduced the probability of employee participation. If only two funds were offered, participation rates peaked at 75 per cent, but when there were 59 funds, it dropped to 60 per cent.

Similarly, Scott and Stein, reporting on redesign of an online financial adviser, found that if decisions were reduced to binary choices, instead of five options, contribution rates went up significantly. People may feel overwhelmed by too much choice and abdicate from making a decision, which helps to explain the common predilection for default investment options. Many would really rather somebody else (preferably an 'expert') made retirement saving decisions for them. Apparently small barriers can cause employees to abandon interest.

Macfarland, Marconi and Utkus consider why common incentives such as tax deductions, employer matching contributions, and workplace education programmes fail to induce one-third of eligible US employees to join their workplace savings plan. They suggest that financial education must be explicit, directive, increasingly focused on present-day benefits and vastly shortened and simplified. Saliternan and Sheckley argue that adult learning is best thought of as a process of 'seeing' relationships between new information on the one hand and knowledge gained from prior experience on the other. Adult learning should be understood as 're-cognition'; and not, following the mind-as-computer

metaphor, as simply information processing.

'Pension Design and Structure' focuses on research in the field of US employer-provided retirement provision, particularly money purchase 401(k) plans. Annuitisation is not compulsory in the US, and later chapters in the book discuss the consequences of this, with Panis especially stressing its importance for satisfaction in retirement. While these might bolster the convictions of UK politicians that we have somehow 'got it right' on this point, there are plenty of lessons yet to be learned.

How best to optimise participation in employer-sponsored schemes is only one of the burning issues. Many individuals in the UK cannot benefit from such an arrangement, because there is no obligation upon any employer to go further than 'designating' a stakeholder scheme, to which employees can contribute if they wish. These workers, and those self-employed, or non-employed, must make their own decisions. Is it putting it too strongly to

say that a sound understanding of the way people think about saving for retirement — or avoid thinking — is crucial to the future of our society? Further research in this field of behavioural finance might, for example, explore to what extent ordinary people considering saving for retirement share (or are put off by) the culture of providers, advisers and regulators who appear to view money purchase pensions as packaged 'retail products', to be sold to consumers.

References

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