

How to get people good pensions

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One of these days the people of Louisiana are going to get good government - and they aren't going to like it.

Huey P. Long,
Governor of Louisiana



One of these days the people are going to get good pensions - and they aren't going to like it.

.....So how can we get around that?



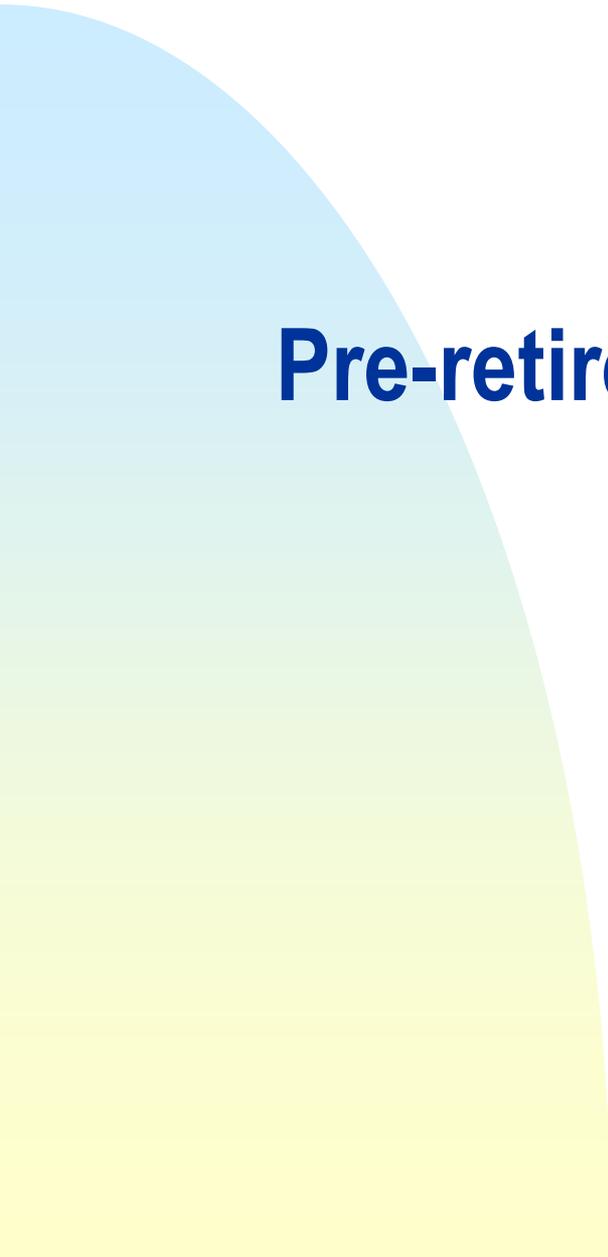
What is a good pension?

A good pension....

- Provides life long income security in retirement
 - Requires a lifetime annuity or other longevity risk hedge
- Provides an adequate income in retirement
 - Poverty protection
 - to prevent poverty in old age
 - pensions account for 80% of older households' income
 - Income maintenance
 - maintaining standards of living

Problems with generating a good pension....

- People have to
 - either save a lot in their pension plan whilst in work
 - or save less but work much longer
- Example 1: Male aged 25 joins pension plan and retires at 65, contributions are invested at 3.5% real. Replacement ratio is:
 - 43% with 9% contribution rate
 - 73% with 14% contribution rate
- Example 2: Male aged 25 joins pension plan, contributions of 9% are invested at 3.5% real. Replacement ratio is:
 - 43% if retire at 65
 - 82% if retire at 70
 - increase follows because five years of additional contributions and returns, and pension paid for five fewer years



Pre-retirement behavioural barriers

Starting to save

- **Procrastination** and **inertia** are enemies of saving:
 - Employees fail to join pension plans where they are required to opt in
- Retirement saving means reducing consumption now:
 - This requires **self-control** - not always easy
 - Similar to losing weight or giving up smoking
 - Insufficient sense of catastrophe to frighten people into preparing for retirement and overcoming self-control problem
 - Does the climate crisis provide a clue? Will come back to this

How much to save

- It is difficult to know how much to save for retirement
- Members may be **anchored** by irrelevant information
 - Default saving rate might be 8%
 - presumably that must be the right rate?

What to invest in

- Most DC members don't want to choose funds
 - 90%+ in default fund
- There are many behavioural biases relevant to investment:
 - **Regret**
 - **Loss aversion**
 - **Choice overload/anxiety (problem of complexity):**
 - Too many investment funds means no decision at all
 - **Weak investment preferences (problem of complexity):**
 - Individuals can easily be led
 - **Framing**
 - 'You are aware equities are risky'
 - 'You are aware that equities tend to generate higher returns in the long run, despite short-term volatility'

Personal valuation biases

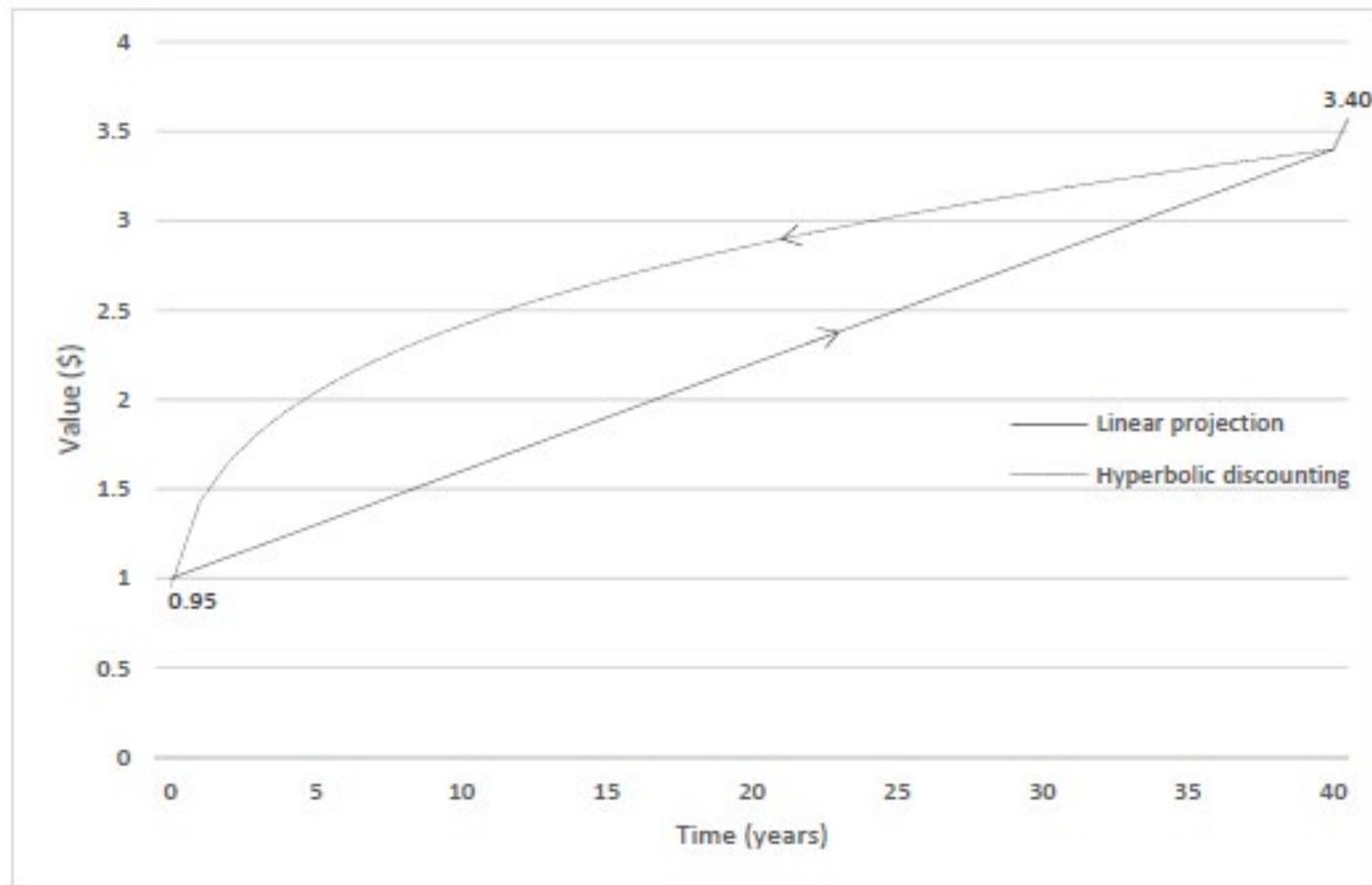
- Personal valuation of pension contributions subject to two psychological biases:
- **Exponential growth (EG) bias** due to linear projection
 - Failure to understand compounding
 - Many people underestimate investment value growth by neglecting compounding
 - Strong tendency for the brain to linearize functions when extrapolating or forecasting

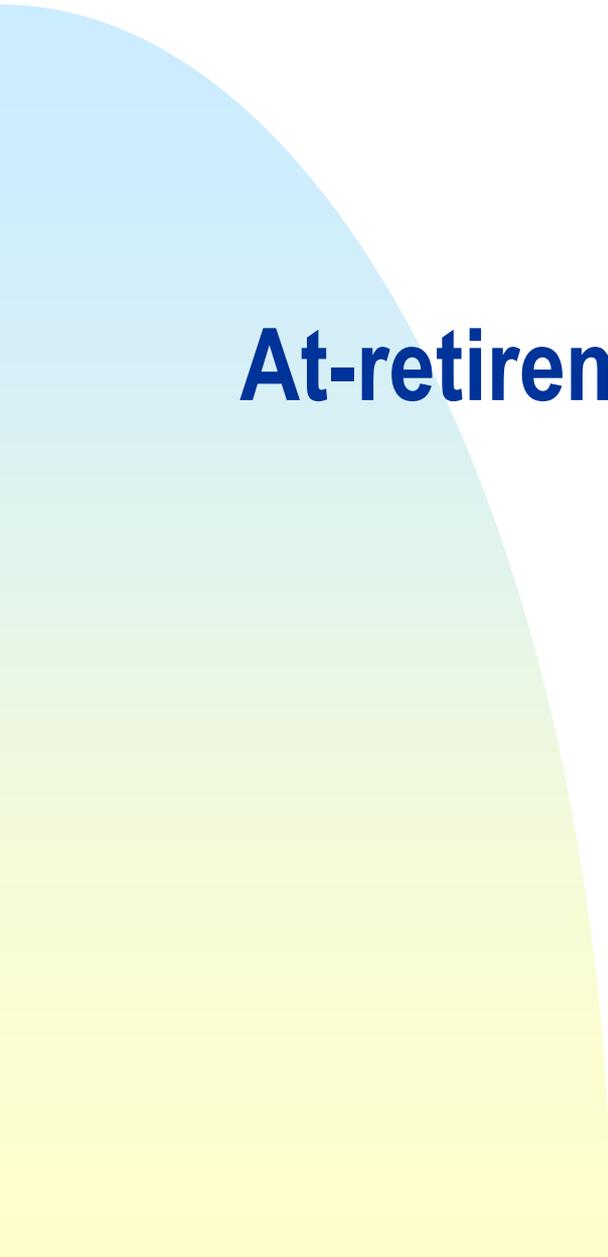
Personal valuation biases

- **Present bias**
 - Tendency to value the present over the future
 - Leads to hyperbolic discounting:
 - Near-future values are discounted much more steeply than far-future values
 - Results in time inconsistency - whereby, even when long-term value is attractive, short-term considerations discourage savings.
- Combined effect of the 2 biases:
 - Tendency to over-consume today and so face the possibility of running out of retirement assets before you die

Linear projection with hyperbolic discounting

Exponential projection (6% pa) = 10.29

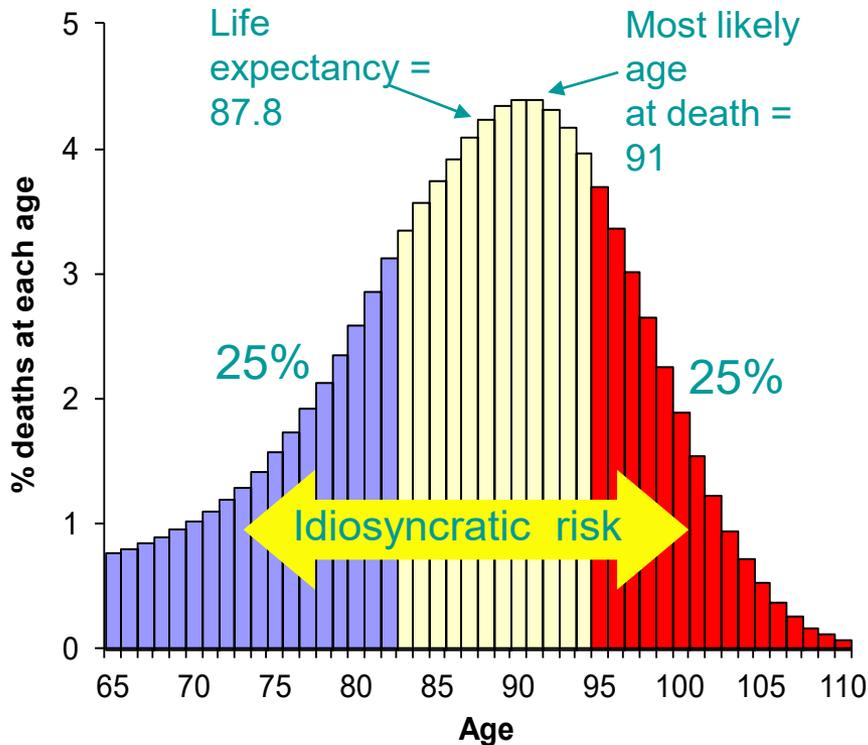




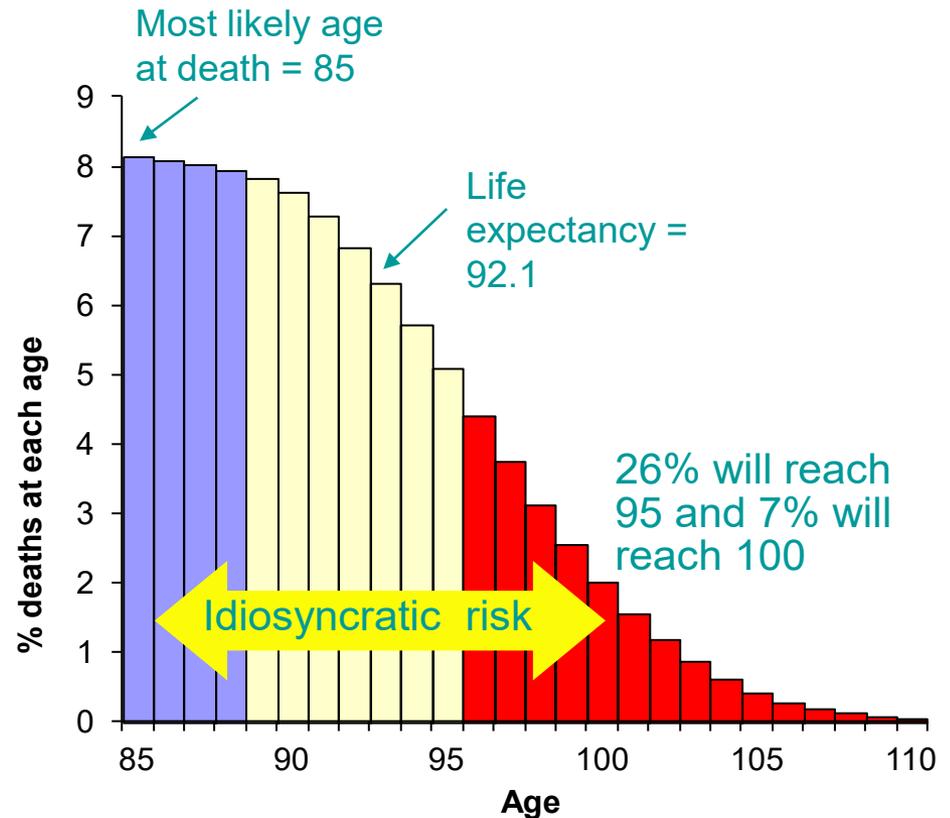
At-retirement behavioural barriers

Poor understanding of longevity risk - variability in life expectancy

Expected distribution of deaths: male 65



Expected distribution of deaths: male 85



100% PNMA00 2010 plus improvements in-line with CMI_2009_M [1.00%]

Annuity puzzle: Aversions

- Few people voluntarily buy annuities
- Reasons:
 - Losing control – giving up ‘large’ lump sum for a ‘small’ annuity
 - Longevity risk – poor understanding
 - Paying for advice - reluctance



Overcoming pre-retirement barriers

Overcoming exponential growth bias

- Improved financial education, especially in schools
- Generic financial guidance:
 - Eg, UK introduced free national guidance service called Money and Pension Service (MAPS)
- Provision of online retirement income projections or pension calculators
 - Eg, Money Helper in the UK (which is a subsidiary of MAPS)
- Independent financial advice
- Face-to-face explanations of compounding along with financial advice
 - Had large effect on savings in rural China

Starting to save

- Classic example is *Save More Tomorrow (SMT or Smart)* plan
 - Scheme member agrees to start or increase savings on regular basis - not now but on date of next pay rise
- SMT plans deal with a number of behavioural traits:
 - Overcomes **present bias**
 - Accept individuals have **self-control problems**:
 - And benefit from using **pre-commitment devices**:
 - **Auto-enrolment with payroll deduction**
 - **Withdrawal restrictions**
 - Utilize **inertia**:
 - Since, once signed up, workers typically do not cancel payroll deduction facility
- Auto-enrolment – now key part of pension planning in US and UK

How much to save

- Importance of an appropriate default contribution rate:
 - Should be 12%+ (combined employer/employee rate)
- Contribution rates in UK are too low to generate a good pension:
 - 8%: 5% employee, 3% employer
- Industry experts ask for auto-escalation up to 12%, but government reluctant

- Similar issue in Australia:
 - Australia did adopt auto-escalation and contributions rose from 3% to 9.5%, with the aim of reaching 12%
 - but government reluctant to increase above 9.5% at the present time

Nudging individuals into increasing their contributions

- Positive messaging to address 3 common weaknesses in preventing increased contributions:
 - affordability, a sense of being overwhelmed, and low confidence.
- Three messages to overcome these barriers:
 - “You’re already on your way to having a retirement income”. Building confidence by emphasizing what they have, including the State pension and any existing pension pots.
 - “Start from today and plan forwards”. Helping people work from what they know, to understand the gap they need to close.
 - “There are steps you can take”. Breaking it down into manageable and meaningful actions and showing the difference each step could make to a retirement income.

What to invest in

- To deal with **choice overload/anxiety**:
 - Have a well-designed and low cost default fund
 - Have only a small number of investment funds to cover the range of risk tolerances

- To deal with **inertia**:
 - Use lifestyle/target date investment strategies:
 - De-risking near retirement is automatic



Overcoming at-retirement barriers

SPEEDOMETER retirement expenditure plan

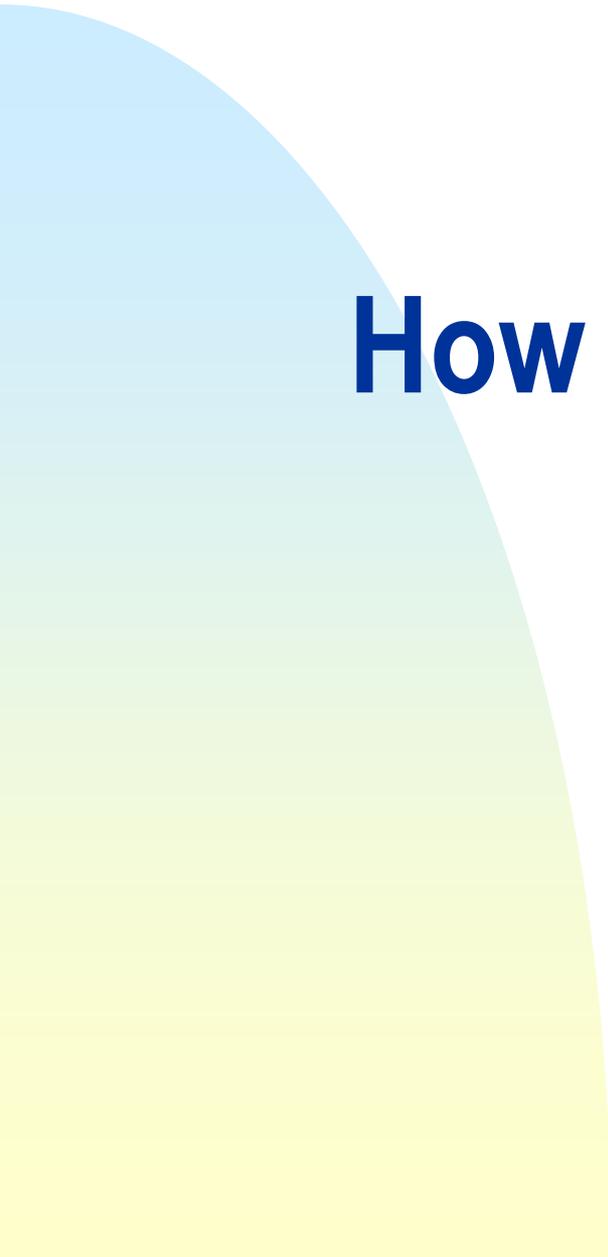
Spending Optimally Throughout Retirement

- **First**, make a plan:
 - Using financial adviser or generic financial advice
- **Second**, secure 'essential' inflation-protected core income
- **Third**, have insurance and a 'rainy day' fund to cover contingencies
- **Fourth**, secure 'adequate' income
 - Minimum lifestyle to which the pensioner aspires in retirement
- **Fifth**, achieve a 'desired' standard of living and make bequests

A universal plan for all retirees which manages *all* assets and income sources holistically to secure retirement income

How a *SPEEDOMETER* plan deals with behavioural traits

- The plan **NOT** the member deals with complexity of decumulation:
 - Through use of defaults and commitment devices
- Use of money-back annuities to deal with loss aversion
- Use of phasing into annuitization
- Positive norming via effective communication
- The slogan ‘spend more today safely’ to reinforce the idea that ‘buying an annuity is a smart thing to do’.



How networks can help

How networks can help

- Now beginning to be recognized that nudging is more effective in networks:
- **Employment-based networks** are most effective for:
 - Encouraging pension savings
 - Helping to pay-off debt via pay-roll deduction with payments used to create positive savings once debt paid off
- **Social networks:**
 - Family, friends and neighbours

The elephant in the room

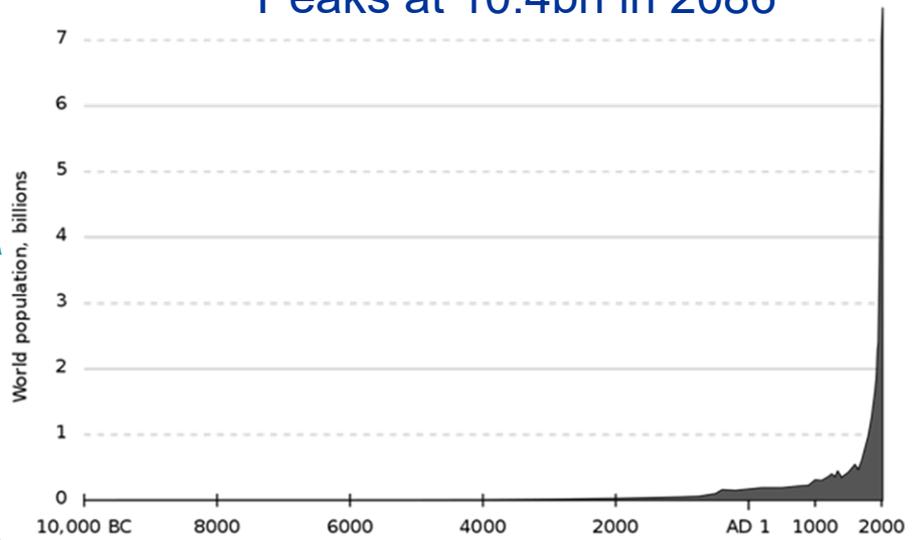
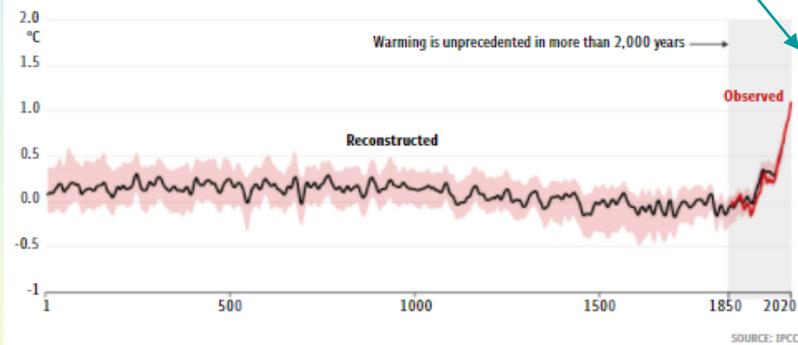


Climate change vs population change

Limited to 1.5°C rise by 2050

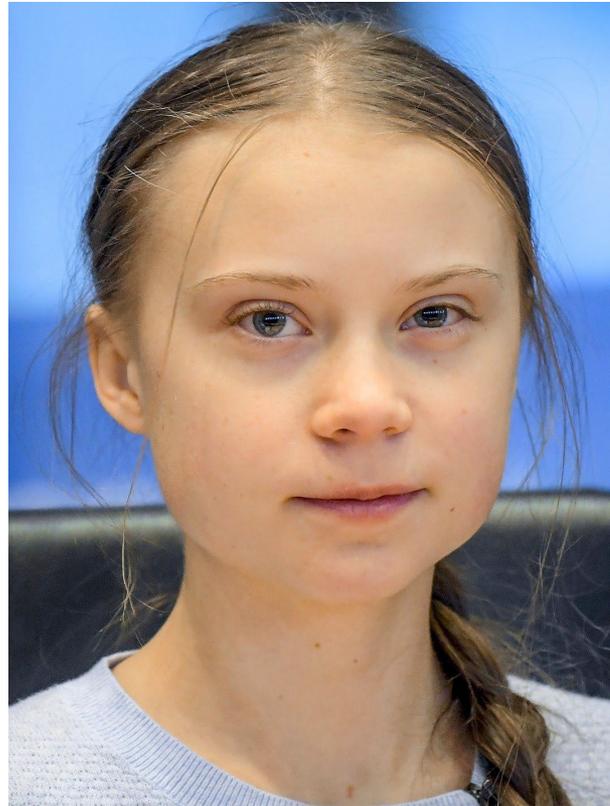
Peaks at 10.4bn in 2086

Climate change over the last 2000 years



Daily Telegraph 10 November 2021, https://upload.wikimedia.org/wikipedia/commons/b/b7/Population_curve.svg

We need a longevity risk champion



Conclusions

How to get people good pensions

- Assume nothing (or very little) about individuals
- Design products and marketing strategies with abilities of less sophisticated, less experienced population in mind:
 - Guiding choice, choice-editing ...
- **Nudging** will help if the product design is good
 - Needs legislative backing to be effective
- **Networks** can help support and reinforce good individual behaviour
- But must be realistic about the costs:
 - high contribution rates or later retirement are unavoidable
- Need a longevity risk champion – like Greta