Network for Studies on Pensions, Aging and Retirement

Summary

Netspar Brief 10: The Psychology behind Retirement Decisions

People in the Netherlands are increasingly being given a range of decisions to make regarding their pensions and retirement. Independent contractors, for instance, must decide for themselves to set money aside for retirement. Employees earning a full-time income of more than €100,000 must decide if they want to voluntarily save extra for later. Members in DC schemes can now decide how they want their pension capital invested through retirement. Moreover, with last year's change in the regulations, people now have a statutory option for assuming investment risk after they retire, allowing them to decide (within limits) how much of their pension savings to take out each month starting from the date of retirement. If, as many are urging, a system based on individual pension savings becomes implemented, the number and types of options are likely to increase. We looked to a combination of behavioral economics, social psychology, and linguistics to find new perspectives on pension communications and decision framing, two things which grow in importance as people are given more freedom of choice.

In this Netspar Brief, we draw some lessons from international experience and the academic literature. These show us that people - in this case, members of pension plans - systematically "deviate" from what might be expected according to the traditional model of rational behavior. This pertains to their preferences, judgments, decision making, and behavior. Almost no scientific evidence exists to back the presumption that financial training leads to better retirement decisions. The correlation found between financial know-how and behavior is the result of personality characteristics that influence these two variables.[1] Having more options generally leads to people not making decisions or to poorer (i.e., less carefully considered) decisions. In addition, people are susceptible to being guided – consciously or not – by their intuition, especially when they find decisions complicated. Feelings elicited by language are extremely influential in this. To compound matters, people systematically put off saving and are inclined to adopt what is offered as the default choice (deciding by not deciding).

These facts argue for limiting the number of options people are given and ensuring that simply not deciding does not become the default option. This can be accomplished by either making saving the standard option, so that people who do nothing are automatically saving, or forcing members to

[1]A simple example: The correlation between eating pasta and being Catholic is attributable not to the fact that one becomes Catholic from eating pasta, but that these two things are influenced by a third factor – being Italian.

actively make a choice (yes or no). Passivity and procrastination can be combated by decoupling the three main decisions (to save or not; how much to save; how much risk to assume), with the provider offering preprogrammed options for saving patterns and degree of risk, so that the individual only has to say Yes or No to the proposal. It would also be advisable to provide a standard option based on what is known about the individual, whereby the person has the option of deviating from that if they truly want. An important facet of this would be to map out the potential risks for people much more attentively than is now common: the usual questionnaires are unsuitable because people unwittingly fill them out incorrectly.

It is critical that the pension providers and pension fund management designing these pension options take into consideration the dynamics of how people arrive at decisions. Only then can freedom of choice provide the fullest added value.