

## The value of Customization in Pensions

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### Summary Netspar Brief 8 – January 2017

The Dutch cabinet, the pension industry, and the social partners are studying the possibilities for providing greater customization and freedom of choice in a new pension system. With the growing diversity of society, differentiation has become increasingly important. Pension providers can respond to this by offering their clients customized solutions, perhaps in combination with more choice. This Netspar Brief offers insight into the potential benefits of customization in supplemental pensions, weighed against the risks of having more room for individual error.

Differentiated pension plans offer participants value through better alignment with their individual situation or preferences. One familiar form of differentiation concerns the start date for a supplemental pension; many people choose to have their pension benefits start earlier – or later – than their target retirement age. Other options that currently exist are those related to the high/low pension arrangement or swapping out a survivor's pension. The need for differentiation might also increase in the future, for instance in terms of better coordinating personal wealth creation through pension savings and home ownership. Many households who currently accumulate assets through their home equity in addition to saving for retirement may actually be saving too much for their old age. Customized plans that balance pension contributions with mortgage payments could prevent such “oversaving” and yield a prosperity boost for individual households of 3 to 5 percent in terms of lifetime consumption. It is even more important to prevent “undersaving” by households with insufficient retirement savings.

With regard to the impact on solidarity of greater customization, the research findings are comforting. For far and away the majority of people, the security of a good collective pension is considered more important than any potential benefit from speculative or strategic behavior predicated on withdrawing from the collective. There is also little indication in actual practice that speculative behavior causes individual choice to adversely affect collective solidarity. The high/low formula, for instance, is adopted more frequently by high-income participants, whereas it actually provides a strategic advantage to people with low incomes because of their lower life expectancy. It would therefore appear that other considerations, such as the desired timing of retirement, take precedence in terms of influencing individual choice.



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Customization in the form of individual choice only produces prosperity benefits if the costs of individual error can be constrained. Modern behavioral theory teaches us that individual behavior is strongly influenced by the way in which choices are presented (nudging). We can reduce the risk of individual error by tailoring the options or freedom of choice to the individual participant. Future efforts should therefore focus on the thoughtful design of the architecture for providing customization and individual choice, appropriately aimed at balancing the desire for differentiation with forestalling individual error. Customization will therefore be limited to a few well-defined, suitable options offered within the collective pension schemes.