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Pension shake-up will leave some high and dry without proper guidance

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Some pensioners forgot to save for a rainy day. PA

The recent budget announcement providing freedom for retirees to decide how to allocate their own pension pots was a bold and surprising move.

However, a number of issues are clearly opened by this policy. The first is squarely in the realm of standard economics and was pointed out by Carl Emerson at the Institute for Fiscal Studies budget briefing. Left to their own devices people with low life expectancies are, on balance, better off not being in annuities schemes. This leads to an “adverse selection” effect where only those with a high life expectancy will chose to stay in, making the funds ultimately difficult to sustain.

Moving to the less traditional realm of behavioural economics there are clearly many potential issues with how people make these types of complex financial decisions.

Indeed the abysmally low levels of defined contribution pension participation in the first place led to the introduction of auto-enrolment in the private sector which has been continuing apace throughout the last year.

While auto-enrolment does preserve an element of choice for individuals in that they can still choose to opt out, the defaults are very strongly set and people are automatically re-enrolled two years after their first opt-out. Substantial guidance and support has been provided to both firms and individuals in choosing default funds that are suitable for people's characteristics.

Initial indications are that the vast majority of people are responding to the new defaults by staying in their pension schemes. Indeed one issue the government will face is the possibility that individuals who might have saved higher amounts without the default will "stick" at the level they have been allocated. With this in mind, there will be active attempts to encourage individuals to escalate their rates of saving through time.

Given the government has been so active in encouraging people to save more, it seems strange to reduce the intervention at the other end of the cycle.

It could be argued that early intervention is important to compensate for inexperience and to get people in the habit of saving. After all, with age comes wisdom, and a better appreciation of personal finances. Perhaps retirees can be expected to suffer less from biases that might influence younger people?

This is unlikely, however. There are many reasons why people may be poor at planning from retirement to death.

Underestimating life expectancy and the costs of long-term care is a key factor and one that will drive individual decisions. People also tend not to pay enough attention to the fees financial firms charge them, and thus end up with lower returns than would be expected in a truly rational market.

Furthermore, people tend to invest in a narrow range of assets they can understand clearly such as property, stock market funds or even just leaving money in low-interest deposit accounts.

The government has partly acknowledged these issues by introducing one-to-one impartial advice sessions for retirees. But it is unlikely such sessions will be able to override the problems arising from a large number of inexperienced investors suddenly arriving onto the market.

The striking increase in pension participation among auto-enrolled employees – 2.9m signups since October 2012 – highlights the futility of many of the attempts to improve pension participation through advice and information that preceded it. Just as people know smoking is bad for you, the fact that saving is a sound long-term strategy is well known; however acting on this proves difficult for many individuals due to the complexity involved.

Some say that attempts to restrain an individual's choice of how to spend their pension pot is disrespectful towards their freedom. But this is a facile argument. Under the announced policy the government will already tax money taken from pension pots and it is no more intrusive to seek to regulate what might happen in the new market created by the budget announcement.

The implications for long-term care provision are particularly worrying. What happens if, or when, a large number of retirees are lured into very low-return or risky investments through

confusion and predatory third-party marketing – who will pay for their care?

The Financial Conduct Authority (FCA) should set very clear guidelines on the type of products that can be offered to people as default retirement funds, and it must enforce strict rules on how fees, risks and rates are communicated to individuals.

The fact people differ markedly in their ability to make good financial decisions has been absent from policy and behavioural economics discussions for many years. If the government's proposed one-to-one consultation initiative is to be effective it must recognise this.

Clearly, some retirees will use the freedom provided by the chancellor's announcement to successfully seek higher value returns than they had previously been receiving. But those others who need far more than a simple advice session must not be ignored.

Both government policy and practical advice needs to recognise the many different types of retirees out there and be tailored accordingly. A blunt one-size-fits-all pensions policy risks simply handing financial companies easy profits at the expense of real financial stability for many households.



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