Summary

• A recent report on consumer engagement written for the Pensions Policy Institute (PPI) examines the use of behavioural science in encouraging pension saving, including both 'nudge' approaches to policy and more direct exploitation of behaviour. The most high profile example of the latter in evidence in recent years has been the use of widespread inertia to help drive the success of auto-enrolment.

• People can resist decisions that involve costs in the present, even if they will provide benefits in future that will outweigh the costs. This tendency to value benefits in different ways at different times is known as hyperbolic discounting.

• Social norms also tend to encourage a 'live for today and let's not worry about tomorrow' attitude.

• Research from the Institute and Faculty of Actuaries (IFoA) shows that just over half (52 per cent) of 1,000 individuals surveyed said they had not saved for their retirement; and one in three of those people said they did not plan to save for retirement at all. Overall 42 per cent of respondents had done nothing to prepare for retirement.

The power of psychology

David Adams analyses the behavioural habits and attitudes people have towards retirement saving

We all know we should save money, but some people just seem to be much better at it than the rest of us. Some of us are not very good at saving money. And some people who want to save money simply cannot afford to do so.

Clearly, people in the first group are most likely to take an active interest in pension arrangements. But what can and should policymakers and employers be doing to encourage and help everyone else to save more for retirement?

Behavioural science

A recent report on consumer engagement written for the Pensions Policy Institute (PPI) by Lauren Wilkinson examines the use of behavioural science in encouraging pension saving, including both 'nudge' approaches to policy and more direct exploitation of behaviour. The most high profile example of the latter in evidence in recent years has been the use of widespread inertia to help drive the success of auto-enrolment.

Another behavioural bias that can often explain this behaviour is present bias. CET suggests people are able to make impartial judgments about the potential costs and benefits to themselves both in the present and in the future in relation to financial decisions. But in practice, it seems, many people assess the value of costs and benefits in different ways depending on how distant a future is being considered. People can resist decisions that involve costs in the present, even if they will provide benefits in future that will outweigh the costs.

As Wilkinson notes in the PPI report: "In some cases a smaller benefit now may be considered preferable to a larger benefit later." This tendency to value benefits in different ways at different times is known as hyperbolic discounting. At present, of course, hyperbolic discounting is tempting in a saving money context in part because interest rates being paid on savings are so low. Even those individuals who understand that the growth of pensions savings depends to a great extent on investment returns may not take much encouragement from the volatility of the financial markets in what feels like a particularly unstable political and economic environment.

Barnett Waddingham senior consultant Malcolm McLean suggests that social norms also tend to encourage a 'live for today and let's not worry about tomorrow' attitude. "It's partly attitude and partly realism: with students coming out of university weighed down by debt it's incredibly difficult for young people to save up for anything," he says. "Also, I think you'd have a hell of a job persuading 20 year olds that this is even an issue. They can't imagine what life will be like in 40 years' time."

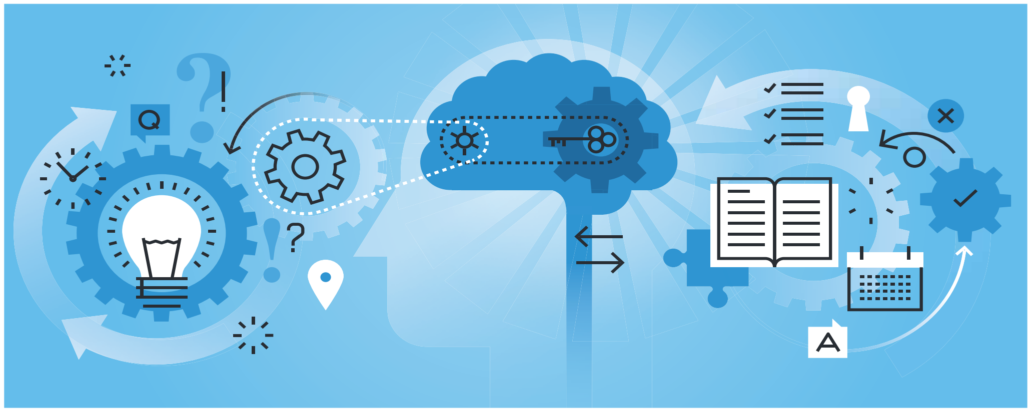
The prevalence of these attitudes seems to be confirmed by research from the Institute and Faculty of Actuaries (IFoA). Just over half (52 per cent) of 1,000 individuals surveyed said they had not saved for their retirement; and one in three of those people said they did not plan to save for retirement at all.

Overall 42 per cent of respondents had done nothing to prepare for retirement. Although, as you might expect, that figure was lower in higher age groups, it was still the case that one in three people aged 55 and over had not done anything to prepare for retirement.

Engagement

"There is a definite lack of engagement when it comes to saving for retirement," concludes IFoA policy manager Rebecca Deegan. "It's just so far away. And many people just don't understand pensions."

So, in addition to exploiting apathy to bring people into pension schemes, making the system simpler and easier to understand might also encourage



more saving. Part of the reason auto-enrolment has been so successful is because it is a default option. "It does seem that if you set a default then people will go along with that up to a point," says Pensions and Lifetime Savings Association (PLSA) DC policy lead Tim Gosling. "There is a point at which that breaks down – with auto-enrolment that is probably related to contribution levels. But we don't know where that will be: we'll have to find out through trial and error."

Deegan says the IFoA agrees that the pensions system needs to encourage and attempt to incentivise people to save more for retirement. "But it's crucial that no changes are made that could increase opt-out rates," she says.

She favours the use of auto-escalation, as is used in the Save More Tomorrow concept used in the US: gradually increasing the proportion of income that an employee is saving over time. This is an effective approach from a psychological point of view for two key reasons, says Deegan: it's a commitment to save more at some point in the future, rather than now, so postpones the feeling of loss associated with less money being available to spend. And if increases are made only when employees receive a pay rise they are not really aware of a larger chunk of money being saved rather than paid directly to them.

Gosling is not sure how applicable this model is to large parts of the UK workforce at present. "I think it works well where you've got a large, stable workforce getting regular payrises and a paternalistic employer committed to the pension scheme," he says. "But the UK at the moment is experiencing very low wage growth. And look at the rate at which master trust membership is churning as people move from one job to another."

But the IFoA has other suggestions to help increase auto-enrolment contributions. Deegan outlines a scenario in which the ratio between the employer and employee contributions might switch, so that if an employee opted for higher contributions the employer would pay slightly more in relation to the employee contribution, perhaps in return for some extra tax relief for the employer. The IFoA sees the potential introduction of such an arrangement as a long term goal – Deegan accepts that the idea doesn't necessarily sit comfortably with the use of simplicity and inertia.

McLean is not completely convinced by the 'nudging' approach: he would like to see more overt encouragement for pension saving from the government – he is concerned that promoting new types of ISA instead may divert attention from this goal. He would also like to see more awareness of the value of tax relief in pensions; and bemoans the mixed messages that have been coming out of government in relation to pensions tax relief in recent years. "I'm pretty sure that the majority of people don't understand how tax relief on pensions works – sometimes they don't even understand they're getting tax relief," he complains. Most of the industry would also like to see more work done to improve financial knowledge, in schools, in the workplace and when individuals have the opportunity to access pension savings after the age of 55.

IFoA research suggests employers have a particularly important role to play in relation to younger employees, says Deegan, perhaps because they are not quite psychologically ready to think too far into the future. Among those people surveyed who had already made some effort to plan for retirement, older people tended to seek further information from their pension provider, but older people tended to ask their employer for information.

"We believe this demonstrates the crucial role of employers, particularly in the earliest stages of a person's working life and before they might believe that the information sent to them by their pension provider is important or relevant to them," she says.

The bigger picture

Ultimately, neither behavioural science nor better financial education can solve completely the problem of inadequate levels of saving for retirement. The bigger picture is important here too, including the impact on personal finances of irregular employment patterns and the outrageous cost of housing in many parts of the country. But more use of behavioural techniques would clearly help ensure that more people enjoyed a better income in retirement. And – just as is the case for the process of saving itself – as we try to overcome widespread behavioural biases and the long-established cultural norms of our spendthrift, credit-addicted society, every little helps.

Written by David Adams, a freelance journalist