Opinion: Dangerous to leave humans in charge of their financial futures

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Humans are irrational. Superheroes also. Credit: Santi Molina, CC BY-NC

Much standard economics research is based on the "homo economicus" decision-maker. This is an entirely rational being. An unbiased, unemotional, non-psychological maximiser of the expected usefulness of things and events. Furthermore, this perfect decision-maker is far-sighted, and has complete self-control.

If that seems instinctively problematic, then you'll be pleased to know that behavioural economics research instead recognises that real-world "homo sapiens" decision-makers are not fully rational, are biased, are emotional satisfiers. Furthermore, such decision-makers are myopic, and lack self-control.

For a long time though, policy-makers have based policy on that "homo economicus" model, not least in the world of financial decision-making, such as investing, saving and pensions. On this basis, there has been a move to give more financial responsibility to individuals.

Benefits trap

In the world of pensions, this has meant moving from defined benefit to defined contribution schemes. In defined benefit, you know what you will end up with and it's up to your employer to dictate the amount of pension contributions and how the fund should invest those contributions. In defined contribution, the onus is very much on the employee to decide how much to save each month and how to invest it into assets like shares which introduce an element of risk.

The "homo economicus" approach is a normative (prescriptive) model: it prescribes how the perfect decision-maker should behave. Given this approach, those defined contribution schemes make sense. The fully-rational all-calculating, unemotional employee chooses their optimal pensions-saving plan. They use sophisticated techniques to calculate the correct balance between monthly consumption and savings for future retirement from monthly salary.

In contrast, the "homo sapiens" approach is a positive (descriptive) approach. It describes how people actually behave in the real world, given their psychological and behavioural biases and emotions, limited rationality, myopia, and lack of self-control.

This behavioural economics approach reveals the dangers in passing the responsibility to employees: a danger of insufficient pension-provision as myopic actors, lacking self-control and having limited financial literacy, spend too much today and save too little for retirement. Indeed, Lucy Ackert and Richard Deaves argue that employees who are required to manage their own retirement accounts through a defined contribution scheme are not like other investors. They are drafted in for the job, and it is reasonable to assume that they would suffer from cognitive biases and limited financial literacy compared to other, professional, investors.

It was this conclusion that led behavioural economists Richard Thaler and Shlomo Benartzi to develop a practical tool to encourage saving for retirement. This tool is known as SMART (save more and retire tomorrow).

Control

Behavioural economists argue that, when faced with a lack of self-control, humans need – and indeed demand – control mechanisms to be imposed upon them. Think of Christmas Club savings plans, and fitness and diet clubs such as weight-watchers which involve people voluntarily submitting to institutional control, because they are aware that they lack self-control. We also hear this week that addicted gamblers can apply to get themselves barred from their local betting shops.

Again, the argument is that they are being invited to substitute external control for a lack of self-control.

In the world of pensions, defined benefit imposes control on imperfect individuals. We haven't entirely left workers to fend for themselves as we move to a defined contribution model. The slow introduction of auto-enrolment has helped to offer some external control to nudge people towards a sensible approach to retirement saving.

But the good news stops there. Besides the move towards defined contribution, a recent disturbing development has been the move towards pensions freedom as workers approach retirement. Once you reach the age of 55, you are no longer tied into a given regular pension payment in retirement; you have the freedom to take your pension pot and spend it any way you desire. You can even spend it all immediately: the "Lambhorgini" or "World Cruise" decision. So, in addition to insufficient savings for retirement along their lifetime career, what they have saved can now be blown at 55 years old.

Making sense of it all

Maybe you're thinking that 55 year-olds are more responsible than 25 year-olds? Well, there is a body of research which investigates the effect of ageing on financial decision-making and which questions that idea.

Some interesting research by Professor Bruine de Bruin emphasises the complex behavioural factors affecting decision-making in old age. Her work demonstrates that, as people age, they become better able than youngsters to engage in emotion-control. Their cognitive abilities, however, decline.

Fears are building that pension freedoms could lead to a generation of pensioners who face the dangersof their pension pots running out during their retirement years. According to the International Longevity Centre UK, this may result in "reduced financial resilience during retirement".

The changes have also introduced more complexity at a time when evidence should be pushing us towards simplification. Take Rob Hardcastle's 2012 report for the Department of Work and Pensions: he argues that, faced with complex financial decisions, people tend to rely on heuristics (rules of thumb), which can lead to bad decision-making. He also argues for keeping pensions as simple as possible.

Just as the government imposes more complexity in pensions, it is ironic that in the past years, it has commissioned a series of reports into "Simple Financial Products" in order to encourage long-term savings, and which appear to recognise the lessons from behavioural economics that complexity, combined with psychological biases, emotions and lack of self-control, has reduced saving, and increased myopia. Freedom is an appealing idea, but handing over complete liberty in retirement planning to us poor, imperfect decision-makers is a huge risk that has implications for the country as a whole – and not just for the individuals forced to trade-in a used Lamborghini to heat their house through the winter.

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