Behavioral economics applied to new pension contracts

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The optimal new pension contract can and must take into account people's need for certainty and the possibility to spread the risk of financial setbacks out over time. Servaas van Bilsen argues this in his PhD thesis, Essays on Intertemporal Consumption and Portfolio Choice, which he defended at Tilburg University on November 4.

Van Bilsen has applied theories from behavioral economics to the current debate on a more sustainable pension system. The classical economic theory on the way in which people take economic decisions does not lead to an optimal pension contract, Van Bilsen states.

"How and when people spend money, how much they put aside for retirement, and how they want to invest that money, behavioral economics teaches us that these decisions may not have the same result in all circumstances. This must be taken into account in the new pension plans", Van Bilsen says

Buffering shocks

As we all know, the pension sector, employers, employees, and the government are designing a new system that is 'adapted to the needs of our times'. It must be able to buffer shocks and needs to be better tailored to individual wishes. In general, participants will have to shoulder more risk and take more individual decisions.

Last year, the Tilburg research institute Netspar launched the concept of the Personal Pension Plan with Risk Pooling (PPR). It concerns a personal investment account with additional arrangements for risk pooling. The PPR has options for tailor-made solutions at an individual level.

Sadness

Van Bilsen has analyzed the ramifications of behavioral economic theory for this PPR. "The theory teaches us, for instance, that potential loss weighs heavier than potential gains: people's sadness over the loss of € 100 is greater than their joy over gaining a similar amount. This means that an optimal investment strategy must be aimed at preventing loss of pension benefits rather than at achieving high potential gains."

Another consequence is that financial setbacks must be gradually absorbed by the pension benefits. Experience, as well as behavioral economics theory, has shown that people only gradually adjust their consumption to financial shocks. A 10-percent reduction of pension assets therefore should not immediately lead to a 10-percent reduction of the pension benefits. There is also a great need for certainty. These options must to some extent be built into the new contracts.

Balance

Incorporating the various wishes into a new pension contract is a complex matter, but it is feasible, Van Bilsen states, "even though they may be conflicting needs, for instance, risk pooling on the one hand and options to withdraw money from the pension account on the other. For an optimal new pension contract, such options must be properly balanced."

Provided by Tilburg University