

What are the risks of automatic enrolment for employees? An analysis using a bounded rationality framework

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Assumptions

- Pensions are deferred income
- AE is mainly aimed at the employees of SMEs
- Automatic enrolment (AE) will be into a DC-type scheme
- The impact of AE pension policy legislation may not be understood for a generation

Bounded rationality

- “The term ‘bounded rationality’ ... takes into account the cognitive limitations of the decision-maker—limitations of both knowledge and computational capacity” (Simon, 2008, p. 893).
- “Our research attempted to obtain a map of bounded rationality, by exploring the systematic biases that separate the beliefs that people have and the choices they make from optimal beliefs and choices...” (Kahneman, 2003, p. 1449)

Liberal paternalism

- “Humans... often need help to make more accurate judgements and better decisions, and in some cases policies and institutions can provide that help.” (Kahneman, 2011, p. 411).
- “...*choice architecture*, understood as the social background against which choices are made” can be used to improve human welfare (Sunstein, 2013, p. 1826).
- Channelling choice through defaults that are enabled through legislation is ‘**paternalism**’.
- ‘**Liberal**’ means that individuals are **free to choose** to move out of the defaults in order to make choices that better reflect their preferences.

Risk and responsibility

Warning: The value of your investment may go down as well as up.

Warning: These funds may be affected by changes in currency exchange rates.

Warning: If you invest in these funds you may lose some or all of the money you invest.

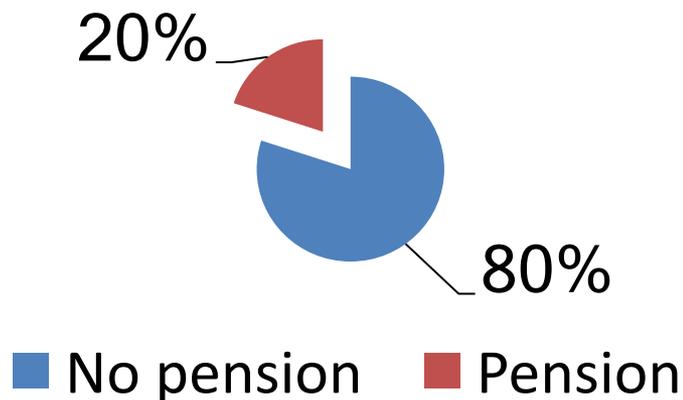
- Pension providers complying with legislation **are not** responsible for risk
- Employers (& trustees) complying with legislation **are not** responsible for risk
- Pension scheme members **are responsible** for risk

- Late 20s
- Full-time employee
- Small enterprise (5-49)
- Soon to be married; no children yet
- Average earnings per week €550; no benefits

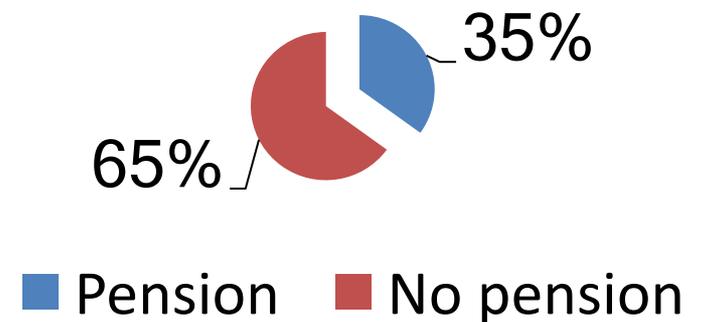


Meet Amy

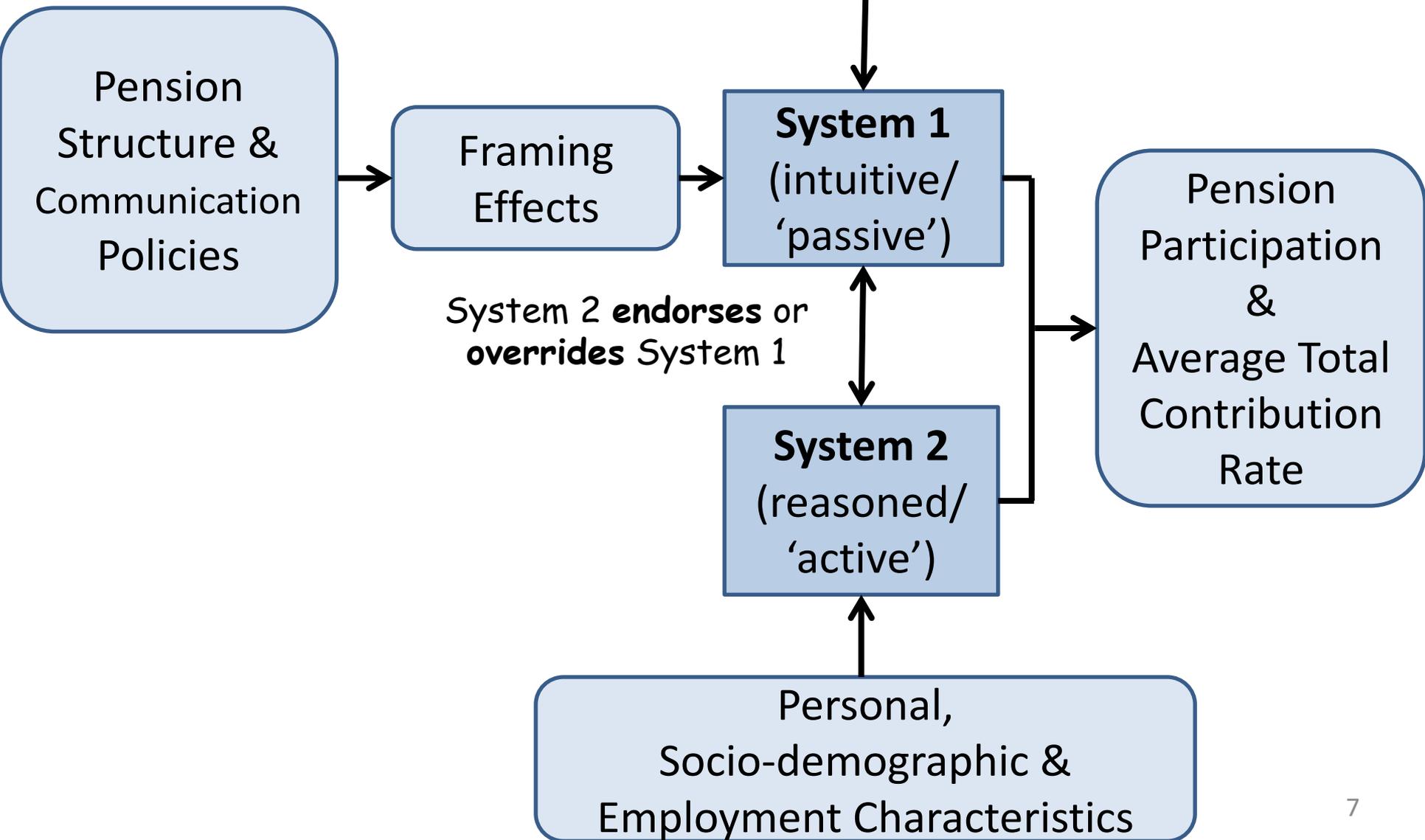
Small enterprise (5-49 employees)

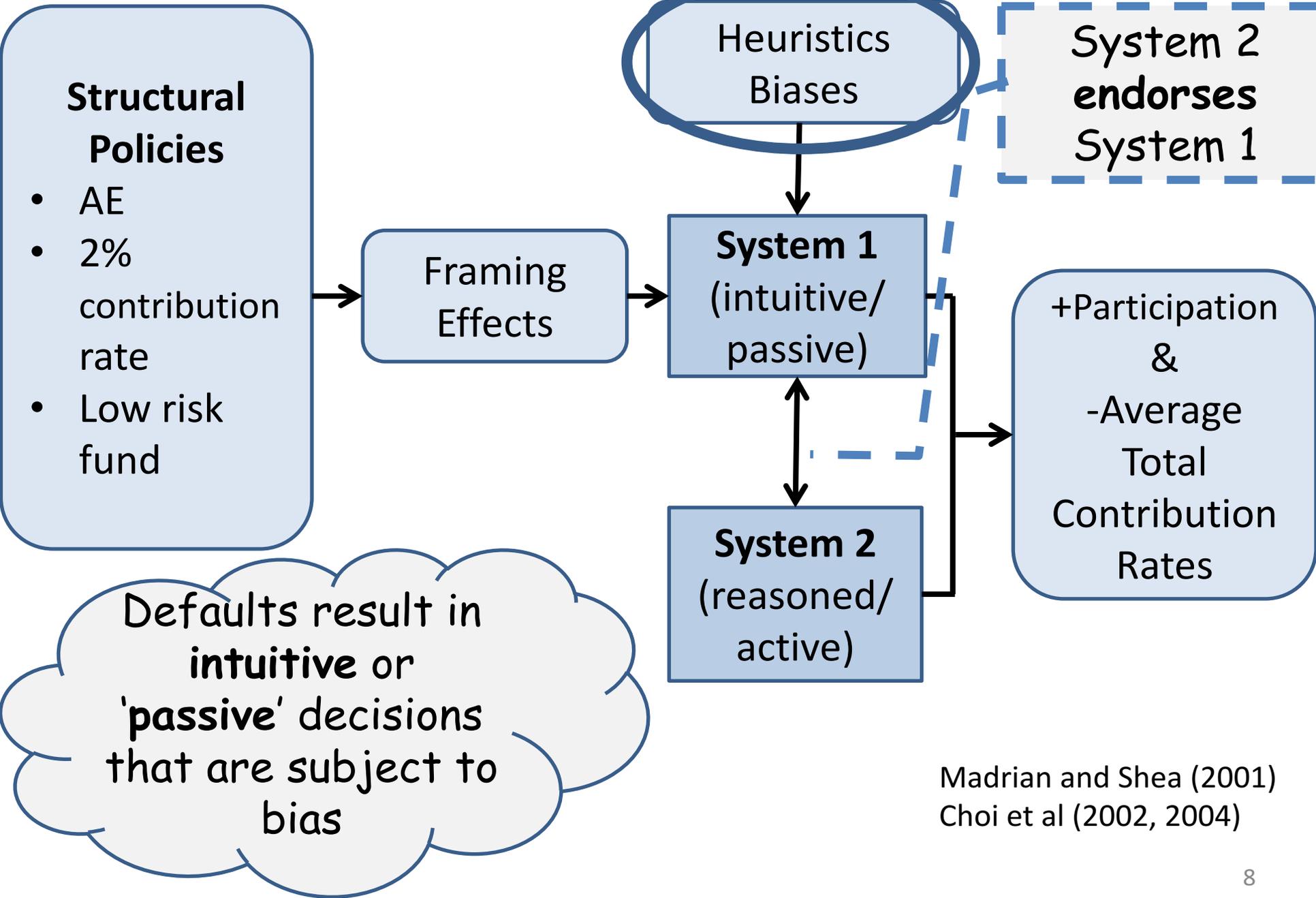


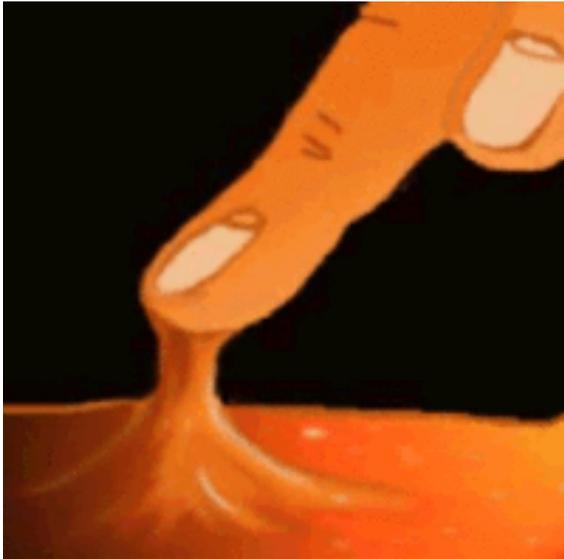
Employees aged 25-34



Bounded rationality framework for **defined contribution** schemes







Very 'sticky' defaults

- Automatic enrolment
- Investment fund

Fairly 'sticky' defaults

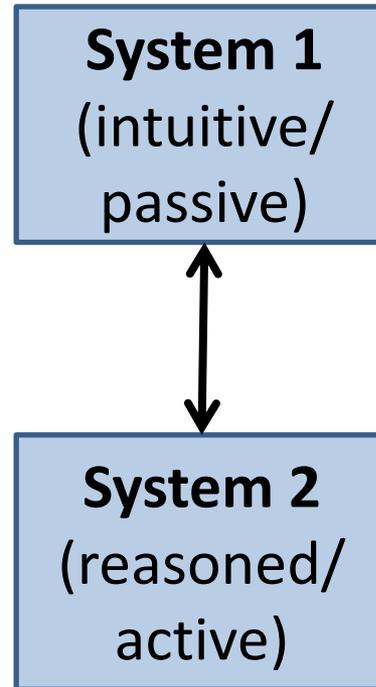
- Contribution rate

- Research suggests that defaults powerfully impact pension savings behaviour

System 2 and the 'Un-pensioned'

System 2 characteristics
Less educated/ less
financially literate

- Young
- Female
- Lower income
- Employees of micro & small organisations
- Part-time
- Weak labour market attachment



Amy is likely to
remain in defaults.

- Low income, recent hires and young employees were most likely to remain in defaults (Beshears et al, 2010; Choi et al, 2004; Madrian & Shea, 2001)



'Passive' does not ensure 'good' or 'bad' outcomes

Country	Provider	Default strategy	ESMA (growth phase)	Glide path (years)	% in equities 10 years from retirement
Ireland	Irish Life	Lifestyle	5	20	60
UK	NEST	Retire- ment date	5	10	100
US	Vanguard	Target date	?	25	60-70

- Defaults are important
- No consensus on the default contribution rate
- Emerging consensus on the default investment fund
- With AE, a large proportion of pension scheme members' assets will be invested in very similar funds

'Passive' does not ensure 'good' or 'bad' outcomes

- 'Good' defaults should lead to better results for many...
- ... but stress tests are needed to see the impact of a '.com' bubble or WFC at periods before retirement assuming that pension scheme members will stay in the defaults
- Having saved for decades, cohorts of workers may not have enough money to retire

Though Amy may not understand the **riskiness** of her default investment fund, the outcome is her **responsibility**



'Active' does not ensure 'good' outcomes

Members...

- prefer **company's stock** rather than a diversified portfolio ...prioritise **historical returns over fees**
- ...use **naïve (1/n) diversification strategies** or **evenly divide investment** between small numbers of funds and decisions are **unconnected** with attitudes to **risk**
- ...**remain in investment fund** in spite of better choices
- ...**buy high, sell low**

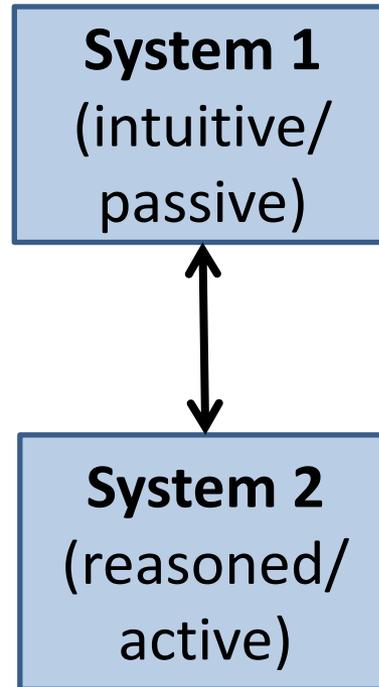
Amy is unlikely to make **GOOD** active decisions



Improve System 2?

Mixed views

- Financial education complements structure
- Financial education can improve decision making
- Financial education should be required in the workplace
- Effectiveness of communication is unclear
- Communication to change thinking is expensive



Communication from Amy's employer will probably be minimal

UK experience

- About 50% of medium-sized employers did little or nothing to promote pensions beyond statutory obligations (U.K. NEST, 2015)
- Statutory minimum communications is 3 (reduced from 5)



Conclusion

- Bounded rationality suggests that our cognitive and computational abilities are limited
 - Pension decisions for DC-type schemes are very complicated for Amy
- AE is a 'sticking plaster' with potentially unintended consequences
 - 'Good' outcomes for Amy will be a result of 'good' defaults and 'good' luck rather than skill
 - 'Bad' luck is Amy's responsibility
- Supporting employees of SMEs to make 'good' decisions through financial education and communication is costly with no guarantees that these policies will work
 - Amy's employer is unlikely to do more than the statutory minimum
 - Amy is unlikely to seek independent financial advice



- We blame Amy for not engaging in pension decisions.
- It is time to look at the schemes that we expect Amy to join.