

# 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.**

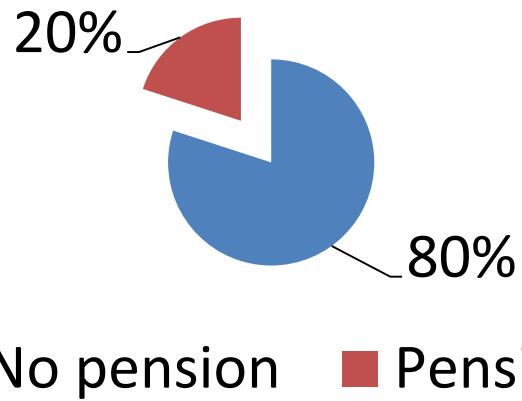
- Pension providers complying with legislation **are not** responsible for risk
- Employers (& trustees) complying with legislation **are not** responsible for risk
- Pension scheme members **are responsible** for risk

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

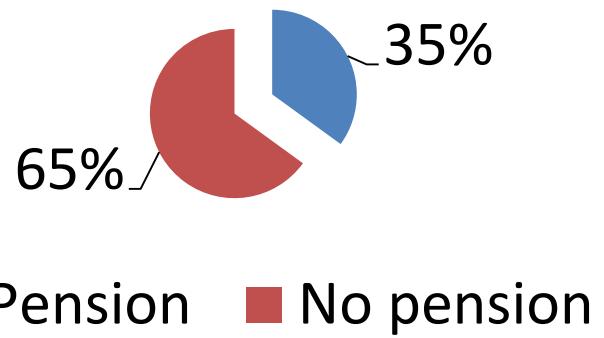


**Meet Amy**

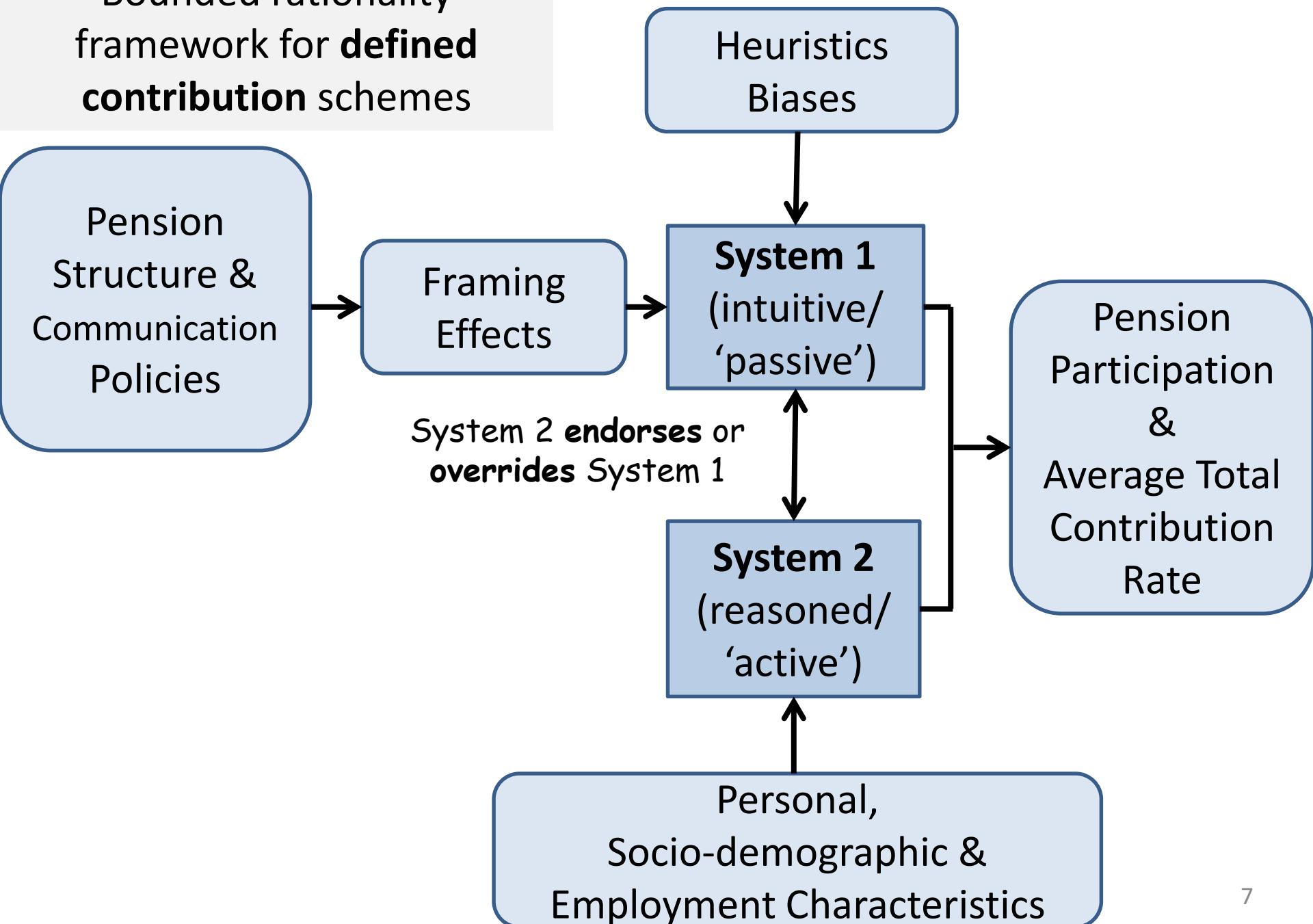
### **Small enterprise (5-49 employees)**



### **Employees aged 25-34**



Bounded rationality  
framework for **defined  
contribution** schemes



# Structural Policies

- AE
- 2% contribution rate
- Low risk fund

# Framing Effects

# Heuristics Biases

System 2  
endorses  
System 1

# System 1 (intuitive/ passive)

## System 2 (reasoned/ active)

+Participation  
&  
-Average  
Total  
Contribution  
Rates

Defaults result in  
intuitive or  
'passive' decisions  
that are subject to  
bias



## Very 'sticky' defaults

- Automatic enrolment
- Investment fund

## Fairly 'sticky' defaults

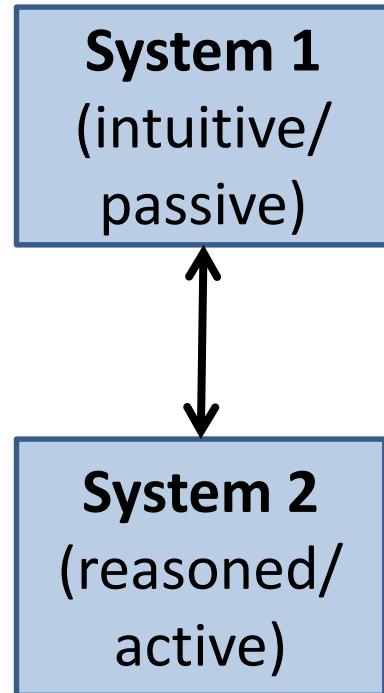
- Contribution rate

- 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	Retirement 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

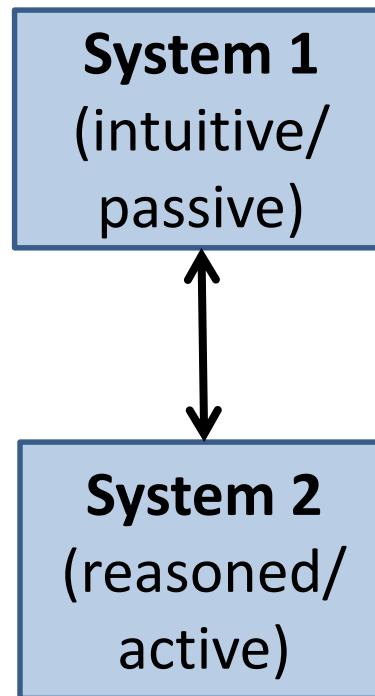
Amy is unlikely to make **GOOD** active decisions



# 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.