Auto Enrolment- A Behavioural Economics approach to encourage saving for retirement.

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The Introduction of Automatic Enrolment into Workplace Pension Schemes and its effect on longer term savings provision.

The Problem

As the UK faces the prospect of a growing population living well beyond retirement, the state must address the provision of an income and associated welfare benefits beyond the working years of far more people than was ever envisaged at the time of Beveridge. When it was published on December 1st 1942 'Social Insurance and Allied Services' more commonly known as the Beveridge report (Beveridge, 1942) was an instant success selling 635000 copies and receiving praise from press and public alike. It proposed an insurance based scheme that promised 'Freedom from Want' from cradle to grave when the popular phrase to measure a good lifespan was 'three score years and ten'.

According to the 2005 Government Actuaries Department projections, a man in the UK, reaching the age of 65 in 2050, now has a projected life expectancy of a further 23.6 years. (Hills, 2006). The prospect of the state providing from 'womb to tomb' for a good life span of three score years and 28.6 presents a significantly increased financial commitment.

There is some debate over the accuracy of such life expectancy predictions. Beveridge's report underestimated the percentage of Britons that would reach state pension age by 1971. As the chart below shows it reached 16.4% and not

the 20.6% predicted.

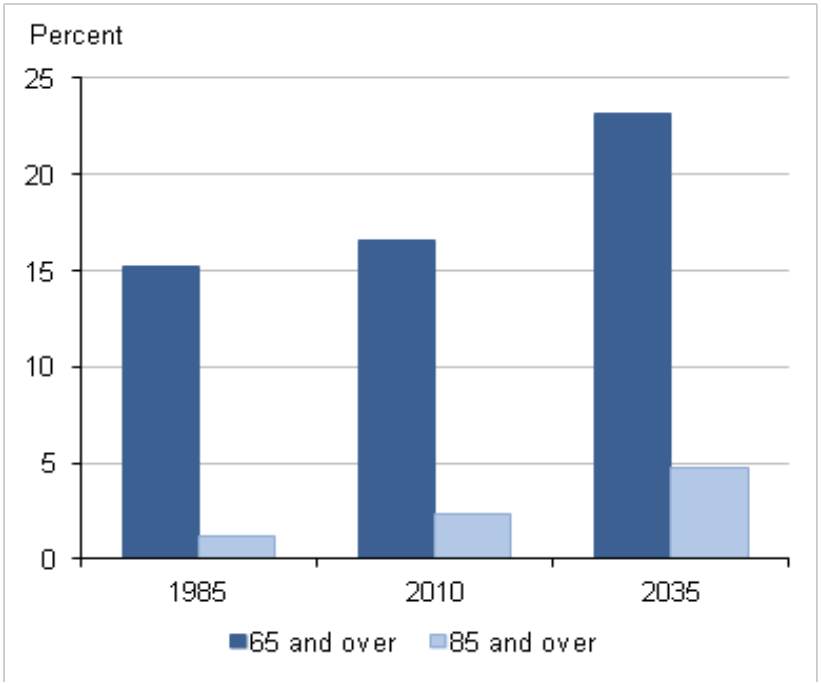
Table 1. 1942 and 2005 projections of age structure†

	Beveridge report projections (%), 1942 (Great Britain)		*Actual (%) (Great Britain) for the following years:*		*GAD principal projections (%), 2005 (UK) for 2031*
	1941	*1971*	*1971*	*2004*	
Under 15 years of age	20.6	16.5	23.9	18.2	16.1
15–SPA	67.5	62.6	59.7	63.3	61.0
SPA and over	12.0	20.6	16.4	18.5	22.9
Old age support ratio	5.6	3.0	3.6	3.3‡	2.6‡

†Sources, Beveridge (1942), Government Actuary's Department (2005) and earlier equivalent for the 1971 actual population.
‡Using the population over 16 years of age.

Whilst such predictions can be challenging, the assumption remains that longer life expectancy and the unwinding of the 'baby boom', which was not predicted in Beveridge, will lead to an increase in the percentage of the population retired as illustrated by the ONS chart published in 2012.

Percentage of older people in the UK 1985, 2010, 2035



02 March 2012

Source: Office for National Statistics, National Records of Scotland, Northern Ireland Statistics and Research Agency. (Ons & Nisra, 2011)

Over recent years there has been a change in the nature of pension provision. Many people were members of large company pension schemes to which they were often contractually obliged to join. Whilst these arrangements were connected to the Capital Markets their benefits were defined and underpinned by guarantees. 'It was understandable that individuals understood these schemes as a form of wage-deferral rather than an investment.' (Berry, 2016) As these schemes closed to new members and the erosion in the real value of the state pension occurred a 'financialisation'of pensions policy in the UK was required. (Berry, 2016). This argument to justify pensions regulation and encourage saving is less salient and saleable than the need to provide for an increasing population of retirees and is rarely mentioned by politicians.

Many Defined Benefit schemes were replaced by Defined Contribution schemes. Unlike Defined Benefit schemes where pension payments are guaranteed and subject to regulations, income provision from alternatives such as Defined Contribution schemes are based on investment returns and require a series of complex decisions to be made by the individual. For millions of people the investment risk to create a savings pot sufficient to support themselves financially through retirement moved from the employer to the individual.

A False Start. The Neo-Classical Economics Approach to Encourage Saving

The Government sought to address the issue by compelling employers to offer a low cost personal pension arrangement. This was a solution based on a neo classical economic view that making the product cheaper would lead to greater demand and making it easily available would ease the cognitive strain of choice. In many cases, however, pension plans are 'sought not bought', so this initiative did not solve the issue of a lack of investors. Individuals still had to make the

conscious effort to ‘opt in’ and employers were not bound to contribute so the new schemes were effectively just cheaper versions of the old ones. The cognitive strain was simply moved from considering ‘where can I access a pension’ to ‘how should I invest my savings’. This ‘financialisation’ of pensions still left individuals responsible for making their own decisions on which funds to invest in, often without advice which many employers were reluctant to provide. This individualisation of pension provision removed the insured nature of the defined benefit schemes replacing them with what are effectively tax advantageous, individual investment plans.

Despite national advertising campaigns and regulations reducing the costs most private sector workers were still not saving for a private pension at all. Figures from the 2006 Pensions Commission showed that in the private sector, membership of pension schemes was falling. In 2002–2003, 10 million private sector employees contributed to non-state pensions, but 10.5 million did not. By 2004–2005, contributors had fallen to under 9 million and non-contributors had risen to over 11.5 million (Pensions Commission (2006),.(Hills, 2006)

‘Pension fund capitalism in the United Kingdom was over before it had really even begun.’ With individuals not saving for their own retirement, and the state pension continuing to lose value in real terms, eligibility for means-tested pensioner benefits was forecast to increase dramatically’. (Berry, 2016). An issue the Government still needed to address.

A Behavioural Economics Approach to Encourage Saving

Neither the regulatory change, the financial incentives granted or the reams of information provided had prompted the ‘rational’ individual to cogitate and make the obvious decision to maximise their utility. The ‘neo classical’ framework had failed and a psychological, behavioural economics framework was required.

The choice architecture needed to be altered to increase membership of retirement plans and advance the ‘financialsiation’ of the individual further. Inertia had to be removed from the initial choice of joining the scheme and further inertia removed with the availability of default funds that would provide a choice for individuals who did not want to research investment markets. The default settings were changed. Employers must now ‘auto enrol’ employees into a pension scheme, although the individual has the option to opt out.

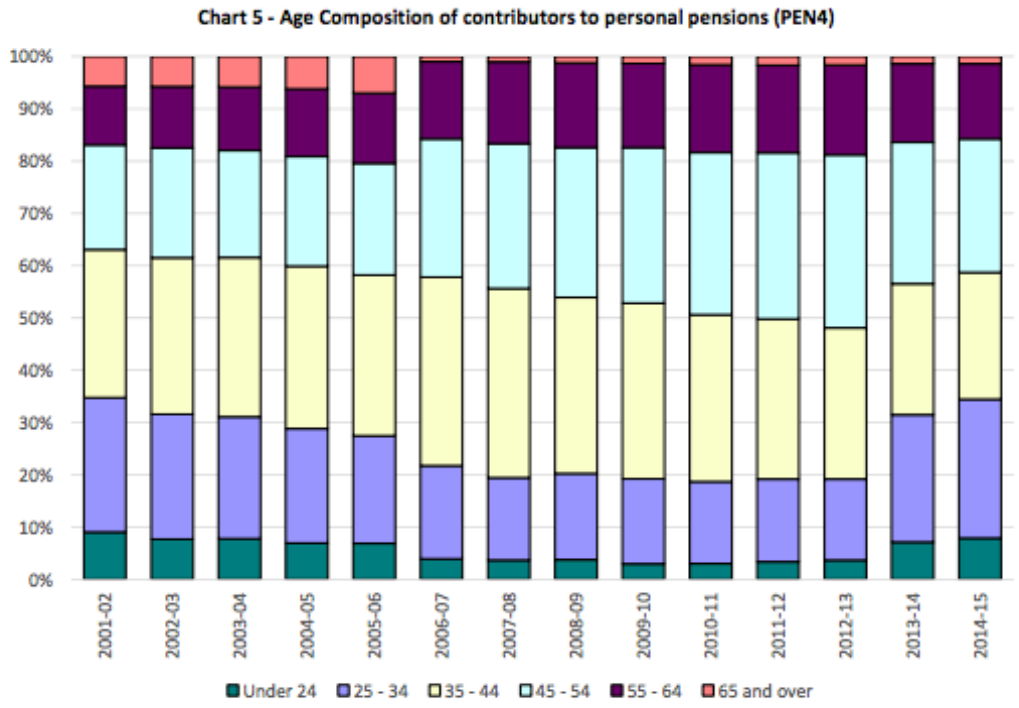
Whilst the tax reliefs remained employers were also compelled to contribute adding a strong incentive to join and to remain a member of the scheme. An aversion to losing these entitlements influences continued membership as once they are being received the motivation not to lose them becomes stronger.

The advertising campaigns featured well known ‘business celebrities’ from TV programs such as the BBC’s ‘Dragons Den’ and so the Messenger changed from a Government Department to someone recognisable and with whom more of the public could identify.

The Theoretical Principals and the Science Behind Them

Changes in the choice architecture and default settings, and awareness campaigns using recognised messengers, resulted in a significant increase in the membership of pension schemes.

There are currently 2.6 million more individuals contributing to personal pensions than the low of 5.3 million in 2011-12, and a 1.3 million increase from 2013-14. As the chart below shows contributions by the under 24 and 25-34 age groups have increased, possibly because of automatic enrolment, and now make up around 35 per cent of contributors in 2014-15 (up from around 20 per cent in 2012-13).



(Mckay & Spivack, 2017a)

Encouraging saving for retirement no longer relies on tax breaks and public information 'but are increasingly grounded in insights from behavioural economics' removing 'present-biased preferences' which produce 'procrastination' and 'inertia' in retirement investors (Benartzi & Thaler 2005). This temporal discounting in which we value what we can have today rather than what we may have at some point in the future can be particularly prevalent in younger adults. (Foster, 2017)

Effectively the environment that allowed the individual to procrastinate was removed and inertia worked in favour of the objective. The opt out preserved individual choice and removed the possibly unwelcome reaction to compulsion.

Individual economic decision-making is 'shot through with apathy, inertia and miscalculation, and Behavioural Economics offers solutions 'that work with, rather than against, these tendencies.' (Langley & Leaver, 2012) This includes the availability of default funds which in many cases reduces the individual

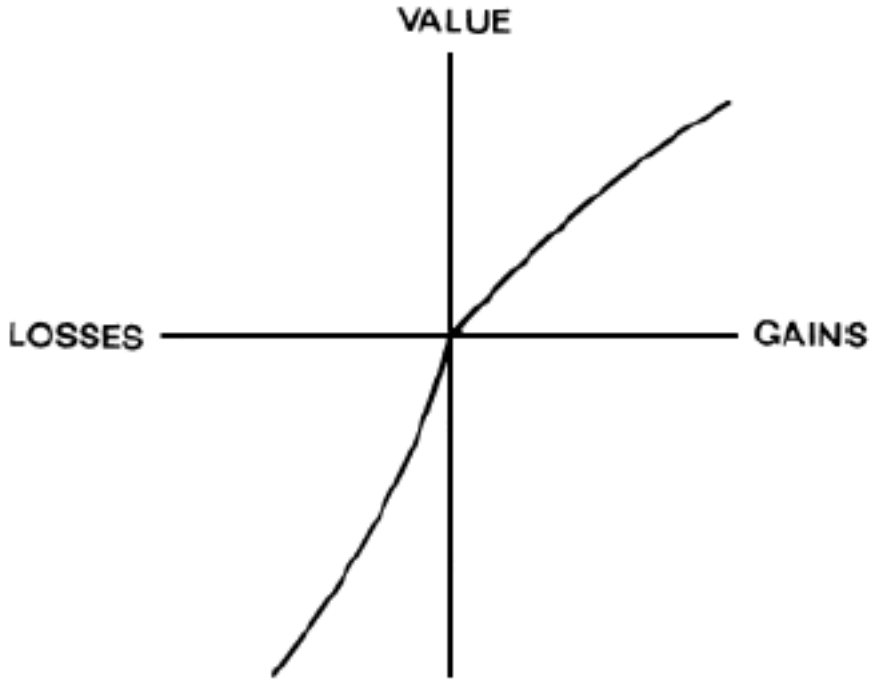
exposure to risk as a pre-set retirement date approaches. The alternative ‘pick and mix’ choice of funds available is overwhelming. Without guidance and advice ‘too many investment options can cause information overload, resulting in greater confusion and complexity, and, consequently, in greater use of the default option’. (Tapia & Yermo, 2007)

We see commercial organisations trying to create defaults with free trials or periods of free membership. Once the offer of a free trial has been accepted it is easier to maintain membership than cancel it. There is also that sense of loss of something that the individual currently enjoys if it is cancelled. Goods can also be loaned out on a trial basis. The decision about their return then becomes one about the loss of the item rather than its initial acquisition.

Behavioural analysis stresses four factors that are important explanatory factors in neglecting to save: ‘bounded rationality, self-control, procrastination (which produces inertia), and nominal loss aversion. They procrastinate about saving more now, thinking that they will get to it later’.(R. H. Thaler & Benartzi, 2004)

There is a bias towards the status quo believed by Thaler to be driven by what he termed ‘the endowment effect’.(R.H. Thaler, 1980) Loss aversion leads to the endowment affect which is about valuing a good more simply because you already own it. When comparing an alternative that involves equivalent gains and losses relative to what an individual already has, the losses will be more heavily weighted, and this will lead the individual to prefer "the bird in the hand."(Madrian & Shea, 2001) As the auto enrolment arrangement includes a compulsory matching contribution element from the employer, the aversion to this loss as well as tax reliefs, default funds and maybe a sense of membership will be significant in maintaining participation.

In their seminal paper on Prospect Theory, Kahnemann and Tversky assigned values to gains and losses rather than the assets themselves. The value function was defined on deviations from the reference point (where the lines intersect). They found it to be normally concave for gains and convex for losses and steeper for losses than for gains. From this the conclusion that 'losses loom larger than gains' was reached as it showed that the pain of a loss was felt more deeply than the corresponding pleasure from an equivalent gain.



(Kahneman & Tversky, 1979)

Should we be nudged? Who is responsible? Will it work?

Auto enrolment plans are a good example of 'Libertarian Paternalism', a phrase used by Sunstein and Thaler to describe 'a philosophy that advocates designing institutions that help people make better decisions but do not impinge on their freedom to choose'. (R. H. Thaler & Benartzi, 2004) (R. H. Thaler & Sunstein, 2003) The Government's Mindspace publication uses the phrase 'changing behaviour without changing minds' suggesting that people want to save but due

to present bias and a lack of will power need assistance in doing so. In these cases, behaviour change can be seen 'to augment individual freedom, helping us do what we want to but can't do, rather than constrain it'. (Cabinet Office., 2010)

But whilst we may recognise our shortcomings, we haven't necessarily given an authority permission to address them. If I am not causing anyone else harm by not saving, then should I be influenced to do so and if so, who is responsible for the result?

If the defaults prove to be such a powerful nudge both to membership and to the funds in which participants are investing, then the correct setting of these defaults is crucial to the potential well-being of investors. The minimum contribution rates that must be matched by employer's act as a very powerful anchor in terms of the size of contributions being made. Madrian and Shea's analysis (2001) shows that many of these employees in the company that they studied would have elected a higher saving rate if left to their own devices. These default contribution rates may prove to be inadequate to create a fund to sustain the investor through retirement. The default funds into which many people contribute may be too conservative for the long-term saver and the compliance procedures may favour cautious funds which may not achieve the required growth rates.

In short, 'pensions provision has been gradually reoriented around the notion that individuals are personally responsible for retirement saving – with even the state pension reimagined as a 'savings platform'.(Berry, 2016) But Government shapes behaviour simply by applying regulations and creating a choice architecture with default options. As authorities gain a greater understanding of the power to Nudge, does their responsibility to ensure Nudges are being applied effectively and appropriately increase? Whilst there is increased personal responsibility to produce an adequate savings fund, will

there be a perceived liability and future recourse if the default rates set prove inadequate or the default funds perform poorly. Figures vary from scheme to scheme but the 2007 NAPF annual survey found that, where available, the default fund, on average, attracts the contributions of 94 per cent of members. (NAPF, 2007).

The Pensions Commission noted that 'while many people say they want to "have to save", many respond adversely to the idea of compulsory savings'. (Cabinet Office., 2010) If this validates the legitimacy of auto enrolment then Nudges have been used to work with our biases whilst the option to opt out has preserved our personal freedom.

If such policies assist those 'whose rationality is bounded from making a costly mistake 'then 'such policies should potentially shift the debate from one about whether or not paternalism is justified, to one about whether the benefits of mistake prevention are larger than the harms imposed on rational people.' (Camerer, Issacharoff, Loewenstein, O'Donoghue, & Rabin, 2003).

A continuous review of economic factors such as expected growth rates, expected levels of inflation and the appropriate asset allocation within default funds will be required to ensure that plans remain on some form of acceptable track.

The tax advantages given to such schemes will need to remain attractive but at the same time this is tax that Governments cannot use for other welfare purposes. 'Gross pension tax relief in 2015-16 is projected to be £38.2 billion'. (Mckay & Spivack, 2017)

Whilst the freedom to choose protects the individual's 'right to be wrong', how do Governments ensure that everyone has an acceptable standard of living in retirement even when they haven't saved? What should that be? If it is too low

then there are implications for future welfare budgets, if it is too high then it may act as a disincentive for others to save.

Those who Byrne referred to as the 'reluctant investor,' are now influenced by employers, the financial services industry and Government agents who are creating this new choice architecture and who arguably now share new responsibilities with retirement investors.

Whilst the availability of a default fund does not constitute advice under current regulatory rules 'it is equally evident that reluctant investors assume that the default fund has been chosen to meet their specific needs'. (Byrne, Harrison, & Blake, 2008) Fear of making the wrong choice is a major factor in the selection of default funds. In doing so investors feel that they are abdicating responsibility for their investment decision. There could be unforeseen consequences for the 'new choice architects 'if retrospectively this is deemed as delivery of advice.

Saving for retirement has put a complex problem into the hands of the inexperienced and untrained and as Thaler and Benartzi pointed out 'In short, they need all the help they can get.'(Benartzi & Thaler, 2007)

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