MySuper — thinking seriously about the default option

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Introduction

Over the past year or so, I've had the great pleasure to be a Panel member of the *Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System*, commonly known as the Cooper Review.

In my time today, I would like to briefly outline the thinking behind our recommendations on MySuper and the choice architecture model proposed in the review.[2]

A decade since the Wallis Report

It has been more than a decade since a review looked into the operation of the super system. The Wallis Report, handed down in 1997, provided a blueprint for regulatory reform of the financial system, including superannuation.

The philosophy underpinning the Wallis Inquiry was an analytical framework rooted squarely in standard neoclassical economics. As applied to super fund members, the starting point was that, on the whole, they should be treated as rational economic agents who know their own business best.

People whose longer-run behaviours diverge from this, because they lack the ability or the desire to obtain the relevant information, are treated as exceptions to the rule.

We can see this from Chapter 5 of the Wallis Report. In describing the case for regulation as a response to information asymmetries, it says:

> ... consumers are assumed, for the most part, to be the best judges of their own interests.[3]

In this paradigm, the regulatory approach adopted by Wallis — one that focuses regulation around market conduct and information disclosure — makes sense.

Market conduct rules would prevent system instability arising from failure to enforce or fulfil financial promises and contracts. Disclosure rules would aid and improve the quality of decision making and thereby improve allocative efficiency.

2 See Super System Review (2010) for more details.
3 Financial System Inquiry (1997), p 191.

The recommendations of the Wallis Report were consistent with this tenet. Its recommendation on disclosure requirements, for example, said that information provided on financial products should be:

> ... sufficient to enable a consumer to make an informed decision relating to the financial product.[4]

In this world, you cannot make someone worse off by giving them more information and, by extension, more choices.

This is because an informed individual can always navigate through, and turn down, unsuitable choices.

As such, the logic of this approach to financial market regulation is that people, for the most part, will use the disclosed information, wade through their set of choices and dynamically optimise where and how they should allocate their financial capital.

One presupposition of the logic here is that, given our laws which (for good reason) compel individuals to save through the super system, members will be sufficiently interested in their super to engage in the first place.

However, there is an increasing body of evidence to suggest that, for many people, these assumed behaviours do not apply unequivocally.

The simplifying assumptions that we use — that agents are far-sighted and rational, and make decisions based on standard (time-consistent) preferences — are exactly as the name suggests — stylisations of the real world.

Don't get me wrong. Our standard economic frameworks have played, and will continue to play, a key role in informing policymaking. Indeed, these frameworks have yielded, and will continue to yield, great benefits for Australia.

The salient point here is that standard economic stylisations do not apply to all people, at all times, in all circumstances. Further, market forces do not endow people with a greater capacity to make rational decisions; they merely provide an incentive for them to do so through price signals.

So we should be cautious about relying solely on standard economic theory in an unquestioning way.

We are not always dealing with rational, engaged, dynamically optimising agents — especially in the area of retirement saving. Borrowing an analogy from Richard Thaler

4 Financial System Inquiry (1997), p 34.

and Cass Sunstein, that would be akin to treating people as being able to think like Einstein, store memory like Big Blue, and exercise willpower like Mahatma Gandhi.[5]

Wallis, despite its general approach to regulation, did recognise that there were cases where market failure cannot be avoided — no matter how much disclosure was afforded. In these cases, Wallis argued that some form of paternalism is justified. As the report points out:

> ... for many financial products, consumers lack (and cannot efficiently obtain) the knowledge, experience or judgement required to make informed decisions ... [this is] a situation where further disclosure, no matter how high quality or comprehensive, cannot overcome market failure.
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> In these cases, it may be desirable to substitute the opinion of a third party for that of consumers themselves.[6]

Perhaps one way of understanding the differences between the Wallis and Cooper reports is that, rather than treating these cases as 'exceptions to the rule', we in the Cooper review considered them to be more widespread — indeed of central relevance when it comes to decisions about retirement savings.[7]

Reflections on behavioural insights

A substantial body of work has emerged in recent decades in the field of behavioural economics.

The behavioural approach has pointed to some of the flaws of standard economics in modelling behaviour and is seeking to better understand and explain people's decision making by developing tractable models that better fit these behaviours.

While it's not possible to do this field of research justice in a 20 minute presentation, it is worth pointing to a few of the insights in relation to how people save.

The standard theory would imply that a savings decision is based on a person's trade-off between consuming today and the risk-adjusted cost of postponing for future consumption, for retirement and for bequest motives.

However, the evidence suggests the standard approach provides only a partial explanation of how people save. For most people, whether to save, and how much to

5 Thaler and Sunstein (2008), p 7.
6 Financial System Inquiry (1997), p 191.
7 Of course, the specific focus of the Cooper Review was on retirement saving and the superannuation system generally, while the Wallis Review examined regulatory issues across the whole financial system.

save, can be a difficult cognitive problem — because of a combination of limited calculation power, along with framing and anchoring biases.

One example is the different impact on saving of a cash transfer presented as a 'rebate' or as a 'bonus' — even when the amount of money involved is the same.

A well-cited study in the US set up four experiments to examine this difference. The first experiment looked at people's recollection of how they spent the 2001 US tax rebate when it was presented to them as a 'rebate' or a 'bonus'. The other three experiments looked at how a sample of Harvard graduates reacted to unexpected windfalls, framed differently.[8]

A windfall presented as a 'bonus' was more likely to be spent than one presented as a 'rebate'. These results are interpreted as evidence of a framing bias and probably loss aversion — where people tend to think of 'bonuses' as windfall gains (which they are more likely to spend) while a 'rebate' is thought of as a recovered loss which they are more likely to save.

Further, the standard theoretical result that more information and choices make people better off — and certainly no worse off — has also been questioned. Large choice sets appear, in some circumstances, to degrade the quality of the decisions people make.

The relevant literature suggests a range of behavioural responses to 'choice overload'. Choice overload increases the likelihood that people (particularly those with low levels of financial education) will choose a default option, or leads people to pick simpler options regardless of their suitability or, finally, degrades people's capacity to make optimal decisions.[9]

This evidence highlights the importance of financial literacy, but also the importance of high-quality default options in retirement saving plans.

It also suggests that people can be made better off if choices are framed to 'nudge' them towards making optimal decisions. This can be achieved by presenting what would typically be sensible retirement saving choices as simple, easy to understand, default options — but at the same time allowing people to opt out if they decide that the default is unsuitable for them.

Another behavioural effect revealed by the evidence relates to self-control problems, such as procrastination.

8 Epley et al (2006).

9 For these results, see Agnew and Szykman (2005), Iyengar and Kamenica (2010) and Besedeš et al (2010).

A nice example of this is reported in George Akerlof's and Robert Shiller's wonderful new book *Animal Spirits*.[10] When assistant professors arrived in Harvard in the 1970s, contributions were automatically deposited into their retirement accounts upon arrival. However, these accounts did not accrue interest until the newly minted academics filled out a form declaring how they wanted these funds invested. These forms would have taken no longer than half an hour to fill out.

Marty Feldstein, of all people, observed that most of these assistant professors filled out their forms four or five years later. For Akerlof's wife (Janet Yellen), who was on the staff at Harvard at the time, filling out the form immediately upon employment meant that she is now $US15,000 better off from the accrued interest.

As a one-time visiting lecturer at Princeton, I can assure you that this sort of thing never happened at Princeton.

College rivalries aside, the point is clear — even highly intelligent, motivated, financially literate people are susceptible to cognitive biases like procrastination. And this remains true even when these biases potentially lead to sizeable financial losses. Unsurprisingly, these observations are not isolated incidents.

Because of these problems, automatic enrolment, compulsion, or the adoption of 'commitment devices' in retirement plans can lead to dramatic increases in employee saving rates.[11]

The economics profession is in the process of changing its mind about the relevance of these behavioural biases for some aspects of public policy. It is increasingly difficult to sustain policy arguments, particularly about retirement saving, which are dismissive of these insights — especially when those arguments are based on caricatured polarisations between behavioural economists and more 'established' thinking.

The recent work of the Squam Lake Working Group on Financial Regulation provides a compelling example of the economics profession's new perspective. Squam Lake is a group of fifteen US academics that formed in 2008, as the global financial crisis deepened, to offer guidance on financial regulation reform.

10 Akerlof and Shiller (2009).
11 See, for example, Thaler and Benartzi (2004). See also Laibson (1997).

The group is a 'who's who' of US academic economists engaged in financial market research.[12] On some contemporary economic issues — for example, the appropriate macroeconomic response to the global financial crisis — members of this group have markedly different, and strongly held, views.

However, when it comes to retirement savings, and the appropriate features of default options for those who do not make an explicit choice, the group has this to say:

> We ... advocate improved default options for defined contribution plans. If employees do not select an alternative, they should be automatically enrolled in their employers' defined contribution plan. Many participants in defined contribution plans tend to anchor their investment decisions on the default options, as though those are optimal.
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> ... The default options for defined contribution plans should encourage an aggressive savings rate and they should nudge employees toward low-fee, diversified investments.
>
> ... High-fee funds argue that their fees are justified by superior performance. A large body of academic research challenges that argument. On average, high fees are simply a net drain to investors. While some investors might gain by selecting successful high-fee funds, the negative-sum nature of the process implies that other investors must lose even more. Most employees saving for retirement are poorly placed to compete in this game. They should not be forbidden from doing so, but disclosure of high fees and a "surgeon general's warning" are appropriate.[13]

While some of these recommendations have specific relevance to the US, the overall approach shares strong similarities with the Cooper review's approach to MySuper.[14]

MySuper and the choice architecture

It is against this intellectual backdrop that the Cooper review made its deliberations.

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12 The members of the Squam Lake Working Group are Martin N Baily, Brookings Institution; Andrew B Bernard, Dartmouth College; John Y Campbell, Harvard University; John H Cochrane, University of Chicago; Douglas W Diamond, University of Chicago; Darrell Duffie, Stanford University; Kenneth R French, Dartmouth College; Anil K Kashyap, University of Chicago; Frederic S Mishkin, Columbia University; Raghuram G Rajan, University of Chicago; David S Scharfstein, Harvard University; Robert J Shiller, Yale University; Hyun Song Shin, Princeton University; Matthew J Slaughter, Dartmouth College; and René M Stulz, Ohio State University.

13 Squam Lake Working Group on Financial Regulation (2009), pp 2, 4, 5.

14 While superannuation contributions in the US are not compulsory, the Squam Lake Group recommend a default savings rate of perhaps 10 per cent of compensation — quite close to the Australian compulsory Superannuation Guarantee contribution.

As is clear from all that has come before, a key driving principle behind MySuper is that, for those people who do not actively choose an option for their superannuation savings, we want public policy to mandate a default option with carefully designed features that we judge will promote the wellbeing of those who use this option.

Crucially, this mandated default option is not imposed on anyone. Freedom of choice is a central feature of the choice architecture model that underpins the MySuper proposal. Actively engaged people can choose a MySuper default option, or they can choose from a potentially wide array of alternative 'choice' options.

The evidence is that around 80 per cent of members of superannuation funds in Australia are invested in the default option in a super fund chosen by their employer or an award. Of that 80 per cent, anecdotal evidence suggests around 20 per cent explicitly choose the default option, with the rest making no active choice.[15]

The Cooper Review Panel interpreted this as evidence of significant community disengagement with super. It could also be interpreted as evidence of an anchoring bias, with some treating the default option as a benchmark — regardless of how suitable it may be for them.

However, we also recognised that there are substantial numbers of people in the community who are very much engaged with their retirement savings — both in the decision making and sometimes in the management of their savings.

The idea is not to have a centrally determined option for everybody; nor is it laissez faire.

While the system compels people to save into super through the Super Guarantee, the Cooper Review's proposed choice architecture means that people are able to choose between the default option (which must be a MySuper product), or opt for a saving plan with greater choice but greater responsibility.[16]

The MySuper component of the proposed choice architecture aims to provide a simple, diversified and cost-effective product. Trustees of MySuper products must comply with a number of requirements which include trustees' duties, the types of fees that can be charged and reporting and disclosure obligations. Trustees would also be

15 See Part One of Super System Review (2010) for references.

16 One prominent industry body argued that 'MySuper will legislate for apathy and disengagement' and 'actively discourage people from engaging with their superannuation'. Putting aside the difficulty of legislating for apathy for even the most accomplished of legislators, the MySuper proposal clearly does not actively discourage engagement. Anyone who does not like the MySuper default options is free to choose an alternative option. Likewise, anyone who wishes to engage with their superannuation will find a whole industry willing and able to help them do so.

required to hold a licence from APRA to offer MySuper products and APRA would have the power to resolve any non-conformity with the criteria.

As you know, the Government, as part of its election commitment Fairer Simpler Superannuation, announced that it plans to implement the Cooper Review's MySuper proposals, with super funds being able to offer MySuper products from 1 July 2013.

As I have argued here, the ideas behind MySuper flow naturally from an evolution in the economics profession's thinking about how individuals make decisions — especially decisions relating to retirement savings, which have long-term but uncertain consequences, in a complex environment in which decision-makers have limited familiarity.

The development of the MySuper proposals, and the associated choice architecture model, has been a challenging and rewarding intellectual exercise that I'm glad to have been a part of.

So I very much appreciate the opportunity extended to me today to outline the thinking behind this particular reform.

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