Fettered Consumers and Sophisticated Firms: Evidence from Mexico's Privatized Social Security Market

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The issue. There is ample evidence that we, as consumers, make poor decisions when faced with complex decisions. When faced with choices that involve uncertainty, imperfect information or delayed benefits, we use advertising, brand name, peer choices as short-cuts and proxies for sound decision making.

This behavior can cause big problems in important markets like savings and investment, where individuals make investment decisions that directly impact their savings and quality of life in old age.

How effective are policy "nudges" when consumers are looking for easily digestible information, and companies are looking to maximize their profits? This study analyzes the success of policy nudges in Mexico's privatized social security market.

Mexico launched a fully-privatized defined contribution plan in 1997, with individual private accounts managed by approved fund managers. Investors have been able to select from between ten and twenty-one well-known fund managers. However, despite the large number of participating firms and tight government regulation, high fees persisted since the start, both up-front fees and fees paid for assets under management. Hastings, Hortaçsu and Syverson (2013) show that much of the high fees can be attributed to low demand elasticity caused by advertising and consumer confusion. Their results point to clearer government information and financial education to make the market competitive.

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Government interventions need to be strategy-proof in complex product markets where fettered consumers face sophisticated firms, such as the market for financial investments. In 2005, the Mexican government introduced a new fee index to increase transparency of the fees charged and to increase consumer sensitivity to these management fees. Did creating and promoting a readily understandable index number help create a more efficient market?

Investigation. In "Fettered Consumers and Sophisticated Firms: Evidence from Mexico's Privatized Social Security Market" Duarte and Hastings use administrative data in partnership with the Mexican Social Security Administration to answer this question. They investigate how investors and fund managers reacted to this policy change. The authors find that investors from all backgrounds paid little attention to management fees before the index was introduced. After the index was introduced, investors became sensitive to the fee index, even if it caused them to choose a higher-cost fund.

Meanwhile, firms also responded to the new fee index, exploiting the formula used and restructuring their fees accordingly. Since the fee index over-weighted load fees and under-weighted fees for assets under management, firms were given an incentive to lower their load fees and to increase their management fees. That is precisely what they did, mitigating the intended gains from the policy, and actually redistributing the burden of management fees from higher income investors to lower income investors. Lower income workers paid more and higher income workers paid less after fund managers restructured fees in response to accidental fee index incentives.

Policy Problem. As programs from school choice to Medicare to savings for retirement are moving towards expanded privatization and personal choice, how can regulators help passive investors make better long-run decisions? Is there a role for regulators to improve performance in privatized social-safety-net markets?

Possible remedies: Simplify the information available to investors. Consumer confusion and the type of price insensitivity like that displayed by investors in Mexico have been linked to financial literacy. Does distilling complex information into an easily understandable index number create more price-sensitive investors? Does it result in a more price-competitive market? Well, yes and no. The authors find that investors in Mexico became sensitive to the new fee index, even if it led them to choose a more expensive product. So, we have more sensitive consumers, but not necessary more savvy ones.

The devil is in the details. While the new policy was successful in making investors sensitive to the new information provided, it led many to make long-term decisions not in their best interests. In theory, the new index adopted by regulators should have made fees simpler and more transparent. However, in their efforts to simplify the various fees charged into a single number, their formula did not accurately reflect true costs to investors.

Firm response. Regulators didn't account for the fact that the participants firms are not passive actors, and that they would re-optimize their fees to take advantage of investors' new sensitivity to the index. Since the index effectively disguised fees on assets under management relative to load fees, sophisticated firms lowered their load fees but dramatically increased fees charged on assets under management. *Ultimately, many workers who chose an asset manager solely based on the new index wound up paying higher actual management costs.* Worse still, the authors find that the policy nudge redistributed management fees from the high-income to the low-income segments of the market.

Take away points

- Consumers are not very sensitive to prices, particularly when confronted with complex information. They are sensitive to simple information, but don't necessary make choices in their best long-run interest.
- In contrast, firms are sophisticated actors, and act to optimize their profits.
- Any government intervention must take firm response into consideration when designing policies aimed at facilitating investor decisions.

Implications and Recommendations. More research is needed to know whether increasing the ease of calculating personal costs in complex markets or aggregating decisions and their costs with a single unbiased decision maker can more effectively address these issues, but either way the authors' results indicate that for any policy to be effective it must incorporate both individual behavior and firm response.

the fine print

technical information

Data
Administrative data on accounts and local sales force exposure in collaboration with the Mexican Social Security Administration.

Methods
Natural experiment
Flexible demand estimation
Instrumental variables
Simulation