

# THE DOWNSIDE OF DEFAULTS

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# No, Not This Kind of Default ...



# The Power of Defaults

- One of the most influential contributions of behavioral economics to business and public policy is to document the impact of default options on individual behavior
- Especially true in the realm of retirement savings
  - Automatic enrollment, escalation of contributions, portfolio rebalancing
- Defaults are often viewed as a “win-win” in many domains
  - Provide paternalistic guidance
  - Maintain individual choice

- Choi et al. 2002, 2004a; Madrian & Shea 2001

- Sunstein & Thaler 2003; Thaler & Sunstein 2003, 2008; Benartzi & Thaler 2007

# The Downside of Defaults

- Glaeser (2006) critique: those who design defaults bring own biases to task, soft paternalism can lead to stricter paternalism, potential to stigmatize behavior
- Carlin, et al (2010): defaults can weaken aggregate knowledge and information accumulation
- Numerous authors: Poorly designed defaults can cause harm
  - Too-low or too-high savings rates
  - Conservative asset allocations
  - Uniform defaults for all
  - Procrastination is a problem
  - High-stakes decision, or changing is costly/impossible

- Choi et al. 2002, 2004a, 2004b; Beshears et al. 2008, 2010a; Carroll et al. 2009; Carlin, Gervais & Manso 2010; Goda & Manchester 2010

# The Gap In This Literature

- Prior literature answers questions about:
  - the power of defaults
  - when defaults may or may not be optimal
- But it doesn't fully answer questions about:
  - What factors affect propensity to default
  - Relative prevalence of reasons individuals default
  - Welfare effects: whether those who default are better or worse off

# How We Begin to Fill That Gap

- Unique setting in which pension choice is financially significant (while holding job fixed)
  - Choice of pension in Illinois State Universities Retirement System
    - 180,000 participants in 70+ institutions/agencies
  - Largest financial asset many will ever own (pension also serves as a substitute for Social Security)
  - Choice (or lack thereof) is permanent and irrevocable
  - Even so, a majority of participants are defaulted!
- Pension choice is extremely complex
  - In a short time period, need to obtain, understand, and weight a myriad of information items
    - Attributes of three significantly different plans
    - Short-term and long-term preferences and needs
    - Relationships between attributes and preferences/needs

- Payne et al. 1993; Benartzi & Thaler 2007; Beshears et al. 2008



# Summary of Our Setting – Three Plans

- Traditional Plan (the default)
  - Very generous to those who retire from system
  - Not generous to participants who leave SURS early
- Portable Plan
  - Less generous for those who retire from the system
  - More generous for participants who leave SURS early
- Self-Managed Plan
  - Defined contribution plan through TIAA-CREF or Fidelity

# Overview of Sample and Survey

- We sent web-base survey to approximately 26,000 participants who made choice.
- We received just under 5,000 responses.
- Response rates roughly comparable plan enrollments for invited participants and respondents
  - Slight underrepresentation of defaulters
- 93% correctly identified their plans in their responses



# Three questions

1. **Who defaults?**
2. Why do individuals default?
3. Does it matter?

# Who Defaults?

- We explore several categories of factors
  - Information-based problems
  - Investment preferences and skill
  - Beliefs about job tenure, political risk
  - General and decision-specific knowledge
  - Socio-economic characteristics

# Who Defaults?

- Position, income, marital status, parental status, health, age and expected tenure in the system are not correlated with default
- Those with net worth of \$500,000 or more are about 7% less likely to default
- Women are 6% less likely to default
- Those more comfortable taking financial risk are less likely to default
- Those lacking confidence in Illinois legislature are less likely to default

# Who Defaults? – Information-Based Problems

	Coefficients from OLS Regression with all controls (Table 2)
Unaware of default provision	14.9% ***
Information provided by SURS rated not helpful	16.0% ***
Adjusted R <sup>2</sup>	19.3%
N	4,502

Robustness check:

- Interactions between trend for enrollment year and information-based problems

# Who Defaults? – General, Specific Knowledge

	Coefficients from OLS Regression with all controls (Table 2)
Correctly answered both questions on:	
basic financial literacy	-3.4% ***
basic SURS knowledge	-2.4% **
advanced SURS knowledge	-6.4% ***
Education level:	
Bachelor's degree	-3.5%
Master's degree	-6.7% **
Doctoral degree	-11.3% ***
Holds business or economics degree	1.7%

# Three Questions

1. Who defaults?
2. **Why do individuals default?**
3. Does it matter?

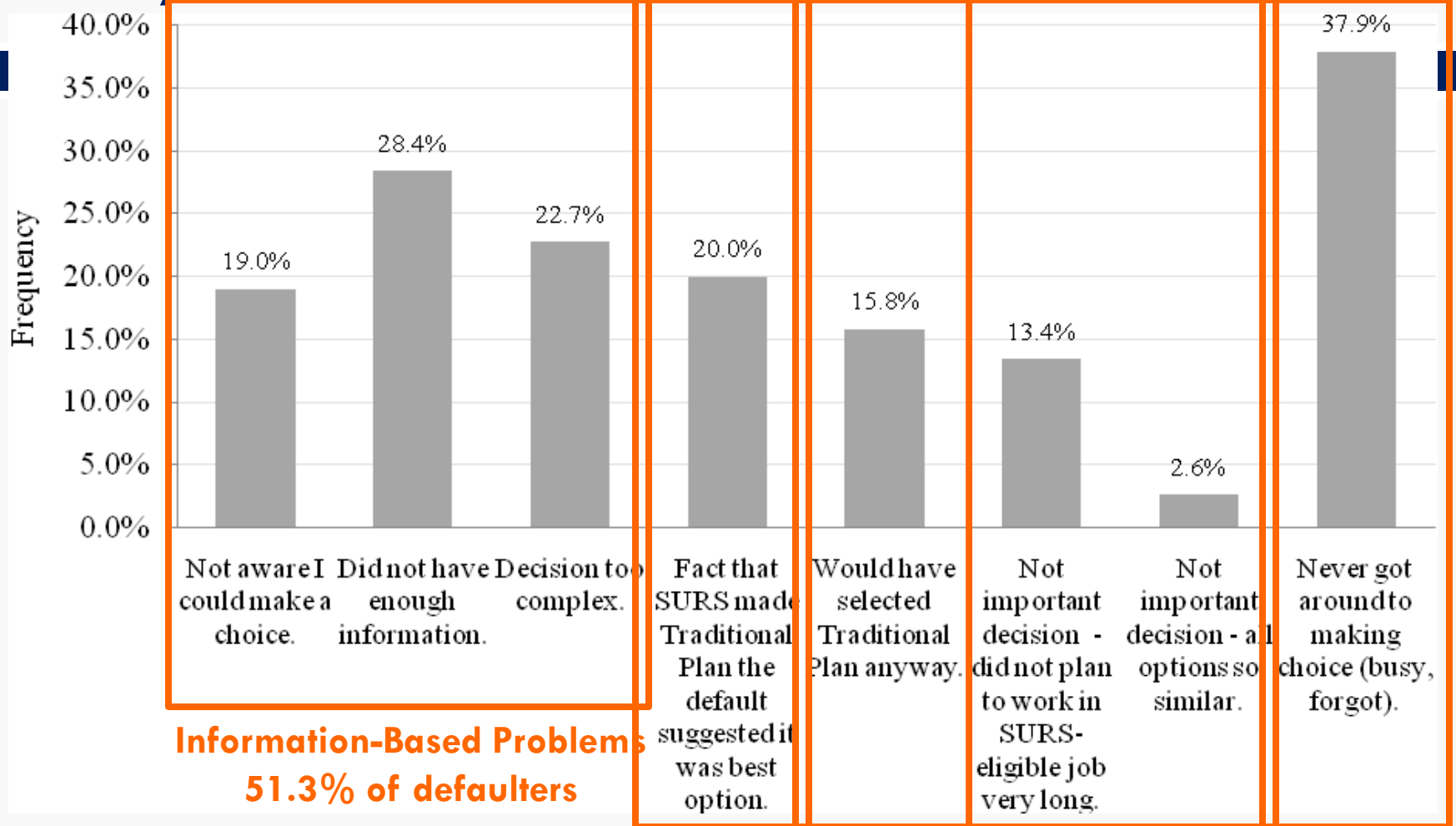
# Why Do Individuals Default?

- Several possible reasons, each with different implications
  - Three proposed in prior literature:
    - Decision complexity
    - Endorsement effects
    - Procrastination
  - We add two others:
    - Deliberate default
    - Those who perceive decision to be unimportant

- Beshears et al. 2008

# Why Do Individuals Default?

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**Information-Based Problems**  
51.3% of defaulters

**Endorsement** 20% of defaulters  
**Irrelevant Decision** 15.8% of defaulters  
**Procrastination** 37.9% of defaulters





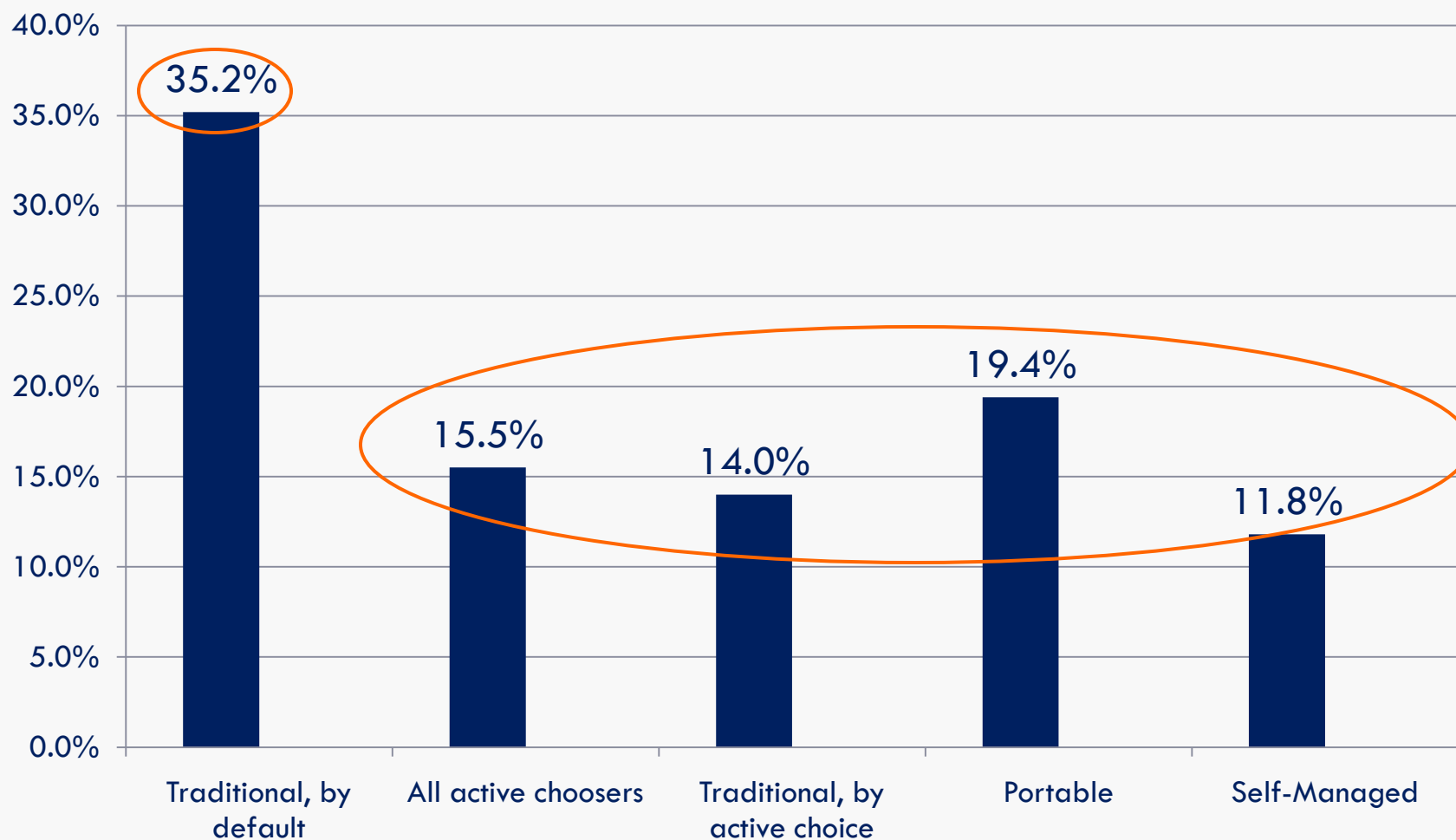
# Three Questions

1. Who defaults?
2. Why do individuals default?
3. **Does it matter?**

# Does it Matter? Plan Choice Regret

- To what extent do individuals subsequently regret being enrolled in their plan?
- We ask respondents:  
*If you were making your pension plan choice today, which plan would you choose?*
- Regret = 100 (0) if the preferred plan today differs from actual plan enrollment

# Percent of Respondents Who Regret Plan Enrollment



# What Factors are Associated With Regret for Defaulters (Table 3)?

- Models with same categories of factors as before
- Those who default are (all effects are statistically significant):
  - more likely to regret if
    - unaware of default provision (+18.6%)
    - SURS information rated not helpful (+14.9%)
    - prefer to take average (+10%) or above average (+24%) investment risks
    - rate investment skills as medium (+10%) or high (+13%)
  - less likely to regret if
    - plan to stay in SURS job for a long time (-8.3%)

# Regret in the Traditional Plan by Enrollment Mechanism (Table 4)

- Regret amongst active choosers of Traditional Plan
  - Lower baseline level of regret compared to defaulters
  - No effect of a lack of awareness of default provision on regret
  - Like defaulters, significant effect of SURS information being rated not helpful on regret (+12.7%)
- Also considered regret of “deliberate defaulters”
  - Deliberate defaulters have a baseline level of regret of 15% (same level of regret as those that made an active choice and much lower than regret expressed by other defaulters)

# Information Problems → Regret?

- The relation between information problems and regret is strongest for those:
  - With basic SURS knowledge
  - Those with financial education
- One interpretation: more financially literate individuals are those better able to (eventually) figure out what plan is best for them.

# Next Steps ...

- We would like to learn more about the “pathways to regret”
  - What information did people obtain, and now did they obtain it, that leads them to subsequently desire a different plan?
    - E.g., learning about plan parameters (e.g., me!)
    - Personal circumstances changed (e.g., thought you were a short-timer, but now plan to stay for life)
- Is regret stronger among those who clearly made an “objectively bad” decision?
- Recent changes to the pension system have changed the relative desirability of the three plans

# Summary of Contributions

- Information matters to defaults
  - Individuals with higher levels of both knowledge and decision-specific knowledge are less likely to default
  - But even after controlling for this (and other factors), information-based problems are significant!
- Heterogeneity in why people default
  - But information-based problems are very important, and this is something that can be affected by practice and policy!
- Those who default are more likely to regret
  - Particularly if default driven by information-based problems