THE DOWNSIDE OF DEFAULTS

Jeffrey R. Brown (Illinois and NBER)
Anne M. Farrell (Miami University)
Scott J. Weisbenner (Illinois and NBER)
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
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

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.
### Coefficients from OLS Regression with all controls (Table 2)

<table>
<thead>
<tr>
<th>Problem</th>
<th>Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unaware of default provision</td>
<td>14.9% ***</td>
</tr>
<tr>
<td>Information provided by SURS rated not helpful</td>
<td>16.0% ***</td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>19.3%</td>
</tr>
<tr>
<td>N</td>
<td>4,502</td>
</tr>
</tbody>
</table>

**Robustness check:**
- Interactions between trend for enrollment year and information-based problems
## Who Defaults? – General, Specific Knowledge

<table>
<thead>
<tr>
<th>Correctly answered both questions on:</th>
<th>Coefficients from OLS Regression with all controls (Table 2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>basic financial literacy</td>
<td>-3.4% ***</td>
</tr>
<tr>
<td>basic SURS knowledge</td>
<td>-2.4% **</td>
</tr>
<tr>
<td>advanced SURS knowledge</td>
<td>-6.4% ***</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Education level:</th>
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<tbody>
<tr>
<td>Bachelor’s degree</td>
<td>-3.5%</td>
</tr>
<tr>
<td>Master’s degree</td>
<td>-6.7% **</td>
</tr>
<tr>
<td>Doctoral degree</td>
<td>-11.3% ***</td>
</tr>
</tbody>
</table>

| 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?

Information-Based Problems
51.3% of defaulters
- Not aware I could make a choice.
- Did not have enough information.
- Decision too complex.

Endorsement Effect
20% of defaulters
- Fact that SURS made Traditional Plan the default suggested it was best option.
- Would have selected Traditional Plan anyway.

Deliberate Default
15.8% of defaulters
- Not important decision - did not plan to work in SURS-eligible job very long.

Irrelevant Decision
15.2% of defaulters
- Not important decision - all options so similar.

Procrastination
37.9% of defaulters
- Never got around to making choice (busy, forgot).
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

- Traditional, by default: 35.2%
- All active choosers: 15.5%
- Traditional, by active choice: 14.0%
- Portable: 19.4%
- Self-Managed: 11.8%
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