

Discussion of “The Importance of Default Options”

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Overview of the Paper

- Ties together a large and growing literature on the power of default options in multiple contexts
- Each of the individual papers underlying this theme are convincing
- Taken as a whole, the evidence is overwhelming
- My job as discussant is difficult, because I agree with the overall conclusions ...

A Simple, but Powerful, Idea

- Defaults Matter!
- Specifically, they matter for every step in the retirement planning process ...
 - Should I participate?
 - How much should I contribute?
 - Which asset allocation should I choose?
 - What should I do with the money when I leave a job early?
 - How should I withdraw the money at retirement?

Why Do Defaults Matter?

- Defaults help to cut through complexity (especially for the unsophisticated)
- Defaults circumvent procrastination
- Defaults provide implicit endorsements
- Likely a combination of all of the above

Why Defaults may be Especially Relevant in this Context ...

- Degree of complexity is especially large
 - Most individuals lack financial knowledge
 - There are virtually an infinite number of possible combinations – “where to start?”
 - Lots of conflicting advice from “experts”
- “You only get to retire once”
 - Opportunities to learn from your mistakes are limited

“Intelligent Design” of Policy

- My take: there is always a default option – just not always specified – so key is to choose it wisely
 - Choose the one that has biggest positive effect on average welfare
- This differs from authors’ view that sometimes the best default is the no default
 - Heterogeneous preferences
 - Procrastination
- Is “active decision” enforcement a good alternative?
 - Still faced with lack of knowledge / sophistication
 - Still must grapple with complexity
 - Seems like this only works if procrastination is the *only* reason that defaults matter

Why Policymakers like Defaults

- “Libertarian Paternalism“
 - Sunstein & Thaler
- Appeals to the left because it posits a positive role of government intervention in improving lives
- Appeals to conservatives because it does so in a way that preserves individual choice
- Rare opportunity for bipartisan action

How this Literature has Mattered ...

- The idea that defaults matter is now accepted as fact in the policy community
- Examples:
 - Social Security PRA proposals
 - Pension Protection Act

Social Security

- Key feature of President Bush's SS reform proposal was voluntary participation in PRAs
- President's 2007 budget assumed participation rate of 2/3
- CBO stated participation would be only 1/3, in part because:
 - “Workers would have to opt in (elect to participate). Recent research on 401(k) and similar plans has shown that opt-in plans tend to have significantly lower participation rates than opt-out plans”
 - CBO “An Analysis of the President's Budgetary Proposals for Fiscal Year 2007” March 2006 Box 1-1.

Social Security

- Not uncommon for new voluntary PRA proposals to specify automatic enrollment when they want higher participation rates (and vice versa)
- An additional policy lever for influencing size and timing of the transition
- Viewed by many as being more important than any other aspect of the PRA design

Pension Protection Act

- Signed into law in August 2006
- Original impetus for Act was to reform the DB insurance system and improve long-term fiscal outlook for PBGC
- Actual legislation will have limited efficacy toward solving DB problems
- Perhaps more important in the long run is its provisions to smooth the path for automatic enrollment in 401(k) plans

PPA and Defaults

- PPA: federal law allowing auto deduction for 401(k) plans preempts state “anti-garnishment” laws (which were designed to prevent employers from making involuntary deductions from employee’s pay)
- PPA allows plans to return auto contributions to employees without tax penalty if employee requests it within 90 days
 - Eliminates concern about tax penalties

PPA and Defaults

- Employers exempt from non-discrimination tests if have auto enrollment + matching
 - At least 3% of pay, escalating to 6%
 - Match 100% of 1%, plus 50% of next 5%
 - Includes *existing* as well as new employees

New DoL Regs on Default Portfolio

- PPA directs Dept of Labor to specify list of default investments that will maintain protection from fiduciary liability (same protection provided when employees affirmatively direct investment)
- Proposed rules released 9/27/06, now in comment period
- Must be life-cycle fund, balanced fund or managed accounts

The Future ...

- “Auto-everything” appears to be the future of private pensions in the U.S.
- Enrollment, contributions, and portfolio allocation have received the most attention
- Time to turn to the payout phase ...

Defaults in the Payout Phase

- Normative judgment is that many households are inadequately insured against longevity risk
 - Absence of annuities from most 401(k) plans
 - Limited annuity take-up when offered
- Current default is “no annuity”
- Simplest annuity products (e.g., single premium immediate annuity) usually irreversible, which means that default may be costly for some individuals who fail to rationally opt out
 - Ex: The terminally ill

A Proposal for an Annuity Default

- Laddered annuitization (e.g., 1/5 of acct per year for 5 years)
 - Not an “all or nothing” decision
 - Helps smooth asset price and interest rate fluctuations
 - If realize they made a mistake, can correct it on other 80%
- For each piece, one could offer a six-month “reversibility” feature
 - Not very costly in terms of selection on new information

Future Research

- Continue to tracking the persistence of the default effect
- Assessing relative value of alternative default strategies
 - Managed accounts vs. life-cycle vs. balanced
- Optimal design of defaults in presence of adverse selection (payouts) ...

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