

Do Defaults Have Spillover Effects? The Effect of the Default Asset on Retirement Plan Contributions

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20th Annual Joint Meeting of the Retirement Research Consortium
August 2-3, 2018
Washington, DC

This research was supported by a grant from the U.S. Social Security Administration (SSA) as part of the Retirement Research Consortium (RRC). The findings and conclusions are solely those of the author[s] and do not represent the views of SSA, any agency of the Federal Government, the NBER Retirement Research Center, the Center for Retirement Research at Boston College (CRR), or the University of Michigan Retirement Research Center (MRRC).

OVERVIEW

There is widespread evidence from the retirement savings literature showing that the default, or the decision that is enacted if no active choice is made, has a substantial effect on savings outcomes of workers including participation, contribution, and asset allocation in employer-provided retirement plans (Madrian and Shea, 2001; Choi et al., 2004; Beshears et al., 2009). While the default governing a particular decision has a powerful effect on that outcome, less is known about how the features of a default in one domain may affect outcomes in separate but related domains. Understanding spillover effects of defaults is of particular interest in the retirement saving realm due to the multiple decisions required (i.e., contribution rate, asset allocation, and distribution decisions). This is of particular relevance to policymakers since federal policy provides guidelines for defaults in retirement savings. The Pension Protection Act of 2006 gave employers the statutory authority to enroll employees automatically in defined contribution plans and established Qualified Default Investment Alternatives (QDIAs), which are safe harbor funds that employers can use as the default fund in which assets are invested. This policy dramatically affected the default terms of employer-provided retirement plans, yet there is little evidence as to how these default provisions spill over across different domains.

In this study, we examine the effect of a change in the default asset fund on contribution rates for new employees in the Thrift Savings Plan (TSP), the defined contribution plan of the Federal government. The change was from a low-risk, low-return government securities fund to a lifecycle fund in which asset allocation changes with employee age. The lifecycle fund may be considered a more appropriate default in that the allocation is likely preferable to a higher percentage of employees as compared to the conservative fund which may not be well-suited for long-term wealth accumulation.

How might a change in the asset default affect contributions? On the one hand, if the lifecycle fund represents an allocation close to the one the employee would choose, then changing to a lifecycle default fund may simplify the employee's decision-making process, eliminating the need to make an active choice and freeing up more time for the employee to think carefully about the contribution rate. On the other hand, a more appropriate default may make passive choice more attractive which could lead to more employees making passive choices. Because the default contribution rate in TSP is lower than that required to obtain the full

employer match, changing to a default fund that is preferred by more employees may lead people to be less well-prepared for retirement. These two scenarios differ in whether the costs of making the contribution and asset decisions as separable or joint.

This paper contributes to the growing literature on the unintended consequences of defaults. While initially thought to be a panacea for retirement saving adequacy through their large effect on enrollment (Madrian and Shea, 2001), more recent work has illuminated downsides of automatic enrollment in retirement savings. Choi et al. (2004) show that, while automatic enrollment dramatically increases participation in DC plans, it comes at the cost of higher persistence by employees at the default contribution rate, which are often set at a rate that does not maximize the match from the employer and may not maintain an adequate level of consumption into retirement. In the asset allocation space, Mitchell et al. (2009) find that the introduction of a lifecycle fund as the default has led some employees to hold portfolios that mix the lifecycle fund with other assets. This is somewhat surprising as lifecycle funds were intended to be standalone portfolios. They find that this group of mixed adopters is prevalent and is comprised of middle-income individuals, who are not typically characterized as having low financial literacy or engagement in retirement savings decisions.

SETTING

We evaluate the effect of the change in the default asset fund on contribution behavior for new hires in the Office of Personnel Management (OPM), the agency that serves as the human resources function for the Federal government. Federal employees participate in the Thrift Savings Plan (TSP) in addition to a defined benefit plan. Employees receive a base TSP contribution of 1 percent. In addition, the agency matches each dollar of an employee's first 3 percent of pay and \$0.50 on the dollar for next two percent.¹ Employees can contribute up to the IRS maximum each year, which was \$18,000 in 2017. Employees can elect to invest their contributions in five different funds or a lifecycle option (L Fund), which is a mix of the other funds based on the employee's

¹ Employees hired before 1984 are covered by a more comprehensive defined benefit plan and receive no base and no match on employee contributions to TSP, although they are allowed to contribute up to the IRS maximum allowable each year. Fewer than 10 percent of the current full-time, non-seasonal employees are in the more comprehensive plan.

age. The five indexed core funds include: Government Securities Investment Fund (G Fund), Fixed Income Index Investment Fund (F Fund), Common Stock Index Investment Fund (C Fund), Small Cap Stock Index Investment Fund (S Fund), and International Stock Index Investment Fund (I Fund). Since August 2010, the federal government has used automatic enrollment for new hires at a 3 percent contribution rate for employees, which is below the contribution rate required for maximizing the agency match (5 percent).

For employees hired before September 5, 2015, contributions are allocated to the G Fund if the employee fails to make an active investment election. A recent report on TSP use indicated that about 41 percent of employees had all of their contributions allocated to the G Fund under this policy (OPM 2015). For those hired on or after September 5, 2015, the default investment choice is the L Fund.

Our sample consists of employees employed at OPM both before and after the change in the default asset allocation. Our data combine personnel records with TSP contribution elections. Asset allocation elections are made through a distinct TSP system. This poses two important points when interpreting our results. First, we cannot directly evaluate the effect of the asset default change on asset allocation decisions. However, given the proportion invested in the G Fund under the prior default, we assume that at least some employees are passively investing assets in the L fund after the default fund changes. Second, the scope for transaction cost efficiencies are low given a separate system needs to be accessed for contribution and asset elections. This is useful as it makes an active choice more likely if individuals view asset and contribution decisions separately.

FINDINGS

We estimate the effect of the lifecycle asset default on a host of retirement saving outcomes after adjusting for differences in time, age, tenure, gender, salary, education, race, work location, and type of position (supervisor/manager, team leader, non-supervisory). Our results show some evidence of spillover effects from the asset default onto contribution decisions. In particular, there appears to be an interaction between the lifecycle asset default and tenure for both the outcome of being passively enrolled and being at the maximum match. The estimated differences between the lifecycle asset default and the government securities asset default are shown for these two outcomes in Figures 1 and 2.

For the outcome of being passively enrolled (Figure 1), employees in the lifecycle asset default group start off 6 percentage points less likely to be passively enrolled and this difference is marginally significant at the 10 percent level. As tenure increases, the difference diminishes, goes to zero by around 10 months, and then reverses. While the government securities default drove more initial passivity than the lifecycle default, the passivity for employees hired with the government securities default diminishes faster with tenure than for employees hired with the lifecycle fund default. By 24 months of tenure, employees in the lifecycle asset default group are approximately 9 percentage points more likely to be passively enrolled in TSP. Relative to the average of 22 percent of the sample, this difference is economically meaningful. These results provide evidence of higher persistence in the passive state at greater months of tenure relative to fewer months of tenure under the lifecycle asset default as compared to the government securities asset default.

For the outcome of being enrolled at the maximum match amount (i.e. 5 percent of salary), the opposite pattern emerges (Figure 2). Immediately after being hired, employees in the lifecycle asset default group are slightly more likely to be enrolled at the amount that maximizes the employer match, though the difference is statistically indistinguishable from zero. As one's tenure increases, employees hired with the lifecycle asset default are significantly less likely to be maximizing the employer match. By 24 months of tenure, employees in the lifecycle asset default group are approximately 8 percentage points less likely to be obtaining the full employer match. Again, this difference is economically meaningful relative to the average proportion at the maximum match amount of 31.1 percent. Our other outcome variables appear to not respond to the lifecycle asset default. In particular, we do not see any spillovers in TSP non-participation, the proportion of individuals at the annual cap, and the overall TSP rate.

These two findings together suggest that the employees who would have made an active choice if the default were the government securities default may be contributing less by remaining passive. The findings also suggest that employees approach asset and contribution decisions jointly, rather than separately. This joint decision-making combined with a better-suited default fund may partly explain why employees fail to maximize their employer matching contributions.

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Figure 1: Remaining Passive for Lifecycle relative to Government Securities Fund by Tenure

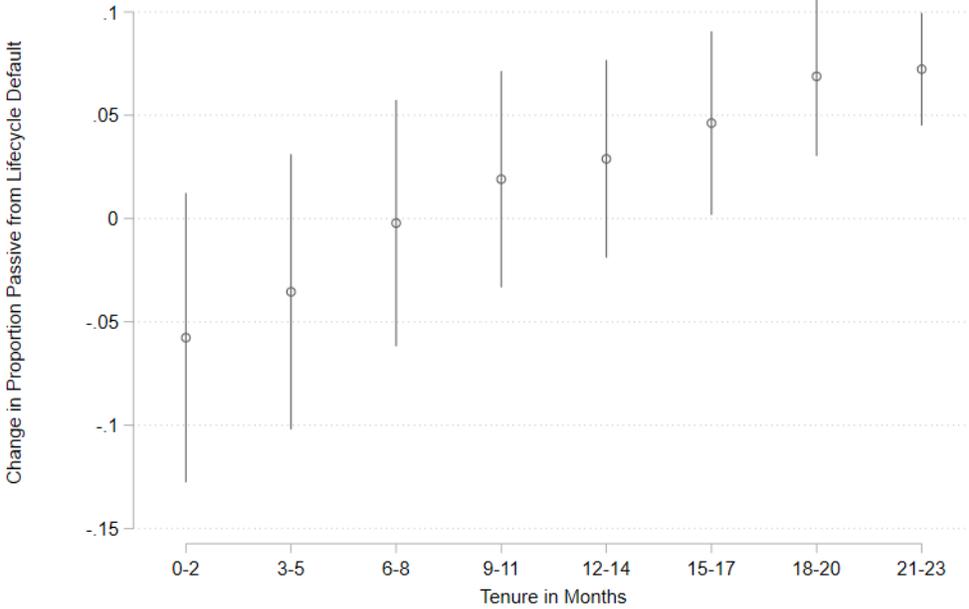


Figure 2: Maximizing Match for Lifecycle relative to Government Securities Fund by Tenure

