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Long term savings decisions: Financial reform, peer effects and ethnicity☆

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ABSTRACT

In 2005, a drastic reform in the Israeli capital market shifted the power to choose savings vehicles from employers to individuals. Using a unique dataset from a large employer, this event provides us a rare window into individuals' savings decisions and the effect of their social environment. In the first year following the reform's implementation, 7% of the employees switched out of the fund in which they all previously saved. Choice of fund was not associated with observable measures of fund performance, but was strongly affected by the employees' social environment. Exploiting within-department variation in peer groups, we find that savings decisions were strongly influenced by the choices of co-workers from the same ethnic group. Interviews also point to the influence of non-professional colleagues.

1. Introduction

Imagine a country in which long term savings instruments are provided solely through the employer. Then a reform is enacted and the choice is given to the individual. How will individuals respond? Which financial instruments will they choose? Will they improve on the choices made by the employer? How will they decide? These are not trivial questions. Population aging and the financial crisis have raised concerns regarding the process by which individuals make savings decisions and allocate their savings among different investment vehicles. Governments around the world are implementing various reforms aimed at improving the quality of long-term savings decisions, promoting competition in the financial sector and addressing fiscal imbalances. According to Holzmann (2012), between 1988 and 2008 twenty-nine countries introduced

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pension system reforms. An important input to the design of such reforms is a better understanding of the consequences of transferring greater responsibility to the individual.

This paper studies decisions following a substantial regulatory change in Israel. Prior to the reform, employees were required to contribute to a default saving plan (provident fund) chosen by the employer. Following the reform, employees were given a choice from over two hundred different provident funds. We use a unique proprietary dataset from a large employer in Israel, which contains detailed information about employees' savings decisions following the reform. This offers a rare window into these decisions. How many employees actually switch out of the default? Who are the early switchers? Which funds do they choose? Are these funds distinguishable from other funds on observable measures? Furthermore, the richness of the data also allows us to investigate how the social environment of employees – and in particular the choices of coworkers – affect their decisions and the outcome of these decisions.[1]

Four features of the data are particularly important. The first is that we observe behavior immediately following a shock to the regulatory environment which affected all employees. The reform was substantial and highly publicized throughout the country: employees were exogenously moved from a no-choice environment to one in which they could choose which fund to save in. As detailed below, the reform affected only the choice of fund and not the amount of savings invested in the fund (which is effectively determined by fixed contributions by the employee and employer). This helps us to isolate an important dimension of savings decisions, namely the choice of the fund provider. It also provides a natural starting point for examining peer effects in the choice of savings vehicles.

A second feature of our dataset is that it contains information on the timing of the decision. Thus, beyond examining the association between choices made simultaneously by different employees – where it may be hard to know who affected whom – we can focus on the association of decisions by peers in an early period with decisions made in a later period. Third, we know not only whether the employee switched out of the default, but also the particular fund chosen. This allows us to investigate whether observable fund characteristics, emphasized in the finance literature, play an important role in savers' decisions. It also helps address some of the challenges involved in identifying peer effects.

Finally, the dataset is rich in terms of information about employees. We know the department in which the decision-makers are employed; several department characteristics (location, size); and employees' personal characteristics (education, family status, etc.). Importantly, we also know employees' detailed ethnic background. That is, we know the country of birth of each employee's paternal grandfather (most Israeli Jews either immigrated themselves or are descendants of people who immigrated to Israel during the past century, hence, paternal grandfather can serve as a proxy for ethnicity). While ethnicity is often unobserved to outsiders (and, importantly, cannot be used by fund providers to target specific groups), it frequently affects an Israeli individual's social circle. Maman (1991) documents that in Israel ethnicity plays an important role in one's social network and hence may serve as a good proxy for communication channels.[2] We can thus examine the association of one's choices not only with the choices of other members of the department in which she is employed, but also with the choices of co-ethnics within that department.

The proprietary data obtained from the employer are augmented by data from the Israeli Ministry of Finance on management fees and net inflows for each provident fund that operated in Israel during the period of investigation. This enables us to compare some of our results to the provident fund industry's total activity during the period we investigated. Specifically, we can check whether the net inflow patterns, resulting from the switch made by savers in the organization we studied, are consistent with the general trend in the provident fund industry.

Given the existing evidence in behavioral finance, the first natural question to investigate following such reform concerns inertia.[3] Indeed, we find that despite the drastic and well-publicized reform, 93% of employees did not switch funds and stayed with the default. However, unlike a common emphasis in the literature on the apparent irrationality of such behavior, in our case staying with the default does not represent an obviously inferior decision. The default fund offered low management fees at the time of the investigation, and in retrospect performed better than most of the funds that employees switched into. We thus focus our attention on the factors that affect the decision to switch out of the default fund.

A first interesting finding is that by far the most popular fund chosen by those employees who switched did not stand out in terms of performance (returns, Sharpe Ratios), transaction costs or services as compared to hundreds of other available funds. The popularity of this fund – which we will call "Fund X" – does not seem to be a peculiar feature of our data. The net inflow of this particular fund in 2007 was close to eighteen per cent of the provident funds management industry (Israeli

[1] Our analysis of the last point builds on the extensive literature on peer effects. Peer effects have been studied in several contexts, including student outcomes and choice of major in college (Sacerdote, 2001; Cipollone and Rosolia, 2007; Ammermueller and Pischke, 2009; De Giorgi et al., 2010; Lavy and Schlosser, 2011; Lavy et al., 2012); health plan choice (Sorensen, 2006); criminal behavior (Bayer et al., 2009); unethical practices (Gould and Kaplan, 2011); mutual funds proxy voting (Matvos and Ostrovsky, 2010) and stock market investment decisions (Hong et al., 2004; Brown et al., 2008). With respect to long term savings, Duflo and Saez (2003), Beshears et al. (2011) and Kast et al. (2012) study how peers influence the magnitude of savings and Chalmers et al. (2012) and Brown and Laschever (2012), document that peer effects are an important determinant of individual retirement dates. A well-known challenge in this literature is the fact that a correlation in behavior (e.g. savings decisions) within peer groups cannot automatically be attributed to a direct influence of group members on one another (Manski, 1993). For example, workers in the same department face the same organizational environment and may respond to common shocks. Further, workers in a given department may share similar unobserved characteristics which lead to similar choices. The richness of our data allows us to plausibly address such concerns.

[2] According to Maman 77% of the "social network" of those whose family origins are from Asia, Africa or the Middle East, are from that same group. 68% of the social network of those whose family origins are European, are from the same origin.

[3] See e.g., Madrian and Shea (2001) on inertia in 401(k) savings behavior.