

## Comments on “Trends in Pension Cash-Out at Job Change and the Effects on Long-Term Outcomes”

by Philip Armour, Michael Hurd, and Susann Rohwedder

James M. Poterba

This paper presents important new evidence on the circumstances under which U.S. workers make pre-retirement withdrawals from their retirement saving accounts. “Leakage” is often cited as an important challenge to the provision of retirement security for U.S. workers, but the causes and consequences of early distributions from retirement accounts have received relatively little attention. A number of policy proposals call for new restrictions on pre-retirement distributions. The impact of these proposals depends critically on the way pension participants respond to such changes; this study presents new information that bears on that issue.

Before turning to the specific findings in this paper, it is important to note that it is very difficult to measure leakage from the U.S. retirement saving system. Not all funds that are withdrawn from a given retirement plan are lost to the provision of retirement security. Withdrawals from one plan may be rolled to another retirement plan. Alternatively, a plan participant might withdraw assets from a DC plan and transfer the assets to another saving account outside the pension system. While this step might forego the benefits of tax-deferred accumulation, the transferred assets would still be available to support retirement consumption.

A number of recent studies have tried to estimate the rate of leakage from the U.S. defined contribution pension system. Munnell and Webb (2015) draw on data from the retirement plans administered by Vanguard. They estimate that cash-outs account for about 0.5% of the plan assets at the start of each year, hardship withdrawals for 0.3%, in-service withdrawals by individuals over the age of 59 ½ for 0.2%, and loan defaults for 0.2%. Taken together, these various components of leakage represent about 1.5% of plan assets. If none of these withdrawals were redeployed in other forms of retirement saving, this rate of outflow would represent a substantial drag on aggregate retirement wealth accumulation. Munnell and Webb (2015) estimate that aggregate retirement wealth would fall by about 20 percent if there were no offsetting participant behaviors. One reason for studying leakage is to determine which retirement plan parameters and public policies may affect it, so that policy-makers and employers have a sound basis for designing both plan attributes and the regulatory environment.

One of the “stylized facts” about pre-retirement distributions is that the likelihood of cashing out at the time of job separation is inversely related to the size of the retirement account balance. Aon-Hewitt (2013), for example, reports that larger account balances are more likely to be left in place, or if withdrawn to be rolled over, than are smaller account balances when workers separate from firms. For accounts valued at between \$1,000 and \$4,000, 49% choose a cash distribution, 31% roll over their balance to another retirement account, and 20% remain in the DC plan at the time of separation. Among those with \$30,000 to \$49,000 in their DC account, the respective proportions were 22%, 36%, and 42%. For those with more than \$100,000, only 6% choose the cash option, while 43% chose to roll over their balance and 51% chose to remain in the plan. These statistics apply only to the “cash outs” identified by Munnell and Webb (2015), which appear in their data to account for about one third of the retirement plan leakage. It would be valuable to understand how the likelihood of other leakage events is related to account size.

This most intriguing finding in this paper is that defined contribution plan attributes, in particular the provisions that affect the ease of pre-retirement distributions, have little if any effect on the level of retirement accumulation by participants. This finding is surprising: one might have expected that more generous plan withdrawal provisions would be associated with lower retirement wealth. Mechanically, if the participants in plans with and without generous withdrawal provisions reach retirement with similar pension resources, it must either be the case that the presence of these withdrawal provisions is not correlated with the level of participant withdrawals, or that some aspect of participant behavior, such as contribution levels or the length of the working life, is adjusting in a way that offsets the impact of easier access to retirement plan accumulations.

Before discussing the empirical findings in more detail, it is helpful to outline a framework that can guide the analysis. The level of DC plan retirement assets ( $A$ ) that a plan participant accumulates by retirement age  $R$  may be written as  $A(R)$ :

$$(1) A(R) = \int_0^R \left[ C(\theta, x(a), z(a)) - D(\theta, x(a), z(a)) \right] e^{r(R-a)} da$$

where  $C$  denotes plan contributions and  $D$  distributions. Net contributions at age  $a$  are  $C(a) - D(a)$ , but equation (1) permits a richer specification by allowing age-specific flows to depend on  $\theta$ , a set of retirement plan characteristics that are set by public policy, such as the age at which an employed worker may take a penalty-free distribution,  $x(a)$ , a set of person-specific traits at age  $a$  that include age itself but might also include health status, and  $z(a)$ , a set of plan-specific traits such as the flexibility of the plan in allowing for distributions prior to retirement age. In this specification,  $C$  and  $D$  are participant choice variables.

The vector of plan attributes,  $z(a)$ , is potentially endogenous, since by choosing which firm to work for, an individual can affect the  $z(a)$  vector he faces. This raises the possibility that employee attributes  $x(a)$  and plan characteristics  $z(a)$  are correlated, which in turn poses a key challenge for empirical work that seeks to determine the effect of changes in the components of  $z$  on accumulation  $A(R)$ . There is very little empirical work on the extent to which plan attributes affect worker decisions about whether to join a particular firm, so it is difficult to assess the magnitude of potential endogeneity bias.

This paper asks how changes in  $\{z(a)\}$ , the vector of plan-specific policies under which a worker was employed, and potentially  $\theta$ , the public policy rules that affect pre-retirement withdrawals, affect  $D(a)$  and ultimately  $A(R)$ . Equation (1) provides a framework for considering the various links between these plan design features and retirement accumulation,  $A(R)$ . The first channel to consider, and the most direct link, is between  $z(a)$  or  $\theta$  and plan distributions before retirement age,  $D(a)$  for  $a < R$ . Do plan participants take advantage of opportunities to withdraw assets? Second, how do greater withdrawal levels relate to the level of assets held in DC plans at retirement? This can be studied by comparing  $A(R)$  with the set of  $\{z(a)\}$  attributes that characterized the plan during an individual's working career. Other choice variables can also be affected by the set of  $\{z(a)\}$  variables. For example, participants might be prepared to contribute a higher share of salary to a plan that they know is more flexible with regard to withdrawals. Thus  $C(a)$  might be positively affected by more generous  $\{z(a)\}$  provisions, offsetting in part or whole the positive effect of these provisions on  $D(a)$ . Alternatively, if participants have drawn

down their retirement wealth by pre-retirement distributions, they might decide to work longer.  $R$  could be a function of  $\{z(a)\}$ .

This paper presents important evidence on the relationship between plan attributes and retirement accumulation. A promising next step in this research program would be a decomposition of this relationship into its constituent parts and to better understand the full set of saving and labor supply adjustments that are associated with more generous plan withdrawal rules.

One important contribution of this study is a detailed description of the circumstances under which pension plan participants make pre-retirement withdrawals. In most cases, such withdrawals coincide with periods of financial stress, such as job loss or a health shock that brings substantial out-of-pocket expenses. The prevalence of such circumstances suggests that many of those who take early distributions are not using these funds for discretionary consumption, but rather are funding expenses that were largely non-discretionary. If this is the case, the alternative to a pre-retirement plan distribution might have been incurring debt, and the net effect on the individual's net worth at retirement might have been modest if anything at all. The fact that a substantial number of plan participants draw on pension assets during times of financial need suggests that at least with regard to this aspect of the pension plan, workers are aware of their plan provisions. Mitchell (1988) and many subsequent studies suggest that pension plan participants have limited knowledge of their plan rules.

This paper's careful analysis of participant distribution behavior raises questions about the design of policies that might affect distributions from retirement plans. There are three broad classes of such policies. First, there are policies that would change the set of allowable provisions in DC plans. For example, the Department of Labor and the Internal Revenue Service could prohibit lump-sum distributions from DC plans when individuals change jobs. Second, either regulatory bodies or employers could try to increase the degree of participant understanding about the linkages between pre-retirement behavior, such as contribution rates and withdrawal decisions, and retirement accumulation.

Finally, there may be other steps that would address the potentially divergent interests of retirement savers, plan providers, and financial advisers with regard to retaining pension assets within the retirement saving system. Because the cost of administering a retirement plan is in most cases increasing in the number of participants, and because the firm's liability is reduced if a former employee withdraws assets from the plan, firms have an incentive to encourage those who leave the firm, whether mid-career or at retirement, to withdraw their funds. The same incentives operate for firms that sponsor defined benefit (DB) plans, which may encourage participants to choose a lump-sum payout at their retirement rather than a lifetime stream of annuity payments. A worker who quits or who is fired well before retirement may therefore face some pressure to withdraw assets, which raises the likelihood of leakage from the pension system.

Personal financial advisers may similarly face conflicts of interest. Since their earnings are related to the assets they manage or the transactions that they intermediate, when an individual leaves assets in a DC plan, they do not generate any revenue for an adviser. When they move assets to an Individual Retirement Account, or when they withdraw assets from the retirement system entirely and reinvest them in a taxable account, the financial adviser's income increases. This can create incentives for advisers to encourage their advisees to withdraw funds from DB and DC plans and to redeploy them in other investment vehicles. As the Baby Boom cohort reaches retirement, the complex incentives of the

various participants in the retirement saving process are likely to come under increased scrutiny. The recent proposal to expand fiduciary standards to retirement advisers is an example of a policy reform that could shift the incentives facing financial advisers as they interact with their clients.

#### References

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