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CHANGING 401(K) DEFAULTS ON CASHING OUT: ANOTHER STEP IN THE RIGHT DIRECTION

BY ALICIA H. MUNNELL AND JAMES G. LEE*

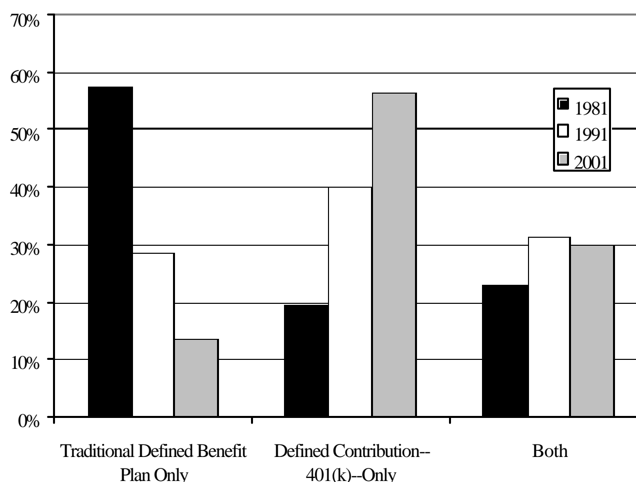
Introduction

Over the last 20 years, pension coverage has shifted from defined benefit plans, where benefits are based on years of service and final salary and generally paid as an annuity, to 401(k) plans, where individual and employer contributions and earnings on those contributions are awarded as a lump sum at retirement. Although the majority of workers lucky enough to have a pension will rely on a 401(k) plan, these plans are coming up short. The main reason is that 401(k) plans shift all the risks and decision-making from the employer to the individual, and individuals make mistakes all along the way. One of the most serious mistakes occurs when young people cash out small pension accounts upon changing jobs. The regulation issued today from the U.S. Department of Labor with regard to provisions in the 2001 Economic Growth and Tax Relief Reconciliation Act should help solve the "cash out" problem.

Background

In 1981, about 60 percent of wage and salary workers were covered solely by a defined benefit plan; today about 60 percent are covered solely by a defined contribution plan, which in most cases is a 401(k) (see Figure 1). The percentage of workers with coverage from both types of plans remained roughly constant.

FIGURE 1. PERCENT OF WAGE AND SALARY WORKERS WITH PENSION COVERAGE BY TYPE OF PLAN, 1981-2001



Source: U.S. Department of Labor (2002) and authors estimates based on Board of Governors, Survey of Consumer Finances (2001).

While 401(k) plans can work in theory, in practice they fall short.[1] In 2001, the median 401(k)/IRA account balance of individuals nearing retirement (ages 55-64) was $42,000, whereas simulations suggest that the steady middle-income contributor could have accumulated almost $300,000. And the shortfall is evident not only among older workers, who may have come to 401(k)s late in their career, but also among younger workers, who surely started with a 401(k) plan (see Figure 2).

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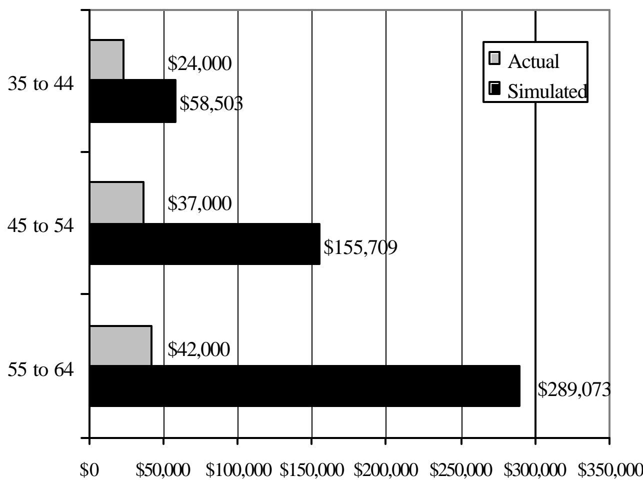
Figure 2. 401(k)/IRA Actual and Simulated Accumulations, by Age Group, 2001



Source: Munnell and Sundén (2004).

The reason balances are so low is because of workers' choices. One-quarter of eligible workers choose not to participate in their plan. Of those who do participate, less than 10 percent contribute the maximum. Many workers fail to diversify their assets, and many over-invest in company stock. Most importantly, many short-change their retirement assets by cashing out when changing jobs rather than rolling their balances into an IRA or a plan with their new employer. The 2001 Survey of Consumer Finances indicated that 55 percent of people changing jobs cashed out their 401(k) plans. In terms of dollar amounts, 21 percent of 401(k) accumulations were taken as cash.[2] These percentages suggest that the transactions generally involve smaller amounts typically associated with younger workers.

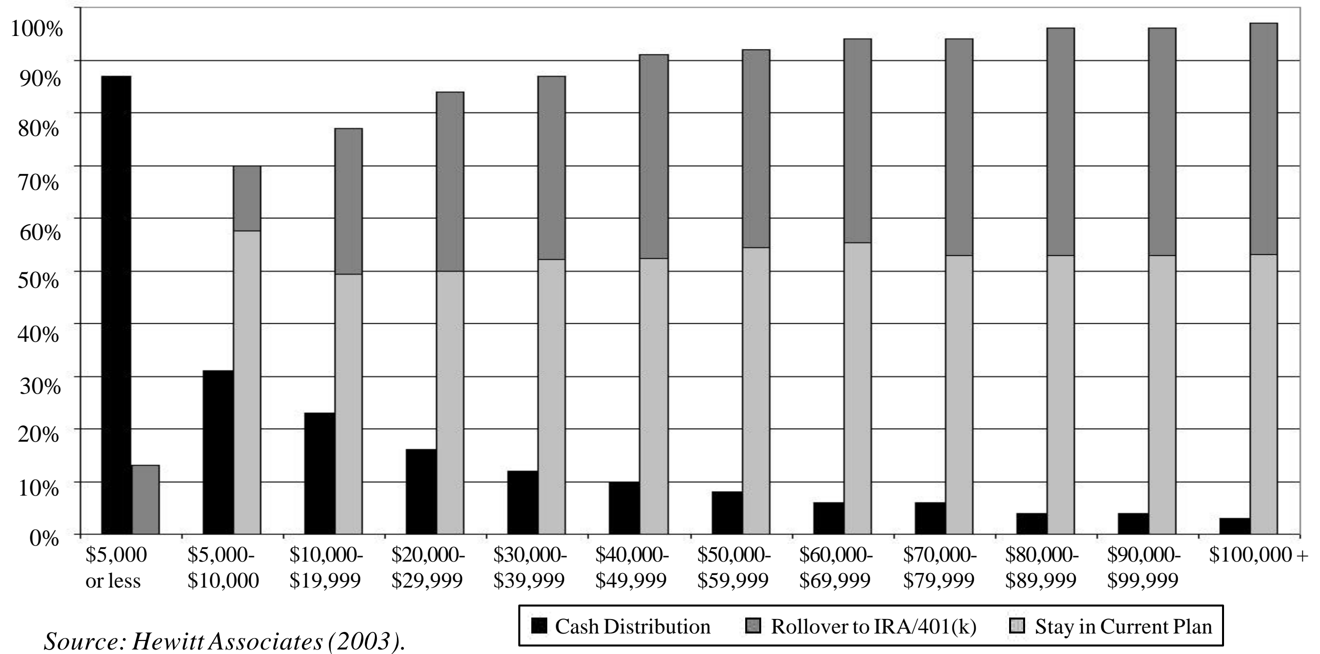
Improving 401(k)s by Improving Defaults

For a variety of reasons, people view the financial decisions involved in managing their 401(k) plans as daunting, and consequently, tend to stay where they are put. Policymakers could greatly improve 401(k) plans by building on this inertia and setting all the options to desirable outcomes. Under the most comprehensive default arrangement, all eligible participants would be automatically enrolled; their contributions set at the level that maximizes the employer match; the portfolios diversified and automatically re-balanced as they age; investments in company stock restricted; lump-sum distributions automatically rolled over; and retirement benefits paid in the form of a joint-and-survivor inflation-indexed annuity.

The first part of this prescription was implemented when the government changed the rules in 1998 and allowed firms to require workers to "opt out" of a plan, instead of the traditional requirement to "opt in." Studies show that this simple change in the default increases participation by as much as 35 percentage points. Even after three or four years, the vast majority of those automatically enrolled were still participating.[3]

Today, policymakers have taken another step in the right direction with the release of a Department of Labor regulation that will change the default for cashing out 401(k) balances when a worker leaves a company.[4] Under the old law, the employer was permitted to cash out any 401(k) account with a balance of $5,000 or less, without the consent of the worker. Because of the costs of maintaining these small accounts, most employers chose this approach. Under this arrangement, the only time a departing worker's 401(k) plan of $5,000 or less was not cashed out was if the worker specifically told the company to roll it over into an IRA or into his new company's 401(k) plan. Given inertia, this action rarely occurred, and as a result 87 percent of all 401(k) balances under $5,000 were cashed out (see Figure 3).

Figure 3. Disposition of 401(k) Balances at Termination of Employment, by Amount in Account, 2002



Source: Hewitt Associates (2003).

Now, under the new law, the employer must roll over any 401(k) plan with a value between $1,000 and $5,000 into an IRA – unless the separating worker elects to have it cashed out or rolled over into a new 401(k) at his new company.[5] In other words, the default is shifted from cashing out to rolling over. Since people tend to stay where they are put and let the default run its course, these new automatic rollover provisions should dramatically reduce the cashing out of 401(k) accounts with less than $5,000. This change will be a major improvement in increasing many people's retirement savings.

Not Quite Nirvana

While establishing automatic rollovers as the default for balances of less than $5,000 is a great improvement, two problems remain. At this point, the rollover amounts will be placed in investments designed to preserve principal, such as money market funds. These funds are safe investments, but, as such, they produce low returns. The profound effect of inertia suggests that most individuals will remain in the conservative investment. And since most of those with low balances are probably young people, many could pass up higher returns on these early accumulations for an extended period of time. To take an extreme example, $5,000 invested for a 30-year-old worker at a money market rate of 2 percent will produce $10,000 in today's dollars at age 65 as compared to $53,000 when invested at 7 percent – the historical real rate of return on equities.

Second, a noticeable amount of cashing out still occurs with amounts greater than $5,000. Remember that when the account exceeds $5,000, the employee must request the employer to write a check; otherwise the amount remains in the account or at the employee's request can be transferred into an IRA or a new 401(k). As shown in Figure 3, more than 30 percent of workers changing jobs with balances between $5,000 and $10,000 cash out their accounts. Although the proportion then drops as balances rise, the share of individuals who go out of their way to cash out is still significant.

Conclusion

Although some problems remain, eliminating the automatic cash-out provision for small 401(k) balances (between $1,000 and $5,000) and placing them into IRAs is a notable improvement. It builds upon the successful results of the automatic enrollment experiments that demonstrated the power of establishing the desirable outcome as the default. It is changes like these that will work toward improving the retirement outlook for today's workers.

Endnotes

[1] See Munnell and Sundén (2004).

[2] Munnell and Sundén (2004).

[3] Madrian and Shea (2002).

[4] The original provision was part of the Economic Growth and Tax Relief Reconciliation Act of 2001.

[5] For amounts of $1,000 or less, the new regulation encourages rollovers by offering fiduciary protection to employers who choose this option. For amounts in excess of $5,000, the employer can continue to cash out balances only at the employee's request.

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