

**Statement of Norman Stein
On Behalf of the Pension Rights Center
Before the ERISA Advisory Council
On the Subject of**

**“Issues and Considerations Around Facilitating
Lifetime Plan Participation”**

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Good morning. I am Norman Stein. I am a professor at the Drexel University School of Law, where I teach and write principally in the areas of employee benefits and tax law. I also am a policy consultant for the Pension Rights Center in Washington, on whose behalf I am today testifying. The Pension Rights Center is the country’s oldest consumer organization dedicated solely to protecting and promoting the retirement security of American workers, retirees, and their families. It is always a pleasure to appear before this advisory council, of which I am an alumnus, on its important work.

I appreciate the opportunity to testify on today’s topic, facilitating lifetime plan participation.

You have asked witnesses to address a number of factual questions and policy issues, including

- (i) Why do participants take their assets out of plan solution?
- (ii) What factors should a rational employee take into account when deciding whether to move assets out of plan solution (a question that overlaps with the first question)?
- (iii) What is the perspective of employers on asset flight?
- (iv) What can employers do to help their employees make good decisions concerning disposition of their accumulations in individual account plans and benefits in defined benefit plans, particularly given concerns about potential fiduciary liability? and
- (v) How can the Department of Labor help plan participants make good decisions?

I note that these questions arise in different contexts: when a current employer removes money from a plan through a loan, hardship withdrawal, or from a profit-sharing plan; when an employee leaves a job but has not yet retired; and when an employee is retired. The practical and policy considerations may differ depending on which of these contexts is applicable.

But the statistics themselves are alarming. Each year, according to Fidelity Investments, approximately 35 percent of participants who leave jobs cash out their retirement benefits, with an average benefit of slightly over \$15,000.¹ Another 2.4 percent of all employees in 401(k) plans take hardship withdrawals from their plans. Of the people who cash out their withdrawals from 401(k) plans and IRAs, approximately five to six million people pay the 10 percent

¹ It is possible that some of these individuals rolled some or all of their assets over to an individual retirement account after Fidelity no longer had contract with them.

additional tax under Internal Revenue Code 72(t).² Over a 10-year period, then, plan participants have at least partly cashed out their retirement benefits before age 59.5 more than 50 million times. And this does not, of course, include the many ill-advised decisions to rollover assets from low-cost plan investment vehicles to high-fee, retail IRAs.

1. Why do plan participants withdraw money?

The classic film noir masterpiece *The Naked City* begins with a narrator telling us that “there are eight million stories in the Naked City and this is one of them,” and this sentiment is important for the issue you are studying, for each plan participant who takes a lump sum from a plan has his own reasons for doing so. But there are, of course, common themes to these stories, and I will try to summarize some of them in two categories: taking cash now for personal consumption and rolling over or directly transferring assets to an individual retirement account to preserve the assets until retirement.

I should note that I am often drawing here not on my or other’s scholarly work, but on my own experiences of running a pension counseling clinic, making decisions about my own retirement plan, and observing and sometimes helping others, including family members and colleagues and friends, make decisions about retirement savings.

A. Reasons for taking cash now (for current consumption):

- i. Immediate need for money: People have pressing financial needs—buying a house, paying for a child’s education, satisfying crushing high-interest debt, throwing a rehearsal dinner for a son’s wedding, meeting medical needs not covered by insurance, helping through a period of unemployment or underemployment, helping out a family member—and often a withdrawal or loan from a qualified plan is the easiest if not the only store of resources available to meet such needs. As Willie Sutton said about robbing banks, many participants cash out their qualified plans because that is where the money is.
- ii. Cash bonus: People who leave jobs suddenly have access to a lot of money and it is tempting to reach, particularly if the amount is small enough that it is difficult for younger people to appreciate how leaving the money in plan solution can help you appreciably 30 or so years from now when you retire. (Fidelity estimates that 40 percent of people under 40 cash out their retirement savings when they leave their job.) Saving for retirement requires people to forego immediate consumption in exchange for financial security later, often much later. This is difficult enough to do when a person’s decision is, say, whether to commit to saving or spending \$50 per pay cycle; it is that much more difficult when the decision is \$20,000 all at once. Who wouldn’t like a new car or vacation or trout boat when you leave a job, particularly when it is hard to visualize how that money, with compounded interest, is going to make your retirement, 30 or 40 years from now, more comfortable? (Sometimes people apparently partly appreciate the importance of keeping retirement savings intact until retirement and will rollover some money to an IRA but use some of the money for current consumption.)
- iii. Seed money for a new business.

² These figures were compiled by Bloomberg and rely on data from the Internal Revenue Service, from a study by Fidelity Investments, and from data compiled independently by Bloomberg. The data, as presented by Bloomberg, is available at <http://www.bloomberg.com/infographics/2014-05-05/americans-raid-their-401k-piggy-banks.html>.

- iv. The loan illusion: People take out loans, not understanding the high fees that are often involved and the poor track record that participants sometimes will not repay an outstanding loan when they leave employment (and many plans require that a participant pay back a loan in full shortly after the participant separates from service). For some people, the loan puts a veneer of responsible stewardship on what will often just be an irresponsible withdrawal from a retirement savings account.
- v. The intended-rollover illusion: Similar to the loan illusion, people sometimes take lump-sum withdrawals believing that they will roll the proceeds over to an IRA within the 60-day rollover period but then fail to do so.
- vi. Difficulty in valuing or appreciating a defined benefit: Younger people sometimes have conceptual difficulties in appreciating the value of a distant annuity benefit and, when offered a cash sum in lieu of that hard-to-value promise of an annuity, will instinctively favor the cash.
- vii. Paying off debt.

B. *Reasons for rollovers and direct transfers to IRAs.*

- i. Some people don't like their former employer and don't want their money in its plan.
- ii. Plan has high fees (not likely to be lower than retail IRAs, though).
- iii. Plan does not have investment options participant wants.
- iv. Advice from a third party (sometimes third parties with interests that conflict with the participant's interests) to roll over.
- v. Mandatory cash-out from plan.
- vi. Don't like benefit payout options available from plan.
- vii. More direct control of money than available from employer plan.
- viii. Poor service from plan's third-party record keeper.
- ix. Desire to consolidate accounts.
- x. Desire to convert to Roth (when that option is not available in plan).
- xi. Not understanding advantages of keeping money in employer plan (particularly the value of compound interest).
- xii. Not wanting default spousal beneficiary under the plan.
- xiii. Rollover to an IRA as a strategy to avoid withholding from 401(k) distribution but intending to make withdrawal from IRA without withholding.
- xiv. Special considerations when people consider taking lump sums from defined benefit plans:
 - a. Aware of likely short-life expectancy;
 - b. Fear of "forfeiture" of benefit in the event of an early death;
 - c. Desire to leave bequests for children;
 - d. Fear of inflationary erosion of defined benefit over retirement;
 - e. Not appreciative of insurance value of annuity form of benefit;
 - f. Not aware of unfavorable interest and mortality factors used to calculate lump sum amount under Internal Revenue Code section 417;
 - g. Pressure/bad advice from investment adviser or broker dealer (sometimes with conflict of interest) to take lump sum;
 - h. Attractiveness of very large sum of money (likely largest sum of money ever available to participant);

- i. Pressure from children or potential heirs to take lump sum because of potential of survivor benefits;
- j. Hybrid plan designs often encourage taking lump sums rather than an annuity as the “regular” form of plan benefit;
- k. Belief that the individual can get extraordinary, low-risk investment returns (not generally true if you are not Mitt Romney);
- l. Concern about the financial solvency of plan, employer, and PBGC;
- m. Generally bad reputation of defined benefit plan because of negative media attention about poorly funded public plans;
- n. Fear of leaving money with an old employer is sometimes particularly pronounced with a defined benefit plan.
- o. Possibility of diminished mental capacity affecting the ability of older employees to make rational choices.

2. Factors that Participants Should Consider in Deciding Whether to Rollover

- A. Relative fees of plan versus fees in an IRA.
- B. Investment vehicles offered by the plan.
- C. Does the 401(k) plan permit loans to former employees (but see 1.a.iv)?
- D. If the employer subsidizes plan administrative fees, will fees increase for a former employee?
- E. If relevant to the participant, does the employer plan provide Roth conversion feature?
- F. Evaluation of plan payout options.
- G. Ability to avoid the 10 percent excise tax on 401(k) distributions in certain situations, if the participant leaves a job when the participant is at least 55 years of age.
- H. Protection against creditors may be weaker in an IRA than in a plan, depending on state law.
- I. IRAs not protected by ERISA fiduciary law.
- J. Does the participant have high-interest consumer debt?
- K. Are there fees on disposition of investments held in a defined contribution plan?
- L. Will the participant lose certain contractual rights already paid for (for example, losing guarantees in certain variable annuity contracts with guarantee features as to payouts)?
- M. Differences in state taxation of distributions from qualified plans and distributions for individual retirement accounts.
- N. Rolling assets over into a new employer’s plan to avoid applicability of minimum required distributions under section 401(a)(9) of Internal Revenue Code;
- O. Special considerations in defined benefit plan:
 - i. Does the participant have terminal illness or enjoy hang-gliding?
 - ii. Unfavorable actuarial factors, both mortality and interest, for the participant in conversion of benefit into a lump sum, especially for woman;
 - iii. Possibility that a male participant might be able to use a lump sum to purchase a more attractive annuity outside plan (although the possibility of this may be something of an urban legend, given that the lump sum does not include the various fees, commissions, and profits built into the premium of an annuity and the insurer’s likely concerns about adverse selection);
 - iv. Possible loss of any special plan subsidies that are available when a participant takes the plan’s annuity benefit;

- v. Concerns about inflation's effect on benefits over time (but better ways to cope with inflation than taking lump sum—for example, can save a portion of each payment);
- vi. Availability of a partial lump sum;
- vii. In hybrid plans, loss of “above-market” interest rates.

3. Employer Attitudes Toward Plan Withdrawals

Different employers can be expected to have differing perspectives on retaining employees in a plan. Among the factors that may play a role in how an employer views the question of former and retired employees keeping benefits in a plan rather than taking a lump sum, are the following:

- A. Whether the employer has a desire to sever all relationships with former employees.
- B. Concerns about potential fiduciary liability to former employees who keep assets in plan.
- C. In some closely held corporations, concern that the employee will use distributions to start a business that will compete with the employer.
- D. The effect of asset retention on fees paid directly by the employer and/or by other employees.
- E. Concerns about future communications to, and retaining up to date information on, the former employee and spouse.
- F. Desire to ensure that employees (for loans and in-service withdrawals) and former employees and retirees (for post-separation payments) make good decisions about retirement.
- G. In a defined benefit plan, often relatively less expensive to pay a lump sum.
- H. In a defined benefit plan, can stop paying PBGC premiums on employees who take lump-sum distributions.
- I. Nuisance value of relatively small accounts.
- J. Administrative costs to the employer and participants of loans and in-service withdrawals.
- K. If the plan has employer stock, whether the employer wants former employees to hold such stock in the plan.
- L. Concern about compliance with Required Minimum Distribution rules.

4. Steps employers can take to discourage pre-retirement consumption of plan assets and to encourage good financial decision making in deciding between a rollover or keeping assets in a plan (without incurring potential fiduciary exposure):

- A. Prohibit or limit loans and in-service distributions through plan design.
- B. Do not permit lump-sum distributions from defined benefit plans.
- C. Provide attractive plan payout options for defined contribution plans, possibly having annuity options that have set interest rate assumptions so amount of annuity does not vary depending on interest rates at time of retirement.
- D. Provide independent and non-conflicted investment advisor to employees about to separate from employment.
- E. Provide on-line educational material for plan participant on plan and financial planning and literacy; have seminars conducted by experts without conflicts of interest with participants.
- F. Include in the contract with the record-keeper that the record-keeper is not permitted to initiate a rollover discussion or discussion about its investment products with an

employee who calls in to arrange for a distribution and may not call an employee or former employee to sell its products unless the employee has requested such a call in writing.³

- G. Provide in the contract that the record-keeper call center accepts fiduciary status.
- H. Ensure that the plan has an attractive menu of investments.
- I. Permit rollovers and direct transfers into the plan.
- J. Adding a deemed IRA to the plan.

5. Possible Department of Labor Actions.

- A. Provide on-line information (on DOL website) on factors that participants should consider in deciding whether to take a lump sum or leave assets or benefits in a plan.
- B. Provide on-line information on questions to ask people providing advice on whether to take a lump-sum distribution from a plan, including questions designed to detect conflicts of interest.
- C. Issue guidance on steps employers can take to educate employees on how to evaluate plan distribution options without creating potential fiduciary liability. Consider creation of model documents for employers to provide employees to guide them in making decisions about plan distribution options or work with professional groups to develop such materials.
- D. Work with the IRS to ensure that individuals over a specified age have sufficient capacity to knowingly consent to elections in a defined benefit plan.
- E. Create prohibited transaction exemptions to facilitate call centers agreeing to accept fiduciary status (see 4.G. above).
- F. Reverse its position that giving advice on whether to leave money in plan or to transfer it to an individual retirement account is not generally a fiduciary activity and issue appropriate related prohibited transaction exemptions.
- G. Work with the IRS to reduce obstacles to rollovers and direct transfers to a new employer's plan.⁴
- H. Work with the IRS to ensure that former employees do not suffer increased fees or decreased access to investment options if they leave their assets in 401(k) plan.
- I. Provide employers with IRS guidance on employer plans receiving a rollover that is later determined to have come from a disqualified plan.

³ There is, of course, value to people rolling over assets rather than consuming them, so a record-keeper's call centers give value to the extent the contract persuades an individual to rollover rather than using their plan distribution for current consumption. But it is better for this advice to come from a party without a conflict of interest.

⁴ This and the next two recommendations come from GAO's March 2013 "401(k) Plans/Labor and IRS Could Improve the Rollover Process for Participants."