Testimony Before the ERISA Advisory Council

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Drivers and Deterrents of Leakage from Defined Contribution (DC) Accounts

Introduction

My name is Warren Cormier, and I am the CEO of Boston Research Technologies, co-founder of the RAND Behavioral Finance Forum, and Chief Behavioral Officer of the National Association of Retirement Plan Participants (NARPP). I am honored to submit testimony to the ERISA Advisory Council on a subject that is extremely important to American's retirement security: leakage of Defined Contribution (DC) account balances.

In America today, more than 50% of our workforce has access to the tax deferral benefit provided by DC plans. Fully 70,000,000 workers participate in a DC plan, and these are highly mobile workers. Each year, millions of DC participants switch jobs, are laid off, or quit. Each time they do, they face a decision: what to do with the thousands – and sometimes tens or hundreds of thousands – of dollars they have saved in their DC plans.

Clearly, the DC system today has become very effective in facilitating the movement of payroll into DC accounts, but that is only half the job. We have a remarkably mobile work force. EBRI estimates that over a 40-year career of fulltime employment, the average American worker will change jobs ten times. Unfortunately, we are significantly less effective in moving an employee's assets between DC accounts at different employers than getting the assets into the DC accounts.

Essentially, the job of building a private retirement system is not complete. There is too much friction surrounding the movement of money between accounts. Imagine the turmoil if the US banking system suffered from the same conditions. And the subtle but very real problem with too much friction is it's creating opportunity for DC assets to leak from the retirement system in the form of cash-outs.

In my testimony I describe the findings, implications and recommendations for model notices and plan sponsor education stemming from a recent study addressing the drivers and deterrents of cash-outs. Of the three forms of leakage (i.e., cashouts, loans, and hardship withdrawals), my focus is on the largest – cash-outs.

The key points of my testimony (submitted in the attached research report) are:

- Cashing-out is not a natural proclivity
- Rolling-into the next plan is the hardest process of all options at job termination
- Cash-outs are a function of financial wellness, primarily, then wealth, but not income
- Cashing-out is not necessarily due to an emergency
- Penalties for cashing-out may be weak deterrents
- Consequence-based decision-making (framing) affects some cash-out choices
- Dampening cash-outs will require a multi-pronged approach

Each of these points are addressed below:

To determine why cash-outs occur, BRT conducted a study in collaboration with Retirement Clearinghouse.

- <u>Methodology:</u>
- 5,000 active DC participants
- On-line data collection
- SSI Respondent Panel
- Survey conducted from April 13 – April 24
- Weighted by geography, age, gender, and RK

FINDINGS

Cashing-out is not a natural proclivity:

- Very few (4%) of those who cashed-out in the past two years say that would be their intent if they left their current plan
- The vast majority who cashed-out agree DC balances should only be used strictly for retirement
- Regret persists among half who cashed-out

Of those who actually rolled-in to their new employer's plan:

- Two-thirds described the process as "requiring some work"
    - Compared to one-third of those cashing-out
- On average it took 3-4 weeks
- Two-thirds who completed the roll-in process solicited help from other people
    - Of those, two-thirds had that person complete the whole process
    - These tend to be people with greater financial resources

The roll-in process is not seen as highly complex, but it is seen as:

- Time consuming – Participants who haven't done a roll-in but shown the process estimate that completing the process would take them 9 hours (median, 18 hours average) of constant work
- A mystery – three-in-four would be uncertain about where to start, even after having it explained to them
- Half say they would not have cashed-out if rolling-in were made as easy as cashing-out

We see indications that the (perception) of the process may be a hindrance to rolling-in when examining why participants strand accounts at previous employers:

- "It wasn't big enough to bother"(20%)
- "It seemed to be very hard to do" (17%)
- "I didn't have the time" (17%)
- "I was not sure how to do it" (22%)

Cash-Outs are most tightly correlated with:

- Financial Wellness,
- Secondarily wealth
- Cash-outs are not correlated to income

Of those who cashed-out:

- Only half said it was an emergency
- A fifth said it was to buy something "nice"
- Largely the money was used as a private unemployment insurance program:
    - Payments on debt and household expenses between jobs
    - Costs of a new job search

Penalties for cashing-out may be weak deterrents:

- Eight-in-ten "say" they were aware there were penalties and taxes due if they cashed-out, yet did it anyway
- Prospect Theory is likely in play: The sense of "loss" is not sufficient to stop the cash-out
    - It may not be perceived as a "loss" at all, but rather a gain of purchasing power
    - The money will come out of the DC account
    - This money has already been removed from the participant's cash flow, in essence it's a prepaid penalty
    - No sensitivity over an arc of prices tested to have the process done for them

Consequence-based decision-making (framing) affects some cash-out choices

- When told what the value of the amount they cashed-out would be at age 65, one-third of those who cashed-out said they would rethink that decision
- Even so, some participants are hyperbolically discounting the future value back to an amount that makes cashing-out feel like the best move.

Roll-in assistance (portability) offered as an employee benefit would be highly valued

- Almost half of participants say, compared to existing benefits, roll-in assistance would be an "excellent" employee offering
- Almost as many rate it a "good" employee benefit
- The most compelling positioning of rolling-in versus leaving the account with the previous employer is better management (i.e., control, awareness, decision-making) of the account

Finally, in a related research study of 5,000 active DC participants recently completed by the National Association of Retirement Plan Sponsors (NARPP), it was established that education is the foundation upon which trust is established. Education and communications can build (or erode) the necessary trust that encourages participants to take trust-dependent actions like enrolling in a DC plan, staying in the DC system, and increasing DC deferral rates. Building trust should be a key goal of any communications or education program.

We know through media richness theory that the clearer and simpler an educational message is, the greater the perceived trustworthiness of the educator. In the NARPP study we found that perceived quality of education substantially drives up trust levels. The characteristics of the education experience that drive credibility of the person or institution (and thereby trust) are:

- Helps employees to envision a more financially secure future
- Materials reflect an empathy for employees and their needs
- Enhances employee understanding of the value and benefits of the savings plan
- Captures participants' attention and engages them with the plan
- Materials do not use confusing bar charts and industry jargon
- The information highlights the consequences of optimal and sub-optimal decisions

Conclusions and Implications for Plan Design

Dampening cashouts will require a multi-pronged approach:

- Substantially simplify the roll-in process…. make the smart move the easiest move
- Change the participant's reference points (i.e., penalties and taxes don't appear to be enough of a "loss")
- Translate the impact of a cash-out decision into longer term values (help them understand the true loss)
- Offer roll-in assistance as an employee benefit to help educate and focus attention on abandoned accounts

Specific Recommendations for Plan Sponsors

Regarding model notices, the messaging to participants should clearly specify the consequences of cashing-out to deal with hyperbolic discounting by applying Enhanced Active Choice. Simply stating that there are penalties and taxes due is clearly not sufficient in many cases. The consequences should be reframed in terms of the long-term impact of cashing-out in terms of the:

a) Loss of asset accumulation from today to retirement, and
b) Loss of monthly retirement income

This could easily be accomplished with a simple algorithm that would be used whenever an employee leaves employment or is welcomed to new employment.

Regarding plan sponsor education, the availability of full-portability services should be a top priority. Although changing the roll-in process is unlikely (or perhaps a distant future) event, the complexity of the process itself can be masked to the participant by a DC-balance-portability service. The result will be to make the roll-in as easy as the cash-out, stemming enormous loss of retirement assets. The plan sponsors should also be educated on the fact that employees will likely see the portability service as an excellent or good benefit compared to their existing benefits package.