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The Face of Friction

Solving the leakage problem requires a clear understanding of why people cash out their balances, including what they do with the money.

We hear a great deal today about leakage, especially its impact on retirement readiness and how it must be stopped. Of the three forms of leakage, cashing out is by far the largest dimension of the leakage issue. Estimates of the percentage of terminating employees who cash out their balances run into the 40% range.

One of the causes of cashouts is that of the various alternatives (leaving the money in the plan, rolling it over to an IRA or rolling it into their next employer's DC plan), cashing out is by far the easiest to accomplish. In a 2014 study Boston Research Technologies completed among recent job changers (*i.e.*, within two years), respondents who cashed out their balances reported, by a wide margin, the greatest amount of ease in completing a cashout compared with those who rolled to an IRA, rolled into their next employer's plan or simply left the money in the plan.

In essence, an unintended consequence of the rules and regulations governing participants' options when they leave their jobs is to encourage cashouts. Further evidence of this is in the annual DCP study of 7,000 active participants. Only 2% overall (and in the singled digits among those with balances under $5,000) said that hypothetically, if they were to leave their current job they would take the money and spend it.

However, we know the actual proportion is above 40%. Obviously, when actually confronted with the reality of doing anything other than cashing out, either the complexity or ignorance of the alternatives drives a huge number of participants to cash out.

Much has been debated about the optimal choice for participants' balances when they change jobs. IRA rollovers have always been a popular choice. According to an ICI study, nine of every 10 dollars in IRAs today come from DC plan rollovers. But this may not be the optimal choice for participants. In 2013, a study conducted by the Government Accountability Office (GAO) revealed misleading sales practices hiding the true costs to participants of choosing that option.

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For many participants with under $5,000, leaving their money in an existing DC account is not an option, as employers are exercising their option to force the participant out of the plan. And if a participant is allowed and decides to stay in the plan, there are often fees imposed by the plan sponsor to do so.

This leaves the option of moving the balances to the next employer's plan. This may be, in many cases, the best option. Virtually all plan sponsors allow such transfers, and there are no fees involved. Furthermore, it is argued that:

- It's easier for participants to manage all their money in one place.
- Participants will more actively manage their money if it is consolidated.
- Participants won't lose track of old accounts.
- Employers won't lose track of former employees.

From the plan sponsor's point of view, the idea of participants moving their money has advantages and disadvantages. Some argue for keeping participants' balances to help with pricing of administration services. Others argue there are fiduciary risks involved, as well as significant operational efforts in communicating and servicing participants who are no longer working at the plan sponsor's firm. (Interestingly, for the average plan sponsor, one out of every four participants no longer works at the firm.)

In contrast, completing a cashout is typically one easy step — what to do with one's balance when a job change occurs. Some refer to this as "friction."

(Interestingly, we talk about friction but few know what this complex phenomenon actually looks like. For a diagrammatic picture of friction — and to fully appreciate the complexity — take a minute to review a set of "do-it-yourself" decision trees for plan-to-plan transfers created by the Retirement Clearinghouse. Go to http://www.rch1.com/knowledge-and-resource-center/resources-downloads and click on "Articles and Whitepapers," then "DIY Roll-In Difficulty Exposed.")

Now let's consider the mindset of the participant who is changing jobs, either voluntarily or involuntarily:

- The participant is in a highly emotionally charged mindset and is making decisions in a suppressed cognitive state.
- The participant tends to move away from his or her reflective, deliberate decision-making processes (which Dr. Daniel Kahneman refers to in his 2011 book *Thinking, Fast and Slow*, as "System 2" thinking) to a more intuitive, rapid, knee-jerk, uninformed, deci-

sion-making process (which Kahneman calls "System 1" thinking).

- To a participant, a job change is almost always treated cognitively as a "loss" in some way (*e.g.*, loss of income, colleagues, familiar routines, etc.).
- The participant is seeking to offset his or her sense of loss as well as hyperbolically discounting to nearly zero the future gains of leaving the money in the system.

All this leads many participants to find the offer of a large lump sum of cash almost irresistible, particularly among lower-income, small-balance DC participants who value even a small amount of money in their account much more than high-income colleagues do. To say the least, the cash is an attractive offer in an emotionally turbulent time where logic is replaced by what "feels good" at the moment. Thus, it is not surprising that so many people take the easier route of simply agreeing to suffer the penalties and take the check.

What do Participants do with the Money?

What do participants do with the money they cash out? Is it for an emergency? Did they take the drastic step to leave their job to gain access to the cash instead of taking a loan or asking for a hardship withdrawal?

In a recent study I completed with the cooperation of the Retirement Clearinghouse, I asked the telephone counselors to query 500 randomly selected callers who indicated they wanted to cash out their DC account balances what plans they had for the money. The question was asked at the beginning of the call, before any information was provided about the penalties and taxes involved with a cashout. Also, we asked callers if they were currently employed or moving to a known new job, or if they were currently unemployed and had no job to go to yet.

Before looking at the data, it is important to note that 20% of the employed participants felt their balances were too small to even consider anything but taking the cash. This compares fairly closely to the 14% of unemployed callers. But keep in mind that this is partly due to their hyperbolically discounting the value of those dollars back to present value, not what they represent in purchasing power decades into the future. Part of the solution to the cashout problem is to make participants aware of the total value they are giving up, as opposed to the net proceeds they receive after a pretty severe haircut today.

Turning to the question of what they plan to do with the net proceeds of their cashed-out balances, we see that the most frequently mentioned factor is to make payments on their cost of housing — rent/mortgage/utilities. To be clear, they did not terminate their employment to get access to their balances to pay their rent; they are simply reporting that with the sudden influx of cash into their household cashflow, they will use it for household expenses. In fact, they will often use it for whatever payments emerge first, as opposed to having a specific plan.

Interestingly, we can see in Fig. 1 that unemployed people are more likely to use the cashed-out balances as a contingency account to keep up with the least discretionary payments (rent/mortgage/utilities), followed by medical bills.

We also see that "above or below $2,000" is a clear inflection point with regard to feeling that a balance is "too small to bother to do anything but cash out." Specifically, of the 84 respondents who said the balances were too low to matter, 100% had balances equal to or under $2,000.

Solving the leakage problem obviously requires a good understanding of why people cash out their balances, including what they do with the money. The results in Fig. 1 clearly suggest that it isn't to keep households afloat for more than a few months, if at all. The picture of "friction" is almost certainly daunting to a high percentage of job-changing participants. Unless we make the best decisions the easiest to execute, other steps will be ineffective.

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Figure 1
How Are Cashed Out Proceeds Spent?

	EMPLOYED	UNEMPLOYED	TOTAL
Rent/Mortage/Utilities	39%	55%	47%
Credit Card/ Student Loan Debt	21%	9%	15%
Medical Bills	12%	21%	17%
Life Event (funeral/wedding/divorce)	3%	4%	4%
Auto/Transportation	5%	4%	5%
Other (nonessentials)	20%	7%	12%