Cash-outs, loans and rollovers fuel the flood from 401(k)s: Cerulli

By Editorial Staff *Thu, Dec 17, 2015*

Liquidity is the defining characteristic of 401k plans. If participants couldn't borrow, cash out, rollover or take hardship withdrawals, they might not join in the first place. But with liquidity comes "leakage," and that's a problem.

Nearly $81 billion disappeared from retirement accounts in 2014 as a result of cash-outs and loan defaults, according to Cerulli Associates, a global analytics firm. Such events are the source of the so-called “leakage” that undermines retirement savings and will likely create financial shortfalls later in life.

In a new report, “Evolution of the Retirement Investor 2015: Insights into Investor Segmentation and the Retirement Income Landscape,” Cerulli examines retirement decisions made by individual investors, with emphasis on 401(k) plan participants, IRAs and rollovers, and retirement income.

Leakage is of great concern to 401(k) providers who hope to retain the assets, to IRA providers who want to capture more of the assets in motion, and to policymakers who worry about potential demand for government services from underfunded elderly Americans. Cash-outs, which become possible when individuals change jobs, are the biggest cause of leakage, with loans a distant second.

The U.S. may be the only developed country where individuals can tap a tax-deferred savings program before retirement. If the cash-out amounts are small, the prospects of a slightly higher tax bill or even a 10% penalty for early withdrawal don’t act as effective deterrents. “Outside of the interaction with their recordkeeper or IRA service provider, there is really nothing stopping anyone from accessing either a terminated DC or IRA account early,” said Shaan Duggal, a Cerulli research analyst.

“Nearly every Gen-Xer who completed a cash distribution from their 401(k) ended up paying an additional 10% penalty on top of regular taxes to the IRS. When a distribution is requested, recordkeepers should spring into action, conveying the benefits of preserving the tax-deferred nature of the assets.”

“Loans are also a source of 401(k) leakage, albeit smaller, but when they are defaulted on immediately they cause a taxed and penalized event for the already cash-strapped individual,” Duggal said in a release. “Removing the entire loan function from the plan may be extreme, but restricting the amount of outstanding loans to only one will slowly do away with the idea that the DC plan is meant to be a source of short-term liquidity.”

But leakage is a sideshow relative to the rollover story. Over the past decade, millions of plan participants have, one by one, moved their retirement plan money into rollover IRAs when they changed jobs. In 2014, those over age 50 represented almost 80% of the flow, according to Cerulli. Retirement providers want to stem the outflow, while advisors and IRA providers hope to capture it.

Full-service firms like Fidelity and Vanguard, which provide retirement plans, serve as IRA custodians and sell mutual funds direct to the public, are positioned to benefit regardless of the direction of the flow. In 2014, Fidelity led the IRA industry with 14.6% of total rollover flows. When people roll over their money, they often roll it over to their plan’s provider or to a brokerage advisor.

“Advisors received the majority of rollover assets ($220 billion), followed closely by self-directed IRAs at $162 billion. Plan-to-plan rollovers were a distant third at $27 billion,” the Cerulli report said. Cerulli speculated that the Department of Labor’s pending proposed “fiduciary rule” could, when it is issued, dampen the flow from 401(k) plans to IRAs. “The DOL viewpoint is that the DC plan is often the best place to leave assets,” Cerulli writes, but it’s still likely that most people will withdraw their retirement income from IRAs, not from 401(k) plans.

Social Security is still the No. 1 source of retirement income (33.9%) for middle-class participants. Defined contribution and personal savings combined provide 32.5% of participants’ income in retirement, Cerulli reported.