Fixing the 401(k)s’ Leakage Problem

By Kerry Pechter *Thu, Sep 25, 2014*

“I think [auto-portability] is an opportunity for a win-win-win,” says Lew Minsky, executive director of DCIIA. “If you keep more people invested for retirement, all of the players in the system benefit. You’re growing the system.”

While plan sponsors, advisers, recordkeepers, asset managers and regulators were cooking up America’s defined contribution system over the past 35 years, they failed to foresee a crucial ingredient: connectivity. In an otherwise well-wired world, there’s still no frictionless protocol for whisking money from one plan to another when people change jobs.

In plans as in plumbing, poor connections cause “leakage.” When people with small 401(k) accounts change jobs—and millions do every year—their plan assets are often spent, lost, forgotten or shunted to a so-called safe harbor IRA. Countless people—especially the young, low-income and minorities—fumble away a chance to start accumulating an adequate nest egg.

Like many financial problems, leakage is also an opportunity. Driven by a combination of self-interest and public interest, a number of peope within the retirement industry have been pushing for a solution to at least a portion of the leakage problem. They envision a “clearinghouse” that would automatically route participants’ old 401(k) assets to their next 401(k) plan, if or when they have one.

Don’t confuse the leakage problem with its wealthier cousin, the rollover IRA issue. The rollover issue focuses on the intense competition for larger DC accounts, including how firms can capture or retain them and how the process should be regulated. The leakage issue, in contrast, involves the millions of tiny accounts that fall through the cracks in the system.

As one observer put it, the rollover issue involves “the 50% of retirement accounts that have 96% of the assets,” while the clearinghouse involves “the 50% of accounts with 4% of the assets.”

The question is, can all the big players in the retirement industry agree to cooperate on a small-accounts clearinghouse? The success of “auto-portability” (or automatic roll-ins or “lifetime plan participation,” as the process has been called) depends on agreements between governmental players, who hope to increase retirement security, and industry players, who want to conserve assets under management, and technology firms, who can provide the digital switchboard that will serve as the missing link of the 401(k) system.

Much of the energy behind auto-portability has come from Retirement Clearinghouse (RCH), a Charlotte, NC-based IRA custodian formerly called Rollover Systems. RCH executive Tom Johnson, formerly of MassMutual and New York Life, has spent the past year trying to drum up support for roll-ins and to clear away whatever legal or technical barriers might stand in its way.

Progress has been made. Twice this year, once on June 17 and again on August 21, the ERISA Advisory Council heard testimony on "Facilitating Lifetime Plan Participation." A few months ago, the IRS issued a rule (2014-09) that would make it easier for 401(k) plan IT systems to certify the tax-deferred status of roll-ins.

Meanwhile, the Defined Contribution Institutional Investment Association (DCIIA), a trade group whose members include almost the entire retirement plan industry, supports the concept of auto-portability. (See today's *RIJ* feature on Lew Minsky). RCH has sponsored analyses by Boston Research Technologies and by Steve Saxon, chair of the influential Groom Law Group, to build an intellectual and legal story around auto-portability.

But the game is still in its early stages. Before recordkeepers can exchange personal participant account data freely, the DoL would need to bless the process with an advisory ruling. An industry software standard, perhaps based on RCH's technology, would need to be shared and adopted across recordkeepers. Finally, if the $7 trillion rollover IRA industry perceives roll-ins as a threat, its opposition might be aroused.

Regarding that last point, the auto-portability enthusiasts are eager not to appear threatening. "I think this is an opportunity for a win-win-win," Lew Minsky, executive director of DCIIA, told *RIJ* this week. "If you keep more people invested for retirement, all of the different players in the system ultimately benefit. You're growing the system."

The DC industry needs a win. It needs to stem the losses that it has experienced due to leakage, rollovers and decumulation. By 2016, for the first time, more money will leave 401(k) plans than goes in, according to Cerulli Associates. By 2019, the system's net loss is estimated at $58 billion.

Interested parties

The common denominator for most of the discussions about auto-portability has been Retirement Clearinghouse, which changed its name from Rollover Systems in preparation for the development of roll-ins. (See earlier ***RIJ* article** on RCH.) Johnson, representing RCH CEO Spencer Williams, has solicited support for roll-ins from congressional aides, DoL officials, ERISA lawyers, the big full-service retirement plan providers, members of the DCIIA, and almost anyone else who will listen.

RCH, according to Johnson, wants to do good and do well by slowing down leakage. "We would be the record mover—the transfer agent—between 401(k) plans. We would hold small balance IRAs for as short a period as possible, and then recycle the money into your active 401(k) plan. Our goal is to keep you invested in a plan," Johnson told *RIJ.*

RCH envisions charging the account owner a $1.50 to $3 per month custodial fee during the holding period between plans and a one-time $49 fee for mediating an electronic transfer to a new plan. While small individual retirement accounts tend to create headaches for large retirement plan recordkeepers, their sheer volume makes them highly profitable for the proprietor of a clearinghouse.

But as RCH tries to spark a fast break to the hoop on this initiative, at least one other observer thinks it should wait until the rest of the team, so to speak, can catch up. Although RCH appears ready to start implement automatic roll-ins at any time after a nod from the regulators, Mark Fortier, a retirement industry veteran who testified at the August 21 ERISA Advisor Council, suggested that addressing the leakage problem in a series of smaller steps might ultimately be more effective.

Fortier, formerly of AllianceBerstein and State Street Global Advisors, recommends that retirement plan providers collectively develop the technology and associated standards for implementing the DoL's lifetime income calculation for inclusion on participant statements. Agreement on standards for those calculations, he said, could serve as a foundation for agreement on standards for automatic roll-ins and perhaps other transactions.

"I'm taking Labor's goal for disclosure around lifetime income, along with their proposed safe harbor assumptions for the calculations, and suggesting that the industry pursue a cooperative approach—not only to reduce costs but also pave the way for a true lifetime view of one's retirement income. That way, people can do the same thing they do at Mysocialsecurity.gov. You see a single monthly retirement income number," Fortier told *RIJ.*

"The Labor Department's proposed requirements have left the industry divided over the approach and methodology. What we need is a cooperative that can facilitate the requirements and foster innovation," he added. "As in nature, organisms are inherently competitive. But the ones that survived and thrived have done it through cooperation." Johnson, for his part, said RCH would share the "essence of its intellectual property" with the rest of the industry.

A similar message is coming from DCIIA. "For something to be successful here, it needs to be a coalition effort," Minsky told *RIJ* this week. "It has to be supported by and participated in by as broad a coalition of key industry players as possible. I would encourage them to think of something that looks like a co-op. There are other clearinghouses that you could use models. Like DTCC, for instance."

The pro roll-in crowd is betting that the DoL wants to make progress on the issue of retirement readiness during the current administration. The financial industry has rebuffed the agency's attempt to slow down the flood of money out of 401(k)s into rollover IRAs—which now have more assets than DC plans—by proposing that rollover recommendations become a fiduciary act. The clearinghouse idea would be another, less controversial way to enhance readiness.

Opposition might still come from Wall Street. Roll-ins might be seen as a threat to broker-dealers and advisers who want to capture more of the money in play when people change jobs. But as long as the roll-in folks stick to the goal of sweeping up accounts worth less than $5,000—the plankton of the rollover world, not the bluefin tuna—active resistance from retail distribution is considered less likely.

"We have a 'red line,'" said Johnson. "If we exceed the $5,000 limit, we'll be messing with other people's business models." Others, he said, think making accounts as large as $15,000—the level at which federal "MyRA" auto-IRAs would be transferred to the private sector—eligible for what Johnson called "managed portability" wouldn't trigger a competitive immune response. "But the asset managers have already said that if we try to do auto-matching at the $250,000 level, no way," he added.

According to August 21 testimony before the ERISA Advisory Council by Steve Saxon of Groom Law Group, 10 million American plan participants change jobs each year. Of those, about one in three have accounts worth less than $5,000. More than half of them take cash-outs; no one knows how they use the money. The remaining million or so small accounts are routinely "forced-out" to a safe harbor IRA.

What might plan participants say about all this? Auto-portability, like auto-enrollment and auto-escalation, works on the principle of the negative option. People who want to opt out can always opt out. Laurie Rowley, founder of the new National Association of Retirement Plan Participants, told *RIJ*, "The industry in general has to do a better job of helping participants at job transition with their retirement savings. Clearly, this is where a lot of problems happen."

Millions of people, strangely, fail to do anything with their retirement accounts when they change jobs. Many abandon their accounts, leave no forwarding address, or forget to cash their distribution checks—leaving behind an administrative mess and disrupting their own progress toward retirement security. But there's money to be made in cleaning up that mess, and there's good to be done by bumping people back onto the path to security.

"Fixing this piece of the leakage issue first is good for everyone," said Cindy Hounsell, president of WISER, the Women's Institute for a Secure Retirement. It [answers] the critics who say that the 401(k) system doesn't work because people cash out too much. It also solves the behavioral issue—that people do whatever is easiest.

"The rollover process for the average participant is a nightmare. It's just easier to take the cash out. Spencer and Tom have figured out a 'Look ma no hands' way for people to continue to stay in the retirement system. It's the best fix I've seen."