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Testimony on “Leakage”

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**G**ood morning and thank you for inviting me to discuss the problem of pension monies that are spent for non-retirement purposes, commonly call leakage. As your Chair Barbara Ann Uberti (Wilmington Trust) and Vice-Chair Mike Fanning (CEO of the IUOE) said, my name is Ron Gebhardtshauer and I'm the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the non-partisan professional organization for actuaries in the United States for issues of public policy.

**Leakage:** Leakage is a more important issue that most people realize. More money leaks out of the pension system than we usually think. But first, I want to take a step back, and ask why are we discussing this issue.

**Eat, Drink, and Be Merry:** As we all know, people are more concerned about today's financial needs than tomorrow's and thus, without encouragement, many of us wouldn't save enough for our retirement years – something which is way off in the distant future (until we approach our 50's).

**Tax Breaks Encouraged Pensions:** Our lawmakers realized that people needed encouragement to plan for retirement, so they created Social Security and gave us tax advantages to save for our retirement. These policies have been quite successful. You'll note that poverty rates for people over 65 have decreased a lot since the 1950's and as of today, are about the same as those of working-age people. [See Chart 1.] However, the average rate of all retirees masks problems. Poverty rates for people over 75 are much worse, especially for women, as my next chart shows. Therefore, our concern lies, not with the age 65-75 subgroup, but with the age 75 and older subgroup.

**Leakage definitions:** That's why I think the Working Group's definition of leakage misses the biggest part of leakage. When I think about leakage, I'm not thinking just about *pre-retirement* leakage in DC plans (i.e., distributions, hardship withdrawals, loans, mandatory lump sums, and withdrawals upon termination of employment or plan). If leakage occurs early in life (i.e., pre-retirement leakage), then something usually can be done about it - you can work longer. This is not as true when you run out of money late in life.

In my definition, I would also include post-retirement leakage (e.g., the portion of lump sums that are spent too quickly or unpaid at death). Even some DB plans pay out Lump Sum Distributions, so I would include DB plans in my leakage concerns. If the income is not for a lifetime, the money may not help improve poverty rates at the very old ages. Some of the lump sum money won't help us in our retirement. It may just help our heirs, and if that is the case, then some may ask why should it get a tax advantage? If people view some of these plans as just savings plans, and not retirement plans, maybe there is less reason for tax-favored treatment. Why should money that goes to heirs get a tax-advantage?

**How much Leakage?** So, how much leakage is there? Under your definition (which just includes pre-retirement leakage), you can get different answers. The speakers last week said about a third of people rolled over their rollover-eligible money (20% for those under \$3,500 and 95% for those over \$100,000). The other two-thirds took some of it out of the retirement system. Did they waste it then? Well, maybe not. One-third lowered their debt, put it into a business,

used it for a home, or saved it in other non-qualified ways. (Some of these may not get as good a return because they are not tax qualified - plus, they often don't help you when you are over 75.) The remaining third spent it. When you look at dollars, about one-third leaked. Thus, the answer depends on whether you look at numbers of people or dollar amounts, DB plans or DC plans, large plans or small plans, whether the whole amount was leaked or just some of it. Some numbers don't reflect the fact that some terminated employees leave their money in their former employer's pension plan. I would prefer to not to give you a firm answer, due to data problems and definitional problems. Your speakers from the last meeting are actually closer to the survey data than I am, and I can't improve on them. Whatever the answer, it is still a lot of people and a lot of money. In 1990, the numbers were:

<u>In 1990</u>	<u># of people</u>	<u>Dollar amounts</u>
Lump Sum Distributions	10.8 million	\$126 billion
Rollovers	<u>-3.1 million (29%)</u>	<u>-\$ 71 billion (56%)</u>
Not rolled over	7.7 million (71%)	\$ 55 billion (44%)
All Distributions in all plans		\$218 billion
<b>Portion leaked (your definition)</b>		<b>25% (= \$ 55 B / \$218 B)</b>
<b>Portion leaked (definition including all lump sums)</b>		<b>58% (= \$126 B / \$218 B)</b>

Thus, some would say that 25% of the retirement funds that get tax breaks, weren't used for income at the older ages. This portion is decreasing due to higher excise taxes, withholding of 20% if not a direct rollover, less use of income averaging for lump sums, fewer layoffs due to a better economy, and the aging baby boomers (who are probably less likely to spend their lump sums than younger employees).

However, I'll bet that most of the rollover money (including the other \$71 billion) does not get paid out as a lifetime annuity. Thus, under the second definition, some would say that maybe 1/2 of retirement money that gets tax breaks may not help people at the oldest ages. An attached pie chart from CPS corroborates this 1/2 number. It shows that more than 1/2 of distributions are paid in lump sums. These figures could increase since the number of employees offered participation in 401(k) plans now is larger than the number of participants in DB plans.

**Any Alternatives?** Am I proposing that we mandate lifetime pensions? No. the Academy doesn't take positions, but the numbers above, surely do show a concern. Possible remedies would be to:

- (1) educate participants on the advantages of lifetime pensions/annuities over Minimum Required Distribution (MRD).
- (2) require a numerical comparison or graph of their benefits versus the benefits payable under MRD (such as the ones that I will soon show)
- (3) require that all qualified plans offer lifetime pensions/annuities,
- (4) require that lifetime pensions/annuities be the automatic option, unless both the employee and spouse elect out of it, or
- (5) require all distributions be in the form of a lifetime pension/annuity.

There are some disadvantages to lifetime pensions/annuities for some people. Employers, especially small employers with DC plans (who don't want to take on the long-term interest, longevity, and other risks), and employees who want the money (especially rich or unhealthy

employees) will have good arguments against this idea. However, we can accommodate their concerns. Small employers could buy annuities rather than take the risks with paying pensions. (But they will say that individual annuities are too expensive. However, annuities are a better deal than they may realize, which I will discuss later.) For rich people, we could waive the annuity requirement if their total retirement income will be greater than the poverty level (or say, half their pre-retirement income, if it is high). Unhealthy people could buy substandard annuities, that would reflect the fact that they may not live as long. (Some insurance companies will give less-healthy people a bigger annuity, reflecting the fact that they won't live as long.) Other people who don't think they will live long and that don't want to "lose all their money to the Insurance Company" could buy refund annuities, that return their principal if they die before getting back all the principal they put in. Annuities can be a good investment, because they can provide the most lifetime income, even when they have lower investment returns. As I mentioned earlier, they are better than you think. How can that be? My next paragraph explains this.

**Lifetime Pensions/Annuities are Better at Providing Retirement Income:** I prepared this next chart for my dad, [Chart 5], showing him a projection of his Minimum Required Distributions (MRD). He doesn't want gifts anymore, so I give him financial advice. The first chart shows the payout pattern for his Minimum Required Distributions that the S&L put him into at age 70 ½. He says they never mentioned the possibility of an annuity. As you can see, the money starts running out at age 84. I showed my Dad the next chart, [Chart 6], which shows he could have bought an annuity and *always* had a higher income (for the rest of his life). Both of them use a conservative interest rate (6.9% prevailing as of the time my Dad reached age 70 ½). You may ask "how does the Insurance Company beat the MRD, since we all know that annuities have high expense loadings (e.g., 5% or more) for premium taxes, administration, mortality and investment margins, adverse selection costs, profits, etc". The answer is that the MRD pay the money to 2 people: the annuitant and the heirs (or the State if there aren't any heirs), whereas the annuity only pays benefits to one person: the annuitant. The MRD pays large amounts to the heirs if the annuitant dies early (leakage), which the insurance company sets aside for people who live longer. In addition, if we mandate annuities, Insurance Company expenses and loads for adverse selection will decrease. Annuities will become an even better deal.

You may point out that the MRD money could be fully invested in stocks. Chart 7 shows that if returns are 9%, then the MRD benefits will be higher than the level annuity half the time. However, once (if?) Insurers start using the newly-issued inflation-indexed Treasuries to create inflation-indexed annuities, the annuity payments will be greater. [also on Chart 7] In addition, this chart hides one very important thing. Stocks can have severe fluctuations. Chart 8, shows what happens when you use a 20% standard deviation in the stock investment returns (the average for the past 70 years per Ibbotson). I'd be very nervous if I was depending on stocks for my entire retirement income. However, investing in stocks is a good idea if I wanted the money for my heirs (and then I would hold the stocks until death so that my heirs get the stepped up basis for capital gains tax). Chart 9 shows several other distribution possibilities, and like the earlier charts are based on a single person age 70 ½.

I added a charts 10 and 11 to show the situation for a married couple. It can be more confusing, since the income may pop up on the first death, if life expectancies are recalculated each year. Another item to note, is that the Joint MRD does better (in about half the years) than a level joint life annuity (because joint MRD's have less leakage than single MRD's), but it's not better than

the indexed joint life annuity, and adding stocks still has the fluctuation problem for MRD's.

**WSJ article on Withdrawal Angst:** You can see this concern coming thru strongly in the June 2, 1998 WSJ article on "... Withdrawal Angst". [follows Chart 11]. The investment advisors explain the difficult calculations needed for deciding how much one should withdraw each year in retirement. They suggest 6.7%, but note later that the percentage varies by age. The investment advisor then says that if you retired in 1973, you'd run out of money within 13 years. They then recommend you sell half your stocks and buy bonds and bills with it. Now you'd be out of money in 15 years! You got only 2 more years. You might think that 15 years is pretty good because it is approximately one's life expectancy. However, life expectancy is not a cliff age at which point everyone has died. It is the age at which only one-half have died - which means the other half are alive, but with no income. Therefore, the financial advisors then suggest you only withdraw 5.1% each year. That would last you 25 years, but you'd suffer a 25% drop in your income. The final suggestion is to compromise, take out 6% (less than an annuity would pay) and watch out for a bear market, at which point, "slash your withdrawals, curtail spending, and work part-time". These are *not* great ideas for someone who is over 75! Pensions/annuities would solve this problem, but not many hear that advice. That needs to change.

### **Leakage due to De Minimis Lump Sums that are spent**

In your last hearing on this topic, you discussed how much is lost from De Minimis lump sums if someone changes jobs every 5 years. I did a calculation for a median income person (\$30,000) with a low contribution rate, a \$20,000 income person with a 3% top-heavy contribution, and a minimum wage earner (\$10,000) with a 4% contribution and 50% match. They all get the same result. If the \$5,000 threshold never increases (unlikely), then they will have a mandatory lump sum distributions after their first 2 jobs. (See calculations for the \$20,000 wage earner.) Assuming the job changer spends the de minimis lump sum (and 80% usually do), when age 65 is reached in 42 years, this person will only have 65% of what they would have had if they had not spent the money. That is, they lost 35% due to spending the lump sum distributions from their first 10 out of the 42 years. This could have kept them above the poverty level. Now, if the de minimis threshold goes up with inflation, then they will get a mandatory lump sum every 5 years until their last job, and have the potential of losing everything. Two attached charts show this even more graphically. Employees with higher contributions will be less likely to have these problems. Thus, the de minimis lump sum rule mostly only affects low income people and people who change jobs a lot.

### **Leakage due to Loans**

In your last meeting you mentioned the GAO study on loans. It shows that loan availability increases participation<sup>1</sup>. Thus, you would hurt participation rates if you eliminated loans from plans. They also show how a 10-year loan can reduce the account balance in the 35<sup>th</sup> year by 7% if the loan interest rate is low, and an additional 20% if the participant suspends contributions while repaying the loan. If more loans occur, these numbers can wipe out your benefits of course, if you suspend contributions.

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<sup>1</sup> KPMG's surveys show that most 401(k) plans allow loans (and withdrawals). The few plans that don't have them, are contemplating adding them. Loans and withdrawals are not quite as common in other profit sharing plans and 403(b) annuity plans, probably because employers don't have to encourage participation of lower paid employees as much.

## Options

So what are some of the options? How can we encourage the right thing? Here are 20 ideas to consider (my mentioning of them does not imply Academy support or lack thereof):

### Reducing Withdrawals and Loans

- **Eliminating or Reducing Withdrawals.** Should they be banned? If not, then how can they be banned for Social Security Individual Accounts? Should exceptions be made for *extreme hardship*? Home purchase expenses should not qualify for hardship. Loans should be preferred, as they can be paid back. Eliminating withdrawals might *not* reduce participation, if loans are still available. In fact, many employees would prefer not having the option to withdraw their money (per Paul Yakoboski). Laws could prohibit withdrawals if the participant could make loan payments. Employers may not want to make these determinations, or hold back the money. Withdrawals use to be easier for employers to administer, before loan systems became more common. The maximum withdrawal could be set to a low amount, such as 1/3 of the account balance or \$25,000 if less. All in-service withdrawals could be subject to withholding and excise taxes, even those withdrawn after age 59½. Does the excise tax need to be increased in order to reduce these withdrawals, or would that just hurt people who really need the money the most?
- **Allow payback of withdrawals until filing taxes.** People will see the tax incentive to pay back their withdrawal more clearly when they are preparing their tax forms the next year. You might consider letting them have this time to pay back the withdrawal.
- **Reducing the maximum loan** to the lesser of say \$25,000 and 1/3 of the vested account balance (or PVAB). This way, the participant will get at least 2/3rds of their benefit. Eliminating loans would reduce participation (per GAO report) and might force people to borrow elsewhere, which might be more expensive to the person's net worth than using a plan loan, which often has lower interest rates. Of course, then their retirement account's return will be lower in the plan. One might ask why loans are allowed on someone's first dollars in the account. Maybe loans should not be allowed until the participant's accrued benefit (plus Social Security) is above the poverty level. This would discriminate against low paid employees, so exemptions would be needed. In addition, it probably would hurt participation rates, which is a fatal problem. This also suggests that the ADP test could be based on amounts deferred less amounts borrowed and withdrawn (less amortization payments). This would radically change the rules, lower deferrals of the highly compensated, be more complicated, and be resisted by employers. Some complications could be reduced by just subtracting withdrawals and loan balances that default for non-payment (and thus turn into distributions that are taxed) in the ADP numerator. This rule would give incentives to employers for discouraging withdrawals and defaults especially at termination of employment.
- **Why are \$10,000 loans allowed (even when it equals the account balance)?** This wipes out 100% of the participants account if they can't pay it back and it is more likely to affect low income people the most - the ones that are most likely to fall under poverty levels in retirement. You might consider eliminating the \$10,000 rule.
- **Reduce the amortization period to 5 years for all loans** (even home loans). These last two bullets will make it more likely that loans won't have large outstanding balances that can't be paid off, especially at termination of employment. Restrictions may be better than eliminating loans. If loans are eliminated, it would probably reduce participation, which is a fatal problem. Starting in 1999, some employers with safe harbor 401(k)

arrangements may eliminate loans and withdrawals anyway, since their incentive may be to discourage participation of lower-paid employees (so that they can avoid the match).

- **Convert Loans at Termination of Employment to Charge Cards.** Often, loans become distributions when employees terminate their employment, because the employee no longer had a easy way to access loan payments through payroll deductions. This could help this problem.

#### **To Reduce Cash Outs - Incentives for Employers**

- **Allow modest plan changes to be applied to vested separateds.** The past 40 years of plan documents need to be saved in case some minor benefit provision applies to a termination 40 years earlier. If modest changes in options and factors could be applied to deferred separated employees, employers might not mind keeping them as much.
- **Allow plans to drop Lump Sum provisions** without violating the §411(d)(6) anti-cutback rule. Alternatively, the plan could be allowed to drop the lump sum option, if the plan allowed purchases of rated annuities from an insurer. If someone might die soon, then they could buy a rated annuity.
- **Reduce PBGC premiums for vested separated participants:** employers often pay lump sums so that they don't have to pay premiums for them. Since they take out the money anyway for lump sums, PBGC might consider this. PBGC may prefer no lump sums in underfunded plans in fact, because it makes the plan worse funded for those that remain.
- **Consider ways to reduce employer's administrative burden** for vested separated participants. See Hybrid plan idea below.

#### **To Reduce Cash Outs - Incentives for Employees**

- **Educate employees** that keeping the money in qualified plans is better; and that lifetime annuities can provide larger incomes than MRD's. This will help, but it may not be enough. When I was a consultant, participants use to call me up to find out when they had to terminate, so that they could still get their \$3,500 out. They would do this no matter how much I tried to educate them.
- **Allow portability between all types of plans** (including 403(b), 401(k), 457, and IRAs). More choices will encourage greater likelihood that the money can be moved to the next employer. (See Pomeroy's RAP bill.) A government clearinghouse could also be set up to take rollovers. If Social Security reform includes an Individual Account (IA), this could be the perfect receiving account. Everyone would have one and it would follow them where ever they live or work. Will the Social Security reform legislation ban withdrawals and loans, and mandate annuities? Try to do it for pensions. If we can't do it for pensions, it may be difficult for Social Security Individual Accounts.
- **Allow rollovers until tax filing date** Currently people only get 60 days to rollover. People will see the incentive to rollover more clearly when they are preparing their tax forms the next year. This also gives them more time to rollover to next employer, if they don't start their next job right away.
- **Exempt half of lifetime pensions (or first \$10,000) from taxes.** It might not help retirees who already pay little in taxes.
- **Create incentives for employers to accept rollover money in the first month of employment.** For example, the 3 Treasury rules from 1997.
- **Requiring all rollovers be *direct* rollovers.** If an employee gets the money, they are more likely to spend it. Inertia is on the side of leakage. In direct rollovers, inertia is on the side of preservation. If an employee needs the money, they may get around this rule by getting the money after the direct rollover or borrow it right before terminating. Give

- qualified tax status only to IRAs that prohibit cash outs.
- **Hybrid Plans: Break down distinction between DB and DC plans.** Allow all plans to have both DB and DC-type elements. In these hybrid plans, the value of an accrued benefit could move to the DC side upon separation of employment and then move back to the DB side when the former employee wants to commence distribution (e.g., the US West Pension Plan does this). This could be at the option of the participant (after they have been provided a notice about the DB features that might not be retained). If this idea happens, we would want to merge all the various rules for DB and DC plans into one set of rules for all plans.
  - **Lump Sum Notices could show the value of the DB benefits being forfeited,** and the costs of buying the DB plan's benefit from an insurance company, in addition to the negative tax consequences of a lump sum distribution.
  - **Increasing the withholding rate** from 20% to the first two FIT rates (15% and 28%) plus the excise tax rate (10%). This equals 25% for lower income people, and 38% for others. (This would raise tax revenue a little, due to amounts being paid in an earlier fiscal year.) If this doesn't greatly reduce leakage, do the next item.
  - **Increase the Early Distribution excise tax** from 10% to 15%. (See Pomeroy bill.) Alternatively, increase it to the same percentages as for *employer* withdrawals (i.e., 50% if no money is preserved; 20% if 25% of the money is preserved). (This would be a revenue raiser. Congress might even claim that lowering the excise rate in a later year might also raise revenue.) Why is it more terrible when employers get the money (which they consider their surplus), than when employees get it (or "waste it"). Note: SIMPLE IRA's already have a 25% excise tax rate for the first 2 years of participation.
  - **Require an automatic J&S option in all plans** to ensure that spouses get benefits too, unless they waive it. The worst poverty rates in retirement are for very elderly women.
  - **Requiring annuitization in qualified plans (DB and DC) and IRAs** (at least up to the poverty level or say 50% of pre-retirement income).
  - **Charge the excise tax and withhold on anything that is not a lifetime annuity,** even if they are over age 59½, since money that goes to heirs does not improve retirement income (the purpose for which it got tax advantages). As discussed, some employers may not like these last 2 options. See earlier comments.
  - **Provide larger benefits to young and short-service employees** (especially in DB plans), since larger lump sums are less likely to get wasted. For example, discourage integration, backloading, and age weighting, and/or require:
    - (1) indexing benefits to inflation (or to a maximum of say 3%) for the working years and the payout years (e.g., employees could be allowed to pay for the indexing through tax-deductible contributions), or
    - (2) a cash balance minimum benefit.
 Employers may find the last two ideas complex to administer. Since employers don't have to provide pensions, they might even drop their plans if the above ideas are mandated, which would really reduce participation.
  - **Mandates versus Incentives:** Whenever Congress creates additional rules for employers like the above bullets, they should make them voluntary. Congress can encourage them to happen by providing incentives, such as waiving top-heavy rules or increasing the maximum limits for those plans that do this. Then sweeten the pot until employers make the switch. If there is any revenue costs for the sweeteners, the fact that the change is voluntary pushes off much of the changes beyond the budget window, so that the revenue rules don't impede the legislation. In addition, the US government

should consider creating a capital budget. They might find that pension plan tax deferrals (which are not tax exemptions) don't cost the US revenue in the long run, because the tax collected in the future should be very close to the value of taxes lost in earlier years. (See my attached article on Tax Policy versus Pensions.)

- **Harmonize the rules:** Make the rules the same for all types of qualified plans, so that the government doesn't bias the decision for one particular type of plan. Note: Sometimes, the availability of loans and lump sum distributions in DC plans, pushes some DB plans to have them (even though their purpose is to encourage participation, which is generally not a factor in DB plans, which are mostly non-contributory). Simpler, and more consistent rules could also encourage more plans and make it easier to keep money in qualified vehicles.

**Conclusion:** We must "keep our eyes on the prize" - which means we need to encourage *lifetime* retirement incomes that will help reduce poverty in all years after retirement, not just the early years. To do this, I have listed many ways to reduce leakage through loans, withdrawals, and lump sum cash outs, including encouraging annuities (or requiring them as an option or automatic option in all plans). I also showed that annuities are a good investment for older people, because they produce the most retirement income (e.g., more than the MRD can). While there are disadvantages in these suggestions, the country may decide the advantages outweigh the disadvantages for some of them. I wish you luck in your deliberations on what we should do. The Academy and I are available if you have any questions now or in the future.