IDEA BRIEF

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Auto-Consolidation of 401(k) Accounts

By Mark Sagat, Anne Kim, and Ryan McConaghy

Today's workers expect to hold multiple jobs over the course of their careers. But one complexity they may not expect is managing multiple retirement accounts as they move from employer to employer. Moreover, nearly half of all workers cash out their 401(k) accounts when they leave a job—despite the hit to their retirement security and the penalties they must pay. To diminish this problem of "cash–out" and help middle–class Americans better manage their retirement savings, Third Way proposes the automatic roll-over and consolidation of 401(k) accounts into a master IRA for workers who leave one job for another.

THE PROBLEM

Leaving a job too often means leaving retirement savings on the table.

In the past, many workers enjoyed the benefit of a single job over their careers and could count on employers to provide a steady pension in retirement. Today, the task of managing retirement security is in the hands of workers, who increasingly depend on 401(k) accounts to provide the bulk of their retirement savings. Making the right investment decision is hard enough, but complicating matters further is the fact that each employer offers its own 401(k) benefit. Because the average worker today can expect to hold as many as ten jobs over the course of a career,[1] workers also face the prospect of managing multiple retirement accounts from previous employers. Too often, workers are choosing to close out their accounts, rather than cope with the hassle of rolling over a balance or juggling multiple accounts. Today's workers need a simple, common sense solution that will help them ensure their retirement security.

Workers lack a simple option for managing a 401(k) account when they leave a job.

Workers face three main options for managing their balance in an employer-sponsored 401(k) plan when they leave a job. They can (1) roll it over into another tax-deferred account, such as an IRA; (2) cash it out (and pay significant taxes and penalties); or (3) keep it with their former employer if the balance is greater than $5,000.[2] Under the current system, none of these options are ideal.

Rollover, for example, is often a cumbersome process that takes significant paperwork and time. Under current law, workers can choose between a "direct" rollover, in which the old employer writes a check to the new employer (but gives the check to the employee to make the actual deposit), or an "indirect" rollover, in which employers write a check directly to the employee, but then it is up to the employee to invest the money within 60 days in another tax-deferred account or face penalties and taxes. Under either option, the principal responsibility for managing the account shifts from the employer to the employee.

As a result, cashing out is all too common among workers who leave a job.

Because of this complexity, as many as 45% of workers with a 401(k) simply cash out their accounts when they leave a job. By doing so, they not only send themselves back to square one on saving for retirement, they subject themselves to income taxes and early withdrawal penalties on the money they had saved.[3] These penalties can be heavy. For someone making $80,000 a year, the taxes and penalties for cashing out a $10,000 401(k) would be as much as $3500.

Many workers keep 401(k) accounts with their former employer, making it more difficult for them to manage their retirement.

Almost as many workers choose to do nothing and keep their accounts with their old employers. According to one study, 44% of workers hold retirement funds in a former employer's 401(k) plan.[4] While holding several accounts is better than cashing out, it's also far from ideal. Multiple retirement accounts are harder to track, which means making good investment decisions becomes more difficult and consolidating of accounts becomes increasingly complex. Workers also have much less flexibility in managing their retirement funds because they cannot make additional contributions or roll over funds from another account into an old employer's account. In addition, workers continue to pay management fees on each of their accounts and perhaps administrative fees as well.[5] Finally, employers also face the burden of administering an account for possibly decades after an employee has left.

THE SOLUTION

Auto-Consolidation of 401(k) accounts.

Under current law, employers can automatically roll over a former employee's retirement savings into a designated IRA—but only if the balance is between $1,000 and $5,000. For example, if a worker leaves a job with $3,000 in his or her 401(k), an employer can roll over this balance into a non-employer-sponsored account managed by, for example, Vanguard, Fidelity or a major bank, provided that the money is put into an account that is designed to preserve principal and will achieve a reasonable rate of return (e.g., a money market fund).

Third Way proposes two changes to current law: (1) to remove the current limitation on employers and make automatic account consolidation an option for all 401(k) accounts with a balance of more than $1,000; and (2) to expand the investment choices for an automatically consolidated account to include any qualified default investment alternative, such as a target date fund.[6] This rollover account could then become a portable "master 401(k) account" into which future 401(k) accounts can be rolled over. This automatic rollover would occur only if a worker has not affirmatively chosen otherwise.

Workers can more easily consolidate and manage their retirement funds.

Unlike the current system, in which employee inaction leads to 401(k) funds being "left behind," this proposal would make it easier for a worker's retirement funds to follow the worker through each step of his or her career. Auto-consolidation in a master account would give workers numerous benefits:

- It would eliminate the current incentive to "cash out" an account when they leave a job;
- It would eliminate much of the paperwork and confusing choices now required to roll over an account when a worker leaves a job;
- It would preserve the ability of employees to choose a different rollover option if they don't want an employer to exercise an auto-consolidation;
- It would make it easier for workers to plan a comprehensive investment strategy for all of their assets and give them more flexibility for making investment decisions; and
- It would lower investment costs by reducing the number of accounts on which a worker must pay fees.

Auto-Consolidation "nudges" workers towards choices that are generally better for their retirement savings.

Studies show that "defaults" can be a powerful mechanism to ensure that individuals avoid poor choices.[7] This proposal ensures that the incentives and disincentives for employees are more closely aligned with decisions that are better for their retirement. In most cases, account consolidation is the best choice for a worker leaving a job. By making consolidation the "default" option, workers will be better positioned to maintain the value of retirement accounts and have an easier time managing their assets.

Workers would be protected in the event of a former employer's liquidation.

Under the current system, former employee's 401(k) accounts managed by a defunct company become "orphaned" until the Department of Labor connects the former employees with the account—**a process that could take years**. In the meantime, plan participants are unable to access their money, change their investments, or receive a distribution upon reaching retirement age.[8] Auto-consolidation to a non-employer-sponsored account would insulate former workers from these risks by automatically giving participants control of their retirement funds when they leave.

Employers would be free from the burden of managing former workers' retirement accounts.

Under current law, former employers maintain responsibility for any accounts left behind by former employees. Under this proposal, an employer that elects to rollover their former employees' 401(k) accounts by default will only have an ongoing duty to manage accounts of former employees who affirmatively elect to keep their account with the former employer. If no election is made, an employer will only have a duty to set up a designated IRA with a plan administrator, effect a roll over into that IRA within reasonable time after the expiration of the 60 day waiting period, and ensure that the funds in the account have been rolled over to a qualified default investment vehicle. Once the funds are rolled over and the employee is informed of the change, the employer will no longer have ongoing responsibility for the account. This means fewer "legacy" costs for companies that are under increasing pressure to compete in a global economy.

Workers' retirement funds would remain intact while still preserving choice.

This proposal ensures that, in the absence of an alternative election, the money an individual sets aside for retirement remains tax-deferred in an investment vehicle designed to be a reasonable but relatively conservative investment choice. It does not disturb any of the options that individuals presently have to manage their 401(k) account upon leaving a job. These individuals can still choose to roll over to another investment vehicle that best suits their needs or to cash out of their retirement plans if they decide that their financial circumstances require it.

THE ROLLOUT

Ideas for launching and rolling out auto-consolidation of 401(k) accounts

- **Issue a report** on the choices employees make with their retirement savings accounts when leaving jobs.
- **Hold a press conference** with an individual who was prevented from accessing their 401(k) plan because of a former employer's bankruptcy.

CRITIQUES & RESPONSES

Auto-Consolidation of 401(k) Accounts

Auto-Consolidation into an IRA is unnecessary because an employee's retirement funds remain in a 401(k) by default when the amount invested exceeds $5,000.

Auto-Consolidation into an IRA would provide additional benefits that a 401(k) cannot provide. First, unlike an employer sponsored 401(k), an employee would be able to roll over other 401(k) accounts into an IRA. Second, an employee would also be able to make additional contributions into the account.[9] Third, an IRA will be more beneficial to individuals because many have more investment choices than an employer sponsored 401(k).[10] Last, individuals and former employers will no longer have to work together to make major changes to the individuals' 401(K) accounts, eliminating a significant administrative burden.

This will be expensive for employers and create additional liabilities for them.

Many employer-sponsored plans already roll over any accounts with balances between $1,000 and $5,000 to a designated IRA. Our proposal merely expands this to retirement plans with over $5,000 in assets and into other qualified default investment alternatives such as target life-cycle funds. Moreover, employers will not incur additional liabilities—if the auto-consolidation to an IRA meets certain safe harbors similar to those already in place under current law, the employer will have satisfied its legal obligations.

A former employer's 401(k) plan could be a better investment choice for some individuals.

Under this proposal, if an individual likes his or her 401(k) plan, they can elect to keep their account with their former employer. Our proposal just ensures that if an individual makes no affirmative election, the money they set aside for retirement is placed in a tax-deferred investment vehicle that is easier to keep track of and manage.

IRAs charge higher fees than 401(k) plans.

401(k) plan fees vary greatly depending on plan characteristics, plan/investment design, range and quality of services provided, and pricing strategies employed by retirement providers.[11] Though certain 401(k) plans with substantial assets sponsored by large employers have smaller fees,[12] many employer-sponsored retirement plans are not entitled to such discounts because the asset size of their plans is too small. According to one study, 39% of plans had asset sizes of less than $625,000[13] and, according to another study, the median fees for 401(k) plans with less than $1 million in assets were 1.89% of assets.[14] By comparison, if an individual invested in a retail mutual fund through an IRA, the fees would average approximately 1.19% of plan assets.[15] That means an individual with a $10,000 in a 401(k) account is likely to have paid $189 in annual fees while an individual with $10,000 invested in a retail mutual fund in an IRA is likely to be paying $119 in annual fees, a savings of $70 that can continue to grow in the retirement account.

APPENDIX I

Details of Auto-Consolidation of 401(k) Accounts

- Employers would have the option of rolling over a former employee's retirement funds into a designated rollover IRA for any balance above $1000 no earlier than 60 days after the employee separated from the employer.[16]
- Safe harbors would be created under ERISA to shield the employer from liability if they created the IRA, rolled over the funds within a reasonable time after the 60 day waiting period expired, and invested those funds in a qualified default investment vehicle as defined by DOL regulations.[17] For example, if the funds in an employee's 401(k) account are rolled over to a target lifecycle fund offered in a rollover IRA 70 days after the employee's relationship with the employer was terminated, the safe harbor would apply.
- Within 60 days after leaving a job, employees could opt-out of the auto-consolidation feature and affirmatively elect to leave the funds in their former employer's 401(k), roll the funds over into a new 401(k) plan or another IRA, or cash them out. If they do not make an affirmative election, the employer could automatically roll over the funds in the account to an IRA.
- An employee would initially be required to set a default rollover to the IRA established by the individuals' former employer upon joining a new employer that provides the default option, but could change their election at any time.[18]

Example of Auto-Consolidation of 401(k) Accounts

- Jane Smith, an employee of Inc. Corp. leaves the company on April 1 to pursue an employment with Company Inc. She has a 401(k) account, administered by Investment Co., that has an account balance of $10,000.
- Upon leaving Inc. Corp., Inc. Corp. provides Jane with notice that she has the option of rolling over her balance into her new employer's 401(k), rolling over her funds to an IRA of her choosing, or cashing out the account subject to taxes and penalty. Inc Corp. informs her that if she doesn't affirmatively make a choice within 60 days, the 401(k) will be rolled over into a target date fund in an IRA.
- 70 days elapse and Jane still has not told Inc. Corp what to do with her 401(k) account. On June 15, Inc. Corp. rolls over her 401(k) into a target

fund in an IRA administered by Investment Co. and informs Jane that the funds have been transferred. This account becomes Jane's "master" IRA.

- Upon starting a new position at Company Inc., Jane provides the company with the account information for her "master" IRA. Five years later when she leaves Company Inc and does not make an alternative affirmative election for her 401(k) account within 60 days, Company Inc. rolls over her Company Inc. into the target date fund in her "master IRA."

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ABOUT THIRD WAY

Third Way is the leading think tank of the moderate wing of the progressive movement. We work with elected officials, candidates, and advocates to develop and advance the next generation of moderate policy ideas.

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ENDNOTES

1 It is estimated that the average worker aged 18-38 will have ten jobs throughout his or her lifetime. www.dol.gov/_sec/media/speeches/archive/20070226_EWeek.htm.

2 If an employee has between $1000 and $5000 invested, the employer can choose to automatically roll over such funds into an employer designated IRA. Under Department of Labor regulations, the rolled over funds need only be invested in an investment product designed to preserve principal and provide a reasonable rate of return. 29 CFR 2550.404a-2, available at http://www.dol.gov/dol/allcfr/Title_29/Part_2550/29CFR2550.404a-2.htm. If less than $1000 is invested in the 401-k plan, the employer can automatically cash out the individual's holdings. 26 U.S.C. 401(a)(31).

3 Hewitt Press Release, "Younger Employees and Workers With Smaller Account Balances More Likely to Cash Out, Significantly Jeopardizing Their Ability to Save Enough for Retirement." October 28, 2009, available at http://www.hewittassociates.com/intl/na/en-us/AboutHewitt/Newsroom/PressReleaseDetail.aspx?cid=7498.

4 Charles Schwab, "Charles Schwab Finds Many Workers Who Have Left Their Jobs Have Also Left their 401(k) Savings Behind." May 21, 2009, available at http://www.businesswire.com/portal/site/schwab/index.jsp?ndmViewId=news_view&ndmConfigId=1016332&newsId=20090521005160&newsLang=en.

5 United States Department of Labor, "A Look at 401(k) Plan Fees." available at http://www.dol.gov/ebsa/Publications/401k_employee.html.

6 A Target Date Fund is an investment where an individual chooses a target retirement year and the fund manager manages the individual's money more conservatively as the individual gets closer to retirement.

7 Cass R., Sunstein, Thaler, Richard, "Nudge: Improving Decisions About Health, Wealth, and Happiness." 2nd ed. New York: Penguin Books. 2009. Print.

8 Bankrate.com, "Company in Trouble: Protect your 401(k)." available at: http://moneycentral.msn.com/content/RetirementandWills/P59135.asp.

9 This is subject to certain contribution limits.

10 Block, Sandra, "Leaving your job: Roll 401(k) into an IRA for More Options." USA Today, June 9, 2009, available at http://www.usatoday.com/money/perfi/columnist/block/2009-06-08-switch-401k-to-IRA_N.htm.

11 Deloitte, Investment Company Institute, "Defined Contribution/401(k) Fee Study: Inside the Structure of Defined Contribution/401(k) Plan Fees: A Study Assessing the Mechanics of What Drives the 'All-In Fee.'" June 24, 2009, p. 18, available at http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf.

12 According to one study, median fees were less than 1% of assets for plans with more than $500 million in assets. Deloitte, Investment Company Institute, "Defined Contribution/401(k) Fee Study: Inside the Structure of Defined Contribution/401(k) Plan Fees: A Study Assessing the Mechanics of What Drives the 'All-In Fee.'" June 24, 2009, available at http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf.

13 Employee Benefit Research Institute, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2008." October 2009, available at http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=4378.

14 Deloitte, Investment Company Institute, "Defined Contribution/401(k) Fee Study: Inside the Structure of Defined Contribution/401(k) Plan Fees: A Study Assessing the Mechanics of What Drives the 'All-In Fee.'" June 24, 2009, available at http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf.

15 Mamudi, Sam, "Battered Mutual-Fund Firms to Raise Fees on Shareholders." Wall Street Journal, March 23, 2009, p. 20, available at http://online.wsj.com/article_email/SB123777172960810321-lMyQjAxMDI5MzI3MDcyNzAxWj.html.

16 Company stock would be exempted from this auto-consolidation option and remain in the employer-sponsored 401(k) account.

17 29 C.F.R. 2550.404c-5.

18 Nothing would preclude an individual from rolling their funds over from the initial master IRA to a different IRA at any time. In such a circumstance, an employee would provide the information for this new IRA to their new employer.