NATIONAL ACADEMY OF•SOCIAL INSURANCE

UNCHARTED WATERS: PAYING BENEFITS FROM INDIVIDUAL ACCOUNTS IN FEDERAL RETIREMENT POLICY

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Fact Sheet #2: Access to Funds Before Retirement in Individual Accounts

Social Security: Social Security retirement payments are disbursed on a monthly basis for life. An individual cannot get any retirement funds before reaching age 62, the age of eligibility for early retirement benefits.

The pros and cons of allowing early access to newly created individual accounts will depend, in large part, on the intended use of the accounts, whether people have any choice about whether to participate, and whether the accounts are viewed as personal property. If the accounts are supposed to provide baseline economic security in old age, the case for banning early access to funds is strong. Leakage from the accounts could seriously erode this security. However, if the purpose of the system is to expand opportunities for voluntary retirement saving, then early access might encourage more people to save and to save more money than they otherwise would.

Private Retirement Savings: Existing personal retirement programs offer other choices. Individual retirement accounts (IRAs) allow unlimited access to the funds as long as account holders pay taxes on money that is withdrawn. If the individual is under age 59½, there is a 10 percent penalty in addition to the income tax, unless certain exceptions apply.

Employer-sponsored 401(k) plans have more limited access, but workers can often get the money if they feel they need it—through a loan or hardship withdrawal, or by leaving the job and cashing out the account. Compared to withdrawals, loans have the advantage of limiting permanent losses from the accounts, if the money is paid back with interest.

Experience with the federal employees' Thrift Savings Plan (TSP) and IRAs show a general trend to reduce restrictions on early access to the money. When the federal TSP began in 1984, it offered only loans for specified purposes; in 1996, the rules were changed to provide loans for any reason, and withdrawals for hardship.

About 17 percent of 401(k) accounts had outstanding loan balances in 2002. The average amount borrowed was about 16 percent of the remaining balance in the account. Borrowers tend to have lower family incomes, lower net worth, and more non-housing debt. African-American and Hispanic participants in 401(k) programs are more than twice as likely as whites to borrow from their accounts.

Giving people the opportunity to borrow funds from a 401(k) program appears to increase participation in 401(k) plans to some degree

Many low- and moderate-income workers face financial hardships during their working lives and they do not currently participate in pension plans or own retirement savings accounts. Because these workers are financially vulnerable, they would be more likely to demand greater access to the money in personal accounts before they reach retirement age, compared with more affluent workers.

Other Issues Concerning Early Access: There are other issues to consider if individuals are allowed to tap the personal accounts before reaching retirement age. If the account holder can get the money, it may also open the way for third parties to make a claim on the funds. Creditors, spouses in a divorce case, and federal and state tax collectors all might make a claim on the funds unless the rules creating new personal accounts banned such claims.

There are benefit programs, such as Medicaid and food stamps, where eligibility is linked to income and financial assets. They are called "means-tested" programs. These programs count accessible retirement funds as assets. This means an individual would be required to spend the money from his or her account before qualifying for public benefits. The money could be safeguarded if new personal accounts were accompanied by rules excluding retirement assets from being counted towards eligibility for means-tested programs.

If access to individual accounts is allowed but restricted in some way, a gatekeeper will be needed to determine whether a particular withdrawal is allowed. Would this gatekeeper be the federal government, the employer, or a financial institution that administered the accounts? What would the penalties be for unauthorized withdrawals?
All these are important, but unanswered, policy questions.

No U.S. precedent yet exists for a total ban on access to individually owned retirement savings accounts. If policymakers create such a ban, history suggests that they will face considerable pressure to ease the restrictions. Imposing limits on access to retirement funds when account holders view the funds as their own money is an important issue and likely to be an ongoing challenge.

Source: Reno, Virginia P., Michael J. Graetz, Kenneth S. Apfel, Joni Lavery, and Catherine Hill (eds.), (2005). *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy,* Study Panel Final Report, Washington, DC: National Academy of Social Insurance, January.

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