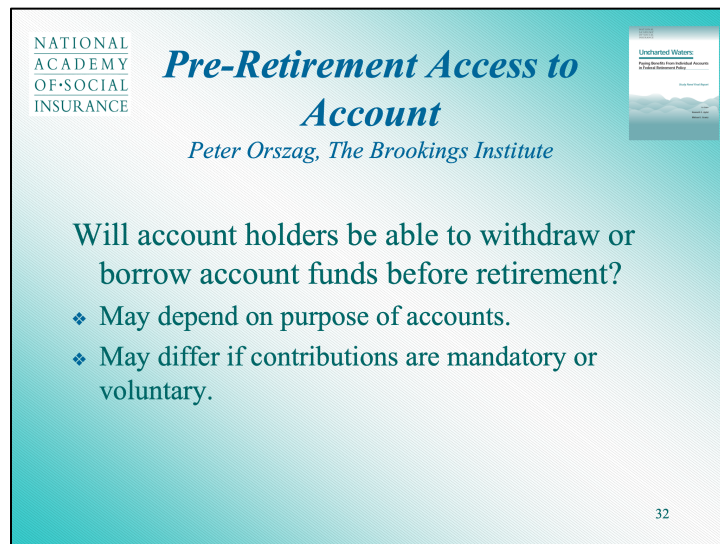




NATIONAL
ACADEMY
OF SOCIAL
INSURANCE

Pre-Retirement Access to Account

Peter Orszag, The Brookings Institute

Will account holders be able to withdraw or borrow account funds before retirement?

- ♦ May depend on purpose of accounts.
- ♦ May differ if contributions are mandatory or voluntary.

32

The pros and cons of allowing early access to 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 is strong. Leakage from the accounts could seriously erode security in old age. Yet, 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 than they otherwise would.

NATIONAL
ACADEMY
OF SOCIAL
INSURANCE

Precedents and Proposals



- ❖ IRAs generally allow access.
- ❖ 401(k) have some restrictions, but funds are often accessible.
- ❖ Social Security is not available except at entitlement in law.
- ❖ Many proposals for Social Security accounts would ban early access.

33

Individual retirement accounts (IRAs) allow unlimited access as long as account holders pay taxes and, in certain cases, a 10 percent tax penalty on amounts withdrawn.

Employer-sponsored 401(k) plans permit somewhat more limited access, but employees can usually get the money if they need it—through a loan or hardship withdrawal, or by leaving the job and cashing out the account.

Many U.S. proposals that envision individual accounts as a partial replacement for Social Security retirement benefits would totally ban early access to the money.



NATIONAL
ACADEMY
OF SOCIAL
INSURANCE

Issues in Early Access

- ❖ Loans or outright withdrawals?
- ❖ Early access for any reason, or only for certain purposes: hardship, medical care, home purchase, education?
- ❖ Loans cost more to administer
- ❖ Policy pressure to expand access over time

34

Compared to withdrawals, loans have the advantage of limiting permanent losses from the accounts, if the money is paid back with interest. The opportunity to borrow funds appears to increase participation in 401(k) plans to some degree. The main drawback of loans is their greater administrative burden. Employers with 401(k) plans are urged to think through the administrative burden of loans before offering them.

Restricting access to only certain uses of the funds has the advantage of limiting leakage from the accounts. On the other hand, documenting reasons for loans or withdrawals involves more administrative tasks, and may require an appeals process if some loans are denied.

Experience with the federal employees' Thrift Savings Plan and IRAs show a general trend to reduce restrictions on early access to funds over time. When the TSP began in 1984, it offered only loans for specified purposes. 1996 changes expanded access to loans for any reason and withdrawals for hardship.



NATIONAL
ACADEMY
OF SOCIAL
INSURANCE

Competing Goals

- ❖ **Ease of access:** (a) unrestricted withdrawals or loans.
- ❖ **Retirement security:** (a) No access at all; (b) Only loans, only for good reasons.
- ❖ **Administrative efficiency:** (a) No access for any reason; (b) Withdrawals for any reason.

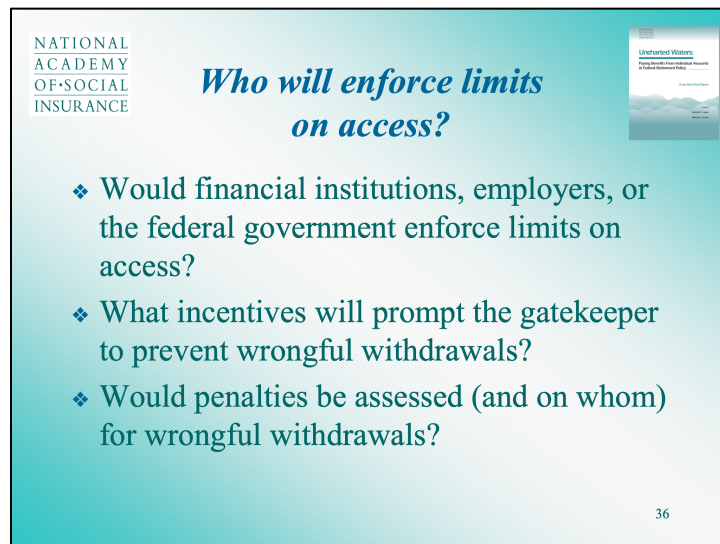
35

Early access rules create tensions among three competing goals: ease of access, retirement security, and administrative efficiency.

Participants will want easy access to their money when they need it.

But the goal of retirement security calls for minimizing leakage from the accounts by banning early access. Yet, if access is allowed, the retirement security goal argues for restricting access to only loans and only for hardship.

The competing goal of administrative efficiency also argues for a total ban on access. As a second choice, administrative efficiency points to the opposite policy of allowing unrestricted withdrawals. More administrative resources are needed to process loans, which involve repayments, and to restrict reasons for withdrawals, which requires documentation, decisions, and perhaps a right to review when access is denied.



The slide features a teal gradient background. In the top left corner is the logo for the National Academy of Social Insurance, which consists of the words 'NATIONAL', 'ACADEMY', 'OF SOCIAL', and 'INSURANCE' stacked vertically. In the top right corner is a small thumbnail image of a document titled 'Unfunded Withdrawals: Proposals for a New System of Withdrawal Limits'. The main title of the slide, 'Who will enforce limits on access?', is centered in a bold, italicized, dark blue font. Below the title is a bulleted list of three questions, each preceded by a teal diamond symbol. The number '36' is located in the bottom right corner of the slide.

NATIONAL
ACADEMY
OF SOCIAL
INSURANCE

***Who will enforce limits
on access?***

- ❖ Would financial institutions, employers, or the federal government enforce limits on access?
- ❖ What incentives will prompt the gatekeeper to prevent wrongful withdrawals?
- ❖ Would penalties be assessed (and on whom) for wrongful withdrawals?

36

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. When access is denied, procedures will be needed to give participants an opportunity to have a denial appealed and reconsidered.

Employers who sponsor 401(k) plans are responsible for deciding whether employees' withdrawals or loans comply with rules of the plan and with the Internal Revenue Code. The employer bears the risk of losing tax-favored status for the entire plan in case of wrongful determination, although the Internal Revenue Service can levy lesser penalties.

A new national system of individual accounts will pose new questions about:

- what entity would play the gatekeeper role;
- what incentives would prompt the gatekeeper to prevent wrongful withdrawals;
- what penalty would be imposed for non-compliance;
- and on whom the penalties should fall.

If the overall purpose of the accounts is retirement income security, a penalty on the accountholder for a wrongful withdrawal might undermine the ultimate goal.

NATIONAL
ACADEMY
OF SOCIAL
INSURANCE

***Third Parties, Means Tests,
Sustaining a Ban on Access***

- ❖ If accountholders have access, creditors might have a claim
- ❖ If accountholders have access, means-tested programs might require a spend down
- ❖ Sustaining a ban might be an ongoing challenge

37

Finally, early access to the accounts can be a two-edged sword. Account holders' access to their own retirement funds may mean that third parties can also make a claim on the funds in cases of bankruptcy, divorce, or unpaid federal taxes. Further, some means-tested benefit programs treat accessible retirement funds as countable assets for the purposes of determining benefit eligibility. In such cases, if the account holder has access to the money, he or she must spend it to qualify for assistance.

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 pressure to ease the restrictions. Sustaining limits on access to retirement funds that are required for income security, but that account holders view as their own money, is an important issue and likely to be an ongoing challenge.