Draining 401(k) accounts when changing jobs: The hidden time bomb undermining retirement savings

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When researchers set out to study 401(k) retirement savings accumulation, they found that thousands of studies of retirement savings

accumulation ignored the surprisingly high rate of departing employees who cash out retirement savings at job separation. This is concerning, because statistically, everyone will likely change jobs multiple times before retirement.

The study, "Cashing Out Retirement Savings at Job Separation," is authored by Yanwen Wang of the University of British Columbia, Muxin Zhai of Texas State University and John Lynch, Jr., of the University of Colorado Boulder, and is published in *Marketing Science*.

"Our findings are eye-opening for any employer and for any employee," says Wang. "We found that 41.4% of employees who separate from an employer with a 401(k) matching contribution withdraw savings when they leave the firm, and 85% of those cash out completely. This means that instead of keeping that money in savings for retirement, they've opted to take the money for other short-term consumption. Only in the U.S. do the rules make this so easy. When people cash out, they are back at square 1, with no more savings than they had when they started the job. They set themselves back years in the ability to accumulate enough savings for a comfortable retirement."

In the study, the authors looked at a data set from 2014 to 2016 of 162,360 employees who left employers that were covered by 28 retirement plans.

"Keep in mind that when a departing employee in America taps 401(k) savings prior to the age of 55, they must pay a 10% penalty in addition to income taxes," says Zhai. "This means that people are losing an extra pile of their money on the way out the door by accepting a 10% penalty in the process."

Through their research, the team found evidence that a large component of cashing out is driven by psychology, not need. If cashing out was

driven by need, it should not depend on whether the money in one's 401(k) account came from the employer or employee. The team found that the bigger the proportion of the balance contributed by the employer, the more employees treated it like a windfall that is legitimate to spend. The researchers call this the "account composition effect." The tendency prompts terminating employees to overlook the penalty and tax consequences of early withdrawals and liquidate their 401(k) savings when leaving a position.

As to why this is happening, the authors said that both psychology and administrative factors are at play.

"Employers have not seen cashing out as a pressing issue," says Lynch. "Presumably, firms that offer more generous matches care about the well-being of their employees in retirement and after they are no longer with the firm. But most firms have a blind spot about what happens at job termination and offer no financial advice to departing employees. Instead, firms delegate all communication to partner financial services firms that administer their plans. Unfortunately, these plans simply send dry letters to employees telling them their options. That's when the account composition ironically partially undermines the benefits a more generous employer match offers."

"The way the plans are administered makes taking a check the path of least resistance for many employees," says Wang. "There is more bureaucratic paperwork to roll savings over into an independent retirement savings account or their next employer's retirement savings program. If departing employees now think of that check as a windfall rather than hard-earned retirement security when the employer contributed more, [they] are less likely to endure the hassle to dutifully roll those monies over. Our work suggests that if firms could deter departing employees from suddenly eyeing their hard-won savings as a free money windfall, those higher employer match rates would generate

the full benefit intended to help the employee retire comfortably. Employees would not have to work many extra years to make up for the compounded value of the savings they cashed out because it was the easiest thing to do in the moment.

"While employers mean well and have every reason to believe they are helping employees prepare for retirement through a 401(k) match, they may in fact be unintentionally nudging employees to cash out when they eventually separate from that employer if they do not take that final step to provide better advice when employees eventually leave."

More information: Yanwen Wang et al, Cashing Out Retirement Savings at Job Separation, *Marketing Science* (2022). DOI: 10.1287/mksc.2022.1404

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