Financial Illiteracy Meets Conflicted Advice:

The Case of Thrift Savings Plan Rollovers

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Abstract

Bad financial decision-making can be due to a combination of lack of financial literacy and conflicted advice from advisers who know that many people are insensitive to differences in fees. The paper sheds light on both the demand and supply sides of the market for financial advice by examining rollovers from the Thrift Savings Plan for federal government workers. The decision to rollover a pension investment to an IRA involves five parties: (1) the pension participant, (2) the plan sponsor, (3) the IRA sponsors, (4) financial advisers and (5) financial regulators. We present a demand-supply model of the individual's decision to rollover, taking into account the behavior of the five parties. The Thrift Savings Plan (TSP) investment options charge less than 3 basis points in fees. By analyzing issues related to TSP rollovers, this paper sheds light on the broader topic of rollovers to IRAs and the yet broader topics of the quality of financial advice that people receive and how that is affected by the fiduciary standard. The paper undertakes a small survey to find out what advice participants receive concerning TSP rollovers and to test the hypothesis that having a fiduciary duty does not affect the quality of advice provided. Because of the extremely low fees the TSP charges, the strategy of assessing advice concerning rollovers from the TSP provides a particularly strong test of the hypothesis that the standard used by many financial advisers for quality of advice is low. Participants in a very low fee plan are being advised to roll over to high fee products. To our knowledge, FINRA and the SEC have not brought a single case involving advice concerning TSP rollovers. While we find a statistically significant difference between the advice provided by advisers with a suitability standard and the SEC fiduciary standard, even advisers with that fiduciary standard often appear to be insensitive to large differences in fees, focusing instead on the benefits of their advice. Thus, the SEC fiduciary standard does not appear to be adequate by itself, without robust enforcement, to overcome the problem arising from the advisers' conflict of interest, combined with the information asymmetry between advisers and clients.

“One of the best things you can do as an investor is to keep the costs that you can control as low as possible.” Wes Moss (2014)

This paper sheds light on both the demand and supply sides of the market for financial advice by focusing on pension rollovers to Individual Retirement Accounts (IRAs). In the market for financial advice, people with low levels of financial literacy (demand side) encounter advisers with conflicts of interest (supply side). For most people, rollovers are a major financial decision that occurs infrequently. For this reason, they may seek financial advice. Unfortunately, they are likely to encounter financial advisers who have a conflict of interest and who may provide advice that is not in their best interests.

Individual Retirement Accounts (IRAs) are the largest type of pension plan in the United States, having overtaken 401(k) plans. Rollovers are the primary source of funding for IRAs, with relatively few people contributing to IRAs (Investment Company Institute 2014). Thus, the topic of rollovers is one of the most important topics in pension policy, involving issues that determine the fundamental structure of the way retirement savings is provided in the United States. Also as a consequence, rollovers to IRAs are an important source of revenue for money managers. One estimate projects that rollovers to IRAs will account for 40 to 50 percent of the net new money received by wealth managers in 2015. Some companies advise financial advisers as to how to grow their IRA rollover business and compete against other advisers seeking that market (McKinsey & Company 2011). As seen in this paper, rollovers can also involve a large amount of money for individuals.

In a rollover, the person receives a check from the pension plan of a former employer, then deposits the check with the IRA. In a transfer, the pension plan sends the check directly to the IRA. We follow common practice and refer to both as rollovers.

We argue that a logical place to look for bad advice concerning pension rollovers is participants in a really low-fee plan. The same words spoken to participants in a high-fee plan advocating a rollover may be good advice, while they would be bad advice to someone in a really low-fee plan. While a lower-cost investment option is not always the best choice, when the cost difference is large, the cost of not taking that option needs to be considered.

We focus on advice concerning rollovers from a single plan, the Thrift Savings Plan. The Thrift Savings Plan (TSP) is a 401(k)-type defined contribution plan for federal government workers, the military, Postal workers, and Members of Congress. It charges extremely low fees—less than three basis points for each of its funds. The Thrift Savings Plan is the largest pension fund in the United States (Towers Watson 2014) and the largest defined contribution plan in the world (White 2011). It has more participants than the social security systems of more than 90 countries (World Bank 2014).

We focus on the Thrift Savings Plan because it charges extremely low fees, making a rollover to an IRA generally a bad decision. In 2014, the fees charged to participants in the Thrift Savings Plan were 2.9 basis points (TSP 2014b), compared to 83 basis points as the participant-weighted average for a survey of 401(k) plans (Deloitte 2011), 58 basis points for an asset-weighted average of 401(k) plans (Investment Company Institute 2015), and 74 basis points for the asset-weighted average of equity mutual funds held in IRAs (Investment Company Institute 2015). [ii] Thus, on average fees were roughly 25 times higher in IRAs than for the TSP, with the difference being substantially larger if the person who rolled over also started using a financial adviser who charged 100 basis points or more. Because of its extremely low fees, focusing on the Thrift Savings Plan allows us to go beyond the question of whether people receive bad advice, which has been addressed in previous papers discussed later. Because of its extremely low fees, we are able to address the question of how costly is the bad advice some people receive.

This paper analyzes financial advice as a reason why rollovers are occurring. In this paper, we make a preliminary attempt to assess the extent to which participants who receive advice from an adviser concerning a rollover from the TSP are receiving bad advice. Based on a survey of TSP participants who made a withdrawal, in 2013, an estimated 16,400 participants made a withdrawal of all or part of their TSP account because they were advised by their financial adviser to do so (AonHewitt 2014). In this paper, we make a preliminary attempt to assess the extent to which participants who receive advice from financial advisers are receiving bad advice.

After briefly discussing the previous literature, and presenting a model of the process of decision-making concerning TSP rollovers, the paper describes the Thrift Savings Plan and the issue of rollovers from it. The paper then compares features of that plan to statistics on IRAs, focusing on fees and investment options. It discusses a few situations where it has been argued that a rollover from a TSP may be advantageous. Next, based on a survey we conducted, it assesses advice that clients receive concerning rolling over their TSP accounts to IRAs. The paper addresses the issue of whether having a fiduciary standard makes a difference in the advice received. To our knowledge, our paper is the first to empirically study whether having a fiduciary duty makes a difference in the quality of advice received. The paper then evaluates several other regulatory issues, including the effectiveness of regulatory efforts by FINRA and the SEC. Lastly, it presents concluding comments.

PREVIOUS LITERATURE

The market for TSP rollovers is complex, involving the activities of five parties: (1) TSP participants, (2) the TSP, (3) IRA providers, (4) advisers and (5) regulators. In this paper, we focus on the behavior of participants and advisers, commenting briefly on regulators and describing the characteristics of the TSP and IRAs but not focusing on the activities of the TSP and of IRA providers. Thus, the previous literature relevant to our study can be divided into studies focusing on the demand side of the market for financial advice and pension rollovers, the supply side, and regulation. These three sections correspond to the behavior of pension participants, advisers and regulators.

***Demand*.** Madrian and Shea (2001) and Choi et al. (2002) present evidence that pension participants tend to exhibit inertia, continuing in the state of participating or not participating without making changes in response to incentives. More recent studies with nationally representative data, find that inertia affects a relatively small percentage of pension participants (Muller and Turner 2013, Butrica and Smith 2012, Dushi, Iams, Tamborini 2013). We argue here that inertia, which has been used to justify defaults as a policy instrument leading to good outcomes, has been overcome by bad advice. Turner and Klein (2014) present an earlier study of pension rollovers, focusing on rollovers from 401(k) plans to IRAs.

A large and growing literature focuses on the lack of financial literacy of most people, and on the adverse effects on financial outcomes that causes. Lusardi and Mitchell (2014) survey this literature. A related literature focuses on financial mistakes that people make. For example, Keys, Pope and Pope (2014) find that about 20 percent of American households fail to refinance their mortgages when interest rates fall. At the median, those people on average lose $11,500 in present discounted cost of higher mortgage payments over the period of the loan. The amounts lost due to TSP rollovers are on average nearly twice as large, and result from an active decision, rather than inertia, as in the case of refinancing.

Survey research indicates that pension participants generally do not know how much they are paying in fees (Turner and Korczyk 2004). A survey of mutual fund investors indicates that most find prospectuses, where fee information is provided, are too long and complex, and thus they do not read them (Investment Company Institute 2006). In the survey, 59 percent said that prospectuses were very difficult or somewhat difficult to understand. We present evidence here that some pension participants are insensitive to large differences in fees.

***Supply*.** A small but growing literature focuses on the quality of advice that people receive as a factor, in addition to financial literacy, leading to poor outcomes. This literature is a subset of a larger literature on the agency problem, where agents may have a conflict of interest and not act in the best interests of their clients. Mullainathan et al. (2012) finds that people with low-fee, well-diversified portfolios are advised to invest in higher-fee, less diversified portfolios. Dvorak (2015) compares the 401(k) plan investment options in the plans of financial advisory firms with the plans of the companies they advise. He finds that the investment options that are in the advisee firms' plans but not in the adviser firms' plans tend to have high fees, with the advisers not putting the high fee funds in their own plans. Christoffersen et al. (2013) find that brokers tend to sell higher-cost funds that give them higher compensation. The Council of Economic Advisers (2015), surveying on the literature on financial advice and conflicts of interest, but fail to recognize the issues relating to pension rollovers differ from those relating to advice as to investments for an established client.

Keller et al. (2011) find that providing advice, through an approach they call enhanced active choice, in circumstances where people feel that they ought to do something, such as take medication, causes a substantially larger percentage of a group to take an action that is viewed as desirable. We argue here that advertising has created the mindset that rollovers are desirable and that people are also reacting to individualized advice encouraging rollovers.

A study of fee disclosures in the Mexican mandatory pension system finds that advertising and disclosures tend to understate the importance of fees, often by not mentioning them. When fees are mentioned, they are described in vague terms, or they focus on a fee dimension where the firm is relatively less expensive. Some fee disclosures, while technically correct, are misleading to unsophisticated participants (Hastings, Hortaçsu, and Syverson 2013). In our survey of advice, we find that fees generally are not mentioned.

Another strand of literature that relates is studies on the interaction between the labor market and the capital market (e.g., Mitchell and Turner 2010). We present evidence that the quality of advice workers receive affects the value of their deferred compensation in the form of pensions.

***Regulation*.** The law and economics literature discusses the role of a fiduciary standard as one way of dealing with the agency problem where the agent has a conflict of interest and superior knowledge, and it is difficult for the client to assess the output of the agent (Sitkoff 2011). With the fiduciary standard, the agent is supposed to act solely in the best interest of the client. Agency problems are common because in a modern economy people must rely on experts to assist them. In our paper, the monitoring problem is due to asymmetric information, with the advisers having superior knowledge to the clients. Clients have a lack of financial sophistication and are unable to evaluate the quality of the advice they receive. For this reason, they play a weak role in the enforcement of regulations protecting them. We test for whether having a fiduciary standard affects the quality of advice. Thus, our paper relates to the effect of a fiduciary standard in dealing with the agency problem.

The paper also touches on the issue of regulatory capture of the Securities and Exchange Commission (SEC) and the Financial Markets Regulatory Authority (FINRA) as it relates to the regulatory oversight of advice concerning TSP rollovers. Regulatory capture refers to the industry so influencing the regulator that the regulator does a poor job in protecting the public. For example, regulatory capture of the SEC has been discussed by Woodward (2000). As far as we are able to determine, the SEC has never filed a case concerning advice about TSP rollovers, despite those rollovers often involving large increases in fees, making it unlikely that the advice would meet the fiduciary standard.

THE MODEL

Our model involves five parties: (1) the TSP participant, (2) the TSP, which includes the plan features and the actions of the TSP Board, (3) IRA providers, which includes IRA features and advertising by IRA providers, (4) financial advisers, and (5) financial regulators. The TSP Board., IRA providers and financial advisers attempt to influence the demand of the TSP participant. The financial regulators influence the behavior of financial advisers, but in turn, the financial advisers attempt to influence the behavior of the regulators.

The following model describes the behavior of each participant, with the following sections of the paper analyzing the behavior in greater detail. The basic element of the model is the participant's demand for a retirement savings vehicle, which is modeled as a choice between the TSP and an IRA. The IRA space is collapsed to the choice of a single IRA.

$$g_1(y_1) = a_1X + a_2Z_1 + a_3Q \qquad (1)$$

where g_1 represents the participant's binary demand function for the TSP versus an IRA. If y_1 exceeds a value c, $g_1(y) = 1$, and the participant stays with the TSP. Otherwise, the participant rolls over to an IRA. The value of the parameter c would depend on the extent of inertia, being lower the greater is the participant's inertia. The vector X is a vector of features of the TSP and IRA, and includes the expected gross rate of return on the TSP and IRA, the fees for the TSP and IRA, the investment options of the two choices, and their withdrawal options. The vector Z is a vector of personal characteristics, which include the person's degree of risk aversion, the person's level of financial literacy, age, gender, and income. The vector Q represents arguments made by financial advisers, IRA providers and the TSP as to whether the person should rollover to an IRA. The vectors a_i are vectors of coefficients.

Both the TSP and IRA have supply functions represented by the vector F_1 that includes the variables in the vector X and the vector Q, now representing the arguments made by the TSP and IRA concerning whether to rollover.

$$F_1(y_2) = a_4X + a_5Q_1 \qquad (2)$$

Because the participant is not financially literate, the participant has a demand function g_2 for financial advice as to whether to roll over, which depends on his vector of personal characteristics Z_1.

$$g_2(y_3) = a_6Z_1 \qquad (3)$$

Financial advisers have a supply function f_2 which is a function of their training and personal characteristics Z_2. It is also a function of regulatory constraints R.

$$f_2(y_4) = a_7Z_2 + a_8R \qquad (4)$$

The compensation model the adviser chooses—hourly rate, percentage of assets, etc.—is taken as endogenous.

The regulator has a supply function F_3 of regulatory constraints, which depends on constraints written into law L, the regulator's budget for enforcement B, and the extent to which the regulator has been captured by the regulated industry (the financial advisers) C, which has a negative effect.

$$f_3(y_5) = a_9L + a_{10}B + a_{11}C \qquad (5)$$

This model of the behavior of the five parties provides the framework for the analysis of the paper.

In our analysis, we distinguish three broad models of choice affecting the individual's demand function for TSP versus IRA participation: traditional economics, behavioral economics, and financial illiteracy with conflicted advice. Rollovers from the Thrift Savings Plan, and indeed from most 401(k) plans, are surprising from an economics perspective. Traditional economics, based on rational decision-makers, and behavioral economics, with its emphasis on inertia, cannot explain rollovers from the TSP.

From the perspective of traditional economics, rational decision-makers presumably would not roll over from the Thrift Savings Plan to an IRA primarily because of the large difference in fees. In addition, pension participants have fiduciary protections in the TSP, but lose those protections when they transfer their assets to an IRA. Loss of fiduciary protections can be particularly important at advanced older ages when the risk of cognitive impairment is greater (Barlyn 2010). IRAs are not protected from judgments in civil law suits, and thus are subject to greater risk than is the TSP (TIAA-CREF 2013).

From the perspective of behavioral economics, rollovers are surprising because some studies have documented the tendency for pension participants to exhibit inertia (Madrian and Shea 2001, Choi et al. 2002; see, however, Muller and Turner 2013). Inertia would cause TSP participants to not roll over because that is the "path of least resistance." Rollovers would seem to be even more unlikely when considering that many participants presumably would be overwhelmed by the large number of options as to IRA providers and then as to investment choices. However, the force of inertia may be less for workers at the point of job change or retirement, when the worker's attention is focused on choices related to the change in employment, than for workers who are continuing in the same job.

Inertia, defined as lack of change, can be separated into inertia that can be explained by traditional economics, which would be because of no incentive to change or an insufficient incentive to overcome transactions costs, and behavioral inertia, which is inertia in the face of substantial incentives to change. Behavioral inertia can be due to a number of different factors, including inattention (lack of awareness of incentives to change), procrastination (awareness of incentives to change, but postponing action), status quo bias (awareness of incentives, but a preference for the status quo), and lack of motivation (awareness of incentives to change but unwilling to make the effort) (Table 1).

From the perspective of financial illiteracy with conflicted advice, the effect of inertia and traditional considerations of differences in fees are offset by conflicted advice. The client is not able to judge the quality of the advice and trusts the expertise and motivations of the adviser. We thus argue that the explanation for rollovers from the TSP, at least to some extent, is bad financial advice, both generalized advice provided through widespread advertising to rollover your "old" 401(k) plan, and advice provided to individuals.

Why do investment advisers give bad advice? While it is possible that some investment advisers lack the necessary skill, training and knowledge to give competent advice, it is also the case that advisers have financial incentives that conflict with the interests of their clients and that the legal standards to which the advisers are subject are not sufficient to address or mitigate the conflicts. Because of concerns that rollovers are being driven by faulty advice, the Department of Labor, the Securities and Exchange Commission (SEC), and FINRA are all considering regulatory action (Manganaro 2014).

Table 1. Arguments whether to roll over to an IRA

Reasons Not to Roll Over	
Traditional Economics	Difference in fees between TSP and IRAs
Behavioral Economics	Inattention
	Procrastination
	Status quo bias
	Lack of motivation
Reasons to Roll Over	
Traditional Economics	Preference for actively managed funds
	Prefer more flexible withdrawal options in IRAs
Behavioral Economics	Effect of generalized advertising concerning rollovers
	Effect of direct advice
Financial Illiteracy with Conflicted Advice	Lack of knowledge about importance of fees
	Lack of knowledge about level of fees

Source: Authors' compilation

THE MARKET FOR RETIREMENT SAVINGS AND FINANCIAL ADVICE

Participants in the TSP face the choice of whether to continue in the TSP at job change or to transfer their TSP account to an IRA. Thus, they presumably consider the relative merits of the two forms of retirement savings. In addition, because they tend to lack financial literacy, they may seek the assistance of a financial adviser. We discuss the relative merits of the TSP and IRAs, then discuss the supply of financial advice.

Is a Rollover From the Thrift Savings Plan (TSP) to an IRA a Good Decision?

This section provides background on the Thrift Savings Plan (TSP), then focuses on issues concerning whether to roll it over to an IRA.

The Thrift Savings Plan is administered by the Federal Retirement Thrift Investment Board, which is an independent board whose members are nominated by the President and confirmed by the Senate. The TSP provides the same type of savings and tax benefits that are offered by 401(k) plans. Participants can make either Roth or traditional contributions. Its 4.6 million participants make it the largest defined contribution plan in the United States. The Thrift Savings Plan as of May 2014 had assets of $412 billion (Long 2014b). The participation rate of 88.6 percent for employees in the Federal Employees Retirement System (FERS) (Thrift Savings Plan 2013) is higher than is typical for 401(k) plans, which tends to be less than 70 percent (U.S. Department of Labor 2014).

Participants in the TSP pay extremely low fees. The fees for all the TSP funds were 2.9 basis points or less in 2013 and 2014 (Thrift Savings Plan 2014b). The fees in 2013 were less than one-twentieth the average cost of a stock index fund (Zweig 2013), and one-thirtieth the average cost of target date funds (Vanguard 2014). Its fees are low primarily because of its large size and in part because some administrative costs are borne directly by the Federal government (Boccia 2014). The advantage of these low fees can be passed on to a surviving spouse, who can maintain an account in the TSP.

TSP Funds. There are two competing approaches to investing—index funds and active management. The TSP uses index funds. Warren Buffet recommends that individuals invest in low-fee index funds because of the importance of low fees (Woodley 2014).

It is important to understand the TSP investment options because one of the primary arguments made by advisers recommending rollovers is that the TSP does not provide an adequate number of funds. The TSP offers five diversified index funds plus five life cycle or target date funds that combine the other five funds. The five basic funds are: (1) the Government Securities Investment Fund (G Fund, which is based on medium term and long term government bond rates), (2) the Fixed Income Index Investment Fund (F Fund, which tracks the Barclays Capital U.S. Aggregate Bond Index), (3) the Common Stock Index Investment Fund (C Fund, which tracks the Standard & Poor’s 500 Index), (4) the Small Capitalization Index Fund (S Fund, which tracks the Dow Jones U.S. Completion Total Stock Market Index), and (5) the International Index Investment Fund (I Fund, which tracks the Morgan Stanley Capital International EAFE, which is the Europe, Australasia, Far East Index) (Thrift Savings Plan 2014f). The domestic stock and small cap funds together represent the broad U.S. equity market.

The TSP funds are now discussed in greater detail in order to show why they are exceptional funds in terms of rates of return earned, which is an additional reason, besides low fees, why rolling the TSP over to an IRA is generally bad advice.

Stock Funds. Market-beating returns are rare among index funds. Generally, index funds perform slightly worse than their benchmarks. Because the benchmarks are calculated without accounting for fees, the fees that funds charge cause them to have lower rates of return than the benchmark.

The TSP large cap stock fund (the C Fund) beat its benchmark index each of the five years from 2009 to 2013 (Table 2).[iii] By comparison, of the 228 funds that track the Standard and Poor's index, 11 beat the index in 2012. The TSP small stock fund (S Fund) beat its benchmark for three years in a row. The TSP International Index Fund (I Fund) in 2012 beat its benchmark for the third year in a row. The TSP bond fund (F Fund) beat its benchmark by 0.07 percent in 2012, the sixth year in a row it beat its benchmark (Zweig 2013). The TSP funds are able to beat their benchmarks for two reasons. First, their fees are extremely low. Second, they benefit from securities lending. TSP portfolio managers are able to earn extra fees by lending securities to hedge funds.

Table 2. Annual rates of return for the TSP C Fund and the S&P 500, 2009-2013

Year	TSP C Fund	S&P 500
2009	26.68%	25.94%
2010	15.06%	14.82%
2011	2.11%	2.10%
2012	16.07%	15.89%
2013	32.45%	32.15%

Sources: TSP (2014a), Damodaran (2014)

Government Bond Fund. The G Fund, or government securities fund, invests in non-marketable government securities and provides an above-market rate of return, given its risk.[iv] The G Fund provides TSP participants a unique investment not available through IRAs.[v] It provides a rate of return that is an intermediate-term rate, but without the risk of loss of principal with interest rate swings, which is a risk associated with intermediate-term and long-term bonds. The G Fund is particularly valuable for retirees because of its low risk and relatively high rate of return, given its risk. Because the G Fund investment is not available outside to IRA participants, it is a particular reason for not rolling over the TSP.[vi] The G Fund generally provides a rate of return higher than the inflation rate, but in the period of low interest rates, in 2011and 2012, its rate of return was slightly less than the inflation rate.[vii]

Life Cycle Funds. A good investment strategy for many pension participants is to invest in low-cost index mutual funds through a target-date or life cycle fund. This approach offers the advantage of low fees, diversification, automatic rebalancing of portfolio shares, and an automatic glide path toward lower risk investment as retirement approaches. The Thrift Savings Plan provides participants that option. The TSP offers five life cycle funds with different target retirement dates. The life cycle funds each move to a slightly more conservative portfolio every quarter. This means that the percentage invested in the G Fund increases as the target retirement date approaches.

The fees for the TSP lifecycle funds are based solely on the fees charged for the TSP funds that make up the lifecycle funds. By comparison, lifecycle or target date funds generally charge a management fee for managing the changing portfolio mix, called the glide path. The management fee is in addition to the fees charged by the underlying funds. The industry average expense ratio for target date funds is 1.05 percent (Vanguard 2014), compared to 0.029 percent for the TSP target date funds. Thus, the industry average is more than 30 times higher than the fees charged by the TSP.

The TSP lifecycle funds provide TSP participants a unique opportunity that is not available to them outside the TSP. For other target date funds, as they increase their percentage invested in bonds, they increase their risk of loss to capital due to interest rate increases. For the TSP lifecycle funds, because the G Fund does not suffer capital value losses with increases in interest rates, they do not have this risk. For this reason, the TSP is particularly desirable for persons nearing retirement.

Table 3 shows fees for selected target date or lifecycle funds with a target date of 2020. Funds with later target dates, outside of the TSP, tend to have higher fees because they have a higher percentage of their portfolios invested in stocks. Table 3 shows a wide range of fees, with the lowest fee funds being 5 times as expensive as the TSP fund and the highest fee fund being 50 times as expensive.

Table 3. Fees for selected 2020 target date funds, 2014

Fund	Actively or passively managed	Fee (basis points)
TSP 2020	Passive	2.8
Vanguard	Passive	16.0
Fidelity	Passive	16.0
T. Rowe Price	Active	67.0
Fidelity	Active	67.0
J.P. Morgan (C class)	Active	151.0
Industry Average	Both	10 5.0

Sources: websites of fund sponsors, also see text

Inertia Has Been Overcome

Inertia, which plays a key role in pension policy based on behavioral economics and choice architecture, has been overcome in the case of TSP rollovers. The default is to remain in the TSP. A survey done in 2008 indicated that relatively few TSP participants planned to rollover their TSP to an IRA when they left government service (Watson Wyatt 2009). In total, 14.0 percent indicated that they intended to rollover to an IRA. The intention to roll over was more prevalent among participants who had small account balances at the time of the survey, with 15.7 percent of those with account balances of between $5,000 and $25,000 indicating that they planned to rollover to an IRA, versus 12.7 percent for those with account balances of $100,000 or more. One-fifth (22.5 percent) of participants planned to not take withdrawals until required to at age 70 ½. That percentage rises with age, and among those already retired, 40.7 percent planned to not take a withdrawal until age 70 ½.

Five years later, in 2013, 47,836 TSP participants requested transfers, which was roughly 5 percent of separated participants. However, of those who separated from service in 2012, by the end of 2013, 45 percent had withdrawn all their funds and closed their TSP account (Long 2014b). The total amount rolled over to IRAs or other plans in 2013 was roughly $7.2 billion. Thus, the average rollover was about $150,000, which is slightly lower than the median account balance for someone with more than 20 years of tenure, which in 2011 was $155,119 and somewhat lower than the average account balance for that group, which was $185,741 (Thrift Savings Plan 2012). This paper documents that on average, participants probably are paying at least $1,000 a year more in fees due to the rollover, with rollovers to high-fee advisers costing as much as $4,000 a year in extra fees. In 2012, transfers of the full account balance to an IRA or another plan accounted for 65 percent of the money withdrawn from the TSP (Long 2014c).[viii]

Among those responding to a survey conducted by the Federal Retirement Thrift Investment Board, the primary reason for withdrawing money (rollovers and withdrawals) was a life event or major expenditure (36%), wanting greater withdrawal flexibility in benefits options (27%), wanting other investment options (23%), and wanting a managed account, wanting investment advice, receiving advice from a financial adviser, or other factors such as account consolidation or required minimum distributions (20%) (Long 2014b).

Workers age 59 ½ and older can take a one-time partial or full withdrawal from the TSP while still working for the Federal government. A survey by the Federal Retirement Thrift Investment Board indicated that 23 percent of persons recently taking an in-service withdrawal were doing so because a financial adviser recommended that they do so (Long 2014b).

Are IRAs a Good Alternative?

In terms of fees, two types of rollovers to IRAs can be identified. In one type, the participant is advised by an adviser to rollover and the adviser manages the account for a fee, which is added to the fees charged by the underlying investments. In the second type, the participant is not charged an ongoing advisory fee, but only pays the investment fees. Advisory fees generally are at least one percent of assets, but in one rollover we encountered involving a major financial adviser in the Washington, DC area fees were two percent.

As indicated earlier, in 2013, $7.2 billion was rolled over from the TSP to other pension plans and IRAs (Long 2014b). If the other pension plans had the average fee of 74 basis points , which is the asset-weighted average of fees for equity mutual funds held in IRAS (Investment Company Institute 2014), the participants would lose in aggregate about $50 million due to higher fees in the first year, with annual losses continuing for the life of the account. That would be a loss of more than $1,000 per participant per year. Because that amount would compound over time due to the loss of investment income due to the smaller asset base, it can be used as the basis of a present value calculation, yielding an estimated present value loss of $20,000 over twenty years. That estimate is an understatement because it does not include fees for financial advice.

To gain an appreciation of the amount TSP participants are losing over time, suppose that a participant had a $150,000 rollover (the average amount of a rollover), the funds earned 5 percent before expenses, and TSP charges 3 basis points. Suppose that the rollover occurred at age 61 and that the person did not start taking distributions until 10 years later, roughly approximating what many people do, not making withdrawals until they face the required minimum distributions. After 10 years, the participant would have lost $21,602 due to higher fees if the fees were 100 basis points (Table 4). The total amount lost in fees would be higher with a longer time period. The amount lost in fees compounds because the person would have received investment earnings on the amount lost in fees. This result is based on a number of assumptions, including that the roll over portfolio performs as well as the TSP. Foerster et al. (2014) provide evidence that most adviser managed portfolios tend to yield gross returns that do not exceed the gross returns on passively managed index funds. Advisers could have a positive effect of getting their clients to take on more investment risk (Foerster et al. 2014), but achieving that result would not require the client to rollover their TSP account.

Table 4. Approximate value of amount lost in fees after 10 years on a rollover of $150,000 with an investment rate of return of 5 percent

Fees (basis points)	Account Balance	Amount Lost Due to Rollover ($)	Amount Lost Due to Rollover (%)
3	$243,638	0 (no rollover)	0
50	$232,946	$10,692	4.4%
100	$222,036	$21,602	8.9%
150	$211,590	$32,048	13.2%
200	$201,588	$42,050	17.3%

Source: authors' calculations

When Would a Rollover Make Sense?

While generally, advice to rollover from the TSP is bad advice because of the substantially higher fees the individual will pay in IRAs and to advisers, in a few circumstances, the higher fees may be outweighed by the benefits of a rollover. We discuss two primary reasons given by financial advisers—lack of investment options and inflexibility in distributions—as well as several other reasons that may affect a smaller number of people.

First, for people having a strong preference for investment options not in the TSP, or a high tolerance for risk, a rollover may be desirable. These options would include high-risk investments, actively managed mutual funds, real estate, and international bonds. However, individuals having the financial sophistication and risk tolerance to want these investments probably have sufficient assets outside of the TSP to use to make those investments. They could make these investments through their IRA, assuming they had one, and would not need to rollover from the TSP to do so.

Second, as indicated by the Federal Retirement Thrift Investment Board survey, some people find the TSP withdrawal options too inflexible. The TSP works well for people who want to receive regular monthly payments, but it does not work well for people who want to make an occasional withdrawal. Because all TSP members also receive a defined benefit plan monthly benefit, some may prefer to use the TSP for irregular withdrawals for special needs, but it cannot be used that way. Retirees can only take one partial withdrawal. People wanting to have extra money for special purposes could do a partial rollover to an IRA. After that, they must withdraw the full amount remaining, either as an annuity, a lump sum payment, or a series of payments, which can be tied to life expectancy. They can use a combination of those options that are available for full withdrawal. For the partial withdrawal, workers cannot choose which fund the withdrawal comes from, with the withdrawal being made on a pro rata basis from all funds in which they are invested. Allowing more than one partial withdrawal, and allowing workers to specify the fund from which it is taken, would be a step toward greater flexibility. The inflexibility in withdrawal options appears to be one reason why workers rollover their TSP accounts. However, because of its low fees, participants should first spend down their non-pension savings and their higher fee pension savings before making withdrawals from the TSP.

Third, all TSP participants, including those with a Roth TSP, must begin taking required minimum distributions by April 1 of the year following the year in which the employee attains age 70 ½. Roth 401(k) plans and Roth IRAs do not require minimum distributions, but the Roth TSP does. Thus, some people might prefer the strategy of rolling over to a Roth IRA so that they will not need to take withdrawals, but if they do from a non-Roth TSP account, they will need to pay taxes at the time of the rollover.

Fourth, people with small TSP account balances may roll over to an IRA rather than to maintain a separate small account. However, a superior strategy would be to maintain a small TSP account and later roll over higher-fee pension assets into that account. This type of rollover can be done by former and current federal employees who maintain a TSP account.

Fifth, a reason that some people roll over is that they fear the government will make changes in the future that will be adverse to them. In fact, the TSP has a history of not making changes adverse to its participants, but rather has continued to develop more options providing more flexibility for participants and has reduced its fees.

In sum, a number of reasons can be raised for rolling over from the TSP to an IRA. Our conclusion from this list is that rarely is a complete rollover from the TSP good advice, and generally the cost of a rollover in terms of higher fees outweighs the advantages of a rollover in the limited circumstances where there are advantages.

SUPPLY OF ADVICE

This section discusses issues relating to advice concerning rollovers.

Conflicts of Interest, Advice and the Compensation Model

Conflicts of interest may arise from the way that advisers are compensated. Conflicted advice arises whenever the adviser earns higher fees from advising a strategy that is not in the best interest of the client. However, the analysis of conflicts of interest relating to investment advice, as has been done by the Council of Economic Advisers (2015), does not directly apply to conflicts of interest in the case of pension rollovers. In the case of investment advice, advisers charging by the hour or based on assets under management dol not have an incentive to provide bad advice, In the case of rollovers, however, advisers charging by the hour or based on assets under management will generally make more money if their clients decide to roll over their assets. When an adviser has a client who is considering a rollover from the TSP or another pension plan, the adviser generally will receive higher fees over time from that client by advising a rollover because that advice will lead to the need for continuing advice on managing the person's investments.

An Assessment of Advice Concerning Rollovers from the TSP

Since the Thrift Savings Plan does not provide individualized advice, participants may turn to the financial services industry for advice. Advice can be categorized in two dimensions. In one dimension, it can be self-interested advice versus neutral advice. In the other dimension, it can be generalized advice versus individualized advice. With self-interested advice, the adviser has a conflict of interest in that his compensation may be higher if he provides advice that is not in the best interest of the client. With neutral advice, the adviser's compensation does not depend on what he advises. With generalized advice, the advice is provided through advertising and through information on websites. With individualized advice, the advice is provided by a financial services professional to an individual. Different regulatory standards apply to generalized versus individualized advice, and arguably different regulatory reforms are needed concerning the current standards.

Generalized Advice. Under the category of self-interested advice, one website advises retired military personnel to consider rolling over their TSP accounts to an IRA (USAA 2014). It advises, "Leaving the Military? Give your TSP some TLC." It compares its mutual funds to the funds offered by the Thrift Savings Plan. It characterizes its mutual funds as low-fee, not noting that its fees are many times higher than those for the Thrift Savings Plan (USAA 2014). For someone who knows enough to search out the expenses of the competing mutual funds, the first fund encountered on the website is the Aggressive Growth Fund, which has expenses of 108 basis points, compared to the 2.9 basis points for the average of TSP funds. Thus, someone with a TSP account of $300,000 would pay an extra $10,000 in fees in less than four years. Taking into account the loss of investment income on that amount and considering the full time period of retirement would provide a more accurate estimate of the loss due to taking this advice. A rough calculation indicates that this advice could cost someone $100,000 in fees and in lost investment income on the fees over the course of their retirement. The present value of the loss would be less, but still substantial.

Another website advises, "A TSP rollover can greatly aid your financial security in several ways. By rolling over your TSP funds out of risk and into a Traditional IRA or Annuity you add Security & Safety: Guaranteed principal protection and you maintain control of your account" (IHC Financial Group 2014).

People also receive generalized advice in the form of advertising to rollover your "old" 401(k) plan to an IRA (e.g., Fidelity 2014). This advice never contains a disclaimer that this would generally be bad advice for people in plans, such as the TSP, with very low investment fees.

Some institutions that provide advice to roll over to an IRA will provide a cash bonus for doing so. For example, Scottrade (2014) offered a $1,000 cash bonus for the rollover of an account greater than $500,000, while other companies, including TD Ameritrade, Ally Bank, E*TRADE, and Bank of America, offered smaller cash incentives. The Navy Federal Credit Union (2014) specifically mentions the TSP, offering to pay people a $200 bonus to roll over from the TSP to fund their first IRA with a minimum of $5,000.

By comparison to advertising, generalized neutral advice tends to praise the TSP. For example, “Nothing measures up against the Thrift Savings Plan” (Burns 2005). Another adviser writes, “Can you beat the markets by not even trying? Yes, if you are among the 4.6 million people fortunate enough to invest in the Thrift Savings Plan (Zweig 2013). Another writes, “Thrift Savings Plan—The Model for All 401(k) Plans!” (Roth 2010).

A Survey Concerning Individualized Advice. In 2013, the Government Accountability Office (2013) conducted a survey of thirty call-in centers to assess what advice people were receiving concerning rollovers from 401(k) plans to Individual Retirement Accounts (IRAs). It found that frequently people were being encouraged to roll over to an IRA by financial advisers who had obtained little information concerning the situation of the person, including information on the fees being charged by the plan they were in.

Because of its extremely low fees, advice concerning rollovers from the Thrift Savings Plan provides a stronger test of the quality of advice people are receiving than does the GAO survey. While for some 401(k) plans a rollover may be desirable because of the plan’s high fees, a rollover from the TSP would generally be an expensive mistake.

Empirical Analysis

Studying advice received by TSP participants provides at least two advantages over studying advice to other pension participants. First, we know how much the TSP participants are paying in fees for their investments—less than 3 basis points. Second, we know that any investment they are advised to roll over to will have higher fees, with the fees generally being substantially higher.

To obtain information on the advice that TSP participants receive from different types of financial advisers, we selected thirty advisers through a telephone survey and an email survey. In addition, we did a few in-person interviews. With these surveys, we test two hypotheses. First, we test the hypothesis that participants in an extremely low fee plan are being advised to rollover to higher fee arrangements. Second, we test the hypothesis that having a fiduciary duty makes no difference in the quality of advice that advisers provide. To our knowledge, this is the first study to test that hypothesis, a weakness of previous studies according to the Investment Company Institute (2015).

Telephone Survey. In the telephone survey, we contacted firms providing IRAs to see what advice one of the authors would receive concerning his own TSP account as a former federal government employee. We obtained contact information in two ways. We obtained telephone numbers from websites encouraging rollovers to IRAs. We also obtained telephone numbers for financial services firms from the Washington, DC telephone book. This survey is a convenience sample survey, and is not meant to be statistically representative of any universe of advisers. In most cases, we believe that the person providing advice was a person subject to a “suitability” standard, rather than a registered investment advisor subject to a fiduciary standard requiring services be in the best interests of the customer.

We contacted seven mutual fund companies, seven banks and one insurance company seeking advice (a total of fifteen service providers) (Table 5).[ix] It was clear that many of the advisers were aware that the TSP charges extremely low fees, but it was also clear that some of the advisers did not know that. The advice generally ignored fees as an issue. The advice we received generally focused on TSP participants having a small number of investment options, while IRA participants had a large number of options. Ten companies indicated that the client should rollover the TSP to an IRA. We can state unequivocally that this was bad advice because we know the details of the person receiving it.

Four declined to provide advice, but instead to differing degrees tried to sell the idea that a rollover would be desirable. One adviser asked about the risk tolerance of the client and then advised that a client with moderate to high risk tolerance should roll over to obtain a greater range of funds, while a client with low risk tolerance should stay in the G Fund. One adviser said that we would receive $600 as an incentive to rollover plus 300 free stock exchange trades through their brokerage service.

From some of the advisers, we received false information that made a rollover seem to be desirable. One adviser said that we could reduce fees by rolling over. The insurance company indicated that we could obtain lower priced annuities outside of the Thrift Savings Plan. One company said we had no control of our investments in the Thrift Savings Plan. Two advisers praised actively managed funds, which are not an option with the Thrift Savings Plan.

Table 5. Telephone survey results for advisers with a suitability standard

Outcome	Number of Firms
Advised not to roll over	1
Declined to advise but suggested a rollover would be a good idea	4
Recommended a rollover	10
Total	15

Source: Author's calculations

Advisers who worked for companies that took a more aggressive stance on their websites concerning IRA rollovers also tended to take a more aggressive stance in advising those rollovers in our phone conversations. We do not know how the people we contacted on the telephone were compensated, but it was clear that they viewed it as their job to encourage us to rollover from the TSP. While most of the companies we contacted advised rollovers, some companies that had more balanced presentations on their websites declined to provide advice, but instead focused on what they considered to be the advantages of rolling over. One adviser indicated that for rollovers, the company would make available mutual funds it managed that were currently closed to new investors as an incentive to rollover. One adviser suggested considering investing in a small cap fund when he learned that our portfolio did not include that. The lowest fee small cap fund that mutual fund company offers has an expense ratio of 91 basis points, compared to 2.9

basis points for the TSP small cap fund (the S Fund). Thus, fees would be more than 30 times higher. One adviser stated that we would have thousands of investment options if we rolled over.[x]

Information received in the mail from one mutual fund company we contacted indicated that an advantage of their IRA was that their investment advisers are noncommissioned, implying presumably that their advice would not be affected by a conflict of interest. An adviser from that company subsequently advised rolling over the TSP account to an IRA at their company.

All the fifteen advisers we contacted worked for companies that sold financial products. In total, two-thirds of the companies advised rollovers, one advised against rollovers for participants who were highly risk averse, and four companies declined to provide advice but indicated that their companies offered a good alternative.

Email Survey. To test the hypothesis that having a fiduciary standard makes a difference in the quality of advice clients receive, we obtained a list of such advisers from the website for the National Association of Personal Financial Advisors (NAPFA 2015). That website provided email addresses, and we contacted the advisers in this survey by email.[xi] All members of NAPFA have a NAPFA fiduciary duty concerning the advice they provide their clients, but we believe that all of the ones we contacted were also subject to the SEC fiduciary standard. In addition, members of NAPFA can only receive compensation as fees from their clients. They cannot receive compensation from investment management companies whose products they purchase for their clients. The fees can be on an hourly basis, as a percentage of assets under management (AUM) or as a combination of those two approaches. Thus, this survey allows us to test for the effect of having a fiduciary duty concerning the advice provided. Our null hypothesis is that having a fiduciary standard has no effect on advice.

Because we did not specify a fixed set of response options, the responses we received were varied, as indicated in Table 6. Among these advisers, the issue of fees was more commonly discussed. Some advisers recognized the extremely low fees charged by the TSP and recommended against rolling over. The majority of advisers argued that in some circumstances a rollover might be advisable. Because it is our conclusion that in most circumstances it would not be advisable, the effect of having a fiduciary standard is weaker than we expected. It appears that having a conflict of interest still affects the quality of advice. For those advisers, we do not know whether they would recommend a rollover to most of their clients, but that is a possibility, given the responses. Nonetheless, when comparing these responses with those in the earlier survey, the null hypothesis is rejected—the two sets of responses are statistically different at the 2.5 percent level according to a chi square test.

One reason why some advisers may recommend a rollover from the TSP is that they have misperceptions concerning the TSP. For example, one adviser told us that the TSP does not have investments in corporate bonds, which it does, and that a comparable Vanguard fund had lower fees, which it does not.

Table 6. Email survey results of fee-only advisers with a fiduciary standard

Outcome	Number of Firms
Advised not to roll over because of low fees	4
Advised not to roll over during accumulation phase, but would recommend rollover during the distribution phase	2
Would recommend partial rollover in some circumstances for greater diversification	3
Would recommend rollover in some circumstances, depending on the individual situation	4
Recommended a rollover for greater diversification	2
Total	15

Source: authors' calculations

This survey suggests that having a fiduciary duty does affect the advice advisers provide. However, the survey suggests that advisers with a fiduciary duty often use the argument that a rollover would provide the opportunity for greater diversification, which is true, without the adviser considering the extra cost in fees that a rollover would entail. This finding suggests that in addition to a fiduciary standard, education of advisers may be needed as to what a fiduciary standard implies, particularly with respect to the cost of alternative investment approaches. Greater enforcement may also be needed.

In-Person Interviews. We also asked six former federal employees who had received advice concerning TSP rollovers to tell us about the advice they had received. They all reported being advised to roll over their TSP. In addition, we found that some former federal employees had rolled over the TSP to an IRA as the result of generalized advice concerning rollovers. The individualized advice people receive may be effective in part because it is consistent with the generalized advice from the advertising of a number of mutual fund companies encouraging rollovers.

One of the major financial advisory firms in the Washington, DC area that advised one of the former federal employees we spoke with to roll over the TSP to an IRA charges an advisory fee of 200 basis points (2 percent) on the first $150,000 of assets under management, a fee that is on top of the fees charged by the mutual funds in the portfolio. AARP recommends using an adviser that charges less than 100 basis points (Fleck 2015). Following that advice resulted in fees being more than 70 times larger. That adviser advertises, "You pay no commissions, trading expenses, brokerage costs." That adviser on his website has a video saying that the TSP funds are not "exciting" and have not performed particularly well. The implicit message in this advice and in that of most of the advisers is that large differences in fees are not important. Generally, when seeking professional advice, it would be thought that receiving the same advice from a number of different sources chosen independently would indicate that that would be good advice, but that is not the case here.

Further, we spoke to a former life insurance company agent who indicated that his company encouraged people in the TSP to rollover to an annuity. The company paid a commission to its agents of 4 percent of the amount rolled over, so an agent would receive $10,000 for a rollover of $250,000. This arrangement was particularly attractive to agents because the paperwork and sales time associated with rollovers was much less than for other insurance products.

This issue has similarities to the "pension mis-selling" scandal in the United Kingdom. Hundreds of thousands of workers were encouraged by financial services companies to switch their pension arrangements starting in 1988, but due to higher fees ended up receiving lower benefits as a result (The Pensions Advisory Service 2009).

Further Reasons Why an Adviser May Advise a Rollover

We have already identified two general categories of reasons why an adviser might advise a rollover from the TSP. First, under limited circumstances, a rollover may be good advice. Second, the adviser may be acting based on a conflict of interest. In addition to those sets of reasons, we now add three other categories.

First, we encountered advisers who are not familiar with the TSP or have incorrect information about it which makes it seem to be less favorable than it is.

Second, advisers may have valid reasons for recommending a rollover, but they fail to balance those reasons against the cost of the rollover in terms of higher fees. Thus, their analysis is flawed by not taking into account costs. In effect, they are telling a half-truth because they are not divulging all the relevant information, and in particular they are ignoring fees. They are not alone in this last respect. NASDAQ (2010) lists five common errors in making rollovers to IRAs, but it does not include considering differences in fees. Similarly, the SEC (2015) provides information on the availability of rollovers, but it does not mention that the person should consider the level of fees in the new plan versus the old plan. FINRA (2013) provides the following advice: "An IRA often enables an investor to select from a broader range of investment options than a plan. The importance of this factor will depend in part on how satisfied the investor is with the options available in the plan under consideration. For example, an investor who is satisfied by the low-cost institutional funds available in some plans may not regard an IRA's broader array of investments as an important factor." This advice does not indicate that the extra diversification should be weighed against the extra cost.

Third, the clients often do not realize when they are receiving bad advice. If they did realize it, they could switch advisers or file complaints with regulatory authorities. In an Australian study, most people who received poor advice thought that they had received good advice (Kell 2012).

Does the TSP Offer Too Few Options? An Analysis of Advice

One of the main criticisms of the TSP by advisers advocating rollovers from it is that it offers too few funds. A survey of TSP active participants found that 36 percent would roll over once they left federal employment to access more or better investment options (Long 2014). Thus, addressing this issue is key in evaluating the advice that TSP participants receive. Hewitt (2013) addresses the question of whether a non-U.S. bond fund and other categories of investments not currently included in the TSP funds should be added. For some categories, such as value and growth stocks, and real estate, it concludes that the TSP funds already provide access to investments in those areas. For the non-U.S. bond fund, it concludes that a small improvement in the efficient frontier (risk-return tradeoff) would be obtained for participants, particularly those with low-risk portfolios. The analysis did not take into account fees charged for such a fund. It argues on behavioral grounds, however, that most participants would not be sufficiently sophisticated to know how much to allocate to this fund. Highly sophisticated participants could benefit from having this option and all participants investing in the target date funds would benefit from its inclusion.

The TSP stock funds do not cover emerging markets, Canada, and international small capitalization stocks, and its other investment options do not international bonds. Copeland (2013) finds that in aggregate, IRA participants invest 13.8 percent of their assets in the category "other," which refers to investments not in stocks, bonds, or target date funds. This finding suggests that IRA participants do hold a wider range of investments, since the TSP does not have any investments in that category. The TSP does not offer actively managed funds.

Adding new funds would improve the opportunity for diversification, but because the TSP already offers the possibility of wide diversification in international and domestic stocks and domestic bonds, the benefits of increased diversification are likely to be relatively small. Investment advisers encouraging rollovers for this reason apparently do not weigh the relatively small benefits against the costs in increased fees. Advisers with a conflict of interest need a justification for advising a rollover, but it appears that when they find one, they do not fully explore its merits.

In addition to traditional arguments relating to the advantage of having more funds to choose from versus the added costs, behavioral economics also provides analysis. The paradox of choice refers to the negative effects of having too many choices. For some pension participants, having too many options may make investment decisions more difficult, which would cause the limited options in the TSP to be an advantage. Several studies have documented problems people have generally in making decisions when facing a large number of options (Iyengar and Lepper 2000, Carosa 2011). Despite the concept from traditional economics that more options are always better, recent research has documented that for psychological reasons of mental overload, above a minimum level, fewer choices are better for many people when the remaining choices allow a sufficient range of choice. A further study found that too many investment options in 401(k) plans lowered participation rates (Iyengar, Huberman and Jiang 2004). The idea that having unlimited choice by rolling over to an IRA is a good feature is thus not supported by behavioral research.

Another aspect of too much choice, in the context of IRAs, is that there may be a tradeoff between quantity of choice and quality of choice, with a larger number of choices including more options that are of poor quality, having high fees, poor rates of return and being poorly diversified because of their limited scope (Goldreich and Halaburda 2011).

In the TSP, where the choices have been preselected by financial experts, the average quality of choice is better than for IRA participants who face a much larger range of choice, with limited or no elimination of poorly performing investment options. Because the TSP has a preselected choice of investments, it may be easier for participants to make good investment choices in that setting than with an IRA, particularly for participants who are not financially sophisticated.

THE REGULATION OF ADVICE CONCERNING PENSION ROLLOVERS

This section discusses the third dimension of the market for advice (after supply and demand), which is the role of regulation.

The regulatory authority over advice concerning pension rollovers is highly fragmented, being different if the rollover goes to a broker-dealer, a financial adviser, a bank, or an insurance company. Financial advice provided by broker-dealers concerning rollovers is regulated by the Financial Industry Regulatory Authority (FINRA), which requires a suitability standard for advice. It has indicated that fees should be taken into account when providing advice, but because fees are one of a number of issues to be taken into account, in practice it appears to be that large differences in fees are not considered an issue when providing advice.

In 2013, FINRA (2013) issued a Regulatory Notice concerning advice as to rollovers to IRAs. The guidance to financial advisers indicates that advice to roll over must be suitable for the person. The guidance clearly states that fees should be taken into account. Because our small survey concerning advice was conducted after the release of this guidance, this paper concludes that the effort by FINRA has been largely ineffective.

Financial advice provided by Registered Investment Advisers (RIAs) concerning rollovers is regulated by the Securities and Exchange Commission (SEC), which requires a fiduciary standard for advice. The SEC standard, which permits conflicts of interests so long as they are disclosed, but requires the adviser act in the best interests of the client, is a more rigorous standard and may be more effective. The advisers included in our second survey were governed by this fiduciary standard. While the quality of advice was higher, they frequently argued that there would be an advantage to greater diversification without weighing the marginal benefits of greater diversification against the marginal costs.

To our knowledge, FINRA and the SEC have not brought a single case involving advice concerning TSP rollovers. That situation may change because in 2015 the SEC launched a new investigative initiative targeting sales practices in the retirement investment sector (Temple-West 2015). The SEC website is not "friendly" to those wishing to file a complaint. While the link to enforcement would seem to be the most obvious path to follow, instead a person would file a complaint under the link to education if they persisted sufficiently to find it under that link. Once finding the right page, it is not set up for easily dealing with complaints concerning advice as to pension rollovers.

Financial advice provided by a bank or a credit union concerning rollovers is regulated by the Consumer Financial Protection Bureau (CFPB). The custodians of IRAs are regulated by the Federal Deposit Insurance Corporation (FDIC) if they are bank custodians.

Financial advice provided by an insurance company is regulated by state insurance company regulators. Financial advice provided by an insurance company concerning rollovers is regulated by FINRA if the advice involves a variable annuity. If it concerns a traditional annuity, it is regulated by state insurance regulators.

The Department of Labor, Employee Benefits Security Administration (EBSA) has jurisdiction over financial advice provided to pension participants in 401(k) and other ERISA plans because of its responsibility for protecting pension participants. Its regulatory standard applies to advisers who are ERISA fiduciaries. That standard prohibits conflicts of interest between advisers and clients unless a specific exemption applied, would be the strongest standard, but the Department of Labor has issued an opinion that a person giving advice on whether to roll over assets is not generally subject to ERISA standards. In any event, ERISA does not regulate government plans such as the TSP.

Under ERISA, individuals who provide investment advice for a fee are defined as statutory fiduciaries, who must act for the exclusive interest of plan participants and are subject to a series of prohibited transactions, which generally prohibit conflicts of interest unless a specific exemption—which can be a statutory exemption or more commonly a class or individual exemption provided through the Department of Labor—applies. Of the three standards (ERISA, SEC, FINRA), the ERISA fiduciary standard, by barring conflicts unless an exemption is available, is the most demanding of the three standards. Our survey results do not provide direct evidence on what the effect of having such a standard would be.

However, the Department of Labor issued regulations shortly after ERISA's enactment that provide that a person that provides investment advice is only a fiduciary if they provide investment advice "on a regular basis to a plan pursuant to a mutual understanding, written or otherwise, between such person and the plan . . . that such services will serve as a primary basis for investment decisions with respect to plan assets."[xii] It is thus reasonably simple for a person or firm offering investment advice to contract out of fiduciary status by explicitly providing that it does not agree that its services will serve as a primary basis for investment decisions.

In any event, the Department of Labor (DOL) in 1975 provided an advisory opinion that took the position that "merely advising a plan participant to take an otherwise permissible plan distribution, even when that advice is combined with a recommendation as to how the distribution should be invested, does not constitute "investment advice" within the meaning of the regulation" of investment advisor.[xiii] Thus, under current DOL guidance, a person is not subject to ERISA merely because they advise a participant to rollover assets to an IRA (29 CFR § 2510-3.21(c)). The Department of Labor, however, has indicated that it is reexamining its position, which would not, in any event, apply to the TSP since the TSP is a government plan not subject to ERISA.

The suitability standard, which presumably governed the advice given by all or most of the advisers in our phone survey, is the least rigorous of the three standards. This paper tests whether the fiduciary standard applicable to registered investment advisers would have resulted in a higher quality of advice. The ERISA standard could put important restrictions on the manner in which compensation, commissions and fees paid to investment advisers are calculated. It should also be noted that the standards are not fully effective unless it is likely they will be enforced. Some investment advice arrangements include mandatory arbitration provisions, which some observers believe tend to favor the investment advisers, who, in contrast to investors, tend to be repeat players in the arbitration system. Generalized financial advice provided through advertising is not subject to these regulatory authorities because it is not advice to a particular individual.

Table 7. Different Regulatory Standards for Advice

Where Money is Going	Regulator	Regulatory Standard for Advice
Another ERISA plan	DOL	Fiduciary +
Registered Investment Advisor (RIA)	SEC	Fiduciary standard
Broker-dealer	FINRA	Suitability standard
Bank or credit union	CFPB and FDIC	
Insurance company	State insurance commission, FINRA if variable annuity	

Source: Authors' compilation

This situation of fragmented regulatory authority (Table 7), different standards for advice that is general rather than individualized, and different standards for different providers of advice is far from ideal. The SEC, the Department of Labor, and FINRA are all engaged in reviews of the standards they administer, and the Dodd-Frank legislation directs the SEC to consider whether a single standard of care for broker-dealers and registered investment advisers is advisable.

CONCLUSIONS

The decision to rollover a pension investment to an IRA involves five parties: (1) the pension participant, (2) the plan sponsor, (3) the IRA sponsors, (4) financial advisers and (5) financial regulators. We present a demand-supply model of the individual's decision to rollover, taking into account the behavior of the five parties. That model forms the framework for the analysis of the paper.

We argue that a logical place to look for bad advice concerning pension rollovers is participants in a really low-fee plan. The same words spoken to participants in a high-fee plan advocating a rollover may be good advice, while they would be bad advice to someone in a really low-fee plan. While a lower-cost investment option is not always the best choice, when the cost difference is large, the cost of not taking that option needs to be considered.

Because of the low fees the Thrift Savings Plan charges and the quality of the investment options it provides, the advice provided by financial advisers concerning rollovers from the TSP permits a particularly strong test of the hypothesis that the standard used by many financial advisers concerning the advice they provide is low. The Thrift Savings Plan provides participants uniquely low fees, many times lower than fees generally available in IRAs. It offers funds that generally beat their indices, due to the low fees and revenues from security lending. The government security fund (the G Fund) provides rates of return based on medium and long-term government bond rates, but at zero risk to nominal principal. This investment option is not available to investors in IRAs. Because it is used in the TSP target date funds, those funds also provide a low risk investment option that is not available in IRAs.

Because of its very low fees and the relatively high rate of return on its investment options, for most people it would be bad advice to rollover from the TSP. For this reason, the advice does not even meet the suitability standard, much less the standard that it is in the best interest of the client. On average, workers taking this advice appear to be paying more than $20,000 extra in present value of fees compared to if they had stayed in the Thrift Savings Plan. In some cases, the fees are more than 70 times larger. We thus provide evidence of insensitivity by some pension participants to large differences in fees. We argue that this is the outcome of financial illiteracy meeting conflicted advice. We also provide evidence consistent with a small literature that people receiving financial advice, at least in some respects, have worse outcomes than they would have otherwise.

Advisers with a conflict of interest need a justification for advising a rollover, which for the TSP often is the possibility of greater diversification, but it appears that when they find one, they do not weigh the added costs against the benefits. Our surveys suggest that a fiduciary standard does have some effect on advice, but it does not guarantee good advice. It appears that advisers with a conflict of interest concerning rollovers may engage in a partial analysis that justifies their position, focusing on the benefits of a rollover, while not fully considering the costs.

In sum, we provide evidence on the following points. First, pension participant inertia has been overcome by advice. Second, pension participant inertia appears to depend on the context, being less at the point of job change than while working for the employer. Third, the analysis of conflicts of interest for pension rollovers differs from the standard analysis of conflicts of interest concerning investment advice. When advising concerning rollovers, advisers generally have a conflict of interest, even if they charge by the hour or by assets under management, because the rollover will lead to the need for further advice in the future. Fourth, bad advice has been followed by pension participants, presumably due to financial illiteracy. Fifth, the bad advice can be very costly, with a present value cost of roughly $20,000 on average for TSP rollovers. Thus, while previous studies have documented that people receive bad advice, this study provides evidence as to how costly that advice can be. Sixth, existing regulatory standards, as they currently are enforced, are not adequate to protect pension participants from seriously bad advice. To our knowledge, FINRA and the SEC have not brought a single case involving advice concerning TSP rollovers, despite the large increase in fees that can result from such advice. Seventh, a fiduciary standard for advisers does make a difference, but it does not completely solve the problem. Eighth, in our survey of advice, we find that among advisers with a suitability standard fees were rarely mentioned. Ninth, advisers with a conflict of interest need a justification for advising a rollover, but it appears that when they find one, they do not fully explore its merits. It appears that even advisers with a fiduciary duty often do not weigh the costs of higher fees against the benefits of a rollover, that being, for example, the benefits of marginally greater diversification. In effect, they are telling a half-truth because they do not fully divulge the relevant information. Thus, the paper provides evidence relating to the economics of conflicts of interests and policy efforts to mitigate the resulting effects.

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[i] We have received valuable comments from Brigitte Madrian, David Laibson and other participants in a session at the 2015 American Economic Association meetings; from Natalya Shnitser and Peter Weidenbeck and other participants at the Fourth ERISA Scholars Conference, and from Daniel Kasprzyk, Anna Rappaport and Steve Vernon.

[ii] The expense ratios on the TSP funds for 2013 varied from 0.026 percent to 0.037 percent, with an overall average of 0.029 percent.

[iii] As of this writing, data are not yet available for 2014.

[iv] Recognizing that the G Fund provides an above-market rate of return, given its risk, Congressional Republicans in 2015 proposed reducing the rate of return it provides to that on 3-month Treasury bills, reducing payments to TSP participants by $32 billion over ten years (Kopp 2015).

[v] In 2014, the Treasury Department released regulations for a new type of individual retirement account called MyRA. Participants in MyRA accounts would be invested in the same type of bonds.

[vi] The only exception is participants in MyRA accounts.

[vii] The federal government has borrowed from the G Fund at times to avoid exceeding the debt limit (Smith 2013). This action has no effect on the amount that is credited to workers who are investing in the G Fund, and thus poses no risk to participants. Nonetheless, discussion with participants indicates that among participants who do not trust the Federal government, this issue is generally mentioned as a reason for not trusting the government and for rolling over their TSP.

[viii] Some of the transfers may have been for the purpose of making a withdrawal, while avoiding the 20 percent withholding tax. We have no information on the importance of that strategy.

[ix] We presented the following scenario. "I am a retired Federal employee. I am trying to decide whether I should keep my Thrift Savings Plan account or I should roll it over to an IRA. What would you advise?"

[x] One adviser told us that he had recently advised his mother-in-law to roll over her TSP account to an IRA.

[xi] We sent the following email text: "I am an economist investigating advice that fee only financial advisers provide concerning TSP rollovers to IRAs. Would you generally advise a retired federal government employee to roll over their TSP account to an IRA? Thanks for your help."

[xii] (29 CFR § 2510-3.21(c).

[xiii] Advisory Opinion 2005-23A. http://www.dol.gov/ebsa/regs/aos/ao2005-23a.html.