

Leakage of Participants' DC Assets: How Loans, Withdrawals, and Cashouts Are Eroding Retirement Income

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Background

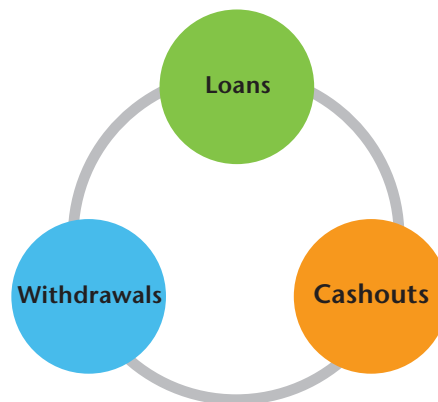
As many studies have shown, there's a growing gap between retirement needs and resources. According to a recent Aon Hewitt report, *Retirement Income Adequacy at Large Companies: The Real Deal 2010*, only one in five full-career contributors in large 401(k) plans is projected to be able to meet their needs in retirement. On average, these savers are expected to have a shortfall of 2.2 times their final pay upon retirement.

Many factors contribute to the savings shortfall, including volatile investment markets, rapidly increasing health care costs and reduced pensions from defined benefit plans. In addition, the real deal study makes one major assumption—that participants do not take any funds out of retirement savings prematurely. In reality, savings leak out of the system before participants retire, further eroding retirement readiness.

This study examines the three main sources of leakage:

- Loans taken out and sometimes not repaid in full
- Withdrawals taken during active employment
- Cashing out retirement savings upon a job termination

This report explores the magnitude of the problems, their impact to participant savings and ideas to curb these behaviors. More than 1.8 million employees were examined across over 110 large defined contribution plans. Participant data was analyzed through year-end 2010. Additionally, the Aon Hewitt *2010 Employer Perspectives on Defined Contribution Plan Leakage Survey* was deployed in October 2010 to gauge employer sentiment and plans related to leakage issues (in total, 200 plan sponsors responded). Finally, Employee Benefit Research Institute (EBRI) provided modeling as to the impact of employee actions through its EBRI Retirement Security Projection Model[®].



Loans

Loans are generally considered an attractive feature in a defined contribution (DC) plan. The knowledge that money is accessible may encourage some employees to save in a plan. Taking a loan from a DC plan may be preferred over other alternatives like high-interest rate credit card loans. If participants continue contributing to the plan while paying off their loans and (eventually) pay off the loan in full, their retirement savings are generally preserved. However, when participants take excessive loans or default on outstanding loans, it can undermine the purpose of the plan and can put participants' retirement income adequacy at risk.

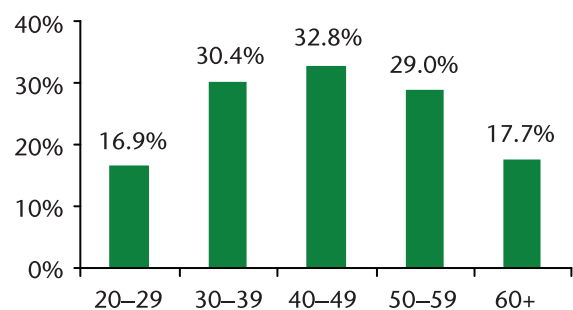
A loan feature is available in nearly all defined contribution plans. According to the Aon Hewitt *2010 Employer Perspectives on Defined Contribution Plan Leakage Survey*, 95% of plans have a loan provision. Virtually all these plans offer general-purpose loans, meaning loans can be for any purpose and have a repayment period of up to five years. Additionally, over three quarters also allow participants to take loans for the purchase of a home with an extended repayment period of up to 10 to 30 years. The majority of plans (58%) permit participants to have two or more loans outstanding at any given time.

The loan feature is highly utilized by participants in DC plans. Through the mid-2000s, loan usage was fairly steady. However, in the years following the 2008 financial crisis, loan usage has steadily climbed. As of year-end 2010, nearly 28% of active participants had a loan outstanding, which is a record high. Nearly 14% of participants initiated new loans during 2010, slightly higher than previous years. The average balance of the outstanding amount was \$7,860, which represented 21% of these participants' total plan assets. Although the majority of the participants (68.3%) had only one loan outstanding, 29.2% had two loans outstanding simultaneously and 2.5% had more than two loans.

Percentage of Participants With Loans—Over Time



Percentage of Participants With Loans—By Age



Loan usage varies significantly based on the participant's situation:

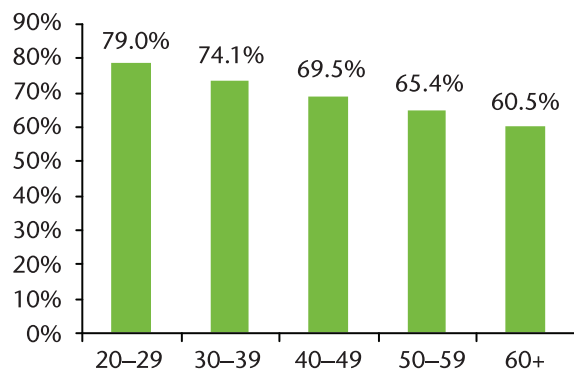
- Middle-aged and middle-income participants are most likely to have outstanding loans—participants in their 40s, and those earning between \$40,000 and \$60,000 had significantly higher loan prevalence.
- Women with lower salaries are more apt to take loans than their similarly paid male counterparts. In fact, among those earning between \$20,000 and \$40,000, 35.9% of women had a loan outstanding versus 33.6% of men.
- Women are also more likely to take more than one loan at a given time as compared to men.

A majority of the participants with a loan continued to contribute in their DC plan. Overall, 81.7% of participants with outstanding loans continued to defer contributions to the DC plan. However, the average savings rate of those with loans was slightly lower (6.2% of pay) than those who did not have loans outstanding (8.1% of pay). Generally speaking, the employees who stopped deferring to the plan while repaying their loans are lower-earning individuals in their 30s or 40s.

Defaulting on a loan makes the leakage permanent, which significantly impairs retirement saving. The most likely point of default occurs when a participant has a loan outstanding at employment termination. Presently, the vast majority of plans require employees to repay loans in full upon termination of employment (usually within 60 days). This can be challenging for employees, and many subsequently default on the loan causing the money to be treated as a taxable distribution and subject to penalties for those under age 59½.

When employees with loans terminate employment, nearly 70% subsequently default on the repayment. Among participants in their 20s, the default percentage jumps to nearly 80%. In contrast, on average, active employees default on their loans less than 3% of the time.

Loan Defaults Among Terminated Employees—By Age



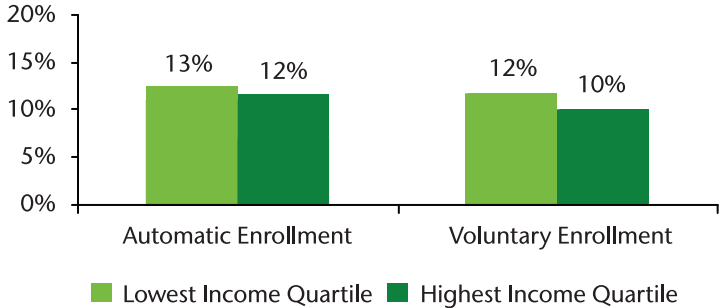
Impact of loans on participant retirement security

EBRI's Retirement Security Projection Model simulated the impact of loans on DC participant retirement savings. The projection simulates a full-career employee who takes a loan and then stops saving for the duration of the loan repayment period (five years). The projections assume the individuals are in the middle to early part of their careers.

Ceasing deferrals during the loan repayment period is expected to erode future retirement income by 10% to 13%, depending on the type of enrollment (automatic or voluntary) and the participant's income level. If two loans are taken, this reduction nearly doubles. On the other hand, if the participant continues to save during the repayment period, the loan causes little changes to expected retirement income.

Defaulting on the loan by terminated employees paints a more ominous picture as the default permanently removes monies from the retirement system.

Median Balance Reduction as Result of One Loan (Loan is Repaid)



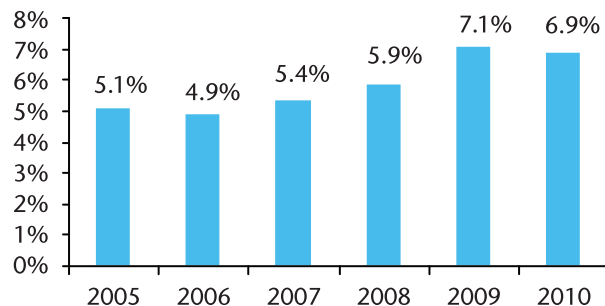
Withdrawals

As tax-qualified plans, DC plans must limit participants' ability to withdraw their savings before they terminate employment. These withdrawals are permanent and cannot be redeposited in the future, yet many organizations make these options available.

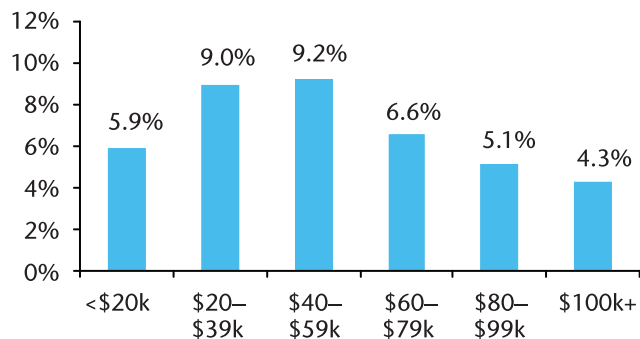
- In general, plans cannot allow withdrawals of before-tax savings in a DC plan except as a last resort when financial crisis occurs (a "hardship withdrawal"). According to the Aon Hewitt *Leakage Survey*, nearly all plans offer employees hardship withdrawals, and the majority of plans also suspend employee contributions into the plan for the ensuing six months after a hardship withdrawal.
- Plans can allow employees who reach age 59½ to take a withdrawal of before-tax savings without a hardship (a "59½ withdrawal"). Nearly all plans offer these types of withdrawals as well.
- Other types of withdrawals, such as the withdrawal of after-tax contributions or withdrawal of employer money, are also possible. More than half of plans offer these types of nonhardship withdrawals.

Similar to loans, withdrawals from DC plans have increased in the wake of the 2008 financial crisis. During 2010, 6.9% of participants took a withdrawal, which is close to the record high of 7.1% in 2009. Before the 2008 economic downturn, only around 5% of participants took a withdrawal. Twenty percent of all withdrawals were hardships, with an average amount of \$5,510. The remainder was nonhardship withdrawals, including 59½ withdrawals, with an average amount of \$15,480.

Percentage of Participants Taking a Withdrawal—Over Time



Percentage of Participants Taking a Withdrawal—By Salary

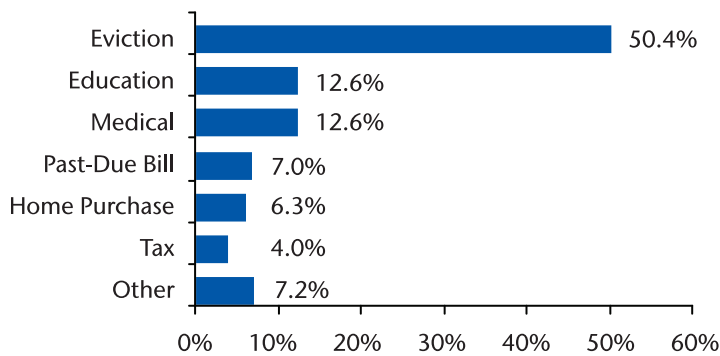


Withdrawals were found to be correlated to pay, age, and gender, as the following details illustrate:

- Participants with lower salaries were more apt to take withdrawals. Among participants with a salary between \$20,000 and \$40,000, 3.6% of participants took a hardship withdrawal and 5.9% took a nonhardship withdrawal during 2010, but only 0.5% of those earning \$100,000 or more took a hardship and 3.9% took a nonhardship.
- Participants age 59½ or older (who are generally able to take nonhardship withdrawals from their before tax account) were nearly three times as likely, on average, to take a nonhardship withdrawal.
- Lower-to-middle income women were more likely to take a withdrawal than men with similar income. Four percent of females earning between \$20,000 and \$40,000 took a hardship withdrawal and 6.5% took a nonhardship withdrawal versus 3.1% of males in the same income bracket took a hardship and 5.1% took a nonhardship.

In terms of the rationale behind hardship withdrawals, half of all employees listed avoiding a home eviction or foreclosure as the reason for the withdrawal. Education and medical bills were tied for a distant ranking of second (12.6%).

Top Reported Reasons for Hardship Withdrawals

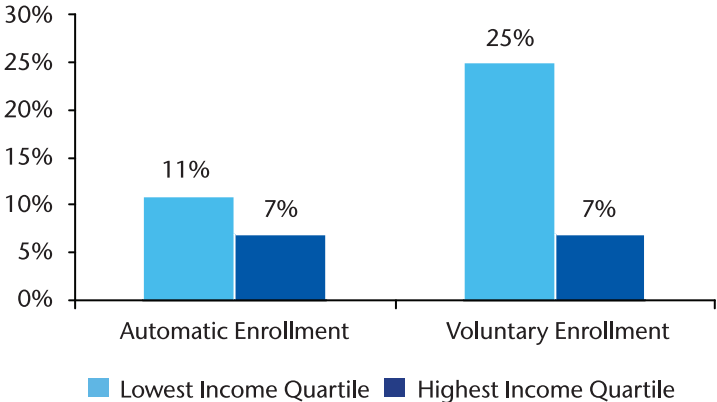


Impact of withdrawals on participant retirement security

Withdrawals can dangerously decrease retirement income for participants.

EBRI's Retirement Security Projection Model simulated the impact of withdrawals on DC participant retirement savings. The projection illustrates that full-career contributors who take withdrawals and stop contributing for two years thereafter reduce their retirement income by 7% to 25% depending on income and enrollment methodology.

Median Balance as a Result of a Withdrawal



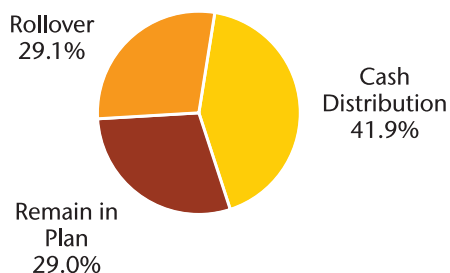
Cashouts

Cashing out retirement accounts also jeopardizes future retirement security. Of the various forms of leakage, cashouts are the most injurious behavior due to the prevalence of the behavior and the magnitude of the impact. Even a seemingly small cash distribution can have an immediate cost impact due to taxes and penalties; however, the larger impact is at retirement when a seemingly small cashout costs tens of thousands of dollars in savings. The time to address plan cashouts is now, as the DC plan has become the primary employer vehicle for retirement income and employees are more mobile.

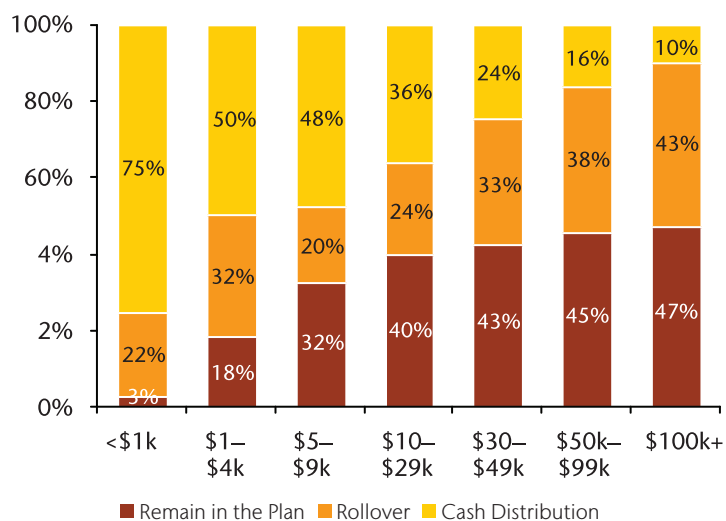
Among workers who terminated from employment in 2010, 42% took a cash distribution, which is consistent with pre downturn levels. Additionally, 29% left assets in the plan and 29% rolled assets over to a qualified plan.

The cashout behavior of terminated employees was greatly influenced by their plan balance, age, and gender. Participants with lower balances are far more likely to cashout their retirement account. Among those workers with balances below \$1,000, 75% took a cash distribution in the past 12 months—of course, many of these participants were forced out of the plan. But even at higher balances, a significant number cashed out. For instance, 24% of individuals with balances between \$30,000 and \$49,999 cashed their money out and one in 10 with balances of \$100,000 or more did so.

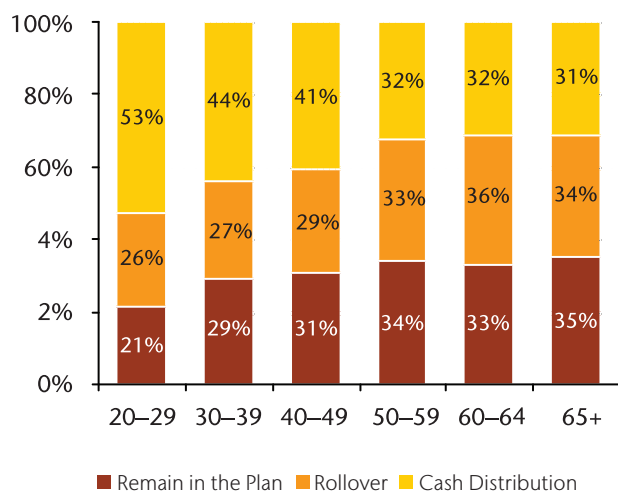
Posttermination Behavior—Percentage of Employees



Posttermination Behavior—Percentage of Employees by Plan Balance



Posttermination Behavior—Percentage of Employees by Age



Younger participants were more prone to take cash distributions at termination compared to older participants, in large part due to their relatively smaller balances. More than half of people in their 20s took cash distributions in 2010, 20 percentage points higher than the rate of those ages 50 and older.

Across gender, women were less likely to cash out their savings and more likely to roll their savings over to another qualified vehicle. This finding was true across all plan balance levels. This difference equated to more women rolling over their accounts when balances were over \$5,000 and thus preserving retirement wealth. For example, when plan balances were between \$30,000 and \$49,999, 36% of women rolled over their assets versus 31% of men.

Notably, the presence of automatic enrollment did not have a significant factor on results. Holding things equal by plan balance, participants subject to automatic enrollment cashed out balances at the same rate as those who actively enrolled in the plan.

While cashouts are the most popular option on a participant-weighted basis, on a plan asset-weighted basis the most popular option is leaving assets in the plan (54.7%) followed by rolling assets to another retirement account (38.0%) and cashout (7.3%). This is attributable to the fact that higher-balance individuals are most likely to keep their balances in the plan and least likely to take a cash distribution.

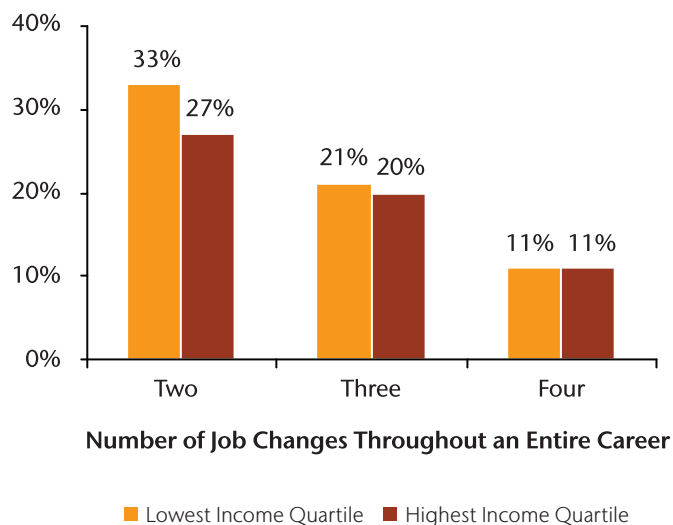
Percentage of Assets—By Location/Action and Age

Age	Assets Remain in Plan	Assets Rolled Over	Assets Cashed Out
20-29	49.3%	30.7%	20.0%
30-39	53.3%	34.0%	12.7%
40-49	53.6%	37.3%	9.1%
50-59	55.8%	38.1%	6.1%
60-64	54.2%	41.1%	4.6%
65+	57.1%	38.8%	4.1%
Overall	54.7%	38.0%	7.3%

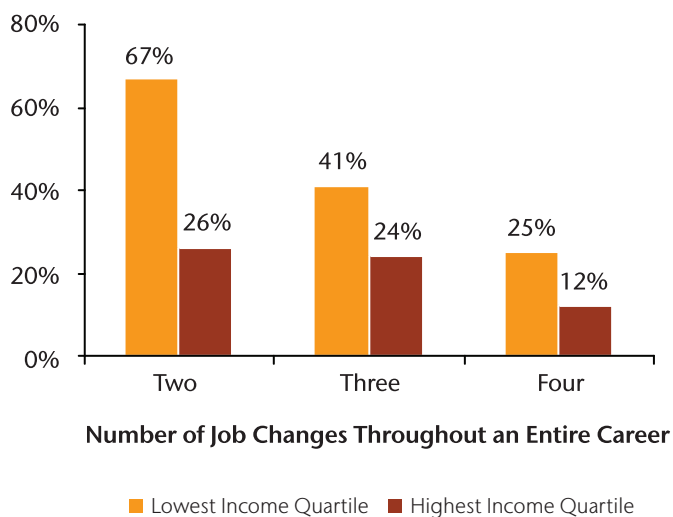
Impact of cashouts on participant retirement security

Cashouts have a substantial impact on savings, typically larger than loans and withdrawals. Depending on the enrollment approach, income level, and the number of job changes, participants who cashout benefits can expect to have a reduction of anywhere from a significant 11% to a startling 67% of retirement income. The EBRI projection assumes a full-career employee takes a cash distribution from the 401(k) plan after a different number of job changes.

Impact of Cashout After the First Job Change— Automatic Enrollment



Impact of Cashout After the First Job Change— Voluntary Enrollment

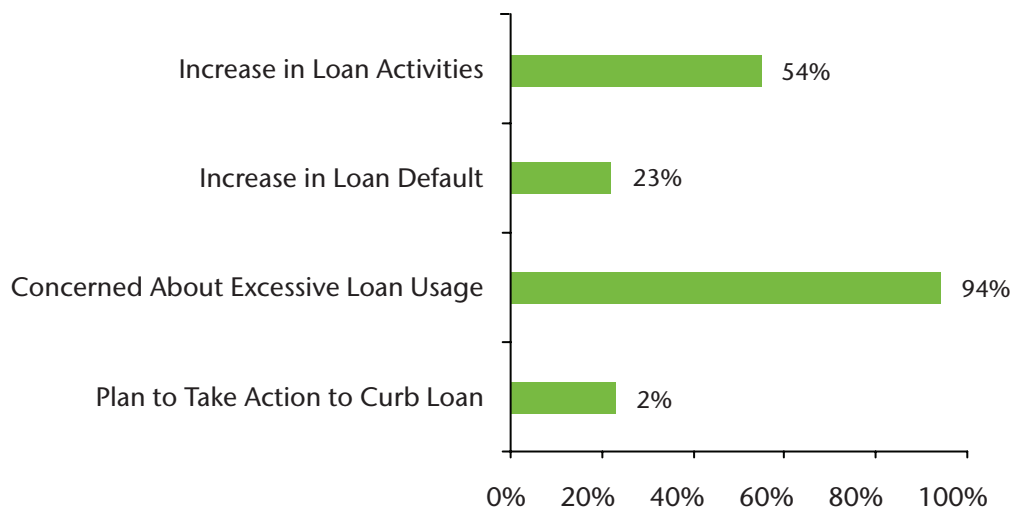


Perspectives and Recommendations on Leakage

Loans

According to the Aon Hewitt's 2010 Employer Perspectives on Defined Contribution Plan Leakage Survey, more than half of DC plans experienced an increase in loan activities in the past two years due to the impact of the recent recession. Nearly a quarter of plans saw a rise in loan repayment defaults. This made the vast majority (94%) of employers concerned about participants paying off a loan and taking another loan right away, carrying multiple loans, or defaulting on a loan. However, while many sponsors note significant concern, only a quarter of plan sponsors plan to take actions to curb loan activity.

Employer Perspectives/Actions on Loans



Plan sponsors could consider the following design, administrative, and communication alternatives to help deter loan usage:

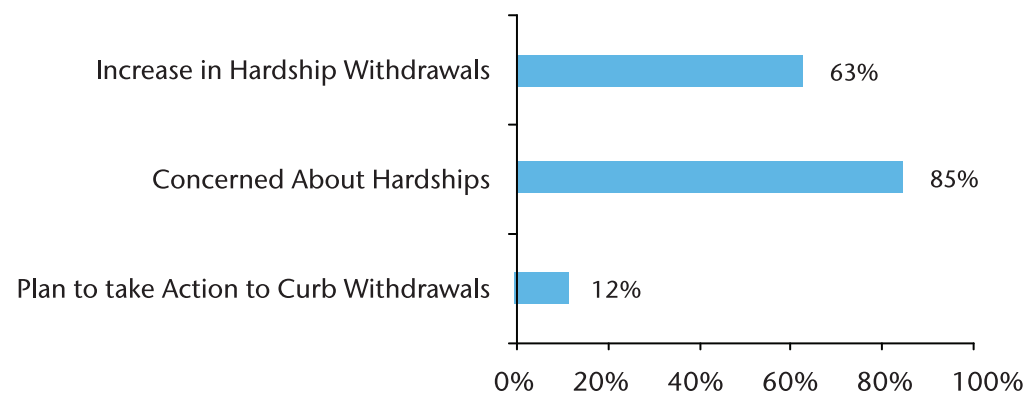
- **Add or increase loan application fee and/or maintenance fee.** Aon Hewitt's research shows that loan fees (exceeding \$75) may lead to fewer loans. Plan sponsors who feel uncomfortable penalizing participants who require a loan can consider a "free" first loan with fees applying to the second and subsequent loans.
- **Reduce the number of loans allowed.** The majority of plans (58%) currently allow employees to take more than one loan. By reducing the number of available loans, it may reposition the loan feature as something to be used for significant needs. And, it will naturally decrease the use of loans among the nearly one-third of participants with multiple loans outstanding.
- **Restrict the available loan balance to only employee monies.** The loan provision can be altered to allow loan access to only employee contributions. In addition to shrinking the size of the available loan, it also sends the message that employer money should be earmarked for retirement.

- **Implement a waiting period.** A newer concept in the industry has focused on stopping the loan cycle of perpetual loan taking. Consider a waiting period, say 6 or 12 months, that forces employees to have a loan fully repaid before they are able to initiate a subsequent loan.
- **Allow loan payments after termination.** Currently, only one in five companies allows a loan repayment option for terminated employees. Most employers do not accept terminated loan repayment largely because payments can no longer be made via payroll deduction. Employers can reconsider this and significantly reduce defaults by allowing repayments through the term of the loan by regular payments from their personal accounts at financial institutions.
- **Educate and communicate with employees.**
 - Provide general education** that explains the pros and cons of 401(k) plan loan-taking, as well as the importance of continued contributions.
 - Embed Internet tools** that will allow participants to model the impact of taking a loan on their future retirement nest egg and include informational links.
 - Target communication** messages to employees, especially those with loans outstanding, to focus on topics such as the importance of continued deferrals, the impact of loans on security, and the dramatic impact of defaults.

Withdrawals

Withdrawals from retirement savings plans can be more detrimental than loans, as withdrawals are permanent losses from retirement accounts. According to the Aon Hewitt *2010 Employer Perspectives on Defined Contribution Plan Leakage Survey*, 63% of plans experienced an increase in hardship withdrawals in the past two years. The survey also shows the vast majority of the employers (85%) are concerned about hardship withdrawals, yet only 12% of sponsors plan to take actions to curb withdrawals.

Employer Perspectives/Actions on Withdrawals



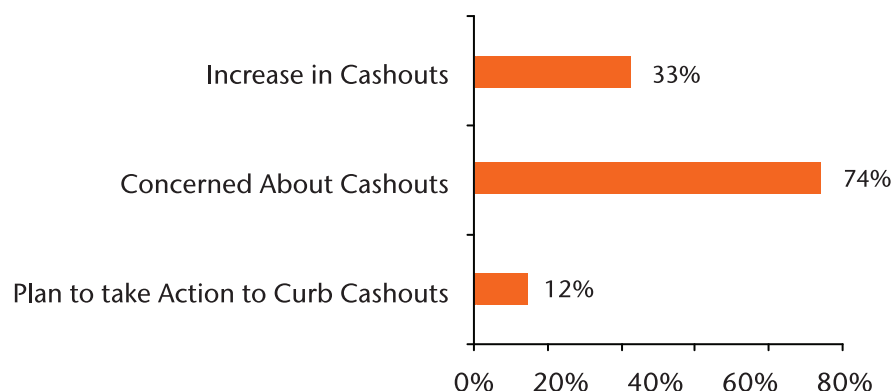
Below are some recommendations on plan design changes and participant communications that can help plan sponsors reduce withdrawal activity in their plan.

- **Restrict the balance that is available for an in-service withdrawal.** For example, the plan can allow participants under age 59½ to withdraw only up to the balance attributable to employee in an after-tax account.
- **Limit the reasons for hardship withdrawals.** Consider limiting the reasons for hardship withdrawals to the six safe harbor criteria.
- **Automatic restart of savings after a suspension.** The majority of plans suspend employee contributions for the six months following a hardship withdrawal. Given many participants may not restart their savings in a reasonable time frame, consider helping them restart their savings by automatically defaulting them into the plan and reinstating their prewithdrawal deferral rate.
- **Educate and communicate with employees.**
 - Consider using distribution specialists or referring to debt counselors when a participant is taking a withdrawal.
 - Provide general education that explains the pros and cons of hardship withdrawals and accessing monies prior to retirement.
 - Embed Internet tools that will allow participants to model the impact of in-service withdrawals, and provide informational links.
 - Target communication messages to employees' posthardship withdrawals to encourage reparticipating in the plan, when able.

Cashouts

Rare are the people who work for only one employer throughout their career. Therefore, it is essential that terminating employees view their DC monies as long-term retirement benefits rather than as consumable income. Nearly 75% of employers in the Aon Hewitt 2010 *Employer Perspectives on Defined Contribution Plan Leakage Survey* are concerned about employee cashout behavior, and one-third have seen an increase in cashouts over the past two years. However, only 12% of employers plan on taking any action to address these worries. Plan sponsors can take the opportunity to help new employees focus on preserving wealth from prior employers to help them meet their retirement needs. And, even with employees who are leaving the plan, there are options and alternatives to help influence behaviors to keep savings focused on long-term needs like retirement.

Employer Perspective/Actions on Cashouts



Below are some plan design, administrative, and communication options to help encourage individuals to maintain a long-term focus and remain in the retirement system.

- **Promote the merits of the qualified plan.** Many employees don't recognize the benefits of the qualified plan (lower-fee institutional assets, investment monitoring and oversight, etc.) or the fact that they can keep money in the plan after they terminate (assuming they have enough assets), so it's important to educate employees on this topic.
- **Simplify rollover process.** Rather than the long, paper-intensive procedure currently used by many employers, companies could adopt a Web-based, paperless rollover process.
- **Provide greater distribution options.** Allow more flexibility around partial distributions, which may encourage more employees to leave monies within the plan and take out only small amounts for current needs.
- **Provide retirees with in plan retirement income solutions,** such as annuity, managed payout funds, and a managed account with drawdown feature. These features help employees buy into the concept of long term retirement income rather than short-term needs before they're tempted by a cash distribution.
- **Educate and communicate with employees.**
 - Consider using distribution specialists when a participant is taking a cash distribution.
 - Provide general education that explains the impact of cashouts and the benefits of assets remaining in the plan or being rolled over to an IRA or another employer plan.
 - Embed Internet tools that will allow participants to model the impact of cashouts and provide informational links.

Keeping Assets in the Plan

In spite of marketing efforts arguing otherwise, there are some tangible benefits to participants in retaining assets in a qualified plan, especially if the individual has access to a mid- or large-sized plan. Within the defined contribution system, plan participants not only generally have access to high-quality investment options at reasonable prices (through lower-cost institutional fund products such as collective trusts and separate account vehicles), but also benefit from fiduciary protections. Workers cannot obtain these benefits individually in the retail market. While inertia is likely playing a role in the retention of assets in the plan, some participants may in fact leave their monies in the plan to take advantage of these benefits. By leveraging the assets of active and terminated plan participants, lower fees may be achieved for the entire population. According to Aon Hewitt's *Leakage Survey*, one third of plan sponsors prefer terminated employees to leave money in the plan and 26% prefer them to leave the plan. The remaining 41% had no preference. As more plans leverage institutional fund alternatives, this trend is expected to continue.

Conclusions

Actions are needed to improve participants' future retirement security. While employers can use automatic enrollment and contribution escalation to encourage earlier participation and higher savings, they should not lose sight of the impact of leakage on the retirement program. Reducing loans, withdrawals, and cashouts is a critical part of the efforts plan sponsors can take.

Removing cash from the retirement program decreases the participants' expected wealth at dramatic rates: by as much as 67% in some cases. It is especially detrimental for younger employees given the greater potential for future compounding. As job tenure declines, it is critical that savings maintain a retirement focus.

References

The following reports and analyses were used throughout this analysis:

- Aon Hewitt's *How Well Are Employees Saving and Investing in 401(k) Plans: 2011 Universe Benchmarks*
- Aon Hewitt's *2011 Employer Perspectives on Defined Contribution Plan Leakage Survey*
- Aon Hewitt's *Retirement Income Adequacy at Large Companies: The Real Deal 2010*

Additionally, the Employee Benefit Research Institute provided modeling as to the impact of employee actions through their EBRI Retirement Security Projection Model.

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