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The Impact of Plan Leakage on Retirement Income Replacement Levels

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Lori Lucas, CFA
Defined Contribution Practice Leader
www.callan.com

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Agenda

- November 2010 Issue Brief
- Impact of Leakage
- Conclusions

November 2010 EBRI Issue Brief

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- Expanded on earlier work by the Employee Benefit Research Institute (EBRI) to simulate the impact of changing 401(k) plan design variables and assumptions on retirement income adequacy.
- Previous research has demonstrated the large potential impact of auto-enrollment on retirement income adequacy.
- The November 2010 study determined implementation impact of auto features.
- Joint project between EBRI and the Defined Contribution Institutional Investment Association (DCIIA).

Measuring Success

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- The definition of “success” for this analysis is a combined real replacement rate from Social Security and 401(k) projected balances of at least 80 percent.
- The analysis is limited to younger employees (with 31–40 years of 401(k) eligibility) and provides separate results for employees in the highest and lowest income quartiles.

Implementation Features Examined

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Using this definition of success, the model is used to determine how success changes with:

- The maximum level of employee contributions allowed by the plan sponsor (6, 9, 12, and 15 percent of compensation).
- The annual increase in contributions (1 vs. 2 percent of compensation).
- Whether employees are assumed to opt out of the automatic contribution escalation.
- Whether employees are assumed to remember/retain their previous level of contributions when they change jobs vs. reverting back to the plan's initial default.

Prevalence of Auto Features

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- **44% of large plans offer automatic enrollment**
  - 62% default auto enrollees at 3% or less of pay.
  - Yet 86% of plan sponsors recommend employees save at least 10% of pay.
  - Large numbers of auto enrolled participants remain at default rates for many years.
- **46% offer automatic contribution escalation**
  - 1/3rd of plans with automatic enrollment offer it in tandem with automatic contribution escalation.
  - 89% use 1% annual deferral increase.
  - A common cap on automatic contribution escalation is the company matching threshold level (e.g., 6%).

Sources: Plan Sponsor Survey: Structuring DC Plan Automatic Features to Pump Up Retirement Savings. 2011 DCIIA Survey; Saving For Retirement on the Path of Least Resistance. Choi et al. 2004.

Impact of Optimizing Auto Features

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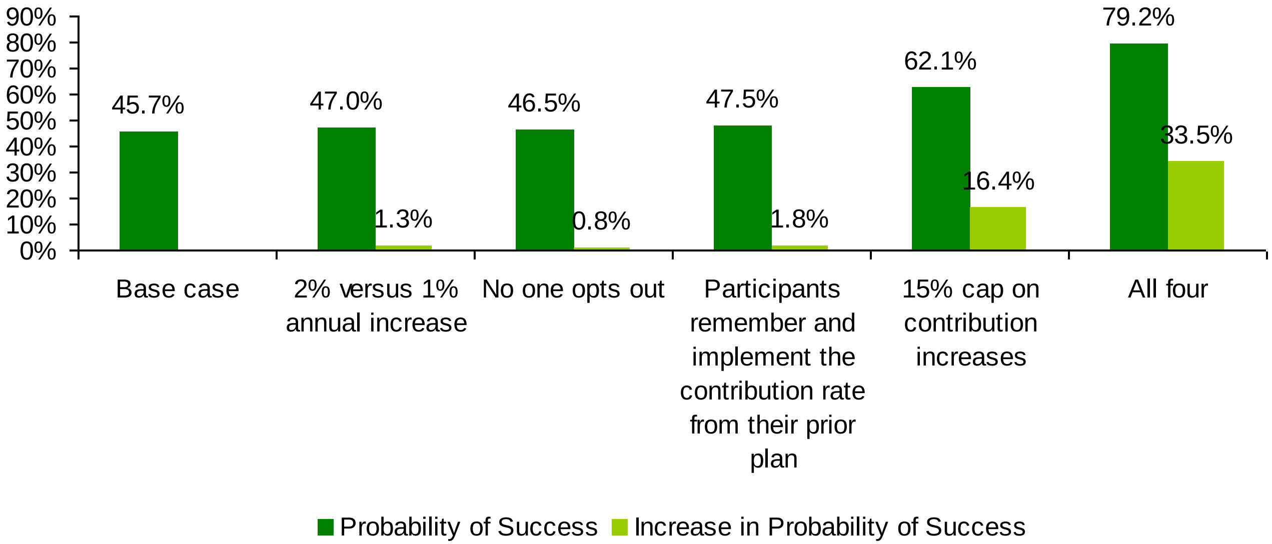
Probability of Replacing at Least 80% of Income in Retirement with Various DC Auto Feature Assumptions (Low Earners)



Prevalence of "Leakage" Features

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- **46% of 401(k) participants cash out of their plan upon termination.**
  - 28% cash out where balances exceed $1,000.
- **Nearly all 401(k) plans permit hardship withdrawals.**
  - More than half permit nonhardship withdrawals
- **<50% of plans allow immediate plan eligibility.**

Sources: Profit Sharing Council's 53rd Annual Survey; The Erosion of Retirement Security From Cash-outs: Analysis and Recommendations. 2008. Aon Hewitt Study. Trends and Experiences in 401(k) Plans. 2007 Aon Hewitt Survey.

Impact of Cashouts

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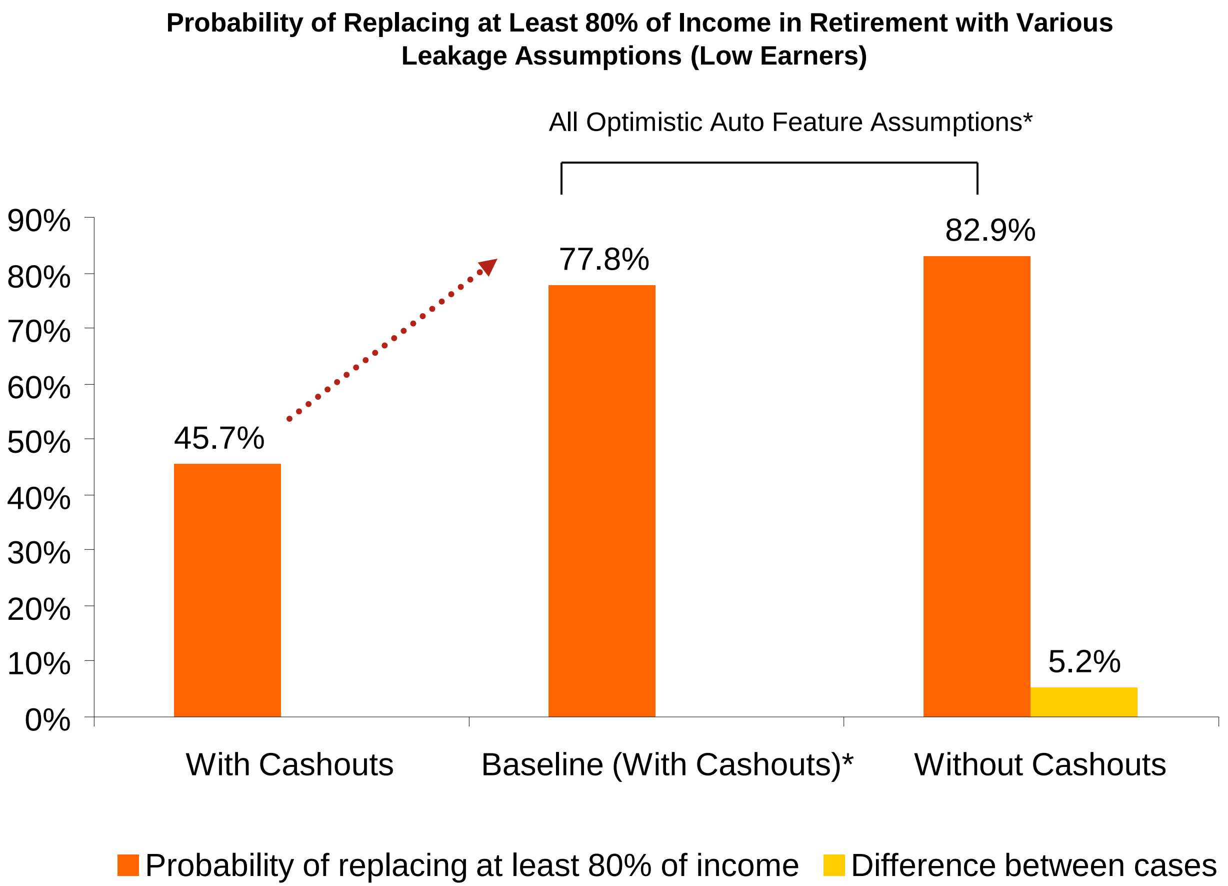

*Updated cashout assumptions

Impact of Other Forms of Leakage

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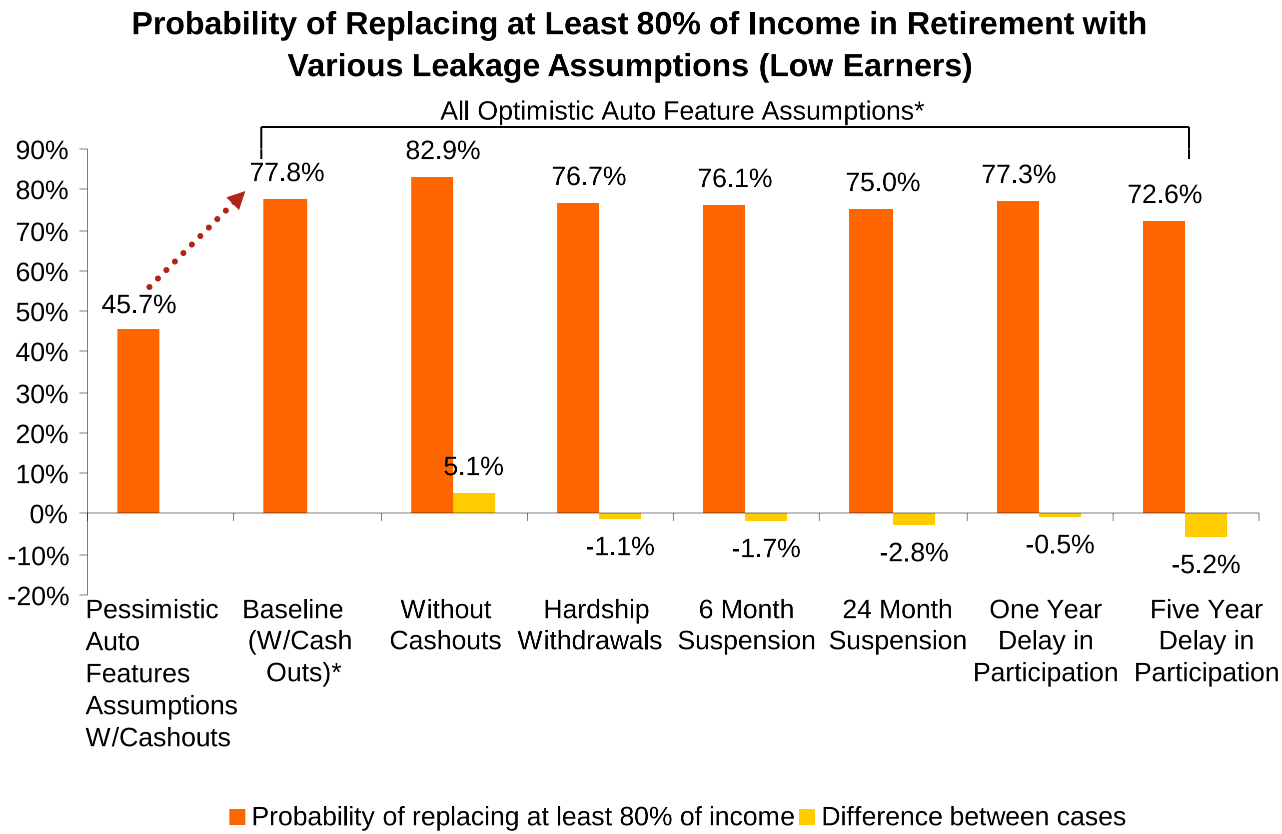

*Updated cashout assumptions

What About Loans

- **97% of plans permit loans.**
  - 55% of those permit more than one loan.
- **Fidelity research shows that one in five 401(k) plan participants have loans.**
- **However, Hewitt research shows that there is no evidence that participants who take loans are more likely to stop contributing than participants who don’t take loans.**
- ***As such, in general the impact of loan taking tends to be negligible on retirement income replacement levels.***
  - *Still, the majority of participants with loans at termination default.*
  - *The is especially pronounced among younger workers.*

Source: Hewitt Associates’ 2009 Trends and Experience in 401(k) Plans Survey, Fidelity, Hewitt 2006 How Well Are Employees Saving and Investing in 401(k) Plans research report.

Conclusions

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- **Plan sponsors are wise to focus on optimizing implementation of auto features—enormous impact on potential income replacement in retirement.**
- **However, leakage can also take its toll on eventual income replacement.**
  - Cashouts have the greatest negative impact
  - Loans' impact appears to be negligible—except in cases of default upon termination.
  - Effects like delays in reinstating contributions after a hardship withdrawal suspension period, and delays in participation may be small but can add up.