The Impact of Plan Leakage on Retirement Income Replacement Levels

May, 2011
Agenda

- November 2010 Issue Brief
- Impact of Leakage
- Conclusions
November 2010 EBRI Issue Brief

- 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

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

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

- **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%).

Impact of Optimizing Auto Features

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

- Base case: 45.7%
- 2% versus 1% annual increase: 47.0% (1.3% increase)
- No one opts out: 46.5% (0.8% increase)
- Participants remember and implement the contribution rate from their prior plan: 47.5% (1.8% increase)
- 15% cap on contribution increases: 62.1% (16.4% increase)
- All four: 79.2% (33.5% increase)

Legend:
- Probability of Success
- Increase in Probability of Success
Prevalence of “Leakage” Features

- 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.

Impact of Cashouts

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

All Optimistic Auto Feature Assumptions*

<table>
<thead>
<tr>
<th>Leakage Assumption</th>
<th>Probability of Replacing at Least 80% of Income</th>
<th>Difference between Baseline and Without Cashouts</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>45.7%</td>
<td></td>
</tr>
<tr>
<td>10%</td>
<td></td>
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<td>20%</td>
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<td>30%</td>
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<td>40%</td>
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<td>50%</td>
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<tr>
<td>60%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>70%</td>
<td>77.8%</td>
<td>5.2%</td>
</tr>
<tr>
<td>80%</td>
<td>82.9%</td>
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</tbody>
</table>

*Updated cashout assumptions
Impact of Other Forms of Leakage

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

All Optimistic Auto Feature Assumptions*

<table>
<thead>
<tr>
<th>Without Cashouts</th>
<th>Hardship Withdrawals</th>
<th>6 Month Suspension</th>
<th>24 Month Suspension</th>
<th>One Year Delay in Participation</th>
<th>Five Year Delay in Participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>77.8%</td>
<td>82.9%</td>
<td>76.7%</td>
<td>76.1%</td>
<td>75.0%</td>
<td>77.3%</td>
</tr>
</tbody>
</table>

-20% to 90% probability levels.

*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.

Conclusions

- 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.