Retirement Plan Services

The Impact of Leakage in 401(k) Plans

With the decline in company-sponsored pension plans and the uncertainty of future Social Security benefits, the popularity of defined contribution 401(k) plans has rapidly spread since the 1980s. The 401(k) plan is a cost-effective way for an employer to offer a retirement savings vehicle to employees while potentially enjoying certain tax benefits. In most cases, the employee retains control of the assets not only after retirement or other termination, but also while employed. Employee access to their 401(k) account balances can lead to plan leakage.

Plan leakage occurs when assets leave the plan for various reasons and are not transferred to another qualified retirement plan or IRA. The major causes of leakage include participant loans, in-service and hardship withdrawals, lump sum cash outs due to job change and, to a lesser degree, participant loan defaults.

Why should you care about plan leakage?

You want to attract the best talent for your business. One way to do that is to offer a rich benefit package, including a 401(k) retirement plan. More importantly, you recognize the value of helping your employees save for retirement. To further enrich this benefit, you may provide employer contributions to your team members to help with their retirement goals. This tax-sheltered vehicle allows substantial contribution limits each year and is one of the primary avenues for Americans to save for the "golden years." With the proper education and planning, it is more than possible for individuals to save enough throughout their career to sustain their lifestyle needs in retirement. But, what happens when individuals access this money before retirement? The long-term impact can be quite detrimental.

According to a study conducted by Hello Wallet, a subsidiary of Morningstar, the leakage in retirement plans is substantial. Over 25 percent of households use all or some of their 401(k) account for non-retirement needs such as mortgages, credit card debt, medical expenses and other debt. By the time workers hit their 40s, one-third have accessed their retirement accounts for non-retirement needs. The same study found that each year, employers contribute $118 billion to retirement savings while employees contribute an additional $175 billion. Of that, $70 billion is removed for non-retirement purposes.

As an employer, you've already demonstrated your commitment to help employees save for retirement by sponsoring a plan. Employees who access their funds prior to retirement may defeat the purpose of saving for those "golden years."

What steps can you take to stop plan leakage?

The first step to stop leakage is to educate your participants about the impacts of taking any form of early withdrawal from the account. More often than not, participants cannot conceptualize the loss they may experience when they withdraw even relatively small amounts. There have been numerous studies conducted and articles written on this topic. Have a graphical example on hand that depicts the dollar impact the withdrawal will have. This may make the employee think twice before withdrawing money out of his account to purchase a vehicle, for example.

Participant education on this topic, and others, is paramount to successfully slow the leakage. Education meetings should be held at least once a year, preferably more, to inform your participants about the plan provisions as well as the investments offered in the plan. Some individuals are confused by investments and how they work and as a result, do not enroll in the plan at all. As long as you offer a wide array of funds in the plan, participants can take on as little or as much risk as they choose, but only if they understand what the offerings are.

Other considerations to reduce leakage are with your plan design. Do you allow employees to roll money into the plan from a former employer's retirement plan? If so, must they first meet the eligibility requirements of your plan? Allowing employees to roll over previous savings prior to meeting eligibility requirements will encourage new and existing employees to rollover the account from a prior employer to your plan. It will also give employees the opportunity to consolidate multiple accounts they may have to your plan. Another plan provision you should offer is the Roth feature. Offering Roth in your plan will provide more flexibility in accepting rollovers from other qualified plans. Does your plan rollover balances less than $1,000 to an IRA or are these smaller balances paid out in a lump sum? By rolling over these balances, you will not only help prevent leakage, you may save yourself the worry of finding lost participants.

It is always good practice to periodically review the withdrawal provisions you offer and your loan policy to ensure they are still prudent for your workforce. Although participant loans are not the largest culprit of leakage, they do contribute. In general, most plan documents require that a loan be paid upon termination to prevent a default. To curb leakage from an outstanding loan balance, the loan policy can be changed to allow a terminated participant to repay the loan balance by the cure period allowed by the IRS or upon the participant's request for distribution, whichever comes first.

Some plan sponsors require a terminated participant to rollover the balance and will not allow a lump sum cash distribution. This may sound too restrictive, but IRA accounts have different taxation rules that may benefit the former employee who still chooses to withdraw money from the account. Other plan provisions that can be changed to help lessen the effect of leakage are with your hardship distributions and in-service distributions. There are limited reasons for hardship distributions to begin with and you are not required to allow all of them. You may choose to offer this feature for only the reasons that truly demonstrate a financial hardship. Additionally, you may place withdrawal restrictions on the employer contributions that you have contributed to the plan. This allows employees access to any amount they have contributed and gives you the comfort of knowing that you are ensuring that a portion of the account will remain intact until that person terminates employment. There are numerous ways to design your plan with your employees long-term retirement needs in mind, while still offering some flexibility.

How can CIBC help?

As a sponsor of a 401(k) plan, the ultimate goal is to offer a savings vehicle meant for long-term goals, not short-term pitfalls. CIBC's Retirement Plan Services group can assist with your 401(k) plan design to control leakage and ultimately enhance your employees' retirement saving power. Contact us at 312.564.3806 for more information.

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