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MANAGEMENT

September 2008

Is Your Defined-Contribution Plan Leaking?

It's in everyone's best interest for companies to keep employees from cashing out their 401(k) plans when they leave, defined-contribution specialist Lori Lucas says in this commentary.

By Lori Lucas

VERY OFTEN, 401(k) PLANS ARE referred to as nest eggs. For some plan participants, however, they are more like sieves—money flows in, but then flows right out the other end.

This issue was recently brought into the limelight with the controversy over 401(k) plan debit cards. These cards provide participants with easy access to 401(k) loans, and were dubbed a "gross distortion" of the intent of 401(k) plans at a July 2008 hearing by the Senate Special Committee on Aging.

Although 401(k) plan debit cards are not widely used, they do symbolize a valid concern: What is the point of increasing participation in 401(k) plans through automatic enrollment, automatic escalation and the like if the monies simply leak out?

As David John and Mark Iwry of the Retirement Security Project put it at the hearing, "It won't matter how tightly we lock the front door of the barn if the horses are free to run out the back."

The reality is, though, when it comes to 401(k) plan leakage, loans may be a relative trickle. A Transamerica Retirement Services survey finds that loan utilization has increased in the past few years, but less than one in five participants have loans outstanding. Almost all participants who take out loans repay them. And according to Hewitt Associates, among

those with loans, the average outstanding loan balance is \$7,800.

What causes that trickle to become more of a torrent is what happens after employees leave their companies. Often, when this occurs, nearly half of them simply take their 401(k) assets in the form of cash. The number is much higher—66 percent—for younger employees, according to Hewitt Associates.

Now consider that figures from the Department of Labor put the median job tenure for workers ages 25 to 34 at less than three years. This creates the specter of many people reaching their 40s with little retirement savings—despite perhaps having actually participated in their defined-contribution plans for a number of years thanks to being automatically enrolled.

Among those who do preserve their retirement savings, many participants roll their money into an individual retirement account versus leaving their money in the 401(k) plan or rolling it over into another 401(k) plan.

Internal Revenue Service data shows that rollovers to IRAs from employer-sponsored plans are the main source of new cash flowing into IRAs. Yet the fees associated with retail mutual funds typically used within IRAs can be significantly higher than that within 401(k) plans.

Consider a participant who has

access to an institutionally priced S&P 500 index fund within a 401(k) plan that costs as little as 2.5 basis points per year. The average retail S&P 500 index fund's expense ratio exceeds 60 basis points. Compounded over time, such a wide differential in fees can have a tremendous impact on retirement accumulation.

Why should plan sponsors care? After all, is it really their responsibility to ensure the retirement income security of people who are no longer in their employ? Further, do they really wish to have fiduciary oversight over former employees' assets?

Some plan sponsors will care because the defined-contribution plan is the only retirement-income vehicle that they provide to employees. The idea of former employees marching toward old age without any employer-provided retirement benefits may be very much at odds with employers' goals in offering a defined-contribution plan in the first place.

Other plan sponsors may recognize that it can be in the best interest of both current and former employees to encourage terminated and retired workers to stay in the plan. After all, increased plan assets mean greater economies of scale that could translate into reduced plan fees, better access to institutional money managers and even improved administrative services.

What can plan sponsors do to keep people in the 401(k) plan once they are no longer with the company? One thing is to emphasize the benefits of the 401(k) plan throughout the tenure of an employee's career.

When employees leave or retire, plan sponsors may wish to reinforce these messages, with a view to countering the barrage of propaganda from IRA providers. Plan sponsors may even want to consider features that may make the 401(k) plan more attractive to former employees (and current employees as well).

For example, some online tools can simplify participants' financial lives by providing an aggregate view of all of their investment accounts (including outside brokerage accounts) through the defined-contribution plan's Web site.

Other tools include drawdown technology, which provides a way for retirees to receive a "paycheck" from their defined-contribution account. Periodic payments are made from the participants' account to the participant on a regular basis, based on employees' needs

in retirement, and the balance available in their account—all of which the draw-down tool calculates.

Finally, if the plan simply allows partial distributions, this in itself may broaden the plan's appeal.

Even if plan sponsors do not wish to actively retain former employees in the 401(k) plan, they can do much to help them avoid cashing out at termination. This might include providing them with statements showing how much they would have at retirement, even for the smallest of balances.

Plan sponsors could provide employees with calculations that show the impact of taxes and penalties on withdrawn amounts. Further, more and more record keepers support "one-click" rollovers by having the record-keeping system connect directly with the systems of rollover providers. This can greatly streamline the often onerous rollover process, which itself can be an obstacle to rolling over plan balances. Again, any communication should start early, and should be reinforced when an

employee leaves the organization.

The weakened economy, higher oil prices and increasing foreclosures mean that 401(k) plan assets are more vulnerable than ever to leakage. Although there's no widespread evidence that a run on 401(k) plan assets is occurring, certainly there are pockets of real concern. This has clearly caught the attention of regulators, who are already taking steps to plug up the holes.

When it comes to helping employees maintain assets for retirement, what sounds like employer paternalism today may well turn out to be a requirement in the future.

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