



SUMMER 2010

Plugging the leaks in the DC system: Bridging the gap to a more secure retirement

A Building Futures Report: Q2 2010

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Executive summary

Over the last quarter, we continued to see an increase in the number of participants improving their age-based asset allocation strategies—as well as those who sought guidance to help them meet their retirement planning needs. However, a few trends in the defined contribution (DC) system remain cause for concern. Over the last decade, the percentage of participants taking loans, hardship withdrawals, and cash-outs has grown slightly.

This increase in 401(k) outflows can be attributed to a variety of factors, including:

- The impact of the economic crisis, including prolonged unemployment and greater levels of financial hardship
- Individuals in their peak savings years faced with both planned and unplanned expenses—from a home purchase and tuition to unforeseen medical emergencies

Allowing participants to borrow or withdraw from their retirement accounts in certain circumstances can provide them with peace of mind. However, we believe more could be done to enforce and reinforce the virtues of the DC system—an essential platform for long-term retirement savings.

The outflow of money from retirement accounts (often referred to as “leakage” in Washington) is a trend that should be addressed through increased communication to participants on the impact their short-term actions can have on their long-term savings goals. Implementation of safeguards that can dissuade some participants from thinking of their retirement savings account as if it were a rainy-day fund can also play a role. The good news is that the leaks in the system can be plugged.

Through better plan design, employers can play a pivotal role in helping their employees keep their savings working for them—especially during the critical accumulation years (ages 30–55). Plan design can be updated to limit the number of loans and to limit hardship withdrawals to safe-harbor parameters. Education can be enhanced along with guidance to help employees better understand their available options—as well as the potential impact their decisions may have.



This *Building Futures* brief is based on our analysis of nearly 17,000 corporate defined contribution plans and 11 million participants as of June 30, 2010. It highlights recent trends of participants leveraging their plan accounts to address short-term needs, while possibly sacrificing their accounts' long-term growth potential.

We will focus on the following **key findings**:

1. More participants are taking loans and hardship withdrawals.
2. Participants taking loans are more than twice as likely to decrease their deferral rate.
3. 45% of participants who took a hardship withdrawal during the 12-month period ending 6/30/09 also took a hardship the same period this year.
4. Seven out of 10 participants kept their money in their workplace savings plan or rolled it over to another tax-deferred retirement savings vehicle after being separated from their employer. Of the remainder who cashed-out some or all of their DC plan assets, the highest rates represented the lowest paid and lowest balance participants.

Loan activity rises measurably

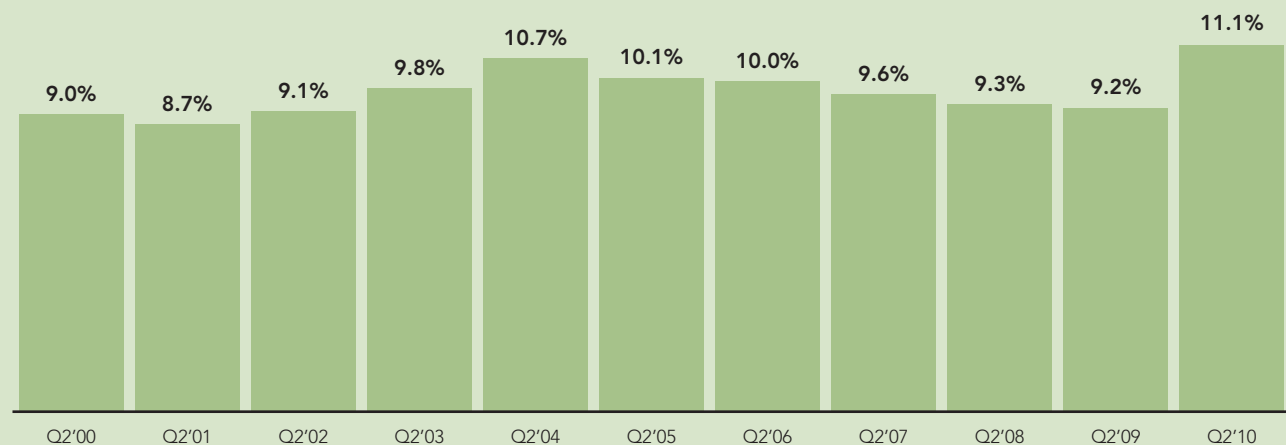
The percentage of active participants taking a loan in the last 12 months increased by almost two percentage points since the same period last year (Exhibit 1). This is a striking statistic for two reasons. The end of Q2 2010 marks the highest percentage of participants seeking to borrow from their 401(k) account in the 10 years analyzed. Also, relative to the 9.2% of participants who initiated a loan a year earlier, the 11.1% level of participant-initiated loans represents a 20% increase in those taking a loan in just one year.

This behavior could be closely correlated to the limited access to credit and other sources of income, as well as the sustained levels of unemployment (e.g., by spouses of active participants). But it's important to address this issue through more analysis and better understanding of who is taking loans, why they are taking them, and whether there are better options.

Important to note: Only 1.3% of loans initiated in the 12 months ending 6/30/10 were for less than \$1,000. This seems to indicate that the vast majority of participants may be using discretion and are not so quick to tap into their 401(k) account—hopefully seeking a loan only at a time of significant need.

Consider what “significant need” means today. With the nation’s unemployment rate close to 10%, this behavior may be due to a number of very real issues: The economy is still suffering, credit is less accessible than in the past, and people are more focused on paying down debt.

Exhibit 1: Percentage of active participants taking a loan by date—rolling 12 months





Loans peak in mid-career

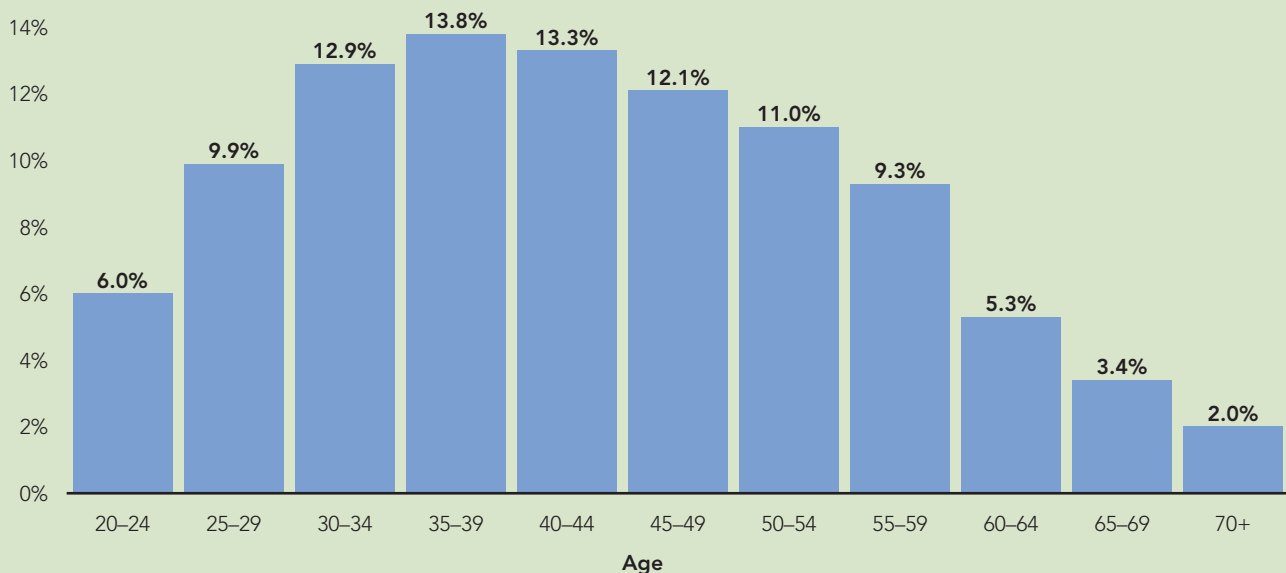
A look at loan initiation by age reveals consistent results as first reported in our 2008 report (Exhibit 2). Based on loan initiation activity for the latest quarter's prior 12 months, active participants age 30 to 50 were more likely to initiate loans than younger or older participants.

Younger employees—those in their early 20s—typically aren't yet focused on saving for the future. If they are participating in their employer's DC plan, they likely have small account balances—providing

them with smaller vested balances from which to borrow. Conversely, 30- to 55-year-olds are more likely to have been participating in their workplace savings plan for longer periods—potentially resulting in higher vested account balances and eligible loan amounts. This same older population is also likely to be juggling competing financial priorities such as buying a home and/or paying for their children's college education.

Nearly 36% of loans taken were for greater than \$10,000. The strong majority of those taking larger loans—nearly three quarters—were between ages 30 and 55, an age when participants should be accumulating as much as possible.

Exhibit 2: Percentage of active participants taking a loan by age—12 months ending 6/30/2010



Loans outstanding climb as well

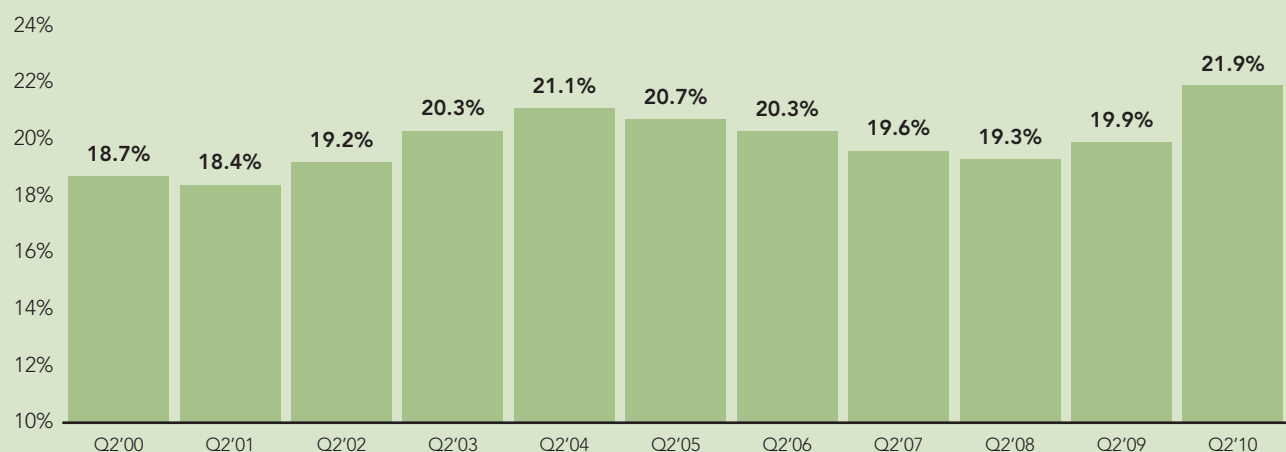
Paralleling the rise in loan initiation is the increase in the portion of active participants with an outstanding loan. After remaining fairly level from Q2 '07 through Q2 '09, the percentage of participants with outstanding loans is now at its highest in the 10 years of data studied—with nearly 22% of the actively employed population holding an outstanding loan (as of 6/30/10) (Exhibit 3). This is a two-percentage-point increase from the same time last year.

The number of participants with multiple loans is small: only 0.8% of active participants have more than three outstanding loans from their account—these participants accounted for 2.9% of total loans outstanding.

So what's driving this trend? Are too many participants juggling too many loans? Is this adding to the number of outstanding loans? Actually, no. Our data shows that the issue isn't that the same people are taking multiple loans—rather, it's that more participants are taking loans for the first time.

This behavior might be expected as the economy begins to recover after a bear market. With account balances beginning to rise, more participants may be seeking to take advantage of being able to tap into their account to meet short-term needs. This behavior was evident over the same period from 2002 through a peak in 2004 before beginning its decline.

Exhibit 3: Percentage of active participants with a loan outstanding



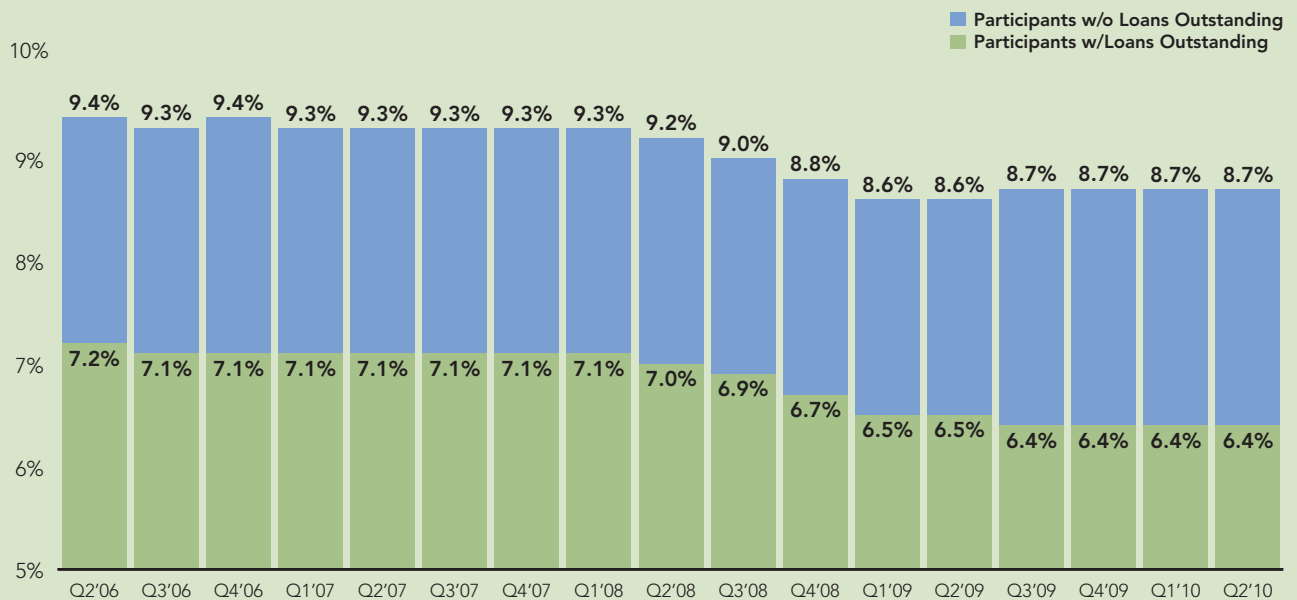
Similar to what we noted earlier among active participants initiating new loans, the portion of participants with loans outstanding is highest among participants between ages 30 and 55.



Loans may lead to lower deferral rates

Participants with an outstanding loan tend to have lower deferral rates—more than two percentage points lower than those who did not take a loan. While on the surface, this may seem to shine a bad light on this behavior, on a positive note, they are still contributing. This allows them to take advantage of employer-matching contributions and continue accumulation through dollar cost averaging (Exhibit 4).

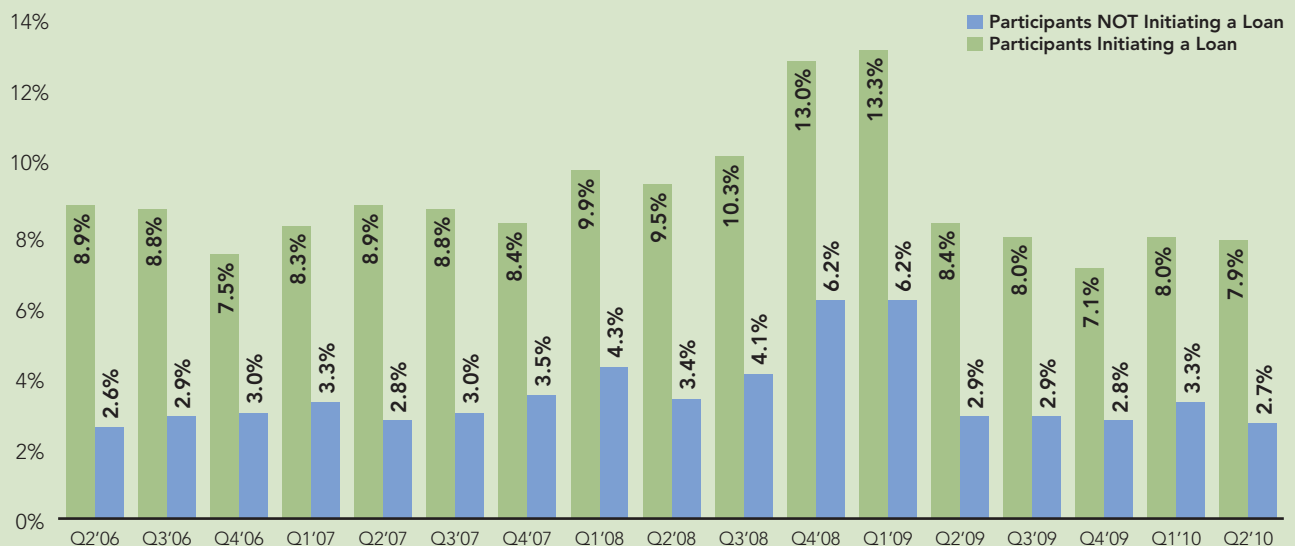
Exhibit 4: Participants with loans outstanding have *lower average deferral rates**



*Total elective deferral rates include employee pretax, post-tax, Roth, and catch-up contributions.

Overall, participants who take a loan tend to be more prone to decreasing their deferral rate. Those who took a loan were more than twice as likely to decrease their deferral rate by some level (Exhibit 5). This may be the result of participants adjusting their deferral rates in order to balance continuing their contributions with making loan repayments.

Exhibit 5: Percentage of continuous active participants *decreasing* deferral rates (3 months)*



*This data does not reflect continuous active participants (with or without a loan) who may have increased their deferral.

Our data does not indicate that loan utilization is being overused as a means to convenient credit, but rather that it may represent a prudent financial decision on the part of the participant. Taking a loan from one's 401(k) account can help solve short-term needs (at potentially less cost than other methods) and allows participants to pay themselves back with interest. Whatever the rationale for taking a loan, the findings do highlight the financial burden loans can have on participants who continue to contribute *and* have to repay their loan. They also shed light on the potential for lower long-term savings for those participants who may have decreased their deferrals and subsequently not increased them after the loan was paid off.



Hardship withdrawals on the rise

Most defined contribution plans allow for some form of hardship distributions. Unlike plan loans, however, hardship withdrawals cannot be repaid, and in fact may result in a six-month suspension from contributing to the plan. In general, they should be viewed—and treated—as a means of last resort.

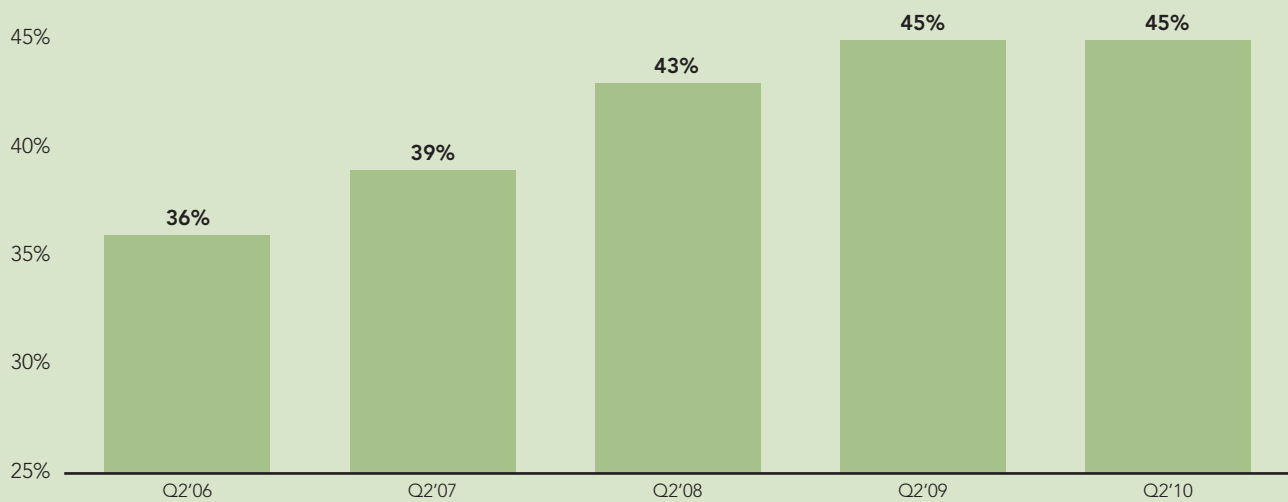
The average 12-month hardship amount requested was just over \$6,000. While higher than the same period last year, this number is consistent with the overall average amounts requested over the past 10 years.

There are numerous reasons for obtaining a hardship withdrawal, including having an immediate and heavy financial need. Our data shows that the top reasons are: preventing a foreclosure or eviction, having to pay for college tuition, the purchase of a house, or for uninsured medical expenses. Some plans follow a “facts and circumstances” approach to allowing hardship withdrawals. This creates the potential for even more hardship requests by leaving more discretionary judgment to plan administrators. By strictly following IRS safe-harbor guidelines, less administrator discretion will be involved and presumably fewer hardship withdrawals will be taken.

Percentage of assets leaving the DC system

The percentage of active participants who took a hardship withdrawal is small; however, it has been increasing steadily over the past 10 years to 2.2% of the active participant population. Interestingly, 45% of participants who took a hardship withdrawal during the same period last year (ending 6/30/09) also took a hardship withdrawal over the same period this year (Exhibit 6). This could be a possible indicator of future behavior that could be preventable.

Exhibit 6: Percentage of continuous participants with a hardship withdrawal last period that took a hardship withdrawal this period (12 months)



Similar to those taking loans, the portion of actively employed participants taking hardship withdrawals is highest among participants between ages 35 and 55. These clearly are years in which people tend to face multiple financial demands, and some reach the point of hardship.



Cash-outs: Key concern over who takes them

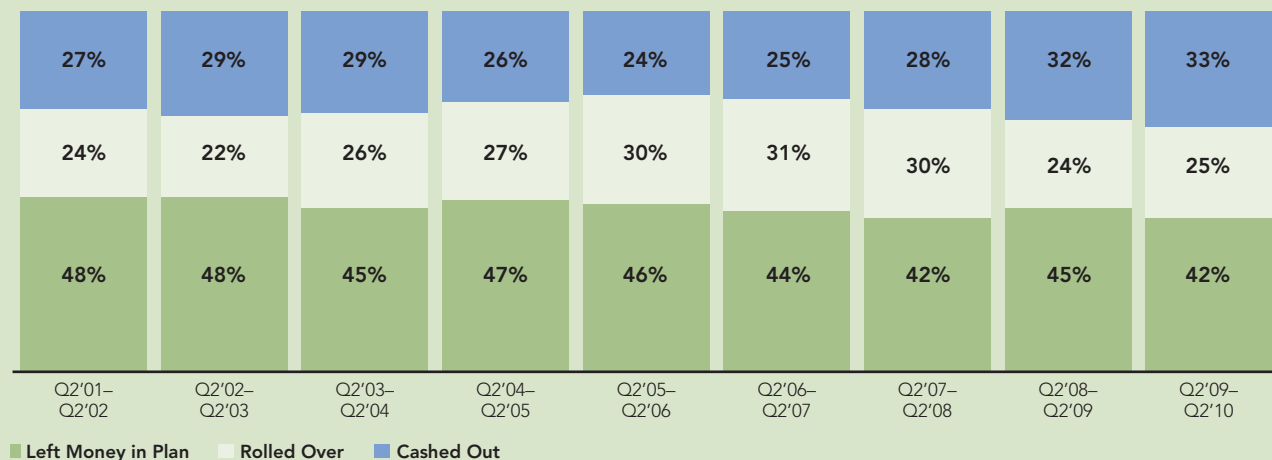
To better understand the behavior of recently terminated participants, we looked at participants who were actively employed by their plan sponsor at a given point in time, and then became terminated in the following nine months. We then examined the “stay-in-plan” versus “withdrawal” behavior of these participants for the one-year period following the beginning given point in time.¹

Participants were classified into one of three mutually exclusive categories:

1. Stay in Plan (those who did not take any withdrawals during the one-year period)
2. Rolled over (participants who took a distribution of some or all of their DC plan assets and rolled them into an IRA or other DC plan)
3. Cashed out (those who took a distribution of some or all of their DC plan assets without directly rolling them into another retirement plan or vehicle)²

The results show that most workers in the one-year periods analyzed did not cash out from their DC plans. In fact, 7 out of 10 kept their money in their workplace savings plan or rolled it over to another tax-deferred retirement savings vehicle. This may be due in part to the success effective programs have had with providing practical guidance for an employee’s next steps, as well as other employee education efforts. On a less positive note, up to a third of participants cashed out some or all of their DC plan assets during these one-year periods. Any level of cashing out is a major concern because it can greatly impact retirement savings.

Exhibit 7: Stay in plan versus withdrawal behavior for one-year historical periods



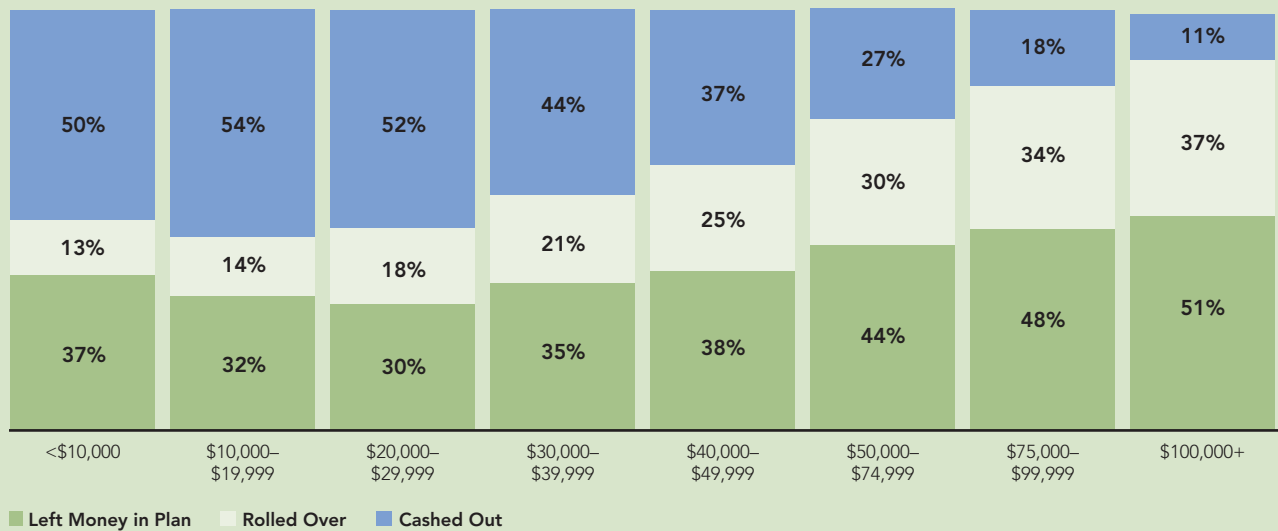
Cash-outs: Key concern over who takes them *(continued)*

Analysis of one-year withdrawal behavior across each of the periods back to 2000 consistently showed that it is the younger, lower compensated, lower balance participants who are cashing out at the highest rates.

A critical moment of truth occurs when individuals leave their current employer. If employees cash out of their workplace savings plan at the time of each job separation (on average 7–10 times in his or her lifetime⁴), these individuals could repeatedly drain their savings, making it extremely hard for them to reach their retirement savings goals.

For the youngest workers, age 20–24, the cash-out rate is 50%.³ These workers—with the longest time until retirement—are significantly impacting the future potential value of their retirement savings by withdrawing, and presumably spending, their savings. Similarly, participants at the lower end of the compensation scale have cash-out rates in excess of 50%, whereas it is only 11% for those earning more than \$100,000 (Exhibit 8).

Exhibit 8: By compensation



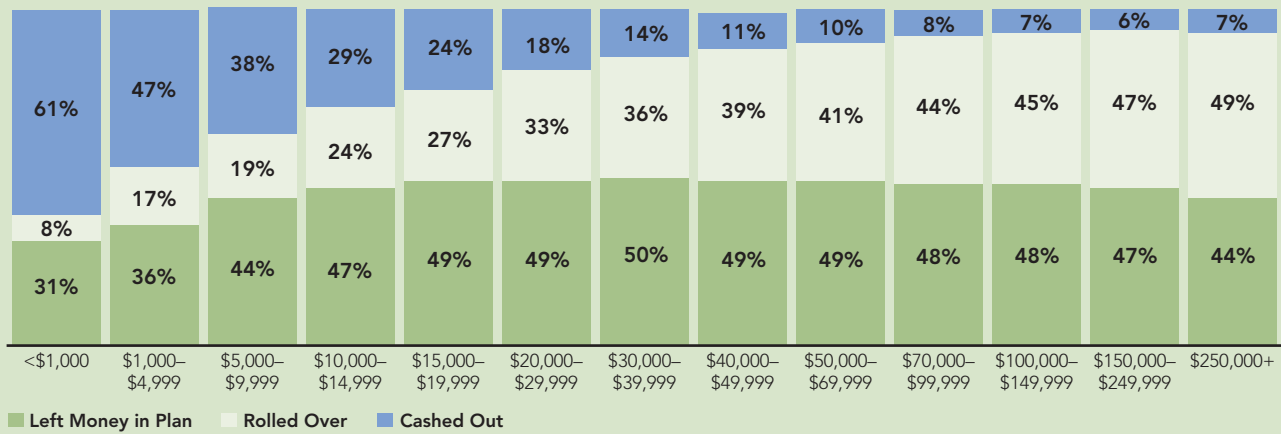
Note: Uses 2008 annualized compensation from our nondiscrimination testing dataset. Participants with unknown compensation are excluded from the above chart; as such, the percentages are close to, but do not exactly match, those in other charts in this report. Numbers have been rounded to the nearest integer percent.



Cash-outs: Key concern over who takes them (continued)

Among participants with low account balances, the cash-out rates were 61% and 47% for those with DC plan balances of less than \$1,000 and \$1,000–\$4,999, respectively.⁵ In contrast, the cash-out rate for participants with higher balances, those with more than \$100,000, was only 7%. Rollover and stay-in-plan rates also increase with account balances (Exhibit 9).

Exhibit 9: By account balance

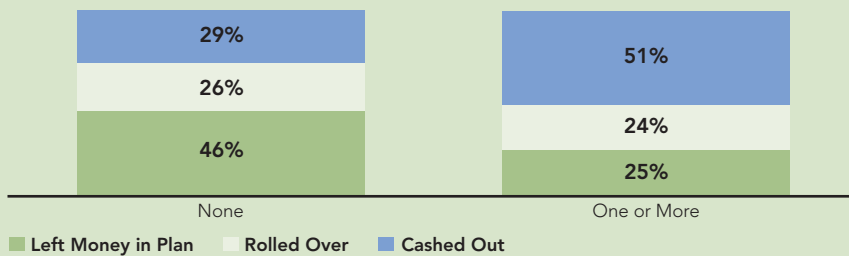


Cash-out rates for those with loans outstanding are 1.8 times higher than for those who don't have a loan (51% versus 29%). This result is not unexpected, given that the taking of a loan indicates a need for cash. Stay-in-plan rates are the opposite (Exhibit 10).

Finally, our analysis shows that terminated participants of small plans have lower overall one-year cash-

out rates than those of larger plans (22% for plans with fewer than 25 participants and 35% for plans with more than 25,000 participants). In addition, terminated participants of smaller plans tend to have higher rollover and stay-in-plan rates than those in larger plans.

Exhibit 10: By outstanding loans



Note: numbers have been rounded to the nearest integer percent.

Moving forward

Fidelity believes that leakage from DC plans is repairable without the need for a radical overhaul or increased oversight. Recommended action plans center on two key areas—modifications to plan design and enhanced efforts to better educate employees on the importance of keeping their account balances intact despite the many temptations to borrow or withdraw from their workplace savings account when under financial constraints.

Employers can take these steps:

Loans

- *Consider allowing only one outstanding loan at a time.* This plan design option would allow participants access to their savings for extreme situations, while helping to prevent abuse or overuse.
- *Evaluate your participants' loan use.* The purpose is to identify whether additional targeted communications and education are needed. Are there signs that your employees could benefit from better guidance on how to manage their personal finances?

Hardship Withdrawals

- *Review the number and/or percentage of participants in your plan who are requesting a hardship withdrawal.* How does this number compare with other plans in your industry or of similar size? If your plan is above the norm, perhaps your employees could benefit from renewed efforts and attention on retirement education.
- *Identify whether the same people are taking hardship withdrawals repeatedly.* If so, they might benefit from one-on-one financial counseling aimed at resolving their current situation and building positive long-term financial habits.
- *Consider offering only safe-harbor hardship withdrawals rather than facts and circumstances.* This could help provide some additional discipline or structure regarding access to hardship withdrawals—which in turn can help limit this type of participant activity.
- *Point to alternatives.* There may be other ways for participants to resolve short-term financial needs without borrowing from their retirement savings and taking from their future financial security to resolve current difficulties.
- *Make sure your employees understand the risks.* Penalties and taxes can apply to withdrawals—and to loans if not repaid in a timely manner. In addition, as the U.S. Government Accountability Office (GAO) pointed out in its report, *401(k) PLANS: Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings*, August 2009, "Few plans provided [participants] with information on the long-term negative implications that leakage can have on their retirement savings, such as the loss of compounded interest and earnings on the withdrawn amount over the course of a participant's career."

Cash-outs

- *Make sure participants know their options by providing them with thorough, effective guidance and education.* As with loans and hardship withdrawals, lack of understanding about the risks and drawbacks to cash-outs can be devastating for the long-term financial security of participants.



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¹One-year periods covering 2000–2010 were analyzed. The analyses were limited to continuous qualified corporate DC plans. In the analysis of the one-year period ending 6/30/2010, 646,000 terminating participants in 11,000 plans were analyzed.

²For the 4% of participants who both cashed out and rolled over portions of their DC plan assets, they were categorized based on whichever category was of a larger withdrawal amount for the one-year period for them.

³Ages and account balances are as of the beginning of the one-year period.

⁴Bureau of Labor Statistics, as of January 2008.

⁵Many plans may have a de minimis threshold of \$5,000 or less, causing an automatic rollover of an account balance into an IRA for those participants who do not meet de minimis requirements. Our data includes de minimis–impacted participants as well as those who made a conscious decision to cash out of their account.

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