Securing the Promise of Retirement: Addressing Leakage in Defined Contribution Plans

Defined contribution (DC) plans play a crucial role in helping Americans build a secure financial foundation for retirement. However, the DC system must evolve to align with the realities of modern economic pressures and a changing workforce. One of the critical challenges facing the system today is "leakage," the premature withdrawal of retirement funds. As we will explore, leakage indicates deeper systemic issues within the DC system. Fortunately, plan sponsors have the opportunity to help address this challenge with innovative solutions and forward-thinking approaches.

Why Leakage Happens: The Human and Structural Factors

At its core, leakage occurs when a framework designed for stable, lifelong employment confronts the realities of today's economy—marked by a fragmented recordkeeping system, high job turnover, and financial hardship. To fully grasp the issue, let's examine its primary drivers:

1. **Cashouts: The Path of Least Resistance.** When individuals leave their jobs, they face a choice: roll over their retirement savings into a new plan or an IRA, or opt for a lump-sum cashout. For many—particularly those with smaller account balances—the process of rolling over funds can be unnecessarily complex and confusing, discouraging even those who wish to preserve their retirement savings (Cormier, 2013).

   This challenge is compounded by most DC plans enforcing automatic cashout rules for small balances after separation from employment (Vanguard, 2024)—a measure primarily aimed at reducing administrative burdens for plan sponsors while minimizing the risk of stranded participant accounts. Cashouts cost the retirement system up to an estimated $105 billion annually (Savings Preservation Working Group, 2019), eclipsing all other sources of DC plan leakage.

2. **Loan Defaults: A Debt Spiral.** For those grappling with financial hardship, loans against DC plans present a less daunting alternative compared to high-interest retail credit. However, when employees lose their jobs, they are often required to fully repay any outstanding DC plan loans soon after. Those unable to do so are forced to default on their debt, often triggering additional tax penalties. According to one study, among participants terminating employment with outstanding loans, 86% failed to repay their loans at separation (Lu, 2017). Loan defaults drain an estimated $25 billion per year from the retirement system (Employee Benefit Research Institute, 2022).

3. **Hardship Withdrawals: Emergency Relief at a Cost.** Hardship withdrawals offer immediate access to funds during emergencies. However, they come with notable drawbacks, including taxes, penalties, and the inability to repay the withdrawals back to the plan.

   Hardship withdrawals contribute relatively modestly to overall leakage today, accounting for an estimated $9 billion annually (Employee Benefit Research Institute, 2022). Encouragingly, with the recent introduction of expanded emergency access provisions through the SECURE 2.0 Act[i], participants may now repay withdrawn amounts in certain circumstances, potentially reducing long-term leakage.

Figure 1: Magnitude of Annual Leakage

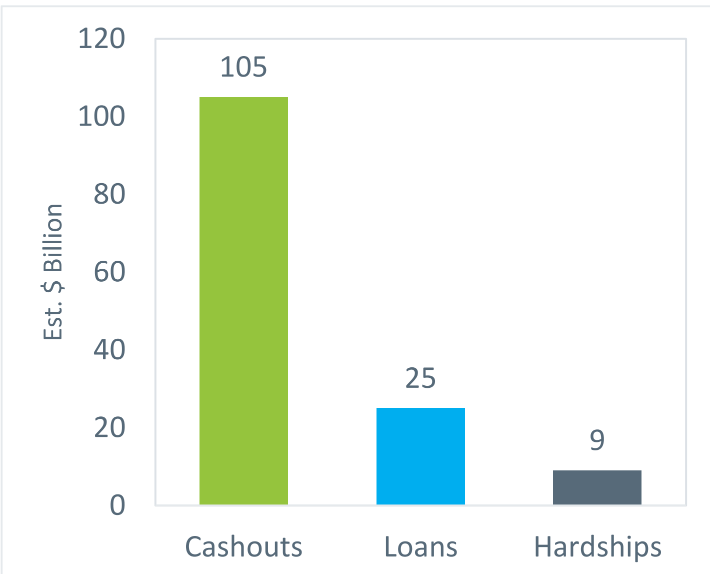

Figure 2: Usage in Plans

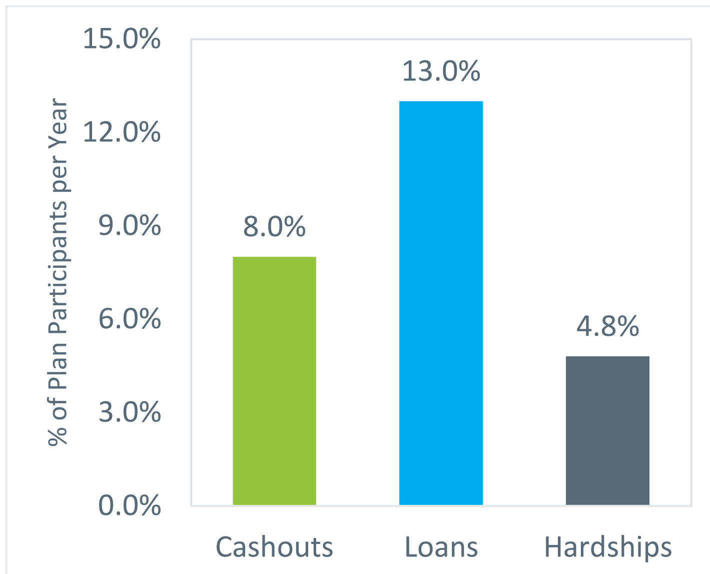

Chart Sources: Employee Benefit Research Institute, 2022; Savings Preservation Working Group, 2019; Vanguard, 2025.

Leakage in Context: Practical Steps to Close the Gaps

The persistence of leakage serves as a stark reminder that the US DC retirement system has yet to fully adapt to today's economic realities. The good news is that there are concrete steps plan sponsors can take to mitigate leakage and safeguard participants' retirement prospects.

1. **Simplify Rollovers.** Reducing cashouts after job separation could remove one of the largest barriers to retaining savings during job transitions. While much of the reluctance to roll over assets between employers is driven by "friction" within recordkeeping systems and complex rollover procedures, demystifying the process through easy-to-follow instructions and better communication from plan sponsors could go a long way in supporting rollovers.

2. **Adopt Auto-Portability.** Auto-portability is a new service that enables the automatic transfer of small balances from a former employer's retirement plan to the new employer's without incurring a tax penalty. Currently being implemented by several major recordkeepers[ii] in the US, this service could be a game changer. By automatically rolling over these funds between employer plans, auto-portability promises to address the root cause of most cashouts, while still giving participants a choice to opt out and cash out their funds instead.

3. **Facilitate Loan Payments.** Offering terminated employees flexible repayment options (such as establishing an ongoing direct debit through the recordkeeper) could help mitigate loan defaults and preserve savings.

4. **Leverage New Emergency Withdrawal Provisions.** The SECURE 2.0 Act introduces several new options for emergency withdrawals that allow participants to repay them over three years. These measures could cushion the impact of hardship withdrawals, reducing their long-term damage to participant retirement accounts.

5. **Prioritize Financial Literacy.** Educating participants about the full cost of leakage—and the long-term benefits of preserving tax-advantaged retirement savings—is critical. Financial literacy should be seen as a core component of plan design and participant communication strategies.

It is tempting to frame leakage as a byproduct of poor financial planning or decision-making by participants, but the reality is far more complicated. While recent legislative and recordkeeper changes have addressed some of these issues, plan sponsors can also play an important role in minimizing leakage in DC plans and ensuring that DC plans deliver on the promise of providing a secure foundation for a dignified retirement.

Endnotes

[i] The SECURE 2.0 Act introduces new emergency withdrawal options for specific hardships, life events, and natural disasters. These provisions generally eliminate the tax penalties and allow participants to repay withdrawn amounts within a three-year window, helping to mitigate long-term leakage. By offering limited, capped access to retirement savings, these options address the needs of vulnerable populations and may encourage greater saving. This approach can enhance financial security, build trust in retirement plans, and ultimately encourage a greater long-term savings commitment.

[ii] The Portability Services Network (PSN), established in 2022 by a consortium of recordkeepers in partnership with Retirement Clearinghouse (RCH), aims to promote the adoption of auto-portability among plan sponsors that utilize participating recordkeepers. Notably, recordkeepers within the PSN do not receive compensation for facilitating auto-portability. Fidelity, Vanguard, Alight, Empower, Principal, and TIAA are members of the consortium. The service is currently available on a limited basis across some participating recordkeepers, however, broader implementation is anticipated in the coming years.

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