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Do Vesting Schedules Enhance Retention?

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IRS rules require defined contribution plans to immediately vest employer contributions or use a cliff or graded vesting schedule. A cliff vest is a schedule in which employer contributions are vested all at once at a point within 3 years of a participant's eligibility. A graded vest is a schedule in which the participant is vested gradually over six years. A plan may also use cliff and graded schedules that are more generous than the minimums.

Vesting and Retention

Vanguard data from 2024 shows that 49% of plans use an immediate vesting schedule, with the rest using either graded or cliff with varying service requirements. The most popular alternatives were a five-year graded schedule with 16% of plans, and a three-year cliff with 9% of plans.

Vanguard analyzed 4.7 million separations across 1,500 Vanguard administered plans between 2010 and 2022.

"Employers who use vesting schedules are often motivated by a desire to retain workers and recoup costs from short-tenured employees," according to Vanguard, but "Our research finds that vesting does not provide a systematic retention benefit and recoups a modest 2.5% of employer contributions for the average plan."

"Forfeitures occur in 30% of job separations, are most common among lower-income participants, and represent 40%, on average, of the affected participants' final account balances," the report adds.

Though losing unvested contributions when leaving an employer can damage a worker's retirement security, "we find that vesting requirements do not affect workers' decisions to leave their jobs."

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“One potential explanation for the lack of retention effects is that many 401(k) participants are unaware of vesting requirements. In a recent survey of current participants in Vanguard administered plans, we found that only 33% of respondents could correctly state whether their plan has a vesting schedule,” Vanguard explained.

To test this, Vanguard examined if workers were more likely to leave their jobs one month after their vesting date compared to one month before. If vesting works as a retention tool, there ought to be a gap such that workers are less likely to leave immediately before their vest date. Vanguard found that this was not the case.

Vanguard noted that the three-year vesting schedules “are the longest type of cliff schedule permitted under federal law. Therefore, the 0%-to-100% jump in employer contribution ownership at the three-year mark represents the largest one-time ownership grant and the strongest retention incentive across all 401(k) vesting schedules.”

The authors went further and tested workers with different vesting schedules within the same plan and found the same results: vesting schedules did not have a significant effect on retention.

Aaron Goodman, the lead author of the report, and Fiona Greig, the global head of investor research and policy in Vanguard's Investment Strategy Group, say that “Some plan sponsors who use vesting for retention purposes may find our results informative. And even if vesting doesn't promote retention, it does help contain costs to a limited extent.

Benefits of Immediate Vesting

Vanguard argued that an immediate vest can bring benefits to participant and sponsor alike.

From the participant side, an immediate vest can shore up their retirement security, since employer contributions often make up a key component of their total balance.

rom the sponsor side, an immediate vest reduces the administrative cost of tracking employee tenure and implementing a schedule, it “could reduce compliance costs by making it easier to obtain safe harbor from annual nondiscrimination testing.”