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CAN WE DO MORE TO KEEP SAVINGS IN OUR RETIREMENT SYSTEM?

HEARING

OF THE

COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS

UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING KEEPING SAVINGS IN THE RETIREMENT SYSTEM

MARCH 19, 2013

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CAN WE DO MORE TO KEEP SAVINGS IN THE RETIREMENT SYSTEM?

TUESDAY, MARCH 19, 2013

U.S. SENATE,
COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS,
Washington, DC.

The committee met, pursuant to notice, at 2:30 p.m., in room SD–430, Dirksen Senate Office Building, Hon. Tom Harkin, chairman of the committee, presiding.

Present: Senators Harkin, Enzi, Alexander, Warren, Murphy.

OPENING STATEMENT OF SENATOR HARKIN

The CHAIRMAN. Good afternoon. The Senate Committee on Health, Education, Labor, and Pensions will come to order. I want to welcome everyone to the latest in our ongoing series of hearings focusing on retirement security. I think we've been doing this now for over 2 years. Today, we're going to take a closer look at an issue that has been in the news a lot recently, namely, whether we're letting too much of our retirement savings leak out of the system. It's an important issue, because we're facing a retirement crisis in this country.

Whether it's a young family struggling to pay off student loan debt and save for their children's education and put something aside for their own retirement, or someone whose body just can't handle the stress of work any longer, Americans are terrified that they will not have enough money to live on when they stop working, and they're right to be scared. As we learned in our last hearing on this topic, most people simply are not saving enough for retirement, and the dream of a secure retirement is growing more and more remote for middle class families.

The retirement income deficit, that is, the difference between what people have saved for retirement and what they should have saved, is estimated to be as high as $6.6 trillion. Half of Americans have less than $10,000 in savings. We have an obligation to address this retirement crisis, so I've made improving the retirement system a top priority of this committee.

Last year, I proposed to provide universal access to a new type of privately run pension plan called a USA Retirement Fund that would ensure that everyone has the opportunity to earn a pension benefit they can't outlive. I'm hopeful that together with my colleagues on this committee we can move a bill this year that helps middle class families save for retirement.

However, addressing the retirement crisis means not only helping people save enough for retirement, but also ensuring that the money is still there at retirement. All too often, people cash out their retirement accounts well in advance of their retirement years. This is especially true when people change jobs, because it's often easier to withdraw from a 401(k) and pay the penalty than to go through all the trouble of rolling over the balance to a new plan or an IRA.

Most 401(k) plans allow people to borrow against their savings. It's common for people to use their 401(k}s for all kinds of things unrelated to retirement, for down payments on a new house, for education, to cover medical expenses, et cetera. Now, I'll be the first to admit that giving people access to their retirement savings is not all bad. There is some evidence that loans may actually increase participation in these plans, plus there's no question that it can be better to borrow from your 401(k) than to take out a high interest payday loan.

But that said, I'm extremely worried that 401(k}s are becoming just a savings account rather than a retirement plan. The whole reason we encouraged employers to offer 401(k) plans in the first place was to prepare people for retirement. We know that when people run out of money when they get old, they see their living standard decline, they become a burden on their families, they lean more and more on the social safety net, squeezing government at all levels.

So it's abundantly clear that 401(k) contribution rates are already too low. And it's troubling that leakage could be taking a toll on America's already meager retirement accounts. Today, our aim is to get a better handle on the extent of the leakage problem and explore whether there are ways to keep more money in the system. I know that one of our colleagues, Senator Enzi, has already done a lot of thinking along those lines, and I applaud him for all the work that he has done on this issue.

I also want to encourage everyone who works with retirement plans to get creative. We'll hear some ideas today, but a lot more thinking needs to be done on this subject of having a good, secure retirement system that will be there when people retire, a pension, so they can't outlive it.

We have an excellent panel of witnesses. It should be an informative discussion. I thank you all for being here today, and I yield to my colleague, Senator Alexander.

Opening Statement of Senator Alexander

Senator ALEXANDER. Thanks, Mr. Chairman and Senator Warren, and thanks to the witnesses for coming today. We look forward to your comments.

Senator Harkin and Senator Enzi, who was the ranking Republican before I was, have done a good deal of work on this. Senator Enzi and Senator Isakson on this side of the aisle have both done some thinking on this and will have some legislation. I think Senator Harkin outlined what we're here today to hear, and I don't need to rehash it.

Basically, we want to know if people will have enough money when they retire. How much should that be—some advisors would say as much as you can—and what are the guidelines that you think are useful for us to hear about? I know that one company suggests a rule of thumb called the eight times plan—have savings of eight times your annual income by the time you retire. So if you make $50,000 a year, that would be $400,000 in the bank by the time you retire at age 65.

Yet if you were to have $400,000 in the bank and you retired at age 62, it helps to see what amount of money that would produce on a monthly basis. One of the things that we try to think about here is how to encourage Americans to think about these issues rather than trying to order them to do specific things with their own money.

I've noticed on the Senate Thrift Savings Plan each year that on my retirement account statement, there's a little number on it that says, if I were to retire with this current account balance, this is the annuity I would receive for the rest of my life. That's very interesting to me. It's printed in pretty bold letters. It stood out, and it got my attention. And I wonder how often that is printed on information that employees receive about the amount of money they have in their retirement accounts.

Senator Harkin mentioned the different reasons that savers take money out of their accounts. They're all valid reasons. It's their money. But it becomes a national issue if too many Americans end up without enough money to help them when they retire.

Today we have a distinguished panel of witnesses. I look forward, Mr. Chairman, to hearing their comments and having a chance to ask questions.

The CHAIRMAN. Thank you very much, Senator Alexander.

We have an excellent panel of witnesses today, people who have done a lot of thinking. I read through your testimony last evening. We'll hear first from Dr. Matt Fellowes, the CEO of HelloWallet. Prior to founding HelloWallet, Dr. Fellowes was a fellow at the Brookings Institute where he specialized in consumer finance.

Second will be Alison Borland, Vice President of Retirement Solutions and Strategies at Aon Hewitt, where, among other things, she oversees the retirement research team. She is also a frequent author and speaker on retirement issues.

Now I'll yield to Senator Warren for an introduction of our next panelist.

STATEMENT OF SENATOR WARREN

Senator WARREN. Thank you, Mr. Chairman. I want to welcome Dr. Christian Weller, who is Professor of Public Policy and Public Affairs at the University of Massachusetts in Boston and a Senior Fellow at the Center for American Progress. Dr. Weller got his Ph.D. in economics from UMass Amherst. And pension work runs in the family. His wife, Beth Almeida, is also a recognized scholar on pensions.

I don't know with a new baby and another baby on the way whether or not you're going to grow another generation of pension experts. But I'm delighted that you're here. And I should say when I was still teaching at Harvard, Dr. Weller and I had many, many spirited lunches talking about retirement pensions, the economics of America's middle class, and I found him always to be thought provoking and a good partner in any conversation.

Welcome, Dr. Weller.

The CHAIRMAN. Thank you very much, Senator Warren.

Your statements will all be made a part of the record in their entirety. We'll start with Dr. Fellowes. If you could sum up in 5 minutes or so, we'd sure appreciate it.

Dr. Fellowes.

STATEMENT OF MATT FELLOWES, Ph.D., FOUNDER AND CHIEF EXECUTIVE OFFICER, HELLOWALLET, WASHINGTON, DC

Mr. FELLOWES. Thank you. Chairman Harkin, Chairman Alexander—I'm sorry—Ranking Member Alexander, Senator Warren.

Senator ALEXANDER. That's OK.

[Laughter.]

Mr. FELLOWES. Thank you for the invitation to testify today. My name is Matt Fellowes, and I am the founder and CEO of HelloWallet, which is a software company that helps employers improve their compensation and benefit outcomes by providing individualized guidance to their employees about their paychecks and benefits.

Prior to HelloWallet, I was at the Brookings Institute, and I also taught at Georgetown and George Washington in their graduate programs. I ultimately decided to leave Brookings because I discovered new technology that could be used to democratize for the first time independent, personalized guidance to U.S. workers.

This was during the mortgage foreclosure crisis when I decided to leave Brookings and work on this, when I was advising numerous elected officials about the fact that 5 million people had bought homes that they were never realistically ever going to be able to afford to keep. That dynamic of U.S. workers having difficulty making good decisions about their paychecks is played out every day in every consumer finance market and every employer benefit market in America. With this new technology, I saw an opportunity to create a scalable solution to this really systematic problem in the U.S. economy.

But I'm here today, specifically, because throughout 2012, I talked to a lot of different plan sponsors. And one of the things I learned is that there are plans today where a majority of the participants in the 401(k) plans, over 50 percent, will cash out their entire 401(k) balances within 5 years of starting their plan, even though in each of those cases, the savings deferral rates have been going up in the plan, the participation rates have been going up in the plan, and the assets under management have been going up in the plan.

I became curious about whether this was a general phenomena in the 401(k) market, and I put my academic hat back on and looked at data from the Federal Reserve and IRS and the Census Bureau. What I found, ultimately, is that about 25 cents of every dollar now that's contributed into a 401(k) plan will be taken out for non-retirement purposes. So with such a large amount now going to non-retirement spending needs, it really is fair to your point, Chairman Harkin, that the 401(k) is becoming an everyday savings account for workers and really not the retirement account it was designed to be.

Since I left Brookings, to be frank, I'm really not involved in the day-to-day policy details of the subject for today's hearing. But I am asked almost weekly by businesses for advice about how to improve their benefit programs and their 401(k) programs. So I thought it would be helpful if I shared just a couple of things that I share with them.

First, I always stress that we need better measures of success for these programs. If 401(k}s are ultimately about the retirement readiness of the participant and, for sponsors, about their ability to attract and retain talent, then those should be the measures of success and not just ultimately the 401(k) balance, which is really only one measure.

Second, my advice is to address the underlying causes of early withdrawals and low savings rates. In our research, we found that workers were much more likely to withdraw from their 401(k}s if they didn't have a budget—about 80 percent of U.S. households don't even budget—or if they lacked three or more months of their monthly income in an emergency savings account, which is about 85 percent of U.S. households.

To see why this is the case, I like to use a step ladder as a metaphor for what's going on in the market. Today, we have a large percentage of workers that are saving for retirement, which I consider a rung that is at the top of the ladder, because they reach that at the end of their career. But underneath that top rung, there are missing rungs which are just as fundamental to retirement security.

Few people have budgets, for instance. Few have emergency savings. Few have college savings. Few have vacation savings. Few have car savings and so on. And those are just as critical to retirement security, that people reach those rungs on the ladder before retirement.

What's happened today as a result is that you've got a large share of U.S. workers kind of dangling at the top of the ladder with sufficient retirement savings or a lot of retirement savings, but they don't have those lower rungs of the ladder filled out. So my advice is ultimately that we put as much attention on helping workers make better paycheck decisions as we do helping them with investment decisions, because, ultimately, workers who make better paycheck decisions can have many more times an impact on the retirement security than just even the best investment advice.

The bottom line is that I think what we've learned is that we can automate good retirement savings referral rates. We can automate good participation rates. But you cannot automate retirement readiness. For that to happen, we've really got to engage employees in their day-to-day decisions that they're making about finances and provide independent solutions to help them make better paycheck decisions on a day-to-day basis.

Finally, I'd just like to thank you, Chairman Harkin, for your years of leadership on this issue. And thank you again to all of you for the invitation to be here today.

[The prepared statement of Mr. Fellowes follows:]

PREPARED STATEMENT OF MATT FELLOWES, PH.D.

THE RETIREMENT BREACH IN DEFINED CONTRIBUTION PLANS: SIZE, CAUSES, AND SOLUTIONS

SUMMARY

For every $1 that is annually deposited into 401(k) and other Defined Contribution (DC) plans every year, approximately $.25 is now withdrawn for non-retirement spending, adding up to about $70 billion in annual withdrawals. Among participants that are younger than 55, up to $.45 of every $1.00 deposited is withdrawn prior to retirement every year for non-retirement spending. About 15 percent of that withdrawn money is in the form of temporary loans, the bulk of which will be repaid. The vast majority of withdrawn funds, however, is in the form of lump-sum cash-outs, which are permanent withdrawals of retirement savings.

Using Federal Reserve data, we considered numerous reasons why households are using their 401(k) and other DC savings for non-retirement spending. The strongest predictors that a participant will use their retirement savings for non-retirement savings is if they (a) do not actively budget (approximately 80 percent of U.S. households) and (b) do not have 3 or more months of emergency savings (approximately 85 percent of U.S. households). Other issues, such as age, income, and educational attainment are also related to this decision.

We also use Census Bureau data to determine the reasons participants self-report that they take money out of their 401(k) and other DC plans for non-retirement needs. Over 50 percent report that they withdraw these funds to pay bills, loans, and other debts; only 7 percent report that they take out this money because they have been laid-off.

These findings indicate that employers are subsidizing an expensive retirement benefit that a large, and growing, share of workers do not use for retirement, signaling a broader misalignment between the advanced financial needs subsidized by employers and the basic, unmet financial needs of workers. Furthermore, because retirement plan breaching is often not among the metrics reported by plan managers, this growing problem is largely invisible to employers sponsoring retirement benefits.

RECOMMENDATION

Among our recommendations, we suggest that attention be given to the (a) data that corporate plan sponsors need to better manage the efficacy and ROI from their retirement investments, (b) the guidance needed to help sponsors improve the access their participants have to independent, holistic, financial guidance and management, which is the foundation of retirement success, and (c) the plan flexibility needed for sponsors to address the basic emergency savings needs of workers alongside their longer term retirement savings needs.

For further information, contact Matt Fellowes at 202–803–5262 or matt@hellowallet.com.

Chairman Harkin, Ranking Member Alexander and members of the Committee on Health, Education, Labor, and Pensions, thank you for inviting me to testify today about the opportunity to help Americans improve their retirement security.

My name is Matt Fellowes, I am the founder and CEO of HelloWallet, a Washington, DC-based Software Company that helps firms improve their benefit and compensation outcomes by providing independent guidance to workers about their benefits and finances. Prior to founding HelloWallet in 2009, I was an academic at The Brookings Institution, and also taught at Georgetown and George Washington Universities here in Washington. I decided to leave Brookings when I discovered new technology and behavioral psychology insights that can be used to democratize access to independent, personalized financial guidance. This was during the mortgage foreclosure crisis when I was advising Governors and the Bush administration about how to respond to the fact that 5 million people had willingly bought homes that they never were going to be able to afford. I saw an opportunity to create a proactive solution to a systematic problem, so I decided to become an entrepreneur and founded HelloWallet.

I'm here today because of conversations I had throughout 2012 with numerous plan sponsors about the health of their defined contribution plans. Among the things I learned in those conversations, is that there are plans today where a majority of participants will cash-out their entire 401(k) balance within 5 years of signing-up, even though in each of those cases the savings deferral rates had increased, the participation rate had increased, and the assets under management had increased. In fact, those data were just a mirage of retirement savings success because underneath those numbers, there was a massive amount of turnover and churn—the majority would not actually be using all or some of their savings for retirement.

I decided to figure out whether the story that these data were telling me were generalizable to the entire defined contribution market, or just isolated to those plans. So, I put my academic hat back on and examined Federal Reserve, Census Bureau, and IRS data so I could better understand the problem these plan sponsors were encountering.

Mr. Chairman, what I learned is that a large and growing number of defined contribution participants are using their defined contribution plans for non-retirement spending needs. In particular, I learned that for every $1 that is annually deposited into 401(k) and other defined contribution plans; approximately $0.25 is now withdrawn for non-retirement spending. Among participants that are younger than 55, up to $0.45 of every $1.00 deposited is withdrawn prior to retirement every year for non-retirement spending. Now, about 15 percent of that withdrawn money is in the form of temporary loans, the bulk of which will be repaid. The majority of withdrawn funds, however, are in the form of lump-sum cash-outs, which are permanent withdrawals of retirement savings. And, no short-term spending needs should ideally be addressed by relying on a long-term savings vehicle like the 401(k).

Now, since I left Brookings I am no longer working in the day-to-day policy details of the subject for today's hearing nor other public policy issues that I used to be involved in for that matter. Nonetheless, large employers ask me weekly for practical business ideas to keep savings in the retirement system, outside of policy. They also ask me how to increase savings into those plans. So, Mr. Chairman, I thought it would be useful for you to hear what I tell them they can do to keep more savings in the retirement system.

First, my advice is to accumulate more data about their plans. If these plans are supposed to be about improving retirement readiness, then the measure of success should not be confined to just 401(k) savings data. The median household near retirement has 10 accounts, and the 401(k) is just one of those. So, I stress that the measure of success should include data on the actual retirement readiness of the workers and the ROI that the company is getting from that retirement investment. That helps sponsors understand what participants the plan is helping, what participants it is not helping, and what specific, and personalized, steps need to be taken to improve program outcomes. Sponsors, in short, need a management dashboard to understand their employees' retirement readiness, not just their retirement program performance.

Second, when participants are not saving enough or, worse, taking money out of their plans for non-retirement spending needs, my advice is to address the underlying causes. In our research, we found that the strongest predictors that a participant will use their retirement savings for non-retirement purposes is if they do not actively budget—which is approximately 80 percent of U.S. households—and if they do not have three or more months of emergency savings—which is approximately 85 percent of U.S. households. Both findings make sense. If workers are not budgeting, its not realistic for us to expect to progress on retirement readiness.

To see why this is the case, I find that a ladder is an effective metaphor. Today, we have a large percentage of workers that are saving for retirement, which I consider a top rung of the ladder that individuals reach because it occurs at the end of a worker's career. But, underneath that top rung, there are missing rungs that people lack, which are fundamental to retirement security. Few people have budgets, for instance, which is a critical step on the ladder because it helps workers control their debt, spend less than they make, and save for other things in life that they need. Likewise, few have adequate emergency savings, few have college savings, few have savings for home ownership and many have high interest credit card debt, all of which are rungs on the ladder that people reach before they retire. What has happened as a result is that you have a large share of U.S. workers that are dangling from the top of the ladder with retirement savings, but they lack any foundation underneath them because they don't have the other rungs of the ladder to stand on. This is why the 401(k) is losing so much money every year to non-retirement spending. It's not a matter of insuring against the risk of falling off the ladder; it's that there are not enough rungs on the ladder to begin with.

Companies can address this market dynamic by giving more attention to the foundations of retirement success, which include making good day-to-day financial decisions, managing debt in a healthy manner, saving for other goals, and so on. In short, I advise that as much attention is given to how the entire paycheck is allocated as companies currently give to retirement investment allocation. Effectively allocating monthly income, after all, has many, many times greater an effect on retirement security than even the best investment allocation.

The bottom line of my advice, Mr. Chairman, is that we have learned that sponsors can automate higher 401(k) and defined contribution plan balances, investment decisions, and savings deferral rates. But, we cannot automate retirement readiness. For that to happen, we need to engage workers in their day-to-day decisions, and provide independent solutions to help them make more optimal choices for their own retirement security.

Mr. Chairman, I'm including a copy of the aforementioned research, "The Retirement Breach in Defined Contribution plans" and a 1-page summary with my written testimony. Thank you for your leadership on this issue and thank you for the opportunity to participate in today's panel.

The above referenced material may be found at *http://www.hellowallet.com/research/retirement-breach-defined-contribution-plans/*.

The CHAIRMAN. Thank you very much, Dr. Fellowes. I appreciate that.

Ms. Borland, please proceed.

STATEMENT OF ALISON THOMAS BORLAND, FSA, VICE PRESIDENT, RETIREMENT SOLUTIONS AND STRATEGIES, AON HEWITT, LINCOLNSHIRE, IL

Ms. BORLAND. Thank you. Chairman Harkin, Ranking Member Alexander, and members of the committee, my name is Alison Borland, and I'm honored to be here today representing Aon Hewitt to discuss retirement plan leakage. We have a unique perspective as the largest independent provider of retirement plan administration services, serving more than 14 million plan participants.

The employer-provided system plays a critical role in helping Americans retire. Significant progress has been made to increase savings through automatic enrollment and contribution escalation, reduced fees, and solutions to help workers make smart decisions. Working against these efforts is leakage or taking funds out prematurely. Our research shows that for every dollar contributed to DC plans today, approximately 20 cents leak out.

Leakage occurs primarily in three ways. First, withdrawals are taken during active employment. Second, loans are taken out and aren't repaid in full. And, third, retirement savings are cashed out upon a job change. I'll talk about the first two briefly, discuss cashouts, and then present recommendations to improve the situation.

First, withdrawals. Our research shows that hardship withdrawals are used by about 2 percent of plan participants each year, and they are used for dire need. They're not being abused. Other withdrawals are made on or after age 59½, perhaps as a part of a phased retirement approach, or they are a withdrawal of aftertax dollars. While they should be appropriately managed and monitored, they are not the worst culprit behind leakage today.

Second, we'll address loans. Loans are widely available in DC plans, and they are used frequently. Significant risk to retirement security occurs when participants default on the loans, which often occurs because loans become payable in full generally within 60 days of termination.

At the same time, loans play an important role because they attract workers who may not otherwise save. Loans also enable workers to access credit without causing them to miss employer matching contributions or, even worse, take a permanent withdrawal. The key to curbing leakage due to loans is to reduce the defaults.

Third, cash-outs. Cash-outs cause a complete and total eradication of retirement savings. Cash-outs occur when workers receive a distribution of their balance after a job change and can occur both in DC plans, defined contribution plans, and in defined benefit plans when benefits are offered in a lump sum. Small balances are much more likely to be cashed out, putting frequent job changers at heightened risk.

Consider the following example. A typical participant retires after saving for 30 years. During her tenure, she changes jobs three times. If assets are retained in the system, when she retires she'll have $872,000. If on the other hand she cashes out her assets with each job change, she retires with only $189,000. Cashing out due to these job changes will cost her more than three-fourths of her retirement nest egg. It's devastating.

In our experience, cash-outs receive the least attention despite the high prevalence and the magnitude of the damage. Decreasing cash-outs is a very important opportunity to increase overall financial security for American workers.

So with that, I suggest 10 recommendations to reduce leakage while balancing the need for flexibility and access for workers. No. 1, modify the types of contributions available for loans and withdrawals, such as allowing them based on employee savings only, not employer contributions. No. 2, consider requiring some to all of an employee's balance to remain within the tax-preferred system until retirement, absent dire need.

No. 3, consider waiting periods before a second loan or withdrawal can be taken. No. 4, support easier repayment of loans following termination of employment, especially upon involuntary termination. No. 5, increase the penalty for withdrawing money from the tax-preferred system, absent dire need, up to 15 percent or even more.

No. 6, allow flexibility to DB-plan sponsors to eliminate lump sum options. Consider encouraging this through funding flexibility and/or reduced PBGC premiums. No. 7, encourage lifetime income regardless of plan design. No. 8, promote the employer system. While in a qualified employer plan, participates often benefit from lower fees, professional management, tools and education, advice, and fiduciary protections.

No. 9, simplify the process of cashing in dollars from one qualified plan to another or from IRAs into qualified plans.

No. 10, provide education and resources to improve overall financial literacy.

We appreciate the opportunity to share our recommendations with the committee and are pleased to offer our data, resources, and expertise to continue efforts that will help improve retirement security for all Americans. Thank you.

[The prepared statement of Ms. Borland follows:]

PREPARED STATEMENT OF ALISON THOMAS BORLAND, FSA

Mr. Chairman, Ranking Member Alexander and members of the committee, thank you for the opportunity to submit this statement for the record.

Aon plc. is the leading global provider of risk management, insurance and reinsurance brokerage, and human resource solutions and outsourcing services. We have 65,000 colleagues in 120 countries around the world. Aon has been named repeatedly as the world's best broker, intermediary, reinsurance intermediary, captives manager and best employee benefits consulting firm by multiple industry sources.

As the global leader in human resources solutions, Aon Hewitt is the largest independent provider of administration services for retirement plans, serving more than 14 million retirement plan participants in the United States. We have more than 7,500 retirement professionals dedicated to helping plan sponsors maximize retirement outcomes for their employees, manage risk and control total plan costs. My name is Alison Borland, and I am the vice president of Retirement Solutions & Strategies at Aon Hewitt. I am honored to be addressing the committee today to discuss retirement plan leakage and opportunities to improve the retirement security of Americans.

The employer-provided retirement system plays a critical role in helping Americans meet their financial needs. Our research of predominately large corporations shows defined contribution (DC) plans are now the primary source of retirement income for Americans at three-quarters of employers, up from 67 percent in 2009[1] and just 41 percent in 1999.[2] This has largely shifted the risk and responsibility of planning for retirement on to the shoulders of workers, which has proven to be a challenging task for many Americans.

Our research shows that only 29 percent of American workers are projected to meet 100 percent of their needs in retirement.[3] While many factors contribute to this savings shortfall, as more people rely solely on a DC plan for their employer-provided retirement income, the risk to individuals and society is growing.

Significant progress has been made to increase savings through techniques such as automatic enrollment and automatic contribution escalation. More employers are reducing fees for participants and hence, improving returns and offering solutions to improve the effectiveness of investments. Working against these efforts is leakage, or taking funds out of retirement savings prematurely. Leakage occurs in both defined benefit (DB) and DC plans, though there are increased risks in DC plans. It is undermining the efforts to help workers address the myriad challenges they face when planning for retirement. Leakage can be particularly damaging to specific segments of the population such as minorities, those who change jobs frequently and lower income workers. Leakage occurs primarily in three ways:

I. Withdrawals are taken during active employment.
II. Loans are taken out and not repaid in full.
III. Retirement savings are cashed out upon a job termination or change.

Plan sponsors have become increasingly focused on leakage and asset retention within their plans. Our data show 94 percent of plan sponsors are concerned about the use of loans, 85 percent are concerned about participants taking hardship withdrawals and three quarters are worried about participants cashing out.[4] As a result, employers are monitoring leakage behaviors. We regularly track and report these findings for our clients and actively work with them to find ways to reduce leakage. We have seen an increase in education about leakage and increased encouragement to roll dollars into qualified plans and retain dollars in plans after job termination or retirement.

Our testimony will discuss the different types of leakage and present tangible ideas about what can be done to curb it.

I. WITHDRAWALS

Withdrawals during active employment are of concern primarily for defined contribution (DC) plans. In-service withdrawals from defined benefit (DB) plans are allowed only in limited circumstances at or near retirement age. Withdrawing money early from a DC plan represents a permanent and irrevocable type of leakage that can significantly reduce long-term savings accumulation, depending on the amount and frequency of withdrawals.

Withdrawals are permitted only under certain circumstances. The vast majority of plans (93 percent) allow hardship withdrawals, which are commonly restricted to very specific and dire needs.[5] Utilization of hardship withdrawals is low—only 2 percent of participants took a hardship withdrawal in 2012 and the reasons were

[1] Aon Hewitt, *2011 Trends & Experience in Defined Contribution Plans* (Lincolnshire, IL: Aon Hewitt, 2011), 15.
[2] Aon Hewitt, *1999 Trends & Experience in 401(k) Plans* (Lincolnshire, IL: Aon Hewitt, 1999), 7.
[3] Aon Hewitt, *The Real Deal* (Lincolnshire, IL: Aon Hewitt, 2012), 6.
[4] Aon Hewitt, *Employer Perspectives on Defined Contribution Plan Leakage Survey* (Lincolnshire, IL: Aon Hewitt, 2010) 13.
[5] Aon Hewitt, *2011 Trends and Experience in Defined Contribution Plans*, 76.

sound; in 54 percent of cases, the withdrawal was taken to prevent eviction or foreclosure. Medical expenses ranked second (15 percent) and education expenses were third (13 percent). Only 18 percent of hardship withdrawals were for other reasons. The average hardship withdrawal was $5,160.[6]

Other permitted withdrawals generally include those for employees who have reached age 59.5, or those based on after-tax contributions. In some cases, employer dollars are available for withdrawal. Nearly 5 percent of active participants took a non-hardship withdrawal in 2012 and the average non-hardship withdrawal amount was $16,167.[7]

Our research shows that lower salaried participants are more likely to take hardship withdrawals than other participants. Those earning between $20,000 and $39,000 per year took hardship withdrawals at a rate of approximately 4 percent, compared to only 0.5 percent for workers earning over $100,000.[8]

Withdrawals by Salary

Salary	Percentage of participants— any type of withdrawal	Percentage of participants— hardship withdrawals	Percentage of participants— nonhardship withdrawals
<$20,000	5.7	1.4	4.5
$20,000–$39,999	8.4	3.9	5.0
$40,000–$59,999	8.8	3.2	6.3
$60,000–$79,999	6.4	1.6	5.2
$80,000–$99,999	4.7	0.9	4.0
$100,000+	3.2	0.5	2.8

Columns do not add because small numbers of participants took multiple withdrawals.

When we view the issue of withdrawals through the lens of race and ethnicity, a more problematic perspective emerges. Our research shows that 9 percent of African-Americans and 3 percent of Hispanic participants initiated a hardship withdrawal during 2010, compared to just 2 percent of Whites and 1 percent of Asian-Americans. Even when contributing factors such as salary and age are held constant, African-Americans are 276 percent more likely and Hispanics are 47 percent more likely to take hardship withdrawals than Whites.[9]

Gender within ethnic and racial groups also significantly impacts the likelihood of hardship withdrawals. Middle-income African-American women (those earning $30,000 to $60,000) are more likely to take a withdrawal than their male counterparts. Approximately 14 percent of African-American women in this group took withdrawals, compared to 9 percent of African-American males in this income level. Our survey shows that half of African-American women took loans to pay for unexpected emergencies, 30 percent for day-to-day living expenses and 28 percent to pay off debt. African-American men cited similar reasons.[10]

While the fact that the percentage of participants who are in dire financial straits is troubling, hardship withdrawals are not being abused today and remain a better alternative than eviction or foreclosure. Other withdrawals are unusual outside of those employees nearing retirement, which could be part of a phased retirement approach and those using after-tax savings in their plans. Withdrawals should be monitored and managed, especially for groups at greater risk, but should remain an important resource to employees in need. Our clients are closely watching trends in hardship and other withdrawals, and taking action to address the volume when appropriate. In some cases, this means changing the eligible reasons for a withdrawal. In others, it could be communication reinforcing the importance of avoiding withdrawals.

II. LOANS

Loans are widely available in DC plans and are used frequently. They are not available in DB plans. Our data show that 94 percent of DC plans provide access to loans.[11] Standard repayment terms are 5 years, though 82 percent of plans also

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[6] Aon Hewitt, *2013 Universe Benchmarks* (Lincolnshire, IL: Aon Hewitt, 2013).
[7] Ibid.
[8] Ibid.
[9] Aon Hewitt, Ariel Investments, *401(k) Plans in Living Color* (Chicago, IL: Aon Hewitt/Ariel Investments, 2012), 11.
[10] Ibid., 12.
[11] Aon Hewitt, 2011 *Trends and Experience in Defined Contribution Plans*, 81.

offer a loan strictly for a home purchase with a repayment term of between 10 and 30 years. Loans are generally available up to the smaller of $50,000 or 50 percent of the worker's total plan balance. In 2012, 27 percent of participants had at least one loan outstanding.[12] The average loan amount outstanding was $8,074, representing about 21 percent of participants' total account balance.[13]

To the extent that loans are repaid in full and participants continue to contribute money to the plan while they repay the loan, there is little impact on long-term financial security. Our research shows that in 2012, 81 percent of participants with outstanding loans continued to make contributions while repaying the loan via payroll deductions.[14] In this way, participants can access savings dollars while still benefiting from the employer match and continuing to accumulate retirement savings.

The primary risk to retirement security occurs when participants default on loans, which almost always follows termination of employment, not during active employment. The vast majority of plans require that if an outstanding loan is not repaid within 60 days, it is treated as a distribution, resulting in taxes and possible penalties that create a permanent loss—a leakage—from participants' retirement savings, in addition to a higher tax bill for that year. Nearly 69 percent of participants with loans who terminate employment default on the repayment following termination of employment.[15]

As with hardship withdrawals, minorities take loans at a higher rate and are more likely to default on their loans, creating greater risk for permanent loss of their retirement savings. Our data shows that almost half (49 percent) of African-Americans and 40 percent of Hispanics have outstanding loans, compared to 26 percent of Whites and 22 percent of Asian-Americans.[16] This disparity remains persistent across all income levels.

In our opinion, loans play an important role because they attract participants who may not otherwise contribute. This is especially true among minorities, where more than a third (34 percent) of African-Americans and 29 percent of Hispanics say the ability to take loans from their plans if they need the money is a "strong" influence on their decision to invest in a DC plan, compared to 17 percent of Asian-Americans and 13 percent of Whites.[17] Furthermore, loans enable participants—who continue to work—to access credit, possibly at lower interest rates than what they might receive from other sources, without permanently reducing financial security by missing employer matching contributions, or even worse, taking a withdrawal. The key to curbing leakage due to loans is to reduce defaults. Plan sponsors are closely monitoring loan activity, and some have taken action to reduce the number of loans. Examples include updating education and communication and providing it at point of need, adding a loan fee as a deterrent and reducing the number of loans available. We have not seen plan sponsors eliminating the loan provision.

III. CASH OUTS

Cashing out of a retirement account occurs when plan participants take a full distribution from their plan, incurring tax liability and, depending on age, an additional 10 percent penalty. Cash outs are available from DC plans upon termination of employment and from DB plans when lump sums are available after termination of employment or retirement. Cash outs often represent a complete and total eradication of retirement savings and are the biggest threat to American's retirement security when it comes to leakage due to high availability and utilization.

Cash Outs in Defined Contribution Plans

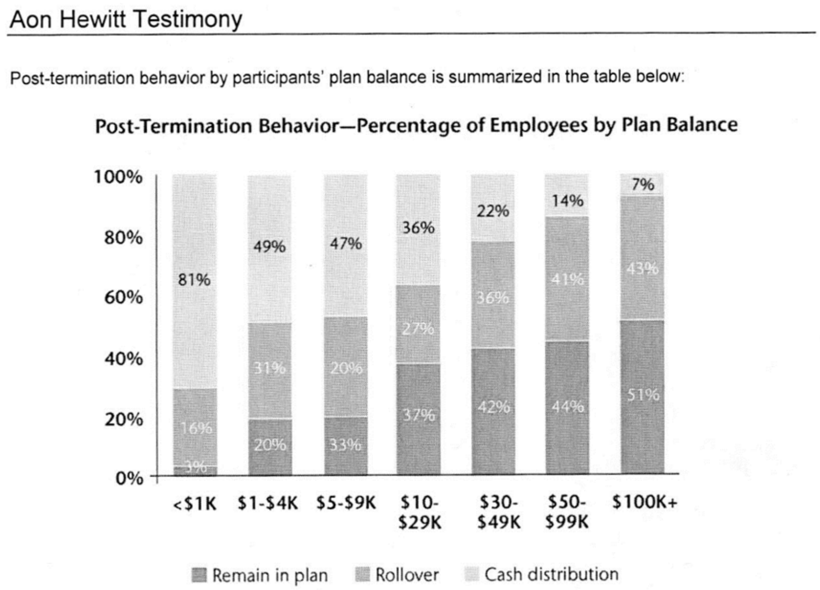
Among participants who terminated employment in 2012, 43 percent took a cash distribution.[18]

Participants with lower account balances are much more likely to cash out, so the 43 percent (above) can be misleading. Fully 81 percent of participants with less than $1,000 in the plan cashed out and 49 percent of those with balances between $1,000 and $5,000 did so.[19] However, only 7 percent of balances of more than $100,000 were cashed out.[20] The larger the balance, the more likely the dollars are to remain in the plan. Rollovers also increase with balance, though more gradually than the

[12] Aon Hewitt, Ariel Investments, *401(k) Plans in Living Color*, 12.
[13] Aon Hewitt, *2013 Universe Benchmarks*.
[14] Ibid.
[15] Ibid.
[16] Aon Hewitt, Ariel Investments, *401(k) Plans in Living Color*, 12.
[17] Ibid. 12.
[18] Aon Hewitt, *2013 Universe Benchmarks*.
[19] Ibid.
[20] Ibid.

amounts remaining in the plan. It is worth noting that the plans in our database are large and benefit from significant scale, so participants with large balances are likely to recognize the value of lower fees, explaining the tendency to remain in the plan.

Post-termination behavior by participants' plan balance is summarized in the table below:



Again, minorities are at a higher risk of leakage from cash outs. Upon termination, 63 percent of African-Americans and 57 percent of Hispanics cashed out their retirement plans, compared to 39 percent of Whites and 34 percent of Asian-American participants.[21] In terms of assets, African-Americans cashed out 19 percent of assets and Hispanics cashed out 17 percent, compared to just 7 percent of assets for Asian-Americans and only 6 percent of assets for Whites.[22]

Even when looking across ranges of account balances, we saw that the tendency to cash out remained markedly higher for African-Americans and Hispanics. Nearly 3 in 10 African-American participants with more than $100,000 in account balances cashed out their plans upon termination, compared to 16 percent of Hispanics, 15 percent of Whites and 11 percent of Asian-Americans.[23]

Cash-out Rate for 2010 by Account Balance

Account balance	African-American (percent)	Asian-American (percent)	Hispanic (percent)	White (percent)
$1,000–$2,499	18	15	21	9
$2,500–$4,999	28	4	23	12
$5,000–$7,499	38	17	26	16
$7,500–$9,999	31	8	30	13
$10,000–$19,999	30	6	16	12
$20,000–$39,999	34	7	26	12
$40,000–$69,999	21	12	29	13
$70,000–$99,999	35	2	20	14
$100,000+	29	11	16	15

Source: Aon Hewitt/Ariel Investments, ***401(k) Plans in Living Color, 2012***. The findings are based on year-end 2010 information from 60 of the largest U.S. organizations across a variety of industries and sectors. The data represents 2.4 million participants.

[21] Aon Hewitt, Ariel Investments, *401(k) Plans in Living Color*, 14.
[22] Ibid., 14.
[23] Ibid., 15.

The threat to participants' financial security from cashing out can be significant, as illustrated in the example below. While very large balances are less likely to cash out, many workers change jobs throughout their career, with a low account balance each time. The accumulated impact of these potential cash outs can be devastating to long-term financial security.

Example of Cash Out Effects

> Consider the impact of three cash outs on a worker who saves for 30 years and retires at age 65. Let's assume she saves 8 percent of pay before tax per year, receives a match of 5 percent of pay per year, earns 3 percent annual salary increases on a starting salary of $50,000, and earns 7 percent in investment return per year.
>
> After factoring in taxes, penalties, and lost interest, if the individual cashed out benefits each time, she would accumulate only $189,000 in her account by age 65, whereas, had she kept the money in the plan, she would have $872,000 in her account by age 65. Cash outs, the largest of which was just over $60,000 after taxes and penalties, cost this individual almost 80 percent of her ultimate nest egg.

In our experience, cash outs from DC plans receive the least attention and focus from plan sponsors compared to loans and withdrawals. While providers do include ample communication and education throughout the experience to discourage cash outs, there are few specific initiatives and changes occurring specifically targeting cash out behavior. Because terminated employees no longer have the relationship with the plan sponsor, plan sponsors are generally less likely to invest time and money in helping them preserve their financial security. Where we do see activity that can help curb cash outs is from the new employers. Plan sponsors are increasingly interested in encouraging participants to "cash in" their prior plan balance by rolling the money into the new employer's plan.

Cash Outs in Defined Benefit Plans

Leakage through cashing out is also a threat for participants with DB plan benefits and the risk is growing as plan sponsors consider adding or expanding lump sum opportunities for participants.

According to the Employee Benefit Research Institute about 73 percent of retirement-aged people take the lump sum option when it is offered.[24] According to our 2012 recordkeeping data, more than half (56 percent) of lump sum payments were cashed out, with the remaining lump sums rolled into another tax deferred vehicle. We see a similar trend with respect to the lump sum value as we see with DC plans, with lower amounts being cashed out at much higher rates than larger amounts. The average size cash out from a pension plan in 2012 was about $14,000, compared to the average rollover of almost $47,000. Once again, the larger the balance, the more likely the participant is to remain in the tax-preferred system.

Lump sum windows also continue to grow in popularity. This option provides a brief period of time, usually 60 days, during which terminated participants can elect a lump sum pension payout that would otherwise not be available. These windows are most often limited to terminated vested participants who leave the organization for another job, though in certain cases plan sponsors are considering offering lump sum payments to retirees already in payment status. Nearly 4 in 10 (39 percent) of companies reported that they are "very likely" or "somewhat likely" to add or liberalize lump sum options through a window approach in 2013.[25] When this option is offered to participants, our research shows the average lump sum election rate is 55 percent, with the alternative being retention of an annuity form of payment.[26]

We see little additional effort to specifically target cash out behavior in DB plans. However, for plans that offer lump sum windows, we are working with many plan sponsors to provide online help, communications and special call center support designed to help participants make informed, smart decisions about their distribution.

While most conversations and research on leakage focus on DC plans, leakage does and has always occurred from defined benefit plans as well. Any efforts to curb leakage should consider possibilities for both.

IV. RECOMMENDATIONS TO DECREASE LEAKAGE

Leakage is, without question, eroding the financial security of American workers. At the same time, providing workers with access to funds in certain situations is

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[24] Banerjee, Sudipto, *Annuity and Lump-Sum Decisions in Defined Benefit Plans* (Washington, DC: EBRI, January 2013)1.

[25] Aon Hewitt, *2013 Hot Topics in Retirement* (Lincolnshire, IL: Aon Hewitt, 2013), 10.

[26] Aon Hewitt, *Pension*, 2.

a benefit that encourages more robust plan participation. To provide some perspective, based on a sample of DC plans totaling about $300 billion in assets, the amounts contributed to plans in 2011 totaled about five times the amount that leaked out. While savings plans are growing and significant assets are being accumulated, a careful balance is required.

Ideas that would decrease abusive leakage while retaining the needed balance are as follows:

Modify the availability of loans and withdrawals. There is room to restrict access to certain funds while retaining sufficient flexibility and access for workers. For example, loans and withdrawals could be permitted only on employee savings, not employer contributions. Or, loans and withdrawals could be available only upon documentation of need, similar to hardship requirements today.

Limit dollars available for loans and withdrawals. While the average loans and withdrawals are relatively small compared to limits in place, reducing the maximum allowable amounts would eliminate some of the largest loans and withdrawals.

Add waiting periods. To discourage repeat borrowers, incorporate a 12-month waiting period before participants can take a loan following repayment of the prior loan and consider a similar waiting period for hardship withdrawals. This will add another deterrent before workers request the distribution.

Enable easier repayment following termination. Most employers currently do not accept loan repayments after employment termination because payroll deductions can no longer be made. To solve this problem, participants could be allowed to continue to make payments through the term of the loan from personal accounts. This is allowable today through employer action. Additional flexibility could be considered for involuntary terminations.

Increase the penalty for withdrawing money from the tax-preferred system. Unless participants receiving a lump sum from a DC or DB plan keep their money within the retirement system by leaving it in the plan, or roll those dollars into other DC plans or IRAs until retirement eligibility, they would incur an increased tax penalty of 15 percent or more. There could be exceptions to this penalty provided only for hardship or other dire need. A variation could be to apply this concept only to employer-funded amounts.

Allow defined benefit plan sponsors to eliminate lump sum options. Under today's legislative structure, the lump sum form of payment is protected and cannot be eliminated. Ironically, only for certain plans that fall below the funded threshold, lump sum payments are limited or eliminated altogether. Other sponsors do not have this flexibility. In spite of the increasing prevalence of lump sum payments and windows, some plan sponsors might be interested in eliminating the lump sum option, if permitted. In fact, more plan sponsors might consider such an approach in exchange for increased funding flexibility or decreased PBGC premiums.

Encourage lifetime income. Whether from a DB plan, DC plan, or annuity, steady lifetime income provides increased security by mitigating risks such as investment risk and longevity risk. By encouraging solutions offering lifetime income within employer plans, to both plan sponsors and workers, you will promote financial security and reduce leakage.

Promote the employer system. While in a qualified employer plan, participants often benefit from lower prices, professional investment management, tools and education, advice and fiduciary protections.

By educating workers about the benefit of retaining dollars in their employer plan after employment termination and/or encouraging rollovers into employer plans and by combating contrary marketing messages, we will reduce leakage that results from higher retail fees and biased advice that can occur when participants move money outside of the qualified plan system. Critical to this effort is simplifying the process of rolling dollars from one qualified plan to another, or from IRAs into qualified plans. For example, regulators have an opportunity to streamline the process by reducing the paper and certification required.

Provide education and resources. As many employers are already doing today, providing education and promoting financial literacy can, over time, make a positive and significant impact on leakage.

V. CONCLUSION

Employer retirement plans play a key and necessary role in the financial security of American workers. Plan sponsors, legislators and regulators have the opportunity to take actions that can help Americans achieve an adequate, financially secure retirement by strengthening these plans and programs for those who have them and offering alternatives for those who do not. Reducing unnecessary leakage from withdrawals, loans and cash outs is a critical part of these efforts—regardless of the plan design—and can especially make an impact for minorities who face an increased risk.

We appreciate the opportunity to share our recommendations with the committee and are pleased to offer our data, resources and expertise to continue efforts that will help improve retirement security for all Americans. Thank you.

The CHAIRMAN. Thank you very much, Ms. Borland.

Dr. Weller.

STATEMENT OF CHRISTIAN E. WELLER, Ph.D., PROFESSOR OF PUBLIC POLICY AND PUBLIC AFFAIRS, McCORMACK GRADUATE SCHOOL, UNIVERSITY OF MASSACHUSETTS BOSTON AND SENIOR FELLOW, CENTER FOR AMERICAN PROGRESS, WASHINGTON, DC

Mr. WELLER. Thank you, Chairman Harkin, Ranking Member Alexander, and members of the committee.

Thank you very much, Senator Warren, for the nice introduction. I very much appreciate it.

I will primarily focus on 401(k) loans, but I'm happy to answer any questions you may have with respect to other policy recommendations regarding leakage in other forms. By 2009, immediately after the great recession, 60 percent of households were not fully prepared for retirement, meaning they didn't have enough savings to maintain their standard of living in retirement.

Households clearly need more retirement savings than they have now, and they need more savings than they did in previous generations. Life expectancy has increased. The growth of social security benefits has slowed relative to a household's pre-retirement earnings. Fewer households have defined benefit pensions than in the past. And rising healthcare costs will require additional spending from retirees.

U.S. policy already incentivizes savings by giving employees the option to contribute to a range of retirement plans, particularly employer-based 401(k) plans, on a tax advantage basis. Contributions to these retirement plans, as you well know, are not subject to income taxes and neither are capital gains that accumulate in these savings accounts during an employee's working career. Employees typically decide how much to contribute, within some limits, to their 401(k) plans, but the widespread lack of adequate retirement savings suggests the contributions to 401(k) plans are likely too low.

Allowing employees to borrow from their 401(k) plans, as is often the case in 401(k) plans, should theoretically raise employees' contributions. Knowing that money will be available in an emergency or for large scale purchases such as a first home should increase employees' willingness to put money into retirement savings accounts. Research studies, including work I conducted with Professor Wenger of the University of Georgia, indeed, suggest that there is a positive correlation between the ability to borrow from one's 401(k) plan and the share of earnings that employees contribute to their 401(k) accounts.

Households often borrow from their 401(k) plans because they have to. We find, for instance, that they borrow mainly because a household member is sick. There are downsides to 401(k) loans, though. Taking out a loan during one's working career can substantially reduce retirement savings up to 22 percent in our simulations compared to savings without taking a loan. And the link between being able to borrow from a 401(k) plan and contributions to a 401(k) plan is weaker among households that already have a hard time saving because they lack financial sophistication, they are myopic, or they look for more instant gratification than is the case for other households.

Furthermore, having the ability to borrow from one's 401(k) plan seems to be associated in our data with more overall debt, such as credit cards and mortgages, possibly because households feel that they can easily dip into their 401(k}s if they have trouble paying back other loans. That is, the increased contributions due to the ability to borrow from one's 401(k) plan seem to be offset in some instances by household characteristics and behavior in other aspects of their finances.

The distinctly mixed evidence on 401(k) loans suggests three policy lessons. First, 401(k) loans fill a critical role for households. Households tend to rely on these loans for a number of reasons, including paying bills when a household member is ill. Eliminating these loans could thus cause substantial economic hardship for some households.

Second, restrictions on 401(k) loans should remain in place. There is no evidence that households frivolously borrow from their 401(k) plans. Most households borrow from their 401(k) plans, if they do so at all, to pay for large scale expenses for which other credit is costly or unavailable, for a down payment on a first home, or for college education, for instance. Existing loan restrictions, especially in the reasons for taking out a loan from a 401(k) plan, seem to work in getting people the money that they need while preventing the financing of conspicuous consumption.

Third, there may be room to strengthen the link between a borrowing option from and contributions to a 401(k) plan. The link in our data, in our research, is particularly strong for households who already handle their finances well, while the link is weaker for households who seem to struggle in managing their finances in other areas. For those who manage their finances well, the effect is about three times larger than it is for households who don't manage their finances well.

One policy option, in our view, may be to make the borrowing option contingent on past contributions to a 401(k) plan. Just to give you an example, if a plan has a standard default contribution rate of 3 percent and has an automatic enrollment, you could say, "Well, you get the loan option if, for at least 12 months or 24 months, you contribute an extra 4 percentage points." My co-author says he's happy with any additional contributions, so I want to make that caveat here. Four percent is what comes out of our data, the additional 4 percentage points.

The minimum required contribution for having the loan option could differ or could be phased in over time as long as there is a requirement for additional contributions to a 401(k) plan to get the loan option. The borrowing option would no longer exist if contributions were, on average, lower than the minimum required during the look-back period.

Getting middle-class Americans closer to a decent standard of living in retirement will require many separate steps. It may be possible to use policy changes to 401(k) loans as a small step in an effort to substantially improve employees' contributions to their savings plans.

Thank you very much, and I'm happy to answer any questions you may have.

[The prepared statement of Mr. Weller follows:]

PREPARED STATEMENT OF CHRISTIAN E. WELLER, PH.D.

SUMMARY

The growth of retirement savings accounts such as 401(k) plans has raised key policy questions related to getting people to save more money for retirement than they have in the past. Giving employees the option to borrow from their 401(k) plans is, at least in theory, one tool to get people to save more money than they otherwise would in their retirement savings accounts. Current U.S. policy allows employees to borrow within limits from their own 401(k) plans as long as they are employed. Knowing that money will be available in an emergency or for large-scale purchases such as a first home should increase employees' willingness to put money into their retirement savings accounts. A number of research studies indeed suggest that there is a positive correlation between the ability to borrow from one's 401(k) plans and the share of earnings that employees contribute to their accounts. And households often borrow from their 401(k) because they have to—because a household member is sick, for example [1]—further underscoring that households indeed rely on their 401(k) savings in an emergency and may have knowingly contributed more to their savings plans than they otherwise would have.

There are downsides to 401(k) loans, though. Taking out a loan during one's working years can substantially reduce retirement savings—up to 22 percent if a household takes out a loan early in one's career and only slowly repays the loan.[2] And the link between being able to borrow from a 401(k) loan and contributions is substantially weaker among households that already have a hard time saving for the future because they lack financial sophistication, they are myopic, or they look for instant gratification than other households.[3] Furthermore, having the ability to borrow from one's 401(k) loan seems to be associated with more overall debt such as credit cards and mortgages, possibly because households feel that they can easily dip into their 401(k) plans if they encounter trouble paying back other loans.[4] That is, increased contributions due to the ability to borrow from one's 401(k) plan seem to be offset in some instances by households' characteristics and behavior in other aspects of their finances.

The distinctly mixed evidence on 401(k) loans points to several public policy lessons. First, 401(k) loans fill a critical role for the economic security of households. They tend to rely on those loans for a number of reasons, including paying bills when a household member is ill. Eliminating these loans could thus cause substantial economic hardships for some households.

Second, restrictions on 401(k) loans should remain in place. There is no evidence that households frivolously borrow from their 401(k) loans—the chance of borrowing and loan amounts are moderate, although both have been growing over time.[5] And households typically borrow from their 401(k) loans when access to other forms of credit is costly or unavailable, such as for down payments on a first home or for a college education.[6] Existing loan restrictions, especially on the reasons for taking out a loan from a 401(k) loan, seem to work and policymakers should keep those in place.

Third, there may be room to strengthen the link between a borrowing option from and contributions to a 401(k) plan. The evidence suggests that the link is particularly strong for households, who already handle their finances well, while the link is weaker for households, who seem to struggle in managing their finances in other areas. One possibility may be to make the borrowing option contingent on past contributions. A plan that has a default contribution rate of 3 percent of earnings, for instance, could grant employees the option to borrow from their 401(k) plan if they contributed more than the default contribution rate—4 percentage points more, for example (that is, if they contributed at least 7 percent of earnings during the past 12 months or 24 months).[7] The additional required contribution could be lower than this and could be phased in—it is important that the loan option is contingent on

additional contributions. The borrowing option would no longer exist if contributions were on average lower than the minimum during the look-back period.

INTRODUCTION

Dear Chairman Harkin, Ranking Member Alexander, and members of the committee, thank you very much for inviting me here today to discuss my research on 401(k) loans.

The Great Recession of 2007–9 put the issue of inadequate retirement savings into sharp relief. Many U.S. households had insufficient savings to maintain their standard of living in retirement well before 2007, but the loss of wealth during the crisis meant that 60 percent of households were not fully prepared for retirement in 2009.[8] The majority of U.S. households had saved too little just as the baby boomer generation started to enter the retirement phase of their lives.

Households clearly need more retirement savings than they have now and they need more than previous generations did. Life expectancy has increased, the growth of Social Security benefits has slowed such that those benefits have declined relative to households' pre-retirement earnings, fewer households have defined-benefit pensions than in the past, and rising health care costs will require additional spending from retirees.[9] The bottom line is that households need to save more than they have in the past just to maintain their standard of living in retirement.

Public policy in the United States incentivizes savings by giving employees the option to contribute to a range of retirement plans on a tax-advantaged basis. Contributions to these retirement plans typically are not subject to income taxes and neither are capital gains that accumulate in these savings accounts during employees' working careers. Employer-sponsored retirement savings plans such as 401(k) plans are the most common form of these tax-advantaged retirement savings. And employees typically decide how much to contribute to their 401(k) plans,[10] although there are frequently employer contributions to their employees' retirement savings accounts as well. The widespread lack of adequate retirement savings outside of Social Security suggests that contributions to all types of retirement accounts, especially 401(k) plans, are likely too low.

Allowing employees to borrow from their 401(k) plans, for instance, should theoretically raise employees' contributions to their accounts. Current U.S. policy indeed allows employees to borrow within limits from their own 401(k) plans as long as they are employed. Knowing that money will be available in an emergency or for large-scale purchases such as a first home should increase employees' willingness to put money into their retirement savings accounts. A number of research studies indeed suggest that there is a positive correlation between the ability to borrow from one's 401(k) plan and the share of earnings that employees contribute to their accounts. And households often borrow from their 401(k) because they have to—because a household member is sick, for example [11]—further underscoring that households indeed rely on their 401(k) savings in an emergency and may have knowingly contributed more to their savings plans than they otherwise would have.

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Second, restrictions on 401(k) loans should remain in place. There is no evidence that households frivolously borrow from their 401(k) loans—the chance of borrowing and loan amounts are moderate, although both have been growing over time.[15] Most households borrow from their 401(k) plans, if they do so at all, to pay for large-scale expenses, for which other credit is costly or unavailable—for a down payment on a first home or for a college education, for example.[16] Existing loan restrictions, especially on the reasons for taking out a loan from a 401(k) loan, seem to work in getting people the money that they need, while preventing the financing of conspicuous consumption. Policymakers should keep those in place.

Third, there may be room to strengthen the link between a borrowing option from and contributions to a 401(k) plan. The evidence suggests that the link is particularly strong for households who already handle their finances well, while the link is weaker for households who seem to struggle in managing their finances in other areas. One possibility may be to make the borrowing option contingent on past contributions. A plan that has a default contribution rate of 3 percent of earnings, for instance, could grant employees the option to borrow from their 401(k) plan if they contributed 4 percentage points more, for instance—that is, if they contributed at least 7 percent of earnings during the past 12 months or 24 months.[17] The minimum required contribution for having the loan option could differ or could be phased in as long as there is a requirement for additional contributions to 401(k) plans. The borrowing option would no longer exist if contributions were on average lower than the minimum during the look-back period.

BACKGROUND ON 401(K) LOANS

A 401(k) loan enables the borrower to act like a bank to himself or herself, albeit within some limits.[18] Households that have the option to borrow from their 401(k) plan can borrow up to $50,000, or one-half the vested balance from the account, whichever is less. Loans must be repaid within 5 years, except for loans that have been taken out for the first-time purchase of a home. Home loans for first-time purchases can be repaid over a period of up to 15 years. Loan repayment is not tax deductible and neither are interest payments unless the primary residence secures the loan.

The interest rates on these loans are generally favorable. Of those 401(k) plans that allowed borrowing, approximately 70 percent charged an interest rate equal or less than the prime rate—the rate that banks charge their best customers—plus 1 percentage point in 1996, according to the Government Accountability Office in 1997.[19]

Borrowers can incur penalties if they fail to repay their pension loan. The outstanding loan amount is then considered a taxable distribution from the 401(k) plan and subject to income tax on the outstanding loan amount plus an additional 10 percent as excise tax. The excise tax disappears for borrowers over the age of 59½.

401(k) loans have risen over time.[20] More people have 401(k) plans; their account balances have grown, and with them the ability to borrow from their 401(k) plans; and employers have made the loan option more widely available, leading to more people borrowing from their 401(k) plans. Data from the major mutual fund firms, which handle most of the assets in 401(k) plans, for example, show that 21 percent of 401(k) plans showed an outstanding loan in 2011. This share had risen from 18 percent in 2007 and 2008 to 21 percent in 2009 and thereafter.[21] The average loan balance has hovered around $7,000 from 1998, the first year for which data are available, to 2011 and stood at $7,027 in 2011.[22]

The below Table summarizes the probability and amount of 401(k) loans in 2010, the last year for which data from the Federal Reserve are available.[23] These data show a 12.1 percent chance of having an outstanding loan in 2010 if the household has a 401(k) plan—the highest share on record, dating back to 1989. And the average loan amount totaled $13,976 in 2010, which is again the highest on record.

Table—Probability of Having a 401(k) Loan and Average 401(k) Loan Amounts by Select Demographic Characteristics, 2010

Categories	Has 401(k) loan, contingent on having a 401(k) plan (percent)	Amount of 401(k) loan, if household has such a loan (dollars)
Total	12.1	$13,976
Age		
18 to 24	7.0	584
25 to 34	9.1	4,916
35 to 44	14.9	6,966
45 to 54	13.8	8,781
55 to 64	11.5	44,921
65 and older	3.1	2,026

Table—Probability of Having a 401(k) Loan and Average 401(k) Loan Amounts by Select Demographic Characteristics, 2010—Continued

Categories	Has 401(k) loan, contingent on having a 401(k) plan (percent)	Amount of 401(k) loan, if household has such a loan (dollars)
Race/ethnicity		
White	10.9	8,521
Black	18.6	3,963
Hispanic	17.3	11,797
Income		
Bottom quintile	3.6	19,175
Second quintile	11.1	2,320
Middle quintile	13.7	6,939
Fourth quintile	13.2	6,891
Top quintile	11.2	27,017
Personal characteristics		
Self-identifies as saver	9.8	20,966
Planning horizon of more than 5 years	10.1	11,566
Relies on professional advice for investments	11.2	18,538
Homeowner	12.1	$16,435

Notes: Calculations based on: Board of Governors, Federal Reserve System, ''Survey of Consumer Finances'' (2012). All demographic characteristics refer to the head of household. Racial and ethnic categories are mutually exclusive. Income refers to normal household income. The upper limit for the bottom income quintile was $20,330, $35,578 for the second quintile, $57,941 for the third quintile, and $94,535 (in 2010 dollars) for the fourth quintile. Self-identified savers are those households who indicated that they save regular or irregular amounts each month. Professional investment advice refers to investment advice from regulated professionals such as lawyers, accountants, investment brokers, insurance brokers, and certified financial planners.

The data summary further shows that the probability of having a loan and the average loan amount tend to move in opposite directions. That is, some population groups such as African-Americans have a high probability of having a 401(k) loan but below-average loan amounts, while other population groups such as self-identified savers show comparatively low probabilities yet large loan amounts. (see Table) Low probabilities and large loan amounts tend to reflect large savings both in retirement accounts and elsewhere, which lower the need to borrow but also give households more assets in their 401(k) assets to borrow from.

THE ECONOMICS OF 401(K) LOANS

Standard economic theory suggests that offering households the option to borrow from their 401(k) plans is unambiguously desirable since it should increase contributions beyond where they otherwise would be. A more nuanced perspective that accounts for potential heterogeneity in households' outlook on the future and for differences in households' savings behavior as a result finds indeed differences in contributions between groups of households, although the 401(k) loan option indeed increases 401(k) contributions.

401(k) Loans and Contributions in Standard Economic Theory

Standard life-cycle models of consumption and saving in economics indicate that the 401(k) loan option will likely increase retirement savings. The assumption in these models is that well-informed workers have stable lifetime preferences, will save in accordance with these preferences, and will save optimally to maintain a preferred level of consumption over their lifetime. With fixed preferences over time, there is no need for added incentives to save and thus also no need for precommitment devices such as limits on 401(k) loans.[24] Individuals and households will save less in their 401(k) plans if there is no loan option than if they can borrow. Alternatively, households will save more in their 401(k) plans if they have a loan option than if they didn't.

Research indeed finds that the borrowing option increases the contribution amount, consistent with the predictions of standard discounting in a life-cycle model. The Government Accountability Office, for instance, finds, based on the 1992 Survey of Consumer Finances, that when plans offered a loan option, workers significantly increased the contribution rate.[25] Similarly, Jack VanDerhei from the Employee Benefits Research Institute and Sarah Holden from the Investment Company Institute find that a loan option increased contribution rates by 0.6 percentage points compared to participants who did not have such a loan option.[26]

These analyses, though, ignore the potential heterogeneity of households and thus ignore the possibility of different effects of 401(k) loan options on household contributions—a point I will return to below.

Looking at reasons for 401(k) loans is another way to understand the standard economic model at work. Households should borrow in this model for unforeseen events, for which they will unlikely have access to other forms of credit.

The reasons for 401(k) loans are not widely studied, but evidence indicates that households borrow out of necessity from their 401(k) plans. An earlier study by two economists at the Federal Reserve summarized data from the 1998 Survey of Consumer Finances and found that 37.7 percent of loans from 401(k) plans were taken out for a home purchase, improvements, and repairs; another 21.6 percent of loans were borrowed to consolidate bills; followed by 16.5 percent for car purchases; and the remaining reasons being education (9.6 percent), nondurable consumption (8.5 percent), medical, legal, or divorce expenses (4.5 percent), and investment purposes (1.6 percent).[27] A later, more detailed study by Jeffrey Wenger and me finds that poor health is a consistent and statistically significant predictor of both the likelihood of having a 401(k) loan as well as the amount borrowed from a 401(k) plan. We also find that poor health is a more important determinant of 401(k) loans than home ownership and that households in poor health with 401(k) loans are most likely to use the loan proceeds to pay for health-related expenditures.[28] The systematic link between health status and 401(k) loans suggests that households indeed use these loans when they encounter an unforeseen event, for which they cannot easily borrow from other sources.

This result leads to an obvious implication of 401(k) loans. Households may face economic pressures in the present that force them to borrow from their retirement savings plans. But the same pressures may slow repayment of the loan and make additional 401(k) plan contributions beyond the loan repayments difficult. A 401(k) loan essentially hits the pause button on accumulating new retirement savings and gaining access to some of the tax advantages of a 401(k) plan until the loan is fully repaid. Gradual repayment and the lack of additional 401(k) contributions beyond the loan repayments can hence substantially slow retirement savings accumulations. The exact impact of a 401(k) loan on total retirement savings will depend on the interest rate charged for the loan, the interest rate earned on savings, whether the borrower keeps up with contributions to the retirement savings plan in addition to repaying the loan, and when the loan is taken out. A loan taken out early in a worker's career can reduce retirement savings by more than 20 percent, particularly if there are no additional 401(k) contributions beyond the loan repayments.[29]

A Behavioral Economics View on 401(k) Loans and Contributions

Taking a loan from a 401(k) plan can have detrimental effects, even in the standard economic model, but the loss of potential retirement savings is likely to be small or even nonexistent if having the loan option leads to higher 401(k) contributions than otherwise would be the case.[30] Contributions not only need to be higher than they would be without a 401(k) loan option, but they need to be high enough to offset the potentially detrimental effects of taking a loan from a 401(k) plan.

This condition that additional contributions need to be high enough to offset the adverse effect of 401(k) loans on retirement savings is an important caveat. The standard economic model sees only one type of household saving for retirement. Allowing for heterogeneity in household behavior, though, can change the conclusion on the link between 401(k) loans, additional contributions, and retirement savings. Additional contributions may in some instances be too small to offset the negative effects of a 401(k) loan and the combined effect of taking a loan and additional contributions may still leave the household with less retirement savings than they would have had without a 401(k) loan option.

This may occur if households do not save optimally because people have dynamically inconsistent preferences, are myopic, or are unsophisticated such that their current desire for future savings is undone by their own future decisions to not save more—by borrowing from a defined-contribution plan, for example. Restricting access to savings before retirement could raise retirement savings and lifetime consumption and may enhance the total savings accumulation of this subset of households.

Jeffrey Wenger and I, in our most recent research on 401(k) loans, thus develop a methodology to separate households into two groups.[31] One group (Type A) represents standard discounting where people behave in ways that are consistent with the standard model and another group (Type B) comprises "inconsistent" discounting whereby households exhibit nonstandard economic behavior. There are many reasons why a household may demonstrate Type B behavior such as hyperbolic discounting, mental accounts, myopia, and lack of financial sophistication. The bottom line, though, is that there are households that systematically exhibit financial behavior that is inconsistent with optimizing financial outcomes.

We identify households that objectively engage in financial decisions that do not easily fit into an optimizing framework and thus their lifetime consumption as Type B households, while all others are Type A households. Specifically, if the household has an outstanding credit card balance beyond the grace period, they compare the credit card interest rate for the card with the largest balance to the interest rate on their home equity line of credit, or HELOC. Households with credit card interest rates larger than HELOC interest rates are Type B households. All other households are Type A households. This measures preference heterogeneity as any household that carries a credit card balance but also has untapped home equity at a lower interest rate. The assumption is that these households are not optimizing in the standard way if they choose a higher cost form of credit when a lower cost one is available to them. Approximately 68 percent of households in the sample are Type A—a percentage that has varied from 59 percent in 1989 to 73 percent in 2001.[32]

The research shows that preference heterogeneity indeed matters for total retirement savings because of varying effects of the availability of 401(k) loans on 401(k) contributions. This research finds that the contribution rate for people with Type B preferences is about two-thirds lower than that of people with standard preferences when the borrowing option is present in 401(k) plans. Type A households increase their contributions by 3.7 percentage points of earnings in the presence of a loan option, whereas Type B households only increase their contribution by 1.4 percentage points.[33]

This research further finds that having the option to borrow from a 401(k) loan is also associated with more overall debt. One explanation is that households, who have the option to borrow from their 401(k) plans, may borrow more on their credit cards and mortgages than other households because they know that they can fall back on their 401(k) plans if they encounter problems in repaying their non-401(k) loans.

The combined effect of higher savings and more debt can again differ between households with different behaviors. Type B households, who contribute somewhat more with a 401(k) loan option than without, could see less retirement savings than in a situation where borrowing from a 401(k) plan would not be possible. Type A households, who show behavior consistent with optimizing financial outcomes, likely end up with more total savings because of the higher contribution rates than would be the case if borrowing from a 401(k) plan was not an option, even if they increase their total amount of debt.[34]

POLICY IMPLICATIONS

The arrival of 401(k) loans creates a curious situation for households. They can save for themselves and borrow from themselves with the same financial instrument. The existing research on the implications of the ability to borrow from a 401(k) loans is somewhat limited, but a few key findings that are of policy relevance emerge nevertheless.

First, 401(k) loans fill a critical role for the economic security of households. They tend to rely on those loans for a number of reasons, particularly for paying for health care and other consumption when a household member is ill. Eliminating the ability to borrow from a 401(k) plan could thus cause substantial economic hardships for some households who already struggle financially.

Second, restrictions on 401(k) loans should remain in place. There is no evidence that households frivolously borrow from their 401(k) loans—the chance of borrowing and loan amounts are moderate, although both have been growing over time.[35] And summary data on the reasons for taking out these loans indicate that most loans are taken for large-scale projects for which other loan options are either costly or do not exist—for the down payment on a first home, for college education, and for health care and related consumption, for example.[36] Existing loan restrictions, especially on the reasons for taking out a loan from a 401(k) loan, seem to work and policymakers should keep those in place.

Third, there may be room to strengthen the link between a borrowing option from and contributions to a 401(k) plan. The evidence suggests that the link is particularly strong for households who already handle their finances well, while the link is weaker for households who seem to struggle in managing their finances in other areas. One possibility may be to make the borrowing option contingent on past contributions. A plan that has a default contribution rate of 3 percent of earnings, for instance, could grant employees the option to borrow from their 401(k) plan if they contributed 4 percentage points more—that is, if they contributed at least 7 percent of earnings during the past 12 months or 24 months.[37] The additional contributions could vary and could be phased in over time as long as people needed to contributed more money to get access to the loan option in their 401(k) plans. The borrowing option would no longer exist if contributions were on average lower than the minimum during the look-back period.

Being able to borrow from one's 401(k) plan can prove valuable to households under the right circumstances. And policymakers can set the terms to make sure that households can balance present demands and future needs with their retirement savings in a thoughtful manner.

ENDNOTES

1. Christian E. Weller and Jeffrey B. Wenger, "Easy Money? Health and 401(k) Loans," *Contemporary Economic Policy* 30 (1) (2012): 29–42.

2. Christian E. Weller and Jeffrey B. Wenger, "Robbing Tomorrow to Pay for Today" (Washington: Center for American Progress, 2008).

3. Jeffrey B. Wenger and Christian E. Weller, "Boon or Bane: 401(k) Loans and Loan Provisions," unpublished manuscript, University of Georgia. Paper available from authors upon request.

4. Ibid.

5. Weller and Wenger, "Robbing Tomorrow to Pay for Today." Jack VanDerhei and others, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2011" (Washington: Employee Benefits Research Institute, 2012)

6. Weller and Wenger, "Robbing Tomorrow to Pay for Today."

7. The recent estimate shows that the borrowing option increases contributions by 3.7 percentage points for households who have a good handle on their finances, but that the contribution increase is only 1.4 percentage points for households who do not have a good handle on their finances in other areas. Requiring an additional 4 percentage points for the loan option would thus make no difference for good financial planners, but it would boost retirement savings for households who arguably need a stronger commitment device to save for their retirement. Wenger and Weller, "Boon or Bane."

8. Center for Retirement Research, "National Retirement Risk Index Fact Sheet No. 2" (2010).

9. Working longer than in the past is an obvious theoretical alternative, but the experience of the Great Recession has shown that older households need to spend more time working longer exactly when fewer job opportunities are available. Labor and financial markets regularly move in tandem, so that the experience of older households in the Great Recession—looking for work after financial markets and labor markets crashed—is the rule not the exception. See: Christian E. Weller and Jeffrey B. Wenger, "Integrated Labor and Financial Market Risks: Implications for Individual Accounts for Retirement," *Journal of Aging and Social Policy* 21 (2) (2009): 256–76.

10. This testimony uses 401(k) plans as shorthand to refer to all employer-sponsored defined-contribution accounts.

11. Weller and Wenger, "Easy Money? Health and 401(k) Loans."

12. Weller and Wenger, "Robbing Tomorrow to Pay for Today."

13. Wenger and Weller, "Boon or Bane."

14. Ibid.

15. Weller and Wenger, "Robbing Tomorrow to Pay for Today"; VanDerhei and others, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2011."

16. Weller and Wenger, "Robbing Tomorrow to Pay for Today."

17. The recent estimate shows that the borrowing option increases contributions by 3.7 percentage points for households who have a good handle on their finances, but that the contribution increase is only 1.4 percentage points for households who do not have a good handle on their finances in other areas. Requiring an additional 4 percentage points for the loan option would thus make no difference for good financial planners, but it would boost retirement savings for households who arguably need a stronger commitment device to save for their retirement. Wenger and Weller, "Boon or Bane."

18. Government Accountability Office, "401(k) Pension Plans: Loan Provisions Enhance Participation But May Affect Income Security for Some," GAO/HEHS–98–5, Report to the Chairman, Special Committee on Aging, and the Honorable Judd Gregg, U.S. Senate, October 1997.

19. Ibid.

20. Weller and Wenger, "Robbing Tomorrow to Pay for Today"; VanDerhei and others, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2011."

21. VanDerhei and others, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2011."

22. Ibid.

23. Calculations based on the Federal Reserve's triennial Survey of Consumer Finances. See: Board of Governors, Federal Reserve System, "Survey of Consumer Finances" (2012).
24. B. Douglas Bernheim and Antonio Rangel, "Behavioral Public Economics: Welfare and Policy Analysis with Non-Standard Decision Makers." Working Paper 11518 (National Bureau of Economic Research, 2005).
25. Government Accountability Office, "401(k) Pension Plans."
26. Sarah Holden and Jack VanDerhei, "Contribution Behavior of 401(k) Participants" (Washington: Employee Benefits Research Institute, 2001).
27. Annika Sundén and Brian Surette, "Households' Borrowing from 401(k) Plans," Paper presented at the Second Annual Joint Conference of the Retirement Research Consortium, "The Outlook for Retirement Income," May 17–18, 2000, Washington, DC.
28. Weller and Wenger, "Easy Money? Health and 401(k) Loans."
29. See: Government Accountability Office, "401(k) Pension Plans"; Alicia H. Munnell and Annika Sundén, *Coming Up Short: The Challenge of 401(k) Plans* (Washington: Brookings Institution Press, 2004); Weller and Wenger, "Robbing Tomorrow to Pay for Today."
30. For a detailed discussion of the implications of the standard economic model, see: John Beshears and others, "The Impact of 401(k) Loans on Saving." Working Paper (National Bureau of Economic Research, 2010).
31. This summary discussion and the results are based on: Wenger and Weller, "Boon or Bane."
32. Ibid.
33. Ibid.
34. This conclusion is based on simulations derived from the empirical estimates in: Wenger and Weller, "Boon or Bane."
35. Weller and Wenger, "Robbing Tomorrow to Pay for Today"; VanDerhei and others, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2011."
36. Weller and Wenger, "Robbing Tomorrow to Pay for Today."
37. The recent estimate shows that the borrowing option increases contributions by 3.7 percentage points for households who have a good handle on their finances, but that the contribution increase is only 1.4 percentage points for households who do not have a good handle on their finances in other areas. Requiring an additional 4 percentage points for the loan option would thus make no difference for good financial planners, but it would boost retirement savings for households who arguably need a stronger commitment device to save for their retirement. Wenger and Weller, "Boon or Bane."

The CHAIRMAN. Thank you very much, Dr. Weller. We'll now start a round of 5-minute questions.

I'll start with Dr. Fellowes. Again, we've made a lot of progress getting savings rates up with plan features like automatic enrollment, and I'll talk more about that after a bit. But as you said in your testimony, we can't automate retirement readiness. People need a lot more education about how to manage their finances. I've heard that from all three.

But why would employers want to spend all the time and money trying to educate their employees? They've got other things they've got to do, like produce things, goods and services. I mean, you say more education on how to manage finances, but why would employers want to do that? What incentive would there be for them to do that?

Mr. FELLOWES. That's a fantastic question. And the answer is that the incentive varies by industry and employer. Some of our earliest customers were interested in us helping increase the savings deferral rates because they have an aging population and are anxious for that population to be able to retire on time.

And the simple reason is that their healthcare costs and their compensation costs increase as workers age. They want to be able to go through a generational cycle that they've been able to do successfully in the past. But if people aren't saving enough for retirement, they're not going to be able to ultimately leave their jobs on time. So that's one incentive. There's a financial incentive for some employers to want to do this.

Second, there's another group of employers out there who are interested in the efficacy of the retirement programs. And that efficacy for them is defined as: "Are these programs really helping my workers prepare for retirement, or are they helping them create savings for other purposes?" And it's effectively higher cost, higher risk compensation.

For those sponsors, they're not interested for financial reasons. They're not getting an ROI from that. They're interested in ultimately the efficacy and want to improve that efficacy by providing a more holistic retirement solution to their workers.

There's a third set out there, and these are employers of lower wage workers who are concerned that they're creating an incentive for their workers to leave their jobs because they lack any other savings. I was actually sitting at a retailer—I won't mention the name—when I was working on this paper and overheard a conversation between two employees there. They were cashiers on their break, and they were talking about—one of them had gotten into an accident on the way there in her car, and she didn't have money to fix that car. And I couldn't believe it, but they were saying, "Well, I've got my 401(k) savings account."

I've heard that from sponsors, that they feel like they're creating an incentive for people to quit their jobs to be able to get access to the funds, the full set of funds. So that's a third set. But the short answer is the incentive structure really varies by industry and by employer.

The CHAIRMAN. OK. I'll try to absorb all that.

Ms. Borland, I want to ask you about making it easier to discourage people from cashing out. Could we make the rollover process simpler? I've heard a lot about this, how tough it is, how much paperwork is involved, and so people say, "It's easier to take my cash. Even though I'd pay a 10 percent penalty, I don't have to go through all that." Is there a way of making that rollover easier?

Ms. BORLAND. There is, and there are a couple of different ways that can happen. I'd say that part of the reason for the problem is that when an individual leaves an organization, that organization has lost that connection and is much less incentivized to help, to go out of their way to make it really easy for that individual to get their money out in a smart way. So once the employment relationship ends, the challenge begins.

The new employer, the new plan, does actually have an incentive to encourage that employee to roll the money in. And we are seeing increased interest in the plan sponsor community in doing just that. The problem is the reliance on the prior plan sponsor and/or provider and/or the IRA provider. In any case, they're losing the assets. They're losing the money, so they don't have an incentive to make it really easy. The requirements that are in place today are reliant on that prior sponsor or provider.

There are opportunities to take the burden off of the prior sponsor or provider, allow the individual, the former employee, to use publicly available information to be able to provide certification of the qualification of the rollover, so there are some opportunities there that can be taken. In addition, quite frankly, there's an opportunity just within the private sector to work together better to create connections to make it much easier as well.

The CHAIRMAN. A value judgment question. Do you think it should be easier?

Ms. BORLAND. Absolutely. We have heard significant noise and feedback both from our plan participants as well as from plan sponsors who are frustrated that it's so hard and that individuals have to try multiple times before they have the adequate documentation in order for their rollover to be accepted. And I do think that contributes to the cash-out problem.

The CHAIRMAN. Thank you.

Senator Alexander.

Senator ALEXANDER. Thanks, Mr. Chairman.

Dr. Fellowes, your business now is to help companies help their employees make better decisions. Is that right?

Mr. FELLOWES. That's right.

Senator ALEXANDER. What are the two or three things, in your experience, that you help the companies do to help their employees that seems to work in making better decisions about retirement plans?

Mr. FELLOWES. We find that engaging workers with their day-to-day decisions is the most important value-add that we can create for someone for their retirement security——

Senator ALEXANDER. But like what?

Mr. FELLOWES [continuing]. For a few reasons. The first is it allows you to be engaged with the worker.

Senator ALEXANDER. No, no. I mean, what specific things do you have the employee do to help him or her make a better decision?

Mr. FELLOWES. Oh, sure.

Senator ALEXANDER. You mentioned a budget.

Mr. FELLOWES. Sure, lots of things. Yes, we will automatically create, for some, a budget. We're able, through technology, to track people's spending and their checking accounts and their credit cards, and that allows us to automatically create a budget for them.

For instance, individuals that walk into a grocery store or walk into a coffee shop or a clothing store can look on their phone and see—it will recognize the store that you're located in, and it will say, "I have $100 to spend safely in this store." Providing that information to them at the moment of transactions is really powerful.

Senator ALEXANDER. Do you find that makes a difference?

Mr. FELLOWES. Yes, we certainly do.

Senator ALEXANDER. Do you think having that kind of budget might make a difference for a government?

[Laughter.]

Now, I want to go to Ms. Borland to followup on Senator Harkin's questions about the cash-out and loans. Listening to Dr. Weller, would it be possible that if you made it harder to get a loan, it could make you think twice before you got a loan? You'd have to make a decision. Would that be an incentive to encourage a cash-out perhaps?

Ms. BORLAND. While the employee is actively employed, he or she can't cash out, generally, until he or she terminates employment.

Senator ALEXANDER. But if we created a more difficult loan option, which might mean fewer employees taking the loan or fewer employees not paying it back, then would employees be more encouraged to cash out as a way of getting their money? Would those two ideas work against each other? That's what I'm trying to figure out.

Ms. BORLAND. While an individual is actively employed, he or she can take a loan for any reason. He or she generally has to document hardship in order to take a withdrawal. So if you're asking whether or not an individual—it may be more difficult to take a loan, so he or she may actually terminate employment to get access to that money, I'd say that's probably an extreme measure to get access to a 401(k) and not something we have seen or experienced.

That said, we do have research that shows the ability to take a loan is encouraging certain vulnerable populations, minorities, in particular, to get into the plan in the first place. So having the existence of a loan, we do think, is very important.

Many plans actually require a loan to be taken before a withdrawal is allowed, and that's actually an important step. The experience an individual has to go through to access a withdrawal is going to push them and say, "You have to take a loan first." What we see is that when individuals have taken a loan, more than 80 percent of them continue to save money in their 401(k) while they're repaying the loan.

So as long as the individual continues to work and continues to repay their loan, there really isn't a leakage out of the system. It's when that termination of employment occurs, which then triggers in most cases a default, that you see a leakage.

Senator ALEXANDER. I'm especially interested and sympathetic to the difficulty of moving your retirement account as one changes jobs. I'm sort of that way myself. If it's too complicated, I'll just say, "Let's just do the simple thing." Maybe this is an opportunity for one of Senator Warren's little competitions that she had for mortgage applications—to have a competition to see whether there could be some simple way of giving an employee a chance, to say, "Here's a 1-page form. Fill it out and you don't have to worry about it."

This has been very helpful. I look forward to the rest of the comments.

The CHAIRMAN. Thank you, Senator Alexander.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, and thank you, Ranking Member. This is a very important meeting and I thank you all for being here.

I want to continue to go down this path asking about the loans against 401(k)s. As I understand it, about one in five 401(k)s has a loan against it. I think that's what I read in your testimony. And I'd like you to speak, if you would, for just a minute about the idea of the 401(k) debit card, that people can actually carry something that looks like a credit card and just hit against their 401(k).

Dr. Weller, you look like you're ready to speak to that.

Mr. WELLER. That's sort of the subprime loan option of the 401(k) market. It's a God-awful idea.

Senator WARREN. OK. So we've got God-awful.

Mr. WELLER. I think what we have in place, the restrictions we have, the standards that you can borrow only a certain amount, up to 50 percent of the balance, that you can borrow only for certain reasons predetermined, I think, works very well. It works on both sides. It helps households when they're in a pinch, but it really doesn't allow them to borrow from their 401(k) to pay for flat screen TVs. And at the same time, it incentivizes them to save more.

And with that, I would like to also very quickly address what Senator Alexander had asked. I think the unintended consequences of making it harder—like our proposal would be to require people to contribute more. We don't see any unintended consequences, because we already see people contributing more if they have a loan option than if they don't.

We're just saying to codify it a little bit and make it more explicit incentivizes, especially people who aren't particularly good financial managers, to contribute—pay up front, pay it forward, if you will, sort of put a little bit of money away for that eventual rainy day. The majority of people don't borrow from their 401(k) plans, though.

Senator WARREN. Thank you.

Ms. Borland, would you like to go beyond God-awful?

Ms. BORLAND. I think God-awful says it quite well, actually. The only point that I'll add is that with all of the hundreds of plan sponsors with whom we work on a daily basis, we have never had a single one actively consider the 401(k) loan debit card. So while there seems to be a lot of noise about it, we've never worked with a company who thinks it's a good idea.

Senator WARREN. Dr. Fellowes, have we covered the ground here?

Mr. FELLOWES. I think the ground has been covered.

Senator WARREN. OK. I just want to say I know that Senator Enzi has in his SEAL plan that's being introduced today—is that right, Senator?—a provision that there will not be 401(k) debit cards. And I just want to express my very strong support for that, and I assume strong support from our panel.

Senator ENZI. I think that would allow us to put the word, God-awful, in there.

[Laughter.]

Senator WARREN. I want to ask you another one about loans against 401(k}s. Our plan, the TSP plan that all of us here, I think, participate in, has this 60-day waiting period, that you can't take another loan within 60 days of having taken a loan. And I believe that when that was instituted, we studied the consequences and there was about a third fewer loans and about 25 percent less in terms of the dollar borrowing. Would you recommend this become the rule nationally?

How about we start the other way this time? Dr. Fellowes?

Mr. FELLOWES. Sure. If the intent is to increase 401(k) account balances or 457 or 403(b) or whatever the account is in question, I think the answer is unequivocally yes. I would agree with the recommendation here. If the intent is, though, to increase the retirement security of workers, then I think, ultimately, we need to address the underlying causes for that loan and cash-out behavior as well, because the economic need that's prompting those loans and cash-outs is not going to disappear, even if their retirement savings balances increase.

Senator WARREN. Fair enough, Dr. Fellowes, and it's a point I'm quite sensitive to, about the need. But we actually have some hard data on this, and I assume, as a group, Federal employees did not become wealthier when this restriction was put in place.

Mr. FELLOWES. That's right.

Senator WARREN. And yet loans against 401(k}s went down by about a third.

Mr. FELLOWES. That's right. And I think it's part of a solution, to be sure. But we are anxious to broaden the conversation to address these underlying causes.

Senator WARREN. Fair enough.

Ms. Borland, do you want to add anything to that? I'm almost out of time.

Ms. BORLAND. No, I think the data is very real. I'd even suggest potentially a longer waiting period, at least, offered or encouraged from plan sponsors, maybe even 6 to 12 months, so that the repeat offenders who continue to take one after the other are forced to get out of the practice and then wait and take one again if it's truly needed.

Senator WARREN. Dr. Weller, just very briefly, because I'm out of time.

Mr. WELLER. I would go with shorter waiting periods.

Senator WARREN. Shorter rather than longer?

Mr. WELLER. Like the 60 days rather than the longer ones, given that most of the loans are taken for good reasons and not just frivolously. I think getting people to think about taking another loan, yes, but I think 6 to 12 months could potentially pose some hardships.

Senator WARREN. Thank you very much.

The CHAIRMAN. Senator Enzi.

STATEMENT OF SENATOR ENZI

Senator ENZI. Thank you, Mr. Chairman, and thank you for having this hearing.

And thank you, Senator Warren, for mentioning the SEAL Act. It's the SEAL leakage. The whole title is Shrinking Emergency Account Losses. I worked on this with Senator Kohl for a while, and I'm now working on it with Senator Bill Nelson and hope that it becomes a part of whatever bill that you do. These are supposed to be rainy day funds, but it's supposed to be raining really hard before they can get them out, not just sprinkling.

There are some problems when they're leaving a job. They have to pay it back immediately or all the penalties are instituted against them, and so this extends the time so they have a little more time to put it back in, because if they pay the penalties, they're not going to put it back in. They've already paid for it once. Right now, if they take one of these hardship loans, they're not allowed to contribute for 6 months. I liked your idea that they ought to have to start paying 4 percent more.

At any rate, they ought to be at least able to put in the amount that they can get their match from their employer so that it continues to grow. And, yes, it does ban the debit card, and I appreciate the list that Ms. Borland had in hers. We'll take a look at some of those, too.

Dr. Fellowes, I didn't get to hear your testimony because I had a circuit court judge that I was getting to introduce that used to be in the State legislature with me. So I had to miss your comments. But in your testimony, you state that the plan sponsors need a management dashboard to understand their employees' retirement readiness. Can you discuss that in a little more detail, what the management dashboard would look like?

Mr. FELLOWES. Sure. The management dashboard is reflective of the fact that the average person near retirement has 10 different bank accounts. The 401(k) is one of those accounts. So retirement readiness is really more a function of everything else that's going on in someone's life and all of those other accounts than it is just the 401(k) account.

When we work with sponsors, we present a dashboard that includes a holistic picture of someone's retirement readiness. The 401(k) is part of that, but it is not inclusive of everything that needs to be looked at. What that helps sponsors do, ultimately, is determine how much bang they're getting for their buck, or what the ROI is from their investment in the 401(k).

They're able to determine who the 401(k) is working for and who it is not working for. And among those that it's not working for, they can see, well, this population has debt problems. This population has expensive private tuition problems. I mean, it really runs the gamut. But this holistic data gives employers a much more clear and actionable set of information about the health of their plans.

Senator ENZI. And that's without encouraging them, then, to go into the higher growth funds?

Mr. FELLOWES. That's right.

Senator ENZI. Ms. Borland, you stated that the key to curbing the leakage due to loans is to reduce defaults, and I think that's pretty basic. But you suggest the plan sponsor should update education and communication and provide it at a point of need. When should plan sponsors provide this education and communication? How did you envision that? What would it entail?

Ms. BORLAND. Some of it is in place today, and we're seeing active engagement and new ideas. An example is when an individual goes on the Internet and clicks a button that says, "I'm ready to take a loan," there's something as simple as a pop-up box that comes up and says, "Are you really sure about that? Have you considered all of your other options? There's a phone number you can call for counseling," for example.

It's one thing to sort of send out a bunch of pamphlets and brochures to everyone when they may or may not even be considering a loan, but it's another thing to deliver the tools and education right when the person is making a decision. Another example is when they go out to model a loan, you're providing links along the way of "Take a look at what this actually means to you. Let's put an example of what this depletion could mean when you turn age 65."

A similar thing with cash-out—cash-out is unique because there's so much marketing and energy out there in the marketplace of "Give me your old 401(k). Let me take it. I can do better. I can guarantee returns." So there's a big risk. There's so much energy encouraging people to get out of the 401(k) system, and plan sponsors find it difficult to compete with those sort of deep pockets in marketing messages to say, "You know what? You don't actually have to take your money out, and you have really inexpensive funds in the plan."

Helping plan sponsors to deliver those kinds of messages without believing that they're putting themselves at risk, fiduciary risk, or other exposure in doing so would be a good way to sort of help market the qualified plan system and the tax-preferred system as well.

Senator ENZI. Dr. Weller, do you have any comments? And maybe you could tell me where the 4 percent came from.

Mr. WELLER. The 4 percent comes out of our estimates. We find that people who are managing their finances well contribute, on average, next to 4 percentage points of their earnings if there's a loan option present in their 401(k) plans. For people who do not manage their finances well in other aspects of their life, the effect is much smaller. It's about 1.3 percentage points extra.

That gets to a point that, I think, cuts across all of these answers, and that is—I'm very sympathetic to Dr. Fellowes' suggestion to sort of have a holistic approach to financial management. But there has to be sort of a policy dimension here, I think, because this proposal comes through the employer side. A lot of people are self-employed, so the employer nexus wouldn't work, and it's only for employers who actually offer a retirement plan. A lot of employers do not offer a retirement plan.

So I think it's very important to get more comprehensive financial and regulated advice to individuals to save and prepare for retirement. But it needs to be much broader than just simply going through the employer-based retirement system, to sort of address all of these issues that we've talked about and many others.

Senator ENZI. My time has expired. Thank you.

The CHAIRMAN. Thank you, Senator Enzi. We'll just start another round.

I wanted to raise one other issue that kind of hasn't come up. When people take a loan, are they charged a processing fee?

Ms. Borland.

Ms. BORLAND. Yes. In the majority of situations, plan sponsors do charge a fee. It's typically around $50 to $75 to initiate a loan, and then a smaller percentage, but not insignificant, also charge an ongoing fee of approximately $25 per year. The reason for that is actually to discourage loan taking to begin with. So we've actually seen some plan sponsors add a loan fee who didn't have one before, specifically to create another sort of speed bump in the process to say, "Are you really sure you want to do this? It's going to cost you something. Please think twice."

The CHAIRMAN. Do the people who are taking the loans—you say they know that up front?

Ms. BORLAND. Yes, absolutely. It's disclosed.

The CHAIRMAN. Dr. Weller, in some of our hearings in the past, people, I think, tend to look—this is my own judgment—people tend to look upon their contributions differently than employer contributions. I have mine, and then the employer puts in his.

So when we come down to this idea of taking loans or withdrawals, what if we tighten the limits on the employer contributions, like saying, "OK. You can take out yours, but you have a limit, you either can't, or you can have a severe limit on what you can take out."

Mr. WELLER. Certainly, you can impose some limits. It would have to be sort of a research question of how much that limit actually would be in terms of the balance. We already have some limits. You can't borrow the entire amount from your 401(k). So it's unclear whether that would change a lot in practicality.

But, certainly, some loan limits—you could certainly impose some on the employer contributions. You could sort of impute the tax advantages and limit that and say that can't be—like the government's money essentially can't be borrowed against, or something like that. There's a number of things you can do in that regard.

The CHAIRMAN. Any views on that, Dr. Fellowes, about limiting how much you can take out from the employer contribution side?

Mr. FELLOWES. Yes. I think that if you put limits in place, you're definitely going to be limiting the loan activity in that account. The waiting period, for instance, that Senator Warren was talking about is one way that you can do that. There are lots of other mechanisms to do that.

But I think that the core issue here is that the consumer is living in a world with lots of different financial demands on them, and the 401(k) is just one of those. So if we're going to ultimately put that restriction in place to increase their retirement security, as I've said, I think it does need to come along with an expectation that we have a more holistic approach to retirement readiness so that whatever that economic need was that's motivating the interest in a loan is addressed at the same time that that vehicle becomes less easy to get access to.

The CHAIRMAN. Dr. Weller, in your written testimony, you said this research finds that having the option to borrow from a 401(k) loan is also associated with more overall debt. You go on to explain that what happens is people will borrow more on their debit cards and all kinds of things, knowing they can fall back on their 401(k).

Mr. WELLER. That's our interpretation. We can only see in the data that having a loan option in a 401(k) is generally associated with more debt generally, typically mortgages. And we do not know from the data sources that we use—we use the Survey of Consumer Finances from the Federal Reserve. We sort of can't look in people's brains to see why they're doing it. But one logical interpretation is that they know they can fall back on their 401(k) if they fall behind on their credit cards or their mortgage payments.

The CHAIRMAN. That's kind of disturbing to think that by having a 401(k), we're actually encouraging people to take on more overall debt.

Mr. WELLER. I think it depends a little bit on what the debt is for. I think at this point we're sort of still shell shocked from the incredible consumer debt boom of the last 10 years. But if you look to the years prior to the mortgage and housing boom, higher levels of debt were associated with faster asset growth and more wealth building.

So there is sort of a fine line in understanding and seeing debt. And I think, hopefully, we're getting back to a more normal situation where, through the regulatory system and the tax system and through sort of steering consumers' behavior, we're getting people to use their debt more wisely and actually build assets rather than destroy assets.

The CHAIRMAN. Thank you very much, Dr. Weller.

Senator Alexander.

Senator ALEXANDER. Dr. Fellowes, do you have many competitors? Have other companies been formed to help employers help their employees make better decisions about these matters?

Mr. FELLOWES. It's a great question to ask. When I was at Brookings, I thought of competition as think tanks competing for the attention of Senators. But today, I am in the private market, and, yes, we have seen in the last year several competitors pop up.

Senator ALEXANDER. And how long have you been in this business?

Mr. FELLOWES. I started the business about 3 years ago. We launched it almost 2 years ago.

Senator ALEXANDER. So you've been in it long enough to get a sense of whether it is growing? Is there a demand for it?

Mr. FELLOWES. Yes, there is. It's growing quite quickly.

Senator ALEXANDER. Let me ask about another form of consumer debt. There's a lot of worry about what some call the student loan bubble. And as I listened to you, one of the solutions to the student loan bubble is the same kind of solution we're talking about with people managing their retirement funds, to help students understand what they're getting into when they're 20 years old or 22 years old and they can get free money pretty easily.

There's a wide divergence of what happens. I know at Tennessee Tech University, students borrow very little money, and it's a cultural thing, I think. It's more of a rural school. It's an engineering school, and I think the school does a good job of counseling about finances. This topic is a little far afield of this hearing, but do you suspect that a similar sort of business might help universities counsel students about how much money to borrow in order to go to college?

Mr. FELLOWES. I do. If I may, I'll give you about a minute response, and then I'll sort of digress just a little bit.

Senator ALEXANDER. Sure.

Mr. FELLOWES. I'll put my Brookings hat back on here. But there's a really interesting trend that happened in the 20th century in the financial services market that Senator Warren knows, I know, very well. But there was a broad democratization of financial products to consumers throughout the 20th century, and student loans were one of those. Mortgages were another. Credit cards were another, and 401(k}s, of course.

What didn't democratize, though, was the advice needed to figure out how to use all these new products and services, primarily because the business model in use is still very expensive, which is you have to pay someone, sit down across the table from them, and ask them for guidance, and that's very expensive. So there's an incentive for advisors, then, to constantly go upstream in terms of income because they want to work with the wealthiest clients as well.

Using new technology today, though, you can really provide an equivalent advisor experience at a very, very low cost, because, ultimately, advisors are working with inputs, which is all your assets and your liabilities. And then the output is what should you do next.

Senator ALEXANDER. So you could imagine a business or a set of advisors who would go to the University of Tennessee and make a contract and say, "We'll advise your students on better practices for borrowing money."

Mr. FELLOWES. Absolutely.

Senator ALEXANDER. And the incentives for the university to do that would seem to me to be similar to the incentives for the employer with retirement plans in many ways.

Mr. FELLOWES. That's right. And in many respects——

Senator ALEXANDER. Well, they might have more, because the default rate on loans can create a real problem for the university.

Mr. FELLOWES. They could probably have more, yes. That's right. And the kids at that university are going to be some of the most amenable in the country to technology solutions.

Senator ALEXANDER. Well, that's right, too.

Mr. FELLOWES. So I think it could be powerful.

Senator ALEXANDER. Well, thanks for wandering off with me on that.

Dr. Weller, I want to make sure I understand. Your point, as I get it, is that loans aren't so bad from your accounts because they encourage more people to set up retirement accounts—there is evidence of that. You could have a requirement to increase contributions to that retirement account as a result of taking a loan. And then, I guess, third, it's the saver's money and they may truly need it. Is that sort of a summary of where you come out?

Mr. WELLER. That is correct, yes. We find that having the option to borrow, not just actually borrowing, but having the option, that people value that and contribute to that, and that's consistent with other research. The other part is that people do borrow, largely because a family member is ill. That's one of the primary reasons, but you'd also look at other things. And when a family member is ill, they use it to pay medical bills, but they also pay for other consumption items.

The other reasons why people take a loan from their 401(k) is for a down payment for their first home or for student loans. In some cases, that may be just simply good finances and lower cost borrowing. And that goes to the question you just had about student loans.

I do agree that giving students and their families more comprehensive financial advice makes sense. That comes out of the data. Having regulated good financial advice from an accountant, from a lawyer, from a regulated broker does lower the cost of borrowing. It manages—increases wealth.

But the important piece here is that the advice has to be regulated, and it has to be from a regulated, responsible adult, if you will. What we find also in the data is that just getting advice at work from colleagues, from friends, from family does nothing and often destroys wealth.

The CHAIRMAN. Thank you, Senator Alexander.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

I hear the point. Don't eliminate the loans. Keep restrictions in place. But there seems to me to be something of a conundrum here. Senator Enzi talked about it. The whole idea behind the loans is that we don't use them when there's a modest need, presumably because you can find other ways to satisfy that need, and you can pay that back over time. We only think about giving people access to 401(k}s or loans against 401(k}s only if there's an extreme need.

But I want to ask about two other parts to the conversation that just haven't been here so far. One is the question around all the people who got in trouble on their homes. I'm just thinking about the most recent crisis and the number of people who, when a teaser rate mortgage reset, cashed out their 401(k}s to try to keep up with those mortgages.

The consequence was they eventually lost the home and had no retirement incomes at the end. I talked to many, many families in Massachusetts for whom that was the case, and I think it's been the case across the country. So here they are with nothing at the end.

The second one goes right to where you are, Dr. Weller, and that is medical bankruptcy. If someone borrows against the 401(k) and pays down or pays off a very large medical debt, they've just lost the asset. If they really can't manage the debt and end up in bankruptcy, then they're in bankruptcy and they're left with nothing.

But we very carefully in our bankruptcy laws said retirement income is so important that we will set it aside. It's an exception, and creditors can't reach it. And so people going into bankruptcy who did not tap their 401(k}s, who did not borrow against their 401(k}s, have more assets and more capacity to recover post bankruptcy.

So I'm a little caught in the heart of this question, and that is we're trying to measure needs now—a person has a medical problem, a person is behind on the home mortgage, a person has lost a job—versus needs later, and that is they will spend many years in retirement and they need some assets to be able to cover them. I welcome any of your thoughts on this.

Dr. Fellowes, do you want to start?

Mr. FELLOWES. Sure. That's another just terrific point, and it points to the complexity of really promulgating good public policy on this issue. And successfully, for workers, being able to convert their paychecks into economic mobility, because they've just got—there's so many different dimensions to this issue, as you were talking about in the housing crisis.

You're absolutely right—as a vehicle for people to save their housing. And, yes, it doesn't promote their long-term retirement security, but it sure does promote their ability to live in a house.

Senator WARREN. For a while.

Mr. FELLOWES. For a while. Sorry to be a broken record here, but I do think what this points to and what prompted me to leave my very comfy perch in a think tank is that, I think through technology now, we really do have a scalable solution to these issues.

And the vision is that you create a private bank relationship for the mass market through technology, because that private banker ultimately is presiding over someone who is wealthy—their assets and liabilities and financial decisions.

Senator WARREN. You raise a good point on this about the advice, because there is a real tilt in the advice.

Mr. FELLOWES. Yes.

Senator WARREN. I am told that debt collectors, not infrequently, will ask if people have a 401(k) and recommend that they tap the 401(k) in order to stop the debt collection calls. It would be nice if people had another place to get advice. The debt collectors are not acting in the best interest of the family.

Thank you, Dr. Fellowes.

Ms. Borland, any comment?

Ms. BORLAND. My only comment—I don't have a solution for the mortgage challenge, but I will say, though, that the way the system is constructed today, the focus on loans and withdrawals is important. But when an individual changes employment—say, they lose their job in that process anyway, they have full access to cash out their total 401(k) regardless.

Even if they repay their loan, if they're going to cash it out the next day, it's really irrelevant. I think focusing on the cash-out issue first and sort of stemming that leakage will then support leakage from other sources as well, since that one is a really big deal.

Senator WARREN. Fair point, although we might just say you need a comprehensive solution here that watches where the money is going.

Ms. BORLAND. Yes.

Senator WARREN. Dr. Weller.

Mr. WELLER. I would just add that we can't expect the 401(k) loans to do everything. And I think we have to recognize that 5 years after the recession we still have 40 percent of unemployed people looking for a job for more than 6 months. So we have a perfect storm for middle-class families, and while there's lots of things going wrong for individuals, changing little things on the 401(k) loans are not going to change the situation.

There are other policy measures that need to be addressed, the labor market risks, the need to comprehensively restructure financial advice, and we need to go beyond that. I think the 401(k) world as it is structured, the 401(k) loans as they work right now, do work relatively well.

Senator WARREN. Well, I appreciate it, and I appreciate you being here to talk about this. Thank you.

The CHAIRMAN. Thank you, Senator Warren.

I just have one last question I want to ask each of you. The purpose of this hearing was to talk about leakage. We all know it's happening. People aren't saving for retirement. They need a lot more money put away for retirement. We know about the leakage problem.

Dr. Fellowes, Ms. Borland, Dr. Weller, if you could do one thing, if you could today say, "I'm going to do this"—"we're going to do this one thing to stem this leakage," what would it be? Just give me your best idea. What's the one thing you'd do?

Mr. FELLOWES. I would define what 401(k) success means. What that will do is create a set of incentives for other issues to be addressed, including more data to be collected about the health of retirement plans, about who it's working for, about who it's not working for. I think that one change would instigate a lot of healthy changes.

The CHAIRMAN. You mean define it legislatively?

Mr. FELLOWES. Perhaps. Again, I am not involved in the day-to-day policy issues of today's hearing. So that's just my own opinion, top of mind.

The CHAIRMAN. Define the purpose.

Mr. FELLOWES. Define what success means for a 401(k) plan.

The CHAIRMAN. Ms. Borland, what would you do? What's the one thing you'd do?

Ms. BORLAND. I'd suggest we recommend tackling the cash-out issue by, at a minimum, requiring employer-funded contributions to remain in the tax-deferred system until retirement, similar to a traditional defined benefit plan.

The CHAIRMAN. That means that if you were to borrow or to take it out, you could take yours but not the employer contribution.

Ms. BORLAND. That's right, and even after job termination.

The CHAIRMAN. Yes, exactly. I understand that. And that could be done legislatively.

Ms. BORLAND. Yes, it could.

The CHAIRMAN. OK. We'll think about that.

Dr. Weller.

Mr. WELLER. Being sympathetic to encouraging more contributions to 401(k) plans, I think what we do need is a universal secure retirement plan that is sort of a default option for people who are not covered, that people can roll into from their current jobs, that would catch when people leave their jobs, similar to what you had proposed, Senator Harkin.

The CHAIRMAN. Anything else? Well, this has been very good, very thought provoking. Thank you very, very much for being here. The record will remain open for 10 days for members to submit other questions or comments. And I hope that as we move along on this that you would make yourselves available to the committee and our staff for further inquiries and suggestions.

Thank you all very much. The committee will stand adjourned.

[Additional material follows.]

ADDITIONAL MATERIAL

RESPONSE TO QUESTIONS OF SENATOR ENZI AND SENATOR WARREN BY ALISON THOMAS BORLAND, FSA

SENATOR ENZI

Question. Ms. Borland, you presented a list of ideas that would decrease abusive leakage. One of those ideas was to promote the employer system by simplifying the process of rollovers. You stated that regulators have an opportunity to streamline the process by reducing the paper and certification required. Can you provide more detail on what that would look like?

Answer. As electronic investing has become the norm and most enrollments are performed via the web, the current rollover process that requires paper certification and qualification of the rollover is often confusing and cumbersome. We envision a process whereby individuals would sign on to their new employer's recordkeeping system as a part of their initial enrollment in the new plan, and merely have to enter a few pieces of information about their old employer and old employer's plan (Employer's Federal ID number, recordkeeper, etc.) and then have the funds electronically transferred from the old employer's plan to the new employer's plan. Relief or clarification from the current documentation requirements, as well as some private sector investment, would be required.

SENATOR WARREN

Question 1. In 2004, the Thrift Savings Plan (TSP) for Federal employees started limiting loans, made lenders cover the administrative expense of issuing the loan, and required a 60-day waiting period between loans. This resulted in a third less loans the following year and a 25 percent decrease in assets loaned out. Do you think more private plans adopting similar rules would lead to less leakage?

Answer 1. It is likely that plans adopting similar rules would lead to less leakage. Based on our data of large employer plans, among companies who allow more than one loan, more than 40 percent of participants with a loan outstanding have multiple loans at the same time. Consequently, we believe limiting the availability of loans would likely reduce leakage, including adding a waiting period.

Generally, we see plan sponsors interested in reducing loans actually add a fee for the borrower, as a deterrent to taking the loan. Those fees align the fees with the individuals who incur the costs, rather than having it paid from general administrative expenses paid by all participants. We would not expect that the loaner cover fees would reduce leakage; on the contrary, we would expect requiring the borrower to cover the cost would reduce leakage.

Question 2. Three and half years ago the Government Accountability Office (GAO) released a report entitled *Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings*. This report suggested Congress should consider changing the current requirement for a 6-month contribution suspension following a hardship withdrawal, Senators Enzi and Bill Nelson have included this provision in the SEAL 401(k) Act. The 2009 GAO report also includes open recommendations to the Department of Labor to promote best practices for reducing leakage and to the Department of Treasury to clarify rules and require plans to document loan exhaustion before allowing withdrawals. Could enacting these recommendations help reduce leakage?

Answer 2. The elimination of the 6-month suspension is unlikely to reduce the number of hardship withdrawals, but it will enable those participants who take a withdrawal to begin accumulating retirement contributions sooner, thus increasing their overall retirement savings and lessening the impact of the leakage.

The other recommendations, including showing participants projections and offering modeling tools, are generally in place today, based on our experience. The market continues to innovate to provide point-of-need education and support to reduce cash outs and help participants make good decisions.

RESPONSE TO QUESTIONS OF SENATOR WARREN BY TROOPER SANDERS, SENIOR ADVISOR, HELLOWALLET

Question 1. In 2004, the Thrift Savings Plan (TSP) for Federal employees started limiting loans, made lenders cover the administrative expense of issuing the loan, and required a 60-day waiting period between loans. This resulted in a third less loans the following year and a 25 percent decrease in assets loaned out. Do you think more private plans adopting similar rules would lead to less leakage?

Answer 1. Yes. The available evidence would suggest that requiring a 60-day waiting period between loans will lead to a lower loan volume. However, there are two important considerations to keep in mind. First, such changes may trigger increases in turn-over and cash-outs. Data from our customers in high-employment industries, for instance, indicate that (a) companies without loan policies tend to have higher cash-out rates and (b) that the loans in these industries tend to cover bills and debts, which is why there is such a high recidivism rate. It would be worth assessing whether the TSP plan changes triggered any of these secondary effects before moving forward with a policy recommendation. Second, and more importantly, limiting loan access may not necessarily improve the retirement readiness of workers, if that's the intended goal of this policy change. Participants that would have borrowed from the TSP prior to this policy change, may instead seek out more readily available and costly sources of cash, such as credit card cash advances, payday loans, and other high cost alternatives. While TSP assets increased, in this scenario, the participants assets may have been flat or declined. Greater impact would be found in policy that strives to reduce the underlying demand for loans in the first place, such as encouraging the TSP and other DC plans to adopt independent financial guidance that supports better day-to-day financial decisions. Most Americans do not budget and spend more than they make in income as a result, for instance, which produces growing financial insecurity as their debt accumulates over time, raising the likelihood that they will take out a loan or cash-out their balances. Similarly, most Americans have fewer than 3 months of their annual income saved for emergencies, which increases the likelihood that they will use their DC plans for non-retirement spending. Independent, holistic guidance can address these, and other, underlining causes of loan volume.

Question 2. Three and half years ago the Government Accountability Office (GAO) released a report entitled Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings. This report suggested Congress should consider changing the current requirement for a 6-month contribution suspension following a hardship withdrawal, Senators Enzi and Bill Nelson have included this provision in the SEAL 401(k) Act. The 2009 GAO report also includes open recommendations to the Department of Labor to promote best practices for reducing leakage and to the Department of Treasury to clarify rules and require plans to document loan exhaustion before allowing withdrawals. Could enacting these recommendations help reduce leakage?

Answer 2. Changing the requirement for a 6-month contribution suspension following a hardship withdrawal is worth serious consideration. Most experts believe that the current suspension policy limits the savings potential of DC plans. Changing the policy may allow individuals facing financial hardship to resume the habit of contributing toward retirement, however modestly, more quickly and avoid penalizing people who may tap retirement savings for hardship events. Similarly, the GAO's recommendations to promote industry best practices, clarifying current rules, and encouraging plans to document loan exhaustion before allowing withdrawals may potentially help reduce leakage. However, leakage is occurring not because of an informational problem: most participants that are withdrawing their funds early are doing so because they have to meet bill and debt obligations, think (often mistakenly) that housing is a better investment than their DC plans over the long term, or because of a cash-flow problem. None of the GAO recommendations address these underlining causes. Any improvements to DC balances from these recommendations, as a result, will be modest, at best, and potentially unsustainable. On the other hand, addressing need for holistic, independent guidance, which attacks the root of the leakage and insufficient savings problem, will create non-incremental improvements to the retirement security of U.S. workers.

For more information, you may contact me at *www.tsanders@hellowallet.com*.

RESPONSE TO QUESTIONS OF SENATOR WARREN BY CHRISTIAN E. WELLER, PH.D.

Question 1. In 2004, the Thrifty Savings Plan (TSP) for Federal employees started limiting loans, made lenders cover the administrative expense of issuing the loan, and required a 60-day waiting period between loans. This resulted in a third less loans the following year and a 25 percent decrease in assets loaned out. Do you think more private plans adopting similar rules would lead to less leakage?

Answer 1. The simple answer is yes, more restrictions on loans from defined contribution plans will result in less leakage. The more complicated answer is that the possibility of access to money in defined contribution plans increases savings rates. Greater restrictions may weaken this savings incentive. I am doubtful that this is the case with carefully limiting the number of loans that an employee can take.

Many employees are not fully aware of their plan's details. They may know if loans are possible, but they are often unlikely to know all of the rules under which they can take a loan from their defined contribution plan. Employees cannot respond to changes in rules governing their defined contribution plans if they are not fully aware of those rules in the first place.

Question 2. Three and half years ago the Government Accountability Office (GAO) released a report entitled *Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings*. This report suggested Congress should consider changing the current requirement for a 6-month contribution suspension following a hardship withdrawal, Senators Enzi and Bill Nelson have included this provision in the SEAL 401(k) Act. The 2009 GAO report also includes open recommendations to the Department of Labor to promote best practices for reducing leakage and to the Department of Treasury to clarify rules and require plans to document loan exhaustion before allowing withdrawals. Could enacting these recommendations help reduce leakage?

Answer 2. Yes, all of the steps outlined seem reasonable in getting employees to save more. Allowing people to more quickly contribute to their defined contribution plans should increase their overall savings in some instances. Informing people about the potentially detrimental effects of taking a loan, which can lower retirement savings by more than 20 percent under reasonable assumptions, should again give pause to some people. And finally, getting employees to take a loan rather than a withdrawal should increase the chance that savings will stay in defined contribution plans for some employees. Each of the measures outlined in the GAO report individually will likely have only small effects, but the widespread lack of adequate retirement savings requires that policymakers should consider all best practices to increase retirement savings by the maximum amount for the maximum number of people.

[Whereupon, at 3:40 p.m., the hearing was adjourned.]

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