Custodia Financial Thought Leadership

Balancing The "Now" With The "Next"

Helping employees build resilience for financial emergencies is easier than employers think

Now more than ever, workers need help striking the right balance between accessing emergency cash and safeguarding future retirement savings. New solutions can help them get there—and they may be easier to implement than employers think. A deeper understanding of saving and spending behavior can help guide employers to the best decision for their employees.

For years sponsors of qualified retirement plans have tried to reduce 401(k) loans and other premature plan distributions in an attempt to improve retirement readiness. At the same time, many workers remained concerned about the present; cash-constrained, especially in this environment, they often find themselves desperately short of money. An influential study from the Federal Reserve found that only 61% of Americans had enough cash on hand to cover a $400 emergency. For many American workers, a 401(k) Plan may be the only source of liquidity they have. Validating that harsh reality, earlier this year, Congress loosened the loan and withdrawal rules through The Coronavirus Aid, Relief, and Economic Security (CARES) Act to help participants access their retirement savings to help navigate difficulties associated with the COVID pandemic.

Personal financial experts often recommend having at least three months of living expenses available in the event of an

SHOULD I SAVE OR SHOULD I SPEND NOW?

Helping U.S. workers improve their financial picture means understanding how best to leverage compounding based on where people are today.

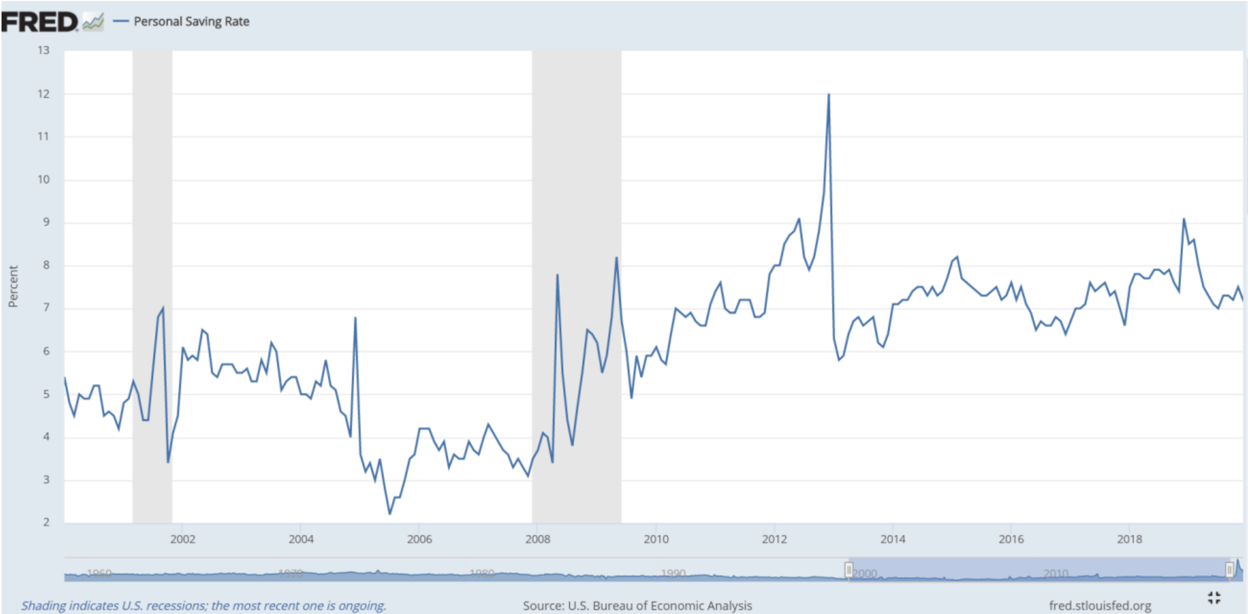
To learn more about low-cost retirement loan insurance protection, click www.loaneraser.com.

emergency, and six months for anyone who can afford it.[1] Few would argue with the fact that access to readily accessible cash can be helpful, especially in the event something unexpected happens, whether that's a personal financial emergency or a global event such as we're currently experiencing.

Many employers are looking to get involved through the financial wellness initiatives they are exploring. One idea being considered[2] is the addition of an emergency savings account that allows employees an additional option beyond their 401(k) plans and traditional bank accounts to save for a variety of short-term expenses. Research into personal savings patterns shows that this approach may work for certain employers, while others can achieve these same objectives and likely leave employees in a better place financially by enhancing existing 401(k) plans.

Understanding Personal Savings Patterns

The Federal Reserve defines the personal savings rate as the ratio of personal savings to disposable personal income, or the amount someone might have saved to invest in capital markets or real assets such as homes. How much do Americans save? This chart from the Federal Reserve Bank of St. Louis shows the *average* U.S. personal savings rate was 7.2% over the last 20 years, ranging from a low of 2.2% in July 2005 all the way to 12% in December 2012.



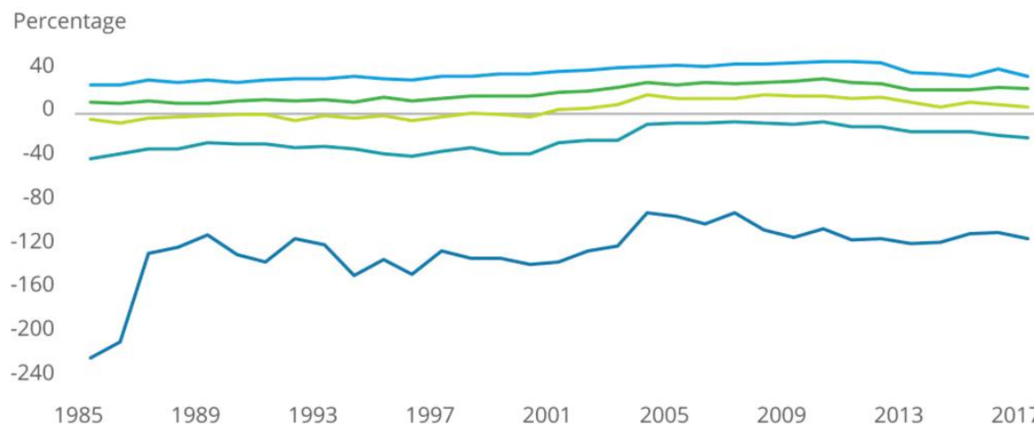
https://fred.stlouisfed.org/series/PSAVERT

[1] Dayana Yochim, "Emergency Fund Guidelines: Do You Really Need 3, 6, or 12 Months?", The Motley Fool 2018
[2] 2019 Employer Approaches to Financial Wellbeing Solutions, EBRI, 2019

An analysis by Economics Help.org found that savings are influenced by a number of factors, including the level of interest rates, rising income, economic growth, age, cultural trends, wealth and inflation[3]. Academic research found that personal saving is most sensitive to changes in internal variables (e.g., personal income, tax, credit outstanding and status of employment) rather than changes in external variables (e.g., real interest rate and status of economic performance).[4]

Thus, savings is most highly correlated with higher levels of disposable income and lower levels of debt, and to a lesser extent based on the level of interest rates and the performance of the economy.

Additional research from Deloitte seemed to confirm that the *level* of savings can be attributed to higher levels of disposable income and less debt, while the *variability* in savings might be more related to economic cycles[5]. This chart from The Bureau of Labor Statistics takes this a step further by showing that U.S. workers in the top three income quintiles are saving, while those at the bottom of the economic ladder are not.



[3] Tejvan Pettinger, "Factors that influence saving levels" Economics Help.org, April 2019
[4] Myeong Hwan Kim, "The Determinants Of Personal Saving In The U.S." The Journal of Applied Business Research – September/October 2010 Volume 26, Number 5

[5] Akrur Barua, "Personal savings: A look at how Americans are saving" Deloitte, 2019

A closer look at income distribution can inform employers interested in improving the financial position of their employees. This table from The Tax Policy Center (TPC), a joint venture of the Urban Institute and the Brookings Institution, provides more detailed information:

Household Income Distribution 2018

Quintile	Mean	Upper Limit
Lowest quintile	$13,775	$25,600
Second quintile	$37,293	$50,000
Middle quintile	$63,572	$79,542
Fourth quintile	$101,570	$130,000
Top quintile	$233,895	--

Tax Policy Center, Urban Institute, Brookings Institution, and individual authors, 2020

A Chief Human Resources Officer could start by understanding how income is distributed across employees and then look to map out the most beneficial programs for workers. This last phase might also include an evaluation of their existing programs, such as longer term 401(k) savings plans, and whether they need any additional insight into how employees might value additional savings programs.

Exploring Paths Forward

Emergency Savings

Emergency savings accounts go by a variety of names, including 'rainy day funds' and 'sidecars' when they are designed to be coordinated with an existing 401(k) savings plan, and represent a new account to which workers can contribute part of their savings. Questions employers might want to consider before adding emergency savings accounts include whether a new account would translate into incremental savings, or would any utilization represent a shift in savings away from longer term retirement plans?

The answer likely depends on the makeup of their workforce.

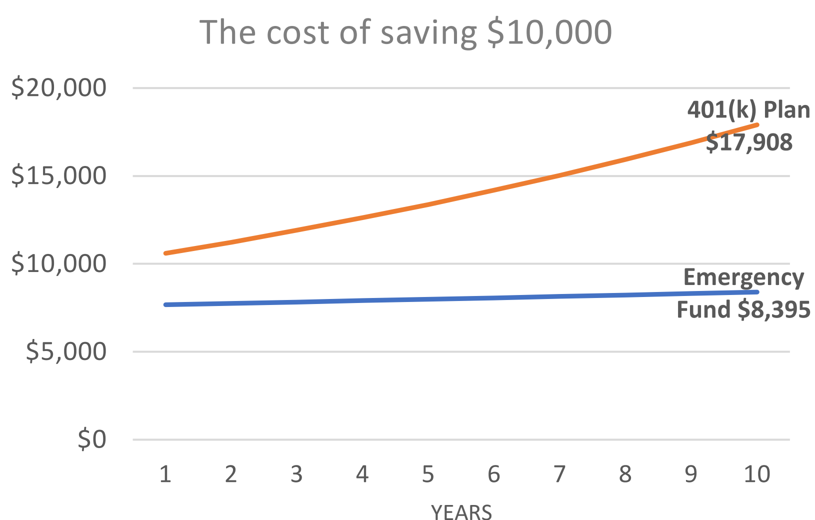
Employers with high concentrations of workers in the lowest income quartiles may not offer a 401(k) savings plan, so any savings accumulated here would truly be incremental. These employers may also have an additional incentive to help. A 2019 FDIC study found minimum wage workers more likely to be among the nation's unbanked households.[6] Adding a savings account that is coordinated with payroll is one way employers can help improve the financial stability of employees, particularly in cases where employees are less likely to have separate relationships with traditional financial services providers like

[6] FDIC, "How America Banks: Household Use of Banking and Financial Services", 2019

banks, savings and loan associations, and credit unions. While these employees may not be in a position to save much of their income, many can still benefit from an account that helps them manage their current finances and begin to save for emergencies.

More Savings Options May Not Mean More Savings

Employers paying a majority of their workers in the second and third quintiles (average incomes from $37,293 to $63,572) might need more data to find the right mix of programs. After all, workers at these organizations are more likely to have established traditional financial relationships to manage their expenses and be contributing to a 401(k) plan to fund future retirement. Prior academic research into personal saving patterns suggest workers in these income levels that elect to fund emergency savings accounts will do so by shifting contributions away from qualified retirement plans, which can actually have a detrimental effect on their longer-term financial security.



Workers who contribute less to 401(k) plans lose out on valuable benefits including the deferral of income taxes, an employer match, and the potential for higher investment returns compared with less volatile short-term investments – **differences that add up over time.** An employee investing $10,000 in a 401(k) Plan earning 6% would have more than doubled the same $10,000 in a conservatively invested emergency fund earning 1% after ten years.

Similarly, financial counselors rightly point out that paying down existing credit card debt would put workers in a significantly better financial position than saving a similar amount in a rainy day fund for an emergency that may never arrive.[7] Consider that in 2019 the average U.S. consumer paid credit card

[7] Adam McCann, "What Is the Average Credit Card Interest Rate?" WalletHub, October 2020

interest of 14.58% on a $6,200 balance – equal to more than $900 in interest payments during one year alone.

Americans are also carrying a cumulative $1.5 trillion in student loan debt. Employers with a high percentage of millennial employees with outstanding school loans may look to integrate matching programs that encourage employees to pay down student loans, which many have indicated prevents them from fully utilizing employer sponsored retirement plans.

What about higher income employees, those earning more than $101,570? Highly paid workers can likely cover an unanticipated expense without additional employer support through existing savings and financial relationships they have in place. This population may benefit more from financial planning services that are integrated with their compensation, or potentially non-qualified deferred compensation arrangements in the top income quintile.

Retirement Plans: A Dual Purpose

Defined contribution plans have grown to be the primary retirement vehicle in the U.S., replacing the role of pension plans for prior generations. The American Benefits Council points out that defined contribution plans have become America's predominant retirement savings vehicle, covering more than 100 million participants (80 million active) and workers.[8] With the exception of smaller employers that offer plans at a lower rate due to cost and complexity, most workers at larger employers have access to a qualified 401(k) plan.[9]

But can defined contribution plans meet the need for emergency cash? It turns out there are a few ways that employers can modify these plans to address the need for financial emergencies without detracting from longer term retirement security.

After-Tax Contributions

Defined contribution plans can permit pre-tax, Roth, and after-tax contributions. After-tax contributions don't generate the same level of buzz the other accounts do, but this source of money can provide certain

[8] American Benefits Council, 401(k) Fast Facts, January 2019

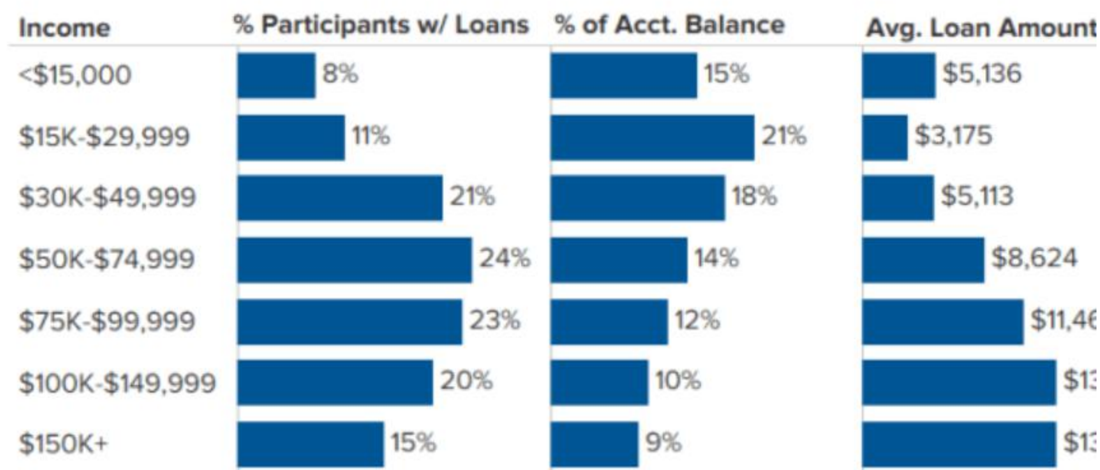
[9] Workers at smaller firms have historically had less access to workplace retirement plans due to cost and complexity. According to Lorie Konish, a Personal Finance Reporter at CNBC.com, 42 million Americans work for small businesses where only 14 percent are likely to offer a retirement plan. To address gaps in retirement savings, these firms can now explore the developing market for pooled plan providers made possible through legislation in The Secure Act.

advantages when it comes to emergency saving. A retirement plan that allows after-tax contributions can also allow those contributions to be withdrawn with less restrictions than 401(k) or Roth savings, in effect creating an emergency savings account within their plan.

There are a few considerations for any employers interested in using after-tax savings as an emergency savings solution. Contributions can detract from pre-tax deferrals (in the same way separate emergency savings accounts can) and may not be eligible for employer matching contributions depending on plan design. In addition, any withdrawal results in taxable income, penalties (for those under 59 ½) and permanent leakage from retirement savings[10].

401(k) Loan Programs

Enhancing a loan program might be a better option than anything else. Retirement plan loans remain a popular choice for employees who participate in these plans. 401(k) loans allow workers to borrow against their accounts at lower interest rates and transaction costs than personal loans while still earning a market rate of return on their deferrals. And because participants have been shown to borrow across income levels the decision to add loan insurance might feel more universal and inclusive. As long as employees maintain their deferrals and eventually repay the loan, their retirement account stays on track.



The risk with retirement loans is that they are not always repaid. Plan loans are often taken as emergency funds, and an employee losing a job after borrowing is rarely in the position to continue making payments

[10] Vishal Jain, "3 Great Reasons to Consider After-Tax Contributions to a 401(k)", Kiplinger March 2020

on the loan. An influential Deloitte study found that ten percent of loans default, and a $7,000 loan default followed by a $70,000 cash out of the remaining account can cost someone up to $300,000 by the time they retire[11]. Deloitte also went on to estimate that loan defaults could cost U.S. workers up to $2.5 trillion dollars in lost retirement savings over the next decade without further attention from the industry. This is where loan insurance can help.

At no cost to the employer, loan insurance can make payments and/or fully repay a loan if a borrower dies, becomes disabled or loses their job in a workforce reduction, and be seamlessly included into a plan's loan program and offered to employees on an opt out basis at the time they borrow. As an example, loan insurance that makes six months of payments while workers find and secure a new job costs about $105 each year for an average $7,000 loan - considerably less than the earnings someone would give up by funding an emergency savings account in lieu of a 401(k) plan.

In a 2019 study by Greenwald & Associates[12] more than 90% of participants valued the retirement plan's loan feature as a source of liquidity for financial emergencies, and two-thirds said they'd consider contributing more if their employer were to add loan insurance. Any innovation that encourages additional incremental savings is a valuable addition, especially in light of the protective measures of preventing loan defaults.

Summary

Allocating money comes with costs – costs that are as obvious as paying the interest on existing credit card debt and as obscure as forgone investment earnings or forfeited tax benefits. It appears lower income workers could realize the most immediate benefit from the addition of an emergency savings account, while minor enhancements to existing defined contribution programs including after-tax contributions, a 401(k) emergency loan with lower minimums, and the use of loan insurance would all allow employers to assess employee behavior toward existing programs before investing further time and effort into other approaches.

[11] Deloitte, Loan Leakage: How Can We Keep Loan Defaults from Draining $2 Trillion from America's 401(k) Accounts? 2018

[12] Greenwald & Associates, "Missing Voices: What 401(k) Borrowers Can Add to the Loan Program Conversation," 2019.