Enhancing Retirement Savings

by

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It is obvious that the innovation of allowing 401(k) participants to utilize for a limited period of time a small fraction of the resources in their account to efficiently finance short term loans is a very valuable benefit to them as well as to employers offering such plans. The absence of a borrowing option in many retirement plans (e.g., Social Security and non 401(k) plans) seriously discourages the accumulation of retirement funds through voluntary employee contributions. The money accumulated in these funds is totally illiquid, i.e., it cannot be used to cover any need or emergency the household may face until the date of retirement except with severe penalties. This situation especially discourages people of limited means (lower paid employees), who having no other resources, are led to save through alternative liquid forms (non retirement accounts), for which there is no guarantee nor restraint that the assets will be there at retirement. In short the ability of limited borrowing for short periods of time makes 401(k) assets more liquid and therefore more desirable and valuable especially to lower income employees. This inference is fully confirmed by available evidence.

> The Response Center in Philadelphia conducted a survey of 640 employees having access to 401(k) plans (491 plan participants and 149 non participants). 22% of the participants said that if this feature (401(k) cards and checks) were available, they would increase their contribution rates. This percentage rose to almost 30% among participants earning less than $ 35,000 per year and dropped to 15% for those earning over $50,000. More importantly, among non participants (i.e., those not contributing to their 401(k) plan), 22% said that they would be "very likely" to begin participating if this borrowing feature were available and an additional 28% said they would be "somewhat likely" to begin participating. Thus this innovative borrowing feature could motivate a significant 50% of employees not yet participating to start contributing to their 401(k) plan for their retirement. These responses are just what a rational observer would expect. It is interesting to note that when Merrill Lynch added bank card access to their brokerage account it revolutionized the industry and caused huge amounts of funds to move into these accounts. The impact of liquidity in attracting investments can be very powerful indeed. (See A Piece of the Action (1994) by Joseph Nocera).

In the past the option of 401(k) borrowing has been limited because the procedure to secure a loan was typically bureaucratic, discouraging the use and limiting the benefit of utilizing it. It was also costly for the employers, so that many, especially among the small firms, have ended up not offering or severely limiting the loan option.

But very recently, utilizing innovative ideas and modern data processing technology, an important new development has occurred that would permit the borrowers (401(k) plan participants) for limited amounts and for limited time to access their own account in an immediate and painless way through a bankcard and/or writing a check against their account.

The idea of borrowing using either vehicle is highly advantageous to the 401(k) participant because while he will be required to pay a competitive market rate of interest he will be paying that interest to himself instead of to a usurer, a financial intermediary or credit card company.

In the case of bank cards the advantage would be very significant as the present plans call for a cost of using the card (plus opportunity cost, i.e. the earnings they may forego when they divert some of the account equity from other assets into financing their loan) that presently may be realistically at 9% per year, as against prevailing credit card charges which most frequently run up to 18% and more.

This newly enhanced system is also very beneficial to the employers who would be interested in offering their 401(k) participants the privilege of limited borrowing from their accounts. In fact the bank card and check and any other 401(k) participant loan will be administered by a professional third party and thereby the cost will be reduced and will be paid by the user of the credit. Thus plan sponsors would be able to offer a borrowing facility at little or no cost to themselves, thereby increasing the availability of 401(k) borrowing to participants. This is especially true of smaller firms who typically employ lower paid employees.

The borrowing privilege (from 401(k) plans), in particular using bank cards has come under some criticism on the very superficial and unfounded argument that borrowing from your retirement account threatens to reduce the resources that will be in that account at time of retirement.

It is superficial and unfounded for many reasons. The first is it ignores the fact that loans have to be paid back within a maximum of five years as prescribed by the DOL and IRS, and which any plan sponsor can shorten if it feels prudent. Failure to pay within the set limits is treated as a total withdrawal of the outstanding loan amount and is seriously penalized with taxes and penalties.

In a world in which the average 401(k) participant already possesses many credit cards and is reasonably smart, people can be counted upon with practical certainty to repay their debt to themselves and avoid the disastrous consequences of 401(k) card default by either cutting spending or borrowing from some other source. With so many other bank cards the likelihood of default on the 401(k) card is negligible.

Another unfounded concern is that once participants are offered a bank card they will use that card to increase the volume of consumer credit card debt. That concern is unfounded since it is known that, on the average, consumers have 4-5 credit cards in hand and are continuously solicited to take more. They can already borrow more than they are currently borrowing, a fact that we know from the observation that lines of credit are a multiple of the average credit balance outstanding (see Bank One's report to the DOL, 5/6/96). There is no reason or evidence why access to one more card should increase the overall borrowing of a consumer. What does happen if the latest bank card offers more favorable credit conditions, is that the consumer may use it to consolidate debt. This development could very well occur with the 401(k) card but the borrowing will be offset by a reduction of other debt as occurs in any debt consolidation.

Instead one result that may be expected with great confidence is an increase in the inflow into and the balances of 401(k) accounts. Because people, especially lower income people, will be much more inclined to add to their 401(k) balances if they know these funds have not been locked away until retirement and are illiquid: but instead they are readily and easily borrowable when the need arises.

Any opposition to this important and highly beneficial financial innovation may come from those who do not understand the true nature of the innovation. The only vested interests that may fear this innovation are the issuers of traditional credit cards who may fear a competitive inroad into their highly profitable business. It has been rumored that opposition to the innovation has come from the large financial institutions that charge outrageous rates (16-22%) on credit cards.

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