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New 401k Rules: Balancing Access and Savings



When considering short-term funding options, participants are often advised to avoid tapping into their 401(k) accounts through loans or hardship withdrawals, as early withdrawals can impede long-term retirement savings. The SECURE 2.0 Act of 2022 introduced enhanced penalty-free emergency withdrawal provisions, offering greater liquidity and flexibility within 401(k) plans. While this development has raised concerns about

potential risks to retirement balances, a recent Vanguard study revealed that participant contribution rates typically remain stable both before and after taking loans or hardship withdrawals.

Increased Accessibility Under SECURE 2.0

Fiona Greig, Global Head of Investor Research and Policy at Vanguard, explained, “I think the promise of [the SECURE 2.0 provision] was that it would cause more people to participate in 401(k) plans or to save more and increase rates in 401(k) plans if they knew that the money was accessible to them in a hardship or a pinch... The downside though, of these expanded liquidity options, is that they could lead to leakage. They could cause more people to take withdrawals and ultimately result in lower balances.”

Turning Withdrawals into Loans

The paper's authors recommend that plan sponsors implement an "automatic repayment" provision, allowing participants to repay withdrawals over time through payroll deferrals, similar to a loan structure. This approach could help maintain consistent saving habits even after accessing emergency funds. Vanguard data indicates that most participants who took hardship withdrawals or loans in 2021 did not reduce their contribution rates afterward.

The study revealed that participants rarely decreased their contribution rates following a 401(k) loan or hardship withdrawal. In 2021, 26% of loan recipients and 24% of hardship withdrawal recipients voluntarily reduced their contribution rates within two years of taking the withdrawal, while an equal percentage voluntarily increased their contributions during the same period.

Additionally, frequent payroll deferrals play a crucial role in helping 401(k) loan recipients repay their loans, provided they remain employed long enough to complete the repayment. Researchers found that a \$1,000 withdrawal could typically be repaid within two years with a modest increase in contribution rates of approximately two percentage points.



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Greig recommends incorporating a feature that prompts participants to increase their contributions facilitating more efficient repayment of emergency withdrawals. Once the loan is repaid, plan sponsors could encourage participants to maintain their higher contribution rate, thereby enhancing long-term retirement savings.

The Bigger Financial Picture

Greig points out that while participants seem to manage 401(k) repayments without issue, the study only covers 401(k) data. Broader financial health, such as credit card debt or student loans, may impact participants' overall financial well-being. Rebecca Liebman, co-founder and CEO of LearnLux, notes that "There's a lot of other data that we see in credit card debt, medical debt, student debt, emergency savings data, credit score data ... that is impacting these decisions". She continues, "When you're only looking at 401(k) data, you are getting a skewed picture of financial health in your organization, because if you look at the macro trends, people are living in debt. People are pulling that money from somewhere."

Liebman stresses that in order to avoid taking out loans from their retirement plan, members should make sure they have emergency reserves and a debt-payoff plan so they know where they can find liquidity.

Automatic Features' Role in Financial Habits

According to Kelli Send, Senior Vice President at Francis LLC, the ability to repay loans does not necessarily signify an improvement in an individual's financial situation. She explains, "We've made auto features so amazing in 401(k) plans, and it's generally been a very good outcome," She says. "But it has lessened the attention required to manage your 401(k), which may perhaps lead to this positive behavior that Vanguard is seeing."

Send recommends setting limits on 401(k) loans to prevent employees from accumulating multiple loans simultaneously, which could lead to financial strain. While she supports 401(k) loans as a useful option, Send emphasizes the importance of mindful financial behavior and advocates for plan designs that promote continued saving after loan repayment.

Overall, Greig believes that thoughtful plan design can make a significant difference in participant behavior. By structuring 401(k) plans to support faster repayment or continued savings, plan sponsors can help participants maintain strong financial habits that benefit their long-term retirement readiness.

Sources:

<https://www.plansponsor.com/are-401k-loans-detrimental-to-retirement-savings-behavior/>

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