Adding a Sidecar Savings Account for Emergency Savings? Better Solutions May Exist

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If financial fragility[1] is the illness to be cured, and if leakage[2] from your participants' retirement savings accounts (401(k), 403(b), etc.) is one of the symptoms, a sidecar emergency savings account may be more likely to add a comorbidity than to provide a cure. Yes, every individual needs to prepare for financial emergencies. However, sidecar savings does not qualify under a standard set by the General Accountability Office (GAO) as "the most appropriate and least damaging option."[3] Your workers already have within their hands the only tool they need—their retirement savings plan "done right"—to achieve financial wellness[4] and to fashion their financial destiny.[5]

Keep it simple, focused. Leverage the commitment you've already made.

Start by challenging your service provider to update plan loan processing to 21st century functionality.

Symptoms of Financial Fragility

Some plan sponsors began to address financial fragility more than a decade ago. Symptoms include the following.

- 36% of surveyed Americans would not have sufficient cash or other assets to cover an unexpected bill of $400, while 10% suffer from income volatility and have difficulty paying regular bills.[6]
- 27% have more credit card debt than emergency savings.[7]
- Only 25% have sufficient savings to cover six months of expenses.[8]
- Less than 20% of households under age 55 have three months of income in liquid savings.[9]
- Many participants who suffered a financial shock confirm they would have to withdraw retirement savings.[10]
- For many years, more than two-thirds of people in the United States have reported that they live paycheck to paycheck.[11]

AT A GLANCE

- Among workers eligible for a retirement savings plan: sidecar savings accounts may be suboptimal for the financially fragile because many, if not most, have insufficient disposable income, have not developed a savings habit and/or do not prioritize retirement preparation.
- Plan loans "done right" may be the best liquidity option—superior to sidecars—most plans already offer plan loans.
- Advantages of plan loans as a liquidity solution include the ability to leverage deferred withholding taxes, and the employer match, coupled with tax-free access, etc.

One 2015 report showed that 56% of surveyed workers ages 20–58 had experienced a financial shock in the past year.[12] More recently, COVID-19 exposed the possibility that a much larger segment of people in the United States may be financially fragile.[13]

Treating Symptoms May Add Complexity

There are hundreds of vendors offering a diverse set of products, programs and services—some incorporating tax preferences—through an employee assistance program (EAP), voluntary benefits, an employee purchase program or as perquisites. The sidebar "Beyond Traditional Benefits" is an illustrative, not exhaustive, list of the diversity of these items.

Some employers limit these beyond traditional benefits (BTB) by offering only those that:

- Fill a gap in traditional benefits
- Are not available in the individual marketplace
- Offer a convenience, and/or
- Offer demonstrably better value than comparables in the individual marketplace.

Other employers accept all items on a platform/website. Vendors may become merchants of complexity—offering "something for everyone" or "something for every need." Where employers add a thick layer of BTB choices over those already present in the traditional benefit plans, workers may address each and every potential need with a separate savings, insurance, investment, perquisite or product. BTB may trigger "choice blindness" as well as prioritization and decision-making challenges.[14] Typically, the result is low rates of BTB take-up, follow-through and/or satisfaction.

Worse, employers may respond to government actions that increase liquidity for emergencies by adding potentially counterproductive choices to their retirement savings plans. Four times in the last four years, Congress authorized plan sponsors to make in-service hardship[15] and other withdrawals easier and/or in greater amounts. Only once were lawmakers prompted by COVID-19.

- The Bipartisan Budget Act of 2018 liberalized the rules for in-service withdrawals.
- The Setting Every Community Up for Retirement Enhancement (SECURE) Act (2019) offered new penalty-

Beyond Traditional Benefits

Following is an illustrative, not exhaustive, list of the diversity of benefits employers offer to their employees.

- Assessments: health, financial risk, biometric
- Bank: (emergency) savings account, checking, split-deposit paycheck, credit cards, loans
- Caregiving: referrals for or on-site child or elder care
- Commuting: parking, mass transit, van, bicycle
- Concierge: dry cleaning, take-home meals, shopping, tradespeople
- Counseling: death, divorce, relationships, stress, substance use, work-family balance
- Disaster assistance: benevolence, disaster relief payments
- Discounts: cell phones, computer, wearables, automobiles, fitness equipment, furniture
- Experiences: "bucket list" opportunities
- Financial: budgeting, coaching, tax advice, debt management, investments, literacy, student loan consolidation
- Fitness: gym memberships
- Insurance: accidental death and dismemberment (AD&D), automobile, critical illness, dental, long-term disability (LTD), home, hospital, pet, umbrella, vision, whole/universal/variable life
- Investments: 529 plan, annuities, individual retirement account (IRA)
- Legal: civil, domestic, vehicle, real estate
- Lunch: subsidized cafeteria
- On site: physical therapy, primary care
- Payroll: pay to date, pay advances*
- Recognition: service awards
- Security: home security programs, identity theft insurance
- Services: dry cleaning, egg freezing, LASIK, prepared meals, lactation/travel, room
- Wealth: beneficiary designations, wills, trusts, durable power of attorney

*J. Towarnicky, "It's My Money and I Need it Now!" November 3, 2019. Accessed August 4, 2021 at https://www.psca.org/news/blog/it%E2%80%99s-my-money-and-i-need-it-now.

tax−free withdrawal options for childbirth or adoption—up to $5,000 per parent and up to $10,000 per child.

- The Coronavirus Aid, Relief, and Economic Security (CARES) Act (2020) eliminated any hardship requirement for qualified individuals who may withdraw up to $100,000, avoid penalty taxes and receive three-year income tax averaging and repayment options. Often, when one spouse qualified, so did the other, meaning up to $200,000 might be available per couple.
- The Consolidated Appropriations Act (2021) added withdrawal provisions similar to CARES Act provisions if a participant's principal residence was within a federal-declared disaster area (for economic losses between December 28, 2019 and February 25, 2021).

Long before COVID-19, Congress created exceptions to waive the 10% penalty taxes on certain premature withdrawals from individual retirement accounts (IRAs)—for higher education, first-time home purchases, unreimbursed medical expenses and more.

And don't forget the states. If you have workers in California, Illinois or Oregon where the spouse of your worker is employed by a firm that does not offer a retirement savings plan, state-mandated IRAs may apply. They tout tax-free access to Roth assets for any need, including emergencies.[16] This convenience may result in opportunity and/or real costs that negatively impact the financially fragile household because:

- Many won't participate, won't contribute enough to obtain the full employer financial support or won't maximize tax-favored savings in the employer-sponsored plan you make available
- IRA distributions are more readily available
- Most state-mandated programs offer only:
  —A limited set of investments (e.g., core options)
  —Limited liquidity only via distributions
  —The Roth IRA, so workers potentially miss out on certain tax preferences.

For example, OregonSaves, a state retirement benefit, had a 101-basis point administrative fee plus investment fees compared with other IRA vendors that offer no-fee IRAs with no-fee index investment options.[17] Fees have an impact. As of December 31, 2020, because of fees, most OregonSaves participants had accounts with values that were less than the amount contributed.[18] Similarly, as of June 30, 2021, after just three years of operation, more than 20% of all contributions to OregonSaves have already been withdrawn ($28,973,811 of $134,886,793).[19]

Traditional Benefit Plan and External Account Sidecars[20]

In-plan assets can be used as a sidecar to create liquidity to address multiple uses/needs other than retirement:

- 401(k), 403(b), 401(a)
- Health savings account
- Deemed IRA.

External sidecars include:

- A bank or credit union savings account
- Traditional or Roth IRA.

All of the above liquidity options have drawbacks and/or limitations.

Automatic enrollment in external sidecars is generally prohibited by state payroll/labor laws—except where part of a state-mandated IRA. A dollar limit is needed to avoid "crowd-out" of retirement savings. Most limit investments to capital preservation. Fees are modest. Only a handful offer an employer match. Most don't limit access. Investment earnings are currently taxable as ordinary income even if not withdrawn. Portability isn't an issue and, for the bankable, neither is compliance.

Experts assert that "having separate rainy-day and retirement savings accounts can facilitate greater saving for short and long-term purposes by helping to psychologically segregate and catalyze these two motives to save." Further, they note that "auto-features and mental accounting can be jointly deployed to reduce the frequency with which short-term needs crowd out long-run retirement savings."[21] The sidebar "Separating Rainy-Day and Retirement Savings Accounts" offers more information.

However, as suggested by numerous targeted initiatives[22] and my decades of plan sponsor experience, sidecars are suboptimal for the financially fragile because many, if not most, have insufficient disposable income, have not developed a savings habit and/or have not prioritized retirement preparation.

For the financially fragile, using a sidecar often means forgoing automatic enrollment. Retirement savings plans with automatic features often have 50+% higher participation, compared with voluntary enrollment plans, for workers:

- Under age 45
- With wages of $50,000 or less, and/or
- With less than seven years of service.[23]

Traditional benefit plans have many advantages over external accounts. Retirement savings plans, deemed IRAs and health savings accounts (HSAs) can all deploy automatic features.[24] Accumulations need not be limited. Most offer diverse investment choices. Fees decline as assets under management increase. An employer match is common on 401(k) and 403(b) pretax or Roth deferrals but not so much on after-tax 401(a), deemed IRA or catch-up contributions. Tax code and Employee Retirement Income Security Act (ERISA) compliance is required. However, access to assets may be illiquid because:

- Only certain refunds of after-tax 401(a), Roth 401(k) and deemed Roth contributions are available without tax consequence
- Access may be limited to specific needs[25] or only after completing a period of service or postseparation
- Taxable distributions are subject to income taxes at the worker's marginal federal and state tax rates and may also be subject to an additional 10% or 20% HSA excise (nondeductible penalty) tax.[26]

Optimal "Treatment" for the Financially Fragile With Emergencies

Eligible workers who forgo retirement savings plan participation are more likely to also be financially fragile—lacking emergency savings.[27] One study showed that 22% of eligible workers do not participate (38% in voluntary enrollment plans, 8% in automatic enrollment plans) and that 34% of participating workers failed to contribute enough to obtain the full employer match.[28]

Surveys show that many may respond to the pandemic by prioritizing emergency over retirement savings.[29] Diverting worker savings to a sidecar bank account, to an IRA or to unmatched after-tax contributions may encourage financially fragile workers to forgo the tax preferences and employer financial support only available through a retirement savings plan. And, what if the emergency never comes or, if by the time it occurs, the worker has made other provisions?

Studies show the prevalence of financial fragility:

- Is greater among those who are less advantaged (recently lost employment, had a reduction in income, have modest education) and/or those with accumulated debts
- Declines as household assets increase.

Retirement savings plans need not be illiquid. Most offer loans. Coupled with other features, plan loans "done right" simplify worker financial decision making.[30]

Unfortunately, many academics, plan advisors, service providers, policy makers and pundits remain hyperfocused on limiting retirement savings as solely for retirement. Many would limit liquidity via plan loans—potentially impeding workers' retirement preparation.[31] However,

Separating Rainy-Day and Retirement Savings Accounts

Plan sponsors may want to consider adding 401(a) after-tax contributions and/or deemed individual retirement account (IRA) sidecars as emergency savings vehicles for households that are *not* financially fragile.

Separating rainy-day and retirement savings may facilitate better financial decision making through better mental accounting—methods that households use to organize, evaluate and keep track of financial activities. A separate rainy-day account may improve financial decisions by those who are not financially fragile. Workers may:

- Recognize the limits of accumulated assets—avoiding the self-deceiving perception that any one dollar could be used to cover both short-term and retirement needs
- Increase savings due to partition dependence—a bias to allocate an equal amount to every discrete category
- Avoid spending rainy-day assets for other purposes
- Avoid spending retirement assets to meet short-term needs.

Studies confirm that dividing a fixed savings amount across multiple accounts increased asset accumulation by reducing withdrawals—tapping one account while leaving the other untouched.

for those workers who aren't saving enough for retirement, highlighting clear, unambiguous access to tax-free liquidity may prompt greater savings. Some may make additional precautionary contributions—more than they might otherwise earmark for a distant, future, uncertain retirement.

Remember that plan loan principal never leaves the plan. In most plans, it becomes a fixed income investment in the borrower/lender. Plan loans can also be used to resolve accumulated debts and break the cycle of payday loans and other indebtedness. So, where a plan loan replaces high-cost debt, it may improve both retirement preparation and household wealth because the interest rate on today's plan loan is typically:

- Less than that of a payday loan, a credit card advance or a loan from a commercial source, *and*
- Greater than the earnings on other available fixed income investments in the plan.[32]

Because plan loans are fixed income investments, participants may need to rebalance to maintain their desired asset allocation.

Plan loans "done right" require that service providers first "sharpen the saw" and update plan loan processes and provisions to 21st century functionality.[33] Changes might include:[34]

- **Electronic banking:** Allows plan loan repayment to continue after separation and enables term vested and retired participants to initiate a plan loan after separation and retain tax-preferred liquidity
- **A line-of-credit structure:** Avoids a numeric limit on loans, ensures participants can readily identify available liquidity and payoff amounts
- **Extensive marketing:** Confirms how loan functionality can enable use of the same assets over and over to meet iterative financial needs without negatively impacting retirement preparation
- **A "hardship loan" provision:** Allows participants to elect small-amount loans (e.g., up to $1,000) to be repaid in a single deduction from a near-term, future paycheck or single-sum payment [35]
- **Behavioral economics tools, concepts and processes:** For example, upon application, you can:
  —Require participants to execute the loan agreement as both the borrower and the lender (the future self)
  —Require participants to execute a commitment bond to acknowledge that repayment continues after separation
  —Confirm that loan activity will be reported to the credit bureaus to build participant credit ratings

TABLE

Optimal Liquidity for Emergencies*

Done right, plan loans offer greater liquidity—starting with the very first contribution.

		Typical 401(k) plan	
	External bank sidecar	Hardship withdrawal	Plan loan
Employee contribution			
Per payday	$90	$120	$120
Per year	$2,340	$3,120	$3,120
Reduction in take-home pay	$2,340	$2,340	$2,340
Employer contribution		$1,560	$1,560
Invested assets	$2,340	$4,680	$4,680
One-year earnings			
Money market fund (.5%)	$5.85		
Target-date investment (6%)		$140.40	$140.40
Gross amount available at one year	$2,345.85	$4,820.40	$4,820.40
Withdrawal net of taxes	$2,344.45	$3,181.46	
Loan			$4,820.40

*Author's calculations: Assumes $52,000 annual salary, paid biweekly, pretax contributions, 24% federal/state marginal income tax rates, age 30, employer match of $50 on first 6% of pay immediately vested.

—Obtain banking information and authorization so payments continue even after payroll deductions stop.

Updating loan functionality as described above:

- Doesn't impact automatic features and/or other plan provisions
- Avoids the need for sidecar or rainy-day limitations
- Doesn't add fees and avoids any portability issues
- Provides quick, tax-free access to a portion of plan assets, typically within one to three business days.

If the goals are financial resiliency as well as preparing for emergencies and retirement, 'tis much, much better to have saved and borrowed than never to have saved at all, to have saved and withdrawn, or to have saved in a sidecar.[36]

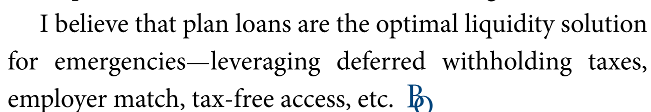
Side-by-side comparisons show that a plan loan may offer a median income worker 105% more than an external bank account and 54% more than a hardship withdrawal. (See the table.)

While a plan loan must be repaid, the bank sidecar and hardship withdrawals must also be replenished for the next emergency need and/or to prepare for retirement income and medical needs.

Finally, plan loans "done right" also includes meeting the financially fragile, savings-hesitant where they are by:

- Providing eligibility at hire and perennial application of automatic features[37]
- Offering onboarding processes that facilitate "roll-on" of assets and loans from predecessor employer plans and IRAs[38]
- Prospectively limiting or removing in-service distributions[39]
- Achieving and maintaining financial resilience—avoiding postseparation leakage by retaining assets and welcoming postseparation contributions and rollovers into the plan via deemed IRAs (Roth and traditional), in-plan Roth conversions, directed brokerage, etc.

I believe that plan loans are the optimal liquidity solution for emergencies—leveraging deferred withholding taxes, employer match, tax-free access, etc.



My comments are my own based on my past experiences in plan sponsor roles, and do not necessarily reflect those of any employer or association I have been employed by or affiliated with, past, present or future.

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Endnotes

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with little tenure. For decades, median tenure for workers ages 25-34 has been less than three years, and less than five years for all workers ages 25+. As a result, illiquidity may be temporary. See: Bureau of Labor Statistics, U.S. Department of Labor, "Employee Tenure in 2020," September 22, 2020. Accessed August 4, 2021 at www.bls.gov/news.release/pdf/tenure.pdf.

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27. C. Copeland, "Emergency Savings: The Reality of Workers' Liquid Savings-Evidence From the Survey of Consumer Finances," EBRI, August 29, 2019. "The families whose heads were defined contribution (DC) plan participants were found to be more likely to have sufficient liquid savings to cover three months of expenses than those with heads who were nonparticipants. . . . 24.7 percent of families with DC-plan-participant heads had more liquid savings than three months of their income, compared with 13.4 percent for families with DC-plan eligible nonparticipating heads . . . despite employees preparing for retirement through their participation in the DC plan, help is needed by a sizable share of these employees for short-term financial issues. The potential need is even more pressing for those who are eligible for the plan but do not participate." Accessed August 4, 2021 at www.ebri.org/docs/default-source/ebri-issue-brief/ebri_ib_490_emergsav-29aug19.pdf?sfvrsn=a26a3c2f_8.

28. Vanguard, note 23, supra.

29. S. Foster, "Survey: Here's what Americans say is their biggest financial regret," Bankrate, May 12, 2021. "Twenty percent of respondents listed a lack of emergency savings as their top regret, compared to 15% two years ago." Not saving enough for retirement was a close second at 19%, followed by racking up too much credit-card debt, at 18%. Saving more for emergencies (26 percent) is the biggest postpandemic change Americans are planning to make to the way they manage their finances. Accessed August 4, 2021 at www.bankrate.com/surveys/biggest-financial-regrets.

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32. G. Li, P. Smith, "Borrowing From Yourself: 401(k) Loans and Household Balance," Federal Reserve Board, August 12, 2008. "We examine 401(k) borrowing since 1992 and identify a puzzle: despite potential gains from borrowing against 401(k) assets instead of from other sources, most eligible households eschew 401(k) loans, including many who carry relatively expensive balances on credit cards and auto loans. We estimate that households with access to 401(k) loans could have saved about $3.3 billion in 2004—about $200 per household—by shifting debt to 401(k) loans." Accessed December 3, 2021 at www.federalreserve.gov/pubs/feds/2008/200842/200842pap.pdf.

33. Abraham Lincoln may or may not have said "Give me six hours to chop down a tree and I will spend the first four sharpening the ax." Perhaps Lincoln experienced a sermon back in 1856 by a Presbyterian minister titled "The Dull Axe," based on Ecclesiastes 10:10: "If the ax is dull and its edge unsharpened, more strength is needed, but skill will bring success."

34. J. Towarnicky, "Debt or Deferrals . . . College or Contributions? A 401(k) Can Do Double Duty," *Benefits Quarterly,* Third Quarter 2019. See also "Qualified Plan Loans, Evil or Essential?" *Benefits Quarterly,* Second Quarter 2017.

35. Treasury Regulation 26 CFR §1.72(p)-1 - Loans treated as distributions. Q&A-3, Q&A-10. To avoid a taxable distribution and provide short term liquidity, a plan may incorporate provisions allowing for a plan loan to be repaid as a single sum, coupled with a "cure period" through the end of the calendar quarter following the calendar quarter in which the loan was initiated.

36. Paraphrasing Lord Alfred Tennyson, In Memoriam A. H. H. OBIIT MDCCCXXXIII: 27, "'Tis better to have loved and lost Than never to have loved at all."

37. J. Towarnicky, "Financial Independence is the Greatest Civil Liberty!" April 9, 2019. Accessed August 4, 2021 at www.psca.org/news/blog/financial-independence-greatest-civil-liberty.

38. J. Towarnicky, "My Financial Wellness Solution: The 401(k) As A Lifetime Financial Wellness Instrument," Society of Actuaries, 2017, Accessed August 4, 2021 at www.soa.org/globalassets/assets/files/resources/essays-monographs/financial-wellness/2017-financial-wellness-essay-towarnicky.pdf. See also: "Stop Leaks: Plan Loans Participants can avoid not only the leakage from the loan outstanding at separation, but also, potentially, leakage of residual balances," 401(k)Specialist.com, November 29, 2020. Accessed August 4, 2021 at https://401kspecialistmag.com/how-to-stop-401k-leakage-from-plan-loans.

39. J. Towarnicky, note 15, supra.

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