It's Becoming Clear, We Need to Increasing Precautionary Savings

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MarketWatch Blog by Alicia H. Munnell

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Or else people will tap their retirement savings when the roof leaks.

As many of you may know, several states – California, Connecticut, Illinois, Maryland, and Oregon – are in the process of **setting up retirement programs** for their uncovered private sector workers. These programs consist of a mandate on employers without retirement plans to automatically enroll their workers in an Individual Retirement Account (IRA) and to transfer between 3 and 6 percent of workers' earnings into that IRA each month. Workers have the right to opt out.

Some skeptics ask whether low-income workers should be compelled to save for retirement when they have such pressing immediate needs. My answer is that even those who should not be saving for retirement should be saving for when their car breaks down or their water heater floods. That is, they need some "precautionary saving." Given that most of these state programs are structured as Roth IRAs, where people put in after-tax money and can withdraw their contributions penalty free, they will encourage precautionary saving even if they do not produce balances at retirement.

Precautionary saving has also become a topic of conversation among researchers and policymakers concerned about increasing the retirement saving of middle-income people

by reducing leakages from 401(k) plans. The idea is that hardship withdrawals from 401(k)s would be unnecessary if workers had another pool of money set aside for emergencies. Indeed, a HelloWallet study found workers who lack emergency saving were more likely to breach their 401(k)s than those with these savings, even when controlling for characteristics like age, education, income, and debt-to-income ratio. At the same time, workers have trouble accumulating liquid assets that can be used in an emergency because of **a preference for instant gratification** that leads liquid funds to be quickly spent.

The effort to increase so-called "precautionary savings" has generated two broad approaches: 1) separating some of workers' existing retirement savings into a liquid "emergency" bucket while maintaining the rest as true retirement savings; and 2) generating entirely new savings.

The first approach recognizes that some leakage may be a response to legitimate emergencies, while other leakage should be limited. **Researchers have shown** that under certain assumptions, 15 percent of retirement savings should be accessible for these emergencies while the remainder should be completely inaccessible until retirement. One way of implementing this theoretical finding has been suggested by David John of AARP in the form of **"split accounts."** This approach envisions separating contributions to 401(k)s into those for emergency use, with penalty-free withdrawals, and those for retirement, which would have the standard withdrawal penalties. Some have suggested that once the emergency fund

becomes large enough, say three months' worth of income, then all contributions would go to retirement.

The other approach, generating new precautionary savings, has been implemented on a small scale in several creative ways. One approach used by credit unions is called "borrow and save" and gives households that request a loan a portion of the money while depositing the rest in a savings account. Once the loan is paid off, the borrower gains access to any savings. Another idea is to encourage saving by tying higher rates of saving to a higher likelihood of **receiving a "prize"** – i.e., a payout much larger than the interest a savings account typically earns. Others have attempted to increase non-retirement savings by taking a lesson from 401(k)s and offering matching contributions, with the match funded by money from foundations and individual donors.

An emerging alternative is to leverage the credit of the employer to offer employees low-interest loans outside of their retirement accounts. For example, MassMutual recently made the "Kashable" service available to employers using its benefit platform. This service allows employees to receive emergency loans at a much lower interest rate than they could receive elsewhere. Repayment occurs automatically out of the worker's paycheck and does not incur the administrative fees or taxation of a loan out of the retirement account.

In short, researchers are starting to recognize the obvious – if we want people not to touch their retirement saving, we need to make sure that they have a small pot of money that is easily accessed without penalty in case of emergency.