

Liquidity without leakage: How to design emergency expense withdrawals from retirement plans

- The SECURE 2.0 Act's emergency expense withdrawal provision, if implemented appropriately, has the potential to provide short-term liquidity many people need without sacrificing their retirement outlook.
- Empirical evidence from small 401(k) loans suggests that participants taking emergency expense withdrawals would have the capacity to continue to save at the same rate while they repay the withdrawals over reasonable time frames.
- By nudging participants to increase their saving rate over and above their regular contributions in order to repay their emergency expense withdrawals, plan sponsors can help achieve the dual objectives of providing liquidity and preventing retirement savings leakage.

The importance of emergency savings

American workers have both long-term and short-term saving objectives. Employer-sponsored defined contribution accounts such as 401(k) plans play an essential role in helping workers accumulate long-run retirement wealth. However, when it comes to short-term expenses, workers are less likely to have access to savings options through their employers and often must build emergency savings buffers in their bank accounts.

Striking the right balance between retirement and emergency savings can be difficult, especially for younger and lower-income

workers. Additionally, non-401(k) savings accounts often lack the automated features, such as automatic enrollment and regular payroll deferrals, that promote steady savings behavior in employer-sponsored retirement plans. Given the challenges to accumulating short-term savings, many Americans do not have sufficient liquid wealth to cover even modest emergency spending needs: National surveys indicate that 37% of adults do not have enough cash on hand to pay for a \$400 emergency expense.¹ When faced with spending spikes that they cannot fund, many people resort to expensive credit card debt and carry a revolving balance.²

¹ See Board of Governors of the Federal Reserve System, *Economic Well-Being of U.S. Households in 2022*; available at [federalreserve.gov/publications/files/2022-report-economic-well-being-us-households-202305.pdf](https://www.federalreserve.gov/publications/files/2022-report-economic-well-being-us-households-202305.pdf).

² See Employee Benefit Research Institute, *How Financial Factors Outside of a 401(k) Plan Can Impact Retirement Readiness*, EBRI Issue Brief, No. 591, September 7, 2023.

New options under SECURE 2.0

SECURE 2.0 was passed in 2022 as a follow-up to the Setting Every Community Up for Retirement (SECURE) Act of 2019. The newer law addresses the emergency-savings challenge by making it easier for workers to save for short-term expenses in their employer-sponsored retirement plans. Beginning in 2024, employers have the option to introduce two new emergency-savings features. First, plan sponsors may allow participants to take penalty-free emergency expense withdrawals from their retirement accounts of up to \$1,000 per year. Second, plan sponsors may establish Pension-Linked Emergency Savings Accounts (PLESAs), which allow participants to build short-term savings through Roth payroll deferrals. We focus on emergency expense withdrawals because they are easier to implement than PLESAs and are thus more likely to be taken up by employers in the near term.³

The new emergency expense withdrawals permitted under SECURE 2.0 are penalty-free and dollar-capped withdrawals. At employers that adopt the provision, participants may withdraw up to \$1,000 per year for "unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses."⁴ The withdrawals are not subject to the 10% early distribution penalty, though participants must pay ordinary income

taxes on the withdrawal amount. The lack of a tax penalty, along with the self-certification of financial need, makes the new emergency expense withdrawals a uniquely flexible liquidity option that could help participants cover urgent expenses.⁵

The ability to draw on 401(k) assets during financial emergencies may also make retirement saving more attractive and induce more employees to contribute to their 401(k) plans. The 401(k) participation rate is particularly low for low-wage earners—40% for those earning less than \$15,000 per year, compared with 95% for those earning more than \$150,000 per year.⁶

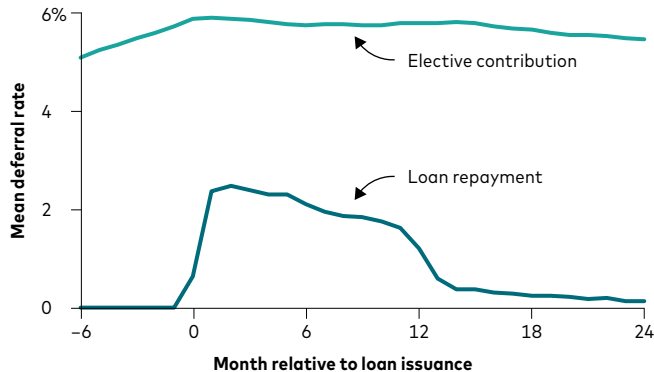
Lessons from small 401(k) loans

Because the relevant provision of SECURE 2.0 only became effective earlier this year, we cannot yet study the repayment capacity of participants who take emergency expense withdrawals. Instead, we analyze the closest analogue available in historical 401(k) data: participants who take plan loans up to \$1,000. Small loans are likely to be used for similar short-term expenses as the new emergency expense withdrawals, and the mandatory nature of loan repayment allows us to assess participants' capacity to make repayment deferrals that are incremental to their elective contributions.

- ³ See, for example, Adam McMahon and Michael Hadley, *Early Secure 2.0 Implementation Challenges for Recordkeepers & Employers*, Bloomberg Law, September 2023 (available at [bloomberglaw.com/external/document/X6919OSO000000/retirement-benefits-professional-perspective-early-secure-2-0-im](https://www.bloomberglaw.com/external/document/X6919OSO000000/retirement-benefits-professional-perspective-early-secure-2-0-im)), which states, "[PLESAs] require adopting employers and their service providers to implement some rather complex rules in order to comply. Most notably, PLESAs cannot accept contributions from highly compensated employees (HCEs). ... Also, separate from the limit for HCEs, PLESAs are subject to a \$2,500 account limit. ... This account limit presents additional operational challenges because retirement plan recordkeepers have previously not been required to monitor or enforce account limits, as opposed to contribution limits." Unlike PLESAs, emergency expense withdrawals are permitted for all participants at adopting plans (including HCEs).
- ⁴ Under SECURE 2.0, participants are limited to one emergency expense withdrawal per calendar year (that is, they cannot take multiple withdrawals with an aggregate amount of \$1,000 or less). Participants who take an emergency expense withdrawal are not eligible to take another emergency expense withdrawal until either the total amount of plan contributions they have made since the withdrawal is at least as large as the withdrawal or three years have elapsed. For example, a participant taking a \$1,000 withdrawal reestablishes eligibility after making \$1,000 in subsequent elective contributions. Since this eligibility condition does not require a contribution increase to offset the withdrawal amount, participants can reestablish eligibility while still incurring leakage.
- ⁵ As with the coronavirus-related hardship withdrawals allowed under the CARES Act in 2020, employers may rely on participants' self-certification that they are experiencing "unforeseeable or immediate financial needs" that qualify them for an emergency expense withdrawal.
- ⁶ See Vanguard (2024). *How America Saves 2024*. Valley Forge, Pa.: The Vanguard Group. Participation rates are estimates for 2023.

Figure 1 illustrates our key finding: Participants appear able to repay small loans while maintaining their elective contributions. The chart shows average elective contribution rates and loan repayment rates for participants who took loans of up to \$1,000 in Vanguard-administered plans in 2021. Mandatory repayments begin in the month of loan issuance and represent about 2% of participants' income. Even as participants make these repayment deferrals, their elective contributions are remarkably stable: The elective contribution rate increases gradually before loan issuance, peaks in the month of issuance, then remains roughly constant for the next 24 months. Most participants complete repayment within 12–18 months (compared with the maximum allowable loan repayment term of five years), at which point the average repayment rate falls back toward zero.⁷

FIGURE 1
Participants maintain their regular elective contributions despite additional loan repayments



Notes: Total contributions are the sum of elective contributions and loan repayments. The chart considers participants in Vanguard-administered plans who took 401(k) loans of up to \$1,000 in 2021. (Participants are restricted to those who are still employed at the lending plan's sponsor 24 months after issuance.) We estimate loan repayment rates in the following way: First, we estimate participants' monthly income as the average monthly employee contributions between month -6 and month -1, divided by the average elective contribution rate between month -6 and month -1. We then divide monthly loan repayment amounts by the monthly income estimate. For participants with multiple outstanding loans, the loan repayment rate reflects only the loan issued in month 0.

Source: Vanguard.

We conclude that those who take emergency expense withdrawals, if prompted to repay them, would likely display the same stable contribution behavior as the loan takers depicted in Figure 1.⁸ An increase in the elective contribution rate of 2 percentage points would be within most participants' saving capacity and would generally ensure that a \$1,000 withdrawal is repaid within 12–18 months. By encouraging small elective contribution increases, plan sponsors can help participants realize the liquidity benefits of emergency expense withdrawals while minimizing long-run leakage costs.

Solution: Minimizing leakage by encouraging repayment

Emergency expense withdrawals provide valuable liquidity in times of financial stress, but they may also raise the risk of costly leakage from retirement savings. Annual withdrawals of \$1,000—and the compounded market returns they forgo—could cause a substantial slowdown in many participants' retirement wealth accumulation. How can plan sponsors offer the short-term liquidity benefits of emergency expense withdrawals while minimizing the long-run costs to participants' retirement saving?

Plan sponsors can help minimize leakage by encouraging participants to repay emergency expense withdrawals through an increase in their contribution rate. Repayment nudges, which could take the form of general participant education or specific communications to participants who have requested a withdrawal, would prompt participants to repay the withdrawn funds in a timely manner, essentially treating the withdrawal as if it were a loan. Our research indicates that most participants would be able to repay the withdrawal amount over a reasonable time frame while maintaining their previous elective contribution rate.

7 We also conduct analyses comparing loan takers to a control group of similar participants who did not take loans. We find that loan takers' contribution rates fall by only a small amount (0.8 percentage points) relative to the control group during the 24 months following loan issuance. For the full set of analyses, see John Beshears, James J. Choi, Joel M. Dickson, Aaron Goodman, Fiona Greig, and David Laibson (2024). *Does 401(k) Loan Repayment Crowd Out Retirement Saving? Evidence From Administrative Data and Implications for Plan Design*; available at papers.ssrn.com/sol3/papers.cfm?abstract_id=4749081.

8 Our definition of "repayment" is more stringent than the one used for eligibility purposes: We consider repayment to be an increase in the contribution rate that maintains participants' prior contribution activity and returns the withdrawn funds to the 401(k) account.

Authors

Fiona Greig
Aaron Goodman
Kelly Hahn

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ISGLWLH 072024