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401(k) breaches undermining retirement security for millions

By Michael A. Fletcher, Published: January 14 | Updated: Tuesday, January 15, 9:34 AM

A large and growing share of American workers are tapping their retirement savings accounts for non-retirement needs, raising broad questions about the effectiveness of one of the most important savings vehicles for old age.

More than one in four American workers with 401(k) and other retirement savings accounts use them to pay current expenses, new data show. The withdrawals, cash-outs and loans drain nearly a quarter of the $293 billion that workers and employers deposit into the accounts each year, undermining already shaky retirement security for millions of Americans.

With federal policymakers eyeing cuts to Social Security benefits and Medicare to rein in soaring federal deficits, and traditional pensions in a long decline, retirement savings experts say the drain from the accounts has dire implications for future retirees.

"We're going from bad to worse," said Diane Oakley, executive director of the National Institute on Retirement Security. "Already, fewer private-sector workers have access to stable pension plans. And the savings in individual retirement savings accounts like 401(k) plans — which already are severely underfunded — continue to leak out at a high rate."

A report due out this week from the financial advisory firm HelloWallet found that more than one in four workers dip into retirement funds to pay their mortgages, credit card debt or other bills. Those in their 40s have been the most likely culprits — one-third are turning to such accounts for relief.

Fresh data from Vanguard, one of the nation's largest 401(k) managers, show a 12 percent increase in the number of workers who took loans against their retirement accounts or withdrew money outright since 2008.

The most common way Americans tap their retirement funds is through loans, which must be repaid with interest. Those who withdraw money face hefty penalties. In most cases, they not only incur a 10 percent federal tax penalty but also pay income taxes. The costs are financially harmful to families even as money-management firms reap massive fees for handling retirement accounts that ultimately are not used for retirement.

In addition, employers often are subsidizing the accounts with matching contributions on the assumption that the money is helping to secure their employees' retirements.

"What you have is 401(k) participants voting with their wallets saying they would much rather use this money for other purposes. I don't think this can be ignored. Employers are dramatically overpaying for retirement, but it is not benefitting the employee," said Matt Fellowes, a former Brookings Institution researcher who is chief executive of HelloWallet. "In many cases, the only one benefiting is the vendor."

Since 401(k)s were created by Congress in 1978, concern about the pervasive use of retirement funds for other expenses has grown as other means of retirement security have dwindled.

In 1980, four out of five private-sector workers were covered by traditional pensions that paid them a fixed benefit based on their salary and length of service once they retired. Now, just one in five workers has a pension, leaving 401(k)s and similar retirement savings accounts as the primary vehicles for retirees to supplement their Social Security benefits.

"Encouraging or enabling people to spend down retirement money in anything other than the most severe circumstances is a terrible mistake," said David C. John, a senior fellow at the Heritage Foundation who studies retirement policy.

But millions of Americans, caught between flat wages and high expenses for everything from sending children to college to making home repairs, feel as though they have little choice. The withdrawals have grown substantially in the wake of the financial crisis.

In 2010, 28 percent of participants reported having an outstanding loan against their retirement accounts, an all-time high, according to a survey of 110 large employers by Aon Hewitt, a human resources consultancy. And nearly 7 percent of employees took hardship withdrawals that year — roughly a 40 percent increase since the recession, while 42 percent of workers cashed out their plans rather than rolling them over when they changed jobs.

Charlotte Knox, 62, has worked as a housekeeper at Baltimore's Hyatt Regency hotel since 1984. She earns $13 an hour, is struggling to recover from a hip replacement and is planning to retire next month. But partly because of past withdrawals, her 401(k) balance is only

$60,000, which is all she has to supplement her Social Security.

“I don’t have any money,” she said. “I’m just taking it a day at a time. That’s all I can do.”

Overall, about a third of American households participate in 401(k)-type accounts, which hold a combined $3.5 trillion in assets. But a large portion of that money does not make it to retirement. A recent study by Boston College’s Center for Retirement Research found that the typical household approaching retirement age has an average of $120,000 in retirement savings, enough for roughly a $7,000-a-year annuity.

“401(k)s are not being used for retirement by a large and growing share of workers because they are misaligned with the very basic financial problems most workers face and must address,” said Fellowes of HelloWallet, which provides benefits advice to companies.

Federal policymakers and employer retirement managers have focused little on the threat to retirement security posed by premature withdrawals from savings plans and instead have worked to devise ways to get workers to put more money into the accounts at an earlier age.

In 2006, employers were given broader latitude to enroll employees in 401(k)-type plans unless workers asked not to participate. Just this year, the annual limit for 401(k)-type contributions increased from $17,000 to $17,500 for workers under age 50 and from $22,500 to $23,000 for those who are older. Meanwhile, the Saver’s Tax Credit provides up to $1,000 to help low-income workers build retirement savings.

Many employers have embraced 401(k) and other defined-contribution accounts as a way of helping workers save for retirement while relieving themselves of the financial risks that come with managing a traditional pension plan. In theory, 401(k) accounts are better suited to an economy in which workers are changing jobs more frequently than ever because the accounts can be rolled over from previous employers.

But their success depends on workers consistently contributing to them and allowing the money to stay in place throughout their careers, allowing their investment returns to compound. Many workers — particularly some earning higher salaries — do just that. But many others, who have precious little savings elsewhere, tap their retirement money as a sort of “rainy day” fund, eroding its power for the future.

Generally, workers are allowed to tap their retirement accounts for loans up to $50,000, or half their account’s value, whichever is smaller. They also can “cash out” the money when they change jobs or they can take “hardship” withdrawals, which often go to pay for housing, overdue bills or educational expenses. The cash-outs and hardship withdrawals subject account holders to taxes on the money they put into the accounts, any investment gains, and if they are under $59^{1}/_{2}$ years old, a 10 percent tax penalty.

Experts warn that when workers draw on their retirement accounts to pay current bills, they put themselves at greater risk of descending into poverty upon retirement, which would leave them dependent on government programs such as subsidized housing or food stamps. Nearly 6 million senior citizens were living in or near poverty in 2010, according to a Senate committee, a number expected to increase sharply over the coming decade after a long period of decline.

HelloWallet’s report found that lower-income people, who are the most frequent users of payday loans, pawnshops and other high-cost credit outlets, were found to be those most likely to cash out their retirement plans when they changed jobs.

Using data from the Federal Reserve’s Survey of Consumer Finances and the Survey of Income and Program Participation, conducted by the Census Bureau, the report said 30 percent of households earning less than $50,000 a year had cashed out a retirement plan for non-retirement purposes. Only 12 percent of households earning between $100,000 and $150,000 a year and 8 percent of those earning more than $150,000 a year have cashed out a retirement account, the report said.

The widespread breaching of retirement accounts has led some advocates to conclude that policymakers and employers should expand their vision when thinking about their workers’ retirement needs.

Fellowes said workers would be better served by establishing emergency savings accounts that steered clear of the potential tax penalties, investment fees, and other risks and costs associated with having money in retirement accounts. Only after establishing an emergency savings fund, he said, should workers plow their money into retirement savings.

“The investment advice out there needs to recognize that a large share of participants is not going to use the money for retirement, so they should not be exposed to risky investments,” Fellowes said. “There is no investment adviser in the country who would put workers in the stock market if they were told the money being invested was for short-term needs.”