

Driving Retirement Innovation: Can Sidecar Accounts Meet Consumers' Short- and Long-Term Financial Needs?

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For decades now, those interested in helping low- and moderate-income Americans build wealth have focused almost exclusively on long-term investments, like home ownership, higher education, and retirement. While such tools are positive drivers of financial security, they can be fully utilized only when a household's day-to-day financial lives are stable.¹

The United States retirement system perfectly embodies this tension. Over the past few decades, trillions of dollars have accumulated in defined contribution retirement accounts. At the same time, Americans have faced rising short-term instability in their finances. On the macro level, wages have stagnated, leaving less slack in family budgets. But the overall wage rate tells only half the story. Week to week and month to month, American households face significant swings in income and expenses. In retail and other service sector jobs, work hours fluctuate unpredictably. Paychecks rise and fall based on the generosity of tips, the size of commission-based sales, the number of hours scheduled, or the number of ride-hailers who need to get across town. As a result, these families often don't know how they will pay for the next car breakdown, leaky roof, or medical expense. Consumers must have access to ample savings to cover the full range of their financial needs.

Unfortunately, the nation's savings system has been slow to adapt to this new reality. A robust infrastructure has been built up around retirement plans, including tax benefits and other incentives to encourage employers to offer retirement savings plans, with complex rules that define what kind of plans can be offered and how much employees can save. Employers sponsor and can automatically enroll their workers into the plans. Financial institutions service the accounts, providing financial advice, asset management, and recordkeeping functions. However, no such infrastructure exists for short-term savings. Employers are not encouraged to help their workers save for short-term

This brief will explore the possibility of linking a short-term savings, or "sidecar," account to a traditional retirement account to better meet consumers' short- and long-term financial needs. Such an innovation could help address families' current inability to cope with financial shocks and volatility, as well as their over-reliance on withdrawals from retirement accounts to fund current consumption. After describing these dual problems in depth, the brief will explore the advantages and disadvantages of various design approaches to implementing a sidecar account.

needs, and few employers do. The result is a retirement system that is also serving as a pool of emergency savings for many employees. Families with no other options are forced to tap their retirement account to meet their short-term needs, sometimes paying early withdrawal penalties and taxes in the process. On top of these fees, many fail to replenish their now-underfunded nest eggs. Both short-term and long-term financial security suffers.

This brief will explore the possibility of linking short-term savings products to traditional retirement accounts to better meet consumers' short- and long-term financial needs. Such an innovation — known as a sidecar account — could help

address families’ current inability to cope with financial shocks and volatility, as well as their overreliance on withdrawals from retirement accounts to fund current financial needs. The first section will describe the problem of withdrawals from retirement plans, or leakage. The second section will explore the growing knowledge base around Americans’ short-term financial challenges, including income and expense volatility. The third section will describe the potential solution in more detail and explain the academic rationale for a sidecar account, citing recent studies in behavioral economics. The fourth section will offer a list of key design choices — such as delivery channel, tax status, account size, and liquidity restrictions — that must be considered before a sidecar account can move forward. The paper will address the main drawbacks and advantages of each pathway, and close with a summary of next steps.

THE PROBLEM OF RETIREMENT ACCOUNT LEAKAGE

Americans have a total of \$25 trillion saved for retirement, funds that are meant to supplement Social Security income in retirement.² Of this impressive amount, however, only \$10 trillion are in defined benefit (DB) or other annuitized plans, which must be used exclusively for retirement. Most retirement assets — \$15 trillion — are held in defined contribution (DC) plans or individual retirement accounts (IRAs). While mainly used for retirement, a portion of these funds are used

for nonretirement purposes. For example, one in four people with a DC plan will use all or some of their savings for non-retirement needs such as paying a bill, buying a home, dealing with a medical emergency, or sending a child to college.³ These preretirement withdrawals from retirement accounts are widely known as leakage.

There is a long-standing debate as to the acceptable level of leakage in a retirement system and what causes it. Withdrawing money from a retirement account to meet a long-term financial goal like home ownership or higher education, or an immediate need like food or shelter, may be a good use of the money. However, sacrificing retirement security for current discretionary spending is usually not a prudent trade-off.

To understand leakage, one first has to understand the rules governing when and how savers can withdraw money from their accounts (see Table 1). As a general matter, the rules are designed to encourage account holders to wait until they reach a minimum retirement age (59½ years old) before accessing the money, but there are many exceptions. For example, federal law gives employers the flexibility to design 401(k) plans that allow savers to borrow from their retirement account or take a “hardship withdrawal” when faced with certain pressing needs. Most employers take advantage of these options and offer loans and hardship withdrawals to their workers under some circumstances.⁴ Workers can also cash out 401(k)s when they change jobs.⁵

TABLE 1: RULES FOR WITHDRAWING MONEY FROM RETIREMENT ACCOUNTS

401(K)*	TRADITIONAL IRA	ROTH IRA
<p>LOANS</p> <ul style="list-style-type: none"> Employers are not required to provide, but normally do No tax or penalty if it is repaid in a timely manner If you still have a loan out when you leave an employer, it must be immediately paid back in full or is considered a withdrawal and subject to penalty and taxes 	<p>QUALIFIED DISTRIBUTION</p> <ul style="list-style-type: none"> Withdrawals before age 59½ subject to 10 percent penalty and income tax <p>Exceptions: Purchase of first home (up to \$10,000), educational expenses, disability, medical expenses (>7.5 percent of Adjusted Gross Income), health insurance premiums, regular distribution schedule, as the result of an IRS tax levy, and for members of the National Guard called to active duty</p>	<p>QUALIFIED DISTRIBUTION</p> <ul style="list-style-type: none"> Can withdraw your contributions — but not your investment earnings — at any time, tax- and penalty-free Withdrawals of investment earnings before age 59½ are subject to 10 percent penalty and income tax <p>Exceptions: Same as traditional IRA</p> <ul style="list-style-type: none"> Withdrawals of earnings after age 59½ are tax- and penalty-free if Roth IRA has been open for five years or more
<p>HARDSHIPS</p> <ul style="list-style-type: none"> Depend heavily on employer and type of plan, but IRS allows for medical, education, first home, funeral, eviction prevention, home damage, and unemployment-related withdrawals — all subject to income tax and a 10 percent penalty if under age 59½ <p>Exception: No penalty for unreimbursed medical expenses that are >10 percent of Adjusted Gross Income</p>		
<p>CASH-OUT</p> <ul style="list-style-type: none"> Income tax (usually 20 percent immediately withheld by the plan administrator and sent to the IRS) and 10 percent penalty if under age 59½ 		

*The rules differ slightly under 403(b) and 457 and for workers ages 50-55, 55-59½, and over 70½. For more complete information, see <https://www.thebalance.com/what-age-can-funds-be-withdrawn-from-401k-2388807>.

Sources: Internal Revenue Service. “Retirement Plans FAQs Regarding Hardship Distributions.” 23 Jan. 2017. <https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-hardship-distributions>; Fidelity. “Beware of Cashing Out Your 401(k).” 31 May 2016. <https://www.fidelity.com/viewpoints/retirement/cashing-out>; Charles Schwab. “Traditional IRA Withdrawal Rules.” 2017. http://www.schwab.com/public/schwab/investing/retirement_and_planning/understanding_iras/traditional_ira/withdrawal_rules.

These cash-outs are by far the biggest source of leakage. In 2006, \$84 billion leaked out of 401(k) plans, 88 percent of which came from cash-outs at job change.⁶ To put that number in perspective, total assets in 401(k)s that year was \$2.7 trillion. A more recent analysis from 2013 found that leakage totaled over \$70 billion per year, again mostly from cash-outs.⁷ This constitutes 24 percent of all the employee and employer contributions to those accounts that year.⁸ Hardship withdrawals are rare and tend to be used for bona fide emergencies.⁹ While loans are quite common, they are often paid back. Vanguard estimates four in 10 of their participants took out a loan between 2004 and 2009, but roughly 90 percent of the funds were paid back.¹⁰ One major exception is loans that are still outstanding when the worker terminates employment. In most plans, this triggers an obligation by the worker to pay back the remaining balance immediately, which leads to default 70 percent of the time.¹¹ For every \$1 contributed to retirement accounts by or on behalf of savers under age 55, \$0.40 leaks out — and that does not include loans.¹² Low-income workers, as well as employees of color and those with low education levels, are the most likely to withdraw from a retirement account.¹³

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This leaves many Americans unprepared for retirement. Even just one hardship withdrawal or partial cash-out can considerably set back retirement preparedness. For example, a low-income worker who takes a \$5,000 withdrawal at age 35 could — because of lost compounded investment earnings — see a 12 percent reduction in his or her final account balance, amounting to over \$30,000.¹⁴ On the more macro level, the Center for Retirement Research at Boston College found that leakage overall depletes Americans' retirement accounts by at least 20 percent.¹⁵ The Employee Benefit Research Institute found, using its simulation model, that leakage reduces low-income workers' chances of achieving a secure retirement by 8.8 percentage points.¹⁶

THE PROBLEM OF SHORT-TERM FINANCIAL INSTABILITY

Ideally, Americans would not need to raid their retirement accounts to meet their short-term needs. However, volatile financial lives and a lack of emergency savings leave many families with little choice.

Compiling evidence from various sources, the Aspen Institute's Expanding Prosperity Impact Collaborative has found that over one-third of Americans struggle with income volatility — positive or negative swings in income from month to month and year to year — and that volatility has likely been increasing over the past few decades.¹⁷ Families are also experiencing volatility in their expenses. According to a recent study from the JPMorgan Chase Institute, the median US family saw a 29 percent change in total expenses from one month to the next, and almost four in 10 families had to make a sizable medical, tax, or auto repair payment at some point over the course of the year.¹⁸ One-time financial shocks — as opposed to chronic instability — are also quite prevalent. A recent survey from Pew Charitable Trusts noted that 60 percent of Americans experienced an unanticipated pay cut, trip to the hospital, spousal separation, major car or home repair, or other large expense in the past 12 months.¹⁹ The median cost of these shocks was \$2,000, and almost 50 percent of households still had not fully recovered from their shock six months later.²⁰

Of course, financial shocks and volatility would not be particularly problematic if families were able to use savings or other financial tools to fill in the gaps. However, most Americans simply do not have these resources. In 2016, 44 percent of Americans said they could not come up with \$400 to cover an emergency expense without borrowing or selling something.²¹ A separate analysis found that 44 percent of all Americans in 2011 were liquid asset poor, meaning they did not have enough readily accessible savings to live above the poverty line for three months should they face an income disruption.²² The US Financial Diaries, an in-depth study of 235 low- and moderate-income families' day-to-day finances, found that just 7 percent of their sample met their emergency savings goals, and 50 percent had no short-term savings at all.²³ Older and higher-income workers — who one might expect to have accumulated higher savings — also tend to have low liquid savings rates.²⁴ This is the case despite solid evidence that even a small amount of precautionary savings can prevent financial hardship.²⁵

The combination of short-term financial instability and lack of short-term savings has led families to turn to their retirement accounts for needed cash, despite hefty penalties for early withdrawal.²⁶ In a forthcoming report, the Pew Charitable Trusts found that families that experienced a financial shock in the previous year are more than six times more likely to withdraw money from a retirement account.²⁷ The Federal Reserve Board, using a broader definition of financial shock, found that those who experienced a hardship were twice as likely to borrow or withdraw funds from a retirement account.²⁸ Similarly, an analysis by HelloWallet found that households without three months of annual income or more in emergency savings were twice as likely to withdraw resources from their retirement accounts than those who did have sufficient short-term savings.²⁹ When asked why they were withdrawing, workers overwhelmingly reported that they intended to use the funds to pay bills, pay back debts, cover general expenses, or otherwise manage their day-to-day financial lives.³⁰

A POTENTIAL SOLUTION: A SIDECAR ACCOUNT

One possible solution to these interrelated challenges, especially for low- and moderate-income savers, is what has been referred to as a sidecar account that could both alleviate leakage and prevent emergencies from precluding a secure retirement.³¹ The idea is simple: Workers would fund a short-term savings account that could be used for emergencies, and once a sufficient savings buffer was built up, additional contributions would automatically be diverted to a traditional, less liquid retirement account. To ensure a constant savings buffer, the short-term account would be automatically replenished as necessary. The hope is that by formalizing the dual role the retirement system currently plays, savers would be in a better position to distinguish between what is available now and what is locked away for retirement. This would allow them to meet short- and long-term financial goals more easily.

The idea is not new. In fact, the US had what could be described as a sidecar system in the decades before the advent of the 401(k). A number of companies offered thrift savings plans as part of their cash or deferred arrangements to complement their DB plans. These were savings accounts that could be used for short-term purposes since employee contributions were made after-tax and thus available for withdrawal tax-free.³² With the shift to the pretax 401(k) system in the 1980s, the long-term nature of traditional pensions and the short-term aspects of thrift savings plans were effectively merged into a single plan.³³

In recent years, several researchers, practitioners, and policy-makers have begun to revisit the dual account idea, laying the groundwork for bringing a sidecar product to fruition. In 2014, economists David Laibson, John Beshears, James J. Choi, Christopher Clayton, Christopher Harris, and Brigitte C. Madrian floated the idea of a two-tiered 401(k) system that better balanced consumers' liquidity needs.³⁴ In 2015, Laibson and his colleagues proposed a "rainy day 401(k)" that would be coupled with a more hands-off account.³⁵ David John at AARP has written about a similar concept, noting the importance of utilizing automatic enrollment to get enrollees saving for emergencies along with retirement.³⁶ In 2016, economist Jonathan Gruber outlined a potential dual account system that would work similarly to a sidecar arrangement, though the sidecar, or "security," account would partially replace unemployment insurance and workers' compensation and be largely publicly funded.³⁷ Others have written about the idea as well,³⁸ and the National Employment Savings Trust in the United Kingdom is working on a project that would field-test a sidecar savings account in the coming years.³⁹

The sidecar idea is also supported by other findings from behavioral economics. University of Chicago professor Richard Thaler found that a person's marginal propensity to consume

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(spend money) is determined by what he or she considers to be available now (in a checking account, for example), what he or she considers to be "savings" (money in a savings account or physical assets such as a car or house), and what he or she considers to be "future resources" (such as a retirement account or Social Security). According to Thaler, our financial decision making is based on our own "mental accounting" of these buckets and not, as suggested by classical economics, on a rational, long-term, life-cycle view of our assets.⁴⁰ This suggests that if an account can be psychologically associated with their future income and long-term assets, account holders may be more successful in resisting temptation and preventing retirement leakage. It also follows that an account more psychologically associated with short-term needs may help clarify which account is for which needs. Subtle differences in how one frames each account (e.g., what the account is called, how the accounts are partitioned, or how easy it is to view an up-to-date balance) can be important when using lessons from mental accounting to nudge consumers toward specific action.

Though there may be little appetite in the US for a complete restructuring of the retirement system, adding a sidecar account, perhaps in combination with a tightening of liquidity restrictions on traditional accounts, could be both effective and politically viable. And in fact, recent research suggests that consumers are intrigued by the idea. A survey conducted by LIMRA shows that two-thirds of workers are interested in an automatic emergency savings account alongside their workplace retirement accounts, and that 89 percent of employers are interested in offering this type of product.⁴¹

Of course, translating academic research and consumer surveys into an actual product is challenging. There are hurdles to implementing a modern sidecar under current benefits law, and key design considerations — like those outlined below — must be addressed in conjunction with political and technical practicalities. This brief is not meant to advocate any one path forward, but rather to critically analyze the advantages and disadvantages of various approaches.

DESIGN CHALLENGES

Sidecar accounts could take several forms. This section is intended to walk through the main design choices that innovators will face when taking the product from a theoretical research exercise to an actual retirement savings vehicle.

DELIVERY CHANNEL

The first design question is who delivers the sidecar account to consumers. Because there is already a payroll-based structure for retirement contributions, employers seem like a natural jumping-off point for new retirement options. An employer could package the sidecar account along with its 401(k) offering and enroll workers in both simultaneously. This option comes with the advantage of being tied to a well-developed system for encouraging people to save, but faces two main drawbacks: (1) It neglects the growing number of contingent, part-time, and other workers without access to a workplace retirement plan; and (2) it raises portability concerns, requiring new processes to ensure continued access to the account even if a worker switches jobs. Of course, even if these drawbacks were not deal breakers, employers might not want to take on the added responsibility — and administrative costs — of offering this new benefit. Indeed, employers would likely want to know the level of worker demand and the concrete benefits that would accrue to their business in the form of a less financially stressed, more productive workforce before launching a sidecar program. Most of the evidence that exists on these points is not definitive — and will likely remain that way until a large-scale experiment is conducted.

Some employers think making short-term savings available to their workers is worth the effort. For example, the Illinois recordkeeper ABG Retirement Plan Services has found high demand for an emergency savings account among its clients and plans to offer such an account within its 401(k) starting this summer.⁴² Additionally, an Atlanta-based startup called DoubleNet Pay offers its emergency savings product to employers as a complement to their workplace-based retirement plans.⁴³ One of the goals of the product, which also helps workers pay bills and manage debt, is to “eliminate the need to rely on high interest or 401(k) loans and hardships.”⁴⁴ These examples raise an important point: There is a difference between being the delivery mechanism for a sidecar — such as an employer — and managing the day-to-day recordkeeping and asset management tasks that such an account requires.

Another option would be individually sold sidecar accounts. Personal finance apps such as Digit and Qapital offer short-term emergency savings accounts that are similar to a retirement sidecar. But there are several drawbacks to this approach. First, linking the account to a retirement account, which is normally provided through an employer, could prove complicated. Second, integrating with an employer’s payroll system — to take advantage of the power of automatically deducting savings from workers’ paychecks — can be difficult. Third, customer

acquisition costs may be prohibitive for an institution that does not already have a broad distribution network. Finally, as described in the “Automatic Enrollment” section below, an opt-out system is probably not viable. These are some of the reasons why no individually sold apps or accounts have achieved much market penetration to date.

The government — at the federal or state level — could deliver a sidecar account. The US Treasury Department took a similar step when it created the *myRA*, a low-cost retirement account targeting those without ready access to an affordable retirement plan. In fact, the *myRA* itself could be partitioned into a sidecar account and a long-term account, or tweaked to serve as the sidecar account that could be linked to a traditional retirement account. A public approach such as this is likely the most inclusive option, as low- to moderate-income workers would have access to short-term savings even if their employers were not interested in offering that benefit. Unlike employers, governments are not in direct control of workers’ payroll systems, but governments have proved adept at harnessing those systems — and reducing administrative burdens on employers in the process — for various purposes, such as tax withholding, workers’ compensation programs, and unemployment insurance. The *myRA* offers such an option as well, in that employers can easily fund their workers’ accounts through payroll deduction.⁴⁵ That said, the *myRA* has suffered from low customer uptake, in part because a marketing budget was not available and in part because savers are not being automatically enrolled (see “Automatic Enrollment” section below). Of course, these shortcomings could be rectified. Another drawback of the public approach is that some workers may not trust the government to manage their money.

A middle ground between a wholly public and wholly private system would be to allow a hybrid delivery method that combines private management with public oversight. This option could mitigate concerns that industry-led solutions will exclude low-income workers, while at the same time allaying fears that government bureaucracies cannot be trusted to invest and manage large-scale savings. Some states have already started pursuing such an approach to retirement coverage in the form of their Secure Choice programs, which are state-led, privately managed retirement programs that automatically enroll workers who do not have coverage through their employers into their own IRA. One of the Secure Choice states, Oregon, has discussed the possibility of including a sidecar account as an option to its savers, and, while no final decision is expected soon, the concept is viewed internally as having some merit.⁴⁶

ACCOUNT STRUCTURE

The next consideration is how the account is structured. Whether the sidecar is attached to the retirement account formally or informally will affect how it is viewed in terms of its tax status and fiduciary liability.

Today, savings in retirement accounts like 401(k)s and IRAs re-

ceive favorable tax treatment. For traditional accounts, savers get to defer paying taxes on contributions until withdrawal in retirement, and investment earnings grow tax-free. For Roth accounts, savers contribute using post-tax dollars, investment earnings grow tax-free, and withdrawals in retirement are tax-free (withdrawals of principal before retirement are also tax-free).⁴⁷ The policy rationale behind this tax subsidy is to incentivize long-term savings, which explains why the withdrawal restrictions for these accounts are enshrined in the tax code. A similar tax incentive does exist for short-term savings in the form of health savings accounts (HSA) and flexible spending accounts. However, to receive the full tax advantage of these accounts, withdrawals must be for medical expenses.⁴⁸ General-use short-term savings accounts do not currently enjoy any tax preference.

Sidecar savings accounts could take many forms. One alternative would be to establish the sidecar as a Roth, since withdrawals of principal from a Roth account are not subject to any tax or penalty. The Secure Choice programs referenced above use Roth IRAs, leading some observers to believe that the accounts may be treated like hybrid accounts, serving both short- and long-term needs.⁴⁹ However, most Roth accounts are not designed to be emergency savings accounts and do not allow for unlimited, quickly available withdrawals. Roth 401(k)s are subject to the same restrictive distribution rules that govern all 401(k)s — namely, no withdrawals until you change jobs or reach 59½ years old unless you promise to pay back the funds (i.e., a loan) or are facing a serious financial hardship. Roth IRAs have much more lenient rules, but electronic transfers from an IRA may take up to three business days.⁵⁰ For example, savers in the federal *myRA*, which is structured as a Roth IRA, must wait roughly three days for withdrawals to reach their bank account.⁵¹ Three days is a long time for a family in the throes of an emergency, and transaction times may need to be sped up or standardized before a Roth IRA-based sidecar account can prove viable for real-world usage.

Another consequence of tax status is how the assets are treated by federal and state officials who determine eligibility for public benefit programs. Some programs, like the Supplemental Nutrition Assistance Program and Temporary Assistance for Needy Families, require applicants to meet certain asset tests before gaining access to benefits. Tax-advantaged retirement accounts, including both Roth and traditional 401(k)s and IRAs, are usually excluded from what is counted against those asset ceilings, but there are exceptions.⁵² Non-retirement savings accounts often do count toward the asset thresholds, though the rules vary considerably by state.⁵³ This means if a worker's sidecar account is not structured as a retirement account, the savings therein could be counted against the worker when he or she applies for public benefits, which could block access to needed social services or discourage saving in the first place.

In addition to tax status, both product and regulatory considerations are factors in deciding whether to make the sidecar a separate traditional bank account or a liquid “pocket” within a

retirement account. Banks and credit unions, which offer traditional checking and savings accounts, are organized to serve the needs of customers making numerous transactions — and have built business models to do so profitably. Brokerage houses, insurance companies, and asset managers, on the other hand, specialize in the long-term wealth management objectives usually associated with retirement accounts. The typical retirement account receives regular payroll contributions (for 401(k)s) or infrequent, larger deposits (for IRAs), and very infrequent withdrawals, which keeps transaction costs low. From a product perspective, it might make sense to structure the sidecar vehicle as a simple bank account, not as a retirement account.

However, bank accounts and retirement accounts are very different products, governed by a completely distinct set of federal and state rules. Banks and credit unions are regulated by the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Federal Reserve Board, and the Office of the Comptroller of the Currency, among other bodies. Brokerage houses, insurance companies, and asset managers, on the other hand, are regulated by the Securities and Exchange Commission, the Financial Industry Regulatory Authority, and, in the case of employer-sponsored retirement plans, the Internal Revenue Service and the US Department of Labor. These unharmonized regulatory regimes would limit the ability of the sidecar, if structured as a simple bank account, to “talk” to the retirement account, which means contributions would not easily flow between the two. This could undermine one of the key principles underlying the sidecar idea — that both the sidecar and the traditional retirement account should be funded and replenished automatically without the saver's involvement.

AUTOMATIC ENROLLMENT

Behavioral science has repeatedly demonstrated the power of automatic enrollment as an effective “path of least resistance” to encourage savings.⁵⁴ Most people will not take the initiative to open an account on their own, and uptake can jump from approximately 40 percent to 90 percent when a program is structured as an “opt-out” instead of an “opt-in.”⁵⁵ If we want to create a sidecar system that is beneficial for the broadest possible swath of people — passive and active savers — an automatic system set at appropriate default levels is key.⁵⁶

Of course, this is easier said than done. Given the heterogeneous preferences in the target population, determining the appropriate default savings rate is challenging. More fundamentally, there are legal barriers to automatic enrollment in nonretirement contexts. The Pension Protection Act of 2006 paved the way for auto-enrollment into 401(k)s and other DC plans by preempting state anti-garnishment laws and creating incentives that allow employers to automatically enroll their workers under certain conditions.⁵⁷ No such policy currently exists for general-use, short-term savings accounts, and so employers

would need a similar legislative fix to be able to automatically enroll their workers in a sidecar account that is not part of a qualified retirement plan.

There are potential ways that employers — perhaps with further regulatory guidance — could automatically enroll their workers into a sidecar-like account. For example, HSAs,⁵⁸ deemed IRAs,⁵⁹ and voluntary after-tax contributions to a qualified DC plan⁶⁰ may, under certain circumstances, be eligible for automatic enrollment. However, each of these options come with serious disadvantages:

- **Health Savings Accounts** – Their triple-tax advantage (tax-deductible contributions, tax-free accrual, and tax-free withdrawal) is maximized when distributions are made for qualified medical expenses (nonmedical withdrawals have a 20 percent penalty). But because you can reimburse yourself for medical expenses years after they are paid, savers can use the HSA like an emergency fund if they have paid enough previous medical bills from non-HSA sources. For example, if you use non-HSA sources to pay a \$250 eye doctor bill in January, you can then take out \$250 tax-free to fix your car in August — you just need to keep your receipt from the eye doctor so that you can claim the second withdrawal as a qualified expense.⁶¹ However, as this example makes clear, using the HSA as an emergency fund is a labor-intensive and complicated undertaking, which may counteract the user-friendly aspects of a sidecar account.
- **Deemed IRAs** – Sometimes called “sidecar IRAs,” these are individually owned retirement accounts that look, feel, and act like an IRA but sit within a 401(k) or another employer-based DC plan. However, if an employer automatically enrolls its workers into the deemed IRA, it will also have to choose a default investment for the funds. For the employer to be shielded from potential lawsuits around violation of fiduciary duty, it may only invest in stable value or capital preservation funds — which would be appropriate for short-term, emergency savings — for a maximum of four months.⁶² Afterwards, the assets must be transferred into more volatile, equity-based investments (unless the saver herself proactively opts to keep it in a stable value fund).
- **Voluntary After-Tax Contributions** – Automatic enrollment in DC plans is usually reserved for pretax contributions, but some industry observers believe that voluntary after-tax contributions could also be eligible for opt-out treatment.⁶³ If automatic enrollment is allowed, these after-tax contribution-funded emergency accounts would presumably face the same default investment problem as faced by deemed IRAs. Moreover, because the contributions are not tax-preferred in the usual sense, investment earnings are taxable upon withdrawal.⁶⁴

If these options are considered unsatisfactory, federal legislation could establish a new short-term savings program that includes automatic enrollment. As noted earlier, state governments could add a sidecar element to their programs, but to the extent such a policy requires action by employers, it may run afoul of the Employee Retirement Income Security Act of

1974, which preempts state laws related to employer-provided benefits.

If full-fledged automatic enrollment is not an option, there are other ways that employers or governments can encourage participation. For example, researchers Gabriel Carroll, Choi, Laibson, Madrian, and Andrew Metrick found that forcing potential enrollees into an active choice — in which the enrollee must affirmatively either opt in or opt out of the savings program — significantly increases participation, though not by the levels achieved by automatic enrollment.⁶⁵

ACCOUNT SIZE

Another design question is how large of a balance should be allowed to accumulate in the sidecar account. For example, it could be that two or three paychecks worth of funds fill up the sidecar before tipping future contributions into the traditional DC plan. If a sidecar is capped at a specific percentage of income or number of paychecks, it may be easier to convince the retirement industry — which may be nervous about short-term savings reducing the amount held in long-term savings accounts — to embed the product into existing DC plans. Another way to ease fears of a retreat from retirement savings is to ensure that at least some portion of every contribution — even those that would otherwise be earmarked for replenishing the short-term account — goes into the retirement account. This approach would have the added benefit of evening out contributions to the retirement account over time, which is a sounder investment strategy than depositing funds only when the sidecar account is fully funded, which may be a rare occurrence if a family faces multiple financial shocks each year.⁶⁶

Alternatively, having no cap preserves individual choice, but essentially means the account will function much like a normal savings account.

LIQUIDITY RESTRICTIONS

Some researchers support a highly liquid sidecar account alongside a virtually untouchable main account.⁶⁷ This ensures that the sidecar is the initial buffer to protect against breaching, and prevents serious damage to long-term retirement readiness. While this may be the best path, it would likely require changing the tax code to restrict employers from allowing for hardship and other withdrawals from their DC plans, which could be a heavy political lift. An alternative option, then, would be to maintain the current framework to ease implementation, and focus first on bringing a sidecar product to market before tightening the lockbox on traditional retirement accounts. Alternatively, Gruber has proposed that withdrawals from the sidecar account be restricted in size and use, to ensure the funds are utilized exclusively for genuine financial shocks⁶⁸ — though this would raise the cost of administering the program and might scare off savers who want ready access to the cash.⁶⁹

INCENTIVES

Though not as powerful as automatic enrollment in driving participation, using financial incentives to boost interest in sidecar accounts could be a critical component of a successful program — one that would also raise savings levels. Employers are unlikely to increase their total retirement matching contributions unless they see a tangible benefit from their workers' participation in sidecar accounts — perhaps increased productivity because of reduced financial stress. Even then, it is unlikely that employers would invest additional money (as opposed to moving matching contributions from the retirement side, or lowering wages to pay for the match) unless nudged by government through a tax subsidy of some kind. It is also unclear if workers would prefer that a match supplement their sidecar account or their retirement account. A financial firm eager to build customer loyalty may also experiment with incentive payments, though fee waivers are more likely. Finally, the Saver's Credit, a government incentive payment already embedded in the federal tax code, could be tweaked to ensure that contributions to the sidecar account are eligible.

CONCLUSION

We believe the time is right to move from theoretical discussions about sidecar accounts into concrete action and real-world testing. Indeed, many researchers and policymakers are answering the call, actively exploring the possibility of pilot testing sidecar models. As they grapple with next steps, we hope that this analysis can help illuminate the key design choices they will face and the main considerations that should inform their decisions. We acknowledge that a sidecar account, if designed poorly, could be yet another complicated, parallel savings structure in the sea of 401(k)s, 403(b)s, IRAs, HSAs, and 529s. But if done well, we strongly believe that a sidecar account could improve the financial well-being and security of Americans in both the short and long term — an outcome that is good not only for families, but for the economy overall.

We believe the time is right to move from theoretical discussions about sidecar accounts into concrete action and real-world testing.

CHALLENGE	OPTIONS	PROS	CONS
DELIVERY CHANNEL	Employer	<ul style="list-style-type: none"> Tied to a well-developed system for encouraging people to save Trusted source of financial services 	<ul style="list-style-type: none"> Neglects contingent, part-time and other workers without access to a workplace retirement plan Raises portability concerns Places perhaps unwanted burden and administrative costs on employers
	Individual	<ul style="list-style-type: none"> Already exists through apps and functionally equivalent individual banking products 	<ul style="list-style-type: none"> Linking to an employer-administered retirement account is difficult Integrating with payroll system is complicated High customer acquisition costs
	Government	<ul style="list-style-type: none"> Most inclusive option because it targets those without access to a workplace retirement plan Systems already in place for tax withholding and other government-required payroll deductions Existing myRA infrastructure could be tweaked to accommodate 	<ul style="list-style-type: none"> Lack of trust in government to invest and manage large-scale savings If initiated by states and if employer participation is required, could trigger regulatory uncertainty under the Employee Retirement Income Security Act of 1974
	Public-Private Hybrid	<ul style="list-style-type: none"> Mitigates concerns that industry-led solutions will exclude low-income workers Mitigates concerns that government cannot be trusted to invest and manage large-scale savings 	<ul style="list-style-type: none"> If initiated by states and if employer participation is required, could trigger regulatory uncertainty under the Employee Retirement Income Security Act of 1974
ACCOUNT STRUCTURE	Retirement Account	<ul style="list-style-type: none"> Tax-advantaged (and could use Roth for penalty-free withdrawals) 	<ul style="list-style-type: none"> Retirement accounts are not designed to be emergency savings accounts and do not customarily allow for unlimited, quickly available withdrawals
	Bank Account	<ul style="list-style-type: none"> Banks and credit unions are organized to serve the needs of customers making lots of transactions 	<ul style="list-style-type: none"> Unharmonized regulatory regimes would limit the ability of the sidecar to “talk” to the retirement account, which threatens automaticity of tipping structure Savings in non-retirement accounts often count against asset tests used to restrict access to public benefits
AUTOMATIC ENROLLMENT	Yes	<ul style="list-style-type: none"> Proven tool for achieving broad participation 	<ul style="list-style-type: none"> Legal barriers to automatic enrollment in non-retirement contexts Heterogeneous preferences make setting default levels difficult
	No	<ul style="list-style-type: none"> No legal barriers “Active choice” still an option 	<ul style="list-style-type: none"> Neglects passive, unsophisticated savers
ACCOUNT SIZE	Capped	<ul style="list-style-type: none"> Cap at a specific percentage of income or number of paychecks could help reassure retirement industry that these accounts will not threaten the health of long-term retirement savings 	<ul style="list-style-type: none"> Heterogeneous preferences make appropriate cap difficult to set
	Not Capped	<ul style="list-style-type: none"> Preserves individual choice 	<ul style="list-style-type: none"> No added benefit, functions like a normal savings account
LIQUIDITY OF RETIREMENT ACCOUNT	More Restrictive	<ul style="list-style-type: none"> Prevents leakage and more closely resembles what some researchers believe is “optimal illiquidity” 	<ul style="list-style-type: none"> Would likely require changing the tax code to restrict employers from allowing for hardship and other withdrawals from their DC plans, which could be politically difficult
	Current Rules	<ul style="list-style-type: none"> Eases implementation for focus on bringing sidecar to fruition 	<ul style="list-style-type: none"> Allows for continued breaching from main account
LIQUIDITY OF SIDECAR ACCOUNT	Restrictive	<ul style="list-style-type: none"> Ensures funds are utilized exclusively for genuine financial shocks 	<ul style="list-style-type: none"> Enforcement challenge raises administrative costs Could scare off savers who want ready access to cash
	Full Access	<ul style="list-style-type: none"> Maximizes individual choice Minimizes administrative costs Ensures immediate access when funds are needed 	<ul style="list-style-type: none"> Money could be depleted on unnecessary expenses
INCENTIVES	Employer Match	<ul style="list-style-type: none"> Could boost interest for and accumulation in sidecar accounts 	<ul style="list-style-type: none"> Employers are unlikely to increase total retirement matching contributions unless there is a tangible benefit
	Government Match	<ul style="list-style-type: none"> A tax subsidy could nudge employers to offer sidecars and/or individuals to enroll Existing Saver’s Credit could be tweaked to apply to sidecar contributions 	<ul style="list-style-type: none"> High budgetary cost and thus politically difficult

ACKNOWLEDGMENTS

The authors would like to thank our colleagues Ida Rademacher and Jeremy Smith for their leadership, input, and guidance; external reviewers John Scott, Cecilia Shiner, and Steve Utkus for reviewing drafts and making invaluable suggestions; John Blossom, Brian Cosgray, Kenneth Forsythe, David John, Jamie Kalamarides, Lisa Massena, and Steve Utkus for the time and wisdom they shared on the topic; Mary Bruzzese and the Vector Talent Resources team and our colleague Balkissa Jacobs for copy-editing; Veronique Morrison and Yeun Lee at the Jake Group for laying out the brief; and Merry Alderman for designing the template. Aspen FSP would also like to thank all the attendees of the inaugural Aspen Leadership Forum on Retirement Savings, particularly those who participated in the session on the interplay of short- and long-term savings, for sharpening our thinking on these issues. Similarly, Aspen FSP would like to thank all the attendees of the 2015 Financial Security Summit, which jump-started our thinking on how short- and long-term financial health go hand in hand — a topic that has animated much of Aspen FSP's work over the past two years. Finally, the authors thank Prudential for its generous support of this work. While this document draws on insights shared at the Leadership Forum, at the Financial Security Summit, and by the aforementioned individuals and organizations, the findings, interpretations, and conclusions expressed in this report — as well as any errors — are the authors alone.

ABOUT ASPEN FSP

The Aspen Institute Financial Security Program (FSP) connects the world's best minds to find breakthrough solutions for America's family financial security crisis. FSP advances a new generation of policies, products, and services that enable more Americans to meet basic financial needs and withstand financial shocks, while saving for long-term goals like college, homeownership, and retirement. For more information on Aspen FSP, please visit www.aspenfsp.org.

ABOUT ASPEN RSI

The Aspen Institute Retirement Savings Initiative (RSI) seeks bold federal, state, and marketplace solutions to America's retirement crisis. We connect experts from government, industry, advocacy, and academia to build consensus around 21st century policies and products that will enable low- and moderate-income Americans to save more for retirement and enjoy dignity and financial security in their golden years.

ENDNOTES

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