The promulgation of employer-sponsored 401(k) accounts has granted employees unprecedented control over their retirement savings and investments. This increased control, however, has led to a phenomenon called “leakage”—the early withdrawal of money by participants from their retirement accounts for uses other than retirement. In this Note, the author discusses the various forms of leakage, emphasizing data from the recent recession and offering an in-depth analysis of two proposed solutions to this problem: the Savings Enhancement by Alleviating Leakage in 401(k) Savings Act and the Lifetime Income Disclosure Act. Ultimately, this Note recommends the adoption of targeted financial literacy measures, along with narrowly crafted legislation, as a means to alleviating the three most damaging forms of leakage: cash outs, non-hardship withdrawals, and defaulted loans.

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I. Introduction

In a time period marked by stagnant job growth, overseas conflict, and a raging health care debate, Americans face no shortage of uncertainties. Polls reveal an American electorate steeped in cynicism about their political leaders, corporations, and future. These sentiments are most prevalent when it comes to retirement prospects. A recent survey, conducted in the midst of the recession, found that Americans’ greatest concern was their ability to adequately fund their retirement. This concern is coupled with extreme pessimism, as more Americans were doubtful about their retirement forecast in 2011 than at any time in the prior twenty years.

This pessimism is certainly understandable. Americans have traditionally relied on three sources to fund their retirement—Social Security, personal savings, and private pension plans. This “three-legged stool,” as Professor Jacob Hacker describes it, is wobbly. Social Security has been raided by short-sighted political interests and underfunded due to an expanding group of retirees and failure to enact meaningful reform. Personal savings rates, a small contributor to retirement funds due to Americans’ poor savings rates, have at times dipped close to zero. The above brief explanations only serve to note the general deterioration of Social Security and personal savings, two legs of retirement security.

3. Id. at 27.
4. Id. at 3.
5. Id.
This Note looks at the third leg of the retirement savings stool: private, employer-sponsored pension plans. Until recently, employers provided defined benefit (DB) plans whereby employees were entitled to regular, guaranteed payments upon retirement. As we shall see, numerous factors pushed employers to shift from DB plans to defined contribution (DC) plans. Currently, 401(k) accounts, a form of DC plans, are the most common form of private pension plans. The plans grant account holders an unprecedented amount of control over their personal savings. Employees are responsible for determining whether, where, and how much to invest each time they receive a paycheck.

With added responsibility, however, comes added risk. Unlike DB plans, 401(k) plans allow their account holders, under certain conditions, to withdraw funds prior to reaching retirement age. This phenomenon is called leakage—“the early withdrawal by participants of money from their retirement accounts for uses other than retirement.” Leakage manifests itself in three forms: cash outs, loans, and early withdrawals. Each has the potential to hinder an employee’s long-term retirement security. The recent recession has caused at least two forms of leakage to rise. Investigating this growing problem and analyzing possible solutions is the focus of this Note.

10. MUNNELL & SUNDÉN, supra note 8, at 3.
11. Id. at 9. See generally The Shift, supra note 9, at 8 (discussing the overall shift of responsibility and risk to the employee).
12. Id.
13. Id. at 10.
15. Id.
16. See id.
This Note argues that a combination of targeted legislative action and financial literacy measures will best stymie leakage from 401(k) plans, while remaining consistent with the move towards maximum worker control over private retirement savings. Part II presents a historical backdrop, chronicling how and why 401(k) plans became the dominant mode of employer-sponsored plans. The Note then explores leakage—its forms, procedural mechanics, frequency, and causes—with emphasis placed on data from the recent recession. Part III analyzes proposed solutions, with particular attention on two bills currently being considered in the United States Congress: the Savings Enhancement by Alleviating Leakage in 401(k) Savings Act and the Lifetime Income Disclosure Act. Finally, Part IV proposes the adoption of specific financial literacy measures, along with narrowly focused legislative fixes, as the ideal means of changing workers’ behavior so the maximum benefits of 401(k) plans may be fully realized.

II. Background

This section will first compare DB and DC plans, analyzing their respective features, risk allocations, strengths, and weaknesses. Because 401(k) plans are the chief kind of DC plan, discussion of DC plans will focus exclusively on 401(k) accounts. It should be noted, however, that employees of nonprofit organizations have access to DC plans via 403(b) plans; similarly, state and local government employees may participate in DC plans through 457 plans. Afterward, this Note explains the causes driving the dramatic migration of American employees from DB plans to DC plans. The overall goal of this section is to provide sufficient context to properly address the issue of leakage. The fundamental criticism levied against DC plans is that employees face numerous risks compared with DB plans. Understanding why DC plans are the preferred mode of retirement savings will enable the crafting of a solution to the issue of leakage, one that re-

19. See MUNNELL & SUNDÉN, supra note 8, at 9.
mains consistent with the move toward increased worker control over retirement savings.

A. **Features and Risk Allocation in Defined Benefit Plans**

A DB plan is a voluntary, private-sponsored pension plan in which employees receive regular, guaranteed benefits from the moment they retire until their death.\(^{20}\) The amount of benefits is determined using a formula that accounts for the number of years worked and wages earned by the employee with that particular employer.\(^{21}\) Because wages vary throughout an employee’s tenure, the baseline wage rate used is the “final salary,” the average wages earned at a specified time prior to retirement.\(^{22}\) Therefore, DB plans are designed to track tenure and earnings so that retirement benefits sufficiently replace pre-retirement wages.\(^{23}\) The employer is obligated to pay these benefits once the employee reaches retirement age, regardless of how well the employer’s investments perform.\(^{24}\)

DB plans place more market risk on the employer than on the employee.\(^{25}\) In a DB plan, the employer is responsible for making steady contributions and investing those contributions into the marketplace.\(^{26}\) Therefore, the employer will bear the loss if its investments do not realize a return sufficient to fund the liabilities accrued to its employees.\(^{27}\) This is termed the “investment” risk.\(^{28}\) The second significant risk the employer is subject to is the “longevity” risk.\(^{29}\) The longevity risk materializes when retired employees live longer than the average lifespan, resulting in a longer employer obligation to provide retirement benefits.\(^{30}\)

23. *Id.*
24. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
The employee also bears certain risks in a DB plan. First, post-retirement benefits are not adjusted for inflation. Assuming a steady rate of inflation and thus, marginally higher prices, retirees will obtain less utility with each additional monthly benefit. Second, and more significantly, employees face the “portability” risk. DB plans are not portable, that is, an employee cannot transfer the “account” balance when changing jobs or after being terminated. Therefore, the balance remains with the prior employer and the employee may not access the funds until reaching retirement age. Additionally, because benefits are directly linked to tenure and wages earned, each of which increase over time, “much of the final benefit accrues in the final years before retirement.” Consequently, the “accrual” risk decreases employee turnover as employees have a strong incentive to remain with the same employer to fully maximize retirement benefits. Nevertheless, the average American worker will change jobs approximately eleven times throughout his or her career. In 2008, the average tenure for an American employee was slightly over four years. Thus, the portability risk inherent to DB plans may be especially problematic in a volatile economy with high job turnover.

B. Features and Risk Allocation in Defined Contribution Plans

A 401(k) plan, the dominant form of DC plan, is a voluntary, private-sponsored pension plan where employees contribute (or defer) certain percentages of their salary to an individual retirement ac-
account and personally direct the investment of their contributions. In short, a 401(k) account “is essentially a savings account.” Employees may contribute up to $16,500 of their pre-tax income into their 401(k) account. Usually, employers will match employees’ contributions up to a fixed percentage. Instead of the amount of benefits representing the product of an employee’s tenure and earned wages, savings are determined exclusively by the return on investment earned over time. While the employer bears the investment burden in DB plans, employees with DC plans exercise direct control over their savings. Employees determine how much of their salary to contribute and where to invest those contributions. The employee may, under certain circumstances, remove contributions from his or her account. Outside of these circumstances, or forms of leakage, employees may remove funds from the 401(k) plan penalty free once they reach the age of fifty-nine and a half. Once the funds are distributed, employees must pay income taxes on their contributions and returns accrued.

DC plans naturally shift more risk to the employee. DC plans place the risk of market fluctuations on the employee. In addition to making important investment decisions, the employee’s savings are not protected against market swings; in contrast to DB plans, the employer is not obligated to insure that a set amount of benefits are available to employees when they reach retirement age. The employee also bears the longevity risk. Because DC plans do not guar-

40. The Shift, supra note 9, at 7.
41. MUNNELL & SUNDÉN, supra note 8, at 2.
43. The Shift, supra note 9, at 7.
44. Id.
45. MUNNELL & SUNDÉN, supra note 8, at 9.
46. Id. at 9–10.
47. See id. at 9.
49. The Shift, supra note 9, at 8.
50. Id.
51. Id.
antee fixed, regular benefits from the moment of retirement until death, employees must consider their expected lifespan when choosing how much to contribute and where to invest. DC plans, however, are not subject to the portability limitations inherent in DB plans. DC plans typically may be transferred between employers, allowing employees to “roll over” prior contributions and accrued returns into a similar DC plan with their new employer.

C. Circumstances Causing Transition from Defined Benefit Plans to Defined Contribution Plans

Since 1980, there has been a substantial shift in the form of private pension plans from DB to DC plans. In the 1980s, less than eight million American employees participated in a 401(k) plan; as of 2006, over seventy million American employees had a 401(k) account. Approximately 70% of all current private American pension plans are DC plans. Numerous reasons explain this shift. The changing composition of American industries and the American workforce has diminished demand for DB plans. New industries have developed that employ workers for shorter periods of time; in contrast, traditional long-tenured employment opportunities, such as manufacturing jobs, have disappeared. Additionally, the presence of “dual-earner couples” positively correlates with a reduction in DB plans and an increase in DC plans. Similarly, an increase in women employees in an industry is positively correlated with a decrease in DB plans. Some researchers argue that these demographic shifts accelerated the move to DC plans because dual-earner couples and

52. Id.
53. Id.
54. Id. at 13.
55. MUNNELL & SUNDÉN, supra note 8, at 2.
56. GAO, supra note 42, at 5.
57. The Shift, supra note 9, at 12. See generally id. at 14 (tracking the inverse relationship between the share of assets in DB accounts and the share of assets in DC accounts from 1985 to 2005).
58. Id. at 18–20.
59. Id.
60. Id. at 18.
61. Id.
women face heightened exposure to the portability and accrual risk, respectively.62 Dual-earners are more likely to demand portability because job turnover occurs twice as frequently.63 Women may demand greater account flexibility as they exit and re-enter the workforce for family reasons.64

DB plans have also become more expensive to fund because employees are retiring earlier and living longer.65 The enactment of the U.S. Employee Retirement Income Security Act of 1974 (“ERISA”) and simultaneous changes to the Internal Revenue Code imposed regulatory and compliance burdens on employers that drove up the cost of DB plans.66 Post-ERISA, employers that provide DB plans must finance a newly created private pension insurance program, obey new reporting requirements, and provide DB plans to a greater number of employees.67 In contrast, DC plans do not need to be insured because they are “fully funded by definition” with employee contributions.68 Finally, 401(k) plans have supplied the vehicle for employees’ increased desire to exercise control over their retirement savings.69 As discussed, 401(k) plans offer employees much more discretion over their retirement savings than DB plans.70 Employees are free to construct individual portfolios that reflect their risk aversion or risk seeking preferences.71 Employees may strategically alter their contribution rate, borrow repeatedly against their account, and transfer their savings into another 401(k) plan when they switch jobs.72

D. Three Forms of Leakage

62. *Id.*
63. *Id.*
64. *Id.*
65. *Id.* at 19–20.
66. *Id.* at 19.
67. *Id.*
68. MUNNELL & SUNDEN, supra note 8, at 3.
69. See generally *Id.* (explaining the appeal of 401(k) accounts to employees); The Shift, supra note 9, at 21 (suggesting that greater notoriety and understanding of complicated financial assets combined with the stock market boom of the 1990’s increased employee interest in managing retirement savings).
70. MUNNELL & SUNDEN, supra note 8, at 3.
71. *Id.*
72. E.g., *Id.* at 9–10.
There are three ways that employees may withdraw funds from their retirement account prior to reaching the age of fifty-nine and a half, the time when 401(k) funds may be distributed without penalty. These three means of withdrawal are known as the sources of leakage. They are: cash outs (or lump-sum distributions), withdrawals, and loans. Cash outs refer to employees’ ability to take a cash distribution from their 401(k), rather than remaining in the original employer’s 401(k) plan or rolling over their assets into another private account. Employees may only cash out when they separate from the employer who was sponsoring their 401(k) plan. Withdrawals refer to employees’ ability to withdraw their 401(k) savings prior to reaching age fifty-nine and a half for “immediate and heavy financial need.” Finally, loans may be defined as employees’ ability to borrow against their 401(k) plan.

E. Defining Cash Outs, Recent Trends, and Effect on Retirement Savings

Employees may liquidate their 401(k) balances when they separate from their employer, rather than moving the balance to another retirement account. Employees who cash out choose to do so instead of retaining the balance with their previous employer, rolling over the balance to an IRA or 401(k) account with their new employer, or annuitizing the balance. Cash outs are distinct from other forms of leakage because employees may cash out all or part of their account

73. AON HEWITT, supra note 17, at 3; Reeves & Villarreal, supra note 48, at 1.
74. AON HEWITT, supra note 17, at 3.
75. Id.
77. Id.
78. GAO, supra note 42, at 9.
79. See LUCAS, supra note 76, at 5.
80. Id. at 4.
balance and may use the money for any purpose.\textsuperscript{82} As with other distributions, employees must pay income taxes on the withdrawal.\textsuperscript{83} Additionally, cash outs taken prior to age fifty-nine and a half are subject to a 10% penalty.\textsuperscript{84} This penalty was enacted to dissuade employees from accessing their retirement funds prior to reaching retirement age.\textsuperscript{85}

Cash outs overwhelmingly make up the greatest portion of 401(k) leakage. In 2006, over 68% of the reported $108 billion in leakage was attributable to cash outs.\textsuperscript{86} In 2010, nearly 42% of terminated employees chose to cash out their funds.\textsuperscript{87} While this percentage is significant, it is noteworthy that cash outs were the only form of leakage not to rise during the recession.\textsuperscript{88} Trends emerge when looking at which employees are cashing out. Cash outs are utilized more frequently by lower-income employees: over one-third of employees earning less than $30,000 cashed out, compared to only 10% of those earning over $100,000.\textsuperscript{89} Young employees were also more likely to cash out: 53% of employees age twenty to twenty-nine cashed out compared to approximately 33% of employees age fifty and older.\textsuperscript{90} Some commentators posit that young, low-income employees are more likely to cash out due to lower marginal tax rates and lack of readily accessible credit.\textsuperscript{91}

Cash outs may substantially hinder an employee’s retirement savings depending on when the cash out occurs and what the employee does with the cash. Employees who cash out after their third or fourth job are less likely to endanger their long-term retirement security because the 401(k) account has accumulated returns over numerous years.\textsuperscript{92} In comparison, employees who cash out and delay participation in a new 401(k) account for several years may suffer a

\begin{itemize}
\item \textsuperscript{82} GAO, \textit{supra} note 42, at 9.
\item \textsuperscript{83} Id.
\item \textsuperscript{84} MUNNELL \& SUNDÉN, \textit{supra} note 8, at 131.
\item \textsuperscript{85} Id.
\item \textsuperscript{86} GAO, \textit{supra} note 42, at 14.
\item \textsuperscript{87} AON HEWITT, \textit{supra} note 17, at 10.
\item \textsuperscript{88} Steyer, \textit{supra} note 14.
\item \textsuperscript{89} AON HEWITT, \textit{supra} note 17, at 10.
\item \textsuperscript{90} Id. at 11.
\item \textsuperscript{91} MUNNELL \& SUNDÉN, \textit{supra} note 8, at 134.
\item \textsuperscript{92} See AON HEWITT, \textit{supra} note 17, at 12.
\end{itemize}
10% decrease in their retirement security. If the employee cashes out and uses the money to repay other debts, the reduction in retirement savings is limited to income tax and penalty payments.

F. Defining Withdrawals, Recent Trends, and Effect on Retirement Savings

Employees may make an early withdrawal from their 401(k) plan for “immediate and heavy financial need.” Unlike cash outs, an employee may only withdraw their own contributions from the 401(k) account. Under current law, the following scenarios qualify as hardships: medical expenses, expenses associated with purchasing a new home, tuition and related postsecondary educational expenses, payments to prevent eviction or foreclosure, funeral expenses, and home repair expenses. Medical, tuition, and funeral expenses were added to the list of hardship withdrawals in 2006. Once again, employees must pay income taxes on the amount they withdraw and may be subject to a 10% penalty if they withdraw funds prior to age fifty-nine and a half.

Other barriers must also be crossed before taking a hardship withdrawal. Employees must exhaust all other distributions and loans prior to applying for a hardship withdrawal. This provision, however, is often leniently enforced by sponsors. Additionally, most plans forbid employees from making 401(k) contributions for six months following their hardship withdrawal. While some plans also allow employees to take non-hardship withdrawals, these plans often limit the funds that can be withdrawn to after-tax contributions or employer contributions. Of course, withdrawals after age fifty-nine

93. LUCAS, supra note 76, at 7.
94. MUNNELL & SUNDÉN, supra note 8, at 135.
95. GAO, supra note 42, at 9.
96. Id.
97. Id. at 9–10.
98. Id. at 7.
99. Id. at 9.
100. Id.
101. Id. at 31.
102. AON HEWITT, supra note 17, at 7.
103. Id.
and a half may be taken without penalty and without proof of a hardship.\footnote{104}

Hardship withdrawals make up the smallest portion of leakage from 401(k) plans.\footnote{105} In 2006, approximately 8\% of the reported $108 billion in leakage consisted of hardship withdrawals.\footnote{106} Total withdrawals, however, have spiked since the recession. In 2006, only 4.9\% of employees took a hardship withdrawal; in 2010, 6.9\% did so.\footnote{107} This represents an approximately 41\% increase in four years.\footnote{108} As only 20\% of total withdrawals were for heavy and immediate financial need, this spike was driven by non-hardship withdrawals.\footnote{109} In fact, withdrawals were used predominantly by middle-income account holders with incomes ranging from $20,000 to $80,000.\footnote{110} Among those taking hardship withdrawals, over half did so to avoid an eviction or foreclosure.\footnote{111} This number is not surprising in light of the significant drop in housing prices during the recession.\footnote{112}

Withdrawals, however small in number, can leave a large dent in retirement security. Unlike loans, which may be repaid, withdrawals lead to a permanent loss in retirement savings.\footnote{113} Simulations show that hardship withdrawals adversely affect young, low-income employees, particularly those who discontinue contributions beyond the six-month contribution suspension required by many plans.\footnote{114} For those who delay contributions for as many as two years, retirement security is worsened by 3\%.\footnote{115}

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\begin{itemize}
\item \footnote{104}{Id.}
\item \footnote{105}{GAO, supra note 42, at 14.}
\item \footnote{106}{Id.}
\item \footnote{107}{AON HEWITT, supra note 17, at 7.}
\item \footnote{108}{See id. (arriving at percentage of increase by subtracting 4.9 from 6.9, and dividing this number by 4.9).}
\item \footnote{109}{GAO, supra note 42, at 14.}
\item \footnote{110}{Id.}
\item \footnote{111}{Id. at 8.}
\item \footnote{112}{See UNITED STATES CENSUS, MEDIAN AND AVERAGE SALES PRICES OF NEW HOMES SOLD IN THE UNITED STATES (2011), available at http://www.census.gov/const/uspriceon.pdf (providing historical data showing stagnation of growth, and drop, in median and average home-price appreciation in recent years, particularly in relation to the previous historical rate of growth in home-price appreciation).}
\item \footnote{113}{LUCAS, supra note 76, at 4.}
\item \footnote{114}{GAO, supra note 42, at 19–20; AON HEWITT, supra note 17, at 9.}
\item \footnote{115}{LUCAS, supra note 76, at 7.}
\end{itemize}
defining loans, recent trends, and effects on retirement savings

seemingly the most controversial and publicized form of leakage, loan provisions allow employees to borrow against their 401(k) accounts. it is estimated that nearly nine in ten 401(k) plans permit employees to take out such a loan. employees may borrow 50% of their account balance or $50,000, “whichever is less.” plans generally place no restrictions on the number of outstanding loans an employee may have at one time. like cash outs, loans may be taken for any purpose, however, special repayment provisions apply when taking out a loan to purchase a home. general purpose loans must be repaid within five years, while home loans are afforded a generous repayment period of ten to thirty years. when repaying a loan, employees must repay the principal and interest into their account. the interest rate on 401(k) loans must be “reasonable” under federal law, and most sponsors peg the interest rate close to the prime rate. indeed, the federal reserve reported that most 401(k) sponsors charge employees only 4.25% interest on their loans. severe penalties are imposed, however, if the employee is unable to repay the loan. a defaulted loan will be treated as if the employee cashed out or made a hardship withdrawal: the employee must pay income taxes and a 10% withdrawal penalty. the most significant penalty occurs when the employee changes jobs or is terminated. when that occurs, the loan’s remaining balance is accelerated and the employee must pay back the entire amount of the loan within sixty to ninety days.

117. gao, supra note 42, at 10.
118. aon hewitt, supra note 17, at 13.
119. gao, supra note 42, at 10.
120. aon hewitt, supra note 17, at 4.
121. gao, supra note 42, at 10.
122. reeves & villarreal, supra note 48, at 1.
123. jason zweig, banking on yourself: is it ever ok to raid your 401(k)?, wall st. j., (june 25, 2011), http://online.wsj.com/article/SB1000142405270230423 120456465902730644780.html.
124. gao, supra note 42, at 20–21.
125. e.g., aon hewitt, supra note 17, at 5.
There are various reasons why employees may be motivated to borrow against their accounts. First, employees may be inclined to take out a loan because interest rates are reasonable and the interest is paid back into their own account.\textsuperscript{126} Instead of forfeiting interest to a bank to borrow funds, employees keep the interest by having it deposited back into their retirement accounts.\textsuperscript{127} Second, the recession has dried up many traditional sources of credit; credit card companies have established more stringent cardholder limits and home lending is difficult to obtain.\textsuperscript{128} Third, employees can quickly fill out a loan application that allows them to use the loan for any purpose, as opposed to undergoing a credit check to obtain a loan for a more defined purpose.\textsuperscript{129} Fourth, 401(k) loans offer access to quick cash; employees may not have the time or desire to liquidate long-term assets such as a home or mutual fund.\textsuperscript{130} Finally, 401(k) loans may allow employees to make purchases that would ordinarily be financed using their “precautionary savings.”\textsuperscript{131}

There are, however, numerous drawbacks to taking out loans. First, the opportunity cost of taking out a loan is the return employees would have earned on their contribution.\textsuperscript{132} Second, it is not uncommon for sponsors to restrict employees from making new contributions during the time they have an outstanding loan.\textsuperscript{133} While this restriction may be inconsequential for a loan that is quickly repaid, contribution limits for a long-term loan such as a mortgage may be especially burdensome. Lastly, the acceleration provision that requires employees to pay back the loan in sixty days, when they sepa-

\begin{itemize}
  \item \textsuperscript{126} Jilian Mincer, \textit{Loans from 401(k)s Are on the Rise as Investors Tap Their Inner Banker}, \textit{Wall St. J.} (June 7, 2011), http://online.wsj.com/article/SB10001424052702304563104576365412803516824.html.
  \item \textsuperscript{127} \textit{Id.}
  \item \textsuperscript{128} \textit{Id.}
  \item \textsuperscript{130} \textit{Munnell & Sundén, supra} note 8, at 127.
  \item \textsuperscript{131} \textit{Id.}
  \item \textsuperscript{132} Bedway, \textit{supra} note 129.
  \item \textsuperscript{133} \textit{Id.}
\end{itemize}
rate from their employer, is particularly risky in a climate of high unemployment.\textsuperscript{134}

Loans make up the second largest portion of 401(k) leakage after cash outs.\textsuperscript{135} In 2006, over 23\% of the reported leakage in 401(k) accounts was attributable to loans.\textsuperscript{136} The number of outstanding loans has risen during the recession.\textsuperscript{137} In 2006, only 21.8\% of employees took out a loan compared to 27.6\% in 2010.\textsuperscript{138} This represents an approximately 27\% increase in four years. Individual company reports support this data: Target reported a 23\% increase in employee loans, while Whole Foods Market reported a 34\% increase in 2010.\textsuperscript{139} Middle-aged employees are nearly twice as likely to borrow against their account as young employees.\textsuperscript{140} A majority of borrowers only have one outstanding loan, and less than 3\% have more than two outstanding loans.\textsuperscript{141} What are loans used for? While slightly outdated, 2001 figures suggest that a majority of loans are used for home purchases and repairs, education expenses, medical expenses, and bill consolidation.\textsuperscript{142} Notably, only 5\% of loans were directed toward current consumption.\textsuperscript{143}

Unlike withdrawals, loans are not necessarily a permanent loss to retirement savings because they have the potential to be repaid.\textsuperscript{144} Employees who continue making contributions during the loan repayment period and timely repay the loan generally face little loss in retirement security.\textsuperscript{145} The only negative effect on retirement security occurs because the loan is being repaid with after-tax income and the loan’s interest rate may be less than that which would have been earned in the 401(k) account.\textsuperscript{146} In contrast, some commentators argue

\begin{itemize}
    \item \textsuperscript{134} \textit{Id.}
    \item \textsuperscript{135} GAO, \textit{supra} note 42, at 14.
    \item \textsuperscript{136} \textit{Id.}
    \item \textsuperscript{137} AON HEWITT, \textit{supra} note 17, at 4.
    \item \textsuperscript{138} \textit{Id.}
    \item \textsuperscript{139} Zweig, \textit{supra} note 123.
    \item \textsuperscript{140} AON HEWITT, \textit{supra} note 17, at 4.
    \item \textsuperscript{141} \textit{Id.}
    \item \textsuperscript{142} MUNNELL & SUNDÉN, \textit{supra} note 8, at 129.
    \item \textsuperscript{143} \textit{Id.}
    \item \textsuperscript{144} AON HEWITT, \textit{supra} note 17, at 4.
    \item \textsuperscript{145} \textit{Id.}
    \item \textsuperscript{146} LUCAS, \textit{supra} note 76, at 5.
\end{itemize}
that unpaid loans can be crippling to retirement security. One 2008 study concluded that 401(k) loans result in a 22% decrease in retirement savings.\textsuperscript{147} A reduction in retirement savings by unpaid loans can be traced to three causes. First, borrowers often discontinue their monthly contributions in order to make their loan payments.\textsuperscript{148} Second, loan payments may be used for any purpose, allowing employees to allocate the money toward non-hardships.\textsuperscript{149} Third, and most importantly, employees are very likely to default on their loan when separation from their job triggers the acceleration provision.\textsuperscript{150} In 2010, separated employees defaulted on approximately 60% to 80% of their loans, depending on the age of the borrower.\textsuperscript{151} Loans that are not accelerated are defaulted on “less than 3% of the time.”\textsuperscript{152} Thus, multiple studies have concluded that fully repaid loans (97% incidence when not accelerated) have the “least damaging” or “negligible” effect on retirement security compared to other forms of leakage.\textsuperscript{153}

III. Analysis

When evaluating potential solutions to curb leakage, three principles should guide the analysis. First, the shift from DB plans to DC plans has come full circle due to changes in the law, changes in the composition of the workforce, and changes in the type of employers.\textsuperscript{154} Furthermore, Americans express satisfaction with the ability to directly manage their own retirement accounts.\textsuperscript{155} Therefore, any solution to leakage should be consistent with this shift toward greater employee control. Second, the solution should target the most egre-

\textsuperscript{147} BESHEARS, supra note 116, at 4 (citation omitted).
\textsuperscript{148} Reeves & Villarreal, supra note 48, at 2.
\textsuperscript{149} Zweig, supra note 123.
\textsuperscript{150} AON HEWITT, supra note 17, at 5.
\textsuperscript{151} Id.
\textsuperscript{152} Id.
\textsuperscript{153} GAO, supra note 42, at 20; LUCAS, supra note 76, at 8.
\textsuperscript{154} See supra text accompanying notes 55–72.
\textsuperscript{155} See MUNNELL & SUNDEN, supra note 8, at 3 (explaining the appeal of 401(k) accounts to employees); The Shift, supra note 9, at 21 (suggesting that greater notoriety and understanding of complicated financial assets combined with the stock market boom of the 1990’s increased employee interest in managing their own retirement savings).
gious forms of leakage, notably cash outs, non-hardship withdrawals, and defaulted loans. Finally, the ideal recommendation will include a mix of measures that address the problem from all sides (legislative, employer-sponsor, and employee). This section begins by analyzing two current legislative proposals designed to curb 401(k) leakage. It then considers alternative proposals, focusing on the viability of financial literacy measures as a means of changing employee behavior.

A. First Legislative Proposal: The SEAL Act

On May 26, 2011, Democratic Senator Herb Kohl and Republican Senator Mike Enzi introduced The Savings Enhancement by Alleviating Leakage in 401(k) Savings Act of 2011 (SEAL Act). The bill is currently being considered by the Senate Committee on Finance. The SEAL Act proposes four major changes to the Internal Revenue Code for the purpose of curbing 401(k) leakage. First, the SEAL Act prohibits employers from allowing their employees to take out more than three loans at a single time. Second, employers are prohibited from allowing their employees to access loans “through . . . credit card[s] or any other similar arrangement[s].” Third, the bill extends the sixty-day time period in which a separated employee must repay any outstanding loans. Under the SEAL Act, employees would have until their tax deadline to repay any outstanding loans.
ly, the bill lifts the required six-month cessation on employee contributions following a hardship withdrawal.\textsuperscript{164}

The SEAL Act addresses some important issues, but falls short. The employee loan limit is inconsequential as less than 3\% of employees have more than two outstanding loans.\textsuperscript{165} The prohibition on credit and debit cards as a means of accessing loans is also misguided. According to a 2010 article by U.S. News & World Report, only 2\% of employers offer their employees a 401(k) debit card.\textsuperscript{166} Because employer-issued 401(k) debit cards are a new phenomenon, there is a dearth of data on the number of loans obtained or default rates from 401(k) debit cards. Admittedly, the number of firms offering these cards may increase in the future. Still, in light of the fact that 97\% of non-accelerated loans were repaid in 2010, this measure appears to be premature.\textsuperscript{167}

Other issues plague this proposal. Research has suggested that the option to borrow against a 401(k) account may increase employee participation in and contribution to 401(k) plans.\textsuperscript{168} The researchers found that the beneficial participatory effects equalize the risk of employees substituting loan repayments for actual contributions or the risk of default, and potentially have a net positive effect on 401(k) savings.\textsuperscript{169} Therefore, the sole issue with 401(k) loans appears to be the high default rate when the loan is accelerated following employer-employee separation.\textsuperscript{170} This SEAL Act provision does not address defaulted loans and unnecessarily limits the means by which employees can borrow against their 401(k) plans.

The third provision, extending the time period to repay accelerated loans, is a potentially useful measure. Many employees that take out 401(k) loans do so because they need instant liquid cash.\textsuperscript{171} There-

\begin{itemize}
  \item \textsuperscript{164} Id.
  \item \textsuperscript{165} AON HEWITT, supra note 17, at 4.
  \item \textsuperscript{167} AON HEWITT, supra note 17, at 5.
  \item \textsuperscript{168} BESHEARS, supra note 116, at 10.
  \item \textsuperscript{169} Id.
  \item \textsuperscript{170} See GAO, supra note 42, at 20; LUCAS, supra note 76, at 8.
  \item \textsuperscript{171} MUNNELL & SUNDEN, supra note 8, at 127.
\end{itemize}
fore, it is not surprising that these same borrowers cannot repay their loan within sixty days, especially following involuntary employer-employee separations.\footnote{See generally GAO, supra note 42, at 21 (implying that although the loan is accelerated for all separated employees, the provision disproportionately affects those who were terminated from their job, rather than those who left voluntarily).} As of 2010, nearly 50% of all employer-employee separations were the result of an employee being terminated.\footnote{Joe Light, More Workers Start to Quit, WALL ST. J. (May 25, 2010), http://online.wsj.com/article/SB10001424052748704113504575264432577146698.html.} Granting a recently terminated borrower more time to repay an outstanding loan should decrease the number of loan defaults as the employee will have more time to obtain new employment or liquidate other assets. The final provision in the SEAL Act calls for removing the six-month suspension on employee contributions following a hardship withdrawal.\footnote{Senate Bill, supra note 157.} This is the SEAL Act’s best and most impactful prescription for curbing leakage. The six-month post-hardship contribution suspension was enacted as a gatekeeper “to ensure that the hardship was real” so that employees would exhaust all other alternatives before taking a hardship withdrawal.\footnote{GAO, supra note 42, at 33.} In a GAO report on leakage, experts universally denounced this provision as ineffective.\footnote{Id.} Some experts contended that the restriction deterred the actual employees who should be taking a hardship withdrawal from doing so.\footnote{Id.} Others suggested that the restriction was overbroad in its reach, deterring borrowers with the capacity to continue contributions from taking a hardship withdrawal.\footnote{Id.} Additionally, employees subject to the post-hardship suspension lose the additional savings gained when an employer matches their personal contributions.\footnote{Id. at 34.} Lastly, this gatekeeping task can be achieved more efficiently through alternative means. Legislators could limit the categories for hardship withdrawals and employers could more effectively enforce the provision requiring employees to exhaust all other avenues before taking a hardship withdrawal.\footnote{See id. at 9–10, 31.}
B. The Second Legislative Proposal: Lifetime Income Disclosure Act

On February 3, 2011, Democratic Senators Jeff Bingaman and Herb Kohl, and Republican Senator Johnny Isakson introduced the Lifetime Income Disclosure Act (LIDA). The bill is currently being considered by the Senate Committee on Health, Education, Labor, and Pensions. A similar bill was introduced in the House of Representatives and the House Committee on Education and the Workforce referred it to the House Subcommittee on Health, Employment, Labor, and Pensions. LIDA advises Congress “to amend the Employee Retirement Income Security Act of 1974 (ERISA) to require a lifetime income disclosure.” LIDA would require employers to provide 401(k) account holders with a periodic statement detailing their hypothetical monthly payments if they converted their account assets into an annuity on that date. Employers would be encouraged to model their statement after a sample disclosure form produced by the Department of Labor (DOL), and use government-produced tables to calculate the expected monthly income from the annuity. According to a news release from Senator Bingaman’s congressional website, “employers and service providers using the model disclosure and following the prescribed assumptions and DOL rules would be insulated from liability.” LIDA itself is modeled after the annual Social Security statements that the federal government distributes. The bill’s sponsors argue that a similar provision for private pensions will educate 401(k) account holders about their retirement options and alert those who are not saving enough.


183. S. 267 § 2.

184. Bipartisan Bill, supra note 181.

185. Id.

186. Id.

187. Id.

188. Id.
LIDA is a strong proposal in two respects. First, it recognizes and embraces increased employee control over retirement planning. Second, it is a low-cost, low-risk plan. Employers will be shielded from excessive costs and litigation through the production of a model form. There is no discernible risk to giving employees more information about their retirement account, and employees are not required to take affirmative actions to obtain the information. Requiring employers to provide a periodic disclosure statement could only prove beneficial to current participants with low financial literacy. Additionally, non-participants may be more likely to join 401(k) plans if they knew they would be provided with simplified financial information.

C. Financial Literacy

Indeed, a multitude of studies suggest that financial literacy is an area ripe for improvement. This section first provides a brief overview of the data concerning financial illiteracy as it relates to retirement savings, and then highlights research focused exclusively on financial illiteracy among elders and 401(k) account holders. Next, it summarizes research findings on the effectiveness and limitations of financial literacy programs in changing financial behavior. It concludes by focusing on the most relevant information for our purposes—the effectiveness of financial literacy measures in mitigating leakage from 401(k) accounts.

1. FINANCIAL LITERACY AND ELDERS

Researchers have long known that financial illiteracy is a widespread epidemic. A 2005 survey by the National Council on Eco-

190. See Bipartisan Bill, supra note 181.
nomics Education reported that adults graded at the “C” level when tested on financial concepts such as interest rates, personal finance, and inflation. In a recent study published by the Journal of Marketing Research, researchers found that some adults lack a basic understanding of how savings grow. As a result, they determined that people underestimate “the cost of waiting to save” when making savings decisions. A 2002 study by Hilgert and Hogarth showed that financial illiteracy was most prevalent regarding financial management and financial markets. While between 65% and 81% of Americans could correctly answer questions dealing with credit cards and mortgages, only about 50% to 60% could do so on topics such as the stock market, mutual funds, and general financial management.

A comprehensive survey conducted in 2008 by Annamaria Lusardi revealed the depth of financial illiteracy among elders. The survey asked respondents three questions designed to gauge their knowledge of standard financial concepts: compound interest, inflation, and portfolio diversification. The questions tested whether respondents recognized that compounding interest increases savings, inflation reduces purchasing power, and portfolio diversification reduces risk. The average age of survey respondents was sixty-five. Only one-third of respondents correctly answered all three questions; a majority of respondents missed the question on portfolio diversification. When sorting the results by age group, Lusardi found that the eldest Americans, those over age seventy, displayed the greatest de-

194. McKenzie & Liersch, supra note 191.
195. Id. at 4.
197. Id. at 3.
199. Id. at 5.
200. See id.
201. Id. at 6.
202. Id.
gree of financial illiteracy. Studies on numeric capabilities of near-retirees, age fifty-one to fifty-six, raise similar concerns. One test required respondents to calculate a percentage, use simple division, and compute compound interest. While more than eight of ten near retirees could calculate a percentage, approximately half missed the division question and less than one of five submitted the correct interest calculation. Together, these studies show that elders are both uninformed and misinformed on how financial instruments function and savings accumulate.

2. FINANCIAL LITERACY AND 401(K) ACCOUNT HOLDERS

More targeted research has demonstrated that financial illiteracy is widespread even among those enrolled in private-sponsored retirement plans. A 2007 study found that, while around half of non-participating employees in voluntary 401(k) plans had low financial literacy, more than one in five participating employees did as well. Other research has revealed that employees often misidentify the features of their DC plan. Employees frequently are unaware of the existence of early retirement provisions and even more are unaware of how the provisions work. Alarmingly, recent findings show that a majority of employees grossly misestimate their future entitlements from both Social Security and their private-sponsored retirement account. Gustman and Steinmeier found that “only 27% of respondents gave estimates within 25% of their true Social Security entitlements, and only 16% of respondents with pensions gave estimates within 25% of their true pension entitlements.”

203. Id. at 28.
204. Lusardi & Mitchell, supra note 193, at 4.
205. Id.
206. Id.
208. Id. (defining low financial literacy as missing three (or more) of eight questions dealing with basic financial concepts and “the features of their employer’s 401(k) plan.”).
210. Id.
211. Id.
212. Id.
ferred no estimate at all, suggesting that even employees who are saving for retirement through private-sponsored plans lack basic financial knowledge.

While these findings show that 401(k) account holders are not immune from financial illiteracy, they tell us little about how financial illiteracy leads to poor decisions by 401(k) account holders. A May 2011 study conducted by the Robert M. La Follette School of Public Affairs at the University of Wisconsin-Madison analyzed the relationship between 401(k) rollovers and financial literacy. Rollovers can happen whenever the employee separates from his or her employer, as previously discussed, cash outs, the first form of leakage, occur when employees choose not to rollover their account balance into a new account. The report stated that “most prospective rollover clients are not fully aware of their options for their 401(k)s upon job separation.” This may indicate that some employees that cash out do so without realizing all of the options available to them.

The researchers compared the level of financial literacy displayed by three different groups of employees when they changed jobs: those who transferred their account balance to an IRA; those who retained their account balance with their previous employer; and those who cashed out. For data, they used the aforementioned 2006 study produced by Lusardi and Mitchell that asked respondents to calculate a percentage, use simple division, and compute compound interest. The results showed that employees’ level of financial literacy was not a determinant of whether they transferred their balance to an IRA or kept it with their previous employer. An employee’s level of financial literacy, however, was a major determinant as to wheth-

213. Id.
215. Id. at 1.
216. See Muller, supra note 81, at 5.
217. 401(k) Rollovers, supra note 214, at 7.
218. See id. at 7, 11, 24, 26.
219. Id. at 19–21.
220. Id. at 20; see also Lusardi & Mitchell, supra note 193, at 4 (drawing data from the 2004 Health and Retirement Study).
221. 401(k) Rollovers, supra note 214, at 21.
er she or he cashed out.\textsuperscript{222} Employees choosing to cash out were more financially illiterate than those who rolled over their balance to an IRA.\textsuperscript{223} The study also compared educational attainment among the three groups and obtained identical results.\textsuperscript{224} Educational attainment was the same between employees who rolled over their balances and those who kept funds with their previous employer.\textsuperscript{225} Employees choosing to cash out, however, had achieved nearly two years less education than their counterparts.\textsuperscript{226} Taken together, these findings strongly support the notion that cash outs are, at a minimum, exacerbated by financial illiteracy.

3. FINANCIAL LITERACY AND CHANGING 401(K) ACCOUNT HOLDERS’ BEHAVIOR

Even accepting that financial illiteracy adversely affects the investment decisions that lead to 401(k) leakage, the question remains whether implementing financial literacy measures can change financial behavior.\textsuperscript{227} Perhaps the most commonly implemented financial literacy measures are employer-offered financial education programs.\textsuperscript{228} Most large employers created these programs in the early 1990s\textsuperscript{229} as the shift from DB plans to DC plans was materializing.\textsuperscript{230} Financial education programs vary by employer, but most cover asset allocation, risk tolerance, investment terminology, pension features, and income calculations.\textsuperscript{231} In a comprehensive report issued by the Federal Reserve Bank of Chicago, researchers concluded that financial education programs are generally effective in positively changing employee’s financial behavior, perhaps without significantly lessening

\textsuperscript{222} See id. at 23.
\textsuperscript{223} Id.
\textsuperscript{224} Id. at 21–22.
\textsuperscript{225} Id.
\textsuperscript{226} Id. at 22–23.
\textsuperscript{227} See generally Review of the Literature, supra note 192, at 2.
\textsuperscript{229} Id.
\textsuperscript{230} See MUNNELL & SUNDÉN, supra note 8, at 2; GAO, supra note 42, at 5.
\textsuperscript{231} Muller, supra note 81, at 52.
financial illiteracy. A telephone survey found a positive correlation between the existence of an employer financial education program and “increases in savings rates, assets held in 401(k) accounts and other retirement accounts.” A 2009 study found that employer financial education programs resulted in greater employee 401(k) contributions. Similarly, Lusardi determined that financial education program attendees save more than non-attendees. Finally, attendance at financial education programs often prompts employees to stop relying on family and friends for their financial information.

The effectiveness of financial education programs depends on the particular attendee and the frequency of the program. These programs are most beneficial for low-income, less-educated employees. Other studies, however, find that the programs are equally beneficial in spurring contribution for employees at both the twenty-fifth and seventy-fifth income percentiles. Nevertheless, because cash outs are predominantly taken by low-income, young employees, these programs may be particularly helpful in alleviating that form of leakage. Financial education programs have proven less effective when the program occurs infrequently or is a one-time event. For instance, attendance at a one-time employee benefits fair led to only marginal increases in employee pension contribution. In comparison, a different study found that frequent financial education programs resulted in greater “contribution rates for non-highly compensated individuals.”

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232. Review of the Literature, supra note 192, at 12 (assessing the entire body of research, they concluded that “there is weaker evidence that these programs increase financial literacy.” (emphasis added)).
233. Id. at 13–14.
234. Id. at 14–15.
235. Id. at 15.
236. Martin, supra note 228, at 12.
238. Id.
239. Martin, supra note 228, at 12.
240. See AON HEWITT, supra note 17 at 10–11; MUNNELL & SUNDÉN, supra note 8, at 134.
241. See Martin, supra note 228, at 11; Lusardi & Mitchell, supra note 193, at 11.
243. Martin, supra note 228, at 11.
deemed helpful, research has shown those positive effects largely diminish within a few months.  

A 2002 study by Leslie A. Muller analyzed whether retirement education programs increase the likelihood that employees will rollover their balance when they separate from their employer.  

Muller found that financial education programs decrease the likelihood that persons under age forty will cash out when they change jobs; however, data on women and college graduates showed such programs increase the likelihood of cash outs. Muller hypothesizes that both groups may cash out, despite attending these programs, because they have less incentive to rollover their balance; specifically, college graduates are better off financially than non-college graduates and women may be secondary income earners. Nevertheless, this study demonstrates that financial literacy measures can reduce cash outs—an important finding in light of the aforementioned study linking the propensity to cash out with low financial literacy.  

4. OTHER COMMON PROPOSALS RELATING TO FINANCIAL LITERACY

Some reformers propose a national financial education campaign as a means to improve financial literacy. The argument is that financially literate employees are less likely to engage in cash outs, take non-hardship withdrawals, and default on 401(k) loans when they fully understand the retirement implications. On the surface, this is an attractive proposal. In recent history, visible national campaigns have been launched, such as former First Lady Laura Bush’s Heart Truth

244.  *Id.* at 13.
245.  Muller, supra note 81, at 48.
246.  *Id.* at 60.
247.  *Id.*
249.  See Lusardi, supra note 198, at 16 (advocating for the Department of Treasury to establish financial education standards); see also *Hearing on Financial Literacy in America Before the Sen. Comm. on Banking, Housing & Urban Affairs 107th Cong., 90–93 (2002)* [hereinafter Blandin] (statement of Don M. Blandin, President, American Savings Education Council). Blandin relayed to Congress that attendees at a 2000 “Forum on Retirement Security and Personal Savings” ranked a national media campaign as their number one recommendation to, among other things, minimize the leakage from cash outs. *Id.*
campaign for women’s health, and current First Lady Michelle Obama’s Let’s Move! campaign against childhood obesity. Additionally, other countries have implemented campaigns to encourage saving. For example, Japan actively encouraged retirement saving through leaflets, posters, advertisements, and films. This approach, however, has drawbacks when applied to the issue of leakage. First, a leading reason behind the shift to DC plans was employees’ desire to handle their own retirement accounts—which includes the ability to withdraw funds. Second, the DOL launched a national campaign fifteen years ago called the Savings are Vital to Everyone’s Retirement Act in 1997; nonetheless, the U.S. savings rate remains dangerously low. Lastly, surveys reveal that employees prefer a more personalized educational experience as opposed to a general seminar. It would be more difficult for the federal government to tailor a program to various groups, compared to implementing programs on a community level.

Lusardi offers two unique proposals: requiring financial licenses and creating a savings pyramid. She compares her proposed financial license to a driver’s license—a state-enforced, mandatory screening device. Similarly, in the financial sector, the 2005 Bankruptcy Abuse Prevention and Consumer Prevention Act instituted a rule requiring, with few exceptions, all individual debtors to participate in credit counseling prior to filing bankruptcy. This proposal, however, fails to acknowledge the shift in recent decades to increased em-

252. Lusardi & Mitchell, supra note 193, at 12.
253. Id.
254. See sources cited supra note 69.
255. Muller, supra note 81, at 49.
256. See Jones, supra note 7.
257. Lusardi & Mitchell, supra note 193, at 15.
258. Martin, supra note 228, at 15.
259. Lusardi, supra note 198, at 17–18.
260. Id. at 17.
ployee control of retirement savings. Lusardi analogizes the savings pyramid to the well-known food pyramid. Although a minor measure, this could be implemented with relative ease. Just as the DOL can create a model disclosure under LIDA, it could produce a simple savings pyramid that employers could distribute to 401(k) account holders. To curb leakage, the savings pyramid could educate employees about the negative retirement implications of cash outs, non-hardship withdrawals, and defaulted loans.

5. LIMITS ON MEASURING THE EFFECTIVENESS OF FINANCIAL LITERACY PROGRAMS

While the financial illiteracy epidemic is widely accepted, many commentators contest researchers’ ability to prove that financial literacy programs directly cause improvements in financial literacy. There are several limitations to studies that attempt to link initiatives to outcomes. First, the total body of research spans only two to three decades, as most employers created financial education programs in the 1990s during the transition to DC plans. Second, results indicating better financial outcomes may merely be correlated with the creation of these programs. This idea is supported by some findings that financial literacy measures positively affect financial outcomes, but have a mixed effect on financial literacy. Third, voluntary participation and individual reporting of financial information may result in selection bias or reporting error. Finally, studies that find better financial outcomes without a rise in an employee’s total assets may

262. See supra text accompanying notes 55–72.
263. Lusardi, supra note 198, at 18 (positing that the saving pyramid would include fundamental concepts “such as diversification of investments, exploitation of the power of interest compounding, taking advantage of tax-favored assets or employer matches.”). Lusardi also suggests creating one website that contains all this information. Id.
264. See Bipartisan Bill, supra note 181.
265. See Martin, supra note 228, at 7 (discussing the difference between correlation and causation, and pointing out that behavioral traits may be influencing financial outcomes).
266. Id. at 2.
268. Lusardi & Mitchell, supra note 193, at 10; Martin, supra note 228, at 10 (discussing survey methods that use individual reports as opposed to employer records).
simply reflect an employee shifting assets from one source to another, without any net gain in retirement wealth.\footnote{269}

While these are legitimate criticisms, research techniques and recent findings regarding financial literacy programs adequately answer these concerns. First, expanding databases containing demographic characteristics control for possible selection bias, and use of employer records reduces the risk of reporting errors.\footnote{270} Second, some studies found concurrent increases in contributions and total savings, countering the idea that newly educated employees merely shift their funds.\footnote{271} Finally, better employee financial outcomes, despite cloudy evidence of long-term increases in financial literacy, is reason enough to support increased use of financial literacy measures to solve the problem of 401(k) leakage.\footnote{272}

IV. Recommendation

Finding a solution to leakage must involve changing employee behavior. With the complete shift to employee-managed retirement accounts, this Note rejects popular calls to institute default plan designs that at the core seek to impose “best practices” on employees while presupposing and accepting financial illiteracy and idleness.\footnote{273} Instead, it embraces solutions that empower employees to make better financial choices and eliminates rules that discourage long-term savings. Therefore, the following measures to curb leakage from 401(k) accounts should be adopted.

A. Cash Outs

\footnote{269} Review of the Literature, supra note 192, at 14; see also Martin, supra note 228, at 10. 
\footnote{270} Review of the Literature, supra note 192, at 15. See generally Martin, supra note 228, at 10. 
\footnote{271} Review of the Literature, supra note 192, at 15. 
\footnote{272} See id. at 2. 
Cash outs are best addressed through implementation of financial literacy initiatives. As previously discussed, cash outs are the most prevalent form of leakage. When employees separate from their employer, they can choose from three options that preserve retirement savings (retain the 401(k) balance with their old employer, rollover the balance to an IRA or new 401(k) account, or annuitize the balance) and one option that threatens retirements savings (cash outs). Research shows no difference in the financial literacy and educational attainment of those employees who retain the balance with their former employer and those who rollover their balance into an IRA. Employees who choose to cash out are, on average, less financially literate and have less educational attainment than the other groups. Other research found that financial education programs decrease the likelihood that employees will choose to cash out when separating from their employer. Together, these studies are strong evidence that the degree of employee financial literacy directly affects the rate at which cash outs occur, and financial literacy education is effective in reducing the rate at which cash outs occur.

Employer-sponsored financial education programs must be better designed and more narrowly tailored. These programs are not effective in improving long-term financial literacy when they are just one-time events. Therefore, employers should offer and actively promote monthly or bimonthly seminars. Because many 401(k) participants lack even a basic understanding of concepts such as interest, inflation, and portfolio diversification, employers should offer multiple levels or tiers of financial education. This would fulfill employees’ stated desire for more personalized instruction —creating a multi-tiered program will ensure financial information is available for all employees. In turn, this may increase participation and effectiveness of the program as employees learn alongside those with similar

274. See GAO, supra note 42, at 14.  
275. See Muller, supra note 81, at 80.  
276. See notes 219–25.  
277. Id.  
278. See notes 243–44.  
279. See Lusardi & Mitchell, supra note 193, at 11; Martin, supra note 228, at 13.  
280. See Lusardi, supra note 198, at 3.  
281. See Lusardi & Mitchell, supra note 193, at 15.
financial knowledge. Employers should expend special effort to encourage participation by low-income employees as they are the most frequent source of cash outs. \footnote{282}

Finally, Congress can help reduce cash outs by passing LIDA. \footnote{283} LIDA is a low-cost, common-sense proposal that merely requires employers to provide basic financial information to their 401(k) account holders on a yearly basis. Research shows that employees grossly overestimate the future income stream from their retirement plan and fail to understand the features of their plans. \footnote{284} By converting current savings into an annuitized figure, employees will have a better grasp of how much they need to save for retirement.

B. Withdrawals

While withdrawals represent the smallest portion of leakage, they may have the most devastating effect because the removed funds are permanent losses to retirement savings. \footnote{285} Because of this, employers should vigorously enforce existing requirements that employees exhaust all other distributions and loans before being able to take an early withdrawal. Additionally, Congress should pass the provision in the SEAL Act that eliminates the six-month moratorium on employee contributions following a hardship withdrawal. \footnote{286} Experts universally denounce the regulation as an ineffective gatekeeper for ensuring that withdrawals are truly for hardships. \footnote{287} Employees suffer twofold as they lose both their own contributions and the employer’s matching contribution. \footnote{288} Because withdrawals are most detrimental to retirement savings when employees discontinue

\footnote{282. See AON Hewitt, supra note 17, at 10–11; Munnell & Sundén, supra note 8, at 134.}
\footnote{283. See Lifetime Income Disclosure Act, S. 267, 112th Cong. (2011).}
\footnote{284. See Review of the Literature, supra note 192, at 7.}
\footnote{285. See Lucas, supra note 76, at 4.}
\footnote{286. SAHRA Legislative Highlights, SAHRA (Feb. 18, 2012), https://www.vshra.org/uploads/docs/1331255392.pdf.}
\footnote{287. See notes 173–76.}
\footnote{288. See id. at 34.}
contributions following the six-month suspension, this change may remove the impetus for leakage.

Interestingly, the recent spike in withdrawals has been driven by an increase in non-hardship withdrawals. Theoretically, there should be less concern about leakage due to hardship withdrawals because the funds often are funneled into a legitimate hardship, such as avoiding a foreclosure. Policymakers should therefore reorient their focus to non-hardship withdrawals being used for current consumption.

C. Loans

While highly controversial, 401(k) loans only cause leakage in limited circumstances. Very few 401(k) account holders have more than two outstanding loans, and account holders only default on 3% of non-accelerated loans. When the acceleration provision is triggered due to a change or termination of employment, however, employees default on their loan 60% to 80% of the time. This default is then treated as a cash out or hardship withdrawal, and it is subject to taxation and the early withdrawal penalty. The obvious solution, proposed in the SEAL Act, is to extend the time period given to employees to repay a loan. From the sponsors’ side, employers should remove limits that prohibit employees from making 401(k) contributions while they have a loan outstanding.

V. Conclusion

This Note analyzed the problem of leakage from 401(k) accounts and attempted to craft a solution that recognizes and embraces the shift to greater employee control over retirement savings. Legislative measures and financial literacy education should focus on alleviating the most egregious forms of leakage—cash outs, non-hardship withdrawals, and defaulted loans. Recent research has shown that com-

289. See GAO, supra note 42, at 16; AON HEWITT, supra note 17, at 7; LUCAS, supra note 76, at 7.
290. See AON HEWITT, supra note 17, at 7.
291. See id. at 4–5.
292. See id. 5.
Comprehensive financial literacy education can reduce employees’ propensity to cash out upon changing jobs. Leakage from withdrawals can be reduced by eliminating the six-month moratorium on employee contributions after a hardship withdrawal, and directing efforts toward reducing non-hardship withdrawals which, by definition, are more likely to be used for current consumption. Finally, Congress should not overreact and restrict the means by which an employee may take out a loan or the number of simultaneous loans; instead, lawmakers should extend the repayment period for accelerated loans, as nearly all leakage from loans is the direct result of the acceleration provision.