washingtonpost.com

A Card to Borrow Your Future

Can Access to Credit Encourage Savings?

By David A. Vise
Washington Post Staff Writer
Sunday, October 24, 2004; Page F01

For a quarter-century, a Boston inventor has been obsessed with a single idea: an innovation that would give millions of American workers the chance to borrow their own money from their 401(k) savings plans using a new kind of credit card.

In 1980 the inventor, an animated fellow named Francis Vitagliano, shared his concept with an MIT professor, Franco Modigliani. The Italian-born economist had been writing for 20 years about his theory of how and when people spend and save money during their lifetime, the so-called Life-Cycle Hypothesis. Modigliani's work would win him the 1985 Nobel Prize in Economics, but the call from Vitagliano would, he thought, give him a way to test his theory in real life.

The men became champions for this new financial instrument, spending untold sums for a patent on the card idea, trying to sell it to banks and credit card companies, and withstanding a barrage of criticism from members of Congress and the financial community.

Franco Modigliani died last year at age 85. But tomorrow in Washington, Francis Vitagliano, now 55, is scheduled to watch as the 401(k) card is unveiled at a financial conference. Appearing on a panel will be an official of ING, the global financial services company that has licensed Patent No. 5206803 and is preparing to introduce the new card to employers and their k-plan participants soon, after receiving final regulatory approval from the state of Connecticut.

In this time of worry about the American retirement system, the card will once again cause a flap -- but possibly not as much as it has in the past. Whatever the immediate outcome, this is not the last stop for the controversial card as it does or does not become a staple of American getting and spending. And the tale of how it came to exist is one worth telling.

A $10 Million Idea

Working in the pension-compliance field, Vitagliano had his breakthrough idea about the retirement card decades ago when 401(k) savings accounts were in their infancy. But even then he could see that workers would apply to borrow some of the tax-deferred savings from their k-plans, putting employers through a cumbersome process to approve loans for purchase of a principal residence or education or large medical expenses. It would be a laborious process at best, one that employers and plan administrators would grow to dislike as much as the employees did. A 401(k) card would make the process much easier.

He and Modigliani also shared the belief that a 401(k) card would give workers the chance to replace costly credit card debt, often bearing interest rates above 20 percent, with lower-cost funds from their own savings. They also held fast to the view that easier access to 401(k) savings would encourage more employees, especially younger ones, to put greater sums of money away for retirement, knowing that they weren't locking it away for decades.

Each of those ideas had powerful critics.

In the mid-1990s, Vitagliano and Modigliani appeared on the verge of success after licensing their patent to Banc One, a major Ohio bank that was ready to roll out the credit card. But bringing a new product to market is fraught with peril, as they found out when they ran into opposition in Washington.

The retirement card would cause people to drain their 401(k) accounts, said then-Rep. Charles E. Schumer (D-N.Y.), who introduced a bill to block it.

What about the chance for people to replace those high-interest-rate credit cards? The major credit card companies lobbied hard to derail the concept.

Facing the political heat, Banc One dropped the idea.

The mettle of the two men was next tested when they were offered up to $10 million to sell their patent. Should they cash in and take a sure thing, or should they wait and pursue the prospect of greater profits through royalties in the future? Ultimately, fearing the card would not be introduced properly without their hands-on involvement, they rejected the millions and decided to continue their quest.

Over the ensuing years, they sometimes spoke about the millions they had passed up. And their frustration mounted as they made one false start after another.

The running joke in Vitagliano's household was that he was lucky to have married a psychiatrist, because there was no other way he could have afforded the therapy needed to endure the anguish. Vitagliano's wife, Halyna, put it in simpler terms: She would not buy curtains for the living room in their townhouse until the new credit card was introduced.

The impending arrival of the 401(k) card is a victory for Vitagliano, whose favorite expression is a childlike "Oh boy!" and who has kept himself fresh by pursuing the invention with vigor while working in a series of pension-compliance jobs to pay the bills.

Years ago, before entering the pension field, Vitagliano did intelligence work at the National Security Agency. That sense of adventure and intrigue remained with him through the years, as he and Modigliani suffered setbacks.

"The journey has been fascinating," Vitagliano said. "If all we really wanted was to make money, we would have taken the money we invested in getting the patent and bought a fast-food franchise. Our commitment has been to the value of the invention and that it be implemented properly."

New Monthly Bills

Here's how the new 401k card would work:

Individuals with money in 401(k) savings plans would, if their employers permit, be able to purchase the new card for a $50 annual fee, enabling them to borrow money for routine purchases or major expenditures or, as with an ATM card, just to have cash readily available. They would not be permitted to borrow more than $10,000, or 40 percent of the money in the account, whichever is smaller. Furthermore, loans made with the card would not be subject to the tax penalties usually associated with early withdrawal from the retirement account.

Participants would receive monthly bills that look like credit card statements, and would be required to make minimum monthly payments to their own 401(k) plans, at an interest rate equal to the prime rate, currently 4.75 percent, plus 2.9 percent. (The 2.9 percent would go to ING to cover costs and pay licensing royalties.) Repayment of loans using the credit card would be made over a maximum of four years.

Monthly payments on the card would be made by automated transfer from checking or savings accounts, by telephone transfer of funds, or by check.

If an employee fell three full months behind on payments, he or she would be considered delinquent on repayment and, under Internal Revenue Service rules, the credit card loan would be converted to a 401(k) withdrawal. At that point, the employee would lose use of the card, and the loan would be subject to ordinary income tax plus a 10 percent tax penalty.

Right now, about 18 percent of 401(k) plan participants have loans outstanding. Under federal rules, the loans may not exceed $50,000, and usually must be repaid within five years.

The single biggest drain on 401(k) savings plans, however, occurs when employees leave a job. Frequently, employees withdraw all of their money rather than roll it over into a tax-deferred individual retirement account or their new employer's k-plan. Sometimes, the cash is needed to pay living expenses between jobs. But pension experts warn that many people find the option of a large lump sum of cash from their 401(k) plan irresistible, even if they are not strapped.

In terms of 401(k) loans, companies normally require individuals to repay them completely when they leave their job. This often leads people to convert their outstanding loans to withdrawals, triggering those tax penalties.

One advantage of the new retirement credit card is that individuals would not have to repay outstanding loans when they leave a job, since the loan is being administered by a third-party processing firm, rather than by their former employer. Pension experts say this loan-portability feature of the 401(k) card is likely to reduce withdrawals tied to loans.

Predictions at Odds

Meanwhile, the debate over whether the 401(k) card is a good idea or a bad idea continues, though it has stronger proponents, and fewer adversaries, than it did a decade ago.

Lawrence H. Summers, president of Harvard University and former secretary of the Treasury, said last week that he supports the new card because he thinks it will increase people's willingness to save money for retirement. People are more likely to put money into a 401(k) account, he said, if they can access the funds as needed.

"Modigliani patented a good idea," Summers said in an e-mail. "Anything that encourages individuals to establish separate accounts for their saving is likely to increase personal saving and preparation for retirement. This is important for individuals as life expectancies increase and retirement ages decrease."

David Certner, director of federal policy for AARP, strongly disagrees, saying the card will lead people to deplete their 401(k) savings. "People are not saving enough for retirement. This just sends absolutely the wrong message about savings and especially about retirement savings. This is just one more example of allowing people to cash out."

Alicia Munnel, director of the Center for Retirement Research at Boston College, said the new retirement card is ready to be tested in the marketplace. Her initial concerns that the card would drain 401(k) savings have been addressed in part by the imposition of the $10,000 maximum on what can be borrowed.

"The fact that it has a cap makes me less worried than I was initially," Munnel said in an interview. "I started out very skeptical. The upside potential is if people feel they have access to these funds and can use them for regular expenditures, it may make it more appealing to join plans, and increase participation. On the other hand, if the $10,000 limit is the camel's nose under the tent, that would be a bad development."

That's what worries Rep. Earl Pomeroy (D-N.D.), who describes Vitagliano as a friend. A member of the House Ways and Means Committee, Pomeroy said he will be monitoring the introduction of the card closely.

"If this is a tightly targeted pilot -- that is, indeed a legitimate test of the theory 'Does this help or hurt retirement savings?' -- maybe there is some merit in giving it a real-world experiment," Pomeroy said. "If, however, this is the foot in the door and an effort not to study it but to blow this wide open across 50 states, I will be opposed to it."

Instead of using the new retirement card to replace costly credit cards, Pomeroy fears, workers will just add to their debt load.

"The easier the access, the faster the money goes away," Pomeroy said. "That has yet to be disproven. I don't believe there is any significant statistical evidence supporting the view that you facilitate savings by making it easier to spend. This whole idea makes sense only if the biggest obstacle to people putting money into retirement accounts is their loss of liquidity, or immediate access to the money. In my own view, that has not been sufficiently established."

What nobody can know for sure -- until after ING begins rolling out the card with some of the 401(k) plans it administers -- is how popular the card will prove to be, and whether the easier availability of loans will alter people's borrowing and repayment habits.

"We are exploring this as a product-enhancement concept, and this is consistent with our ongoing interest in new ideas that may give rise to savings incentives," ING spokesman Philip Margolis said.

Lyn Dudley, a retirement expert, said her parents paid for her college tuition at Vanderbilt University using money from their 401(k) plan that they later repaid in full. She predicted that the new 401(k) card would lead to some increase in borrowing, but not much.

The credit card industry is not opposing the card's introduction, in part because the first 401(k) card will be a Visa card. In addition, ING is willing to sub-license the rights to the product to other financial services firms, which means that eventually there may be 401(k) American Express and MasterCards too.

The Labor Department and the Internal Revenue Service have approved the use of credit cards for 401(k) loans. Dudley said credit card borrowing rather than loans through employers would cut down on the cost and hassle of administering loans because sophisticated credit card technology would be used to track repayment. She also said ready access to loans through credit cards may encourage people at lower income levels to put more money into the plans.

"Most people accept the fact that having a loan available in your 401(k) plan up to a certain point encourages people to participate at good amounts," Dudley said. "I venture to guess there will be some increase in loans with credit cards, but not as much as you would have feared."

The Exchange

Last year, Modigliani passed away, his life ending before the new retirement card made it to market.

Vitagliano recalled one conversation with the economist about whether they would have been better off selling the patent for millions of dollars years ago and moving on to other things, rather than struggling together for so long.

"Remember," the economist said to his partner, "we have had over 20 years of close friendship. That is worth dramatically more than they were offering us."

David Vise will conduct a live online chat about the new 401(k) credit card at 1 p.m. tomorrow at www.washingtonpost.com.