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401(k) Loan Protection Helps Address Leakage. How it Works.

May. 25th, 2022

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"Retirement Plan Leakage" has been a pressing issue for policymakers and practitioners for a number of years. A report issued to the Senate Special Committee on Aging by the GAO in 2021 showed plan participants ages 25 to 55 withdrew $9.8 billion from retirement plans without rolling the account over into another qualified plan or individual retirement account. However, the most significant element of this leakage, by far arises from plan loans which default upon termination of the participants' employment.

EBRI's "Retirement Security Projection Model®" (RSPM") has been used to calculate the impact of this leakage. According to EBRI, RSPM measures" retirement security, or retirement income adequacy in the United States," and is often used to calculate the "retirement security" impact of different legislative initiatives. For example, RSPM simulated the likely impact on retirement income

adequacy of three of the SECURE Act's important provisions (that is, widening access to multiple employer plans (MEPs) through PEPs; increasing the cap under which plan sponsors can automatically enroll workers in "safe harbor" retirement plans, from 10 percent of wages to 15 percent; and covering long-term part-time employees). Taking all three of these provisions into account, the reduction in retirement savings deficits was simulated to be $114.9 billion..

There are two telling RSPM reports which help quantify the true magnitude of leakage. The first is the report that determined that the aggregate retirement deficit for all U.S. households ages 35–64 as of January 1, 2020, was $3.68 trillion. The second report, labelled "The Impact of Adding an Automatically Enrolled Loan Protection Program to 401(k) Plans",, was published this past February. That report established that loan defaults prevented by automatic enrollment in loan protection (protection which would be triggered default following termination from employment) decreases that deficit by $1.96 trillion, or by 53%. This identifies loan defaults following termination of employment as being a key source of "leakage," as well as an important element of the nation's "retirement savings deficit."

The massive size of this systemic retirement security loss from loan defaults has largely gone unnoticed in the past by policymakers, plan sponsors and plan advisers because of a very simple fact: the DOL does not require this data to be separately reported on the Form 5500. These defaults are merely reported as plan

distributions in Schedule H or I to the 5500, being treated-instead-as similar to and along with a successful retirement outcome. These defaults and their associated negative impact are clearly very real and should be alarming to an industry whose focus has been on "financial wellbeing" and improved retirement outcomes.

There has been a fundamental misconception about loans (which approaches a sort of "legacy" status) which has lent to the extent of this leakage. It is the pervasive notion that a participant borrowing from an individual account plan is simply and harmlessly "borrowing from themselves." This is simply not true. Participants are actually entering into a formal commercial relationship with the plan, under which the loan is collateralized with the participant's accrued retirement benefit in the plan. Though virtually all 401(k) plans "raise" the funds which are being lent to the participant by liquidating the participants account investments and replacing it with the value of a promissory note, there are a number of other arrangements-such as under certain 403(b) annuity contracts-where the "lent" funds are actually not actually derived from the liquidated investments in participant accounts. No matter how automated and simple a record keeper may make it to borrow from a plan, a plan loan creates a legally substantive relationship between the participant and the plan.

This means that it is the plan, not the participant which suffers an economic loss when a participant defaults on the loan, even if it's a default which is forced

simply by the employee's separation and removal from the sponsor's payroll system. It is the plan which does not receive the repayment of outstanding loan balance. Nothing in the statute or regulations force the plan to automatically exercise its lien on the participant's retirement account upon the loan's default. To the contrary, there is actually telling language from plan loan's regulatory history which suggests that this should be the last, not the first, resort of the plan's fiduciary. The sponsor can choose, instead, to design into its loan program the ability for the participant to continue post-severance loan repayments, and a number of plans allow that practice. Another option is to build into the plan's loan policy the "loan protection" program which is referenced by the EBRI study. This type of program is especially useful when participants suffer "involuntary defaults" such as layoff, permanent disability or death, all essentially events beyond their control.

An automatically enrolled loan protection program of the type referenced by EBRI works by the plan sponsor adopting it as part of the plan's written loan policy. A B2B commercial P&C insurance policy is purchased, covering the losses the plan would incur should a participant's loan default, under clearly specified circumstances described in the policy (such as involuntary unemployment). This insurance can either cover the entire outstanding balance of the loan, or a stream of loan payments for a period of time, usually chosen for a sufficient amount of time for the participant to become reemployed. Any insurance recovery received by the plan from the insurer will then, by virtue of the language of the loan policy,

be allocated to the participant's account as a payment on the loan. The premium for the protection is a plan expense of the same nature as loan set up or maintenance fees, and can be paid in the same manner as any other loan expense. As per the EBRI report the $1.96 trillion retirement assets that are retained are net of the cost of the insurance.

Adding further gravitas to the protection of a participant's account from involuntary loan defaults is the status of the loan held in the participant's account as a plan investment under ERISA. As such, loans are to be treated prudently. In fact, he DOL had noted in its Advisory Opinion on 401(k) credit cards (AO 95-17), that the purpose of the participant loan prohibited transaction exemption under ERISA Section 408(b)(1) "is not to encourage borrowing from retirement Plans, but rather to permit it in circumstances that are not likely to diminish the borrower's retirement income or cause loss to the Plan."

That EBRI report is a rare occurrence, as it pulls the curtain aside from a long-standing, serious, but almost entirely unrecognized problem related to defined contribution plans, which dramatically impacts their ability to provide for a secure retirement. It also describes the equally rare circumstance where a dramatic change to "leakage" can be provided by the market, without the need for legislative or regulatory change.