THE **ADVANTAGES** OF MAKING **RETIREMENT PLAN LOANS** MORE ACCESSIBLE

New technology makes borrowing from retirement plans **easier**, which can make them **more attractive** to participants.

BY HOWARD M. PHILLIPS, MSPA

Studies have shown that retirement plans that allow for loans have a significantly higher employee contribution rate than plans that don't allow for loans. The law allows participants in most retirement plans to access retirement savings by a tax-free loan. I say "most" because some government plans, and all IRAs, don't allow for loans. Recent studies have shown that about 85 percent of plans that can allow for loans do so; and about 23 percent of participants in those plans use the provision.

Section 72(p) of the Internal Revenue Code defines loan rules. These highlights include:

- Maximum Loan—lesser of 50 percent of vested account or $50,000 (with an additional limitation for multiple loans in the same year).
- Maximum repayment period—five years level amortization (exceptions—longer periods allowed for home purchases).
- A discussion of this area of retirement plan design must include:
  - » Advantages of allowing the loans
  - » Disadvantages of allowing the loans
  - » Issues involved in initiating, processing, and administering loans
  - » Are loan repayments taxed twice?

ADVANTAGES OF ALLOWING LOANS

Formal studies in both the private and the public sector have demonstrated that the existence of a loan provision in a plan increases employee retirement savings. In these studies, employees cite the comfort they have in knowing their retirement funds are available in case of an emergency. An October 1997 study of loan provisions in 401(k) plans, conducted by the Government Accountability Office, showed that average annual contribution amounts are 35 percent higher in 401(k) plans with loan provisions compared with those without loan provisions. A 2004 LIMRA study confirmed that an increase does occur with availability of loans, albeit by only 21 percent. It's reasonable to believe that similar results exist in 403(b) and 457 plans.

Most plan participants, especially those who don't have access to a home equity loan or a margin securities account loan, borrow through credit cards, which have significantly higher interest rates. Consolidating those debts through a loan from a retirement plan reduces the cost of borrowing and frees up funds to enhance savings.

A mid-2009 research paper published by the Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., authored by Fed economists Geng Li and Paul A. Smith, concludes that there is significant positive value available from participant loans in retirement plans.

Here are some of those conclusions:

- "…we find that many loan-eligible households carry relatively expensive consumer debt that could be more economically financed via 401(k) borrowing."
- "…we note that allowing households to repay 401(k) loans gradually even after separation from their employment could improve household welfare by reducing the risks of 401(k) borrowing."
- "…401(k) loans are not 'double taxed,' as is sometimes argued by analysts. The argument is that since 401(k) loan repayments are not deductible, they are double taxed when taxed upon withdrawal in retirement. But the appearance of double taxation is a misperception."
- "The key way a household could gain by using a 401(k) loan is by shifting high-cost debt to relatively low-cost 401(k) loans. We focus on the potential gains from swapping 401(k) loans with credit card and auto debt, which are two common sources of higher-cost household debt."

Similar conclusions will apply to 403(b) and 457 plans.

Economist Franco Modigliani, who won the 1985 Nobel Memorial Prize in Economic Sciences for his work in the field of retirement savings, explored the interplay between income, consumption, saving, and wealth through the life cycle. Modigliani pointed out that to maintain a stable utilization of monetary resources during life, people must borrow.

Modigliani once wrote:

One of the most valuable and attractive options that the 401(k) (type) program(s) has sanctioned is that of permitting plan sponsors to allow 401(k) and 403(b) participants to invest a portion of their capital in a temporary loan to themselves. This facility has the effect of increasing the liquidity of the capital accumulated in the account, making the accumulation much more affordable and attractive, especially for young people and people of more limited income, who tend to have little by way of reserves and therefore cannot afford to stash money away in a form where it becomes inaccessible for decades, no matter how great

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the need. In addition, the 401(k)/403(b) self-loans provide a source of credit that is not only available but also generally cheaper than available alternatives, especially for younger and poorer people.

Author's Note: Loans are now also available in Section 457 retirement plans.

DISADVANTAGES OF ALLOWING LOANS

But there are disadvantages to making loans available out of retirement savings. Significant leakage from retirement savings accounts can occur when a plan participant terminates employment. If the participant has a loan in place at that date, he or she is compelled to repay the loan or suffer a burdensome tax. One argument against the practice includes concerns that the participant will stop making contributions to the plan while his or her loan is in effect. Other arguments include that the participant will be taxed twice since he or she is paying back the loan with after-tax dollars, and that more access to credit will necessarily mean greater debt for the plan participant.

The issues involved in initiating, processing, and administering loans:

- Bureaucratic paper shuffling permeates the conventional arrangement. Each loan requires a separate loan application, a separate individually signed note, and a nonroutine accounting transaction. In addition, repayment is left to the participant by means of an amortization schedule, or is assigned to a rigid payroll deduction.
- Since loans are difficult, participants facing a need will borrow to meet the entire need at its outset.
- Plan sponsors incur substantial expenses to administer the program. Fees account for part. Internal staff resources account for much more.
- Employment termination inevitably closes out the loan, causing retirement assets to leave the system—usually forever—to pay off the loan. Alternatively, the participant is compelled to pay tax on the voided loan when he can least afford it.
- Participants must expose their personal finances to clerks and supervisors with each borrowing.
- Because loans are difficult and invade privacy, participants carry substantial credit card debt, paying between 18 percent and 26 percent at the same time they invest in conservative retirement plan investment options earning far less.

How can we remedy the leakage (loss) of retirement savings at termination of employment?

A terminating employee has these choices with respect to his retirement account:

- Take the money; pay the tax and possible penalty; and consume it.
- Directly roll the money over to an IRA, or a subsequent employer's plan.
- Leave the money in the plan, continuing that relationship as an inactive participant.

Here are the reasons why each of these alternatives has some negatives:

- Once consumed, that retirement savings is most likely gone forever.
- IRA rollovers may not have a better investment menu than that available in the ex-employer's program. Emergency access to an IRA account (or availability to pay off high-interest credit card debt) will involve tax and possible penalty. Also tax-free access via a loan is not available in an IRA. There may be no subsequent employer, or a subsequent employer plan. If there is a plan, that plan may not allow for loans, or may allow for severely restricted access via a loan.
- If there is a loan, it has to be paid in full then. If funds are unavailable to do so, more borrowing, possibly at high interest, may be required to pay the tax and possible penalty.

The solution is for the record keeper to adopt a system that encourages terminating participants to leave their account within the record keeper's menu. This accomplishes the following:

- There is no leakage from

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retirement savings.

- The investment menu remains unchanged, including the availability of loans.
- Existing loans need not be repaid at termination.
- The plan sponsor/staff experiences no additional work or cost to allow the plan to have inactive participants.

New user-friendly systems to initiate, process, and administer loans should remedy many of these problems. Among other things, new technology allows for:

- Monthly billing
- Easy access to loan information by Internet or telephone
- Summary loan information on a participant's quarterly statement through a link with the plan vendor
- Expanded loan repayment options
- Flexibility in repayment amounts above the minimum required by the Internal Revenue Service
- And greater flexibility in handling leaves of absence, defaults, and repayment after termination of employment.

The focus of these new systems is monthly billing for repayments. An automated, monthly billing system allows for loans to be granted without detailing a specific reason, and it extricates the plan sponsor and the third-party administrator from the loan initiation process and from setting up repayment after termination of employment. (No setup is needed because monthly billing continues.) And enhancing the monthly billing system with loan initiation by a bank card brings additional positive value. This is especially true where the participant needs access to funds in an emergency or in situations in which a balance transfer will immediately substitute a high bank-card borrowing cost for a significantly reduced borrowing cost (freeing up funds for more retirement savings).

New technology also enables plan record keepers, plan sponsors, and third-party administrators to fine-tune the ways in which they provide those loans. By allowing loans without explanation, permitting loans to be initiated with a bankcard, and limiting loans to a selected amount no greater than $10,000, the plan sponsor can extricate itself from involvement in loan procedures. This would be especially meaningful for non-ERISA 403(b) plan sponsors that don't want their employer involvement in providing loans from the plan to kick the plan into being an ERISA 403(b) plan. It will also maintain privacy for the participant and give the plan's third-party administrator only one job—that of initially determining if the line of credit requested by a participant is within the limits of the plan's loan procedures.

ARE LOAN REPAYMENTS TAXED TWICE?

Loan proceeds that are repaid are later distributed from a qualified retirement plan and are taxed once. The loan is a tax-free transfer, and when the loan principal is repaid, ignoring investment growth, the transaction puts the retirement account in the same position it would have been had there been no loan. If we trace cash flow, we'll find the financial transaction accommodated by the loan is fulfilled with pre-tax dollars. Some future after-tax money is used to pay back the loan interest, and ultimately is taxed again.

The net result of all the flow out of the plan, however, is a single tax on the amount of the loan principal in the distribution. When the plan account is distributed, the participant receives a double-taxed distribution but already owns a never-to-be-taxed financial transaction, the algebraic net of which is a single tax.

The advantages of loan availability in retirement plans significantly outweigh the disadvantages. However, these advantages disappear unless the loan initiation, processing, and administration are simplified.
All current loan systems should take this quiz:

If one or more of these questions is answered "NO," then a contemporary loan system will be an improvement to the loan system now in place:

1. Does the current loan system allow for immediate balance transfer from high-interest credit card debt to a loan where interest at prime (today 3.25 percent) is paid to the participant's account? Even with the loan administrative fee, the

18 percent–26 percent credit card interest cost is replaced with about 6 percent, thereby increasing personal disposable income, increasing retirement savings, or both.

2. Does the current loan system allow for a line of credit to be held in a loan fund earning higher yields than plan investments held in a money market (loan fund today of 2.5 percent vs. money market rates of .25 percent or less)? Therefore, an unused line of credit earns 2.5 percent at today's rates; a used line of credit earns 3.25 percent at today's rates.
3. Does the current loan system allow for participant privacy in applying for a loan? If a reason is needed for the loan, then the participant must reveal his financial duress to his employer, and the employer must take the time to determine if the reason is valid (or violate the plan's terms). Loans don't require a reason (since the law doesn't require one).
4. Does the current loan system provide for immediate emergency access to funds in the account?
5. Does the current loan system remove the employer and the TPA from adjusting loan repayments for leaves of absence (different for military vs. non-military leaves)—and from the handling of defaults?
6. Does the current loan system provide loan information to the participant 24/7?
7. Does the current loan system give the participant a loan calculator to assist the participant deliberating a loan?
8. Does the current loan system allow the participant to set up one line of credit with a single one-time application, so that line of credit may be used in smaller pieces than having to apply once for a larger loan to avoid the hassle of applying for smaller loans as they're needed?
9. Does the current loan system allow for variable payments above the minimum required, including a full payoff?
10. Does the current loan system allow the participant to continue repayment after termination of employment, without the creation of and handling of coupon books by the employer or the record keeper or the TPA? Such a continuation of repayments avoids the participant's having to find the money to repay the loan, or pay the tax and possible penalty if the loan cannot be repaid.

Borrowing is a fact of life. A limited loan from one's retirement account offers an inexpensive way to handle borrowing needs. Millions of retirement plan participants have used their plan's loan provision. New technology now available to initiate, process, and administer these loans has enhanced its advantages.

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