Qualified Plan Loans—Evil or Essential?

Plan liquidity provisions will impact retirement security—negatively for some (evil) but favorably for others (essential). Since the Great Recession, there have been dozens of articles in the benefits trade press about the (in)advisability of qualified plan loans. As debate continues, some service providers have pursued initiatives that encouraged plan sponsors to eliminate or restrict loans. Such restrictions may improve retirement security for some but would certainly reduce it for others. This article reviews the continuing debate over plan loans and offers recommendations.

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Leakage From Defaulted Plan Loans Is Bad, but the Alternative Might Just Be Worse

Leakage from loan defaults is a concern of policy makers, participants, service providers and plan sponsors alike.[1] There are entire campaigns targeted to curtail loan use.[2] Yes, loan leakage exists. Yes, it is "bad." But reducing liquidity aims at the wrong target. Curtailing plan loans will take many participants from "bad" to "worse"—It may trigger more taxable distributions and/or encourage use of high-cost forms of debt (payday loans, pawn shops or other commercial loans) that will likely reduce, not increase, overall household wealth. Service providers should first look in a mirror: Start by updating antiquated loan processes to 21st century functionality.

The Case That Loans Are Evil

Loan Provisions Are Prevalent, Loan Amounts Are Modest and Loans Trigger Leakage

Surveys show that 87% of Internal Revenue Code (IRC) §401(k) plan participants have access to a loan feature, while 20% of participants have a loan outstanding, with an average balance of $7,780 (median of $4,239) or 11% of account assets.[3] Most loans are repaid successfully.

Loans are not leakage. They are not a taxable event if they include:

- A legally enforceable agreement
- A market rate of interest
- A maximum five-year term (longer if a principal residence loan)
- Quarterly repayment in substantially level amounts
- A loan limit maximum equal to the lesser of (a) $50,000 less the highest outstanding principal of all loans on any day in past 12 months (including new loans) or (b) the greater of 50% of the vested account balance or $10,000.[4]

The risk of loan defaults/leakage is inversely correlated with continued employment. Most loans are repaid fully and successfully when employment continues. So approximately 90% of loans are repaid in full, and almost all defaults occur when assets become available at or after separation. Accurate data about the level of loan defaults do not exist. One estimate of annual loan defaults is approximately $6 billion.[5] Other study estimates range from $561 million to $37 billion (75 times greater!).[6] Loan defaults are recharacterized as ordinary income distributions subject to income taxes and, unless an exception applies, a 10% penalty tax under IRC §72(t).[7] As a result, a loan default may also trigger additional taxable withdrawals to cover the tax liability.

Finally, while defined benefit pension plan loans are possible, they are rare (and no data exist).

The Case That Loans Are Essential

Plan Loans Are Superior to Other Debt, Preretirement Withdrawals

With apologies to poet Alfred Lord Tennyson, it is better to have saved and lost than never to have saved at all. Generally, a 401(k) account decimated by multiple loan defaults would achieve a better retirement outcome than a failure to save at all—if only because many plans include an employer match and because plan loans are more efficient and less expensive compared with other forms of debt.

Debt (as well as savings) allows individuals to move consumption from one point in time to another. Unfortunately, worker liquidity needs are substantial, widespread and ongoing. One survey consistently shows that two-thirds of workers live payday to payday—that it would be very or somewhat difficult to meet current financial obligations if the next paycheck were delayed for only one week.[8] New, expensive "voluntary benefit" options have sprung up to fill workers' liquidity needs.[9] Some employers have responded with assistance/benevolence funds or IRC §7872 no-interest/below-market-rate-interest, compensation-related loans.[10]

Americans' recent experience in the 2008 financial crisis, the "Great Recession," was one wild ride. However, even after deleveraging, indebted households still had average debt of $129,579 as of September 30, 2015 (generally excluding outstanding principal from qualified plan loans)[11]—and households paid annual average interest of $6,658. Surprisingly, despite all the outstanding debt, many American households have little or no access to liquidity to meet short-term needs, income and expense variations, or unanticipated expenses. Studies have shown that "one-quarter of . . . households confirm they could not come up with $2,000 within 30 days; another 19% would meet the need in part by selling or pawning possessions or taking payday loans . . . [and that] [r]equired . . . liquid assets . . . were largely unavailable."[12]

Too frequently, critics of plan loans forget that the choice most workers have is not between a plan loan and no loan but between a plan loan and a much more costly taxable withdrawal or payday/commercial loan. In 2013, 20% of households that had checking/savings accounts used nonbank money orders, nonbank check-cashing services, nonbank remittances, payday loans, rent-to-own services, pawn shops or refund anticipation loans.[13] The Consumer Financial Protection Bureau (CFPB)[14] confirmed widespread payday loan serial borrowing—15 million-plus payday loan users with incomes of $22,400 took out loans of $350 ten times a year and paid $458 in fees (all medians). Payday loan serial borrowing creates a negative financial loop—a "strategy" that successfully depresses wealth accumulation. (See the sidebar, "Payday Loans May Ensure Retirement Poverty.") Should CFPB-proposed limits on payday loans be implemented and successful at curtailing payday loan usage, access to liquidity via a qualified plan loan will become that much more valuable.[15]

When Liquidity Is Needed, the Qualified Plan Loan Offers an Opportunity to Improve Household Wealth

The qualified plan should always be considered when liquidity is needed, as it is a debt option that offers an opportunity to improve household wealth. One study confirms that participants should favor borrowing from qualified plans over other liquidity sources: "Participants could have saved $3.3 billion in 2004—almost $200 per household—by shifting debt to 401(k) loans."[16] Today's "hot topic" regarding liquidity is student debt—even though the average student loan payment is $203/month. The change in real, per capita debt from 2003 to 2015 shows that average debt has declined 12% for individuals under the age of 30 (the 174% or $6,912 increase in average student loans has been fully offset by a reduction in mortgage, credit card and auto loan debt), while per capita debt for those aged 65+ grew by 48% (for those aged 65+, the increased debt generally

Payday Loans May Ensure Retirement Poverty

Serial borrowing is a big issue in payday loans. Once a person starts down that road, it is all too typical for workers to continue taking payday loan after payday loan. This may have a major impact on wealth.

Each $200 semimonthly payday loan typically triggers a $30 fee (a nearly 400% annual percentage rate). If there is serial borrowing over five years, we're talking $3,600 in fees.

For comparison, if the participant instead took a single plan loan of $428 (average daily balance of $200 over a five-year repayment period), it might trigger a $50 one-time fee and, at 6%, a $4.14 semimonthly payment. That semimonthly difference of $25.86, at 6%, accumulates to approximately $3,631 in five years. Assuming the five years of serial payday loan borrowing ends at the age of 30, the $3,631 increased at 6% becomes $31,359 at normal retirement age of 67. Talk about missed opportunities!

Source: Author's calculations.

was offset by a commensurate increase in assets).[17] Plan loans can be effective solutions for reducing the debt burden for nonfederal student loans or for the portion of federal student loans not eligible for the taxpayer-paid "windfall" from student loan forgiveness.

As noted, high-cost debt is a poor alternative for a worker's liquidity needs. Hardship withdrawals may be even worse. Such withdrawals are offered by approximately 90% of 401(k) plans, with estimated annual volume ranging between $9 billion to approximately $20 billion or 0.3% of plan assets.[18] Like loan defaults, hardship withdrawals trigger added, indirect leakage to pay taxes; plus, there is a six-month suspension of employee deferrals and employer contributions.[19] Economic shocks, such as job loss, have a particularly adverse effect on the retirement savings of workers, because those households are more likely to withdraw to meet emergency needs.[20] Simply, the loss of household wealth due to hardship withdrawals significantly exceeds loan default losses.

After separation, many plans incorporate mandatory distributions (for accrued benefits of less than $5,000). So leakage after separation is highly concentrated among participants with small account balances.[21] As account balances increase, more participants leave money in the plan. However, most individual account plans allow full payout after separation—which the U.S. Government Accountability Office (GAO) estimated as $74 billion of leakage in 2006.[22] Income and penalty taxes may apply for distributions before the age of 59½. Importantly, retirement plan participants in low-income households were significantly more likely than those in moderate- and upper-income households to withdraw money from their accounts, exacerbating the effect of income inequality in retirement preparation.[23] So the loss of household wealth from postseparation distributions significantly exceeds that of hardship withdrawals, which also significantly exceeds the loss from loan defaults—all of which disparately impact those least able to save.

With regard to liquidity needs after separation or in retirement, a reverse mortgage generally is a nonrecourse loan where the lender is responsible for *crossover risk* (where the collateral value of the home is less than the outstanding balance when the loan is repaid). Crossover risk, plus the quarterly repayment requirements, make plan loans an inappropriate source for a reverse mortgage. The optimal solution could well include a combination of a qualified plan home equity line of credit coupled with a reverse mortgage outside the plan.[24]

The ability to access loan proceeds electronically offers liquidity to vested and retired workers. Why borrow when distributions are available? Borrowing can be preferable to a distribution for many of the same reasons that apply to active workers—favorable terms, tax avoidance, access to money despite low credit scores, etc. Plan loan liquidity offers a fixed income investment that retirees may value as a means to avoid losses related to a temporary reduction in the market value of their investments.

Approximately 11% of workers are eligible for both a defined benefit pension and an individual account retirement savings plan.[25] Very few defined benefit pension plans offer liquidity via loans, either in-service or postseparation. Instead, payouts usually take the form of lump sums or annuities. In 2010, in plans with no restrictions on lump sums, most participants with five or more years of service and accrued benefits of $5,000+ cashed out. For those aged 50–75, approximately 45% annuitized, while for those aged 20–50, approximately 0% annuitized![26]

Some of these monies likely were rolled over to individual retirement accounts (IRAs). Investment Company Institute data show that almost 2.6 million accounts received contributions, compared with the 1.7 million accounts that received rollovers in 2013; however, amounts rolled over to IRAs were 14.5 times greater than new contributions.[27]

Internal Revenue Service (IRS) data suggest leakage was less than many estimates. In 2013, early withdrawal penalty taxes were assessed on 5,726,292 tax returns, totaling $5,873,596,000 or an average of $1,026 per return. That suggests an average premature taxable distribution (leakage) of $10,260 and preretirement leakage totaling approximately $59 billion. In 2014, the comparable numbers were 5,725,795 returns, totaling $5,840,378,000 or an average of $1,020 per return—suggesting an average taxable distribution of $10,200 with annual leakage mostly unchanged from 2013.[28] So while annual leakage from qualified plans is not well defined,[29] it is clear that only a small portion of leakage was the result of loan defaults. And, importantly, where the only liquidity option is a distribution (as is often the situation with defined benefit plans), access via a plan loan after separation could curtail leakage. So if expanding and improving postseparation liquidity through plan loans might reduce leakage from qualified plans by, say, 10%, it would add between $5 billion and $10 billion annually to retirement assets.

One final argument against using plan loans is that access to plan loans may increase consumption. However, various studies confirm most participants are circumspect about borrowing, choosing plan loans because (1) assets may be costly to liquidate, (2) plan loans are a cheap and convenient debt source and (3) plan loans allow households to maintain precautionary savings.[30] To conclude, a plan sponsor that wants to improve participant wealth should curtail hardship and postseparation withdrawals in favor of liquidity via plan loans.

Participants demand liquidity because these assets often are a worker's only cash-equivalent savings. A plan that deploys and highlights best-practice loan provisions may interdict or reduce workers' use of taxable withdrawals or more destructive forms of debt like payday loans. Just as important, actions that limit loans miss the opportunity to improve worker financial literacy. My favorite financial literacy illustration is a simple, three-question quiz—two questions on compounding (one on savings, one on inflation) and a third on the comparative risk between two investments. Only one-third of survey participants get all three questions right. Access to plan loans, done right, will improve worker financial and debt literacy, with the potential to significantly improve worker wealth and financial resilience.[31]

While leakage from loan defaults is "bad," eliminating or curtailing loans may lead a household to increase use of withdrawals or debt options that are likely much, much "worse."

Liquidity Is Essential to Increasing Savings

"You see things; you say 'why'? But I dream things that never were, and I say 'why not.' "

—George Bernard Shaw, *Back to Methuselah,* Act 1

The data are in: Participants with plan loans contribute less than those without plan loans. Other studies confirm that plan loan liquidity improves participation and contribution rates. Can both occur at the same time?

The Case That Loans Are Evil

People Who Take Plan Loans Save Less

Generally, a 401(k) participant may decrease her or his contributions at any time. Some participants voluntarily reduce or stop their contributions so as to have sufficient money for loan repayments. Some plans penalize participants who take loans: "[S]ome retirement plans do not allow you to make new contributions to your 401(k) plan if you have an outstanding loan."[32] There is an impact even when contributions continue, as "81.7% of participants with outstanding loans continued to [contribute, but] the average savings rate of those with loans was slightly lower (6.2% of pay) than those who did not have loans outstanding (8.1% of pay). . . . Ceasing deferrals during the loan repayment period is expected to erode future retirement income by 10% to 13%. . . . If two loans are taken, this reduction nearly doubles."[33] Finally, one study concludes that if a plan sponsor can limit loan

The Bank of (Insert Your Name Here)

The seven-step retirement savings discipline starts with a worker's first job and continues until his or her death (or, if married, the second spouse to die):

1. Save more than you believe you can afford to earmark for retirement.
2. Get the employer match.
3. Invest.
4. Accumulate.
5. Borrow to meet immediate need, then adjust investments to maintain target asset allocations.
6. Continue contributing while repaying the loan.
7. Contributions and loan payments rebuild the account for a future, greater use/need.

Repeat as needed up to and through retirement.

usage without impacting participation and contribution rates, it can improve successful retirement preparation by 3.2% to 8.1%, depending on income quartile.[34]

The Case That Loans Are Essential

Participation and Contribution Rates Are Higher in Plans Offering Liquidity

Four studies are cited here. Each showed that plan loan liquidity resulted in higher participation and contribution rates. One had 6% higher participation and 35% higher contributions, and a second had 9% higher participation. A third showed loan access didn't appear to impact participation, but contributions by non-highly paid participants were up 10%, and a fourth estimated participation was up 3–7%.[35]

Retirement preparation using an individual account savings plan to accumulate money over 20, 30, 40 or more years is a structure likely to fail unless savings commence at an early age. Some service providers now suggest accumulation goals at specific ages.[36] Achieving such goals requires workers to develop a savings habit early, followed by consistent participation over decades. Based on this author's experience, individuals who do not accumulate sufficient assets in a retirement savings plan fail because, in order of prevalence:

1. Approximately 49% of workers did not have access (in 2013) to an employer-sponsored retirement plan.[37]
2. Too many workers do not enroll when first eligible.
3. Too many workers select a savings rate that is insufficient.
4. Leakage.

So failure to save is a much greater impediment than leakage. At younger ages, short-term and intermediate needs are more imminent and often perceived to be more important. Few workers have sufficient disposable income to fund all expected needs. The top benefits priority for both Millennials and Baby Boomers continues to be active employee health coverage.[38]

Competing long-term financial priorities are also a challenge. Which comes first, retirement or a child's education? Maybe we can do both.[39] In his life-cycle hypothesis, Nobel Laureate Franco Modigliani argued that the amount an individual spends remains fairly stable over his or her lifetime, while savings fluctuate depending on life stage. His hypothesis challenged the Keynesian idea that savings fluctuate with income: A person saves for retirement when his or her earnings peak. Unfortunately, retirement preparation will fail if individuals don't save until they reach their peak earnings years, often in their 50s or 60s. Modigliani embraced loans from qualified plans: "The loan 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."[40]

Adding 21st-century loan functionality ensures savings are interchangeable, so workers can develop a savings habit without having to manage an "envelope" savings system, identifying and setting aside money for each need. In such a system, workers face a series of difficult predictive challenges: identify/estimate the date money is needed, the amount needed on that date, the best product for savings, projected rates of return and the date to start saving; adjust for variable rates of return and back into the amount of periodic savings that will be needed if all estimates/projections are accurate; and then reconcile this with all other needs and complete a sensitivity analysis to create a savings cushion should projections prove faulty.

Instead, using the 401(k) plan's loan functionality enables accumulation of assets for any purpose—which, through successful repayment, can be used, over and over, to sequentially meet various financial needs. See the sidebar, "The Bank of (Insert Your Name Here)."

Today, half of all American households have no accumulated wealth. The explosion in wealth inequality results, in part, from the "growing disparity in the ability to save for most Americans."[41] So any provision that increases participation and contribution rates, such as liquidity via plan loans, must be highlighted, not curtailed—particularly among younger workers.

Embrace or Avoid— The Pros and Cons of Plan Loans

"Neither a borrower nor a lender be; For loan oft loses both itself and friend, and borrowing dulls the edge of husbandry."

—William Shakespeare, *Hamlet,* Act 1

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

—Mark Twain

As with much about employee benefits, the devil *is* in the details. Frightening examples of the negative impact of loans on retirement preparation are often misleading. A common misleading example mixes the impact of accessing assets via a loan with the impact from separate decisions to stop contributing or to allocate fewer assets to equity investments. Fortunately, practical experience and academic analysis confirm that such tales of woe are more anecdotal than typical, often resulting from inattentive service providers, antiquated loan provisions/processes or participant mistakes.

The Case That Loans Are Evil

Loans Can Harm Retirement Preparation

Factors to consider when using plan loans include:

- Bankruptcy—In bankruptcy, most debt is excused, but not plan loans. So workers may want to avoid plan loans when there is potential for bankruptcy.
- Impact on credit rating—Most 401(k) plans do not report activity to credit bureaus.
- Involuntary termination—Avoid taking on debt prior to a period of unemployment or without access to a line of credit.[42]
- Interest—Regulations require a market rate of interest. The market rate on plan loans is lower than on other loans, given that this is secured debt.
- Fees—Commercial lender fees may be lower, the same or higher than plan loan fees.
- Convenience, but only while employment continues—Plan loan processing generally is straightforward and understandable, with simple repayment via payroll deduction. Most plans accelerate repayment at separation.
- Tax preferences—Interest on most plan loans (and commercial loans) is paid with after-tax dollars. However, three tax preferences may apply to interest paid on plan loans:
  1. Interest on residence loans secured with mortgages may be tax-deductible for federal income tax purposes for those who itemize deductions.
  2. Where loan principal is Roth 401(k) assets, loan interest generally will qualify for the same tax treatment as applies to interest or earnings on Roth 401(k) assets.
  3. If neither No. 1 nor No. 2 applies, then taxation on plan loan interest is the same as any other interest credited on plan assets, meaning it isn't tax-deductible (same as interest on commercial loans not secured with a mortgage) and, when received, it is taxable income (same as other interest or earnings on plan investments). It is "double taxed" only because participants receive the interest as a distribution and only if they assume they could have avoided the loan and made higher, pretax/Roth contributions.

Service providers are confident ("know for sure") that plan loans result in massive, dramatic harm to retirement preparation. Many service providers now encourage plan sponsors to consider actions that would restrict plan loans.[43] Here are three service provider examples.[44]

Plan Design Opportunities

Plan sponsors may want to consider:

- Implementing 21st-century loan functionality:
  —Add electronic banking/automated clearing house (ACH) functionality to enable cost-effective, postseparation loan repayment (individual account plan) and to enable plan loan initiation (individual account plan and defined benefit pension plan, if any).
  —Use a line-of-credit methodology (with a minimum loan amount, perhaps $500) to create a single loan that workers can access as needed, for emergencies and to minimize administrative costs and fees.
- Communicating the impact on household wealth at retirement by comparing plan loans with payday loans, commercial loans, taxable distributions and other high-cost debt options
- Fully offsetting all loan-processing costs with participant-paid loan initiation/default fees and expense margins incorporated into the interest rate
- Adding behavioral economics concepts (e.g., "commitment bonds") to loan processing so as to require participants to explicitly commit to repay the loan, in writing, at origination
- Adopting the maximum loan "cure period" (last day of the calendar quarter following the calendar quarter of missed payment)
- Favoring loans by eliminating in-service, hardship withdrawals; eliminating access via postseparation distributions before the age of 59½ on future contributions; or limiting such withdrawals/distributions to situations where access to loans has been exhausted[1]
- Adopting a default at separation to maintain the current account (eliminating provisions that encourage distribution while highlighting the advantages of maintaining the account balance when compared with an IRA—fees, loan repayment, loan access, etc.)
- Limiting future loan access to those who successfully repaid prior loans
- Adding withdrawal transaction fees, excepting income and mandatory payouts, (e.g., minimum required distribution, direct transfers, life expectancy installment payouts via ACH, etc.)
- Reducing leakage by extending fiduciary protections to all retirement wealth by adding "deemed IRA" functionality and by soliciting rollovers:
  —At hire as part of the onboarding process (and annually thereafter)
  —For those not yet eligible and for those who won't become eligible
  —At termination as part of the separation process (and annually thereafter)

1. A 40-year-old who contributes $100 per semimonthly payday borrows $10,000 for five years at 5% interest, with semimonthly payments of $94.27. The example assumes the participant doesn't contribute while repaying the loan, reducing the account value at retirement by $77,813: "That difference could mean a reduction of more than $6,749 a year for 25 years of retirement income."
2. This service provider's infographic compares three imaginary 55-year-old employees, each earning $100,000 a year, with $100,000 saved to date. The infographic comparison shows that the hypothetical accumulated savings at retirement, aged 65, is substantially different for two of them—$364,000 for Jen but only $131,000 for Hugh.
3. A third example suggests a significant "opportunity cost." This participant has a $100,000 account balance, all invested in equities; experiences market returns of 10%; and borrows $25,000. The author concludes: "[Y]ou are gaining $7,500 versus $10,000."

The Case That Loans Are Essential

Usually, Plan Loans Do Not Negatively Impact Retirement Preparation

As far as plan loans harming retirement preparedness, "it just ain't so." Consider the examples above, and note the explanations below.

- **Example 1:** This "loss" is solely the result of suspending contributions while the loan is being repaid, not the loan itself. For comparison, had the participant

Plan Design Opportunities (Continued)

- Encouraging plan sponsors to limit loan access to 33% of the vested account balance, so a successor employer plan can use a combination of two loans to facilitate the rollover of any loan outstanding at separation, where plan sponsors highlight that functionality to participants postseparation as part of the loan default and distribution processes
- Adding a sentinel effect by reporting plan loans to credit bureaus to build credit ratings and curtail misuse and defaults.[2]

All participants benefit when leakage and withdrawals are minimized. The author's former employer's plan recently had a total of $4.8 billion in assets (approximately 50,000 participants), where $1.6 billion belonged to 15,000+ term vested/retired participants (including the author). So the assets of former workers, particularly retirees with a lifetime of accumulated assets, add significant economies of scale when negotiating investment and other fees.

Plan sponsors may be able to increase participation and contribution rates by:

- Communicating "success stories" of those who successfully leveraged plan loan provisions
- Communicating why qualified plan savings should be/can be the No. 1 savings priority
- Identifying/highlighting liquidity options so as to minimize post-automatic enrollment/escalation opt-outs
- Where a loan is outstanding, applying all automatic enrollment and escalation provisions without regard to the loan principal and removing any limits on continuing contributions
- Per IRC §132(m), adding a formal, third-party retirement planning process highlighting the impact of high-cost debt and premature withdrawals on retirement preparation—confirming retirement savings tax preferences and options to maximize tax preferences (timing, geography, annuitization, saver's credit).

To maximize the tax preferences participants receive:

- All residence loans should be capable of being secured with a mortgage.
- Participants should be required to review their investment allocations coincident with initiating a loan.
- Employee contributions should be continued unchanged after a loan is initiated.
- Plan sponsors should ensure that all asset allocations (target date, target maturity model, etc.) recognize plan loan principal as a fixed income investment.

Endnotes

1. ERISA Advisory Council, "Issues and Considerations Surrounding Facilitating Lifetime Plan Participation," Recommendations. Available at www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2014ACreport2.pdf.
2. Kenneth Brevoort, Philipp Grimm and Michele Kambara, "Data Point: Credit Invisibles," Consumer Financial Protection Bureau, May 2015: "As of 2010, 26 million consumers in the United States were credit invisible, representing about 11% of the adult population. An additional 19 million consumers, or 8.3% of the adult population, had credit records that were treated as unscorable by a commercially-available credit scoring model. These records were about evenly split between those that were unscored because of an insufficient credit history (9.9 million) and because of a lack of recent history (9.6 million)." Available at http://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf.

used a credit card cash advance with a 24% interest rate, the semimonthly payments would have been 45% higher, at $136.64. Would she be more or less likely to suspend her contributions with that extra payment burden?

- **Example 2:** The comparison assumes that Jen took no loans and Hugh took loans and hardship withdrawals. So the comparison is apples to oranges, because either Jen took loans and withdrawals from other sources of wealth, or she did not need those resources.
- **Example 3**: The identified result might be obtained for the handful of participants who are 100% allocated to equities, who have no other fixed income investments outside the plan and who manage to avoid all periods of decline in market returns.[45] And maybe there is an impact for the minority who borrow when the equity markets are depressed, where the majority of loan repayments are made once the equity markets have rebounded. But for most individuals, all of these losses can be avoided by encouraging the participant to reallocate her account so as to "true up" the investment allocation after taking a loan (as the loan is a "fixed

Opportunities for Future Research

To confirm plan loan efficacy and cost-effectiveness, researchers may want to:

- Conduct a historical, longitudinal study (segmented by tenure, income, gender, age) to identify the long-term impact on participation and contribution rates from loan access
- Conduct a study to identify and compare the participation and contribution rates between participants with plan loans and participants who obtain liquidity by other means/other sources
- Update Form 5500 reporting to confirm leakage by plan type and by form of distribution, specifically identifying leakage from loan defaults, hardship withdrawals and postseparation, preretirement withdrawals.
- Study the impact on participation and contribution rates of limiting the number of loans, adding a waiting period between loans, adding spousal consent, adding loan fees, restricting loans to hardship criteria, limiting loans to employee contributions, etc.

income" investment in the participant herself).

Despite the advantages of using plan loans, many continue to favor commercial sources—despite higher fees and interest rates. Some perceive plan loans as a cushion or buffer or, perhaps, as a last resort. Others may perceive the lack of 21st-century functionality to be an impediment. Finally, modeling a choice between a plan loan and a commercial loan can be difficult.

The net advantage of the 401(k) loan compared with commercially available credit depends on:[46]

- The difference in interest rates between the plan loan and the alternative source of credit
- The tax rate
- The tax preference, if any, on interest paid on the plan loan versus the alternative source of credit.

So while some participants may be better served by borrowing from a commercial source at today's ultra-low interest rates, most participants will want to consider the favorable financial results from replacing commercial loans with plan loans.[47]

Conclusion

Loans from 401(k) accounts are not inherently evil and, for some participants, they are essential. They are not always magical, nor are they always leakage. But where plan loans are limited and specifically designed and structured to facilitate and encourage repayment, they could work a miracle.

Plan sponsors fool themselves and risk injury to participants when they curtail plan loan liquidity. Where plan loan liquidity is limited, participants may meet their short-term liquidity needs by reducing their savings or by repeatedly choosing hardship withdrawals, payday loans or other forms of high-cost credit. Such behavior could trigger a significant loss of retirement wealth—a loss younger workers can ill afford given the impact of compounding.

This author recommends that plan sponsors:

- Challenge the orthodoxy that plan loans are evil[48]
- Challenge service providers to improve loan processes and communications to achieve 21st-century functionality
- Participate in academic studies
- Support legislation that improves plan loan processes. (See the sidebar, "Plan Design Opportunities.")

It is time to change the paradigm and focus. (See the sidebars, "Opportunities for Future Research" and "Budget-Neutral Legislative/Statutory and Regulatory Changes.") Since passage of the Pension Protection Act of 2006,[49] most service providers and plan sponsors have focused on overcoming behavioral biases and cognitive limitations impeding retirement savings/investment. However, those solutions won't reach many workers who have modest incomes and who do not prioritize retirement. Evidence exists that behavioral factors may lead households to "overborrow" as well as "undersave." For this segment of the population, debt decumulation is a more efficient route to increasing household net worth, because many more households hold debt, not financial assets, and historical credit card and auto loan interest rates exceed historical equity returns.[50]

Incorporating 21st-century loan functionality enables plan sponsors to freely encourage workers to save more than they otherwise feel they can afford to earmark for retirement. It also enables workers to avoid or overcome behavioral biases, cognitive limitations and low levels of debt literacy. Household wealth can be improved where the tax-qualified plan becomes a tool that facilitates both increased savings *and* debt decumulation—where "[p]eople have within their own hands the tools to fashion their own destiny."[51] A tax-qualified plan with 21st-century loan functionality is one such tool, incorporating "Bank of (Insert Your Name Here)" capability:

> Contribute, get the match, invest, accumulate, borrow, continue contributions, repay the loan and rebuild the account to an even greater balance so as to finance a future need. Repeat as needed, up to and through retirement.

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Budget-Neutral Legislative/Statutory and Regulatory Changes

The following legislative/statutory changes could help improve household wealth.

- Because savers don't become undisciplined serial borrowers once their account balance exceeds $100,000, increase the $50,000 IRC 72(p)(2)(A)(1)(i) limit (unchanged for more than 40 years since the Employee Retirement Income Security Act) to $250,000, index after 2016 and, if needed, initially limit loans in excess of $50,000 to reasons that would qualify for IRA hardship withdrawal purposes (home purchase, college education, out-of-pocket medical expenses, etc.).
- Suspend loan payments for periods of unemployment compensation, up to one year.
- Give individuals a full year to cure loan defaults via an IRA rollover.
- Eliminate those penalty-free distribution rules that apply more favorably to IRAs.
- Reduce leakage by creating a "cashless conversion" of taxable assets to Roth 401(k) by allowing for a separate plan loan to fully fund federal and state withholding taxes (on the same basis as any other plan loan, except that the dollar amount of the loan would not be considered in applying the IRC §72(p) dollar amount limits).
- Adjust Savers Credit to incorporate a tax carry-forward provision. In 2013, 7.4 million returns claimed $1.3 billion in tax credits, averaging $178. However, tens of millions won't qualify for a Savers Credit each year, because they paid no income tax that year.[1]

Suggested regulatory changes

- Enable IRA trustees to accept outstanding loans from employer-sponsored plans as assets eligible for rollover into an IRA (so loan repayment can continue into the IRA).
- To facilitate consolidation of accounts and reduce leakage, allow rollover of Roth IRA account assets to Roth 401(k) accounts in employer-sponsored plans.

Endnote

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Endnotes

1. Tens of millions have found 401(k)s and other plans more than adequate to prepare for retirement. However, many academics and some practitioners assert that past 401(k) designs were not effective—particularly for workers with lower incomes. I agree. Many of those designs had hands-off features—a sort of a retirement "prime directive." However, many academics and regulators believe that employer plan redesigns that influenced worker decision making using behavioral economics strategies, tools and methods violated the traditional, hands-off, ambivalent plan designs common in the 1980s and 1990s. (See Janet Stemwedel, "The Philosophy Of Star Trek: Is The Prime Directive Ethical?" August 20, 2015. Available at www.forbes.com/sites/janetstemwedel/2015/08/20/the-philosophy-of-star-trek-is-the-prime-directive-ethical/#24aa0162642b.) More recently, many more 401(k) plan designs ignore the hands-off retirement prime directive, making changes that embrace "libertarian paternalism" concepts—behavioral economics designs and tools that meet workers most likely to end up in the "retirement crisis"—those with minimal financial and investing skills, those living paycheck to paycheck, etc. (See *Nudge: Improving Decisions About Health, Wealth and Happiness,* Richard H. Thaler, Cass R. Sunstein, 2009). And in addition to automatic enrollment, escalation and investment features as well as qualified default investment options, etc., some plans have adopted 21st-century loan functionality (commitment bonds, electronic banking, tax effectiveness, etc.)—changes that reduce leakage and improve the likelihood of loan repayment while also increasing savings rates and retirement asset accumulations.

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4. ERISA §408(b)(1) and corresponding regulations at 29 CFR §2550.408b-1 provide an exemption that loans will not be treated as prohibited transactions if they (a) are available to all such participants and beneficiaries on a reasonably equivalent basis, (b) are not made available to highly compensated employees, officers or shareholders in an amount greater than the amount made available to other employees, (c) are made in accordance with specific provisions regarding such loans set forth in the plan, (d) bear a reasonable rate of interest and (e) are adequately secured. See also DOL Advisory Opinion 95-17, which states, in part: " . . . the responsible Plan Fiduciaries must act prudently and solely in the interest of the participants and beneficiaries in deciding (whether and how to provide loans) . . . and in negotiating the terms and conditions of the Program. In this regard, it should be emphasized that the purpose of section 408(b)(1) and the regulations thereunder 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. Thus, plan fiduciaries must assess and monitor loan programs, in particular loan programs like the one at issue which are designed to facilitate borrowing, to ensure the programs continue to be in the interest of the participants and beneficiaries of the plan and otherwise in compliance with Title I of ERISA. . ." Available at www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/advisory-opinions/1995-17a. See also Daniel Schwallie, "Plan Loans—Whose Money Is It Anyway and Why Should You Care?," Aon Hewitt, *Journal of Pension Planning & Compliance,* Fall 2016. Available at www.aon.com/attachments/human-capital-consulting/Schwallie_Plan_Loans_Whose_Money_Is_It_Anyway_and_Why_Should_You_Care_JPPC_Fall_2016.pdf. See also Robert Toth, "The Fiduciary Underpinnings of Plan Loans." Available at www.asppa.org/News/Browse-Topics/Details/ArticleID/7069.

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