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Loans, Loans, Everywhere! Addressing the Loan Utilization Issue

Based on several of my recent plan reviews, the continued fragile economy has caused loans and loan defaults to spiral out of control in many retirement plans. Of particular concern, is the rise of so-called "serial borrowers." It is no longer unusual to see retirement plan participants who have borrowed 10, 20, or even 30 times in the course of their working careers.

The problem of overutilization is two-fold. Loans reduce retirement savings, which means that an employee may need to work longer at their employer than planned; a disadvantageous situation for both the employee and the employer. Additionally, loans are among the most difficult of recordkeeping transactions. More loans (and defaults) mean a greater potential, upon audit, for the IRS to discover errors relating to the administration of loans. This article will examine the problem of excess loan utilization and attempt to offer practical solutions for plan sponsors.

Scope of Problem and Possible Causes

In my experience, I have not reviewed a plan as of yet that does not have either more outstanding/defaulted loans than it should or a relatively small number of individuals responsible for a significant number of outstanding/defaulted loans in the plan (the "serial borrowers"), or both. The scope of the issue can be exacerbated by plans with multiple vendors, as it is not unusual for participants to take out several loans with each vendor. This, of course, must be aggregated for the purposes of the loan limits, a cumbersome task.

Plan sponsors should obtain a loan report from the plan's vendor or vendors. If a plan sponsor does not have access to all plan vendors, typically reviewing even one report from a vendor who permits loans will be eye opening.

Upon review of the loan utilization reporting, plan sponsors can then work with their vendor(s) and advisor(s) to establish possible causes for loan overutilization issues. Does the plan or vendor have a loan policy in place? What does the loan policy state? Many vendor policies allow for unlimited loans, or place no restriction as to the number of loans that may be initiated within a given time period. Also, vendor communications to participants often serve as marketing pieces for loans, rather than an honest assessment of the advantages and disadvantages of borrowing.

On the default side, I have seen countless situations where employees were permitted to borrow again after defaulting on a loan. Under the final loan regulations, reborrowing after default is only permitted when the loan is a) repaid by payroll deduction or b) secured by outside collateral (and I have yet to come across a vendor who will accept outside collateral).

However, most of the plans with which I work do not have payroll deduction for loans. Why, then, is a participant permitted to borrow? The answer is most

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likely that the contract from which loans are being made was in effect prior to January 1, 2004. There is a grandfathering provision in the regulation that allows such contracts to continue to permit reborrowing after loan defaults without the payroll deduction requirement.

Some vendors have implemented a policy that will prohibit such reborrowing regardless of contract, but others have not. Again, this is a situation that may not be desirable for a plan sponsor.

Solutions

The most obvious solution is to eliminate loans entirely, but, not surprisingly, this is an approach that has not been adopted by many plan sponsors. The loan feature has been accepted by many participants as a fundamental feature of the plan, whether they use it or not. If it were taken away, no doubt participant satisfaction with their retirement plan(s) would diminish to the point where some might even consider the cessation of participation in such plans.

Fortunately, there are a number of actions that plan sponsors can take to address loan utilization and loan defaults without eliminating loans entirely:

- Improve communication of the loan provision to participants: Loans are highlighted in vendor communications as a desirable plan feature, with little emphasis on the disadvantages of borrowing. Plan sponsors should work with their vendor/advisor to provide loan communication materials to participants that balance the advantages and disadvantages of borrowing. Participants should be aware of the tax consequences of the loan, as well as the impact on their retirement plan balance and ultimately their ability to retire in a timely fashion. They should also understand that taking out multiple loans exacerbate these concerns.
- Consider the implementation of payroll deduction or automatic checking account deductions for loan repayments; both methods should dramatically reduce the number of loan defaults.
- Consider limiting the number of loans outstanding to three or less.
- Consider limiting the number of loans that may be taken in a 12 month period to one.
- Consider restricting borrowing to a certain contribution type, such as employee elective deferrals only.
- Considering altering the fee structure for loans. Some vendors, for example, may have fee structures that promote borrowing, either by charging a below-market fee or a fee that it not transparent.
- If a vendor utilizes contracts that permit borrowing after loan defaults, consider implementing a plan level provision that prohibits such borrowing.
- If a plan utilizes multiple vendors, consider limiting the loan provision to a select group of vendors, or even a single vendor. Note, however, that such a restriction may result in participants selecting a vendor based solely on

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the ability to borrow. Of course, some vendor contracts prohibit loans at any rate.

Any restrictions regarding loans should be articulated in a loan policy, either at the plan level, vendor level, or both, so that all parties are clear as to what is and what is not permitted.

If vendor communications regarding loans do not meet the goals of the plan sponsor, an advisor can add value by drafting a loan communication. Also, advisors can be of valuable assistance in finalizing a plan/vendor loan policy that addresses utilization issues.

Conclusion

By implementing some or all of these suggested actions, plan sponsors can keep the number of loans in their retirement plans from mushrooming. Of course, plan sponsors should work with their advisors/vendors to insure that any new loan provisions can be successfully implemented on the plan's recordkeeping platform(s). As with all initiatives, there should be an infrastructure in place to measure results, and in this case, hopefully, the reduction of the number of loans as well as defaults.

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