ADMINISTRATION

LET'S TRY A MODERN APPROACH TO PLAN LOANS

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Participants should be able to use debit cards when accessing automated loan programs.

A participant's ability to borrow from retirement savings has been a part of 401(k) plans since the enactment of Section 401(k) of the Internal Revenue Code in 1978. And it's well established that participants are likely to defer a higher percentage of their salaries if a loan program is in place. This is because participants feel comfortable deferring a portion of their salaries when funds are available for borrowing if needed. If a participant chooses to borrow from his or her account balance, the principal amount of the loan plus interest will be repaid to the plan.

Unlike traditional paper loans, automated loan processing systems are simply a more efficient way to facilitate plan loan transactions. These systems use modern financial mechanisms, such as debit cards, to allow the participant to withdraw loan funds as-needed, yet do so within the boundaries of all applicable regulations and plan rules. It doesn't make sense to restrict these automated loan systems simply because they take advantage of modern technology.

TRADITIONAL PLAN LOAN PROGRAMS

The process for applying for a traditional 401(k) loan is relatively easy for a plan participant. A participant can apply for a traditional loan on a plan provider's website with just a few mouse clicks. Unlike loans taken from an automated system, once the traditional loan is approved, the entire amount of the loan is withdrawn from a participant's plan account in a lump sum. The entirety of a traditional loan balance, therefore, is no longer invested by the participant in the plan's investments.

Data suggests that participants in traditional plan loan programs tend to borrow 25 percent more funds than are actually needed for the costs that led them to borrow in the first place. This is an understandable trend, especially if a plan only allows a participant to take out a single loan. When forced to estimate the total amount of funds needed, participants tend to create a "cushion" so that the funds borrowed safely cover all the necessary costs.

Traditional loans are repaid only through payroll deduction, and these loans typically become due upon termination of employment. A participant who is unable to repay the outstanding loan balance will incur a taxable distribution when he or she loses or leaves employment, meaning the participant will be charged income tax and an additional 10 percent penalty on the loan balance, and the participant's retirement savings will then be reduced by the loan balance.

AUTOMATED PLAN LOAN PROGRAMS

The automated 401(k) loan program differs from a traditional loan program by giving participants flexibility to establish a loan account in the plan without actually withdrawing funds until the time of purchase. The participant's loan account can remain in an investment option in the plan, continuing to earn investment returns and interest until the participant makes a loan withdrawal.

The participant may withdraw (purchase or expend) as little or as much as needed at any time, up to the approved amount of the loan account. The amount of unused funds in the participant's account continues to remain invested, earning tax-deferred dividends and interest.

This is a significant departure from the lump-sum withdrawal required under traditional loan programs. Automated systems allow participants to borrow the exact amount of funds needed, eliminating the leakage caused by overestimation in the traditional loan environment.

Unlike traditional loan programs, automated loan programs don't depend on payroll deduction as the only method of repayment. These programs can allow participants to continue paying their loan balance long after termination of employment, without any deemed distribution tax implications and penalties. Thus, the participant can avoid paying taxes and penalties if he or she loses employment or takes on a new position.

In addition, automated programs allow for accelerated payment of loans, enabling the participant to repay the loan faster. With traditional loans, a predetermined minimum amount is withdrawn from the participant's paycheck. There is no ability for the participant to make additional principal payments each month or to make one-time payments. The only options are for the participant to pay the loan back over the term of the loan or pay off the entire balance of the loan. Automated programs have flexible repayment options. A participant can make payments of his or her loan at any time in any amount.

THE SEAL ACT

Recently, Senators Kohl (D-WI) and Enzi (R-WY) introduced pension legislation called the Savings Enhancement by Alleviating Leakage in 401(k) Savings Act of 2011 (SEAL Act). The SEAL Act contains several provisions designed to reduce leakage from retirement plans. Particularly, the Act would extend the rollover period for plan loans, allowing employees to contribute the amount outstanding on their loans to an IRA by the time they file their taxes for that year.

As discussed above, most plan loan provisions require a traditional plan loan borrower to repay the entire loan balance upon termination of employment. This provision recognizes the difficulty of repaying a plan loan when income suddenly ceases and it lessens that burden on the participant.

Another provision in the SEAL Act would allow 401(k) participants to continue to make elective contributions during the six months following a hardship withdrawal. Currently, after an employee receives a hardship withdrawal from a 401(k) plan, she or he is prohibited from making elective contributions to the retirement account for at least six months. The loss of both employee contributions and the employer's matching contributions during this period can exacerbate the long-term negative effects on retirement savings. The SEAL Act allows participants to continue to make contributions during the six months following a hardship withdrawal.

Despite the several beneficial provisions of the SEAL Act, by banning the use of "credit cards and other similar arrangements" as a mechanism to allow participants to access borrowed funds, the Act is counterproductive to the interests of participants. In the news release accompanying the SEAL Act, Senator Enzi contends that 401(k) loan debit cards "actively encourage participants to tap into their savings before retirement." We discuss this more fully below.

RESTRICTING PLAN LOAN AUTOMATION MECHANISMS WILL INCREASE LEAKAGE, NOT LESSEN IT

While automated loan systems have been criticized as encouraging participants to take larger loans, data suggests that the average loan balance for a participant in an automated loan program is approximately 30 percent less than a participant's average balance in a traditional loan program.

Automated systems allow the participant to leave more assets in the plan to continue earning investment returns. When a participant is placed in the difficult financial situation of having to borrow from retirement savings, it makes sense for the law to allow that participant to use a debit card to borrow the exact amount of funds needed. The SEAL Act's ban of debit card programs would foreclose the use of this helpful technology.

Participants who terminate employment and can't afford to pay off their outstanding balances on their traditional-form loans when due, which usually is within 60 to 90 days after termination, are subject to a taxable distribution. Automated loan programs don't impose these onerous repayment requirements. As a result, participants who have taken an automated loan are less likely to have their retirement savings reduced by a taxable distribution when their employment terminates. Therefore, automated programs, which allow participants to continue paying down loans after they leave employment or lose their jobs, alleviate this type of leakage from retirement plans. This feature is especially important given today's increasingly mobile workforce.

Moreover, according to the article, "Plan leakage can be less of an issue than participation," by Vanguard on June 1, 2011, approximately one-third of eligible employees weren't participating in their company's retirement plan. This represents between $100 million and $200 million annually not being contributed. Automated loan programs would address this issue.

Use of the debit card isn't just a convenient feature, it also helps to minimize leakage from retirement plans. This feature is increasingly expected by consumers given the prevalent use of electronic banking today. If the feature isn't offered by automated programs and customers are only able to access retirement loan proceeds via check or ACH methods, customers will wind up making purchases using their proceeds by use of an alternative debit card associated with their checking account.

Some commentators have criticized automated loan programs because they don't restrict the kinds of purchases participants can make with 401(k) debit cards. Restrictions could be placed, but ERISA doesn't impose limits on how the proceeds of a participant loan may be used.

The Department of Labor (DOL) has specifically recognized that its regulations governing loan programs don't impose any restrictions on the use of the money borrowed by participants. Had the DOL chosen to regulate how loan proceeds are used, difficult choices would have to be made. Would the DOL permit loans for education expenses, but not medical expenses? Perhaps the DOL would permit loans for educational or medical but not transportation or residential expenses.

The bottom line is that the DOL, to date, has not dictated how participants use loan proceeds. Thus, participants with traditional or automated loans can use loan proceeds for any purpose, whether it's for a medical emergency, for education, or to meet some other financial requirements.

AUTOMATED LOAN PROGRAMS APPLY MODERN TECHNOLOGY

ERISA (29 CFR § 2550.408b-1) specifically authorizes plans to adopt a participant loan program. Loans are generally considered an attractive, if not necessary, feature of defined contribution plans. According to a 2010 Aon Hewitt study, 95 percent of defined contribution plans offer a loan feature.

Debit cards are the most convenient and efficient mechanism on the market to aid a participant and loan provider in carrying out this type of legally permissible transaction. Nothing in ERISA prohibits a plan from adopting an automated loan processing system including debit cards, so long as the program complies with ERISA's participant loan requirements as well as the statutory prohibited transaction exemption for participant loans. In fact, the DOL issued advisory opinion 95-17A in 1995 addressing a 401(k) debit card loan program and didn't raise any concerns that the program violated ERISA.

In the 401(k) defined contribution plan arena, the plan loan option is a well-established and prevalent feature. Debit cards are a sensible and advantageous method in which to effect automated participant loans. While certain provisions of the SEAL Act make sense and while the overall objective of the legislation is noble, the proposed ban on debit cards misses the mark.

The ban on the use of this kind of technology is being proposed for no other apparent reason than that it works effectively. Loans are an important incentive to greater participant participation in 401(k) plans. Congress should not restrict the use of today's technology and punish participants for undertaking an otherwise permissible activity that enables participants to access funds in the exact amount needed, which keeps more assets in their retirement plans. PC

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