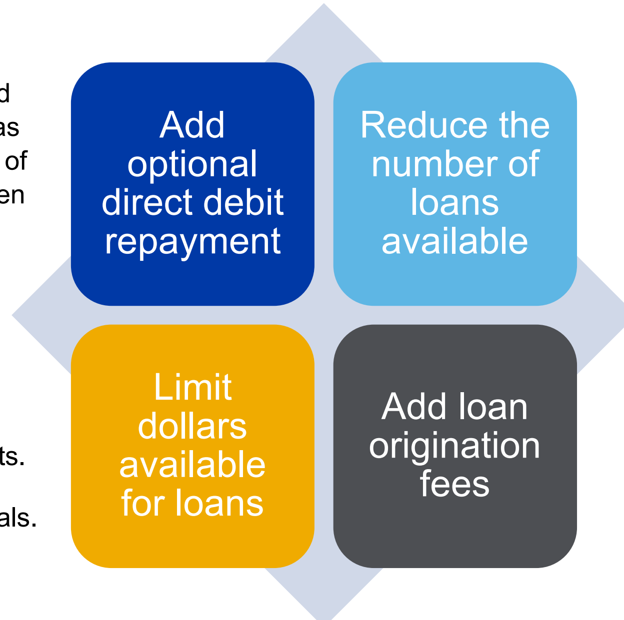
Minimizing Defined Contribution Plan Loan Leakage

October 2013

Retirement Research

Introduction

Recent studies have illuminated the problem of defined contribution plan leakage and the negative impact it has on retirement income savings[1]. One prominent source of plan leakage is loan defaults which primarily occur when a plan participant with an outstanding loan terminates employment. This paper outlines four actions plan sponsors can implement to decrease DC plan loan leakage:



1. Add a direct debit repayment option.
2. Reduce the number of loans available to participants.
3. Limit available loan dollars to only employee deferrals.
4. Add loan origination fees.

The main objective of this paper is to show that when employers take these actions, there is less money in outstanding loans and fewer defaults. Consider the following:

- Employers who have a loan direct debit repayment option have 22% fewer defaults
- Plan sponsors who allow only one outstanding loan have an average loan balance that is $1,600 less than the average loan balance among sponsors who have two loans available to participants
- The average loan balance at companies that disallow loans on the employer-provided money is $370 less than the average balance at companies that permit loans on the company-provided funds
- The average outstanding balance of loans that charged a loan origination of $50 or less is over $4,600 more than the average outstanding balance of loans that charged $100 or more

Loan Prevalence at a Glance

According to Aon Hewitt's *2013 Trends & Experience in Defined Contribution Plans* survey, nearly all plans (95%) allow participants to take at least one loan against their savings. Many plan sponsors feel that there are some desirable features of loans including that participants are essentially repaying their debt through payroll deductions and often at competitive interest rates. The Ariel/Aon Hewitt 2012 *401(k) Plans in Living Color* study found that having a loan feature had a strong influence on an individual's decision to participate in the plan[2]. In 2013, approximately one-quarter (23%) of all defined contribution

[1] See, for example, the Aon Hewitt report *Leakage of Participants' DC Assets: How Loans, Withdrawals, and Cashouts Are Eroding Retirement Income* or Defined Contribution Institutional Investment Association's report *Plug the Drain: 401(k) Leakage and the Impact on Retirement.*

[2] 34% of African-Americans and 29% of Hispanics, compared to 17% of Asian-Americans and 13% of whites, say that the ability to take a loan from their plans if they need the money is a "strong influence" in their decision to invest in a defined contribution plan. Source: 2012 Ariel/Aon Hewitt Study: *401(k) Plans in Living Color—A Study of 401(k) Savings Disparities Across Racial and Ethnic Groups.*

plan participants had an outstanding loan.[3] The average outstanding loan amount was just over $8,000 and represents approximately one-fifth of the individual's balance.[4]

Loan Provisions

There is no standard to how plan sponsors structure their loan provisions and there is wide legislative leeway in terms of the number of loans available, the required repayment period, and the interest rates charged to participants during the payoff period.

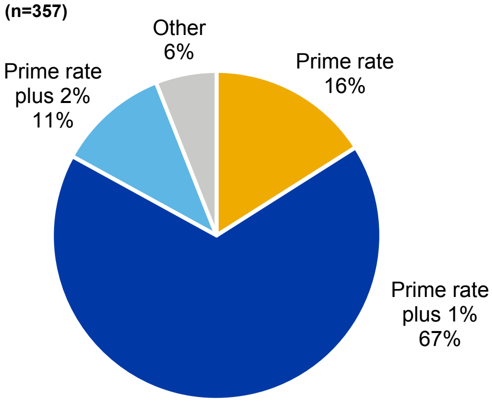
Plan sponsors are fairly evenly divided in their approach to the number of loans available at any one time. Forty-five percent of plans permit only one loan to be outstanding and an equal number allow two loans, with 32% allowing two loans of any type and 13% allowing one primary residence loan and one general purpose loan. The balance of plan sponsors surveyed allows more than two loans.

Number of Loans Permitted per Participant at One Time

	2013
Only one	45%
Two—any type	32%
Two—one general purpose loan and one primary residence loan	13%
Three—any type	3%
Three—one primary residence loan and up to two general purpose loans	2%
Four or more	1%
Other	4%
n=	*370*

Virtually all plans with loan provisions (99%) allow participants the ability to take a loan for any purpose. Additionally, 81% of plans offer loans to purchase a primary residence. The primary difference between these two loan types is the repayment period: For general purpose loans, the median repayment period is five years and for primary residence loans, the median is 15 years.

Loan Interest Rate
(n=357)



The majority of plans charge participants a relatively modest interest rate. Two-thirds of all plans with loan availability charge the prime rate plus 1%, 16% charge prime only, and 11% use prime plus 2%.

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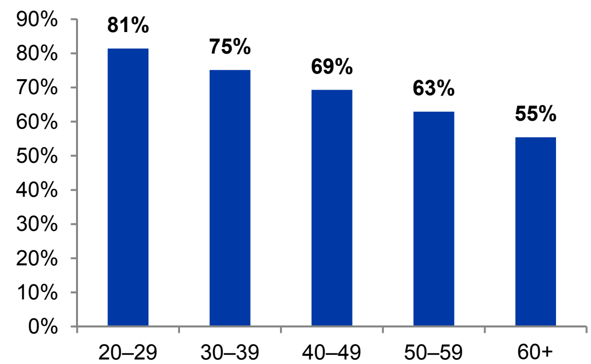
[3] Aon Hewitt's *2013 Universe Benchmarks.*
[4] Ibid.

Loan Defaults

If an individual takes a loan and repays it in full, there is generally little overall impact on the total projected retirement savings. Depending on the market conditions during the repayment period, the person will miss out on the difference between the loan's interest rate and the rate the money would have earned had it been invested. However, overall, this has a small impact on the total defined contribution balance. A different story emerges when the individual defaults on the loan which often results in permanent erosion of retirement funds.

It is rare to have actively employed individuals default on their loans: however, it is quite common to see terminated employees default. Our data shows that only 3% of actively employed loan recipients default, but close to seven out of 10 participants (69%) with an outstanding loan balance defaulted on the loan when they terminated employment.

Loan Default Rates in 2012 (Among Terminated Workers)—By Age



The reasons for this are clear: Often, an individual's termination triggers an acceleration of the loan repayment, usually to 60 days. Given that most plans do not allow ongoing loan payments outside of payroll deferrals, an immediate payoff becomes a burden, and therefore many participants subsequently default on the loan. This ultimately causes the outstanding loan balance to be treated as a taxable distribution and may incur tax penalties if the individual is under age 59½.

Plans With Direct Debit Options Have Fewer Loan Defaults

Some plan sponsors have decided to curb such high loan default rates by providing participants with the option to make loan repayments from a personal bank account. This so-called "direct debit repayment option" allows for the continuation of loan payments when payroll deductions are no longer available. While manual repayments may be another option, most individuals are familiar with automated bill pay banking services and welcome the ability to have their payments on an automated schedule to avoid a potential late payment.

We reviewed five plans that provide a direct debit method for loan repayment and found that their loan default rates were notably less than those of plans without this provision. The combined average default rate for these plans was 47%—sizably less than the 69% overall average.

Plan	Loan Default Rate Upon Termination	Difference From Aon Hewitt Universe
Aon Hewitt Universe	69%	—
Plan 1	53%	(16%)
Plan 2	54%	(15%)
Plan 3	31%	(38%)
Plan 4	37%	(32%)
Plan 5	61%	(8%)

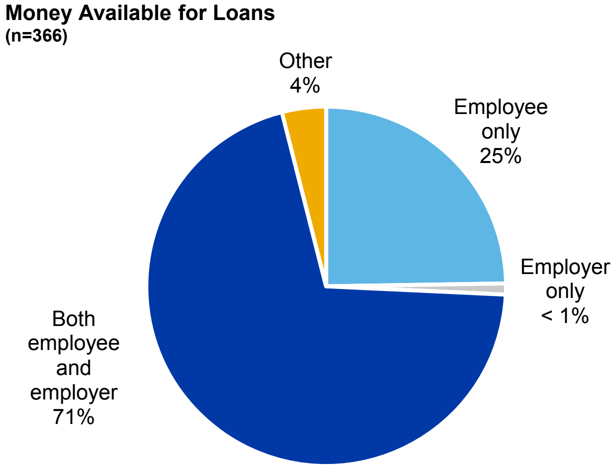
One employer surveyed recently implemented the loan direct debit repayment option. Their data can be a case study for how this option can decrease the number of loan defaults. In the past year, there were a total of 504 individuals who had an outstanding loan at the time of termination and were eligible for the direct debit option. Of these 504, 54 individuals (11% of the eligible group) enrolled in the program, and only nine of them (16%) defaulted on the loan.

Plans With Fewer Loans Available Have Smaller Outstanding Loan Balances

In many ways, it should come as no surprise that as the number of loans available from the plan increases, so too does the average outstanding loan balance. What may be surprising, however, is the effect that the number of loans available has on the average number of outstanding loans by participants. When plan sponsors offer at least two general purpose loans, the majority of individuals with loans have at least two outstanding loans. Said differently, if a plan sponsor provides the option for multiple loans in the plan, participants are apt to take them. Consequently, the average outstanding balance is higher for plans that allow multiple outstanding loans at any one time.

Number of Outstanding Loans	Average Outstanding Loan Principal
1	$7,994
2	$9,627
3	$11,381
4	$11,912
5	$13,590

Plans Limiting Loans to Only Employee Deferrals Have Smaller Outstanding Loan Balances

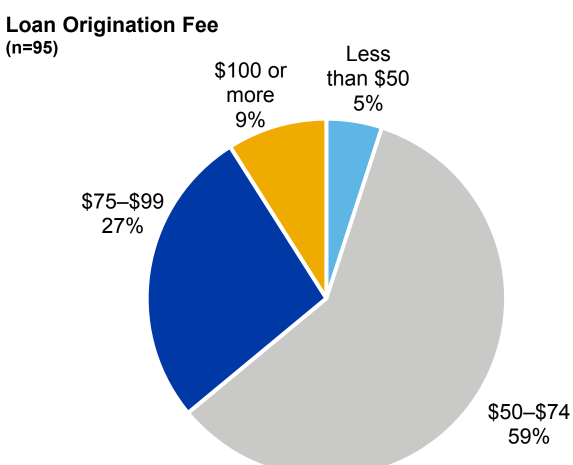


Nearly three-quarters of all plans (71%) allow individuals to take a loan on their defined contribution balance whether the money was derived from employee deferrals or employer contributions. However, among the 25% of employers who disallow loans on the employer portion of the account and instead restrict the loan to only the money that is attributable to employee contributions, the average outstanding loan balance is over $370 less than employers with the wider permissions. In addition, we find that there are fewer individuals with outstanding loans if the money is restricted to only employee contributions.

Money Types Available for Loans	Percentage of Participants With an Outstanding Loan	Average Outstanding Loan Principal
Only employee contributions	26%	$8,797
Both employee and employer contributions	29%	$9,168

Plans With Higher Loan Origination Fees Have Smaller Outstanding Balances

More than three-quarters (77%) of plan sponsors charge participants a fee to originate a loan. The most common service charge is $50 followed by $75 but, some sponsors charge participants more than $100. Our data shows that the higher the service fee, the lower the average outstanding balance.



Service Fee	Percentage of Participants With an Outstanding Loan	Average Outstanding Loan Principal
Less than $50	28%	$10,467
$50–$74	30%	$9,479
$75–$99	28%	$8,838
$100 or more	20%	$5,857

Recommendations for Plan Sponsors Wishing to Reduce Loan Leakage

To address the growing problem of defined contribution plan leakage, some plan sponsors have taken steps to help curb the number of outstanding loans allowed under their plans. Others have turned their attention to mitigating the number of individuals who default upon termination. As the data here shows, the actions plan sponsors are taking—such as adding direct debit repayment, reducing the number of loans available, limiting the dollars available for loans, and adding or increasing loan origination fees—can dramatically reduce the drip of defined contribution plan loan leakage.

Plan sponsors considering any one of the approaches presented in this document should proceed thoughtfully and take the following steps:

- Work with the plan recordkeeper to determine the viability of the concept and implementation timing
- Amend the plan document as necessary, keeping an eye on how current participants may be transitioned to the new provisions
- Collaborate with the trustee for feasibility and cost of the direct debit or manual repayment approach
- Determine the best manner in which to communicate the new provision(s) to plan participants

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