The $2.5T Retirement Readiness Problem No One Is Talking About: Until Now

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The Coming Decade

It’ll be different from the past . . . pay attention
Agenda

• The loan default landscape
• A growing fiduciary reality
• The remedies: What’s working and what’s not
• Your questions
The Loan Default Landscape
401(k) Loans Serve a Valuable Purpose

- Employers place a high priority on the retirement readiness of their workforce
- DC plans are the go-to solution
- Loans are a common feature, providing access to liquidity and attracting greater retirement plan participation

90% of plans offer loans
20% of participants have a loan outstanding

Average borrower is 42. Median loan is $4,600. Average loan is $7,800.
Source: Borrowing from the Future: 401(k) Plan Loans and Loan Defaults, Wharton/Vanguard Study, 2014
Loan Default Statistics are Troubling

Loan defaults are a major source of retirement plan leakage

- 10% of borrowers default annually
- 86% of 401(k) loans default when employees leave their jobs

Average borrower is 42. Median loan is $4,600. Average loan is $7,800.
Source: Borrowing from the Future: 401(k) Plan Loans and Loan Defaults, Wharton/Vanguard Study, 2014
Deloitte: America Has a $2.5T Loan Default Problem

$7.3B estimated loan defaults in 2018

$2.5T will drain out of 401(k) accounts in the next decade at current rates

Source: "Loan leakage: How can we keep loan defaults from draining $2 trillion from America’s 401(k) accounts?", Deloitte, October, 2018.
The Hidden Cost of Loan Defaults

Defaults People See
Only 8% of loan defaults are reported

True Cost of Defaults
The Unseen Threat to Retirement Readiness

- Loan Offsets
- Taxes
- Penalties
- Cash outs
- Lost earnings
A Growing Fiduciary Reality
More Than a Business Decision, a Fiduciary Obligation

A participant loan program isn’t just a means of advancing a participant his or her own money.

**Offering a loan program**
A “settlor” (business) function

**Managing a loan program**
“Fiduciary” function—the sponsor must act in the best interest of the participants
# Myths and Realities of Loan Administration

<table>
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<tr>
<th>Myth</th>
<th>Reality</th>
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<td>“Participants are borrowing from themselves. It’s not our problem.”</td>
<td>Extending, monitoring and approving loans are fiduciary acts. Loans are a plan investment.</td>
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<td>“Our risk is low.”</td>
<td>Increased risk given IRS changes, corporate reductions in force and plaintiffs’ lawyers seeking class-action suits.</td>
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<td>“We disclose loan terms and risks—isn’t that enough?”</td>
<td>Fiduciaries need to take prudent action to preserve retirement benefits; disclosure isn’t sufficient . . . or working.</td>
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Fiduciary Realities of 401(k) Loans

The plan sponsor as fiduciary needs to make sure that participant benefits—including loans—are protected.

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<th>Reality</th>
<th>Legal Guidance</th>
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<td>A loan program can only be offered where it will not diminish the retirement benefit of the participant.</td>
<td>DOL Advisory Opinion 95-17A</td>
<td>ERISA 29 CFR 2550.408b-1(a)(3)</td>
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<td>Loans are a plan investment under ERISA. Approving and monitoring are fiduciary functions.</td>
<td>ERISA 29 CFR 2550.408b-(d)(vii)</td>
<td>Form 5500 Schedule H</td>
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<td>Plan sponsors must take steps to preserve assets in the event of such (loan) default.</td>
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10B-12
Assumes a 42-year old borrower defaults on a 401(k) loan. Taxes and penalties will apply.

Source: "Loan leakage: How can we keep loan defaults from draining $2 trillion from America's 401(k) accounts?", Deloitte, October, 2018.
Loan Default Reporting Has Been Opaque

Form 5500 Section H Financial Information

Defaults by terminated participants are reported as benefit payments (92% of defaults)

Only defaults by active participants are reported on Form 5500 as “deemed” (8% of defaults)
New Reporting Lifts the Veil

IRS Issues 2018 Form 1099-R for Plan Distributions

IRS Form 1099-R (Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.) with new code.

New Distribution Code “M”

New code M—used to report a qualified plan loan offset when a participant’s account balance is reduced to repay a plan loan upon severance from employment or termination of the plan.
Loan Defaults May Increase Risk

- **Audit risk with IRS or DOL**
  - Regulators could use 1099-R reporting change to target audits

- **Possible litigation targeting plan fiduciaries**
  - Historically, disclosure hasn’t been a sufficient defense against lawsuits (e.g., excessive fees)
Plan Design Measures

- Eliminate Loans
- Raise loan fees
- Allow payments after termination
- Offer financial education
- Help with emergency savings
Solution: 401(k) Loan Insurance

- Automated 401(k) loan insurance prevents defaults
- Repays outstanding loan balance upon job loss, preventing taxes and penalties
- Maintains account balance, allowing retirement savings to grow and preserve retirement
- Peace of mind and retirement safety net for financially-vulnerable employees
- Reduced risk for plan sponsors
How 401(k) Loan Insurance Works

1. Employee takes a loan. Automatically protected by 401(k) loan insurance.

2. Loan payments with loan protection begin.

3. Employee separated and misses payment due to job loss.

4. Loan is repaid. Loan default and cash out are prevented.
What Steps Can Employers Take?

- Review the loan default issue with plan counsel and advisors, taking advantage of free tools & resources.
- Consider the potential for corporate actions or reductions in force.
- Review your loan policy and ERISA.
- Consider your use of automated services, and how the addition of loan insurance can measurably prevent loan default leakage.
Questions?

Thank you!