The Hidden Problem of Defined Contribution Loan Defaults

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Abstract

Plan sponsors of defined contribution ("DC") plans are required to report to the Internal Revenue Service and the Department of Labor the status of the plan at year end on Form 5500. The data collected through this reporting requirement includes many important facts related to the plan, but overlooks one very important piece of information – participant loan defaults offset against the participant's account. Because this information is not collected separately, plan fiduciaries and policy makers are unaware of a massive and growing problem of participant loan defaults. Each year billions of Americans' retirement savings dollars leak from DC plans due to involuntary loan defaults, placing millions of American workers at an increased risk of insufficient retirement savings. It is estimated that in 2009 alone, $10 billion of defined contribution plan assets leaked from plans as a direct result of involuntary defaults on participant loans. Worse yet, current industry data suggests a much larger problem and trend.

Participant Loans Against DC Plans

Individuals are gaining ever-increasing responsibility and control over their retirement savings as employers have moved away from Defined Benefit ("DB") Plans to Defined Contribution ("DC") Plans as the primary tool to assist employees in saving for retirement. A common feature of most DC plans is the ability of participants to borrow against their account. Industry data indicate that approximately 87% of plans[1] now allow participant borrowing, and 95% of active DC participants[2] have access to plan loans. A positive outcome of allowing plan loans is increased participation in plans by employees and higher contribution rates of participants.[3] At the same time, borrowing has become a significant feature within plans because it provides participants a source of liquidity in times of emergency and is preferred to an early withdrawal. In fact, almost a third of all participants with access to borrowing have a loan outstanding.[4] According to a recent Ariel study the primary reasons given for borrowing were "to deal with an emergency, to pay off debt, or to simply use for day-to-day expenses."[5] Borrowing from plans occurs at a higher rate among minorities; 49% of African-Americans and 40% of Hispanics with access to plan borrowing have loans outstanding.[6]

While access to loans is helpful for participants, the potential for involuntary defaults puts retirement savings at risk of loss.[7] It is common practice for plans to require the full amount of the loan and accrued interest to be paid off within 60 days of cessation of repayment. If not

[1] Plan Sponsor Council of America, PSCA's 54th Annual Survey of Profit Sharing and 401(k) Plans, 2011
[2] Aon Hewitt, 2010 Employer Perspectives on Defined Contribution Plan Leakage Survey
[3] 401(k) Pension Plans: Loan Provisions Enhance Participation but May Affect Income Security For Some", U.S. General Accounting Office, October 1997
[4] Aon Hewitt, Leakage of Participants' DC Assets: How Loans, Withdrawals, and Cashouts Are Eroding Retirement Income 2011
[5] "401(k) Plans in Living Color: A Study of 401(k) Savings Disparities Across Racial and Ethnic Groups", Ariel/Aon Hewitt 2012
[6] *ibid*
[7] Involuntary defaults are those defaults resulting from exogenous factors placing the participant in a position where they are unable to repay the loan (e.g. death, permanent disability or job loss)

repaid within this period, the full amount is considered in default and treated as a taxable distribution from the plan. Such a default results in leakage of retirement savings in the form of the defaulted loan as well as the tax liability and penalties.

Actual Versus Deemed Distributions

Under Internal Revenue Code Section 72(p) a disbursement to a participant in the form of a loan is a taxable distribution unless it meets specific criteria of Section 72(p). A violation of these criteria can occur at the time the loan is made (e.g. the structure of the loan itself doesn't meet the criteria, such as not having level payments) or at any time thereafter until the loan is repaid (e.g. failing to make payments on the loan according to the repayment schedule). A violation of the criteria will result in a default which will be classified as either a deemed distribution or an actual distribution (loan offset), both of which are taxable to the participant. The determining factor in how the default is classified is whether the participant is eligible for a distribution according to the plan documents. As described in the ASPPA study materials for the *Qualified 401(k) Administrator* program:

> "If these rules are violated, the loan will be taxable to the participants. If this occurs when the participant is eligible to take a distribution, a **loan offset** will occur – that is, the loan proceeds will be considered to be a real distribution and will be removed permanently from the participant's account. On the other hand, if the loan becomes taxable at a time when the participant is not permitted to take a distribution, the effect is a **deemed distribution**. A deemed distribution is a

taxable event – that is, the taxation of loan proceeds to the participant – but not a real distribution."[8]

The distinction between an actual distribution (loan offset) and a deemed distribution is significant because of the manner each is reported by plan sponsors on Form 5500 and because deemed distributions comprise only a fraction of all loan defaults.

Reporting of Participant Loan Default

The Department of Labor, Internal Revenue Service, and the Pension Benefit Guaranty Corporation jointly developed the Form 5500 Series so employee benefit plans could utilize the forms to satisfy annual reporting requirements under Title I and Title IV of ERISA and under the Internal Revenue Code. While this reporting is extremely helpful in gaining a broad understanding of the status of the defined contribution plans in the aggregate, it contains one failing which masks a multi-billion dollar problem affecting millions of American workers. Under the current Form 5500 reporting structures, "if a loan offset occurs (i.e. the unpaid loan is reported as an actual distribution) when it goes into default…the loan offset is reported as an actual distribution from the trust"[9] along with other distributions unrelated to participant loans.

For instance, if a participant ceases to make payments on the loan and is eligible for a distribution (e.g. due to employment separation, death or permanent disability) the plan will offset the loan against the participant account balance. From an IRS perspective, this is an ***actual distribution*** from the plan and will be reported on Form 5500 Schedule H or I line 2(e)(1)[10] "benefit payment and payments to provide benefits: directly to participants or

[8] Ferenczy, Ilene H. (2011) "The ASPPA Defined Contribution Plan Series Volume 2: 401(k) Plans and Intermediate Administrative Topics", 4th Edition.
[9] *ibid*
[10] For small plans the proper line is Schedule I line 2(e) "Benefit Paid (including direct rollovers)"

beneficiaries, including direct rollovers" -- the same as any other distribution. Because these actual defaults (loan offsets) are bundled with all other distributions on the reporting form, there is no way to determine the amount of actual defaults from Form 5500 reporting.

Additionally, the "Certain Deemed Distribution" category on Form 5500 creates further confusion surrounding loan defaults. Form 5500 Schedule H or I line 2(g) titled "Certain deemed distributions of participant loans" is the line commonly, and incorrectly, referred to as the total amount of "defaulted participant loans." The purpose of this line is not to capture the amount of loans which actually default but to capture the amount of loans which meet a specific set of criteria and need to be classified as "deemed distributed" because they cannot yet be treated as an actual distribution.

For instance, if a participant ceases to make loan payments according to the loan agreement and is *ineligible* for a distribution from the plan according to the plan documents then the plan is unable to offset the loan against the participant's account. This situation arises when the participant defaults while still employed by the plan sponsor, but either the plan documents do not allow for this participant to receive an "in-service" distribution or the loan is secured by plan assets that do not allow for "in-service" distribution,[11] thus creating a situation where the loan is in default but cannot be treated as an actual distribution under the IRC. Instead, the plan must report the defaulted loan amount and accrued interest as a ***"deemed distribution"*** from the plan and rather than being offset by the account balance is held in suspension until the loan default is cured or the participant is eligible for a distribution. This "deemed distribution" is reported on Schedule H or Schedule I, line 2(g) "Certain deemed distributions of participant loans."

[11] "Reporting Defaulted Loans" Sunguard Relius, www.relius.net/news/technicalupdates.aspx?id=262

Further confusing proper understanding of loan defaults is Form 5500 Schedule H or Schedule I line 4(b) which reads as follows:

> "Were any of the loans by the plan or fixed income obligations due the plan in default as of the close of the plan year or classified during the year as uncollectible? Disregard participant loans secured by participant's account balance."

The phrasing of this question and accompanying instructions specifically excludes participant loans under an individual account plan with investment experience segregated for each account and secured by the account balance, which is the typical arrangement with virtually all plan loans in DC plans. Therefore, all participant loans are excluded from line 4(b), and thus defaults on these participant loans are not identified by this question. An unintended consequence for individuals unfamiliar with the specifics of question 4(b) is the assumption that if the answer is "No," then ZERO participant loans were in default during the year, which is grossly incorrect. Each and every participant loan could theoretically be in default at the close of the plan year and the answer would remain "No" as they would be excluded according to the form instructions.

Because Form 5500 does not specifically capture actual loan defaults as an individual line item but rather includes actual defaults (loan offsets) in the total amount of distributions, there is no way to ascertain from Form 5500 data the total amount of defaults each year. This reporting structure unfortunately masks the severity of participant loan defaults.

Magnitude of the Problem

As previously stated, Form 5500 does not directly provide the amount of participant loan defaults and actually misleads the industry and policy makers into utilizing the wrong data in understanding and reporting the total amount of loan defaults. Since loan offsets (actual defaults) from each plan are not reported separately from other distributions, the only way to determine the amount of retirement savings lost due to involuntary defaults is to apply reasonable analytic methods to conservatively estimate the size of the problem. In order to do this one must rely on empirical studies and statistical analysis to apply default rates to the total amount of participant loans outstanding. By applying this scientific method, it is estimated that in 2009 alone nearly $10 billion of retirement assets were leaked from defined contribution retirement accounts -- and the problem is growing.

Defaults on participant loans can be dissected into two categories: voluntary defaults and involuntary defaults. ***Voluntary defaults*** result when a participant with the means and access to repay the loan according to the loan terms decides by his own volition to cease repayment. An example of such a default is an employee of the plan sponsor who ceases loan repayments even though there has been no change in job status. ***Involuntary defaults*** result when a participant who borrowed either no longer has the means to repay the loan or no longer has access to repay the loan. Involuntary defaults can be further classified into the following subcategories:

- Death of the participant;
- Total and permanent disability of the participant;
- Involuntary job separation of the participant.

The commonality among the three Involuntary categories is that an event occurred which prevented the participant's ability to continue to make loan repayments. In the last two

(disability and unemployment), the plan documents may allow for the participant to continue to repay the loan but the participant does not likely have sufficient capital to make payments as they are no longer gainfully employed and lack enough liquidity to repay the loan.

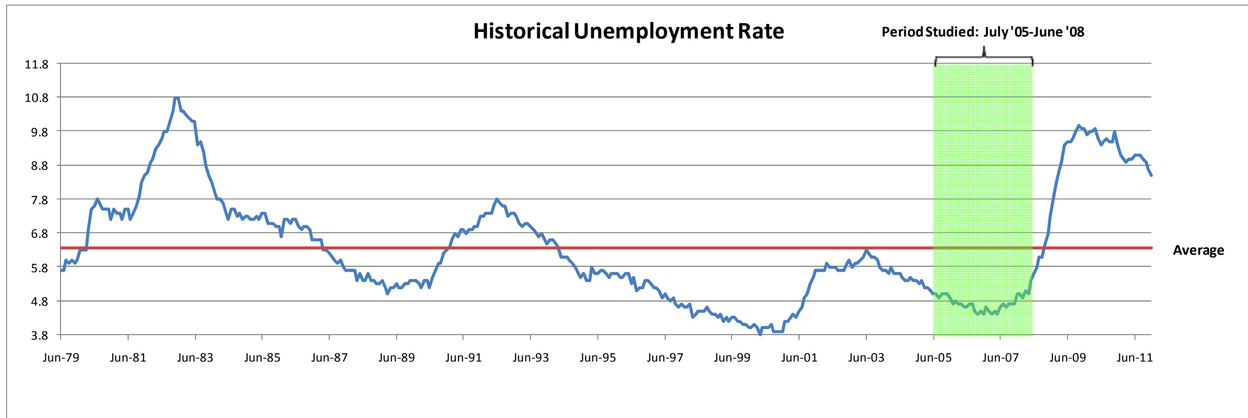
As previously discussed, plans generally require the full repayment of the outstanding loan balance upon cessation of repayment, and if not paid within 60 days the loan goes into default and is offset against the participant's account balance. The amount becomes a taxable distribution to the participant or beneficiary.[12] In the case of job separation, the participant also incurs a 10% penalty if not eligible for a distribution. Typically, as reported in several studies, the participant has only the remaining assets in the account as a means to pay the taxes and penalty and must take further distributions from his retirement savings to satisfy payment. This is a significant further erosion of future retirement security.

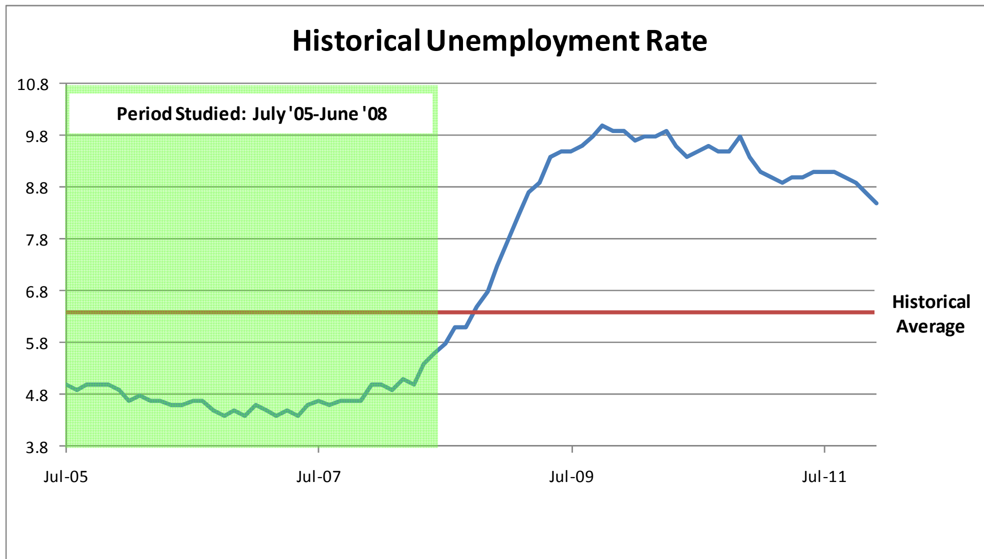
Loan Default Due to Job Loss

According to a study conducted by the Financial Literacy Center, ***almost 10% of all 401(k) participants with loans will default on their loans***.[13] The authors filtered a substantial dataset from Vanguard, one of the leading defined contribution plan record keepers, spanning a three-year period from July 2005 – June 2008 utilizing1.5 million 401(k) participants to analyze 100,000 plan participants who terminated employment. The authors determined that during this three-year period, an average of 11.9% of participants with a loan outstanding terminated employment; approximately 80% of those terminating employment with a loan defaulted on their loan at termination. Therefore 9.6% (80% of 11.9%) of all participants with a loan outstanding defaulted on their loan due to job termination.

[12] The tax liability could be avoided if the loan balance is rolled over to a new employer's plan but this option is not commonly offered by plans absent special circumstances.
[13] "An Empirical Analysis of 401(k) Loan Defaults", Timothy Lu, Olivia S. Mitchell, Stephen P. Utkus, October 2010

It is important to point out that the dataset spanned a period of one of the lowest unemployment rates since 1980.[14] Extrapolating the results to today's troubled environment would produce a significantly higher rate of default as the rate of unemployment is considerably higher; therefore one could reasonably expect the rate of default of terminated employees to likewise increase due to exacerbated liquidity constraints.





Source: U.S. Bureau of Labor Statistics

[14] The study covered July 2005 through June 2008 which had an average unemployment rate of 4.8% according to data from the U.S. Bureau of Labor Statistics.

Loan Default Due to Death & Disability

According to an actuarial analysis produced by CreditRe, the industry leader in actuarial consulting and risk transfer solutions for all debt-related protection products, 1.2% of participants with loans die or become permanently disabled. This analysis utilized demographics of 401(k) plan participants reported by the Investment Company Institute in 2008.[15] The actuary then used that demographic data to determine the appropriate death and disability rates representative of plan participants with loans outstanding based on age, gender and occupation class.[16]

While there is no data available as to the actual default rate of individuals who die or become permanently disabled while having a loan outstanding, it is reasonable to assume that most if not all of these default on the loan. According to the Bureau of Labor Statistics only 59% of private sector employees have access to life insurance benefits and only 37% have access to long-term disability insurance through their employers. While some employees have access to coverage it is highly unlikely that the beneficiaries or participants have the presence of mind after such a life-changing event to apply group life or disability insurance proceeds to prevent a default. In the case of disability it is even more unlikely that the participant is deemed permanently disabled and issued their benefit within a 60-day period after the most recent payment in order to prevent a default.

[15] The demographics used for the actuarial analysis were from the Investment Company Institute "Research Perspective Vol. 15, No. 2: 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2008", October 2009.

[16] Incident of death was derived on the 1990-95 Ultimate Mortality Table representing the age, gender and occupation class distributions reported by the ICI 2008 401(k) Plan Statistics. Incident of permanent disability was derived from the 1985 Commissioners Individual Disability Table A (1985 CIDA) based on the same ICI plan statistics.

However, for purposes of being conservative, it is estimated that 20% of individuals with access to coverage apply insurance proceeds to prevent default on the loan.[17] This would imply that 1.1% of participants with DC loans will default due to death or permanent disability.[18]

Amount of Participant Loans

Again, it is impossible to discern from Form 5500 data the aggregate amount of participant loans which default in any given year. However, by applying loan default rates to the amount of outstanding participant loans, one can estimate the amount of defaulted loans. One additional problem with Form 5500 data arises at this point. The amount of "Participant Loans" as reported on Form 5500 Schedule H or I line 1c(8)(b) is actually the gross amount of participant loans at the end of the reporting period *less* all deemed distributions and offsets (actual defaults) during the year (herein defined as "Net Participant Loans").[19] As a result, one must divide the Net Participant Loans amount (line 1c(8)(b)) by one minus the default rates to arrive at the Gross Participant Loans amount and then deduct the Net Participant Loans amount to determine the amount of defaulted loans which were "offset" against the participant's account (actual distribution).

[17] Based on the 80% loan default rate for individuals who lose their jobs from "An Empirical Analysis of 401(k) Loan Defaults", Timothy Lu, Olivia S. Mitchell, Stephen P. Utkus, October 2010 as the only source of rates of defaults.

[18] Calculated as [0.36% frequency of death * ((59% of employees with access to life insurance * 80% will not apply insurance proceeds) + 41% of employees who have no access to life insurance)] + [0.84% frequency of permanent disability * ((37% of employees who have access to disability insurance * 80% will not apply insurance proceeds) + 63% of employees who have no access to permanent disability coverage)] = 1.10% rate of default due to death and disability.

[19] Per Form 5500 Instructions a participant loan which has been deemed distributed during the plan year is not included on the Participant Loans line 1(c)(8) if (1) under the plan, the participant loan is treated as a directed investment solely of the participant's individual account and (2) as of the plan year, the participant is not continuing repayment under the loan. Loan offsets are actual distributions and deducted from year-end participant loans balance. Per The ASPPA Defined Contribution Plan Series Volume 2: 401k Plans and Intermediate Administrative Topics, p 10-49 "In the year of the offset, the loan is reported as an actual distribution from the trust and is not included in the end-of-year asset column on the Schedule H or Schedule I submitted with Form 5500 filed for that year."

The most recently published Form 5500 data is for the end of year 2009. According to the Form 5500 Abstract for 2009, Defined Contribution plans reported $51,733,000,000 of Participant Loans outstanding on Schedules H and I at the end of the plan year. We must divide this amount by one minus the aforementioned default rates, to arrive at the Gross Participant Loans and thus the amount of actual distributions (i.e. defaults):

$51,733,000,000 / [1 - (9.6% job termination defaults + 1.1% death & disability defaults)]

= $57,929,000,000 Loans including actual defaults

Less Net Participant Loans of $51,733,000,000

= **$6,196,000,000 of Actual Loan Defaults**[20]

For the reporting year ended 2009, over $6 billion of actual loan defaults occurred and were offset against participant account balance resulting in actual distributions from plans.

Additional Asset Leakage

When a participant defaults on a loan, the resulting offset against the participant's account balance creates a taxable distribution to the participant. The plan issues a 1099-R to the participant for the amount of the loan offset on which the participant must pay taxes and a 10% early distribution penalty in the case of defaults due to job termination. Most participants borrow from their retirement savings because they are illiquid and do not have access to other sources of credit. This clearly demonstrates that participants who default on a participant loan do not have the financial means to pay the taxes and penalty. Unfortunately, their only source of capital is their retirement savings plan so many take the remaining account balance as an

[20] This amount of actual loan defaults does not include "deemed distributions".

additional early distribution to pay the taxes and penalty, further increasing the amount of taxes and penalties due. These taxes and penalties become an additional source of leakage from retirement assets.

The additional leakage above the defaults can be estimated by applying both Federal and State tax rates as well as the early withdrawal penalty. David Wray, President of the Profit Sharing/401(k) Council of America, in a Kiplinger's post online provided guidance on the this tax and penalty impact:

> "Wray cautions workers who are considering taking a 401(k) loan to be aware that should they default, 40% or more of the money could go to the government, assuming 25% in federal taxes and 5% in state taxes, plus the 10% early-withdrawal penalty."[21]

Applying these tax and penalty rates to the loan defaults results in an additional $2.4 billion in annual leakage from retirement accounts. In addition, that leakage must be grossed up for the Federal and State taxes due on the $2.4 billion to account for those funds having been withdrawn from as an early distribution. On top of the $6.196 billion in defaults, this additional $3.139 billion is leaked from accounts for a total of $9.335 billion of retirement assets lost from defined contribution accounts in 2009 alone as a result of defaults due to death, disability and job termination.

[21] Goldwasser , Joan (March 2010) "Will a 401(k) Loan Default Hurt My Credit".

	Job Separation	Death & Disability	Total
Loan Defaults	**$5,561,153,373**	**$634,527,600**	**$6,195,680,973**
10% Early Withdrawal Penalty	$556,115,337	NA	$556,115,337
25% Marginal Federal Tax Rate	$1,390,288,343	$158,631,900	$1,548,920,243
5% Marginal State Tax Rate	$278,057,669	$31,726,380	$309,784,049
Subtotal Penalty and Tax Liability	**$2,224,461,349**	**$190,358,280**	**$2,414,819,629**
Gross up on Taxes and Penalty for Additional Tax	$667,338,405	$57,107,484	$724,445,889
Total Penalty and Tax Liability	**$2,891,799,754**	**$247,465,764**	**$3,139,265,518**
Total Plan Leakage (Defaults + Penalty and Tax Liability)	**$8,452,953,128**	**$881,993,364**	**$9,334,946,492**

It is important to reiterate that this example is based on 2009 data. The trend line since 2009 shows an increased rate of borrowing which today is up to 28%[22] of participants. If one were to base the analysis on recently reported industry reports rather than the outdated Form 5500 data, the analysis would reveal a problem of even greater severity. For instance, according to the Plan Sponsor Council of America (PSCA) annual survey of plans, participant loans equaled 2.4% of plan assets of the survey respondents in 2010.[23] The survey reported on 2010 plan-year experience of 820 plans with $691 billion in plan assets. Based on an estimated $4.5 trillion of U.S. retirement assets in defined contribution plans[24], the survey results imply $108 billion in loans outstanding – nearly twice the amount of participant loans reported on Form 5500 for 2009.

[22] Aon Hewitt (2012), "Leakage of Participants' DC Assets: How Loans, Withdrawals, and Cashouts Are Eroding Retirement Income 2011"
[23] Plan Sponsor Council of America, "PSCA's 54th Annual Survey of Profit Sharing and 401(k) Plans", 2011
[24] Investment Company Institute, "Defined Contribution Plan Participants' Activities 2011", April 2012

Conclusion

The loss of billions of dollars of retirement savings from defined contribution plans due to involuntary loan defaults is a large and growing problem affecting millions of hard working American families. Unfortunately, this problem is almost completely unknown to policy makers, plan fiduciaries and advisors as a result of reporting that masks the amount of loan defaults. Because of this masking, it is only by careful analysis and extrapolation that one can determine the true leakage from retirement plans as a direct result of involuntary loan defaults. It is the intention of this analysis that DC plan stakeholders understand the magnitude of involuntary loan defaults and recognize the problem of using Form 5500 data as it relates to those defaults.

About the Author

Kevin Smart joined Custodia in 2009 as Chief Financial Officer. He is part of the leadership team working to champion a comprehensive solution to the systemic problem causing more than $10B of retirement leakage from 401(k) plans annually. Prior to Custodia, Mr. Smart served in various finance roles focusing on venture capital investment, mergers & acquisitions, and strategic & operations planning for companies including Harvest Partners, i2 Technologies and Deloitte & Touche. He holds a B.A. in Economics from The University of Texas at Austin and an M.B.A. with a concentration in Finance from the University of Oklahoma and is a current candidate for The Chartered Financial Analyst (CFA) designation; the most respected and recognized investment credential in the world. Mr. Smart is an active member in his local community serving as Precinct Chairman and Executive Committee member for a Rockwall County political organization, and serves on the Board of Directors for the Rockwall County YMCA and the Lake Ray Hubbard Texas Exes. He resides in Rockwall, TX with his wife, Susan Smart M.D., and their two children.