

Electronic Processing of Participant Loans in Retirement Plans

SOME CALL THEM LOANS; others refer to them as tax-free distributions. Whatever you call them, most salary savings retirement plans offer them to participants who are in need of pre-retirement funds. According to a September 2003 Employee Benefit Research Institute issue brief, based on 2002 data, 84 percent of 401(k) participants are in plans that offer loans. Only 51 percent of all plans, however, have a loan provision. Ninety-two percent of plans with more than 5,000 participants have loan provisions, and this grades down to 82 percent for plans of between 501 and 5,000 participants; 75 percent, 251 to 500; 66 percent, 101 to 250; 60 percent, 51 to 100; 54 percent, 26 to 50; 44 percent, 11 to 25; and 35 percent, one to 10.

Because the main focus of a retirement plan is having an accumulation at retirement to sustain home and family, IRS rules and regulations with respect to participant loans are strictly enforced. These rules and regulations stipulate to the maximum loan and the maximum period over which it may be repaid.

Retirement plan participants like the idea of accessible cash when they need it. Participants also enjoy the lower cost of borrowing from their own retirement funds. A government study has concluded that there is more than a one-third increase in retirement savings when a salary savings retirement plan provides for loans. A Government Accountability Office study of loan provisions and 401(k) plans, *GAO/HEHS 98-5 401(k) Pension Plans*, presents analysis indicating that the average annual contribution amounts are 35 percent higher in 401(k) plans with loan provisions compared with 401(k) plans without.

The current loan system is not without flaws. Loan processing can take three days to three weeks, which can be a real hardship for borrowers faced with an emergency. Plan sponsors dislike the paperwork and administrative burden of processing loans and the unpleasant task of chasing after loan payment defaults.

When a participant terminates employment, most plans require full repayment of the loan. A participant who cannot repay the loan is deemed to have received the loan amount as a distribution, subject to tax (and a possible penalty) in that year.

But the availability of participant loans does have positive value for participants. Contribution amounts increase, and participation rates increase, because participants take comfort in knowing that pre-retirement access via a tax-free distribution from their account is available, should there be a need to retrieve some of the retirement savings. This positive value applies especially to plans with fewer than 500 participants,

because there is a significant amount of room for improvement in plan participation in plans of this size.

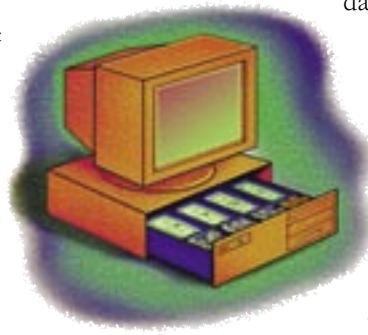
Consolidation of high-interest debt is accomplished with a loan, where the interest cost is paid to the participant's retirement savings account. Such a consolidation would fit into one of the plan's reasons for a loan (should the plan require a reason).

Leakage from retirement savings occurs when a participant terminating employment must repay an outstanding loan or pay tax on the unpaid debt. Many participants not only lose that part of their retirement account previously taken as a loan they also have to borrow from high-interest cost sources

to pay the tax. Leakage is extinguished by loan administration systems that allow for post-employment repayment to the retirement savings account. According to the *401(k) Handbook*, Employee Benefits Series, Vol. 14, No. 1, Dec. 2004, "Outsourcing loan administration would make it easy for plans to eliminate the immediate repayment requirement."

Those who do borrow from retirement accounts typically have a good deal of that account invested in low-yielding money market accounts. Investing one's account in a loan to oneself may increase the yield on that part of the account to the prime rate (or prime plus one). The interest rate charged for participant loans must be commensurate with the prevailing rate charged by a person who is in the business of lending money for a comparable loan.

In practice, it's very common, if not universal, for the plan's loan interest rate to be stated as the prime rate on a given date. Since the prime rate is generally a lending measurement by financial institutions, and since most



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participant loans are secured loans with identical security (the participant's vested interest), the prime rate for participant loans has been an accepted interest rate applicable to participant loans.

Participant loans are processed and administered manually, through privately created software or payroll deduction systems. A better resource to process and administer these loans would be a bank card processing company. Such a company can provide:

- monthly billing statements;
- 24/7 access to loan information via Internet or telephone;
- summary loan information on participant quarterly statements through a link with the plan vendor (as if loans were an investment option);
- loan repayment collections by an automated clearinghouse, Internet, telephone, or check;
- flexibility in repayment amounts above the IRS-mandated minimum repayment schedule;
- handling repayments after termination of employment.

If a retirement plan participant wants to accomplish a stated financial transaction, he or she can access cash reserves, a home equity loan, a margin securities account loan, a credit card, or a retirement plan loan for the funds.

Most participants, especially those who don't have access to a home equity loan or margin securities account loan, fulfill their borrowing needs with a credit card, paying high interest. Consolidating such debt through a retirement plan loan significantly reduces the cost of borrowing.

Some would argue that borrowing from a tax-favored retirement savings account is a poor decision. Participants tend to stop making contributions to the plan while the loan is in effect. They pay back the loan with after-tax dollars and are therefore taxed twice (because the distribution later is taxed). And the participants lose investment return.

On the other hand, participants paying back high-cost credit card debt may transfer that debt to a participant loan and free up a portion of the debt service to inflate retirement savings, because the borrowing costs on the participant loan are significantly less than the credit card debt.

Loan proceeds that are repaid are later distributed from a qualified retirement plan and are taxed once. The loan is a tax-free transfer, and repaying the loan principal, ignoring investment growth, puts the retirement account in the same position it would have been had there been no loan. If we trace the cash flow, we find that the financial transaction accommodated by the loan is fulfilled with pre-tax dollars. When some future after-tax money is used to pay back the loan principal

and ultimately is taxed again, the net result of all the flow from the plan is a single tax on the amount of the loan principal in the distribution. When the plan account is distributed, the participant receives a double-taxed distribution but already owns a never-to-be-taxed financial transaction, the net of which is a single tax.

It can be demonstrated that many loans taken by participants reside in a plan money market account. The likelihood is that the pay-back interest rate from the participant to his own account after it's borrowed may be higher than the money market rate the money earned before it was detoured into the loan. Therefore, there may be no loss of investment return; there may even be a gain.

Participant loans are here to stay. Our focus should be on establishing loan systems that have positive value for participants, plan sponsors, and third-party administrators. ●

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