intac Actuarial Services, Inc.
545 Route 17 South
Ridgewood, NJ 07450
www.intacinc.com

NEWS & Highlights

401(K) LOAN DEFAULTS – REDUCING & ELUDING THE RISKS

Intac Actuarial Services continually works to ensure its plan sponsors and their participants not only receive the finest quality service possible, but also are educated and informed of the risks and difficulties that may be encountered due to the ever-changing rules and regulations in the retirement planning industry. This edition of INTAC's News & Highlights newsletter focuses on 401(k) loan defaults: who is at risk and ways to avoid this potential economic pitfall.

Let's begin with illustrating precisely what it means to default a loan. In finance, default occurs when a debtor has not met his or her contractual debt obligations (e.g. has not made a scheduled payment or has violated a loan condition of the debt contract). A default is the failure to pay back a loan and may occur if the debtor is either unwilling or unable to pay their debt. This can transpire with any debt obligations including bonds, mortgages, loans and promissory notes.

Specifically, in regards to retirement plans, many 401(k) plans allow participants to borrow from their accounts prior to retirement. In most cases, if a participant leaves their job with an outstanding loan, they must repay the loan in full immediately; otherwise they are deemed in default. Certain income and/or excise taxes may also be applied if the employee is under the age of 59. Therefore, an important issue when applying for a loan through a retirement plan is whether these loans pose financial risks and, if so, what guiding principles may be incorporated to reduce this risk. Charles Rosenberg, INTAC Vice President, cautions, "Although loan defaults are not overwhelmingly prevalent considering the enormity of assets held within 401(k) plans (defaults account for a nominal fraction of 0.2 percent of $3.7 trillion in assets), they could nevertheless pose significant risks for groups such as monetarily susceptible or financially unsophisticated individuals."

INTAC recently reviewed a comprehensive study comparing participants who terminated employment and defaulted on their 401(k) loans with those who employees who repaid their loans upon termination. The Financial Literacy Center conducted this research by utilizing a collection of data from Vanguard, a leading 401(k) plan administrator, covering over 100,000 401(k) plan participants who terminated employment during the three-year period from July 2005 through June 2008. This data was pulled from a more extensive base of information accounting for more than 4.3 million total 401(k) plan participants

Following are the points of interest addressed and uncovered in the analysis:

How many 401(k) participants default on loans?

The results show that of the total 401(k) plan participants, about 20 percent had outstanding loans. Of this number, about 12 percent terminated their employment with a loan and *nearly 80 percent of these individuals subsequently defaulted*. This means that approximately 1 in 10 loans resulted in a default.

What employee characteristics, plan design features, and other factors are associated with 401(k) loan defaults?

The research team found that a few specific characteristics such as individuals with smaller 401(k) balances, lower incomes and modest savings funds, as well as plans that allow for multiple loans were associated with a greater likelihood of defaulting.

How INTAC Can Help

What policy changes could reduce the likelihood of defaults?

INTAC, as a TPA, might suggest the following potential ways to reduce the number of defaults:

- Limit borrowers to one loan at a time.
- Allow participants to repay 401(k) loans even after a job change (although this change would likely benefit only participants who immediately begin another job and would also require extra recordkeeping, raising administrative costs).
- Limit the size and scope of loans—for instance, allow participants to borrow only 25 percent of their account balances instead of the maximum 50 percent.

With each party involved in a loan, each said party holds significant responsibilities. Here is a breakdown of what you need to know:

As a Participant: Be an informed consumer and know the terms of your loan, including your payment schedule, fees and what to do if you miss a payment or employment ceases. Participants remain liable for all scheduled payments; and therefore, should verify that loan payments are being deducted and that no payments are missed. The loan must be paid within the term taken, but no later than a maximum of 5 years, with a principal residence loan as the sole exception.

Know that extenuating circumstance may occasionally interrupt your payment amortization. For example, if a participant is out on a leave of absence, arrangements must be made to bring the loan current upon return to work. Accrued interest, as well as fees, may be applied to the loan balance.

As a Plan Sponsor: Ensure that the loan specifications are communicated to the payroll company and that loan payments are being deducted for the term of the loan. *Important: It is a fiduciary responsibility of the Plan Sponsor to ensure that all participant loan payments are made on time and that loans remain current.* All loans must be paid within the term taken, but no later than a maximum of 5 years, unless it is a principal residence loan. There are no other exceptions. Non-adherence to this can disqualify a plan. Additionally, the employer should also contact their TPA when participants terminate, take a leave of absence, stop making payments for any reason or if loan payments are behind (which may lead to a default).

At any time, contact INTAC's loan specialists if you need assistance with your loan application, have a question about your loan agreement or to discuss ways of avoiding default.

ABOUT INTAC

Intac Actuarial Services has been providing complete administration and consulting to employer sponsored retirement plans since 1977. INTAC's professional staff of experienced and innovative plan administrators designs, creates, and continually refines a wide range of qualified retirement plans. We are committed to meeting our clients' needs by providing these services in a timely, accurate and cost effective manner. INTAC has been ranked as New Jersey's #1 401(k)/Defined Contribution Provider by NJBIZ® for four consecutive years. For more information, visit www.intacinc.com.

intac Actuarial Services, Inc.

VisitOurWebSite: www.intacinc.com

Intac Actuarial Services, Inc.

Design • Implementation • Administration • Consultation

545 Route 17 South • Ridgewood, NJ 07450 201.447.2525 • 800.221.3563