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Loan leakage

How can we keep loan defaults from draining \$2 trillion from America's 401(k) accounts?

Executive summary

While financial wellness remains an important topic within the retirement plan landscape, a little understood yet disturbing problem in defined contribution plans has escaped greater scrutiny: Retirement plan leakage from 401(k) loan defaults.

America's \$2 trillion retirement loan default dilemma

Deloitte's analysis finds that more than \$2 trillion in potential future account balances will be lost due to loan defaults from 401(k) accounts over the next 10 years, potentially threatening the retirement security of millions of Americans and undermining years of efforts by plan sponsors and providers to keep money in the retirement system. This figure includes the cumulative effect of loan defaults upon retirement, including taxes, early-withdrawal penalties, lost earnings, and any early cash-out of defaulting participants' full plan balances. For a typical defaulting borrower, this represents approximately \$300k in lost retirement security over a career.¹

With the growth of Defined Contribution (DC) plans as the primary savings vehicle for most Americans, the industry has focused its efforts on strategies to support participant retirement readiness. An overlooked issue is the significant drain on participants' accounts caused by loan defaults. Leakage from 401(k) loan defaults not only derails retirement readiness for financially stressed employees, but it may also introduce risk to plan fiduciaries.

A growing fiduciary risk for plan sponsors

As fiduciaries of the retirement plan assets that are critical to employees' financial wellness, plan sponsors cannot ignore the growing risk and potential liability

represented by loan default leakage. While offering plan loans is a voluntary and not a fiduciary function, many aspects of loan administration fall under the fiduciary standard, which may carry risk for plan sponsors.

The Department of Labor states that loan programs should not diminish a borrower's retirement income or cause loss to the plan, and views loans as investments, requiring the same fiduciary oversight as any other plan investment option.² Yet in practice, loans are viewed as an administrative burden passed on to the recordkeeper with minimal oversight. In the event of an economic downturn, borrowing tends to increase, and the magnitude of these losses grows, leaving fiduciary responsibility potentially exposed.

A majority (90 percent) of 401(k) plans offer a loan feature and nearly 40 percent of participants have taken advantage of a loan offering to finance current consumption.³ Although many participants repay their loans as intended, 10 percent of loans default each year.⁴ While on the surface it may seem like a small number, the compounding effects from loan defaults add up to a much larger number in lost savings. Leakage from 401(k) loan defaults not only impairs employee financial wellness but may also place fiduciaries at risk.

Exploring mechanisms to prevent loan leakage

Plan sponsors, providers, and policymakers have taken steps to reduce loan leakage by limiting loan options (e.g., allowable amount, for a particular purpose, number allotted), but more awareness is necessary to mitigate inherent risks tied to participant financial wellness. One of the main reasons for loan leakage is due in part to participants who are under financial stress, who typically withdraw financial assets in a time of need and are unable to repay them—resulting in default. Eliminating loans altogether is likely not the answer, as loan programs tend to increase plan participation and contribution levels. However, finding the right balance of product innovation, technology, plan design, and education considerations could help plug the leak.

Introduction and background

Despite participation rising to nearly 80 percent in Defined Contribution (DC) plans in 2017, plan sponsors continue to express concern over the retirement readiness of their participants, with nearly 75 percent of surveyed employers worried their employees aren't saving enough for retirement.⁵ Recent efforts made in investment selection, financial education, and innovative tools are helping participants to better understand how to benefit from their plans. However, failing to sufficiently save for the future may force employees to stay in the workforce longer, complicating employer planning and raising questions about the structure and integrity of what a retirement savings plan is truly intended to be—a means of supporting retirement security.

With 401(k) plans holding distinction as a go-to solution for retirement preparation, trending awareness of participant financial wellness has ignited discussions on how prepared individuals truly are. Retirement assets are intended to be stowed away solely for use post-retirement; however, in recent years there has been a prevailing trend in borrowing from that future today. Nearly 90 percent of 401(k) plans today offer a loan feature, with 20 percent of participants holding an outstanding balance at year-end and nearly 40 percent holding a loan over a five-year period.⁶

Borrowing from the future

The practice of borrowing against a retirement account has become a flexible and quick way for participants to access funds that ordinarily wouldn't be accessible until age 59½. While 401(k) loans have been shown to increase plan participation, recent studies have found that nearly 40 percent of participants have taken advantage of a loan offering to finance current consumption.⁷ Another study from the TIAA Institute found that outstanding loans and withdrawals tend to offset about 40 percent of automatic enrollment's potential savings increase, further elevating concerns.⁸ "We have figured out how to get money into the retirement savings system," says Harvard economist Brigitte Madrian and coauthor of the TIAA Institute study. "Now we need to think about how to keep that money in the system."⁹

The reasons participants access their savings prior to retirement vary, but 401(k) plan loans have become a strongly attractive solution for lower-income participants experiencing liquidity constraints. Employers who offer a Health Savings Account (HSA) can assist with addressing emergency funds for health issues—but what about the other big drivers, such as living needs, student loan debt, and credit card expenses? Participants end up pulling assets from their DC plans for use as an "emergency fund."

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If a participant leaves a job, experiences involuntary job loss, or undergoes a life-changing event (e.g., death or disability), the remaining balance due on a loan will typically be accelerated and payable immediately or soon thereafter. Participants without an income may have no choice but to default on the loan, thereby triggering a taxable event with early-withdrawal penalties. An estimated 10–12 percent of loan holders are expected to default each year¹⁰ incurring withdrawal penalties and tax liabilities, commonly leading to participants withdrawing their full remaining account balances sooner than expected.

Lost compounding potential

Many borrowers and plan sponsors may fail to consider the impact of compound growth that retirement assets could have otherwise earned in the market during and after loan repayment. Given the costs to participants and plan sponsors alike, there is a call to mobilize plan sponsors, providers, and advisers to seek alternative solutions to plug the loan leakage potentially deterring participants' retirement readiness.

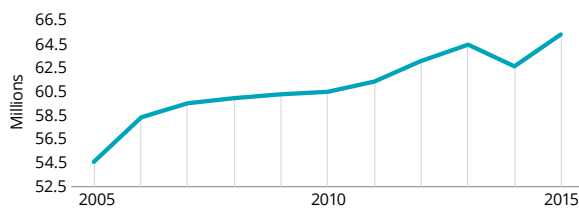
America's \$2 trillion retirement loan default dilemma

Financial burdens and loan defaults go hand in hand when participants are laid off or leave their job. Some 401(k) participants liquidate their retirement plans altogether in those circumstances, paying income taxes and a 10 percent tax penalty, all just to make ends meet.¹¹ We analyzed the compounding impact of loan leakage on participants' 401(k) balances.

We begin our analysis with research published by Wharton/Vanguard's Pension Research Council in 2014. This study analyzed 401(k) loan default patterns in the years 2004–2009 for 6.6M participants. The results estimated the aggregate 401(k) loan default in 2006 to be \$6.3B.¹² Other demographic data applicable included the average 401(k) borrower's age, which was found to be 42.

We projected forward the study's estimate of the 401(k) loan default amount in 2006 to \$7.3B in 2018, using historical growth in active participation from the DOL Private Pension Bulletin.¹³ The number of 401(k) active participants for the years 2005–2015 is shown below.

Figure 1. 401(k) active participation



In determining the average loan default as a percentage of total account balance, we referenced Vanguard's 2018 report on "How America Saves," which indicated 10.1 percent.¹⁴

The Pension Research Council found that 86 percent of participants defaulted on their loans after leaving employment.¹⁵ A more recent study conducted by the Employee Benefit Research Institute (EBRI) found that approximately two-thirds of participants' diminished retirement savings is due to leakage associated with cash-outs from job change.¹⁶

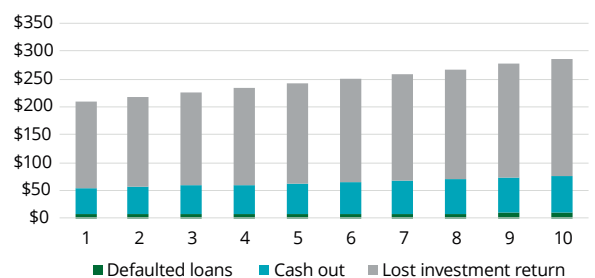
Considering Deloitte's estimate of \$7.3B in loan defaults in 2018, the subsequent withdrawal of remaining retirement account balances is estimated to reach \$47.8B. The lost opportunity costs associated with these leakage amounts were projected from age 42 to normal retirement age 65 (i.e., 23 years), at a long-term investment return of 6 percent based on reasonable asset allocation.

Figure 2. Estimated opportunity cost due to loan default

\$Billions	Loan default	Voluntary cash-out	Leakage opportunity cost	Projected leakage at retirement
2018 Leakage	\$7.3	\$48	\$155	\$210
10-year cumulative leakage	\$86	\$560	\$1,822	\$2,468

This study was then produced for a 10-year business cycle and the result was a projected shortfall in account balances at retirement of approximately \$2.5T.

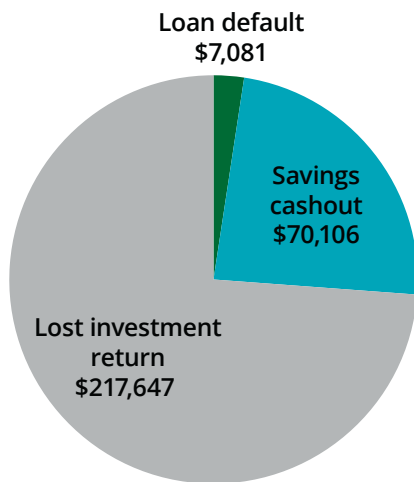
Figure 3. Impact of loan leakage—over 10-year period



Impact on individuals

With those system-wide projections in mind, the Deloitte analysis estimates the individual impact of a 42-year-old borrower defaulting on a loan of \$7K and withdrawing the remaining account balance of \$70K to reduce the participant's retirement savings by nearly \$300k. A sample impact of loan default on aggregate leakage is shown in the chart below.

Figure 4. Sample participant impact



The lost opportunity cost of the loan default and subsequent cash-out is calculated based on a similar annual investment rate of 6 percent and a 23-year time horizon.

Impact on Americans' retirement prospects

This potential retirement shortfall is likely to produce a considerable shift in standards of living during a period where participants are lacking employment income and relying upon their nest eggs.

Without substantive guardrails in place for 401(k) loan policy, management, and default prevention, the results may be large leakage amounts within retirement savings and, consequently, significant detriment to US investment markets if this leakage isn't stemmed with alternative solutions.



A growing fiduciary risk for plan sponsors and providers

Under ERISA, a plan is typically prohibited from lending money; however, exemptions are routinely provided to permit loans to participants if certain statutory conditions are met (ERISA 29 CFR 2550.408b-1(d)(vii)). These strict guidelines require plan fiduciaries to monitor loan activity and performance, and take steps to prevent losses in the event of a loan default, as loan programs should not diminish the borrower's retirement income or cause loss to the plan (DOL Advisory Opinion 95-17).

Plan sponsors may further determine and impose conditions on loans, including whether loans are permissible at all. Sponsors may also determine the number of individual loans allowed and contractual terms for the loan, including minimum amounts (e.g., \$1k), payback periods, and borrowing interest rates. Regardless of the terms, fiduciaries hold an obligation to preserve plan assets in the event of a participant default (408(b)(1)(C)).¹⁷

The fiduciary liability for plan sponsors

Plan fiduciaries who have discretionary authority over plan design and loan offerings may be held liable for insufficient details when assets are pulled from an employee's retirement plan. Fiduciary responsibility places the onus on plan sponsors to communicate and advise participants of the inherent risks 401(k) loans may introduce. As economic factors play a key role in job changes for participants, it is imperative that plan fiduciaries educate their participants about the risks incurred should they be unable to repay a loan. In 2017, an administrator's failure to properly deduct loan repayments for one participant resulted in deemed distributions that incurred tax penalties of over \$3k.¹⁸

While participants may be more likely to contribute to DC plans that include a loan feature, qualified plan loan defaults burdens retirement readiness. This and the potential cascading effects of its leakage may likely result in lost retirement income for plan participants—imposing a fiduciary risk to plan sponsors.

This is especially true if, during a workforce reduction, a significant portion of the reduction involves participants with outstanding loans approved by the sponsor as a fiduciary function. The law states that if participants fail to reimburse the account for the remaining balance due on the loan within a predetermined "cure" period (typically 60–90 days post-departure), the loan is considered in default and the participant will incur a taxable event on the balance due.¹⁹ A recent legal change allowing participants to roll over amounts attributable to loan defaults in the following tax year is not expected to add much relief to out-of-work borrowers without income.²⁰

If a taxable event occurs, it may lead participants to remove additional assets from their 401(k) accounts to help pay penalties and taxes—resulting in further retirement readiness deterioration. These participants may hold the plan sponsor responsible for their inability to pay back the loans, resulting in litigation and possible liability.²¹

To reduce hidden implications, plan sponsors may want to consider available options and advanced solutions to mitigate the cascading effect of loan defaults.

Exploring mechanisms to prevent loan leakage

While access to plan loans encourages higher participation and contribution rates, the impending risks associated with loan leakage—from potential delay of retirement readiness to increased tax liability should a participant default—can be mitigated through various solutions available today.

Understanding the various options available while they're struggling with financial obligations can be stressful and tedious. Programs that enable transparency and awareness of the money that employees hold in various accounts can be improved upon to better accommodate continual savings for retirement while taking care of short-term needs. Options such as automated solutions integrated with digital and custom financial education, on-site advice that is tailored to the employee's needs, and adviser-ready outreach to help employees develop basic money-management skills should be considered in an effort to slow retirement plan withdrawals.

“Programs that enable transparency and awareness of the money that employees hold in various accounts can be improved upon to better accommodate continual savings for retirement while taking care of short-term needs.”

The most common solutions that exist today to limit future retirement setbacks from retirement loan defaults include policy changes to plan design, loan education programs, debt consolidation, payroll program automation, and 401(k) loan insurance. Finding the right balance of product innovation, plan design, and technology can help to collectively increase financial wellness and readiness for retirement.

Products as a potential solution:

- A suite of pre-tax wellness plans (e.g., HSA, FSA, 529) as part of current benefit lineups
- Debt-management programs for participants who are low-income and struggling to pay student debt, credit card debt, and household debt
- 401(k) plan loan insurance that automatically prevents loan defaults and consequences (taxes, penalties, anticipated cash-outs) due to involuntary job loss
- Preapproved emergency loan options that allow automatic payroll deductions from a participant's paycheck to assist with last-minute needs
- Rainy-day savings plans holding a fixed rate of return on a small percentage of payroll assets that are automatically deducted each pay period

Policies to consider:

- Establish and enforce robust 401(k) education and loan risk awareness programs designed and curated for fiduciary responsibility, prior to lending approval
- Reduce the permissible loan amounts and number of loans outstanding per participant, and increase flexibility in payback timelines
- Enforce waiting periods for plans that are currently designed with multiple loan originations and payoff dates, resulting in overall reduction of loans available

Technology to consider:

- Develop and deploy a custom and targeted strategic communications plan that enables a two-way conversation between employees and employers to better educate employees and support their needs
- Develop applications to generate more informed, calculated decisions by employees based on assumptions of loan amounts—pending employee withdrawal
- Enable automated post-separation repayment opportunities to allow defaulting participants to access and repay their loans, reducing the need for manual pay-back after a job loss
- Reduce manual processing by enabling auto-transfer participant rollovers from one plan to the next

Retirement readiness is the end goal

Without the proper education and advice, appropriate plan design, and implementation of new solutions, the trend of loan leakage from retirement assets may continue alongside an ongoing trend of loan utilization.

Improving participants' financial wellness is key to assuring the retirement assets necessary for tomorrow are safe today. The detrimental effects of loan defaults on retirement readiness can be reduced by plan providers and plan sponsors taking steps to adopt new and improved DC plan products, policies, and processes.

Hidden impacts to participants financial wellness should continue to be exposed, and are dependent on plan sponsors and participants working together to continue to resolve and improve the benefits influencing retirement readiness for many Americans.

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Endnotes

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Cumulative Leakage Model Methodology: The research findings are based on a publication by the Pension Research Council in 2014, which studied 401(k) participant loan default patterns in years 2004-2009. This study showed the total amount of loan default of \$6.3B in 2006 with 86% of the participants that defaulted on their loans taking their entire account balance out at the time of loan default and the average age of the loan defaulter being age 42. Deloitte projected forward the loan default amount from 2006 to an estimated \$7.3B in 2018 using historical growth in active participation from the DOL Pension Bulletin. The 2018 Vanguard paper "How America Saves 2018" estimated that the average loan default as a % of total account balance was approx. 10.1%. Based on anecdotal data from recordkeepers, the model took a conservative approach and assumed 66% of participants that defaulted on their loan also took their entire account balance out vs. 86% from the study. The total account balance \$47.8B that would be withdrawn early plus the outstanding loan amounts were then projected from age 42 to normal retirement age 65 (i.e., 23 years) at a reasonable long-term investment return of 6% based on a typical asset allocation over the 23-year time horizon. This study was then produced for a 10 year business cycle and the result was a projected shortfall in account balances at retirement of approx. \$2.5T.





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