

Participant Loans: A Fiduciary Storm Brewing?

Bruce Ashton, with Drinker Biddle & Reath, discusses the fiduciary risk defined contribution (DC) plan sponsors could face when participants default on plan loans.

DO plan sponsors have fiduciary risk when a participant defaults on his or her loan from the company's retirement plan? The short answer is likely yes.

The fiduciary duties related to participant loans haven't received much attention, partly because, in the defined contribution (DC) plan era, we've focused almost entirely on accumulation of retirement savings. Fortunately, both plan sponsors and the retirement industry are beginning to pay closer attention to retirement savings adequacy and other factors that can leave participants without enough money to have a decent retirement. A 2018 Deloitte study estimates that loan defaults will drain \$2.5 trillion from the system over the next 10 years.

As my partner Fred Reish has noted, fiduciaries "need both a periscope and a microscope." They need to accurately assess the present, but also "scan the horizon ... to see the issues that should be looked at, but aren't on the agenda."

Most plan sponsors have blind spots about fiduciary duties for loans, and are operating under an incorrect assumption that disclosure alone satisfies Employee Retirement Income Security Act (ERISA) loan requirements.

Fiduciary Duties for Loans

Here's what ERISA and the Department of Labor (DOL) say about the fiduciary responsibility for loan programs:

- ERISA only allows loan programs where they will not diminish participant retirement benefits (DOL Advisory Opinion 95-17A).
- Loans are a plan investment under ERISA; approving and monitoring loans are fiduciary functions; loans and a loan program

must be administered for the exclusive purpose of providing benefits to the participants (ERISA 29 CFR 2550.408b-1(a)(3)).

- Plan sponsors must take steps to preserve both plan and participant assets in the event of a (loan) default (ERISA 29 CFR 2550.408b-1(d)(vii)).
- Loan programs fall under ERISA's prudence standard (ERISA Section 402(a)(1)(B)).

These rules may be both surprising and a bit scary. Even with what appears to be thorough disclosure, how can a plan sponsor "prudently" facilitate access to loans, when a loan can wipe out retirement benefits for so many borrowers? While the level of risk may feel like it's off on the horizon, it isn't hard to see that the tide may be coming in.

The Rising Level of Risk

The wave of class action suits for excessive fees may have crested, which means the plaintiff's bar may be scanning the horizon. Guess what. They've got a periscope, too.

Another risk may come from the regulators. Form 1099-R, which reports on money coming out of plans, has been amended to require expanded reporting of loan defaults. Until this year, plan sponsors have only been required to report loan defaults for active employees who received a "deemed distribution." These defaults only represent about 8% of the total. Loan default offsets by terminated participants, which represent the other 92%, are reported as actual distributions and lumped in for reporting purposes with other distributions by the plan. This reporting masks the magnitude of the problem almost entirely.

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Going forward, in addition to reporting “deemed” distributions to active employees, the updated 2019 Form 1099-R will require plan sponsors to separately report terminated participants’ loan default offsets. It doesn’t require a crystal ball to foresee the IRS using this new data to target plan audits. Simply put: the higher the number of defaults, the higher the possibility of audit.

There may be more change coming. The U.S. Government Accountability Office recently issued a report identifying loan defaults as a substantial component of plan leakage. The report’s primary recommendation is that DOL and IRS revise Form 5500 to require plan sponsors to report the incidence and amount of all plan loans that are not repaid—not just deemed distributions to active participants—similar to the revised Form 1099-R. DOL’s response to the recommendation (included in the GAO report) is that plan sponsors should already be keeping records that differentiate loan offsets from other benefit distributions. This reply bolsters the notion that plan sponsors are responsible—today—for having a prudent process in place around their loan programs.

Plugging the Leakage

The industry seems lost at sea when it comes to the loan default issue. Suggested “solutions” include educating participants, disclosure, limiting the number or amount of loans, providing access to ACH repayment, or increasing fees to discourage participants from taking loans. Realistically, none of these measures has a meaningful impact on reducing loan defaults. A participant who has an emergency needs the money and will take a loan. Besides, the obligation to “preserve both plan and participant assets in the event of a (loan) default” presumes the loan default and offset occurred. None of the above measures will fix a problem that only cash can solve.

One promising innovation currently available is loan insurance, which automatically repays outstanding participant loans in the event of job loss, preventing the default and associated taxes, penalties, and lost earnings. Loan insurance may also be accompanied by education, which discourages taking a distribution from a replenished account, but instead leaving the money in the plan or an IRA in the event of job loss to keep retirement savings on track. Loan insurance is available for a relatively small, participant-paid fee, paid outside of plan assets, and only those participants who choose to borrow pay for the coverage.

Rather than just sitting back and hoping for smooth sailing, plan sponsors should consider raising their periscopes and reviewing their loan programs. That means evaluating the default activity in their plans, but also taking action—such as including loan insurance—to go beyond disclosure to satisfy fiduciary duty, mitigate risks and, most importantly, improve retirement outcomes.

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