October 2019

MISSING VOICES:

# What 401(k) borrowers can add to the loan conversation

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GREENWALD & ASSOCIATES

# What's Inside

# Introduction

## MISSING FROM THE CONVERSATION: THE VOICE OF THE PARTICIPANT ON 401(K) LOANS

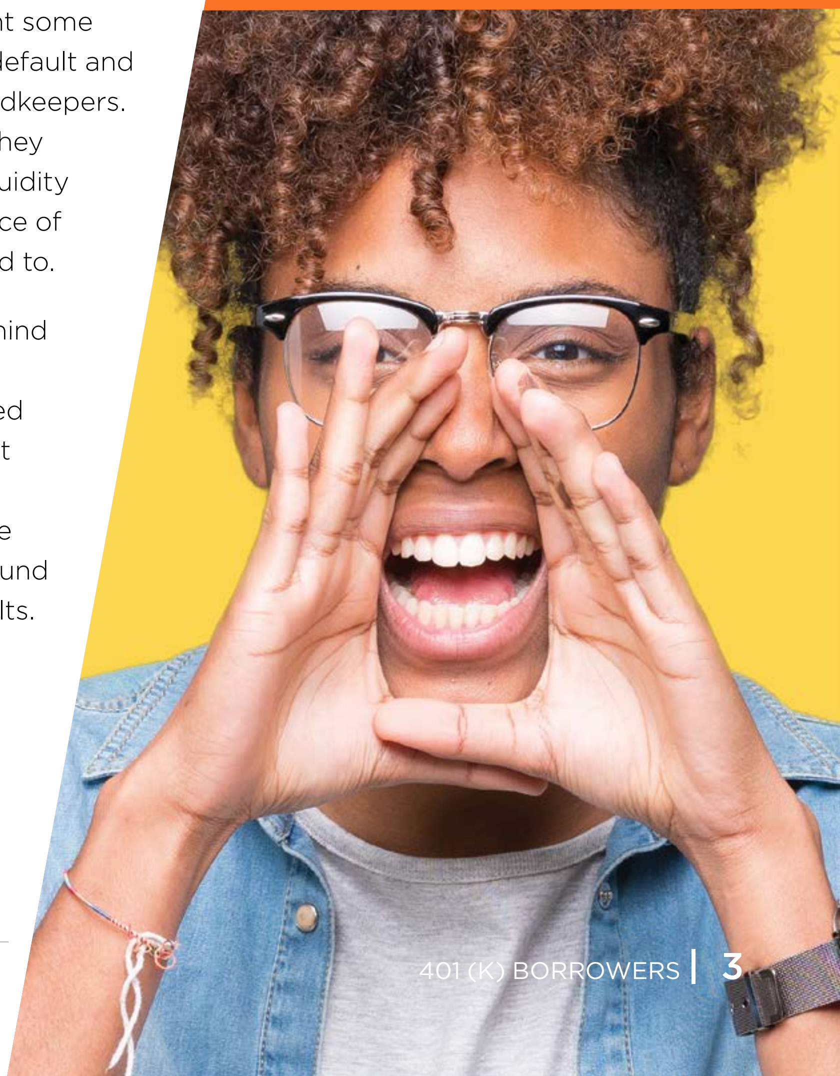
Over the past few years, the industry has learned a lot about the extent to which plan leakage from loan defaults is harming American workers. According to Deloitte, loan leakage will drain $2.5 trillion in retirement security from the U.S. retirement system over the next ten years. The loan default conversation has picked up steam. Plan sponsors are starting to act by implementing plan design changes and other new measures—but what do participants think, and how should that "voice" inform the way forward?

How do participants feel about loans, how are they using them, and how are participants affected by plan sponsor decisions related to the loan feature? Addressing the "voice of the participant" — and what we can learn from these voices — is the purpose of this report.

Indeed, participant loans are a standard feature in today's defined contribution plans; 90 percent of plans offer a loan feature. Among participants in plans with a loan feature, 20 percent have a loan outstanding.[1] Loans present some challenges, including risk of leakage if borrowers default and administrative burden for plan sponsors and recordkeepers. Loan features have important benefits, however: they provide participants with access to emergency liquidity and encourage participation. People have the peace of mind that they can access their money if they need to.

Early in 2019, Custodia Financial, the company behind Retirement Loan Eraser, engaged Greenwald & Associates to conduct a study, surveying a targeted cohort of plan participants who have taken at least one plan loan. Greenwald & Associates also conducted in-depth interviews with a subset of the respondents to better understand the context around loan-taking, participant education, and loan defaults. This report summarizes the key findings from the research, as well as implications for plan sponsors and others in the industry tasked with addressing plan leakage, retirement readiness, and effective financial wellness.

**Addressing the "voice of the participant" — and what we can learn from these voices— is the purpose of this report.**



[1] Fidelity Investments, "Building Financial Futures," as of Q2 2019.

## Research Highlights

As it turns out, not only is loan leakage harming retirement readiness and increasing plan sponsors' fiduciary risk, the current system also is creating significant financial stress for many of the 49% of participants who think it's likely they'll need to use money held in retirement plans for expenses other than retirement.[2] A summary of the study's key findings is below.

**Employees value the opportunity to borrow in 401(k) plans.**

- The vast majority of participants (91 percent) value the plan's loan feature as a source of liquidity for financial emergencies.
- The top three reasons to take a loan are simply to make ends meet, to pay off a credit card bill or credit card debt, and to cover out-of-pocket medical expenses.
- More than half of the participants surveyed (55 percent) feel it is unlikely that education would have caused them to reconsider borrowing.

**Many—particularly millennials—are concerned about being able to repay their loans, especially if they lose their jobs.**

- A majority (70 percent) believe losing a job would make paying off loan more difficult.
- Respondents age 25-34 are the most concerned that they could not pay back their loan if they lost their job (69 percent for 25-34 vs. 48 percent for all ages).

**A majority supports the addition of automatic, participant-paid loan insurance as a "safety net"—and believe that it would reduce their financial stress.**

- Almost 80 percent find low-cost loan insurance appealing; almost 60% believe their employer should add it, with sentiment strongest among those ages 25-34 and 35-44.
- Borrowers are far more likely to rank loan insurance first (63%) than they are extended repayment via ACH (21 percent) or consumer loans (17 percent).
- Two-thirds (67 percent) say they'd consider contributing more to the plan if their employer were to add loan insurance.
- More than 80 percent of borrowers who are financially stressed say loan insurance would reduce that stress.

### KEY TAKEAWAYS

- **Employees value the loan feature in their 401(k) plan.**
- **Most are concerned about being able to repay their loans, especially if they lose their jobs.**
- **A majority supports the addition of automatic loan insurance, and believe that it would reduce the stress they are feeling.**

[2] PWC Employee Financial Wellness Survey, 2019.

# Who Is Borrowing?

## THE FINANCIALLY VULNERABLE ARE THE PRIMARY USERS OF THE LOAN FEATURE.

While borrowing happens across different participant demographics, participant loans are most popular among those who are financially vulnerable. In this study, seven out of ten borrowers have total household income of less than $70,000 annually, and more than 6 out of 10 report plan balances under $100,000.

| Household Income | |
|---|---|
| Under $50K | 32% |
| $50K-$100K | 36% |
| $100K-$150K | 19% |
| $150K+ | 12% |

| DC Plan Balance | |
|---|---|
| Under $25K | 19% |
| $25K-$50K | 20% |
| $50K-$100K | 26% |
| $100K-$250K | 18% |
| $250K+ | 18% |

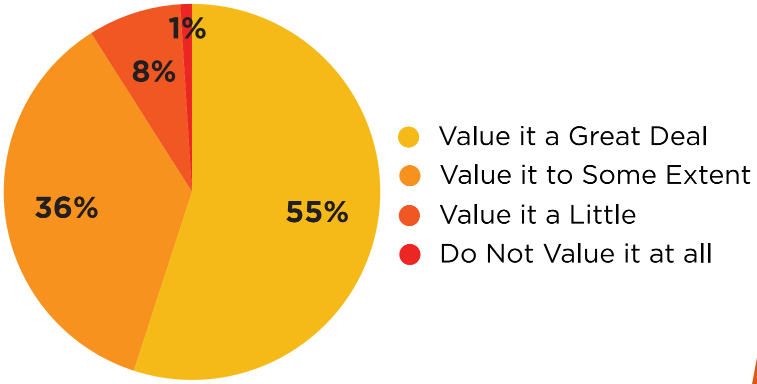
| Age | |
|---|---|
| 25-34 | 19% |
| 35-44 | 28% |
| 45-54 | 22% |
| 55-64 | 25% |
| 65+ | 7% |

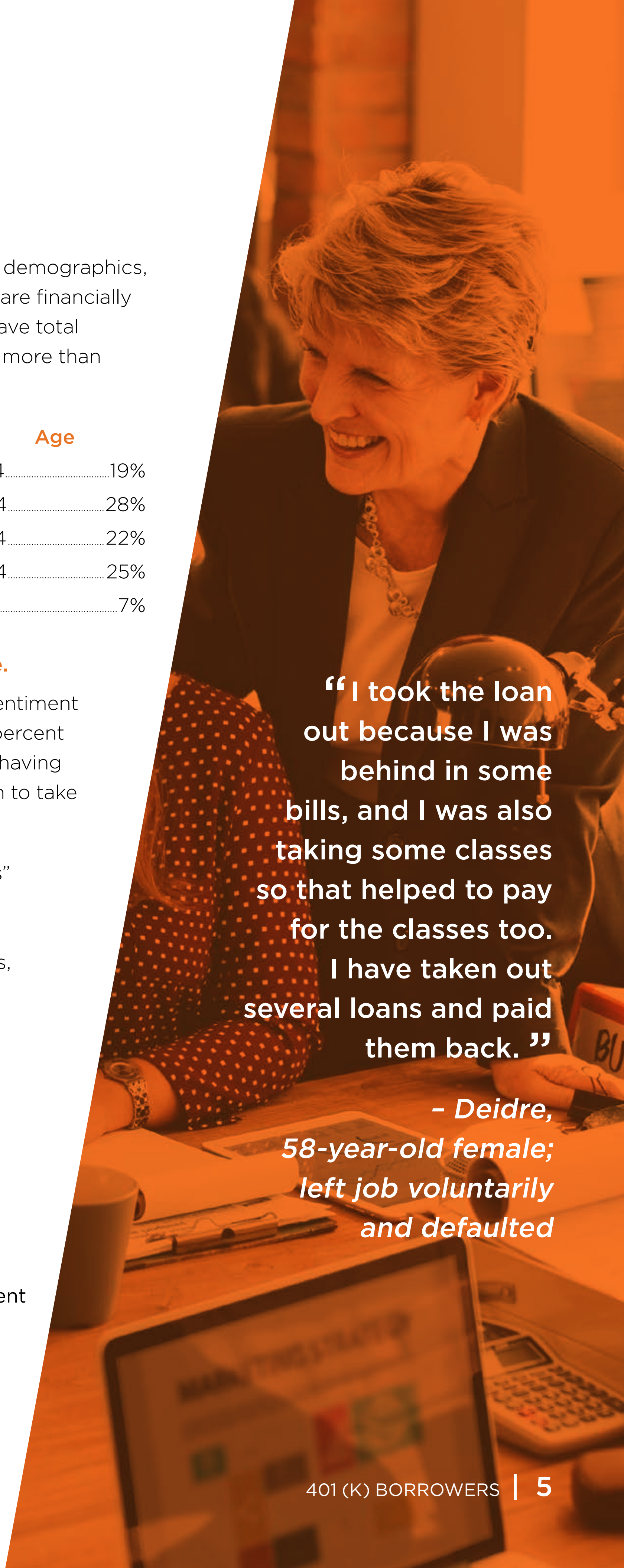
### Borrowers Overwhelmingly Value their Loan Feature.

Among borrowers in the study, the most consistent sentiment is how much they value the loan feature. Ninety-one percent of all borrowers in the survey indicate that they value having the ability to borrow money from their retirement plan to take care of financial emergencies.

This isn't surprising, as the focus on "financial wellness" has uncovered how often day-to-day financial pressures are creating stress for everyday people. A recent CareerBuilder study[3] corroborates these results, with 78 percent of employees reporting that they are living paycheck to paycheck. For people with modest means, their defined contribution plan may be their *only* source of emergency liquidity.

### Value that Participants Ascribe to the Loan Program

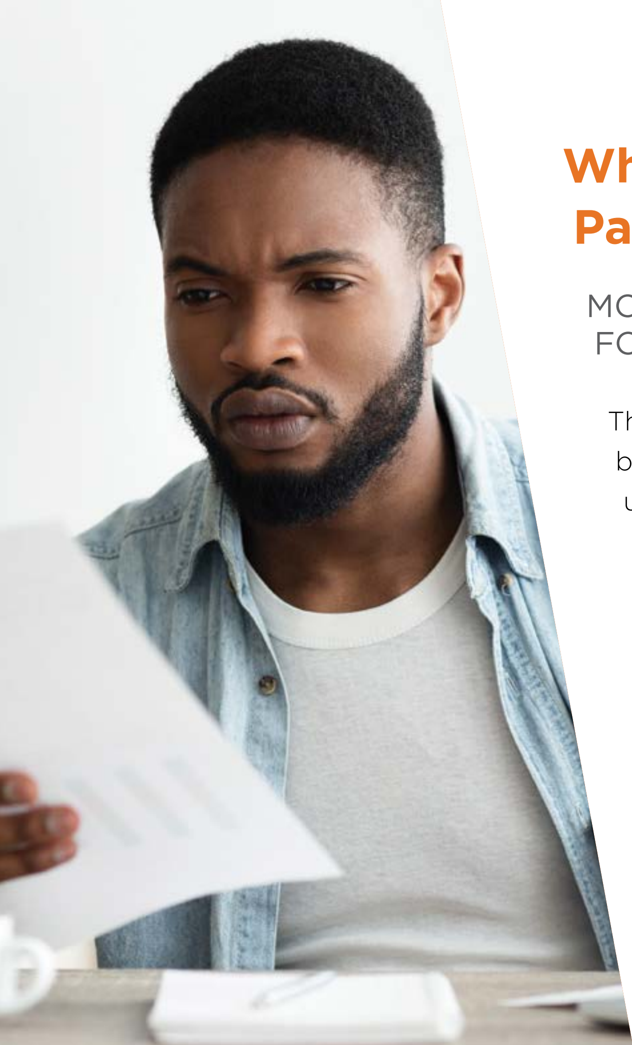


**"I took the loan out because I was behind in some bills, and I was also taking some classes so that helped to pay for the classes too. I have taken out several loans and paid them back."**

***– Deidre, 58-year-old female; left job voluntarily and defaulted***

[3] "Living Paycheck to Paycheck is a Way of Life for Majority of U.S. Workers," CareerBuilder Survey, August, 2019

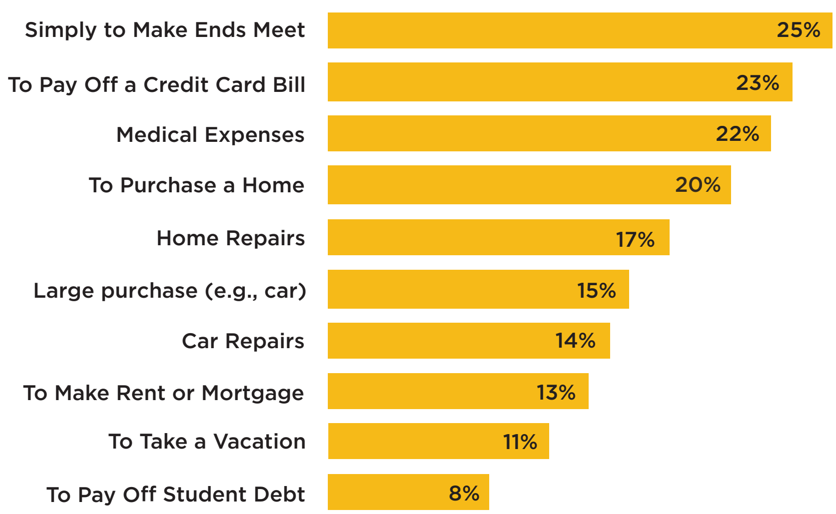


# Why—and How Much—Participants Are Borrowing

## MOST BORROWERS TAKE MODEST LOANS FOR URGENT FINANCIAL NEEDS.

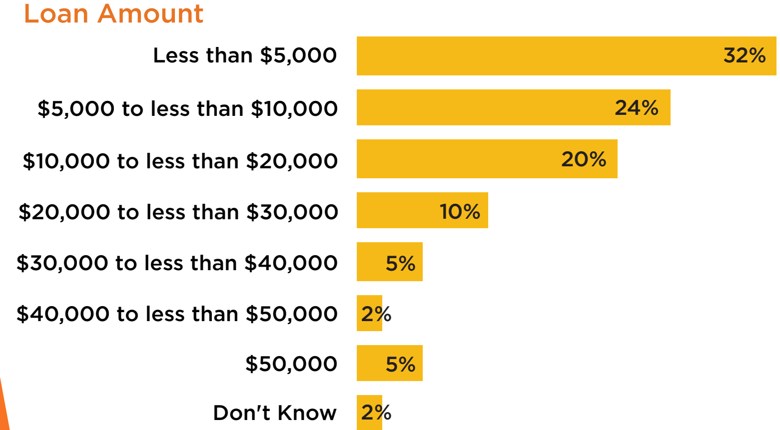
The research findings also shed light on the reasons why participants borrow, and supports the notion that, by and large, participants are using the loan feature for "financial firefighting," rather than for discretionary expenses such as vacations. The top five reasons in this study are simply to make ends meet; to pay off a credit card bill or credit card debt; to cover out-of-pocket medical expenses; to purchase a home; and to make home repairs.

**Reasons for Taking Loan (Top Responses Shown)**




The findings on loan size are also notable. The vast majority of loans are modest: 76 percent are under $25K. In addition, the quantitative results and in-depth interviews suggest that people don't want to crack their nest egg, and borrow only what they need vis-à-vis the expense that they're facing, not the maximum allowed (i.e., 50 percent of balance or $50K, whichever is lower).

**Loan Amount**




**"The reason we were in this spot to begin with, we had depleted most of our savings fairly close to this time. New vehicle and credit cards, there wasn't enough balance available to handle it."**

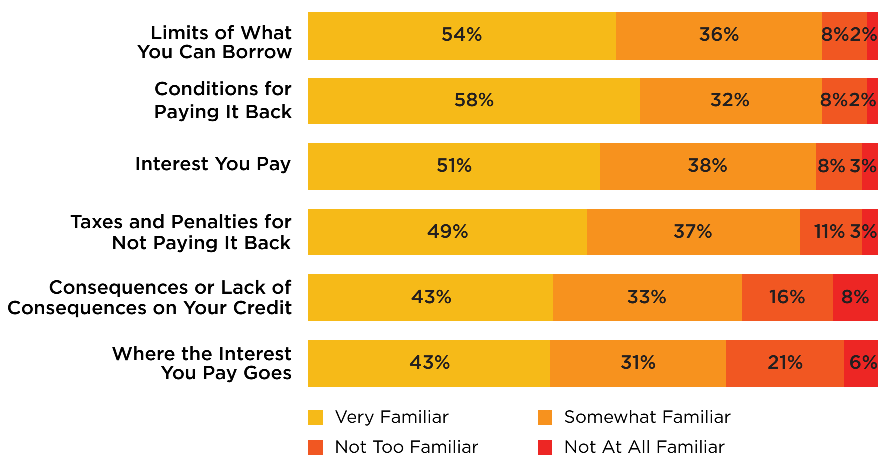
***– Marcus, 46 years old; became disabled and defaulted***

# Engaging and Educating Participants

## BORROWERS THINK THEY UNDERSTAND LOAN TERMS AND RISKS — BUT THEY HAVE LARGE KNOWLEDGE GAPS.

Like other areas in which plan sponsors are attempting to educate participants, the research suggests some significant challenges. First, when looking at the quantitative survey results in combination with the in-depth interviews, participants may appear to overestimate the extent to which they understand how the loan feature works and the consequences of default. While there was some variability across these areas, in this self-reported survey, more than seventy percent of borrowers believe that they understand the limits of what they can borrow, the conditions for paying the loan back, the interest they pay, the taxes and penalties, and implications from a credit history standpoint. In the in-depth interviews, however, it became clear that there were significant knowledge gaps. Two-thirds of those interviewed didn't even know if they'd defaulted on their loan.

### Familiarity with Terms and Conditions




Another finding that emerges from the in-depth interviews is the significant challenge from an education standpoint. Participants don't want to be educated about loans when they don't need one, because it's not relevant. When they do need a loan, they tend to be under financial stress, and simply want to access their money as quickly as possible. The participants interviewed tend to blame themselves just as much or even more than their employer for their knowledge gaps.

**"All I knew was that I needed to get some cash.**

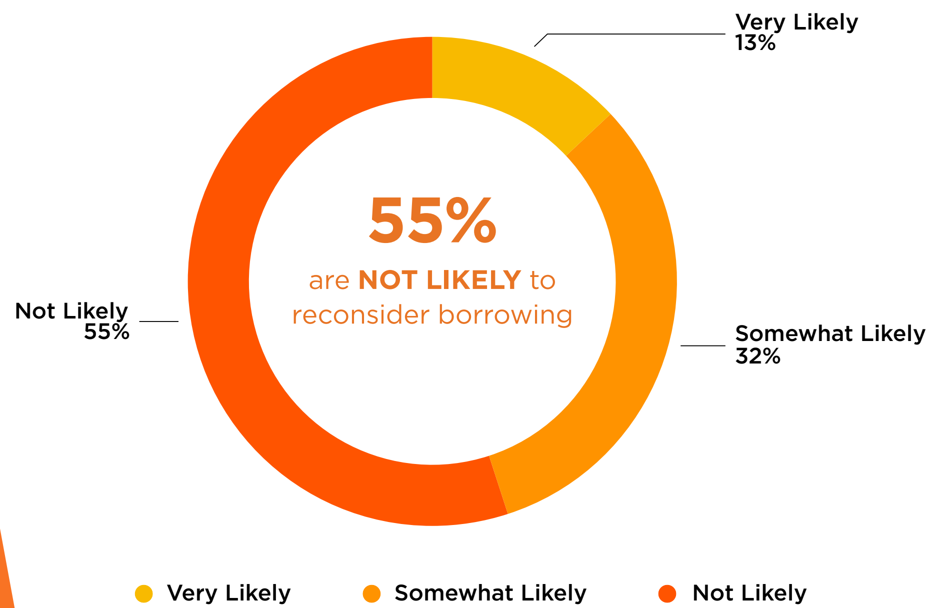
**They could have probably told me anything and it wouldn't have made much of a difference."**

***– Marcus, 46 years old; became disabled and defaulted***

Furthermore, because the 401(k) is the only source of emergency liquidity for many borrowers, a majority (55%) believe that more education on the risks of loan taking wouldn't have caused them to reconsider borrowing.

On the other hand, despite the challenges with education upstream of the loan decision, over 80 percent of participants are interested in timely communications to help them better manage their loan *after* they've taken it, when they may be in a better state of mind to learn.

**Likelihood to Reconsider Borrowing If Employer Offered Loan Education**




**"I didn't really understand the loan very well, and I was kind of desperate at the time, so I took it out."**

***– Peter, 71-year-old male; involuntarily terminated, defaulted, and cashed out entire balance***

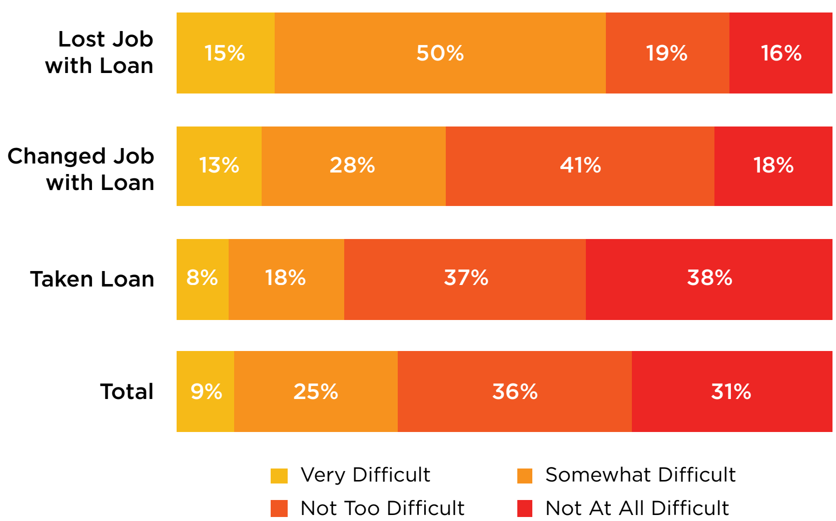
# The Impact of Job Loss

## BORROWERS ARE STRESSED ABOUT THEIR ABILITY TO REPAY.

In 2014, a seminal report, “Borrowing from the Future: 401(k) Plan Loans and Loan Defaults,”[4] shined a light on the issue of plan loan defaults following job loss. In the report, 86% of those with a loan outstanding at termination ended up defaulting. In this study, while borrowers are very likely unaware of this statistic, they report a significant amount of concern about their ability to repay a loan following job loss.

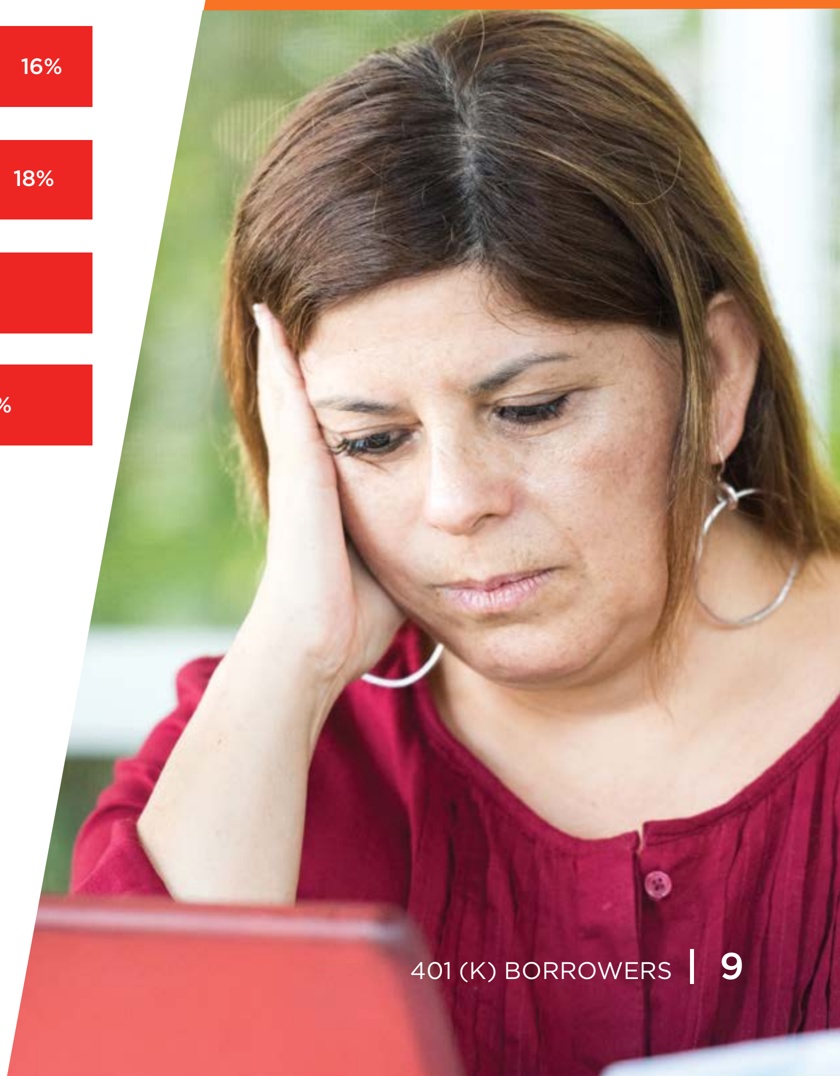
About a third of all borrowers report that repaying their loan is or was at least somewhat difficult, but difficulty goes up drastically among those who lost their job or changed jobs with a loan outstanding. Unsurprisingly, those who lost their job with a loan report the highest level of difficulty paying back their loan – two in three consider it at least somewhat difficult. Similarly, those with household incomes lower than $50k are much more likely to have had difficulty repaying their loans (46 percent vs. 30 percent with $50k-$99k and 25 percent with $100k+).

**Difficulty of Repaying Loan**




**“I actually became disabled with fibromyalgia. So I had to stop working.”**

***– Abby, 53-year old female; became disabled, defaulted, and cashed out her entire balance***



[4] Borrowing from the Future: 401(k) Plan Loans and Loan Defaults, Wharton/Vanguard Study, 2014.

"I don't know what the future is going to bring. I could have gotten sick or injured or I could have lost my job and with a private loan, then I would have been stuck paying it back."

*– Deidre, 58-year-old female; left job voluntarily and defaulted*

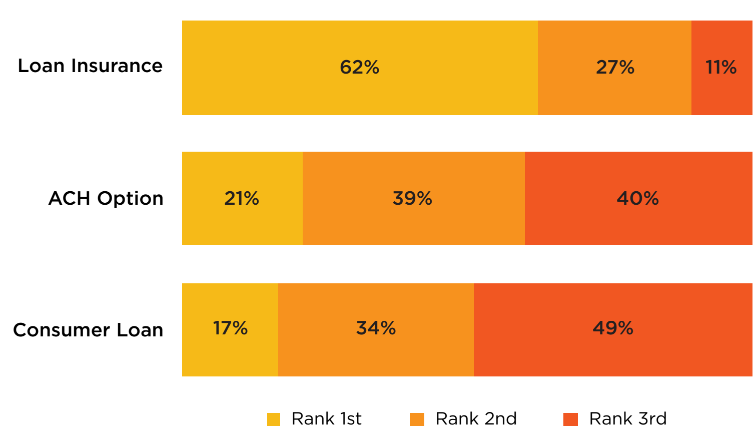
# In Search of the Best "Safety Net"

## THE INDUSTRY HAS SUGGESTED SEVERAL SAFETY-NET OPTIONS, BUT BORROWERS SHOW A CLEAR PREFERENCE FOR AUTOMATIC LOAN INSURANCE.

While participants may view their 401(k) as a potential "safety net" if they face a significant unforeseen expense, without mechanisms to protect them from default, that safety net is gone. Recognizing this challenge, the industry has been trying different measures to address the issue. This study obtained participant sentiment on three potential ways of enhancing participant access to emergency liquidity: a loan feature with post-termination repayment via ACH, access to consumer loans separate and apart from the 401(k) plan, and automatic loan insurance that protects against default in the event of involuntary job loss, disability, or death.

While there were participants who ascribed value to all approaches, automatic loan insurance emerged as the clear leader. Participants find access to consumer loans particularly problematic because of the potential for adversely impacting credit scores. While extended repayment may appear to be a good fit for job-changers, for those who have lost their job or become disabled, the challenge isn't about access; it's about having the cash to pay the debt. Loan insurance is the only option that automatically addresses this liquidity problem. Furthermore, the number of participants actually taking advantage of extended repayment is extremely low, with Vanguard[5] recently reporting usage at less than 5% of those eligible.

### Rank Order Appeal of Loan Options




[5] Vanguard, "How America Saves," 2019.

# Plan Loans and Financial Stress

## LOANS ARE SYMPTOMATIC OF BROADER FINANCIAL STRESS AMONG PARTICIPANTS.

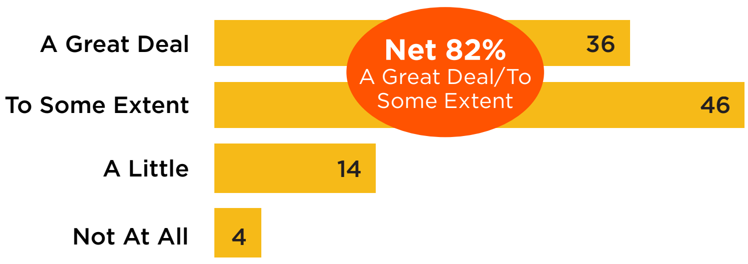
It turns out, not only is loan leakage harming retirement readiness and increasing plan sponsors' fiduciary risk, the current state is also creating financial stress for most of the 20% of participants with loans outstanding. If you had to sum up the mindset of participants when they take a 401(k) loan in two words, "financial" and "stress" are probably just about right. Remember, the top five reasons to take a loan are simply to make ends meet, to pay off a credit card bill or credit card debt, to cover out-of-pocket medical expenses, to purchase a home, and to make home repairs—already stressful situations.

In the in-depth interviews, participants explained that stress is the reason it's hard to educate them about how the loan feature works at the time they need a loan. When they're financially stressed, most participants simply need their money as fast as possible. The majority (55%) say that more education would not have made them reconsider borrowing.

It's intuitive that access to the 401(k) should relieve stress, but it also introduces new stress: concern about being able to repay the loan. Respondents age 25-34 are the most concerned that they could not pay back their loan at all if they lost their job (69% for 25-34 vs. 48% for all ages). In addition, those who lost their job with a loan are more likely to be financially stressed.

Fortunately, there is a way to deal with this dilemma. Of the roughly seven in ten borrowers surveyed who report being financially stressed, over 80 percent say that automatic loan insurance would reduce that stress.

**Extent Financial Stress Would Be Reduced By Retirement Loan Insurance**




***"They were closing the plant. They laid off a bunch of people over a period of time, and he was one of the last crew that got laid off, so he still, of course, had the 401(k)."***

*– Wife of Stan, 62 years old, involuntarily separated and repaid loan*

> “Anybody can lose their job and wind up paying back all these penalties and everything. Why do I insure my house? Why do I insure my car? Protection. So if it was insurance protecting my financial assets, I think it’s very important.”
>
> *– Peter, 71-year-old male; involuntarily terminated, defaulted, and cashed out entire balance*

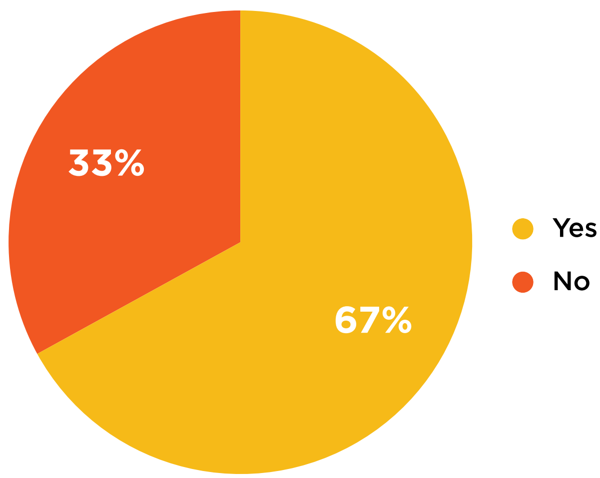
## Impact on Savings

AN AUTOMATIC LOAN INSURANCE SAFETY NET COULD ENCOURAGE GREATER SAVINGS.

The virtual ubiquity of the loan feature suggests that plan sponsors see its value in encouraging participation and savings, because participants know that they can access their money if they need to, while staying on track for retirement.

The participant sentiment in this survey was aligned with that notion, in that 67 percent reported that they’d consider contributing more to their plan if their employer were to enhance their safety net by adding automatic loan insurance. Currently, many borrowers reduce or even suspend entirely their savings after they take out a loan. These findings suggest that automatic loan insurance could help to reduce or reverse this behavior.

**Would Contribute More to Plan If There Was Loan Insurance**



# Implications for Plan Sponsors

## BORROWERS ARE SENDING A CLEAR MESSAGE TO PLAN SPONSORS.

These findings suggest several key implications for plan sponsors who are committed to addressing loan leakage, driving financial wellness and retirement readiness, and reducing employees' financial stress.

### Ensure a Strong Fiduciary Process

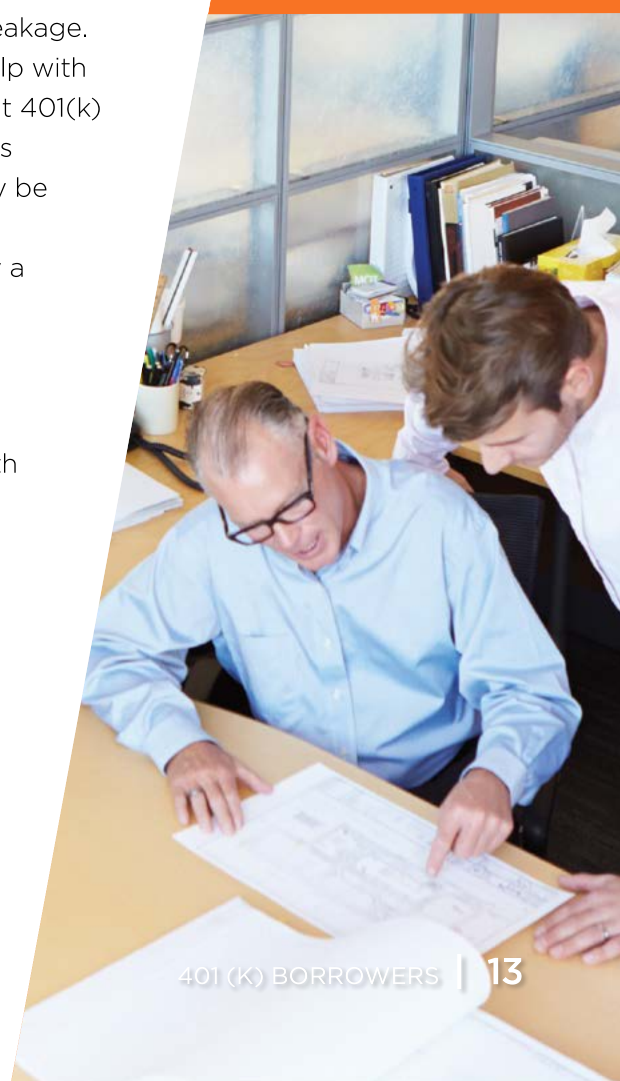
- The loan feature is important to participants; it should be important to fiduciaries as well. It's essential to have a strong handle on key loan feature benchmarks within the plan—such as loan volume, loan amounts and default rates.
- **Implication:** Ensure that the loan portfolio is a part of regular plan fiduciary reviews. First, because DOL regulations require participant loan programs be treated as any other plan investment, designed prudently with periodic performance monitoring and review; and second, because participants derive significant value from the loan feature.

### Optimize Plan Design

- Based on a strong endorsement by participants, plan sponsors should recognize the value of the loan feature—and the importance of maintaining and optimizing it.
- **Implication:** Investigate measures that would minimize loan default leakage. While alternatives such as a $500 or $1,000 emergency fund may help with small emergencies, they may be insufficient for the costlier needs that 401(k) borrowers are addressing. According to Vanguard, the average loan is $9,900[6]. Bear in mind that an extended loan repayment via ACH may be a suitable solution for some participants—particularly job changers—but does not solve for a cash-strapped participant's inability to repay a loan due to financial stress following a layoff or disability.

### Leverage Automatic Solutions

- Participants who are experiencing financial stress and borrowing from the plan are not "tuning in" to loan education, despite good faith attempts by plan sponsors.
- **Implication:** Given the challenges of educating participants in this situation, consider addressing loan leakage in an automatic fashion, such as the addition of built-in loan insurance. Automatic loan insurance can leverage the success of other "auto" features, such as auto-enrollment and auto-deferral increase, proven behavioral techniques.



[6] Vanguard, "How America Saves," 2019.

# Profile of In-Depth Interview Participants

| Borrower* | Industry | Household Income | Account balance (when loan taken) | Loan amount / % of bal. | Reason for loan | Separation | Loan Status |
|---|---|---|---|---|---|---|---|
| **Deidre, 58 years old** | Manufacturing | $50K-$75K | $10K-$12K | $5K (50%) | Essential everyday expenses, education | Voluntary: left for better job | **Defaulted** |
| **David, 57 years old** | Health care | $50K-$75K | $36K | $12K (33%) | Investment property | Voluntary | **Defaulted** |
| **Stan, 62 years old** | R&D | $125K-$150K | $400K | $32K (8%) | Boat purchase | Involuntary: plant closed | Repaid |
| **Abby, 53 years old** | Health care | $35K-$50K | $9K | $6K (67%)** | Medical bills | Involuntary: disabled due to medical condition | **Defaulted** |
| **Marcus, 46 years old** | Manufacturing | $75K-$100K | $7K | $4K (57%)** | Essential everyday expenses | Involuntary: disabled due to injury | **Defaulted** |
| **Jim, 37 years old** | Construction | $100K-$125K | $120K | $15K (13%) | Home purchase | Involuntary: laid-off | **Defaulted** |
| **Peter, 71 years old** | Health care | $100K-$125K | $130K | $30K (23%) | Education, home purchase | Involuntary: laid-off | **Defaulted** |
| **Chuck, 60 years old** | Retail | $25K-$35K | $40K | $40K (100%)** | Essential expenses | Voluntary: care for sick family member | **Defaulted** |
| **Laura, 57 years old** | Retail | $150K+ | $50K | $5K (10%) | Car purchase, start business | Voluntary: quit to start own business | Repaid |

* Names are for illustrative purposes only to protect anonymity.

** Borrowers are likely self-reporting incorrectly in these cases, as the IRS does not allow a participant to borrow more than 50% of his or her balance.

# Methodology

A QUANTITATIVE SURVEY WAS CONDUCTED ONLINE DURING AUGUST 2019.

**This report includes results from following report displays results from:**

- 500 respondents who have taken a retirement plan loan
- 96 respondents who lost their job with an outstanding loan
- 116 respondents who changed jobs with an outstanding loan

**The following screening requirements were in place:**

- Must have taken a retirement plan loan
- Must be employed, disabled, or unemployed but seeking work
- Must have participated in a retirement plan (401k, 403b, 457)

**Topics covered in the survey include:**

- Experience and circumstances surrounding retirement plan loan
    - Amount of loan
    - Sources used or would use to repay loan
    - Reasons for taking loan
- Familiarity with terms and conditions and concern with repaying the loan
- Appeal and receptivity of automatic loan insurance, consumer loans, and post-termination ACH option
- Appeal and receptivity to retirement plan loan education
- Demographics