



AMERICAN BENEFITS COUNCIL

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BACKGROUND ON H.R. 3656, THE RETIREMENT SAVINGS SECURITY ACT: WHY 401(K) PLAN LOANS DO NOT NEED CREDIT INSURANCE

A bill has been introduced in the House of Representatives that would default certain participants in 401(k) plans into purchasing credit insurance to cover the balance of their 401(k) plan loans. Payments for this credit insurance would come out of the participant's account each month as the loan is repaid.

The company advocating this insurance says that it is necessary to protect the participant and/or his or her heirs from the loss of retirement funds and payment of income or excise taxes on a defaulted loan repayment.

The need for this proposal is not supported by the arguments. Here are some reasons why.

- The vast majority of 401(k) plan loans are repaid in full and never default. Only a small fraction of 401(k) plan loans are not repaid and the failure to repay is seldom due to death or disability but to job loss or job changes. One large plan administrator estimated that over an 18 month period that of all loan accounts resulting in a "termination payout" (i.e. *default*), only 1.3 percent were due to death or disability. All other such payouts were due to termination of employment.
- There are extensive rules limiting 401(k) plan loans. They are designed to protect the retirement account and the participant while encouraging plan participation. Congress enacted these rules after lengthy public debate.
- Loans are limited to no more than \$50,000 or one-half of the account balance, *whichever is less*. In practice however, loans are much smaller than the maximum (see below).

- Loans must be repaid, within five years, be subject to a repayment schedule with a level amortization and made according to a legally enforceable agreement with a market rate of interest.
- Most loans are repaid through payroll deduction. While loans that are not repaid are treated as a distribution and subject to tax, companies can – and many have begun to -- allow repayment after an individual leaves employment. In fact, legislation has been introduced in the U.S. Congress to provide statutory protection for such loan repayment programs for these individuals by repayment to an offset IRA (*see*, S.1121(Kohl and Enzi) and H.R. 3287 (Sam Johnson and Richard Neal).
- Participants who are automatically defaulted into purchasing life and disability insurance because they took out a 401(k) plan loan would bear unnecessary costs and deplete more of their existing 401(k) accounts. Plan sponsors are under pressure from Congress to reduce costs for participants. This legislation would do the opposite and increase costs. Employers have reported that this proposal could expose them to criticism for raising costs with little or no benefit to the participant.
- Most large employers that sponsor 401(k) plans already offer group term life insurance to their workers, and many such employers also offer disability insurance. If 401(k) plan loan programs were likely to trigger a default purchase program for another layer of life or disability insurance in addition to that already maintained by those employers, the employer sponsoring the plan could be accused of violating its fiduciary duty to the participants by requiring participants to pay for excessive products and services.
- At the end of 2009, the average unpaid account balance was \$7,346 with the median loan balance outstanding being only \$3,972. Data from U.S. Labor Department (DOL) indicates that for 2007, loan amounts made up an extremely small percentage of total account balances. Similarly, DOL reported that only a small percentage of plan loans are ever converted to distributions, i.e. the vast majority are repaid-in-full. DOL's data suggests that plan participants take loans for modest amounts and are diligent regarding repayment.
- Unemployment or job change is the most common cause of 401(k) loan default. The proposal does not provide insurance against unemployment. Instead, it would default participants who take a 401(k) loan into the purchase of life and disability insurance as a protection against an extremely small chance of death or disability. As a result, the firm would have a captive audience to buy its product, but rarely make a payment.

This proposal is based upon a faulty theory, namely that huge numbers of workers default on 401(k) plan loans because they die or become disabled and cannot repay their loans. That is not correct. Defaults on 401(k) plan loans due to death or disability are extremely rare. The majority of defaults are due to job loss or job changes.

Plan sponsors are concerned that defaulting 401(k) plan loan participants into insurance to cover a very slender risk might be viewed as inappropriate and subject them to fiduciary challenges. The cost of this insurance would be borne by participants but would give them little to no benefit. This proposal will be even more problematic where sponsors already offer life and disability products or participants are otherwise protected.