Retirement plan leakage
Plan loan defaults can put participant retirement security and plan fiduciaries at risk

The majority of workers (53%) name a workplace retirement plan as a major retirement income source.\(^1\) Even though most workers are relying on these assets to fund their future financial security and many are worried about saving enough for their retirement years, research finds that some employees tap into these funds to pay current expenses and may find themselves unable to repay the loans. Defaulting on a retirement plan loan can have grave financial consequences — including steep penalties and tax consequences. Analysis by Deloitte estimates over a career a typical default can result in $300,000 in lost retirement assets.\(^2\) If job loss is also a factor, the loan default can also lead to the cash out of the borrowing employees’ entire account balance to repay the loan — which, in turn, may further diminish their retirement readiness.

While the majority of workers repay loans from their 401(k) plan with interest, defaulting on a loan has tax consequences and other penalties if they are under age 59 ½. And to make matters worse, if those who default decide to pull the rest of their balance out as well, there can be far reaching effects that some workers may not fully understand, such as:

- Tax consequences that may push the participant into a higher tax bracket
- Additional 10% financial penalty if the participant is under 59 ½
- Opportunity costs for lost investment returns and lost compounding over time

In addition, loan defaults may have an impact on an employee’s retirement readiness. For those workers who haven’t saved enough, delaying retirement may become necessary — which can limit advancement opportunities for other employees and impact your company’s benefits costs.

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\(^1\) Retirement Confidence Survey. EBRI, April 2018.
\(^2\) Loan Leakage — How can we keep loan defaults from draining $2 trillion from America’s 401(k) accounts? Deloitte, 2018.
The problem of plan leakage

Loan defaults are part of a problem known as retirement plan "leakage" which is defined as 401(k) assets lost prior to retirement, such as through borrowing without repaying the loan or taking retirement plan funds early. Although most participants who take a loan from their retirement plan account repay it, each year about ten percent of loans default according to a loan leakage study published by Deloitte in 2018. If this trend in plan loan defaults continues, the study suggests it could result in over $2 trillion in potential future participant account losses after 10 years, putting millions of participants’ retirement security in jeopardy, according to Deloitte.

Such losses may also put retirement plan fiduciaries at risk. Retirement plan loans are viewed as an investment and, as such, should not cause loss to the plan or diminish a borrower’s retirement income, according to the Department of Labor. Many plan sponsors, however, do not treat the plan loan feature with the similar fiduciary care and oversight as plan investments.

Defaulting on a retirement plan loan can have grave financial consequences — including steep penalties and tax consequences.
Plan loans offer easy access to retirement money

Defined contribution retirement plans like 401(k) plans are not required to offer loans but most do — almost 90 percent have a loan feature and 31 percent of plan sponsors allow participants to take two loans at a time. Employees can borrow up to half of their vested account balance to a maximum of $50,000, and the money must be paid back with interest within five years — with the exception of loans used for the purchase of a primary residence.

Getting a loan from a retirement plan offers an easier process compared to applying for one from a bank or other financial institution. The loan can often be completed with just a few forms with no credit information requirement. Repayments are typically automatically deducted from the borrower’s paycheck along with applicable interest, and because you are borrowing from your own savings, some may view a loan from their retirement plan to be an interest-free financing option. Plan loans are perceived as an attractive feature among plan participants. Many say they would save less in their retirement plan if pre-retirement loans and withdrawals were prohibited.

Twenty-six percent of workers have made a retirement plan withdrawal, and 42 percent anticipate that it’s likely they will need to use their retirement funds for expenses that are not related to retirement. At year-end for 2017, 20 percent of participants had an outstanding loan balance and nearly 40 percent held the loan over a five-year period.

Workers would contribute less to their retirement account if loans or withdrawals were prohibited during working years.

MILLENNIALS 59%  
GENERATION X 43%  
BABY BOOMERS 20%


3 Loan Leakage — How can we keep loan defaults from draining $2 trillion from America’s 401(k) accounts? Deloitte, 2018.
6 Loan Leakage — How can we keep loan defaults from draining $2 trillion from America’s 401(k) accounts? Deloitte, 2018.
A Chronic Problem

Often, dire circumstances drive participants to withdraw retirement money. According to the PWC’s Employee Financial Wellness Survey from May, 2018, over one in four workers have made a retirement plan withdrawal, and almost half anticipate they will likely need to use some of their retirement money prior to retiring. PWC’s research reports that the top reasons participants offer for taking an account loan include for use in the payment of unexpected expenses, medical bills, credit card debt, and education expenses.

Financial burdens can lead to retirement plan loans and loan defaults can lead to greater financial burdens. Money is the number one cause of stress for today’s workers — about half say financial matters cause them the most stress. PWC’s Employee Financial Wellness research reports that:

- Forty-nine percent of workers consistently carry a credit card balance and 41 percent say it’s difficult to make on-time minimum payments
- Thirty-seven percent have difficulty paying household expenses timely
- Nearly 1 in 3 use a credit card to purchase necessities they otherwise couldn’t afford

Rather than borrowing from their future financial security, savings set aside for emergencies would be the better financial resource to turn to for these types of expenses. Unfortunately, less than half (47%) of employees have emergency savings on hand for expenses should they find themselves out of work for an extended period of time, and over 60 percent do not have enough emergency savings to cover an unexpected expense of just $1,000. In addition, workers with student loans — which include almost 40 percent of Millennials and over 1 in 5 of Generation X workers — are overall found to be in worse shape financially than others. Financial pressures such as these are not exclusive to low-wage workers — research finds they are even prevalent among employees with incomes that exceed $100,000.

### Top 5 Retirement Concerns

- **40%** Running out of Money
- **33%** Health Issues
- **28%** Healthcare Costs
- **17%** Meeting Monthly Expenses
- **17%** Maintaining Standard of Living


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8 Taylor Tepper — Most Americans don’t have enough savings to cover a $1K emergency. Bankrate.com, January 2018.
10 ibid
The high price of borrowing

Despite easy access, there are downsides to borrowing from a 401(k). Plan loans can be difficult and expensive to administer for employers and some pass these costs on to borrowers. In addition to interest, other loan costs borrowers may be responsible for may include origination, administration and maintenance fees. Borrowers also risk losing potential compounded growth, and some may stop (or be required to stop) retirement plan contributions to compensate for the loan repayments — which can result in workers who are less financially prepared for their retirement years.

Nearly 40 percent of participants have used a retirement plan loan to fund current expenses, and although most borrowers repay their loans, each year ten percent of loans go into default.11 Until recently, retirement plan loans required repayment of the full outstanding balance immediately or shortly thereafter — typically within 60 days of voluntary or involuntary termination of employment, death or disability. However, concerns about leakage recently led to legislation for a longer allowable loan repayment period for loans taken after January 1, 2018. Now, borrowers who are fired or change employers have until October of the following year to repay owed outstanding loan money into their 401(k), an IRA or a 401(k) at a new employer. If the participant is unable to repay the loan, it is treated as a distribution with applicable tax consequences and early withdrawal penalties.

11 Loan Leakage — How can we keep loan defaults from draining $2 trillion from America’s 401(k) accounts? Deloitte, 2018.
Compounded effect of taking a loan

For workers without an income, such as those who terminate employment due to a layoff, defaulting on the plan loan can trigger the withdrawal of the remainder of their retirement account balance. Approximately two thirds of diminished retirement savings are attributed to leakage associated with cash-outs that result from a job change.\footnote{Loan Leakage — How can we keep loan defaults from draining $2 trillion from America’s 401(k) accounts? Deloitte, 2018.}

The compounded effect of a loan default is substantial — according to calculations by Deloitte Consulting, workers who borrow from the future pay a high price. A typical loan of $7,000 from a $70,000 401(k) account taken by a 42-year-old borrower can result in the loss of $300,000 in retirement assets at retirement age.

Loan defaults put plan fiduciaries at risk

401(k) loan default leakage also puts retirement plan fiduciaries at risk. Because the Department of Labor (DOL) considers loans an investment, they require that loans are treated with the same fiduciary oversight as other retirement plan investment options. Under this definition, the DOL states that plan loan programs should not cause loss to the plan or diminish a borrower’s retirement income. However, rather than taking prudent care over this fiduciary responsibility, many plan sponsors treat loans as an administrative burden they look to their plan recordkeeper to manage. Deloitte calculates the potential lost future account balances that result from 401(k) loan defaults to be in excess of $2 trillion over the next 10 years. Calculated at an individual level, this represents roughly $300,000 in diminished retirement income for the typical defaulting borrower over a career.\footnote{ibid} Plan sponsors who do not actively manage plan loan policies to prevent defaults and help protect retirement assets may unwittingly increase their exposure to fiduciary risk.
How employers can reduce loan defaults and fiduciary exposure

Empowering participants to gain control over their finances through education, coupled with prudent loan policies and sensible management of the plan loan feature may help keep retirement money in participant accounts for their intended purpose — retirement.

Help workers get financially well

Employers who make financial wellness programs available to workers can help reduce retirement plan leakage at the source and reduce the chances that loans turn into defaults and account cash outs. With few employees with adequate savings on hand to use for unexpected expenses, many could benefit from education programs that help them grow their knowledge and improve their financial skills. Rather than relying on retirement assets, emergency savings give employees an alternative to the potential risks involved with taking a plan loan and may help them keep money invested for future use. It’s also critical that employees considering taking a retirement plan loan fully understand the risks involved — and financial information and loan calculators can help them accomplish that.

Financial wellness programs are a powerful motivator to financial change for employees. Many find them helpful for overcoming financial challenges from everyday spending and debt management to saving for major goals and preparing for future financial needs.¹⁴

The power of financial wellness programs

44% CONTROL SPENDING

44% PREPARE FOR RETIREMENT

35% SAVE FOR MAJOR GOALS

33% PAY OFF DEBT

26% BETTER MANAGE INVESTMENTS

13% BETTER MANAGE AND/OR SAVE FOR FUTURE HEALTHCARE EXPENSES


Evaluate plan loan data and apply sensible loan policies

Because the availability of retirement plan loans is an attractive feature among plan participants, eliminating it in efforts to improve participant retirement outcomes may not be a practical solution. Instead, applying sensible loan policies along with prudent oversight of utilization may be an option that may help participants build retirement income and help keep plan fiduciary exposure from defaults in check.

How do you know if your plan has a leakage issue? A good place to start is with a detailed analysis of your plan’s loan activity to understand feature utilization. Are certain employees repeat borrowers? Are loan defaults and cash outs common? Is employee turnover a regular concern? Determine if plan loan provisions are too permissible and make changes if needed. Lowering allowable loan amounts, reducing the number of outstanding loans per participant, and enforcing waiting periods may help reduce the number of loans taken. Adding flexibility to loan payoff timeframes may also prevent loans from defaulting. And, certain employees who tap into retirement assets repeatedly may benefit from financial wellness targeted communications campaigns or participant investment advisory services.
Redefining retirement

ADP offers employers financial wellness solutions that are easy to manage from administration to participation through innovative, smart technology that engages employees in a meaningful way. Our solutions go beyond retirement to help participants better manage their money and reduce stress related to personal financial matters. When your employees benefit, so does your business — and that’s smart for everyone.

When you work with ADP, you get the long-term experience of a trusted provider who:
- Leverages innovation to help drive plan success
- Makes managing your plan and controlling administrative risk easy
- Puts you and your plan’s interests first because that’s the smart — and right — thing to do

Let's Talk.

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