Building a carefully constructed plan can help avoid common pitfalls

In recent months, the media has paid particular attention to loans and hardship withdrawals from 401(k) plans. This focus is most likely due to the ongoing market recovery and because some retirement plan service providers have reported that loans and hardships have reached an all-time high.

T. Rowe Price is not one of those providers. “Our numbers have been consistent,” explains Theresa Vondersmith, director of transactions for Retirement Plan Services. “We are not seeing an uptick in loan or hardship withdrawal activity.”

Recent quarterly figures support Vondersmith’s assessment. The number of participants initiating a loan in the second quarter of 2010 equaled 2.7% of the total participant base. In contrast, the number of participants initiating a loan in the second quarter of 2009 equaled 2.3% of the total participant base, which is not a significant difference from the previous year.

Similar evidence is available for hardship withdrawals. In the second quarter of 2010, the number of people taking hardship withdrawals was .46% of the total participant base compared to the .42% taken in the second quarter of 2009. Again, the numeric differentiation is not significant from year to year.

According to Vondersmith, the number of hardships taken in any given month is usually in the 2,000 to 2,500 range. Although, only 1,400 hardships were taken in February 2010 and 1,900 were taken in March 2010. She observes that the numbers are fairly consistent and notes that hardships are currently being taken for the usual reasons such as education or purchase of a primary residence.

Vondersmith feels that plan sponsors should continue educating participants about the impact a loan or hardship withdrawal could have on their account. Regardless of what the numbers say, she explains, the message is the same as it has always been. Sponsors should encourage participants to continue contributing and to avoid tapping into their accounts unless absolutely necessary.
EDUCATION AND PLAN DESIGN INFLUENCE DECISIONS

Many plan sponsors have started including basic financial planning as part of their participant education campaigns. While participant education plays a key role in avoiding potential spikes in the rate of loan initiation and hardship withdrawals, plan design is also an important consideration. “Education works best as a complement to thoughtful plan design,” explains Robert Sage, a senior relationship manager for Retirement Plan Services. “If you really want to influence behavior, however, you need to put some structure around the plan features.”

HARDSHIP WITHDRAWALS: WHAT TO CONSIDER

For many years, hardship withdrawals have functioned as the primary safety net for plan participants who encounter difficult financial circumstances. To help plan sponsors administer this feature, the IRS has defined a specific list of circumstances that automatically qualify for hardship withdrawals. Going outside of that list places a burden on sponsors to determine which circumstances qualify and which don’t.

An additional consideration regarding hardship withdrawals is leakage. When participants take money out of the plan for hardship, contributions are suspended for six months. This means that there is less money invested to grow over time. When reviewing plan design, sponsors need to keep in mind that hardship withdrawals are meant to be a last resort—only certain types of money are available and other resources must first be exhausted. When it comes to hardship withdrawal and loan features within a plan, Sage suggests that sponsors think about how easy it should be for participants to access the funds in their accounts.

LOANS: WHAT TO CONSIDER

Sage also suggests that sponsors consider the purpose of offering loans and their repercussions when determining how to structure the feature within the plan. Historically, loans have been offered as a method of encouraging participation—particularly among the non-highly compensated population. He identifies three consequences that should be on the mind of all sponsors.

1. Consistency. Participants borrow money directly from their accounts. Although the amount borrowed is still considered an asset of the plan, if a participant takes too many loans, repayment may become burdensome. Additionally, many participants who take loans stop making contributions. Sage points out that even if the participants are paying their accounts back with interest, it is generally not enough to last throughout retirement.

2. Default. Participants must follow a strict loan payment schedule. If they don’t, the loan can go into default and the outstanding balance becomes taxable. Most employers rely on automatic paycheck deductions for employees to make their payments and following the payment schedule for the entire term of the loan can be especially challenging for workforces with high turnover rates or variable pay.

3. Tax considerations. When paying back a loan, the interest payment comes out of the participant’s paycheck after taxes. This means that there is no tax deduction for that interest payment. If the money was borrowed from a pretax source, the interest payment goes back into that source and may be taxed again at the time of distribution.

BEST-PRACTICE CONSIDERATIONS

In light of the consequences outlined above, Sage suggests that sponsors consider whether loans are truly necessary at all. In today’s environment of automatic enrollment and safe harbor plan designs, loans are no longer necessary to entice employees to participate in the plan.

“Clearly, there may be a legitimate need for plan money that outweighs the need to save it for retirement,” Sage explains. “But that is why the hardship withdrawal exists.” He concludes that the most optimal solution would be to eliminate the loan feature altogether. But he knows such a course of action is not always feasible. The more palatable solution, he says, is to structure the plan design so that it allows employees to access the money while discouraging overuse. The following best-practice suggestions offer some basic parameters for that structure:

- Limit number of concurrent outstanding loans to one.
- Establish a minimum loan amount of $1,000.
- Adopt the IRS definition of “hardship.”
- Automatically resume participant contributions after the end of a hardship suspension period.

Additionally, Sage suggests that sponsors also consider limiting the type of money that’s available for loans and hardship withdrawals (employee contributions only, for example) and including a mandatory waiting period between loans. He asks that sponsors keep in mind that the plan’s function is not to serve as a savings or checking account. It is designed and regulated to help participants save enough to last throughout retirement.

FINAL THOUGHTS

Now may be a good time to review your plan’s design. Consider making changes to your plan based on the best-practices suggestions provided here and continue educating participants on loan consequences. “A combination of education and plan design,” concludes Sage. “That’s what helps put your participants in the best possible situation.”

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