STATE OF WISCONSIN
DEPARTMENT OF EMPLOYEE TRUST FUNDS
801 West Badger Road
Madison, WI 53702

CORRESPONDENCE MEMORANDUM

DATE: October 24, 2002

TO: Deferred Compensation Board Members

FROM: Mary Willett, Director

SUBJECT: Informational Item - Participant Loans

At the last meeting, staff informed the Board that the proposed Section 457 regulations that were released last May set forth specific requirements on the administration of a loan option in a government Section 457 plan. As a result of this, staff noted that the Board could consider offering loans in the Wisconsin Deferred Compensation Program (WDC) to provide participants with the ability to borrow assets from their account. This memo provides background on this issue, describes the pros and cons of adopting a loan feature, and explains how this would be administered in the WDC.

Background

Prior to the proposed 457 regulations, it was unclear if the trust requirements (resulting from the 1996 Small Business Job Protection Act) created an opportunity for these plans to offer loans as allowed in other types of qualified retirement plans, such as 401(k) plans. Now the regulations clarify that this is an optional provision in government Section 457(b) plans, and the Board can consider this for the WDC. In the past, we have provided participants as much discretion and flexibility as possible within the mandates of governing federal and state laws.

The current contract with NRS (Article V., 5.7 J.) requires them to administer a loan provision if adopted by the Board. The specific administrative requirements and costs are detailed in the 1997 proposal for services. NRS has not yet confirmed if they would propose any changes to their 1997 loan administration procedures or participant fees. The participant fees outlined in the current NRS contract are as follow:

- $50 application fee
- $2 per deduction for payroll repayment
- $5 per payment if made by check (plus any bank assessed not sufficient funds, NSF, charges if checks returned)

Provisions of 457 Proposed Regulations

Under the proposed 457 regulations, only eligible government 457(b) plans can adopt loans pursuant to Internal Revenue Code Section 72(p), which regulates loans in all types of qualified retirement plans. If adopted, loans must be for the exclusive benefit of the participant or beneficiary. Even though the participant is borrowing from his or her own money, with the loan amount being deducted from the account and repayments (principal plus interest) being reapplied, it must be a bona fide loan process. This means that there must be an application procedure, with an approval and denial process, and an expectation that the participant can fulfill the repayment plan.

Loans are not bona fide and will be considered a distribution to the participant unless the following criteria are met:

- The loan plan must include safeguards to require repayment as would be required by any other prudent lender, with an enforceable agreement and repayment schedule
- A fixed payment schedule must be established with the balance repaid within 5 years except for loans for a home (principal residence)
- Participants must be required to make loan repayments at least quarterly

Under Section 72(p), the loan amount cannot exceed the lesser of $50,000 (in total outstanding loans from all plans) or 50% of the deferred compensation account balance. A reasonable interest rate must be assessed, which is usually set at prime plus 1%. If a participant fails to make scheduled repayments, or terminates employment with an outstanding loan and does not repay the balance into the account within a specified period of time, the remaining balance of the loan is in default. Loans that are in default are treated as a distribution and the outstanding balance is considered taxable income to the participant in that year.

Considerations "For" and "Against" Loans

As previously noted, offering loans is a permissive feature, and there is no requirement that they be made available in the WDC. The following provides information regarding the reasons for and against offering loans in a supplemental retirement plan.

The arguments "for" offering loans:

- It encourages employees to participate at a younger age if they know they can access their money if needed (e.g., for purchase of home, child's education, etc.) through a loan from their account balance.

- It can be argued that some participants will contribute larger amounts to their deferred compensation account if they know they have access to the funds via loans should the need arise.

- Older participants may find a loan from their account desirable to help plan for retirement before terminating employment, such as to supplement income during a bridge job or to help purchase a retirement home.

- Participants who do not qualify for a financial hardship withdrawal under Section 457 may be eligible for a loan to meet a current financial need.

The arguments "against" loans:

- This is a retirement benefit, not a bank account and participants will not have the money when they need it…at retirement.

- Drawbacks of loans can be complicated to explain. These are: 1) the cost of the lost investment opportunity; 2) income used to repay loans is after-tax; and 3) an outstanding loan balance becomes a distribution and is fully taxable at termination.

- There is more paperwork and plan administration is more complicated, which can result in additional administrative cost.

Loan Features

Should the Board adopt a loan provision in the WDC, the following illustrates possible administrative features:

- All participants will be eligible to request a loan; the minimum loan amount is $1,000 and the maximum is 50% of account balance up to $50,000 *(any other outstanding loans through an employer-sponsored plan must be considered when determining this maximum).*

- Participants must complete a loan application and demonstrate repayment capabilities, pay an application fee and acknowledge receiving a *Truth in Lending* document.

- Loans are repaid with after-tax income over a period of five years or less, and payments include interest at prime + 1%; the full payments are re-deposited into their WDC account.

- Loan payments must be made at least quarterly but can be made as often as each pay period through payroll deduction; payments can also be made by check or Automated Clearing House (ACH) wire transfers.

- Participants can only have one outstanding loan from their WDC account.

- Loans are in default if a participant misses a scheduled payment and does not pay the past due amount, including interest, no more than 30 to 90 days of due date (federal tax laws require one payment per quarter). The outstanding loan balance will be a deemed distribution and subject to federal and state tax; participant will be ineligible for any future loans.

Steps Necessary to Implement Loans in WDC

If the Board should decide to adopt a loan provision in the future, amendments to the Wisconsin Plan and Trust Document will be necessary to set forth the policies and procedures regarding loan administration. In addition, amendments to the NRS administrative services contract may be necessary.

NRS would be responsible for providing participants with information about the loan feature (e.g., written material, one-on-one contacts and group presentations). They also would approve or deny loan applications, administer repayment activities, as well as determine loan defaults and issue necessary tax forms. A well-planned communication effort would be needed to clearly explain to participants how borrowing from their WDC account could affect their future retirement income.