The Inconvenient Truth of Fiduciary Loan Regulation

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Many plan sponsors falsely believe that loan defaults do not merit fiduciary attention. Yet the Employee Retirement Income Security Act characterizes plan loans as investments, requiring care and prudence to meet the fiduciary standard. With all the litigation targeting defined contribution plans, now is a good occasion for plan sponsors to re-evaluate their loan practices.

Plan sponsors have historically treated loans as an administrative program, outside the boundaries of fiduciary standards and review. They drafted loan policies in line with ERISA, collected payments from employees, and monitored the level of plan loans. They understood that participants stopped making loan payments after separating from service, but assumed their obligations were met when loans were defaulted after collections notices went unanswered.

The Department of Labor (DOL) takes the position, however, that a participant loan is a plan investment, and requires the same fiduciary oversight as any other investment in the plan.1 This article focuses attention on loan defaults, and challenges plan sponsors to reconsider the circumstances and their responsibilities related to the handling of participant loans and their default. The retirement losses created by these circumstances have substantial fiduciary implications.

LOANS ARE A PLAN INVESTMENT

Section 401(k) loans form an ever-growing asset in America’s corporate retirement plans. Although these loans are typically secured by the participant’s individual account balance, a participant loan is a loan from the plan itself, similar to a bank extending credit to a borrower. While retirement plan sponsors have not historically viewed participant loans as plan investments for which they have fiduciary responsibilities, this traditional “hands-off” practice is not supported by ERISA.

All assets in a 401(k) plan are owned and controlled by the plan (through an authorized fiduciary) until they are eventually distributed. The ERISA regulations themselves characterize plan loans as investments of the plans. The Asset and Liability Statement of Form 5500 Schedule H treats participant loans as investments of the plan in the same manner as any other plan investment. In addition, the DOL has consistently taken the position that participant loans, like any other plan investment, are subject to the fiduciary responsibility requirements of ERISA. For example, DOL has maintained that a “reasonable” rate of interest for a participant loan is to be determined based on the rate a commercial lender would charge for similar loans.

Loans are not negligible plan investments. Loans are used by 20% of plan participants at any one time and 40% over a five-year period, more often than many traditional investments.2 An independent fiduciary, or individuals or companies holding themselves out as experts, would be expected to consider any such material plan investments as being subject to periodic fiduciary review. ERISA imposes the same prudent investment criteria that apply to other plan investments despite the market regularly treating loans otherwise.

INVESTMENT DUTIES REQUIRED BY ERISA

ERISA §404(a)(1)(B) requires that fiduciaries “discharge their duties with respect to a plan with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would

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use,” otherwise known as the Prudent Man Rule. Loan programs are not excluded from this prudence requirement.

The regulations specifically require investment fiduciaries to review the factual circumstances of any investment, including the role the “investment course of action” plays in the plan’s investment portfolio, and then to “act accordingly” given those facts and circumstances.

A fiduciary’s purpose in conducting the review is to ensure that an investment will “further the purposes of the plan.” The plan’s purpose under ERISA and the Code is to provide participants a retirement benefit. Loan programs, as plan investments, are thereby required to be reviewed in this light. The DOL itself has stated that a loan program should only be permitted under circumstances that are not likely to diminish the borrower’s retirement income or cause loss to the plan, and that plan fiduciaries “must assess and monitor loan programs.”

One is compelled to ask whether fiduciaries who routinely approve participant loans under circumstances that are likely to result in default (such as prior to, or during an employee layoff program), without informing participants of circumstances that might impair their ability to repay plan loans, or who apply mechanical loan offsets to retirement plan accounts with no effort to otherwise protect the retirement benefit, will meet this fiduciary standard.

LOANS MUST PERFORM LIKE OTHER INVESTMENTS

When a plan provides for a participant loan program, the plan’s fiduciaries should (as noted above) determine commercially reasonable interest rates to ensure that loans earn a sufficient rate of return for the plan.

DOL guidance states, “a participant loan as a plan investment would not be prudent if it provided a plan with less return, relative to risk, than available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return.” Whereas setting a rate too low would limit the opportunity for gain, using an interest rate tied to the prime lending rate (a common practice) shows recognition that loans need to perform in a comparable fashion to other plan investments. In fact, loan interest as measured by the prime rate plus 1% actually outperformed the Vanguard Total Bond Market Index Fund in four of the past five years (and outperformed the Vanguard 500 Index Fund as recently as 2015).

Given these facts, a fiduciary review should also take into account the risk of loss. Losses occur when loans default, yet this information is seldom if ever reported to plan fiduciaries. A detailed 2017 study provides more information. Borrowing from the Future: 401(k) Plan Loans and Loan Defaults found that fully 10% of loans from qualified plans default each year, equal to $5 billion excluding taxes, penalties, and lost earnings, and that virtually all loan defaults occur upon job separation (92%). Even though participant loans must be adequately secured, what prudent fiduciary would accept such risk from plan investments, especially considering the resulting plan leakage once the offset takes place?

Approving loans with a commercial rate of interest positions a plan for gains, but only if the plan is able to collect on the loan. A 10% default rate negatively impacts the interest plans collect from loans, and further harms the plan’s ability to provide a retirement benefit. A mass layoff raises additional concerns around disclosure and whether participants fully understand the risks they are taking.

Assessing the risk also involves taking a look at the practical impact of how loan programs operate. While loans are available to all participants, they are disproportionately made to lower paid employees. An increased turnover at these levels leads to a higher concentration of defaults, a lower rate of return, and ultimately reduced retirement benefits for the affected group.

CURRENT PRACTICES IGNORE LOANS

Existing practices involving collections and default notices, particularly to those who have lost their incomes, yield little protection to the retirement benefit the fiduciaries are bound to preserve. The risk of fiduciary liability becomes especially pronounced where news of a corporate layoff can be anticipated to result in participant losses totaling hundreds of millions of dollars from loan defaults, taxes, penalties, and lost retirement income accumulation.

Some plan sponsors have instituted limits on the number of plan loans participants can take, which, to

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3 All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.
4 DOL Adv. Op. 95-17A.
5 DOL Adv. Op. 81-12A.
8 Id.
be sure, will reduce the number of defaults. However, it is important to note that a reduction in loan access has the unintended consequence of increasing hardship withdrawals, causing immediate and permanent plan leakage. Moreover, a smaller pool of loans will not improve the interest actually collected by plans, particularly with respect to loans taken by lower income employees. Other plan sponsors have begun to allow participants to make post-separation repayments, though this feature has yet to demonstrate any meaningful take up to reduce loan defaults.

An evolving option for plan sponsors to mitigate losses is loan insurance. When a plan sponsor adopts loan insurance, a participant loan is automatically covered at the time of borrowing, and in the event of an involuntary separation the loan is repaid before default and the imposition of taxes and penalties.

TIME TO RE-EVALUATE LOAN PRACTICES

It is time for plan sponsors to re-evaluate their loan practices. Is it sufficient to make loans available and simply record gains and losses in the accounts of plan participants? Or should the high rate of defaults and the subsequent material negative impact to participant accounts attract the attention of plan fiduciaries, whose job it is to implement policies to protect the retirement benefits provided by the plan? Not surprisingly, there is already class litigation regarding the fiduciary practices related to plan loans. It is only reasonable to expect further litigation over loan programs going forward.

ERISA §404(a)(1)(B) requires that fiduciaries review the factual circumstances of any investment. A fiduciary’s purpose in conducting the review is to ensure that an investment will “further the purposes of the plan.” Plan fiduciaries would be wise to review their loan portfolios as actual plan investments to ensure they preserve the funds entrusted to them under ERISA.

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