STATE OF WISCONSIN
Department of Employee Trust Funds
Eric O. Stanchfield
SECRETARY

801 W Badger Road
PO Box 7931
Madison WI 53707-7931

1-877-533-5020 (toll free)
Fax (608) 267-4549
TTY (608) 267-0676
http://etf.wi.gov

CORRESPONDENCE MEMORANDUM

DATE: May 4, 2007

TO: Wisconsin Deferred Compensation Board

FROM: Katie Schultz, Department Intern
Shelly Schueller, Director, Wisconsin Deferred Compensation Program

SUBJECT: Participant Loans

As clarified in federal regulations in 2002, deferred compensation plans such as the Wisconsin Deferred Compensation Program (WDC) may choose to offer loans to participants, provided that Internal Revenue Code section 72(p) requirements are followed. This memo describes the pros and cons of adopting participant loans, and provides suggestions on how loans could be administered in the WDC, if the Board were to adopt a participant loan provision. The Board has not discussed participant loans since the November 2002 Board meeting, when the Board decided not to pursue including this feature in the WDC.

The Department receives between three and five WDC participant letters requesting participant loans each year. One of the most recent requests, which came from the Dane County Employee Management Insurance Advisory Committee, is included in the miscellaneous section of the May 2007 Board meeting packet.

Federal Regulations
Eligible s. 457(b) government retirement plans may provide loans to participants if the plans abide by Internal Revenue Code (IRC) section 72(p). Section 72(p) regulates loans in all types of qualified retirement plans. The attached leaflet “Defined Contribution Plan Loan Basics” from the National Association of Government Defined Contribution Administrators (NAGDCA) provides a high level overview of s. 457 plan loan requirements. Under the IRC, tax-free loans from s. 457 plans may be made, as long as they are for the exclusive benefit of the participant or beneficiary. Even though a participant may be borrowing from his or her own account, with the loan amount being deducted from the account and repayments (principal plus interest) being reapplied, there must be a real, 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.

Reviewed and approved by David Stella, Deputy Secretary

Signature ______________________ Date __________

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A loan will be considered a taxable distribution to a participant unless the following criteria are met:

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

Under section 72(p), a 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 the prime rate plus 1%. If a participant fails to 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.

National Experience

Many s. 457(b) plans nationwide have added the option to provide participant loans. States such as Colorado, Maryland, Texas, California (CalPERS), Michigan and Tennessee, as well as some larger cities and counties offer participant loans programs through their s. 457 plans. According to the results of the 2006 NAGDCA survey, 32% (12 of 40) state s. 457 plans responding to the survey have adopted a loan provision[1]. Of these states, 75% report that less than one percent of their total plan assets are currently used in loans.

Data on the use of participant loan programs, as collected by NAGDCA, is limited and varied. Some plans permit participants to continue deferring to the plan, even while the participants are paying off a loan, while other plans do not. The State of Tennessee's program offers a plan match in an effort to encourage participants to continue to defer. Other plans have a mandatory participation policy. The data also indicates that many participants take out a new loan as soon as they pay off their original loan. All of the programs charge fees for application, processing and maintenance.

Considerations "For" and "Against" Participant Loans

As previously noted, participant loans are optional; there is no requirement that s. 457 plans must offer them. The following table provides additional information regarding the reasons for and against offering participant loans.

Pros and Cons of Offering Participant Loans	
Points For Offering Loans	**Points Against Offering Loans**
• Offering loans may increase participation rates, as participants may be more inclined to choose to defer to the plan if they know they can access their money via a loan if needed.	• S. 457 plan loans are made with pre-tax money, while loan repayments are made with post-tax money.

[1] NAGDCA 2006 Biennial State and Local Government Defined Contribution Plan Survey

Pros and Cons of Offering Participant Loans	
Points For Offering Loans	**Points Against Offering Loans**
• Participants may be encouraged to defer greater income because they know they can access it in the future.	• The amount of interest a participant pays on a plan loan may be less than the amount of interest it could have earned – or the opportunity cost – had the money remained invested during that time.
• Participants pay interest to themselves instead of an outside lender.	• Participants may stop or decrease contributions to their account as they try to pay off the loan balance, further reducing their retirement savings and potential investment earnings.
• Offering loans may help decrease the need for emergency hardship requests because participants are able to access their accounts via a loan instead.	• If the participant is laid off or retires, any outstanding loans quickly become due. Any outstanding loan balance at termination is taxed as a distribution.
• Offering loans may help a plan's overall competitiveness in the marketplace.	• Participants will not have the money when they need it -- at retirement.
	• Because of additional paperwork and potential complications, may result in higher overall plan administrative costs.

Plan Providers' Opinions
Section 457 plan providers responding to NAGDCA's 2005 survey on loans provided the following comments on participant loans[2].

- "Loans are time-consuming to administer." – California Savings Plus Program
- "I do think it improves participation, but some people get loans too often and end up in trouble." – State of Michigan
- "They don't have a major impact on the plan either way. It gives participants some comfort to know that they are available and provides relief to [the] hardship committee." – State of Tennessee
- "It was suggested by our record-keeper that hardships would decrease when loans were implemented. We have not seen that happen. I think offering loans is contradictory to the purpose of contributing for the long term." – State of Colorado
- "I think the bad points outweigh the good. Our participants tend to use it was a credit union, with no thought to their retirement fund. Administratively, it has become a full time job for loans!" – City of Philadelphia
- "Like hardships, loans reduce reluctance to participate initially and usage is commonly discouraged. We could use better communications to illustrate the long-term reduction of plan accumulations due to loans/hardships." – State of Maryland

[2] http://www.nagdca.org/resources/Loan%20Survey%20-%20August%202005.xls

Section 457 plan administrators clearly have mixed feelings regarding offering participant loans. While there is some recognition that loans may help increase participation, plan sponsors remain concerned that participants fail to recognize the long-term costs of taking loans from their deferred compensation accounts. In addition, offering a loan provision is acknowledged to create an increase in a plan's administrative burden.

Administration

If the Board should decide to adopt a loan provision, amendments to the Wisconsin Plan and Trust document would be necessary to explain loan policies and procedures. If the Board decided to offer participant loans, Great-West Retirement Services (GWRS) could administer them under the current administrative services contract. GWRS would be responsible for approving or denying all WDC loan applications, administering repayment activities, determining loan defaults and issuing necessary tax forms.

As administered by GWRS, loans could be available for amounts between $1,000 to $50,000. Participants would need to have at least $2,000 in their account balance to request the minimum $1,000 loan. Each participant would pay a loan origination fee of $50 and an administrative fee of $25 per year per loan from their WDC accounts.

GWRS would also be responsible for providing participants with information about the loan feature, via written publications, the WDC Web site, the call center, one-on-one contacts, and group presentations.

Conclusion

Department staff will be available at the meeting to discuss participant loans. If the Board were to decide to include a loan feature in the WDC, staff would draft proposed Plan and Trust document revisions and work with GWRS to ensure a well-planned communication effort is created that clearly explains to participants how using a loan to borrow from their WDC account could affect their future retirement income.

Attachment