STATEMENT FOR THE RECORD

OF

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FOR THE HEARING ON

"TAX REFORM AND TAX-FAVORED RETIREMENT ACCOUNTS"

BEFORE

THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS & MEANS

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Thank you for the opportunity to submit this statement for the record. We applaud the Committee for its leadership on tax reform and retirement security issues.

Retirement security is an important policy objective. Done properly, comprehensive tax reform offers the opportunity to achieve the goals of simplification, efficiency, and strengthening retirement and financial security for American families.

In the interim, we want to ensure the Committee is aware of an issue that requires more immediate attention. As other sources of credit have become scarce for American families, more and more are turning to their defined contribution plans and accessing their retirement savings to meet emergency cash needs. American families lose billions of retirement savings annually due to defaults on these loans as a result of death or disability. This easily avoidable loss of retirement savings is growing rapidly and is the result of the current policy framework that does not ensure access to insurance or debt protection options to plan participants.

THE PROBLEM

Approximately 90 million Americans participate in defined contributions plans, including 401(k) plans.[1] More than 85 percent of these plans allow participants to borrow from plans.[2] Plan loans are preferential to an early withdrawal and allowing participants to borrow from such plans has had a positive effect in increasing participation levels and contribution amounts.

However, due in large measure to recent economic events, the incidence of participants borrowing from their accounts has dramatically increased.[3] The borrowed funds are largely being used by plan participants to assist in meeting emergency financial obligations, such as to mitigate the impact of unemployment, to make mortgage payments and prevent foreclosure, or to pay medical expenses. 28 percent of all allowed participants have elected to take loans.[4] However, the borrowing rate is higher for those of more modest incomes and among minority groups.[5] Additionally over a quarter of borrowers have multiple loans outstanding.[6]

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[1] U.S. DEPARTMENT OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, ABSTRACT OF 2009 FORM 5500 ANNUAL REPORTS (Dec. 2011).

[2] CONGRESSIONAL RESEARCH SERVICE, AN ANALYSIS OF BORROWING FROM DEFINED CONTRIBUTION RETIREMENT PLANS, R40828 (Sept. 22, 2009).

[3] ARIEL/AON HEWITT, LEAKAGE OF PARTICIPANTS' DC ASSETS: HOW LOANS, WITHDRAWALS, AND CASHOUTS ARE ERODING RETIREMENT INCOME (2011).

[4] *Id.*

[5] Loan frequency peaks among those with incomes between $30,000 and $89,999. Nearly 50 percent of all African-Americans and 40 percent of Hispanics, compared to about a quarter of whites and Asian-Americans, carried a plan loan balance in 2010. ARIEL/AON HEWITT, 401(K) PLANS IN LIVING COLOR: 401(K) PLANS IN LIVING COLOR: A STUDY OF 401(K) SAVINGS DISPARITIES ACROSS RACIAL AND ETHNIC GROUPS (2012).

[6] ARIEL/AON HEWITT, LEAKAGE OF PARTICIPANTS' DC ASSETS, *supra* note 3.

Outstanding loans present a considerable risk to retirement security, as the consequences for an unprotected borrower are significant. The unfortunate reality is that, from time to time, participants with outstanding plan loans die and become disabled. If a borrower does die or become disabled without this type of protection, the borrower would be required, within 60 days, to pay back the outstanding balance or have the entire amount treated as an "early withdrawal" from the plan. This forced early withdrawal immediately becomes a liability for the borrower at the state and federal income tax levels. Regrettably, in most instances, borrowers or their beneficiaries are left with no alternative other than using their remaining account balances to cover the resulting tax liability, thus eliminating the pre-tax accumulation of the plan for retirement.

Exacerbating this problem, defined contribution plans are tax-advantaged and are governed by the Employee Retirement Security Act ("ERISA") which, under present law, effectively dissuades plan sponsors from embracing private market solutions for fear of litigation. Providing legal certainty would ameliorate this issue.

THE SOLUTION

Insurance or debt protection could mitigate the leakage of retirement savings that occurs as a result of borrowers' death or disability. Unfortunately, the current policy framework does not ensure access to such coverage.

However, H.R. 3656 presents a solution to this problem. Mirroring the auto-save features of the highly successful and bipartisan Pension Protection Act,[7] this legislation would amend the Internal Revenue Code ("Code") so that defined contribution plans may elect to provide automatic enrollment for plan participants into loan life and disability insurance or similar protection. The bill also provides plan sponsors with an incentive to incorporate auto-enrollment options by affording greater legal certainty as a safer risk path than what currently exists. If enacted, this modification to the Code would create a mechanism to assist millions of plan participants by providing the option to protect their retirement savings from the adverse consequences of loan defaults.

Under the proposal, if a plan chooses to automatically enroll participants into coverage, a borrower may elect to decline ("opt-out of") this protection. This protocol ensures guaranteed coverage at the most affordable cost available and is issued at the time the emergency loan is initiated. With coverage in place, in the unfortunate event of death or disability of the borrower with an outstanding loan, the insurance provider would repay the full amount of the loan balance as well as an amount sufficient for the borrower or beneficiary to pay any accompanying Federal tax liability as a result of the deemed distribution or early withdrawal. Upon a participant's affirmative decision to borrow and

[7] Research has widely demonstrated that plan participation rates have increased significantly as a result of the auto-enrollment provision contained in the Pension Protection Act. Enrollment in plans has increased significantly among younger and lower-paid employees and the participation gap has decreased among racial groups among employees subject to auto-enrollment. For these reasons, some commenters have recommended building on this success and expanding auto-enrollment into other areas. *See, e.g.,* ARIEL/AON HEWITT, 401(K) PLANS IN LIVING COLOR, *supra* note 5.

access coverage, the protection afforded would provide repayment and avoid loss of retirement savings. This repayment would avoid loss of retirement savings by effectively replenishing the borrower's account balance. Thereafter the borrower or his or her beneficiary would have the same options currently available to them under current law (*e.g.*, a rollover of the plan balance to an Individual Retirement Account ("IRA")). This legislative solution is budget neutral in that it does not require new federal spending to implement. Moreover, it provides a private market "backstop" provided by an efficient market with various providers that would ensure taxes are paid on the loan proceeds deemed to be a distribution.

The proposal would also encourage plan fiduciaries to take the costs of protection into consideration when determining the interest rate to be charged on loans. Allowing plans to offset the cost of the optional coverage to borrowers would still deliver a healthy rate of return on a protected loan. This solution does not create any undue imposition on plan sponsors and actually maintains current operational and distribution protocols. In addition, this broadly supported solution would create thousands of new jobs and provide an estimated $5 billion plus of new overall economic impact.

CONCLUSION

Current policy fails to include a provision for loan insurance or debt protection options, exposing plan participants to significant risk of loss of retirement security. As recommended in the 2012 Ariel/Aon Hewitt Study, in recognition of the stress faced during difficult economic times, public policy should "allow retirement plan participants to weather short-term economic hardship without compromising their financial future."[8] We strongly urge Congress to consider H.R. 3656, which would provide a solution to this problem and strengthen retirement security.

We greatly appreciate the opportunity to submit this statement. We are pleased to be a resource to the Congress, the Committee, and the Subcommittee on these and related matters. We look forward to our continued work together on these important issues.

[8] *Id.*