Loan Default Background

Employee 457 loans are paid directly to the Plan Administrator by the employee, typically a monthly ACH deduction from their checking account.

Monthly we review the plan administrators delinquent loan report and contact employee's with past due loans, the plan administrators notifies the employee as well. We have a few instances where employee's take a loan and don't make any payments. My main concern is employees may be taking loans so they can get access to their 457 funds. The only way for an employee to get funds from the plan prior to retirement is to take out a loan or apply for an emergency hardship.

The IRS takes a very dim view on loan defaults. Loans are one of the first items look at in an audit. Loans have very traceable information and fiduciaries are usually lax with loans. Our loan defaults as a percentage of total loans are not at a level to be questioned by the IRS, however it's in our best interest to maintain some control.

The plan could lose its pre-tax status and be disqualified as a 457 plan if we do not monitor and control loans properly. The following chart is a list of loans with each Plan Administrator.

	MassMutual	ICMA	Nationwide
Number of Loans	314	122	89
Loans in default	23	7	0
% in default	8%	6%	0%

Currently, we allow employees who have defaulted on a prior loan to get another loan. The following formula is used to compute the funds available in the event of a loan default; the account balance minus the defaulted loan amount, the employee can get a maximum of 50% of the sum. There have been incidences where employees who have defaulted on one loan also defaulted on subsequent loans.

Due to the risk associated with 457 plan regulations for loans and a potential disqualification of the plan from tax free status (which would trigger a taxable event for all participants) it is suggested that employees who have defaulted on a loan not be allowed to get a second loan during their employment with the city.