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Outsourcing as a Means to Enable Efficient 401k Loans Processing

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The U.S. sub-prime crisis is not news anymore. However, the circumstances have gone to another extreme in recent times. With the take-home earnings taking a dip, and overtime wages being scrapped in most organizations, workers have started tapping their 401k accounts, which are otherwise intended to serve as the retirement nest egg. 401k funds are portions of paychecks typically matched by employers that are meant to grow tax-deferred continuously until the retirement age. These accounts hold important and final savings for the future. Accessing 401k funds, which should be the last resort for employees, is being dipped into in the light of the current U.S. economy.

There are two ways that cash can be taken out from a 401k account: A 401k loan or a withdrawal.

Consequences of 401k withdrawal: Most employers set 401k withdrawal rules with guidelines circulated by the Internal Revenue Service as to what the funds can be used for. Certain factors that qualify a participant for 401k hardship withdrawal are:

- To pay education expenses for self, spouse, or child
- To prevent foreclosure or eviction from their home
- To pay for medical expenses that are not reimbursable
- To buy a first-time residence

All 401k hardship withdrawals are subject to taxes and the 10 percent penalty if withdrawn before the age of 59 and half. This means that a USD 10,000 withdrawal can result in significantly less cash in the pocket (approximately as little as USD 6,500 or USD 7,500 if one is in a high income tax bracket). Also, the opportunity for those assets to grow tax-deferred is lost. 401k hardship withdrawal proceeds cannot be returned to the account once the disbursements have been made, and most plans prohibit contribution for six months after the withdrawal. As a result, one is suspended from making 401k retirement contributions for six months. The further taxes on the amount are incurred since IRS requires that the amount withdrawn be reported as gross income.

"According to a report, 45 percent of participants who took a hardship withdrawal a year ago, took another one this year," said Beth McHugh, Vice President, Fidelity Investments, on 401k withdrawals. The number of people taking fresh withdrawals for financial hardship thus increased to 2.2 percent from 2 percent a year earlier.

401k Loans: The other option is taking a 401k loan. Workers are inclined toward these loans as they find it a convenient means of resource that does not require thorough credit checks and long application forms to qualify. It's their own money with low interest paid to self account and all it takes is a phone call to make.

The primary benefit of 401k loans is that the proceeds are not subject to taxes or the 10 percent penalty fee except in the event of default. It is up to the employer and plan administrator (like Vanguard, Fidelity for larger corporate plans) to determine the minimum and maximum loan amounts. The government does not set guidelines or restrictions on the usage of 401k loans.

However, IRS imposes a rule that the 401k loan must be paid back over the subsequent five years with the exception of home purchases, which are eligible for a longer time horizon. Repayment of loans will occur automatically from payroll checks. Therefore, there is no control over repaying the money; it is automatically deducted from the paychecks.

Trend of Borrowing on the 401k: The number of people borrowing from their retirement savings plans reached 11.1 percent, a 10-year high in the second quarter of 2010, according to Fidelity Investments. The portion of 401k accounts with loans outstanding rose to 22 percent by the end of June from 20 percent a year earlier, the Boston-based asset manager said in a study. Fidelity manages 17,000 plans, which represents 11 million participants. In the second quarter, approximately 62,000 workers initiated a hardship withdrawal compared to 45,000 in the same period a year ago. The statistics represent continued rise of plan holders availing 401k loans and withdrawals.

Opportunity for Administrators and the Case for Outsourcing

The data mentioned earlier demonstrates an increasing trend of borrowing from 401k accounts via loans and withdrawals. Withdrawal turns out to be a risky alternative since it involves penalty, federal and state taxes plus the chance of that money growing tax-deferred is lost.

Borrowing against 401k loans, on the contrary, presents a win-win situation for both the participants and the plan providers. The administrators maintain their relationship with the participants by servicing them with loan options.
The borrowers benefit since the loan option gives them a chance to repay to their 401k accounts, and hence prevents them from entirely losing their retirement nest egg. For the administrators, the trend actually presents an opportunity to setup efficient processing units.

But, administrators are not particularly receptive of loans due to the additional administrative duties they entail, which add to total plan costs. Considering the fees and the fact that the core business of the providers is to focus on managing and maximizing returns on 401k for the participants rather than providing loans for them, does outsourcing the 401k loans make more sense for both? In my opinion, it does, and the reasons for the same are:

- Outsourcing plays a role when small businesses cannot afford the high cost of adding the loan feature to their plans
- Outsourcing firms can focus on the day-to-day issues involved in the loan plan provision cost-effectively
- Since these firms will only be dealing with facilitating participant loans, they will be able to handle regulatory situations efficiently when there is lack of clarity on concerns. For instance, when an employee misses a payment, the loan is in default, the employee dies, or an employee leaves the company before a loan is repaid.

Outsourcing of end-to-end loan processing can offer the much-needed competitive advantage to the plan providers. Selective functions, which can be immediate targets and hence can bring down the total cost of the offering are:

- Processing loan applications
- Determining the loan amount
- Disbursal and administration of loan

Undoubtedly, the growing popularity of loans plays a vital role in the 401k space and is hence, a compelling case to outsource.

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