DEFERRED COMPENSATION PLAN
BOARD REPORT 08-06

EMPLOYEE BENEFITS DIVISION

Date: February 20, 2008

To: Board of Deferred Compensation Administration

From: Staff

Subject: Two-Loan Policy for Loan Program

Recommendation:
That the Board of Deferred Compensation Administration approve a change to Plan Document provisions regarding the Deferred Compensation Plan Loan Program to permit a maximum of two simultaneous loans which participants may take from their accounts.

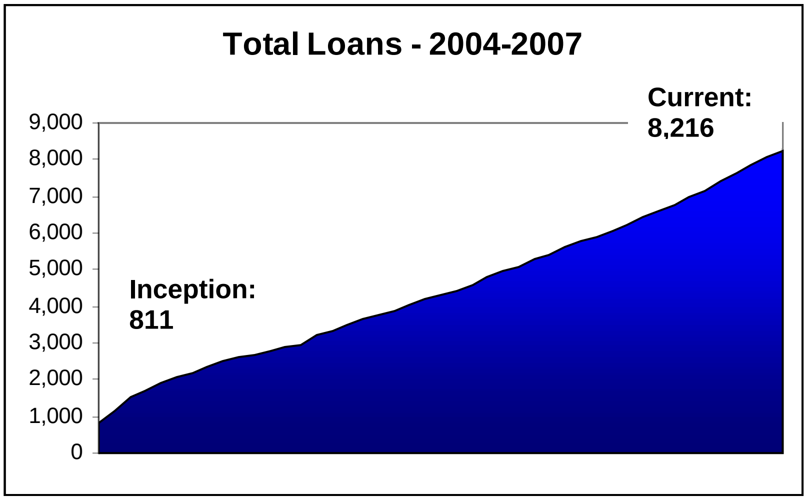
Discussion:
As the Board is aware, many of our Plan participants are facing financial difficulties in connection with the deterioration of the economy, decline in property values and freezing up of credit availability. Staff has recently given consideration to a potential step the Board could take which would provide Plan participants with greater utility from their Deferred Compensation Plan accounts to help deal with their financial problems.

Internal Revenue Code provisions regarding §457 plan loans do not limit the number of loans participants can take from their accounts. When the City initiated its loan program in April 2004, the Board elected to establish a one-loan policy. In large part this was done because loans for §457 plans had only recently been permitted under new Internal Revenue Service regulations, the City's Plan was one of the first to initiate a loan program for its membership, and there was some concern regarding how loans would be used by participants.

The loan program has proven to be enormously popular among participants. Although staff does not have hard data, anecdotal evidence suggests that loans are used for a wide variety of reasonable purposes consistent with securing a participant's financial well-being: debt consolidation, a safety valve for financial emergencies, home purchase, home improvement, vehicle purchase and assorted other financial needs. Further, because loan repayments are collected through mandatory payroll deduction, there is almost no ability for a participant to avoid repaying a loan, short of going off payroll (which in any event would typically indicate financial distress).

Since introduction of the loan program the number of participants with loans outstanding has grown steadily. There are presently 8,216 loans with outstanding balances, which represents 28.8% of all participant accounts.

As a percent of assets, however, the amount that has been loaned is much smaller – currently just 3.9% of total Plan assets.



Benefits of a Two-Loan Policy

The Board could adopt a change which would allow more than one loan. Participants would still be subject to the absolute loan limits provided for in federal regulations (50% of a participant's account balance or $50,000, whichever is less), but an increase in the number of loans would provide participants with the option of borrowing additional amounts as well as adding a higher level of flexibility.

As one example, suppose a participant with a balance of $100,000 takes a loan for $25,000 to deal with a financial emergency. Then, shortly after doing so, another unexpected event occurs which creates a second emergency. With a one-loan policy, the participant has effectively no option for pulling additional funds from his/her Deferred Compensation Plan account other than applying for hardship withdrawal. Although the theoretical borrowing limit is $50,000, $25,000 has already been borrowed. Because of the One-Year Highest Balance rule[1], repaying the $25,000 would reduce the eligible loan amount to $25,000, fully negating the value of repaying that loan.

A two-loan policy, however, would allow the participant to take a second loan out for $25,000, for a total borrowed amount of $50,000. Staff does not recommend going beyond permitting two loans, however. Although regulations do not place any limit on the number of loans a participant may take, Great-West advises that the communication challenges and administrative burdens of loans increase with each additional loan that is permitted.

The biggest burden is on participants who fall behind on one or more of their loan payments. Even with a one-loan policy, participants who fall off the payroll often have difficulty understanding the complex rules that govern their obligations to avoid default.

[1] The One-Year Highest Balance Rule provides that an individual may borrow up to 50% of an account balance, up to $50,000, whichever is less, with the eligible amount reduced by the highest outstanding loan balance within the previous 12 months.

Every additional permitted loan increases that complexity. Staff believes that a two-loan policy represents a reasonable expansion of the loan program's flexibility without unduly increasing communication burdens for participants.

Proposed Plan Document Revision

The legal authority for the City's Loan Program comes from Section VIII of the Plan Document. To increase the number of loans, the following language in Section VIII(c) would need to be amended as follows:

> ***"Number of Loans Permitted*** *– Participants are only permitted to have ~~one~~ two loans outstanding. If a Participant has two ~~an~~ outstanding loans and wishes to initiate another loan, the Participant must first repay at least one of the current outstanding loans in full."*

Conclusion

As indicated previously, staff believes that moving to a two-loan policy will represent a way that the City's Plan can increase its responsiveness to our participants during current difficult economic times. Even after current conditions improve, staff finds that a two-loan policy is justified over the long term given our experience with the Loan Program and the maturity of the Plan. As a result, staff recommends that the Board approve moving the City's Plan to a Two-Loan policy and amending the Plan Document as indicated in this report.

Submitted by: ____________________________

Steven Montagna

Approved by: ____________________________

Maryanne Keehn