Deferred Compensation Plan
BOARD REPORT 14-12

Date: March 18, 2014

To: Board of Deferred Compensation

From: Staff

Subject: Plan Document Review - Deferred Compensation Plan Loan Program

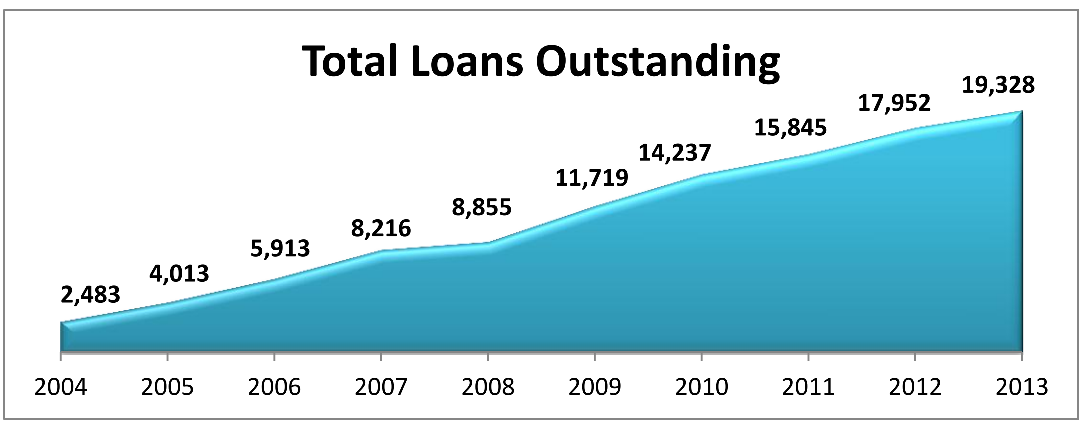
Recommendation:
That the Board of Deferred Compensation approve proposed revisions to the Deferred Compensation Plan Document Section VIII regarding the Plan's Loan Program.

Discussion:
Staff has initiated a process of reviewing, updating and refining various sections of the Deferred Compensation Plan's "Plan Document" in order to address technical or administrative improvements which will better serve the Plan and its participants. The first of these concerns the City's Loan Program, which is detailed in Section VIII of the Plan Document.

A. LOAN PROGRAM BACKGROUND

The Deferred Compensation Plan implemented its active employee loan program in April 2004. Initially Plan participants were eligible to take out a single loan. In March 2008, in order to provide Plan participants with greater flexibility, the program was modified to allow up to two loans. In November 2012 the loan program was further expanded to allow participants who have retired or otherwise separated service to also take loans.

Loan activity, as measured by the total number of loans outstanding, has grown at steadily since it was first introduced, as indicated by the following chart:



As of 12/31/13, there were 13,293 Plan participants with a total of 19,858 loans and $171,911,323 in outstanding loan liabilities. Below is a detailed breakdown:

	Total Participants with a loan *(1 or 2 loans)*	Total Participants with 1 Loan only	Total Participants with 2 Loans	Total Active Loans
Active	12,991	6,481	6,510	19,501
Retiree	302	247	55	357
	13,293	**6,728**	**6,565**	**19,858**

The loan program has expanded the utility and accessibility of participant accounts. It provides a strong incentive for participants to enroll and increase contributions; manage other non-retirement financial needs; and pay interest to their own accounts rather than third party lenders. For the Board's reference, the current Loan Policy is summarized in Attachment A.

However, as the City's loan program has grown, more issues have arisen with respect to its administration. Federal loan regulations are complex and not easily communicated. A recent issue involving the default issue as it applies to retiree loans has triggered a comprehensive review by staff of ways in which both the administration as well as communications of loans can be improved. This report contains staff's recommendations for addressing ways in which the City's loan program can be made as responsive as regulations allow within the Plan Document.

B. RECOMMENDATIONS FOR IMPROVING LOAN ADMINISTRATION

Staff recommends the following changes to the City's Plan Document provisions concerning its Loan Program:

(1) Permit participants to borrow again on previously defaulted loans.

(2) Explicitly direct participants of their obligation to cure any missed payments or to otherwise notify the Plan, particularly in instances prior to and upon return from a leave of absence (if their intent is to suspend and/or re-amortize a loan).

(3) Provide that retired participants are able to take out future loans even if they previously defaulted on a loan, provided the prior loan has been repaid or offset.

(4) Reduce the 15-day hold on personal check loan repayments.

The proposed Loan Program provisions are provided in proposed final form as Attachment B; the changes are in "track changes" form as Attachment C. **These recommendations have been reviewed by Board counsel and by Great-West for administrative, operational and regulatory compliance.**

(1) Permitting Participant to Borrow Again on Previously Defaulted Loans

At the end of each quarter, participants who fail to cure missed payments from the previous quarter are defaulted on their loans. When a loan default occurs, in addition to incurring additional tax liability for the year in which the default occurred, participants are precluded from borrowing again on a loan, as set forth in the Plan Document, Section VIII, paragraph (h). As a participant is allowed up to two loans, after defaulting on both loans, the participant is ineligible from borrowing again.

However, in researching this**, staff found neither the IRC nor any Treasury regulation prohibit participants from borrowing after default.** The source of the requirement in the City's Plan Document may have likely been an administrative or operational requirement in the early implementation stages of the Loan Program (to better mitigate potential error) or a carryover from the original Model Amendment language the IRS provided for 457 plans. As the City's Loan Program has grown, so has guidance on the loan provisions of the IRC.

Based on the IRC and the applicable Treasury regulations, participants with a defaulted loan that is not yet repaid can obtain a subsequent loan if the future loan is repaid via payroll deduction. Staff did not find any restrictions for issuing a loan after default if the defaulted loan has been paid back or offset. As the loan program allows a participant to only two outstanding loans at one time, staff believes allowing participants to borrow again after default is reasonable and in accordance with federal law, while allowing the participant more financial flexibility.

As such, staff recommends participants be allowed to borrow after defaults by clarifying that an "outstanding" loan is any loan being repaid, even if it previously defaulted. This approach is similar to that taken by the New York State Deferred Compensation Plan.

(2) Missed Loan Payments

Prior to default, a loan is determined to be delinquent if, after the conclusion of a given quarter, a participant is in arrears on his/her loan. Great-West issues a late loan letter to the participant in the quarter following the quarter that the Great-West recordkeeping system notes the arrearage. If the arrearage is not cured by the end of the subsequent quarter, the loan is defaulted. The initial loan confirmation letter and the *Loan Promissory Note & Truth in Lending Disclosure Statement* indicate that it is the responsibility of the participant to ensure delivery of payment to Great-West. This is also indicated on the loan FAQ communication document that is available on the website or upon request.

The Plan Document further provides that if a participant is out on an approved leave of absence, the loan may not be deemed in default for a period of up to one year of the leave or until the loan matures, whichever is earliest (there are additional allowances for military leave). However, the participant must first notify the Plan prior to the loan going into default. Notification to the Plan of the approved leave is achieved through the *Loan Payment Change Request Form,* which must be submitted prior to and upon return from a leave of absence. Currently, many participants do not notify the Plan of their leave, which generally results in a loan default.

Participants who contact the Plan to request reversal of their default cite their unfamiliarity with the process, despite communications that indicate the participant is responsible for curing any missed payments prior to a default. Communications include the initial loan confirmation letter, the *Loan Promissory Note & Truth in Lending Disclosure Statement,* and the late loan letter that is mailed to the participant's address approximately six weeks prior to the default effective date.

As the Plan Document does not presently explicitly state the participant's responsibility to either remedy missed payments or to otherwise notify the Plan, and in what form, of a leave prior to default, staff recommends this language be added for clarity.

(3) Repayment Requirement for Retiree Loans After a Loan Default

For retiree loans, Great-West has indicated that an employee who defaults on a loan (whether while active or retired/separated) is not eligible to take a retiree loan. Per Great-West's interpretation, a loan cannot be issued after a default for a retiree/terminated employee because they believe that Treasury regulation §1.72(p)-1 requires that loans issued subsequent to default are required to be paid via payroll deduction only. Retired/separated employees are, obviously, no longer on payroll, so Great-West indicates this precludes them from taking future loans.

There are a number of retired participants currently impacted by Great-West's interpretation. Retiree loans were introduced November 2012. Prior to this, retirees who had loans at the time of retirement were advised by local Great-West counselors that they had the option to (a) submit a form to "offset" their loan balance (which means the outstanding loan balance is reported to the IRS as a distribution); or (b) allow the loan to go into default at which time it would be tax reported just as it would have if it had been "offset." Participants that chose the default option now find themselves ineligible to take part in the new retiree loan program.

Staff believes that Treasury Regulation §1.72(p)-1 actually implies that the requirement for repayment via payroll deduction is relevant only in the circumstance where a defaulted loan remains unpaid or has not been offset. As the language indicates: "If a loan is deemed distributed to a participant…**and has not been repaid (such as by a plan loan offset)**, then no payment made thereafter to the participant…is treated as a loan…unless…repayments will be made by payroll withholding." Thus, retirees wishing to take a retiree loan can simply offset or payoff any outstanding loan balances that have defaulted, and be eligible to borrow again. As noted before, staff also did not find language in the IRC or Treasury regulations that prevented participants from borrowing again after a default.

Given this, staff recommends incorporating language in the Plan Document that would make explicit that retiree loans are permitted even in situations where a participant has previously defaulted on a loan, so long as that loan has been repaid or offset.

(4) Reduce the 15-Day Hold on Personal Check Repayments

When the retiree loan program was implemented, language was changed in the Plan Document to allow for personal checks as payment. However, as these funds were not certified, Great-West indicated a 15-day hold on personal checks would be required in order to ensure funds availability. Participants would not be allowed to take a distribution of any type until the hold cleared. Upon implementation, the Plan discovered the 15-day hold also significantly affected active employee loans. Many active participants will pay off one of two outstanding loans in order to borrow again for a larger amount, and this can often be due to an emergency or time-sensitive situation. A check hold is necessary in order to prevent the complications that would arise from canceled checks, but upon discussion with Great-West it appears that reducing the check hold to 10 days is reasonable and provides sufficient time to prevent the possibility of canceled checks. The drafted language also provides the Plan with flexibility for special or emergency situations involving participants.

C. COMMUNICATIONS

As this report makes clear, loan administration is an area of Plan administration which contains a considerable amount of complexity. Disclosure does not necessarily equal effective communication, and in staff's view considerable room for improvement exists in improving communications on this topic. Upon adoption of these changes to the Plan Document, staff will work with Great-West to develop changes or enhancements to existing communications communication materials which will attempt to simplify some of the inherent complexity and fully describe both the rules as well as operational aspects of loan administration.

Participant feedback has been an integral part of designing these recommended improvements to the loan program. As always, staff will continue to support participants who encounter issues with application of loan program provisions. Participants who have concerns can continue to direct them to the Plan Manager or to correspond directly to the Board.

CONCLUSION

Given the Plan's commitment to provide innovative and flexible solutions to benefit the Plan's participants, staff asks that the Board approve the above revisions to Section VIII of the Plan Document as reflected in Attachment B.

Submitted by: ______________________________
Esther Chang

Reviewed by: ______________________________
Steven Montagna

Approved by: ______________________________
Alejandrina Basquez

OVERVIEW OF CURRENT LOAN PROGRAM

Following is a summary of the essential features and operations of the Plan's Loan Program:

Loan Types	There are two types of loans a participant can request: ➢ Active Employee Loan Active employees pay back their loans on a bi-weekly basis, with payments that are deducted automatically from their paychecks. ➢ "Retired" or Separated from Service Loan Employees who have retired or otherwise separated from City service may repay their loans on a monthly amortization schedule, and can opt to send in payment via coupon book or ACH payment. An active loan can be converted to a retiree loan upon separation from service. This takes the participant from a bi-weekly to monthly repayment schedule.
Number of Loans Allowable	• Participants are allowed up to **two** outstanding loans at one time.
Allowable Loan Amount	• A minimum of $1,000 (requires at least a $2,000 balance) • Whichever is less: ➢ 50% of their account balance, or ➢ $50,000 – less the highest outstanding loan balances within the past 12 months
Term	• General Purpose Loan: select 1 to 5 year term • Purchase of principal residence: select 1 to 15 year term
Interest	• 2% over the Prime Rate published in the Wall Street Journal on the first business day of the month before the loan is originated.
Fees	• Origination Fee (one-time): **$50** • *Optional Fee* for Express Delivery of Check (one-time): **$25** • Loan Maintenance Fee (on-going until loan is repaid): **$25 annually**, deducted quarterly
Early Payoff	• No penalties for early payoffs or pre-payments
Missed Payments	• The participant is responsible for ensuring all payments are received by Great-West by the due date. • Leave of Absence: If a participant is on an approved leave of absence and will not receive

	pay or enough pay to cover their loan payments, they must notify the recordkeeper to prevent default via the *Loan Payment Change Request Form*. Loan repayments may then be suspended until the end of the leave, up to a maximum of one year, but the leave cannot extend the term of the loan (unless due to a military leave). Upon returning from leave, a participant may choose to either (a) pay the outstanding payments in order to bring the loan current, or (b) re-amortize remaining payments over the remaining term. This is done so by completing the *Loan Payment Change Request Form.* The participant is responsible for notifying the Plan before and after a leave.

Loan Default	• If payment is not received for missed payments in the previous quarter, the loan will default and will be deemed distributed to the IRS.
	  ○ Great-West issues a late loan letter to the participant in the quarter following the calendar quarter that payments are missed.
	• The participant is allowed only up to two outstanding loans; once they default on both loans, they are prohibited from borrowing again.
	  ○ A retiree loan cannot be issued to a participant who has ever had a default on file.
	• The loan will continue to be recordkept until the loan has been paid.

Loan Offset	• Upon separation from service, an outstanding loan balance can be “offset,” meaning the outstanding amount can be treated as a taxable distribution without being treated as a “default;” the participant does this by completing an offset form and the remaining principal and interest are then deemed a non-default taxable distribution.
Repayment Requirement	• A loan is considered a binding agreement and must be repaid, even after a default.

PLAN DOCUMENT
Section VIII – Loan Program
FINAL PROPOSED VERSION

VIII. LOAN PROGRAM

A Loan Program is hereby established for the Plan, the effective date for which will be the earliest date that all administrative and operational requirements for such program have been met. The Loan Program shall operate under the following requirements:

(a) **Eligibility** – Both active employee Participants in the Plan and Participants who have had a severance from employment may participate in the Loan Program. To be eligible for a Loan, a Participant must have a minimum account balance of $2,000 at the time of loan initiation.

(b) **Minimum and Maximum Loan Amounts** – The minimum loan amount available to a Participant for a loan is $1,000. The maximum loan amount available is $50,000, reduced by the highest outstanding loan balance during the past twelve months, or 50% of the account balance, whichever is less.

(c) **Number of Loans Permitted** – Participants are only permitted to have two loans outstanding. An outstanding loan is defined as any loan with an outstanding balance that is being repaid or not yet repaid, whether or not the loan has ever been in default. If a Participant has two outstanding loans and wishes to initiate another loan, the Participant must first repay at least one of the current outstanding loans in full.

(d) **Cost** – Each Participant will be required to pay a loan origination fee and ongoing maintenance fee as established by the Plan recordkeeper and approved by the Board. Loan recipients will be required to bear the full cost of the Loan Program.

(e) **Distribution of Loan Amount** – Loan distribution amounts will be prorated across all Money Types and all available Core investment options excluding the brokerage window.

(f) **Types of Loans Available:**

(i) General Purpose Loan – A General Purpose Loan will have a duration of one to five years as designated by the Participant at the time of loan application. No reason or documentation will be required other than a signed promissory note. The interest rate for this loan type will be fixed for the life of the loan. The interest rate will be 2% over the Prime Rate published in the Wall Street Journal on the first business day of the month before the loan is originated.

(ii) Principal Residence Loan – A Principal Residence Loan will have a duration of one to fifteen years as designated by the Participant at the time of loan application. This loan may be utilized only for the purchase of a primary residence. The interest rate for this loan type will be 2% over the Prime Rate published in the Wall Street Journal on the first business day of the month before the loan is originated.

(g) **Interest** – Interest paid on loans is not deductible.

(h) **Payment Requirements** – Scheduled payments for active employee Participants must be made by payroll deduction except in the cases of lump-sum correction of delinquencies as outlined in this Section or lump-sum early payoff. Payments for Participants who have had a severance from employment must be made by direct payment from the Participant to the Administrator on no less than a monthly basis and in accordance with a payment schedule established by the Administrator. Payments may be made by cashiers check, money order, Automated Clearing House (ACH), or personal check. Payments made using personal check will typically restrict future distributions from the account for a period of 10 calendar days to ensure fund availability. Certified methods of repayment will be immediately available for withdrawal. Any payment received will be applied to the first immediately due payment; in instances when there are previously missed payments, any payments subsequently received will be applied to the earliest missed payment(s) first.

Loans will be considered to be in arrears and delinquent when any payment is missed. A late loan payment notice will be issued at the end of the calendar quarter in which the payment is delinquent. If the loan is not paid up-to-date by a lump sum payment (of the amount of the missed payment plus interest on the missed payment from the original due date to the payment date) by the end of the calendar quarter after the calendar quarter in which a payment in which a payment is first delinquent, the loan will be in default and considered a "deemed distribution." In such cases, the outstanding loan balance, consisting of the principal and interest due under the terms of the loan, plus additional interest accruing through the date of default, will be reported to the Internal Revenue Service as income on a 1099R for the year in which the loan default occurs. It is the sole responsibility of the Participant to ensure loan payments via payroll deduction are taken appropriately or that payments are otherwise transmitted to the Administrator by the payment due date to avoid the tax consequences associated with a defaulted loan.

Despite any grace periods permitted with respect to late loan payments, if a loan has not been fully repaid by the end of its term, the outstanding balance will be treated as a "deemed distribution" and reported to the Internal Revenue Service as income. Thereafter no further efforts will be made at correction or accrual of interest liability. If the Participant has a loan that defaulted at any time in the past, they will not be eligible to take out subsequent loans unless any outstanding loans are being repaid or have been paid in full or offset. Participants who have a Severance from Employment must first offset or pay in full any defaulted balances prior to issuance of a new loan.

Participants who have a Severance from Employment prior to the end of the loan term will be required to either pay off or offset the loan at Severance from Employment or submit monthly payments in accordance with a payment schedule established by the Administrator. A former Participant may also avoid treatment of an unpaid loan as a "deemed distribution" and reporting of income to the Internal Revenue Service by paying the loan balance by the end of the grace period via lump sum payment. Non-payment will force a "deemed distribution" and reporting of income for the year in which the "deemed distribution" occurs.

As required by federal tax regulations, the defaulted loan of a Participant will remain recorded until a qualifying event occurs, even though income has been reported to the Internal Revenue Service.

Partial lump sum loan repayments, via cashiers check, personal check or money order, are permitted in order to catch up on a past-due amount or reduce the principal amount of the loan. If a Participant sends in a partial payment, the loan payment amount will not change but the loan would be paid off earlier. Repayments made using personal check will typically restrict future distributions from the account for a period of 10 calendar days to ensure fund availability. Certified methods of repayment will be immediately available for withdrawal.

(i) **Leave of Absence** – If a Participant who has an outstanding loan incurs an authorized leave of absence, ceases loan repayment, and his or her rate of pay (after income and employment tax withholding) is not sufficient to meet the required repayment under the terms of the loan, then the loan will not be deemed in default for a period equal to the lesser of (A) the length of the leave of absence, or (B) one year, as long as the loan (including interest that accrues during the leave of absence) is repaid by the latest permissible term of the loan and the amount of the installments due after the leave of absence ends is not less than the amount required under the terms of the original loan. The Participant must notify the Plan of the authorized leave of absence by completing and submitting the proper form to the Plan Administrator prior to and upon return from the approved leave of absence. Notwithstanding the preceding provisions, loan repayments during a period of military service will be suspended under this Plan as permitted under IRC §414(u)(4). In accordance with IRC §414(u), a loan suspended because of military service will not be deemed in default even if the suspension exceeds one year, as long as loan repayments resume upon completion of the military service and the loan (including interest that accrues during the military leave) is repaid by the end of the period equal to the sum of the latest permissible term of the loan plus the period of military service.

(j) **Compliance** – The Loan Program established under the Plan is intended to comply with the requirements of IRC §72(p) and §457 and the Treasury Regulations promulgated thereunder.

PLAN DOCUMENT
Section VIII – Loan Program
(Tracked Changes Version)

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Loans will be considered to be in arrears and delinquent when any payment is missed. A late loan payment notice will be issued at the end of the calendar quarter in which the payment is delinquent. If the loan is not paid up-to-date by a lump sum payment (of the amount of the missed payment plus interest on the missed payment from the original due date to the payment date) by the end of the calendar quarter after the calendar quarter in which a payment in which a payment is first delinquent, the loan will be in default and considered a "deemed distribution." In such cases, the outstanding loan balance, consisting of the principal and interest due under the terms of the loan, plus additional interest accruing through the date of default, will be reported to the Internal Revenue Service as income on a 1099R for the year in which the loan default occurs. It is the sole responsibility of the Participant to ensure loan payments via payroll deduction are taken appropriately or that payments are otherwise transmitted to the Administrator by the payment due date to avoid the tax consequences associated with a defaulted loan.

Despite any grace periods permitted with respect to late loan payments, if a loan has not been fully repaid by the end of its term, the outstanding balance will be treated as a "deemed distribution" and reported to the Internal Revenue Service as income. Thereafter no further efforts will be made at correction or accrual of interest liability. If the Participant has a loan that defaulted at any time in the past, they will not be eligible to take out subsequent loans unless any outstanding loans are being repaid or have been paid in full or offset. Participants who have a Severance from Employment must first offset or pay in full any defaulted balances prior to issuance of a new loan.

Participants who have a Severance from Employment prior to the end of the loan term will be required to either pay off or offset the loan at Severance from Employment or submit monthly payments in accordance with a payment schedule established by the Administrator. A former Participant may also avoid treatment of an unpaid loan as a "deemed distribution" and reporting of income to the Internal Revenue Service by paying the loan balance by the end of the grace period via lump sum payment. Non-payment will force a "deemed distribution" and reporting of income for the year in which the "deemed distribution" occurs.

~~The Participant's outstanding loan balance will be offset upon receiving any type of distribution after Severance from Employment.~~ As required by federal tax regulations, the defaulted loan of a Participant will remain recorded until a qualifying event occurs, even though income has been reported to the Internal Revenue Service.

Partial lump sum loan repayments, via cashiers check, personal check or money order, are permitted in order to catch up on a past-due amount or reduce the principal amount of the loan. If a Participant sends in a partial payment, the loan payment amount will not change but the loan would be paid off earlier. Repayments made using personal check will typically restrict future distributions from the account for a period of ~~15~~ 10 calendar days to ensure fund availability. Certified methods of repayment will be immediately available for withdrawal.

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~~(i)~~(j) **Compliance** – The Loan Program established under the Plan is intended to comply with the requirements of IRC §72(p) and §457 and the Treasury Regulations promulgated thereunder.