Your Dollars, Your Sense: Pros and Cons of a 401(k) Loan

RETIREMENT SERVICES

Most people understand that debt is something to be avoided and that long-term investments should be left untouched. But neither of those things changes the fact that sometimes a person needs money for the unexpected. In those situations, taking a loan from your 401(k) may seem like a good idea. But is it?

The Positives

- **Ease.** People who take 401(k) loans are borrowing from themselves. As a result, there is no credit inquiry, no lengthy application, and no impact on credit rating. Usually requesting a loan is as simple as a phone call or a few clicks on a website.
- **Payment Flexibility.** While most plans specify a repayment schedule, usually five years, there is no penalty for paying the loan down more quickly. Usually, the payments happen automatically through payroll deduction.
- **Inexpensive.** The median loan origination fee is $75 with an annual $50 service charge.[1] In addition, the interest rate is usually much lower than what a credit card would charge, and more important, the interest is paid to the plan. Borrowers are essentially paying themselves.

CONSIDERING A 401(K) LOAN? YOU'RE NOT ALONE

Almost **83%** of retirement plans allow participants to take loans.[1]

Nearly **1 in 5 people** take loans from their retirement plans.[2]

The average loan is **$9,700**.[2]

The median interest rate for a retirement plan loan is **4.5%**.[1]

Nearly **2 in 5 retirees**, who once took loans from their 401(k)s, regretted doing so.[3]

The Downside

- **Lost Opportunity.** Even though borrowers pay themselves back, that repayment only replaces what was in the account. Other than the interest, no new funds are added. And because one of the benefits of long-term investments is compounding, where invested dollars may earn more dollars through dividends and market growth, that opportunity is lost as well.

  Note: Some would argue that a loan is actually a better investment in down markets because the money won't be lost when stock prices fall. While this is true, over the long-term, the market has historically been up more than down and the increases have been greater than the losses.

[1] 59th Annual Survey of Profit Sharing and 401k Plan Loans, Plan Sponsor Council of America, 2016
[2] How America Saves, Vanguard, 2017
[3] Fidelity, 2011

- **Taxes.** The money used to pay back a 401(k) loan is invested after tax. This means that a borrower loses the tax deferral benefits of retirement plan savings and must pay taxes on the repayment as well as when he or she withdraws the funds in retirement.
- **Termination Risk.** A 401(k) loan depends on continued employment with the organization sponsoring the plan. If a borrower loses his or her job, or goes to work for a different employer, plan rules may require an immediate repayment of the outstanding loan. Any amounts not repaid by the plan deadline are immediately taxed and subject to an additional 10% early withdrawal penalty if the borrower is younger than 59½.

Loans to Purchase a Primary Residence

There are special rules if you use a 401(k) loan for the purchase of a primary residence. All the positives still apply plus the repayment time frame is usually longer. On the downside, though, borrowers would not receive tax deductions for the interest paid on the loans the way they would with other forms of credit and the impact of an even longer-term loan on retirement goals would be compounded.

Is a Loan Right for You?

A financial planner can help those considering a 401(k) loan evaluate their personal goals, credit, and options to make this determination. But a few rules of thumb can help. If you answer "No" to any of the following questions, you may want to reconsider taking a loan from your plan:

After you take the loan, will you maintain or increase the amount you are contributing to your retirement plan?

Are the fees and interest rates charged less than what you would pay to a third party lender? (Remember to consider how long you will need to repay the money and the loss of tax deferral benefits.)

Do you expect your investment portfolio returns to be less than the interest rate on the loan?

Can you comfortably repay the loan over the repayment period?

Do you expect to continue working for your current employer through the loan repayment period?

Your retirement plan service provider will have more information about taking loans from your 401(k). See the provider's website or the call the service center for information about your plan's specific rules, calculators that can help you evaluate your options, and articles that can explain more.

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