401(k) Loans
Deal or No Deal?

401(k) conventional wisdom is that loans are just a part of any well-rounded 401(k) plan. Because TRI-AD tends to be a leader rather than blindly following conventional wisdom, we are going to express the opinion that largely unfettered access to 401(k) accounts is counter to the plans' purpose of providing a way for participants to save successfully for retirement.

Don't get us wrong – we do believe there is a place for the 401(k) loan. Borrowing money from the plan to buy a house, hold onto the house you have, or pay for education can be a great idea. After all, each of these items is, for the most part, an appreciating long-term asset. Sometimes loans are inevitable in the face of severe financial pressures, such as paying medical bills or bridging the gap if a spouse loses his/her job.

What alarms us is the number of participants who request loans for items that are not appreciating assets or for hardship purposes. For example, a recent article in the San Diego Union Tribune profiled a man who was taking out a loan – a man who was sitting in front of his $550 per month leased BMW. Granted he is trying to offload the Beemer, but he overextended himself and now is raiding his future to support today.

The Downside to 401(k) Loans

On the surface it seems as though a 401(k) loan would be a great way to fund a financial need. The participant borrows from and pays interest to him/herself. It might even seem like a great way to ensure a decent rate of return on the money in a volatile market or a market with low prevailing interest rates. However, there are some serious drawbacks:

- **If the employee leaves, the loan is generally due in full or automatically defaulted.** Some plans provide that the loan will automatically default. Many plans do allow for immediate payment in full, but this can create a significant financial burden for the participant. If the participant does not immediately repay the loan, it becomes a taxable distribution.
- **Repaying often interferes with ongoing contributions.** Participants often cut back on contributions or stop contributing entirely while they repay the loan. This further erodes retirement savings.
- **The loan money does not accrue earnings while it is outstanding**. The principal is not in the account earning money. The only earnings are the interest paid, which often is lower than market returns. This can have a significant long-term effect on the overall account value due to compounding.
- **The money used to repay the loan ends up being double-taxed.** The after-tax loan payments are mixed with the pre-tax money and are taxed again at the time it is distributed in retirement. Thus, the true cost of the loan can be 20% to 40% higher than is evident due to this double-taxation.
- **Loans create plan compliance risks.** Loan administration is an area that frequently trips up plans: the amortization schedule and payroll deductions can get out of sync if a participant misses a payment; if the employee goes on leave and doesn't make payments it can create issues; early repayments require recalculation of the payoff amount…the list goes on. They take careful attention to detail and good

Loans by the Numbers

Percentage of 401(k) Plans offering loans	87.5%
Percentage of these who offer loans for any reason (unrestricted)	84%
Percentage permitting multiple loans	45.9%
For those who offer multiple loans, percentages offering:	Two loans: 74.9% Three loans: 15.4% Four + loans: 4.7%
Percentage of participants with loans	23.7%*
Average loan amount	$8,595*

Source: PSCA's 50th Annual Survey of Profit Sharing and 401(k) Plans. www.psca.org

* This is 2006 plan year data. Industry experts say that this number has jumped in the last few months as the economy has soured.

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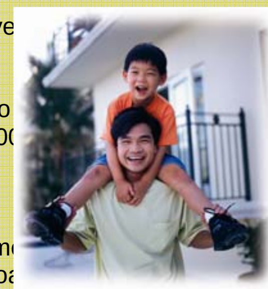
coordination between the administrator and payroll to get it right, and if they are wrong, the issues often aren't caught until a 401(k) audit is conducted. The problems are hard to correct after-the-fact.

- **Multiple loans at a time create an administrative headache.** Unless your plan specifically prohibits multiple loans, your participants may expect they can do this. It creates headaches, is expensive, and even further erodes the participants' savings to allow concurrent loans.
- **Loan fees can be substantial.** With loan origination fees typically in the $50 to $150 range, participants are often dismayed by the chunk of their loan that disappears off the top in fees. Also, some plans have an annual loan maintenance fee, which further increases the loan's cost and depletes savings.
- **If the participant can't repay the loan, it becomes a distribution and is heavily taxed.** Let's use James in our profile as an example. If he were to default on his loan, he would owe taxes on $35,000, plus a 10% penalty because he is under age 59½. The taxes and penalties come to almost half the loan amount, or $17,000. If James doesn't have the money to pay the taxes, he might take out a hardship withdrawal to do that, which becomes a vicious circle of depleting his assets to pay the tax bills.

The Newest Loan Development: The 401(k) Debit Card

Retirement investment advisors, financial planners and retirement plan administrators were by and large appalled when Reserve Solutions, Inc., a New York financial firm, recently unveiled its ReservePlus debit card. This new "feature" lets participants use ATMs to withdraw money from their 401(k) plans. Essentially, they open a line of credit for the amount available for borrowing.

Profile: James, Age 35



James and his wife have two small children. They are replacing a car, and choose a Volvo with a price tag of $35,0 to take a 401(k) loan to pay for it so that they pay themselves the interest. In the meantim so they can repay the loa without impacting their lifestyle, James stops contributing to the plan.

Starting 401(k) balance: $80,000
Monthly contribution before the loan: $400
Loan amount: $35,000

	With Loan	Without Loan
Starting Balance	$80,.000	$80,000
Loan amount	$35,000	N/A
Loan origination fees and annual servicing fees (total)	$250	N/A
Total monthly loan payments, 9%*** interest	$42,500	N/A
Balance at age 40, when loan is paid off	$118,000	$146,000
Balance at age 65*	$1,192,000	$1,389,000
Double taxation on loan repayment amount (25% rate)**	$11,000	N/A
Total impact of the loan period on age 65 account balance	($208,000)	N/A

* assumes 8% rate of return
** loan repayments were made with after-tax dollars, but are taxed again at distribution.
*** Average interest rate per PSCA 50th Annual Survey of Profit Sharing and 401(k) Plans

The general consensus in the financial planning industry is that this could be disastrous to a participant. It would be way too easy for participants to raid their 401(k) plans and run up debt to themselves – after all, just look at the credit card burden that most Americans carry. Why would this be any different? Also, the savings and earnings erosion that could occur as a result would most likely leave participant with this plan "feature" much less prepared to retire.

Most administrators, including TRI-AD, do not offer this feature to their clients because it has been deemed inadvisable by the vast majority of reputable financial professionals who have weighed in on the subject.

Prudent Loan Practices: TRI-AD’s Recommendations

Given the issues that we see clients and their participants experiencing with loan provisions, we have the following recommendations:

- **Re-emphasize – again – the Plan’s purpose.** Participants can’t hear too often that the 401(k) plan is a *retirement* savings plan. It’s not a save-for-your-next-vacation plan. It is in their best interests not to raid the account, and they need to understand what they forfeit in terms of long-term growth when they do so.
- **At a minimum, educate participants about the tradeoffs.** Even if you decide to keep your plan’s loan provisions wide open, it’s important that participants understand what the “cons” are that offset the “pro” of an easy source of loan money. After all, if the participant’s only choices end up being a 401(k) loan or racking up thousands of dollars of high-interest credit card debt, the 401(k) loan is still the better choice.
- **Consider tightening up the loan provisions.** Consider restricting loan purposes to those similar to a hardship distribution. Your loan provision might be somewhat less restrictive. For example, you might want to allow people to take out a loan to buy a car to provide reliable transportation, or for educational purposes, or to purchase or make improvements to real estate. The intent is to provide for items that allow participants to keep working, invest in their futures, or take care of a financial emergency.
- **Revisit the role of a loan committee.** Most employers prefer *not* to decide which loans are acceptable, which is why they offer open-ended loan provisions. If your loan committee approves loans, there needs to be a clear policy that protects it from accusations of discrimination. You may also need to have an appeals process in place.

Common Loan Restrictions

For plans that do restrict loans, these reasons are commonly allowed:

Expense	% Permitting
Home purchase	95%
Education expenses	92%
Medical expenses	86%
Financial hardship	65%
Home improvement	43%
Automobile purchase	16%
Other	8%

Source: PSCA www.psca.org

- **Only allow one outstanding loan at a time.** Given the headaches with multiple loans, we recommend restricting loans to one at a time in your Plan Document and Summary Plan Description.
- **Consider requiring a call with a financial planner as part of the process.** Perhaps there are better ways the participant can meet the needs. As a service, consider requiring or at least strongly encouraging a discussion with a financial planner as part of the loan application process.
- **Don’t make loans too quick and easy.** There are times that a participant will face a true financial crisis and need his/her money fast. However, there are other times when this is not the case. Giving the participant time to reconsider can be worthwhile.

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Valerie Gieseke, SPHR, is a Senior Communications Consultant at TRI-AD. Her responsibilities include product development, client services, consulting, and new business initiatives consistent with the firm's strategic direction. She joined TRI-AD in 1993 and has more than 20 years of experience in the Human Resources industry including small and large-scale HRIS systems analysis, design and implementation; compensation and benefits design and implementation; employee communication initiatives; and extensive experience with selecting and implementing a wide variety of HR technology solutions. She has also held roles at TRI-AD as a Client Service Manager, Client Relationship Manager, and Senior Health and Welfare Consultant.

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