

# Borrowing From Your Retirement

## Understanding loans from workplace savings plans

We've all heard that we *should* have enough cash to cover three to six months of expenses stashed in an emergency account. But what happens if you need more? Or if an emergency strikes and you aren't prepared?

Well, if you have an essential expense and don't have the money to cover it you will probably begin looking at your credit options. Most Americans have credit cards, many have access to bank loans or other lines of credit, and some tap into another source: their own retirement plans.

Workplace plan loans are widely available: according to a recent study by the Employee Benefit Research Institute, 88% of 401(k) retirement plan participants have access to a loan from their savings plan.<sup>1</sup> Plans may choose to offer these loans to give their participants a way to access some cash, but deciding if you should use one is complicated. Like any loan, you have to consider the costs and fees of borrowing and your ability to handle the debt. But in many ways, borrowing from your own retirement savings plan is different. There are some major advantages, like paying interest to yourself instead of a bank, but there are also unique risks and costs that you should consider before you tap into your nest egg.

"For potential borrowers who will be able to comfortably pay off their loan, the workplace option should be compared to other lenders to see if the total cost of the financing is cheaper," says Stephen Barkhuff, CFP® and senior quantitative analyst at Strategic Advisers, part of Fidelity Investments. "But, because of the special rules surrounding loans from workplace savings plans they aren't for everyone. If you can't be sure you will be able to pay off the loan on time while continuing to save for retirement, or if you won't be able to repay the loan in the event that you lose or leave your job, you should look elsewhere for credit or re-evaluate your need for the loan."



# Do you really need this?

## Retirement Plan Loan Basics

- You can still contribute to your retirement plan while you have a loan.
- The money you borrow will be removed from your investments, lowering your balance and removing the possibility of investment gains or losses. As you pay the loan back, the interest and repaid principal are added to your investment portfolio.
- You must repay your loan with interest at regular intervals—at least quarterly or more often if your plan requires it. Failure to pay may generate taxes and penalties.

Before you take on debt, you should ask yourself if it's worth it. No matter where you get your loan, debt is going to cost you. First, there are the hard costs in the form of fees and interest payments. But debt also reduces your financial flexibility. If your future income is already earmarked for debt payments, you can't use that money to respond to emergencies, save for your goals like college or retirement, or reward yourself with a vacation or other indulgence.

"We all need to be careful about debt," says Chris McDermott, senior vice president, investor education, retirement, and financial planning at Fidelity. "Debt can be expensive, especially high interest debt like credit cards. When you're stuck in a situation with an essential expense you can't cover, it pays to be a smart borrower and explore all your options."

## Shop around

If you do need a loan, it makes sense to compare the terms of the loans offered by credit cards, banks, and your retirement savings plan. The federal government provides some general guidelines for plan loans, like a maximum loan repayment period of five years, except for loans used to purchase a primary residence, and a maximum limit on the size of the loan (see the table below). But critical elements are left up to each individual plan, including whether or not to offer a loan, the interest rate, sizes, fees, loan requirements, and repayment schedule.<sup>2</sup>

If you are comparing a 401(k) or 403(b) loan with a bank loan or credit card, be sure to get details on your plan's interest rate, fees, and other loan terms, and compare them to your other choices.

## The upside

Beyond the normal considerations for a loan, borrowing from your retirement plan has some unique considerations. In the wake of the 2008 credit crisis, gaining access to a bank loan has become more difficult, and rates for many borrowers have risen. With a loan from your workplace savings plan, you won't need to pass a credit check. And that's not all. Generally, the loan application process is much more complicated at your bank than at your retirement plan account. But maybe the biggest benefit of borrowing from

yourself is interest. When you pay a loan off with a bank, they keep the interest. When you borrow from your own retirement, you pay the interest back to yourself—instead of handing it over to a bank or credit card.

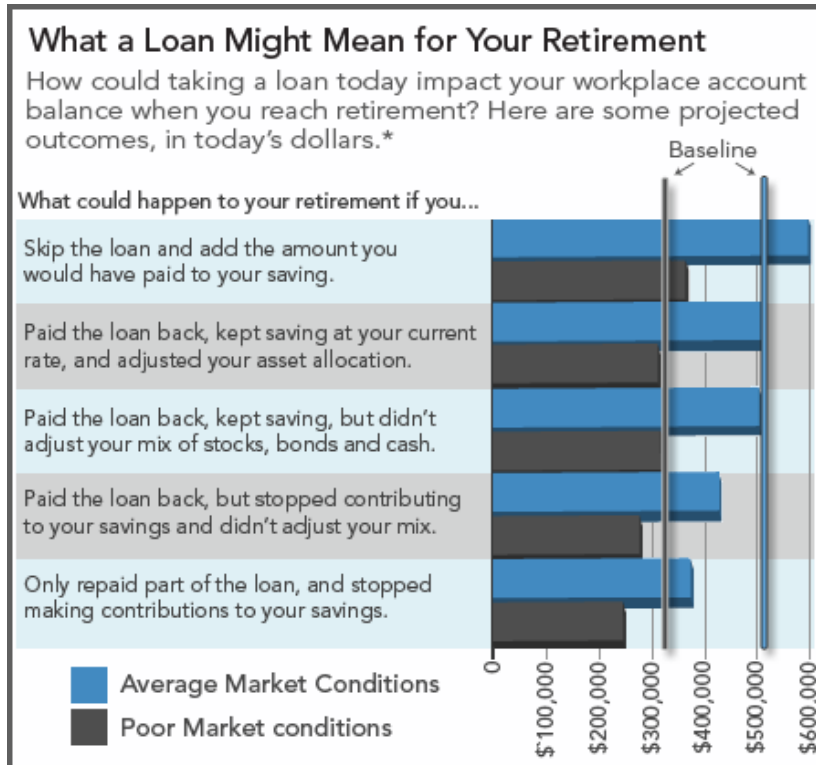
How much can you borrow?	
Vested Balance	Maximum Loan Amount
Less than \$100,000	50% of Vested Balance
Greater than \$100,000	\$50,000
<small>Note: This assumes there are no outstanding loans on the account. The \$50,000 is reduced by the highest outstanding loan balance during the one-year period ending on the day before the date on which such loan was taken.</small>	

## Some unique penalties

Sounds great, right? Not so fast. A lot of the benefits of loans from your retirement plans are double-edged swords. Among the risks to consider:

- **Losing track of your goals.** Not having to go through a formal bank application process and credit check means you may have easier access to a loan. But, with that access comes the potential for problems. There is no loan officer to help you determine how much you will be able to pay back realistically—that becomes your job. If you borrow more than you can handle, you won't be able to fund your top financial priorities, like preparing for retirement. If you can't afford to make the loan payment and can't continue to save for retirement, that's a big problem.
- **Paying penalties.** If you fail to make your payments, your outstanding balance and any accrued interest may be treated as a distribution. That's going to cost you, big time. Distributions from a 401(k) or 403(b) are taxed as ordinary income, plus if you are under age 59½ you may get hit with a 10% early withdrawal penalty. For a person in the 25% tax bracket, that could mean a \$3,500 tax bill on a \$10,000 loan.
- **An early due date.** There is another risk to a workplace loan that you won't find in the private market. If you leave your job or you are laid off, many plans require complete repayment of the loan within 60 days or else it is viewed as a distribution. Again, that may come with a hefty tax bill and penalty. If you were to lose your job and didn't have the cash to cover the debt, you could find yourself with reduced income, a big tax bill, and a depleted retirement account.

“You don’t want to rob your future to pay for today,” says McDermott. “If you take a loan from your workplace savings plan and it ends up costing you the ability to save for retirement—or even worse, you can’t pay it back—your retirement could suffer in a way you might not be able to fix down the road.”



The chart above is hypothetical and for illustrative purposes only. Please see below for the methodology.

*IMPORTANT: The projections or other information generated by Fidelity's planning tools regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. They are intended to provide a rough estimate of investment scenarios over time.*

## A taxing situation

There is one other cost to consider. If you do take a loan from your retirement plan, the interest payments are not tax deductible, just as with a car loan. So, unlike pretax contributions to your workplace savings plan, your interest payments will not reduce your taxable income today, and they will be taxed again when that money is withdrawn from your account.

Also, conventional loans that are used to purchase a house or home equity loans used for home improvement or repairs are generally tax deductible. That’s not true if you

borrow the money from your retirement plan. If you itemize deductions, that could make a difference to your bottom line.

## Rethinking your mix

Once you have a plan in place to pay yourself back on time and avoid distribution penalties, you should next consider your loan as you manage your mix of stocks and bonds. Why? Because instead of having the potential to earn investment returns or suffer losses in the market, the outstanding balance of your loan will be earning the interest you pay into your workplace savings account. Those payments of principal and interest share some similarities to a bond: both offer a preset interest payment over a period of time.

As a result, it might be helpful to think of your loan as part of the fixed income portion of your portfolio. What does that mean for your asset allocation? It may mean you need to increase the amount of money you invest in stocks to keep the same portion of your portfolio in the equity markets.

Look at the example below. In this example, taking the loan adds to the fixed income portion of the investment mix. How to react? To get back to the original asset mix, increase the stock allocation. The loan, plus the remaining fixed income investment, will keep the mix in line with the original.

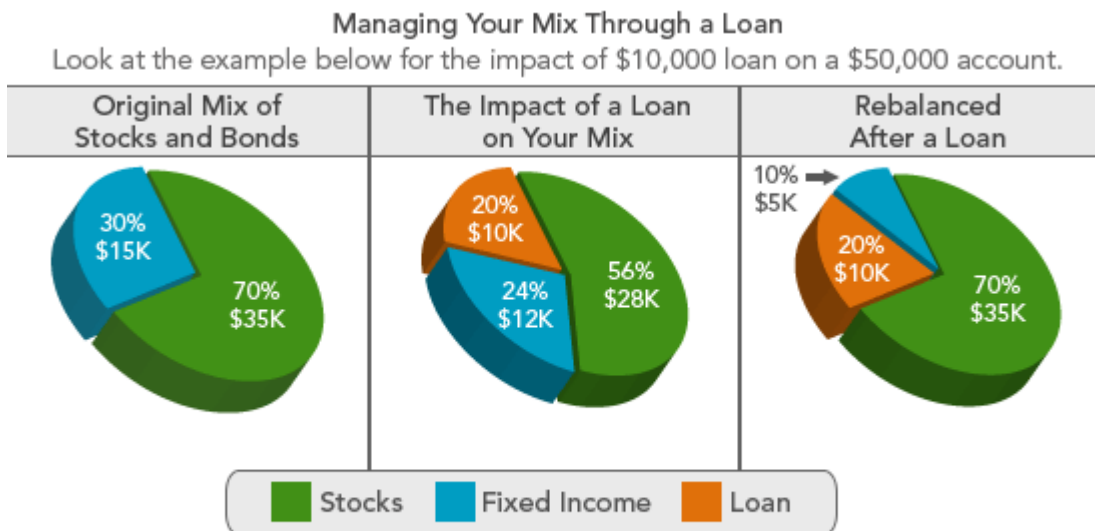


Chart is for illustrative purposes only.

As you repay your loan, you should monitor and adjust your mix to stay in line with your targets. Staying in line with your target mix may help to manage the impact of a loan on your opportunity to earn returns in the markets. Having the right mix is especially important if you have a longer-term loan, for instance if you borrow for your primary residence.

## So when does a workplace loan make sense?

“When taking a loan you should seek out the lowest cost source of credit after taking tax deductions, fees, and other considerations into account,” said Barkhuff. “If your workplace savings plan is the lowest cost, then it may be fine. But you should be very aware of the risk to your retirement if you can’t make contributions while you pay off the loan, or if you fail to pay off the loan. If you can’t manage those risks you should consider borrowing from someplace else or reconsider your need to borrow.”

### How Do You Know if a Loan from Your Plan Makes Sense?

A workplace savings plan loan may make the most sense in the following cases:<sup>1</sup>

- Your financing goals are sensible and not driven by over-consumption.
- You are merely seeking the best terms among all available financing sources.
- After you take the loan, you intend to maintain or even increase your contributions to your plan.<sup>2</sup>
- The interest rate offered by your plan is lower than the rate offered by third-party lenders. After-tax interest rates should be compared to account for differences in tax deductibility.
- The fees charged by your plan are lower than the fees charged by third-party lenders. This may be particularly meaningful if your expected loan period is short.
- The potential opportunity cost is low. This may occur in two cases:
  - You expect your portfolio to produce lower returns than the interest rate on the loan.
  - You take steps to adjust the asset allocation to better capture potential market returns during the loan period.
- You can comfortably repay the loan over the loan period.
- You don’t expect to leave your company (voluntarily or involuntarily) over the loan period.<sup>3</sup>

1. Two recent studies examined several of these cases: Beshears, J., J. Choi, D. Laibson, and B. Madrian (2008): “A Primer on 401(k) Loans,” Manuscript prepared for the 10th Annual Joint Conference of the Retirement Research Consortium, August 7-8, 2008 and - Li, G., and P. A. Smith (2009): “New Evidence on 401(k) Borrowing and Household Balance Sheets,” Federal Reserve Board, FEDS Working Paper 2009-19.

2. Ideally, the savings realized from the lower cost 401(k) loan should be used to increase plan contributions.

3. Borrowers who face a higher likelihood of leaving their company may wish to maintain sufficient liquid assets in a taxable account to repay the loan and avoid a distribution upon termination.

About the chart "What a Loan Might Mean for Your Retirement": Assumes today's date is 1/1/2010, the participant was born Jan. 1, 1970, and has saved \$50,000 in a 401(k). Participant has a balanced portfolio (50% stocks/40% bonds/10% cash), no other savings, and earns \$60,000 each year and saves 5% of salary to the 401(k). Employer matches dollar for dollar up to 5%. Salary increases at a real rate of 1.5% per year. Participant works for 25 more years and retires at age 65. Participant lives in a state with no income tax. The loan is \$20,000 for five years at an interest rate of 5.25%. The 401(k) assets are reduced pro rata, and this assumes no fees.

The second scenario—hypothetically paying the loan back, saving, and adjusting asset mix—assumes an asset rolldown from 83.3% stocks and 16.7% cash to 50% stocks,

40% bonds, and 10% cash.

The third example listed, paying the loan off but not adjusting the asset mix, assumes that both employee and employer contributions are suspended until the loan is repaid.

For the borrower in the final example, where the loan is not paid back, the outstanding balance at end of year 2 (\$12,622.29) is not repaid. That example is a basic model that simply withdraws \$12,622.29 from a \$50,000 401(k) balance in year 1.

Market results reflect 10,000 simulations in today's dollars. The illustrations result from running 10,000 hypothetical market simulations. The market return data used to generate the illustration is intended to provide you with a general idea of historic performance. Our analysis assumes a level of diversity within each asset class consistent with a market index benchmark that may differ from the diversity of your own portfolio. Please note that the projections do not reflect the impact of any transaction costs or management and servicing fees.

Average market conditions means that in 50% of the historical market simulations run, a similar asset allocation performed at least as well as the results shown half of the time. Poor market conditions means that 90% of the time the asset allocation performed at least as well, while 10% of the time a similar asset allocation failed to reach the results shown.

1. Jack VanDerhei, Sarah Holden, and Luis Alonso, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2008," EBRI Issue Brief, no. 335, and ICI Perspective, Vol. 15, no. 2, October 2009.
2. Beshears, J., J. Choi, D. Laibson, and B. Madrian (2008): "A Primer on 401(k) Loans," Manuscript prepared for the 10th Annual Joint Conference of the Retirement Research Consortium, August 7-8, 2008.

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