ARE 401(K) LOANS A GOOD IDEA?

Global Financial Private Capital

SYNOPSIS

- Many Americans view their 401(k) as an easy way to borrow for short-term financing needs.
- Despite the temptation, the dangers of borrowing against a retirement fund are too great.
- Instead of trading one debt with another, address the real problem that created the need for the loan.

THE 401(K) LOAN

The chart below shows the rise in credit card debt by plotting the Federal Reserve's consumer credit balance over the last several decades, and it appears that consumers are now back to the record highs experienced prior to the financial crisis.

It's not uncommon for consumers to fall into credit card debt at some point in their lives, and those who owe large balances want out as fast as possible because the pain of interest payments can take an emotional toll. One option that many consider is using their 401(k) to pay off these bills.

While each 401(k) plan establishes its own loan provisions, most 401(k) plans are set up in a way that allows employees to borrow up to 50% of the value of the fund with a maximum of $50,000. The appeal of such a loan is that the interest rate is usually quite low relative to a credit card, and the borrower is paying interest back to himself (since he is both the lender and borrower).

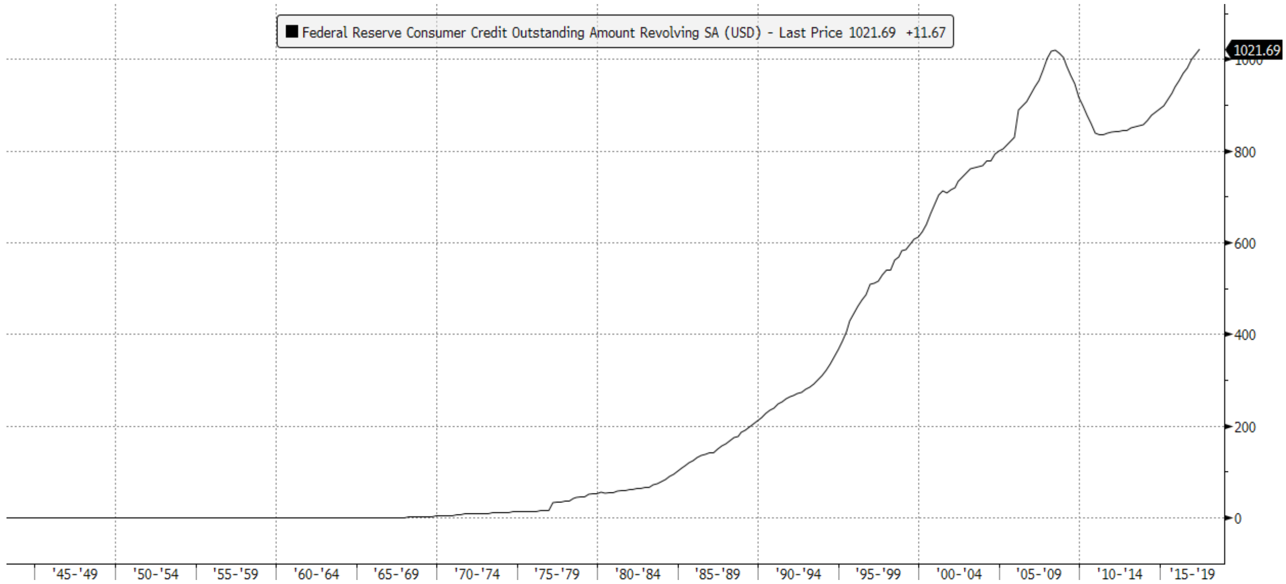
"...solving one problem by creating a much larger one is not the answer."

The popularity of 401(k) loans surged after 2008, primarily since borrowers were no longer able to use home equity loans as easily as in years leading up to the financial crisis.

However, investor should be cautious when considering these loans for five very important reasons:

1. **After-Tax Dollars**: One of the best features of a 401(k) is that they get funded with pre-tax dollars and loans are not taxed. However, 401(k) loan repayments are made with after-tax dollars even though the funds will be taxed again when they are taken as distributions at retirement.

2. **Missing Out:** The money removed from the 401(k) is no longer being invested, which means that the amount removed will not have the potential to grow and/or compound over time. Furthermore, many



Source: Bloomberg

employers will not allow future contributions until the loan is repaid.

3. **Don't Quit or Get Fired**: If the borrower were to lose his job for any reason, he must repay the entire loan amount in full, usually within 90 days. Otherwise, the loan is treated as a distribution, which means the full amount will be subject to income tax and a 10% withdrawal penalty if he is under the age of 59½.

4. **Repayment Closer to Retirement**: The older the borrower, the less time that individual will have left to pay back the loan before retiring.

5. **Defeats the Purpose**: A 401(k) exists for the sole purpose of preparing the borrower for retirement. No matter how urgent he may think his present situation may appear, it will be nothing compared to what he'll experience if he's in his 70s or 80s without adequate funds.

Simply put, any perceived advantage to using a 401(k) loan is significantly outweighed by the risks associated with paying it back.

IMPLICATIONS FOR INVESTORS

The media may lead us to believe that North Korea, instability in Europe, pandemics, and terrorist attacks are what poses risk to investors' nest eggs, but the real threat to one's financial future is more frequently him or herself.

According to the IRS, over $5.7 billion in penalties were collected from early withdrawals in 2011[1]. Since the penalty for early withdrawal is 10%, Americans must have withdrawn $57 billion from their funds before retirement. This scares me way more than Kim Jong-un.

Making matters worse, these loans almost never alleviate the real problem. Robbing Peter to pay Paul does not teach an individual to cut up those credit cards and stop spending money on stuff they don't need.

All it does is hit a psychological reset button to where the individual now thinks that he/she is free from credit card debt, which ultimately leads to new credit card debt down the road. Add it to the 401(k) that has to get repaid, and this downward spiral gains momentum that can often be irreversible.

Life is not fair, bad things happen to good people, and we all make financial mistakes along the way. But solving one problem by creating a much larger one is not the answer. Find another way to pay off that debt.

The bottom line is that a 401(k) should be kept off limits until retirement.

Sincerely,

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1 https://www.bloomberg.com/news/2014-05-06/early-tap-of-401-k-replaces-homes-as-american-piggy-bank.html

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