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A Closer Look at Retirement Plan Loans

In a perfect world, no one would need to prematurely withdraw funds from their retirement plan. Reality, however, proves that sometimes situations call for plan participants to dig into those savings. With approximately ¾ of retirement plans allowing participants to take a loan, the question lies in whether offering loans interferes with the ultimate objective of saving for the future.

A recent study published by the National Bureau of Economic Research (NBER) found that 401(k) loans are not as great a problem as politicians and press have led people to believe. The NBER study found that loan provisions may have the subtle effect of raising asset accumulation by making 401(k) participation more appealing - employees who can access their 401(k) assets are willing to put more money into an otherwise illiquid 401(k) account. The study concluded that it may be possible to structure 401(k) loan provisions in a way that reduces the potential to negatively impact retirement wealth accumulation. It also found that plans that allowed for multiple loans had low minimum loan amounts, and lower interest rates had high loan utilization and potentially greater negative impact on retirement savings.

The decision to permit plan loans is unique to each company. Multiple factors need to be taken into consideration when determining if allowing plan loans, and in what capacity, is appropriate. Allowing 401 (k) loans will increase plan administration costs. The following can help keep loan program costs under control and reduce the impact on retirement savings accumulation:

- Limit the number of loans a participant may have outstanding at one time to one. This serves as an effective way to prevent overuse.
- Restrict loans to financial hardship reasons and only allow participants in extreme need to withdraw funds.
- Impose a minimum loan amount of $1,000 to keep administration cost down.
- Require loan repayments be made through payroll deduction, which reduces loan defaults and simplifies loan administration.
- Charge loan fees directly to the participant taking out of the 401(k) loan.
- Charge an appropriate interest rate on loans.

For some employees, loans are taken all too easily. Education is another important aspect of allowing 401(k) plan loans. Participants need to recognize the unrealized cost of taking a loan and the potential tax implications. As a Plan Sponsor, it is important to communicate the considerable long-term impact of taking a 401(k) plan loan and help employees work towards building up their retirement savings.

Employers Slow to Resume Matching Contributions

In response to the economic downturn in 2008, many employers eliminated or reduced matching contributions to their 401(k) plans. Today, many of those companies have returned to profitability, yet less than half (44%) have resumed their match. Another survey reveals that of the companies that planned on restoring their match at the beginning of 2010, only about 33% have done so.

"It's the lack of confidence in the future. Companies don't like to make commitments to their employees and withdraw them. It's not good for the morale of the workforce," David Wray, president of the Profit Sharing/401k Council of America said.

One way employers can restore their matching contribution but still give themselves some flexibility is to reinstate their match as a discretionary year-end matching contribution. The year-end match can be based on company profitability and would serve not only as incentive to contribute to the 401(k) plan, but also provide motivation to work towards the company's success.

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