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Participant Loans in Retirement Plans – Part 1

With recent studies indicating that the majority of qualified retirement plans allow for participant loans, retirement plans have become a popular source for short-term borrowing. Below we will outline the rules that apply to loans from retirement plans, and identify some pros and cons associated with allowing employees access to funds earmarked for retirement.

The Basics

Retirement plans are not required to provide for loans; however, if loans are available, the following general rules are applicable to this feature:

- Maximum Loan Limit – 50% of vested account balance up to a maximum of $50,000.
- Repayment Terms – repayment must occur within five years (exceptions apply for the purchase of employee's primary residence).
- Frequency of Payments – substantially equal payments must be made at least quarterly to avoid default.

In addition to these rules, plan sponsors can modify their plan's loan policy to address items such as:

- Maximum number of loans allowed at one time,
- Reasons for which loans are allowed (e.g. hardship criteria, etc.),
- Applicable interest rate,
- Refinancing of existing loan balance, and
- Manner of repayment, such as automatic payroll deductions.

Difference of Opinion

Like most things, there are conflicting opinions as to the benefits of allowing loans in a retirement plan. Whether deciding upon implementing a loan feature or simply reviewing existing policy, plan sponsors should consider the following viewpoints for and against borrowing from retirement plan accounts:

Pros:

- Allows quick access to funds without incurring taxes and penalties associated with distributions.

- Provides employees access to low-cost borrowing with interest paid back to employee's

- Avoids negative impact on credit rating, even if ultimately defaulted.
- If the retirement plan allows 401(k) deferrals, encourages participation in the plan, along

Cons:

- Increases administrative burden on plan sponsors.
- Compounds inadequate savings as investments are sold and opportunity for market

- Results in prohibitive taxes and penalties if employee terminates employment and does

- Leads to adverse tax consequences as loan payments are not tax-deductible and will

While allowing loans in your retirement plan may be an attractive option, it can also result in unintended negative consequences for plan participants and sponsors. If you would like additional information on your plan's loan policy, or the potential of implementing the loan feature, please contact your plan's relationship manager for further guidance.

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