How Loans May Affect Your Retirement Savings

Is taking a loan from your retirement savings account a good idea?

Before taking a loan from your retirement plan, consider:

- The impact of borrowing from your future
- The costs of a retirement plan loan
- Other influential factors
- Your alternatives
- A loan's impact on your investment strategy

Having the option to borrow from your retirement savings plan can provide a sense of comfort. Knowing you can access your money in a pinch may even make you willing to save a little more. But is it really a good idea?

Individual circumstances vary, so there is no simple answer to this question.

The Impact of borrowing from your future

The common perception is that borrowing from yourself is the best approach — you pay interest and principal back to your account. And it's easy — your loan payments are usually taken directly out of your paycheck. Another advantage is that qualification is usually automatic *(if your loan request meets your plan's borrowing criteria)*.

However, taking a loan from your retirement savings plan may not be in your best interest. Before you draw from your retirement savings, consider your retirement savings goals. The reason that you save in a retirement savings vehicle is to grow and accumulate a nest egg to secure your future. When you draw upon that, you may be setting yourself back from reaching your goals. It's important to weigh the particular need for a loan with your intent to grow your retirement savings. Consider the costs and alternatives before you decide whether or not to borrow from your future.

The costs

Compare the costs of other loan alternatives with the costs of borrowing from your retirement savings:

Loan fees

Each Participant loan will be subject to a $50 origination fee and a $35 annual administrative fee for the duration of the loan. The loan origination fee will be deducted from the Participant's account at the time the loan is made and the annual administrative fee will be deducted semi-annually in installments of $17.50 each. Fees may be revised prospectively by the Board.

Interest rates

Every loan must bear a reasonable rate of interest. The interest rate for a loan will be specified at loan origination and will be fixed for the term of the loan. The applicable interest rate will be determined by the Knox County Retirement and Pension Board, upon recommendation of its Investment Committee. The interest rate for a new loan will be reviewed periodically and may be subject to change. The current interest rate is 6% per annum.

Other influential factors

There are a few other factors you should be aware of before choosing to take a loan from your retirement savings plan:

What if you leave your employer before your loan is paid off?

One major factor to consider when deciding whether or not to borrow from your retirement savings account is what happens if you leave your employer. Pursuant to the Loan Program, you have a short period of time to repay the loan. If you don't do so, the outstanding balance is treated as a distribution and subject to income tax and often a 10% tax penalty *(if under age 59 ½)*. Taxes may be as much as 45% of the total loan amount!

Tax considerations

A general misperception is that borrowing from your retirement savings plan gives you a tax advantage. In fact, there is no tax advantage to taking a loan from your retirement savings. Even though the loan amount is taken from your pre-tax dollars, you will use after-tax dollars to repay the loan and interest. Loan repayments are not tax-deductible. If you don't repay your loan, the balance plus interest will be reported as taxable income.

Your alternatives

Other borrowing options may provide the cash flow that you need without dipping into long-term savings. Loans are available from many different sources with a variety of rates and terms. Some, like home equity loans, offer attractive interest rates and possibly a tax deduction.

A loan's impact on your investment strategy

When you borrow, you actually create a fixed income investment *(bond)* in your retirement plan. A bond is a loan — you pay yourself back principal plus regular interest payments. Fixed income investments produce returns only from interest payments. Stocks, on the other hand, have the potential to generate higher returns.

If you are an aggressive investor with most of your savings invested in stocks, taking a loan could significantly alter your investment mix. It is important to keep this in mind when you calculate your expected rates of return and savings goals. You may find you'll need to adjust your investment strategy to compensate for the portion of your account now allocated as a fixed income investment *(the loan)*.

Here for you and your Nest Egg!
KNOX COUNTY
RETIREMENT & PENSION BOARD

This information is for educational purposes only. All investments have some kind of risk. This is an educational tool to help
you make informed financial decisions in planning for your retirement. It does not advise or recommend specific investments or investment strategies.

©2016 Arnerich Massena Education, Inc. All rights reserved. All investments contain some risk. This piece is an educational tool to help you make informed financial decisions in planning for your retirement. It does not advise or recommend specific investment or retirement plan strategies. This piece is protected by U.S. and international copyright laws. For information about obtaining special rights, contact Arnerich Massena Education at www.arnerichmasseducation.com or 1-800-929-5179.