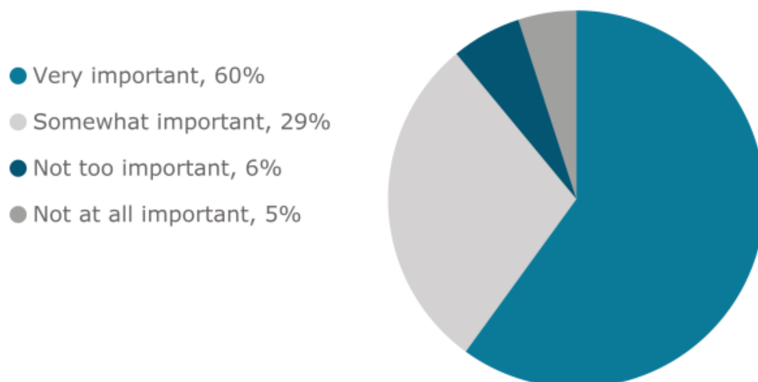
Why 401(k) loans are the worst possible investment

Taking a 401(k) loan is such a bad investment choice that it should not be allowed in any 401(k) plan other than for hardship reasons. And yes, it is an investment because when plan participants take 401(k) loans, they become one of the investments in their accounts.

Before allowing workers to pull money out of their accounts, employers and employees should consider these importance factors.

Borrowers often lose the company match. Many participants who borrow from their 401(k) accounts end up stopping or lowering their 401(k) contributions while they are paying back their loans. This often results in the loss of 401(k) matching contributions when a participant's contribution rate falls below the maximum matched percentage.



Job changes can force defaults. Most participants considering a job change don't realize that their outstanding 401(k) loan balance becomes due when they leave their current employer. In the case of involuntary job loss, an outstanding 401(k) loan can add significant pain to an already difficult situation. Regardless of whether a job change is voluntary or involuntary, nearly all participants don't have the financial resources available to pay back their 401(k) loans when they separate from service. As a result, a large percentage of these participants are forced to default. The defaulted balance becomes subject to state and federal taxes and possibly state and federal early withdrawal penalty taxes. Plan balances that leave a 401(k) plan forever before retirement are referred to as leakage. "Leakage" from defaulted 401(k) loans makes it less likely that participants will build adequate retirement savings.

Opportunity costs can be substantial. Assume that a participant takes a $10,000 loan for five years at 6%. The investment experience on that portion of the participant's balance will be a 6% return for five years. Had the loan balance been invested in the investment options in the plan for the same period, the participant may have earned a lot more. For example, the

five-year return on the Vanguard 500 Index Fund through March 31, 2017, was more than 13%.

Interest on a 401(k) loan is not tax-deductible. Anyone needing a loan should investigate the possibility of taking a home equity loan first, since interest on these loans is tax-deductible.

Paying interest to yourself is not such a good idea. I've heard many participants say that they believe 401(k) loans make sense because they are paying interest to themselves. They often add that the higher the interest rate, the better. First, it is normally not a desirable financial strategy to pay interest of any kind. Second, why would you want to pay a higher interest rate on a loan just because you are paying interest to yourself? That just means you have less of a paycheck to live on. Finally, it appears that the interest on 401(k) loans is double taxed. Since loan payments are made on an after-tax basis, interest on each payroll loan payment is first taxed then and taxed for a second time when paid out as a distribution at retirement.

Bad loans end up being made. Unless the plan uses hardship provisions to qualify for a loan, a plan sponsor cannot deny a participant loan request. This makes the 401(k) plan the lender of last resort and results in many bad loans being made to participants who are not creditworthy. Easy access to 401(k) loans can often make a participant's bad financial situation worse.

Many participants have said, "Bob, if taking a 401(k) loan is so bad, why would the company let me do it?" Good question. It is clear that participant loans can drastically reduce an employee's chances of achieving retirement readiness. As a result, plan sponsors should seriously consider limiting loan availability to hardship criteria or eliminating loans entirely from their plans.

Robert C. Lawton, AIF, CRPS is president of Lawton Retirement Plan Consultants, LLC, a RIA firm helping 401(k) plan sponsors with their investment, fiduciary, employee education and compliance responsibilities.