401(k) Loans

The Pros and Cons of 401(k) Loans

Many employers today allow their employees to take loans from their 401(k) accounts. But just because you can borrow from your retirement savings doesn't mean you should.

A 401(k) loan means temporarily taking money out your workplace retirement account that could have remained in the account and potentially generated investment earnings. If you don't pay the loan off quickly, it could reduce the long-term value of your retirement savings.

That said, a 401(k) loan could make sense in certain circumstances. It's important to understand how the loans work—and the alternatives—before you sign the loan document.

How 401(k) Loans Work

Employers can decide whether to allow employees to borrow from their 401(k) accounts, and 87 percent of employees are in a 401(k) plan that offers loans, according to a study by the Employee Benefit Research Institute.[1]

Typically, an employee is allowed to borrow up to 50 percent of his or her account balance up to a maximum $50,000. Loans generally must be repaid within five years, though an extended repayment schedule may be given if you're using the money for a down payment on a home. Repayment is typically made through ongoing paycheck deduction until the loan is fully repaid.

If you quit your job or are terminated, you must repay the outstanding loan balance within 60 days or it's treated as a taxable distribution. You will also owe income taxes and a 10 percent early-withdrawal penalty (assuming you're under age 59½) on the balance.

The Upsides

Unlike traditional bank loans, 401(k) loans can be approved and processed within a few days—after all, you're essentially lending money to yourself. That means you don't have to wait weeks to access the funds.

Moreover, interest rates may be lower than those charged on standard bank loans, especially if you don't have a stellar credit rating. Plans must offer all employees the same interest rate, which is typically a point or two above the prime rate. Another bonus: Instead of paying interest to a bank, you're paying it to yourself.

The Downsides

Despite the positives, there are many good reasons to think twice before taking a loan from your 401(k). For one, you may lose several years' worth of potential earnings on the money you borrow. If you take a $20,000 loan, for example, that amount may have grown to $25,000 over the five-year loan period had it remained in your 401(k). And, if you stop contributing new money to your 401(k) while you repay the loan, you'll lose out on all the potential benefits of doing so—including growth of your 401(k) balance, any matching contribution from your employer and the tax break for contributions.

Also consider that the repayment terms of 401(k) loans are not usually as flexible as other types of loans. Unlike bank loans, you generally cannot extend the loan beyond five years and you must repay the loan within 60 days if you leave the company or get laid off. And unlike home-equity loans, the interest you pay on 401(k) loans is not tax-deductible.

Weigh Your Options

Before borrowing from your 401(k), consider the alternatives. An advisor with BOK Financial Advisors can help you evaluate possible options. Even taking a loan from a family member or friend may be a smarter move than borrowing from your retirement savings.

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1 – Employee Benefit Research Institute, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2014," April 2016.

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