Are your employees borrowing from their futures?

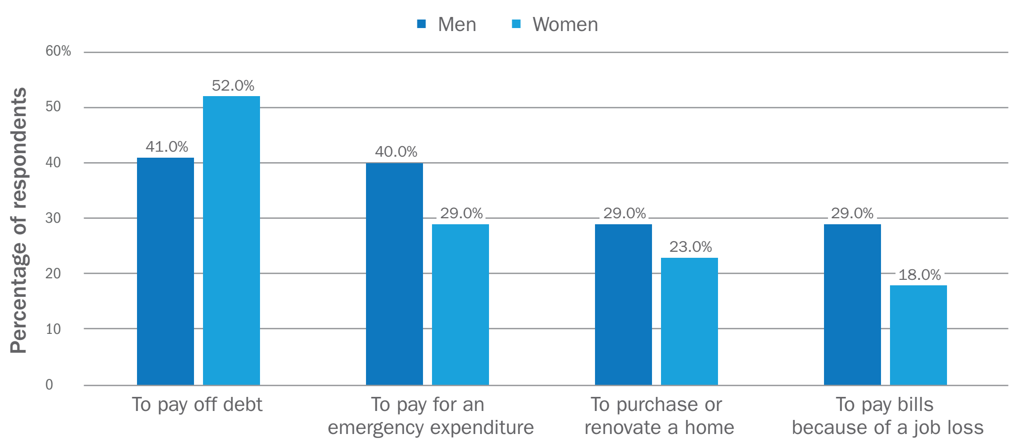
Retirement plans should promote long-term savings rather than act as a source of funds for big-ticket items or unexpected expenses. Yet 29% of Americans with an employer-sponsored retirement plan have taken a loan from the savings in their retirement plan and almost half of these regret having done so, according to the TIAA-CREF 2014 Borrowing Against Your Future Survey.[1] As a plan sponsor, you can help protect your workforce's retirement assets and improve their retirement readiness by:

- educating employees about alternatives to taking out loans, and
- limiting the number of loans they can take.

The long-term effects of loans

Employees are taking sizable loans that can have a meaningful impact on their retirement savings—and they are not doing so just once, for an emergency. More than 40% of respondents have taken two or more loans, and nearly half (47%) borrowed more than 20% of their retirement plan savings. Although "emergency expenditures" was the #2 reason respondents cited for taking a loan, the #1 reason was to pay off debt.

Exhibit 1: Men and women borrow from retirement savings for different reasons



Source: TIAA-CREF 2014 Borrowing Against Your Future Survey

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When employees take out retirement plan loans, they are missing out on some of the potential growth of those assets during the loan payback period. Even worse, 57% of respondents slow down their contributions while they pay back the loan: 21% reduced their contributions by at least 50%, and 5% stopped contributing altogether. This trend is even more pronounced among Generation Y, with 81% of respondents aged 18-34 decreasing contribution rates while they paid back loans.

Guardrails help protect retirement assets

There are good reasons for plan sponsors to offer employees the option to take loans. Employees, particularly those just starting out in their careers, may be wary of putting money into retirement savings if they know they can't use it in an emergency. Furthermore, some TIAA-CREF plans allow employees to continue earning interest while paying back the loan,[2] which is more forgiving than traditional 401(k)-style loans.

But that doesn't mean that employees should have unrestricted access to their retirement savings. If employees have the ability to take multiple plan loans, they will be more likely to treat their retirement plan as a source of funds during the years when they should be saving. And if they default, they not only reduce the amount of funds available for retirement—they can also trigger tax penalties.

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Therefore, plan sponsors should consider limiting loans to no more than three per participant, which is a common best practice in the 401(k) space. Loans should be available only from participant contributions rather than employer contributions.

As an added benefit, limiting loans can also keep down plan expenses and have a positive impact on overall plan fees.

Understand the rules

The IRS has clear provisions around loans from retirement plans.[3] Below are some highlights; for more information and details specific to your plan, contact your TIAA-CREF relationship manager.

- An employee can borrow 50% of the vested account balance or $50,000—whichever is less.
- Generally, the employee must repay a plan loan within five years, although there is an exception if the employee uses the loan to purchase a primary residence. He or she must make payments at least quarterly.
- If a loan is not paid back on schedule, it is considered a distribution that is subject to income tax and may be subject to the 10% early distribution tax.

Help employees understand their actions

Plan sponsors also have a responsibility to educate employees about the long-term impact of taking loans and cutting their contribution rates. Calculators and tools that show just how much employees stand to lose can be effective deterrents against loans. Many people believe that there is no harm in a retirement plan loan since they are, in effect, paying themselves back. They may feel differently if they see, for instance, that a $10,000 loan paid back over five years could mean they are forgoing more than $3,500 in potential earnings.[4] Similarly, calculators can show the long-term effects of decreasing their contributions, even temporarily.

An effective loan education program should also make employees aware of different financing options or planning strategies that are available to pay off expenses. For example, employees could use a student loan, if appropriate; a home equity loan or home equity line of credit (HELOC); a loan from a life insurance policy; or a distribution from a Roth IRA. (Click here for an article that helps participants understand their options.)

The good news is that employees do not consider taking loans lightly. Four in ten of the survey respondents regretted taking out a loan and an additional 23% don't regret it, but would not do it again. By providing employees with the knowledge to make the right decisions, plan sponsors can help them avoid future loan regrets.

Saving retirement funds for retirement

With the right approach to education and plan design, you can promote positive savings behavior that can help improve employees' retirement outlook. To learn more, contact your TIAA-CREF relationship manager.

[1] The survey was conducted online by KRC Research, a third-party research firm, among a national random sample of 1,000 adults contributing to a 401(k), 403(b) or defined benefit plan. Data was weighted by key demographic variables to ensure that the sample reflects the national population distribution.

[2] For some TIAA-CREF retirement plans that offer the TIAA Traditional account, employees' borrowed funds will be moved to TIAA Traditional as collateral, which will continue earning interest, while they repay the loan to TIAA with interest.

[3] http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics---Loans

[4] This scenario assumes the borrower is 40 years old, with 25 years left until retirement; that it is a five-year loan, with 6% loan interest; and that there would have been an 8% return on funds over the next 25 years if the loan had not been taken. This is a hypothetical illustration. These returns are for illustrative purposes only and do not reflect actual performance or the fluctuations inherent in investing.

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