Initiative Cautions Against Tapping Into Retirement Plans

by Marc Shapiro

In the midst of a slowing economy that could cost them their jobs, increasing gas prices and a growing credit crisis that has put their homes at risk, millions of U.S. workers, including public sector employees, are eyeing their defined contribution retirement plans as a source of cash to ease them through.

But borrowing from an employer-sponsored defined contribution retirement plan — on the rise according to recent surveys from several financial institutions — can be an expensive idea and one that should be far down any public sector worker's list of options.

The rate of borrowing from 401(k), 457 and other workplace savings programs is on the rise, according to reports from several major financial institutions. The Employee Benefit Research Institute estimates private sector participants have nearly $50 billion in outstanding loan balances in their retirement plans.

To emphasize their concern, NLC and ICMA-RC have joined to encourage public sector employees to use other resources before borrowing from their retirement plans. ICMA-RC provides retirement plans exclusively to state and local governments and is an NLC Corporate Partner.

“We are working closely with cities and city employees to ensure they know the wealth of resources available to help them cope with mortgage payments and other financial pressures during these tough economic times,” said NLC Executive Director Donald J. Borut. “By joining with ICMA-RC, we are working to raise awareness with city workers and are encouraging them to consider all the alternatives.”

The joint NLC/ICMA-RC effort includes links to resources available to homeowners facing economic uncertainty because of job loss or impending home foreclosure. Links to information about saving for retirement as well as basic financial education tools available at www.ICMARC.org are also on the NLC website. The websites will provide links to articles, worksheets, and other resources including interviews with NLC and ICMA-RC officials.

“These are challenging times for many Americans who face economic uncertainty,” said Gregory Dyson, senior vice president of marketing at ICMA-RC. “But it is important for people to remember that building a secure retirement depends on regularly saving money now and not borrowing against their future. ICMA-RC is pleased to join with the National League of Cities on this important issue.”

Pitfalls of Tapping Retirement Plans

The NLC website raises issues that city leaders should share with their city employees including warning those considering a retirement plan loan that using these plans first is almost always a bad idea.

- It would mean employees are borrowing potentially expensive money because they are forfeiting whatever the loan balance would have earned while they are paying off the loan.

- Because of future compounding on the money they borrowed the final cost of the loan could have a significant impact on their savings at retirement.

- They've added additional risk because the loan may be due immediately if they quit or lose their job.

They may also qualify for a “hardship distribution” if their plan offers one. Rules vary by plan, and federal regulations are specific on how these withdrawals can be used. The withdrawals do not have to be repaid, but the employee must pay taxes and any applicable penalties on the hardship distribution. The impact on retirement savings can be substantial in the long run.

For example, if an individual received a $15,000 hardship distribution at age 35 from an account with a balance of $30,000, over the course of 30 years the distribution would cost more than $122,000 in lost savings, assuming a return on investment of 7 percent.

Alternative Moves to Avoid Borrowing

The NLC website offers advice on alternatives to borrowing from a retirement plan:

- If an employee is falling behind their mortgage payments, they should contact their lender immediately

- If they have an adjustable-rate mortgage and have good credit, they could refinance to a fixed-rate mortgage.

- Counseling services can help homeowners work through a financial crisis such as this.

- Retirement plan sponsors may offer financial education on their web sites. Or go to www.ICMARC.org to learn more about saving and investing.

The NLC resource page also provides examples of city foreclosure prevention practices and anti-predatory lending ordinances as well as links to federal and national organizations providing assistance on mortgage financing and foreclosure, including HOPE NOW and NeighborWorks America, among others.

Details: For more information, visit the "Resources for Responding to the Home Mortgage Crisis" page on the NLC website at www.nlc.org/resources_for_cities/nlc_icmarc_resources.aspx.