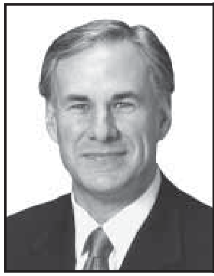

KNOW THE COST OF A 401(K) LOAN

by Texas Attorney General Greg Abbott

TEXANS WHO ARE STRUGGLING WITH mortgage payments and rising credit card debt may be tempted to view their retirement savings as a short-term solution to their cash crunch. This temptation may be especially prevalent among 401(k) participants, who are allowed by federal law to borrow money from their retirement accounts within certain guidelines. Given the long-term financial costs of a 401(k) loan, Texans should carefully consider other financing options before opting to borrow from their retirement plans.

According to the Employee Benefits Research Institute, 40% of the professional-aged population uses 401(k)s or IRAs to save for retirement. In 2006, about 18 percent of eligible 401(k) participants have outstanding loans, with an average outstanding balance of $7,200.

For some employees, borrowing against their 401(k) plan may make sense in emergency situations. Indeed, borrowing from retirement plans has become even easier in recent years with the introduction of the 401(k) debit card, which allows employees to withdraw money directly from their 401(k) plans for purchases. But Texans who are considering any financial transaction involving their 401(k) plans should pay close attention to applicable federal income tax laws and IRS regulations in order to avoid financial penalties.

Typical 401(k) debit card programs transfer a specified amount from an investor's 401(k) fund into a money market account that is managed by the debit card issuer. Because most money market accounts typically earn lower returns on investment than retirement plans, investors who withdraw money from their 401(k) plans sacrifice long-term earnings and depletes the retirement account.

The lost earnings and investment potential may be in addition to the debit card program's higher money management fees, enrollment costs and annual membership charges. Other potential costs include advance fees, for which investors are charged as much as $2 per cash withdrawal. Each debit card transaction also means reduced investment assets, less return on investment and fewer retirement savings in the 401(k) account.

Despite the negative long-term implications, however, Texans facing financial difficulties may turn to 401(k) loans since they do not require a credit check and typically appear to offer low interest rates on the debt. But even a small loan from a retirement account can have a big impact on long-term savings goals, and the pervasive myth that repaying the borrowed money with interest is like "paying yourself" simply is not true.

Investors who borrow against their 401(k) plans lose interest income that would have accrued if the borrowed funds were still invested in the retirement plan. That reduction lowers the overall value of the fund because there is less compounding principal to generate investment income.

Prematurely withdrawing 401(k) investments also costs investors more money in the long run, because assets that could be appreciating and earning income are put to less efficient uses. While a 401(k) loan may appear to offer a better interest rate, the fees and lost investment appreciation generally offset the interest rate savings.

An additional problem arises when employees fail to promptly repay their 401(k) loans. Federal law penalizes investors who withdraw money from their 401(k) accounts before reaching the age of 59. Similarly, when employees fail to repay 401(k) loans within five years, their loans are treated as premature distributions and therefore subjected to a 10 percent early withdrawal penalty, plus taxes and fees on the outstanding loan balance. In addition, the employee is considered to have defaulted on the loan, which can negatively impact consumer credit scores and further increase the cost of borrowing money.

In many cases, employees who use a 401(k) loan for extra cash find themselves struggling to fully fund their retirement plan and repay the loan. Saving for retirement may take a backseat to repaying the loan. Texans considering a 401(k) loan should always keep in mind that reducing monthly 401(k) contributions lowers overall retirement savings and therefore negatively impacts their retirement investment portfolio's value.

Before taking out a consumer loan, Texans should carefully review the proposed interest rate, payment schedule and any associated fees. Borrowers who have encountered misleading information about a consumer loan may file a complaint with the Office of the Attorney General by calling (800) 252-8011 or visiting our Web site at **www.texasattorneygeneral.gov**.

Despite the ever-increasing ease and convenience of borrowing against a 401(k) plan, Texans must remember that using retirement funds to pay themselves now will cost them later.