T. ROWE PRICE INSIGHTS
ON RETIREMENT

How Untimely 401(k) Loans Can Impact Your Retirement Savings Over Time

Having an emergency fund for short-term financial challenges could improve financial wellness.

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KEY INSIGHTS

- Multiple small loans from retirement savings correlate with lower retirement plan contributions.
- A lack of emergency savings could lead to untimely loan withdrawals and hinder successful retirement outcomes.
- It's important to maintain an emergency fund that could cover three to six months' worth of expenses.

Financial wellness can be defined as your level of comfort with your current financial situation and confidence in your future financial outcomes. For many people, the challenges of balancing day-to-day household finances while also juggling competing financial goals often persist throughout their careers.

There is growing recognition that the financial stresses caused by managing these responsibilities could be barriers to successful retirement outcomes. We recently examined how the lack of emergency savings can negatively affect your retirement savings. And how maintaining an emergency fund that can cover at least three to six months of expenses may significantly influence your retirement contribution rates and savings balance over the long run.

What Are People Struggling With?

Many workers are not saving the typically suggested 15% of their pay, including any employer match, for retirement. In our most recent study, 55% of survey respondents stated that they are not saving enough for retirement or are not sure if they are. Among these respondents, 62% indicated that they were saving all they could afford.[1]

In our analysis of retirement plan records kept by T. Rowe Price, we examined how untimely retirement account loan withdrawals—many times to fund emergency needs—can hamper successful retirement outcomes. We believe that addressing these financial wellness challenges can help enable individuals to save sustainably for retirement.

[1] T. Rowe Price Retirement Savings and Spending Study, 2022. See end disclosures for additional important information on the study.

2.3 percentage points

Average lower contribution rate for participants who take multiple 401(k) loans per year.

Lack of Emergency Savings

Life is full of surprises, some of which can be quite expensive. Unexpected illness, home repairs, vehicle breakdowns, etc., can cost thousands of dollars. According to a recent survey, 57% of Americans couldn't afford to pay for a $1,000 emergency expense.[2] More common is the tendency to accumulate debt, such as using credit cards (50% of respondents in our survey[3]) to pay for an unexpected expense.

The inability to cover life's sudden, and often unforeseen, costs can end up damaging your chances for a comfortable retirement. Among our survey respondents, 14% stated that they were likely to tap in to their workplace retirement accounts to cover emergency expenses. These untimely withdrawals can negatively affect your retirement savings in the long term.

Loan Activity, Dipping Into Retirement Plan Account Balances

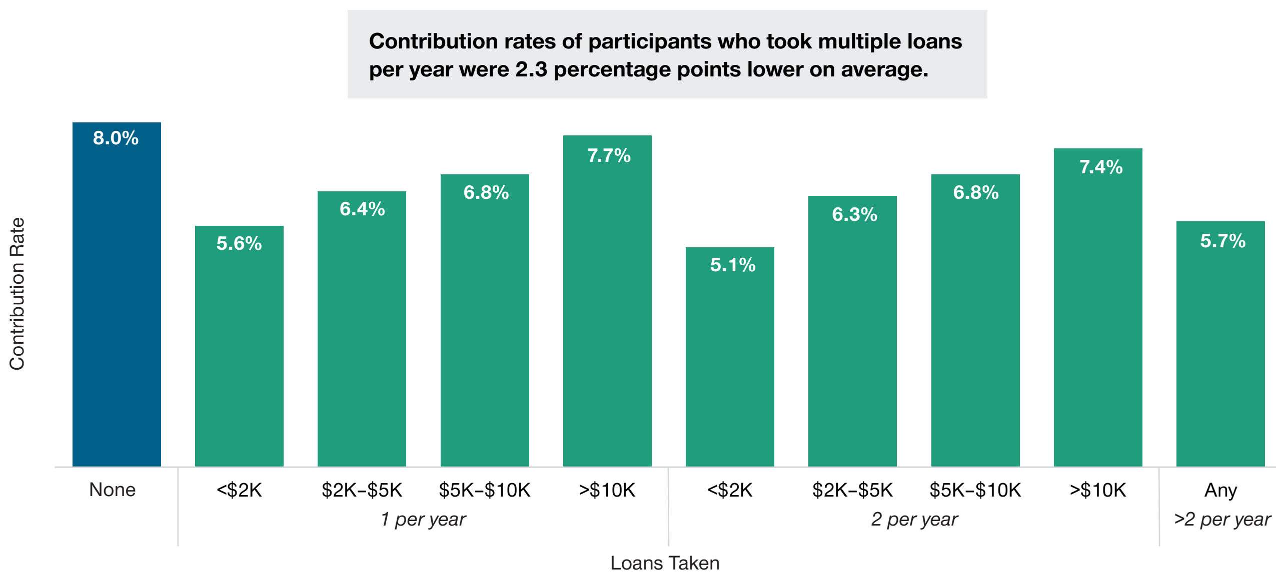
Relying on retirement savings to cover unexpected expenses can develop into an ongoing pattern, and unless the real underlying problem is addressed—often a lack of emergency savings—this cycle is likely to continue. Our research shows that retirement loan activity actually increases with age through working years and is not a generational issue limited to younger employees.

We also discovered that people who borrowed frequently from their retirement plan accounts had lower savings rates—by 2.3 percentage points, on average—than those who rarely, or did not, borrow from their accounts.

Our data shows that, if taken strategically, you can minimize the long-term impact of a retirement plan loan on your retirement outcome. In fact, we found

Retirement Plan Loans Are Associated With Lower Contribution Rates

(Fig. 1) Contribution rates by number of loans taken per year and average amount



As of December 31, 2022.
Source: T. Rowe Price recordkeeping platform. Data represent participant behavior 2018–2022. We reviewed loan behavior among the more than 2 million plan participants in T. Rowe Price's recordkeeping database.

[2] Bankrate.com, "Majority Unable to Afford $1,000 Emergency Expense as Inflation Increasingly Stifles Ability to Save," January 2023. https://www.bankrate.com/f/102997/x/fca64133d1/2023-january-fsp-emergency-savings-press-release.pdf

[3] T. Rowe Price Retirement Savings and Spending Study, 2022. See end disclosures for additional important information on the study.

Maintaining an adequate emergency savings fund can help you absorb financial shocks without sacrificing your retirement security.

that the contribution rates for employees who took one large loan (over $10,000) were in line with employees who did not take retirement plan loans (Figure 1).

However, a focus on smaller loans is more telling. The average contribution rate for people who took multiple small loans (less than $2,000) per year was meaningfully lower. This means that even an emergency fund of $1,000 to $2,000 could provide a financial buffer and prevent the need for small retirement plan loans.

Not only did employees who took retirement plan loans save less than their peers who did not take loans, but they also had lower average plan account balances. Despite a consistent average age and job tenure, account balances for people who took an average of more than two loans per year were 60% smaller than for employees with no loans.

Maintaining an adequate emergency savings fund can help you absorb financial shocks without sacrificing your retirement security.

Starting an Emergency Fund

The primary purpose of an emergency fund is to keep your financial and savings goals on track should you lose your job or expect a change in income for a brief time. It can also help cover large, unanticipated expenses that you may not have included in your budget. Having this money handy can save you from putting unexpected expenses on a credit card or taking money out of retirement accounts—and likely paying taxes and penalties as a result.

For starters, try to save $1,000 immediately for emergencies. Then, gradually build up to an amount that can cover three to six months of expenses if you are in a two-income household. If you only have one income, or your income is less predictable—such as with freelance or commission-based work—you may want to set aside enough for six months or more. If you need to tap into this account for an emergency, make sure you start building it up again.

Conclusion

Managing everyday living expenses and debt are often cited as the top sources of financial stress, as well as barriers to saving for retirement. Establishing an emergency fund can help with unanticipated expenses and potentially alleviate the need to borrow from your retirement plans, which can preserve your retirement savings and provide greater peace of mind.

Retirement Savings and Spending Study

The Retirement Savings and Spending Study is a nationally representative online survey of 401(k) plan participants and retirees. The survey has been fielded annually since 2014. The 2022 survey was conducted between June 24 and July 22. It included 3,895 401(k) participants, full-time or part-time workers who never retired, currently age 18 or older, and either contributing to a 401(k) plan or eligible to contribute and have a balance of $1,000+. The survey also included 1,136 retirees who have retired with a Rollover IRA or left-in-plan 401(k) balance. NMG Consulting conducts this annual survey on behalf of T. Rowe Price.

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SECURE 2.0 AND OPTIONAL EMPLOYER PLAN PROVISIONS TO SUPPORT FINANCIAL WELLNESS

Through optional provisions in SECURE 2.0, employers may choose to implement some meaningful changes that could have a positive impact on retirement savings for many Americans by helping to address these challenges. Employers, retirement industry professionals, and lawmakers are paying close attention as employees continue to express a need for comprehensive financial wellness programs that can help them manage the competing priorities of saving, spending, and servicing debt. In late December 2022, U.S. lawmakers passed SECURE 2.0. This legislation builds on the retirement reforms introduced by the original SECURE Act of 2019.

Offering a Roth "Emergency Fund"

SECURE 2.0 includes provisions that allow employers to implement solutions that could improve their employees' financial wellness. In particular, a provision in the new law will allow employers to elect to update their plan to offer a Roth "emergency fund" to their non-highly compensated employees starting in 2024.

Eligible employees in plans that adopt this provision may be able to make contributions up to $2,500 to Roth emergency savings accounts, which will mean they will be able to access those funds penalty-free. These contributions to the account are invested in short-term investment vehicles, such as money market funds, and would be eligible for any employer match into the employee's retirement account as an extra incentive to save.[4]

SECURE 2.0 optional provisions aside, your employer might also offer an emergency savings program separate from your retirement plan.

SECURE 2.0 also recognizes that financial realities can drive the need to tap in to retirement assets. Employers could, therefore, opt to allow their employees to take emergency withdrawals of up to $1,000 generally once every three years. The amount withdrawn would be penalty-free and could be repaid to your plan account within three years. If repaid, or if you subsequently make contributions to the plan at least equal to the amount of the prior emergency withdrawal that has not been repaid to the plan, you would be entitled to take another emergency withdrawal before the full three calendar years following your prior emergency withdrawal have elapsed.

Boosting Retirement Savings

SECURE 2.0 not only addresses barriers to retirement savings, it also includes provisions intended to boost savings. Starting on January 1, 2025, individuals between the ages of 60 and 63 will be able to make larger catch-up contributions to employer-based retirement plans. The limit for people in that age range will be the greater of $10,000 or 50% more than the regular catch-up amount, indexed to inflation.

It is important to consider how these changes to the laws could affect your personal circumstances. Taking advantage of the SECURE 2.0 provisions, where available as a workplace benefit, could have a meaningful impact on your financial well-being and your retirement outcome.

[4] Mutual funds are not FDIC-insured (FDIC=Federal Deposit Insurance Corporation) and are subject to possible loss of principal. While money market funds typically seek to maintain a share price of $1.00, there is no guarantee they will do so.

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