

## **A Primer on 401(k) Loans**

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Borrowing from defined contribution savings plans, including 401(k) plans, has long been permissible and such loans are prevalent. The Investment Company Institute reports that 18% of 401(k) participants had a 401(k) loan in 2006. Nevertheless, the impact of this borrowing on economic outcomes has only recently begun to attract attention in the academic and policy worlds. A concern raised by some is that easy access to one's retirement nest egg will lead to excessive consumption in the present at the expense of future financial security.

Although the popular press and politicians often describe 401(k) loans as a problem, classical economic theory has a more benign view. Loans from a 401(k) can relax liquidity constraints and increase household utility. Moreover, loan provisions may have the subtle effect of raising net asset accumulation by making 401(k) participation more appealing. Employees who know that they can access their 401(k) assets if they need them may be willing to put more money into an otherwise illiquid 401(k) account. This study is a background primer on 401(k) loans, including both theoretical and empirical components.

The empirical work draws on multiple data resources, including participant level administrative data, firm-level data, household survey data, and published statistics. About half of 401(k) programs offer a loan option, but they are much more common in large plans; thus about 85 percent of savings plan participants are eligible for loans, according to the most recent EBRI/ICI data. Most loan programs have no restriction on how the proceeds are used; those with restrictions typically allow loans for home purchases, education and medical expenses. Regulations limit the maximum size of accumulated 401(k) loans to the minimum of 50 percent of the vested account balance or \$50,000. The typical plan also has a minimum loan limit of between \$500 and \$1000. About half of all plans and most large plans allow multiple loans. The maximum repayment period is typically 5 years for general purpose loans; longer for primary residence loans. Interest rates vary across plans, though 60 percent of plans in one database set the rate at the prime rate plus 1%; the large majority are between the unadjusted prime rate and prime plus 2%. Loan defaults are treated as a taxable distribution from the plan and are subject to the 10% early withdrawal penalty for participants under age 59 ½.

Loan utilization follows a hump pattern with respect to age, peaking among employees in their 40s. Employees in their 20s or 60s have substantially lower loan utilization rates. Participants with balances between \$10,000 and \$40,000 have the highest participation rates, with loan utilization generally declining among those with higher balances. Loan utilization rates are also highest for middle-income participants, though the variability by income is less pronounced. Average loan balances are very similar across several data sources and are in the range of \$7000 for the last couple of years for which data is available. Loans are less likely in plans that allow just one loan, in plans with higher interest

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rates, and in plans with higher minimum loan requirements. These variations suggest the plan features that could be adjusted to contain loan use, if that were an important policy objective.

Compared with other loan options, our preliminary research suggests that 401(k) loans may be a reasonable source of credit in many circumstances. We further show that the net impact of 401(k) loans on asset accumulation is likely to be small (and could be either positive or negative) for a reasonable range of parameter assumptions. Our empirical analysis also suggests that it may be possible to structure the provision of 401(k) loans in ways that reduce their potential to negatively impact retirement wealth accumulation, as we find that 401(k) loan utilization is responsive to the types of loan features adopted by firms.

The full working paper is available on our website, [www.nber.org/programs/ag/rrc/books&papers.html](http://www.nber.org/programs/ag/rrc/books&papers.html) as paper NB08-09.

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