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Comment Gopi Shah Goda

The transition from defined-benefit (DB) pension plans to defined-contribution (DC) savings plans, including 401(k) plans, has involved employees making a variety of choices regarding their retirement saving decisions. Employees who work at firms that offer DC plans decide whether to enroll in their employer's plan, how much of their salary they wish to contribute, and how they wish to invest their plan assets.

The chapter by Beshears, Choi, Laibson, and Madrian investigates the parameters of another choice that is often available to 401(k) plan participants: whether they wish to take a loan against their 401(k) balance. The authors perform this analysis by collecting an impressive array of data sets from several sources to describe: (a) the prevalence of 401(k) loan availability and stipulations that govern their use, and (b) how utilization of 401(k) loans varies across plan characteristics and individuals. Understanding the basic landscape of 401(k) loans is an important first step in assessing the broader implications of the ability of plan participants to take loans against their retirement savings accounts.

The ability to borrow against 401(k) account balances provides some implicit insurance to eligible workers against negative shocks. While participants may have other sources of credit, borrowing 401(k) assets can be attractive because the process to borrow funds is typically simpler and does not involve an evaluation of credit. In addition, the financial costs of a 401(k) loan may dominate the costs of alternative sources of credit depending on the borrower's rate of return on assets in the savings plan, the 401(k) loan interest rate, the market borrowing cost, and the borrower's marginal tax rate. Finally, while defaulting on a 401(k) loan affects the accumulation of retirement wealth and may trigger penalties and tax consequences, it does not affect credit ratings. It is worth noting that this type of implicit insurance is not available to employees with DB pensions, representing another important difference between DB and DC pension plans.

The chapter documents the terms of 401(k) loans in terms of restrictions regarding the use of the proceeds from the loan, minimum and maximum loan amounts, fees associated with loan origination, restrictions on the number of loans, loan repayment procedures, and the loan interest rate. A typical firm does not restrict the use of loan proceeds and restricts loan amounts to be between approximately \$1,000 and \$50,000 (or 50 percent of the participant's vested account balance, if lower). Loan application fees tend to be

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between \$25 and \$50 and participants are often limited to having only one or two loans outstanding at any given time. A typical interest rate charged is the prime rate plus 1 percentage point. Loan durations are often limited to five years but may be longer if the loan is for a primary residence. Users of 401(k) loans are more likely to be in their thirties and forties and have moderate plan balances and income.

The chapter motivates two basic questions about 401(k) loan provision and utilization: (1) what determines whether firms allow 401(k) loans and the stipulations governing their use, and (2) what factors influence whether employees take loans against their 401(k) plan? The chapter suggests that loan provision is related to firm characteristics that tend to be correlated with richer employee benefits, such as employer size, and that loan availability has been increasing over time. However, it is unclear how the provision of 401(k) loans correlates with firm characteristics other than plan size. For instance, conditional on offering a 401(k) plan, are firms with other types of employee benefits more likely to allow 401(k) loans? Are the costs of administering loans levied against the borrowers (through the application fee) or spread across all plan participants? Finally, once an employer decides to offer a 401(k) loan provision, how are the terms of the loan determined?

Understanding how rules dictating 401(k) loans affect loan utilization is important because employers and policymakers might be able to affect loan utilization by adjusting various plan features. The chapter shows that there are some correlations between utilization and the maximum number of loans and the interest rate. However, the causal impact of different plan features is difficult to tease out because loan features may not be exogenous to loan utilization. For instance, the pool of workers contributing into a 401(k) plan at a firm where the rules governing 401(k) loans are lax may be different from the pool who contributes into a 401(k) plan with strict rules.

Despite the richness of the data, the authors face several data limitations in their ability to address certain important features of 401(k) loan availability and utilization. For instance, the authors are not able to link the data on plan features with data describing the reasons for obtaining 401(k) loans. Therefore, it is difficult to conclude whether loan proceeds from the minority of plans that restrict how loan proceeds may be utilized differ from plans without such restrictions. The authors are also not able to determine the account balance at the time the loan is initiated. This information would be useful to assess whether the maximum loan amount is a binding constraint and would provide suggestive evidence of the effect of changing the maximum loan amount on loan utilization. Finally, the multiple data sources the authors use often show the same trends over time but very different levels in the fraction of 401(k) plans that allow loans, the fraction of 401(k) participants in plans with a loan option, and outstanding loan balances as a fraction of 401(k) balances.

This work on 401(k) loans opens up several interesting directions for future research. While media attention has focused on the potential of 401(k) loans to deplete one's retirement resources, the effect of 401(k) loan provision on retirement wealth accumulation is not clear. By employers offering relatively easy access to borrow against retirement accounts, wealth accumulation could be reduced because funds used for loans do not earn investment returns and defaulting on a 401(k) loan can reduce retirement wealth permanently. On the other hand, employees may find participating in the plan more appealing if a loan provision exists and contribute a higher amount than they would in the absence of a loan provision. In addition, the effect of 401(k) loan provision on retirement wealth accumulation may vary across workers. The workers induced to contribute more into their 401(k) plan may not be the same as those whose savings could be reduced by the ability to borrow against 401(k) assets. Therefore, assessing the heterogeneity of the effects of 401(k) plans on saving and retirement wealth accumulation could have important implications.

Another interesting line of research is related to consumer financial decision making more generally. It is possible that 401(k) loans are *underutilized* relative to alternative ways to finance current consumption. If participants with sufficient account balances are accessing funds through alternative, higher-cost sources (such as credit cards with high interest rates), it would be important to understand the factors that lead participants to access funds through these alternative sources rather than against their 401(k) accounts. Such a finding may suggest that eligible participants are not fully aware of the availability of 401(k) loans. Indeed, recent work suggests that the average household could reduce borrowing costs by approximately $200 to $275 by accessing loans via their 401(k) accounts rather than more costly sources (Li and Smith 2010).

Finally, 401(k) loans may have an impact on other employee outcomes such as turnover. Leaving the firm (either voluntarily or involuntarily) requires the employee to pay back their loan within a specified time period to avoid a default; therefore, there could be a "job lock" effect on employees with loans outstanding or employees who value the option of taking a loan against their 401(k) balance with their current employer.

The results of these analyses would inform the general welfare effects of 401(k) loans. As mentioned before, 401(k) loans offer some insurance value because they provide access to credit that may be less costly relative to alternative sources. While it may be optimal for plan participants to reduce their retirement wealth and increase current consumption, myopic participants may be more likely to access funds for current consumption because of the ease of the 401(k) loan process and be left unprepared for retirement. Therefore, the welfare implications of 401(k) loan availability are unclear.

Overall, the chapter helps us understand the availability and utilization of 401(k) loans. The findings of this chapter and future work on this topic will help inform how 401(k) loans affect retirement wealth accumulation and how loans may be structured to improve the adequacy of retirement income while still offering 401(k) participants the ability to borrow against an important component of their household assets.

References

Li, Geng, and Paul A. Smith. 2010. "401(k) Loans and Household Balance Sheets." *National Tax Journal* 63 (3): 479–508.