A Primer on 401(k) Loans

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Policy Abstract

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 can access their 401(k) assets if they need them may be willing to put more money into an otherwise illiquid 401(k) account. Our research suggests that 401(k) loans are neither a blessing nor a bogeyman. Conditional on borrowing to finance consumption, we show that a 401(k) loan 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. 401(k) loan utilization is higher in plans that have lower minimum loan amounts and in plans that allow employees to take out multiple loans. 401(k) loan utilization is lower in plans that have higher loan interest rates.