The Impact of 401(k) Loans on Saving

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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 2008. Nevertheless, the impact of this borrowing on economic outcomes has only recently begun to attract attention in the academic and policy worlds. Anecdotally, the recent economic slowdown has caused the fraction of 401(k) participants with a 401(k) loan to rise. This increase, coupled with the introduction of the 401(k) debit card motivated Senators Herb Kohl and Charles Schumer to propose legislation that would limit the number of outstanding 401(k) loans to three per participant and ban 401(k) debit cards outright. The concern 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.

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 find that a 401(k) loan dominates credit card borrowing in all circumstances. We also find that a 401(k) loan dominates a personal loan, although they appear to be close substitutes as the assumed return on plan assets increases. A 401(k) loan is weakly dominated by a home equity loan for consumers with a very high marginal tax rate (35%). At lower tax rates (0% or 15%), a 401(k) loan is preferable to a home equity loan.

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. In our calibration of the impact of 401(k) loans on overall wealth accumulation, we find that loans have at worst no impact on wealth accumulation, and at best, they generate a modest increase in 401(k) savings rate. These results are driven largely by the fact that the positive effects of loan availability on savings rates are experienced by all participants, whereas only a minority of savings plan participants actually take out a 401(k) loan. Furthermore, many of the presumed negative effects of 401(k) loans turn out to be quite small. Loan repayments crowd out very little active savings, and loan defaults impact only a small fraction of total 401(k) assets.

The full working paper is available on our website www.nber.org/programs/ag/rrc/books&papers.html as paper NB09-05.
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