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HOUSEHOLD BORROWING FROM 401(K) PLANS

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Introduction

In order to encourage participation, 401(k) plans increasingly offer loans and withdrawals.[1] This means that more and more families have access to pension funds prior to retirement. The newly released 1998 Survey of Consumer Finances shows that borrowing from pension plans has more than doubled between 1992 and 1998. The problem with using pension funds prior to retirement is the risk that retirement income will be inadequate. The questions are "Why do people borrow" and "What do they do with the money?"

Why Do People Borrow from Their Pension Accounts?

Compared to the population in general, families with pensions are affluent. They typically own their home, have financial assets, and access to loans from traditional lenders. So, why do households borrow from their pension accounts?

Assets are costly to liquidate. Non-financial assets are costly and difficult to liquidate. Even financial assets such as equities and mutual funds often have costs associated with liquidating; selling stocks and mutual funds incur brokerage or other fees. Many assets are bought as long-term investments and selling them to finance a purchase may involve sacrificing returns. Borrowing from a pension account avoids these costs.

Pension loans are a convenient and cheap way to borrow. Pension loans require no loan-approval process and have low transaction costs. Participants can borrow a sum that is equal to 50 percent of the vested account balance or $50,000, whichever is smaller. Loans can be paid back over 1 to 5 years, and loans for home purchases can have longer payback periods. The interest rates on pension loans vary, but are usually 1 to 2 percentage points above the prime rate.

Pension loans allow families to keep their precautionary savings. Some households have precautionary reasons for saving; the family wants to keep a share of assets liquid for "a rainy day." They do not want to use this buffer-stock for consumption. In this case, a pension loan offers the possibility to keep the buffer-stock at the desired level and still buy a new car or pay for a wedding.

The Effects of Pension Loans on Retirement Wealth

The effect of borrowing on the accumulation of retirement wealth depends on two factors: the extent to which the loan increases current consumption and the extent to which the loan is paid back or not.

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[1] Pension loans are also available from thrift plans and profit sharing plans. GAO (1997) reports that approximately half of all 401(k) plans offer loans, with the share increasing among larger plans. Mitchell (1999) reports that 51 percent of 401(k) plans and 32 percent of profit sharing plans allowed loans in 1997. Van Derhei et al. report that 90 percent of large 401(k) plans allow loans.

If the pension loan is used to reshuffle the balance sheet without increasing consumption, the effect on retirement wealth should be modest regardless of whether the loan is paid back or not:

- *The loan is paid back in full.* The pension borrower pays himself the interest rate on the loan. If the interest rate on the loan is lower than the rate of return on other account assets, earnings will be forgone. During the recent run-up in the stock market this is likely to be the case. By borrowing, some of the advantage of tax-deferred earnings will also be lost. If the funds are left in the account, interest is earned on a tax-deferred basis. When the loan is taken out, it is repaid with after-tax income. Hence, more income is needed to pay back the amount borrowed. The effect of forgone earnings and the loss of tax-deferral should not be very large, however, since the maximum loan is $50,000. Of course, the wealth accumulated for retirement will also be negatively affected if the fact that the family took out a loan reduces the normal contributions to the plan.

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- *The loan is not paid back.* If the loan is not paid back because the borrower defaults or leaves his job, the loan is treated as a lump-sum distribution and is subject to a 10 percent penalty and income taxes.[2] However, the level of net worth will not be affected very much since the loan was used to reshuffle the balance sheet.

The other possibility is that the loan is used to increase current consumption. In this case, the effect on retirement wealth may be more serious:

- *The loan is paid back in full.* Lifetime consumption will be reduced slightly because of forgone earnings and loss of the tax-deferred treatment of the account, both discussed above.
- *The loan is not paid back.* In this case, the effect on the accumulation of retirement wealth is much more severe. The account balance is permanently reduced since the loan is treated as a lump-sum distribution. Because the loan was used to increase current consumption, there is no equivalent increase in assets or reduction in other debt, and net worth is reduced. In addition, the household has to pay the tax penalty.

Data on Pension Loans

The 1998 Survey of Consumer Finances (SCF) sheds some light on the likely effects of borrowing on retirement wealth. It is the first nationally representative data source that details pension loan activity.[3] Earlier data sources either did not contain a sufficient number of borrowers for detailed analysis (earlier SCFs), or were not generalizable to the population (administrative plan data). The 1998 SCF is also the first data source to collect information on the purpose of pension loans.[4]

How Common Are Pension Loans?

Borrowing from pension accounts has increased steadily during the 1990s. Three factors contributed to this trend: more households are covered by

[2] No penalty is levied if the borrower is older than age 59½.

[3] The SCF is a triennial survey sponsored by the Federal Reserve Board in cooperation with the Statistics of Income Division of the Department of the Treasury. It collects detailed information on households' assets, liabilities, and demographic characteristics, and pension plan characteristics, such as contribution information, account balance, and loan activity. For a description of the 1998 SCF see Kennickell, Starr-McCluer, and Surette (2000).

[4] Only a few other studies have examined loan activity from 401(k) plans. GAO (1997) used data from the 1992 SCF and concluded that less than 8 percent of participants borrow from their 401(k) plans. The study also found some evidence that credit-constrained households were somewhat more likely to borrow from their plans. A recent study using administrative plan data from firms indicates that the share of borrowers has increased over the 1990s; almost 20 percent of participants had a loan from their 401(k) plans in 1996 (Van Derhei et al. 1999).

401(k) plans; more plans allow borrowing; and more households borrow from their plans. Table 1 shows that 40 percent of families had a defined contribution plan in 1998. The share of plans that allowed borrowing increased from 64 percent to 75 percent between 1992 and 1998. Among families that could borrow from their plans, roughly 18 percent had a loan in 1998. This means that the share of *all* U.S. families with loans from a defined contribution account more than doubled from 2.1 percent in 1992, to 5.3 percent in 1998. The median amount borrowed increased from $2,200 in 1992, to $3,100 in 1998. However, the typical loan balance is less than one-fourth of the account balance, and has declined somewhat over time.

TABLE 1: TRENDS IN DEFINED CONTRIBUTION PLAN BORROWING

	1992	1995	1998
Share of families with a DC plan	26.9	34.4	39.9
Share of plans that allow loans	63.9	66.3	75.7
Share of families with DC plans that allow loans that borrow	12.5	16.1	17.5
Share of all families that have a pension loan	2.1	3.7	5.3
Median pension loan balance (Thousands of 1998 dollars)	2.2	2.1	3.1
Average ratio of loan amount to account balance (percent)	24.8	20.9	18.5

Source: Survey of Consumer Finances
Sample: Household head age 25-64

How Are Pension Loans Used?

The most common reason for borrowing from a pension plan is to buy a home or improve an existing residence. As shown in Table 2, 38 percent of loans were used for these purposes. About 22 percent of loans were used for general "bill consolidation." Both home purchases and consolidation of debt involve a reorganization of the household balance sheet; neither implies additional consumption. In fact, less than 10 percent of loans were used for non-durable consumption, such as vacations or weddings.

TABLE 2: REASONS FOR BORROWING FROM PENSION PLAN

REASON FOR LOAN	PERCENT OF LOANS
Home purchase, improvement, or repairs	37.7
Bill consolidation	21.6
Automobile or other vehicle purchase	16.5
Investment purposes	1.6
Education expenses	9.6
Medical, legal, or divorce expenses	4.5
Non-durable consumption	8.5

Source: 1998 Survey of Consumer Finances
Sample: Families with pension loans and household head age 25-64

Who Borrows from Pension Accounts?

A model that relates households' financial, demographic, and credit characteristics to the decision to take out a pension loan provides some information on who borrows from pension plans. Surprisingly, this analysis indicates that the higher account balance a household has, the more likely it is to borrow. This suggests that households tend to borrow only after they have accumulated a substantial amount in their accounts. On the other hand, those who borrow have lower financial assets and higher total debts indicating that they have less other assets available to them. Households that are credit constrained (turned down for traditional loans) are much more likely to use pension loans than households that are not credit constrained.

Conclusion

- The share of families that borrow from their pension plans has increased dramatically in the 1990s.
- A majority of pension loans are used for home purchases, consolidation of debt, or to enhance families' long-run economic well-being.
- Households that are credit constrained are more likely to borrow from their pension accounts.

"The most common reason for borrowing from a pension plan is to buy a home or improve an existing residence. In fact, less than 10 percent of loans were used for non-durable consumption."

Should we worry about pension loans? Several reasons suggest that pension loans may be more of a problem than the findings suggest:

- Although defined contribution plans have grown dramatically over the last decade, they still constitute a relatively small fraction of households' overall portfolios, and most participants are 15 to 25 years away from retirement. As contributions grow, the possibility for larger loans increases.
- No information is available on the share of households that default on their loans or leave their employers prior to having paid back the loan. Whatever the level of default among current borrowers, it could be higher in the population in general, which tends to be less affluent. This should be of concern if access to retirement funds broadens across the population, for example if the Social Security system included individual accounts that allowed borrowing.

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