Research Note

Hardship Withdrawals and the Mortgage Crisis

Authors: William E. Nessmith, Stephen P. Utkus

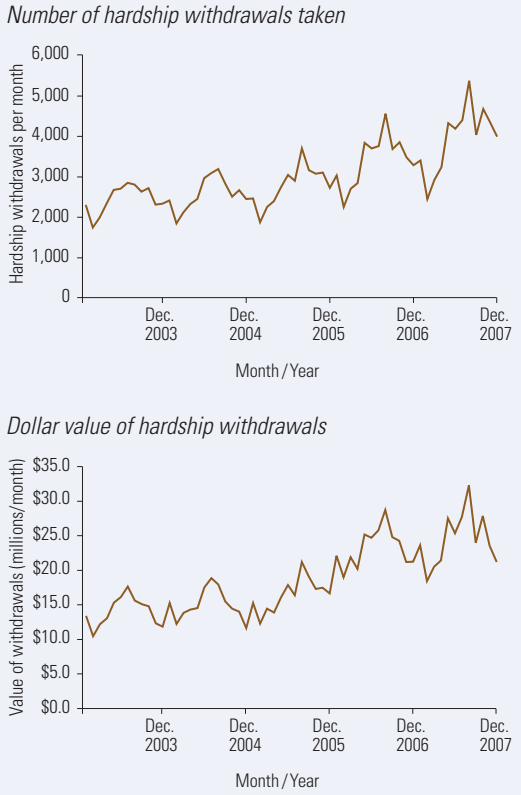
Hardship withdrawals from Vanguard® defined contribution plans rose in 2006 and 2007, although the absolute level of withdrawals is still quite low. The increase may be correlated with either the emerging home mortgage crisis or broader economic stress among financially vulnerable plan participants.

In a hardship withdrawal, plan participants are able to withdraw a portion of their contributions to a defined contribution (DC) plan in order to meet a pressing financial need. This financial need is defined by Internal Revenue Service (IRS) rules, as well as specific provisions of the participant's plan. Federal tax law seeks to discourage such withdrawals by imposing ordinary income taxes, as well as an additional 10% tax on pre-tax amounts withdrawn. At the same time, for low-income households who pay payroll taxes but little or no federal income tax, the tax disincentive of taking a hardship withdrawal may actually be quite modest.

DC plan recordkeepers have recently begun to report a sharp increase in hardship withdrawals, suggesting rising economic pressures on financially vulnerable households, possibly related to the national crisis in subprime and adjustable rate mortgages. For Vanguard DC recordkeeping plans, both the number of withdrawals and their dollar value have grown in recent years (Figure 1). As just one example, December 2007 hardship withdrawals were up 22% from a year earlier.

Although the rate of change is high, the absolute level of withdrawals remains quite low. Even after the recent growth in withdrawals, only 1.5% of accounts recorded a hardship withdrawal in 2007—a very low absolute level of activity.

Figure 1. Hardship withdrawals 2003–2007



Source: Vanguard, 2008.

Meanwhile, the total dollar amount of all hardship withdrawals represented only about 1/10th of 1% of total recordkeeping assets at Vanguard in 2007.

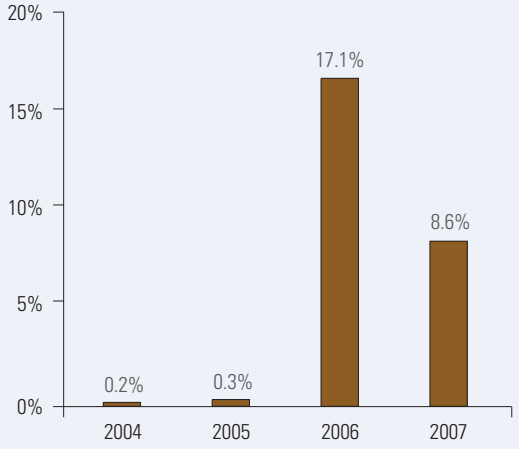
Separately, there is a seasonal trend in hardship withdrawals in a given year, with withdrawal activity typically peaking in July or August. No formal studies have identified the reasons for this spike in activity. One possibility is that it is linked to tuition expenses (an authorized form of hardship withdrawal) or a seasonal increase in home purchases.

These aggregate statistics tend to exaggerate the growth of hardship withdrawals, given the increase over time in the number of plan participants and a change in the composition of Vanguard's recordkeeping business. After normalizing withdrawals for these factors, it is still the case that hardship withdrawals grew at a significant rate in the past two years, rising 17.1% in 2006 and 8.6% in 2007 (Figure 2).

Meanwhile, the actual dollars per withdrawal are also up, but by a smaller amount (Figure 3). The average 2006 withdrawal of $6,811 was up 15% from 2005. The average 2007 withdrawal of $6,194 was down 10% from the 2006 level, but still up about 5% from 2005.

Figure 2. Increase in hardship withdrawals 2004–2007

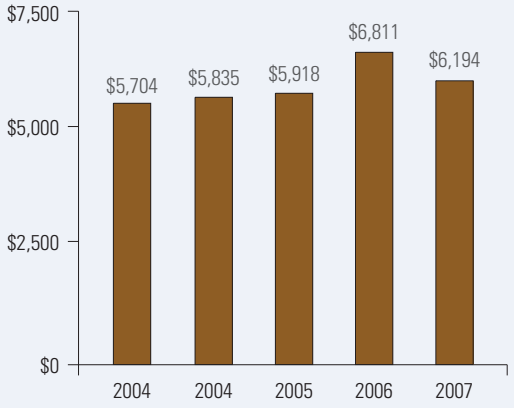
Percentage increase in hardship withdrawals over prior year (normalized for growth in plan/participant base)



Source: Vanguard, 2008.

Figure 3. Average value of hardship withdrawals 2003–2007

Dollar value of hardship withdrawals taken



Source: Vanguard, 2008.

Observations

Although hardship withdrawals grew meaningfully in 2007, a look at the longer-term data suggests that the trend began a year earlier. One explanation for the increase is that economically vulnerable households were more likely to take on subprime and adjustable rate mortgage debt in recent years. Thus, the increase in hardship withdrawals is due to difficulties facing financially stretched homeowners. This is a plausible explanation, although there is no direct evidence of a link between the recent surge in withdrawals and subprime or adjustable rate mortgage debt.

Another possibility is that the rise in hardship withdrawals is less a direct fallout of the mortgage crisis, and instead, an early warning sign of general economic stress among financially constrained households. This explanation seems more likely, given the actual timing of the increase in withdrawals.

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Vanguard®

Vanguard Institutional Investor Group

P.O. Box 2900
Valley Forge, PA 19482-2900

CRRHP 042008