Commentary

September 2023

# How Americans withstand financial hardships

A common objective among American workers is to achieve financial wellness by meeting current and near-term financial obligations while still being able to save for long-term goals. An essential component of financial wellness is allocating portions of income for future needs—both expected and unexpected. Saving for retirement is vital. It provides a means for building a nest egg that can support a person's lifestyle after they retire. Employer-sponsored retirement plans provide a simple and effective way for workers to financially prepare for that retirement.

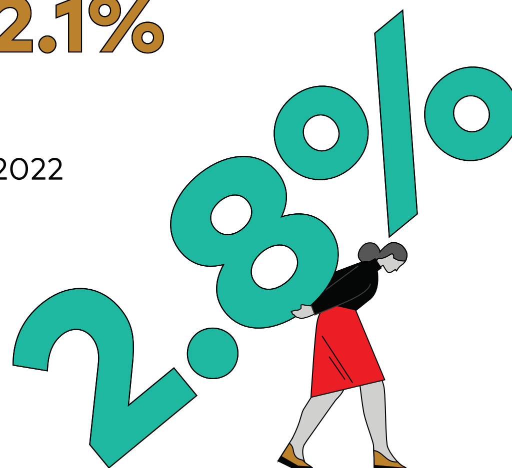
However, if a plan participant doesn't have emergency savings outside their plan, they might look to access retirement plan assets to cover an unexpected expense, commonly through a hardship withdrawal. Such withdrawals can be a double-edged sword. They provide access to needed funds but also come with penalties, deplete retirement savings, and may cause long-term financial strain. The balance between saving for retirement and initiating hardship withdrawals from a defined contribution (DC) plan is a critical consideration for anyone planning for retirement.

## Hardship withdrawals increased in 2022.

2021

2.1%

2022





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The authors extend a special thanks to Dan Kiesel for his support with data and analysis.

# Background

## The landscape for Americans without emergency savings accounts is a concerning one. Many workers and their families are living paycheck to paycheck, with little or no savings to fall back on in the event of an emergency.

Forty-seven percent of people in the United States do not have a rainy-day fund that would cover three months of expenses.[1] According to a 2020 survey by Bankrate, only 39% of Americans have enough savings to cover a $1,000 emergency expense. This leaves many of them vulnerable to unexpected expenses, such as car repairs, medical bills, or a job loss, which can lead to financial stress and even bankruptcy.

In addition, the lack of emergency savings can have a negative impact on financial wellness. Financial wellness refers to the overall health and well-being of an individual's financial situation, including the ability to manage money, make sound financial decisions, and plan for the future.

Without emergency savings, individuals may rely on high-interest credit cards or loans to cover expenses, which can lead to a cycle of debt and financial insecurity. They may also turn to their retirement savings.

While DC plans are designed as long-term retirement savings vehicles, participants in these plans may need to rely on hardship withdrawals from their accounts to cover financial emergencies.

**1** *Financial Capability in the United States: Highlights from the FINRA Foundation National Financial Capability Study.* 5th edition. July 2022.

# Hardship withdrawals

Hardship withdrawals from DC plans are generally permitted under certain circumstances, such as:

1. Medical expenses for the employee, their spouse, or dependents.
2. Purchase of a primary residence.
3. Payment of tuition, fees, and related educational expenses for the next 12 months of post-secondary education for the employee, their spouse, or dependents.
4. Prevention of eviction or foreclosure on the employee's primary residence.
5. Funeral expenses for the employee, their spouse, or dependents.
6. Expenses to repair the employee's primary residence.
7. Costs related to a federally declared disaster.

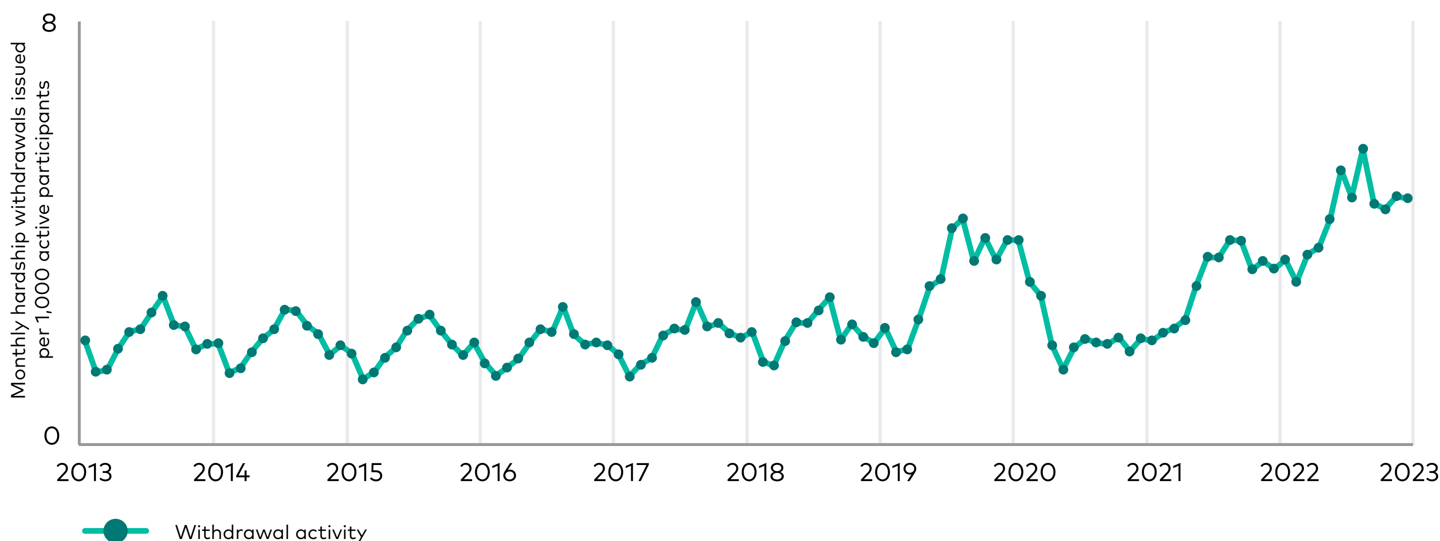
The amount that can be withdrawn is limited to what is necessary to meet the immediate need, and the withdrawal is subject to income tax and a 10% early withdrawal penalty for those younger than 59½.

## Use of hardship withdrawals

Based on data from Vanguard's *How America Saves 2023*, hardship withdrawal transactions from 2013 to 2018 followed a consistent pattern **(Figure 1)**. But in 2019, hardship withdrawal activity increased. The Bipartisan Budget Act of 2018 introduced changes designed to increase the availability of retirement plan assets for hardship reasons, while the IRS eased requirements for supporting documentation. However, in 2020, the frequency of hardship withdrawals decreased 29%, likely because of the availability of coronavirus distributions in most retirement plans during the year, which had more favorable tax treatment and did not incur penalties. Since the beginning of 2021, hardship withdrawal activity has increased.

**FIGURE 1.**

**Hardship withdrawals**



As a plan feature, hardship withdrawal provisions are commonplace. As of 2022, 95% of all DC plans offered hardship withdrawals, up from 85% in 2017.[2] While a typical plan feature, hardship withdrawals are generally not used by participants. In 2022, 2.8% of participants took a hardship withdrawal, up from 2.1% in 2021 **(Figure 2)**.

However, one-third of participants who took a hardship withdrawal in 2022 had also taken one in 2021. Some participants could, over time, jeopardize their retirement savings if they continue to rely on this feature throughout their working careers **(Figure 3)**. For example, if a participant starts saving 10% of their income at age 27 (earning $40,000/year) and subsequently withdraws $5,000 once every five years in the form of a hardship withdrawal, they could deplete their final retirement savings by nearly 20%. In addition, there is a 10% penalty incurred with each withdrawal.

One third of participants who took a hardship withdrawal in 2022 **had also taken one in 2021.**

**FIGURE 2.**

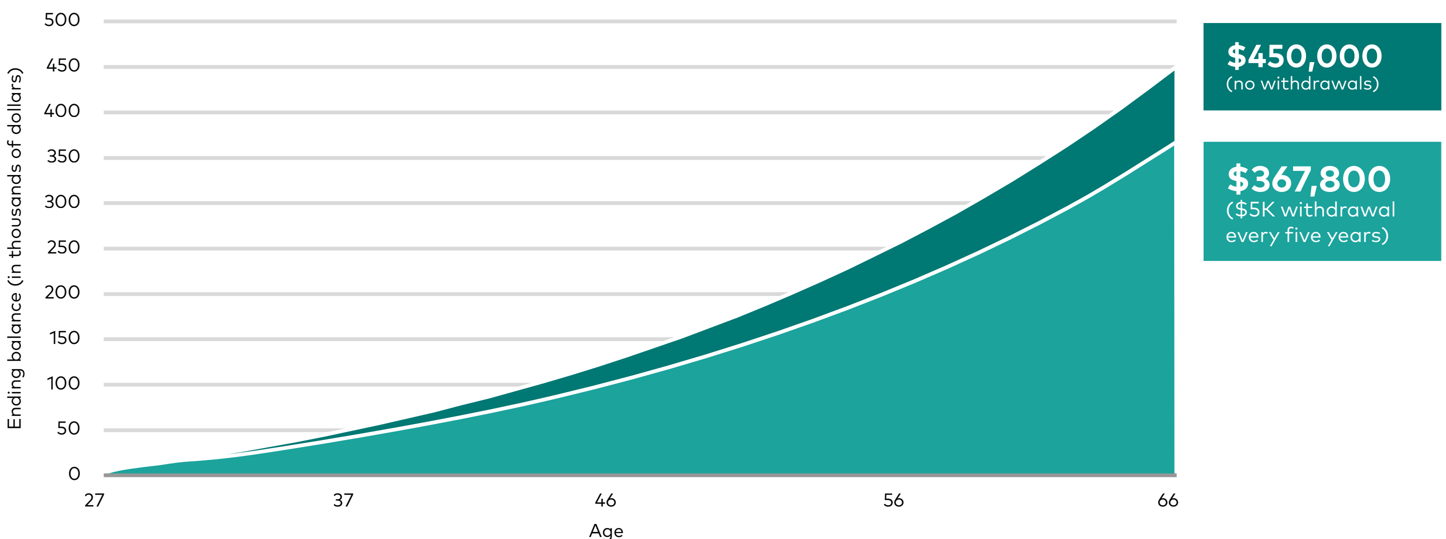
**Participant use of hardship withdrawals**

| | 2021 | 2022 |
|---|---|---|
| **Percentage of participants initiating a hardship withdrawal** | 2.1% | 2.8% |

Source: Vanguard, 2023.

**FIGURE 3.**

**Potential impact of hardship withdrawals**




Source: Vanguard, 2023

This hypothetical example assumes an annual real return of 4%; it does not represent the return on any particular investment, and the rate is not guaranteed. The final account balance does not reflect any taxes or penalties that may be due upon distribution. Withdrawals from a tax-deferred plan before age 59½ are subject to a 10% federal penalty tax unless an exception applies.

2 *How America Saves 2023*, Vanguard.

## Hardship withdrawal use by demographics

When examining hardship withdrawal activity by demographic segments, participants who had four to nine years of tenure and were between the ages of 35 and 44 were most likely to take a hardship withdrawal in 2021 and 2022 **(Figure 4)**. Additionally, participants with an income of between $30,000 and $75,000 were significantly more likely to take a hardship withdrawal than those with a higher income. Longer-tenured and older participants had higher withdrawal amounts than younger participants, with presumably smaller account balances. Participants in automatic enrollment plan designs were more likely to initiate a hardship withdrawal. Given that automatic enrollment significantly increases the likelihood of lower-income workers' participation, it's not surprising that participants in these designs were more likely to tap their retirement savings.

**FIGURE 4.**

**Hardship withdrawal use by demographics**

| | | Percentage of participants who took a hardship withdrawal (2021) | Average withdrawal (2021) | Percentage of participants who took a hardship withdrawal (2022) | Average withdrawal (2022) |
|---|---|---|---|---|---|
| Tenure | Less than 2 years | 1.5% | $2,000 | 1.0% | $1,400 |
| | 2–3 years | 2.7% | $2,900 | 3.1% | $2,600 |
| | 4–6 years | 3.0% | $4,300 | 4.0% | $3,800 |
| | 7–9 years | 2.9% | $6,300 | 3.9% | $5,200 |
| | 10+ years | 2.3% | $10,400 | 3.0% | $9,000 |
| Age | Younger than 25 | 1.3% | $2,000 | 0.8% | $1,800 |
| | 25–34 | 2.5% | $3,800 | 2.5% | $3,200 |
| | 35–44 | 3.4% | $5,500 | 3.8% | $4,500 |
| | 45–54 | 3.2% | $7,500 | 3.7% | $6,500 |
| | 55–64 | 1.2% | $9,000 | 1.6% | $7,700 |
| | 65 and older | 0.1% | $10,000 | 0.2% | $13,300 |
| Income | Less than $30,000 | 2.1% | $2,200 | 2.2% | $2,700 |
| | $30,000–$50,000 | 4.9% | $3,100 | 5.3% | $2,400 |
| | $50,000–$75,000 | 3.7% | $5,800 | 4.4% | $4,200 |
| | $75,000–$100,000 | 2.2% | $9,500 | 2.7% | $6,500 |
| | $100,000–$125,000 | 1.4% | $14,300 | 1.7% | $9,500 |
| | $125,000+ | 0.7% | $23,000 | 0.8% | $16,000 |
| Plan design | Automatic enrollment | 2.5% | $5,700 | 3.0% | $4,800 |
| | Voluntary enrollment | 1.7% | $6,600 | 2.3% | $6,000 |

Source: Vanguard, 2023.

## What are the reasons for hardship withdrawals?

In 2022, the most common reason for a hardship withdrawal was to avoid a foreclosure or eviction, with 36% of hardship requests initiated to avoid loss of home, up from 31% in 2021 **(Figure 5)**. And one-third of hardship withdrawals were initiated to cover medical expenses, in line with 2021.

Hardship withdrawal use remains relatively low. But the increase in participants initiating hardship withdrawals to avoid foreclosure or eviction may be a signal of the financial strain felt in households in 2022 due to economic challenges such as high inflation, rising interest rates, and significant declines in the equity and bond markets.

**FIGURE 5.**

**Reasons for hardship withdrawals**

| Type of hardship | Percentage of overall hardships (2021) | Average withdrawal (2021) | Percentage of overall hardships (2022) | Average withdrawal (2022) |
|---|---|---|---|---|
| **Avoid foreclosure/eviction** | 31% | $3,000 | 36% | $3,000 |
| **Medical expenses** | 33% | $2,800 | 32% | $2,800 |
| **Tuition payment** | 13% | $5,200 | 13% | $5,000 |
| **Home purchase** | 14% | $22,100 | 11% | $22,000 |
| **Home repair** | 5% | $6,200 | 4% | $5,800 |
| **Other** | 4% | $5,800 | 4% | $5,700 |

Source: Vanguard, 2023.

**36%**

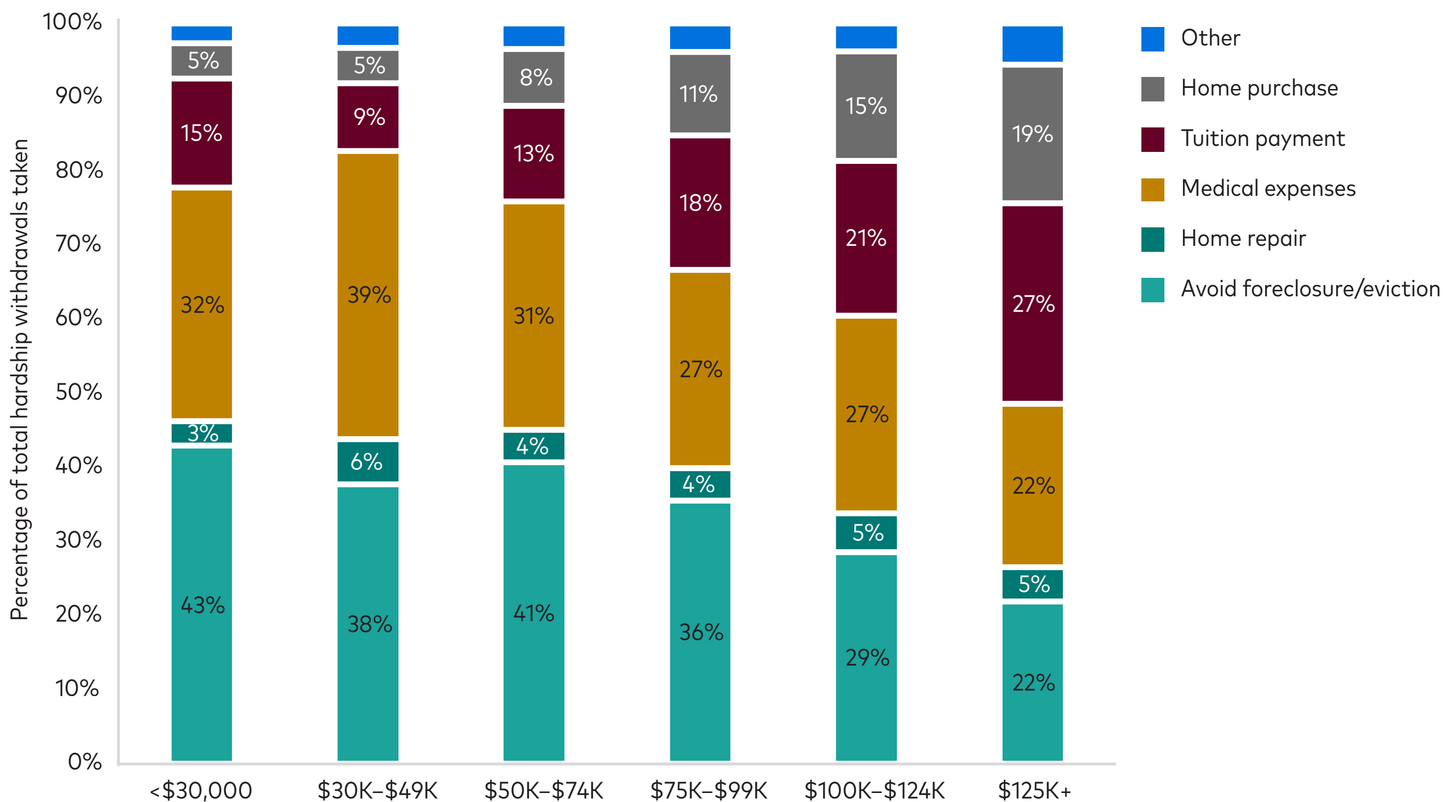
of hardship withdrawals in 2022 were initiated to avoid foreclosure or eviction.

In addition, while higher-income participants were less likely to initiate a hardship withdrawal, they were more likely to request one for a home purchase or tuition payments **(Figure 6)**. Conversely, about 80% of hardship withdrawals by lower-income participants were used to avoid eviction, make home repairs, or pay medical expenses.

This data underscores the value financial wellness offers to all participants. For lower-income workers, establishing an emergency savings account can help them prepare for unexpected and unwanted spending shocks. For higher-income workers—who are more likely to take hardship withdrawals for more investment-related purposes (tuition, home purchase)—educating them on more efficient methods to save for these generally planned expenses can benefit their overall financial wellness and prevent pre-retirement outflows and monetary penalties.

**FIGURE 6.**

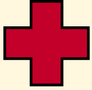
**Hardship withdrawal reasons by income, 2022**




Source: Vanguard, 2023.

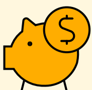
# SECURE 2.0 Act

In December 2022, Congress passed, and the President signed, the Consolidated Appropriations Act, 2023. This omnibus appropriation bill (referred to as SECURE 2.0) contains numerous retirement-related provisions, including emergency savings provisions and distribution options for specific reasons (for example, federally declared disasters and victims of domestic abuse). These emergency provisions are intended to provide Americans with greater financial security and stability, particularly during times of economic uncertainty.



## Emergency withdrawals

Effective January 1, 2024, employers can offer participants the option to withdraw a maximum of $1,000 per year in the event of an emergency without an additional 10% early withdrawal penalty. A participant may self-certify their eligibility for this distribution to meet unforeseeable or immediate financial needs related to personal or family emergency expenses. Further, participants can repay the distribution over three years but may not take further emergency distributions during that period unless prior emergency distributions have been repaid.



## Emergency savings accounts

Also effective January 1, 2024, employers may offer emergency savings accounts as part of a retirement plan for non-highly-compensated employees. Employers may (but are not required to) automatically opt employees into these accounts at no more than 3% of their salary. Emergency account contributions are capped at $2,500 (or lower if set by the employer). Contributions are treated like Roth elective deferrals for purposes of retirement matching contributions, with an annual matching cap of $2,500 (or lower if set by the plan sponsor). The first four withdrawals from the account each plan year may not be subject to any fees based solely on such withdrawals. At separation from service, employees may take emergency savings accounts as cash or roll the balance into a Roth plan account or an individual retirement account (IRA).

## Specific situation withdrawals

Over the years, Congress has recognized there are circumstances where access to retirement funds is necessary to prevent further hardship. Examples include withdrawals for those in military service, for those affected by the coronavirus, or for the birth or adoption of a child.

SECURE 2.0 builds on previous event-specific withdrawals by adding several optional in-service withdrawal provisions that permit participants to access retirement funds without the 10% early withdrawal penalty tax and with the ability to repay those withdrawals within three years from the date of distribution. These include a withdrawal for domestic abuse victims (in the amount of the lesser of $10,000 or 50% of the participant's vested account balance) and a 10% excise tax exemption on distributions to participants younger than 59½ with a terminal illness.

A plan may also permit distributions of up to $22,000 for those affected by a federally declared disaster. A disaster distribution would not be subject to the 10% early withdrawal penalty and may be repaid within three years of distribution. Taxes on the distribution are spread over three years unless the participant chooses otherwise. Plans may also offer special loan provisions to participants affected by a federally declared disaster, including loans with an increased limit of up to $100,000 (or full vested balance), as well as the suspension of existing loan repayments for up to a year.

# Financial wellness tools

In addition to having access to retirement funds in case of an emergency, building an emergency fund outside of the retirement plan to cover unexpected expenses is crucial to financial wellness and building a sufficient retirement nest egg. Developing a budget and prioritizing saving goals are important steps. Some employers and financial institutions offer financial wellness programs that provide education, resources, and tools to help individuals improve their financial health. For example, to help pay for medical expenses, many plan sponsors offer health savings accounts.

At Vanguard, financial wellness is about addressing three factors that affect a participant's ability to retire successfully.

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The first is **debt and expense management**. For example, student loan debt and credit card debt are areas that employees need help in understanding how to manage the expense and debt side of their balance sheet.

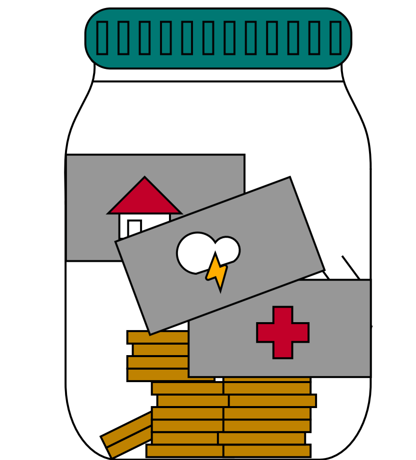
The second factor is **emergency savings**. The ability to withstand financial shocks, whether because of job loss or unexpected expenses, is vital. Ensuring participants have sufficient cash reserves and liquidity to handle a financial shock is critical to preserving retirement assets.

The last factor is **multigoal savings**. Participants are often juggling competing financial priorities: How do I think about balancing saving for a home, saving for a child's education, etc.? How do I stack those objectives against retirement savings?

Recognizing the long-term drawbacks of using retirement funds to pay for short-term emergencies, Vanguard has developed an approach that educates participants and provides calculators and other tools to help them understand the importance of building savings outside of the retirement plan. For participants who have already taken a hardship withdrawal, targeted messaging can help them begin the process of building savings to avoid the need for future hardship withdrawals.

**47%**

of people in the U.S. do not have a rainy-day fund that would cover three months of expenses.[3]



[3] Financial Capability in the United States: Highlights from the FINRA Foundation National Financial Capability Study. 5th edition. July 2022.

# Final thoughts

Unexpected expenses are a fact of life. Every participant will have one (or more) at some point during their working career. Ensuring these unexpected expenses and hardships are planned for and addressed appropriately is an important component of financial wellness. Withdrawing assets from retirement plans through hardship withdrawals or other options can have a significant impact on a participant's long-term retirement goals. The balance between financial wellness and withdrawals from an employer-sponsored plan requires careful consideration of a variety of factors, including age, financial situation, purpose of the withdrawal, and tax consequences. Through education and advice, Vanguard's financial wellness tools and resources can help participants make informed decisions that can help meet short-term needs without sacrificing their long-term goals.

*All investing is subject to risk, including the possible loss of the money you invest. Diversification does not ensure a profit or protect against a loss.*

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