



ANC Foundation Research Paper

Presented at 2007 NAGDCA Annual Conference

Monday, September 17, 2007

Hyatt Grand Champions Resort & Spa

Indian Wells, CA



ANC FOUNDATION CALL FOR PAPERS SUBMISSION:

HARDSHIP WITHDRAWALS

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HARDSHIP WITHDRAWALS

In a perfect world, we would all contribute the maximum allowable in our defined contribution plans, our accounts would never suffer losses, we would retire at the earliest possible time and we would live out the remainder of our days in excellent health and the life-style that in our heart of hearts, we had always imagined. The unexpected would be something to look forward to with eagerness.

Unfortunately, perfection is more often than not a result of airbrushing and the unexpected leads to trepidation rather than anticipation. Reality finds us contending with medical bills in addition to other personal emergencies leaving us stressed emotionally, physically, and yes, financially. For these reasons, although defined contribution accounts were intended for retirement, they make allowances for financial hardships. These provisions, though available, are not automatic. In the pages to follow we will explore how such provisions relate to public sector employees.

UNFORESEEABLE EMERGENCY VS. IMMEDIATE AND HEAVY NEED

In a 457(b) plan, a hardship withdrawal can only occur when the employee is faced with an “unforeseeable emergency”, which according to the Code is defined as “a severe financial hardship resulting from an illness or accident, loss of property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary.¹” In order to receive a withdrawal as a result of a hardship from a 401(k) plan, it must be as a result of “an immediate and heavy financial need of the employee and the amount must be necessary to satisfy the financial need.²”

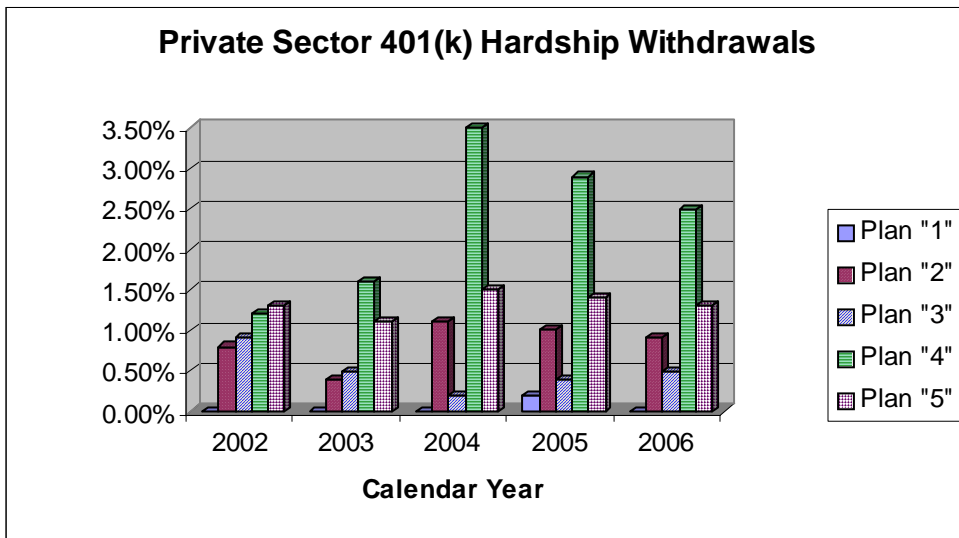
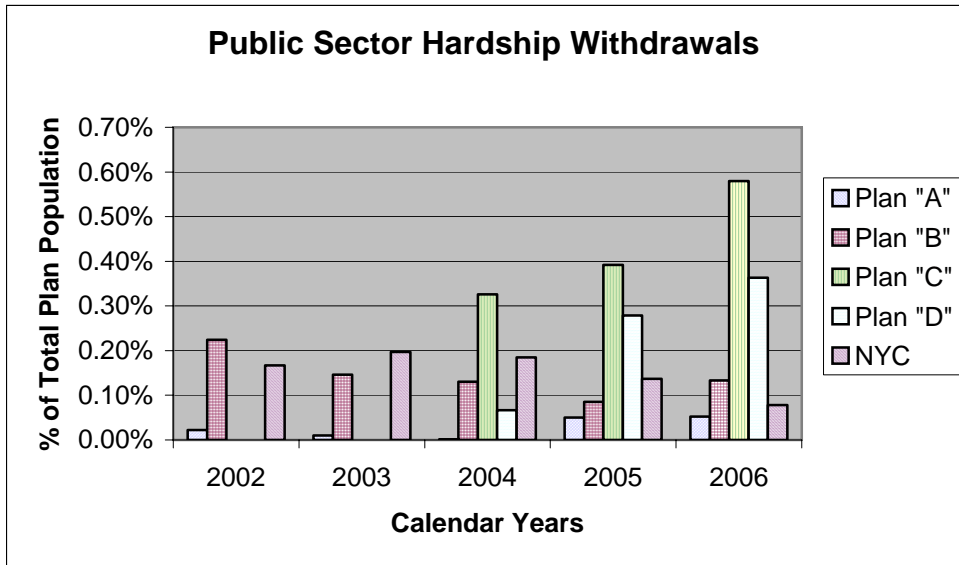
To those who are experiencing a hardship, the expressions “unforeseeable emergency” and “immediate and heavy need” may seem synonymous. However, for the purposes of hardship withdrawals, while there are some similarities, they are as different as the sections of the Internal Revenue Code from which they are derived. 457 Plan participants are very aware that one of the key differences is that in addition to having a

severe financial hardship, it must be unforeseeable and due to events beyond your control. The 401(k) on the other hand recognizes that “a financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred.”³ As a result, the older and more popular sibling allows for the purchase of a principal residence as well as payment of tuition. What cannot be overlooked is that regardless of in which plan an employee wishes to participate, it is the Plan Administrator, and not the individual employee that determines what may reasonably be considered a financial need. Moreover, a distribution of a hardship withdrawal does not occur because an individual was faced with an “unforeseeable emergency” or an “immediate and heavy financial need”, rather the extent to which the “emergency” or “need” cannot be satisfied by other resources that are reasonably available to the employee. This is not to say that a plan participant should take counter-productive measures in order to alleviate the situation, but they should consider withdrawals from their defined contribution accounts as a last resort. Suffice it to say, this task has proven challenging to many plan administrators, as they are responsible for providing specific criteria to be used in order to determine what is or is not considered a hardship, with little guidance from the IRS.

Irrespective of who determines what qualifies as a hardship, does the seemingly less stringent criteria mean then that participants in a 401(k) plan are more likely to apply for a hardship withdrawal than 457 plan participants despite the possibility of incurring a 10% early withdrawal penalty? Not necessarily. There are only approximately a dozen public sector plans that offer a 401(k) plan, and while examining several of them it seems that the percentages of participants, who have taken hardship withdrawals versus the total participants in the respective plans, were similar. In the New York City Deferred Compensation Plans, in cases where employees participate in both, they tend to apply for a hardship withdrawal from the 401(k) as a result of the more flexible criteria. Regardless of which plan, in all cases examined, the percentage of hardship withdrawals in the public sector was less than one percent. How does this compare with the private sector?

PRIVATE VS. PUBLIC SECTOR

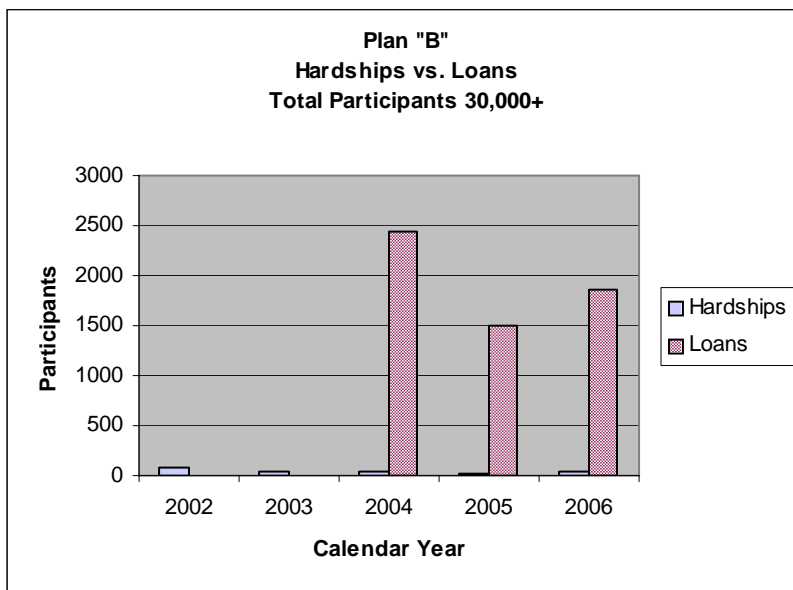
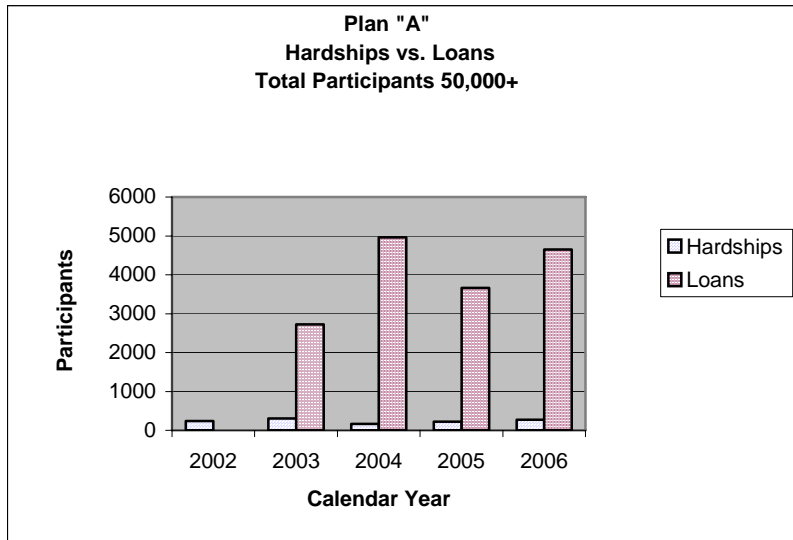
Because of the disparity in the sizes of public sector versus private sector plans, we again compared the number of hardship withdrawals as a percentage of total plan populations. From the plans examined, it appears that the private sector employees are more likely to take a hardship withdrawal than their public sector counterparts.⁴

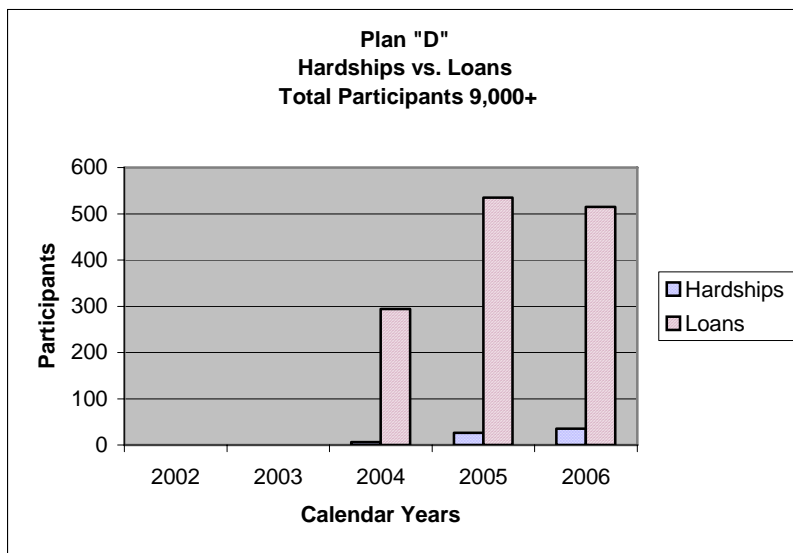
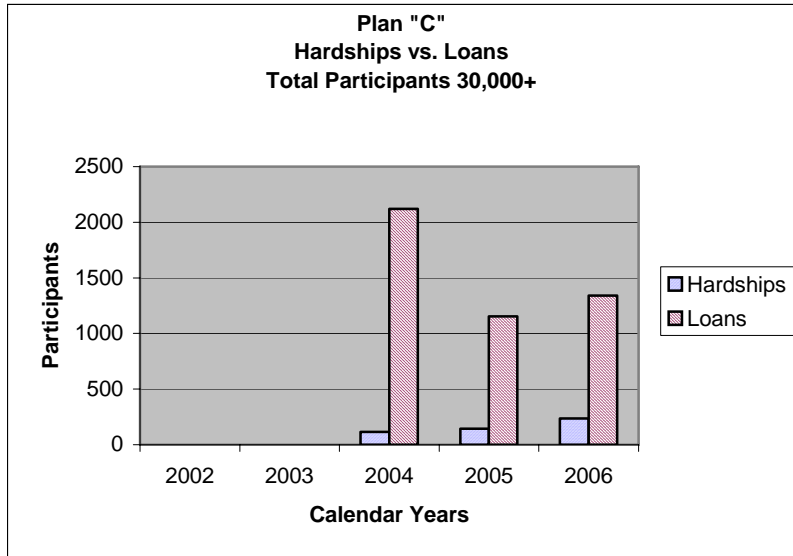


Given the fact that hardship withdrawals are already few in the public sector, could they be lessened even more by the presence of loans? Can the availability of loans eliminate the need for hardship withdrawals?

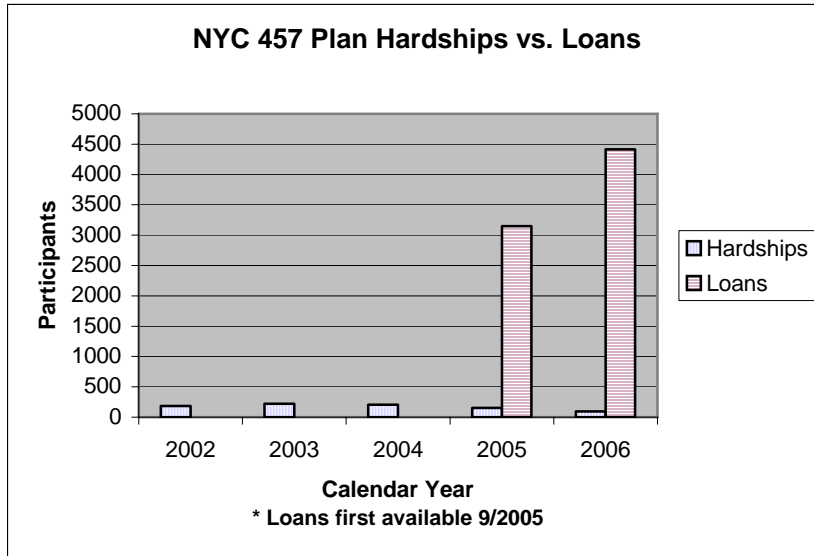
LOANS VS. HARDSHIP WITHDRAWALS

Despite the ability to offer loans, the majority of 457 Plans have opted not to do so, leaving hardships as the only option for in-service withdrawals. In plans where both are available, although the availability of loans has lured many, for the most part, they do not appear to have an overwhelming impact on the number of hardship withdrawals that are issued. The charts below represent four public sector plans of various sizes that allow both loans and hardships in the 457 plans.





Of the handful of plans examined, there was of course one exception, the City of New York whose hardship withdrawals were cut almost in half in the year following the introduction of loans.



Whether or not this trend continues remains to be seen. What is clear is that the percentage of participants who received hardship withdrawals are but a fraction of the total plan populations and remains somewhat consistent regardless of the availability of loans. In other words, loans may diminish the number of hardship requests and withdrawals, but it will not eliminate it.

One could speculate that those who choose to take a hardship withdrawal are simply not in a position to make loan payments. Perhaps the addition of a loan to an already financially stressful situation will only exacerbate the problem and taking a hardship withdrawal rather than a loan is the more prudent decision.

The consequences of taking a hardship withdrawal instead of a loan are that in most cases employee contributions must cease for a prescribed period of time (up to 12 months) and a hardship withdrawal cannot be paid back therefore permanently reducing the participant's account balance. Realistically speaking, when faced with a financial hardship this is rarely a deterrent, but a consequence nonetheless.

As we have established, plan administrators are charged with the responsibility of determining what is or is not considered a hardship, but is there anything that can forewarn them that "hard times" are on the horizon for their participants? For example, are there any economic factors that may lead to plan participants being in a situation where they need to take a hardship withdrawal?

HARDSHIPS AND THE ECONOMY

In the New York City Deferred Compensation Plans, one of the major reasons for hardship withdrawals is eviction/foreclosure. Are there external economic forces at work? Could the economy as a whole be a reason? In order to answer those questions, we approached it from two perspectives, the stock market and the Cost of Living for the New York Tri-State Area.

Past performance is not an indicator of future results in the market place, but does it lead to hardship withdrawals? In a comparison of hardship withdrawals taken from the New York City Deferred Compensation Plans and the trailing performance of the S&P 500 for the last five years, the answer was no, there was not a strong correlation between the two.

	Combined	Trailing Performance of S&P 500 ⁵							
	\$ amount	Qtr	2 Qtr	3 Qtr	1 Year	2 Year	3 Year	4 Year	5 Year
12/31/2001		10.69	-5.56	-0.03	-11.89	-10.51	-1.03	5.66	10.70
3/31/2002	\$ 225,326	0.28	11.00	-5.29	0.25	-11.40	-2.53	2.34	10.17
6/30/2002	\$ 283,792	-13.40	-13.16	-3.87	-17.99	-16.43	-9.18	-2.08	3.66
9/30/2002	\$ 393,949	-17.29	-28.36	-28.16	-20.48	-23.62	-12.90	-4.13	-1.63
12/31/2002	\$ 495,778	8.43	-10.30	-22.32	-22.10	-17.15	-14.56	-6.78	-0.59
3/31/2003	\$ 259,515	-3.15	5.02	-13.12	-24.77	-13.16	-16.10	-8.64	-3.77
6/30/2003	\$ 443,819	15.39	11.76	21.19	0.25	-9.33	-11.20	-6.91	-1.62
9/30/2003	\$ 611,379	2.64	18.45	14.72	24.40	-0.54	-10.14	-4.78	0.99
12/31/2003	\$ 525,688	12.19	15.15	32.87	28.69	0.12	-4.05	-5.34	-0.57
3/31/2004	\$ 403,870	1.70	14.08	17.10	35.12	0.83	0.63	-5.48	-1.20
6/30/2004	\$ 334,494	1.71	3.44	16.04	19.11	9.27	-0.69	-4.44	-2.21
9/30/2004	\$ 492,445	-1.87	-0.18	1.50	13.87	19.02	4.05	-4.66	-1.31
12/31/2004	\$ 640,174	9.23	7.19	9.03	10.87	19.45	3.59	-0.52	-2.30
3/31/2005	\$ 394,567	-2.15	6.88	4.88	6.69	20.06	2.74	2.11	-3.17
6/30/2005	\$ 432,960	1.36	-0.81	8.35	6.32	12.53	8.28	1.01	-2.38
9/30/2005	\$ 667,270	3.60	5.03	2.77	12.26	13.06	16.72	6.04	-1.49
12/31/2005	\$ 379,948	2.09	5.78	7.22	4.92	7.86	14.40	3.92	0.54
3/31/2006	\$ 110,643	4.20	6.39	10.23	11.74	9.18	17.22	4.92	3.97
6/30/2006	\$ 398,021	-1.43	2.71	4.86	8.64	7.47	11.22	8.37	2.50
9/30/2006	\$ 452,537	5.67	4.15	8.53	10.80	11.53	12.30	15.21	6.98
12/31/2006	\$ 223,000	6.70	12.75	11.13	15.80	10.23	10.44	14.75	6.19
Correlation		0.29	0.09	0.16	0.26	0.24	-0.05	-0.19	-0.45

One would imagine that the Cost of Living would be a more likely indicator of the necessity of hardships withdrawals, but that is not the case either. While it has a slightly stronger correlation than the S&P 500

Traditionally, hardship withdrawals were limited to the needs of the employee as well as the needs of the employee's spouse or dependents. The Pension Protection Act of 2006 has extended the provision to include the needs of non-spousal, non-dependent beneficiaries as well. Perhaps this will lead to a slight increase, as it affords single participants without dependents the opportunity to provide assistance to their beneficiaries, which they might not have had otherwise. Only time will tell.

The goal of 457 and 401(k) plans is to provide sunny days in the future to those that participate in them. The knowledge that the monies in them are accessible on rainy days in the present provides comfort to many. Regardless of whether participants hope for the best or live in expectation of the worse, two things are certain. Accidents happen and even the best-laid plans are subject to the unknown. The overwhelming majority of plan participants will fortunately never need to make a hardship withdrawal. However, in the event that they do, the hardship withdrawal provision makes allowances for that. As a result, plan participants can focus on living the life they have always imagined at retirement knowing that in the event something does not go according to plan, they have the ability to access a portion of tomorrow to help with today.

¹ Reg. § 1.457-6(c)(2)(i)

² Reg. § 1.401(k)-1(d)(3)(i)

³ 401(k) Resource Guide – Plan Sponsors – General Distribution Rules

⁴ Statistics provided by FASCore, LLC. The data provided did not include Plan names or participant specific information with regard to hardships or loans.

⁵ Data provided by Milliman USA.