Credit Builders Alliance Webinar

The Role of Credit in a Healthy Balance Sheet

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Today's Agenda

- The Center for Household Financial Stability
- What is a household balance sheet and why does it matter?
  - How balance sheets differ across demographic groups
  - Characteristics of a healthy balance sheet
- The role of credit (and debt) in a healthy balance sheet
  - Credit: Ability to buy what you want or need
  - Debt: A longer-term obligation to repay what you borrowed
  - Key to a healthy balance sheet: Maximize credit and minimize debt

The St. Louis Fed's Center for Household Financial Stability

- A research and policy initiative of the Federal Reserve Bank of St. Louis: www.stlouisfed.org/hfs.
- Our research and policy questions
  - What is the state of American families' balance sheets?
  - How do households' balance-sheet conditions affect communities and the broader economy?
  - What can we do to enhance the stability of household balance sheets and the economy?

The St. Louis Fed's Center for Household Financial Stability

- **Our analytical framework: Isolate the demographic drivers of household financial choices and outcomes**
  - **Age: The life cycle and birth-year cohort effects**
  - **Educational attainment: Genetic and social endowments**
  - **Race and ethnicity: The role of culture and cumulative advantage or disadvantage**
- **The policy challenges**
  - **Encourage focus on causes rather than symptoms**
  - **Identify and implement solutions rather than palliatives**

The St. Louis Fed's Center for Household Financial Stability

- **Find our research, public presentations, and media coverage at www.stlouisfed.org/hfs.**
- **Upcoming public events:**
  - **May 8-9, 2014: 2nd Annual Household Financial Stability Research Symposium, at the St. Louis Fed.**
    - **Topic: The Balance Sheets of Younger Americans—Is the American Dream at Risk?**
    - **Sessions on student loans, homeownership, economic mobility, macro-economic impacts of young families, and more.**
  - **October 16-17, 2014: Policy Symposium in Washington DC.**
    - **Topic: Topic: Millennials After the Great Recession.**
    - **In partnership with the *New America Foundation* and the *Young Invincibles* (an advocacy group for young Americans).**

Balance Sheet of Family A

Family head is 70 years old, white, 4-year college degree

Assets	Estimated values as of Sep. 30, 2013*		Liabilities and Net Worth
Durable goods	$47,000	$12,000	Non-mortgage debt
Financial and business assets	$1,552,000	$84,000	Mortgage debt
Residential real estate	$576,000	**$96,000**	**Total liabilities**
Total assets	**$2,175,000**	**$2,079,000**	**Net worth = T.A. – T.L.**

*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Balance Sheet of Family A

Family head is 70 years old, white, 4-year college degree

Assets	Estimated values relative to total assets as of Sep. 30, 2013*		Liabilities and Net Worth
Durable goods	2%	1%	Non-mortgage debt
Financial and business assets	71%	4%	Mortgage debt
Residential real estate	27%	**5%**	**Total liabilities-to-assets ratio**
Total assets	**100%**	**95%**	**Net worth-to-assets ratio**

*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Balance Sheet of Family B

Family head is 50 years old, white, high-school graduate

Assets	Estimated values as of Sep. 30, 2013*		Liabilities and Net Worth
Durable goods	$25,000	$19,000	Non-mortgage debt
Financial and business assets	$244,000	$69,000	Mortgage debt
Residential real estate	$179,000	**$88,000**	**Total liabilities**
Total assets	**$448,000**	**$352,000**	**Net worth = T.A. – T.L.**

*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Balance Sheet of Family B

Family head is 50 years old, white, high-school graduate

Assets	Estimated values relative to total assets as of Sep. 30, 2013*		Liabilities and Net Worth
Durable goods	6%	4%	Non-mortgage debt
Financial and business assets	55%	16%	Mortgage debt
Residential real estate	39%	**20%**	**Total liabilities-to-assets ratio**
Total assets	**100%**	**80%**	**Net worth-to-assets ratio**

*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Balance Sheet of Family C

Family head is 35 years old, African-American, 4-year college graduate

Assets	Estimated values as of Sept. 30, 2013*		Liabilities and Net Worth
Durable goods	$15,000	$38,000	Non-mortgage debt
Financial and business assets	$35,000	$61,000	Mortgage debt
Residential real estate	$96,000	**$99,000**	**Total liabilities**
Total assets	**$146,000**	**$47,000**	**Net worth = T.A. – T.L.**

*Sources: Federal Reserve Board’s *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors’ estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Balance Sheet of Family C

Family head is 35 years old, African-American, 4-year college graduate

Assets	Estimated values relative to total assets as of Sep. 30, 2013*		Liabilities and Net Worth
Durable goods	10%	26%	Non-mortgage debt
Financial and business assets	24%	42%	Mortgage debt
Residential real estate	66%	**68%**	**Total liabilities-to-assets ratio**
Total assets	**100%**	**32%**	**Net worth-to-assets ratio**

*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Balance Sheet of Family D

Family head is 35 years old, white, did not finish high school

Assets	Estimated values as of Sep. 30, 2013*		Liabilities and Net Worth
Durable goods	$12,000	$9,000	Non-mortgage debt
Financial and business assets	$11,000	$25,000	Mortgage debt
Residential real estate	$38,000	**$34,000**	**Total liabilities**
Total assets	**$61,000**	**$27,000**	**Net worth = T.A. – T.L.**

*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Balance Sheet of Family D

Family head is 35 years old, white, did not finish high school

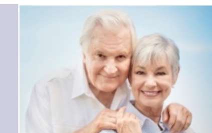
Assets	Estimated values relative to total assets as of Sep. 30, 2013*		Liabilities and Net Worth
Durable goods	20%	15%	Non-mortgage debt
Financial and business assets	18%	41%	Mortgage debt
Residential real estate	62%	**56%**	**Total liabilities-to-assets ratio**
Total assets	**100%**	**44%**	**Net worth-to-assets ratio**

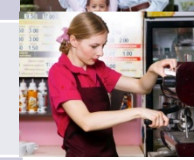
*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Comparing Balance Sheets of Families A, B, C, and D

Family	Net worth, Sep. 30, 2013*		
A: 70 yrs. old, white, college grad	$2,079,000		
B: 50 yrs. old, white, HS grad	$352,000 77 x		
C: 35 yrs. old, black, college grad	$47,000		
D: 35 yrs. old, white, no HS degree	$27,000		
Average all families (Sep. 30, 2013 estimate*)	**$591,000**		
Median all families (2010 SCF)	**$77,000**		



*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Comparing Balance Sheets of Families A, B, C, and D

Family	Net worth, Sep. 30, 2013*	RRE as share of assets*	
A: 70 yrs. old, white, college grad	$2,079,000	27%	
B: 50 yrs. old, white, HS grad	$352,000	40%	
C: 35 yrs. old, black, college grad	$47,000	66%	
D: 35 yrs. old, white, no HS degree	$27,000	62%	
Average all families (Sep. 30, 2013 estimate*)	**$591,000**	**33%**	
Median all families (2010 SCF)	**$77,000**	**45%**	

77 x

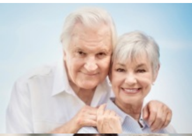
*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Comparing Balance Sheets of Families A, B, C, and D

Family	Net worth, Sep. 30, 2013*	RRE as share of assets*	Debt-to-assets ratio*
A: 70 yrs. old, white, college grad	$2,079,000	27%	4%
B: 50 yrs. old, white, HS grad	$352,000	40%	20%
C: 35 yrs. old, black, college grad	$47,000	66%	68%
D: 35 yrs. old, white, no HS degree	$27,000	62%	56%
Average all families **(Sep. 30, 2013 estimate*)**	**$591,000**	**33%**	**13%**
Median all families **(2010 SCF)**	**$77,000**	**45%**	**22%**

77 x




*Sources: Federal Reserve Board's *Survey of Consumer Finances* and *Flow of Funds Accounts*; authors' estimates based on data from Bureau of Economic Analysis, Bureau of the Census, Equifax.

All figures are in terms of 2010 purchasing power, adjusted by the CPI-U-RS.

Economic Vulnerability and Financial Fragility Are Related—Why?

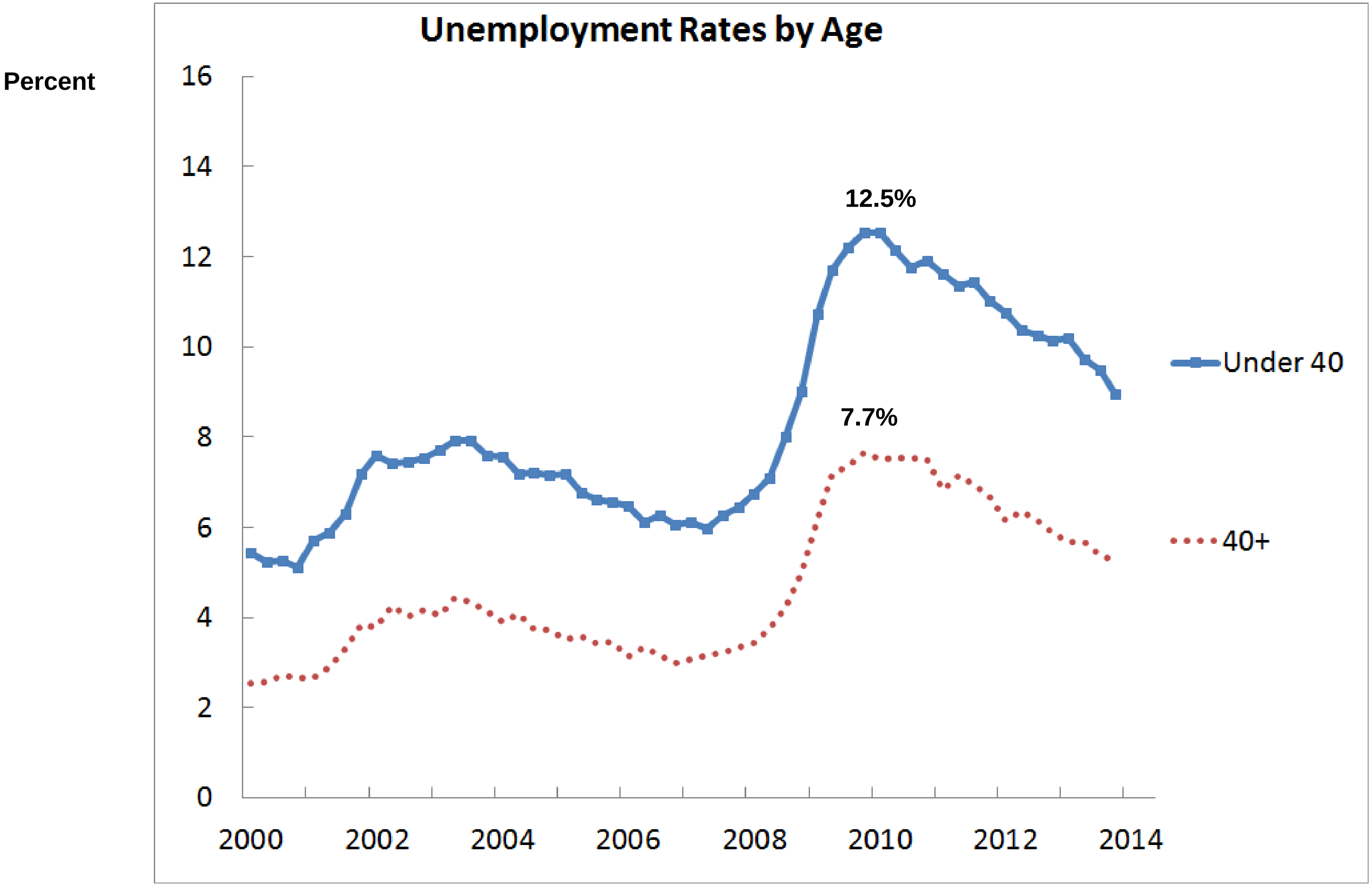
- **Economic vulnerability: Elevated risk of job and income losses**
- **Financial fragility: Risky financial behavior and risky balance sheets**
- **Fact: Economic vulnerability and financial fragility are positively correlated in the population across demographic sub-groups**
- **Puzzle: Why don't vulnerable families use their balance sheets to reduce overall risk?**

- **Source: William R. Emmons and Bryan J. Noeth, "Economic Vulnerability and Financial Fragility," Federal Reserve Bank of St. Louis *Review*, Sept./Oct. 2013, pp. 361-88.**

What Financial Choices do Economically Vulnerable Families Make?

- **Who are the economically vulnerable?**
  - **Young (under 40)**
  - **No college degree**
  - **Historically disadvantaged minority (African-American or Hispanic of any race)**

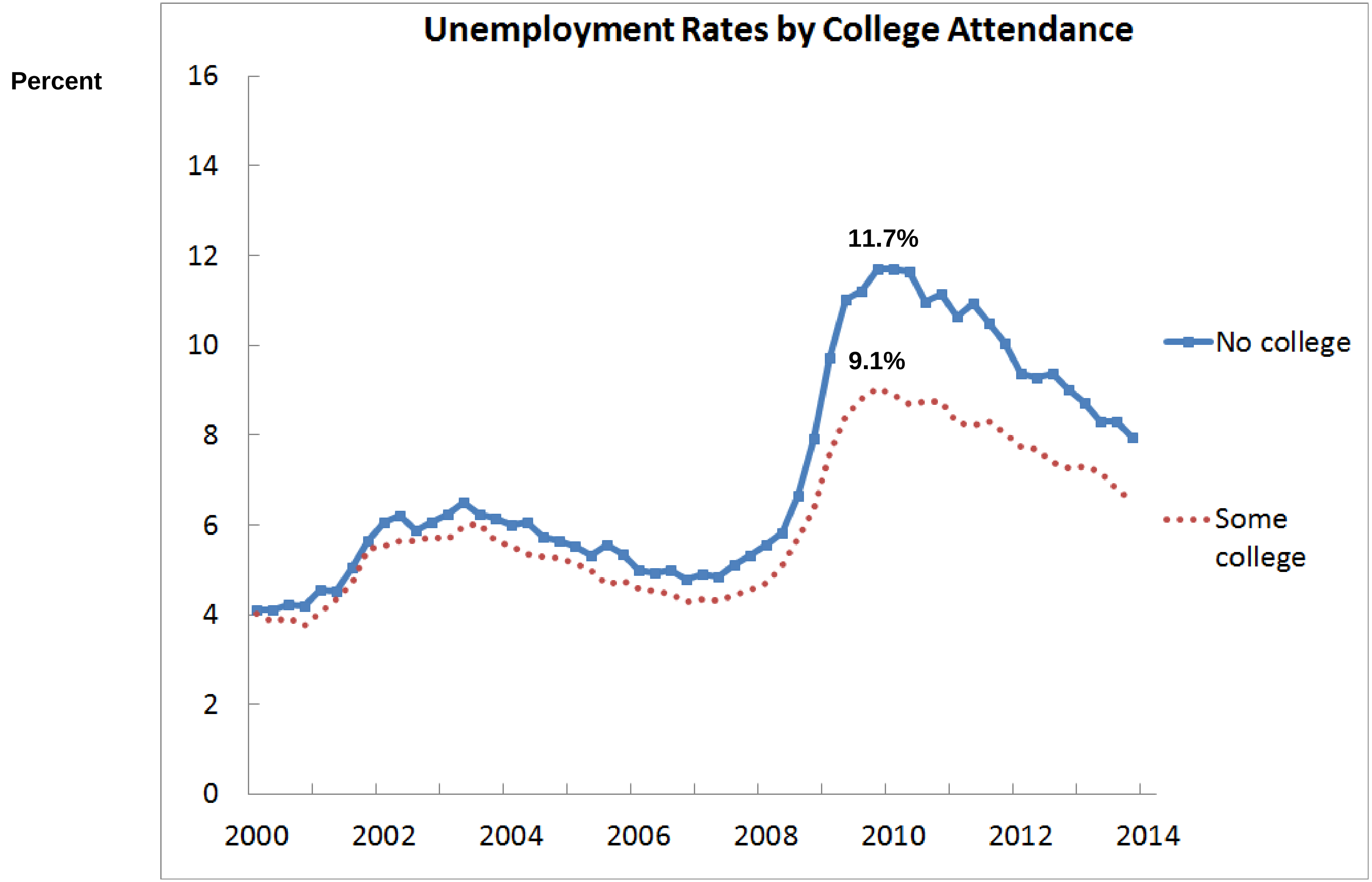
Economically Vulnerable Group 1: Young Adults



Source: Bureau of Labor Statistics

Quarterly through Q4.2013

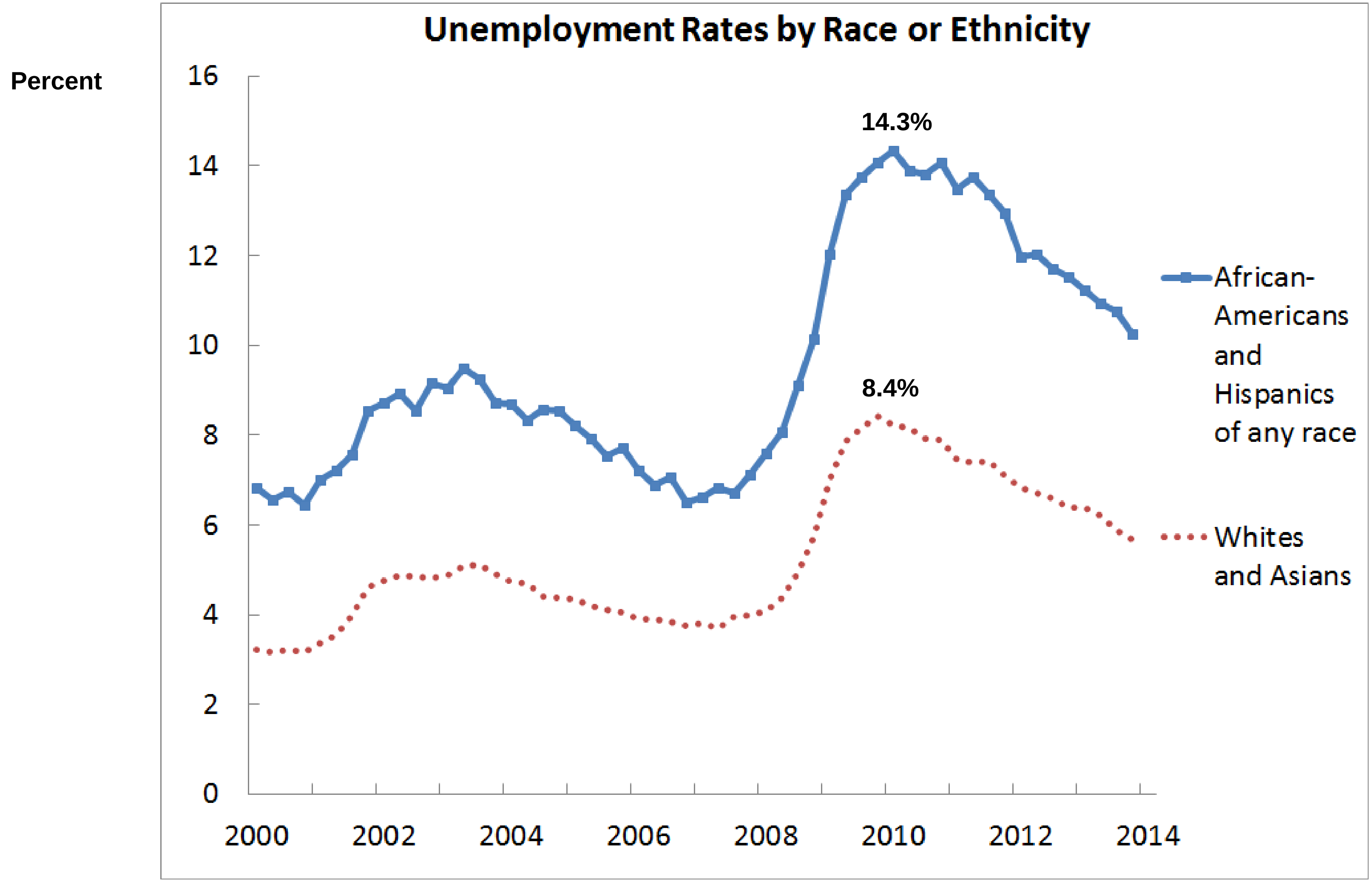
Economically Vulnerable Group 2: Less-Educated



Source: Bureau of Labor Statistics

Quarterly through Q4.2013

Economically Vulnerable Group 3: African-Americans and Hispanics



Source: Bureau of Labor Statistics

Quarterly through Q4.2013

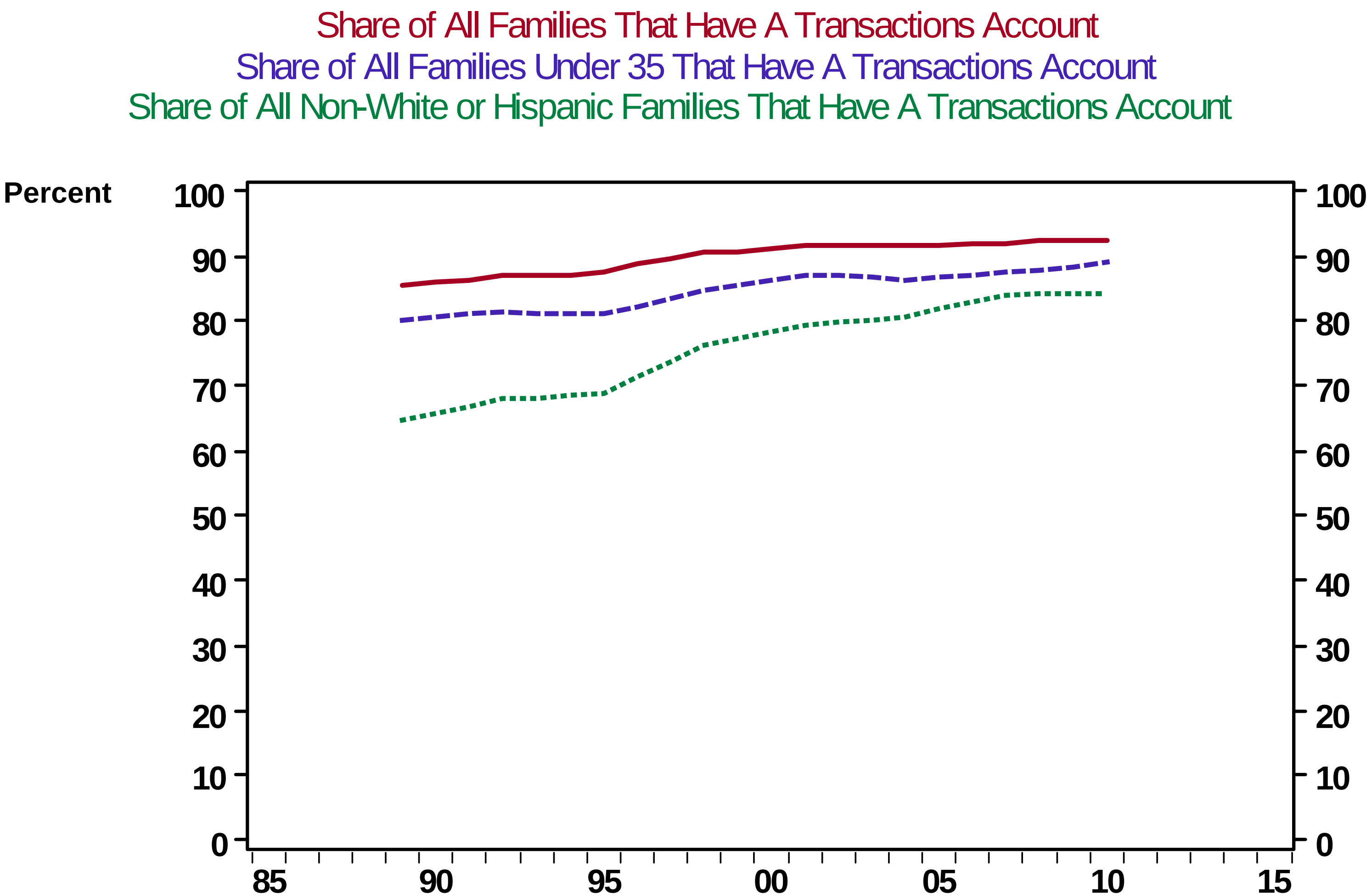
Risky Financial Behavior and Risky Balance Sheets

- **We define risky financial behavior to include:**
  - **Low saving rate**
  - **High-cost financial services**
  - **High debt-service-to-income ratio**
- **We define risky balance sheets to contain:**
  - **Low ratio of safe and liquid assets to income and assets**
  - **High housing concentration (low diversification)**
  - **High balance-sheet leverage**

What Financial Choices do Economically Vulnerable Families Make?

- **Our research shows that economically vulnerable families…**
  - **Were more likely than average to have risky and fragile balance sheets in 2007**
  - **Suffered larger percentage wealth losses during the crisis (2007-10)**
  - **Have recovered wealth more slowly since 2010**
- **Why? Economic vulnerability and financial fragility are driven by common factors**
  - **Youth and inexperience and/or**
  - **Low human capital (innate or acquired) and/or**
  - **The legacies of discrimination and cumulative disadvantage**

Many Economically Vulnerable Families Have Entered the Financial Mainstream



Sources: Federal Reserve Board /Haver Analytics

Our Focus: Building Stronger Household Balance Sheets

- **Characteristics of a healthy balance sheet:**
  - **Adequate liquid assets (or access to low-cost credit) to handle emergencies**
  - **Broad asset diversification to withstand asset-price volatility, such as the housing crash**
  - **Low or no debt to avoid financial distress**

The Role of Credit (and Debt) in a Healthy Balance Sheet

- **Credit is the ability to buy what you want or need whenever you want**
  - **Credit = credibility you have with others**
  - **Obviously a good thing for everyone to have**
  - **Your credit score is a measure of your access to credit**
- **Debt is the on-going obligation you have to repay what you borrowed**
  - **Debt = what you owe someone else**
  - **Debt is expensive and risky**
  - **Your debt ratios are a measure of how close to financial disaster you are**
  - **Financial disaster = loss of access to credit**

Balancing Credit and Debt

- **Key to a healthy balance sheet: Maximize credit while minimizing debt**
  - **Access to credit is liberating and can help a family take advantage of opportunity**
  - **Credit becomes debt when repayment is deferred**
  - **Ideal situation: Pay off all of your credit purchases before interest payments are due—that is, before it becomes debt**

But Realistically Speaking...

- **Some debt is unavoidable for most families**
  - **Life-cycle events like paying for college or buying a house or car**
  - **True emergencies**
- **Strategies for managing debt**
  - **Save and build liquid assets to minimize need to borrow**
  - **Anticipate borrowing needs and shop for a good loan**
  - **Repay diligently**

If Credit is a Good Thing, Why is Household Debt Such A Problem?

- **Self-control and planning problems**
  - **No one takes on debt planning to default**
  - **Lots of economic evidence that many people over-estimate their ability to repay their debt quickly**
  - **Things happen!**
  - **Many people do not realize how quickly interest compounds on their loans, especially if the rate is high**

Things the Consumer May Not Know

- **Tricks and traps**
  - **Consumer lenders do not have a fiduciary obligation toward borrowers**
  - **Our regulatory regime has been based on disclosure of credit terms, not necessarily understanding by consumer**
  - **CFPB critics are right and they're wrong**
    - **The Consumer Financial Protection Bureau will reduce access to credit and raise the cost of borrowing**
    - **But the alternative—the status quo—was unsatisfactory**

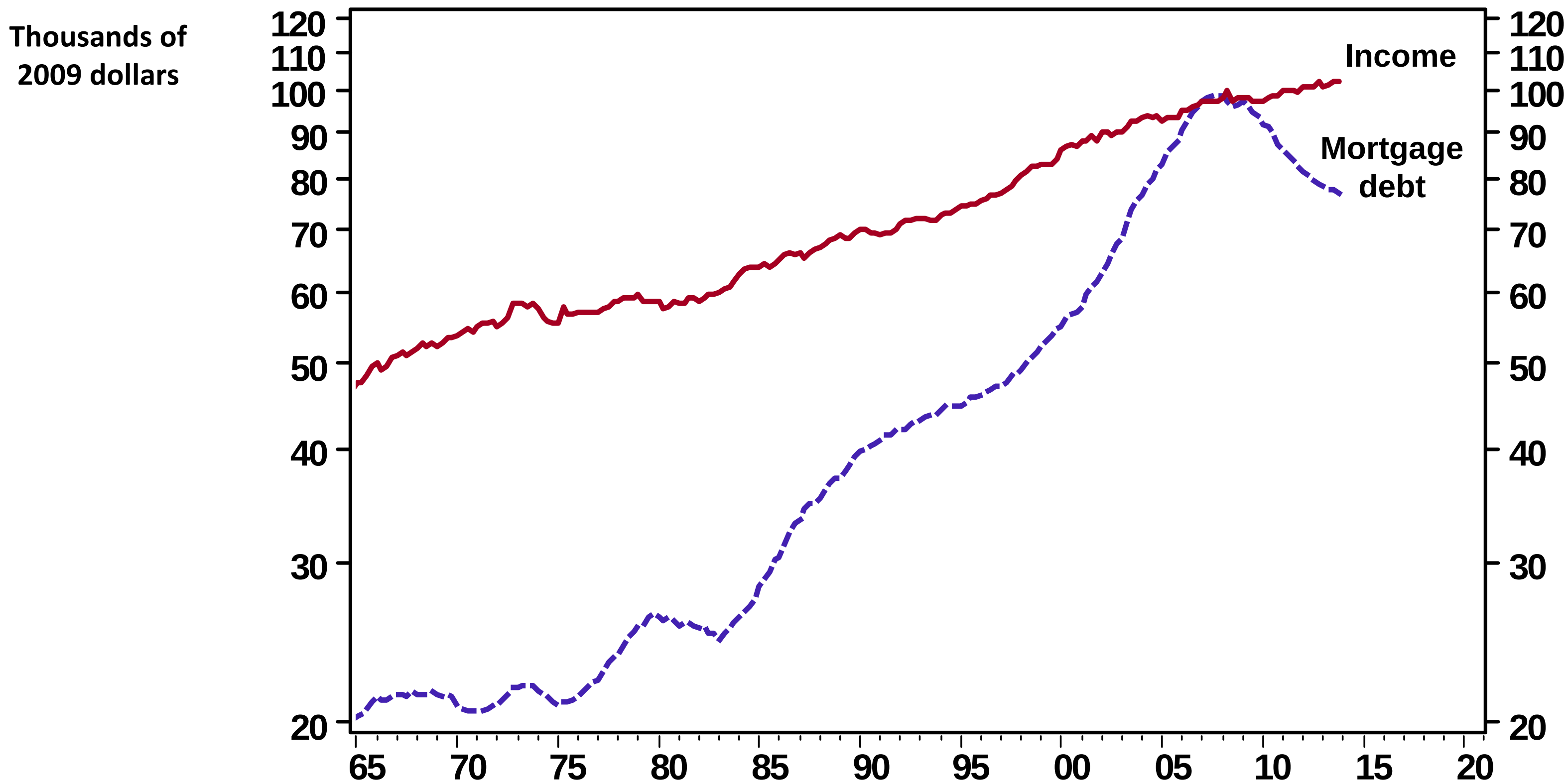
Things Most Economists Did Not Know

- **Household borrowing (credit) spurs the economy, but overburdened consumers (debt) can bring it down**
  - **Spending in the U.S. and other economies grew faster than incomes for many years**
  - **Consumer borrowing (and government borrowing on their behalf) made up the difference**
  - **The global financial crisis and the Great Recession were largely the result of a household-debt crisis**
  - **We have entered a period of deleveraging, slowing economic growth for years**

We Couldn't Increase Our Debt Faster than Income Forever

Average Disposable Income Per Household in Real Terms
Thousands of 2009 dollars

Average Mortgage Debt Per Household in Real Terms
Thousands of 2009 dollars



Sources: Bureau of Economic Analysis, Census Bureau, Federal Reserve Quarterly through Q4.2013

In Sum: The Role of Credit in a Healthy Balance Sheet

- **Household balance sheets matter for the prosperity and resilience of families and the economy.**

- **Credit is necessary and good; debt is costly and dangerous.**

- **Economically vulnerable families face difficult challenges balancing credit and debt.**

- **Our economy depends on families getting the balance right.**