Why Did So Many Economically Vulnerable Families Enter the Crisis With Risky Balance Sheets?

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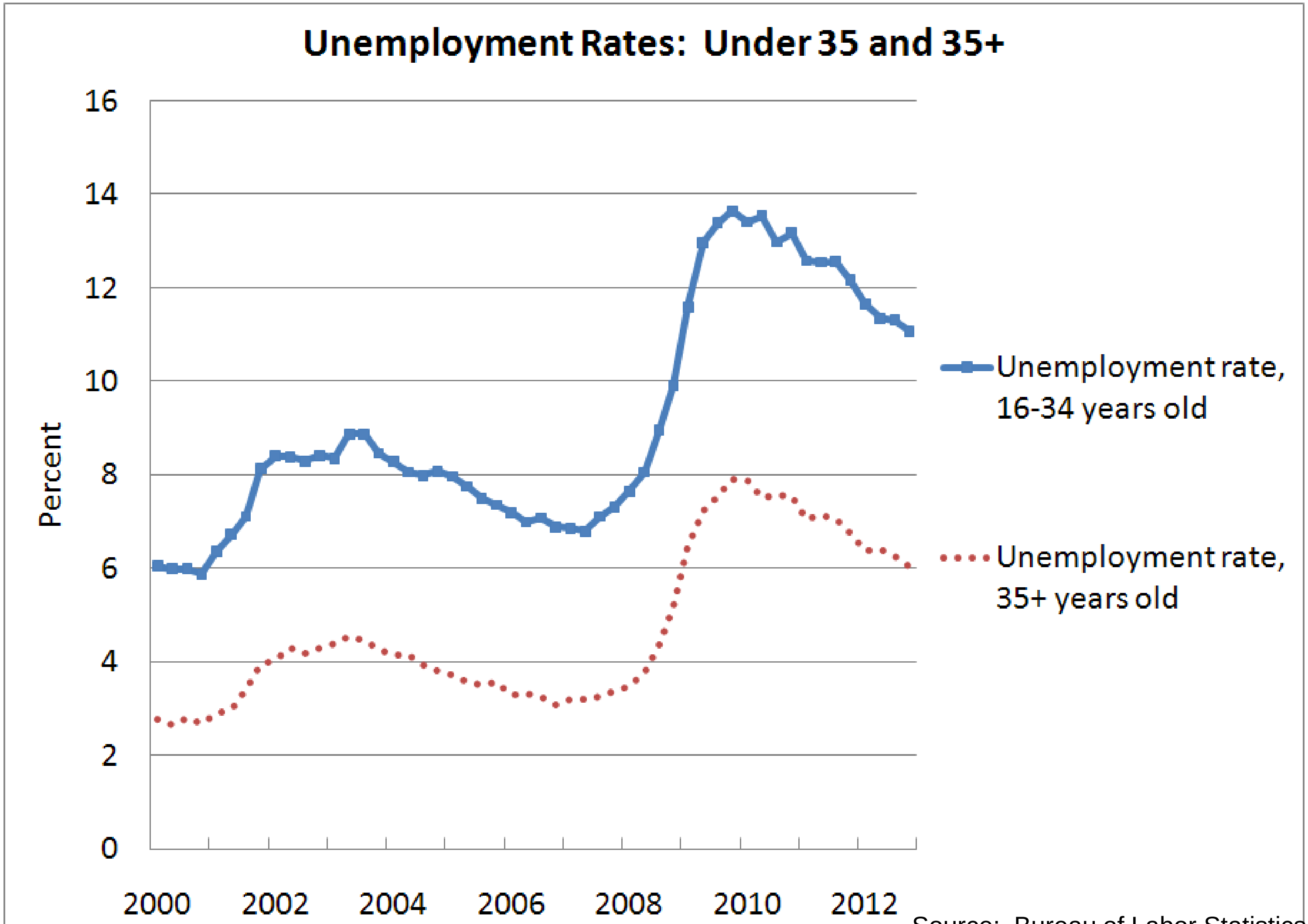
Why Did Economically Vulnerable Families Enter the Crisis With Risky Balance Sheets?

- **Evidence from the Survey of Consumer Finances: Economically vulnerable families were more likely to have risky balance sheets in 2007, then suffered larger percentage wealth losses during the crisis.**

- **Shouldn't a family's balance sheet be used to dampen its economic risk, rather than amplify it?**

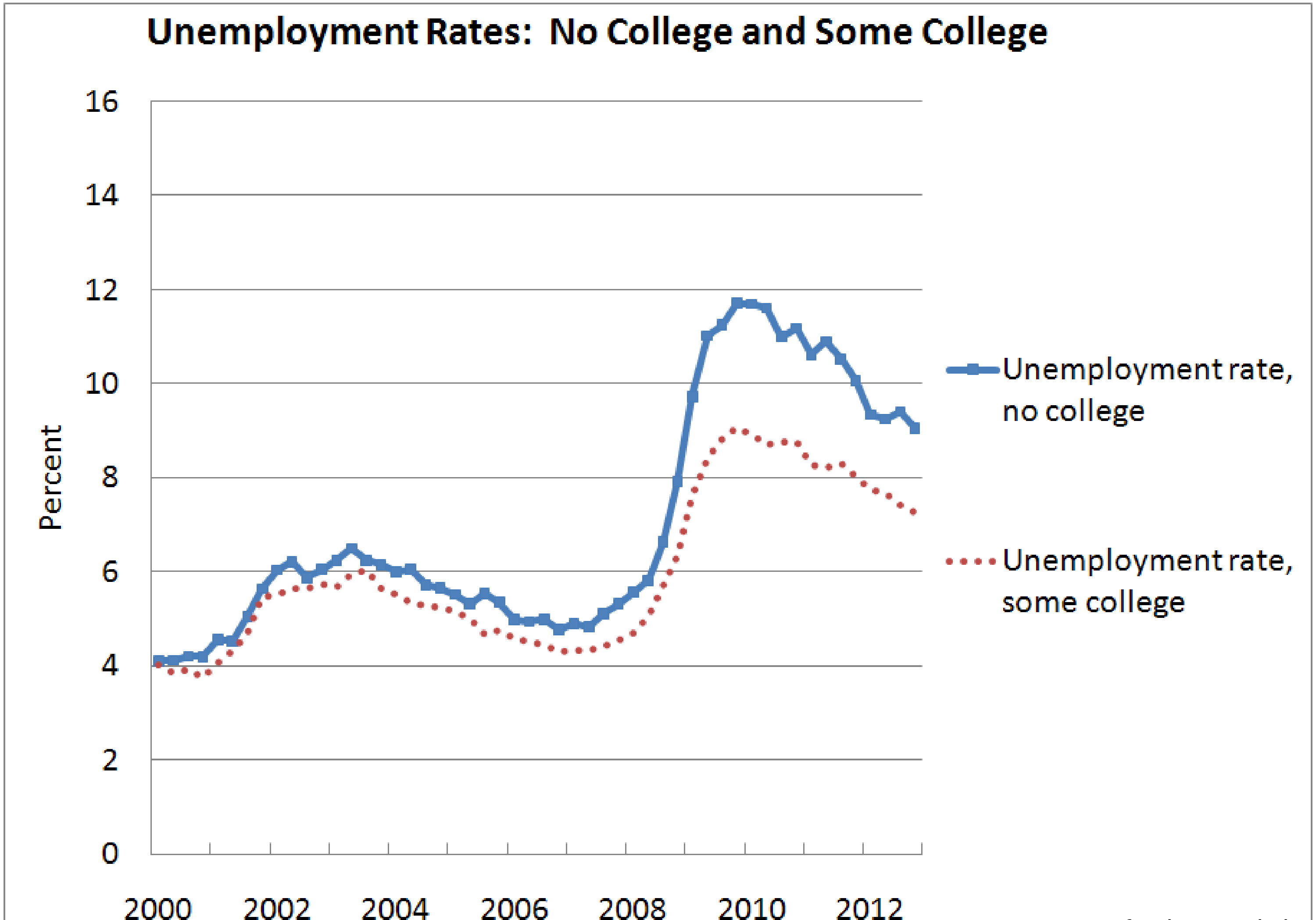
- **Which interventions are most likely to break the link between economic vulnerability and financial fragility?**

Economically Vulnerable Group: The Young



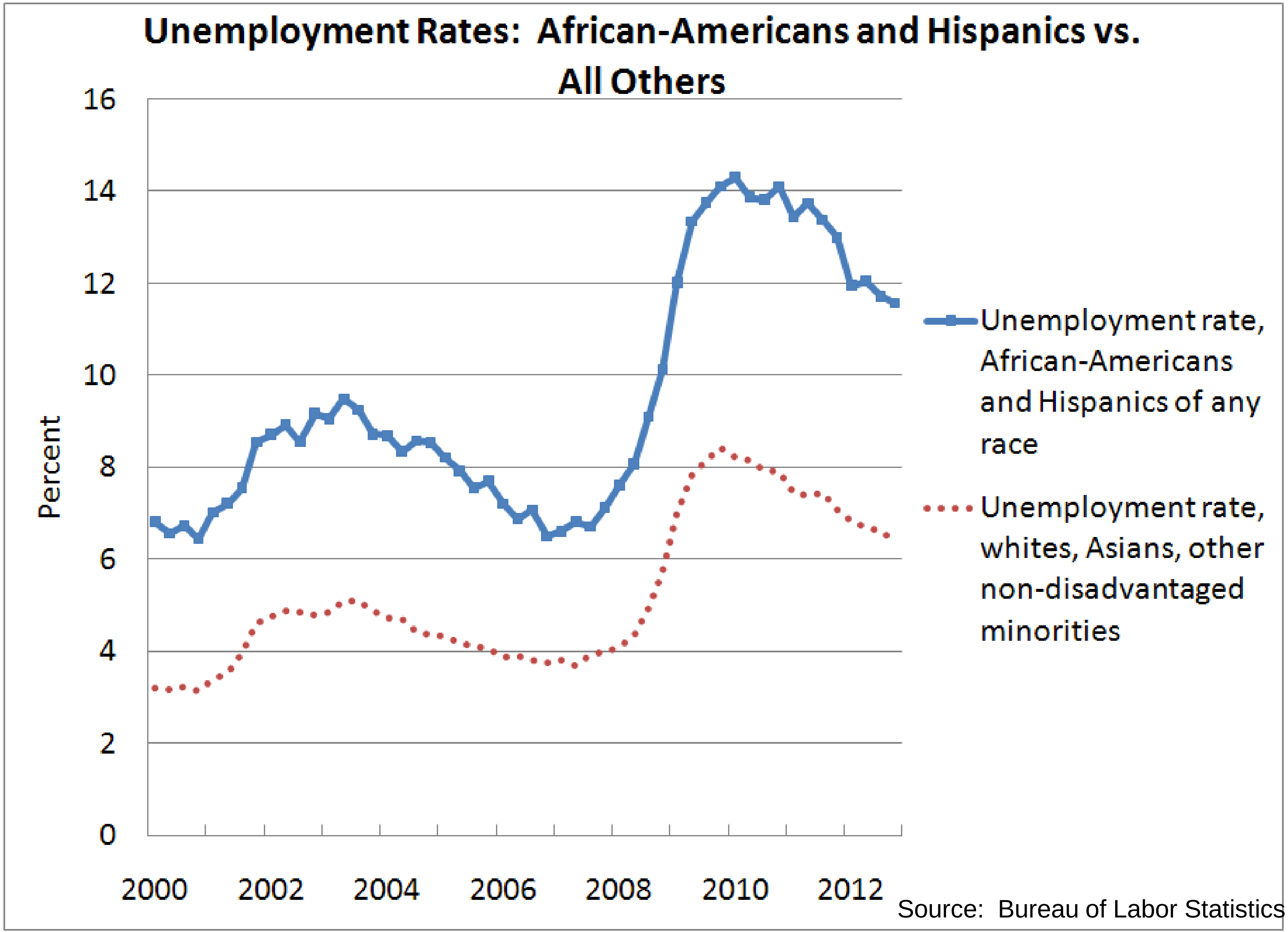
Source: Bureau of Labor Statistics

Economically Vulnerable Group: Less-Educated



Source: Bureau of Labor Statistics

Economically Vulnerable Group: African-Americans and Hispanics



Source: Bureau of Labor Statistics

Economic Vulnerability and Financial Fragility

- **<u>Economic vulnerability</u>: Susceptibility to job and income losses**
- **<u>Financial fragility</u>: Risky financial behavior and risky balance sheets**
  - **<u>Fact</u>: They are positively correlated in the population across demographic sub-groups**
- **Why don't economically vulnerable families take <u>less</u> financial risk to hedge their consumption risk?**
- **<u>Our explanation</u>: They're driven by common factors—youth and inexperience, low human capital, and the legacy of discrimination**

Economically Vulnerable Groups Suffered Very Large Wealth Losses

- **Wealth losses during the crisis (2010 wealth vs. 2004/07 average, inflation-adjusted)**
  - **Overall: -10%**
  - **Young (<40) families: -41%**
  - **Less-than HS families: -28%**
  - **Minority families: -31%**

- **Groups with smaller average losses**
  - **Old (62+) families: -4%**
  - **College grads (2- or 4-yr): -9%**
  - **Whites and Asians: -6%**

Source: Federal Reserve, Survey of Consumer Finances

Economically Vulnerable Groups Had Risky Balance Sheets Going into the Crisis

Demographic Influences on Balance Sheets			
Demographic group	*Marginal effect of belonging to a demographic group on:*		
	Safe and liquid assets relative to annual income		
Young families (< 40 years old)	-16 percentage points		
High-school drop-out families	-16		
African-Americans and Hispanics	-20		

Source: Emmons and Noeth (2013), based on Survey of Consumer Finances

Economically Vulnerable Groups Had Risky Balance Sheets Going into the Crisis

Demographic Influences on Balance Sheets			
Demographic group	*Marginal effect of belonging to a demographic group on:*		
	Safe and liquid assets relative to annual income	**Share of assets invested in housing**	
Young families (< 40 years old)	-16 percentage points	+13 percentage points	
High-school drop-out families	-16	+9	
African-Americans and Hispanics	-20	+14	

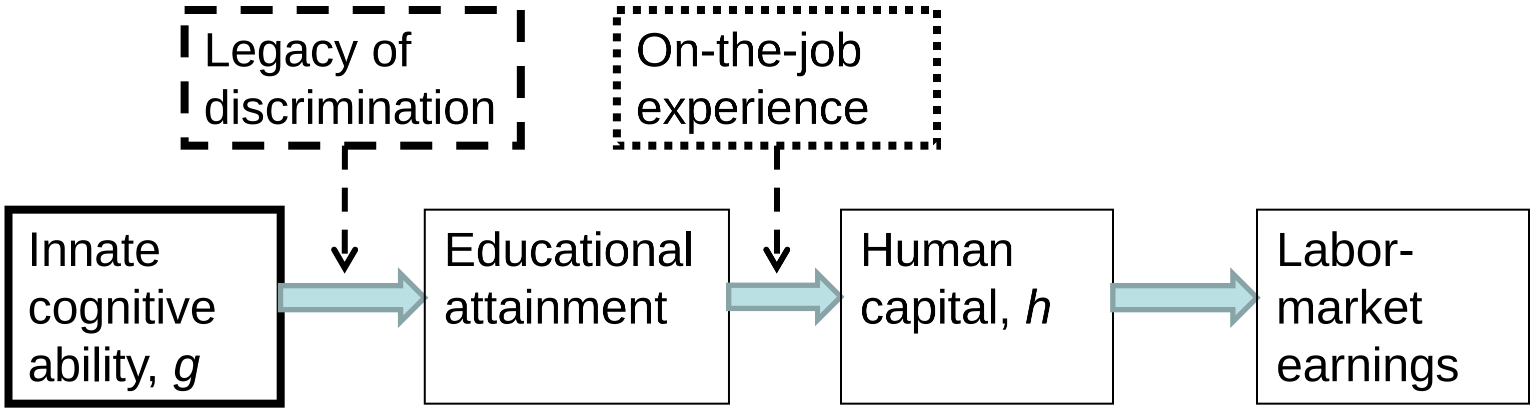
Source: Emmons and Noeth (2013), based on Survey of Consumer Finances

Economically Vulnerable Groups Had Risky Balance Sheets Going into the Crisis

Demographic Influences on Balance Sheets			
Demographic group	*Marginal effect of belonging to a demographic group on:*		
	Safe and liquid assets relative to annual income	**Share of assets invested in housing**	**Ratio of total debt to total assets**
Young families (< 40 years old)	-16 percentage points	+13 percentage points	+32 percentage points
High-school drop-out families	-16	+9	-4
African-Americans and Hispanics	-20	+14	+7

Source: Emmons and Noeth (2013), based on Survey of Consumer Finances

Our Model of Earnings Determination...



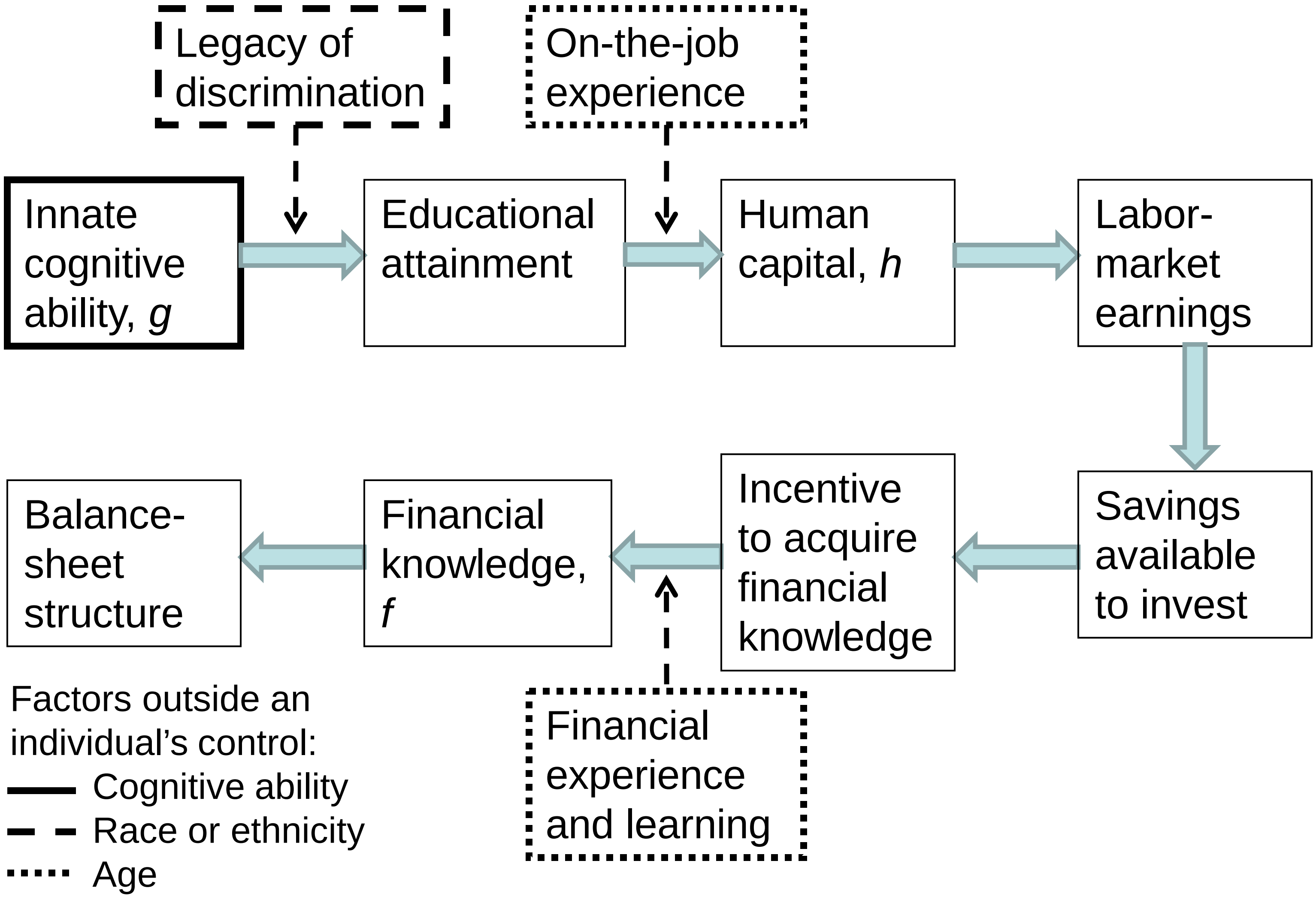
Factors outside an individual's control:

Cognitive ability

Race or ethnicity

Age

… And Balance-Sheet Coice



Key Implications

- **Economic vulnerability and financial fragility co-exist because they have common causes, including one or more of the following:**
  - **Being young and inexperienced**
  - **Low human capital**
  - **Historically disadvantaged minority**
- **What's new and counter-intuitive?**
  - **New: Endogenous acquisition of financial knowledge interacts with human capital (and all of its determinants)**
    - **See Lusardi, Michaud, Mitchell (2013)**
  - **Counter-intuitive: Balance sheets of groups with the most economic risk amplify their risk, rather than dampening it**

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**
  - **High housing concentration**
  - **High balance-sheet leverage**

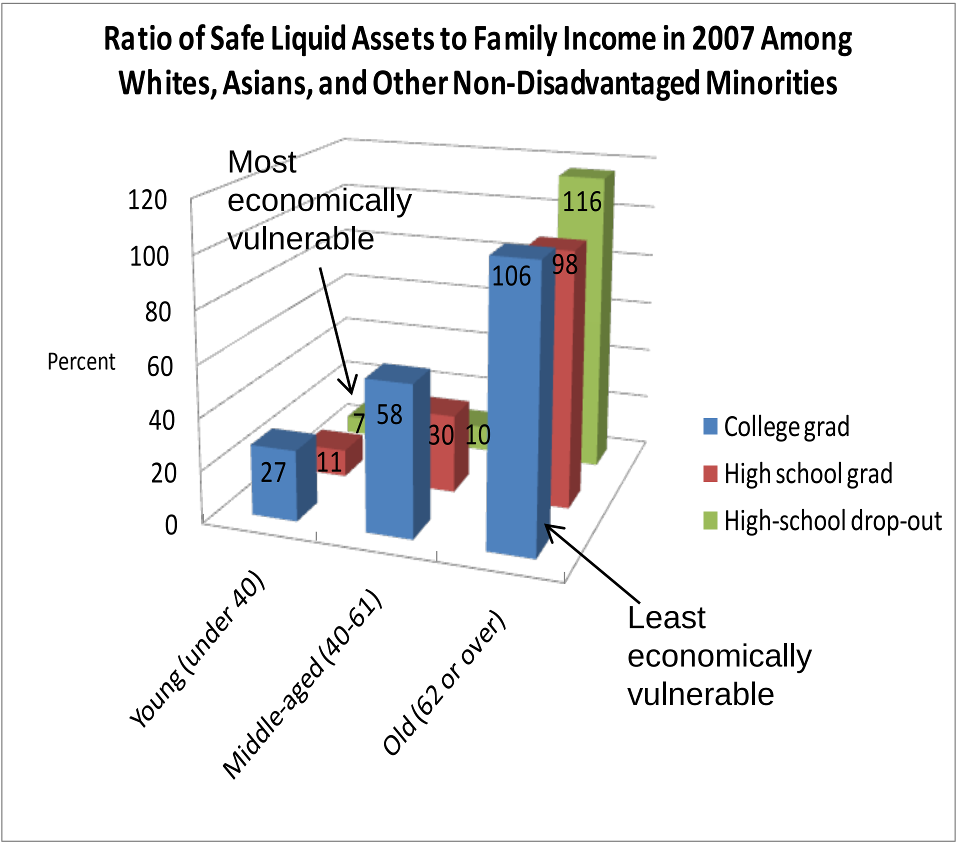
1) Ratio of Safe and Liquid Assets to Annual Income Before the Crash

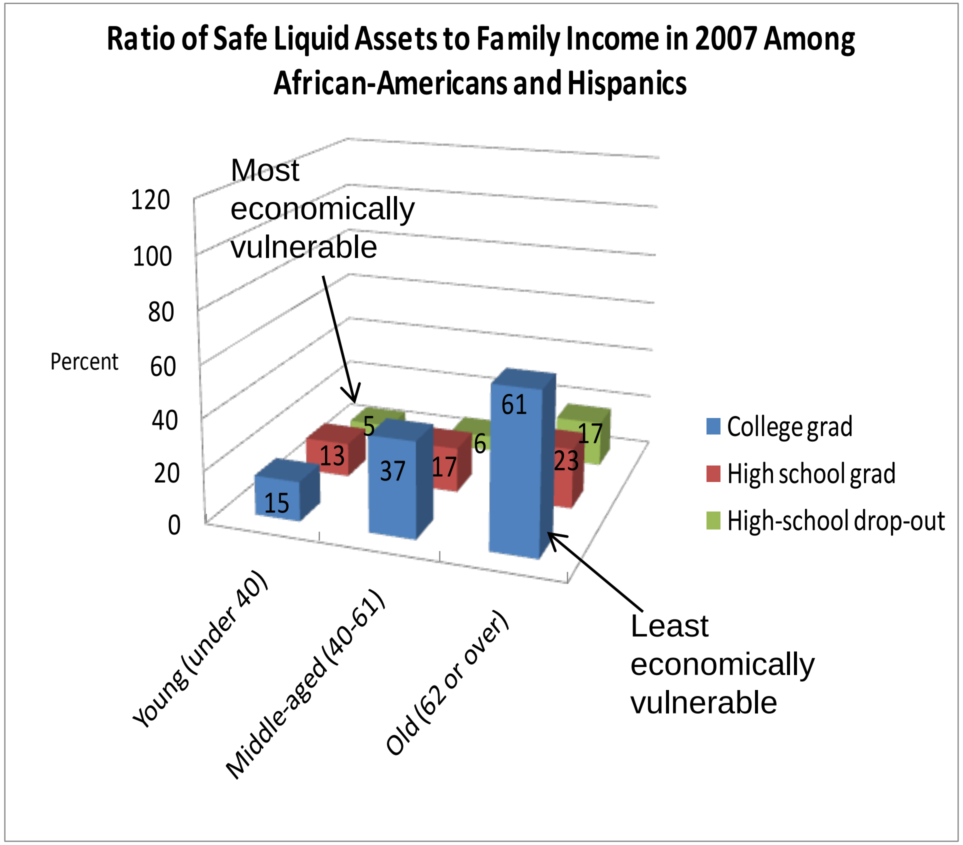
- **All families, average 2004/2007 safe-assets-to-income ratio**
  - **Overall: 56%**

- **Economically vulnerable groups**
  - **Young (<40) families: 20%**
  - **Minority families: 19%**
  - **Less-than HS families: 54%**

- **Less-vulnerable groups**
  - **Old (62+) families: 126%**
  - **Whites and Asians: 61%**
  - **College grads: 63%**

Ratio of Safe and Liquid Assets to Income

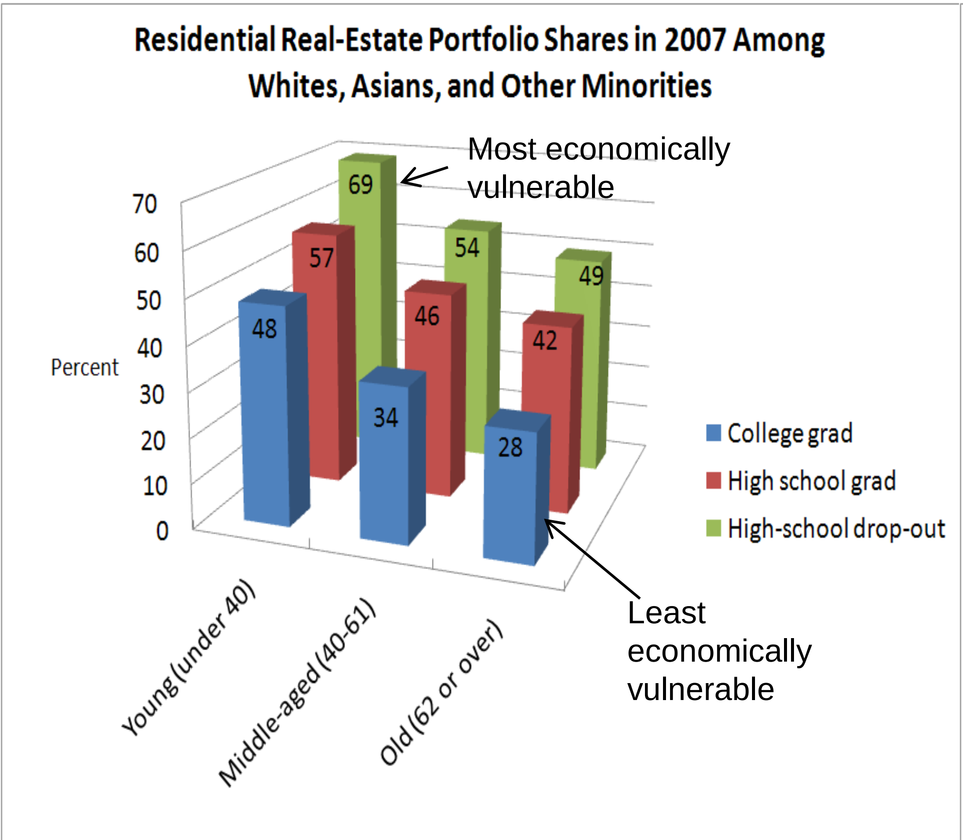


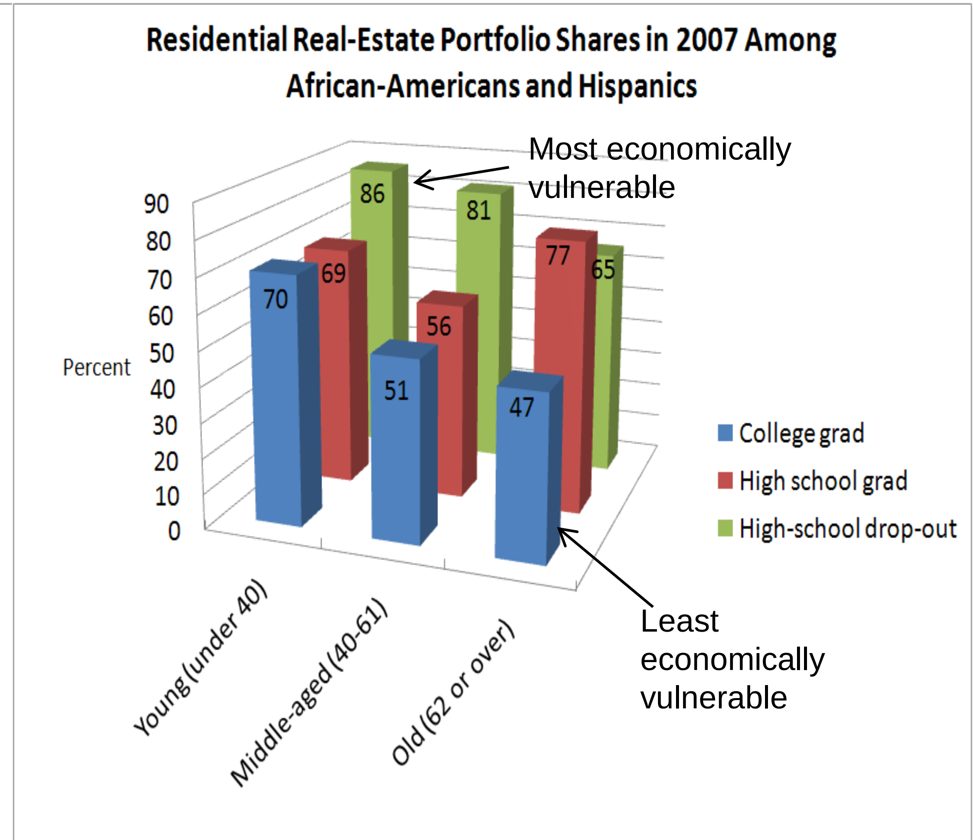


2) Share of Total Assets in Residential Real Estate Before the Crash

- **All families, average 2004/2007 RRE portfolio share**
  - **Overall: 39%**
- **Economically vulnerable groups**
  - **Young (<40) families: 54%**
  - **Minority families: 58%**
  - **Less-than HS families: 59%**
- **Less-vulnerable groups**
  - **Old (62+) families: 34%**
  - **Whites and Asians: 37%**
  - **College grads: 35%**

Residential Real-Estate Portfolio Shares





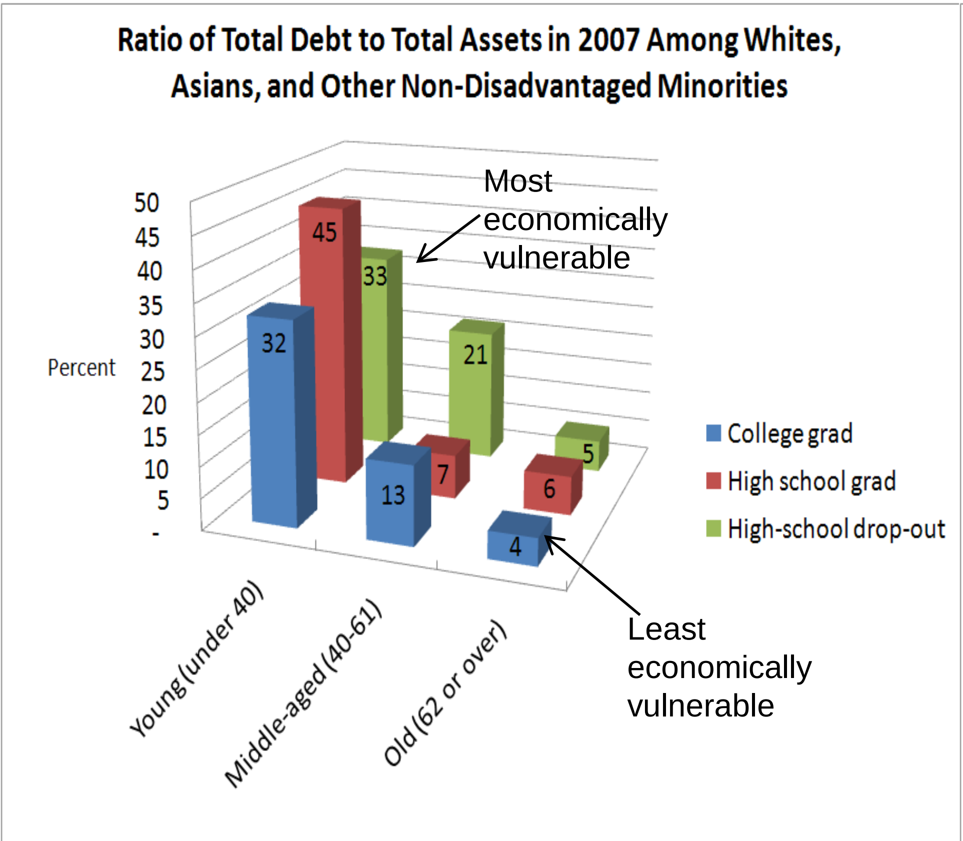
3) Ratio of Total Debt to Total Assets Before the Crash

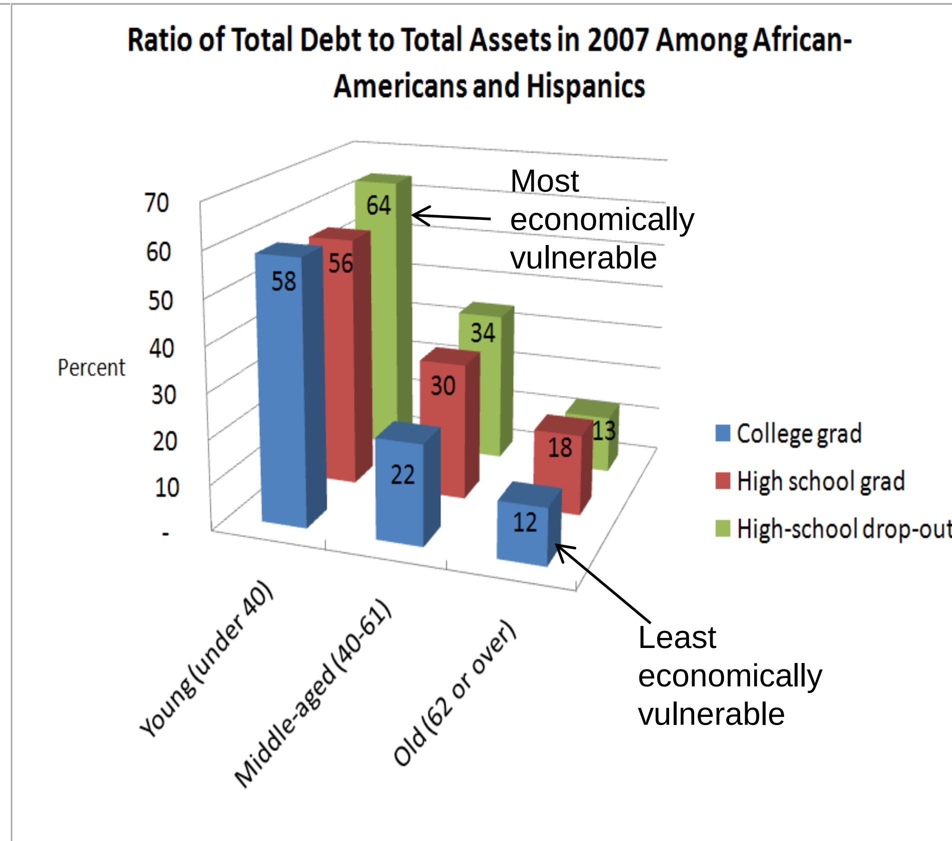
- **All families, average 2004/2007 debt-to-assets ratio**
  - **Overall: 15%**

- **Economically vulnerable groups**
  - **Young (<40) families: 39%**
  - **Minority families: 31%**
  - **Less-than HS families: 16%**

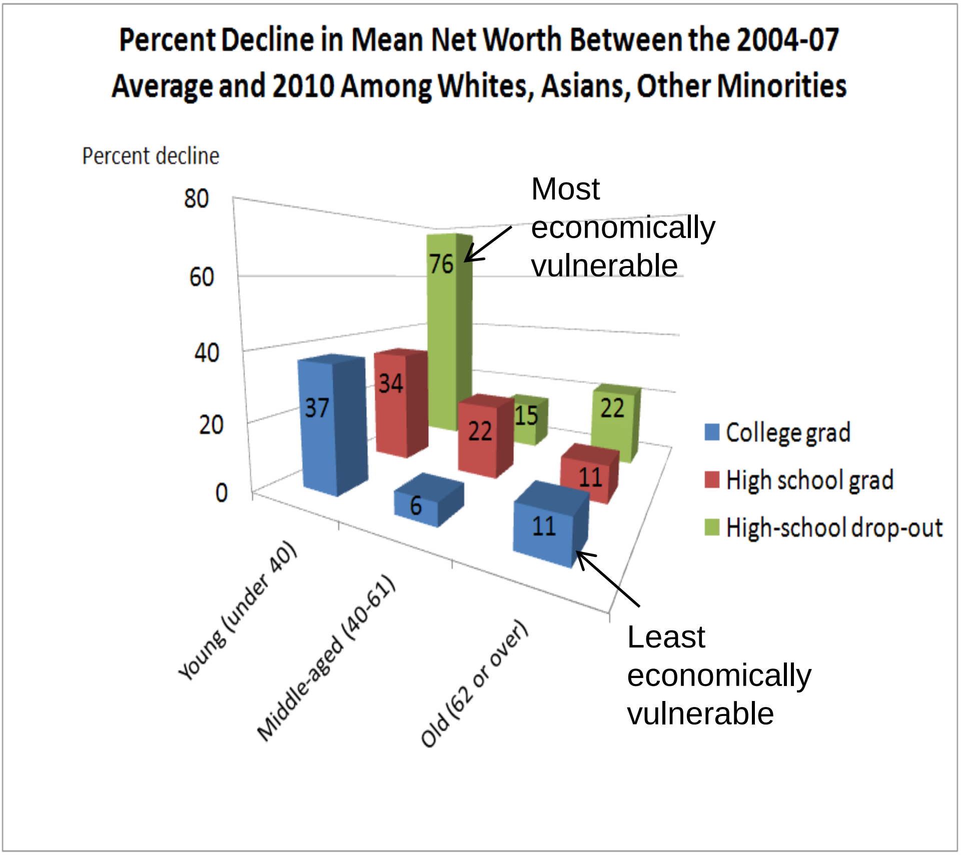
- **Less-vulnerable groups**
  - **Old (62+) families: 5%**
  - **Whites and Asians: 14%**
  - **College grads: 13%**

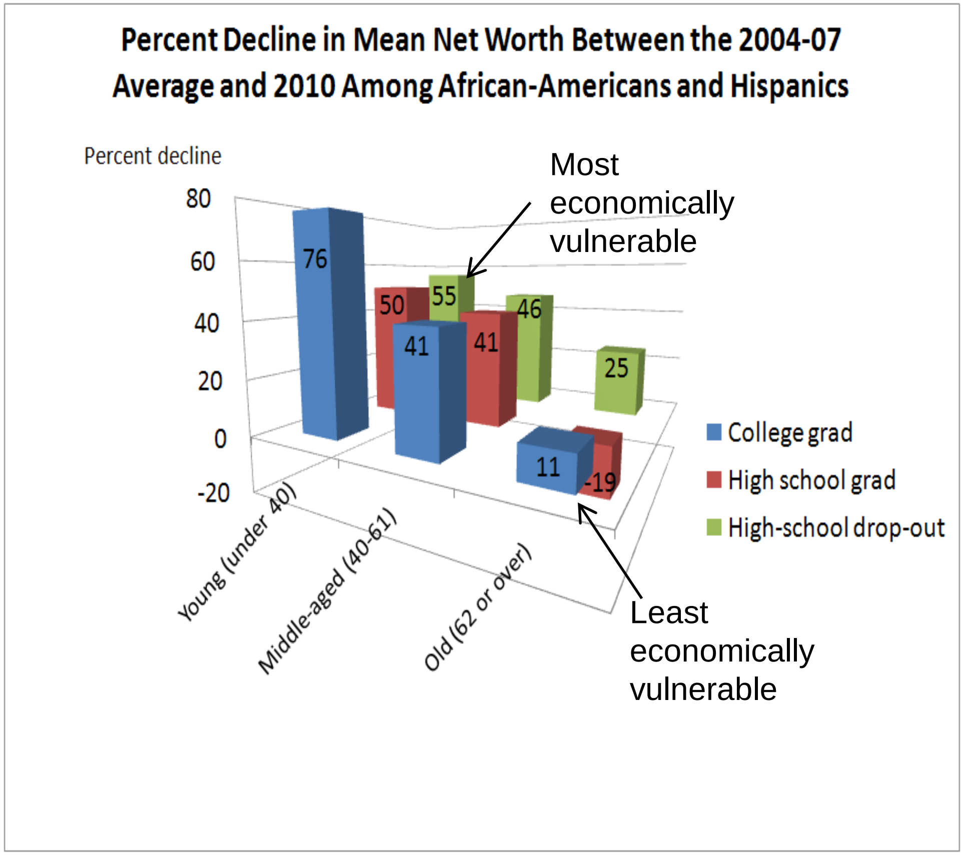
Ratio of Total Debt to Total Assets





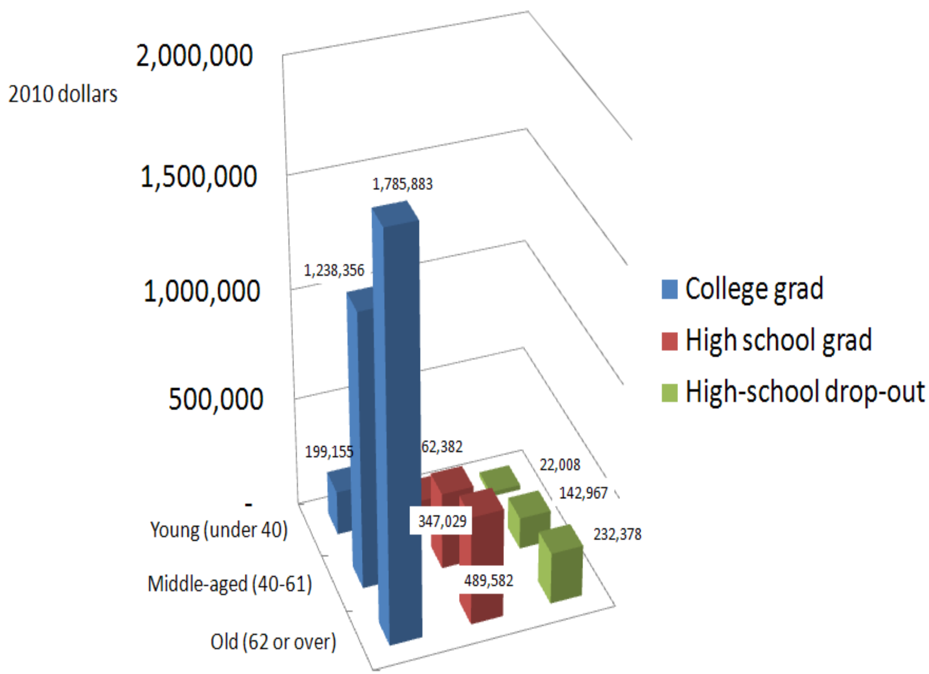
Wealth Loss During the Crisis



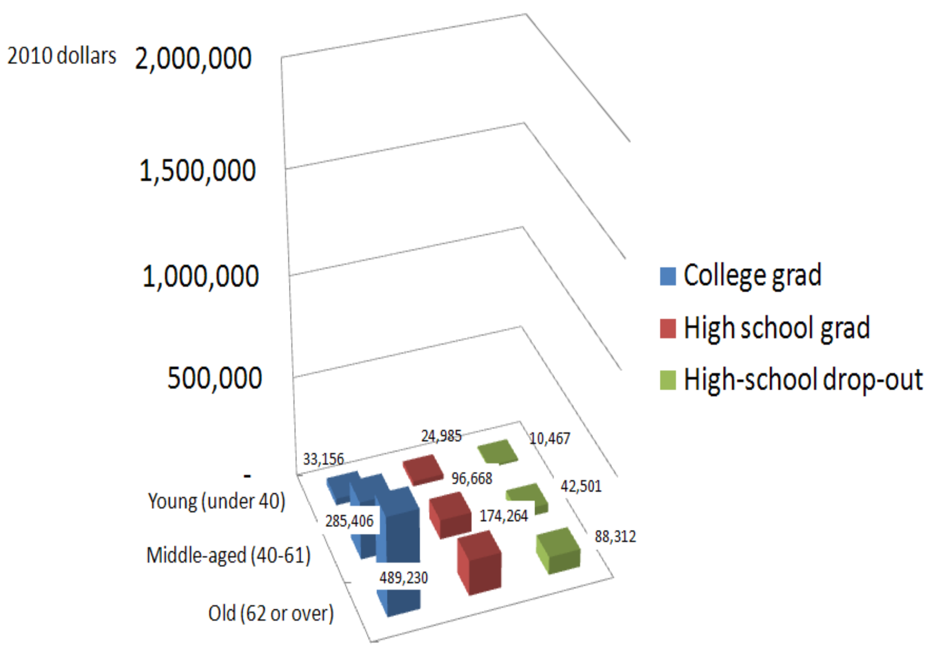


Wealth in 2010: Pre-Crisis Disparities Re-inforced by Crisis Losses

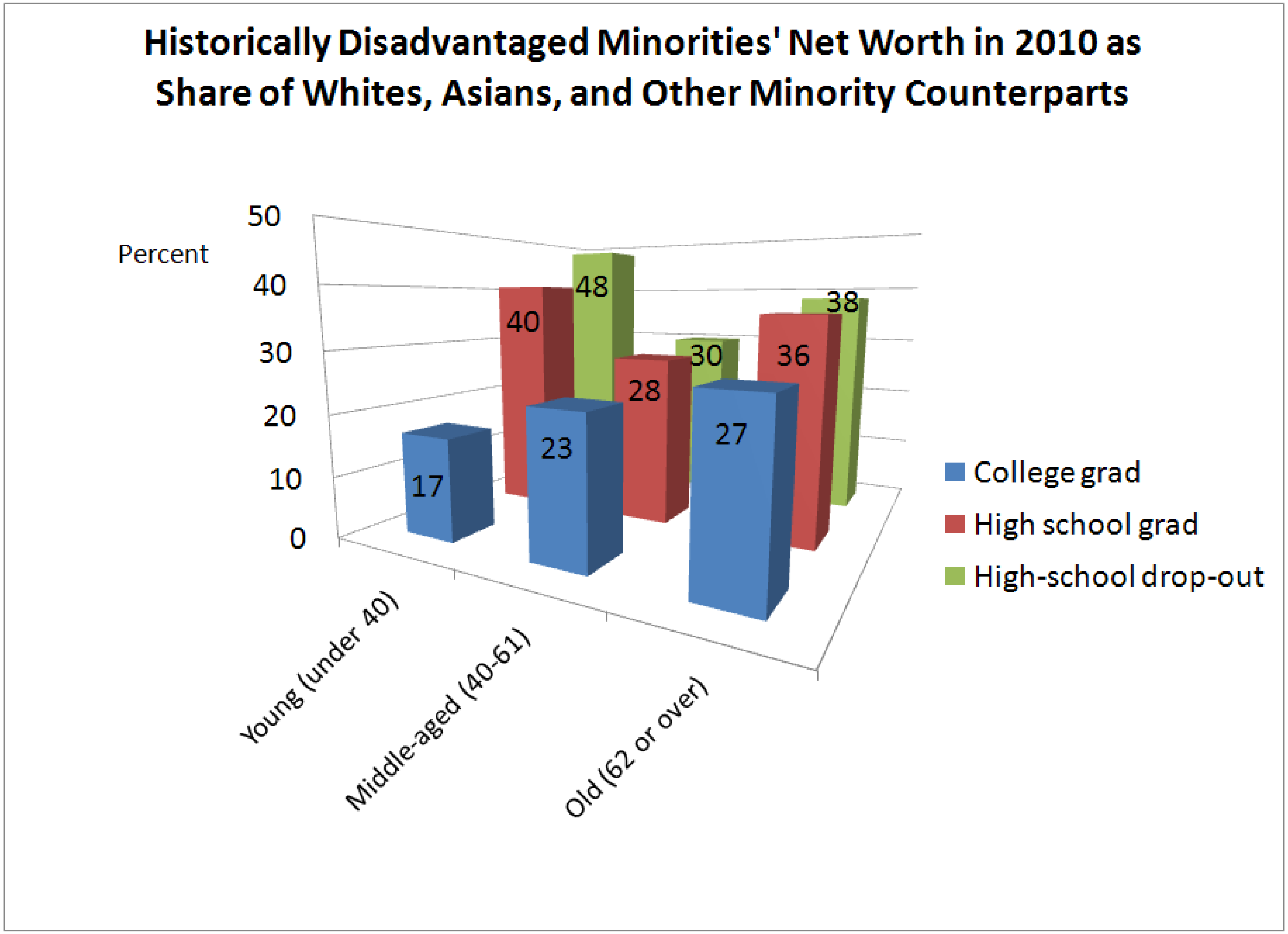
Average White or Asian Family Net Worth in 2010



Average African-American or Hispanic Family Net Worth in 2010



Ratio of African-American or Hispanic Wealth to Non-Minority Wealth

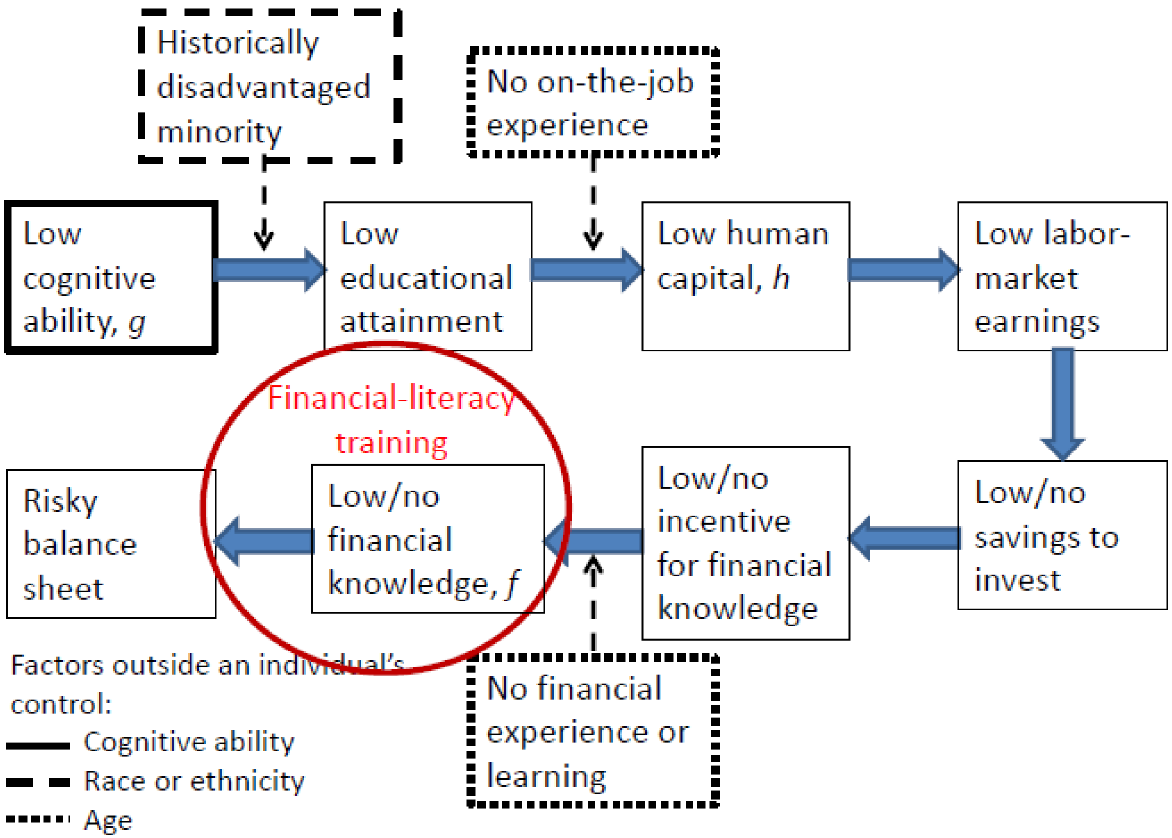


Can We Break the Link Between Economic Vulnerability and Financial Fragility?

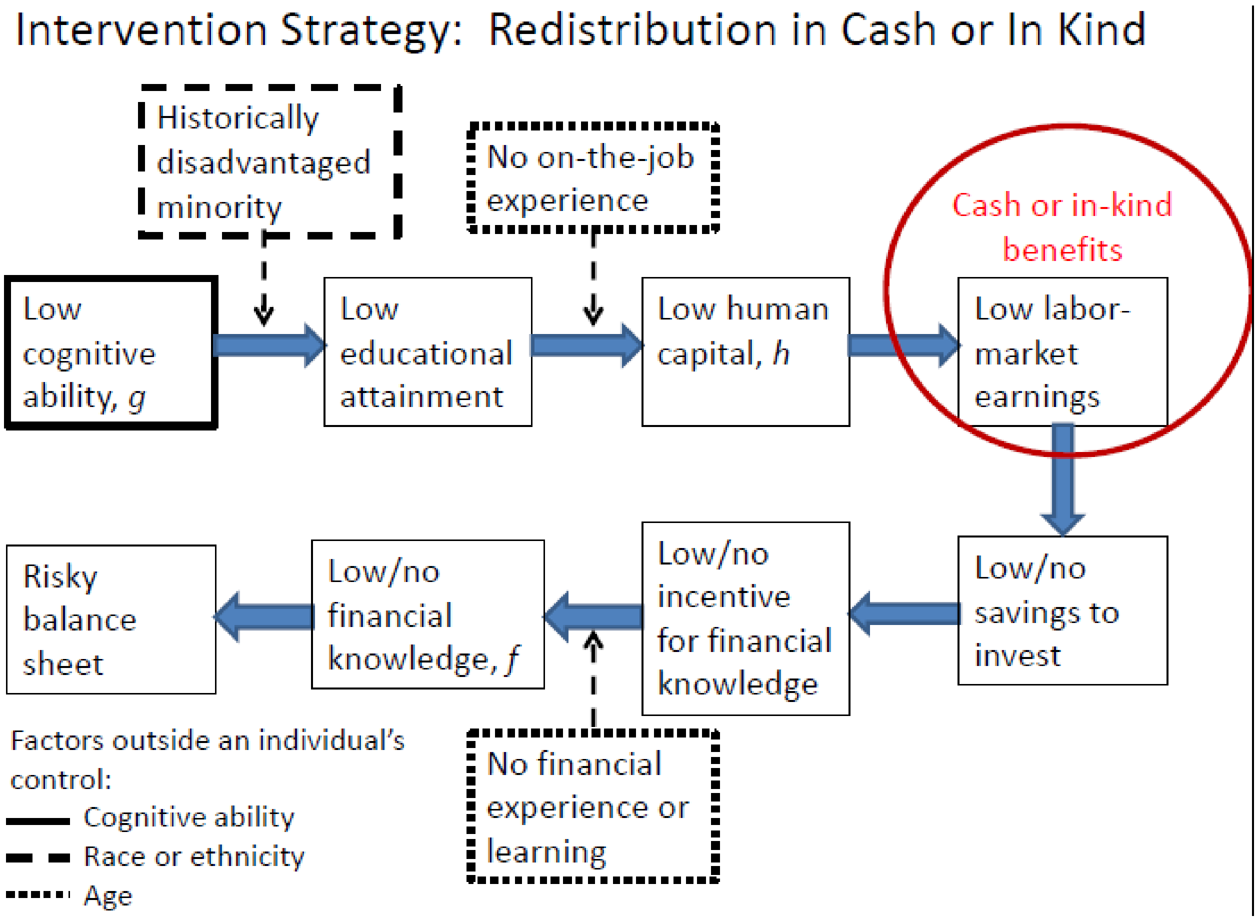
- **Financial-literacy training**
- **Cash and in-kind benefits**
- **Individual-Development Accounts (IDAs)**
- **Early-childhood enrichment**

Adult Financial-Literacy Education Comes Too Late

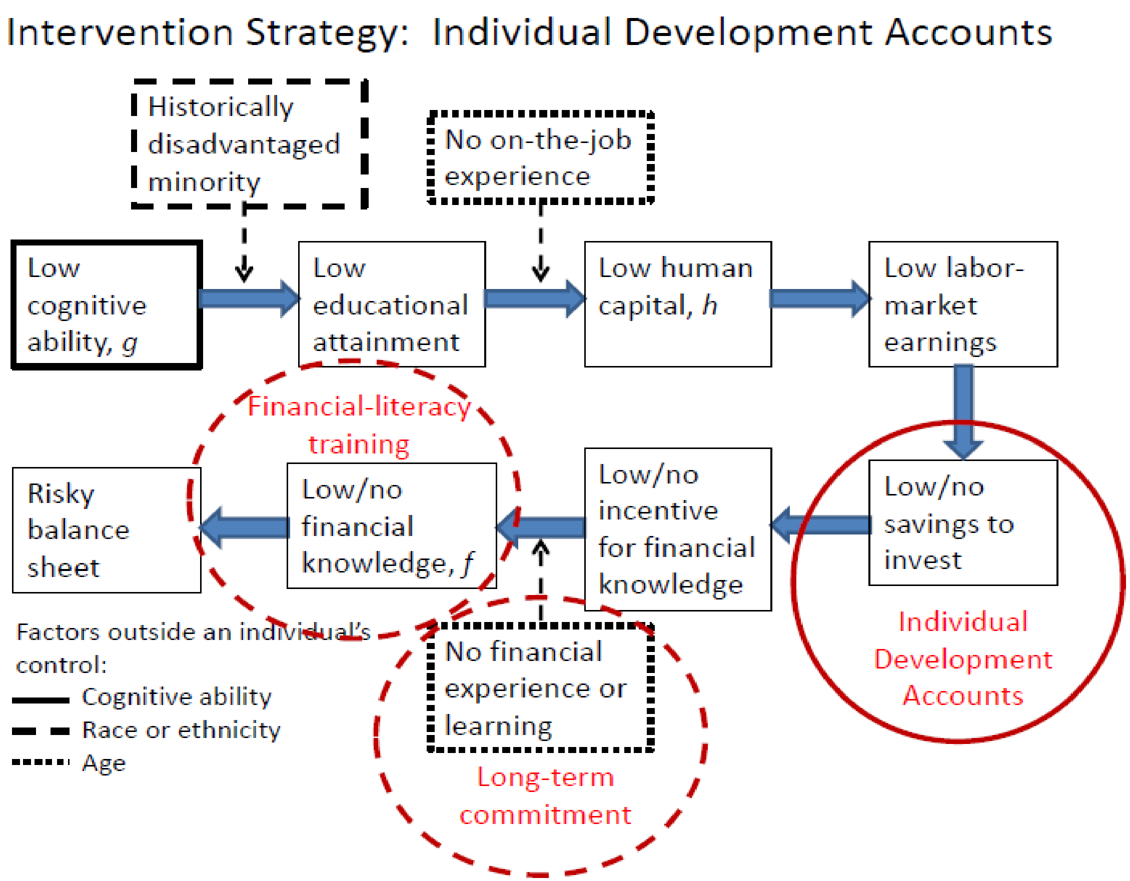
Intervention Strategy: Financial-Literacy Training



Cash and In-Kind Benefits May Not Translate into Financial Knowledge

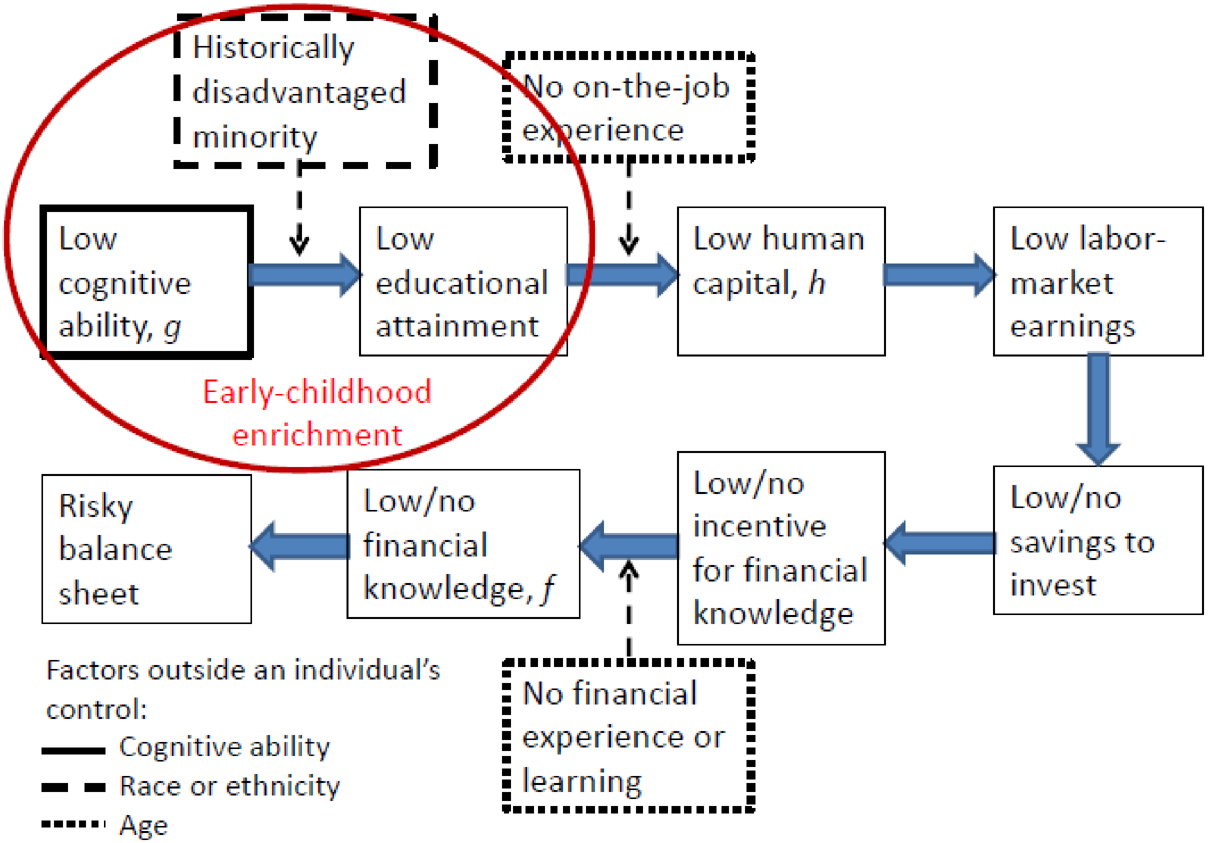


Individual Development Accounts Intervene at Several Points



Early Childhood Interventions Target Human Capital

Intervention Strategy: Early-Childhood Enrichment



Why Did Economically Vulnerable Families Enter the Crisis With Risky Balance Sheets?

- **Economically vulnerable families were more likely to have risky balance sheets in 2007, and then to suffer large percentage wealth losses during the crisis.**

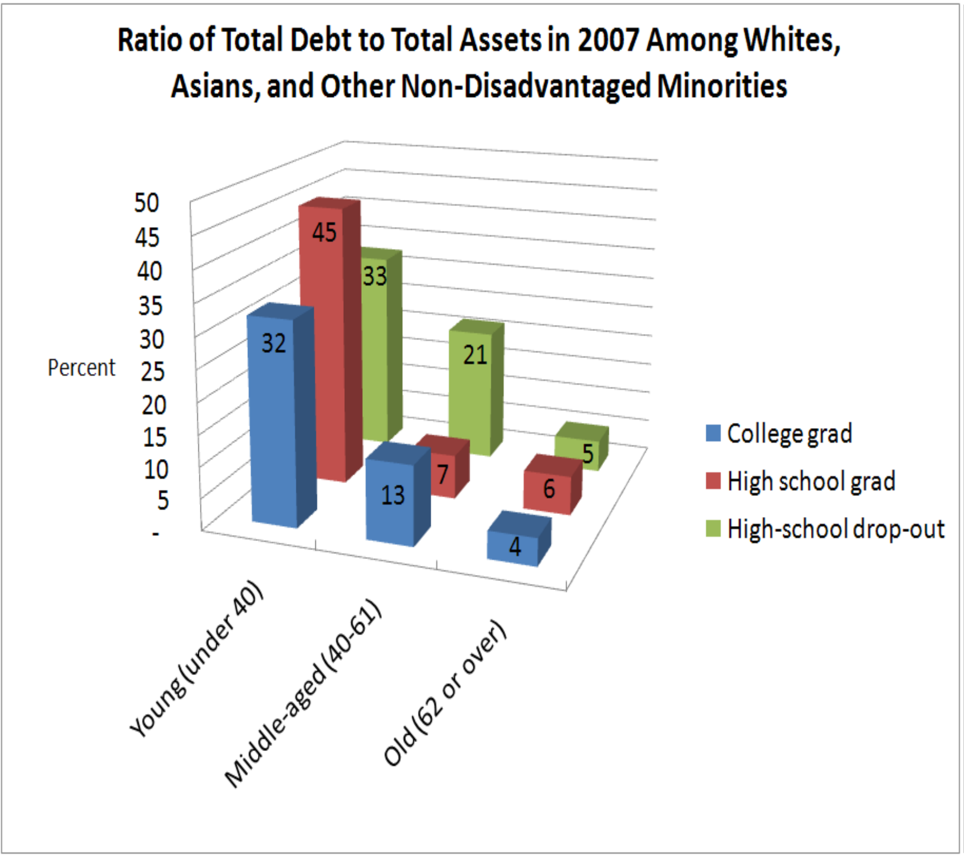
- **Common causes drive both:**
  - **Youth and inexperience**
  - **Low level of human capital**
  - **Legacy of discrimination**

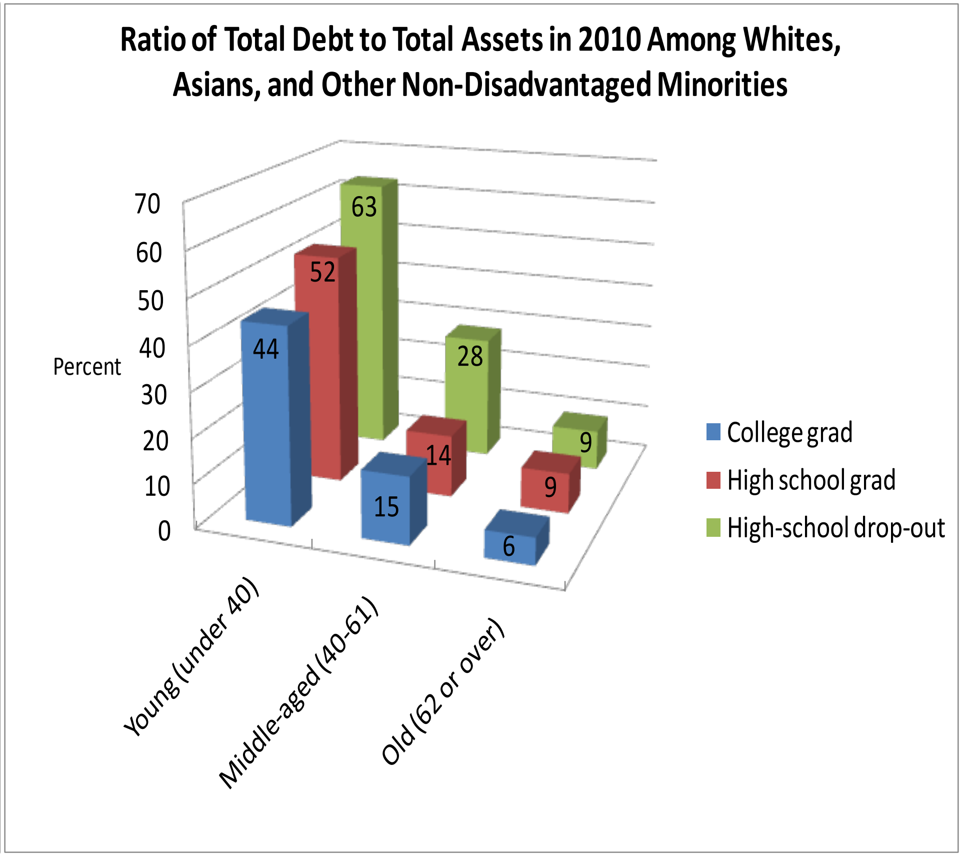
- **Interventions should target human-capital formation and experience-based learning.**

Appendix

- **Balance-sheet leverage in 2010**

Non-Minorities: All 9 Subgroups Had Higher 2010 DTA Ratios Than Before the Crisis





Minorities: 8 of 9 Subgroups Had Higher 2010 DTA Ratios Than Before the Crisis