USRT Conference:
Underserved Roundtable

Economic Vulnerability and Financial Fragility

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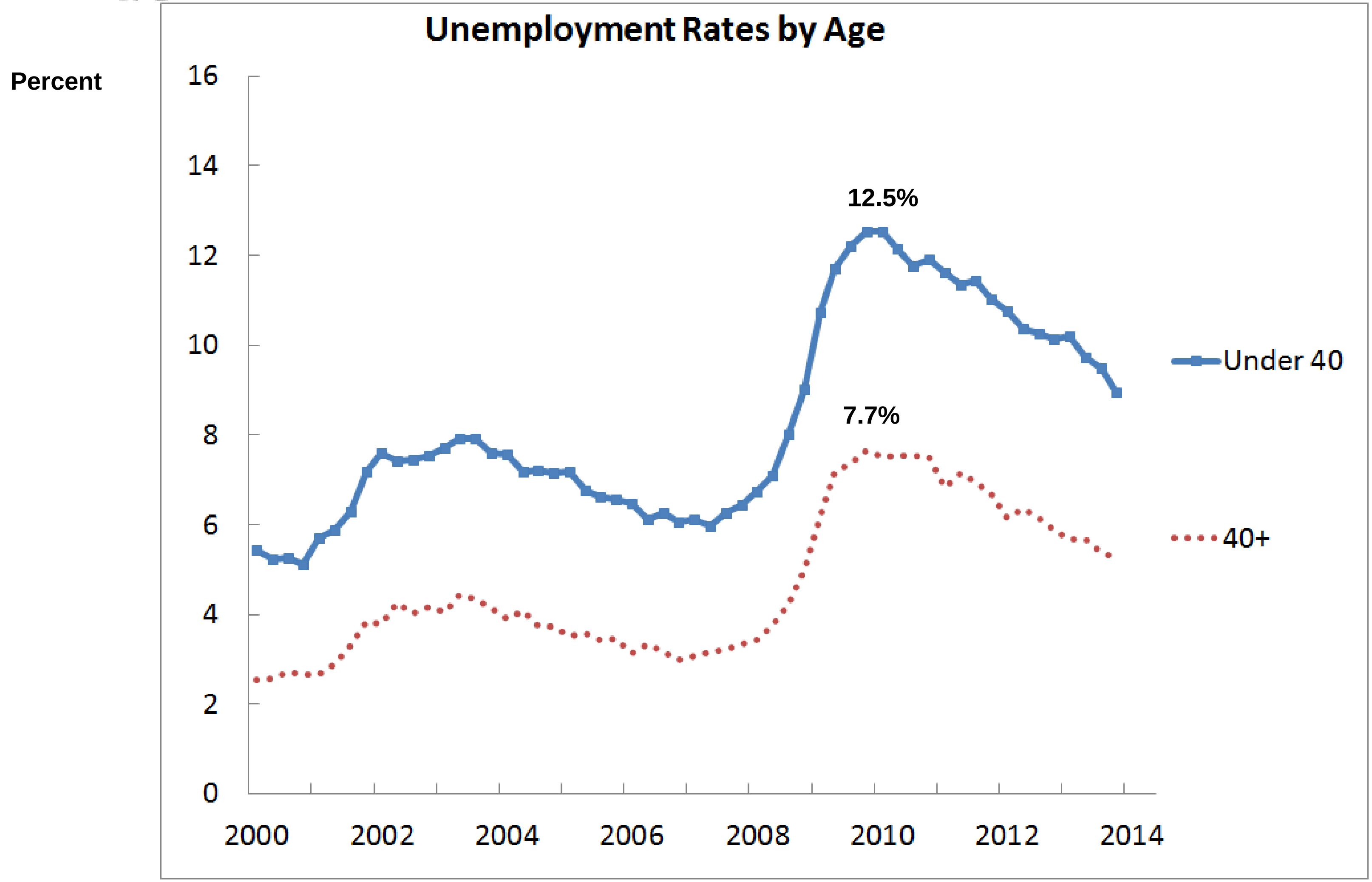
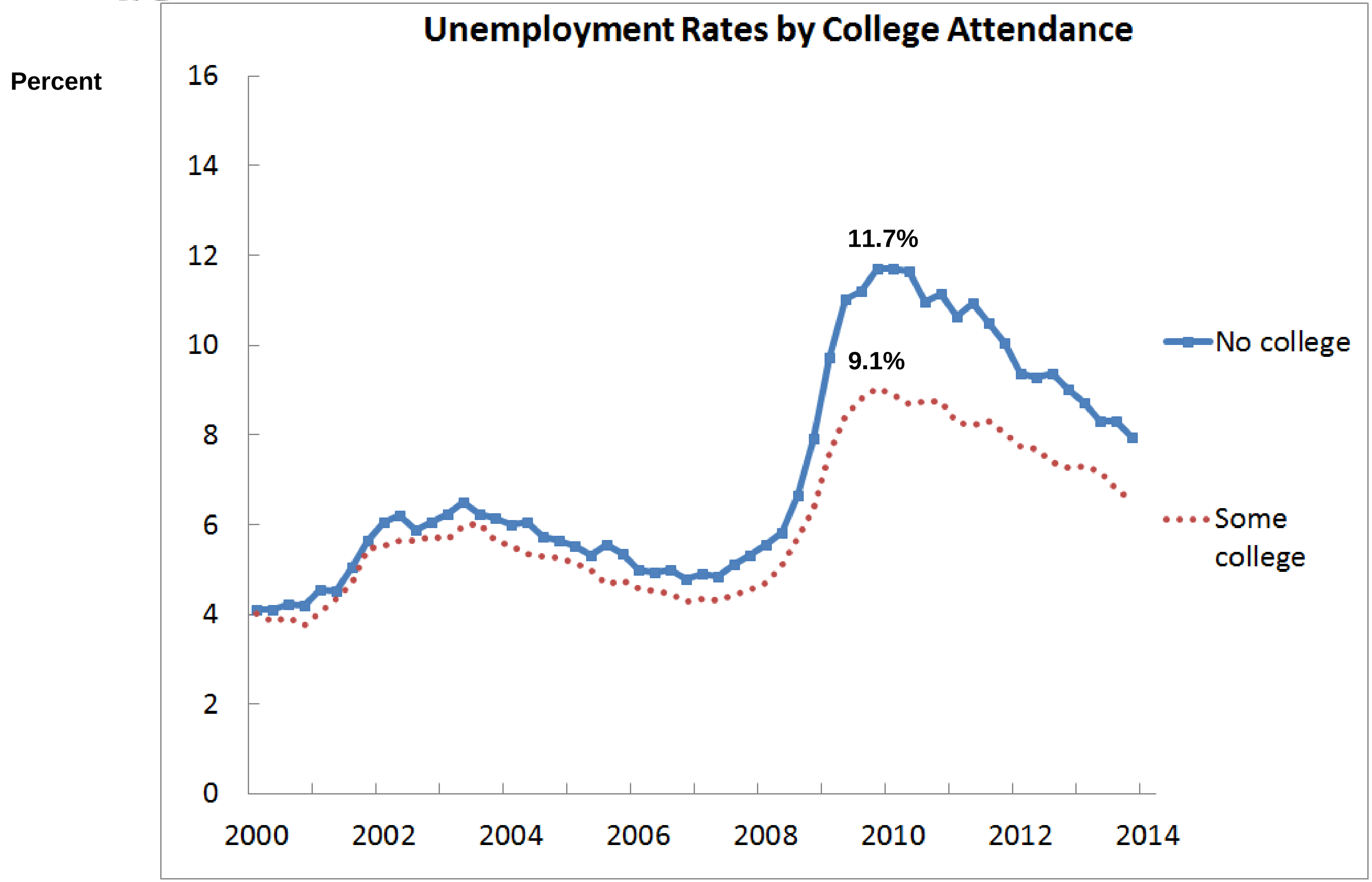
Economically Vulnerable Group 1: Young Adults



Source: Bureau of Labor Statistics

Quarterly through Q4.2013

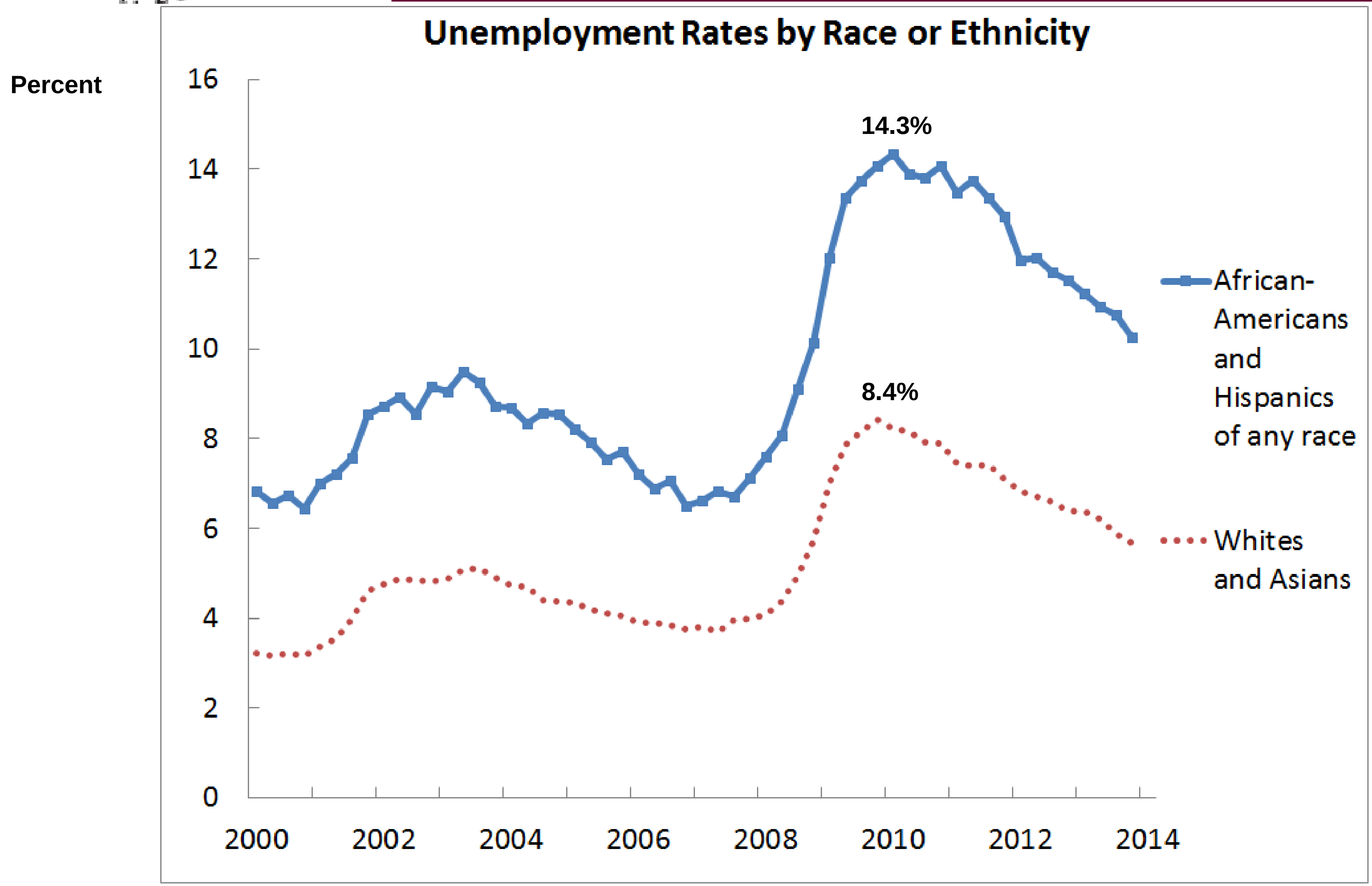
Economically Vulnerable Group 2: Less-Educated



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

What Financial Choices do Economically Vulnerable Families Make?

- **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**
  - **Have recovered wealth more slowly since 2010**

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

- **How can we break the link between economic vulnerability and financial fragility?**

What's Driving Economic Vulnerability and Financial Fragility?

- **Which families are likely to be both economically vulnerable and financially fragile?**
  - **Young: Under 40**
  - **Less-educated: No college**
  - **Historically disadvantaged minorities: African-Americans and Hispanics of any race**

- **Underlying causes of both vulnerability and fragility**
  - **Lack of experience in job and financial markets**
  - **Low cognitive ability and skills**
  - **Legacies of discrimination in housing, education, jobs, etc.**

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**

- **What does this mean for homeownership among economically vulnerable families?**

The Links Between Economic Vulnerability and Financial Fragility

- **Economic vulnerability: Elevated risk of job and income losses**

- **Financial fragility: Risky financial behavior and risky balance sheets**

- **Fact: EV and FF are positively correlated in the population across demographic sub-groups**

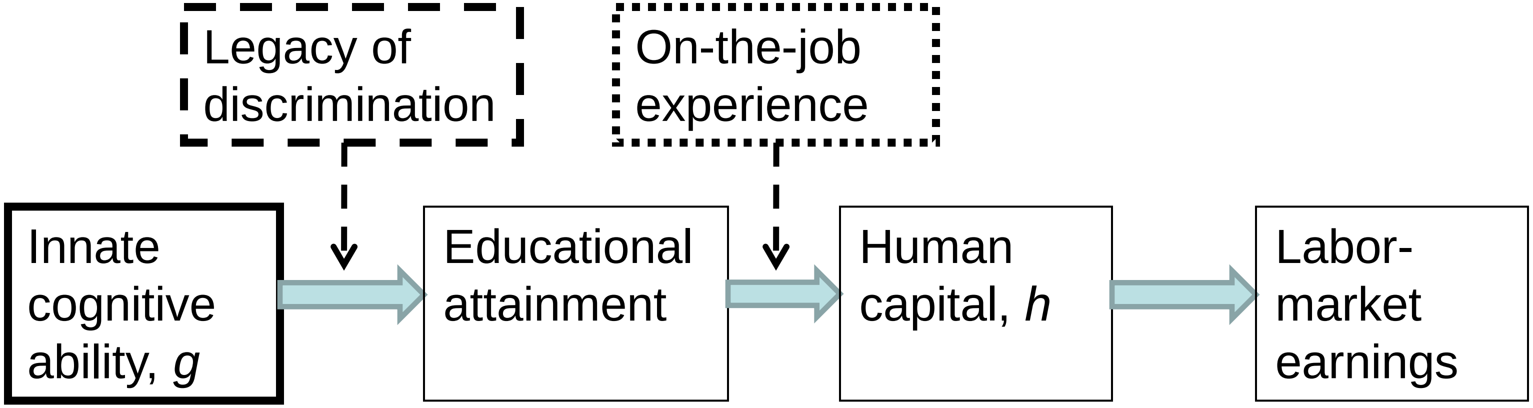
- **Source: William R. Emmons and Bryan J. Noeth, "Economic Vulnerability and Financial Fragility," Federal Reserve Bank of St. Louis *Review*, Sept./Oct. 2013, pp. 361-88.**

The Links Between Economic Vulnerability and Financial Fragility

- **Why don't economically vulnerable families take *less* financial risk to hedge their income risk?**

- **Our explanation: Economic vulnerability and financial fragility are driven by common factors**
  - **Youth and inexperience**
  - **Low human capital (innate and acquired)**
  - **The legacies of discrimination**

Our Model of Earnings Determination...



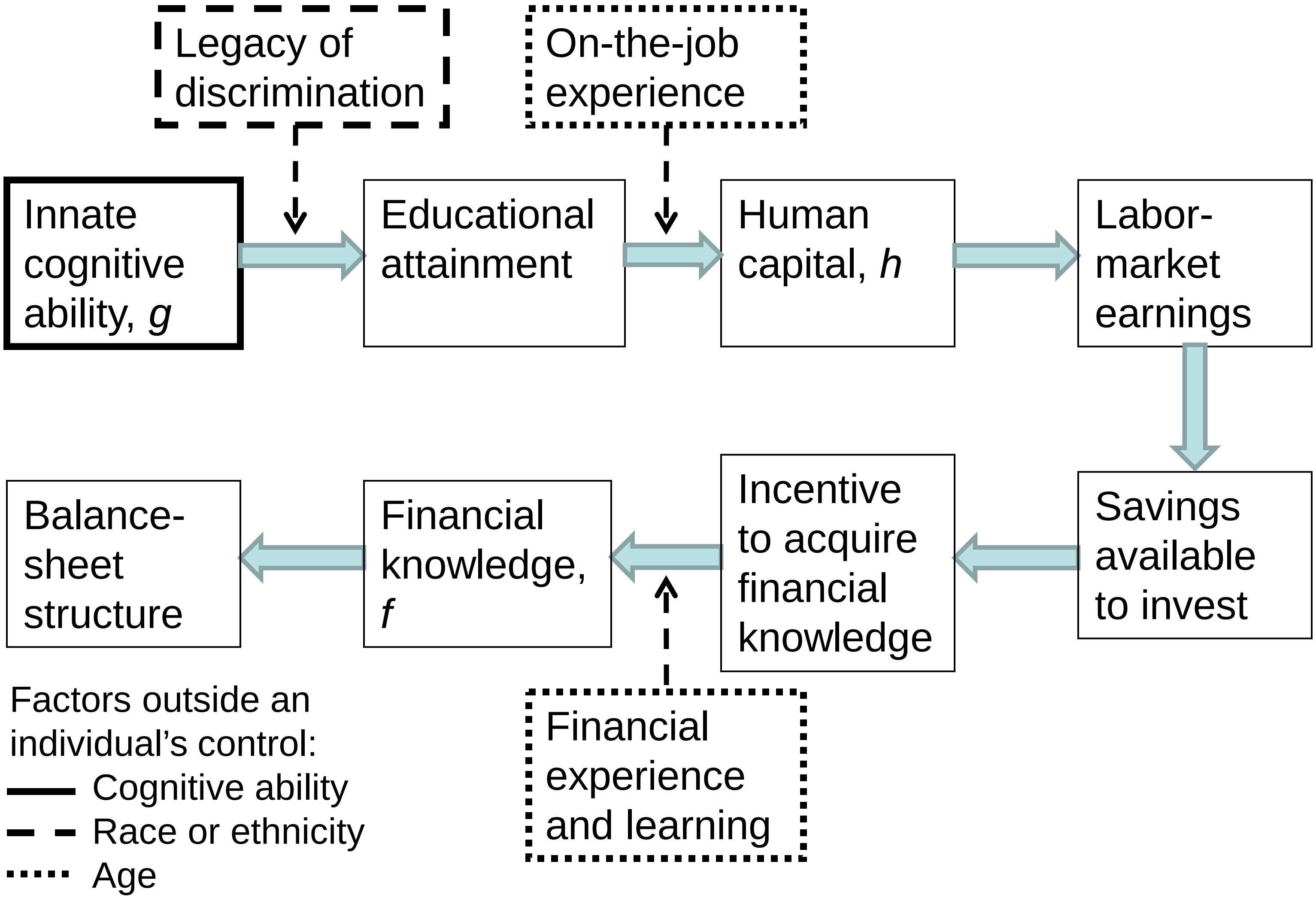
Factors outside an individual's control:

Cognitive ability

Race or ethnicity

Age

... And Balance-Sheet Choice

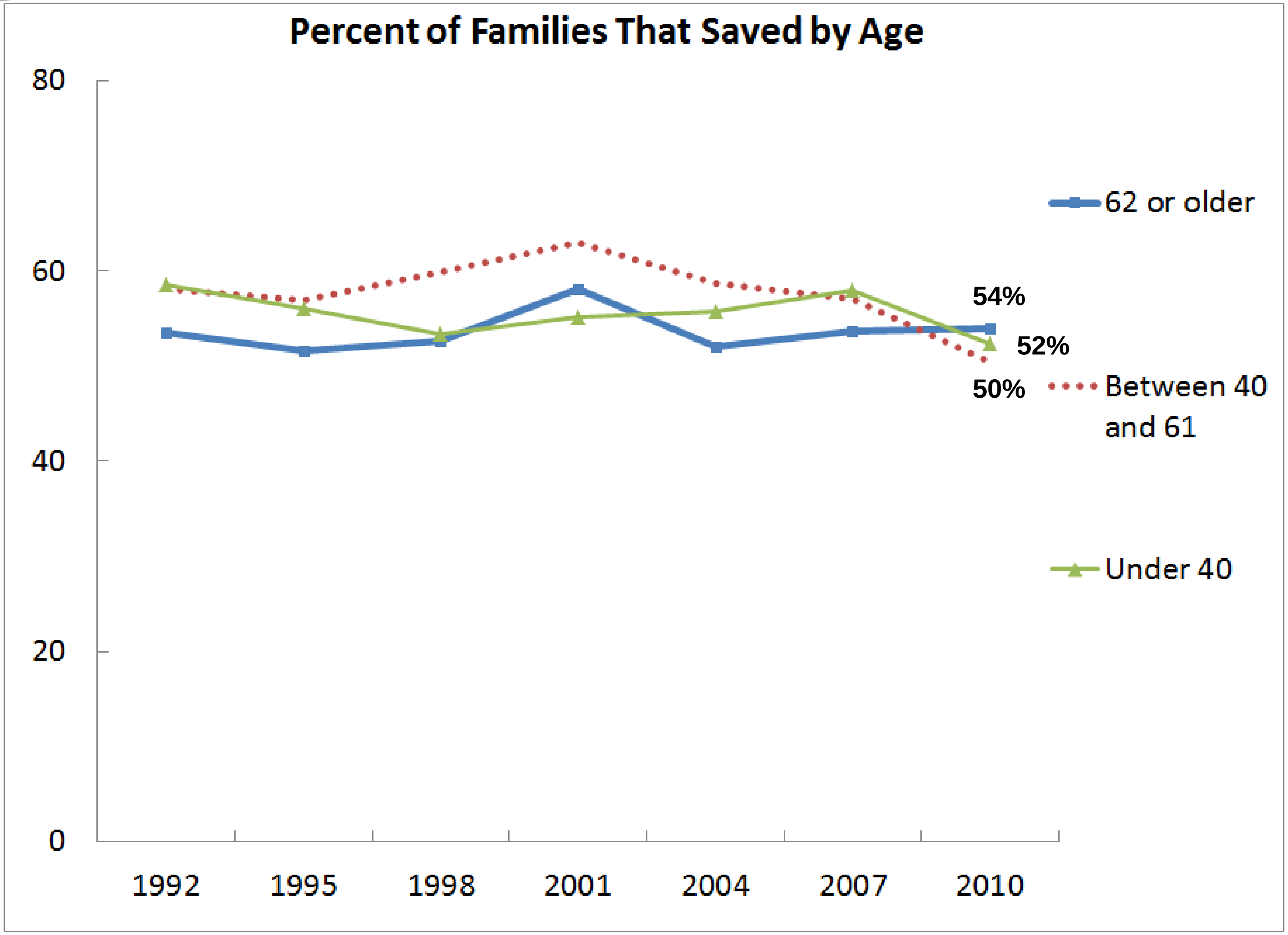


Risky Financial Behavior and Risky Balance Sheets

- **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**
  - **High balance-sheet leverage**

Basic Financial Indicator: Saving Rates

Percent

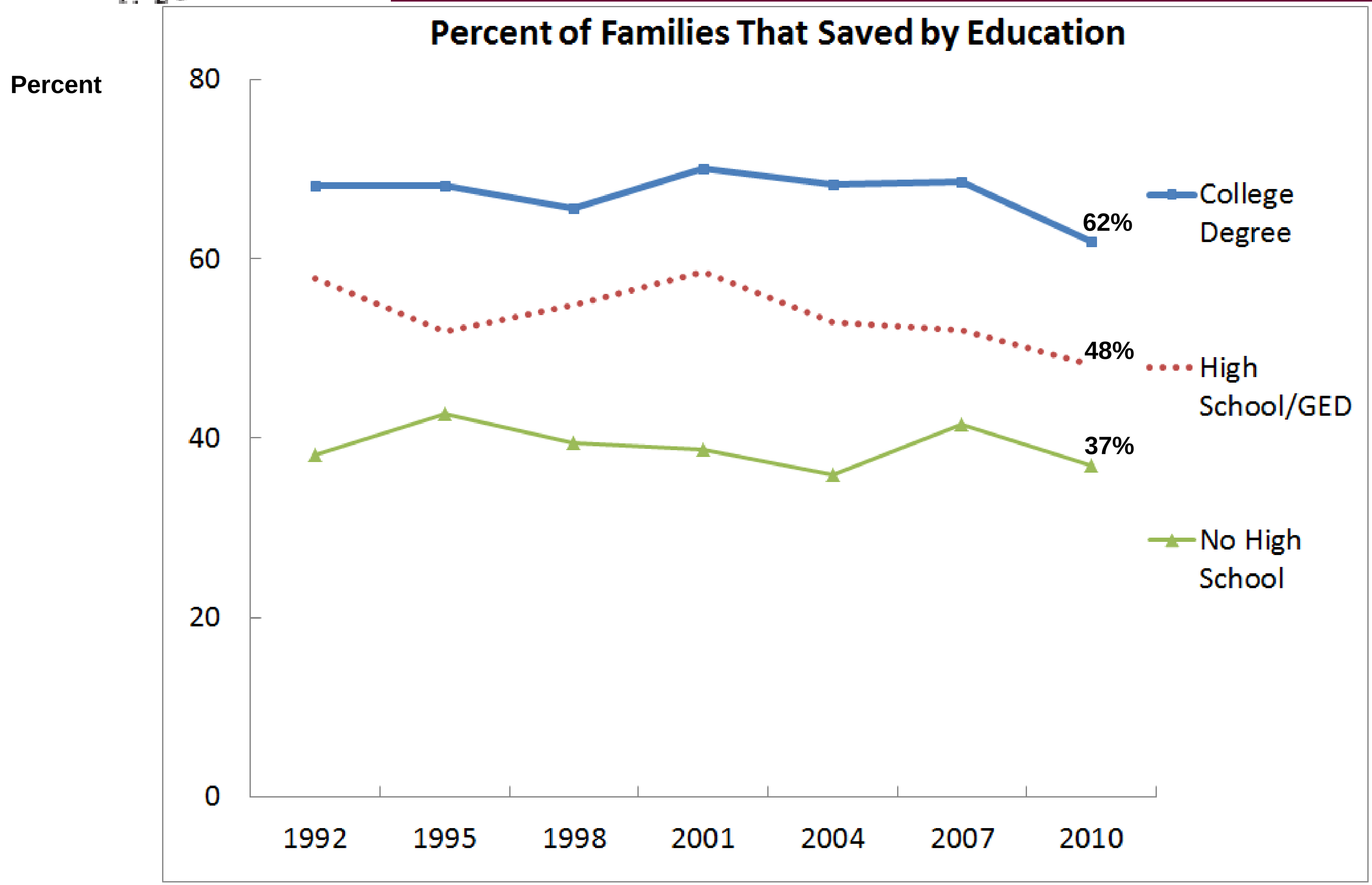


<u>The anomaly</u>: Saving rates should be much higher among young and middle-aged families than among older families.

Source: Federal Reserve Board

Tri-ennial through 2010

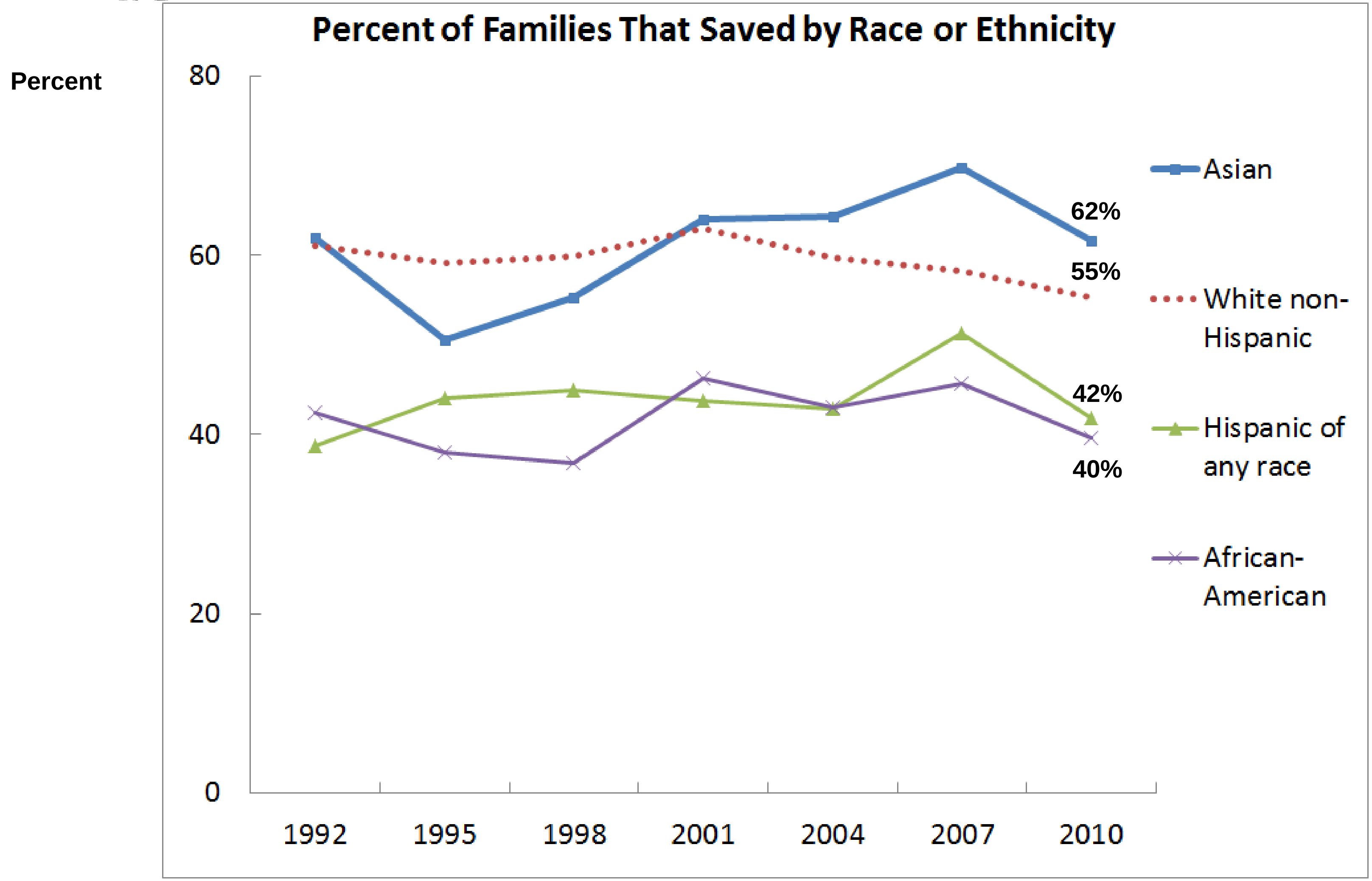
Basic Financial Indicator: Saving Rates



Source: Federal Reserve Board

Tri-ennial through 2010

Basic Financial Indicator: Saving Rates



Source: Federal Reserve Board

Tri-ennial through 2010

Economically Vulnerable Groups Hold Fewer Liquid Assets

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 Overinvest in Housing

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 Have High Debt

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

How Can We Break the Link?
Restructure Household Balance Sheets

- **Increase liquid assets**
  - **Buffer against financial distress**
  - **Low-interest savings account pays off in the long run**

- **Diversify asset holdings**
  - **Insurance against big asset-price swings**
  - **Over-investment in housing hurt many vulnerable families**

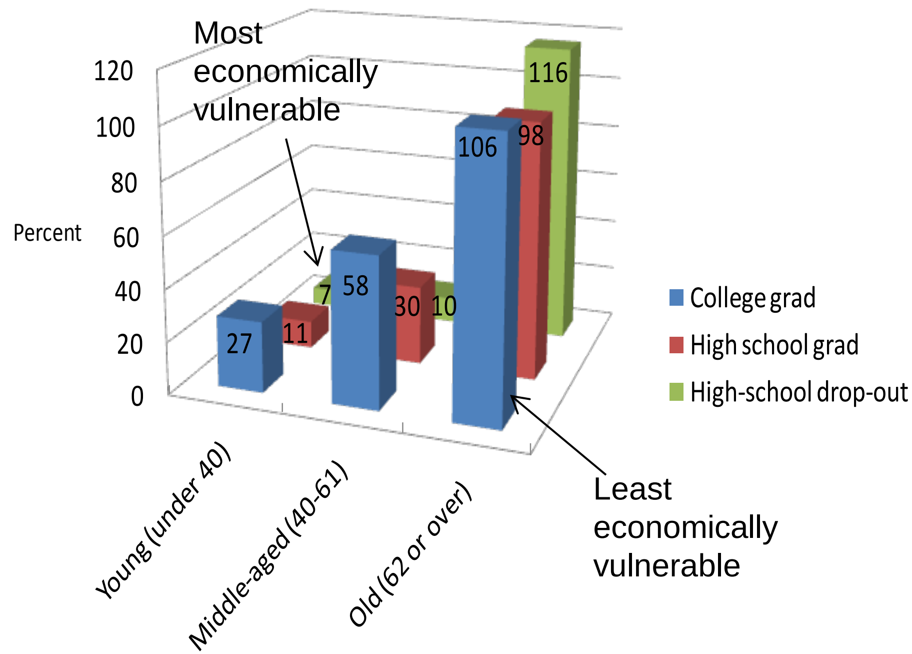
- **Keep borrowing to a minimum**
  - **Debt is expensive—especially sub-prime debt!**
  - **High debt service increases financial fragility**
  - **Balance-sheet leverage amplifies asset-price shocks**

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

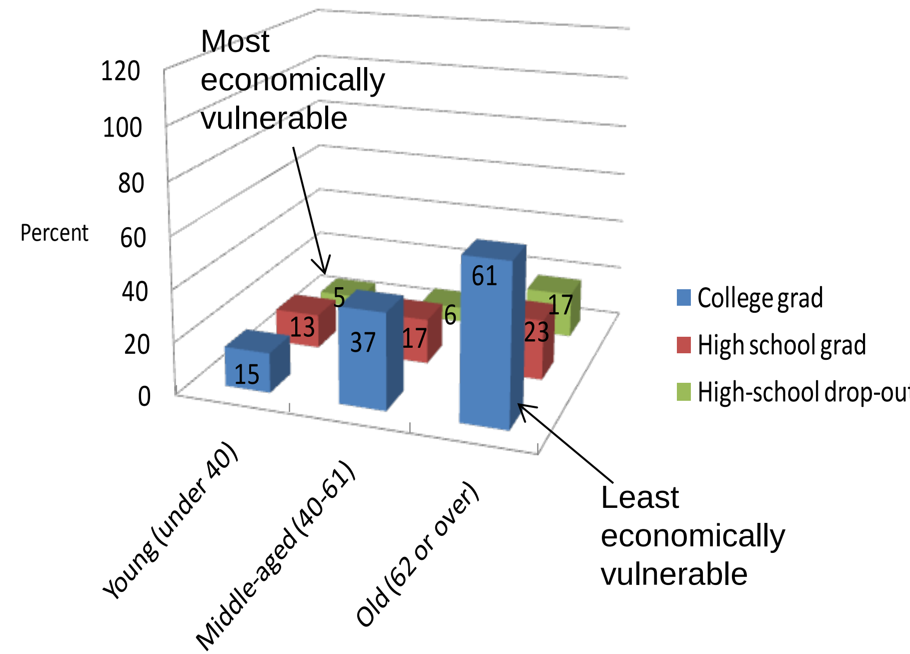
- **All families, average 2004/2007 safe-assets-to-income ratio**
  - **Overall: 56%**
- **Economically vulnerable groups**
  - **Young (<40) families: 20%**
  - **Minority families: 19%**
  - **Less-than-HS families: 54%**
- **Less-vulnerable groups**
  - **Older (62+) families: 126%**
  - **Whites and Asians: 61%**
  - **College grads: 63%**

Ratio of Safe and Liquid Assets to Income

Ratio of Safe Liquid Assets to Family Income in 2007 Among Whites, Asians, and Other Non-Disadvantaged Minorities



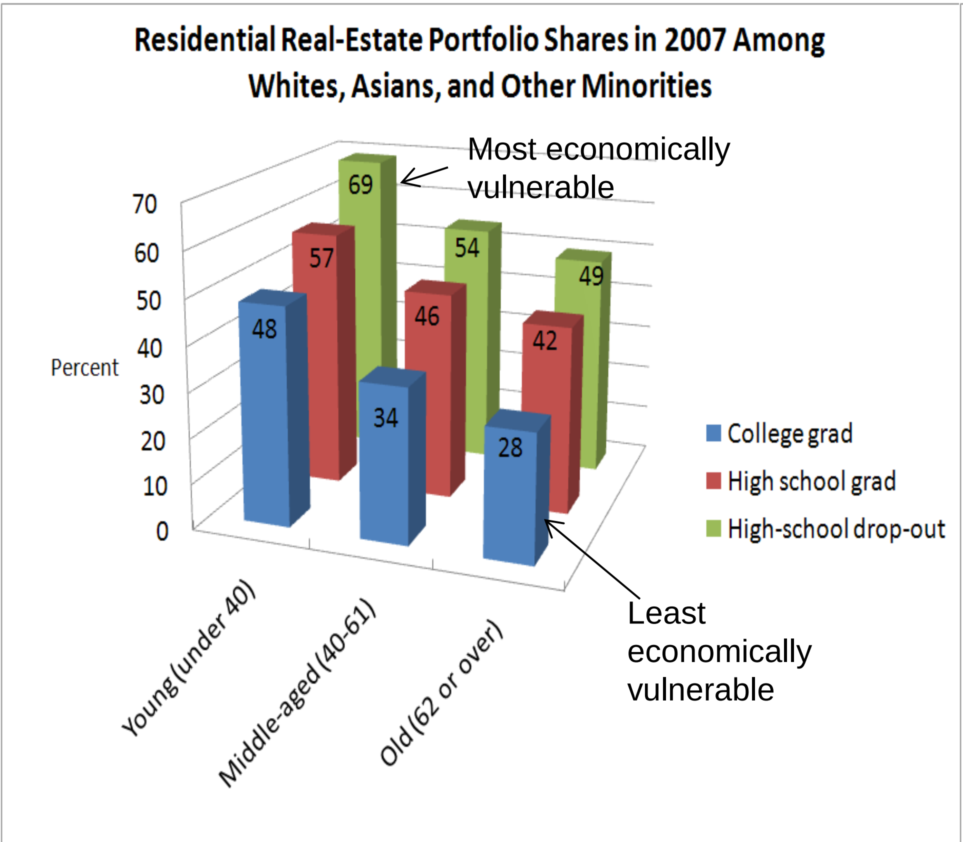
Ratio of Safe Liquid Assets to Family Income in 2007 Among African-Americans and Hispanics

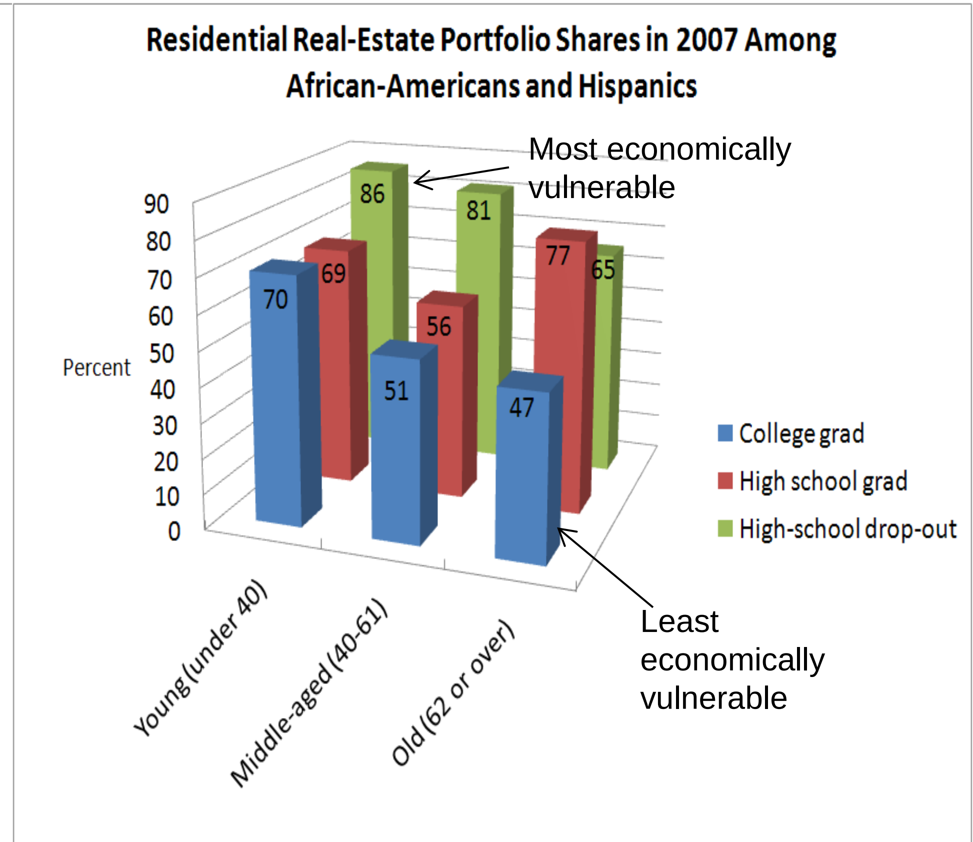


2) Share of Total Assets in Residential Real Estate Before the Crash

- **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**
  - **Older (62+) families: 34%**
  - **Whites and Asians: 37%**
  - **College grads: 35%**

Residential Real-Estate Portfolio Shares

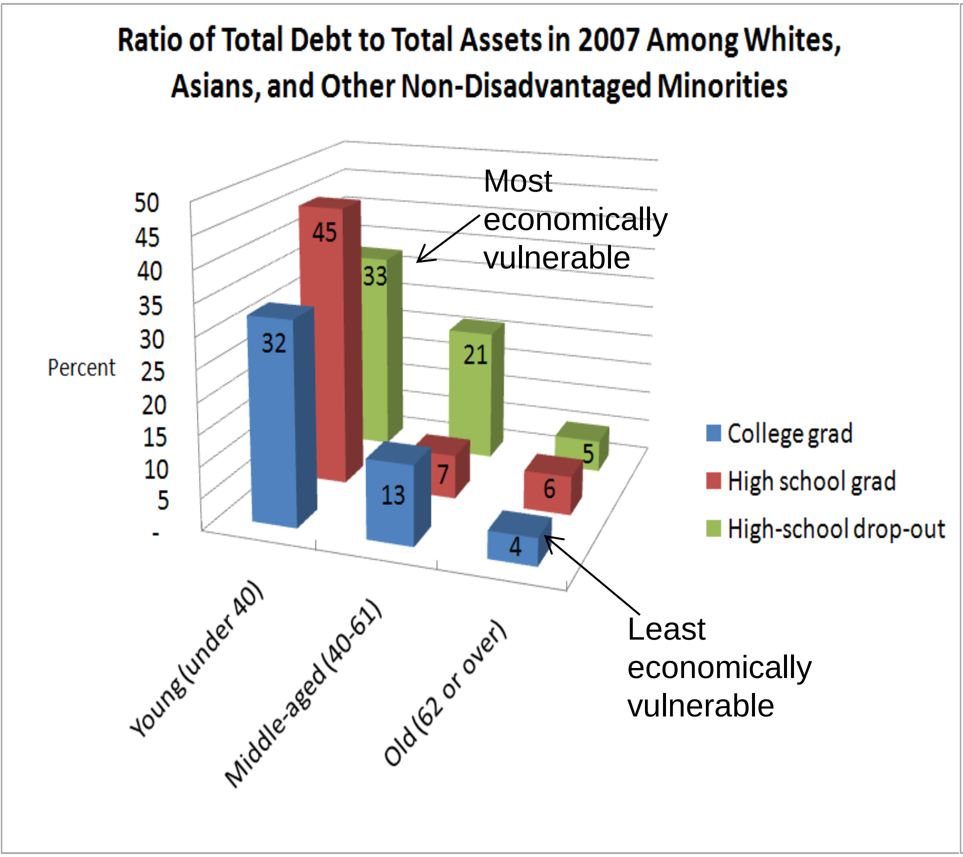


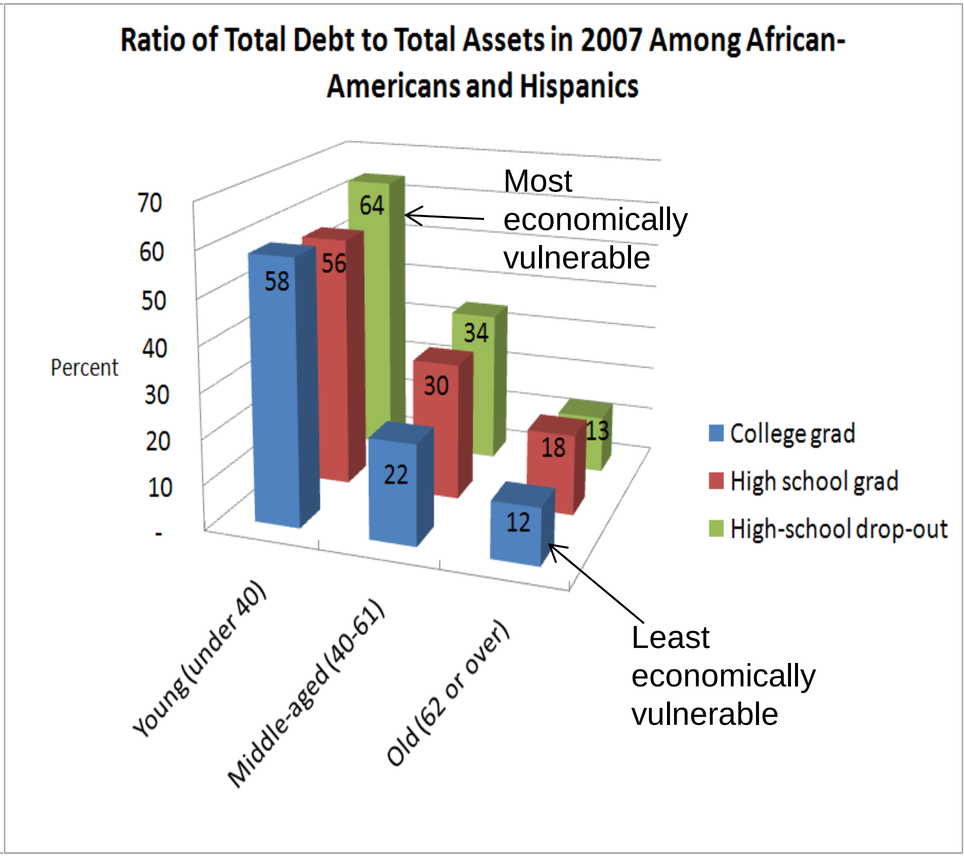


3) Ratio of Total Debt to Total Assets Before the Crash

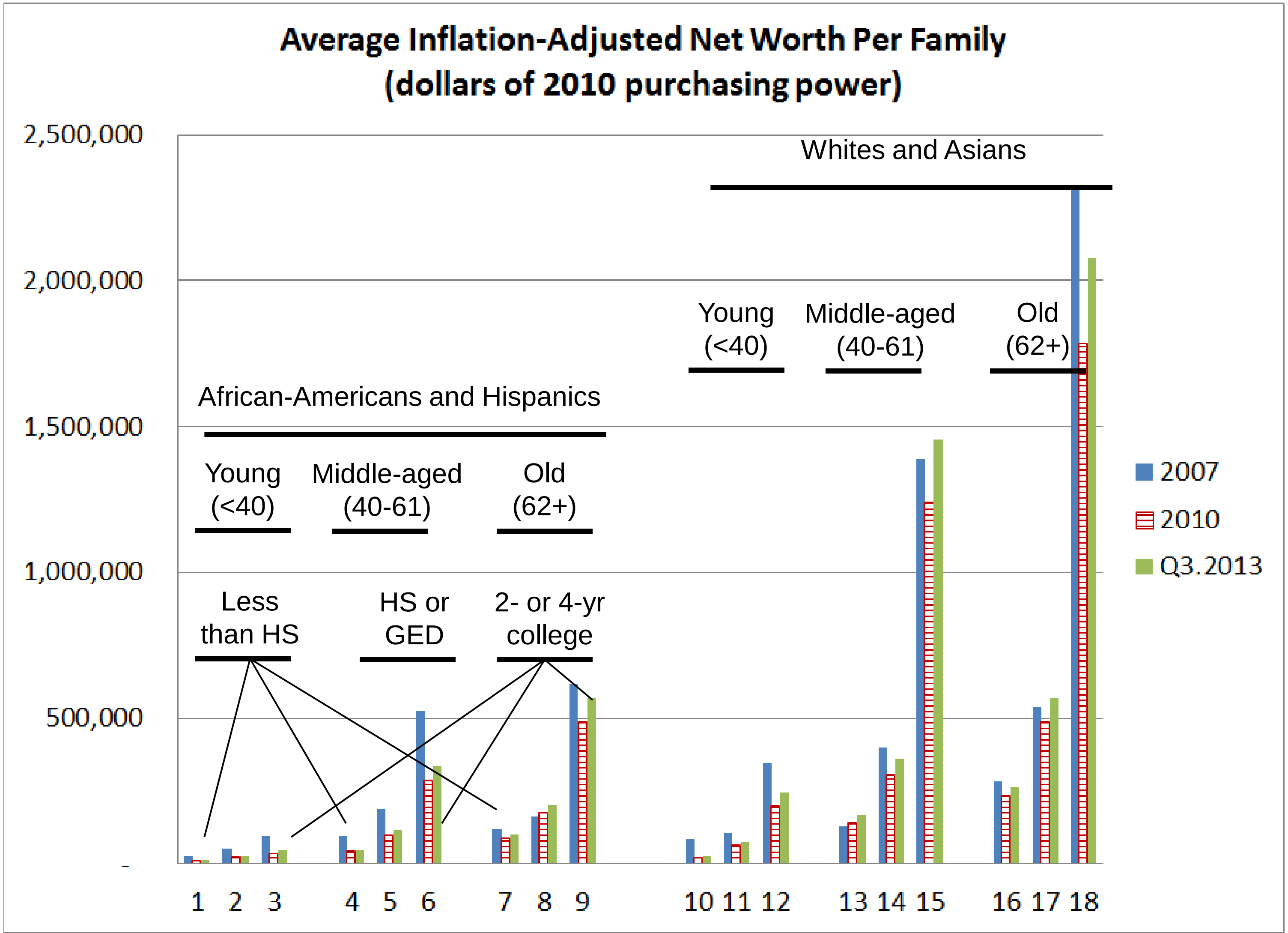
- **All families, average 2004/2007 debt-to-assets ratio**
  - **Overall: 15%**
- **Economically vulnerable groups**
  - **Young (<40) families: 39%**
  - **Minority families: 31%**
  - **Less-than-HS families: 16%**
- **Less-vulnerable groups**
  - **Older (62+) families: 5%**
  - **Whites and Asians: 14%**
  - **College grads: 13%**

Ratio of Total Debt to Total Assets

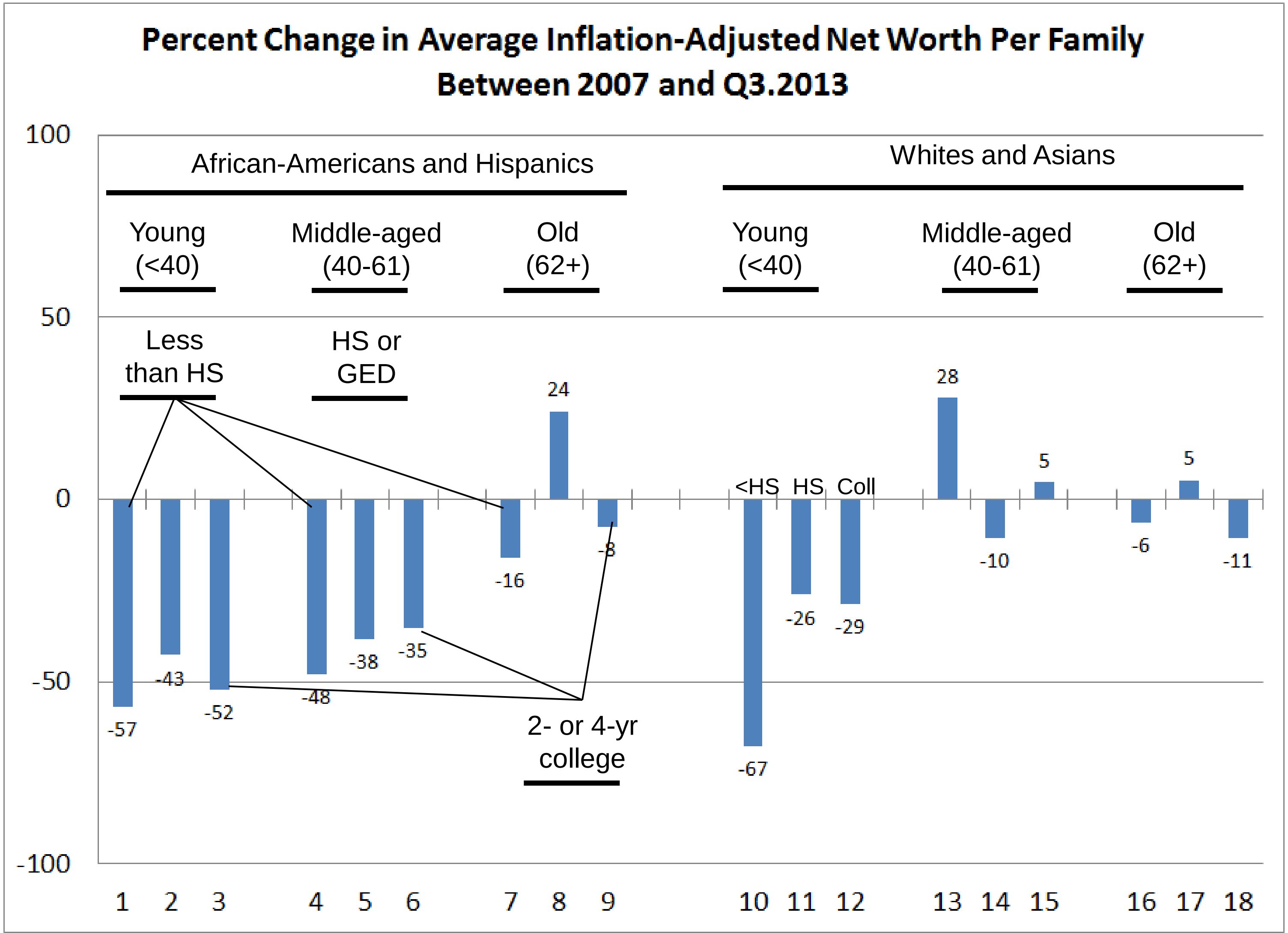




Wealth is Held Mostly By Middle-Aged and Older Families with College Degrees



Big Wealth Losers Through 2013: Young, Less-Educated, and Minority Families



What About Homeownership For Vulnerable Families?

- **Homeownership should be a means, not an end**
  - **Every family's goal should be high-quality housing *without financial fragility.***
  - **Homeownership is not the only version of the American Dream.**

- **Homeownership is not the best wealth-building strategy for most economically vulnerable families**
  - **A diversified portfolio of financial assets is likely to provide a higher long-run return without the risk of default.**
  - **A home should be part of a liquid, well-diversified, low-debt portfolio—if that's not feasible, then it's not a good idea.**

Can We Break The Links Between Economic Vulnerability and Financial Fragility?

- **The underlying causes of both economic vulnerability and financial fragility are deeply rooted and/or unchangeable.**
  - **Youth and inexperience**
  - **Low human capital (innate and acquired)**
  - **The legacies of discrimination**

- **Specific behavioral/balance-sheet changes can dampen the negative financial-feedback loop.**
  - **Increase holdings of liquid assets**
  - **Diversify across asset types—even at the expense of homeownership**
  - **Borrow as little as possible**

To Learn More About the 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, 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).**