USRT Conference: Underserved Roundtable

Economic Vulnerability and Financial Fragility

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These comments do not necessarily represent the views of the Federal Reserve Bank of St. Louis or the Federal Reserve System.
Economically Vulnerable Group 1: Young Adults

Unemployment Rates by Age

Source: Bureau of Labor Statistics
Quarterly through Q4.2013
Economically Vulnerable Group 2: Less-Educated

Unemployment Rates by College Attendance

Source: Bureau of Labor Statistics
Quarterly through Q4.2013
Economically Vulnerable Group 3: African-Americans and Hispanics

Unemployment Rates by Race or Ethnicity

Percent

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

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
Innate cognitive ability, $g$

Educational attainment

Human capital, $h$

Labor-market earnings

Factors outside an individual’s control:
- Cognitive ability
- Race or ethnicity
- Age

Our Model of Earnings Determination...
Innate cognitive ability, $g$

Educational attainment

Human capital, $h$

Labor-market earnings

Balance-sheet structure

Financial knowledge, $f$

Incentive to acquire financial knowledge

Savings available to invest

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

The anomaly: Saving rates should be much higher among young and middle-aged families than among older families.
Basic Financial Indicator: Saving Rates

Percent of Families That Saved by Education

- College Degree: 62%
- High School/GED: 48%
- No High School: 37%

Source: Federal Reserve Board Triennial through 2010
Basic Financial Indicator: Saving Rates

Percent of Families That Saved by Race or Ethnicity

Source: Federal Reserve Board Triennial through 2010
Demographic Influences on Balance Sheets

<table>
<thead>
<tr>
<th>Demographic group</th>
<th>Marginal effect of belonging to a demographic group on: Safe and liquid assets relative to annual income</th>
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<tbody>
<tr>
<td>Young families (&lt; 40 years old)</td>
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<td>African-Americans and Hispanics</td>
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Source: Emmons and Noeth (2013), based on Survey of Consumer Finances
Demographic Influences on Balance Sheets

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<td>+9</td>
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<tr>
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Source: Emmons and Noeth (2013), based on Survey of Consumer Finances
### Demographic Influences on Balance Sheets

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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

Residential Real-Estate Portfolio Shares in 2007 Among Whites, Asians, and Other Minorities

- Young (under 40):
  - College grad: 48%
  - High school grad: 34%
  - High-school drop-out: 28%

- Middle-aged (40-61):
  - College grad: 69%
  - High school grad: 54%
  - High-school drop-out: 49%

- Old (62 or over):
  - College grad: 46%
  - High school grad: 42%
  - High-school drop-out: 42%

Most economically vulnerable: Young (under 40)
Least economically vulnerable: Old (62 or over)

Residential Real-Estate Portfolio Shares in 2007 Among African-Americans and Hispanics

- Young (under 40):
  - College grad: 70%
  - High school grad: 69%
  - High-school drop-out: 56%

- Middle-aged (40-61):
  - College grad: 86%
  - High school grad: 81%
  - High-school drop-out: 77%

- Old (62 or over):
  - College grad: 51%
  - High school grad: 65%
  - High-school drop-out: 47%

Most economically vulnerable: Young (under 40)
Least economically vulnerable: Old (62 or over)
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

Ratio of Total Debt to Total Assets in 2007 Among Whites, Asians, and Other Non-Disadvantaged Minorities

Ratio of Total Debt to Total Assets in 2007 Among African-Americans and Hispanics
Wealth is Held Mostly By Middle-Aged and Older Families with College Degrees

Average Inflation-Adjusted Net Worth Per Family
(dollars of 2010 purchasing power)

- Whites and Asians
- African-Americans and Hispanics

- Young (<40), Middle-aged (40-61), Old (62+)
- Less than HS, HS or GED, 2- or 4-yr college

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

### Percent Change in Average Inflation-Adjusted Net Worth Per Family Between 2007 and Q3.2013

<table>
<thead>
<tr>
<th></th>
<th>African-Americans and Hispanics</th>
<th>Whites and Asians</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Age Group</strong></td>
<td><strong>Young</strong></td>
<td><strong>Middle-aged</strong></td>
</tr>
<tr>
<td><strong>Young (&lt;40)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
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<td></td>
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<tr>
<td><strong>Old (62+)</strong></td>
<td></td>
<td></td>
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<tr>
<td><strong>Education</strong></td>
<td></td>
<td></td>
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<tr>
<td>Less than HS</td>
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<td></td>
</tr>
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</tr>
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<tbody>
<tr>
<td>2007</td>
<td>-57</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>-52</td>
<td>28</td>
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<tr>
<td>2009</td>
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<td>2010</td>
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<td>2011</td>
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<td>2013</td>
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<td>-6</td>
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<tr>
<td>2014</td>
<td>-8</td>
<td>-11</td>
</tr>
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### Notes
- The chart shows the percent change in average inflation-adjusted net worth per family between 2007 and Q3.2013 for different age and education groups among African-Americans and Hispanics, and Whites and Asians.

### Observations
- Young African-Americans and Hispanics have shown the largest decrease in net worth among all groups.
- Whites and Asians have generally had smaller decreases in net worth compared to African-Americans and Hispanics.
- Education levels also play a significant role in net worth changes, with lower education levels experiencing more significant decreases.
What About Homeownership For Vulnerable Families?

- Homeownership should be a means, not an end
  - Every family’s goal should be high-quality housing \textit{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:

    - 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: Millennials After the Great Recession.
    - In partnership with the New America Foundation and the Young Invincibles (an advocacy group for young Americans).