The Role of Credit in a Healthy Balance Sheet

April 22, 2014

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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.
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?
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:
    - 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: 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**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Estimated values as of Sep. 30, 2013*</th>
<th>Liabilities and Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Durable goods</td>
<td>$47,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Financial and business assets</td>
<td>$1,552,000</td>
<td>$84,000</td>
</tr>
<tr>
<td>Residential real estate</td>
<td>$576,000</td>
<td>$96,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$2,175,000</strong></td>
<td><strong>$2,079,000</strong></td>
</tr>
</tbody>
</table>

*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**

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

*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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Estimated values as of Sep. 30, 2013*</th>
<th>Liabilities and Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Durable goods</td>
<td>$25,000</td>
<td>$19,000</td>
</tr>
<tr>
<td>Financial and business assets</td>
<td>$244,000</td>
<td>$69,000</td>
</tr>
<tr>
<td>Residential real estate</td>
<td>$179,000</td>
<td>$88,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$448,000</strong></td>
<td><strong>$352,000</strong></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Estimated values relative to total assets as of Sep. 30, 2013*</th>
<th>Liabilities and Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Durable goods</td>
<td>6%</td>
<td>4%</td>
</tr>
<tr>
<td>Financial and business assets</td>
<td>55%</td>
<td>16%</td>
</tr>
<tr>
<td>Residential real estate</td>
<td>39%</td>
<td>20%</td>
</tr>
<tr>
<td>Total assets</td>
<td>100%</td>
<td>80%</td>
</tr>
</tbody>
</table>

*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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Estimated values as of Sept. 30, 2013*</th>
<th>Liabilities and Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Durable goods</td>
<td>$15,000</td>
<td>$38,000</td>
</tr>
<tr>
<td>Financial and business assets</td>
<td>$35,000</td>
<td>$61,000</td>
</tr>
<tr>
<td>Residential real estate</td>
<td>$96,000</td>
<td>$99,000</td>
</tr>
</tbody>
</table>

**Total assets** | **$146,000** | **$47,000** | **Net worth = T.A. − T.L.**  |

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## Balance Sheet of Family C

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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Estimated values relative to total assets as of Sep. 30, 2013*</th>
<th>Liabilities and Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Durable goods</td>
<td>10%</td>
<td>26%</td>
</tr>
<tr>
<td>Financial and business assets</td>
<td>24%</td>
<td>42%</td>
</tr>
<tr>
<td>Residential real estate</td>
<td>66%</td>
<td>68%</td>
</tr>
<tr>
<td>Total assets</td>
<td>100%</td>
<td>32%</td>
</tr>
</tbody>
</table>

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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

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

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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**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Estimated values relative to total assets as of Sep. 30, 2013*</th>
<th>Liabilities and Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Durable goods</td>
<td>20%</td>
<td>15%</td>
</tr>
<tr>
<td>Financial and business assets</td>
<td>18%</td>
<td>41%</td>
</tr>
<tr>
<td>Residential real estate</td>
<td>62%</td>
<td>56%</td>
</tr>
<tr>
<td>Total assets</td>
<td>100%</td>
<td>44%</td>
</tr>
</tbody>
</table>

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

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

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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

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

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

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

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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?

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

Unemployment Rates by Age

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

Unemployment Rates by College Attendance

Percent

Economically Vulnerable Group 3: African-Americans and Hispanics

Unemployment Rates by Race or Ethnicity

- 14.3% for African-Americans and Hispanics
- 8.4% for Whites and Asians

Source: Bureau of Labor Statistics
Quarterly through Q4.2013
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
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
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
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.