

Department of the Treasury

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Debt and Financial Fragility: Findings from the 2012 National Financial Capability Study

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Relevance

Major changes that increase individuals' responsibility for their financial well-being

- **Changes in the pension landscape**
 - DC pensions and IRAs
- **Changes in the labor markets**
 - Divergence in wages – skills are critical
 - One of the most important decisions (invest in education) has to be made early in life
- **Changes in the financial markets**
 - Increased complexity
 - More opportunities to borrow and large amounts



To understand fragility we start by looking at debt

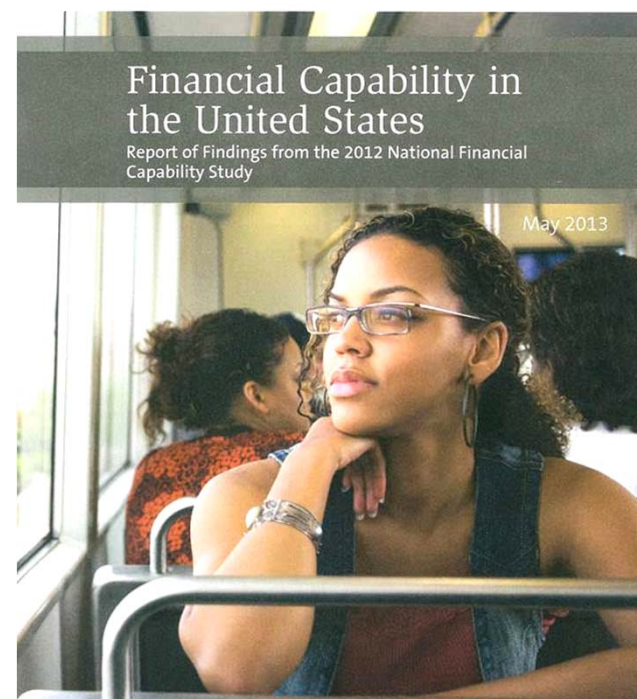
Need to look at liability side of balance sheets

- **A lot of research has been done on asset building and wealth accumulation**
 - Precautionary savings
 - Retirement savings
 - Saving for education
- **Need to focus on debt as well**
 - A high proportion of families carry debt
- **Debt instruments normally charge higher interest than asset instruments**
 - Some are high-cost

National Financial Capability Study (NFCFS)

State-by-State Survey: Online survey of more than 25,000 respondents (roughly 500 per state + DC)

- 2012 wave was released on May 29, 2013.
- First wave collected in 2009.
- Survey offers unique information on Americans' financial capability
- The data provide an encompassing overview of workers' personal finances



Sample

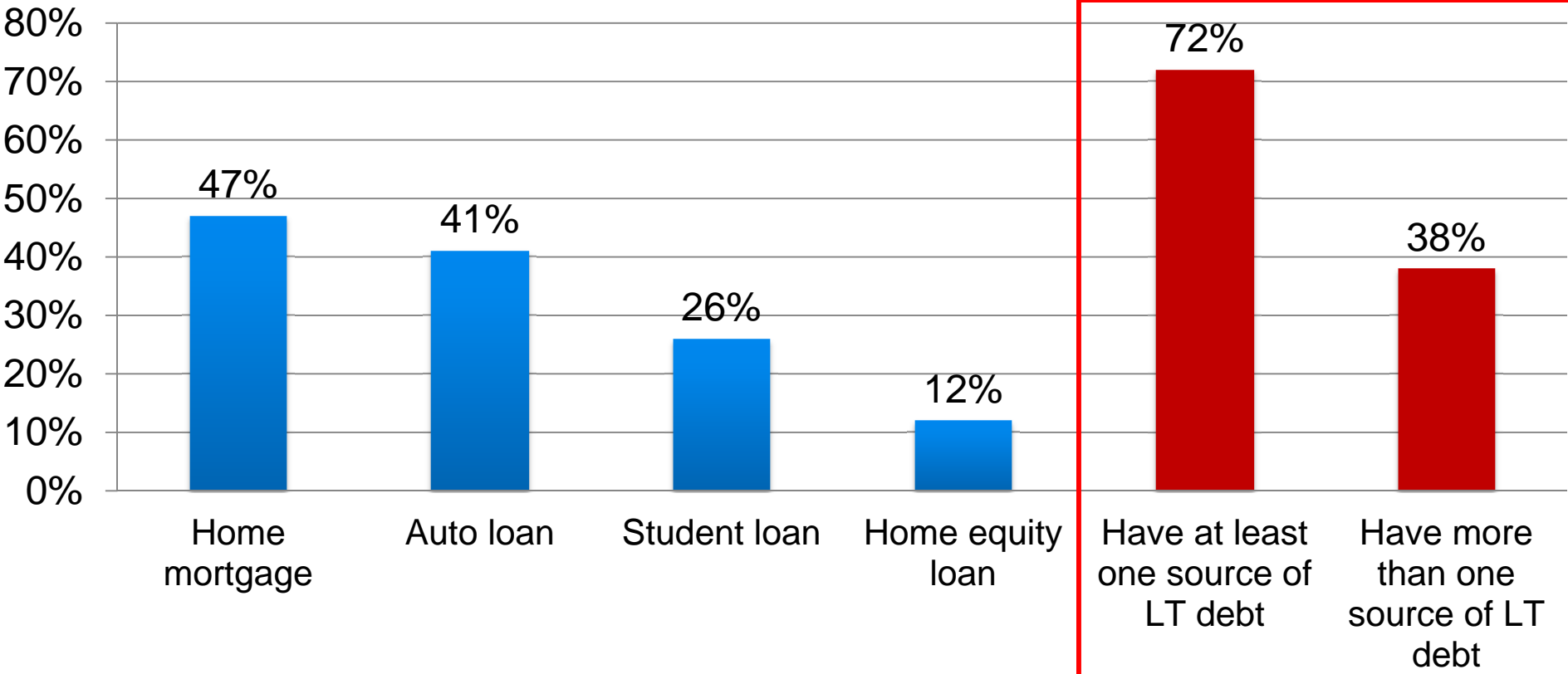
- We restrict the sample to respondents who are employed (full-time, part-time, self-employed)
- We restrict the sample to respondents age 23 to 61
- We identify three distinct career stages: **Millennials** (age 23-35), **Mid-career** (age 36-50), and **Pre-retirees** (age 51-61).
- N= 11,544

Sample characteristics:

- Balanced by gender (49% women)
- Minorities make up 31% of the sample
- 44% have undergraduate degree
- 58% are married, 28% are single
- 51% have at least one financially dependent child
- 60% have annual household income greater than \$50,000
- 55% are the most knowledgeable person in the household regarding saving, investing and debt; an additional 33% reported being just as knowledgeable as another adult in the household



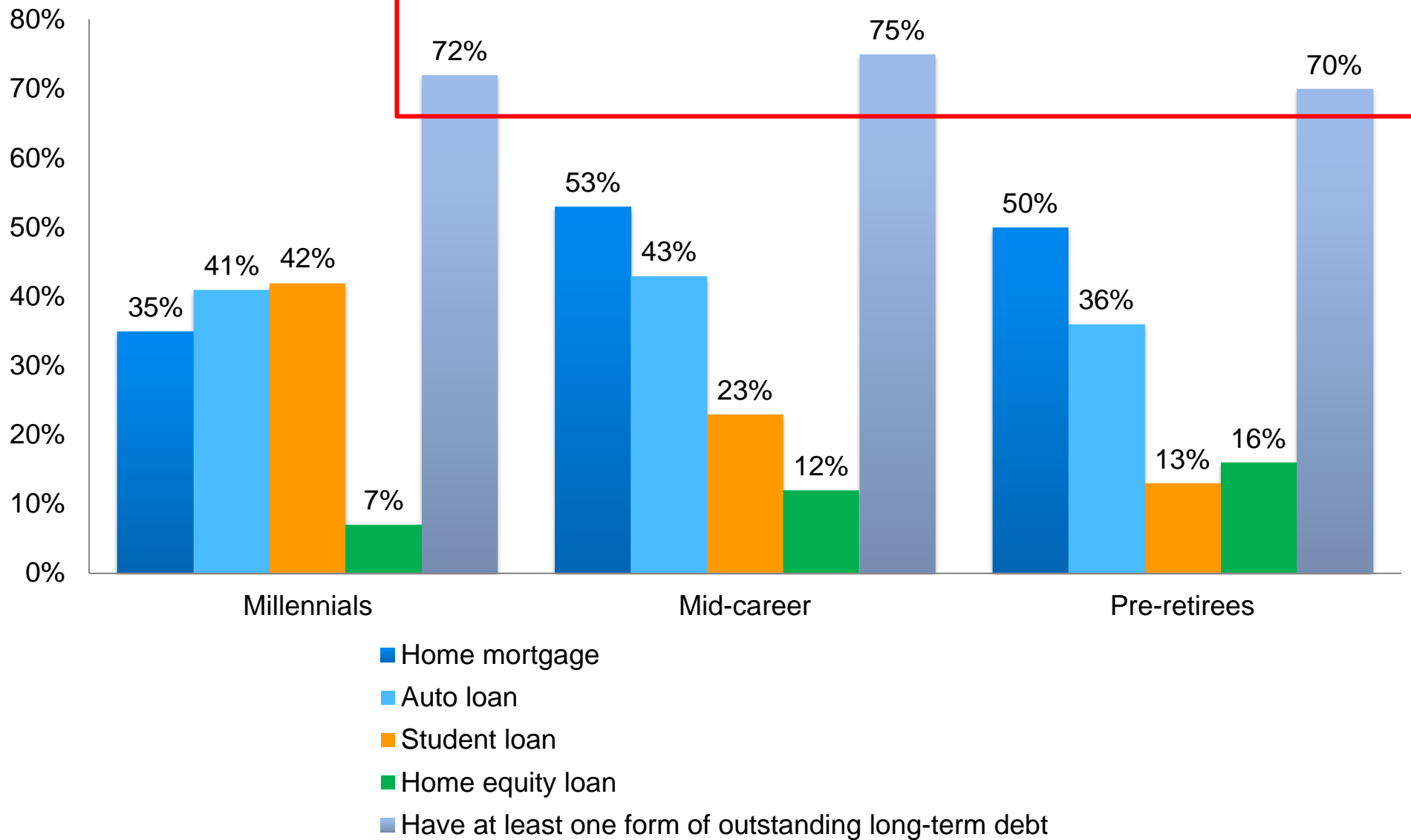
An overview on debt: Long-term debt among the working population (age 23-61)



Note: Percentages related to home mortgages and home equity lines are not conditional on home ownership

- Many workers have long-term debt: 72% have at least one source of long-term debt and 38% have at least two.

Long-term debt by career stage



Dealing with mortgage payments

- **23% of homeowners age 23-61 reported being underwater, owing more on their homes than they believe they would receive by selling them.**
- **20% of homeowners age 23-61 reported being late with their mortgage payments at least once in the last year.**



Indebtedness among pre-retirees (Lusardi and Mitchell, 2013)

- Lusardi and Mitchell (2013) examined data from the Health and Retirement Study to evaluate changes in debt among three cohorts of individuals age 56 to 61 at different time periods (1992, 2002, and 2008).
- Results indicate that more recent cohorts have taken on more debt and face more financial insecurity, mostly due to the purchase of more expensive homes with smaller down payments.
- The percentage of people age 56 to 61 who arrived on the verge of retirement with debt swelled to 71% in 2008 from 64% in 1992.
- Median debt in 1992 was about \$6,200.* By 2002 it had more than tripled. By 2008, it was \$28,300—nearly quadruple the 1992 level.
- The top quartile of the debt distribution held \$50,000 in debt in 1992. In 2008, the top quartile held \$117,300 (that is, 2.3 times as much).
- Having a lot of debt near retirement can have important implications. For example, debt can influence when workers retire or start claiming their Social Security benefits (Butrica and Karamcheva, 2013).

**Note: All dollar values are in \$2012.*

Debt Patterns in HRS

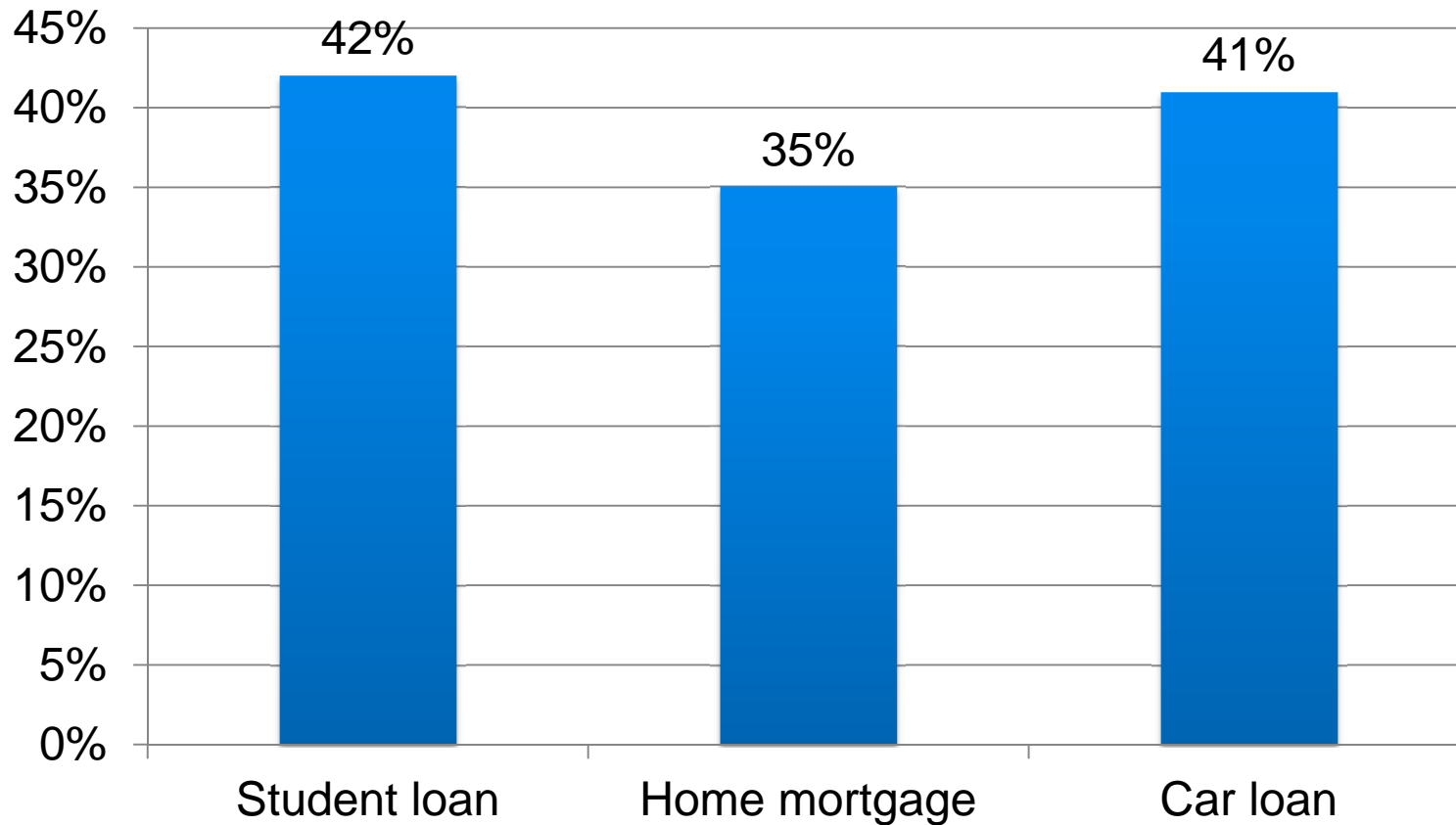
(Lusardi and Mitchell, 2013)

	% debt owners in sample	p50 (\$)	p90 (\$)
Total debt			
HRS	63.8%	6,218	106,363
War Babies	67.6%	19,147	191,470
Baby Boomers	71.4%	28,259	259,130
Value of all mortgages/land contracts (1y residence)			
HRS	40.5%	0	81,818
War Babies	47.2%	0	165,941
Baby Boomers	47.8%	0	207,944

	p50	p75	p90
Value of residence			
HRS	130,909	212,726	327,271
War Babies	178,706	306,352	478,676
Baby Boomers	213,275	351,904	533,189

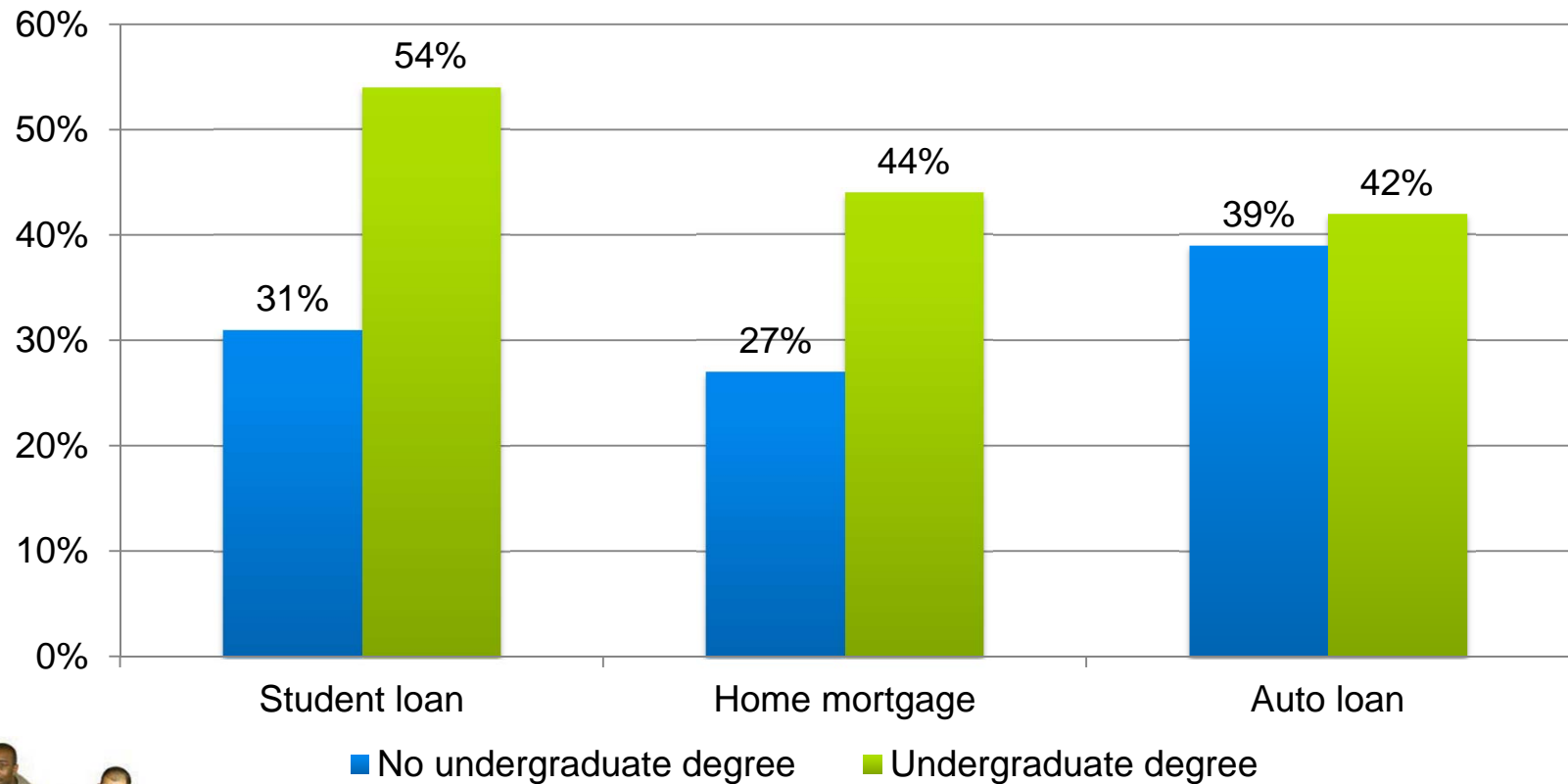
**Note: All dollar values are in \$2012.*

Long-term debt among Millennials



Note: The statistics relative to home mortgage and car loan are unconditional means.

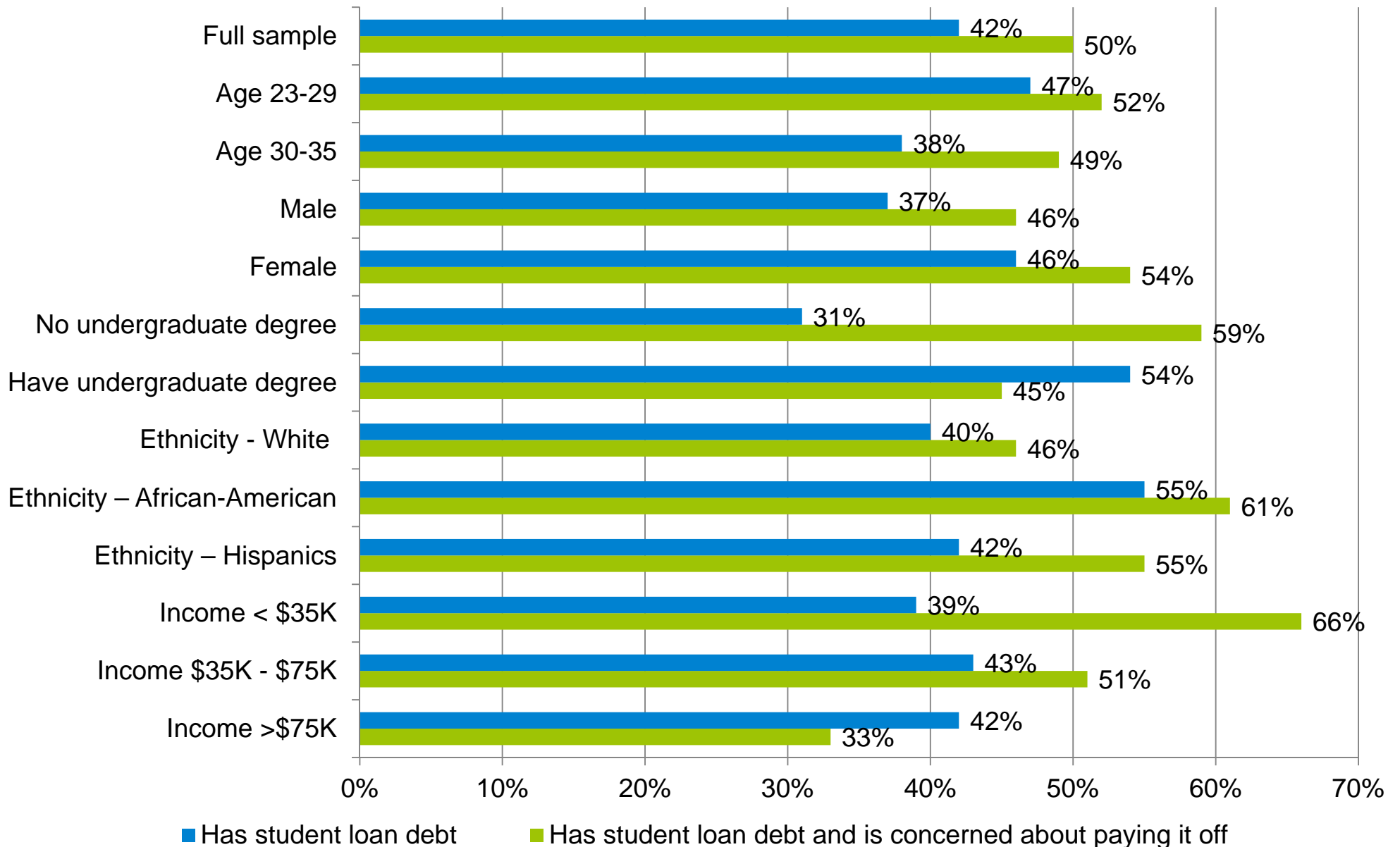
Millennials' long-term debt by education



Note: The statistics relative to home mortgage and car loan are unconditional means.



Millennials: Student loans



Considerations on student loans among millennials

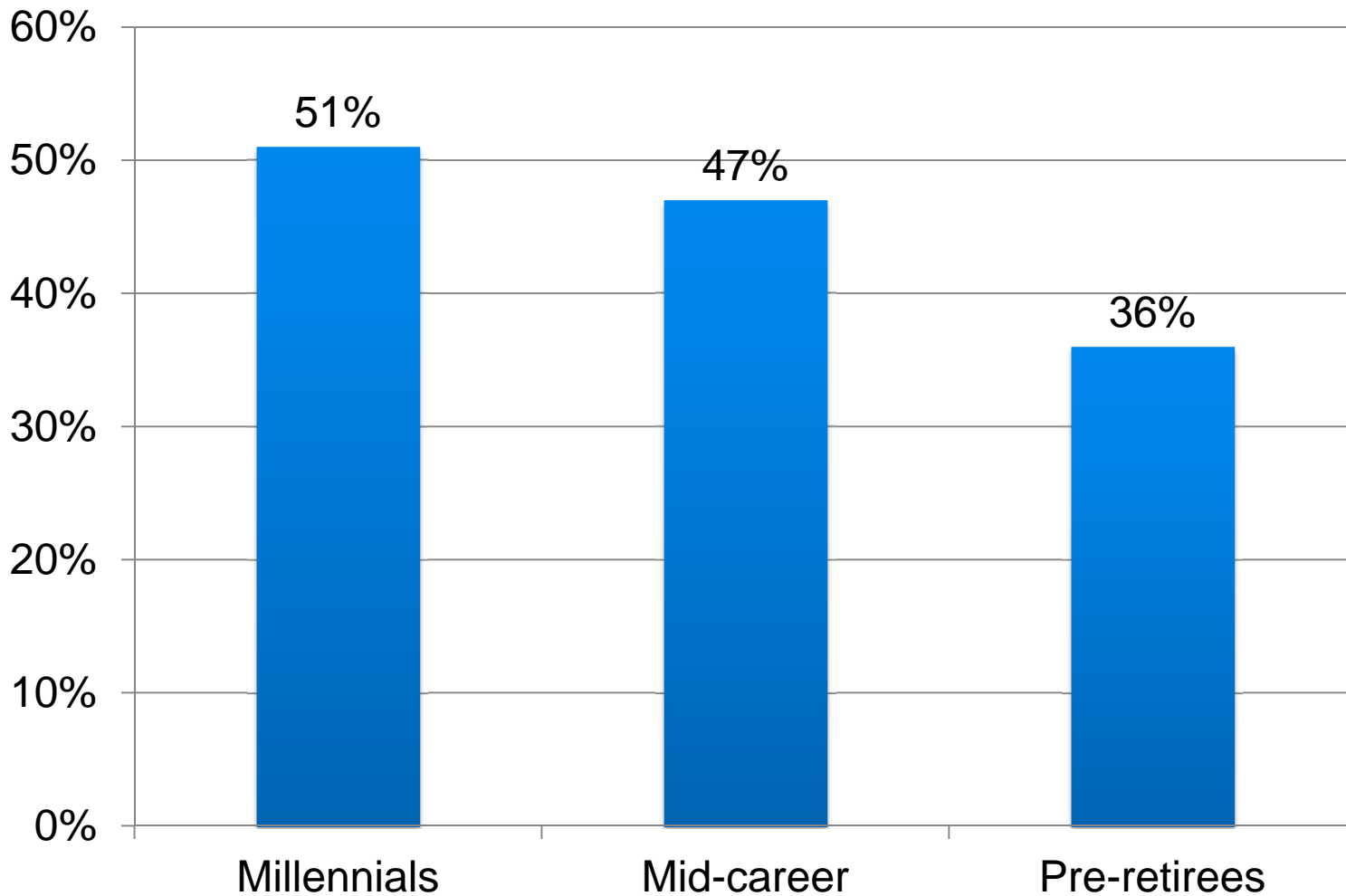
1. Student loans common across demographic characteristics, such as gender, ethnicity, and income.
2. Student loans disproportionately affect those with higher education: 54% of college-educated respondents carry student loans.
3. Higher education is typically associated with higher income, but because the cost of education is frequently financed through debt, college education may no longer be a guarantee of a better financial future.
4. Concerns about the ability to pay off student loans are present among 50% of survey respondents, especially women, minorities, and individuals who have student loans but not an undergraduate degree.
5. Even high income Millennials worry about student loans: 33% of those with annual household income above \$75,000 doubt they will be able to repay their student loans.
6. The percentage of individuals worried about repaying student loans remains high even several years after college.

Short-term debt: Credit cards

In the past 12 months...	Total	Millennials	Mid-career	Pre-retirees
I always paid credit cards in full	45%	49%	40%	47%
In some months, I carried over a balance and was charged interest	55%	53%	59%	52%
<i>Expensive credit card behavior:</i>				
In some months, I paid the minimum payment only	38%	43%	41%	30%
In some months, I was charged a fee for late payment	19%	22%	20%	14%
In some months, I was charged a fee for exceeding my credit line	9%	13%	9%	5%
In some months, I used the cards for a cash advance	11%	14%	11%	8%

45% of total sample engaged in at least one expensive credit card behavior in the 12 months prior to the survey

Expensive credit card behavior by career stage



Note: The figure shows the percentage of respondents who engaged in at least one expensive credit card behavior in the 12 months prior to the survey.

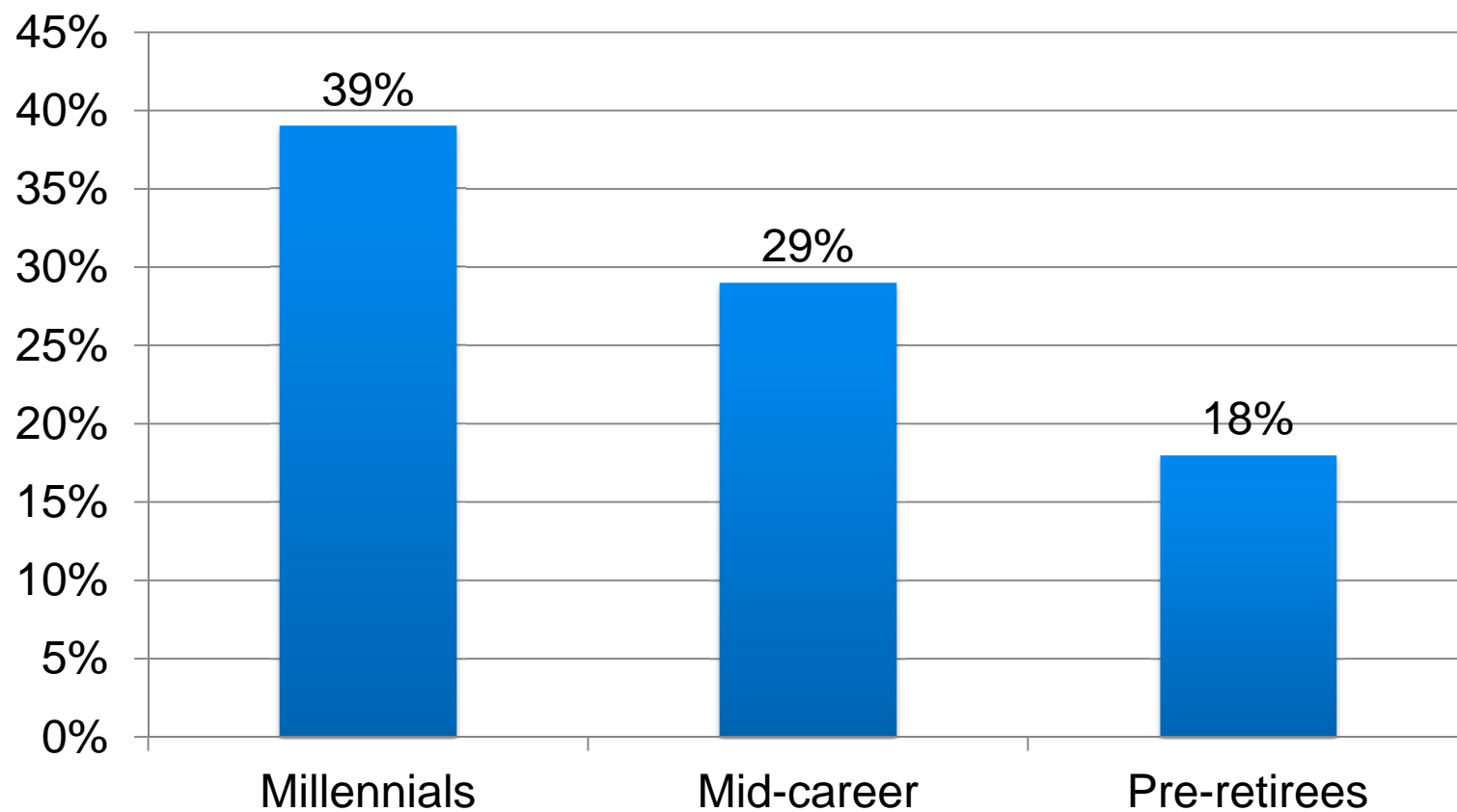
High-cost borrowing: Use of Alternative Financial Services (AFS)

Many Americans use high-cost borrowing—**29%** have used one of these methods in the past 5 years

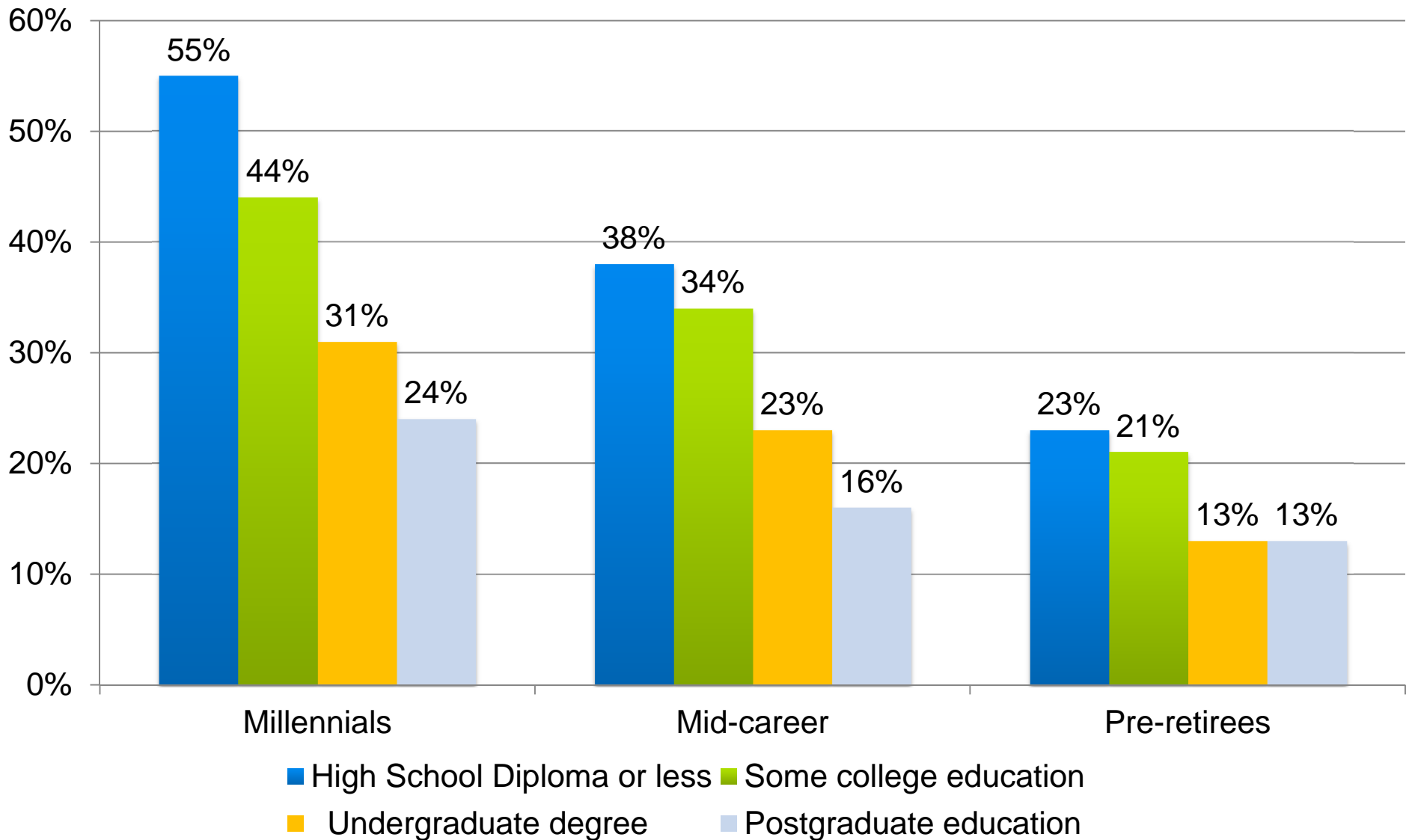
- ❖ Pay-day loans (14%)
- ❖ Pawn shops (16%)
- ❖ Refund anticipation loans (8%)
- ❖ Auto title loans (10%)
- ❖ Rent-to-own stores (10%)



Who borrows high-cost? AFS use by career stage



AFS use by education



Financial Literacy and High-Cost Borrowing in the United States (Lusardi and de Bassa, 2013)

Analysis of the 2009 National Financial Capability Study data shows that:

- Borrowing through products such as payday loans, auto title loans, and refund anticipation loans and using pawn shops or rent-to-own stores has become common in the United States: about one in four Americans has used one of these methods in the five years prior to the survey.
- While a high proportion of those with low income borrow using these methods, there is also a sizeable fraction of higher-income individuals who make use of AFS
- The young are heavy AFS users; 34 percent of individuals aged 18–34 and 43 percent of young respondent with a high school degree have used one of these methods
- There exists an educational divide, in particular among the young, in the use of high-cost methods of borrowing
- Borrowers display very low levels of financial literacy: the majority lack numeracy and basic knowledge of financial concepts at the basis of financial decision-making
- Financial literacy is strongly associated with AFS use, even after controlling for a very rich set of demographic and economic characteristics.

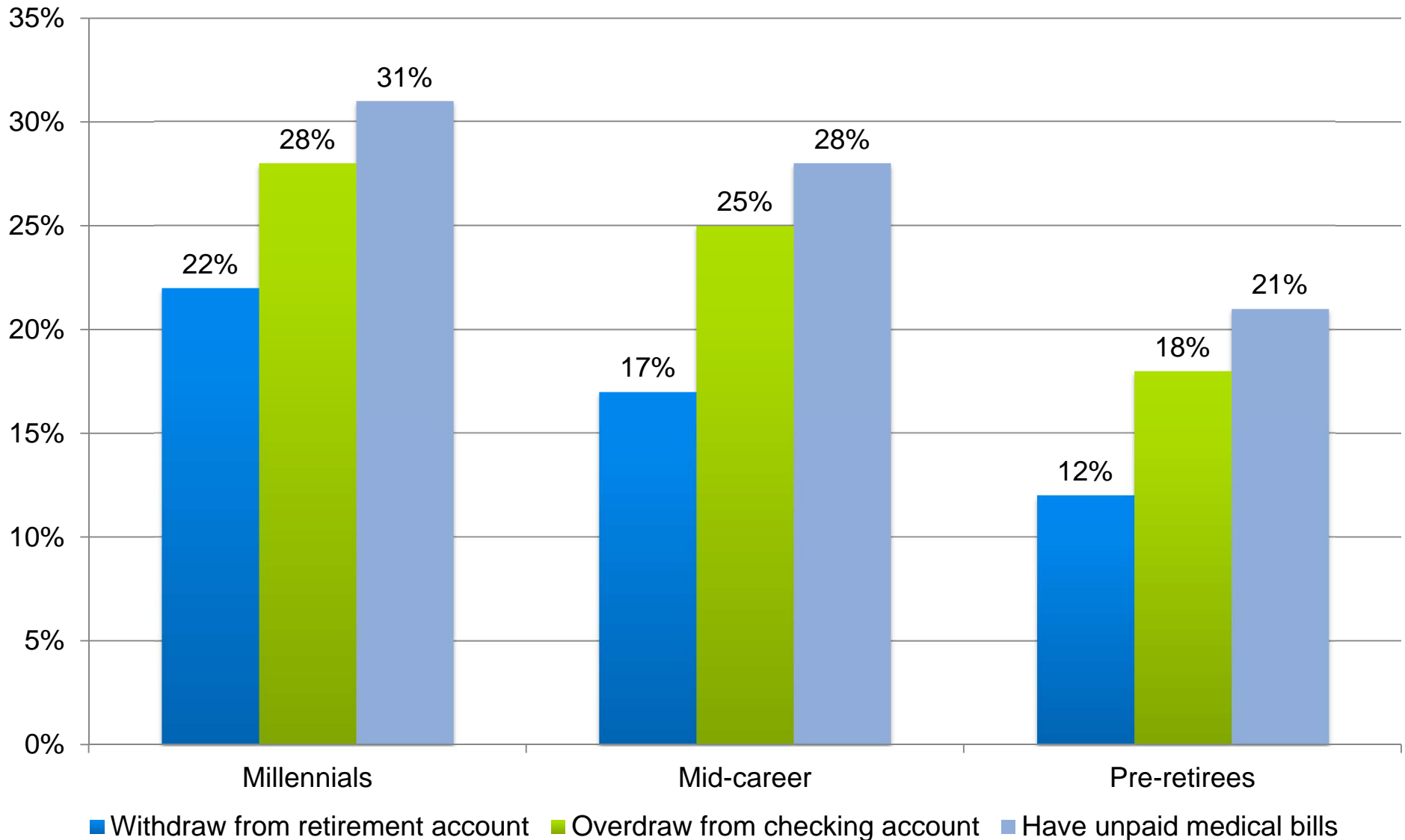
Other evidence of financial distress

Other indicators showcase the degree of financial distress among workers.

For example among workers age 23-61:

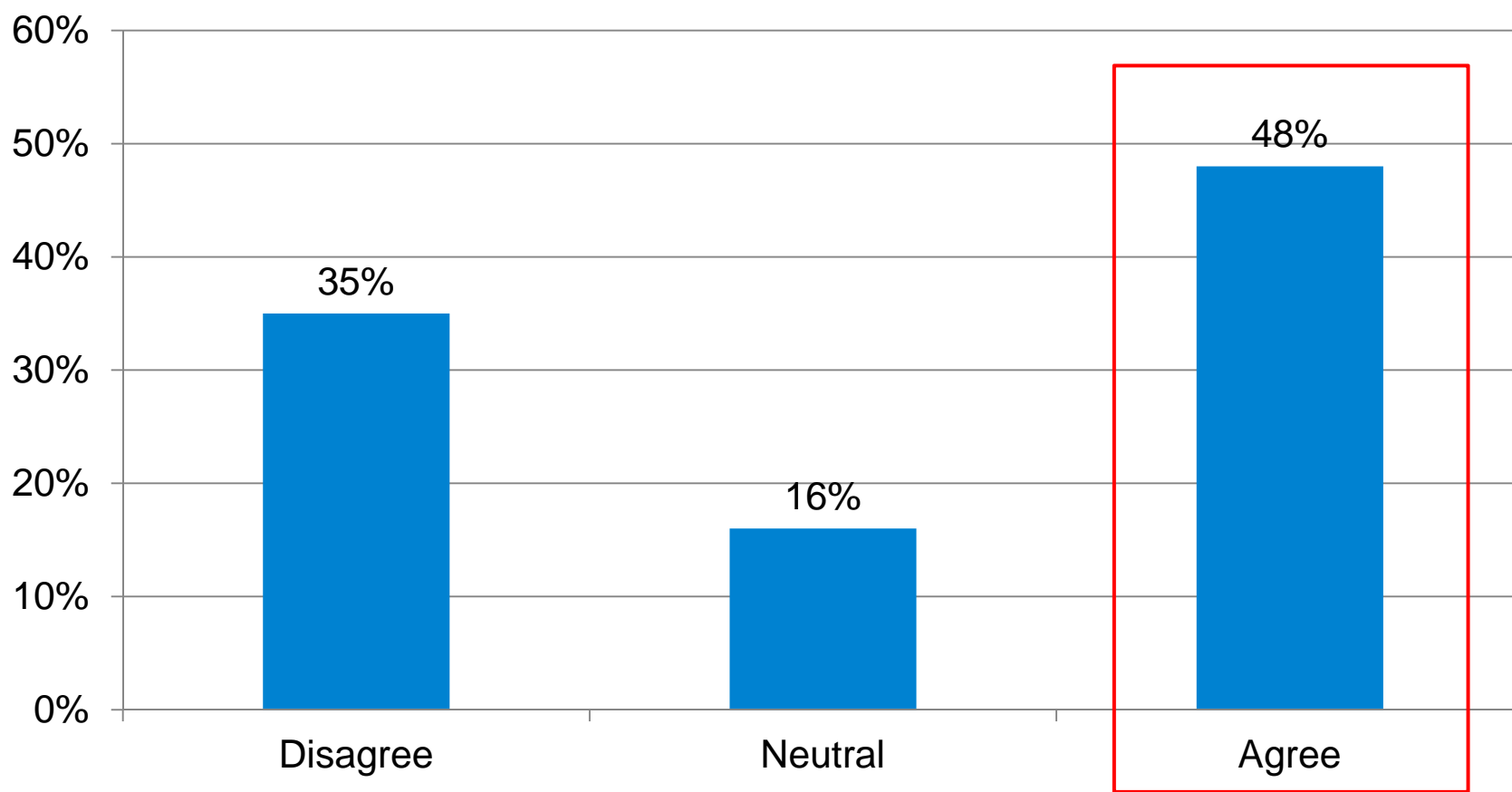
- 17% of those who have a retirement account made withdrawals from that account
- 24% of those who have a checking account occasionally overdraw from that account
- 27% have unpaid medical bills

Other evidence of financial distress by career stage



Debt burden (total sample, age 23-61)

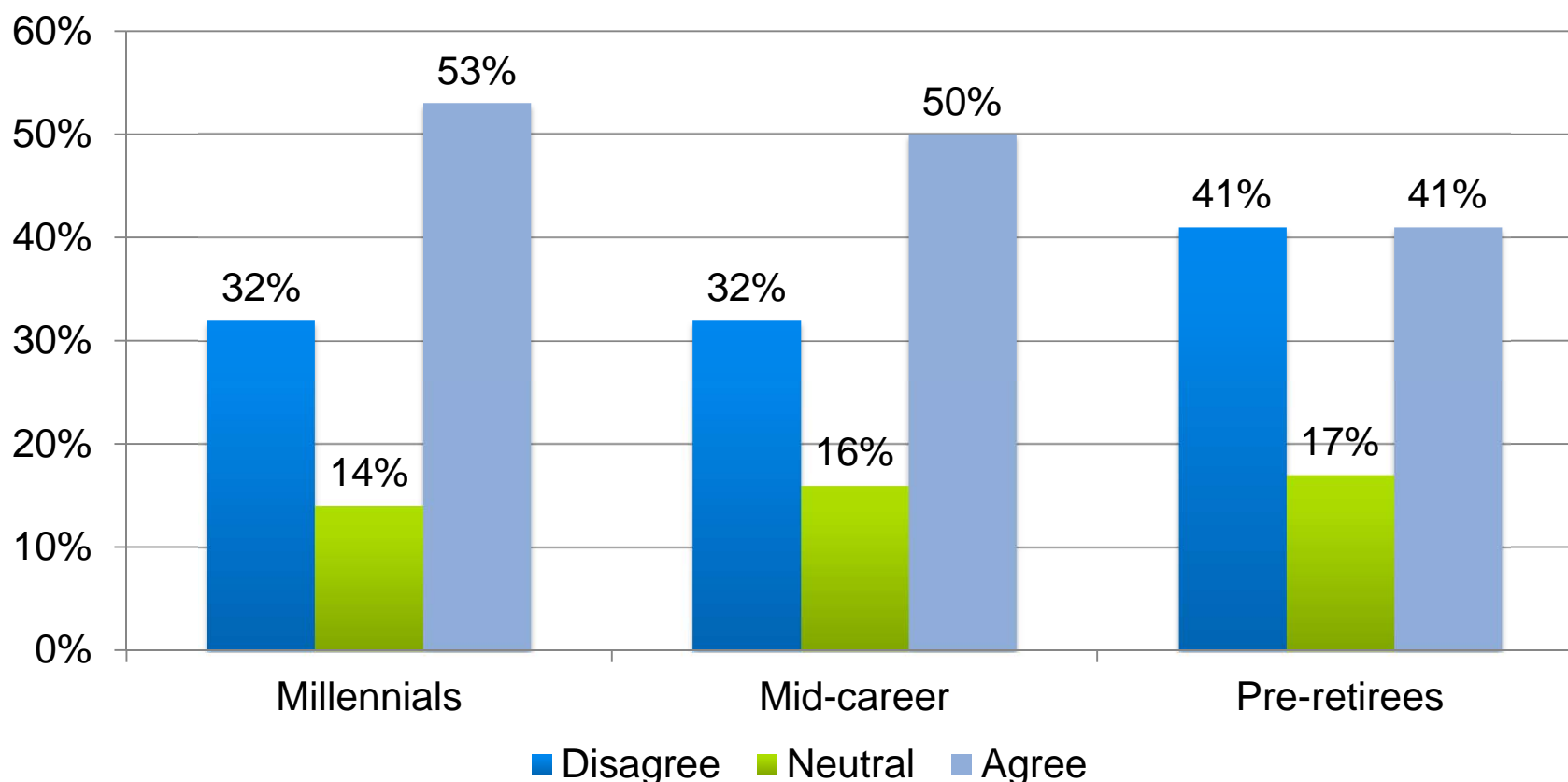
How strongly do you agree or disagree with the following statement? – I have too much debt right now.



Note: Percentages do not total 100 percent because “do not know” and “prefer not to say” answers are not reported in the figure.

Debt burden across career stages

How strongly do you agree or disagree with the following statement? – I have too much debt right now.



Note: Percentages do not total 100 percent because “do not know” and “prefer not to say” answers are not reported in the figure.

Reconnecting liabilities with assets: Rainy day funds

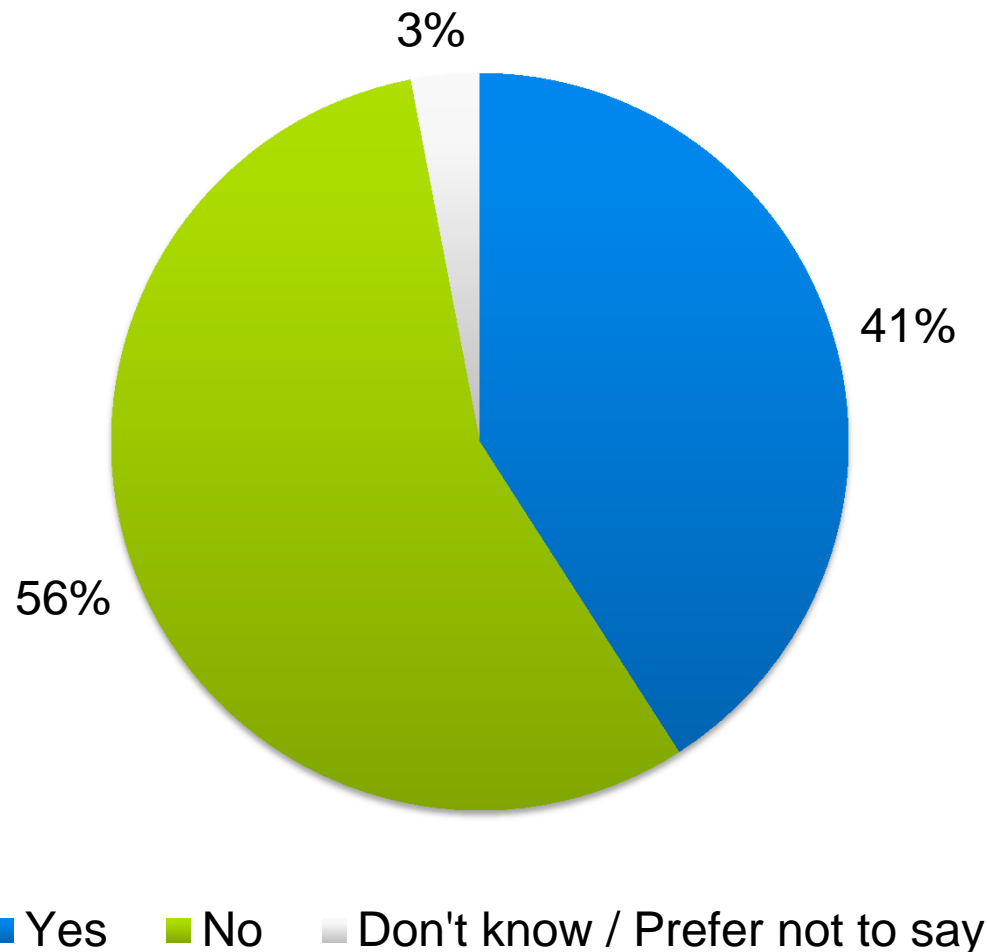
Given this widespread indebtedness, do people have precautionary savings? Can they cope with unexpected expenses?

To understand this, the survey asks:

- Have you set aside emergency or rainy day funds that would cover your expenses for 3 months, in case of sickness, job loss, economic downturn, or other emergencies?

Rainy day funds in the total sample

Do you have 3 months emergency funds to cover your expenses in case of sickness, job loss, or economic downturn?



Reconnecting liabilities with assets: Evidence of financial fragility

Given this widespread indebtedness, can people cope with unexpected expenses?

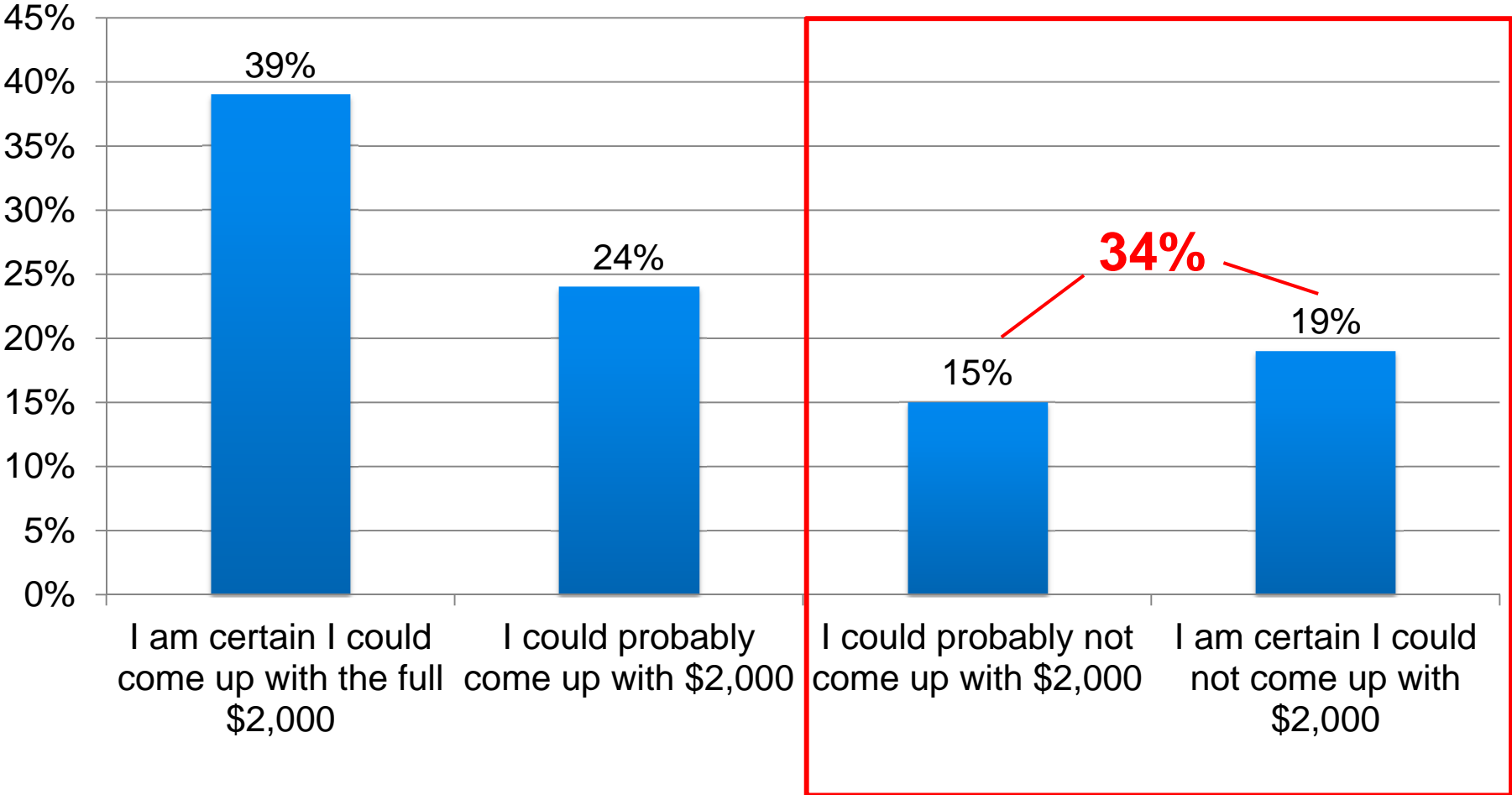
Use a measure of financial fragility developed by Lusardi, Schneider and Tufano (2011):

- How confident are you that you could come up with \$2,000 if an unexpected need arose within the next month?
 - I am certain I could come up with the full \$2,000
 - I could probably come up with \$2,000
 - I could probably not come up with \$2,000
 - I am certain I could not come up with \$2,000
 - Don't know / Prefer not to say

Lusardi, Schneider, and Tufano (2011)

- Propose a new measure of financial fragility
- Document how American households plan to cope with shocks
- Show that, in 2009, many would rely on pawning or payday loans
- Document which methods households resort to in order to cope with unexpected expenses

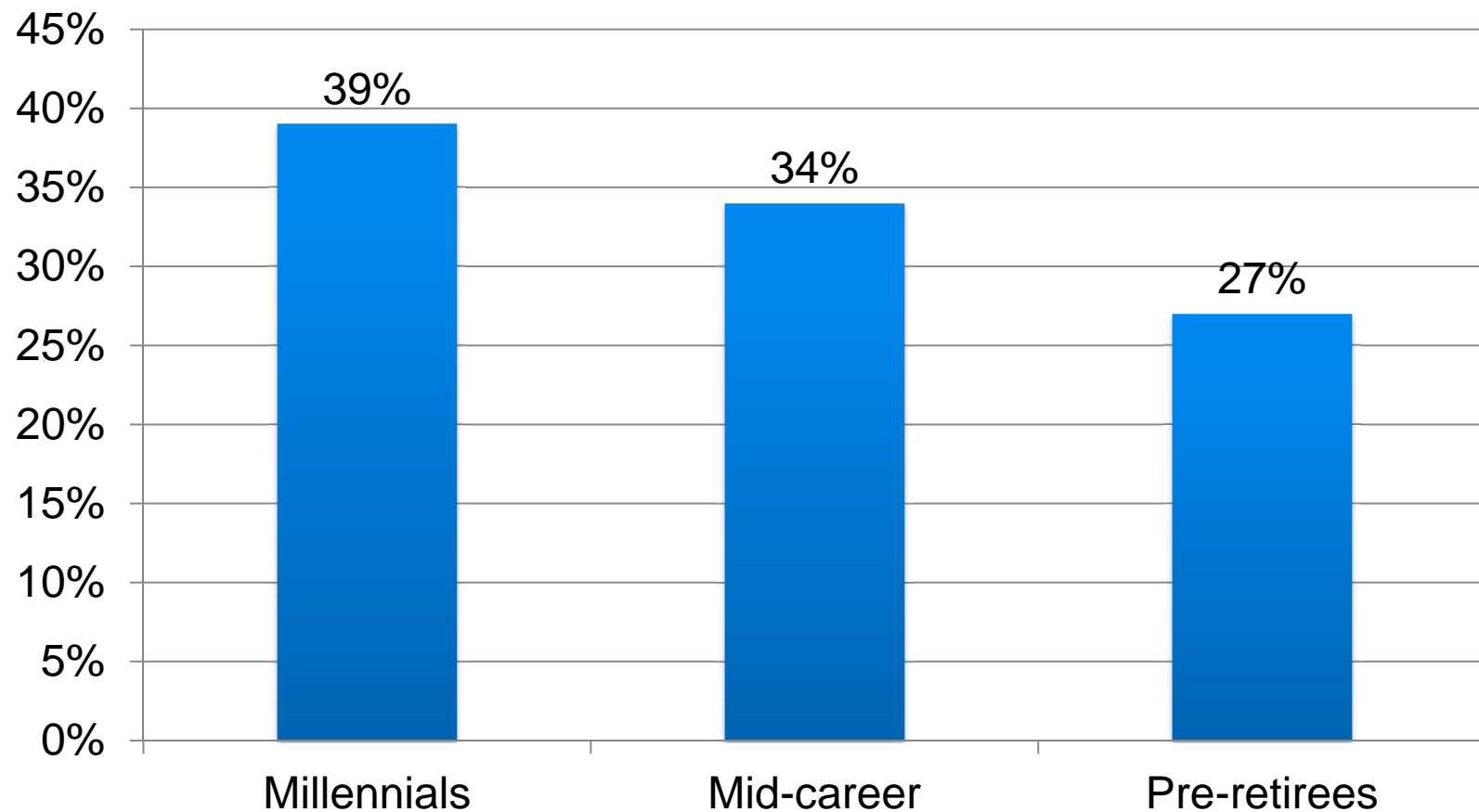
How confident are you that you could come up with \$2,000 if an unexpected need arose within the next month?



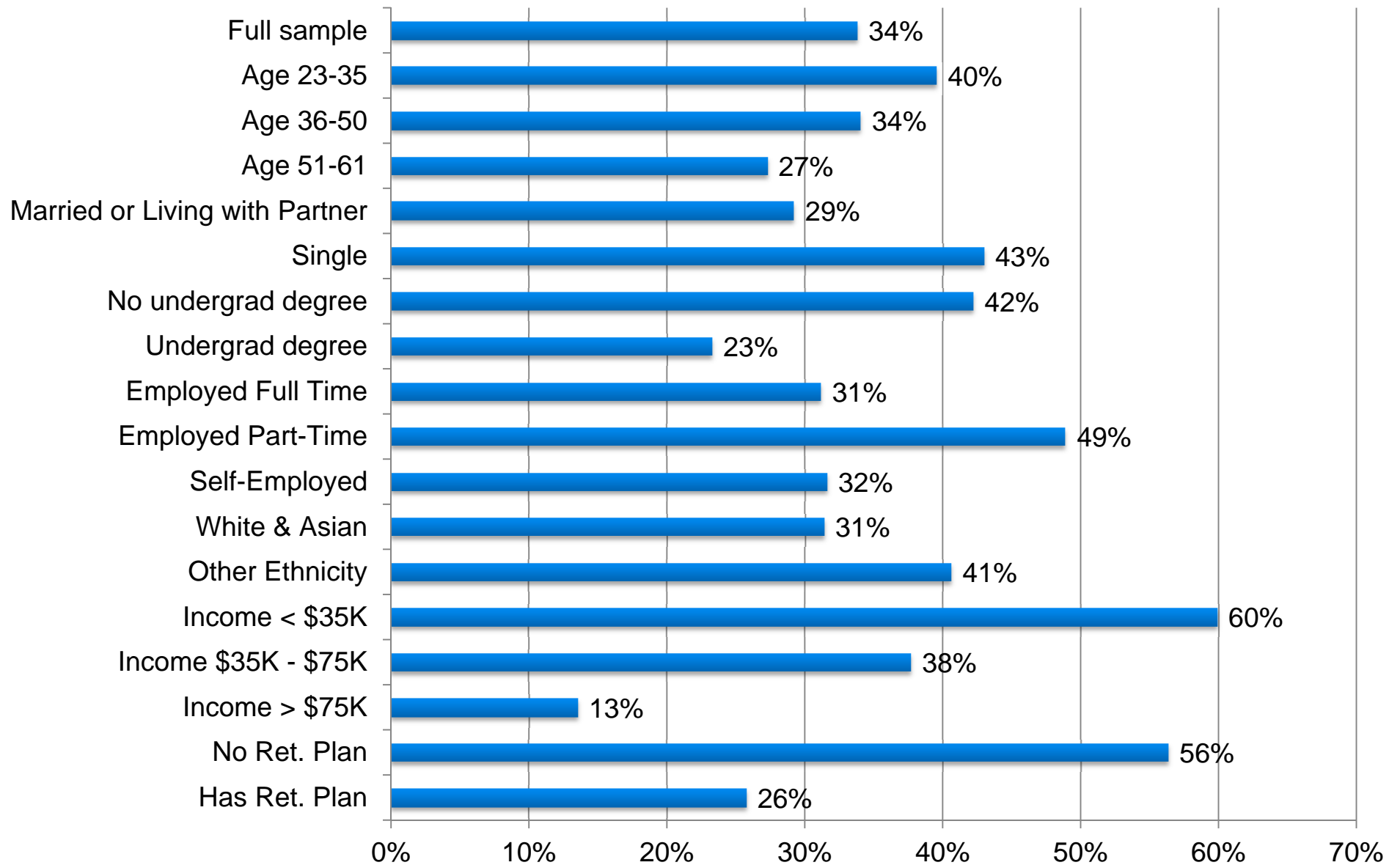
Note: The figure reports answers to the question “How confident are you that you could come up with \$2,000 if an unexpected need arose within the next month?” Percentages do not total 100 percent because “do not know” and “prefer not to say” answers are not reported in the figure.

Financial fragility by career stage

% of respondents certainly or probably unable to come up with \$2,000 in case of unexpected emergency

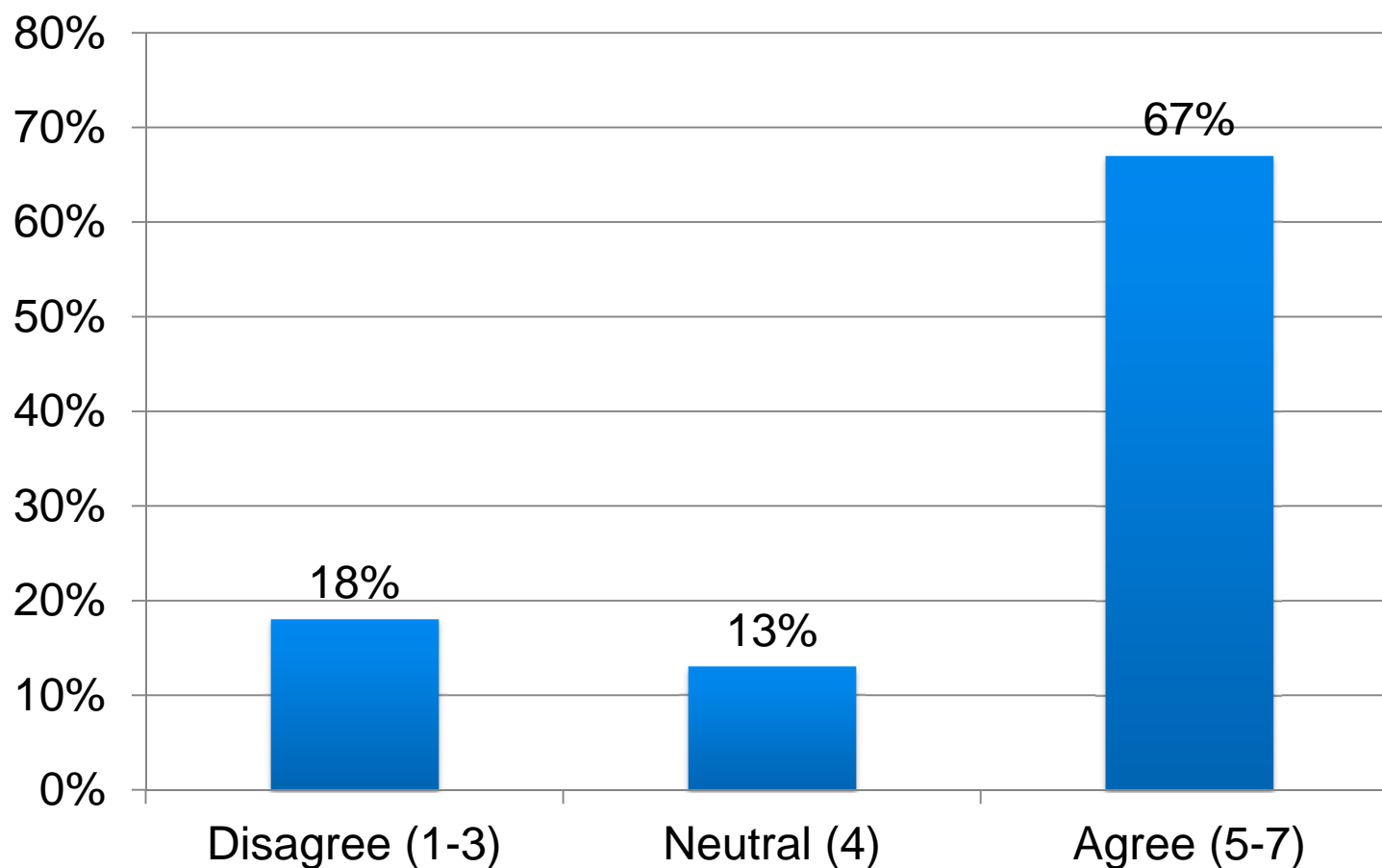


Financial Fragility - data breakdown



Connecting indebtedness and financial fragility

**Among only those who certainly or probably cannot come up with \$2,000:
Do you agree with the statement: *I have too much debt right now***

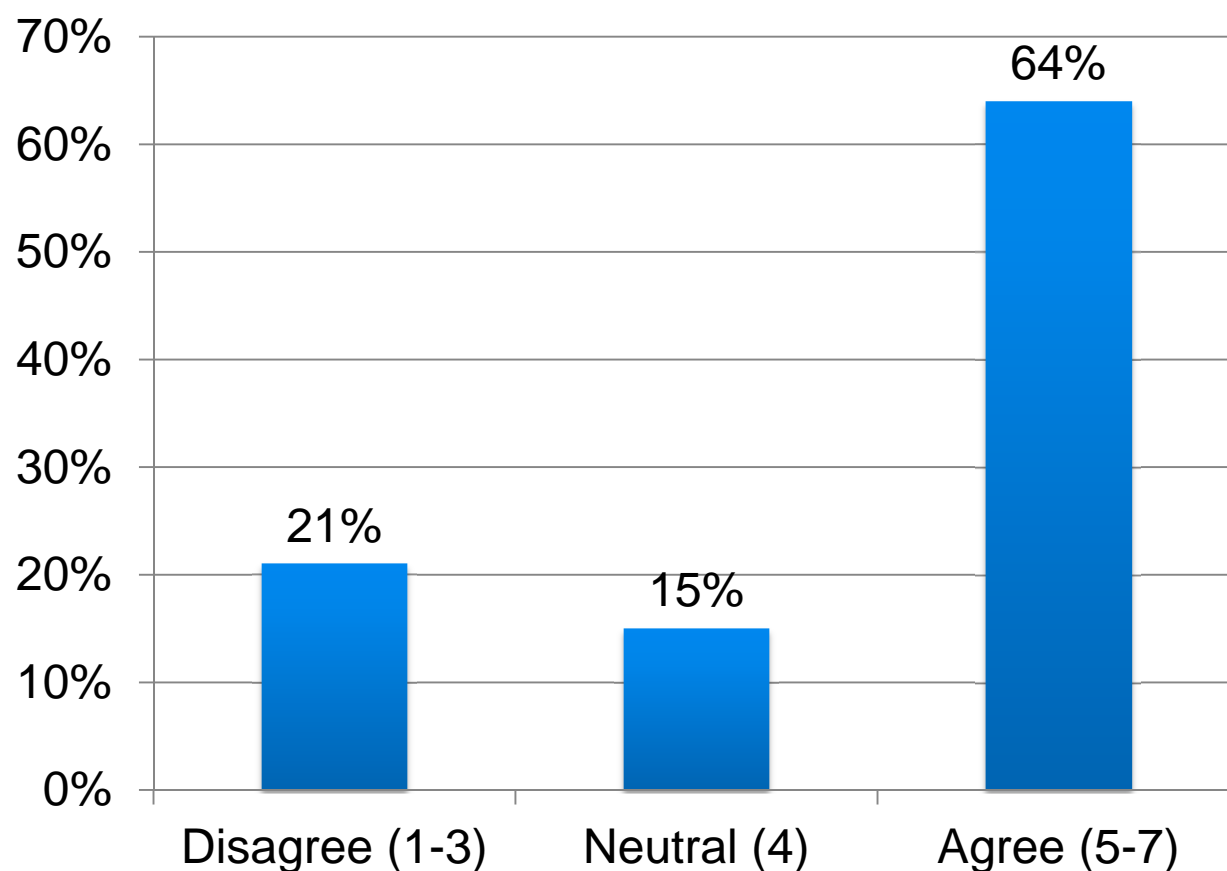


Note: Percentages do not total 100 percent because “do not know” and “prefer not to say” answers are not reported in the figure.

Connecting indebtedness and financial fragility (cont'd)

Among only those who do not have emergency funds

Do you agree with the statement: I have too much debt right now



Note: Percentages do not total 100 percent because “do not know” and “prefer not to say” answers are not reported in the figure.

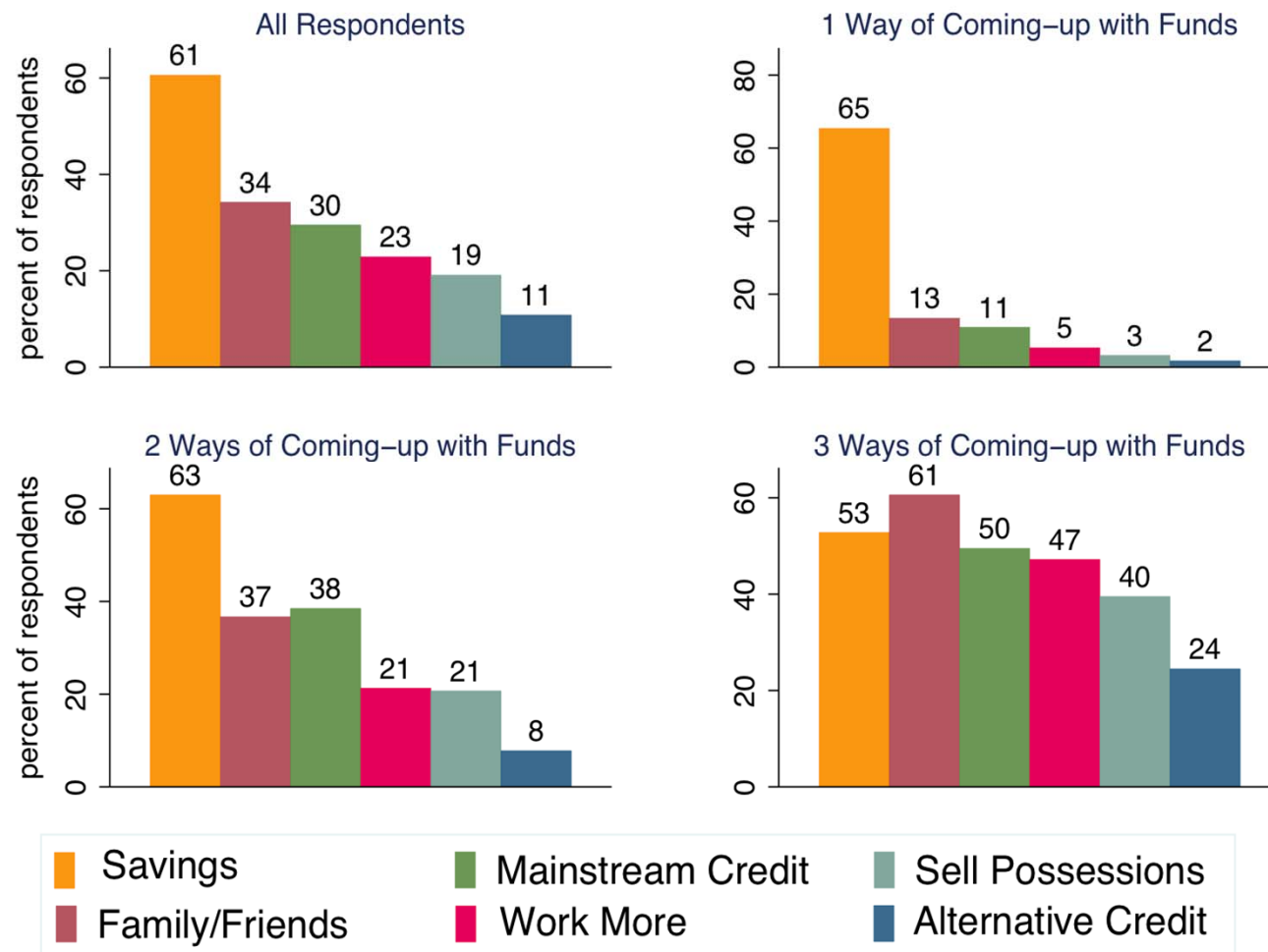
Coping strategies (Lusardi, Schneider, and Tufano, 2011),

“If you were to face a \$2,000 equivalent unexpected expense in the next month, how would you get the funds you need?”

- Asked of those who had some capacity to cope
- Allowed to select up to three ways out of 14 options

Coping strategies: Empirical evidence (Lusardi, Schneider, and Tufano, 2011)

Coping by Number of Methods



Financial illiteracy adds to the challenge

- People lack knowledge of basic financial concepts such as interest compounding, inflation, and risk diversification
- Lack of financial knowledge can be linked to financial behavior including debt.
 - See Lusardi and Mitchell (JEL, 2014)

Measuring financial literacy

1. Suppose you had \$100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?

- *More than \$102 ***
- *Exactly \$102*
- *Less than \$102*
- *Do not know*
- *Refuse to answer*

2. Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account?

- *More than today*
- *Exactly the same*
- *Less than today ***
- *Do not know*
- *Refuse to answer*

3. Please tell me whether this statement is true or false. "Buying a single company's stock usually provides a safer return than a stock mutual fund."

- *True*
- *False ***
- *Do not know*
- *Refuse to answer*

Financial (il)literacy

The widespread lack of financial literacy

	Total sample	Millennials	Mid-career	Pre-retirees
Interest Q correct	80%	75%	81%	83%
Inflation Q correct	65%	50%	68%	79%
Risk Q correct	54%	44%	56%	62%
All 3 Qs correct	41%	28%	43%	51%

Take Aways

- Households carry a lot of debt
 - Millennials start their career in debt
 - Debt is also important for pre-retirees
- Evidence of costly borrowing behavior
- Evidence that many families are financially fragile and are vulnerable to shocks
- Most financially fragile households are heavily indebted

Work cited

- Lusardi and Mitchell (2014) “The Economic Importance of Financial Literacy: Theory and Evidence.” *Journal of Economic Literature* 51 (2): 5–44.
- Lusardi, Schneider, and Tufano (2011), “Financially Fragile Households: Evidence and Implications.” *Brookings Papers on Economic Activity*.
- Lusardi and de Bassa Scheresberg (2013), “Financial Literacy and High-Cost Borrowing in the United States.” NBER Working Paper No.18969
- Lusardi, de Bassa Scheresberg, and Yakoboski (2014), “College-Educated Millennials: An Overview of Their Personal Finances”, GFLEC Report.

Thank you

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