

# Financial Fragility in the US: Evidence and Implications

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## Introduction

The capacity to cope with unexpected expenses is a crucial component of financial well-being. The lack of such preparedness is like balancing on a beam—a shock or unexpected financial adversity can immediately shake one off and it is hard to regain footing. Lusardi et al. (2011) introduced an innovative measure of the capacity to cope with shocks, which they termed *financial fragility*, by assessing U.S. households' capacity to come up with \$2,000 in 30 days. In the aftermath of the financial crisis of 2007–09, they found that almost 50% of the U.S. population could be classified as financially fragile. Using the same measure to analyze data collected in 2015, we find that financial fragility still affects more than one-third of the population. Such high incidence of fragility is concerning when we juxtapose the crisis, which occurred nearly ten years ago, with an economy that has been recovering steadily.

## Financial fragility in the U.S.

Since its introduction, this measure for financial fragility has been used in various surveys and has become a well-established and comprehensive measure of households' coping abilities. In the 2015 National Financial Capability Study (NFCS), 34% of the surveyed population said that they could probably or certainly not come up with \$2,000 in 30 days if the need arose. This amount is considered an approximation of a mid-size shock such as a car or house repair, a medical bill, or a legal expense, and the timeframe of 30 days allows individuals to assess not only the resources that they can access but also the various payment obligations that affect their coping capacity. To better understand financial fragility in the U.S., we build upon the financial fragility measure used in the NFCS by identifying subgroups that are most financially fragile, the major factors causing fragility, and the long-term implications of financial fragility for individuals and households.

We complement the data with focus group discussions, which we conducted in Austin, Baltimore, and Cincinnati, with individuals who are members of the population subgroups that were identified as the most financially fragile (women, young people, and individuals doing blue-collar work). We also use data from the 2015 Survey of Household Economics and Decisionmaking (SHED) and classify people as being financially fragile if they could not immediately cope with a \$400 emergency expense with cash or savings in their checking accounts or with credit card debt that they could pay off by the next statement, but would instead cope by selling possessions or borrowing money. We consider this alternative measure to be comparable to the original \$2,000 within 30 days financial fragility indicator because of its lower amount and shorter time horizon. We seek to strengthen our analysis of American households' financial fragility by exploring both these measures and the focus groups discussions, which provide useful insight into households' income and spending patterns, levels of indebtedness, financial behavior, decision making, and assessment of well-being.

Using data from the 2015 NFCS, we find that financial fragility is not only pervasive today, but is prevalent among a broad cross-section of the population. While low-income households are the least able to cope with emergency expenses, middle-income households also struggle with financial hardships. Specifically, while fragility does fall with income, almost 30% of middle-income households (with income in the range \$50–75K) and 20% of those with income in the \$75,000–\$100,000 range are financially fragile. We also find a constant share of financially fragile individuals across all age groups. The expected accumulation of wealth and experience over the life-cycle does not seem to contribute to lowering financial fragility rates at older ages. Moreover, women are more likely to be financially fragile compared to men. Specifically, over 40% of women stated that they could probably or definitely not come up with \$2,000 within 30 days, whereas the percentage of financially fragile men is below 30%. The data also show a strong link between financial fragility and educational attainment. Those without a bachelor's degree are much more fragile than those with a college degree. It is important to note that the educational divide is observed even after controlling for income in our regression analyses, implying that there are components of education that can affect financial fragility beyond its effect on income. Given that the U.S. economy has been slowly recovering from the Great Recession, this prevalence of weak personal finances, especially among the most vulnerable groups, is concerning and points to the need for programs and initiatives that promote short-term savings and make households more resilient to shocks.

### Three determinants of financial fragility

The empirical findings, complemented by the focus group discussions, show that both the asset and debt sides of a household's balance sheet affect the likelihood of being financially fragile. By letting respondents estimate their capacity to cope with a mid-size shock, we can capture many aspects of personal finance, including asset levels, indebtedness, and financial planning behavior. The variety of responses and coping mechanisms listed in the data show that financial fragility is not only a problem of too few assets, but can also be caused by too much debt. One

other component of personal finance that is shown to cause financial fragility is low levels of financial literacy.

The following sections lay out each source of financial fragility, describe our research findings and note potential policy and practical solutions.

### Levels of assets

Financial fragility can be attributed to both low savings and to lack of assets, such as homes or cars, retirement accounts, and insurance policies. Those who are more financially fragile are less likely to have assets. Discussions with focus group participants reveal that few individuals in these groups save for the short term or for emergency expenses, yet they do own retirement accounts and save for the long term. Many admit to not having short-term savings because they do not have the resources or do not see the reason to save for an unlikely and unpredictable event. Meanwhile, in the face of an income or other financial shock, withdrawing or borrowing from retirement accounts is a commonly cited coping mechanism. Consequently, their saving patterns lead to difficulties in coping with short-term financial emergencies in a manner that simultaneously lowers retirement security. Inability to deal with shocks matters: a sizeable fraction of the focus group participants reported that they could face severe setbacks if they needed to spend on small repairs for their cars or houses, or even if they received a traffic ticket. Low-income individuals struggle the most with unexpected expenses and it often takes them a longer time to recover as paying for an unforeseen expense often involves allocating income away from other needs.

The problem of lack of short-term savings needs a targeted solution, for example in the form of incentives similar to those that encourage long-term savings—such as automatic enrolment in retirement plans, and tax incentives to invest in retirement and housing. Incentives might also include new provisions of existing employer contribution plans that encourage allocation of employee earnings toward short-term savings or interest rates that incentivize short-term saving habits. Solutions could also come from tax incentives for those who put funds away for the short term. Overall, short-term saving tools should be institutionalized just like programs for building long-term financial assets.

## Levels of indebtedness

Accumulation of assets, however, may not be sufficient to protect individuals from being financially fragile. Our analysis shows that people who are highly indebted or have large payment obligations have more difficulty managing unexpected expenses. The 2015 SHED data show that among those who have education debt, almost 50% claimed that they did not have the cash, savings, or credit card capacity to pay for a \$400 emergency expense, while the corresponding figure for those without education debt is 39%. Moreover, data from both the NFCS and the SHED show that medical debt makes respondents approximately twenty percentage points more likely to be financially fragile. The link between financial fragility and debt was discussed among focus group participants, with several people attributing their weak financial positions to too many expenses and loans compared to assets. The relationship between financial obligations and the ability to cope with emergency expenses could also explain the higher financial fragility observed among middle-aged households, as they may be at the peak of financial obligations such as childcare costs, student loan repayments, and mortgage payments. Debt may be a contributor to financial fragility even for younger individuals, who are entering the workforce with more debt, such as higher education loans, compared to previous generations. Pre-retirees (ages 55–61) are also racking up non-housing debt (such as credit cards and medical debt) much more than previous generations (Lusardi et. al, 2017).

Because financial fragility is prevalent among people in their prime working years, the workplace is an ideal place in which to offer programs that provide effective debt-management resources. Financial planning and other topics should also be incorporated into curricula at the high school and college levels to prepare students for taking on loans later in their lives.

## Levels of financial literacy and financial education

The NFCS also assesses financial literacy of respondents. We see that financial literacy significantly lowers the likelihood of individuals being financially fragile, independent of

education levels. Better financial decision making among those who are financially literate could be one explanation for this association, as they may manage their resources better, or they may have higher ability and motivation to make a budget and plan, lowering unpredictability and volatility in their personal balance sheets.

Weak financial management and lack of planning behavior also came across in focus group discussions. Several people admitted to incurring avoidable expenses related to cable subscriptions, multiple pets, or even more cars than they need. Furthermore, when asked how they would cope with an emergency expense or income shock, most indicated that they would turn to borrowing, even within their network of friends and family, or work more to supplement their income. Few participants referred to saving for emergencies or building a buffer stock of savings. Data from the NFCS show that higher financial literacy is associated with a higher probability of not being financially fragile. Financially literate individuals overall display better financial decision-making abilities (Van Rooij, Lusardi, and Allesie, 2011), lower indebtedness (Lusardi and Tufano, 2015), and overall financial well-being.

Interestingly, our results show that the returns on financial literacy are highest for the most vulnerable subgroups of the U.S. population. For instance, financial literacy makes men around two percentage points less likely to be financially fragile. However, financially literate women are seven percentage points less likely to be financially fragile. Women are, therefore, ideal candidates for financial literacy programs, as they are overall also more likely to be financially fragile, compared to men. The strong and statistically significant link between financial literacy and financial fragility shows the importance of improving financial literacy to any effort to raise the financial well-being of the overall population. To boost financial literacy levels, it is important to devise effective and widely available financial education programs. Given that financial fragility prevails at all age levels, financial literacy strategies need to target different age groups, from financial education in schools and colleges to programs in the workplace.

## Implications of financial fragility

An important finding from the analysis is that those who are financially fragile are almost eighteen percentage points less likely to think about how much they should save for their retirement. Thus, besides the lack of the short-term ability to cope with financial hardships, financial fragility can have adverse consequences for long-term financial security. From the focus group sessions emerge other consequences of financial fragility that can be harder to measure empirically, such as the inability to pay medical bills leading to avoidance of medical care and declining health, which ultimately affects job prospects; or a car accident leading to the loss of a vehicle, and potentially to job loss due to lack of transportation to work, then to higher health expenses and inability to pay rent, which affects creditworthiness and results in higher interest rates on future loans. While such a feedback loop may not exist for all financially fragile individuals or households, the potential for compounding problems resulting from financial fragility is far-reaching

## Conclusion

Financial fragility is highly prevalent, even many years after the financial crisis, and is borne by a broad cross-section of the U.S. population. It is clear that more work is required to understand the problem's structure, its various causes and implications, and how different population subgroups cope with it. Future research must include the comprehensive indicators that we observe through our measure to improve understanding of the financial health of individuals and households, and to observe the variety of ways in which financial fragility can prevail. A better understanding of the causes of financial fragility will aid in the creation of solutions that effectively help individuals and households; acknowledging the heterogeneity in the incidence of financial fragility is a good step in this direction. Financial fragility has adverse implications for those who are vulnerable, and we see that vulnerability cannot be pinned to a single, avoidable attribute. Low asset levels, debt obligations, and lack of financial literacy are all factors that lead to financial fragility. Identification of vulnerable subgroups can help guide tailored solutions, whereas policy initiatives such as incentivizing short-term savings, and requiring financial

education in colleges and workplaces can help the entire population. While the data show several sources of vulnerability for households, the effect of financial literacy in particular should be noted. It is not just resources (or lack of resources) that matter; improving individuals' capacity to manage those resources can ensure that American families are financially sound and resilient.

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