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Building a Healthy Balance Sheet Early in Life

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Members of the Commission, thank you for the opportunity to appear before you today to briefly discuss research and ideas around building a healthy balance sheet early in life. I would like to recognize and thank my colleagues Bill Emmons, an economist and the Center's senior advisor, and Bryan Noeth, the Center's policy analyst, for their excellent research, which I convey today. My remarks today are largely derived from the St. Louis Fed's most recent *Annual Report*, co-authored by myself and Bill Emmons, as well as from recent publications on our website: www.stlouisfed.org/hfs.

I would like to address five questions:

1. Why family balance sheets? There are three reasons. First, the balance sheet unites the work of those of us here today. Whether working on savings, financial inclusion, access to credit, homeownership, retirement security, financial capability, regulation of credit cards, college savings, mortgage rules, etc., we ultimately would all like to see families with stronger balance sheets. Second, balance sheets—as distinct from income, earnings, education and other common measures of economic well-being—offer new insights into how families and the economy move forward. And third, when we were too focused on building wealth—especially homeownership wealth—at the expense of the health of the broader balance sheet, we paid—and are still paying—a price.

During the previous decade, we achieved the highest rate of homeownership ever recorded; the highest concentration of wealth in homeownership ever recorded; the highest ratio of

[1] These are my own views, and not necessarily the views of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

personal debt to income since we began keeping records; and the lowest personal savings rate since 1933.These balance sheet failures, as we painfully learned, helped bring families and the economy down. Not surprisingly, the Great Recession has also been called a balance-sheet recession.

2. Has the wealth lost in the recession been recovered? Not for most Americans. Headlines from last year, generated from research conducted by economists at the Federal Reserve Board, stated that we have more than recovered the wealth lost in the recession, and that household deleveraging—paying down debts and rebuilding savings—is over. Well, that is true for perhaps one-quarter of the population, those we call "thrivers." But if you are among the three-quarters of the population who are less educated, non-white and younger (in your 20s or 30s), the "strugglers," you have yet to fully recover your wealth. For some, the wealth loss may be permanent.

One reason for this highly uneven recovery is that thrivers have a disproportionate share of stock market wealth which, thanks to a booming stock market over the last couple of years, accounts for well over 80 percent of the recovered wealth. Meanwhile, housing, where most strugglers have their wealth, has contributed only 12 percent to the wealth recovery. This is among the reasons we have to work towards helping struggling Americans diversify their balance sheets beyond homeownership. Thrivers took a hit in the recession, too, but bounced back pretty well, largely because they had diversified or "balanced" balance sheets. How, then, can we diversify the balance sheets of more Americans? I will return to this question later.

3. What do we know about the balance sheets of younger Americans? In our research, we have looked at demographic drivers of balance sheet health and have found that age, race and education are the strongest and most reliable predictors a family's wealth. For those strugglers I mentioned, well, it turns out that age was the strongest predictor of balance sheet health, even controlling for race and education. According to our research, Americans in their 20s and 30s lost the greatest amount of wealth in the recession and have been the slowest to recover it. Middle-age (ages 40-61) and older (62 and older) Americans are either at or above their pre-crisis levels of wealth, whereas younger Americans (under age 40) have recovered only about one-third of their wealth—largely because they were significantly over-invested in homeownership and severely over-leveraged. Our estimates show that, in 2013, median net worth was $928,000 for those age 62 and older and $691,000 for those ages 40-61, but only $108,000 for those under age 40.

As a result of the downturn, we are learning a couple of important lessons about younger Americans. One: They are especially sensitive to recessions, given relative age and youth, low levels of liquid assets and, recently, too much exposure in the housing market. And two: Despite economic vulnerability going into the recession, they counterintuitively took on more balance-sheet risk, not less. As a result, those of us in this room face a key challenge: encouraging better financial capability to help younger families prevent these types of failures in the future.

But it is not just a financial capability challenge; something historic and unprecedented is underway: Succeeding generations appear not to be as wealthy as previous ones. Holding the key determinants of income and wealth constant, each generation born during the first half of the 20th century earned more and was wealthier than the one before, whereas real incomes and wealth of generations born during the second half of the century have stagnated at levels below those of Americans born in the late 1930s and the 1940s.

We at the Center for Household Financial Stability are not the only ones observing this. Research conducted by the Urban Institute finds that Generations X and Y have accumulated less wealth than their parents did at that age over a quarter-century ago. And preliminary research from the Pew Research Center shows that daughters are on track to do better than their mothers on a every well-being measure they considered, except wealth. Yes, there are still lifecycle- effects—earnings start off low, rise through middle age, and then decline again late in life. But the curve has shifted down, perhaps permanently.

4. <u>How can we help build healthy balance sheets early in life?</u> First of all, I would like to applaud the previous speakers and panelists for their excellent ideas. I will second some of their ideas, and add just a couple more. First I will talk about what we can do early in life for children, and then what we can do early in careers for young adults.

For children, I would suggest three ideas, all designed to get kids to start saving and building financial know-how. First, build financial capability in schools with links to real savings accounts that kids own and manage. If the assets field has learned anything in the last 20 years, it is that institutions matter—that building or losing wealth is primarily a function of the kinds of institutions you have access to. If you have access to a pro-saving institution, such as a credit union, community development organization, tax preparer, employer, etc., you can build wealth, even if your income is very low. If, however, you primarily encounter wealth-depleting institutions, such as pay-day lenders and check-cashers, you are likely to lose wealth.

Institutions, in fact, may matter more than income, match rates, and the simple availability of stand-alone accounts. Well, schools can be (and in some cases are) those key institutions. And it is essential for schools to not only teach financial basics, but also to offer real accounts that kids own and manage. Accounts and financial knowledge reinforce one another; in fact, there is some research showing that saving is a pre-condition of financial know-how, not the result. So lead with real savings accounts, where possible. This is the experiential learning model mentioned by one of the previous panelists.

Second, we have to work toward some kind of a national, standardized or longer-term child savings account (CSA) product. Many of you may know that the assets field has been bedeviled by product design challenges in our efforts to test CSAs over the last two decades. Sometimes we would have to make a basic savings account resemble a longer-term, restricted account, while other times we would encounter a flawed or expensive 529 college savings plan (that is changing rapidly, though: over the last several years, a growing number of states, including Nevada, Maine and Oklahoma, started offering excellent 529 plans for CSA and college savings innovations targeted at lower-wealth families).[2] To move the national product discussion forward, one might consider a child-friendly version of President Obama's new MyRA proposal—a low-cost, low-barriers starter account that would let kids start saving, ideally for longer-term uses.

That account, then, could lead to a more permanent life-long account, something like the low-cost Roth at Birth or KidsRoth idea that Ted Beck and I proposed for the President's Advisory Council on Financial Capability, which later endorsed the idea. Roths are ideal in many ways, especially since they are well known, can help build medium-term assets such as a first home or education, and span a lifetime. Right now, though, most children do not save in Roths because of the earned-income requirement; the Roth at Birth proposal, then, would add children to the earned income exemption that currently only applies to non-working spouses. It also would add a few other features to make the product more attractive to lower-income families.

Ultimately, however, the Roth at Birth should be (a) created automatically for every child in America, either when they are born or enter Kindergarten; (b) embedded in a "plan" structure, such as the federal Thrift Savings Plan; and (c) funded progressively. These ideas are all embodied in the bi-partisan ASPIRE Act I worked on for several years while at the New America Foundation. I understand that the Senate Finance Committee's new chairman, Ron Wyden, recently stated his support for this idea. The simple availability of a new product, absent defaults and institutional supports, may have limited impact.

My third and final idea to consider for children is something unofficially called "Early Pells." Many of the excellent CSA initiatives around the country, like Treasurer Cisneros's, seed college savings accounts when kids enter kindergarten. But finding a stable, targeted and relevant source of funds for those accounts could be a challenge nationwide. So, in a slight variation of a proposal by the College Board[3], I recommend taking a small portion (perhaps $100) of what an income-eligible family would receive in a Pell grant if entering college and use those funds to start a college savings account, ideally a 529, when the child enters kindergarten. The family's Pell Grant would then be reduced by that amount when they enter college. The forthcoming reauthorization of the Higher Education Opportunity Act presents an opportunity to seriously consider this idea.

I cannot emphasize enough how important it is for all kids to start saving. Once kids have accounts, ideally ones set up automatically, we can build financial skills more effectively, and then link those accounts to public and private funds, such as the Child Tax Credit, the Earned Income Tax Credit, Pell Grants, and contributions from families, friends, and the community.

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[2] See the Center for Social Development website for excellent research, innovations and ideas around 529s, as well as the potential of 529s to provide a more national platform for child savings accounts. http://csd.wustl.edu/Pages/default.aspx

[3] The College Board recommends new funding for college accounts for 11- and 12-year-olds as part of what they call "Early Promise" programs. I differ in that I suggest using a small percentage of existing Pells and starting the accounts at ages 5 and 6; some of the Pell funds would simply be front-loaded to start the accounts.

The account can become a magnet. And encouraging kids not just to save, but to invest, is critical, especially in targeted funds for college. This also gets children on a path toward a diversified balance sheet—an essential concept that children should learn in school.

Now, for those who are in the early stages of their careers and lack savings and financial know-how, the key is just starting to save. But when they do, we cannot miss the opportunity to teach them how to work toward a diversified balance sheet. As I stated earlier, the families who bounced back from the recession had wealth beyond homeownership, while the ones that got walloped—younger, minority and less-educated families—did not. And, as I mentioned, those with financial assets and stocks have accounted for the overwhelming majority of the recovery, while those with housing wealth continue to lag. A great place to get on a path toward a diversified balance sheet is through unrestricted savings, which cut across the health of the balance sheet. Families with liquid savings have access to better financial services, can better weather financial emergencies, can pay down high-interest debts, and can invest in a small business, a home, higher education and skills, and retirement.

And when more young Americans save for college and retirement, it makes sense for the default investment choice to be life-cycle or targeted funds (even as efforts are underway to improve them) so that they have some way of owning equities. More Americans need to have a stake in the growing parts of our economy which, as I have already mentioned, account for the overwhelming part of the wealth recovery. This is not without risks, of course, so we would have to proceed carefully; but without some level of risk, greater benefits and financial security may be forfeited.

And, recognizing that this is part of a much longer discussion, I would say that saving and investing for college and retirement, building emergency savings and paying down consumer and unsecured debts should take priority over saving for and buying a first home. Younger families, especially, should gradually work toward a goal of buying a home, not start there. This is not an argument against homeownership, but an argument—based on the experience of the Great Recession—for diversification.

<u>5. What difference does it make to start saving and building a healthy balance sheet early in life?</u> The benefits of saving early go well beyond a strong balance sheet later in life. First, recent research shows that when families have savings, assets, fewer debts and generally higher levels of net worth—as distinct from higher incomes—they are more likely to attend college, complete college, realize better social and economic outcomes for their children, experience higher rates of intra- and inter-generation mobility, achieve better health and labor market outcomes later in life, and enjoy many other positive outcomes.

And second, stronger balance sheets can help reignite and grow our economy. As we observe in our *Annual Report*, family balance sheets impact the broader economy, through both wealth effects (changes to spending and consumption based on real or perceived changes in housing or financial wealth), and the spending or consumption effects of deleveraging (paying down debts and rebuilding savings). For example, research shows that two out of every three jobs lost from

2007-2009 were due to deleveraging and weak balance sheets. Well, if weak balance sheets can destroy jobs, then stronger ones can help create them. So any policy efforts to strengthen the balance sheets of average Americans will help both those families and the economy move forward.

To conclude my remarks today, let me observe that the severe and, in many ways, unprecedented balance-sheet challenges facing younger Americans are compounded by double-digit unemployment, fiscal pressures, aging of the population, delayed family formation, student loans and many other challenges. While it has always been smart to start early to achieve financial success, for younger generations it may now be a necessity.

Thank you.