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Financial Regulation and the Economic Security of Low-Income Households

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October 14, 2010

Note. This presentation was prepared for the Institute for Research on Poverty (IRP) at the University of Wisconsin–Madison seminar series “Instability in the Lives of the Poor: How Policy Helps or Hurts.” All views expressed are my own and not those of the Brookings Institution or any of its other affiliates.

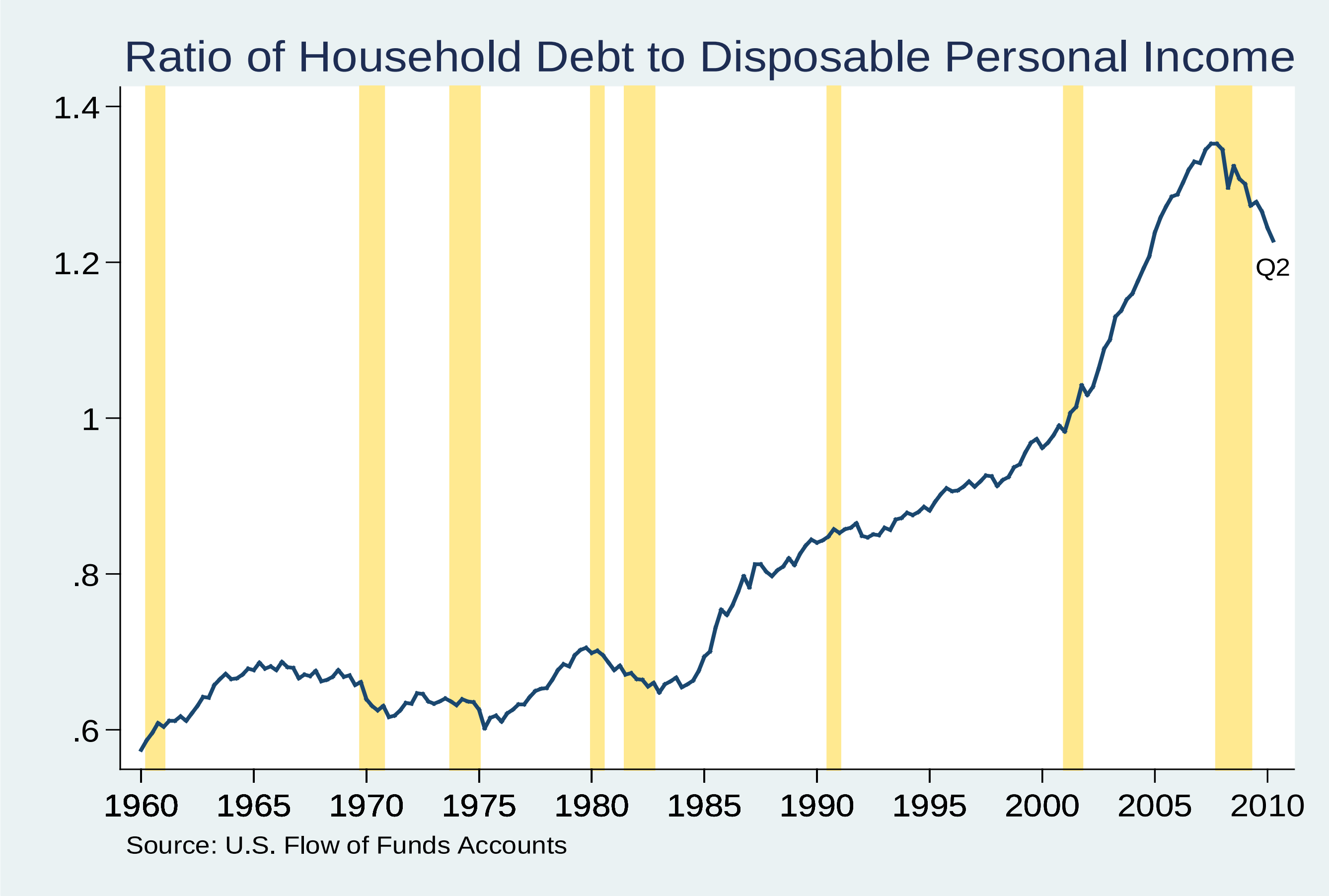
Regulation of Household Credit is Key Financial Reform Issue

- Motivated by view that misguided use of credit contributed importantly to crisis.
- Dodd-Frank created new independent consumer financial protection bureau.
  - » Law gives it certain powers, but how these powers will be used has yet to be determined.
  - » What lessons can we draw from academic studies and introspection about the experience of the past few years?

Outline for Talk

- Trends in household credit use:
  - Explanations
  - Broadly and for low-income households
- Credit use and household economic security
- Financial regulation: goals and challenges

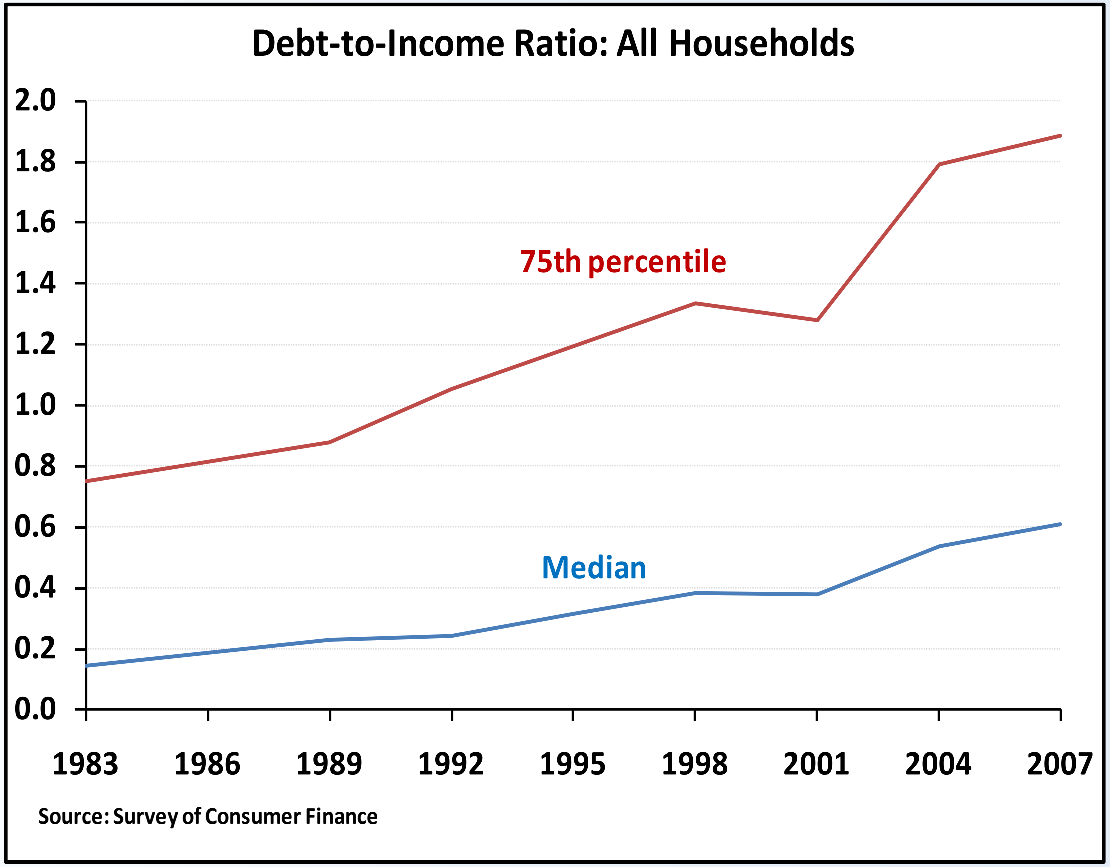
Trends in Aggregate Household Debt



What Explains the Longer-Term Uptrend in Household Credit?

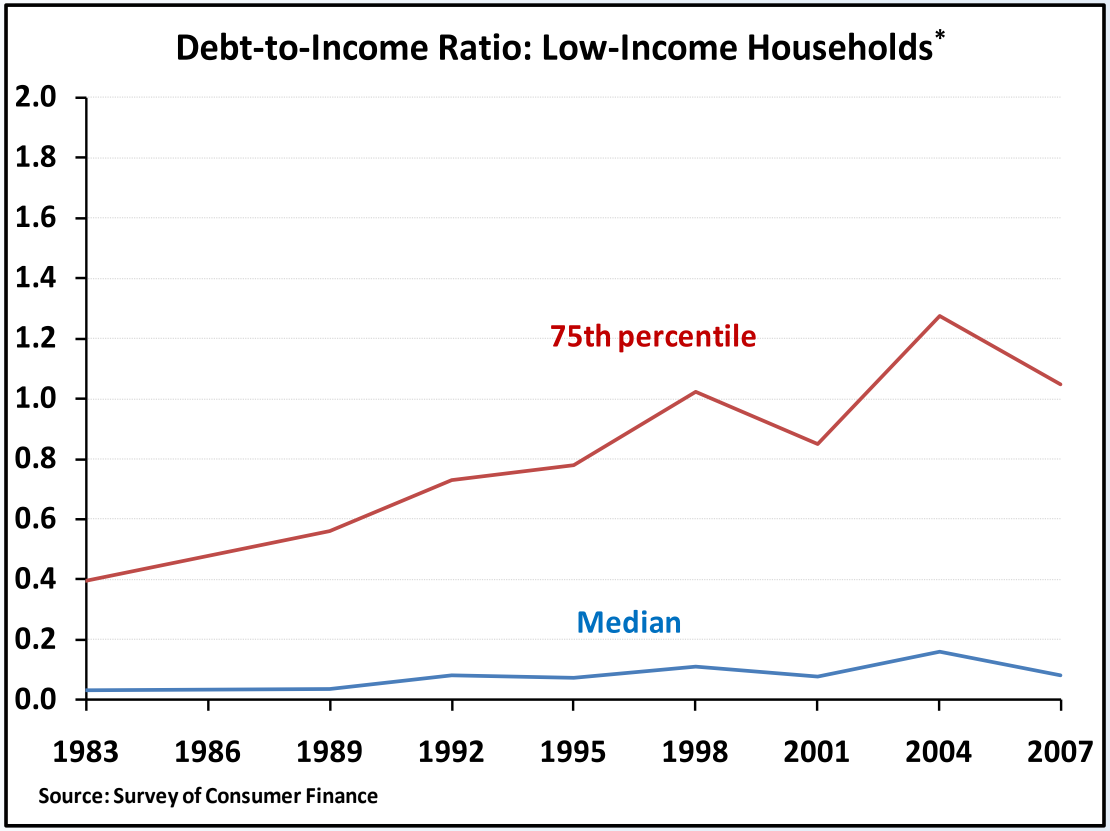
Rise Reflects "Democratization" and Greater Credit Use Among Those With Access

Share of All Households with Debt	
1983	70.2%
1989	72.4%
1992	73.2%
1995	74.8%
1998	74.4%
2001	75.2%
2004	76.5%
2007	77.0%



Patterns Similar for Low-Income Households

Share of Low-Income Households* with Debt	
1983	57.8%
1989	58.7%
1992	63.7%
1995	61.8%
1998	63.7%
2001	62.3%
2004	63.6%
2007	60.8%



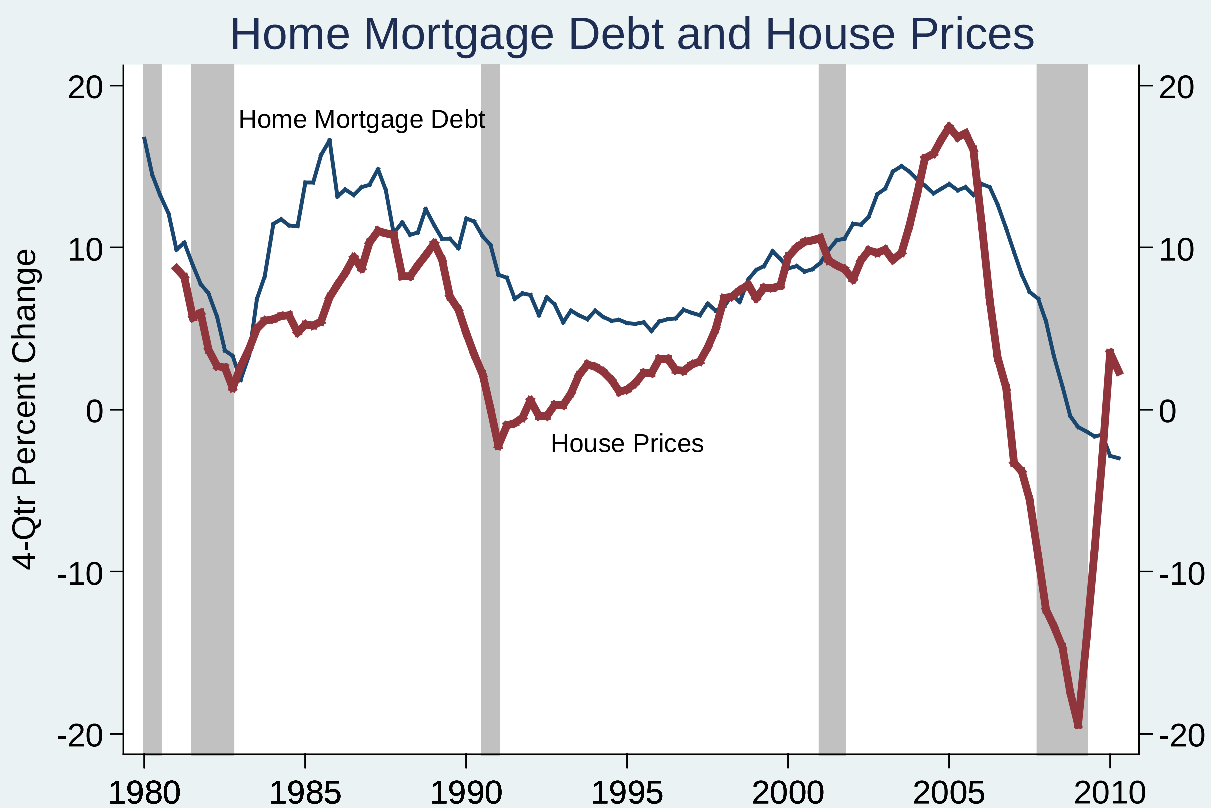
*Group defined as lowest income quintile of households with heads younger than 60.

Why Did Household Debt Rise?

"The most important factors behind the rise in debt and the associated decline in saving out of current income have probably been the combination of increasing house prices and financial innovation."

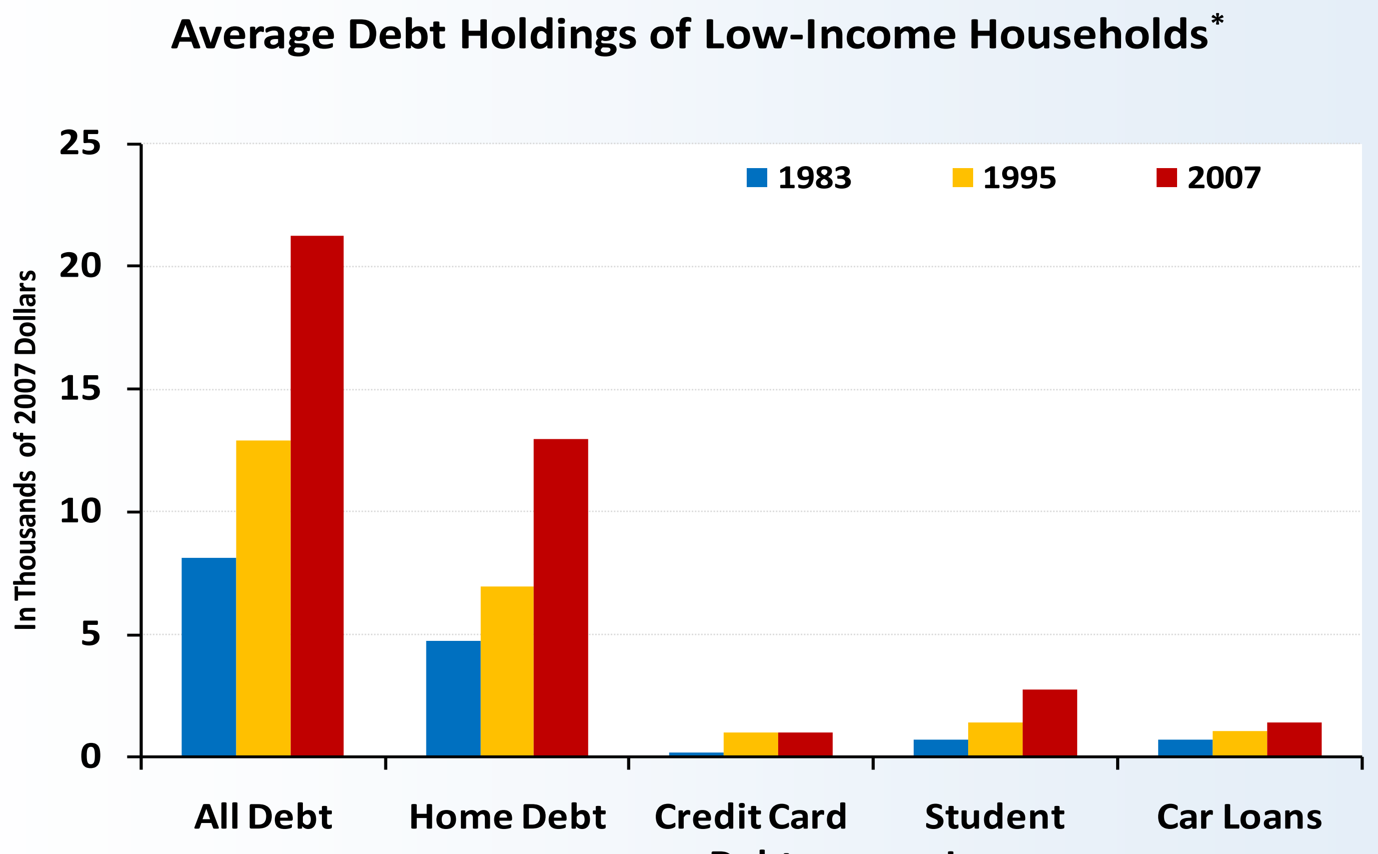
Dynan and Kohn, *The Rise in U.S. Household Indebtedness: Causes and Consequences* (2007)

Role of House Prices



Source: U.S. Flow of Funds Accounts and CoreLogic
Debt data through 2010q2. House price data through July, 2010

Mortgage Debt Also Seems to Be Key Factor for Low-Income Households



Source: Survey of Consumer Finance
*Group defined as lowest income quintile of households with heads younger than 60.

Financial Innovation and Rising Debt

- Technological advances have made it easier to collect, disseminate, and process information, so easier to assess creditworthiness and price credit accordingly.

- Contributed to "democratization" and lowered costs for those already able to borrow.

- Hard to quantify full effect of innovation as it has been incremental and taken so many forms.
  - » But story consistent with widespread and gradual increases in indebtedness: all age, education, income groups (Dynan, JEP 2009).

Some Specific Innovations Are Very Relevant for Low-Income Households

- Subprime and other “affordable” mortgages: e.g. Mayer, Pence, and Sherlund (JEP, 2009).
- Subprime auto markets: Adams, Einav, and Levin (AER, 2009)
- Payday lending: Skiba and Tobacman (2008); Barr, Dokko, and Keys (2009).

Credit Use and Household Economic Security

Credit Use and Household Economic Security

- Credit use has both benefits and risks for households.
- **For low-income households, it's a double-edged sword:**
  - » Credit can be more beneficial for this group
  - » Credit can be also be more dangerous for this group—things can be more likely to go awry and when they do the consequences can be worse.

Benefits of Credit Use

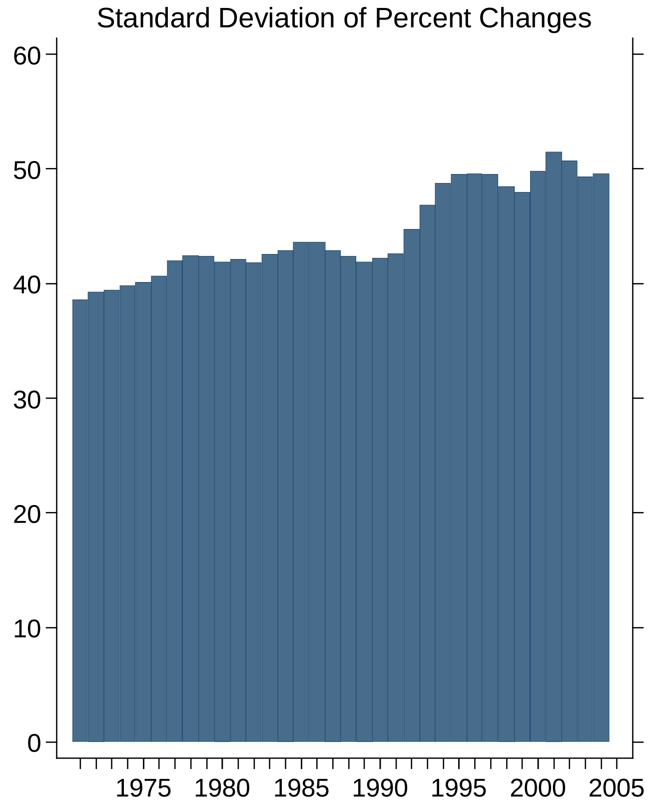
Credit Makes It Easier to Smooth Consumption

- Increases in credit availability have allowed consumption to be less responsive to income than in earlier decades.

- Dynan, Elmendorf, and Sichel (JME, 2006):
  - » Sensitivity of consumption to unusual declines in income has fallen much more than for unusual increases.

Ability to Smooth Consumption Smooth May Be Particularly Important Given Evidence of Rising Income Volatility

Figure 1. Volatility of Household Income.



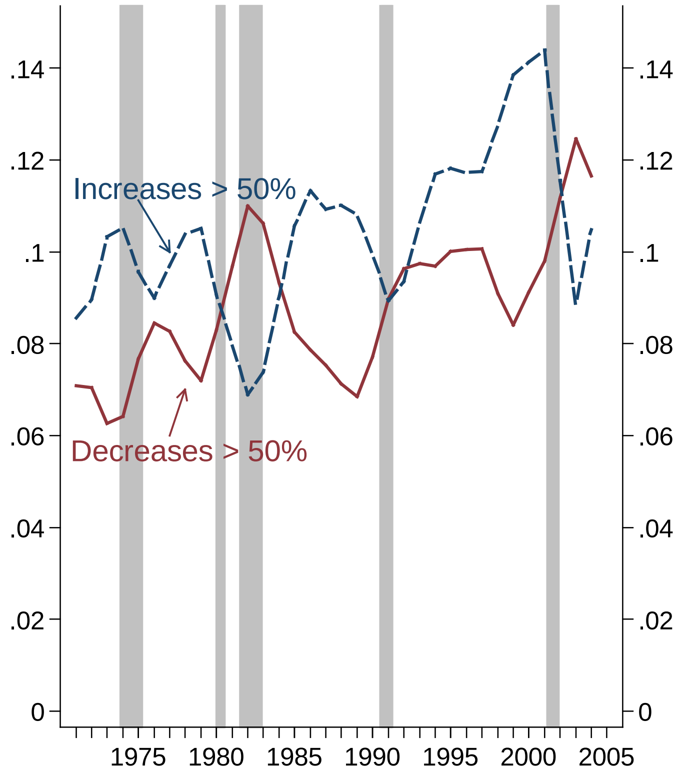
Source. Panel Study on Income Dynamics; 3-year moving averages of 2-year percent changes.

Dynan, Elmendorf, and Sichel, 2009:

- PSID data through 2005
- Focus on "family" income
- Standard deviation of growth across HHs up by 1/3 since late 1960s.

More Volatility Results from DES (2009)

Figure 2. Frequency of Large Increases and Decreases in Household Income.



Source. Panel Study on Income Dynamics; 3-year moving averages of 2-year percent changes; shaded areas denote recessions.

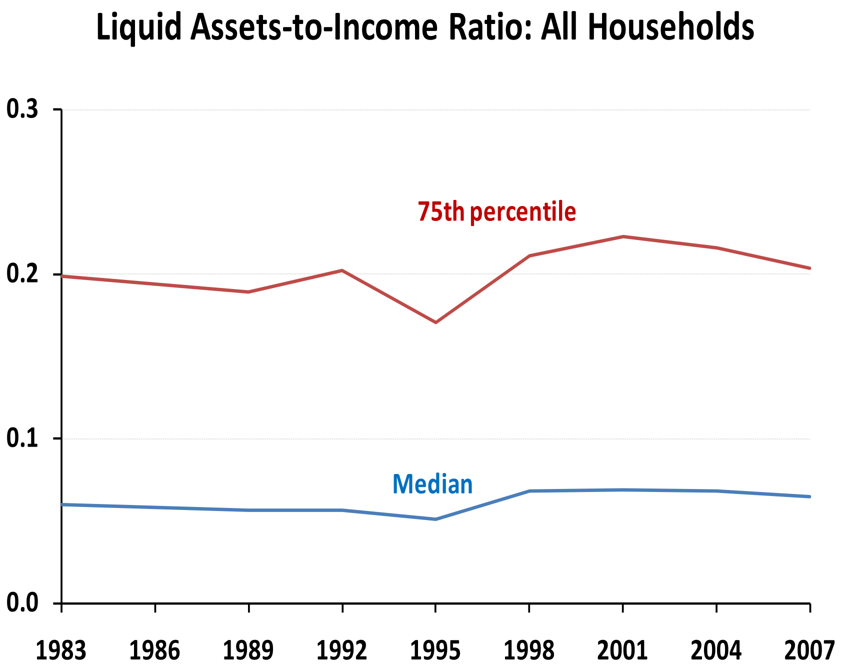
Much of the increase reflected rise in frequency of large income changes.

Pattern does not appear to be the result of voluntary choices.

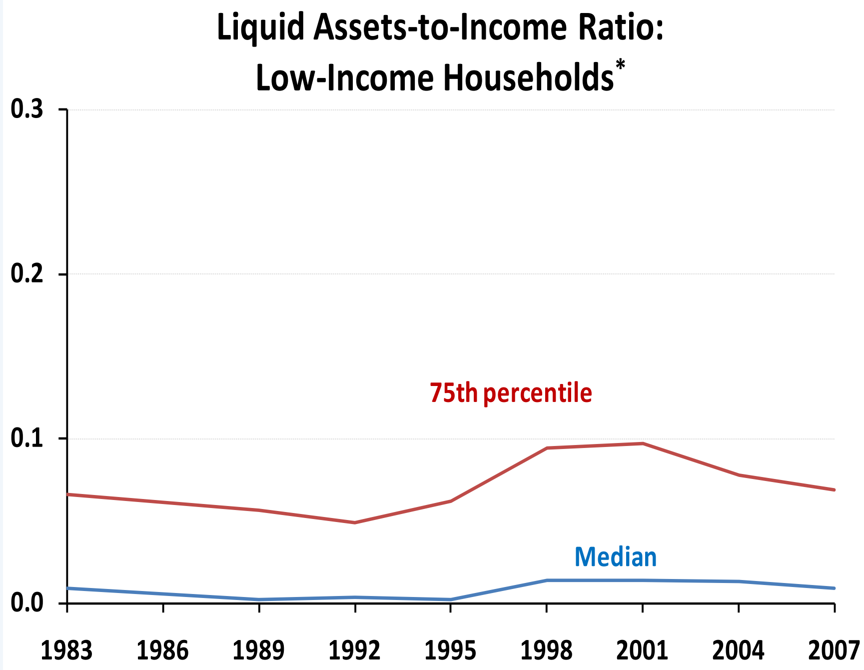
Benefits of Credit Related to Homeownership

- Homeownership not for everyone, but if financed prudently, it can be a way to promote household saving.
- For those who already had access to homeownership: increase in availability of mortgage credit allowed households to buy homes more in line with permanent incomes (Gerardi, Rosen, and Willen, JF, 2010).

For Low-Income HHs, Lower Levels of Liquid Assets Mean Credit Can Offer More Benefits



Source: Survey of Consumer Finance



Source: Survey of Consumer Finance

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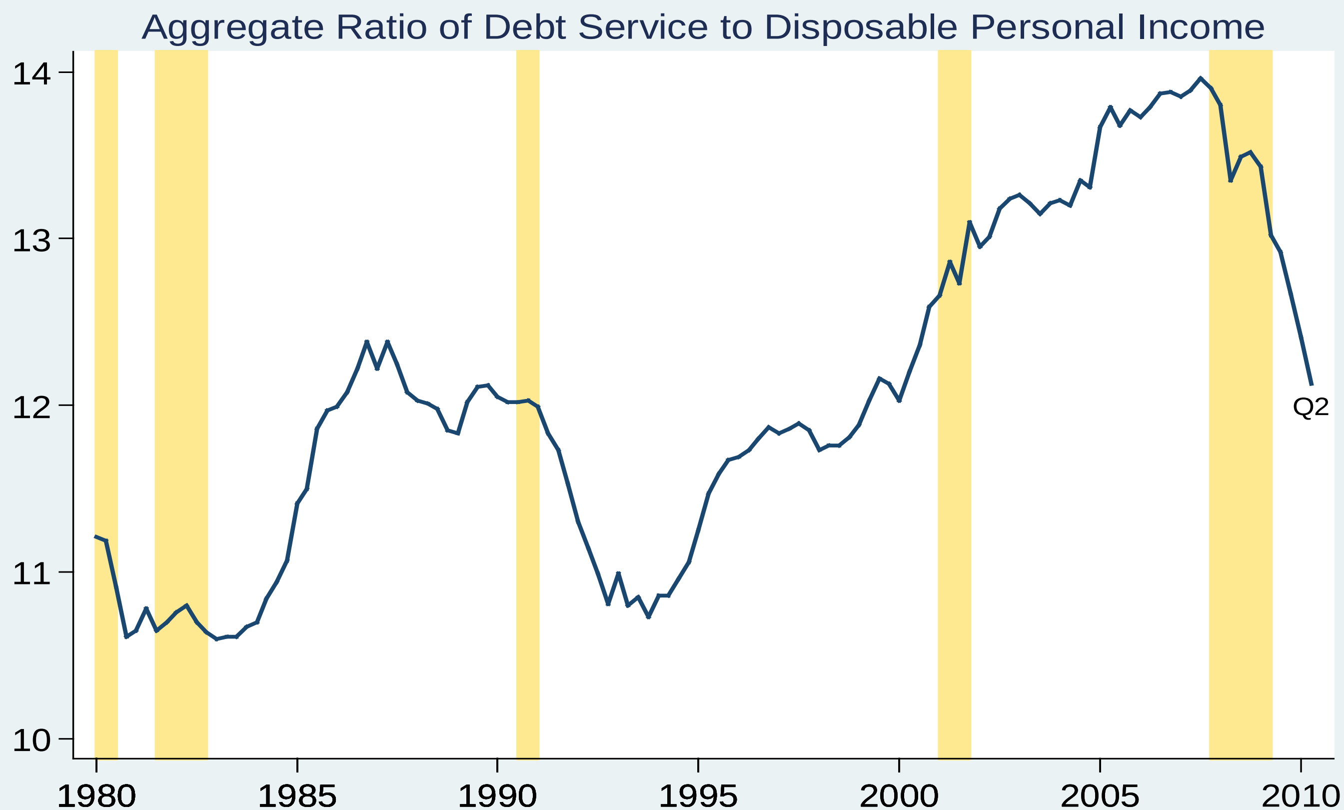
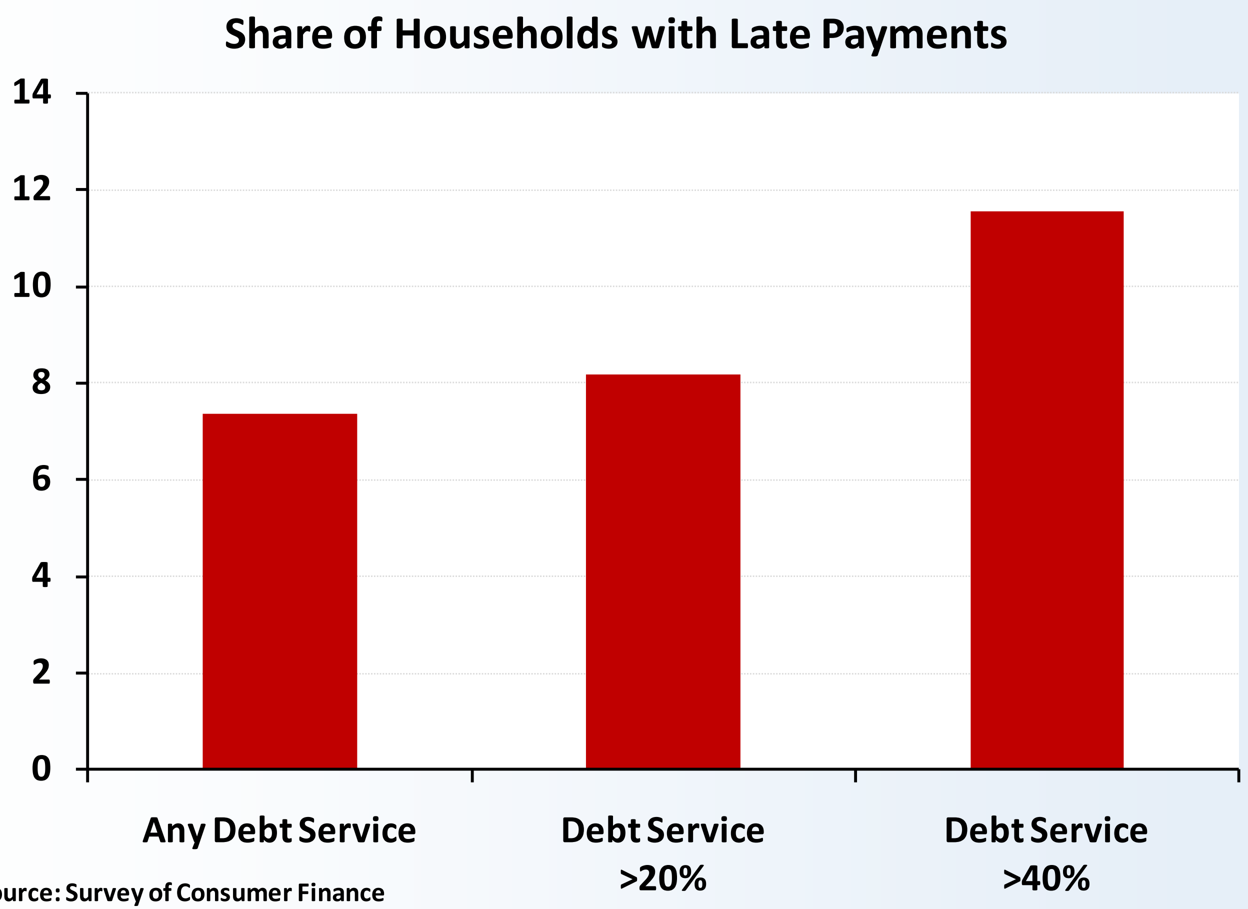
Risks Associated with Credit Use

Debt Service Obligations Grew with Debt



Source: Federal Reserve

Higher Debt Service Associated with More Financial Distress



Source: Survey of Consumer Finance
Note: Average across all surveys since 1989

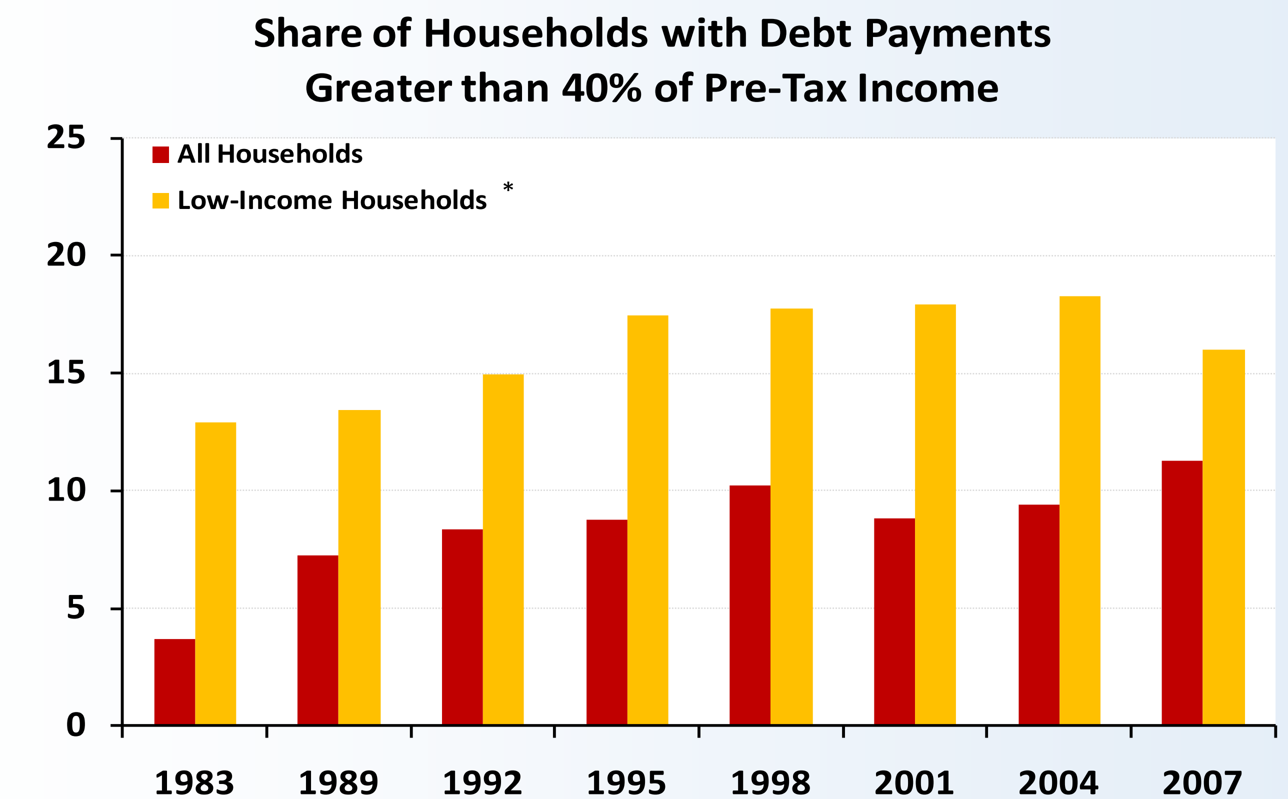
Consequences of Debt Payment Problems

- Impaired future access to credit

as well as …

- Possible bankruptcy: costs of filing, stigma.
- Possible foreclosure: stigma, may lose home, relocation may lead to loss of job and other family disruptions, communities suffer when foreclosures are concentrated.

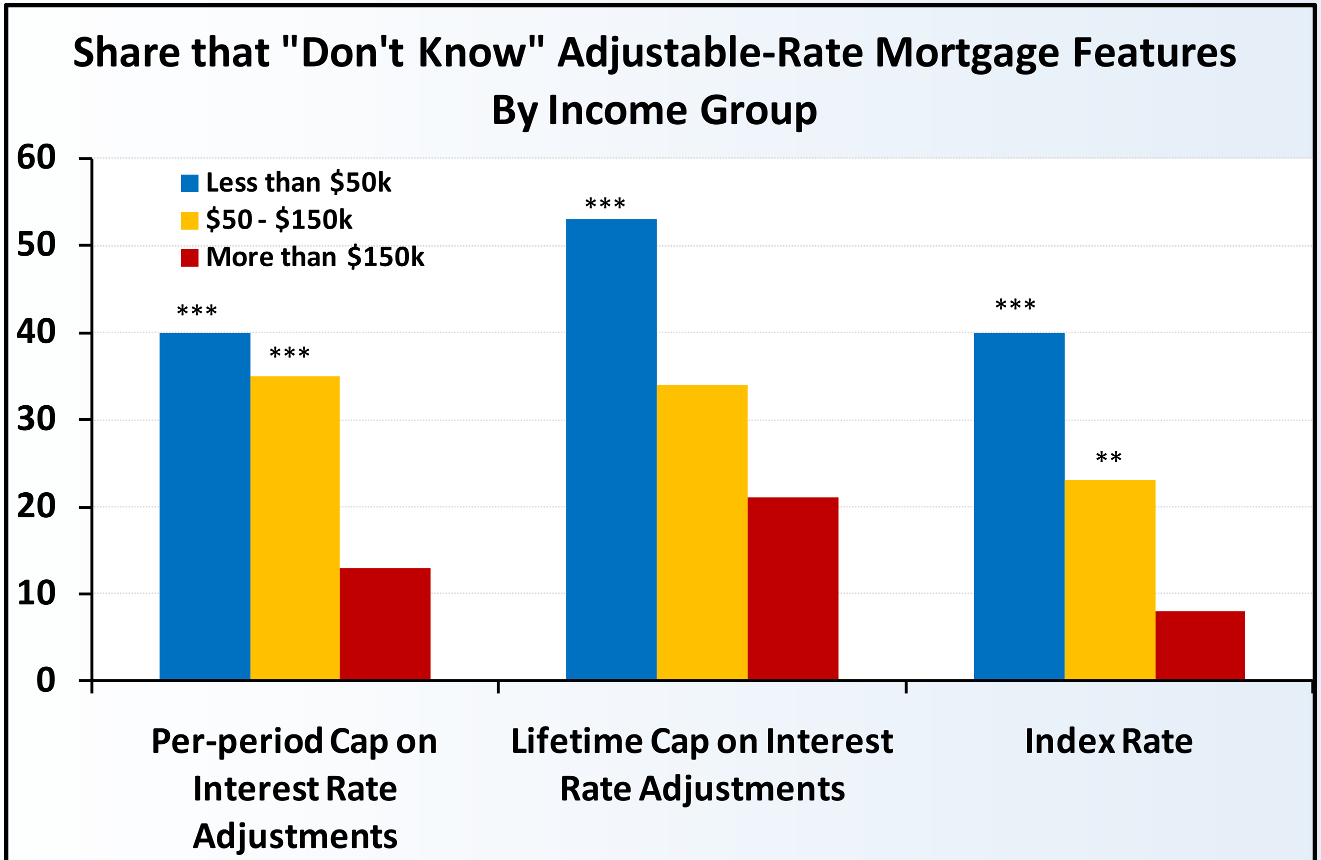
Debt Service Obligations Tend to Be Higher For Low-Income Households



Source: Survey of Consumer Finance

*Group defined as lowest income quintile of households with heads younger than 60.

Low-Income Households Also More Likely to Be at Risk of Debt Service Surprises



Source: Bucks and Pence (2006) based on Survey of Consumer Finances
Note: Statistically Different from Zero at 1% level (***) and at 5% level (**)

Another Downside of More Credit: Enables An Increase in Exposure to Risky Assets

Change in Wealth Implied by a 20% Decline in Median House Value (as a Fraction of Median Homeowner Income)

	1995	2001	2007
All Households	-.47	-.47	-.65
Low-income Households*	-.80	-.87	-.95

Source: Survey of Consumer Finances.

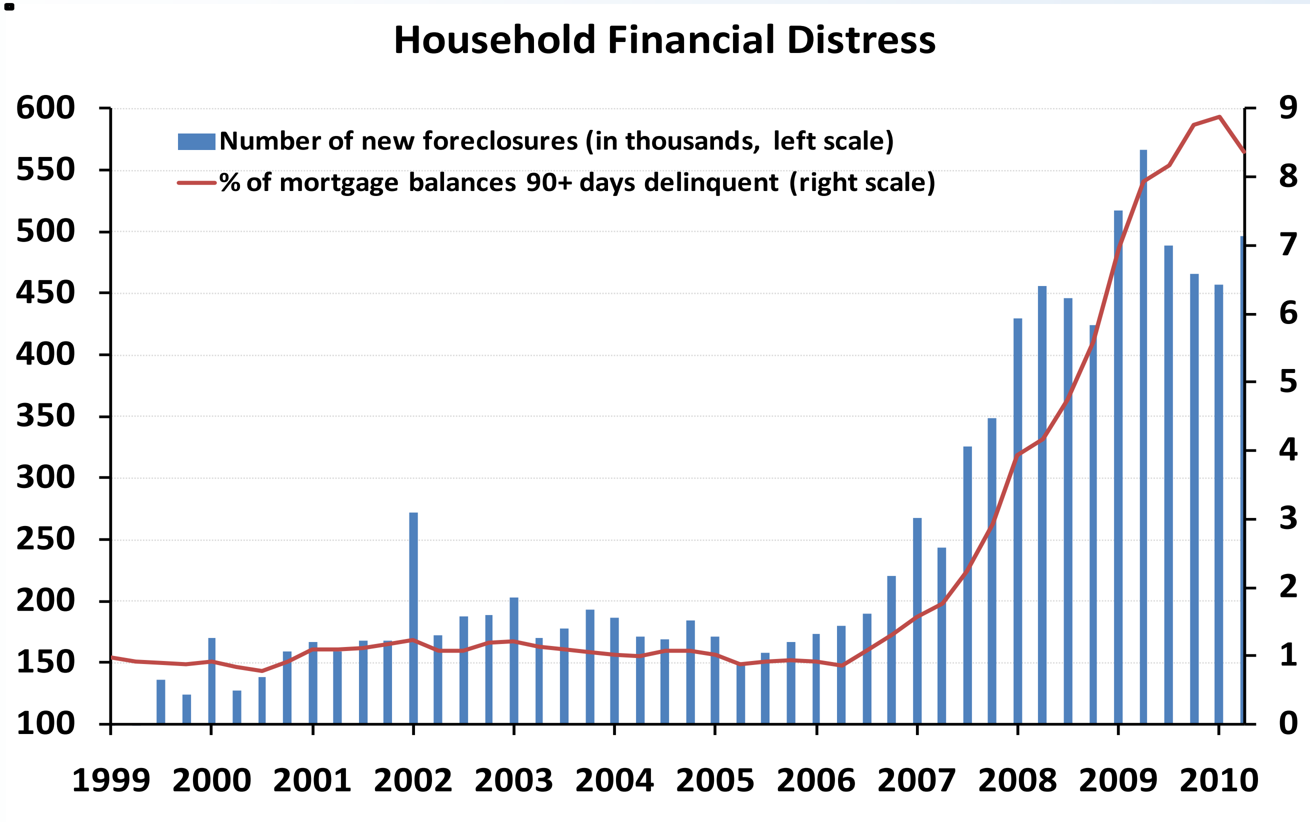
*Group defined as lowest quintile of households with heads less than 60.

Thoughts about Financial Regulation

Point #1: Recent Crisis Example of How Judging How Much Credit is Too Much Credit is Difficult Ex Ante

- Not so hard ex post (see next graph!)
- Why didn't regulators do a better job?
  - » Reluctance to call bubble
    - – not just in regulatory community
  - » Measures showing the risky tails of the household credit distribution were not readily available
    - – should do better on this next time
  - » Didn't recognize exposure of broader financial system
    - – issue for future systemic regulators

Too Much Credit



Source: Federal Reserve of New York. Last chart point is 2010:Q2

Point #2: Goal in Credit Regulation Should Be to Achieve Balance

- Need to strike the right balance between protecting consumers from predatory lenders and financial products that are prone to misuse, while at the same time ensuring that creditworthy households have access to an evolving range of sensible financial products.
- Achieving the right balance is particularly important for low-income households because of the "double-edged" sword aspect of credit access for them.

Point #3: Getting to this Goal Will Be Challenging

- **Financial education and disclosures** appealing because of the potential to solve problems without restricting choice but have inherent limitations:
  - » Some (many?) products are just too complicated for many people to understand.
  - » Self-control and other behavioral issues may lead to problems even if people understand what is best for them.

Point #3: Getting to this Goal (cont'd)

- Trying to manage risk by **controlling the range of products offered** is complicated:
  - » Doing so by ruling out specific products puts regulators in a potentially unwinnable race with financial innovators.
  - » Doing so by limiting offerings to a small number of "plain vanilla" products seems overly restrictive.
    - – One variant is making people "opt out" of standard products but unclear how effective that would be.

Point #3: Getting to this Goal (cont'd)

- New ideas coming out of behavioral literature but these are largely untested:
  - » Create CFPB "seal of approval" for safer products
  - » Force lenders to reveal full range of products for which borrower qualified
  - » Make lenders liable for mortgage broker misconduct
  - » Change fiduciary duties of mortgage brokers

Concluding Thoughts

- Credit pendulum swung too far in the “easy” direction in the early to mid-2000s, imposing high costs on many borrowers and—by triggering a credit crunch—on the broader economy.
- Consumer regulators need to reduce odds of this happening again but also need to be careful not to overreact:
  - » Wouldn’t want to undo all of the benefits of greater access to credit, particularly for low-income households.
- New agency granted important powers and large budget but will it be able to attract staff and resist competing pressures.