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Making Sure Money Is Available When We Need It

Protecting Household Assets Must Become an Integral Part of U.S. Savings Policies

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Introduction and summary

Household wealth—the difference between a household's assets and its debt—is a crucial aspect of economic security. It allows households to pay for necessities during an economic emergency, and it permits families to invest in their future—pay for their children's or their own education, start a business, switch jobs, move to advance their careers, and plan for a secure retirement.

For a family to benefit from it, household wealth has to actually be there when households need the economic security that comes from having wealth. Over the past few decades, however, household wealth has become increasingly volatile, meaning that wealth has swung up and down much more widely over the past two decades than it did in the preceding decades after World War II.[1] Macroeconomic instability due to the housing and stock market bubbles—and bursts—is one of the contributing factors, but so is greater household-wealth risk exposure due to more investments in the housing and stock markets and greater household debt than in the past.

Some risk in household wealth is unavoidable; wealth will always fluctuate somewhat due to household risk exposure in the stock and housing markets and debt. But families need to better manage their risk exposure to make sure that they can rely on their wealth when they need it. Household-wealth risk captures the unpredictability of future incomes that are derived from household wealth. Financial markets, especially those for stocks and housing,[2] will always be subject to substantial ups and downs and will thus entail risk. Households could, in theory, buy insurance to protect themselves from financial risk, but insurance products can be costly and ineffective—if, for example, the insurance companies fail just when financial markets crash. The alternative is for households to manage their risk in such a way that they take advantage of potential investment upsides while keeping the downsides to an acceptable level. Households, for instance, could maintain a steady allocation of their assets in the stock and housing markets by selling stocks when prices rise and investing more in the markets as prices fall.

Poorly managed risk could result in excessive wealth volatility and—ultimately—in less wealth than would be the case with well-managed financial risk. First, increased wealth volatility likely reduces the amount that households save. This is because households react to rapidly rising wealth by saving less or borrowing more so that they can spend more on things such as food and clothing than they have in the past. This is known as the "wealth effect," when households believe they have more money on paper than they actually have. But when a market correction occurs and wealth suddenly decreases, households often cannot save enough money—or shed debt quickly enough—to make up for their losses.

Second, greater wealth volatility makes it harder for households to plan and save for their future. When faced with greater wealth volatility, households have a harder time predicting how much money they will be able to rely on for retirement—which is the main reason people save money. Households are left guessing what their future retirement income will be, and their guesses can become increasingly inaccurate if their wealth fluctuates more as they get closer to retirement. Some households will retire too early—in other words, they will have a lot less money in retirement than they thought they would have, lowering their standard of living in retirement. Alternatively, some households will retire much later or save more and spend substantially less than they did before retiring. Less spending by retirees, though, could slow overall economic growth.

Third, greater wealth volatility also means that people will be unhappier than they would be if they managed their risk well. They will feel more anxious about their financial future and thus buckle down, investing less in long-term projects such as starting a business, sending their kids to college, and switching to careers where their skills are a better fit. They will put their money into cash accounts instead of investing it, they will not save enough money to pay for their children's college education, and they will stay in jobs that no longer adequately fit their skills—and again, households end up with lower standards of living over time.

This report considers data on household wealth—and particularly, household-level data for older nonretirees[3]—to see if household risk exposure, on average, has become excessive and if policymakers should therefore consider encouraging better risk management strategies for savers. The comparison of household risk exposure over time—specifically, from 1989 to 2010—and between household groups can provide a general indication of whether risk has been more poorly managed in recent years, thus becoming excessive.[4]

The first indication that risk has become excessive is that the amount of wealth over time has not trended upward. Well-managed risk would have allowed households, on average, to reap the upsides of booming markets without losing their shirts in the down markets. Wealth-to-income ratios—a typical measure of economic security, since wealth is intended to replace income once it disappears—should have therefore trended upward over time.[5] The evidence shows, however, that wealth-to-income ratios were essentially flat from 1989 to 2010, although they have fluctuated much more than in the past.

Second, risk exposure between household groups should have converged over time. Financial-market changes—especially greater access to individual investments through retirement savings accounts, broader access to credit markets due to regulatory changes, lower costs of investing due to increased competition, and lower interest rates as inflation has declined—should have made it easier for households to manage their risk. The gap between those groups of households that had high levels of risk exposure and those who had low levels of risk exposure in 1989 should have declined by 2010. The household-level data, however, shows no convergence in household risk exposure. In fact, the gap widened depending on some household characteristics such as race and ethnicity.

Third, household risk exposure should have fallen during market crises, when asset prices fall and access to debt declines, lowering the exposure to further asset-price declines in the future. The United States experienced three substantial economic and financial crises between 1989 and 2010—the savings and loan industry crisis that took place in the late 1980s, the bursting of the dotcom bubble coupled with the recession of 2000 to 2001, and the burst of the housing bubble in 2007 coupled with the Great Recession of 2007–2009. Crises are periods of substantial financial and economic turmoil that make it harder for households to properly manage their risk exposure. In other words, external trends—stock- and house-price changes, as well as debt—dominate what happens to household risk exposure, but not necessarily how households make decisions. All external trends should primarily decrease during a crisis, as stock and house prices fall and access to credit declines. Household risk exposure should therefore decline as actual risk materializes because risky asset prices fall, making it harder to go into debt and allowing households to save. The data analyzed in this report suggest that risk exposure did not actually fall during the three crises that have occurred since 1989—and that households may have, in fact, been exposed to more risk as risk materialized, which has possibly set the stage for the next boom and bust cycle.

Fourth, household risk exposure between the crises should have been relatively stable. According to the data, there were two periods of stability between the three crises: one lasting from 1992 to 1998 and the other lasting from 2001 to 2007. These should have been periods of less economic and financial turmoil than the crisis periods, which should have made it easier for households to manage their risk exposure. Household risk exposure, therefore, should have been relatively stable between crises, at least in the aggregate. The data suggest, however, that household risk exposure grew, especially in the latter period.

The data on household risk exposure suggest that household risk was not managed well from 1989 to 2010 and that there is room for policymakers to encourage better strategies to manage household risk as part of incentivizing the public to save more money. Better risk-management strategies include greater transparency of financial risks to households, more accessible risk disclosure for households, and more comprehensive risk disclosure in financial statements to households. Policymakers can also suggest more regulatory and financial incentives by, for example, promoting model investment portfolios—whereby the ratio of risky assets stays constant over time—and safe investments—such as Treasury Inflation Protected Securities and life insurance annuities, among other strategies.

It is time to start addressing rising household risk exposure. Policies addressing household risk exposure have changed little in the aftermath of the Great Recession: Requirements for risk disclosure are still limited and complex, and there is still only some regulatory relief for employers who offer safe investments with some rate of return as default investments in their 401(k) plans, among other things. There are already signs that household risk exposure may rise again, especially because banks stopped tightening lending standards for mortgages and other key forms of consumer debt in 2010.[6]

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