Delving into the murky metrics of financial risk

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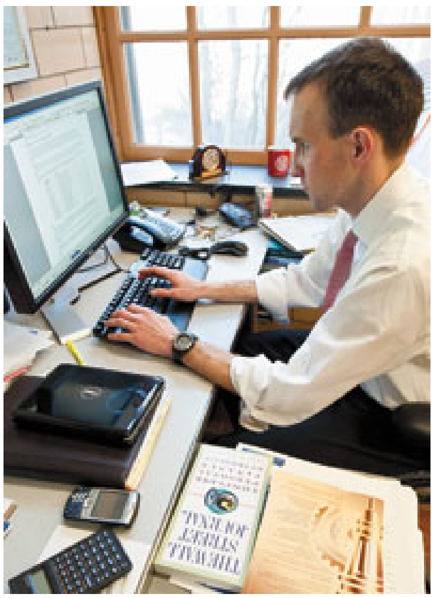

Michael Collins, an assistant professor in the School of Human Ecology, is pictured in his office. Photo: Jeff Miller

(PhysOrg.com) -- The way J. Michael Collins sees it, United States consumers aren't necessarily less informed about financial risk than consumers from other industrialized nations. What Americans do have, however, are an abundance of ways to screw up.

Whether it's option-arm mortgages and credit card teaser rates or simply taking on too big of a credit burden, it has become increasingly easy to tumble down the rabbit-hole of personal financial trouble. As an assistant professor of consumer science, Collins is interested in how people assess their own financial risk — whether we understand it, view it accurately and why in some cases we choose to ignore it.

“There is a very big issue right now surrounding consumer debt literacy,” says Collins, who joined the School of Human Ecology (SoHE) faculty last fall. “The trend nationally is to move more of the credit risk onto individuals. People now manage their own 401(k) plans, and there are fewer restrictions on credit-card debt. For better or worse, we’ve democratized a lot of these financial products, and many people aren’t prepared.”

Collins teaches a hugely popular course in SoHE on personal financial planning, and a number of his research projects are built around those financial “teachable moments” in the lifespan. It’s a tough topic to broach in high school settings, he says, since money management may seem like an alien concept to teenagers who’ve yet to open a checking account.

The key opportunities for an engaged audience are at the start and completion of college, the start of a new job, during income tax season, or when the first child comes along, Collins says. And there’s always the early-50s retirement panic. Collins has some interesting research projects involving some of these key milestones.

For example, one current project is investigating how college students make credit-card decisions. The average student now graduates with $2,500 to $3,000 in credit-card debt, Collins says, a financial drain routinely compounded by 18-19 percent interest rates. “Most students get their credit cards at freshman year, then make the minimum payments. So those late-night pizzas might end up costing $100 a pop.”

Collins’ study looks at how much students really know about their contracts. Do they know the interest rate? Is it a fixed or introductory rate? Are there annual penalties or fees? Many students, even those in business or quantitative fields, got the answers wrong.

His study also looks at the metrics of mood, or affective science, and how it affects thinking about risk. Students who were generally anxious, for example, had a harder time determining whether key information was missing about their cards, such as annual fees. “Students who were in more positive frames of mind were more discriminating in their answers,” he says.

Another current study is looking at ways to encourage more people from lower-income backgrounds to use their tax returns on investments, such as savings bonds or CDs. His study is connected to programs in Madison and nationally that help residents below a certain income level get their taxes done for free.

“Many people get more than they expected through earned income tax credits, housing credits and child care credits,” he says. “They have a windfall and everyone knows it — major retailers are also gunning for that money. We’re trying to get people not to look at it as free money but as a financial management opportunity.”

Of course, one of the biggest financial “teachable moments” is home ownership — arguably the sector experiencing the greatest pain in the current economy. Collins worked as an analyst from 1998-2004 with NeighborWorks America in Chicago, an agency that helps connect people with affordable housing options. It was during this time that Collins first began studying a surge in foreclosures in a specific south Chicago neighborhood, which turned out to be a “canary in the coal mine” for the impending housing bust.

This community of solid working-class families had a very high concentration of recently granted sub-prime mortgages, and home equity was being extended to many people with poor credit. The national average for foreclosures was about 2 percent, but in this neighborhood it was 5-8 percent and in a few spots, as high as 15 percent.

Foreclosure is a financial bomb that destroys a credit record for at least seven years, and usually comes after people have run through every conceivable financial option. “By the time they are actually losing their home,” he says, “there is nothing left.”

In this neighborhood, Collins wanted to understand the fallout that occurred from this rash of foreclosures, and whether it had a spillover effect on the next generation of renters looking to buy. His study found a lot of pessimism and a recognition that loans would be much harder to attain. However, they became much more open to credit counseling and home-buyer education.

“We see that as a very good sign whenever people are driven to become more informed,” Collins says. “There was a far different pressure in the early part of this decade, which was ‘act now or you could lose out.’ People now realize there was a high price to pay for that.”

Provided by University of Wisconsin

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