The Federal Reserve Board

Testimony of Governor Janet L. Yellen

Trends in consumer lending

Before the Subcommittee on Financial Institutions and Regulatory Relief of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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I am pleased to appear before this Subcommittee today to discuss trends in consumer lending and the Federal Reserve Board's view of how recent developments in this sector are affecting U.S. commercial banks. As the Subcommittee knows, consumer delinquencies on nonmortgage debt have increased in recent periods and are beginning to affect profit margins at some financial institutions. The Federal Reserve has been monitoring these conditions and discussing their implications with individual banking organizations and industry groups. However, given the generally strong financial condition of the institutions most affected by these developments and that of the U.S. banking system, we believe that these adverse trends do not currently present a material threat either to individual banking organizations or to the overall banking system.

In my remarks, I would like to begin with an overview of the economic developments that have caused the Federal Reserve to devote greater attention to consumer lending matters. I shall then turn to the emerging--and still well contained--consequences that these developments are having on the banking organizations that are most affected and on the industry, overall. Since current concerns are predominantly centered on revolving credit portfolios, I shall focus my comments on a discussion of credit card lending activities. Finally, I shall discuss the steps taken by the Federal Reserve throughout the past year to caution its examiners, state member banks, and bank holding companies about the risks inherent in weakening credit standards and to ensure that financial institutions are taking appropriate action to address emerging problems in consumer loan portfolios.

Economic Trends

Economic conditions in the United States have in recent years been favorable to growth in spending and borrowing by the household sector and to strong growth in consumer lending by U.S. banks. Just since early 1992, nonfarm payroll employment has increased nearly 11 1/2 million, driving the U.S. unemployment rate to 5.3 percent in June of this year, its lowest level in six years. As one consequence, personal income has risen substantially. The dramatic rise in stock and bond prices in recent years has also produced sharp gains in wealth for some households.

During this same time period, rates and fees on consumer financing products have been coming down. Average credit card rates which stood at about 18 1/4 percent in late 1991 declined to less than 15 1/2 percent by May of this year. At the same time, annual fees on credit cards were dropped by many institutions. In addition, declining residential mortgage rates throughout most of this interval contributed to a significant reduction in monthly payments on such debts. While mortgage rates have recently backed up, the relatively low mortgage rates of the early 1990s precipitated a refinancing boom that allowed many consumers to significantly reduce their monthly mortgage obligations.

Combined, these generally favorable developments have given consumers the confidence and financial foundation to incur additional debt in order to finance major purchases. Nevertheless, some concerns remain about the increase in consumer debt. Aggregate statistics do not address conditions in individual households, an important consideration because the economic expansion has not affected all households equally. Further, while for some households the use of credit in making a purchase is simply a matter of convenience or a means of managing liquidity, for others, borrowing may be a means of sustaining consumption through a period of household economic distress.

Nonmortgage consumer debt has grown at double-digit rates over the past two to three years. This rapid pace is not unusual for a period of economic expansion. Indeed, as the economy emerged from recession in 1991, growth in nonmortgage consumer debt was much slower than typical, reflecting sluggish spending on durable goods and lingering fears about long-term layoffs and other threats to job security. However, by 1994, consumer confidence had recovered considerably and demand for autos and other durable goods had strengthened. Nonmortgage consumer debt grew by about 15 percent that year and the next, but even this rapid pace remained below that of a decade earlier. Lower inflation in recent years can account for some of the difference.

Recently, revolving credit--primarily credit card debt--has been, by far, the fastest growing component of consumer debt, averaging annual increases of 20 percent over the past two years. However, that performance--rapid growth during an expansion--is also typical of the last two decades. The cumulative effect has been a dramatic rise in the relative importance of revolving credit. In 1977, when first reported separately to the Federal Reserve, revolving debt of U.S. consumers totaled $30 billion, or 14 percent of all consumer debt. In May of this year, the amount outstanding was $444 billion, or nearly 40 percent of the total. Surveys show that 80 percent of U.S. households now have at least one credit card.

A consequence of the increase in consumer borrowing of recent years is that debt servicing requirements--that is, the amount of scheduled payments of principal and interest--have consumed a bigger share of disposable income. Our staff estimates that this ratio, which includes both mortgage and nonmortgage payments, peaked in late 1989 at about 17 1/2 percent, and then declined over the next four years to about 15 1/2 percent in 1993, as households curtailed their borrowing and average interest rates on their debts fell. Since then, the ratio has risen to about 16 3/4 percent. This standard measure is based on aggregates that include households without debt and uses estimates of scheduled payments. The Survey of Consumer Finances, conducted periodically by the Federal Reserve, suggests that the median ratio of actual debt payments to pretax income of debtholders was relatively constant from 1989 to 1995, as was the proportion of the debtholders that had very high debt repayment to income ratios. What has tended to rise over time is the proportion of low income households with an unusually high fraction of their income absorbed by debt repayments. Unfortunately, the latest data-- which are still preliminary--are a year old.

To be sure, some of the increase in consumer debt is merely a reflection of the greater prevalence of convenience use of credit cards as a substitute for cash or check payment, with card balances paid in full each month. This is a trend that has been reinforced in recent years by a variety of incentives, such as the availability of frequent flier miles. But--as our Survey of Consumer Finances suggests--there are also signs that some households have let their debts build up to the point where they may have difficulty servicing them: loan delinquency rates and personal bankruptcies are both up.

Generally speaking, delinquency rates on nonmortgage consumer loans have been trending up for the past year, with some of the increase in delinquency rates merely the result of the "seasoning" of recently underwritten loans, a typical pattern. However, for credit cards, the widely followed statistics of the American Bankers Association show that the delinquency rate by number of accounts is historically high. The more comprehensive figures from the official bank call reports based on the dollar volumes of loan balances, however, show a much milder upturn in delinquencies--but still one warranting our attention.

Credit Card Lending by Commercial Banks

These economic and market developments have had clear effects on banks. As a percent of total bank loans, consumer debt (including mortgages) has been increasing steadily for some time--from 33 percent of total bank loans in 1980 to roughly 40 percent five years ago and about 44 percent today. This shift in asset allocation by banks reflects several factors, not the least of which is a declining market share of the credit extended to commercial customers. In part, it also reflects substantial growth in credit card debt. Since late in 1991, credit card debt has risen about twice as fast as total loans. If one adds back estimates of the outstanding securitized credit card debt of banks, such credit has risen almost three times as fast as total loans at banks.

The industry's total increase in credit card loans has come about with the growing popularity of cards, supported by their aggressive marketing by some banks. Marketing campaigns typically involve broad-based, regional or nationwide solicitations and often include pre-approved lines of credit based on the results of "credit scoring" models that statistically evaluate an individual's creditworthiness. In addition, banks' success in securitizing consumer debt instruments for resale in capital markets has increased both their willingness and their ability to make such loans.

Also encouraging more aggressive competition have been heavy investments in the technological infrastructure needed to evaluate, originate, and manage effectively such credits. Indeed, the major competitors have increasingly used special promotions offering reduced fees and rates to obtain market share and maximize the scale economies of their operations. Some have also been more willing to take on greater risk in the interest of increasing loan volumes. Such competitive zeal all too often attracts weak or otherwise marginal borrowers. The resultant adverse selection of credit risks has contributed to a decline in asset quality at some banks.

While these problems have eroded returns at individual institutions, a critical factor that continues to contribute to the emphasis on such lending has been the significant, overall long-term profitability of the credit card business. This is not irrelevant for a banking system whose largest institutions had been under earnings pressure through much of the 1980s due to their exposures to developing countries, energy sector borrowers, and commercial real estate markets.

One indication of the profitability of credit card lending can be seen in analyzing the so-called credit card banks (defined here to include banks with more than $1 billion in assets and with credit card balances comprising more than 50 percent of total assets). For various legal, tax, and operating reasons, most large banking organizations find it convenient to establish such banks, separate from their other operations, as a vehicle for booking most, if not all, of their credit card loans. These roughly 30 entities most recently reported an average return on assets of 2 percent, compared to 1.1 percent for all insured commercial banks. They also maintained average equity to asset and loan loss reserve to total loan ratios well above industry averages.

The strong earnings profiles of the credit card banks, and their associated capital and reserve allocations, are reflections of the risks associated with this form of lending. Higher risk and higher return go hand- in-hand, and the higher capital and reserves associated with this form of credit are required to balance the risk. Put another way, lenders active in the credit card business are conscious of higher potential loss rates and expect returns that will fully absorb these losses and still provide an adequate profit margin. They also are aware of the necessity to take steps to assure that the variance in returns on these loans do not create significant solvency concerns for their organizations.

Increased Incidence of Personal Bankruptcy

On several occasions during the past year or so, various industry and professional groups have expressed concern about perceived weakening of credit standards within consumer lending, including the aggressive marketing of credit cards. At these meetings, some of the private sector participants have given anecdotal evidence of practices that they believe to be potentially harmful in the long run, either to financial institutions or to the consumer lending market, in general. Similar, and still anecdotal, indications of declining standards and increased competition have been provided by various state banking delegations that periodically visit the Federal Reserve and other bank regulatory agencies.

One concern cited with increased frequency is a higher incidence of borrowers with substantial credit card debt declaring bankruptcy, without any previous record of missed or delinquent payments. Bankers often cite borrowers who have tens of thousands of dollars of outstanding loans on a number of credit card accounts with various financial institutions. Such borrowers may not always be readily detected by controls and monitoring procedures and could contribute to increased chargeoffs at card issuers.

Several factors are said to be contributing to higher rates of personal bankruptcy, including greater social acceptability of the practice, changes in law that have made bankruptcy less onerous for individuals, and increased advertising by bankruptcy attorneys. Whatever the underlying causes, it is a reality that credit card issuers and others must address. Moreover, banks and nonbanks that issue credit cards and other consumer lines of credit should also consider the extent to which the trend is fueled by their willingness to lend to individuals whose credit history is dubious. One may not wish to foreclose the possibility of renewed credit access to those who have been forced by uncontrollable circumstances to seek the protection of bankruptcy, but it should be recognized that undue generosity on this score only encourages greater use of the bankruptcy remedy and consequent chargeoffs.

Supervisory Response

In response to these and other indications that terms of credit and credit standards may have been declining, about a year ago the Federal Reserve issued an advisory letter to its examiners and supervised banking organizations cautioning them about the risk of weakening standards. This advisory also requested Federal Reserve examiners to discuss any questionable easing of standards with bank management, regardless of whether quantitative measures of problem loans had begun to increase.

Since March 1995, the Federal Reserve has also been conducting a quarterly survey of its most senior examiners to track their assessments of conditions in the banking market, including their assessments of any changes in lending terms and conditions for consumer loans. To supplement these surveys, regular discussions are conducted with bankers and supervisory officials at the Reserve Banks to ascertain their opinions on current lending conditions.

The Federal Reserve has also recently undertaken a number of initiatives to focus its examinations more tightly on the activities exposing financial institutions to significant risks and to heighten its emphasis on evaluating management processes to identify, measure, monitor, and control the risk of banking activities. We believe that these enhancements to our supervisory procedures will further improve our ability to detect nascent problems--such as those arising from the increased and more accommodating consumer lending of recent years--and will foster appropriate responses by bank management. Consistent with these initiatives, an interdistrict task force of Federal Reserve examiners is currently conducting a comprehensive review of the retail credit and credit scoring operations of several large bank holding companies.

Earlier this year, we also implemented procedures whereby examiners assign specific ratings to an institution's overall risk management processes, including its internal controls. This requirement, we believe, further highlights the importance of sound management practices and should help to provide more specific feedback to senior management of the examined institution. In the context of consumer lending, such assessments generally address a banking organization's operating strategies for increasing market share, its goals, and the controls in place to maintain credit standards, including ongoing review of the credit strength of its loan portfolio. Examiners also typically evaluate the adequacy of the institution's information systems and the appropriateness of the information provided to directors and senior managers.

Recently, our supervisory activities, surveys of examiners, and discussions with bankers all have supported the view that banks are recognizing weaknesses in the consumer lending market and are actively adjusting their underwriting and monitoring procedures for these loans. Some banks have also increased their levels of reserves for these loans in recent months.

I should also note that in each of the two most recent Federal Reserve Senior Loan Officer Surveys approximately one quarter of the respondent banks, on net, had tightened underwriting standards for approving new credit card applications. More broadly, the proportion of respondents less willing to make consumer installment loans slightly exceeded the proportion that was more willing to lend, for the first time since 1991. Such a revisiting of current credit standards and practices seems well considered, given the length of the current period of economic expansion and the signs of weakness in some elements of consumer finances that we have seen.

Conclusion

To sum up, the rapid growth in consumer lending by banks, particularly that involving credit card loans, reflects a natural evolution of banking activities toward the household sector and has generally enhanced consumer convenience and produced significant profits for banks. In recent years, this growth has been due, in part, to aggressive solicitations of credit card customers by a relatively small number of large bank and nonbank organizations and by an active market for securitized credit card debt.

The recently emerging trend of higher delinquencies and personal bankruptcies has certainly increased the costs of making consumer credit card loans and is forcing some institutions to review and modify their marketing strategies and underwriting standards. It has also prompted the Federal Reserve to devote more attention to the monitoring of consumer loan exposures, both on and off bank balance sheets, and to the evaluation of risk management practices, including internal controls, for these activities. Nevertheless, the industry's condition is strong when measured in terms of its profitability, capital ratios, loss reserves, and overall asset quality. Moreover, banks price and reserve for credit card loans with the expectation of occasional periods of relatively high rates of loss. Therefore, unless future conditions deteriorate dramatically, we believe that the industry is well- positioned to absorb any problems resulting from the competitive consumer underwriting practices of the recent past.

Return to top

1996 Testimony
