TESTIMONY OF
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ON
CONSUMER CREDIT
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND REGULATORY RELIEF
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
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Mr. Chairman and members of the Committee, thank you for the opportunity to present the views of the Federal Deposit Insurance Corporation (FDIC) on recent developments in consumer lending.

Today we are witnessing a period of unprecedented prosperity for commercial banks and savings institutions. In the last four years, commercial bank profits have reached the highest levels in the 63-year history of the FDIC. Capital-to-asset ratios are higher than at any time in more than 50 years. Overall asset quality is the best it has been in the fourteen years that we have been able to track it. Last year, insured savings institutions posted their highest return on assets since 1962, and set a new record for full-year earnings. Their average capital levels now exceed those of commercial banks.

Historically, consumer lending has been profitable for insured depository institutions. It remains so today for the vast majority of institutions. Dark spots on the banking industry's otherwise rosy picture are the rise in personal bankruptcies, increases in consumer debt, and rising losses in credit card lending. The percentage of credit card loans that are delinquent (more than 30 days past due) has been rising since the middle of 1994, while the net charge-off rate on credit card loans has been increasing for the last four quarters. At the same time, data suggest that the profitability of credit card lending has been declining gradually since the second half of 1994. Even with this decline, however, credit card lending remains twice as profitable as other types of banking business.

While the FDIC does not believe that there is cause for significant concern, we are closely monitoring industry trends as well as the performance of credit card and other consumer loan

portfolios at individual institutions. My testimony will provide an overview of the consumer credit market; analyze trends in delinquencies and charge-offs for two of the largest categories of consumer lending (home mortgages and credit card loans); address structural changes in the credit card market, including personal bankruptcies and increases in consumer debt burdens; and discuss the FDIC's supervisory initiatives to monitor consumer lending.

OVERVIEW OF THE CONSUMER CREDIT MARKET AND TRENDS IN DELINQUENCIES

The consumer credit market in the United States -- composed of credit card loans, home mortgages, home equity loans, and other loans to consumers -- amounted to $4.8 trillion in outstanding balances as of March 31, 1996. As shown in Exhibit 1, banks and savings institutions accounted for a large share of this market, together constituting $1.7 trillion, or more than one-third of consumer loans. Exhibit 2 shows the composition of these loans held by insured depository institutions. Mortgage banks, credit unions, consumer finance companies, captive auto finance companies and investors hold the balance of consumer loans.

In recent years, consumer loan demand has been robust as evidenced by the expansion of the credit card market. Consumer lending has helped propel industry asset growth and has contributed to the current record earnings of commercial banks and savings institutions. The less positive side of this trend is that the rapid growth in credit has contributed to the present ratio of consumer debt to income, which is at an all time high, and debt service payments relative to income, which also are approaching historically high levels.

Exhibit 3 shows that banks and thrifts with high asset concentrations in consumer debt generally specialize in either one- to four- family mortgages (home mortgages) or credit card loans. For this reason, my testimony primarily focuses on developments in these markets. Although home mortgages constitute the majority of outstanding consumer loans, some of the highest concentration levels of consumer credit at individual institutions are in credit card loans.

FDIC studies show that most commercial bank failures can be attributed to bank lending decisions, or "credit risk." However, credit risks from consumer lending are highly diversified and have not caused significant losses to the FDIC. The largest consumer lenders have customers spread throughout the United States and thus are less vulnerable to regional recessions or the failure of a major employer or industry. Consumer loans tend to have relatively small balances spread among a large number of borrowers. Defaults by a single borrower or small groups of borrowers typically do not impair an institution's capital as may be the case with other categories of loans. Many of the higher-balance consumer loans tend to be well-secured by residences or automobiles. Thus, borrowers have strong incentives to make

loan payments. Consumer loans, other than credit card loans, have historically had lower and less volatile charge-off rates than commercial loans, as shown in Exhibits 4 and 5.

Credit card specialty banks are major participants in the consumer credit market. Credit card specialty banks are insured commercial banks and savings institutions whose total loans exceed 50 percent of total managed assets, and whose credit card loans exceed 50 percent of total loans. (For these purposes, credit card and total loans include those that have been securitized and sold and managed assets include both on-balance-sheet loans as well as off-balance-sheet assets resulting from loan securitizations.) Together, 77 specialized credit card institutions now hold almost two-thirds (63.3%) of all credit card loans outstanding at commercial banks and savings institutions. The profitability and other performance characteristics of these credit card specialty banks are a useful proxy for the profitability and performance of credit card operations in more diversified institutions.

Typically, credit card specialty banks have very high rates of return, but also high charge-off rates. From the end of 1994 through March 31, 1996, the average credit card past due ratio at credit card specialty banks rose from 3.54 percent to 4.14 percent. The average net charge-off rate at these institutions rose from 3.60 percent in 1994 to 3.98 percent in 1995. In the first quarter of 1996, the average net charge-off rate at credit card specialty banks was 3.89 percent, up from 3.41 percent in the first quarter of 1995. While these increases are significant, they should be viewed in the context of historical experience; the average net charge-off rate at specialty credit card banks peaked in 1992 at 4.66 percent.

Credit card losses and personal bankruptcies have been increasing despite a general economic expansion. Data from the 1990-1991 recession suggest that another recession would exacerbate these increases, particularly since consumer debt levels are at an all time high. As Exhibit 6 illustrates, loss rates on credit card loans and personal bankruptcies show a striking correlation over time. In addition to these recent increases, two other trends are evident. One is the peak in bankruptcies and credit card loan loss rates during the last recession. The other is an overall long term rising trend in both personal bankruptcies and charge-off rates.

These recent adverse trends merit our attention. They affect credit card lenders and could affect other consumer lending if they indicate general consumer financial weakness. The remainder of this testimony focuses on the risks and concerns that have arisen in home mortgage lending and credit card lending, and the risks these activities entail from an insurance perspective.

HOME MORTGAGES

Historically, loan-loss rates on home mortgages are among the lowest and least volatile of any consumer loan category. In each year from 1990 through 1995, between one-half and three-fourths of all FDIC-insured institutions that held home mortgages had no charge-offs on these loans.

The FDIC measures home mortgage delinquencies based upon the dollar amount of past due loans. Using this measure, mortgage delinquencies at commercial banks and thrifts have remained fairly steady over the past year. The Mortgage Bankers Association (MBA), on the other hand, measures delinquencies on the basis of the number of loans delinquent. Using this measure, the MBA reports a recent increase in mortgage delinquencies. The rate calculated by the MBA is about twice the rate calculated by the FDIC, suggesting that a greater proportion of delinquencies occur among smaller balance loans.

According to the MBA, three factors may explain the increase in delinquency rates they report: (1) lower down payment requirements; (2) increased use of adjustable rate mortgages; and (3) a larger portion of loans at the age at which delinquencies generally peak. Typical mortgage foreclosure patterns show few foreclosures in the first two years after issuance and a rapid increase through years four and five; thereafter, foreclosures drop off.

According to the Mortgage Research Group, Inc., many top quality borrowers refinanced their mortgages during the low interest rate period of 1991-1993. In 1993, mortgage originations were a record $1.1 trillion. When interest rates rose in 1994 and 1995, lenders may have tried to preserve origination levels by increasing lending to less creditworthy borrowers and by lowering loan-to-value requirements. These factors may explain the increase, albeit small, in delinquencies in a generally favorable economy.

Nevertheless, compared to mortgage delinquency rates over the past ten years, today's rates of about 4.46 percent (as measured by the MBA) remain relatively low. From 1985 through 1991, the delinquency rate consistently exceeded 4.46 percent and was close to six percent at one point.

Although it appears unlikely that credit losses on home mortgages will threaten the capital adequacy or solvency of FDIC-insured institutions, two caveats should be noted. First, home mortgage lending is a highly competitive, low margin business. Second, sustained unfavorable interest rate movements could pose substantial risks for some home mortgage lenders.

CREDIT CARD DEBT

High yields on credit card loans have spurred institutions to rapidly expand credit card lines of credit. Exhibit 7 shows the large growth in credit card loans, especially in unused credit commitments -- lines of credit that have been made available but not drawn upon by consumers -- over the past five years. Over the past ten years, credit card loans as a percentage of institutions' consumer loan portfolios have grown by about two-thirds, from 7.6 percent at the end of 1985 to 12.6 percent at the end of the first quarter of 1996.

Credit card lending has remained highly concentrated -- at the end of the first quarter of 1996, the fifty largest lenders together accounted for more than three-quarters (78.8 percent) of all credit card loans held by the more than 6,000 banks and thrifts with credit card loans in their portfolios. In the past five years, the number of specialty credit card banks has increased only slightly -- from 71 to 77 banks between 1991 and 1996 -- but both the assets and earnings of these institutions have more than doubled.

As Exhibit 8 shows, credit card specialty banks have higher charge-off rates than other insured institutions. However, credit cards carry high average interest rates and are very profitable for the industry. Exhibits 9 and 10 show that high average yields and margins traditionally have more than offset high loan-loss rates, and these specialized credit card lenders have remained highly profitable.

A number of recent structural trends in the credit card industry are worth examining for their potential impact on delinquency and charge-off rates, since structural change in an industry may make past performance less relevant as a guide to future prospects. Recent structural changes in credit card lending include stronger competition in an increasingly saturated market, demographic changes in underwriting, rises in personal bankruptcies and the consumer debt burden, growth in unused lines of credit and an explosion in securitization.

STRUCTURAL CHANGES IN THE CREDIT CARD MARKET INCREASED COMPETITION

With the aid of information technology and increasingly sophisticated underwriting techniques, companies have been able to mine vast amounts of consumer information -- such as credit histories, credit use, and spending patterns -- to segment and expand the credit card market. Institutions also rely on complex credit scoring models to qualify borrowers and to price credit. By combining automated underwriting methods with direct mail and phone solicitations, institutions have been able to acquire new customers quickly and cost-effectively.

The credit card industry, like any other highly profitable industry, has attracted competition. While the number of specialty credit card banks remains small, they are intensifying their price competition. As competition among the major players escalates, profit margins come under pressure. This pressure principally stems from underwriting competition, the proliferation of

introductory "teaser" interest rates, greater offerings of low or no annual fee products, and growth in marketing costs.

As discussed below, this intense competition for new business may be changing the demographic profile of borrowers. Increased competition also may cause structural changes within the industry over time. Increased marketing costs, lower fee income and razor thin interest spreads during introductory periods on cards with "teaser" rates will tend to raise the financial barriers to entry into the business. Economies of scale may encourage additional industry consolidation.

DEMOGRAPHIC CHANGES IN CREDIT CARD UNDERWRITING

As a result of changes in underwriting, marketing and funding over the past several years, more households now have bank credit cards, including in many cases multiple credit cards. According to RAM Research, a recognized authority on the credit card industry, at the end of 1995, Americans held over 400 million bank credit cards or 1.6 cards for every American. This growth in the number of cards has been accompanied by a change in the demographics of card holders. Loans to demographic segments typically associated with stronger credit characteristics show a slight decline in median balances. Credit card loans to lower income individuals have increased substantially. The age distribution of credit card users has also changed, with a higher percentage of lending to younger borrowers and the elderly. Aggressive marketing techniques that target previously under-represented segments of the population with unknown or limited credit histories may be contributing to the rise in credit card delinquency rates.

INCREASES IN PERSONAL BANKRUPTCY

Another structural change posing a challenge for the credit card industry is the steady increase in personal bankruptcies despite favorable economic conditions. Some analysts estimate that personal bankruptcies now account for 40 to 50 percent of losses in bank card lending. Personal bankruptcies have increased rapidly since 1980, and annual filings in 1996 are expected to exceed one million for the first time.

Several reasons are commonly offered for the growing number of personal bankruptcies. Total consumer debt as a percentage of disposable personal income is now at an all time high (83 percent), as shown in Exhibit 11. This trend merits continued close monitoring. Debt service payments as a percentage of personal disposable income (16.7 percent) are approaching the historical high of 17.6 percent (see Exhibit 12). In addition, the social stigma surrounding bankruptcy may have diminished, causing consumers to be less averse to filing for bankruptcy.

GROWTH IN UNUSED LINES OF CREDIT

The significant growth in outstanding credit card debt has been accompanied by an even greater growth in total unused credit card commitments. For all commercial banks, unused lines for credit card loans increased from $476 billion at year-end 1991 to $1.1 trillion by year-end 1995. Unused lines of credit would seem to pose a risk to institutions from consumers who may draw down their lines of credit without the ability to repay the borrowings. Credit card lenders typically, however, monitor their borrowers' credit card use and have the authority to freeze or cancel credit at any time. In addition, as shown in Exhibit 13, credit card loans have had the lowest utilization rates -- the proportion of the credit lines that are actually drawn upon -- of any category of commercial or consumer lending. Unless historical patterns change, we can expect utilization rates to remain low. Moreover, many borrowers use their credit cards for "convenience" -- as a substitute for cash or checks -- and do not maintain balances on their cards.

SECURITIZATION

Another structural change occurring in the credit card industry is the growth in the securitization of credit card receivables. While the use of securitization has been concentrated in relatively few insured institutions, the dollar amount of securitizations has doubled in the past five years. As of March 31, 1996, 39 commercial banks reported over $136 billion of securitized credit card receivables. Some specialty credit card banks have relied heavily on securitization to fund additional credit card loans. Because most securitizations are non-recourse sales, securitized loans are not considered when calculating an institution's capital requirements.

In general, banks profit from the difference between fees and interest income generated by the securitized credit card pool, less the investors' coupon rate and charge-offs. Therefore, the amount of income earned by the bank on the securitized pool of credit cards depends upon the performance of the credit card receivables.

Disruptions in the market or deterioration in the receivable pool could result in early repayment of principal. If this occurs, banks may begin retaining credit card receivables, previously securitized, which could create potential liquidity problems and capital constraints.

EVALUATION OF RISKS TO THE INSURANCE FUNDS

In credit card lending, income has traditionally more than offset high credit losses. With adequate risk-management practices by lenders, credit card lending should remain profitable

for most institutions. Conversely, institutions that neglect these practices may be more vulnerable to adverse developments. Risk-management practices include continuous updating of credit scoring models, updates on borrower information, and frequent review and adjustment of credit limits. To improve their ability to predict risks in credit scoring models, which depend on accurate information, institutions should, for example, periodically determine whether their borrowers have acquired other credit cards. They also should "backtest" models by comparing past risk assessments with actual results. This is especially important in evaluating how well the institution's risk management techniques are working. Pursuant to the Equal Credit Opportunity Act, institutions must periodically revalidate credit scoring models.

For safety and soundness and surveillance purposes, the FDIC broadly defines "high concentrations of credit card loans" as outstanding credit card receivables equal to 25 percent or more of total loans or credit card receivables equal to 100 percent or more of Tier 1 capital. This definition captures 140 commercial banks, including the 77 specialty credit card banks. As the profiles on the next page indicate, 135 of the 140 insured commercial banks with high concentrations of credit card loans are rated CAMEL 1 or 2. These ratings indicate that, overall, examiners view current risk-management practices as acceptable at the present time.

CAMEL* RATING PROFILE BANKS WITH HIGH CONCENTRATIONS OF CREDIT CARD LOANS

FDIC Supervised Institutions

Rating	Number of Banks	(Total Assets)	(Insured Deposits)
1 & 2	42	71,401	18,442
3 & 4	3	309	240

All FDIC Insured Institutions

Rating	Number of Banks	(Total Assets)	(Insured Deposits)
1 & 2	135	352,614	135,046
3 & 4	5	453	366

* Represents the CAMEL rating (Capital,

Asset Quality, Management, Earnings,

Liquidity).

A number of factors suggest that overall, credit card banks do not pose a threat to the deposit insurance funds. Credit card lending is a more diversified risk than the lending that led to past losses to the deposit insurance funds, such as commercial real estate lending. Underwriting practices appear to be more rigorous and analytical than the underwriting that led to problems in the late 1980s and early 1990s. Credit card lenders should be able to manage exposures by repricing to reflect risk, adjusting credit limits, calling in cards, or otherwise changing marketing practices to target more creditworthy borrowers. Much credit card lending is conducted in institutions that rely heavily on the equity market as a source of funding and, as shown in Exhibit 14, have low levels of insured deposits. Of the 77 specialty credit card banks, 27 have total assets greater than $1 billion. As of March 31, 1996, these 27 banks collectively held $137 billion in total assets, but only an estimated $20.2 billion in insured deposits. Their reliance on nondeposit borrowings lowers the risk to the deposit insurance funds and subjects these institutions to market discipline. Moreover, many of these institutions have corporate parents that might cover losses in credit card subsidiaries.

What is true of the credit card industry on average, however, may not be true for particular institutions. The FDIC's losses at any given time are determined not by the average performance of the industry, but by the performance of individual institutions. While most institutions with higher concentrations of credit card receivables are highly capitalized and profitable today, individual institutions could encounter problems in the future. The FDIC is closely following the condition and performance of individual institutions through special quarterly reporting on credit card institutions. The next section describes our supervisory initiatives in this area.

FDIC SUPERVISORY INITIATIVES

The FDIC insures all federally insured banks and savings associations, and is the primary federal supervisor of about 6,230 state nonmember banks and state-chartered savings banks. For the more than 11,000 insured depository institutions, the FDIC has developed a series of specific offsite monitoring reports to more closely track consumer lending trends and financial institutions' responses to these trends. For those banks for which the FDIC is the primary supervisor, the FDIC also recently has developed specialized on-site examination procedures to evaluate credit card lending. In addition, the FDIC has instituted a series of regional round table meetings with representatives of the specialty credit card institutions to discuss current developments in the industry.

ONSITE EXAMINATION PROCEDURES

The FDIC is the primary federal supervisor of 45 of the 140 institutions with high concentrations of credit card loans. These 45 institutions hold $71.7 billion in total assets, which represents over 20 percent of the $353 billion in total assets held by all 140 banks with high concentrations. Either the FDIC or state authorities have examined 35 of these 45 institutions over the past year and all 45 since January 1, 1995. The FDIC's specialized examination procedures for banks with high credit card concentrations address the banks' present financial condition and the adequacy of their risk management practices. In reviewing risk management, examiners look at underwriting standards, internal controls and loan delinquency guidelines.

Examiners review both on-balance-sheet and off-balance-sheet (or managed) assets, such as credit card securitizations. They also compare their findings with peer group data that the FDIC compiles quarterly. The peer group data include selected earnings performance and asset quality ratios, as well as trends in credit card receivables, unfunded loan commitments, securitized credit card receivables, and returns on managed assets.

The FDIC also is testing a new, comprehensive procedural manual for examining credit card banks. The manual provides examiners with detailed information on the credit card industry and guidance on examination procedures.

ROUND TABLE MEETINGS

As part of a continuing program, the FDIC holds periodic round table meetings with selected credit card specialty banks that it supervises. These meetings allow participants to provide their assessments of the current state of credit card lending and to discuss current underwriting policies, procedures and practices, and payment and collection experiences. The meetings give the banks an opportunity to respond to the FDIC's concerns about increasing delinquencies and charge-offs within the industry and to discuss their overall credit card lending plans. Recently, representatives of the FDIC held round table meetings with specialty credit card banks in Utah and Delaware.

OFFSITE REVIEWS AND REPORTS

The FDIC has developed a quarterly consumer loan report for commercial banks with assets greater than $300 million. This internal supervisory report uses data from the quarterly Report of Condition (Call Report) to identify those banks with high volumes of consumer-related credit. Performance ratios are calculated to analyze home equity lines, credit card and related plans, and other consumer loans. Examiners review the report to identify possible adverse trends. To date, examiners have identified only a small number of banks that require an increased level of supervisory attention.

The FDIC also prepares comprehensive quarterly offsite reviews of banking organizations with total assets in excess of $3 billion, which includes the major credit card issuers. This review includes an analysis of uninsured subsidiaries that may be involved in consumer credit, including finance companies and mortgage banking operations. In general, the performance of these subsidiaries is not detrimental to the overall company performance.

The FDIC has developed another series of quarterly reports to assist examiners in their monitoring of commercial banks with high concentrations of credit card loans. The reports, initially produced using year-end 1995 data from the Call Report, are used to track more closely the condition of banks that have significant levels of credit card lending relative to their capital. The FDIC uses these reports to set priorities for its onsite examinations and to monitor changes in underwriting practices. The FDIC conducts quarterly offsite reviews of these institutions and shares concerns and questions resulting from its findings with the other state and federal regulators.

Recently, for instance, reports on several large institutions led the FDIC to request the primary regulator to join the FDIC in reviewing the modeling systems these institutions use to evaluate credit card portfolios. The review revealed no significant problems with the modeling systems.

As part of every examination since early 1995, the FDIC has surveyed its examiners on the credit underwriting practices of each bank. The survey addresses underwriting characteristics of many kinds of loans, including consumer loans. The first published results of the survey revealed that for the twelve months ending March 31, 1996, almost 95 percent of banks examined made consumer loans, but no major problems were reported in their underwriting practices. Ninety percent of banks examined evidenced no loans with a "lack of demonstrable repayment ability" for consumer lending. A similar percentage of banks showed no weaknesses in the adequacy of collateral. Since April 1996, the FDIC's credit underwriting survey has sought specific information on credit card underwriting practices. This information will help the FDIC monitor credit card lending more closely.

CONCLUSION

In conclusion, the FDIC believes that, at this time, consumer lending does not pose a significant risk to the deposit insurance funds. By many measures, the banking industry is the strongest it has ever been. Earnings and capital levels are at some of the highest levels in the history of the FDIC. Overall, consumer lending continues to be profitable, despite increases in personal bankruptcies and credit card delinquencies. Delinquency rates on home mortgages remain low compared to rates over the past decade. The great majority of financial institutions have sustained no credit losses on home mortgages. High levels of income and capital at credit card

banks have typically provided a more than adequate cushion against losses. Credit card lenders should be able to manage exposures properly by repricing to reflect risk, adjusting credit limits, canceling or curtailing unused credit lines where appropriate, or otherwise tailoring their marketing efforts to manage risks.

Notwithstanding the overall profitability of consumer lending, the adequacy of an individual institution's risk management practices will significantly affect its performance. The FDIC will continue to monitor closely the performance of individual institutions as well as trends in unused credit card commitments, credit card losses, consumer debt burdens and personal bankruptcies.

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