



Testimony of Governor Lawrence B. Lindsey

Trends in consumer lending

Before the Committee on Banking and Financial Services, U.S. House of Representatives

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I am pleased to appear before this Committee today to discuss trends in consumer lending, the Federal Reserve Board's view of the likely causes of these developments, and their likely effect on the U.S. economy, banks, and consumers.

As Chairman Leach noted in his letter of invitation, consumer delinquencies on nonmortgage debt have increased in recent periods and bankruptcy filings could well exceed one million in 1996. These developments have begun to affect profit margins at some financial institutions and the Federal Reserve has been closely monitoring these conditions and discussing their implications with individual banking organizations and industry groups. In our view, given the generally strong financial condition of the institutions most affected by these developments and that of the U.S. banking system, these adverse trends do not currently present a material threat either to individual banking organizations or to the overall banking system.

We have also been carefully monitoring the effect of higher debt levels on the potential for sustained noninflationary growth in the U.S. economy. While household debt levels are at or near record levels, we believe that the balance sheet of the household sector viewed in the aggregate is sound. Barring unexpected developments in either consumer credit policies or the wealth or income position of households, we do not believe that current debt levels pose a threat to the continuation of the present economic expansion. However, although balance sheets are sound overall, the trends affecting different household groups have been uneven. As a result, we might expect, and are seeing, increased caution on the part of lenders regarding further extensions of credit. Lenders are, and should be, on heightened alert for potential signs of increased financial stress among households.

In my remarks, I would like to begin with an overview of the economic factors that are likely to have contributed to the rising levels of consumer debt. 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. Finally, I shall consider some of the potential economic ramifications of the current levels of consumer debt.

Reasons for Higher Debt Levels

Economic developments in the United States have, in recent years, been favorable to growth in both spending and borrowing by the household sector and to strong growth in consumer lending by U.S. banks, making both supply and demand factors conducive to consumer credit expansion. On the demand side, rising levels of employment and income coupled with the dramatic increases in stock and bond prices, and thus aggregate household wealth, have

led to both a greater ability and a greater willingness of consumers to spend.

During this same time period, rates and fees on consumer financing products have been coming down. For example, 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. The relatively low mortgage rates of the early 1990s precipitated a refinancing boom that allowed many consumers to reduce significantly their monthly mortgage obligations and to pay down higher cost consumer debt.

Combined, these generally favorable developments have given consumers the confidence and financial foundation to incur additional debt in order to finance major purchases. The net effect is that we have increased our spending faster than we have increased our income. Since the second quarter of 1991, when the present expansion began, real per capita disposable personal income has risen \$1264, while real per capita expenditures have gone up \$1389. Essentially, for every \$1.00 our income has gone up, we've spent \$1.10. This extra spending has been particularly concentrated among big ticket items, what economists call "durables". While real spending per capita has risen about 8.5 percent overall, real per capita spending on durables has risen more than three times as fast (27.3 percent). It is not unusual for consumers to borrow to finance these durable purchases. High rates of durable purchases and consumer confidence usually occur during business cycle expansions. So, much of the higher level of consumer debt could be attributed to acquiring additional assets, a normal development at this stage of the business cycle.

The growth in nonmortgage consumer debt has been particularly robust in the past two to three years. 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 about 15 percent that year and the next. 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.

In part, the rapid rise in credit card debt is part of a long-standing trend. 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 July of this year, the amount outstanding was \$454 billion (preliminary), or nearly 40 percent of the total. Some surveys show that 80 percent of U.S. households now have at least one credit card. In addition, 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. Convenience users typically pay their card balances in full each month. The increased convenience use of credit cards has been reinforced in recent years by a variety of incentives, such as the availability of frequent flier miles. But the Federal Reserve's Survey of Consumer Finances suggests that the convenience share of outstanding credit card debt, defined as credit extended to people who always pay their credit card bills each month, has not risen markedly in recent years, and still accounts only for roughly one dollar in seven of aggregate credit card debt.

The particularly rapid growth in the demand for unsecured credit coupled with changes in

both legal and social attitudes raises another potential, albeit disturbing, factor affecting demand: the increased incidence of personal bankruptcy. Late last month, the American Bankruptcy Institute reported that personal bankruptcy filings in the second quarter neared the 300,000 mark, and had exceeded one million in the previous twelve months for the first time in history. On the basis of available information, it is hard to refute the observation of Sam Gerdano, the head of the Institute, that "Today's bankruptcy boom is the natural result of three years of sustained consumer spending increases that far outpaced income growth in an era of greater social acceptance of bankruptcy."

A recent survey of the causes of consumer bankruptcy by VISA indicated that being over-extended was the most commonly cited reason. Interestingly, it exceeded event-specific reasons such as medical emergencies, unemployment, and divorce.

While rising levels of consumer debt may be contributing to the climb in bankruptcies, bankruptcy law may also be contributing to rising debt levels. 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. To the extent that bankruptcy is perceived by consumers as an easier option, the demand for credit, and particularly the willingness to take on high levels of credit, is enhanced. With the consequences of bankruptcy reduced, individuals, other things equal, may be more willing to borrow than would otherwise be the case. 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.

In sum, a variety of macroeconomic and socioeconomic factors have contributed to the rise in the demand for consumer credit. The lower cost of credit is certainly a factor. Higher income and wealth, and the consequent increase in consumer confidence have increased the willingness to both spend and borrow. A long-term trend toward greater willingness to use household debt, particularly credit card debt, has also played a factor. The reduced consequences of personal bankruptcy may also have played a role.

Accompanying the increase in demand for consumer credit have been developments on the supply side of the market. 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. Credit card debt has been a particularly fast growing segment of bank portfolios. 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 been supported by the aggressive marketing of 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. Credit scoring and computer-based statistical evaluation have sharply lowered the cost of making a decision to extend credit. This has greatly facilitated the mass marketing of credit to individuals who are not bank customers and who live outside banks' traditional service areas.

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. Securitization and credit scoring have necessitated heavy investments in the technological infrastructure needed to evaluate, originate, and effectively manage such credits.

In turn, this has changed the cost structure of the industry to favor an expansion of volume in order to exploit scale economies. 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 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. Thus, both supply and demand factors help explain the increase in the levels of consumer debt that we have recently experienced.

Effect on the Banking Sector

One indication of the profitability of credit card lending can be seen in analyzing the so-called credit card banks (defined 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 thirty entities most recently reported an average annualized return on assets for the second quarter of 2 percent, compared with a 1.3 percent quarterly return for all insured commercial banks. While credit card banks remained more profitable than other banks, their profitability has declined a good bit in recent years owing to heightened competition and the erosion of credit quality. Credit card banks also maintain average equity to asset and loan loss reserves 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 ensure that the variance in returns on these loans does not create significant solvency concerns for their organizations.

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 *number* of delinquent 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.

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.

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. In the most recent Federal Reserve Senior Loan Officer Survey, nearly half of the respondent banks, on net, had tightened underwriting standards for approving new credit card applications, up from about a quarter in the two previous surveys. 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 such as rising delinquency and bankruptcy rates.

Potential Economic Ramifications

Reduced Willingness To Lend

The survey results on banks' willingness to lend to finance consumer purchases raises a natural macroeconomic question. Could a pullback in bank willingness to lend create potential difficulties for the sustainability of the economic expansion? Figure 1 provides some historical detail on this issue. The shaded areas in the figure represent business cycle recessions. As the figure indicates, there seems to be a degree of coincidence between pullbacks in banks' willingness to lend and economic downturns. Nonetheless, it would be premature to expect that any current pullback in the willingness to lend to consumers would necessarily precipitate a recession.

First, although the chart does indicate an apparent relationship, it is not at all clear that a cause-and-effect relationship exists, or in which direction any economic causality might run. On theoretical grounds, one could argue either that a pullback in credit leads to lower spending and thus to a recession, or that recessions produce a deterioration in credit quality which causes banks to be less willing to make further extensions of credit.

Second, as the data on delinquencies and bankruptcies makes clear, a good case can be made that reductions in credit are appropriate responses to past excess credit extensions. In this regard, they increase the long term health and viability of the economic expansion by ending potential economic excesses before they adversely affect the banking and credit delivery system.

Third, the development of computerized credit scoring models offers the potential for more discerning and carefully targeted reductions in the willingness to extend credit or adjustments in the terms on accounts. In this regard, a reduced willingness to lend may be more narrowly focussed than in the past. The adverse impact of a reduction in credit

availability might therefore be less in the present expansion than it has in the past.

Still, the potential for a systematic and widespread pullback in credit access is something that needs careful monitoring. Our first concern is that banks engage in safe and sound lending practices. As I mentioned earlier, we believe that they are. Thus, any regulatory or legislative mandate to reduce bank credit extensions to consumers is unnecessary. We also do not believe that the reduced willingness to extend credit at the current time is sufficiently widespread to create any significant macroeconomic risk to the expansion.

Excessive Debt Service Burdens

A second potential economic concern involves high debt service burdens (i.e. the amount a household must pay each month to cover their debt obligations). At some point, one would imagine that the cost of servicing rising levels of debt would absorb such a large chunk of consumers' disposable income that they would have no choice but to reduce current consumption. However, neither economic theory nor empirical evidence provides any good indication of the level at which debt service constraints begin to reduce spending.

Figure 2 shows the level of estimated debt service as a percent of disposable personal income over the past thirty years. While high, the current level of debt service payments is not out of the range of past experience. As conventionally measured, the level is now 16.9 percent, up from a cyclical low of 15.3 percent at the end of 1993, but below its peak of 17.6 percent at the end of 1989.

A number of developments have taken place recently which have affected this measure. First, the level of mortgage debt service has fallen by a full percentage point of disposable personal income, from 6.8 percent at the end of 1989 to 5.8 percent currently. This has been partially offset by a higher level of consumer installment debt.

Second, the use of auto leasing has expanded rapidly in recent years, in part acting as a substitute for taking out an installment loan to purchase an automobile. If one adjusts the measure of debt service burden for leasing, our staff estimates that we would now be about matching the previous peak in the debt service burden. Since the previous peak at the end of 1989, the effect of auto leasing has more than doubled, raising debt service payments by more than one percent of income currently versus just 0.5 percent of income in late 1989.

The Level and Distribution of Household Debt

The balance sheet of the American household sector, taken as a whole, has improved substantially in recent years. The dramatic increase in the stock market, for example, has increased the financial assets of households by \$4.75 trillion since the end of the recession in 1991. Overall, household assets have increased by \$9.5 trillion, while household liabilities have risen \$1.5 trillion. This rise in aggregate household wealth has doubtless supported the level of consumption spending of recent years and allowed households to increase their consumption faster than their incomes have risen.

From an economic point of view, there is nothing wrong with consumers increasing their debt, per se. Increasing debt to finance long term investments such as housing, durables, or even education, may be prudent depending on one's individual circumstances. Furthermore, taking on debt may be a prudent means of maintaining consumption levels during a period when income is below one's expectations of its long term trend. As I shall argue later, this may be one reason for higher levels of consumer debt at present.

Suffice it to say that there are good reasons for any individual American family to take on additional debt and it would be wrong for a Federal Reserve Governor to opine that some particular American family is too much in debt. Individuals know their own circumstances far better than any government official. But a look at disaggregated data provides insights into economic trends regarding the willingness of American families to add to their levels of debt.

Figure 3 combines information from the Federal Reserve's Survey of Consumer Finances (SCF) on the distribution of household debt with our estimates from the Flow of Funds accounts on the debt-to-income ratio of the American household sector¹. We estimate that, on average, the household sector increased its debt-to-income ratio about 5 percentage points between 1992 and 1995. This was the result of a 2 percentage point increase in mortgage debt, from 59.8 percent of income to 61.9 percent of income and a 3 percentage point increase in nonmortgage consumer debt, from 16.9 percent of income to 19.8 percent of income.

Nevertheless, the survey data suggest some interesting trends in the distribution of this debt. Typically, households earning more than \$100,000 per year sharply reduced their debt levels between 1992 and 1995. The share of total household debt held by these households fell from one-third to one-quarter and this decline was particularly concentrated among households earning more than \$250,000 per year. These upper income groups experienced a decline in both the mean and median absolute level of debt outstanding, while all other income groups increased their debt.

The decline in the debt levels for these groups makes the rise in debt levels for other groups more striking. For example, households with incomes between \$50,000 and \$100,000 increased their rates of aggregate mortgage debt to aggregate income by about one-sixth and their corresponding consumer debt to income ratio by roughly 50 percent.

Of course, some households increased their debt substantially more than this, some not at all. The Survey of Consumer Finances does indicate a striking increase in the willingness to go into debt in the \$50,000 to \$100,000 income group. The proportion of survey households in this income group reporting credit card debt rose 13 percentage points, from 51 percent in 1992 to 64 percent in 1995, compared to a 4 point increase, from 44 percent to 48 percent for the whole population. Those holding installment debt such as auto loans increased from 52 percent to 59 percent in this income group while the proportion in the overall population with this type of debt was unchanged. Nearly 60 percent of the total increase in non-mortgage debt outstanding was assumed by households in this income group.

Debt increases for households earning under \$50,000 were also sizable. The increasing attractiveness of various types of financing tied to one's home produced a particularly large increase in the ratio of mortgage debt to income. It should be noted that although the mortgage debt to income ratio increased just 7 percentage points for households earning under \$25,000, compared to 10 to 11 percentage points for households earning \$25,000 to \$100,000, homeownership rates are much lower among this segment of the population. Adjusted for the lower level of homeownership rates among this income group, mortgage debt to income ratios increased more for these lower income groups than for the \$50,000 to \$100,000 income group. I might add that the rapid expansion of mortgage financing among low and moderate income groups is borne out by other data as well. We will not know for some time what the overall effect of this lending will be on default and delinquency rates.

But these data also show that, while some of the added credit extension during this period is to people in income groups that traditionally haven't owed much debt, the bulk is not. While overall debt levels increased for all groups earning under \$100,000, the only group to increase its relative share of such nonmortgage debt was the \$50,000 to \$100,000 income group. Thus, it is reasonable to conclude that the main reason for the household debt expansion of recent years is not so much an extension of debt to new households, but an increase in the debt levels taken on by fairly well-to-do segments of the population to whom being in debt (albeit not at these levels) is not an unusual experience.

From a macroeconomic perspective, we must therefore consider why these middle- and upper-middle-income households have increased their debt levels. Unfortunately, this is the type of question that will only be definitively answered in hindsight. I mentioned one likely explanation earlier. It is not at all unusual for these households to expand their levels of durable purchases and debt to finance these purchases. Consumer confidence is high, and up from levels earlier this decade, thus increasing demand. Thus, one possibility is that what we have experienced is a cyclical phenomenon linked to acquisition of consumer durables by relatively affluent households.

A related possibility is that households may be using their access to both mortgage and consumer credit to finance purchases of financial assets. The expectation of high returns in the stock market may have induced some households to borrow to finance these investments. Tax rules regarding both home mortgages and pension plans such as 401(k)s, may have made such purchases of financial assets with debt in which the interest is tax deductible particularly attractive. Whatever the economic performance of such a financial arrangement, consumers are reducing the liquidity of their balance sheets by such actions. I might also add, however, that our most recent Survey of Consumer Finances found little evidence to support this explanation.

Yet another possibility, consistent with both the data and economic theory, is that consumers' long-term confidence is high, but recent experience with earnings has been disappointing. Consumers might be choosing to cover what they perceive as a temporary reduction in their wages from their long-term trend through debt. During the three-year period discussed previously, the increase in wage and salary payments has constituted a smaller share of increased GDP than is usual during expansions. During these three years, increased wage and salary payments constituted only 44 percent of increased GDP, versus 47.2 percent during the 1981-1990 period. Stated differently, if wages and salaries constituted the same share of GDP in 1995 as they did in 1990, workers would have enjoyed about \$52 billion more in income that year.

Given that overall employment conditions are quite good, workers might reasonably expect this shortfall to be temporary. An economically rational response to this situation would be to borrow temporarily to maintain consumption levels with the expectation that the added debt would be repaid when wages rise to more normal levels. This theory comports with anecdotal concerns about corporate downsizings, which also lend anecdotal support to the sharp debt rise in the \$50,000 to \$100,000 income group. An open question remains as to whether this wage shortfall is indeed temporary. The comparatively poor performance of labor productivity in recent years is not an encouraging sign. On the other hand, as Chairman Greenspan has noted before this committee, there are reasons to expect that we may not be measuring the impact of new technologies on our economy appropriately.

Thus, we cannot tell for certain what the dominant reasons for the debt increase might be. We cannot tell how the habit of households increasing spending faster than income will break: will productivity increase to allow wages to constitute more normal portions of GDP, or will consumers ultimately be forced to reduce their spending? Nor can we tell when this current pattern will end. Consumers can probably continue to maintain current spending patterns by increasing their debt levels further for the foreseeable future. The prudence of continuing to do so depends crucially on the household's individual situation.

But at present the Board does not believe that current debt service levels are a necessary impediment to continued economic expansion. We also see no reason to believe that this expansion of consumer debt on the balance sheets of the nation's banks is any cause to worry about their underlying safety and soundness. Thus, the Federal Reserve believes that the best policy is to continue to monitor and study developments in this area but that no immediate regulatory or legislative action is warranted.

Footnotes

1 The data are from 1992 to 1995 because these are the years in which SCF surveys were conducted.

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