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Remarks by

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Introduction: Credit Unions and Consumer Lending

Credit unions have long focused on the needs of their members. Traditionally, the industry has specialized in personal and automobile loans, and the bulk of lending at many credit unions remains concentrated on these types of loans. In the past decade, however, many credit unions have become more involved in first- and second-lien mortgage loans. With credit unions' lending efforts focused on consumer and residential mortgage loans, credit unions have a natural interest in the financial health of America's households.

We have a similar interest at the Federal Reserve. Consumer spending accounts for more than two-thirds of gross domestic product, and residential investment--the construction of new homes--makes up another 4 percent or so of GDP. In addition, households own more than \$14 trillion in real estate assets, almost twice the amount they own in mutual funds and directly hold in stocks. Over the past two years, significant increases in the value of real estate assets have, for some households, mitigated stock market losses and supported consumption.

Measuring the Financial Health of Households

One concern of many lending institutions has been the increase in bankruptcy rates during the past several years to an unusually high level. Elevated bankruptcy rates are troubling because they highlight the difficulties some households experience during economic slowdowns. But bankruptcy rates are not a reliable measure of the overall health of the household sector because they do not tend to forecast general economic conditions, and they can be significantly influenced over time by changes in laws and lender practices.

In contrast to bankruptcy rates, delinquency rates may be a bit better measure of the overall health of the household sector. The recent experience with some delinquency rates has been encouraging, with rates falling for several measures of credit card and automobile debt. But, like bankruptcy rates, delinquency rates can reflect changes in underwriting and collection practices, and they may measure the financial health of a relatively narrow set of households.

A primary measure used by the Federal Reserve to assess the extent of American household indebtedness and to provide a view of the financial health of the overall consumer sector is the quarterly debt service ratio. The debt service ratio measures the share of income committed by households for paying interest and principal on their debt. When the debt service ratio is high, households have less money available to purchase goods or services. In addition, households with a high debt service ratio are more likely to default on their obligations when they suffer adversity, such as job loss or illness.

Of course, debt payments are not the only financial obligations of households and thus the Federal Reserve also calculates a more general financial obligations ratio. This measure incorporates households' other recurring expenses, such as rents, auto leases, homeowners' insurance and property taxes, that might be subtracting from the uncommitted income available to households. The Federal Reserve splits the aggregate financial obligations ratio into separate measures for homeowners and renters, measures that I will discuss in detail below.

Changes in the Debt Service and Financial Obligation Ratios over Time

Both the debt service ratio and the financial obligations ratio rose modestly over the 1990s. During the past two years, however, both ratios have been essentially flat. The debt service ratio has

remained a touch above 13 percent, whereas the financial obligations ratio has hovered a bit above 18 percent.

These ratios move slowly because both the stock of debt and the interest rates associated with the stock change slowly. Another reason is the stability in the ratio for homeowners, who hold the bulk of all household debt. Despite annual mortgage debt growth that exceeded 12 percent a year over the past two years, the financial obligations of homeowners have stayed about constant because mortgage rates have remained at historically low levels. The homeowners' financial obligations ratio has also remained relatively constant despite this very rapid growth in mortgage debt, partly as a result of an enormous wave of refinancing of existing mortgages, which ended only in the fall of 2003. Refinancing has allowed homeowners both to take advantage of lower rates to reduce their monthly payments and, in many cases, to extract some of the built-up equity in their homes. These two effects seem to have roughly offset each other, suggesting that homeowners might set a target for their mortgage payments as a proportion of income and adjust their borrowing accordingly.

Indeed, the surge in mortgage refinancings likely improved rather than worsened the financial condition of the average homeowner. Some of the equity extracted through mortgage refinancing was used to pay down more expensive, non-tax-deductible consumer debt or used to make purchases that would otherwise have been financed by more expensive and less tax-favored credit. Indeed, the refinancing phenomenon has very likely been a supportive factor for the general economy. The precise effect is difficult to identify because it is hard to know how much of the spending financed by home

equity extraction might have taken place anyway. Nonetheless, we know that increases in home values and the borrowing against home equity likely helped cushion the effects of a declining stock market during 2001 and 2002.

Rising Credit Card Debts for Homeowners and Renters

The rise in homeowners' debt service burdens over the 1990s, albeit small, is associated with increases in their nonmortgage debt and, in particular, with rising levels of credit card debt. The financial obligation associated with credit card debt is difficult to measure. On the one hand, households are obligated to pay only a minimum amount and thus, in times of financial stress, a household can forgo making more than this minimum payment. On the other hand, we know that many households make more than the minimum payment and indeed likely would be quite uncomfortable paying only the minimum amount. During financial difficulties, these households might even consume less to pay more than the minimum. Defining the point at which households feel they should pay down their credit card debt is difficult, and thus our measure of debt service relies on estimates of minimum payments required by credit card lenders.

There are several reasons that homeowners might carry more credit card debt than they did a decade ago, but these reasons generally do not indicate financial weakness among homeowners. Indeed, as noted, delinquency rates on credit card payments have been falling during the past year, despite households' relatively larger holding of credit card debt.

One possible reason for the secular increase in credit card debt is rising U.S. homeownership rates. According to the Bureau of the Census, the share of U.S. households that own homes rose from about 64 percent in 1990 to almost 68 percent in 2003 even as the population grew substantially.

Because of rising incomes, lower interest rates, and increased rates of household formation, more people have chosen to buy homes rather than to rent, increasing the value of mortgages outstanding. Although it does not show the relationship conclusively, the Federal Reserve's Survey of Consumer Finances suggests that these newer homeowners who make smaller down payments tend to bring with them higher levels of nonmortgage debt and, in particular, credit card debt. The ability of lending institutions to manage the risks associated with mortgages that have high loan-to-value ratios seems to have improved markedly over the past decade, and thus the movement of renters into homeownership is generally to be applauded, even if it causes our measures of debt service of homeowners to rise somewhat.

Another possible reason for rising credit card debt ratios is the use of credit cards for a variety of new purposes. The rise in credit card debt in the latter half of the 1990s is mirrored by a fall in unsecured personal loans. Reflecting this general trend, the proportion of personal loans in credit union portfolios has been declining as well. The wider availability of credit cards and their ease of use have encouraged this substitution. The convenience of credit cards also has caused homeowners to shift the payment for a variety of expenditures to credit cards. In sum, credit card debt service ratios have risen to some extent because households prefer credit cards as a method of payment.

In contrast to the increase for homeowners, the rise in debt service ratios was steep for renters in the latter half of the 1990s. The rise for renters, as for homeowners, is concentrated in credit card lending and thus may reflect some of the same factors that have influenced homeowner debt service ratios. But unlike homeowners, renters in recent years have been using a higher fraction of their

incomes for payments on student loans and used-car debt. Renters tend to be younger and have lower incomes than homeowners, so the fact that student loans and used-car payments are a larger share of their income is not surprising, although this trend might be worrisome if it indicates greater difficulties in becoming financially established.

In addition, some of the rise in the debt service ratios of renters, unlike that of homeowners, occurred during the most recent recession, a difference highlighting the fact that incomes of renters are generally more at risk during economic downturns. Renters' debt service ratios have stabilized during the past two years, a hopeful sign that is likely correlated with the overall improvement in the economy. However, the rise in the renter debt service ratio might indicate some trends among these households that may be of concern and that need to be investigated further.

Mitigating Homeowner Payment Shocks

Rising debt service ratios are a concern if they reflect household financial stress and presage a drop in consumption or a rise in losses by lenders. Most homeowners and renters are aware of the possible difficulties should they lock themselves into a high level of debt payment obligations. Financial institutions might be able to help some households in this regard by looking for ways that households--both renters and homeowners--can shield themselves from unexpected payment shocks.

One way homeowners attempt to manage their payment risk is to use fixed-rate mortgages, which typically allow homeowners to prepay their debt when interest rates fall but do not involve an increase in payments when interest rates rise. Homeowners pay a lot of money for the right to refinance and for the insurance against increasing mortgage payments. Calculations by market analysts of the "option adjusted spread" on mortgages suggest that the cost of these benefits conferred by fixed-rate

mortgages can range from 0.5 percent to 1.2 percent, raising homeowners' annual after-tax mortgage payments by several thousand dollars. Indeed, recent research within the Federal Reserve suggests that many homeowners might have saved tens of thousands of dollars had they held adjustable-rate mortgages rather than fixed-rate mortgages during the past decade, though this would not have been the case, of course, had interest rates trended sharply upward.

American homeowners clearly like the certainty of fixed mortgage payments. This preference is in striking contrast to the situation in some other countries, where adjustable-rate mortgages are far more common and where efforts to introduce American-type fixed-rate mortgages generally have not been successful. Fixed-rate mortgages seem unduly expensive to households in other countries. One possible reason is that these mortgages effectively charge homeowners high fees for protection against rising interest rates and for the right to refinance.

American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage. To the degree that households are driven by fears of payment shocks but are willing to manage their own interest rate risks, the traditional fixed-rate mortgage may be an expensive method of financing a home.

Conclusion

In evaluating household debt burdens, one must remember that debt-to-income ratios have been rising for at least a half century. With household assets rising as well, the ratio of net worth to income is currently somewhat higher than its long-run average. So long as financial intermediation continues to expand, both household debt and assets are likely to rise faster than income. Without an examination of what is happening to both assets and liabilities, it is difficult to ascertain the true burden

of debt service. Overall, the household sector seems to be in good shape, and much of the apparent increase in the household sector's debt ratios over the past decade reflects factors that do not suggest increasing household financial stress. And, in fact, during the past two years, debt service ratios have been stable.