FEDERAL RESERVE BANK OF DALLAS
FIRST QUARTER 1996

FINANCIAL INDUSTRY Issues

Has Consumer Credit Growth Jeopardized Bank Profits?

Closer examination of consumer credit trends suggests that while the growth in bank lending to the consumer may indeed slow, consumer lending poses little risk to the banking industry.

Banks continued to earn strong profits in 1995, posting a return on assets of 1.2 percent for the year, both in the Eleventh District and in the rest of the United States. One factor that contributed to banks' profitability was rapid growth in bank lending to the consumer; the U.S. banking industry's consumer loans increased 37 percent from early 1990 through 1995.

Emerging signs of deteriorating quality in consumer credit have, however, raised questions about whether the rapid growth in bank lending to the consumer will continue and whether banks' future profitability is in jeopardy. Yet closer examination of consumer credit trends suggests that while the growth in bank lending to the consumer may indeed slow, consumer lending poses little risk to the banking industry.

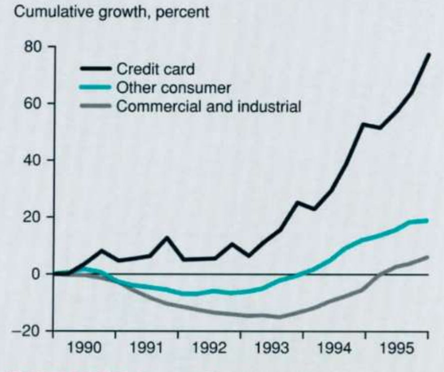
Rebalancing of Bank Portfolios

Bank credit to the consumer, particularly credit extended to the consumer through credit cards, has been growing rapidly. As shown in Chart 1, banks' credit card lending to the consumer has increased by 77 percent since the beginning of 1990, with much of that growth occurring during 1994 and 1995. Other consumer credit increased as well, growing by 19 percent during 1990–95. The growth in consumer loans significantly outpaced growth in commercial and industrial (C&I) loans over this period, with C&I loans growing only 6 percent during 1990–95. As these growth rates show, the banking industry has rebalanced its portfolio away from traditional business loans toward consumer loans, especially loans through credit cards.

Another measure of the shift in bank portfolios is the share of interest income various types of loans contribute. Chart 2 shows the percentages of interest income from C&I and credit card loans during 1990–95. The share of banks' interest income from credit cards is on an upward trend but remains a small fraction (11 percent) of total interest income. A second trend is the decrease in interest income from C&I loans between 1990 and 1995, despite a rise in 1994. These trends provide additional evidence of the rebalancing of bank portfolios away from C&I loans toward consumer loans.

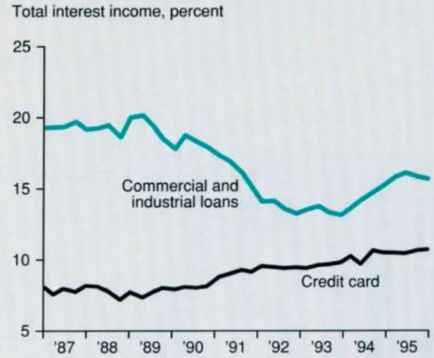
Credit card debt has been growing for several reasons. Consumers are not only using their credit cards as a traditional borrowing source; consumers are also using credit cards for so-called "convenience

Chart 1
Loan Growth
(*U.S. Insured Commercial Banks*)



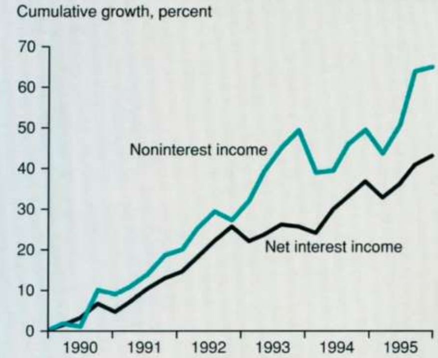
DATA SOURCE: Report of Condition and Income.

Chart 2
Interest Income
(U.S. Insured Commercial Banks)*



* Data include only banks with $300 million or more in assets.
DATA SOURCE: Report of Condition and Income.

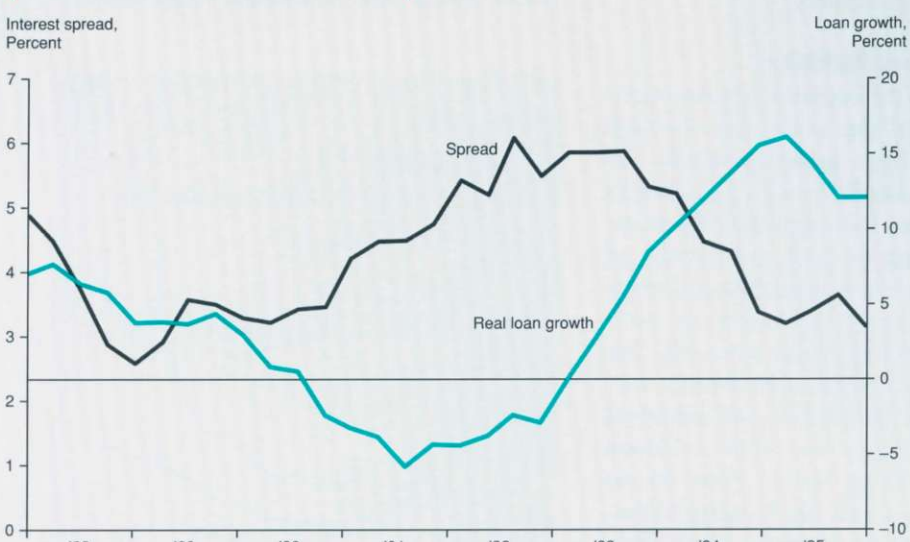
Chart 4
Income Growth
(U.S. Insured Commercial Banks)



DATA SOURCE: Report of Condition and Income.

The implications of debt growth for credit quality depend on debt growth in relation to borrowers' ability to pay.

Chart 3
Interest Income Spread and Consumer Loan Growth
(U.S. Insured Commercial Banks)*



* Data include only banks with $300 million or more in assets.
DATA SOURCES: Report of Condition and Income, Citibase.

credit." Convenience credit refers to the use of credit cards as a substitute for cash or checks, both for convenience and for incentives such as frequent flyer miles. Convenience credit users pay their current charges at the end of each billing cycle, so they pay no interest on credit card purchases.

To the extent that the growth in credit card debt reflects convenience credit, banks' exposure to consumers may have been overstated in recent financial data. The trends in interest income, however, reveal significant growth in interest paid on credit card debt. The growth of interest income suggests that the new credit card debt does not belong solely to convenience users.

Income and Growth in Consumer Loans

While some signs of deteriorating consumer credit quality have emerged, consumer credit has remained a profitable line of business for the banking industry. Chart 3 reflects the extent to which the growth in consumer lending can be attributed to the profitability of consumer lending. The chart shows the interest income spread that banks have earned on their consumer loan portfolio and the year-over-year growth rate of consumer loans. The interest income spread is the difference between the interest yield on the consumer loan portfolio and the interest rate on three-month Treasury bills; the interest yield on the consumer loan portfolio is the interest income earned from the consumer loan portfolio, less net charge-offs, divided by the size of the consumer loan portfolio. As the chart indicates, banks began to accelerate their growth in consumer loans in early 1993 and continued the increase in 1994 and 1995. The growth in consumer lending began after the spread on consumer loans widened. The spread then narrowed as banks accelerated their loan growth. Such a result is consistent with the premise that banks took advantage of the profit opportunity offered by the large spread on consumer loans, and the resulting competition narrowed the spread.

Besides producing interest income, consumer loans also yield noninterest income. Credit cards, in particular, yield income from annual fees and fees on individual transactions. While data are not available to separate how much comes from consumer loans, Chart 4 shows the growth in banks' noninterest income and net interest income. Both sources of income have grown rapidly since the beginning of 1990, which is consistent with the strong recent profitability of the banking industry. While both noninterest income and net interest income have grown, noninterest income has grown more rapidly, reflecting the rising importance of fee income for banks.

Asset Quality

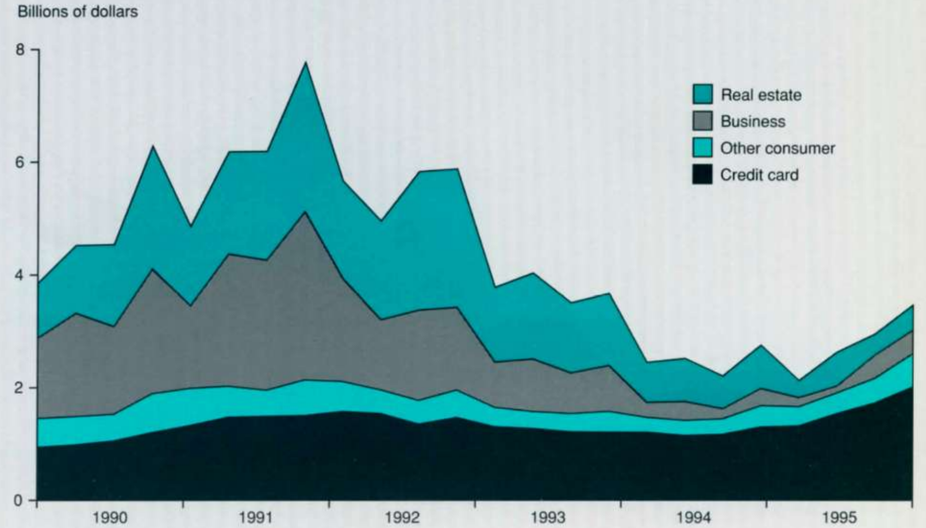
The banking industry's recent expansion in consumer lending has been a successful effort to earn profits by providing valuable credit services to consumers. Some concerns exist, however, regarding the decline in the quality of consumer loans in 1994 and 1995. Chart 5 shows net charge-offs for four categories of loans. The sum of charge-offs among the categories was lower at the end of 1995 than at the peak in 1991. On the other hand, the combined charge-offs were 13 percent higher in 1995 than in 1994; charge-offs on credit cards and other consumer loans were 39 percent higher in 1995 than in 1994.

Aside from the rise in the dollar amount of charge-offs on credit cards and other consumer loans in 1995, the charge-off rate on those loans also increased. In 1995, 3.4 percent of credit card loans were charged off, up from 3 percent in 1994. The charge-off rate also rose on other consumer loans, with 0.7 percent of other consumer loans charged off in 1995, up from 0.5 percent in 1994. Also, the percentage of credit card and other consumer loans that were noncurrent increased in 1995, rising from 3.4 to 4.1 for credit cards and from 2.5 to 3.1 for other consumer loans during 1995. So, trends in the percent of consumer loans that were noncurrent and in the charge-off rate are consistent with the deterioration of consumer credit quality suggested by the rise in charge-offs on consumer loans.

Outlook for Consumer Loan Growth

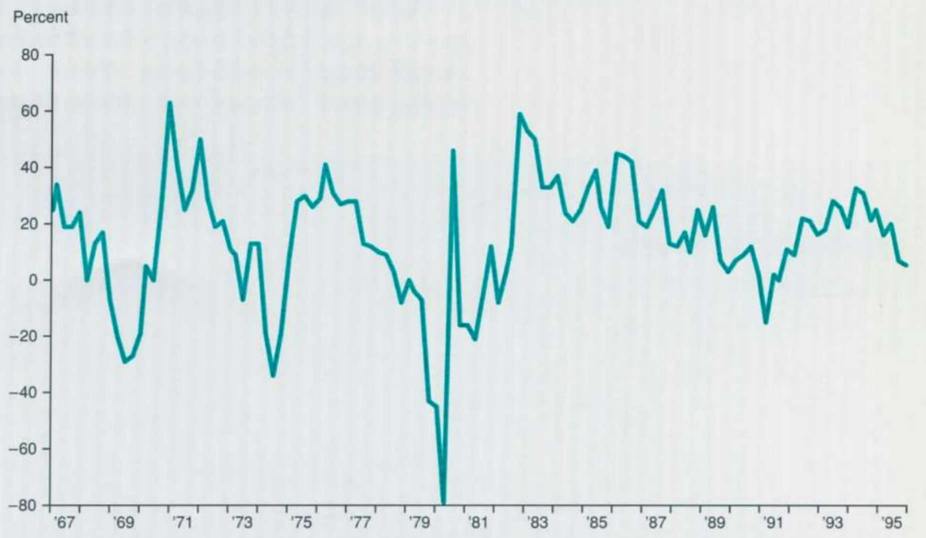
How are banks likely to respond to the signs of deteriorating consumer credit quality? One indication comes from the Federal Reserve's Senior Loan Officer Opinion Survey, which tracks bankers' response to the statement, "Please indicate your bank's willingness to make consumer installment loans now as opposed to three months ago." The solid line in Chart 6 summarizes banks' response to this query. The line shows the

Chart 5
Net Charge-Offs
(U.S. Insured Commercial Banks)*



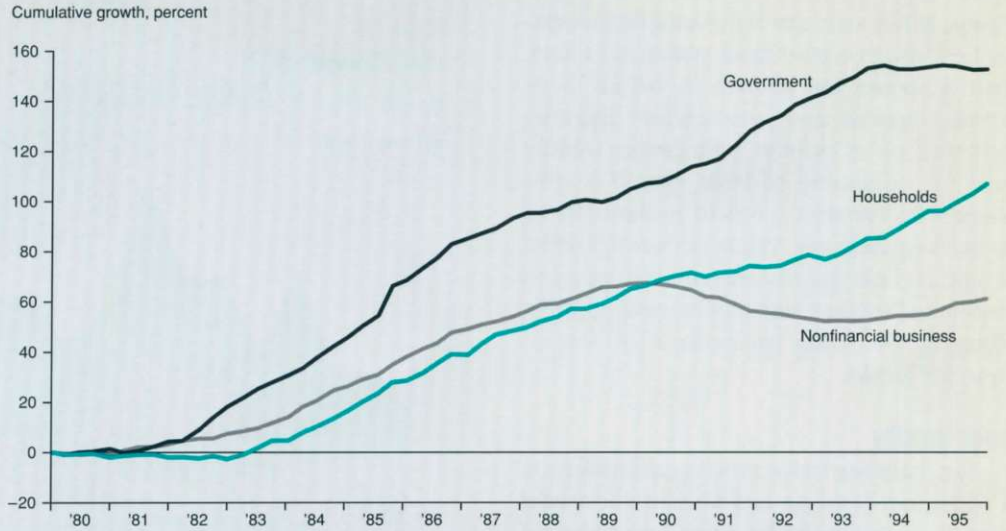
* Data include only banks with $300 million or more in assets.
DATA SOURCE: Report of Condition and Income.

Chart 6
Bankers' Willingness to Make Consumer Loans
(Net Percentage More Willing to Make Consumer Installment Loans)*



* Net percentage equals the percentage of loan officers who said they were more willing to make consumer loans, minus the percentage of loan officers reporting that they were less willing to make consumer loans.
DATA SOURCE: Federal Reserve Senior Loan Officer Opinion Survey.

Chart 7
Debt Growth



NOTE: Data are adjusted for inflation.
DATA SOURCES: Board of Governors of the Federal Reserve System, Flow of Funds Accounts; Citibase.

net percentage of survey respondents who reported being more willing to lend. To the extent that these survey results reflect general banking industry trends, Chart 6 indicates that banks have lost enthusiasm for making consumer loans. This loss of enthusiasm for consumer loans could slow growth in bank lending to consumers.

Consumers' Financial Strength

To put banks' consumer lending in perspective, it is helpful to examine consumers' overall financial well-being. Broad credit market trends affecting consumers' financial strength will affect consumers' ability to repay debts, including bank debts.

One credit market trend affecting both the consumer and the overall economy is the growth in the inflation-adjusted amount of debt, as shown in Chart 7. Of the three sectors shown on the chart, the largest percentage increase in inflation-adjusted debt occurred in government, followed by households and nonfinancial businesses. Much of the increase in debt in the economy, then, is not the result of businesses borrowing to finance productive investment projects but comes instead from an increase in government and household borrowing. And household debt has roughly doubled in inflation-adjusted terms since 1980.

The implications of debt growth for credit quality depend on debt growth in relation to borrowers' ability to pay. One way to gauge debt relative to ability to pay is to look at debt-to-income ratios, as in Chart 8. The economy's debt-to-income ratio, measured as the ratio of nonfinancial debt to gross domestic product (GDP), rose during the 1980s but has stabilized in the 1990s. In other words, debt in the overall economy grew faster than income in the 1980s, but in the 1990s debt growth and GDP growth have been nearly equal. For households, the debt-to-income ratio (measured as the ratio of household debt to disposable personal income) increased during the 1980s, like the overall economy's debt-to-income ratio, but the debt-to-income ratio continued to increase in the 1990s, reaching a new high in late 1995. Viewed as an isolated event, this recent peak in households' debt-to-

Chart 8
Debt Relative to Income

DATA SOURCES: Board of Governors of the Federal Reserve System, Flow of Funds Accounts; Citibase.

income ratio could suggest that households may have difficulty servicing their debt and that the quality of banks' consumer loans could suffer.

Additional evidence, however, indicates that households' ability to service debt is greater than the debt-to-income ratio alone implies. Chart 9 shows one type of additional evidence, the fraction of disposable income devoted to debt service. This ratio, unlike the debt-to-income ratio, was not unusually high in late 1995, implying that households' debt is not unusually burdensome.

Several factors help explain why debt service payments are not unusually high relative to income, despite unusually high debt relative to income. One factor that has held down debt service payments is low market interest rates. Another factor that has held down debt service payments is the lengthening of maturities on consumer loans, especially auto loans; this lengthening of maturities has reduced principal payments. Finally, the rapid growth in credit card lending itself has helped hold down debt service payments for some consumers; to attract new customers, offers for new credit cards often come with low "teaser" rates that allow consumers to roll over their existing credit card balances into the new card and its low rate for a few months.

Another measure of consumer debt burden is debt relative to financial assets because, in addition to income, consumers can also use their financial assets to repay their debt. Chart 10, a graph of consumers' debt relative to their financial assets, shows that this ratio was not unusually high by recent historical standards. The implication from this ratio is that consumers' debt is not unusually burdensome. Also, the ratio was falling during 1995, reflecting the rapid growth in stock prices during that period that increased consumers' wealth.

Some doubt remains, however, about the extent to which households' financial assets are available for the repayment of debt. For instance, the households that owe the debt may not be the same households that hold the assets. Second, some of the households' financial assets are inaccessible, such as assets held in pension funds. Finally, the value of the financial assets can fluctuate, although consumers must still repay debt.

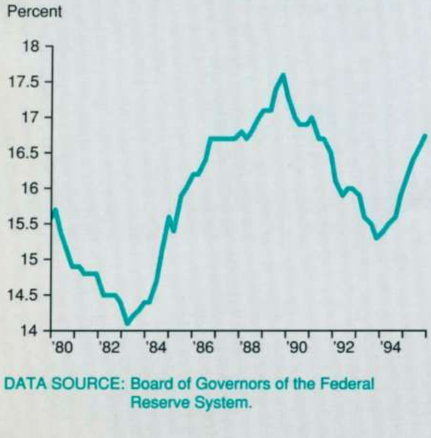
To summarize the evidence on consumers' financial strength, current consumer debt does not appear to be unusually burdensome; neither the proportion of disposable income devoted to debt service nor the amount of debt relative to financial assets is unusually high. High debt relative to income, however, implies that the consumer's position is somewhat vulnerable; a decline in income could push the proportion of income devoted to debt service to an uncomfortably high level, and a decline in the value of financial assets would increase debt relative to financial assets.

Several factors suggest that banks' ability to weather deterioration in consumer credit quality is great.

Banks' Ability to Weather Deterioration In Consumer Credit Quality

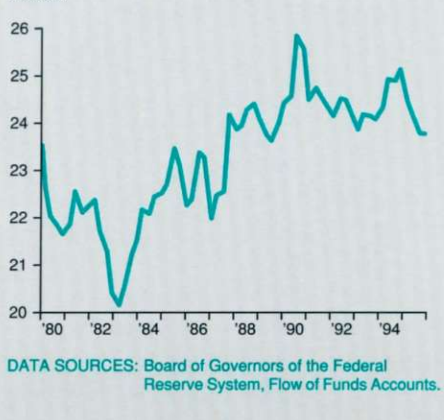
These indications that consumers' financial position may be somewhat vulnerable raise the question of how well banks could weather deterioration in consumer credit quality. Several factors suggest that banks' ability to weather deterioration in consumer credit quality is great. The recent high

Chart 9
Debt Service Payments as a Percentage of Disposable Income



DATA SOURCE: Board of Governors of the Federal Reserve System.

Chart 10
Debt Relative to Financial Assets (*Household Sector*)



DATA SOURCES: Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

level of bank profits implies that if difficulties in consumer lending caused profits to fall by 15 percent, banks' return on assets would remain above 1 percent. Also, consumer loans remain a relatively small part of bank lending, accounting for only 20.6 percent of total bank loans. Finally, if the fraction of consumer loans that are noncurrent and the fraction of noncurrent consumer loans that are charged off both rose to the peaks reached after the 1990–91 recession, banks' return on assets would fall by only 11 basis points.

Conclusion

Over the past several years, banks have significantly increased their lending to the consumer in response to the profit opportunities offered by consumer loans. During 1995, signs of deteriorating credit quality emerged, raising questions of whether troubles with consumer lending could present difficulties for the banking industry. The broader trends in consumer credit markets suggest that consumers' ability to service their debt is currently adequate. Going forward, however, consumers' financial position may be somewhat vulnerable. If consumers' vulnerable financial position does cause consumer loan quality to continue to slip, the banking industry's recent vigorous profits, high capital ratios, and modest exposure to the consumer puts the industry in a strong position for handling consumer loan problems.

—Robert R. Moore

Financial Industry Issues
Federal Reserve Bank of Dallas

Financial Industry Issues is published by the Federal Reserve Bank of Dallas. The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

Financial Industry Issues is available free of charge by writing the Public Affairs Department, Federal Reserve Bank of Dallas, P.O. Box 655906, Dallas, Texas 75265–5906, or by telephoning (214) 922-5254 or (800) 333-4460, ext. 5254.

11K Bank Notes

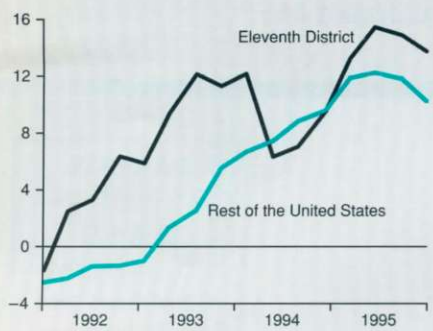
District Lending Outpaces U.S. Total

A stable net interest margin and double-digit growth rates in their loan portfolios helped make 1995 another profitable year for Eleventh District banks. Total loans increased by $14.3 billion, or 13.8 percent, during 1995. The biggest gains came in real estate loans, which were up $10 billion, or 22 percent. Commercial and industrial loans recorded the second highest gains—$4 billion, or 14 percent. Consumer loans were up $1 billion, a 6 percent increase for the year. (Other loans declined $500 million.) The rise in lending activity in the Eleventh District outpaced the rest of the United States, which had loan growth of 10.3 percent during 1995.

The District's asset quality ratios remained good, as noncurrent loans and other real estate owned constituted only 0.55 percent of total assets at year-end, the lowest troubled asset ratio reported by the 12 Federal Reserve Districts. Net loan losses rose but remained at a relatively low level of 0.23 percent of average loans for 1995, compared with 0.16 percent for 1994. Outside the District, net loan losses equalled 0.51 percent of average loans in 1995.

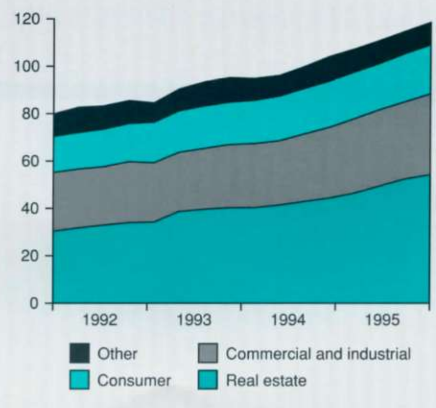
Loan Growth at Insured Commercial Banks

Year-over-year growth, percent



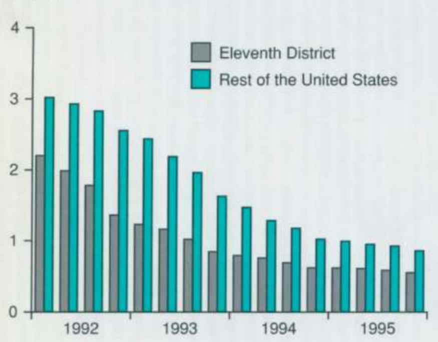
Loans Outstanding at Eleventh District Insured Commercial Banks

Billions of dollars



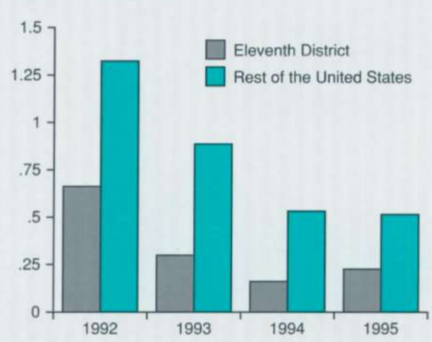
Troubled Asset Ratio for Insured Commercial Banks

Percent



Net Loan Losses at Insured Commercial Banks

Percent of average loans



NOTE: The Eleventh District of the Federal Reserve System encompasses Texas, northern Louisiana and southern New Mexico.
DATA SOURCE: Report of Condition and Income.

A New Look, A New Location


FINANCIAL INDUSTRY

Issues

Has Consumer Credit Growth Jeopardized Bank Profits?

This issue of *Financial Industry Issues* introduces a new, expanded format. Now the newsletter's lead articles present more graphics, and a new feature, "11K Bank Notes," offers quarterly updates on banking data for the Southwest.

The publication also has a new home on Fed*Dallas*, the Dallas Fed's new World Wide Web home page. Text and PDF versions of all 1995 issues are available online, and 1996 issues will be added as they are published. The Internet address is http://www.dallasfed.org

FEDERAL RESERVE BANK OF DALLAS
P.O. BOX 655906
DALLAS, TEXAS 75265–5906