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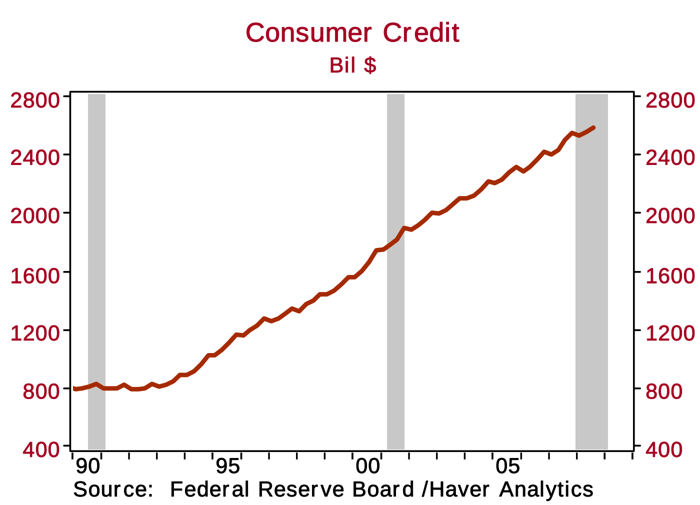
Feb 27, 2009 | Economic Commentary

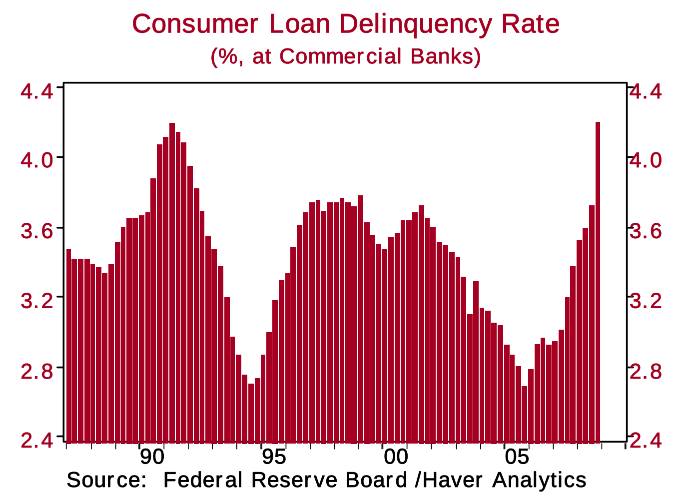
Consumer Loans Not the Next "Crisis"

Summary: *In dollar terms, consumer debt hit an all-time high in 2008 and recent data show a sharp increase in consumer loan delinquencies. However, despite significant fears, non-mortgage consumer loans are unlikely to experience anywhere near the problems that mortgage debt has seen. First, residential mortgage debt is about four times greater than consumer loans. Second, the recent increase in consumer loan delinquencies is consistent with typical recessions. Third, while mortgage debt is at a record high relative to total household assets, consumer debt relative to assets is near its long-term average. And last, while mortgage payments remain high relative to after-tax incomes, consumer debt payments by homeowners, as well as the financial obligations of renters, are noticeably lower as a share of after-tax income than in the late 1990s and earlier this decade.*

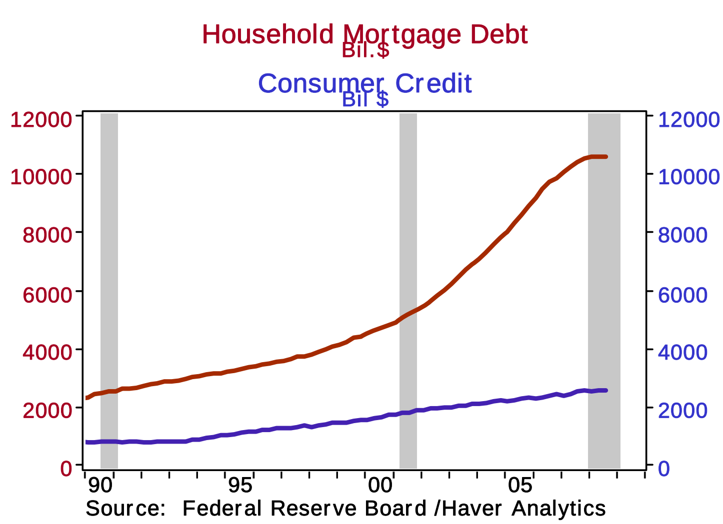
Consumer loans include most short- and medium-term credit not secured by real estate. Given the rise in consumer debt in raw dollar terms, it is not hard to see why some observers think consumer debt is a major problem. Consumer credit outstanding is up from about $800 billion in the early 1990s to about $2.6 trillion today.



Consumer loan delinquencies (those past due 30 days or more) hit 4.2% at the end of 2008, matching the previous peak in mid-1991.

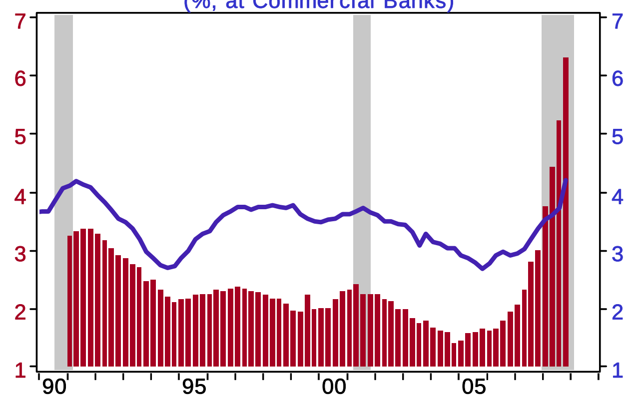


However, consumer borrowing is not nearly as much of a problem as residential mortgage debt. Mortgage debt is about four times the size of consumer credit, and recent increases in delinquencies on consumer loans are roughly consistent with the recent rise in the unemployment rate.



The jobless rate was 6.9% in the fourth quarter of 2008, when the delinquency rate was 4.2%. The last time the delinquency rate was 4.2% was in mid-1991, when the jobless rate was 6.8%. In contrast, delinquencies on home mortgages are far above what would be expected given the loss in jobs.

Home Mortgage Delinquency Rate
(%, at Commercial Banks)
Consumer Loan Delinquency Rate
(%, at Commercial Banks)

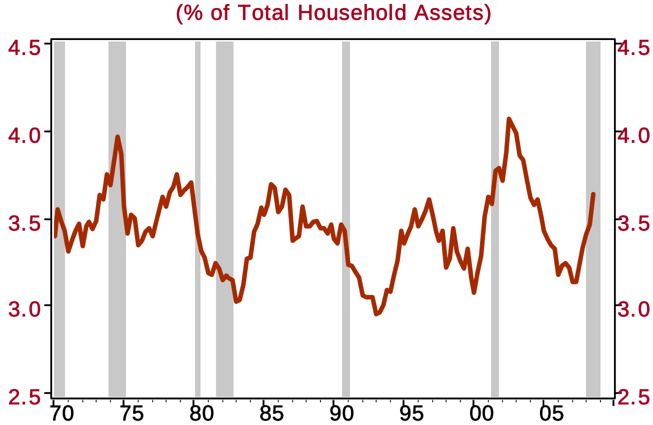


Source: Federal Reserve Board /Haver Analytics

Surely, consumer loan delinquencies will continue to rise in the months ahead, as the unemployment rate rises. In addition, the difficulty some households have in maintaining their mortgage debts may cause some additional rise in consumer loan problems, over and above what would normally be associated with higher unemployment. However, the pattern is not any more alarming than would normally be projected in a recession of this severity.

Another reason not to be alarmed by the level of consumer debt is that it is within the normal range relative to household assets (stocks, bonds, life insurance, real estate, and durable goods).

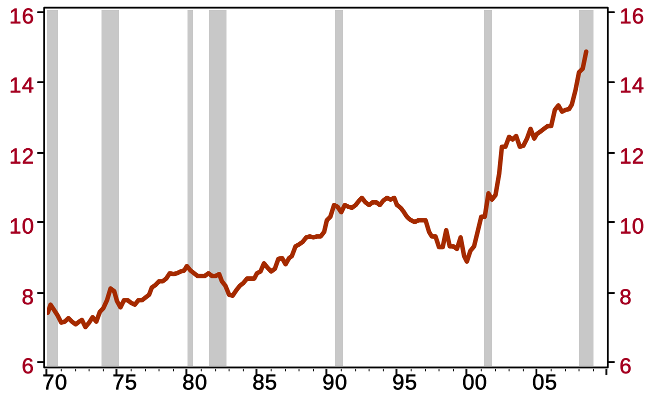
Household Consumer Credit
(% of Total Household Assets)



Source: Haver Analytics

In other words, consumer loans have not climbed to anywhere near the level of mortgage debt, which is at a record high relative to household assets. Mortgage debt skyrocketed earlier this decade when interest rates were held artificially low by the Fed – well above what fundamental real-estate values could sustain. But this did not happen with other consumer debt.

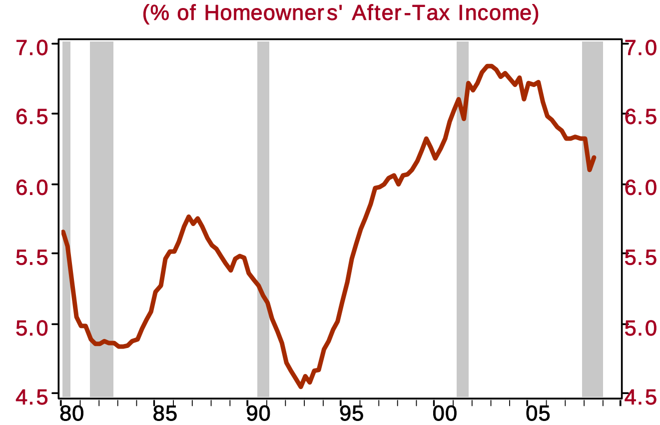
Household Mortgage Debt
(% of Total Household Assets)



Source: Haver Analytics

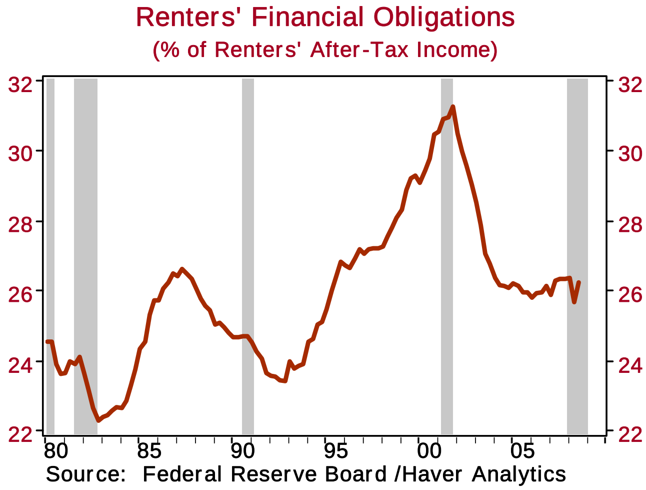
Separating homeowners (mortgage borrowers) from renters, the data show that the consumer (non-mortgage) obligations of homeowners have fallen relative to their after-tax incomes during the past several years.

Homeowning Consumers' Financial Obligations
(% of Homeowners' After-Tax Income)

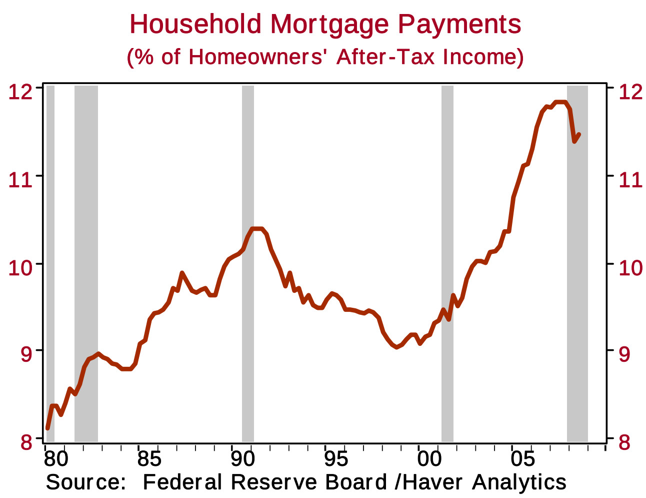


Source: Federal Reserve Board /Haver Analytics

And as the chart on the next page shows, the monthly financial obligations of renters have fallen dramatically from where they were in the late 1990s and the early part of the 2000s.



The same cannot be said for mortgage payments (including principal, interest, homeowners' insurance, and property taxes), which remain very high relative to homeowners' after-tax incomes.



A mortgage payment that absorbs 11.5% of after-tax income may not seem particularly high. After all, even the new Obama Administration's plan for homeowner bailouts will try to reduce payments to 31% of income. But this overall figure of 11.5% includes many homeowners who own their homes outright, with no mortgage at all, as well as others who have lived in their homes for many years since the initial purchase, meaning rising incomes, inflation, and refinancing have reduced the share of income needed to support their mortgage obligations.

In sum, overall household debt increased substantially in the past decade due to a large expansion in mortgage obligations, which many homeowners are now having difficulty servicing. The recession is going to make consumer debt burdens harder to bear in the months ahead. But this is normal. Contrary to conventional wisdom, households did not enter the recession with an unusually high level of non-mortgage debt.

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