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Looming Consumer Debt: A Comparison to the Great Recession

Andrew Jenks
Grand Valley State University, jenksan@mail.gvsu.edu

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Professor Dimkoff

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The Great Recession is still fresh in the minds of many Americans. On the surface, the American recovery from its worst economic downturn since the Great Depression seems to be complete and the United States economy seems to be booming once again. However, digging deeper, there are several worrying trends that can be seen in the current economy that should catch the attention of the American people. Reports surfaced in 2017 that household debt had surpassed the peak levels from the 2008 financial crisis (Liesman, 2017). This is indicative of an underlying problem that has arisen because of the economic recovery efforts. As money has become more readily available for borrowing due to the monetary policy put into effect to restore the economy (which the fed has taken its time rolling back), Americans find themselves taking on more debt. While this is happening, the stock market has hit all-time highs thus far in 2018, interest rates are still low (although slowly rising), the unemployment rate is shrinking and the economy is expanding. Given these signs of a strong economy, it is often easy to get complacent and not pay much attention to debt or bad lending practices taking place. That is what happened to some extent in 2007-2008 after all. While the economy seemed to be doing very well, there was a massive amount of subprime mortgage lending going on, and subsequently bet on or against through the utilization of collateralized debt obligations. Thus, when the economy finally slowed, the full extent of the negligent lending practices and underlying issues were fully exposed and unfortunately played a big role in toppling the American economy. With the memory of this so clear in the mind of the American public, it would seem that rising debt and poor lending practices would trigger some sort of response. However, with a fair amount of these things taking place in the United States right now, maybe not. The areas in which improper lending and rising debt are potentially problematic at current times are not necessarily shocking. Mortgage debt has grown significantly during our economic recovery and boom for example. Other areas of potential problems are in student loan debt, credit card debt and subprime auto-lending practices. The consolation for the American people is that the ratio of household debt to overall GDP is significantly lower than it was prior to the financial crisis, as can be seen at Figure 1 (FRED, 2018).

As of February 2018, mortgage debt was up to $8.8 trillion in the United States. This means that mortgage debt makes up approximately two-thirds of total US debt (Ben-Achour & Kasperkevic, 2018). The trend of mortgage debt rising does not by itself indicate that the economy could be on the verge of downturn. In fact, investment in real estate could simply indicate that the housing market is finally really bouncing back to levels it has not seen since before the recession. It is worth noting that in 2007, there were several signs of a problem in the housing market that either went unnoticed, were ignored, or had their potential negative effects underestimated. Since that time, there have been measures passed through congress that attempt to regulate banks in a way that would not allow for the mortgage crisis to repeat itself. This hopefully means that that rising mortgage debt levels are indeed a consequence of a healthy economy in which more people are buying homes. The real question at hand is how much of the mortgage debt being taken on fits the mold of a subprime mortgage loan? The answer to that question is not necessarily one that is met with much optimism. Fannie Mae and Freddie Mac, two government-sponsored enterprises created to expand the secondary market for mortgages in the US, redefined subprime to a credit rating of below 620. The rating that was previously considered subprime was 660. In other words, people with credit scores from 620 to 660 that would have been categorized as subprime borrowers in the past are now considered “safe” essentially. This is a small workaround that allows these mortgage lenders to buy even weaker mortgages than they were before the crisis. Freddie Mac’s 2016 annual report said that 36% of its obligations are “credit enhanced,” meaning they carry mortgage insurance, which usually signifies weaker mortgages. If home values level off it is possible that subprime debt will again fail (Poole, 2017). However, it seems that the actual amount of subprime mortgage debt out of the total has remained relatively low compared to the levels prior to the financial crisis. This can be seen in Figure 2 in the appendix. Banks have abided by much more stringent lending standards when it comes to mortgages because of the financial crisis. With this being the case, it is rather unlikely that the amount of mortgage debt that is outstanding right now is any indication of an imminent crisis. In this case, it is more likely that the real estate market is finding its footing once again and is probably an indication of a strong economy.

Credit card debt is another area that concern could be raised upon. In November 2017, revolving credit (which mainly consists of credit card debt) hit $1.023 trillion and has continued to rise into the first couple of months of 2018 as well. These are the highest levels of revolving credit that the United States has seen since right before the recession in 2008. Credit card delinquency also rose from 7%

in 2016 to 7.5% in 2017. This means more people are falling behind on their credit card payments, which does not spell good things. However, 7.5% delinquency is nowhere near the 15% that was reached before the financial crisis hit. Also, the ratio of credit card debt to US GDP is about 5% compared with 6.5% in 2008 (Morris, 2018). The revolving credit outstanding can be viewed in Figure 3 in the appendix. It is worth noting that the revolving credit outstanding is not adjusted for inflation, so even though it has surpassed the pre-crisis 2008 levels, it has not actually surpassed the pre-crisis levels in real terms and does not appear ready to spiral the US into another crisis. The general trend of this debt has been growing since 1970. As was the case in the mortgage space, a downturn in the economic fortunes of the United States could potentially cause more failure to pay back this debt and could result in much higher delinquency levels. Further putting the minds of the American public at ease, both jobs and incomes are on the rise. This indicates that a financial downturn is not imminent. A key indicator of the recession that was to come in 2008 was the economic stagnation that took place in late 2007. The job market was shrinking, and values of assets started to level off instead of grow. At current times, this is certainly not happening. The worrying thing about credit card debt is how many people have taken on amounts that they cannot manage. In a survey conducted for CreditCards.com, 35% of U.S. adults with credit card debt, or about 31 million people, said they do not think they will ever get out of debt. Another 33% of Americans with credit card debt don’t know when they will be debt free (Carrig, 2018). With such a large population buried in credit card debt that they cannot manage already, it is scary to think of what an economic downturn could cause. Unfortunately, credit cards seem easier and easier to come by. More and more retailers are offering their own store cards, cards are being tailored to college students, there are cards for frequent travelers, etc. As credit cards become easier and easier to come by for the average consumer, education on them becomes more necessary. Very few high schools teach financial skills such as proper credit management. This is a potential factor in why they are misused so frequently.

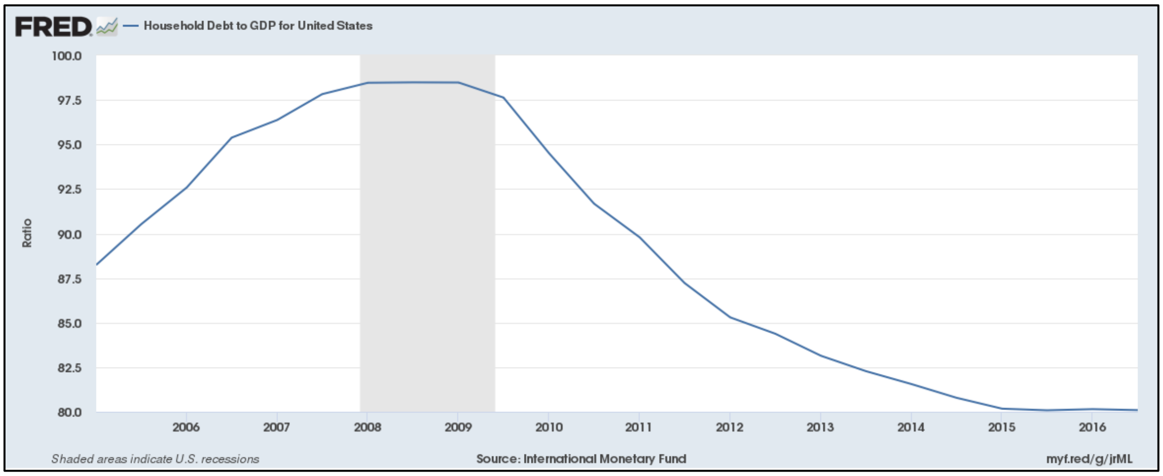
The worrying debt trends are not unique to the revolving credit market however. There is a significant amount of debt being borrowed in both the student loan, and auto markets. The market for auto loans is constantly ever-present as almost everyone in the United States needs a car to hold down a job or just travel to the grocery store. The exception, of course, being in large metropolitan areas where cars are an impractical form of transportation due to heavy traffic. Even these people generally own cars as sometimes it is good to escape the city limits. This need for cars as a form of transportation for American consumers has led to the rise of many auto finance companies and captive auto lenders which essentially are wholly owned subsidiaries of car manufacturers that help customers finance a vehicle from the parent company. This setup helps car manufacturers sell more cars and reduce their risk exposure, because if a customer defaults on their loan, the losses are incurred by the captive company and not the manufacturer itself. The other major benefit of having these captive auto lenders underneath the parent company is that consumers are more likely to buy from the parent company in the future since they already have a credit account with their captive company that enables them to capitalize on some special deals. However, much with everything else, these companies do not come without their disadvantages. Captive financing companies often approve customers for loans that they cannot afford because they are more willing to give out high-risk loans. This can lead to significantly more defaults in the auto-lending market. Captive financing companies also often get labeled as predatory, in the sense that they can charge higher monthly payments and incentivize buyers to pay ridiculously high interest rates to get “special prices.” People are using these companies more and more to get an auto loan for the simplified access that they grant, but it is important when dealing with one of these companies to make sure that they are offering a loan under proper terms with agreeable fine print. It is important that this is covered because only one third of auto loans is currently held by a bank. Auto finance companies and captive finance companies are continuously picking up a larger share of these loans. The troubling characteristic of this trend is that many of the loans being shouldered by these companies are subprime loans that are beginning to fail. The 90-plus-day delinquent rate for subprime auto loans originated by auto finance companies now stands around 10%, which is higher than the highest rate after the dot-com crash and very close to the highs in 2009 after the financial crisis. Banks have for the most part backed out of risky subprime auto lending, so their delinquency rates have been steadily improving while auto finance companies’ rates diminish. The United States should not have to worry too much about a large failure of the financial sector because of these subprime auto loans since they have largely got away from them, but these auto finance companies’ loans still represent a large risk. Consumers who default on their loan will have their credit destroyed, they will most likely have their vehicle repossessed and they will experience financial difficulty as it gets even more complicated for them to borrow money (Turner, 2017). The major reason for this rapid increase in subprime delinquencies is that lenders have loosened requirements to try to keep high profits as the market for vehicles has declined in recent years. By loosening their lending standards, they could provide deep subprime loans to customers that otherwise would have been unable to obtain a loan. The amount of subprime auto debt can be seen in Figure 4 in the appendix both in terms of subprime auto debt outstanding and share of US auto loans that are subprime. Many people are looking at the structure of the auto market and drawing similarities to the 2007 housing market pre-crash. This similarity may be merited as many auto loans are starting to fail and there is a high rate of subprime and deep subprime lending. The amount of subprime auto loans that are delinquent can be seen in Figure 5 in the appendix. There is a clear trend since 2010 of growing instances of delinquency in the subprime auto market. The key distinctions between the current auto market and the pre-crisis housing market are that these loans are mostly not funded by banks, these loans are generally much smaller than a mortgage, and the car being repossessed as collateral remains decently liquid. These characteristics mean that if the poor auto loans fail on a large scale, they are likely going to cause a much smaller cumulative affect than the housing market crash.

The fourth segment of debt that is really affecting the United States consumers is student loan debt. Attendance at some college or university is pushed more than ever in current times, as it is increasingly difficult to find a living wage job with less than a 2-year degree. With this pressure to continue education after high school, college enrollment has been on a rising trend for some time. However, attending a college or university does not come without significant expenditure. The average yearly cost of tuition and fees for a four-year public institution for in-state students is $9,410, while the yearly tuition and fee costs for public four-year college for out of state students is $23,890. Private schools have an even steeper price. These are costs that don't factor in housing costs, food, books, supplies, transportation, etc. (College Board, 2018). These costs add up fast and can vary greatly depending on which institution is being attended, but the cumulative costs of attendance have led to 44 million current borrowers of student loans totaling $1.48 trillion. This amount of debt represents an average of about $37,000 of student loan debt per borrower. The student loan delinquency rate for 90 or more days delinquent is 11.2% (Student Loan Hero, 2018). That is a pretty substantial amount of failure to repay these loans on time. Figure 6 in the appendix shows the actual amount of student loans outstanding in the United States. It is clear from the graph that this figure continues to rise consistently at a significant rate. This is worrying because more and more debt is required to fund a four-year education, but the worth of a degree seems to be lessening. Between 1985 and 2011, average tuition prices have increased 498% on a nationwide scale. This increase is more than four times the rate of general inflation measured from the Consumer Price Index, which sits at 114% over the same period. This means that the cost of college is not just increasing to match inflation growth, it is far outpacing inflation and growing substantially in real costs (Lindsay, 2017). President Obama had said near the end of his term that a college degree "has never been more valuable." However, a Federal Reserve Bank of New York study revealed that wages of typical college graduates working full time have risen just 1.6% over the last 25 years after adjusting for inflation, while student debt burdens have increased about 163.8% (Nasiripour & Nicky, 2016). This represents a major problem in terms of the solvency of student loan debt. As pointed out earlier, student loan delinquency rate for people delinquent by more than 90 days is already at 11.2%. If wages are only increasing 1.6% for full time working graduates while student debt burdens are increasing by 163.8%, it is going to continue to be harder and harder for students to pay back their debts. Figure 7 show this disparity in growth between wages and debt for graduates. This is likely to lead to a raise in delinquency rate and default rates. The student loan debt market is unique, in that its consequences have potential to flow into the other markets that have been discussed. For many Americans, it is not until they finish college that they go to buy a house, car or take on credit cards. If a graduate is already buried in student loan debt that they are having trouble paying back, it is going to be very difficult for them to pay back a car loan or mortgage. In a sense, this is undermining the classic definition of the "American Dream" where individuals own a house, own a car and have the means to live very comfortably. Supposedly, going to college is something that is supposed to help people achieve this dream, but more and more it seems it may be hurting that pursuit. The other difficult thing about student loan debt is that it always follows the borrower. Student loan debt does not go away with bankruptcy and it will still need to be repaid even after someone defaults on it. There have been many studies as of late that have concluded that millennials are pushing back major life events because they cannot afford to do them with their student loan debt totals.

In conclusion, mortgage debt, credit card debt, auto debt and student loan debt all represent some potential problems that could really hurt the current economy. However, none of these issues are likely significant enough, by themselves, to cause another financial crisis like the one the United States saw in 2008. The housing market is seemingly much more secure than it was pre-crisis and much less subprime lending is being done in that sector. The biggest potential issue with the housing market is that they have redefined subprime mortgages as mortgages to people with credit scores under 620, when it used to be 660. This means that the actual number of mortgages granted to people with credit scores under 660 may be closer now than believed to the 2007 number prior to the crash. However, more stringent requirements of lending are most likely making this further from the reality. Regulations are also now in place to ensure that the same path is not followed. Credit card debt has been higher than it should be for quite some time now, but it is nice to see that delinquency rates are only half of what they were immediately preceding the recession. Even with this being the case it is an area worth paying attention to, especially if delinquency rates start to rise even more. The auto market is potentially an area for concern as there is a lot of bad lending taking place, but it is good for the overall economic health of the United States that most of this bad lending is taking place outside of banks and through private lenders. This will help mitigate damages to the overall economy if these loans fail. Student loans represent the largest financial concern to our economy. As costs of attending college continue to rise, the economy may be stagnated by the inability of graduates to consume in the economy with student debt hanging over their heads. This is an issue worth addressing as more people than ever are starting their professional lives with a large pile of debt. As far as another financial crisis goes, the 2007-2008 crash should show the United States that it is not impossible for a crisis to arise from seemingly nowhere. It is important to carefully monitor each of these four areas and make sure that nothing is happening under the surface that could potentially derail the economy. The media likes to post eye-catching stories that are headlined things like “Mortgage Debt Surpasses Levels Seen Prior to the Great Recession,” because it gets readers interested and fear of the past repeating itself sells. However, after adjusting for inflation, the only type of debt discussed here that has grown since 2007 in real terms is student loan debt. There is likely no imminent financial crisis, but vigilance is key in preventing another.

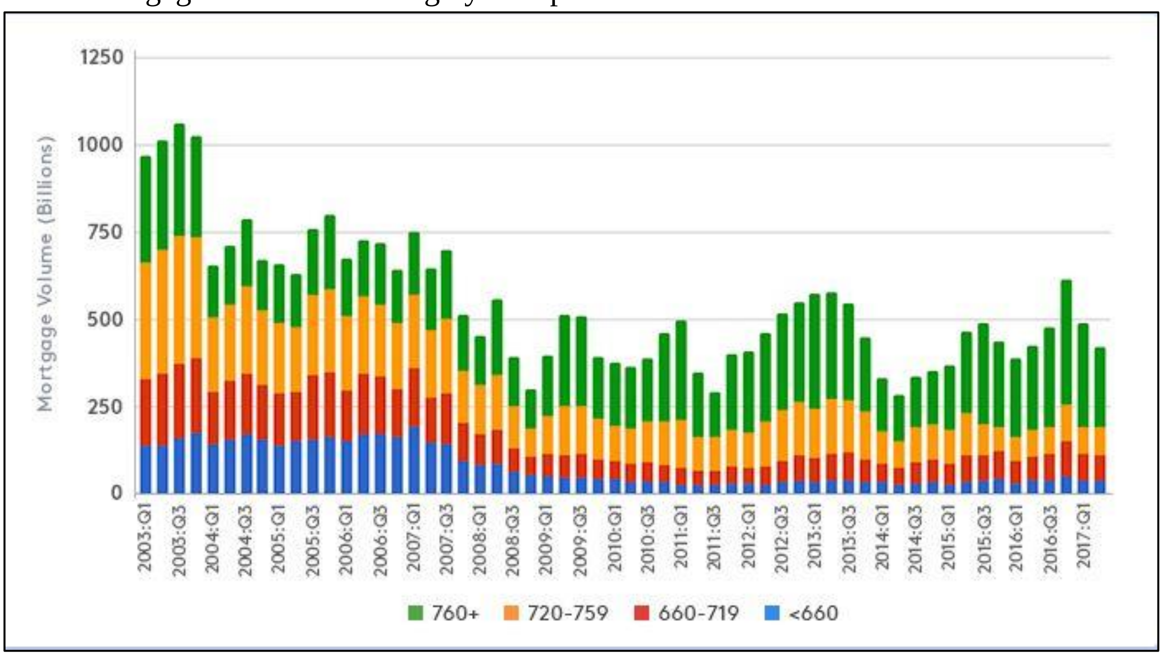
Appendix

Figure 1. Household Debt to GDP for United States



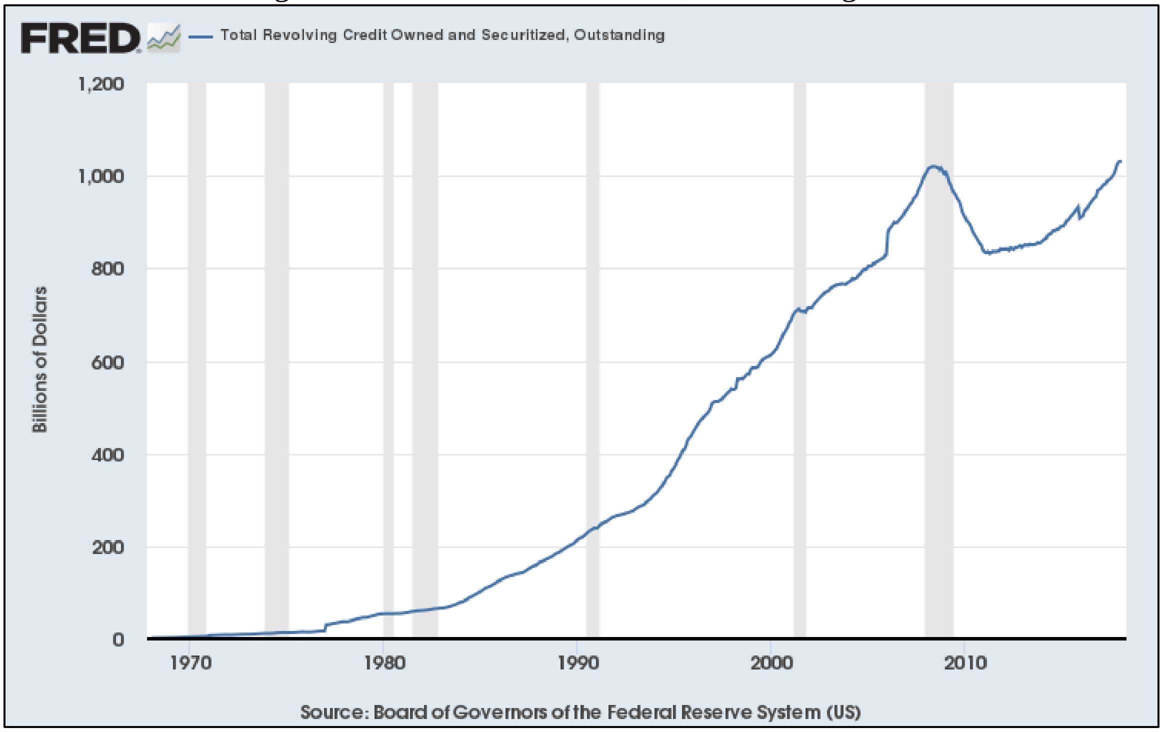
(FRED, 2018)

Figure 2. Mortgage Debt Outstanding by Composition of Credit Scores



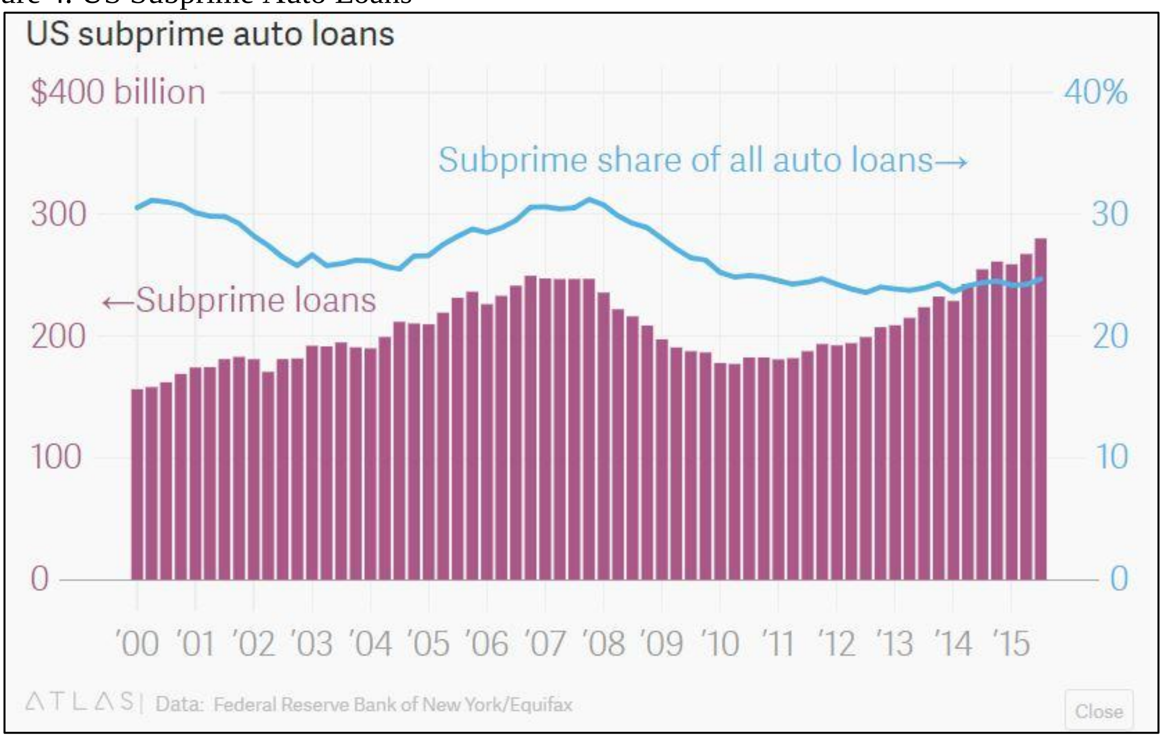
(Rounds, 2017)

Figure 3. Total Revolving Credit Owned and Securitized, Outstanding



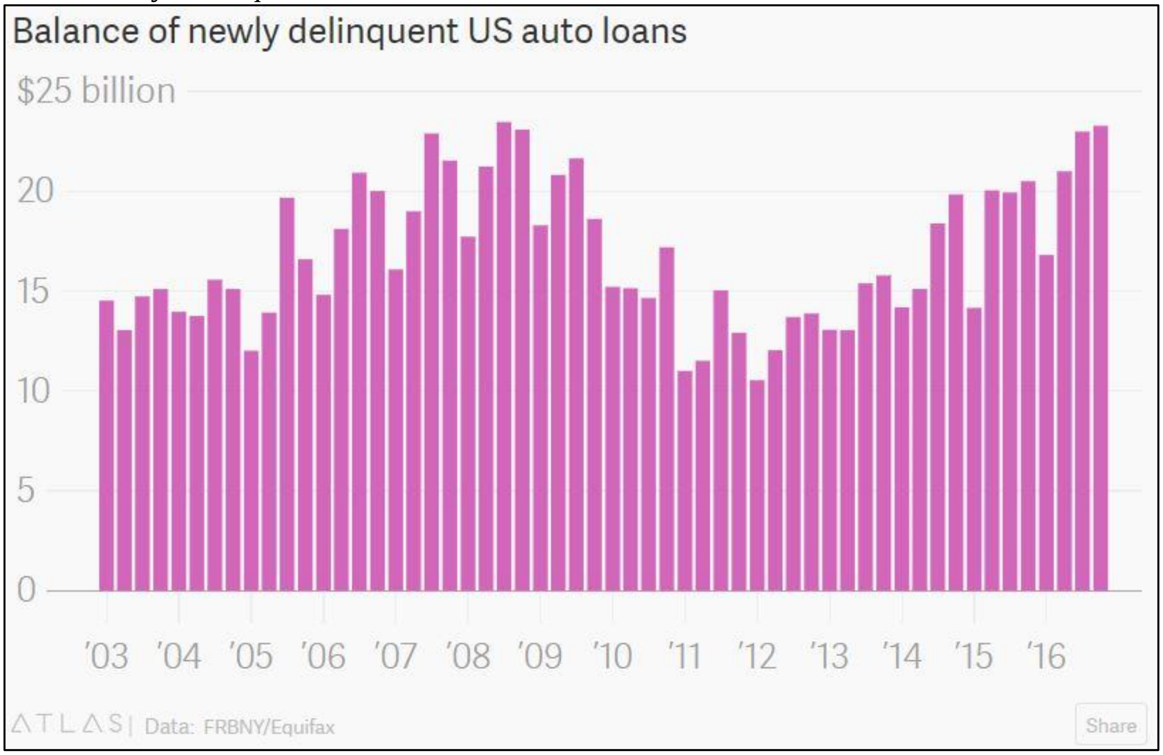
(FRED, 2018)

Figure 4. US Subprime Auto Loans



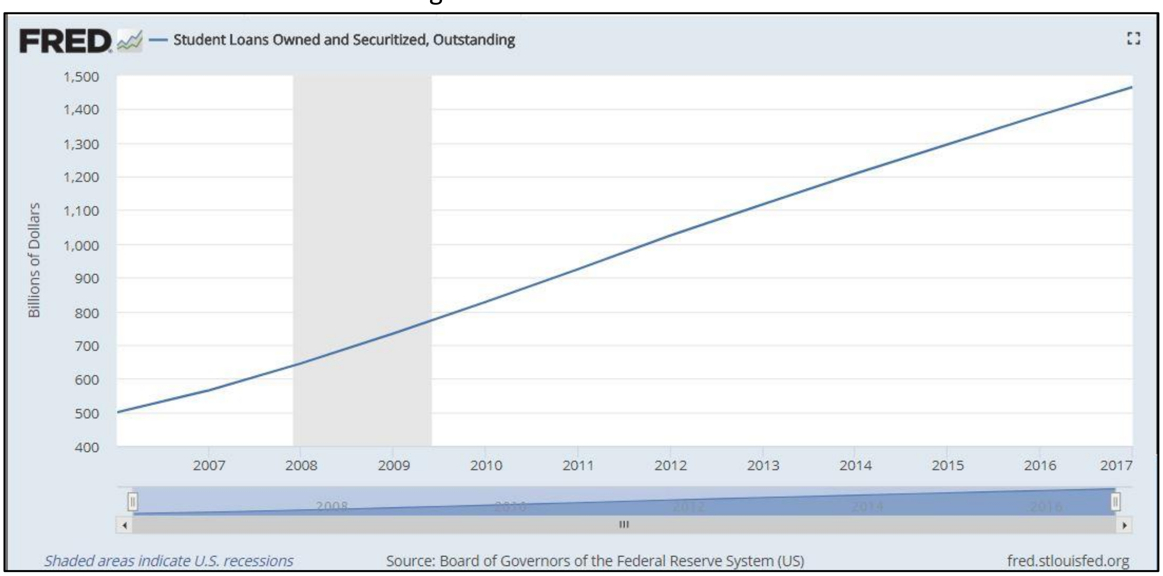
(Federal Reserve Bank of New York/Equifax, 2017)

Figure 5. Newly Delinquent US Auto Loans



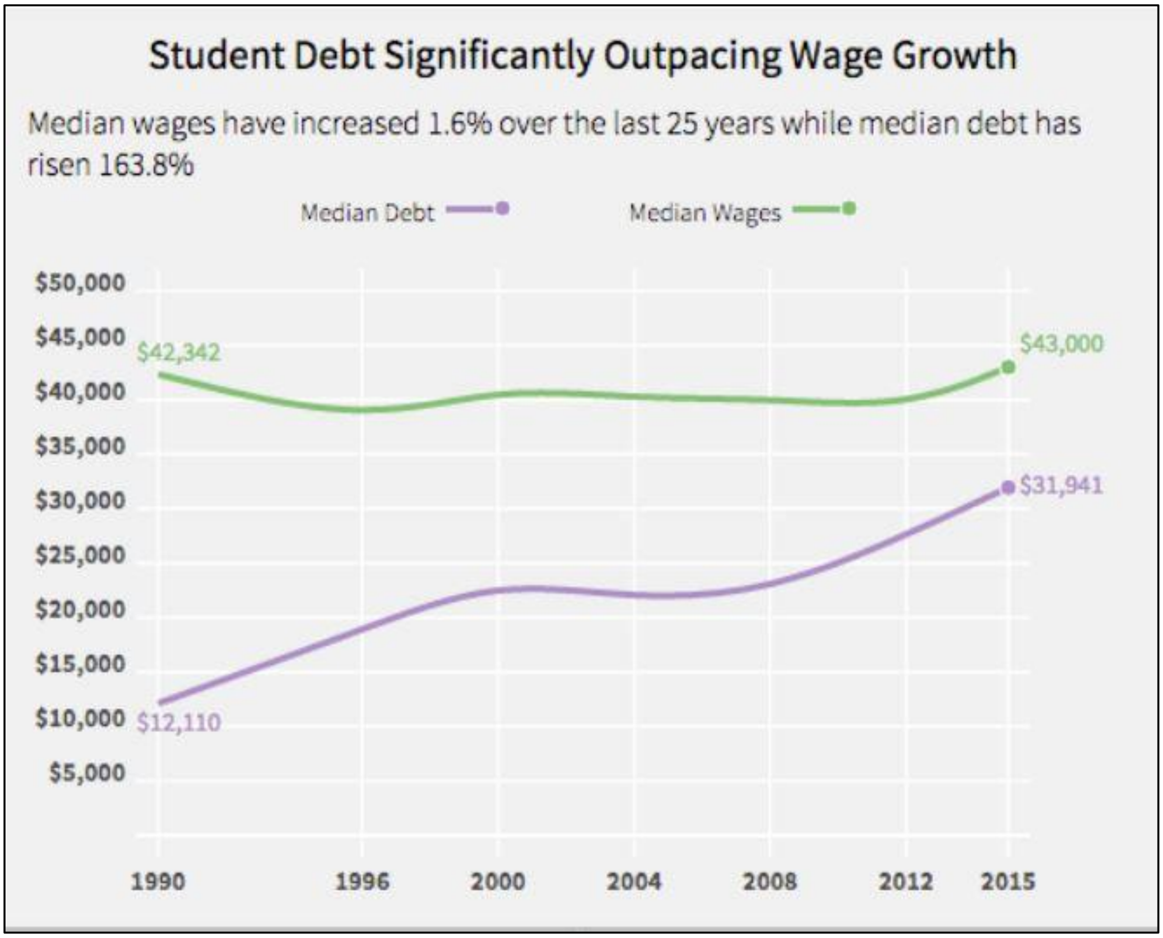
(Federal Reserve Bank of New York/Equifax, 2017)

Figure 6. Student Loan Debt Outstanding



(FRED, 2018)

Figure 7. Median Student Loan Debt vs. Median Wages



(Nasiripour & Nicky, 2016)

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