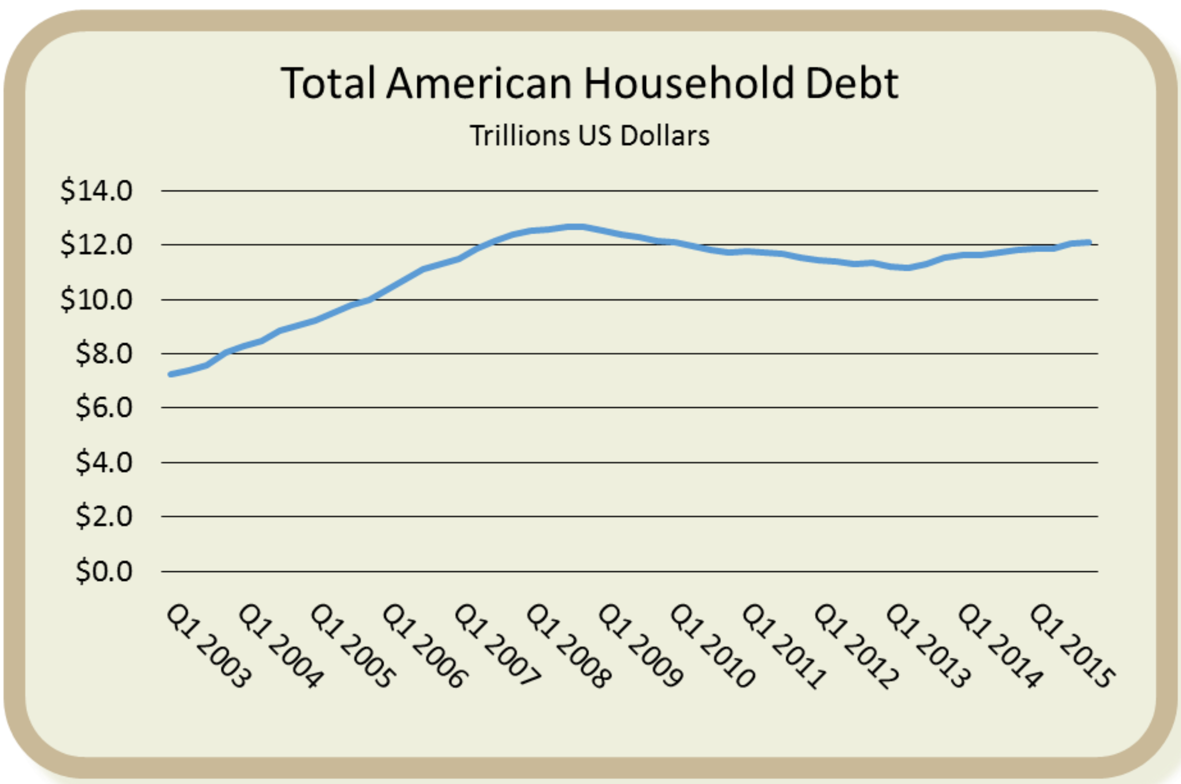
American Household Debt

Post 2008 Credit Crisis Update

By Kevin Chambers

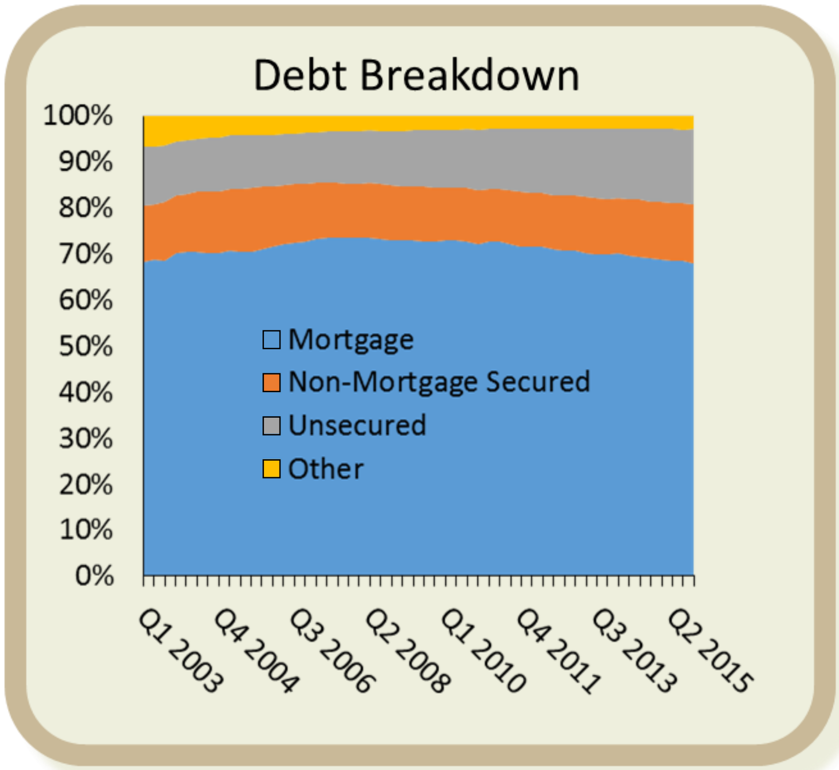
2008 was the worst financial crisis in the United States since the Great Depression. One of the factors that led to the severity of the crash was an unprecedented accumulation of debt by American consumers. A variety of factors contributed to the run-up of debt for consumers. Interest rates were kept artificially low by the Federal Reserve to combat the bursting of the Dotcom Bubble and the financial instability after the 9/11 attacks. The housing market was booming; the mortgage industry was using predatory tactics, and many American's had mortgages they could not afford. Between 2000 and 2008, the total debt of U.S. households more than doubled from $6.5 trillion to almost $14 trillion. This is a story that we have all heard before, but what has happened to household debt since the credit crisis?



Source: FRBNY

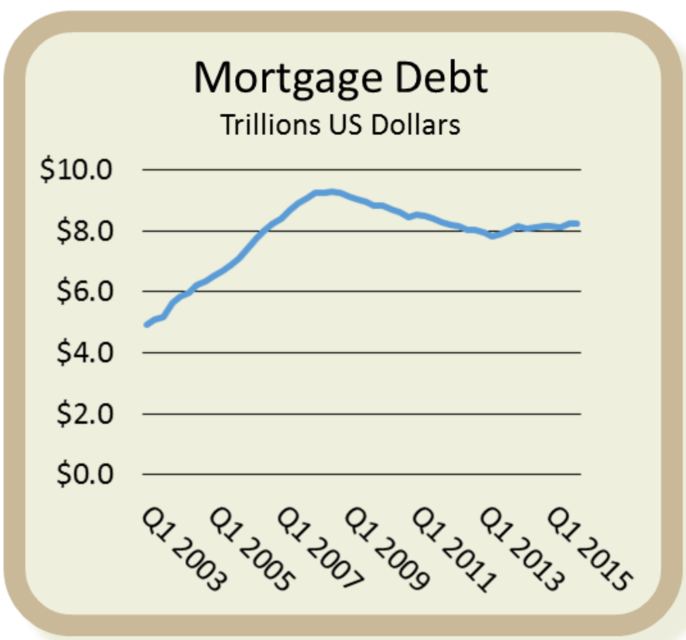
Background

First, let's start with a little bit of context for this subject. Household debt can be split into two general categories: secured and unsecured. Secured debts are loans that are protected by an asset such as a house, car, or boat. Mortgages, home equity lines, and auto loans are all secured debt. Unsecured debt is riskier as it does not have collateral to back the loans and usually has higher interest rates. Credit card debt, student loans, and personal lines of credit are all examples of unsecured debt.



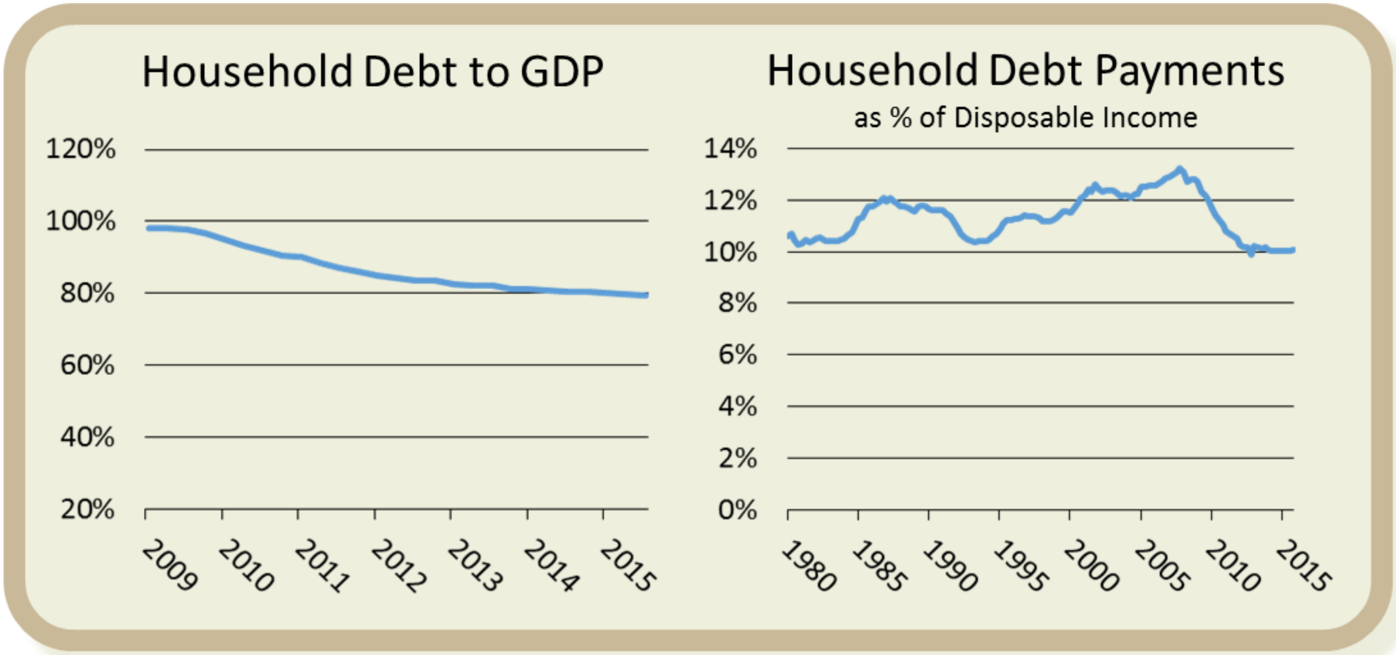
Source: FRBNY

One constant prevails throughout the history of American debt: the majority of debt is collateralized home mortgages and auto loans. In 1962, 85% of total U.S. debt was in homes and vehicles. In 2001, the percentage was a comparable 90% (Campbell and Hercowitz 2006). Even through the 2008 crisis, the percentage of debt by sector has stayed fairly consistent with home mortgages making up 65%-75% of total debt.



Source: FRBNY

Because mortgages make up the majority of American debt, changes in mortgage regulations impact the debt landscape immensely. In the early 1980s, the Monetary Control Act and the Garn-St. Germain Act were signed into law by President Carter and President Reagan, respectively. This legislation led to a large restructuring of the mortgage environment (Campbell and Hercowitz 2009). The goal of the acts was to help savings and loan banks compete; however, both of the acts had little oversight provisions, which led to a rapid expansion of loans being issued by thrift banks. The next legislative shake-up was the repeal in 1999 of the Glass-Steagall Act of 1933, which undid the legislation that had made it illegal for banks to combine traditional savings and loan activities with investment and insurance operations. This repeal led to the creation of the mega investment banks that we know today (Sherman 2009). Relaxed regulation of financial



Source: FRED

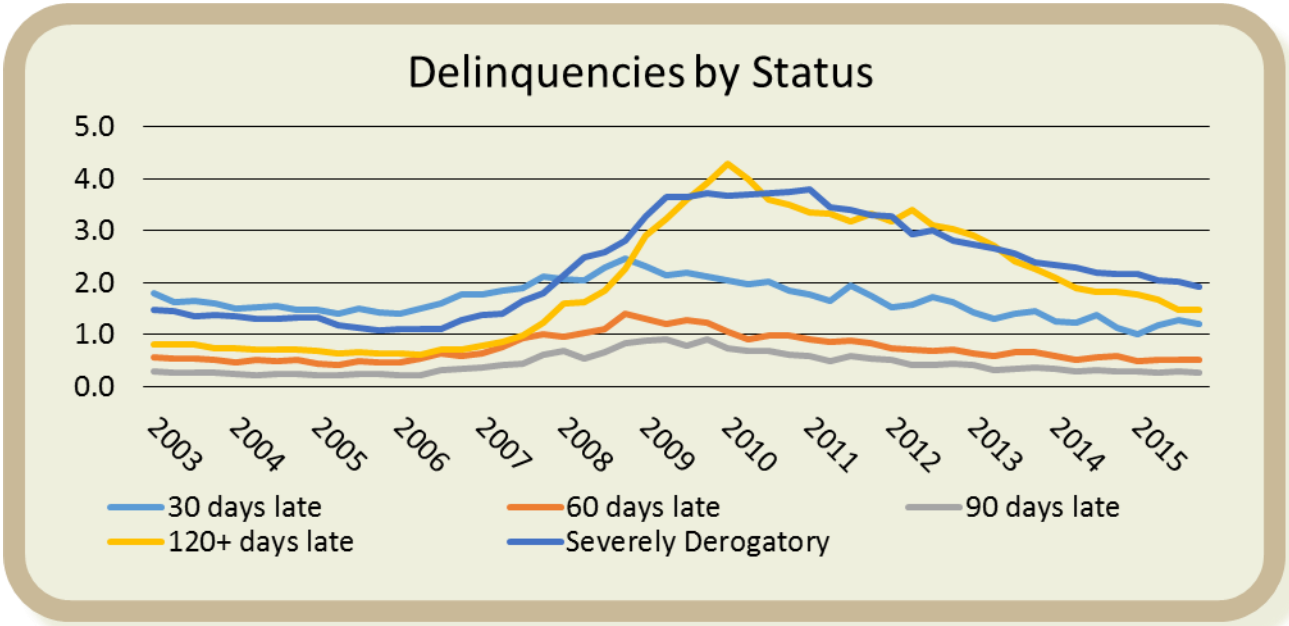
institutions and falling interest rates contributed to the largest increase in personal debt in American history, and eventually, the crisis of 2008.

One of the big changes since the 1980s was a large increase in the ratio of household debt to personal income. In 1980, just before the start of bank deregulation, total debt was 69% as a percentage of disposable personal income in the United States. In the run-up to the financial crisis, the debt-to-income ratio topped out at about 130%. The ratio was just above 100% at the end of 2013. This indicates that the rate of borrowing has outpaced the increase in disposable income. This is especially true after the repeal of Glass-Stegall. From 2000 to 2007, disposable income in the United States rose by 30%, while household debt rose by 50%, mostly due to the increase in mortgage debt.

Post-Crisis

The credit crisis put the growth in American household debt into perspective. Housing prices dropped, the recession took hold, and many families found themselves unable to afford their mortgage. As early as the 3rd and 4th quarters of 2009, the U.S. economy resumed a growth cycle and financial markets showed strong positive gains. Furthermore, the growth of total household debt declined in 2009, 2010, and 2011.

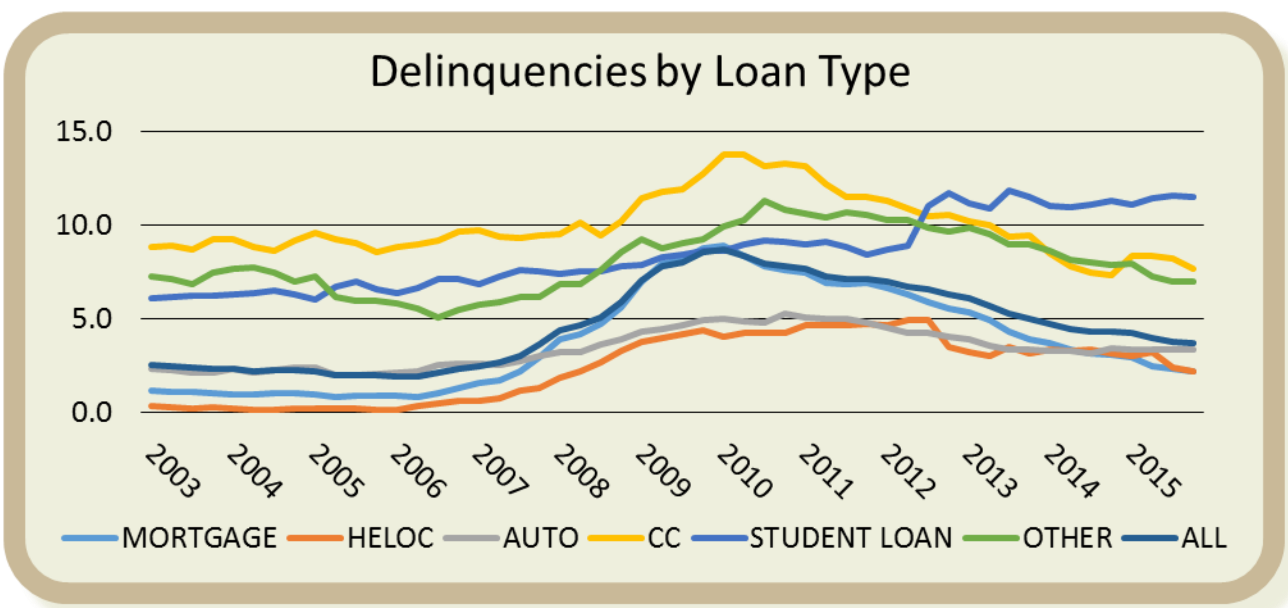
In general, many debt indicators have remained low, even as the US economy picks up steam. The Fed raised interest rates slightly, yet they are still near historical lows. In 2009, the household debt to GDP ratio was right at 100%. Since then it was fallen and has stayed steady at about 80%. Debt payments as a percentage of disposable income dropped from over 13% to 10% and have stayed there. Conversely, household debt in total has almost returned to pre-crisis highs. Mortgages are still lagging at 8.3 trillion, after hitting highs of over 9 trillion. However, non-mortgage household debt is at higher levels than before the crisis. This has been mostly driven by the expansion of student loan debt, up over 1.2 trillion, and by auto loans, which have increased fairly dramatically since the end of the crisis. Auto loans are up 52% since their post-crisis low in 2010. They are now the second largest non-mortgage loan at just over $1 trillion outstanding. Both the student loan and auto loan trends are dramatically different than the other loan categories.



Source: FRBNY

Delinquency Rates

From 2003-2006, an average 4% of total loans were delinquent. Predictably, delinquencies and defaults had a sharp uptick after the crisis. By the end of 2009, 12% of all loans in the United States were delinquent. The distribution of delinquencies was not equal. Before the crisis, loans that were severely delinquent (over 90 days late) and loans that were 30-89 days delinquent were equal at about 2% each of total loans. From 2007-2009, severely delinquent loans increased at a much larger proportion than delinquencies of 30-89 days. Of the 12% delinquent loans at the end of 2009, 8.6% were over 90 days late.



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Since the crisis, delinquencies have continued a trend of decreasing in frequency. As of the end of 2015, delinquencies have fallen to 5.4% of all loans. Off of highs around 12% in 2010. The worst offenders, loans that haven't had a payment in over 120 days, have fallen to 3.4% from a high of 8%. Although delinquencies across the board have fallen, student loans are the exception. Student loan delinquency rates remain at about 11.5%. They have continued to rise through the recovery. On the other hand, auto loans have been growing substantially in the last couple years, yet they have continued to have one of the lowest delinquency rates, currently at about 3.4%.

Conclusion

Debt is a necessary financial tool for most Americans, especially when it comes to home purchases. The most important factor when it comes to the amount of debt an individual can afford is their income. The uptick in overall debt can be attributed to the recovering economy and millennials entering the debt market. After the crisis, and with the weight of student loans, many young people delayed home, car, and other major purchases. Now they are willing and able to take on a bit more of the debt load. The low indicators of indebtedness, debt to GDP and debt to income, are a good sign that American's are not taking on undue burdens.

The one major red flag is student loans, both for their continued overall increase and for their sustainability of their high delinquency rates. At Headwater Investments, we have been following this indicator for a while and are not encouraged by the most recent data. Hopefully, real change can be implemented in the higher education sector, otherwise, we could be in trouble. Overall, the debt sector in American households seems more robust than before the crisis. We are not seeing the huge increase in debt, especially when it is compared to relative statistics. We will continue to monitor the situation. Good personal financial budgeting is essential. Going forward, with new financial regulations and stricter lending standards, the hope is that fewer people will be granted loans that they truly cannot afford, and we can continue to use debt in an effective way to generate growth in our economy.

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