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**Consumer Debt:
Myths About the Impact of the Recession**

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CONSUMER DEBT: MYTHS ABOUT THE IMPACT OF THE *RECESSION*

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Introduction

If you believe the popular business press, the household debt burden leftover from the 1980s has been holding back the US. economy for nearly four years. In 1989 we were warned that household debt levels could trigger a recession at any time as overextended consumers, unwilling or unable to borrow more, quit purchasing autos and appliances. By 1990, consumer debt had become a bomb waiting to detonate in creditor portfolios if jarred by income interruptions, as would surely -occur when the economy edged downward in recession. Once in the recession, consumer-debt was an albatross around the economy, depressing willingness to spend and holding back the recovery. By 1992 the image of the overextended consumer was well entrenched in the pitch and tone of most economic commentary.

Consumer debt did reach historic highs during the 1980s. Excluding loans secured by real, estate, installment credit outstanding grew from \$330 billion dollars in late 1982 (at the close of the 1981-82 recession) to over \$730 billion by mid-1990 (at the beginning of the 1990-91 recession). In real terms, consumer installment credit increased 47.3 percent over the seven and one-half years of expansion. Household residential mortgage debt grew even faster during the same period, from a nominal \$1.1 trillion at the end of 1982 to nearly \$2.7 trillion by mid-1990, a real increase of 75.4 percent over the period.

What was the impact of rapid debt growth on household finances, and how did they adjust their debt portfolios through the recession? The following sections examine three myths that have gained a foothold in popular thinking and writing about household debt and the economy.

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Myth #1: Undisciplined use of credit fueled rite-spending binge of the 1980s. The average household staggered into the 1990 recession with record levels of debt.

The expansion in consumer debt during the 1980s was unique only in its longevity, not in its intensity. Chart 1 displays the annualized growth rates (in nominal terms) since 1973 for consumer installment credit (CIC).¹ The debt expansion from 1983-1989 was typical of the pro-cyclical pattern of consumer credit usage over time. As was the case in 1975 the fledgling economic recovery of early 1983 boosted employment, personal income and consumer spending. Since the demand for credit is derived from the demand for the items financed with credit as spending on consumer durables rose so did consumer installment credit outstanding. The prolonged growth in CIC outstanding was a direct product of the longest peace-time expansion in US history.

The intensity of the debt build-up was attributable to additional shifts in the demand for and supply of consumer credit. Demographic shifts boosted the demand for credit from 1970 through the mid-1980s as the last wave of the baby-boom generation moved into their prime credit-using years typically defined as ages 23-45. Between 1970 and 1984, the percent of US households headed by a person aged 25-45 rose from 23.6 percent to over 30 percent, an increase of over 6 million households. The economic expansion of 1983 arrived just as a record proportion of US households were in their prime credit-using years.

At the same time creditors obtained new tools for managing risk and expanded the supply of credit. Many states relaxed or removed the interest rate ceilings on consumer loans particularly credit cards. Statistical scoring models for screening applications were developed and adopted. With the ability to charge higher rates commensurate with higher risk and with improved technical ability to predict risk, creditors altered their lending standards to accept greater risks from their applicant pool.

The expansion of credit opportunities to traditionally higher risk customers was probably greatest for unsecured revolving bankcard products. A major increase in bankcard ownership is evident in a series of three nationally representative household surveys sponsored by the Federal Reserve Board between 1977 and 1989. Table 1 shows that the percentage of households who owned at least one bank credit card rose significantly over the 12 year period across all age income and education categories. Not surprisingly, revolving credit was the fastest growing component of CIC, increasing from 19.4 percent of total CIC in 1980 to 31 percent of installment debt by 1990.²

Conclusion: Build-up of consumer debt during the 1980s was a consequence of 1) prolonged economic growth, 2) demographic shifts which brought millions of additional consumers into their prime credit using years, and 3) expansion of credit opportunities and products to a wider segment of the population.

Myth #2: By 1990, households had reached a debt thresh -hold beyond which they were either unwilling or unable to borrow. Mired in a sea of debt and unwilling to, borrow further, households quit spending, deepening the recession.

¹ In the jargon of the Federal Reserve, consumer debt falls into two major Categories: mortgage debt (first and second mortgages, home equity lines of credit and consumer installment credit (CIC) which includes all other types of personal loans, none of which are secured by real estate.

² Like CIC, real home mortgage debt experienced two prolonged growth periods during the past twenty years. The overwhelming factor driving the mortgage debt buildup was the impact of baby boomers moving into their home-buying years.

CHART 1 Annualized Growth Rate in Consumer Installment Credit



Source: Federal Reserve Board

TABLE 1 Bank Credit Card Holdings, 1977-1989
(Percentage of households with at least one bankcard, by Income, Education and Age)

Household Income (1989 dollars)	19--	1983	1989
< 10,000	11	10	16
10,000-19,999	18	27	37
20,000-29,999	33	42	63
30,000-49,999	49	60	74
50,000 or more	67	80	87
Education of Family Head			
0-8 grades	16	16	23
9-11 grades	24	28	32
High School diploma	36	39	49
Some College	46	50	65
College Degree	71	71	85
Age of Family Head (Years)			
<25	18	20	29
25-34	43	39	48
35-44	52	54	62
45-54	43	50	63
55-64	42	53	57
65 or more	22	53	49

Source: Federal Reserve Surveys of Consumer Finances. See Glenn S. Canner and Charles A. Lueckert. –Developments in the Pricing of Credit Card Services. -Federal Reserve Bulletin, September, 1992, p.656.

Measures of Debt Burden

The simple observation that total consumer debt has reached historically high levels indicates nothing about the debt burden carried by individual households. This is particularly true when the number of households rises along with the proportion of households using credit.

Perhaps the best-known and most misleading measure of household debt burden is the ratio of aggregate consumer installment credit outstanding to disposable income. From late 1982 through 1987 (the years of most rapid growth in CIC outstanding) this ratio grew from just under 14 percent to nearly 19 percent an historical peak. Because past statistical studies found a positive relationship between the debt/income ratio and delinquency rates the upsurge in the ratio from 1984 through 1988 raised fears of an impending rise in delinquencies.

Such fears were premature for several reasons. First, by its method of calculation, the debt/income ratio will rise as more people use credit, even maintaining a constant payment burden per household. Another fundamental problem is that the debt/income ratio focuses on total debt instead of monthly payments, as if payments would always rise proportionally with the amount borrowed. Of course, creditors are not oblivious to the affordability problem for households. The competitive lending markets have consistently developed products to minimize the impact of higher loan balances on monthly payments.

The two most prominent examples during the 1980s were 1) extended maturities of auto loans (average 46 months in 1982; average 56 months in 1988, for loans issued by captive auto finance companies) and 2) the development of the adjustable rate mortgage. Both allowed the loan amount to rise faster than monthly payments, thereby reducing the impact of rising prices for new cars and homes on household budgets. Because the market tends to adjust loan terms to fit the borrower, a measure of debt burden based only on amounts outstanding is seriously misleading.

Indeed, the 1986 Survey of Consumer Finances sponsored by the Federal Reserve Board revealed that consumer installment debt per household grew at an average annual rate of about 18 percent between 1983 and 1986, but monthly installment debt payments grew at only an 11.3 percent annual rate. The Federal Reserve Board estimates that the average ratio of installment debt payments to disposable income was 9.3 percent in 1983, peaked at 11.0 percent in 1990, and declined to 9.8 percent by the fourth quarter of 1992.³ Thus, the fraction of income necessary to service consumer debt did rise over the last decade, but not by as much as the aggregate debt/income ratio suggests.

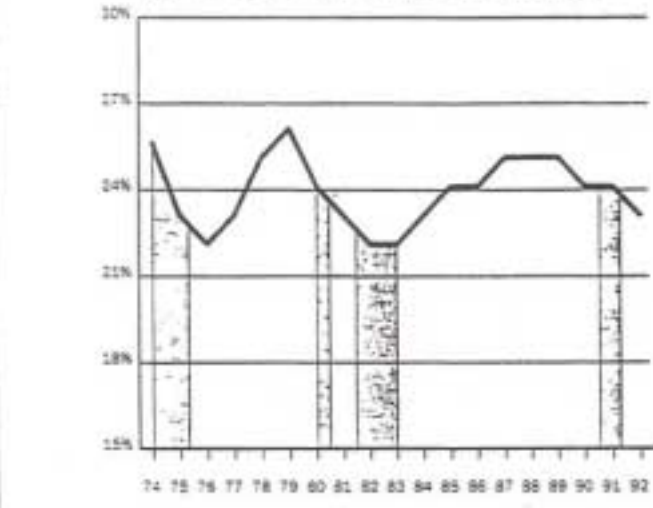
Of course debt need not be repaid solely out of current income. Household financial assets can be tapped to repay debt. Chart 2 illustrates that liquid assets (checkable deposits + money market fund shares + small time deposits) grew at the same pace as CIC between 1985 and 1990, keeping the ratio of CIC to liquid assets around 25 percent.

Delinquencies

Now that the recession of 1990-91 appears to be behind us we can examine how consumers handled the record levels of consumer debt carried into the downturn. The evidence clearly demonstrates that concerns based on the growth in the aggregate debt/income ratio were unwarranted.

³ Payment-to-income, ratios which include home mortgage payments are naturally higher than those which include only installment debt, including mortgage payments, the ratio of consumer debt payments to disposable income rose from 14.6 percent in 1983 to 18.1 percent by the end of 1990, before the refinancing boom pushed back the ratio back to 16.3 percent by the end of 1992.

CHART 2 Consumer Installment Credit as a Percentage of Household Liquid Assets



Note: Shaded areas denote recessions, as designated by the National Bureau of Economic Research, Inc. Household Liquid Assets = checkable deposits + money market fund shares + small time deposits.
Source: Federal Reserve Board

Chart 3 focuses on auto loans from two sources: those made by captive auto finance companies as well as indirect auto loans held by commercial banks. These two types of lenders; originate over 73 percent of the automobile credit in the US. The chart reveals an upward trend in the percent of loans 30 days or more past due for both issuers beginning in 1984.⁴ As the decade drew to a close the delinquency series flattened throughout 1990 before the effects of the recession pushed both series to a peak in August, 1991. Both series have declined since. Certainly the 1991 peak was not unprecedented: at 2.93 percent of all bank loans the delinquency rate was not dramatically higher than the peak of 2.68 percent of loans in August of 1980.

In contrast to the auto series, bank credit card portfolios exhibited significantly rising delinquencies throughout the decade, prior to the recession. However, as we saw in Table 1, banks aggressively marketed their product throughout this period to increasingly risky segments of the population. Rising delinquencies, relative to bench marks set 5-10 years earlier were predictable. The product was priced accordingly.

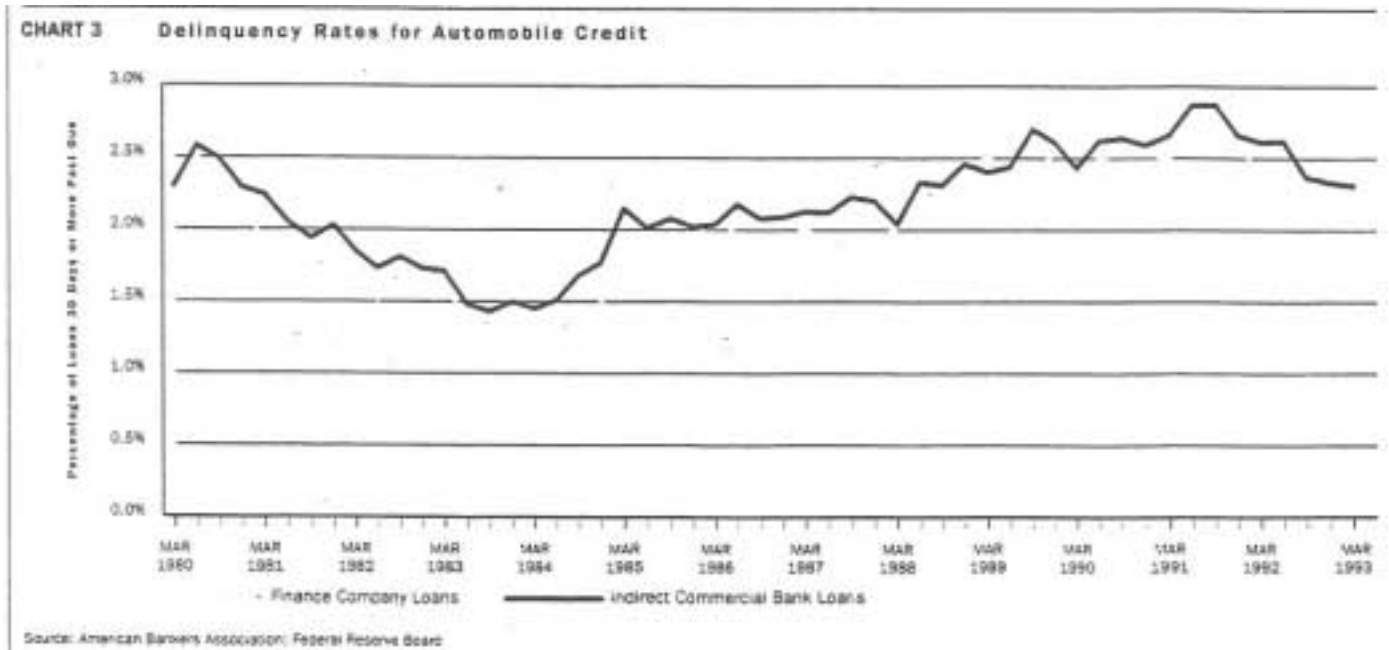
Because the broader bankcard portfolios had never been tested by an economic downturn many analysts feared that a recession would trigger soaring charge-offs. The recession did elevate credit card delinquencies, but not dramatically above levels experienced just prior to the recession. Chart 4 displays a delinquency series compiled by VISA, USA based on a survey of its 100 largest issuers. Delinquencies peaked in 1991 at about 4.89 percent of outstandings but since then have moderated to 4.21 percent of outstandings as of December 1992.

Personal Bankruptcies

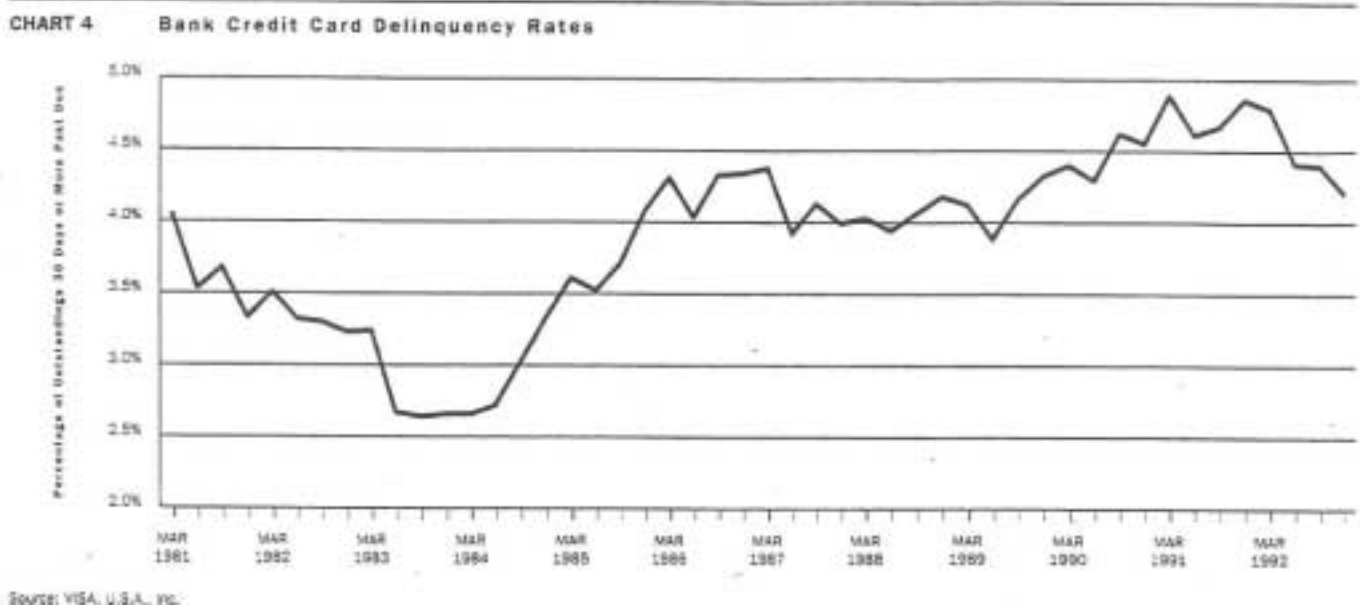
After fluctuating widely, but with no clear trend during the 1970s, personal bankruptcies surged upward for three consecutive years, rising from about 196,000 estates (individuals) in 1979 to 430,000 by 1982 (Chart 3). Much of the increase is explained by back-to-back recessions between 1980 and 1982 which caused the unemployment rate to rise from 6 percent to over 10 percent. However, economists have found that up to one-third of the increase in bankruptcies was due to the revision of the federal bankruptcy statutes in 1978

⁴ Some of the upward trend is clue to the lengthening maturities on auto loans mentioned above.

which lowered the cost to an individual filing for bankruptcy relief by increasing the dollar value and type of assets that were exempt from liquidation in the bankruptcy process.



As economic growth began anew in late 1982, bankruptcies plateaued for three consecutive years. However, in 1985, bankruptcies surged upward, at double-digit rates, through 1990. Unlike the 1979-81 period, neither an economic downturn nor new legislation explained the prolonged upsurge from 1985 through 1990.



Two forces generated the acceleration in petitions beginning in 1985, at least until mid- 1990 when recession induced layoffs added a third factor. First, as described earlier, the demand for consumer credit expanded and creditors accepted higher risk customers, by traditional standards. This increased the pool of potential bankrupts. The social stigma attached to bankruptcy fell as the number of petitions expanded. Personal bankruptcy became increasingly familiar to consumers through acquaintance with a friend or relative who had filed in the past (over 3 million consumers filed between 1980 and 1990), through widespread attorney advertising, and through publicized accounts of celebrity bankruptcies.

However, another force was also at work. Consumers learned through the decade that credit was often available to them after bankruptcy, thereby diluting another powerful deterrent to filing.⁵ The interplay of smaller social and economic penalties substantially lowered the perceived cost to a consumer of choosing the bankruptcy alternative, and petitions rose. The 1990-91 recession accelerated an upward trend.

After eight years of uninterrupted growth, bankruptcy petitions have finally plateaued. Annual growth rates in 1990, 91 and 92, were 16.4 percent, 22.8 percent and 3.3 Percent, respectively. Even better news was imbedded in the second quarter, 1993 statistics. For the twelve months ending June 30, 1993, petitions filed nationally declined by 5.3 percent compared to the 12-month period ending one year earlier.

Interestingly, the growth in bankruptcies since 1983 resembles the growth in credit card delinquencies over the same period. In percentage terms. Both series have been profoundly effected by the expansion of credit opportunities to a broader (riskier) cross-section of the US population. Continued adoption of risk-based pricing of credit products may prolong this trend. These fundamental shifts in the supply of credit render obsolete the benchmarks used to judge portfolio performance a decade ago. Petitions for bankruptcy will not soon return to the 400,000-person level that prevailed in the mid-1980s, nor will aggregate bankcard delinquencies drop back to 3.0 percent of outstanding.

Conclusion: The image of the household sector tottering on the brink of insolvency under record-setting levels of debt isn't supported by the available data. Commonly used measures of the debt build-up overstate the rate at which debt service payments grew relative to income, and mask the addition of millions of new households to the borrowers ranks. Also ignored is the growth in liquid financial assets, at a pace equaling debt growth, leaving the ability of consumers to tap into their reserves unchanged.

Despite a fundamentally riskier base of customers, the recession failed to cause the meltdown of creditor portfolios that many had feared. The recession-induced increase in delinquencies, followed by a decline, was consistent with patterns normally observed through the business cycle.

Myth #3: Chastened by the recession, consumers are rejecting debt. This "sea-change" in attitudes has triggered a widespread pay down of consumer debt and continued reluctance to borrow to finance durable purchases. Consumer use of debt will be more conservative in the 1990s than was the case in the 1980s.

Contrary to the "rejection of debt" theory, consumer spending on durable goods did not plummet in 1990 because of the burden of existing debt. Beginning in August, 1990, consumers cautiously delayed durable good purchases in reaction to a combination of uncertain global politics (Iraqi invasion of Kuwait) and rising fears of unemployment. The preceding ninety months of growth in incomes and spending left consumers well-stocked

⁵ "The impact of Post-Bankruptcy Credit on the Number of Personal Bankruptcies." Credit Research Center, Working Paper #58. Krannert Graduate School of Management, Purdue University, January 1993.

with durable goods. Consumers found it cheaper to be cautious, relative to the same scenario occurring earlier in the expansion period.

Unemployment fears became self-fulfilling as the drop in consumer spending triggered production slowdowns and layoffs. The Michigan survey of consumers throughout 1991 and early 1992 found that unemployment fears were the dominant reason for consumer pessimism. Since consumers take on new debt based in part on their expectations about their future income uncertainty about the stability of future income reduced consumers willingness to borrow and spend. The decline in consumer spending was attributable to uncertainty, not frugality.

To be sure household balance sheets have been restructured over the past three years, but due more to savvy financial management than a "sea-change" in consumer attitudes toward debt usage. Consumer borrowing has slowed since 1990 for at least three reasons (in addition to the fundamental decline in spending on durable goods) none of which involve a critical debt threshold beyond which consumers dared not borrow. Rather the apparent debt pay down derived from economic incentives which altered the decision to hold debt as well as the form in which it was held.

First, consider the magnitude of the consumer debt pay down through 1992. A recessionary period normally triggers a decline in consumer installment credit outstanding, because spending on consumer durable goods declines while payments continue on outstanding loans. By this criteria, the recession of 1990-91 did not differ markedly from prior recessions. Consumer installment credit (in current dollars) declined for a longer period of time, but the reduction was not as deep. From December, 1991 (the first month of decline in CIC following the onset of the recession) through July of 1992, CIC declined in 14 out of 20 months. Over the period, nominal CIC outstanding fell about \$8.3 billion dollars, or only 1.1 percent (real decline of 3.6 percent). By comparison, the recession of 1980 triggered a 6-month decline in nominal CIC during which time it dropped \$7.5 billion, or 2.5 percent (real decline of 7.0 percent). Thus, using the CIC measure, the consumer debt pay down has not been nearly so dramatic as popularly believed.

As for the incentives to borrow less at least three combine to explain the apparent decline in installment credit outstanding.

Shifts to home equity credit: The tax reforms passed in 1986 began a gradual phase-out of the deductibility of interest paid on consumer debt nor secured by real estate. Loss of the interest deduction raised the cost of borrowing via traditional installment credit such as credit cards and closed-end auto loans. Of course higher borrowing costs reduce the use of such debt. The impact of this important change in policy was increasingly felt on CIC even prior to the recession.

Moreover, by preserving the deductibility of interest on real-estate secured loans, the tax reforms created an incentive to substitute across types of debt. Not surprisingly, as the tax advantages of non-real estate loans melted away consumers with home equity to cap found home equity loans to be a low-cost substitute for traditional installment credit. Home equity loans were readily available in either of two forms: closed-end installment loans (traditionally called second mortgages), and open-end revolving home equity lines of credit (HELCS). Both categories grew rapidly after 1986. Survey data reveal that consumers with home equity accounts regularly used them to finance purchases for which they otherwise would have used traditional installment loans.⁶

⁶ A 1991 Survey of home equity lenders found that 11.0 percent of advances on HELCS that year were for automobile purchases, 1991 Home Equity Loan Survey, Consumer Bankers Association.

Because loans secured by real estate are not included in the Federal Reserve's CIC statistics the CIC series has been increasingly understating the amount of consumer installment borrowing. Chart 6 shows that real annual growth in HELC balances at commercial banks averaged over 19 percent for the period 1988 through 1990 and continued to grow during the recession even as CIC was falling.⁷ The Federal Reserve Bank of Chicago estimates that, as of third quarter 1992, a total of \$469 billion in home equity credit was outstanding with \$169 billion in HELCs.⁸ Compare this with the beginning of 1988, when total home equity credit outstanding was \$268 billion with \$80 billion in HELCs.

Clearly a focus on traditional installment credit as an indicator of consumer indebtedness is far too narrow. Given the modest \$8 billion decline in CIC between December, 1990 and July, 1992 which does not include changes in home equity balances, there is good reason to believe that consumer installment debt did not decline at all during the heralded 1991-92 debt paydown.⁹

High borrowing costs: As previously mentioned, the full impact of the loss of tax deductibility of non-mortgage interest payments was felt by the time the recession was under way. Moreover, loan interest rates fell more slowly than inflation from late 1990 through mid-1992. Consequently, during this period real borrowing costs for loans not secured by real estate were historically high. High real interest rates discourage consumers from taking on new debt.

Wider spread between loan and deposit rates: By 1992 interest rates had plummeted to the lowest levels in three decades. The spread between rates paid on deposits and the prevailing interest rates on old consumer debt widened dramatically. Chart 7 illustrates the upward trend in one such spread. The deposit rate is a national average of money market fund rates paid by credit unions. The loan rate is the national average rate for 48-month new automobile loans issued by banks, lagged 24 months to simulate the payoff decision confronting an average consumer midway through the term of an auto loan.¹⁰ Given a build-up in liquid assets through the previous 6 years (Chart 2), and a rising opportunity cost of leaving funds in low-rate deposit accounts many borrowers chose to pay off their loans early, further reducing consumer installment credit outstanding.¹¹

Conclusion: The recession slowed the growth in consumer credit, but did not trigger a large-scale reduction in consumer debt. Assertions that consumers will continue to shun debt in the 1990s are unsubstantiated.

Summary

Both the household debt build-up of the 1980s and the debt pay down of 1991-92 have been overstated by the popular press. Through the last decade, flexible, revolving consumer credit became available to a much wider segment of the US. Population, just as a greater number of households moved into their prime credit-using years. Aggregate household debt levels increased because more households were using consumer credit. Armed with more sophisticated risk management tools, including risk-based pricing credit grantors

⁷ The data underestimate the amount originated by banks because they do not count securitized HELC receivables.

⁸ Francesca Eugeni, "Consumer Debt and Home Equity Borrowing." Economic Perspectives, Federal Reserve Bank of Chicago, March/April 1993, pp. 2-13.

⁹ It should be noted that in the absence of significant debt pay down, the moderation in delinquencies beginning in 1992 is even more reassuring as economic growth accelerates.

¹⁰ Using credit union data for deposits overstates the average money market yield available to individuals who are not credit union members. Consequently, the spread is understated somewhat, although, given competitive markets for deposits, the trend should be accurately represented.

¹¹ The 1993 Automobile Finance Study (covering auto loans made during 1992) sponsored by the Consumer Bankers Association found that 64 percent of all auto loan payoffs during the year were early payoffs, up from 57 percent in 1991.

consciously accepted more risk in building their portfolios. Consequently, aggregate delinquency levels on most types of consumer loans rose through the decade.

The recession of 1991-92 slowed credit growth as it slowed consumer spending, as is normally the case through the trough of a business cycle. Suggestions that consumers have emerged from the recession with a fundamentally changed attitude toward debt are not supported by the data. Indeed, households have become increasingly sophisticated in their choice of credit sources, as evidenced by the dramatic shift toward home equity loans in response to tax advantages. Higher income taxes are likely to accelerate this shift, making home equity lending the fastest growing segment of the consumer credit market for the remainder of the decade.

RECESSION IMPACT ON CONSUMER ABS CREDIT QUALITY

1. Twelve fixed rate, fully amortizing, pass-through securities originated prior to 1991, backed by automobile loans totaling \$4.0 billion, for which comparable delinquency and loss data were available.
2. Sixteen securities originated prior to 1991, backed by pools of credit card receivables totaling \$14.4 billion, for which comparable delinquency and loss data were available.
3. Eleven securities originated prior to 1992, backed by home equity loans totaling \$4.9 billion for which comparable delinquency and loss data were available.