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Household Credit Conditions Never Better

Introduction

Households continue to manage their debts extraordinarily well. Household debt loads remain low and stable, as do delinquency rates across household liabilities, based on data through June constructed from all of the credit files in the country provided by credit bureau Equifax. A significant number of particularly lower- and middle-income American households do struggle with their finances. But that is largely the result of long-stilted incomes, low or no saving, and few if any assets. For the most part, debt burdens are well-managed.

Household Credit Conditions Never Better

BY MARK ZANDI

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Households have deleveraged since the financial crisis. At the peak of household indebtedness in the leadup to the crisis, household debt surged to a record 110% of after-tax household income. But the flood in defaults during the severe recession and the more cautious borrowing and lending that resulted have pushed debt to income down to around 80%. It has stayed there for more than five years. The growth in household debt has remained remarkably consistent with growth in wages and income during this period (see Chart 1).

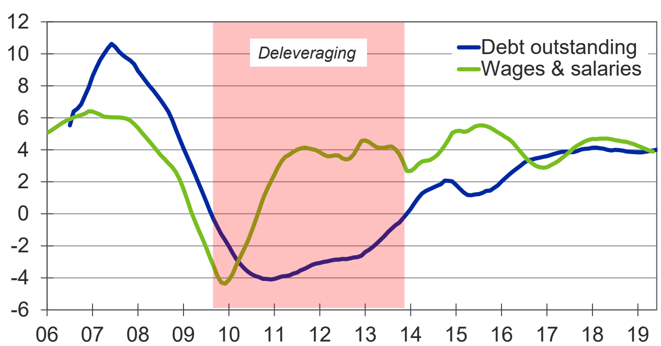
Household debt service—the share of income that households must pay to stay current on their obligations—has also declined. It is currently stable and as low as it has been over the 40 years of available historical data from the Federal Reserve. And households have done an admirable job of locking in low interest rates. Due to several massive mortgage refinancing waves over nearly two decades, most homeowners now have long-term fixed rate mortgages with an average coupon of only 4%. Less than one-fourth of household liabilities have interest rates that adjust within one year of a change in market rates.[2]

Also encouraging, lenders continue to be prudent in extending credit to households. Only one-fifth of household liabilities are owed by subprime households—borrowers with a credit score of less than 660 at origination.[3] This is down nearly 10 percentage points since just prior to the financial crisis (see Chart 2). Subprime debt outstanding is growing, but at a stable and low single-digit pace. Of late, there has been some pickup in subprime first mortgage lending, but this has been offset by flat to down auto and retail card subprime lending.

Given the prudent borrowing and lending, household credit quality has steadily improved and in aggregate remains about as good as it has ever been. In June, the delinquency rate (30 days and over) on all $13 trillion in household liabilities remained near 2.5%. For context, this is lower than it was in the very best of times leading up to the financial crisis and compares to a peak of more than 8% during

Chart 1:
Borrowing Is Consistent With Income

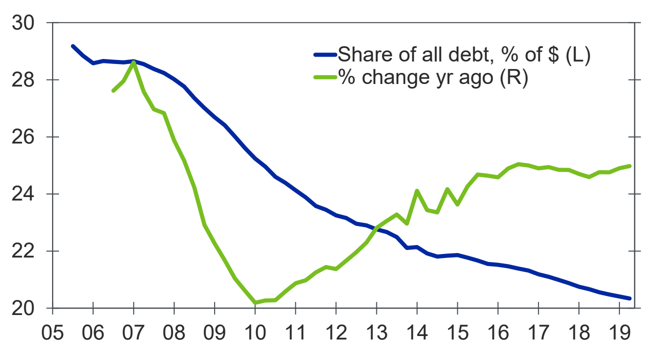
% change yr ago, 12-mo MA



Sources: Equifax, Moody's Analytics

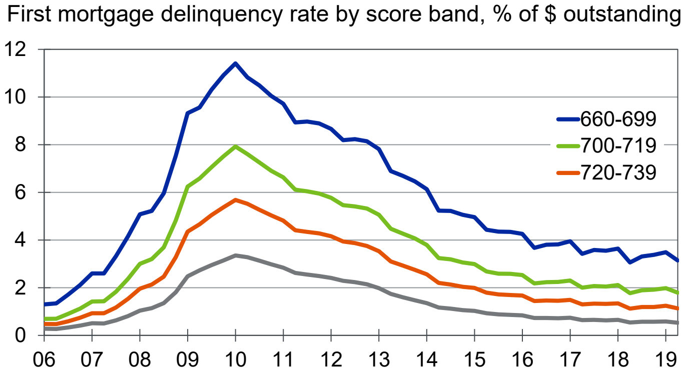
Chart 2:
Tighter Underwriting Standards

Debt owed by borrowers with less than 660 score



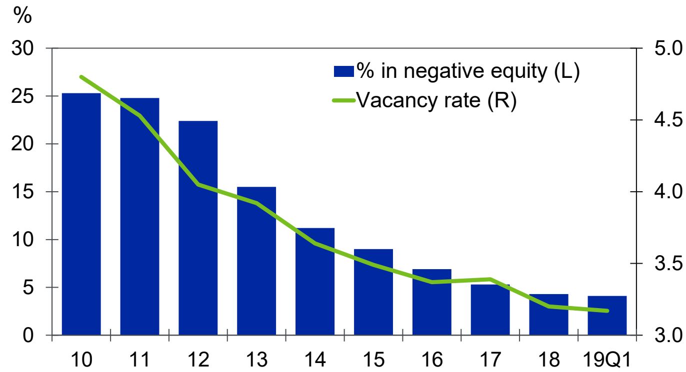
Sources: Equifax, Moody's Analytics

Chart 3:
Mortgage Quality Is Strong and Stable



Sources: Equifax, Moody's Analytics

Chart 4:
Homeowners Are Well Prepared



Sources: CoreLogic, Moody's Analytics

the height of the last recession. While any further improvement in credit quality is unlikely, and some erosion seems probable as credit conditions continue to normalize, it is safe to say that over-indebted households will not be at the center of the next economic downturn.

Mortgage quality shines

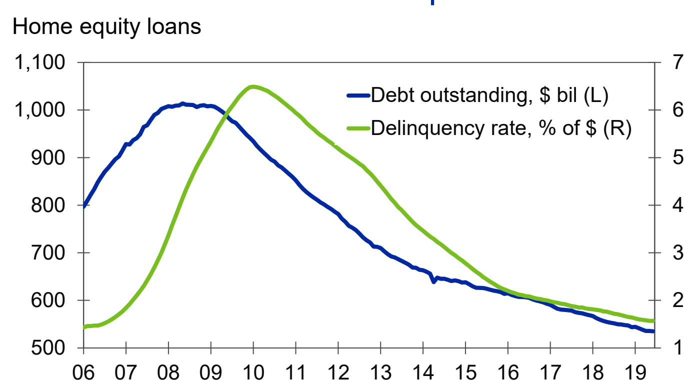
Residential mortgage loan quality has arguably never been better. Of the nearly 49 million first mortgage loans outstanding, only 2.5% are delinquent, and more than half of these have been delinquent no more than one month. Loans that are seriously delinquent—three months or more past due—and in foreclosure are low and continue to decline (see Chart 3). The foreclosure overhang that plagued the housing market for much of the past decade has been worked off. On a dollar basis, of the $9 trillion in first mortgage debt outstanding, only 2% is delinquent. This has never been lower and compares to a 9% delinquency rate at the peak of the housing bust.

Behind the stellar mortgage credit conditions are low unemployment and consistently strong house price gains, which have added significantly to homeowners' equity. An estimated only 4% of homeowners are in a negative equity position—they owe more on their home than it is worth—down from 25% of homeowners a decade ago. House price growth has moderated more recently, due to the runup in mortgage rates last year, the hit to housing demand, and recent tax law changes that have significantly reduced the value of tax preferences for homeownership. Yet low and falling housing vacancy rates will support continued house price gains (see Chart 4). Housing is in particular short supply for lower-priced homes, which will buoy prices for lower- and middle-income homeowners who would be more vulnerable if the job market were to falter.

Prudent mortgage underwriting is also contributing to pristine mortgage credit quality.[4] Close to 15% of mortgage debt outstanding is owed by subprime borrowers with less than a 660 risk score at origination, and 5% to borrowers with a less than 620 score. Prior to the crisis, more than 25% of borrowers had a score of less than 660, and 15% had less than a 620 score. Underwriting had eased significantly a year or two ago, as more borrowers with higher debt-to-income ratios got loans. This is showing up now in somewhat higher 30-60 day delinquency rates for recent loan origination vintages. However, this has prompted action by Fannie Mae, Freddie Mac, the Federal Housing Administration, and private mortgage insurers, all of whom have recently tightened down on the high DTI loans they are willing to insure.

Credit problems created by aggressive home equity lending during the housing bubble have also faded away. Home equity debt outstanding has been steadily declining to just over $500 billion in lines of credit and closed-end second mortgages. This is about half the home equity debt outstanding at the peak of the bubble (see Chart 5). Despite the slide in outstandings, delinquency rates are low and continue to decline. As long as fixed mortgage rates remain low and cash-out refinancing attractive, home equity borrowing will remain dormant.[5] The recent tax law change, which scaled back the use of the mortgage interest deduction, will also weigh on the use of home equity loans for the longer run.

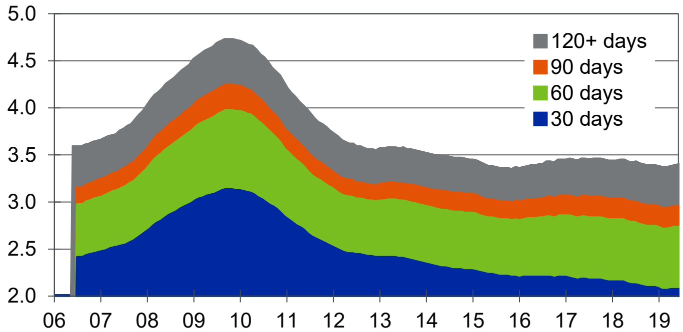
Chart 5:
HE Loans Continue to Evaporate



Sources: Equifax, Moody's Analytics

Chart 6:
Hands Firmly on the Credit Wheel

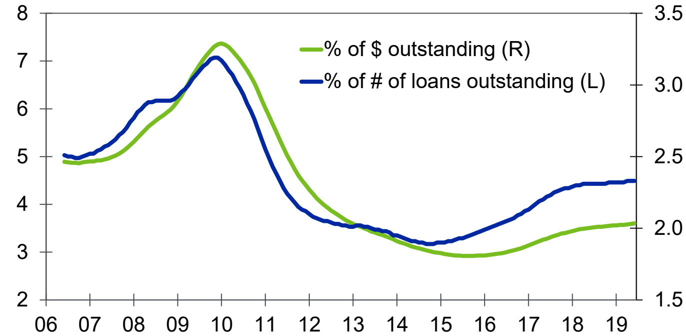
Auto delinquency rate, % of # outstanding



Sources: Equifax, Moody's Analytics

Chart 7:
Unsecured Credit Quality Normalizes

Unsecured consumer credit delinquency rate, 12-mo MA



Sources: Equifax, Moody's Analytics

Strong grip on the credit wheel

Auto lending has experienced some of the fastest growth since the financial crisis, with auto loans and leases outstanding nearly doubling since bottoming out early in the decade to $1.25 trillion.[6] This growth reflects record vehicle sales, but also a meaningful easing in underwriting standards coming out of the crisis. Lending to subprime borrowers—those with credit scores of less than 660 at origination—expanded quickly, as did loans with increasingly long maturities. Used-vehicle prices also slumped about the same time, because the used-car market was flooded by an increase in off-lease cars and trade-ins as new-vehicle sales surged. Not surprisingly, credit problems began to mount, particularly when measured as a percent of the dollar amount of loans and leases outstanding and at auto finance companies.

This erosion in loan quality, despite continued low and falling unemployment, spooked auto lenders, and they quickly tightened their underwriting in response. Debt outstanding to subprime auto borrowers has come to a virtual standstill, and their share of all auto loan borrowers has fallen significantly over the past three years. Auto finance lenders have turned especially circumspect in making loans. Delinquencies have subsequently stabilized. Measured as a percent of the number of auto loans and leases outstanding, delinquencies remain low by any historical standard (see Chart 6).

Given that auto lenders finally appear to have a firm grip on their underwriting, prospects for continued solid credit conditions are good, especially since unemployment should remain low and used-vehicle prices sturdy. This is presaged by the better credit performance of more recent vintages of originated loans. Loans originated in the first quarter of 2015, when underwriting was at its weakest, had a 3.1% delinquency rate one year after origination and a 4% delinquency two years after origination. Loans originated in the first quarter of 2017, after some tightening in underwriting, had a 2.7% delinquency rate one year after origination and a 3.3% delinquency after two years. And loans originated in the first quarter of 2018 have a 2.65% delinquency rate one year on.

Unsecured lenders are secure

Unsecured consumer credit lenders, including those in the bank and retail card and consumer finance businesses, lately have been skittish in extending credit. The results are low and stable delinquency rates. According to the Fed's Senior Loan Officer Survey, lenders have significantly tightened their standards over the last two years. The tightening in the second quarter of this year was especially aggressive.

Caution by lenders has slowed growth in the $900 billion in outstanding unsecured consumer credit. Growth in bankcard and consumer finance outstandings has slowed to a mid-single digit pace, and retail card growth has come to a standstill. The slowing in credit growth is evident across all score bands but has been particularly sharp for lower-score bankcards, and particularly for retail cards.

Delinquency rates have stabilized in response and remain low by historical standards (see Chart 7). Precrisis, bankcard delinquency, as measured by the percent of outstandings, hovered close to 4.5%, but it is now closer to 3%. Retail card delinquency has pushed up to 6.5%, but this too is well below the precrisis norm of 7.5%.[7] Consumer finance delinquency is currently a rock-solid 4.5%, down from a typical 7% before the crisis.

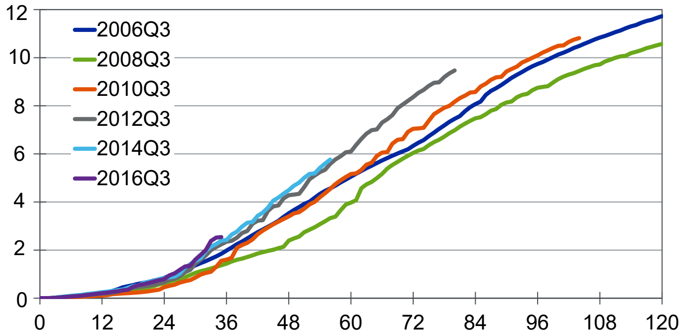
Also encouraging is that utilization rates on bankcards remain low. Balances per card were as high as $2,000 during the recession but have fallen back and, after accounting for inflation, have remained close to $1,500 in recent years. This is a good sign that households are not reliant on their cards to pay their bills.

Student lending stabilizes (for now)

Far and away the most worrisome aspect of household debt is student loans. They are a vexing problem for some 46 million Americans that owe approximately $1.5 trillion on their loans. That is a threefold increase in the past decade alone.[8] The financial stress created by this rapid accumulation of debt is evident in high delinquency and default rates. More than 2.5% of those who took out a loan only three years ago have already defaulted—gone more than a year without making a payment. This is about double the rate for those who took out a loan before

Chart 8:
Weak New Student Loan Vintages

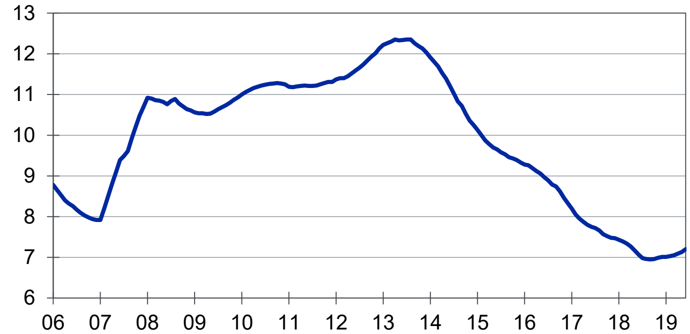
Cumulative default rate, % of loans at origination by origination qtr



Sources: Equifax, Moody's Analytics

Chart 9:
Student Loan Quality Has Improved

Delinquency rate on nondeferred loans, % of $, 12-mo MA



Sources: Equifax, Moody's Analytics

the financial crisis at the same point in their loan's life cycle (see Chart 8).[9]

The burden of student loans weighs most heavily on young people, with about half of all student debt owed by those in their 20s and early 30s and one-tenth by those just entering college. However, older Americans also owe an increasing amount of student loan debt. About one-third of student loans are owed by those in their late 30s and 40s and an increasing number of baby boomers and their parents are taking out loans to help children and grandchildren. Several hundred thousand retired Americans have their Social Security or other federal government support payments garnished to pay their defaulted loans.

As in other areas of economic distress, minorities also bear a disproportionate burden. Almost 80% of African American students have to take out a student loan to get a college education, compared with less than 60% of white students. Worse, a disproportionate number of African Americans pursue their higher education at for-profit colleges, where less than half of attendees ever get a degree. So, a disturbing share of African Americans are taking on debt with little hope of ever paying it back.

There is some good news. Student loan borrowing has cooled off substantially in the past several years, and debt outstanding is now growing in the mid-single digits. Borrowers are also deferring less of their debt. Deferred loans outstanding have been unchanged for several years and have declined to just over one-third of total student loan debt outstanding. Most encouraging is that delinquency rates across all non-deferred student loans have fallen substantially over the past five years and are now back to where they were precrisis (see Chart 9). Nonetheless, student loans will continue to be a significant financial problem, particularly for millennials and Generation Z, which is only now beginning to enter college.

Never better

It is hard not to be impressed with the strength of household credit conditions. Debt loads are low, debt service burdens never lighter, and credit growth is closely tracking gains in wages and household income. Delinquency rates, defaults and foreclosures are low and stable. Most encouraging, lenders appear sensitive to outsize credit growth and erosion in credit quality, and they quickly tighten up their underwriting in response. Auto and retail card lenders responded swiftly to rising delinquencies a few years ago, and credit problems there have abated. More recently, bankcard and first mortgage lenders have battened down their standards.

More than a decade after the financial crisis that was caused in significant part by debt-burdened households, there is no indication that household debt will be at the center of the next economic recession. Moreover, while credit problems would surely increase if the economy were to falter and unemployment to rise soon, delinquencies and defaults should remain low by the standards of past downturns. Lenders remain prudent in extending credit and households adept in managing their debts and other financial obligations.[10]

Endnotes

1 This stands in contrast to the widely followed Federal Reserve Bank of New York consumer credit panel, which paints a less upbeat picture of household credit conditions. The New York Fed data are derived from a 5% sample of Equifax credit files that is updated quarterly. There are other significant differences between the data used for this analysis and that provided by the New York Fed, which Deniz Tudor and Michael Brisson of Moody's Analytics provide in their recent paper "Consumer Credit Data: A Comparative Analysis of CreditForecast.com versus New York Fed Consumer Credit Panel."

2 According to Moody's Analytics estimates, the percent of household liabilities that adjust within one year of a change in market interest rates peaked in the late 1980s at more than one-third of liabilities.

3 The credit scores used in this analysis are constructed by VantageScore, a joint venture between the three large credit bureaus. The VS score has the same range as the more ubiquitous FICO score. For context, the credit score for the typical American household is currently just over 700.

4 Another measure of mortgage underwriting is provided by the Urban Institute, which calculates the expected severe delinquency rate on loan originations based on the credit score and debt-to-income ratio of the borrower and the loan-to-value ratio on the property. According to this measure of underwriting, standards tightened sharply during the housing bust and have yet to ease significantly. While this may overstate the case—DTI is difficult to measure, and this is where most of the easing in standards has occurred in recent years—it makes a strong case that underwriting standards remain strong.

5 Freddie Mac provides timely estimates of cash-out refinancing activity.

6 Auto lenders were the first household lenders to ease lending standards coming out of the recession. They were emboldened because they had come through the downturn substantially less scathed than mortgage or credit card lenders. Behind their better performance were firmer used-vehicle prices, as the dramatic collapse in new-vehicle purchases during the downturn led to a subsequent dearth of used cars for sale.

7 Complicating things for retail card lenders has been the rash of retailer bankruptcies due to the onslaught of online retailing. Borrowers must still pay on the cards of bankrupt retailers, but they either do not know this or have pretended not to.

8 Powering this rapid growth in student lending were more individuals going to school given the tough economy, rapidly increasing tuition costs, and the collapse in home equity borrowing, which had been the principal way families raised cash to pay their bills before the housing collapse. That the bulk of student loans are government-backed, and not underwritten based on the creditworthiness of borrowers, likely also supported growth.

9 The financial stress created by the massive amount of student debt is also having broader economic impacts. Millennials are delaying marriage, starting a home, and becoming homeowners. There is also evidence that student loan debt is one reason for the falloff in new business startups since the crisis.

10 Indebtedness remains higher and credit problems much more significant for lower- and middle-income American households. According to the new Distributional Financial Accounts constructed by the Federal Reserve, those in the bottom half of the income distribution hold only 6% of all the assets owned by households, but owe 37% of the liabilities. And the difference in these shares has grown steadily and substantially wider over the past 30 years. This is a serious problem and represents a significant macroeconomic and societal vulnerability.

About the Author

Mark Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi's broad research interests encompass macroeconomics, financial markets and public policy. His recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets.

A trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public, Dr. Zandi frequently testifies before Congress on topics including the economic outlook, the nation's daunting fiscal challenges, the merits of fiscal stimulus, financial regulatory reform, and foreclosure mitigation.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, Meet the Press, CNN, and various other national networks and news programs.

Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis*, is described by the New York Times as the "clearest guide" to the financial crisis.

Dr. Zandi earned his BS from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

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