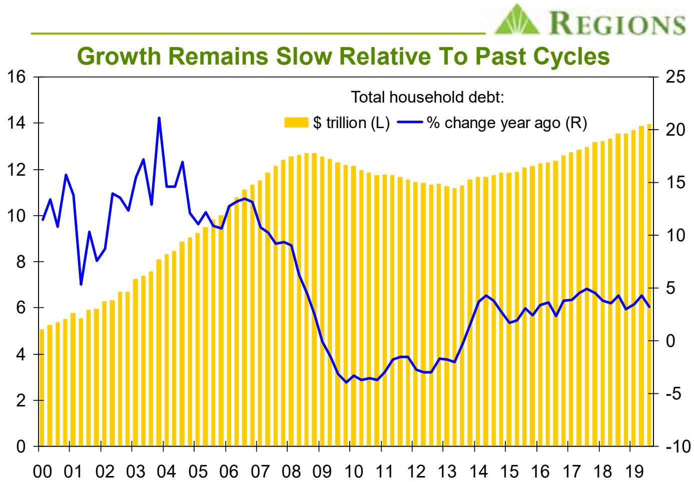
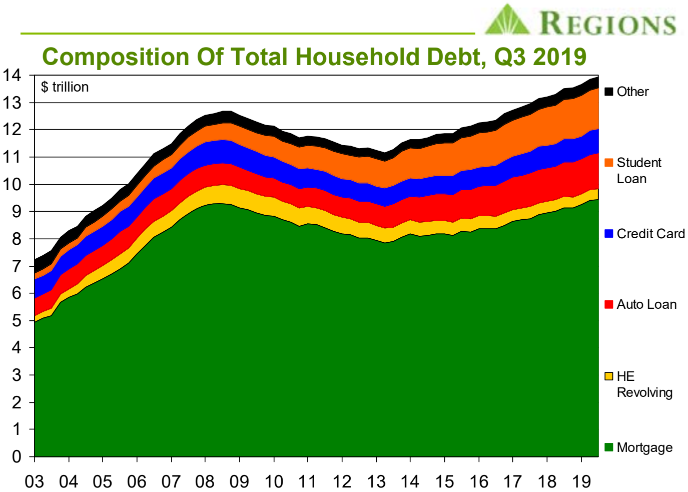
Q3 2019 Household Debt and Credit: Pockets Of Concern, But Big Picture Looks Solid

- Total household debt rose to $13.952 trillion in Q3 2019, an increase of $92 billion from Q2 2019
- Mortgage balances rose by $31 billion in Q3, accounting for 34 percent of the increase in total debt outstanding
- As of Q3, 4.78 percent of outstanding household debt was in some stage of delinquency, up from 4.37 percent in Q2

The Federal Reserve Bank of New York (New York Fed), in conjunction with Equifax, has released their latest quarterly report on trends in household debt. Total household debt rose to $13.952 trillion in Q3 2019, a $92 billion increase from Q2 2019, marking the 21st consecutive quarterly increase in outstanding household debt. Mortgage debt was once again the main driver of growth in total household debt in Q3, but it was far less dominant than was the case in Q2 – after having accounted for 84 percent of growth in total household debt in Q2, mortgage debt accounted for "only" 34 percent of growth in Q3, with student loan debt accounting for 22 percent and auto loans accounting for 20 percent of growth. The overall delinquency rate on household debt rose to 4.78 percent in Q3, up from 4.37 percent in Q2 and the highest overall delinquency rate since Q3 2017. As we discuss later, however, there are clear seasonal patterns in delinquency rates, and increases in the third quarter of any given year are common. While there are differences in loan performance across loan types, overall performance remains solid.



Source: Federal Reserve Bank of New York; Equifax; Regions Economics Division



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On an over-the-year basis, total household debt increased by 3.26 percent in Q3, following a 4.27 percent increase in Q2. As we have routinely noted, growth in total household debt over the course of this cycle has been significantly slower than in prior cycles. While this is hinted at in the first chart above, the New York Fed data series has a somewhat limited life, but the *Flow of Funds* data published by the Federal Reserve Board date back to the 1950s and affirm how relatively slow growth in household debt has been during the current cycle. Our view is that this mainly reflects what, in the post-recession years, has been a greater degree of discipline on the part of both borrowers and lenders. What will bear watching is the extent to which this discipline will hold up as we move even further into the current expansion, now the longest U.S. expansion on record. It is, after all, typically in the later stages of a cycle that discipline starts to break down. That said, starting points matter, and that both borrowers and lenders have been somewhat restrained over the course of this expansion should mean that any breakdowns in discipline won't result in excesses as egregious as seen in some past cycles, thus subjecting the financial system and the broader economy to considerably less stress during the next downturn than was the case the last time around. To be sure, what has been a notably subdued housing market over much of the current expansion has acted as a drag on growth in total household debt, given that mortgage debt is far and away the largest single component of total household debt (as illustrated in the second chart above).

Sure, for anyone scoring at home, Q3 marks another record level of household debt, and that is just as relevant this quarter as in any other quarter, which is to say not at all. There are a number of ways to put each quarter's new "record high" level of household debt into proper context, something sorely lacking from much of the coverage on this topic. For instance, the aggregate debt-to-income ratio has fallen significantly over the course of the current expansion and continues to recede from the pre-recession peak (not to mention a record high that, you know, actually matters). To help put that in perspective, as of Q3 2019 the level of household debt stands 10.07

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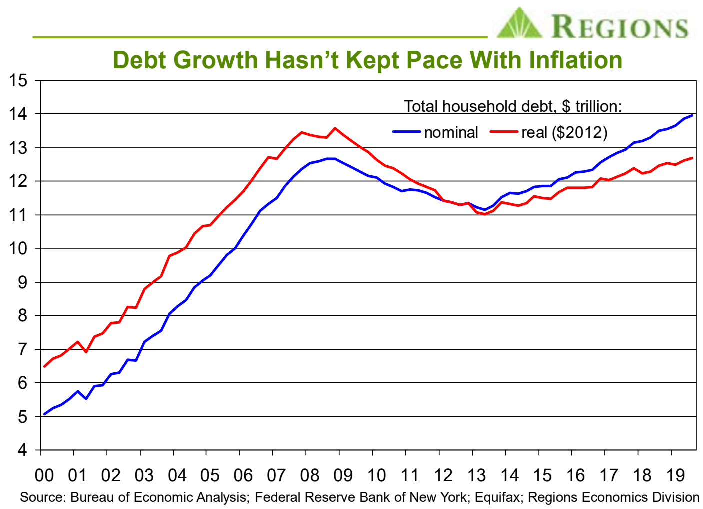
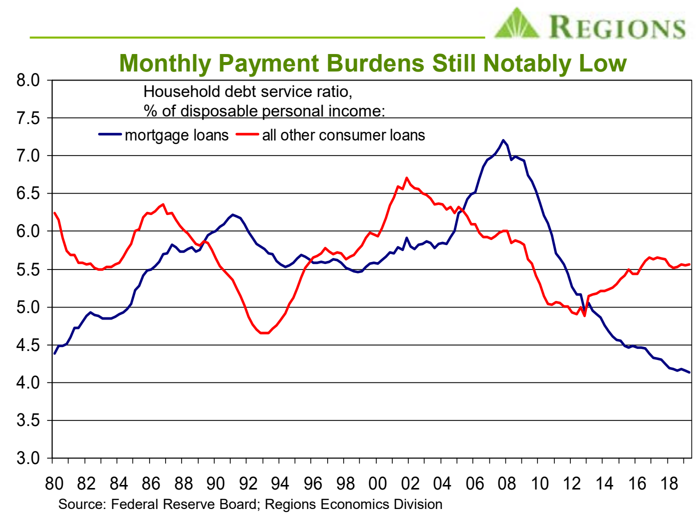
percent above the prior cyclical peak (Q3 2008), while the level of disposable personal income excluding transfer payments, which we routinely argue is the relevant income stream in assessments of debt service burdens, stands 48.17 percent above its prior cyclical peak.

The first chart below, showing the paths of nominal and real (or, inflation-adjusted) household debt, adds context to our point about growth in debt being notably slow during the current cycle. Unlike nominal household debt, the level of real household debt remains well below its prior peak – 6.53 percent below, as of Q3 2019. That is even more noteworthy given how mild inflation has been over much of the current expansion. Additionally, monthly debt service burdens (monthly principal and interest payments as a percentage of disposable personal income) continue to hover around the lowest shares in the four-decade history of this series. As a side note, the Federal Reserve's calculation is based on disposable personal income inclusive of transfers; were disposable personal income excluding transfer payments used as the base, the level of the ratio would be higher, but the patterns would be the same. Moreover, while the broader measure of monthly financial obligations, which also accounts for rent and lease payments, is higher than the debt service ratio, this is always the case and of more significance is that the broader financial obligations ratio is also hovering near all-time lows. In our second chart below, we segregate the overall debt service ratio into its two main components – mortgage loans and all other consumer loans. That the monthly debt service ratio for mortgage loans is at an all-time low despite what over recent years has been robust house price appreciation simply points to the power of low interest rates in keeping monthly debt service obligations manageable.





It is more than fair to note that looking at aggregate ratios masks what can be significant distribution issues, so that the debt-to-income ratio or the monthly debt service burden for any individual can vary, perhaps dramatically, from the aggregate. Lacking sufficient detail, however, we cannot draw meaningful distinctions across various cuts of household income, but we nonetheless think there is some signaling value in the aggregate measures. For instance, though many opted to ignore it, the sharp and significant increase in the aggregate debt-to-income ratio seen in the pre-recession years was a clear warning sign well before the ratio topped out at 133.60 percent. That brings back the memories of being scolded for actually worrying about excessive household debt which, as we were told at the time, was just old-fashioned. We didn't say it brought back fond memories, just memories. In any event, we work with the aggregate measures because that is what we have at our disposal, and at least in the aggregate, "record high" or not, household debt remains quite manageable for most households. To be sure, a prolonged period of notably low interest rates has contributed to holding the debt service burden down near record lows, but it does not necessarily follow that higher interest rates would lead to significant increases in monthly debt service burdens. Households have, on the whole, been very adept at managing their balance sheets and replacing variable-rate debt with fixed-rate debt, such that payment shocks triggered by higher interest rates should not be nearly as big of a threat to consumers, and in turn lenders, in the current cycle as was the case in past cycles. It is also open for debate just how much upside there is for interest rates given the expected paths of growth and inflation, which would mitigate the extent of any payment resets on floating rate debt.

Though loan performance deteriorated somewhat in Q3 2019, it isn't clear to us how much of this deterioration is real and how much of it is seasonal noise. As of Q3 2019, 4.78 percent of all outstanding household debt was in some stage of delinquency, up from 4.37 percent as of Q2 – which was the lowest delinquency rate of the current expansion, while the Q3 2019 delinquency rate is the highest rate since Q3 2017. It is worth noting, however, that just as there are clear seasonal patterns in the utilization of debt, there are also clear seasonal patterns in delinquencies, particularly early-stage delinquencies. We'll add, though, that the causes of these seasonal patterns are not as intuitive as are seasonal patterns in utilization. For whatever reason, in any given year the Q3 30-day delinquency rate on household debt tends to be the highest intra-year 30-day delinquency rate, followed by declines in Q4 and in Q1 of the next year before turning higher in Q2 and Q3. This is not to say the increase in delinquencies in Q3 can be dismissed out of hand, but is instead a caution against jumping to conclusions based on the Q3 data. While delinquency rates in each bucket – 30-days, 60-days, 90-days, and 120-days – rose in Q3, aside from any seasonal patterns in the data, the Q3 increases come off Q2 rates that were at or just above cycle lows in each bucket.

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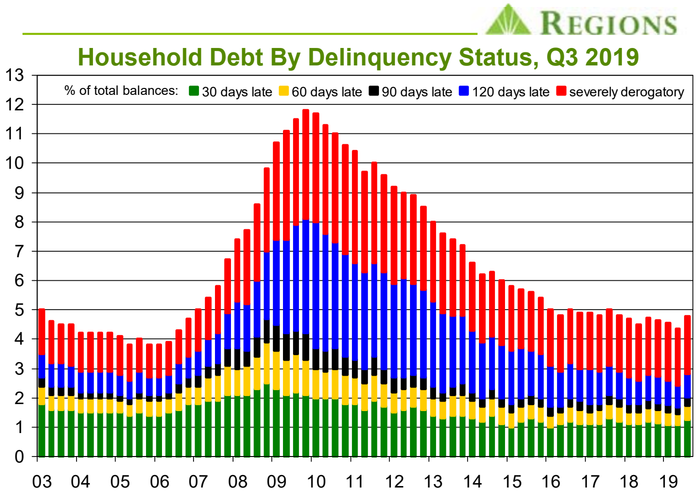
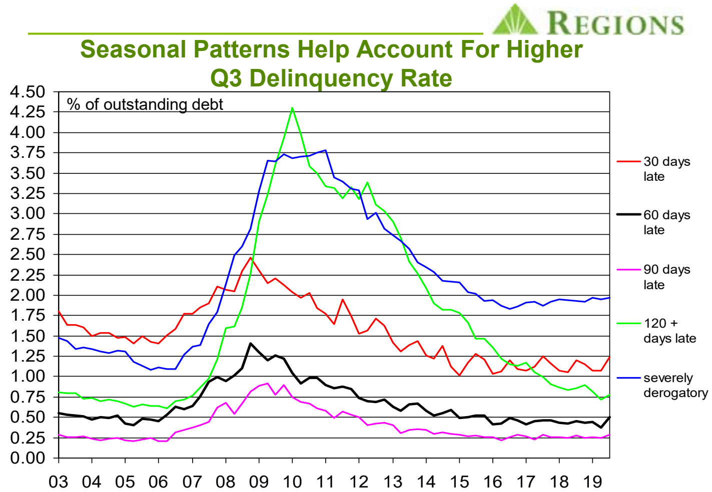
Of the $667 billion of household debt in some stage of delinquency in Q3, $424 billion was "seriously" delinquent, i.e., delinquent for at least 90 days or seriously derogatory, up from $405 billion in Q2 (seriously derogatory means debt in some stage of delinquency combined with reports of a repossession, charge-off to bad debt, or foreclosure). About 186,000 consumers had a bankruptcy notation added to their credit file in Q3 2019, down from 215,000 in Q3 2018. Transition rates into serious delinquency, or, the new seriously delinquent balance expressed as a percentage of the prior quarter's balance that was not seriously delinquent, were generally flat or lower in Q3 than was the case in Q2. For mortgage loans, the 0.99 percent transition rate into serious delinquency is the lowest rate in the life of the data.

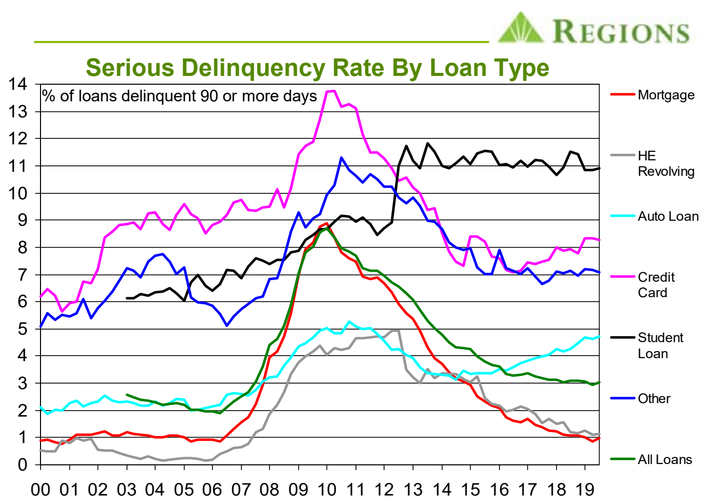


Source: Federal Reserve Bank of New York; Equifax; Regions Economics Division



Source: Federal Reserve Bank of New York; Equifax; Regions Economics Division

As of Q3, 10.9 percent of outstanding student loans were seriously delinquent, up from 10.83 percent as of Q2 but down from 11.53 percent as of Q3 2018. The New York Fed notes, however, that delinquency rates on student loans are likely understated, as roughly half of student loans are in deferment, in grace periods, or in forbearance and, as such, not currently in the repayment cycle. This would suggest that amongst loans actually in the repayment cycle, delinquency rates could be around twice as high as the reported rate. Of outstanding credit card debt, 8.27 percent was seriously delinquent as of Q3 2019, while the serious delinquency rate on outstanding auto loan balances was 4.71 percent. As has been the case in each quarter since Q3 2014, mortgage loans logged the lowest rate of serious delinquency in Q3, at 0.97 percent. In general, while overall loan performance remains strong across the various components of household debt, the main areas of deterioration have been in the subprime segments of auto loans and credit card loans.



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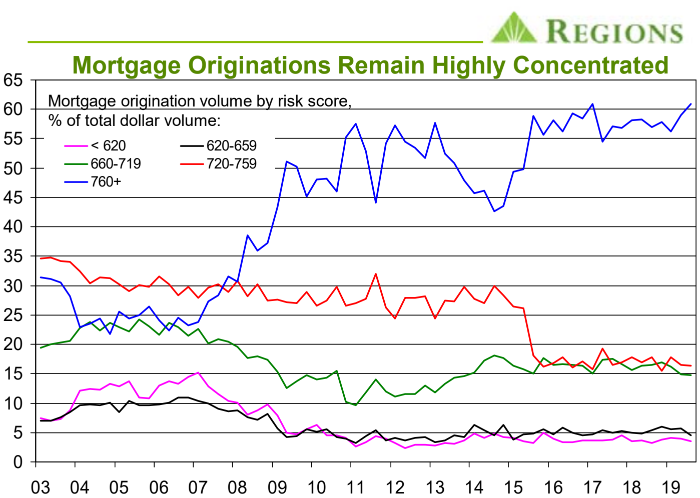

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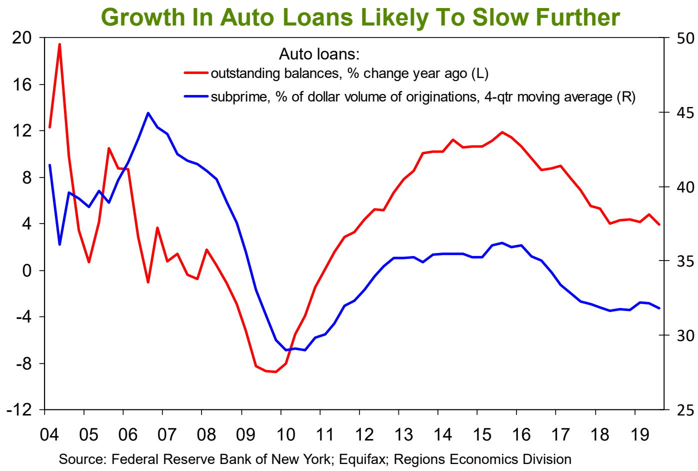
That mortgage loan performance has steadily improved over the past several years reflects what have been more stringent underwriting standards in the post-recession years. As seen in the second chart above, mortgage loan originations have been highly concentrated amongst those with credit scores of 760 or higher – in Q3, borrowers in this bucket accounted for 60.94 of all mortgage loan originations (which includes purchase loans and refinancings). The median credit score on mortgage loan originations in Q3 was 765, up from 759 in Q2 and the highest median score in the life of the data – by way of comparison, the median score in Q3 2006 was 713. What is interesting is that the Federal Reserve's quarterly surveys of senior commercial bank loan officers show that, on net, banks have been easing lending standards on mortgage loans over the past several quarters, which seems at odds with the New York Fed/Equifax data.

The availability of mortgage credit becomes more relevant at a time when many homebuilders are setting their sights on first-time buyers as a means of sustaining sales, particularly as many prospective first-time buyers have been effectively shut out of the market for existing homes due to supply and affordability constraints. This is something we've been talking about for several months, and we would have expected median origination credit scores to have at least edged a bit lower, rather than rising further, in the Q3 data.



In contrast, the median credit score on newly originated auto loans rose to 711 in Q3, up from 703 in Q2 and the highest median origination score since Q3 2010. As a point of reference, the post-recession low of 683 came in Q3 2015. The New York Fed/Equifax data are consistent with the data from the Federal Reserve's quarterly survey of senior commercial loan officers, which show banks have, on net, been raising lending standards on auto loans over the past several quarters. This can be seen in the chart to the side, with subprime borrowers accounting for a smaller share of auto loan originations over the past few years. At the same time, the slowing pace of motor vehicle sales, which has been gradual to this point, is reflected in outstanding balances on auto loans. With our baseline forecast anticipating further deceleration in motor vehicle sales, we'd expect to see the same in terms of growth in auto loan balances.

Whether we are talking about auto loans or any other type of household debt, the glaring hole in the data is with the non-bank lenders, in terms of lending standards, distributions across credit scores, and other metrics. The New York Fed/Equifax data do not distinguish between banks and non-bank lenders, and while loan performance amongst banks is routinely reported, that is not the case across the spectrum of non-bank lenders. One can make inferences from patterns seen in the aggregate data reported by the New York Fed, but our worry is that should there be a meaningful deterioration in economic conditions, particularly labor market conditions, it could be that delinquency rates rise faster and by more than would be expected. This is by no means to say that something on the order of what we saw around the 2007-09 recession is likely to happen during the next downturn, but instead just to raise the possibility that there are problems lurking under the surface that are not apparent in the aggregate data. The reality is that there is only one way we're going to find out, and, in all honestly, we're not in that much of a hurry to learn the answer to this question. For now, growth in household debt remains fairly steady at a pace well below historic norms, and monthly debt service burdens remain notably low while overall loan performance remains strong, with mortgage loan performance exceptionally strong. As long as the current expansion endures, household debt should pose no major risks to the broader economy.