We've Built a House of Cards

Peter Duffy reflects on consumer debt—how high the house is and how far and painful the fall will be

November 11, 2004

By Peter Duffy

Duffy's column on finance is published the second Thursday of every month.

It has been nearly a year since we discussed the legacy of the "greatest" generation. In December 2003's column, "How Consumers' Debt Affects CUs," we introduced the concept that the "greatest" generation spawned the most indebted generation (ours).

My concern last year was that consumers were piling on record levels of debt motivated by the 50-year lows in interest rates. In previous low-rate environments, consumers typically refinanced and paid *down* debt. During the past five or six years, the consumer/homeowner refinanced (some more than once), but this time piled on more debt. The worry has been whether we were building a credit house of cards.

The new worry is how tall the house is and how far and painful the fall will be.

Take a look at the consumer credit trend appearing on this graph. From 1995 to 2003, U.S. consumers added $1 trillion in debt, doubling the 1995 level. That's right, the United States finished 2003 with $2 trillion in debt, and half this sum was generated in the last seven years.

During this time, banks and CUs put more exposure to the risk on their balance sheets in the form of home equity lines of credit (see graph). HELOC concentrations more than doubled on CU balance sheets and nearly tripled at banks.

CUs have also been adding a significant number of indirect car loans, with many written below "A" paper. And, what is "A" anyway? In the December 2003 column, I noted that "good" credit risks went from current payers to dropping the keys off in the lobby with no warning during the late '80s recession. With a 0 percent savings rate, most households have no liquidity to withstand a job loss, medical event, or cost of living increase (picking up more of the tab for medical coverage, a health event, and reduction in pension plan payout or coverage).

All this has an increasing and direct impact on CUs. Unsecured loans, along with the credit card debt and HELOCs, not to mention second mortgages, leave CUs more exposed than any other risk.

Americans have felt wealthy for over 15 years. In the '90s it was the dramatic (and now we know, flawed) run-up in the stock market that gave many that "wealth effect" feeling. In the past 6-7 years it has been home values and low rates. This slide shows you how much home prices have escalated since 1986. Of particular interest is the acceleration since 1996. Over 35 percent of the current price of the median home in America relates to price appreciation over the last seven years.

This "wealth" effect has given consumers the confidence to rack up record levels of debt, even though income has not been growing on a real basis. What if home prices retract and equity goes down? Home equity lines of credit and other unsecured debt become stressed. Like anything else, it's the *amount* of exposure that seems out of line for some institutions.

Is it possible the music is about to stop? Hard to say. The consumer's confidence seems to be wavering. We just saw our third consecutive month of declining consumer confidence ... even as consumers

Copyright © 2004 Peter F. Duffy

continue to spend! Previously, consumer confidence had been rebounding this year after a three-year decline.

Household Debt Horrors

Household debt as a percentage of household net worth now stands at an eye-popping 21+ percent. Even more noteworthy is that household debt as a percentage of disposable income is hovering in the 110 percent range (see graph).

Americans have become drunk on consumption, and low financing rates have been baiting them.

Lending institutions that chase loans put their capital at risk just as much (or more) than chasing yield in the investment portfolio (not that *that* is good either).

Chasing loan business is one thing. Generating loans that have no collateral behind them is another. Unsecured loans in this market are worrisome. The economy has not really produced enough traction to give employers more confidence to hire. Those folks who have found jobs after the layoffs of a few years ago are, in many cases, being paid less and sharing in the cost of medical coverage.

United Airlines is already in bankruptcy, and Delta pilots took a 35 percent pay cut this week to keep that airline out of bankruptcy. General Motors has plans to close plants and idle 10,000 workers for a "few months." All this makes you wonder just how long the corporate recovery is going to last, especially when you consider that GM has been selling *a lot* of cars, yet can't turn a profit.

If I am a lender, I'm double checking my lending standards right about now. I'd also look into selling as much of my unsecured debt and/or questionable loans now, before it's too late. Because once (or if) the debt story unfolds, it *will* be too late. You won't be able to get a bid.

If this credit bubble bursts, we're going to need a lot more than low rates to bail us out of the next recession, as the consumer thanks us for the low financing with (perhaps) record levels of bankruptcies.

Pete Duffy *is associate director, Sandler O'Neill & Partners, L.P., New York. The views expressed by the author do not necessarily reflect those of Sandler O'Neill & Partners, L.P., do not constitute an offer to purchase or sell a security, and should not be construed as offering investment or strategic advice to any individual or institution.*

Copyright © 2004 Peter F. Duffy