Economic Watch

What's in Store for Consumer Credit?

Filip Blazheski

The ratio of consumer credit excluding student loans to household assets is historically low

The slowdown in the growth of student debt opens opportunities for releveraging in the other consumer credit categories, especially credit cards and unsecured personal loans

While delinquencies are at historically low levels, they have started inching up, especially in energy industry-exposed states

Consumer lending, especially credit cards, can be very profitable if risks are managed properly

Ultimately, stronger consumer credit depends on the continued solid performance of the economy in general and the labor market in particular

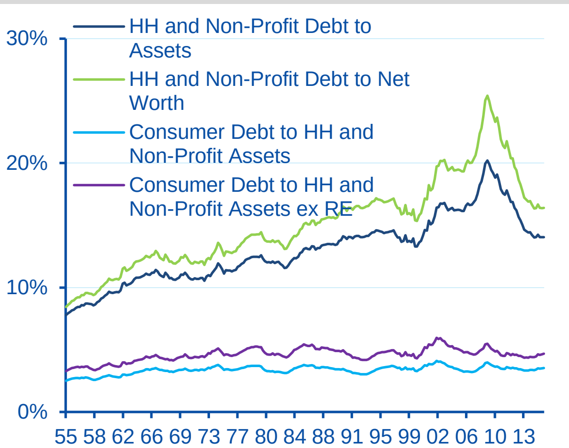
U.S. banks are increasingly more interested in consumer credit. One needs to look no further for evidence of the relative attractiveness of consumer lending than to the entry of traditional investment banks in the unsecured personal loans business during the second half of last year. This brief analyzes the most important recent trends in consumer credit, and what we can expect in the upcoming period in light of our baseline macroeconomic scenario, which suggests continued economic expansion in the short- to mid-term.

Household Debt vs. Consumer Credit

Household debt growth started to outpace nominal GDP growth in the second quarter of 2016, for the first time since the Great Recession. The reason it took 28 quarters (seven years) for this to happen was the heavy mortgage deleveraging following the subprime mortgage crisis (Figure 1). Consumer credit, on the other hand, which accounts for about 25% of total household debt, has been outpacing GDP for some time, its growth being primarily a result of the strong expansion in student debt and more recently auto loans (Figure 2).

Figure 1

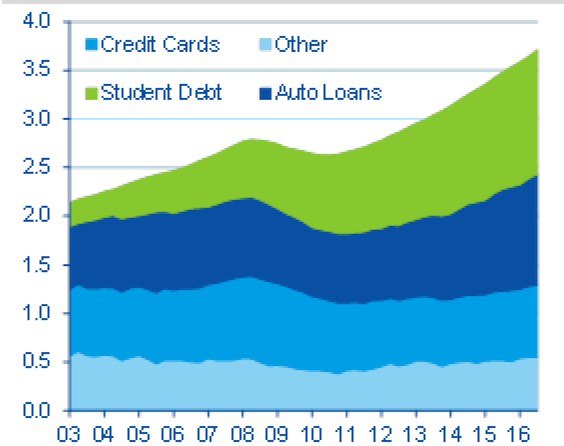
Relative debt levels
%



Source: Federal Reserve & BBVA Research

Figure 2

Consumer Loans
$ Trillion

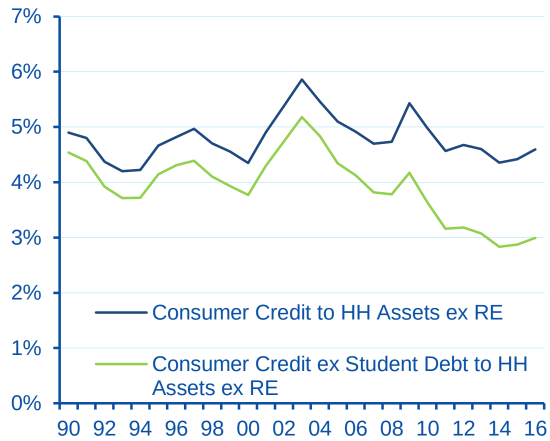


Source: Federal Reserve & BBVA Research

While the overall ratio of consumer credit to household assets has been remarkably stable, the ratio of consumer debt ex-student loans to household assets is very low relative to historic values (Figure 3). As student loan growth slows (Figure 4), further opportunities could be opening in the other components of consumer loans, as long as the overall economic situation, especially employment, continues to improve.

Figure 3

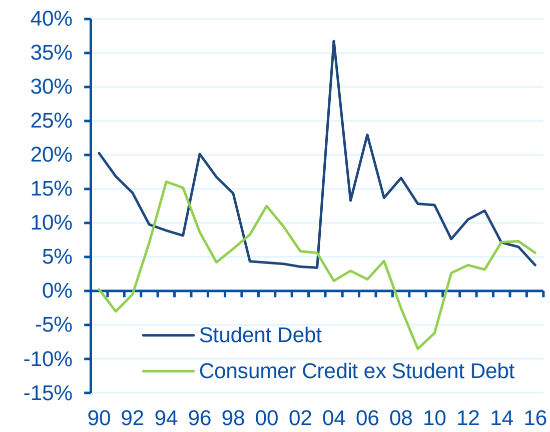
Relative Debt Levels
%



Source: Federal Reserve & BBVA Research

Figure 4

Consumer Credit
% YoY



Source: Federal Reserve, NY Fed & BBVA Research Calculations

Consumer Credit and Spending

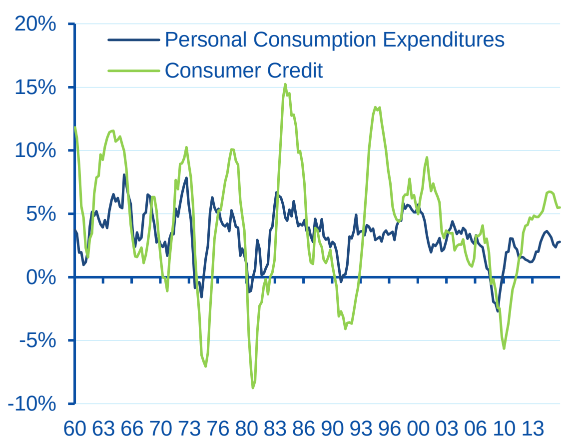
Not surprisingly, consumer credit is highly correlated with consumer spending (Figure 5). The higher amplitude of the consumer credit growth pattern is a result of its alignment with durable goods consumption (autos, appliances, etc.), which tends to have larger swings compared to services and nondurable goods spending. Spending on durable goods tends to be more cyclical than spending on nondurable goods because it can be more readily postponed in times of economic weakness, as the services that these goods provide can be maintained in the absence of new purchases, and also because of the discretionary nature of many durable goods.[1] Furthermore, during an economic expansion, once consumers purchase what they need after their economic situation improves, the demand for durable goods can decrease more rapidly compared to nondurable goods.

Consumer credit growth has been outpacing personal consumption expenditures (PCE) since the end of 2011, as has historically been the case in expansionary periods. The difference between the PCE growth rate and the consumer credit growth rate is significantly affected by lenders' willingness to extend consumer credit. We find that higher willingness to lend leads to stronger consumer credit growth. According to our models, consumer credit will continue to expand faster than PCE in 2017, but the difference will narrow (Figure 6) as the cycle matures. That said, the environment remains supportive of solid consumer credit growth even beyond 2017, as long as the positive macroeconomic developments, especially in regards to employment, persist.

[1] Black S., Cusbert T. (2010). Durable Goods and the Business Cycle. Reserve Bank of Australia Bulletin https://goo.gl/94n85X

Figure 5

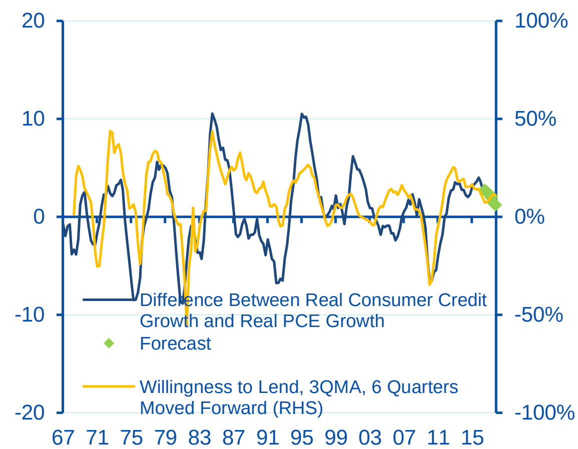
Real Spending and Real Consumer Credit % YoY, Constant $



Source: Federal Reserve, BEA & BBVA Research

Figure 6

Consumer Credit, PCE and Willingness to Lend PP and Net % Balance (More/Less Willing to Make Consumer Installment Loans)



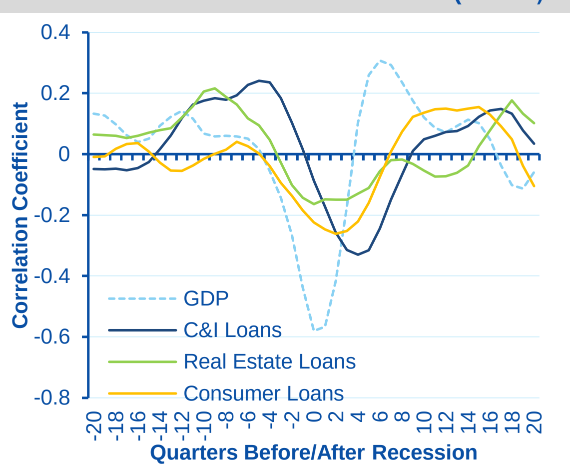
Source: Federal Reserve, BEA & BBVA Research

Bank Credit Sequencing

From what we have seen so far, consumer credit growth depends on consumer demand for goods and services, as well as lenders' willingness to extend credit. Willingness to lend is inversely correlated with delinquencies, which tend to increase when GDP growth slows. Because of all this, lenders pay a lot of attention to the business cycle. Predicting the next recession has proven to be very challenging, but what is certain is that the future holds one in store. Historically, for banks, the consumer credit portfolio has typically been the first to decelerate in the run-up to a recession, and has been the first to accelerate after one (Figure 7). The pattern during the current expansionary period has been different (Figure 8) because real estate and consumer loans

Figure 7

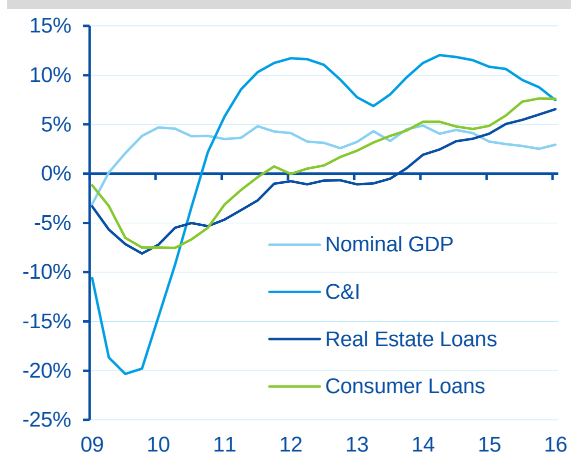
Crosscorellograms of Recession Dummies with Real GDP and Real Bank Loan Growth ('59-'16)



Source: Federal Reserve & BBVA Research Calculations

Figure 8

GDP and Commercial Bank Loans % YoY



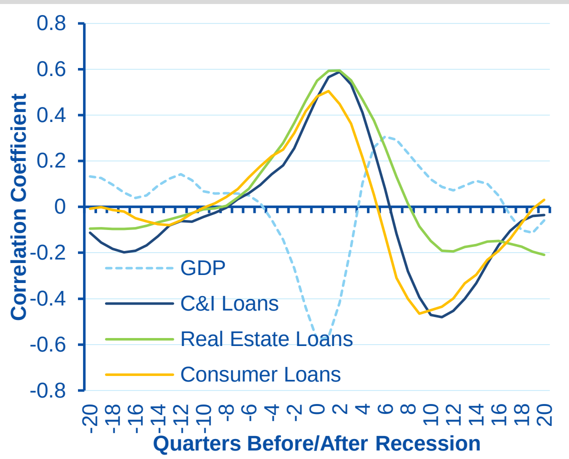
Source: Federal Reserve & BBVA Research

were slow to pick up, as households deleveraged after the recession and have dealt with higher levels of student debt compared to previous periods[2]. Commercial and industrial (C&I) loans also rebounded earlier than they would have otherwise due to the demand for financing of the shale oil and gas boom and the positive second-round effects it had on businesses in parts of the country exposed to the energy industry. Regardless, now that the economy has rebalanced, it is likely that the sequencing will revert to its historic pattern, which would imply that consumer loan growth will decelerate first as the cycle turns.

Consumer loans are not only the first ones to slow in a run-up to a recession, but also the first ones to show an increase in delinquencies (Figure 9). That said, consumer credit still has several factors going in its favor this time around: it picked up relatively late in the current expansion, lenders have been more conservative than before the crisis, and the labor market has performed very well so far. All of this has contributed to a historically low delinquency rate. According to the Federal Reserve, delinquency rates for consumer loans stood below 2.1% in 3Q16, compared to the lows of 2.7% in each of the last two expansions (3Q94 and 4Q05). Furthermore, delinquencies in 3Q16 were just a notch above the record low of 2.0% in 3Q15 and 4Q15, and even this slight increase could partially be explained by the economic slowdown in some parts of the country exposed to the energy downturn. According to TransUnion data, while credit card and auto loan delinquency rates in 3Q16 were higher YoY in all states, the highest increases were generally in states heavily exposed to the energy industry[3] (Figure 11). Thus, the recent uptick in energy prices and the expected improvement in the energy sector and thus in these states suggest that delinquencies will stabilize and stay close to the historically low levels, which would be consistent with our baseline scenario. In hindsight, the current uptick in delinquencies (Figure 10) could

Figure 9

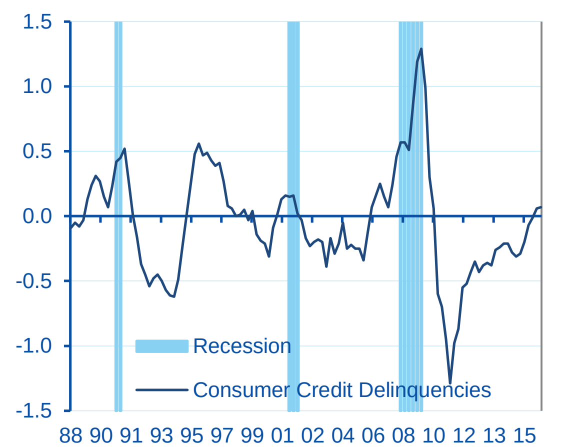
Crosscorellograms of Recession Dummies with Real GDP Growth and Change in Delinquencies ('88-'16)



Source: Federal Reserve & BBVA Research Calculations

Figure 10

Consumer Loan Delinquencies PP YoY



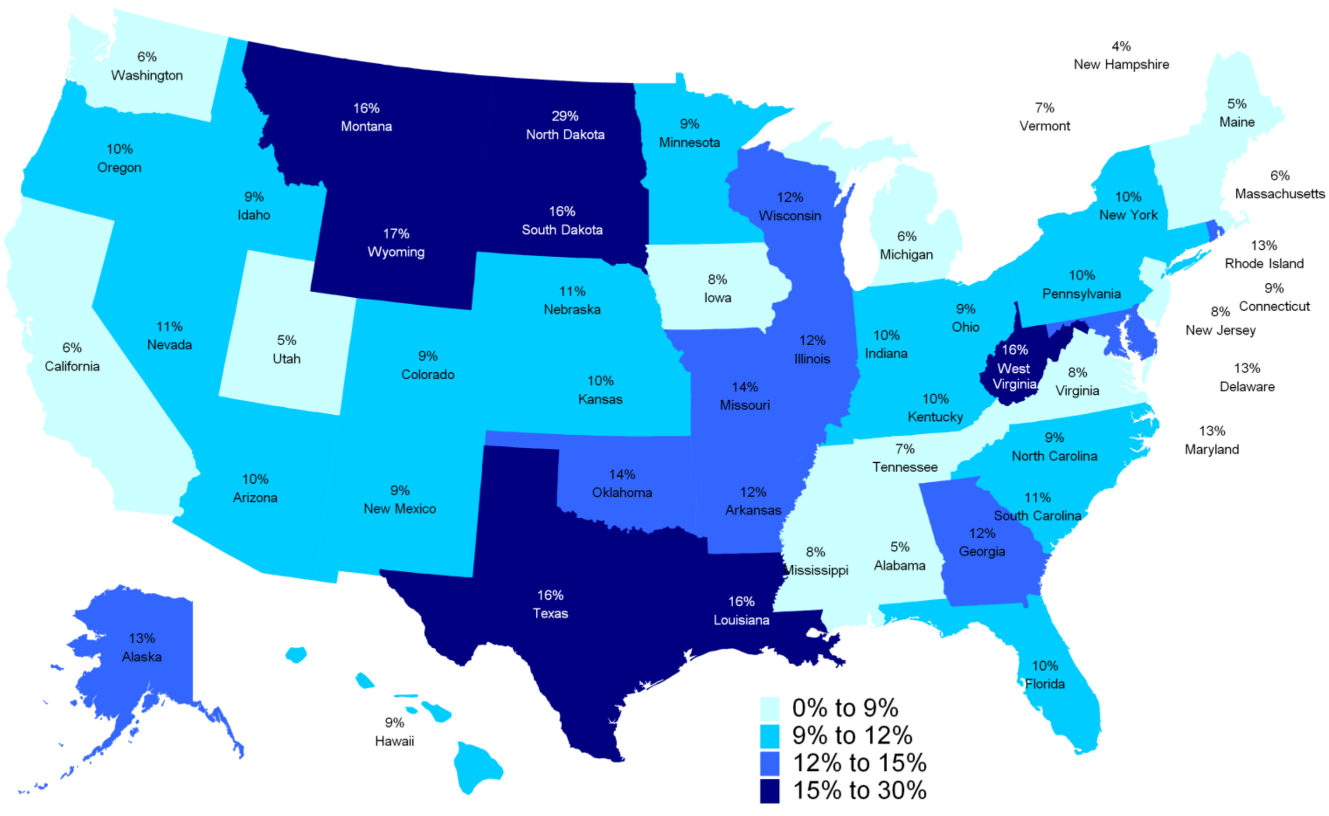
Source: Federal Reserve & BBVA Research

[2] Only a small portion of student debt is issued by banks, and the data analyzed in this section is for commercial banks only
[3] The change in delinquencies in energy-industry exposed states (Alaska, Louisiana, North Dakota, Oklahoma, South Dakota, Texas, West Virginia and Wyoming) was compared to the rest using standard tests, the change being measured both as percent and percentage point difference. The average change in the energy-exposed states is statistically significantly higher than the average change for the other states at 99% level of confidence

prove to be temporary, and look like something in between the delinquency developments in the mid-1990s and the ones in 2004.

Figure 11

Weighted Average Credit Card and Auto Loan Delinquencies by State, 3Q16
% YoY



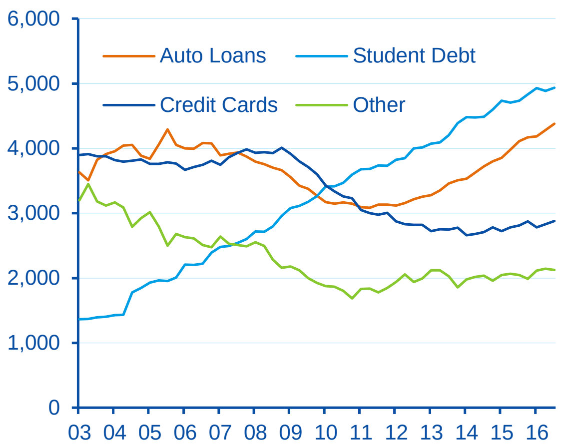
Source: TransUnion & BBVA Research Calculations

Credit Cards and Personal Loans

Our outlook for credit cards and personal loans is optimistic. While in real per capita terms, auto loans and certainly student loans exceed their pre-crisis levels, credit card debt and other consumer debt (which includes unsecured personal loans) remain significantly below pre-crisis levels (Figure 12). As mentioned earlier, the slowdown in growth of student debt should open an opportunity for releveraging. And while auto loan growth is likely to continue, its growth rate will likely decline as a result of tighter credit standards (Figure 13).

Figure 12

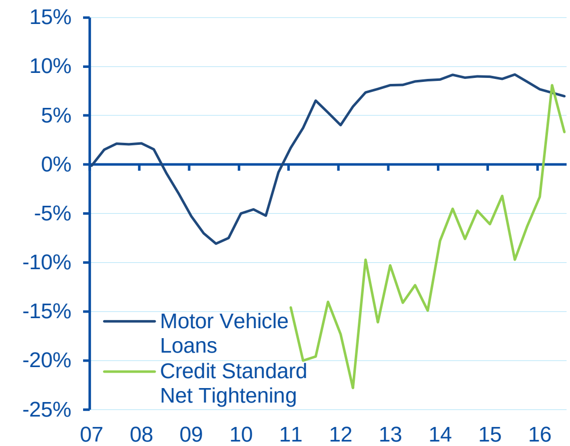
Consumer Credit Per Capita
2016 $



Source: Federal Reserve & BBVA Research

Figure 13

Auto Loans
% YoY and Net % Balance of SLOOS Respondents (Tightened / Eased Credit Standards)



Source: Federal Reserve & BBVA Research

Consumer Lending Profitability, Risks and FinTech Competition

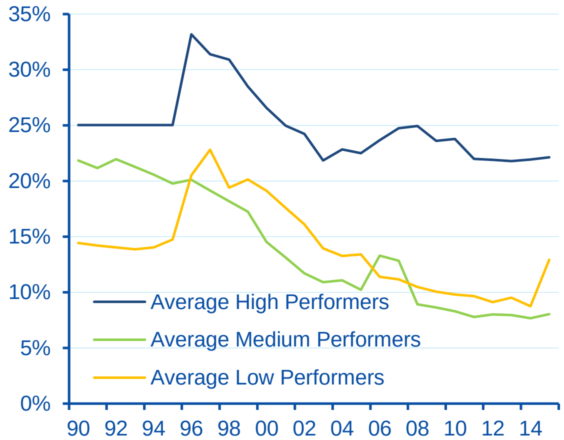
Consumer credit, especially credit cards, can be more profitable than other types of loans, but also more risky. We find that commercial banks with sustained above average RoA tend to have a higher share of consumer loans and a lower share of C&I loans (Figure 14). On the other hand, these banks tend to have a higher share of charge-offs to loans (Figure 15). This implies that the high performers are able to deliver higher RoA by successfully managing the tradeoff between profits and risks. It is important to note, however, that these results are affected by the performance of the credit card banks, which are generally in the "high performers" category. Regardless, this implies that consumer loans, especially credit cards, as well as higher risk tolerance, can improve commercial banks' profitability as long as the risks are managed properly.

Because of the difficulty of managing the tradeoff between profits and risks, the credit card and auto segments have not been targeted by technology companies so far, while the more straightforward segment of personal loans has been disrupted. While commercial banks have upped their ante recently, FinTech firms have already carved out a significant share of that market segment for themselves. According to TransUnion, around 26-27% of the unsecured personal loan balances in the first three quarters of 2016 were originated by these firms[4]. If banks are to hold onto their market shares in auto loans and credit cards, they will have to be innovative and deliver excellent customer service, two areas where FinTechs have proven to be formidable competitors.

[4] Laki, J. (2016). Personal loan balances reach exciting new milestones https://goo.gl/CxRmXe

Figure 14

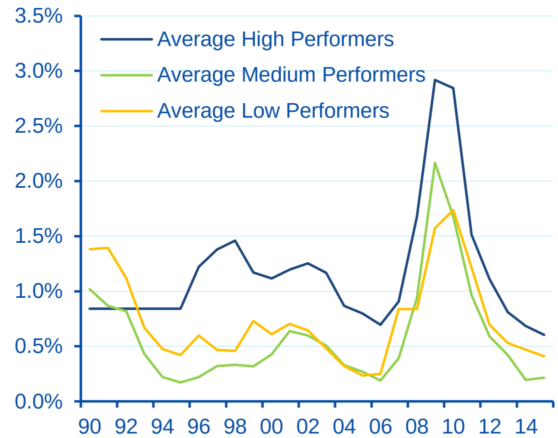
Share of Consumer Loans in Loan Portfolio[5]
%



Source: SNL & BBVA Research Calculations

Figure 15

Charge-offs to Total Loans
%



Source: SNL & BBVA Research Calculations

Bottom line

At the beginning of 2016, American Banker published an article that started with the following words: "We may be in the early stages of a seismic shift in the macroeconomics of banking. Consumer lending is back on the rise, while the commercial sector is getting less attractive."[6] The fundamentals of consumer credit and our baseline macroeconomic scenario imply continued opportunities in the consumer credit area, especially as the growth of student debt slows down. The factors supporting this process include: low delinquency rates, solid job formation, anticipated income growth due to a tightening labor market, and an improved outlook for energy industry-exposed states. Consumer lending, especially credit cards, can contribute to banks' profitability, but since we are likely at an advanced stage of the credit cycle expansion, a particularly important factor for the success of any lender is the ability to manage the tradeoff between risks and returns that consumer lending entails.

[5] Banks are divided into groups by number of years of above average RoA in the 1990-2015 period
[6] Cummins, C. (2016). Learn to Love Consumer Lending. https://goo.gl/6JDiYs