# Alan Greenspan: The mortgage market and consumer debt

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at America's Community Bankers Annual Convention, Washington, DC, 19 October 2004.

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In recent years, banks and thrifts have been experiencing low delinquency rates on home mortgage and credit card debt, a situation suggesting that the vast majority of households are managing their debt well. Yet many analysts focusing on broader macroeconomic conditions are far less sanguine in their assessments. They have been disturbed particularly by the rising ratio of household debt to income and the precipitous decline in the household saving rate. The analysts point out, correctly, that the ratio of household debt to disposable income has risen especially steeply over the past five years and, at 1.2, is at a record high. Moreover, many have recently become increasingly concerned about the exceptional run-up in home prices. They argue that a collapse of such prices would expose large, recently incurred mortgage debt to decreasing values of home collateral.

These concerns cannot be readily dismissed. Debt leverage of all types is often troublesome when one judges the stability of the economy. Should home prices fall, we would have reason to be concerned about mortgage debt; but measures of household financial stress do not, at least to date, appear overly worrisome.

About three-fourths of all outstanding first-lien mortgages were originated with a loan-to-value ratio of 80 percent or less, and in aggregate, the current loan-to-value ratio is estimated to be around 45 percent. Even though some down payments are borrowed, it would take a large, and historically most unusual, fall in home prices to wipe out a significant part of home equity. Many of those who purchased their residence more than a year ago have equity buffers in their homes adequate to withstand any price decline other than a very deep one.

Housing price bubbles presuppose an ability of market participants to trade properties as they speculate about the future. But upon sale of a house, homeowners must move and live elsewhere. This necessity, as well as large transaction costs, are significant impediments to speculative trading and an important restraint on the development of price bubbles.

Some homeowners drawn by large capital gains do sell and rent. And certainly in recent years some homebuyers fearful of losing a purchase have bid through sellers' offering prices. But these market participants have probably contributed only modestly to overall house price speculation.

More likely participants in speculative trading are investors in single residence rental and second home properties. But even though in recent years their share of purchases of single family homes has been growing, in 2003 their mortgage originations were still less than 11 percent of total home mortgage originations. Overall, while local economies may experience significant speculative price imbalances, a national severe price distortion seems most unlikely in the United States, given its size and diversity.

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Although I scarcely wish to downplay the threats to the U.S. economy from increased debt leverage of any type, ratios of household debt to income appear to imply somewhat more stress than is likely to be the case. For at least a half century, household debt has been rising faster than income, as ever-higher levels of discretionary income have increased the proportion of income spent on assets partially financed with debt.

The pace has been especially brisk in the past two years as existing home turnover and home price increase, the key determinants of home mortgage debt growth, have been particularly elevated. Most analysts, even those who do not foresee a mounting bubble, anticipate a slowdown in both home sales and the rate of price increase.

Sales of existing homes increase debt because the home seller's cancellation of debt on sale tends to average less than half the size of the mortgage origination of the buyer of the home. The difference, the net debt increase on the home upon sale, has historically closely approximated the realized capital gain on the transaction. Increases in debt from turnover tend to exceed those from the extraction of equity, most generally of unrealized capital gains, through cash-out refinancing and home equity loan extensions. The latter, however, has recently accelerated with the increased pace of home price appreciation.

If house turnover and price increases both slow, and presumably mortgage debt extensions on new homes do as well, increases in home mortgage debt will slow. Outright declines in mortgage debt seem most unlikely. Home mortgage debt has increased every quarter since the end of World War II.

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Some of the rise in the ratios of household debt to income may not be evidence of stress. The dramatic increase during the past decade in home purchases by previous renters has expanded both the assets (that is, owned homes)and the liabilities (mortgages) of the total household sector without significantly affecting either overall household income or net worth. Federal Reserve staff members estimate that approximately one-tenth of current home mortgage debt outstanding, or almost 1 percentage point of the average annual growth of home mortgage debt, is attributable to renters who have become homeowners since the early 1990s. One can scarcely argue that those previous renters are less well off since becoming homeowners; yet, all else being equal, the overall household debt as a percentage of income is 8 percentage points higher currently than it presumably would have been had the homeownership ratio been stable since 1992.

In addition, improvements in lending practices driven by information technology have enabled lenders to reach out to households with previously unrecognized borrowing capacities. This extension of lending has increased overall household debt but has probably not meaningfully increased the number of households with already overextended debt. Finally, the pronounced rise in home equity loans, which have been a growing share of home mortgage debt since 1994, likely reflects the recent marked increase in home equity, the consequence of rapidly rising house prices.

Despite the recent high debt-to-income ratios, at least some of which is more statistical than real, the ratio of households' net worth to income has risen to a multiple of more than five after hovering around four and one-half for most of the postwar period. Taking into account this higher level of assets, all in all, the household sector seems to be in reasonably good financial shape with only modest evidence of an increased level of household financial strain.

To be sure, some households are stretched to their limits. The persistently elevated bankruptcy rate remains a concern, as it indicates pockets of distress in the household sector. But the vast majority appear able to calibrate their borrowing and spending to minimize financial difficulties. Thus, short of a significant fall in overall household income or in home prices, debt servicing is unlikely to become destabilizing.

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The share of income committed by households for paying interest and principal on their debt is a useful measure of the likely inclination of households to default on their obligations when they suffer adversity, such as job loss or illness. As an indicator of stress, this debt-service measure has many advantages over debt-to-income ratios, but it is admittedly sensitive to assumptions about household debt contracts. The Federal Reserve publishes both the ratio of households' debt-service to their incomes and a broader financial obligations ratio because debt payments are not the only regular payments faced by households.

The financial obligations ratio incorporates other recurring expenses, such as rents, property taxes, and payments associated with homeowners' insurance and auto leases, that might subtract from the uncommitted income available to households. The Federal Reserve also calculates separate aggregate financial obligations ratios for homeowners and renters.

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Both the debt-service ratio and the financial obligations ratio rose over the 1990s, but that upward trend has not continued in this decade. The debt-service ratio has been hovering close to 13 percent for three years, whereas the financial obligations ratio, after peaking above 18-1/2 percent in 2002, has moved down to near 18 percent.

The recent stability of the aggregate debt-service and financial obligations ratios reflects largely the evolution of the financial situations of homeowners, who owe more than nine-tenths of all household debt. Despite average annual mortgage debt growth in excess of 12 percent over the past two years, the financial obligations of homeowners have exhibited little change as a share of their income because mortgage rates have remained at historically low levels. The enormous wave of mortgage refinancing, which ended only in the fall of 2003, allowed homeowners both to take advantage of lower rates to reduce their monthly payments and, in many cases, to extract some of the built-up equity in their homes. In the aggregate, the cash flows associated with these two effects seem to have roughly offset each other, leaving the financial obligations ratio little changed.

Indeed, the surge in cash-out mortgage refinancings likely improved rather than worsened the financial condition of the average homeowner. Some of the equity extracted through mortgage refinancing was used to pay down more-expensive, non-tax-deductible consumer debt or to make purchases that would otherwise have been financed by more-expensive and less tax-favored credit.

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By our calculation, both homeowners and renters have seen an increase in the share of income used to cover credit card payments over the past decade. The Federal Reserve's Survey of Consumer Finances suggests that renters who have recently purchased homes tend to carry higher levels of nonmortgage debt and, in particular, credit card debt.

Moreover, credit card debt ratios have been rising among all households because of the use of credit cards for new purposes. The convenience of credit cards has caused homeowners to shift the way they pay for various expenditures to credit card debt. In short, credit card debt-service ratios have risen to some extent because households prefer credit cards as a method of payment, and hence, the increase does not necessarily indicate greater financial stress.

All told, the rise in short-maturity, high-repayment-rate credit card debt has accounted for about one-third to more than one-half the increase in the debt-service ratio for homeowners since the early 1990s. Moreover, the rise in the share of income going to other homeowner nonmortgage financial obligations has also been relatively small so that the overall homeowner ratio has risen only modestly.

In contrast, the rise in the financial obligations ratios for renters since the early 1990s has been steep. The increase for renters, as for homeowners, is concentrated in credit card lending and thus may reflect some of the same qualifying factors that have influenced homeowner debt-service ratios. But unlike homeowners, renters over the past decade have been using a materially higher fraction of their incomes for payments on student loans and used-car debt. Renters tend to be younger and have lower incomes than homeowners, so the fact that student loans and used-car payments are a larger share of their income is not surprising. However, this trend might be worrisome if it indicates greater difficulties in becoming financially established.

In addition, some of the rise in the debt-service ratios of renters, unlike in those of homeowners, occurred during the most recent recession. This difference highlights the special risks to their incomes that renters face during economic downturns. Difficulties among renters may pose some risk to the economy overall, but this risk is likely to be limited, since renter households currently receive only one-sixth of overall after-tax household income.

Renters' debt-service and financial obligations ratios have trended down a little during the past two years, a hopeful sign that is likely correlated with the overall improvement in the economy. However, the longer-term rise in the renter debt-service ratio may indicate some trends among these households that may be problematic.

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One might expect interest rates and debt-service ratios to move in lockstep with each other. But other influences on debt-service ratios, such as significant changes in household income, play a major role in their movements. In addition, most consumer and mortgage loans have fixed rates, suggesting that debt-service payments respond only gradually to interest rate changes. That said, debt-service ratios are likely to remain high so long as mortgage debt continues to expand faster than historical trends relative to household income. Altogether, even in a rising interest rate environment, debt-service ratios at least for a while should rise only modestly.

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In summary, although some broader macroeconomic measures of household debt quality do not paint as favorable a picture as do the data on loan delinquencies at commercial banks and thrifts, household finances appears to be in reasonably good shape. There are, however, pockets of severe stress within the household sector that remain a concern and we need to be mindful of the difficulties these households face.

In addition, a significant decline in consumer incomes or house prices could quickly alter the outlook; nonetheless, both scenarios appear unlikely in the quarters immediately ahead. If lenders, including community bankers, continue their prudent lending practices, household financial conditions should be all the more likely to weather future challenges.