Deflating the Debt Balloon

by Steve Brown

There have been some encouraging numbers regarding the average "debt service ratio" for American households as of late. Prior to the financial blowup, consumers borrowed lots of money, some through credit cards, but especially with HELOCs and other means. They borrowed against what we now realize were significantly and artificially inflated home values. It's been an ugly unwinding and taken more than 5Ys, but in the final quarter of 2012, the household debt service ratio hit its lowest level since record keeping began in 1980. Like the air coming out of a balloon, things are finally deflating back toward normal.

Household debt service ratio tells us how much disposable income is being spent toward paying interest, whether it is on mortgages, consumer loans or other types of credit. Low interest rates have played a large part in the reduction of this number of course. Almost anyone who is able has refinanced their mortgage and that has been good. Mortgage rates were around 7.00% for a 30Y loan in 2007 and fell to around 3.40% in the late part of 2012. This added substantial cash to homeowners' pocket books and rates also fell on car loans and credit cards. To be sure, this has been the aim of the Fed all along, in its efforts to keep interest rates low by various means to restart the economy.

Part of the improvement in the ratio though is because there have also been many defaults. People have walked away from debts they could not repay, especially mortgages. Through foreclosures and repossessions, homes flooding the market, prices fell and supply looked around for demand. New buyers just don't need to borrow as much given all of this, which helps the average debt service ratio. It does not help those homeowners who are underwater on their mortgages, however as home prices declined by a third between 2005 and 2012. Since then, there has been a recovery in many areas and with that home prices have also recovered. The past year alone, some 1.7mm under- water homeowners escaped negative equity.

There could be opportunity for community banks in this trend, so we wanted to highlight it. In the recent past, consumer lending has primarily been the market of either very large banks or credit unions, but with the improved health of household balance sheets, community banks may want to consider it as well. The loans are smaller sized and the rules have shifted, so banks should be careful in how they proceed (or admin costs may quickly override the value of assets added and interest earned).

Banks already have a lot of the information necessary to make wise decisions though. If your bank has refinanced a mortgage for a customer, then you already have tax returns and income statements for that customer and this should help you make a good decision based on live information.

The debt service ratio should be watched no matter what you do, as it ticked upwards in Q1 of 2013 (so we may have already seen the best of this trend). Consumers may be binging on credit cards again, but more likely the rise in mortgage rates is causing an increase in household interest payments. If an uptick in the ratio occurred in Q1, then you can be assured more is probably on the way, in particular with the rise in rates over recent weeks.

BANK NEWS

Branch Changes

A recent Celent survey finds 55% of banks said they planned to make significant changes to their branches this year vs. 24% 2Ys prior.

TBTF

Regulators have proposed doubling the supplementary leverage ratio for bank holding companies (BHCs) with $700B or more in assets (systemically significant financial firms) to 6% to be considered well capitalized. BHCs that fail to meet the standard would see limits placed on their ability to pay discretionary bonuses or make capital distributions.

Financial Stability

The Financial Stability Oversight Council (FSOC) has designated AIG and GE Capital as systemically important financial institutions, marking the first nonbanks to be named. The companies must now file a plan indicating how they would unwind themselves if they were on the edge of failure, likely face increased capital requirements and heightened regulatory scrutiny.

Less Teller Activity

Celent reports the average number of teller transactions has declined 18% in the 6Y period from 2005 to 2011 (from 19.1 per hour in 2005 to 15.6 per hour in 2011).

Best CRE

Analysis by real-estate research firm Reis Inc. finds the 5 cities that have seen the biggest office rent increases over the past year are: San Francisco CA (+7.2%), San Jose CA (+4.6%), New York NY (+4.4%), Houston TX (+4.0%) and Dallas TX (+3.2%).

Worst CRE

Analysis by real-estate research firm Reis Inc. finds the 5 cities that have seen the biggest office rent decreases over the past year are: Chattanooga TN (-0.6%), Long Island NY (-0.5%), Las Vegas NV (-0.2%), Columbia SC (- 0.2%) and San Bernardino/Riverside CA (-0.2%).

Lower Delinquency

The ABA reports bank card delinquencies declined to a 22Y low of 2.31% in Q1.

Libor Change

Bloomberg reports a British government commission and the NYSE have announced official Libor reporting has been sold to NYSE Euronext. The index had been run by the British Bankers' Association since 1980, but recent scandals prompted the change.

Retail Lending

A report by eMarketer projects 102mm people will use smartphones to shop in 2013 and 94mm will use tablets. That is interesting, but of note for banks that lend to retailers, the report also finds only 52% of those using smartphones will make a purchase vs. 76% of those who use a tablet. Alert your retail customers they might want to explore giving out tablets when customers enter their store to increase the opportunity to sell more.