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Special Commentary

Anika R. Khan, Senior Economist
anika.khan@wellsfargo.com • (704) 410-3271
Michael A. Brown, Economist
michael.a.brown@wellsfargo.com • (704) 410-3278

Are Risks Brewing in Consumer Lending?

Executive Summary

Over the course of the past several quarters, there has been acceleration in the pace of consumer credit issuance. While economic fundamentals have improved, the exceptionally low-interest rate environment combined with the expansion of consumer credit has led some to question whether there are credit risk imbalances building in the consumer sector. In this report, we survey current trends in consumer credit and explore which segments of consumer credit are growing the fastest. We then turn our attention to what is fueling the growth in consumer credit segments to make a determination of whether credit imbalances exist.

Through our analysis, the overall level of consumer debt remains well off its pre-recession levels. After carefully reviewing the three fastest growing consumer credit segments of credit cards, auto loans and student loans, we find very little evidence of significant imbalances in the consumer credit market. With little evidence of delinquencies building, a much slower pace of new credit issuance and a much more cautious lending and borrowing environment, we currently do not see any immediate evidence that the low-interest rate environment is fueling a concerning rise in consumer credit.

The overall level of consumer debt remains well off its pre-recession levels.

Consumer Credit Trends in a Low-Rate Environment

Overall consumer credit outstanding has grown at an average rate of $16.8 billion per month since 2012, above the average pace of $11.7 billion observed back in the 2005-2007 period. The bulk of the gains in consumer credit over this period have been concentrated in nonrevolving credit, such as student loans, as opposed to revolving credit, which mostly captures credit cards and lines of credit. Even with these upward trends in consumer credit, the rate of growth in household debt is not growing anywhere near the pace observed during the last economic expansion (Figure 1).

On the revolving credit side of the equation, total revolving credit has increased 4.7 percent over last year's levels as of September. There is also evidence to suggest that credit card access is opening up to a wider range of borrowers. TransUnion's research found that subprime borrowers are presenting a larger share of new credit card accounts.[1] They also point out, however, that lenders remain cautious about subprime lending with average new credit lines that are much smaller.

Within the nonrevolving consumer credit space, two areas that make up the bulk of the category are auto loans, which accounted for 0.95 percentage points of the total 3.0 percent growth rate in total consumer credit, and student loans, which accounted for 0.66 percentage points of the total consumer credit growth as of the third quarter of 2015.[2] Both categories have seen sizable year-over-year growth rates since the end of the recession (Figure 2). The annualized pace of auto sales has been accelerating on a quarterly basis every quarter so far this year and shows no signs of

[1] TransUnion. (2015). "TransUnion: Credit Card Delinquency Rates Remain Low; Subprime Borrowers Represent Larger Share of New Loans." TransUnion Industry Insights Report.
[2] Consistent with the Federal Reserve's definitions of nonrevolving credit, we exclude credit secured by real estate.

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letting up anytime soon. The low-interest rate environment, low retail gasoline prices and pent-up consumer demand for autos and trucks have helped to boost lending demand.

Figure 1

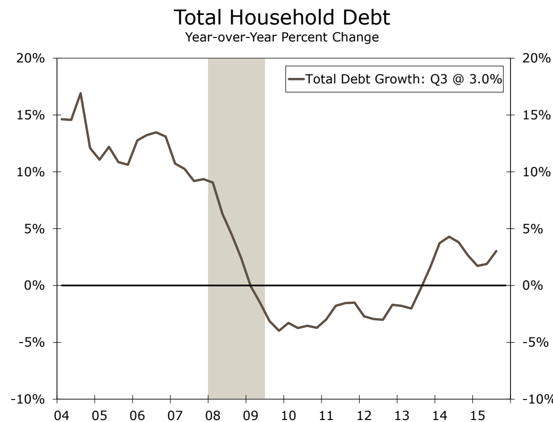
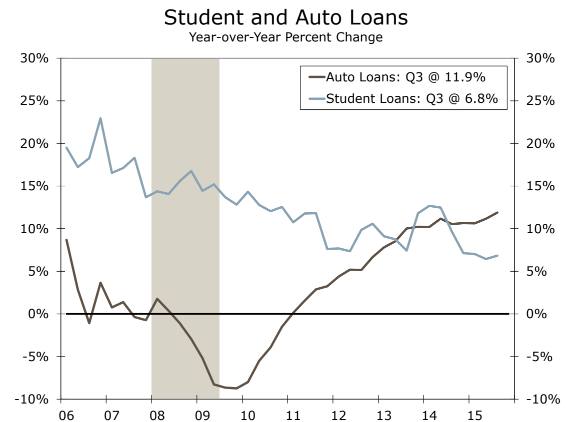


Figure 2



Source: Federal Reserve Bank of New York and Wells Fargo Securities, LLC

The growing cost of higher education along with public policy changes around federal student loans have been the two main drivers of student loan growth.

On the student lending front, the growing cost of higher education along with public policy changes around federal student loans have been the two main drivers of student loan growth.[3] The increasing costs of higher education have been well documented, and are having some effect on loan growth. However, the size and volume of actual loan growth would only be allowed to grow if underwriting standards were eased in order to improve access to these products. The bulk of the student loan market, roughly 91 percent, is federally-backed in some way.[4] With such a large part of the student loan market backed by the federal government, there is evidence suggesting that a public policy change may be one of the key drivers of the loan growth. In 2010, as part of the Affordable Care Act, a package of student loan reforms was included that shifted the student loan model away from providing subsidies to student lenders to an entirely federally run student loan program. These reforms in some ways have made it easier to access student loans, particularly for parent-backed student loans.[5]

While the pace of student loan growth has started to show some signs of downshifting, auto lending has been steadily rising since 2010 (Figure 2). Of all of the consumer credit segments, auto lending has outpaced all other types of consumer loans. As of the third quarter of this year, auto loans were growing at 11.9 percent over the year. The growth in auto lending has led to rather dramatic changes in the make-up of auto loans. Average debt per account for auto loans has been outpacing that of all other types of household debt since 2011 (Figure 3). The average amount financed for a new car loan today is $26,932, up 5.7 percent from 2010. In addition, the average length of an auto loan now spans 65 months.[6] In addition, the New York Federal Reserve's data includes auto leases which have also been trending higher. Given the extended terms of auto loans and the increases observed in leased vehicles combined with the low-interest rate environment, more consumers have been able to qualify for auto loans in the current modest income growth environment by accepting these longer repayment terms. The result over the past couple of years has been sizable growth in the number of subprime auto loans.[7]

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[3] In the case of student loans, it makes little sense to compare current personal income growth with student loan growth. The bulk of student loans are taken out with the expectation of future income growth rather than being issued based upon current income.
[4] The College Board. (2014). Trends in Student Aid 2014.
[5] Clark, K. (2010). "Big Changes Coming to Student Loans." U.S. News and World Report.
[6] Consumer Credit G.19. (2015). Federal Reserve Board.
[7] Quarterly Report on Household Debt and Credit. (2015). Research and Statistics Group: Microeconomic Studies. Federal Reserve Bank of New York.

Figure 3

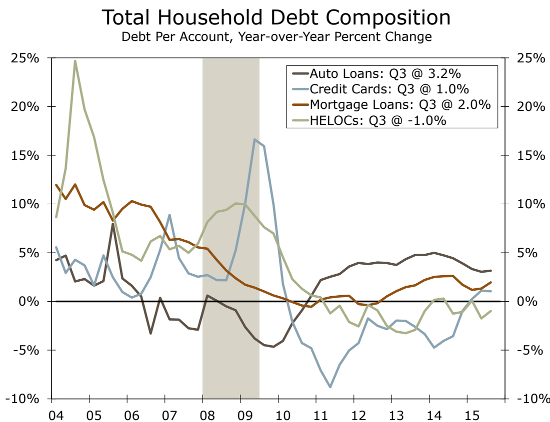
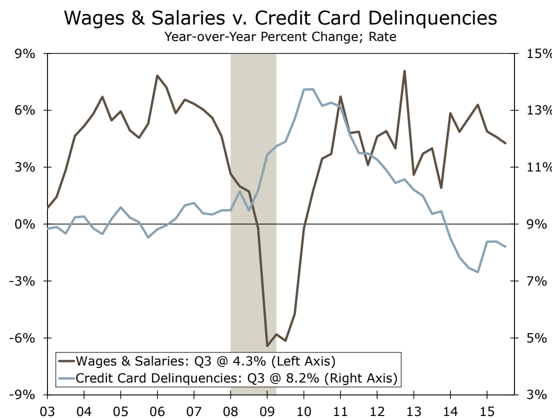


Figure 4



Source: U.S. Dept. of Commerce, Federal Reserve Bank of New York and Wells Fargo Securities, LLC

What Is Fueling the Rise in Consumer Credit?

With consumer credit growth occurring across a number of consumer segments, the question is what is fueling this credit growth? In particular, what are the key drivers of consumer credit growth for the three fastest growing segments of credit cards, student loans and auto loans?

Credit card growth appears to be following economic fundamentals.

Credit card growth appears to be following economic fundamentals as the pace of income growth and credit card delinquencies are inversely related (Figure 4). After several quarters of robust job gains, there are now signs of much greater full-time as opposed to part-time hiring that is helping to support greater consumer spending and also the ability for consumers to take on additional leverage in the form of credit cards. In terms of potential issues building in the consumer credit card space, we currently do not find any evidence that the greater expansion of consumer credit is creating challenges for consumers. Overall default rates are trending down and the number of serious delinquencies continues to fall suggesting that there are little signs of pressure building in the near term (Figure 5).[8]

Figure 5

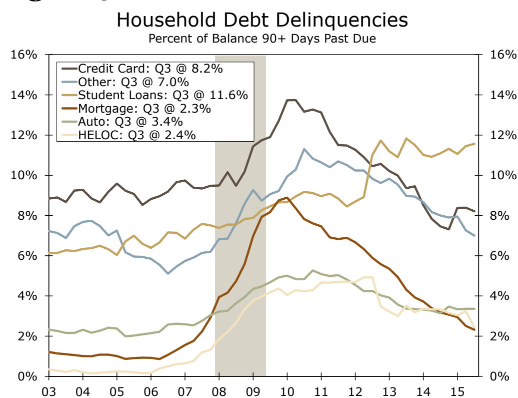
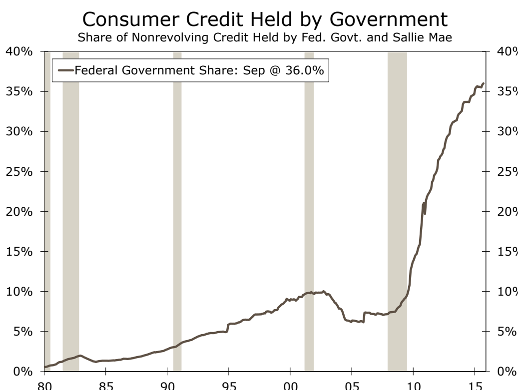


Figure 6



Source: Federal Reserve Bank of New York, Federal Reserve Board and Wells Fargo Securities, LLC

[8] Quarterly Report on Household Debt and Credit. (2015). Research and Statistics Group: Microeconomic Studies. Federal Reserve Bank of New York.

As mentioned earlier, student loan growth is likely being fueled by a combination of both public policy changes, which had the effect of increasing the number of borrowers, and the rising costs of higher education. Of all of the credit categories discussed, the one consumer credit segment with elevated and rising serious delinquencies is the student loan sector. The open question is whether or not the rising delinquencies suggest that there is a "student loan bubble" about to burst. The answer, in our view, is no. First, student loans cannot be forgiven in the bankruptcy process and, therefore, remain with the borrower regardless of other defaults.[9] In addition, as we have pointed out, most of the student loans outstanding are held and backed by the federal government (Figure 6). Should a mass wave of defaults occur, the federal government (i.e., taxpayers) would be on the hook for paying for restructuring the terms of the student loans and allowing for further reductions in interest rates and other payment terms. In fact, there is currently an uptick in the number of loans which are being modified through programs offered by the U.S. Department of Education. We recognize that the large amount of student loan debt could crowd out other forms of credit, in turn, delaying purchasing decisions or the ability to spend for some consumers but again should the issue become widespread there would likely be political pressure to further modify student loan terms and or provide outright loan forgiveness through legislation.[10]

Auto loan growth, while following improvement in economic fundamentals appears to be growing at a pace consistent with aggregate personal income growth and nominal GDP growth. Another argument presented for credit imbalances within the auto sector has been the growth in asset-backed finance instruments as global investors search for yield. According to Wells Fargo's Structured Products Research, the level of ABS issuance has picked up in the auto space but there is little evidence to suggest that ABS is driving a large part of the growth in auto lending activity.[11] In addition, there is currently little evidence of serious delinquencies and while there has been an increase in subprime auto lending, many lenders have started to pull back on the pace of subprime lending, as can be seen in the latest release of New York Fed's Quarterly Report on Household Debt and Credit.[12]

The Bottom Line: Are There Signs of Default Risks in Consumer Lending?

We currently do not see any immediate evidence that the low-interest rate environment is fueling a concerning rise in consumer credit.

The overall level of consumer debt remains well off its pre-recession levels, but the open question remains: Are there some consumer credit segments that are showing some signs of imbalances? After carefully reviewing the three fastest growing consumer credit segments of credit cards, auto loans and student loans, we find very little evidence of significant imbalances in the rate of issuance of consumer credit for credit cards and auto loans. While the level of issuance of student loan debt on the surface is concerning, the nature of student loan debt being federally- backed and the fact it cannot be generally forgiven through the bankruptcy process, we see little credit market impact from the student loan segment. With little evidence of delinquencies building in other consumer credit segments, a much slower pace of new credit issuance and a much more cautious lending and borrowing environment we currently do not see any immediate evidence that the low-interest rate environment is fueling a concerning rise in consumer credit.

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[9] While there are some exceptions in extreme cases, in general, student loan debt cannot be forgiven in the bankruptcy process.
[10] Edmiston, K.D., Brooks, L. and Shepelwich, S. (2012). Student Loans: Overview and Issues (Update). Research Working Papers. RWP 12-05. Federal Reserve Bank of Kansas City.
[11] McElravey, J. and Brinkoetter, R. (2015). ABSolute Value: Auto Market Review 2015: More Risk – Longer Loans, Leasing Up; but Few Broad Excesses. Wells Fargo Structured Products Research.
[12] Quarterly Report on Household Debt and Credit. (2015). Research and Statistics Group: Microeconomic Studies. Federal Reserve Bank of New York.

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Erik Nelson	Economic Analyst	(704) 410-3267	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com

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