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Structured-Finance Research

State of the U.S. Consumer--Please Sir, Can You Lend Me Some More?

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Author:

Stephanie K. Mah | Director of Research, Structured Finance | stephanie.mah@morningstar.com | +1 646 560-4571

Morningstar Perspective

Nonhousing consumer debt levels are increasing, with student-loan debt leading the charge, according to the Federal Reserve. Student-loan delinquencies more than 90 days past due have risen since late 2011. With the proliferation of postcrisis loans made to students, especially to those attending for-profit colleges with focused specialties, Morningstar Credit Ratings, LLC expects to see challenges in the sector.

Meanwhile, after little change over the past few years, auto-loan delinquencies have edged higher, as competition among underwriters led to an increase in subprime auto loans. While we expect to see an uptick in auto delinquencies given the larger subprime component, overall auto-loan delinquency rates remain at relatively low levels. If unemployment remains in check, those auto-loan delinquency gains should be within reason, while we expect credit-card and mortgage delinquency rates to remain low.

Consumer fundamentals have improved, with delinquency levels across credit cards and mortgages retreating from their postcrisis highs. The one consumer-related sector to exhibit marked deterioration, the student-loan segment, has seen delinquencies surpass levels during the crisis.

90-Plus Days Delinquency Rates for Consumer Loans

(%)	2009:Q4	2010:Q4	2016:Q1
Auto Loans	4.92	5.27	3.52
Credit Cards	12.70	13.27	7.60
Mortgages	8.75	7.61	2.08
Student Loans	8.66	9.12	11.04

Sources: Federal Reserve Bank of New York, Equifax

Consumer Spending and Sentiment

Even with the first-quarter sequential slump, real consumption growth year over year remains healthy, though perhaps not as robust. Inflation-adjusted consumption growth has done fairly well, growing 3% or more from mid-2014 to mid-2015. Consumers also opted to save more over the first four months of this year, with an average 5.6% personal savings rate, up from an average 5.3% in the last quarter of 2015, as reported by the Bureau of Economic Analysis.

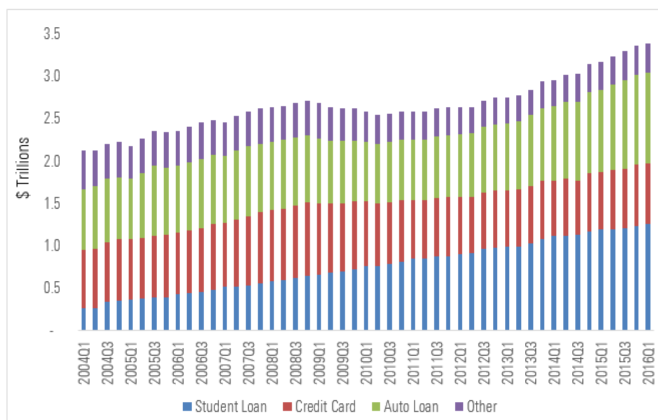
Unfavorable warmer weather conditions and some slowing in employment caused consumer spending to slow modestly in the first quarter, as it often does. This transitory slowing of consumption, along with export declines and depressed spending, knocked first-quarter gross domestic product growth to 0.8%. But figures reported by the Bureau of Economic Analysis for consumer spending indicate a possible turning point, with spending increasing by a healthy 1.0% in April. Bob Johnson, Morningstar, Inc.'s director of economic analysis, estimates 2.0% to 2.5% GDP growth for 2016 but notes the forecast is leaning toward the lower end of that spectrum given the weakness in GDP growth in the first quarter. Morningstar Credit Ratings, LLC is a nationally recognized statistical rating organization; parent Morningstar, Inc. is not an NRSRO and does not issue NRSRO credit ratings.

Data on consumer sentiment is mixed. Consumers are more optimistic about the future, as the University of Michigan's Sentiment Index surged to 94.7 in May from 89.0 the prior month. June's report saw slightly tempered optimism, with the index at 93.5. Another metric, the Conference Board's Consumer Confidence Index, showed a 2.2% decline in May. Survey respondents noted concerns regarding lack of employment opportunities. Morningstar Credit Ratings concludes that while consumers are concerned about the job market and business conditions, they remain optimistic about their abilities to purchase big-ticket items.

Consumer Indebtedness

Total household debt reached $12.252 trillion at the end of March, up 1.1% from the level seen at year-end 2015, as reported by the Federal Reserve Bank of New York. Nonetheless, consumer debt growth remains modest and in line with consumer wages. Housing debt, which stood at $8.854 trillion at the end of the first quarter, dwarfs nonhousing debt. Nonhousing debt peaked at $3.398 trillion at the end of first quarter, outpacing the $2.708 trillion registered at the end of 2008. Student-loan debt comprised the bulk of consumer credit and has experienced the greatest growth, accounting for $1.261 trillion at the end of March 2016, up from $1.190 trillion one year earlier. Auto-loan debt ranked second, representing $1.071 trillion, followed by credit-card debt, at $712 billion.

Outstanding Nonhousing Debt



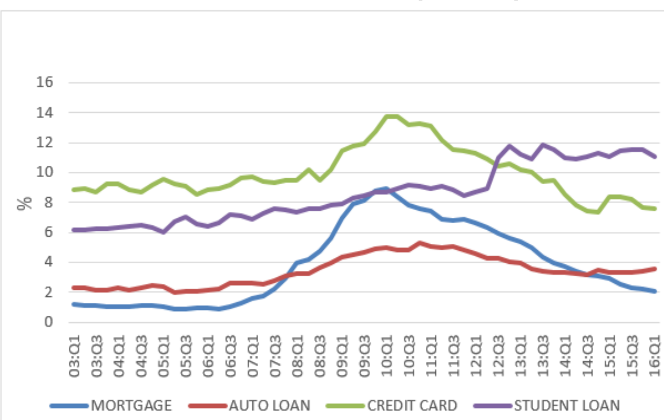
Sources: Federal Reserve Bank of New York, Equifax

The low interest-rate environment over the past few years has attracted new borrowers who would not have previously been able to afford a larger monthly payment under a higher interest rate. However, while consumer debt continues to grow, the pace appears to be decelerating. Consumer-credit data published by the Federal Reserve for April shows that the pace of consumers adding to their outstanding debt has slowed, with the level of consumer credit increasing by a 4.5% seasonally adjusted annual rate, down from the previous month's reading of 9.6%.

Student Loan Delinquencies Remain Elevated

As mentioned, the one outlier among consumer debt was the student-loan sector, which despite marginal improvement in the first quarter of 2016 and outside of a dip in the second half of 2011, has seen an increase in the percentage of delinquencies more than 90 days overdue since the crisis. While the rate for student loans more than 90 days past due declined to 11.0% in the first quarter, from 11.5% in the fourth quarter 2015, it has been rising since the end of 2011 when delinquencies were 8.5%.

Percent of Balance More Than 90 Days Delinquent



Sources: Federal Reserve Bank of New York, Equifax

In addition, student-loan delinquency rates are understated, as delinquencies have become more difficult to accurately assess in the face of deferment, forbearance, and income-driven repayment programs. Student-loan delinquency rates recorded by the Federal Reserve Bank of New York do not consider loan balances that are in deferment or forbearance. By including Direct and Federal Family Education loans in deferment because of unemployment or financial hardship and assuming all those deferments are more than 90 days past due, Morningstar Credit Ratings estimates that the rate of student loans more than 90 days past due could be two percentage points higher, at 13%. If we factor in loans in forbearance categorized as discretionary, the delinquency rate could jump to an estimated 17%.

For-profit colleges saw enrollment numbers quadruple over a decade-long period starting in 2000, according to the National Center for Educational Statistics, as they marketed heavily to a lower income demographic with the promise of higher paying jobs. After acquiring significant amounts of debt, those graduating students, often schooled with a specialized focus, were unable to find employment.

According to a Brookings Papers on Economic Activity study authored by Adam Looney of the U.S. Treasury Department and Constantine Yannelis of Stanford University, 70% of students who started paying back their federal loans in 2011 and subsequently defaulted by 2013 were attributed to "nontraditional" (students at for-profit colleges and two-year institutions) borrowers. Taking a closer look at the five-year default rate for the 2009 cohort provides further evidence of the struggles these nontraditional buyers are experiencing. Students at for-profit schools defaulted in alarming numbers, with 47% defaulting by 2014. Borrowers from two-year institutions ranked second, with 38% defaulting within five years, compared with 27% from nonselective four-year institutions.

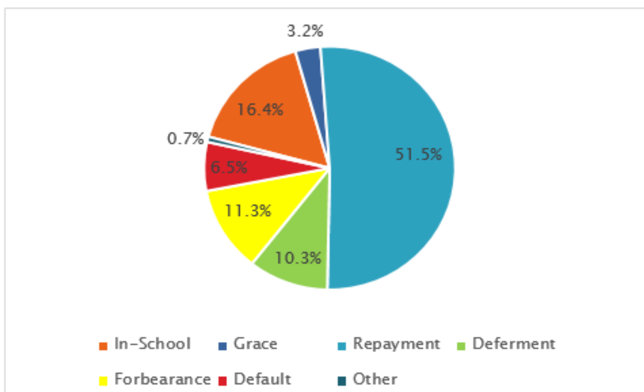
Enrollment has sharply curtailed at for-profit educational institutions amidst greater government scrutiny. Despite the expected decline in loans because of government investigations into for-profit colleges, it will take time before we see whether those existing loans become delinquent or ultimately pay off.

Deferment allows borrowers to postpone payment on a loan during a grace period, and in some cases the loan does not accrue interest. Forbearance is different, in that a financially strapped borrower is granted a temporary reprieve from making monthly payments. However, while principal payments are postponed, the interest continues to accrue and subsequently gets capitalized, or added to the principal. While loans in forbearance may offer a short-term reprieve, borrowers may be digging themselves into a deeper hole over the longer term.

So-called income-driven repayment plans enable qualified borrowers to reduce their monthly payments. Income-based repayment plans are among the most widely known of four IDR plans. According to the Department of Education, IBR offers borrowers the opportunity to reduce their monthly payments, capping them at a percentage of discretionary income (previously 15% but reduced to 10% for federal loans taken out after July 1, 2014). It is conceivable that a borrower may have yet to make a single monthly payment if his or her income meets certain income thresholds and would be considered current on the loan. As a result, deferment and forbearance have the potential to skew the delinquency trends, masking the magnitude of deterioration.

There were approximately 30.3 million borrowers through the federal government's Direct loan program, accounting for $854.8 billion of loans at the end of last year. While 15.3 million borrowers, representing $440.1 billion of Direct loans are in repayment, another 5.8 million borrowers, representing $185.2 billion are in either deferment or forbearance, according to the National Student Loan Data System.

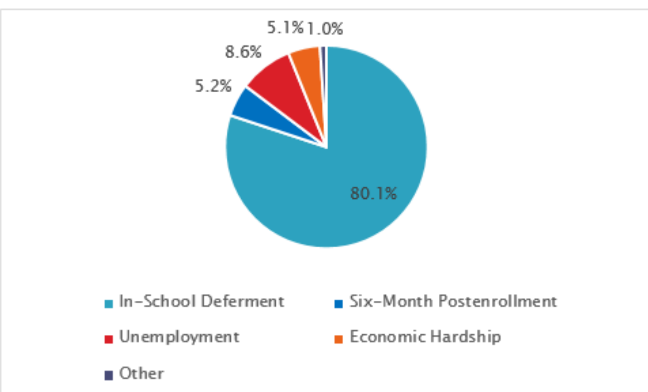
Direct Loan Status by Dollar Amount as of Year-End 2015



Source: National Student Loan Data System

Delving deeper into the $88.3 billion of Direct loans in deferment at year-end 2015 indicates that the majority (80% by amount outstanding) are attributed to in-school deferments, which is not a major concern. However, an accelerating trend of deferments attributed to unemployment or economic hardship should be scrutinized, as it serves as a warning to investors. Nonetheless, deferments from those two categories combined declined to 13.7% at the end of 2015, an improvement over the 18.1% reported one year earlier.

Direct Loans in Deferment by Dollar Amount as of Year-End 2015

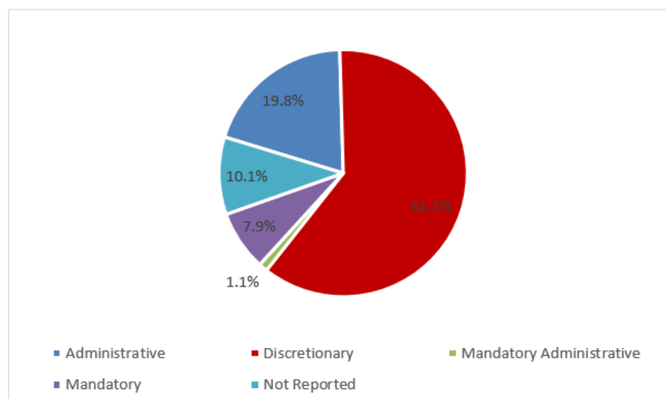


Source: National Student Loan Data System

A closer look at Direct loans in forbearance, which stood at $96.8 billion at year-end 2015, tells a slightly different story. About 61% of loans in forbearance are attributed to the discretionary category. According to the National Student Loan Data System, suspended or reduced payments on loans categorized as discretionary are due to temporary financial hardships related to unemployment or medical reasons. Given the large proportion of loans in forbearance because of financial difficulties, this growing statistic may be a precursor of future defaults.

An additional 19.8% of loans are categorized as administrative, which includes loans with suspended or reduced payments as lenders consider the borrower's eligibility for IDR programs. The other two mandatory categories include loans with suspended payments because of extenuating circumstances such as death, military mobilization, or entrance into medical programs.

Direct Loans in Forbearance by Dollar Amount as of Year-End 2015



Source: National Student Loan Data System

Auto-Loan Delinquencies Accelerating

Auto delinquencies have crept higher, with the rate of loans more than 90 days late reaching 3.5% in first quarter, up from 3.4% in the prior quarter. While oil prices have rebounded, the oil slump that began in 2014 has taken its toll on oil-dependent regions such as North Dakota and Wyoming. Indeed, North Dakota auto loans more than 60 days delinquent skyrocketed by 67.3% to 0.75% year-over-year, and

Wyoming auto delinquencies jumped by 42.9% to 1.14%, according to TransUnion. This compares with the 1.12% auto delinquency rate reported across the U.S. in the first quarter of 2016.

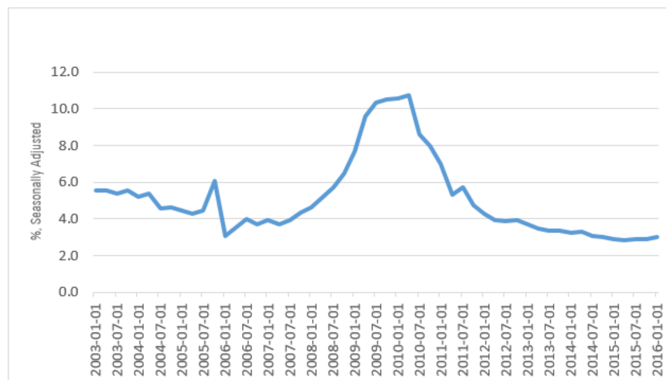
In particular, subprime auto-loan delinquencies experienced the sharpest gains. Subprime auto-loan volume increased as originators have become more competitive in offering loans to less creditworthy borrowers. Experian reported a 10.9% year-over-year increase in the balance of subprime auto loans and leases held by consumers in the first quarter of 2016. Given the rise in subprime origination volume, it is not surprising to see a corresponding increase in auto delinquencies. The added exposure to subprime loans makes the auto sector vulnerable to an economic downturn.

Credit Card and Mortgage Delinquencies at Lows

Since the crisis, credit-card and mortgage delinquencies have improved, with the balance more than 90 days delinquent declining, according to the Federal Reserve Bank of New York. After peaking at 8.9% in the first quarter 2010, mortgage delinquencies have come down considerably from their highs, resting at 2.1% at the end of the first quarter. Credit-card delinquencies have also dropped, with the current level of 7.6% nearly half the 13.7% recorded in the first quarter of 2010. Low interest rates made it easier for consumers to either refinance or stay current on their debt obligations.

However, the credit-card sector has shown weakness, with charge-offs on loans of the top 100 banks increasing to 3.04% in the first quarter of this year from 2.92% the previous quarter, according to the Federal Reserve. In addition, Synchrony Financial, the largest provider of private-label credit cards, saw its stock price nosedive 13.1% on June 14 after releasing projections for higher net charge-offs of 20 to 30 basis points on its credit-card portfolio over the next year, or 4.5%-6.5%. For the first quarter of 2016, net charge-offs reported by Synchrony were 4.7%, up from 4.53% in the year-earlier quarter.

Charge-Off Rate on Credit-Card Loans, Top 100 Banks



Source: Federal Reserve

Despite this weakness, Morningstar Credit Ratings is not concerned, as credit-card delinquencies and net charge-off rates remain near all-time lows. Moreover, Dan Werner, Morningstar, Inc.'s senior equity analyst who covers U.S.

banks, recently published a research note[1] indicating that the worries over Synchrony's higher projected losses are overblown given the small increase in net charge-offs forecasted. Werner maintains his $40 fair-value estimate with a narrow moat rating.

Eye on the Road: Student and Auto Loans Bear Watching

Consumers are adding to their household debt levels, with student-loan debt leading the way behind mortgages. Postcrisis, students enrolled in for-profit colleges in record numbers, with dreams of a future career. For many, those dreams never materialized, and they were left saddled with heavy student-debt obligations that they were unable to meet. This pool of nonpaying indebted students contributed to the student loan delinquency rate rising steadily since the end of 2012. While the pace of student-loan delinquencies has slowed, Morningstar Credit Ratings views the sector as vulnerable to declines in employment as the delinquency rate remains near record levels despite a generally healthy job market.

Auto loans should also be watched, as an increase in origination volume has targeted less creditworthy borrowers. Nonetheless, Morningstar Credit Ratings expects auto delinquencies to hover near a 3.5% to 4% range. Meanwhile, as long as unemployment does not trend higher, we do not expect to see spikes in delinquency levels across credit cards and mortgages.

DISCLAIMER

[1] Werner, D. 2016. "Synchrony Spreads Its Wings as It Flies Solo." Morningstar.com. June 20, 2016. As noted previously, Morningstar Credit Ratings is an NRSRO; parent Morningstar, Inc. is not an NRSRO and does not issue NRSRO credit ratings,