

Record Consumer Debt Service Poses Risk to Commercial Banks

Household debt service in the United States rose to an all-time high in the first quarter of 2006, as measured against household disposable income, and is headed higher (see Exhibit 1).¹ This circumstance may portend developing quality issues for commercial banks' consumer loan portfolios, primarily of credit cards and home mortgages.

With required mortgage and other consumer debt payments absorbing a record 13.9% of disposable income, and with the personal saving rate negative,² consumers increasingly are pushed to compromise between meeting their financial obligations and maintaining current consumption. This situation is strained further by the recent sharp increase in gasoline prices.

To the extent that households pull back on meeting required debt service, loan delinquency rates rise. To the extent consumption is reduced, economic activity slows. Some mixture of effects appears to be unfolding. For example, national retail sales as of August 2006, adjusted for inflation, have contracted in three of the past four months.³

From the perspective of U.S. commercial banks, there appears to be a leading relationship between the household debt-service ratio and consumer loan delinquency rates shown in Exhibit 2, particularly as to credit cards and mortgages. Delinquency rates are determined as loans past due by 30 days or more as a percentage of end-of-period loans.⁴ Major turning points in the debt-service ratio tend to coincide with or lead turning points in the consumer loan delinquency rate by as long as a year.

The debt-service ratio has risen steadily and sharply — more than 80 basis points — since its near-term bottom in the fourth quarter of 2004. Credit card delinquency

rates bottomed in the fourth quarter of 2005 and have risen by 63 basis points in the

Exhibit 1

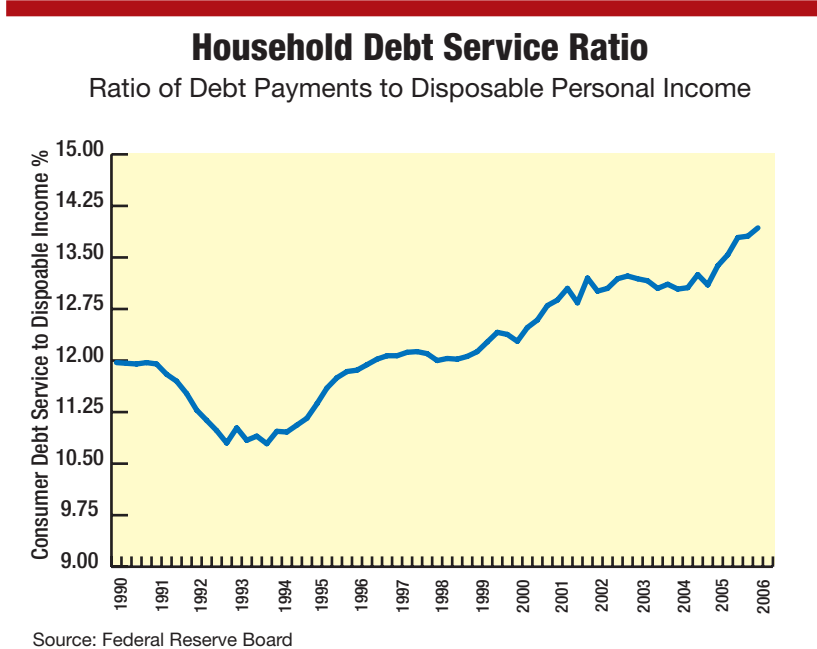
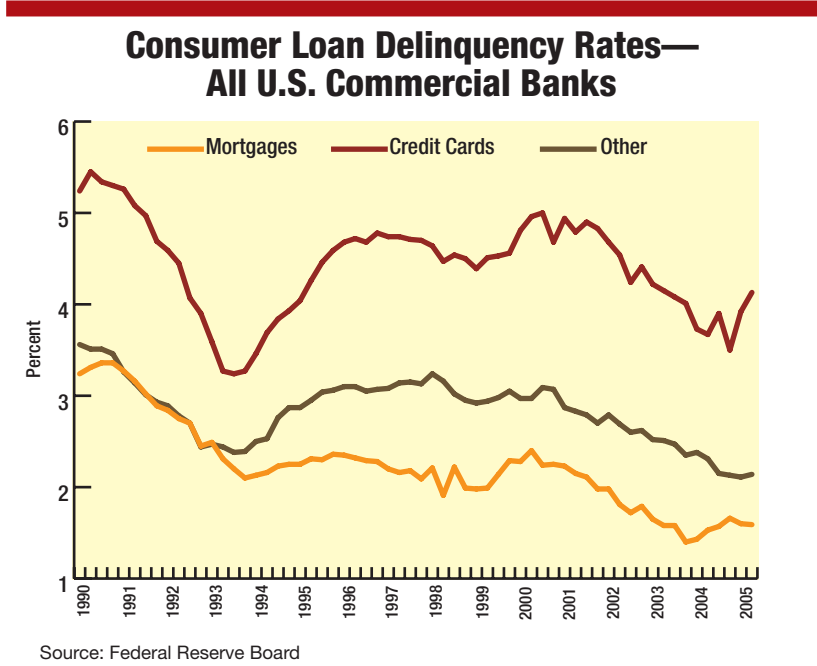


Exhibit 2



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ensuing two quarters.

A more ominous circumstance, however, has started to unfold related to consumer mortgage portfolios. Rate adjustments to adjustable-rate mortgages (ARMs) promise not only to increase mortgage delinquency rates but also to push the debt-service ratio still further into uncharted waters.

Consumer mortgage delinquency rates bottomed in the fourth quarter of 2004 — the same time as the debt service ratio — and subsequently increased in the range of 20 to 30 basis points. While those delinquency rates eased minimally in the first and second quarters of 2006, the current reading still is at the highest level since the first quarter of 2004 and has just started to reflect the impact of upward rate adjustments on ARMs.

With the prime rate having risen by 425 basis points during the past two years, to 8.25%, ARM adjustments increasingly are kicking in and will continue to intensify over time, pushing the debt-service ratio higher and reducing the portion of disposable income available to consumers for consumption of goods and other services.

Consumer-related loans account for roughly 60% of U.S. commercial bank loan assets and roughly a third of total commercial bank financial assets, per the Federal Reserve's Flow of Funds Analysis. With delinquency rates likely to be under upside pressure across all classes of consumer loans in the months ahead, A.M. Best's financial analyses of commercial banks will pay particular attention to the developing quality of consumer loan portfolios.

¹ Federal Reserve Board, Household Debt Service and Financial Obligation Ratios, seasonally adjusted data updated as of July 10, 2006.

² Bureau of Economic Analysis.

³ Federal Reserve Bank of St. Louis, FRED database.

⁴ Federal Reserve Board, Charge-off and Delinquency Rates on Loans and Leases at Commercial Banks, seasonally adjusted data (all banks) updated as of Aug. 22, 2006.

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