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Eric Gillin

Consumer Debt Looks Set to Keep Soaring

By Eric Gillin
Staff Reporter
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Now more than ever, we are a debtor nation. And we're likely to borrow more in 2003.

Over the last 12 months, consumers racked up a record amount of personal debt, and with it record numbers of personal bankruptcies and foreclosures. And experts on personal debt and the economy say consumers will continue to spend.

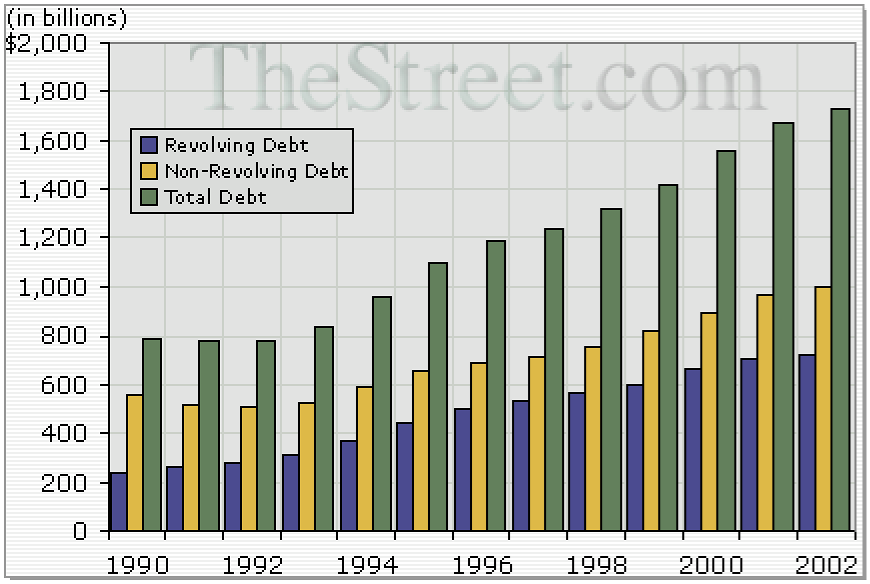
"The consumer has been the hedonist of last resort," said Alan Levenson, chief economist for T. Rowe Price. "We expect that will continue to be the case."

That's bully for the 2003 economic outlook, since the consumer has propped up the U.S. economy as corporate America took a two-year breather from its information-technology spending binge. However, it raises long-term concerns for an economy whose foundation is mounting potentially unsustainable individual debt levels.

According to the **Federal Reserve**, Americans rang up a record $1.7 trillion in personal debt through October, with $724 million of that in unsecured forms, such as credit-card debt. But as the chart (below) shows, rising debt is nothing new -- personal debt has only decreased once, in 1991, during the 50 years the Fed has been tracking it.

"I don't see us slowing at all," said Don White, a financial planning expert with the Million Dollar Roundtable, an association of financial sales professionals. "Do you have any idea how much money a trillion dollars is? $1.7 trillion is three times Russia's gross domestic product -- almost four times. Our total debt is three-and-a-half times [the market capitalization] of the largest companies in the world. That is frightening."

A Nation of Debtors?
Since 1991, the total amount of personal debt has more than doubled in the last decade



* -- As of October 2002.
Source: Federal Reserve

Even more frightening is the prospect of paying that debt off. If Americans were to stop credit-card spending completely, it would take decades to wipe out the $700 million in credit-card debt currently owed. Assuming an annual percentage rate of 20% and a minimum payment of 2%, it would take 601 monthly payments -- or 50 years -- for America to pay off that much debt, racking up more than $3 trillion in interest in the process.

Mired in this debt quicksand, consumers are getting themselves into trouble. More than 1.5 million bankruptcy filings were recorded over the last 12 months. Through the second quarter of 2002, data from the Mortgage Brokers Association of America showed that foreclosures accounted for four out of every 1,000 homes, a level unseen in the 30 years the MBAA has been tracking the data. And seriously delinquent loans, those well past due and on their way to foreclosure, now account for 5% of all loans -- levels unseen since the last recession.

"Three million people have gone through bankruptcy in the last 24 months," said Harvey Warren, president of the National Consumer Council, a nonprofit consumer advocacy group. "The data literally ensure that 2002 will set records, shattering last year's total. Next year will be more of the same."

The Good News

But while debt levels continue to rise, there's little in place fiscally to make consumers stop spending, and that will be a boon for the economy in 2003. The powerful combination of **Federal Reserve** cuts to short-term interest rates, widespread availability of credit and low prices on everything from new cars to clothing will keep consumers driving economic growth.

Unemployment recently rose to 6%, a small number from historical perspectives. And wages are rising steadily. Mortgage rates hover near four-decade lows, and that will drive home sales and refinancing. If corporate spending increases while consumers toe the line, the economic outlook for 2003 is brighter than it's been since the go-go 1990s.

With Republicans in control of Washington, consumers will get a small boost from the Bush administration's proposed tax cuts, which will certainly aid those with the deepest pockets. Experts also expect Congress to finally pass the long-awaited bankruptcy overhaul bill, which many banks believe will put the stigma back on individual bankruptcy and encourage fiscal responsibility.

So while debt is rising, efforts are being made to usher in some constraints. Under the overhaul bill, would-be bankruptcy seekers must undergo a means test to weed out the uber-rich, who have been known to use Chapter 7 bankruptcy protection to avoid paying their exorbitant debts. Also, anyone who seeks bankruptcy protection, regardless of income, must undergo financial counseling.

"I'd say 2003 could be the year for bankruptcy reform, with a Republican Congress and a Republican president" said Mike Croxson, president of Amerix, which provides technology to the debt-management industry. "Ultimately, it might not stop all the filings, but it's a good effort."

While 2003 may set another debt record, credit counselors say that consumers are quietly growing concerned about their finances. In a survey from the Million Dollar Roundtable, 56% of Americans say they will make a New Year's resolution to get out of debt. "There are loads of people who want to deal with this. I'm getting dozens of calls every single day," said White. "But most people aren't scared enough yet."

The Bad News

Economic watchers can breathe a near-term sigh of relief, but the lack of urgency consumers feel in getting their finances under control raises some serious concerns about the long-term health of the economy. In particular, experts worry about a domino effect of insolvency, as aggressive banks with loose lending standards will be forced to write down bad loans.

"When you take a financial company and push for growth, well, you can go insolvent overnight," said Jeff Auxier, who manages the Auixer Growth Fund and invests in the space. "It's hard to say if we'll see more of that in 2003, but it all depends on the institutions. Balance sheets are better than they were in the early '90s, but I'd be wary of the ones who are pushing for lots of growth."

Trouble has already turned up for subprime lenders. This year, Federal regulators forced **Capital One** (COF:NYSE - news - commentary) to increase the cash reserves backing its loans by $247 million. Later, the company revealed that 40% of its loan portfolio was in the subprime market, twice what was expected by Wall Street. As a result, its stock dropped 40% in 2002. Bad loans have also pushed **Conseco** into bankruptcy.

"The biggest bubble could be growing in single-family homes," said Auxier. "More than 60% of those mortgages require two incomes. What happens if people get sick? Or housing values drop?"

The spate of cash-out refinancing, in which homeowners receive cash for their home equity, is especially dangerous because consumers own less of their homes and are that much closer to foreclosure if something goes wrong. But nothing has gone wrong yet, which is one reason why banks are more than willing to allow homeowners to get a loan without a down payment.

Even though banks wrote off $3.9 billion in credit-card debt in the third quarter, lending is still a very profitable business, with the Federal Deposit Insurance Corp. also reporting that bank profits were up 34.8%. The reason? Banks can buy their money from the Federal Reserve at a low rate of 1.25% and mark it up to consumers at 22%. The huge profit margin ensures safety for the banks because the profits roll in as long as people keep making minimum payments.

"When financial institutions aren't able to withstand the price of people not being able to pay their debts, defaulting on their mortgages and credit card payments -- that's when the boom gets lowered and consumers can't use credit anymore," said Kathleen Gurney, author of *Your Financial Personality: What It Is and How You Can Profit From It*.

Ultimately, this creates a situation where banks and the economy react to the debt crisis because there's little incentive to put on the breaks right now. According to Robert Kiyosaki, the best-selling author of *Rich Dad, Poor Dad*, 2003 will be yet another year on a road to potential ruin.

"Take this problem out 10 more years," Kiyosaki said. "Millions of baby boomers won't be able to retire because they're carrying all this debt. At that point, there isn't enough in the 401(k) and medical insurers will cancel their insurance when they turn 65. It's a perfect storm. There's not enough money for retirement, too much debt, no medical insurance and they're out of time, financially."
