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## Economics Group

Special Commentary

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# Credit Quality Monitor: June 2012

## Worrisome Signs Amid General Improvement

For the most part, the news regarding credit quality in the first quarter was good. Most loan delinquency and foreclosure rates declined further, loan demand strengthened, credit expanded and consumer confidence improved. However, there were a couple of worrisome signs, as well as a couple sighs of relief. According to the Federal Reserve, the overall loan delinquency rate fell again in the first quarter, but it is still nearly twice as high as the peak reached in the 2001 recession. Every loan category saw a decline in delinquency rates from a year ago, with the largest decline coming from commercial real estate loans. Compared to the prior quarter, every category had a lower delinquency rate except for residential real estate loans, which saw a worrisome increase. This category has by far seen the least improvement since the end of the recession. While low interest rates and rising profits have shored up credit quality for businesses, and sustained job growth and further bank charge-offs have helped to bring down delinquency rates for consumer loans, homeowners just can't seem to make much headway. Widespread negative equity, legal battles and less than desirable results from loan modification programs have prevented the pipeline of distressed properties from clearing out. Due to the large number of homeowners affected and the sheer complexity of the situation, it will take much longer for credit quality to improve in the housing market than any other sector of the credit market.

***The first quarter saw general improvement in credit quality, but also some worrisome signs and some sighs of relief.***

That being said, the share of mortgages either delinquent or in foreclosure fell in the first quarter, according to the Mortgage Bankers Association. In this report, which uses a different methodology than the Federal Reserve report[1], the delinquency rate fell while the foreclosure inventory rate was unchanged. While the decline in the delinquency rate was largely seasonal in nature, the seasonally-adjusted delinquency rate also fell. But it was disturbing to see that, while the subprime foreclosure inventory rate fell, the rate for prime loans, those held by homeowners with good credit, increased. This is not a welcome development and suggests that the labor market, although gradually improving, is still having a noticeable impact on mortgage credit quality, even for those with good credit. The good news is that the foreclosure start rate fell. At this point, we expected it to begin rising again now that the foreclosure filing issues have been resolved. However, it may be that tighter lending standards over the past few years are helping to curb the flow of new foreclosures. These tighter lending standards have been one reason why applications to purchase a home remain subdued, despite the lowest mortgage rates in history.

As the yield curve continued to narrow in the first quarter, we were becoming increasingly concerned that it would lead to a further pullback in lenders' willingness to lend. We were thus relieved to see that lenders actually increased their willingness to lend despite the flatter yield curve. However, as with just about every other economic indicator, we believe that lenders got caught up in the euphoria of the late winter and early spring that was driven largely by unseasonably mild weather. As homebuilding and shopping gathered steam at a time of the year

[1] There are many differences in methodologies. For example, the MBA reports delinquencies based on the number of loans delinquent, whereas the Federal Reserve reports based on loan values; the MBA survey includes different types of mortgage lenders, whereas the Federal Reserve survey only includes commercial banks; the MBA survey does not include second mortgages, whereas the Federal Reserve survey does; the two reports also use different timing in their methodologies to determine when a loan is considered delinquent.

that generally sees much less activity, job growth picked up, as did demand for new loans. As a result, it appeared that the economy was on the mend, thus leading lenders to become more willing to lend. But we feared that once the weather effect faded, much of the economic optimism would as well. The economic reports over the last few weeks have confirmed our fears. Therefore, while willingness to lend improved and demand for both mortgages and business loans strengthened, we would not be surprised to see these numbers soften again in our next report.

***The recent surge in consumer credit is not necessarily something to celebrate.***

Total credit outstanding at all financial institutions rose further in April, but at a much slower rate than seen in previous months. Torrid demand for student loans and strong demand for auto loans have been the primary drivers of consumer credit over the past couple years. In general, expanding credit is a good thing for the economy as it leads to more spending by consumers and businesses. But with student loans comprising the lion's share of consumer credit growth, at a time when delinquency rates on those loans are rising and graduates are having a tough time finding a job to pay off those loans, the recent expansion in consumer credit is not necessarily something to celebrate. It is not a stretch to say that if the economy were in better shape and jobs were more plentiful that college enrollment would likely not be as robust, and student loan debt would not be rising nearly as fast. In addition, rather than spending thousands of dollars on loans that they may not be able to pay back, those people would be spending money on other goods and services, which would help to spur stronger economic growth and even more job creation. As it is, most of that money is going to the government rather than being circulated throughout the economy. Thus, soaring student debt is a burden on both students and the overall economy.

Meanwhile, the rise in auto sales and loans is good news. Autos play a very integral role in the economy due to the complex nature of their production, which requires a very broad supply chain that includes metals, electronics, paints, rubber, plastics, etc. Generally, a rise in gas prices tends to restrain auto sales. But with interest rates low and incentives very favorable, the surge in gas prices during the first quarter appears to have driven folks who have waited a long time to replace their aging vehicles to upgrade to more fuel-efficient models. Strong job growth and warm weather have also helped, but with these factors fading auto sales have moderated recently.

***Bankruptcies rose in the first quarter despite strong job growth and a decline in the foreclosure start rate.***

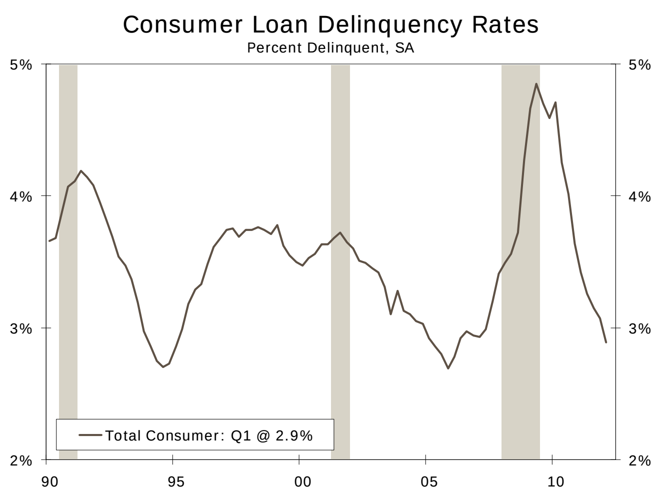
Another worrying sign was the rise in bankruptcies in the first quarter, driven by the first increase in personal bankruptcies since the second quarter of 2010. We thought personal bankruptcies might rise this year if foreclosure filings ramped up again. However, the increase came even though the foreclosure start rate fell and job growth improved. We surmise that some homeowners had already received a foreclosure notice before the issues with foreclosure filing procedures surfaced and were thus in limbo during the negotiations. Therefore, once the issue was settled with the state attorneys general, it could be that those who didn't qualify for loan modifications finally filed for bankruptcy as they realized foreclosure was imminent. The news was not much better for businesses, as the quarterly decline in business bankruptcies was the smallest in two years. We believe that the sharp slowdown in corporate profit growth could have something to do with the leveling out in business bankruptcies. Recent stock market performance suggests that this slowing trend in profit growth is likely to continue, meaning we are not likely to see much more improvement in business bankruptcies in the near term.

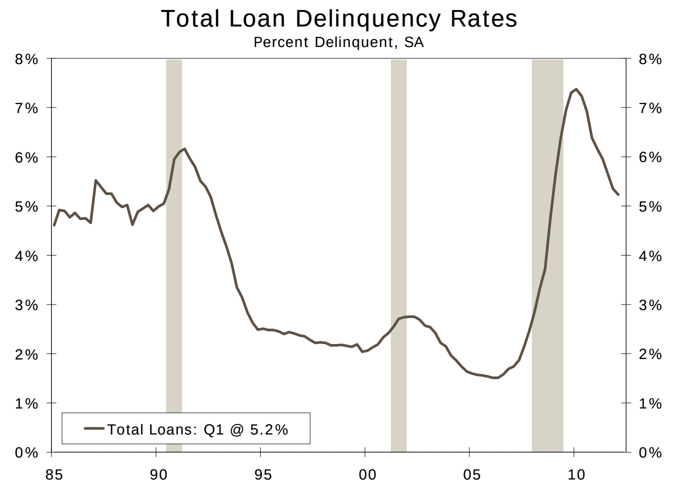
Finally, consumer confidence saw nice gains toward the end of last year and the beginning of this year, again largely due to improved economic conditions driven by mild weather and the perceptions of progress in Europe. But recently, confidence has soured as job growth has cooled and Europe has moved closer to the precipice. Even so, real ex-gas retail sales have held up well. One reason could be moderating inflation as energy prices have receded, which has helped to slow the decline in real earnings. Yet, the May employment report showed weak job growth and hourly earnings growth slowed even further, suggesting ex-gas retail sales growth could taper soon.

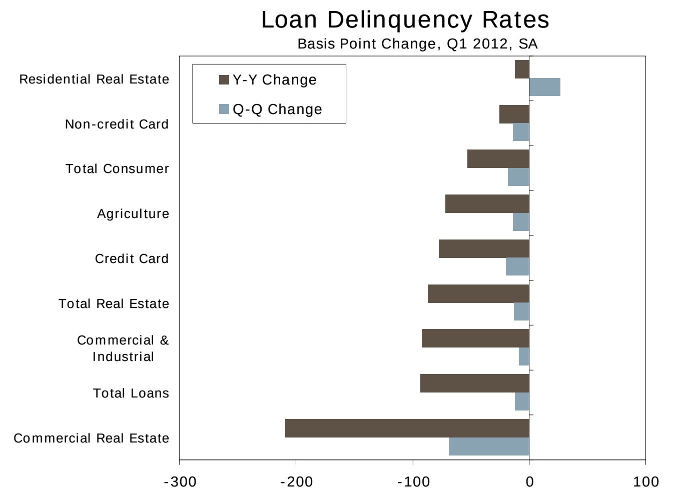
It appears the economy has reached another inflection point. While the past couple years have seen steady improvement in credit quality, the economy has muddled along in fits and starts. But with Europe on the brink of an historical collapse and growth slowing in the United States and around the globe, the improvement in credit quality is at risk of stalling. We are already starting to see some signs of this. In light of this, banks, businesses and consumers would do well to remain extremely cautious in their plans for lending, investing and spending in the near term.

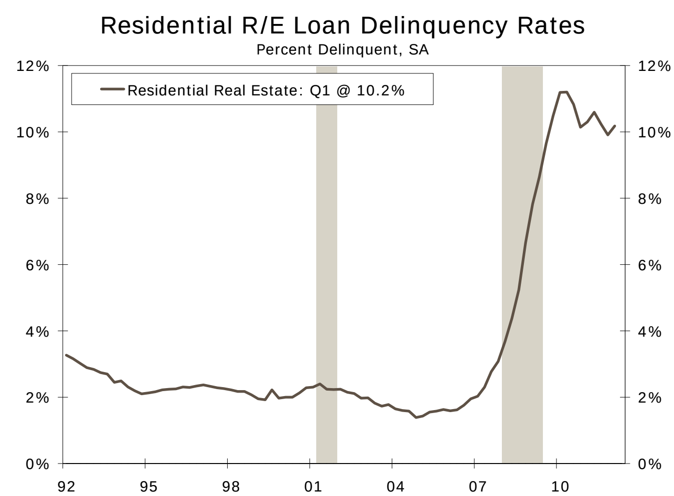
## Loan Delinquency Rates

- Loan delinquency rates continued to improve nearly across the board in the first quarter. The overall delinquency rate fell from 5.35 percent to 5.23 percent, the lowest since the fourth quarter of 2008. However, the 12 basis point decline was the smallest since delinquency rates started declining in the second quarter of 2010.
- On a year-ago basis, every category saw a further decline in delinquency rates, led by commercial real estate, which was down more than 200 basis points from the prior year. An improving economy has helped boost commercial real estate prices, while credit conditions have eased as banks have loosened lending standards and interest rates continue to fall. On the other side of the spectrum, residential real estate saw the smallest decline from a year ago and the only increase from a quarter ago. Homeowners continue to struggle with high unemployment, negative equity, tight lending standards and declining real incomes. As a result, there has been very little improvement in residential delinquency rates since the peak in the second quarter of 2010. This is a concern because residential real estate loans account for the biggest share of bank loans.
- There has been much more improvement in the delinquency rate for consumer loans, which fell to 2.9 percent. The delinquency rate on credit cards reached a new record low of 3.1 percent in the first quarter as consumers continue to deleverage while banks continue to charge off bad debt. The non-credit card loan delinquency rate also fell to 2.7 percent, the lowest in almost four years.



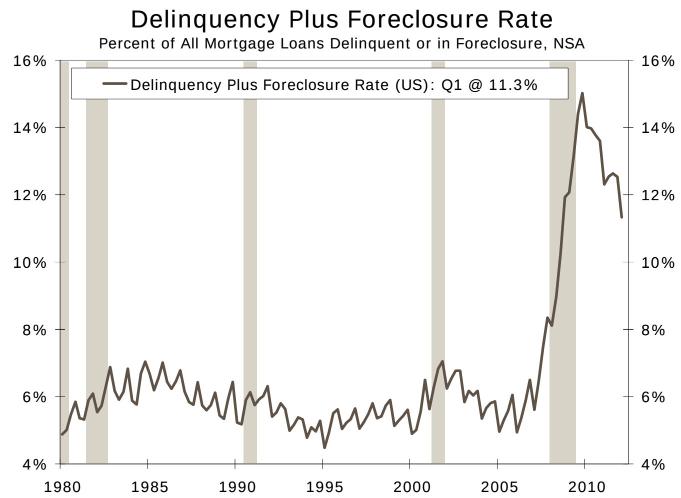



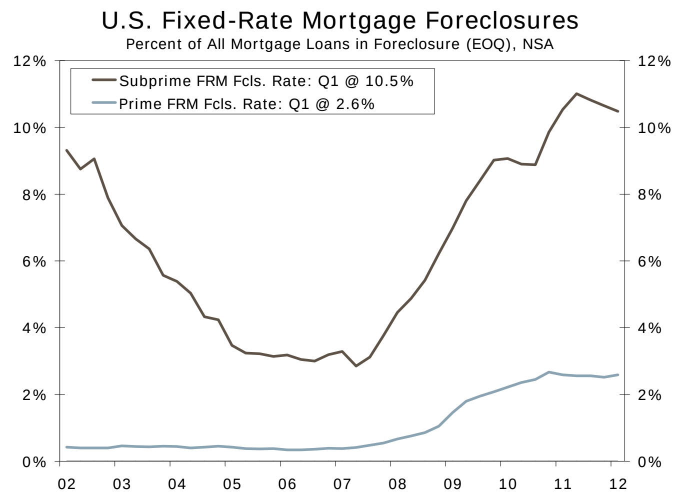



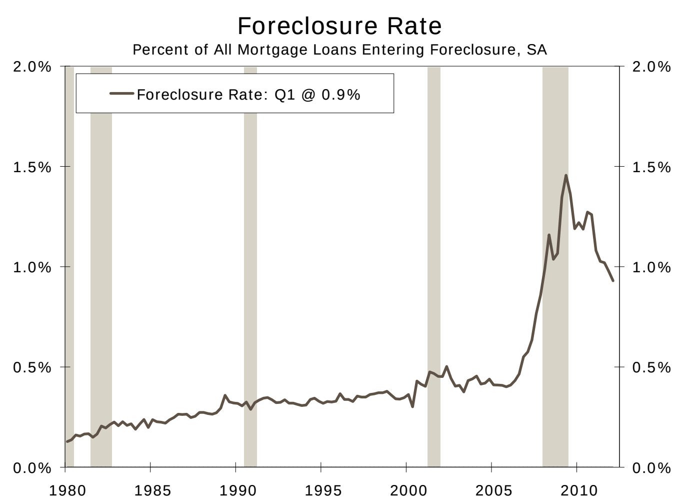

Source: Federal Reserve and Wells Fargo Securities, LLC

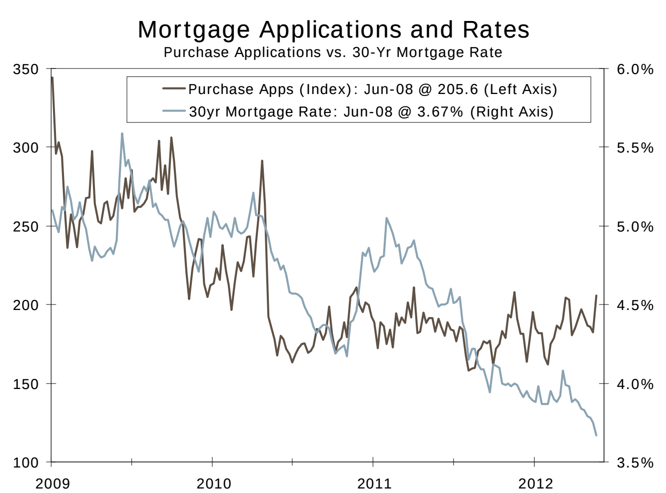
## Mortgages

- The share of all outstanding mortgages that were either delinquent or in foreclosure fell to 11.3 percent in the first quarter, the lowest since the third quarter of 2008. However, the decline was all due to a lower delinquency rate, which fell noticeably from 8.15 percent to 6.94 percent. The decline was largely seasonal as the delinquency rate tends to fall in the first quarter, but the drop was much bigger than usual. In addition, in terms of number of days delinquent, delinquency rates fell throughout the pipeline. Meanwhile, the foreclosure inventory rate was virtually unchanged at 4.39 percent as many homes remain in the foreclosure process due to changing procedures and programs.
- The subprime fixed mortgage foreclosure inventory rate fell to 10.5 percent in the first quarter and was down from a year ago for the first time since the second quarter of 2007. Unfortunately, the prime fixed foreclosure inventory rate rose to 2.6 percent, certainly not good news in light of gradual economic improvement and continuing efforts to help homeowners avoid foreclosure. Since these are loans to people with good credit, it just goes to show how the still-difficult job market continues to weigh on mortgage credit quality.
- The foreclosure start rate fell to 0.9 percent, showing that banks have not yet ramped up foreclosure filings in the wake of the settlement with state attorneys general. However, we expect this will happen as the year progresses. On the front end, purchase applications remain subdued as many still cannot take advantage of record-low mortgage rates.



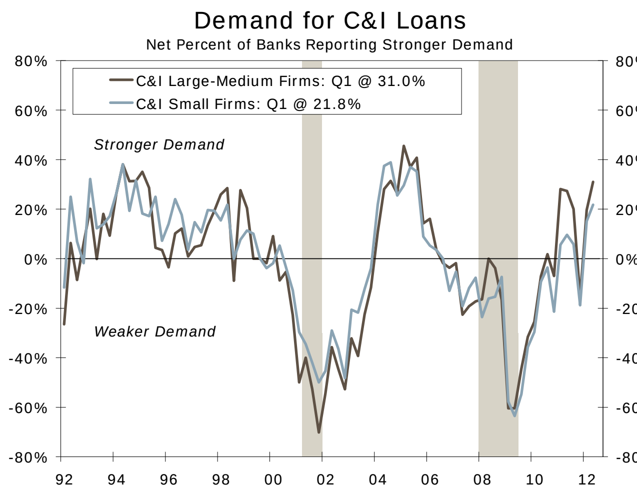



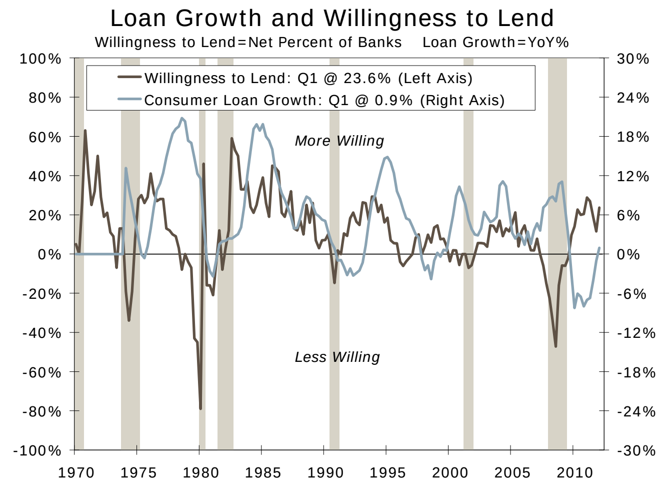



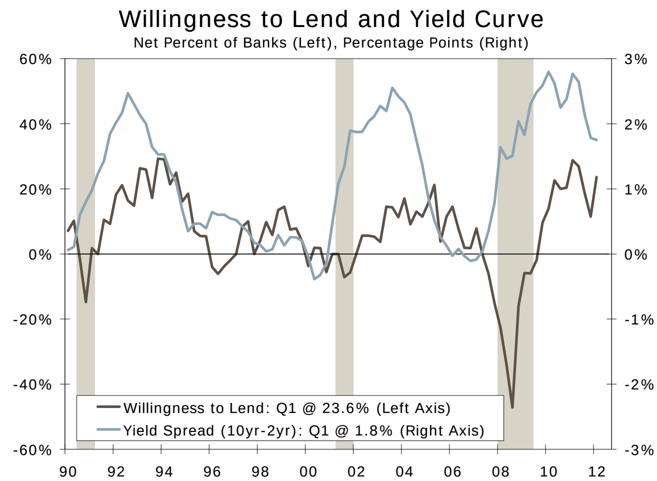

Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

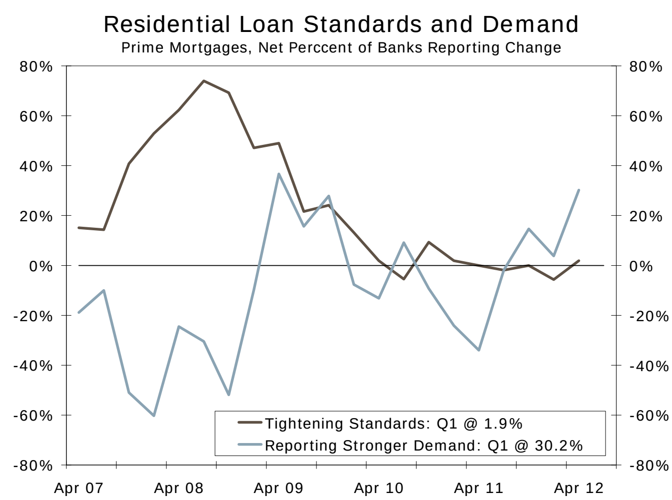
## Lending Trends

- Recently, we have been getting a little concerned about the slowing in banks' willingness to lend to consumers, as this can often be a sign of a looming recession. But we were pleased to see that bankers were more willing to lend in the first quarter, alleviating some of our concern for the time being. Meanwhile, consumer loan growth turned positive on a year-ago basis in the first quarter for the first time since the third quarter of 2009. Consumer loans outstanding were up 0.8 percent from the prior year. However, while non-credit card loans were up 2.0 percent, driven primarily by auto loans, credit card loans were down 1.3 percent. This decline in outstanding credit card balances partly reflects bank charge-offs.
- As the yield curve continued to narrow in the first quarter, we were concerned we would see another pullback in willingness to lend because there is a fairly tight relationship between these two indicators. That is why the improvement in willingness to lend was such a relief. Still, some of the exuberance of lenders may have been driven by the optimism the warm winter weather fueled late in the fourth quarter and early in the first quarter. With job growth slowing, the weather boost fading and the yield curve narrowing further, we would not be surprised to see willingness to lend fall back again in the next report.
- Banks reported stronger demand for mortgage loans in the first quarter as some buyers sought to take advantage of record-low mortgage rates. Demand was also very strong for C&I loans.



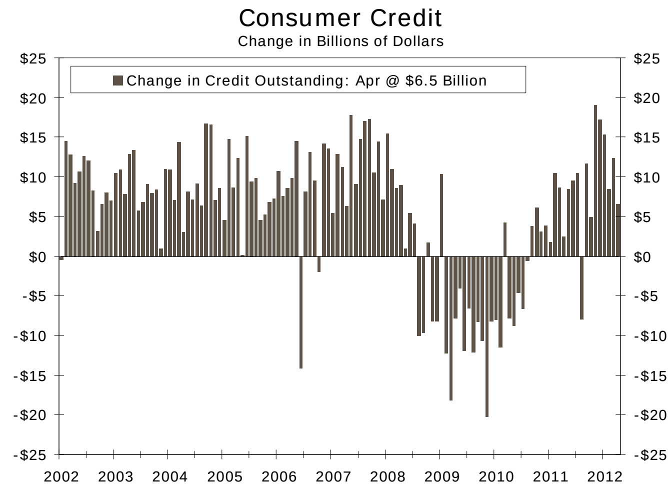



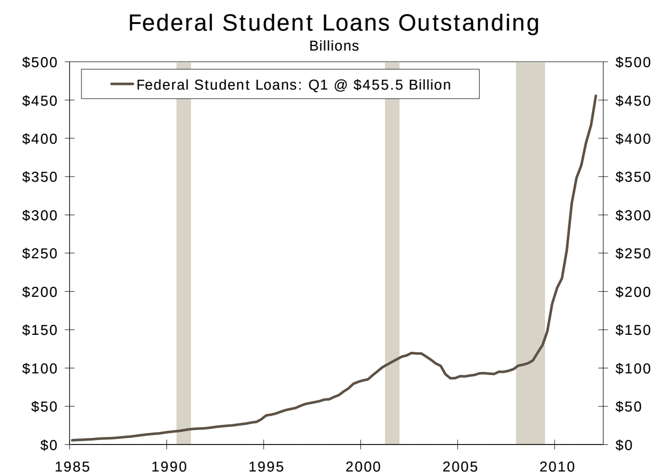



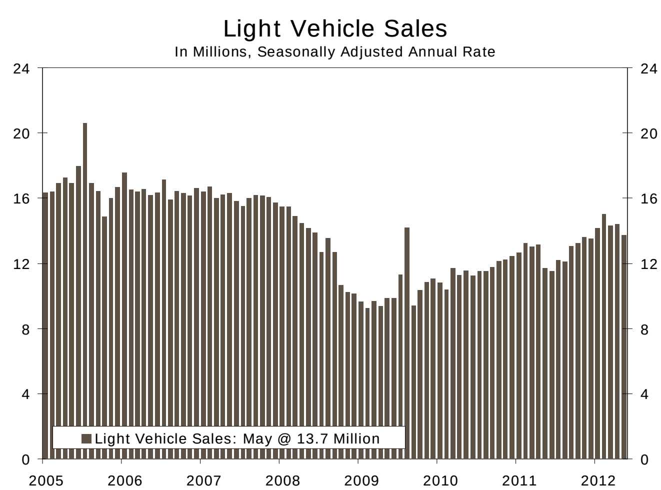

Source: Federal Reserve and Wells Fargo Securities, LLC

## Consumer Credit

- In April, consumer credit outstanding rose $6.5 billion. Revolving credit fell $3.4 billion, the biggest decline in a year, while nonrevolving credit, which includes auto and student loans, rose $10.0 billion.
- The story continues to be the rise in student loan debt. Over the past year, consumer credit outstanding has risen by $116 billion, with $107 billion, or 92 percent, coming from student loans. Federally held student loans outstanding jumped again in the first quarter to $455 billion. According to the New York Federal Reserve, total student loan balances, which include private student loans, rose to $904 billion in the first quarter, far above the $679 billion outstanding on credit cards. What's worse, the delinquency rate on student loans increased to 8.69 percent, compared to 6.13 percent nine years ago. With student debt mounting, delinquency rates rising and graduates entering a tough job market, it appears that student loan defaults could be the next in a long line of crises the nation has to deal with.
- According to the New York Fed, the only other category to see an increase over the past year is auto loans, which rose 4.4 percent. This is in line with auto sales, which have risen fairly steadily since the end of the recession. Low interest rates and favorable incentives, along with pent-up demand and a gradually improving labor market, have supported sales. In addition, the run-up in gas prices in the first quarter actually helped auto sales as consumers looked to replace older vehicles with more fuel-efficient models.



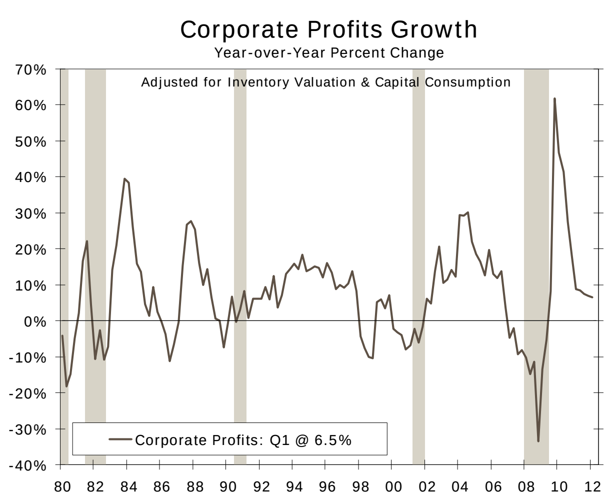



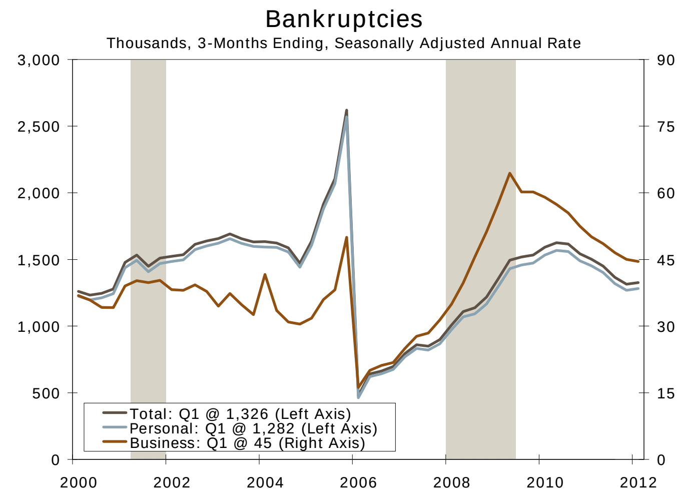


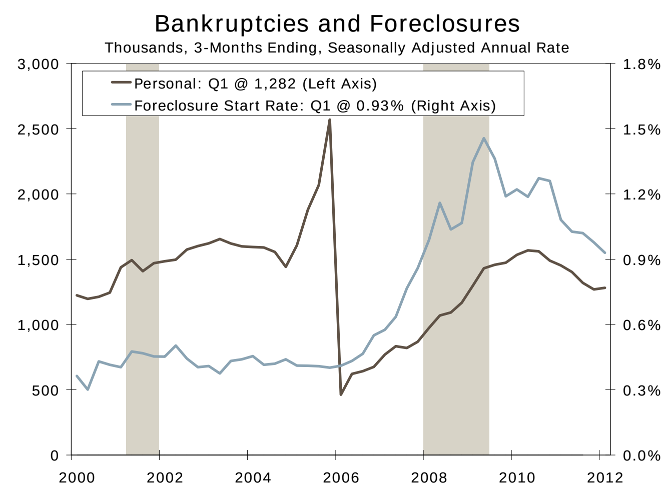
Source: Bloomberg, Federal Reserve, U.S. Department of Labor and Wells Fargo Securities, LLC

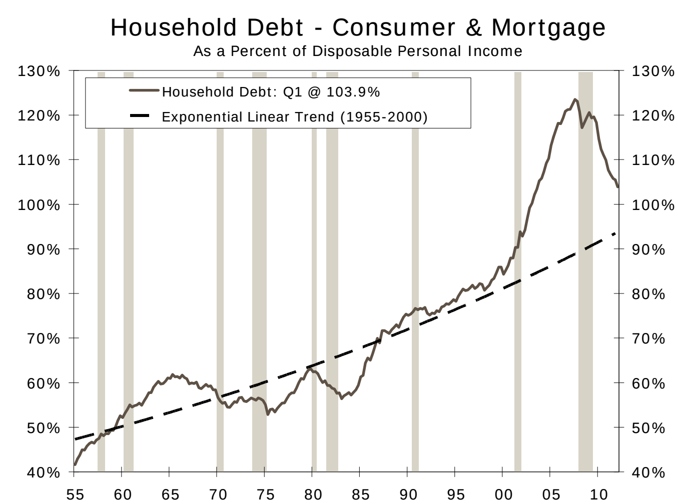
## Bankruptcies

- There was some rather disconcerting news on the bankruptcy front in the first quarter. Overall bankruptcies rose, led by the first increase in personal bankruptcies since the second quarter of 2010. We have been postulating for some time that one factor helping to bring down bankruptcies over the past couple years has been the slowdown in foreclosure filings. Part of that slowdown was due to an improving job market, which helped households to shore up their balance sheets. But over the past year, banks have pulled back on filing foreclosures amid inquiries into filing processes and procedures.
- We had a hunch that once foreclosure filings resumed after the settlement with state attorneys general that we may also see a rebound in personal bankruptcies. However, personal bankruptcies rose in the first quarter even though the foreclosure start rate fell and the job market gained strength. One possible explanation is that many homeowners had already received notices of foreclosure and were in limbo until the settlement. Thus, as banks resumed the process, it did not lead to an increase in the foreclosure start rate, but it likely led to some homeowners filing for bankruptcy to save their home as foreclosure came closer to reality.
- That being said, the news was not much better for businesses, as the quarterly decline in bankruptcies was the smallest in two years. Although corporate profits continue to rise, they are rising at a slower and slower rate. Thus, it appears that the slowdown in corporate profit growth may be contributing to the stalling in the decline in business bankruptcies.



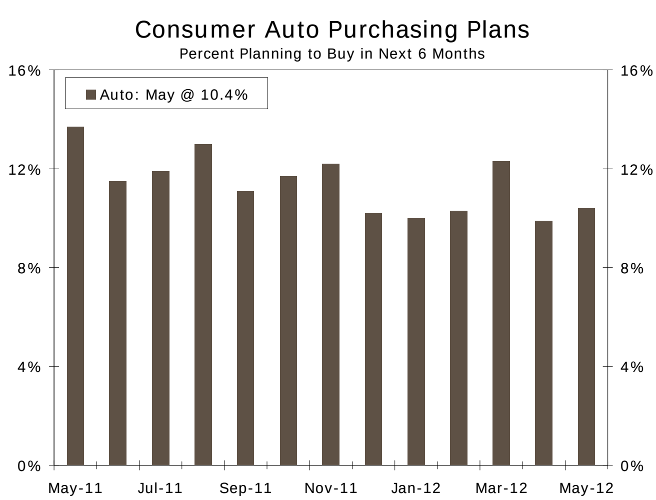



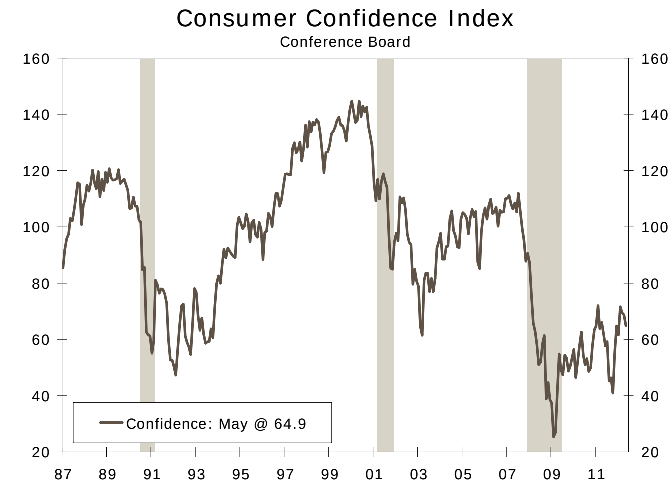



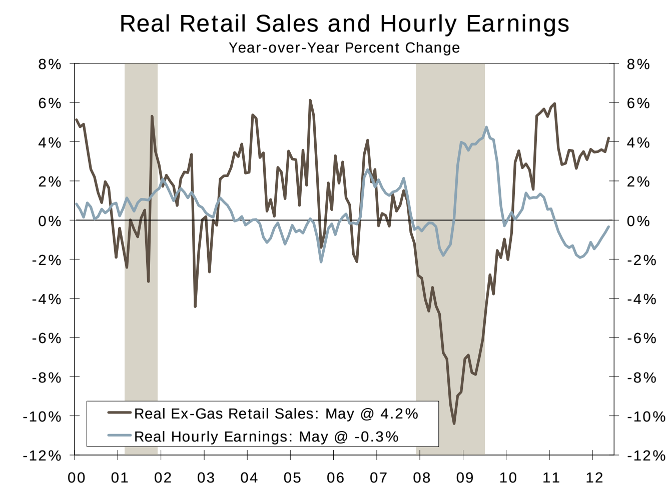

Source: Adm. Office of U.S. District Courts, BEA, Federal Reserve, MBA and Wells Fargo Securities, LLC

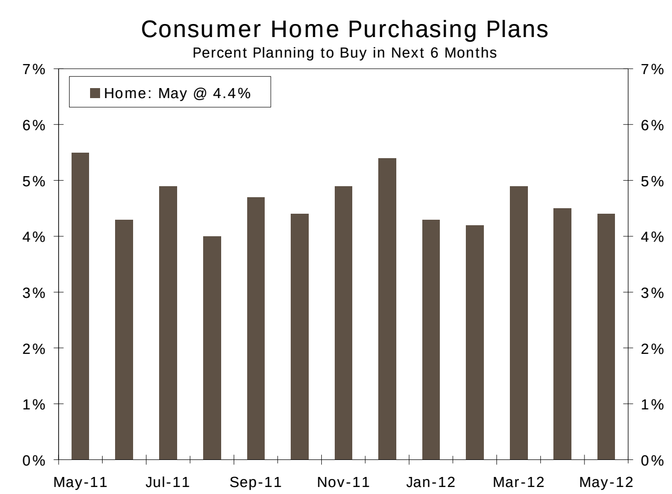
## Consumer Purchasing Plans

- An improving labor market helped to revive consumer confidence toward the end of last year and the beginning of this year. This, along with mild weather, helped to support consumer spending over the last several months. More recently, however, slowing job growth and the intensifying European debt crisis have weighed on consumer confidence, which fell for the third straight month in May to 64.9, well below expectations. Both the present situation and expectations indices declined to the lowest levels since January.
- Even so, real ex-gas retail sales have held their ground. Income expectations have been trending up since October, giving consumers more confidence to open their wallets. In addition, while still falling, the decline in real hourly earnings has slowed. Although this is due to cooling inflation rather than stronger earnings growth, it nonetheless has helped to curb the erosion of consumers' purchasing power.
- Although plans to purchase a home have been little changed over the past several months, home sales have been trending higher since last summer. Strong investor demand, falling prices and record-low mortgage rates have all factored into the rise. The mild weather has also provided a boost recently. With affordability at a record high and rents rising, the outlook for home sales is the best in years.
- Favorable financing terms and pent-up demand have supported strong auto sales over the last several months, despite little change in purchasing plans. Low interest rates should keep auto sales respectable, but slowing job growth is a headwind.




Source: The Conference Board, U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

## Wells Fargo Securities, LLC Economics Group



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