Extra Credit: The Rise of Short-term Liabilities

By Kristie M. Engemann and Michael T. Owyang

The average American is carrying more debt than ever. According to the 2004 Survey of Consumer Finances (SCF), the percentage of families holding debt rose from 72.3 percent in 1989 to 76.4 percent in 2004. Among families holding debt, the median value of the debt more than doubled during that time from $22,000 to $55,300 (in 2004 dollars). These numbers reflect both a rise in collateralized debt (e.g., mortgages) and uncollateralized debt (e.g., credit cards). During the same period, median family income increased by only 12.8 percent to $43,100.

This shift toward more debt appears to have long-term ramifications for the U.S. economy, as evidenced by the growing number of personal bankruptcies over recent decades. Perhaps playing a role in this rise is the increase in debt accumulated via credit cards and payday loans.

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Paper or Plastic?

In 1989, a total of 55.8 percent of American families owned at least one credit card; in 2004, a total of 74.9 percent owned at least one card. Over time, the characteristics of credit card holders have changed to include people who are riskier for the lenders.[1] For example, a higher percentage of single people and renters now have a credit card. Also, workers with less job seniority, lower incomes and unskilled jobs are now more likely to hold a credit card. Attitudes toward borrowing have changed as well; for example, people increasingly borrow to finance things like vacations and living expenses.

While credit card usage has increased across the income spectrum, the largest increases occurred among lower-income groups. (See the accompanying table.) Among those in the lowest 20 percent of the income distribution, the fraction with credit card debt nearly doubled between 1989 and 2004, and their median credit card debt increased to $1,000 from $400. For those in the next lowest 20 percent, the fraction with credit card debt increased by 51 percent, and their median debt doubled to $1,800.[2]

Data from the Federal Deposit Insurance Corp. (FDIC) provide some perspective as to the magnitude of the credit card industry.[3] Between 1992 and 2006, the total dollar amount of credit card loans nearly tripled while the dollar amount of loans that are 90 days delinquent more than tripled. At the end of 2006, FDIC-insured institutions had $385 billion in credit card loans to individuals, and $6.5 billion were past due 90 days or more (1.7 percent of the total).

What's in the Balance?

In addition to carrying a balance, borrowers do not appear to rush to pay off their credit cards. Several economists have found that some consumers carry credit card balances even though they have sufficient funds in the bank to pay off their high-interest debt. Using data from the 2001 SCF and the 2000-2002 Consumer Expenditure Survey, economist Irina Telyukova categorized households into three groups: borrowers, savers, and borrowers-and-savers. She found that about 28 percent of those surveyed had at least $500 both in credit card debt and liquid assets. This group—the borrowers-and-savers—held an average credit card debt of $5,766 and an average of $7,237 in liquid assets. Furthermore, the average interest rate on the debt was 13.7 percent and only about 1 percent on their liquid assets.

To explain why some continued to hold both high-interest debt and liquid assets, Telyukova hypothesized that households keep liquid assets for payments where cash is required.[4] While many of these expenses are predictable, others may arise in an emergency. To protect themselves in the event such a case arises, households may forgo paying off credit card debt in order to keep cash available.[5]

I Want It All, and I Want It Now

Another increasingly common form of short-term debt is the payday loan. From 2000 to 2003, the industry quadrupled in size to $40 billion.[6] Payday loans are designed to lend small amounts of money for short amounts of time, usually two weeks. Typical interest rates for two weeks can range from 15 to 18 percent, which translates into about a 400 percent annual interest rate. Payments are due on the borrower's payday but may be renewed with additional fees.

Similar to credit cards, payday loans have become popular among lower-income households. A Center for Responsible Lending (CRL) report argues that 90 percent of lenders' revenue comes from borrowers who have five or more loans per year, not one-time borrowers.[7] To demonstrate, an average borrower renews a loan eight times and

Credit Card Debt by Income Distribution

	Percentage with credit card debt			Median credit card debt (2004 dollars)		
	1989	2004	Difference	1989	2004	Difference
All families	39.7	46.2	6.5	$1,300	$2,200	$900
Percentiles of income < 20 percent	15.0	29.1	14.1	$400	$1,000	$600
20 – 39.9 percent	28.2	42.5	14.3	$900	$1,800	$900
40 – 59.9 percent	48.8	55.0	6.2	$1,200	$2,200	$1,000
60 – 79.9 percent	57.4	56.2	–1.2	$1,500	$3,000	$1,500
80 – 100 percent	49.0	48.1	–0.9	$2,600	$3,400	$800

SOURCE: 2004 Survey of Consumer Finances. See www.federalreserve.gov/pubs/oss/oss2/2004/scf2004home.html.

ends up paying back $793 for a $325 loan. According to the CRL estimates, Americans paid $4.2 billion in payday loan fees in 2005.

Economists Paige Skiba and Jeremy Tobacman found that applicants for payday loans from a particular lender in Texas had an average monthly income of $1,699 and $235 in their checking account.[8] Additionally, 77 percent of the applicants were black or Hispanic and 62 percent were women. Based on the study's results, it seems that access to loans can lead to recidivism. Within one year, a consumer whose first-time application for a payday loan was approved would apply for another loan an average of 8.4 more times; in comparison, a consumer whose first-time application was rejected would apply 1.8 more times on average. The total loans for the former were for $2,200 with roughly $400 in accompanying fees/interest payments.

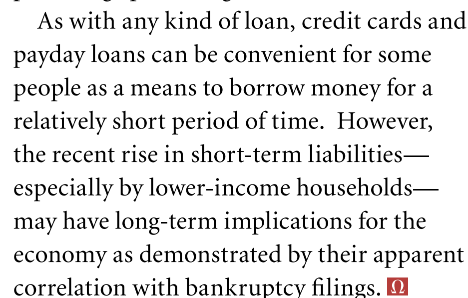
You Get What You (Don't) Pay For

Americans appear willing to trade substantial interest payments for access to short-term credit markets. But, does this new behavior have detrimental long-term effects? Based on data from the American Bankruptcy Institute, for every 1 million adults in the U.S. population, about 1,800 filed for bankruptcy in 1980, a number that increased to about 7,300 in 2004.[9]

According to a study by economist Michelle White, an increase in the amount of revolving debt per household (especially in the form of credit card debt) coincided with the increase in personal bankruptcy filings from the 1980s to 2005. There were 5.4 times more bankruptcies in 2004 than in 1980, and revolving debt per household was 4.6 times larger in 2004 than in 1980. White discussed other possible explanations for the increase in bankruptcy filings, such as job loss and medical bills. However, these types of adverse events have not increased since 1980. Therefore, she concluded that the rise in personal bankruptcies can be attributed in large part to the rise in credit card debt.

Similarly, the payday loan applicants in Skiba and Tobacman's study were six times more likely to file for bankruptcy between January 2001 and June 2005 than the general population in Texas. The bankruptcy filing rate for the state was 0.38 percent per year versus 2.3 percent per year for loan applicants.

Skiba and Tobacman tested whether access to payday loans increased bankruptcy filings.[10] They found no effect on the number of Chapter 7 filings, but the number of Chapter 13 filings increased significantly.[11] Within one year of his first payday loan, a borrower's likelihood of filing Chapter 13 increased by 1.9 percentage points, and within two years, the likelihood was 2.5 percentage points higher.



As with any kind of loan, credit cards and payday loans can be convenient for some people as a means to borrow money for a relatively short period of time. However, the recent rise in short-term liabilities—especially by lower-income households—may have long-term implications for the economy as demonstrated by their apparent correlation with bankruptcy filings.

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ENDNOTES

1. See Bucks, Kennickell and Moore (2006) and Black and Morgan (1999) for a description of changes in credit card holders.
2. Note that the numbers are only for families with credit card balances.
3. The data include all institutions insured by the FDIC. See www2.fdic.gov/sdi/sob/.
4. "Cash" here refers to cash and similar payments, e.g., check, debit card.
5. For the average household in each group, the borrower-and-saver kept 3.4 times more, the borrower kept 0.1 times more and the saver kept 10 times more money in the bank than needed for cash-only goods in a typical month.
6. From the Center for Responsible Lending. See www.responsiblelending.org/issues/payday/briefs/page.jsp?itemID=29557924.
7. See www.responsiblelending.org/pdfs/rr012-Financial_Quicksand-1106.pdf.
8. The authors obtained data from a provider of financial services.
9. New bankruptcy laws effective in October 2005 made it harder for consumers to file for Chapter 7 bankruptcy, which caused a sharp increase in the bankruptcy rate in the first three quarters of 2005 and a sharp decline in 2006.
10. To obtain a loan, the applicant's credit score must reach a certain threshold. Of first-time applicants, 99.6 percent below that threshold were rejected, and 96.9 percent above the threshold were accepted. Because the difference between a consumer whose application was barely accepted and one whose application was barely rejected is very small, the authors focused their analysis on those near the acceptance threshold.
11. Chapter 7 bankruptcy eliminates all dischargeable debts, and Chapter 13 bankruptcy creates a long-term repayment plan.

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