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Consumer debt loads at record What happens when interest rates rise?

By Barbara Hagenbaugh
USA TODAY

WASHINGTON — U.S. consumers have taken on record levels of debt as low interest rates have lured them to buy bigger houses and fancier cars and to charge more on credit cards than ever before.

But while historically low interest rates make the higher debt levels manageable now, the big unknown is what will happen when interest rates rise.

Weighing in on the increasingly heated debate, some economists warn consumers might be in over their heads when their payments increase. Others, including those at the Federal Reserve, say interest rates won't rise until economic growth — and incomes — are also gaining strongly, making the higher payments possible. Plus, much of the increase in debt in recent years has been for mortgages, and millions of Americans have low rates locked in for 30 years.

It's a debate that's central to the outlook for the U.S. economy. Consumer spending accounts for more

than two-thirds of U.S. economic activity. If households are forced to pare spending to pay debts, that could hamper the economy's ability to grow and create jobs.

"I don't think it will be what does in the expansion any time this year or next," says Mark Zandi, chief economist at Economy.com in West Chester, Pa. "I am concerned about it (in the) longer run, however. I can see scenarios where household debt is the problem that undoes the economy some five, 10 years down the road."

But Chicago Fed senior economist Francois Velde says fears about consumer debt are overblown. Although debt is growing, so are household assets.

"Over the past 50 years, we've been reaching (debt) records almost every other quarter," Velde says. "It's not a sign that there's an impending catastrophe."

Velde points to people such as Laura Gross, whose overall debt rose last year. Gross, 31, increased the size of her mortgage when she refinanced her Washington, D.C., condo. But her

payments fell because of the low interest rates.

"Rates were going down, and I also wanted to use some of the equity on my home to remodel my kitchen and to pay off my car loan," she says.

David Moran, 56, owes \$85,000 on his home equity line of credit. Since being laid off from his tech writing job in January 2002, Moran has paid for just about everything, such as health insurance, college tuition for his son and basics like groceries and gasoline, with the home equity line.

Currently, the interest rate on his equity line of credit is only 3.75%. He figures rates won't go up quickly, and, since rates are starting off so low, they won't be high even when they do increase.

If you have to be unemployed and borrowing money, now is a "good time to have to be suffering," Moran of Lincoln, Mass., says.

Mortgage debt jumps

Household debt levels rose nearly 11% in 2003. Excluding mortgages,

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consumer indebtedness rose more than 5%, above the 4.4% gain measured in 2002 but below the 2000 and 2001 gains, according to Fed data.

Where the debt is:

► **Homes.** U.S. consumers had \$6.8 trillion in mortgage debt, accounting for nearly three-quarters of their total debt at the end of 2003, according to the latest detailed data from the Federal Reserve. That's up 64% from five years ago and includes home equity lines of credit and "cash out" refinancings, when consumers increase their overall mortgage amount and take out money based on the increased value of their homes.

Tyler Beardsley, 34, took some cash out when he refinanced his home a few years ago to buy a fixer-upper that he turned into a rental property. He has since used a home equity line of credit to help buy another rental home. The Arlington, Va., consultant says he keeps a close eye on interest rates.

"We're in a good period now," he says. But, "Eventually, interest rates are going to march up, so you want to take as little out as you can and pay it off as soon as you can."

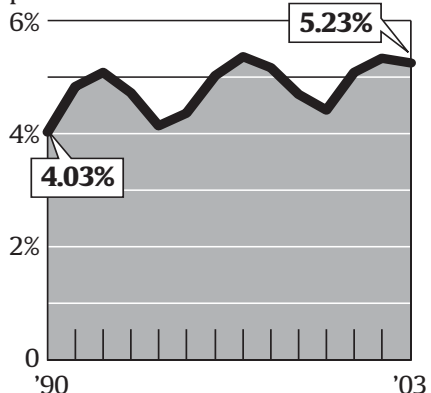
► **Plastic.** Households in 2003 racked up \$412 billion in credit card charges, up 185% from five years ago, according to Standard & Poor's. The average balance on open credit cards in December was \$4,616.90, according to credit bureau Experian.

Economists caution, however, that the trend is partly explained by a rise in usage of credit cards to replace cash and checks, and does not necessarily point to a jump in the desire to hold debt.

The sweeping impact of debt

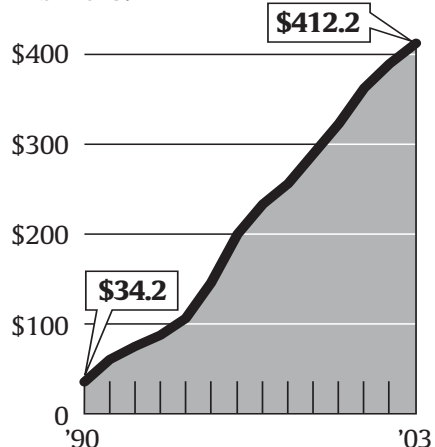
Credit card delinquency rates

The percentage of credit card debt outstanding has risen since the economy slowed in 2001. Percentage of charges and interest that are 30 days past due:



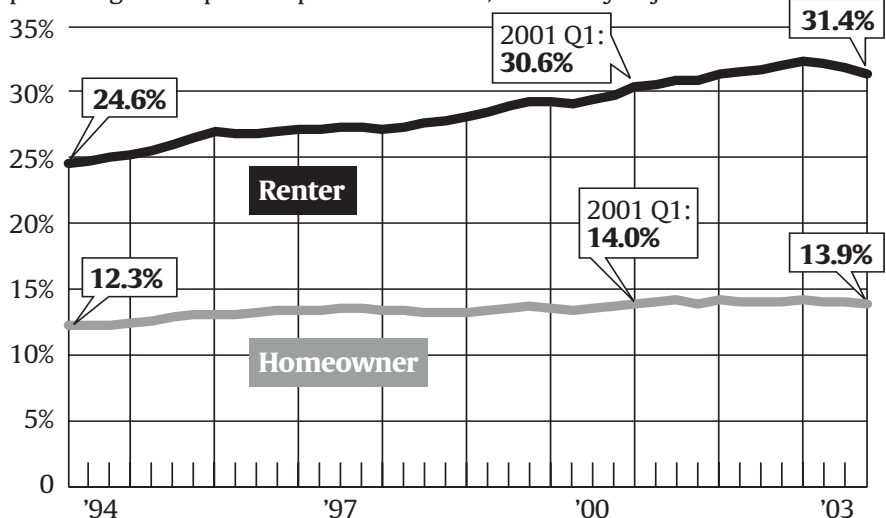
Credit card usage

Credit card usage has more than quadrupled in the last 10 years. Charges, in billions:



Easing financial obligation

Although debt has been rising, low interest rates recently have made it easier for both homeowners and renters to pay up. Financial obligation ratios as a percentage of disposable personal income, seasonally adjusted:



Sources: Federal Reserve Board, Economy.com, Standard & Poors

By Marcy E. Mullins, USA TODAY



By Tim Dillon, USA TODAY

Changes: Laura Gross refinanced her condo in Washington, D.C., to a seven-year adjustable-rate mortgage. While cutting her interest rate by 1.5 points, she also took money out to redo her kitchen, pay off her car and set up a rainy-day fund.

But that doesn't hold true for everyone.

Kin Powell, 57, of Florida has been using his credit cards to finance his commercial real estate development business. Since October 2002, he has accumulated \$180,000 in credit card debt on 16 cards. As soon as he makes money in his business, he puts it toward paying off his cards. But the high debt doesn't bother him.

"I'm effectively betting that I'm going to win," he says.

► **Wheels.** Borrowing for cars has jumped as consumers are lured into auto showrooms by promises of no money down and 0% interest rates. Through mid-February, the average amount financed for a new car purchase in 2004 was \$24,157, up 11% from 2001, according to Power Information Network, an affiliate of consultant J.D. Power and Associates. About 40% of consumers trading in cars currently owe more than their car is worth.

► **Students.** College undergraduates graduating in 2002 had a median \$16,500 in student loans, up 74% from 1997, according to Nellie Mae, one of the nation's biggest education lenders. Grads' debt burdens go beyond student loans. The median credit card debt for college students was \$1,770 in 2001, up 45% from three years earlier, according to Nellie Mae. The median is the point that half owe less and half owe more.

Despite the increase in debt, delinquency rates for mortgages, car loans and credit cards were largely flat last year, as low interest rates made paying easier.

About 5% of credit card balances at the end of the year were at least 30 days past due, the lowest rate since mid-2001, Standard & Poor's says. About 5.4% of student loans were in default in fiscal 2001, the most recent data, down dramatically from 17.8% in 1991. Interest rates on government student loans, which float up to a certain cap, are currently the lowest since the federal program began nearly 40 years ago.

A measure of consumers' abilities to repay their debts from their current income, the Federal Reserve's financial obligations ratio (FOR), fell to the lowest level in two years in the third quarter, the period of most recent data. The FOR measures debt as a percentage of after-tax income.

Rates rise, then what?

The Fed's target for short-term interest rates, which influence a variety of borrowing costs such as credit card and mortgage rates, has been at 1% since June. That's the lowest level in 45 years.

Although the Fed is not expected to raise rates anytime soon, economists are starting to think about what will happen when rates do increase. Will it show that consumers are maxed out?

That's a particular concern, considering half of households live paycheck-to-paycheck, according to a recent survey by MetLife.

"We don't have a lot of wiggle room," says Sung Won Sohn, chief economist at Wells Fargo in Minneapolis.

"It's not going to kill us, it's just going to slow the rise in consumer spending."

The higher levels of debt likely could become a much more serious issue as the baby boomers approach retirement and realize they need more money in the bank, Goldman Sachs senior economist Jan Hatzius says.

"Households will find out they are falling short of their financial goals without increasing their saving," he says. "I think it is going to be a pretty big drag."

Standard & Poor's chief economist David Wyss says he's concerned that when interest rates rise, consumers with high debt who are so used to low interest rates will not want to spend any more money and instead will stay in cramped condos or continue to drive beat-up minivans rather than buy new.

But, says Rich Brown, chief economist at the Federal Deposit Insurance Corp.: "Consumers are sold short fairly often. The key thing is how balanced the economic recovery is. If we see higher interest rates in conjunction with higher job growth and income growth, then the impact will not be that bad."

Members of the Federal Reserve, including Chairman Alan Greenspan, have repeatedly said they are not worried about rising debt levels.

"Overall, the household sector seems to be in good shape," Greenspan said in a speech in February. "Much of the apparent increase in the household sector's debt ratios over the past decade reflects factors that do not suggest increasing household financial stress."

Like other economists, Greenspan

noted the recent surge in mortgage refinancing as a source of confidence. Millions of consumers have lowered their mortgage interest rates, decreasing their monthly payments, and took out equity to pay down more expensive debt, such as student loans and credit cards. Many homeowners have locked in low mortgage interest rates for 30 years.

"The surge in mortgage refinancings likely improved rather than worsened the financial condition of the average homeowner," he said.

Homeowners scrap fixed rates

But one cause for concern on the mortgage debt front is the growing number of consumers taking out adjustable-rate mortgages to get the lowest possible rate for the near term. More than a quarter of mortgage applications currently are for ARMs, according to the Mortgage Bankers Association. That's more than twice the portion going for ARMs just a year ago.

After a set period of time, the interest rate on ARMs adjusts to market rates, sometimes to a set cap. If interest rates go up, homeowners will likely be faced with higher payments,

once their fixed rate period ends, typically in five or seven years.

There is little information on who is taking out ARMs. While some say less-educated, poorer people are attracted to the lower rates, others hypothesize that savvy homeowners are taking out ARMs, knowing they can refinance if rates seem ready to skyrocket.

Gross, who last year refinanced her Washington, D.C., condo from a 30-year fixed to a seven-year ARM, reduced her interest rate 1.5 percentage points to 5.375%, as well as taking out money to redo her kitchen, to pay off her car loan and set up a rainy-day fund. Despite the bigger mortgage, her monthly payments declined because of the lower rate.

Gross doesn't plan to still be in her condo when the seven years are up, but if she is, she figures she'll be able to manage it.

"It was definitely worth it," says Gross, who does public relations for National Public Radio.

Contributing: James R. Healey

Consumer debt loads at record

Objectives:

Students will:

- examine the article, “Consumer debt loads at record,” for information on credit card and other consumer debt.
- research the various interest rates for different loan types.
- compare and contrast three different types of mortgage loans and determine which would best suit a particular couple’s needs.

Concepts:

- Savings
- Investing
- Interest rates
- Budgeting
- Costs
- Benefits

Preparation:

- Give each student a copy of the article “Consumer debt loads at record.”
- Give each student a copy of the mortgage comparison graphic organizers.

Activity at a glance:

- Grade level: 9-12
- Subjects: economics, personal finance, responsibility, synthesis
- Estimated time for this activity: 60 minutes

Materials:

- Reading: "Consumer debt loads at record"
- Mortgage comparison graphic organizers

Consumer debt loads at record

Discussion:

Why have U.S. consumers taken on record levels of debt? What is the “big unknown” about current debt levels? According to some experts, under what circumstances will interest rates rise? How vital is consumer spending to the U.S. economy? How are individuals capitalizing on current interest rates? Where does most consumer debt lie (i.e., in what type of loans, etc.)? What does the Federal Reserve’s financial obligation ratio (FOR) measure? How could higher levels of debt affect baby boomers? What are some indicators of a healthy economic recovery?

Activity:

(Visit one of online banking sites listed at the top right for information on various loan types and their respective interest rates.)

When it comes time to purchase a house, the overwhelming majority of buyers need to take out a mortgage (a home loan) to help them pay for the purchase of their home. Most banks require borrowers to make some type of down payment, depending on the type of loan. In most cases, the down payment amount will also determine the interest rate. (All lenders charge interest on loans.)

Use the profile below (or create your own) to determine which type of loan would be in the best interest of the buyers in both the short-term (over the next five years) and long-term (over the next 15 years or longer).

Profile: A married couple with two children ages 9 and 11 with an annual household income of \$89,000. They are in the market to buy a home for about \$187,000 (give or take \$10,000), and can afford to put up to 20% down, but would prefer to keep some money out, if possible. They do not want their house payment to exceed \$1,100 per month (excluding insurance and taxes). They also have car payments totalling \$630 per month, as well as utilities, food and other expenses to consider.

If the purchasers plan to sell their home in 4 years, what type of loan should they opt for? What if they plan to stay in the home for at least 15 years? Explain your reasoning.

Additional resources:

For information on home loans, interest rates, points and other mortgage information, visit:

- money.usatoday.com
- www.bankrate.com
- mortgages.interest.com
- www.bankofamerica.com
- www.navyfcu.org
- www.goodpayer.com

Activity extensions:

- Identify one other type of home loan (FHA, VA, etc.), and complete the activity at left (a graphic organizer is available on the next page) using that mortgage’s downpayment and rate information.
- Estimate the amount that a homeowner would pay in annual taxes and insurance on the loan information you analyzed for the activity at left. (Base your estimates on tax rates and insurance costs in your state.)

Using an online mortgage calculator, fill in the graphic organizer below with the amounts the couple would pay each month on a **30-year fixed rate mortgage** with a **20% down payment** and a **10% down payment**. Note: Their interest rate and monthly payment will *remain the same* over the life of the loan.

Loan type: 30-year fixed rate

Purchase price: \$_____

Downpayment (20%): \$_____

Amount financed: \$_____

Interest rate: \$_____

Monthly payment: \$_____

Interest paid over 30 years:\$_____

Loan type: 30-year fixed rate

Purchase price: \$_____

Downpayment (10%): \$_____

Amount financed: \$_____

Interest rate: \$_____

Monthly payment: \$_____

Interest paid over 30 years:\$_____

Using an online mortgage calculator, fill in the graphic organizer below with the amounts the couple would pay each month with a **15-year fixed rate mortgage** with a **20% down payment** and a **10% down payment**. Note: Their interest rate and monthly payment will *remain the same* over the life of the loan.

Loan type: 15-year fixed rate

Purchase price: \$_____

Downpayment (20%): \$_____

Amount financed: \$_____

Interest rate: \$_____

Monthly payment: \$_____

Interest paid over 30 years:\$_____

Loan type: 15-year fixed rate

Purchase price: \$_____

Downpayment (10%): \$_____

Amount financed: \$_____

Interest rate: \$_____

Monthly payment: \$_____

Interest paid over 30 years:\$_____

Using an online mortgage calculator, fill in the graphic organizer below with the amounts the couple would pay each month with a **7-year adjustable rate mortgage** with a **20% down payment** and a **10% down payment**. Note: Their interest rate and monthly payment will *change* each year.

Loan type: 7-year ARM

Purchase price: \$ _____

Downpayment (20%): \$ _____

Amount financed: \$ _____

Interest rate (Year1): \$ _____

Interest rate (Year2): \$ _____

Interest rate (Year3): \$ _____

Interest rate (Year4): \$ _____

Interest rate (Year5): \$ _____

Interest rate (Year6): \$ _____

Interest rate (Year7): \$ _____

Monthly payment (Y1): \$ _____

Monthly payment (Y2): \$ _____

Monthly payment (Y3): \$ _____

Monthly payment (Y4): \$ _____

Monthly payment (Y5): \$ _____

Monthly payment (Y6): \$ _____

Monthly payment (Y7): \$ _____

Interest paid over 7 years: \$ _____

Loan type: 7-year ARM

Purchase price: \$ _____

Downpayment (10%): \$ _____

Amount financed: \$ _____

Interest rate (Year1): \$ _____

Interest rate (Year2): \$ _____

Interest rate (Year3): \$ _____

Interest rate (Year4): \$ _____

Interest rate (Year5): \$ _____

Interest rate (Year6): \$ _____

Interest rate (Year7): \$ _____

Monthly payment (Y1): \$ _____

Monthly payment (Y2): \$ _____

Monthly payment (Y3): \$ _____

Monthly payment (Y4): \$ _____

Monthly payment (Y5): \$ _____

Monthly payment (Y6): \$ _____

Monthly payment (Y7): \$ _____

Interest paid over 7 years: \$ _____