Rising Rates Sounding Alarm Bells for Debt-Laden U.S. Consumers

By Ben Steverman
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- Credit-card spending has surged 9.4% as delinquencies rise
- Fewer U.S. consumers using ARMs than before financial crisis

A healthy economy can be a dangerous thing.

Americans have a history of loading up on debt in good times, then paying dearly when the bills come due. Adding to the pain: A booming economy is often accompanied by rising interest rates, which make mortgages, credit cards and other debt much more expensive.

As the U.S. Federal Reserve raises rates, there are signs that consumers could be putting themselves in peril.

"When consumers are confident, or over-confident, is when they get into credit-card trouble," said Todd Christensen, education manager at Debt Reduction Services Inc. in Boise, Idaho. The nonprofit credit counseling service has seen a noticeable uptick in people looking for help with their debt, he said.

Return of the Credit Card

U.S. credit-card debt has been rising for several years

Source: Federal Reserve

Spending on U.S. general purpose credit cards surged 9.4 percent last year, to $3.5 trillion, according to industry newsletter Nilson Report. Card delinquencies are also rising. U.S. household debt climbed in the fourth quarter at the fastest pace <https://www.bloomberg.com/news/articles/2018-03-08/u-s-household-debt-rose-last-quarter-at-fastest-rate-since-2007> since 2007, according to the Federal Reserve.

"There are warning signs out there," said Kevin Morrison, senior analyst at the Aite Group. Especially concerning is a surge in student and auto loans over the past decade, he said.

See also: The unloved Libor is back, bringing trouble and opportunity <https://www.bloomberg.com/news/articles/2018-03-27/the-rate-the-banks-once-rigged-is-jumping-and-causing-trouble>

Meanwhile, the Federal Reserve is steadily hiking rates, most recently on March 21 when the federal funds rate rose a quarter point to a target range of 1.5 percent to 1.75 percent. Libor, a benchmark rate the world's biggest banks charge each other, is also on the rise. The 3-month Libor reached 2.3 percent last week, the highest since November 2008. That could be a problem for companies, especially those with lower credit ratings, looking to refinance debt. Overall, an estimated $350 trillion of contracts are based on Libor, according to its administrator, ICE.

To be sure, overall economic trends are anything but gloomy. The savings rate is headed back up, according to data released Thursday, while real wages are on the mend and recent U.S. tax cuts could help fatten some peoples' wallets.

In fact, the typical American might not notice much pain from rising rates –- at least for now. The vast majority of mortgages, auto loans and student debt are taken out at fixed rates, guaranteed for the life of the loan. New loans are linked to long-term rates, which haven't risen along with short-term Libor and fed funds rates.

'Affordability' Crutch

Adjustable-rate mortgages, or ARMs, are often tied to Libor, typically resetting once a year. ARMs proved to be a big problem during the housing bust, when it became clear that many Americans were using them to buy houses that they otherwise couldn't afford.

A decade after the financial crisis, the good news is that ARMs are far rarer — and their holders should be able to afford, or avoid, rate hikes.

"People aren't using them as the crutch of affordability like they did before the housing crisis," said Greg McBride, chief financial analyst at Bankrate.com. Thanks to tighter lending standards, homeowners with ARMs now tend to be affluent, he said. "They either plan to sell the home before the first adjustment comes, or it's a product that works with their cash flow."

That leaves rising rates on credit card debt as the biggest financial worry for many U.S.

families. Card debt is typically based on a "prime rate" that's directly linked to the fed funds rate. If the Fed pushes through a quarter-point increase, your card's rate could go up by the same amount a month or two later.

Card Debt

If you owe money on your credit card, however, an extra quarter point might not make much difference. Take, for example, a consumer who owes $1,000 on a card with a 19 percent annual rate. If she only meets the minimum payments, Credit Karma estimates she won't pay off the debt for more than five years, racking up $600 in total interest charges over that time period. If it goes up by a quarter point, she'll end up owing just $16 extra in interest.

Still, there are reasons to worry about consumers' credit card debt load long-term. Use of credit cards is rising faster than debit cards, as banks offer users lucrative rewards <https://www.bloomberg.com/news/articles/2017-06-26/the-credit-card-rewards-war-rages-are-you-the-loser> .

While unemployment is very low, Americans' income <https://www.bloomberg.com/news/articles/2018-03-29/u-s-consumer-spending-gain-lags-behind-income-for-second-month> still isn't surging despite decades of stagnant wages. Fewer than 40 percent of consumers say they "always" pay their credit card bills in full each month, according to the CFPB. In a 2016 study <http://www.usfinancialcapability.org/> by the Finra Investor Education Foundation, just 2-in-5 Americans said they're able to spend less than they earn.

"It's most impactful for the households that are already maxing out their household budget," Debt Reduction Services' Christensen said. "They don't have any wiggle room."

— With assistance by Claire Boston, and Jennifer Surane