Over-Extension of Credit

Consumer Credit

The concept of credit is very old – historians have found that ancient civilizations had complex systems of lending and repayment. Very early banking systems even created regulation of debt, interest and credit extension. The historic philosophy on lending and debt was that individuals in debt would work hard to repay what they owed – the crop yields of farmers with debt were found to be significantly higher than those without debt. It is said that credit was defined as "a state of mind that all will honor their obligations" [1].

The practice of individuals and entities granting installment loans has been around in the U.S. since the time of the Pilgrims, although loans became more structured as we turned into an industrialized nation. At the turn of the 20th century, individuals frequently obtained items of luxury, such as sewing machines, radios, washing machines and other electrical appliances, and automobiles through credit. During this period, retail giants such as Sears & Roebuck and Ford Motor Company tried to encourage cash only sales, but many merchants ending up issuing credit due to consumer demand for the means to "buy up" in social status [2].

Personal credit and lending evolved further during the period of prosperity following World War II. Private citizens had traditionally built long term relationships with their local savings & loans, neighborhood merchants, etc. and credit was extended based on the trust gained in that relationship. However, as communities became less close-knit, creditworthiness was less about personal relationships and more of an impersonal ranking system. Following the war years, the first revolving charge cards and bank issued credit cards were issued to consumers and our economy and culture changed dramatically as the 20th century came to a close. Although the concept of credit and financing is an ancient one, we now had more advanced instruments with which to complete credit transactions.

One major innovation was the advent of credit bureaus and the FICO score. Fair, Isaac & Company (now known as Fair Isaac Corporation) began developing the concept of credit scoring in the late 1950's. By 1975 they delivered the first risk based credit scoring system and in 1981introduced FICO credit bureau scores. The intention of the FICO score is to ascertain an individual's creditworthiness based on a variety of factors. These factors have become much more complex over time.

By today's standards it is entirely common for the average person to obtain consumer goods, such as large ticket items such as appliances and electronics, through credit and continue to carry those purchase balances. In addition to larger purchases, everyday expenses, such as fast food, groceries and gasoline, are easily purchased on credit cards – the average household has approximately six bank credit cards and approximately six store credit cards. A shocking number of consumers make little more

[1] Rhode, Steve. "The History of Credit and Debt by Steve Rhode". Copyright 2000-2007. The Myvesta Foundation. 27 Sept. 2007. <http://myvesta.org/history/>. Path: Early Regulations of Interest and Credit

[2] Ibid

than the minimum payment on their credit cards causing their credit debt load to grow exponentially [3].

Individuals will often carry credit card debt around for years and have also had the ability to pay off debts with new lines of credit. The addition of high interest rates and fees to these balances has become a house of cards, crashing down on many people. While it has been established that credit as a concept has always been with us advances in technology and commerce have made it very easy for consumers to over-extend their credit liability.

Credit + Mortgages

Evolution of the Mortgage Industry

The extension of credit as it pertains to a home or property mortgage is also a historical principle. The concept of the mortgage dates back to the 12th century to English common law where a creditor could be provided an interest in the debtor's property if the debtor did not make good on repayment of a loan. The term "mortgage" comes from the Latin word "mort" – meaning death – and the Germanic word "gage" – meaning pledge. The idea was that the property would be forfeited, or dead, if the debt was not repaid, and the pledge itself would be "dead" if the loan was repaid.

The mortgage concept made its way to the U.S. based on European fundamentals and by the turn of the 20th holding a home mortgage was very common for many individuals. The difference between home ownership 100 years ago and today, was that borrowers were typically required to put a 50% down payment on the purchase of a home and mortgages were generally only extended for terms of about 5 years, with the option to refinance at that time. People who couldn't afford the down payment or who were projected to be financially unable pay the balance within the term simply didn't get mortgages.

During the Great Depression years, the mortgage system fell apart. Lenders no longer had money to lend and borrowers could not repay their loans. Foreclosures were inevitable and savings and loans went bankrupt. President Roosevelt's administration passed legislation, part of what was known as the New Deal, to rejuvenate the economy and assist consumers. The creation of the Federal Housing Administration in 1934 started the mortgage industry comeback by insuring mortgage lenders against loss from loan defaults.

The FHA generated standard loan programs – such as the 30-year fixed rate mortgage – and stability began to return to mortgage lending, however many lenders were still struggling from financial losses and funds were scarce to make loans. So in 1938, the US government created the Federal National Mortgage Association (FNMA), better known as Fannie Mae. Fannie Mae purchased FHA insured loans and sold them as securities on the financial market. This kept the pool of mortgage funds full and gave birth to the secondary market.

[3] Day, Kathleen and Caroline E. Mayer. "Credit Card Penalities, Fees Bury Debtors, Senate Nears Action On Bankruptcy Curbs." 6 Mar. 2005. The Washington Post (online edition). 11 Oct. 2007. <http://www.washingtonpost.com/ac2/wp-dyn/A10361-2005Mar5?language=printer>.

Fannie Mae also introduced fair and consistent lending practices to the mortgage industry; if lenders wanted their loans sold on the secondary market, they were required to adhere to consistent loan terms and stringent underwriting guidelines. As with consumer credit in general, the demand for mortgages increased after World War II and the Veteran's Administration (VA) was give the right to guarantee loans being offered to military personnel.

Baby Boomers - individuals who were born between the end of the war and the early 1960's - created the next evolution in the mortgage industry. The US experienced dramatic cultural changes as Baby Boomers grew up. Women entered the workplace, for instance, and the lending industry began to see a demand for financing of larger, more expensive homes from double income families. In 1970, Congress chartered Federal Home Loan Mortgage Corporation (FHLMC), more commonly known as Freddie Mac. Like Fannie Mae, Freddie Mac's purpose is to purchase mortgage securities and keep money flowing to lenders and available to consumers.

From the 1970's through today, the mortgage industry has rapidly changed and advanced as consumers' needs have evolved. Homeowners may buy and sell several homes over the course of their lifetime – purchasing bigger or more expensive properties as their family needs or income increases. Many homeowners might also refinance their homes at least once to tap into their home equity in order to pay off other debts or for the purchase of other goods and services, such as home improvement.

The 1980's were typically regarded as a period of consumer extravagance, while the technology boom of the late 1990's signaled advances in fast, easy credit. As expansion in the housing market followed, home buyers rationalized that even if they couldn't really afford the loan they were taking, they could always sell the property for a profit and pay off the mortgage.

The Tax Reform Act of 1986 (TRA) strengthened the demand for mortgage debt even further by increasing interest deductions for home owners. This legislation made high-cost mortgages cheaper than consumer debt for many Americans. Latest reports from the Federal Reserve (consumer credit statistical release Sept 10, 2007) show total consumer credit at over two trillion dollars by mid-2007, according to preliminary numbers. Revolving credit accounted for over nine hundred billion, while non-revolving credit came in at one and a half trillion. Fannie Mae and government backed credit accounted for a little over two hundred billion of the non-revolving credit.

According to the Administrative Office of the U.S. Courts, non-business bankruptcy filings for the period from March 2006 through March 2007 totaled 673,615. Chapter 7 (total cancellation of debt) was 399,456 filings, with a majority of the remainder Chapter 13 (court supervised repayment of debt, versus surrendering any property)[4]. Revisions to bankruptcy legislation over the past few years have complicated the matter of credit debt. Debtors are now subjected to income tests to determine repayment ability for their debts. The ability to completely discharge debt under Chapter 7 has become much more difficult. Consumers with mortgages financed by jumbo loans face further hardship since there are limits on the amount of secured debt an individual may have in order to file for some types of bankruptcy.

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[4] Bankruptcy statistics, 11 Oct. 2007 < http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm>

Mortgage industry professionals can assist consumers with debt consolidation, the dream of owning a home, financial security planning and a lot of other value added services. However, the mortgage industry may also have played a part in creating the tidal wave of credit issues plaguing many Americans. Despite HOEPA's prohibition on making loans without considering a borrower's ability to repay, creative mortgage products and lax underwriting standards have contributed to situations where borrowers hold a mortgage they are not financially able to handle.