Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Shifting Demographics Raise Orange Flags[*]

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Recent demographical trends present a changed economy and citizenry to lenders searching for that elusive desirable borrower. The traditional pyramid of bad to good borrowers with a smooth risk curve has been somewhat corrupted by a variety of changes, including the tendencies of different age groups to use expansive technology in different ways, the exposure of those technologies to attack and theft, the accumulation of student debt beyond that ever before experienced, movements to an urban life style that opens more widely the possibility of renting rather than buying a home, and for some the elimination of both the need and desire to own a car. On top of that has been added a plethora of new regulations designed to minimize risk and the need to install new systems, training and compliance systems.

Student Loan Debt

— Recent articles have highlighted the very large student loan debt now owed by Americans.[1] It is truly amazing. While statistics calculated by different groups are not exactly comparable, student loan debt now appears to exceed $1 trillion and the average amount owed per debtor exceeds $29,000. Ten percent owe more than $54,000; for 3 percent, the debt owed exceeds $100,000; and for a relatively very few, it exceeds $200,000. Those graduating twenty years ago, for comparison purposes, had a total of $24 billion in debt, and in 2000, had about $33 billion in debt. These have become very large amounts of debt.

Bankruptcy does not discharge student loan debts, so the debt is not subject to the kinds of manipulation that were available to other borrowers during the recent downturn. It will remain with the borrower. That is seen by realizing that the majority of borrowers still repaying their loans are over 30 years of age, and a surprising 17 percent are over 50 years of age.

The student loan debt seems to have an effect on their daily lives. According to American Student Assistance, 63 percent of those in debt say that the debt affected their ability to make large purchases such as a car; 73 percent said it delayed their ability to put away retirement funds, and 75 percent said that the debt affected their decision or ability to purchase a home.

[*] The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] "Household Debt and Credit, Student Debt," Donghoon Lee, New York Federal Reserve Bank, February 28, 2013: "Burden of Student Loans Stifles the Housing Market," Scott Stucky, American Banker, March 24, 2014; "Life Delayed, Impact of Student Debt on the Daily Lives of Young Americans," American Student Assistance, September 25, 2013.

In addition, the debt has affected important life decisions, such as career field (30 percent says it affect that choice), marriage (29 percent) and establishment of a family (43 percent).

Population Growth in Cities

— A second demographic is the growth in cities. In the recent census, the growth in cities outstripped the growth in suburbs for the first time in decades. Lifestyles in cities are different from lifestyles in the suburbs, and apparently Americans and not-yet-Americans are recently finding the lifestyle of cities more appealing.[2] It is not simply gentrification, it is absolute growth in the number of residents. Anyone walking the streets of a large urban area such as Washington, D.C. must be struck by the large number of new high-rise multi-family buildings being developed and put into the inventory.

It is in the nature of cities to have everything closer together, and public transportation and taxicab services are generally more accessible there than in the suburbs. Therefore, the need for a car, for example, is minimized in the city, and recent surveys seem to show that owning a car may not be as desirable as it once was (other surveys say cars are still desirable but are unaffordable).[3] Bicycle lanes are being established that make it safer for cyclists to cycle to work, notwithstanding the mini-road rage it creates among the automobile drivers, thereby incentivizing persons to use bicycles rather than cars.

In that environment, many consumers find that renting is a better solution, even if for the time being,' than buying. For some, based on their recent credit history, it is the only solution. Morgan Stanley analysts pegged the homeownership rate at less than 60 percent in 2011 if delinquent borrowers were removed from the statistics, a percentage well below the 63 percent rate in 1965, the previous lowest rate.[4] It has recovered somewhat since then.[5] Still the delinquencies, loan modifications, short sales, and principal reductions are in the books, and the willingness and ability of those borrowers to return to homeownership in the near future is suspect.

As important, younger consumers burdened by debt and having decided to defer marriage and family may well find it easier to simply rent for a period, deferring the question of whether to buy a home for "a while," while they sort out the problems associated with finances in an environment in which unemployment remains sticky at 6.7 percent. In addition, Americans are living longer, and older consumers may find it easier to use the urban community in city center areas for their needs, sell their house and car and obtain additional retirement income they need now that they are living longer, and join the younger consumers in renting.

There is a different opinion on all of this, however. Joel Kotkin in Forbes.com says that is a temporary passion and that in their hearts, the younger Millennials want to return to suburbia, have a family and raise kids, all in a house they will own.[6] His thesis is that the younger citizens enjoy the big city through their 20s, then loose that itch and begin the return flight to the suburbs, just like monarch butterflies flapping down to Central America to mate and reproduce the species. He also cites a survey by TD Bank that says that 84 percent of renters age 18 to 34 intend to purchase a home in the future.

[2] ***"Millennials Prefer Cities to Suburbs, Subways to Driveways"***, The Nielsen Company, March 3, 2014.
[3] "Why Young People Are Driving Less," Todd Lassa, Motor Trend, August 2012; "Young People Still Want Cars, They Just Can't Afford Them," Christina Rogers, WSJ, March 11, 2014.
[4] "U.S. Moves Toward Home "Rentership Society" Morgan Stanley Says," John Gittlesohn, Bloomberg News, July 20, 2011.
[5] "Homeownership Rate Climbs From Lowest Level Since 1995," Prashant Gopal, Bloomberg News, November 5, 2013.
[6] "The Geography of Aging: Why Millennials Are Headed To The Suburbs," Joel Kotkin, Forbes.com, December 9, 2013.

Cyber risks

— There is a third factor that is harder to integrate. Younger consumers are more apt to utilize sophisticated technology to engage in financial and other kinds of transactions. Their love of their PEDs is well known and accepted as a part of the current culture. Pew Research says that 56 percent of all consumers had smart phones in June of 2013, and 80 percent of those in the 18 to 29 age group making $30K to $75K have a smart phone.[7]

The technology in those phones permit consumers who are savvy users to utilize those phones for all of their financial transactions, leading to orphan bank branches. In addition, the need to have a relationship with a financial service firm that is personal and face to face has diminished. Many younger consumers do not visit their bank; that result has spread to even older consumers as they become comfortable with their electronic devices.[8]

That of course builds a feeling of neutrality to a brand, unless that brand is very good at being useful for the online user. Most consumers, however, find banks' use of social media is very poor, so banks start from behind.

Assuming that a relationship on a product or service is consummated, what are the risks that must be level set for the bank. While the high profile cyber-attacks of the last number of months have involved attacks through vendors' sites and from there into the target, that doesn't mean they have to in the future. Browsers have been attacked, and there is no question that determined attackers could find a way into the PED systems and thence into the financial institutions. So far it just hasn't been sufficiently profitable, although prior to the ATM hacks, it wasn't clear that hackers making illegal withdrawals from ATMs could collect $45 million in 10 hours from machines in 26 countries.

While the smart phones are the current technology of choice, consumers, particularly the millennial and younger, are utilizing other technology to engage in financial services, including their iPads and home computers. All of those are vulnerable.

Commercial firms are even savvier, and have begun to utilize a wide variety of technology to conduct their business. To the extent the dollars per hack would be higher, they are even a better target, however.

While the danger is real and apparent, it is not so easy to see how it will affect the purchase of financial products and services that consumers and commercial firms want. The use of technology and the Internet, with its many facets, has, for some consumers, always been a way of life. It will take massive breakdowns to drive them to other means of communication. If confidence is questioned, however, economic activity through that technology could be reduced.[9]

New regulations

One cannot talk of orange flags in the environment without at least a passing reference to the massive regulations adopted following the recent economic downturn. The Dodd-Frank Act spawned most of them, and they have definitely put a crimp on economic activity. Over the long run, the effect they have may

[7] "Pew: 61 Percent In US Now Have Smartphones," Greg Sterling, June 5, 2013, Pew Research.

[8] "Mobile Phones Set To Reduce Banking Branches In 2014," Tom Groenfeldt, Forbes.com, January 6, 2014.

[9] A Harris poll reported by Business Insider, on the other hand, found that over half of smartphone owners said they were uninterested in using their smartphone to pay in-person, which is an increase from the previous year. They don't want to store sensitive information on a smartphone or transmit sensitive information to a merchant are two of the leading reasons, although a simple lack of a reason to adopt it is just as important. "Here Are The Top Reasons Why People Aren't Using Smartphones To Make Payments," BI Intelligence, April 3, 2014.

not be as significant, but adjusting to new rules always puts a hitch in activity. Adapting to this many new rules creates more than just a hitch.[10]

A few of the rules, such as the Volcker rule or Living Wills, or QM for residential mortgages, have drawn most of the media attention. While they alone would be significant changes, there are many more rules that themselves require changes in systems and additional training for officers with supervisory responsibilities. Compliance staff has had to be increased and the difficulties in understanding and applying these rules have required the addition to hire a category of employees and third parties that can handle stress and complexity in an unchartered environment.

From a customer standpoint, education tools have had to be developed to assist customers in understanding the new rules and the impact they have. Some of the rules will restrict economic activity, the QM rules in residential mortgage lending, for example. In particular, smaller loans and loans to those with somewhat damaged credit will not be easily available, if at all. Since there is a correlation between that group of consumers and protected classes of individuals under various fair lending laws, and since this Administration does not require intentional discrimination for violations of those laws, lenders will have to proceed cautiously. This is a definite orange flag.

Summary

Changes have occurred in the consumer base with the increasing costs of higher education and the resulting embedded debt. In addition, consumers had adapted rapidly to the new forms of communication and are not only comfortable with technology but are demanding its use in financial transactions. That technology has weaknesses that have been exploited by bad guys and will be in the future. Cities are becoming the default place to live, particularly with younger persons. The life style in 21st century cities leads to the need for firms to review how to connect with the new residents, and whether old assumptions remain valid. Finally, Dodd-Frank has layered on a massive regulatory requirement on financial firms, and how the polycentricity of regulatory control and authority under these new rules will play out is yet to be determined.

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[10] As of March, 2014, 205 rules under Dodd-Frank have been finalized that cover thousands of pages in the Federal Register. Over 200 rules remain to be finalized. "DavisPolk Dodd-Frank Progress Report," DavisPolk.com, March 3, 2014.