

***CONSUMER***

***FINANCE***

***REPORT***

***Nassau County Office of Legislative Budget  
Review***

***March 2007***

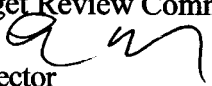


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### **Inter-Departmental Memo**

To: Hon. Lianne Altmann, Chairperson  
Members of the Budget Review Committee

  
Eric C. Naughton, Director  
Legislative Budget Review

March 14, 2007, 2007

Re: Consumer Finance Report

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Attached is a copy of the Office of Legislative Budget Review's Consumer Finance report. This report is being circulated to highlight the financial status of Nassau County households. OLBR believes that it is increasingly important to monitor the purchasing power of resident households since more and more residents are living beyond their income levels by using debt instruments to finance their purchases. This shift is significant to monitor since it directly impacts County sales tax collections. This report monitors debt obligations, credit limits, interest rates, bankruptcy rates and household income levels. A special focus is placed on home equity financing. The robust appreciation rates seen in residential housing over the past few years has left households with a significant amount of home equity. This equity is both easily accessible and in most cases tax deductible. The data presented is the most current as of the date of circulation and is the most geographically relevant.

## *Introduction*

Recent indicators reveal a shift in consumer psychology in that individuals are to a greater extent using debt to finance their purchases. Individuals are much more comfortable living with debt and much more willing to take on debt. This shift is significant to monitor since it directly impacts County sales tax collections, which comprise 38.5% of all County revenues, and County fee collections associated with home and car ownership. It implies that it is increasingly important to monitor debt obligations, credit limits, interest rates, bankruptcy rates and household income levels. A special focus should be placed on home equity financing. The robust appreciation rates seen in residential housing over the past few years have left households with a significant amount of home equity. This equity is both easily accessible and tax deductible. According to Alan Greenspan, former Federal Reserve Chairman, for every dollar increase in home equity, personal consumption expenditures rise 10¢ to 15¢.<sup>1</sup> To accomplish this, OLBR will begin to circulate a report on household/consumer finances which will provide statistics on the previously listed variables as well as highlight developments in this field.

The Commerce Department reported that the national savings rate for all of 2006 was negative 1%. This implies that people spent all the money that they earned and also dipped into savings or increased borrowing to finance their purchases. That was the lowest national savings rate seen since the Great Depression, when national savings fell to negative 1.5%. The current negative savings rate may be seen as a turning point in individual's propensity to take on debt. Economists have put forth two theories to explain this change in personal consumption expenditures. According to one theory, there is a feeling on the part of some people that they do not have to save because of the run-up in their investments such as homes and stock portfolios. Another line of thought surmises that many middle-class wage earners are willing to take on more debt to maintain their current lifestyle even though their wage gains have been depressed by the effects of global competition.<sup>2</sup>

The increased propensity to take on debt may be seen in the credit card market. A recent survey by Experian found that the average American holds four credit cards, up from 3.2 in 2004. They found that credit card use is heaviest in the northeast where the typical New Englander carries five credit cards.<sup>3</sup> The chart on the following page records credit card use by state for the 10 states where credit card use is most prevalent.

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<sup>1</sup> Nothaft, Frank E., "The Contribution of Home Value Appreciation to US Economic Growth", Urban Policy and Research, Vol. 22, No. 1, 23-34, March 2004.

<sup>2</sup> "Depressing News on Savings", Long Island Business News, February 1, 2007.

<sup>3</sup> Lewis, Marilyn, "1 in 7 Americans Carry 10 or More Credit Cards", MSN Money.com, February 14, 2007.

## Credit card use by State

State	Avg. # of cards held	% of residents with 2 or more cards	% of residents with 10 or more cards	% of residents using half of their credit line
New Hampshire	5.3	63.4%	20.3%	15.5%
New Jersey	5.2	58.7%	20.0%	15.4%
Massachusetts	5.1	61.8%	18.9%	15.3%
Rhode Island	5.0	60.7%	18.7%	16.1%
Minnesota	4.9	61.1%	18.1%	14.8%
Connecticut	4.8	58.6%	17.6%	14.6%
Michigan	4.5	55.0%	16.6%	15.1%
New York	4.5	54.3%	16.4%	14.8%
Florida	4.4	52.7%	16.2%	15.5%
Maryland	4.4	55.6%	15.9%	16.8%
Source: Experian				

In the housing market, realtors emphasize that younger buyers have such different approaches to real estate that they are prompting developers to change the way they sell apartments. According to Dottie Herman, chief executive of Prudential Douglas Elliman Real Estate, “Twenty years ago, it was “Pay everything off in cash and have no debt”. Ten years ago, it was “Have some debt”. If they want something now, they figure out a creative way to finance it.”<sup>4</sup> According to data collected by the National Association of Realtors, nearly 65% of first-time home buyers financed more than 95 percent of the cost. Experts opine that it is the mind-set of younger buyers that will dominate the patterns of buying in New York City in the future and is helping to keep prices stable. This mind-set is also seen as making condominiums more appealing since they allow for more flexible financing.<sup>5</sup>

This liberal approach to debt has negative consequences. Without any savings to fall back on, when housing prices fall, when an individual becomes unemployed or when an individual requires expensive medical treatments, many households will find it difficult to pay their monthly debt service costs and be forced into bankruptcy. This trend may be seen in the recent increase in New York State bankruptcy filings. According to American Bankruptcy Institute statistics, the number of filings in New York State increased 58.7% from 2001 to 2005. Much of the increase seen in 2005 bankruptcy filings may be attributed to the fact that Federal Bankruptcy laws were changed in October 2005. A surge in filings occurred prior to the change and a substantial decline was recorded after the change. Prior to the law change, from 2001 through 2004, on average there were 56,633 bankruptcy claims filed during the first three quarters of the calendar year. After the law change, there were 13,082 bankruptcy claims filed over the same time period. The new laws make it more difficult to claim bankruptcy. The table on the next page depicts bankruptcy filings in New York State by year from 2001 to 2006.

<sup>4</sup> Haughney, Christine, “Young Buyers, Prepared and Fearless”, The New York Times, February 4, 2007.

<sup>5</sup> Same as above.

<b>New York State Annual Bankruptcy Filings</b>		
	<u>Number</u>	<u>Annual Growth</u>
<b>2001</b>	<b>69,045</b>	
<b>2002</b>	<b>72,279</b>	<b>4.7%</b>
<b>2003</b>	<b>75,790</b>	<b>4.9%</b>
<b>2004</b>	<b>79,960</b>	<b>5.5%</b>
<b>2005</b>	<b>109,572</b>	<b>37.0%</b>
<b>*2006</b>	<b>13,082</b>	

\*2006 figure represents the sum of the first three quarters data.  
Source: American Bankruptcy Institute

This problem is particularly acute in the market for subprime mortgage loans, loans made to less-creditworthy buyers. The default rate in this sector has jumped faster than expected and is causing concern for the housing market and overall economy. According to the National Association of Realtors, these loans accounted for 8.7% of all mortgage originations in the New York region the first half of 2006.<sup>6</sup> As a result of this, lenders are tightening their underwriting standards. This tightening is expected to cause a 20% decline in total mortgage loan origination volume in 2007.<sup>7</sup>

### **Current Market Conditions**

Current indicators for the consumer finance market indicate that households are achieving new heights in debt to income ratios, that effective interest rates have increased and that loan to price ratios within the New York metropolitan area are rising but still remain below historical highs.

Throughout the nation, household debt service costs are outpacing income levels by ever increasing amounts. The Federal Reserve Board monitors this trend by computing two ratios, the household debt service ratio (DSR) and financial obligations ratio (FOR). The household debt service ratio estimates the ratio of debt payments to disposable personal income, where debt payments consist of the estimated required payments on outstanding mortgage and consumer debt. A second financial obligations ratio is computed by adding automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance, and property tax payments to the debt service ratio. The chart on the following page details the annual changes seen in these ratios over the past seven years.

<sup>6</sup> "Home Price Analysis for New York Region", [National Association of Realtors](#), July 2006.

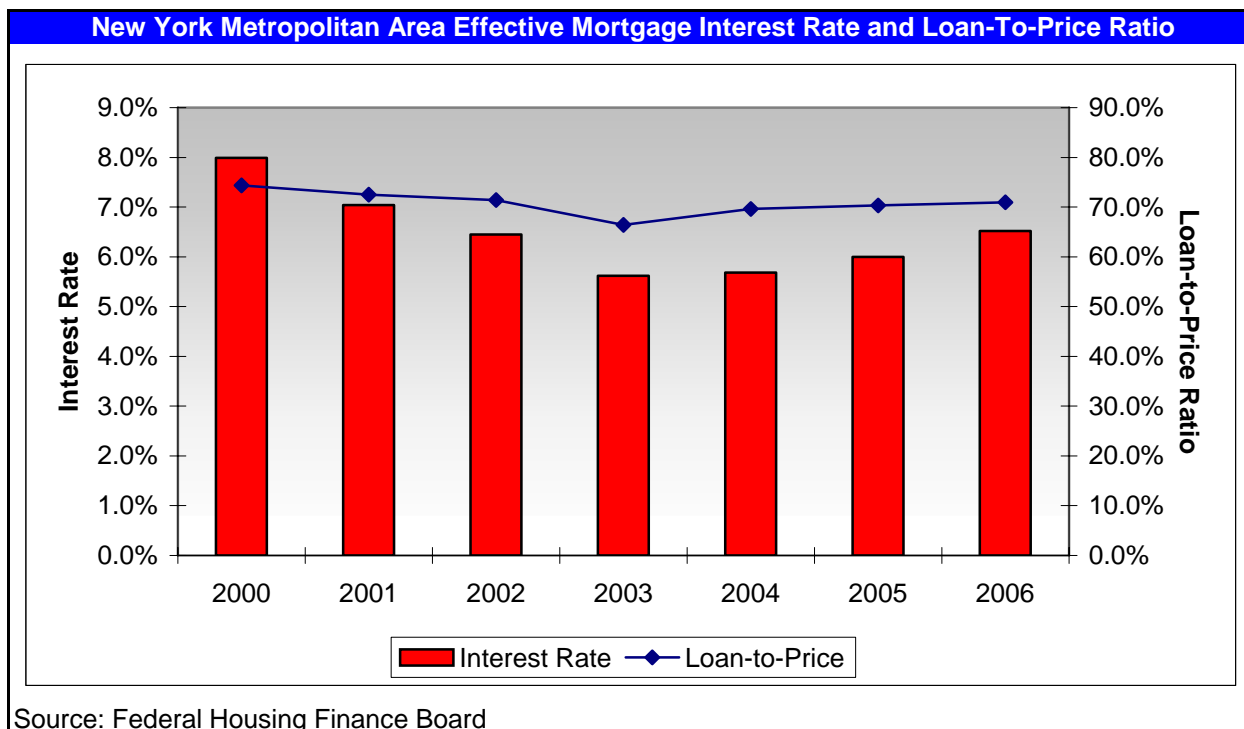
<sup>7</sup> Niedzielski, Joe, "A Sinking Sensation for Subprime Loans", [Businessweek.com](#), February 14, 2007.

National Household Debt Service and Financial Obligations Ratios		
	Debt Service Ratio (DSR)	Financial Obligations Ratio (FOR)
2000	12.58	15.52
2001	13.14	16.02
2002	13.39	16.43
2003	13.51	16.80
2004	13.53	16.96
2005	14.13	17.72
2006*	14.43	18.09

\*2006 figure based on first three quarters of data  
Source: The Federal Reserve Board

The DSR has increased 14.7% over the past seven years while the FOR has increased 16.6% over the past seven years. Both ratios have increased every year since 2000.

Statistics from the Federal Housing Finance Board reveal that effective mortgage interest rates throughout the New York metropolitan area have been rising steadily since 2003. However, current effective mortgage interest rates stand at 6.52%, 9.63 percentage points below the historic high of 16.15% recorded in 1982. Similarly, loan-to-price ratios have been steadily increasing since 2003, yet still remain below the historic high of 76.7% registered in 1997. The chart below details the annual changes seen in effective mortgage interest rates and loan-to-price ratios seen throughout the New York metropolitan region since 2000.





On a positive note the average mortgage down payment in the New York Metropolitan area has been 27.7% over the last ten years. This implies that as the residential housing market slows down, households will continue to have home equity available. In fact, using the subset of houses that have changed hands in Nassau County over the past ten years, OLBR estimates that with the 2006 annual 0.53% decline seen in average Nassau County closed home prices, there is a substantial amount of untapped home equity throughout Nassau County.

	December Average Closed Home Price	New York Region Annual Loan to Price Ratio	Annual Closed Transactions	Estimate of Minimum Available Home Equity, in billions
1997	\$214,364	0.77	7,835	\$3.4
1998	234,491	0.76	8,199	3.5
1999	262,275	0.76	7,389	3.0
2000	280,505	0.74	7,002	2.7
2001	330,201	0.73	7,545	2.7
2002	439,720	0.71	8,659	2.5
2003	493,691	0.66	9,627	2.6
2004	549,300	0.70	11,154	2.4
2005	601,900	0.70	11,521	2.0
2006	598,700	0.71	10,560	1.8

Figures in billions  
Sources: MLSLI and Federal Housing Finance Board

The table above records the average Nassau County home price, the New York State annual average loan to price ratio, and the annual number of closed Nassau County transactions, all of which were utilized to compute the level of home equity currently in existence in Nassau County.

To determine how much of the existent home equity has been spent several methodologies were used. A current, National Bureau of Economic Research, NBER, working paper found that the marginal propensity to consume from a \$1 change in housing wealth is 2¢ in the short-run and 9¢ in the final, long-run.<sup>8</sup> Under this methodology, Nassau County residents can be assumed to have spent \$2.4 billion of their home equity. According to Alan Greenspan, former Federal Reserve Chairman, for every dollar increase in home equity, personal consumption expenditures rise 10¢ to 15¢.<sup>9</sup> Using 15¢ as an upper bound, Nassau County residents can be assumed to have tapped \$4.0 billion of their home equity. Lastly, a study of mortgage re-finance activity found that from 2001 to 2002, the median household extracted approximately \$20,000 and used 60% of the funds for new consumption. Applying those figures to Nassau County’s housing stock, implies a 21¢ for every dollar consumption rate.<sup>10</sup> The table on the following page records these calculations.

<sup>8</sup> Carroll, Christopher D., Misuzu Otsuka and Jirka Slacalek, “How Large is the Housing Wealth Effect? A New Approach”, NBER Working Paper No. 12746, December 2006.

<sup>9</sup> Nothaft, Frank E., “The Contribution of Home Value Appreciation to US Economic Growth”, Urban Policy and Research, Vol. 22, No. 1, 23-34, March 2004.

<sup>10</sup> Bostic, Raphael, Stuart Gabriel and Gary Painter, “Housing Wealth, Financial Wealth, and Consumption: New Evidence from Micro Data”, Lusk Center for Real Estate, University of Southern California, December 2005.

	Tapped Home Equity, 9¢/\$1	Tapped Home Equity, 15¢/\$1	Tapped Home Equity, 21¢/\$1	Minimum % of Taxable Sales	Maximum % of Taxable Sales
1997	\$306.2	\$510.4	\$714.5	1.88%	4.38%
1998	310.8	518.0	725.2	1.85%	4.31%
1999	266.5	444.1	621.7	1.49%	3.48%
2000	245.8	409.6	573.5	1.29%	3.02%
2001	244.0	406.6	569.3	1.25%	2.91%
2002	221.9	369.8	517.8	1.09%	2.54%
2003	234.7	391.2	547.6	1.11%	2.60%
2004	217.2	362.0	506.9	0.98%	2.29%
2005	182.0	303.4	424.8	0.81%	1.89%
2006	165.0	275.0	385.0	0.71%	1.65%

Figures in millions  
Sources: MLSLI and Federal Housing Finance Board

Applying the estimated home equity consumption levels to Nassau County taxable sales yields the following result, on average, over the past ten years, 1.3% to 2.9% of annual taxable sales were financed with home equity.

A look at New York State personal income figures reveals why so many household have begun to finance their purchases with debt instruments. According to U.S. Bureau of Economic Analysis and U.S. Bureau of Labor Statistic figures, real wage growth has averaged 0.41% throughout New York State since 2000. Over the same time period, average consumer price growth has been 3.22%. The chart below details annual New York State real wages, New York State real wage growth and regional consumer price growth.

New York State Personal Income and Consumer Price Data			
	Real Wages	Real Wage Growth	CPI Growth
2000	\$2.65		
2001	2.65	0.02%	2.52%
2002	2.58	-2.83%	2.57%
2003	2.55	-0.93%	3.07%
2004	2.64	3.47%	3.54%
2005	2.65	0.22%	3.86%
2006*	2.71	2.51%	3.76%

Figures are in billions. Year 2000 was considered the base year.  
\*2006 figures are projections based on data through the third quarter 2006.  
Sources: U.S. Bureau of Economic Analysis and U.S. Bureau of Labor Statistics

### Conclusion

This report highlights the fact that real wages throughout New York State have essentially stagnated since 2000. In order to keep themselves afloat/maintain their existing lifestyle, households have begun to finance more of their purchase with debt instruments. It is becoming increasingly important to monitor household debt, since County sales tax collections and fees will diminish as home equity diminishes, credit underwriting standards are tightened, and credit lines get maxed out. In 2007, consumer spending could be curtailed since New York State residents carry more credit cards than the typical American, household debt service ratios are at all time highs, regional loan-to-price ratios are rising implying that there is less home equity to tap and regional real wages are stagnating. However, even with the dampening effects of the previously listed variables, as long as interest rates do not rise rapidly, it seems that there are



ample home equity and credit lines available for residents. Moreover, although regional wage growth has been slow, it has been sufficient for residents to cover their minimum debt service costs. In New England, where credit cards are used the most, residents record the highest average credit score since they are able to pay their bills on time.<sup>11</sup>

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<sup>11</sup> Lewis, Marilyn, “1 in 7 Americans Carry 10 or More Credit Cards”, [MSN Money.com](http://www.msn.com), February 14, 2007.