Understanding changes in credit supply and demand

An Experian white paper

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Summary

In 2009, the U.S. economy experienced a record drop in consumer borrowing. According to the Federal Open Market Committee meeting notes released on Jan. 27, 2010, household spending "remains constrained by a weak labor market, modest income growth, lower housing wealth and **tight credit** [author's emphasis]."[1] The committee's outlook for 2010 suggests that "while bank lending continues to contract, financial market conditions remain supportive of economic growth"; however, "**economic recovery is likely to be moderate for a time** [author's emphasis]."[2]

In recent months, the contraction in lending has been largely attributed to consumers reducing leverage, or "consumer deleveraging." To understand the impact and implications of consumer deleveraging, Experian® tracked a sample of 426,185 credit-active consumers, representative of the credit population, over a six-year period from 2004 Q2 to 2009 Q2.

The data show that consumer deleveraging has occurred and that demand for credit has also declined. However, demand has not declined as drastically as recent reports have suggested. In fact, the decline in demand has been outpaced by the decline in supply. As part of our study, we have charted credit demand versus credit supply to determine when demand outstripped supply.

Key findings

- The credit contraction began in 2008. Though the rate of growth in outstanding balances and tradelines slowed between 2005 Q2 and 2008 Q2, our research indicates that 2008 marked the start of the credit contraction. From 2008 Q2 to 2009 Q2, the data show a 13 percent decline in open tradelines (open loans) and a 3 percent decline in outstanding balances.
- Demand outstrips supply. Using new originations and inquiries (credit applications made by consumers) as a proxy for credit supply and credit demand, respectively, we discovered that demand outpaced supply in the period from 2008 Q2 to 2009 Q2. Prior to that time period, supply generally met demand.
- Change in demand varies with credit quality. Despite an overall decrease in credit demand, higher VantageScore®[3] consumers showed flat demand even through 2009 Q2. Credit supply, as measured by new originations, declined rapidly. Relative to demand, the drop in supply is greater for good-credit-quality borrowers.

[1,2] Federal Reserve Board press release, Jan. 27, 2010
[3] A consistent tri-bureau standard credit score utilized by many lenders to make credit decisions.

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Key finding No. 1: The credit contraction began in 2008

Experian's research shows that the total number of tradelines and total outstanding balances were expanding until 2008 Q2.

From 2008 Q2 to 2009 Q2, we find that overall tradelines declined by 13 percent and outstanding balances declined by 3 percent. Over this 12-month period, bankcards and retail cards are responsible for 92 percent of the total open tradeline decline, and first mortgages and home-equity loans (HELOANs) accounted for 70 percent of the drop in outstanding balances. Home-equity line of credit (HELOC) balances increased despite a decline in the number of outstanding lines, indicating increased utilization or inactive lines being closed. These results are consistent with numbers reported in the media, which tend to quote changes in outstanding balances.

Figure 1 displays the year-over-year growth trends for open tradelines and outstanding balances.

Year-over-year percent change in tradelines and outstanding balances

Figure 1

	2004 Q2–2005 Q2		2005 Q2–2006 Q2		2006 Q2–2007 Q2		2007 Q2–2008 Q2		2008 Q2–2009 Q2	
Credit product	Tradeline	Balance	Tradeline	Balance	Tradeline	Balance	Tradeline	Balance	Tradeline	Balance
Auto	0%	-3%	-1%	-4%	0%	-2%	-2%	-5%	-7%	-10%
Bankcard	1%	-2%	-1%	-2%	2%	0%	3%	1%	-18%	-3%
HELOC	23%	29%	9%	5%	2%	0%	1%	5%	-4%	7%
Installment loan	-6%	-4%	-1%	0%	0%	-1%	-1%	-3%	-3%	-5%
First mortgage	6%	10%	4%	9%	3%	6%	1%	1%	-4%	-3%
HELOAN	11%	-1%	18%	14%	27%	28%	3%	0%	-10%	-12%
Retail card	1%	1%	2%	5%	3%	1%	2%	-2%	-16%	-7%
Overall	2%	8%	1%	7%	2%	5%	2%	0%	-13%	-3%

Key finding No. 2: Demand outstrips supply

To understand the supply and demand for consumer credit, we have used new loans and lines opened in the last six months as a proxy for credit supply and consumer inquiries in the last six months as a proxy for credit demand. Inquiries analyzed here include credit applications made by consumers, but not inquiries resulting from prescreen campaigns.

Figure 2 compares new origination volume to inquiries between 2004 Q2 and 2009 Q2. Since 2004 Q2, demand for new credit by credit-active consumers gradually declined, and until 2008 Q2, supply generally met demand. From 2008 Q2 to 2009 Q2, however, supply did not meet the demand for new credit.

New origination tradeline volume and inquiries (indexed to 2004 Q2)

Figure 2

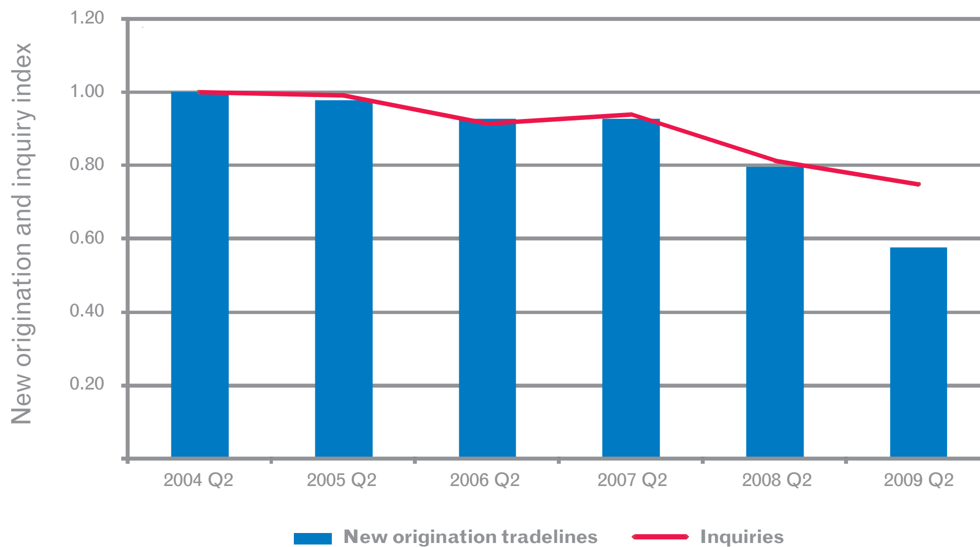

Figure 3 presents Experian's Credit Supply Ratio. This measures the gap between supply and demand — the lower the supply relative to demand, the lower the ratio value.

Figure 3

Credit Supply Ratio	2004 Q2	2005 Q2	2006 Q2	2007 Q2	2008 Q2	2009 Q2
Overall Population	0.96	0.94	0.97	0.95	0.94	0.74

Figure 3 shows that the ratio has declined by more than 20 percent from 2008 Q2 to 2009 Q2, a significant drop when compared to previous time periods. This ratio of 0.74 for 2009 Q2 is being driven by an 8 percent decline in inquiry volume and a 27 percent decline in new tradeline origination volume.

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Key finding No. 3: Change in demand varies with credit quality

Though consumers across the credit spectrum continue to apply for new credit, there is a supply shortfall across most credit-quality bands. Perhaps surprisingly, the largest shortage is for higher-credit-quality consumers.

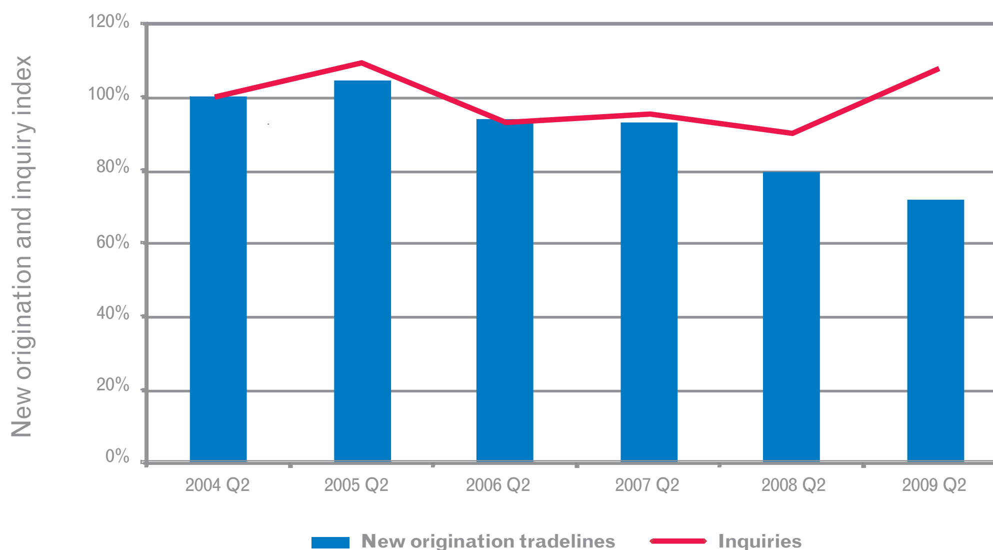
Figures 4 to 8 compare newly originated tradelines in the last six months and inquiries in the last six months, segmented by VantageScore bands. Consumers in the higher-credit-quality bands continue to apply for credit at near five-year-high levels, while lower-quality risk bands show marked declines in the volume of credit applications. We interpret the decline in credit applications as reduced demand for credit among lower-credit-quality consumers. They may be actively trying to reduce their credit usage or simply assuming that it is futile to attempt to get any credit given the market conditions. It is also possible that these consumers are trying to apply for credit, but loan officers are deterring them from filing applications. Unfortunately, we are not able to separate this effect, as any requests for credit that do not result in a credit report being pulled are not recorded in our data.

Figures 4 to 8 also show that credit supply has not matched demand for any credit-quality bands from 2008 Q2 to 2009 Q2.

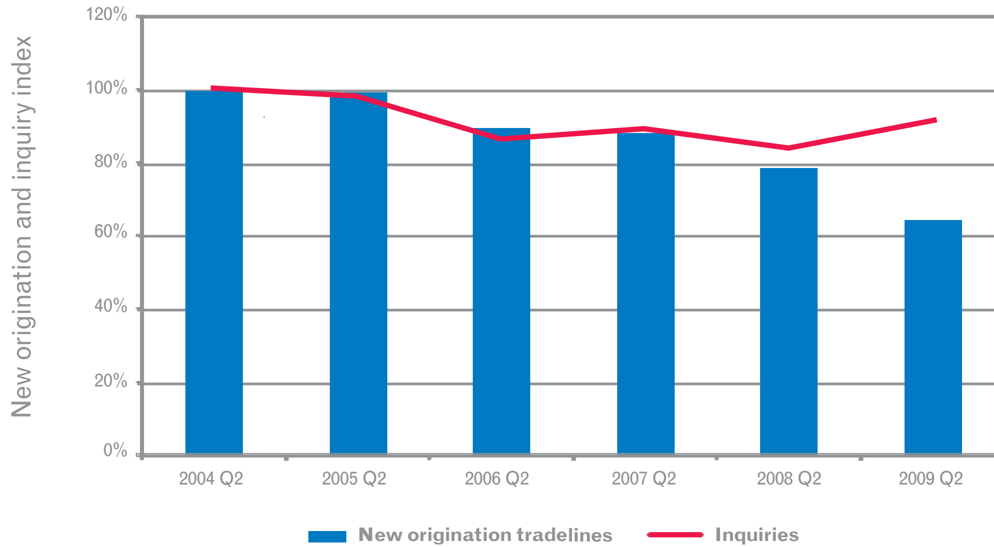
*A: 901–990 — **Super Prime** VantageScore Population*

New origination and inquiries (indexed to 2004 Q2)

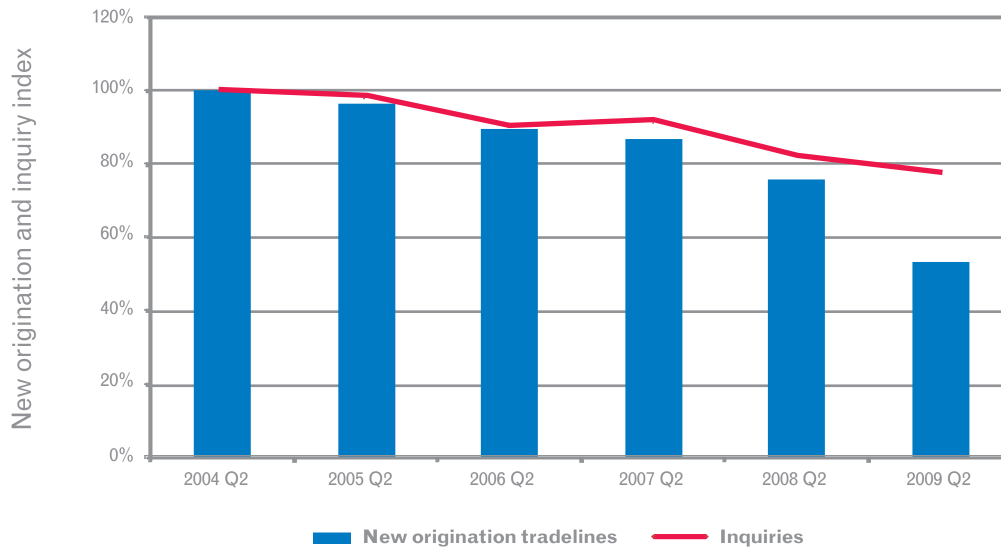
Figure 4



*B: 801–900 — **Prime** VantageScore Population*
New origination and inquiries (indexed to 2004 Q2)
Figure 5



*C: 701–800 — **Near Prime** VantageScore Population*
New origination and inquiries (indexed to 2004 Q2)
Figure 6



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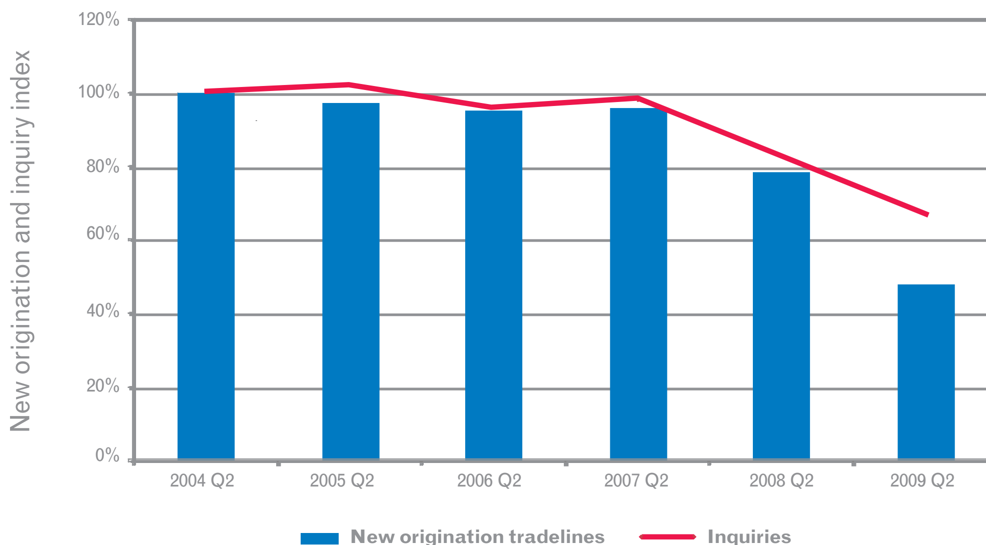

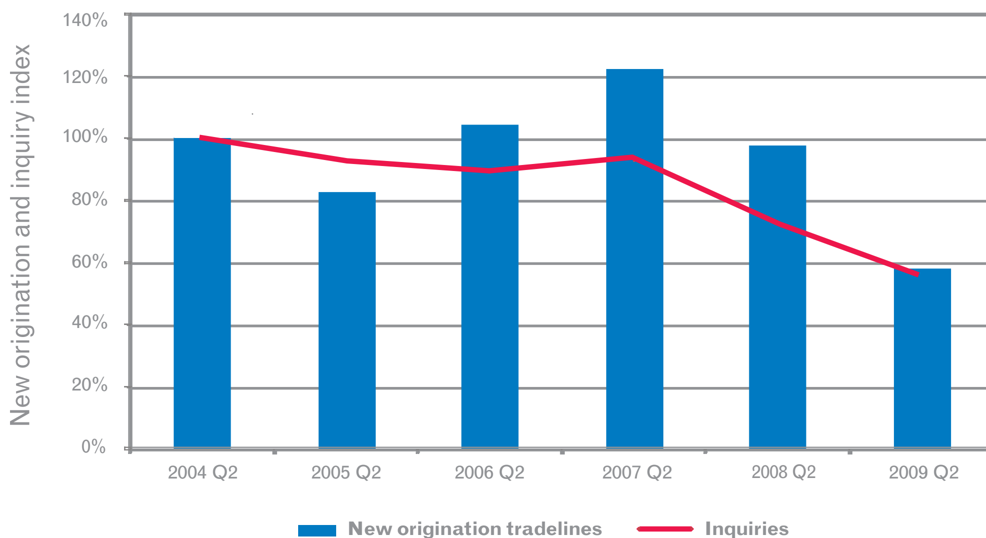

To confirm that we aren't just capturing shifts in inquiries due to downward or upward migration in scores, we also replicated the analysis, segmenting consumers by their VantageScore at each point in time. This test yielded similar results to those

observed in figures 4 to 8, confirming our finding that across the VantageScore spectrum, individuals continue to express an appetite for new credit.

To measure the gap that has grown between credit supply and credit demand from 2008 Q2 to 2009 Q2, we generated the Credit Supply Ratio by VantageScore band as illustrated in Figure 9.

Credit Supply Ratios by VantageScore

Figure 9

VantageScore Bands	2004 Q2	2005 Q2	2006 Q2	2007 Q2	2008 Q2	2009 Q2	Avg. ratio 2004 Q2–2008 Q2	2008 Q2–2009 Q2 % Change	Avg. ratio–2009 Q2 % Change
A: 901–990	1.59	1.52	1.61	1.55	1.40	1.06	1.54	-24%	-31%
B: 801–900	1.47	1.48	1.52	1.45	1.37	1.04	1.46	-25%	-29%
C: 701–800	1.17	1.15	1.16	1.11	1.08	0.80	1.13	-26%	-29%
D: 601–700	0.76	0.73	0.76	0.75	0.73	0.55	0.75	-25%	-27%
F: 501–600	0.33	0.29	0.39	0.43	0.45	0.34	0.38	-23%	-9%

The last column in Figure 9 shows the percentage change in the Credit Supply Ratio found in 2009 Q2 compared to the average Credit Supply Ratio taken from 2004 Q2 to 2008 Q2. We have taken the average over 2004 Q2 to 2008 Q2 to account for the variation of this ratio over time. The percentage change in the Credit Supply Ratio is largest in the low-risk bands A to C and smallest in the high-risk band F. This suggests that individuals in the low-risk bands are finding it difficult in today's environment to find credit, while those in the riskiest population, band F, have either stopped looking for credit or are being blocked even before an application is filed. Another hypothesis is that the gap in demand and supply for the low-risk consumers reflects their attempts to refinance their mortgages due to the very low mortgage rates in 2009. Of course, even if this were the main reason for a high volume of inquiries in 2009, the data still indicate that many of these attempts to refinance were unsuccessful.

Conclusion

Our research corroborates other analyses showing a contraction in credit supply as measured by outstanding volume as well as new originations. However, using our unique data assets, we have also analyzed whether the driver of the reduction in credit volume is demand or supply. We find that credit demand has declined less than credit supply. In fact, for higher-credit-quality consumers found in VantageScore Band A and Band B, demand has rebounded to near prerecession levels, with little decline at any time during the recession.

The implication of this analysis is that as lenders turn their attention to credit origination after surviving the current loss mitigation battle, credit volume should start to grow quickly. A lack of demand from consumers, at least those with good credit scores, will likely not be an impediment to growth. Whether such growth will be prudent is a separate question.

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