# Will Baby Boomers drown in debt?

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By Mauricio Soto*

## Introduction

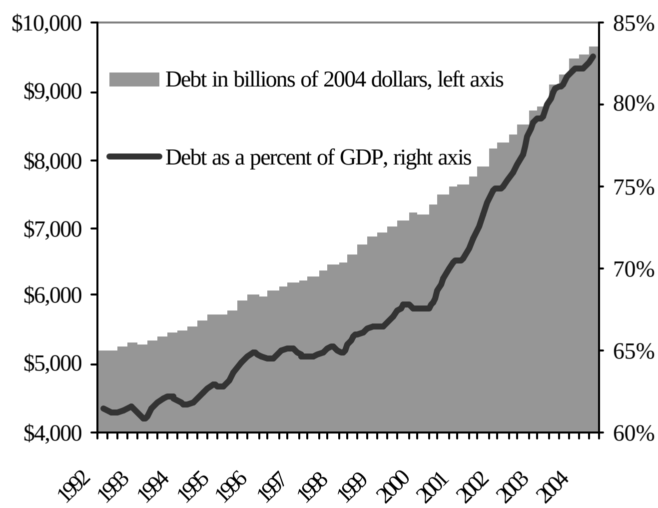
The fact that American households have debt is not a surprise: credit cards finance our purchases, car loans pay for our wheels, student loans help us with tuitions, and mortgages buy our homes. Yet the size of the debt can seem shocking. The aggregate burden runs to nearly $10 trillion, nearly twice what it was in 1992, even after adjusting for inflation.[1] Today, household debt is equivalent to more than 80 percent of the nation's economy, up from about 60 percent in the early 1990s (see Figure 1). Filings for bankruptcy have also soared. In 1991, 6 out of every 1,000 adults filed for bankruptcy. This rate climbed to 9 in 2001.[2] Given the potential of debt to undermine the retirement security of an aging population, this *Just the Facts* examines trends in the debt burden for older workers over the past decade and assesses how vulnerable baby boomers may be in the future.

Households aged 50 to 62 represent about 20 percent of American households and hold about a quarter of the total debt. About 11 percent of them have declared bankruptcy at some point in their lives.[3] As a result, some analysts have questioned whether baby boomers will have a comfortable retirement, and whether they will be able to pay back their obligations.[4]

Are future retirees going to be in trouble? Important measures of financial vulnerability suggest that the growth of debt might not be that worrisome. The combination of extraordinary asset growth and historically low interest rates allowed households to increase their debt relatively painlessly: their net worth grew significantly, and the portion of income used to pay for debt did not increase. This is not to say that baby boomers might not encounter a few bumps in the road or that some groups might not be vulnerable. But baby boomers as a group do not appear to have an immediate debt crisis.

Figure 1. Household Debt Has Soared

Household Debt, All Households, 1992-2004




Department of Commerce, *National Income and Product Accounts*, 2004; U.S. Department of Labor, *Consumer Price Index Data*, 2004.

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## Debt Trends for Households Aged 50-62

Table 1 shows that the extraordinary growth of assets between 1992 and 2004 compensated for the soaring debt. In the aggregate, the balance sheets of households did not deteriorate. On the contrary, the balance sheet of the group aged 50-62 in 2004 seems healthier and less leveraged than that of previous pre-retirement cohorts.

A common concern is the ability of households to meet the debt payments required by their lenders. The ratio of debt payments to income gauges this burden. Table 1 shows that only about 10 percent of the income of households aged 50-62 is used to service their financial obligations, a number that has changed little during the last ten years. In the aggregate, then, pre-retirement households appear to service their debt comfortably.[6]

How did households increase their debt and still keep their payments under control? The answer lies in two factors. First, lower interest rates reduced payments for every dollar borrowed. For example, the mortgage rate paid by households aged 50-62 went from 11.6 percent to 6.4 percent between 1992 and 2004.[7] Second, home-secured loans displaced other forms of debt. In 2004, mortgage debt was 77 percent of total debt, up from 67 percent in 1992 (see Table 2). The shift towards home-secured loans indicates that pre-retirement households held less of the "expensive" debt (e.g., credit cards, unsecured lines of credit) in 2004.

Table 1. Debt Burden Have Not Increased

Debt Ratios for Households Aged 50-62

| | 1992 | 2001 | 2004 Estimate |
|---|---|---|---|
| Debt as Percent of Assets | 10.0 | 9.1 | 10.0 |
| Debt Payments as Percent of Income | 10.7 | 10.0 | 10.2 |

*Note: Values adjusted for cohort size and inflation.

Source: Author's calculations based on U.S. Board of Governors, *Survey of Consumer Finances*, 1992 and 2001; U.S. Board of Governors, *Flow of Funds*, 2004.

Table 2. Mortgage Debt Has Become More Important as Interest Rates Have Dropped

Mortgage Debt Charactertistics for Households Aged 50-62

| | 1992 | 2001 | 2004 Estimate |
|---|---|---|---|
| Mortgage Debt as Percent of Total Debt | 66.5% | 73.9% | 77.1% |
| Average Interest Rate on Mortgage | 11.6% | 7.8% | 6.4% |

Note: Values adjusted for cohort size and inflation. Interest rates are weighted by mortgage size.

Source: Author's calculations based on Federal Housing Finance Board, *Monthly Interest Rate Survey*, 2004; U.S. Department of Labor, *Consumer Price Index*, 2004; U.S. Board of Governors, *Flow of Funds*, 2004; and U.S. Board of Governors, *Survey of Consumer Finances*, 1992 and 2001.

## Will Debt Haunt Future Retirees?

The previous analysis indicates that there will not be a debt crisis in the foreseeable future. But future retirees are not completely off the hook. They face risks that could create financial difficulties — especially for vulnerable groups.

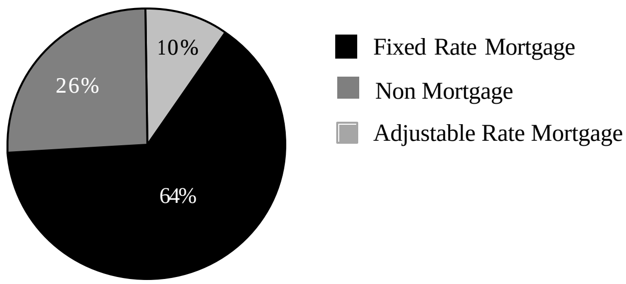
### Interest Rate Risk

Payment risks on adjustable rate loans depend directly on short-term interest rates. If short-term rates continue their recent upward trend, households with adjustable rate debt will see their debt payments increase in the near future. For example, a 100 basis point jump in rates increases payments on adjustable mortgages by more than 10 percent.

But the extent to which pre-retirement households will be affected by increases on interest is questionable. The effect will be limited because only about one third of the total debt held by households aged 50-62 is in the form of adjustable rate loans (see Figure 2); the majority of their liabilities are isolated from interest rate risk. In addition, much of the adjustable debt is of shorter duration or already carries a high interest rate, such as credit cards, so a rise in short-term rates would not dramatically increase these payments. In short, it is unlikely that future interest rate increases will require dramatically higher payments.

Figure 2. Most Household Debt Is Not Vulnerable to Rising Interest Rates

Composition of Aggregate Household Debt, Households Aged 50-62, 2001

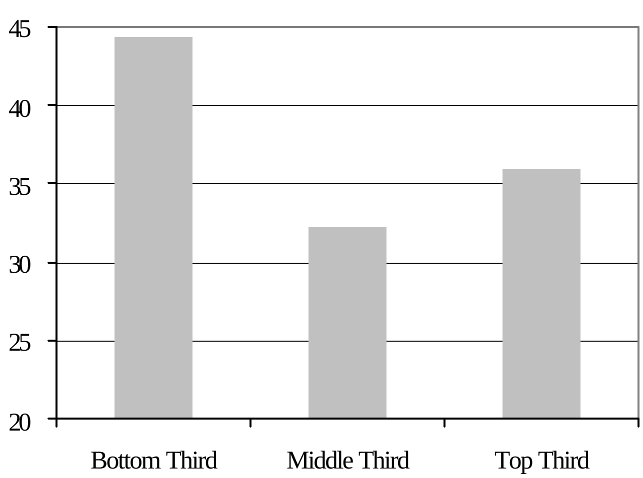



Source: Author's calculations based on U.S. Board of Governors, *Survey of Consumer Finances*, 2001.

A word of caution is necessary here. Risk derived from interest rate changes is spread unevenly across income brackets. Those in the lowest third of the income distribution tend to have a larger part of their total debt exposed to interest rate changes, which makes them more vulnerable than households with higher incomes. In 2001, for example, households in the lowest income bracket had nearly 45 percent of their liabilities in the form of adjustable-rate debt compared to 35 percent for the upper brackets (see Figure 3).

Figure 3. Low-Income Households are More Exposed to Higher Interest Rates

Adjustable Rate Debt as a Percent of Total Debt, by Income for Households Aged 50-62, 2001




Source: Author's calculations based on U.S. Board of Governors, *Survey of Consumer Finances*, 2001.

## Asset Value Risk

A sudden drop in asset values is another factor that could damage a household's balance sheet, increasing the possibility of financial distress. For example, as shown in Table 3, a rapid decline in real estate values would reduce housing equity and net worth, limiting access to further credit. This potential risk is especially important for those nearing retirement because home equity represents an important share of the total wealth holdings of this cohort, and home equity could potentially help to maintain consumption during adverse income or health shocks.[8]

Table 3. Declines in Housing Values Have Significant Effects on Home Equity

Changes in Home Equity Resulting from Declining Housing Values for Households Aged 50-62, 2001

| Change in Housing Value | Produces a Multiplied Change in Housing Equity |
|---|---|
| -10% | -14% |
| -25% | -35% |
| -50% | -71% |
| -75% | -106% |

Source: Author's calculations.[9]

Currently, there is no clear indication of an imminent and generalized drop of housing or any other asset values. But if this were to occur, to what extent would it affect households nearing retirement? For households aged 50-62, home equity is about 70 percent of the total house value. These households are fairly leveraged: a ten percent decrease in the value of the house reduces home equity by nearly 14 percent, and larger drops will reduce housing equity considerably (see Table 3). But the mortgage leverage works both ways, and households that hold debt are also likely to have benefited more than proportionally from increases in housing prices during the last few years.

Contrary to the patterns in interest rate risk, it seems that low-income households have lower exposure to changes in housing values relative to higher income groups. In fact, Figure 4 shows that for the lowest third of income, housing equity is more than three-fourths of the housing value; for the top third of income, home equity corresponds to only two-thirds of the total value of the house.

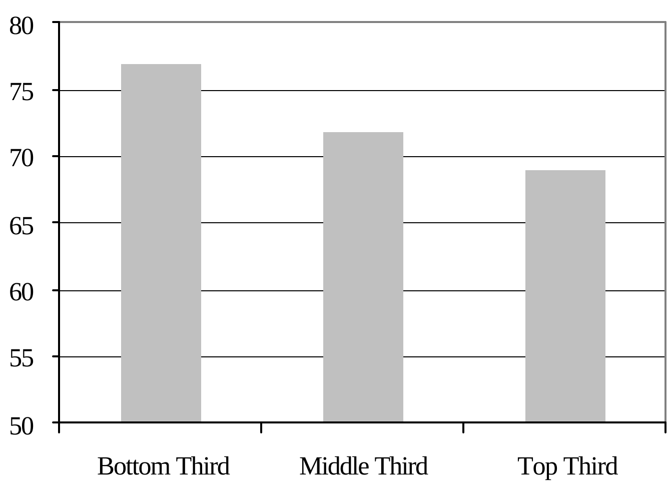
### Vulnerable Households

11 percent of households aged 50-62 in 2001 had previously filed for bankruptcy. This group is particularly vulnerable. They are much more leveraged than the rest of the baby boomers, and their debt payments constitute a relatively large part of their income. These households have not recovered completely from the financial troubles that lead them to bankruptcy. Table 4 compares the debt to asset and payment to asset ratios of this group with the rest of the cohort. These numbers show that those who filed for bankruptcy are at a higher risk of financial distress.

The lack of comparable bankruptcy data from 1992 limits the analysis of the trends for households that are vulnerable to financial distress. Another measure — the proportion of households that use more than 40 percent of their incomes to service debt — indicates that the share of households under high risk of distress remained at about 13 percent between 1992 and 2001.[10] If anything, the cohort of households aged 50-62 in 2004 looks less prone to financial distress than the previous generation.

Figure 4. Higher-Income Households Have a Lower Share of Home Equity

Home Equity as a Percent of Gross Housing Value, by Income for Households Aged 50-62, 2001




Source: Author's calculations based on U.S. Board of Governors, *Survey of Consumer Finances*, 2001.

Table 4. Households Who Have Filed for Bankruptcy Have Higher Debt Burdens

Debt Burden of Households Aged 50-62 that Previously Filed for Bankruptcy, 2001

| | Filed for Bankruptcy Before | Never Filed for Bankruptcy |
|---|---|---|
| Debt as Percent of Assets | 28.6% | 8.5% |
| Debt Payments as Percent of Income | 18.7% | 9.5% |

Source: Author's calculations based on U.S. Board of Governors, *Survey of Consumer Finances*, 2001.

## Conclusion

Although the debt of baby boomers increased dramatically, it does not appear to have endangered them as a group. Baby boomers do not seem to have trouble meeting monthly payments, as changes in the terms and composition of the debt kept their debt service close to 10 percent of their income and the extraordinary asset growth more than compensated for the increased use of debt.

Looking forward, baby boomers face risks that could create financial difficulties — especially for vulnerable groups. Future increases in interest rates could affect the payments for some households, especially those with low incomes. The end of the double-digit asset growth rates of the 1990s could limit future use of debt. And although in the aggregate these factors might have only a limited effect, at least one out of every ten households remains exposed to the risks of financial distress.

## Endnotes

1 All of the dollar values are expressed in 2004 dollars; all of the growth rates are real growth rates.

2 Warren (2003).

3 Author's calculations from the Survey of Consumer Finances, 2001. There are no comparable data for 1992. About 7 percent of households aged 63-79 in 2001 declared bankruptcy at some point in their lives.

4 See Draut and McGhee (2004), and Warren and Tyagi (2003).

5 Sources for 2004 projections: *1- Assets, Debt, Income and Mortgage Debt*: Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the US" (table B.100): Adjusted for pensions, non-profit organizations and other differences (See: Antoniewicz, 2000): Assets: subtract lines 5, 6, 27, 28 and the historical share of non-profits (4 percent from the total assets); Debt: subtract lines 35, 38, 40, 41 and the historical share of non-profits (9.5 percent of the total debt). *2- Payments:* Board of Governors of the Federal Reserve System, Household Debt Service and Financial Obligations Ratios.

6 Recent estimates of the "financial obligations ratio"– an alternative measure of the ability to pay used by the Federal Reserve – also suggest that the debt payment to income ratio has changed little since 1992.

7 For a 15-year mortgage, for example, a one-percentage point interest rate reduction allows households to increase their debt by about 5 percent without affecting monthly payments.

8 Venti and Wise (2000) find that home equity is generally not used to support "general non-housing consumption." However, older households use home equity to respond to "precipitating shocks" such as death or entry of a family member into a nursing home.

9 The leverage multiplier is calculated as 1/(1-DR), where DR=[Mortgage/House Value]. Households 50-62 have an aggregate leverage multiplier of 1.42.

10 Aizcorbe, Kennickell, and Moore (2003) and author's calculations.

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