July 22, 2019

Economics Group

Special Commentary

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Should We Worry About American Debt?: Part VI

Financial Sector Debt Not Overly Concerning at Present

Executive Summary

Leverage in the financial sector increased significantly in the years leading up to the financial crisis, and the rise in debt was especially marked among the government-sponsored enterprises, their associated mortgage pools and issuers of asset-backed securities. However, debt in the financial sector currently stands nearly $2 trillion lower than at its peak ten years ago, and the debt-to-GDP ratio of the sector has receded to a 20-year low. Deleveraging has been especially pronounced in the asset securitization part of the sector. Any concerns that readers may have about American debt at this time should probably not be focused on the financial sector.

The Overall Financial Sector Has De-Levered

In a series of reports that we have published recently, we have been analyzing debt in a number of sectors in the U.S. economy. As we showed in Part I, the aggregate amount of debt in the U.S. economy has trended higher over the past few decades and totals nearly $70 trillion today. We addressed debt in the household sector in Part II, and the debt of the non-financial business sector was the topic of Part III. We next turned our attention to public sector debt by delving deeper into federal government debt in Part IV and the debt of state and local governments in Part V. In this, our sixth report in the series, we analyze the debt of the U.S. financial sector.

Let's start with a brief overview of the private financial sector in the United States. For starters, the size of the sector mushroomed to $70 trillion on the eve of the financial crisis from $15 trillion in 1990. The sector subsequently contracted by about 5% by early 2009 before growing anew. Today, the financial assets of the private financial sector are just shy of $100 trillion.

Financial sector assets are fairly well distributed across different types of institutions.

Figure 1 shows the composition of the private financial sector on the eve of the financial crisis in Q3-2008. The assets of depository institutions (largely commercial banks) totaled $13.8 trillion, which represented about 20% of total sector assets at that time. Insurance companies (both property & casualty and life) had $6.7 trillion worth of financial assets, pension funds (private and public) accounted for $13.9 trillion, and mutual fund assets stood at $11.5 trillion. The assets of the government-sponsored enterprises (GSEs) and their associated mortgage pools together totaled $8.3 trillion, and issuers of asset-backed securities (ABS) had $4.4 trillion worth of assets.[1] The combined assets of other types of financial institutions, which include securities brokers & dealers, REITs, finance companies, funding corporations and holding companies, totaled $10 trillion in Q3-2008. In sum, financial sector assets were fairly well distributed across different types of institutions ten years ago.

The distribution of financial sector assets today is largely similar, although there have been some subtle changes over the past decade. The relative shares of depository institutions and insurance companies are little changed today relative to ten years ago (Figure 2). The relative sizes of mutual

[1] The GSEs include Fannie Mac and Freddie Mac as well as some smaller institutions. ABS issuers buy assets such as non-conforming mortgages, credit card receivables, etc. and package these cash flows into securities that are then sold to investors.

funds and pension funds are a bit larger today than they were in Q3-2008 due to the significant rise in asset prices over the past ten years. But the most notable change in financial sector assets relative to 2008 is the shrinkage in the relative shares of the GSEs and their associated mortgage pools and the issuers of ABS. Together, those institutions accounted for more than 18% of financial sector assets in 2008. Their combined share today is less than 11%. We will discuss the relative shrinkage of these sub-sectors in more detail subsequently.

Figure 1

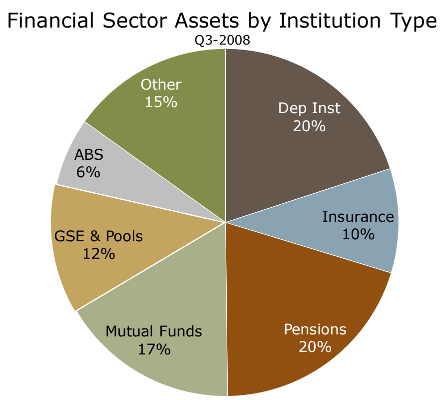
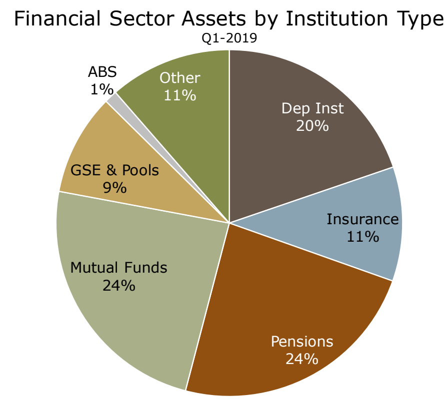


Figure 2

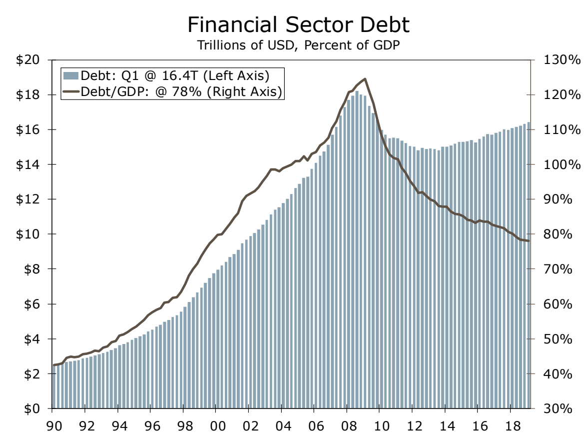


Source: Federal Reserve Board and Wells Fargo Securities

The debt-to-GDP ratio of the financial sector has receded to less than 80% today from nearly 125% in 2008.

As noted above, the financial assets of the private financial sector grew significantly between 1990 and 2008, and so too did the sector's debt. Specifically, debt in the U.S. financial sector exploded from $2.5 trillion in early 1990 to more than $18 trillion at its peak in 2008, which represents an average growth rate of more than 11% per annum (Figure 3). This rapid growth in debt pushed the sector's debt-to-asset ratio from 16% in 1990 to 27% in late 2008. Measured as a percent of GDP, financial sector debt trebled from 42% in 1990 to nearly 125% in 2008. But the bursting of the housing bubble led to some de-leveraging in the financial sector, and the amount of outstanding debt in the sector fell by more than $3 trillion between 2008 and 2012. It has subsequently inched higher, but at a rate of only 2% per annum on average. Debt in the financial sector currently stands nearly $2 trillion lower than at its peak ten years ago, and the debt-to-GDP ratio of the sector has receded to less than 80%, the lowest ratio in 20 years.

Figure 3



Source: Federal Reserve Board and Wells Fargo Securities

If the amount of financial sector debt is lower today than it was in 2008, then how have the assets of the sector grown by $30 trillion over that period? Part of the answer is that commercial banks and other depository institutions are relying more heavily today on checking and savings deposits, which are non-debt liabilities, to finance their assets than they were a decade ago. Because deposits tend to be a more stable form of financing than short-term debt instruments, the banking sector is not as vulnerable today as it was prior to the financial crisis. In addition, the value of pension assets and mutual fund shares, neither of which is financed *via* debt issuance, have increased markedly over the past ten years.[2]

De-Leveraging Has Been Paced by GSEs and ABS Issuers

Figures 1 and 2 showed assets held by type of financial institution. Figure 4 shows the breakdown of financial sector debt on the eve of the financial crisis. Whereas assets of the financial sector were (and still remain) broadly distributed, financial sector debt in 2008 was more concentrated. GSEs and their associated mortgage pools held 44% of the financial sector's debt at that time. ABS issuers, which securitized hundreds of billions of dollars of non-conforming mortgages, accounted for another 24% of the debt of the financial sector. All other types of financial firms (*i.e.,* finance companies, REITs, securities brokers & dealers, holding companies, and funding corporations) held one quarter of the sector's debt in aggregate.

Figure 4

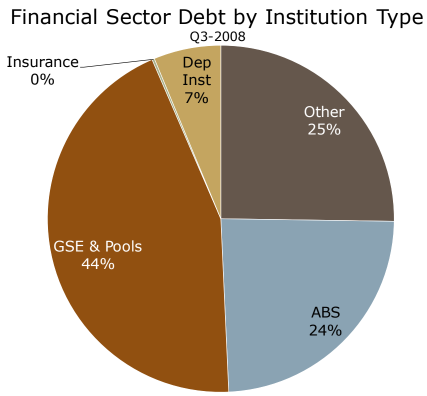
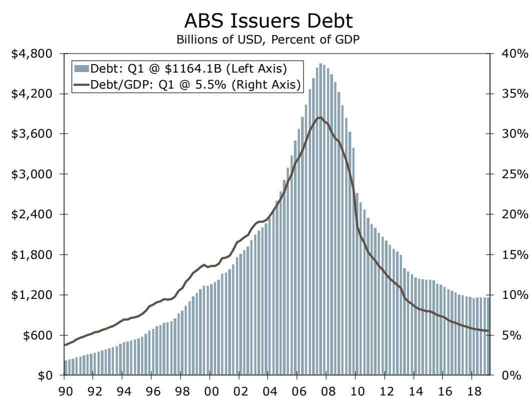


Figure 5



Source: Federal Reserve Board and Wells Fargo Securities

Institutions that securitize mortgages account for most of the debt in the financial sector.

In absolute terms, the GSEs, their associated mortgage pools and issuers of ABS together accounted for more than $12 trillion of the financial sector's debt of $18 trillion in Q3-2008. This relatively high level of debt reflects the business models of these institutions. Specifically, these institutions would issue debt to finance their purchases of mortgages, which they would then package into mortgage-backed securities (MBS) that they sold to investors. There was a seemingly insatiable demand for MBS as the housing bubble inflated, and the GSEs and ABS issuers had little trouble issuing debt securities to finance their purchases of mortgages during the early years of the past decade.

The implosion of the housing bubble caused the demand for MBS that were securitized by non-conforming mortgages to nosedive. The amount of debt among ABS issuers plunged from nearly $4.7 trillion in mid-2007 to less than $1.2 trillion today (Figure 5). Consequently, the share of financial sector debt that is held on the books of ABS issuers has dropped to only 7% today (Figure 6) from 24% in Q3-2008 (reference Figure 4). As a percent of GDP, ABS debt swooned from more than 30% in 2007 to roughly 6% in Q1-2019.

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[2] The bulk of the pension assets of the private sector are held today in defined contribution plans such as 401k plans. The shares that investors own are liabilities of the mutual fund companies and pension plans. We discussed the pension obligations of the state and local governments in Part V of this series.

Figure 6

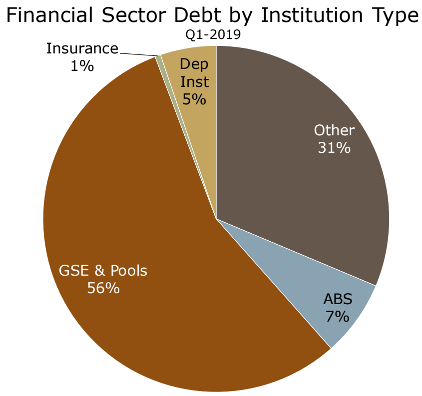
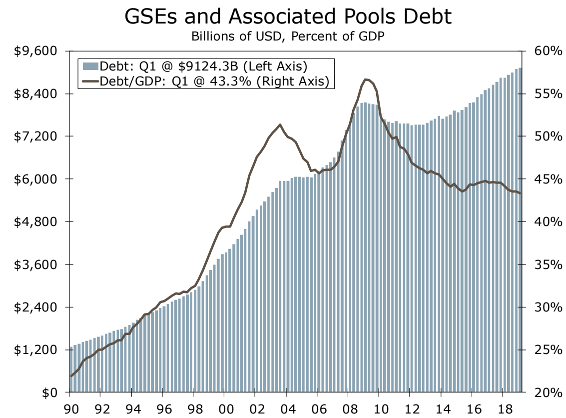


Figure 7



Source: Federal Reserve Board and Wells Fargo Securities

Debt is not an important means through which to finance asset acquisition for many types of financial institutions.

Whereas GSEs and their associated mortgage pools accounted for 44% of financial sector debt ten years ago, their share has risen to 56% today. Part of this increase in share reflects a smaller pie. As noted previously, the aggregate amount of financial sector debt is $1.8 trillion lower today than it was a decade ago. But part of the increase in share reflects the modest net increase in GSE and mortgage pool debt over the past decade. As shown in Figure 7, the debt of these institutions totaled more than $8 trillion in early 2009. After a modest decline, debt started to grow again and currently exceeds $9 trillion. As a percent of GDP, however, the debt of the GSEs and their associated mortgage pools has receded from 57% ten years ago to 43% today. Aside from the GSEs and ABS issuers, debt is not an important means through which to finance asset acquisition (depository institutions, insurance companies and mutual funds) or it represents a relatively small portion of the overall financial sector (finance companies, REITs, broker/dealers, holding companies and funding corporations).

Conclusion

The debt of the U.S. financial sector rose significantly in the first decade of the 21st century as the American housing bubble inflated. The leveraging of the household sector, which we addressed in Part II of this series, and the build-up in debt in the financial sector occurred in tandem. Consumers were eager to take on mortgage debt to finance house purchases, and these mortgages were subsequently purchased by the GSEs and ABS issuers, *via* debt issuance of their own, and then sold to investors in the form of MBS. However, the bursting of the housing bubble led to a de-leveraging of both the household and the financial sector. In that regard, the debt-to-GDP ratio of the financial sector has receded to a 20-year low.

More than one-half of the financial sector's debt is held on the balance sheets of the GSEs and their associated mortgage pools today. Indeed, the combined debt of those institutions is higher today than it was a decade ago. But a replay of the events that brought the GSEs to their knees in 2008 does not seem likely in the foreseeable future. As we discussed in more detail in Part II, the financial health of the household sector has improved markedly over the past ten years. The household debt-to-income ratio has receded by more than 30 percentage points since its peak in 2008, and the financial obligations ratio of the household sector currently stands near a four decade low. Widespread defaults by households on their mortgage debt does not seem to be in the cards.

More broadly, we do not view the debt of the financial sector to be overly concerning at present. The amount of sector debt today is nearly $2 trillion lower than it was a decade ago, and the debt-to-GDP ratio of the financial sector is down by nearly 50 percentage points. Any concerns that readers may have about American debt at this time should probably not be focused on the financial sector.

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