Center for American Progress

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Introduction and Summary

The U.S. credit card market is showing signs of trouble just as the home mortgage crisis surges to unprecedented heights across the United States and throughout the global financial marketplace. Against the backdrop of record-high numbers of home foreclosures, lenders are tightening mortgage lending standards, making it harder for families to maintain their consumption in the face of weakening income growth. At the same time, credit card issuers present their all-too-convenient lending product as a much needed but inevitably dangerous pressure valve for cash-strapped borrowers.

As borrowing in the mortgage market slows, credit card borrowing is accelerating—a dangerous trend because borrowers still face weak income growth. That means the credit card market could eventually run into the same problems that now afflict the subprime mortgage market.

The lending industry that no longer aggressively issues subprime mortgages continues to aggressively market credit cards, especially credit cards with subprime-like lending terms, such as a variety of higher fees that are poorly disclosed. In the end, more and more borrowers could end up defaulting on their credit card debt because they do not fully understand the terms and conditions of their new plastic, which could prove detrimental to their financial health. Déjà vu all over again!

The consequences could deliver further uncertainty to financial markets and additional turmoil to the economy as more consumers file for bankruptcy, driving down the value of securitized credit card receivables. Evidence of these consequences is now emerging. Specifically:

- **Growth in mortgages slowed as the subprime crisis unfolded, but simultaneously credit card debt began to rise again.** Between April 2006 and December 2007, the last month for which complete data are available, inflation-adjusted credit card debt accelerated at a rate four times faster than between March 2001, when the last business cycle ended, and April 2006. This increase in credit card debt compensated for a substantial part of the slowdown in mortgages.

- **Banks tightened access to mortgages, but at the same time continue to aggressively offer credit cards.** Lenders tightened mortgage standards in 2007 more than at any point since 1991. At the same time, lenders continued to push credit cards with a particular emphasis on subprime-like credit cards.

- **High fees, heavy interest rate burdens, and complex terms may lead to increased default.** Credit card debt tends to carry substantially higher costs than other forms of credit due to myriad fees in addition to high interest rates. The result is that many borrowers unwittingly slide deeper and deeper into debt as they fall prey to the lack of transparency in credit cards.

- **Already the share of credit card debt that is written off by banks has risen sharply.** Between March 2006 and September 2007, the last month for which this data is available, the share of credit card debt that was charged off by credit card lenders rose from 3.0 percent to 4.0 percent—a growth rate of 34.2 percent in less than two years.

- **Increased defaults could unravel the $915 billion in securitized debt backed by credit card receivables, just as delinquencies in the housing market unraveled the $900 billion in mortgaged-backed securities.**[1] Just like mortgage-backed securities, credit card debt is packaged and sold to investors. An increase in defaults could lead to losses not just for the credit card lenders, but also for pension funds and investors who bought the debt.

A possible unraveling of the U.S. credit card market, with all the attendant costs to global financial markets, could be partially nipped in the bud with improved transparency for credit cards. Policymakers should take two approaches.

First, implement a credit card safety rating system that can give consumers better information about their credit cards and thus help them make better decisions. This system would be similar to the five-star crash test rating system for new cars. Credit cards would be awarded stars based on a points system, with cards earning points for consumer-friendly terms and losing them for terms designed to get consumers into trouble.

Such a system has already been introduced in the Senate by Sen. Ron Wyden (D-OR) as the Credit Card Safety Star Act. The safety rating system would not preclude additional regulation or legislation that will eliminate other features that may be considered abusive or unfair.

Second, in addition to a credit card safety rating system Congress should go further to mandate a higher level of fairness in credit card terms. Several members of Congress have introduced bills that would do that. Rep. Carolyn Maloney (D-NY), with the backing of House Financial Services Committee Chair Rep. Barney Frank (D-MA), recently introduced the Credit Cardholders' Bill of Rights Act. This bill takes a balanced approach to banning several of the most abusive credit card practices.

Another balanced approach was introduced by Sen. Carl Levin (D-MI) as the Stop Unfair Practices in Credit Cards Act, which also contains limits on many of the most unfair practices. These bills would eliminate the most common pitfalls consumers face and could help them make better decisions with their debt.

In the pages that follow, we will examine in detail the relationship between slowly growing U.S. mortgage markets, the suddenly aggressive growth of credit card debt, and what both trends could mean to borrowers, their lenders, and global financial markets. With this analysis in hand, it becomes increasingly clear that the credit card disclosure reforms we suggest are timely and necessary.

The Swift Turn to Plastic

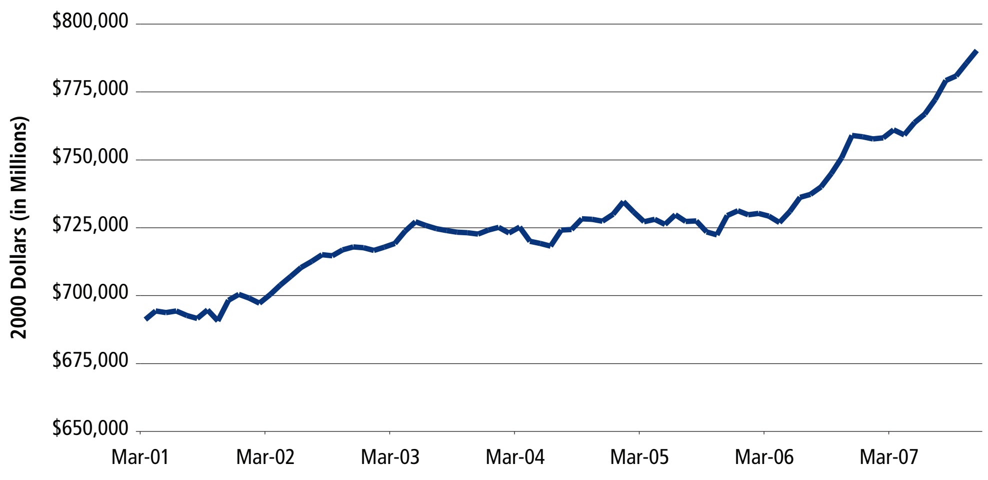
Credit card debt increases as growth in mortgages slumps

Between April 2006 to September 2007, growth in mortgage lending declined as the subprime mortgage crisis unfolded, yet over the same period credit card debt rose dramatically. This important shift in lending and borrowing patterns—amid the turmoil in global financial markets due to subprime mortgage crisis—went largely unnoticed.

But consider the suddenly accelerated growth of real credit card debt in the most recent 20 months of data available. The level of credit card debt, adjusted for inflation, has been on the rise since the start of the current business cycle in March 2001. Between April 2006 and December 2007, however, inflation-adjusted credit card debt increased at an annualized average monthly rate of 4.7 percent—more than four times faster than the annualized average monthly rate of 1.1 percent between March 2001 and March 2006, when credit card debt was already at a record high level (See chart, below)

In November 2007, real credit card debt stood at $790.2 billion, the highest amount of credit card debt ever recorded.

ACCELERATED GROWTH, RECORD AMOUNT OF CREDIT CARD DEBT
Real Credit Card Debt (in Millions), March 2001 to December 2007



Source: Authors' calculations based on Board of Governors, Federal Reserve System, 2008, Release G.19 Consumer Credit. Washington, DC: Board of Governors, Bureau of Economic Analysis, 2008, National Income and Product Accounts, Washington, DC: Department of Commerce.

Credit card debt is increasing not only in real terms but also relative to family's incomes. Credit card debt as a percent of disposable personal income stood at a record high level of 9.6 percent in May 2001, just after the last economic expansion ended (see Chart, below), and actually declined for a period of time during the housing boom. Over most of the current business cycle, credit card debt relative to income declined as other, lower-cost forms of credit, especially home equity lines of credit and refinancings in the mortgage market, became increasingly available.

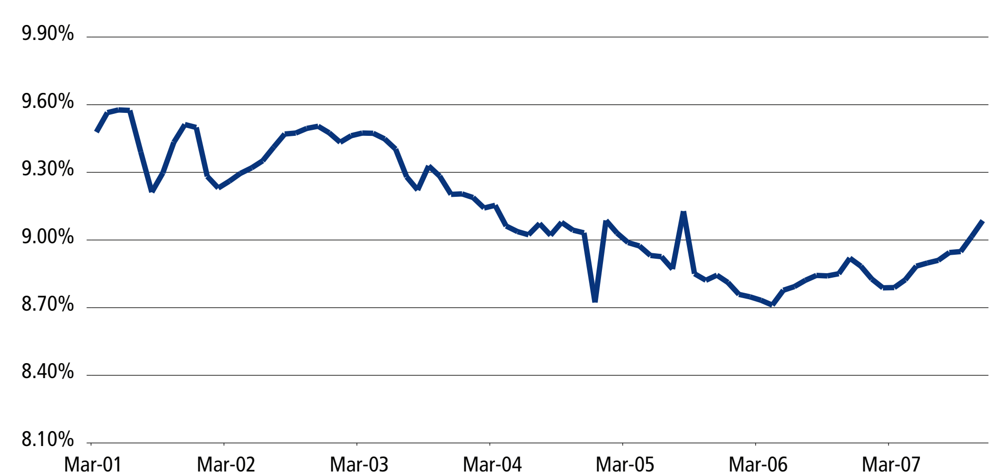
Between March 2001 and March 2006, credit card debt as a percent of disposable personal income *decreased* at an annualized average monthly rate of 0.2 percentage points. But starting in April 2006, credit card debt grew relative to disposable income, increasing at an annualized average monthly rate of 0.2 percentage points from April 2006 to December 2007. By December 2007, credit card debt relative to disposable income stood at 9.1 percent.

This sudden acceleration in credit card debt came at a time when homeowners turned away from new mortgage loans, loan refinancings, or home equity lines of credit. It would seem that tightening access to credit in the mortgage market forced families to look elsewhere to borrow money to pay for ever more costly necessities, such as health care, transportation, utilities, and food, in a weakening labor market.

Mortgage debt as a percent of income did grow between April 2006 and September 2007, the last period in which complete data was available. The chart below shows the year-over-year percent change in the growth of mortgage debt as a share of personal disposable income. Yet even though the growth rate since March 2001

RELIANCE ON PLASTIC ON THE RISE

Credit Card Debt as a Percent of Disposable Personal Income, March 2001 to December 2007



Source: Authors' calculations based on Board of Governors, Federal Reserve System, 2008, Release G.19 Consumer Credit. Washington, DC: Board of Governors, and Bureau of Economic Analysis, National Income and Products Accounts. Washington, DC: U.S. Department of Commerce.

remained positive, it has declined precipitously since the first quarter of 2006. In fact the growth rate was a mere 1.9 percent in September 2007—the lowest rate since the start of the current business cycle in March 2001.

Comparing the deceleration of mortgage debt with the acceleration of credit card debt shows that a substantial part of the lost mortgage debt appeared in the form of credit card debt. On average, mortgage debt expanded at an annualized average rate of 6.0 percentage points relative to disposable income between March 2001 and March 2006. After March 2006, the rate of increase slowed to an average of 3.5 percentage points.

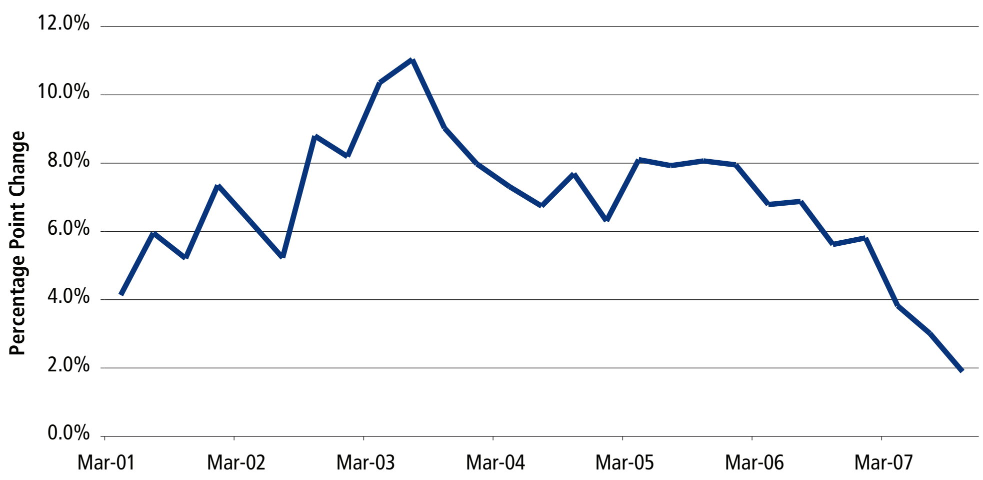
The difference in the mortgage expansion rate, however, is 2.5 percentage points when comparing the slow mortgage growth period after March 2006 with the high mortgage growth period before March of last year. In comparison, the expansion rate of credit card debt accelerated by 0.4 percentage points during the same period. That means 15.6 percent of the lost access to mortgages was compensated for by increases in credit card debt after the spring of 2006.

The upshot: Rising credit card debt since April 2006 amid the decrease in the mortgage expansion rate resulted in a substantial shift to credit card borrowing from mortgage debt. This is a clear warning sign that consumers who once relied on home equity to make ends meet are now increasingly relying on credit cards.

And just as homeowners defaulting on their mortgages set off the subprime mortgage fiasco, in the near future consumers who default on credit cards could cause a credit card crisis in financial markets.

MORTGAGES MAKE UP LESS OF DISPOSABLE INCOME

Year-Over-Year Percent Change: Mortgages as a Share of Personal Disposable Income, March 2001 to September 2007



Source: Authors' calculations based on Board of Governors, Federal Reserve System, 2008, Release G.19 Consumer Credit. Washington, DC: Board of Governors, and Bureau of Economic Analysis, National Income and Products Accounts. Washington, DC: U.S. Department of Commerce.

The Swift Growth of Plastic Debt

Banks tighten access to mortgages, continue credit card marketing

The increase in credit card debt may also be due to lenders' more strict standards for mortgages, which increasingly tightened over the past three quarters of 2007. In a survey conducted by the Federal Reserve in January 2008,[2] 52.9 percent of senior loan officers indicated that they had tightened their lending standards on prime mortgages over the prior three months, as compared to only 14.3 percent that reported having done so in a July 2007 survey.

When asked about subprime mortgage loans, 84.6 percent of respondents in January 2008 had tightened their lending standards over the prior three months. In fact, when asked this question in July, 40.5 percent of respondents tightened standards in the prior three months. These numbers tell us that lenders are increasingly pulling back the amount of credit available through mortgage lending.

Even though the rise in credit card debt largely is demand-driven, lenders seem to be increasing their presence in the subprime credit card market, if not the prime credit card market. Credit card solicitations are still sent out to U.S. families en masse—some estimate that over 6 billion mailings are sent by credit card issuers to U.S. families every year.[3]

The Boston Globe recently reported that direct mail credit card offers to subprime customers jumped 41 percent in the first half of 2007 as compared to the first half of 2006.[4] Similarly, offers sent to high-risk households—defined as those using more than 30 percent of their available credit—grew 5 percent between the second and third quarters of 2007, to 363 million mail offers.[5]

This continued high rate of solicitation by credit card lenders occurs as fewer consumers are able to tap equity in their home to bankroll their expenses. More and more borrowers may turn to credit cards to satisfy their credit needs. Lenders, it seems, are willing to see their credit card customers go deeper and deeper into debt.

Plastic debt comes at a high price

Credit card debt tends to carry substantially higher costs than other forms of credit due to a myriad of fees and confusing terms—especially the terms that determine what actions could cause the lender to raise rates. Credit card companies now have innumerable fees that may apply—late fees, annual fees, over-the-limit fees, cash advance fees, balance transfer fees, annual fees or set up fees, fees for foreign transactions, and fees to pay the balance by telephone.[6]

This is worrisome as about 35 percent of active cardholders already pay late and/or over-the-limit fees, among the most costly fees associated with credit cards. All of this is hidden in the legalese of cardholder agreements. A 2006 Government Accountability Office report found that credit card disclosures are written well above the eighth grade level at which about 50 percent of U.S. adults read.[7]

Due to unclear cardholder agreements, many cardholders don't understand what actions can cause credit card lenders to raise their rates, according to interviews with cardholders conducted as part of the GAO report.[8] Credit card companies can raise their rates for a number of reasons. A lender most commonly raises its rate when the borrower is in "in-card default," or when she is late on payments on that lender's card.

A lender, however, can also raise its rate if the borrower is late on a completely *different* credit card. This phenomenon is known as universal default, a condition where a late payment at one lender can lead to increased rates among all of a borrower's credit cards. This is legal so long as a lender notifies borrowers in advance—a clause that is usually buried in the legalese.

In fact, credit card lenders can raise the rate for no reason at all. A prime example: In mid-January 2008, Bank of America sent letters to its cardholders, saying it would more than double their rates to as high as 28 percent, giving no explanation for this move. As reported in an article in *Newsweek*, cardholders who called the lender were unable to get a clear answer about the increase, even after explaining that they had good credit and their accounts were in good standing.[9]

Other terms in cardholder agreements are equally misleading and opaque. For example, in the feature known as "double-cycle billing," consumers are charged interest on debt that has already been repaid. Consider a consumer who begins a billing cycle with a zero balance, charges $1,000 on her credit card and makes a payment of $900. Under double-cycle billing, he or she would be charged interest on the full $1,000, rather than on the remaining $100 that is still owed. Double-cycle billing is one of many opaque terms of cardholder agreements that make it very difficult for consumers to perform on their loans.

The result is that many borrowers unwittingly slide deeper and deeper into debt as they fall prey to the lack of transparency in credit cards. Fifty-eight percent of credit card customers carry balances every month, and 35 million customers can only afford to make the minimum payment every month, which means it could take years for them to pay off their debt.[10]

Banks charge off an increasing amount of credit card debt

Lenders are increasing the amount of credit card charge-offs, a warning that defaults have increased and may continue to do so. Charge-offs are the value of loans a lender removes from its books and charges against its loss reserves once these loans are deemed delinquent. In the third quarter of 2007, all lenders charged off 4.0 percent of their credit card loans, an increase of 25 percent from the first quarter of 2006, when lenders charged off 3.0 percent of credit card loans in their portfolios.[11]

Due to a change in the bankruptcy code, data from 2005 and earlier are not comparable to these figures. But other pre-2005 data is relevant to this analysis: Over the twenty-year time period from 1986 to 2005,[12] quarters with a lower than normal increase in disposable personal income were followed by quarters with credit card charge-off rates that were higher than normal.

That is, quarters in which the year-over-year growth rate in disposable personal income was less than the mean growth rate of this time period—minus half a standard deviation—were followed by a charge-off rate that averaged 4.6 percent of total credit card debt. In contrast, over periods of steady income growth, the average charge-off rate was 4.2 percent of total credit card debt.

Reports of increased defaults are already surfacing: In December, an average of 7.6 percent of credit-card loans were either at least 60 days delinquent or had gone into default, up from 6.4 percent a year earlier.[13]

The weakening of income growth since 2000[14] makes defaults all the more likely. Historically, weakening income growth was followed by higher credit card default rates than was otherwise the case. In times when consumers' incomes do not increase at their usual rate, a period of higher charge-offs follow—an indicator that consumers are turning to credit cards just before credit card defaults begin to rise.

With our nation's economy teetering dangerously toward recession, and the possibility of income growth slowing even further, the likelihood for increased charge-offs is high.

The risk of rising defaults on credit card-backed securities

For credit card borrowers, this is obviously dangerous to their overall financial health, but for financial markets in general this could also be worrisome. The credit card securitization market has many similarities to the mortgage securitization market, not the least of which is their size: Credit card securities are valued at $915 billion, an eerily similar number to the $900 billion in mortgaged-backed securities now central to the subprime fiasco.[15]

Further, lenders package credit card debt into securities through the creation of so-called special purpose vehicles for sale to investors, which is similar to the securitization process for subprime mortgages. And, just like mortgage-backed securities, the debt in these securities is classified into tranches by risk. Investors who want a decent return on their investment pick a safe level of risk, while those investors who are willing to take more risk may have a greater payoff.

This has several benefits for the lender: Through securitization, a lender can free up its capital to make more loans, and can diversify its funding sources. Securitization, however, is not without its risks: If the quality of the receivables—the inflow of payments on the loans—turns bad, the securities don't perform well, and their investors lose money.[16]

We saw how this played out in the subprime mortgage crisis. Poor underwriting standards—that is, consumers' inability to understand their mortgage loans, and borrowers' inappropriate financial situation to take out these subprime loans—led to increased defaults by borrowers. This in turn led to losses by investors holding mortgage-backed securities.

Yet credit card securitization and mortgage securitization differ in a couple of ways. The market for credit card securities is over 20 years old, as opposed to the more recent development of private sector mortgage-backed securities. And loan underwriting is done by lending institutions rather than brokers who drew up terms that were more difficult to understand and may not have been fully scrutinized by the lending institutions and rating agencies before being securitized and sold.

This may explain why, in the face of rising concerns over and shrinking volumes of subprime mortgage securitizations, credit card securitization has not experienced substantial material changes. In fact, the volume of credit card securitization made between the beginning of 2007 and October 2007 was $83.84 billion, up from $58.12 billion over the same period of 2006.[17]

The rating agencies also see no immediate adverse implications to the rise in bad credit card debt for the performance of these credit card debt-backed securities. Moody's stated that rising amounts of bad credit card debt until some time in 2009 carries "no immediate ratings implications" for securities backed by credit card receivables.[18] Moody's also expects repayment levels and average yields on securitization bonds "to remain strong."

Similarly, the rating agency Standard and Poor's said that credit card securities investors are unlikely to experience payment defaults, even on lower-rated securities.[19] The rating agency says that the only apparent and limited consequence of the turmoil in the credit markets for bonds backed by credit card debt is that there "elevated securitization spreads, including on highly rated securities."

So, banks pay more and investors receive more, although the volume of securitization does not seem to be affected and the higher risks underlying this price increase do not appear in changed ratings.[20] Still, it is unclear how the growth in credit card defaults will ultimately impact the securitization of credit cards. Some of the primary concerns are that increased credit card defaults could ultimately translate into higher loan default and thus a liquidity crisis similar to that in the mortgage market.

Lenders give mixed signals on how they deal with rising defaults

In response to what appears to be a brewing storm, lenders are giving mixed signals on how they will respond. As news of increased defaults broke in February 2008, credit card lenders announced that they were tightening lending standards on existing credit card accounts and new credit card offers.

A number of big card issuers said they would limit how often they increase credit lines for their customers, or were in fact reducing the amount of existing credit lines held by their customers. Others announced they would require higher credit scores before issuing new cards, and would offer lower initial credit lines to those applying for new cards.[21]

Yet regardless of their tightened standards, credit card lenders persist in indiscriminately marketing credit cards with opaque terms that make them difficult for consumers to use them responsibly. Despite the warning signs, lenders still send innumerable solicitations by mail and market heavily through other channels—showing that they demonstrate little discretion in expanding the market both to new customers and to customers who already have credit lines.

Conclusion

As warning signs pop up, credit card lenders and financial regulators should pay attention to the similarities between the credit card market today and the subprime mortgage market before the beginning of the meltdown at the end of last summer. The data also show that homeowners who once relied upon mortgage debt to stay financially afloat are quickly becoming reliant on credit card debt.

That's a dangerous trend for credit card borrowers, lenders, and financial markets alike. To give consumers better information on the terms of their credit cards, and to eliminate the most opaque and difficult-to-understand credit card terms, we recommend a two-fold approach.

First, to give consumers better information on the terms of their credit cards, policymakers could implement a credit card safety rating system, as proposed in the Center for American Progress paper "Safety Sells."[22] Such a system has been introduced to the Senate by Sen. Ron Wyden (D-OR) as S. 2411, the Credit Card Safety Star Act.

Similar to the five-star crash test rating system for new cars, a credit card rating system would give consumers information about their credit cards so they can make better decisions. Credit cards would be awarded stars based on a points system, with cards earning points for consumer-friendly terms and losing them for terms designed to get consumers into trouble.

Card issuers, for example, that can change the terms of an agreement at any time for any reason would receive a one-star safety rating, while credit cards that give 90 days notice before the issuer intends to change terms, or cards that write their agreements at an accessible reading level would get more stars.

Many of the cards available on today's market may be rated only one or two stars under such a system, but once card issuers had to compete on the basis of providing a consumer-friendly product, they would soon begin to offer four- or five-star cards. Further, the safety rating system would not preclude additional regulation or legislation that will eliminate other features that may be considered abusive or unfair.

Second, in addition to a credit card safety rating system, Congress should go further to mandate a higher level of fairness in credit card terms. Several members of Congress have introduced bills that would do exactly that. Rep. Carolyn Maloney (D-NY), with the backing of Rep. Barney Frank (D-MA), chair of the House Financial Services Committee, recently introduced the Credit Cardholders' Bill of Rights Act. This bill takes a balanced approach to banning several of the most abusive credit card practices.

Among its provisions, Rep. Maloney's bill would require lenders to give cardholders 45 days notice of any interest rate increases and the right to cancel their card and pay off the existing balance before the increase takes place. This would give more information and decision-making ability to consumers like those stuck in the aforementioned scenario where Bank of America arbitrarily raised their rates without notice.

Another balanced approach was introduced by Sen. Carl Levin (D-MI) as the Stop Unfair Practices in Credit Cards Act, which also contains limits on many of the most unfair practices. Like Rep. Maloney's bill, Sen. Levin's bill would also prohibit lenders from practicing double-cycle billing, the practice where lenders can impose interest charges upon debt paid on time and in full. Among its other provisions, Levin's bill would also limit penalty interest rate increase to no more than 7 percent.

When consumers better understand the terms and conditions of their credit, and if cardholder agreements are changed to give more decision-making ability to consumers, Americans will be able to make better choices about their credit cards. Unless action is taken, credit card debt could become the latest financial fiasco.

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Tim Westrich is Research Associate at the Center for American Progress. He works primarily on the Economic Mobility Program, which focuses on developing innovative solutions to address low-income households' experience with housing, debt, and higher education. Prior to working at the Center, Westrich was a research analyst at the National Community Reinvestment Coalition, where he helped to develop NCRC's policy positions on subprime mortgage lending and provided technical assistance to local housing organizations.

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