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TALKING BUSINESS

Credit Cards Are Frothy, Not Bubbly

By [JOE NOCERA](#)

A month ago, BusinessWeek ran a cover article essentially predicting that credit cards would be the next shoe to drop in our increasingly precarious economy. “The party was paid for with credit cards,” read the magazine’s bold cover line. “The hangover will be a whopper.”

In the article itself, BusinessWeek had anecdotes about rising defaults, weakened credit card securitizations (all of which, by the way, have triple-A ratings, just as their subprime brethren once did), and lower profits for the big credit card banks like [JPMorgan Chase](#) and [Capital One](#). [American Express](#) has raised its loan loss provisions by 70 percent; Capital One has put \$2 billion aside for loan losses, and might need to do more. And on and on.

As for consumers, BusinessWeek had no trouble finding people who were facing suddenly higher interest rates and lower credit limits as the companies began taking measures to hold their losses down. Even bankruptcies are once again on the rise — this despite the tougher bankruptcy law that the banking industry helped pass three years ago. The article ended with a bank analyst saying, “We’re in uncharted territory.”

Yes, we are. As it happens, I spent this week rummaging around the world of credit cards, trying to answer the same question as BusinessWeek. I found my own set of scary statistics, and talked to credible bears who feared the worst. “Is it a ticking time bomb?” asked Sean Egan, co-founder of the independent ratings firm Egan-Jones — and a man who has been prescient about the subprime crisis. “Absolutely.” And I watched, via the Web, a Congressional subcommittee hearing aimed at stopping some credit card abuses that have become rampant.

My initial instinct was also to believe that credit cards would be a rerun of the subprime mess — as consumers got in deeper and deeper trouble, the pain would move up the food chain, affecting Wall Street and the companies as much as Main Street. Capital One would become the credit card version of Countrywide; securities built around credit card receivables would crumble, just like subprime securities.

But what I actually discovered has made me question that assumption, and now I’m not so sure it’ll turn out that way. Which is not to say there aren’t problems with credit cards — or that many credit card users aren’t going to feel a fair amount of pain. They surely are. It’s just that, to a maddening degree, credit card companies will actually do O.K. while the rest of us suffer. Annoying, isn’t it?

There are few consumer products that generate as much psychic conflict as credit cards. We love their ability to allow us to buy things on the spur of the moment, and we fear that same ability. We like knowing that we are carrying a \$20,000 or \$30,000 line of credit in our pockets — and we worry about the trouble such an

unsecured limit can cause. Credit cards enable foolish impulse purchases, but they also make it possible to buy things on credit — furniture, television sets, refrigerators — that are absolute necessities. They help us get through crises, but they can also help create crises if we're not careful.

Stuart Vyse, a psychology professor at Connecticut College and the author of a new book on the psychology of credit cards, said that “immediate choices are extremely powerful and difficult to resist” and that credit cards play into that desire for immediate gratification. He believes that they have played a big role in the fact that the United States now has a negative savings rate.

Our inner conflict over credit cards has been there, really, ever since cards first became popular in the 1960s. Ministers used to denounce them from the pulpit as the devil's plaything — and yet people embraced them nonetheless: credit card spending increased every year in the 1960s and 1970s. Back then, of course, they were far more benign than they are now, with high minimum payments, fairly low credit limits, and interest rates that were kept low by state usury laws. I remember one of the original credit card pioneers explaining to me years ago what he hoped the new BankAmericard might do for the bank's customers.

“The biggest thing a credit card can do is enable families to take advantage of sales — to buy your skis in the summer and your barbecue grill in the winter,” he said. It was a simpler world, wasn't it?

Now it's not so simple. Over the past 15 years especially, credit card issuers have become among the most sophisticated businesses on earth, with proprietary research that tells them almost everything about their customer base. They know how to extract the maximum profit from those customers; they've created all kinds of hidden fees, used teaser rates to draw in new customers. With their low minimum payments and exorbitant interest rates — those state usury laws were rendered moot nearly three decades ago — they can even make money in cases where the customer never actually pays off the loan. They can also tell from customer behavior when a borrower is becoming “higher risk” — and they have the contractual right to jack up the interest rates to hedge that risk, even if the customer hasn't missed a payment.

As Dean Starkman nicely phrased it in the latest issue of *The Columbia Journalism Review*, the credit card industry “has shifted from a lending and underwriting paradigm to a sales paradigm; penalties, fees and default interest at rates that were illegal a generation ago are no longer regrettable outcomes to be avoided but central to the business model.”

Elizabeth Warren, a credit card critic who teaches at Harvard Law School, says that credit card contracts have become “a thicket of tricks and traps.” There is a powerful sense among consumers that you have to keep an incredibly close eye on your credit card bills because the companies are going to try to sneak one past you if they can. This is not an industry that gives you the warm and fuzzies — rather, it's one of the more rapacious businesses on the planet. (When I called the American Bankers Association to talk about credit cards, I was told that the people I needed to talk to were all out of pocket.)

So what has happened with credit card debt? Since the early 1980s, debt has gone from 80 percent to 133 percent of disposable income, according to Kathleen Keest of the Center for Responsible Lending. But the rate of increase in credit card debt actually slowed at the beginning of the century. Why? Because the housing bubble had begun, and with it came a shift from credit card debt to home equity loans. From 2000 to 2006,

Americans borrowed a staggering \$1.3 trillion from their homes. By comparison, credit card debt rose much more slowly.

By the end of 2006, however, the housing bubble had ended, and so had the ability of homeowners to use home equity loans. But it was hard to turn off the debt spigot entirely because so many people had become accustomed to living beyond their means.

Sure enough, it was right about then that credit card debt began climbing. In 2004, for instance, credit card debt grew at a rate of \$6.25 billion a quarter. In just the fourth quarter of 2007, it grew by \$20 billion. Total credit card debt stands today at about \$950 billion. That is still not close to the \$11 trillion in mortgages, but it's within spitting distance of auto loans.

It is that rapid rise in credit card debt that has the bears worried. "Never in history has the American family skidded into recession with so much debt," Ms. Warren said.

"It is unsecured debt," said Daniel Alpert of Westwood Capital. "Eventually people are going to hit the wall."

It is this prospect, I think, that has caused Congress to suddenly become so interested in credit card practices. In both the Senate and the House, bills have been introduced to eliminate some of the worst of the fee practices, as well as the ability of credit card issuers to, for instance, impose retroactive interest rate charges. At the hearing I watched, most of the legislators who supported the bill had their own stories about getting hit with some fee they hadn't expected.

In good times, people don't worry so very much about credit card practices. Money seems flush, and if you have to pay a late fee because you forget to pay your bill on time, you write it off to your own laziness. In good times as well, people don't worry about the rising level of debt or whether it is a problem that the country is piling up more debt than it has in disposable income. We shrug it all off and keep spending.

But in tough times, those fees suddenly feel wrong, and the debt we have piled up suddenly feels onerous. One false move, we think, is all it will take to bring us to the brink of ruin. But here's where the story takes a different turn from the mortgage and subprime industry. Unlike those industries, which got caught unawares when their bubbles burst, the credit card industry is fully aware of what is happening, and is making adjustments — if you want to call them that — to control its loan losses. It will indeed raise interest rates on problem borrowers — and quite possible on borrowers who really aren't problems — and it will hit people with fees for the smallest infractions. It has been through recessions before. It knows how to do this sort of thing. Its profits will drop, but they won't evaporate entirely; Capital One is simply not about to become the next Countrywide.

Indeed, even though people who are already in trouble are likely to default, there is a whole other category of credit card users who are likely to become profitable for credit card issuers: those who usually pay off their balances every month, but because of the recession find themselves needing to go into debt. That ability to do so may be costly, and surely will breed resentment, but it will also wind up saving the credit card companies. Heads you lose, tails they win.

In good times, credit cards symbolize the joys of our consumer culture. In bad times, they symbolize the

dangers of that same culture. We're never going to stop feeling conflicted about credit cards. This may be, in the end, why credit cards will never be the shoe that finally drops.

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